BoE Watch

AIB Treasury Economic Research Unit

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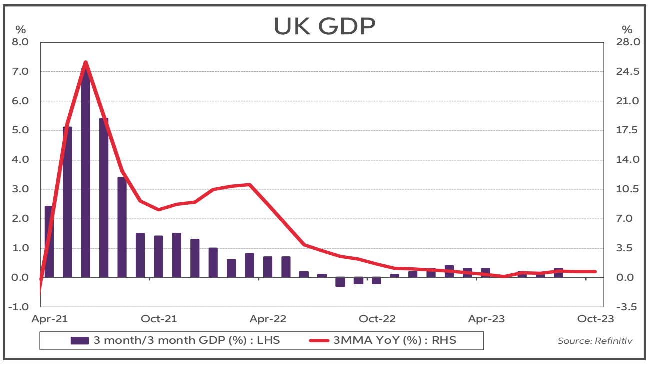
BoE holds rates at 5.25%, in no mood to ease policy

The December meeting of the Bank of England's Monetary Policy Committee (MPC) saw the central bank keep its key interest rate unchanged at 5.25%. This decision was very much in line with market expectations. It marked the third meeting in-a-row where the BoE has remained on hold. This followed fourteen consecutive meetings at which rates were hiked, dating back to December 2021. The last rate increase was in August.



Similar to September and November, the decision this month to leave rates on hold was not unanimous, with three of the nine MPC members again voting for a rate hike. The majority of MPC members, though, judged that maintaining the Bank Rate at 5.25% was warranted. However, they did note it was too early to conclude that services sector inflation and wage growth were on a firm downward path. One member of this group, though, again highlighted the growing risks of overtightening policy.

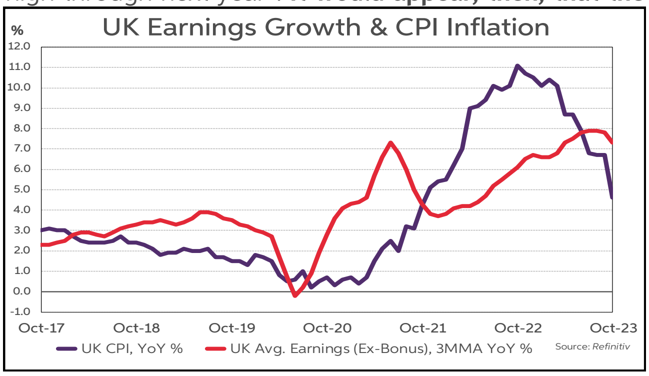
The three MPC members who voted in favour of hiking rates by 25bps noted that the labour market was still relatively tight, real household incomes had continued to rise and forward-looking output indicators remain positive. They also referenced that wage growth and services inflation remained elevated. In their view, a further hike in rates was needed to address the risks of more deeply embedded, persistent inflationary pressures.

The BoE's last set of detailed macro forecasts were published in November in its quarterly Monetary Policy Report (MPR). The BoE is projecting a prolonged period of very weak activity in the UK economy. GDP growth is forecast at 0.5% for 2023, slowing to 0% in 2024 and then picking up slightly to 0.25% in 2025 and 0.75% in 2026. The BoE commented today that it expects growth to be broadly flat in Q4 2023 and remain stagnant over the coming quarters.

On the inflation front, the November MPR projections indicated the BoE envisages that the CPI rate will be running at 4.75% by the end of this year, falling to 3.25% at end 2024. It anticipates that inflation will decline to 2% at the end of 2025. It continued to emphasise today that the risks to these inflation forecasts remain skewed to the upside. In this regard, its mean November inflation projections for end-2024 and end 2025 were 3.4% and 2.2%, respectively.

There was no press conference today, but it is clear from the meeting statement and minutes that **the MPC retains a tightening bias**. The minutes indicated that a further tightening in monetary policy would be required if there were to be evidence of more persistent inflationary pressures. In this regard, the MPC stated that it will continue monitoring incoming data closely, including the tightness of the labour market and the behaviour of wage growth and services sector inflation. **It once again said that monetary policy will need to be sufficiently restrictive for a sufficiently long period to bring inflation down** to the 2% target sustainably in the medium term.

These comments are clearly designed to dampen market expectations of rate cuts. BoE Governor Bailey recently stated that "We're not in a place now where we can discuss cutting interest rates – that is not happening." Deputy Governor Ramsden said we "think that inflation is going to stay stubbornly high through next year". **It would appear, then, that the BoE is not minded to lower rates anytime soon**.



Futures contracts, though, show the market believes that UK rates will be lowered appreciably next year, with further easing expected in 2025-2026. Rate cuts of circa 75bps had been priced in for 2024, but this moved to 115bps this week on the back of a fall in October GDP and last night's dovish FOMC meeting in the US. Further cuts totalling 75bps are anticipated for 2025-26, which would bring the official rate down below 3.5%. There was **no movement in these rate cut expectations following toady's MPC meeting, despite its hawkish soundings, with 115bps of easing still being priced in for 2024, starting with a 25bps move in May.** It would seem that wage growth and core CPI inflation will need to slow sharply in the UK during 2024 if market expectations of significant rate cuts next year are to be realised.

