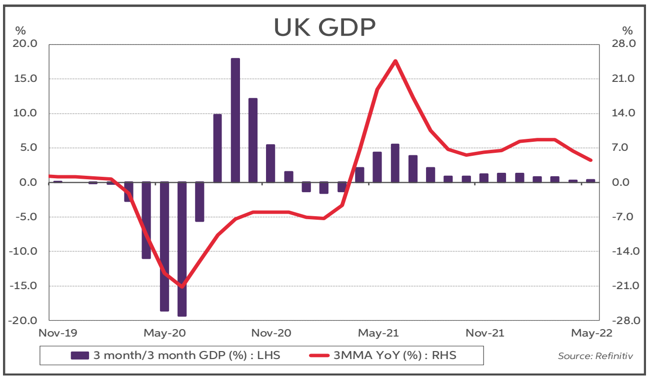
BoE Watch

AIB Treasury Economic Research Unit

4th August 2022

BoE hikes as expected by 50bps to 1.75%

The August meeting of the Bank of England's Monetary Policy Committee (MPC) saw the announcement of a further tightening of policy for a sixth consecutive meeting. The MPC increased the Bank Rate by 50bps to 1.75%, which represented an acceleration in its pace of tightening, from the 25bps increments it had implemented since December 2021. It was the first 50bps hike since 1995. The 50bps hike was in line with expectations following comments from Governor Bailey on this issue over recent weeks. The voting breakdown showed that eight MPC members were in favour, while one member (Tenreyro) preferred a 25bps rate increase.



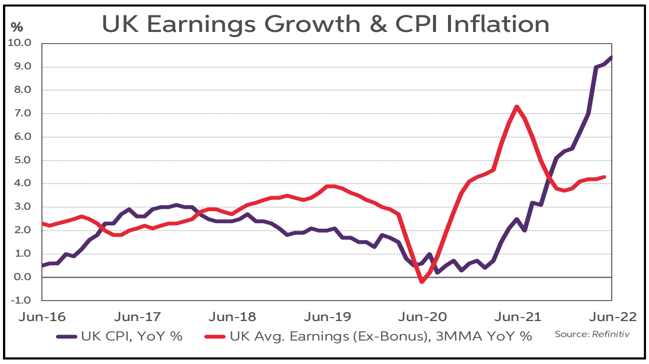
The meeting statement outlined the rationale for the 50bps hike. It noted that the "more forceful policy action" was against the backdrop of another jump in energy prices, as well as signs that there had been a more persistent and broadening of domestically sourced inflation. At the same time, the labour market remained tight. Overall, the MPC viewed that a faster pace of rate hikes would help it to met its 2% inflation target over the medium term and reduce the risks of a "more extended and costly" magnitude of rate hikes later.

The BoE provided a detailed assessment of its view of the inflationary and economic outlook in the August edition of its Monetary Policy Report (MPR). The report noted that the level of uncertainty around its projections was exceptionally high, with significant risks around its baseline assumptions. Therefore it emphasised that given this heightened uncertainty it was placing much less weight on its base case than previously and more attention should be focused on its alternative scenarios. Across all scenarios, the UK economy enters recession.

In terms of the baseline, which assumes global energy prices follow futures contracts until end year and remain unchanged thereafter, it is pencilling GDP growth of 3.5% this year (compared to 3.75% in the May MPR), with the economy expected to enter a recession in the fourth quarter. The BoE expects a contraction of 1.5% in 2023, followed by a more modest decline of 0.25% in 2024.

In its alternative scenario, where energy prices follow their futures curves throughout the forecast horizon, GDP is forecast to contract by 1.5% in the four quarters to Q3'2023. By comparison, its baseline scenario has GDP contracting by 2.1% over the same period. The BoE envisages GDP rising by 0.6% over the four quarters to Q3'24, where its baseline has the economy being flat over the same time period.

Meanwhile on the inflation front, the BoE has once again revised higher its peak inflation projection. It now expects inflation to reach a high of just over 13% by Q4 of this year. In the May MPR, it had the peak at close to 10%. The BoE commented that the main reason for this upward revision was due to higher than expected household energy prices that primarily arose from the significant further increase in wholesale gas prices. For next year, inflation is expected to decline but remain above target, with the BoE projecting a 5.5% rate in Q4'23. By the end of 2024, inflation is anticipated to have fallen below its target to 1.5% and is projected to decline even further to under 1% in 2025.



