BoE Watch

AIB Treasury Economic Research Unit

AIB

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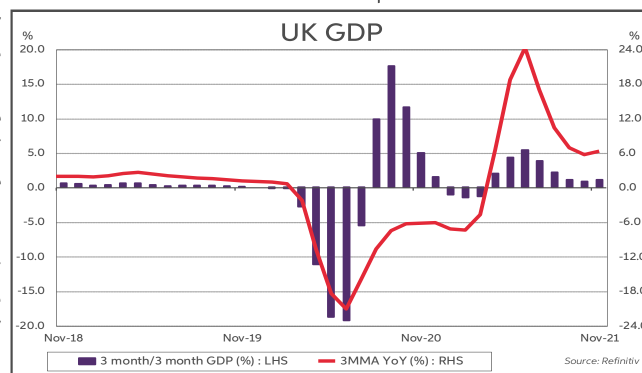
BoE hikes again, and guides more to come

The first meeting of the Bank of England for 2022 saw the central bank start the year with a further tightening of monetary policy. It increased the Bank Rate by 25bps to 0.50%, which was in line with market expectations. This was the second consecutive meeting where the Monetary Policy Committee (MPC) increased interest rates, following a 15bps rise in December. **All nine MPC members were in favour of hiking interest rates, however, there were differing views on the extent of tightening.** The Committee voted by 5:4 in favour of the decision to raise rates by 25bps. Those four members in the minority had a preference for a 50bps rise in the Bank Rate.

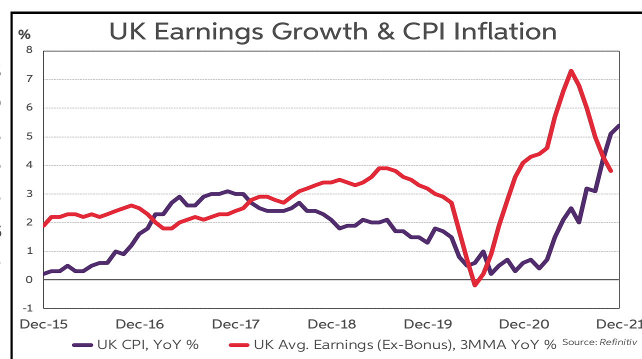


The MPC justified its decision to raise interest rates by referencing the current tightness in the labour market and the continuing signs of greater persistence in domestic costs/ prices. This resulted in the BoE revising higher its inflation projections also. These updated forecasts were contained in the release of the latest Monetary Policy Report (MPR) for February.

The BoE now expects inflation to peak at 7.25% in April 2022, which is around 2 percentage points higher that it had forecast in the November MPR. Meanwhile, it anticipates inflation averaging 5.75% (from 3.5%) in the fourth quarter of this year. Further out, it envisages inflation remaining above its 2% target by Q4' 2023, at 2.5% (from 2.25%) and just below 2% by the end of 2024. These central scenario forecasts are based on the assumption that global energy prices remain constant after six months, even though futures contracts are pricing in that they will fall back. The BoE outlined in its meeting statement, though, that there are two-way risks to its medium term inflation outlook. On the upside, this related to wage developments, while on the downside, it referenced energy and imported goods prices.

In terms of its assessment of the growth outlook for the UK economy, the BoE downgraded its GDP forecasts for the period 2022/23 compared to the November MPR. It is now anticipating GDP growth for this year of 3.75% (from 5%). For 2023, it is forecasting growth of 1.25% (from 1.5%), while its 2024 projection for GDP growth was left unchanged at 1%. The BoE commented that the main reason for the slowdown in growth envisaged over the period 2023-24 is due to the negative impact on UK incomes and spending from higher global energy and tradable goods prices as well as tighter fiscal and monetary policy. On the back of this, it has amended upwards its unemployment rate expectation to 5% (from 4.5%), while also projecting that excess supply accumulates to around 0.75% by the end of 2024.

Meanwhile, on this issue of its balance sheet, the BoE, as planned, has initiated its programme of reducing the size of its Corporate Bond holdings, from the current £20bn. In relation to its far more significant holdings of UK sovereign bonds (£875bn), it noted it will begin to reduce its stock of these bonds, by ceasing to reinvest maturing assets as the Bank Rate has now reached 0.5%. **Meanwhile, it also reaffirmed its commitment to consider the process of actively selling these bonds "only once Bank rate has risen to at least 1%".** However, it also repeated its preference to use interest rates as its main policy tool.



Looking ahead, the BoE retains a strong bias to hike rates further. It repeated its view that some modest tightening of policy was likely to be necessary to meet its 2% inflation target. Its hawkish bias was further reflected in the fact that 4 of the 9 MPC members were in favour of a 50bps rate hike today.

Following the BoE meeting, the market has started to price in a more aggressive path of rate hikes in the near term. It now expects the Bank Rate to be hiked in both March and May, bringing it to 1%, compared to its pre-meeting view that this would not happen until late summer/early autumn. The market is anticipating the Bank rate will get to 1.50% by end-2022. The pace of rate hikes is expected to slow notably in 2023, with the Bank rate envisaged to settle at around 1.75% next year.

