Bank of England raises interest rates to 4.5%

May 2023

The Bank of England's Monetary Policy Committee (MPC) voted 7-2 to raise Bank Rate by 25 basis points (to 4.5%), in line with CBI and market expectations. This marks the 12th consecutive increase in interest rates. Inflation has remained higher than the Bank previously expected and, with the risk that strong domestic price pressures prove to be more persistent, the majority of the MPC judged that another rate hike was needed in this meeting.

The Bank's latest forecast painted a less gloomy picture of the UK economic outlook. GDP is expected to be flat over H1 2023 and then grow at a moderate pace over the next three years, compared with previous expectations of a shallow recession throughout 2023 and Q1 2024. Inflation is projected to ease considerably from April, mostly due to lower energy prices, but services inflation – which is more domestically-driven – is anticipated to remain elevated. This means that inflation does not fall below its 2% target until early 2025, and the MPC warned that inflation may prove harder to bring down if domestic pay pressures remain strong.

The MPC's messaging continues to suggest that we're approaching the peak in interest rates. In the coming months, the MPC will be looking closely at indicators of domestic price pressures, such as wage growth and services price inflation, to determine if further monetary tightening is required. It's reasonable to expect at least one or two more rate rises in the coming months, but the degree of further monetary tightening will be heavily dependent on just how these much domestic price pressures persist.

Why did the Bank raise interest rates?

- The majority of the MPC (seven members) voted to raise interest rates due to concerns that persistent strength in domestic pay pressures could lead to inflation remaining above target for longer.
- Two MPC members (Swati Dhingra and Silvana Tenreyro) voted in favour of keeping rates at 4.25%. They believed that monetary policy risked being too restrictive, which could require the recent rate hikes needing to be reversed sooner rather than later (to support economic activity).

What do the Bank's latest forecasts tell us about the UK outlook?

- UK GDP growth through 2025 is expected to be less weak than previously expected. Notably, the Bank no longer expects the UK to fall into a recession. The improvement in the outlook reflects stronger global economic activity, lower wholesale energy prices, fiscal support from the Spring Budget, and more resilience in consumer spending (due to the tight labour market).

    - In the near term, GDP is expected to be flat due to the impact of industrial action and the extra Bank holiday in May. However, underlying activity (i.e., stripping out these temporary factors) is anticipated to increase modestly due to improved consumer and business confidence.
    - The Bank only expects a small impact on GDP stemming from the recent banking turmoil in the US. This reflects the fact that the collapse of Silicon Valley Bank (SVB) only had a short-lived impact on UK credit conditions.
    - In the medium term, higher interest rates will weigh on economic activity, alongside a waning boost from recent fiscal stimulus measures and weak potential supply capacity.
- Inflation is expected to slow sharply in the coming months, due to lower energy prices, and finally falls below the Bank's 2% target in 2025. However, the MPC warned that risks were skewed significantly to the upside, due to the possibility that strong domestic pay pressures remain more persistent than expected.
    - Headline inflation peaked at just above 11% in October last year. While it has fallen since, it remains far above the Bank's target (at 10.1% in March). Recent inflation outturns have exceeded the Bank's forecast, partly due to stronger food price growth.
    - Looking ahead to the coming months, inflation is expected to decline quickly. This reflects last year's energy price increases falling out of the annual comparison, in addition to the Energy Price Guarantee extension and lower wholesale energy prices.
    - Nevertheless, food inflation is set to ease more slowly than previously expected, and services inflation is forecast to remain elevated in the near-term. This means that inflation is set to remain above the Bank's 2% target until Q1 2025.
    - The MPC heavily emphasised their concern that more persistent strength in domestic price pressures (stemming from the tight labour market) could lengthen the amount of time it takes for inflation to fall back to target. If realised, this scenario may prompt the MPC to increase interest rates further and/or maintain them higher for longer.

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

- The latest 25bp hike in the UK Bank Rate matched the scale of recent increases from the US Federal Reserve and European Central Bank.
    - The Bank Rate (4.5%) sits between the US Federal Funds Rate (5.00-5.25%) and the ECB Deposit Rate (3.75%).
- The MPC's messaging on future rate hikes broadly chimed with the recent signalling from the ECB, with a firm likelihood that both central banks will implement a measure of further tightening.
- Meanwhile, the Fed has suggested that it will wait to see how recent rate hikes feed into the economy before taking further action. This difference in messaging (compared to the Bank and ECB) likely reflects the US' lower inflation and softening economic outlook (due to tighter credit conditions as a result of higher interest rates and banking turmoil).

