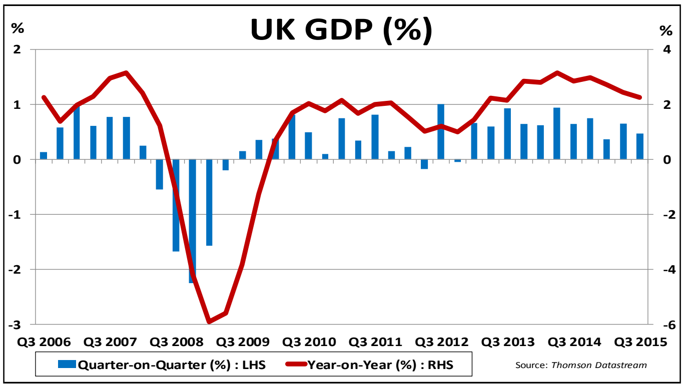
Bank of England Watch

10th December 2015

AIB Treasury Economic Research Unit

MPC still some way off from hiking rates

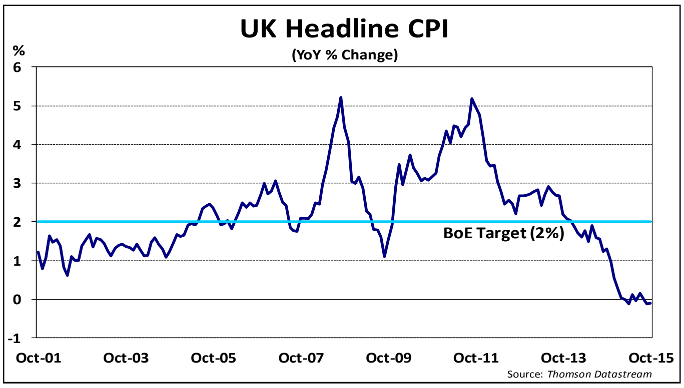
As expected, today's meeting of the Bank of England's Monetary Policy Committee (MPC) concluded with no changes to policy. The BoE base rate has been kept at 0.5% since mid-2009. The minutes of today's meeting showed that for a fifth straight month, the decision to keep rates on hold was not unanimous. Ian McCafferty, was once again the sole 'hawkish dissenter' voting for a 25bps rate hike. He remained of the view that the "risks around domestic cost growth were to the upside, and were sufficient to justify an immediate increase" in interest rates. However, the remaining eight MPC members voted to keep rates unchanged. They considered "the currency stance of monetary policy to be appropriate".



The MPC aims to set monetary policy so as to achieve its "2% inflation target" over the medium term (UK headline inflation is currently at just −0.1%). The policy deliberations within the MPC on when to start to tighten policy are in the context of the "balance between persistent drags from factors such as sterling and world export prices and prospective further increases in domestic costs growth".

The MPC notes that the **prospect for inflation returning to target** "depends on an increase in domestic cost growth sufficient to balance the drag on prices from very subdued global inflation and past increases in the value of sterling". It commented that **there would "need to be sustained firming in domestic cost pressure, compared with current rates",** in order to achieve its inflation target. News in the month in this regard was 'soft', with the MPC noting that there was an "apparent flattening off in pay growth". Meanwhile, in terms of external cost pressures, the further weakness in oil prices, increases the "likelihood that headline inflation rates would remain subdued".

The most recent BoE macro forecasts were contained in its November Quarterly Inflation (QIR), which showed downward revisions to its growth and inflation forecasts compared to its August Report. The Bank expects the UK economy to grow by 2.7% in GDP terms this year and by 2.5% in 2016. Meanwhile, the BoE's inflation projection for this year is now at just 0.1% and at 1.1% in 2016. Indeed, the QIR noted that inflation is likely to remain low "until late 2017".



Overall, today's update from the Bank of England does little to alter the view that the MPC is still some way off from starting the rate tightening cycle in the UK. Based on the Bank's recent macro projections, it could be early 2017 before it starts to increase interest rates. Even after it starts to hike, the pace of rate increases is likely to be very modest, a point the MPC continues to emphasise. Indeed, while there is a range of views On the Committee about the balance of risks to inflation, "all members agree" that the increases in the Bank Rate is expected to be more "gradual" and "to a lower level than in recent cycles".

In terms of market expectations, futures contracts do not envisage a UK rate hike materialising until the end of next year, or early 2017. For 2017, there are just close to two rate hikes being priced in. This would bring the Bank Rate up to just 1.25% by the end of 2017.

