U.K. Outlook: BoE Should Resist Raising Rates in November

BY BARBARA TEIXEIRA ARAUJO — SEPTEMBER 25, 2017
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- The BoE has und doubtlessly turned hawkish, stating that a rate hike may not be far off.
- We think that the bank would be making a mistake by raising rates as soon as November.
- Above-consensus retail sales pushed the pound higher, but the details weren't bright.
- Most important, wage growth remains subpar, and the jump in inflation will prove temporary.
- Brexit negotiations haven't progressed much, keeping uncertainty high.

It's not an exaggeration to say that the Bank of England's recent hawkish U-turn caught markets completely by surprise. True, expectations were that yet another member of the Monetary Policy Committee would have joined Ian McCafferty and Michael Saunders in their vote for a rate hike, leaving the split at 3-6 in the bank's September meeting. But no one dared imagine that the MPC would be hinting at a policy tightening as soon as November. The bombshell came in the meeting minutes, saying that "if the economy continues to follow a path consistent with the prospect of a continued erosion of slack and a gradual rise in underlying inflation pressures, some withdrawal of monetary stimulus is likely to be appropriate over the coming months".

Just a nudge will do

While the statement still leaves a move clearly contingent on future developments on the inflation and growth fronts, it marks a huge change from the bank's previous stance. True, in August the bank claimed that rates could rise more than was implied by the yield curve. But the curve assumed only two rate hikes over the next three years, with the first of them coming only in the third quarter of 2018, far from the current scenario assuming an imminent tightening.

And, even if neither inflation nor growth lives up to expectations and the bank ends up standing pat, in our view what's most important about September's announcement is that the MPC's aggressive, heightened rhetoric indicates that little upside surprise is now needed to push the bank to action.

Retail sales beat expectations, but...

It's not for nothing, then, that the pound soared after retail sales figures for August were released Wednesday, and that markets raised their expectations for a November rate hike to 65%, from the previous 60%.

That's because August retail sales were up 1% m/m, far stronger than our and the consensus expectation for no change and pushing the yearly rate to 2.4% from the previous 1.4%.
Behind the market optimism is an expectation that the retail numbers mean a consumption-led slowdown may not be as sharp as previously expected. If so, investment and exports will not need to rise as much to provide an offset, and the MPC may hike rates with confidence. But that’s the problem. We caution that the central bank as well as markets should not read too much into the monthly headlines. First, monthly statistics are volatile. Second, the details sometimes tell a much less upbeat story, and that’s the case for retail sales.

It was mainly nonstore retailing and sales in other nonfood stores that supported growth in August, and both subsectors have a track record of being highly volatile. We wouldn’t be surprised by a massive mean reversion in September. Other sectors more representative of the broader trend in sales, such as clothing and textiles, food products and household goods, saw their August sales remain steady or even contract.

![Retail Sales Jump Isn’t Sustained](image)

To that we add that, despite recovering in August, at 2.4% the yearly growth rate is still much lower than the past-year average of 3.6%, and the average 4.9% increase in 2016.

**Q2’s growth breakdown is nothing to write home about**

On the upside, even penciling in a mean reversion in September, retail sales are nonetheless set to make a positive contribution to third-quarter growth. But that does not mean much; despite retail sales’ 1.4% q/q jump in the second quarter, total consumer spending still rose by only 0.1%, its slowest since the fourth quarter of 2014 and far below the 0.7% average recorded for 2015 and 2016.

![Weak Correlation Between Spending and Retail](image)

Retail sales only make up 30% of total consumer spending, so service spending and spending on cars are expected to have languished and offset any positive contribution from the retail sector in the second quarter. Services and retail spending are normally substitutes, meaning that, all things equal, when consumers’ step up their spending in one of the two sectors, they spend less on the other. Regarding prospects for the third quarter, despite the jump in retail sales in August, the Bank of England’s agents are reporting that household spending at services firms eased further, with increased reports of tightening discretionary spending. All in, then, even if retail sales increase, there is little evidence
suggesting that overall spending will perform well.

True, a pullback in spending was already priced-in by the BoE, so the downbeat numbers shouldn’t prompt any revisions to the outlook. But, not priced-in was that net exports would have again failed to support growth and that business investment would have flatlined. Exports rose by only 0.7% q/q, but so did imports, so net trade made a neutral contribution to the GDP headline. This is extremely worrying. It means that, in total, net exports have dragged on growth since the pound started to depreciate at the end of 2015, making the current depreciation one of sterling’s less successful in history.

Looking ahead, business investment should remain subdued, notably in the services sector, given the soft outlook for consumer demand. Manufacturers should start to invest in export capacity, but it will still take a long time before the economy rebalances, notably if firms continue to get little clarity on what the U.K.-EU future ties will look like. By contrast, we are more optimistic with regards to the country’s export performance. We expect that exports will gather momentum in the third quarter in line with the recent surge in export orders at manufacturing firms. But imports will also remain robust—the U.K. depends heavily on imported inputs—meaning that net trade’s contribution to growth won’t improve much.

