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Markit Economic Research

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United Kingdom

Policymakers hint at 2014 rate hike amid uncertainty over economic slack

- **Bank of England leaves policy unchanged but meeting minutes fuel likelihood of 2014 rate rise**
- **MPC members uncertain of amount of slack**
- **Wage growth seems to be a key area of uncertainty**

The Minutes from the latest Bank of England Monetary Policy Committee Meeting add to the expectation that rates will start to rise later this year, providing the economy maintains its current momentum as we move through the summer months.

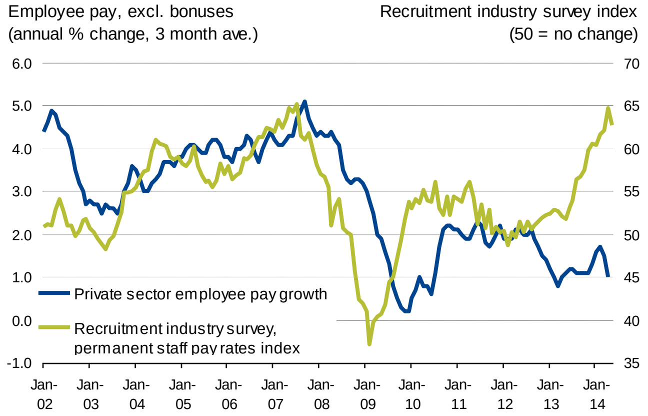
Growing uncertainty among MPC

At the June meeting, the MPC once again left interest rates at a record low of 0.5% and the stock of asset purchases unchanged at £375bn. As with previous meetings, the decision to keep policy unchanged was unanimous, but some members saw the case for an earlier rate rise was becoming '*more balanced…than earlier in the year*'.

In particular, the minutes noted that *'There was considerable uncertainty around the current level of slack, and a range of views on the Committee. That uncertainty had been reinforced by the contrasting trends in the economy since August 2013, when the Committee had set out its forward guidance strategy. On the one hand, output growth had been stronger, and unemployment had fallen faster, than had been anticipated by the MPC and most other forecasters. On the other hand, wage growth and inflation had been weaker.'*

Some of the uncertainty reflects a lack of understanding as to why official wages data remain so weak. The minutes noted that *'Further work was needed to investigate the differences between the official data and a range of survey indicators, which were significantly stronger.'* While official wages data showed the annual rate of growth of employee earnings was just 0.7% in the three months to April. Markit's recruitment industry survey shows that salaries for new recruits have been growing at the steepest pace in seven years in recent months amid widespread skill shortages.

Employee pay indicators



Sources: Markit, ONS via Ecowin.

Markets mis-pricing 2014 rate hike risk

The minutes also indicated that it was "somewhat surprising" that the markets were not pricing in a greater chance of rates rising in late-2014, on the basis that a stronger than expected economic recovery could be eating into spare capacity at a greater rate than previously envisaged (the minutes noted that options prices pointed to a 15% chance of a rate hike by the end of the year). The Bank is estimating that the economy will have grown by 0.9% in the second quarter, with strong survey evidence suggesting their current forecast of 0.7% growth in the third quarter could now be looking too cautious.

The release of the minutes follows Bank Governor Mark Carney's Mansion House speech last week, in which he warned that rates may need to start rising earlier than markets were expecting. The expectation that higher interest rates were not likely until at least the spring of next year, had been largely based on the Bank's previously stated guidance.

This all seems rather odd. Carney's speech and the minutes imply that the markets and households should have been downplaying the importance of the Bank's interest rate guidance.

The conclusion we draw from this is that, if the economy continues to grow strongly in the third quarter, a rate hike by the end of the year is on the cards. The best guess at this stage looks to be November, as this will coincide with the new forecasts published in the Bank's *Inflation Report*.

However, policy will also be influenced by the wide-ranging revisions to the national accounts, including GDP, by the ONS in September. These revisions, which have already been flagged up by the ONS as being significant, may provide the Bank with an additional valid reason to change its policy guidance and, we expect, announce an earlier than previously expected tightening path for interest rates.

Households get ready for rate hikes

Certainly households are now pricing in a rate hike this year. Markit's HFI survey showed that the number of households expecting rates to start rising within the next six months doubled between May and June, leaping from 30% to 60% of those surveyed that expressed a view (data were mainly collected after Carney's speech last week). Some 27% expect a rate hike in the next three months, up from just 12% in May. The survey also showed that the earlier-than-previously expected upturn in mortgage costs was a key factor behind a marked easing in households' views on their future finances.

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