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United Kingdom

Bank of England holds rates amid mixed views on economy

- **Bank leaves monetary policy unchanged, as expected**
- **Debate grows on timing of first rate hike**

The Bank of England left monetary policy unchanged at its October meeting. The Bank's base rate remains at a record low of 0.5% and asset purchases were unchanged at £375bn. While the lack of action was universally expected among economists, the debate rages as to when stimulus will be reined in.

On the one hand, the economy is some 15% smaller than it would have been had the pre-crisis economic growth trend persisted and, with 7.7% unemployment, there should remain substantial amounts of unused capacity in the economy. There is therefore plenty of catch-up still to do, meaning inflation will not be a worry for some time to come.

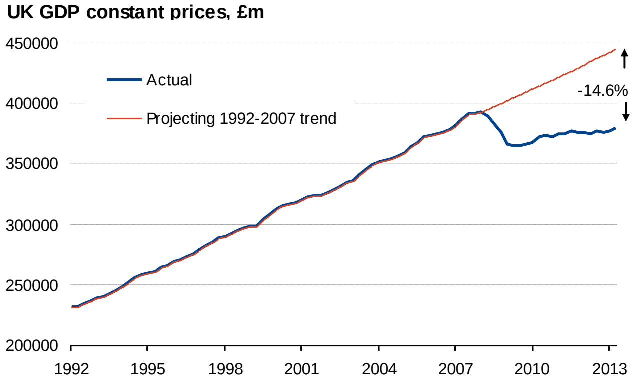
However, on the other hand, if the current buoyant pace of growth signalled by the business surveys persists, we may soon see the Bank becoming increasingly confident that the economy can withstand rate hikes earlier than outlined in its current 'forward guidance'.

The questions the Monetary Policy Committee (MPC) will be asking itself will therefore not be confined to which of the three 'knockouts' – conditions under which the Bank may start hiking interest rates earlier than the current expectation of 2016 – might apply, but also just how quickly unemployment will fall below the Bank's chosen 7% threshold.

Looking first at the knockouts, forward guidance would cease to apply either if inflation is expected to be above 2.5% in 18-24 months' time, if medium-term inflation expectations become unanchored, or if the stance of monetary policy is deemed to pose a significant threat to financial stability.

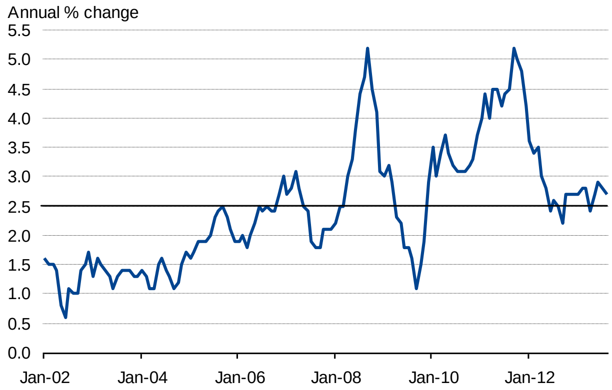
The most likely of these knockouts to kick-in is the first: the possibility of inflation running above 2.5% in 18-24 months. This would be no major surprise given current inflation trends: inflation has been below 2.5% in only three of the last 45 months.

UK economy still has a long road to recovery



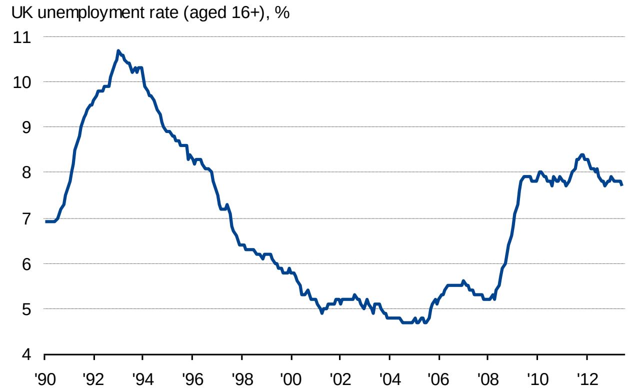
Sources: Markit, ONS

Inflation



Source: Office for National Statistics (via Ecowin).

Unemployment



Source: ONS via Ecowin.

However, where forward guidance may also come unstuck is in relation to the expected date by which unemployment will fall below 7%. It has taken a year for unemployment to drop from 8.1% to 7.7%, but the pace of economic growth has accelerated sharply in recent months, as has the rate of job creation. Surveys of recruitment agencies and the PMI business survey show demand for staff leaping as firms meet growing demand for goods and services. In 1997, it took just eight months for the unemployment rate to fall from 7.7% to 6.8%.

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