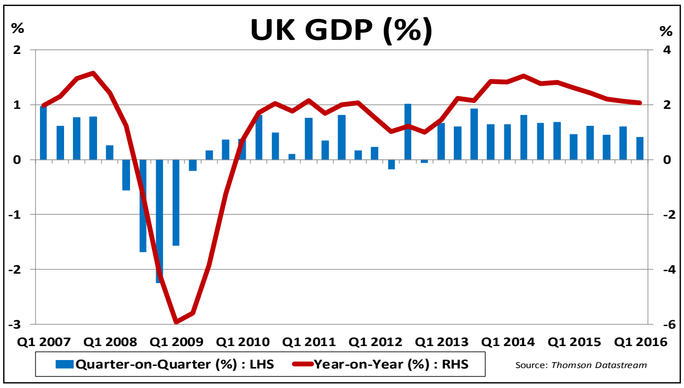
Bank of England Watch

12th May 2016

AIB Treasury Economic Research Unit

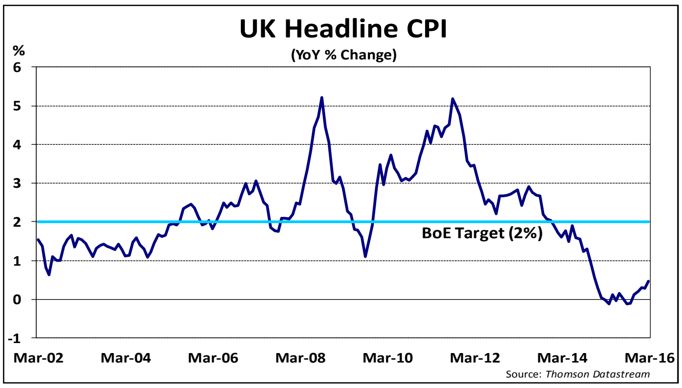
BoE highlights EU Referendum risks to UK economy

As expected the May meeting of the BoE's Monetary Policy Committee (MPC) concluded with no changes to policy. The decision to leave the Bank Rate unchanged, at 0.5%, was once again unanimous. Headline inflation in the UK economy, at just 0.5%, remains "well below the 2%" target set by the BoE. Despite further tightening in the labour market, it is the **MPC's assessment that "annual wage and unit labour cost growth" are "below rates consistent with meeting the inflation target".** The BoE commented that the "pick-up in inflation depended on both a lessening drag from external factors and an increase in domestic cost growth". **The "best collective judgement of the Committee" was that inflation would return "to the 2% target by mid-2018**, before rising slightly above it in the third year of the projection".



Today's various updates (meeting summary, minutes, Inflation Report and press conference) from the May edition of the BoE's 'Super Thursday' highlighted the risks to the economic outlook from the upcoming EU referendum. The MPC stated that "there are increasing signs that uncertainty associated with the EU referendum has begun to weigh on activity". In the press conference, Governor Carney said that the forthcoming referendum or as he called it, the "elephant in the room", has "pushed up uncertainty measures to levels not seen since the euro-area crisis". He elaborated further by saying that "**a vote to leave the EU could have material economic effects – on the exchange rate, on demand and on the economy's supply potential".**

Indeed judging by the text of the minutes, there appeared to be a detailed discussion at this month's meeting on the economic impact of a vote to leave. **The minutes stated that a vote to exit the EU "could materially affect the outlook for output and inflation".** The MPC noted that "**sterling was likely to depreciate further**, perhaps sharply", that "households could defer consumption and firms could delay investment decisions, **lowering labour demand and increasing unemployment**". Meanwhile, "UK activity growth was expected to pick up in the event of a remain vote".



The latest set of forecasts contained in today's Inflation Report were based on the assumption of continued UK membership of the EU. Growth over the forecast horizon was "expected to be slightly weaker than in the February projection". GDP growth is now expected at 2.0% this year (from 2.2%) and at 2.3% in 2017 (from 2.4%). Meanwhile, the inflation forecasts were broadly unchanged, remaining at 0.4% this year and at 1.5% next year (from 1.6%). **Governor Carney stated that the "MPC judges the most significant risks to its forecast concern the referendum".**

Overall, 'Super Thursday' shows that the BoE remains 'super cautious' and in no hurry to hike interest rates. This level of caution is heightened by the uncertainty associated with the upcoming referendum. In terms of market expectations, futures contracts do not envisage a UK rate hike materialising till the latter stages of 2018, which would bring the Bank Rate up to just 0.75% by end-2018. 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, the BoE could start to hike rates next year.

