REDINGTON

Bank of England Announces Forward Guidance: Low Rates Guaranteed?

August 2013

For Institutional Investors

Contents

Executive Summary

The Announcement

- The **Bank of England** (BoE) has provided **details on 'forward guidance'** for its future monetary policy, **spelling out** the **economic conditions** under which it **would consider raising** its **benchmark interest rates** from the current record low of 0.5%.

- The BoE said that the official **unemployment rate must fall below a 'threshold' of 7%** before it would consider increasing benchmark interest rates. The Bank stressed that this does **not** represent **a trigger for raising rates automatically**.

- The BoE has also **set out conditions under which this threshold level would cease to apply** as a guide for monetary policy, **in particular inflation being too far away from the target level**. This permits policymakers to remain true to their primary objective (price stability).

- The BoE **may engage in further quantitative easing** as long as the unemployment rate is higher than 7% if the Monetary Policy Committee thinks this is necessary to support the recovery.

The Rationale

- **Provide greater confidence around the future path of the BoE's monetary policy**, in particular, to **re-iterate that interest rates will remain low until the UK economy has recovered sufficiently**. The idea is that this will help support the recovery by keeping borrowing costs down.

- Unemployment has been chosen as the target measure as the BoE regards it as a good, readily available and easy-to-understand indicator for the general state of the economy and the progress of the recovery.

The (Immediate) Impact

- Based on the **BoE's projections**, **benchmark interest rates** will **not** be **raised until 2016/2017**, **potentially putting further downward pressure on longer-term rates and pension schemes' funding levels**.

- Many commentators have said that the **guidance is only 'soft'** with the BoE reserving itself **several 'get out' clauses** to react flexibly to changing economic circumstances (especially above target inflation). They added that this would explain the timid market reaction to the announcement.

- There was also **concern that inflation would rise further** as the BoE's base case involves keeping rates low for a significant length of time.

What’s happened?

The Bank of England (BoE) on 7th August provided details of its keenly expected “forward guidance”. The aim of such an exercise is to provide investors and the economy at large with a clearer picture of how the central bank expects monetary policy to develop in the future. This is particularly the case when economic data releases appear to show a gradual strengthening of the economy, as recently in the UK, and the central bank wants to communicate the circumstances when monetary would be tightened again, for example, by raising interest rates.

The BoE’s Monetary Policy Committee (MPC) announced that, if and when the official rate of unemployment falls to 7% (it currently stands at 7.8%), it would consider raising interest rates. Consequently, investors should not expect monetary policy to tighten until the UK economy has recovered further, resulting in a significant decline in the unemployment rate.

Based on the BoE’s own projections for future unemployment rates, this means that interest rates would not be raised until 2016/2017.

The MPC regarded the unemployment rate as the most suitable indicator for forward guidance because:

- It relates directly to the amount of slack in the economy;
- It is less volatile than some alternative measures of activity;
- It is not prone to substantial revisions;
- It is widely understood.

Importantly, the MPC also stressed that an unemployment rate of 7% merely represents a threshold which would lead to discussions about raising interest rates. It does *not* represent a trigger that would lead to an automatic tightening of monetary policy.

The MPC additionally also stated that there were three ‘knockouts’ which would lead to the unemployment threshold ceasing to apply:

1) If it is more likely than not that CPI inflation 18 to 24 months ahead will be 0.5% or more above the BoE’s 2% target (see Chart 1).

2) If medium-term inflation expectations no longer remain sufficiently well-anchored (see Chart 2).