The BoE retains a hawkish bias, stating that it would take all necessary action to return inflation to its target. It emphasised that it remained especially alert to signs of more persistent inflationary pressures and "would if necessary act forcefully in response". However, it added a new line to its guidance today stating that "policy was not on a pre-set path". This could be interpreted as the BoE communicating that just because it hiked by 50bps today, does not mean that it will maintain this pace going forward. **In terms of these market expectations, futures contracts are pricing in around 100bps of tightening over the remaining three MPC meetings this year.** This would see the Bank rate end the year near to 2.75%. The market is envisaging that there may be a further small rise in rates in Q1 2023, but see them ending next year at just below 2.75%.

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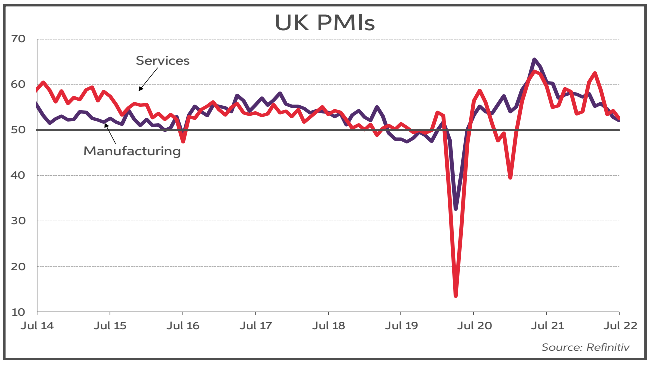
Risks rise of a UK recession in 2023



UK GDP rose by 0.8% in Q1, as COVID restrictions were eased at the start of the year. However, the growth was concentrated at the beginning of the quarter. Monthly data show output rose by 0.7% in January and stagnated in February, before contracting by 0.1% in March.

The available monthly readings of GDP in Q2 have been mixed. Output contracted by 0.2% in April, as a rebound in private sector activity was more than offset by a further decline in pandemic related health spending. Without the fall in Covid related expenditure though, GDP would have been +0.3%. Meanwhile, output jumped by 0.5% in May, as a sharp rise in industrial production offset weakness in the consumer sector. GDP data is expected to fall again in June though, as a result of the double Bank Holiday for the Queens' Platinum Jubilee. The BoE is forecasting a contraction of 0.2% in the quarter. Regarding some other hard data, retail sales fell by 1.2% in Q2, having declined by 1.5% in Q1.

The limited amount of survey data available for July suggest economic growth remained subdued. The manufacturing PMI declined to its lowest level since June 2020 in July, at 52.1, indicating that the recovery in the sector is slowing. Elsewhere, the services PMI fell to 52.6 from 54.3 in June, as business confidence continued to wane due to higher costs and concerns regarding the economic outlook. Consumer confidence is very weak also. It has moved sharply lower since the start of the war in Ukraine, and remained at an all-time low of –41 in July, as the cost of living squeeze hits real household disposable incomes.

In terms of inflation, headline CPI jumped to 9.4% y/y in June, its highest level in over 40 years. The core CPI rate edged slightly lower to 5.8% from 5.9%. However, price pressures are broad-based, with services prices up 5.2% y/y in June, their fastest annual rate since 1992. Inflation is set to spike higher again in Q4, as Ofgem is expected to sanction a further increase in the energy price cap in October. The BoE sees inflation rising to above 13% in October.

Labour market conditions are very tight. The unemployment rate remained at 3.8% in the three months to May, 0.2 percentage points below its pre -pandemic level. Meanwhile, job vacancies stood at a record 1.3m in Q2, although the pace of increase has slowed recently. However, there are now roughly 210k fewer people in employment than before the pandemic struck. The smaller pool of workers is placing upward pressure on wages. Average earnings, excluding bonuses, were up 4.3% y/y in May. Private sector wages were 5.3% higher y/y. Businesses responding to the BoE's Agents Survey noted they expect pay settlements to be much higher, at 4-6% this year compared to 2.5-3.5% in 2021, further evidence of the much higher wage growth this year.

Overall, the UK economy is facing a number of significant headwinds. The cost-of-living squeeze, due to an increase in taxes and higher inflation, is being accentuated by the war in Ukraine. As a result, the BoE estimates real household disposable incomes will drop by 1.5% in 2022 and 2.25% in 2023, the biggest fall since records began in the 1950's. Despite the recent government support package worth around £15bn, fiscal policy is set to be less supportive this year also. Tighter monetary policy is also starting to have an impact, with a two-year fixed mortgage rate rising at the fastest pace since 1995 in the first half of the year. Meanwhile, UK exports are continuing to struggle from the double–hit of the pandemic and Brexit, while tensions with the EU regarding the NI Protocol have flared up once again recently.

Indeed, the BoE is now forecasting a recession for the UK economy next year, with GDP projected to decline by between 1.0-1.5%, depending on the course of energy prices. The OCED and IMF see the economy largely stagnating in 2023, but with the risks tilted to the downside.

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