Bank of England Watch

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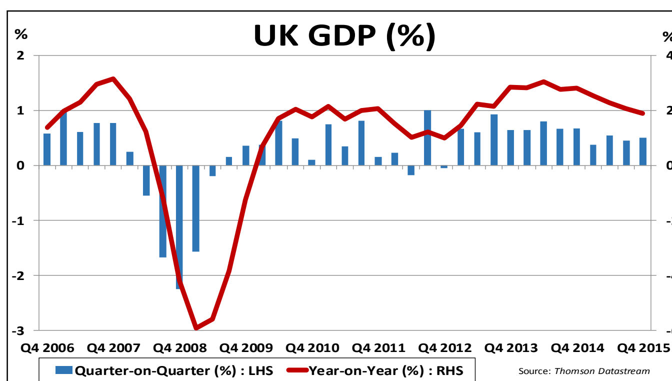
AIB Treasury Economic Research Unit

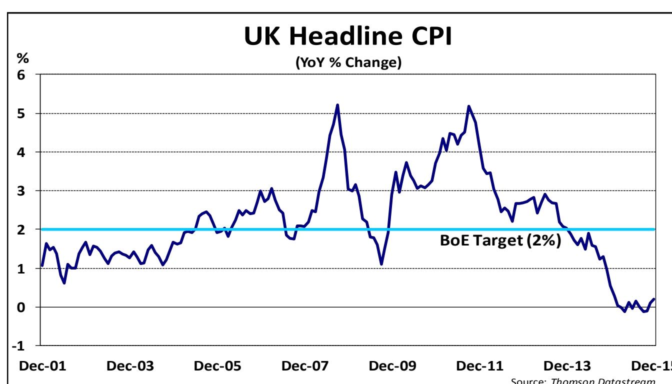
Cautious MPC, very much on hold, for now

As expected, today's meeting of the BoE's Monetary Policy Committee (MPC) concluded with no changes to policy. **However, the February edition of the BoE's 'Super Thursday' did indicate an increased level of caution amongst the MPC.** For the first time in seven months, the decision to leave rates unchanged was unanimous, with "all members of the Committee" voting that "maintaining the current stance of policy was appropriate". The minutes noted that for the one previous 'hawkish' dissenter the "more prolonged period of low inflation suggested that the pick up in wage growth" would be "more muted than previously expected" and therefore "an immediate tigthening in monetary policy was no longer necessary".



It is clear from the minutes, as well as the Quarterly Inflation Report (QIR), that the MPC has become more concerned about developments in the global economy/ financial markets and the potential headwinds these could pose to the UK inflationary outlook. The MPC made reference to the "muted growth in world prices", and the dampening impact on import prices from the "appreciation of sterling" as accounting for the "vast majority of the deviation of inflation" from its 2% target since the time of the November QIR. The "remainder of the undershoot" was attributed to "subdued domestic cost growth, particularly unit labour costs". Indeed, Governor Carney noted in the QIR press conference that the **MPC's current policy deliberations are taking place "amid sluggish global growth, turbulent financial markets" while at the same time, domestic wage growth "has been weaker than anticipated".**

Not surprisingly then, against this macro backdrop, the forecasts in today's Inflation Report incorporated some downgrades. The Bank anticipates CPI inflation to average just 0.8% this year, down from its previous forecast of 1.1%, and at 1.9% (from 2%) in 2017. Meanwhile, the changes in GDP projections, see growth now expected at 2.2% this year (from 2.5%) and 2.3% in 2017 (from 2.6%). There was also a lowering of the Bank's wage inflation forecasts. It now projects average weekly earnings to be around 3% by the end of this year (from 3.75%).



Governor Carney stated that **the BoE's objective of returning inflation to target** will require "balancing the protracted drag from sterling's past appreciation and lower commodity prices with expected increases in domestic cost growth". In the near term, the MPC "judges the risks to inflation lie to the downside", reflecting the possibility that wage pressure might "take a little longer to build following a period of low inflation". Therefore, the MPC will be "watchful for signs that low inflation is having more persistent second-round effects on wages".

Overall, today's various updates from the BoE reinforce the view that the MPC is in no hurry to hike interest rates, with the chances of a rate hike this year now lower**.** Market reaction to today's events has been fairly muted as market expectations were already very much on the dovish side with futures contracts not envisaging a full 25bps rate hike till the first half of 2018 at the earliest. However, this may be too dovish, as Governor Carney commented that CPI inflation is likely to exceed its 2% target at the "two year point" and that the MPC "judges that it is more likely than not that the Bank Rate will need to rise" over this forecast period.

