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UK UPDATE

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BANK OF ENGLAND'S AGGRESSIVE QUANTITATIVE EASING PACKAGE ADDS TO 2016'S DELUGE OF FOREIGN MONETARY STIMULUS

The Bank of England (BoE) aggressively eased monetary policy on August 4 to offset the June 23 Brexit referendum's headwinds. The BoE cut the bank rate from 0.50 percent to a new record low of 0.25 percent, and signaled that another bank rate cut to just above zero is likely in the fourth quarter of 2016. They also announced a package of quantitative easing and other unconventional monetary policy measures. They will increase their holdings of government bonds by £60 billion pounds and will buy up to £10 billion pounds of corporate bonds, increasing the BoE's total stock of asset purchases to £435 billion pounds. The BoE did not announce the rate at which it will make these purchases, but since its previous purchases were carried out at a £12-£17 billion pound per month rate, 8-10 percent of the UK's £1.9 trillion pound ($2.5 trillion US dollar) annual GDP, this program looks as aggressive as the Federal Reserve's QE3 or the European Central Bank's QE program. Finally, the BoE announced a Term Funding Scheme (TFS) to loan up to £100 billion pounds to British commercial banks at interest rates close to the bank rate, reducing pressure on British commercial banks' net interest margins (the profit margin between average deposit rates and average loan rates). This will reduce the Bank of England's concerns that further cuts in the bank rate might erode the British financial system's capital base and undermine financial stability. In this respect, the TFS makes it easier to trust that the BoE will keep monetary policy expansionary for as long as necessary to make the UK's economy recover.

The inflation and growth forecasts in the BoE's August *Inflation Report* justify their expansion of stimulus (See Chart 1). Compared to the prior *Inflation Report* released in May before the referendum, the August *Report* reduces the forecast for real GDP growth in 2017 and 2018 by 1.5 percentage points and 0.5 percentage points, respectively, to 0.8 percent and 1.8 percent, respectively. The *Inflation Report* raises the forecast for the UK's unemployment rate in third quarters of 2016, 2017, and 2018 by 0.1 percentage points, 0.5 percentage points, and 0.7 percentage points, respectively, to 5.1 percent, 5.4 percent, and 5.6 percent respectively. The BoE also raised its forecast for annual CPI inflation in the third quarters of 2017 and 2018 by 0.4 percentage points to 1.9 percent and by 0.3 percentage points to 2.4 percent, respectively, reflecting the pass-through of the weaker exchange rate to imported food, energy, and other costs in the British consumer basket. The BoE seems to be trying to avoid spooking skittish business managers and consumers by forecasting a "recession," and there are signs its forecasts are overly optimistic: The Markit/CIPS PMIs for the manufacturing, services, and construction

CHART 1: A RECESSION BY ANOTHER NAME IS NO LESS PAINFUL

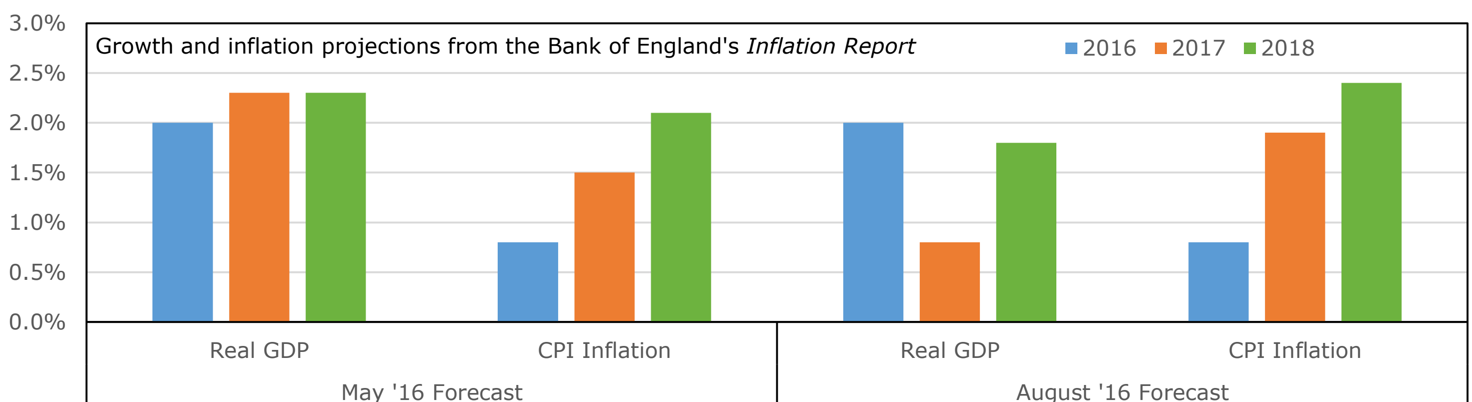

Chart sources: Bank of England *Inflation Report*, May 2016 and August 2016, The PNC Financial Services Group

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sectors were the weakest in July 2016 since March 2013, June 2009, and March 2009, respectively. Prior to the referendum, capital spending was already weakening. While little statistical data is available so far on Brexit's implications for real estate, construction, and home prices, the rush of investor redemptions that shut down several British real estate investment funds in July is a bad omen. Since the BoE's monetary stance, like the Federal Reserve's, is data dependent, a sharper downturn could compel the BoE to expand monetary stimulus further. PNC Economics' baseline forecast is for another cut in the bank rate to near zero in the fourth quarter of 2016, and for another round of quantitative easing (government and corporate bond purchases) in late 2016 or early 2017. If real estate prices make a widespread and significant decline, the BoE may expand monetary stimulus even more than that. While the BoE currently does not see negative interest rates as a policy option, they cannot be entirely ruled out if the British economic outlook deteriorates significantly.

