BoE Watch

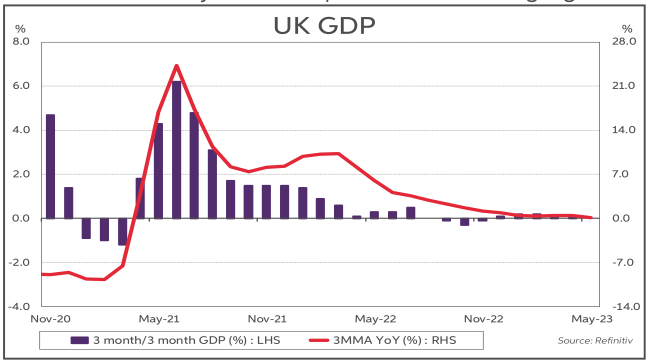
AIB Treasury Economic Research Unit

3rd August 2023

BoE raises rates by 25bps to 5.25%, as they near peak

The August meeting of the Bank of England's Monetary Policy Committee (MPC) saw the central bank revert back to a 25bps rate hike following the 50bps increase it delivered at its previous meeting in June. That move had followed two 25bps hikes at its March and May meetings. Prior to this, the BoE had implemented 50bps increases in both February and December. Today's rate hike was largely in line with market expectations and brings the Bank rate up to 5.25%. It marks the fourteenth consecutive meeting where the BoE has raised rates. It has now increased rates by a total of 515bps since it commenced hiking in December 2021.

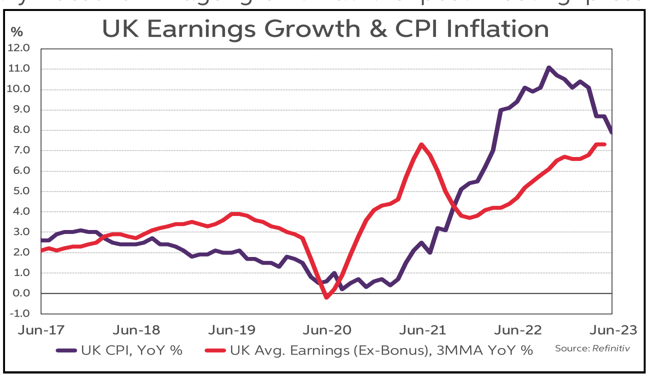
The voting breakdown showed that the MPC was quite split in terms of the rate decision. Six of the nine members voted in favour of hiking rates by 25bps to address greater 'inflation persistence', as they noted in particular that wage growth has surprised significantly to the upside. Two members wanted to raise rates by 50bps, arguing the continued high level of inflation measures warranted the MPC leaning more actively against persistent inflation . One member preferred to keep rates unchanged as policy had become increasingly restrictive and sizeable impacts from the lagged effects of previous hikes had still to work their way through the economy.



The BoE's latest set of detailed macro forecasts were released at this meeting, with the publication of its quarterly Monetary Policy Report (MPR). The BoE's GDP growth forecast for 2023 was raised to 0.5% from 0.25%, but lowered for 2024 and 2025. The downgrades reflected the marked upward shift in the interest rate curve compared to three months ago, as well as an appreciation of the exchange rate. Very subdued GDP growth of 0.5% in 2024 and 0.25% in 2025 is now projected, down from the previous forecast of 0.75% for both years.

On the inflation front, the August MPR projections show that the BoE still expects inflation to slow to 5% by the end of this year. It is projected to fall further to 2.5% by end 2024 and 1.5% by end 2025, which represents and upgrade to the previous MPR forecasts of 2.3% and 1.0%. **Thus, inflation is still projected to fall below target in the medium term, but to a lesser degree than in the May Report.** The BoE emphasises, though, that the risks to the inflation forecasts are skewed to the upside. **Thus, the mean inflation rate projections are 2.0% and 1.9% on a two and three-year horizon**, respectively. These inflation forecasts are conditioned on the market view at the time they were compiled that the Bank Rate would peak at slightly above 6% this winter and average just under 5.5% over the next three years. The BoE indicated, though, that the inflation projection is broadly the same if interest rates are held constant at 5.25% over the forecast period.

The BoE did not provide any specific guidance on the future course of interest rates. However, it indicated a willingness to hike rates further if there were to be evidence of more persistent inflationary pressures, most notably in regard to wage growth and services sector prices. The BoE put a heavy focus on wage growth at the post-meeting press conference. It also highlighted the recent volatility in inflation data, making if difficult to discern trends. The Bank will be monitoring incoming data very closely and it moves to an evidenced based approach in regard to future rate decisions.



