# BoE Watch

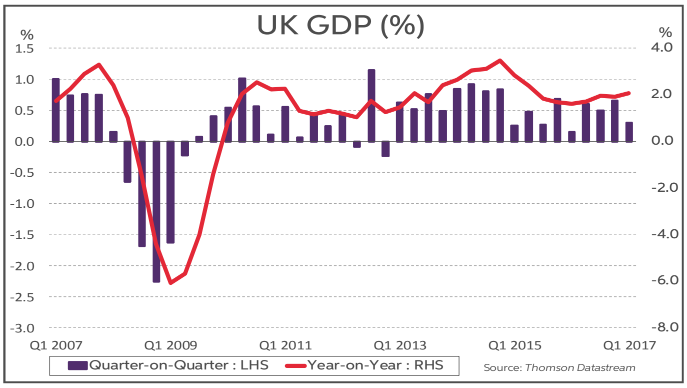
AIB Treasury Economic Research Unit

11th May 2017

# BoE remains concerned about above target inflation

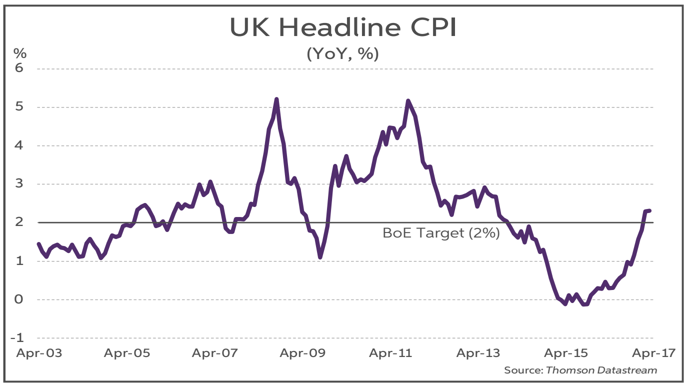
**As expected, the May meeting of the Bank of England's Monetary Policy Committee (MPC) concluded with no changes to policy.** The decision to leave interest rates unchanged was for a second consecutive month not unanimous, with a 7-1 vote (note: only eight members on MPC in May) to maintain the Bank Rate at 0.25%.

Once again, Kristin Forbes assessment was that underlying economic variables indicated there was "no justification for tolerating inflation overshooting the target for such an extended period". Therefore this warranted an "immediate increase in Bank Rate". **However, for the remaining seven members, they considered the "current stance of monetary policy to be appropriate".** They noted that the "actual and prospective" overshoot of inflation was "entirely due to the effects" of a weaker sterling which was due to factors that "monetary policy could not effect".




**In its discussion of the current performance of the UK economy, the BoE commented that "aggregate demand slowed markedly"** in the first quarter of the year. This slowdown was concentrated in the "consumer-facing sectors" in part "reflecting the impact of sterling's past depreciation on household income and spending". **The MPC stated that consumer spending is now likely to be "slower in the near term than previously anticipated".**

**The BoE's updated set of macro forecasts were also released today in the Inflation Report for May** and these reflected its re-assessment of the near term prospects for household spending. The Bank revised modestly lower its 2017 GDP forecast from 2% to 1.9%. Meanwhile, for 2018, it is now forecasting growth of 1.7% (from 1.6%) and for 2019 it is pencilling in GDP growth of 1.8% (from 1.7%). **On the inflation front**, the MPC expect it to peak at just under 3% towards the end of this year and decline thereafter. Overall, Inflation is "**projected to remain above the MPC's 2% target throughout the forecast period.**




**In the press conference, BoE Governor Mark Carney once again emphasised the difficult "trade off"** facing the MPC in terms of the timeframe with which "it intends to return inflation" to 2% and the key support that "monetary policy provides to jobs and activity". He noted that the economy over the next 2-3 years is expected to "operate with a degree of spare capacity" thereby "justifying that some degree of above-target inflation could be tolerated".

**Overall, while the MPC continues to state that monetary policy can respond "in either direction" it seems to be primarily concerned about above target inflation.** The minutes in May repeated the text that first appeared at the last meeting in March that for "some members" 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 MPC also stated that "monetary policy could need to be tightened by a somewhat greater extent over the forecast horizon than the very gently rising path" currently envisaged by markets. It must be noted that the MPC is assuming a "smooth" post-Brexit transition.

**Futures contracts indicate that the market is expecting a rate hike in early 2019.** However, we think that the UK economy will slow over the next two years in the run-up to Brexit, while the rise in inflation could also prove transitory given that wage inflation is quite subdued. Thus, we think monetary policy in the UK will remain on hold for the foreseeable future.

