BoE Watch

AIB Treasury Economic Research Unit

AIB

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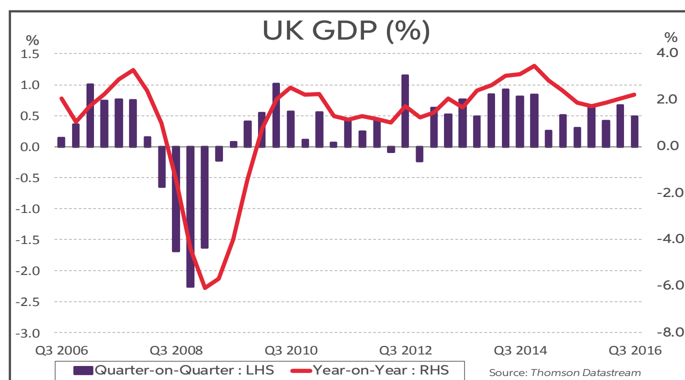
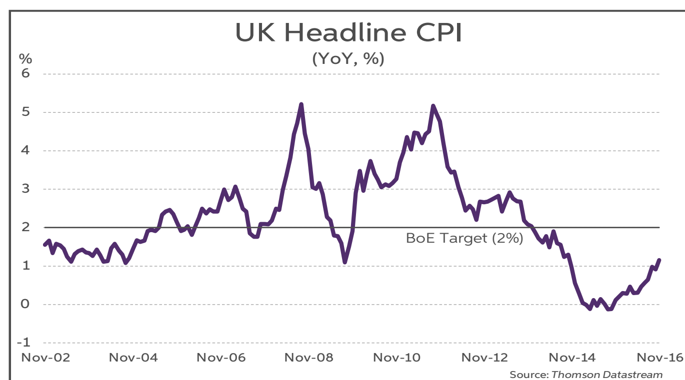
Bank of England expecting economy to slow

The December meeting of the Bank of England's Monetary Policy Committee (MPC) concluded in line with expectations for no changes to policy. The decision today to leave policy unchanged was unanimous. However, two MPC members continue to have reservations about the need for QE. The BoE introduced a raft of easing measures back at its August meeting (including rate cut of 25bps to 0.25% and restarting its QE programme) in the aftermath of the Brexit vote**.** However, the UK economy has displayed surprising resilience since the referendum outcome, with GDP expanding by 0.5% in Q3. The BoE has acknowledged that the UK economy has been materially better than expected since the referendum outcome. Hence, at its meeting in November, the MPC removed "the guidance it had previously issued regarding the likelihood of a further cut in Bank Rate".



This better than expected performance was also reflected in the BoE's most recent set of macro forecasts, which were contained in the November Inflation Report. The GDP forecasts saw upgrades to its 2016 (to 2.2% from 2.0%) and 2017 (to 1.4% from 0.8%) growth projections, while the 2018 figure was revised down (to 1.5% from 1.8%). In terms of inflation, the BoE said that CPI inflation was now expected to be higher throughout the three year forecast period, mainly due to the deprecation of sterling. The current projections have inflation peaking at around 2.8% by mid-2018. The Bank is of the view that sterling's impact on inflation will ultimately prove temporary.

The text of the meeting minutes for December show that the BoE expects the economy to continue to grow at a moderate pace in the "near term", but a "**slowdown in growth remained likely"** thereafter. It referenced that "forward looking components of business surveys were weaker" and "reported investment intentions remained below pre-referendum levels". The minutes went on to say that the "timing and extent" of a slowdown in the economy would "depend crucially" on wage growth and the resilience of consumer spending to "pressure on real incomes from higher inflation".



The BoE continues to emphasise that there were "limits to the extent to which above-target inflation could be tolerated". Factors that would need to be considered in this context, included the "cause of the inflation overshoot", the magnitude of "second round effects on domestic cost pressures", changing inflation expectations and the extent of any "shortfall in economic activity below potential". Therefore, the MPC retained the view that "monetary policy could respond, in either direction" depending on the changing economic outlook. **Futures contracts suggest that the market anticipates that the next move from the BoE will be a rate hike.** However, it is not expecting this to happen until mid-2018. In our view, it is difficult to see the BoE hiking rates in mid-2018 during what are likely to be very difficult negotiations on Brexit with the EU. We also agree with the BoE that UK growth will slow in 2017 and 2018, again suggesting that rate hikes are unlikely by mid-2018.

In our view, rates are likely to remain on hold in the UK until at least early 2019, with monetary policy decisions thereafter likely to be largely influenced by the nature of the UK's departure from the EU. However, given the stronger than expected performance by the UK economy, the BoE may well decide not to increase its QE programme any further, when the current round of purchases have been completed, probably in the spring.

