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BOE PREVIEW: TIME FOR SOME CLARITY ON NEGATIVE RATES

Berenberg Macro View

Words matter: Although we do not expect the BoE to announce any significant policy changes at the February Monetary Policy Report on Thursday, a combination of policymakers a) downplaying the chance of negative rates soon and b) sounding optimistic in their economic assessment could shift financial markets' interest rate expectations upward somewhat. In our view, financial markets during 2020 placed too much weight on the prospect of negative interest rates as a response to the pandemic shock. Based on overnight index swap curves, financial markets still expect the bank rate (currently 0.1%) to fall below zero at the August meeting and to -0.04% by the December meeting. Neither looks likely, in our view.

Ahead of the policy announcement at midday GMT on Thursday, we assess the four key issues:

1. **The appropriateness of the current policy stance**

When it had become clear in late 2020 that the UK was likely to remain under strict lockdown until spring this year, market participants began to wonder if the BoE would need to further enhance its policy stimulus to support the economy through the turmoil. But key data since the return of lockdowns in November - including November GDP, December retail sales and December employment - show that the economic hit from the winter wave of the virus is a mere fraction of the initial shock in spring 2020. Further stimulus is thus not necessary for now. Whereas the BoE needed to send a big signal in spring 2020 to prevent the pandemic from morphing into a serious deflation and financial crisis, the calmer reaction by markets and economic participants to restrictions this time around allows the BoE to remain focused on its primary goal of price stability.

In addition, across all key metrics, BoE policy continues to work well: 1) despite the ongoing disinflation from the pandemic-restrictions, inflation expectations are well anchored at close to the upper end of the 10 year range – Chart 1; 2) money and credit data for December continue to show that businesses can still access the credit they need on generous terms; and 3) the BoE still has plenty of stimulus still in the pipeline – including around £140bn of the £150bn asset purchase commitment for this year (announced on 4 November 2020).

2. **An assessment of Brexit impact so far**

Policymakers may provide an updated assessment of the expected long-run impact of Brexit based on the deal signed by the UK and the EU in late 2020. Ahead of a deal being struck, the BoE had assumed that the UK would leave the EU Single Market and Customs Union on 31 December 2020 and immediately move to a free trade agreement for goods with the EU on 1 January 2021. As the outcome was in line with the BoE's assumption, any adjustments to the BoE's estimated impact on potential growth and the like should be minor at this stage.

In time, the BoE may adjust such estimates based on the observable impact of leaving the Single Market. Less than five weeks since that happened, it is probably a bit too early for that yet. In addition, the harsh virus restrictions and related border and trade disruptions make it hard to fully distinguish between Brexit and pandemic effects on international trade, cross border investment and flows of migrant workers. At the press conference that follows the policy meeting, BoE Governor Andrew Bailey may provide some commentary on the outlook for UK financial services absent any UK-EU deal to manage trade in this sector.

3. **An update on negative rates**

The BoE's Deputy Governor and CEO of the Prudential Regulation Authority, Sam Woods, has already announced that the BoE plans to publish the conclusions from last years' consultation with financial institutions about the viability of negative rates alongside the February Monetary Policy Report. While Bailey has signalled that the BoE plans to make negative rates "operational" – so that they could be a viable policy option in the future –he has played down the idea that they could be used soon in recent speeches, highlighting their negative impact on banks.

While it is not exactly clear what we can expect from the BoE on Thursday, as a best guess, we expect guidance along the following lines: a) the BoE could cut the bank rate to below zero if necessary (and such a policy is or will soon be operationally ready) – despite the potential negative consequences for some institutions; but b) economic conditions currently do not warrant such a move. This would be in line with our own analysis from October 2020, Staying positive – alternatives to negative rates.

4. **Sizeable forecast revisions**

In the age of Covid-19, economic forecasting is even trickier than normal. As a result, we would advise against putting too much weight on the precise numbers contained in the BoE's updated economic forecasts. The unusually high level of uncertainty and the need for sweeping assumptions (such as when lockdowns may be eased) to underpin any such projections reinforces this point. In other words, focus on the forest - not the trees.

