BoE Watch

AIB Treasury Economic Research Unit

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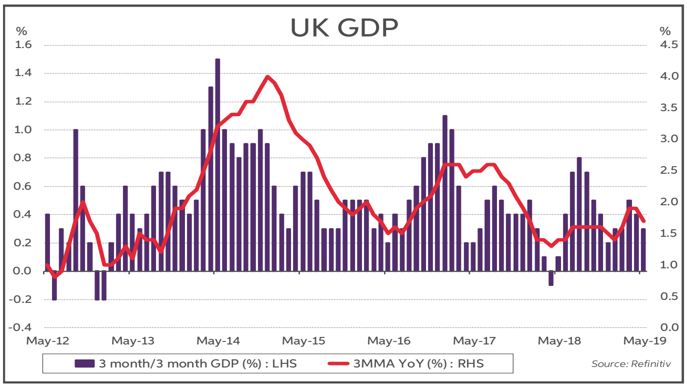
BoE in wait-and-see mode

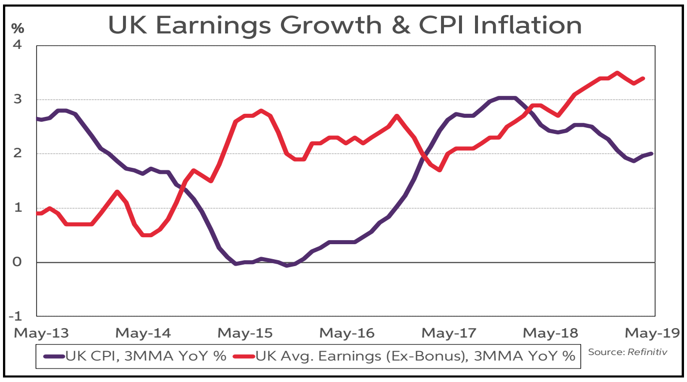
As expected, the August meeting of the Bank of England's Monetary Policy Committee (MPC) concluded with no changes to policy. The bank rate was left at 0.75%. The decision to leave rates unchanged was unanimous. The last time the rate was altered was back in August 2018, when it was raised by 25bps.

The meeting statement and minutes emphasised the difficulties facing the BoE in its policy deliberations due to Brexit. Indeed, in the press conference, Governor Carney referenced the impact that Brexit related uncertainty is having on UK macro data. He noted that UK GDP growth had become "more volatile than usual owing to stock building and plant shutdowns linked to Brexit". However, Governor Carney said that notwithstanding these temporary factors, the underlying pace of growth in the UK economy had slowed to "below-potential rates" due in part to a weaker global economy.



The BoE's comprehensive update to its view on the UK's economic outlook was detailed in the release of the latest Quarterly Inflation Report. The macro projections in the report continue to be based on the assumption of a relatively "smooth adjustment" following the UK's exit from the EU. The BoE is now expecting growth of 1.3% this year (previous f'cast was for 1.5%), 1.3% (was 1.6%) and 2.3% (was 2.1%) in 2021. Meanwhile, in terms of the inflationary outlook, the MPC latest forecasts show that it continues to anticipate that inflation will be above its 2% target in two years time and will still be on an upward trend at the end of its 3 year forecast horizon.

However, the BoE downplayed the significance of its latest macro forecasts. This is because these are conditioned on asset prices which have started to price in a greater risk of a hard Brexit (reflected in expectation of lower interest rates and a weaker sterling) which are inconsistent with the BoE's smooth Brexit assumption. Analysis carried out by the BoE suggest these prevailing asset prices have acted to boost its GDP and inflation projections.



In terms of market expectations, futures contracts indicate that the market is expecting the next move from the BoE to be a rate cut. A 25bps reduction in the bank rate is envisaged for the first half of 2020. This expectation is against the backdrop of increased concerns over the risks of a no deal hard Brexit and the weaker global macro environment. Back at the time of its last meeting in June, the market view was for no change to rates for a two to three year period.

Overall, today's update from the BoE indicates that it is very much in wait-and-see mode. It is awaiting clarity on how Brexit will evolve and the consequences this will have for its monetary policy outlook. If a no deal Brexit develops it is likely the BoE will act by cutting interest rates. Meanwhile, if its assumption of a smooth Brexit materialises, combined with "some recovery in global growth" then this could bring rate hikes back on the policy agenda for the BoE next year. In this regard, the BoE continues to be of the view that increases in interest rates, albeit at a gradual pace and to a limited extent, are required in order for it to achieve its inflation objective of 2%.

