Group Economics

BoE Quarterly Inflation Report (QIR) – November 2012

Contact: Richard Ramsey
Group Economics
02890 276354

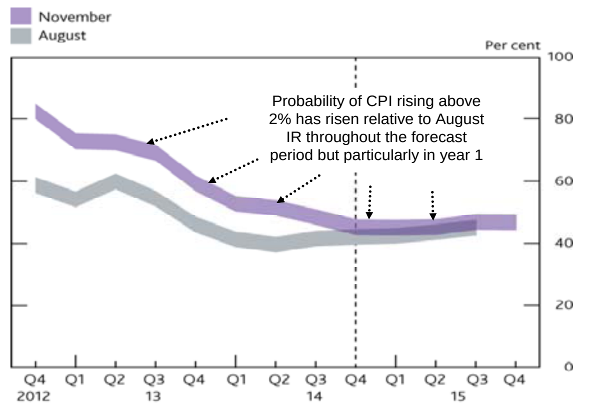
richard.ramsey@ulsterbankcm.com

www.ulsterbank.com/economics

BoE raises its inflation forecasts

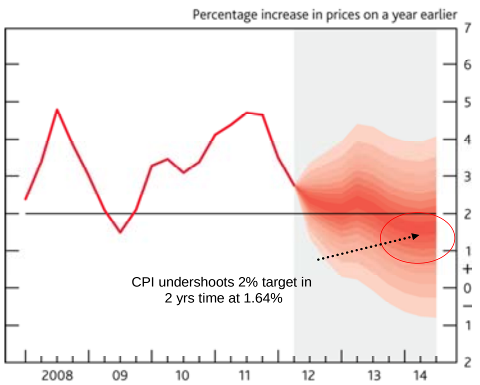
Overall, there were few surprises in the latest Bank of England (BoE) Quarterly Inflation Report (QIR) which proved to be a dovish report at the margins. Inflation forecasts were revised upwards while the economic growth projections were revised downwards. Back in August, the MPC expected Q4 CPI to come in at 2.2%. However, yesterday saw October's CPI inflation figures accelerate to 2.7% from 2.2% in September.

Probability of an inflation overshoot based on market interest rate expectations has risen particularly in the near term



However, 0.3 percentage points of this increase resulted from higher tuition fees. Rising electricity and gas prices are also contributing to additional inflationary pressures. The MPC's central projection for CPI inflation has been raised during the near-term (*Year 1)* relative to the August QIR. The chart above also highlights that the probability of CPI rising above the MPC's 2% target has also increased in years 2 & 3 relative to what was expected three months ago. Nevertheless, inflation is still expected to fall back towards the 2% target from the second half of 2013.

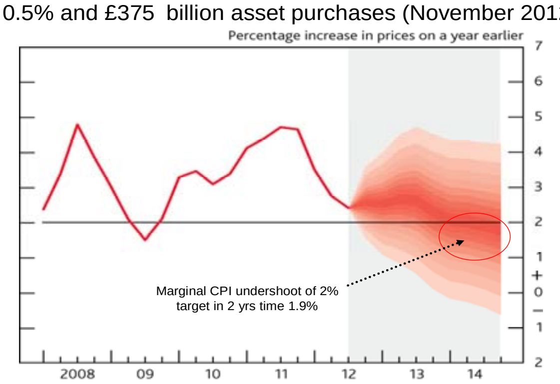
CPI inflation projection based on constant nominal interest rates at 0.5% and £375 billion asset purchases (August 2012)



A marginal CPI undershoot is expected at 2-yr horizon

Given that the MPC did not embark upon further quantitative easing (QE), or asset purchases, at its policy meeting last week it was inferred that the projection for CPI would not signal a significant undershoot. Indeed, the latest central projection *(based on unchanged monetary policy)* forecasts a CPI undershoot of just 0.1pp *(i.e. CPI = 1.9%)* in 2 years time *(Q4 2013).* This compares with an undershoot of 0.36pp in the August *(CPI = 1.64%)*. This projection also takes on board the additional stimulus provided by last Friday's announcement to transfer the coupon payments *(yield or return)* accruing to the BoE, from its £375bn of asset purchases, to HM Treasury. These gilt coupon payments essentially amount to QE by the back door with the *'excess cash'* presently amounting to £23.8bn. By the end of the first year this figure is expected to reach £37bn. The UK exchequer will then use these funds to reduce its stock of debt *(by purchasing from private sector holders of gilts).* In turn, the private sector will have more cash available. As a result, the process outlined above acts as a monetary stimulus and in a similar way to the £375bn of gilts purchased so far.

CPI inflation projection based on constant nominal interest rates at 0.5% and £375 billion asset purchases (November 2012)



No more stimulus expected in the months ahead

It is noted that the MPC judges the risks to inflation to be broadly balanced around the target. It is also noted that the CPI projection for 3 years time *(Q4 2015)* also remains fractionally below 2%. All of this suggests that the MPC is not signalling that more policy stimulus *(i.e. more QE)* will be forthcoming. However, Sir Mervyn King did state in his opening remarks that *"the Committee has not lost faith in asset purchases as a policy instrument, nor has it concluded that there will be no more purchases".*

Richard Ramsey
Chief Economist, Northern Ireland
Ulster Bank
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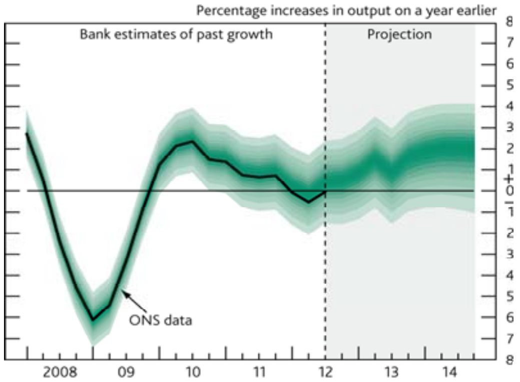
Economic growth forecasts revised down as expected

The latest GDP growth forecasts were revised down marginally relative to the August QIR. However, this merely follows the downward revisions made by other forecasters in recent weeks. Following the surprisingly strong GDP growth in Q3 2012 *(1.0% q/q)* the Governor warned that the Q4 outturn could be negative. Therefore if this is being flagged now a negative outcome should not in itself necessarily lead to more policy stimulus. The QIR highlights that the economic outlook *"will depend critically on developments in the global environment, with strains in the euro area posing the greatest risk to a sustained recovery".* Clearly the UK economy, like economies elsewhere, remains vulnerable to an unfavourable external economic environment.

GDP projection based on constant nominal interest rates at 0.5% and £375 billion asset purchases



A long slow recovery

As the Governor reminded us today, the economic outlook is challenging with economic growth to remain sluggish and inflation above target. *"The road to recovery will be long and winding".* To put the challenge into context it is noted that in the MPC's latest economic growth projections, the level of GDP is not expected to return to its Q1 2008 peak until after 2014. The BoE is not anticipated to raise its Bank Rate from its record low of 0.5% within the same timeframe either.

Projection of the level of GDP based on market interest rate expectations and £375 billion asset purchases (Nov 2012)