BoE Watch

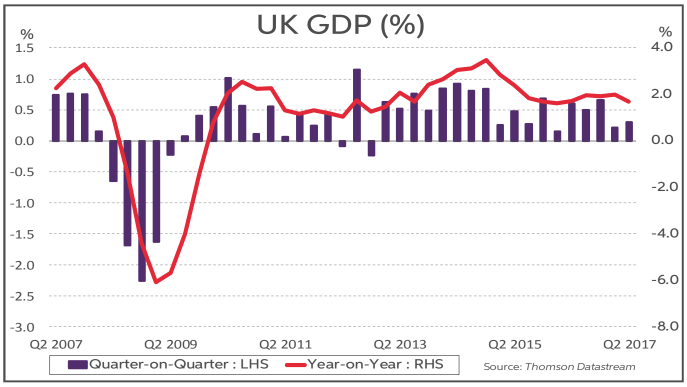
AIB Treasury Economic Research Unit

14th September 2017

Rate hike likely in the coming months

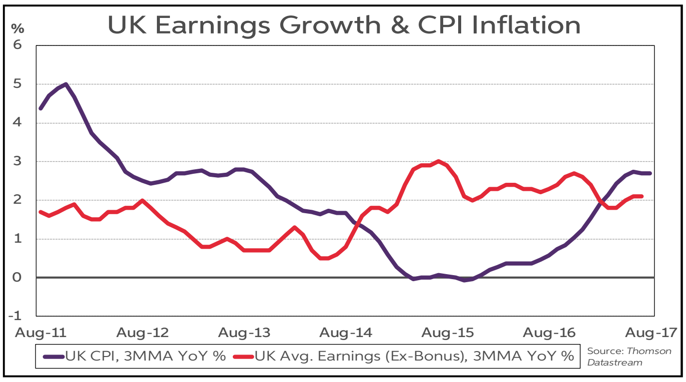
The September meeting of the Bank of England's Monetary Policy Committee (MPC) concluded, as expected, with no changes to interest rate policy. The decision to leave rates unchanged was, once again, not unanimous, with a 7-2 majority vote in favour of maintaining the Bank Rate at 0.25%. However, the MPC turned decisively more hawkish in indicating that a rate hike is likely in the coming months.

The meeting statement summarised the MPC's assessment on the economy's performance and outlook. The MPC set out three key "judgements" in this regard. Firstly, it stated that the weakness in sterling "continues to boost consumer prices" in the short term. Secondly, wage growth "remains modest in the near term" but is expected to pick up over the medium term. Thirdly, the MPC is of the view that "subdued household spending growth is largely balanced by a pickup in other components of demand".



The minutes of the meeting indicated a somewhat upbeat tone from the BoE on the macro backdrop. They referenced the fact that a large degree of the weakness in consumer spending in Q2 was due to a drop in car sales and "was expected to unwind partially in Q3". The minutes also noted that "most early indicators were consistent with a somewhat stronger profile" for household spending in Q3 "than had been incorporated" in the August Inflation Report. Their overall view was that the data releases so far suggested a "slightly stronger growth picture than anticipated". It also acknowledged that the unemployment rate was a "little lower than forecast".

Overall, the MPC's assessment of the incoming data had lead it to conclude that if **anything the data suggested that the remaining spare capacity in the economy was being absorbed a little more rapidly than previously envisaged**, resulting in inflation being likely to "overshoot the 2% target over the next three years". Against this backdrop, the minutes stated that "**a majority of MPC members judged" that** if the growth and inflation outlook continues to develop along their expected paths consistent with a further "erosion in slack", then "**some withdrawal of monetary stimulus was likely to be appropriate over the coming months**" for the Bank to be able to achieve its inflation target of 2%.



The MPC has a difficult balancing act in setting an appropriate monetary policy. It is facing an environment where inflation is overshooting its target and expected to remain the case for quite some time, while at the same time, low unemployment has yet to translate into a sustained uplift in wages and GDP growth has slowed. Its task is further complicated by Brexit and the raft of uncertainties that surround it. **However, it is clear from today's meeting that the MPC is becoming increasingly hawkish and its tolerance for above target inflation continues to lessen, meaning a rate hike is likely sooner rather than later.**

Indeed, following today's meeting, futures contracts are now pricing that a rate hike will occur by March 2018. A further rate hike is expected by markets around mid 2019, bringing the Bank Rate to 0.75%. This marks quite a hawkish shift in UK rate expectations in a short space of time. At the beginning of September, the market was not expecting a BoE rate hike till H2 2019. Now, one cannot rule out a rate increase by the end of this year.

