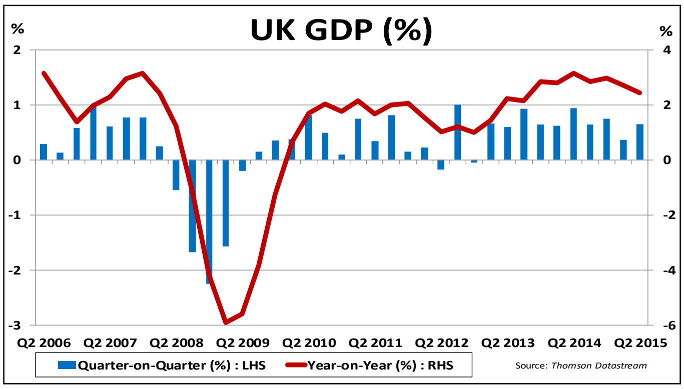
Bank of England Watch

9th October 2015

AIB Treasury Economic Research Unit

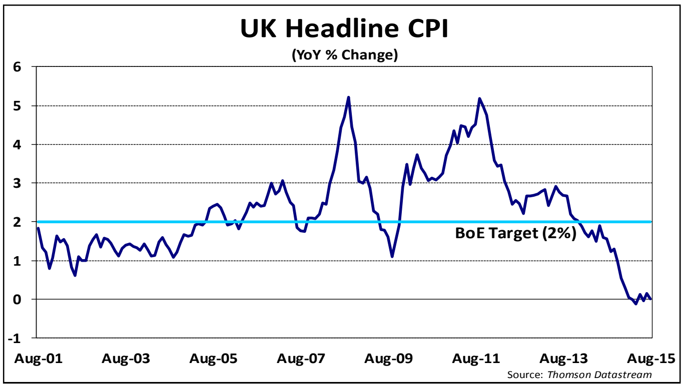
MPC in no hurry to raise rates

As had been widely anticipated, the MPC's October meeting concluded yesterday with no changes to monetary policy. The BoE Bank Rate, which has been kept at 0.5% since mid-2009, was left unchanged while the Bank's QE programme was maintained at £375 billion. As per the Bank of England's new publication schedule, the meeting minutes were released alongside the policy decision announcement. These showed that for a third consecutive month, the decision was not unanimous, with one member, Ian McCafferty, once again voting for a rate hike in an 8-1 split. He was of the view that inflation would probably overshot its 2% target in the medium term due to rising domestic cost pressures.



However, for the other eight members, the current policy stance remained appropriate. These members preferred to take a more cautious approach in terms of when to tighten policy. This is hardly surprising given the continuing very low inflation rate in the UK, the deceleration in the pace of UK economic activity this year and growing downside risks to global growth largely related to the weakening of activity in emerging economies. Earlier this week, the IMF cut its growth forecasts for the world economy in 2015 and 2016.

The most recent BoE macro forecasts were contained in its August Quarterly Inflation Report (QIR). These show UK GDP growth at 2.8% this year and 2.6% in 2016. Recent data indicate that the UK economy has slowed and therefore these forecasts may be difficult to attain. Indeed, Bank staff have lowered their estimate of GDP growth in Q3 slightly from 0.7 to 0.6%. Meanwhile, the Bank's CPI inflation projection for this year is now at just 0.3%, and it is projecting a 1.5% rate next year. These forecasts may also prove difficult to achieve, given the increased downward pressure on inflation in the past couple of months.



Nonetheless, the minutes of the MPC meeting suggest that members are not overly worried by recent developments. Members noted that there was little evidence that the slowdown in emerging markets was having much impact on advanced economies. They also described the slowdown in the UK as a gentle deceleration and a natural consequence of the economy approaching full capacity. Overall then, the minutes point to quite a relaxed MPC.

The MPC continues to emphasise that once it begins to raise rates, the pace of monetary tightening will be slow paced and rates are not expected to return to previous levels. **Overall then, the BoE still looks to be some time away from hiking rates and the tightening process is expected to be very gradual indeed.**

With the US Federal Reserve not in any hurry either to begin hiking rates, **markets have greatly scaled back their expectations on the extent of policy tightening** in both countries during the next couple of years. **Futures contracts now don't see a UK rate hike materialising until the end of next year,** with one further rate hike expected by mid-2017, which would take the Bank Rate up to 1%. While markets are correct in their view that the Bank of England is in no hurry to start tightening policy, they may have scaled back their rate hike expectations too far, unless there is a further slowdown in the pace of growth in the UK next year that keeps the BoE on hold for virtually all of 2016.

