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The BoE walks a narrow path

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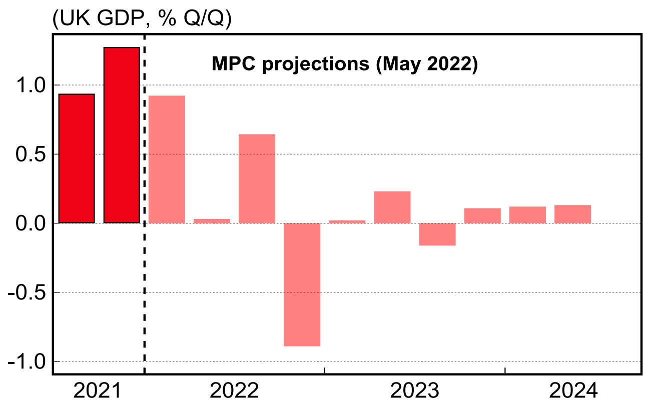
Against an increasingly gloomy economic backdrop the BoE has to weigh up whether a recession is a price worth paying to rein in soaring inflation. After four hikes in a row the MPC looks divided on the next steps, but projections imply that the current pace of tightening is unlikely to be maintained.

Storm clouds are gathering over the UK economy

As expected the Bank of England made it four hikes on the trot at its May policy meeting, taking rates to a 13-year high. At the same time, a gloomy set of macro projections were unveiled: double-digit inflation, a GDP contraction and rising unemployment. Governor Bailey said that the word ‘stagflation’ is poorly defined, but this scenario would surely meet the threshold under most definitions. With consumer confidence now even weaker than it was during the pandemic, there is certainly a sense that storm clouds are gathering over the UK economy.

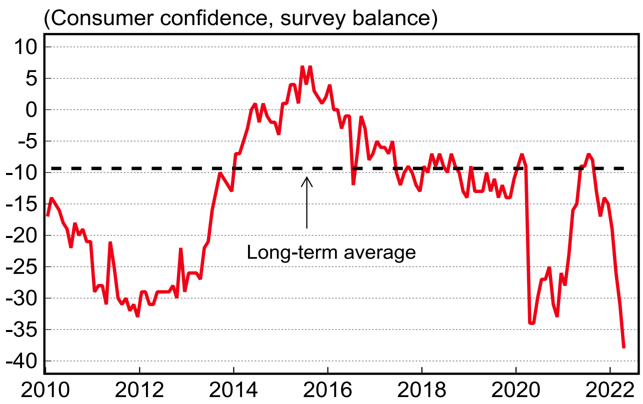
The BoE’s updated projections show GDP to be “broadly unchanged” this quarter and contract sharply in Q4. With an expansion in Q3 the UK economy could avoid a technical recession (i.e. consecutive quarters of negative growth). We have a similar view on the outlook (see here). However, it will certainly *feel* like a recession for many as the pressure on disposable income is set to intensify over coming months. Inflation may have reached around 9% in April, and could move into double figures when the consumer energy price cap is set to increase again in the autumn.

THE BOE EXPECTS THE ECONOMY WILL CONTRACT



Source: BoE Monetary Policy Report May 2022, MUFG Bank Economic Research Office

CONSUMER CONFIDENCE HAS FALLEN SHARPLY



Source: GfK, MUFG Bank Economic Research Office

The risk of higher domestically generated inflation, the chief concern for the BoE, will increase while external price pressures remain elevated. The energy price cap effect could add extra fuel to the fire in the UK at a time when we could see headline CPI rates starting to fall elsewhere.

