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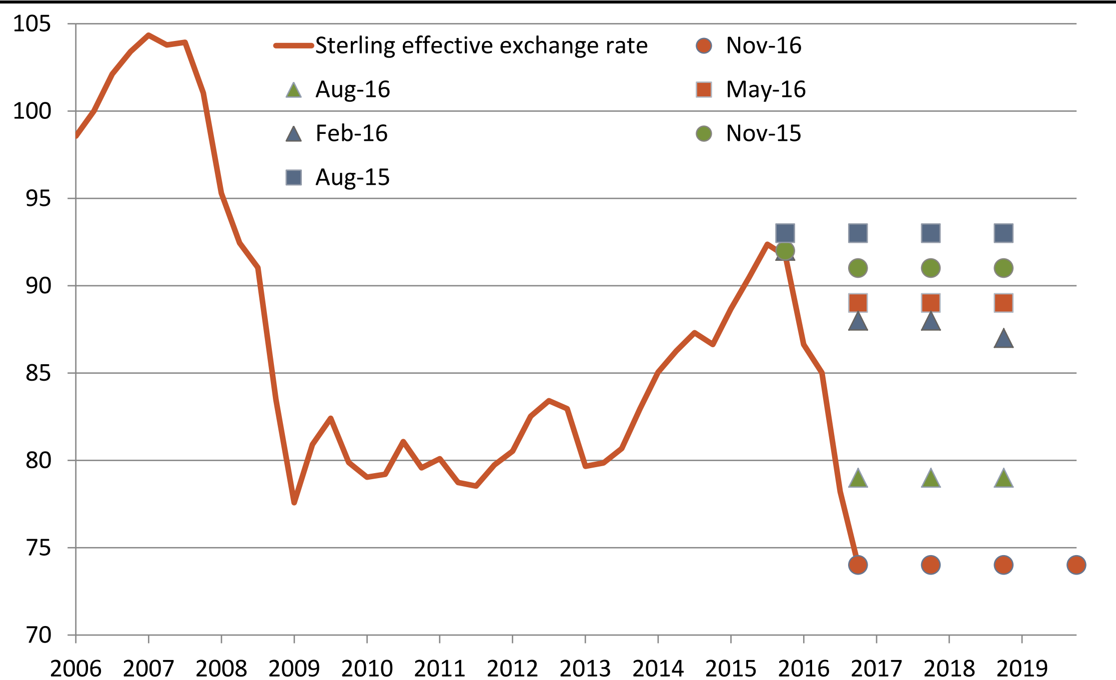
ALWAYS READ THE SMALL PRINT: BOE INFLATION FORECAST IS HIGHLY SENSITIVE TO FX RISK

Berenberg Macro Flash

Chart 1: Trade-weighted sterling vs. the BoE's forecasts for trade-weighted sterling



Quarterly data. Source: Bank of England, Berenberg. BoE projections show the average level in Q4 of each year taken from the forecasts in each of the last six Inflation Reports.

The sterling effect

At yesterday's November Inflation Report the BoE revised up its outlook for inflation over its forecast horizon – from 2.0% and 2.4% at the end of 2017 and 2018, to 2.7% in both years, respectively. In his opening remarks, Governor Carney said 'largely as a result of the depreciation of sterling, CPI inflation is expected to be higher throughout the three year forecast period than in the Committee's August projections.'

On a trade-weighted (effective) basis, sterling was around 6% lower at the time of the BoE's November forecast compared to August, thus a downward revision to the bank's sterling forecast was required. Currency weakness causes a rise in inflation by increasing import prices. Looking at the details of the Inflation Report, and the uncertain outlook for sterling, the BoE's inflation forecast may be subject to heavy revision in the coming quarters - mainly due to a technical issue with the BoE's forecast and the likely continued volatility in the exchange rate. We would, therefore, caution on reading too much into what the higher inflation forecast may or may not mean for monetary policy over the medium-term.

The world is not flat

Some underlying assumptions about the future are required for any type of economic forecast. But they need to be understood in order to properly interpret the forecasts. The BoE makes the assumption that the sterling exchange rate follows a path that is half way between the starting level of the sterling effective rate at the time of the forecast and the path implied by interest rate differentials. Given that we live in an unprecedented environment of protracted low interest rates, the product of such a forecast is likely to be a broadly flat line. As Chart 1 shows, this has been the case for at least the last six forecast rounds.

From a purely theoretical point of view, this is a sensible method for forecasting exchange rates. But the output of such a forecast isn't very edifying. Exchange rates move due to other factors beyond monetary policy. Recent experience and a second glance at Chart 1 would indicate that an assumption that trade-weighted sterling remains stable for the next three years is a little unreasonable, to put in mildly. But in times of uncertainty, using the technical assumption of a flat exchange rate makes sense.

In our view, trade-weighted sterling will likely appreciate somewhat over the next three years, as the economy continues to remain resilient to Brexit uncertainty and the Prime Minister's hard-Brexit stance softens a little, encouraging markets to take a more favourable view on the UK. This would imply a lower rate of inflation towards the end of the BoE's forecast.

The devil is in the detail

As with other inflation targeting central banks, the BoE's forecasts for GDP, unemployment and inflation provide a guide to future monetary policy. With Brexit-uncertainty hanging overhead, the UK economic outlook is highly uncertain, both in the short and long-run. As we note, the BoE's inflation forecast is susceptible to strong influence from a fairly simplistic assumption for the exchange rate outlook. As a result, the outlook for monetary policy is also highly uncertain.

Yesterday, Governor Carney noted in his opening remarks that the upward revision to inflation creates a more challenging trade-off for supporting real economic activity and achieving a stable long-run rate of inflation at the 2% target. But the eventual outcome for inflation could be very different depending on how sterling evolves from here. That households and firms could begin to respond more sensitively to such uncertainty tilts the balance of probability towards looser rather than tighter policy while Brexit uncertainty looms large. We would therefore caution in assuming that the higher expected rate of inflation would hold the BoE back from further easing, if it were needed.

In the long-run, however, the policy outlook will be determined by the evolution of inflation which reflects the balance of demand and supply – a product of Brexit. Lower trade, investment and migration with the EU represents a supply-side shock for the UK. Brexit could be inflationary in the long-run.

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