BoE Watch

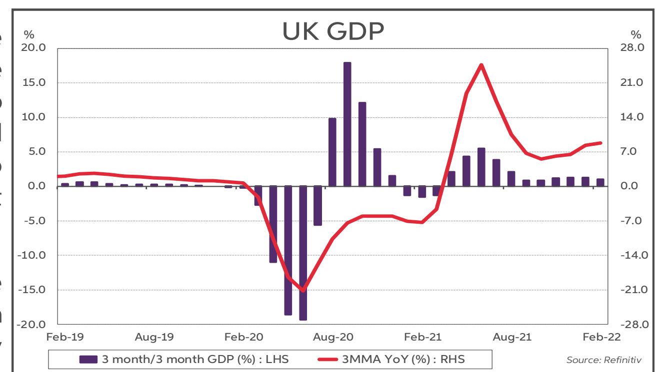
AIB Treasury Economic Research Unit

5th May 2022

BoE hikes as expected but rate guidance is less hawkish

The Bank of England announced a further tightening of monetary today. The Bank's Monetary Policy Committee increased the Bank Rate by 25bps to 1.00%. This marks the fourth consecutive meeting where the BoE has hiked rates. It commenced its tightening cycle last December with a 15bps rate hike. This was followed by a 25bps increase at both its February and March meetings. Today's decision was very much in line with market expectations. The policy deliberations showed a badly divided MPC, with different members placing different weights on the arguments for whether to increase the Bank Rate by 25bps or 50bps. This was reflected in the voting breakdown, with the Committee voting 6:3 in favour of the decision to raise rates by 25bps, with three members preferring a 50bps rate hike.

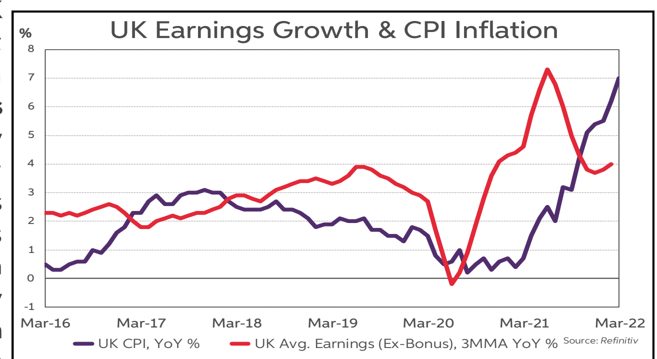
Meanwhile, the Bank has been engaging in quantitative tightening (QT) by ceasing to reinvest maturing assets over the last number of months. Today it announced it plans to commence actively selling some of its small corporate bond holdings in September. Bank staff have also been asked to prepare a strategy for UK Gilt sales, which will be considered at its August MPC meeting.



The MPC referenced that recent developments (including the war in Ukraine) had exacerbated materially both the near-term peak in inflation and the potential negative impact on activity and on medium-term inflationary pressures. It noted that despite signs of weakness in household spending, labour market activity was stronger than expected, while at the same time the stronger than forecast domestic inflationary pressures warranted a further increase in the Bank Rate.

The BoE's detailed assessment of the inflationary and economic outlook were contained in the May edition of its Monetary Policy Report which was released today. It now anticipates that inflation will average slightly over 10% at its peak in Q4 of this year. This compares to its view in the February MPR when it expected inflation would peak at 7.25% in April. Further out, it envisages inflation remaining above its 2% target in Q4 2023, at 3.5% (was 2.5%), but expects it to fall to 1.5% (from 1.75%) by the end of 2024. It stated that risks to its inflation projections are "skewed to the upside".

In terms of its assessment of the growth outlook for the UK economy, its GDP growth forecast for this year was left unchanged at 3.75%. It continues to expect a major slowdown in the UK economy from next year. **However, it now expects this slowdown to be much more severe than previously envisaged.** It is anticipating that GDP growth will contract by 0.25% (from previous forecast for +1.25%) in 2023. For 2024, it is projecting very modest growth of just 0.25% (was 1%). This constitutes a mild recession followed by a period of stagnation lasting two years. At the press conference, Governor Bailey described it as a "very sharp slowdown in activity". The main drivers of the recession are the negative impact on UK incomes and spending from higher global energy and tradable goods prices, as well as the headwind to activity from tighter fiscal and monetary policy.



Regarding its guidance on the future path of interest rates, the BoE once again emphasised today that most members judged that some degree of further tightening in monetary policy might still be appropriate in the coming months. **However, in a important change compared to its previous guidance, some MPC members were of the view that the risks around activity and inflation were more evenly balanced and therefore such guidance was no longer appropriate.** This suggests some within the MPC have become less hawkish on the rate outlook**. This development prompted a sharp reaction on markets. Futures contracts are now pricing in around 15bps less of rate tightening than before the meeting.** The market is now pricing in the Bank rate ending this year at 2.1% (was 2.25% pre-meeting). It sees rates peaking at around 2.55% in mid-2023 (pre-meeting peak was nearer to 2.7%) and remaining at this level into 2024. Meanwhile, sterling has come under some downward pressure, falling by around 1% against a raft of currencies, with EUR/GBP back above 85p and GBP/USD falling below the $1.24 threshold.

