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Bank of England reduces growth forecast while cutting interest rates to a new record low

By **Gordon Douglass,** Supervisory Economist, **Brian Smith**, Economist, and **Emma Christie**, Economist

On 4 August the Bank of England cut interest rates to a new historic low of 0.25 per cent from 0.5 per cent. This was the first change in UK interest rates for over seven years (see Figure 1) and goes against the expectations at the beginning of the year that the first move the Bank would make on interest rates would be to raise them. However, given the increased risk of a slowdown in the UK economy following the outcome of the UK's EU referendum, this cut had been expected by the markets.

The Monetary Policy Committee (MPC) of the Bank observed that further cuts could be possible although interest rates are unlikely to go negative. The Minutes to the MPC's meeting noted that "the Committee discussed whether to cut Bank Rate immediately to its effective lower bound, close to but a little above zero, or whether to cut Bank Rate by 25 basis points at this meeting. For a majority of Committee members a case could be made for cutting Bank Rate immediately to the effective lower bound. However, most Committee members also thought there

Latest news...

Regional gross value added estimates for London by different geographies, 1997-2014

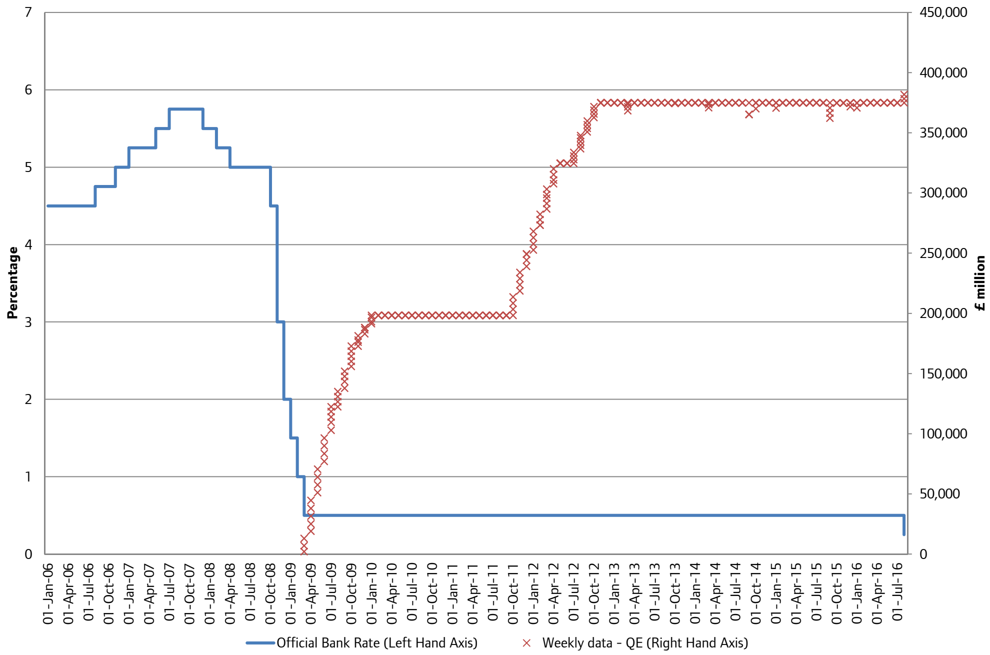
Current Issues Note 47 shows that Westminster had the highest level of GVA of any London Local Authority in 2014 with it producing output worth £51.0 billion followed by the City of London at £48.1 billion, while Barking and Dagenham had the lowest GVA of any London Local Authority in 2014 at £3.5 billion.

Download the publication.

Figure 1: Bank of England base rate and Asset Purchase stock

Last Data Point: 18 August 2016

Source: Bank of England



was value in delivering the required stimulus via a broad package of measures and recognised that there would be further opportunities to assess economic prospects at coming meetings in the light of new data".

The MPC further observed that with interest rates so close to zero "it was likely to be difficult for some banks and building societies to reduce deposit rates much further, which in turn might limit their ability to cut their lending rates. Analysis by staff across the Bank had suggested that a reduction in Bank Rate towards zero from 0.5 per cent could, by itself, lower banks' net interest margins a little, which could in turn lead to upward pressure on margins on new lending. In such circumstances, the transmission of monetary policy would be less effective than usual". The Bank has therefore introduced "a Term Funding Scheme (TFS) that would provide funding for banks at interest rates close to Bank Rate, and was calibrated so that any reduction in Bank Rate had a broadly neutral impact on building societies' and banks' margins in aggregate". The Bank has also announced that it will extend its Quantitative Easing (QE) programme to £435 billion by purchasing £60 billion of UK government bonds. Finally the Bank will purchase £10 billion of sterling non-financial investment-grade corporate bonds of companies that are considered to be contributing to the UK economy.

The MPC decided to make this move as the Bank, in its August Inflation Report, has significantly changed its view on the short-term outlook for the UK economy with it observing that "the outlook for the UK economy has changed markedly since May. It now seems likely that demand growth will weaken significantly over coming quarters and that the path for supply growth will be below that assumed three months ago. Despite those downward revisions to supply, demand is projected to be sufficiently weak to raise unemployment and economic slack, constraining wage growth and putting downward pressure on domestic inflation. As a consequence, the MPC now faces a policy trade-off as the upward impetus from the fall in sterling is likely to push inflation somewhat above the 2 per cent target in the second half of the forecast period. Under its remit, the MPC aims to support demand to reduce the variability of output, and by extension employment, and so ensure that the return of inflation to the target is sustainable. If a margin of slack were to remain once the temporary boost from higher import prices fades, inflation would subsequently be likely to fall back below the target". Despite this, the Institute for Fiscal Studies (IFS) estimates that for the August forecast the "central projection suggests that GDP at the end of this period would be 2½ per cent below the level in the Bank's May projection".

