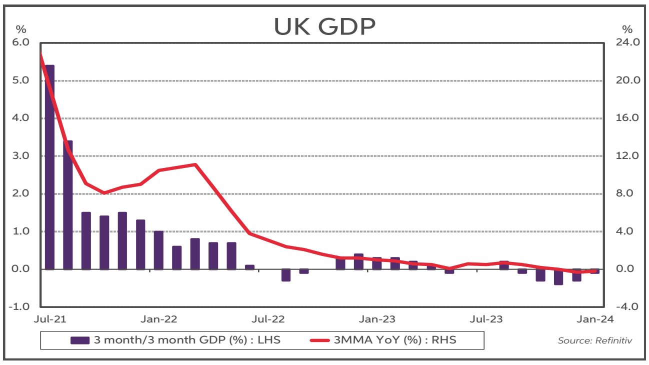
BoE Watch

AIB Treasury Economic Research Unit

21st March 2024

BoE gradually moving towards cutting interest rates

The March 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 fifth 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.

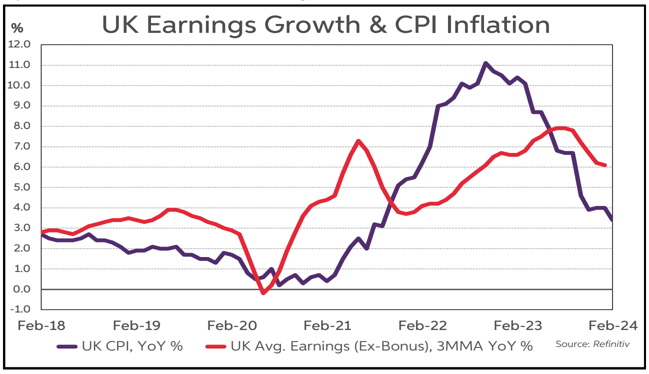


As has been the case for some time now, the voting breakdown showed the MPC remained split on its rates decision. However, the vote split has shifted to 8:1 in favour of no change, from 6:3 in February (6 for no change, 2 for a rate hike and one in favour of a rate cut). This is significant, as two members who had previously been in favour of raising rates, are no longer of that view, suggesting that the risk of inflationary pressures becoming embedded has declined. However, the statement noted that among this group of 8, *"there was a range of views on the extent to which the risks from persistent inflationary pressures had receded"*. Meantime, one member remained of the opinion that a 25bps cut was necessary. This was based on their view that waiting for more reassurance on the inflation outlook before cutting Bank Rate *would "weigh further on living standards and supply capacity"*.

The BoE's latest set of detailed macro forecasts were released in February, 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.** GDP growth is forecast at 0.25% this year, then picking up slightly to 0.75% in 2025 and 1.00% in 2026. The BoE commented today that Business surveys remained consistent with an *"improving outlook for activity"*.

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%. However, the meeting statement noted that inflation is now projected to fall *"slightly below the 2% target in Q2 2024"*. For 2025, its end-year forecast is 2.5%. Meanwhile, it is projecting that inflation will decline to 2% by the end of 2026. 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. Furthermore, the BoE remains concerned that services inflation remained elevated.

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 BoE appears to be shifting towards a rate-cutting stance. The BoE noted that it remains prepared to adjust rates as warranted by the economic data to return inflation to 2% sustainably, but that ***"the stance of policy could remain restrictive even if Bank Rate were to be reduced"***. Furthermore, the MPC guided it would *"consider the degree of restrictiveness of policy at each meeting"*. However, the BoE is waiting for further evidence on the persistence of inflation before it changes the stance of monetary policy.



Futures contracts softened slightly in the initial aftermath of the policy announcement. Current pricing indicates there is now a 75% chance of a first rate cut in June, compared to expectations of a first cut in August before hand. Rate cuts of circa 75bps are currently being priced in by year end, which would see the Bank Rate end 2024 at 4.50%. Further out, the market envisages cut of 75bps in rates to 3.75% by end-2025, with rates seen as being cut to 3.50% in 2026. Overall, it is clear from today's meeting that the BoE is gradually moving closer to cutting interest rates. A first rate cut by mid-year seems a reasonable expectation.

