BoE Watch

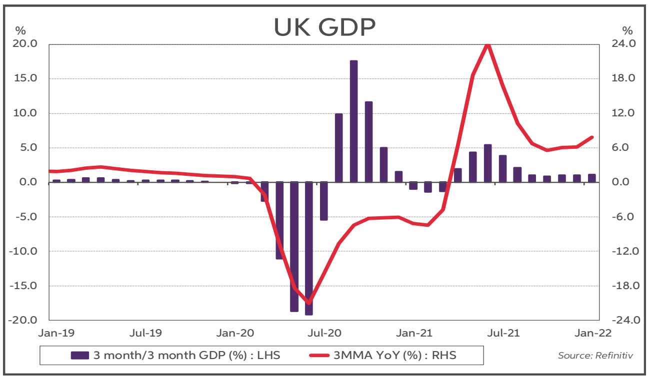
AIB Treasury Economic Research Unit

16th March 2022

BoE expected to continue on its tightening cycle

This week's meeting of the Bank of England Monetary Policy Committee (MPC) occurs against the backdrop of heightened uncertainty regarding the economic and inflationary outlook arising from the war in Ukraine, all of which adds an additional layer of complication to the policy deliberations. However, the MPC is widely expected to raise official rates by 25bps to 0.75%. This would mark the third consecutive meeting where the BoE has hiked rates. It commenced its tightening cycle in December when it raised its key Bank Rate by 15bps to 0.25%. This was then followed by a 25bps increase in February. Meanwhile, the Bank has also commenced quantitative tightening (QT) by ceasing to reinvest maturing assets and plans to consider actively selling bonds once the Bank Rate rises to at least 1%.

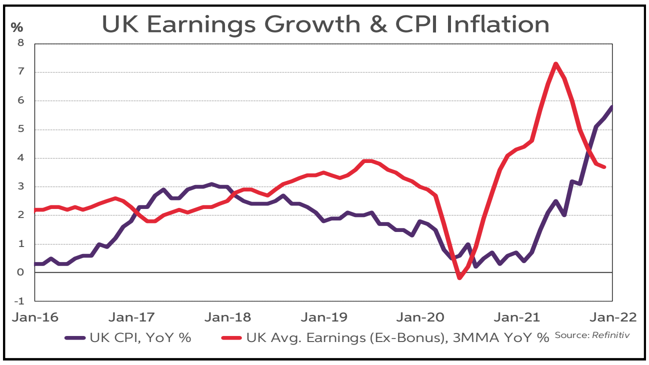
One noteworthy aspect of the February meeting was that four of the nine MPC members voted in favour of a 50bps rate hike. However, while a 50bps rate hike cannot be ruled out this week, the general consensus as mentioned above, against the more uncertain economic outlook, is for 25bps. MPC member, Michael Saunders, who was one of the four, stated recently that just because he had a preference for 50bps in February "does not necessarily imply" a similar preference for the next rate hike.



The MPC is likely to justify its decision to raise interest rates by referencing the current tightness in the labour market and the on-going signs of greater persistence of upward pressure on costs/prices from both domestic and international sources. The most recent data from the UK labour market, which the MPC will be assessing during its policy discussion, includes the unemployment rate falling to below 4% in the three months to January, very near to its pre-pandemic low of 3.8%. Meanwhile, data showing job vacancies rising to a new record high of 1.3m reflects the on-going strong demand for workers combined with reduced labour supply. The workforce was around 600k below its pre-pandemic level in December.

Meanwhile, since the BoE had its previous policy setting meeting, the inflationary outlook has deteriorated further amid the surge in global commodity prices following the Russian invasion of Ukraine. The BoE last updated its inflation forecasts in the Monetary Policy Report (MPR) for February. These projections showed that the BoE expected inflation to peak at 7.25% in April 2022. Meanwhile, it anticipated inflation averaging 5.75% in the fourth quarter of this year. Further out, it envisages inflation remaining above its 2% target in Q4' 2023, at 2.5% and just below 2% by the end of 2024. However, the risks to its near terms inflation forecasts are clearly to the upside, with many forecasters now expecting inflation to rise above 8%.

In terms of its growth projections for the UK economy, the BoE downgraded its GDP forecasts for the period 2022/23 in the February MPR. Its GDP growth forecast for this year was lowered to 3.75% from 5%. It foresees a major slowdown in the UK economy from next year. It is forecasting below trend growth of 1.25% and 1% in 2023 and 2024, respectively. The BoE commented that the main reason for the slowdown in growth is due to the negative impact on UK incomes and spending from higher global energy and tradable goods prices as well as tighter fiscal and monetary policy.



A key point of focus of markets from the March meeting will be what guidance is given by the BoE regarding the extent of rate hikes. Futures contracts indicate that the market is currently pricing in the Bank rate ending this year near to 2%, and it sees rates peaking at circa 2.3% in mid-2023. However, a number of MPC members have attempted to rein in market expectations. Deputy Governor Ramsden repeated the BoE's view that some further modest tightening would likely be warranted and he stated that "the word 'modest' is significant". Meanwhile, Governor Bailey in his recent appearance before the Treasury Select Committee commented that while there were differing views within the MPC on the pace of rate hikes, there was "not much difference" on the level rates would rise to.

