BoE Watch

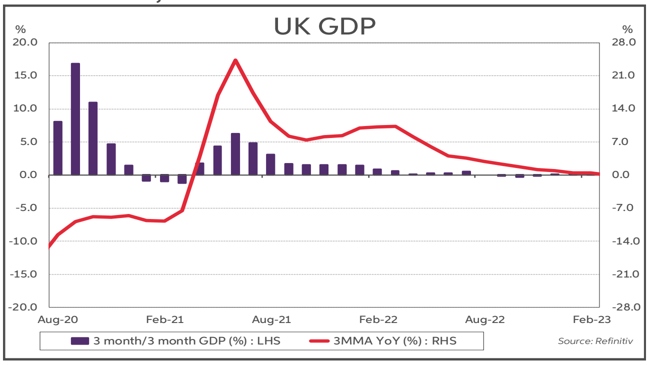
AIB Treasury Economic Research Unit

11th May 2023

BoE hikes by further 25bps to 4.5%, raises growth forecast

As expected, the May meeting of the Bank of England's Monetary Policy Committee (MPC) saw the central bank announce a 25bps rate increase. This followed a similar-sized hike in March and 50bps increases in both February and December. Today's rate hike brings the Bank rate up to 4.5%. It marks the twelfth consecutive meeting where the BoE has raised rates. The Bank has now raised rates by a total of 440bps since it commenced hiking in December of 2021.

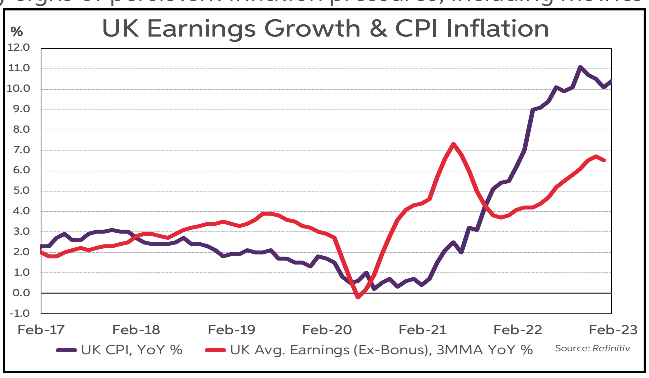
The voting breakdown showed that the MPC continued to be split on its rate decision. Similar to February and March, seven of the nine members were in favour of hiking rates. They were of the view, that given inflation is running higher than expected, GDP is also proving stronger than anticipated with the labour market remaining tight, domestic price pressures risked becoming more persistent. Thus, a further 25bps rate hike was justified to ensure CPI inflation returns to its 2% target. Meanwhile, two members preferred to keep rates unchanged at 4.25%. Their analysis remains that headline CPI inflation should fall sharply during the year. They also referenced the lagged effects from the previous rate hikes and that the current policy setting would likely see inflation fall below target.



The BoE's latest set of detailed macro forecasts were released at today's meeting, with the publication of its quarterly Monetary Policy Report (MPR). For this year, the BoE upgraded its UK GDP growth forecast to +0.25%, from –0.5% in February. It has also upped its 2024-25 forecasts. For next year, the May MPR shows that the BoE is now expecting growth of 0.75%, compared to the 0.25% fall in GDP projected in February. Further out, the BoE is forecasting growth of 0.75% in 2025, up from 0.25% previously. These are the biggest upgrades to its growth forecasts since the MPC was established in 1997. However, as the BoE Governor pointed out, this is still a very subdued outlook with growth running at below 1% in 2023-25, following a twelve month period of economic stagnation. With the growth outlook upgraded, the BoE has lowered its unemployment forecasts, with the rate now seen staying at or below 4% to end 2024, before rising to 4.5% by end 2025, which is well below the previous forecast of 5.5%.

On the inflation front, the central bank reaffirmed that despite the CPI being higher than envisaged in Q1, it still expects the annual rate to decline sharply over the balance of the year, starting in Q2. This is due to changes in the Budget, including in relation to the Energy Price Guarantee, as well as sharp falls in wholesale energy prices. Today's MPR projections indicate that the BoE is now expecting inflation to slow to circa 5% by around the end of this year, compared to 4% in its February Report. Inflation is projected to fall further to 2.3% by end 2024 and 1% by end 2025. The MPC emphasised, though, that the risks around its inflation forecasts are skewed significantly to the upside. **The mean CPI inflation profile**, which incorporates this risk, **projects a rate at or just below the 2% target in the medium term.**

The BoE refrained from giving clear guidance on the future course of monetary policy. However, it indicated a willingness to hike rates further if required. It will continue to monitor closely signs of persistent inflation pressures, including metrics on labour market tightness, wage growth dynamics and services inflation. If it sees evidence of more persistent inflationary pressures then it says a further tightening in monetary policy would be required. Indeed, **its inflation forecasts are conditioned on the market view that the Bank rate peaks at around 4.75% in Q4 2023.** Given the mean CPI profile is for inflation to fall to its medium term target of 2%, a further 25bps rate hike could well be on the cards to achieve this.



