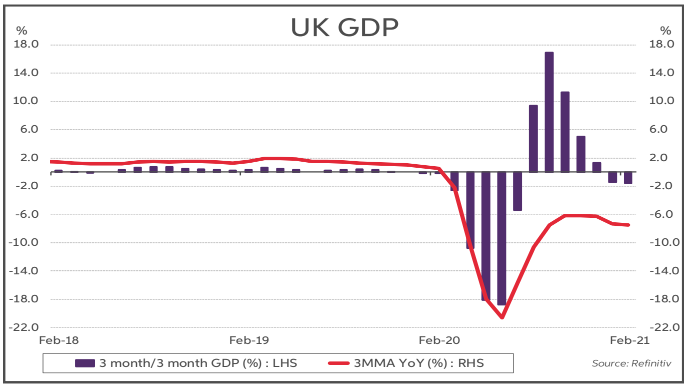
BoE Watch

AIB Treasury Economic Research Unit

6th May 2021

Technical, tepid taper on growing optimism on economy

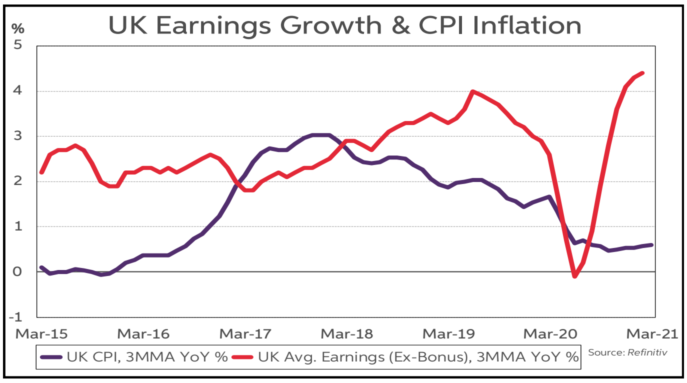


The Bank of England Monetary Policy Committee (MPC) meeting for May concluded with no changes to the broad parameters of its monetary policy settings. The Bank Rate remains at its historic low of 0.1%. It also left unaltered the size of its QE, at £895bn (£875bn in UK Gilts, £20bn in corporate bonds). **There was unanimity within the MPC on its decision in relation to interest rates.** Meanwhile, there was a majority 8-1 vote to leave its Gilt purchases at its current size, with one MPC member, Andrew Haldene (who is leaving the MPC after June's meeting), preferring to reduce the target stock of these purchases to £825bn.

There had been some speculation in the lead up to today's meeting that the BoE may announce a tapering of its QE programme. While the BoE did indeed announce a slowing in the pace of asset purchases, it emphasised that "this operational decision should not be interpreted as a change in the stance of monetary policy". Though the BoE reduced its weekly asset purchases to £3.4bn from £4.4bn, this can be viewed as a largely technical move as the size of the QE programme remained unchanged at £875bn. The BoE still intends to complete its existing programme around the end of this year.

The general tone from the meeting statement and minutes was one of growing optimism in relation to the outlook for the UK economy. The statement noted that new Covid cases had continued to fall, the vaccination programme is proceeding swiftly, while restrictions on economic activity are easing. However, the BoE also acknowledge the still high degree of uncertainty. It stated that the economy's growth prospects still depend on the evolution of the pandemic, measures taken to protect public health and how consumers, businesses as well as markets react to these developments.

A more detailed insight into the BoE's assessment of the economic outlook was contained in the May edition of its Monetary Policy Report. It revised higher its GDP growth forecast for this year to 7.25%, from 5%. It referenced a number of factors underpinning the strong recovery it expects over the remainder of the year. This included the boost to demand growth from reduced health risks and uncertainty, fiscal and monetary stimulus, a rundown of household savings as well as business investment levels benefitting from rising sales and less uncertainty. It anticipates that GDP will recover to its pre-Covid levels over the remainder of this year. **Thereafter, the pace of growth was expected to slow as the boost from some of this factors started to wane.** As a consequence, for 2022, it is now anticipating growth of 5.75% compared to its previous forecast of 7.25%. Meanwhile, for 2023, the BoE left its growth forecast unchanged at 1.75%. **The MPC judged that the risks to its economic outlook were skewed to the downside in the first year** of its forecasting horizon, reflecting the uncertainty in relation to the pandemic. **However, over the period 2022-23, it assessed the risks to be "broadly balanced".**



On the inflation front, the BoE expects that the CPI rate will "rise temporarily" above its 2% target towards the end of this year. It attributes this anticipated increase mainly to developments in energy prices. It expects these to be transitory and have few direct implications for inflation over the medium term, with inflation expected to return to around 2%. Meanwhile, in terms of labour market conditions, it now envisages the unemployment rate peaking at just under 5.5% in Q3'21. This compares to its previous assumption in the February Monetary Policy Report of it peaking at 7.75% midway through this year.

Overall, given its objective to eliminate spare capacity and achieve its 2% inflation target sustainably, the BoE still seems some way off from contemplating raising interest rates. However, futures contracts indicate that the market is pricing in a rate hike from the BoE in the second half of next year, to 0.25%. Market reaction was muted given the stance of policy remained unchanged.

