# BoE Watch

AIB Treasury Economic Research Unit

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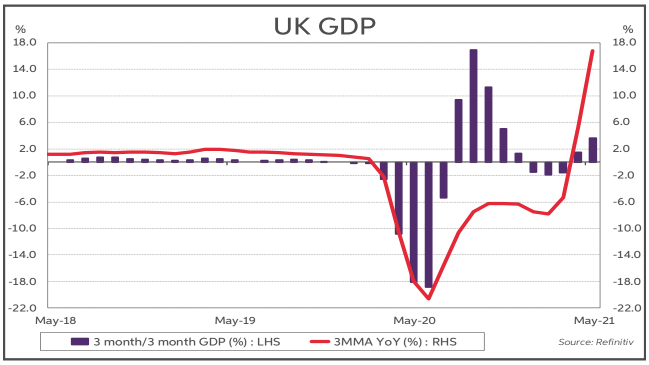
# BoE sticks to loose policy, but drops clues about tightening

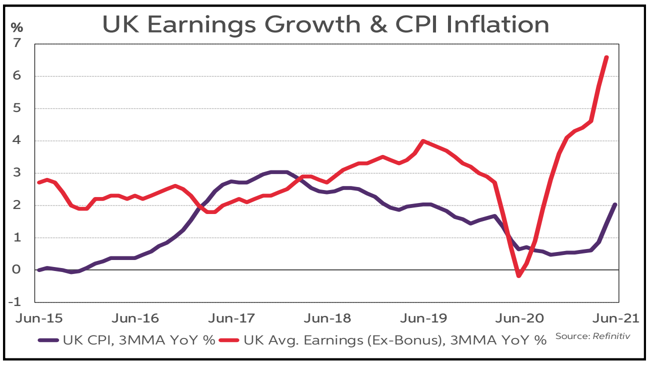
**The August meeting of the Bank of England's Monetary Policy Committee (MPC) concluded as expected with no changes to its monetary policy settings.** The Bank Rate remains at its historic low of 0.1%. It also left unaltered the size of its QE programme, at £895bn (£875bn in UK Gilts, £20bn in corporate bonds). **There was unanimity within the MPC on its decision in relation to interest rates.** Meanwhile, as at the previous meeting in June, there was a majority vote to leave its Gilt purchases at its current size, with just one MPC member dissenting. He wanted to reduce the target stock of these purchases to £830bn, resulting in a 7-1 vote in favour of leaving QE unaltered.




**A couple of MPC members had voiced some concerns in recent weeks about the risk of a possible overshoot of the BoE's inflation target over the medium term** and, as a result, indicated policy might need to be tightened a bit sooner than previously expected. Thus, it was not a surprise to see a vote again today in favour of rowing back somewhat on the scale of asset purchases. However, by far the majority view on the MPC was to continue with the current asset purchase programme, which is to run until the end of the year. Nonetheless, the **MPC did indicate that "some modest tightening of monetary policy" was likely over the forecast period to meet its inflation target. This points to rate hikes within the next couple of years.**

In this regard, today's Monetary Policy Report, containing the latest quarterly updates to the Bank's macroeconomic forecasts, showed significant upward revisions to its near-term inflation projections compared to May. **The CPI rate is now seen rising to 4% in Q4 2021 compared to the previous forecast made in May of 2.5%, with the Q4 2022 forecast upped to 2.5% from 2.0%.** The BoE still believes that the rise in inflation will prove transitory as it is largely due to one-off factors as global economic activity rebounds, such as a recovery in commodity prices and temporary supply bottlenecks. These price pressures are expected to start subsiding next year. Thus, the BoE has stuck to its forecast of inflation at 2% in Q4 2023. It says the risks to its inflation forecasts are broadly balanced.

**The MPC remains optimistic about the economy's growth prospects.** It made no change to its GDP growth for this year of 7.25%. The pace of growth is expected to slow from next year as the boost from factors such as the very stimulatory stance of both fiscal and monetary policy and the rundown of household savings, start to wane**.** Therefore for 2022, it is anticipating growth of 6%, up from May's 5.75% forecast. Meanwhile, for 2023, the BoE also upgraded its GDP growth forecast by 0.25% to 1.5%.




**In summary, the BoE envisages that the UK economy will experience a temporary period of very strong GDP growth and well above-target CPI inflation**, after which it expects growth and inflation to ease back. Thus, as expected, there were no signs today that the BoE is contemplating any early tightening of policy. It is not surprising that the bulk of MPC members are reluctant to alter monetary policy at present, given the high level of economic uncertainty, including in relation to the outlook on inflation. The MPC will also want to assess the impact of the scaling back of fiscal supports on the economy, in particular, the effect of the expiry at the end September of the job furlough scheme on the labour market. **It was noteworthy today that the BoE has changed its view on unemployment and now believes that the jobless rate has already peaked, pointing to only a limited rise in unemployment when the furlough scheme ends next month.**

