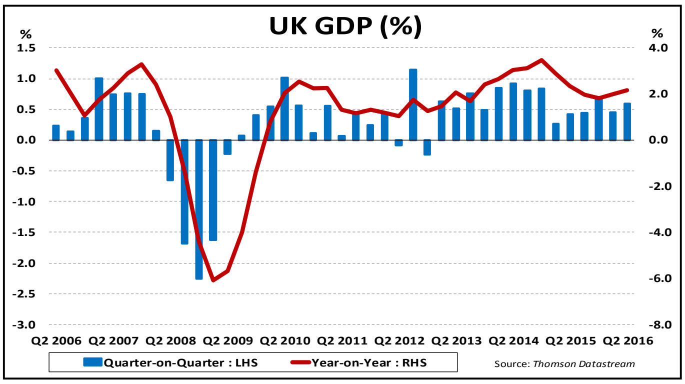
Bank of England Watch *15th September 2016*

AIB Treasury Economic Research Unit

Majority of BoE members expect another rate cut

The September meeting of the Bank of England's Monetary Policy Committee (MPC) concluded with no changes to monetary policy. The lack of any policy changes was expected as the BoE announced a raft of easing measures only last month. Indeed, the BoE commented that the "**focus of the Committee's September discussion had been on the immediate impact of the policy package** and whether the latest economic data had been in line with their projections" detailed in the August Inflation Report. The decision today to leave its current stance of monetary policy unchanged was unanimous.

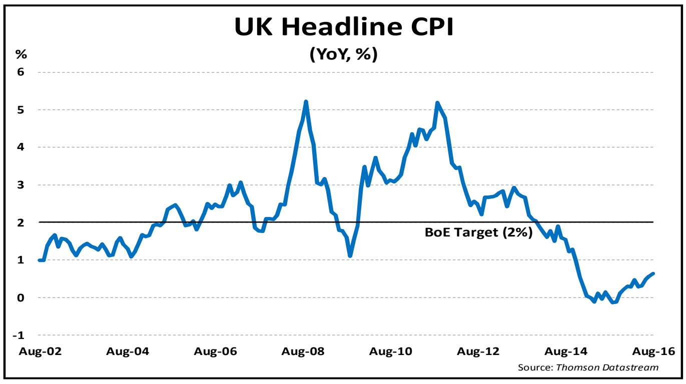


The August easing package was in response to the referendum outcome in favour of Brexit which the BoE viewed as leading to a "materially lower path of growth and notably higher path for inflation than would otherwise have been the case". **The monetary stimulus was designed to reduce the "amount of spare capacity in the economy and thus ensuring inflation returned sustainably"** to the Bank's 2% inflation target over time.

The measures included cutting the Bank Rate by 25bps to 0.25%. In addition, the BoE increased its asset purchase programme of UK gilts by £60bn over the next six months (bringing its total gilt purchases to £435bn) as well as announcing plans to purchase £10bn worth of UK corporate bonds. The BoE also announced that a new Term Funding Scheme which "will provide funding for banks at interest rates close to Bank Rate".

The September meeting statement remarked that the above measures had "led to a greater than anticipated boost to UK asset prices". The MPC noted that market rates (both short and long term) "fell notably following the announcement", corporate bond spreads narrowed and "equity prices rose". While commenting that the initial impact of its policy easing has been "encouraging", the MPC remains cognisant that it is still early days in its policy implementation and therefore stated that it will "monitor closely changes in asset prices and in interest rates" and "their effect on economic activity".

The BoE acknowledged that some recent macro data has been "less negative than expected" and "slightly to the upside relative to the August Inflation Report projections". However, **its overall assessment of the economic outlook has not changed, with the BoE continuing to expect that the "UK economy was likely to see little growth in the second half of 2016"**. Although, the pace of slowdown might be slightly less severe than had been expected.



In terms of the outlook for monetary policy, today's BoE meeting delivered a similar message to the one given in August. Namely, **the BoE retains a strong easing bias, and if required, will take action and provide additional monetary stimulus before the end of the year**. The September minutes stated that the MPC will assess incoming data "during its November forecast round". Following this, if the economic outlook is "judged to the broadly consistent" with the August Inflation Report, **"a majority of members expect to support a further cut in Bank Rate to its effective lower bound" at one of its two remaining meetings (November and December) this year.** The MPC judges this bound to be "close to, but a little above zero", meaning a 10-15bps cut could well be on the cards before the year is out.

