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Markit Economic Research

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United Kingdom

Bank of England policy makers plagued by data uncertainties

- **'Forward guidance' has revealed a great deal of uncertainty with regards to current economic conditions**
- **Uncertainty exacerbated by confusing official economic data**

The Bank of England's new policy of forward guidance, introduced last summer, has revealed how policymakers have been caught out by the speed of the economic recovery. The faster than expected upturn has risked eroding credibility at the Bank.

However, the lack of understanding of economic trends since the financial crisis is not surprising given the confusing official economic data that the Bank is working with. This includes GDP that are subject to major revision, unexplainable productivity data, questionable employment numbers and a volatility of several key official statistics which make the identification of long-term trends difficult to discern.

Forward guidance unravels

The publication of next week's Inflation Report is being seen by many as a key opportunity for the Bank of England to review its policy of 'forward guidance'.

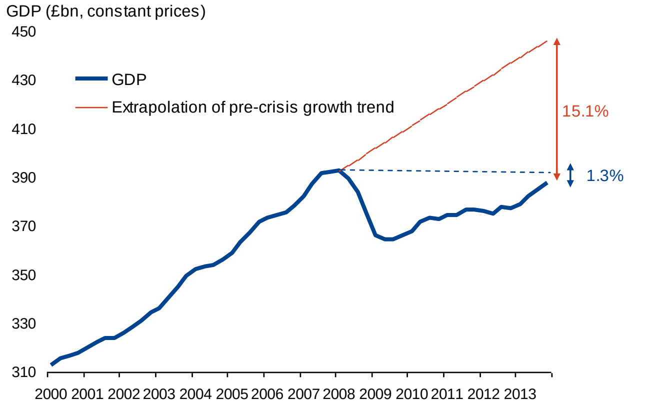
The new policy was intended to reassure businesses and households that interest rates would stay at historical low levels for several years, allowing the recovery to become truly entrenched. When introduced last summer, the Bank said that it would not consider hiking rates until unemployment dropped below 7% compared to its rate at the time of 7.8%. It did not see this likely to happen until 2016.

With the jobless rate having plummeted to 7.1% by last November (the latest month for which data are available), the new policy of 'forward guidance' has meant the Bank urgently needs to update its guidance.

It's all about spare capacity…

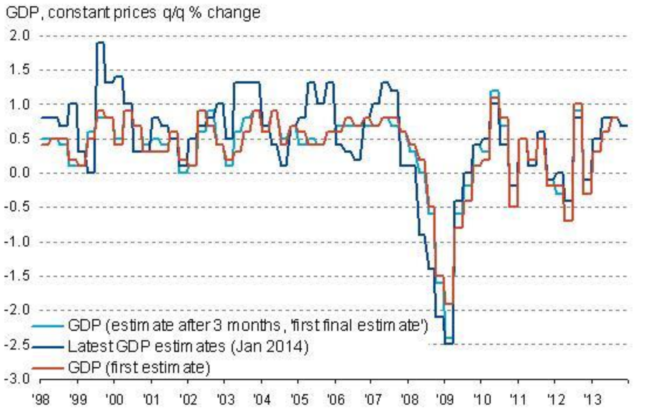
The idea behind forward guidance is grounded on the fact that, even despite the recent growth spurt, the economy remains 1.3% smaller than its pre-crisis peak. The extent of the destruction caused by the recession is further highlighted by the fact that the economy is

Gross domestic product



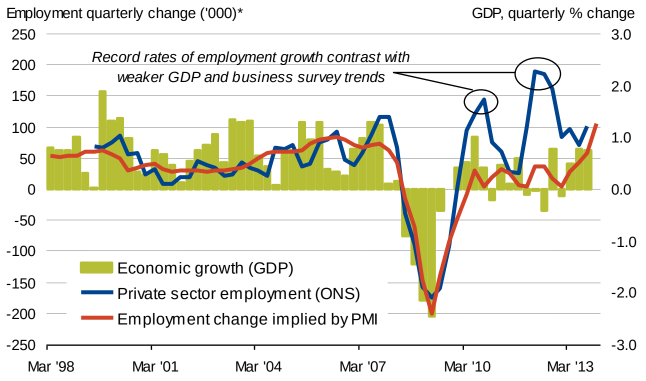
Source: ONS, Markit.

