FOREX TRADING

HOW HEALTHY IS THE UK ECONOMY?

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THE BRITISH ECONOMY

FOREWORD

Ahead of the EU referendum, economists and political pundits predicted economic difficulty for the United Kingdom should it opt for 'Brexit'.

Now, almost 18 months after the British public voted for Leave, we've seen the Bank of England raise interest rates for the first time in a decade to address increasing inflation.

A tightening of monetary policy usually reflects a healthy economy. But is this the case for the UK? The purpose of this eBook is to answer that question - and explain how it could impact your trading decisions.

Patrick Latchford
CEO, Blackwell Global Investments (UK) Limited

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MAKING SENSE OF THE RATE HIKE

INFLATION - A BREXIT PROBLEM?

In early November 2017, the Bank of England increased its benchmark interest rate from 0.25% to 0.5%. It's the first rate hike from the central bank since 2007.

The reason for the adjustment is simple. The United Kingdom has seen its rate of inflation increase beyond the central bank's target of 2%. For October 2017, the key rate of UK inflation was 3%.

Usually, inflation is a symptom of fast economic growth. Economies that experience booming growth usually see an increase in demand for goods and services. To compensate for the increased pressure this puts on supply chains, businesses raise prices for goods and services. Consumers also tend to have more purchasing power as wages grow. This is how inflation typically works.

However, the United Kingdom has experienced a unique phenomenon. One of the key factors of rising inflation in the UK has been the devaluation of the pound since the EU referendum result.

Following, the confirmation of Brexit, the pound sterling dropped 10% against the US dollar. Remember - the markets expected the 'Remain' campaign to win the referendum, and favoured the UK staying within the European Union.

Since that time, the pound has steadily recovered. At the time of writing (November 2017), GBPUSD is floating around the 1.31 level.

However, a weaker pound has made it more expensive for businesses to import goods and services from abroad. As a result, UK businesses have had to increase their prices to cover a rise in supply chain costs.

A good example of this comes from UK supermarkets. They import many products from abroad. Since June 2016, this has become more expensive to do because of a weaker pound. To make up for this additional expense, supermarkets have increased the prices of food and drink products.

WHY THE ADJUSTMENT?

By increasing its key interest rate, the Bank of England is hoping to taper the rise in inflation.

Keep in mind that central banks control inflation with interest rates. By increasing interest rates, policymakers are tightening monetary policy. Higher interest rates also make it more expensive to borrow capital and encourages consumers to save money. This helps to lower the price of goods and services.

Like most major central banks, the Bank of England believes that 2% inflation is a sustainable rate. By tightening its monetary policy, policymakers are hoping to see the inflation peak at approximately 3.1% or 3.2%, before falling towards the 2% mark in the months ahead.

As a trader, it’s important to note that the Bank of England has stated that two further interest rate hikes might be required before 2020 to get inflation to the desired level. Also, the central bank has stressed that many of its forecasts are based upon a smooth Brexit transition process.

IS THE UK ECONOMY HEALTHY?

UNCERTAINTY

A central bank usually hikes interest rates when its economy is healthy. The US is a good example of this. A sustained period of economic growth and job creation resulted in the Federal Reserve entering a hiking cycle in December 2016.

However, as described above, the UK situation differs slightly. The UK interest rate hike is intended to curb inflation, primarily caused by the pound's drop in value.

The uncertainty around Brexit adds further complexity. At the time of writing (November 2017), the UK is negotiating a 'Brexit deal' with the rest of the European Union. This deal will determine important post-Brexit arrangements - including migration and trade deals.

The truth is that nobody knows what the outcome of these negotiations will be.

It's this Brexit uncertainty which hangs over the UK economy. Clearly, the nature of (if any) the 'Brexit deal' that is secured will have a significant impact on the UK's economy.

For example, future trading terms with the European Union could affect UK foreign direct investment. Over the long-term, this would likely impact UK economic growth.

This is why the Bank of England's future monetary policy approach will take the outcome of the Brexit negotiations into consideration.

ECONOMIC DATA

Despite the uncertainty of Brexit, the UK is still posting some positive economic data.

One such metric is unemployment, which stands at 4.3%. Furthermore, UK GDP grew at 0.4% in the third quarter of 2017. While consistent, the UK's rate of economic growth is one of the slowest amongst the G7 for 2017.

Wage growth in the UK also stands at 2.1% (in the three months to September 2017). While the rate of wage growth is steady, it currently falls below the UK's rate of inflation, which is 3% (October 2017). This means many Britons will experience an increase in the cost of living.

IS THE UK ECONOMY HEALTHY?

Overall, the UK economy is relatively healthy. In particular, it has proven to be robust following the Brexit vote in 2016.

However, the UK economy is delicately balanced. Considering that the UK is entering uncharted waters with Brexit, some economic turbulence should be expected.

The key metric traders should monitor in the coming months is inflation. The Bank of England believes that inflation will peak around the 3% mark before starting to fall. The task of traders is to track whether that forecast runs true.


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Tel: +44 (0)203 695 0898
Email: cs@blackwellglobal.com