



BANK OF ENGLAND

The Bank's view of the economic and financial outlook

17 May 2016

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Agent

Agency for South West England

Major statutory decision-making responsibilities of the Bank of England

Monetary policy

Monetary Policy Committee

Created in 1997

Responsible for maintaining price stability and, subject to that, supporting the economic policy of the Government, including its objectives for growth and employment.

Microprudential regulation

Prudential Regulation Authority

Created in 2013

Responsible for promoting the safety and soundness of PRA-authorized persons; and, specifically for insurers, contributing to securing an appropriate degree of protection for those who are or may become policyholders.

Macroprudential regulation

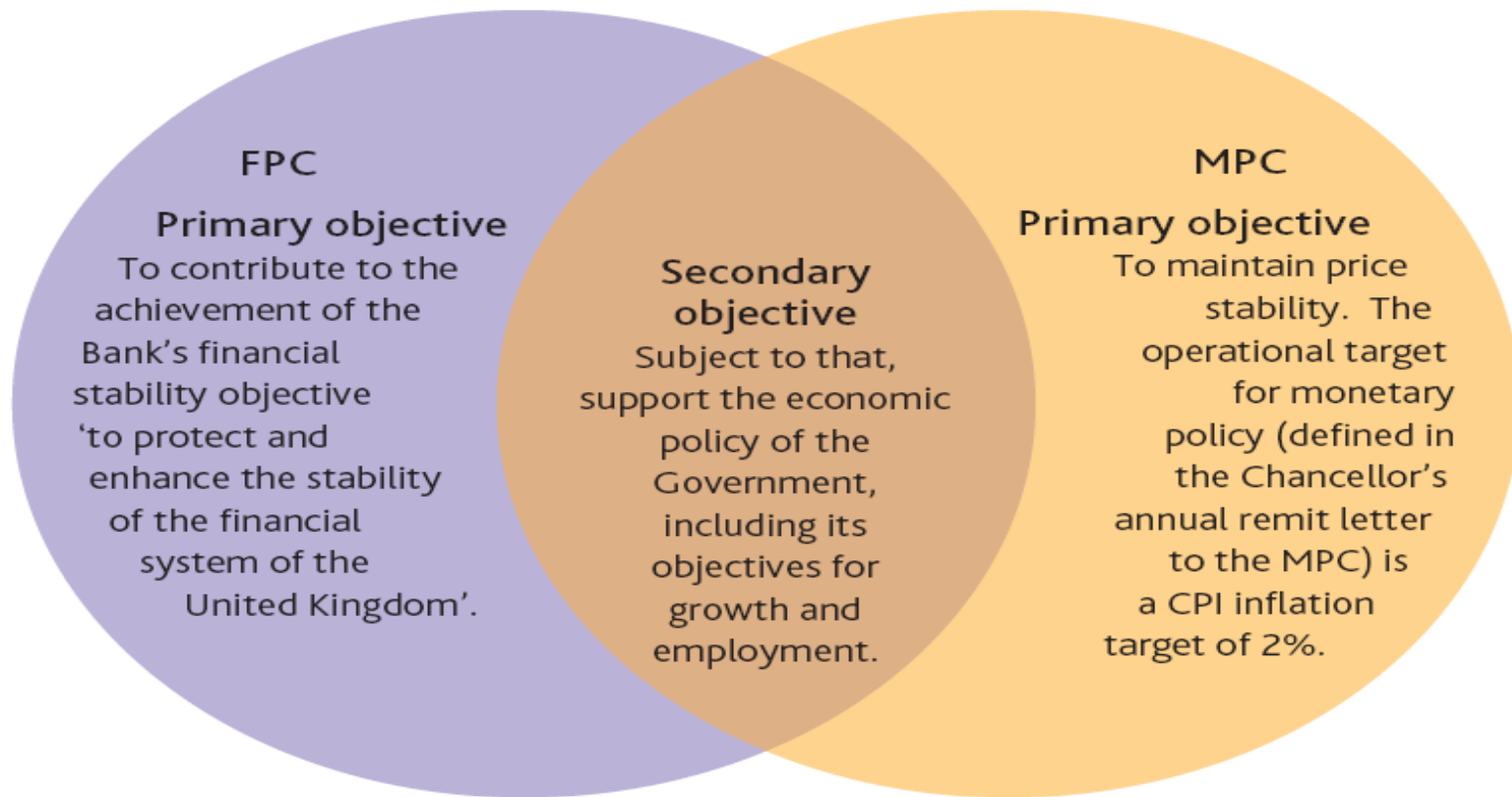
Financial Policy Committee

Created in interim form 2011, statutory form in 2013

Responsible for identifying, monitoring and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the UK financial system. And, subject to that, supporting the economic policy of the Government, including its objectives for growth and employment.



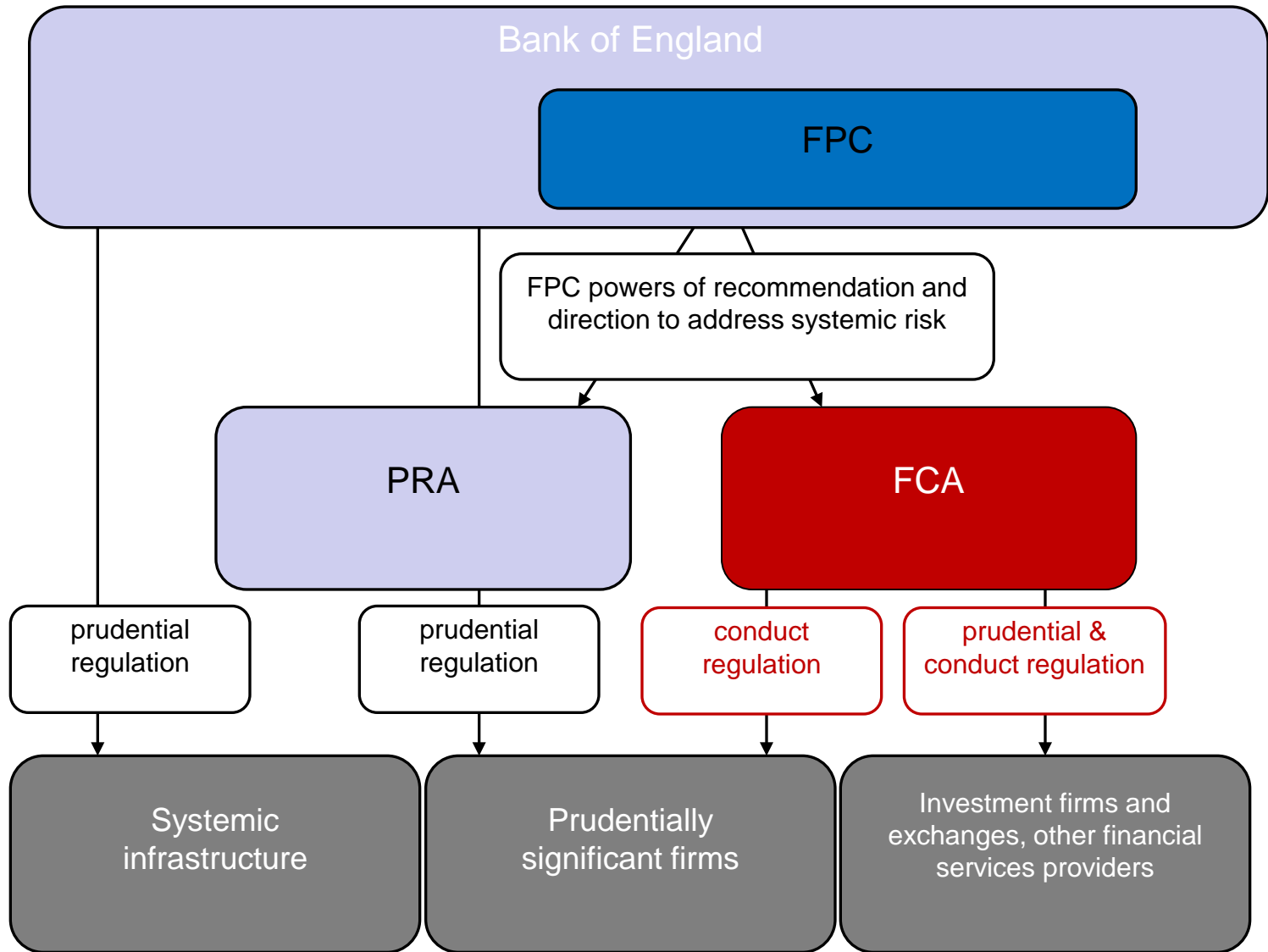
How do our policies fit together?



Some commonality in FPC and MPC statutory objectives – active dialogue is key



Regulatory structure



INFLATION REPORT

May 2016



BANK OF ENGLAND

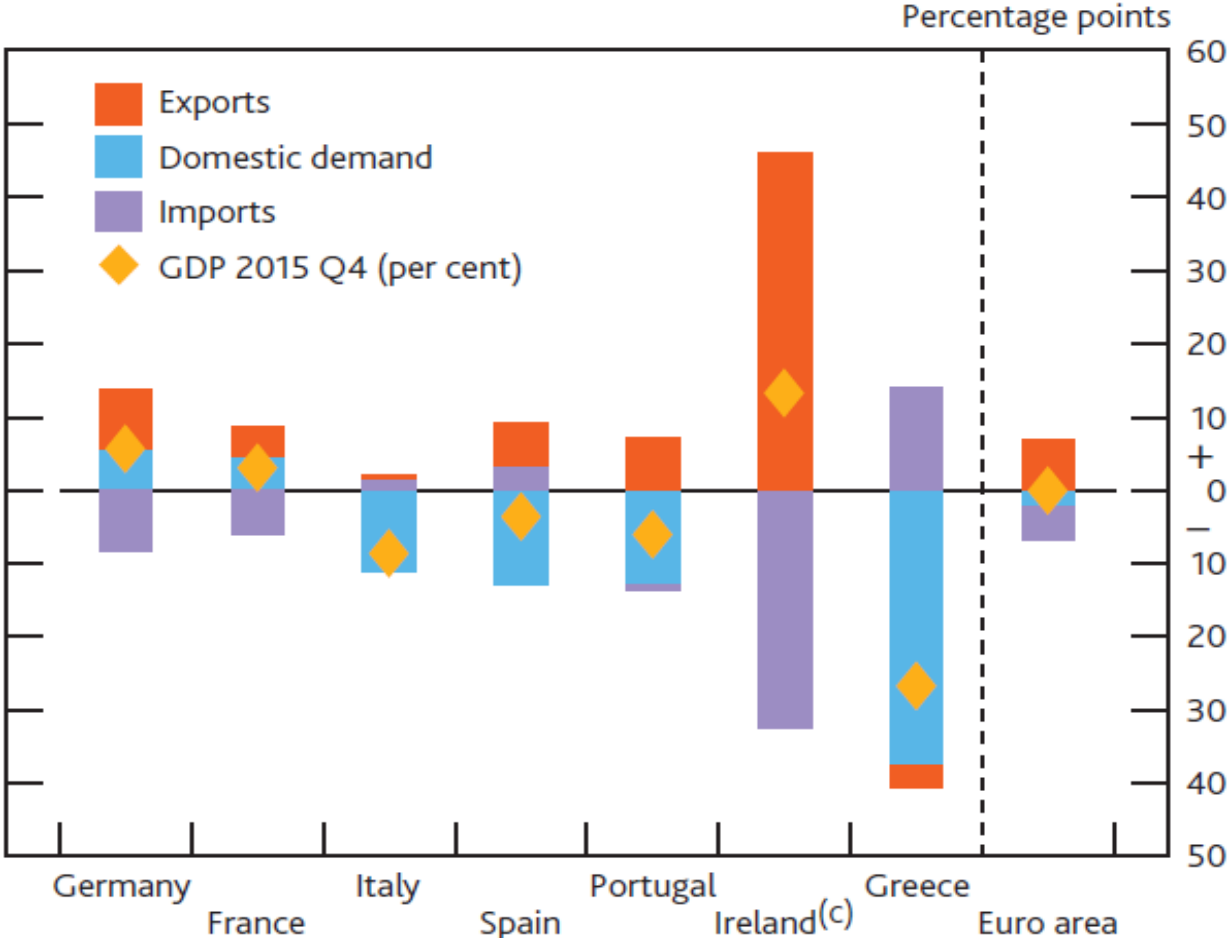
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EXTERNAL ENVIRONMENT



The extent of the recovery in GDP has varied across euro-area countries

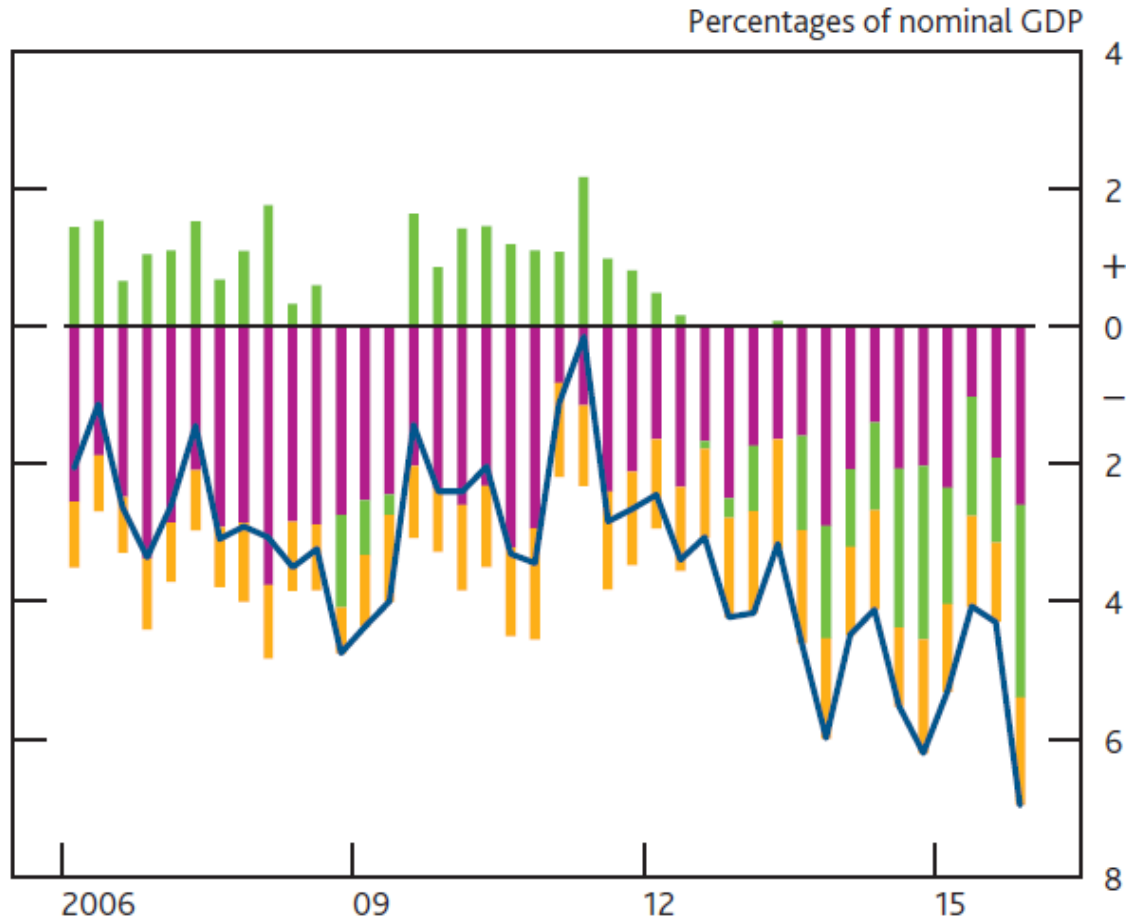
Contributions to cumulative change in GDP since euro-area pre-recession peak in selected countries^{(a)(b)}



The current account deficit widened in 2015 Q4

UK current account

Trade balance Secondary income
Primary income Current account balance

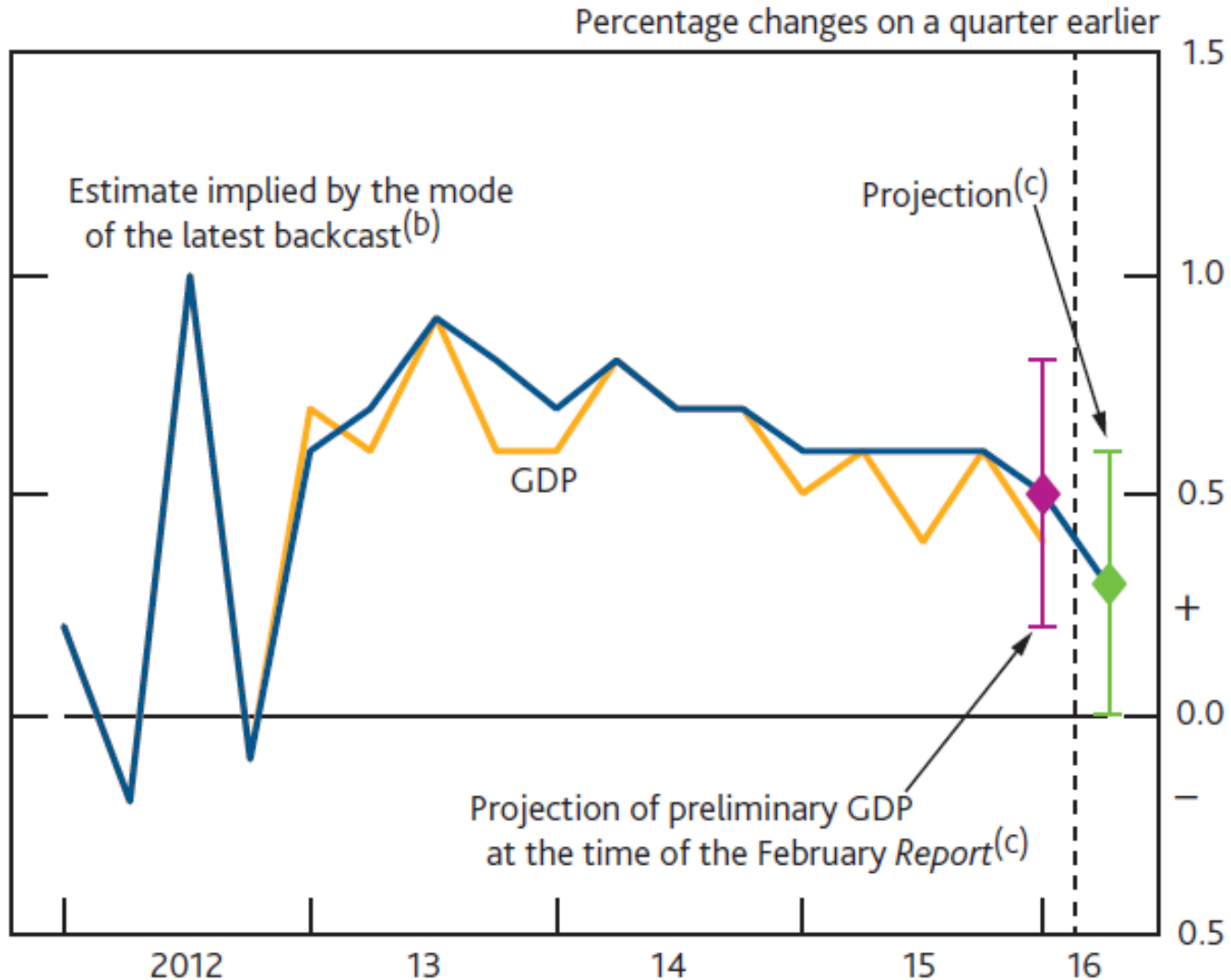


OUTPUT AND DEMAND



GDP growth was 0.4% in Q1

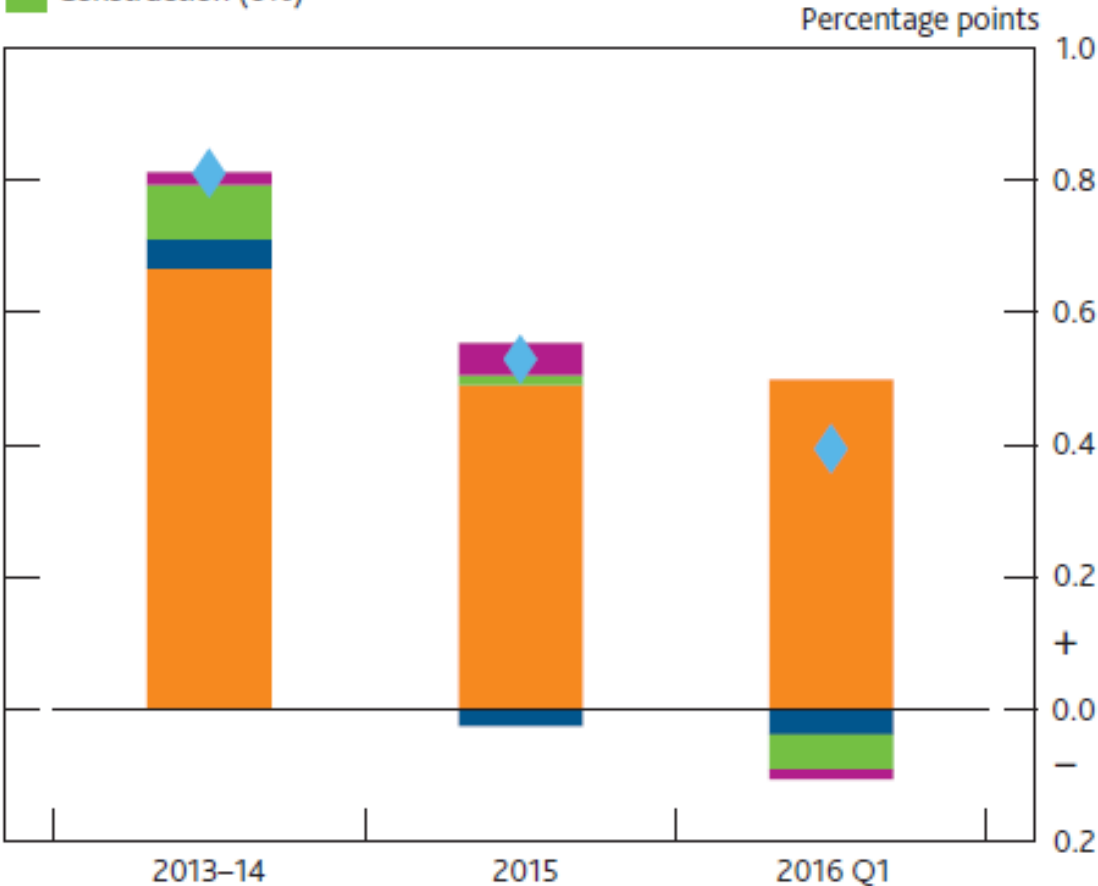
Output growth and Bank staff's near-term projections(a)