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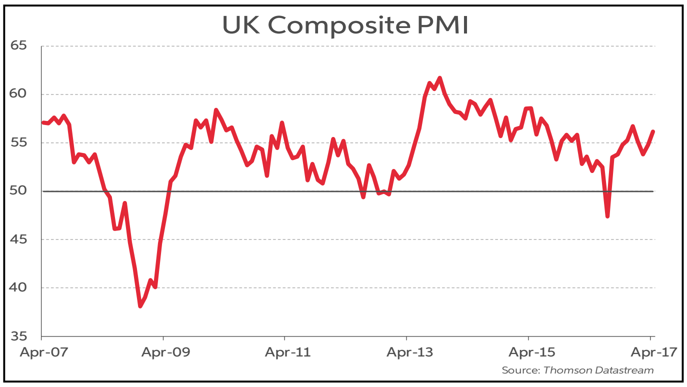
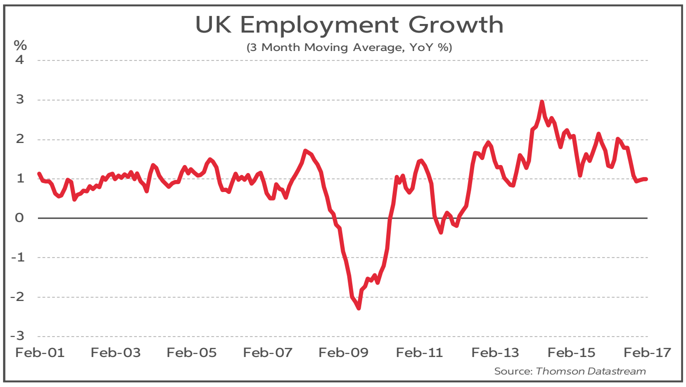
# UK economy growing at a slower pace

**Quarterly GDP growth in the UK slowed in Q1, from 0.7% to 0.3%.** However, soft growth at the start of last year meant that the pace of year-on-year growth edged up to 2.1%, from 1.9%. **The breakdown of GDP shows that the slowdown in Q1 was primarily due to the services sector.** It grew by 0.3%, compared to 0.8% in Q4. The 'retail trade' sub-sector was the largest contributor to the slowdown in services. Meantime, production edged up by 0.3%, matching its performance from Q4 2016.




**While an expenditure based breakdown of GDP is not due until May 25th, other Q1 data suggest that consumer spending slowed, or even possibly declined,** in the quarter. Retail sales fell by 1.4% in Q1, the first decline since Q4 2013 and their largest fall since Q1 2010. The ONS noted that the decline "seems to be a consequence of price increases". Meantime, despite the weaker sterling, the UK has not seen an improvement in its trade balance. Imports rose by 3.3% (in value terms) in Q1, while exports fell 0.5%. The resultant widening in the trade deficit suggests **trade may have acted as a drag on growth in Q1**. Meanwhile, industrial production rose by just 0.1% in Q1 (vs +0.4% in Q4), weighed down by a sharp fall in energy supply (-4.3%), likely as a result of mild weather.

**The aforementioned rise in prices is becoming a concern for the UK economy. CPI inflation rose to 2.3% in March.** Unlike in the Eurozone, 'core' inflation has also risen, coming in at 1.8%. 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 3.6% in March.** Further rises in producer costs may hurt the competitiveness of UK exports, while also feeding into additional upward pressure on consumer prices.




Meanwhile, **the labour market has seen some signs of improvement, after it softened around the middle of H2 2016.** Employment rose by 39k in the three months to February, having declined by 9k in the previous three month period. Overall, employment growth has fallen to 1% year-on-year. **The unemployment rate remained low at 4.7% in February.** Despite this, earnings growth has softened in recent months. The headline measure slowed to 2.2% year-on-year in February, indicating a further weakening in real wage growth.

**In terms of Q2 data, leading indicators have generally suggested that the economy improved at the start of the quarter.** The manufacturing PMI rose to 57.3 in April, a 3-year high. The services PMI picked up to 55.8, above its Q1 average of 54.3.

**Overall, the UK's so-called Brexit 'sweet spot' may be ending**. The economy has benefited from loose monetary policy and the weaker sterling. However, negative factors like higher inflation now seem to be coming to the fore. **The economy is facing into a period of heightened uncertainty. The negotiating process to decide on the UK's EU exit terms and any new trading arrangement is likely to drag on until near the end of next year.** Business investment may be adversely impacted, while jobs growth could remain subdued if employers expect weaker growth and a more difficult trading relationship with the EU. This would dampen consumer spending, as would rising inflation. However, there are expectations that the weaker sterling will have a positive impact on net trade, while we could also see higher levels of investment to meet stronger external demand. **Overall, the BoE expects GDP growth of 1.9% this year, 1.7% in 2018 and 1.8% in 2019.**



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