It should however be noted that although these policy measures are expected to provide some support to the UK economy they have not been universally welcomed as UK government bond yields have dropped lower with them trading at a negative rate on 10 August, the third day of the six month QE programme. These yields have led to widening gaps in many large pension funds as they are used to estimate how much additional funding pension funds need to meet their benefit payments. Indeed some commentators have warned that a rate cut could have a negative impact on the economy, with for example Kate Barker, a former MPC member, arguing that "the economic implications of the Brexit vote would be better tackled by loosening fiscal policy". She added that her "contention is rather that a cut in the present circumstances might actually prove negative for the economy . . . The economy is slowing — and the cry is for a confidence-boosting cut in the Bank rate. I fail to see why a policy move which will prove bad for the economy should have that effect".

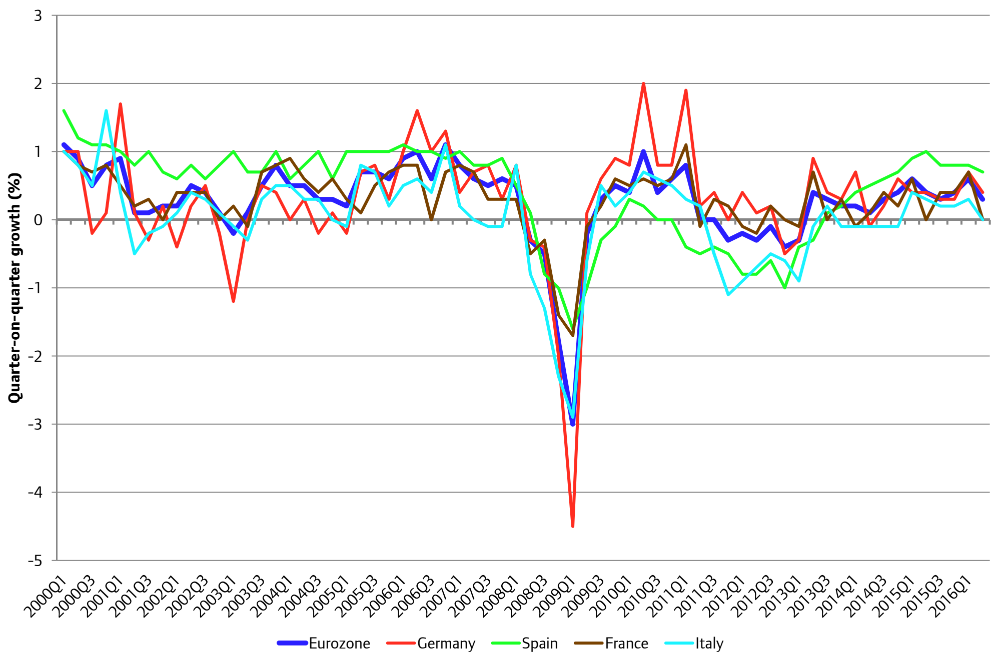
Eurozone and US growth continues

Internationally, the economic outlook, although mixed, has generally improved since the beginning of the year, with, for instance, data published on 12 August showing that GDP in the Eurozone increased by 0.3 per cent in the second quarter of 2016 (see Figure 2), although this was slower than the 0.6 per cent seen in the first quarter of 2016. However, there was a degree of variability between the various Eurozone countries' growth rates, with, for example, Spain growing by 0.7 per cent and Germany by 0.4 per cent in Q2 2016, while France and Italy saw no growth in Q2 2016.

Figure 2: Eurozone and selected countries quarterly GDP growth

Last Data Point: Q2 2016

Source: Eurostat



In other EU related news, the London based European Banking Authority published their latest bank stress tests of EU banks at the end of July, which examined the impact on the banks of a 7 per cent fall in GDP between now and 2018. The test found that if this were to occur most European banks would see a modest, and what many believe would be survivable fall in their capital levels. However, Italy's Monte dei Paschi di Siena bank saw the worst projected fall with its key capital ratio projected to turn negative with it falling by over 14 percentage points in this scenario. Of the UK banks tested (Barclays, HSBC, Lloyds & RBS) HSBC saw its estimated capital ratio after the test fall to a level slightly lower than the level it fell to under the 2014 test, but the other banks estimated capital ratios were higher after this test than the tests in 2014. Commenting on the results for the four UK banks tested, the Bank of England said that the results were "consistent with those of previous Bank of England stress tests". They added that "they provide evidence that major UK banks have the resilience necessary to maintain lending to the real economy, even in a macroeconomic stress scenario".

Elsewhere the US economy continued to grow in the second quarter of the year but at a relatively disappointing annualised rate of 1.2 per cent, below what forecasters were predicting. However in July, US jobs growth beat forecasts with the US adding 255,000 in that month and all three major US stock indices hit record highs in August indicating strong market sentiment. The minutes of the July meeting of the Federal Reserve's Open Market Committee, which were published in August, showed that the members were split on a rate rise with some feeling that conditions "would soon warrant taking another step", whereas others felt more data was needed.

Economic growth in Japan in the second quarter of 2016 was very slow at an annualised rate of 0.2 per cent, below market expectations and also below the 2 per cent annualised growth seen in Q1 2016. Thus in an effort to improve the growth rate of its economy, Japan's government approved in August a ¥28 trillion (over £200 billion) stimulus package.

In an attempt to tackle its low level of inflation (currently below 1 per cent and below a target of between 2 and 3 per cent) the Reserve Bank of Australia cut interest rates to 1.5 per cent, a record low. However, concerns have been raised about the impact of low interest rates on Australian house prices.

The economic picture remains mixed post the referendum result

With only one months' worth of data so far available it is still too early to say what the short-term impact of the referendum result will be on London's economy, while the longer-term impact is shrouded in mystery of what the UK's future trading relationships and deals will be. Nevertheless examining the data published in August gives a mixed economic picture. The Purchasing Managers Index (PMI) for business activity and new orders in London fell in July to its lowest level since March 2009, while for the UK as a whole, PMI's for construction, manufacturing and services all indicated a decline in activity in these sectors. Consumer confidence also declined in July, with the measure for London turning negative for the first time since April 2014. Business Confidence at the UK level has likewise declined according to the Q3 2016 ICAEW Business Confidence Monitor, but with perhaps a more recent slight rebound. The ICAEW observed that "confidence, already on a firmly downward trend, has been hit further by Brexit. It stands now at -10.2, a fall from +0.8 last quarter. Since the referendum some recovery in confidence is evident, but only modest". They further observed that "employment growth has continued to soften and Brexit has weakened expectations further".