Output growth has slowed since 2014

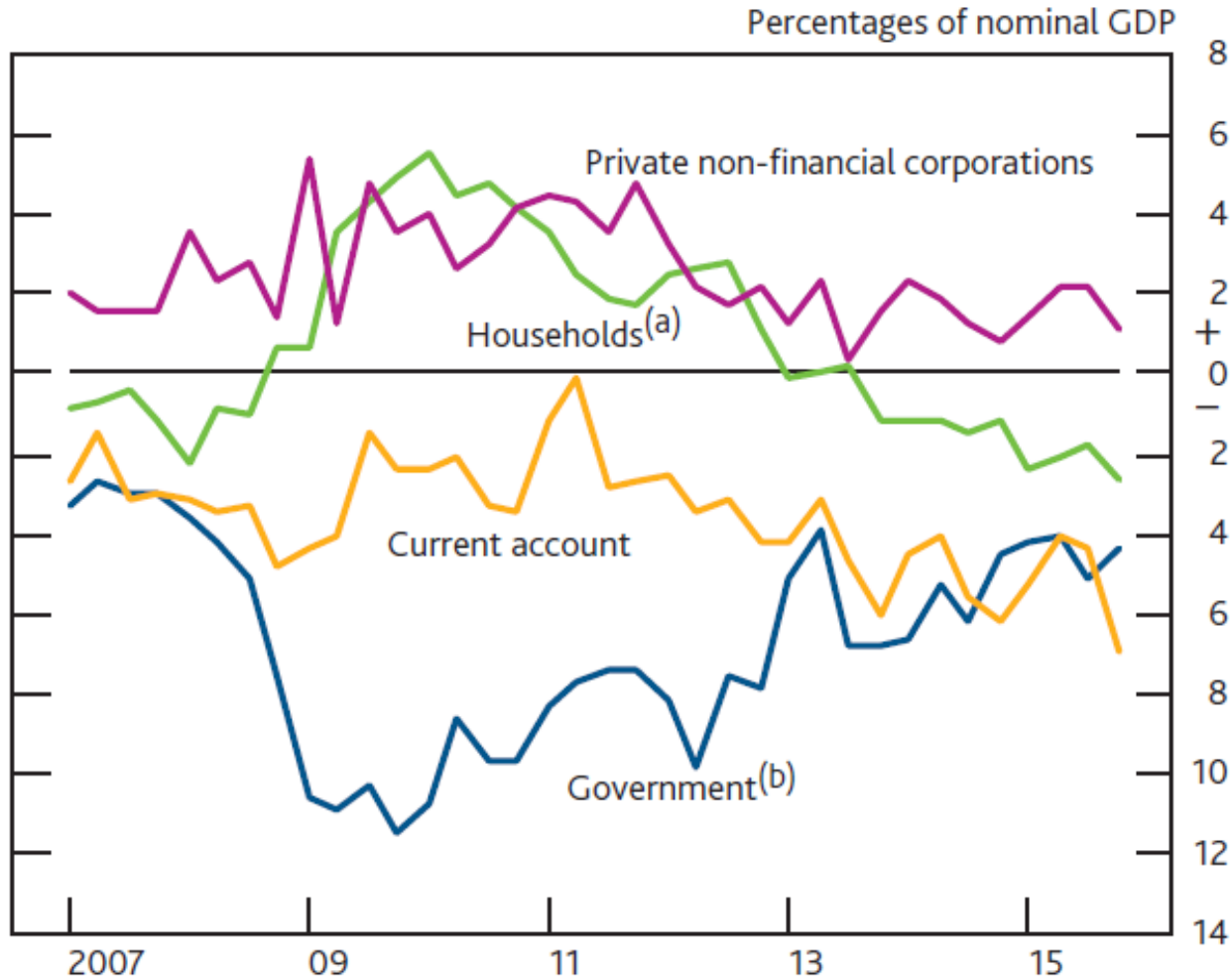
Contributions to average quarterly GVA growth by output sector(a)

- Services (79%)
- Manufacturing (10%)
- Construction (6%)
- Other production (5%)
- Gross value added (GVA) growth (per cent)



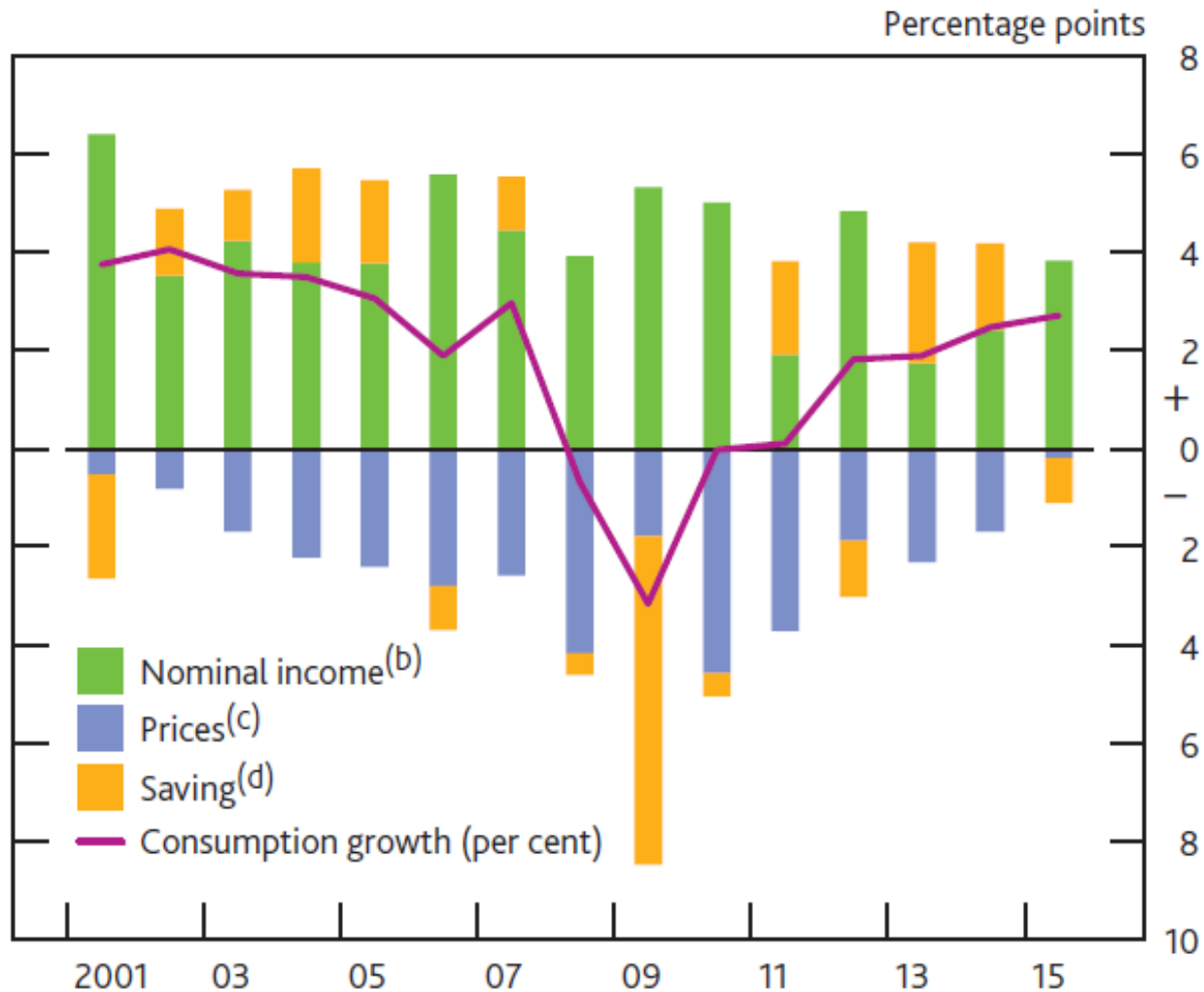
The household financial balance has fallen into deficit over recent years

Financial balances by sector



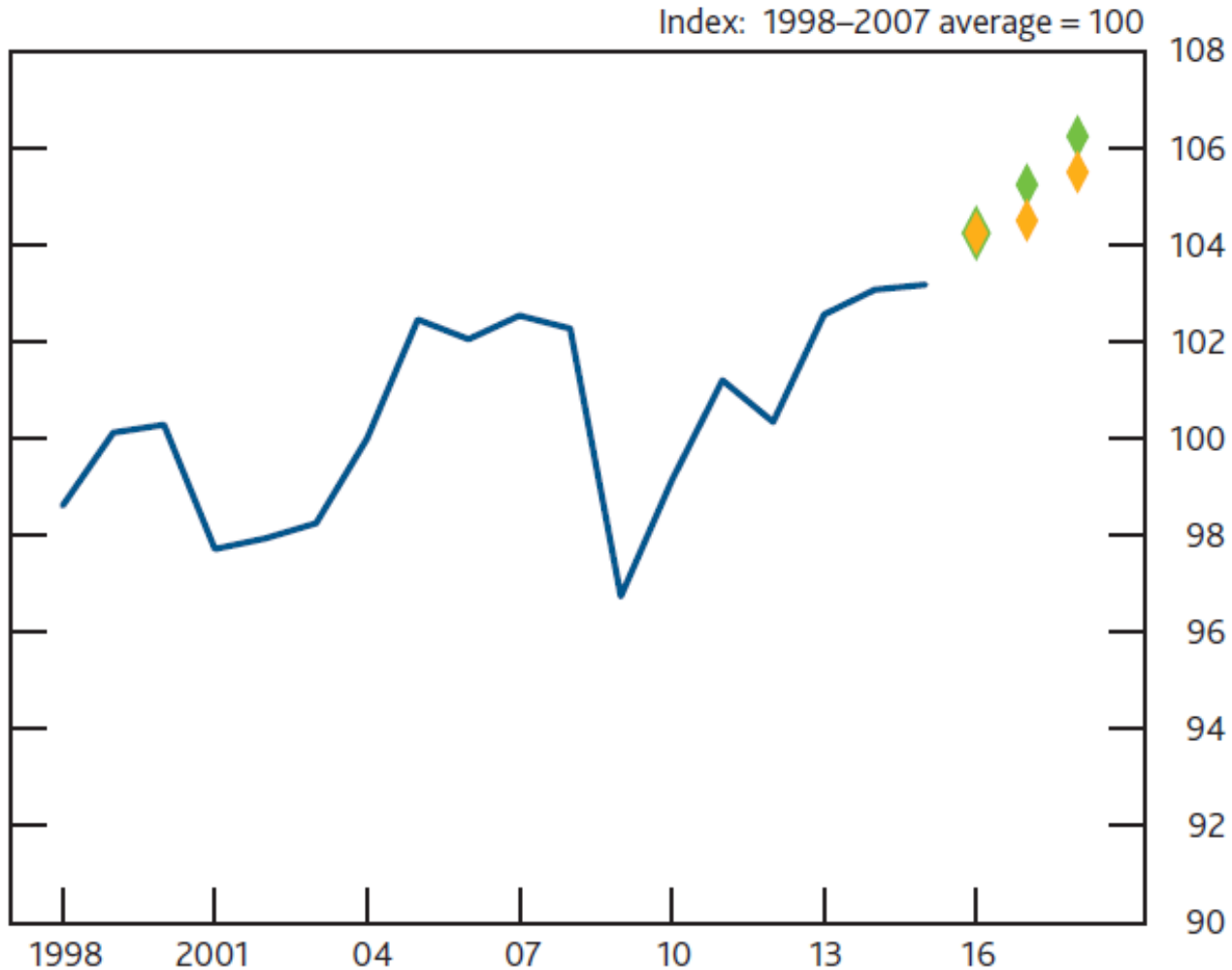
Nominal income growth and low inflation have supported consumption growth in 2015

Contributions to annual consumption growth^(a)



Consumption to labour income

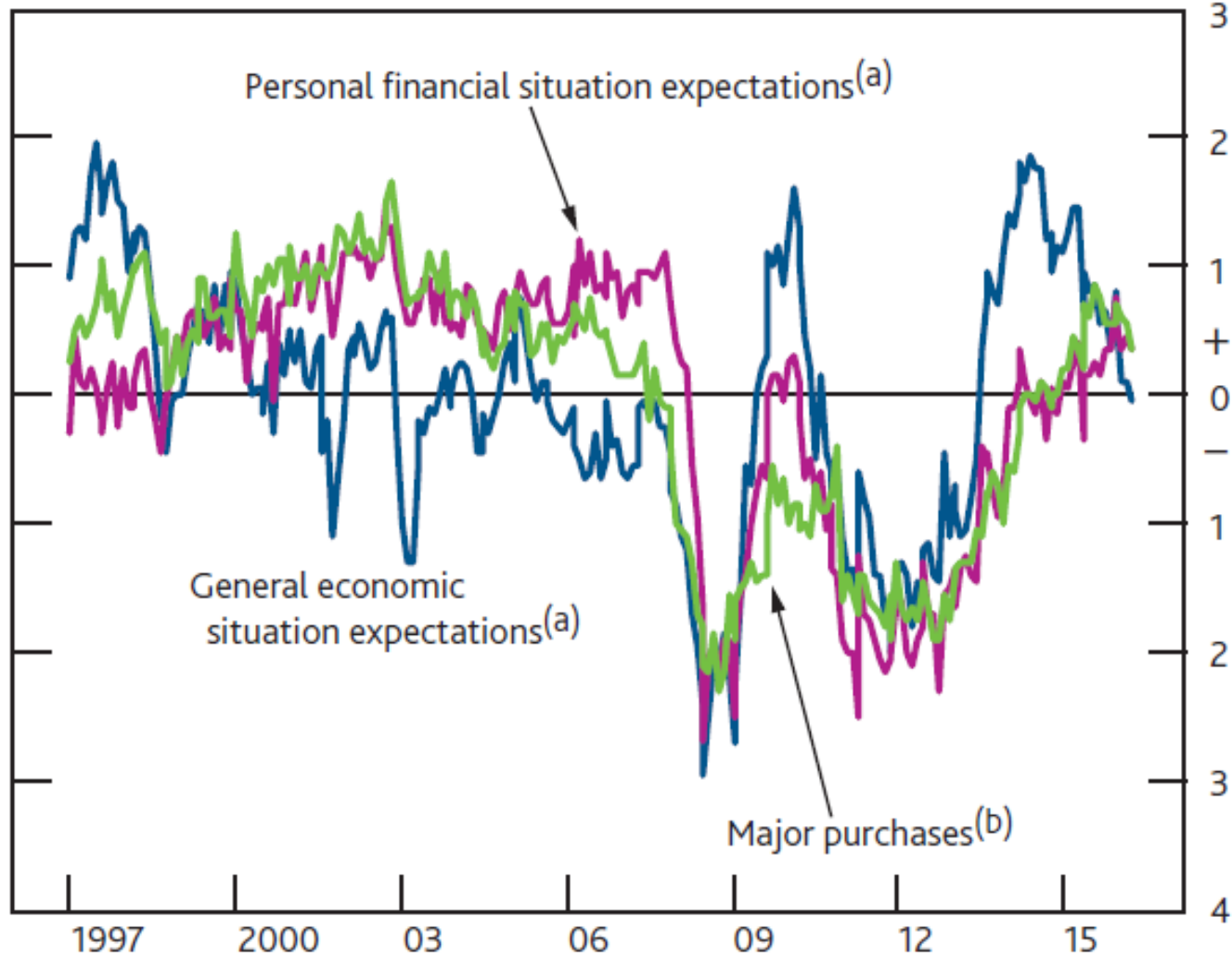
- ◆ Projection at the time of the February Report
- ◆ Projection consistent with MPC key judgements in May



Consumer confidence has eased

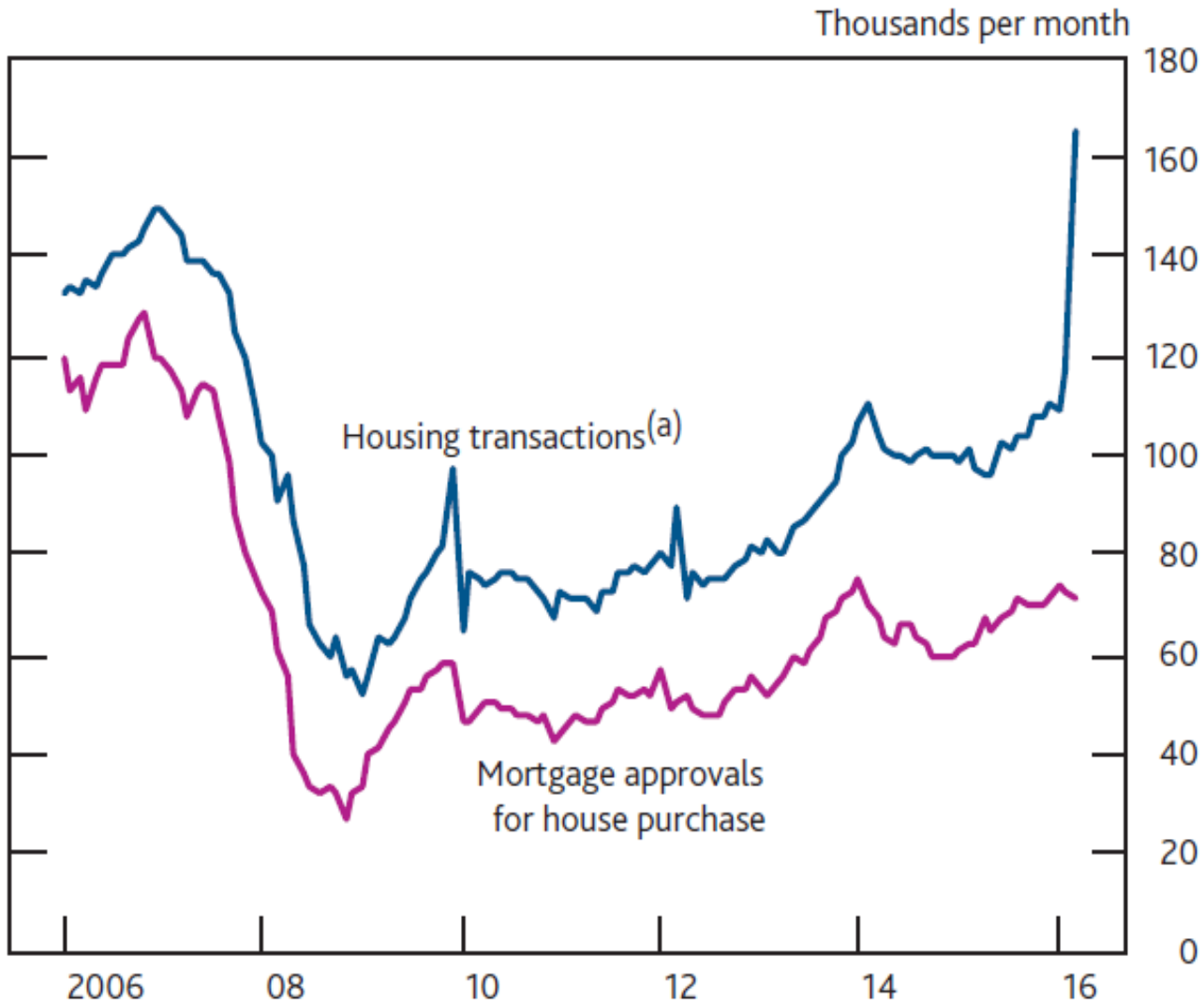
Measures of consumer confidence

Differences from averages since 1997 (number of standard deviations)



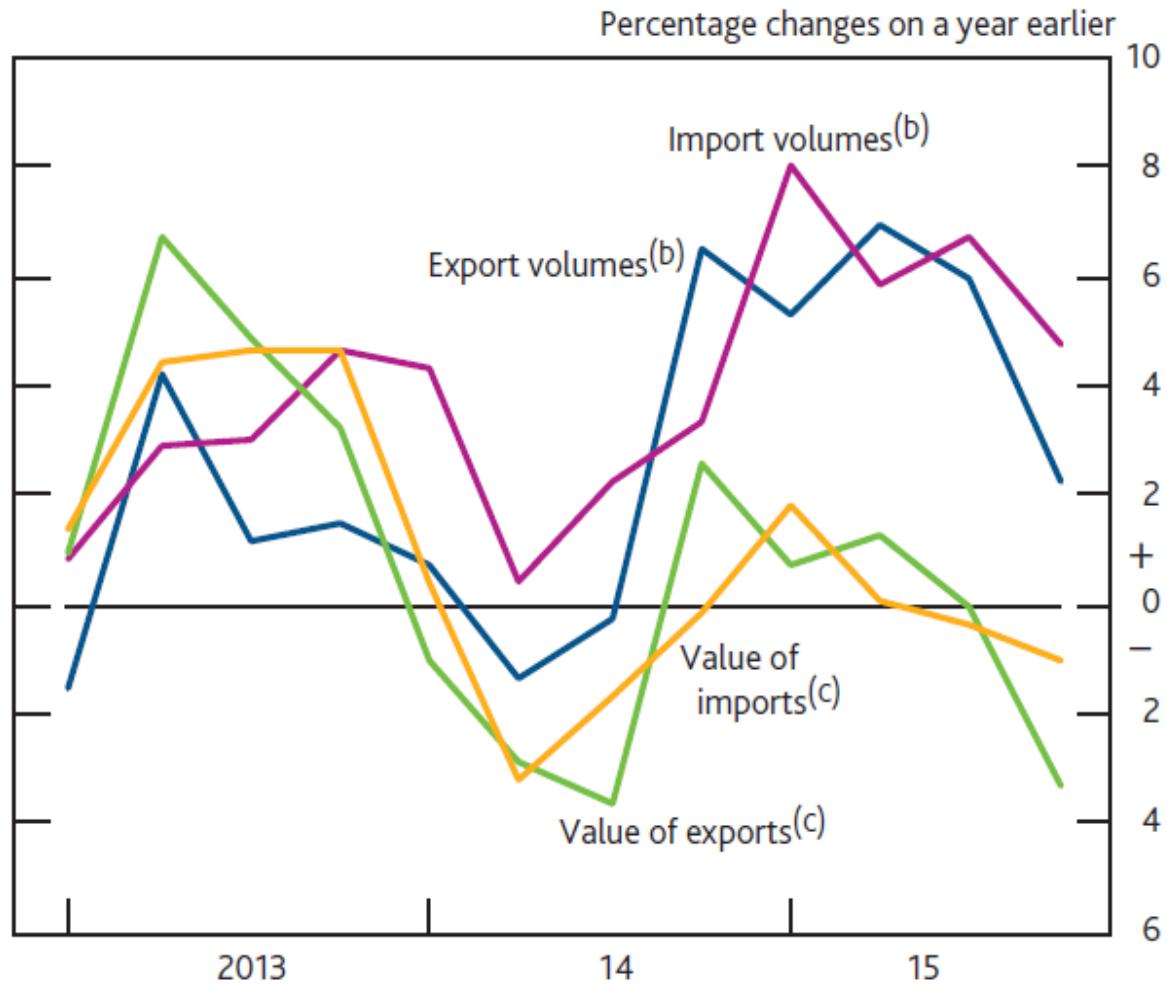
Housing transactions rose sharply in March

