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IB Economics - internal assessment coversheet

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Section of the syllabus the article relates to (please tick the one that is most relevant)	Section 1: Microeconomics Section 2: Macroeconomics √ Section 3: International economics Section 4: Development economics

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Brexit: Bank of England upgrades growth forecasts but still expects UK economy to be hit

In its latest Inflation Report the Bank upgraded its 2017 GDP growth forecast to 2 per cent, up from 1.4 per cent in November

The Bank of England has dramatically upgraded its growth forecast for this year but stressed that households will still experience a major squeeze on incomes due to rising inflation.

In its latest Inflation Report, the Bank upgraded its 2017 GDP growth forecast to 2 per cent, up from 1.4 per cent in November.

The revision is certain to be seized upon by Brexiteers as evidence that the economy will not suffer from leaving the European Union and that previous economic warnings from the Bank have now been exposed as scaremongering.
Yet the Bank's forecasts continue to project a growth slowdown in 2018 and 2019, with GDP expected to expand by 1.6 per cent and 1.7 per cent in those years.

The Bank had previously projected that the economy would take a cumulative hit by 2019 of 2.5 per cent of GDP due to Brexit. It now forecasts a 1.5 per cent of GDP hit, equivalent to around £30bn in today's money.

Despite today's upgrade the 2017 growth forecast is still below the 2.3 per cent the Bank projected in May 2016, when it was working on the assumption that the UK would vote to remain in the European Union.

"This stronger projection doesn't mean the referendum is without consequence," the Bank of England's Governor Mark Carney said at a press conference.

The Bank ascribed the upgrade to the Chancellor's infrastructure boost in the November Autumn Statement, stronger global growth, higher stock market prices and cheaper credit for households.

Stronger growth in the final quarter of 2016 also automatically and arithmetically boosts the Bank's overall 2017 GDP forecast.

But Mr Carney further stressed that the Bank's decision to stimulate the economy by cutting interest rates and injecting money into the economy last August was part of the reason why the economy was performing better than feared.

"The stimulus is working. The cost of of borrowing is down, availability of credit is up, and some of the uncertainty on households and businesses has been mitigated," he said.

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He added that the monetary stimulus had had "more traction" than the Bank initially estimated.

Despite the GDP upgrade the Bank stressed that households' incomes would take a hit from inflation this year as rising inflation almost offsets any increase in wages.

The Bank stressed that its central policy trade-off had not changed, and that it was balancing the need to support a slowing economy with the need to be vigilant about the risk of spiralling inflation.

Despite the growth forecast upgrade, the Bank's inflation outlook was pretty much unchanged, with prices expected to rise 2.7 per cent at the beginning of 2018 and 2.6 per cent at the start of 2019.

Inflation unexpectedly jumped to 1.6 per cent in December according to the Office for National Statistics.

The Bank's Monetary Policy Committee voted unanimously on Thursday to keep rates on hold at 0.25 per cent, but the minutes of the meeting suggested that "some members" of the nine-person committee were reaching the limits of their toleration for price rises, suggesting that they may soon start to vote for rate rises.

The minutes stressed that the Bank could move "in either direction" on rates, and the direction would depend on the outturn of the economic data.

In the run-up to last June's referendum Mr Carney, attracted criticism from Brexiteers for warning that there was a risk of a "technical recession" if the UK voted to leave the bloc.

Instead the economy has continued to grow at a rate of 0.6 per cent a quarter, showing no signs yet of a slowdown.

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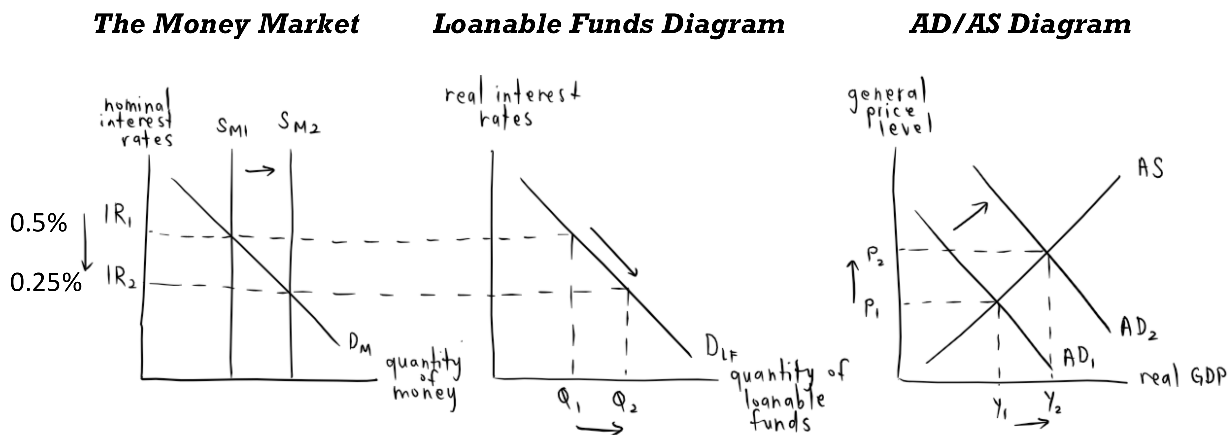
Commentary On: Bank of England's Monetary Policy Following Brexit

The article talks about the post-referendum state of the UK economy, with the enactment of a monetary stimulus where interest rates are cut and more money is injected into the economy in fear of a recession. The Bank's Monetary Policy Committee (MPC) has made the decision to maintain the interest rate at 0.25%, but the interest rate faces the possibility of moving "in either direction", depending on the outturn of the economic data.

