Markit Economic Research

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United Kingdom

Bank of England holds policy as Inflation Report awaited for more guidance

- **The Bank of England's Monetary Policy Committee left interest rates on hold, providing no statements to accompany the decision**
- **Next week's Inflation Report to provide more guidance on future course of interest rates**

The Bank of England left monetary policy unchanged at its February meeting. The Monetary Policy Committee decided to hold the Bank's main interest rate steady at 0.5% and the stock of asset purchases at £375bn.

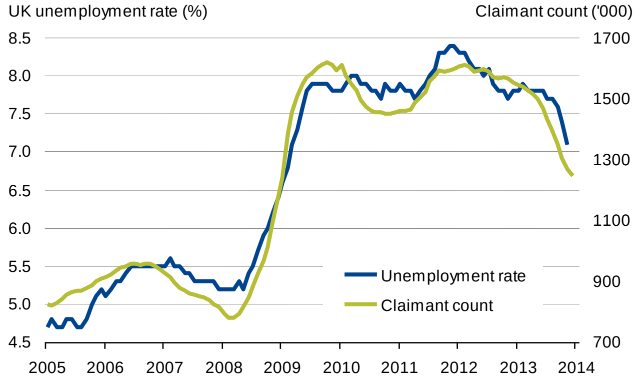
As long as inflation and wages remain weak, the Bank's ongoing ultra-loose policy is justified. But there is a growing risk that policy might fall behind the curve as far as inflationary forces are concerned. If interest rates are kept too low for too long and inflation starts to rise sharply, the danger is that rates will then have to rise sharply, risking a "boom-bust" scenario.

Until a few months ago, the balance of risk was very much tilted towards ensuring policy allowed the economy to achieve what Bank governor Mark Carney has described as "escape velocity". More recently, with the economy growing rapidly (many forecasters are projecting 3% growth or more in 2014) and the speed of job creation far exceeding expectations, it could be argued that "escape velocity" was reached in the second half of last year.

At the moment, the hard data show little evidence of inflationary pressures. Wage growth, according to the latest data available up to November, remained muted, growing at an annual rate of just 0.9%. Consumer prices were up just 2.0% on a year ago in December, the rate slipping down to the Bank's target for the first time in over four years.

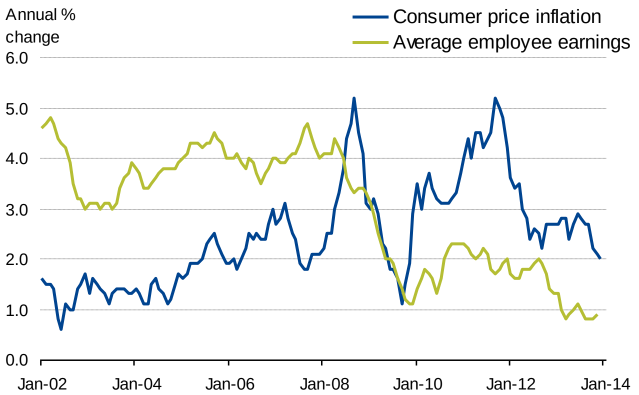
However, the more up-to-date surveys are indicating that wage pressures are starting to build. The latest PMI surveys showed private sector job creation rising to meet its previous record peak in January, and recent reports from recruitment agencies indicate that pay pressures for new recruits are rising at the fastest rate since 2007 amid surging demand for staff and growing skill shortages.

Unemployment



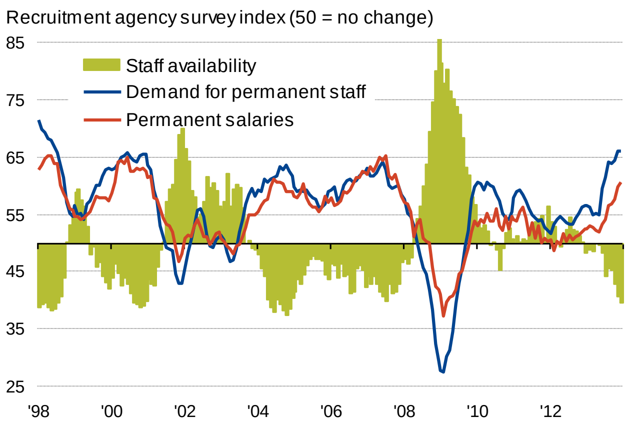
Source: ONS via Ecowin.

Inflation and wages



Sources: Markit, Office for National Statistics

Wage pressures



Sources: Markit, REC, KPMG.

The risk is therefore growing that the Bank may have to raise rates higher than a more gradual approach would have required if policy continues to be kept loose for too long in this growth environment. We look to next week's Inflation Report for more guidance on how the Bank sees these risks being balanced.

If the survey data on wages are borne out by official data, we would expect the recent pace of growth and labour market improvement to feed through to create real-term wage growth by mid-2014, with the rate of increase strengthening into 2015. If such a scenario is presented in the Inflation Report, we would expect the Bank to start preparing businesses and households for a gradual tightening of policy by the end of 2014, with the emphasis on interest rates edging up slowly in very small increments.

More guidance on forward guidance

The Inflation Report will hopefully also give more clarity on how the Bank will review its forward guidance. Many are expecting the Bank to reduce its unemployment threshold to 6.5%, but it is more likely that we will see policy be once again guided more by simple inflationary indicators rather than the unemployment rate, with a particular focus on wages.

The issue of forward guidance is explored more fully in our accompanying research note "Policy plagued by data uncertainties".

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