BANK OF ENGLAND ESTABLISHES FORWARD GUIDANCE

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On July 1 of this year, Mark Carney assumed the role of governor at the Bank of England (BOE), and in the short time since he's made some impressive changes at one of the most conservative central banks in the developed markets. At Carney's very first policy meeting, just three days into his tenure, the BOE instituted explicit forward guidance with respect to the amount of time interest rates were expected to stay low—to combat expectations of rising yields. He later outlined the conditions necessary for changing the path of monetary policy during the inflation report on August 7. Carney's tenure has already been marked by improvements in economic data and consumer sentiment, namely: • Stronger-than-expected industrial production numbers in June (+1.1%) announced August 6, 2013 • Stronger-than-expected UK services PMI, from 56.9 to 60.2 in July (57.4 was expected); announced August 5, 2013 • Manufacturing PMI rose 1.7 points to 54.6, the highest since March 2011; announced August 1, 2013 It is thus not surprising that the August 7 inflation report was slightly less aggressive in terms of easing monetary conditions further. Below, we investigate the conditions the BOE laid out for forward guidance of interest rates. In the August inflation report, the Monetary Policy Committee (MPC) committed not to raise bank rates above their current level of 0.5% until the unemployment rate falls to 7%. The MPC also attached three conditions upon which this threshold would be deemed not to hold[1]: 1. In the MPC's view, it is more likely than not that CPI inflation will be above 2.5% in 18–24 months 2. Medium-term inflation expectations are not sufficiently well anchored 3. The Financial Policy Committee (FPC) believes that the stance of monetary policy poses a "significant threat" to financial stability that cannot be contained by the policy actions of the FPC, the Financial Conduct Authority (FCA) or the Prudential Regulation Authority (PRA) For the first time, the committee published its forecast of the unemployment rate and predicted that unemployment would need approximately three years to fall to 7%. The committee mentioned that further quantitative easing (QE) is possible as long as the unemployment rate is above 7%. In addition, it proposed that the existing stock of QE would not be reduced as long as unemployment remained above the threshold. This implies that the BOE does not foresee offloading its Gilt holdings from its balance sheets anytime in the near future. On the other hand, the Federal Reserve's (Fed) plan to potentially taper as early as the fourth quarter of 2013 and ending QE altogether by late 2014 contrasts starkly with the BOE's stance. Additionally, the committee argued that current market interest rates "imply a faster withdrawal of monetary stimulus than appears likely given the current economic outlook." We take this to signal a lower-for-longer rate guidance for market participants well into the second half of 2016. The policy divergence between the FED and the BOE suggests a relative easing of monetary conditions in the UK relative to the U.S. and potential implications for further weakness of the pound against the dollar. **Bernanke's Take on the Significance of Forward Rate Guidance** Bernanke underscored the importance of forward rate guidance in his Jackson Hole speech last year[2]. He spoke about the merits of this policy tool particularly when rates were at their lower bound. One can draw parallels here for the United Kingdom: • Bernanke discussed how forward guidance lowers private sector expectations regarding future short-term rates, which in turn caused longer-term interest rates to decline, leading to more accommodative financial conditions • Investors as well as private forecasters have considerably pushed out the date at which they expect the federal funds rate to begin to rise; moreover, policy expectations appear to align well with the Federal Open Market Committee's (FOMC) forward guidance • The committee's forward guidance may have conveyed a greater willingness to maintain accommodation than private forecasters had previously believed • The behavior of financial market prices in periods surrounding changes in the forward guidance is also consistent with the view that the guidance has affected policy expectations. **Conclusion:** We believe that forward rate guidance is a key ingredient for capping longer-term rates such that financial conditions will continue to be simulative for the United Kingdom economy. Carney and the MPC have hit the nail on the head and delivered a monetary policy tool that will serve as a bedrock for economic growth in the months ahead. Given current expectations that the Fed will be earlier to tighten its monetary policy, one can make a good case for the U.S. dollar strengthening against the British currency—which would further stimulate UK export markets. [1]Source: Bank of England Inflation Report, August 2013. [2]Chairman Ben Bernanke, "Monetary Policy since the Onset of the Crisis," Jackson Hole Address, August 31, 2012.

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DEFINITIONS

Forward guidance : A central bank policy tool intended to guide market expectations regarding the future of policy rates.

Monetary easing policies : Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.

Industrial production : A measure of manufacturing activity within the economy.

Purchasing Managers' Index (PMI) : An indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. A reading above 50 indicates an expansion of the manufacturing sector compared to the previous month; below 50 represents a contraction while 50 indicates no change.

Consumer Price Index (CPI) : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

Gilt : Bonds issued by the UK government and generally considered to be low risk and the primary vehicle in which QE is carried out in the UK.

Lower bound : : Central bank target rates that are at or close to zero, implying limited room for further easing.