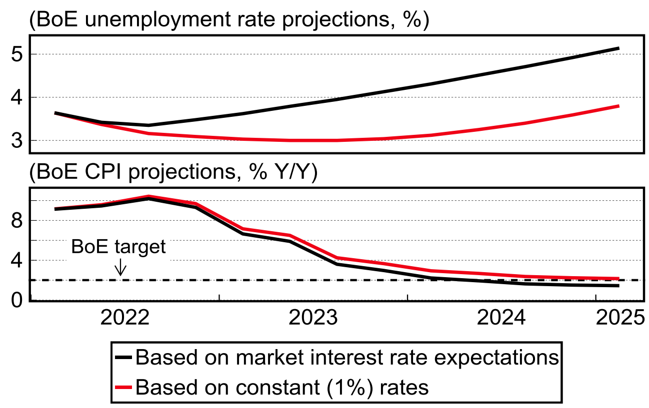
For now, higher inflation in the UK is still mostly imported and evidence of pass-through to wages has been limited so far. But there are some signs that pay growth is now accelerating. The XpertHR gauge of negotiated wages showed a 4% increase in pay awards in April, the highest rate since 2008, and in line with the BoE estimate of underlying wage growth. There are also signs in survey data that consumer inflation expectations, especially over the short-term, have risen in recent months.

Between a rock and a hard place

It's a narrow path for the BoE to navigate as it continues to tighten into a very foreseeable real income squeeze in order to prevent higher inflation from becoming embedded. Most of the current drivers of higher inflation (energy, supply bottlenecks) are likely to be temporary, and headline rates are set to fall through 2023. But whether inflation will fall sufficiently towards the BoE's 2% target is another question.

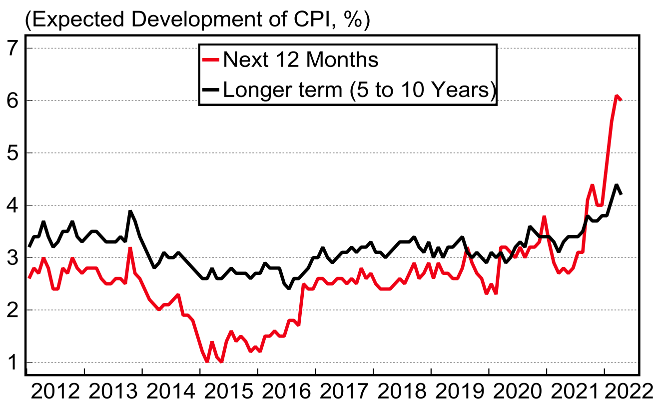
It's clear that there are big disagreements at the BoE with the MPC notably split about what the most appropriate course of action from here is. Three members voted for a larger 50bp hike instead of 25bp – while some other members "said that guidance for further tightening in coming months was not appropriate at this juncture". So there are some mixed messages coming out of Threadneedle Street, with views likely to differ on whether a recession is a price worth paying to rein in inflation.

UPDATED PROJECTIONS IMPLY THAT MARKET PRICING HAD GONE TOO FAR



Source: BoE Monetary Policy Report May 2022, MUFG Bank Economic Research Office

SHORT-TERM INFLATION EXPECTATIONS HAVE RISEN SHARPLY



Source: YouGov/Citi Inflation Tracker, MUFG Bank Economic Research Office

Prior to the meeting our analysts thought that the BoE would struggle to deliver the degree of tightening priced in by rates markets (see here). The BoE didn't explicitly push back against these market expectations at yesterday's meeting, but it did make it clear through the updated projections that market pricing may have gone too far. The MPC's forecasts are conditioned on *the market implied path for rates*. These show the unemployment rate increasing to 5.5% and CPI falling below target to 1.3% by the end of the three-year horizon. However, an alternative set of projections, conditioned on *current interest rates* (i.e. 1%) across the horizon, has unemployment remaining close to its current rate and inflation remaining slightly above target (2.2%).

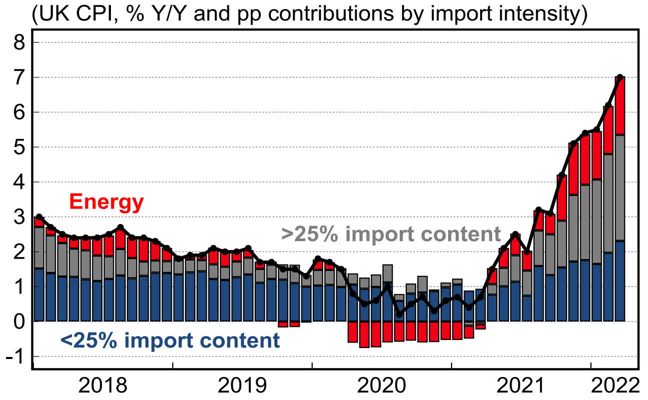
Based on these projections, the assessment seems to be that only a small degree of further tightening could be sufficient to bring inflation back to the 2% target. After four moves on the trot, **the BoE may be close to pressing 'pause' on this rate hike cycle**, perhaps after another move in June.

