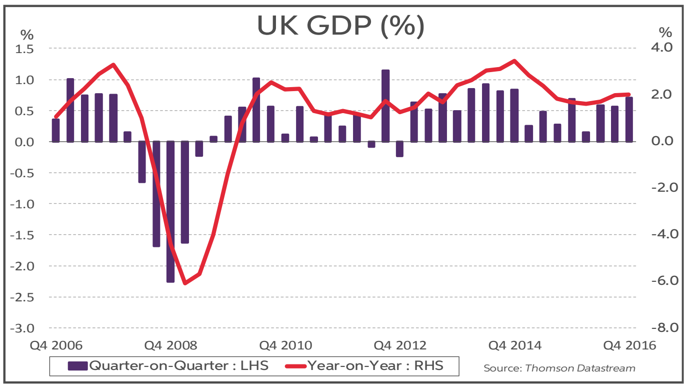
BoE Watch

AIB Treasury Economic Research Unit

16th March 2017

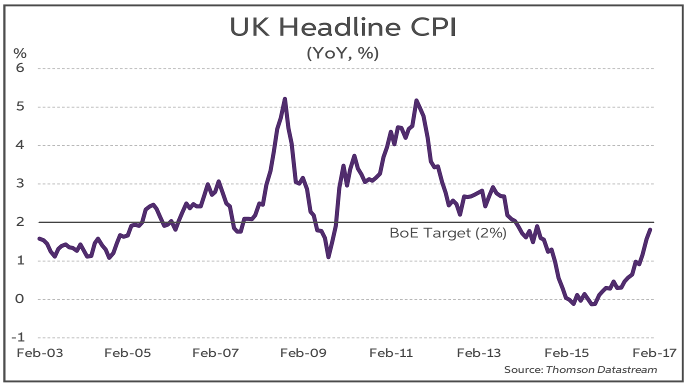
BoE paying closer attention to inflation outlook



The March meeting of the Bank of England's Monetary Policy Committee (MPC) concluded with no changes to policy. This was in line with the market consensus. Although, there was some surprise that the decision to leave policy unchanged was not unanimous. One MPC member (Kristin Forbes) was of the view that "inflation was rising quickly and was likely to remain above target for at least three years" while "domestically generated inflation had also increased notably", thereby justifying an "immediate increase in Bank Rate".

For the remaining eight members, they considered the "current stance of monetary policy to be appropriate". They noted that pay growth remained muted along with signs that the "squeeze in households' real income growth" was acting as a headwind to spending. The potential uncertainty over the UK's future trading arrangement and negative impact this could have on the economy was also referenced as posing a "downside risk to the economic outlook". **However, despite these concerns and uncertainty over the economic outlook, there are signs of a more 'hawkish' tone emanating from some MPC members**. The minutes detailed that "some members noted that it would take relatively little further upside news on the prospects for activity or inflation for them to consider that a more immediate reduction in policy support might be warranted".

The BoE's most recent set of macro forecasts were contained in last month's Quarterly Inflation Report. These contained upgrades to its GDP projections. The Bank revised up its 2017 forecast (from 1.4% to 2%). 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, the net effect of these changes is that growth is now envisaged to be around 1 percentage point stronger over the three year period when compared to its forecasts back in November. On the inflation front, the MPC's forecasts were broadly unchanged compared to the November version, with the MPC continuing to expect inflation to peak at around 2.8% in 2018.



The BoE once again emphasised this month the difficult "trade off" that it must try and balance in its policy deliberations. This is between the "speed with which it intends to return inflation" to its 2% target and the "support that monetary policy provides to jobs and activity". Trying to "offset fully the effect of weaker sterling on inflation" could result in "higher unemployment" and "even weaker income growth". **However, at the same time, the Bank continues to emphasise that there are "limits to the extent that above-target inflation could be tolerated".** Therefore, the MPC retained its guidance this month that "monetary policy can respond, in either direction, to changes to the economic outlook".

