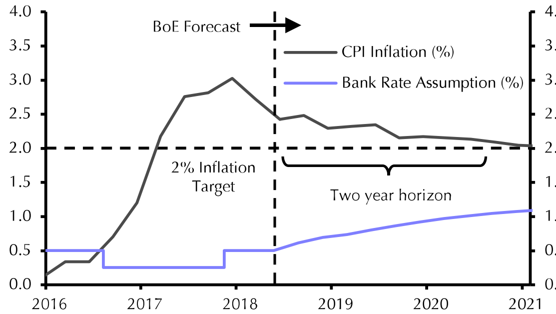
UK ECONOMICS UPDATE

MPC starts gradual process of policy normalisation

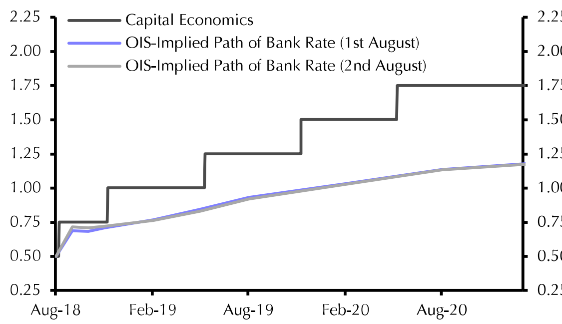
- **Despite the Monetary Policy Committee (MPC)'s hawkish forecasts accompanying the second rise in interest rates for a decade, markets are still anticipating only a very modest pace of monetary policy tightening over the coming years. We continue to think that the markets are underestimating the likely pace of monetary tightening ahead.**
- **The increase in Bank Rate from 0.50% to 0.75% in August was not much of a surprise, given that markets had been pricing in around a 90% chance of a hike.** After all, the MPC only appeared to keep its finger off the interest rate trigger in May and June due to weak growth in Q1. And the monthly GDP figures and the business surveys suggest that the economy regained some momentum in the second quarter.
- **Meanwhile, the announcements were, on the whole, pretty hawkish**, lending some support to our view that interest rates will rise by more than markets currently expect over the next few years. First, contrary to expectations of a 7-2 split, the vote to raise rates in August was unanimous.
- Second, the MPC's new forecasts in the August *Inflation Report* showed a slight upgrade to GDP growth in 2019, from 1.7% to 1.8% – although it left its growth projection in 2018 and 2020 unchanged. The unemployment rate is now projected to fall to 3.9% (4.0% previously), well below the MPC's estimate of the equilibrium unemployment rate (of 4¼%). And the Bank of England now thinks that the economy will be operating with a small amount of excess demand by 2020 (2021 previously).
- Finally, inflation is now projected to be a touch *above* its target at the two-year policy horizon, suggesting that markets might be slightly underestimating the degree of monetary tightening required. (See Chart 1.) Markets are currently pricing in just two further interest rate hikes over the next three years.
- **Despite this, after jumping initially, the pound has fallen by 0.2% against the US dollar since the meeting.** Indeed, in the press conference Mark Carney sounded a note of caution on the impact of Brexit-related uncertainty on the economy, noting that the Bank's forecasts are conditioned on a relatively smooth transition and the outlook could deteriorate if the negotiations were to go badly.
- We suspect that the Governor's comment that policy would need to "walk not run to stand still" might have played a part too. The fact that the Bank of England shied away from publishing a *medium-term* estimate of the neutral interest rate (i.e. the level at which rates have neither an expansionary nor a contractionary effect on growth and inflation), is perhaps not *too* surprising given the Bank's track record on forward guidance. Indeed, all it said was that the neutral rate is likely to be gradually rising towards a rate of around 2.5% in ten years' time.
- **Overall, we continue to suspect that market expectations for interest rates will prove too low. We are sticking to our expectation that Bank Rate will rise to around 1.75% by the end of 2020. (See Chart 2.) This is well above market expectations, but still consistent with the MPC's guidance of a "gradual and limited" tightening.**

Chart 1: MPC Inflation Forecasts (%)



Sources: Bank of England, Markit, Thomson Reuters

Chart 2: Market Expectations for Bank Rate (OIS, %)



Source: Bloomberg

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