BoE: Begins a gentle taper but is not ready to tighten policy

- **The Bank of England (BoE) maintained its status quo on expected lines, but surprised the markets by announcing a tapering of its asset purchases**
- **The decision to taper came earlier than we had anticipated. The decision was taken to reflect an upgrade in 'economic projections' over the remainder of 2021**
- **We expect the BoE to reduce the size of its weekly purchases further, in the August policy meeting and end its asset purchases programme by end-2021**
- **However, we expect the BoE to ensure that the size of its balance sheet remains stable over 2022-23. We also do not expect rate hikes anytime over 2021-23, given that the negative output gaps could persist over this period**
- **The GBP/USD pair has moved higher, reflecting the 'anti-USD' trade in the global markets and the subtle hawkish surprise from the BoE. A key event risk in the near-term, will be the outcome of the Scottish Parliamentary Elections. We see some volatility in response to the outcome.**

Policy announcement: The Bank of England (BoE) maintained its status quo, by keeping its policy rate unchanged at 0.1% and maintaining the target for its stock of asset purchases at GBP 895 billion (bn). The unchanged stock of asset purchases implies that there is another GBP 150 billion left of the targeted purchases, which can be used over the remainder of 2021. The decision of maintaining the size of purchases was, however, not unanimous with an 8-1 vote. It appears that the BoE Chief Economist Mr Haldane, who is set to leave his post next month, voted to reduce the stock by GBP 50 billion.

Mild tapering of purchases was introduced: Besides, a decision was also taken to reduce the size of the BoE's weekly purchases from GBP 4.4 billion to GBP 3.4 billion per week, over the June-August period. The BoE was quick to clarify that this decision to introduce a tapering of purchases was 'operational in nature' and that 'the decision should not be interpreted as a change in the stance of monetary policy'. It also indicated that if the economy improves in line with expectations, a decision could be taken to further reduce the weekly purchases programme in the August policy meeting. However, guidance on policy rates was kept unchanged and no rate hikes are expected until H22023.

Guidance was unchanged: Despite the decision to reduce weekly purchases, the BoE was quick to indicate that 'it does not intend to tighten its policy, until there is clear evidence of a rebound'. In its assessment on the economy, it indicated that the 'downside risks remain in place from a resurgence in COVID-19'.

Growth projections were raised: While risks to the outlook were identified as being on the downside, it raised its economic projections for 2021, taking into account the pace of vaccination and continued fiscal support provided to the Government. Gross Domestic Product (GDP) growth projections were revised higher for 2021 from 5% YoY in the February policy meeting to 7.5% YoY. However, GDP growth projections were lowered for 2022 from 7.25% YoY to 5.75% YoY. The main reason for the change in the projections were based on the assumption of a much sharper front-loading of pent-up demand, given that the excess savings is estimated to stand to the tune of 10% of GDP. However, the 2023 growth projections were left unchanged at 1.25% YoY. The labour market was expected to perform slightly better as well, even after the expiry of the furlough scheme in September, as the economy reopens. However, the unemployment rate could drift slightly higher over 2021, post the expiry of this scheme.

Inflation: Not getting carried away by an overshoot: Despite the upward revisions that were made to the growth projections, the BoE also emphasised that the economy at the end of Q1 2021 would remain about 10% below its pre-pandemic levels, implying that considerable slack will remain in place. However, similar to most other DM Central Banks, the BoE raised its inflation profile over 2021-22. It sees a strong possibility of an inflation overshoot of 2.5% YoY in 2021, before it corrects lower to 2% YoY in 2022 and remains at that mark in 2023. Economic slack was only expected to turn positive by end-2022. However, we think that the negative output gaps in the United Kingdom (UK) economy could persist for a while longer.

Outlook: Tapering does not mean tightening: We had anticipated the BoE to begin tapering purchases in Q4 2021 and an announcement on this front to come in Aug 2021. However, the BoE appears to have brought forward its plan. Assuming that the UK Government moves forward with its vaccination programme and the economy reopens fully going in to H2 2021, we expect no further increase in QE. We expect the BoE to end its purchases programme by the end of 2021, but signal that it plans to continue reinvesting maturing securities, to ensure that the size of its balance sheet remains unchanged. However, given that the negative output gaps are likely to persist, we do not see the BoE tightening policy anytime over 2021-23.

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GBP/USD impact: The GBP/USD responded sharply to the announcement, as there was some confusion about the taper and what it actually meant. However, post the period of volatility the pair has moved slightly higher, reflecting the bearish USD trend in the global markets. We think that the pair will move in sync with the overall risk sentiment and see a range of 1.37-1.40 in the near-term. The outcome of the Scottish elections will prove to be an important event risk for the GBP. If the Scottish National Party does not get an adequate majority to push forward with its plans for a referendum, it should provide some support to the GBP.

Chart 1: BoE's projections

BoE's MPC: Economic projections

	Feb-21					
	2021F	2022F	2023F	2021F	2022F	2023F
UK GDP: (%YoY)	5.0	7.3	1.3	7.3	5.8	1.3
--Household consumption (%YoY)	4.3	11.8	1.0	5.3	9.3	1.8
--Business Investment (%YoY)	4.0	12.0	4.5	7.0	13.5	1.3
--Housing investment (%YoY)	10.8	3.5	6.3	13.5	4.8	3.3
--Exports (%YoY)	-3.0	5.5	4.3	1.0	4.5	4.5
--Imports (%YoY)	5.3	12.8	3.5	8.5	10.0	4.0
Excess supply/excess demand*	-1.3	0.3	0.0	-0.8	0.3	0.3
Unemployment rate (%)	6.5	5.0	4.5	5.0	4.5	4.3
CPI inflation (%YoY)	2.0	2.3	2.0	2.5	2.0	2.0

Note: These forecasts are derived from the fan charts that the BoE presented in the monetary policy report
Excess supply/excess demand is computed as the function of percent of potential GDP
Source: BoE & ICICI Bank Research

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