BoE Watch

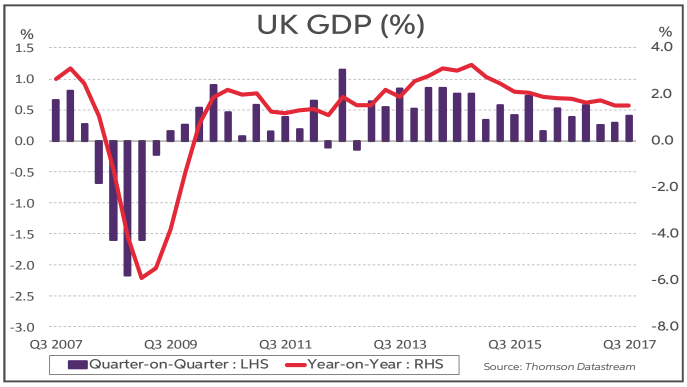
AIB Treasury Economic Research Unit

2nd November 2017

BoE hikes for the first time since 2007

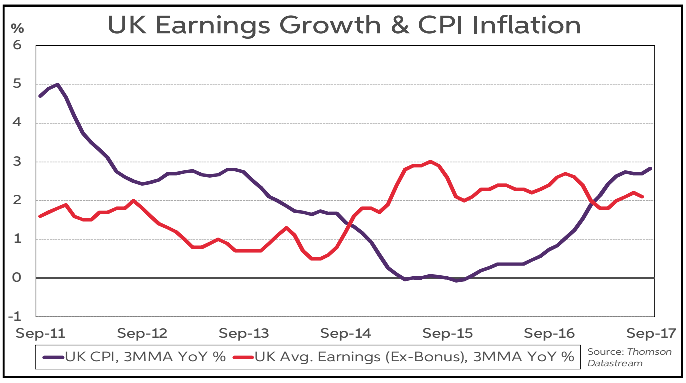
As expected, the Bank of England's Monetary Policy Committee (MPC) increased the Bank rate by 0.25% to 0.5%. This reverses the 25bps rate cut that the BoE introduced following last Summer's Brexit referendum. It represents the first time since July 2007 that the MPC has hiked interest rates. The decision to increase rates was not unanimous, with a 7-2 majority vote in favour of the decision.

The statement and minutes outlined the MPC's rationale for the decision to raise the Bank rate. The Committee noted that spare capacity in the economy appeared to have eroded "if anything a little more rapidly" than expected, while the margin of slack in the economy "now seemed fairly limited" while at the same time, "underlying inflationary pressures" had "shown signs of picking up". It also stated that it had become "increasingly evident that the pace at which the economy could grow without generating inflationary pressures had fallen".



The BoE said that this "steady erosion of slack has reduced the degree" to which the Central Bank can "accommodate an extended period of above target inflation". As a result, a majority of MPC members considered "it appropriate to tighten modestly the stance of monetary policy in order to return inflation sustainably" to its 2% target. In his press conference, Governor Carney reinforced this message by saying that "inflation is unlikely to return" to target "without some increases in interest rates". He was also keen to emphasise that "even after today's rate increase, monetary policy will provide significant support to jobs and activity".

The BoE's updated set of macro forecasts contained in the November Inflation Report, which assume a 'smooth Brexit adjustment' are 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% (from 1.8%) in 2019, while in the first release of its 2020 growth projection, it is pencilling in growth of 1.7% also. **In terms of the inflation outlook, the MPC continues to expect inflation "to peak above 3% in October"** 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 the forecast period".



The BoE's assessment on the inflation outlook is "conditioned" on market rate expectations. **The curve implies that the market expects two additional 25bps increases by the end of 2020.** In terms of timing, futures contracts are expecting another increase by end 2018, with a subsequent increase not priced in until 2020. This marks quite a hawkish shift in UK rate expectations over the last 2-3 months. At the beginning of September, the market was not expecting a BoE rate hike till H2 2019.

