BoE Watch

AIB Treasury Economic Research Unit

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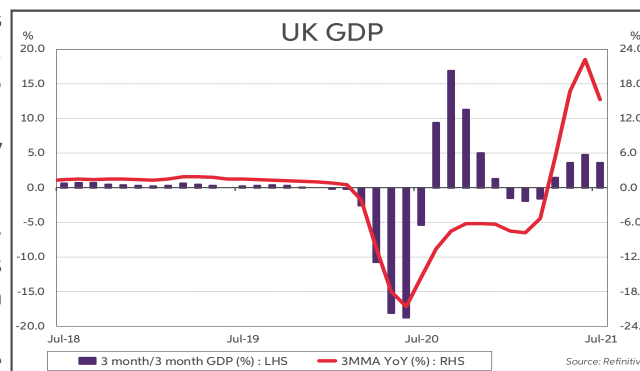
BoE on hold for now, but rate hike expected in early 2022

As expected, the September meeting of the Bank of England's Monetary Policy Committee (MPC) saw no changes to policy. The Bank Rate remains at its historic low of 0.1%. The MPC also left unaltered the size of its QE programme, at £895bn (£875bn in UK Gilts, £20bn in corporate bonds). **There was unanimity within the MPC on its decision in relation to interest rates.**

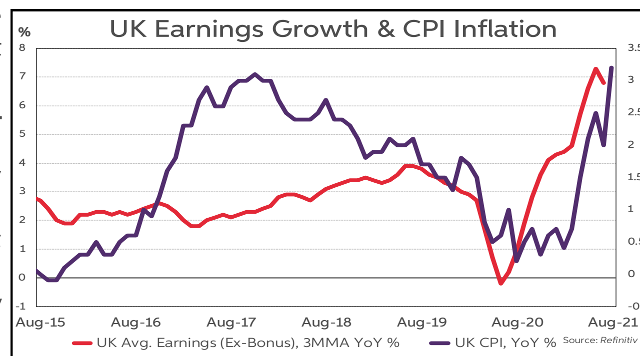


Meanwhile, as was the case at the two previous meetings, there was **disagreement regarding leaving QE unchanged.** There was a 7-2 vote to leave the Gilt purchases at its current size, **with two members voting to reduce the target stock of these purchases by £35bn to £840bn** - notably, there was just one vote to reduce purchases at the previous two meetings.

The MPC indicated at its August meeting that "some modest tightening of monetary policy" was likely over the forecast period to meet its inflation target. More recently, BoE Governor Bailey's appearance at the Treasury Select Committee struck a hawkish tone. He commented that the Monetary Policy Committee was evenly divided on whether the minimum conditions had been met to raise interest rates, while adding that he was among those who think they have. These comments helped to reinforce the market view that rates will start to rise next year in the UK, with futures contracts now pricing in the timing of the first hike by March.

The minutes of today's meeting show **that inflation is rising at a somewhat quicker than anticipated pace** and is now likely to breach 4% later this year, with some signs also that wage pressures are building as the labour market tightens. Against this, the Delta variant and associated rise in infection numbers in the UK have seen the pace of economic recovery slow markedly since mid-year. GDP rose by just 0.1% in July, with weak retail sales data for both July and August. The BoE indicated today that it has lowered its forecast for Q3 GDP by 1% since its August meeting.

The Bank of England faces a difficult balancing act with the recovery slowing, but inflationary pressures on the rise. In this regard, last month's Monetary Policy Report, containing the Bank's latest macroeconomic forecasts, showed significant upward revisions to its near-term inflation projections compared to May. **The CPI rate was seen rising to 4% in Q4 2021 compared to the previous forecast made in May of 2.5%. Today, the Bank indicated that inflation could rise slightly above the 4% level.** However, it repeated that it still believes the sharp rise in inflation will prove transitory. The BoE forecast from August is that inflation will fall to 2% by Q4 2023. However, **upside risks to inflation have increased and it may take longer to fall back than initially expected**.



Meanwhile, the MPC view, as set out in its August Report, is that the economy will grow strongly in 2021 and 2022, although today it acknowledged that growth will be weaker than expected in Q3 at circa 2%. The pace of growth is likely to slow sharply in 2023 as the boost from factors such as the very stimulatory stance of both fiscal and monetary policy and the rundown of household savings, wanes. The BoE forecast is for GDP growth of 1.5% in 2023.

In summary, the BoE still envisages that the UK economy will experience just a temporary period of well above-target CPI inflation, though it has risen more than expected. This increases the prospect that rates could be increased next year, with the **BoE noting the case for a modest tightening of monetary policy has strengthened since its last meeting. Futures contracts hardened after today's meeting, with the market expecting the first rate hike by next March and 50bps in total of rate increases now being priced in for 2022**. This would bring rates up to 0.6% by the end of next year. Rates are seen as rising by another 20bps by end 2023. They start to level out after that, no doubt reflecting the view that both economic activity and inflation should have returned to much more moderate growth paths by then. The BoE was a bit more hawkish today than markets expected, so gilt yields rose and sterling was slightly stronger.

