Market Insights Economics

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BoE MPC preview (Sept-26): Unchanged Bank Rate, more cautious tone

- We expect the MPC to keep Bank Rate unchanged at 3.75% in September, with July's 6-3 vote split likely to be repeated
- Higher energy prices have increased the upside risks to near-term inflation, but still limited evidence that these pressures are feeding through into wages, inflation expectations or broader price-setting
- The MPC is therefore likely to retain a cautious stance, while the annual QT review is expected to see the APF reduction target lowered from £70bn to £50bn, largely reflecting fewer gilt redemptions rather than a significant reduction in active sales

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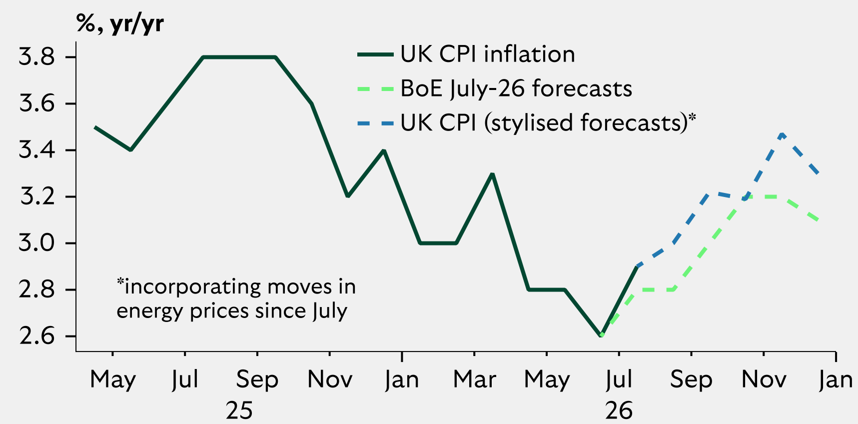
We expect the MPC to leave Bank Rate unchanged at 3.75% in September, with a repeat of July's 6-3 vote split the most likely outcome. Developments since July have not materially altered the balance within the Committee. Higher wholesale energy prices should keep Megan Greene, Catherine Mann and Huw Pill in favour of a precautionary 25bp increase, while subdued private-sector pay growth, weak labour demand and limited evidence of broader inflation persistence should leave the six-member majority comfortable holding. The decision and vote may be unchanged, but the statement is likely to sound somewhat more cautious than in July and place greater emphasis on upside risks to the near-term inflation outlook given recent moves in global energy prices. Alongside the rate decision (announced at 12pm BST on the 17th), we expect the Bank to lower the annual Asset Purchase Facility reduction target from £70bn to £50bn.

July's framework remains broadly intact

The key question for September is whether developments since the July meeting have materially altered the outlook facing the Committee. On balance, we believe that they have not. The Bank expected headline inflation to rise as higher energy prices fed through to household bills and supply chains, while subdued demand and a looser labour market limited the risk of a broader inflation process. That remains a reasonable description of the economy. Headline inflation has risen broadly as expected and activity has been somewhat firmer than the Bank anticipated. But services inflation, wage growth and labour-market indicators have not shown the deterioration that would suggest a materially stronger domestic inflation process. The domestic side of the July assessment has therefore held up reasonably well; the main challenge has come from oil and gas prices moving above the assumptions used in the forecast. The August Decision Maker Panel reinforces that distinction. Firms' year-ahead CPI and own-price expectations eased, while expected wage growth was unchanged. Many businesses also expect higher energy costs to be absorbed partly through lower margins. That is more consistent with limited pass-through than with the emergence of a broader wage-price process.

Chart 1: Views on the near-term inflation outlook are likely to be revised higher



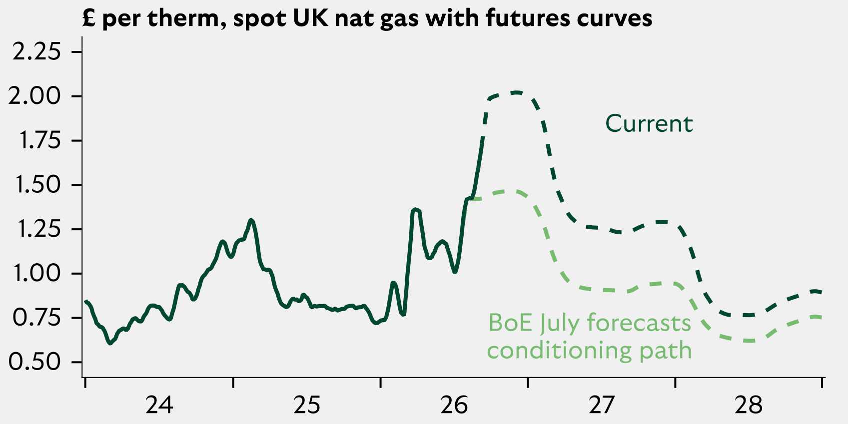
Source: BoE, ONS, Macrobond, Lloyds Market Insights

