4 August 2016

FX Strategy

UK Economic Comment

National Australia Bank

Bank Rate cut by 25bp to 0.25%

- **UK GDP forecast for 2017 slashed by 1.5% to just 0.8%; the biggest ever downward revision. GDP growth in 2018 is cut from 2.3% to 1.8% with zero growth expected in H2 2016**
- **After 87 months at 0.50%, Bank Rate is cut by 25bp to 0.25%**
- **Existing £375bn Asset Purchase Programme is expanded by £60bn plus £10bn of corporate bond purchases**
- **A Term Funding Scheme (TFS) is introduced to reinforce the pass-through of the cut in Bank Rate**
- **Measures called "comprehensive, coherent and timely"**

Having forewarned three weeks ago that there would have to be a "muscular" monetary policy response to the economic threat posed by the June 23rd EU referendum result, the Bank of England Monetary Policy Committee today delivered a package of measures designed to support the economy as it transitions towards new arrangements with the European Union. There was certainly a danger of over-promising then under-delivering but the MPC's response, designed in conjunction with the FPC and PRA, appears a very positive, well-crafted and internally consistent set of monetary measures designed to help mitigate the expected near and medium-term downturn in the economy.

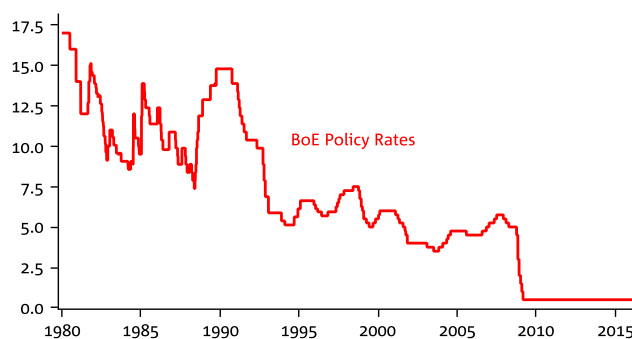
Table 1: Revised Bank of England Economic Projections

	Projections			
	2016	2017	2018	
GDP(b)	2.0 (2.0)	0.8 (2.3)	1.8 (2.3)	
Excluding backcast	*1.8 (1.9)*	*0.8 (2.3)*	*1.8 (2.3)*	
	2016 Q3	2017 Q3	2018 Q3	2019 Q3
CPI Inflation(c)	0.8 (0.8)	1.9 (1.5)	2.4 (2.1)	2.4
LFS unemployment rate	5.0 (5.1)	5.4 (4.9)	5.6 (4.9)	5.3
Bank Rate(d)	0.3 (0.4)	0.1 (0.5)	0.1 (0.6)	0.2

The Bank of England has taken an axe to its forecast of UK economic growth in 2017, slashing it from 2.3% to just 0.8%. For the near-term, "weakness in demand is likely to open up a margin of spare capacity, including an eventual rise in unemployment. Consistent with this, recent surveys of business activity, confidence and optimism suggest that the United Kingdom is likely to see little growth in GDP in the second half of the year".

On inflation, the sterling Trade-Weighted Index is around 10% lower than the path assumed in the last Quarterly Inflation Report, and around 15% below its peak in November 2015. Those large falls in sterling are expected to push up UK import prices, which will be passed through to consumer prices in coming years. CPI in 12 months' time is revised up by 0.4% to 1.9% and on a 2 year horizon by 0.3% to 2.4%. New forecasts for Q3 2019 show CPI at 2.4%; still above the Bank's 2% inflation target.

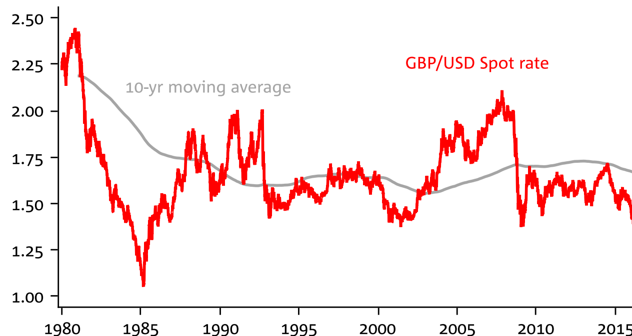
Chart 1: Bank Rate cut to 0.25% after 87 months at 0.50%



Source: National Australia Bank, Macrobond

Just as in GFC when a sharp fall in the exchange rate led to a sharp pick-up in inflation to a peak of 5.2%, the Bank of England now has flexibility in its remit allowing it to look through a temporary rise in inflation if it believes the near-term costs of lost output and employment are too great. Expectations of weaker GDP growth and higher inflation now present a similar policy challenge. Today's QIR notes, "Given the extent of the likely weakness in demand relative to supply, the MPC judges it appropriate to provide additional stimulus to the economy, thereby reducing the amount of spare capacity at the cost of a temporary period of above-target inflation."