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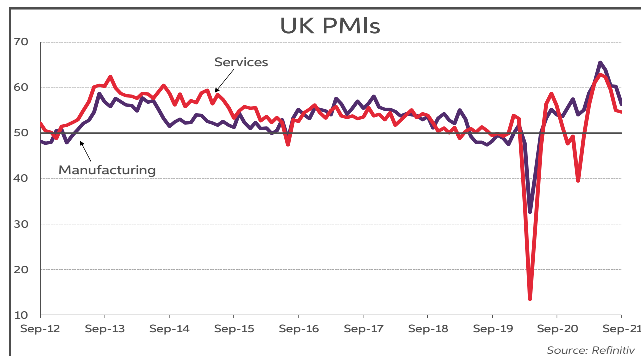
Recovery loses momentum in Q3

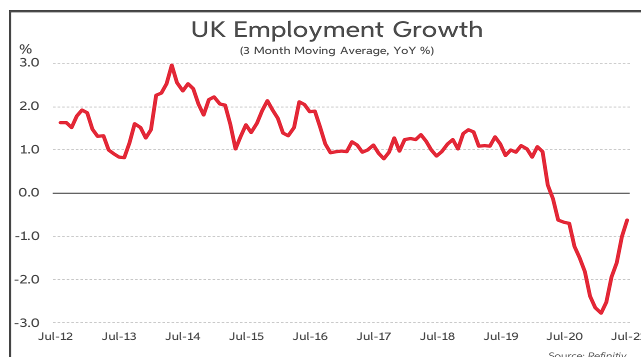
Having contracted by 1.6% in Q1, the UK economy rebounded strongly in the second quarter. GDP grew at a robust pace of 4.8% as most restrictions were eased. The underlying breakdown shows a sharp 7.3% rise in personal consumption, added 4.4 percentage points (p.p.) to growth. Government spending contributed a further 1.3 p.p. to the total. Meanwhile, net trade clipped 0.9 p.p. from output, as imports (+6.5%) outpaced exports (+3.0%). However, this allowed firms to replenish stocks, as inventories lifted output by 0.3 p.p.. Fixed investment though, declined by 0.5% in Q2, shaving 0.1 p.p. from GDP.



However, there are clear signs that the recovery has lost some momentum in Q3. GDP expanded by a measly 0.1% in July, as a rise in Covid cases weighed on activity. Worryingly, retail sales fell by 2.8% in July and by a further 0.9% in August. Indeed, retail sales have declined for the past four months. **Survey data also indicate that while the economy is continuing to rebound, the pace of growth has eased.** Both the services and manufacturing PMIs have declined in recent months, albeit they remain firmly in expansion mode. In Q3 for example, the manufacturing PMI averaged 59 compared to 63.5 in Q2. Likewise, the services PMI averaged 62.1 in the three months to June, but just 56.4 in the three months to September. Firms in both sectors report supply shortages in terms of parts and labour, which is hampering the recovery and may take time to resolve.

Supply shortages and base effects are leading to a surge in inflation. Headline CPI spiked higher in August, rising to 3.2%, its highest level in nine years, up from 2.0% in July. However, most of the increase in August was due to base effects from the “Eat-Out-to-Help-Out” initiative last year which resulted in restaurant prices falling by circa 6% last August. This August though, restaurant prices increased by 0.2%, lifting the year-on-year inflation rate to 7.9% from 1.7% in July, in the sector. Nevertheless, underlying price pressures are also building, and inflation is set to move higher as the year progresses. Utility prices are due to rise by 12% in October which will push inflation higher in Q4. Indeed, the Bank of England is already forecasting that inflation will rise slightly above 4% by the end of the year, but note that the rise will be transitory. Although, the risk is growing that inflation proves stickier than the BoE anticipates.

Meanwhile, conditions in the labour market have continued to improve. The unemployment rate, which peaked at 5.2% in December, fell to 4.6% in July. The claimant count fell by a further 59k in August also, and the number of PAYE Employees grew by 241k. However, labour shortages are intensifying. There were over one million vacancies in July, the highest level ever recorded. The demand for workers has placed further upward pressure on wages, which have already risen by more than anticipated recently. With the furlough scheme set to end in September the strong demand for labour should help limit the rise in unemployment. The August Monetary Policy Report showed the BoE believes that the unemployment rate has already peaked.



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. The economy, though still faces challenges. Supports which were kept in place beyond the full re-opening date are due to be wound down over the coming months, ending a recent tailwind to GDP. Shortages, particularly in the labour market, may also hinder the pace of growth. It also remains unclear if the twin effects from the pandemic and Brexit have reduced the size of the UK workforce, increasing the chance that vacancies will take longer to fill, and placing more upward pressure on wages. Brexit may dampen trade and investment in the UK over the medium term as well. Furthermore, a host of tax hikes, on workers incomes and corporate profits are planned over the coming years in order to counterbalance increased government spending. This could hinder growth in the UK in the years ahead. **The latest OECD update published this week sees the economy expanding by 6.7% this year and 5.2% next year, but growth is set to slow sharply from 2023 onwards.**

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