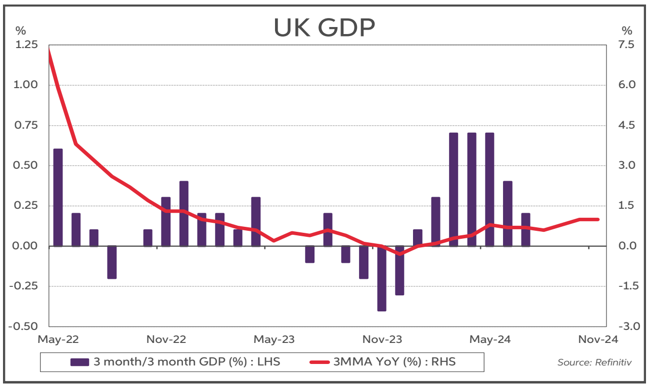
BoE Watch

AIB Treasury Economic Research Unit

6th February 2025

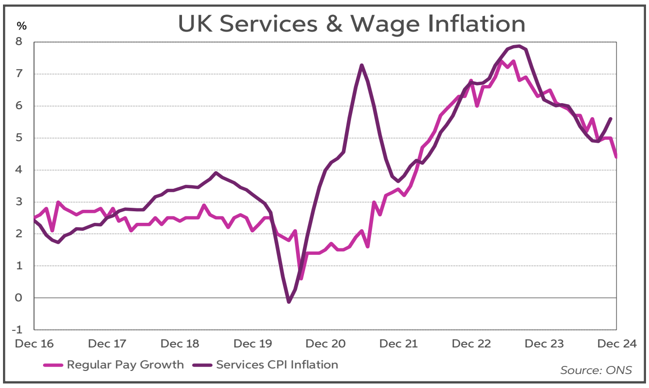
BoE cuts as expected and retains easing bias

The first policy setting meeting of the Bank of England's Monetary Policy Committee (MPC) for 2025 saw the central bank cut the Bank rate by 25bps to 4.50%. This means that the central bank has now cut by a total of 75bps in its current easing cycle, which began in August of last year. Today's rate reduction was in line with market expectations. **Once again, there was no unanimity within the MPC on its policy decision.** However, the voting breakdown was somewhat surprising, with a 7:2 split. Seven MPC members voted for a 25bps cut, while two members voted for a 50bps reduction. One of the two was Catherine Mann, which is noteworthy given she has previously been regarded as a "hawk" on interest rate policy. In terms of their respective viewpoints, for the majority, they were satisfied that a 25bps reduction was appropriate in light of the "sufficient progress on disinflation in domestic prices and wages". Meantime, for the two dissenters, their overall view was that "the prospect of weak activity and lower labour demand was likely to reduce wage pressures", warranting a larger rate reduction.



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 become more pessimistic on the UK economy's near term growth prospects, reflected in it revising down its GDP forecasts compared to its November update. This is due to growth being weaker than previously envisaged as well as taking on board the fact that "indicators of business and consumer confidence have declined". It is forecasting GDP growth of just 0.75% for this year, down from its previous (Nov'24) forecast for 1.5%. Meanwhile, for 2026, it marginally upgraded its GDP projection to 1.50% from 1.25%. Further out, it also revised slightly higher its growth outlook for 2027, with GDP growth of 1.5% (from 1.25%) now being pencilled in.

On the inflation front, the February edition of the MPR incorporates the BoE's updated view that inflation will rise "quite sharply" over the coming months to 3.7% due to "global energy costs and regulated prices". However, the central bank is reasonably confident that this pick-up in inflation will "be temporary" and "will not lead to additional second round effects on underlying domestic inflationary pressures" and remains of the view that it will return to "around the 2% target" over the medium term. It now expects inflation to be at 3.5% by the end of this year (was 2.75%). The end-26 and end-27 forecasts were revised up modestly to 2.5% (from 2.25%) and 2% (from 1.75%), respectively.



In terms of policy guidance, what is clear is that that the BoE retains a bias to ease policy further. However, what is unclear is the extent of further rate cuts. Its easing bias is illustrated in Governor Bailey's comment that "we'll be monitoring the UK economy and global developments very closely and taking a gradual and careful approach to reducing rates further". Interestingly, the word "careful" was added to the BoE's guidance this month. Governor Bailey stated that this was due to greater uncertainty in the economic outlook, from both a domestic and global perspective. Meanwhile, Catherine Mann's apparent dovish conversion certainly grabbed the headlines and also appeared to coincide with some softening in market rate expectations, as well as putting some downward pressure on sterling. Overall though, across the various BoE communications today (statement, minutes, macro forecasts and press conference) it is apparent the BoE favours a steady approach to further rate cuts.

As referenced above, futures contracts have softened by around 10bps in the aftermath of today's BoE meeting. The market is now attaching a higher probability that rates will get below 4% before year end. Our view for some time is that the market has been underestimating the extent of rate cuts from the BoE over the course of this year given the subdued growth outlook and easing in underlying inflationary pressures. A Bank rate of 3.75% by year end is consistent with both the macro backdrop and the BoE's preference for a "gradual" and "careful" approach to rate cuts.

