6 February 2013

# Bank of England Preview

## Waiting for Carney

- We expect the Bank of England (BoE) to remain on hold at Thursday's Monetary Policy Committee (MPC) meeting (13:00 CET). Any policy changes on Thursday would be a surprise. All analysts surveyed by Bloomberg expect both unchanged rates and the Asset Purchase Facility (APF) to be kept on hold at GBP375bn.
- Recent statements from MPC members, as well as the latest minutes, suggest that the MPC in general has less confidence in additional quantitative easing. We do not expect any policy changes for the remaining period of Mervyn King's governorship.
- More interesting is that on Thursday Mark Carney will appear before the Treasury Committee (10:45 CET). Mr Carney has recently promoted nominal GDP (NGDP) targeting as a way to communicate and manage monetary policy expectations. Here we review his comments as well as the possible implications of NGDP targeting.

| | Danske | Cons. | Last |
|---|---|---|---|
| Bank Rate | 0.50% | 0.50% | 0.50% |
| APF | 375bn | 375bn | 375bn |

*Source: Bloomberg, Danske Bank Markets*

### No changes on Thursday's MPC meeting

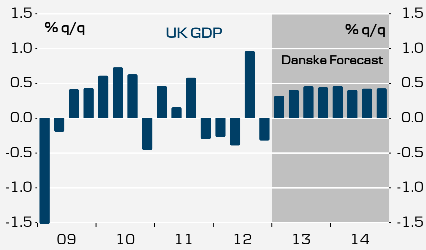
The MPC minutes from the January meeting were largely as expected, with David Miles continuing to vote for an immediate expansion of gilts purchases (he has done it for three meetings now). The minutes indicated some concerns about the potential for inflation persistence and uncertainty of the effectiveness of additional asset purchases: '*There remained uncertainty about their [asset purchases] impact on nominal demand , and they might prove less effective in boosting real output (...) had strengthened the belief of some of these members that no further asset purchases were required at the current juncture'*

More colours of this view was given in recent comments from MPC members. In his final regional speech in Northern Ireland, Governor King stated his view that monetary policy cannot solve all economic problems, *'generalised monetary stimulus is not a panacea'*. But he did not rule out further asset purchases should the economy deteriorate further. This was also the essence of external MPC members Ian McCafferty's first public speech a couple of weeks ago. He expressed concerns about the marginal efficiency of asset purchases and '*fears of such demand stimulus would have inflationary consequences*'. Without over-interpreting his wording we would classify McCafferty as a median voter with a hawkish bias.

Hence, we think the MPC view the economy developing in line with the November Inflation Report (with GDP slow recovering and inflation to be above target until mid 2014). We do not see the MPC to impose any material policy changes before Mark Carney takes over the chair as governor. One possible change could though be a reinvestment of the redeemed gilts currently in the APF (GBP 6.1bn in March, 1.6bn in September). But such a change should merely be viewed as a technical adjustment to maintain the current policy.

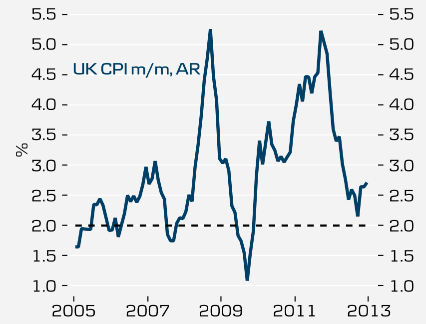
Note, that BoE will publish the next Inflation Report next week (13 Feb) and new forecasts will be available on this week's MPC meeting.

**We forecast a slow recovery**




*Source: Danske Bank Markets*

**Inflation above target**




*Source: Macrobond, Danske Bank Markets*

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# Debate on UK monetary framework

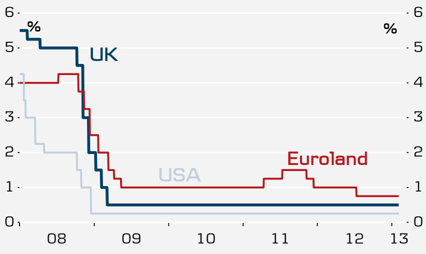
There have been an increasing number of comments and discussions on the Bank of England's monetary framework with the appointment of Mark Carney as the next governor taking over the chair in July 2013.

