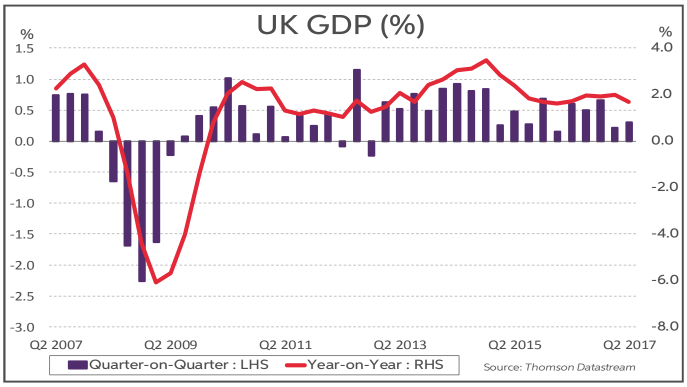
BoE Watch

AIB Treasury Economic Research Unit

3rd August 2017

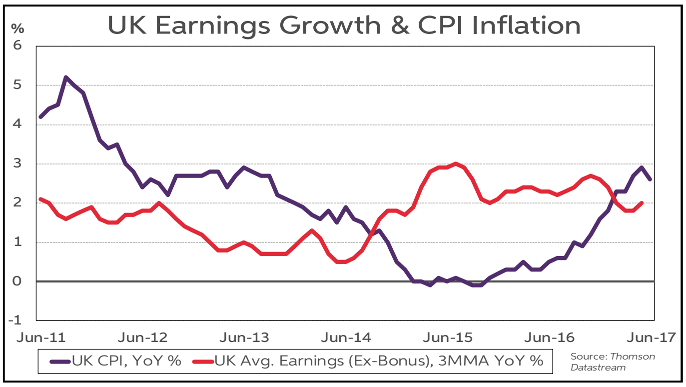
BoE holds fire, for now

As expected, the August meeting of the Bank of England's Monetary Policy Committee (MPC) concluded with no changes to interest rate policy. The decision to leave rates unchanged was, once again, not unanimous. There was a 6-2 majority vote in favour of maintaining the Bank Rate at 0.25%. This voting outcome was less hawkish than the June vote, when there were three votes in favour of a rate hike. However, one of the three, Kristin Forbes, has since left the Committee



The meeting minutes detailed the policy deliberations that took place on the current stance of monetary policy. Arguments put forward justifying an immediate rate hike included that inflation remained substantially above target and is expected to remain so over the forecast period, while employment growth had strengthened again. Meanwhile, some of the points put forward in arguing for leaving the policy rate unchanged included the sluggish GDP growth in H1 2017, with an expectation this would persist in the near-term, heightened domestic uncertainty, which could weigh on investment, and no evidence yet of a pick-up in wage growth. **The minutes noted that MPC members placed differing weights on these arguments, and that in the end, on balance, for six members the current stance remained appropriate.**

In his press conference, Governor Carney outlined the BoE's analysis of the recent performance of the UK economy. **He observed that the "UK economy is beginning the process of adjusting to a new, as yet uncertain, economic relationship" with the EU**. He noted that households initially appeared to look through Brexit-related uncertainties. However, more recently, the impact of sterling's fall, rising prices and squeeze on real incomes means consumers have cut back on spending, slowing the economy. He also commented that businesses have "invested much less aggressively than usual" since the referendum.



The BoE's updated set of macro forecasts also released in the August Inflation Report, incorporated a more cautious view on the economic outlook**. The Bank revised its 2017 GDP forecast modestly lower** from 1.9% to 1.7%. For 2018, it is now expecting growth of 1.6% (from 1.7%) and for 2019 its forecast remains at 1.8%. In terms of its inflation outlook, the MPC expects inflation to peak around 3% in October and to remain above 2.75% until early next year. **Inflation is projected to remain "a little above" its 2% target at the end of the forecast period based on the current market curve which implies a 50bps rise in the Bank Rate over the next three years.** It is important to note that the Bank's macro forecasts are based on the assumption of a "smooth" Brexit.

