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Markit Economic Research

13/11/2013

United Kingdom

Bank of England sounds upbeat note on economy, revises up growth forecasts

- **Unemployment rate to fall below 7% by end-2014 if interest rates stay at 0.5%**
- **Recovery remains dependent upon policy staying loose**
- **GDP forecast revised up, inflation down**

As expected, the Bank of England has revised up its growth forecasts, and has brought forward its expectations for unemployment to fall below 7%, the threshold for rate hikes to be considered. While the Bank stressed that it did not expect to raise rates "until there has been a substantial reduction in the degree of economic slack", the markets and households are anticipating rates to start rising earlier than late-2016. A recent poll of households (also published today) showed 71% expect rates to start rising in the next two years, of which 47% expect a rise in the next year.

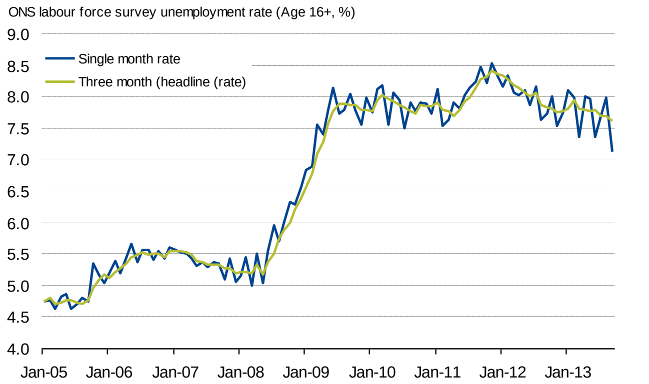
Recent data and survey analysis of productivity also suggest that the amount of slack in the economy is also falling fast, adding to the sense that it might be appropriate for policy to be tightened earlier than 2016.

More rapid fall in unemployment

In its latest quarterly Inflation Report, the Bank of England has pulled forward its expectation of when unemployment will fall below 7% from late-2016 to late-2014 (assuming current interest rates). However, the Bank stressed that it was in no hurry to raise interest rates as the amount of spare capacity in the economy means inflation is unlikely to rise, and that headwinds – notably the eurozone – means the strength of the recovery remains at risk.

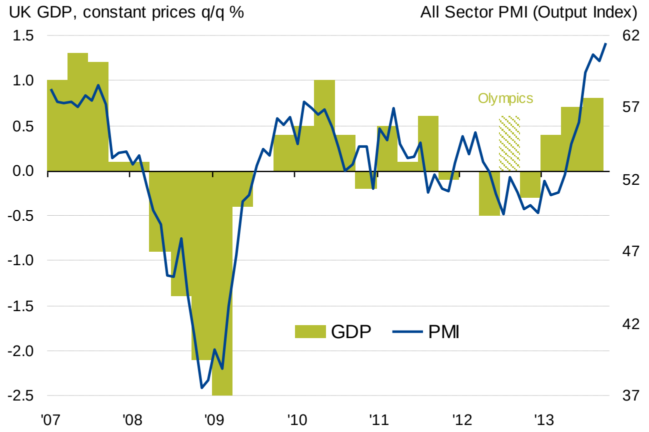
The Bank also notes that a rise in market interest rates (which these new forecasts are likely to result in) would mean there is only a 41% change of the 7% jobless rate being hit by late-2014, with a central forecast of the unemployment rate staying above 7% until the end of 2016 given the Bank's market interest rate assumptions. This is therefore seen by the Bank as justifying policy remaining ultra loose.

UK unemployment rate – single month measure



Source: ONS.

GDP and the PMIs



Sources: ONS, Markit.

Still too pessimistic?

However, even these new projections could prove to be overly pessimistic, given the rate at which the job market is recovering. We note that the ILO unemployment rate which the Bank is targeting with a 7% threshold is a three-month average, and **the single-month jobless rate in fact fell to 7.1% in September**. Another month at that level and the three month headline rate will fall to 7.4% in October. Clearly, another month without change in November pushes the headline rate down to 7.1% in November. The monthly unemployment rate is very volatile (it had been 8.0% in August), and such a steady rate in coming months is by no means assured, but these monthly numbers nevertheless indicate how a steep fall in the jobless rate is entirely feasible. We shouldn't forget that between January 1997 and September of that same year, the unemployment rate fell from 7.7% to 6.8%.

The Report also shows that economic growth is likely to be stronger than previously expected, in line with the recent upbeat message from the business surveys. The PMIs are currently signalling the fastest pace of economic growth for 15 years. An anticipated 0.9% increase in GDP in the final three months of the year will push 2013 whole-year growth up to 1.6% instead of the previous estimate of 1.4%. Growth is then expected to accelerate to 2.8% next year, up from a prior forecast of 2.5%.

How much spare capacity?

The Bank's forecasts are based on the economy having so much spare capacity that this acceleration in growth will not lead to capacity constraints, which in turns means there will be no intensification of inflationary pressures. The Bank now expects inflation to fall below its 2% target in early-2015, half a year earlier than it set out in its August projections. However, the recent surprisingly strong surge in employment puts a big question mark over this assumption, and corroborates survey evidence which suggests that spare capacity does not exist to the extent the Bank currently believes.

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