Bank of England Watch

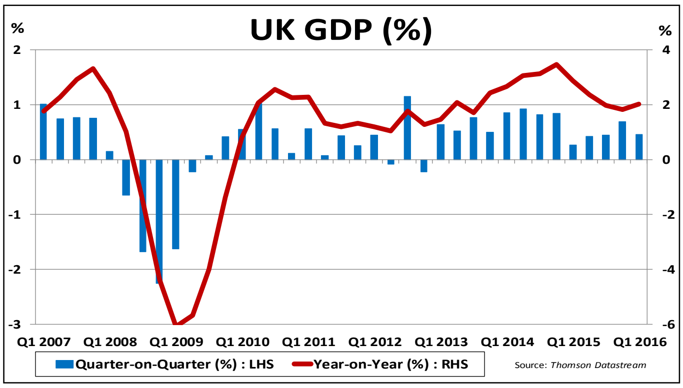
14th July 2016

AIB Treasury Economic Research Unit

BoE signals policy easing likely in August

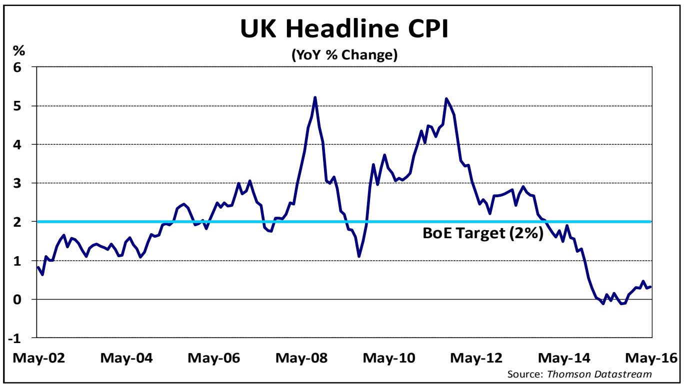
The July meeting of the BoE's Monetary Policy Committee (MPC) concluded with the Bank Rate left unchanged at 0.5%. The decision was not unanimous, with one (out of nine) MPC member voting for an "immediate loosening of monetary policy". However, "most members judged it appropriate to leave the stance of monetary policy unchanged". The Bank Rate has been kept at 0.5% since March 2009.

However, the meeting statement and minutes provided a clear signal that policy easing was likely in August. The MPC stated that it was "committed to taking whatever action was needed to support growth and to return inflation to target". To achieve this, most MPC members at this month's meeting "expected monetary policy to be loosened in August".



The current policy deliberations within the BoE are taking place against a backdrop of heightened uncertainty in light of the referendum vote in favour of a UK exit from the EU. At the same time, inflation, at 0.3% in May, remains "well below the 2%" target. The BoE is of the view that the shortfall in inflation versus target is "due predominantly to unusually large drags from energy and food prices which are expected to attenuate over the next year".

The BoE's economic assessment of the referendum impact is limited by the lack of official data covering the period since the vote. However, it said that there "are preliminary signs that the result has affected sentiment among households and companies". The MPC referenced business and consumer confidence surveys as well as its own research to back up this viewpoint. Indeed, it mentioned reports that "**some businesses are beginning to delay investment projects and postpone recruitment decisions".** It also stated that survey data on the housing market "point to a significant weakening in expected activity".



Looking ahead, **the MPC remains consistent in its view that "a vote to leave the European Union could have material implications"** for the UK's economic outlook. The severity of this "would depend on the degree and timing of any further retrenchment in business investment and the flow through to households via the labour market", all of which could "take some time to gauge".

Overall, while the BoE kept policy on hold today, it provided an explicit reference to next month's meeting (4th August) as to when monetary policy easing could be announced. At that stage, the Bank will have had time to undertake a full economic assessment in conjunction with the preparation and publication of the August Inflation Report. At this month's meeting, the MPC had an "initial exchange of views on possible packages of measures" that it could use. The minutes noted that the "exact extent of any additional stimulus measure would be based on the Committee's updated forecasts" which will be contained in next month's Inflation Report. The BoE's decision to leave the Bank Rate unchanged today disappointed market expectations for a 25bps rate cut. As a result, sterling moved higher, trading above $1.33 versus the dollar and near 83p against the euro.