Market reaction to today's raft of updates from the BoE suggests that sterling watchers had been expecting a more hawkish tone. Sterling weakened this afternoon, down around 1% on the exchanges, reflected in EUR/GBP trading back above 90p and GBP/USD down near $1.31. This reaction is somewhat surprising given that the BoE stated that rates may need to rise by a "somewhat greater extent" than markets are currently expecting.

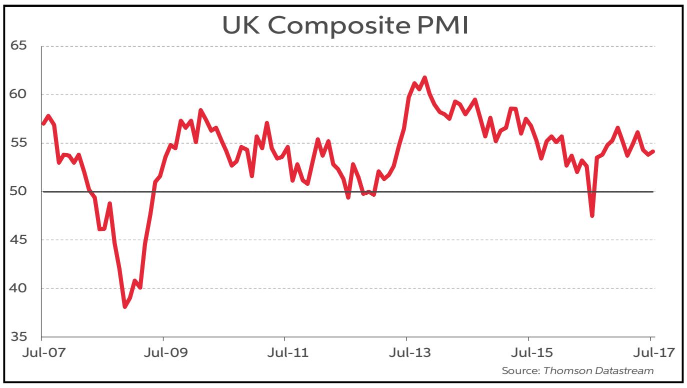
Overall, the extent of any rate hikes will be very much dependent on how the Brexit negotiations progress. A 'soft' Brexit could see rates rise by more than the 50bps currently priced in by markets by spring 2020, while rate increases look unlikely in a 'hard' Brexit scenario.

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

UK economy loses momentum in H1 2017



UK GDP rose by 0.3% in Q2, a slight improvement on Q1's weak 0.2% result. This compares to growth of 0.5% and 0.7% in the previous two quarters. Year-on-year growth slowed to 1.7% in the second quarter, from 2%. The preliminary breakdown of Q2 GDP, shows that the economy continued to rely on the services sector. It contributed 0.42 percentage points (p.p.) to growth, benefitting from the rebound in the retail trade (added 0.12 p.p.). Production and construction both dragged on growth, deducting 0.06 p.p. each.

While we do not get the expenditure breakdown of growth until later this month, **hard data in the quarter suggest that consumer spending may have resumed its role as the main source of UK growth.** Retail sales rose by 1.5% in Q2, after falling by 1.4% in Q1. Meanwhile, industrial production declined by 0.5% in April/May compared to Q1. The decline party reflects weakness in the volatile pharmaceuticals component. At the same time, the UK trade deficit widened in April/May.

How sustainable the pick-up in consumer spending is remains to be seen. While CPI inflation slowed from 2.9% to 2.6% in June, it remains above the BoE's 2% target. In addition, fresh falls by sterling against the euro and some rebound in oil prices in July mean inflation could tick back up. Meantime, producer price data show that input prices were up 9.9% in June, while output costs were up just 3.3%. This suggests that businesses continue to absorb a large part of their higher input costs, which are largely related to sterling weakness. However, they could yet pass on more of these increased costs in higher prices to consumers.

While inflation remains high, earnings growth continues to slow. Underlying wages rose by 1.8% year-on-year in May, meaning earnings growth remains negative in real terms. Other signs from the labour market have been more positive. Employment rose by 175k in the three months to May, compared to just +43k in the previous three months. Meantime, **the unemployment rate fell to 4.5% in May, its lowest level since 1975.**

In terms of activity in early Q3, leading indicators have generally suggested that the economy has maintained the more subdued pace of growth seen in H1. The Markit services PMI came in at 53.8 in July, below its Q2 average of 54.3. Likewise, while the manufacturing PMI moved up to 55.1 in July, this is below the 55.8 averaged in the second quarter.

The UK economy benefited from a loosening of monetary policy and weaker sterling in the aftermath of the Brexit vote. However, negative factors like higher inflation are now having a more pronounced influence. **The economy is also in a period of heightened uncertainty. The negotiating process to decide on the UK's EU exit terms and any new trading arrangements is likely to drag on until near the end of next year.** Business investment may be adversely impacted, while high inflation continuing to dampen consumer spending. However, a weak sterling and stronger external demand should have a positive impact on net trade. Overall, the BoE is forecasting that GDP growth will be steady at around 1.7% in the period 2017-2019, assuming that the UK achieves a "smooth" exit from the EU.