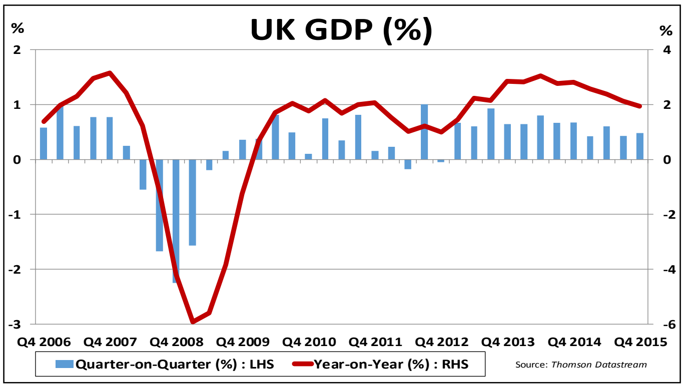
Bank of England Watch

18th March 2016

AIB Treasury Economic Research Unit

Cautious MPC

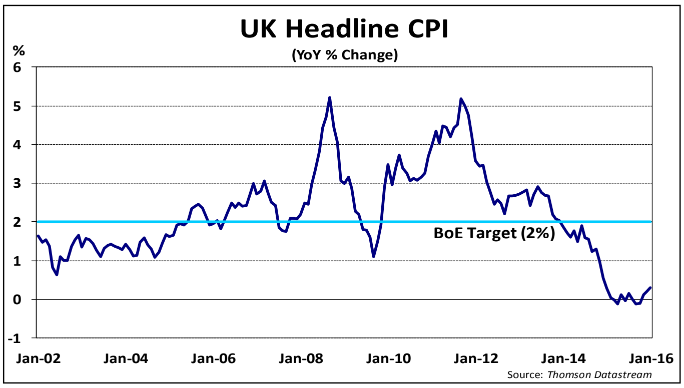
Yesterday's meeting of the BoE's Monetary Policy Committee (MPC) concluded in line with market expectations, with no changes to policy. For a second consecutive month, the decision to leave rates unchanged was unanimous, with "all members of the Committee" of the view that "maintaining the current stance of policy was appropriate".



While inflation in the UK has ticked up recently, as noted by the BoE, it remains "well below the 2% inflation target". **Of particular concern is that "core inflation also remains subdued"** due to a combination of past sterling strength, weak global inflation and limited domestic cost growth.

The most recent BoE macro forecasts were contained in its February Quarterly Inflation Report (QIR), which included downward revisions to its inflation and growth forecasts compared to its November QIR. The Bank expects CPI inflation to pick up to 0.9% by Q4 this year, down from its previous forecast of 1.1%. Inflation is forecast to rise to 1.9% by Q4 2017. There was also a lowering of the Bank's wage inflation forecasts. It now projects average weekly earnings to be around 3% by the end of this year. Meanwhile, GDP projections see growth expected at 2.2% this year and 2.3% in 2017.

The MPC's assessment of the global economic outlook at this week's meeting is that the risks to its central projection of "only modest global growth lie to the downside". **At the same time, on the domestic front, the issue/risk of 'Brexit' seems to have been a key talking point this month.** The meeting statement states that "there appears to be increased uncertainty surrounding the forthcoming referendum". The MPC commented that this uncertainty is likely to have "been a significant driver of the decline in sterling" and it could also "delay some spending decisions and depress growth of aggregate demand in the near term". **Despite this though, the MPC judges that the "outlook for domestic activity to be little changed"** since the February QIR.



Overall, the March BoE meeting statement/ minutes continue to suggest that the Bank is still some way off from starting to hike interest rates. There remains a "spread of views" among members on the inflation outlook, especially in relation to how "wages would respond to the past declines in unemployment and the prospective increase in inflation". In terms of market expectations**, futures contracts do not envisage a UK rate hike materialising until the second half of 2018**. There is only one rate hike priced in for 2018, which would bring the Bank Rate up to just 0.75% by end-2018.

However, given that the BoE repeated its stance that "it is more likely than not that Bank Rate will need to increase over the forecast period", markets may be too dovish with their UK rate hike expectations. With the unemployment rate already down near 5%, we could see the BoE hiking rates next year, if the UK economy continues to grow solidly, the downside influence on prices from commodity markets ease and domestic cost pressures start to help push inflation up closer to the MPC's inflation target.