Mortgage approvals for house purchase and housing transactions



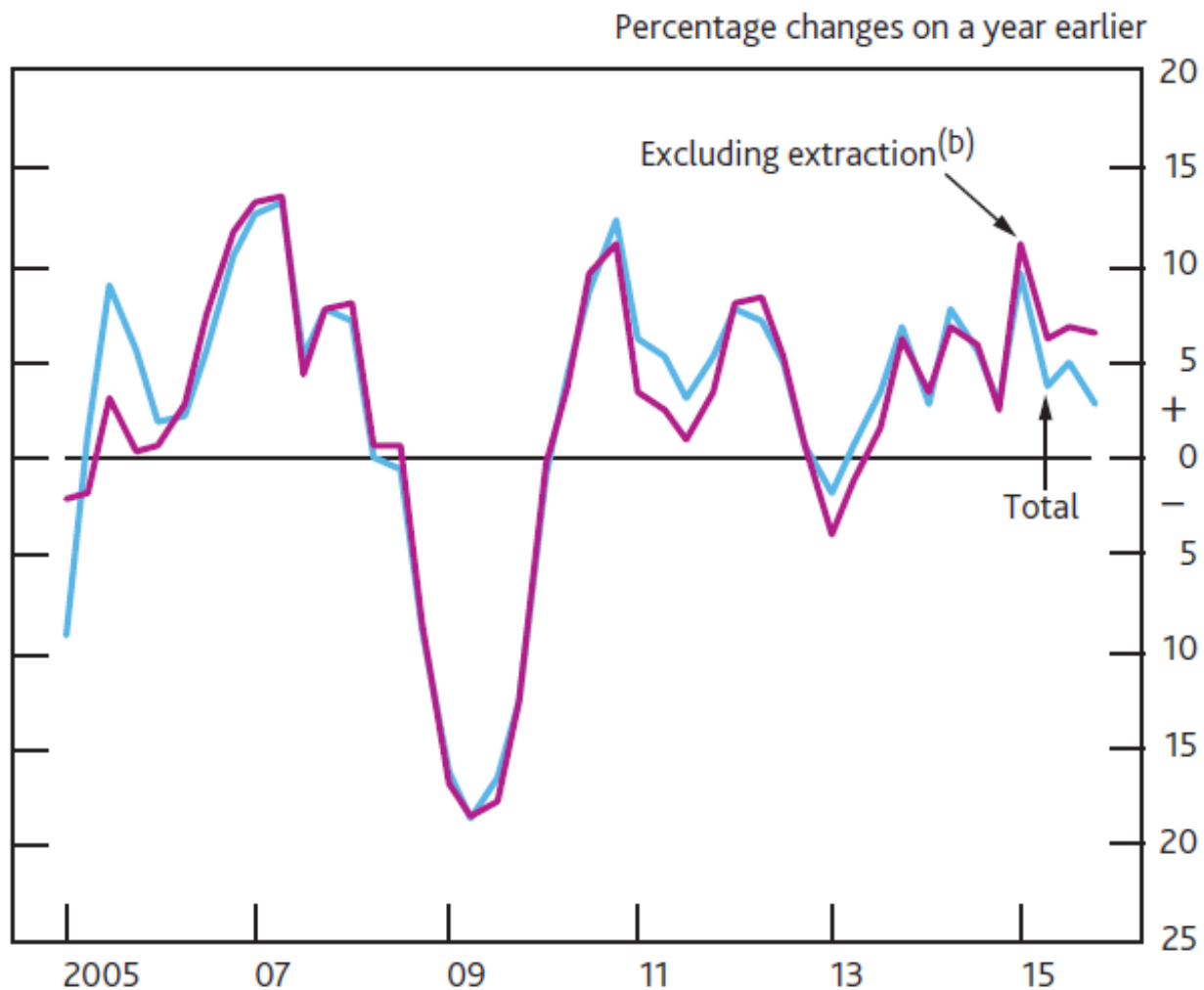
Import and export values have fallen over the past year

Imports and exports(a)



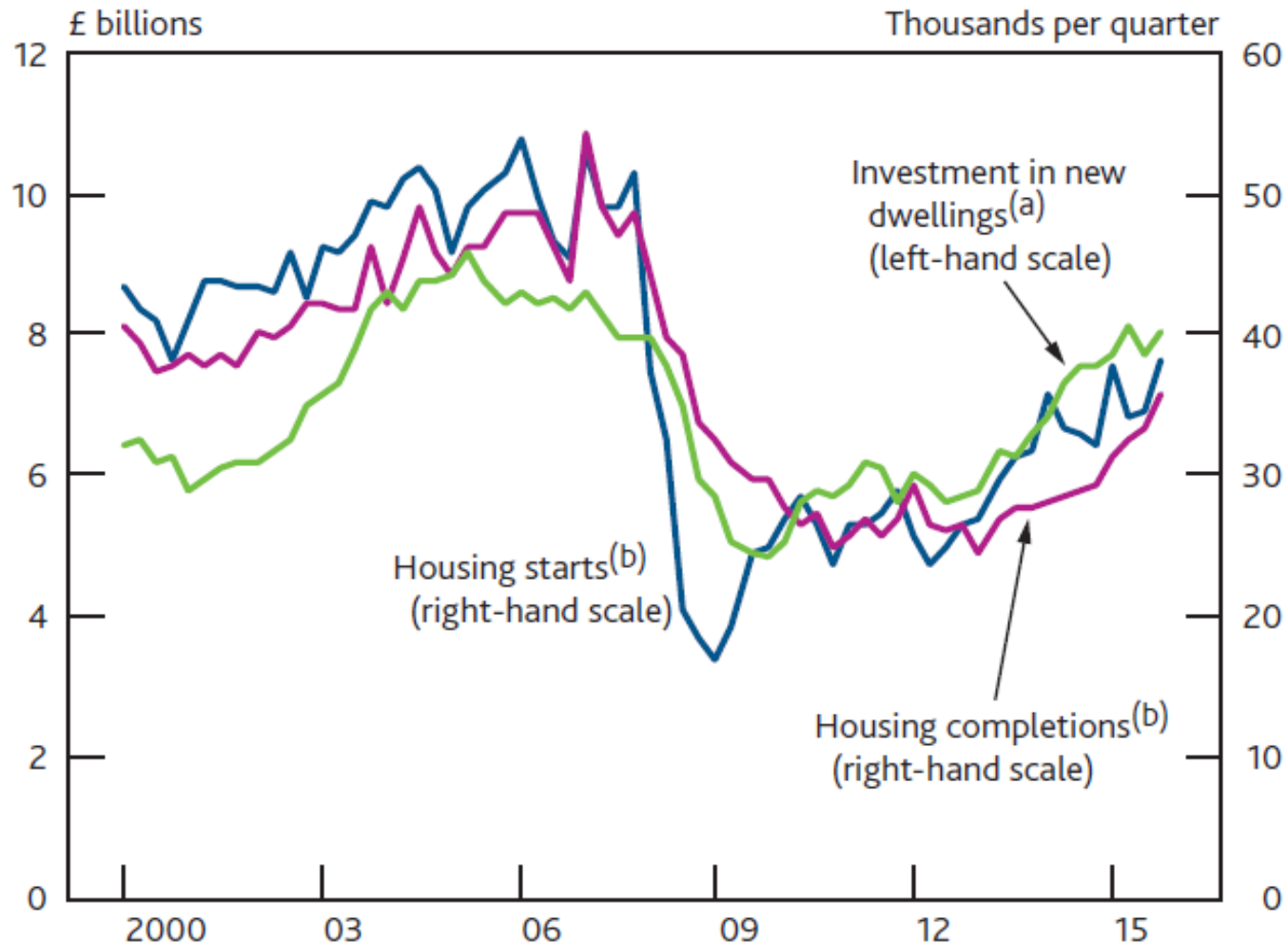
Extraction investment has recently depressed overall business investment growth

Business investment(a)



Housing starts and completions continue to rise

House building and investment in new dwellings

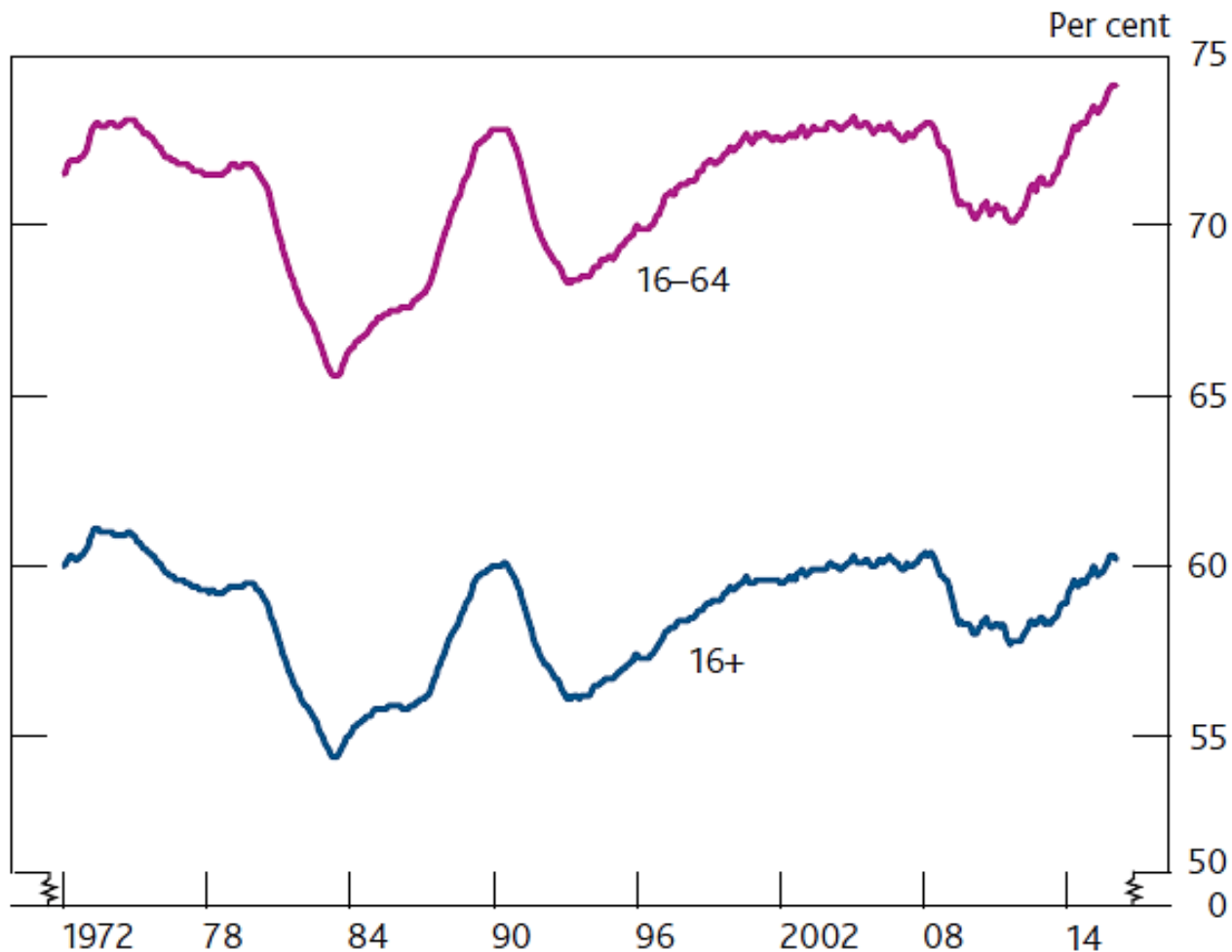


SUPPLY CAPACITY



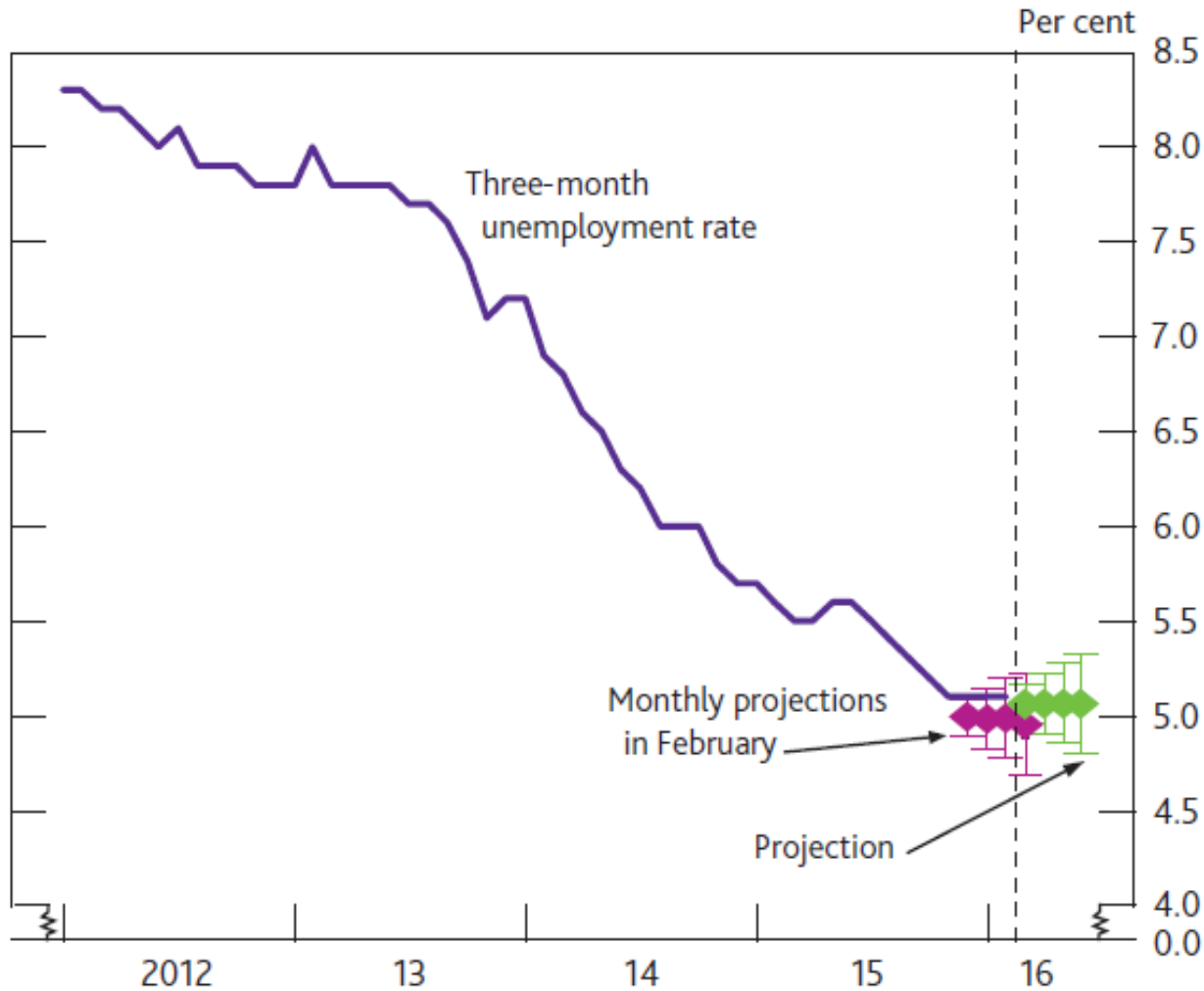
The employment rate is close to previous peaks

Employment rates for selected age groups(a)



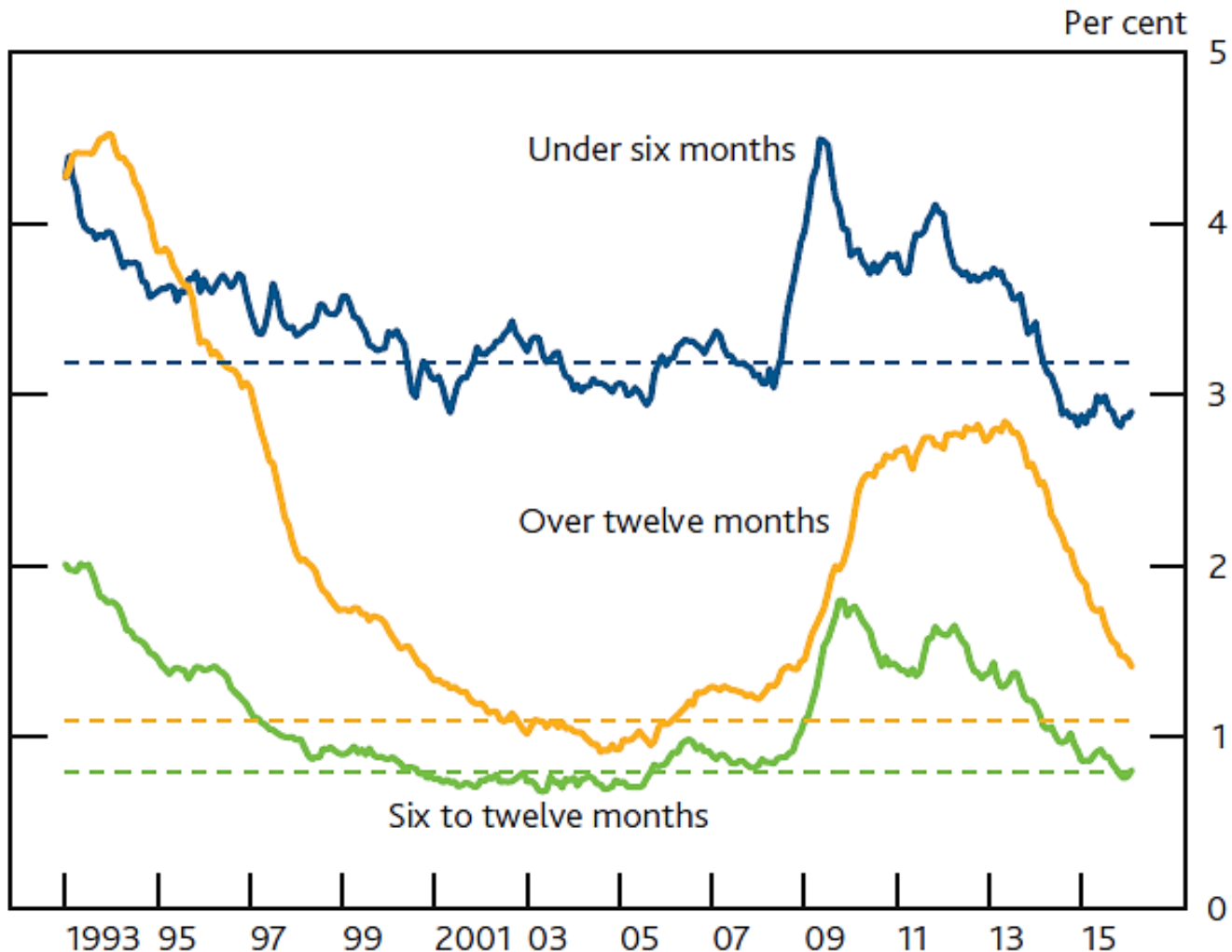
The unemployment rate has been stable

Unemployment rate and Bank staff's near-term projection(a)

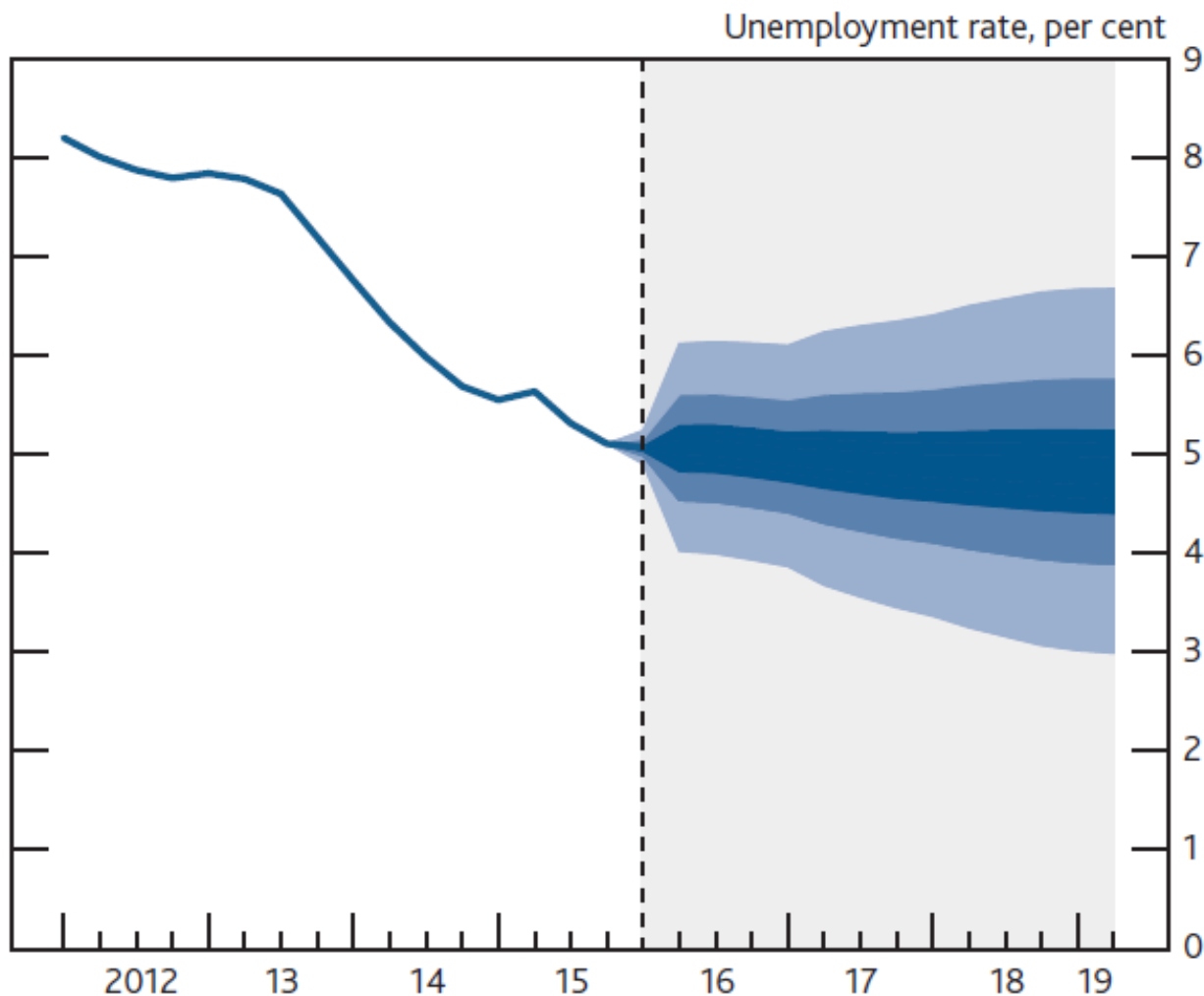


Long-term unemployment remains somewhat elevated

Unemployment rates by duration(a)



