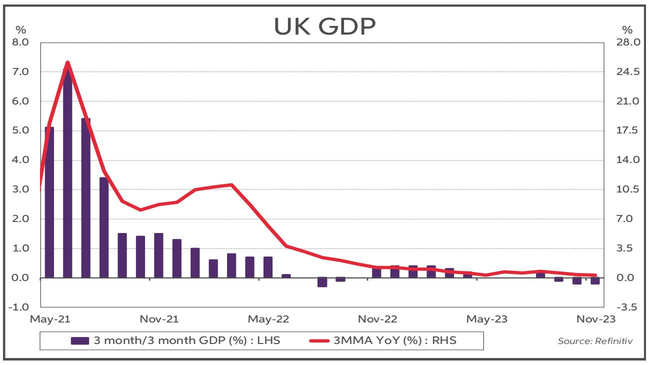
BoE Watch

AIB Treasury Economic Research Unit

1st February 2024

BoE remains on hold, but removes its tightening bias

The February 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 fourth consecutive meeting where the BoE has remained on hold. This was preceded by fourteen consecutive meetings at which rates were hiked, dating back to December 2021. The most recent rate increase was in August of last year. Overall rates were increased by a total of 515bps over this period.

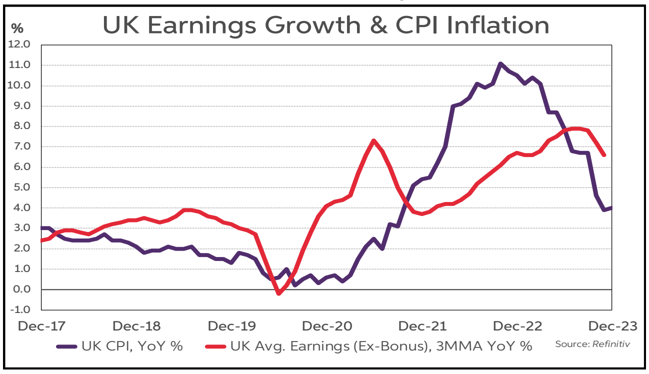


Similar to the last three meetings of 2023, the decision today to leave rates on hold was not unanimous, with a 6:3 split vote. The majority of MPC members judged that maintaining the Bank Rate at 5.25% was warranted. Two MPC members though preferred a 25bps increase in the Bank Rate. They viewed that a further rate hike was necessary to address the risks of inflation becoming more deeply embedded. In contrast, one member was of the opinion that a 25bps cut was necessary. This was based on their view that by delaying policy easing, it could risk "overtightening".

The BoE's latest set of detailed macro forecasts were also released today, with the publication of its quarterly Monetary Policy Report (MPR). These forecasts are based on 3 main assumptions—(1) GDP is forecast to increase gradually over the next 2-3 years (2) Excess demand is expected to turn into excess supply and (3) Second round effects in prices and wages will take longer to unwind than they did to emerge. **In terms of its growth outlook, the BoE continues to project a prolonged period of very weak activity in the UK economy, although not to the same extent as it had outlined in the November MPR.** This is due to a lower market implied interest rate path compared to when it compiled its November forecasts. GDP growth is now forecast at 0.25% (from 0%) this year, then picking up slightly to 0.75% (was 0.25%) in 2025 and 1.00% (from 0.75%) in 2026.

On the inflation front, the February MPR projections indicate the BoE envisages that the CPI rate will fall temporarily to 2% in Q2 before increasing again in Q3 and Q4 to end this year at 2.75%, which is lower than the 3.25% expected in the November MPR. For next year, it revised higher its end-year forecast to 2.5% (from 2.0%). Meanwhile, it is projecting that inflation will decline to 2% by the end of 2026, which represents an upward revision to the 1.5% rate it had pencilled in at the time of its November forecasting round. The MPC commented that it judged the risks to its inflation projections as being skewed to the upside over the first half of the forecast period. It elaborated that this stemmed from external geopolitical factors, whereas domestic price and wage pressures were now more evenly balanced.

With no changes to rates expected for today's meeting, the focus was on what signals or guidance would be forthcoming from the BoE on the potential timing and magnitude of rate cuts. In this regard, the post-meeting press conference did provide some insight. Governor Bailey stated that the question for the MPC to ponder is 'no longer how restrictive monetary policy has to be. Instead, its deliberations are now centred on 'how long do we need to keep policy restrictive'. **In other words, the BoE has dropped its tightening bias in relation to interest rates**. Governor Bailey also noted that the inflationary backdrop has "come a long way", and "things are moving in the right direction". However, he was keen to state that, the MPC needs to be "more confident that inflation will fall all the way back to the 2% target and stay there" and the current view within the Committee is that "we're not yet at the point where we can lower interest rates".