GDP revisions



Source: ONS.

Employment



* Centered 3-quarter average.

Sources: ONS, Markit.

15% smaller than if it had grown at the trend rate seen in the two decades prior to the financial crisis (see chart).

The theory is therefore that the economy still has a long way to catch up before capacity starts becoming sufficiently constrained that shortages start to develop. When demand runs ahead of supply, prices and wages tend to rise in a 'sellers' market.

By focusing on a widely recognised indicator of excess capacity – the level of unemployment – forward guidance gives a framework by which interest rates can be kept lower than would normally be permitted given the current pace of expansion seen in the UK at the moment (see chart comparing policy decisions with the PMI).

Data uncertainties

However, the problem is that there is great uncertainty about just how much useable spare capacity exists in the economy at the moment, and the economy's ability to grow without generating inflation.

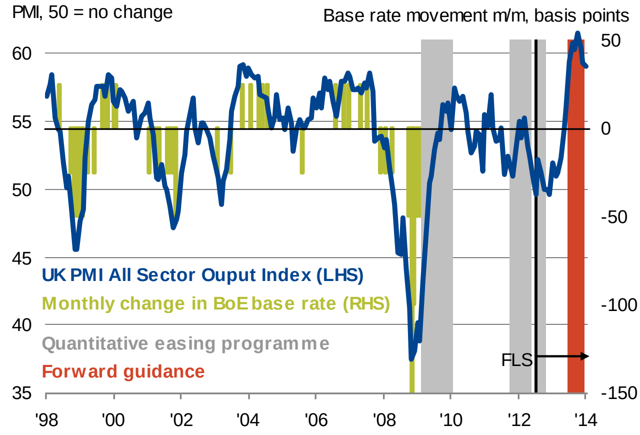
Economists are unsure about how much capacity was permanently destroyed in the recession, and many – including the Bank of England – have expressed doubts about the quality of official data on business investment, therefore raising a question mark over the rate at which new capacity is being created.

There is also a lack of understanding about productivity. Policymakers commonly cite the 'productivity puzzle', whereby the UK has seen an extraordinary loss of productivity since the financial crisis which cannot be fully explained. The puzzle is perhaps best illustrated by the fact that official data showed a record increase in employment in 2012 at a time when economic output more or less flat-lined. Business survey data from Markit (the PMI) and the British Chambers of Commerce showed no such rapid job creation over this period.

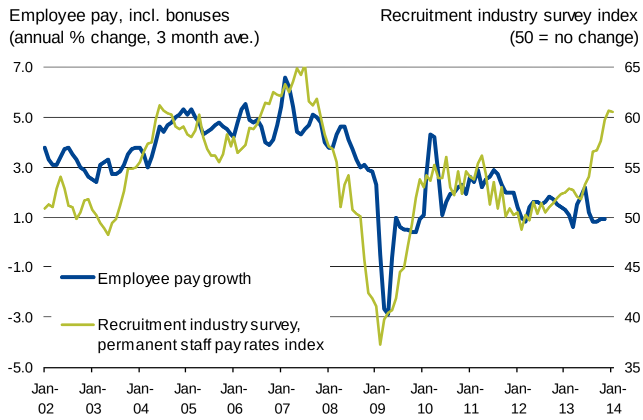
We have previously expressed doubts about the official employment data, which may have been subject to distorting factors, raising question marks about whether productivity really is as weak as official data suggest at the moment.

The uncertainties over productivity also have an implication for wages growth. If the employment numbers have possibly been distorted, then wages growth may have also been understated: the theory being that a clamp down on tax evasion and illegal welfare benefit claimants may have led to more people,

Bank of England policy and the PMI



Diverging wages indicators



Sources: Markit, ONS via Ecowin.

especially at the lower end of the labour market, appearing in the official labour market statistics. (The calculation of average wages uses the number of people as the denominator.)