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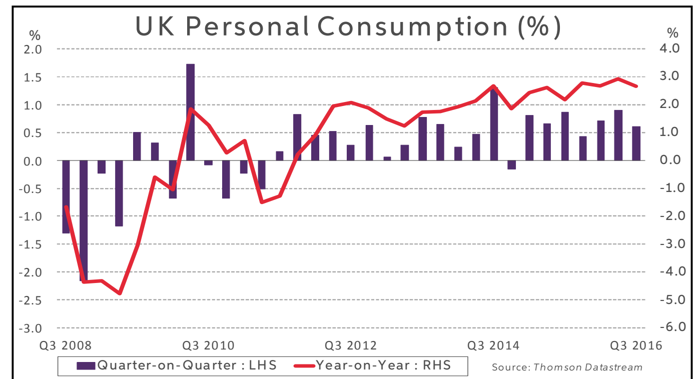
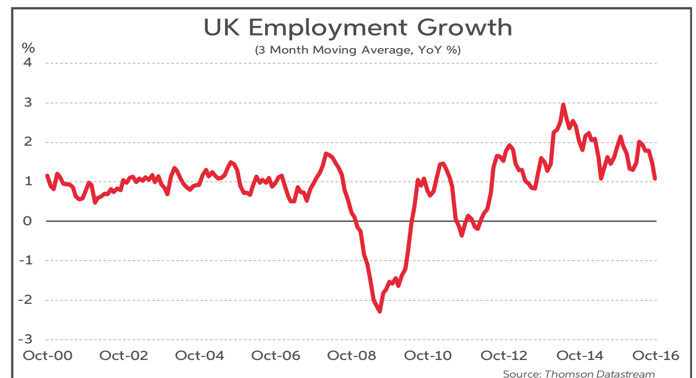
UK economy continuing to grow at a solid pace

The UK economy grew by a solid 0.5% in Q3, down from 0.7% in Q2. The pace of year-on-year growth increased from 2.1% to 2.3%. **The underlying data show that net trade was the primary driver of growth,** adding 0.7 percentage points (p.p.) in the quarter (though this looks set to be revised down in line with updated Q3 trade data). Personal consumption was softer, adding 0.4 p.p. in Q3. Growth in business investment remained encouraging, rising by 0.9%. **Overall, the GDP data show very little evidence of negative Brexit related impacts.**



Leading indicators of activity for Q4 suggest that the economy has continued to perform solidly. The key Markit composite PMI rose to a 10-month high of 55.2 in November, from October's already firm 54.7 result. The EC measure of UK economic sentiment moved up to 107.3 in November, a 2016 high. **'Hard' data measures of the economy have been mixed in Q4.** Retail sales grew by 2.1% in Oct/Nov versus Q3, in which they grew by a very strong 1.9%. The UK trade deficit (goods & services) narrowed significantly in October, from £5.8bn to £2bn. The weaker sterling is likely to be a factor. Although, industrial production continued to struggle in October, falling by 1.3%, with oil and gas extraction the main drag. Meantime, manufacturing was also weak, falling by 0.9%, with underlying data showing broad based declines.

Meantime, **the labour market has seen a marked slowdown recently.** This has coincided with uncertainty related to the Brexit vote. **Employment declined by 6k in the three months to October** (first fall since Q2'15), compared to growth of 173k in the previous three months. The year-on-year rate of growth slowed to 1.1%, its lowest level since May 2015. The timelier claimant count also rose further in November, suggesting we could see further declines in employment in the coming months. Although, the unemployment rate did remain at an 11-year low of 4.8%, due mainly to a decline in the size of the labour force.



Despite the weaker jobs market, wage growth has shown some improvement of late. Year-on-year growth in earnings (ex-bonus) rose for a fourth consecutive month in October, to 2.6%, though it remains moderate. Meantime, CPI inflation rose to 1.2% in November. Sterling depreciation and rising oil prices are likely to put further upward pressure on prices in the coming months. Thus, we are likely to see a decline in the pace of real wage growth.

The UK economy could be in something of a Brexit 'sweet spot' at present, benefiting from the looser monetary policy and the weaker sterling before negative impacts such as rising inflation take hold. Overall, **the UK economy is facing into a period of heightened uncertainty.** Business investment could be adversely impacted by Brexit uncertainty. We are already seeing signs of weakness in the labour market and this could continue, with employers potentially holding off on hiring if they expect weaker growth and there is a lack of clarity over future access to the EU Single Market. This would dampen consumer spending, as will rising inflation. **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. The impact of the referendum is still likely to be negative overall, leading to a more subdued pace of growth in the next couple of years. **Hence, the BoE anticipates that GDP growth will slow from this year's expected 2.2% rate to around 1.5% in 2017 and 2018.**

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