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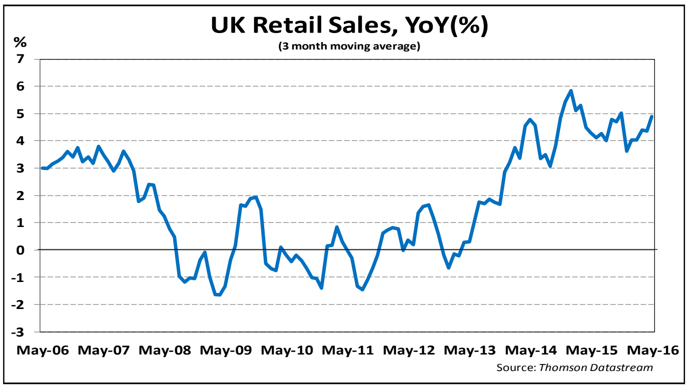
Brexit uncertainty to weigh on UK economy

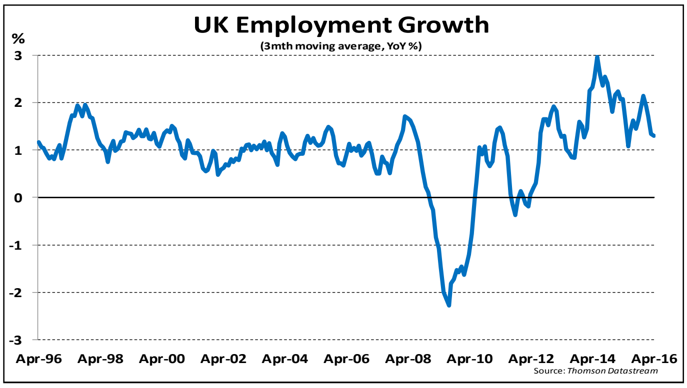
The UK economy grew by 0.4% in the first quarter of the year, slowing from the 0.7% recorded in Q4 2015. Year-on-year growth increased slightly to 2%, from 1.8%. The underlying data showed that personal consumption remained the main driver of growth, contributing 0.5 percentage points (p.p.). Net trade acted as a drag on growth, knocking 0.2 p.p. of GDP. Business investment remained weak, falling by 0.6% in Q1, after Q4's 2.2% decline. **Overall, the figures indicate that the economy remained unbalanced, relying on consumer spending.**

While we do not have Q2 GDP data (due July 27), **leading indicators of activity suggest that growth remained modest.** The composite PMI averaged 52.4 in Q2, versus 54.2 in Q1. This corresponds to its weakest performance since Q1 2013. The survey data were impacted by the high level of uncertainty in the lead up to the EU referendum.



Meanwhile, **hard data have pointed to a pick-up in growth in Q2.** Indeed, the BoE is pencilling in growth of 0.5% for the quarter. Industrial production recorded a marked improvement in April/May, rising by 2.1% versus Q1, when it declined by 0.2%. Retail sales rose by 1.8% in April/May compared to Q1's growth of 1.3%. Underlying data show broad based sales growth.

Slower UK growth has corresponded to a deceleration in the pace of improvement in the labour market. Employment rose by just 56k in the three months to April, well below the 200k+ figures seen around the end of last year. Although, the unemployment rate did fall to a 10½ year low of 5% in April. The timelier composite employment PMI averaged just 51.2 in Q2, its weakest performance since Q1 2013. This suggests that employment growth could moderate further, or possibly register declines.



Despite the low level of unemployment, year-on-year growth in average weakly earnings has remained subdued. The ex-bonus measure of wage growth came in at 2.3% in April, still well below last July's recent high of 2.9%. Meantime, CPI inflation has continued to be weighed down by the impact from lower oil prices, as well as declines in the price of food. It remained very weak in May, at just 0.3%. Core inflation, which excludes food and energy, was also subdued, at 1.2%. Weak headline inflation means that real wage growth remains solid, despite the overall moderate pace of earnings growth.

The UK economy is facing into a period of heightened economic uncertainty. This is likely to weigh on consumer spending, the key driver of growth in the past few years. Already, the Gfk measure of UK consumer confidence recorded its largest monthly fall in 21 years in July. Business investment is also likely to be further adversely impacted by Brexit related uncertainty, following on from declines in the last two 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 a number of years. The outcome of these talks will ultimately determine the long-run implications of Brexit for the UK economy. In the meantime, the sharp fall in sterling could boost UK exports to some extent, while BoE easing may also help mitigate some of the negative effects. **The impact of the referendum is still likely to be negative overall. We expect that the current uncertainty could knock about 3% off UK growth between now and the end of 2018, versus previous expectations.** As such, we could see UK growth of around 1.5% this year.

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