Elsewhere the August Summary of Business Conditions from the Bank of England's Agents covering late June to late July found that the result of the EU referendum was likely to have a negative effect over the coming year. Following a survey of 270 businesses in the month after the referendum, the balance of companies expected that turnover, hiring and capital spending would likely fall over the next year. For specific sectors, only the manufacturing sector saw the net balance of businesses expecting an increase in turnover, "reflecting an expected boost to export demand from the fall in sterling". Capital spending and hiring activity was expected to be negative for all sectors, "but particularly so for construction businesses". The report summarised that "consistent with the survey results, Agents' scores for companies' investment and employment intentions have weakened in absolute terms since the referendum result", however the Agent's report also states that "those scores point to broadly unchanged levels of staff numbers and capital spending over the next six and twelve months respectively".

While surveys point to a potential slowdown in the months to come, those statistics that have been published and which relate to the July or later period have yet to show a discernible impact from the EU referendum. UK retail sales appeared to hold up in July with them increasing by 1.1 per cent according to data from British Retail Consortium & KPMG. This result was supported by the first estimate of retail sales for July from the Office for National Statistics (ONS) which indicated that the volume of retail sales in July was up 1.2 per cent compared with June. Commenting on these data Joe Grice, Chief Economic Adviser at the ONS said "these are strong numbers showing a pronounced increase in sales compared with last July. Better weather this year could be a major factor with sales of clothing and footwear doing particularly well. There is also anecdotal evidence from respondents suggesting the weaker pound has encouraged overseas visitors to spend. Department stores and specialist retailers like jewellers are among those reporting a good month". Data from the New West End Company found that sales in the West End in July were 4.9 per cent higher than the previous year, citing that the weakening of the pound encouraged tourists to spend more while on their visits. The view that a weak pound may have encouraged overseas visitors was further supported by travel researcher ForwardKeys which said that the depreciation of the pound led to a 4.3 per cent increase in flight bookings to the UK in the 28 days following the vote. Further, the Claimant Count measure of unemployment showed a very slight fall in the numbers claiming unemployment related benefit in July compared with June for both London and the UK.

A number of organisations have been responding to the impact of the Brexit vote in recent weeks, with for instance TheCityUK, the financial and related professional services industry lobby group, calling for the industry to "continue to trade freely with the EU-27 and vice-versa" with it adding that "mechanisms approximating single market passporting" were also of vital importance for the City's post Brexit trading relationship with the EU. A number of economic forecasts have also been released with the National Institute of Economic and Social Research (NIESR) saying the UK economy has a 50/50 chance of suffering a recession in the next 18 months, with it forecasting overall that the UK economy will grow by 1.7 per cent in 2016 and 1 per cent in 2017. While Moody's has forecast that the UK will avoid a recession but will see a slowdown in growth to 1.5 per cent this year and 1.2 per cent in 2017.

In an examination of the long-term impact of the various trading options for the UK once it leaves the EU, the IFS has argued that "overall, maintaining access to the Single Market in an EEA [European Economic Area] scenario could be worth potentially 4% on GDP – adding almost two years of trend GDP growth – relative to a WTO [World Trade Organization] scenario". However, it also observed that "single Market Membership is particularly important for financial services. So-called 'passporting rights' mean that UK-based financial firms can service EU businesses and customers directly. To maintain these rights would likely require membership of the European Economic Area (EEA). But that would come at the potentially considerable cost of submitting to future regulations designed in the EU without input from the UK. The UK may have to make some very difficult choices between the benefits from passporting and the costs of submitting to external imposed regulation".

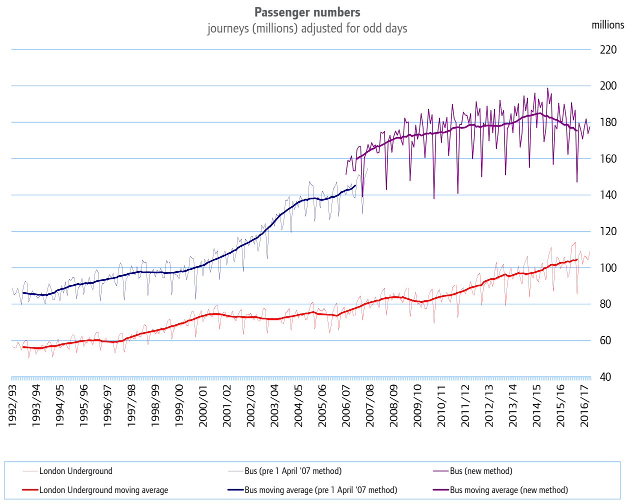
Thus while there are no immediate signs of a direct impact, if survey findings are borne out then the economy is likely to slow in coming months. However, quantifying the magnitude and pace of any slowdown is difficult at the moment. Nevertheless, despite this uncertainty the fundamental strengths of London's economy remain and make it equipped to deal with the challenges it faces over the coming year or so.

Economic indicators

Increase in number of passenger journeys

- The most recent 28-day period covered 26 June – 23 July 2016. Adjusted for odd days, London's Underground and buses had 286.5 million passenger journeys; 177.5 million by bus and 109.1 million by Underground.
- The annual moving average of passengers rose to 279.9 million, from 279.7 million in the previous period. The moving average for buses was 175.4 million. The moving average for the Underground was 104.6 million.
- The methodology used to calculate the number of bus passenger journeys was changed by TfL from 1 April 2007. For a detailed explanation please see LET issue 58 (June 2007).

