

## Economics

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### UK – MPC On Hold

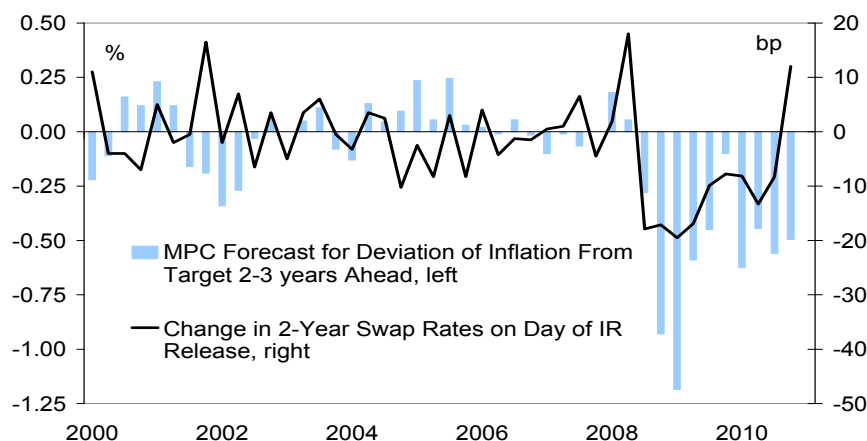
- The MPC left rates on hold, matching consensus expectations. As usual when policy does not move, there is no statement. We believe that the MPC is waiting to see more data on Q4/Q1 GDP growth and the trend in early 2011 pay deals. We still expect rates to rise soon and rise further than markets price in.
- We expect that the *Inflation Report* next week will project that inflation two years ahead (risk-adjusted) will slightly exceed the target with stable rates, while the “market rates” profile will show inflation a little below target 2-3 years ahead. Such an IR would intend to signal that the MPC expects to hike fairly soon, but believes that market rate expectations are too high. The nine IRs from Aug-08 to Aug-10 inclusive all projected sub-target inflation 2-3 years ahead (with market rates). These forecasts succeeded in persuading markets that rates will stay low for an extended period, with two-year swap rates falling by an average of 13bp on those nine IR release days. However, the Nov-10 IR failed to gain similar traction: the MPC again projected below-target inflation but 2-year rates rose 12bp on the IR release day. It appears that repeated inflation overshoots versus the MPC’s forecasts have diminished the credibility of the MPC’s policy message. We suspect that, if the MPC again forecasts sub-target inflation 2-3 years ahead with market rates in the upcoming IR, investors may again be sceptical, doubting the MPC’s inflation forecasts and hence also doubting their message that rates will rise slower than markets price in.

**Michael Saunders**

+44-20-7986-3299

michael.saunders@citi.com

**Figure 1. UK – MPC Forecast for Inflation 2-3 years Ahead (with “market rates”) and Change in 2-Year rates on Inflation Report Release Day, 2000-10**



Source: BoE, Citi Investment Research and Analysis

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

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