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Bank of England Takes It Easy On Monetary Easing

Economist(s)

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Summary

- The Bank of England (BoE) delivered a widely expected 25 bps policy rate cut to 4.75% at today's monetary policy announcement. The central bank's accompanying comments were mildly hawkish on balance, suggesting the U.K. central bank will continue to lower interest rates at only a gradual pace in the quarters ahead.
- The BoE projected above-target inflation over much of its forecast horizon, and relatively steady GDP growth through 2025 and 2026. The central bank also highlighted the boost to growth and the inflationary implications from the recent U.K. government budget. Altogether, BoE policymakers said “a gradual approach to removing policy restraint remains appropriate.”
- Given the overall expansionary U.K. budget, we have also nudged our U.K. GDP growth forecasts higher, to 1.7% for both 2025 and 2026. We have also revised our CPI inflation forecasts slightly higher.
- Considering our revised forecasts, recent economic data which remain encouraging overall, and still-elevated wage and price inflation, we expect the Bank of England will continue to adopt a gradual approach to monetary easing in the quarters ahead. Specifically, we forecast 25 bps policy rate cuts in February, May, August and November next year, followed by a final 25 bps rate cut in February 2026. That would see the BoE's policy rate end 2025 at 3.75%, and reach a terminal rate of 3.50% by early 2026.

Bank of England Cuts Interest Rates, Signals Gradual Easing To Continue

The Bank of England (BoE), in a widely expected decision, lowered its policy rate by 25 bps to 4.75% at this week's monetary policy statement. However, there were mixed messages in the BoE's accompanying statement, guidance and updated economic projections, suggesting to us that the U.K. central bank will continue to lower interest rates at only a gradual pace in the quarters ahead.

BoE policymakers voted 8-1 to lower interest rates at today's meeting, with the one dissent in favor of holding rates steady at 5.00%. In opting to lower interest rates, the BoE said:

- There has been continued progress in disinflation, particularly as previous external shocks have abated, although remaining domestic inflationary pressures are resolving more slowly.
- Policymakers judged "that the labor market continues to loosen, although it appears relatively tight by historical standards."
- Policymakers offered various scenarios for the economic outlook, and said their forecasts are based on the scenario in which a period of economic slack may be required to fully normalize pay and price-setting dynamics.

The BoE's updated economic projections sent a mildly hawkish message. The central bank upwardly revised its CPI inflation forecast for the end of 2024 to 2.7% and raised it forecast for the end of 2026 to 2.2% (both above the inflation target), while forecasting 1.8% by the end of 2027 (slightly below the inflation target). The central bank projected relatively steady U.K GDP growth of 1.5% in 2025 and 1.4% in 2026. That said, it's worth keeping in mind these projections are based off a market-implied policy rate path which is slightly lower than that which currently prevails, given that the market's rate expectation have moved higher in recent days.

Importantly, the Bank of England also highlighted the potential growth and inflationary effects of last week's U.K. government budget announcement. The BoE said the announced measures are provisionally expected to boost the level of GDP by around 0.75% at their peak in a year's time, relative to their August projections. The Budget is provisionally expected to boost CPI inflation by just under 0.5 percentage points at the peak, reflecting both the indirect effects of the smaller margin of excess supply and direct impacts from the Budget measures.

Based on this assessment, BoE policymakers wrapped up by saying "a gradual approach to removing policy restraint remains appropriate. Monetary policy will need to remain restrictive for sufficiently long until the risks to inflation returning sustainably to the 2% target in the medium term have dissipated further. The Committee continues to monitor closely the risks of inflation persistence and will decide the appropriate degree of monetary policy restrictiveness at each meeting." We see little in the central bank's guidance that would suggest an acceleration in Bank of England easing any time soon. That message was reinforced by BoE Governor Bailey, who said we "need to make sure inflation stays close to target, so we can't cut interest rates too quickly or by too much."