Latest release: August 2016
Next release: September 2016

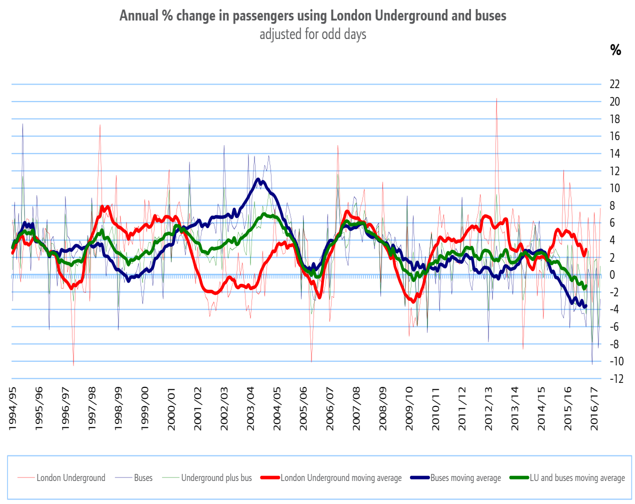


Source: Transport for London

Average annual growth of passengers remains negative

- The moving average annual rate of growth in passenger journeys increased to -1.3 per cent from -1.6 per cent in the previous period.
- The moving average annual rate of growth in bus passenger journey numbers increased to -3.6 per cent from -3.7 per cent in the previous period.
- The moving average annual rate of growth in Underground passenger journeys increased to 2.9 per cent from 2.2 per cent in the previous period.

Latest release: August 2016
Next release: September 2016

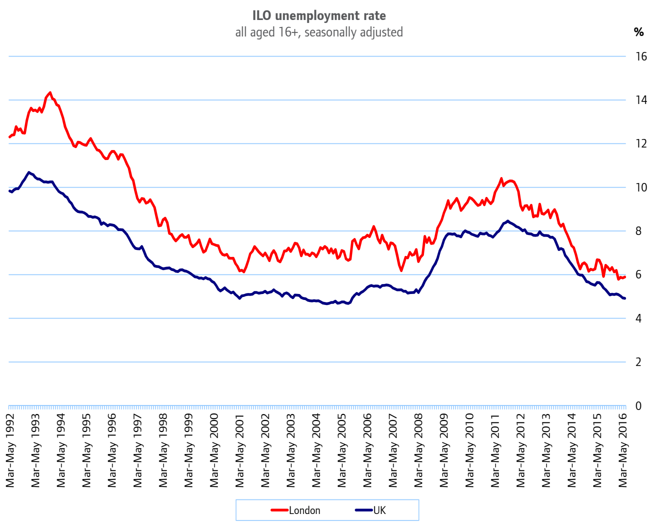


Source: Transport for London

ILO unemployment increases in London

- The ILO unemployment rate in London increased to 5.9 per cent in the quarter to June 2016, compared to 5.8 per cent in the quarter to March. In the UK, the unemployment rate was 4.9 per cent in the quarter to June 2016, down from 5.1 per cent in the previous quarter.
- There were 281,000 seasonally adjusted unemployed in London in the quarter to June 2016, an increase of 7,000 on the previous quarter. There were 1,641,000 seasonally adjusted unemployed in the UK in the quarter to June 2016, a decrease of 52,000 on the previous quarter.
- From LET Issue 154 (June 2015), GLA Economics now reports on the ILO unemployment rate.

Latest release: August 2016
Next release: September 2016

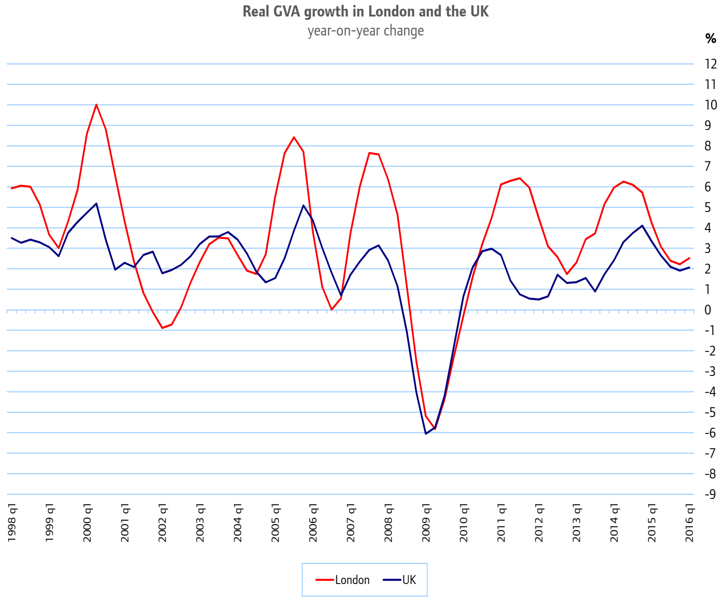


Source: Labour Force Survey - ONS

Annual output growth increases in London in Q1 2016

- London's annual growth in output increased to 2.5 per cent in Q1 2016 from a downwardly revised 2.2 per cent in Q4 2015.
- Annual output growth in the UK increased to 2.1 per cent in Q1 2016 from 1.9 per cent in Q4 2015. In Q1 2016, London's annual output growth was higher than the UK as a whole.
- From LET Issue 165 (May 2016), GLA Economics now reports our own GVA estimates for London and ONS data for the UK.

Latest release: July 2016
Next release: September 2016

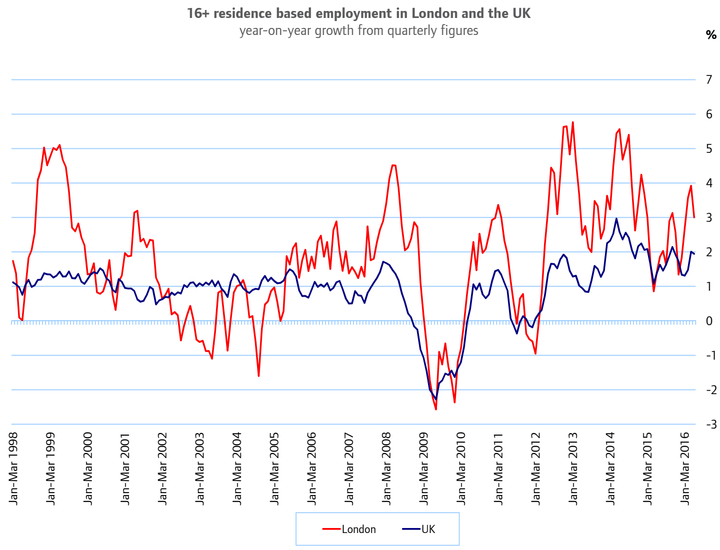


Source: GLA Economics and ONS

Annual employment growth increases in London

- The annual growth rate of London's residents in employment increased to 3.0 per cent in the quarter to June 2016, compared to 2.7 per cent in the quarter to March 2016. For the UK as a whole, the annual growth in employment increased to 1.9 per cent in the quarter to June 2016, compared to 1.3 per cent in the previous quarter.
- There were 4.49 million residents in employment in London in the quarter to June 2016, an increase of 25,000 on the previous quarter (and an increase of 131,000 on the previous year). There were 31.75 million people in employment in the UK in the quarter to June 2016, an increase of 172,000 on the previous quarter (and an increase 606,000 on the previous year).
- From LET Issue 165 (May 2016), GLA Economics now reports ONS labour market data.