The Bank of England is the monetary authority of the UK, performing functions of issuing currency, managing money supply, and controlling interest rates. How they carry out their role is through the implementation of the monetary policy, defined as the manipulation of money supply subsequently manipulating the general level of interest rates. Post-referendum, the fear of a recessionary period led the Bank of England to issue an expansionary monetary stimulus, by cutting interest rates and injecting more money into the economy. The effect of such a stimulus is observed in **Figure 1** below.

Figure 1 Expansionary Monetary Policy



Injection into the market through quantitative easing increases money supply, represented by a rightward shift of the Money Supply (SM) from SM_1 to SM_2, causing the interest rates (IR) to fall from IR_1 to IR_2. A fall in interest rate takes effect in the market for loanable funds where there is an extension in quantity demanded for loanable funds from Q_1 to Q_2. In the aggregate demand and aggregate supply (AD/AS) diagram, households and firms are more willing and able to loan funds from the banks for consumption and investment at lower interest rates as cost of borrowing falls and credit becomes more available, building confidence among households and firms. As such, the AD shifts from AD_1 to AD_2, resulting in an increase in real gross domestic product (GDP) from Y_1 to Y_2, and an increase in the general price level from P_1 to P_2.

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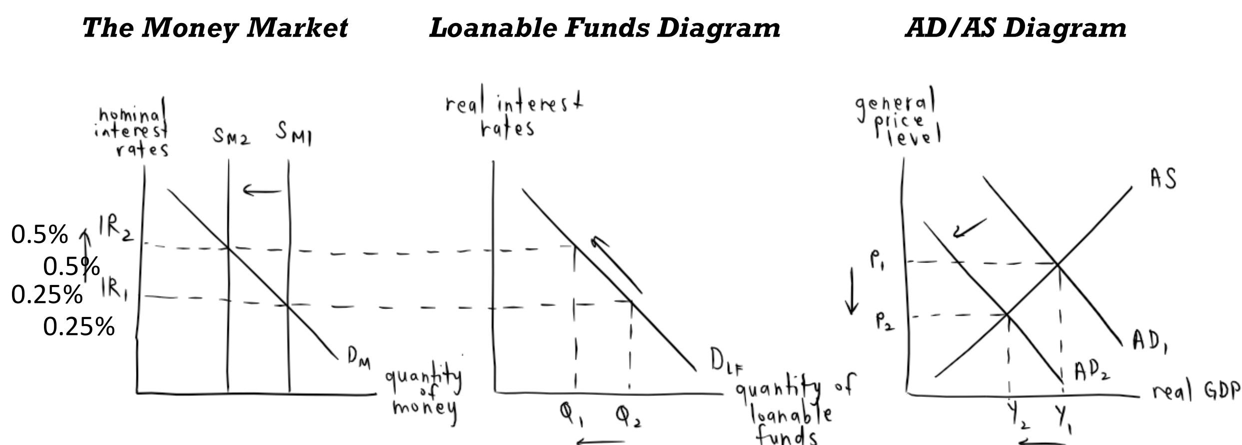
With inflation expected to rise in 2017, following an unexpected jump to 1.6% in December of 2016, the Bank of England must decide whether maintaining the interest rates at 0.25% is the best.

They could raise interest rates, as a contractionary policy. The effect of this is shown in **Figure 2** below, where money supply decreases from SM_1 to SM_2, leading to rising interest rates from IR_1 to IR_2 as money is more scarce. This rise in interest rates affects the market for loanable funds, causing a contraction of quantity demanded for loanable funds from Q_1 to Q_2. High rates deter borrowing, so households and firms would consume and invest less respectively. This causes the AD to shift leftwards from AD_1 to AD_2, causing a fall in real GDP and demand-deficient unemployment, but decreases inflation.

Figure 2 Contractionary Monetary Policy



Implementation of a monetary policy causes a conflict in goals. The inaccuracy of predictions following Brexit, where UK leaves the EU, is evident in the article. The Bank of England have made predictions, enacting policies following said predictions but all of them are almost overstated. This uncertainty may make it hard for policymakers to set clear macroeconomic goals for the country.

The current adoption of a low interest rate in an expansionary monetary policy, as stated above, achieves increased growth and reduced unemployment but at the expense of inflation (mainly demand-pull) and a lower exchange rate, making imports costlier and decreasing UK's trade deficit.

Another limitation to the monetary policy is that it is ineffective against cost-push inflation, which is one that materialised because of the Sterling depreciation. By implementing an expansionary monetary policy with cost-push inflation present, it would cause an inflationary spiral, which has its own set of problems such as slower economic growth and a fall in standard of living.

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A possible solution to the problem would be for the government to introduce a fiscal policy alongside the monetary policy to stabilize the economy. The fiscal policy, even with the time lags and crowding out effect, has a lasting effect on the economy whereas the monetary policy is more suited for short-term success. Taking into consideration the inaccuracy of predictions, having a safety net in the form of the two policies would minimise any losses lest the economy takes an unexpected turn for the worse. By cutting the budget deficit, where government expenditure exceeds revenue, the government would be able to ensure budgetary room for such a policy to be implemented.

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