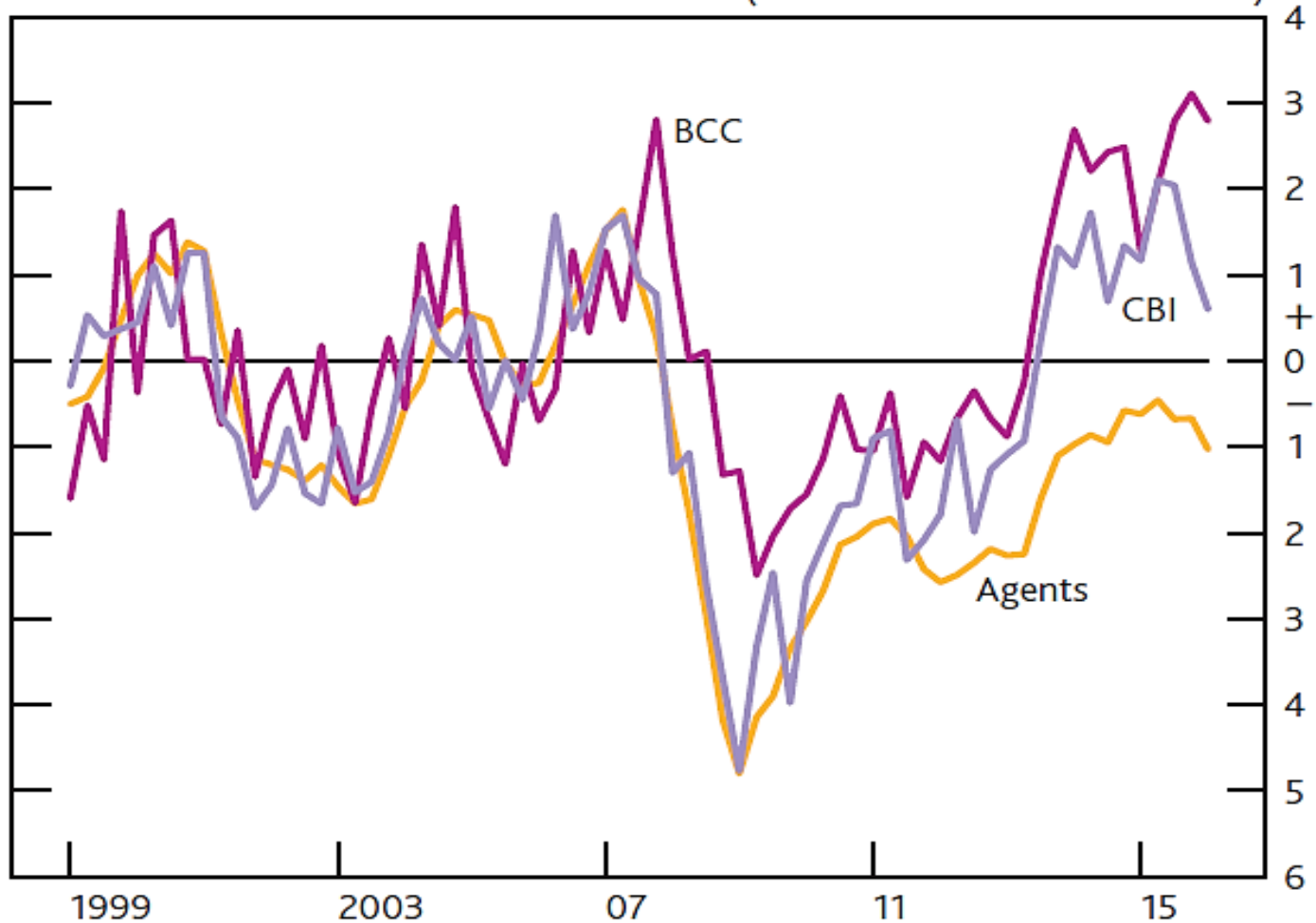
Unemployment projection based on market interest rate expectations and £375 billion purchased assets



Companies' capacity pressures have eased

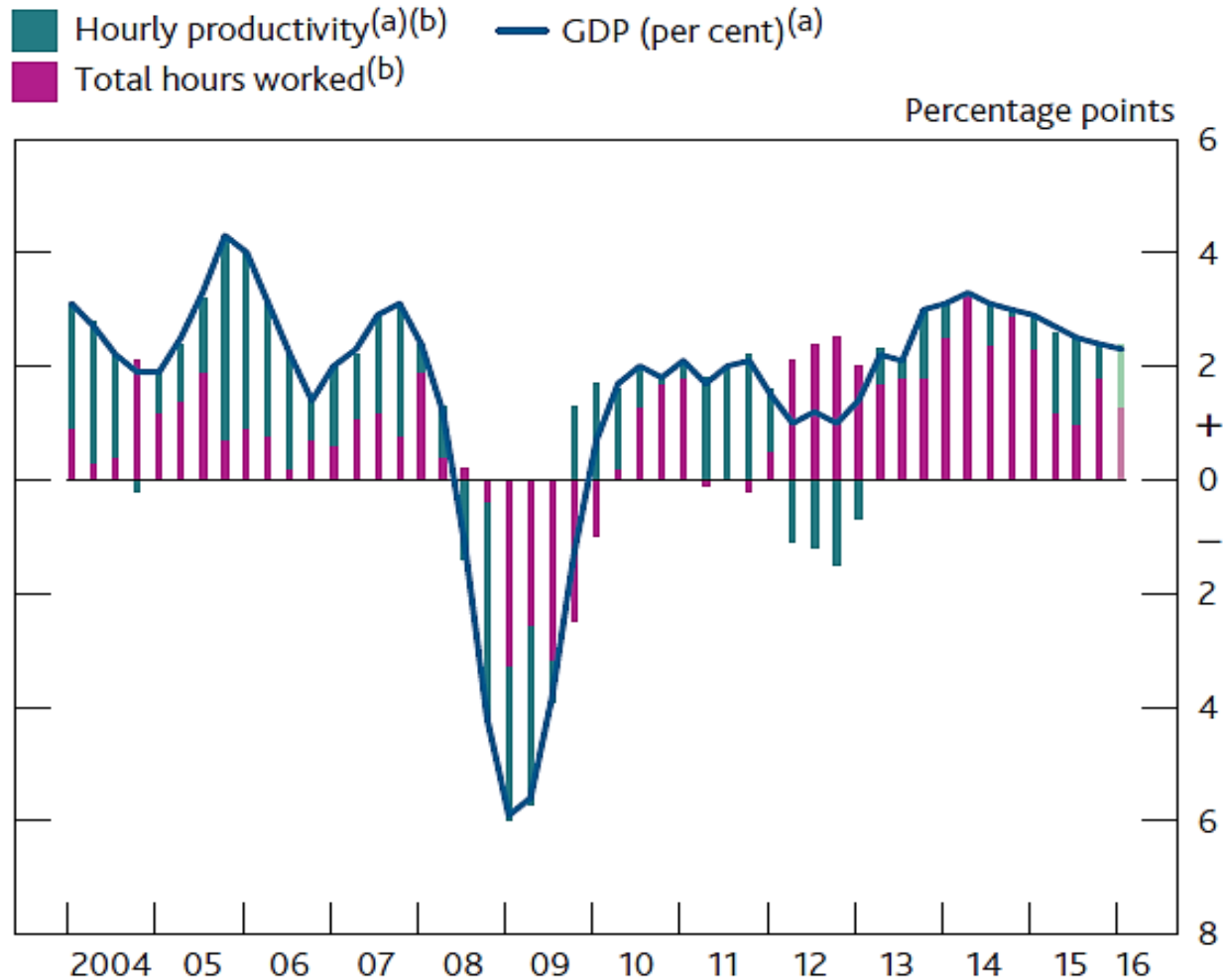
Survey indicators of capacity utilisation(a)

Differences from 1999 Q1–2007 Q3 averages
(number of standard deviations)

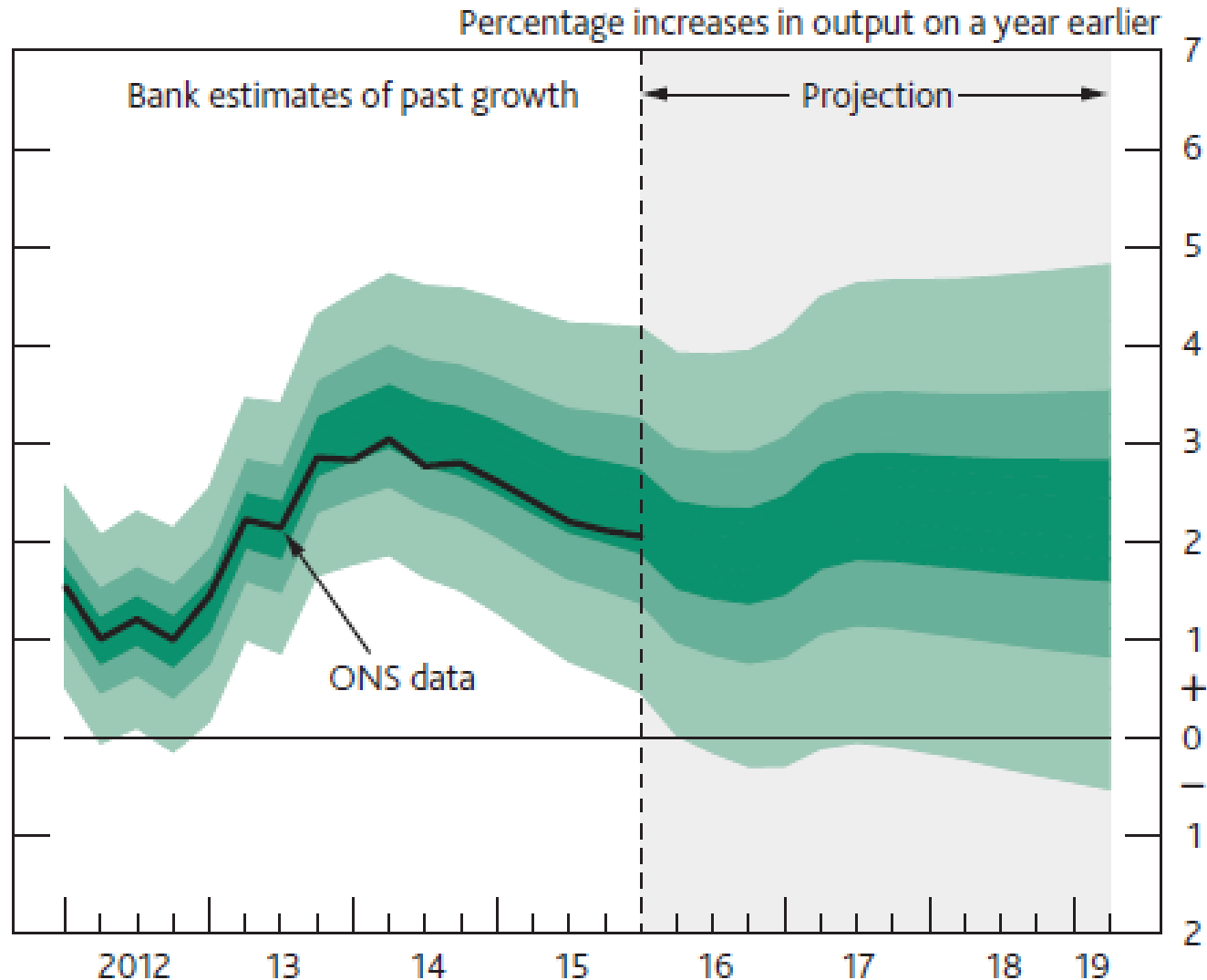


Over the past year productivity growth has accounted for a greater share of GDP growth

Decomposition of four-quarter GDP growth

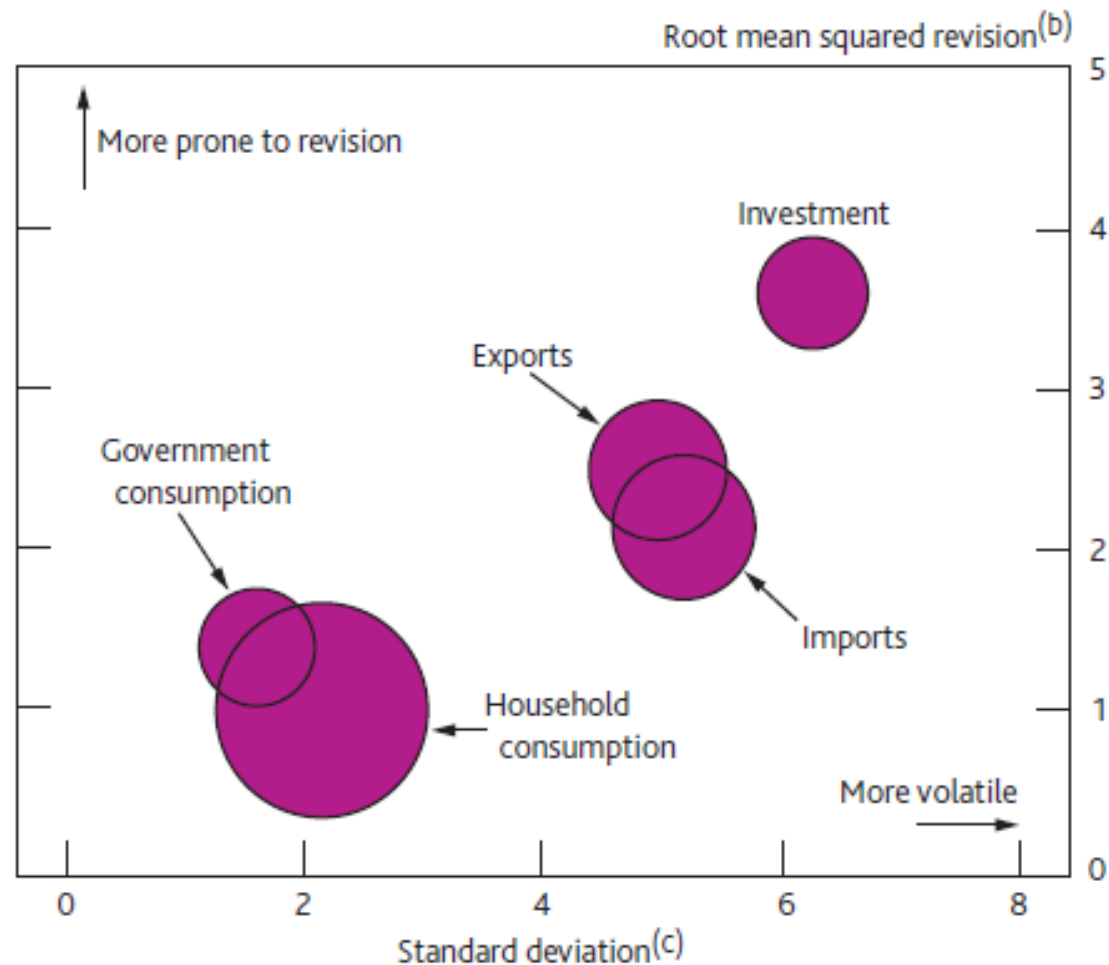


GDP projection based on market interest rate expectations and £375 billion purchased assets

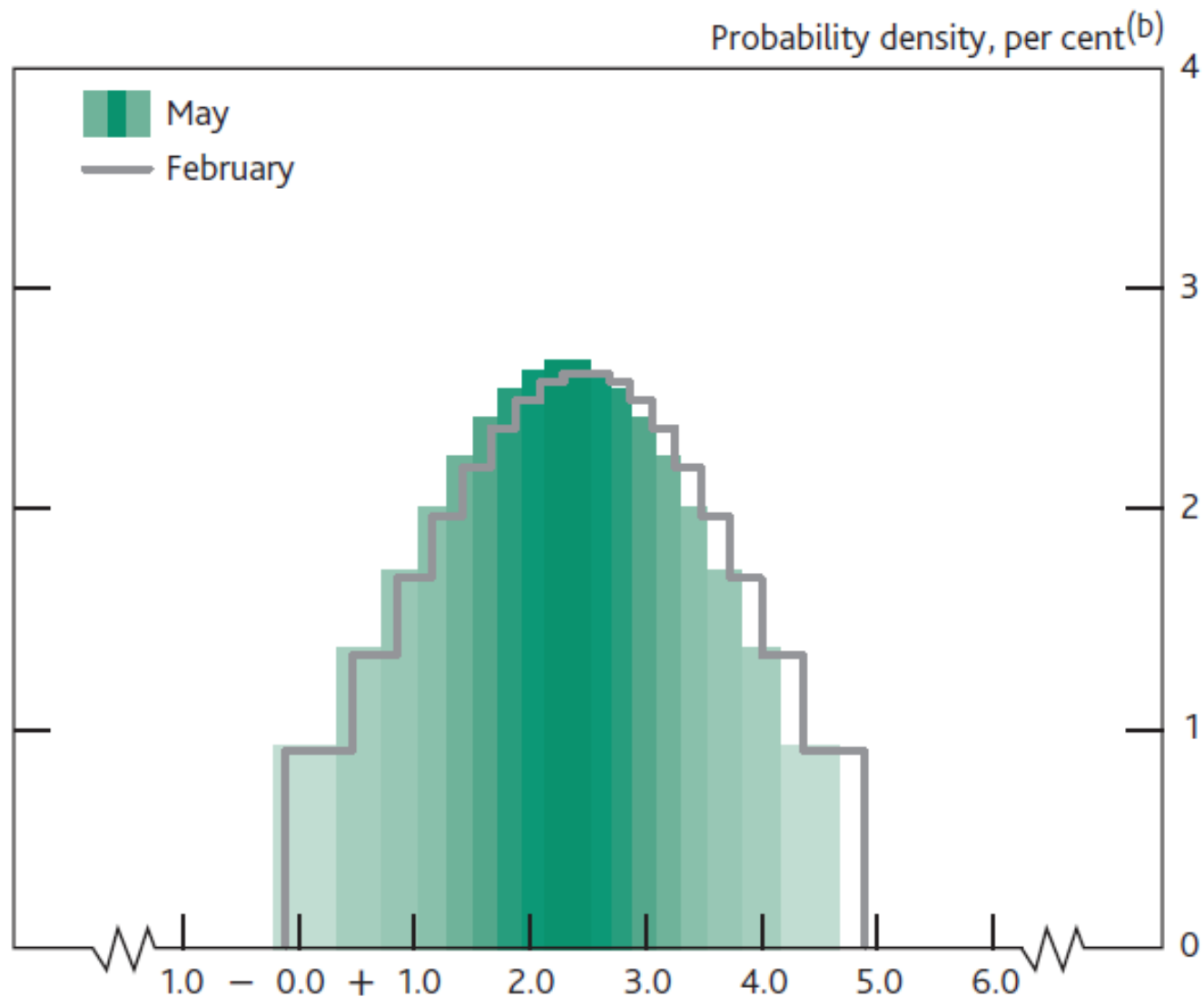


Investment data are more volatile and prone to revision than other expenditure components

Volatility of, and degree of past revisions to, growth in expenditure components^(a)



Projected probabilities of GDP growth in 2018 Q2 (central 90% of the distribution)(a)