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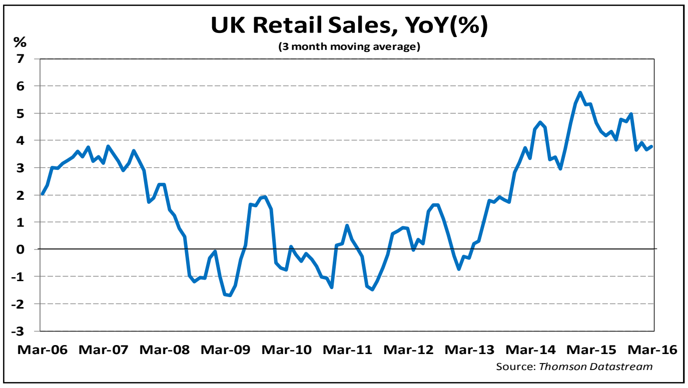
Referendum uncertainty weighing on activity

The preliminary estimate of UK Q1 GDP showed that the pace of quarterly growth slowed to 0.4%, from 0.6% in Q4 last year. Year-on-year growth remained at 2.1%. The underlying data showed that growth remained unbalanced, with the services sector accounting for all of the rise in GDP in the quarter, adding 0.5 percentage points (p.p.). The production and construction sectors each deducted approximately 0.05 p.p.

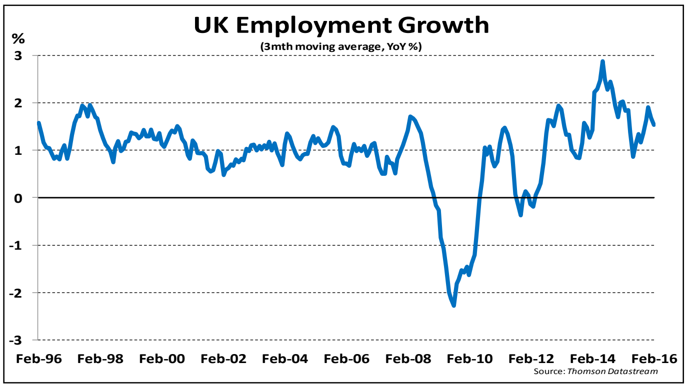
While we do not yet have the expenditure breakdown of GDP, data from Q1 suggest that consumption remained a key driver of growth. Retail sales had another solid quarter, rising by 0.8% following a rise of 1% in the previous quarter. In year-on-year terms, retail sales grew 3.8% in Q1.



Meanwhile, **industrial production fell by another 0.4% in Q1,** with the largest drag coming from the mining & quarrying (-2.3%). Manufacturing also declined (-0.4%). Furthermore, **the UK trade deficit (goods and services) widened in Q1 to £13.3bn, its highest level since Q1 2008.** This suggests that net trade likely remained a drag on growth in Q1. **Overall then, GDP growth seems to have remained skewed towards domestic spending in Q1.**

In terms of the more recent data, leading indicators have suggested that growth slowed at the start of Q2. The composite PMI fell to 51.9 in April, a three year low. The data suggest that the services sector has weakened, while manufacturing survey indicates that the sector continues to contract. The PMIs are mirrored by the EC sentiment indices. The economic sentiment index fell to a near three year low of 104.4 in April.

The slower pace of growth is starting to weigh on the job markets. Employment rose by just 20k in the three months to February, versus 267k in the previous three months. This equates to year-on-year growth of 1.2%, down from 1.9%. The unemployment rate held at a 10-year low of 5.1% for a fourth consecutive month in February. The timelier composite employment PMI fell further in April to 52.1, an over 2½-year low. This suggests that employment growth could moderate further in the coming months.



Despite low unemployment, year-on-year growth in average weakly earnings remains quite subdued. The ex-bonus measure of wage growth held at 2.2% in February, 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 March, coming in at 0.5%. The core CPI rate did pick up to 1.5% in March, although this seems to be due in part to the timing of Easter. Weak headline inflation means that real wage growth remains at a healthy level, despite the softer 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 clear signs that the uncertainty in regard to the outcome of EU referendum vote on June 23rd is beginning to impact on activity.** 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 European Commission is forecasting growth in the UK of 1.8% in 2016 and 1.9% in 2017.**

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