Economist Insights

Manners maketh the policy

Markets had expected the Bank of England to signal last week that a rate hike this year might be likely. But instead its statements highlighted concerns about the exchange rate and oil prices. The BOE has historically waited for the Federal Reserve to move before changing monetary policy. There are several good reasons for caution and waiting to see what the impact of a Fed move will be.

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The British have a reputation for politeness (for the most part), a reputation that the Bank of England (BOE) seems keen to uphold. At a time when both the BOE and the Federal Reserve are looking to raise interest rates, the BOE is politely stepping out of the way and saying 'please, you first; I insist'.

Only it is not saying that in so many words. The British also have a reputation for indirectness, never addressing the topic directly. There always seems to be an excuse for dovishness. A few months ago, some members of the BOE's Monetary Policy Committee (MPC) appeared to be gearing up to vote for a rate hike, but then the Greek crisis worsened and this was seen as a good enough reason to delay.

Once the Greek crisis passed, or at least subsided, markets had expected the hawkishness to return. Not that anyone was expecting a majority of MPC members to vote for a hike, but at least if a few voted it would signal that a hike this year might be likely. On the face of it there are quite a few reasons for the MPC to turn more hawkish. Their own forecasts for economic growth have improved, and they are even forecasting an excess of demand in three years' time. UK GDP growth has been revised up in the most recent estimate by a very significant half a percent per year on average since 2011. Many MPC members see the risks for inflation to the upside.

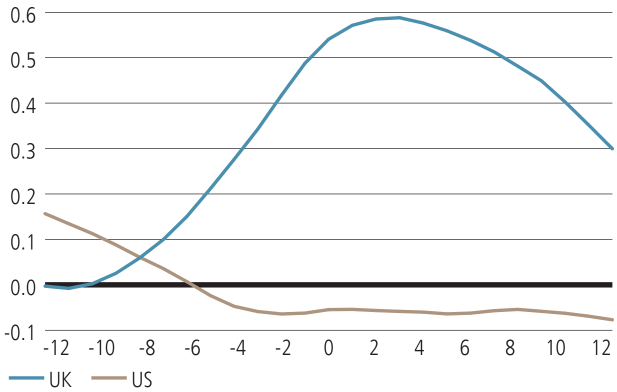
Yet in their statements on "super Thursday" last week, the BOE instead highlighted concerns about the exchange rate and the fall in the oil price. These are likely to push near-term inflation down compared to earlier expectations. But central banks are meant to look further out than that, so in principle the BOE should be driven by its expectation of excess demand in the future. Given the delayed impact of monetary policy on the economy, the BOE could end up behind the curve on interest rates, at least relative to its economic outlook.

Of course, expectations about the future are simply expectations and could be wrong. Maybe the BOE is conscious of how wrong some of its forecasts have been in the past. And the oil price is not really an excuse: the effect is one-off and it provides a boost to consumers that can add to domestic inflationary pressure.

The exchange rate provides a more compelling excuse for caution, even though it is supposedly not a target for monetary policy. Nevertheless, for a small open economy like the UK the exchange rate does matter. It definitely matters more than it would for the US, which is a large and relatively closed economy (see chart 1). The Fed does not have to worry too much about the exchange rate (except when they want to use it as an excuse, see *Economist Insights*, 13 October 2014). Not only is the USD exchange rate not so important for the path of growth and inflation in the economy, but the path of monetary policy is not so important for the USD. While there is a high correlation between the BOE policy rate and the effective GBP exchange rate, there is virtually no correlation for the USD.

Chart 1: Rates of exchange

Correlation between 12m change in the policy rate and lags of the YoY % change in nominal effective exchange rate