Headling inflation higher but limited evidence of persistence

July CPI inflation rose from 2.6% to 2.9%, broadly in line with the Bank's expectations. The increase was largely driven by the anticipated rise in household energy prices following the July Ofgem reset, with gas and electricity making the largest contribution. The composition was more reassuring than the headline. Motor-fuel inflation was somewhat firmer than expected, but food inflation and parts of the core-goods basket were softer. Core inflation was broadly in line with the Bank's profile and services inflation eased. The modest deviations from forecast were therefore mixed and did not amount to a common domestic inflation signal.

For policy, the distinction is between the direct effect of higher fuel and utility prices on the one hand and their potential propagation through firms' costs, expectations, wages and wider price-setting on the other. The first channel is clearly visible, but there remains little evidence of the latter. Higher energy costs should increasingly work through supply chains, and 2027 wage settlements will provide a more demanding test, but the evidence so far is closer to the July central case than to a materially more persistent outcome.

Chart 2: Current energy prices present upside risks to the inflation outlook



Source: BoE, Macrobond, Lloyds Bank Market Insights

Wholesale energy adds upside risk to the headline profile

The more important inflation development since July has come from wholesale energy markets. Oil and gas prices have moved materially above the assumptions underpinning the Bank's central forecast, increasing the likelihood that near-term CPI will run above the July profile through motor fuels, future utility bills and energy-intensive business costs. The comparison depends on the horizon. Parts of the near-term oil and gas curves have moved towards the assumptions used in the July 'adverse' scenario, while longer-dated prices remain more anchored. The principal implication is therefore a higher near-term inflation profile, rather than necessarily a permanently higher path.

Even an energy curve resembling the Bank's adverse assumptions would not, by itself, imply the adverse inflation scenario. That outcome also requires a materially stronger response in expectations, wages and firms' price-setting. Evidence of that transmission has not emerged so far. Higher energy prices therefore increase the probability and potential size of the shock, but do not automatically require a higher Bank Rate. If energy prices remain elevated, the November forecast round would provide a more natural point for the MPC to reassess the full inflation profile and any evidence of propagation.

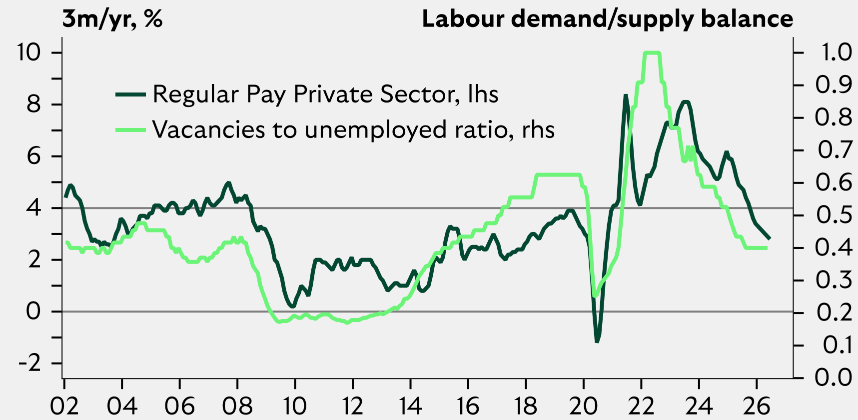
Stronger activity growth but wage pressures continue to cool

Q2 GDP growth of 0.4% was slightly stronger than the Bank anticipated, while the August PMIs suggest that activity remained reasonably resilient through the summer. That argues for a somewhat firmer assessment of near-term demand, but stronger activity has not been accompanied by a corresponding strengthening in the labour market or domestic cost pressures.

Private-sector regular pay growth slowed to 2.8% in Q2, in line with the Bank's forecast. Payroll employment remains weak and vacancies continue to point to subdued labour demand. Recruitment surveys suggest conditions may be moving from contraction towards stabilisation, but candidate availability remains high. The economy has therefore been more resilient than expected, but not materially more inflationary.

