Markit Economic Research

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United Kingdom

Bank of England holds rates amid confusing policy picture

- **Bank of England keeps rates on hold at 0.5%**
- **Mixed economic data likely to have spurred lively debate**
- **GDP revisions add to policy confusion**

The Bank of England left interest rates unchanged at its September meeting, but it's likely that the discussion about whether the UK is ready for higher interest rates has intensified amid an increasingly confusing picture of the country's economic health.

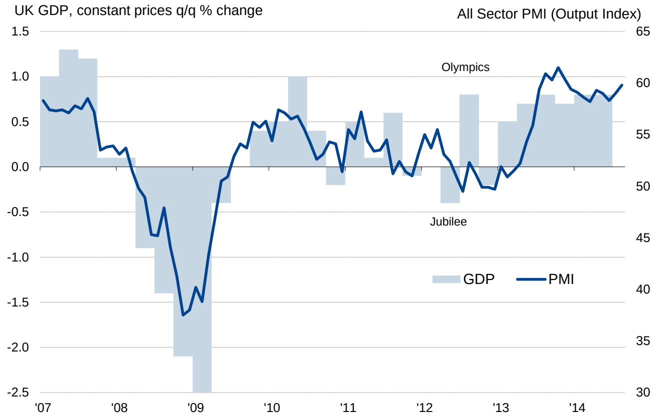
The recent data flow continues to support the view that rates will rise in early next year or even later this year, most likely at the November meeting. Upward revisions to the recent economic growth trend could, arguably, also add to the case for rates to start rising sooner than previously thought appropriate. However, concerns linger about the lack of wages growth and some signs that growth may be faltering in the manufacturing sector.

The possibility of the Bank of England being the first major central bank to hike interest rates has increased after the minutes from the August Monetary Policy Committee meeting revealed that two members – Martin Weale and Ian McCafferty – broke the long-standing unanimity on keeping rates at the record low of 0.5%. Both voted for a quarter point rate rise.

Mixed signals from PMI surveys

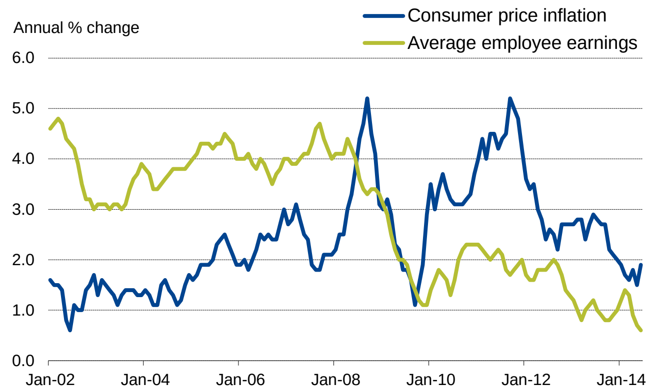
Since the August meeting the economic news has been mixed. The latest PMI survey data suggest the economy is on course to grow by 0.8% again in the third quarter, maintaining the strong pace of expansion seen in the first half of the year. However, signs of manufacturing growth slowing, most likely in response to trade being affected by the escalating crisis in Ukraine, will have unnerved some policy makers. On the other hand, the vast service sector – which has in the past provided the major steer to policy making – continues to boom, as does the construction sector. Rate setters will therefore probably want to wait and see the extent to which any slowing of factory output feeds through to the rest of the economy before making any decisions.

UK economic growth



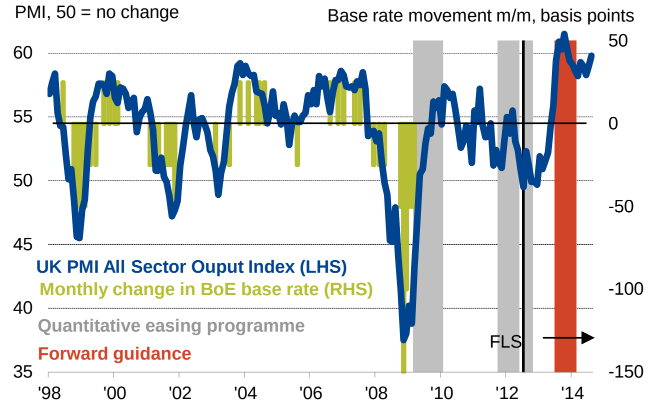
Sources: ONS, Markit.

Pay and inflation



Sources: Markit, Office for National Statistics

PMI and policy decisions



On-going labour market puzzle

The labour market puzzle adds to the uncertainty. Despite employment rising and unemployment dropping to its lowest since November 2008, pay growth sank to a record low of 0.6%.

The lack of wage growth is a major worry for policy makers and remains the main rationale for keeping policy on hold. With incomes under pressure, households may cut back on spending if interest rates and mortgage costs rise, threatening the recovery.

Re-telling history

Adding yet further confusion is the major retelling of recent economic history by the Office for National Statistics. The 'Great Recession' now appears to have been not quite so great, and the subsequent recovery stronger than first thought. At face value, this improved performance adds to the argument for policy to return to normal sooner than previously anticipated.

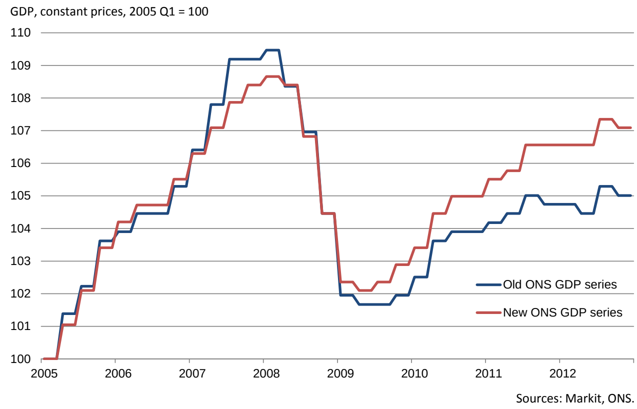
On the other hand, if the stronger recovery has been due to upwards revisions to business investment – as appears to have been the case to some extent – then the economy may in fact have more productive capacity than policy makers had been aware of, meaning there is more scope for the economy to grow without stoking inflation.

It will be important to see quite what the Bank makes of the new version of recent economic history in determining the timing of the first rate rise.

GDP revisions

The details of the GDP revisions show that the economy shrank by 6.0% in the 2008-9 downturn instead of 7.2%. We don't yet know the full picture of the subsequent recovery, as the revisions have only so far been published up to the end of 2012. But these data show a 4.7% increase in GDP since the recession low instead of the previously estimated 3.4% rise. This suggests the economy regained its pre-crisis peak earlier than previously thought, probably in the autumn of last year rather than the second quarter of this year.

UK GDP before and after revisions



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