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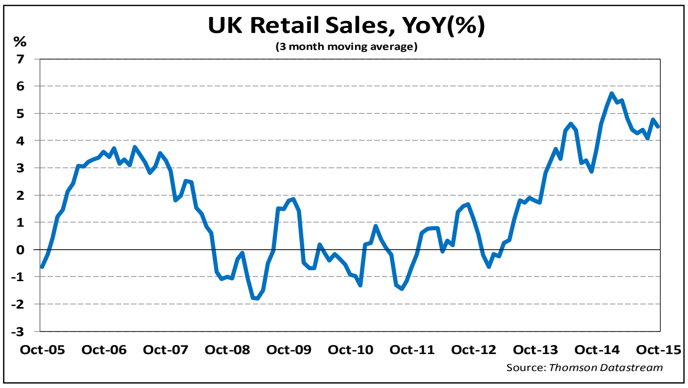
UK Q3 growth driven by the domestic economy

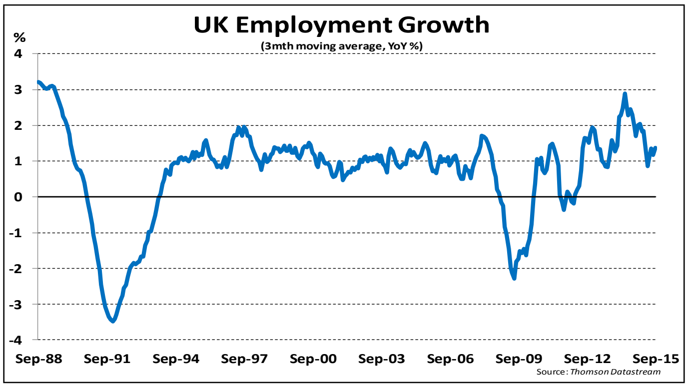
The second reading of UK Q3 GDP confirmed that growth slowed slightly from 0.7% in Q2 to 0.5%. In year-on-year terms, growth slowed further, although at 2.3%, it remains solid. The revised data also provided a first look at the expenditure based breakdown of GDP. It showed that growth was concentrated in the domestic economy. **The largest contribution to growth came from inventories, which added 0.9 percentage points (p.p.) to GDP.** This reflects companies rebuilding stocks in Q3 that were run down during Q2. Meanwhile, consumer spending remained a key driver of the economy, providing another 0.5 p.p. contribution. Government spending increased (+1.3%, 0.3 p.p.), while business investment recorded a third consecutive quarter of strong growth (+2.2%, 0.2 p.p.).

However, net trade proved to be a significant drag on growth in the third quarter. It knocked a massive 1.5 p.p. off GDP, the largest drag on record. The aforementioned rebuilding of inventories was likely an important factor in the growth in imports (+5.5%). Meantime, export growth slowed (0.9% from 1.9%), which may in part reflect the impact from the stronger sterling and a fall in oil exports.



In terms of Q4 indicators, **survey data suggest that growth has remained more modest.** The UK composite PMI averaged 55.6 in October/ November, slightly above Q3's 55.1 performance. Although, the EC economic sentiment index has pointed to a possible further slowdown, averaging 108.3 in Oct/Nov after 112.5 in the third quarter.

Despite the slower rate of economic growth, the pace of improvement in the labour market picked up again in Q3. Employment grew by 178k in the quarter, compared to the 63k decline seen in Q2. The unemployment rate fell to 5.3%, from 5.6% in Q2. This represents its lowest rate since May 2008. Looking ahead, the composite employment PMI averaged 54.7 in Oct/Nov, suggesting that we could see further jobs growth in the coming months.



Meantime, the pick-up in wage growth, which has been a notable feature of the UK economy in 2015, has eased somewhat recently. The pace of year-on-year growth slowed, with the ex-bonus measure at 2.5% in Q3 compared to 2.8% in Q2. At the same time, **CPI inflation remains weighed down by the impact from lower energy prices, as well as declines in the price of food.** Inflation slipped back into negative territory in September/October. Overall, real wage growth remains at an encouraging level, although further increases in wages would be needed to help bring inflation back to its 2% target rate.

On the housing market, both the Halifax and Nationwide indices have pointed to some 'stabilisation' in year-on-year house price growth in recent months. This is backed up by the RICS house price survey. Meanwhile, mortgage approvals have continued to pick-up recently, averaging 70k in the 3 months to October. The volume of transactions has continued to show some modest improvement, recovering to their best levels since the start of 2014, after having slowed towards the latter part of last year.

Overall, **the increased pace of employment growth, weak inflation, real wage growth, an improved Eurozone economy and low interest rates all suggest that the UK economy should continue to grow at a reasonable pace.** It 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, GDP growth may be slowing towards 2%, from 3% in 2014.