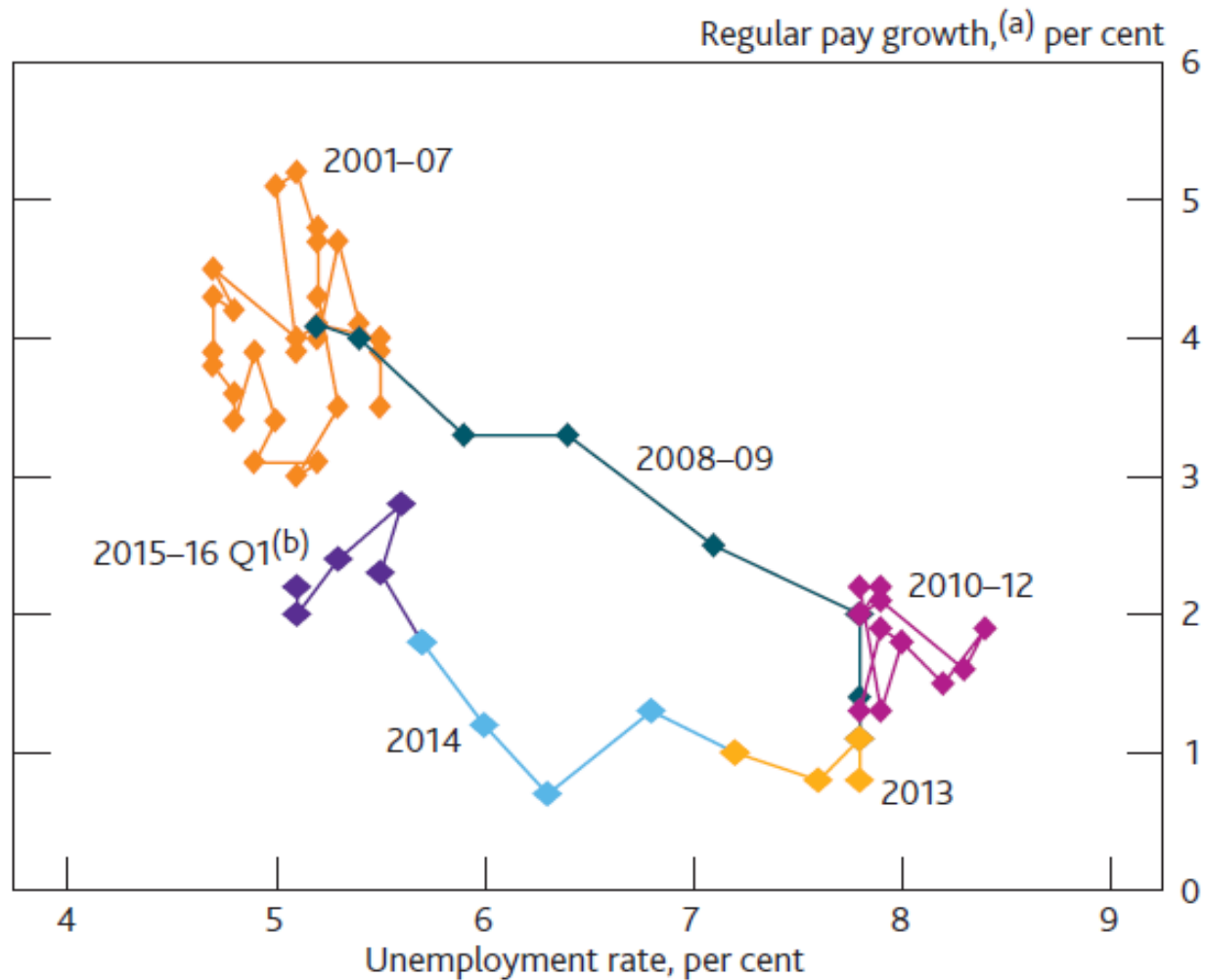


INFLATION



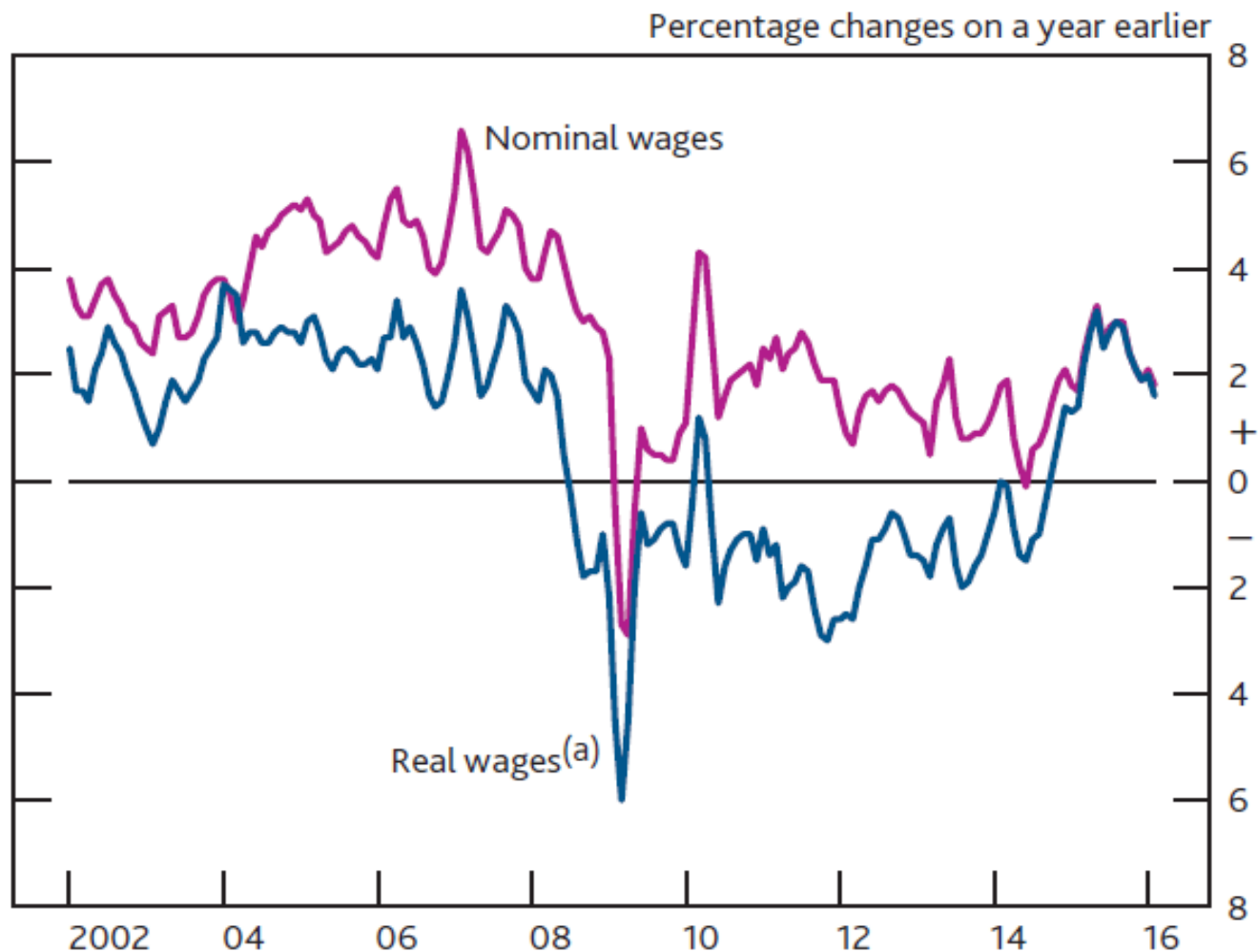
Wage growth has been weak relative to the unemployment rate

Wage Phillips curve: wages and unemployment



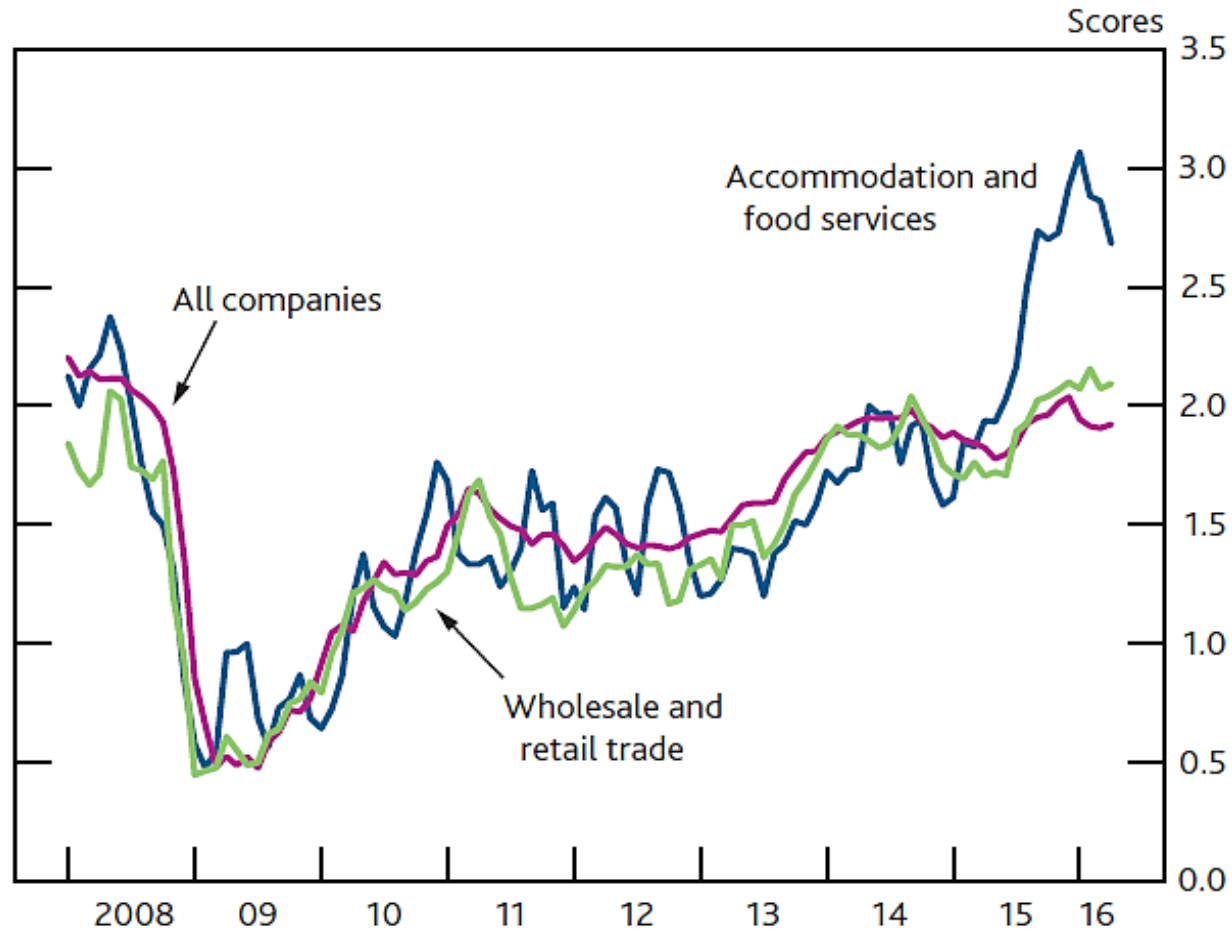
Real wage growth is close to its past average rate

Average weekly earnings: real and nominal



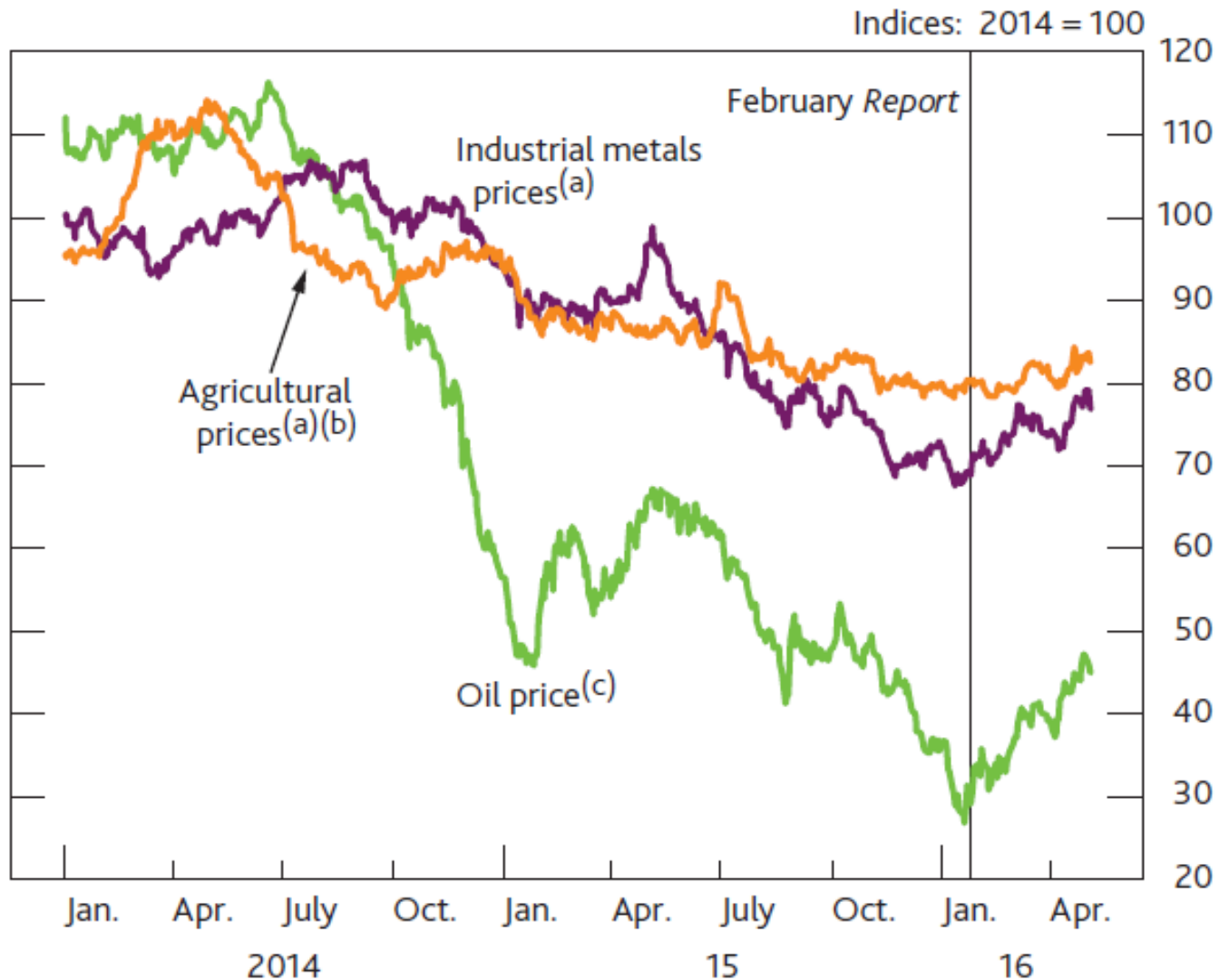
The National Living Wage is likely to affect some sectors more than others

Agents' company visit scores: average expected change in labour costs for selected industries^(a)



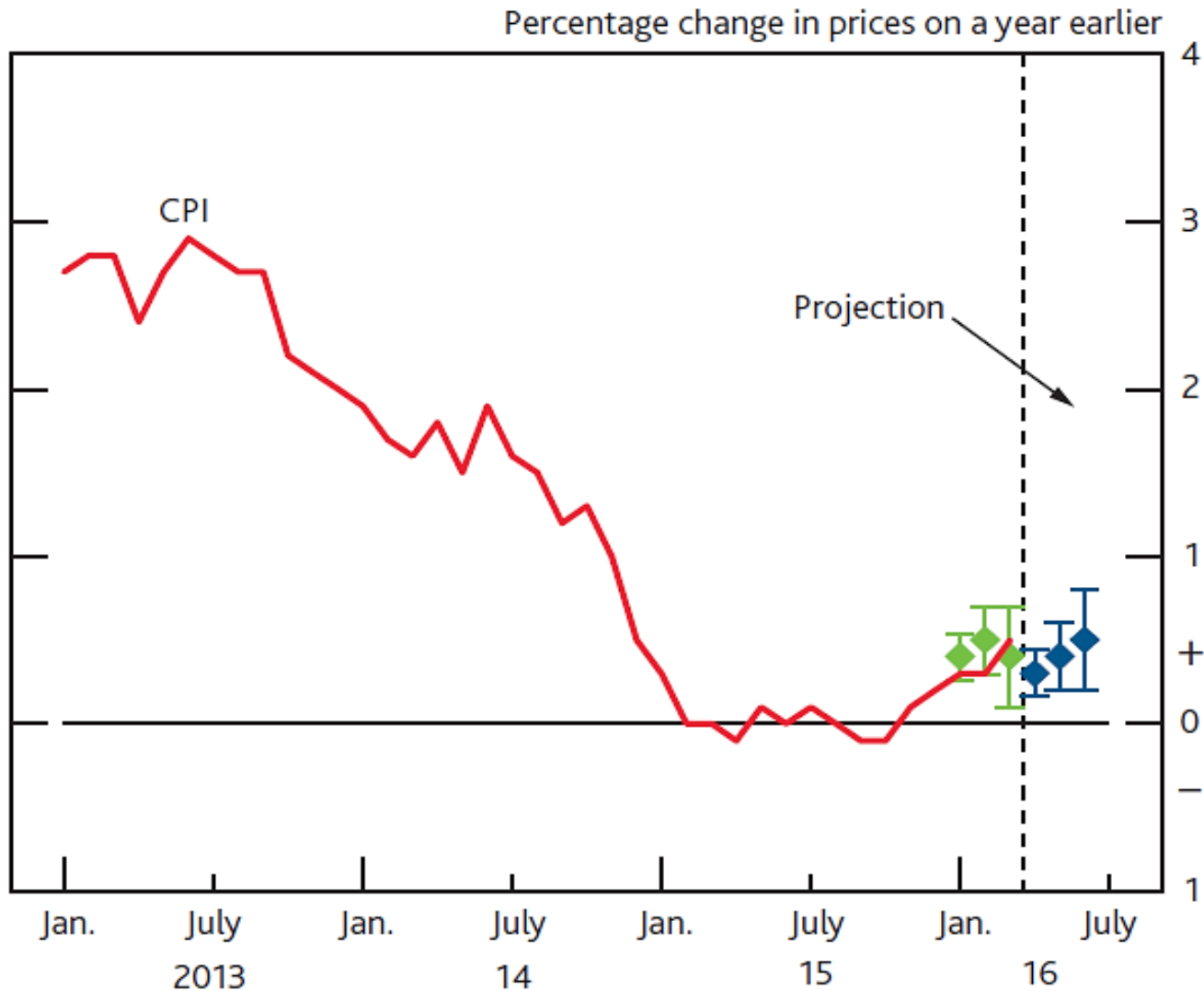
Commodity prices have risen since February

US dollar oil and commodity prices



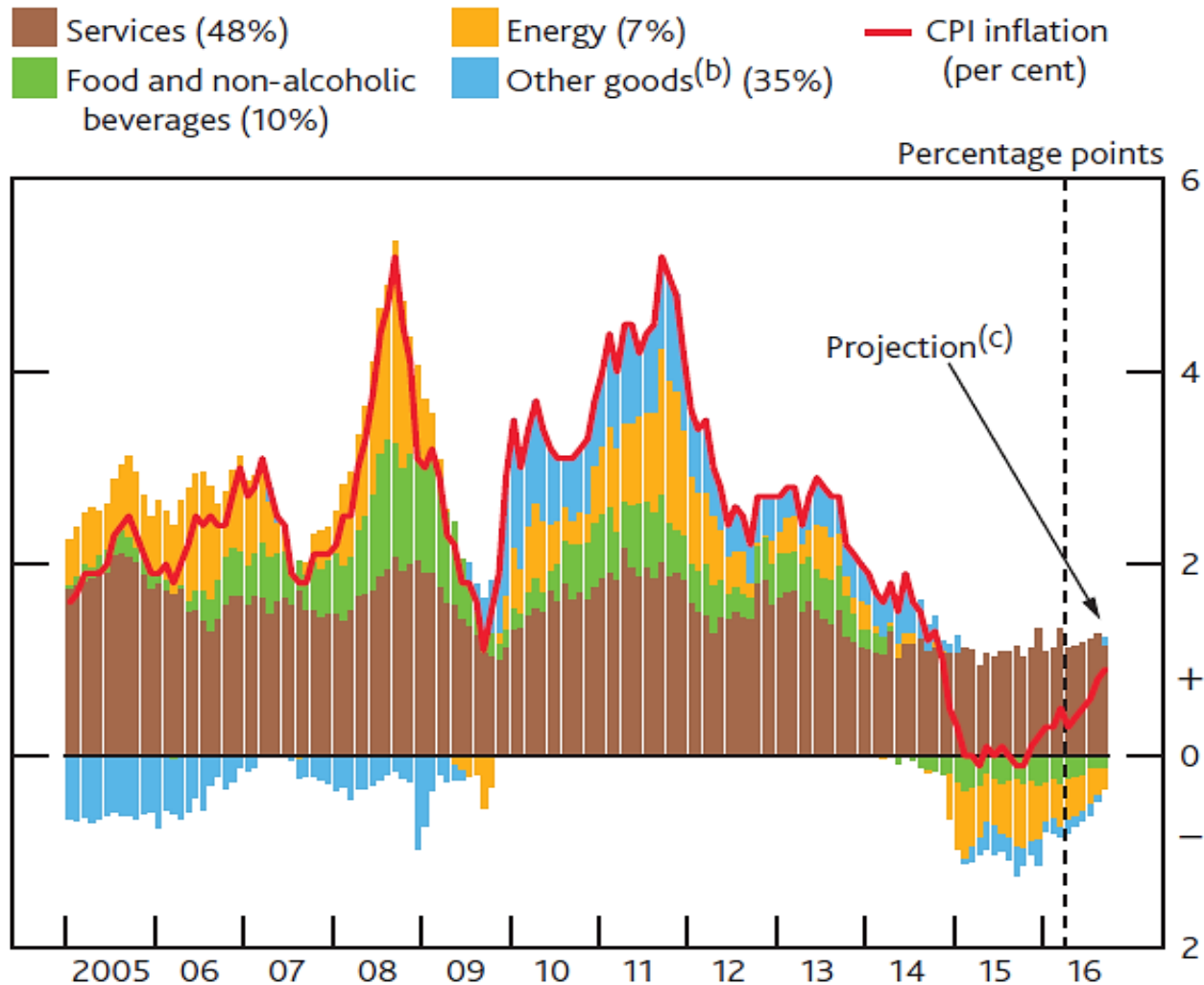
CPI inflation rose to 0.5% in March

CPI inflation and Bank staff's near-term projection(a)



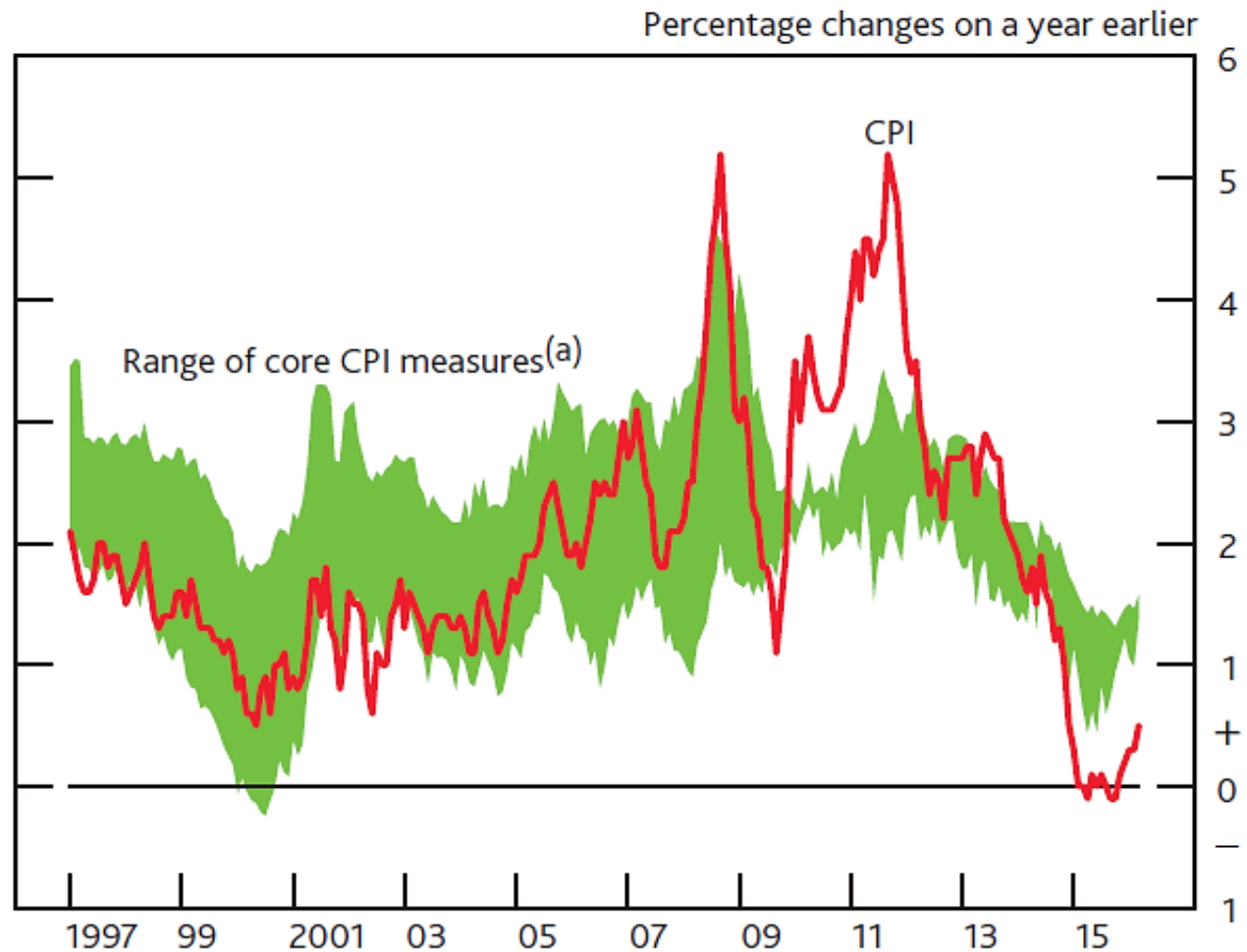
The drag on inflation from food and energy prices should continue to fade