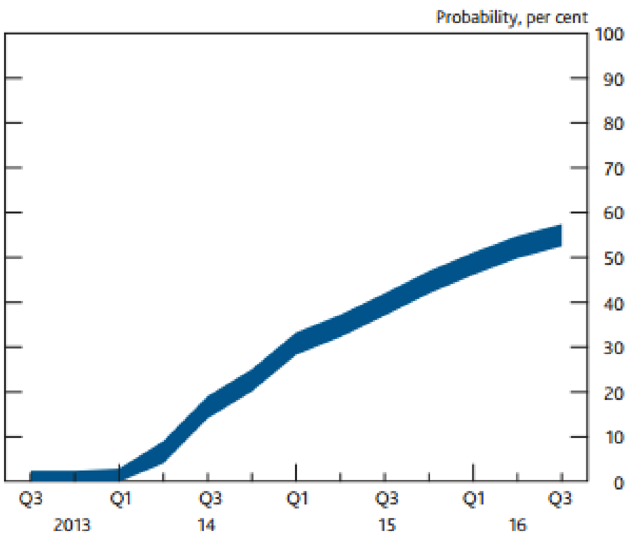
   If either of these two conditions is met, the MPC would therefore expect to raise interest rates even if unemployment is higher than 7% in order to adhere to its primary policy objective of price stability (defined as CPI inflation of close to but below 2% per annum over the medium term).

   Forward guidance entails an important distinction between the central bank’s expectations of future economic conditions and how it reacts to changes in key economic variables (such as inflation). In other words, is the central bank expecting to keep rates low for several years because it believes that economic conditions warrant it, or because it is less concerned about controlling inflation? The first two knockouts aim to communicate to investors that the BoE's forward guidance belongs to the first, and not the second, category.

3) If the Financial Policy Committee (FPC) judges that the stance of monetary policy poses a significant threat to financial stability that cannot be contained by mitigating policy actions.

In its quarterly Inflation Report, the BoE published analysis providing further information around the unemployment threshold and the inflation knockouts.

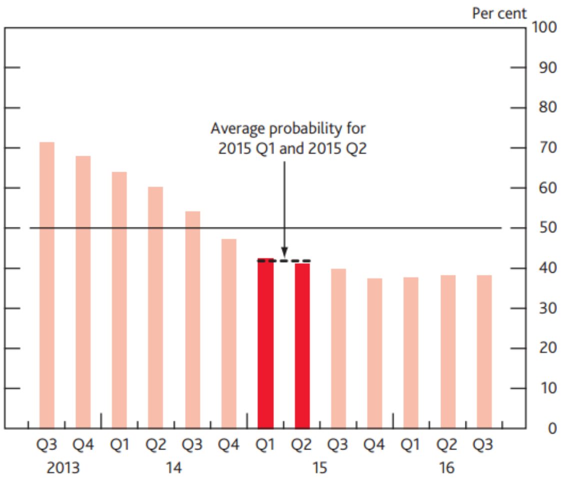
Chart 1: Cumulative probability of unemployment having fallen below the 7% threshold



Source: Bank of England Inflation Report August 2013, p.48

The chart shows that the BoE would currently not expect the unemployment rate to reach the threshold level of 7% before the end of 2016.

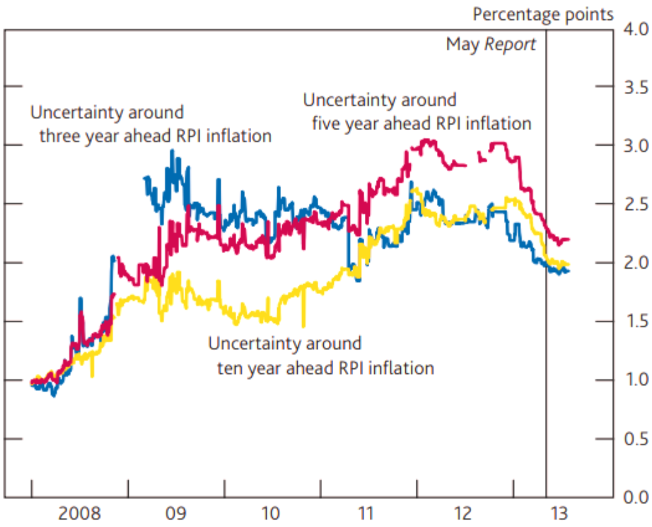
Chart 2: Probability that CPI inflation will be at or above the 2.5% knockout



Source: Bank of England Inflation Report August 2013, p.48

The chart shows that the 2.5% knockout would currently not apply as the BoE judges the probability of inflation being higher than 2.5% in 18 to 24 months' time to be less than 50%.