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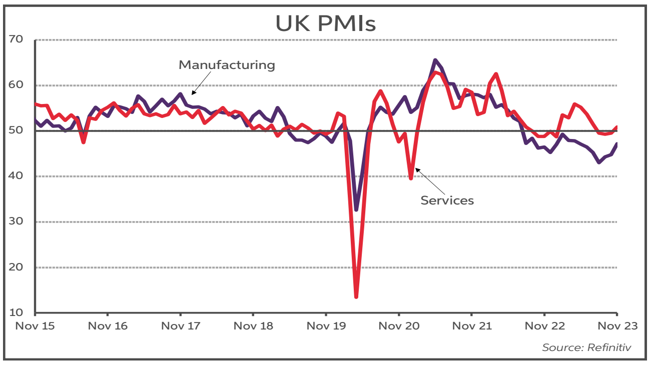
Inflation falls but still elevated, despite weak economy

The UK economy has performed better than anticipated this year, avoiding the recession that had been widely predicted last winter. Growth, though, remains weak, with GDP expanding by 0.3% and 0.2%, respectively, in Q1 and Q2, before stagnating in Q3. The underlying data show that consumer spending, government expenditure and fixed investment all performed well in the opening half of the year, while net trade was a significant drag on growth. These trends reversed in Q3, with all the components of domestic spending contracting, but net trade adding to growth.



Overall, GDP was up 0.6% year-on-year in Q3, pointing to a sluggish performance by the economy over the past year. It should be noted, though, that significant revisions to the data for 2020 and 2021, mean that the UK economy regained its pre-pandemic level earlier than previously thought, with GDP 1.8% higher at the end of Q3 2023, than in Q4 2019.

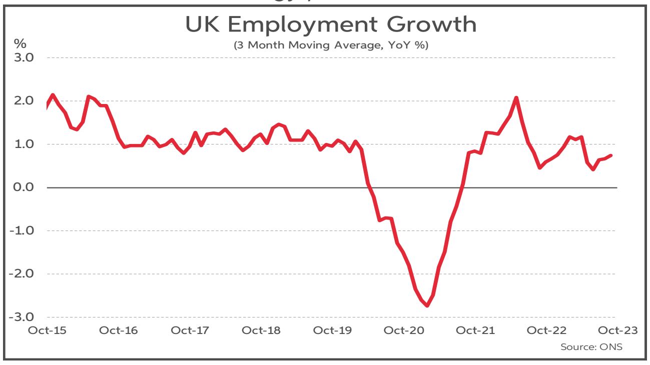
The monthly reading for October shows GDP fell by a bigger than expected 0.3%, pointing to ongoing weakness in economic activity. Meantime, industrial production also continues to struggle, falling by 0.8% in October leaving it up just 0.4% on year earlier levels. Retail sales are also struggling, declining by 0.8% in Q3 compared to Q2 in volume terms. They fell again in October by 0.3% meaning they were 2.7% lower in year-on-year terms, as continuing high inflation weighs on household spending power.

Survey data also indicate that economic growth is likely to remain subdued in the fourth quarter. The manufacturing PMI, which has been below 50 since August 2022, averaged 46.0 in October/November, up somewhat from 44.2 in Q3, Meanwhile, the services sector PMI averaged 50.2 in October/November, very much in line with the 50.1 reading in Q3. Elsewhere, consumer confidence, which had been trending higher in 2023 deteriorated sharply in October, before recovering somewhat in November.

In terms of the labour market, conditions have softened slightly this year, but remain tight overall. The unemployment rate is still very low by historical standards, at 4.2% in the three months to October, but this is up from 3.7% at the start of the year. Meanwhile, employment rose by 50,000 in the three months to October. On-going tight conditions are placing upward pressure on wages. Private sector average earnings growth rose by 7.2% y/y in the three months to October, though the MPC noted other measures pointed to lower and more stable wage growth. The BoE Agent's Summary Survey for Q4, shows most respondents reported lower pay settlements on average in H2, and they expect this to continue in 2024.

Meantime, inflation while in decline, remains elevated. It fell sharply in early summer, but stalled thereafter, before declining once more in October. Headline CPI inflation fell from 6.7-6.8% in the July-September period to 4.6% in October as steep increases in utility prices a year previously dropped out of the annual rate. Meanwhile, core-CPI inflation is proving to be quite sticky, with the annual rate falling to 5.7% in October from 6.1% in September. The BoE has said 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 has noted that the UK economy has been more resilient than anticipated this year, but the outlook remains challenging. Significant BoE rate hikes are weighing on investment and activity. Housing transactions have fallen sharply this year due to the impact of higher rates. As well as this, global growth remains sluggish, with the BoE also noting a waning boost from fiscal policy.



Overall, UK growth is expected to remain very subdued over the next couple of years. The IMF is forecasting GDP growth of 0.5% this year, and 0.6% next year for the UK. The OECD is also forecasting growth of 0.5% this year and 0.7% in 2024, picking up to 1.2% in 2025. Meanwhile, the BoE is more pessimistic. It sees the economy stagnating in 2024 and growing by a meagre 0.25% in 2025 and 0.75% in 2026.