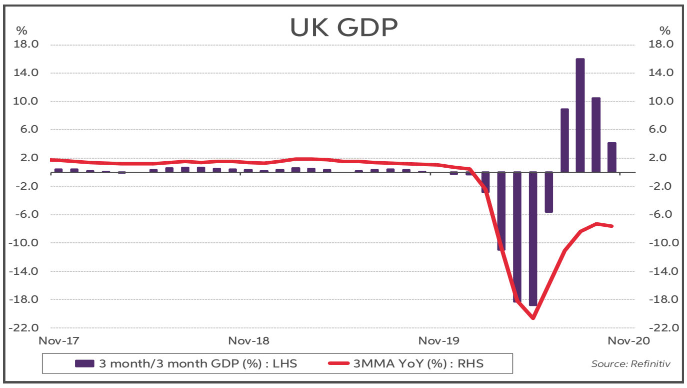
BoE Watch

AIB Treasury Economic Research Unit

4th February 2021

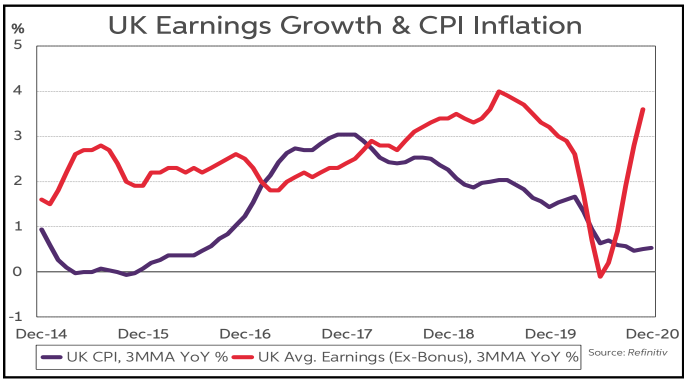
BoE less dovish than expected



The first Bank of England Monetary Policy Committee (MPC) meeting for 2021 saw the central bank leave its policy settings unaltered. This outcome was very much in line with market expectations. The Bank Rate remains at its historic low of 0.1%, a level it has been at since March of last year. Meanwhile, it also left unchanged the size of its asset purchase programme, at £895bn. The last policy change made by the BoE to this programme was in November, when it increased its total target stock of QE by £150bn. There was unanimity within the MPC on its decision to leave policy unchanged. In the meeting statement and minutes, the BOE outlined its rationale for this. It noted that the outlook for the economy remained "unusually uncertain". It emphasised the trajectory for the economy would depend on how the pandemic and the measures introduced to deal with the associated public health issues evolve.

The Monetary Policy Report for February provided a more comprehensive insight into the BoE's current thinking on the economic outlook. From a near term viewpoint, it expects the economy to contract by around 4% in Q1 of this year due to the imposition of another 'lockdown', whereas at the time of its last set of forecasts in November, it had anticipated the economy would expand in Q1. However, it expects GDP to "recover rapidly" towards its pre-Covid levels over the course of this year on the assumption of the success of the vaccination programme allowing the easing of restrictions. The BoE also stated that the EU-UK FTA that is now operational had broadly similar features to the assumptions it used for its November forecasts. The MPC was of the view that the near term risks to the economy from the pandemic remained tilted to the downside, although not to the same degree as had been the case in November.

For 2021, the BoE is now projecting growth of 5% compared to its previous forecast of 7.25%. It envisages growth slowing in 2022 as the boost to activity from the comprehensive fiscal and monetary policy initiatives starts to fade. Nonetheless, it revised higher the 2022 growth forecast to 7.25% from 6.25%. The BoE expects the economy to get to back to its pre-Covid level by Q1'2022 (similar to the timeframe expected in November).



On the inflation front, the BoE expects that the CPI rate will increase "quite sharply" towards its 2% in the spring as the VAT reduction for certain services expires and on base effects from higher energy prices. Further out, it anticipates inflation remaining near to its 2% target over the period 2022-23. Meantime, it once again stressed that underlying labour market conditions remained difficult to interpret. It does however, expect the unemployment rate to continue to rise over the coming quarters, with it peaking at around 7.75% midway through this year.

The other main point of interest from the meeting was the update from the BoE's exploratory work on the operational feasibility of "zero or negative" interest rate policy for the UK banking sector. The Bank stated this assessment indicated that the sector would not be able to implement such a policy, if required, without potentially incurring operational risks, for at least another six months. The MPC was keen to emphasise that it did not wish to send any signal that it intended to implement a negative interest rate strategy. **Futures contracts indicate that the market is no longer pricing in the possibility of the Bank Rate moving into negative territory, given that the BoE has effectively ruled out such a move for at least the coming six months.** Meanwhile, by repeating that it expected QE purchases to be completed "around the end of 2021", the MPC implied that the pace of QE will slow from the current £4.4bn a week.

In conclusion, there was nothing from BoE's February meeting to suggest that it is preparing for any further policy changes in the near term. Indeed, judging by the reaction of sterling, which has made some gains in the meeting's aftermath, with EUR/GBP below 88p, it suggests that the market viewed the latest BoE update as being less dovish than it had been expecting.