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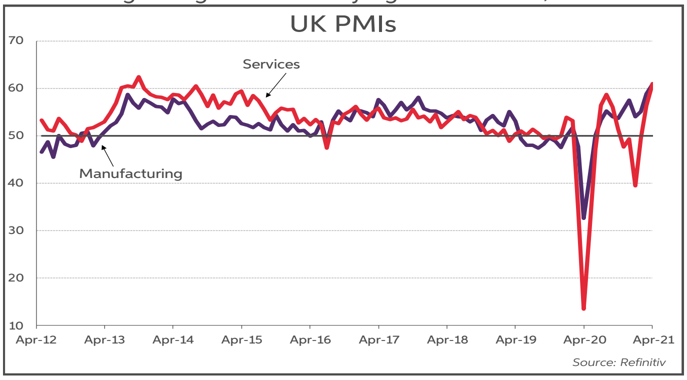
UK recovery gathering momentum

The economic recovery in the UK slowed in the final quarter of 2020. GDP grew by just 1.3% as the UK battled a second wave to the Covid-19 pandemic. Regarding the underlying breakdown, household consumption fell by 1.6% in Q4, clipping 1.0 percentage points (p.p.) off GDP. Government expenditure added 1.3 p.p. and investment contributed a further 0.8 p.p to the total. Net trade subtracted 1.5 p.p. from growth, as imports outpaced exports, although this was offset by a rise in inventories (+1.4 p.p.).



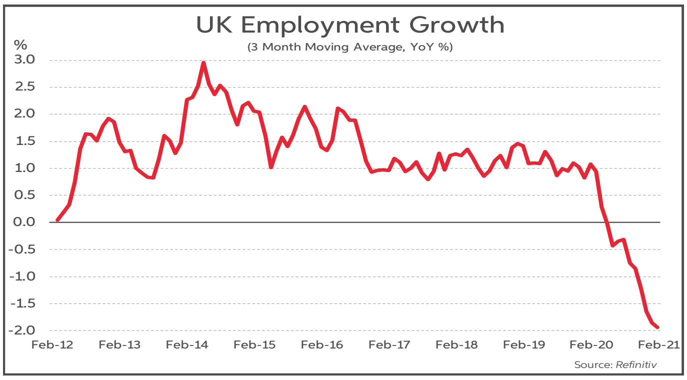
In Q1 the manufacturing PMI averaged 56.0, slightly above its average in Q4 of 55.6, and solidly in expansion territory, consistent with an increase in output. In contrast, the services PMI held steady just below the 50 threshold in Q4 and plunged to 39.5 in January, as the national lockdown was put in place. However, the index rose to 49.5 in February, and climbed higher again in March to 56.3 as businesses started to prepare for a gradual re-opening of the economy due to the vaccine programme.

Hard data indicates that economic activity remained weak in Q1, but started to pick-up as the quarter progressed. Industrial output grew by 1% in February, only a partial rebound following a fall of 1.8% in January, leaving output 3.5% below its pre-Covid level. Monthly GDP data shows that the UK economy contracted by 2.2% in January 2021, as restrictions were tightened to stop the spread of a more virulent strain of the virus. The economy expanded by just 0.4% in February, as services activity remained weak. Meanwhile, retail sales fell by 5.8% in the quarter, although sales did rise by 5.4% in March.

The Government's recently extended furlough scheme continues to shelter the labour market from the pandemic. The unemployment rate was 4.9% in February, up from its lows of 3.9% of last June. The scheme has been extended until September, beyond the expected June deadline for most of the Covid-19 restrictions to be eased. This should limit the rise in unemployed, although, it is still expected to increase this year.

In terms of inflation, the headline CPI rate rose from 0.4% to 0.7% in March. The core rate edged higher to 1.1% from 0.9% also. Overall, though inflation remains subdued, a sharp rise is expected this year. In particular an increase in energy costs, and the unwinding of most of the VAT cut will see inflation rise over the coming months. As these transitory measures wash through the index, inflation may reach 2% by year end.

Turning to the limited amount of Q2 data available, there are signs the recovery is starting to gather momentum. Both the services and manufacturing PMIs soared in April. The manufacturing index printed at 60.9, while the services index rose to 61.0, its highest level in over 6 years. Consumer confidence also improved in April, edging higher to –15 from –16 in March, and up from –28 in January.



Thus, there are signs of optimism for the UK economy. The quick pace of the vaccine rollout has allowed the economy to start gradually re-opening, with most domestic restrictions set to be removed by the end of June. The Budget kept supports in place beyond the reopening, and introduced measures to boost investment. The extension to the stamp duty holiday is providing a further fillip to activity in the housing market, with prices rising by 2.1% in April, the largest monthly rise since February 2004. Thus, the economy is primed to recover strongly in 2021-2022. **The IMF expects UK GDP to expand by 5.3% this year and by 5.1% in 2022. Meanwhile, the BoE is forecasting GDP growth of 7.25% and 5.75% over the same period.**

However, longer term there are economic headwinds on the horizon that will need to be navigated carefully. To counterbalance increased spending, a host of tax hikes, including to corporation tax in 2023 have been announced. By that stage global growth may have cooled somewhat as well. The "skinny" FTA signed with the EU last December will also act as a drag on UK exports over the coming years.

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