Higher market rates and mortgage costs add to the restrictive financial backdrop. During the MPC members' recent appearance before the Treasury Select Committee, Governor Andrew Bailey cautioned against treating market tightening as a substitute for MPC action or as evidence that a Bank Rate increase is inevitable. Financial conditions provide some additional insurance against propagation, but the Committee would still act if wages, expectations or broader pricing behaviour deteriorated.

Chart 3: Labour market tightness continues to ease



Source: ONS, Macrobond, Lloyds Bank Market Insights

Another 6–3 vote

We therefore expect Greene, Mann and Pill to repeat their votes for a 25bp increase. Their case remains one of risk management: the longer energy prices remain elevated, the greater the danger that expectations and wage-setting adjust before the effects are clearly visible in the data by which time, a much bigger policy adjustment may be needed.

The six-member majority should nevertheless remain intact. Comments during the recent appearance by Bailey, Ramsden, Greene and Taylor before the Treasury Select Committee reinforced that assessment. Greene continued to focus on the risks from a prolonged energy shock, but Ramsden described domestic inflation pressures as relatively benign and took reassurance from wages and the labour market. Bailey pushed back against the suggestion that a hike was inevitable, while Taylor continues to view 3.75% as sufficient insurance while evidence of second-round effects remain limited.

A narrower majority remains possible if another member places greater weight on the duration of the energy shock, but the hearing gave us no reason to move away from 6-3 as the clear central case.

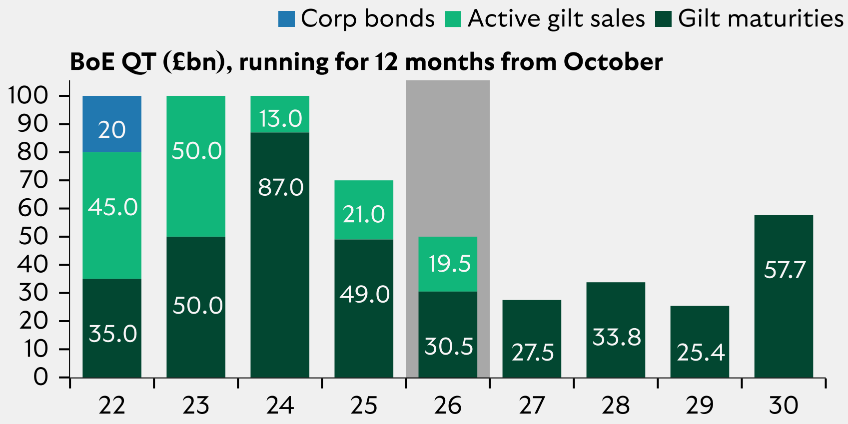
QT: slower headline runoff, but active sales continue

The annual QT review should deliver the meeting's main policy change. We expect the Bank to reduce the target decline in APF gilt holdings from £70bn to £50bn over the coming year. On the current redemption profile, around £31bn should come from maturing gilts and approximately £19bn from active sales. The lower headline target would therefore largely reflect fewer redemptions rather than a retreat from active QT.

We expect sales to remain concentrated in short and medium maturities, with limited long-end supply. That would allow the balance sheet to continue shrinking while recognising elevated term premia and a more difficult absorption environment at the long end of the gilt curve.

The Treasury Select Committee appearance was consistent with the Bank's established framework: QT should remain gradual and predictable and operate in the background, while Bank Rate remains the active instrument for setting the monetary-policy stance. A £50bn target should therefore be seen as an operational response to the redemption profile and market conditions, not as a dovish substitute for the rate decision.

Chart 4: Annual pace of QT expected to slow again



Source: Bank of England, Macrobond, Lloyds Bank Market Insights

Bottom line

The September meeting should deliver the same Bank Rate and the same 6-3 vote, but with a somewhat more cautious statement and a slower headline pace of balance-sheet reduction. Incoming data have broadly validated the domestic side of the July MPR: headline inflation has risen largely for anticipated reasons, private-sector wage growth remains subdued and labour demand continues to point to spare capacity. The principal challenge is the further rise in wholesale energy prices, which raises the near-term inflation profile though without yet demonstrating greater persistence.

We therefore expect Bank Rate to remain unchanged at 3.75%, by 6-3, alongside a £50bn annual APF reduction target comprising roughly £31bn of passive runoff and £19bn of active sales.

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