Interest rates rise for the 14th consecutive time to 5.25%

August 2023

The Bank of England's Monetary Policy Committee (MPC) voted 6-3 to raise the Bank Rate by 25 basis points in August (to 5.25%), in line with market expectations. This marked the 14th consecutive increase in interest rates. The majority voting bloc in the MPC noted that key indicators of domestic price pressures, particularly wage growth, remained elevated, which necessitated a further tightening of monetary policy to bring inflation back down to target.

The MPC's latest forward guidance kept open the possibility of further rate hikes to rein in persistent price pressures. Furthermore, the guidance was changed to suggest that interest rates will remain higher for longer. This adjustment is noteworthy as financial markets had previously been expecting that the Bank would cut interest rates from Q3 2024.

The Bank's latest forecast expects that higher interest rates, weak potential supply, and waning support from fiscal policy will weigh on economic activity going forward. As a result, GDP growth is expected to remain below its pre-pandemic rate through the medium-term. CPI inflation is projected to fall to around 5% by the end of 2023 and finally returns to the Bank's 2% target by Q2 2025. The MPC did warn, however, that risks to the inflation forecast were skewed to the upside, as wage and domestic price growth may take longer to ease than expected.

Why did the Bank raise interest rates?

- The majority of the MPC (six members) voted to increase interest rates by 25bp. Although recent data on the UK economy had been mixed, these members judged that another rate hike was necessary to rein in elevated wage and domestic price pressures.
- Two MPC members (Jonathan Haskel and Catherine Mann) preferred a 50bp hike in order to take a more aggressive stance against inflation persistence and, consequently, reduce the likelihood that the MPC may need to hike more in the future.
- One MPC member (Swati Dhingra) voted to keep the Bank Rate unchanged (at 5.00%), arguing that the impact of recent rate hikes had yet to feed through fully into the economy. In their view, additional rate hikes risked overtightening monetary policy, which would lead to an excessive drag on activity.

What does the Bank's new forward guidance tell us?

- The most noteworthy change to the MPC's forward guidance was that they would "ensure that the Bank rate was sufficiently restrictive for sufficiently long" to bring inflation back to target. This wording could be interpreted as a signal to markets that interest rates will remain higher for longer.

    - Markets previously expected the Bank Rate to peak above 6% in Q2 2024 and then start falling from the following quarter.
- The forward guidance was also adjusted to include a judgement that the "current monetary policy stance was restrictive", which mirrored recent statements from the US Federal Reserve (Fed) and European Central Bank (ECB) when referring to their own policy stance.
- The MPC continued to state that further evidence of inflation persistence would require more tightening. They said that they will, specifically, focus on indicators of labour market tightness, services prices, and wage growth to evaluate the broader outlook for inflation and whether or not further rate hikes are needed.
- Given the strength in domestic price pressures – which have generally been stronger than the Bank's forecasts – the new forward guidance suggests that we may still see further rate hikes in the coming months. However, this will be very data-dependent, and developments in the indicators that the Bank have flagged will be key to watch.
- Furthermore, rates are likely to stay higher for longer, contrary to the expectations of market participants.

What are the main takeaways from the Bank's latest forecasts?

- Although economic activity has been somewhat resilient so far this year, higher interest rates are expected to increasingly weigh on GDP growth going into 2024. Weak potential supply and a waning boost from fiscal policy also contribute to slower growth.
    - As a result, the Bank projects GDP growth to remain below its pre-pandemic rate through the medium-term (0.5% y/y in 2023 and 2024, and 0.3% in 2025).
    - The path for GDP growth is somewhat weaker than the Bank's projections in May, which mostly reflects the projected impact of higher market interest rate expectations (on which the Bank condition their forecast) on consumer spending, business investment, and the housing market.
- Inflation is anticipated to fall to 5% by the end of this year, due to lower energy and goods price growth. The forecast then expects inflation to decline to the Bank's 2% target by Q2 2025 and, subsequently, fall below target in the medium term.
    - Compared to the Bank's May forecast, inflation falls less rapidly and remains higher in the medium-term – partly due to firmer near-term GDP growth, alongside a judgement that domestic price pressures will prove to be more persistent.
    - The MPC judged that risks to their headline inflation forecast are skewed to the upside. This is mostly due to the possibility that domestic price pressures (especially wage growth) take longer than expected to ease.

