BoE Watch

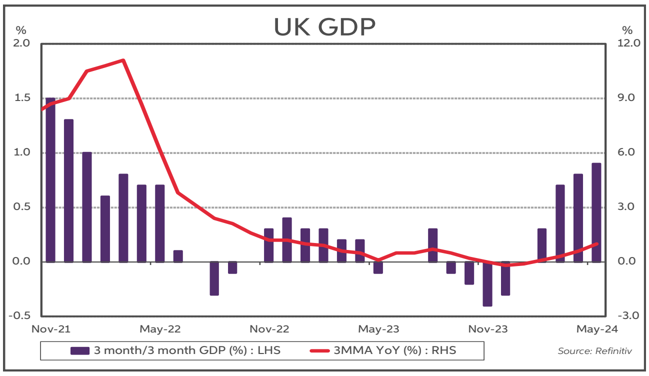
AIB Treasury Economic Research Unit

1st August 2024

BoE eases rates to 5%, but non-committal on rate outlook

The August meeting of the Bank of England's Monetary Policy Committee (MPC) saw the central bank lower the Bank rate by 25bps to 5.00%. This was the first rate change from the Bank of England in eight meetings. Subsequent to this, the central bank had been on a rate tightening cycle over the period December'21 to August'23. Market expectations had leaned towards a rate cut in the lead up to today's announcement.

The decision to cut rates was not unanimous, with the voting breakdown showing it was a close call or in the words of Governor Bailey, a "finely balanced decision". Five MPC members voted in favour of the rate reduction, while four voted against, preferring to keep rates unchanged.

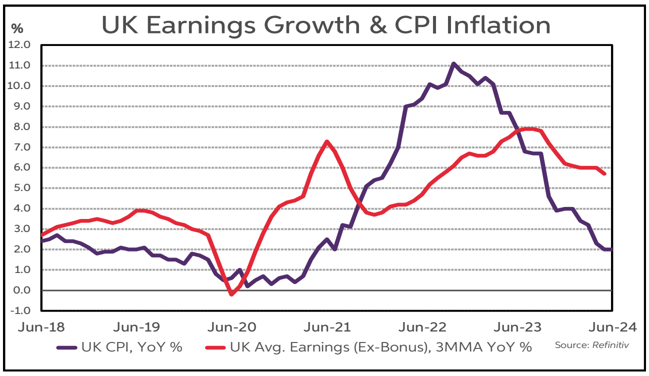


For the five voting for a rate hike, they viewed that the impact from the "past external shocks" had eased and there had been "some progress in moderating risks of persistence in inflation". They also assessed that the recent elevated services inflation was in part due to volatile components.

Meanwhile, for the four members in favour of no rate change, they judged that the recent upside developments in services inflation as well as stronger than expected GDP outturns suggest that "second-round effects were having a greater impact on wage and price setting behaviour in the economy" beyond what they had accounted for. They preferred to maintain interest rates at their current level until there was "stronger evidence that these upside pressures would not materialise".

Today also saw the BoE release its latest set of macro forecasts, with the publication of its quarterly Monetary Policy Report (MPR). In terms of its growth outlook, the BoE has revised higher its near term growth expectation. It is forecasting GDP growth of 1.25% for this year. This compares to its previous forecast for 0.5%. The upward revision to this year's GDP forecast is due to the BoE taking on board that year-date growth has been stronger than it previously envisaged, although the meeting statement also noted that "underlying momentum appears weaker". Meanwhile, for 2025 and 2026, it left its GDP projections unchanged at 1% and 1.25% respectively. Overall, this set of GDP projections still represent a relatively weak growth outlook for the UK economy.

On the inflation front, the August MPR projections showed that the BoE anticipates the CPI rate will end this year at 2.75%, which represents a slight upward revision to its May MPR forecast for 2.5%. The BoE attributes the acceleration in inflation, which is currently at its 2% target, to the unwinding of energy related base effects. Further out, it continues to expect that inflation will ease to 2.25% by the end of next year. It also maintained its end-2026 forecast for inflation at 1.5%. The MPC commented today that its anticipates that domestic inflationary persistence will "fade away over the next few years, owing to the restrictive stance of monetary policy".



In terms of guidance on future policy changes, the meeting summary, minutes and press conference offered very little in the way of insight. The BoE continues to state that policy will need to remain "restrictive for sufficiently long" until the risks to inflation returning sustainably to its 2% target have "dissipated further". It also continued to guide that it will take a meeting-by-meeting approach to any additional changes to interest rates.

Futures contracts pricing suggest the market is attaching a 60% probability to another 25bps rate cut as soon as the BoE's next meeting on September 19th. A 25bps rate cut is fully priced in by its November MPC. Given that today's decision was such a close call, our view is that a 25bps rate cut happening at the November MPC is a reasonable expectation as this meeting also corresponds to the BoE's next macro forecast update/MPR publication. If such a cut materialises, this would see the Bank rate at 4.75%. We would expect it to end the year at that level.

