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UK: OH LORD, PLEASE DON'T LET ME 'BOE' MISUNDERSTOOD

Berenberg Macro Flash

WHY IS THE BOE HIKING RATES NOW?

'With Brexit uncertainty hanging over the economy, and real GDP growth slowing from 1.8% in 2016 to 1.6% in 2017, this is not the time for higher rates.' Sound familiar? This summarises the common position among many pundits as the BoE looks set to hike the bank rate for the first time in over a decade at the November Inflation Report this Thursday. It will probably be the major question put to BoE governor Mark Carney in the press conference after his policy statement. But after calling for an early hike from the start of this year we disagree with the logic of this position. Instead, we think the BoE would be wise not only to hike once this week, but to begin a gradual tightening cycle over the coming years.

The rate of economic growth in the UK since the Brexit vote has slowed by much less than the BoE had initially anticipated. Instead of cutting back on spending as inflation is temporarily rises above wages, households are leaning on their balance sheets, borrowing more and saving less, in order to finance their increasing real demand. Solid employment gains, record real household net wealth and cheap credit enable them to do this. If left unchecked, households are set to borrow more than they can afford and save less than they will need for the future. Meanwhile, uncertainty from Brexit seems to be weighing on supply more than demand. Without higher interest rates, continued excess demand growth will cause domestic inflation to remain well above the BoE's 2% target even as the temporary effects of imported inflation from a weaker sterling fade. By incentivising households to borrow less and save more, higher rates can take some steam out the inflation cooker.

Any chance the BoE won't hike? Of course there is always a chance. But it seems incredibly small. When markets responded to Carney's comments last month that 'some rise in interest rates over the coming months may be appropriate' by bringing forward estimates of the first hike from as 2019 to November 2017, the BoE has had ample opportunity since then to re-adjust the market's expectations. That the BoE has not attempted to influence the market since the governor's remarks signals it is satisfied with current pricing. When it comes to monetary policy, talk matters almost as much as action. Now that the market is ready and waiting for a hike this week, the BoE would risk a major hit to its credibility if it did not meet this expectation. In short, if the BoE didn't intend to hike it probably would have told us by now.

THE BENEFITS OF MODESTLY HIGHER RATES

Because debt and savings are unevenly distributed across the economy, interest rate changes affect economic agents in different ways. Rate hikes will not be painless. Sure, it would be nice if the BoE was hiking because of the economy's strength rather than rising inflation risks. But the job of the central bank is to decide whether there is an overall benefit to its policy decisions. After the financial crisis, when the BoE cut its policy rate to an historical low of 0.5%, and then to 0.25% since the Brexit vote, many people complained about the sudden hit to the returns on their hard-earned savings. But these costs had to be weighed against the benefit of higher employment and stronger growth for the whole economy that would come from lower rates. Now, while higher rates would likely to squeeze some highly indebted firms and households, they will discourage many more from running into the same problem. By preventing households and firms from becoming overextended, modestly higher rates can lengthen the current business cycle.

Although the market is pricing in a c90% chance of a rate hike later this week, it only expects one further 25bps hike next year. With little reason to significantly alter its forecasts from August (see tables below),

a series of gradual rate hikes seems appropriate given the outlook for stable real GDP growth, above-target inflation and full employment, in our view. After the first hike, we look for two more 25bps hikes in 2018 and one 25bps in 2019. While we acknowledge the Brexit-linked risks to growth and still high debt levels, these are reasons why the bank rate will need to rise slowly and then remain far below its pre-Lehman levels of c5%. They are not sufficiently strong arguments against not hiking at all. As long as the BoE goes early and slowly with its tightening we do not expect any major negative effects on real GDP growth or employment.

Critically, the first 25bps hike will have trivial effects on the real economy, removing no more than a third of the emergency stimulus the BoE introduced back in August 2016. Moreover, monetary policy will remain highly accommodative well into the medium-term. Even if the bank rate were 100bps higher, the real policy rate would remain negative and the bank's balance sheet large by historical standards. It is also worth noting that the costs of business and consumer credit and mortgages are set by market forces and not directly by the BoE, so the rise in borrowing costs in the real economy is likely to be less than the eventual increases in the bank rate.

For more detail on our arguments favouring higher rates in the UK, please see our report 'The BoE's job is done: it is time for rate hikes' from 1 September 2017.

POLICY OUTLOOK
On Thursday we expect:

- At least six of the nine Monetary Policy Committee members to vote for a 25bps hike to take the bank rate to 0.5% from 0.25%. Dave Ramsden, Silvana Tenreyro and Jon Cunliffe might vote in favouring of holding rates for now;
- The MPC to signal that raise rises will be 'at a gradual pace and to a limited extent' – in keeping with recent guidance;
- All MPC members to vote in favour of keeping the bank's asset purchases unchanged. That is, to maintain the stock of sterling non-financial investment-grade corporate bonds at £10 billion, and the stock of UK government bonds at £435 billion.

Further out we expect:

- A continued tightening to sustainably return inflation to close to its 2% target, with four 25bps hikes in total between now and the end of 2019 (two in 2018 and one in 2019);
- The BoE to strengthen its guidance after the first hike in order to raise market expectations for further hikes next year. This would lead to a somewhat higher gilt yields and possibly a stronger sterling on a trade-weighted basis by the turn of the year;
- The BoE to, in a similar fashion to earlier in the year, indicate if it thinks the market is appropriately pricing the path of rate hikes by explicitly commenting on the shape of the curve that reflects the market's expectations for the path of interest rates.

As an aside, do not expect the BoE to follow the Fed with its balance sheet unwind anytime soon. In line with past guidance from several MPC members, the BoE will probably choose to raise the bank rate to a level from which it could cut in a 'normal downturn' before reducing the size of its balance sheet. The BoE appears to see little risk from it bloated balance sheet and wants the market to refocus its attention on the bank rate as its main policy tool. As the BoE usually cuts the bank rate by around 250bps during a normal downturn, we should not expect any unwinding until the bank rate is nearing 3%. As four 25bps hikes, taking the bank rate to 1.25%, spread over 24 months may be all that is needed to achieve the BoE's goal of

sustainably returning inflation to its 2% target, the beginning of a balance sheet unwind seems very, very far off indeed.

BoE (modal projections) & Berenberg forecasts

Real GDP (yoy %)	**2016**	**2017**	**2018**	**2019**
August Inflation Report		1.7	1.6	1.7
Berenberg	1.6	1.6	1.7	

CPI inflation (yoy %)	**2017 Q3**	**2018 Q3**	**2019 Q3**	**2020 Q3**
August Inflation Report	2.7	2.6	2.2	2.2
Berenberg	2.7	2.7	2.4	

LFS unemployment rate (%)	**2017 Q3**	**2018 Q3**	**2019 Q3**	**2020 Q3**
August Inflation Report	4.4	4.5	4.5	4.4
Berenberg	4.4	4.3	4.3	

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