United Kingdom

Bank of England's brighter outlook marred by wage growth pessimism

- **Bank of England sees slightly brighter outlook for economy but slashes wage forecast**
- **Wage growth key to rate rises**
- **First rate rise likely early next year**

The Bank of England's latest quarterly *Inflation Report* revealed a brighter outlook for unemployment and a modest upward revision to the pace of economic growth, as well as a more benign inflation outlook. However, the latter was driven by the Bank taking a knife to its outlook for wages, halving its forecast for pay growth this year.

Such weak pay growth adds to the sense that any first rate rise will be delayed until early next year.

The Bank's forecasts assume interest rates will rise by 0.25% in the first quarter of next year and reach 2% by the end of 2016. This is based on financial market data, though also fits with the Bank's rhetoric about the timing and future pace of rate rises.

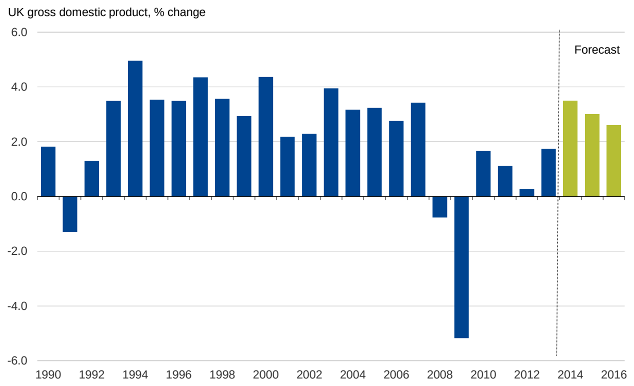
Gross domestic product is now expected to rise 3.5% this year against the prior forecast of a 3.4% rise, with next year's growth revised up from 2.9% to 3.0%. A previously expected expansion of 2.8% in 2016 has, however, been revised down to 2.6%.

The projections assume a 0.7% rise in third quarter GDP this year, which matches the signal from PMI surveys.

Inflation, meanwhile, is expected to be running at 1.8% in two years' time against 1.9% in the May. This in part reflects the 2% appreciation of sterling since the previous forecast. The pound has risen 10% over the past year against a trade weighted basket of currencies, making imported goods cheaper.

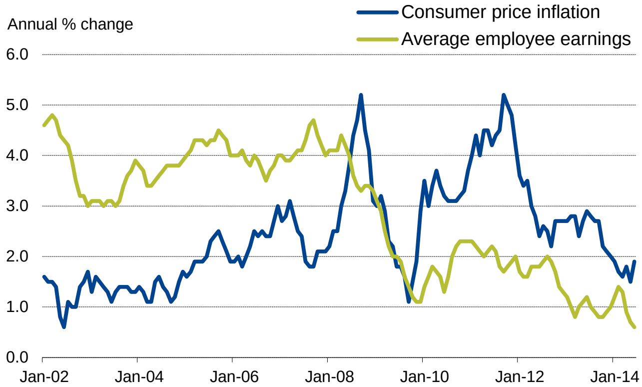
However, the main change to the inflation outlooks reflects the slashing of the wage growth forecast. The Bank now forecasts wages to rise by 1.25% this year, which is half the 2.5% increase it expected to see in the May report. Pay growth is then expected to accelerate to 3.25% next year (against a prior forecast of 3.5%) and 4% in 2016.

Bank of England economic growth projections



Source: Office for National Statistics, Bank of England.

Pay and inflation



Sources: Markit, Office for National Statistics

The cutting of the wage growth outlook comes despite the Bank being more optimistic about prospects for unemployment. Back in May the Bank had expected the jobless rate to fall to 5.9% in two years' time, but it now expects to see the rate at 5.4%.

Pay trends key to rate rises

There's little new to be gleaned in relation to the timing of the first rate rise. The Report and recent rhetoric from policymakers gives the impression that rates will not rise until wage growth is showing clear signs of picking up.

While it seems likely that calls to raise interest rates will start to gather strength in coming months, a majority vote for a rate rise still looks some way off.

February therefore still looks the most likely month for the Bank to dip its toe into the water as far as tightening policy towards more normal levels is concerned, though November remains a possibility if the wages data pick up in coming months.

There's also very little to change the longer term outlook for interest rates, which Carney stresses, will remain below pre-crisis norms for a long time.

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