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BOE GETS CREATIVE IN RESPONSE TO BREXIT SHOCK

Berenberg Macro Flash

Here are the key points from the August Inflation Report.

- A 25bp rate cut, £60bn increase in quantitative easing (QE), £10bn corporate bond purchases and new Term Funding Scheme.
- More easing likely: A "majority of members expected to support a further cut in the bank rate…during the course of the year".
- The MPC unanamously voted for a rate cut, voted 8-1 on corporate bond purchases and voted 6-3 on expanding QE.
- There is no recession in the Bank of England's (BoE) central forecast, but the Monetary Policy Committee (MPC) sees "little growth in GDP during the second half of year".

At its August MPC, the BoE's rate-setting committee agreed on a broad package of measures to offset the negative shock coming from the Brexit vote. At the Inflation Report press conference today, Mr Carney repeated the message that all tools could be advanced if needed - all policy levers "can go further". Presumably this reflects concerns that the BoE is facing constraints in its capacity to expand monetary policy.

The BoE sharply downgraded its outlook for GDP and marginally raised its outlook for unemployment (see Tables 1 and 2). Importantly, the BoE does not anticipate a recession in the second half of 2016. The BoE, like other central banks, uses its forecasts as forward guidance. Providing forecasts and a policy change at the same time sheds light on the BoE's reaction function.

The minutes note that if the economy follows the path outlined in the August Inflation Report then a "majority of members expected to support a further cut in the bank rate… during the course of the year". Extending this argument in light of the central expectation of no recession indicates the BoE will add additonal easing beyond a cut if the economy does begin to shrink.

The unanamous support for a rate cut versus split support for additional measures indicates that while all members expected the economy to weaken, there was a variation in views about just how much economic activity would soften. The upward revision to inflation coming from the weaker sterling – pushing up import prices – did not play a significant role in the BoE's deliberations for the immediate policy decision.

A broad stimulus

The 25bp cut to the policy rate and the £60bn increase in QE was in line with expectations. In addition, the MPC decided to purchase £10bn sterling non-financial investment-grade corporate bonds and launch a new Term Funding Scheme.

Headroom to cut the bank rate is limited by the BoE's apparent unwillingness to take rates negative. During the press conference, Mr Carney repeatedly signalled that zero is the "effective lower bound" for the bank rate.

In order to boost the pass through of rate cuts, the BoE announced a new policy – the Term Funding Scheme. With interest rates close to zero, it is already difficult for some lenders to further reduce deposit rates. This could limit their ability to pass on rate cuts to the real economy. The Term Funding Scheme will provide £100 billion of central bank reserves to lenders at "close to the bank rate" to boost the pass through of interest rate cuts and other policy measures. The BoE will purchase £60bn of gilts over the next six months, taking the total stock of QE assets to £435bn. QE can reduce long-term yields and can support other asset prices, too. In addition, the MPC decided to buy £10bn of corporate bonds – intended to a have a "greater boost to activity, pound for pound, than purchases of government bonds". The MPC expects the asset purchases to support the economy by triggering "portfolio rebalancing". Asset purchases by the central bank increase money holdings by the sellers of those assets. Rather than holding cash, the sellers try to refill their gilt allocations with other substitutable assets from other sellers. The prices of those assets increase and so on. QE also boosts liquidity in markets. As the liquidity premium to hold an asset falls, its price rises.

Policy outlook

With just a few breadcrumbs of soft data for the post-vote period, it is not yet clear if UK GDP growth will slow, stagnate or turn negative in the near term. Risks are heavily tilted to the downside and the balance of probability favours a worse, rather than better, outlook relative to the BoE's forecast. In line with the comments in the minutes that the majority of members expect to support a further cut in the bank rate during the course of the year, we expect a further 15bp cut in Q4, taking the bank rate to 0.1%. In addition, if the UK economy begins to contract, we expect the additional policy measures announced today to be expanded.

Table 1

GDP (% yoy)	2016	2017	2018
BoE May Report	2.0	2.3	2.3
BoE August Report	2.0	0.8	1.8
Berenberg	1.7	1.3	

Table 2

Unemployment rate (%)	2016 Q3	2017 Q3	2018 Q3	2019 Q3
BoE May Report	5.1	4.9	4.9	
BoE August Report	5.0	5.4	5.6	5.3
Berenberg	5.3	5.2		

Table 3

Inflation (CPI, yoy %)	2016 Q3	2017 Q3	2018 Q3	2019 Q3
BoE May Report	0.8	1.5	2.1	
BoE August Report	0.8	1.9	2.4	2.4
Berenberg	1.1	1.7		

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