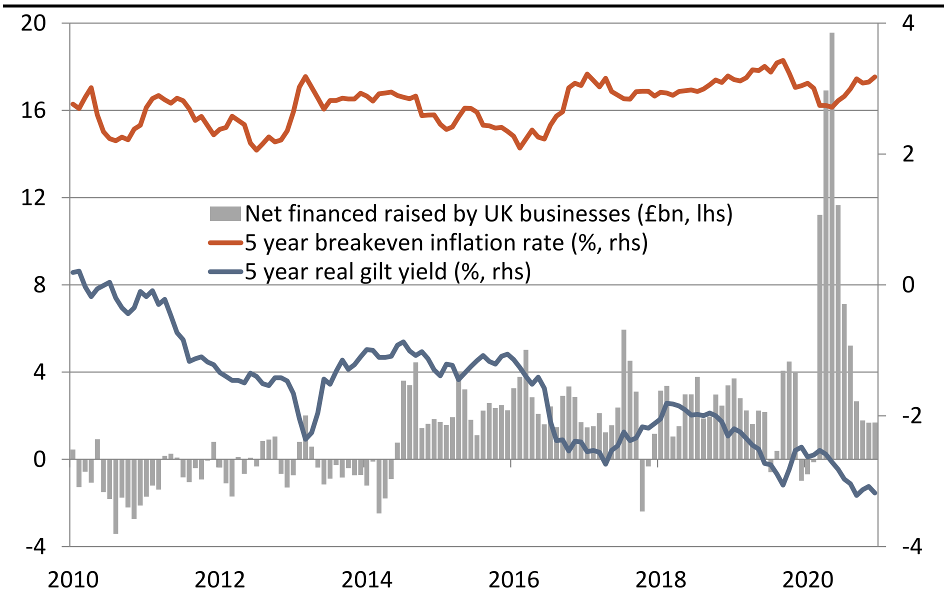
Following recent upward revisions to 2020 GDP data as well as the less bad than expected Q4 2020, we expect the BoE to revise up its estimate for 2020 GDP from -11.0% (November) to close to our own call of -10.1%. With a smaller estimated shock for 2020 but harsher restriction in H1 2020 than anticipated in November, the BoE is likely to revise down its growth projections of 7.3% for 2021 (Berenberg - 6.1%) and 6.3% for 2022 (Berenberg 5.0%) – Chart 2. Due to the persistent upside surprises in the labour market in H2 2020, the BoE may lower its estimate of unemployment for 2021 from the 6.8% rate in its November forecast (Berenberg – 5.7%). Markets would view such a revision as a hawkish signal if the BoE also revised up its outlook for wages and inflation. In November, the BoE projected that headline inflation would recover from its 0.6% annual rate in December to 2% by Q1 2023.

Because of the aforementioned challenges related to forecasting at present, governor Bailey may provide a clear verbal assessment of the economy that adds important colour to any revisions. While he probably will not be quite as explicit as BoE chief economist Andy Haldane was recently - the recovery could be going 'at a rate of knots from the second quarter' - such supplementary commentary may provide a better guide to the BoE's general view of the outlook than the forecast changes themselves.

