BoE Watch

AIB Treasury Economic Research Unit

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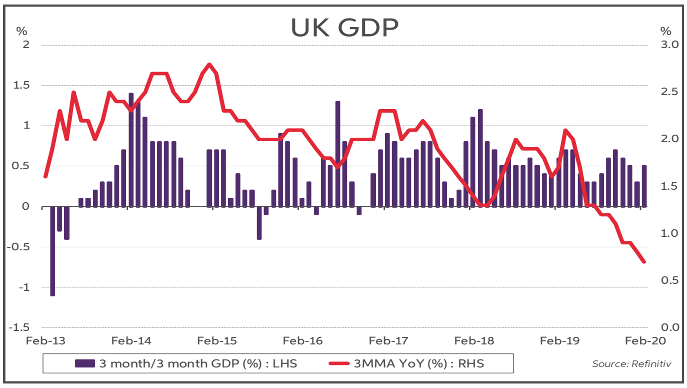
BoE leaves policy unchanged but stands ready to do more

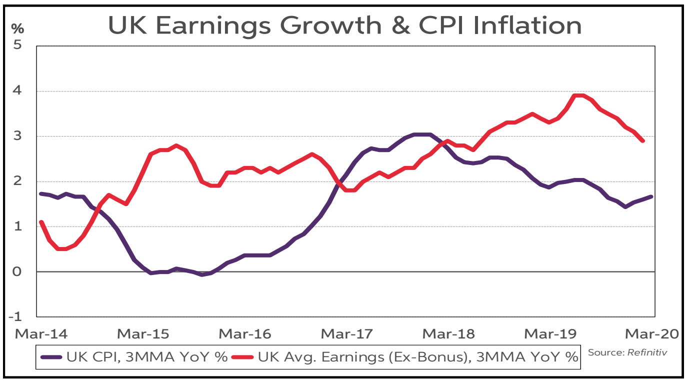
The May meeting of the Bank of England's Monetary Policy Committee (MPC) concluded with no changes made to policy. The Bank Rate was left at 0.1%, while the central bank opted against increasing the size of its QE programme above £645bn. The decision was not unanimous, with two members instead voting to increase the latter by £100bn. The meeting statement, press briefing and minutes emphasised that the central bank stands ready to do more to support the economy, if necessary.



Since the onset of the Covid-19 crisis, the central bank has acted aggressively. This has included cutting the Bank Rate by a total of 65pbs, leaving it at a record low of 0.1%. It also announced another round of QE, adding another £200bn assets to its holdings, thereby increasing its portfolio to £645bn. As well as this, the central bank agreed to expand the government's overdraft facility, in effect allowing for temporary monetary financing. On the liquidity side, the central bank moved to support businesses by introducing a corporate financing facility and a SME term funding scheme.

In the meeting statement, the BoE acknowledged that the onset of the Covid-19 crisis has led to a "sudden and very marked drop" in activity, while "unemployment has risen markedly". It noted there has been some stabilisation in the timeliest UK indicators, but at very low levels. The central bank emphasised the uncertain outlook facing the UK economy as the future path for growth will depend on "the evolution of the pandemic, and how governments, households and businesses respond to it". **Given the lack of clarity, producing accurate projections is a difficult task. Therefore, the BoE produced the forecasts contained in the May Monetary Policy Report using an "illustrative scenario".** The central bank assumed the lockdown will remain in place until early June, with restrictions then gradually removed by end Q3.

In the above scenario, the BoE projects falls in GDP of 3% in Q1 and 25% in Q2 as consumption and business investment plummet. Activity is then expected to rebound quickly in H2, but full year growth is put at –14%. The central bank expects minimal scarring from the shutdown, essentially allowing for a V-Shaped recovery. As a result, output growth is estimated at 15% in 2021. The unemployment rate is seen peaking at 9% in Q2, reflecting the assumed success of the government payroll retention scheme in preventing bigger lay-offs, before declining back down to 4% by 2022. With regard to inflation, headline CPI is seen averaging 0.6% in 2020 before rising back up to 2% in 2022.



The meeting statement acknowledges the optimism embedded in the forecast, noting that "the balance of risks to the economic outlook lie to the downside". One such downside risk regarding the projected strong recovery in activity is the **assumption of minimal scarring**. A second risk is the possibility of a **second wave to the virus** which may necessitate the re-introduction of restrictions later in the year. Finally, the analysis does not allow for the **potential re-emergence of Brexit related uncertainty** in the latter half of the year and assumes a comprehensive trade deal will be agreed with the EU by end-2020.

In terms of the monetary policy outlook and the possibility of more action, the BoE commented that it is ready to respond further if necessary. In the lead-up to the meeting it was noted that the central bank is on track to use up the £200bn QE envelope announced in March by July. However, the meeting minutes stated that the MPC felt there was "value in waiting" for information related to how the economy would re-open before increasing asset purchases. The UK government is expected to announce this Sunday its exit strategy. In relation to the Bank Rate, it is widely held that it is at its effective lower bound. However, it is worth noting that Governor Bailey stated that while negative rates are unlikely, he "thinks it's wise not to rule anything off the table". Futures contracts are not pricing in any further cuts and so see rates remaining positive. **There was little market reaction to the meeting.** Sterling saw some support following the policy announcement, but it proved temporary. There was also a negligible reaction in the Gilt market.

