Research Institute - Insight

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BoE hikes by 25bps and signals risk to inflation outlook

Despite the Bank stressing the upside risks to its inflation forecasts, we continue to think that Bank Rate has now peaked for this cycle and policy will start to ease later this year. However, the hurdle to future rate increases is not high if inflation proves more persistent.

Key Takeaways

- The Bank of England voted 7-2 to hike Bank Rate by 25bps to 4.5%. This was expected by the market given recent growth and inflation developments.
- The Bank's policy guidance stresses the data dependency of the next policy move, with underlying inflation data particularly important.
- We continue to think UK rates have now peaked. However, should core inflation fall less quickly than expected at least one more rate hike is possible.
- The Bank's growth forecasts were significantly upgraded, and it no longer sees the economy in a recession this year.
- Our forecasts are more pessimistic, with the lagged effects of monetary tightening by the BoE along with spillovers from a US recession causing recession-like conditions in the UK.
- As such, we still see a significant rate-cutting cycle starting later this year that takes Bank Rate well below current market pricing.

25bps hike with data-dependent guidance

The Bank of England's Monetary Policy Committee (MPC) voted to increase Bank Rate by 25bps to 4.5%. The decision was widely expected despite signals from the Bank at the last MPC meeting that it had expected rates to peak at 4.25% given the more resilient growth and inflation data since then.

The 7-2 vote in favour of the decision was also as expected, with both Tenreyro and Dhingra once again voting to leave policy unchanged. In particular, they emphasised the risks that policy was already sufficiently restrictive and time should be given for the lagged effects to be felt. We are not unsympathetic to these arguments.

However, Tenreyro, who has been a consistent dove throughout her time on the MPC, is set to leave the Committee after the June meeting. So the composition of votes and voices could be drifting towards a slightly more hawkish position later this year.

Governor Bailey claimed in his press conference that the Bank is not giving any explicit directional steer on rates from here, but the statement does give the data-dependent guidance that "if there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required".

We read this as signalling a data-conditional pause in policy, with a relatively narrow hurdle to tightening further.

Overall, this is consistent with our expectation that today's hike will represent the end of the tightening cycle, with rates peaking at the current level. However, the risks are heavily skewed toward one further hike should upcoming data show further signs of inflation persistence.

The April inflation report – released on 24 May – will be particularly important in that respect. Headline inflation should drop sharply in the report on powerful base effects, but core inflation will be crucial to watch.

BoE more optimistic on growth. We expect recession-like conditions to continue

The growth forecast showed significant upward revisions for this year and next, and the Bank is no longer expecting a technical recession.

The Bank now forecasts growth of 0.25% this year (vs -0.5% previously) and 0.75% next year (vs -0.25% previously).

The upward revisions make sense in the context of the sharp fall in energy prices – on which the Bank conditions its forecasts – and other supply side improvements; combined with a more resilient demand outlook in part boosted by easier than expected fiscal policy.

We continue to expect the economy to experience recession-like conditions for much of the year as the lagged impact of past monetary tightening and the spillovers of a US recession weigh on growth.

The Bank discussed the uncertainties over its policy transmission and the way in which the now fixed-rate dominant structure of the UK market has slowed the economic impact of its hikes.

The stock of mortgages rolling off onto a higher fix is set to increase markedly over the next few months, and we are expecting an increase in economic stress through this channel which will weigh heavily on the housing market and consumption more generally.

Inflation is expected to fall sharply but risks are skewed to the upside

There were also upward revisions to the inflation forecasts, largely on the back of higher food price growth projections. The MPC now expects headline inflation to fall to 5% (vs 4% previously) by the end of 2023 and to 1.2% by the end of the forecast horizon (vs 0.4% previously).

Despite the upward revisions, this is still a material inflation undershoot. As the inflation forecasts are conditioned on the market path of rates, a large undershoot in inflation is typically seen as sign that the Bank is suggesting the market path is too aggressive in terms of how high it expects interest rates to be.

However, the Bank went some way to distinguish between its modal forecasts, showing a large undershoot, and the mean forecast showing inflation only very modestly below target.

The mean forecast incorporates the full distribution of potential inflation outcomes, and so reflects the fact that "the risks around the inflation forecast are skewed significantly to the upside". This upside risk reflects the Bank's concern about risk of inflationary pressure being ingrained in domestic price-setting behaviour as firms and households try to claw back real-term improvements in living standards.

Overall, this sounds like a reasonable assessment. Should the economy evolve in line with our baseline modal forecasts for growth and inflation, then rates are likely to end up considerably lower than market pricing, with a cutting cycle starting later this year.

But there is a considerable risk of great inflation persistence, which keeps rates higher in the near term, and blunts the degree of eventual monetary easing.

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