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BOE PREVIEW: READY TO ACT ON BREXIT, EITHER WAY

Berenberg Macro Flash

Ready for a rate hike? Or maybe a rate cut? That depends on the outcome of Brexit. If UK parliament soon takes steps to take the hard-Brexit risk off the table, expect a rate hike in May. However, if the UK exits the EU without a deal on 29 March 2019, the BoE could find itself moving in the opposite direction and aggressively easing policy. If parliament opts for a second EU referendum, the likely delays to a final resolution on Brexit would create additional complications for the monetary policy outlook. The BoE thus faces a tricky communication challenge on Thursday at the February Inflation Report. Any guidance on the likely future path of rates must be contingent on a currently unknown outcome for Brexit.

Brexit uncertainty warrants a cautious 'wait-and-see' approach for now. We expect the nine member MPC (Monetary Policy Committee) on Thursday to unanimously vote to: a) keep rates on hold; and b) make no changes to the bank's balance sheet. We see a slim chance that Michael Saunders, the most hawkish member of the MPC, could vote for a hike. Saunders has front-run the previous two rate hikes. However, the key information on Thursday will come from the bank's forward guidance and any responses given by Govenor Mark Carney in the post-statement Q&A.

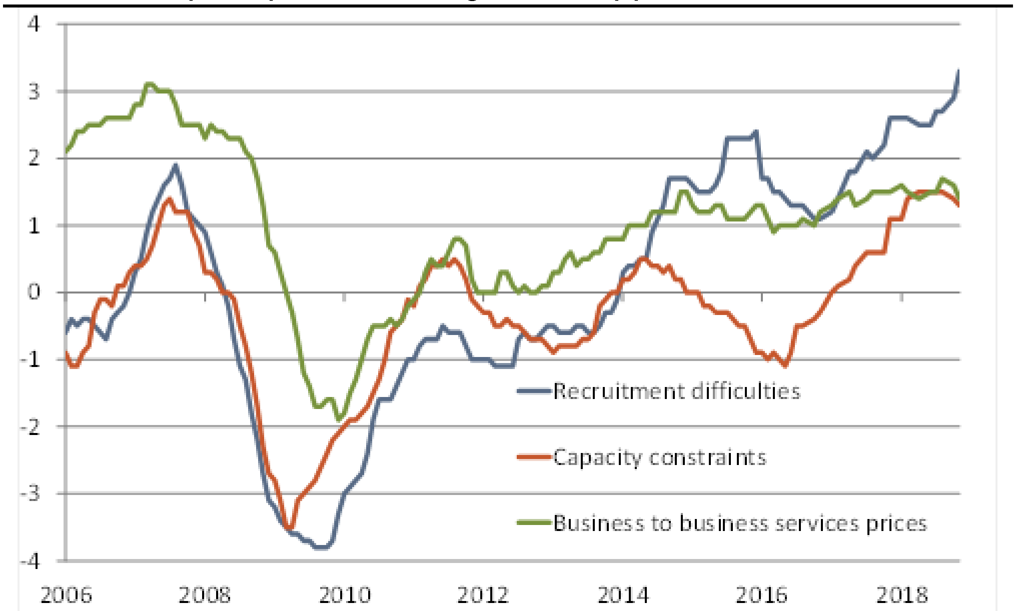
All eyes on Brexit: This could be the final Inflation Report before the UK leaves the EU. As the next policy change will probably hinge on the currently unknown outcome of Brexit, the BoE's guidance will strongly affect how the market reacts if and when we get some clarity on Brexit. The MPC will likely stick to the official government line as its base case for both its economic forecasts and policy guidance - i.e. that the UK and EU will reach a deal and avoid a no-deal hard Brexit outcome. This would be consistent with guidance of the recent meetings that 'were the economy to continue to develop broadly in line with the November Inflation Report projections, an on-going tightening of monetary policy over the forecast period would be appropriate'. We expect the BoE's revised forecasts to be broadly unchanged from November – see tables below. In our view, the BoE merely repeating its previous guidance would be consistent with a rate hike in May, followed by at least one more hike in 2019 (probably in November) and two further hikes in 2020.

In a Brexit deal scenario, the case for rate hikes is strong: Inflationary pressures are building as the UK economic upswing matures. BoE survey data point to building inflationary pressures coming from the labour market, capacity constraints and rising costs of inter-business trade – Chart 1. Nominal wage growth is gradually edging up. Weekly earnings grew by 3.4% yoy in November 2018, up from 2.5% a year earlier. At 4% the unemployment rate is at its lowest since the mid-1970s. Employment and job vacancies are at record highs. Wage pressures are likely to build further over the medium-term as the labour market continues to tighten. Meanwhile, the jump in import prices following the drop in sterling after the Brexit vote in 2016 has lifted inflation expectations on a sustained basis to well above the BoE's 2% target – Chart 2. With the economy at full employment, there is little hope that inflation and inflation expectations could self-correct without further normalising monetary policy. If parliament backs Prime Minister Theresa May's deal (10% chance), goes for a full Customs Union plus single market for goods (25% chance), or a Norway-plus (15% chance) agreement, we expect the BoE to proceed as mentioned above.

