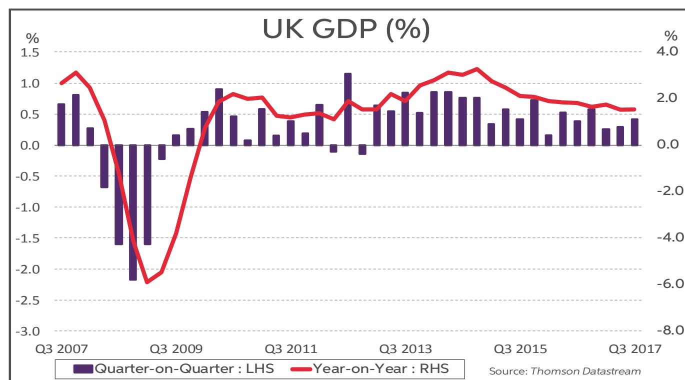
Uneventful end to 2017 for the BoE

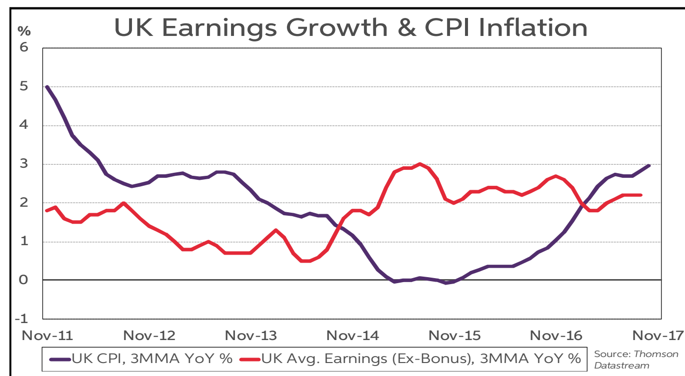
The December meeting of the Bank of England's Monetary Policy Committee (MPC) concluded as expected, with no changes to interest rate policy. There was unanimity within the MPC on its decision to leave rates unchanged. At its previous meeting back in early November, the BoE increased interest rates for the first time since July 2007, announcing a 25bps hike in the Bank Rate to 0.5%. The decision to hike last month was in response to signs that underlying inflation was picking up and increasing evidence that the pace at which the economy could grow without generating inflationary pressures had lessened.



This month's meeting statement contained no major changes to the MPC's assessment of the UK economic backdrop and outlook. It noted that the labour market remains tight, and surveys suggest this will continue. The MPC also commented that some activity indicators imply that growth in Q4 might be slightly softer than in Q3. The Bank remains of the view that inflation has been pushed above its 2% target arising from the "boost to import prices due to past depreciation of sterling". CPI inflation reached 3.1% in November.

The BoE's most recent set of macro forecasts were contained in the November Inflation Report. These forecasts are underpinned by the assumption that there will be a 'smooth Brexit adjustment'. They were broadly similar to the August edition. The Bank revised slightly lower its 2017 GDP forecast to 1.6% (from 1.7%). It anticipates growth of 1.6% in 2018 and 1.7% in 2019. It is also pencilling in growth of 1.7% for 2020. In terms of the inflation outlook, the MPC expects headline CPI "to peak above 3%" in Q4 as the past depreciation of sterling and recent increases in energy prices continue to pass through to consumer prices. The BoE envisages that inflation will approach the 2% target by the end of its forecast period.

The issue of Brexit is the key challenge for the BoE as it contemplates the economic outlook and the appropriate stance of monetary policy. Indeed, the meeting statement once again emphasised that the UK's exit from the EU remains the "most significant influence on, and source of uncertainty about, the economic outlook". Although the text of the minutes did reference the recent positive developments in this regard. It said that the progress on the Brexit talks reduces "the likelihood of a disorderly exit". It also stated that these developments would be given more detailed consideration when it is updating its macro forecasts for the February Inflation Report.



In terms of market expectations, the curve implies that the market is envisaging two 25bps increases by the end of 2019. From a timing perspective, futures contracts are expecting another increase by around end 2018, with a subsequent hike priced in for end-2019. This marks quite a sharp shift in UK rate expectations over the last 3-4 months. At the beginning of September, the market was not expecting a BoE rate hike till H2 2019. It has since hiked in November, with two further hikes now anticipated by end-2019. It suggests that the market is assuming that there will be a 'soft' Brexit in March 2019.

Overall, it is clear from today's meeting that the BoE is content with its current policy stance. It gave no indication that any further rate hikes were imminent. However, it continued to point out that further "modest" increases in rates would be needed over the coming years, but would be at a "gradual pace and to a limited extent".

