markit
4th floor
Ropemaker Place
25 Ropemaker Street
London
EC2Y 9LY
United Kingdom

tel +44 20 7260 2000
fax +44 20 7260 2001
www.markit.com

Markit Economic Research

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United Kingdom

PMI surveys highlight the risks of nominal GDP targeting

- **GDP and PMI are sending conflicting messages for policy, but revision-prone GDP data have sent misleading signals on many occasions**
- **Current level of the PMI is consistent with no change in monetary policy**

The PMI surveys signalled a return to growth of the UK private sector economy in January, and have also moved back to a level consistent with policymakers keeping monetary policy on hold. This contrasts with the latest available GDP numbers, which signal a deteriorating economy and would support the case for further policy stimulus.

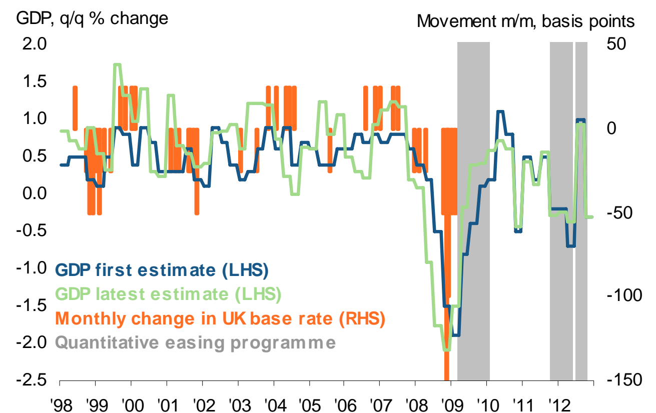
The current divergence between the PMI and GDP highlights one of the key problems associated with the possible adoption of a nominal GDP target by the Bank of England. Not only are GDP data subject to a considerable delay before they are published, but the data are also often revised significantly to the extent that misleading signals were sent for almost one-third of rate cuts made over the past 15 years.

There have been 25 months since 1998 when the Bank of England has cut its main policy interest rate. On 15 of these occasions, the latest available PMI reading had fallen to a level which indicated that the economy was either close to stagnation (a reading around the 50 neutral level) or contracting (a reading below 50). But on ten occasions, clustered around five periods (Spring 1999, early 2001, 2003, August 2005 and late 2007/early 2008) rates were cut when the PMI was higher than 51, and therefore signalling an expansion of the economy. On all of these occasions except the latest (the start of the financial crisis[1]) rates were cut in part because the initial estimates of GDP at the time were signalling weak economic growth.

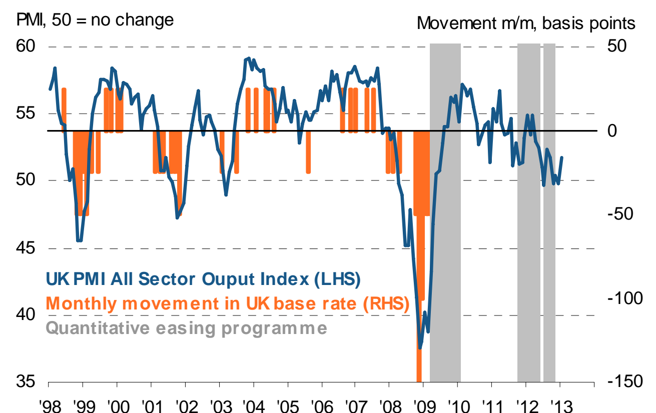
However, with the exception of late 2007/early 2008, on all of the occasions when rates were cut when the PMI was well above 50, the initial estimates of GDP were subsequently revised – sometimes quite substantially – to show strong growth. i.e. the PMI was sending a correct signal that rate cuts were inappropriate.

In contrast to GDP data, the PMI data are not revised after initial publication with the exception of minor tweaks to seasonal adjustment factors.

GDP and policy



PMI and policy



As an illustration, in April 1999 the Bank of England cut its base rate by 25 basis points, extending the loosening of policy that had been driven by the 1998 financial crisis. At the time, official data had shown GDP rising at a quarterly rate of just 0.1% in the first quarter. The PMI, in contrast, had already started rising from the lows seen in 1998, climbing to 52.3 in March. The official estimate of GDP in the first quarter

[1] Note that the PMI had been falling sharply in late 2007 and early 2008 from prior highs, being one of the first indicators to highlight the impending crisis, and could therefore arguably have been indicating the need for looser policy despite remaining above 50.

of 1999 has since been revised up to show quarterly growth of 0.5%.

In August 2005, the Bank also cut rates by 25 basis points, encouraged by an easing in growth of GDP from 0.6% in the first quarter of that year to 0.4% in the second quarter. The PMI at the time had risen to a four-month high of 55.1. The initial estimate of 0.4% quarterly GDP growth for the second quarter of 2005 has since been revised up to 1.2%.

There are no observed instances of policy changes based on subsequently revised GDP whereby GDP has *overstated* growth according to the PMI (i.e. meaning unwarranted rates hikes may have been made). All rate hikes since 1998 have been made when the all-sector PMI has been above 54.

The danger in moving towards nominal GDP targeting is therefore weighted more towards policy being loosened too much (or kept too loose for too long) by initially weak, revision-prone GDP data, than towards policy being tightened too early due to initially strong GDP data. At the moment – and until the PMI climbs above 54 – the PMI suggests that UK monetary policy should be kept on hold.

Chris Williamson

Chief Economist

Markit

Tel: +44 207 260 2329

Email: chris.williamson@markit.com

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