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BOE: THE BIG HAWKISH BET

Berenberg Macro Flash

BoE really sticking its neck out
Yesterday the US Fed cut rates. Next month, the ECB is likely to cut rates and restart its asset purchase program. The UK is an open economy wedged between the US and the Eurozone. One might therefore expect BoE policy to be closely aligned with the Fed and ECB. Not so fast. The BoE's Monetary Policy Committee (MPC) decided at its August policy meeting to keep rates on hold while continuing to guide markets towards further hikes over the medium-term. The BoE conditioned its hawkish guidance on two big bets: 1) that Brexit will go smoothly; and 2) the global economy will improve next year.

While acknowledging that '*increased uncertainty about the nature of EU withdrawal meant that the economy could follow a wide range of paths over coming years*' the August minutes state that '*assuming a smooth Brexit and some recovery in global growth, a significant margin of excess demand is likely to build in the medium term. Were that to occur, the Committee judges that increases in interest rates, at a gradual pace and to a limited extent, would be appropriate to return inflation sustainably to the 2% target.*'

In case of on an orderly Brexit at the end of October, we would expect two hikes in 2020 to take the bank rate to 1.25%. In case of a further lengthy Brexit delay, the risks to that call would be to the downside ie fewer hikes.

Although some MPC members (including Govenor Carney) have signalled that the BoE would likely cut rates in case of a hard Brexit, the official guidance in the August minutes did not mention specifically how the BoE would react to a hard Brexit, '*the monetary policy response to Brexit, whatever form it takes, will not be automatic and could be in either direction*'. In our view, the BoE would probably look to ease monetary policy in case of a hard Brexit.

The updated forecasts should be taken with a pinch of salt
The BoE conditions its forecasts on the market implied path for the main BoE policy rate. At the time of the August Inflation Report forecast round the market was pricing in a 25bps cut in the bank rate over the next year. However, we doubt this actually reflects the central view of most market participants. Instead, it probably reflects a weighted average of the markets' view, dominated by judgements about a wide ranging possible Brexit outcomes. Oversimplifying it, suppose half the market believed that the BoE would cut rates to zero – ie 75bps – over the next year because a hard Brexit would happen, and the other half expected one hike of 25bps on the back of an orderly Brexit, the market implied path would show a 25bps cut over that period ie. the average of the two views.

Because the BoE's forecasts are very sensitive to the assumption for the bank rate, and given the binariness of Brexit, chances are that the actual path the economy follows will differ greatly from the BoE's August base case.

The August minutes address this problem '*These projections are affected by an inconsistency between the smooth Brexit conditioning assumption underpinning the forecast and the prevailing market asset prices on which the forecasts are also conditioned. These asset prices reflect market participants' perceptions of the likelihood and consequences of a no-deal Brexit. If, as assumed, Brexit proceeds smoothly to some form of deal, market interest rates would likely rise and the sterling exchange rate would likely appreciate. A* *more consistent forecast would therefore have somewhat lower paths for GDP growth and CPI inflation.'*

Summary of forecast changes

The August minutes summarise the BoE's updated forecasts as follows, *'GDP is projected to accelerate to robust growth rates, reflecting a gradual recovery in global growth and firming UK domestic demand growth, driven in large part by a recovery in investment growth as uncertainties dissipate in line with the Brexit conditioning assumption. The acceleration in GDP results in a significant build-up of excess demand, to around 1¾% of potential GDP by the end of the forecast period. After falling in the near term, CPI inflation is projected to rise above the 2% target, as building excess demand leads to firmer domestic inflationary pressures. Conditioned on prevailing asset prices, CPI inflation reaches 2.4% by the end of the three-year forecast period.'*

The key forecast changes are as follows:

-Real GDP (Table 1): The BoE downgraded its GDP forecast in the near-term but dramatically revised it up towards the end of the forecast horizon. The BoE now forecasts real GDP growth of 1.3% in 2019, down from 1.5% in May, 1.3% in 2020 - down from 1.6%, and 2.3% in 2021 – up from 2.1%. Looking at the quarterly forecasts, the BoE projects annual growth accelerating to 2.5% by 2022 Q3, a full percentage point above the BoE's estimate of potential growth of c1.5%.

-Unemployment rate (Table 2): Despite a recent slowdown in employment growth and a leveling off of job openings, albeit at a near-record high, the BoE kept its unemployment rate projections broadly unchanged –projecting a fall to 3.6% in 2021 (up from 3.5% in the May forecast).

-Inflation (Table 3): The inflation outlook is lower in 2019 (1.6% vs. 2.0% in May) but higher in the final year (2.2% in 2021 vs 2.1% in May) with inflation accelerating to 2.4% by the end of the quarterly forecast.

August monetary policy decision

The MPC voted unanimously to maintain:

- the Bank Rate at 0.75%;

- the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at £10 billion;

- the stock of UK government bond purchases, financed by the issuance of central bank reserves, at £435 billion.

Table 1: GDP (% yoy)	2019	2020	2021
Bank of England August 2019	1.3	1.3	2.3
Bank of England May 2019	1.5	1.6	2.1
Berenberg	1.2	1.8	1.7

Table 2: CPI inflation (% yoy)	2019	2020	2021
Bank of England August 2019	1.6	2.1	2.2
Bank of England May 2019	2.0	2.1	2.1
Berenberg	1.6	2.0	2.1

Table 3: LFS unemployment rate (%)	2019	2020	2021
Bank of England August 2019	3.8	3.9	3.6
Bank of England May 2019	3.8	3.6	3.5
Berenberg	3.8	3.6	3.6

Source: Bank of England, Berenberg.

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