Why UK interest rates now look set to rise in December

Latest labour market data and higher inflation likely to push Bank of England to raise borrowing costs

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The Bank of England (BoE) has been warning for some time that it may need to raise interest rates sooner rather than later. At the November policy setting meeting, only two of the nine-member committee backed a rise, surprising and probably disappointing many investors.

Our view at the time was that it was too soon to raise rates, as considerable risks remained around the outlook for the labour market. We also felt it was more likely that the BoE would keep policy rates on hold until 2023. However, this week's labour market statistics release has revealed a much stronger environment, and so we have changed our call.

We now forecast the BoE to raise the policy interest rate from 0.1% to 0.25% at the December Monetary Policy Committee (MPC) meeting (16th), and then to hike again to 0.50% in February 2022. We except further increases to follow in 2023.

As stated, the main reason for the change is the much stronger than expected labour market data published this week. Not only did we see a large rise in hires (and drop in the number of unemployed), but more significantly, we saw a very sharp increase in average hours worked.

Average hours worked are a good indicator of slack and capacity, or, in this instance, lack of. There was also a record rise in job turnover, also referred to as the "quit rate". The higher rate of turnover is likely to lead to higher pay growth in the coming months, as higher salaries are often the motivation for moving companies.

An upside surprise from the inflation statistics this week also influenced the decision to change our rates forecast. Inflation based on the consumer price index (CPI) rose from 3.1% to 4.2% year-on-year in October, disappointing consensus expectations of 3.9%.

Although most of the increase was caused by energy inflation, and in particular, the rise in the energy price cap for households, there are signs that companies are more freely passing on cost increases to end consumers. This raises the risk that higher wage inflation pressures feed back into higher domestic inflation, which in turn could prompt further demand for higher pay.

Our previous call was predicated on two factors, which remain as downside risks for the interest rate forecast. The first is the possible rise in unemployment following the conclusion of the furlough scheme. The data covering the period is not yet available and so we cannot be sure how many individuals ended up being unemployed, or went back to work.

October's labour statistics will be released on 14 December, just before the BoE's next MPC meeting. But in our view, the following release in January is needed to have a better understanding of the situation due to the lags involved in the data capturing these types of events.

However at this stage, and as evident from recent data, even if unemployment rises by half a million to one million people, conditions are so strong that it will not be long before this extra slack is absorbed.

The second factor is the eventual undershoot in inflation in 2023. The BoE openly states that the way it constructs its inflation forecast means it is potentially overestimating inflation in 2023.

This is because the methodology essentially ignores the expected fall in the price of natural gas as shown in forward markets. The BoE has published an “alternative” scenario that uses all the information available, and it shows CPI below 2% in 2023. Our forecast has CPI falling to just over zero by April 2023 before slowly rising again.

As we move into the new year and as the BoE rolls its forecast forward, more of these downside risks will be included in the official forecast. This may stop the MPC from even delivering the February hike that we are now expecting.

We think that on balance, projections of inflation going above 5% in the near-term will dominate headlines and hence, the BoE can press ahead in February. But we then think the BoE will then remain on hold until 2023. Once we move past the trough in inflation in April 2023, we should then see further policy normalisation.