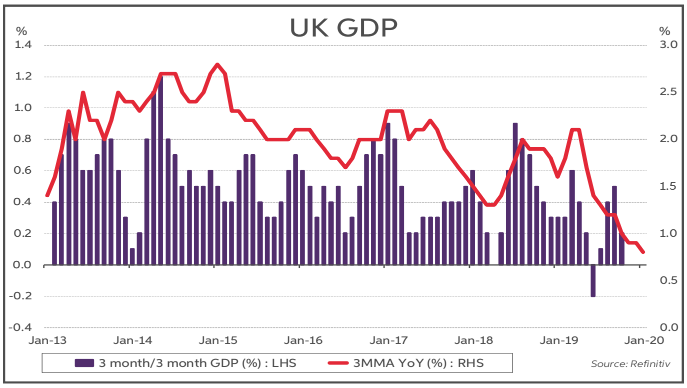
BoE Watch
AIB Treasury Economic Research Unit
26th March 2020

BoE ready to do more if required

The scheduled Monetary Policy Committee (MPC) meeting for March concluded with no changes to its current policy stance. There was unanimity within the MPC on this decision. This was in line with market expectations as the BoE had already this month, over the course of two special meetings, introduced various forms of monetary stimulus to support the economy and ease financial market disruption amid the coronavirus crisis.

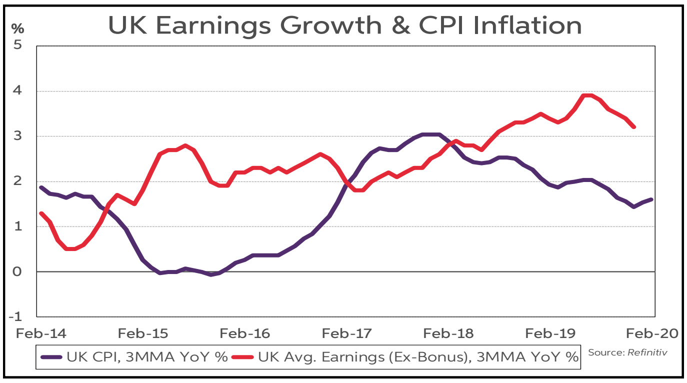
These measures included rate cuts totalling 65pbs, leaving the Bank Rate at an all-time record low of 0.1%. The BoE also restarted net asset purchases, announcing £200bn of additional QE, thereby increasing the size of its holdings to £645bn. The majority of these new purchases will comprise UK gilts, but some sterling non-financial investment grade bonds will also be purchased.

On top of this, the central bank introduced other measures to support UK businesses, including a corporate financing facility and a term funding scheme for SMEs. It also announced that it was reducing the countercyclical capital buffer rate to 0% to improve the ability of banks to supply credit to both household and businesses.



In the meeting statement, the BoE emphasised the very difficult and uncertain economic outlook arising from the disruption to activity caused by the spread of Covid-19. It noted the likelihood of a sharp fall in global GDP in the first half of the year ,combined with the probability of a rapid rise in unemployment across a range of economies.

Against the backdrop, the central bank stated that a very sharp reduction in economic growth is likely in the UK economy. However, it did not provide a forecast of the size of the decline in activity that it is expecting, other than to say that initial survey data is consistent with a "material contraction in GDP". It referenced the near term drag on activity across all sectors of the UK economy, including consumer spending, business investment and exports.



The BoE also pointed out that given the severity of the disruption, there is a risk to the economy of "longer term damage", especially in relation to the potential for large scale business failures and/or very large increases in unemployment. However, if the degree of job losses and business failures can be "minimised", the BoE believes that while the scale of the economic shock will be "large and sharp", it should "ultimately prove temporary".

In terms of the monetary policy outlook and the possibility of further action, the BoE commented that it is ready to respond further if necessary to prevent an unwarranted tightening in financial conditions and to support the economy. In this regard, the BoE left open the possibility of an increase in the size of its QE programme**.** It stated that "if needed, the MPC can expand asset purchases further".

