Kallum Pickering, Senior Economist | Kallum.pickering@berenberg.com | +44 203 465 2672

BOE: LESS DOWNBEAT, NEGATIVE RATES REMAIN FAR OFF

Berenberg Macro View

Words really do matter

Although the BoE's nine member Monetary Policy Committee (MPC) voted unanimously to keep current policies unchanged at their February meeting, updated policy guidance has lifted financial market expectations for the main policy rate in 2021. In line with our expectations, the BoE has downplayed the chance of negative rates while sounding cautiously optimistic about the outlook. Markets now no longer expect the bank rate (currently 0.1%) to turn negative in 2021. Ahead of the policy announcement at 12:00 GMT, overnight index swap (OIS) curves had suggested that financial markets expected the bank rate to fall below zero by mid-2021 and to c-0.05% by December 2021. As of 13:30 GMT, OIS curves suggest that markets expect the bank rate to remain positive through 2021 (December at 0.01%).

No material changes to the medium-term outlook

Relative to the November 2020 projections, the BoE has sharply revised its estimates for real GDP in Q4 2020 and Q1 2021. In November, the BoE projected that real GDP would decline by 2.0% qoq in Q4 2020 before rebounding by 2.4% qoq in Q1 2021. In the updated forecasts, following the better-than-expected performance in Q4 but prolonged lockdowns in Q1, the BoE now estimates that real GDP will contract by 4.2% qoq in Q1 after gaining 0.6% qoq in Q4. Thereafter, the medium-term path for real GDP remains broadly unchanged. Despite faster catch up growth during summer 2021 versus the November projections, the BoE continues to expect that the UK will reach its pre-pandemic level of GDP by Q1 2022 – Chart 1 (unchanged versus November). The updated projections for other key variables remain largely unchanged from November, with the unemployment rate heading towards 5% some two years from now and inflation converging with the BoE's 2% target in early 2022 – Table 1.

We would not put too much weight on the precise numbers in the BoE's updated projections. The unusually high level of uncertainty and the need for sweeping assumptions (such as when lockdowns may be eased) means that such estimates should be taken as a general guide only. Instead, we take our cue from the less pessimistic commentary in the minutes *'relative to the February Report central projections, the Committee judged that the risks around economic activity from pandemic developments were, on balance, tilted to the downside,* ***although less so than in the Bank of England Minutes of the Monetary Policy Committee*** *meeting ending on 3 February 2021'.*

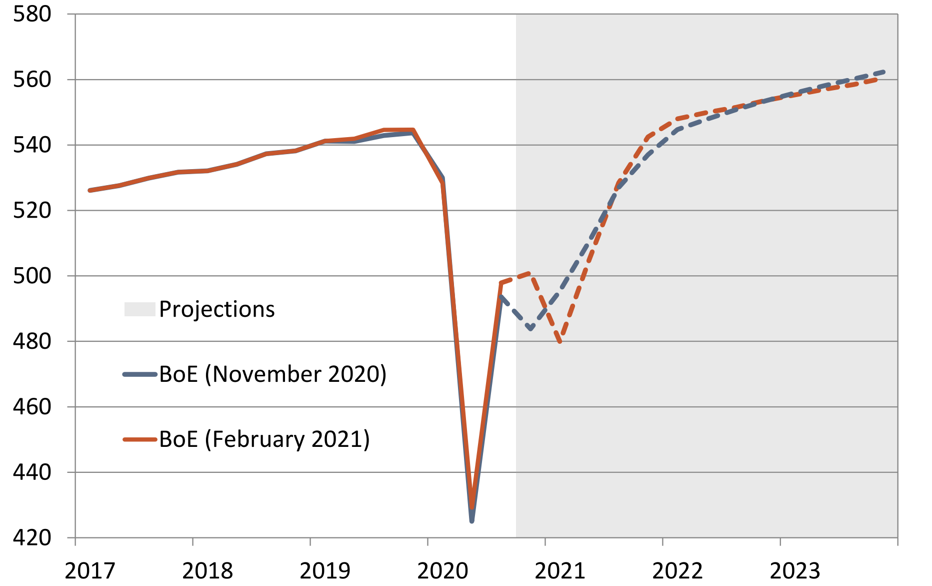
Update on negative rates

The February policy meeting minutes summarise the key conclusions from the Prudential Regulation Authority's (PRA) engagement last year with UK financial institutions about their operational readiness for a negative bank rate. In summary, the BoE has said that while negative rates will be part of policymakers' toolkit (with a potential option for tiering) once the operational risks for some institutions are dealt with, such a move remains far off. From the February MPC minutes:

'Implementation of a negative Bank Rate over a shorter timeframe than six months ***would attract increased operational risks'***
'While the Committee was clear that ***it did not wish to send any signal that it intended to set a negative Bank Rate at some point in the future****, on balance, it concluded overall that it would be appropriate to start the preparations to provide the capability to do so'*
'The MPC also requested that Bank staff should commence internal technical preparations to deliver the option of ***a tiered system of reserve remuneration*** *that could be ready to be implemented'*
'The MPC stressed again that these requests, and any subsequent related supervisory actions determined by the PRA, ***should not be interpreted as a signal that the setting of a negative Bank Rate or a tiered system of reserve remuneration were imminent, or indeed in prospect at any time'***

Policy outlook
Despite ongoing lockdowns and a highly uncertain outlook, the MPC judged that the current stance of monetary policy remained appropriate at the February meeting: bank rate at 0.1%, the stock of sterling non-financial investment-grade corporate bond at £20bn, and the target for the stock of government purchases at £875bn.
As in November, the MPC today provided two-pronged guidance that '*if the outlook for inflation weakened, the Committee stood ready to take* ***whatever additional action was necessary*** *to achieve its remit. The Committee* ***did not intend to tighten monetary policy at least until there was clear evidence that significant progress was being made in eliminating spare capacity and achieving the 2% inflation target*** *sustainably'*.
As our base case, we expect BoE policy to remain unchanged through 2021 as the bank completes its current round of £150bn of gilts purchases announced last November (due to end in December 2021). We look for the BoE to remain on hold during 2022.
The BoE had been buying gilts at a weekly pace of c£4.5bn during December and January – down from a peak of c£13.5bn per week in April, May and the first half of June 2020. 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 the BoE expects – once restrictions are eased, policymakers may spend the second half of 2021 leaning against further rises in interest rate expectations that reflect improving expectations for growth, inflation and the potential for a tighter policy stance eventually.

Chart 1: BoE February projections vs. November 2020 projections



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

Table 1: February 2021 MPC projections

	Projections			
	2021 Q1	2022 Q1	2023 Q1	2024 Q1
GDP(c)	-9.2 (-6.5)	14.2 (10.0)	1.3 (2.1)	1.3
CPI inflation(d)	0.8 (0.7)	2.1 (2.1)	2.1 (2.0)	2.0
LFS unemployment rate	5.5 (6.7)	5.7 (6.1)	5.0 (4.7)	4.5
Excess supply/Excess demand(e)	-1 (-2)	+¼ (0)	+¼ (+¼)	0
Bank Rate(f)	0.1 (0.0)	-0.1 (-0.1)	-0.1 (-0.1)	0.0

(a) Modal projections for GDP, CPI inflation, LFS unemployment and excess supply/excess demand. Figures in parentheses show the corresponding projections in the November 2020 *Monetary Policy Report*.
(b) Unless otherwise stated, the projections shown in this section are conditioned on: Bank Rate following a path implied by market yields; the Term Funding Scheme and Term Funding Scheme with additional incentives for Small and Medium-sized Enterprises; the Recommendations of the Financial Policy Committee and the current regulatory plans of the Prudential Regulation Authority; the Office for Budget Responsibility's assessment of the Government's tax and spending plans as set out in *Spending Review 2020*, updated to incorporate policy announcements made up to 4 January 2021; commodity prices following market paths for two quarters, then held flat; the sterling exchange rate remaining broadly flat; and the prevailing prices of a broad range of other assets, which embody market expectations of the future stocks of purchased gilts and corporate bonds. The main assumptions are set out in the 'Download the chart slides and data' link at *Monetary Policy Report* – February 2021.
(c) Four-quarter growth in real GDP. The growth rates reported in the table exclude the backcast for GDP. Including the backcast 2021 Q1 growth is -9.2%, 2022 Q1 growth is 14.2%, 2023 Q1 growth is 1.3% and 2024 Q1 growth is 1.3%.
(d) Four-quarter inflation rate.
(e) Per cent of potential GDP. A negative figure implies output is below potential and a positive figure that it is above.
(f) Per cent. The path for Bank Rate implied by forward market interest rates. The curves are based on overnight index swap rates.