Contributions to CPI inflation^(a)



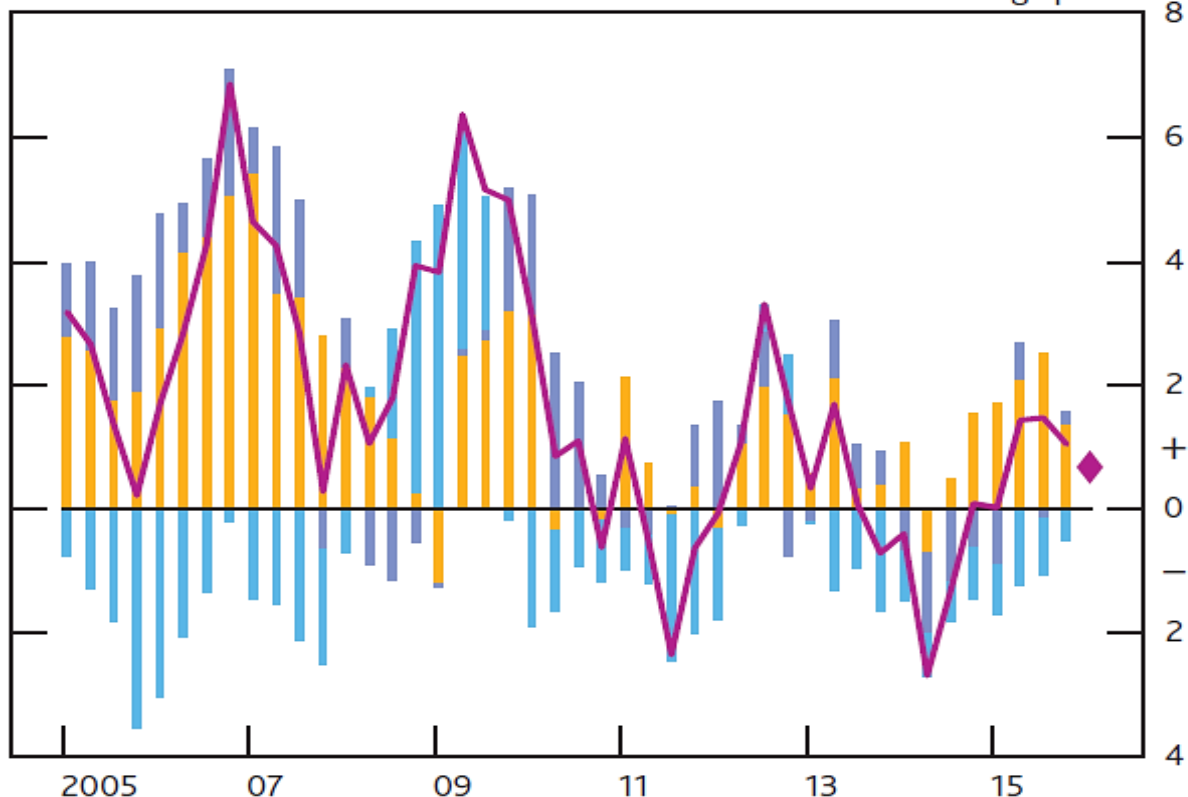
Core inflation measures remain relatively subdued

CPI inflation and measures of core CPI inflation



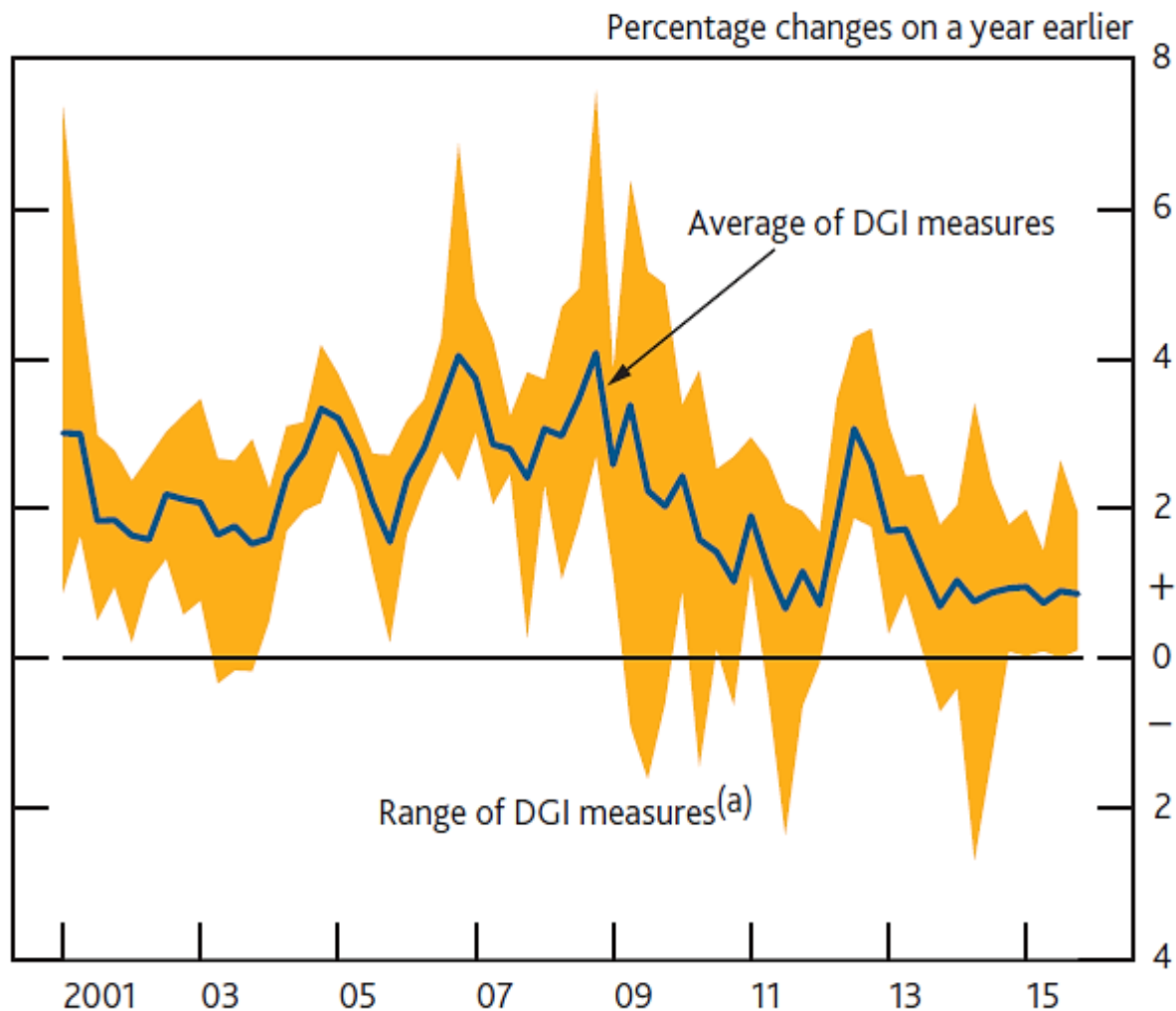
Unit labour cost growth is expected to have slowed further in Q1

Decomposition of four-quarter whole-economy unit labour cost growth^(a)



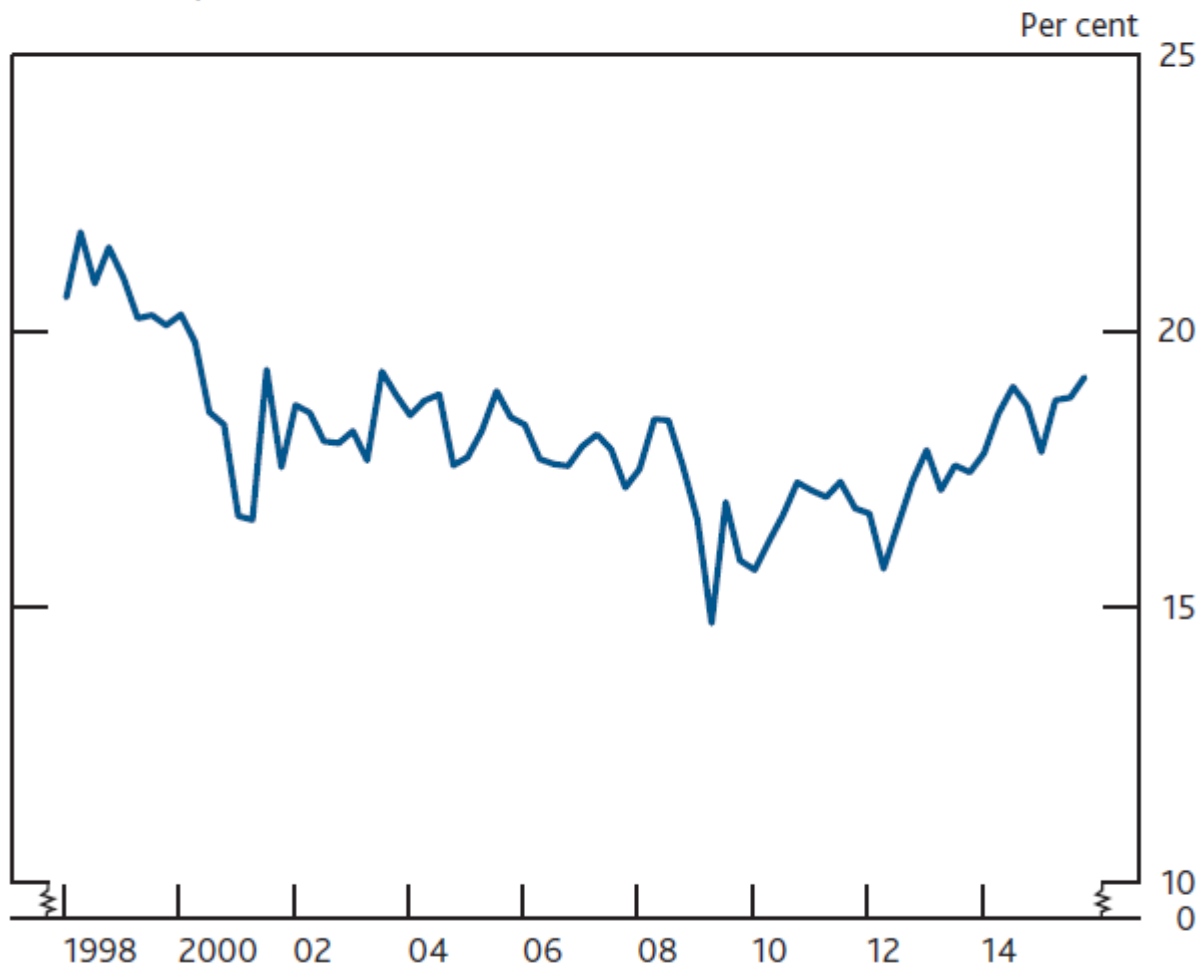
Domestically generated inflation remained broadly flat in 2015 Q4

Measures of domestically generated inflation (DGI)

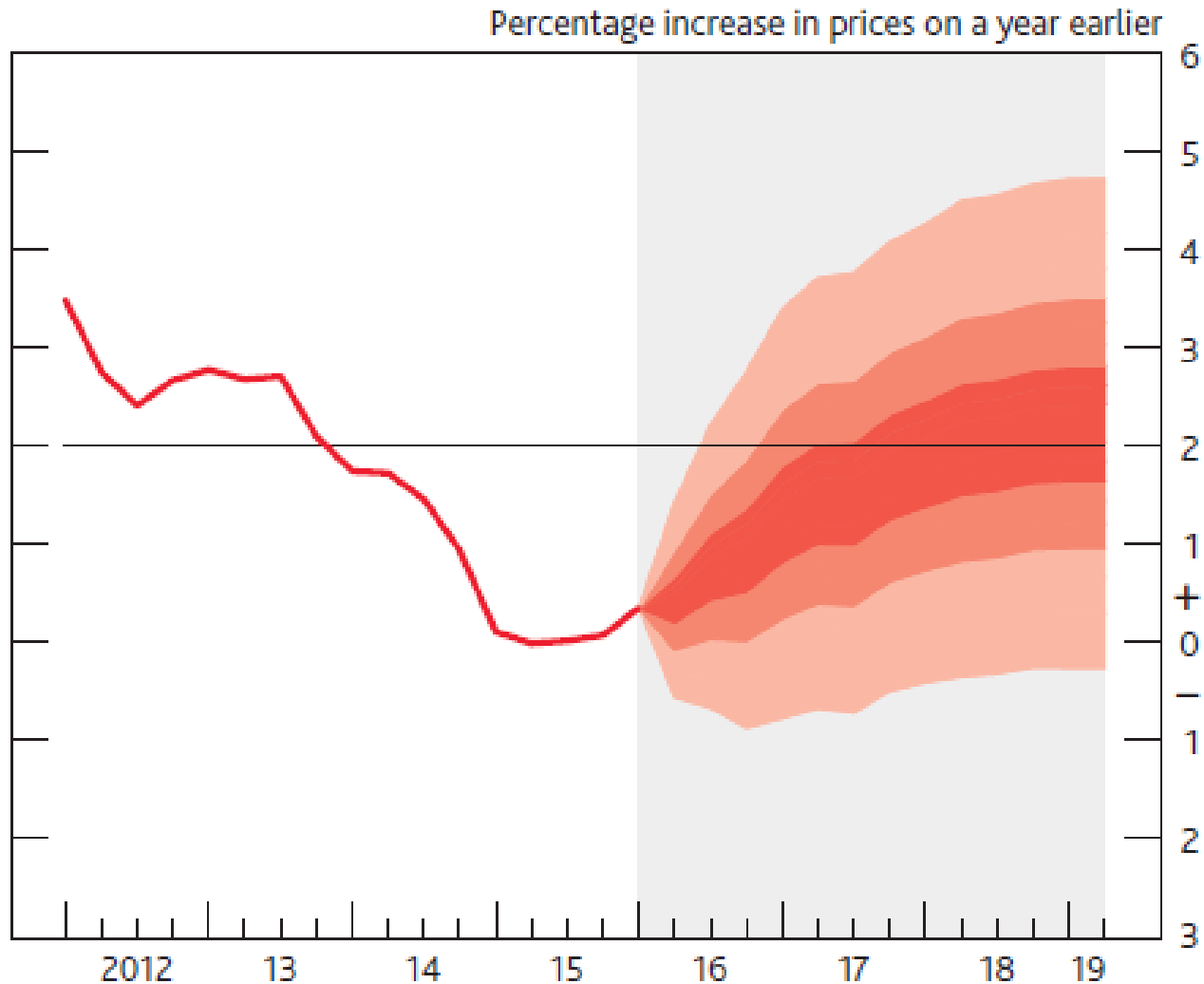


Companies' margins appear to have recovered in recent years

Private non-financial corporate profit share (excluding the oil sector)(a)



CPI inflation projection based on market interest rate expectations and £375 billion purchased assets



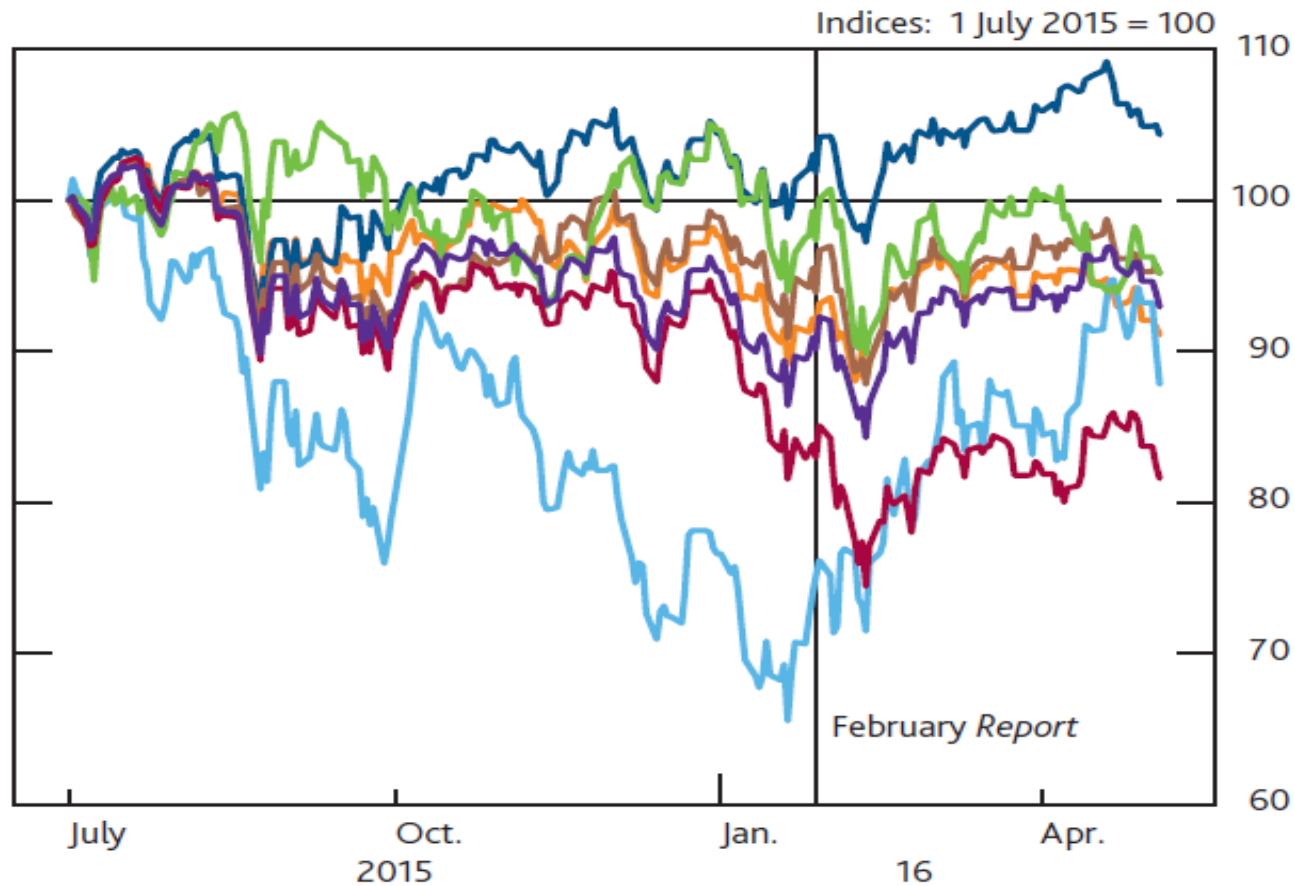
FINANCIAL MARKETS



The recovery in UK equity prices has been most pronounced in the energy sector

UK equity indices for selected sectors(a)

- Manufacturing (28%)
- Consumer services (9%)
- FTSE All-Share
- Construction (3%)
- Mining and quarrying (15%)
- Business services (15%)
- Financials (26%)



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South west Agency

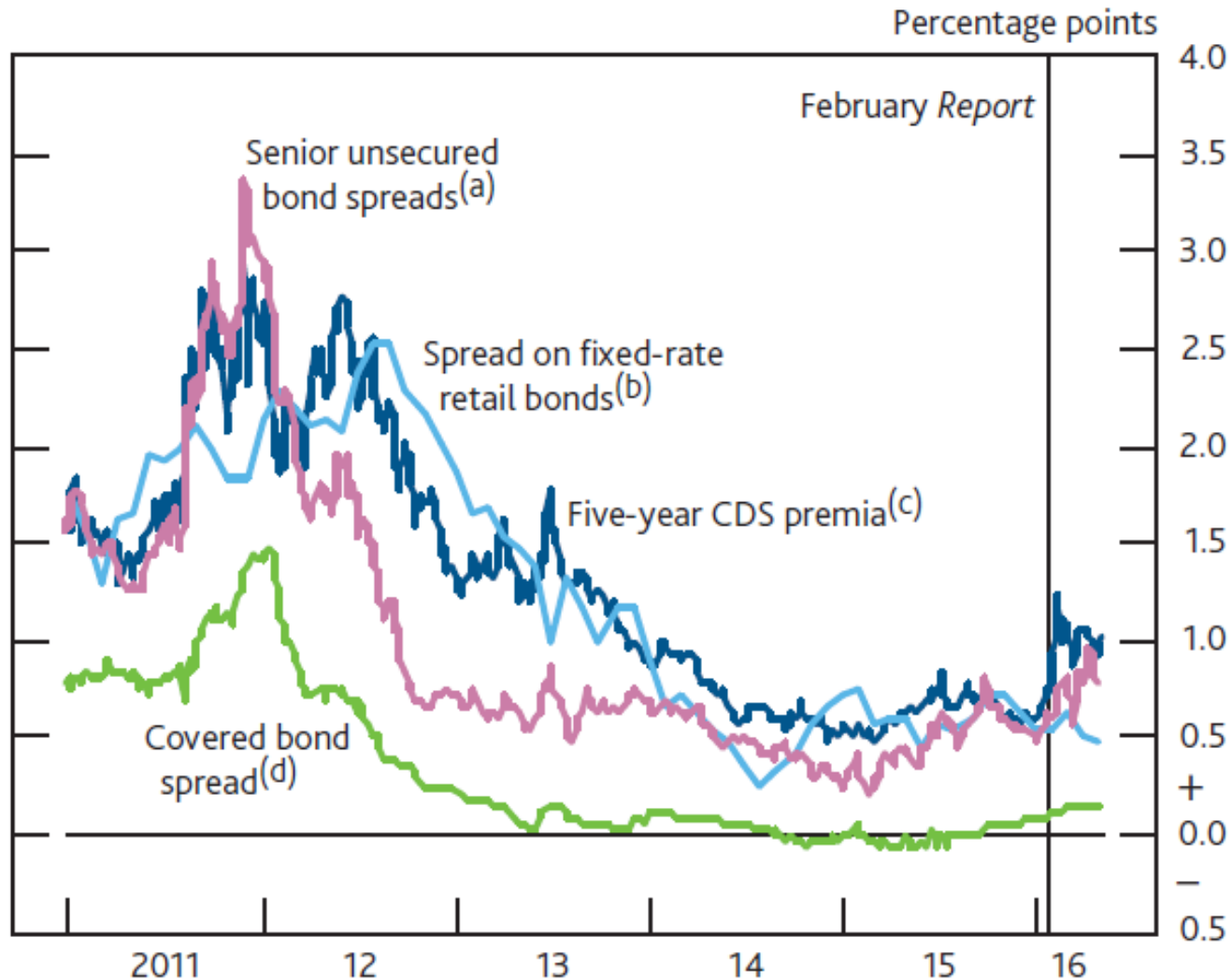


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Sources: Thomson Reuters Datastream and Bank calculation.