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

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

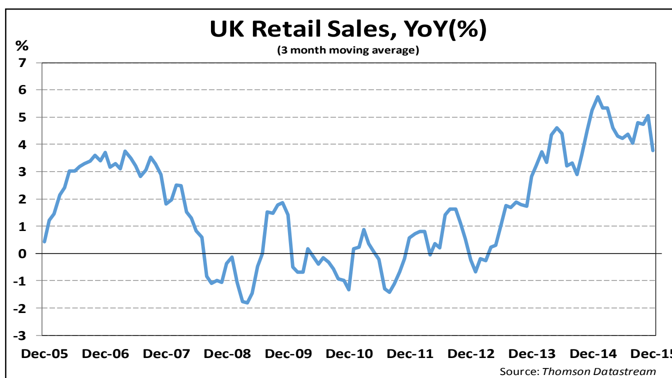
Dara Turnbull
Economist
dara.c.turnbull@aib.ie

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

UK growth relying on the domestic sector

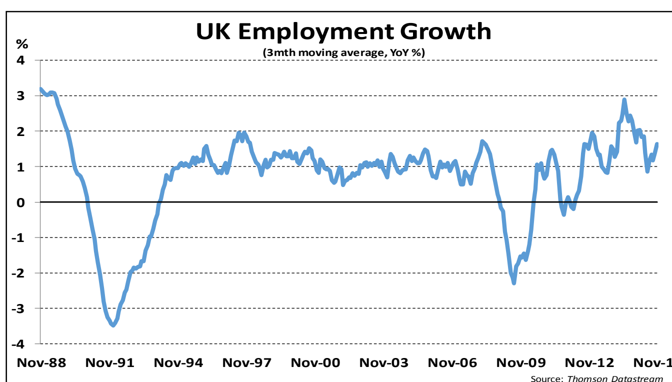
Last week's UK Q4 GDP data confirmed that the economy slowed in 2015, growing by 2.2% compared to 2.9% in 2014. On a quarterly basis, though, growth picked up in Q4, increasing by 0.5% after Q3's 0.4% reading. The underlying data showed that growth remained unbalanced, with the services sector accounting for all of the rise in GDP. The production and construction sectors detracted slightly from GDP.

While we do not yet have the expenditure breakdown of GDP, data from Q4 suggest that consumption remained a key driver of growth. Retail sales had another strong quarter, rising by 1.1% versus Q3, in which they grew by 0.9%. Sales growth in Q4 was helped by pre-Christmas discounting by retailers (e.g. Black Friday). In year-on-year terms, retail sales grew 3.8% in Q4.



Meanwhile, **industrial production was flat in Oct/Nov compared to Q3.** The sector had been supported by increased oil production, though this looks to have waned, due in part to lower oil prices. The stronger sterling was likely another headwind to output. It also seems to be having a negative impact on trade, with the aforementioned drop off in oil production seeing the trade deficit widen in Oct/Nov. The goods trade deficit with the EU rose to an all-time high in November. Thus, **net trade looks to have continued to weigh on UK growth in Q4.** Overall, GDP growth seems to have remained skewed towards the domestic economy.

The somewhat improved performance in Q4 coincided with a pick-up in job growth. **Employment rose by 267k in the three months to November**, compared to 140k in the previous three months. This equates to year-on-year growth in employment of 1.9%. The unemployment rate fell to 5.1% in November, its lowest rate since January 2006. Meantime, the composite employment PMI remained at an encouraging level in January.



However, despite the further fall in unemployment, **the pace of year-on-year growth in average weakly earnings has continued to slow.** The ex-bonus measure came in at 1.9% in November, having been as high as 2.9% as recently as July. Part of this can be explained by a fall in average hours worked. Meantime, CPI inflation remains weighed down by the impact from lower energy prices, as well as declines in the price of food. It remained very weak in December, coming in at just 0.2%. As a result, **real wage growth still remains at a healthy level despite the deceleration in earnings growth.**

On the housing market, the Halifax and Nationwide indices have shown that price inflation is beginning to pick up again. This is backed up by the RICS house price survey, as well as the lagging official ONS price data. The underlying data from the RICS survey and other indicators suggests that this is due to rising demand for housing combined with falling supply.

In terms of timelier updates on the economy, the UK composite PMI rose in January to 56.1, above the Q4 average of 55.5. In contrast, the UK EC economic sentiment index fell in January, though this was following a strong increase in December.

Overall, solid 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 this year. It still faces some headwinds, though, including high household debt, on-going fiscal tightening, uncertainty regarding the upcoming 'Brexit' referendum and the negative drag on trade from a stronger sterling, as well as slower growth in emerging economies. Overall, **GDP growth may average around 2% or slightly below in 2016.**

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