

UK

MPC Leave Policy on Hold

- The MPC left rates and QE on hold, in line with consensus (and our) expectations. This is Mervyn King's last meeting as Governor and his 194th MPC meeting since BoE independence in 1997 (with of course additional BoE/Treasury monetary policy meetings in the pre-independence days).
- Mark Carney takes over as Governor next month and we expect he will supplement the existing balance-sheet stimulus (QE, credit easing) with forward guidance¹. Carney used guidance in 2009 and has expressed several times his belief that forward guidance can be a useful tool for stimulus at the zero bound (see for example, his speech of May 1 this year). At the BoC, Carney used time-contingent guidance in 2009 (committing to keep the policy rate stable for at least a certain period of time). At the BoE, we expect that Carney will seek and obtain support to introduce Fed-style guidance that is linked to economic conditions, with the MPC committing to not tighten in terms of Bank Rate and QE at least until the economy has achieved specified thresholds. As with the Fed, we expect that the key threshold will be set in terms of the jobless rate (perhaps at 6.5% or 7.0%), with an inflation knockout (in terms of the MPC's inflation forecast perhaps 2 years ahead) set at 0.5% above the inflation target.
- Such a framework would signal that the MPC will keep rates low until the economy has used up much of its slack but not allow it to overheat before starting to tighten (the OBR judges that the UK's sustainable jobless rate – the NAIRU -- is 5.5%, the IMF puts it at about 6%). By setting the inflation knockout a little above the inflation target (as the Fed does), the MPC would signal that it will be somewhat slower to hike than implied by its normal reaction function with a 2% inflation target, while not allowing a major inflation overshoot. This would be very much in line with academic work on forward guidance at the zero bound.² An inflation knockout slightly above the target could also be read as showing some willingness to look through the sizeable regulatory-driven effects on the CPI. It might have been hard for the MPC to implement forward guidance under the old remit, but the changes to the remit made earlier this year seem designed (in our view) to allow the use of forward guidance. With the jobless rate stuck around 8% (and roughly stable) recently, we suspect that guidance on these lines would help lower market rate expectations and ensure that the message of extended monetary support cuts through to the general public to a much greater extent than normal BoE rhetoric manages.

Michael Saunders

+44-20-7986-3299

michael.saunders@citi.com

¹ See "Options for Forward Guidance", Michael Saunders, UK Economics Weekly, 10 May 2013, Citi.

² See for example "Methods of Policy Accommodation at the Interest-Rate Lower Bound", Michael Woodford, presented at the Fed's Jackson Hole conference in 2012.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Appendix A-1

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