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Economist's Weekly Market View

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UK Economy Running on Empty

Last week's Bank of England's Monetary Policy Report certainly caught people's attention. It lays bare the impact of soaring energy costs on the UK economy. Inflation is now seen peaking at an eye-watering 13% this autumn, up from the forecast in the Bank's previous Report in May of just above 10%. This reflects, in particular, the further very steep increase in the price of natural gas over the summer amid falling Russian exports of the product to Europe.

The hit to real household disposable incomes is substantial, with the Bank forecasting that they will decline by close to 4% during 2022-23. As a result, the Bank is now expecting a recession for the UK economy next year, with GDP projected to fall by between 1.0% and 1.5% in 2023, depending on the course of energy prices. Growth is expected to remain very subdued in 2024-25.

It is the surge in gas prices that is doing the real damage according to the BoE. Brent oil prices are expected to average close to $100 per barrel this year. This is high, but not that very far above their average of $78 per barrel for the period 2010-2019, or indeed, last year's level of $79 per barrel.

By contrast, wholesale gas prices in the UK are likely to average 420 pence per therm in 2002 according to the BoE. This is an eight fold increase on their level over the period 2010-20 when they averaged 52 pence per therm. The marked fall in the flow of gas from Russia to Europe and fears of a complete cessation in supply over the winter are responsible for the enormous surge in global gas prices.

The Bank acknowledges that the risks around its projections are exceptionally large at the present time and there is a range of plausible paths for the economy. Thus, it produced a number of alternative economic scenarios, but all show very high inflation in the near-term and a fall in GDP next year.

Inflation, though, is forecast to decline sharply over the medium term under all its scenarios from a combination of static or lower energy prices and recessionary conditions in the economy. Indeed, inflation is seen declining to below its 2% target by end 2024 and falling even further to under 1% in 2025. All this makes it very challenging for the BoE to set monetary policy at the present time.

The Bank rate was raised by 50bps at last week's meeting to 1.75%, representing an acceleration in the pace of tightening from the 25bps hikes seen since December. The Bank warned that policy is not on a pre-determined path and the 50bps hike does not imply that rates will now be raised in 50bps steps in forthcoming meetings.

Markets expect the Bank to raise rates to a peak of circa 3% by early next year. The peak could turn out to be higher or lower. The surprising thing, though, given the Bank's medium-term projections for growth and inflation, is that markets see rates being cut only modestly thereafter to a floor of 2.25% in 2024-25. Interest rates will go much lower by then if the Bank's economic projections are anyway close to the mark.

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