Markit Economic Research

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United Kingdom

Bank of England keeps rates on hold, but data raise questions about policy

- **BoE makes no change to policy at December MPC meeting**
- **Recent growth spurt has led to growing speculation that forward guidance needs to be reviewed**

The Bank of England's Monetary Policy Committee voted to leave interest rates unchanged at the all-time low of 0.5% in December, and left asset purchases unchanged at £375bn.

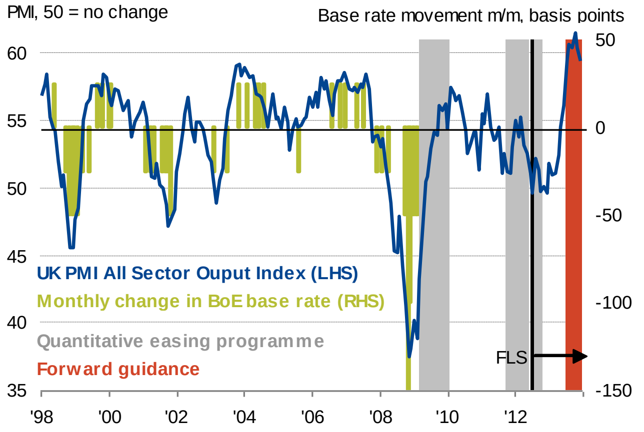
There was much speculation that the Bank would issue a statement to accompany the decision, perhaps to reiterate its forward guidance that rates would not be rising for a considerable time, or to suggest how policy might react to recent signs of a faster than anticipated improvement in the labour market, but no additional communication was forthcoming. However, it seems likely that recent buoyant economic data may cause the Bank to review its forward guidance, most likely with the February Inflation Report.

Growth spurt

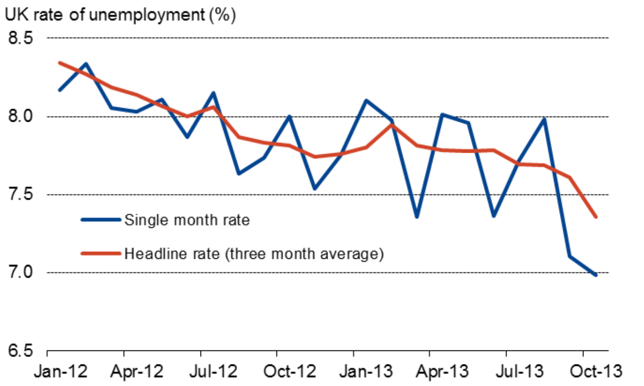
The Bank has pledged not to consider raising interest rates until unemployment has fallen below 7%. Its' latest forecast, issued in November, indicated that it did not expect this to occur until late-2014. It now seems highly possible that the threshold could be reached imminently, and perhaps could have even been reached before the end of last year. The headline jobless rate had sunk to 7.4% in the three months to October, with the single-month rate already down to 7.0% in October.

Surveys such as the PMI have for some time now signalled that the Bank should have started tightening policy already, given the historical trend in the Bank's reaction to the data and the current strong rate of expansion signalled. The PMI and the British Chambers of Commerce surveys both suggest the robust pace of expansion seen in the summer persisted into the fourth quarter, perhaps accelerating to a well-above average 1.0%, meaning the economy grew by 1.9% in 2013.

BoE policy and the PMI

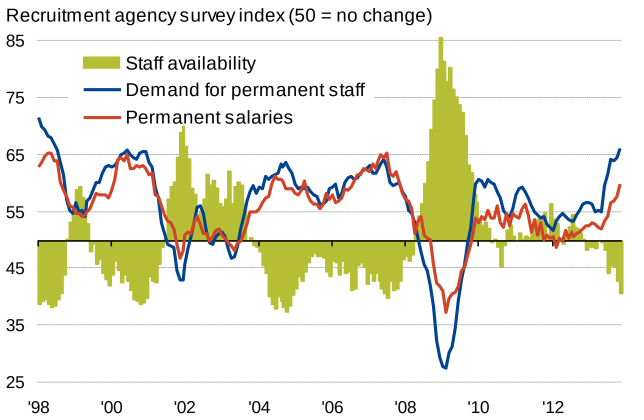


Unemployment



Source: ONS.

Recruitment industry survey



Sources: Markit, REC, KPMG.

Rather than hike interest rates in the face of this surging growth, the Bank has instead chosen to focus on the fact that the economy remains smaller than its pre-crisis peak, meaning much spare capacity exists. This should allow interest rates to stay low for longer without generating inflation pressures.

However, while prices have yet to pick up, this theory is increasingly looking incorrect, as there are few signs of much slack in the business sector. Companies have been hiring staff at a rate not seen for 15 years in recent months, according to recruitment agencies, to cater for rapid business growth, and skill shortages are already the most widespread for nine years. It may not be long until wages start to rise (starting salaries are already rising at the fastest rate since 2007), which will inevitably fuel higher inflation.

Forward guidance review?

It's clear that the Bank has greatly underestimated the speed of the economic upturn, though in all fairness it is possible that the faster than expected recovery is a function of the Bank's recent action. Forward guidance is, after all, an untested policy tool in the UK.

The dilemma the Bank now faces is whether to keep policy ultra-accommodative to ensure robust recovery (which might risk having to tighten policy to a greater extent than would otherwise have been required at some point in the future), or to bite the bullet and state that the better than expected performance of the economy, and possibly the stronger than expected stimulus generated from forward guidance, means that it needs consider starting to raise rates soon if the economy continues to exceed expectations. The flow of recent data suggest that, at the very least, a review of current forward guidance is needed

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