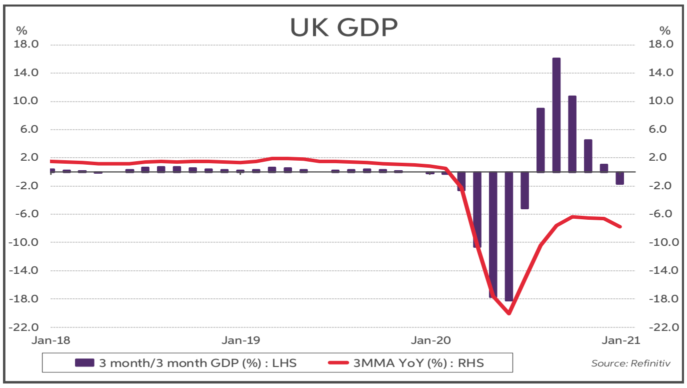
BoE Watch

AIB Treasury Economic Research Unit

18th March 2021

Uneventful March BoE meeting

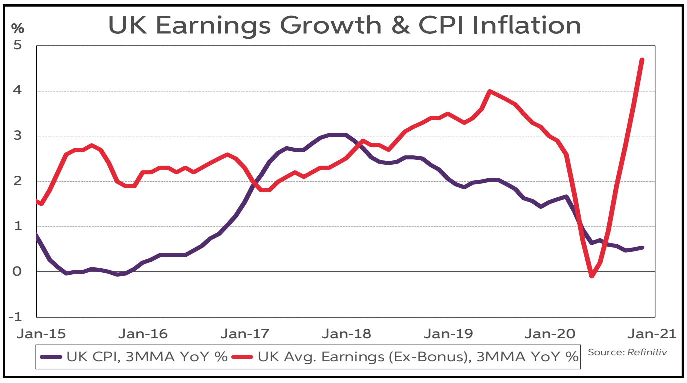
In line with expectations, the Bank of England Monetary Policy Committee (MPC) meeting for March was a non-event. The central bank left its policy settings unaltered. The Bank Rate remains at its historic low of 0.1%, a level it has been at since March of last year. Meanwhile, it also left unchanged the size of its asset purchase programme, at £895bn. There was unanimity within the MPC on its decision to leave policy unchanged.



The most recent detailed macro forecasts from the BoE were contained in its Monetary Policy Report, released at its last meeting in February. For this year, the BoE is projecting growth of 5%. The BoE expects the economy to get to back to its pre-Covid level by Q1'2022. It envisages growth slowing over the course of 2022 as the boost to activity from the comprehensive fiscal and monetary policy initiatives starts to fade. However, it still projects growth to average 7.25% next year. **In terms of inflation, the BoE expects that the CPI rate will increase sharply towards its 2% in the spring** as the VAT reduction for certain services expires and on base effects from higher energy prices. Further out, it anticipates inflation remaining near to its 2% target over the period 2022-23. Meantime, it forecasts that the unemployment rate will continue to rise over the coming quarters and stands at 6.5% by Q4'21.

In its discussion during this month's meeting of the economic backdrop, the BoE stated that recent performance of the global economy had been somewhat stronger than it had been anticipating and that the news on near term economic activity had been positive. It acknowledged the progress of the vaccination programme in the US as well as the recently announced fiscal stimulus package there. Therefore, it viewed the recent rise in "advanced economy" longer term bond yields as being consistent with this improving backdrop and did not appear overly concerned by the higher yield environment, similar to the US Fed and in contrast to its counterparts in the ECB.

In terms of its assessment of what has been happening in the UK economy since its last meeting, the BoE struck a cautiously upbeat tone. It noted the marked fall in the rate of Covid infections and hospitalisations as well as the rapid pace of vaccine programme rollout. It also referenced the number of what it termed "significant" new policy announcements contained in Budget 2021, including the extension of the Coronavirus Job Retention Scheme. While it was unsure yet what impact all of these would have on its medium term outlook, it did suggest that its forecasts for a 4% contraction in the first quarter was tilted to the upside now.



The BoE also said that the extension of Governments labour market supports would likely mean that the near term rise in the unemployment rate would be more moderate than what it outlined in February. Meanwhile, it remained of the view of a "material degree of spare capacity at present" in the economy. **The MPC said it would be able to make a "fuller assessment" of the impact of all of these recent developments, including the measure contained in Budget 2021, on growth, unemployment and inflation when it was preparing its updated forecasts for the May Monetary Policy Report.**

In conclusion, there was no indications from the BoE's March meeting to suggest that there are any near term policy changes on the horizon. The MPC continued to emphasise that the economic outlook remains "unusually uncertain". It also once again stressed that it does not expect to tighten policy until there is clear evidence of progress in eliminating spare capacity and inflation sustainably meeting its 2% target. **The success of the UK vaccine rollout though has resulted in the market pricing in the possibility of rate hikes sooner than it had been anticipating at the time of the BoE's February meeting.** Futures contracts indicate that the Bank Rate could start to rise during the second half of 2022, ending the year at 0.25% and reaching 0.5% by end 2023.

