Markit Economic Research

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United Kingdom

Bank of England holds policy despite signs of booming economy

- **Monetary Policy Committee voted to keep interest rates at record low at its May meeting**
- **Eyes turn to Financial Policy Committee to rein in housing market**
- **Wages to provide key to first rate hike**

The Bank of England's Monetary Policy Committee left interest rates unchanged at a record low of 0.5% at its May meeting, as widely expected. The stock of asset purchases made under its Quantitative Easing programme was also left unchanged at £375bn.

Given the recent growth surge in the economy and signs from surveys that the strong momentum has spilled over into the second quarter, as well as worries about rising house prices, the discussion is likely to have heated up.

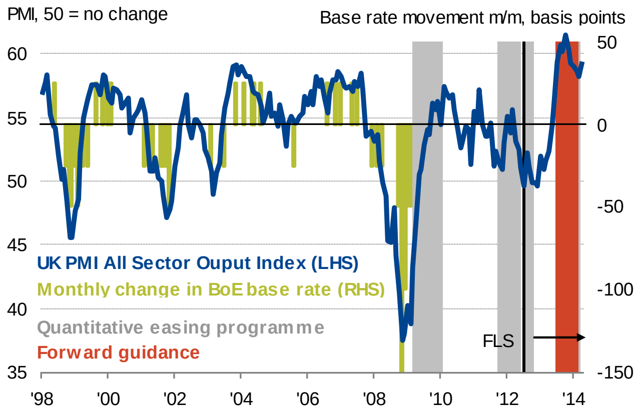
FPC to deal with housing market

That the decision was made despite growing calls for policymakers to rein in the galloping housing market is no real surprise. The OECD as well as previous Chancellors have recently added to the view, recognised by Bank of England officials, that the recent rise in house prices represents a threat to financial stability in the UK. However, instead of hiking rates and potentially damaging the wider economic recovery, the onus will be on the Bank's Financial Policy Committee to seek more targeted means of controlling house prices growth via 'macroprudential tools'. These may include raising lenders' capital requirements, making house buyers' affordability tests tougher and possibly applying pressure to amend the government's Help-to-Buy scheme.

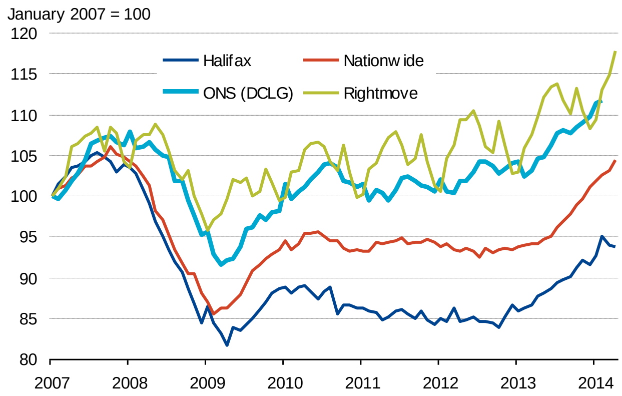
MPC to feel the heat

However, that's not to say the heat is not being turned up on the MPC as well due to other developments in the economy. While the FPC is dealing with the issue of house prices rising as a result of demand exceeding supply, the MPC may increasingly have to deal with a similar situation in the labour market.

