Economic Research Unit

Economics Weekly

Bank of Ireland

Evidence UK inflation pressures easing hits sterling

Markets had expected the Bank of England to lag behind other central banks in cutting rates through to the end of 2025, mainly due to evidence of persistent inflationary pressures. However, this week saw both UK private sector regular pay growth (4.5%) and CPI inflation (1.7%) ease. Hence, investors now expect the Bank of England to cut rates towards 3.5% by end-2025, vs 3.8% previously. Also, UK 10-year Gilt yields have fallen back to 4.08%, no longer with a marked spread to US Treasury yields. Similarly, the sterling/dollar exchange rate has fallen back to $1.299, having peaked at $1.34 in late September. The next key event is the October 30th Budget, with speculation growing a £40bn package of spending cuts and tax rises, worth 1.4% of GDP, will be implemented. If so, this will act to cool the UK economy, perhaps persuading markets the Bank of England has even more scope to loosen its monetary policy.

UK jobs and pay growth continue to soften: Tuesday's (October 15th) UK labour market data suggested underlying conditions continue to loosen. True, the unemployment rate fell slightly to 4.0%, but has been volatile over the past year. In contrast, the ONS's measure of pay-rolled employees was 30.35 million, down -0.1% over the past three months, the first decline in over 3 years. There has also been a clear downward trend in vacancies, which fell again in September to 841,000, back to pre-pandemic levels (see chart below). Hence, private sector regular earnings growth eased to 4.5% in August, a two-and-a-half year low.

CPI inflation falls below Bank of England target for the first time: Fresh data released Wednesday (October 16th) indicated UK CPI inflation fell to 1.7% in September, well below market expectations for a 2% rate. This is the first time CPI inflation has fallen below the Bank of England's 2% target since April 2021. Crucially, the weaker CPI figures reflected a decline in both the core CPI inflation rate to 3.2% and services inflation to 4.9%. This is clearly welcome news for the Monetary Policy Committee, reinforcing the view that loosening labour market conditions and weaker pay growth are easing cost-price pressures in the services sector.

UK gilt yields fall back, sterling depreciates: UK 10-year Gilt yields peaked at 4.25% on October 11th, 15 basis points above US Treasury yields (see chart below). In the wake of September's CPI inflation data this spread narrowed, 10-year Gilt yields falling to 4.08%. Markets are now more confident the Bank of England will cut official rates, the overnight index swap (OIS) curve implying 3.5% by end-2025, vs 3.8% previously. Options prices now fully price in a rate cut at the November 7th meeting with close to a 70% probability of a second cut to 4.5% at the December 19th meeting. The sterling/dollar exchange rate has now fallen to $1.299 having peaked at $1.34 in late September.

October Budget now the key challenge: The next key event for the UK economy is the Budget on October 30th. The new Labour government has said it has identified a £22bn spending hole, which will need to be funded by cuts elsewhere, or tax rises. However, the spending plans new Chancellor of the Exchequer Rachel Reeves has inherited from the Conservatives, have been criticised as unrealistic. Hence, it has been reported Labour is now considering an even larger £40bn (1.4% of nominal GDP) package of tax rises and spending cuts - to avoid real cuts to Departmental spending - and rein in public sector borrowing, of 4% of GDP. Of course, the more aggressive the austerity measures announced in October's budget, the more likely it is the Bank of England will have scope to cut rates.

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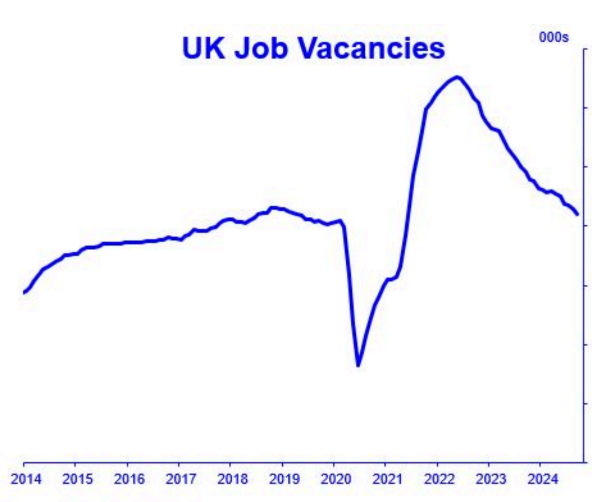

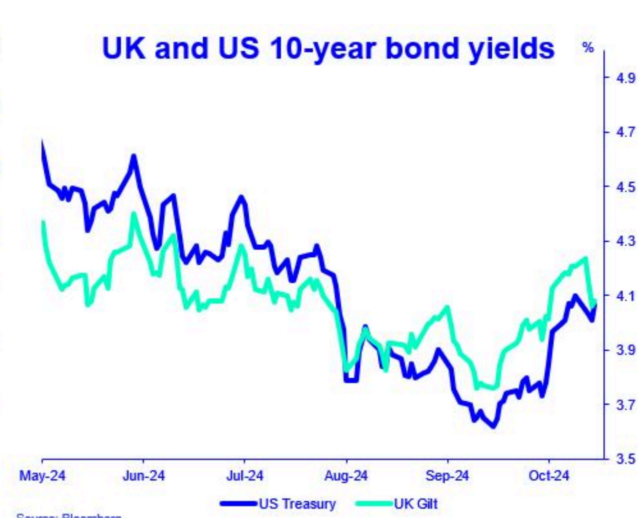

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