Bank of England cuts rates and downplays budget impact

Despite big spending increases in last week's UK budget, the Bank of England has signalled that it's not a game changer for future interest rate cuts. We think the Bank will keep rates on hold in December but accelerate the pace of cuts from February onwards

The Bank of England in London

Don't read much into the BoE's latest forecasts...

Nobody will be very surprised to learn that the Bank of England has cut interest rates this month. Bank Rate has been taken a quarter point lower for the second time this year, which leaves it at 4.75%.

Instead, everyone wanted to know what the Bank made of the latest budget. Big spending increases will, investors have assumed, reduce the scope of the BoE's rate-cutting cycle.

Take a glance at the BoE’s new forecasts, and it’s tempting to conclude that the Bank agrees. Growth is higher and it expects inflation to be at 2.2% in two years’ time. On paper, that’s a very subtle way of saying that if interest rates were to follow the path expected by markets, then inflation would still be fractionally above target.

But that would be the wrong conclusion to reach. There's a big caveat to all of this which is that the Bank hasn't accounted for the market reaction to the latest budget in its new forecasts. The numbers are based on market rates averaged out over several days up until 29 October, the day before the budget was announced.

Markets are now pricing Bank Rate some 40 basis points higher this time next year than in the numbers used by these latest forecasts. In other words, if the models were run again today, the upward forecast revisions to growth and inflation would be more muted.

In fact, away from the forecasts, the analysis of the budget looks much more nuanced. Take the tax hike on employers. The hawks might argue that firms are likely to pass on those costs in the form of higher prices, but the committee as a whole is reluctant to reach that conclusion. There's plenty of discussion about the uncertainty of how the budget will affect the economy, and the Bank has also emphasised that fiscal policy will become tighter beyond next year.

We still expect faster cuts in the spring

In short, the Bank is refusing to be drawn on where interest rates are likely to go next.

It was always very unlikely that Governor Andrew Bailey would also choose to double down on his comments a month ago when he hinted that rate cuts could become "more aggressive". Interestingly, the Bank has used its latest Monetary Policy Report to play down the latest fall in services inflation which, at 4.9%, is well below the Bank's forecast from August. Like us, it expects those numbers to stay broadly unchanged into the end of the year.

So what should we take from all of this? A December rate cut, we think, now looks unlikely. Previously we'd thought that the Bank would accelerate its cutting cycle beyond today, but uncertainty surrounding the budget's impact has changed our mind on that.

But the overarching message from the Bank today is that while the budget will have some impact, it is just one of a number of factors affecting the inflation outlook right now. If services inflation continues to fall more meaningfully next year, as many of the surveys seem to indicate, then we think we are still likely to see rate cuts accelerate.

Remember, markets are pricing fewer than three rate cuts from here on in. That would leave UK rates more than two percentage points above the European Central Bank in a year or so. We don't think that sounds particularly realistic. Our view is that rate cuts will be cut at every meeting from February until rates reach 3.25% next autumn.

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