BoE Watch

AIB Treasury Economic Research Unit

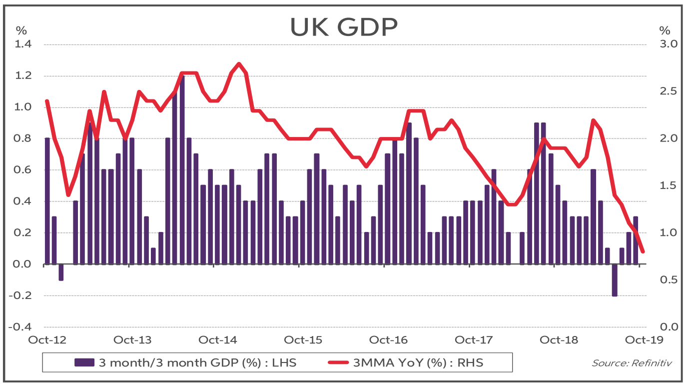
19th December 2019

BoE keeps rates on hold for now, but may cut in 2020

The December meeting of the Bank of England's Monetary Policy Committee (MPC) concluded, as expected, with no changes to policy. The Bank Rate was left at 0.75%. As in November, though, the decision to leave policy unchanged was **not unanimous**, with the same **two members (Haskel and Saunders) voting for a 25bps cut** in interest rates. The meeting statement and minutes also struck a somewhat cautious tone.

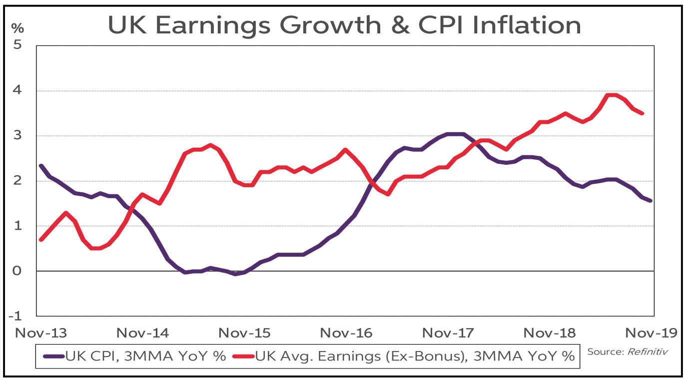
The BoE indicated that it remains on hold for now, as it waits to see how the economy responds to the evolving situation on Brexit, with the UK set to leave the EU at end January 2020 in an orderly manner. It is also watching developments in the global economy. **The meeting statement says that if global growth fails to stabilise or if Brexit uncertainties remained entrenched, then monetary policy may need to be eased.**

Brexit seems likely to remain a headwind for the UK economy as uncertainty will persist on trade next year. The large majority won by the Conservative Party in the recent election paves the way for the UK to leave the EU with a deal in place on 31 January 2020 and allow the transition period to come into effect.



However, **difficult talks to reach agreement on the UK's future trading relationship with the EU will follow in 2020.** Prime Minister Johnson has stated that his intention is to conclude these talks by end 2020. However, this is a very ambitious timeline to conclude a comprehensive Free Trade Agreement. Faltering trade talks, or indications that the UK is only interested in pursuing a bare-bones deal, would be a negative for business confidence and a headwind for fixed investment. In this scenario, the UK economy would likely continue to struggle.

The BoE, though, continues to keep its options open, emphasising that policy could move in either direction. However, given the cautious tone of today's update and with two members voting for a rate cut, **the likelihood is that if we do get a rate move next year, then it will be a rate reduction.**



In terms of market expectations, futures contracts are leaning in the direction that rates will be cut next year. **They are currently pricing in that rates will be lowered by 15bps in 2020, so they have yet to fully discount a 25bps move.**

Given the very weak finish by the UK economy to 2019, with activity looking like it has stagnated in Q4, the fact that inflation is comfortably below its 2% target and with Brexit uncertainty in relation to trade likely to continue to act as an economic headwind next year, **we expect rates to be cut by 25bps by mid-2020.**

We also think that the BoE growth forecasts will not be met, which may make it more minded to lower rates. In its latest set of projections published last month, which assume a very benign Brexit, the BoE forecasts GDP growth of 1.6% for 2020 and 1.8% in 2021, up from 1% this year. While, the economy could rebound in 2021 if the UK strikes a favourable trade deal with the EU by then, we expect that growth will remain below trend next year.

