BoE Watch

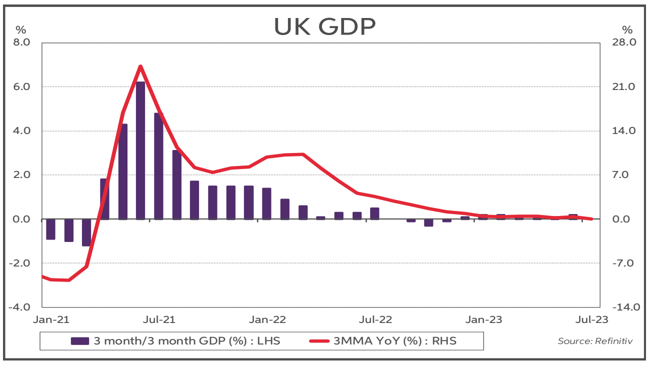
AIB Treasury Economic Research Unit

22nd September 2023

BoE holds rates at 5.25% in finely balanced decision

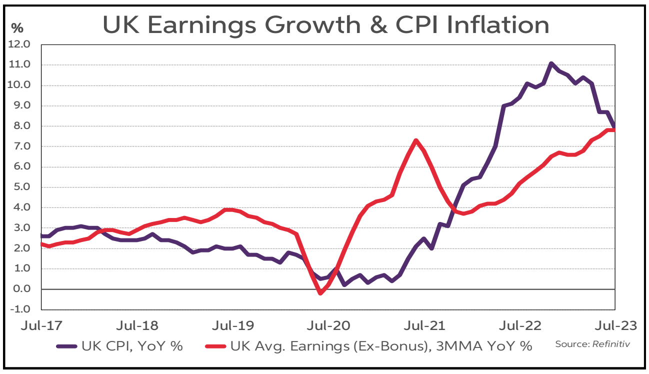
After fourteen consecutive rate hikes, stretching back to December 2021, **yesterday's meeting of the Bank of England's Monetary Policy Committee (MPC) saw the central bank leave rates unchanged at 5.25%. The BoE indicated that this was a finely balanced decision as reflected in the tight 5-4 vote split** on whether to leave policy on hold or hike by 25bps. The market was unsure if the BoE would hike following the release on Wednesday, of August inflation data, that showed a sharp and unexpected decline in the core CPI rate. Market pricing pointed to a slightly greater than 50:50 chance of a rate increase in advance of the meeting.

The MPC commented that bank staff now expect GDP growth to be weaker in the second half of 2023 than projected in last month's Monetary Policy Report, noting in particular the fall of 0.5% recorded in July. There have also been some further signs of a loosening in the labour market, with the unemployment rate higher than expected in the three months to July at 4.3%. In a significant observation, the MPC said that while the annual growth in private sector **average weekly earnings, which has accelerated sharply to 8.1%, was higher than expected, this was difficult to reconcile with other indicators of pay growth,** which tended to be more stable and not quite as high. It **also highlighted that inflation in August had fallen more quickly than anticipated** and is expected to decline significantly further in the near term. **It was on this basis that five MPC members voted to keep rates unchanged, including the Governor and three other top BoE officials.** The minutes did note, though, that for most within this group, the decision was finely balanced.



Meantime, four MPC members, all of whom bar one are external, voted in favour of hiking rates by 25bps as they believed measures of wage growth and services inflation had remained at rates above those consistent with meeting the 2% inflation target. They noted that the labour market remained tight, volatile components had driven part of the decline in inflation, real household incomes had started to rise and forward looking indicators of output remained positive. **In their view, there was evidence of more persistent inflationary pressures that required a further hike in interest rates.**

While the BoE did not provide any specific guidance in the meeting minutes about the future course of interest rates, and there was no press conference today to give further colour to the rate decision, **the MPC retains a clear tightening bias**. The minutes indicated that a further tightening in monetary policy would be required if there were to be evidence of continued persistent inflationary pressures. The Bank said it will continue monitoring incoming data closely in this regard, including the tightness of the labour market and the behaviour of wage growth and services sector inflation. **It also added that monetary policy would need to be 'kept sufficiently restrictive for sufficiently long' to bring inflation down to 2%**. In terms of market expectations, **while futures contracts do not see a rate hike at the next meeting in November, they are pricing in about a 70% probability of another 25bps rate increase by early spring.** Beyond that, they anticipate that rates will be lowered to 4.9% by end 2024, while another 60bps of cuts are priced in for 2025. Rates are expected to be lowered somewhat further in 2026 to just above 4%.



The main market reaction to the BoE rate decision came from sterling, which weakened appreciably on the exchanges. Cable fell below $1.225 at one stage, while the euro climbed close to the 87p level. Gilt yields were little changed after the meeting as markets continue to anticipate that rates may still be hiked to 5.5%. The meeting outcome highlights once again that the BoE is the most unpredictable of the main central banks. **Governor Bailey said after the meeting that "we will be watching closely to see if further increases to interest rates are needed". However, the case for raising rates in unlikely to be any stronger at upcoming meetings,** with inflation expected to fall significantly further and economic activity likely to remain sluggish at best. **Yesterday was the best opportunity, if the BoE wanted to deliver one final rate increase**, notwithstanding it would take only one MPC member to change view again and vote to hike, to see such an outcome.

