BoE Watch

AIB Treasury Economic Research Unit

AIB

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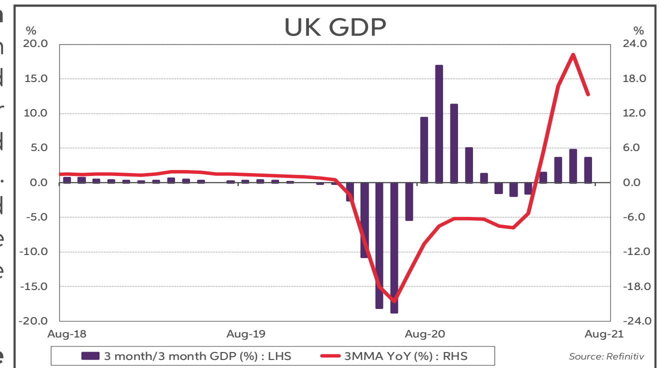
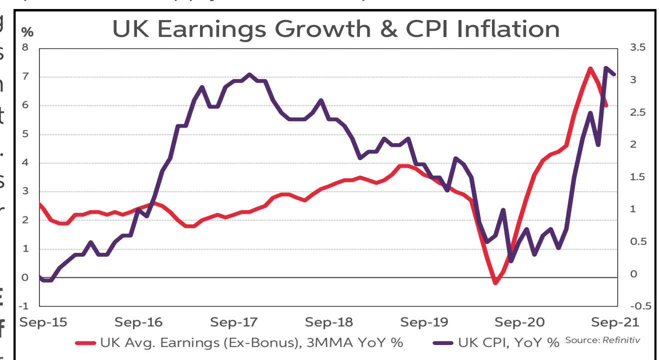
BoE fails to act on recent hawkish rhetoric

The November meeting of the Bank of England concluded with the Bank rate unexpectedly remaining unchanged at 0.1%. In the lead up to the meeting, market expectations had hardened on the prospect of near term rate hikes on the back of a number of hawkish comments from BoE Governor Bailey. This included him stating that the BoE "will have to act" to curb rising inflation. On top of this, no MPC member, including Governor Bailey, had sought to downplay market expectations of near term rate hikes. As a result, futures contracts had priced in a 15bps rate rise for this month's meeting.



Another surprise, was despite his hawkish comments, the Governor did not follow through by voting himself for a rate hike. The voting split was 7 to 2 in favour of no change, although in the press conference the Governor stated "it was a close call". The two members voting for a 15bps rate hike were Dave Ramsden and Michael Saunders. Meanwhile, as was the case at the three previous meetings, there was also disagreement regarding leaving QE unchanged. There was a 6-3 vote to leave the Gilt purchases at its current size, with three members voting to reduce the target stock of purchases from £875bn to £855bn. There were two votes to reduce purchases at the previous meeting. The minutes of today's meeting showed the majority of the MPC were of the view that there would be "value in waiting for additional information" on incoming labour market metrics before deciding on when to raise interest rates. This includes assessing the impact on the jobs market from the ending of the Government's furlough scheme. For two members, an immediate rate rise would reduce the risk of a need for abrupt tightening of policy and in turn the negative impact this could have on growth and employment.

Today's meeting also saw the release of the Bank's latest macroeconomic projections with the publication of the Monetary Policy Report (MPR) for November. There were downgrades to its growth forecasts for the period 2022/23 compared to the August MPR. These changes reflected the impact from supply chain disruptions as well as a more modest pick-up in consumer spending. It is now anticipating GDP growth for this year of 7% (from 7.25%). For 2022, it is anticipating growth of 5% (from 6%). Meantime, its expectation for 2023 growth was left unchanged at 1.5%, while its first release of a 2024 projection, has GDP growth slowing to 1%. The slowdown in growth envisaged over the period 2023-24 is in the context of growth easing back to pre-Covid rates, higher energy prices and the fading of monetary/fiscal stimulus.



In terms of its assessment of the inflationary outlook, the BoE revised higher its CPI projections amid the persistence of supply disruptions. Its 2021 forecast was revised slightly higher to 4.25% (from 4%). It now expects inflation to peak at around 5% in April 2022, noting that this was "materially higher" than had been expected in the August MPR. Meanwhile for the full year 2022, it now anticipates inflation averaging 3.5% (from 2.5%). Further out, it envisages inflation to be modestly above its target in 2023, at 2.25% (from 2%) and just below 2% by the end of 2024.

In conclusion, today's MPC meeting outcome was a major surprise for markets, which expected a rate hike in a large part, based off Governor's Bailey's hawkish remarks. However, the BoE did state that if incoming data was in line with its forecasts (contained in the November MPR), then it would be "necessary over the coming months to increase rates" to achieve its objective of returning inflation sustainably to a 2% target. Indeed, it referenced a number of times that a 1% Bank rate would be consistent with reaching its inflation target. Not surprisingly there were significant moves in futures contracts following today's meeting. At the moment, there is no rate hike priced in until February 2022. Meanwhile, the market is now envisaging rates getting to 1% by end 2022. Prior to the meeting, the market was pricing in the Bank Rate at 1.25% by the end of next year. Rates are now seen as remaining at the 1% level thereafter. Short-dated gilt yields fell by 20bps, with longer yields down 5-10bps. Meanwhile, sterling fell by close to 1%.

