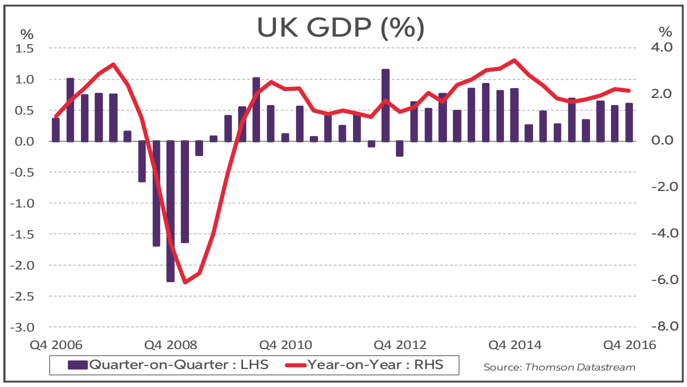
BoE Watch

AIB Treasury Economic Research Unit

2nd February 2017

BoE more optimistic on economic outlook

In line with market expectations, the February meeting of the Bank of England's Monetary Policy Committee (MPC) concluded with no changes to policy. The decision to leave policy unchanged was unanimous.

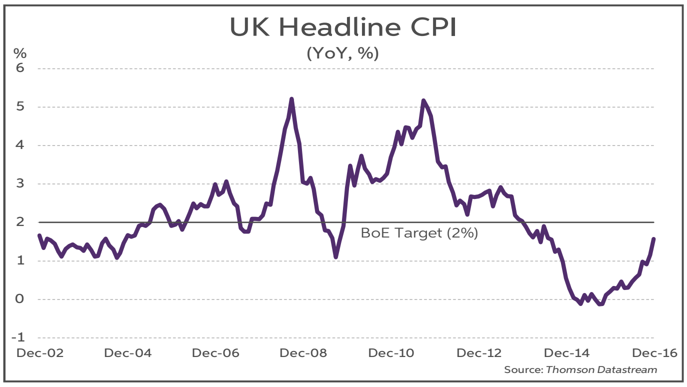


The Bank noted that the economy continued to perform better than it had anticipated. It stated that "there had been few signs of a slowdown in consumer spending". It also acknowledged the "new fiscal stimulus" announced by the Chancellor, the "firmer momentum in global activity", "higher equity prices" and "supportive credit conditions". **Therefore, on the back of these factors, the MPC upgraded its assessment of the outlook for growth in the UK economy.**

This is reflected in the revisions to the GDP forecasts contained in today's Inflation Report. The Bank now expects growth of 2% this year compared to 1.4% back in November. For 2018, it is forecasting growth of 1.6% (from 1.5%) and for 2019 it is pencilling in GDP growth of 1.7% (from 1.6%). Overall, economic growth is now envisaged to be "around 1 percentage point stronger than in the November projections" over the three year forecast period. However, in the press conference, Governor Carney commented that the "Brexit journey is really just beginning" and could entail "twists and turns along the way".

In terms of inflation, despite a stronger growth outlook, the MPC's forecast were "roughly unchanged compared to the November projections". The Banks rationale for this is that the "stronger path for demand" is likely to be "matched by higher supply capacity", notably in the labour market. As a result, the MPC continues to expect inflation to peak at around 2.8% in 2018.

In this context of an overshoot of its 2% inflation target, the BoE referenced the "balance" that must be obtained in the "trade off" between "returning inflation to the target" and the support that "monetary policy provides" to the economy. The BoE judges that it remains "appropriate to seek to return inflation to the target over a somewhat longer period than usual".



Notwithstanding this view, the Bank continues to state that there are "limits to the extent that above-target inflation could be tolerated". The BoE outlined three key judgements in this assessment. Firstly, that inflation expectations would not be "adversely" impacted by the boost to consumer prices from sterling weakness. Secondly, that pay growth would remain "modest" and thirdly, that "household spending would slow as real income gains weaken". Therefore, the MPC retains its guidance that "monetary policy can respond, in either direction, to changes to the economic outlook"

Futures contracts suggest that the market expects that the next move from the BoE will be a rate hike, sometime around mid-2018. However, we think this is unlikely as the UK will be in middle of difficult Brexit negotiations at this time, while we also expect the economy to slow in the run up to the exit from the EU. Market reaction to today's MPC meeting saw sterling weaken, with downward pressure on UK yields also. This suggests that the market had been expecting a more hawkish tone from the BoE, in line with its expectation that rates would be hiked in 2018 and 2019. There was no sign today that the Bank is thinking along these lines, giving the market some food for thought.

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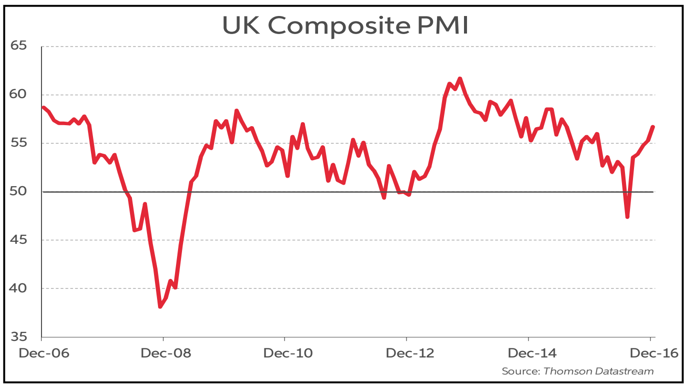
UK economy growing solidly, but risks remain

The UK economy grew by 0.6% for a third consecutive quarter in Q4 2016, continuing its impressive post-Brexit vote performance. This means that the economy grew by 2% in the year as a whole, only slightly slower than the 2.2% rise recorded in 2015.



However, **the underlying data, which were by the output method, showed that growth remained unbalanced,** with the services sector accounting for all of the rise in GDP, for a second consecutive quarter. Within this, retail and wholesale trade were the two largest contributors to GDP growth.

While we will not get an expenditure based breakdown of growth until later on this month, **the indications from the preliminary figures, as well as other hard data in Q4, are that the UK economy continued to rely on consumption for growth.** For example, retail sales grew by 1.3% in Q4. While this does represent a slowdown versus Q3's 1.9% increase, it is still a strong figure. Meantime, industrial production declined by 0.5% in October/November. Although, trade figures from Oct/Nov suggest net trade may have had a slightly positive impact on growth in Q4.

However, **rising inflation could begin to temper the positive trend in consumption. Both headline and core CPI inflation rose to 1.6% in December.** The underlying data show broad based price pressures. Meantime, the producer price (output) index has continued to rise, hitting 2.7% in December, its highest level since early 2012. This likely reflects the weaker sterling, leading to higher fuel and materials costs for many companies. Further increases could hurt the competitiveness of UK exports, while also increasing CPI.

Meantime, **the labour market has seen a slowdown recently.** Employment declined by 9k in the three months to November, compared to a very healthy 106k increase in the previous three month period. **The unemployment rate has remained at just 4.8%,** aided by a decline in the size of the UK labour force. At the same time, earnings growth has continued to edge higher, with the ex-bonus measure edging up to 2.7% year-on-year in November, though rising inflation still means real wage growth is slowing.

The UK economy could be in something of a Brexit 'sweet spot' at present, benefiting from loose 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. 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 the UK's future trading relationship with the EU. This would dampen consumer spending, as will rising inflation.

The negotiating process to decide on the UK's EU exit terms and any new trading arrangement could drag on for quite some time. The outcome of these talks, which should begin in the coming months, 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.