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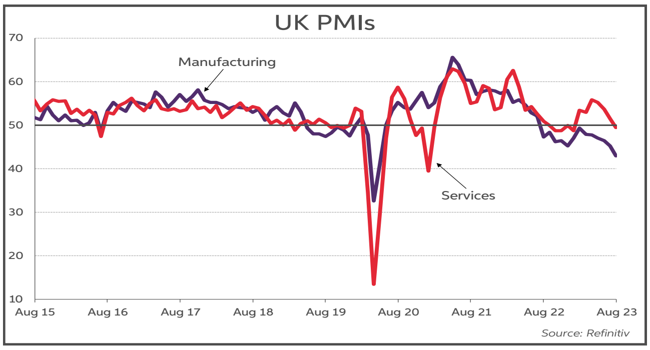
UK economy stagnant, inflation falls but still elevated

The UK economy has performed better than anticipated so far this year, avoiding the recession that had been widely predicted last winter. GDP expanded by 0.1% and 0.2%, respectively, in Q1 and Q2. Regarding the underlying breakdown for Q2, growth was driven by personal consumption and a sharp rise in government expenditure. Consumption rose by 0.6% in the quarter, contributing 0.4 percentage points (p.p.) to GDP, while government spending jumped by 3.1%, adding 0.6p.p. to the total. In contrast, investment was flat, and net trade knocked 1.1 p.p. off growth. However, this was partly offset by changes in inventories and the net acquisitions of valuables components. It should also be noted, that **significant revisions to the data in 2020 and 2021, now show that the UK economy regained its pre-pandemic much earlier than previously thought,** with GDP now 1.6% higher than in Q4 2019.

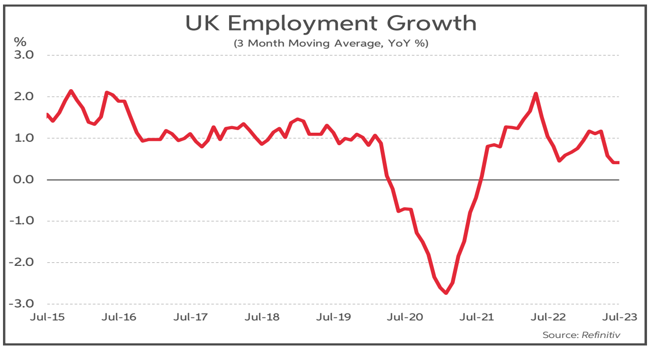


Turning to Q3, the monthly reading of GDP for July indicates the economy contracted by 0.5% in the month. Meanwhile, as in most other economies, industrial production has continued to struggle, falling by 0.7% in July. Retail sales, which have been volatile so far in 2023, fell sharply by 1.2% in July, and were 3.2% lower in year-on-year terms. **Meantime, the available survey data so far in Q3 indicate that economic growth remains subdued at best.** The manufacturing PMI, which has been in contractionary territory since August 2022, fell further to 45.3 in July, and to 43.0 in August. Output, new orders and employment have all contracted in recent months. Meanwhile, the services sector PMI dipped below 50 to 49.5 in August, registering its lowest reading since January. Consumer confidence, which had been trending higher so far this year, albeit from a low base, unexpectedly declined in July before rebounding slightly in August.

Labour market conditions have softened somewhat recently, but remain quite tight overall. The unemployment rate is still very low by historical standards, but it rose to 4.3% in the three months to July, up from 3.5% last August. Furthermore, following a marked pick-up in employment between February-May, the number of people working has fallen sharply in June/July, by circa 270k. Tight conditions are placing upward pressure on wages. Private sector average earnings growth accelerated to 8.1% y/y in the three months to July, though the MPC noted other measures pointed to lower and more stable wage growth. The BoE Agent's Summary for Q3, released yesterday, shows pay settlements running at 6.0-6.5% so far this year.

Meanwhile, inflation remains elevated, but has fallen sharply over the summer. Headline CPI fell to 6.7% in August, down from 6.8% in July, and 7.9% in May and June. Similarly, food inflation has been tracking lower, but remains at very elevated levels, running at 13.6% in August, down from 14.9% in July and 17.4% in June. Meantime, core-CPI inflation has proven to be very sticky until recently, rising to 7.3% in May, before edging slightly lower to 6.9% in June and July. However, it fell sharply and unexpectedly to 6.2% in August. The BoE reiterated today that inflation should decline significantly further over the coming months and throughout 2024, helped in particular by substantial moves lower in energy prices.

The BoE also noted that the UK economy has proven to be more resilient than anticipated this year. However, economic growth remains listless, and the outlook contains a number of headwinds. The OBR estimates real household incomes declined by 3.1% in 2022, and that they will fall by 3.4% this year, with inflation remaining elevated. Meanwhile, the numerous BoE rate hikes are weighing on investment and activity. Housing transactions have already fallen sharply by 19.4% year-to-date in July, due to the impact of higher rates. As well as this, global growth remains sluggish. **Overall, UK growth is expected to remain very subdued over the next couple of years.** The OECD, in its latest update released this week, is forecasting GDP growth of 0.3% this year, and 0.8% next year for the UK. Meanwhile, the BoE sees the economy expanding by 0.5% in both 2023 and 2024 as high interest rates weigh on activity.



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