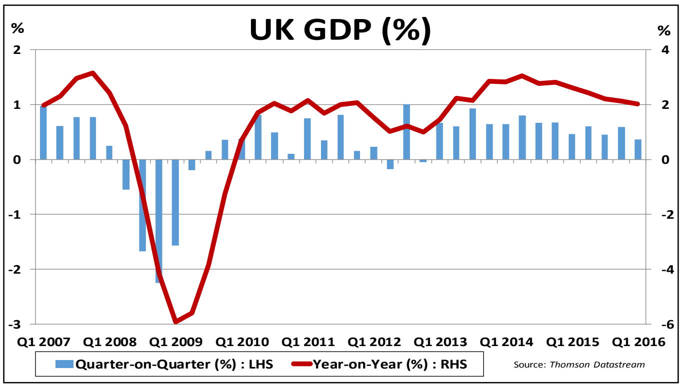
Bank of England Watch

16th June 2016

AIB Treasury Economic Research Unit

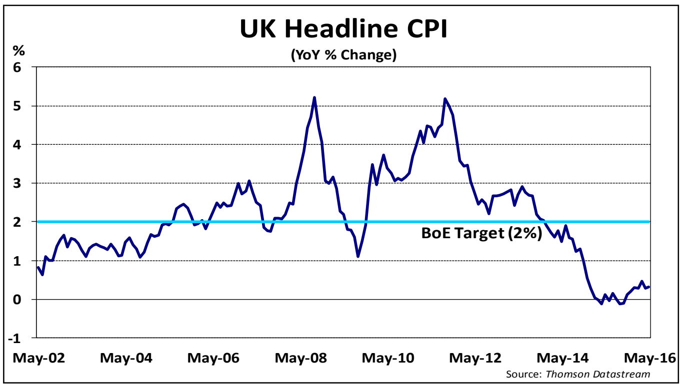
BoE continues to emphasise referendum risk

The June meeting of the BoE's Monetary Policy Committee (MPC) concluded in line with market expectations, with no changes to policy. The decision to leave the Bank Rate unchanged, at 0.5%, was once again unanimous.



The Bank Rate has been kept at 0.5% since March 2009. The current neutral stance within the BoE is set against a backdrop of very weak inflation in the UK economy. Headline CPI inflation, at just 0.3%, remains well below the BoE's 2% target. The minutes noted that the "shortfall relative to the target" continued to be mainly due to "unusually large drags from energy and food prices". The MPC also stated that core inflation, which stands at 1.2%, "remained subdued" owing to "weak global price pressures, past movements in sterling and restrained domestic cost growth". The Bank expects that "growth of domestic costs, and wages in particular, would continue to recover". However, their recovery was not yet to the extent that "would be consistent with meeting the inflation target in the medium-term.

The latest set of BoE macro forecasts, which were based on the assumption of continued UK membership of the EU, were contained in the May Inflation Report. Growth over the forecast horizon was "expected to be slightly weaker than in the February projection". GDP growth is expected at 2.0% this year and at 2.3% in 2017. Meanwhile, the inflation forecasts were broadly unchanged, remaining at 0.4% this year and at 1.5% next year (from 1.6%).



Governor Carney is on record as stating that the "MPC judges the most significant risks to its forecast concern the referendum". Indeed, the text of the meeting minutes indicate that the upcoming referendum, the uncertainty associated with the outcome and the potential negative economic consequences of a vote to exit once again dominated the BoE's policy meeting. The MPC commented that based on recent currency market moves, "it appears increasingly likely that, were the UK to vote to leave the EU, sterling's exchange rate would fall further, perhaps sharply". It added that this would be consistent with fundamentals including "worsening terms of trade, lower productivity and higher risk premia". The BoE also discussed how there is "growing evidence that uncertainty about the referendum is leading to delays to major economic decisions that are costly to reverse". As well as this, the BoE repeated its view that "potential referendum effects are making economic data releases more difficult to interpret".

Overall, in light of the 'referendum' uncertainty and difficulty in interpreting current maco data, the BoE is on a very cautious standing and appears to be still some way off from contemplating increasing interest rates. In terms of market expectations, futures contracts do not envisage a UK rate hike materialising till the end of 2019/early2020 which would bring the Bank Rate up to just 0.75%. However, if the UK economy continues to register solid growth, the headwind on prices from commodity markets lessens and domestic cost pressures start to push inflation up towards the MPC's 2% target, there exists the potential for the BoE to start hiking interest rates next year, assuming of course the outcome of the upcoming referendum is a vote to remain in the EU.