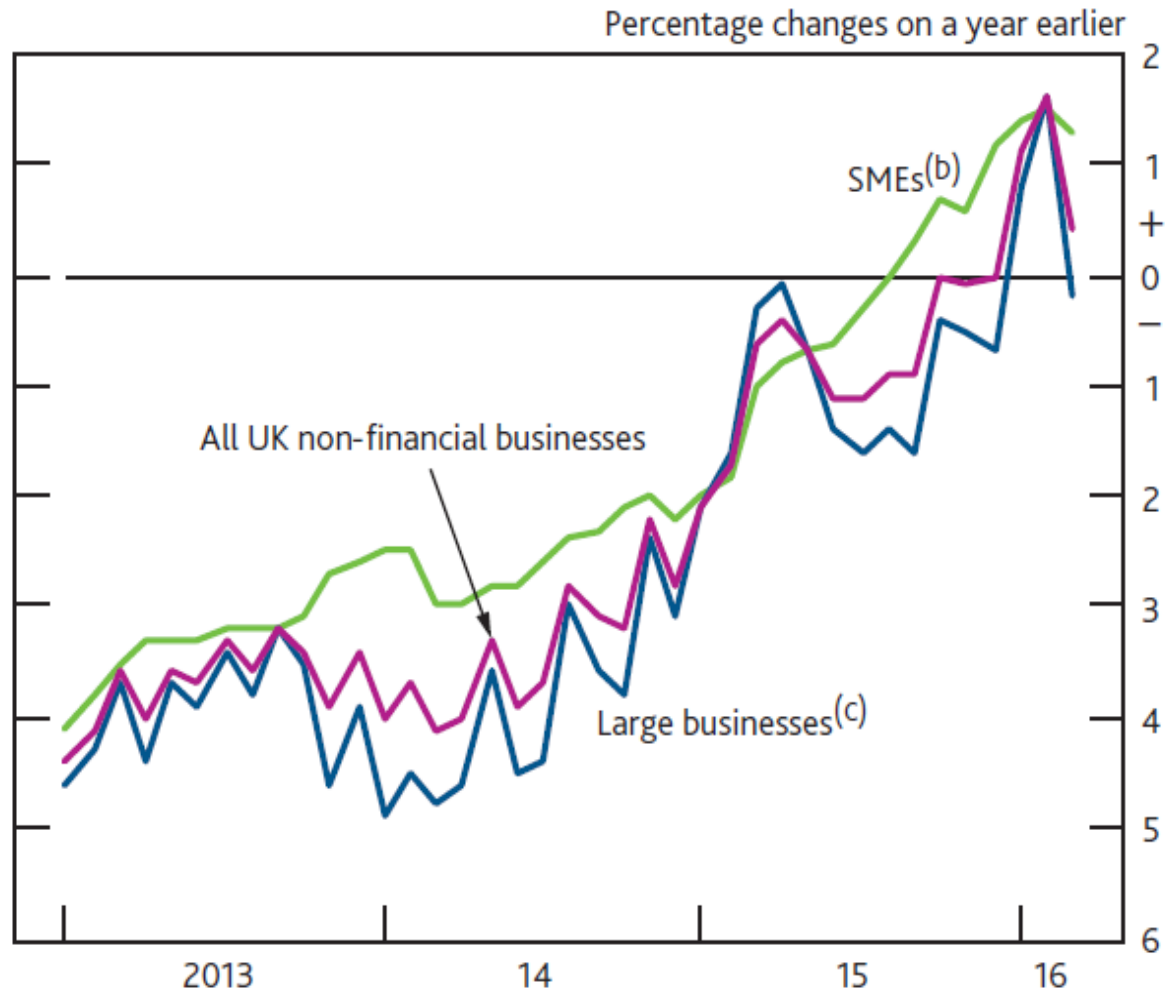
Bank funding spreads have widened

Indicative long-term UK bank funding spreads



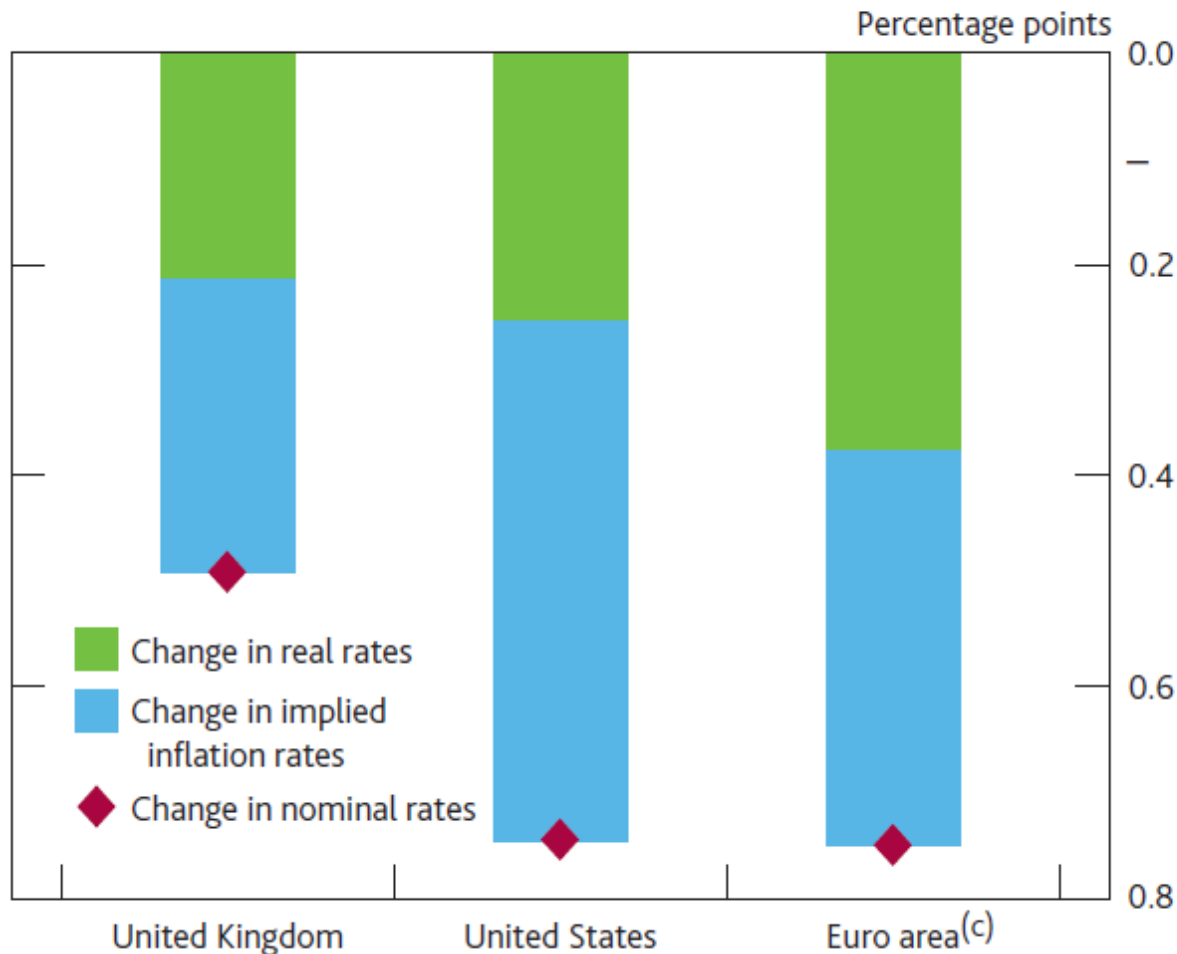
Growth in bank lending to companies fell back in March

Lending to UK non-financial businesses^(a)



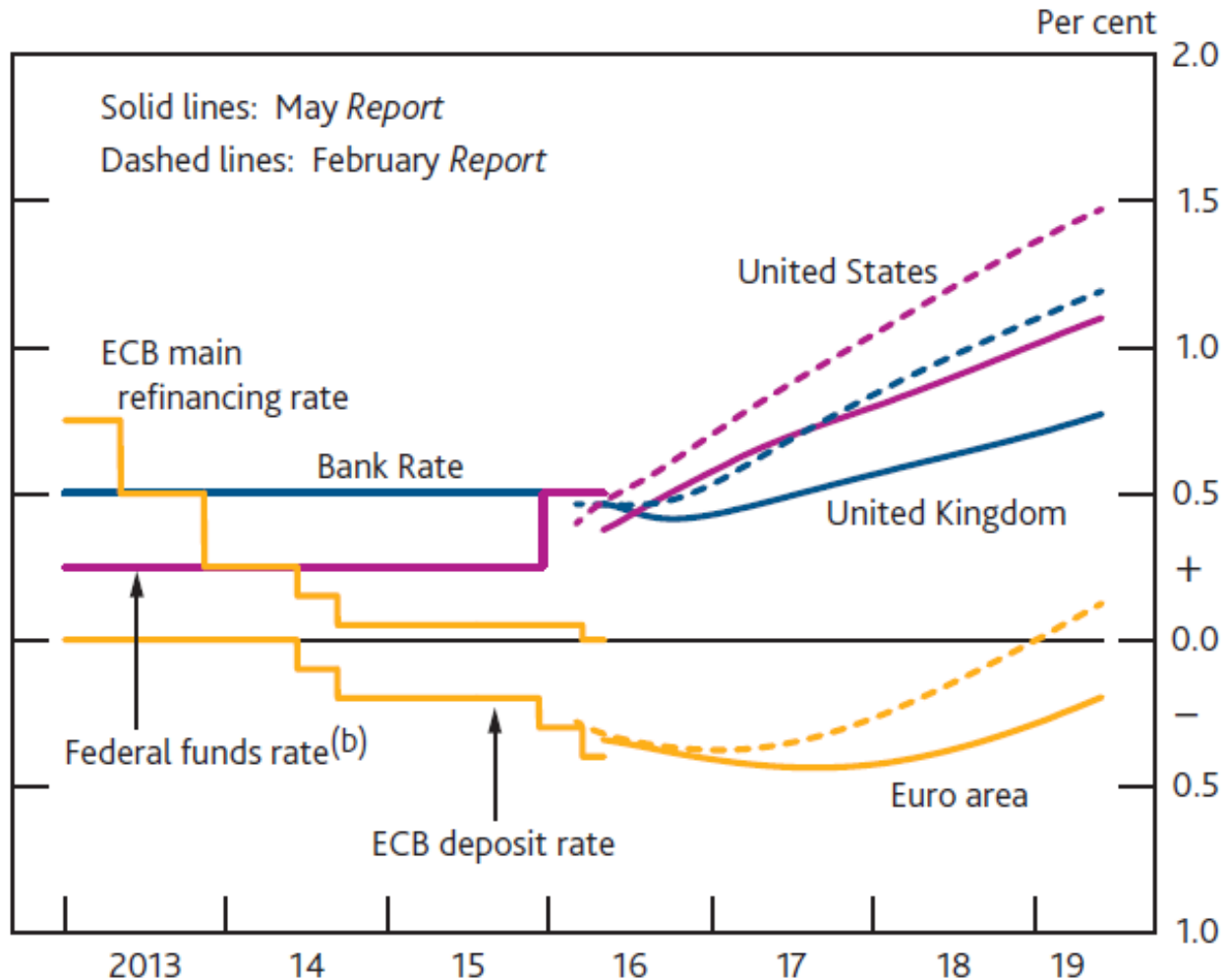
Real rates and implied inflation have fallen since mid-2015

Contributions to the fall in five-year, five-year forward nominal interest rates since mid-2015(a)(b)



Market-implied paths for US, UK and euro-area policy rates have all flattened

International forward interest rates^(a)

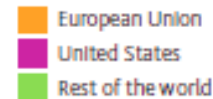


REFERENDUM UNCERTAINTY

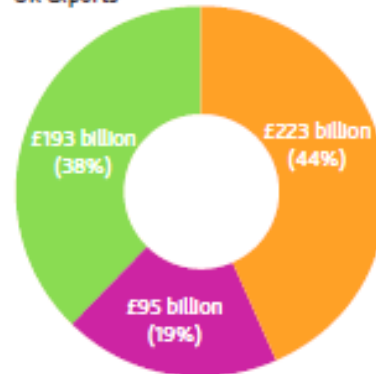


The rest of the European Union is the United Kingdom's biggest trading and investment partner

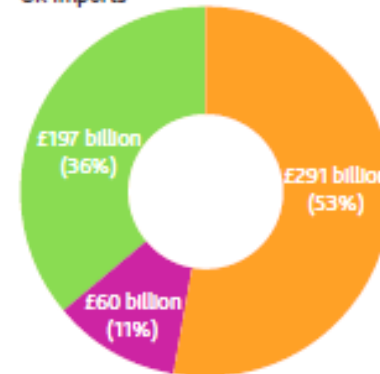
Sources and destinations of UK imports and exports and UK foreign direct investment (FDI)^(a)



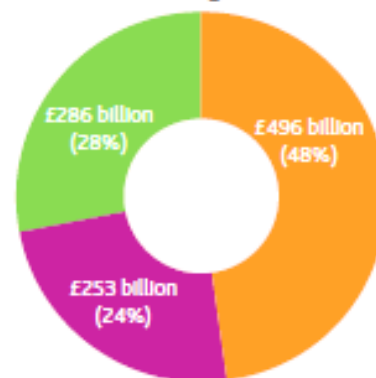
UK exports



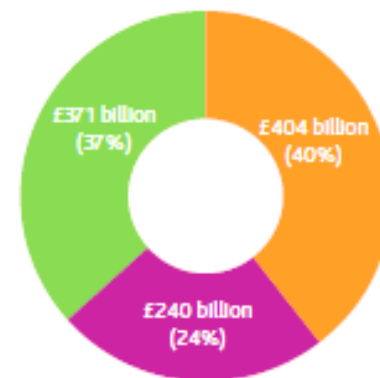
UK Imports



FDI in the United Kingdom

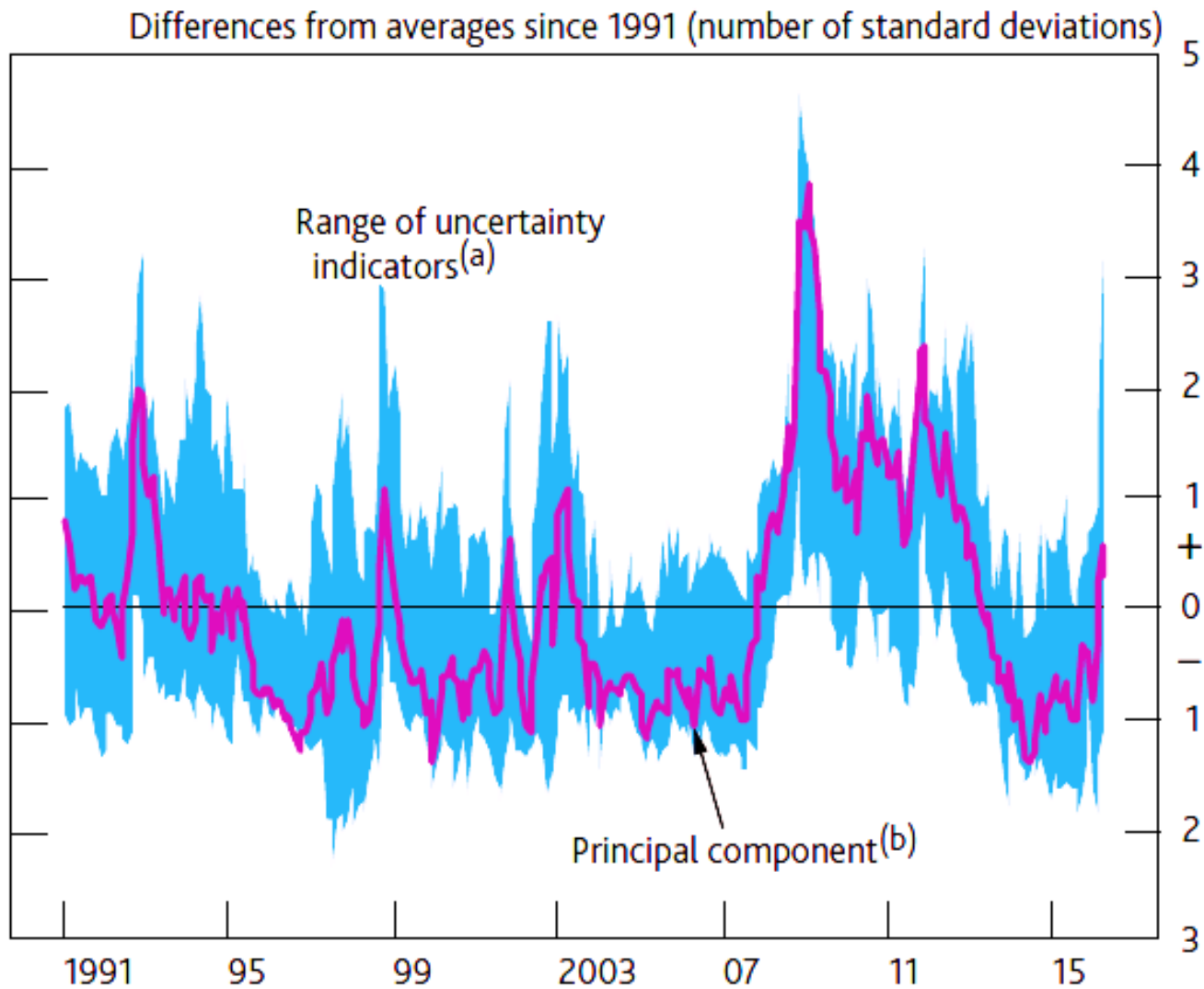


UK FDI overseas



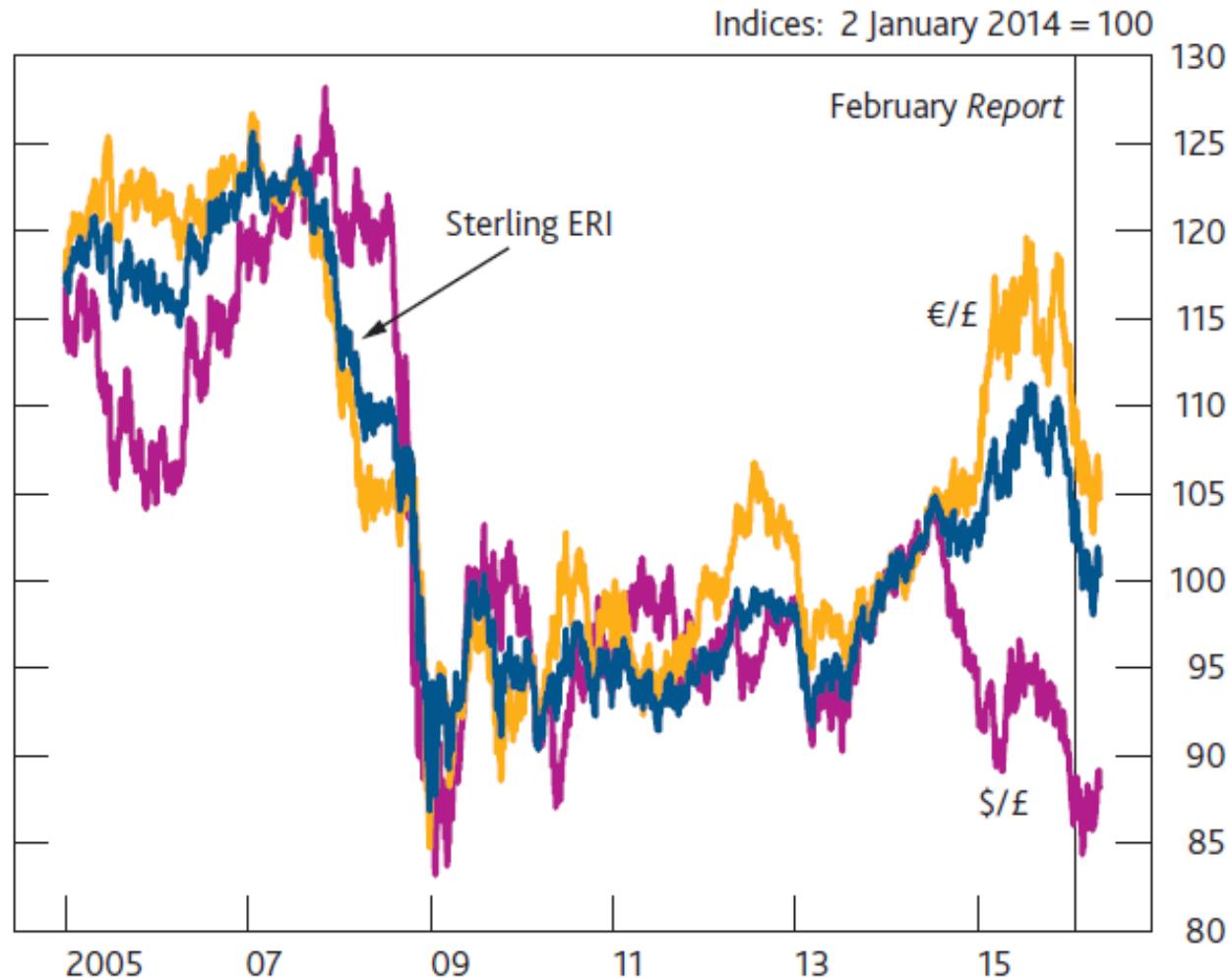
Uncertainty has risen in recent months

Range of uncertainty measures



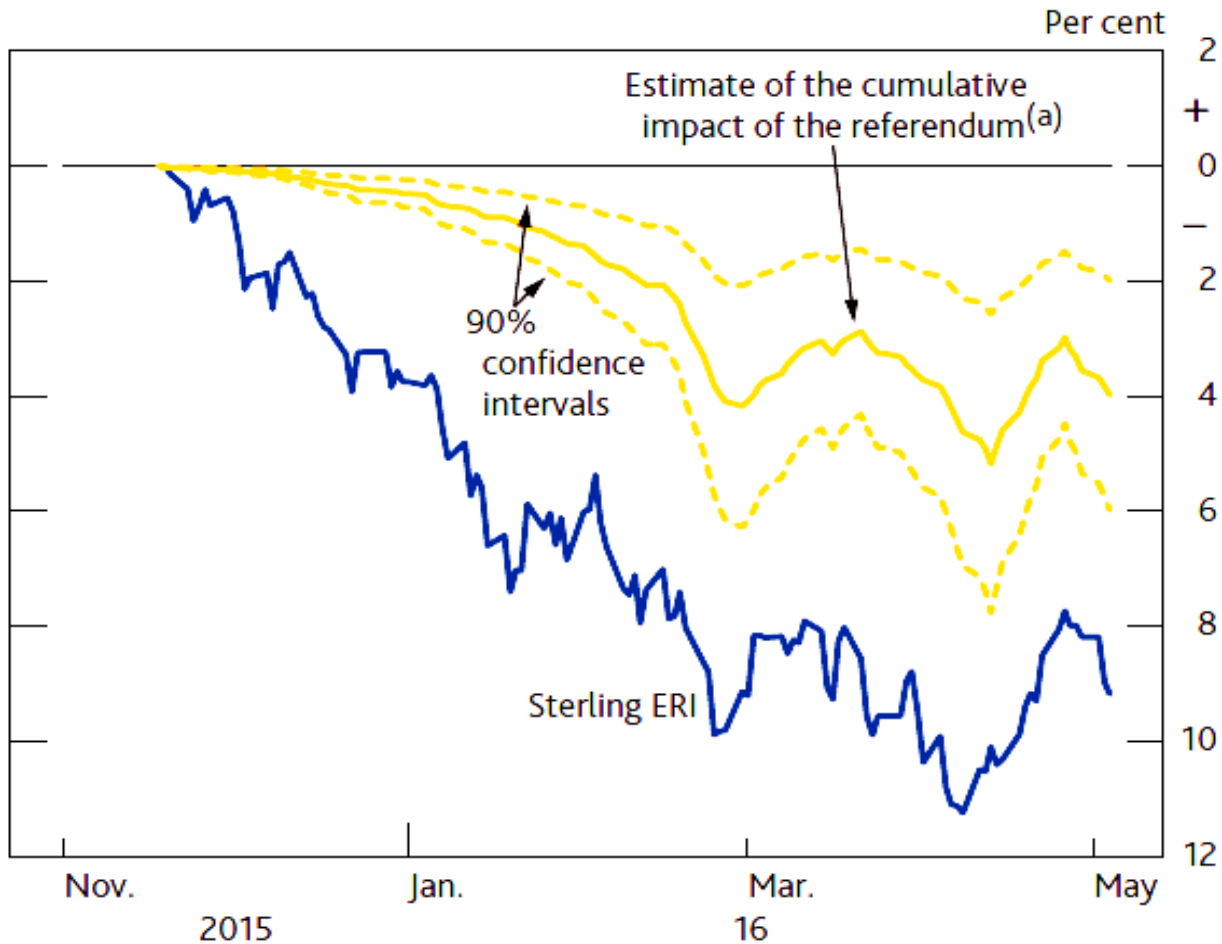
Sterling has depreciated significantly over the past six months