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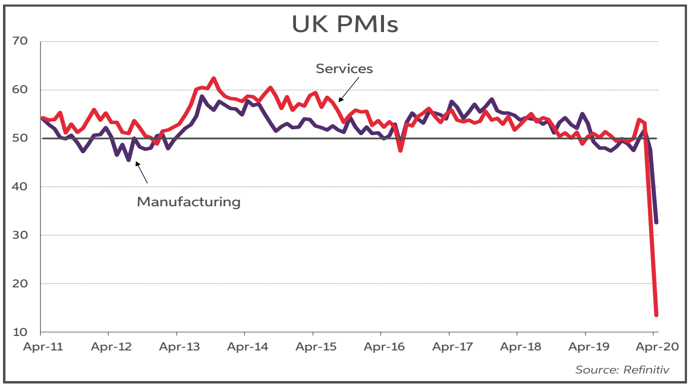
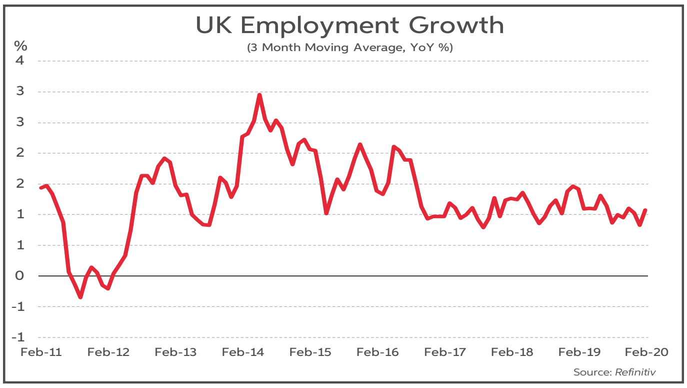
Covid-19 sees UK enter deep recession

Prior to the onset of the Covid-19 crisis, the UK economy was already struggling, having stagnated in the final quarter of Q4. The year-on-year growth rate slowed to just 1.1%, which left the average annual rate for 2019 at 1.4%. In the quarter, government spending carried activity, adding 0.3 percentage points (p.p.) to growth. Consumer spending made a negligible contribution, reflecting the impact of Brexit uncertainty, while fixed investment subtracted 0.2 p.p..



The first evidence of the economic impact from the virus outbreak was seen in the Markit PMIs for March. The composite index sank from 53.0 to 36.0, primarily driven by a sharp fall in the services component, which dropped from 53.2 to 34.5. In contrast, the scale of the decline in the manufacturing PMI was less severe, with the output sub-index declining from 52.2 to 43.9. **Meanwhile, the only available 'hard data' that do not precede the crisis are March retail sales figures.** Predictably, retail expenditure plummeted by 5.1% on a month-on-month basis as shops closed. April data will be even worse given lockdowns were implemented only halfway through the March survey period.

With regard to the labour market, the most recent figures pre-date the Covid-19 lockdown. In the 3 months to February, year-on-year employment growth held close to the 1% level it has hovered around in the past year, while the jobless rate edged up to 4.0%, from 3.9%. Underlying wage inflation also eased to 2.9%. Looking ahead, the outlook for the labour market is grim. While the UK government's moves to encourage firms to keep employees on payroll will provide some protection, the unemployment rate is still set to spike higher. Some 1.8 million have filed for jobless benefits since mid-March, six times the normal claimant rate.



On the inflation front, headline CPI moderated to 1.5% in March from 1.7%. The sharp fall in oil prices will see this rate decelerate further in the coming months. The core rate, which was put at 1.6% in March, will also ease on the back of declining domestic demand.

Turning to Q2, the limited data that have been released point to a severe economic contraction. The PMIs collapsed in April, with the composite index dropping to a historic low of 13.8. With regard to the breakdown, the services index was put at just 13.4. The output subcomponent of the manufacturing PMI dropped to just 16.3. On the demand side, the GfK measure of consumer confidence also dived in April.

Overall, as elsewhere, the outlook for the UK economy is contingent on how long Covid-19 restrictions remain in place and to what extent 'normal life' can resume thereafter. The ongoing lockdown has seen economic activity come to a virtual standstill. An exit strategy is due to be announced this Sunday, but restrictions will be lifted only gradually. Action taken by both the UK government and the BoE will provide some support to the economy as it re-opens. The former has ramped up fiscal spending, rolled out state guarantees for loans and established income replacement schemes to reduce the scale of lay-offs. The latter has provided significant monetary stimulus and put in place liquidity supports for businesses.

Nonetheless, the UK has entered a deep recession. Consumer spending will plunge in H1 due to the combined impact of the closure of businesses and rising unemployment. The abysmal macro backdrop will also weigh heavily on investment. **The economy should, though, rebound in the second half of the year, as restrictions are lifted.** The IMF is forecasting that GDP will contract by 6.5% this year. Growth of 4% is forecast for 2021 assuming a second wave of the virus is avoided. In an illustrative scenario released today, the BoE estimates that GDP could contract by a much starker 14% in 2020, though it is also projecting a strong bounce back in 2021, with growth projected at 15%. Note, these forecasts also assume that a comprehensive free trade agreement with the EU is in place at the beginning of next year.

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