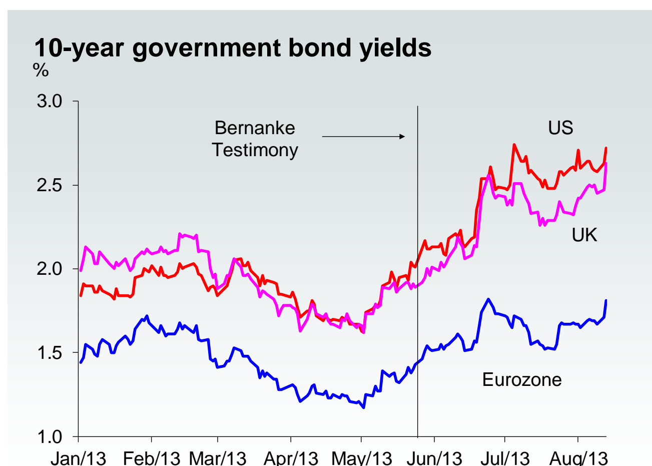
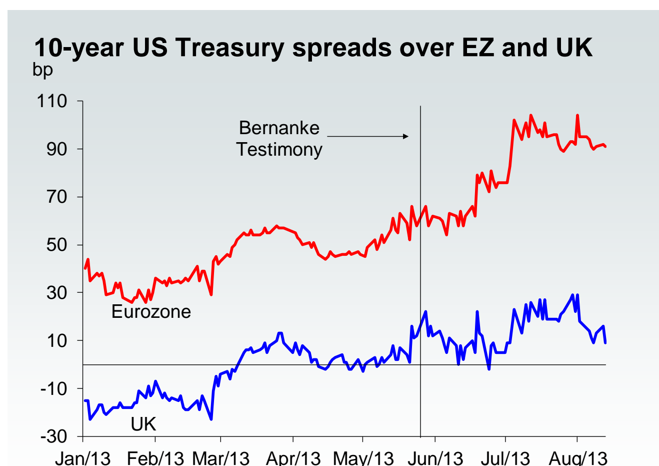
Fighting the Fed

Since the US Federal Reserve signalled that a turn in the interest rate cycle may be on the horizon, UK and to a lesser extent Eurozone interest rates have tracked US rates higher. But the UK and Eurozone economies are less well placed than the US to cope with higher interest rates. Simulations carried out on our Global Economic Model show that higher rates would be particularly harmful to the UK economy's embryonic recovery. In an attempt to stem the rise in interest rates, the Bank of England and the ECB have introduce forward guidance but with little, if any, success. Markets do not seem convinced by the Bank of England's commitment to forward guidance and are testing its resolve. It seems likely that over time both central banks may have to strengthen their forward guidance, in the case of the Bank of England by augmenting it with further quantitative easing.

UK bond yields and, to a lesser extent, Eurozone bond yields are following US yields higher

Since Ben Bernanke, the chairman of the US Federal Reserve, signalled in a testimony to Congress on 22 May that the Fed could soon start to slow the pace at which it buys government bonds, the yield on US 10-year bonds has risen by 79bp from 1.93% to 2.72%. To an extent, this rise in US interest rates has been mirrored in the UK and the Eurozone. Over the same period, yields on equivalent UK government bonds have risen by 71bp to 2.63% and on Eurozone bonds by 40bp to 1.81%. As a result, the spread of US Treasuries over Eurozone bonds has widened from 52bp to 91bp but the spread over UK gilts has only increased from 1bp to 9bp as UK rates have tracked US rates higher

