

BoE Quarterly Inflation Report (QIR) – August 2011

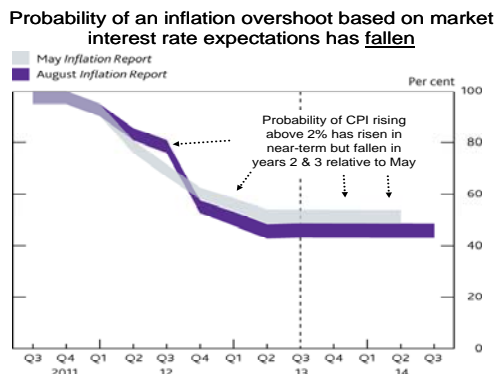
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BoE lowers its inflation forecasts

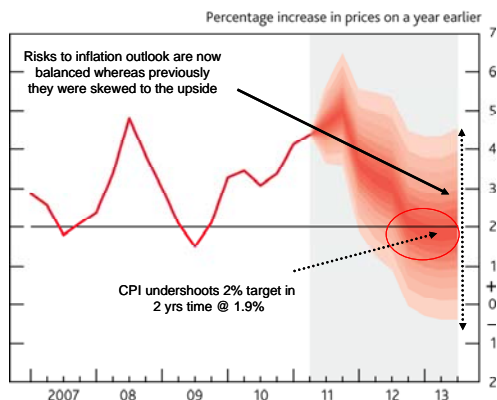
Overall, the latest Bank of England (BoE) Quarterly Inflation Report (QIR) proved to be a dovish report with downward revisions to the outlook for both inflation and economic growth. The MPC's central projection for CPI inflation was raised during the near-term (*Year 1*) relative to the May QIR. The Governor noted that CPI is likely to rise above its current level of 4.2% y/y over the next few months, possibly to 5%, as a result of energy price rises feeding through. However, at the turn of the year inflation should start falling back. Beyond the near-term (*Years 2&3*), however, the probability of a target overshoot has fallen. This is highlighted in the chart below.



BoE now projects a CPI undershoot at 2-yr horizon

The latest central projection (*based on unchanged monetary policy*) forecasts a CPI undershoot of around 0.1pp (i.e. $CPI = 1.9\%$) in 2 years time (Q3 2013). This compares with an overshoot of 0.35pp in the May QIR ($CPI = 2.35\%$). From this perspective today's QIR is more dovish vis-à-vis May. Whilst the MPC views the most likely outcome of CPI inflation to be slightly below the 2% target in the medium term (Q3 2013), the risks to CPI inflation are skewed slightly to the upside. However, relative to the May report the risks are more balanced.

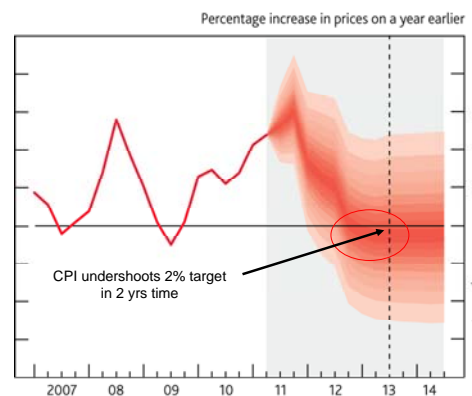
CPI inflation projection based on constant nominal interest rates at 0.5% and £200 billion asset purchases



Larger CPI undershoot using market rate expectations

The BoE projects a slightly larger undershoot in inflation ($@1.8\%$) at the two year horizon using the market interest rate expectations (*using the fifteen working day averages up to 3 August*). This compares with a 1.9% central projection in May, which had a steeper interest rate profile than in August (*see table below*). It is noted that there remains an undershoot even if rates are kept on hold until Q4 2012. However, the market projections used by the MPC are higher than they actually are today. The implication being that the CPI undershoot would be even greater. Furthermore, the QIR stresses that the MPC's economic growth and inflation charts 'do not include a specific calibration of the impact on the UK from the risk of a further serious economic and financial disruption'. Such a scenario would incur an even greater undershoot and raising the possibility of further policy stimulus in the shape of further asset purchases (*or Quantitative Easing*). Indeed, following today's QIR financial markets are increasingly pricing in a further round of asset purchase / quantitative easing.