Overall, while the BoE continues to expect a "slowdown in aggregate demand over the course of this year", the tone of today's minutes do suggest at some signs of a "hawkish rhetoric" starting to emerge. Market reaction has seen futures contracts bring forward their rate hike expectation from 2019 back into Q4 2018**.** We remain of the view, though, that a rate hike around then is unlikely as the UK may be in the middle of difficult Brexit negotiations combined with the likelihood that the economy may slow in the run up to its EU exit. **Elsewhere on markets, sterling has made some modest gains, while UK gilt yields are also somewhat higher.**

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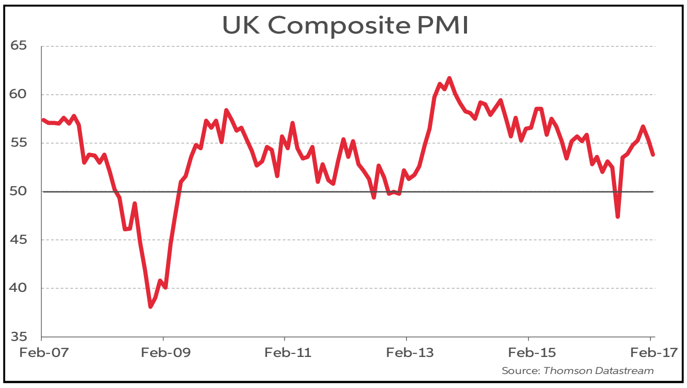
Signs of slower growth in the UK

The UK economy grew by 0.7% in Q4 2016, firmer than the initial estimate of 0.6%. Softer growth in H1 meant that the economy grew by 1.8% in 2016, slower than 2015's 2.2% increase.



Underlying Q4 data were less encouraging than the headline might suggest. Consumption grew by 0.7%, adding 0.5 percentage points (p.p.), while inventories added another 0.2 p.p. Net trade (ex-distortions from gold exports) was a slight drag on growth in Q4, while business investment fell by 1%.

Leading indicators of activity have largely point to a slower pace of growth in Q1 2017. For example, both the manufacturing and services PMIs fell in January and February. They averaged 54.6 and 53.9, respectively, in the two months, compared to 55.2 and 55.3 in Q4. As a result, the composite PMI came in at 53.8 in February, its lowest level since August.

'Hard' data for Q1 have been mixed. Retail sales declined for a third consecutive month in January (-0.3%). This suggests that sales are virtually certain to drag on Q1 growth, as monthly increases of c.2% in both February and March would be needed to record a pick-up in the quarter. Industrial production declined by 0.4% in January, but this came after two months of strong increases. Meantime, the UK trade deficit remained at £2bn in January, while the ex-erratics measure, which excludes things like oil and gold, was wider at £3.3bn.

Rising inflation seems to be acting as a headwind to retail spending. CPI inflation rose to 1.8% in January. 'Core' inflation has also risen, coming in at 1.6%. This likely reflects higher import prices as a result of the weaker sterling. This is also impacting on producer price (output) inflation. It has continued to rise in recent months, hitting 3.5% in January. Further increases may hurt the competitiveness of UK exports, while also further increasing CPI.

Meantime, **the labour market has seen some signs of improvement, after it softened around the middle of H2 2016.** Employment rose by 92k in the three months to January, having declined by 5k in the previous three month period. **The unemployment rate edged back down to 4.7% in January.** Despite this, earnings growth has softened in recent months. The headline measure slowed to 2.2% year-on-year in January, meaning a further weakening in real wage growth.

The UK Brexit 'sweet spot' may be unwinding. The economy has benefited from loose monetary policy and the weaker sterling recently. However, negative impacts from factors like higher inflation are starting to take hold. Overall, **the UK economy is facing into a period of heightened uncertainty.** Business investment may be adversely impacted, while jobs growth could remain more subdued if employers expect weaker growth and a more difficult 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 BoE's most recent forecasts are for GDP growth of 2% this year, followed by a 1.6% increase in 2018. The risks to the BoE's forecasts look to be to the downside, especially if difficult negotiations cause the full extent of the potential negative ramifications of Brexit for the economy to crystallise in the minds of consumers and businesses. The outcome of the UK/EU talks, which should begin in the coming months, will ultimately determine the long-run implications of Brexit for the economy.

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