Chart 3: Indicators of uncertainty about future inflation – RPI 3, 5, 10 years ahead implied by options



Source: Bank of England Inflation Report August 2013, p.36

The chart shows that whilst the level of uncertainty about future inflation (a measure of how well anchored inflation expectations are) is higher than in 2008, it has decreased noticeably since the beginning of the year.

The BoE also made it clear that it may engage in further quantitative easing when the unemployment rate is above the threshold level if it believes that such an additional stimulus is necessary to support further recovery.

Why has it happened?

Forward guidance is a tool that central banks can use to communicate what they regard as the level of future interest rates appropriate to the economy's expected performance. The market's pricing of interest rates can clearly move out of line with how monetary policymakers see rates evolving. A particular instance occurred earlier this year when the BoE described the increase in gilt yields in May and June as 'unwarranted' given the performance of the UK economy, implying that low rates should continue to prevail.

In the current environment, this has meant that market rates occasionally have been higher than envisaged by the BoE and led to tighter monetary conditions than desired, thus hampering the economic recovery. The use of forward guidance aims to harmonise market pricing with BoE thinking. The aim is to keep market rates low in line with monetary policy, giving investors and market participants more confidence that credit will remain cheap for a significant period of time. This in turn should help to support the economic recovery.

In the BoE's words, explicit forward guidance can enhance the effectiveness of monetary stimulus in the following ways:

1) It provides greater clarity about the MPC's view of the appropriate trade-off between the horizon over which inflation is returned to the target and the speed with which growth and employment recover;

2) It reduces uncertainty about the future path of monetary policy as the economy recovers;

3) It delivers a robust framework within which the MPC can explore the scope for economic expansion without putting financial stability a risk.

In the MPC's view, guidance in the form of the "likely response of monetary policy to economic developments" is more effective than keeping policy unchanged for a specific time period. Conditions can change unexpectedly and, in this way, the MPC maintains flexibility should the economy improve or deteriorate faster than forecast. This will help individuals and businesses to understand the future path of rates, feeding back into borrowing and investment decisions being made today.

What are the implications?

It is clear that forward guidance is just that – guidance, not a guarantee. While this can remove some volatility in short-term interest rates (as the BoE is now communicating the conditions necessary for higher rates), it may well increase volatility and uncertainty in inflation expectations (as there is some room for inflation to diverge from the policy target as long as it is expected to return to target in the medium future).

The guidance is designed to encourage economic growth and any signs of this are likely to feed directly into expectations for future inflation (as higher growth often implies higher inflation), which will be watched even more closely. The style of guidance chosen suggests that the MPC wants to make sure that inflation expectations do not become unanchored as this could have serious knock-on effects for actual inflation. For example, had the MPC decided to move to a nominal GDP target (i.e. real GDP multiplied by the price level as measured by CPI, for example) then the implications for market participants could have been that inflation would be allowed to run higher than the official target while real GDP growth remains subdued.

For pension schemes, the implicit takeaway is that real yields are likely to remain under pressure – medium and long-term interest rates should be anchored by the even more extended period with a Base Rate of 0.5%, while above-target inflation will likely be tolerated as long as it is projected to fall to the 2% target in the medium-term.

Obviously, benchmark interest rates could rise more quickly than anticipated under the BoE's forward guidance if inflation expectations become unanchored or medium-term inflation is expected to remain significantly above the 2% target. This could imply an increase in real interest rates if the increase in nominal interest rates (driven by higher benchmark rates) outpaces higher inflation.

The immediate market reaction to the BoE's announcement could be described as timid. Sterling rose against both the Dollar and the Euro and equities fell during the day (a commitment to lower interest rates should theoretically have the opposite effect). Long-term gilt yields and swap rates showed little reaction with only very small moves.

Market commentators stated that the guidance was too 'soft' – i.e. the BoE said that it will keep interest rates low only if inflation is kept in check – to have much (immediate) impact on markets.

Further details on forward guidance can be found in the BoE's full official report:

http://www.bankofengland.co.uk/publications/Documents/inflationreport/2013/ir13augforwardguidance.pdf

About the Authors

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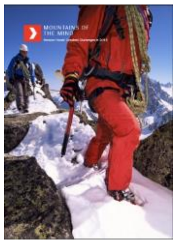

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