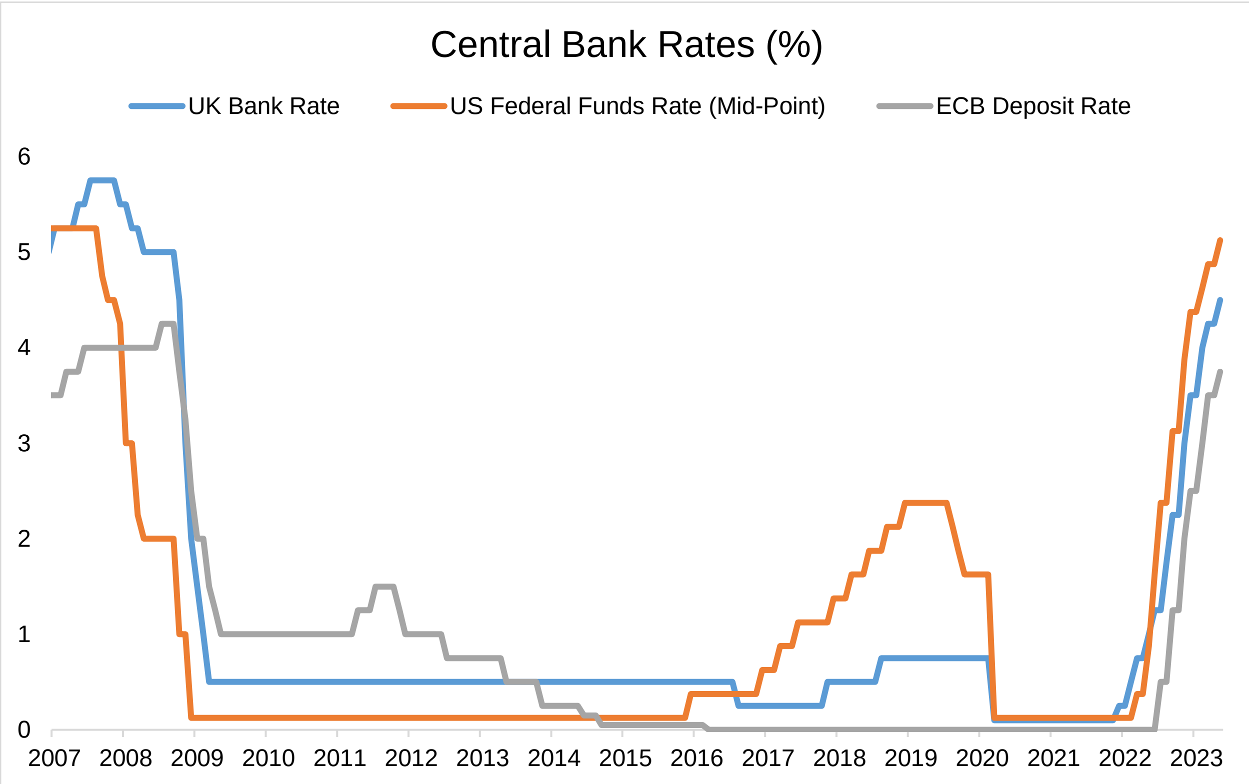
What does this mean for UK businesses?

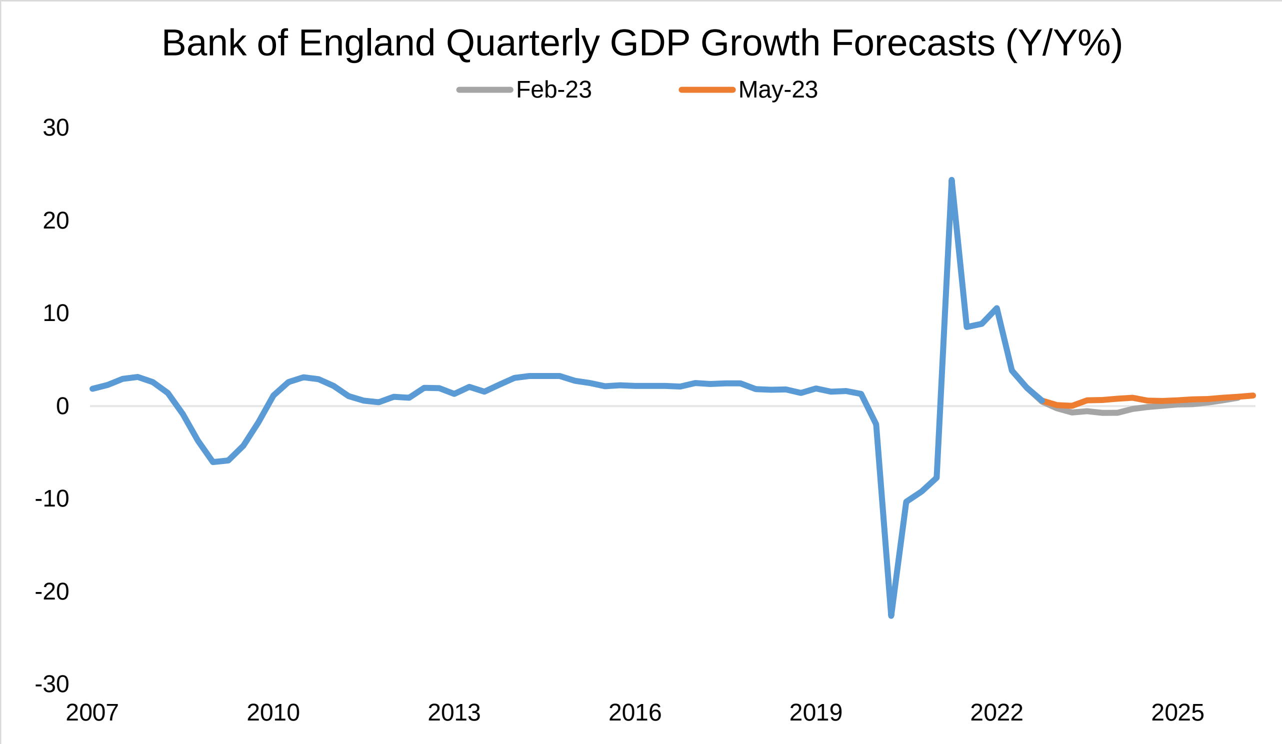
- Despite upgrading their outlook for the economy, the Bank's latest forecast paints a picture of lacklustre economic growth through 2025. With inflation also set to stay above the Bank's 2% target for another couple of years, which will weigh on household incomes (albeit to a lessening degree).