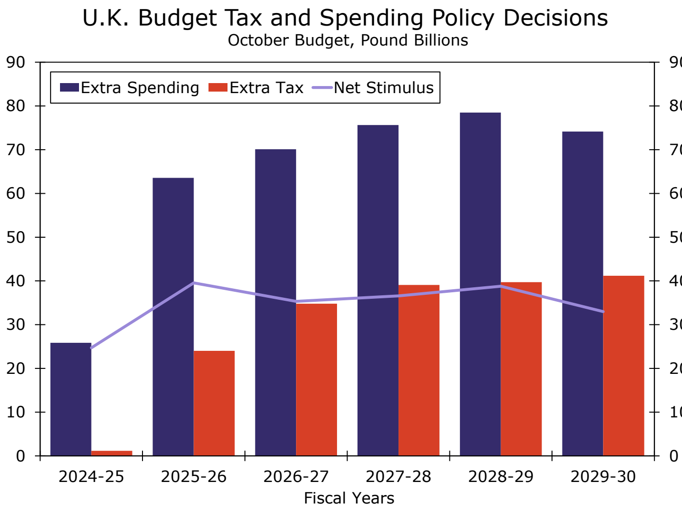
U.K. Budget Consistent With A Measured Pace of Monetary Easing

Today's Bank of England monetary policy announcement comes in the wake of, and incorporates the implications of, the widely anticipated U.K. Autumn Government Budget that was delivered. While the budget included both tax increases (primarily aimed at businesses and capital gains) and spending increases, it was overall an expansive budget, at least compared to prior fiscal plans. To that point, relative to the prior baseline, the government announced new spending of £74.2 billion by 2029/30 and increased taxes of £41.2 billion by 2029/30, representing a net giveaway of £33.0 billion. Also of note, new spending ramps up reasonably quickly over the next couple of years while the tax increases phase in more gradually over time, suggesting the government's budget plans should be somewhat supportive of economic growth at least through 2025—as highlighted in the Bank of England's announcement.

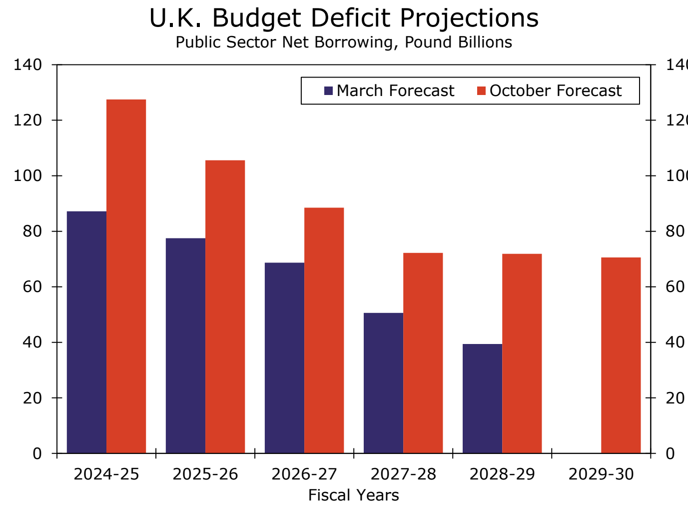
The government's ability to deliver a more expansive budget stems from new announced fiscal rules. These include a:

- **Stability rule:** to move the current budget into balance, day-to-day spending is met by revenues, and the government will only borrow for investment.
- **Investment rule:** to reduce net financial debt (public sector net financial liabilities) as a proportion of GDP. This rule keeps debt on a sustainable path while allowing the step change needed in

investment, by capturing not just the debt that government owes but also financial assets that are expected to generate future returns.



