BoE Watch

AIB Treasury Economic Research Unit

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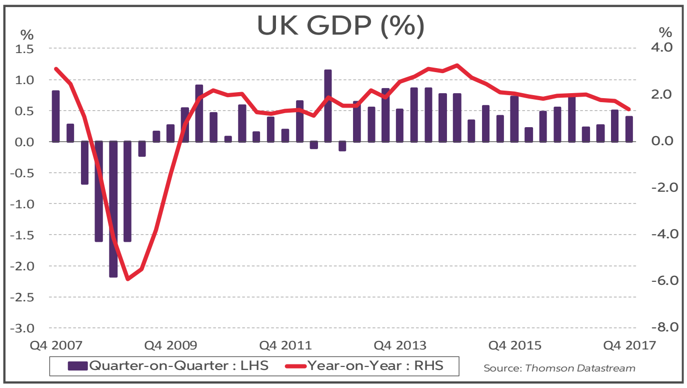
Next UK rate hike on the cards for this summer

The March meeting of the Bank of England's Monetary Policy Committee (MPC) concluded, as expected, with no changes to rates. The key Bank Rate was left at 0.5%. However, in something of a surprise for markets**, two members of the MPC voted for an immediate hike of 25bps,** opening the door for a possible rate increase as early as its next meeting in May. **Sterling immediately jumped on the news, although the gains were not sustained.**

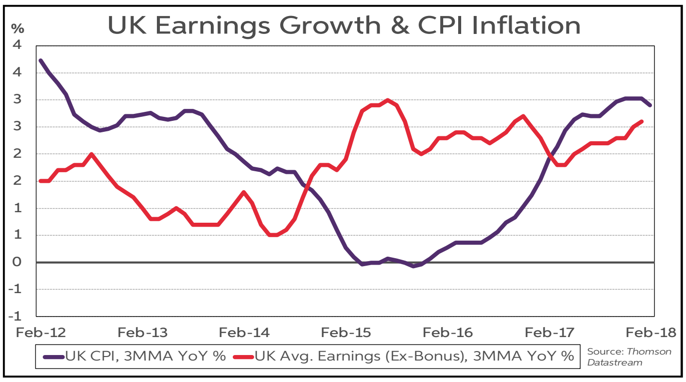
The BoE had signalled at its previous meeting in February that it will likely be necessary to raise rates to a somewhat greater extent than it had previously expected. As a result, markets have moved to price in a rate hike at some stage this summer, as well as further increases over the next couple of years.



Markets see rates rising by 100bps in total to 1.5% by end 2020. There was nothing in the minutes of today's MPC meeting to cause markets to change their view on rates. **The chances of a May rate hike, though, have risen following the vote by two MPC members to increase rates now.**

The MPC notes in the minutes of today's meeting that recent data releases have been broadly in line with its view of the medium-term outlook as set out in the Bank of England's February inflation report. While the MPC has indicated that further rate hikes are likely, a rate increase was not seen as necessary at today's meeting for the majority of Committee members. The MPC, though, added that **the May forecast round would enable it "to undertake a fuller assessment of the underlying momentum in the economy, the degree of slack remaining and the extent of domestic inflationary pressures"** at its next policy meeting.

The Bank of England faces a challenging backdrop as its debates the appropriate stance of monetary policy. While inflation looks to have peaked at around 3%, with the CPI rate easing back to 2.7% in February, it is still running well above the 2% target. Meanwhile, following its yearly analysis on the supply side of the economy contained in last month's Inflation Report, the MPC judges that the economy "has only a very limited degree of slack", potentially leading to increasing inflationary pressures. At the same, though, Brexit and the raft of uncertainties associated with it, as well as the slowdown in the UK economy, add further complications to its policy deliberations.



Data over the coming weeks are likely to play an important role in whether the MPC decides to hike rates at its next meeting in May, or waits until later in the summer. The MPC has not boxed itself in as there was no repeat in these minutes of the guidance given ahead of the November rate hike that rates would rise "in the coming months". By May, the MPC will have the Q1 GDP report, as well as further data on inflation and wage growth on which to base a decision.

Overall, what is clear from today's meeting is that the Bank of England has embarked on a steady rate hike path, but rate increases are "likely to be at a gradual pace and to a limited extent". Raising rates to 1.5% by the end of 2020 would still leave them at a very low level and imply that policy would remain quite accommodative. The Bank of England has been in existence since 1694 and it is only in the past decade of its near 325 year history that rates have been pitched below 2%. It is also interesting to note that the US Fed is guiding that its interest rates could rise to 3.4% by end 2020, more than double the projected level for the Bank of England.

