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JULY MPC MEETING PREVIEW: READY TO ACT, CHANCE OF RATE CUT

Berenberg Macro Flash

The Bank of England's (BoE) rate setting committee will meet on Thursday for the first Monetary Policy Committee (MPC) meeting since the UK voted to leave the EU on June 23. The minutes released at midday will detail the MPC's assessment of the economy since the Brexit vote as well as any policy changes. We see a 60% chance that the nine member MPC votes to cut the bank rate, if so, probably by 25bps. However, there is a chance that the MPC holds for now, and instead opts to send a dovish signal that the bank will ease monetary policy three weeks later at the August Inflation Report when it is due to publish its revised economic forecasts.

The July minutes will likely reveal a downbeat assessment of the economy since the Brexit vote, marked by sharp fall in confidence and a rise in political uncertainty. A rate cut or close vote to hold policy for now coupled with a negative assessment of the economy could suppress sterling and gilt yields (Chart 1 and 2) a little further. It will be the second key message on monetary policy since the Brexit vote. It follows Governor Mark Carney's speech on 30 June where he said that 'some easing will likely be required over the summer'. Since Carney's words, much of the potential easing has been priced in already.

Preserving the recovery

The UK economic recovery from the 2008 financial crisis has been solid. While growth rates have been less vigorous that in the past, averaging just 0.5% qoq compared to 0.7% in the pre-Lehman expansion, the quality of the expansion has been better this time around. The private sector has deleveraged, total debt (households and businesses including financials) has fallen from 460% of GDP in 2009 to 360% at the end of last year. The financial system is better capitalised and the labour market recovery has been exceptionally strong. The current UK employment rate is a record 74.2% with unemployment at 5.0%. The near-term drop in demand could reverse some of these positive trends temporarily. With necessarily aggressive monetary easing, the BoE can hope to prevent a protracted and/or deep contraction in GDP.

Bank has already signalled a readiness to act

By providing extra liquidity to the financial system around the referendum and reducing bank's capital requirements by the BoE's other key policy making arm, the Financial Policy Committee, the BoE has already shown a readiness to act to arrest the post-Brexit vote fallout. While sterling has dropped sharply on Brexit uncertainty and the gilt yield curve has flattened to a record low, the moves in markets have been orderly – justifying the BoE's decision to step in to provide support. Looking to the real economy, the key question is not if domestic demand will weaken while both the domestic and European political obstacles of Brexit are tackled, but by how much. Early confidence indicators for businesses and households point to stagnation in the second half of the year, with a high chance of a recession. This warrants some form of easing to offset what Governor Carnet described as 'the prospect of a material slowing of the economy'.

What can the BoE do? Rate cuts, more QE or both

The already low policy rate of 0.5% limits the scope for rate cuts. Governor Carney has already stated that negative rates are 'a zero sum game'. 0.0% is probably the lower limit on the bank rate. We think the BoE will probably stop at 0.25%. While it might send a strong signal that the BoE is ready and willing to act,

realistically, cutting the policy rate from its current level of 0.5% to 0.0% will not materially support nominal demand. History shows the average scale of cuts to the bank rate during an easing cycle is around 3ppt. But the BoE is not constrained by the supply of gilts in expanding its existing QE program. According to UK Debt Management Office the current size of the gilt market is a little under GBP1.5trn, of which the BoE currently has around GBP400bn on its balance sheet, mostly through its existing GBP375bn QE purchases. That leaves around GBP1.1trn available on the market for purchase.

Dovishness on Thursday will signal easing in August

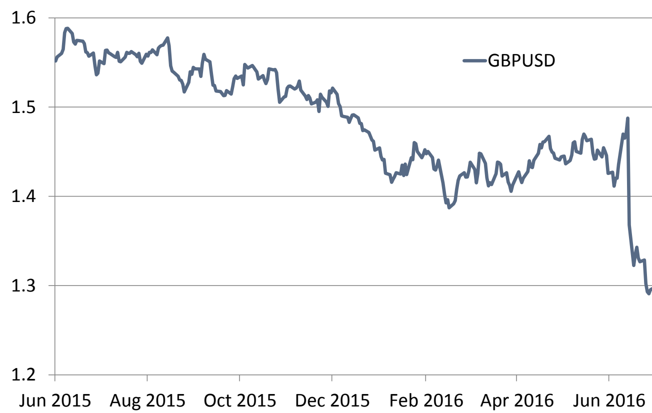
While there is a good chance the BoE will ease monetary policy on Thursday, we would not be surprised if the MPC chooses to wait until next Inflation Report on 4 August before loosening policy. There are two key reasons for this. (1) By next month, the MPC will have more data to assess the performance of the economy since the June 23 vote. The scale of scope of the easing will be directly related to the expected size of the negative shock. (2) Like other central banks, the BoE uses its forecasts as a form of forward guidance. Publishing forecasts at the same time as policy changes gives markets more insight into the BoE's reaction function.

We see a 60% chance the MPC votes in favour of cutting the bank rate on Thursday. If so, it will likely be by 25bps.

August Inflation Report - 60% chance of QE

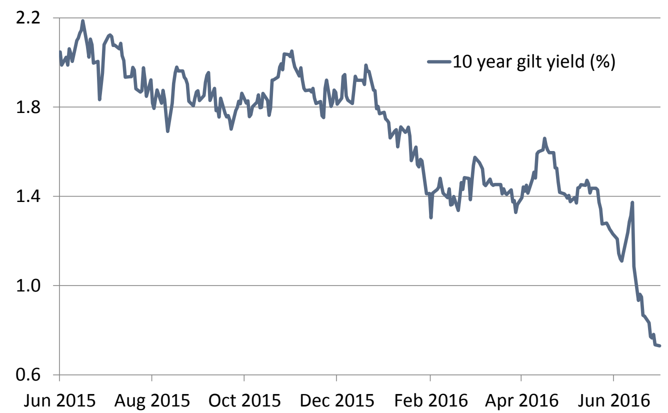
In addition to a rate cut in either July or August, we look for the BoE to restart its asset purchase programme ("quantitative easing", QE) in August. The BoE purchased GBP200bn of assets in 2009 during the financial crisis and GBP175bn in 2011-12 during the euro-crisis. As a start, we expect the BoE to purchase around GBP100bn of gilts. The combination of a lower bank rate plus more QE would mean that 10 year gilt yields and trade-weighted sterling will remain at or even below current levels until the end of the year before rising modestly in 2017 as the economy begins to regain some momentum. While monetary policy is not an antidote to political uncertainty, monetary policy can underpin the supply of loans to the real economy, bolster confidence and support households and businesses with weak balance sheets. UK GDP growth is unlikely to return to trend until the major negotiations between the UK and EU begin in earnest and the economic outlook linked to EU trade becomes clear. But with appropriate monetary policy support, the economy could scrape through with only a big dent to growth over the next year or two, rather than a big recession.

Chart 1: GBPUSD



Source: Bloomberg. Daily data

Chart 2: 10 year gilt yields



Source: Bloomberg. Daily data

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