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

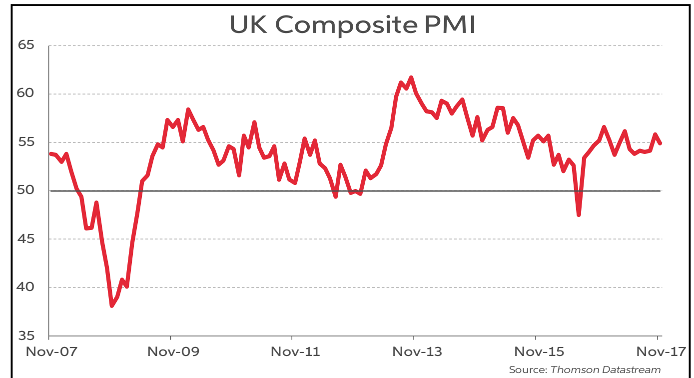
John Fahey
Senior Economist
john.j.fahey@aib.ie

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

AIB

Economic outlook remains challenging

UK GDP rose by 0.4% in Q3, up from 0.3% in Q2, while year-on-year growth held at 1.5%. An acceleration in consumer spending was the main reason for the modest improvement. The sector added 0.4 percentage points (p.p.) in the quarter, versus 0.2 in Q2. However, growth in business investment softened further. It rose by 0.2% in Q3 (0.5% in Q2), with the year-on-year rate slowing to 1.3% (2.5%). The largest drag on activity in Q3 was net trade, which deducted 0.5 p.p. after adding 0.4 in Q2.



Recent survey data have been somewhat mixed, while continuing to point to a moderate pace of expansion in Q4. The composite PMI averaged 55.4 in October/November, above Q3's average of 54.1. The sectoral breakdown suggests stronger activity in manufacturing and construction. The manufacturing PMI rose to 58.2 in November, its best level since August 2013, while the construction PMI is back above the key expansion indicating 50 level. The services PMI averaged 54.4 in Oct/Nov compared to 53.5 in Q3. While the PMIs have shown some modest improvement, the EC measure of UK economic sentiment averaged 109.6 in Oct/Nov, below Q3's 110.5. As with the PMIs, the index suggests a strengthening in industry, though it indicates a marked weakening in the services sector, with the services sub-component at its weakest level in November since May 2013.

The limited 'hard' data which have been released have also been mixed. Retail sales grew by 0.9% in Oct/Nov versus Q3, in which they rose by 0.8%. This likely reflects some 'Black Friday' distortion, meaning sales could fall back in December. Industrial production was flat in October, following on from Q3's very encouraging 1.1% pick-up. The trade deficit (good and services) increased in October to £1.4bn, from September's £1.1bn. Although, this is still better than Q3's monthly average deficit of £2bn.

Meanwhile, **there has been a noticeable weakening in the UK labour market in recent months. Employment declined by 56k in the three months to October,** compared to a 182k increase in the three months to July. Although, the labour force is declining more sharply, falling by 82k in October. This partly reflects a significant fall in the numbers of people emigrating to the UK since the Brexit vote. This has helped to keep the unemployment rate at a 42-year low of 4.3% in the three months to October.

Despite the tightening labour market conditions, earnings growth has remained relatively subdued. Underlying wage inflation (ex-bonus) came in at 2.5% in the three months to October. CPI inflation averaged 3% in the same period, keeping real wages negative. CPI inflation edged up slightly to 3.1% in November, its highest level since March 2012.

Overall, the UK economy is in a period of high uncertainty with the UK/EU negotiations on exit terms and trading arrangements likely to drag on for some time. Thus, business investment could continue to be subdued, while squeezed household incomes remain a headwind to consumption. However, a weak sterling and stronger external demand should have a positive impact on trade, while BoE policy remains highly accommodative. **The recent OECD forecasts are for growth of 1.5% this year, 1.2% in 2018 and 1.1% in 2019.** The recent forecasts from the Office for Budget Responsibility are slightly less downbeat at 1.5%, 1.4% and 1.3%, but this is a downgrade versus its previous forecasts, largely due to on-going weak productivity growth.

This publication is for information purposes and is not an invitation to deal. The information is believed to be reliable but is not guaranteed. Any expressions of opinions are subject to change without notice. This publication is not to be reproduced in whole or in part without prior permission. In the Republic of Ireland it is distributed by Allied Irish Banks, p.l.c. In the UK it is distributed by Allied Irish Banks, plc and Allied Irish Banks (GB). In Northern Ireland it is distributed by First Trust Bank. In the United States of America it is distributed by Allied Irish Banks, plc. Allied Irish Banks, p.l.c. is regulated by the Central Bank of Ireland. Allied Irish Bank (GB) and First Trust Bank are trade marks used under licence by AIB Group (UK) p.l.c. (a wholly owned subsidiary of Allied Irish Banks, p.l.c.), incorporated in Northern Ireland. Registered Office 92 Ann Street, Belfast BT1 3HH. Registered Number NI 018800. Authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. In the United States of America, Allied Irish Banks, p.l.c., New York Branch, is a branch licensed by the New York State Department of Financial Services. Deposits and other investment products are not FDIC insured, they are not guaranteed by any bank and they may lose value. Please note that telephone calls may be recorded in line with market practice.

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