

European interest rates

PMI data signal greater likelihood of Eurozone rate hike compared to UK

- **UK and Eurozone policy rates unchanged in January.**
- **Bank of England has tolerated high inflation in the past, meaning UK rates may stay low for longer than in the Eurozone.**

'No change'

The Bank of England and European Central Bank (ECB) held policy rates steady at 0.5% and 1.0% respectively in January, despite inflation being above target in both regions (3.3% in the UK and 2.2% in the Eurozone). Past experience suggests the Bank of England will tolerate above-target inflation in the current weak growth environment, as this will prevent 'second round' inflation effects (notably a wage-price spiral) taking hold. In contrast, the ECB has previously shown itself to be more eager to quash rising inflationary pressures even in a period of slowing growth.

The announcements were as expected, although recent data on inflation and commodity prices have led many to bring forward their expectations of an increase in UK rates to the first half of this year, as consumer price inflation is expected to accelerate further above the Bank of England's inflation target of 2% in coming months. A rise to 4% is by no means outside the bounds of possibility.

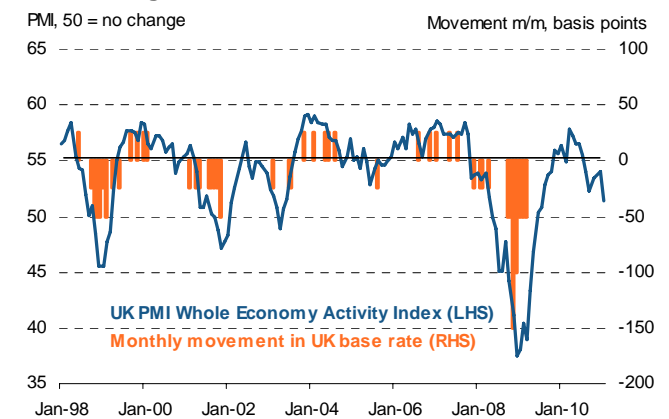
UK growth has slowed, limiting the prospect of 'second round' effects

However, there are reasons to believe that even a rise in inflation to this pace will not force the Bank of England's hand. Most importantly, the UK central bank looks at what inflation will be in the longer term, and seems to believe the factors that are expected to drive inflation higher, including January's VAT rise, are temporary. Only if these factors generate 'second-round' inflationary effects is the Bank likely to feel the

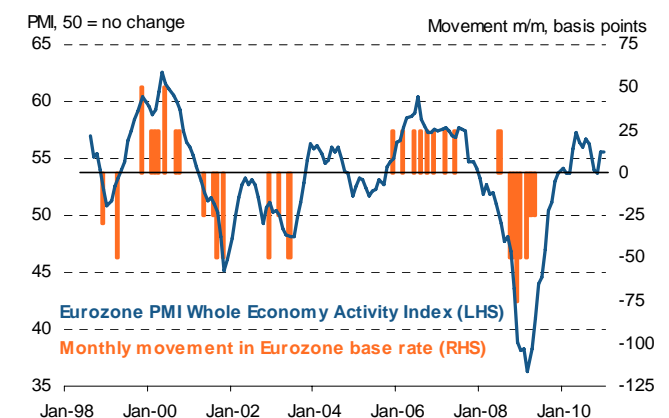
need to act to keep a lid on price expectations. At the moment, the signs are that the economy has slowed, despite a pocket of growth in the manufacturing sector. Job security will remain at its current weak levels for some time, meaning these second-round effects are not likely to pose any problems in the near future.

At the moment, the latest PMI data show that the UK services and construction sectors slid back into contraction in December, leaving manufacturing (which represents only around 13% of the economy) as the sole driver of economic growth. Taken together, the three PMI surveys have moved into territory which would historically have been consistent with lower interest rates (see chart).

Bank of England interest rate decisions and the PMI



European Central Bank interest rate decisions and the PMI



ECB less likely to tolerate above-target inflation than the Bank of England

This toleration of high inflation by the Bank of England has been demonstrated clearly in the past, when record oil prices helped drive inflation to 4.4% in July 2008. A similar jump in inflation stimulated a rate rise by the ECB, but the Bank of England held steady. A key reason for the Bank of England to hold UK rates was the fact that economic growth was already beginning to slow, something which the ECB chose to pay less attention to. Inflation in the UK subsequently reached a peak of 5.2% in September of that year (although, by the time that number was published, Lehman's had collapsed and the financial crisis moved into a new phase). This goes to illustrate that the Bank of England will tolerate inflation higher than even the 4% peak which many analysts are expecting to see in the first half of this year without hiking rates, providing that the underlying trend in economic growth is not

consistent with rising second round effects - as is the case at the moment.

It seems likely, therefore, that the Bank will want to wait and see how the economic growth data move in coming months before being confident that the economy can withstand a signal that interest rates are on the rise.

The case is less clear cut in the Eurozone, where the PMIs are in what would normally be considered rate-hike territory and inflation is above target. Alongside the lessons from history, one would therefore expect the ECB to begin its normalisation process sooner than the Bank of England. However, wide national growth disparities and the sovereign debt crisis muddy the picture as far as policy making is concerned.

Chart sources: Markit, Bank of England, European Central Bank.

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