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

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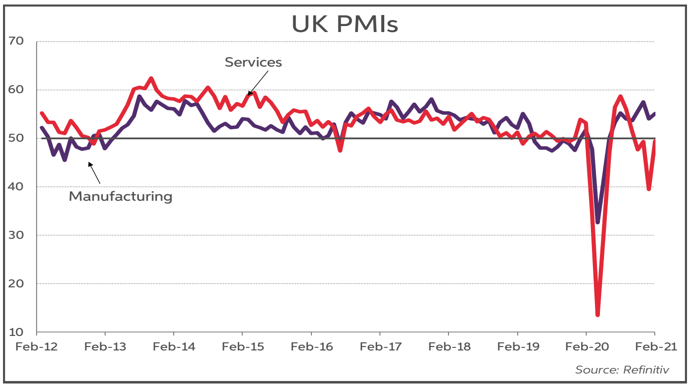
Vaccine rollout lays the foundation for GDP rebound

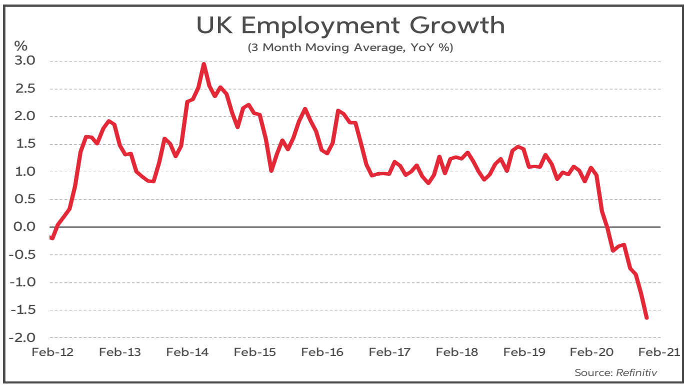


The economic recovery in the UK stalled in the final quarter of 2020. GDP grew by just 1%, as the UK battled a second wave to the coronavirus. Overall, output contracted by 9.9% in 2020. Regarding the underlying breakdown in Q4, household consumption edged lower by 0.2%. Government expenditure (+6.4%) and gross fixed capital formation (+2.1%) both increased in the quarter. A sharp rise in imports (+8.9%), outpaced a slight uptick in exports (+0.1%).

Survey data suggest that the divergence between the manufacturing and services sector has continued in 2021, reflecting the uneven impact of containment measures. Since June of 2020, the manufacturing PMI has printed in expansion mode as production was able to better adapt to social distancing measures. In Jan/Feb the manufacturing PMI averaged 54.6, slightly below its average in Q4 of 55.6, but still solidly in expansion territory and consistent with an increase in output. In contrast, the services PMI held steady just below the 50 threshold in Q4 and plunged to 39.5 in January, its lowest reading in 8 months, as a national lockdown was put in place to stem the surge in Covid-19 cases. The index rose to 49.5 in February, suggesting activity in the sector remains subdued.

GDP data shows that the UK economy contracted in January, falling by 2.9%, led by a sharp decline in the services sector. Services output fell by 3.5% m/m. Manufacturing output declined by 2.3% m/m also, partially reflecting a drop-off in activity that was brought forward ahead of the end of the Brexit transition period.

The Government's furlough scheme continues to shelter the labour market from the pandemic. The unemployment rate has been on a steady upward trend since the summer, rising to 5.1% in December from 3.9% in June. The government furlough scheme has been extended until September, beyond the expected June deadline for most of the Covid-19 restrictions to be eased, which should limit the rise in unemployed as the year progresses. Indeed, the claimant count fell by 20k in January.



In terms of inflation, the headline CPI rate rose from 0.6% to 0.7% in January. The core rate edged higher to 1.4% from 1.3% also. Overall, though inflation remains subdued, a sharp rise is expected this year. In particular a marked increase in energy costs, and the unwinding of most of the VAT cut will see inflation rise, as these transitory measures wash through the index. The BoE expects inflation to rise sharply towards 2% in Q2, and stay at this level through to 2023.

There are signs of optimism for the UK economy. The quick pace of the vaccine rollout has allowed the government to put in place a comprehensive roadmap to reopen the economy over the coming months, with most domestic restrictions set to be removed by the end of June. The Budget also left supports in place beyond the reopening, and introduced measures to boost investment over the next few years. Thus, the economy is primed to recover strongly from the Covid shock in 2021-2022. **The forecasts from the BoE's Monetary Policy Report in February, show that GDP is expected to rise by 5% in 2021 and 7.25% in 2022. Similarly, the OECD has UK GDP growth of 5.1% pencilled in for this year.**

However, longer term there are economic headwinds on the horizon that will need to be navigated carefully. To counterbalance increased spending over the next two years, Chancellor Sunak outlined a host of tax hikes, including to corporation tax in 2023, when economic supports have ended fully. By that stage global growth may have cooled somewhat as well. The "skinny" FTA signed with the EU last December will also act as a drag on UK exports over the coming years. **Indeed, the BoE projections from February also have UK GDP expanding by just 1.25% in 2023, much less than in the proceeding years.**

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