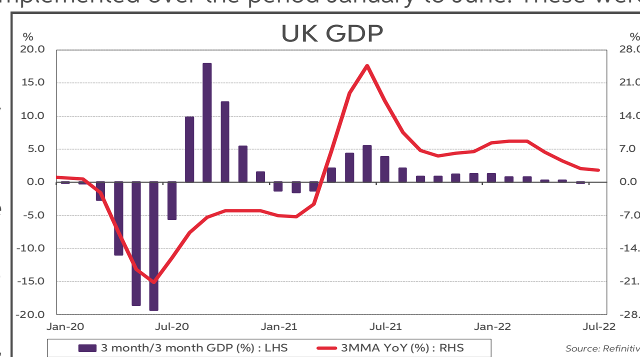
BoE Watch

AIB Treasury Economic Research Unit

22nd September 2022

Split MPC opts for 50bps hike, bringing Bank rate to 2.25%

The September meeting of the Bank of England's Monetary Policy Committee (MPC) saw it hike rates by 50bps for a second consecutive month, bringing the key Bank rate up to 2.25%. This means that monetary policy has now been tightened for a seventh consecutive meeting in the UK. The pace of tightening accelerated in Q3, with two 50bps hikes, which compares to the more modest 25bps rate rises that were implemented over the period January to June. These were the first 50bps hikes since 1995.



Interest rate futures have been hardening everywhere recently. **Markets had begun to price in that UK rates might be hiked by 75bps today**, in line with the recent moves by the ECB, SNB and Fed, not to mention the very big 100bps rate rise from the Riksbank. **The MPC was badly split on the size of today's rate increase.** The voting breakdown showed that three members were in favour of hiking by 75bps, five opted for a 50bps increase, while one member preferred a 25bps move.

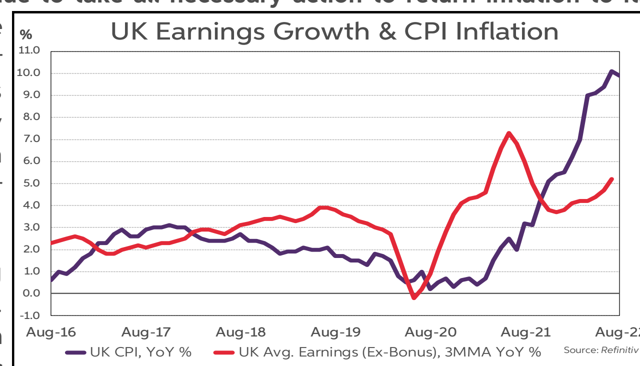
The meeting statement gave some colour to the rationale for today's rate hike decision. The MPC noted that the labour market is still tight and domestic cost and price pressures remain elevated. Headline and regular pay growth has continued to accelerate and exceed expectations. It also observed that the recently announced **Energy Price Guarantee** cap means that household spending is likely to be less weak than envisaged previously.

The last detailed assessment of the BoE's view of the economic outlook was provided in its August Monetary Policy Report (MPR). In terms of the baseline, which assumes global energy prices follow futures contracts until end year and remain unchanged thereafter, it pencilled in GDP growth of 3.5% this year. However, the MPC now thinks the economy will contract by 0.1% in Q3 rather than expand by 0.4% as projected in the August MPR. This would **imply a technical recession given that GDP also fell by 0.1% in Q2,** with the falls in output occurring in the context of extra bank holidays in both quarters. The BoE looked for GDP contractions of 1.5% in 2023 and a more modest 0.25% in 2024, in its baseline scenario.

In its alternative scenario, where energy prices follow their futures curves, the decline in GDP is smaller in 2023 than in the baseline scenario, while the economy expands in 2024. **The MPC also noted today that the Energy Price Guarantee will help support demand,** with further fiscal supports expected to be announced by the Chancellor tomorrow.

Meanwhile on the inflation front, the **BoE forecast in the August MPR that it expected the CPI rate to reach a high of just over 13% by Q4** of this year, largely on the back of further big jumps in household energy bills. However, since then, gas prices have fallen back while the Government price cap should limit the average household energy bill to £2,500 per annum. As a result, **the BoE indicated today that it now anticipates the CPI rate will peak at just under 11% next month.** The MPC said it would make a full assessment of the impact on demand and inflation from all these announcements at its next meeting in November, when the next quarterly MPR will be published.

The BoE retains a tightening bias, stating that it would continue to take all necessary action to return inflation to its target. It indicated that should the outlook suggest more persistent inflationary pressures, including from stronger demand the MPC will respond forcefully as necessary. In this regard, the BoE expects inflation to fall back from next year. By the end of 2024, it is anticipating that the CPI rate will have fallen below its target to 1.5%, before declining even further to under 1% in 2025.