However, there was no reference in the meeting minutes to a discussion on reducing the Bank Rate any further, which suggests that rates are now at their lower bound at 0.1%. The BoE has in the past indicated that it was unlikely to adopt a zero or negative interest rate policy. **This viewed is shared by markets with futures contracts indicating that the market expects no further rate cuts.**

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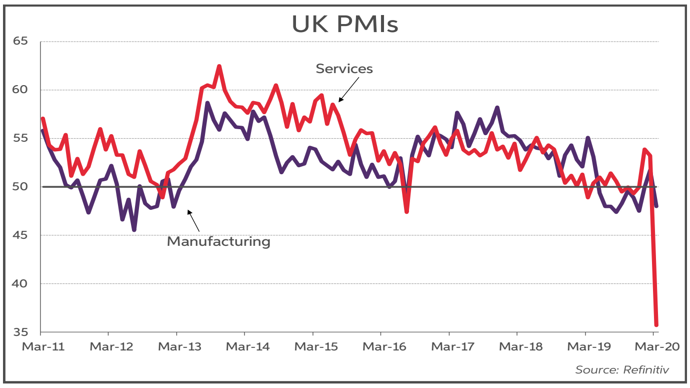
Coronavirus to see recession in UK in H1 2020

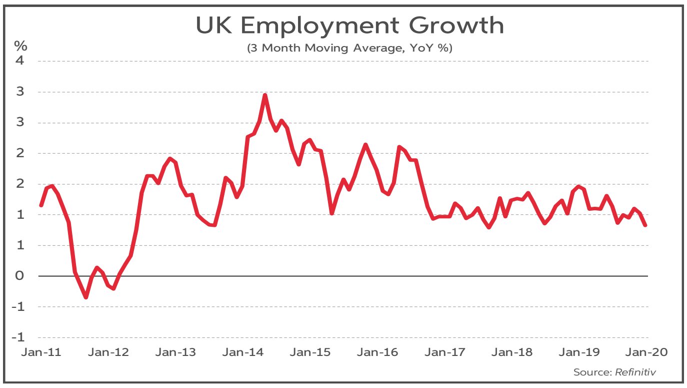
Having expanded by 0.5% in Q3, the UK economy stagnated in the final quarter of Q4. The year-on-year growth rate slowed to just 1.1%, which left the average annual rate for 2019 at 1.4%. In the quarter, government spending carried activity, contributing 0.4 percentage points (p.p.) to growth. Consumer spending made a negligible contribution, reflecting the impact of Brexit related uncertainty at that time, while fixed investment subtracted 0.3 p.p.. Net trade was mildly contractionary.



The available 'hard' data for the first couple of months of 2020 have been disappointing, despite pre-dating the onset of the coronavirus. The monthly estimate of GDP once again flat-lined in January, leaving the moving 3-month-on-3-month growth rate at 0%. In January, the industrial sector continued to struggle, with output down 0.1% in the month. On the demand side, retail sales have increased by just 0.2% in January/ February on Q4 levels.

The first evidence of the economic impact from the virus outbreak can be seen in the flash Markit PMIs for March. The composite index plummeted from 53.0 to a historic low of 37.1, primarily driven by a sharp fall in the services sub-component, which dropped from 53.2 to 35.7. In contrast, the scale of the decline in the manufacturing PMI was less severe, with the index moving from 51.7 to 48. The fall would have been greater but for an increase in the suppliers' delivery time subcomponent, which ironically was caused by the disruption to supply chains due to the virus outbreak. It is worth noting that the PMI surveys were carried out prior to the imposition of the three week lockdown. As a result, we would expect the final prints of the indices to paint an even worse picture of activity.

With regard to the labour market, employment increased by 184k in the three months to January. This saw the year-on-year growth rate slow to an over two year low of 0.8%. As a result, the jobless rate edged slightly higher to 3.9%, from 3.8%. There has also been a marked easing of underlying wage inflation since last summer, with earnings growth slowing to 3.1% from 3.9% in July. Looking ahead, the outlook for the labour market is bleak. While the UK government's moves to encourage firms to keep employees on their payroll will provide some protection, the unemployment rate is still set to spike higher.



On the inflation front, price pressures were relatively subdued ahead of the virus outbreak. In February, lower oil prices saw the headline rate of CPI ease to 1.7% from 1.8%. The core measure was also registered at 1.7%.

Overall, as elsewhere, the outlook for the UK economy is contingent on how long it takes for the coronavirus to subside and to what extent normal life can resume thereafter. The lockdown measures that have been put in place for the next three weeks at minimum will hurt many sectors. The UK government has taken significant action to help firms cope from the associated economic fallout, with state guarantees put in place for loans to firms that are struggling due to reduced cash flow. As mentioned above, income replacement schemes have also been established to encourage firms to keep employees on their payrolls, which will reduce the scale of lay-offs and provide support for consumer spending.

Nonetheless, the economy will enter a deep recession in H1 2020. The economy will, though, rebound in the second half of the year, assuming the coronavirus abates, allowing restrictions to be lifted. It is hoped that the measures introduced by both the government and the BoE will aid the recovery, but a significant fall in GDP will still occur in 2020.

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