Research Institute - Insight

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#UK / #Monetary policy / #Inflation

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Too much, too late

The BoE increased Bank Rate by 50bps. The reacceleration in the pace of tightening reflects upside inflation surprises and demonstrates a more hawkish reaction function. We raise our terminal rate forecast to 5.5%, but think policy is unlikely to follow the market. Risks are skewed to the upside, especially if government policy starts to work in opposition to monetary policy.

Key Takeaways

- In a surprise decision, the Bank of England increased Bank Rate by 50bps to 5%.
- We have increased our terminal rate forecast to 5.5% in light of the hawkish signal about the reaction function the decision provides.
- We remain sceptical that rates will follow the market curve, which sees Bank Rate climbing above 6%, given the risks of significantly overtightening policy.
- Most of the impact of past tightening has yet to be felt by the economy, with a large stock of mortgages set to roll on to much higher rates in coming months.
- The economy is heading for a recession. While a sustained period of economic weakness is unfortunately now required to sustainably bring inflation back to target, policy makers do not want to make the downturn any deeper than what is required to restore price stability.
- There is mounting pressure on the government to introduce substantial mortgage relief or ease fiscal policy more generally. This would make monetary policy less effective and exacerbate the UK's inflation problems. Interest rates would need to stay higher for longer, making it the key risk to our forecasts given the political incentives facing the government.

BoE surprises with 50bps rate increase

In a shock to almost all forecasters, us included, the Bank of England's Monetary Policy Committee voted 7-2 to raise Bank Rate by 50bps to 5%.

The two members of the MPC dissenting from the decision – Tenreyro and Dhingra – are both well-established doves having also voted against rate increases at the last few meetings. They both continue to think that policy is now so tight that it risks causing a very deep recession and pushing inflation too far *below* target in several years.

In re-accelerating the pace of tightening without any clear guidance in advance, the Bank will be seen by some as looking panicked. In its defence, the Bank would argue that its data-dependent policy framework means that explicit meeting-by-meeting guidance is inappropriate. Instead, policy was just being set in light of the recent (very concerning) underlying inflation picture.

Either way, it does feel like we have learnt something about the BoE's reaction function, both in terms of its sensitivity to upside inflation surprises and its tolerance for shocking markets. As such, it is reasonable for markets to price a higher terminal rate and more risk premia into the short sterling curve.

In that light, we have increased our terminal rate forecast to 5.5%, with two further 25bps moves in August and September.

This represents a further 100bps of tightening compared to our forecast before the last two inflation reports.

Meanwhile our conviction that the economy is heading to a recession in the near future has increased.

In a word, the economic outlook has become significantly more "stagflationary" over the last two months.

A sustained period of economic weakness is unfortunately now required to sustainably bring inflation back to target given the strength of core services inflation and the labour market more generally.

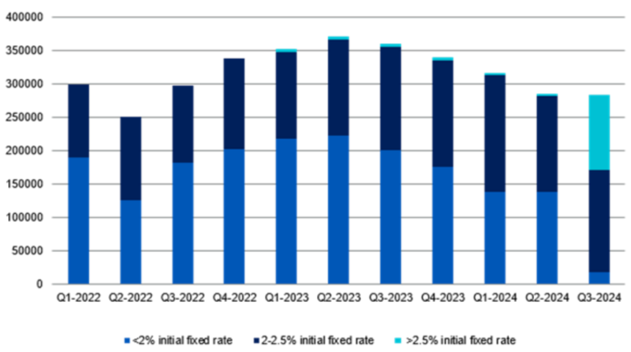
The coming mortgage crunch

The reason we see policy rates ultimately falling short of the market-implied rate path is that we think the Bank risks creating an even deeper recession were interest rates to move that high.

There has been some commentary about 5% being a particularly sensitive level for Bank Rate in terms of its impact on the mortgage market. This seems to be more of a psychological level than anything else.

But what is clear is that the coming period is very important for the UK mortgage market given the stock of mortgages set to roll off. The end of the stamp duty holiday in 2021 encouraged a pick-up in housing activity almost exactly two years ago. Two-year fixed mortgages taken out to refinance those purchases are now about to roll off onto much higher rates, with mortgage rates tripling for a large number of households (see Figure 1).

Figure 1: Number of mortgages coming off fixed rate deals in the next year



Source: ONS, abrdn, June 2023

With perhaps only a third of the impact of past monetary tightening so far felt by the economy, the Bank is already at serious risk of overtightening, and taking Bank Rate to the level implied by markets looks to us like it would be a policy error.

Authors

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We still see rates being cut next year as a result of the recession the economy is rapidly heading towards. However, the starting level for the cuts will now of course be much higher than originally anticipated, and the cutting cycle is likely to be slower in the first instance.

Fiscal easing a significant source of upside risk to rates

The risks to our view are skewed to the upside, and the biggest source of uncertainty relates to the political response to the mortgage, and wider economic, pain.

Indeed, the pressure is growing on the government to take action to address the steep increase in mortgage rates. Chancellor Jeremy Hunt will meet with banks and mortgage providers tomorrow to discuss "what help they can give to people struggling to pay more expensive mortgages and what flexibilities might be possible for families in arrears."

The government is for now maintaining its position that it cannot offer fiscal support for mortgage holders, and Hunt has ruled out introducing a mortgage protection fund subsidising the cost of repayments and any form of tax break for mortgage interest.

However, the government will likely use its influence with mortgage providers to push for additional flexibilities, including allowing borrowers to break their current fixed rate mortgage contracts and move to interest-only payments. Pressuring providers to introduce some form of payment holiday to those in arrears could also be an option, though it is unlikely to be announced at this stage.

Beyond mortgage relief, the government's political strategy for some time has been to announce various tax cuts next year in the run-up to a general election. Fiscal easing under current economic conditions risks making the inflation problem even worse.

The Treasury view seems clear that any policy that sets up fiscal policy in opposition to monetary policy or blunts the monetary transmission would be a mistake. We strongly agree. But these economic arguments may carry little weight given the political context.

Were fiscal policy eased or substantial mortgage relief provided, this would lead to interest rates staying higher for longer. Anything that reduces the impact of monetary policy on the economy just means that monetary policy will have to work even harder to bring inflation back under control.

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