BoE Watch

AIB Treasury Economic Research Unit

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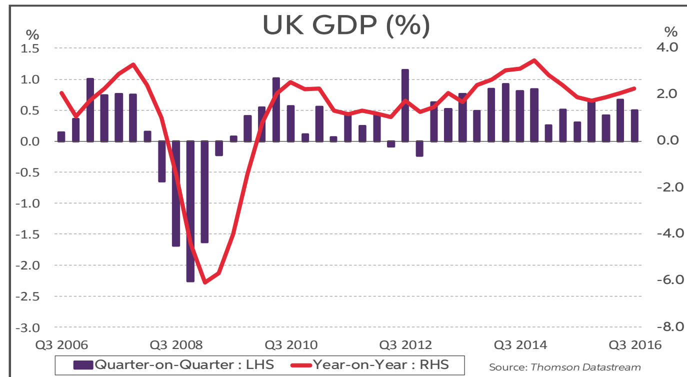
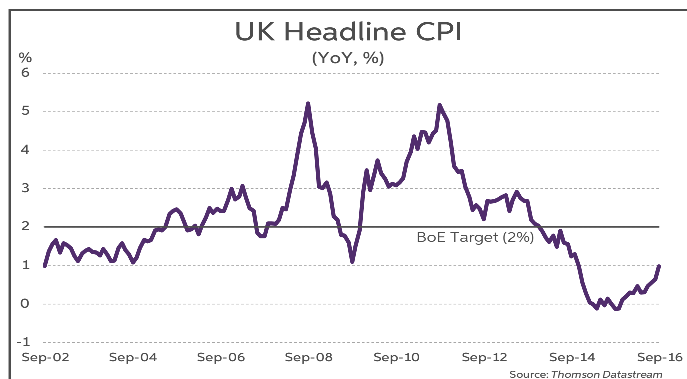
Another BoE rate cut now unlikely

As expected, the November meeting of the Bank of England's Monetary Policy Committee (MPC) concluded with no changes to policy. The decision today to leave its current policy stance unchanged was unanimous. Back in August, along with the publication of its Quarterly Inflation Report (QIR), the MPC introduced a raft of policy easing measures in response to the potential headwinds for the economy arising from the referendum vote in favour of Brexit. The measures included cutting the Bank Rate by 25bps to 0.25% and increasing its asset purchase programme.



Since then, the BoE acknowledged that the performance of the UK economy has been "materially better than expected" supported in part by the Bank's policy easing measures. Household spending has "been even stronger" as consumers appeared to "entirely look through Brexit-related uncertainties". This positive tone to consumer sentiment helped the housing market. The BoE also stated that "business investment had been "somewhat less soft" than expected. Although at the same, time it emphasised a "discernible pattern", whereby indicators of business investment, employment decisions and the commercial property market had been more subdued and less resilient than those related to the household sector.

The Bank now expect "growth to be stronger in the near term" aided by the resilience in household spending/ sentiment**. However, it envisages growth to be "weaker than previously anticipated in the medium term"** due in part to the impact of lower real income growth on household spending arising from the depreciation of sterling**.** This is reflected in its latest set of GDP forecasts contained in today's QIR with upgrades to its 2016 (to 2.2% from 2.0%) and 2017 (to 1.4% from 0.8%) growth projections, while the 2018 figure has been revised downwards (to 1.5% from 1.8%).



On the inflation front, the BoE said that "largely as a result of the deprecation of sterling, CPI inflation was now expected to be higher throughout the three year forecast period" than at the time of the August QIR. In the subsequent press conference, Governor Carney said that "it is the fall in sterling that will have the more significant implications for the path for inflation at the monetary policy horizon". The updated projections have inflation peaking at around 2.8% by mid 2018, before gradually falling back over 2019. The Bank is of the view that sterling's impact on inflation would "ultimately prove temporary". Therefore, it believes that attempting to deal with higher inflation by tightening monetary policy could prove "excessively costly in terms of the foregone output and employment growth"

However, the BoE also emphasised that there were "limits to the extent to which above-target inflation could be tolerated" and that it would monitor closely the evolution of inflation expectations. Against this backdrop, "all MPC members agreed that the guidance it had previously issued regarding the likelihood of a further cut in Bank Rate had expired" and that "**Monetary policy could respond, in either direction"** to the evolution of the economy the exchange rate and inflation. Overall, following the November edition of the BoE's 'Super Thursday', another rate cut in the UK seems unlikely. This is in line with what futures contracts have been indicating in recent weeks. The immediate market reaction has seen sterling strengthen, with GBP/USD trading above $1.24 and EUR/GBP testing below 89p. Meanwhile, UK gilt yields have risen, with the 10 year yield up c.7bps to 1.2%.

