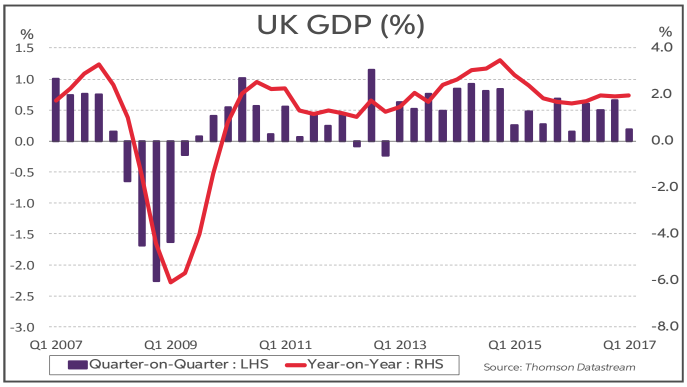
BoE Watch

AIB Treasury Economic Research Unit

15th June 2017

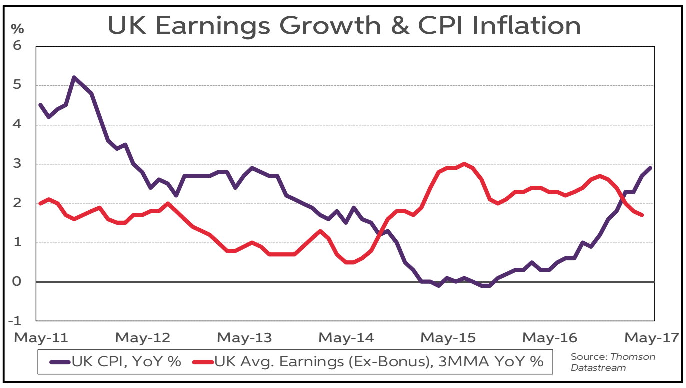
BoE turning more hawkish

The June meeting of the Bank of England's Monetary Policy Committee (MPC) concluded with no changes to policy. This was in line with market expectations. However, the voting breakdown was a surprise, with a majority vote of 5:3 (note: only eight members on MPC in June) to maintain the Bank Rate at 0.25%. The expectation had been, that there would be only one 'hawkish dissenter'-Kristin Forbes. However, she was joined by Ian McCafferty and Michael Saunders in voting to increase the Bank rate by 25bps.



The meeting minutes outlined the policy deliberations that took place, with the discussion centred on the outlook for inflation. Back at its May meeting, the MPC's view was that the "economy was expected to operate with a small degree of spare capacity for most of the three year forecast period". This view underpinned and justified the BoE's "tolerance of some degree of above target inflation".

However since then, the MPC acknowledged that "CPI inflation had risen further above target to 2.9%", which was higher than its own expectations. The MPC also commented that "measures of core inflation had also been higher than expected". This inflation backdrop, combined with the recent fall in sterling "meant the overshoot of inflation relative to the target might be somewhat greater than previously supposed" with the extent of "spare capacity" in the economy appearing to be "limited". **These developments "lessened the trade-off that the MPC was required to balance" which in turn "reduced the MPC's tolerance of above target inflation".**



As a result of the "change in the trade-off", arguments were put forward at the meeting in favour of a "moderate tightening in policy". In this context, along with referencing the fact that "slack in the labour market appeared to have diminished", it was noted that the withdrawal of part of the stimulus injected back in August 2016, would "help to moderate the inflation overshoot". At the same time, monetary policy would still remain "very supportive".

On the other hand, the arguments in favour of leaving rates on hold, included the fact that both household consumption and the economy as a whole had slowed and that it was "too early to judge with confidence how large and persistent it would prove to be". It was also stated that "a period of slower than expected growth could see a margin of slack re-opening". In the end, five members were in agreement that "the current policy stance was still appropriate to balance the demands of the Committee's remit".

Overall, the latest update from the BoE indicates some increased 'hawkishness' within the MPC. However, the minutes also stated that while there was differing views on whether rates should be hiked or left on hold, "**all committee members agreed that any increase in Bank Rate would be expected to be at a gradual pace and to a limited extent".** It must also be noted that the MPC is assuming a 'smooth' post-Brexit transition.

In terms of market expectations, futures contracts indicate that the market is expecting that a rate hike could occur towards end-2018/early-2019. However, a rate hike around this time may be unlikely. The UK economy is expected to slow over the next two years in the run-up to Brexit, while the rise in inflation could also prove transitory given that wage inflation is quite subdued. Thus, monetary policy in the UK could remain on hold for the foreseeable future.

