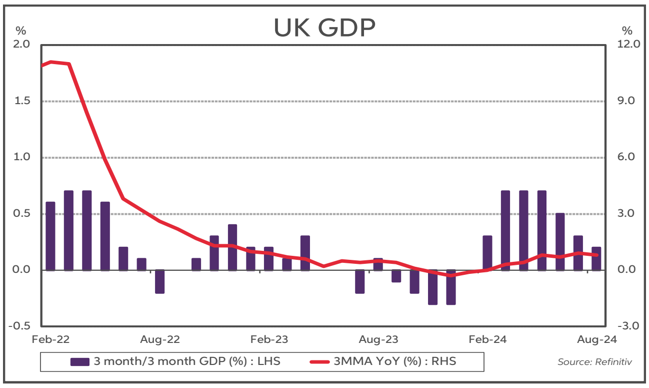
BoE Watch

AIB Treasury Economic Research Unit

7th November 2024

BoE cuts by 25bps, gradual trajectory expected from here

The November meeting of the Bank of England's Monetary Policy Committee (MPC) saw the central bank lower Bank rate by 25bps to 4.75%. This was the second rate cut from the Bank of England (BoE) in three meetings. Subsequent to this, the BoE cuts rates for the first time in August, following its rate tightening cycle, which had been in place since the end of 2021.

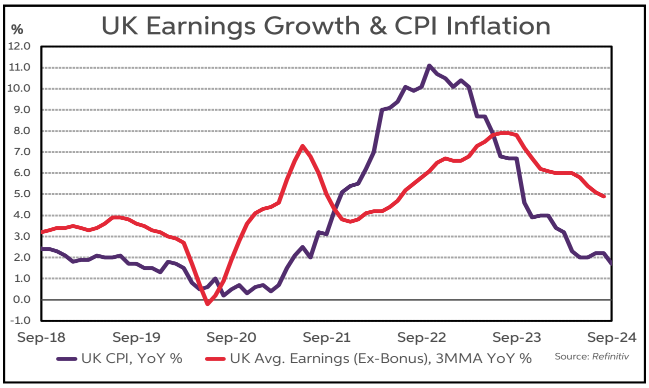


The decision to cut rates was not unanimous, with the voting breakdown showing a 8-1 split on the MPC. As expected, Catherine Mann voted to hold rates at 5.00%, pointing to still strong wage pressures. However, compared to the finely balanced decision in August to cuts rates (5-4), this was a resounding majority to continue the current easing cycle.

For the majority who voted for the cut, they viewed that the impact from the "past external shocks had abated" and progress in disinflation had been made. This gave comfort that the BoE could continue on its path of policy easing today. However, in a subtle shift in language, the minutes noted "remaining domestic inflationary pressures were resolving more slowly". The statement also noted the potential impact of Budget decisions on inflation, including the rise in the minimum wage. The BoE judged that the total impact of the Budget measures may boost CPI inflation by just under 0.5 percentage points at the peak, although there is some uncertainty around this projection.

Today also saw the BoE release its latest set of macro forecasts, with the publication of its quarterly Monetary Policy Report (MPR). In terms of its growth outlook, the BoE has revised down its near term growth expectation. It is forecasting GDP growth of 1% for this year, down from 1.25% in its previous forecast in August. Meanwhile, for 2025, it revised up its GDP projection to 1.5% from 1%, some of this reflecting the positive impact of higher Government spending in the Budget. Growth is expected to moderate to 1.25% in 2026. Overall, this set of GDP projections still represent a relatively modest growth outlook for the UK economy.

On the inflation front, the November MPR projections showed that the BoE anticipates the CPI rate will end this year at 2.4%, which represents a downward revision to its August MPR forecast for 2.7%. The BoE attributes the deceleration in inflation, which is currently close to its 2% target, to the unwinding of energy related base effects. Further out, it expects that inflation will rise to 2.7% by the end of next year, higher than its August forecast at 2.2%. The end-2026 forecast was also revised higher to 2.2% from 1.6%. These revisions reflect the persistence of domestic inflation and also the impact of Government Budget decisions, which are expected to push up prices further in the coming years.



In terms of guidance on future policy changes, the meeting summary offered some insights, and have been interpreted by markets as slightly more hawkish than prior statements. The BoE continues to state that policy will need to remain restrictive until the "risks to inflation returning sustainably to its 2% target have dissipated." Indeed, Andrew Bailey emphasised concerns around domestic price pressures, stating "we need to make sure inflation stays close to target, so we can't cut interest rates too quickly or by too much," In addition to this, Governor Bailey also stated that the easing in inflation pressures meant the BoE should still be able to cut rates "gradually from here".

Futures contracts firmed in the immediate aftermath of the meeting, with the market not fully pricing in another rate cut until the March 2025 meeting, implying the BoE will hold at its December and February meetings. The combined effects of the measures announced in the Autumn Budget are expected to boost the level of GDP by around 0.75% at the peak in a year's time, relative to the August projections alongside higher inflation. Therefore, the market move appears to be consistent with the BoE's "gradual approach" to easing policy, and factors in the fact that UK core inflation and wage growth remain elevated. In slight contrast, we expect the BoE to hold in December, but cut again in February 2025 alongside the next MPR, and to follow a gradual easing path thereafter.

