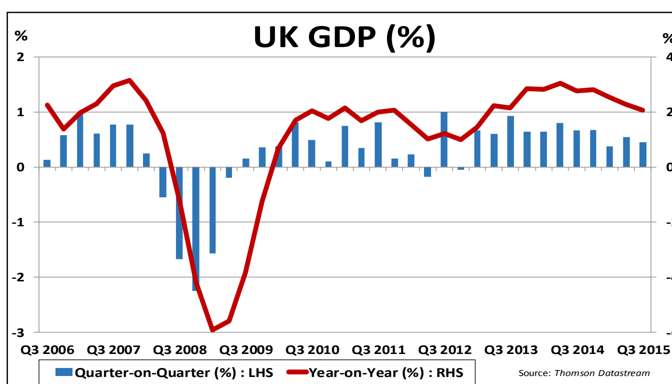
Bank of England Watch

14th January 2016

AIB Treasury Economic Research Unit

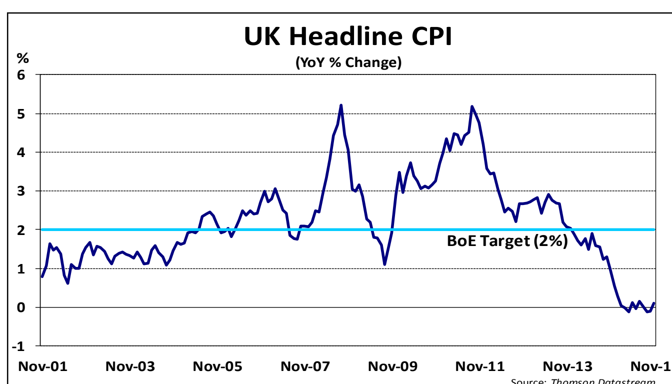
MPC remains in a holding pattern

Today's meeting of the Bank of England's Monetary Policy Committee (MPC) concluded with no changes to policy, which was in line with market expectations. For a sixth consecutive month, the decision to keep the Bank rate at 0.5%, where is has been since mid-2009, was not unanimous. Once again, Ian McCafferty was the sole 'hawkish dissenter', voting for a 25bps rate hike. He was of the view that the "risks to domestic cost growth remained to the upside" and this along with the recent depreciation of sterling was "sufficient to justify an immediate increase" in the Bank rate. **However, the remaining eight MPC members "judged that leaving the stance of monetary policy unchanged would best balance the risks around achieving the MPC's objective of returning inflation sustainably to the target in around two years' time".**



The minutes noted that **the Committee "focused its discussion" on the further sharp fall in oil prices and the implications, if any, this had for the UK's inflation outlook** and in turn the appropriate stance of monetary policy. The MPC commented that the 40% fall in dollar oil prices means that "**the increase in inflation is now expected to be slightly more gradual in the near term"** than it had expected at the time of its November Inflation Report forecasts.

The text included reference to the fact that at 0.1% in November, **CPI inflation "remained well below the target**", mainly due to "unusually low contributions from energy, food and imported goods, but **also reflecting the weakness of domestic cost growth**". Indeed, on the issue of domestic cost pressures, the MPC discussed the "different signals" being implied by recent wage and employment data. **The MPC stated that the recent easing in wage growth "had been significantly more pronounced than the Committee had expected**". However, at the same time, employment figures had been more robust. Overall though, domestic cost growth over the past year was described as being "below that necessary for inflation to return sustainably to the 2% target".



There was also downward revisions to the near term growth outlook. Bank staff lowered its base case GDP forecasts in Q4'15 and Q1'16 by "0.1 percentage points to 0.5% in each quarter", reflecting revised official data and the latest business surveys.

At the time of its November Inflation Report, the MPC's view was that if the bank rate were to follow the path implied by the prevailing market yields, CPI inflation would "slightly exceed the 2% target in two years time". Following this week's policy deliberations, the MPC now judges that the "**risks to this projection lay a little to the downside in the first two years".**

Overall then, today's update from the Bank of England reinforces the view that the MPC is still some way off from starting the rate tightening cycle in the UK. We await the release of the February Inflation Report (4th February) for a more comprehensive and up-to-date insight into the Bank's view on the economic outlook and the timeframe for policy tightening. Current futures contracts suggest that the market does not see a rate increase until the first half of 2017.

