UK: November rate hike likely despite inflation dip

A November UK rate hike seems likely given Governor Bailey's recent comments, despite the dip in September's inflation rate, and the elevated uncertainty facing the economy over the winter. Headline inflation is set to peak above 4% next April, but we think markets are overestimating the scale of tightening likely to come from the Bank of England

Bank of England Governor Andrew Bailey

Source: Shutterstock

UK inflation has come in a touch lower than expected, though this will do little to ease market concerns that the Bank of England is poised to raise rates considerably over the next few months.

This month's headline rate of CPI of 3.1% is also marginally lower than August, though the underlying details reveal no massive surprises, and the bigger recent driver has been the volatility from last year's Eat Out to Help Out Scheme, which temporarily depressed restaurant prices over the summer of 2020. More importantly, this relative stability in the rate of inflation won't last – next month's figure will come close to 4%, linked to the 12% rise in the household electricity cap at the start of October. A further 25-30% increase next April will likely see headline inflation peak at around 4.5% or higher next April.

4.5% Possible inflation peak next April

Still, as we wrote in more detail earlier this week, we think markets are overestimating the scale of the Bank of England's inflation challenge.

While Governor Bailey has signalled concern about the risk of higher inflation rates becoming a virtuous cycle, surveys of longer-term household price expectations do not (yet) indicate cause for concern.

Meanwhile, wage growth has been rising amidst shortages of workers in certain industries, but the ending of the furlough scheme will have increased the slack in the jobs market. Hopefully, that won't push up unemployment considerably – and indeed that is what the recent jobs data tentatively suggests – but it will likely result in an increase in employees working fewer hours than they'd ideally like. That should reduce some of the pressure on wage growth over the coming year.

Governor Bailey's recent comments have made it clear that the Bank of England is gearing up for an imminent rate rise, most likely at the November meeting. It will probably be followed by another 25bp rate hike next spring or summer. But there's a difference between this, which could perhaps be viewed as a hedge against the rise in inflation expectations Governor Bailey is concerned about, and the series of rate hikes markets are now expecting, taking Bank rate above 1%.

Growth headwinds are building, while it's worth remembering that any rate hikes are likely to be coupled with some balance sheet reduction - another form of tightening.

Author

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