Sterling exchange rates



Roughly half of sterling's depreciation is estimated to be attributed to the referendum

Cumulative change in sterling since 18 November 2015 and estimated referendum impact



Possible effects of Referendum

- Most significant risk to the MPC's forecast
- Increased uncertainty before Referendum and if vote is to leave
- Might delay companies' and households' spending decisions (already manifest in surveys and some data)
- Effects on financial asset prices, raising funding costs
- Fall in exchange rate (already manifest); likely to fall further if vote is to leave
- Effects could be amplified by implications of already very large current account deficit
- Implications for inflation:
 - higher because of lower exchange rate;
 - but mitigated by expected fall in aggregate demand
 - but possible offsetting effects on aggregate supply
- All leading to challenging trade-off for MPC



FINANCIAL STABILITY REPORT

December 2015



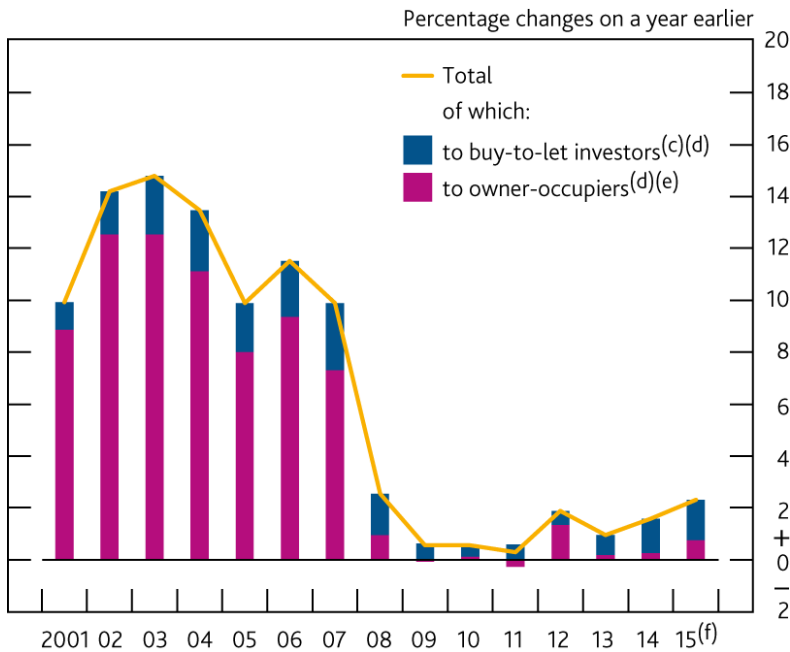
UK property markets



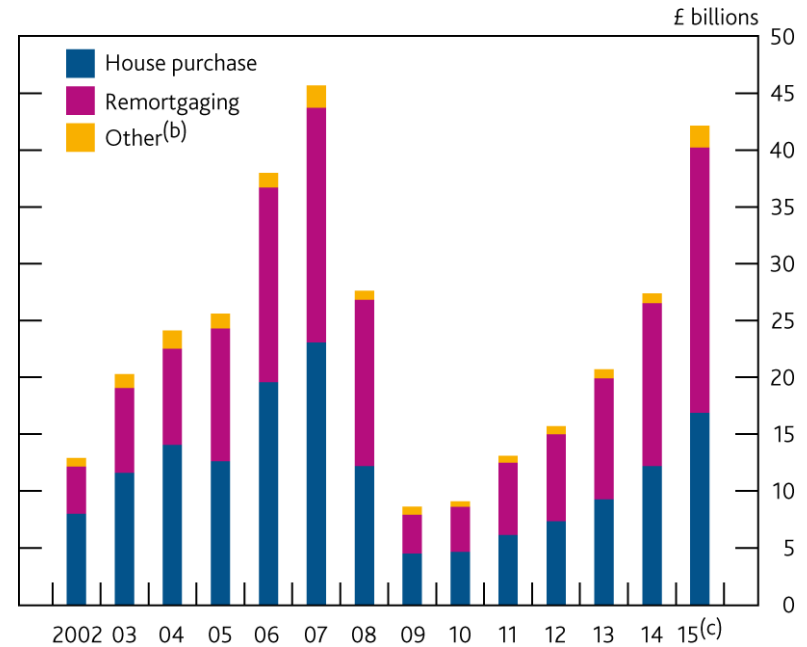
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Mortgage lending growth has been driven by buy-to-let lending, which is near its pre-crisis peak

Change in outstanding mortgage lending, by borrower type

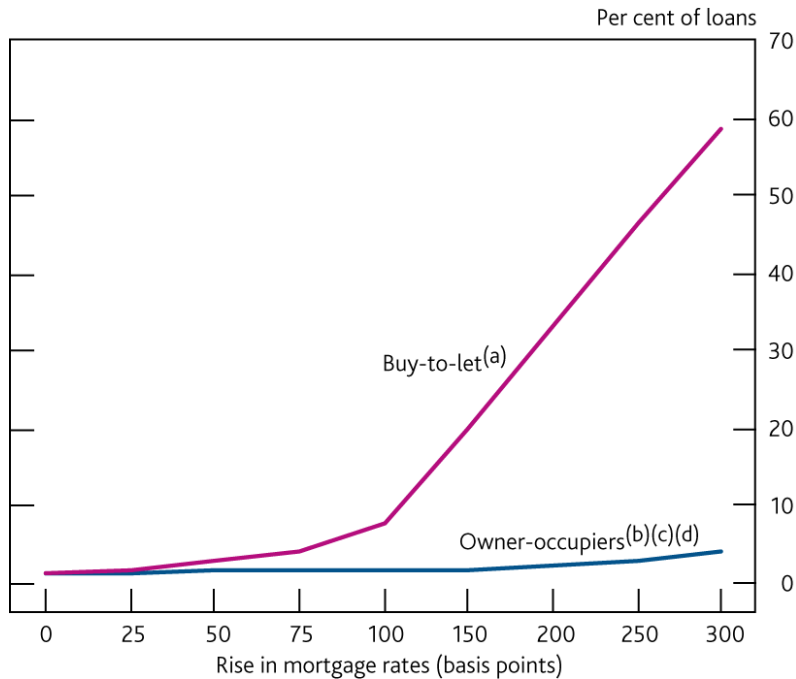


Gross advances of buy-to-let lending split by purpose

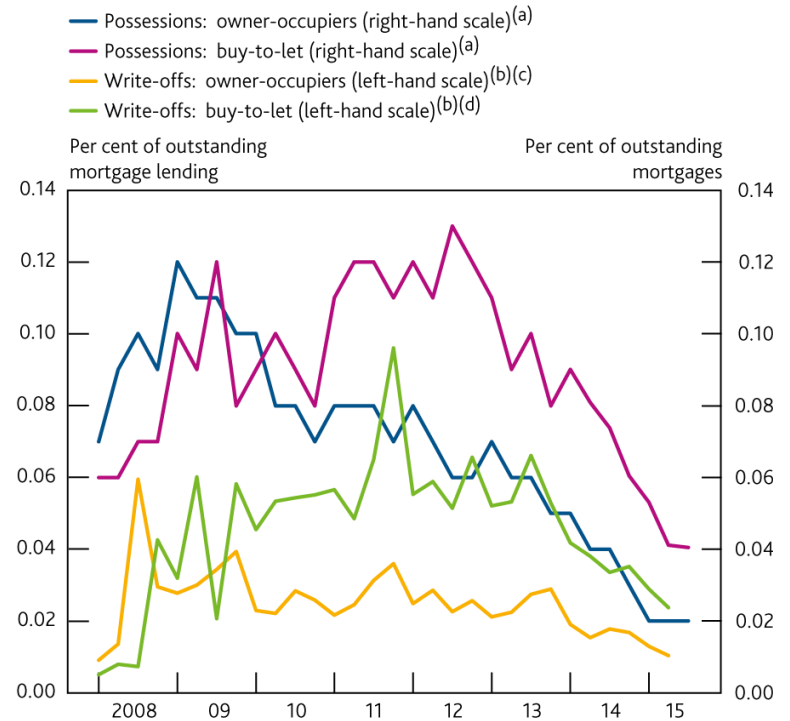


Growth of buy-to-let could have implications for financial stability

Borrowers vulnerable to interest rate rises

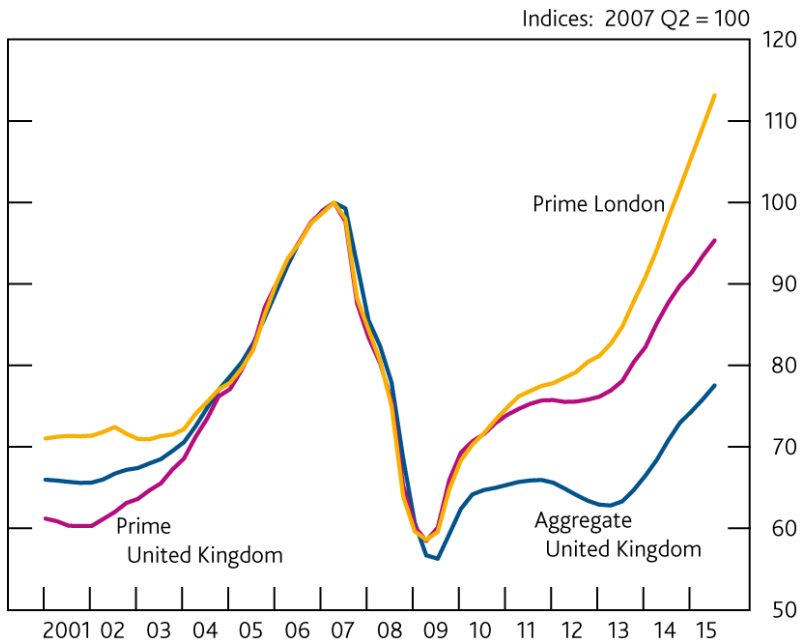


Quarterly possessions and write-offs on mortgage lending

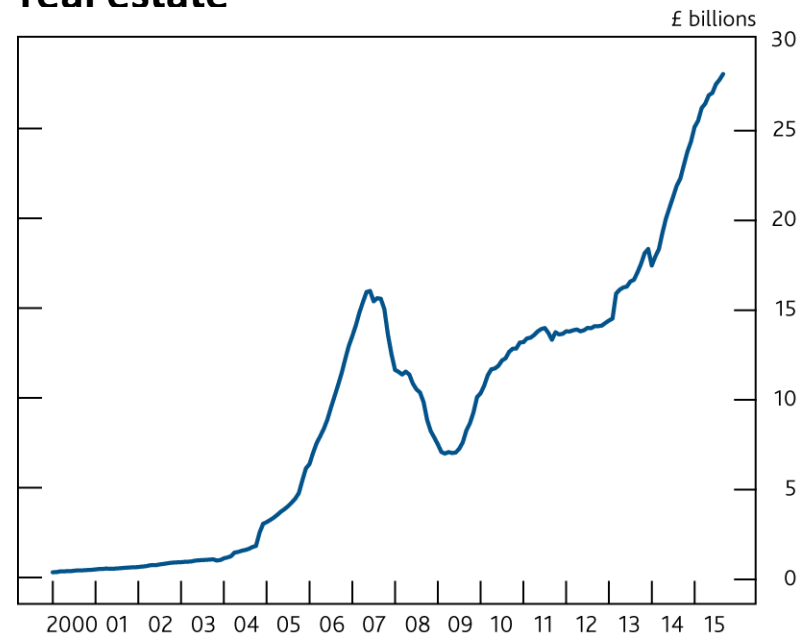


Commercial property prices continue to rise rapidly... with the sources of finance becoming riskier

UK commercial real estate prices



Assets under management in open-ended funds investing in commercial real estate



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Framework of capital requirements for UK banks

FPC has set its strategy for the countercyclical capital buffer (CCB)

- Primary objective is to ensure the banking system can withstand stress without restricting essential services to the real economy
- The buffer will be varied up and down in line with risks to UK exposures
- Increasing the CCB may also restrain credit growth and mitigate the build-up of risks. But this is not its primary objective
- Intention to set the CCB at around 1% in a 'standard' risk environment
- By moving early, before risks are elevated, the FPC expects to be able to vary the CCB gradually, and to reduce its economic cost



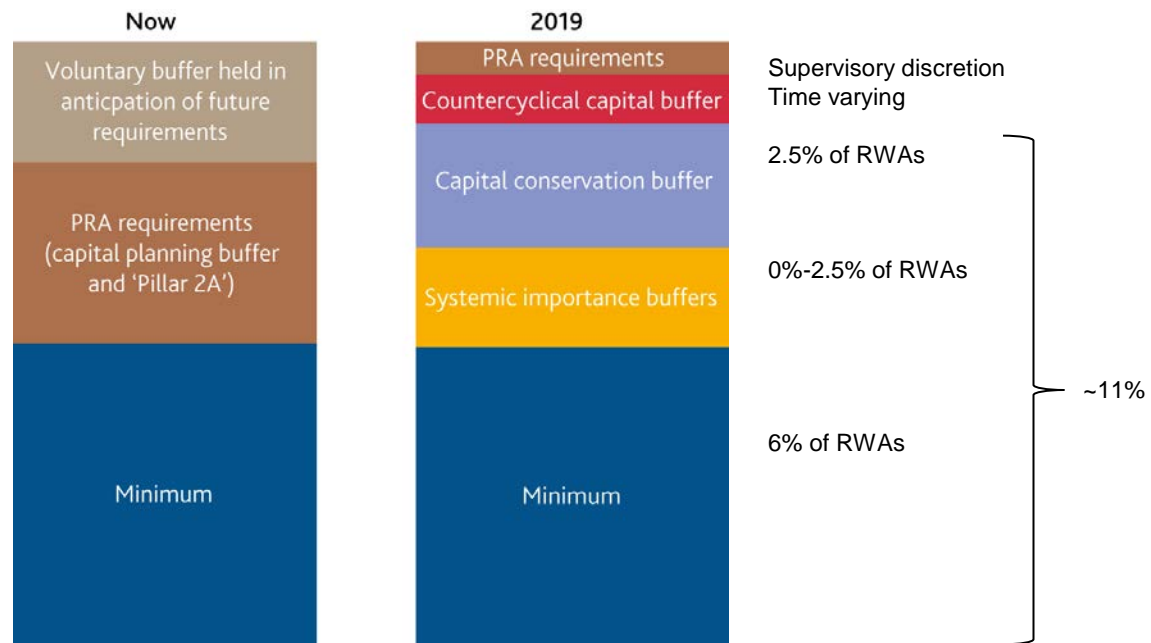
Banks are in sight of overall level of capital requirements

- **The FPC judges the appropriate structural Tier 1 equity requirement for the UK banking system to be 11% of risk weighted assets (RWAs)**
- The '11%' assumes existing shortcomings in the definitions of RWAs are corrected.
- These shortcomings are currently tackled via compensating supervisory requirements ('Pillar 2A') and average around 2.5% of RWAs
- If risk measurement shortcomings are not addressed, appropriate Tier 1 equity would be around 13.5% of RWAs
 - As currently measured, UK banking system has Tier 1 equity of 13%
- Time-varying macroprudential buffers are on top of the 11%.
- Finishing point is lower than in some studies



New buffers will be offset by lower individual firm 'Pillar 2' requirements

Transition to 2019 Tier 1 capital requirements





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Stress testing the UK banking system: 2015 results

2016 stress test of the UK banking system: main features

Second concurrent stress test	
Coverage	<ul style="list-style-type: none">• Seven major UK banks and building societies
Scenarios	<ul style="list-style-type: none">• Severe global stress which affects the UK, with significant deflationary pressures and low policy rates• Significant trading book losses• Severe misconduct stress unrelated to global outlook
Hurdle rate framework	<ul style="list-style-type: none">• 4.5% CET1 <u>and</u> 3% T1 leverage thresholds: ‘strong presumption of action’• Firms may be required to take action based on other factors• Banks had to maintain the supply of lending to the real economy
Qualitative assessment	<ul style="list-style-type: none">• Key part of the framework, with feedback provided to firms
Transparency	<ul style="list-style-type: none">• Disclose firm-specific results



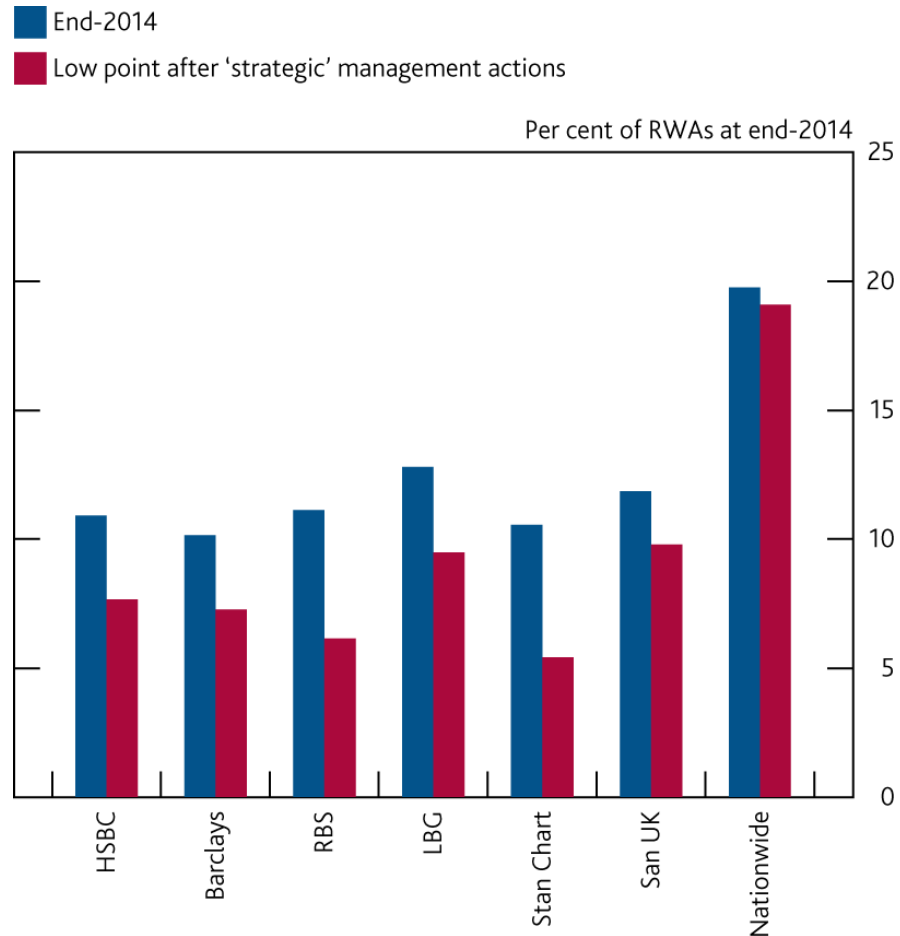
FPC stress test conclusions

- The FPC judged that no macroprudential actions on bank capital were required in response to the 2015 stress test.
- The results suggest the banking system is capitalised to support the real economy in a severe global stress scenario, which adversely affects the UK.
- Capitalisation of the system has improved further over the course of 2015.



Individual bank headline CET1 ratio results

End-2014 and low-point CET1 capital ratios in the stress, after the impact of 'strategic' management actions



PRA Board conclusions

- RBS did not meet its individual capital guidance. In light of the steps that RBS has already taken to strengthen its capital position, coupled with its plans for future additional Tier 1 (AT1) issuance, no revised capital plan required.
- Standard Chartered Bank (SCB) did not meet its Tier 1 minimum capital requirement of 6% (Pillar 1). In light of SCB's recent strategy review and the associated steps taken to strengthen its capital position, no revised capital plan required.
- The other five banks were adequately capitalised.



Next steps

Over the next three years, the Bank aims to:

- Develop an approach to stress testing that is explicitly countercyclical, with the severity of the test varying systematically with the state of the financial cycle.
- Improve the consistency between the concurrent stress test and the overall capital framework.
- Enhance its own modelling capability, while ensuring that participating banks continue to play an important role.