Source: Office for Budget Responsibility and Wells Fargo Economics



Source: Office for Budget Responsibility and Wells Fargo Economics

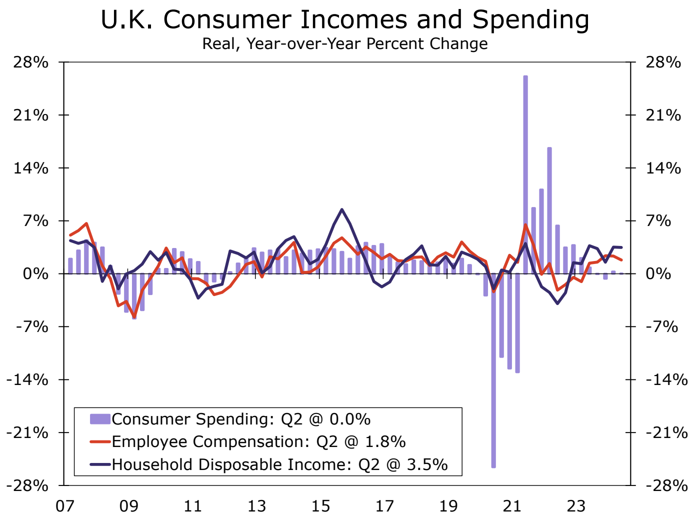
While the budget is expansive relative to prior plans, it is important to note that it still implies some consolidation in the U.K. public finances over time. That is, the U.K. budget deficit is still forecast to narrow over the forecast horizon, just at a more gradual pace than previously. For example, the Spring budget projected that Public Sector Net Borrowing would decline from £87.2 billion in 2024/25 to £39.4 billion in 2028-29. With the updated projections and new policy measures, the Autumn budget now sees Public Sector Net Borrowing declining from £127.5 billion in 2024/25 to £71.9 billion in 2028-29. While we think the government budget could provide some boost to economic growth in 2025, we doubt it will provide much in the way of additional support in 2026 and beyond.

Firmer Economic Growth, Lingering Inflation, Measured Monetary Easing

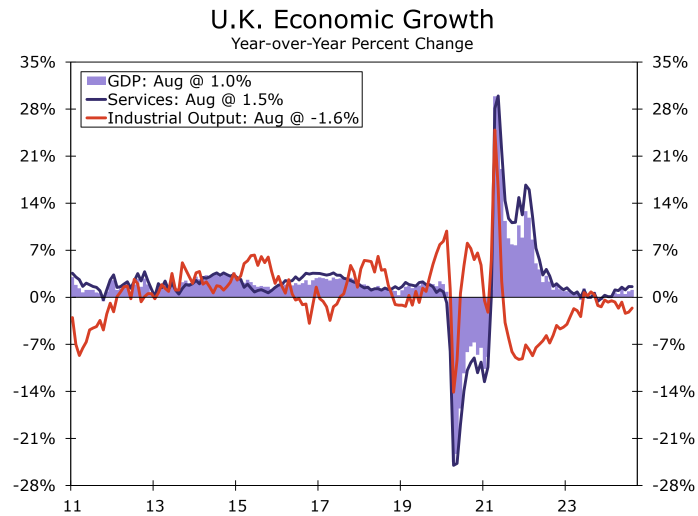
The additional government spending announced last week comes on top of other favorable economic signals, prompting us to upgrade our U.K. economic growth forecast slightly for next year. We expect U.K. GDP to grow 1.7% in 2025, compared to our prior forecast for a 1.5% gain, while in 2026 we also see U.K. GDP growth of 1.7% (previously 1.6%). The outlook for households and consumers in particular remains relatively encouraging, as Q2 real household disposable income rose 3.5% year-over-year, well in excess of real consumer spending, which was essentially flat. The household saving rate also rose to 10.0% of disposable income in Q2, indicating that consumers should have a reasonable degree of capacity to keep spending.

Recent activity data also point to a modestly encouraging economic outlook. The volume of retail sales rose in every month during the third quarter, such that Q3 retail sales were 1.8% higher than Q2. While monthly GDP outturns have not been as strong, the U.K. still appears on track for another quarter of expansion, with relatively steady gains in the services sector outweighing a mixed performance from the manufacturing sector. Sentiment surveys, as reflected in the October manufacturing and service sector PMIs, have also softened recently but remain consistent with overall economic growth.

The mixed performance of the manufacturing sector combined with slowing profit growth (including a 4.5% year-over-year decline in Q2 gross entrepreneurial income) does suggest some challenges for investment spending. However, given a more positive backdrop for household and consumers, and with increased government expenditures (both day-to-day spending and investment spending) also set to offer support, we are constructive overall on the U.K. economy's prospects in 2025. That said, we acknowledge the outlook remains fluid, especially in the wake of the U.S. elections and the potential for significant policy changes from a new U.S. administration; accordingly, the revisions to our U.K. GDP growth forecast are relatively modest.