In terms of market expectations, back in early July, futures contracts had been pricing in that rates could get as high as 6.5% by Q1 2024. This was in response to May inflation data printing much higher than expected and labour market reports showing stronger than anticipated wage growth. However, **there has been a marked easing in market pricing over the last number of weeks, following the publication of better than expected CPI data for June.** Futures contracts now point to rates peaking at 5.75% around the turn of the year. This view has solidified in the aftermath of today's BoE meeting. Further out, some 50bps of easing is anticipated by end 2024, with rates falling back to 5.25%, while another 50bps of cuts are priced in for 2025. This would see rates fall to 4.75%. An appreciable moderation in wage growth and core CPI inflation, especially in the services sector, though, could well see the MPC deliver just one final 25bps hike this autumn, with rates thus peaking at 5.5%. Incoming inflation data will decide.

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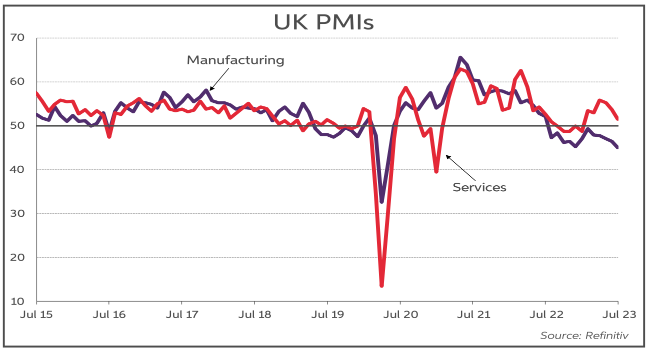
UK economy stagnant, while inflation remains elevated

The UK economy narrowly avoided falling into a technical recession over the past number of quarters, exhibiting a flat trend in GDP over the period. GDP rose by just 0.1% in Q4, having contracted by 0.2% in Q3 of last year. The economy than expanded by 0.1% in Q1 of this year. However, growth in Q1 was concentrated at the start of the quarter, with output falling in March. The economy, though, has managed to avoid falling into recession, which has been widely predicted last winter.



The available monthly readings of GDP in Q2 indicate that economic growth has continued to flat-line. The April reading of GDP showed output rebounded by 0.2% in the month, as a sharp 10% increase in the value of benefit payments provided a boost to real household disposable incomes. However, GDP fell by 0.1% in May, although, this was partly due to an extra public holiday for the coronation of King Charles. It means that overall, GDP was 0.4% lower in year-on-year terms at the end of May. As in most other economies, industrial production has continued to struggle, falling by 0.2% in April, before contracting by 0.6% in May. Meantime, retail sales, which have been volatile so far in 2023, rose by 0.4% in Q2, although, they were still 1% lower in year-on-year terms at the end of June.

The limited amount of survey data for July indicate that economic growth remained subdued. The manufacturing PMI, which has been in contractionary territory since last August 2022, fell to 45.0 in July, its lowest level so far this year. Output, new orders and employment all contracted in the month. Meanwhile, the services sector PMI stayed in expansion mode in July, but declined to 51.5, its lowest reading since January. Consumer confidence, which had been trending higher so far this year, albeit from a low base, unexpectedly declined in July also.

Labour market conditions have softened slightly recently, but remain tight overall. The unemployment rate is still very low by historical standards, but it rose to 4% in the three months to May, up from 3.5% last August. Furthermore, there was a marked pick-up in employment between February-April, with the number of people employed in the UK now back at pre-pandemic levels. Employment continued to grow in May, but at a slower pace. Tight conditions are placing upward pressure on wages. Average earnings growth accelerated to 7.3% y/y in the three months to May. The BoE Agent's summary of business conditions survey released in June, shows that companies pay settlements have averaged 6-6.5% so far this year.

Meanwhile, inflation has proven to be much stickier than expected. Headline CPI eased to 7.9% in June, down from 8.7% in May and April. Food inflation in particular is at very elevated levels, running at 17.4% in June. Meantime, core-CPI inflation which had been on an accelerating trend, rising to 6.8% in April, and to 7.3% in May, edged slightly lower to 6.9% in June. This compares to core inflation rates of 5.5% and 4.8%, respectively, in the Eurozone and the US. The BoE noted today, that CPI data had been volatile in recent months , but reiterated that inflation should decline sharply over the coming quarters and throughout 2024, helped in particular by substantial moves lower in energy prices.

The BoE also noted that the UK economy has proven to be more resilient than anticipated this year. However, economic growth remains listless, and the outlook contains a number of headwinds. The OBR estimates real household incomes declined by 3.1% in 2022, and that they will fall by 3.4% this year, with inflation remaining elevated. Meanwhile, the numerous BoE rate hikes are weighing on investment and activity. Housing transactions have already fallen sharply by 21% YTD in May, due to the impact of higher rates. **Overall, growth is expected to remain very subdued over the next couple of years.** The IMF is forecasting GDP growth of 0.4% this year, and 1% next year. The BoE sees the economy expanding by 0.5% in both 2023 and 2024 as high rates bite.

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