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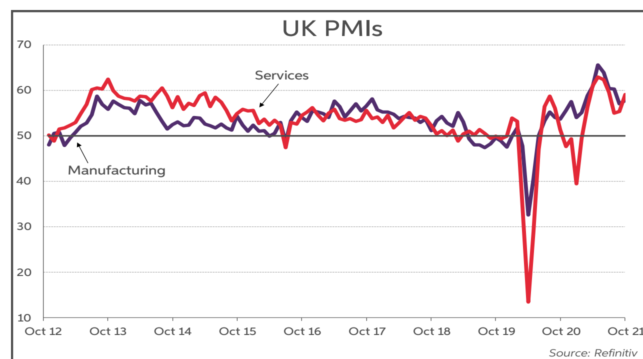
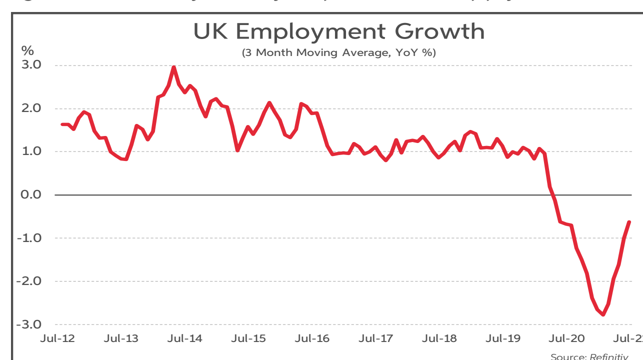
Marked slowdown in the recovery in Q3



The UK economy staged a robust rebound in Q2, growing by 5.5%. The quick pace of the vaccine rollout in the UK allowed for restrictions to be eased. However, it should be noted that the strong rebound was coming off a very low base. In 2020, the UK was one of the worst performing advanced economies, with output contracting by 9.7%. GDP declined by 1.4% in Q1 also, as the UK remained in lockdown. This means, that even with the strong rebound in Q2, the UK economy was still 3.3% below its pre-Covid level from Q4 2019.

Survey data for the third quarter indicate that the pace of growth slowed again in the three months to September. Although the services PMI remained well in expansion mode, it averaged 56.7 in Q3, down from 62.1 in Q2, consistent with a slower pace of growth. Similarly, the manufacturing PMI averaged 59.3 in Q3, below the 63.5 reading in Q2. Firms reported increased problems in sourcing inputs and labour, as well as lower demand for exports as factors restricting the pace of growth throughout the third quarter.

The available hard data for Q3 also suggest that the economy lost considerable momentum. Retail sales declined for the fifth consecutive month in September. This is the longest run of consecutive declines in retail sales since the series began in 1996, although, it should be noted, sales remain 4.2% above their pre-Covid peak. The monthly readings of GDP show that output declined in July by 0.1%, before rebounding by 0.4% in August. A surge in Covid-19 cases owing to the Delta variant and the associated "pingdemic" which forced more than one million people to self-isolate likely weighed on activity in July in particular. Supply constraints contributed to the slowdown in momentum also.



Meanwhile, conditions in the labour market have continued to improve. The jobless rate, which peaked at 5.2% in December, fell to 4.5% in August. The demand for workers remains elevated also, as the number of PAYE employees grew by 207k in September. However, the furlough scheme closed in September, with more than one million people still on the scheme at the start of the month. Nonetheless, the BoE believes that the unemployment rate will remain around 4.5% in the months ahead, owing to continued strong demand in the labour market.

Supply shortages and base effects are contributing to a rise in inflation. Headline CPI spiked higher in August, rising to 3.2%, its highest level in nine years. However, in September, CPI edged lower to 3.1%. Nevertheless, underlying price pressures are building. The core rate is at 2.9% currently. Inflation is set to continue to move higher as the year progresses, with utility prices due to rise by 12% in October. Indeed, the Bank of England is forecasting that inflation will rise to circa 4.5% by end year and peak at around 5% in April 2022. The rate is expected to fall to 3.4% by Q4 2022 and 2.2% in Q4 2023.

Overall, despite robust growth earlier in the year, there are clear signs the recovery has lost momentum in Q3. However, activity should pick up pace again in Q4, if as expected, Covid cases stabilise or fall back. Indeed, both the manufacturing and services PMIs moved higher in October for the first time since May.

The economy, still faces challenges though. Supports which were kept in place beyond the full re-opening date have now started to be wound down. Shortages, particularly in the labour market, may also hinder the recovery. It also remains unclear if the twin effects from the pandemic and Brexit have reduced the size of the UK workforce. Brexit may dampen trade and investment in the UK. Issues regarding the Northern Ireland Protocol have yet to be fully resolved. Furthermore, a host of tax hikes on workers and corporate profits are planned over the coming years, which may weigh on growth in the medium term.

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% next year, before slowing to 1.5% in 2023.

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