How do the Bank of England's actions compare with other central banks?

- The Bank's 25bp hike matched the scale of the latest increases from the Fed and ECB.
    - The Bank Rate sits at the lower end of the Federal Funds Rate range (5.25-5.50%) and above the ECB Deposit Rate (3.75%).
- Market expectations for UK interest rates are noticeably higher than those for the US and Eurozone over the medium term. This mostly reflects the persistent strength of UK inflation, which remains higher than in most other advanced economies.

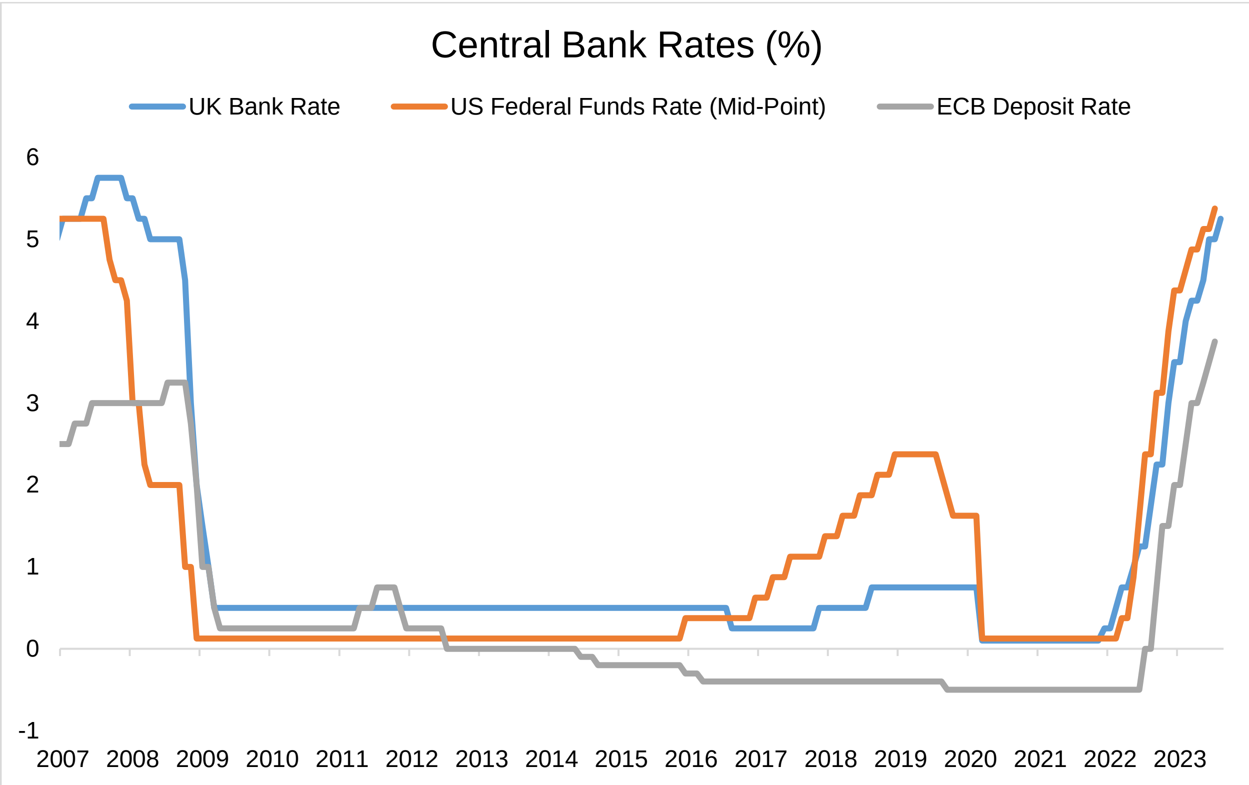
What does this mean for UK businesses?