Oliver Mangan
Chief Economist
oliver.n.mangan@aib.ie

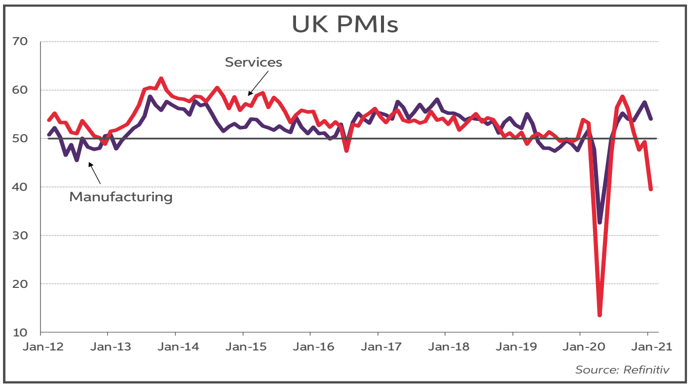
John Fahey
Senior Economist
john.j.fahey@aib.ie

Daniel Noonan
Economist
daniel.x.noonan@aib.ie

Strong rebound, following Q1 contraction

The UK economy expanded by 16% in Q3, following an unprecedented contraction of 18.8% in Q2. GDP also fell by 3% in Q1. In terms of the rebound in activity in Q3, consumer spending led the recovery, up by 19.5% on a q/q basis. Fixed investment also performed well, rising by 17.9% q/q. Government expenditure increased by 10.4% q/q. In terms of net trade, imports increased (+11.7%), while exports declined (-0.4%).

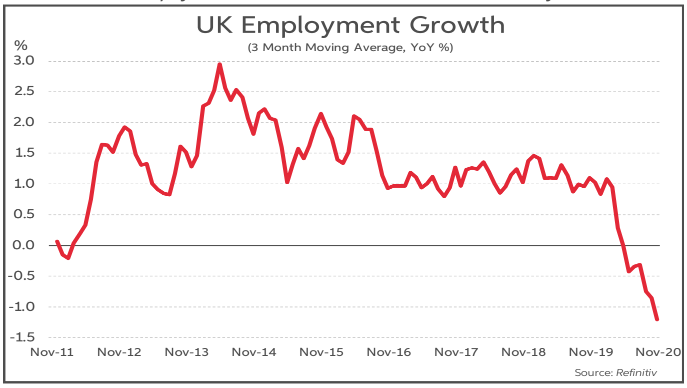
The available "hard" data suggest that the economic recovery may have stalled in Q4. The monthly GDP estimate for October, which is calculated by the output method, was up just 0.6% m/m. Meanwhile, a second national lockdown saw GDP fall by 2.6% in November, but it almost certainly rose in December when restrictions were eased. Retail sales fell by 0.2% in Q4, although, they remained 2.7% above their pre-Covid level with consumers and businesses having better adapted to life under lockdown.



The PMI data also suggest that the economy is better equipped to deal with restrictions than in the spring. The composite PMI averaged 50.5 in Q4. While this is lower than it was in September (56.5), it is nowhere near as low as it was in the spring. However, social distancing rules and travel restrictions continued to supress activity in the service sector, which averaged 49.5 in Q4, down from 56.1 in September. Again though, the index did not plummet, as it did earlier in the year. The manufacturing PMI remained in expansion mode throughout Q4, with an average reading of 55.6.

The Government's furlough scheme continues to shelter the labour market from the pandemic. The unemployment rate has been on a steady upward trend since the summer, rising to 5% in November from 3.9% in June. However, the claimant count for December rose by just 7k, which suggests that the rate of deterioration in the labour market may have slowed. However, the government furlough scheme is due to expire in April which may lead to a sharp rise in unemployment.

In terms of inflation, the headline CPI rate rose from 0.3% to 0.6% in December. The core rate rose from 1.1% to 1.4% also. Overall though, inflation remains subdued as lower energy prices and the VAT cut continue to act as headwinds. However, the BoE expects inflation to rise sharply towards 2% in Q2 as transitory measures, such as the VAT cut, wash through the index.



The limited available data for January, suggests the third national lockdown is more adversely impacting the economy than in Q4, especially the services sector. The services PMI fell to 39.5 in January from 49.4, while the manufacturing PMI remained in expansion mode at 54.1.

A number of downside risks to the UK economy remain in the near-term. The most pressing is the increased transmissibility of new variants of Covid-19. The lockdown has already been extended until the 8th of March to try and ease pressure on the health system. A side effect of this, will be the continued level of subdued economic activity. This will likely see the UK economy contract again in Q1. The EU -UK FTA is also a limited agreement which does not include services, and is far inferior to the Single Market. The removal of supports and potential tax hikes in next months Budget would also slow the pace of the economic recovery once restrictions are unwound.

However, there are signs of optimism also. The UK's vaccine rollout programme is well under way with more than 10 million people having already received their first dose of a vaccine. The sharp rebound in economic activity in Q3 last year demonstrates that the economy can recover quickly once restrictions are removed. Monetary policy will also remain accommodative as the recovery gets underway. **The latest forecasts from the BoE show GDP contracting by about 4% in Q1 2021. However for the full year, output is expected to rise by 5% in 2021 and 7.25% in 2022. Thus the bank is anticipating a very strong rebound in activity.**