UK Monetary Policy: walking to stand still (eh? what?)

In Governor Carney's prepared opening remarks to the press conference after the Bank of England's Monetary Policy Committee unanimously agreed to raise its Bank Rate from 0.50% to 0.75% he made a couple of statements. There was the obvious and expected one:

> *"With domestically generated inflation building and the prospect of excess demand emerging, a modest tightening of monetary policy is now appropriate to return inflation to the 2% target and keep it there."*

Then the curious one:

> *"Policy needs to walk – not run – to stand still."*

Classic Carney. He is such a sharp cookie. He knew that the unanimity on raising rates in the MPC would be interpreted as a hawkish surprise by markets, and it was. Immediately GBPUSD rose on the announcement to above 1.31 with market commentators highlighting that unexpected unanimity.

We fully expected that he would row back on that perceived hawkishness in the press conference. He duly did with the seemingly throwaway comment on "walking to standstill". The markets duly responded strongly with a sharp drop in GBP to below the level where it started the day to near 1.30.

The event as a whole was then widely summed up as being a dovish rate rise according to many monetary policy watchers in the markets. It makes you wonder why the Bank of England bothered to raise rates at all. Was it just to give themselves room to cut them later?

r-star madness

There was also an extended riff on r* from the BoE that threw up an intriguing admission: that monetary policy over the last few years has not been ultra-easy, highly accommodative or anything of the sort.

“The second issue – the equilibrium interest rate, or r* – is as obscure as Brexit is prominent.

The equilibrium interest rate is the interest rate that, if the economy starts from a position with no output gap and inflation at target, would sustain output at potential and inflation at target.

r* is not a direct guide to the setting of monetary policy. Rather, it provides a way to think about the forces acting on the economy, and whether policy is stimulative or contractionary.

The appropriate level of the Bank Rate depends not only on the level of r* but also on the need to close any output gap or whether shocks merit varying the horizon over which the MPC seeks to return inflation to target.

The MPC published today its assessment of the factors influencing the equilibrium interest rate. The key messages are:

> *– The level of Bank Rate consistent with output at potential and inflation at target has fallen significantly from pre-crisis levels.*
>
> *– This is the result of both structural forces – such as productivity and demographics – and shorter-term forces – such as uncertainty and private and public deleveraging – that have pushed the equilibrium interest rate down further.*
>
> *– As a consequence, even though Bank Rate has been very low, the stance of monetary policy in recent years has been mildly rather than wildly accommodative.*
>
> *– Indeed, the facts that today the economy is at full employment and core CPI is 1.9% tell us that the combination of historically low rates and asset purchases of two years ago was about right. Tighter policy then would have led to worse outcomes now.”*

We would definitely take issue with the policies of the last few years as being “about right”. Why condemn the UK to a slow and faltering expansion that was not even preceded by a recovery? Why not get it going quicker? The last decade has been and will remain

a lost decade for many, many workers – especially those coming of age in 2009 and now into and approaching their 30s. The same is true in many countries blighted by over-cautious central bankers.

The purpose of this digression into the dark world of r* was to reinforce the BoE view that they are actually dovish, and markets noticed his conclusion:

> *"([This] … provides context to our long-held guidance that rate rises are expected to be limited and gradual. Limited because we think the structural factors that have pushed down the trend equilibrium real rate are likely to persist. Gradual because we think the domestic short-term factors (particularly headwinds from uncertainty and fiscal drag) will fade slowly. As a result, r* can be expected to rise gradually."*

As the BoE of congratulates itself on its success in so well managing the economy we remain extremely concerned about the trending down in UK NGDP growth. Nominal growth is just too weak to take these Cheshire cat games played by Carney. He should lobby for a change in his objectives, to managing something he can control directly like the level and growth of NGDP and leave the puzzling of the level of the actual or correct level of r* to the markets.

He bemoaned the lack of productivity growth but at the same time ties himself to academic and central bank consensus that growth follows productivity improvement rather than the other way round.

We hope that his successor from mid-2019 will see things differently.