BoE Watch

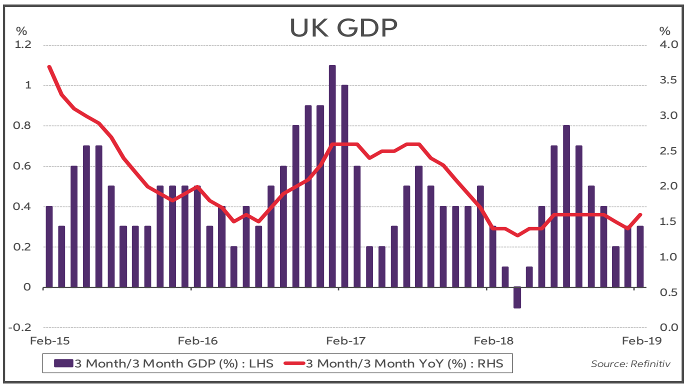
AIB Treasury Economic Research Unit

2nd May 2019

BoE remains in a holding pattern, for now

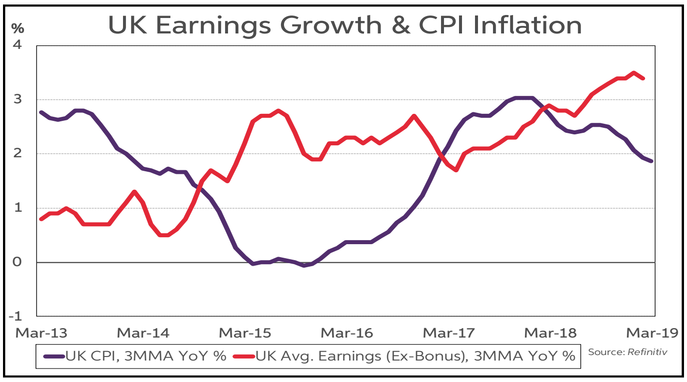
The Bank of England Monetary Policy Committee (MPC) meeting for May concluded in line with expectations, with no changes to policy. The bank rate was left at 0.75%. The last time the rate was changed was back in August 2018, when it was raised by 25bps. The decision today by the MPC to leave interest rates unchanged was unanimous.

In the accompanying press conference, Governor Carney outlined a more positive global backdrop compared to a few months ago. In this regard, he referenced the "further marked easing in global financial conditions" as well as the apparent abating of global trade tensions. The Governor also commented that the hard data suggests that the global growth "troughed towards" the end of 2018 and the data for early 2019 is consistent with a "modest pick up" in growth over the course of this year.



Meanwhile, in terms of the UK economy, the meeting minutes indicate that the MPC's assessment is that GDP growth appears to be "slightly stronger than previously anticipated". It is now forecasting GDP growth of 0.5% in the first quarter, boosted in part by a larger than expected impact from UK companies stockbuilding ahead of the original Brexit deadline at the end of March. However, it envisages this boost to be temporary in nature and is pencilling in quarterly growth of 0.2% in Q2.

The BoE's full updated assessment of the UK's economic outlook was detailed in the release today of its latest Quarterly Inflation Report. The projections outlined in the report continue to be based on the assumption of a relatively "smooth adjustment" following the UK's exit from the EU. The latest set of growth forecasts represent upward revisions compared to the February edition. The BoE is now expecting growth of 1.5% this year (previous f'cast was for 1.2%), 1.6% (was 1.5%) in 2020 and 2.1% (from 1.9%) in 2021.



Meanwhile in terms of the inflationary outlook, the MPC projects CPI inflation (currently at 1.9%) to fall slightly further below its 2% target in the first half of this year, mainly arising from its expectation of lower retail energy prices. **However, it anticipates inflation**, on the back of emerging excess demand and a firming in domestic inflation pressures, **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**.

In terms of market expectations, futures contracts indicate that the market is not anticipating any rate hike this year. Contracts suggest that the market is not envisaging a rate increase until the end of 2020, taking rates up to 1% and remaining at this level by the end of the BoE's three year forecast horizon in 2021.

Overall, the BoE retains a tightening bias, evident in its assessment that the economy will likely require rate hikes over the next three years. Given on-going Brexit uncertainty, a rate hike seems unlikely this year. However, Governor Carney remarked that current market expectations for the future path of the BoE Bank rate are "unequal to the task of achieving the MPC's remit". As a result, in the event of a soft Brexit, the BoE could tighten policy considerably earlier (possibly Q1 2020) and to a greater extent than markets currently expect. At the same though, the BoE continues to emphasise that any policy tightening will be gradual in pace and to a limited extent.

