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BOE INFLATION REPORT PREVIEW – CAUTIOUSLY HAWKISH

Berenberg Macro Flash

At the August Inflation Report on Thursday the BoE may turn a few heads by maintaining its hawkish guidance from recent Monetary Policy Committee (MPC) meetings while also downgrading its forecast for 2017 real GDP growth a little. But in the context of the economic developments since the last Inflation Report in May a cautiously hawkish policy stance remains appropriate. As long as growth rebounds to c0.4% qoq in the second half of this year – broadly in line with the BoE's May estimates - we expect a first hike of 25 bps in November 2017.

FORECAST CHANGES

Growth in H1 2017 has slowed notably since H2 2016, with the average quarterly growth rate dropping to 0.25% from 0.6%. The BoE will likely therefore, nudge its real GDP growth forecast down to 1.7% this year from 1.9% previously while keeping the forecast for the remaining years broadly unchanged as growth will likely rebound over the medium-term to a quarterly pace of c0.4%. The weakness in H1 was mainly driven by temporary factors that negatively affected headline GDP through the trade balance. Domestic demand growth has remained firm over the past year.

The unemployment rate has fallen further since May, to a 40+ year low of 4.5%, while wage growth surprised a little on the upside (2.0% versus 1.9% expected, from 1.8% in April). This will probably lead the BoE to reduce its forecast for unemployment over the medium-term by around 0.1-0.2pt per year, while bringing its wage forecast for a gradual rise to around 3.5% by 2018 marginally forward.

The inflationary effects of modestly tighter supply conditions will be offset by the soft H1 growth and the lower oil price since May. We therefore do not expect any major changes to the BoE's headline inflation forecast. The BoE expects inflation to peak at 2.8% this year before gradually easing by to 2.2% by 2019 but remaining above its 2% target throughout the entire forecast horizon. As there has been no major shift in trade-weighted sterling since May (down < 1%) the BoE's previous estimates of the impact of higher import prices on inflation, following the post-Brexit vote depreciation, should not have changed much either.

In the BoE's forecast, the causes of the above-target inflation differ at the start and end of the forecast horizon. During 2017/18 the above-target inflation is caused by the temporary inflationary effects of the rise in import prices since the Brexit vote. But by 2019, as the MPC noted in the May policy statement, 'In the final year of the forecast, however, the output gap closes and inflation rises slightly further above the target.' With tighter-than-expected labour market conditions since May, the BoE may place further emphasis on the inflationary risks from underlying factors this time around.

POLICY OUTLOOK

With three MPC members – all known hawks – voting for a rate hike at the last meeting in June, the committee is divided between those concerned that the BoE will overshoot its 2% inflation target unless it tightens now, and those that need more evidence of economic resilience before tightening. The BoE has not been so hawkish since 2011 when three MPC members voted for a hike – it never came. As one of those that voted for a hike (Forbes) has left the MPC, the number of dissents will probably drop to two (McCafferty and Saunders) this month.

The softer-than-expected growth since the start of the year and the recent drop in core inflation from 2.6% to 2.4% in June will probably keep other committee members from voting for a hike this month. We expect new MPC member (Tenreyro) to side with Governor Carney and vote to keep policy unchanged. Until the new deputy governor (Sir Ramsden) joins in September the committee will remain at just 8 for another month, rather than the usual 9. The governor has the deciding vote in case the committee is tied.

For the voting pattern at the August MPC meeting, we expect two dissents in favour of rate hikes, and unanimous support for maintaining the stocks of asset purchases (gov. and corp. bonds) unchanged (£435bn and £10bn, respectively.)

The most recent MPC minutes from June noted that, 'Overall, the degree of spare capacity in the economy appeared limited but, at the same time, the inflation overshoot relative to the target could be more pronounced than previously thought. This lessened the trade-off that the MPC was required to balance and, all else equal, reduced the MPC's tolerance of above-target inflation.' In addition, the MPC noted that 'The withdrawal of part of the stimulus that the Committee had injected in August last year would help to moderate the inflation overshoot while leaving monetary policy very supportive.'

We expect this key guidance to remain broadly unchanged from previous meetings. That is, to acknowledge the underlying inflationary risks and signal that some of the August 2016 stimulus (25bps rate cut, plus purchases of £60bn government bonds and £10 bn corporate bonds) could be withdrawn soon. However, such guidance will be conditioned on the continued resilience of household spending amid the temporary real wage squeeze and a continued recovery in nominal wage growth.

SLOWER TREND GROWTH DOESN'T MEAN LOWER INFLATION – THE BoE'S COMMUNICATION CHALLENGE

Thanks to Brexit, slower growth is the new normal. The 1.9% real GDP growth the BoE forecast in May is probably a little above what the economy can sustain in the long-run outside of the single market. We expect Brexit to reduce trend growth to 1.8% per year from 2.2% previously. As a best guess, anything around 1.8% real GDP growth from now on should be considered normal. But slower trend growth does not mean lower inflation. Inflation depends upon the relationship between demand growth and supply growth – the output gap. To make its reaction function more transparent, the BoE will likely begin to gradually ratchet down markets' and economic participants' expectations of what constitutes normal growth – and the conditions for rate hikes – after Brexit.

Ultimately, we will not know just how Brexit will affect the UK until after the negotiations are complete. Over time, supply and demand will converge towards their new growth paths at different rates. While the UK economy is settling into its new long-term growth path, the BoE will likely proceed cautiously, continuing the post-Lehman trend, and be generally reluctant to make any major changes to monetary policy or guidance over a short period – especially when tightening policy. Therefore, if the BoE hikes for the first time in Q4 this year, as we expect, a continued tightening thereafter will be very, very gradual. We would look for two more hikes in 2018 and one further hike in 2019.

For a detailed analysis of the last 20 years of UK monetary policy and insights for Brexit, please see UK: Lessons from two decades of BoE policy, 2 March 2017

MACRO FORECASTS – BoE (MAY) vs. BERENBERG

Table 1: Real GDP (yoy, %)	2016	2017	2018	2019
BoE		1.9	1.7	1.7
Berenberg	1.8	1.7	1.6	1.7

Source: BoE, Berenberg. Notes: Calendar-year growth in real GDP consistent with the mean projection for four-quarter growth in real GDP. The MPC's projections are based on its back cast for GDP.

Table 2: CPI (yoy, %)	2016	2017	2018	2019
BoE		2.8	2.4	2.2
Berenberg	1.2	2.8	2.4	2.1

Source: BoE, Berenberg. Notes: Four-quarter inflation rate in Q4.

Table 3: Unemp. rate (%)	2016	2017	2018	2019
BoE		4.7	4.7	4.5
Berenberg	4.7	4.5	4.4	4.4

Source: BoE, Berenberg. Notes: LFS unemployment rate in Q4.

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