Latest release: August 2016
Next release: September 2016

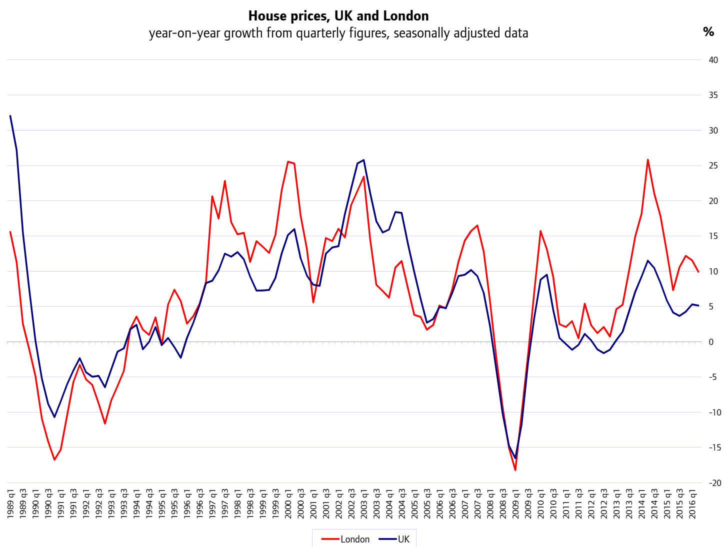


Source: Labour Force Survey - ONS

Annual house price inflation in London slows in Q2 2016

- House prices, as measured by Nationwide, were higher in Q2 2016 than in Q1 2016 for London as well as the UK as a whole.
- Annual house price inflation in London was 9.9 per cent in Q2 2016, down from 11.5 per cent in Q1 2016.
- Annual house price inflation in the UK was 5.1 per cent in Q2 2016, down from 5.3 per cent in Q1 2016.

Latest release: July 2016
Next release: September 2016

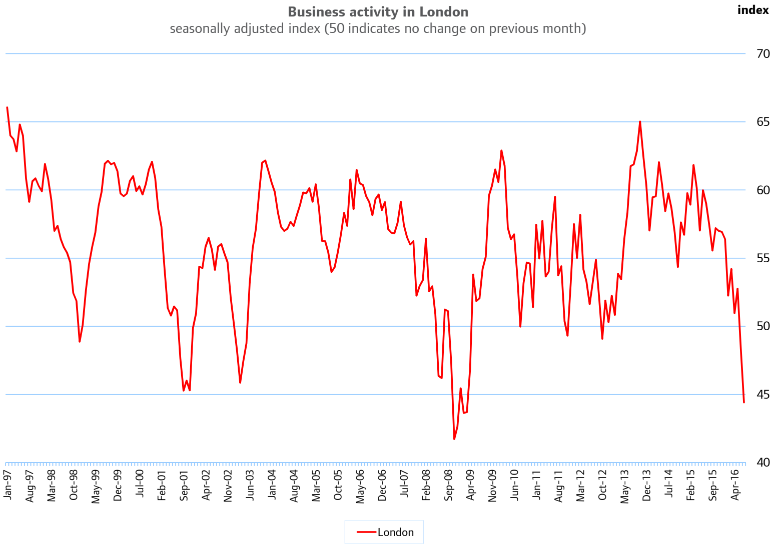


Source: Nationwide

London’s business activity decreases

- Firms in London reduced their output of goods and services in July 2016.
- The Purchasing Managers’ Index (PMI) of business activity recorded 44.4 in July 2016, down from 48.4 in June 2016.
- An index above 50 indicates an increase in business activity from the previous month.

Latest release: August 2016
Next release: September 2016

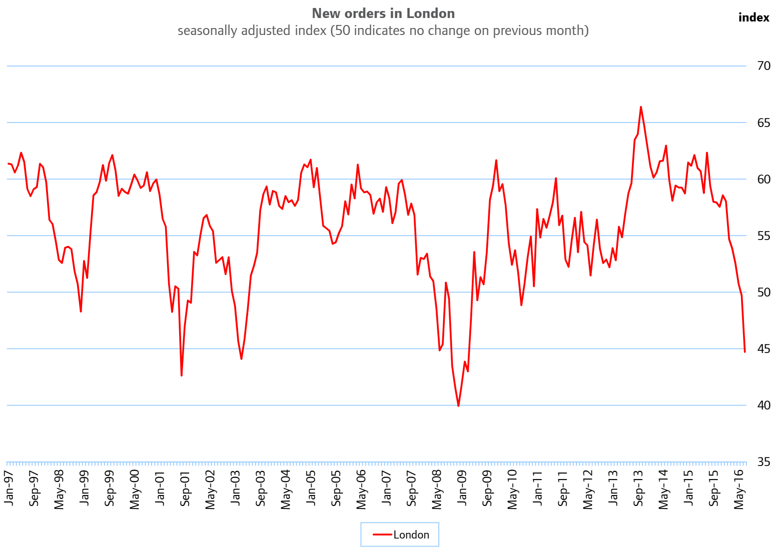


Source: Markit Economics

New orders in London falling

- July 2016 saw a decrease in new orders for London firms.
- The PMI for new orders recorded 44.7 in July 2016 compared to 49.7 in June 2016.
- An index above 50 indicates an increase in new orders from the previous month.