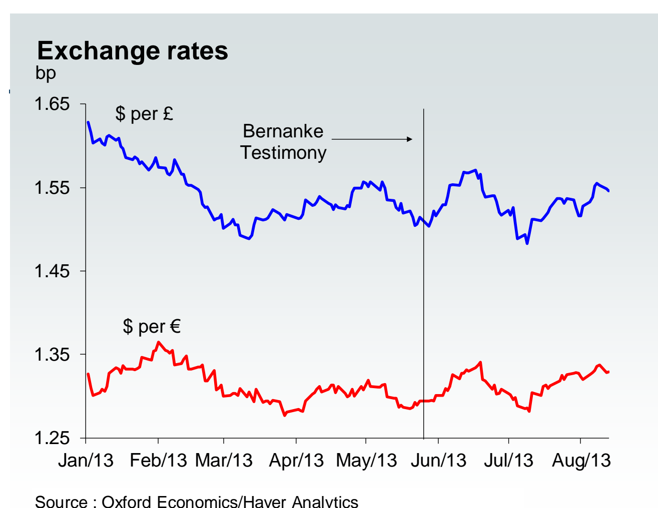


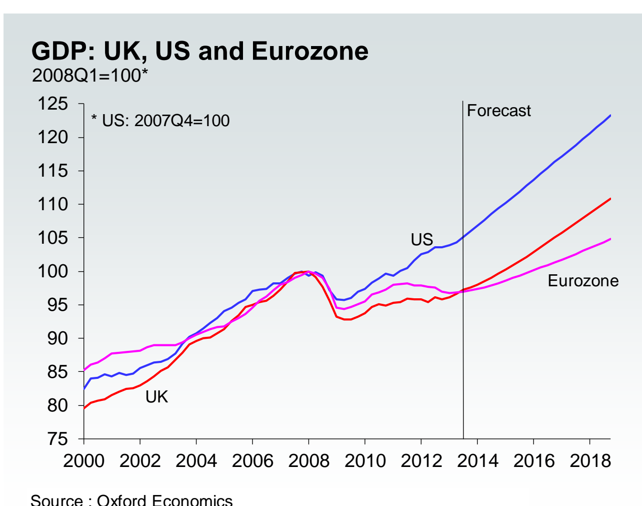


The UK and, to an even greater extent, the Eurozone are not as ready to cope with higher interest rates

About 90% of the rise in US Treasury yields has been mirrored in the UK and about 50% in the Eurozone. And the rise in UK and Eurozone bond yields has not been offset by currency depreciation. Sterling has risen 0.2% on a trade weighted basis since Bernanke's testimony and the euro has appreciated by 1.5%. Unfortunately, the UK and Eurozone economies are less well placed than the US economy to cope with higher interest rates. Although the US economy has recovered sufficiently for its output to now be 4.4% above its pre-2008/09 global financial crisis peak, the UK and Eurozone economies are still around 3% smaller than they were before the recession.

The outlook for the US economy is also stronger than it is for the UK or Eurozone economies. We expect the US economy to grow by 3.2% over the next year but we only expect the UK to grow by 1.9% and the Eurozone by 0.8%. Consequently, we do not expect UK output to reach its pre-financial crisis peak until Q1 2015 and the Eurozone will only passed that milestone a year later.



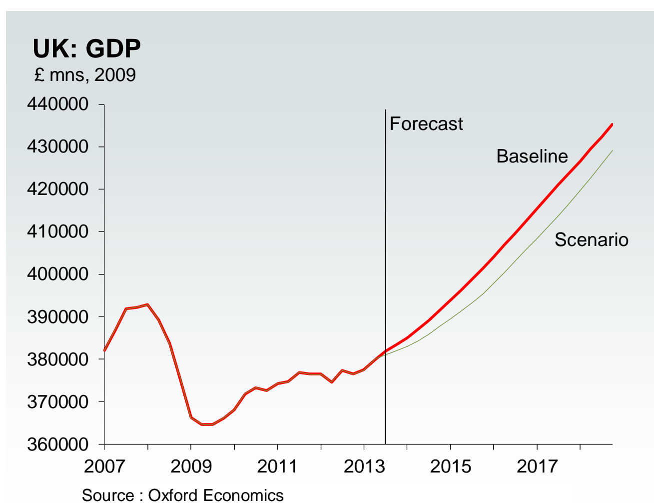


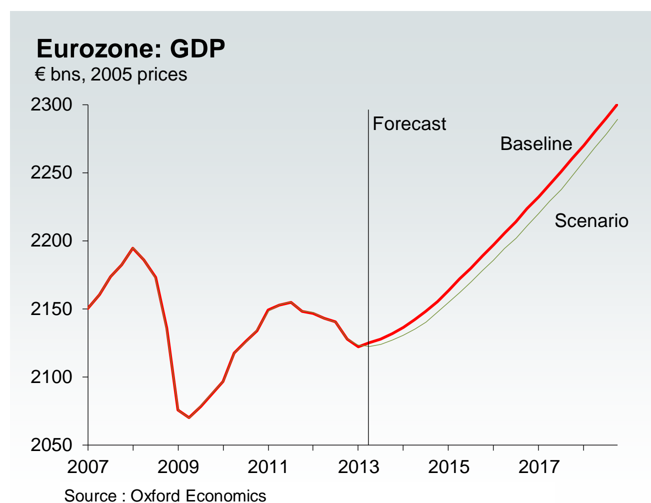
Higher rates are more harmful to the UK economy than to the Eurozone

Simulations carried out on our global economic model show that an immediate and sustained 100bp rise in UK 10-year bond yields, assuming no offsetting policy response from the Bank of England and no impact on sterling, would reduce the level of UK GDP by 0.6% by the end of 2015 compared with our baseline forecast and increase the number of unemployed by 110,000. As a result, the UK would grow by 1.6% in 2014 and by 2.1% in 2015, 0.4 percentage points and 0.2 percentage points respectively below our baseline forecast.

