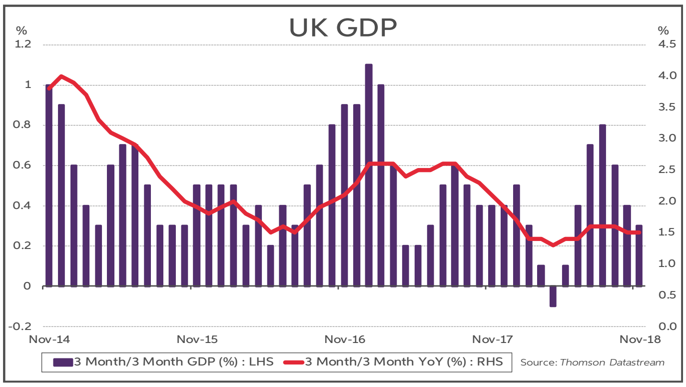
BoE Watch

AIB Treasury Economic Research Unit

7th February 2019

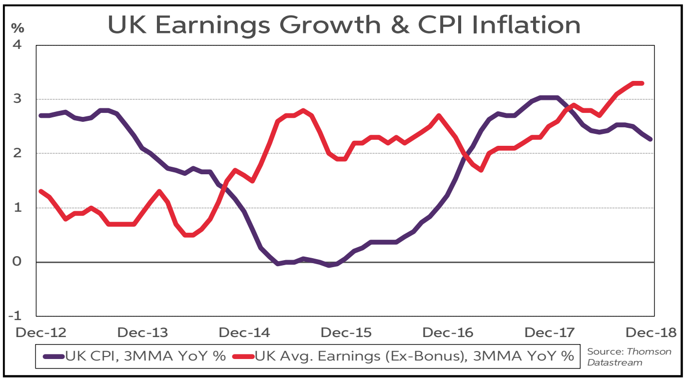
BoE waiting for Brexit fog to clear

The first Bank of England Monetary Policy Committee (MPC) meeting of 2019 concluded as expected with no changes to policy. The bank rate was left at 0.75%. It was last raised by 25bps at its meeting back in August 2018. The decision today by the MPC to leave interest rates unchanged was unanimous. **It was clear from the meeting statement, minutes, Inflation Report and Governor Carney's press conference that the BoE is adopting a much more cautious approach to the economic outlook and in turn the evolution of its monetary policy.** This is in keeping with the trend from other central banks recently, including the US Fed, which have embraced a more patient approach to their policy outlook in light of a more uncertain global economic outlook.



Of course, the BoE had already been in somewhat of a pause mode as it awaits the outcome of Brexit before determining its next course of action. Governor Carney elaborated further today on what he called "The Fog of Brexit". He referenced a "series of tensions" for the different sectors of the economy. In terms of businesses, he stated that the "economy as a whole is still not prepared for a no-deal" Brexit. He also referenced the weakness in business investment, estimating that it is likely to "have fallen 3% over the past year".

Meanwhile, for households, the Governor cited falling consumer confidence despite a strong labour market and how it is possible that Brexit uncertainty is "holding back spending on durables, including cars and housing". He also mentioned tensions in financial markets, commenting that a "variety of risk premia on UK assets are elevated". On top of this, a further complicating factor for the BoE due to Brexit uncertainty is the resulting greater than usual short term volatility in UK data. As a result, the data may provide less of a signal about the medium term outlook.



The more cautious outlook from the BoE amid heightened Brexit uncertainty and a slowing global economy **were reflected in its updated forecasts contained in the February Quarterly Inflation Report.** Once again, the projection in the report are based on the assumption of a "relatively smooth" Brexit transition for the UK economy. It is now expecting **growth of just 1.2% this year, compared to previous forecast for 1.7%. It also downgraded its projection for 2020 to 1.5% (from 1.7%),** but raised its 2021 forecast to 1.9% (from 1.7%). Meanwhile in terms of the inflationary outlook, while the MPC expects CPI inflation to fall slightly below its 2% target in the near term, it still envisages it settling "a little above the target" over the medium term.

