ECONOMICS: EUROPEAN PERSPECTIVES

DOVISH INFLATION REPORT BUT MARKET STILL TOO OPTIMISTIC ON UK RATES

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Although the November Inflation Report was dovish and the Bank of England is in no hurry to tighten, the market is probably too optimistic on the outlook for UK interest rates. While ECB easing is likely to act as a constraint, it's important to note that the cyclical position in the UK has more in common with the US—where the Fed is about to raise rates—than the euro area.

For much of 2014, it looked as if the Bank of England would beat the US Federal Reserve (Fed) to the punch and be first to raise interest rates. Now the roles have been reversed. While the Fed looks increasingly likely to raise interest rates in December, the Bank's latest Inflation Report displayed no such urgency.

The Bank of England's relaxed stance on interest rates reflects several factors.

First, growth has slowed (*Display 1*) and, in the words of the Bank's chief economist Andrew Haldane, is now running at "little more than trend". This means it will eat only slowly into existing spare capacity (thought to be about 0.5% of GDP, according to the Bank). It also means that the crystallization of any downside risks from abroad could push growth below trend, making it more difficult to lift inflation back to target.

Second, there's little evidence of inflation pressure at present. This is not just about the very low rates of headline (-0.1%) or core (1.0%) inflation, which have been depressed by global factors and the strength of the pound (*Display 2*). It's also about relatively soft domestic cost pressure, evident in a slower-than-expected acceleration in average-earnings growth.

Third, while the Fed is on the verge of raising interest rates, the European Central Bank (ECB) is likely to ease policy again in December. A tightening of UK monetary policy against this backdrop would risk pushing the pound even higher, adding to disinflationary pressures and pushing the inflation target further out of reach.

D-Day Postponed

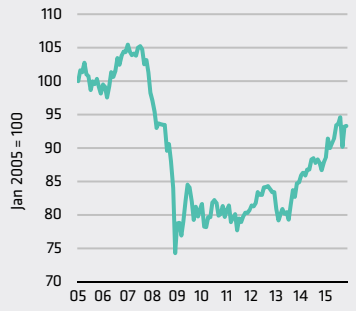
In July, Bank of England governor Mark Carney said that the UK rate decision would "come into sharper relief around the turn of this year". But now the turn of the year is nearing, that timetable seems to have slipped. Indeed, the November Inflation Report was distinctly dovish, with the Bank making significant downward revisions to its growth and inflation forecasts (based on constant interest rates), highlighting downside risks to the global outlook and arguing that disinflationary forces from abroad and the pound were likely to be more persistent than previously thought.

That said, the Bank also made it clear that

Display 1
Growth Slows

As of September 30, 2015
Source: Haver Analytics

Display 2
Strong Pound



As of November 12, 2015
Source: Bloomberg

the market interest-rate expectations used in the Inflation Report were too optimistic. That's because such a slow pace of tightening—just 15 basis points over the coming year and less than 50 basis points over the next two—would, in the Bank's view, lead to an eventual overshoot of the inflation target. That's "not the preference" of the Monetary Policy Committee, which would like to "bring inflation back to target and keep it there".

It's important to note that market interest-rate expectations are now higher than at the time of the Inflation Report (*Display 3*). But, with just 25 basis points of tightening over the next year and 65 basis points over the next two, not by much.

So while the Bank is in no hurry to tighten and future rate rises are likely to be "limited and gradual", the risk is that the market is still too optimistic on the outlook for UK interest rates.

In this respect, it's important to remember that while ECB easing is likely to restrict the Bank's room for maneuver, the cyclical position in the UK has more in common with the US than the euro area. And it wasn't so long ago that the market expected the Bank of England, rather than the Fed, to be first mover. ■

Display 3
Too Optimistic?

As of November 12, 2015
One-month forward interest-rate curve. *Bank of England November 2015 Inflation Report.
Source: Bloomberg