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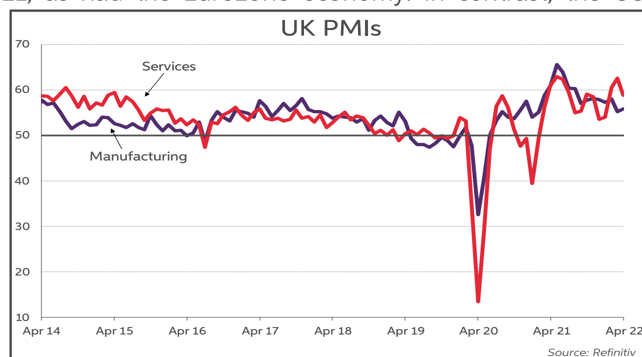
Cost of living squeeze to weigh on UK growth

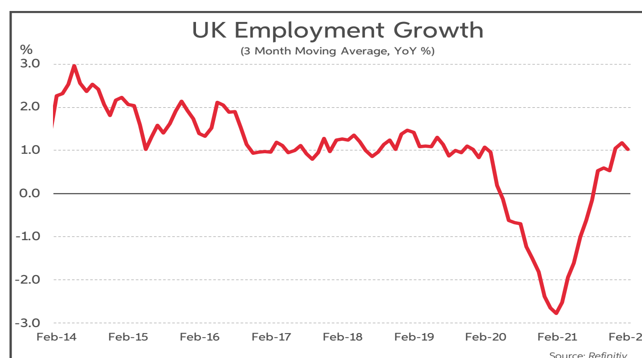
Overall, the UK economy staged a robust rebound in 2021, expanding by 7.4%. However, this needs to be viewed in the context of the very sharp contraction in GDP, of 9.3% in 2020. The UK economy had largely recovered to its pre-Covid output level by end 2021, as had the Eurozone economy. In contrast, the US economy was 3.2% above its pre-pandemic size.



The economic recovery in the UK remained on track in the final quarter of 2021. GDP grew by 1.3% in the three months to December. Consumer spending and government expenditure both contributed 0.3 percentage points (p.p.) to GDP. Meanwhile, gross fixed capital formation added 0.2 p.p. to output. Net trade boosted growth by a further 1.6 p.p., although, this was offset by a fall in inventories.

However, hard data suggest that the pace of economic growth may have slowed as Q1 2022 progressed. The monthly readings of GDP show that the economy grew by 0.8% in January. In February though, the pace of growth slowed to just 0.1%, as a rise in consumer services due to the removal of COVID-19 restrictions was offset by a sharp fall in healthcare sector output. Industrial output which rose by 0.8% in January, fell by 0.6% in February, in part due to a 0.4% fall in manufacturing output as delays in the delivery of some key components continued to snarl supply chains. Meanwhile, retail sales declined by 0.5% in February and by a further 1.4% in March suggesting that households are starting to tighten their belts as they feel the pinch from the cost of living squeeze.

The limited amount of survey data for April have been mixed so far. Consumer confidence plunged to –38, lower than any time during the worst of the pandemic, and just slightly above its record low from July 2008. Respondents to the survey noted concerns regarding their own personal finances over the next 12 months as costs continue to rise, with little prospect of economic relief. Encouragingly though, both the manufacturing and the services PMI remained comfortably in expansion mode in April, at 55.8 and 58.9, respectively.



Meanwhile, inflation has continued to rise by more than anticipated throughout Q1. Headline CPI rose to 7% in March, while the core rate jumped to 5.7%. 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 spike higher again in April as Ofgem sanctioned a 54% rise in the cap on retail prices in the month. Furthermore, the ongoing war in Ukraine is placing even more upward pressure on energy and commodity prices. A further jump in retail energy prices is anticipated in October. **Indeed, the BoE has upped its inflation forecasts to peak around 10% in Q4.**

Meanwhile, conditions in the UK labour market remain very tight. The official jobless rate declined to 3.8% in February, its level just before the pandemic began in early 2020. However, there are now roughly 580k fewer people in employment than before the pandemic struck. The smaller pool of workers appears to be placing upward pressure on wages. Average earnings, excluding bonuses, were 4% higher YoY in February. Businesses responding to the BoE's latest Agents Survey noted they expect pay settlements to be much higher than a year ago, at 4-6% this year compared to 2.5-3.5% in 2021.

Overall, despite a strong start to 2022, the UK economy is facing a number of headwinds which will have to be navigated carefully. The cost-of-living squeeze, due to an increase in taxes and higher inflation, is being accentuated by the war in Ukraine, which is driving inflation even higher. As a result, living standards are set to drop by 2.2% this fiscal year, the biggest fall since records began in the 1950's. Conditions in the labour market are very tight also, increasing the risks of second-round inflation effects, resulting in the need for more aggressive increases in interest rates. Fiscal policy is set to be less supportive this year also. Meanwhile, UK exports are continuing to struggle from the double–hit of the pandemic and Brexit. **The latest IMF World Economic Outlook sees the economy expanding by 3.7% this year, and 1.2% next year. The BoE sees GDP rising by 3.75% this year, before contracting by 0.25% in 2023, and expanding by just 0.25% in 2024.**

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