Upbeat Bank of England outlook clouded by Brexit

November's statement makes it pretty clear the Bank of England would like to be hiking rates further. But given that it may be quite some time before we know for sure that a 'no deal' Brexit has been avoided, we suspect policymakers will struggle to hike rates before May 2019 at the earliest

Source: Bank of England

Upbeat set of forecasts make it clear Bank wants to tighten further

The fact that the Bank of England's forecasts are largely unchanged from August when it decided to hike interest rates says quite a lot itself.

Despite the rise in Brexit uncertainty, trade tensions and modest Eurozone slowdown, the Bank still expects a slight acceleration in UK growth over the next year relative to it's August predictions. It's also worth noting that these projections don't include the expansionary fiscal actions from this week's budget, so growth would otherwise be forecasted to be even better.

Put bluntly, policymakers think that rates should be rising more *quickly than markets currently expect, and in an ideal world, we suspect they would want to be tightening policy again quite soon*

Meanwhile wage growth - something that has been central to the Bank's rate hike rationale - is expected to continue rising well above the current 3% level over the next couple of years, as skill shortages intensify.

Importantly, this means that the Bank now believes demand and supply to be "broadly in balance", implying that by the end of its forecast horizon, the economy will be running hot. Put bluntly, policymakers think that rates should be rising more quickly than markets currently expect, and in an ideal world, we suspect they would want to be tightening policy again quite soon.

Brexit means no hikes before May 2019 at the earliest

But in reality, the big rise in Brexit uncertainty since the August meeting means that the Bank is likely to sit on the sidelines for the next few months. The Bank has said that uncertainty has "intensified", but interestingly makes it clear that it sees investment growth recovering over coming months when there is greater clarity.

However, as we noted in our latest Brexit article, there is a clear risk that it could be quite some time until we know for sure that the threat of 'no deal' has been avoided. Despite the more encouraging headlines over the past couple of days, it may not be until December or even next year until an agreement is finalised and voted on by Parliament. Until then, we are likely to see a greater number of firms considering contingency plans. If companies also become more vocal about the risks of 'no deal' to their operations, it's possible consumers may also begin to get more nervous if job security fears build.

In a 'no deal' scenario, the Bank has suggested rates could go in either direction. However, given the widescale disruption that would likely occur, we suspect policymakers would 'look through' any spike in prices caused by a weaker pound, and cut interest rates/increase QE fairly swiftly

For that reason, there is a risk that growth momentum is slower than the Bank of England expects over the winter and we, therefore, don't expect a rate hike before Brexit. If a deal is agreed relatively soon and despite the noise, passed by Parliament with relatively few roadblocks, then this would open the door to a May rate rise and potentially a second move later in the year.

However if a deal isn't agreed until early next year, or indeed much closer to the March 29th Article 50 deadline (which shouldn't be completely ruled out), then the date of the next rate rise could easily get pushed back into the second half of 2019.

In a 'no deal' scenario, the Bank has suggested rates could go in either direction. However, given the widescale disruption that would likely occur, and the resulting shock to confidence, we suspect policymakers would 'look through' any spike in prices caused by a weaker pound, and cut interest rates/increase QE fairly swiftly.

Author

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

Disclaimer