United Kingdom – Bank of England may find it hard to deliver even "gradual and limited" tightening

HENRY COOK
ECONOMIC RESEARCH OFFICE | LONDON
T: +44-(0)20-7577-1591
E: henry.cook@uk.mufg.jp

MUFG Bank, Ltd.
A member of MUFG, a global financial group

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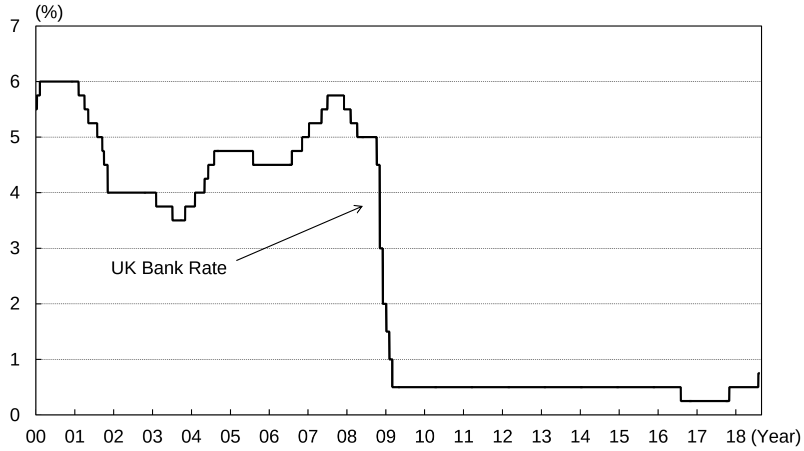
1. Introduction

The Bank of England (BoE) raised its benchmark rate to 0.75% on 2 August, the first time it has stood above 0.5% for almost a decade (Chart 1). In the absence of any remarks from policymakers to dampen expectations the move was not a surprise for market participants, but the unanimous (9-0) vote by the rate-setters on the Monetary Policy Committee (MPC) was a hawkish twist. The judgement remains that any future increases in the policy rate are "likely to be at a gradual pace and to a limited extent". Attention turned to any clues over the future path of rates (for the first time the BoE has published an estimate of the trend "natural rate" of interest, or R*), and mention of the effect of Brexit on the economy as we approach a critical phase in the talks.

Chart 1: Bank Rate



Source: BoE, MUFG Bank Economic Research Office

To our minds, the need for a rate hike was not clear. Recent activity data has been underwhelming, core inflation slipped to 1.9% in June (the target for headline inflation is 2.0%) and there is scant evidence of serious acceleration in wage growth. Looking ahead, we expect that UK economic activity will continue to disappoint with just 1.5% annual GDP growth in 2019. With inflation subdued, the BoE may be hard pushed to follow up this month's move with any further hikes next year.

2. The Case for a Rate Hike was Unconvincing

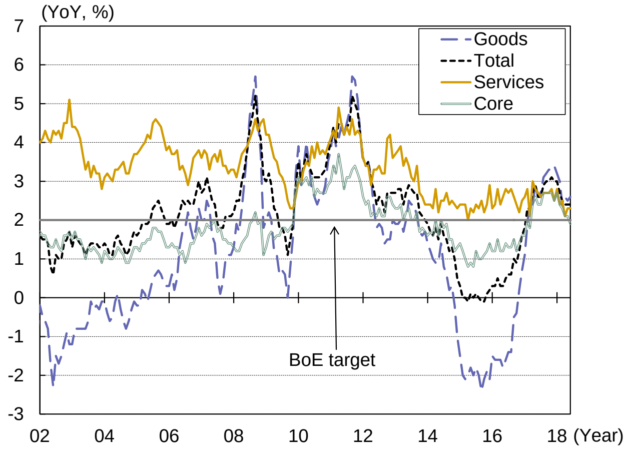
The unanimous vote (9-0) from the MPC to hike appeared hawkish after the 6-3 split to hold in June. It was explained that:

> *The MPC continues to judge that the UK economy currently has a very limited degree of slack. Unemployment is low and is projected to fall a little further. In the MPC's central projection, therefore, a small margin of excess demand emerges by late 2019 and builds thereafter, feeding through into higher growth in domestic costs than has been seen over recent years.*

However, despite this assessment, we do not think that recent data has not enhanced the case for a rate hike. Headline inflation remained at 2.4% in June – and that was despite higher energy prices with average petrol prices in the month being the highest since September 2014. The standstill in overall price growth came with goods inflation slowing as the effect of the EU referendum-related sterling depreciation fades (Chart 2). Core inflation, an indication of underlying price pressure, dipped to 1.9% in June, below the BoE's target for headline CPI inflation of 2.0%.

