Very uncertain period ahead for the UK

Even though growth in the UK economy has slowed a lot since the Brexit referendum vote in June 2016, the Bank of England pushed ahead with a rate increase at last week's meeting of its Monetary Policy Committee. The key Bank rate was raised by 25bps to 0.75%, its highest level since 2009.

While growth may have slowed, the unemployment rate has fallen to 4.2%, its lowest level since 1975. This has seen some pick-up in wage growth. Meanwhile, inflation remains above its 2% target rate. Thus, the Bank felt a rate increase was justified at the present time. Not surprisingly, given the uncertain economic backdrop, the decision has attracted some criticism.

However, the Bank of England Governor, Mark Carney, emphasised that any future rate increases are likely to be modest and at a gradual pace. He stated that monetary policy 'needs to walk, not run'. Futures contracts are pricing in another 25bps rate increase by mid-2019, with a further rate rise expected in 2020, which would take rates up to 1.25%.

The Governor also highlighted the uncertainty for the economy posed by Brexit. The Bank is forecasting that growth in the UK economy will pick up to around 1.75% in 2019 and 2020, However, this is based on the assumption of a relatively smooth Brexit when the UK departs the EU next March, which causes little disruption to the economy.

Uncertainty around Brexit, though, has grown over the summer. The expectation still is that the UK and EU will be able to finalise a withdrawal agreement by the end of the year that will allow for a soft Brexit next March. In particular, such an agreement is expected to provide for a transition period that would last until the end of 2020, which would largely maintain the current free trade arrangements. It is hoped that a new UK-EU free trade agreement can be put in place by the time the transition period expires at the end of 2020.

However, there is a growing risk of a no-deal, hard Brexit. First, wide differences remain between the UK and EU in the Brexit negotiations, so there is no guarantee that the two sides will be able to finalise a withdrawal agreement. Second, it will be a real challenge for the minority Conservative Government to get a withdrawal agreement through Parliament.

A withdrawal agreement is unlikely to be welcomed by either those who want to remain in the EU or those favouring a clean break, hard Brexit. Thus, the withdrawal agreement may have to fudge some issues so it can gain the support of the UK Parliament. If there is deadlock in Parliament on the issue, then one could not rule out a second referendum on Brexit.

Thus, a very uncertain period lies ahead. Sterling has weakened in recent months amidst growing concerns about Brexit. The euro has risen by around 3 pence since early summer, but support for sterling is holding at around the 89.5p level. The UK currency is likely to be further tested, though, by the difficult exit negotiations that lie ahead and the challenges of getting any withdrawal agreement through Parliament.

UK GDP data due at the end of this week are expected to show that the economy regained some momentum in the second quarter of the year. However, the growing uncertainty around Brexit could see growth slow again over the second half of the year and early part of 2019.

It is hardly surprising, then, that the Bank of England availed of the current window to hike rates as it could be some time before another opportunity presents itself to tighten policy.

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