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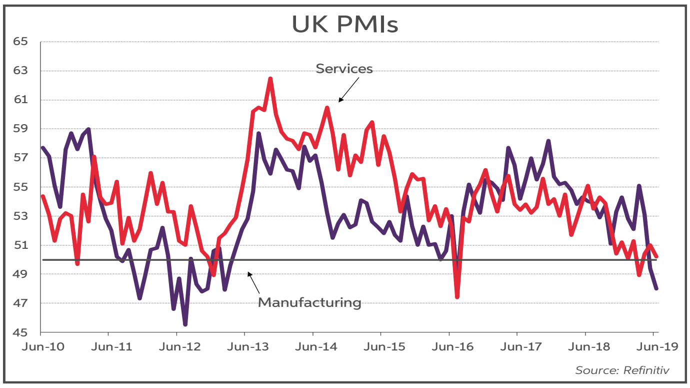
Growth slows as Q1 Brexit boost unwinds

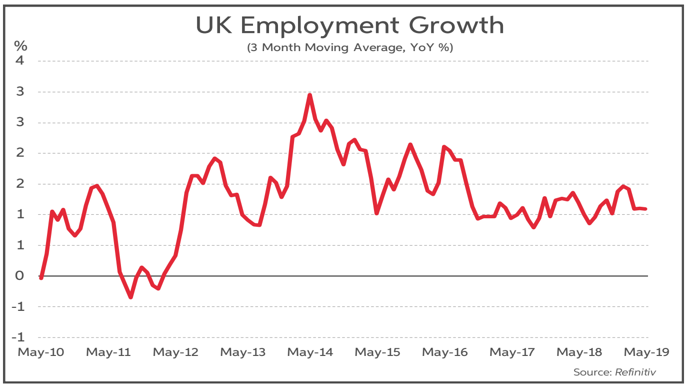
UK GDP expanded by a solid 0.5% in the opening quarter of 2019. Household spending drove growth in the quarter, contributing 0.4 percentage points (p.p,) to the total. However, this may have been due to consumers stockpiling ahead of the original Brexit date. Government spending was also mildly expansionary (+0.1 p.p.), while business investment rose for the first time in a year, albeit only slightly. Meanwhile, a large increase in inventories was offset by a widening of the UK's trade deficit.



The economy, though, lost significant momentum in Q2. The manufacturing PMI averaged 50.2 in the quarter, falling to 48.0 in June (held at this level in July). This is well below the key 50.0 level that separates expansion from contraction. This compares to Q1's 53.3 average, although that reading was pushed higher by the aforementioned Brexit boost to stock building activity. Meanwhile, the service sector index averaged 50.5 in Q2 (Q1 in 50.1), a level consistent with very weak growth. On the demand side, consumer sentiment, as measured by the GfK confidence index, remains well below 2018's levels.

The available 'hard' data also suggest that activity slowed markedly in the second quarter of the year. Indeed, the latest 3-month estimate of GDP, for the period to end-May, put growth at 0.3%. The underlying breakdown, which is by the output method, suggests that both the service and industrial sector are performing sluggishly. However, retail expenditure was relatively solid in the quarter. While it dipped in both April and May, it rebounded strongly in June, leaving the quarterly growth rate at 0.7%. Overall though, the expectation is that GDP growth was near flat in Q2.

Labour market developments have remained positive in the quarter. Numbers in employment continue to increase, with jobs growth holding at a solid 1.1% in the three months to end-May. The employment rate is close to an all-time record high. At the same time, the unemployment rate was put at 3.8%, a multi-decade low level. The tight labour market conditions have helped underlying earnings growth pick-up, most recently to a new cycle high rate of 3.6%.



However, despite the acceleration in wage inflation, price pressures remain subdued. Headline inflation has now held at the BoE's target rate of 2% for two consecutive months. At the same time, the core measure (ex-food & energy) edged up slightly to 1.8%, from 1.7%.

Overall, the outlook for the UK economy remains highly uncertain. Ultimately, its performance is contingent on the final form that Brexit takes. Until a clearer picture emerges, uncertainty is likely to continue to depress activity. **Furthermore, if the House of Commons is unable to pass a version of the Withdrawal Agreement or if the UK cannot obtain an extension to Article 50 from the EU by October 31st, the UK will leave without a deal.** A study by the Bank of England has shown that this would result in a marked decline in activity, with the impact likely to be frontloaded.

However, on a more positive note, the BoE looks set to maintain its accommodative policy stance this year. Last October's fiscally expansive budget, as well as the strong labour market which has aided consumer spending, should also boost activity. **The most recent BoE forecasts are for growth of 1.3% in 2019, followed by 1.3% in 2020. These are in-line with the IMF's projections for GDP growth of 1.3% in 2019 and 1.4% in 2020**. Note these forecasts are based on the assumption of a soft Brexit.

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