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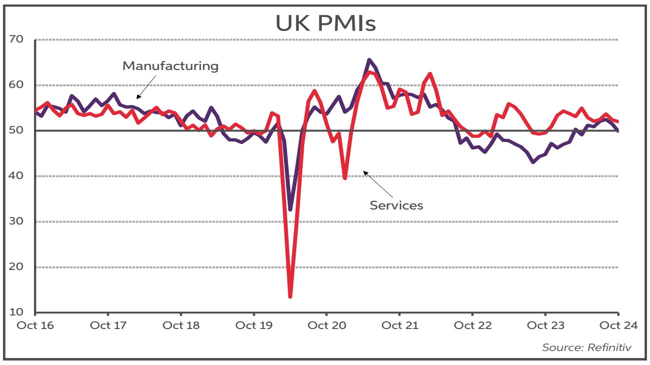
UK economy gains momentum in 2024

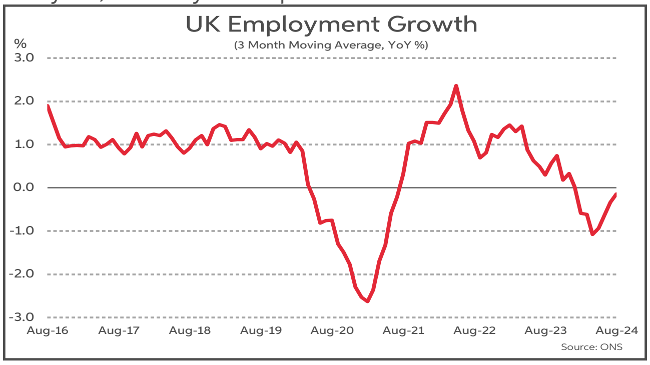
The UK economy gathered some momentum in the first half of the year, with GDP rising by 0.7% in Q1 and by 0.5% in Q2. The underlying breakdown for Q2 showed household consumption rose by 0.1% in the quarter, contributing 0.1 percentage points (p.p.) to growth. Meanwhile, gross fixed capital formation added a hefty 2.4 p.p. to the total, owing to increases in fixed investment, and a sharp rise in inventories. Government expenditure boosted output by a further 0.2 p.p.. Imports expanded at a faster pace than exports (+7.7% vs. +0.8% q/q) meaning net trade clipped 2.2 p.p. from GDP.



Data for Q3 have been solid. The monthly reading of GDP flat-lined in July for a second consecutive month, before rising by 0.2% in August. Meantime, industrial production remains volatile, contracting by 0.7% m/m in July, erasing a 0.7% increase in June, before rebounding by 0.5% in August. Elsewhere, retail sales rose throughout Q3, leaving them 3.9% higher on a year-on-year basis at the end of September. **Likewise, survey data indicate the economy continued to expand in Q3.** The manufacturing PMI averaged 52.0 in the quarter, up from 50.4 in Q2, consistent with activity levels rising at a faster pace. The services PMI also remained firmly in expansion mood, averaging 52.9 in Q3, albeit this was slightly below the average of 53.3 in Q2. However, consumer confidence dropped sharply, to –20.0 in September from –13 in August.

Meanwhile, consumer confidence deteriorated further at the start of Q4, falling to –21.0 in October. The other available survey data for the month also suggest the economy may have lost some momentum. The manufacturing PMI inched back into contractionary territory, falling to –49.9 in October. The services PMI printed at 52.0 in the month, below its average reading registered in the third quarter.

In terms of the labour market, there were clear signs of softening in the first five months of the year. More recently though, conditions appear to have tightened once again. The unemployment rate increased steadily from 3.8% in December to 4.4% in April and May. Furthermore, the number of people in employment had fallen by 108k by the end of April. However, the unemployment rate declined to 4.0% in August, while the employment level rose by 373k in the three months to August. At the same time, average earnings growth has cooled, but it remains elevated at +4.9% y/y in the three months to August. The Indeed wage tracker data also indicates that earnings pressures are robust, with wages up by 6.7% y/y in the three months to September, albeit this figure is inflated by a chunky one-off rise in the minimum wage. However, other measures of wage inflation continue to point to lower and more stable earnings growth. The BoE Agent's Summary Survey for Q3 noted that pay settlements are likely to average 5.5% this year, but they are expected to fall to 2-4% in 2025.



On the inflation front, headline CPI fell to 1.7% in September, having printed at 2.2% in the two months prior. Furthermore core-CPI fell to 3.2% in the month, down from 3.6% in August. Services inflation remains very high and is a key area of concern for the BoE, but it fell to 4.9% in September, its lowest level since May 2022. Looking ahead, the BoE expects headline inflation to rise between now and year end, reaching 2.5% in Q4 2024, before rising slightly to 2.75% by Q4 2025.

Overall, the UK economy has gathered some impetus this year as inflation has eased, paving the way for real income growth. Increased political stability following the recent election and the BoE's decision to cut rates in August have also provided a supportive backdrop. As inflation continues to fall, there should be added scope for the BoE to lower rates further next year also. Furthermore, increased government spending and investment, as announced in the Autumn Budget, could boost GDP in the near-term. **However, the outlook for UK growth remains subdued.** The IMF is forecasting that UK GDP will rise by 1.1% this year, before accelerating to 1.5% in 2025. Meanwhile, the updated Monetary Policy Report released today shows the BoE sees the economy expanding by 1.0% in 2024 and by around 1.5% in 2025.