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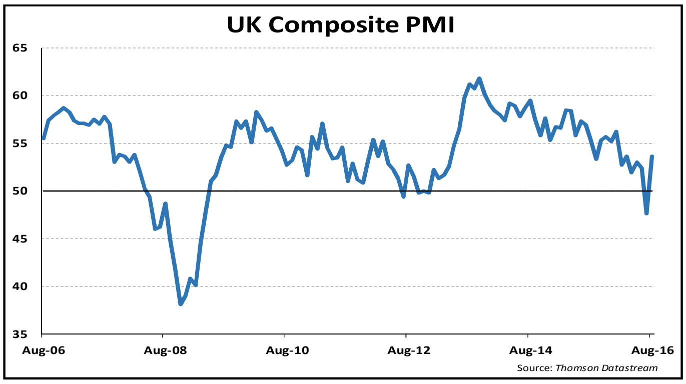
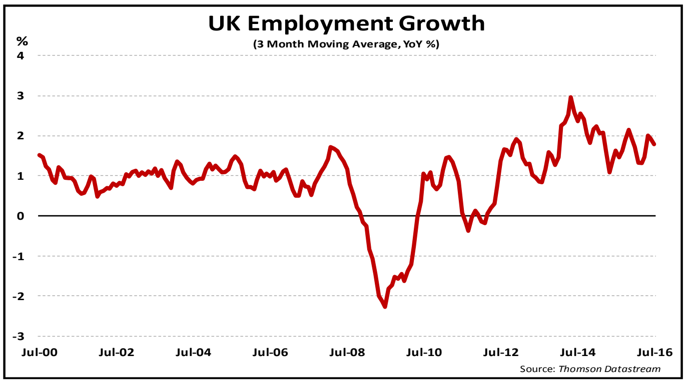
Mixed economic signals following Brexit vote

The UK economy grew by 0.6% in Q2, in the lead-up to the referendum. This represents a pick-up compared to Q1's 0.4% rise. The economy grew by 2.2% year-on-year in Q2, up from 2%. The underlying data show that consumer spending remained the primary driver of growth, contributing 0.6 percentage points to GDP. Business investment rose modestly (+0.5%) in Q2, after declining in the two previous quarters, adding 0.05 p.p. Inventories also boosted GDP, adding 0.3 p.p. Net exports, though, remained a drag, deducting 0.3 p.p. **Overall, UK growth remains unbalanced, with a heavy reliance on domestic spending.**



Data for Q3 (post-Brexit vote) have been mixed. Leading indicators of activity fell sharply in July, reflecting initial shock at the referendum outcome, before largely recovering in August as this abated. For example, the composite PMI fell to 47.6 in July, a seven and a half year low, before bouncing back to 53.6.

Consumer confidence indices have not rebounded to the same extent as the business surveys. This is of concern given that consumer spending has been the key driver of growth in the UK in recent years. For example, the Gfk confidence measure fell from -1 in June to -12 in July, only showing a modest improvement to -7 in August. However, actual spending data has been more encouraging. Retail sales grew by a solid 1.5% in July/August versus Q2, in which they grew by 1.6%. The breakdown of the sales data show that growth in retail spending remained relatively broad based.



Labour market data have also been somewhat mixed. Employment maintained a solid pace of growth in the three months to July, rising by 173k. This translates into year-on-year growth of 1.8%, which is consistent with the trend over the past couple of years. This would suggest that there was no marked slowdown in the jobs market in the run-up to the referendum or in the immediate aftermath. However, the UK composite employment PMI has been weaker in recent months, hovering close to the expansion indicating 50 level since May. **This suggests that we could yet see a slowdown in the labour market in the near-term.**

Despite low unemployment of 4.9% in July, year-on-year growth in average earnings has softened. The ex-bonus measure slowed to 2.1% in the three months to July, well below the previous July's 2.8% figure. Meantime, CPI inflation held at 0.6% in August, though it will likely begin to rise as a result of sterling depreciation. This could see real wage growth weaken further, acting as another headwind for GDP growth.

Overall, the UK economy is facing into a period of heightened uncertainty. This is likely to weigh on consumer spending, the key driver of growth in the past few years. Business investment is also likely to be adversely impacted by Brexit related uncertainty, following on from weak figures in recent quarters. Employers may hold off on hiring new workers, amid expectations of a weaker pace of growth and a lack of clarity over future access to the EU's Single Market.

The negotiating process to decide on the UK's EU exit terms and agree a new trading arrangement could drag on for quite some time. The outcome of these talks will ultimately determine the long-run implications of Brexit for the economy. In the meantime, the sharp fall in sterling could boost UK exports to some extent, while BoE easing should help mitigate some of the negative effects. **The impact of the referendum is still likely to be negative overall, leading to quite subdued growth in the next couple of years.** Indeed, the MPC now estimates that UK GDP will be around 2.5% lower at the end of 2018 than previously expected.