Futures contracts indicate that the market believes the BoE will be at this point, to cut rates, by the time of its June meeting. Rate cuts of circa 110bps are currently being priced in for this year, which would see the Bank Rate end 2024 near to 4.25%. Further out, the market envisages cut of 75bps in rates to 3.5% by end-2025, with rates seen as being maintained at this level throughout 2026. Overall, it is clear from today's meeting that the BoE is gradually moving itself towards cutting interest rates and the first rate cut by mid-year seems a reasonable expectation.

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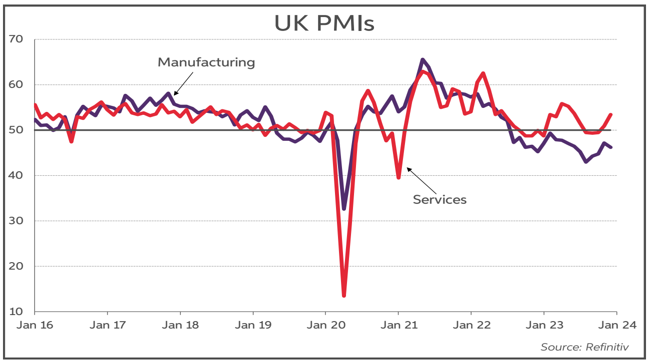
UK economic outlook remains challenging



The UK economy performed better than anticipated in 2023, with data for the first three quarters of the year showing it avoided the recession that had been widely predicted. Growth, though, remains weak, with GDP expanding by 0.3% in Q1, stagnating in Q2, before contracting by 0.1% 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. However, these trends reversed in Q3, with personal and government spending contracting, but net trade adding to growth. Overall, GDP was up 0.3% year-on-year in Q3, pointing to a sluggish performance by the economy.

The data suggest economic growth remained weak in the fourth quarter. The monthly reading of GDP shows that output declined by 0.3% m/m in October, although, it did rebound by 0.3% m/m in November. Meantime, industrial production fell sharply by 1.3% in October, before rising by a modest 0.3% in November. Retail sales have also been volatile, but declined by 0.8% overall in Q4, largely on the back of a sharp 3.2% m/m fall in December. At the same time, both the services and manufacturing PMIs moved higher in Q4. Indeed the former averaged 51.3 in the quarter (compared to 50.1 in Q3), while the latter stayed in contraction territory, but rose to 46.1 on average (compared to 44.2). **The limited available data for January indicate the economy may be bottoming out.** Both the manufacturing and services PMIs recorded further improvement in the month, although, once again, manufacturing remained below the key 50 level. Elsewhere, consumer confidence rose to –19.0 in January, its highest level since the start of 2022.

In terms of the labour market, conditions have softened slightly, but remain tight overall. The unemployment rate is still very low by historical standards, at 4.2% in the three months to November, but this is up from 3.7% at the start of 2023. Meanwhile, employment rose by 73,000 in the three months to November. On-going tight conditions are placing upward pressure on wages. Average earnings growth rose by 6.5% y/y in the three months to November. However, this is the slowest pace of expansion since Q1 2023, and the MPC noted that other measures of wage inflation pointed to lower and more stable earnings growth. The BoE Agent's Summary Survey for Q4, showed most respondents reported lower pay settlements on average in H2 2023, 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 falling once more in Q4. 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 previous dropped out of the annual rate. It eased further to 4.0% in December. Meanwhile, core-CPI inflation is proving to be quite sticky, with the annual rate falling to 5.1% in December 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. Indeed, the BoE sees headline inflation easing temporarily to 2% in Q2, but rising to 2.75% in Q4 2024.

The BoE has noted that the UK economy was more resilient than anticipated in 2023, but the outlook remains challenging. Significant BoE rate hikes over the past 18 months are weighing on investment and activity. Housing transactions fell sharply in 2023 due to the impact of higher rates. Furthermore, an additional 1.5m households with fixed-rate mortgages are set to move onto higher rates this year. However, financial markets are pricing in significant rate cuts of circa 110bps in 2024. Similarly, the drag from fiscal policy on the economy is set to wane also. **Overall, UK growth is expected to remain subdued in 2024 before picking up modestly in 2025.** The IMF is forecasting GDP growth of 0.6% this year, rising to 1.6% next year. Meanwhile, the BoE sees the economy growing by a meagre 0.25% in 2024 and by 0.75% in 2025.

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