Markit Economic Research

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United Kingdom

Bank of England sets out expected course for interest rates

- **Central bank signals first hike in UK interest rates in spring 2015, but only small increments thereafter**
- **Forward guidance' amended to focus on wide range of indicators**
- **Economic outlook improves but inflation tamed by persistent slack in economy**

Interest rates may need to rise by the spring of next year, according the Bank of England, but the speed of rate hikes thereafter will be slow and gradual. Even after several years rates will not return to anything like the 5% levels typically seen prior to the financial crisis.

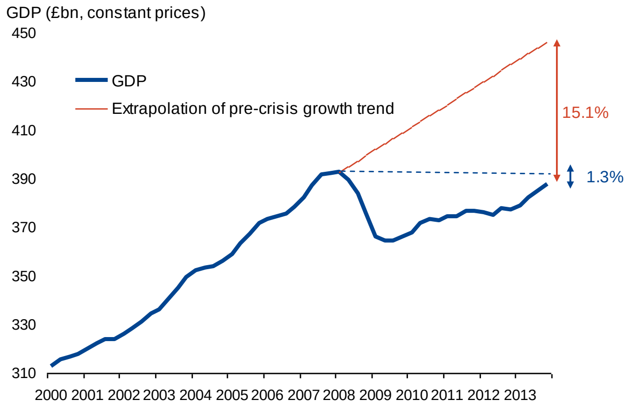
Although the Bank revised up its medium-term growth forecast, the high degree of spare capacity in the economy, especially in the labour market, means that there is scope for the country to grow without pushing inflation higher, allowing interest rates to stay low for several years.

The Bank of England has also reviewed its policy of forward guidance, introduced last summer, which tied interest rates to unemployment. Instead, the latest Inflation Report indicates that Bank will be monitoring a wide variety of economic indicators with a view to gauging how much spare capacity exists in the economy and tuning interest rates accordingly. This economic slack, the Bank estimates, currently amounts to 1.0-1.5% of gross domestic product, concentrated in the labour market.

The Bank also set out its revised expectations of the future course of interest rates, noting that current financial market pricing of a first rate rise in the second quarter of 2015 were consistent with inflation running close to its 2% target. On the basis of the economy following the Bank's expected path, rates are then projected to rise to 2% by early 2017.

Beyond 2017, the message from the Bank is that "even when the economy has returned to normal levels of capacity and inflation is close to the target, the appropriate level of Bank Rate is likely to be materially below the 5% level set on average by the Committee prior to the crisis".

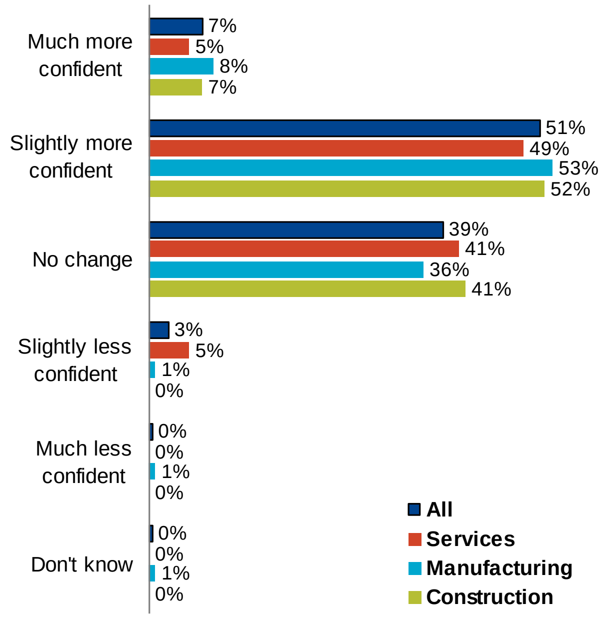
Gross domestic product



Source: ONS, Markit.

How companies' confidence about prospects for UK economy have been affected by policy change*

How have the Bank's recent policies and communications affected your confidence about the near-term (1-2 year) prospects for the UK economy as a whole?



** The survey data were collected from 231 UK manufacturing, service sector and construction companies between 8th – 11th November. The companies are regular participants in Markit's regular monthly PMI surveys.*

The Bank stressed that it will not take undue risks with the economic recovery, hence this dovish path for interest rates over the course of the next few years.

Forward guidance reviewed

The Bank is therefore now not tying forward guidance to one indicator, which could be a hostage to fortune, but instead linking interest rates to some 18 economic variables which will help gauge the amount of spare capacity in the economy. In this "phase 2" of forward guidance, the Bank therefore introduces a lot of flexibility into its decision making.

The change in forward guidance means policymakers will be watching developments in indicators of slack such as the business surveys, the length of time that people are unemployed, the number of people in temporary work because they cannot find a permanent job, vacancies relative to unemployment, recruitment difficulties, pay rates and average hours worked.

However, a criticism is that the amount of spare capacity is notoriously difficult to measure as we discussed in a recent paper, noting "It's all about spare capacity…". There is therefore great uncertainty about just how much useable spare capacity exists in the economy at the moment, and therefore a lack of clarity on the economy's ability to grow without generating inflation, especially in terms of labour productivity.

Given the Bank's forecasting error in respect to the faster than expected decline in unemployment, and the confusing and contradictory signals from economic indicators in recent months, there are reasonable grounds for scepticism that the Bank can be so confident in its projections for the economy over the next few years and the appropriate path for interest rates.

However, we would agree that 'forward guidance' has had a material beneficial impact on the economy since it was introduced last year.

Forward guidance working

The Bank defended its policy of forward guidance, citing survey evidence compiled by Markit on how companies had responded to the promise for keeping interest rates low for long last year. The survey showed UK companies feeling more confident about economic prospects due to 'forward guidance' and that investment plans had been boosted by changes in Bank policy.

Improved outlook

The detail of the Inflation Report showed that the Bank revised up its economic growth forecasts, anticipating GDP to rise by 3.4% in 2014 (up from a prior estimate of 2.8%), with further growth of 2.7% and 2.8% in 2015 and 2016 respectively.

Exports are expected to continue to disappoint, meaning trade will act as a drag on the economy, but business investment is set to provide a meaningful boost, rising 11.5% this year.

Inflation is meanwhile projected to bottom-out at 1.7% in March of this year, running at 1.9% at the end of the two-year forecast horizon.

The lack of inflationary pressures is simply due to the amount of slack in the economy, which in turn means wage growth will remain subdued.

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