**Wage growth is not picking up**

That’s all to say that the growth numbers provide little evidence that the economy is strengthening, or that the output gap is closing. But the BoE also keeps an eye on wages—a preferred measure of domestically built inflation pressures and constantly on the spotlight. We were extremely surprised by the argument committee member Gertjan Vlieghe used on September 15 to justify a rate hike. He claimed that wage growth now was not as weak as earlier in the year, with annualized growth in private sector pay already averaging over 3% over the past five months.

That’s misleading, and we cannot stress this enough. Wage growth remains extremely weak: including bonuses, pay increased by as little as 1.4% y/y in July, down from 2.8% in June. Even if we exclude bonuses, which are notably volatile, wage growth was only 2% y/y, which is still below 2016’s 2.4% average and the MPC’s 3% target. So was Vlieghe lying? No, he was just smart enough to use the statistics in his favor. He made reference to the five-month average only because it included the exceptional 6.9% m/m annualized jump in salaries in April, which was due entirely to the planned rise in the National Living Wage. April excluded, wages rose by only 2% m/m annualized on average over the past five months, while they rose by a mere 1% in July.
All is not gloom, though, as the labour market remains pretty tight and there is evidence that starting salaries are rising. According to the REC/Markit Report on Jobs, permanent starting salary growth accelerated for the fourth month running in August, to a 25-month high. We caution, though, that this is not representative of wage pressures in the broad labour force, notably now that confidence is extremely depressed and few people are changing jobs. Job-to-job moves need to improve considerably in order for them to drive up total wage growth.

**The pickup in inflation is temporary**

Maybe it was inflation’s pickup to 2.9% in August from 2.6% in July that spooked the MPC; the figure came in 0.2 percentage point above the bank’s forecast. But here too it does not take much to recognize that the increase was not really broad-based, but mainly due to a pickup in energy prices driven by the recent recovery in oil prices. Domestically generated inflation pressures remained relatively unchanged.

Services inflation—which together with wages is one of the best measures of domestically generated inflation—rose only marginally to 2.7% from 2.6%, and only because of a jump in accommodation services inflation to 5.8% from 3.3%, mainly due to an unusual plunge in accommodation prices between July and August 2016. We expect a correction in September.

What’s more, the jump in core goods inflation is clearly because of a faster-than-expected pass through from import prices to consumer prices. This means inflation pressures should ease considerably in 2018—more than the MPC is forecasting. Granted, we still think that CPI will continue to rise and peak at 3% in October, but that will be mainly because British Gas is expected to raise electricity prices by 12.5% in September, with the data incorporated into October’s figures.

**No advancements on Brexit negotiations**

Mark Carney said earlier this year that he would not vote for a rate hike before he saw wages growing firmly, net trade and investment supporting growth, and Brexit uncertainty declining. As we have seen above, wages have not picked up, investment and trade are still
subdued, and there has clearly been no major advancement in negotiations with the EU.

Granted, Theresa's May speech on September 22 was aimed at bringing some clarity over future negotiations, but the British prime minister delivered little substance. Though she claimed that the U.K. would ultimately honor all of its financial commitments with the EU, that’s far from agreeing on a specific figure, and we expect negotiations on a final bill to take a while. Similarly, little progress has been made in negotiations over citizens' rights and the Irish border. The thing is, together with the financial bill and despite U.K. pleas, the EU has insisted that finding an agreement on these three issues is essential before both parties can move on to talks over a future trade deal. The latter were expected to start in October, but the current impasses have made us change our baseline. We now expect trade talks to be postponed until December.

On the upside, May confirmed rumors that the U.K. will seek a two-year transition period following the exit, during which the status quo will remain. While this brings some relief to business, we think a two-year transition is short enough for economic risks surrounding Brexit to continue to influence investment decisions, notably in the services sector. What’s more, during her speech May confirmed that the U.K. is pushing for a hard Brexit, which will see the U.K. leave the Customs Union and the Single Market. True, May still aims for a tariff-free 'bespoke' deal, and she urged the EU to be creative and inventive, but there is nothing set in stone. That's why we think it would make sense for the BoE to await more clarity on what type of Brexit the U.K. is heading to.

Other reasons to wait

But there are other reasons that make a rate hike less than two months from now premature. The BoE has already announced that the Term Funding Scheme will be scrapped in February 2018, while the counter-cyclical capital buffer for banks will be raised further to 1%, from 0.5%, by the end of November. Both have been crucial in reducing borrowing costs for financial institutions—the TFS alone has reduced banks’ funding costs by almost 100 basis points since it was implemented last year. We think that the MPC should wait until it could assess the impact that both the unwinding of the TFS and the raising of the capital buffer will have on lending to the economy before it decides to unwind stimulus.

Meanwhile, the chancellor is expected to deliver the Autumn Budget by November 22. The Autumn Budget will be the main fiscal event of fiscal 2018-2019, as the Spring Budget will be abolished and replaced from now on only by a Spring Statement, which shouldn't hold any major fiscal changes. Similarly as with the TFS and the countercyclical capital buffer, we think that it would make sense for the BoE to postpone its decision on rates until after the budget is delivered, notably as we expect that the chancellor won’t ease the fiscal consolidation and keep some headroom for the future.
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