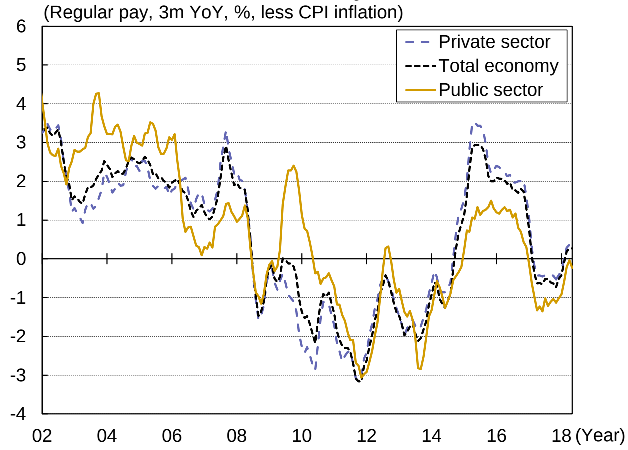
As inflation continues to fall from the referendum-induced peak of 3.1% in November 2017, the relief for real wage growth is welcome (Chart 3). But nominal wage pressure appears muted. Annual growth in regular pay (the BoE's preferred gauge) has slipped back from 3.0% in March to 2.5% in May. The percentage of firms reporting labour as a factor limiting production has hardly changed since 2015. The BoE's own agents' survey paints a mixed picture too – its gauge of recruitment difficulties has not taken off, while employment intentions, especially for consumer services, look muted. We do note, though, that the removal of the public sector pay cap will support overall wage growth going forward.

Chart 2: CPI Inflation Measures



Source: ONS, MUFG Bank Economic Research Office

Chart 3: Real Wage Growth



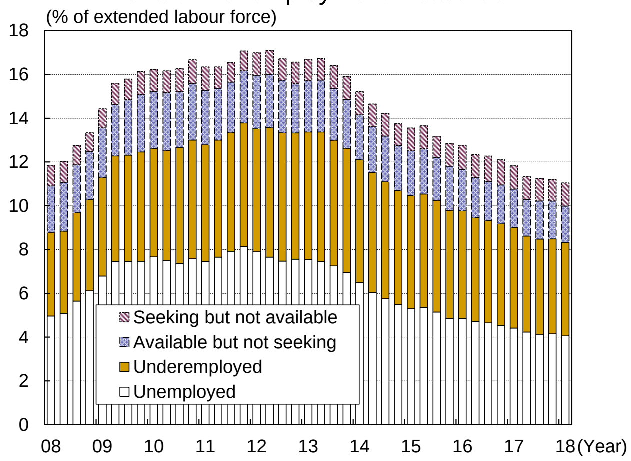
Source: ONS, MUFG Bank Economic Research Office

The unemployment rate (4.2% in the period March to May) has not been lower since 1975, so this lack of obvious upward pressure on wages is curious. It can perhaps be explained by the number of people who remain marginally attached to the labour force. This can mean both those that are "underemployed" (meaning they have a job but would like to work more hours) or those that fall outside the International Labour Organization (ILO)'s strict definition of unemployment (people are classed as "inactive" if, for example, they cannot start work within two weeks or they are not actively looking for work). In Q1 2018, 1.5 million workers were classified as underemployed. As a percentage of the extended workforce, the rate is still above that seen at the start of the global financial crisis (GFC) suggesting there remains a degree of labour market slack (Chart 4). On top of this, some of those not actively seeking work may not think that jobs are available but some could also be encouraged back into the labour force (which may be harder to achieve if rates rise).

Turning to economic activity, Q1 GDP growth was revised up from a preliminary 0.1% QoQ to 0.2% in a subsequent estimate. This was still disappointing, but the country had been affected by heavy snowfall in February and March. BoE Governor Carney said in July that recent data had given “greater confidence that the softness of UK activity in the first quarter was largely due to the weather, not the economic climate.” However the same transitory factor could easily be used to justify the improved performance in Q2 this year. Temperatures have been around 2.0 degrees above the average since 1910 in Q2 – after being 1.1 degrees below in February and March – and this warmer weather is likely to have been short-term boost for retailers at the start of the summer. Using the newly published monthly output numbers (available for April and May) and survey indicators for June, we are tracking Q2 GDP growth at 0.3 to 0.4% QoQ. The first estimate for the quarter is released on 10 August.