**Futures contracts were little moved by the meeting outcome today. They continue to price in a very gradual pace of policy tightening in the UK,** with rates remaining at very low levels over the next few years. The market is expecting the first rate hike of 0.125% by the middle of next year, with a second 0.125% rate increase following in late 2022, which would bring rates up to 0.375% by the end of next year. Rates are seen as rising by just another 25bps in total by end 2024, and only getting to 0.75% in 2026. Such a slow upward trajectory in rates suggests the market agrees with the BoE that the rise in inflation this year will prove temporary and not necessitate any significant policy tightening.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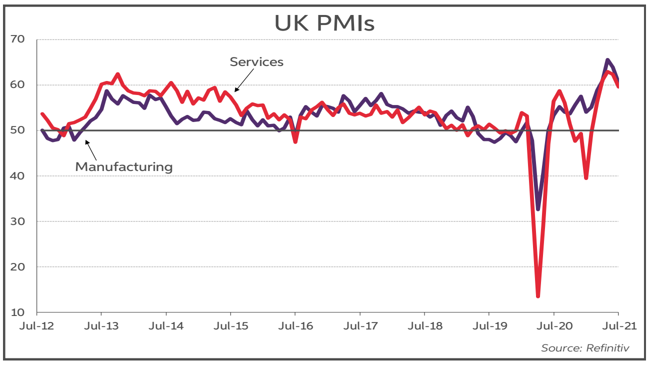
# Strong pace of growth may be starting to ease

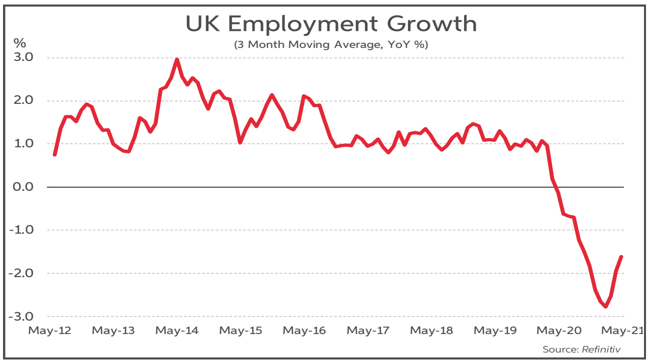



**UK GDP contracted by 1.6% in Q1, due to restrictions that were reintroduced to slow the spread of a more virulent strain of Covid-19.** The underlying breakdown shows a decline in personal consumption was the main driver, falling by 4.4% in the quarter, stripping 2.8 percentage points (p.p.) from the total. Meanwhile, net trade contributed 2.5 p.p.. By the end of Q1 though, the UK economy was in expansion mode, owing to the quick paced vaccine rollout. This was reflected by monthly GDP rising by 2.4% in March, as measured by the output method.

**In April, the economy grew by a further 2.0% as more restrictions were eased.** In May though, output grew by a much more modest 0.8%. The return of indoor hospitality was the main driver of growth in the month, as manufacturing and construction both declined owing partly to a shortage of materials. The return of indoor hospitality also likely contributed to the fall in retail sales in May, as consumer spending patterns changed. Indeed, the meagre 0.5% rise in retail sales in June is perhaps a larger cause for concern. It suggests that the resurgence in the virus, this time in the form of the Delta variant, may have slowed the economy's momentum somewhat. Data from the Bank of England shows that household savings increased by circa £10bn in June, compared to £7bn in May.

**Survey data also indicates that while the economy is continuing to rebound, the pace of growth may be starting to ease.** Both the services and manufacturing PMIs declined for the second month in a row in July, albeit they remained firmly in expansion mode, with readings around the 60 level. Likewise, although the Gfk measure of consumer confidence regained its pre-pandemic level in July, the pace of improvement has levelled off in recent months.

**Meanwhile, the Government's furlough scheme, continues to shelter the labour market.** The unemployment rate, which has been trending downwards since its peak of 5.2% in December, was at 4.8% in May. More encouragingly, the claimant count fell by 115k in June, and the number of PAYE Employees grew by 356k. With the furlough scheme extended until September and the recent improvement in the labour market data, the rise in unemployment later this year should be more limited than had previously been anticipated. Indeed, the BoE now believes that the unemployment rate has already peaked.




**Regarding inflation, the headline CPI rate jumped from 2.1% to 2.5% in June, a near three year high.** The core rate moved higher to 2.3% from 2.0% also. Higher commodity and energy prices, supply shortages, and the unwinding of the VAT cut have been key drivers in the spike higher in inflation. However, the BoE notes that it still expects inflation to be transitory, rising further this year to 4%% by Q4 before falling back to 2.5% by Q4 2022, and 2% in Q4 2023.

**Overall, despite some easing in the pace of recovery, the near term outlook for the economy still looks positive.** The quick pace of the vaccine rollout has allowed the economy to re-open, with most restrictions now removed. The Budget kept supports in place beyond the re-opening, and introduced measures to boost investment. New cases owing to the Delta variant have also been falling more recently, which should help keep the recovery on course. **Thus, the BoE sees the economy growing by 7.25% this year and 6% next year.**

**However, longer term there are potential economic headwinds on the horizon that will need to be navigated carefully.** Brexit could well dampen investment and trade over the medium term. Furthermore, to counterbalance increased spending, a host of tax hikes, including to corporation tax in 2023, are planned. Theses may hinder growth in the UK in the years ahead. By that stage global growth may have cooled somewhat also. **In its August Monetary Policy Report, the Bank of England projects that GDP will slow sharply to 1.5% in 2023.**