BoE Watch
AIB Treasury Economic Research Unit

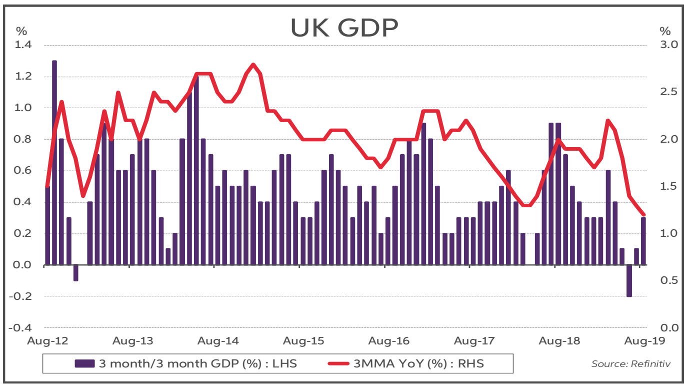
7th November 2019

BoE stays on hold, but sounding more dovish

The November meeting of the Bank of England's Monetary Policy Committee (MPC) concluded, as expected, with no changes to policy. The Bank Rate was left at 0.75%.

However, in a surprise versus market expectations, the decision to leave rates unchanged was not unanimous, with two members (Haskel and Saunders) voting for an immediate 25bps reduction in interest rates. Sterling experienced some modest weakening following this news. **The meeting statement, minutes and Governor Carney's press conference were all cautious in tone.**

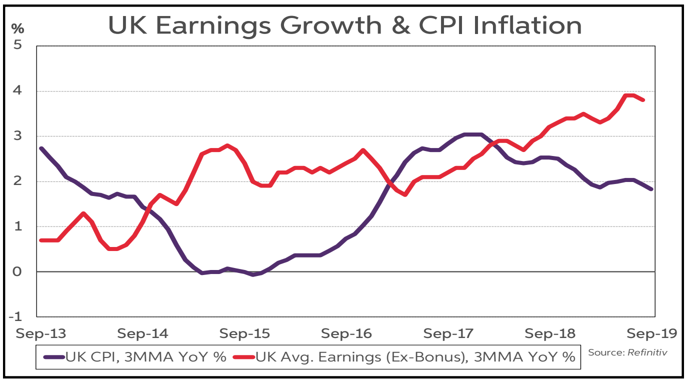
The BoE indicated that it remains on hold for now, as it waits to see how Brexit evolves and on developments in the global economy, before deciding its next policy move. In the minutes it stated that if global growth fails to stabilise or if Brexit "uncertainties remain entrenched", it may need to cut interest rates.



Source: Refinitiv

In the Brexit context, the outcome of the upcoming UK general election on December 12th could have an important bearing on the BoE's next move. The election could result in a new Parliament that is in a position to come to a decision on Brexit and pass the necessary legislation required to enact the revised Withdrawal Agreement Bill (WAB). In these circumstances, the BoE may stay on hold.

However, another hung Parliament, where the Brexit issue remains unresolved and the risk of a no-deal scenario start to rise again, could see the central bank cut interest rates before year end or early next year. **While the BoE continues to keep its options open by emphasising that policy could move "in either direction", given the tone of today's update (incl. two members voting for a rate cut), the likelihood is that if we do get a rate move in the near term, then it will be a rate cut.**



Source: Refinitiv

Today also saw the release of the BoE's latest economic update, rebranded as the 'Monetary Policy Report' (previously titled 'Inflation Report'). The macro projections in the report are predicated on the assumption of an "orderly transition to a deep free trade agreement" between the UK and EU.

The BoE is expecting GDP growth of 1% this year (previous f'cast was 1.3%), rising to 1.6% (was 1.3%) in 2020. For 2021 it revised lower its expectation to 1.8% (from 2.3%). Meanwhile, it is envisaging GDP growth of 2.1% in 2022. **In terms of the inflationary outlook,** the BoE's November forecasts show that it anticipates that inflation will rise towards 2% in 2021 and be slightly above its 2% target by end 2022.

In terms of market expectations, futures contracts have scaled back their view on BoE rate cuts in recent weeks. This has occurred due to the risk of a no deal Brexit at end-October abating, as well as polls suggesting the Conservative Party could win an overall majority in the December election (thereby increasing the likelihood of parliament passing the WAB). Markets no longer expect a 25bps rate reduction in the coming months and are now discounting a cut of around 20bps in rates during 2020.

