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Snap

Bank of England hikes rates and keeps options open for further increases

The BoE has hiked rates by another 25 basis points and kept the door open to more if inflation data come in higher than expected between now and the next meeting in June. Another hike is possible, but with inflation forecasted to be well below target in a couple of years' time, we think this tightening cycle is reaching its limit

The Bank of England in London

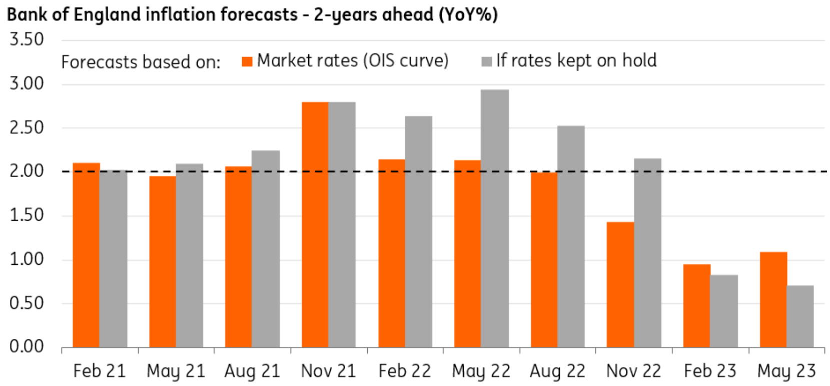
The Bank of England has raised rates, as widely expected, to 4.5% – and has kept its options wide open for future meetings.

There are no massive bombshells here – the decision to hike rates was backed by seven committee members, as it was at the previous two meetings. Lots of the post-meeting headlines will focus on the big upgrades to growth, but ultimately this was flagged by the BoE in its previous set of meeting minutes, and as much as anything else, it reflects lower natural gas prices in recent months. Importantly, the Bank has retained its deliberately vague forward guidance that further hikes could come if inflation shows greater signs of "persistence".

Scratch beneath the surface though, and there are hints that this tightening cycle is reaching its limit. Policymakers often point to the inflation forecast for two years' time, the time horizon over which interest rates have their biggest impact. And as we saw in the last set of forecasts from February, the committee sees inflation well below target at around 1% in mid-2025 – and crucially, that's regardless of whether interest rates follow the path expected by financial markets, or if rates stay fixed at 4.5%.

Admittedly, some of this will be accounted for by energy, and the committee has made a point of saying the risks are skewed to the upside. But the simple fact is that the Bank's own forecast shows little need to take rates higher. As the chart below shows, it's unusual that the two-year-ahead forecast is so far below target.

The BoE is forecasting inflation well below target in two years' time



Source: Bank of England

Based on the MPC's modal inflation forecast

What next? We continue to feel that this will most likely mark the top in this tightening cycle, though we accept this is heavily contingent on the next set of wage and inflation data. Another hike in June is possible, though for now it is not our base case. The Federal Reserve's widely-expected rate cuts later this year do provide the BoE with some breathing room.

The more interesting question is when rates will ultimately be cut. Our view is that it is unlikely to be this year, in part because the jobs market is proving resilient. The Bank has watered down its forecasted rise in the unemployment rate, and with that lifted its predictions for wage growth. But equally, the story on inflation is starting to look better.

Yes, inflation has been higher than the BoE predicted in February, but that's largely because of stickier food and goods prices – neither of which are as relevant for monetary policy as service sector inflation, which has been less unpredictable and appears to be nearing a peak. Survey indicators are suggesting that firms' pricing expectations are cooling off, and assuming gas prices stay low, we think there are good reasons to think service sector inflation will fall materially over the next 12 months or so.

With interest rates now, by any reasonable definition, in restrictive territory, we think the Bank will begin the process of taking them back to a more neutral footing with rate cuts by this time next year. We're pencilling in the first cut for May next year.

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

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