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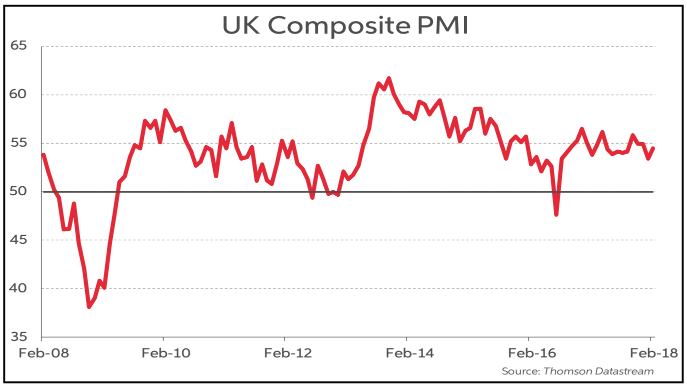
UK economy growing at a moderate pace

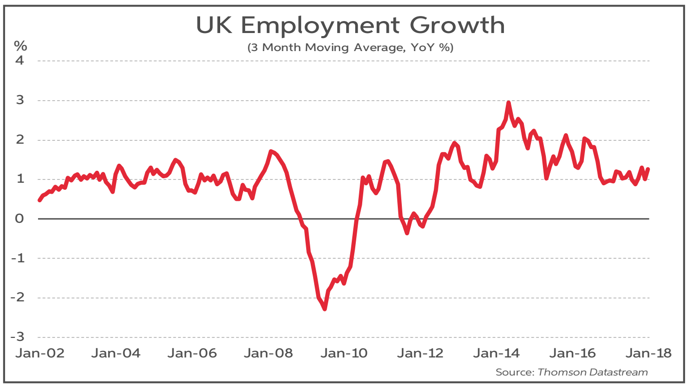
UK GDP rose by 0.4% in Q4, a slight slowdown versus Q3's 0.5% increase. Growth slowed for a third consecutive year in 2017 as a whole, coming in at 1.7%, its weakest performance since 2012. The breakdown of the Q4 GDP report showed that personal consumption, government spending and capital investment all made modest positive contributions to growth. Business investment was flat. Net trade continued to act as a drag on the economy.



The data released to date for Q1 2018 suggest that GDP growth may have slowed slightly in the quarter. The Markit composite PMI averaged 54.0 in January/February following on from 55.2 in Q4 2017. The slightly weaker index is reflected in both the services and manufacturing PMIs. However, the EC measure of UK economic sentiment edged up slightly in Jan/Feb (110.3 vs Q4's 109.9).

In terms of 'hard' data, retail sales declined by 0.4% in Jan/Feb versus Q4 2017, in which they recorded a modest 0.5% increase. Meantime, manufacturing edged up by 0.1% in January, recording a ninth consecutive monthly increase, the most since records began in 1968. However, the 3mth-on-3mth growth rate slowed.

Meanwhile, **labour market statistics have improved in recent months.** For example, employment increased by 168k in the three months to January, after falling by 56k in the three months to October. At the same time, the unemployment rate remained at a 42-year low of 4.3%. **Indicators suggest that labour market 'slack' has continued to dissipate, with the BoE's Business Conditions survey showing that difficulty in recruiting workers in the UK was at its highest level in January since October 2004.**



The tighter labour market seems to be translating into firmer wage growth. Average weekly earnings rose by 2.8% year-on-year in the three months to January. This is its strongest rate since the three months to September 2015. CPI inflation averaged 3% in the three months to January, meaning that real wage growth remained slightly negative.

However, **inflation moved down from 3% to 2.7% in February, meaning the data are likely to show a return to real earnings growth in the coming months.** This should provide a fillip to the key consumer side of the UK economy. Meantime, core inflation (ex-food & energy) moved down from 2.7% to 2.4% in February as the base effects from the post-Brexit vote fall in sterling, which boosted import prices, unwind.

Overall, the UK economy continues to be impacted by the uncertainty associated with the UK/EU negotiations on Brexit. Although, the recent agreement, that little will change during a post-Brexit 'transition' period that is to run until the end of 2020, does offer some comfort for UK businesses. However, investment could continue to be subdued, while squeezed household incomes remain a headwind to consumption. At the same time, the relatively weak sterling and stronger growth in the UK's main export markets should eventually have a positive impact on trade, while the BoE is set to keep policy very accommodative.

The UK Office for Budget Responsibility recently released updated growth forecasts, with the economy still expected to grow quite modestly in the coming years. The OBR is projecting that GDP will rise by 1.5% this year, followed by increases of 1.3% in both 2019 and 2020. The BoE's most recent forecasts are more upbeat, with the Bank expecting GDP to grow by 1.8% this year, followed by 1.7% in 2019.

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