Markit Economic Research
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United Kingdom

Bank of England policymakers unanimous in holding rates low

- **Monetary Policy Committee voted 9:0 to keep rates and QE unchanged in November**
- **Policymakers see downside risks to growth outlook and few inflation risks**
- **But households have started pencilling in higher rates in the next two years**

The minutes from the November meeting of the Bank of England 's Monetary Policy Committee showed that policymakers had decided unanimously to leave monetary policy unchanged, meaning the Bank's base rate remained at a record low of 0.5% and its stock of asset purchases were held at £375bn.

The minutes also struck a dovish tone, indicating that the Bank's current projections for growth and inflation suggest "that there could be a case for not raising [the] Bank Rate immediately when the 7% unemployment threshold was reached. Once unemployment had reached 7%, the Committee would reassess what it had learned about the nature of the recovery".

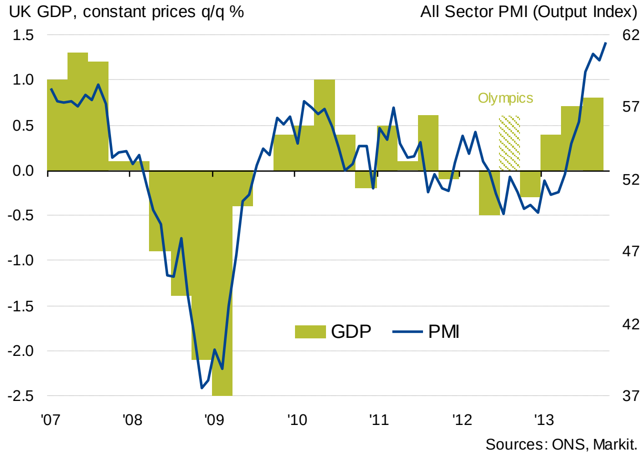
However, assuming the economy continues to expand at the robust pace we have seen in recent months, the debate that is likely to dominate the discussions in coming months is whether it would be prudent to start normalising policy slowly, and earlier than had previously been signalled. Such a gradual increase in interest rates, it can be argued, reduces the risk of leaving policy loose for too long, which might then require a sharp shock of markedly higher interest rates to cool the economy again.

All will depend on whether the UK can sustain the surprisingly strong pace of growth we have seen in recent months, and the extent to which wages will pick up alongside economic recovery.

Rate hike expectations rise

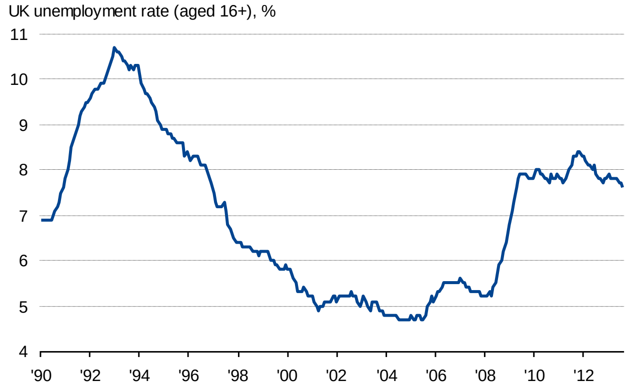
The bank is eager to dampen expectations of higher interest rates. A recent survey showed that, of those that had an opinion, some 72% of households expect rates to start rising within the next years, of which 47% expect to see rates rising within the next 12 months.

GDP and the PMIs



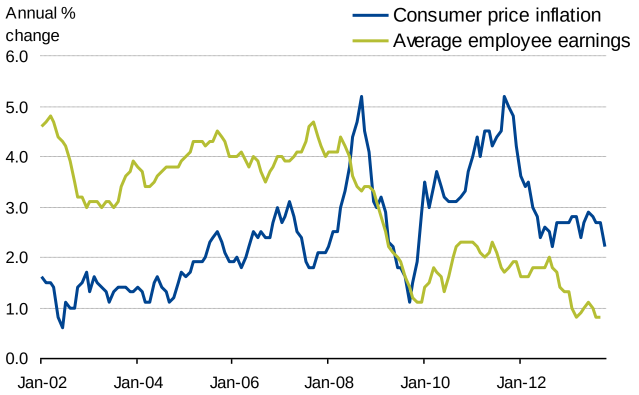
Sources: ONS, Markit.

UK unemployment



Source: ONS via Ecowin.

Inflation and employee pay growth



Sources: Markit, Office for National Statistics

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It therefore looks like households are already pricing in a hike in interest rates earlier than the Bank had previously been signalling. These expectations most likely reflect the improvement in the economic news flow in recent months.

Brighter outlook

The Bank, as well as many other forecasters – including most recently the OECD – have revised up their projections for UK economic growth in the light of recent upbeat economic data. Official data showed the economy expanding 0.8% in the third quarter, and the PMI surveys suggest that the rate of expansion has accelerated further in the fourth quarter. The minutes noted that the "Bank staff's central expectation was for growth in Q4 of 0.9%, although indications from the surveys pointed to growth of over 1%."

The sustainability of the upturn is by no means assured, however. At the moment, the Bank sees downside risks to the economy, reflecting the euro area's ongoing problems, weakness in emerging markets and the dampening of domestic demand due to the continuing need to repair household and banking sector balance sheets at home.

At the same time, the Bank sees few inflationary risks, and in particular the MPC noted that there were few indications that a recent upturn in inflationary expectations was feeding into higher wages.

Most importantly, the recovery is generating a rate of job creation far stronger than almost anyone had anticipated. This has led to a rethink by the Bank as to when unemployment might fall below the threshold of 7%, after which the Bank will re-evaluate the health of the economy and consider whether it is appropriate to start raising interest rates. Instead of late-2016, it now looks possible that the 7% threshold could be reached in late-2014. According to the minutes, the "Bank staff's central projection for headline unemployment was 7.6% for Q4, although the recent decline in the claimant count indicated that sharper declines were possible."

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