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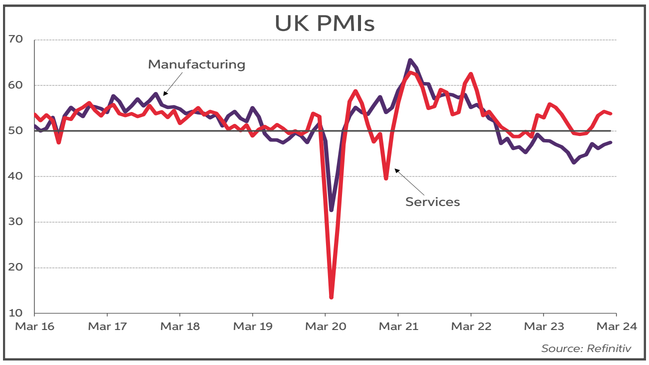
UK economic outlook remains challenging



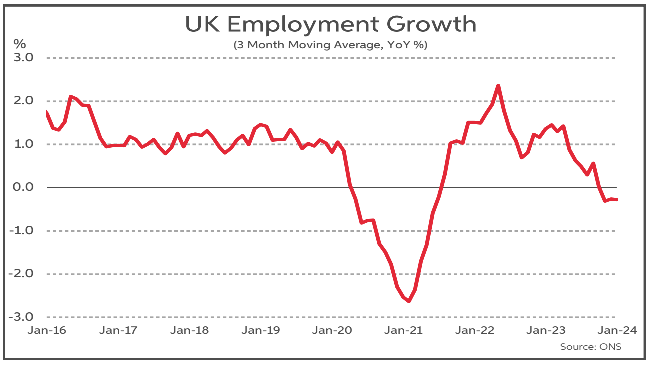
The UK economy performed better than anticipated in 2023, as it avoided the deep recession that had been widely predicted. However, the economy did slip into a shallow technical recession in the second half of last year. Having expanded by 0.3% in Q1, GDP growth stagnated in Q2, before contracting by 0.1% and 0.3% in Q3 and Q4, respectively. It means that for the full year, the economy was just 0.1% larger than in 2022. 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.

The most recent hard data have been somewhat mixed, although there are tentative signs that the economy may be bottoming out at the start of 2024. Having declined by 0.1% in December, the monthly reading of GDP for January registered a 0.2% increase. Meantime, retail sales rebounded sharply by 3.4% in January, after declining by a hefty 3.2% at the end of last year. In contrast, industrial production fell by 0.2% in January, while manufacturing output flat-lined.

Survey data suggest the economy regained some momentum in the first quarter of 2024. The services PMI rose to its highest level since May 2023 in February, and was little changed in March. Meantime, the manufacturing PMI has also improved in Q1. It rose to 49.9 in March, its highest level in a year. Overall, the former averaged 53.8 in the quarter (compared to 51.3 in Q4), while the latter rose to 48.1 on average (compared to 46.1). Elsewhere, consumer confidence rose to –19.0 in January, its highest level since the start of 2022, before edging slightly lower to –21.0 in February.

In terms of the labour market, conditions remain quite tight. The unemployment rate fell steadily from a peak of 4.3% last July to a low of 3.8% in December. It edged slightly higher to 3.9% in January, but this is still a very low level. On-going tight conditions are placing upward pressure on wages, albeit earnings growth has slowed in recent months. Average earnings growth rose by 5.6% y/y in the three months to January. However, the MPC has noted that other measures of wage inflation continued to point to lower and more stable earnings growth. The BoE Agent's Summary Survey for Q1, showed most respondents reported lower pay settlements this year than in 2023, and that cost of living payments are not expected to be made this year.

Meantime, inflation is in decline. Headline CPI inflation fell to 3.4% in February from 4.0% at the start of the year. Core-CPI inflation which had been proving to be quite sticky, dropped to 4.5% in February, from 5.1% in December, and from 6.1% last September. The BoE noted in February that inflation should decline significantly further over the coming months and throughout 2024, helped in particular by substantial moves lower in energy prices. Indeed, Ofgem is set to reduce the energy price cap by 12% in April, which will push the headline rate lower. The BoE sees headline inflation easing temporarily below 2% in Q2, but rising to 2.75% in Q4 2024.



Overall, the UK economy was more resilient than anticipated in 2023, but it still performed poorly. Furthermore, 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 and an additional 1.5m households with fixed-rate mortgages are set to move onto higher rates this year. However, financial markets are pricing in rate cuts in the second half of the year. Similarly, fiscal policy is no longer a drag on the economy. **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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