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Mark Carney Faces His First Test

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Recent data have indicated that there is no longer a need for fresh monetary stimulus in the UK, but that doesn't mean new Bank of England Governor Mark Carney is having an easy ride. In fact, he's finding it difficult to keep market interest-rate expectations in check. In our view, he may continue to do so.

When Mark Carney was appointed governor of the Bank of England in November 2012, the economy was stuck in the doldrums and there was widespread speculation that the UK was about to enter a "triple-dip" recession. Carney's mandate was therefore clear: get the economy moving at all costs. The government even made things easier for him. In this year's Budget, Chancellor of the Exchequer George Osborne changed the Bank's remit and instructed the Monetary Policy Committee (MPC) to give greater weight to the real economy when setting monetary policy.

Nine months on, the economic backdrop has changed markedly. Real gross domestic product (GDP) rose by 0.3% in the first quarter of the year and by 0.7% in the second. Survey data have been even more impressive. In August, the composite Purchasing Managers' Index (PMI) for manufacturing and services reached 60.8%, the highest reading in the history of this series **(Display 1)**. Far from entering another recession, the economy is booming, recent data suggest.

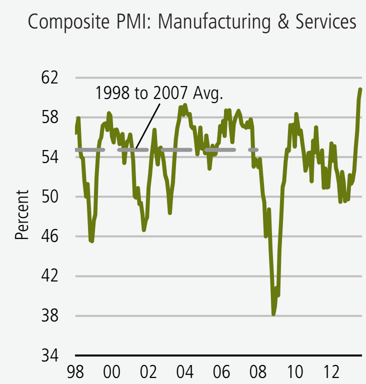
Luck or Judgment?

When news of Carney's appointment broke, there was understandable concern that he had not really been tested in his role as governor of the Bank of Canada. The UK—with its broken banks, demand weighed down by private-sector deleveraging, fiscal tightening and close links to the euro area—would surely present a stiffer challenge.

Or maybe not. Recent data suggest that the new governor may have had the good fortune to take over at a major turning point for the UK economy.

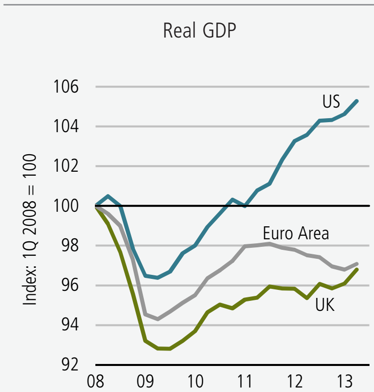
Still, it would be wrong to think that Carney is having everything his own way. Stronger data have clearly removed the need for fresh monetary stimulus in the UK. But the recovery is still in its infancy and two quarters of growth hardly make up for the feeble performance of recent years **(Display 2)**. Against this backdrop, the Bank's emphasis is now on preventing a market-driven tightening of financial conditions that could bring the nascent

Display 1
PMI Reaches Record High



Through August 31, 2013
Source: Haver Analytics and Markit

Display 2
Disappointing Recovery So Far



Through June 30, 2013
Source: Haver Analytics

recovery to a premature end. As **Display 3** shows, though, it is not being particularly successful in this endeavor.

What must be particularly disappointing for the new governor is that his first innovation—explicit forward interest-rate guidance—is not preventing market rates from rising. And this is despite the fact that the Bank has indicated that it does not expect to tighten monetary policy until 2016 at the earliest. So why is the Bank's guidance not working?

We think there are a number of reasons. The most important is that the guidance has simply been overtaken by the data. In reaching a decision about the future path of monetary policy, market participants need to make judgments about both the way in which the Bank of England reacts to economic data—its reaction function—*and* the future path of the economy. So even if the market thinks the reaction function has changed (which, in our view, it has), it may not believe the shift has been big enough to keep policy on hold until 2016, given the strength of recent data.

Nor does the particular form of forward guidance help.* The Bank's commitment is that it will not even consider tightening monetary policy until the unemployment rate has fallen to 7.0%, something that it does not expect to happen until 2016 **(Display 4)**.

The rationale for such a gradual decline in the unemployment rate is that the Bank thinks the recovery will be accompanied by a marked improvement in productivity growth. This assumption may well be correct. However, it is a rather subtle argument. Moreover, if the economy grows on a sustained basis at anywhere near the rate indicated by recent survey data, there is every likelihood that unemployment will fall much more quickly than the Bank anticipates. In this respect, recent data showing that unemployment is already undershooting the Bank's forecast will only confirm the market's worst fears.

Hawks Ascending?

Carney also faces the problem that a number of his colleagues do not seem to share his (apparently) dovish tendencies. This is clear from the minutes of the August MPC meeting, at which some participants seemed to approve of the recent increase in market interest-rate expectations. This difference of views may also explain why the Bank compromised on a 7.0% target for the unemployment rate—rather than 6.5%, which would have given much greater credibility to its commitment to keep interest rates low.

Another reason why forward guidance may not be working as hoped is that one of the key ingredients is missing. Prior to joining the Bank, Carney said that forward guidance had worked in Canada because "we put our money where our mouths were." For the UK, this would mean making additional gilt purchases, something which is most unlikely in the current environment.

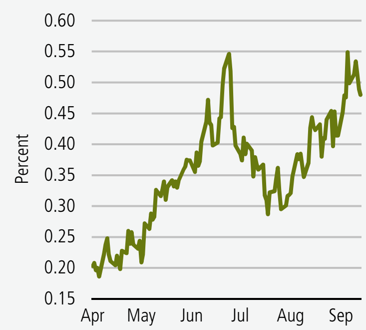
Unless there is a relapse in the economic data, prompting market participants to question their assumptions about the strength of the recovery, Carney is going to have a difficult time keeping a lid on market interest-rate expectations. Indeed, this task is likely to be particularly challenging if global bond yields continue to rise.

But would this really be such a bad thing? With house prices starting to respond to ultraloose monetary conditions, the risks of monetary policy being too slack for too long may be as big as the risks stemming from the early withdrawal of some monetary stimulus. After all, it was lopsided monetary policy that drove the global economy into the credit crunch in the first place. ■

Display 3

Market Rates Start to Rise

Two-Year Government Bond Yield: 2013

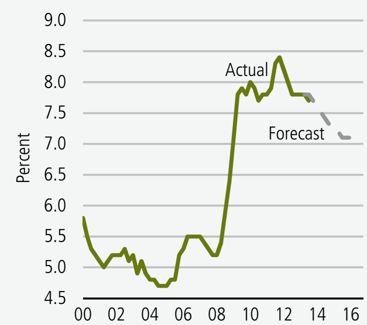


Through September 13, 2013
Source: Bloomberg

Display 4

Unemployment Undershoot

Unemployment Rate and Bank of England Forecast



Actual data through July 31, 2013. Forecast as of August 7, 2013
Source: Bank of England and Haver Analytics

*Note that the Bank's forward guidance is subject to three "knockouts," two relating to inflation and one to financial stability. Whether or not these would ever be triggered is, however, subject to debate.