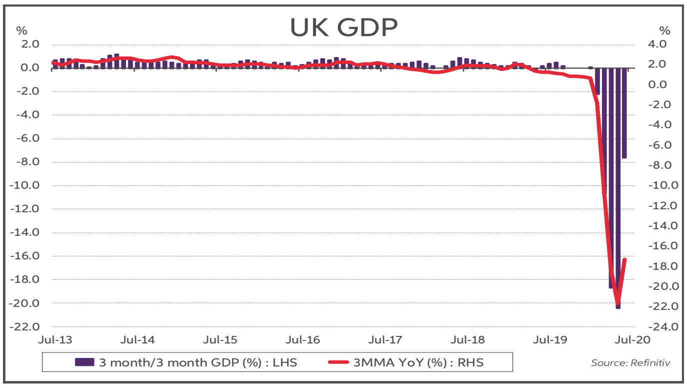
BoE Watch

AIB Treasury Economic Research Unit

17th September 2020

BoE maintains current policy stance

The Bank of England's Monetary Policy Committee (MPC) meeting for September concluded in line with expectations for no changes made to policy. The Bank Rate remained at 0.1%, having been cut by a total of 65bps earlier in the year in response to the economic fallout from the Covid-19 crisis. The BoE is also currently implementing a £100bn expansion (announced back in June) to its QE programme, which will see its total stock of assets at £745bn by the turn of the year. The MPC voted unanimously to maintain rates at their current level and leave QE unchanged.

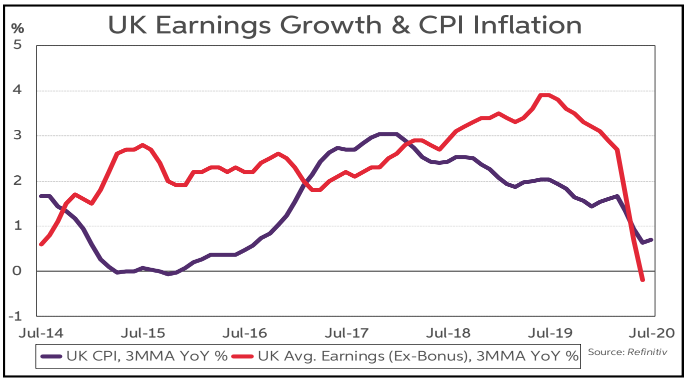


The BoE continued to emphasise that the economic outlook for the UK remains unusually uncertain. There are two key sources of this uncertainty. Firstly, the path of growth and inflation will be heavily dependent on the evolution of the pandemic and the measures taken to deal with the public health aspects of this. Secondly, the uncertainty over the outcome of the current trade talks between the UK and EU and the move to a new relationship at start of 2021.

However, the BoE in its meeting statement and minutes did acknowledge that recent incoming data have been better than expected in some areas. It noted that high frequency payment data suggest that consumption has recovered at a stronger than expected pace compared to when it was compiling its August macro forecasts. However, it also stated that investment dynamics remained very weak and uncertainties among businesses remained high. It should be noted that a key assumption underpinning these forecasts is for an orderly and comprehensive UK-EU free trade agreement.

From a growth perspective, the Bank is now expecting Q3 GDP to be stronger than anticipated in August. It is now pencilling in the size of the economy to be around 7% below its Q4 2019 level. As a result, it will likely be revising upwards the 9.5% contraction it had forecast for 2020 when it releases its next forecasts in November (subject obviously to no change in its Brexit assumption). This would be in keeping with the revisions by both the ECB and Fed recently, which have seen their 2020 contraction forecasts, for their respective economies, become less severe.

On the inflation front, it continues to be of the view that CPI inflation will remain below 1% until early 2021, albeit not quite as low as it had been envisaging during its August forecasting round. These projections are for headline CPI to rise to 1.75% by end 2021, reaching its 2% target in the second half of 2022, before rising above this level in 2023.



It is clear, though, that the BoE retains a bias to ease policy further if required. It continued to state that it will adjust monetary policy accordingly to meet its remit, including saying that it "stood ready to increase" its asset purchase programme to ensure the effective transmission of monetary policy.

Its forward guidance also continues to indicate that the BoE will not rush into raising rates in a scenario where inflation moves above 2%. This is based on its assertion that it does not intend to tighten policy "until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably".

