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BOE ON HOLD AS NEAR-TERM GROWTH OUTLOOK RAISED - CAUTIONS ON TOLERANCE TO HIGHER INFLATION

Berenberg Macro Flash

The better-than-expected near-term economic performance kept the BoE on hold its November meeting. The BoE also removed its previous signal for a second rate cut in 2016 - in line with expectations. In the press conference Governor Carney noted that, so far, there had been no major uncertainty effect on consumption, that the housing market had been more resilient than expected, but that business investment and commercial real estate activity had softened. Today's sharp upward revision to near-term growth, following the even bigger downward revision at the August Inflation Report, underlies the unprecedented degree of uncertainty about the long-term economic outlook following the Brexit vote.

Economic outlook

The BoE upgraded its assessment of near-term economic growth noting a 'smaller drag from uncertainty' and 'solid confidence' in the immediate period after the vote. The BoE raised its forecast for GDP in 2016 and 2017 to 2.2% and 1.4% from 2.0% and 0.8%, respectively. The BoE forecast slightly weaker GDP growth in 2018 (1.5% in November versus 1.8% in August) due to slower real income growth and 'uncertainty over future trading arrangements' that could constrain supply. These revisions to GDP take the BoE's forecasts broadly in line with our own above-consensus calls. The unemployment forecast was little changed. The BoE expects unemployment to rise to 5.6% by 2018 and remain there throughout the forecast horizon – a little above our own call (5.3%).

Following the recent depreciation of sterling the BoE has reduced its conditioning assumption for trade-weighted sterling by 6% over the forecast horizon. In conjunction with the better demand growth relative to supply, the BoE has revised up its inflation forecasts over the forecast horizon. Inflation was revised to 2.7% by the end of 2017 from 2.0%, and to 2.7% from 2.4% in 2018. Governor Carney noted in his opening remarks that the upward revision to inflation creates a more challenging trade-off for supporting real economic activity and achieving a stable long-run rate of inflation at the 2% target.

Crucially, and in line with previous guidance on the implications of weaker sterling, Carney noted that while there are 'limits' to the extent to which above target inflation will be tolerated, he pointed out that the sterling effect would be 'temporary'. Any attempt to offset it with tighter monetary policy would be 'costly' in terms of output and employment. As long as the sterling selling is orderly, we see no major reason for the BoE to step in. The BoE may reiterate risks around sterling but, if demand began to seriously deteriorate, we would expect the MPC to vote in favour of more easing.

Policy outlook

Following the resilient performance of the economy immediately after the vote, and the large upward revision to the near-term growth outlook, the MPC removed its post-August Inflation Report guidance that most MPC members 'expected to vote for another rate cut by the end of the year'. Instead, the minutes included vanilla message, presumably intended to reset expectations essentially to zero, 'Monetary policy could respond, in either direction, to changes to the economic outlook as they unfolded to ensure a sustainable return of inflation to the 2% target.'

Given ours and the BoE's outlook for GDP growth and inflation we do not expect the BoE to further ease monetary policy again over the medium-term. However, as we have been reminded today by the High

Court ruling (see note), Brexit creates significant protracted uncertainty. That households and firms could begin to respond more sensitively to such uncertainty tilts the balance of probability towards looser rather than tighter policy while Brexit uncertainty looms large.

In the long-term, however, the policy outlook will be determined by the evolution of inflation which reflects the balance of demand and supply – a product of Brexit. Lower trade, investment and migration with the EU represents a supply-side shock for the UK. Brexit could be inflationary in the long-run. The policy-rate would thus need to be higher in the long-run.

Policy summary from the November MPC meeting
The nine member MPC voted unanimously in favour of maintaining the bank's current monetary policy stance:

- To keep the bank rate at 0.25%;
- To continue with the programme of sterling non-financial investment-grade corporate bond purchases totalling up to £10 billion, financed by the issuance of central bank reserves;
- To continue with the programme of £60 billion of UK government bond purchases to take the total stock of these purchases to £435 billion, financed by the issuance of central bank reserves.

BoE and Berenberg forecasts

GDP %	2016	2017	2018	2019
November Inflation Report	2.2	1.4	1.5	1.6
August Inflation Report	2.0	0.8	1.8	
Berenberg	2.0	1.5	1.5	

Inflation %	2016 Q4	2017 Q4	2018 Q4	2019 Q4
November Inflation Report	1.3	2.7	2.7	2.5
August Inflation Report	1.2	2.0	2.4	- (Q3: 2.4)
Berenberg	1.3	2.4	2.0	-

Unemployment %	2016 Q4	2017 Q4	2018 Q4	2019 Q4
November Inflation Report	4.9	5.4	5.6	5.6
August Inflation Report	5.1	5.5	5.5	- (Q3: 5.3)
Berenberg	5.0	5.3	5.3	-

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