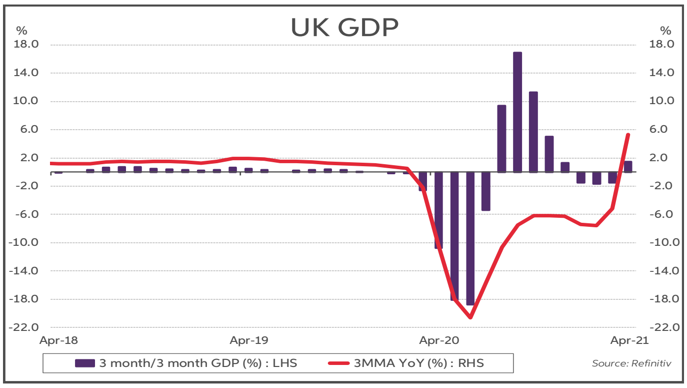
BoE Watch

AIB Treasury Economic Research Unit

24th June 2021

No signs of any near term policy tightening

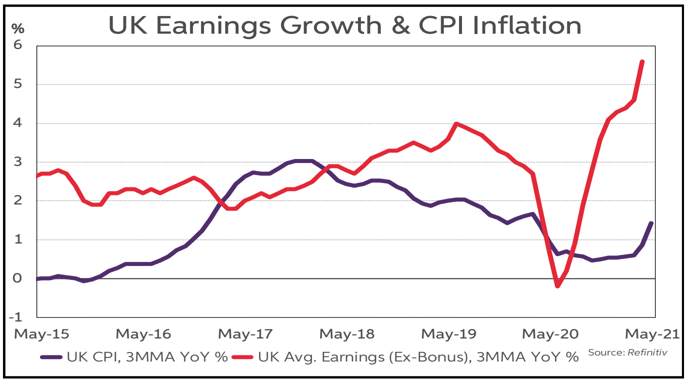
The June meeting of the Bank of England's Monetary Policy Committee (MPC) concluded as expected with no changes to its monetary policy settings. The Bank Rate remains at its historic low of 0.1%. It also left unaltered the size of its QE, at £895bn (£875bn in UK Gilts, £20bn in corporate bonds). **There was unanimity within the MPC on its decision in relation to interest rates.** Meanwhile, there was a majority 8-1 vote to leave its Gilt purchases at its current size, with once again, Andrew Haldene, at his last MPC meeting, preferring to reduce the target stock of these purchases to £825bn.



The overall message from the June meeting statement and minutes was one of on-going optimism regarding the economic outlook. The BoE noted that since its May gathering, developments in the global economy have been "somewhat stronger than anticipated", with activity expected to pick up more quickly than forecast in the second quarter. Its also referenced that changes in the composition of spending had led to a robust rebound in world trade and manufacturing. At the same time, it acknowledged that global price pressures have started to be reflected in consumer price inflation in advanced economies.

In terms of the UK economy, the BoE said that news on activity and inflation since its May meeting had mostly "been to the upside". It stated that the further easing of restrictions in recent months has seen the recovery in activity become most evident in the consumer facing services sector. It also commented that the housing market remained strong and consumer confidence indicators had increased. Meanwhile, assessing the economic implications of the recent delay in the final stages of the relaxation of Covid restrictions, it was of the view that the direct impact would be relatively small compared with previous stages.

The MPC's most recent set of detailed macro forecasts on the UK economy were contained in the May edition of its Monetary Policy Report (MPR). These projections represented upward revisions to the near term outlook. It revised higher its GDP growth forecast for this year to 7.25% (from 5%). However, there appears to be upside risks to this forecast now given that today the MPC stated that it had moved higher its expectations for the level of GDP in Q2 by around 1.5% compared to what it was anticipating in May.



The pace of growth is expected to slow from next year as the boost from factors, such as policy stimulus (both fiscal and monetary) and the rundown of household savings, start to wane**.** Therefore for 2022, it is anticipating growth of 5.75%. Meanwhile, for 2023, the BoE left its GDP growth forecast unchanged at 1.25%. While near term uncertainty remains, over the period 2022-23, the BoE assessed the risks to be "broadly balanced".

On the inflation front, the BoE stated today that it was unclear how persistent global price pressures would prove to be. However, the Committee was of the view that UK inflation expectations "remained well anchored" and that the direct impact of higher commodity prices on CPI inflation would be "transitory". The inflation forecasts from the May MPR showed that the BoE anticipates **that the CPI rate will rise temporarily above its 2% target towards the end of this year**. Indeed in the minutes from today's meeting, the BoE said that it was likely to exceed 3% for a short period, peaking higher than previously thought. Over the medium term, inflation is expected to return to around 2%

In summary, the BoE envisages that the UK economy will experience a temporary period of strong GDP growth and above-target CPI inflation, after which growth and inflation would fall back. While it has become even more optimistic on the economic outlook, there were no signs today that the BoE is contemplating any tightening of policy in the near term. However, futures contracts indicate that the market is pricing in the first rate hike of 0.125% by the middle of next year, with a second 0.125% rate increase following in H2'2022, which would bring rates up to 0.375% by end-22.

