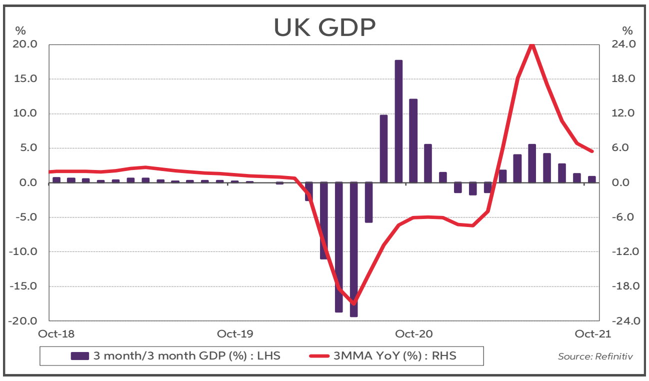
BoE Watch

AIB Treasury Economic Research Unit

16th December 2021

BoE surprises with a rate hike

In keeping with its recent trend of surprising markets, the December meeting of the Bank of England saw the central bank increase the Bank Rate by 15bps to 0.25%. The Monetary Policy Committee (MPC) voted by 8:1 in favour of the decision to raise rates.

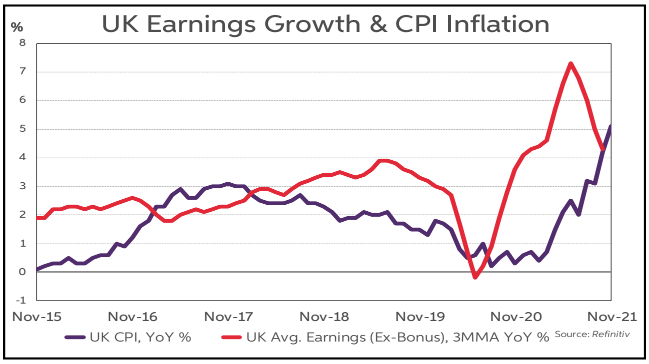


Expectations for a hike had firmed somewhat in recent days following CPI inflation hitting a ten-year high in November. However, the move by the BoE still caught the market off guard. This was evident in sterling rising sharply in the immediate aftermath. In level terms, the EUR/GBP rate fell from above 85p down into the lower half of the 84-85p band. The GBP/USD pair traded up from the midpoint of $1.32-1.33 into the upper half of $1.33-1.34.

The decision to hike the Bank Rate came despite the heightened level of uncertainty due to the Omicron variant. The MPC acknowledged these risks, however, it also noted that since March 2022 "successive waves of Covid appear to have had less impact on GDP". Meanwhile, in terms of the potential implications on inflation of the latest Covid-19 developments, it came to the conclusion that the balance of risks was unclear. On the one hand, the possibility of renewed social distancing meant that the improvements in supply side constraints could be delayed. On the other hand, demand in the economy could slow, thereby reducing inflationary pressures.

It justified its decision to raise interest rates by stating that the backdrop of, rising inflation, while at the same time the labour market continued to strengthen, meant that the conditions had been meet to warrant a tightening of policy. In terms of inflation, the BoE said there were some signs of a greater persistence in domestic cost and price pressures. It commented that the November headline CPI rate of 5.1% was 0.6 percentage points higher than it had expected at the time of its November Monetary Policy Report (MPR) projections. Compared to its assumptions made in November, it stated that there had been significant upside surprises in core goods and to a lesser extent in services price inflation.

The BoE now anticipates inflation will remain around 5% over the winter and peak at around 6% in April 2022. This represents an upward revision versus its previous expectation for inflation to peak at around 5% in April 2022 contained in the November MPR. The BoE still envisages CPI inflation falling back in the second half of 2022.



Meanwhile, in terms of its view on the labour market, it stated that there was "little sign" yet that the ending of the furlough scheme in September has led to a weakening in any of the key job metrics. It referenced that the unemployment rate had fallen to 4.2% in the three months to October, while payrolls data had continued to register healthy increases in November. It now expects the unemployment rate to fall to around 4% in Q4 this year in contrast to its 4.5% projection contained in the November MPR.

In summary, amid the continued upward pressure on inflation and the expectation that this will continue during the first half of next year, combined with the on-going tightening in the labour market, the BoE came to the conclusion that a rate hike was warranted to maintain price stability over the medium term. The MPC also put its decision in the context of the timelag between changes in monetary policy and the effects of this on inflation, including inflationary expectations.

Looking ahead to next year, the BoE retains a bias to hike rates further if necessary, reflected in its view that some modest tightening of policy was likely to be necessary to meet its 2% inflation target. Futures contracts suggest the market is not ruling out another increase at the BoE's next meeting in February with around 12bps being priced in at the moment. The market is anticipating around 75bps of tightening over the course of next year, which would bring the Bank rate to 1% by end-2022. The market anticipates that rates will level off at this level thereafter.