In the following, we look at recent statements from Mr Carney, revisit NGDP as a monetary framework and examine the market implications of a change of framework.

## Pricing in Carney (and NGDP targeting)

In a *speech* on 12 December 2012, Mr Carney reflected o guidance and central bank options at the zero lower bound and he expressed some sympathy for nominal GDP targeting. His views on monetary policy were elaborated in a panel discussion in Davos in January. Mr Carney insisted that monetary policy was far from '*maxed out*' and that it should continue to accommodate the recovery until economics has achieved '*escape velocity'* even if inflation was above target.

Central banks at zero lower bound




*Source: Reuters EcoWin*

Furthermore, according to the press, it seems as though there is some – if not considerable – sympathy for NGDP targeting within the UK government and speculation about using Carney's nomination to change the monetary framework has flourished.

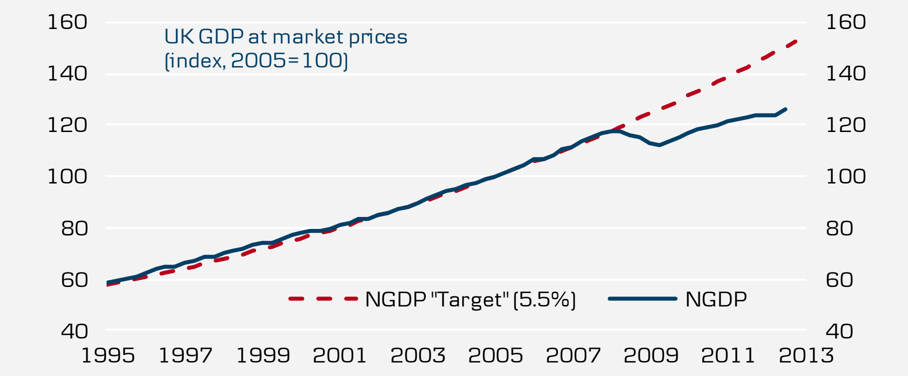
If the BoE were to change its operational target from the present inflation target to a NGDP target, it would have a considerable impact on the outlook for the GBP, as it would imply a considerable easing of monetary conditions in the near term.

Since mid-December, the GBP has weakened against both the EUR and the USD. However, we think that the weakening trend is far from over. There are numerous reasons for our bearish view but longer term we would stress in particular the outlook for a change in Britain's monetary policy regime.

## What is NGDP targeting?

From the mid-1990s until 2007-08, UK nominal GDP grew at close to 5.5% year-on-year. Proponents of NGDP (level) targeting basically propose that the Bank of England should implement this as an actual monetary policy target rather than the present 2% inflation target. Carney's expression of '*bygones are not bygones under NGDP'* is illustrated in the chart below.

Actual UK nominal GDP and 5.5% path 1995-08 extrapolated



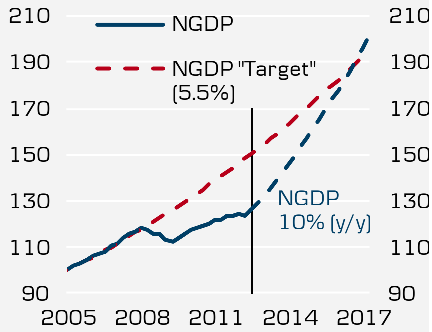

*Source: Reuters EcoWin, Danske Bank Markets*

NGDP targeting proponents would argue that if real GDP growth is 3% in the long run and the BoE targets 5% NGDP growth, it would bring 2% inflation in the long run. Hence, from a long-run perspective, the inflation outcome would be the same whether the BoE targets 2% inflation or 5% NGDP growth. Therefore, an NGDP target in general does not imply an easier monetary policy stance but would probably imply a more stable development in both real and nominal GDP growth. As a consequence, whether the BoE targets 2% inflation or 5% NGDP growth, it would not make much difference to the outlook for the GBP.