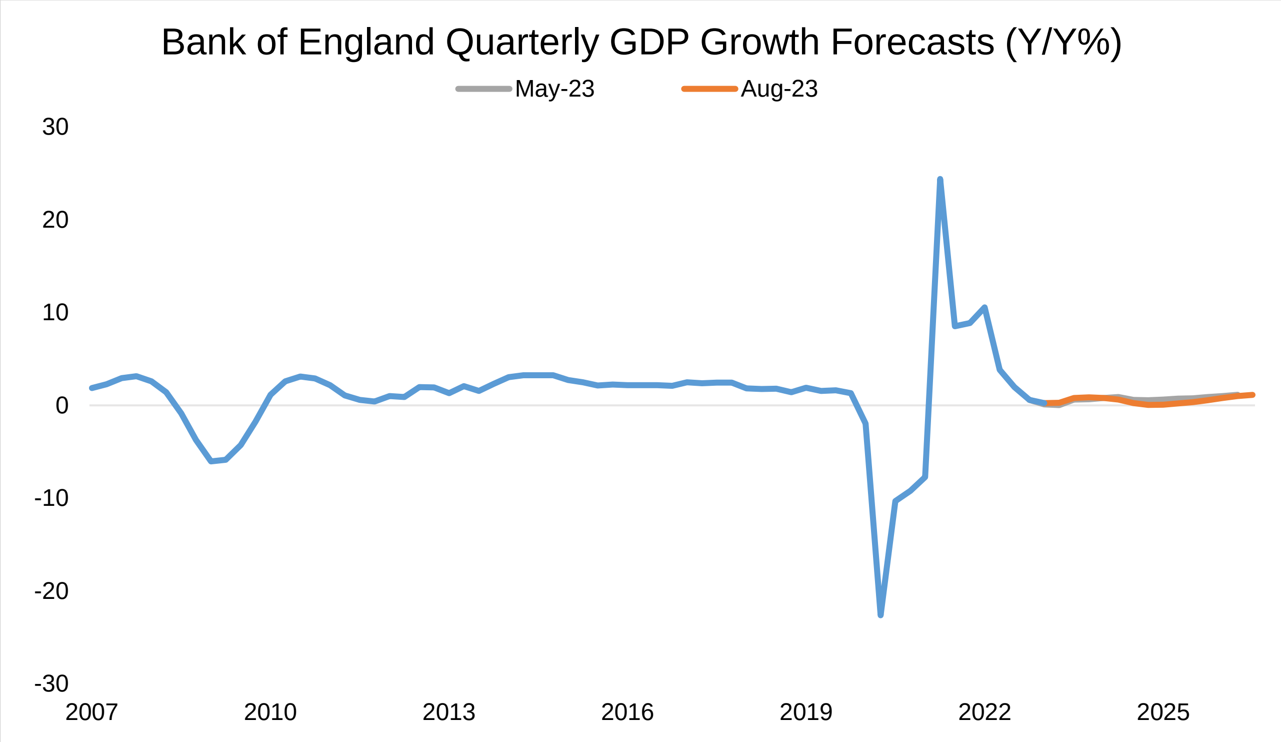
- Economic activity is expected to be lacklustre in the coming years, with higher interest rates impacting certain sectors (such as construction and real estate) more than others.

