UK: Bank of England set to hike less quickly than markets expect

The UK central bank looks poised to increase rates this December and we expect two further hikes next year. But growth headwinds and a comparatively less severe inflation issue suggest markets are overestimating the pace of tightening. Brexit is also set to return as a source of uncertainty, as tensions build between the UK and EU

Protest March Against Northern Ireland Protocol In London, United Kingdom - 09 Oct 2021

Source: Shutterstock

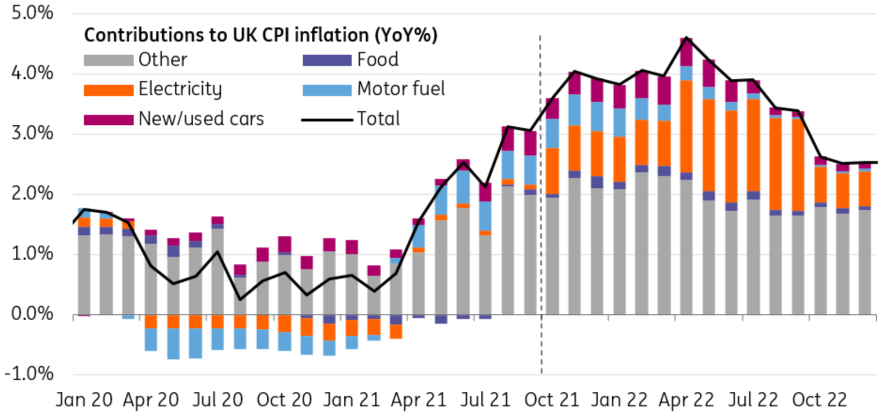
Bank of England set to hike rates imminently

After weeks of excitement, the Bank of England defied market expectations and left rates on hold at its November meeting. In the end, policymakers wanted more time to assess the impact of the recent conclusion of the furlough scheme, though early evidence suggests there hasn't been a material rise in unemployment. The Bank's latest policy statement makes it clear a rate hike is coming in either December or February.

Still, the UK's recovery is undoubtedly slowing, even if GDP will reach pre-virus levels in the next couple of months. Inflation is set to peak at around 4.5% next April, linked to higher household energy prices. Meanwhile, it's far less clear that wage growth will keep pace, despite often-cited shortages of certain occupations. And while savings levels remain pretty elevated, individuals have shown very little appetite to spend them.

Markets are probably therefore wrong to price in over four rate hikes next year. At most, we expect two.

Electricity is set to drive UK inflation higher



Source: Macrobond, ING

Brexit is returning as a source of uncertainty

There's also a growing chance that the UK and EU's ongoing war-of-words surrounding the Northern Ireland (NI) protocol may be about to escalate into concrete action.

The 2019 Brexit deal means NI has effectively remained within the EU's single market for goods, which means that some products coming from the British mainland need to be checked on entry. Prime Minister Boris Johnson argues that this is causing unwarranted friction within the UK's internal market.

The EU has recently made some substantive proposals that could make it easier for companies to bring goods into NI, though the UK government has signalled that these don't go far enough. The UK wants the role the European Court of Justice plays in resolving disputes linked to the NI protocol, to be watered down.

Britain appears close to suspending parts of that 2019 deal under the so-called Article 16 clause. If that happens – and there is growing discussion that it might now that world leaders have left COP26 – then it would almost certainly provoke a counter-response from Brussels. The question is whether this takes the form of targeted tariffs on politically sensitive goods, or a full suspension of the trade deal agreed last year.

Either way, it adds another layer of economic uncertainty this winter.

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