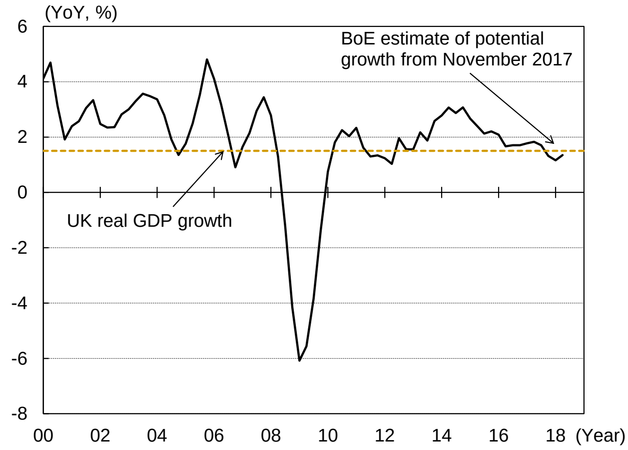
The YoY figure for Q1 GDP growth was just 1.2%. We expect the Q2 figure will be around 1.3% YoY. This means that GDP growth has been below the BoE’s own estimate for potential growth which “is likely to remain modest” at around 1.5% (Chart 5). On this basis, at least, the economy does not appear to be overheating, but the BoE expects a small positive output gap to open up with GDP growth averaging around 1.75% YoY over its forecast period.

Chart 4: Unemployment Measures



Source: Eurostat, MUFG Bank Economic Research Office

Chart 5: UK Real GDP Growth



Source: ONS, MUFG Bank Economic Research Office

3. Brexit and R*

In the absence of any comments from MPC members to suggest that the BoE may not have hiked in August, market participants more or less fully priced in the move, even in the face of the disappointing data mentioned above. But there were two issues raised in the Inflation Report and press conference which are pertinent to the outlook.

(1) The natural rate

R* is the trend real natural rate of interest. It is expected to prevail when output equals its potential rate and inflation is constant (which now usually means at target). The concept has existed since the end of 19th century but for a long time the assumption was that it does not change much over time. However, recently the theory has garnered a lot more attention from central bankers and academics in the aftermath of the GFC. Demographic trends, higher demand for safe assets and lower productivity have probably dragged R* lower than it was in the past. This has consequences for monetary policy. After years of rates at, or close to, the lower bound, there are suggestions that the natural rate could now be increasing again in developed economies. An increasing R* implies that policy rates ought to increase just to maintain the same level of monetary accommodation. The problem is, just like some other numbers such as NAIRU or potential output, R* is unobservable and has to be estimated.

The BoE estimated R* for the first time in the August Inflation Report. The timing of this choice was interesting: R* gives some indication of how policymakers expect interest rates will evolve in the future, which must have been intended to some extent. According to the BoE's models, R* is in the range of 0% to 1%. Assuming the 2% inflation target, this implies nominal values for the neutral interest rate between 2% and 3%. This is lower than in the past. For this reason, Carney said that the current monetary stance has been "mildly rather than wildly accommodative". Nonetheless, the BoE is still five 25bp hikes away from the lower end of its estimated range implied by its R* estimate as it looks to normalise policy.

(2) Brexit

Due to the frequency of revisions to the BoE's estimate of equilibrium unemployment we are cautious to place much weight on its first guess at R*. Of more immediate importance to the outlook is its thinking on Brexit, which Carney said is approaching a "critical" phase of talks. The UK is due to leave the EU on 29 March 2019 and then, possibly, start a transition period. With uncertainty high, and a transition deal still not confirmed, Carney admitted that there are "signs that business investment is softening again" and households are not "indifferent" to Brexit news.

As we wrote in April[1], it always seemed likely that tensions would increase as it became clear to different groups what compromises had been made, and 'Leave' MPs in particular were likely to become increasingly vocal in their opposition. This became apparent on 7 July when Theresa May, the Prime Minister, presented a relatively soft vision for the UK's future relationship with a "facilitated customs arrangement" which would remove the need for customs checks, and a "common rulebook". This was not acceptable to some 'Leave' MPs (or, indeed, the European Commission) and led to the resignation from the Cabinet of both the Foreign Secretary and the chief Brexit negotiator. Now, the aim of a political agreement in place by the 18-19 October EU summit seems at risk, and any negative effect on business confidence is not surprising. It even prompted Carney to later say that the possibility of a no-deal Brexit is "uncomfortably high".

