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UK Economy Notes: Bank of England: Risky rates

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Our view was that the slowdown in growth and rise in unemployment after the end of the furlough scheme would imply that the BoE waits until mid-next year to raise rates. But it seems that despite these risks, the hawkish contingent of the BoE is focused more on the risks of higher inflation becoming embedded into inflation expectations.

So we now think the BoE will raise rates sooner. The need to clamp down on inflation expectations means they hike aggressively in the first instance, raising rates by 15bps in November 2021 and another 25 bps in February 2022 or delivering a 40bps hike in November 2021. Either way we think rates can reach 50 bps by Q1 2022.

The BoE hiking rates on the back of rising energy prices, which are temporary and supply side driven, and into a slowing economy would be a policy mistake, in our view. On top of other headwinds, we think rate hikes to 50bps by Q1 2022 can slow the economy such that it gives the BoE room to pause for some time thereafter. So we think, once the Bank Rate reaches 0.50% by Q1 2022, the hiking cycle will slow and the next hike is likely to come at least after six months. We forecast the Bank Rate will reach 0.75% by August 2022 and don't think rates will rise as aggressively as markets expect (which expect rates to rise to 1.25% by end 2022).

Comments from BoE officials over the last few days imply that they are quite keen to raise rates, citing the risk of persistently higher inflation feeding into inflation expectations and labour shortages as well as wage pressures in some sectors. Governor Bailey said explicitly on the weekend that it will “have to act” to curb rising inflation and made no attempt to dial back market hike expectations, which have priced in the first rate hike before the end of the year.

Our view was that the slowdown in growth and rise in unemployment after the end of the furlough scheme would imply that the BoE waits until mid-next year to raise rates. But it seems that despite these risks, the hawkish contingent of the BoE is focused more on the risks of higher inflation becoming embedded into inflation expectations.

So we now think the BoE will raise rates sooner. The need to clamp down on inflation expectations means they hike aggressively in the first instance, raising rates by15bps in November 2021 and another 25 bps in February 2022 or delivering a 40bps hike in November 2021. We think it is a close-call between a November and December 2021 liftoff, with November having the advantage of being an MPR month with new forecasts and December having information on the performance of the labour market after the end of the furlough scheme.

Either way we think rates can reach 50 bps by Q1 2022. We also think it will be a split hiking decision, with the doves (Catherine Mann and Silvana Tenreyro) voting to keep rates on hold, given concerns on the recovery path and the end of the furlough scheme. Silvana Tenreyro noted that “raising interest rates to counter one-off price rises would be self-defeating”.

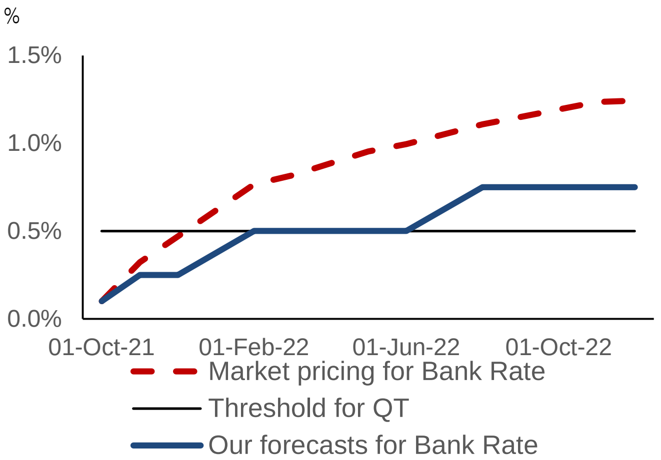
We tend to agree with the doves. The BoE hiking rates on the back of rising energy prices, which are temporary and supply side driven, and into a slowing economy would be a policy mistake, in our view. As we noted, the economy already faces headwinds such as supply side bottlenecks and slowing demand. Given higher inflation and less supportive fiscal policy, consumer disposable incomes can fall by 1.5% in 2022, weighing on consumer spending. Higher energy bills are also likely to hit business margins, which are already squeezed by higher input and wage costs.

Rate hikes can further dent consumer and business confidence and incomes, pushing up bills for households on variable mortgages, which make up a fifth of the total stock. Moreover, it is still uncertain how the labour market absorbs the pool of furloughed workers after the end of the furlough scheme. The BoE rate hikes can risk slowing the economy even further, without having much of an impact on inflationary pressures, which themselves can fade away as supply side issues subside and more labour supply comes into the economy.

So on top of other headwinds, we think rate hikes to 50bps by Q1 2022 can slow the economy such that it gives the BoE room to pause for some time thereafter. Moreover, the BoE has said it is likely to stop reinvesting QE assets once the Bank Rate reaches 0.50%. If the Bank Rate reaches 50bps by Q1 2022 as per our forecasts, then the BoE will stop reinvesting £25bn worth of QE assets, which are due to expire in March 2022 and total £34bn in 2022. This will give the BoE another lever to tighten policy besides bank rates.

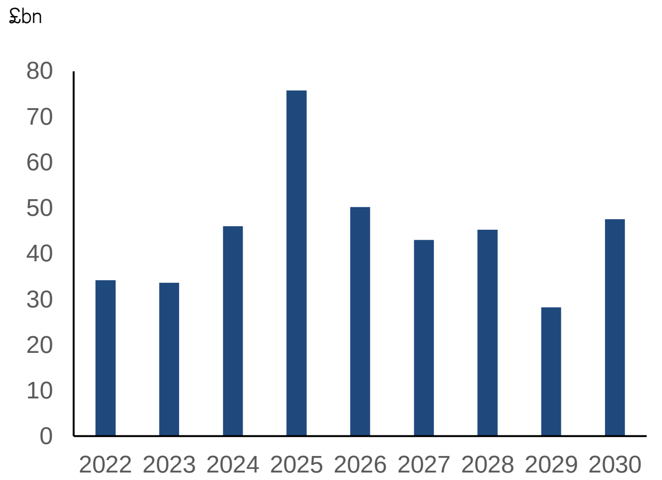
So we think, once the Bank Rate reaches 0.50% by Q1 2022, the hiking cycle will slow and the next hike is likely to come at least after six months. We forecast the Bank Rate will reach 0.75% by August 2022 and don’t think rates will rise as aggressively as markets expect (which expect rates to rise to 1.25% by end 2022).

Figure 1: Market pricing of rate hikes



Source: Bloomberg, Credit Suisse

Figure 2: Gilts held by the Bank of England maturing in the next few years



Source: Bloomberg, Credit Suisse