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Andrew Wroblewski
Chief Economist, Eurozone and UK

London
+44 20 7959 3244
awroblewski@decisioneconomicsinc.com

UK: Rate hike not around the corner?

The latest (May) BoE Inflation Report suggested that the unchanged BoE decision last week probably reflected continued, and still wide, divides about inflation risks. This was no surprise at all, with the Report being far from illuminating. More notably, the Report did not imply that a BoE rate hike was very much around the corner, instead largely corroborating market expectations which now envisage the first tightening in policy coming only by the last quarter of the year.

Higher inflation envisaged..

Admittedly, the BoE now sees CPI inflation being higher in the near-term than envisaged in February, with a continued risk of it hitting 5% for a while. This reflects the recent increases in energy prices, including the likelihood that they will lead to higher utility bills. Inflation is likely to fall back through 2012 and into 2013 as the temporary impact of those factors raising inflation wanes and some downward pressure from spare capacity persists. The extent of that fall is likely to be moderated by upward pressure on nominal wages, as the continuing squeeze in real wages is resisted and inflation expectations drift up further. The prospects for inflation remain highly uncertain, however. Domestically, the degree of spare capacity and its dampening impact on inflation is uncertain, perhaps more so. Externally, continued strong global growth may increase the upward pressure on import prices, particularly those of commodities.

..alongside weaker growth

As for GDP growth, also using assumptions based on market rate expectations, albeit embodying rates rising to 0.8% by year end, the projection is weaker than in the February Report for much of the period into 2012, reflecting the dampening effects of both further increases in energy prices and recent disappointing outturns for consumption. Fiscal consolidation is likely to continue to weigh on activity throughout the forecast period. However, the Report stresses that the considerable stimulus from monetary policy, together with strong growth in global demand and the current level of sterling, should support recovery by shoring up private sector spending and encouraging a rebalancing of the economy towards exports and away from imports. The Report underlines that there are some key uncertainties surrounding the likely strength of the recovery. Private domestic demand growth could be boosted if more of the historically large corporate financial surpluses were spent on capital investment or transferred to households in the form of higher wages or dividends. But there are significant downside risks to consumers' expenditure.

Inflation risks balanced?

On balance, and a result of the updated Report, the MPC judged once again that the most likely outcome is that CPI inflation will fall back to around the (2%) target in the second half of the forecast period, but the risks around that most likely outcome still seem to be skewed to the upside. Taking that skew into account, the Report suggests that the best collective judgement of the MPC is that the chances of inflation being either above or below the 2% inflation target in the medium-term remain broadly equal.

Little new learnt

Clearly, the fact that the inflation target is met only with rates starting to rise by year-end does imply that the BoE will start raising rates in due course, albeit not in coming months. However, too much should not be read into this Inflation Report given the poor predictive power they have had in the recent past: the last Report was consistent with the first hike already having occurred. Indeed, the Report is a very clear consensus trying to combine what are still a wider than usual range of opinions within the MPC, with it possible that the Bank itself being very aware that the inflation projections do not provide that much transparency regarding monetary policy. As a result, perhaps more will be learned when the minutes to the last MPC meeting released next Wednesday with the tone of the latest BoE remarks suggesting continued dissent. However, perhaps the most pertinent point raised by the Governor is that from his perspective, bank funding spreads may be the key to when the rate hike cycle begins.