

United Kingdom

Bank of England upbeat on economic outlook, but doesn't rule out rate cuts

- **Economy expected to grow 2.9% in 2015 and 2016**
- **No rate hikes expected until Q3 2016**
- **Downside risks potentially underestimated**

The Bank of England presented a surprisingly upbeat view of the UK economy's outlook at the publication of its latest quarterly *Inflation Report*, but managed to also raise concerns that it sees the possibility of having to cut interest rates in the event of a deflationary spiral setting in.

The Bank expects the economy to continue along what's really a quite remarkable recovery path, growing 2.9% in both 2015 and 2016. Unemployment is set to fall to 5% (a rate not seen since 2005) by the end of the two-year forecast horizon.

Inflation is meanwhile expected to turn negative by the spring, but to then return to 2% in two years' time assuming current market interest rate expectations. Importantly, those expectations have been pushed back since the last *Inflation Report*, with the Bank calculating that the markets are now not pricing in the first rate rise until the third quarter of 2016.

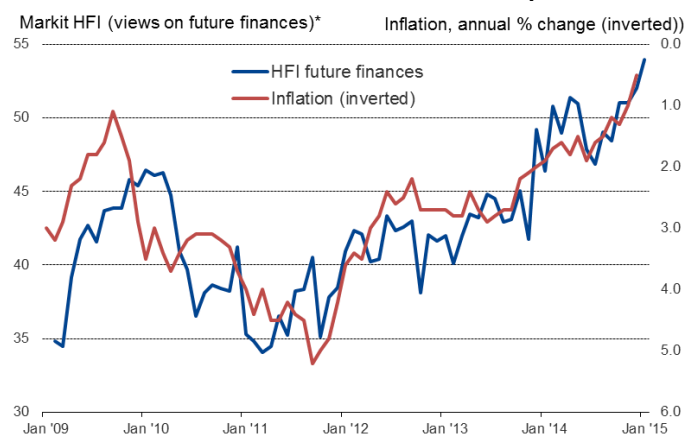
Consumer-led recovery

The Bank sees no sign yet of a deflationary spiral setting in. In fact, quite the reverse seems to be happening. Wage growth is 'beginning to pick up' and the Bank's projections see real pay growing at its fastest rate for a decade this year, boosting consumer spending and helping achieve the expected 2.9% GDP expansion.

At the same time that wages are growing, lower energy and food prices (estimated by the Bank to account for two-thirds of the shortfall of inflation, currently running at 0.5%, compared to the 2.0% target) are seen as unambiguously benefitting the consumer.

The Bank sees investment picking up alongside the upturn in the economy over the coming year, but in essence what we are seeing here is a consumer-led recovery.

How lower inflation has boosted household optimism



* Monthly survey of 1500 households.
Index based on 50 = no change on prior month, seasonally adjusted.

Sources: Markit, ONS

'Limited and gradual' interest rate hikes

This outlook gives the Bank the luxury of being able to watch the economy grow strongly over the next year-and-a-half without having to tighten policy, after which only 'limited and gradual' interest rate hikes are anticipated by the Bank.

There are of course upside and downside risks to the forecast, which the Bank sees as broadly-balanced.

Lower oil prices could generate even stronger than anticipated UK and global economic growth, meaning interest rate hikes would need to be more aggressive.

On the downside, there is a danger that low inflation could feed through to weaker wage growth negotiations, pushing inflation down even further. Such a scenario would require looser policy which, according to Mark Carney, could include interest rates even being cut. The cutting of rates below their current level of 0.5% represents a new development from previous Bank guidance, with 0.5% having previously been seen as a lower bound (below which rate cuts would be ineffective and problematic for the banking sector).

However, some further downside risks can be added, which were not addressed in the *Inflation Report*, suggesting the Bank is being somewhat optimistic in its

outlook for growth. The escalating Greek crisis threatens to destabilise the euro area, while concerns over Russia are likely to lead to risk aversion and dampen global growth. At home, an inconclusive General Election could lead to heightened economic uncertainty. Finally, having halved over the past six months due to factors that nobody can properly explain (with speculation likely to have been a significant contributor) oil prices may well start to rise again.

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