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

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

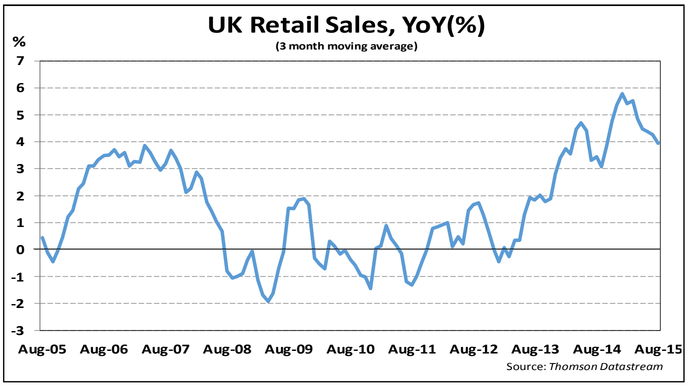
Dara Turnbull
Economist
dara.c.turnbull@aib.ie

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

Growth has turned more modest

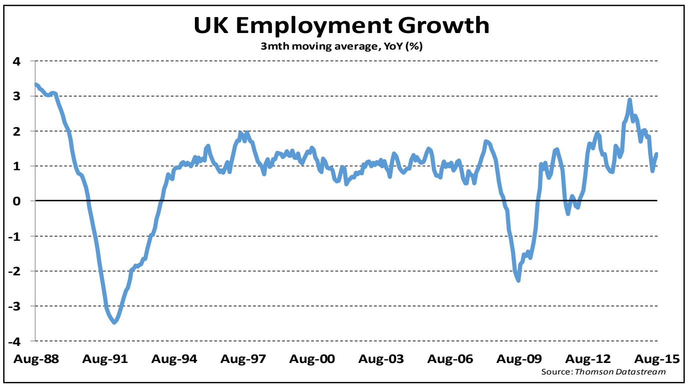
The most recent UK GDP figures show the economy grew by 0.7% in Q2 following Q1's somewhat disappointing 0.4%. On a year-on-year basis, growth slowed from 2.7% to 2.4%. This is down on the 3% growth recorded in 2014. Excluding oil output, the slowdown in the UK is even more pronounced. Unlike in 2014, **GDP growth in Q1 and Q2 2015 was boosted by oil output, something which is unlikely to be sustained in the long run.** Excluding oil and gas, the UK economy grew by just 0.5% in Q2 and 0.3% in Q1.

The breakdown of Q2 GDP shows that once again, consumer spending remained a key factor, contributing 0.5 percentage points (p.p.) to growth in the quarter. **The volatile trade sector made the largest contribution though, adding 1.4 p.p.** However, this seems to be mainly due to a temporary boost to exports from the rise in oil output as well as lower import growth as a result of destocking. This, too, is unlikely to prove to be sustained.



UK survey data indicate that the pace of GDP growth slowed in Q3. The key composite PMI averaged 55.1 in Q3, its weakest performance since Q2 2013. It is consistent with quarterly growth of around 0.4-0.5%. This largely reflects a weaker performance by the services PMI (55.4 avg in Q3 vs 58.2 in Q2). The manufacturing index continued to point to very subdued growth in the sector (avg 51.7 in both Q3 and Q2).

A weaker pace of growth is also reflected in 'hard' data. For example, retail sales grew by just 0.15% in July/August compared to Q2, continuing the broadly slowing trend seen since the start of the year. Growth in industrial production is also more modest, picking up by 0.1% in July/Aug. Manufacturing (excludes oil) contracted by 0.7% in the same period. In terms of the housing market, though, there have been some tentative signs that activity might be picking up again in Q3, after stalling in Q2, with transactions and mortgage approvals improving.



The pace of improvement in the labour market has also slowed. Employment rose by a very modest 43k in the 3 months to July, way below the 200k+ growth seen earlier in the year. The year-on-year growth rate in employment has been on a broadly slowing trajectory this year. It declined from 2% at the start of the year to 1.3% in July. **The employment component of the composite PMI continued to move lower in Q3 (avg 53.9 from 55.4 in Q2) suggesting that employment growth may slow further.** Meanwhile, the decline in the unemployment rate has levelled off at 5.5-5.6% since February.

While employment growth has slowed, earnings growth continues to improve. Year-on-year growth (ex-bonus) reached a 6½-year high of 2.9% in July. Meanwhile, inflation in the UK, as in most developed countries, has remained very weak. The CPI rate fell back to 0% in August, remaining weighed down by the impact from lower energy prices. This means that growth in real wages has remained strong.

Moderate employment growth, weak inflation, rising real wages, a stronger Eurozone economy and low interest rates all suggest that the UK economy should continue to grow at a reasonable pace. The economy still faces some headwinds, though, including high household debt, fiscal tightening and the negative drag on trade from a stronger sterling, as well as slower growth in emerging economies. Thus, it is not completely surprising that GDP growth may be slowing to around a 2% rate, from 3% in 2014.