Bank of England Watch

4th August 2016

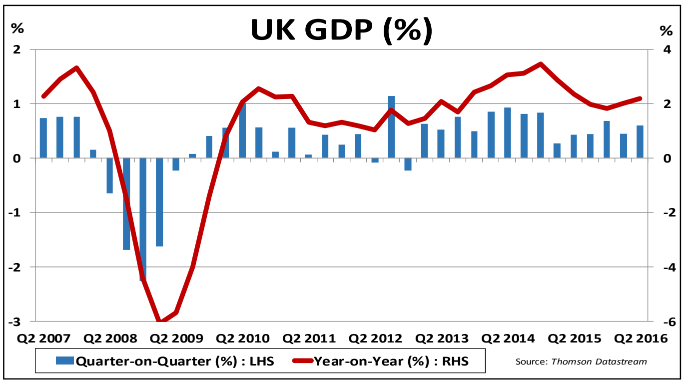
AIB Treasury Economic Research Unit

BoE announces significant policy easing measures

As expected, the Bank of England announced a 25bps cut in its Bank Rate to 0.25% from 0.50% following today's MPC meeting. The decision was unanimous, with all nine Committee members feeling that "policy easing was needed to reduce the amount of spare capacity and thus ensure that inflation returned sustainably to the target" of 2%. The decision to cut rates represents the first move in the Bank Rate since March 2009, when it was cut from 1.00% to 0.50%.

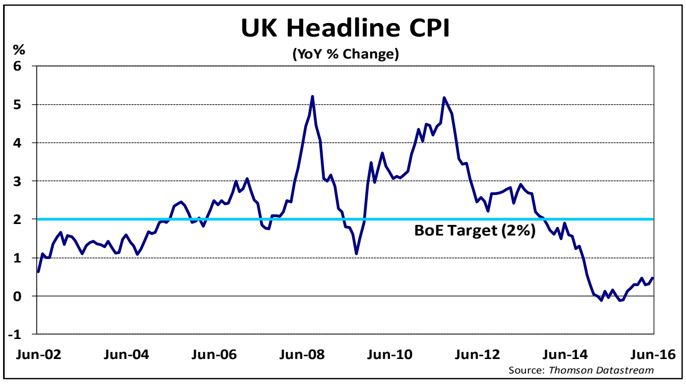
Meantime, **the BoE provided something of a surprise by also announcing that it would purchase an additional £60bn of UK gilts (i.e. fresh QE) over the next six months.** This will bring its total gilt purchases to £435bn. The decision to expand gilt purchases was not unanimous, though, with three MPC members voting against it. The BoE is also to purchase up to £10bn in UK corporate bonds. The BoE also announced that a new Term Funding Scheme which "will provide funding for banks at interest rates close to Bank Rate". **Overall, today's package of easing measures went further than had been anticipated by many market watchers.**

Today's various updates (meeting summary, minutes, Inflation Report and press conference) emphasised that the policy easing measures were being adopted in order to help mitigate the "weaker medium-term outlook for activity" following the UK's vote to leave the EU. **The Inflation Report acknowledged that policy easing was a "trade-off between delivering inflation at the target and stabilising activity around potential".** The BoE now foresees "a temporary period of above-target inflation".



Despite this, the tone of the BoE updates was highly dovish. **The meeting minutes stated that if "incoming data prove broadly consistent with the August Inflation Report forecast, a majority of members expect to support a further cut in Bank Rate to its effective lower bound** at one of the MPC's forthcoming meetings during the course of the year". In his press conference, BoE Governor Carney indicated that the MPC "see the effective lower bound for interest rates as a positive number". He highlighted that "I am not a fan of negative interest rates" and that the Bank has "other options to provide stimulus if more stimulus is needed". Thus, while another rate cut is a distinct possibility, it looks unlikely to be a full 25bps reduction— the Bank Rate is more likely to be cut to 0.1%, or possibly 0.05%.

Meanwhile, the latest set of forecasts contained in today's Inflation Report showed **a marked downgrading of the MPC's outlook for UK growth. The economy is now expected to show little growth in H2 2016.** The previous 2.3% GDP growth forecasts for both 2017 and 2018 have been cut to 0.8% and 1.8%, respectively. Meanwhile, the inflation forecasts were revised slightly upwards, reaching 2.4% by end 2018, compared to 2.2% previously.



Overall, today's BoE updates showed that the Bank has now adopted a very dovish policy stance, with further monetary easing in the near-term a distinct possibility. The immediate market reaction has seen sterling weaken, with GBP/USD falling from $1.33 down towards $1.31, while EUR/GBP moved from 83.5p up near to the 85p mark. Meanwhile, UK gilt yields fell, with the 10-year yield falling by around 10bps to below 0.7%, while stock markets gained.