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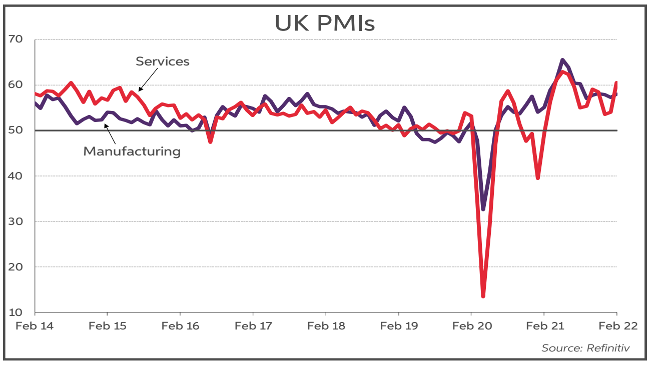
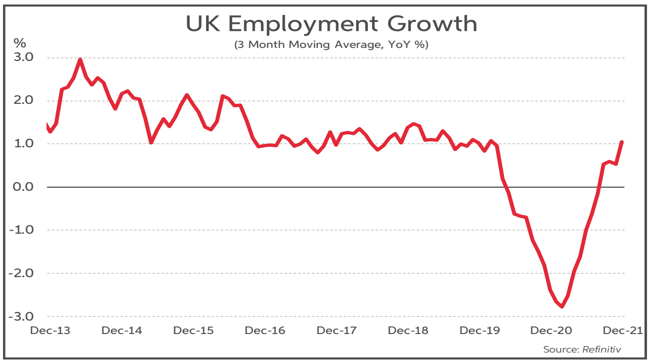
UK economy gathers steam, but faces headwinds

The economic recovery in the UK remained on track in the final quarter of 2021. GDP grew by 1% for the second quarter in-a-row in the three months to December, even as the UK grappled with the Delta and Omicron waves of Covid-19. Overall, the economy staged a robust rebound in 2021, expanding by 7.5%. However, this needs to be viewed in the context of the very sharp contraction in GDP, of 9.4% in 2020. As a result, UK GDP was still 0.4% below its pre-pandemic level in Q4. In contrast, the Eurozone was broadly in-line with its pre-Covid level, while the US economy was 3.2% above its pre-pandemic size.



Growth in Q4 was primarily driven by a 1.2% q/q increase in consumer spending, and a 0.9% rise in business investment. Government expenditure rose by 1.9% in the quarter, meaning it was roughly 10% above its pre-pandemic peak from Q4 2019. Meanwhile, net trade contributed 1.6 percentage points to growth, as imports fell by 1.5% and exports rose by 4.9% in Q4. However, in contrast to government spending, both imports and exports are well below their Q4 2019 levels, down 9.2% and 18%, respectively.

The available hard data suggest that the pace of economic activity increased at the start of 2022. The monthly reading of GDP shows that the economy grew by 0.8% in January, despite some restrictions remaining in place and still elevated levels of Covid-19 cases/self isolation caused by the Omicron wave of Covid-19. Retail sales rose by 1.9% in the month, the largest monthly increase since April 2021. Meanwhile, industrial production rose by 0.7% in January, boosted by a 0.8% increase in manufacturing output. Construction output jumped by a healthy 1.1% also. **Survey data suggest the economy maintained this momentum in February.** Both the manufacturing and services PMI remained firmly in expansion mode rising to 58 and 60.5. However, consumer confidence plummeted to –26 from –19, as the cost of living squeeze on household incomes weighed on sentiment.



Indeed, headline CPI edged higher in January, rising to 5.5%, from 5.4%. The core rate rose to 4.4% from 4.2% also. Inflation, which is already the furthest above the Bank of England's 2% target than at any point since it was adopted, is set to spike higher again in April, as Ofgem, the utilities regulator, has announced the cap on retail prices will rise by 54%. Furthermore, the ongoing war in Ukraine is placing even more upward pressure on energy and commodity prices. **The BoE has forecasted that CPI will peak at 7.25% in April, and will average 5.75% in 2022. However, more recently, most analysts have upped their inflation forecasts to peak above 8%, averaging close to 7% in 2022.**

Meanwhile, conditions in the UK labour market are very tight. The official jobless rate declined to 3.9% in January, its level just before the pandemic began in 2020. However, there are now roughly 600k fewer people in the labour force than in February 2020. The smaller pool of workers appears to be placing upward pressure on wages, although, the data remain distorted by the changing composition of the labour force.

Overall, despite a strong start to 2022, the UK economy is facing a number of headwinds which will have to be navigated carefully. The cost-of-living squeeze due to higher inflation and an increase in taxes will be accentuated by the war in Ukraine which will drive inflation even higher in the months ahead, and may result in Ofgem having to increase the consumer energy price cap once more in October. Conditions in the labour market are very tight also, increasing the risks of second-round inflation effects in the medium-term, resulting in more aggressive increases in interest rates. Fiscal policy is set to be less supportive this year also. UK exports are continuing to struggle from the double–hit of the pandemic and Brexit as well. **The latest IMF World Economic Outlook sees the economy expanding by 4.7% this year, and 2.3% next year. The BoE sees GDP rising by a more modest 3.75% this year, and 1.25% in 2023, before slowing to just 1% in 2024. Thus, growth is expected to slow markedly over the next few years.**

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