Latest release: August 2016
Next release: September 2016

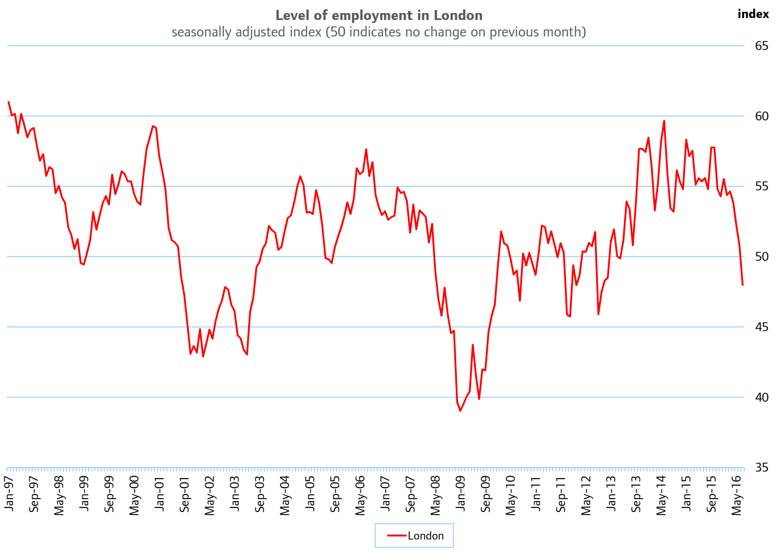


Source: Markit Economics

Businesses report falling employment in July

- The PMI shows that the level of employment in London firms decreased in July 2016.
- The PMI for the level of employment was 48.0 in July 2016, down from 50.8 in June 2016.
- An index above 50 indicates an increase in the level of employment from the previous month.

Latest release: August 2016
Next release: September 2016

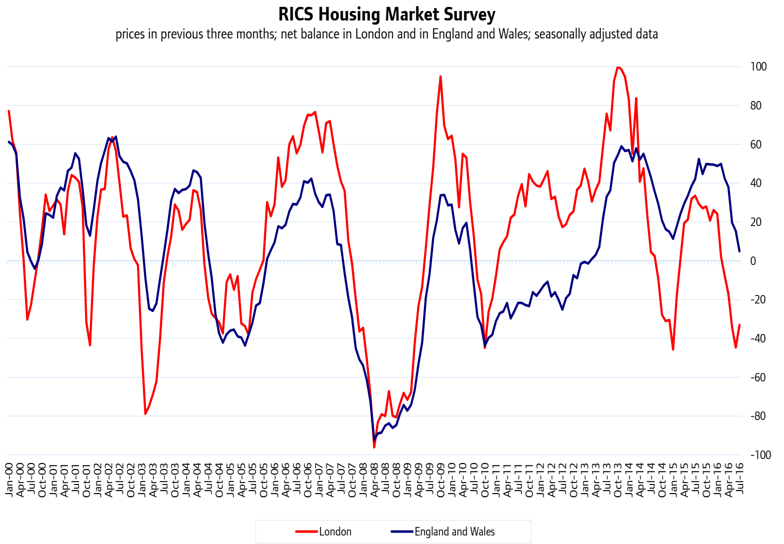


Source: Markit Economics

Surveyors report that house prices are decreasing in London

- The RICS Residential Market Survey showed a net balance of -33 for London house prices over the three months to July 2016.
- Surveyors reported a positive net house price balance of 5 for England and Wales over the three months to July 2016.
- London's net house price balance is lower than that of England and Wales.

Latest release: August 2016
Next release: September 2016

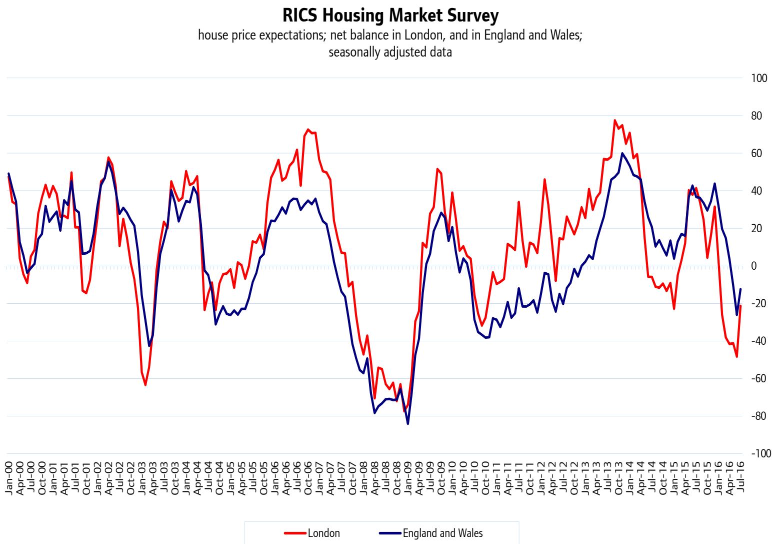


Source: Royal Institution of Chartered Surveyors

Surveyors expect house prices to fall in London, as well as in England and Wales as a whole

- The RICS Residential Market Survey shows that surveyors expect house prices to fall over the next three months in London, as well as in England and Wales as a whole (but to a lesser extent).
- The net house price expectations balance in London was -21 in July 2016.
- For England and Wales, the net house price expectations balance was -12 in July 2016.