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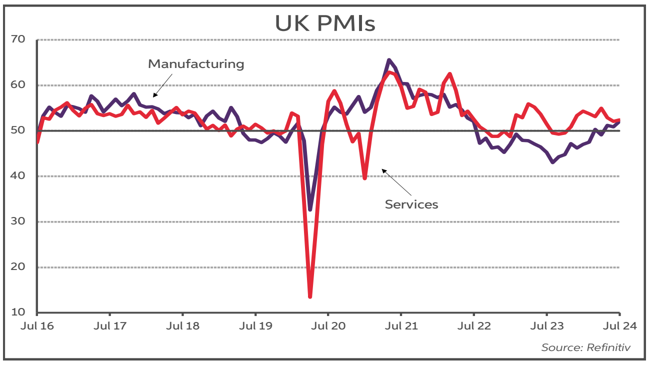
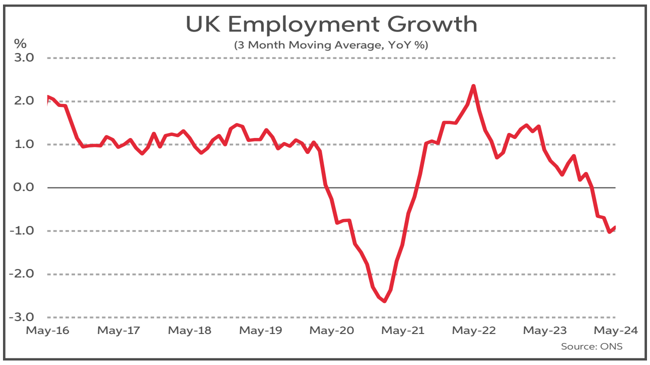
Economy gains momentum but outlook still challenging

Last year the UK economy avoided the deep recession that had been widely predicted but expanded by just a minuscule 0.1%. Encouragingly, though growth accelerated in the first quarter of 2024, with GDP rising by 0.7%, the fastest pace of expansion since Q4 2021. The underlying breakdown shows consumption, fixed investment and net trade were the main drivers of growth at the start of the year.



The available hard data for Q2 suggest the economy may have lost some momentum. The monthly reading of GDP stagnated in April, as poor weather dampened activity in the consumer facing services and construction sectors, before rising by 0.4% m/m in May. Meanwhile, industrial production has remained volatile, contracting by 0.9% in April, before rebounding by a modest 0.2% in May. Likewise retail sales have been very volatile in recent months, declining in April, rising sharply in May, and falling once again in June. It meant that overall, retail sales contracted by 0.1% in Q2 when compared to Q1. They were also 0.1% lower versus Q2 2023. **In contrast, survey data indicate the economy continued to expand at a solid pace in Q2.** The services PMI remained in expansion mode and averaged 53.3 in the quarter, just below its average of 53.7 in Q1. Meantime, the manufacturing PMI averaged 50.4 in the second quarter, up from 48.3 in the first, consistent with a rise in activity in the sector. Consumer confidence also continued to improve during Q2. **Furthermore, all three metrics remained on an upward trend in July, which suggests that activity levels have accelerated further at the start of the third quarter.**

In terms of the labour market, there have been some signs of softening this year. The unemployment rate has increased steadily from 3.8% in December to 4.4% in April and May. Furthermore, the number of people in employment has fallen by 108k so far in 2024. At the same time, average earnings growth remains elevated at +5.7% y/y in the three months to May. The Indeed wage tracker data also indicates that earnings pressures are robust, with wages up by 7% y/y in Q2. However, the MPC has noted that other measures of wage inflation continue to point to lower and more stable earnings growth. Indeed, a significant increase in the minimum wage has provided a one-off boost to wage growth. The BoE Agent's Summary Survey for Q2, noted that pay settlements this year have been lower than in 2023, although, the rise in the National Living Wage is masking the downward pressure on wages.



Meantime, inflation is in decline. Headline CPI fell to 2% in May, reaching the target for the first time since July 2021. Core-CPI which had been proving to be quite sticky, dropped to 3.5% in May, from 3.9% in April. Furthermore, both measures were unchanged at 2% and 3.5% again in June. However, services inflation remains very high, running at 5.7% in June, well above the BoE's forecast of 5.3%. Looking ahead, the BoE sees headline inflation at 2.75% in Q4 2024, easing to 2.25% by Q4 2025.

Overall, having performed poorly in 2023, the UK economy has gathered some steam this year. Meantime, inflation is falling, which should pave the way for real income growth and interest rate cuts in the second half of 2024, helping to underpin a rebound in consumption. **However, the outlook for UK growth remains subdued.** The IMF is forecasting that UK GDP will rise by just 0.7% this year. Growth is expected to accelerate to around 1.5% in 2025. Meanwhile, the updated Monetary Policy Report released today shows the BoE sees the economy expanding by 1.25% in 2024 and by 1% in 2025. **Thus, the near-term UK economic outlook remains challenging.** Longer-term the UK economy faces a number of difficulties. A core policy of the new Government's election manifesto was to get the economy growing faster. To do this, it will need to boost productivity growth, which has been dire post the Global Financial Crisis. A bout of political stability may support business investment, but ultimately a sustained rise in productivity may only be achieved by making difficult reforms to the planning system and tax code. A better trading relationship with the EU would also improve the economy's growth prospects, although currently, only incremental changes have been proposed.

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