In terms of market expectations, futures contracts indicate that the market is not anticipating any rate hike this year. Indeed, these contracts suggest that the market is not envisaging a rate increase until end 2020, with another one not expected till end 2022. **The BoE's assessment is that the economy will not likely require any rate hikes in the near term.** However, over the medium term, it expects that excess demand 'will likely build' resulting in above target inflation. Therefore, the MPC judges that ongoing, gradual tightening of monetary policy will be required over the next 2-3 years to "return inflation sustainable to the 2% target". With inflation expected above target in 2020 and 2021, this may require the Bank to have one additional rate hike to the one the market is expecting over this period.

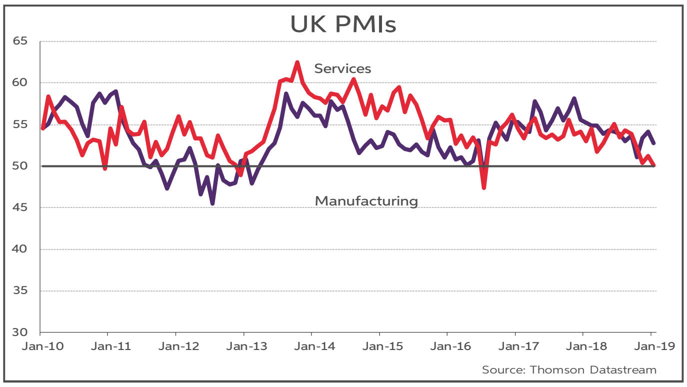
Oliver Mangan
Chief Economist
oliver.n.mangan@aib.ie

John Fahey
Senior Economist
john.j.fahey@aib.ie

Conor Beakey
Economist
conor.x.beakey@aib.ie

Uncertain economic outlook

UK GDP rose by a strong 0.6% in Q3 2018, improving on Q2's solid 0.4% growth rate and Q1's anaemic 0.1% rise. The underlying data show that household expenditure and changes in inventories drove growth in the quarter. **In a timelier update, the ONS' monthly GDP estimate indicates that the economy lost some momentum in the closing months of last year.** GDP growth slowed to 0.3% in the three month period to end November, as the temporary boost to activity in the summer faded. The detailed breakdown, which is by the output method, showed that the service and construction sectors drove growth in the period, while industrial production was a drag.



Other hard data available for Q4 also suggest that growth slowed in the quarter. For instance, retail sales declined by 0.2% in Q4, despite a 'Black Friday' boost to sales in November. This followed the rise of 1.3% recorded in Q3. The weak Q4 performance may in part have reflected the impact of increased Brexit uncertainty. Industrial production figures have also been very disappointing. As of November, output had declined by 1.1% on Q3 levels. Meantime, the trade deficit has been broadly static in the quarter.

Labour market data have remained generally positive to-date in Q4. Year-on-year employment growth edged down slightly to 1%, from 1.2%, in the three month period to November. However, the unemployment rate fell back to its August low of just 4.0%.

The tightness of the labour market now appears to be manifesting itself in higher wage inflation. The yearly growth rate of underlying earnings was recorded at 3.3% in November, a 10-year high. Meanwhile, the recent drop in energy prices saw headline CPI inflation moderate to 2.1% in December, from 2.3%. The core measure edged up slightly to 1.9% in the month, from 1.8%.

The limited survey data available for January suggest that economic growth remains sluggish as 2019 gets underway. The manufacturing PMI slipped back to 52.8 in January, having been boosted to 54.2 by the impact of Brexit stockpiling in December. Meanwhile, the services index fell to 50.1, its lowest level since July 2016. Consumers also remain downbeat, likely reflecting on-going Brexit uncertainty. The GfK measure of consumer confidence held at December's low level in January.

Overall, the outlook for the UK economy is highly uncertain. October's fiscally expansive budget, combined with a still very accommodative monetary policy stance, should help to support growth. However, the economy's performance is contingent to a large degree on the nature of the UK's exit from the EU. Today's BoE forecasts are for growth of 1.2% in 2019, followed by 1.5% in 2020. The European Commission forecasts released today are for GDP growth of 1.3% in both years. 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. A recent Bank of England analysis suggests the economy would likely enter recession in this scenario.