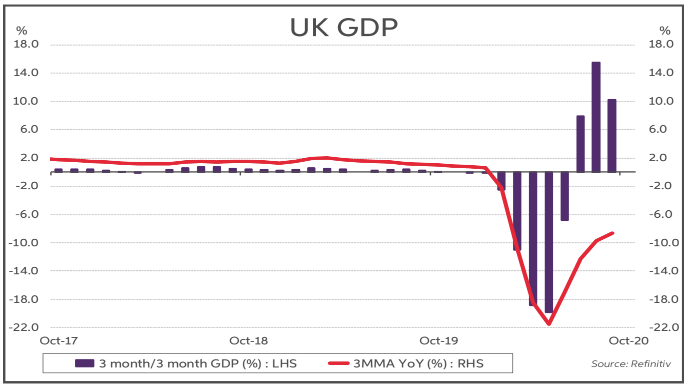
BoE Watch

AIB Treasury Economic Research Unit

18th December 2020

BoE on hold, but ready to do more if needed

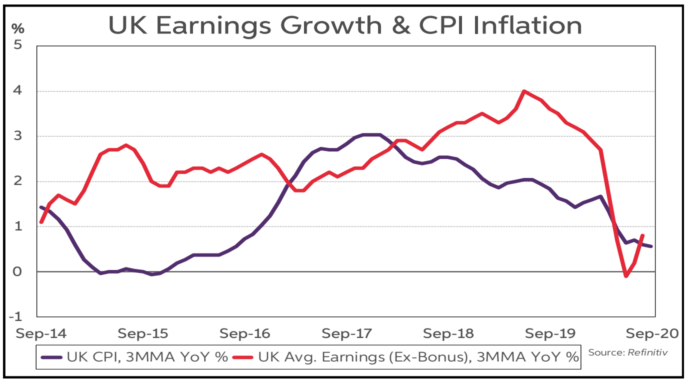
The last Bank of England Monetary Policy Committee (MPC) meeting for 2020 concluded in line with market expectations for no changes to policy. The Bank Rate remains at 0.1%, its lowest level on record. It has been unchanged since March, having been cut by a total of 65bps during the first quarter in response to the fallout of the economic crisis caused by the Covid-19 pandemic.



The MPC also left unchanged the total stock of purchases it is carrying out under its QE programme at £895bn. It had announced at its previous meeting in November a £150bn increase in its total target stock. The Committee judged yesterday that its current policy stance was appropriate and there was unanimity within the MPC on both its interest rate and QE decisions. However, the MPC did vote to extend its term funding scheme for SME's by six months to keep favourable financing conditions in place for small companies.

The most recent detailed forecast update from the BoE on the economic outlook was contained within its Monetary Policy Report, released at its November meeting. The BoE is forecasting a GDP contraction of 11% for the full year 2020. Its projection for 2021 is for a 7.25% rebound in growth. For 2022, it is pencilling in GDP growth of 6.25%. These forecasts indicate that the BoE expects the UK economy will only get back to its pre-Covid levels during the first half of 2022. In terms of the inflation outlook, the BoE anticipates headline CPI will remain below 1% until early 2021. Thereafter, it is forecasting inflation will rise sharply by spring as the VAT cut comes to an end and the substantial fall in energy prices in early 2020 falls out of the year-on-year comparison. The BoE expects inflation to be at 2% in two years time. These macro projections were based on the assumption of there is a UK-EU FTA in place at the start of 2021.

The December meeting statement and minutes noted that the near-term outlook for the UK economy had "evolved broadly in line" with what it expected when compiling the above forecasts. It commented that recent news in relation to Covid-19 vaccines was likely to reduce the downside risks to the economic outlook. **However, it also emphasised that the outlook for the economy remained highly uncertain.** The evolution of the pandemic and the associated measures/ restrictions to contain the virus were one source of uncertainty. The BoE also has to factor in the uncertainty/risks caused by Brexit in its policy deliberations. Specifically, the nature of the transition to the new trading arrangement between the EU and UK at the start of 2021 and whether this relationship is based on a FTA or WTO rules. The other aspect adding to the uncertainty is how households, businesses and financial markets will react to these developments.



The BoE also repeated that it is prepared to ease policy further if required. Although, once again there was no reference in the minutes to any discussion that took place on negative interest rate policy. Previously, Governor Andrew Bailey, along with some other MPC members, had opined that it could form part of their toolkit. However, over the last few months it appears that the BoE has cooled on the idea and any such policy move does not appear to be on the near-term horizon, at least. Instead, the MPC continues to state that its stands ready to take "whatever additional action was necessary to achieve its remit". It also repeated its guidance that it does not intend to tighten policy until there is well defined evidence that "significant progress was being made in eliminating spare capacity" in the economy, thereby helping it to achieve its 2% inflation target.

In terms of market expectations, futures contracts indicate that the market is not ruling out the possibility that the Bank rate could be cut further. These contracts point to a rate cut of up to 10bps, which would take the Bank Rate down to zero. The market is not currently envisaging rates going into negative territory, though that would change in a no-trade deal scenario. Meanwhile, further out, official rates in the UK are not expected to rise from their current levels until 2024.