However, in the short run there is a considerable difference in the monetary policy stance depending on whether the BoE targets 2% or the NGDP *level*.

Since the crisis struck in 2008, UK NGDP has fallen more than 15% compared with the pre-crisis trend level. Proponents of NGDP level targeting have advocated that the BoE should implement a policy to bring back UK NGDP to the pre-crisis level – or at least to a level considerably higher than the present level. Judging from Mark Carney's comments, he seems to have sympathy for 'pushing' NGDP to a level somewhat higher than implied by the NGDP trend of the last four to five years.

**Return to pre-crises GDP trend**




*Source: Reuters EcoWin*

Therefore, an NGDP level target in its purest form would imply that the BoE would pursue a policy to bring back NGDP to the pre-crisis trend over, for example, two or three years. Given that NGDP has fallen significantly short of the pre-crisis trend over the last four to five years, it would take above pre-crisis trend growth to bring NGDP back 'on track'. Indeed, it would take more than 10% NGDP on average per year until mid-2016 to bring NGDP back to the pre-crisis trend. However, we find it very unlikely that the BoE would try to close the 'NGDP gap' even if there was a formal shift to NGDP level targeting.

## How could NGDP level targeting be implemented in the UK?

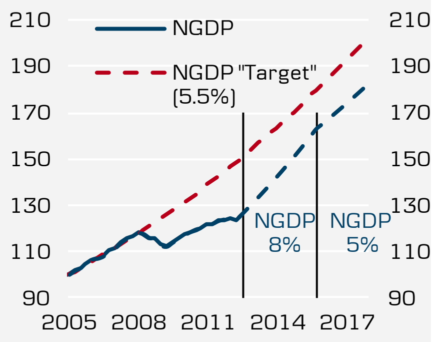
The level of NGDP has fallen so much short of the pre-crisis trend that we find it very unlikely that the BoE will ever try to bring the level of NGDP all the way back to the pre-crisis level. There are numerous reasons for this. *First*, it would simply be seen as too extreme to try in a period to increase NGDP growth above 10%. *Second*, one can certainly argue that the 5.5% growth trend in NGDP in the period prior to the crisis was in itself excessive and therefore serves as a bad benchmark. *Third*, we are in uncharted territory in terms of conduct of monetary policy, which would be likely to necessitate some conservatism in terms of implementing an NGDP level target in UK.

Therefore, if the BoE and the British government were to opt for implementing some form of NGDP level targeting, we see two possible options, both of which involve a short-term (two to three years) 'lift' to the UK NGDP level.

1. *Temporary NGDP targeting.*
   This option would imply that the BoE and British government announce that they would implement a monetary policy to ensure a lift in NGDP of, for example, 10% over a two-year period from the present level to 'normalise' the UK economic situation. Thereafter, they would return to the BoE's present 2% inflation target. The BoE would probably be able to argue that that is within the BoE's flexible inflation targeting regime. This would have considerable attraction for policymakers for practical-political reasons, as it could boost NGDP without any reputational risk (i.e. being accused of changing the BoE mandate as a means to get re-elected). However, it would, in our view, be less preferable from a longer term perspective, as it would be a less credible policy shift. Nonetheless, it could be seen as the compromise between those policymakers who advocate a stronger monetary response to the crisis and the 'traditionalists' within the BoE who do not welcome this change.

