BoE Watch

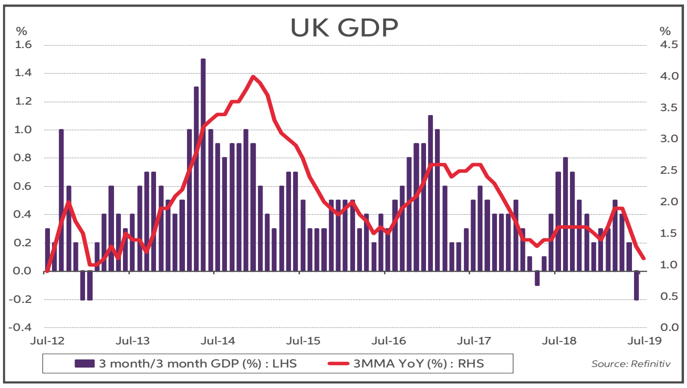
AIB Treasury Economic Research Unit

19th September 2019

BoE sits tight, awaiting Brexit fog to clear

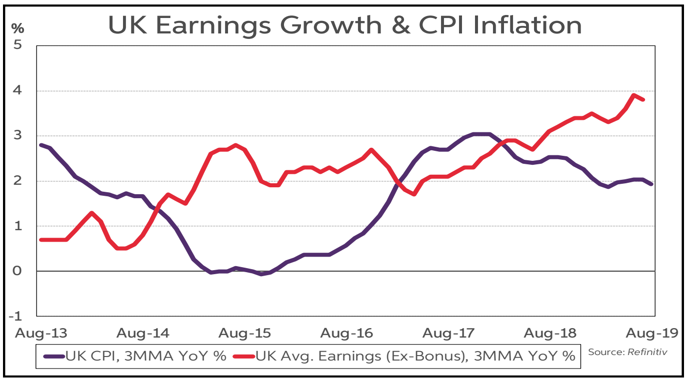
As expected, the September meeting of the Bank of England's Monetary Policy Committee (MPC) concluded with no changes to policy. The bank rate was left at 0.75%. The decision to leave rates unchanged was unanimous. The last time the rate was altered was back in August 2018, when it was raised by 25bps.

The meeting statement and minutes highlight the difficulties facing the BoE in its policy deliberations due to Brexit. UK GDP growth has become more volatile than usual this year, owing to fluctuations in inventories and changes to production schedules linked to Brexit. Furthermore, the underlying pace of growth in the UK economy has slowed to below-potential, in part due to a weaker global economy, but also the ongoing Brexit uncertainty. Indeed, **in a somewhat dovish comment, the MPC says a margin of spare capacity has opened up in the economy.**



The BoE's latest view on the UK economic outlook was set out in its August Quarterly Inflation Report. The macro projections in the report continue to be based on the assumption of a relatively "smooth adjustment" following the UK's exit from the EU. The BoE is expecting growth of 1.3% this year and next. Meanwhile, in terms of the inflationary outlook, the BoE's August forecasts show that it anticipates that inflation will be above its 2% target in two years time. Inflation has been weaker than expected recently, though, with the core CPI rate falling to 1.5%.

In terms of market expectations, futures contracts indicate that the market is no longer expecting a 25bps rate cut from the BoE. A 25bps reduction in the bank rate had been envisaged for the first half of 2020, with possibly another cut to follow later in the year. This expectation was against the backdrop of increased concerns over the rising risk of a no-deal hard Brexit and the weaker global macro environment. However, recent weeks have seen markets scale back their expectations on the extent of policy easing globally, while the risk of a no-deal Brexit at end October has diminished. Thus, markets are now pricing in at most a 15bps rate cut in the UK around the middle of next year.



Overall, today's update from the BoE indicates that it is very much in wait-and-see mode. It is awaiting clarity on how Brexit will evolve and the consequences this will have for monetary policy.

If a no-deal Brexit emerges, the MPC says that policy could move in either direction. In our view, we think the BoE would act quickly, cutting interest rates by up to 50bps to offset some of the negative effects of a hard Brexit on the economy. On the other hand, the MPC warns that continuing major uncertainty over Brexit could see growth remain weak and reduce inflationary pressures. However, if a smooth Brexit materialises, combined with some recovery in global activity, then this **could well bring rate hikes back on to the policy agenda**. The MPC indicated in the minutes of today's meeting that in this scenario, an increase in interest rates, albeit at a gradual pace and to a limited extent, would be "appropriate" in order for it to achieve its inflation objective of 2%.