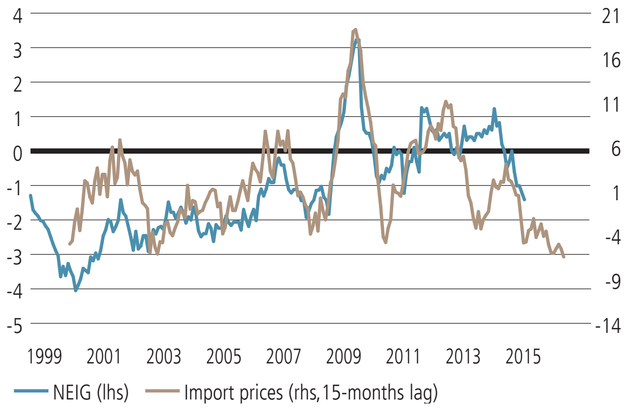


Source: Bank of England, Federal Reserve Bank, UBS Global AM

In an open economy like the UK, import prices are very important for inflation. An appreciation of GBP pushes down the price of imports in GBP terms, so you get downward pressure on prices. The imported part of inflation is best represented by the non-energy goods component of GDP (which makes up almost a third of the inflation basket, compared to a fifth in the US). Unlike energy prices, which feed through to inflation right away, import prices tend to take about 15 months to have an impact on inflation (chart 2). This is much closer to the kind of time frame that central banks need to think about. In short, if you want to target inflation in two years you will need to take into account that a stronger currency will push down inflation. Ultimately inflation should be a domestic phenomenon, but it is a brave central bank that can take that long-term view.

Chart 2: Import duties

Non-energy industrial goods prices and import prices (%, YoY)



Source: ONS

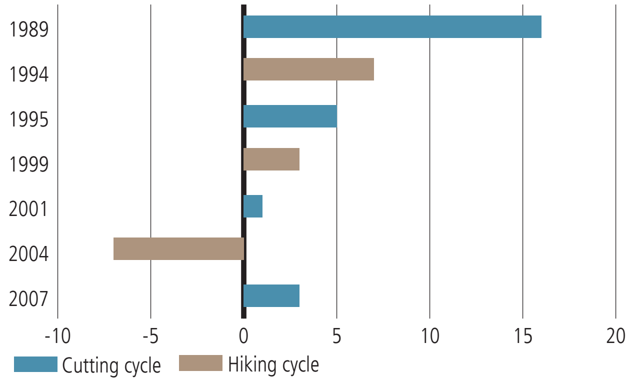
If the Fed raises rates before everyone else, the USD will rise. It has already risen a lot in anticipation of just this event, but the Fed is just not that worried about the impact. But if the BOE raises rates before the Fed, GBP will rise relative to the US, one of the UK's major trading partners. A rise against the EUR is almost given, since the ECB is going to remain loose, but to rise against the USD at the same time would just compound the pressures on inflation.

Perhaps it is no surprise that the BOE has almost always waited for the Fed to move before changing the direction of monetary policy (chart 3). The hiking cycle of 2004 is the only exception but that was because the bursting of the "dot-com" bubble did not have the same economic impact in the UK as it had in the US. Therefore, the Fed not only had to cut more in 2001 but also waited longer before starting to hike rates again.

At least in the external sense, hiking rates after the Fed has already hiked is a bit like keeping monetary policy neutral. There is still a domestic tightening, but at least the currency impact is less than if the BOE was to tighten early. You might think that a few months here or there would make little difference, but the signalling effect could be important (especially when the Governor of the BOE is still writing a monthly letter to the UK Treasury explaining why inflation is so low). If the BOE is willing to tighten before the Fed in this cycle, then might it not also hike faster or further?

Chart 3: Follow the leader

Number of months between a change in the Fed Funds Rate and the BoE base rate



Source: Bank of England, Federal Reserve Bank, UBS Global AM

The UK current account deficit is already huge, and a GBP appreciation would probably just make things worse. The last major economy to be spending so far beyond its means was Spain prior to the financial crisis. Ignoring this kind of build-up may store up trouble for the future as the UK keeps spending beyond its means. On the other hand, keeping interest rates too low will also encourage over-spending. There are no easy answers for a small open economy.

So even though the UK has just had its growth rate in recent years revised up, while the US has just had its recent growth rate revised down, the BOE is still going to want to wait. And perhaps with good reason. US core inflation (excluding food and energy) currently stands at 1.8%, close to target. UK core inflation is at 0.8%, well below target. The BOE has more to fear from deflationary pressures than the Fed does.

Another good reason to wait is the uncertainty about how the economy will react to rate hikes. With all the changes to the financial system in recent years, and so much quantitative easing still sloshing around the system, the monetary transmission mechanism may react in unusual ways. Sometimes someone politely stands to one side because they want the other person to be the one to find out what is on the other side of the door.