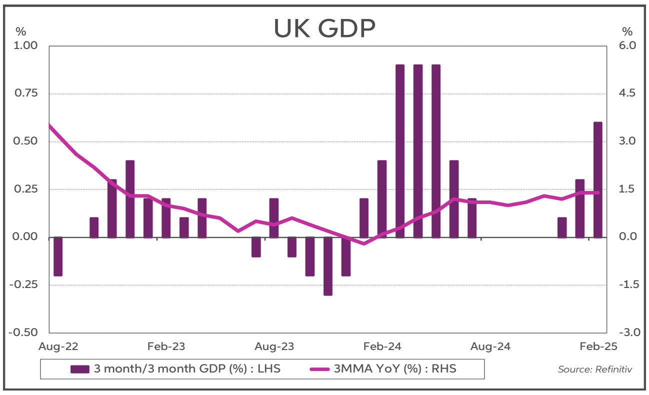
BoE Watch

AIB Treasury Economic Research Unit

8th May 2025

BoE cuts rates as expected but continues to guide gradual approach

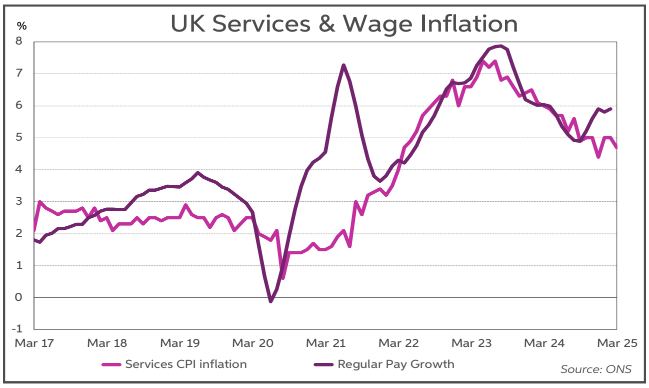
The Bank of England's Monetary Policy Committee (MPC) meeting for May saw the central bank cut the Bank rate by 25bps to 4.25%, marking its second rate reduction this year (previously cut at the February MPC). Futures contracts in the lead up to today's meeting had a 25bps rate cut fully priced in. **Once again, there was no unanimity within the MPC on its decision to cut rates today.** The voting breakdown showed an 5:4 split. Five MPC members voted in favour of a 25bps basis rate cut. However, even within this cohort, it was a finely balanced decision for "most members" between a cut to rates and leaving policy on hold. Overall, the eventual consensus among the five voted for a 25bps cut amid the backdrop of underlying domestic disinflation evolving as expected. Of the other four, two MPC members (Dhingra and Taylor) were in favour of a 50bps rate cut, citing that "a less restrictive policy path was warranted" given the risks to the outlook. Meanwhile, for the other two MPC members (Mann and Pill) the presence of "continued inflation persistence" justified leaving policy unchanged.



The meeting statement and minutes acknowledged the high degree of uncertainty and unpredictability in trade policy and the "growing risks" to the economic outlook from this. The central bank noted that depending on "how trade policies unfolded" it could be "materially more disinflationary" than envisaged or "it was also possible" that it "could be slightly inflationary in the longer term". Overall though, the BoE assessed it was "too early to conclude" the actual impacts at this stage.

Today also saw the release of the BoE's most recent detailed assessment of the UK economic outlook, with the publication of its quarterly Monetary Policy Report (MPR) for May. In terms of its baseline growth outlook, the updated forecasts saw only minimal changes compared to their February edition. There was a modest upward revision to its 2025 GDP growth forecast to 1.0% (from 0.75%). Meanwhile, for 2026, it marginally downgraded its GDP projection to 1.25% (from 1.50%). Further out, it maintained its projection for GDP growth to average 1.5% in 2027.

On the inflation front, similar to its GDP projections, the forecasts saw relatively minor revisions compared to what was expected back at the time of the February MPR. The BoE continues to expect that inflation will rise quite sharply over the coming months, although it now anticipates it to peak at 3.5% (was 3.7%) due mainly to developments in "household energy bills" as well as "regulated prices". However, the central bank remains confident that this pick-up will "be temporary" and "fall back thereafter" and continues to expect that inflation to return to its 2% target in the medium term. It now expects inflation to be at 3.25% by the end of this year (was 3.50%). The end-26 and end-27 forecasts were also revised down modestly to 2.25% (from 2.50%) and 1.75% (from 2.0%), respectively. Given the huge uncertainty in relation to the outlook, the BoE also set out two alternative scenarios. In the first scenario, more persistent weakness in demand relative to supply "might further mitigate inflationary pressures. In the second scenario, greater persistence "in domestic wage and price-setting" might "exacerbate the persistence of inflation".



In terms of policy guidance, the BoE continued to emphasis a gradual and careful approach to any further rate cuts. Indeed, the one area where the MPC was unanimous at the May MPC was in its statement that "monetary policy was not on a pre-set course". UK futures contracts have softened since early April amid the significant shift and subsequent uncertainty in US tariff policy. The market is now anticipating that UK official interest rates will fall below 4%, possibly as low as 3.5% by the end of this year. At the time of its last meeting in March, the market was envisaging rates getting to 4.00% by the end of this year. Our view since the start of the year has been a Bank Rate of 3.75% by end 2025 would be consistent with the BoE's preference for a gradual pace to rate cuts and evolving economic outlook. We see no reason to change that view following today's update from the BoE.