Latest release: August 2016
Next release: September 2016

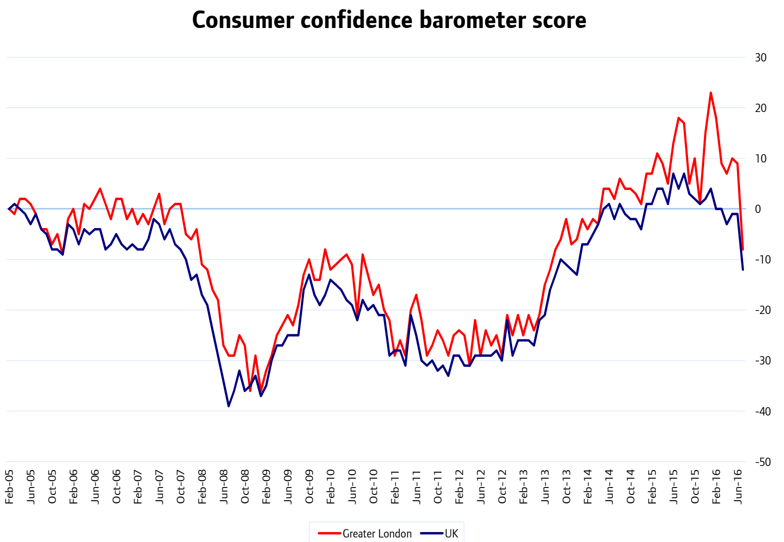


Source: Royal Institution of Chartered Surveyors

Consumer confidence negative for both London and the UK as a whole

- The GfK index of consumer confidence reflects people's views on their financial position and the general economic situation over the past year, as well as their expectations for the next 12 months (including whether now is a good time to make major purchases). A score below zero signifies negative views of the economy.
- For Greater London, the consumer confidence score stood at -8 in July 2016, down from 9 in June 2016.
- For the UK, the consumer confidence score stood at -12 in July 2016, down from -1 in June 2016.

Latest release: July 2016
Next release: August 2016



Source: GfK NOP on behalf of the European Commission

London in comparison with other global cities

By **Mark Wingham,**
Economist

GLA Economics has recently published research which compares the economic characteristics of London with other international cities[1]. Many comparisons between London and other global cities to date have focussed on particular topics or sectors, such as tourism and foreign direct investment. These comparisons have been outlined in Chapter 3 of the Draft Economic Evidence Base[2]. The analysis in this report adds to this body of research by looking at output, employment and productivity for selected global cities. However, from the offset, international comparisons are fraught with difficulty – differences in definitions, geography and data collection methods are well documented[3]. This analysis is no exception and should therefore be considered as experimental and be treated with some caution.

Acknowledging the above, London's total economic output using the Gross Value Added (GVA) measure was £364.3bn in 2014 according to the ONS[4]. Figures for the other global cities examined in this report have been converted from their national currencies into pound sterling using purchasing power parities and show that London's economy was smaller than Paris (£486.7bn), though this refers to 2013 and also the Île-de-France region. A number of other global cities use the Gross Domestic Product (GDP) measure which is not directly comparable with GVA. That said, London was also smaller than Tokyo and New York (though this refers to the New York, Newark and Jersey City metropolitan area), but larger than Singapore and Hong Kong.

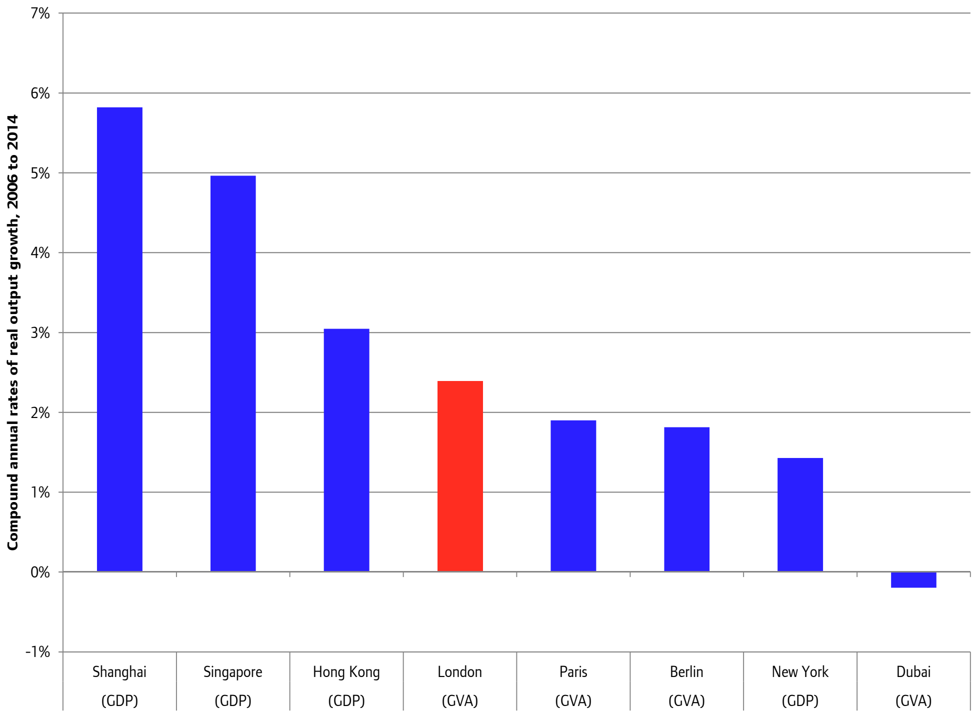
Figure A1 shows the compound annual rates of output growth in real terms for the global cities between 2006 and 2014. The cities with the strongest growth over these years were Shanghai and Singapore, with compound annual rates of real output growth of 5.8 per cent and 5 per cent respectively. That was twice as fast as London (2.4 per cent), though its rate of growth was nonetheless stronger than New York and Paris.

1 Wingham, M. 2016, 'Current Issues Note 48: London in comparison with other global cities,' GLA Economics.
2 GLA Economics, 2016, 'Draft Economic Evidence Base 2016'.
3 See GLA Economics Working Papers 9, 13 and 21, as well as Current Issues Note 17.
4 ONS, 2015, 'Regional Gross Value Added (Income Approach): December 2015'.

Figure A1: Compound annual rates of real output growth for selected global cities between 2006 and 2014

Source: ONS, US BEA, INSEE, Statistik Berlin Brandenburg, Tokyo Bureau of Statistics, SingStat, HK Census & Statistics Dept., China NBS, Dubai Statistics Centre

Note: Paris refers to the 2006 to 2013 period and Shanghai only includes output of urban units.



The largest sector in terms of output in London was the Finance & insurance sector, which contributed 18.9 per cent of total output in 2014. This share was larger than any other global city suggesting the importance of finance to London's economy. One common aspect across all global cities was that they were all orientated towards services, though Shanghai and Berlin generally had larger Manufacturing sectors.

