BoE Watch

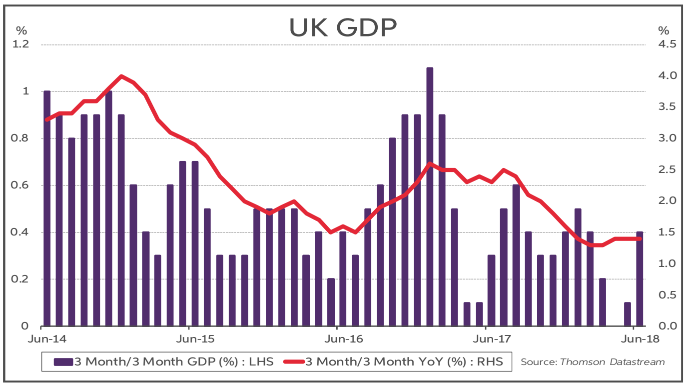
AIB Treasury Economic Research Unit

13th September 2018

BoE in no rush to hike rates further anytime soon

As expected, the September meeting of the Bank of England's Monetary Policy Committee (MPC) concluded with no changes to policy. The bank rate was left at 0.75%, after having being raised by 25bps at its previous meeting in August. The decision today by the MPC to leave interest rates unchanged was unanimous. The view shared by all committee members was that the economy continued to evolve generally in line with its expectations**.** The minutes noted that business surveys continued to suggest steady growth, while the 0.6% rise in GDP in the three months to July was slightly ahead of its expectations. Meanwhile, both inflation and developments in the labour market were broadly consistent with its economic outlook.

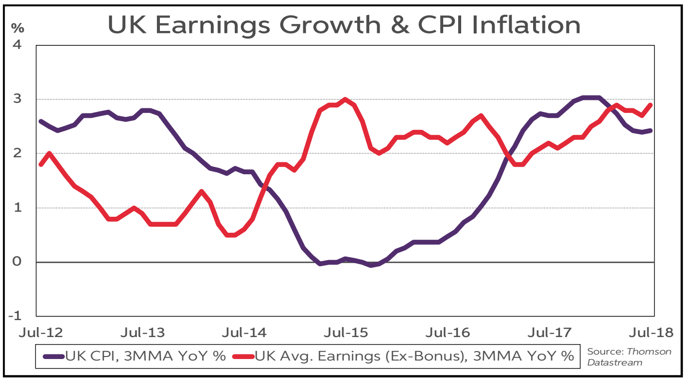
The most recent set of BoE macro forecasts were detailed in the August edition of its Quarterly Inflation Report (QIR). The MPC left its 2018 GDP forecast unchanged at 1.4%. Although in today's meeting minutes, it has revised slightly higher its Q3'18 growth forecast to 0.5%, from 0.4%, on the back of recent GDP data. For 2019 and 2020, the Bank is forecasting growth of 1.8% and 1.7% respectively.



Meanwhile in terms of its inflation projections, the BoE's forecasts were modestly higher compared to their May version. This was as a result of it factoring in the impact from higher energy prices and some weakness in sterling. The BoE envisages inflation remaining slightly above 2% through most of the forecast period, reaching the target in 2020. **The Bank's economic projections are based on a "relatively smooth" Brexit transition**.

In this regard, the BoE noted the "greater uncertainty" that has arisen since its previous meeting in relation to the UK's withdrawal from the EU. It referenced PMI data as well as recent financial market action in this regard. It also highlighted its own Bank Agent surveys, which suggested that UK firms were "becoming more uncertain" about the future and were considering their "Brexit contingency plans more carefully". The Bank cited the fact that "only a small minority" of companies had started to implement contingency type planning/measures. **The minutes stated the importance for the MPC to carefully monitor these type of developments and any potential impact from them on the broader economic outlook.**

Overall, from a policy outlook perspective, while it is on-hold in the short-term, the BoE continues to maintain a tightening bias. This is predicated on its assessment that GDP is forecast to grow by around 1.75% per year on average over its forecast period. This is slightly faster than the rate of supply growth, which it is projecting to average around 1.5% per year over the same period.



As a result, the BoE envisages the economy moving into 'excess demand' by late-2019. This is likely to feed through into increased domestic cost pressures, including on wages. Therefore, the BoE expects this scenario to warrant further rate hikes to return inflation sustainably to its 2% target. However, at the same time, the **BoE has been keen to emphasise that any future rate increases are "likely to be at a gradual pace and to a limited extent".** The market appears to share this view on the rate outlook. Futures contracts currently imply two additional rate hikes by 2020. This would take the Bank rate up to 1.25%. In terms of the timing of the hikes, the market is pricing in the 25bps rate increases for summer 2019 and summer 2020.