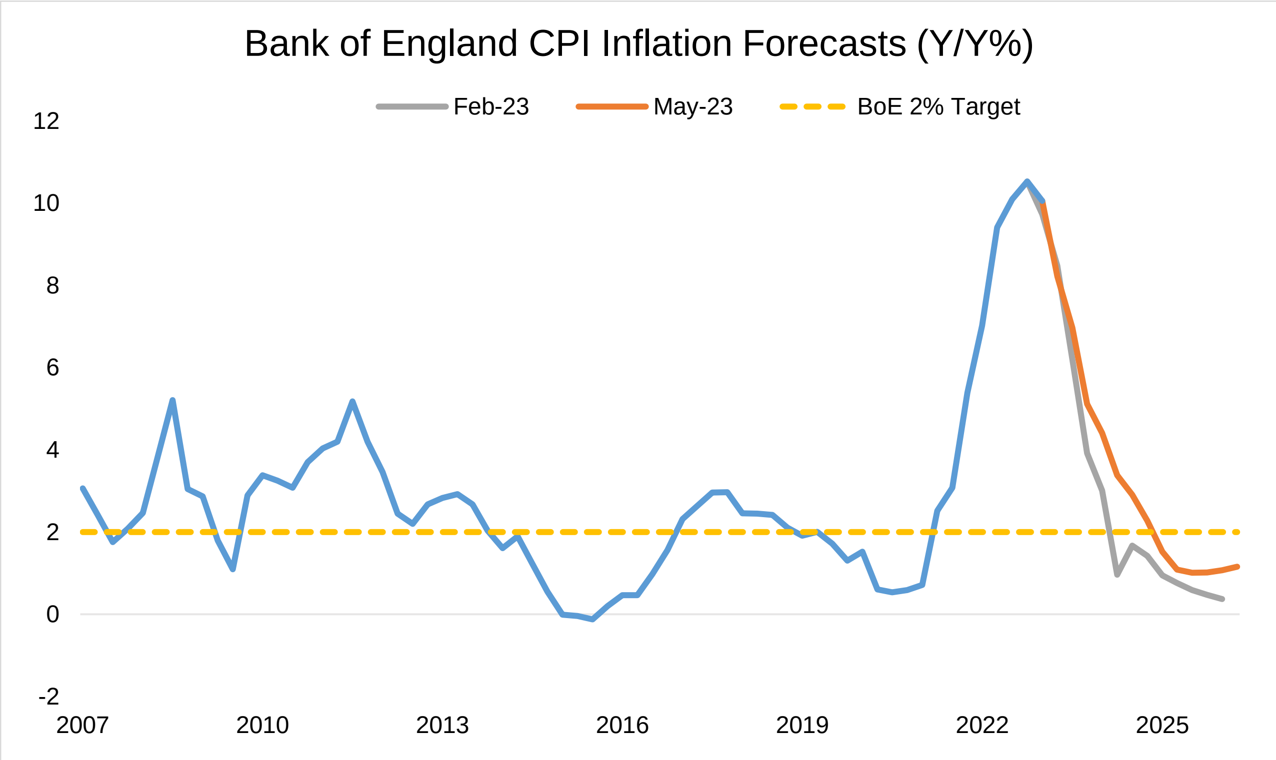
- While we may be nearing the peak in interest rates, the MPC is likely to keep its policy stance relatively restrictive (compared to the 2010's). The market-implied path for interest rates, on which the Bank's forecasts are based, suggests that rates peak around 4.75% in Q4 2023 before gradually easing to above 3.5% in Q4 2025.
- Therefore, it's reasonable for businesses to plan for one or two more rate rises at the very least. While financial markets expect rates to fall thereafter, companies should bear in mind the bigger picture that tighter financial conditions are here to stay.

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)	
	May 23	Feb 23		May 23	Feb 23		May 23	Feb 23
2023	0.3	-0.5		5.0	4.0		3.8	4.3
2024	0.8	-0.3		2.3	1.5		4.0	4.8
2025	0.8	0.3		1.0	0.5		4.5	5.3







Sources: Macrobond, Bank of England.

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