ECONOMIC UPDATE

UK

August 2018

BANK OF ENGLAND “SUPER THURSDAY”: BANK RATE HIKED SLIGHTLY HIGHER TO 0.75%

Bank rate hiked slightly higher

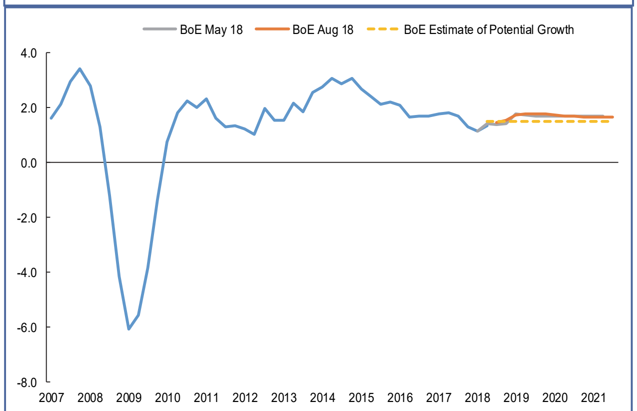
- “Super Thursday” saw the Bank of England’s Monetary Policy Committee (MPC) vote unanimously (9-0) to increase rates by 25 basis points to 0.75%. The decision to hike rates was in line with the CBI’s and consensus expectations
- The MPC’s decision was supported by UK economic activity regaining some of its momentum in Q2 after a weak Q1 (due to the poor weather), which was in line with the MPC’s forecasts in May
- This modest acceleration in Q2, the MPC argued, supported the notion that the UK economy was growing above its potential, which, in turn, puts upward pressure on prices. Consequently, the MPC made the decision to tighten monetary conditions slightly in order to gradually bring inflation back into line with the Bank of England’s target (2%)
- The MPC’s guidance on the future path of rate rises remained unchanged: an ongoing tightening in monetary policy will be necessary to return inflation to target, assuming that the economy evolves in line with the MPC’s forecast.

What does this mean for Finance Directors?

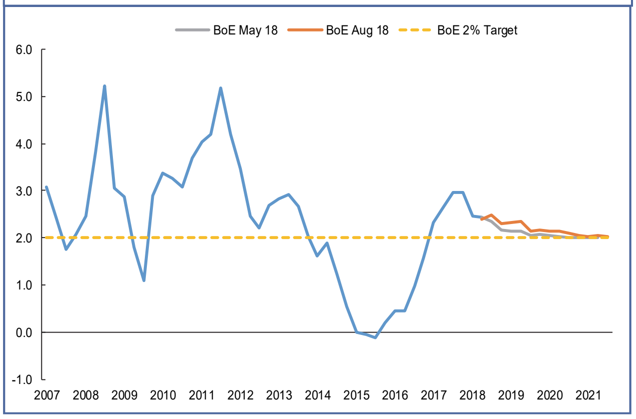
- Although the MPC decided to hike the Bank Rate to 0.75%, their forward guidance on interest rates remained the same
- Therefore, we can still expect a few more incremental rate rises over the next few years. It is worthwhile for businesses to work this into their forward planning
- In macroeconomic terms, this slight tightening will still leave the stance of monetary policy very stimulative, particularly when accounting for the Bank’s £445bn stock of asset purchases
- The path of monetary policy remains dependent on the economy evolving as the MPC expect; Brexit persists as both a key risk and influence on the economic outlook.

	Bank of England Forecasts					
	GDP Growth (Y/Y %)		CPI Inflation (Y/Y %)		Unemployment Rate (Y/Y)	
	Aug 18	May 18	Aug 18	May 18	Aug 18	May 18
2018	1.5	1.4	2.3	2.2	3.9	4.1
2019	1.8	1.7	2.2	2.1	3.9	4.0
2020	1.7	1.7	2.0	2.0	3.9	4.0

GDP Growth and Bank of England Forecasts (Y/Y%)



CPI Inflation and Bank of England Forecasts (Y/Y %)



Economy developing largely as expected

- Several indicators point to a recovery in economic activity over Q2, which supports the MPC's assertion in May that weak growth in Q1 was a blip caused (mostly) by the poor weather conditions
- UK growth remains supported by robust global growth and accommodative financial conditions, but this only partly offsets more subdued domestic demand
- The MPC also believes that inflationary pressures are building: the labour market remains tight, with pressures to increase pay packets starting to come through. Coupled with this, weak productivity is pushing up unit labour costs.

MPC forecasts broadly unchanged

- The MPC's forecast for GDP growth is mostly the same as in May, with the economy growing at an average pace of 1.8% y/y through to mid-2021, above their estimate of potential growth (1.5%). This pushes up domestic inflationary pressure, thus is the key reason why they expect to raise interest rates further going forward.
- Expectations for CPI inflation are higher in the near future due to increased energy prices and the recent further fall in sterling. But inflation still steadily falls back to 2% (the Bank of England's target) over the next few years through 2021 as these upward pressures wane
- The MPC continued to assert that developments in the Brexit negotiations – and the uncertainty surrounding them – will "hang over like a cloud" on the UK economic outlook throughout the forecast period
- The Bank's forecasts remained conditioned on a range of outcomes for the UK's trading relationship with the EU, and assume a smooth transition to such an eventual relationship.

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