January 30, 2020

BoE: A Dovish Start to a Long Hold

- **The Bank of England's Monetary Policy Committee (MPC) held the Bank Rate unchanged today in a 7-2 vote that belied recent dovish signals from MPC Members. Nevertheless, the Bank softened its growth forecasts and its forward guidance.**
- **Going forward, we expect new fiscal stimulus in the Johnson Administration's March 11 budget and resurgent Brexit-related uncertainty as UK-EU trade talks unfold to counterbalance once another and keep the BoE on hold over our forecast horizon unless inflation slows appreciably or the European and global economies sputter further.**

A DOVISH HOLD AT GOV. CARNEY'S LAST MEETING

The Bank of England's (BoE) Monetary Policy Committee (MPC) voted 7-2 to hold its Bank Rate unchanged at 0.75%, accompanied by unanimous decisions to hold its stock of asset purchases at existing levels. The decision was much more clearly cut than markets had anticipated (chart 1) and delivered a marginal tightening to financial conditions that has added support to the GBP despite the Bank's delivery of weaker economic forecasts and more dovish forward guidance.

The MPC's *Summary and Minutes*, as well as the ensuing press conference made it clear that improving post-election business sentiment trumped recent soft data prints in the MPC Members' deliberations. Dovish comments in mid-January from Governor Carney and MPC Members Vlieghe and Tenreyro implied that downside surprises in pre-election macroeconomic data from Q4-2019 would move them to join Members Haskel and Saunders in voting for a cut at this meeting. In the end, MPC Members prioritized the recent uptick in post-election business optimism captured in January's purchasing manager indices (PMIs), noting that it had improved "quite markedly in some cases", over the softness in actual data.

For some journalists at the press conference, this prioritizing of information recalled the "unreliability" of some of Gov. Carney's early communications at the BoE. In the past, Gov. Carney has argued that sentiment indicators, such as the purchasing managers' indices (PMIs), can be misleading during times of particular uncertainty, such as the present period. MPC Members Saunders and Haskel echoed this concern in their vote for a rate cut at this meeting, noting that expectations indicators haven't necessarily been a good predictor of economic activity (chart 2) and that downside risks remain prominent.

In defense of the MPC's decision, Gov. Carney argued that it reflects "less of a case of so far so good, and more a case of so far, good enough."

SOFTER FORECASTS, SOFTER FORWARD GUIDANCE

Today's MPC communications make clear, however, the outlook has shifted materially toward the bottom end of the "good enough" range. The *Monetary*

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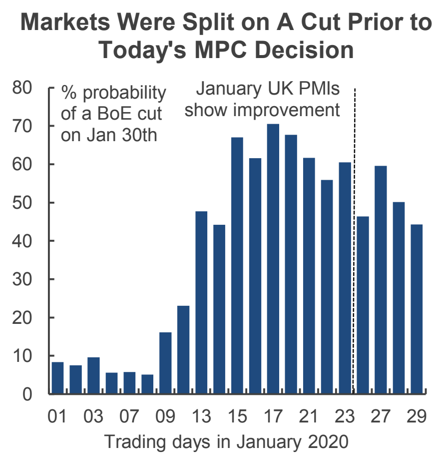
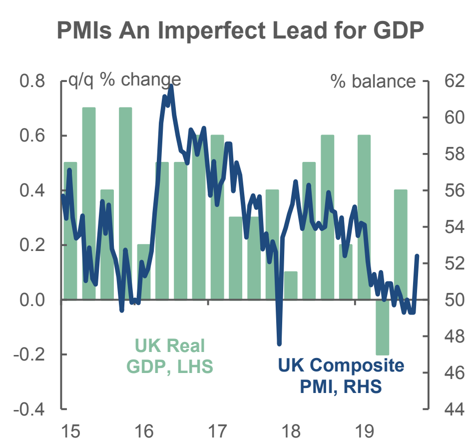
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, Markit, Bloomberg.

Policy Review (*MPR*) released today materially downgraded the BoE's forecasts for the UK's economy, with real GDP growth in 2020 sliced from 1.25% to 0.75% y/y, while the projections for 2021 and 2022 were both cut by a quarter-point (table 1). This represents the most sluggish growth performance since the global financial crisis. Inflation still does not get back up to the BoE's 2% target until 2021, even under the market's expectation that the BoE will deliver a rate cut during 2021.

Table 1

BoE November vs January MPR Forecasts

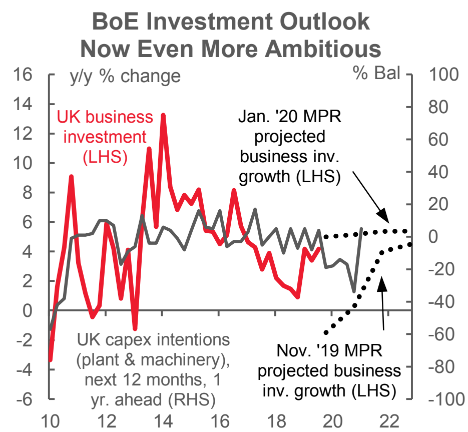
	2019		2020		2021		2022	
	Nov. '19	Jan. '20	Nov. '19	Jan. '20	Nov. '19	Jan. '20	Nov. '19	Jan. '20
Real GDP (% y/y)	1.3	1.3	1.3	0.8	1.8	1.5	2.0	1.8
CPI Inflation (% y/y)	1.5	1.5	1.5	1.5	2.0	2.0	2.3	2.3
LFS unemployment rate (%, eop)	4.0	3.8	4.0	4.0	3.8	3.8	3.5	3.5
Output gap (% potential GDP)*	-0.25	-0.25	-0.25	-0.50	0.50	0.25	1.00	0.50
Bank Rate (%, eop)**	0.70	…	0.50	0.60	0.50	0.50	0.50	0.50

