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#UK / #Monthly / #Monetary Policy

The UK faces a long road back to credible policy

We expect the Bank of England to hike rates by 75bps this week, but its tone is likely to be quite dovish. The Bank considers the market-implied path of interest rates to be too aggressive. Rates probably will start falling earlier than the market anticipates, but UK policymakers still have work to do to rebuild their credibility.

Key takeaways

- The new UK government seems to have restored some economic credibility. The recent fall in gilt yields will lower the amount of fiscal consolidation required in the Autumn Statement, now due on 17 November.
- The bigger test for the government's fiscal policy will come next year, with economic and market constraints making fiscal easing difficult even in the face of a recession.
- In the much shorter term, we expect the Bank of England to hike rates by 75bps at its November meeting. We continue to think a 100bps hike would be more appropriate. But with market and economic consensus clustering around a 75bps move, this now looks the most probable outcome.
- The Bank is clearly uncomfortable with the current, aggressive path of market-implied interest rates, seeing it as excessively contractionary given the headwinds facing the economy. What remains to be seen is how open the market will be to a more dovish message from the Bank. After all, the MPC has tended to significantly underestimate how much monetary tightening it ultimately delivers.

From fiscal easing to fiscal consolidation

The UK government's decision to delay the 31 October fiscal event until 17 November means that the Bank of England's November Monetary Policy Report will no longer be explicitly conditioned on that updated fiscal forecast. Nonetheless, the monetary/fiscal nexus in the UK remains tight.

At one point, the need to rebuild the UK's institutional credibility seemed to demand that monetary policy be seen as moving *after* a fiscal event. However, the new government's improved standing with financial markets altered that, allowing the fiscal announcement to be pushed back.

The virtue of the delay from the prospective of the government is that the Office for Budget Responsibility's (OBR) forecasts will be conditioned on substantially lower gilt yields, resulting in lower debt servicing costs. So less fiscal consolidation will be needed to meet the government's fiscal rules.

What's more, by upgrading the fiscal event to an Autumn Statement, the government also has an opportunity to deliver a more comprehensive assessment of government spending, which might imply that more of the fiscal consolidation will take place via spending cuts.

Just how much consolidation the government needs to deliver is a moving target and depends on: the OBR's economic growth assumptions (which are being downgraded), the structure of interest rates, and whether the government is targeting stabilising or falling debt-to-GDP by the end of the forecast horizon.

Reports had suggested that the government would need £72 billion in consolidation to fill the fiscal hole, of which £32 billion has already been found when the Chancellor reversed the bulk of the Truss tax cuts. The drop in gilt yields is probably worth another £10 billion to £20 billion, leaving around £20 billion to £30 billion of further fiscal tightening left to do. This is a painful but achievable target.

The bigger challenge for the government will come next year. The economy will very likely be in a recession, and political attention will have shifted to the prospect of a general election. There will be significant political pressure on the government to ease fiscal policy, which may be difficult given the economic and financial constraints the country faces. In other words, fiscal policy remains a potential source of market volatility, even if near-term risks have fallen.

We now expect a 75bps interest rate hike in November

Market-implied interest rates have fluctuated a lot recently, with the market now expecting much less monetary tightening than it did just a few weeks ago. Market and economic forecasts have generally settled on 75bps as the likely size of the increase this week. And Bank policymakers have done little to push back on this consensus. Given the recent criticism the Bank has faced for its communication strategy and its limited appetite to shock the market given all the recent volatility, we now also expect a 75bps hike.

We still think a 100bps hike would be more appropriate. After all, the Bank has been behind the curve on inflation for much of the year. Underlying inflation pressure remains high, and the Bank would do well to buttress its credibility after recent weeks. However, if anything, the debate within the Bank seems to be around whether 50bps or 75bps is more appropriate. Indeed, we expect several MPC members to dissent from the decision, with at least two voting for a 50bps move.

Forecasting the Bank's forecasts

The Bank's forecasts will be complicated this time around by the lack of clarity on fiscal policy. In particular, the announcement that the Energy Price Guarantee will end in its current form in April next year significantly increases uncertainty around growth and inflation.

Compared to the Bank's current forecasts, the existence of the Energy Price Guarantee this winter should reduce the expected peak in inflation and result in a slight upgrade to Q4 growth, all else being equal. Expected inflation is then likely to be higher in April as household energy bills are once again linked to wholesale energy prices.

Even before the huge increase in market interest rates and the various shifts in fiscal policy, the Bank was already forecasting a recession next year. We agree, and continue to expect the combination of monetary tightening, an adverse terms-of-trade shock, a wider US and global recession, and now the prospect of further fiscal tightening, to see the economy enter recession in the near future.

The MPC thinks too much tightening is priced in

Perhaps most significantly, the Bank's forecasts are likely to show inflation falling well below target at the three-year forecast horizon – and that's typically how the Bank seeks to convey its view that the market rate path is too aggressive.

Deputy Governor Ben Broadbent recently argued that the market path of rates is significantly higher than what the Bank's internal modelling sees as appropriate.

We are sympathetic to the view that rates won't stay as high as is priced in, given the economic outlook. We expect rates to peak at 4.5% early next year before being cut to 2.25% by the end of the year.

However, it remains to be seen how receptive investors are to this message right now, especially given how often the Bank has underestimated the number of rate hikes it ends up delivering. It is possible this week that a more dovish message from the Bank is interpreted by investors as a sign that it is once again falling behind the curve on inflation. Ironically, this might lead to another increase in gilt yields as investors anticipate greater inflation pressure in the future. And so a monetary policy strategy that is designed to try to lower future interest rate expectations may end up increasing them if policy is not seen as credible.

Our latest Eurozone and UK forecasts

- **Activity:** The latest data suggests activity is decelerating sharply across the major European economies amid the energy and cost-of-living crisis, terms of trade shock, and tightening financial conditions. We expect the Eurozone to enter recession in Q4 this year and remain there for most of next year. The UK economy looks set to contract in Q3 this year. After some upward revisions to the rate of growth in Q2 this year, a decline in Q3 would no longer mark a second successive quarter of contraction. Nonetheless, the UK economy is heading into recession in the near future.
- **Inflation**: Eurozone inflation reached a new record high of 10.7% in October, with price increases expected to peak by the end of the year. Policy interventions in energy markets will likely mitigate further increases over the winter, but fiscal easing risks increasing inflation pressure next year. In the UK, inflation will decline from October this year through to April next year, when the removal of the energy price guarantee will see inflation pop higher again. Underlying inflation pressure looks stickier.

  Monetary policy: Since abandoning its forward guidance in July, the ECB hiked by 200bps bringing the depo rate at 1.50%. A 50bps hike is likely in December, although it might be too early to say that another 75bps is completely off the table. We expect the Bank of England to push up rates by 150bps by year-end.

	2021	2022	2023	2024
Eurozone				
GDP (%)	5.3	2.9	-2.2	0.8
CPI (%)	2.6	8.7	5.6	2.0
Depo Rate (%)	-0.50	2.00	1.50	0.0
UK				
GDP (%)	7.4	3.6	-1.0	-0.2
CPI (%)	2.6	8.9	4.8	1.7
Bank Rate (%)	0.25	3.75	2.25	0.1

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