UP, UP AND AWAY?

Interest rates in the US and the UK are likely to rise over the next 12 months, but central banks will take a softly-softly approach, predicts Rob Wood

The developed world's recovery from the 2008 financial calamity has been painfully slow. But the US and the UK are now in the midst of a solid expansion. As a result, their respective central banks need to begin raising interest rates over the next 12 months. My money would be on Britain going first.

The monetary kitchen sink that the US Federal Reserve and the Bank of England threw at the recession and the subsequent recovery has been working. Huge sovereign bond purchases, along with forcing banks to clean up their acts, have got the economies on the move again. Excluding North Sea oil production, UK GDP growth has averaged 1.9% a year since 2010, not far off average US GDP growth of 2.2%. That is well ahead of the eurozone's 0.7% average.

Those growth rates are slow when compared with a normal recovery. That is unsurprising. Slow recoveries usually follow financial crises because banks and households are burdened by bad debt that needs to be worked off. That is important for judging how much slack there is left. The lack of a post-recession bounce could, in principle, suggest there is oodles of spare capacity left to use up. But that is hard to square with inflation not venturing very far from normal.

True, inflation is running below the 2% inflation target in the UK. But core inflation is still 1.9% and has averaged 2.3% since 2008. The Bank of England cannot control commodity prices, but it can control domestic price pressures. Indeed, trying to offset the drag from weak world price pressures was one of the mistakes that inflamed the credit boom before 2008.

Still, UK GDP is around 16% below where it would have been had it kept growing at its pre-crisis average rate. But that rate was too high to be sustainable. Also, much of the undershoot represents permanently lost capacity. As a result, labour markets on both sides of the Atlantic have been tightening in response to solid growth.

The UK unemployment rate has tumbled from a peak of 8.4% in late 2011 to 6.2% in the latest data. US unemployment has fallen from 10% in 2009 to 5.9% in September. Another year at the recent pace of decline would see both countries' unemployment rates fall below their pre-crisis averages of 4.8% in the US and 5.2% in the UK.

Russia's covert war in Ukraine, as well as events in the Middle East, pose a less than favourable global backdrop for continued solid expansion. But domestic signals remain strong in the UK and the US.

Fortunately, quiescent wage growth gives the central banks plenty of room to pursue their softly-softly approach, despite rapidly declining unemployment. But the UK has less room to wait. There is one big difference between the two countries. Many workers have left the US labour force since 2008, and some could return in the coming months and years. In contrast, the UK's employment rate is close to a record high (records began in 1971). Rising numbers of older workers staying in work have kept wages subdued in the UK. But that will not last forever.

Britain is also more closely tethered to the slow-growing eurozone, so the UK current account deficit has ballooned as Bank of England policy has stimulated a domestic recovery. The US does not have a problem of the same degree.

Ultimately, neither the Fed nor the Bank of England needs to drastically restrict growth. But their economies have moved on since the depths of the crisis. Monetary policy needs to as well. The recovery has been slow to come, however, as will the forthcoming interest rate hikes. Both banks will take a softly-softly approach.

Banks and households are burdened by bad debt that needs to be worked off

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