In terms of market reaction to the outcome of the MPC meeting today, interest rate futures contracts were little changed, while there was hardly any movement in sterling.

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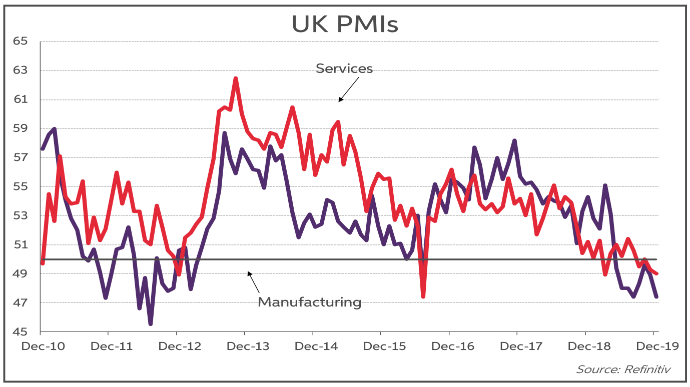
UK economy stagnates

The UK economy expanded by 0.3% in Q3, having contracted by 0.2% in the previous quarter. However, this left the year-on-year rate at just 1.0%, the slowest in almost a decade. In terms of the underlying breakdown, a large drag from changes to private inventories was offset by a strong contribution from net trade. With regard to domestic demand, household and government expenditure added a combined 0.3 percentage points to the quarterly total. Meanwhile, fixed investment was flat.



The available 'hard' data for the final quarter of the year have generally been downbeat. The rolling average of GDP growth pointed to stagnant activity in the 3 months to October. The data, which are by the output method, suggest that the service sector is still expanding but at a very modest pace, while both industrial production and construction are contracting. On the demand side of the economy, retail expenditure has also been weak, with sales falling by 0.5% in October/November on Q3 levels.

Likewise, the PMIs suggest that UK economy has been performing poorly in Q4. Indeed, having averaged 49.3 in the quarter, the composite index is consistent with a slight contraction in activity, though it has tended to understate growth in recent quarters. The surveys point to broad-based weakness, with both the manufacturing and service sector indices down below the key 50 level in December, at 47.4 and 49.0, respectively. In relation to consumer confidence, the GfK measure of sentiment is at a joint 6-year low.

More positively, the labour market appears to be holding up reasonably well. Jobs growth regained some momentum in the 3 months to October, with numbers in employment increasing by 34,000. This was enough to see the unemployment rate hold at 3.8%. Underlying wage inflation has eased as the economy has slowed, but remains strong at 3.5%.

However, the strong earnings growth has not led to a build-up in price prices. In fact, inflation has moderated in recent months, with headline CPI recorded at an unchanged 1.5% in November. In the same month, the core measure was put at a similarly subdued rate of 1.7%. As a result, workers have continued to enjoy significant gains in real wages.

Overall, the medium-term outlook for the UK economy is still contingent on the final form that Brexit takes. In the near-term, Brexit looks set to remain a headwind as uncertainty persists. The large majority won by the Conservative Party in the recent election should pave the way for the UK to leave the EU with a deal in place on 31 January 2020 and allow the transition period to come into effect. However, **difficult talks to settle the UK's future trading relationship with the EU will follow in 2020.** Prime Minister Johnson has stated that his intention is to conclude these talks by end 2020, but this is a very ambitious timeline to conclude any comprehensive Free Trade Agreement. Faltering trade talks, or indications that the UK is only interested in pursuing a bare-bones deal, would be a negative for business confidence and a headwind for fixed investment. In this scenario, the UK economy would likely continue to struggle. On the other hand, if it becomes clear that the UK will largely retain its current trading arrangements with the EU, then growth should accelerate as uncertainty abates.

Brexit aside, the BoE looks set to maintain its accommodative policy stance, which will help growth. A more expansionary fiscal stance, as well as the still solid labour market which has aided consumer spending, should also support activity. **The most recent BoE forecasts are for growth of 1.6% in 2020, followed by 1.8% in 2021. These are more optimistic than the IMF's projections for GDP growth of 1.0% in 2020 and 1.2% in 2021.**

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