Bank of England Watch

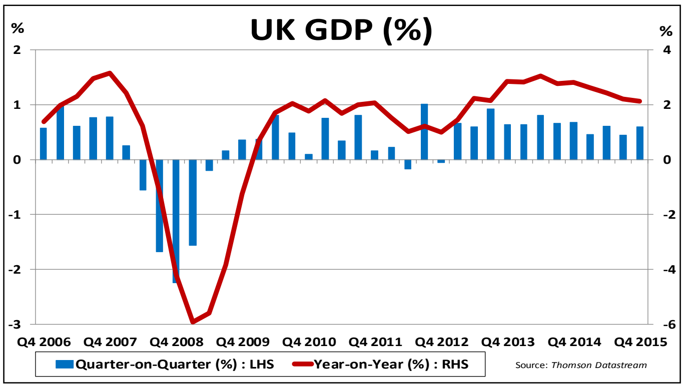
14th April 2016

AIB Treasury Economic Research Unit

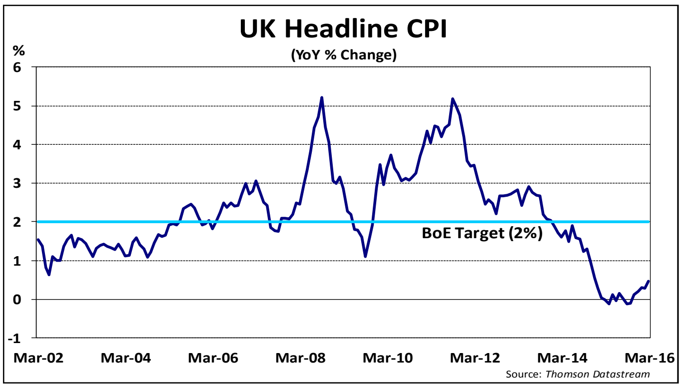
MPC cognisant of Brexit related uncertainty

The April meeting of the BoE's Monetary Policy Committee (MPC) concluded today, with no changes to policy as expected. For a third consecutive month, the decision to leave the Bank Rate unchanged, at 0.5%, was unanimous. The **minutes stated that "developments over the past month had done little to change the broad outlook for activity and inflation".**

The decision to leave policy on hold takes place against a backdrop of very weak inflation in the UK economy. Indeed, while headline CPI inflation increased in March to 0.5% (from 0.3%), it "remains well below the 2% inflation target". **The MPC's assessment of productivity and wage inflation trends implied that "growth in unit wage costs" were below levels "consistent with meeting the inflation target in the medium term".** The MPC also took a cautious view on the pick-up in inflation, noting it had been boosted by "a rise in airfares related to the timing of Easter" which was unlikely to be sustained in April, causing inflation "to drop back slightly". **Nonetheless, "expectations remained for a gradual pickup" in inflation** over the next twelve months as the "impact of past falls in energy and food prices dissipated".



One noticeable development at the April MPC meeting was the increased level of discussion that took place on the upcoming 'In-Out' EU referendum. The MPC commented that there had been "signs that uncertainty relating to the EU referendum had begun to weigh on certain areas of activity". It stated that business surveys "had reported a softening in investment intentions, consistent with expenditure decisions being deferred" pending the referendum outcome. It referenced survey evidence that referendum uncertainty "might be affecting hiring intentions". The minutes mentioned that it was "possible that referendum-related uncertainty would have a more pronounced effect on household sentiment and behaviour as the vote drew nearer". The MPC also stated that "referendum effects" would make it "harder to interpret" macroeconomic and financial market data over the coming months and therefore it was likely to "react more cautiously to the data news". In its discussion of the likely implications of a vote to leave the EU, the MPC said that "such a vote might result in an **extended period of uncertainty about the economic outlook",** as well as "significant implications for asset prices, in particular the exchange rate".



Overall, the **April BoE meeting statement/minutes reinforces the view that the MPC is still some way off from starting the rate tightening cycle** in the UK. Futures contracts, indicate that the **market does not envisage a UK rate hike materialising until the second half of 2018.** There is only one rate hike priced in for 2018, which would bring the Bank Rate up to just 0.75% by end-2018. **However, as we have stated previously, markets may be too dovish with their UK rate hike expectations.** With the UK unemployment rate already down near 5%, we could see the BoE hiking rates next year, if the UK economy continues to grow solidly, the downside influence on prices from commodity markets ease and domestic cost pressures start to help push inflation up closer to the MPC's 2% inflation target. In the meantime, we await the release of the May Inflation Report (12th May) for a more comprehensive and up-to-date insight into the Bank's views on the economic outlook, and the timeframe for policy tightening.

