BoE Watch

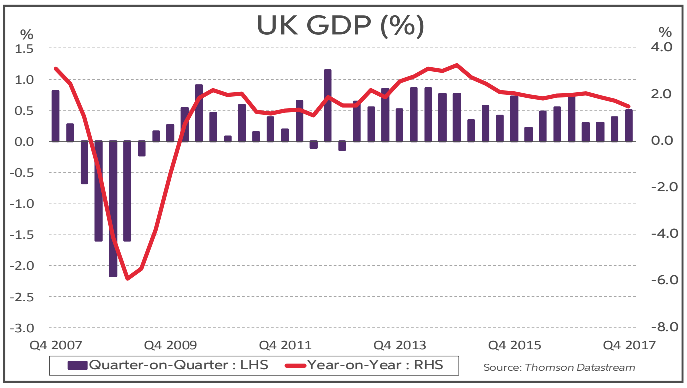
AIB Treasury Economic Research Unit

8th February 2018

BoE signals earlier and more frequent rate hikes

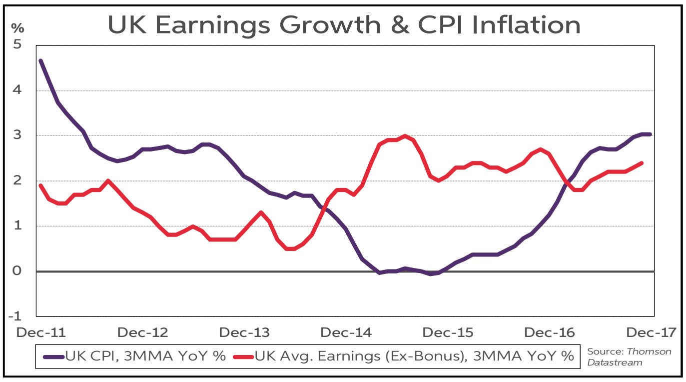
As expected today's Bank of England's Monetary Policy Committee (MPC) meeting concluded with no changes to interest rate policy. There was unanimity within the MPC on its decision to leave rates unchanged at 0.5%, which was also in line with market expectations. **The BoE, though, clearly signalled that it is likely to be necessary to raise rates to a somewhat greater extent than it previously expected.**

Today's meeting also coincided with the release of the February Inflation Report. This included updated macro projections. The Bank revised slightly higher its GDP forecasts for 2018 from 1.7% to 1.8%. Meanwhile, its growth forecasts for 2019 and 2020 were left unchanged at 1.7%, for both years. The BoE expects business investment to remain "restrained by Brexit-related uncertainties" and consumer spending to continue to be subdued, reflecting "weak real income growth". In terms of the inflation outlook, the MPC is projecting headline CPI to remain around 3% in the short term. It anticipates **inflation will fall back gradually "but remain above the 2% target" over the period 2019-2020**.



The Bank of England faces a challenging backdrop as its debates the appropriate stance of monetary policy. Inflation, at 3%, is running well above its 2% target. This persistent above target inflation is, as the meeting statement noted, "almost entirely due to the effects of higher import prices following sterling's past depreciation" which itself is as a consequence of the Brexit vote. Meanwhile, following its yearly analysis on the supply side of the economy, the MPC judges that the economy "has only a very limited degree of slack", potentially leading to further inflationary pressures. At the same, though, Brexit and the raft of uncertainties associated with it, as well as a slowing economy, add further complications to it deliberations on monetary policy.

Taking all these factors into account, it is the BoE's assessment that the degree to which it is appropriate to tolerate an extended period of inflation being above target has further diminished. The MPC also added that it is "appropriate" that **monetary policy be altered to return inflation back to its target within a shorter time horizon than the three years previously envisaged.** This suggests the **BoE will be more proactive in terms of the frequency and extent of rate hikes than had been previously anticipated.**



There was a firming of rate hike expectations in the UK in the aftermath of the BoE meeting. The market is now envisaging around 100bps of policy tightening by the end of 2020. From a timing perspective, futures contracts are expecting the next 25bps increase in Q3 2018. Two hikes are priced in for 2019, while one hike is anticipated by December 2020, which would bring the bank rate up to 1.5%. This suggests that the market is assuming that there will be a 'soft' Brexit in March 2019, as it is unlikely to be factoring in a series of rate hikes in a 'hard' Brexit scenario.

Overall, it is clear that the level of hawkishness within the BoE has increased further. While it gave no indication that a rate hike was imminent, it explicitly stated that **rates would need to rise "somewhat earlier and by a somewhat greater degree" than envisaged at the time of the November Inflation Report**. Market reaction to this increased "hawkishness" has seen UK gilt yields rise by between 7-10bps. Sterling has also rallied, gaining around 1% on the exchanges, with EUR/GBP below 88p and GBP/USD back above $1.40.

