Boxed in by Brexit

Bank of England Post-Meeting Comment

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Summary

- As expected, the Bank of England MPC kept rates unchanged at 0.75%. There were no dissenters
- The forward guidance of a gradual rise in interest rates is now explicitly conditioned on the assumption that the economy is on a clear path to a smooth Brexit *and* some recovery in global growth
- The MPC also warned that the "entrenched uncertainty" regarding Brexit could lead to a period of below-potential growth in demand. That is yet another clue that the Bank of England isn't going to raise interest rates anytime soon
- While we stick to our forecast for no changes in Bank rate in 2019 and 2020 on the premise that the UK will eventually leave the European Union with a deal in place, the risk of a no-deal Brexit remains a sword of Damocles hanging over the UK economy

Entrenched uncertainties

As expected, the Bank of England MPC kept rates unchanged at 0.75%. There were no changes to the asset purchase facility either. Whilst the forward guidance that "*the Committee judges that increases in interest rates, at a gradual pace and to a limited extent, would be appropriate to return inflation sustainably to the 2% target*" has been left untouched, **it is now explicitly conditioned on the assumption that the economy is on a clear path to a smooth Brexit *and* that global growth recovers a bit**. These assumptions remain far-fetched, in our view.

The rest of the Monetary Policy Summary also read dovish. The MPC warned that the "*entrenched uncertainty*" regarding Brexit could lead to a period of below-potential growth in demand. This would reduce domestically generated inflationary pressures. This is new language, and it is unambiguously dovish. It is yet another clue that the Bank of England isn't going to raise interest rates anytime soon, even though the official line remains that the "*appropriate response of monetary policy will depend on the balance of the effects of Brexit on demand, supply and the sterling exchange rate.*"

While this change in language could of course be inspired by recent policy actions from the ECB and the Federal Reserve, we remain of the view that the Bank of England remains boxed in by Brexit. The passage of the Benn bill, which is designed to block the government from forcing through a no-deal Brexit on October 31, has allayed market fears of a no-deal Brexit and lifted the forward OIS curve. But if Prime Minister Johnson ups the ante once again, for instance by explicitly hinting that he might try break the law and force a no-deal Brexit, it is likely that market worries increase and that we could see a quick reversal in the forward OIS. **The Bank of England, meanwhile, can't do much else than standing by and watch how the political situation unfolds.**

Brexit, Brexit, and… Brexit?

The faith of the UK economy and by extent the Bank's monetary policy remains indeed highly dependent on Brexit. Whilst nothing is impossible in politics, and especially not in the UK, the odds remain against a quick deal with the EU.

The talk of the week is about a Northern Ireland-only solution to the backstop, and expectations of such a deal may build further in the coming weeks. A full NI-only backstop, which –and this is a simplification– leaves Northern Ireland in the Single Market and in the Customs Union, ticks all the boxes. The EU wouldn't necessarily object as it respects the integrity of the sacred four freedoms, whereas it does 'deliver Brexit' for most of the UK. But Prime Minister Johnson doesn't have the numbers in the House of Commons. He has already lost its majority, while it looks certain that the DUP and a number of Tory unionists would vote against such an agreement. This means that he needs the support of dozens of Labour MPs, which are probably much more interested in an election anyway. Moreover, a full NI-only backstop could open up routes to a relatively hard Brexit for the rest of the UK, which isn't in Labour's interest.

A failure to get a deal would require the Prime Minister to ask for an extension of Article 50 to avoid a no-deal Brexit on October 31. An election would then follow later in November or December. This remains our base case. We've described the latest Brexit developments and our views extensively in this Brexit outlook and in last week's Brexit update.

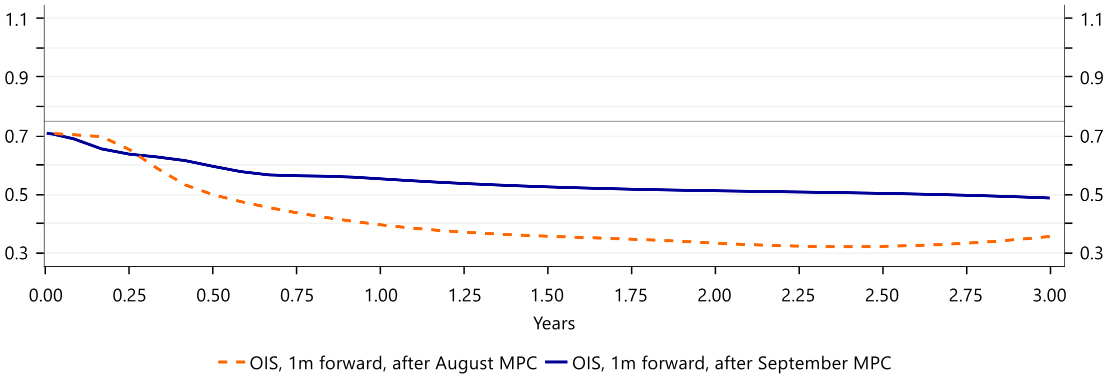
Outlook

The MPC's ambiguity leaves all the options open, but Governor Carney has already revealed that the sought balance between supply, demand, and the exchange rate following a no-deal Brexit is not "equally weighted". It is therefore likely that the MPC will cut rates back toward record lows in such a scenario. The changing external environment, with slowing growth and both the Fed and the ECB easing their policy stance, has surely contributed to this shift in balance.

But our base case regarding Brexit remains that there will be a third extension of Article 50, followed by a general election. But whoever replaces Prime Minister Johnson would potentially run into difficulties too, unless he/she is able to command a majority on a clearly defined type of Brexit. The curious strategy of Labour (win an election, renegotiate a deal with a EU, hold a referendum… and then campaign against that deal), shows that we're a long way from that still.

The damaging and "entrenched uncertainties" will therefore continue to cloud the outlook for the UK economy. It also means that economic forecasts are inherently uncertain. **It is however clear that the risk to the outlook for Bank rate is asymmetric**. While we stick to our forecast for no changes in Bank rate in 2019 and 2020 on the premise that the UK will eventually leave the EU with a deal in place, the risk of a no-deal Brexit remains a sword of Damocles hanging over the UK economy.

Figure 1: The MPC is losing its grip on the OIS curve



Source: Bloomberg, Macrobond

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