However, it remained non-committal on the introduction of negative interest rates, preferring to keep its options open in this regard. In the meeting statement, the Bank said that following the discussion that took place in the August Monetary Policy Report on the effectiveness of negative policy rates, BoE officials have subsequently briefed the MPC on how such a policy could be implemented effectively if the economic outlook warranted it. **In terms of market expectations, against the backdrop of elevated Brexit concerns, futures contracts indicate the market has not ruled out the possibility of the Bank Rate moving into negative territory, with around 15-20bps of additional easing being currently priced in from its current level of 0.1%.**

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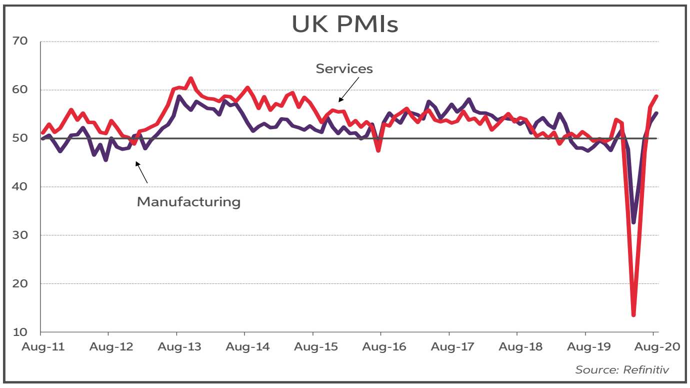
UK recovery continues, but challenging outlook

The UK economy contracted by 20.4% in the second quarter of 2020, leaving the annual growth at –22%. The decline was the largest on record for the UK, with the economy being one of the worst impacted by the Covid-19 recession. This largely reflected the long duration of the UK restrictions. In terms of the breakdown, household expenditure plummeted by 25.2%, while business investment collapsed by 31.3%. Government expenditure also fell 16.9% though net trade pushed GDP higher.

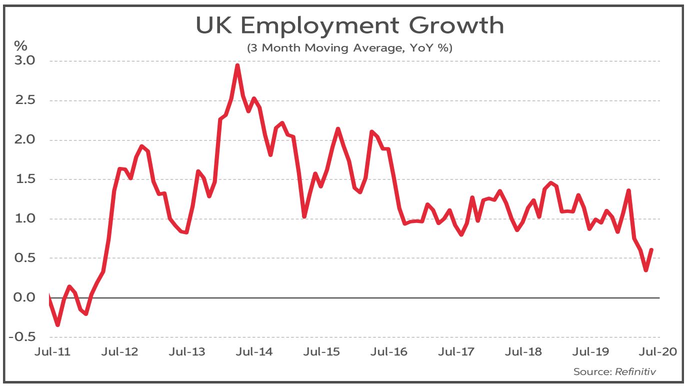


GDP contracted sharply in March and especially April. Activity staged only a slight recovery in May (+2.4%), reflecting the fact restrictions largely remained in place during the month. A more pronounced rebound was apparent in June (+8.7%) and this continued in July (+6.6%). Although the economy has staged a recovery, output in July was still 11.7% below the pre-pandemic levels.

Most other hard data for July also suggest a continuing recovery. Retail sales for July were up 3.6% on the month, after rising by 13.9% in June. This pushed retail sales 3% above their pre-Covid levels. Industrial output has also continued to trend upwards. Production increased by 5.2% in July, although it remains down by 7.8% on last years level. **PMI data for August suggest there may be more life to the recovery yet.** The services PMI moved to 58.8 from 56.5 a month previous, while the manufacturing PMI remained expansionary for the third month running, rising higher to 55.2 from 53.3. However, on the demand side, the Gfk consumer confidence index for August remained at a very subdued –27.

The labour market continues to be sheltered by the Government's furloughing scheme. Nonetheless, the unemployment rate has ticked higher in July to 4.1% from 3.9%. However, the unemployment rate is expected to rise later in the year, with the Job Retention Scheme due to be wound down in October, although there have been suggestions recently that it could be extended.

A sharp fall in inflation saw the headline CPI figure drop to 0.2% in August from 1% a month previous. The core rate also registered a sharp decline to 0.9% from 1.8%. The recent cut made to the VAT rate applied to the hospitality sector and the "Eat Out to Help Out" scheme, combined with the negative demand shock stemming from the crisis dampened inflation. The ending of these schemes will likely see prices rise in the coming months but inflation is unlikely to reach 2% anytime soon.



Despite the continued improvement in macro data, the outlook for the UK economy remains very challenging. The likely deterioration of the labour market will act as a significant headwind to consumer spending, as will heightened levels of uncertainty linked to concerns over the likelihood of rolling Covid-19 related restrictions. On top of this, recent negative Brexit newsflow is adding to uncertainty.

The government's continued fiscal support and the BoE's monetary policy stimulus are providing support to the economy. Nonetheless, scarring effects from bankruptcies and job losses will weigh on the recovery in 2021, especially if the Job Retention Scheme is wound down. **Nevertheless, growth will be strong next year given the recovery will be from a very low base in 2020.** The latest forecasts from the BoE, based on the assumptions that there will not be a second wave, and the UK and EU agreeing a FTA, sees GDP contracting by 9.5% in 2020, before rebounding by 9% in 2021. This would leave output less than 2% below its 2019 level. However, both the IMF and OECD are much more pessimistic in their respective outlooks. The IMF's current projections are for UK GDP to fall by 10.2% in 2020 before recovering by 6.3% in 2021, while the OECD expects output to fall by 10.1% before recovering by 7.6% in 2021. The large divergence in the economic forecasts highlight that the economic outlook remains unclear, although the risks remain to the downside.

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