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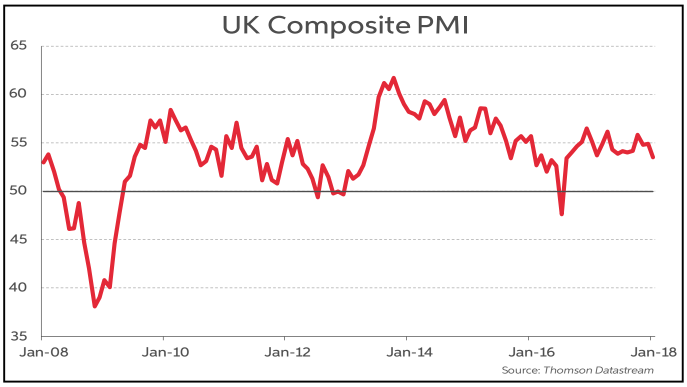
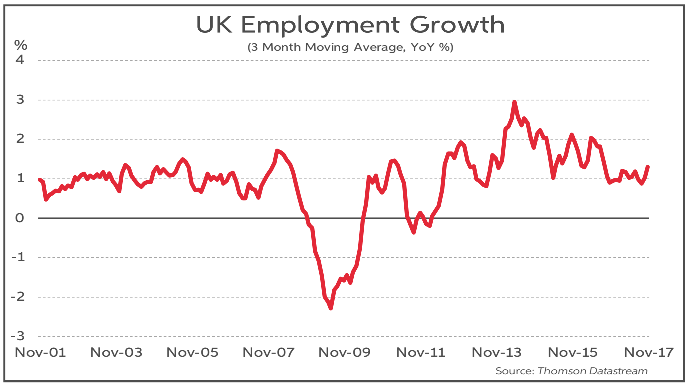
Brexit vote sees UK growth moderate



UK GDP rose by a slightly stronger than expected 0.5% in Q4, up from 0.4% in Q3, though year-on-year growth slowed further to 1.5%. For 2017 as a whole, growth slowed for a third consecutive year, coming in at 1.8%, its weakest annual performance since 2012.

The initial Q4 GDP data, which are by the output method, showed that the key services sector remained the main driver growth, increasing by 0.6% and contributing 0.45 percentage points. Strong manufacturing growth (+1.3%) helped to offset declines in construction (1%) and agriculture (0.4%), though the impact off all three on GDP was minimal. We will have to wait for the second reading of GDP (22nd February) for information on the key business investment and consumer spending metrics.

Meanwhile, **labour market statistics for the three months to November were more upbeat in nature.** They showed that employment grew by 102k in the period, compared to the 56k fall registered in the three months to October. At the same time, the unemployment rate held at a 42-year low of 4.3%. This largely reflects soft labour force growth (0.8% year-on-year in November). ONS figures show that the number of people emigrating to the UK looking for work has fallen sharply since the Brexit vote. Indeed, **indicators suggest labour market 'slack' has continued to dissipate, with the recent BoE Q4 Business Conditions survey showing that difficulty in recruiting workers in the UK rose for a fourth consecutive quarter,** reaching its highest level since Q3 2004.



Despite the tight labour market conditions, earnings growth has remained relatively subdued. Underlying wage inflation (ex-bonus) did edge up slightly to 2.4% in the three months to November, its highest level since the end of 2016. However, CPI inflation averaged 3% in the same period, meaning real wage growth remained negative.

In terms of a timelier look at the economy, the Markit PMIs weakened in January. The headline composite index came in at 53.5, below its solid Q4 average of 55.2. This reflected weaker performance from all three of the main sectoral indices—services, manufacturing and construction. At the same time, the EC measure of UK economic sentiment also fell back in January, from 111.8 to 111.1. This suggests growth slowed again at the start of 2018.

Overall, the UK economy remains in a period of high uncertainty with the UK/EU negotiations on exit terms and trading arrangements likely to drag on. Thus, business investment could continue to be subdued, while squeezed household incomes remain a headwind to consumption. At the same time, the relatively weak nature of sterling and stronger growth in the UK's main export markets should have a positive impact on trade, while the BoE looks set to keep policy very accommodative.

The recent IMF forecasts are for moderate growth of 1.5% this year and again in 2019. These are broadly in line with the recent forecasts from the Office for Budget Responsibility for GDP growth of 1.5% and 1.4%. Today's revised BoE forecasts are slightly more upbeat, predicting growth of 1.8% this year, followed by 1.7%.

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