The BoE's decisiveness stands in sharp contrast to the UK government's mixed messaging about implementing the referendum. Prior to it, Former Prime Minister David Cameron had pledged to formally initiate the UK's withdrawal from the EU if "leave" won; instead, he resigned the day after the vote. His replacement, Prime Minister Theresa May, opposed Brexit prior to the referendum. After it, she professes to plan to make it happen, but like Augustine of Hippo ("Give me chastity and continence, but not yet") is in no rush. PM May has stated that the UK government will wait until after the turn of the year at the earliest to activate Article 50 of the Treaty of Lisbon governing EU membership, which would start the two year countdown to the UK's withdrawal. The British public may become disenchanted with Brexit by early 2017, either because of a weakening economy, because pro-leave politicians have begun walking back campaign promises to increase spending on social services, or because the UK could lose its right to export services to the EU as a non-member. The UK's service exports to the EU account for 4 percent of British GDP. If so, Brexit could be delayed indefinitely – that is, permanently.

PNC Economics is revising down our forecast for the British exchange rate after the Bank of England's more-aggressive-than-expected easing in August. We now forecast for the UK's exchange rate to be $1.30 US dollar per pound sterling at year-end 2016 and $1.28 at year-end 2017, leaving the pound 3.75 percent weaker against the dollar at the end of 2017 than its $1.33 per pound rate before the BoE's August 3 monetary policy decision. Further depreciation of the pound will only modestly add to the drag on US net exports from the strong dollar, since US exports to the UK are only about 0.7 percent of US GDP. The Brexit referendum's more important effects on the US economy are the spillovers from the aggressive monetary easing that foreign central banks are announcing in response to it. In the six weeks following the referendum, in addition to the Bank of England's increase in monetary stimulus, the Bank of Japan eased monetary policy and signaled additional easing was likely in September, and the European Central Bank signaled an extension of its quantitative easing program would likely be announced in September as well. PNC Economics forecasts that the Reserve Bank of India, the Central Bank of Brazil, and possibly the Bank of Canada could reduce their benchmark interest rates in the fourth quarter of 2016. The spillovers of this renewed deluge of monetary stimulus outside of the United States are an important reason why US long-term interest rates are still extremely low in the second half of 2016, despite seven years of economic expansion which have returned the U.S. unemployment rate to below 5 percent (See chart 2). Spillovers from expansionary monetary policy overseas will continue to exert downward pressure on long-term US interest rates in late 2016 and 2017.

CHART 2: SPILLOVER FROM MONETARY STIMULUS OVERSEAS HELPS EXPLAIN EXTREMELY LOW US INTEREST RATES

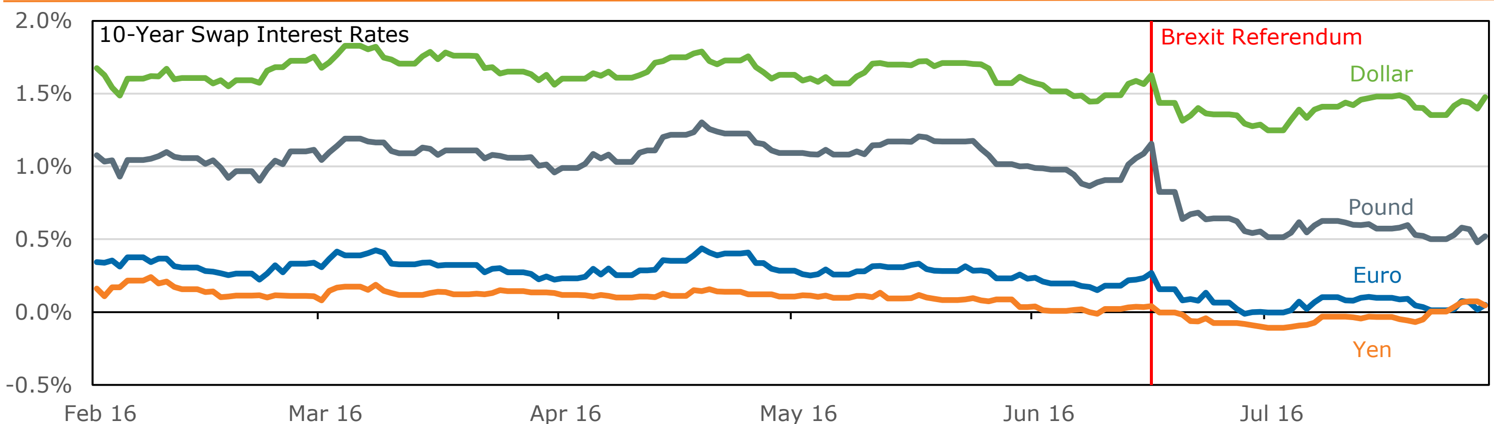

Chart sources: Bloomberg, The PNC Financial Services Group

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