In a second referendum, the case for a May rate hike still holds: The UK could need at least four months to prepare for a second Brexit vote. Should the BoE wait for the outcome of such a vote before altering its policy again? In our view, no. Inflationary dynamics are not yet so strong that the BoE needs to shock demand with a big rate hike. But inflationary dynamics can build fast. Better the BoE hikes in May and deals with a hard Brexit if and when that happened than risk falling behind the curve by waiting too long to hike again.

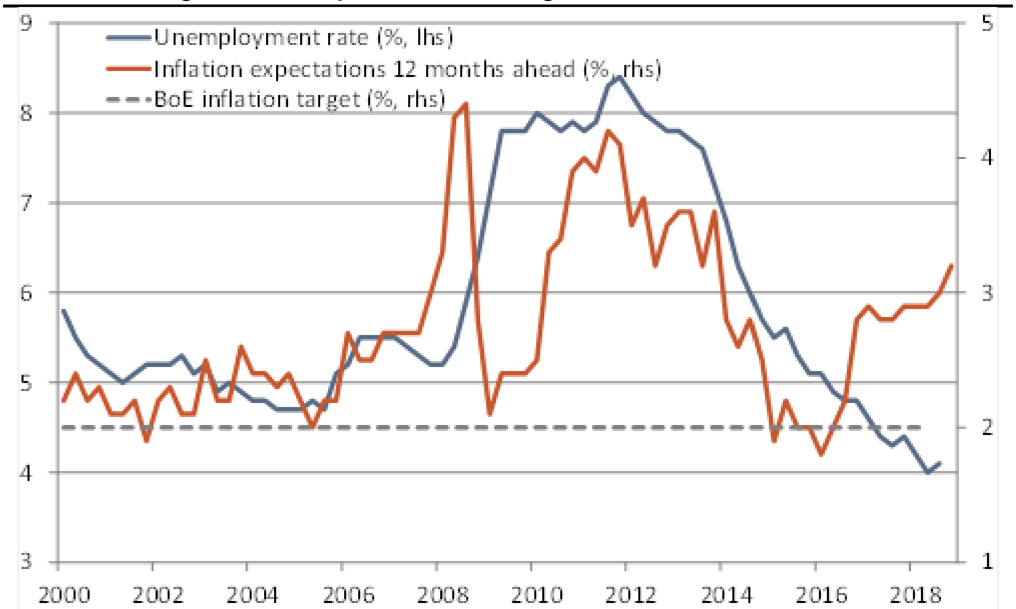
What would the BoE do hard Brexit? Governor Carney signalled in December that the BoE could hike rates in a hard Brexit scenario. We expect much of the questions by the press following Carney's policy statement to focus on this issue. Of course, there is some economic logic underpinning the case for rate hikes in a hard Brexit scenario (20% risk). If inflation rose due to domestic supply contracting by more than domestic demand, and not just due to one-off effects of a sterling depreciation, rate hikes could remedy this problem by reducing demand to correct the imbalance. Nevertheless, we see this as a highly unlikely scenario. It would be the equivalent of losing a leg and deciding the best way to regain one's balance is to chop the other leg off. If pressed on this issue, we would expect Carney to signal that the BoE would be ready to respond with monetary policy in either directions, depending on how the economy developed. In a hard Brexit, we would expect the BoE's to re-open the Brexit-vote playbook: first, lean into any market panic by promising to do what it takes to ensure sterling markets remain liquid; second, signal early, and later follow up with, a monetary stimulus to support the domestic economy; and third, once the initial adjustment panic is over begin to raise rates, if needed, to deal with any inflation problem caused by an imbalance between demand and supply.

Chart 1: Survey data points to building inflationary pressures



Data shows results from the BoE Agents' Survey (% bal). Source:, Bank of England

Chart 2: Rising inflation expectations and tight labour markets



Unemployment rate versus inflation expectations (%). Quarterly data. Source: ONS, Bank of England, TNS

Table. 1 GDP (yoy %)	2018	2019	2020	2021
BoE *(Nov. forecast)*	1.3	1.7	1.7	1.7
Berenberg	1.4	1.7	1.8	

Source: BoE, Berenberg.

Table. 2 Unemployment rate (%)	2018	2019	2020	2021
BoE *(Nov. forecast)*	3.9	3.9	3.9	3.9
Berenberg	4.1	3.9	3.8	

Source: BoE, Berenberg.

Table. 3 Inflation (yoy %)	2018	2019	2020	2021
BoE *(Nov. forecast)*	2.5	2.1	2.1	2.0
Berenberg	2.5	2.1	2.2	

Source: BoE, Berenberg.

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