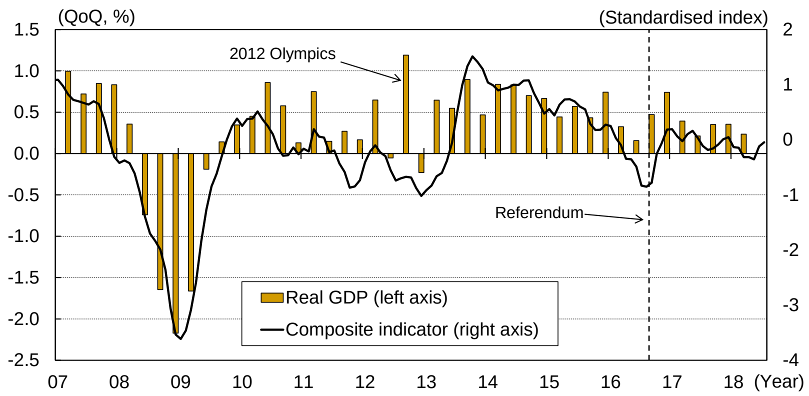
[1] See here: www.bk.mufg.jp/report/ecoeu2018e/specialreport_20180409.pdf

On the risk of a hard Brexit and monetary policy, Carney also said that "it's not as simple as saying Brexit equals a reduction in interest rates" in the press conference. Weaker sterling and possible tariffs would be inflationary but, to our minds, a hard Brexit would probably necessitate increased monetary support for the economy.

4. Outlook

Over the short term, the continued warmer weather combined with England's better-than-expected run in the 2018 FIFA World Cup suggests there could be some momentum into Q3. But the day after the BoE's move, the services PMI for July fell to 53.5 (from 55.1 in June). This is a concern – but we note that the survey does not cover the retail sector. Our composite indicator, which does, still looks muted in July compared to the pre-referendum period (Chart 6).

Chart 6: GDP Growth and Composite Confidence Indicator



Note: The composite indicator is constructed using standardised survey measures weighted by GVA shares.
Source: IHS Markit, European Commission, MUFG Bank Economic Research Office

Looking a bit further ahead, we expect UK GDP growth to average 1.5% YoY in 2019 – exactly in line with the BoE's estimate for potential output. This would be a steady but not spectacular outcome. We remain sceptical of a "key judgement" from the February 2018 MPC meeting that there will be a rotation in UK growth "towards external demand and investment". There was a disappointing figure for Q2 GDP in the euro zone (0.3% QoQ), a key trading partner, and there are also concerns over US-led protectionism.[2] This suggests that net exports may struggle to contribute meaningfully to GDP growth. Meanwhile, Brexit uncertainty means that the outlook for business investment is similarly uncertain with survey measures of investment decisions (BoE Agents' scores, BCC, CBI) not inspiring a great deal of confidence.

[2] See here: www.bk.mufg.jp/report/ecoeu2018e/specialreport_20180802.pdf

Turning to other expenditure components of growth, there may be a small fiscal boost in the Autumn Statement. The faster-than-expected recovery in public finances allows some wiggle room and the Chancellor may be under pressure to cushion the economy from Brexit headwinds, but we do not think that a meaningful departure from fiscal consolidation is likely. So, it is up to consumer spending to do most of the heavy lifting. But as we wrote in June[3], we think that the outlook is fairly gloomy and that consumer spending will remain subdued over the next 18 months as households increase saving rates.

[3] See here: www.bk.mufg.jp/report/ecoeu2018e/MUFG-Economic-Brief-UK20180607.pdf

Meanwhile, we expect inflation will continue to fall as the effect of the referendum-induced depreciation of sterling fades. Against this background, it seems like even rate hikes at “a gradual pace and to a limited extent” may be challenging. The BoE’s forecasts are conditioned on a market-implied pace of about one hike a year which suggests that the next opportunity for a hike is not until at least the May 2019 Inflation Report meeting. But, with our downbeat assessment for 2019 growth, we think that this is not a done deal.

5. Conclusion

To retain credibility the BoE, often plagued with the “unreliable” tag, had to push through with the long-signalled hike. But the case for a rate hike was thin and which makes it harder to judge the BoE’s reaction function in the future. It did not hike in May because the data were not strong enough. Since then, core inflation has fallen to just 1.9% YoY, nominal wage growth has slowed and any uptick in economic activity has probably been helped in part by the transitory weather boost.

Looking ahead, we expect that GDP growth will be lacklustre in 2019 and inflation will fall steadily. The BoE has said that future hikes will be gradual, but we think that it could be some years before we see the 1.5% rate at which the BoE has said it would consider reducing its asset portfolio, and even longer until the policy rate reaches the 2% to 3% range indicated by the BoE’s new R* estimate.

We stress that there are clear risks to our forecast on both sides because of Brexit uncertainty. On the upside, a favourably soft Brexit deal (or significant extension to the transition period) would be a fillip for investment and overall growth. But a cliff-edge scenario would work the other way, while tariff troubles pose an additional concern on a global scale.

Lastly, a reminder that Carney is due to step down as Governor at the end of June 2019 and the choice of his successor will have important implications for the direction of future policy.

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