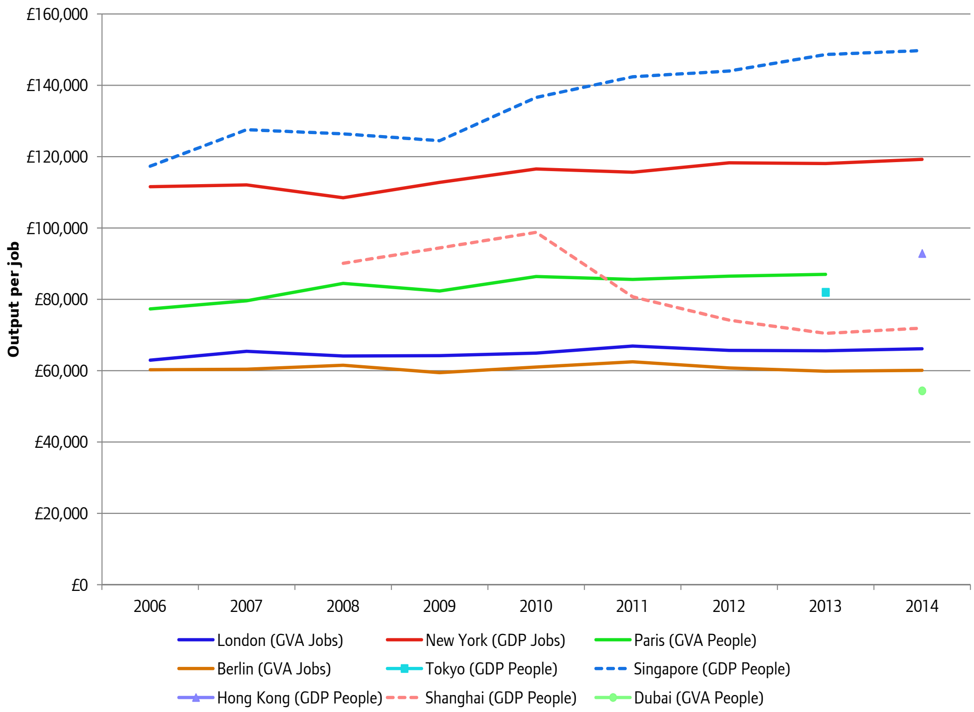
Meanwhile, London's employment rate was one of the highest among the global cities. Only Dubai and Singapore posted higher employment rates than London.

Another key international comparator is productivity – an important indicator of economic performance with it measuring the efficiency of converting inputs into outputs. Ideally, multifactor productivity would be the focus of any analysis of productivity, but these are usually calculated at the national level partly due to a lack of regional data. Instead, due to data availability, labour productivity in terms of output per job and output per hour worked were used in this analysis.

Looking at output per job as shown in Figure A2, London had the third-lowest figure of the global cities examined at £66,100 in 2014. It should be noted however that cities cannot be directly compared as some measure output in terms of GVA and others in GDP (as noted above), and some measure jobs in terms of jobs themselves or people in work. Nonetheless, the compound annual rate of growth in real terms for London (0.6 per cent) was comparable with New York (0.8 per cent).

Figure A2: Output per job for selected global cities between 2006 and 2014, constant 2014 prices

Source: ONS, US BEA/BLS, Eurostat, INSEE, Statistik Berlin Brandenburg, Tokyo Bureau of Statistics, SingStat, HK Census & Statistics Dept., China NBS, Dubai Statistics Centre



Similar trends were observed for output per hour. For example, the figure for London using the median number of hours worked was £35 per hour worked in 2014, which was below that for Hong Kong (£42) and Paris (£47 for 2013) yet above Berlin (£31).

Current Issues Note 48 examines the reasons for the lower productivity in London and finds that differences in the economic structure and workforce characteristics, like skills, age and foreign-born workers do not appear to explain why London's productivity is lower than in the other global cities examined. Instead, this could potentially be explained by the differences in definitions and data measurement.

To view the complete analysis including tables broken down by industry for each global city, please download Current Issues Note 48 from our website.

Additional information

Data sources

Tube and bus ridership	Transport for London on 020 7222 5600 or email: enquire@tfl.gov.uk
GVA growth	Experian Economics on 020 7746 8260
Unemployment rates	www.statistics.gov.uk

Glossary

Civilian workforce jobs
Measures jobs at the workplace rather than where workers live. This indicator captures total employment in the London economy, including commuters.

ILO unemployment
The International Labour Organization (ILO) measure of unemployment assesses the number of jobless people who want to work, are available to work and are actively seeking employment.

Residence-based employment
Employment measures the number of people in work rather than the total number of jobs (as people may have more than one job). It consists of employees, self-employed as well as unpaid family workers and those on government supported training and employment programmes. The measure included here is residence-based.

Gross domestic product (GDP)
A measure of the total economic activity in the economy.

Gross value added (GVA)
Used in the estimation of GDP. The link between GVA and GDP is that GVA plus taxes on products minus subsidies on products is equal to GDP.

Tube ridership
Transport for London's measure of the number of passengers using London Underground in a given period. There are 13 periods in a year. In 2016/17 there are eleven 28-day periods, one 27-day period and one 30-day period. Period 1 started on 1 April 2016.

Bus ridership
Transport for London's measure of the number of passengers using buses in London in a given period. There are 13 periods in a year. In 2016/17 there are eleven 28-day periods, one 27-day period and one 30-day period. Period 1 started on 1 April 2016.

Acronyms

BCC	British Chamber of Commerce
BRES	Business Register and Employment Survey
CAA	Civil Aviation Authority
CBI	Confederation of British Industry
CLG	Communities and Local Government
GDP	Gross domestic product
GVA	Gross value added
ILO	International Labour Organisation
IMF	International Monetary Fund
LCCI	London Chamber of Commerce and Industry
LET	London's Economy Today
MPC	Monetary Policy Committee
ONS	Office for National Statistics
PMI	Purchasing Managers' Index
PWC	PricewaterhouseCoopers
RICS	Royal Institution of Chartered Surveyors

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