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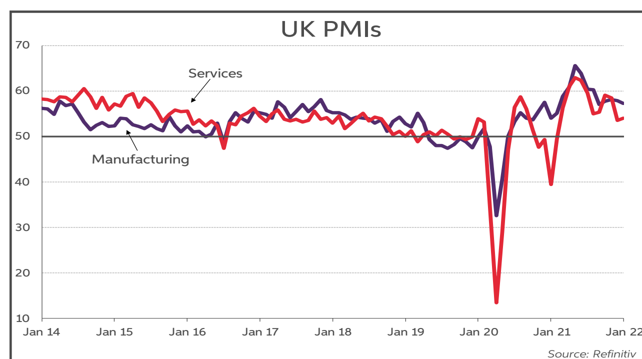
UK economy off to a weak start in 2022

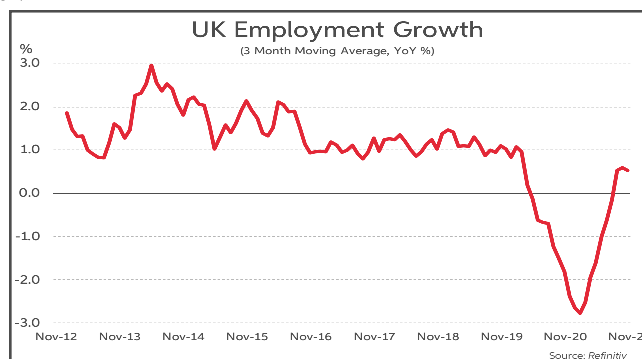
Having staged a robust rebound in Q2, growing by 5.5%, the UK economy expanded by just 1.3% in Q3. Regarding the underlying breakdown, household consumption rose by 2%, contributing 1.2 percentage points (p.p.) to growth. Government expenditure and investment combined, added a further 0.9 p.p to the total. Net trade subtracted 1.2 p.p. from GDP, although, this was offset by a slight rise in inventories (+0.3 p.p.). Overall, the UK economy was 2.1% below its end 2019 pre-pandemic peak in the third quarter.



The available hard data suggest economic growth slowed further in Q4. The monthly readings of GDP show that the economy narrowly avoided contraction in October, expanding by just 0.1%, although growth accelerated to 0.9% in November. However, a mixture of restrictions and increased cases/self-isolation caused by the Omicron wave of Covid-19 is likely to see GDP contract in December. Retail sales data for the month registered a sharp decline, falling by 3.7% as activity was curtailed by the new variant and the move to "Plan B" rules in the run-up to Christmas.

The limited available data for January indicate the economy continued to struggle at the start of 2022. The composite PMI fell for the third month running, to an 11-month low of 53.3. The services PMI edged down to 53.3 in January from 53.6. Similarly, the manufacturing PMI declined in the month to 56.9 from 57.9, as supplier delivery times continued to lengthen, albeit at the slowest rate since November 2020. Consumer confidence plunged in January also, as restrictions, rising inflation weighed on sentiment. The index fell to its lowest level since February of last year, –19 from –15 in December.

Meanwhile, the conclusion of the furlough scheme has not led to a surge in unemployment. Although, employment fell by 220k in October and by a further 120k in November, the number of people unemployed rose by just 50k in the same period. However, this suggests the labour force shrunk by around 290k since the scheme ended. The official jobless rate declined in November, to 4.1% from 4.2%. The demand for workers remains elevated, as the number of PAYE employees grew by 184k in December, while the claimant count fell by 43k. Job vacancies rose to anew record high of 1.2m also. The shortage of workers appears to be placing upward pressure on wages, although the data remains distorted by the changing composition of the labour force.



Supply pressures and base effects are continuing to contribute to a rapid rise in inflation. Headline CPI moved upwards in December once again, rising to 5.4%, from 5.1%. The core rate rose to 4.2% from 4.0% also. Inflation, which is already the furthest above the Bank of England's 2% target than at any point since it was adopted, is set to remain elevated over the next few months. It will spike higher again in April, as Ofgem, the utilities regulator, has announced the cap on consumer prices will rise by 54%. However, the UK Government has announced an energy bill rebate in response to this, to try and cushion the blow to household incomes. **The BoE is forecasting CPI will peak at 7.25% in April, and will average 5.75% in 2022.**

Overall, despite robust growth early in 2021, the recovery lost steam in the second half of the year and it has failed to regain momentum in early 2022. However, restrictions have now been lifted once again and the pandemic is expected to recede further over the course of the year which should allow growth to gather pace. There are other headwinds ahead though. Fiscal policy is set to be less supportive this year. The cost-of-living squeeze due to higher inflation and an increase in taxes is going to arrive at a time when rates are already rising in the UK. Conditions in the labour market appear extremely tight also, increasing the risks of second-round inflation effects in the medium-term, resulting in a more aggressive increases in interest rates. **The latest IMF World Economic Outlook sees the economy expanding by 4.7% this year, and 2.3% next year. The BoE sees GDP rising by a more modest 3.75% this year, and 1.25% in 2023.**

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