2. *Permanent NGDP level targeting*.
   There is no doubt that the proponents of NGDP level targeting – both in the increasingly active blogosphere and advocates within the UK administration – would prefer a shift to the pure form of NGDP level targeting. We could imagine the BoE under such a permanent NGDP targeting regime announcing that it would target 6-8% NGDP growth in two to three years, thereafter returning to a 'steady state' target of NGDP around a 4-5% growth path. This would not close the 'NGDP gap' in the sense of returning the NGDP to the pre-crisis trend but it would provide monetary stimulus to lift the level of NGDP and furthermore – and from a long-term perspective – would re-establish a rule-based UK monetary policy. The chart on the right illustrates how this would look in a 'stylised' setting with a couple of years of above-trend NGDP growth and then a 'return' to stable NGDP growth of 4% or 5%.

**Minimising NGDP gap with temporary above-trend growth**

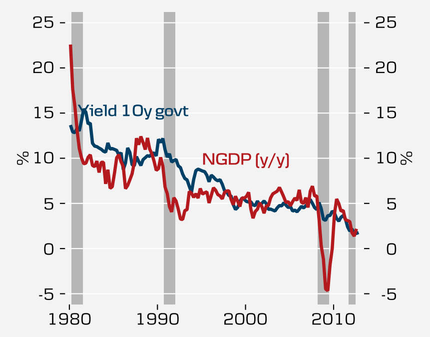



*Source: Reuters EcoWin, Danske Bank Markets*

Assuming that the BoE decides to implement one of the above, we would expect the BoE at the same time to announce open-ended quantitative easing to achieve the new target and hence follow the lead from the Federal Reserve and the Bank of Japan, which in the last couple of months have announced new monetary policy frameworks. In our view, an announcement of open-ended asset purchases is a pre-condition for making a new target credible.

Regardless of whether a new NGDP level target is implemented temporarily or permanently, there is no doubt that it would necessitate significant monetary easing – in the form of both quantitative easing and, equally importantly, clear communication about the BoE's intention to increase the nominal GDP level (some sort of commitment or guidance).

**UK government bonds and NGDP**




*Source: Macrobond, Danske Bank Markets*

Therefore, we conclude that a shift to any form of NGDP level targeting would have significant implications for the UK FX and fixed income markets.

## How much is priced in already? What are the markets telling us?

It is no longer a secret that the UK government and the Bank of England are both discussing and thinking seriously about implementing a form of NGDP level targeting. Therefore, we could expect to see some impact on the markets.

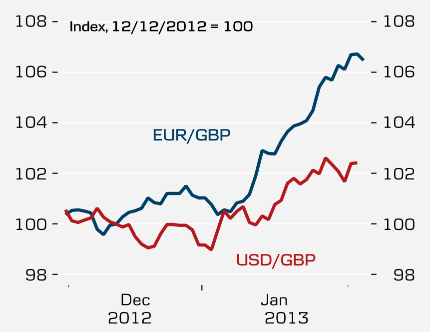
Overall, we would eventually expect to see the markets reacting to the announcement and implementation of an NGDP level target in the following way:

1. The GBP should weaken – against both the EUR and the USD – as the BoE initiates monetary easing. However, after the initial correction to the 'lift' in the NGDP level, the GBP should settle at a new weaker 'fair value' level. Longer term (after the NGDP level has been lifted), we would not expect the GBP to trend either weaker or stronger against the major cross, as we would expect inflation to settle down close to what we should expect in the US or the eurozone (2% or so).

2. If the BoE is able to lift NGDP and, more importantly, is able to lift the expectation of future NGDP growth then over time we should expect a significant increase in longer UK yields. Historically, UK bond yields have more or less tracked NGDP growth. So, if the BoE targets NGDP growth of 4-5% in the long run then we should assume this to be the 'steady state' level of UK long-term bond yields. Hence, the yield curve should steepen.

3. A boost to NGDP growth would be likely to give a boost to the earnings growth of UK companies and, as a consequence, we would expect a lift in the level of NGDP to also lift UK equity prices.

**Sterling weakened in January**




*Source: Macrobond, Danske Bank Markets*

These are what we could call stylised market reactions to the announcement of a lift in the NGDP level and this serves as a useful benchmark in terms of assessing how much monetary easing is already priced into the UK markets.

