BoE Watch

AIB Treasury Economic Research Unit

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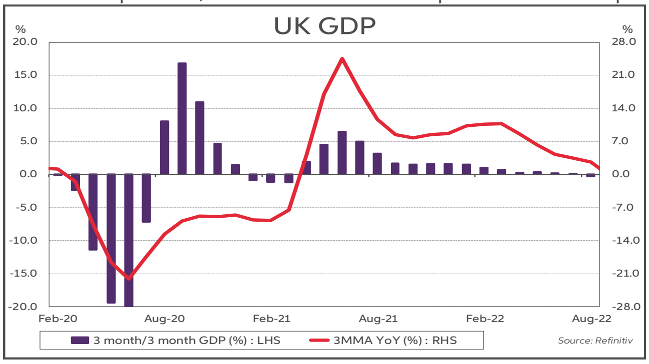
BoE hikes by 75bps, signals peak will be below expectations

The Bank of England's Monetary Policy Committee (MPC) meeting for November saw the Central Bank hike rates by 75bps. This brings the key Bank rate up to 3.0%. Monetary policy has now been tightened for an eighth consecutive meeting in the UK. It also represent a further acceleration in the pace of tightening following two 50bps rate increases in Q3, which compares to the more modest 25bps rate rises that were implemented over the period January to June. The voting breakdown, showed that seven members were in favour of the 75bps hike, while one member preferred a 25bps move and another favoured a 50bps rise.



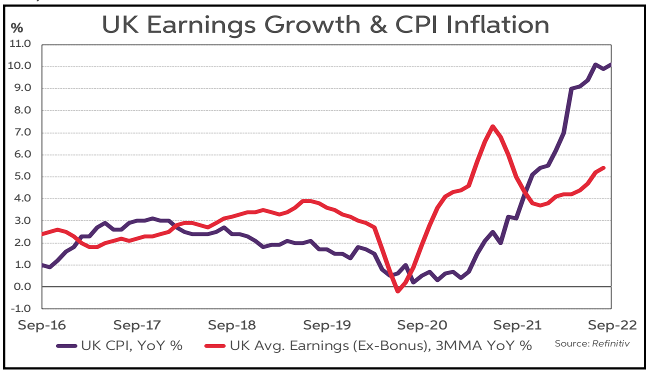
The meeting statement outlined the rationale for today's rate hike decision. The MPC noted that the labour market remains tight. At the same time, there have been continuing signs of firmer inflation in the domestic economy in terms of both prices and wages, which could be a sign of greater persistence in inflation dynamics. Overall, it assessed that a further front-loading of policy tightening was necessary to get inflation back to its 2% target over the medium term. **In the words of Governor Bailey "if we do not act forcefully now, it will be worse later on".**

Today also saw the release of the November Monetary Policy Report (MPR) which provides a detailed assessment of the BoE's view of the economic outlook. There was some added uncertainty for the BoE when it was preparing these forecasts, amid the raft of fiscal policy U-turns by the UK Government and associated market volatility, as well as the fact that the government pushed out the timing of its medium term fiscal statement from Oct 31st to November 17th. It is also important to note that these projections are based off market interest expectations, which at the time were pricing a peak Bank Rate of 5.25%.

In devising its growth forecasts it now assumes global energy prices follow futures contracts over the forecast horizon. For 2022, it has revised up its GDP forecast from 3.5% to 4.25%, largely due to upward revisions to earlier data. It expects the economy will contract by 1.5% next year and by 1% in 2024. In its first published GDP forecast for 2025, the BoE is expecting only modest growth of 0.5%.

Meanwhile on the inflation front, the BoE envisages it will peak at near to 11% in October. It anticipates a prolonged period of above target inflation. By the fourth quarter of next year, it is expecting inflation to have declined to 5.2%, before falling to 1.4% at end 2024 and 0% by end 2025. **In short, the BoE believes the UK economy would experience a severe recession over the period 2023-24, if it hiked rates to 5.25%, while inflation would fall to zero, well below its 2% target.**

However, in the press conference Governor Bailey gave clear guidance that the BoE does not envisage the Bank Rate rising to this extent. He stated that he thinks the Bank Rate will "have to go up by less than currently priced in financial markets". Indeed, the Bank highlighted that if rates were to remain at 3%, inflation would fall to 2.2% by Q4 2024 and to 0.8% in Q4 2025. **The BoE retains a tightening bias though.** This was reflected in the meeting minutes, with a majority of the MPC expecting that further increases in UK rates will likely be required as the balance of risks to its inflation forecasts is skewed to the upside.



