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BoE – Stagflation case materialising

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- **Yesterday, the BoE's Monetary Policy Committee (MPC) raised its Bank Rate by 50 bps to 1.75%. The decision was taken by a majority of 8-1; one member preferred an increase by only 25 bps.**
- **The bank expects CPI inflation to rise by about 3 pp higher than in the May forecast, i.e., to 13% in Q4 2022. It also sees GDP growth to turn negative in Q2 but to recover somewhat in Q3. While most of the inflation pressures are due to energy prices, it also considers second-round domestic price pressures as increasing.**
- **In its central longer-term scenario, the MPC expects two years of negative growth with -1.5% in 2023 and -0.25% in 2024. Inflation will still strongly exceed the 2% target by the end of 2023 but returns below target by end 2024.**
- **Governor Baily stressed that the MPC is not on a predefined key rate path. Against the backdrop of the recession outlook, we still expect the BoE to finish its cycle slightly above the neutral range at 2.25%. However, upside risks have increased not least due to the announcement of Liz Truss to spent about GBP 30 bn to fight the "cost-of-living-crisis" in (the likely) case she becomes next Prime Minister.**

The MPC continues to see the main culprit for the high inflationary pressures in the near doubling of wholesale gas prices since May due to Russia's restriction of gas supply. For a majority of households, this will be strongly felt through another update of the Ofgem price cap. For these consumers, the typical annual household fuel bills are projected to rise by around 75% in October. Consequently, the MPC sees CPI inflation to rise further in autumn to just over 13% in 2022 Q4, much more than forecast in the May Report. In addition, the bank becomes increasingly weary of more wide-spread second round effects, as price pressures are feeding through the economy against the backdrop of a still strong labour market. It is estimated that these indirect effects would contribute around 1 pp to CPI inflation in 2022 Q4 and add "*significantly to inflation during the following year*".

The high inflation will have of course a strongly negative impact on household's real income and consumption. In the short term, the bank expects Q2 growth at -0.2% qoq, but a Q3 rebound to 0.4% qoq. Its longer-term projections reveal two recession years with growth rates of -1.5% in 2023 and -0.25% in 2024. These projections are based on the usual set of assumption, in which Bank Rate is set to follow the implied market rates (i.e. 3% in mid-2023 by the time of the estimate) and energy prices are kept on the current level for six months. Despite the strong recession, CPI inflation proves rather sticky with 9.5% yoy in Q3 2023 and 2.0% yoy in Q3 2024. In sum, it will take two years to bring inflation back to target. But then, the projection shows it to keep slowing t 0.8% yoy in Q3 2025, thus strongly undershooting. In an alternative scenario, the BoE also models the results of keeping its Bank Rate at the current level of 1.75%. Inflation were to take more time to come down, still staying at 2.5% yoy in Q3 2024, but much less undershooting with 1.3% yoy in Q3 2025. At the same time, the induced recession would be less severe. Given that the BoE projection with an assumed Bank Rate rising to 3% induces an unwarranted undershooting of inflation in the long run, we see this as the main argument to expect the MPC to stop short of rate hikes earlier. We stick to our view of a terminal rate of 2.25% in the current cycle, which is slightly above the neutral range of 1.5% to 2% (with all due scepticism for this concept in a stagflation environment).

However, stronger second round effects could jeopardise this outlook. Even more upside risks are generated by the announcement of Liz Truss, currently the most likely next Prime Minister. She announced an GBP 30 bn (0.5% of GDP) package to mitigate the cost-of-living crisis. While this is good news for households, it could also lengthen the period of higher inflation.

As the BoE only includes officially announced fiscal policy into its forecasts, the model impact remains to be seen. Liz Truss also recently suggested that the government should have a "bigger role" in how the central bank operates, possibly by targeting money supply as a way to control inflation. While she certainly wants to benefit from blaming high inflation on the BoE, suggestions to touch central bank independence could quickly backfire on markets. Governor Bailey rejected those interference.

Table 1.A: Forecast summary of the MPC's baseline projections (a) (b)

	2022 Q3	2023 Q3	2024 Q3	2025 Q3
GDP (c)	2.3 (2.9)	-2.1 (-0.8)	0.0 (0.4)	0.4
CPI inflation (d)	9.9 (9.5)	9.5 (5.9)	2.0 (1.8)	0.8
LFS unemployment rate	3.7 (3.5)	4.4 (4.1)	5.5 (4.8)	6.3
Excess supply/**Excess demand** (e)	**+¾ (+¼)**	-2¼ (-1½)	-3¼ (-2)	-3¾
Bank Rate (f)	1.6 (1.5)	3.0 (2.6)	2.5 (2.3)	2.2

(a) Modal projections for GDP, CPI inflation, LFS unemployment and excess supply/excess demand. Figures in parentheses show the corresponding projections in the May 2022 Monetary Policy Report.

(b) Unless otherwise stated, the projections shown in this section are conditioned on: Bank Rate following a path implied by market yields; the Term Funding Scheme and Term Funding Scheme with additional incentives for Small and Medium-sized Enterprises; the Recommendations of the Financial Policy Committee and the current regulatory plans of the Prudential Regulation Authority; the Office for Budget Responsibility's assessment of the Government's tax and spending plans as set out in the March 2022 Economic and Fiscal Outlook and the May Cost of Living Support package; commodity prices following market paths for six months, then held flat; the sterling exchange rate remaining broadly flat; and the prevailing prices of a broad range of other assets, which embody market expectations of the future stocks of purchased gilts and corporate bonds. The main assumptions are set out in the '**Download the chart slides and data – August 2022**'.

(c) Four-quarter growth in real GDP.

(d) Four-quarter inflation rate.

(e) Per cent of potential GDP. A negative figure implies output is below potential and a positive that it is above.

(f) Per cent. The path for Bank Rate implied by forward market interest rates. The curves are based on overnight index swap rates.

Source: BoE Monetary Policy Report, August 2022

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