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

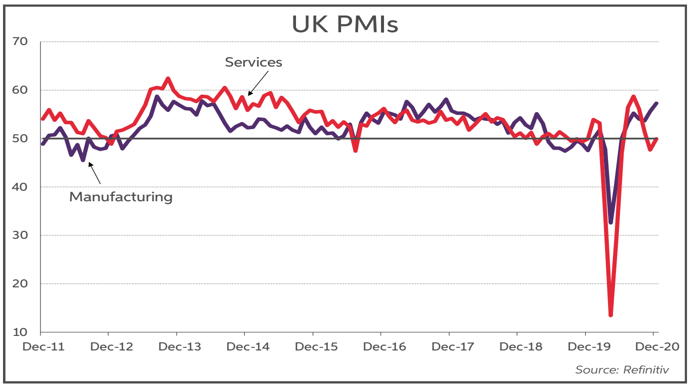
John Fahey
Senior Economist
john.j.fahey@aib.ie

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

AIB

UK to enter a double-dip recession in Q4

The UK economy expanded by 15.5% in Q3, following an unprecedented contraction of 19.8% in Q2. Activity also fell by 2.2% in Q1, meaning UK GDP was still 9.6% below its level in Q4 2019 at the end of September. In terms of the rebound in activity in Q3, consumer spending led the recovery, up by 18.3% on a q/q basis. Fixed investment also performed well, rising by 15.1% q/q as the housing market performed strongly, although business investment was more subdued. Government expenditure increased by 7.8% q/q. In terms of net trade, the pace of imports (+13.2%) outstripped the rise in exports (+5.2%), leading to an increase in inventories.



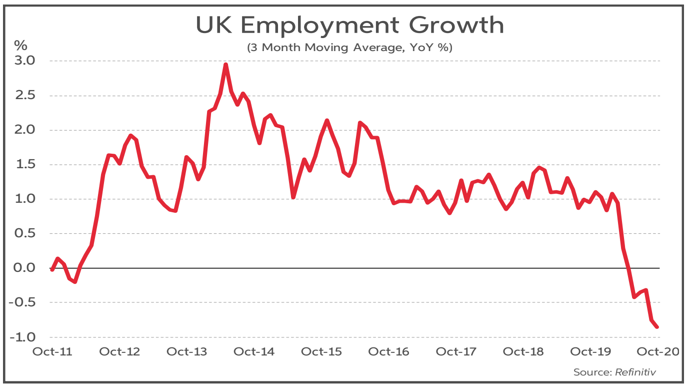
Survey data have been mixed in Q4. The manufacturing PMI has averaged 55.5, maintaining upward momentum throughout the quarter. The services PMI printed in contraction mode in November and December as the restrictions impacted the sector, but the decline has been nowhere near as sharp as in the Spring. Overall, the index has averaged 49.6 in Q4, just below the key 50 threshold. However, consumer confidence has been trending downwards from an already subdued level. The latest reading of consumer confidence was −33 in November, which is just above the historic lows reached earlier in the year of −34.

Hard data for October were reasonable good, but are set to weaken sharply in November and December. Industrial production rose by 1.3% in October, although, this still leaves output 4.4% below its pre-Covid levels. Retail sales continued to rise, up by 1.2% in October. However, GDP grew by just 0.4% m/m in October as Covid restrictions increased, suggesting that the UK recovery was running out of steam. The national lockdown in November is likely to see GDP contract sharply once again, while the newly introduced tier system will also keep a lid on the pace of the recovery in December. The UK economy is thus expected to enter a double-dip recession in the fourth quarter.

The labour market remains sheltered by the Government's furlough scheme. Although, the labour market continues to deteriorate, given the scale of the crisis the situation should be far worse. The unemployment rate has been on a steady upward trend since the summer, rising to 4.9% from 3.9% in June. The claimant count for November rose by just 64.3K, which suggests that the unemployment rate is now rising at a slower rate. However, the government furlough scheme is due to expire in April which may lead to a sharp rise in unemployment. Thus, the outlook for the labour market remains tilted to the downside.

In terms of inflation, the headline CPI rate fell from 0.7% to 0.3% in November. The extended VAT cut and the sharp decline in energy prices earlier in the year are the main factors contributing to the subdued inflation readings. The national lockdown also weighed on price pressure in November. However, the BoE expects inflation to rise "quite sharply" towards 2% in the Spring as temporary measures wash through the index.

The near term risks for the UK economy remain to the downside. The November lockdown will see the UK enter a double-dip recession in Q4. Covid restrictions are set to remain in place well into the new year. On top of this, the UK economy is also facing a scenario at the start of 2021 where its trading relationship with the EU will be based on either a very basic free trade agreement or on WTO rules.



However, the Government's fiscal supports and the BoE's monetary policy stimulus are providing support to the economy. The furlough scheme is also shielding the labour market from the full brunt of the pandemic. The news on vaccines is also positive for medium term growth prospects. The latest forecasts by the BoE (from November) see GDP contracting by 11% in 2020, before rebounding by 7.25% in 2021, and 6.25% in 2022. This would mean that GDP would not regain its 2019 level until H1 2022. It is worth noting that this forecast assumes a trade deal between the EU and UK.

AIB, 10 Molesworth Street, Dublin 2 Tel: 353-1-6600311 https://aib.ie/investorrelations/economic-research-unit