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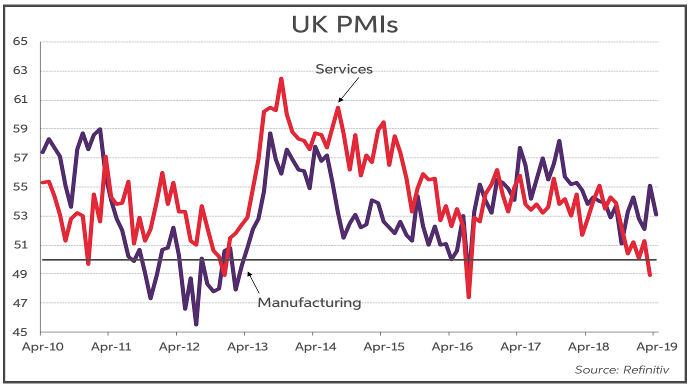
UK data more positive, but Brexit still a headwind

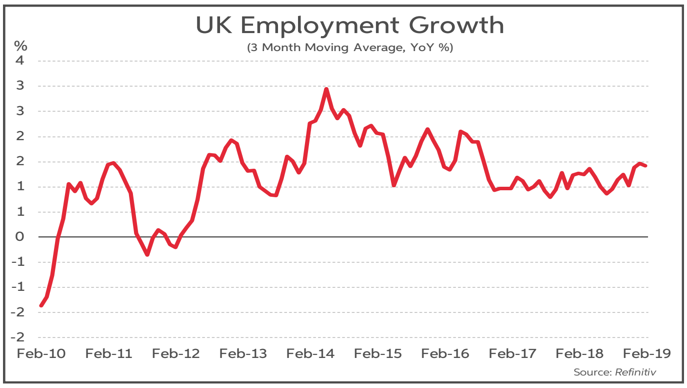


UK quarterly GDP growth slowed to 0.2% in Q4, from 0.7% in the previous quarter. The underlying data showed that while household and government expenditure contributed positively to growth, business investment and net trade acted as headwinds. GDP growth in 2018 came in at 1.4%, down from 1.8% in 2017, as Brexit related uncertainty continued to weigh on activity.

In terms of more timely updates, the latest monthly GDP estimate showed growth at 0.3% in the three months to February. The detailed breakdown, which is by the output method, showed that the service sector, as well as rising industrial output in early 2019, helped to drive growth in the period.

Survey data paint a mixed picture of economic activity in the opening quarter of 2019. In contrast to global trends, the UK PMIs suggest that the manufacturing sector is now performing better than the services. The manufacturing index moved up slightly in Q1 to 53.3, from 52.9. However, this was largely due to a significant jump in the index in March, related to Brexit stockpiling. This was partly reversed in April according to data released yesterday. Meanwhile, the services PMI dipped to 50.1 in Q1, barely above the level separately contraction from expansion, from 51.3 in the previous quarter. On the demand side of the economy, the GfK measure of consumer confidence index remains well below 2018 levels.

However, labour market data for the three month period to end-February were generally encouraging. Year-on-year employment growth, which has picked up since H2 2018, stood at 1.4% in the period. Meanwhile, the jobless rate dipped to 3.9%, a multi-decade low level. **Overall, the tight labour market conditions have helped boost earnings.** Underlying wage inflation has remained consistently above the 3% level since the autumn and was recorded at 3.4% in February. **However, price pressures have remained relatively contained in recent months.** Indeed, despite rising oil prices, headline CPI inflation held at 1.9% in March, just below the BoE's 2% target level.



The available 'hard' data for Q1 have been positive. For instance, retail sales figures were very encouraging. Sales rose by a strong 1.5% in the quarter as gains to real wages helped to boost consumer purchasing power. On the output side of the economy, industrial production was boosted by the impact of Brexit related stockpiling in the first two months of 2019, increasing by 0.8% on Q4 levels. Although, the trade deficit widened over the period, partly for the same reason.

Overall, in spite of better data recently, the outlook for the UK economy remains highly uncertain. Until a clearer picture on Brexit emerges, uncertainty will continue to act as a headwind to business investment. At the same time, the slowdown in global growth may also act as a drag on activity. However, on a more positive note, the BoE looks set to maintain its accommodative policy stance this year. October's fiscally expansive budget, as well as the strong labour market which has aided consumer spending, should also support activity.

The most recent BoE forecasts are for growth of 1.5% in 2019, followed by 1.6% in 2020, somewhat above the IMF's projections of 1.2% GDP growth in 2019 and 1.4% in 2020. However, these forecasts are based on a smooth exit by the UK from the EU. A disorderly hard Brexit would result in much weaker growth in 2019 and beyond, as suggested by BoE research.

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