Policy outlook

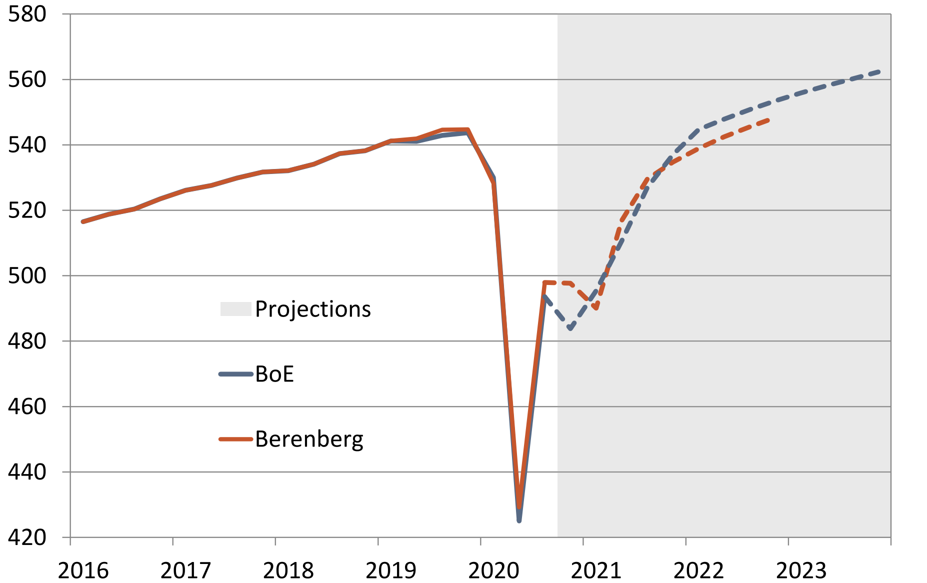
We expect the BoE to end its ongoing easing in December 2021 once it has completed its current round of £150bn of gilts purchases announced last November. The BoE had been buying gilts at a weekly pace of £4.4bn during December and January – down from a peak of £13.5bn per week in April, May and the first half of June 2020 – Chart 3. If needed, the BoE could adjust the distribution of such purchases, perhaps frontloading them in the months to come in order to provide more support during the current difficulties. Beyond that, if economic activity begins to recover strongly as we and the BoE expect once restrictions are eased, the BoE may spend the second half of 2021 leaning against rising long-term rates that reflect improving expectations for growth, inflation and the potential for a tighter policy stance eventually.

Chart 1: Monetary policy impact – credit and inflation expectations up, real rates down



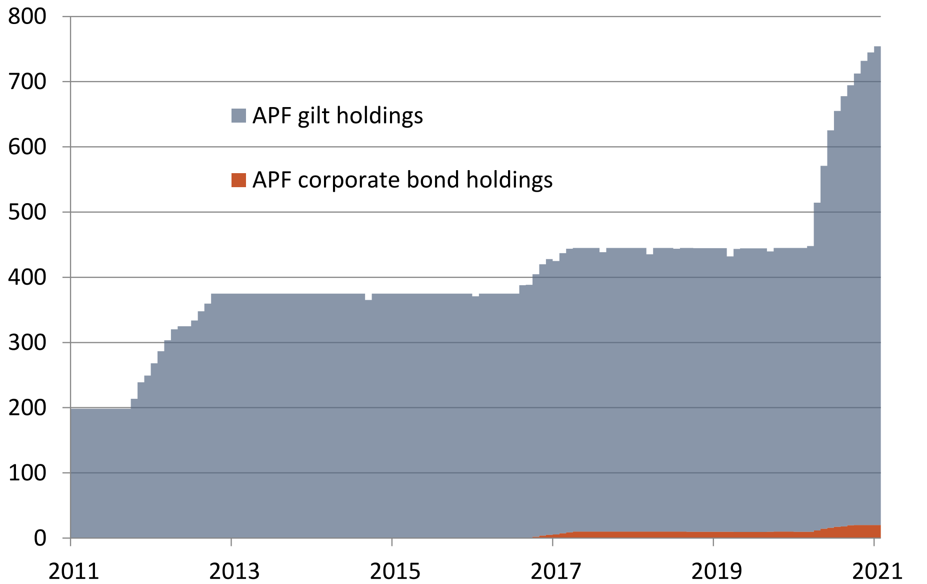
Monthly data. Net-finance data is three month moving average. Source: BoE

Chart 2: BoE November 2020 projections versus Berenberg projections



Real GDP in 2018GBP. Quarterly data. Source: BoE, Berenberg

Chart 3: BoE Asset Purchase Facility (APF) - £ billions



Monthly data. Source: BoE

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