Fodder for hawks

Bank of England Post-Meeting Commentary

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Summary

- The Bank of England's MPC voted unanimously to keep Bank rate on hold at 0.10%. The asset purchase target remains at £895 billion, but this vote was split 7-2
- The central bank is faced with the conundrum of rising inflation and decelerating growth. The minutes suggest 'some developments' have strengthened the case for modest tightening, although 'considerable uncertainties' remain
- The MPC now expects CPI inflation to rise 'slightly above 4%', whilst the recent surge in wholesale gas prices is considered as an upside risk to its 2022 inflation outlook
- The market is buying into the central bank's warnings, and bets for a first 15 bps rate hike are brought forward to February 2022
- In our view, the UK economy is likely to underperform the central bank's forecast. Even as inflation reaches an uncomfortably high rate, and may even be stickier than thought, our base case remains there won't be a rate hike this year or next

The Bank of England's MPC voted unanimously to keep Bank rate on hold at 0.10%. Three factors were perceived as hawkish and supportive for a relatively early rate increase.

First of all, the asset purchase target remains at £895 billion, but this vote was now split 7-2 rather than 8-1. In August, Michael Saunders was the only member voting for an early end; David Ramsden has now joined him. That was a surprise, even as he was one of the four policymakers who believed in August that the minimum criteria for tighter policy had been met. Their dissent on asset purchases potentially indicates an early (dissenting?) vote for a rate increase.

According to the two policymakers, tightening earlier would help to mitigate the risk of a more abrupt tightening in the monetary policy stance later, as that would have more of an adverse impact on growth and employment. This view seems, however, based on the notion of a closed output gap, whilst the MPC still projects the level of Q3 GDP to be around 2.5% below its pre-Covid level. Moreover, the growth outlook is decelerating, and downside risks are accumulating. **This implies that Brexit and the pandemic have deeply scarred the economy's supply capacity.**

Secondly, the forward guidance was updated in August to reflect the MPC's judgment that "*some modest tightening of monetary policy over the forecast period is likely to be necessary*". The MPC added today that "*some developments during the intervening period appear to have strengthened that case, although considerable uncertainties remain*" (emphasis is ours). The market perceives this as hawkish relative to what it expected to hear. We, however, regard the explicit mention of "considerable uncertainties" as a very important caveat to be used in later meetings.

There was even more hawkishness. We also find that "*all members in this group* [i.e. the seven members who voted to keep the APF's target stock unchanged] *agreed that any future initial tightening of monetary policy should be implemented by an increase in Bank Rate, even if that tightening became appropriate before the end of the existing UK government bond asset purchase programme*". **This signals that an early rate hike can't be ruled out, and explicitly allows for a very brief gap between the latest gilt purchase and a first rate hike.** (NB: it even opens up the theoretical possibility of the APF ending its gilt reinvestments *before* it completes its gilt purchases, if the MPC suddenly hikes by 40 bps in November!).

Stagflation?

Whilst this is all fodder for hawks, we remain reluctant to buy into the central bank's warnings. With inflation expected to rise above 4% later this year, and with surging gas prices adding some very expensive fuel to this outlook, it is not surprising that some policymakers get nervous. In aggregate, the MPC also needs to demonstrate its vigilance in looking at, and possibly dealing with, inflationary risks. This particularly holds after last year's accusations of fiscal dominance. After all, it needs to be perceived as a central bank that fights off above-target inflation.

The rest of the minutes, however, convey a rather '**stagflationary**' feeling, even though we would probably never find this word in the Bank's communication. We find, for instance, that "*the pace of recovery of global activity had showed signs of slowing*", whilst "*against a backdrop of robust goods demand and continuing supply constraints, global inflationary pressures had remained strong and there were some signs that cost pressures might prove more persistent*".

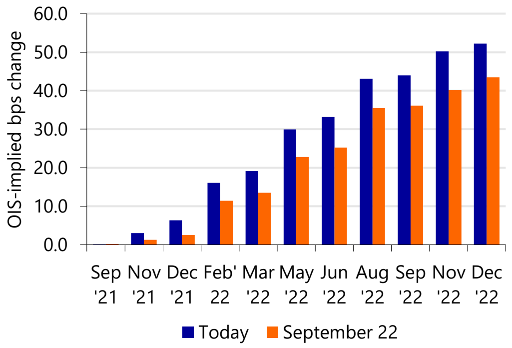
We note once more that the increase in inflation has been driven by elevated energy prices, global supply bottlenecks, an unusual bias in consumption towards goods instead of services, and low levels of inventories as firms were surprised by the strong policy response of the world's fiscal authorities (indeed facilitated by central bank policies). These are all global factors –not affected by the Bank's monetary policy– that bite into purchasing power, curb volume growth and significantly weaken the economic recovery. **And if the Bank can't control the rise in inflation, it should concentrate on returning the economy to its pre-Covid trend as quickly as possible.**

The slowdown already shows up in UK data, and has prompted the Bank to revise down its forecast for 2021 Q3 GDP growth from 2.9% to 2.1%. This is a very significant downgrade. Shortages and bottlenecks continue to affect output in manufacturing and construction –as also evidenced by today's PMI's– whilst the recovery in consumer-facing services was much slower than expected. Unless spending has somehow picked up sharply in August and September, which various high-frequency data don't seem to suggest, a forecast of 2.1% q/q still seems optimistic. **We expect further downward revisions to the growth outlook, in particular once the MPC is able to factor in the effects of the imminent fiscal tightening.**

The final uncertainty is the end of furlough. Today's BICS data indicate that 6% of the businesses' workforce, approximately 1.5 mn people, was still on furlough in the two weeks to 5 September, more than six weeks after "Freedom Day". Roughly one-third of this group was still on full furlough, even as payments are reduced. There are also more than a million vacancies, a record-high, a significant mismatch between available jobs and workers remains. This suggests that the transition out of furlough could be a rough ride.

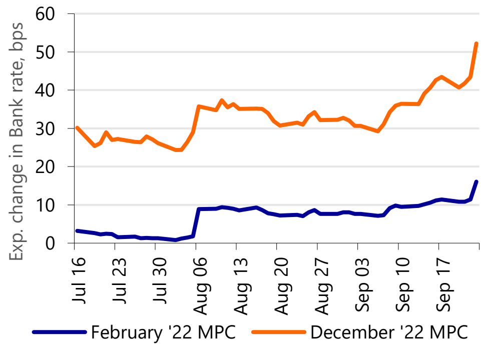
If the Bank of England indeed raises interest rates in early-2022, fiscal and monetary policy are simultaneously hitting the brakes. An "ECB 2011"-policy error would be in the making.

Figure 1: The BoE has opened the door for a February rate hike...



Source: Bloomberg, RaboResearch

Figure 2: ... but may be setting the market up for disappointment (50 bps are priced for 2022)



Source: Bloomberg, RaboResearch

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