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BOE BEGINS GRADUAL TIGHTENING AMID DOWNBEAT PRODUCTIVITY OUTLOOK

Berenberg Macro Flash

And they're off: For the first time in a decade the BoE's nine member Monetary Policy Committee voted in a split 7-2 decision in favour of hiking the Bank Rate by 0.25ppt to 0.5%. This takes the bank rate to where it was before the Brexit vote and removes around a third of the stimulus the BoE introduced in August 2016 (25bps rate cut, plus purchases of £10bn corporate bonds and £60bn gilts). In his opening remarks Governor Mark Carney said, when describing why the MPC had voted for a hike, 'with inflation high, slack disappearing, and the economy growing at rates above its speed limit, inflation is unlikely to return to the 2% target without some increase in interest rates.' Today's 25bps hike was in line with ours and the market's expectations. During the press conference Carney stressed on a number of occasions that the MPC's decision to tighten was driven by medium-term inflation risks rather than the impact of near-term temporary factors i.e. the drop in sterling. The two dissenting members judged that there was yet insufficient evidence that wage costs would pick up in line with the latest projections.

No major changes to the medium-term projections: The BoE has further revised down its estimates for unemployment by c0.3ppt over the forecast horizon while pushing up the near-term inflation outlook a little because of 'less slack at the start of the forecast' compared to the August projections. But note that despite the further projected falls in unemployment, reflecting stronger expected employment gains, projections for real GDP remain broadly stable at c1.7% per year – see next section. Within the components of output, there were no major changes. The BoE continues to expect stable consumption gains of 1-1.5%, business investment growth of 2-3% and a modest improvement in the trade balance from stronger global growth and the weaker sterling.

The supply story is critical for the policy outlook: In his press conference Governor Carney stated that, due to 'persistent' productivity weakness, the 'pace at which the economy can grow without generating inflationary pressures has fallen relative to pre-crisis norms'. Before the Brexit vote the BoE typically projected long-term growth at a little north of 2%. Back then, when there was more slack in the labour market than now, the BoE was less decided on whether low productivity was a cyclical or structural issue. But now the labour market is reaching full employment, the BoE states that growth of 1.6-1.7% is 'above' what it considers the economy's speed limit. While the long-term outlook for potential growth depends on many factors, including the nature of post-Brexit UK-EU trade relations, the BoE's forecast of 1.25-1.5% productivity growth in 2019/20 as labour market participation stabilises is probably not far off its estimate of potential growth. Carney blamed the cumulative impact of weak investment growth since the financial crisis for the UK's structural productivity woes.

'Limited and gradual' withdrawal of stimulus: In his key piece of policy guidance Carney said that, 'To be clear, even after today's rate increase, monetary policy will provide significant support to jobs and activity. And the MPC continues to expect that any future increases in interest rates would be at a gradual pace and to a limited extent.' The second part is broadly in line with the MPC's recent commentary prior to today's hike. The critical question remains, what happens next? Keep in mind that the Bank's central estimates are conditioned on the market's estimate of the path of rate hike at the time of the forecast. This path indicates the Bank Rate will be at 1% in 2020, slightly below our forecast of 1.25%. That the Bank's inflation forecast hits 2.1% in 2020 Q4, almost in line with the BoE's 2% target, could imply the MPC is subtly endorsing the markets current projections. This implies the risks to our call for three hikes between now and 2019 are skewed a little to the downside.

Monetary policy summary

The MPC voted:

- For the bank rate to be increased by 25 basis points to 0.5%;
- For the BoE to maintain the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at £10 billion;
- For the BoE to maintain the stock of UK government bond purchases, financed by the issuance of central bank reserves, at £435bn.

On the Bank Rate, seven members of the Committee (the Governor, Ben Broadbent, Andrew Haldane, Ian McCafferty, Michael Saunders, Silvana Tenreyro and Gertjan Vlieghe) voted in favour of the proposition. Two members (Jon Cunliffe and Dave Ramsden) voted against the proposition, preferring to maintain Bank Rate at 0.25%.

Regarding the stock of purchased assets, the Committee voted unanimously in favour of the second and third propositions.

GDP	2017	2018	2019	2020
Bank of England Nov. 2017	1.6	1.6	1.7	1.7
Bank of England Aug. 2017	1.7	1.6	1.8	
Berenberg estimates	1.6	1.6	1.7	

CPI inflation	2017 Q4	2018 Q4	2019 Q4	2020 Q4
Bank of England Nov. 2017	3.0	2.4	2.2	2.1
Bank of England Aug. 2017	2.8	2.5	2.2	
Berenberg estimates	2.9	2.5	2.2	

Source: BoE, table 5.A, page 34, November Inflation Report 2017 Berenberg.

LFS unemployment rate	2017 Q4	2018 Q4	2019 Q4	2020 Q4
Bank of England Nov. 2017	4.2	4.2	4.2	4.3
Bank of England Aug. 2017	4.4	4.5	4.5	
Berenberg estimates	4.3	4.3	4.3	

Source: BoE, table 5.A, page 34, November Inflation Report 2017 Berenberg.

Bank rate	2017 Q4	2018 Q4	2019 Q4	2020 Q4
Bank of England Nov. 2017	0.5	0.7	0.9	1.0
Bank of England Aug. 2017	0.3	0.5	0.7	
Berenberg estimates	0.5	1.0	1.25	

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