Economic Research Unit

Economics Weekly

Bank of Ireland

Outlook for Bank of England rate now more finely balanced

For now, we are sticking with our view that the Bank of England will raise rates to a peak of 4.25% – but given the ongoing surprising strength of UK GDP growth – it is now finely balanced whether or not the MPC will be forced to hike in both December and February to 4.5%. Activity has held up due to the tailwinds from the AI-investment cycle and because households have used savings to smooth consumption and offset the rise in CPI inflation.

Also, recent Bank of England analysis has provided a far less sanguine interpretation of the muted readings for core CPI inflation and pay growth and the indirect effects of energy prices. That said, the deterioration in the housing market will give the MPC pause for thought, providing a case not to tighten monetary policy too aggressively. Of course, the key uncertainty remains events in the Middle East and whether Brent oil prices have further to fall, from $91pb this morning.

Markets still pricing in three Bank of England rate hikes to 4.75%: Markets are still fully pricing in three 25bp rate hikes from the Bank of England over the next 12 months to 4.75%. This is despite the fall in Brent oil prices to $91per barrel. These expectations for higher rates have also supported sterling, trading at 83.7p against the euro this morning.

Our recent Global Watch set out our view that rates would peak at 4.25% in Q1 2027, similar to the median expectation in the Bank of England's Survey of Market Participants (see chart below). However, several factors mean there is a risk of hikes in both December and February to 4.5%. Principally, UK GDP growth has been far stronger than expected, but also recent Bank of England analysis has pointed to a less sanguine view of the inflation outlook in 2027.

Several upside risks to UK GDP growth in 2027: UK GDP rose by 1.9% in the year to Q3 2026. Why? First, consumer spending has been resilient, up 1.8% yoy in Q3 2026, with households likely cutting savings to smooth consumption. Should they continue to do so, the slowdown in H1 2027 many are anticipating may not emerge even as CPI inflation climbs above 4% when the Ofgem price cap is raised in January.

Second, the AI-investment cycle is playing a strong role, supporting investment and evident in B2B services and manufacturing output. The Bank of England estimated AI-related activity accounts for a fifth of GDP growth in 2026. This tailwind could still prove stronger than expected in 2027 – rather than dissipating. Finally, October's Budget reiterated that public spending growth will slow sharply in 2027, having made a substantial contribution to GDP growth in 2026. However, it remains to be seen whether these efforts to rein in borrowing will come to fruition.

Why is the Bank of England so pessimistic on inflation? The Bank's November Monetary Policy Report forecast that CPI inflation would rise close to 5% by mid-2027, well ahead of the 4.2-4.4% peak forecast by many others for Q1 2027. One explanation is the Monetary Policy Committee's (MPC) pessimistic forecast that food price inflation will rise close to 5% by mid-2027, as indirect effects from energy are passed on. The MPC's forecasts were also based on spot oil prices close to $120pb.

Thus far, MPC members have expressed some satisfaction that the indirect effects of energy have been smaller than expected, evident in core CPI inflation at 2.8% in October. However, their recent analysis suggests this is just a matter of time. Specifically, measures of companies' electricity and gas input costs have not yet risen significantly – likely explained by the use of fixed-price contracts and hedging arrangements. So less inflation now means more in 2027.

Finally, the Bank's analysis has suggested that, after stripping out volatile items and accounting for various measurement issues, both underlying services inflation and regular pay growth are closer to 4% than the 3.7% and 3.1% rates in the most recent data. Looking ahead, the MPC will be closely watching pay settlements at the turn of the year to see whether workers are successfully bargaining for higher wages.

Is the labour market really stabilising? Well-known sampling problems mean little weight can be placed on last week's news that the Labour Force Survey (LFS) unemployment rate fell to 4.6%. Rather, the MPC had highlighted recent, more encouraging readings on job creation from the KPMG/REC and S&P Global PMI readings.

However, the more recent surveys have deteriorated. Yesterday's flash PMI for November indicated a fresh fall in employment as companies sought to cut costs and boost productivity. The October KPMG/REC survey signalled fresh falls in permanent and temporary billings. Finally, HMRC's real-time measure of employees fell by 0.1% in October to 30.3 million.

The housing market will give the MPC pause for thought: Moneyfacts reported last week that the average two-year fixed mortgage rate is now 5.95%, and the five-year rate is 5.88%. Here, retail mortgage interest rates have surged as markets have priced in the Bank of England rate rising to 4.75% – showing how the expected tightening of monetary policy is already hurting economic activity.

At these rates, coupled with stretched affordability, UK housing market activity is now clearly starting to contract. In September, mortgage approvals for house purchase were down an enormous 19% yoy. According to Lloyds, house price inflation is now in negative territory, at -1.2% in October. The October RICS survey painted a bleak outlook, with a net majority of estate agents reporting falling prices (-36%), new buyer enquiries (-24%) and agreed sales (-24%).

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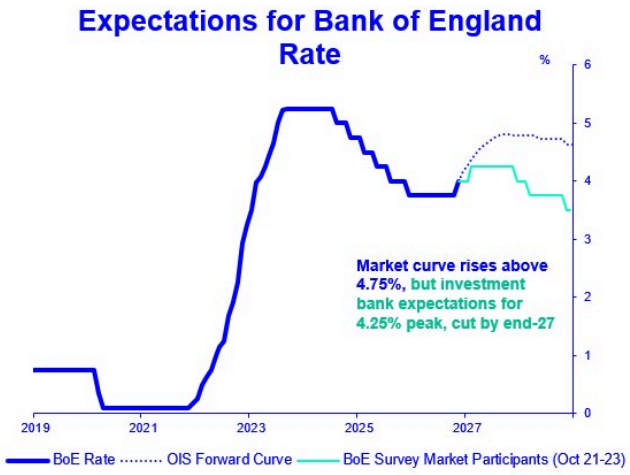

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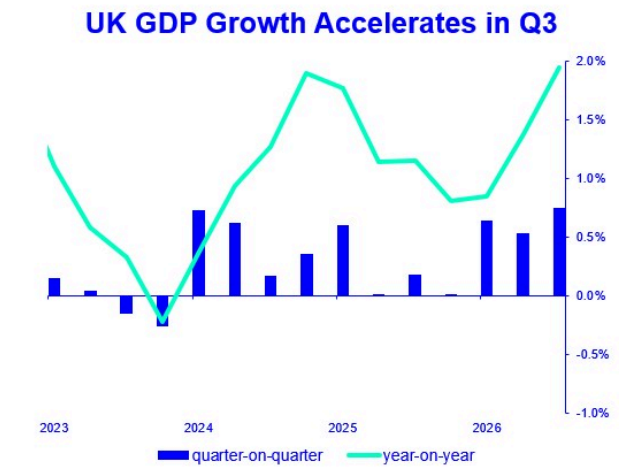

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