Sterling has rallied following today's 'hawkish' BoE meeting, with the currency gaining around 1% on the exchanges. This is reflected in EUR/GBP falling to 89p after having started the day near 90p and GBP/USD hitting a one year high above the $1.33 level. Meantime, the yield on 2 year gilts is up around 8bps on the day.

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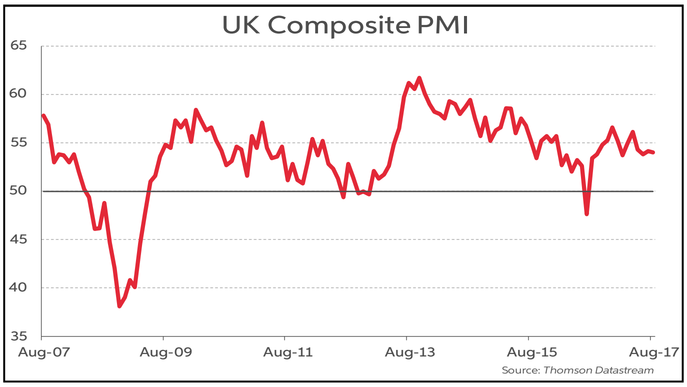
UK economy continues to grow at a modest pace

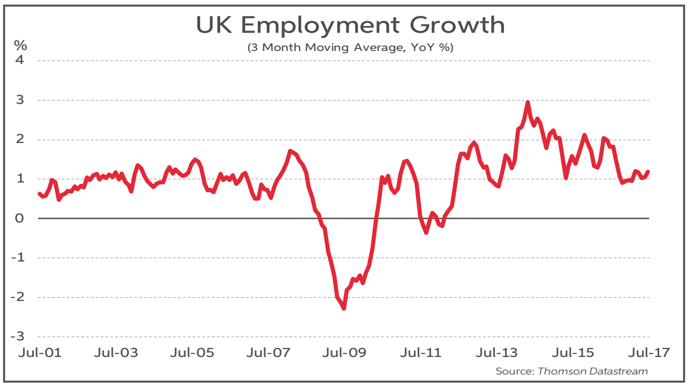
UK GDP rose by 0.3% in Q2, a slight improvement on Q1's weak 0.2% result. This compares to growth of 0.7% and 0.5% in the previous two quarters. The underlying data show that consumer spending, the key component of UK growth in recent years, slowed further in Q2, growing by just 0.1% and adding only 0.1 percentage points (p.p.) to GDP. Both business investment and trade were flat in the quarter. Indeed, the main impetus behind growth in Q2 was a rise in inventories (0.3 p.p.).



Q3 survey data have suggested that economy continues to grow at a modest pace. For example, the Markit Composite PMI averaged 54.1 in July/August, slightly below Q2's 54.6 reading. Within this, the manufacturing index actually points to an improvement in growth (39 month high in August), while the services and construction sectors look to have slowed.

In terms of 'hard' data, retail sales grew by a healthy 0.3% in July, following on from Q2's 1.5% increase. Although, retail sales are just one part of overall consumer spending, which has been slowing in recent quarters. Meantime, despite the better PMIs, industrial production recorded a modest 0.2% gain in July, after it fell by 0.4% in the second quarter. Meantime, despite the weaker sterling, UK net trade has not seen much improvement. The trade deficit (goods & services) was broadly unchanged in July at £2.9bn.

How the UK economy performs in the coming months seems likely to depend on consumer spending. The main reason for its aforementioned slowdown in H1 was a squeeze on household incomes. CPI inflation rose to 2.9% in August, remaining above the BoE's 2% target rate. Meantime, producer output price inflation picked up to 3.4% and input price inflation rose to 7.6%. 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.



Compounding the negative economic impact of higher inflation is the still weak wage growth. Earnings rose by 2.1% year-on-year in the three months to July, while inflation averaged 2.7% in the period, meaning earnings growth remains negative in real terms. Thus, household spending power continues to decline. Although, other signs from the labour market have been generally more positive. Employment rose by 182k in the three months to July, compared to 108k in the previous three months. Meantime, **the unemployment rate fell to 4.3%, its lowest level since 1975.**

The UK economy benefited from a loosening of monetary policy and weaker sterling after the Brexit vote. However, negative factors like higher inflation are now having a more pronounced influence. **The economy is also in 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.** Thus, business investment is likely to remain weak, with high inflation continuing to dampen consumer spending. However, a weak sterling and stronger external demand should have a positive impact on trade, while BoE policy should remain accommodative. Overall, the BoE is forecasting that GDP growth will be steady at around 1.7% in the period 2017-2019, though this is based on an assumption that the UK sees a "smooth" exit from the EU.

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