Finally, policymakers also regularly raise questions over the quality of official GDP data. Certainly the scale of revisions between initial estimates and final estimates of GDP highlights how the numbers need to be treated with a large dose of salt (see chart on page 1). Over the last 20 years, the average difference between the initial estimate of GDP and the series now published by the ONS is 0.4% (ignoring plus or minus signs). Some of the revisions have been far larger, and also retold the story as to whether the economy is contracting or growing.

In the second quarter of 2008, for example, the initial estimate of GDP form the ONS showed the economy growing 0.2%. This contrasted with the PMI, which showed a gathering downturn that spring. The ONS now estimate GDP to have fallen some 0.9% in that period.

In the third quarter of 2009, the initial estimate of GDP showed an economy still in recession, contracting 0.4%. The PMI had already signalled the start of a recovery. The latest estimate for that period from the ONS is no change in GDP.

Perhaps most widely cited, however, are the revisions to data which meant that the much-vaunted 'double-dip' recession never actually occurred.

It's not just the GDP numbers that are subject to raised eyebrows. Official data recently showed exports collapsing late last year, having previously been enjoying strong growth. This collapse occurred despite the global economy faring well and contrasted with buoyant survey data on exports.

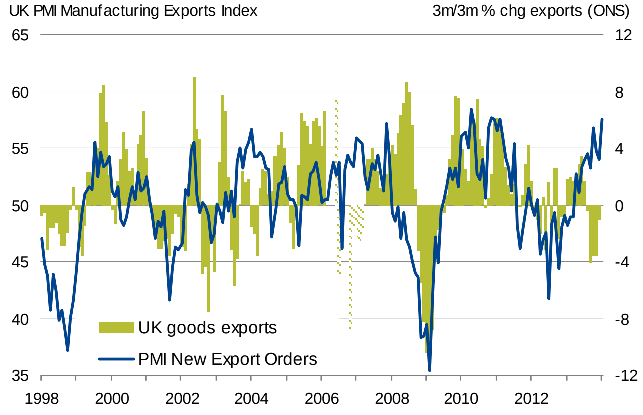
Similarly, construction industry output fell in the final quarter of last year according to official data, representing a sudden reversal of a strong growth trend that has been evident in previous quarters. Survey data, in contrast, suggest that the sector continues to expand at a near-record pace – a finding that is more in tune with the country's booming housing market.

Forecasting errors

The question marks raised over official economic data in recent years, and the confusing or unexplainable trends within those data, highlight why it has become unusually difficult to produce accurate forecasts

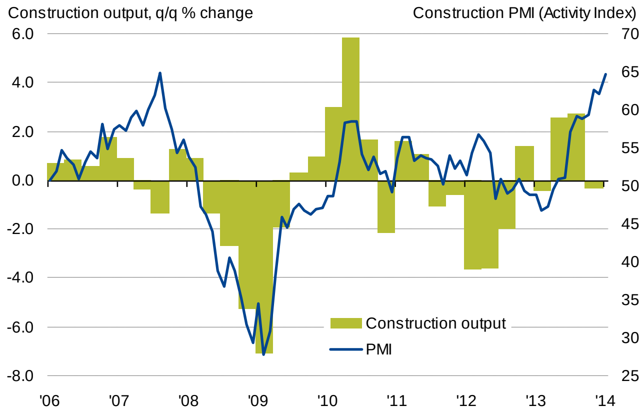
Given the extent of the uncertainties surrounding the official statistics, it could therefore also seen as an unusually risky move for any policy maker to say with any degree of confidence what the appropriate level of interest rates will be in one year's time, let alone three years, as originally set out in the Bank's forward guidance.

Diverging export indicators



Sources: Markit, ONS (via Ecowin).

Diverging construction data



Sources: Markit, ONS.

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