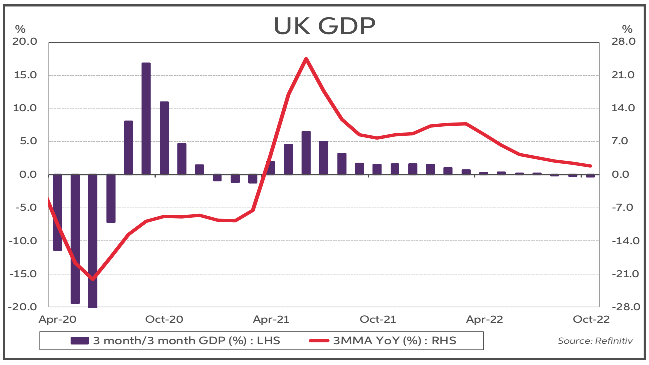
BoE Watch

AIB Treasury Economic Research Unit

15th December 2022

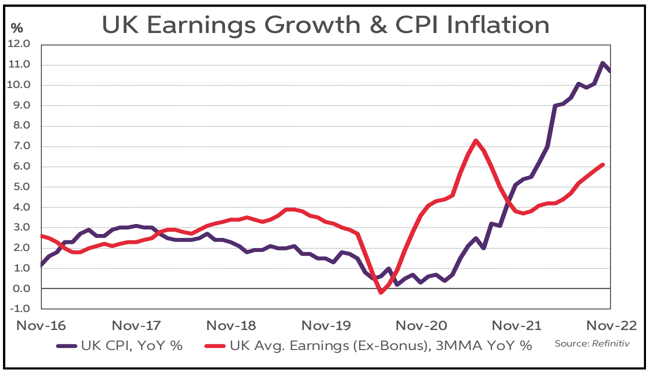
BoE, as expected, slows the pace of rate hikes

The final Bank of England Monetary Policy Committee (MPC) meeting of 2022 saw the Central Bank hike rates by 50bps. This brings the Bank rate up to 3.5%. Today's decision was in line with market expectations. It marks the ninth consecutive meeting where the BoE has raised rates. The latest increase represents a slowdown compared to the 75bps hike in November, which followed two 50bps increases in Q3. The BoE has now hiked rates by a total of 340bps since it commenced its current tightening cycle last December.



However, the voting breakdown showed that the MPC was split on its rate decision. Six members were in favour of the 50bps hike. They were of the view that conditions in the labour market remained tight and that there was evidence of upward pressures on both prices and wages in the domestic economy, justifying a "further forceful monetary policy response". Meanwhile, two members preferred to maintain rates at 3%, on the basis that the real economy remained weak, increasing signs that the downturn was starting to affect the labour market, as well as the fact that lag effects of previous rate hikes had still to come through. Finally, one member voted for a 75bps increase, noting that there were greater signs that price and wage pressures would "stay strong for longer" than had been assumed in the November Monetary Policy Report (MPR). In contrast, at the previous meeting, all members were in favour of raising rates.

This MPR contained the most recent detailed economic forecasts from the BoE. In the report it revised up its 2022 GDP forecast from 3.5% to 4.25%. It expected a contraction of 1.5% next year and 1% in 2024. For 2025, the BoE was expecting only modest growth of 0.5%. However, these projections were based off market interest expectations, which at the time were pricing a peak Bank Rate of 5.25%, something which Governor Bailey guided was not likely in the subsequent press conference. They were also published before the Autumn Statement, which outlined some changes to fiscal policy. **The BoE commented that there had been limited macro news both from a domestic and global economy perspective since the publication of the November MPR.** The BoE though now expects GDP to decline by 0.1% in Q4 of this year, versus its previous expectation for a 0.3% contraction. Meanwhile, it has assessed the impact of the near term fiscal supports that were announced in the Autumn Statement as well as the impact from the Energy Price Guarantee, but it did not update its GDP forecasts for 2023-25, which will be done in the February edition of its MPR. The BoE did indicate, though, that they could increase GDP by 0.4%, on a one year horizon, but leave it lower in three years time.



On the inflation front, in the November MPR, the BoE anticipated a prolonged period of above target inflation. By the fourth quarter of next year, it was expecting inflation to have declined to 5.2%, before falling to 1.4% at end 2024 and 0% by end 2025. It assessed that the overall impact on CPI inflation of the fiscal policy changes is "estimated to be small". However, it once again stated today that the risks surrounding its assumption of a declining path for inflation were "judged to be to the upside".

While the MPC was split on today's policy decision, the BoE does retain a tightening bias though. The meeting minutes noted that a majority of the MPC envisage that further increases in its key interest rate "may be required" in order to achieve a "sustainable return of inflation" to its 2% target. Although, unlike in November, it no longer stated that the peak in rates would be "lower than priced into financial markets".