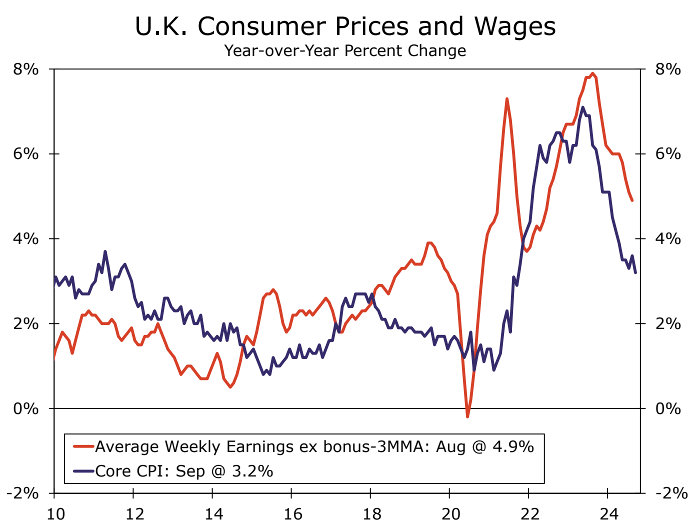


Source: Datastream and Wells Fargo Economics

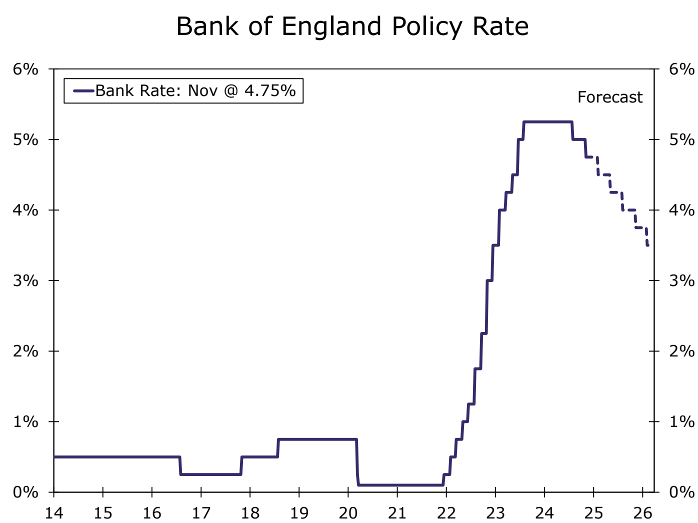


Source: Datastream and Wells Fargo Economics

With respect to wages and prices, recent trends have been more encouraging, although for now both wage and price inflation remain at elevated levels. In recent weeks, average weekly earnings slowed further to 4.9% year-over-year for the three months to August, while some measures of underlying price pressures surprised to the downside. The September core CPI slowed to 3.2% year-over-year, while services inflation slowed to 4.9%. While those latter readings were below the Bank of England's prior forecasts, they still remain well in excess in of the Bank of England's 2% inflation target. Moreover, with BoE policymakers still favoring a careful approach to removing monetary policy restriction and given the potential for the government's budget to prove growth-supportive in 2025, we have nudged our forecasts for U.K. CPI inflation modestly higher or, in other words, anticipate a more gradual deceleration in U.K. inflation. After headline CPI inflation of 2.5% in 2024, we see headline inflation remaining modestly elevated at 2.4% in 2025, before moving closer to central bank's target at 2.1% in 2026.



Source: Bloomberg Finance L.P. and Wells Fargo Economics



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Against this backdrop, we believe the Bank of England will continue to adopt a gradual approach to monetary easing in the quarters ahead, and expect an "every-other-meeting" approach to rate cuts through 2025 and into early 2026. Specifically, we forecast 25 bps policy rate cuts in February, May, August and November next year, followed by a final 25 bps rate cut in February 2026. That would see the BoE's policy rate end 2025 at 3.75%, and reach a terminal rate of 3.50% by early 2026. That represents a slightly slower pace of monetary easing relative to our prior forecasts, and relative to many other G10 central banks, a trend that may also translate to a relatively moderate pace of decline in the pound versus the U.S. dollar over the medium term.

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