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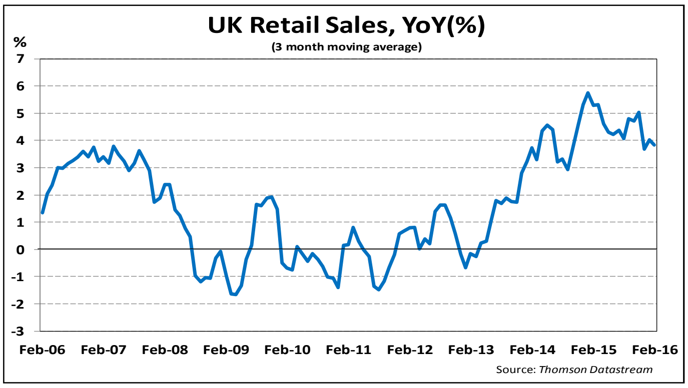
Moderate growth expected to continue

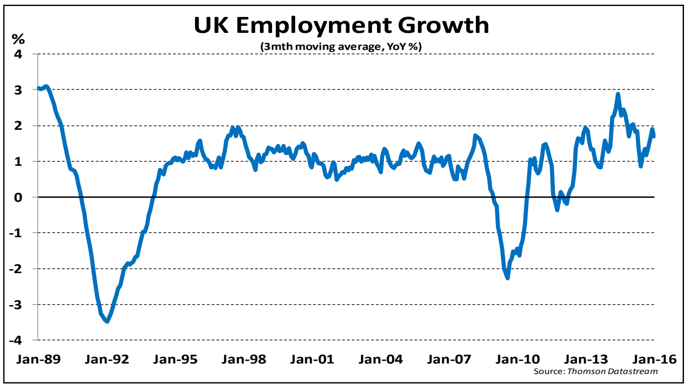
The UK economy slowed last year, growing by 2.3% compared to 2.9% in 2014. The most recent data, though, did show that quarterly growth had picked up pace in Q4, to 0.6% from the 0.4% recorded in Q3. However, the underlying data showed that the UK economy remained heavily on the domestic economy for growth. Consumer spending and a pick-up in inventories were the largest contributors to growth. Meanwhile, net trade and business investment both acted as drags on growth in the quarter.

In terms of more recent developments, leading indicators of activity suggested a more modest pace of growth in Q1. The Markit composite PMI averaged 54.2 in the quarter, after Q4's 55.4. This is consistent with quarterly growth of 0.4-0.5%. Meanwhile, the EC economic sentiment index averaged 105.9, compared to 108.5 in Q4.



The recent 'hard' data have been mixed. Retail sales grew by 1.6% in January/February compared to Q4. This in part reflects strong post-Christmas sales. Meantime, industrial production has continued to struggle, declining by 1% in Jan/Feb versus Q4. With most of the weakness concentrated in manufacturing, the underlying data suggest that output is being impacted by weaker global growth, the stronger sterling and soft business investment. These factors are also reflected in the latest trade data, which showed a further widening in the trade deficit. **Overall, the data for Q1 suggest that growth remained skewed towards the domestic economy.**

Softer growth has begun to be reflected in the labour market. Employment rose by 116k in the three months to January, versus 207k in the previous three months. This equates to year-on-year growth of 1.5%, down from 1.6%. The unemployment rate held at a 10-year low of 5.1% for a third consecutive month in January. The composite employment PMI averaged 53 in Q1, its weakest performance since Q3 2013. This suggests that employment growth could moderate further in the coming months.



Despite the low level of unemployment, year-on-year growth in average weakly earnings remains quite subdued. The ex-bonus measure picked up in the last two months, recording growth of 2.2% in January. However, this is still well below the recent high of 2.9% registered in July last year. Meantime, CPI inflation remains weighed down by the impact from lower oil prices, as well as declines in the price of food. It remained very weak in March, coming in at 0.5%. The core CPI rate did pick up to 1.5% in March, although this seems to be due in part to the timing of Easter. Overall, weak headline inflation means that real wage growth remains at a healthy level, despite the softer pace of earnings growth.

On the housing market, the Halifax and Nationwide indices have shown that price inflation is picking up again. This is backed up by the RICS house price survey. The RICS data and other indicators suggest that price increases are driven by higher demand combined with a falling supply of available units.

Overall, solid employment growth, weak inflation, real wage growth, an improved Eurozone economy and low interest rates all suggest that the UK economy should continue to grow at a reasonable pace. It does still face some headwinds from on-going fiscal tightening, uncertainty regarding the Brexit referendum and the negative drag on trade from a stronger sterling, as well as slower growth in emerging economies. **The IMF's April 'World Economic Outlook' forecast UK GDP growth of 1.9% in 2016 and 2.2% in 2017.**