In terms of market expectations, there has been a fair degree of volatility in UK futures contracts over recent months against the eventful fiscal/political backdrop. However, there has been a clear trend of a softening in market expectations of where UK official interest rates will peak, which at one stage was a high as 6%. Futures contracts are now implying rates topping out at near to 4.5% during the summer of 2023. This is around 5bps softer than what was priced in before today's rate announced and the release of the meeting statement/minutes. The market is not envisaging rate cuts to materialise in the UK until 2024-2025 and the extent of these reductions is expected to be circa 100bps in total.

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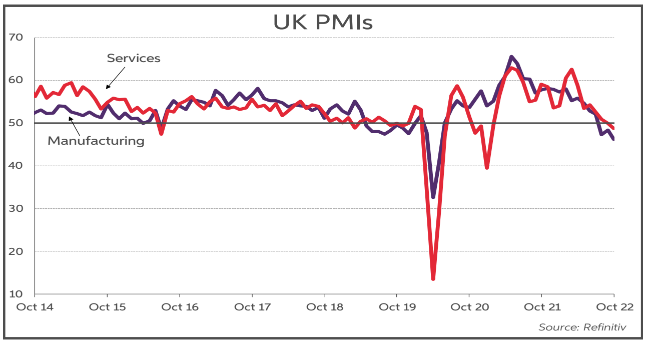
UK economy set to enter a recession



Having expanded by 0.7% and 0.2% in Q1 and Q2, respectively, UK GDP contracted by 0.2% in the Q3. However, the Q3 figure was negatively affected by a Bank Holiday to mark the Queen's funeral in September. The underlying breakdown for the quarter showed that household spending fell by 0.5% in Q3, subtracting 0.3% percentage points (p.p.) from growth. Government expenditure rose by 1.3%, contributing 0.3% to GDP. Meanwhile, investment jumped by 2.5%, adding 0.5 p.p. to the total. Net trade rose sharply, boosting output by 3.3 p.p., but this was more than offset by associated changes in the inventories and valuables components.

The monthly reading of GDP for October shows the economy grew by 0.5%, having declined by 0.6% in September, although, this was largely due to the unwinding of the impact of the Queen's funeral. GDP was also supported by a temporary rise in output in the health sector, from the rollout of Covid booster jabs. However, GDP was still 0.1% below its pre-pandemic level at the end of October. Industrial production, which has also yet to regain its pre-Covid level, was unchanged in October. Meanwhile, retail sales rebounded by 0.3% in October, having declined in eight of the previous nine months, including by a substantial 1.5% in September.

Survey data for Q4 suggest the economy is entering a recession. The manufacturing PMI fell into contraction territory in August, and has deteriorated further in October and November. Similarly, the services PMI fell below the key 50 threshold to 48.8 in October, and remained at that level in November. Consumer confidence is very weak also, at –44 in November, close to its all-time low of –49 from September. The BoE is forecasting a marginal decline of 0.1% in GDP in the final quarter of 2022.

In terms of inflation, headline CPI edged lower to 10.7% y/y in November from 11.1% in October. The core CPI rate also fell to 6.3% from 6.5%. Although the Energy Price Guarantee (EPG) and other government supports to cap household energy bills are due to expire in April, a recent fall in wholesale energy and commodity prices suggests inflation may have peaked in the UK. However, the BoE still expects inflation to remain elevated next year, running at 5.2% in Q4 2023 before falling to 1.4% in Q4 2024.

Despite the unemployment rate edging higher to 3.7% in the three months to October, conditions in the labour remain very tight. There are now roughly 300k fewer people in employment, and 413K less in the labour force than before the pandemic struck. The tight labour market is placing upward pressure on wages, with average earnings, excluding bonuses, up 6.1% y/y in October.

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. However, the EPG should help cushion the blow to household finances in the near-term. Nevertheless, the BoE estimates real post-tax household income will be 0.25% lower in 2022 and fall by 1.5% in 2023. Meanwhile, UK exports are continuing to struggle from the double–hit of the pandemic and Brexit, resulting in a widening balance of payments deficit. Fiscal policy is also set to be tightened significantly over the next number of years, which will act as an additional headwind to growth.

The BoE forecast a significant recession for the UK in its last set of forecasts, published in November. GDP is projected to decline by 1.0-1.5% in 2023, depending on the course of interest rates, with a further contraction of 0.5% in 2024. The OECD are forecasting a more modest 0.4% fall in GDP in 2023, and very weak growth of 0.2% in 2024. Longer-term, the UK economy faces a number of challenges, including arresting its low productivity growth rate post the 2009 Financial Crisis as well as weakness in the public finances.

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