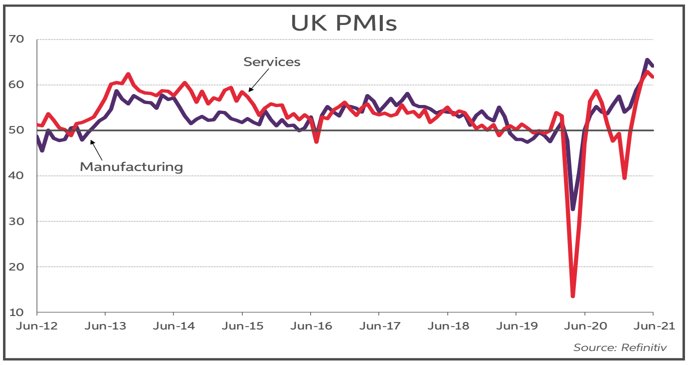
Oliver Mangan
Chief Economist
oliver.n.mangan@aib.ie

John Fahey
Senior Economist
john.j.fahey@aib.ie

Daniel Noonan
Economist
daniel.x.noonan@aib.ie

UK recovery well underway in Q2

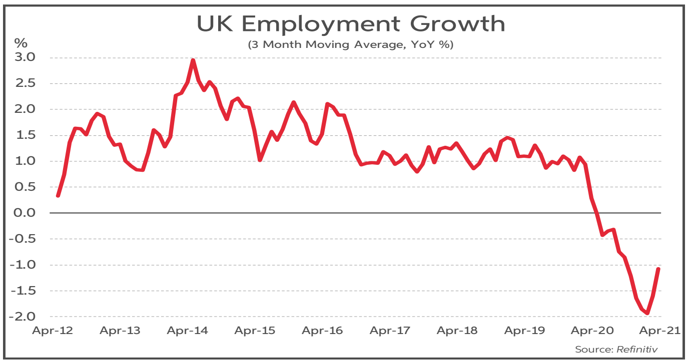
UK GDP contracted by 1.5% in Q1, due to restrictions that were reintroduced to slow the spread of a more virulent strain of Covid-19. Regarding the underlying breakdown, personal consumption fell by 3.8% in the quarter, stripping 2.4 percentage points (p.p.) from the total. Fixed investment subtracted a further 0.4 p,p.. Meanwhile, increased government spending added 0.5 p.p. to GDP. Net trade contributed 2.2 p.p. to growth, as imports (-13.9%) fell by more than exports (-7.5%). However, this led to a rundown of inventories, which clipped 1.0 p.p. from the total. By the end of Q1 though, the UK economy was in expansion mode, owing to the quick paced vaccine rollout. This was reflected by monthly GDP rising by 2.1% in March, as measured by the output method.



In April, the economy grew by 2.3% as more restrictions were eased. Industrial production though, fell by 1.3% in the month, and remains 3.1% below its pre-Covid level. Retail sales unexpectedly fell in May also. Sales were 1.4% lower, although this probably reflects a change in consumer behaviour, away from shops and towards hospitality, as indoor dining returned. Thus, despite the somewhat weaker production and sales data, the economy is still expected to grow strongly in Q2, although the pace of the recovery may have peaked.

Indeed survey data from Q2 indicate that the economy has continued to grow, although the pace of growth may be starting to slow. The manufacturing PMI printed above 60 each month, and had an average reading of 63.6 in Q2, up from 56.0 in Q1. Likewise, the services PMI was in expansion mode in April, May and June, with an average value of 61.9, as the sector continued to re-open. However, while both indices were at elevated levels in June, they moved lower for the first time since January.

Meanwhile, the Government's furlough scheme, which was extended in March continues to shelter the labour market. The unemployment rate, which has been trending downwards since its peak of 5.1% in December, edged lower again in April to 4.7%. The scheme has been extended until September, beyond the expected deadline for most of the Covid-19 restrictions to be eased, even with the potential four week delay in re-opening the economy fully. This should limit the rise in unemployment, although, it is still expected to increase this year.



In terms of inflation, the headline CPI rate jumped from 1.5% to 2.1% in May. The core rate moved higher to 2.0% from 1.3% also. An increase in energy costs, higher commodity prices, and the unwinding of most of the VAT cut has seen inflation rise over the past few months. The increase in prices has been greater than the BoE anticipated. The central bank expects inflation to rise further in the near term, but to be transitory over the medium term.

Overall, the near term outlook for the economy looks very positive. The quick pace of the vaccine rollout has allowed the economy to gradually re-open, with most domestic restrictions now removed. The Budget kept supports in place beyond the re-opening, and introduced measures to boost investment. The extension to the stamp duty holiday is providing an added fillip to activity in the housing market, with prices rising by 1.8% in May, lifting the annual rate to 10.9%. Thus, the economy appears to be in the midst of a strong economic rebound. The OECD expects UK GDP to expand by 7.2% this year and by 5.5% in 2022.

However, longer term there are potential economic headwinds on the horizon that will need to be navigated carefully. The Delta variant has already delayed the full re-opening of the economy by up to four weeks, and failure to stop it spreading risks delaying it re-opening further. Brexit could also dampen investment and trade over the medium term. Furthermore, to counterbalance increased spending, a host of tax hikes, including to corporation tax in 2023, are planned. Theses may hinder growth in the UK in the years ahead. By that stage global growth may have cooled somewhat as well.

AIB, 10 Molesworth Street, Dublin 2 Tel: 353-1-6600311 https://aib.ie/investorrelations/economic-research-unit