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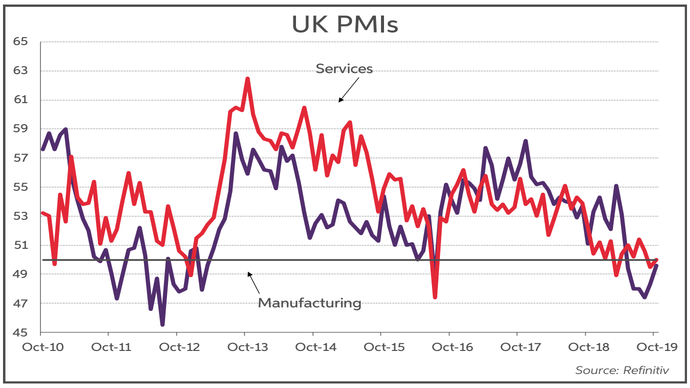
Brexit uncertainty weighs on UK economy

The UK economy contracted by 0.2% in Q2, as the boost to growth in Q1 from Brexit related stockpiling that saw GDP rise by 0.5% unwound. Indeed, changes to inventories subtracted 1.2 percentage points (p.p.) from the quarterly growth total. Net trade (excl. impact of non-monetary gold exports) added 0.5 p.p.. In terms of domestic demand, household spending, which has been boosted by rising real incomes, and government expenditure each contributed 0.2 p.p.. Business investment was essentially flat. Overall, GDP was up by 1.3% yoy in Q2.

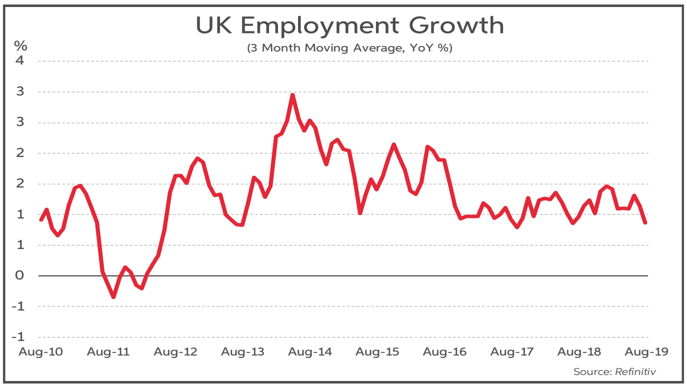


Source: *Refinitiv*

The available 'hard' data suggest that the UK avoided entering into a recession in Q3. The ONS' monthly estimate of GDP, which is by the output method, increased by 0.3% in the 3 months to August. Services continued to drive growth in the period, with the industrial sector acting as a drag. On the demand side, retail sales rose by a solid 0.6% in Q3 on Q2 levels, though they weakened as the quarter progressed.

In contrast, the PMIs for Q3 were consistent with continued economic contraction, though they have tended to understate growth recently. The manufacturing index held below the key 50 level throughout the quarter, averaging 47.9. In October, the PMI moved up to 49.6, though this partly reflected the effect of Brexit-related stockpiling ahead of the October 31st leave date. The service sector also appears to be going through a soft patch, with its PMI averaging just 50.5 in Q3, little changed from the previous quarter. The index came in at 50 in October, an improvement on September's reading when it was in contraction territory.

Meanwhile, some signs of weakness have begun to emerge in the labour market. Employment fell by 57,000 in the 3 months to August, the first decline in almost 2 years. This in turn led to the unemployment rate edging up to 3.9%, still a very low level. Underlying wage inflation, though, remains robust at 3.8%.



Source: *Refinitiv*

However, strong earnings growth has not led to a build-up in price prices. Indeed, lower energy inflation saw both the headline and core measures of CPI come in at 1.7% in September, below the BoE's target of 2%. Low inflation has allowed workers to enjoy an extended period of strong growth in real incomes, which is supporting household spending.

Overall, the outlook for the UK economy remains highly uncertain as its performance is largely contingent on the form that Brexit takes. Some clarity in this regard could be provided by the upcoming general election on December 12. However, there is considerable uncertainty regarding the future composition of Parliament, given the difficulties involved in forecasting UK election results. This in turn means a wide range of Brexit outcomes are still possible. A Conservative majority would likely see MPs ratify the revised Withdrawal Agreement, but difficult trade negotiations with the EU would follow in 2020. On the other hand, victory for the 'Remain Alliance' (Labour, SNP and Lib Dems) could result in a second referendum. It is also possible that there might be another hung Parliament, still deadlocked over Brexit. This could increase the risk once again that the UK might leave the EU without a deal.

On a positive note, the BoE looks set to maintain its accommodative policy stance. The more expansionary fiscal stance, as well as the still strong labour market which has aided consumer spending, should also support activity. **The most recent BoE forecasts are for growth of 1.0% in 2019, followed by 1.6% in 2020. These are close to the IMF's projections for GDP growth of 1.2% in 2019 and 1.4% in 2020**. It should be noted that these forecasts are based on the assumption of an orderly Brexit.

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