

# 'G4' policy rates

## PMIs highlight how policymakers remain in uncharted waters

### Past relationships with PMIs signal rate hikes

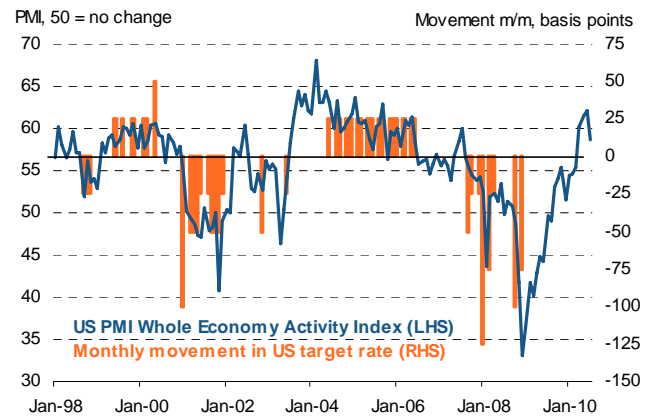
With one member of the Bank of England's Monetary Policy Committee calling for higher interest rates at its latest meeting, we thought it would be interesting to look at what the PMIs are currently signalling for monetary policy.

Prior to the financial crisis, the PMIs for the US, UK and Eurozone exhibited close relationships with central bank policy rates, as illustrated in the accompanying charts. Higher PMI readings indicate stronger demand for goods and services, meaning companies can raise prices, and vice versa.

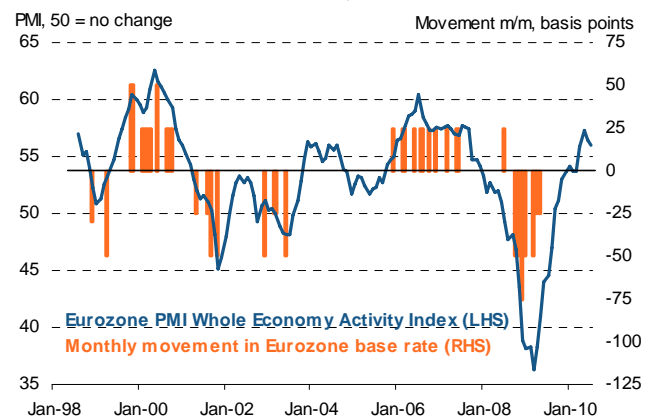
According to these pre-recession, PMI-policy rate relationships:

- Earlier this year, the US All-Sector PMI Output Index rose above levels which have triggered a shift to a rate hiking phase in the past. The PMI peaked at 62.1 in May and the three-month moving average peaked at 61.2. These levels are roughly consistent with a 40% probability of a hike in the Fed policy rate.
- The shift to an ECB hike phase has in the past been triggered when the three-month average of the All Sector PMI Output Index has risen above 54.7 (December 2005), so the current three-month average of 56.6 is above this trigger level. The PMI's peak of 57.3, attained in April, was consistent with a 30% chance of an ECB rate rise.
- A shift at the Bank of England from a rate cutting or neutral stance to a hike phase has been triggered only when the three-month average of the All Sector PMI Output Index has risen above 57.2. This level was reached in May, though the publication of weaker PMI numbers in June has brought the average back below this threshold. Even at its peak, the PMI was only consistent with a 20% probability of a rate rise.

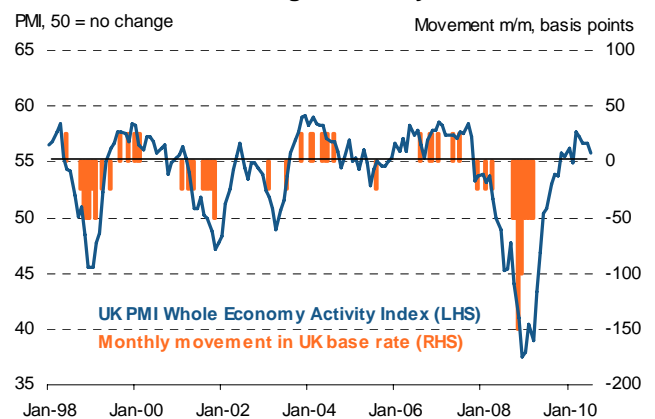
### United States PMI and Fed Policy Rate



### Eurozone PMI and ECB Policy Rate



### UK PMI and Bank of England Policy Rate



Sources: Markit, ISM, US Federal Reserve, ECB, Bank of England.

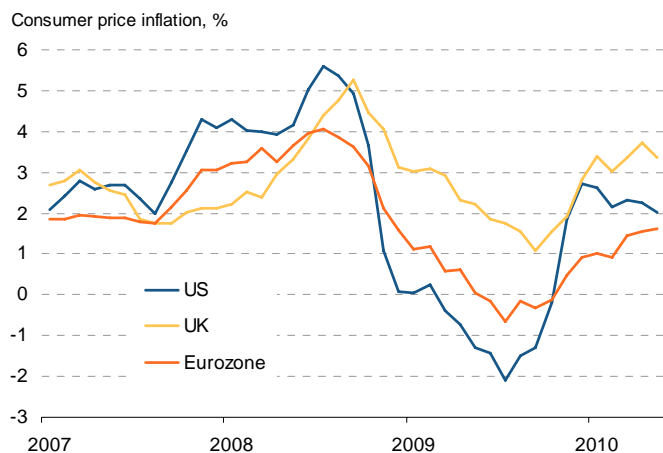
So the US, UK and Eurozone PMIs have all reached levels which have triggered a shift to a rate hiking phase by central banks in the past. The US survey has sent the strongest hike signal, followed by the Eurozone. The UK PMIs have sent the weakest signal.

However, calls for higher UK rates are strengthened by the fact the consumer price inflation (CPI) has been well above the Bank of England's 2% target rate for some time, running far above equivalent rates in the US and Eurozone. In fact it could be argued that the spectre of deflation still hangs over the US and Eurozone: core inflation in the US (stripping out volatile food and energy components) is at its lowest level for over 40 years.

## Still in uncharted waters

The lone voice on the Bank of England's Monetary Policy Committee certainly has some grounds for concern, based on PMI and inflation signals in the past. However, the very fact that the PMIs have risen above historical rate hike trigger levels without wider calls for rate hikes serves to highlight just how unusual the economic situation remains in the developed world. Three years after the start of the financial crisis, and almost two years after the collapse of Lehmans, normal relationships still do not hold, and policy makers must continue to operate in largely uncharted territory.

## Inflation rates



Source: Ecwin.

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