Overall then, **there are a wide range of possible outcomes next year for the UK economy, interest rates and, indeed, sterling, depending on how Brexit evolves in the coming months. For now, though, the MPC says the existing stance of policy is appropriate.**

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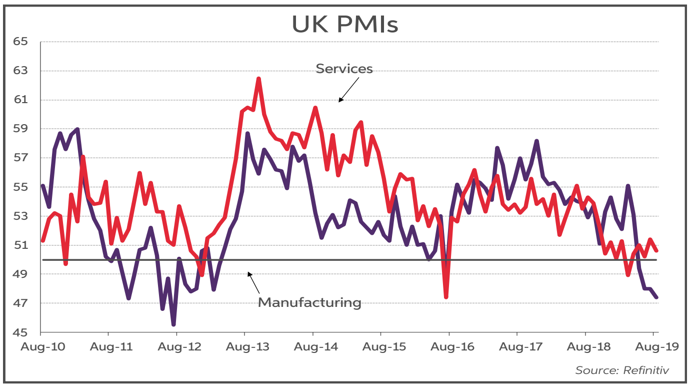
Very modest growth in UK economy

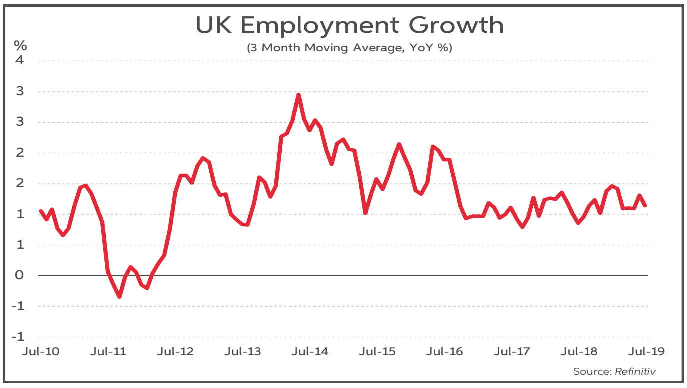
The UK economy contracted by 0.2% in Q2, as the boost to growth in Q1 from Brexit related stockpiling that saw GDP rise by 0.5%, unwound. Changes in private inventories and net trade combined to subtract 0.7 percentage points (p.p.) from GDP in Q2. In terms of domestic demand, household spending, which has been boosted by strongly rising real incomes, added 0.3 p.p., while government expenditure contributed 0.1 p.p.. Business investment was flat. Overall, GDP was up by 1.2% yoy in Q2.



Leading indicators of activity suggest that the economy has not regained much momentum in Q3. Survey data show that the manufacturing sector remains mired in difficulty, as both uncertainty regarding Brexit and the slowdown of the global economy act as headwinds. The sector's PMI averaged 47.7 in July/August, compared to 50.2 in Q2. Meantime, the services PMI came in at a subdued 51 for the same two months, versus 50.5 in Q2. Finally, Brexit related concerns saw the GfK measure of consumer confidence fall sharply in August.

The available 'hard' data, though, suggest the UK economy should expand, albeit only marginally, in Q3. The ONS's monthly estimate of GDP, which is by the output method, increased by 0.3% in July, with the services, manufacturing and construction sectors all growing in the month. Retail sales were weaker in August, contracting by 0.3%, but in the quarter-to-date are still up by a robust 0.7% on Q2 levels. The BoE is now forecasting that GDP will grow by 0.2% in Q3.

Meanwhile, labour market developments have generally been positive. Employment growth has eased but remains solid at 1.1% in year-on-year terms in the three months to July. At the same time, the employment rate is at a joint record high. The jobless rate has also held at 3.9%, close to a multi-decade low level. Overall, the tightness of labour market conditions has seen underlying wage inflation pick up to 3.8%, just below the cycle high hit in Q2.



The acceleration in earnings growth has not yet translated into an increase in price pressures. Indeed, headline inflation fell below the BoE's 2% target in August to 1.7%, while the core measure decelerated to 1.5%. Low inflation has allowed workers to enjoy an extended period of strong growth in real incomes, which is boosting household spending.

Overall, the outlook for the UK economy remains highly uncertain. Ultimately, its performance is largely contingent on the final form that Brexit takes. Until a clearer picture emerges, uncertainty is likely to continue to weigh on activity. Recent developments in the House of Commons have helped reduce the possibility of a no-deal Brexit at end-October. Various studies, including one from the Bank of England, suggest that that a no-deal Brexit could result in a marked weakening in activity, with the impact likely to be frontloaded. On the other hand, activity could rebound next year if there is a soft Brexit that maintains existing trading relations with the EU during a transition period. Trends in the global economy and a likely general election in the UK in November could also prove risk factors for the economy.

On a positive note, the BoE looks set to maintain its accommodative policy stance. The more expansionary fiscal stance, as well as the strong labour market which has aided consumer spending, should also support activity. **The most recent BoE forecasts are for growth of 1.3% in 2019, followed by 1.3% in 2020. These are in-line with the IMF's projections for GDP growth of 1.3% 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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