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02 APRIL 2014

AHEAD OF THE CURVE: UK – GUIDING US TO THE PEAK INTEREST RATE...

After six years of abnormally loose policy, central bank messaging will be critical in guiding us toward the 'exits'. Neil Williams, Group Chief Economist at Hermes Fund Managers, believes this leaves financial markets increasingly sensitive to deviations from the forward guidance set in train by the US Fed and BoE.

In the UK, the risk is that governor Carney's new 'Son of Forward Guidance,' based on cutting economic 'slack,' proves so vague it stretches credibility. Unlike the Fed, the BoE has moved not just the goalposts (by pushing back its unemployment thresholds), but also the rules (by devaluing unemployment as a key policy driver). It now monitors 18 different indicators to guide us toward that first rate rise.

By slowly unwinding QE, the BoE could cap the peak rate around 3%...

We expect the US and UK's policy normalisation to start in 2015, with just two 25bp rate hikes. Thereafter, to preserve growth, the Fed and BoE will try to minimise 'peak' interest rates by first allowing their QE-bought bonds to 'roll-off' (*i.e.* to mature without reinvestment), before eventually having to sell some of them back to the market via quantitative tightening (QT). However, even this will be a gradual process.

The difficulty the BoE will have is presentation. While they now look explicitly at a range of capacity indicators, including business surveys, labour participation rates, and average earnings, they will have most difficulty explaining the 'output gap'.

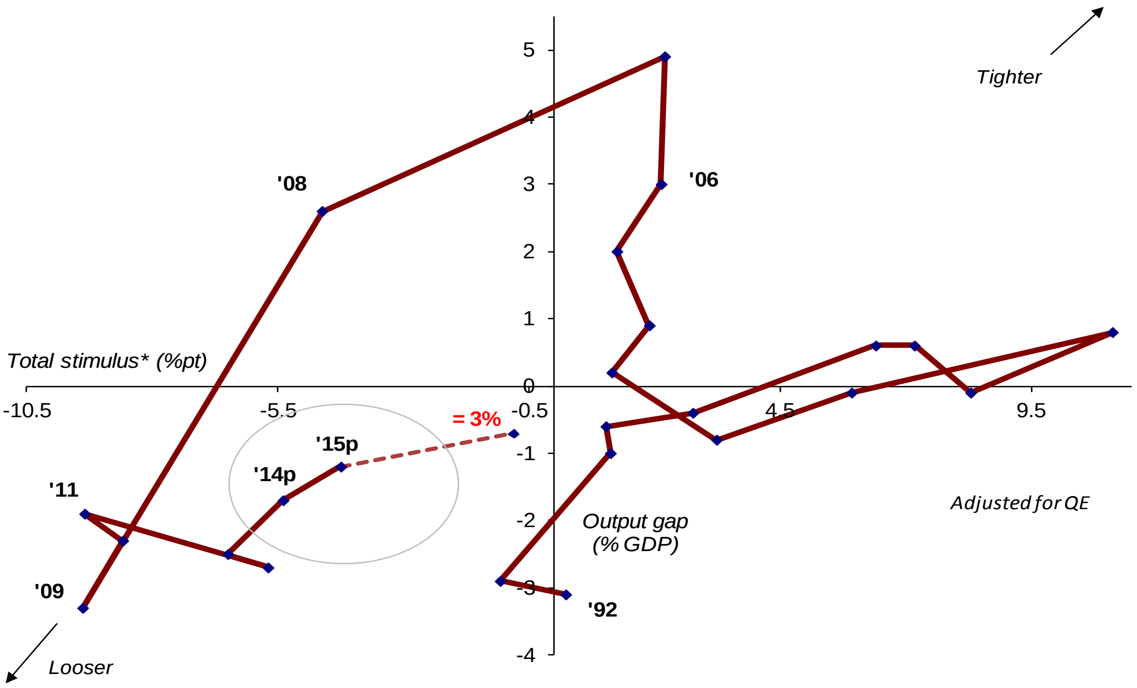
MPC members disagree about both its importance and size. The gap is a theoretical, unobservable concept used in modelling, whose size rests on assumptions for such things as potential growth, and which needs reliable GDP data.

'Son of Guidance' thus seems a bit like a university student having been given a straightforward essay to write, but going out of his way to make it seem as complicated as possible to gain extra marks. As recovery builds, markets may fear the MPC is subordinating inflation control to growth considerations, especially nearer next year's election.

The intention is to absorb, though not completely remove, spare capacity before hiking. The MPC does not publish output gap estimates. As a guide, the OECD's projections, which are consistent across countries, pitch the UK's at -1.7% in 2014 and -1.2% in 2015. This also implies no rate hike before 2015.

We use the OECD's output gaps in our *Policy Looseness Analysis*, which quantifies the likely path of a country's overall (monetary and fiscal) policy tightening. The UK's outlook is shown in the graph below.

UK - quantifying where the peak interest rate may end up
*{(QE adj real rate – its long run av)+(cyc adj fiscal bal as % GDP – its long-run av)}



Source: Hermes Fund Managers Ltd, based on OBR & OECD data, & Bloomberg

It suggests:

- if money markets are right to expect around 75bp in total BoE rate tightening by the end of 2015, no more than half the UK's extreme policy loosening since 2008 will have been corrected. This defers correction of what has been a long-term UK loosening, unmatched in the G10;

- second, by adjusting real rates for the BoE's estimate that £200bn in QE is akin to taking 150bp off the Bank rate (and interpolating for the full £375bn QE stock) implies a de facto UK Bank rate now as low as -2%, or -4% in real terms; and

- third, the MPC would need to take rates to 4% to normalise policy fully (*i.e.* to move back to the origin in the chart). This gets close to threatening Carney's mantra that the peak Bank rate will fall well short of its 5% historic average. Therefore, they may keep the peak rate down by letting QE roll off.

As a guide, the trade-off in the above chart is that a meaty £107bn erosion of QE (to £268bn) would be needed to normalise policy at a lower peak rate of 3%. However, given the redemptions profile, this would take till March 2018! In which case, the *quid pro quo* for keeping rates down is the Bank will, at some stage (probably after 2015), have to run QT.

In taking the monetary/fiscal mix back to 'normal', messaging will be critical. Only time will tell, in the US and UK, how helpful guidance was in carrying us smoothly to the exits without repeat of the kind of turbulence sparked by the Fed's un-telegraphed tightening of 1994.

In the UK it may be more difficult to judge. After all, by stripping out the initial unemployment target which was a puzzle, the 'knock outs' which are judgement calls, and now 'slack' which is inexact, doesn't this just get us back to 'flexible inflation targeting'?

-ENDS-

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Notes to Editors:

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