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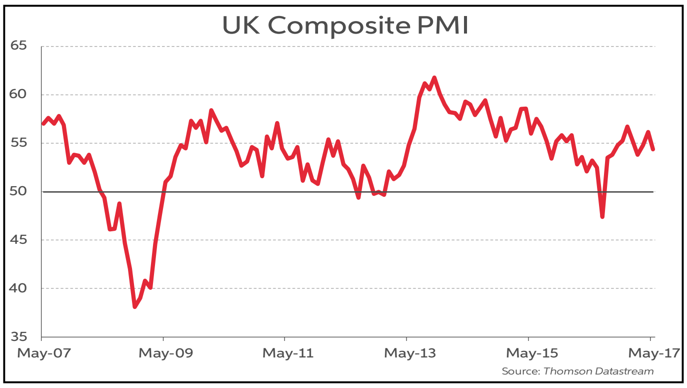
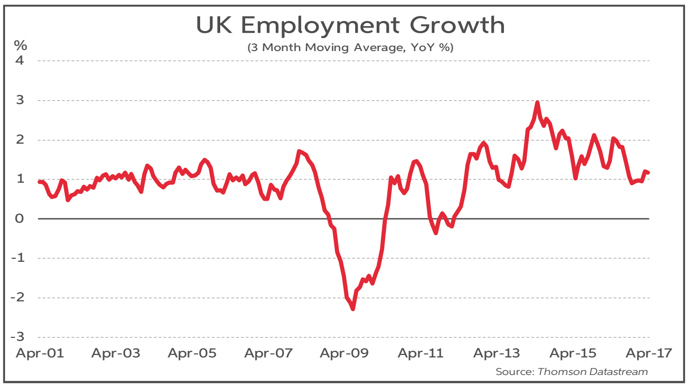
Household incomes getting squeezed



GDP growth in the UK slowed in Q1, from 0.7% to 0.2% on a quarterly basis. The breakdown of GDP shows that net trade was the largest drag on growth. It deducted 1.4 percentage points (p.p.), after adding 1.7 p.p. in Q4 2016. Although, trade in both quarters was distorted by 'erratics' (i.e. gold), with Q1's rise in gold imports netting off elsewhere in the GDP figures as investment. Indeed, business investment rose by a relatively encouraging 0.6% in Q1, adding 0.1 p.p. to GDP.

Another significant factor behind the slowdown in Q1 was consumer spending, which added just 0.2 p.p. to GDP, its weakest contribution since Q4 2014. Household spending has not been helped by that fact that inflation is rising more quickly than average earnings, squeezing household incomes.

Worryingly for the UK economy, CPI inflation has continued to rise in Q2, hitting a four-year high of 2.9% in May. Core inflation (ex-food & energy) has also risen, coming in at 2.6% in May, showing broad based price pressures. Meantime, producer price data show that input prices are up 11.6%, though output costs are up just 3.6%. This suggests that businesses continue to absorb some of their higher input costs, which are largely related to sterling weakness. However, higher output costs are likely to exert further upward pressure on inflation, acting as a headwind to consumer spending, as well as reducing the competitiveness of UK exports.



Meanwhile, **signs from the labour market have been mixed.** Earnings growth has continued to soften, with the headline measure slowing to 2.1% year-on-year in April, indicating a further weakening in real wage growth. This is despite an apparently tight labour market, with **the unemployment rate at just 4.6% in April**. Employment rose by an encouraging 108k in the three months to April. Although, the growth rate has slowed to 1.2% year-on-year, below the c.2% rate seen around the middle of 2016.

In terms of Q2 activity, leading indicators have generally suggested that the economy is improving at a slightly faster pace than in Q1. The Composite PMI averaged 55.3 in April/May compared to 54.6 in Q1. The EC measure of UK economic sentiment averaged 109.4, versus 108.9. The little 'hard' data that have been released have been somewhat upbeat. Retail sales, which have been volatile recently, grew by 1.4% in April/May, after falling by 1.6% in Q1. Meantime, industrial production edged slightly higher in April (+0.2%) after declining throughout Q1.

Overall, the UK's Brexit 'sweet spot' may be ending. The economy has benefited from loose monetary policy and the weaker sterling. However, negative factors like higher inflation now seem to be coming to the fore. **The economy is facing into a period of heightened uncertainty. The negotiating process to decide on the UK's EU exit terms and any new trading arrangements is likely to drag on until near the end of next year.** Business investment may be adversely impacted, while jobs growth could remain subdued if employers expect weaker growth and a more difficult trading relationship with the EU. This would dampen consumer spending, as would rising inflation. However, there are expectations that the weaker sterling will have a positive impact on net trade, while we could also see higher levels of investment to meet stronger external demand. **The OECD expects GDP growth of 1.6% this year and 1% in 2018, below the BoE's projections of 1.9% and 1.7%.**

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