In terms of market expectations, similar to elsewhere, futures contracts have experienced a lot of volatility over the last couple of months in reaction to the stresses that have emerged in parts of the global banking system. However, **the market is once again pricing in that Bank Rate will peak in a 4.75-5.0% range by the autumn.** Thus, the markets see one or possibly two further 25bps hikes before policy is put on hold. Some 75bps of easing is then anticipated by end 2024, with rates falling back to near 4%. **Traders reaction to today's meeting was relatively muted, with the BoE not seeking to alter the market's view that some further rate tightening may be required.**

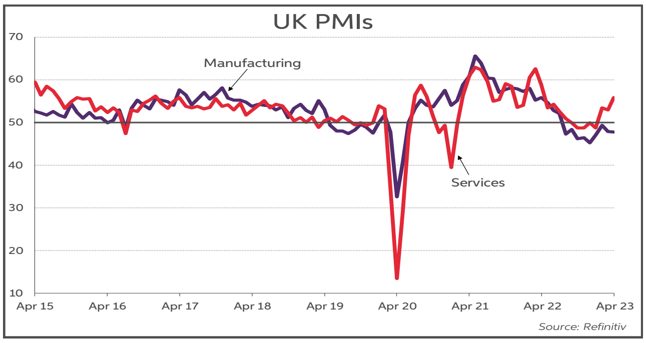
Oliver Mangan
Chief Economist
oliver.n.mangan@aib.ie

John Fahey
Senior Economist
john.j.fahey@aib.ie

Daniel Noonan
Economist
daniel.x.noonan@aib.ie

UK economy stagnates in past year, but outlook improves

The UK economy narrowly avoided falling into a technical recession in the second half of last year. GDP contracted by 0.1% in Q3, before stagnating in Q4. Overall, the UK economy grew by 4.1% in 2022, but **growth essentially flat-lined from Q1 onwards,** meaning the annual growth rate had slumped to just 0.6% by Q4. Furthermore, UK GDP was still 0.6% below its pre-COVID level at the end of last year, whereas it was 5.1% and 2.4% higher in the US and Eurozone.



The most recent hard data suggest growth remained meagre at best, at the start of 2023. Having declined sharply by 0.5% in December, the monthly reading of GDP for January registered a 0.4% increase. However, growth stagnated again in February, as a renewed fall in services output was offset by a sharp uptick in activity in the construction sector. Elsewhere, industrial output fell in by 0.5% in January and 0.2% in February, leaving it down by 3.1% y/y. GDP is projected to have risen by 0.1% in March, which would leave it flat for Q1 as whole and just 0.2% higher than in Q1 2022.

The limited amount of survey data available for Q2 have been for April. The data have been mixed, but one thing that has remained clear, is that the services sector is outperforming manufacturing. The services PMI has been in expansionary territory for the past three months, rising to 55.9 in April, its highest level in a year. In contrast, the manufacturing PMI has been in contraction mode for the last nine months running, and deteriorated slightly further to 47.8 in April, Meanwhile, consumer confidence remain soft, but has improved in six of the past seven months, since reaching an all-time low of –49 last September.

Labour market conditions remain tight. The unemployment rate edged slightly higher to 3.8% in the three months to February, but this is still very low by historical standards. This partly reflects, the fact that the fall in participation during COVID has not reversed. Despite a recent pick-up in employment, there are roughly 123K fewer people in employment, than before the pandemic struck. Meantime, average earnings growth has decelerated only slowly over the past few months, and stood at 5.9% y/y in the three months to February down from a peak of +6.9% y/y last year. The latest BoE Agent's summary of business conditions survey for Q1 also shows that companies pay settlements have averaged 6% so far this year.

Meanwhile, inflation has proven to be stickier than anticipated in the UK throughout Q1. Headline CPI averaged 10.2% y/y in Q1, down from 10.8% y/y in Q4, but this was above the 9.7% y/y rate forecast by the BoE in February. Increases in food prices in particular at the start of 2023 are offsetting falls in fuel prices, meaning headline CPI remained in double-digit territory. Core CPI, which excludes food and energy, is also proving to be stubbornly slow to fall. It was unchanged at 6.2% in March, and just 0.3pps below its peak of 6.5% in September/October. The BoE noted in its Monetary Policy Report today, that the inflation rate should fall significantly from Q2 onwards, as base effects from the surge in energy prices take hold. It expects the CPI rate to be 8.2% in Q2, before declining to 5.1% by Q4 2023, and 2.3% in Q4 2024.

The UK economy continues to face a number of headwinds. The ongoing cost-of-living squeeze from higher inflation is weighing on consumers, with the OBR estimating real household incomes declined by 3.1% in 2022, and that they will fall by 3.4% this year. Tighter monetary and fiscal policy are also dampening activity. Meantime, the risk of a wage-price inflation spiral taking hold remains, with rises in wages and consumer prices staying elevated, amid widespread industrial disputes. **However, the BoE did make significant upgrades its growth projections today. It now sees GDP rising by 0.25% in 2023 and 0.75% in 2024. In February, it projected that GDP would fall by 0.5% this year and 0.25% in 2024.** Meanwhile, the OECD and IMF expect the UK economy to expand by circa 1% in 2024 as inflation falls sharply. **Overall, it suggests the outlook for UK economy has improved and it will avoid a recession this year, but growth is expected to be very subdued over the next couple of years.**

AIB, 10 Molesworth Street, Dublin 2 Tel: 353-1-6600311 https://aib.ie/investorrelations/economic-research-unit