Judging by the recent development in EUR/GBP we could be tempted to conclude that the market is already pricing in significant monetary easing. However, the recent spike in EUR/GBP mostly reflects EUR strength rather than GBP weakness, as can be seen by the USD/GBP having been much more ‘flat’. This said, there seems to be some GBP weakness ‘sneaking in’ recently and this could be an indication that the market is beginning to price in more monetary easing. This said, if the BoE were to implement NGDP targeting – either permanently or temporarily – we would expect a much stronger negative impact on the GBP than we have seen so far.

On the yield side, the same story materialises, as we do not see the UK curves steepening significantly. The 10Y-2Y swap spread has steepened some 25bp since December but the US curve has steepened even more. On a similar note, 10Y gilts yields have not risen significantly compared with German bunds, as would be expected from the above mentioned stylised market reactions.

Regarding break-even inflation, expectations of future inflation seem unchanged (if we disregard the volatility caused by the ONS announcement of not imposing changes to the RPI methodology). So, all in all, bond and rate markets have not bought into higher yields or steeper curves.

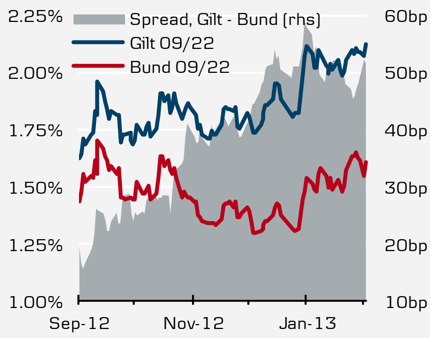
The UK equity markets have rallied recently and are up 5% since Mr Carney first mentioned NGDP level targeting on 12 December. However, the rally in UK equity markets is of a similar magnitude to what we have seen in other major stock markets for 2013 and it seems unlikely that it reflects an increase in the expectations for UK monetary easing – rather it reflects expectations for Japanese and US monetary easing and a global recovery. Hence, if the BoE were to implement a form of NGDP level targeting then we would expect the UK equity market to rally further.

## Conclusion: markets are waiting for Carney

Overall, even though the UK markets are showing some (weak) signs of pricing further monetary easing, we have far from fully priced for NGDP level targeting being implemented. Hence, if we believe that the BoE will implement an NGDP level target then we should expect a weaker GBP, a steeper UK yield curve, higher long-term bond yields and higher stock prices.

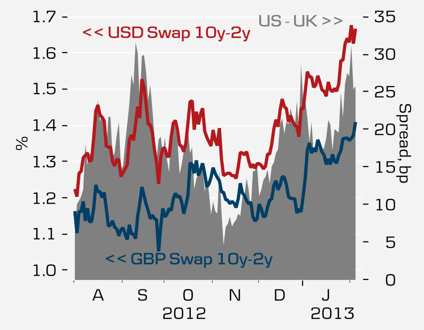
There are numerous reasons why we have not seen this already. It is certainly not a given that the UK will get an NGDP level target, as there still is considerable opposition to the idea both within the BoE and within the British government. This said, we find it more likely to happen than the markets are presently pricing. There is no doubt in minds though that markets on Thursday will pay much more attention to Mr Carney’s testimony at the Treasury Committee than to the MPC meeting.

**Gilts still trade around 50bp to Bunds**



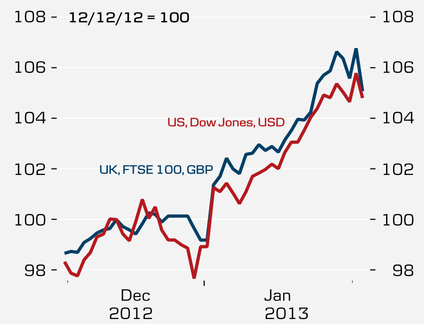

*Source: Bloomberg, Danske Bank Markets*

**GBP swap curve steepened relative to USD swaps**




*Source: Bloomberg, Danske Bank Markets*

**UK equities rally along with US**




*Source: Macrobond, Danske Bank Markets*

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