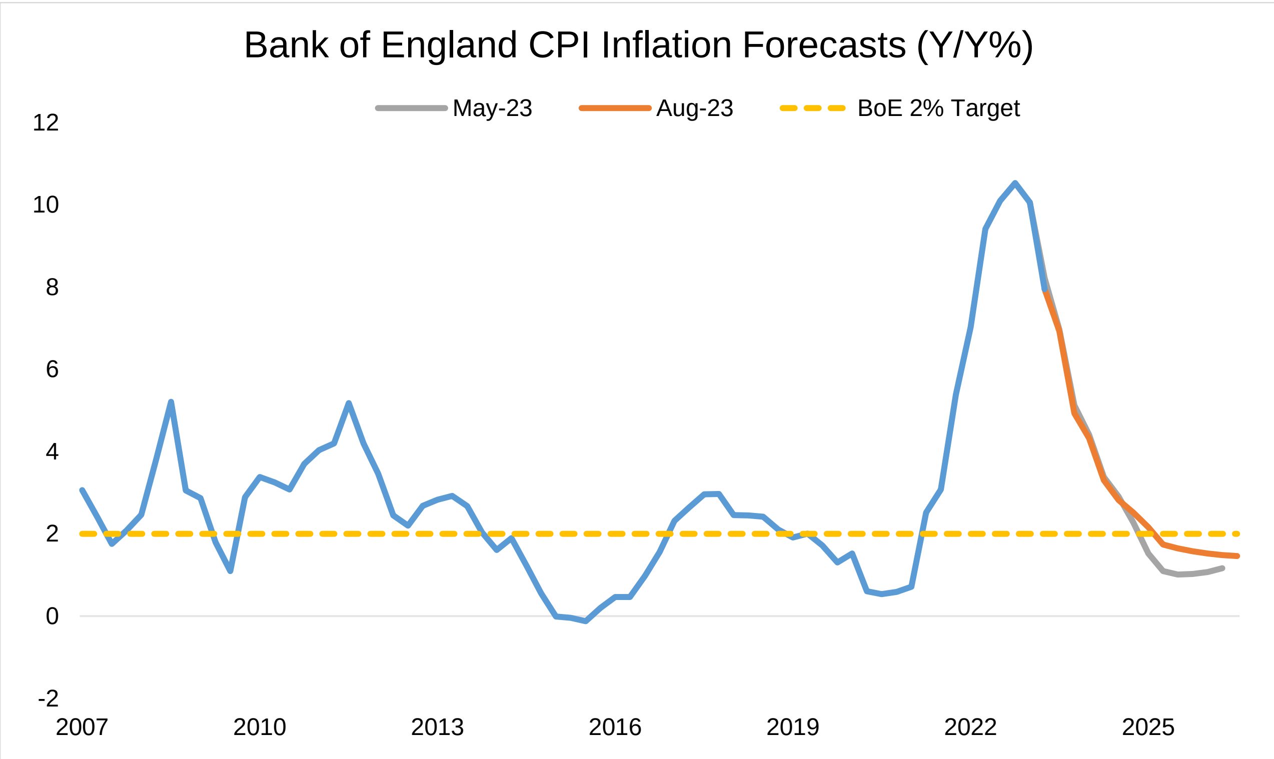
- Interest rates will likely remain more restrictive for longer than financial markets currently expected. The market-implied path for interest rates, on which the Bank's forecasts are based, suggested that rates would peak at 6.12% in Q2 2024 before easing to 4.33% in Q4 2026.
- Therefore, businesses should consider the impact of operating in a higher interest rate environment for longer in their forward planning. The possibility of further rate hikes this year should also not be discounted.

To read the full detail of the MPC's interest rate announcement and economic forecasts, click here.

Bank of England Forecasts (%)						
	GDP Growth		CPI Inflation (Q4)		Unemployment Rate (Q4)	
	Aug 23	**May 23**	**Aug 23**	**May 23**	**Aug 23**	**May 23**
2023	0.5	0.3	5.0	5.0	4.0	3.8
2024	0.5	0.8	2.5	2.3	4.5	4.0
2025	0.3	0.8	1.5	1.0	4.8	4.5







Sources: Macrobond, Bank of England.

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