Futures contracts are pricing in another 125bps of tightening from the final two MPC meetings this year, taking rates to 3.5%. The market is envisaging an additional 125-150bps of rate rises in H1 2023, **bringing the Bank Rate up close to 5%. This seems rather aggressive for an economy that is expected to be in recession next year** and is also likely to see a marked fall in inflation over 2023-24. **We look for two further 50bps hikes this year, with rates likely to peak at below 4% in 2023.**

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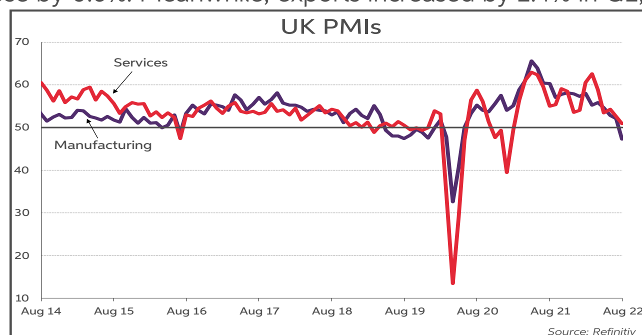
UK economy stagnates - recession risks rise

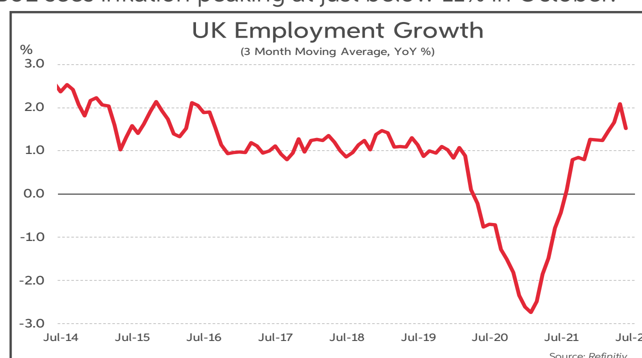
UK GDP contracted slightly by 0.1% in the second quarter. However, this was partly due to the double bank holiday weekend to celebrate the Queen's Platinum Jubilee. The underlying breakdown for Q2 showed that consumption fell by 0.1%. Government expenditure declined by 2.9%, as pandemic related spending continued to decrease. However, fixed investment rose by 0.6%. Meanwhile, exports increased by 2.4% in Q2, while imports fell by 1.5%.



The monthly reading of GDP for July shows the economy grew by 0.2%, although, this was largely due to the unwinding of the Jubilee hit to growth. Indeed, since January the average monthly increase in GDP is 0%, indicating the economy has stagnated over the past 6 months. Industrial production - which has yet to regain its pre-Covid level in the UK - has largely stagnated since January. Meanwhile, retail sales have declined in seven of the last eight months, including by a substantial 1.6% n August, as the cost of living squeeze weighs heavily on households.

The available survey data for July and August have continued to trend lower. The manufacturing PMI fell into contraction territory in August, declining to 47.3, its lowest level since May 2020. Elsewhere, the services PMI fell to 50.9 from 52.6 in August, as business activity continued soften. Consumer confidence is very weak also, reaching a new all-time low of –44 in August. The BoE now thinks GDP may contract by 0.1% in Q3 also, a technical recession, with an additional bank holiday for the Queen's state funeral acting as a new headwind.

In terms of inflation, headline CPI eased slightly to 9.9% y/y in August. The core CPI rate was at 6.3%. However, price pressures are broad-based. Service price inflation, which was already at its highest level since 1992, rose further to 5.9% y/y in August. However, the Government plan to cap household energy bills at £2,500 per annum for the next two years will limit the rise in inflation over the winter months and into next year. Indeed, coupled with the £400 household credit which is still being implemented, the effective annual price cap for households will be £2,100 in 2022. The BoE sees inflation peaking at just below 11% in October.



Labour market conditions are very tight. The unemployment rate fell to 3.6% in the three months to July, 0.4 percentage points below its pre-pandemic level. Meanwhile, there are now roughly 320k 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 5.2% y/y in July. Private sector wages were 5.3% higher y/y.

Overall, the UK economy is facing a number of significant headwinds. The cost-of-living squeeze, due to higher inflation is weighing heavily on real incomes. Tighter monetary policy is also having an impact, with a two-year fixed mortgage rate rising at the fastest pace since 1995 in the first half of this year. Meanwhile, UK exports are continuing to struggle from the double–hit of the pandemic and Brexit. However, the Energy Price Guarantee (EPG), should cushion the blow to households real incomes this winter. Further supports are expected be announced by the Chancellor tomorrow. **In August, the BoE forecast a significant 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.**

Longer-term, the UK economy also has a number of challenges to deal with. Before the Global Financial Crisis, the UK had the second fastest productivity growth rate in the G7. However, between 2009-2019, it had the second lowest rate in the G7. Meanwhile, although UK debt-to-GDP remains below the G7 average, it has risen substantially over the past decade, to 99.6% in Q1 of this year. Estimates for the EPG put the cost at £100billion (or circa 4% of GDP), although, the Government has not yet fully outlined how it will pay for the scheme. Nevertheless, research from the IFS, shows Government borrowing is expected to increase over the next number of years, while borrowing costs for the UK Government have risen substantially since the start of this year. With a widening balance of payments deficit also, pressure on sterling could continue to mount.

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