Bank of England takes another small step towards tightening

The big news is that the Bank of England could begin reducing the amount of government bonds it holds once rates reach 0.5% - so potentially in mid/late 2023. The change in threshold is not too surprising, but the finer details possibly hint at a more rapid unwind than might have been expected

Bank of England, in the City of London

Source: Shutterstock

Bank of England upbeat on growth but opts against more concrete hints on rate hike timing

It may be summer, but there's plenty to digest in the Bank of England decision.

The central message remains fairly upbeat. And what's striking is that despite the spread of the Delta variant over the summer, the Bank's latest growth forecasts are barely changed from the May meeting. Policymakers are still pencilling in roughly 3% GDP growth for the third quarter, and expecting GDP to reach pre-virus levels in the fourth. We suspect activity over the summer months may be a little more lacklustre given the recent dataflow (we're forecasting 1.5% growth in 3Q), though agree that the current situation is more likely to pause rather than write-off the recovery.

The first rate hike is likely to come in early 2023, or perhaps a little earlier

When it comes to rate hike hints, the Bank has made some fairly wholesale changes to its statement here – and is now formally acknowledging that some tightening is likely over the three year forecast horizon. As expected though, policymakers have avoided saying anything more concrete than that – but we can find some clues by doing some 'reverse engineering' of the latest forecasts.

Like many economists, the Bank now expects inflation to hit 4% over the winter, but the more policy-relevant forecast for 2023 is at 1.9%. And importantly, the Bank isn't forecasting any overheating (or 'excess demand') at that point. Given that these forecasts are based on market pricing, that suggests policymakers are broadly comfortable with the modest amount of tightening investors are factoring in over the next couple of years.

Our own view is that the first rate hike is likely to come in early 2023, or perhaps a little earlier.

New balance sheet reduction plan: Bolder than expected?

Another big question for this meeting was whether the committee would end its quantitative easing (QE) programme ahead of schedule. There were no real surprises here – Michael Saunders voted to lower the total package of bonds the BoE is planning to buy, having hinted so in recent speeches, but the wider committee remain unconvinced.

It's worth remembering though that if we put the Bank of England in the context of the international tightening debate, the UK's QE programme has already seen the purchase pace tapered, and active purchases will end in December – most likely ahead of the Fed.

Finally, we also got confirmation that the Bank will look to shrink the size of its balance sheet when rates reach 0.5%, much earlier than the 1.5% level that policymakers had previously set, and was never reached in the post-crisis years. Initially, that might involve 'ceasing' reinvestments of maturing bonds, but the BoE also said it would consider selling gilts when rates reach 1%.

The speed of unwind has the potential to be a little quicker than we might have expected

Is this plan more aggressive than expected? On the Bank rate threshold, we think 0.5% is roughly consistent with Governor Andrew Bailey's past comments. But the speed of unwind has the potential to be a little quicker than we might have expected, assuming the Bank were to immediately stop all reinvestments - and indeed ultimately sell bonds back into the market.

We'd previously wondered whether the Bank might initially seek to cap the number of gilts that roll-off the balance sheet, perhaps through some kind of annual target. That would account for the fact that the frequency and size of bond maturities is more sporadic than is the case for the Fed, which was able to take things month-by-month when it shrank its Treasury holdings a few years back.

In reality, all of this is some way off - and we don't expect rates to reach 0.5% until late 2023. And when thinking about the possibility of selling gilts back into the market, it's worth remembering that rates haven't reached 1% since the Global Financial Crisis.

Author

James Smith
Developed Markets Economist, UK
james.smith@ing.com

Disclaimer