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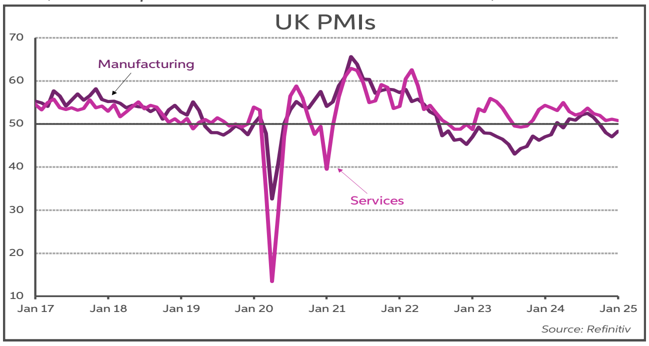
UK economy performs well but momentum is slipping

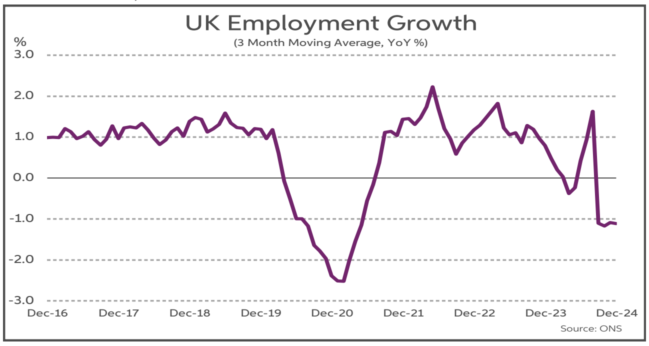
The UK economy performed better than anticipated in 2024, particularly in the first half of the year. GDP rose by 0.7% in Q1 and by 0.4% in Q2, with consumer spending, government expenditure and fixed investment all performing well in the first half of the year. However, GDP stagnated in Q3, albeit this was largely attributable to a substantial change in inventories and acquisitions less disposable assets. The underlying breakdown for Q3 indicates that most of the major components of GDP (consumption, investment and net trade) continued to support growth in the quarter.



Worryingly though, the available hard data for Q4 suggest the economy has lost some momentum. For a second successive month, GDP contracted by 0.1% m/m in October, although it rebounded by 0.1% m/m in November. Meanwhile, industrial production continued to struggle, falling by 0.6% in October and by 0.4% in November, leaving it down by 1.8% in year-on-year terms. Retail sales also declined throughout Q4. However, owing to significant base effects, retail sales were 3.6% higher on an annual basis in December.

Likewise, survey data indicate the economy slowed somewhat in the final quarter of the year. The manufacturing PMI printed in contraction territory throughout Q4, averaging just 48.3 compared to 52.0 in Q3. The services PMI remained in expansion mode but averaged 51.3 in Q4, down from 52.9 in Q3, consistent with a slower pace of growth. Elsewhere, consumer confidence deteriorated to −21.0 in October, its lowest level since March, before recovering slightly in November and December. **Furthermore, the limited available data for January also show that growth remains muted at best.** The manufacturing PMI was little changed at 48.3 in January. Meantime, the services PMI fell to 50.8, matching November's low, which was the weakest reading since October 2023. At the same time, consumer confidence plunged to −22.0 at the start of the year.

In terms of the labour market, conditions appear to have softened in recent months. However the data remain volatile and are judged to be somewhat less reliable currently owing to low survey response rates. Nevertheless, the unemployment rate increased steadily from a low of 4.1% in August to 4.4% in November. Meanwhile, data for the full year show the number of pay-rolled employees fell by 0.9% across 2024 if you strip out government-dominated sectors such as health and education. Regarding wage inflation, average earnings growth had cooled throughout the first three quarters of 2024, falling to a low of +3.9% y/y in the three months to August. More recently though, it has re-accelerated sharply, climbing to +5.6% y/y in November, broadly in-line with the January 2024 reading of +5.7% y/y. However, other measures of wage inflation continue to point to lower and more stable earnings growth. The BoE Agent's Summary Survey for Q4 noted that pay settlements are likely to average 3-4% in 2025, down from 5.5% in 2024.



On the inflation front, there have been signs of stickiness in the recent data. Headline CPI fell to a low of 1.7% in September, but it rose during Q4 and stood at 2.5% in December. Meanwhile, core-CPI eased to 3.2% in December, matching its September level, having printed at 3.5% in the two months prior. Encouragingly though, services inflation, a key area of concern for the BoE, declined to 4.4% in December its lowest level since March 2022. Looking ahead, the BoE now expects headline inflation to rise to 3.7% in Q3, before falling slowly back towards the 2% target in 2026 and 2027.

Overall, the UK economy beat expectations in 2024 with good growth recorded in H1. At the same time, inflation fell, averaging just 2.5% last year, compared to 7.4% in 2023, paving the way for a return to real income growth and allowing the BoE to cut rates by 75bps thin recent months. If inflation eases there should be scope for the BoE to lower rates further in 2025. Increased government spending and investment, could also boost GDP in the near-term. **However, the most recent data suggest growth has slowed and price pressures remain high. Thus, the BoE will have to proceed cautiously when setting monetary policy this year.** The IMF is forecasting that UK GDP rose by 0.9% in 2024, but it will expand by circa 1.5% in 2025 and 2026.

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