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UK: BOE AT RISK OF FALLING BEHIND THE CURVE AFTER MAJOR UPGRADES TO GROWTH OUTLOOK

Berenberg Macro Flash

The Bank of England (BoE) is running the risk of falling behind the curve. The sharp falls in survey measures of economic activity immediately after the Brexit vote provided a strong and valid case for a monetary ease last August. But circumstances can change. That the UK economy did not show any major Brexit related effects in 2016, and looks set to carry significant momentum into 2017, has led the BoE to upgrade its outlook for GDP growth significantly over its forecast horizon. But despite the upgrades to growth, the BoE inflation outlook has remained broadly unchanged, thanks to a reduction in the BoE's assessment of equilibrium unemployment. That the governor announced the, 'current policy stance remains appropriate', despite the improvement in economic prospects, reflects the highly-dovish bias of the MPC. At close to full employment and with stable expected growth, with its large balance sheet and negative real rate policy, the BoE is at risk of engendering a return to high indebtedness, inadequate saving and ultimately a return to boom-bust.

FORECAST REVISIONS

The BoE has increased its estimate of GDP growth in every year of its forecast, cumulating to a 1ppt rise in total output over the horizon. The revision of GDP in 2017 to 2.0% from 1.4% in November was the largest of the upgrades. At the press conference Governor Carney outlined four reasons for the upward revision; (1) the fiscal stimulus announced in the Chancellor's Autumn Statement, (2) firmer momentum in global activity, (3) higher global equity prices, and (4) more supportive credit conditions. The governor said the BoE had underestimated the strength and resilience of consumer spending since the referendum. The BoE revised up consumption growth, in part driven by an expected fall in the household savings rate to a record low of below 4% by 2019.

While the outlook for supply-boosting capital investment remains weak, the BoE broadly held its inflation forecast unchanged. The BoE raised its estimate of labour market slack as it sharply reduced its forecast for unemployment through to 2019, ' the updated assessment means that the stronger path for demand in the February projection is roughly matched by higher supply'. Reflecting the slower than expected growth in nominal wages, the BoE has reduced its estimate of the natural rate of unemployment to 4.5%, from 5.0% previously. The current rate of unemployment is 4.8%. The BoE does not expect unemployment to fall to the new estimate of the natural rate in the updated November forecasts. Importantly, the BoE's forecast for inflation is conditioned on a very precise estimate of the natural rate. Just a small under-estimation could trigger an inflation overshoot.

POLICY OUTLOOK – NEUTRAL WITH RISKS TILTED TOWARD A HIKE IN LATE 2017

Barring an unexpected and sharp economic downturn, the next move for the BoE is likely to be up, eventually. *In the February Inflation Report the BoE conditioned its forecasts on a full 25bps - as implied by market indicators at the time of the forecast - hike by end-2018.* Today's Inflation Report supports our conviction that the BoE is likely to stay put for the foreseeable future as growth slows and Brexit uncertainty remains elevated. Given the BoE focus on labour market slack, stronger-than-expect wage growth will likely be the critical factor that could push the BoE toward a first hike. Despite the BoE's high tolerance for above-target inflation, a first rate hike could be one of the surprises of the year. We see a 30% chance of that.

POLICY SUMMARY FROM THE FEBRUARY MPC MEETING

Critically, the BoE did not alter its neutral guidance from previous subsequent minutes, 'Monetary policy can respond, in either direction, to changes to the economic outlook as they unfold to ensure a sustainable return of inflation to the 2% target.'

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 (yoy %)	**2016**	**2017**	**2018**	**2019**
February Inflation Report	2.2	2.0	1.6	1.7
November Inflation Report	2.2	1.4	1.5	1.6
Berenberg	2.0	1.8	1.6	

CPI inflation (yoy %)	**2017 Q1**	**2018 Q1**	**2019 Q1**	**2020 Q1**
February Inflation Report	2.0	2.7	2.6	2.4
November Inflation Report	1.8	2.8	2.6	
Berenberg	2.1	2.7		

LFS unemployment rate (%)	**2017 Q1**	**2018 Q1**	**2019 Q1**	**2020 Q1**
February Inflation Report	4.9	5.0	5.0	4.8
November Inflation Report	5.0	5.5	5.6	4.8
Berenberg	4.8	5.2		

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