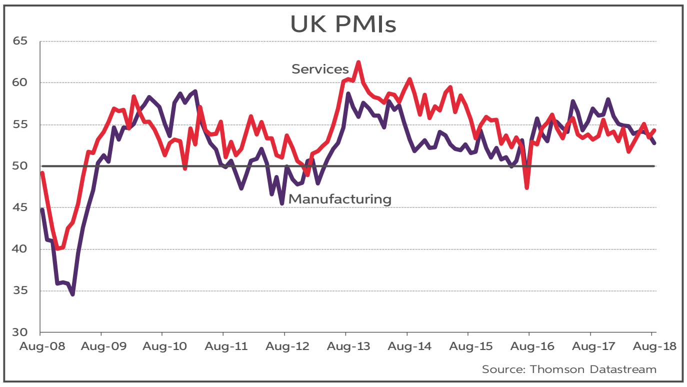
Oliver Mangan
Chief Economist
oliver.n.mangan@aib.ie

John Fahey
Senior Economist
john.j.fahey@aib.ie

Dara Turnbull
Economist
dara.c.turnbull@aib.ie

Economy maintaining moderate pace of growth

UK GDP rose by 0.4% in Q2 2018, improving after Q1's disappointing +0.2% result. However, year-on-year growth remained modest in Q2 at just 1.3% (1.2% in Q1).

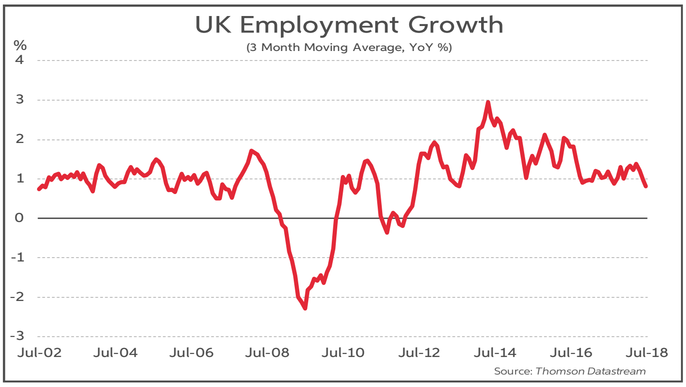


The ONS' new monthly GDP estimate shows that the economy grew by a strong 0.6% in the three months to July, with year-on-year growth of 1.4% in the period. The underlying data show that the key services sector expanded by 0.6% in the period. Construction, which declined earlier in the year, largely due to poor weather conditions, jumped by 3.3%. The production sector remains a drag on growth, declined by 0.5% in the three months to July. Declining energy output has been the main headwind to the sector, falling by 4.5% in the three month period, while the key manufacturing component remained negative, recording a slight 0.1% decline.

In terms of other measures of UK activity in Q3, the data have been generally positive. Retail sales grew by 0.7% in July, boosted by the warm weather and World Cup. This followed off the back of an already very strong 2% rise in sales in Q2. Year-on-year growth in sales has been stronger in recent months, coming in at 3.5% in July. Meantime, the goods trade deficit narrowed further in July, though at c.£10bn, it remains large.

Recent survey data also suggest that the UK economy has maintained a healthier pace of growth in Q3. The services PMI averaged 53.9 in July/August, virtually unchanged from Q2's 54 reading. The manufacturing PMI has moved lower, though, at 53.3 in July/August compared to 54.1 in Q2. The EC measure of UK economic sentiment has been more encouraging, averaging 109.3 in the last two months, ahead of Q2's 106.6.

On the labour market front, **employment rose by a paltry 3k in the three months to July.** This equates to year-on-year growth of just 0.8%, its weakest rate in six years. However, given that the unemployment rate held at a 43-year low of 4%, the weak employment growth may be partly due to a lack of available workers given that the number of job vacancies has risen to its highest level since records began in 2001. Indeed, the BoE's "recruitment difficulties" index is currently at a 16-year high.



The tighter labour market has so far failed to translate into a sustained acceleration in wage growth. Although, average underlying earnings rose by 2.9% year-on-year in the three months to July. This compares to 2.8% in the three months to April. With CPI inflation softening recently, averaging 2.4% in the three months to July, **the UK has now returned to a period of real, albeit still very modest, wage growth.**

Overall, the outlook for the UK economy remains challenging. It continues to be impacted by the uncertainty associated with the Brexit negotiations, which is weighing on investment. The only very modest growth in real wages is a challenge for the key consumer sector. The European Commission noted recently that it expects any potential boost from lower inflation to be offset by a rise in household saving. On the plus side, the BoE looks set to maintain a very accommodative policy stance in the coming years, which should help to support activity. **Overall though, the European Commission expects the UK economy to grow by just 1.3% this year and 1.2% in 2019.** The BoE remains more upbeat on the outlook for the economy, though, expecting growth of 1.4% in 2018 and 1.8% in 2019, assuming a "smooth" Brexit next March.

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AIB Bankcentre, Ballsbridge, Dublin 4 Tel: 353-1-6600311 www.aibeconomics.com