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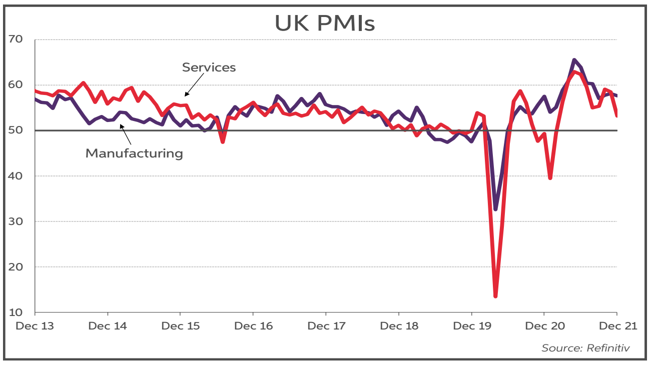
UK recovery running out of steam

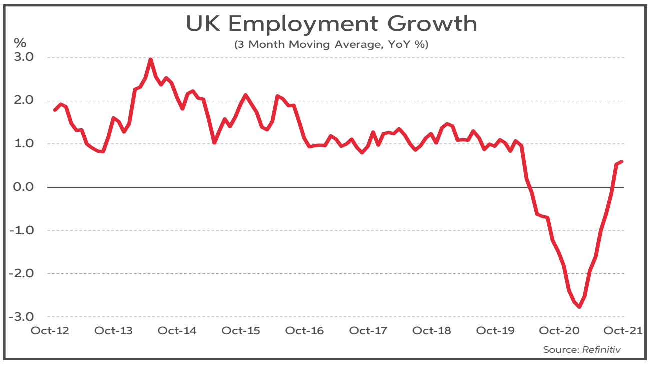
Having staged a robust rebound in Q2, growing by 5.5%, the UK economy expanded by just 1.3% in Q3. The Delta surge and continued supply chain shortages dampened the level of activity in the quarter. Regarding the underlying breakdown, household consumption rose by 2%, contributing 1.2 percentage points (p.p.) to growth. Government expenditure added 0.2 p.p. and investment contributed a further 0.7 p.p to the total. Net trade subtracted 1.2 p.p. from GDP, as imports rose and exports declined, although this was offset by a slight rise in inventories (+0.3 p.p.). Overall, the UK economy was 2.1% below its pre-pandemic peak at the end of 2019 in the third quarter.



Survey data for the fourth quarter suggest that the economy continued to expand in the three months to December. The services PMI remained well in expansion mode in Q4, averaging 56.9, up very slightly from 56.7 in Q3, consistent with a strong pace of growth in the sector. In December though, the PMI fell to 53.2, its lowest level since February. The manufacturing PMI has averaged 57.8 in Q4, below the 59.3 reading in Q3, but still consistent with a strong level of activity in the sector. However, firms continued to report increased problems in sourcing inputs and labour, as well as lower demand for exports as factors restricting the pace of growth throughout the fourth quarter.

The available hard data though, suggest that the economy regained very little momentum at the start of Q4. Industrial production declined for the second month in a row, falling by 0.5% in October as weak activity in the energy sector and the largest fall in construction since April (owing to shortages of raw materials), weighed on output. Meanwhile, retail sales increased by 0.8%, rising for the first time in six months in October. The monthly reading of GDP though, shows that the economy grew by just 0.1% in October. Worryingly, health output made the biggest contribution to GDP for the second month in-a-row, adding 0.3 p.p. to the total. Without it, the economy would have contracted.

However, conditions in the labour market have continued to improve. The conclusion of the furlough scheme at the end of September appears to have had only a very limited impact on the jobs market so far. Although, employment fell by 240k in October, the number of people unemployed rose by just 75k. Furthermore, the official jobless rate actually declined to 4.2% from 4.3%. The demand for workers remains elevated also, as the number of PAYE employees grew by 257k in November.



Supply pressures and base effects are continuing to contribute to a rapid rise in inflation. Headline CPI moved upwards in November once again, rising to a ten-year high of 5.1%, from 4.2%. The core rate rose to 4% from 3.4% also, and is currently at its highest level since July 1992. Inflation is set to remain elevated over the next few months, and is expected to spike higher again in April, with Ofgem, the utilities regulator, likely to raise customer prices in response to higher wholesale prices for energy.

Overall, despite robust growth earlier in the year, the recovery has lost momentum in Q3, and it has failed to regain steam so far in Q4. The emergence of the Omicron variant and the rapid rise in cases may lead to further restrictions being introduced, which could weigh on activity over the winter months. Furthermore, most of the supports which were kept in place beyond the initial full re-opening date have now been wound down. Shortages, particularly in the labour market, may also hinder the recovery, and some outstanding issues regarding Brexit, which has dampened trade, have yet to be fully resolved also. However, it should be noted that firms have become more resilient to the introduction of restrictions since the pandemic began, and consumers have adapted their spending patterns also. **The latest IMF World Economic Outlook sees the economy expanding by 6.8% this year and 5% next year.** Similarly, the BoE sees GDP rising by 7% this year, and 5% in 2022. However, both forecasts were made before the discovery of the Omicron variant of Covid-19.

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