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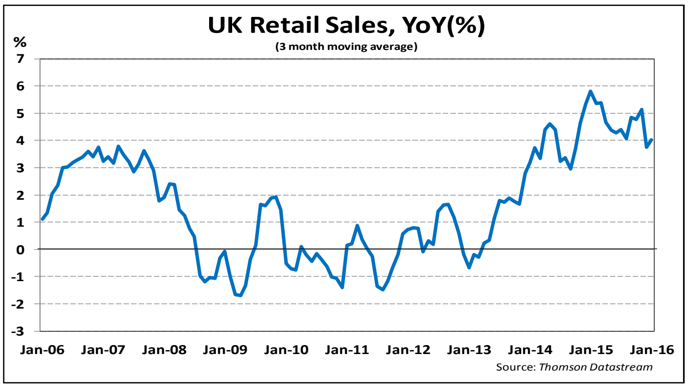
Growth remaining subdued

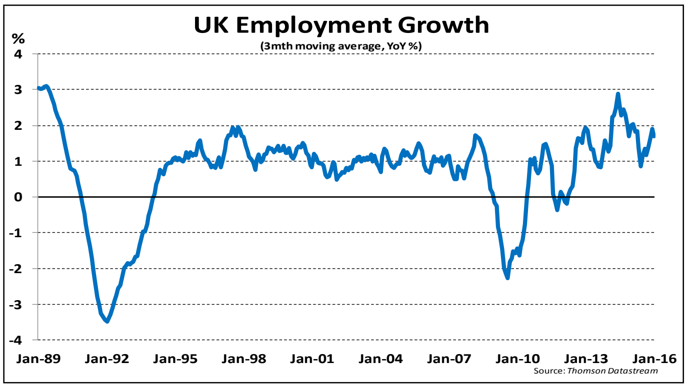
The UK economy slowed in 2015, growing by 2.2% compared to 2.9% in 2014. On a quarterly basis, growth picked up slightly in Q4, increasing by 0.5% after Q3's 0.4% reading. Growth remained heavily reliant on the domestic economy in the quarter. Consumer spending continued to be a key source of growth, contributing 0.4 percentage points (p.p.) in the fourth quarter. Exports remained weak, due in part to the impact from the stronger sterling and a further fall in energy exports.

Leading indicators of activity for the first two months of this year have pointed to a slower pace of growth. The Markit composite PMI averaged 54.5 in January/ February compared to 55.4 in Q4 last year. Meanwhile, the EC economic sentiment index averaged 105.8 compared to 108.5 in Q4. The underlying surveys point to a weaker performance in both the manufacturing and services sectors.



The recent 'hard' data have been mixed. Retail sales jumped by 2.3% in January, following a pick-up of 1.2% in Q4. Meantime, industrial production saw a modest 0.3% increase in January, following on from Q4's 0.4% decline. The sector was aided by a rebound in energy production. Trade data, though, remain a source of concern. The UK monthly trade deficit (goods & services) came in at £3.5bn in January. The goods trade deficit with the rest of the EU (UK's largest trading partner), reached an all time high of £8.1bn, likely reflecting the negative impact from the stronger sterling. **Overall, the early data for Q1 suggest that growth remained skewed towards the domestic economy.**

Softer growth has begun to be reflected in the labour market. Employment rose by 116k in the three months to January, versus 207k in the previous three months. This equates to year-on-year growth of 1.5%, down from 1.6%. The unemployment rate held at 5.1% for a third consecutive month in January, a 10-year low. The timelier composite employment index fell to 52.6 in February, its lowest level in 2½ years. This suggests that employment growth could remain more modest in the coming months.



Despite the low level of unemployment, year-on-year growth in average weakly earnings remains quite moderate. The ex-bonus measure picked up in the last two months, recording growth of 2.2% in January. However, this is still well below the recent high of 2.9% registered in July. Meantime, CPI inflation remains weighed down by the impact from lower energy prices, as well as declines in the price of food. It remained very weak in January, coming in at 0.3%. As a result, real wage growth still remains at a healthy level despite the softer pace of earnings growth.

On the housing market, the Halifax and Nationwide indices have shown that price inflation is picking up again. This is backed up by the RICS house price survey. RICS data and other indicators suggest that this is due to higher demand for housing combined with a falling supply of available units.

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 this year. It still faces some headwinds from on-going fiscal tightening, uncertainty regarding the upcoming 'Brexit' referendum and the negative drag on trade from a stronger sterling, as well as slower growth in emerging economies. **GDP growth may average around 2% or slightly below in 2016.**