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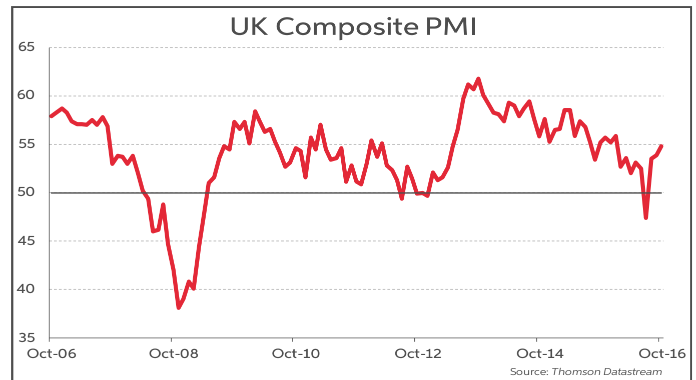
Economy showing little sign of Brexit impact

The UK economy grew by 0.5% in the third quarter, above market expectations for a 0.3% pick-up. This does represent a slowdown from Q2's inventory boosted 0.7% rise. The pace of year-on-year growth increased to 2.3%, from 2.1%. The preliminary breakdown of GDP, which is by the output method, showed that the services sector remained the primary source of growth, adding 0.6 percentage points (p.p.) in the quarter. Meantime, both the production and construction sectors knocked around 0.1 p.p. off growth.



While we will not get an expenditure based breakdown of growth until later this month (25th), **data for Q3 suggest that consumption remained the key driver of growth. Retail sales grew by a strong 1.8% in in the quarter, their best performance since Q4 2014.** Underlying data show that growth in sales was broad based. Elsewhere, industrial production fell by 0.3% in July/August, following its strong 2.1% increase in Q2, with most output components struggling. Meanwhile, the July/August trade data suggest that the UK's trade deficit may have narrowed somewhat in Q3.

Meantime, **labour market data have so far shown little major sign of Brexit related impact.** While growth in employment slowed to 106k in the 3 months to August compared to 176k in the previous three months, this still represents a solid rate of growth. The year-on-year rate of employment growth remains close to 2%. The UK unemployment rate held at 4.9% in August. The composite employment PMI is recovering from its recent lows, suggesting the potential for the jobs market to continue to register further improvement.

Despite the low level of unemployment, there has been no significant impact on wages. Year-on-year growth in earnings has been stuck around 2.2% since the start of the year. Meantime, CPI inflation rose to 1% in September. Sterling depreciation could put further upward pressure on prices in the coming months. Thus, real wage growth could continue to slow, which would likely have a negative impact on consumption.

Leading indicators of activity for October have generally suggested that the UK economy continued to grow at a healthy pace at the start of Q4. The Markit composite PMI rose to 54.8 in the month, from 53.9. This represents its strongest level since the start of the year. Measures of consumer confidence, such as the Gfk index, did edge lower, though they remain well above their recent post-EU referendum lows.

In the near-term, the economy could be in something of a 'sweet spot', benefiting from the impact of looser monetary policy and the weaker sterling before the negative impacts such as rising inflation take hold. Overall, **the UK economy is facing into a period of heightened uncertainty.** This is likely to weigh on consumer spending, the key driver of UK growth. Business investment could also be adversely impacted by the Brexit vote. The labour market may also suffer with employers potentially holding off on hiring new workers, if they expect weaker growth and there is a lack of clarity over future access to the EU Single Market.

The negotiating process to decide on the UK's EU exit terms and agree a new trading arrangement could drag on for quite some time. The outcome of these talks will ultimately determine the long-run implications of Brexit for the economy. The impact of the referendum is still likely to be negative overall, leading to quite a more subdued pace of growth in the next couple of years. Indeed, **the BoE anticipates that GDP growth will slow from this year's expected 2.2% increase to around 1.5% in 2017 and 2018.**

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