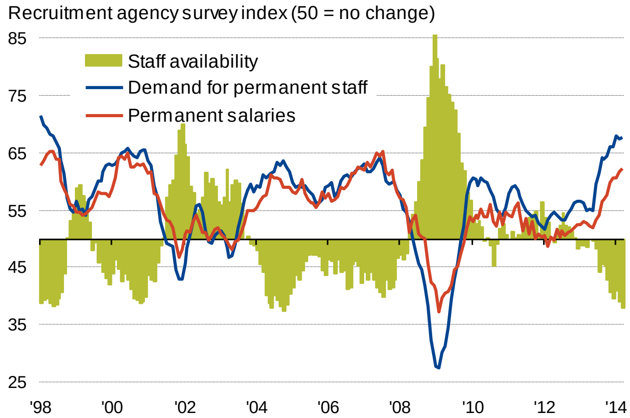
Policy announcements and the PMI



House price indices



Skill shortages and wages



Sources: Markit, REC,

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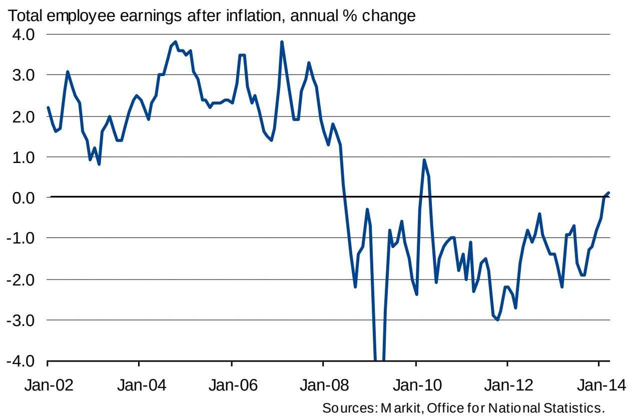
The economy is undergoing a strong growth spell, with GDP rising 0.8% in the first quarter and a further rise in the PMI surveys suggesting a similar buoyant pace of growth will be seen in the second quarter, taking GDP above its pre-crisis peak. This growth spurt is leading to rapid job creation. The PMI surveys' all-sector Employment Index rose in April to the highest ever seen since the survey began in the late-1990s.

Although the MPC is focusing on a wide variety of indicators which give guidance on the amount of slack in the economy, rising wages are likely to be the key trigger of the first hike in interest rates, as growing wages tend to feed through to high inflation. Although unemployment remains relatively high at 6.9%, companies are reporting widespread skill shortages. The pool of jobless people may be large, but this matters little if the unemployed do not have the skills and experience necessary to fill vacant positions, which is what appears to be happening now.

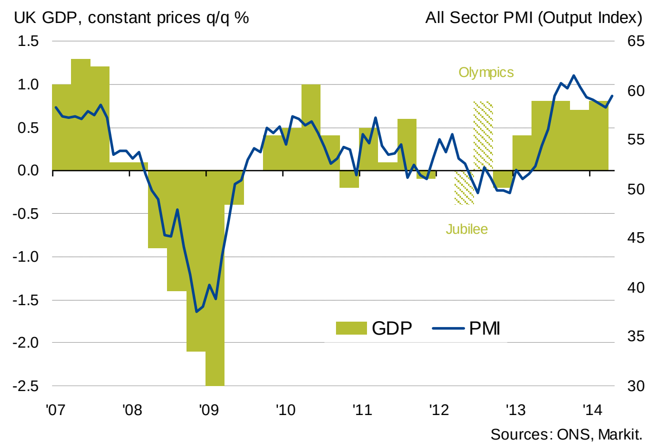
The April survey of UK recruitment agencies found that the availability of staff to fill permanent vacancies deteriorated at one of the steepest rates seen in the survey's 16-year history, as demand for staff also surged at a near-record rate. Salaries awarded to those people that were successfully placed in permanent jobs showed the largest increase since mid-2007.

Whether pay growth rises to an extent that will worry policymakers into hiking rates before 2015 remains a big unknown, especially as low wage growth in the public sector is likely to hold down average earnings. However, it seems likely that pay will certainly be firmly in the MPC's spotlight and the indicator most likely to trigger higher interest rates.

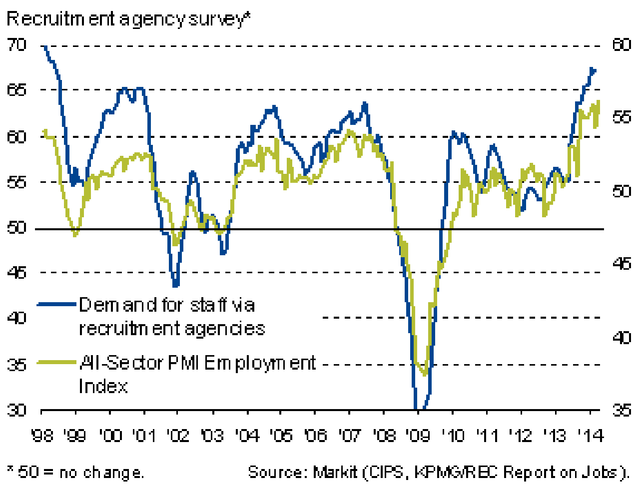
Real wages growth



Economic growth



Survey employment indices



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