CPI inflation projection based on market interest rate expectations and £200 billion asset purchases



Conditioning path for Bank Rate implied by forward market interest rates^(a)

Per cent	2011		2012				2013				2014		
	Q3 ^(b)	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
August	0.5	0.5	0.6	0.6	0.7	0.8	0.9	1.0	1.2	1.4	1.5	1.7	1.9
May	0.7	0.8	1.0	1.2	1.5	1.7	2.0	2.2	2.4	2.6	2.8	3.0	

^(a) The data are fifteen working day averages of one-day forward rates to 3 August 2011 and 4 May 2011 respectively. The curves are based on overnight index swap (OIS) rates.

^(b) August figure for 2011 Q3 is an average of realised spot rates to 3 August, and forward rates thereafter.

Financial Market Reaction

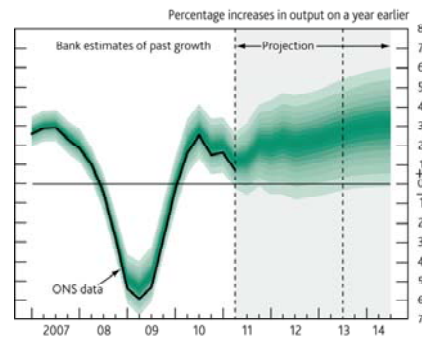
Overall, the latest QIR is more dovish than financial markets had anticipated. 2-yr interest rate swap markets have fallen by 7bps since yesterday and at the time of writing are at 1.09%. Meanwhile, 5-yr interest rate swaps (which are used in the pricing of fixed rate mortgages) are now at a record low of 1.72% and are down 18bps since yesterday. This reflects not only the view that Bank rate will remain at its record low of 0.5% for even longer but a partial pricing in of further monetary stimulus – further asset purchases (QE).

Rate hikes now off the table for 2011 and 2012

In light of recent economic and financial market developments and today's QIR it now looks increasingly likely that Bank rate will remain on hold not just for the rest of this year but throughout 2012 as well. At this stage we view the prospect of further policy stimulus – asset purchases or quantitative easing - as a possibility rather than a probability.

BoE also downgrades growth prospects

A key influence on the inflation profile, and therefore by extension interest rates, will be the strength of the economic recovery. The central projection (the dark shaded area) for economic growth is weaker than it was in May. This is not surprising as independent forecasts have been steadily revised down on the back of the weaker than expected incoming economic data, at home and abroad. In the Committee's view the weakness in economic activity is likely to be more persistent than previously expected. Sir Mervyn King's opening comments also referred to "a number of headwinds to world and domestic growth over the forecast period, not least the private and public sector debt overhang. And these headwinds are becoming stronger by the day." Clearly, we have seen notable adverse developments on the financial markets over the last week (e.g. intensification of sovereign debt concerns in the euro zone and the US ratings downgrade). Despite these developments GDP is likely to "recover modestly during the second half of 2011 and beyond". Overall, GDP is projected to be 1.4% higher y/y in 2011 relative to the May forecast of 1.8%. Meanwhile, the 2012 projection has been trimmed from 2.5% to around 2.1%. However, the risks to this growth trajectory are judged to lie to the downside.



Big risks facing the UK economy are external

In his opening remarks the Governor highlighted that the big risks facing the UK economy stemmed from the rest of the world. The MPC's projections are predicated on the assumption that there is a prolonged period of adjustment within the euro area. After all, the latter accounts for just under half of UK exports. However, risks surrounding the sustainability of the indebtedness of some of its members are also flagged. This has knock-on negative effects on financial market liquidity, the stability of the wider banking system and confidence in general.

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10 August 2011