Focus to increase on the government's fiscal support

Whether or not there are any subsequent hikes through the rest of the year may hinge on 1) labour market developments and 2) the government's fiscal response to the cost of living crunch.

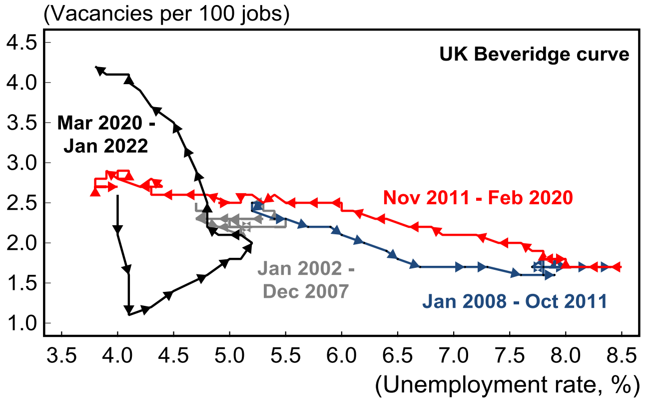
On the first point, it's clear that the UK labour market is very tight right now (and indeed tighter than the BoE expected in its previous set of projections in February). Any signs of pay growth rising much above the 4% mark over the summer, or of firms struggling to retain and hire staff, could spook wavering MPC members towards further hikes. It's hard to gauge whether the post-pandemic rebound effect or the rising cost of living will dominate when it comes to aggregate demand and the labour market outlook. On balance **our judgement is that unemployment will start to edge higher through H2**. However, certain sectors, such as transport and hospitality may continue to face shortages of available labour. Brexit-related effects (e.g. on the availability of seasonal workers) may also become easier to distinguish as the economy moves away from pandemic distortions.

INFLATION MOSTLY DRIVEN BY EXTERNAL FACTORS



Source: ONS, MUFG Bank Economic Research Office

THE LABOUR MARKET WILL BE KEY IN COMING MONTHS



Source: ONS, MUFG Bank Economic Research Office

The BoE will also be watching to see if there are any changes to the UK government's response to the cost of living crisis. So far **there has been an absence of meaningful fiscal support** to cushion the blow from high energy prices. Quite the opposite, in fact: the tax-to-GDP ratio is set to reach a long-term high this year. This reduces the chances that higher inflation will become embedded. However, the BoE expects the energy price cap will rise by another 40% in October (after 54% in April) and that there will be a GDP contraction of around 1% Q/Q in Q4. In this case, the political pressure on the government to intervene with direct fiscal support to households would be huge. The new energy price cap will be revealed in August, but developments in wholesale gas prices before that will allow for increasingly accurate predictions of the change. This may prompt the government to announce any measures well before the autumn. **A greater degree of fiscal support could give the MPC more confidence to go further with its hiking cycle in H2.**

Another thing to watch for over coming months will be the BoE's balance sheet plans. Yesterday's 25bp hike took rates to the 1% threshold at which the BoE announced it would consider active balance sheet reduction (i.e. gilt sales). However, the can has been firmly kicked down the road on that front. The MPC has asked staff to "work on a strategy for UK government bond sales, and will provide an update at its August meeting". The MPC will then "make a decision at a subsequent meeting on whether to commence sales". So, while the BoE may have led the way amongst major central banks when it came to first implementing post-pandemic rate hikes, it seems it will lag well behind the Fed in terms of actively reducing the size of its balance sheet.

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