The impact on the Eurozone would be smaller, due mainly to the prevalence of long-term fixed-rate mortgages making Eurozone consumer spending less sensitive to interest rate rises, with just a 0.2% hit to the level of GDP by the end of 2015.

A 200bp rise in interest rates would reduce UK GDP by 1.1% by the end of 2015 and increase unemployment by 199,000 relative to our baseline forecast. As a result, GDP growth would be 1.3% in 2014 and 1.9% in 2015, 0.7 percentage points and 0.5 percentage points lower than in our baseline. Eurozone growth would be 0.7% in 2014 and 1.3% in 2015, compared with 0.9% and 1.4% under our baseline, and the number of unemployed would be 200,000 higher.





The Bank of England and the ECB are trying to limit the rise in interest rates

Given that base rates are already as low as they can go, the main ways in which the Bank of England and the ECB can attempt to reduce the tendency of their domestic interest rates to rise in tandem with US interest rates is either via purchasing government bonds with the aim of driving down their yields – quantitative easing (QE) – or by using forward guidance to try to reduce interest rate expectations and hence bond yields.

The first line of response to rising bond yields from both the Bank of England and the ECB has been to introduce forward guidance. Forward guidance is a communication instrument used by a central bank to convey its future monetary policy orientation, conditional on its assessment of the economic outlook.

Although the BoE and the ECB are new converts, the use of forward guidance is not new. For example, the Fed used forward guidance in August 2003 when it perceived that deflation was a risk. In its policy statement, the Fed indicated that monetary policy accommodation could be maintained for a "considerable period". In the most recent business cycle, the Fed reintroduced forward guidance in December 2008, saying that it anticipated that economic conditions were "likely to warrant exceptionally low levels of the federal funds rate for some time".

The BoE used forward guidance for the first time in the statement published after the meeting of its Monetary Policy Committee on 4 July, the first with Mark Carney as governor. This statement said "the implied rise in the expected future path of Bank Rate was not warranted by the recent developments in the domestic economy."

Along with its quarterly inflation report, the Bank issued more detailed forward guidance on 7 August. It said that it does not intend to increase base rates from 0.5% at least until unemployment has fallen to 7%, subject to inflation remaining under control and no asset price bubbles developing.

The ECB also introduced forward guidance for the first time on 4 July when its President, Mario Draghi, said in his introductory statement to the press conference following the ECB's Governing Council meeting on 4 July "The Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time."

So far, the BoE and ECB's first forays into forward guidance have not been particularly successful

The aim of the forward guidance issued by the Bank and the ECB is to convince financial markets that their reaction functions have changed and that they will increase interest rates more slowly as their economies recover

than their previous behaviour suggests. Given that aim, their first attempts at forward guidance have not been an unqualified success. Since July's MPC meeting, 10-year gilt yields have risen by 22bp from 2.41% to 2.63%, rather than reversing their earlier rise, and Eurozone bond yields have risen from 1.67% to 1.81%.

In the case of the UK, this is because investors believe that the MPC's 7% unemployment threshold will be hit more quickly than the BoE, which does not expect this to happen until at least 2016. We think the BoE is more likely to be proved right than the market. Due to the amount of labour that companies have hoarded in recent years, we expect jobs growth to be pretty slow over the next couple of years and as a result we do not expect unemployment to hit 7% until late 2016.

Markets are testing the BoE's commitment to forward guidance

Markets have sensed that the BoE is not fully committed to forward guidance, a feeling that has strengthened since the August minutes showed that one member of the MPC voted against it, and are testing the strength of its commitment to keep rates low. Unless the economic data weaken materially, the BoE is likely to have to strengthen its forward guidance.

The Fed's 10-year history with forward guidance shows that it tends to get strengthened if it does not have the desired impact. One way that could be done in the UK would be to lower the unemployment threshold, which at 7% seems too close to the current rate of 7.8% to enable forward guidance to have a marked impact and is well above our estimate of the NAIRU. Given that the BoE has only just set this threshold, it seems unlikely to lower it in the near term. The minutes of the August meeting of the MPC suggest that the Bank is more likely to augment forward guidance with further QE if UK yields continue to rise in tandem with those in the US. The ECB, in contrast, would face stiff German resistance to using QE so is much less likely to do so than the BoE. Its next step is more likely to be to specify a date at which it expects to keep rates on hold until, or even state that policy will be kept loose until a particular threshold of economic improvement has been reached. However, given the lower sensitivity of the Eurozone economy to higher interest rates and the smaller rise in Eurozone interest rates in in recent weeks, the issue is less pressing for the ECB than it is for the BoE.

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