The BOE leads the way with interest rates hikes- but context is important

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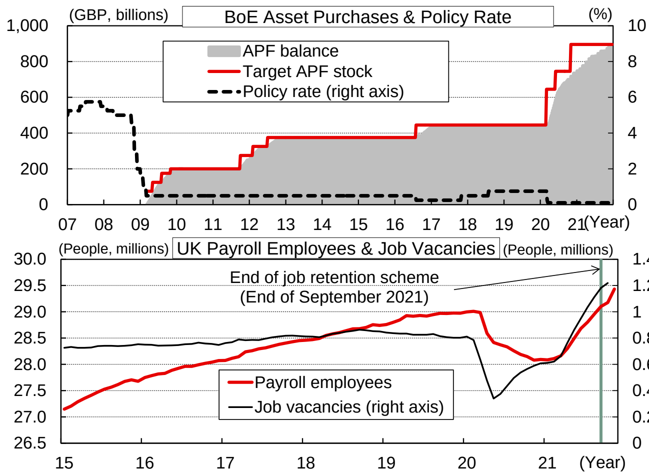
The Bank of England (BoE) hiked its main interest rate from 0.1% to 0.25% on 16 December 2021. In doing so, it became the first major central bank to raise rates since the start of the pandemic. In the same month, the US Federal Reserve (Fed) announced that reductions to its monthly bond purchases will occur at a higher pace. Based on median projections, the Fed's so-called dot plot now points to three rate hikes in 2022 (with this pace continuing in 2023). The post-pandemic normalisation of monetary policy has now begun in developed economies.

However, there are important differences between the approaches of the BoE and the Fed. The interest rate hike by the BoE should be placed in the context of its asset purchase schemes. The interest rate hike by the BoE should be placed in the context of its asset purchase schemes. The BoE, unlike the Fed or the European Central Bank (ECB), announces a total target stock of asset purchases without specifying a monthly pace of purchases. Therefore, the idea of 'tapering' monthly purchases is not part of the discussion. The focus of monetary policy normalisation instead falls on interest rate hikes or reductions in the stock of assets (chart 1, upper). With this in mind, the BoE set out its plans to wean the UK economy off monetary stimulus in August last year. It will consider ending the reinvestment of maturing bonds once rates have reached 0.5%.

Future interest rate rises could be quite gradual. While there are plenty of signs of labour market tightness (Chart 1, lower) and indications of greater persistence in domestic price pressures as written in the BoE statement, the effect of the Omicron wave of COVID infections on inflation remains unclear. COVID-related restrictions were tightened in December. While US real GDP had already recovered to pre-pandemic levels by Q1 2021, UK GDP remained 1.3% below its 2019 level in the Q3 2021 release. UK inflation has risen sharply but it has remained below the rates seen in the US (Chart 2, lower).

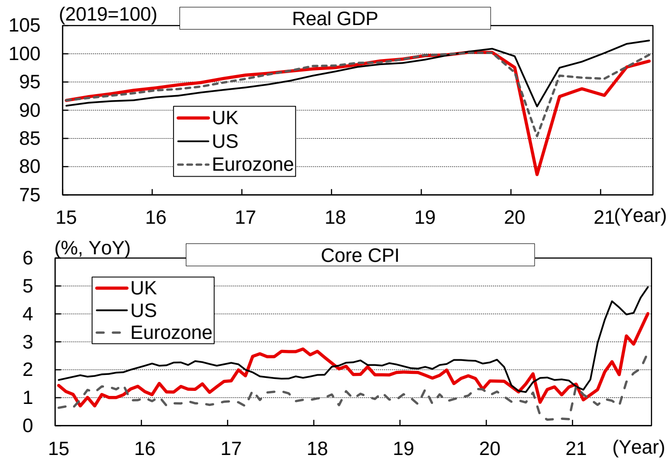
Our view is that the evolution of the COVID-19 situation remains key for the outlook. We expect the BoE to raise rates again to 0.5%. However, at that mark passive balance sheet reduction will come into play and we suspect that subsequent rate hikes are likely to occur at a slower pace than in the US.

Chart 1: BoE QE and UK Employment



Source: BoE, ONS, MUFG Bank Economic Research Office

Chart 2: Real GDP and CPI in UK, US & Eurozone



Source: ONS, DoC, Eurostat, MUFG Economic Research Office

Translated by Rebecca Whitter