

## **PRESS RELEASE**

### **TO HIKE OR NOT TO HIKE? BANK OF ENGLAND'S GREAT DILEMMA**

**Paris, May 30, 2023** – On May 11, the Bank of England (BoE) decided to raise its key interest rate for the 12<sup>th</sup> time in a row, bringing it to 4.5%. At its latest meeting, the BoE stated that it would stay the course to ensure that inflation returned to 2%, and did not rule out further hikes if there are signs of persistent inflation. The latest figures show a slowdown in headline inflation, from 10.1% in March to 8.7% in April, but core inflation reached its highest level in 30 years.

The UK, which is often considered as a bridge between the United States (US) and Europe, now finds itself between the two's different hiking cycles. The US has seemingly paused its rate hike cycle, while the ECB has indicated that more hikes are to still to come. In this environment, the IMF has recently revised upwards its growth forecasts for the British economy. At Coface, we are still forecasting a slowdown in 2023. BoE's dilemma is at its peak.

#### **British monetary policy in a fog**

Until now, the BoE has generally been closer to the Fed's rate cycle than the ECB's. It was the 1<sup>st</sup> major central bank to start hiking in December 2021, with combined hikes of 440bp. The Fed began its cycle in March 2022 and has since raised rates by 500bp, while the ECB began raising rates in July 2022 (+375bp in total).

Persistent inflation – which is higher in the UK than in other countries - is the main reason why the BoE now doubts where in its hiking cycle it is. Inflation was 8.7% in April, whereas inflation in the US had fallen to 4.9% and 7.0% in the Euro Area. Core inflation - which excludes energy or food - was 6.8% in the UK in April 2023, while it was 5.5% in the US and 5.6% in the Euro area.

While the British economy has shown itself more resilient than many feared, it is still expected to shrink in 2023, unlike most other comparable economies. Figures for Q1 2023 show that the UK could avoid a technical recession, but the outlook is nonetheless challenging with the economy still not back to its pre-pandemic level and financial services being an important part of the economy.

#### **The British economy and the BoE at a crossroads**

Today, central banks have to balance between fighting inflation, dampening economic growth and, since the turbulence in the US banking sector, ensuring financial stability.

In a context where growth prospects were better and where inflation would be more similar to peers, the BoE would likely have followed the Fed, as it has done until now, by pausing rate hikes. However, the current stickiness of inflation might force it to hike further, even if this puts additional pressure on companies and households that have seen interest rates more than double in a year. Conversely, not hiking enough could result in more persistent inflation with a wage-price spiral that is quite difficult to get out of.

Uncertainty now reigns as to the trajectory of the monetary cycle. Some still expect the BoE will maintain its rate until the end of the year, while the markets now prices in two or four further 25bp hikes before the end of the year.

The UK economy has defied many economists' expectations in the past nine months with,

particularly, its services sector holding up. However, the immediate outlook has worsened for the service sector with current turmoil on the financial markets, and the worsening of talks with some unions that is resulting in further strikes.

That the BoE finds itself at a crossroads is immediately clear. Is the risk of persistent inflation higher than the risk of more financial instability and further dampening the recovery of the UK services sector? Coface's main scenario calls for at least one further hike at the 22 June 2023 meeting, with further hikes coming down to upcoming figures, especially core inflation and wage growth in May and June.

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