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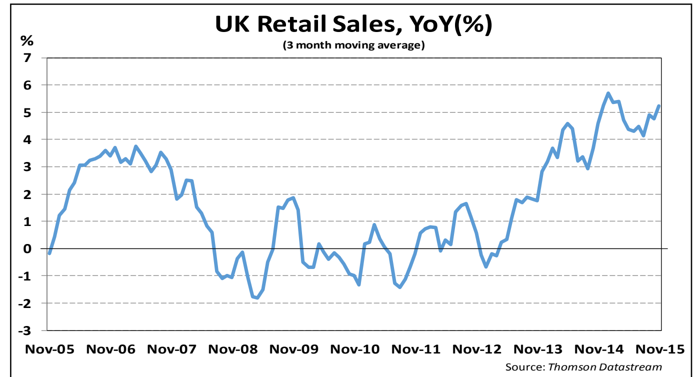
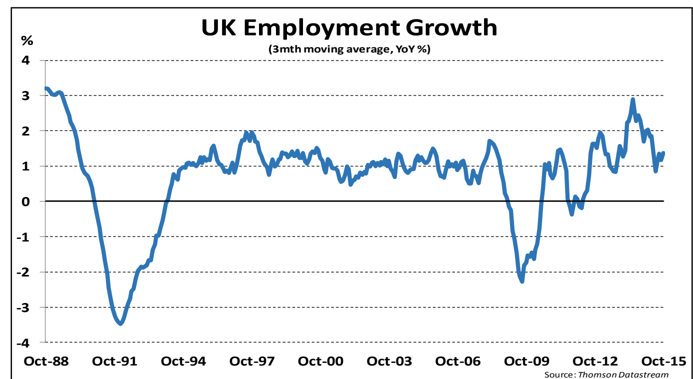
UK economy disappoints in 2015

Growth in the UK economy slowed last year, with GDP likely to have risen by 2.2%, down from 2.9% in 2014. Growth in Q3 was at 0.4%, compared to 0.5% in Q2. The expenditure based breakdown of Q3 GDP showed that growth continued to be somewhat 'unbalanced'. Personal consumption remained the driving force of the economy, contributing 0.6 percentage points (p.p.). Inventories (0.5 p.p.) and business investment (0.2 p.p.) were the other main sources of growth. Net trade proved to be a significant drag in Q3, taking 1.0 p.p. from growth. This, though, primarily reflects a pick-up in imports in order to rebuild inventories run down in Q2.



While we do not yet have an official estimate of Q4 GDP, available data suggest that growth remained modest in the quarter. The UK composite PMI, a good leading indicator of activity, averaged 55.5 in Q4, broadly in line with Q3's 55.1. Although, the EC economic sentiment index pointed to a possible further slowdown, averaging 109 in Q4 after 112.5 in Q3.

The hard data have also generally reinforced the picture of modest, but still unbalanced, growth. Industrial production was flat in October/November compared to Q3. While the sector had been supported by increased oil production, this seems to have waned in Q4, perhaps in part due to the mild winter. The stronger sterling has also weighed on output. On the consumer side of the economy, retail sales were strong in Oct/Nov, up 1.5% compared to Q3. However, with the very strong 'Black Friday' related sales in November, December sales could well be softer than usual. Thus, overall sales growth in the quarter may not be markedly different from the c.1% recorded in Q2 and Q3.



Despite the moderation in economic growth, **job growth has picked up pace again. Employment rose by 207k in the three months to October**, compared to 43k in the previous three months. The unemployment rate fell to 5.2% in October, its lowest rate since May 2008. Looking ahead, the composite employment PMI averaged a solid 54.3 in Q4, suggesting that we should see continued solid job growth.

However, despite the continued fall in unemployment/jobs growth, **the pace of year-on-year growth in average earnings has begun to slow.** The ex-bonus measure came in at 2% in October, having been as high as 2.9% as recently as July. Although 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. It has been stuck in a -0.1% to +0.1% range since last February. As a result, **real wage growth still remains at an encouraging level.**

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 data. The underlying data from the RICS survey suggests that this is due to rising demand combined with falling supply.

The solid 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. Overall, **UK GDP growth may average around 2% or slightly below it in 2016.**

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