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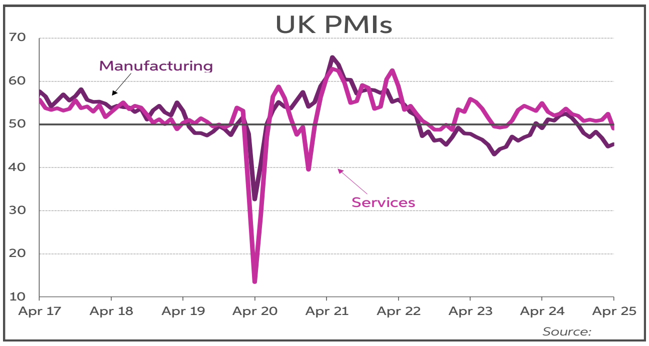
UK growth expected to remain muted in 2025



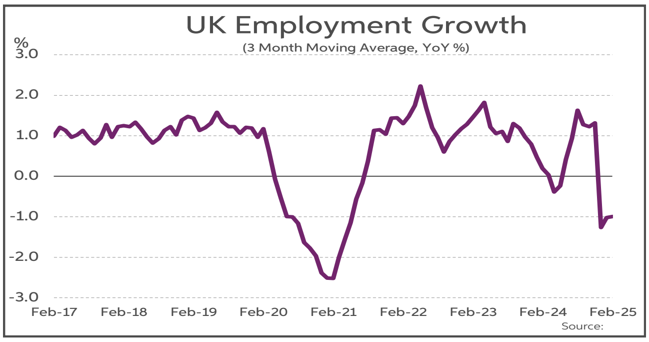
The UK economy performed better than anticipated in 2024, particularly in the first half of the year. GDP rose by 0.9% in Q1 and by 0.5% in Q2, with consumer spending, government expenditure and fixed investment all performing well during this period. However, GDP stagnated in Q3, albeit this was largely attributable to a substantial change in inventories and acquisitions less disposable assets, before rising by a meagre 0.1% in Q4. Overall then, the UK economy expanded by 0.9% in 2024, but growth lost considerable momentum in the second half of the year.

Encouragingly though, recent hard data suggest the economy has regained some steam in the opening months of 2025. The available monthly readings of GDP show that growth flat-lined in January, before rising by 0.5% in February. Elsewhere, retail sales have increased throughout Q1, rising by 1.4%, 0.7% and 0.4% in the first three months of the year. On an annual basis, they were up by 2.3% in March. Meantime, industrial production contracted by 0.5% in January, but rebounded strongly by 1.5% in February.

In contrast, survey data indicate that activity levels have declined and sentiment has soured in the early part of the year. The manufacturing PMI remained firmly in contraction territory in Q1, having moved below the key 50 mark at the start of Q4. Despite rising in April, it stayed well in contraction mode, at 45.4. In contrast, the services PMI was in expansion mode, and improved as the first quarter progressed. However, it fell to 49.0 in April, consistent with a first fall in activity levels in the sector since October 2023. At the same time, consumer confidence has deteriorated in the first four months of 2025, plunging to –22.0 in January, recovering somewhat in February/March, to –19.0 (still quite a weak level), before falling to –23.0 in March, its lowest reading since November 2023.

In terms of the labour market, conditions appear to have stabilised in recent months. However the data remain volatile and are judged to be somewhat less reliable currently owing to low survey response rates. Nevertheless, the unemployment rate increased steadily from a low of 4.1% in August to 4.4% in November, and has stayed at that level throughout the winter and in February. Regarding wage inflation, average earnings growth had cooled throughout the first three quarters of 2024, falling to a low of +3.9% y/y in the three months to August. More recently though, it has re-accelerated, climbing to +5.6% y/y in February. However, other measures of wage inflation point to lower and more stable earnings growth. The BoE Agent's Summary Survey for Q1 noted that pay settlements are likely to average 3.5-4% in 2025.

Elsewhere, there has been some softening in inflation, but overall price pressures remain elevated. Headline CPI fell to a low of 1.7% in September, before rising throughout the winter. It stood at 3.0% in January. However, it fell over the next two months, to 2.6% in March. Meanwhile, core-CPI jumped to 3.7% in January, its highest level since last April, but eased to 3.4% in March. Looking ahead, the BoE expects headline inflation to rise to 3.5% in Q3, before falling slowly back towards the 2% target in 2026 and 2027.



Overall, the UK economy's performance has been chequered so far this year. Measures of output have improved in Q1, but survey data suggest activity levels have dropped and sentiment has deteriorated. At the same time, inflation remains elevated, while labour market conditions have been relatively steady. If inflation eases further there should be scope for the BoE to lower rates this year, providing additional support to the economy. Increased government spending and investment could also boost GDP in the near-term. However, the outlook has become less clear owing to uncertainty around US trade policy, and the potential for spillovers to slower global growth. Against this backdrop, the IMF sees UK GDP rising by 1.1% in 2025, and by 1.4% in 2026. Similarly, the BoE expects GDP to rise by 1% and 1.25% over the same period.

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