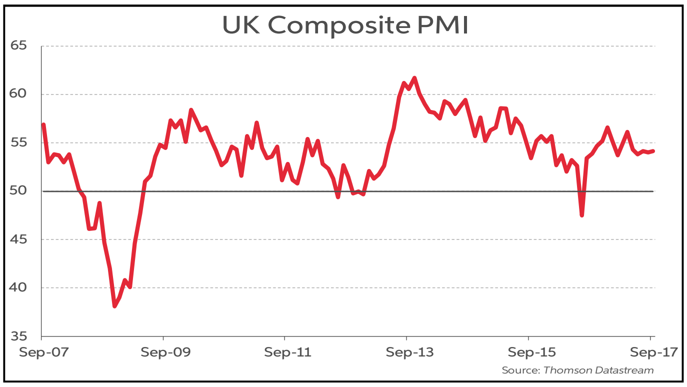
Market reaction to the BoE's November version of 'Super Thursday' has seen sterling weaken and UK gilt yields down around 6-8bps on the day. The currency had been gaining ground in the lead up to the meeting. In level terms, the weaker post-BoE tone is reflected in EUR/GBP moving up from 87.5p to near 89p and GBP/USD edging below $1.32 to trade closer to $1.31. The market's less hawkish interpretation of today's proceedings may in part be due to the fact that the BoE removed the reference that rates may have to rise by a somewhat greater extent than market expectations. Another factor may be that the BoE placed strong emphasis on Brexit being the "biggest determinant of the outlook" and the difficulties implied by this in assessing future policy decisions.

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

UK growth has remained modest



UK GDP rose by a slightly firmer than expected 0.4% in Q3, up from 0.3% in Q2. The pace of year-on-year growth held at 1.5%. Growth in the first three quarters of the year suggests that we may see modest average annual GDP growth of 1.5% in 2017, a slowdown from 2016's 1.8% and 2015's 2.3%.

The preliminary breakdown of Q3 GDP, which is by the output method, showed that the services sector remained the main driver of growth, adding 0.3 percentage points (p.p.). Production bounced back from its 0.3% decline in Q2, growing by a solid 1% and adding 0.1 p.p. to growth. Manufacturing, which accounts for c.70% of production also grew by 1%. Although, **construction declined for a second consecutive quarter** (deducting 0.05 p.p.). This tallies with the PMI construction surveys, which have shown declining activity in commercial and civil construction, likely due to Brexit uncertainty.

While we will not get an expenditure based breakdown of GDP growth until later this month (23rd), **retail sales data (accounting for around one third of overall spending) for the quarter suggest that weaker consumer spending remained a headwind to overall growth.** Retail sales grew by 0.6% in the third quarter, compared to a 1.1% rise in Q2.

The main reason for the weaker performance in consumer spending in the UK has been the squeeze on household incomes. CPI inflation has risen in recent months, reaching 3% in September. At the same time, year -on-year growth in earnings has been broadly stagnant, remaining at 2.2% in the three months to August. This means that real earnings are in decline, reducing purchasing power.

Producer output price inflation was broadly steady in September at 3.3%, while input price inflation was at 8.4%. Looking ahead, this suggests that **businesses continue to absorb some of their higher input costs. However, they could yet pass on more of these increased costs in higher prices to consumers,** pushing inflation higher.

While wages have remained subdued, the unemployment rate has continued to decline, falling to a 42-year low of 4.3% in the three months to August. However, this partly reflects the sharp slowdown in labour force growth. It rose by just 42k in the three months to August (+0.3% in year-on-year terms). This was easily outpaced by employment, which recorded a modest 95k rise (+1% year-on-year) in the same period..

Overall, the UK economy is in a period of heightened uncertainty with the negotiating process to decide on the UK's EU exit terms and any new trading arrangements likely to drag on for some time. Thus, business investment could continue to be weighed down, 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 despite today's rate hike, BoE policy remains highly accommodative. The IMF is forecasting growth of 1.7% for this year and 1.5% in 2018.

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