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Markit Economic Research

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United Kingdom

Bank of England maintains ultra-loose policy stance

- **Bank of England leaves policy unchanged**
- **Discussion of need for rate hike likely to have intensified amid strong economic growth**
- **Worries focused on weak wage growth**

There was no change in interest rates at the Bank of England at its August meeting, but we expect the minutes to show that opinion is moving closer towards raising rates. It's all about when wage growth starts to pick up: if pay starts to rise in coming months, the first rate hike looks likely in November. Otherwise, any tightening of policy can wait until next year.

Policymakers left UK interest rates at a record low of 0.5% and the stock of asset purchases unchanged at £375bn at the August Monetary Policy Committee meeting.

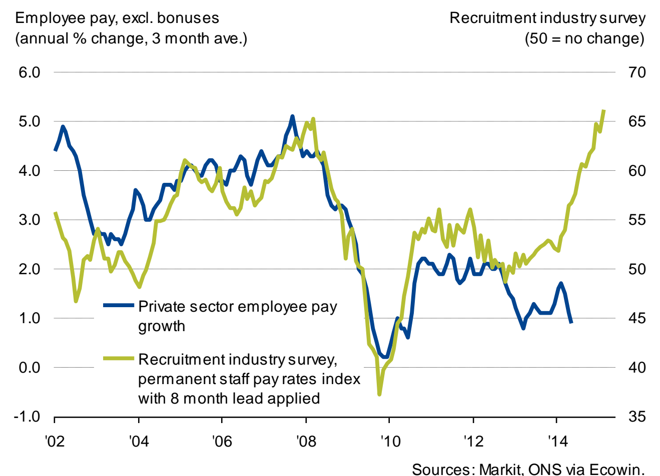
We need to wait until the minutes are published to learn more about how the policy debate developed at the meeting, especially as uncertainty has been heightened by new member Nemat Shafik joining (and Kirstin Forbes having just joined in July). However, it's reasonable to assume that the debate has continued to intensify as to whether interest rates should start rising from their record low and that we're getting closer to the first tightening of policy since prior to the financial crisis.

The Bank has certainly started to prepare the ground for rates to start rising. Most significantly, the minutes from the July MPC meeting included a detailed discussion of the case for higher interest rates, despite no members having actually voted for a rate rise.

The Bank has made it clear that the debate hinges on whether household finances remain too vulnerable to cope with higher borrowing costs, despite the economy's impressive recovery over the past year.

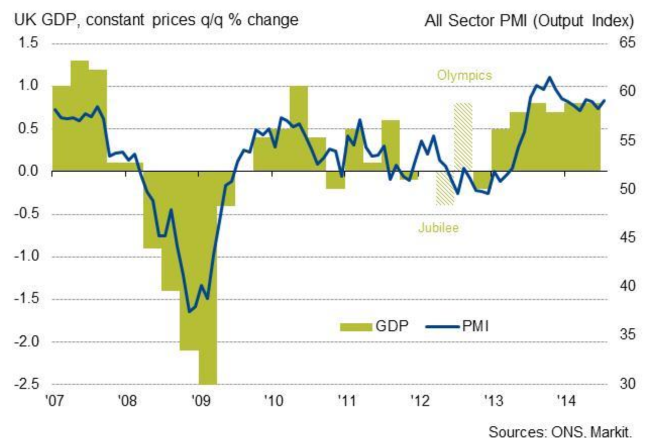
The economy has grown at a rapid pace since the middle of last year, and survey data suggest GDP is on course to rise strongly again in the third quarter, defying expectations of a slowdown (albeit with signs of growth weakening starting to appear in the manufacturing sector). Unemployment has meanwhile fallen sharply alongside record rates of job creation.

Employee pay indicators



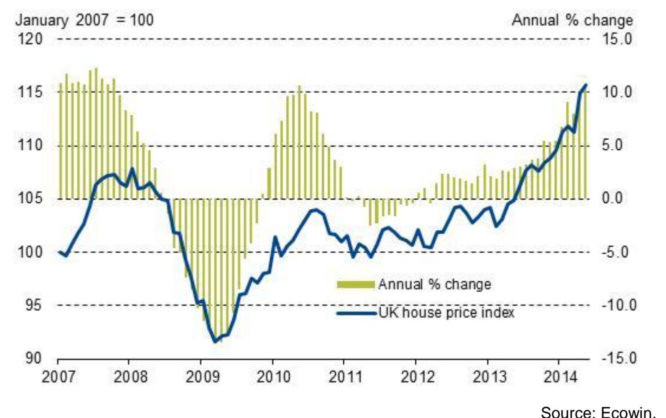
Sources: Markit, ONS via Ecowin.

Economic growth indicators



Sources: ONS, Markit.

House prices



Source: Ecowin.

Signs of the housing market upturn gaining momentum again add to the argument for borrowing rates to rise. House price indices are signalling double-digit house price growth and mortgage lending picked up again in June.

With the economy set to grow by at least 3.0% in 2014 and unemployment on course to fall below 6% by the end of the year, the argument to start bringing interest rates back to more normal levels would be compelling, if it wasn't for a puzzling lack of wage growth. The latest official data showed average weekly employee earnings growing at the slowest rate on record in the three months to May, up just 0.7% on a year ago excluding bonuses.

The concern at the Bank is that, with such weak pay growth, even small rises in mortgage rates could lead to over-extended borrowers having to rein in their spending, driving the economy back into recession.

Lack of understanding of pay trends

Adding to the confusion is the lack of understanding as to why pay growth is so weak when the economy and employment are growing so strongly. Survey data are pointing to the sharpest rises in starting salaries for staff since 1997 as skill shortages become increasingly widespread, but the official data remain stubbornly subdued.

Next week's *Inflation Report* will also provide more insight into whether the Bank has changed its outlook for the economy, and the appropriate path for interest rates. The Bank is currently projecting that economic growth will slow in the second half of 2014, but remain robust. The resulting gradual depletion of 'slack' in the economy suggests it would probably be appropriate for rates to start rising early next year, although guidance from policymakers has chopped and changed, with Mark Carney raising the possibility that rates could start rising later this year. Hopefully next week's *Inflation Report* will add clarity to the Bank's policy guidance rather than fuel further confusion.

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