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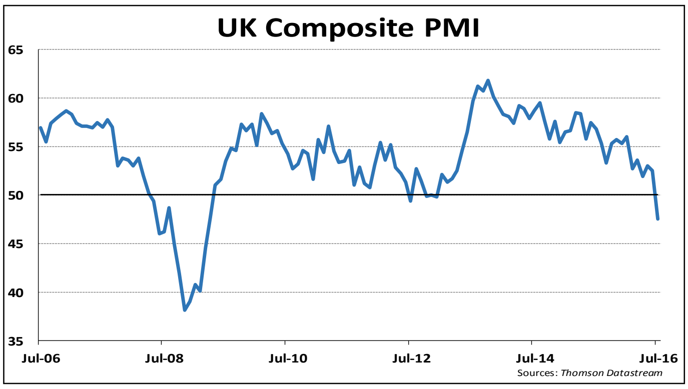
UK economy weaker following Brexit vote

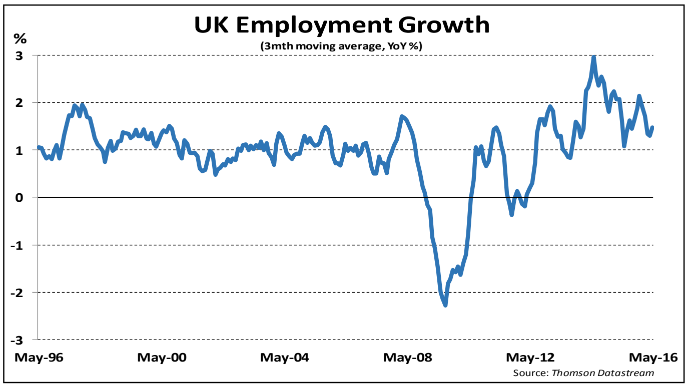
The UK economy grew by 0.6% in the second quarter of the year in the lead-up to the referendum. This represents a pick-up compared to Q1's 0.4% rise. On a year-on-year basis, the economy grew by 2.2% in Q2, up from 2% in Q1. The preliminary GDP estimate, which is output based, showed that services remained the primary driver of GDP, adding 0.37 percentage points (p.p.) to growth, while industrial production contributed 0.30 p.p. in the quarter. Construction once again acted as a drag.

Leading indicators of activity suggest the economy contracted following the vote to leave the EU. The headline Markit composite PMI fell below the expansion indicating 50 level in July, hitting an over 7-year low of 47.5. The sector PMIs —services (47.4), manufacturing (48.2) and construction (45.9)—also fell to multi year lows. Meanwhile, the EC measure of UK economic sentiment fell to 102.6, an over three year low.



Measures of consumer sentiment have also recorded large declines. This is of particular concern given that consumer spending has been the key driver of growth in the UK in recent years. The EC measure fell to -9.2 in July, from -1.2 in June. This represents its largest month-on-month fall since January 1991. Likewise, the Gfk measure of consumer confidence fell from -1 to -12 in July, its sharpest fall since March 1990. The falls in all these indices, if sustained, would point to a likely decline in GDP in Q3.

There have also been some indications of the potential impact of the referendum on the labour market. **The employment component of the composite PMI fell to 49.6 in July, pointing to a contraction in hiring.**



Employment had already seen some signs of slowing this year. Employment rose by 0.1% in Q1, compared to the +0.6% recorded in both Q4 and Q3 last year. Although, there are signs that it may have performed more strongly in Q2, while the unemployment rate stood at 4.9% in May, a 10½-year low. However, the claimant count saw a net decline of just 4,000 in H1, compared to a 30,000 fall in H2 2015.

Despite low unemployment, year-on-year growth in average weakly earnings has remained soft. The ex-bonus measure slowed to 2.2% in May, well below last July's high of 2.9%. Meantime, CPI inflation edged up to 0.5% in June and it looks likely to rise further given sterling depreciation. This could see real wage growth weaken further, which would act as another headwind for GDP growth.

Overall, the UK economy is facing into a period of heightened uncertainty. This is likely to weigh on consumer spending, the key driver of growth in the past few years. Business investment is also likely to be further adversely impacted by Brexit related uncertainty, following on from weak figures in recent quarters. Employers may hold off on hiring new workers, amid expectations of a weaker pace of growth and a lack of clarity over future access to the EU's single market.

The negotiating process to decide on the UK's EU exit terms and agree a new trading arrangement could drag on for quite some time. The outcome of these talks will ultimately determine the long-run implications of Brexit for the economy. In the meantime, the sharp fall in sterling could boost UK exports to some extent, while BoE easing should help mitigate some of the negative effects. **The impact of the referendum is still likely to be negative overall, leading to quite subdued growth in the next couple of years.** Indeed, the MPC now estimates that UK GDP will be around 2.5% lower at the end of 2018 than previously expected.

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