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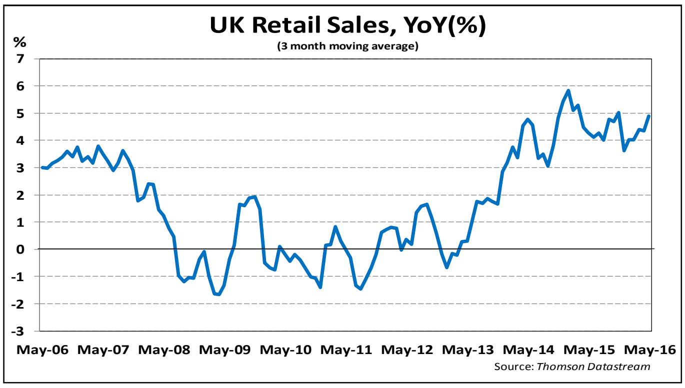
Mixed tone to UK data in Q2

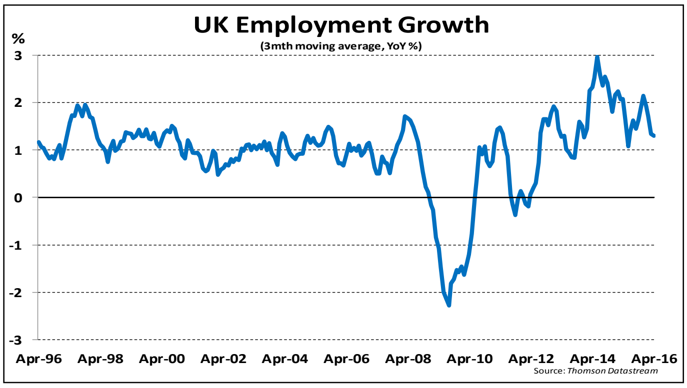
The UK economy grew by 0.4% in the first quarter of the year, slowing from the 0.6% recorded in the final quarter of last year. Year-on-year growth slowed slightly to 2%, from 2.1%. The underlying data showed that personal consumption remained the main driver of growth, contributing 0.4 percentage points (p.p.). Net trade dragged down growth for a third consecutive quarter, taking 0.4 p.p. from GDP. Business investment also continued to decline (-0.05 p.p.). Although, government spending continued to grow, adding a modest 0.1 p.p. in Q1. **Overall though, the figures indicate that UK growth remained unbalanced, relying on domestic spending.**

In terms of the economy in Q2, leading indicators of activity have pointed to a further slowdown. The composite PMI averaged 52.5 in April/May compared to 54.2 in Q1. The data suggest that the services sector has weakened, while manufacturing continues to contract. Meantime, the EC UK economic sentiment index has also weakened, averaging 105.1 versus Q1's 105.9. The survey data could be reflective of the uncertainty that exists ahead of the Referendum.



However, hard data have been more upbeat, perhaps pointing to a pick-up in growth in Q2. Retail sales rose by 1.8% in April/May compared to Q1, in which they grew by 1.3%. Underlying data show sales growth was broad based. On the output side of the economy, industrial production jumped by 2% in April. This was in part driven by an 8.6% monthly rise in pharmaceutical production and a pick-up in the energy sector as temperatures cooled. Thus, we could see production fall back in the next couple of months, though it should still register an increase in Q2, after Q1's decline.

The moderation in the pace of growth has had an impact on 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 fell further in May to 50.9, an over 3 year low. This suggests that employment growth could remain moderate in the coming months. Although, some of this weakness could be 'referendum' related.



Despite low unemployment, year-on-year growth in average weakly earnings remains relatively 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 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, holding at 0.3%. Core inflation, which excludes food and energy, also remains subdued, at 1.2%. Weak headline inflation means that real wage growth remains strong, despite the overall moderate pace of earnings growth.

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. However, **there are some signs that the uncertainty in regard to the outcome of EU referendum vote on June 23rd is impacting activity, especially investment.** Growth, though, can be expected to rebound in the second half of the year if the UK votes to remain in the EU, allowing the economy to expand by close to 2% this year. By contrast, a vote to leave the EU is likely to generate quite an economic shock, creating a lot of uncertainty and resulting in considerable weakness and volatility on financial markets. Growth is likely to continue to slow in the UK in the second half of the year and into 2017 on such a vote. Thus, the referendum result will be the key factor determining the performance of the economy in the near-term. **The OECD expects growth in the UK of 1.7% in 2016 and 2% in 2017, broadly in line with the IMF and European Commission forecasts.**