Sources: Scotiabank Economics, BoE Monetary Policy Reports.
* +'ve = excess demand, -'ve = excess supply.
** The path for Bank Rate implied by forward market interest rates. The curves are based on overnight index swap rates.
Forecasts in Nov. '19 MPR are for Q4 of the respective year; forecasts in Jan. '20 MPR refer to Q1 of the respective year.

The *MPR*'s forecasts do not include the anticipated fiscal boost that the Johnson Government is expected to provide in its March 11 Budget because the Bank takes government policy as it currently exists when formulating its forecasts. As a result, the MPC may have taken the view that risks are to the upside on the Bank staff's forecast.

In contrast with other aspects of the outlook, the *MPR*'s investment forecast was reprofiled (chart 3), with stronger growth upfront in a reflection of the rise in post-election business optimism captured by the January PMIs. Nevertheless, the BoE's forecast still looks overly optimistic against UK business' capex intentions from the Confederation of British Industry's (CBI) most recent survey.

Chart 3



Sources: Scotiabank Economics, ONS, BoE Monetary Policy Report, CBI.

The one notable change to the MPC's *Summary* also tilted the Bank's forward guidance more dovishly. The MPC replaced reference to the need for "limited and gradual" interest-rate increases with an expectation of "some modest tightening" if the *MPR*'s growth projections are met. Gov. Carney clarified that "Things are gradual if they are multiple, and things are modest if they're not," implying that any future tightening cycle would be materially shorter than previously imagined. Instead, if the *MPR*'s outlook is not realized, the *Minutes* noted that, "Policy may need to reinforce the expected recovery in UK GDP growth should the more positive signals from recent indicators of global and domestic activity not be sustained or should indicators of domestic prices remain relatively weak." The coronavirus outbreak appears to have played little role in the MPC's view of the outlook at this stage.

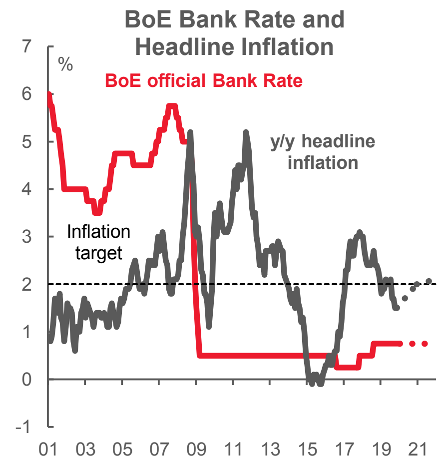
FISCAL STIMULUS & EU TRADE TALKS: COUNTERVAILING FORCES SHAPING THE OUTLOOK

Looking forward, prospects for the UK economy and the BoE's monetary-policy process will likely be guided by the extent to which the Johnson Government delivers on its election platform promises to increase spending materially while also achieving a comprehensive trade deal by end-2020 to ensure continued frictionless trade with the European Union. As noted above, since the Bank takes government policy as it exists, not as it might be, additionally fiscal stimulus is not reflected in its projections, but a smooth transition to a future trading relationship with the EU in 2021 is.

Substantial possible fiscal support augurs against any future rate cuts. The Conservative election manifesto outlined plans to boost fiscal stimulus by about 0.2% of GDP by end-2022 and loosen fiscal rules sufficiently to allow another 1% of GDP in additional spending. There's little reason to expect that the Johnson Government won't follow through on these promises, particularly since its additional spending is likely to be targeted toward areas in the English North and Midlands where the party stole seats from Labour in the December election.

Leaning against a rate hike any time soon, it remains highly unlikely that the UK will come close to achieving a deal with Brussels by end-2020 that secures ongoing frictionless trade in goods and services with the European Union, as we argued in our Q1 *Global Outlook*. PM Johnson will have to compromise either on his deadline or on the degree to which access to the Common Market is preserved. Either way, Brexit uncertainty is likely to weigh again on business sentiment as 2020 progresses and dampen the effectiveness of the Johnson Government's fiscal efforts.

Chart 4



Sources: Scotiabank Economics, BoE, Bloomberg.

CUT WINDOW CLOSES, A LONG HOLD FROM HERE

The downside surprises in the Q4-2019 data released over the last few weeks opened a small window for the MPC's doves to argue for an interest-rate cut for insurance purposes. Now that they've passed this window without going through it, we expect that the countervailing forces of fiscal stimulus and resurgent Brexit uncertainty related to the UK-EU trade negotiations will keep the BoE on hold over our forecast horizon (chart 4) unless there is a material worsening in the European and global economies over the coming months or the UK's below-target inflation slows further.