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MIXED POLICY SIGNALS THREATEN TO UNDERMINE CONFIDENCE

Strategy and economics

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Following its August meeting, the Monetary Policy Committee (MPC) of the Bank of England (BoE) has announced three changes to policy. First, it has reduced Bank Rate from 0.5% to 0.25%, the first change since March 2009. Second, it has introduced additional quantitative easing (QE) of £70 billion. Third, the Bank has introduced a Term Funding Scheme. Clearly, the MPC felt it needed to be seen to be taking action, following the economic uncertainty created by the UK's EU referendum result. However, we think it is unlikely that these policy measures will have a significantly positive impact on activity. Indeed, through the implication that the economy is being hit harder by the Brexit vote than actually seems to be the case (or we judged likely), the MPC is risking sending a signal that will have detrimental consequences for growth. The contrary argument is that for the Bank to do nothing in the face of uncertainty would be unacceptable, and that such seeming indifference would also send the wrong signals. It could also be contended that the directly negative consequences of the new measures are unlikely to be substantial and therefore, that they are worth instituting even if the positive impact turns out to be limited. To reiterate, however, we believe that policy over-reaction risks eliciting a negative economic response, by suggesting to households that it would be better to undertake a precautionary reduction in spending and to companies that it would be prudent to postpone capital investment.

Even if you believe that Brexit will have a relatively severe impact on the economy over the period ahead, it is hard to understand why that outlook would be changed materially by the latest policy package. For instance, if investment programmes are put on hold as a result of uncertainty, it is unlikely they will be reinitiated simply because interest rates are fractionally lower or the BoE is buying corporate debt.

I have long been sceptical about efficacy of the QE programme. There is little evidence that it had a measurable impact on economic activity on the post-recession environment, although it is possible that in the early days it provided some reassurance vis-à-vis the availability of liquidity in the monetary system. In current circumstances, with gilt yields already exceptionally low and with demand for investment-grade corporate bonds very healthy, it is hard to understand what the beneficial impact will be of £60 billion of gilt purchases and £10 billion of investment-grade non-financial corporate bonds. Ironically, the BoE is likely to find it problematic sourcing £10bn of corporate bonds, even though the buying programme is to take place over a period of 18 months. The gilt purchases are due to take place over the coming six months. Both programmes are due to begin in the week beginning 8th August.

When looking at the structure of bond yields in the UK and other major markets, it is hard not to conclude that QE programmes have caused major market distortions. A fair-value level of gilt yields, which combines expected inflation and productivity growth rates, suggests a level of around 3.75% for 10-year gilts. Following the policy changes announced today, the 10-year yield fell to just 0.67% – which is one third of the 2% inflation rate that is targeted. While the adjustment to more normal (positive real) gilt yields may not take place for some while, when it does begin, it will be a painful process, and is likely to cause significant disruption in financial markets.

Interestingly, while the vote in favour of reducing interest rates was unanimous, three of the nine–member MPC voted against extending QE. Maybe they have similar concerns to those expressed above.

Through the Term Funding Scheme the BoE is aiming to provide funds to commercial banks at interest rates close to Bank Rate. This is designed to ensure the benefit of the 0.25% reduction in Bank Rate is passed on to borrowers. Of course, it is possible that Brexit uncertainty will cause banks to restrict the supply of credit to households and companies. However, it is too early to judge whether this is happening. Were it to happen, we see no reason why banks would change their assessment of the risks of lending simply because they have access to slightly cheaper funding. At the same time, there is no evidence to suggest that interest rates of 0.5% have been acting as a deterrent to borrowing – in fact, the prevailing evidence would lead to the opposite conclusion. Albeit the latest data are for June (and, therefore, largely pre-Brexit), the year-on-year growth in consumer credit of 10.3% is high – arguably, worryingly so.

Another adverse consequence of reducing interest rates could be that, notwithstanding the Term Funding Scheme, the further reduction in the structure of rates make lending less profitable and is thereby unhelpful to credit provision in the wider economy. On this score, there is marginal comfort in the apparent rejection by the Governor of introducing negative interest rates in the UK.

The evidence to date on the post-Brexit performance of the economy is equivocal, but largely reassuring. The negative response from the supply side of the economy, as evident in the sharp falls in the Purchasing Managers' Indices for activity in the manufacturing and services sector, was to be expected but should be treated with caution. While some economic disturbance was to be expected, following the Brexit shock, it is significantly too early to judge the likely extent and longevity of the impact.

Looking at data relating to consumer confidence and demand, the numbers are reassuring. While, according to the latest GfK confidence survey, there has been a dip in the positive balance of households saying they are more optimistic about the outlook for their finances over the next year, a reading of -1% is by no means worrying. More 'real' evidence on spending – as provided, for instance, by the weekly sales numbers published by John Lewis – show no obvious Brexit effect.

Of course, the MPC can point to the sharp reduction in growth forecasts for 2017 as justification for the easing package. Recent surveys suggest that economists have cut growth expectations for 2017 to an average 0.5% from 2.1% prior to the Brexit vote. However, it is evident that the spread of forecasts is very wide (from -1.3% to +1.5%), and we suspect that knee-jerk changes to forecasts have been too extreme. The MPC's forecast, published in the *Inflation Report* alongside the policy announcements, is that growth in 2017 will dip to 0.7% from 2.0% in 2016 (these projections are based on Bank Rate remaining at 0.25% and also on the Bank's assessment of the likely revisions to historic growth rates). We are more optimistic with regard to growth in 2017, based partly on what we anticipate will be a positive response from the corporate sector to the challenges posed by Brexit.

Consistent with its growth expectations, the MPC now expects the unemployment rate to rise over the remainder of this year to 5.1% from 4.9% currently, and then again in 2017 to 5.6%.

With regard to prices, the MPC has acknowledged that the recent fall in sterling is likely to lead temporarily to higher inflation. For the fourth quarter of this year, it is now looking for the annual rate of increase in the CPI to be 1.3%, compared to its May forecast of 1.0%. For the fourth quarter of next year, inflation is expected to be 2.0%, an increase from the previous forecast of 1.8%. We believe this understates inflation risks, given the decline in sterling.

While the MPC's forecasting track record is not strong, one observation can be made about the latest changes in its projections – and about the policy announcements that have been made – they are consistent with the dire forecasts for the performance of the economy it made prior to the referendum.

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