Chart 2: GBP/USD exchange rate at 30-year low



Source: National Australia Bank, Macrobond

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For financial markets, the key points to note are that the Bank fully intends to use all the flexibility and tools it has at its disposal. It was clear from Governor Carney's Press Conference that there is no explicit target for the exchange rate and that there was no particular level which would cause him discomfort. Indeed, the Financial Stability Report published 4 weeks ago had a special feature on the risks associated with the UK's current account deficit and how a fall in the external value of the pound would help mitigate these. This is essentially the same script as followed by his predecessor Lord Mervyn King. We'd note that whilst GBP/USD is some 30 cents below its 10 year average, it is still 30 cents *above* its all-time low. Against the euro, meantime, a current rate of GBP/EUR1.17 is more than 15% above its GFC-low. The pound has a long way to fall before it could be considered to be in 'crisis' territory.

On Bank Rate, the new rate of 0.25% is the lowest in the BoE's 322 year history but is unlikely to mark the low point of this renewed easing cycle. As the QIR noted, "If the incoming data prove broadly consistent with the August Inflation Report forecast, a majority of members expect to support a further cut in Bank Rate to its effective lower bound at one of the MPC's forthcoming meetings during the course of the year. The MPC currently judges this bound to be close to, but a little above, zero".

In the Press Conference, Governor Carney went out of his way to stress – and repeat – that he would not be voting for negative interest rates, a view echoed by Deputy Governor Ben Broadbent. Much discussion surrounded the effective bound for monetary policy but we could reasonably expect another 15bp off Bank Rate from current levels.

Indeed, "The MPC can act further along each of the dimensions of the package by lowering Bank Rate, by expanding the TFS to reinforce the monetary transmission mechanism, and by expanding the scale or variety of asset purchases." Bear in mind that a Bank Rate cut is likely to be delivered *even if* the economic forecasts materialise. Should incoming data disappoint on the downside then the MPC has scope - and intent - to provide an aggressive policy response with the fresh tools in its box.

In summary, we'd say the Bank of England over-promised in its haste but then managed to over-deliver in its response. It is a cleverly crafted package of measures which should mitigate the worst of the medium-term shock on the UK economy. The prospect of further monetary easing should keep the GBP under pressure, especially if, as we believe, even its newly-downgraded economic forecasts for H2 2016 prove to be somewhat over-optimistic.

Table 2: BoE's four key economic judgments and likely developments if these evolve as expected

Key judgement	Likely developments in 2016 Q3 to 2017 Q1 if judgements evolve as expected
1: a period of heightened uncertainty and weakness in property markets weighs on private domestic demand	• Business investment is projected to fall by around 1¾% a quarter, on average, reflecting the impact of post-referendum uncertainty. • A slowing in real income growth leads quarterly consumption growth to slow gradually to around ¼% in 2017 Q1. • Credit spreads to increase slightly. • Mortgage approvals for house purchase to be 56,000 a month, on average. • Quarterly growth in housing investment to average -1%. • The average of the Halifax and Nationwide price indices is expected to decline a little over the next year.
2: potential supply growth remains well below past average rates	• Quarterly growth in hourly productivity of around ¼%. • Participation rate to remain around 63½%. • Average hours to fall by ¾% in the year to 2017 Q1. • Unemployment starts to rise from its current trough, reaching just over 5% by 2017 Q1.
3: the fall in sterling leads to a narrowing in the current account deficit against a backdrop of modest global demand growth	• Quarterly euro-area growth to average around ¼%. • Annual euro-area HICP inflation to increase in the coming months as past falls in oil prices drop out of the annual calculation. • Quarterly US GDP growth to average a little above ½%. • Annual US PCE inflation to pick up in coming months, averaging a little below 1½%. • Indicators of activity consistent with four-quarter PPP-weighted emerging market economy growth of around 4¼%; within that, Chinese GDP growth to average around 6½%. • Net trade contributes positively to real GDP growth. • The current account deficit narrows to around 5% by early 2017.
4: domestic cost pressures remain soft but higher import prices take inflation back to the 2% target then somewhat above it	• Weak productivity growth means that four-quarter growth in whole-economy unit labour costs reaches 2¼% by the turn of the year. • Commodity prices and sterling ERI to evolve in line with the conditioning assumptions set out in www.bankofengland.co.uk/publications/Documents/inflationreport/2016/augca.pdf. • Domestic gas and electricity prices are unchanged in 2016. • Four-quarter AWE growth remains around 2¾% at the turn of the year. • Non-fuel import prices to rise by 6% in the year to 2017 Q1. • Indicators of inflation expectations continue to be broadly consistent with the 2% target.

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