UK interest rate markets have pared back somewhat further their peak rate expectations on the dovish soundings from the BoE today. Futures contracts are now implying rates topping out at 4.65% next year, down from 4.75% pre-meeting. Nearer term, the market continues to envisage Bank rate ending this year at 3.5%. **Meanwhile, the main market reaction from the BoE meeting has been in relation to sterling.** The currency has experienced a notable weakening, falling by between 1-2% on the exchanges. The GBP/USD rate which had been on a weakening trend since last night's Fed meeting has fallen below the $1.12 threshold. Meanwhile, the EUR/GBP pair is back above 87p.

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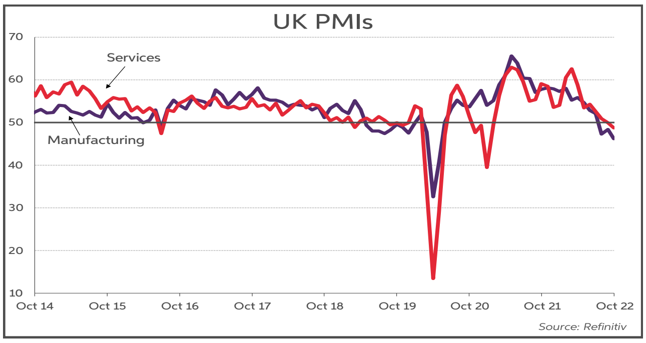
UK economy is heading into recession

UK GDP rose by 0.2% in the second quarter. However, growth in Q2 was negatively impacted by the double bank holiday weekend to celebrate the Queen's Platinum Jubilee. The underlying breakdown for Q2 showed that consumption rose by 0.1%. Government expenditure declined by 1.5%, as pandemic related spending continued to decrease. Fixed investment fell by 1.4%. Meanwhile, exports increased by 3.6% in Q2, while imports fell by 1.5%. Following revisions in the data for 2021 and 2020, UK GDP is now estimated to be 0.2% below its-pre-pandemic level at the end of Q2.



The monthly reading of GDP for July shows the economy grew by 0.2%, although, this was largely due to the unwinding of the Jubilee hit to growth. In August though, GDP fell by 0.3%, led by a 1.8% fall in output from consumer-facing service sectors, as the squeeze on real incomes intensified. Industrial production - which has yet to regain its pre-Covid level in the UK - declined by 1.8% in August also. Meanwhile, retail sales have declined in eight of the last nine months, including by a substantial 1.4% in September, a further indication that the cost of living squeeze is weighing heavily on households.

The latest available survey data are also trending lower. The manufacturing PMI fell into contraction territory in August, remained there in September, and deteriorated further to 46.2 in October. Similarly, the services PMI fell below the key 50 threshold for the first time since February 2021, to 48.8 in October. Consumer confidence is very weak also, at –47 in October, close to its all-time low of –49 from September.

In terms of inflation, headline CPI edged higher to 10.1% y/y in September. The core CPI rate rose to 6.5% as price pressures became more broad-based. However, the Government plan to cap household energy bills at £2,500 per annum will limit the rise in inflation over the winter months and into early next year. Indeed, coupled with the £400 household credit, the effective annual price cap for households will be £2,100 in 2022. However, newly appointed Chancellor Hunt has announced the energy price cap will only run in its current form until April before it is reviewed, instead of for the next two years as was initially planned. Overall, inflation is expected to rise sharply in October on higher energy bills, reaching a peak at close to 11%.

Labour market conditions remain very tight. The unemployment rate fell to 3.5% in the three months to August, 0.5 percentage points below its pre-pandemic level. Meanwhile, there are now roughly 320k fewer people in employment than before the pandemic struck. The smaller pool of workers is placing upward pressure on wages. Average earnings, excluding bonuses, were up 5.4% y/y in August.

Overall, the UK economy is facing a number of significant headwinds. The cost-of-living squeeze, due to higher inflation is weighing heavily on real incomes. Tighter monetary policy is also having an impact, with a two-year fixed mortgage rate rising at the fastest pace since 1995 in the first half of this year. Meanwhile, UK exports are continuing to struggle from the double–hit of the pandemic and Brexit. However, the Energy Price Guarantee (EPG), should help cushion the blow to households real incomes this winter. **Nevertheless, the BoE forecast a significant recession for the UK economy. GDP is projected to decline by between 1.0-1.5% in 2023, depending on the course of interest rates. It is expected fall again, albeit more modestly in 2024 as well.**

Longer-term, the UK economy has a number of challenges to deal with. Before the Global Financial Crisis, the UK had the second fastest productivity growth rate in the G7. However, between 2009-2019, it had the second lowest rate in the G7. Meanwhile, although UK debt-to-GDP remains below the G7 average, it has risen substantially over the past decade, to 99.6% in Q1 of this year. Borrowing costs for the UK Government have also risen sharply since the start of this year. Fiscal policy is set to be tightened significantly over the next number of years. The UK faces a widening balance of payments deficit also.

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