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IS THE MARKET MISREADING THE BOE?

Berenberg Macro Flash

A surprising outcome: Yesterday's drop in UK bond yields and fall in sterling indicate that markets took the BoE's August policy statement as dovish. We disagree. In his key message to markets, governor Carney explicitly pointed out that the Monetary Policy Committee (MPC) expects to raise rates more often than the market was pricing in: 'if the economy were to follow a path broadly consistent with the August central projection, then monetary policy could need to be tightened by a somewhat greater extent over the forecast period than the path implied by the yield curve underlying the August projections'. The BoE believes that inflation would overshoot its 2% inflation target for the next four years if it were to raise rates only twice until the end of 2020 as markets were pricing in when the BoE prepared its August report. As the BoE normally aims to return inflation back to target following deviations away from its target within two years, it would need to raise rates more than twice to meet its mandate.

Why do we think that the market is misreading the BoE?

1. **The market is focusing too much on demand – and is missing the supply story**
   Inflation overshoots its target – 2% - when demand expands faster than supply. Yes, the BoE downgraded its forecast for real GDP growth in 2017 from 1.9% to 1.7%. On its own, the acknowledgment that demand did less well in early 2017 than the BoE had expected could be seen as dovish. However, that misses the main story: the BoE yesterday cut its forecast for supply by even more. While demand growth has slowed since the Brexit vote, supply growth has slowed by greater extent. In addition, the BoE expects nominal wage growth to outpace inflation over its forecast horizon. As the BoE rightly pointed out yesterday, without a policy tightening, this imbalance will prevent inflation from sustainably returning to the 2% target.

   The bank now puts its estimate of long-term potential growth at around 1.7% - well below the +2% that the BoE typically estimated as its long-term growth forecast before the Brexit vote. This new estimate of potential growth represents the high water mark that the market should focus on. Thanks to Brexit, slower growth is the new normal. As governor Carney pointed out yesterday, the BoE expects growth to pick up to 'just above its reduced potential rate over the balance of the forecast'. ' As inflation depends upon the balance between demand growth and supply growth – the output gap, the BoE is trying to ratchet down market's growth expectations to make its reaction function more transparent. Based on yesterday's market outcome, the BoE is currently not achieving this goal.

2. **The BoE has a credibility problem**
   From a monetary policy point of view this is the most problematic. It could simply be that the market thinks the BoE's guidance and/or forecasts are plain wrong. During the post-Lehman recovery there have been a couple of occasions where the MPC, either through its voting pattern, its guidance, or in speeches from key committee members, has worked up market expectations for a rate hike but hasn't followed through. Yesterday's dovish market response to the BoE's hawkish guidance could simply be, 'we hear you, but we aren't listening'. The only way the BoE could rebuild its credibility – if this is indeed the problem - would be by following through on its guidance consistently over time, so that markets begin to trust its communications and follow them more closely again.

3. **Recent comments from the bank's chief economist**
   MPC member Andy Haldane had suggested back in June that he could vote in favour of rate hikes 'relatively soon'. Market pricing before the August meeting might have priced this in, and that Haldane voted in favour of keeping the bank rate unchanged at the August MPC meeting, could have led markets' to unwind their previous expectations. However, the comment of one member, out of a nine member committee, should not carry as much weight as the consensus view which is summarised in the key piece of guidance we quote above. Likewise, the 'relatively soon' comment could easily be in reference to the MPC meetings scheduled for later in the year.

What next? On the back of yesterday's Inflation Report and press conference, we continue to expect a first hike of 25bps in November and four hikes in total between now and the end of 2019. Of course, we see a clear risk that the BoE may wait with the first hike until Q1 2018. But overall we think that our call is broadly consistent with the bank's guidance. That the BoE is being unusually explicit in trying to talk the yield curve up suggests that it could be on the cusp of hiking and would like to avoid a potentially disorderly adjustment in markets and in the real economy. In the coming months, we should expect key MPC members to try to influence market expectations through their usual speeches. Importantly, a first 25bps hike have trivial effects on the real economy. It would remove no more than a third of the emergency stimulus the BoE introduced back in August 2017. Even if the bank rate were 100bps higher, the real policy rate would remain negative and the bank's balance sheet large by historical experience. Monetary policy will therefore remain highly accommodative over the medium-term.

Our summary of the August Inflation Report can be found here.

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

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