Market Bulletin

2 August 2018

UK Bank of England raised interest rates 25 basis points : Walking not running

In brief

- The Bank of England (BoE) monetary policy committee voted unanimously to raise interest rates by a quarter of a percentage point to 0.75%.
- Governor Carney stressed that further increases would be gradual but all forecasts right now must be taken with a pinch of salt given Brexit uncertainty.

The Bank of England raised interest rates by 25 basis points today to 0.75%. The hike was fully priced in to the markets and although it came as a surprise that the vote was unanimous, there was relatively little market reaction.

In the press conference the Governor was at pains to stress that any further hikes will be gradual—that it was necessary to walk and not run.

'Gradual' is the buzz word for most central banks normalising policy. And yet the meaning differs wildly. For the U.S. Federal Reserve, gradual appears to translate to 25 basis points a quarter. For the Bank of England, gradual appears to mean 25 basis points *per year*.

There weren't many meaningful changes to the Bank's forecasts for growth or inflation (see **Exhibit 1**, next page). The interesting new analysis is the Bank's assessment of 'R-star'. In simple terms, this is the appropriate interest rate to deliver inflation to its 2% target in 'steady state' i.e. when the economy is not affected by short-term cyclical considerations including the uncertainty of Brexit. The Bank estimates this 'R-star' to be 2.5% nominal.

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This is clearly well below the interest rates we might have considered to be 'normal' pre-crisis. The governor emphasised that we all need to get used to a new normal. The BoE's assessment is that 'normal' real gross domestic product growth is 1.5% and normal wage growth is 3% (in the ten years before the crisis these numbers were 3% and 4.5% respectively). Effectively the BoE is saying that while neither the economy—nor pay-cheques—feel particularly boomy, this is likely as good as it gets. A sombre message indeed.

A 2.5% nominal interest rate is still well above 0.75%. The Governor stressed that there are three particular headwinds likely to persist, which means interest rates are likely to remain below 'R-star'. These are household and government deleveraging, low productivity and a higher degree of uncertainty because of Brexit.

We are slightly more optimistic than consensus on a few of these short-term headwinds. The government is likely to be increasingly tempted to loosen the fiscal purse strings (as the recent announcement of additional spending on the National Health Service shows). We expect the heads of terms of a relatively 'soft Brexit' to have been agreed between British Prime Minister Theresa May and the European Union by year end. And we believe some of the recent weakness in productivity is cyclical.

As a result, going into next year we expect the BoE to be moving back to 'R-star' a little more quickly than either it, or the market, anticipates right now. Given the Brexit negotiations are likely to drag into November it is unlikely the BoE hikes again this year. But we expect at least two further 25 basis point hikes in 2019.

EXHIBIT 1: Forecasts were relatively unchanged from those produced in May

	GDP (y/y)			CPI inflation (y/y)		
Meeting	2018	2019	2020	2018	2019	2020
May-18	1.4%	1.7%	1.7%	2.2%	2.1%	2.0%
Aug-18	1.4%	1.8%	1.7%	2.3%	2.2%	2.0%
Change	0.0%	0.1%	0.0%	0.1%	0.1%	0.0%

Source: Bank of England, J.P. Morgan Asset Management. y/y is year on year. Data as of 2 August 2018.

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