

UK MPC WATCH

29th Oct. 2009



Another £50bn of fireworks

- *Weakness of economy points to further policy action*
- *Risks of doing too little still outweigh those of doing too much*
- *Previous boldness on QE points to at least another £50bn of asset purchases*

We anticipate more monetary fireworks from the Monetary Policy Committee (MPC) at its meeting on 5th November. With the previous extension to its quantitative easing (QE) programme now complete and the economy still stuck firmly in recession, we expect it to announce another £50bn of asset purchases over the next three months. And given the Committee's record of boldness when it comes to QE, we would not rule out an even bigger amount.

Committee open to more QE

At least some further extension of the Bank of England's asset purchase facility at its November meeting has always looked more likely than not. Remember that Governor Mervyn King and several other Committee members had voted back in August for a bigger increase than the £50bn extension implemented. And although they dropped their votes for more purchases at the subsequent meetings in September and October, that seemed to reflect the view that QE decisions should be aligned with Inflation Reports, rather than any sense that further purchases were no longer required.

Of course, one of August's proponents of bigger asset purchases – Tim Besley – has since left the Committee. But his replacement, Adam Posen, seems likely to take a similar stance after a recent speech in which he effectively branded those who believe that quantitative easing would create an inflation threat “nutters”.

Admittedly, some other members have sounded rather less convinced that QE should be extended

further. In recent speeches, Deputy Governors Paul Tucker and Charlie Bean, and external member Kate Barker, all cited evidence that the asset purchases already undertaken might be starting to have some effect in supporting asset prices, money growth and activity.

Inflation Report to support further action

Nonetheless, we suspect that the recent news on the economy - summarised in Table 1 - will persuade at least a majority of Committee members that yet more policy support is required in order to prevent inflation from undershooting its 2% target over the medium-term.

TABLE 1: DATA BACKGROUND TO MEETING

Indicator	At previous meeting	Latest	Influence on policy*
CPI inflation (%y/y)	1.6	1.1	↓
GDP (%q/q)	-0.6	-0.4	↓
Retail sales (%y/y)	2.2	2.4	→
Unemployment (m/m)	+23,000	+20,800	↓
Av. earnings (3m y/y)	1.8	1.6	↓
Man. output (%y/y)	-10.2	-11.3	↓
NW house price (%y/y)	-2.7	0.0	↑
M4 (%y/y)	12.3	11.5	→
FTSE 100	5108	5140	→
10 yr yields (%)	3.35	3.67	→
£ TWI	78.2	80.3	↓
Brent Oil (\$pb)	68.9	77.8	→

* An upward arrow indicates an upward influence on monetary policy. The more arrows, the more important the development.

Source – Thomson Datastream, various

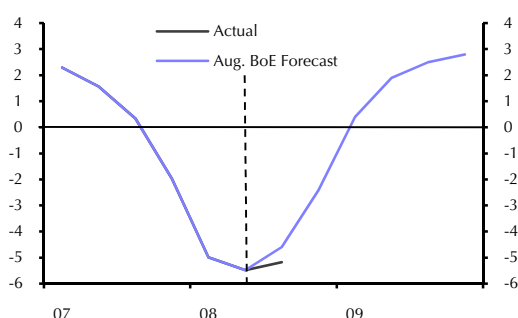
That news will be incorporated into the growth and inflation forecasts prepared for the November Inflation Report to be published the week after the MPC meeting, upon which the Committee will

largely base its policy decision. The Bank's near-term forecast for inflation is likely to have risen a bit compared to that presented in the last Report in August, reflecting both the stickiness of inflation itself and the recent rise in commodity prices.

CPI inflation averaged 1.5% in Q3 compared to the Bank's August forecast of 1.3%. Meanwhile, oil prices have risen further than the August Report assumed, with the result that domestic energy bills have not fallen as predicted. These developments are likely to push inflation further above its 2% target in the early months of next year than the MPC previously expected, perhaps to 2.5% or even towards 3%.

Further ahead, however, we suspect that these upward forces on inflation will be outweighed by the disinflationary effects of a rather weaker outlook for activity than the MPC previously anticipated. Note that Q3's unexpected 0.4% quarterly decline in GDP left the annual rate of expansion in that quarter some 0.6% below the projection in the August Report. Of course, it is quite possible that Q3's figure will be revised higher in due course. But, as things stand, it makes the very sharp acceleration in GDP growth predicted in the August Report over the next year or so look all the more demanding. (See Chart 1.)

CHART 1: REAL GDP GROWTH (%Y/Y)



Source – Thomson Datastream, Bank of England

Admittedly, some of the effect on inflation of weaker activity may be offset by the unanticipated weakness of the sterling exchange rate. At 80.3,

the trade-weighted index is almost 4% lower than the August Report assumed. However, insofar as the fall largely reflects the weaker outlook for the economy, the MPC is unlikely to view it as a significant upward influence on inflation. Indeed, recent comments from the Governor and other members suggest that the Committee is extremely relaxed about the pound's fall and would be happy to see it go further.

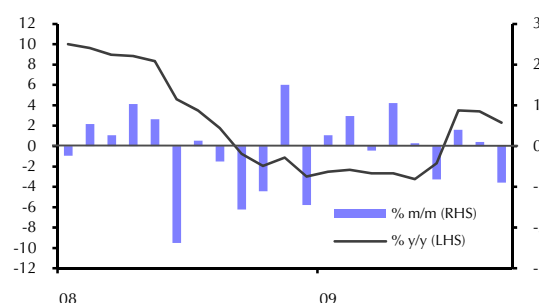
Previous QE still having little effect

Finally, despite the recent comments of some members, the evidence that the quantitative easing already undertaken is having a significant impact is tentative at best. No doubt the purchases have continued to have some positive effect on asset prices and hence helped to maintain the low levels of gilt yields and other market interest rates. This has probably contributed to the pick-up in corporate bond issuance over recent months.

But there are still few signs of any material pick-up in broad money supply or bank lending.

As Chart 2 shows, for example, the MPC's favoured measure of the broad money supply (M4 excluding intermediate other financial companies) contracted by a monthly 0.9% in October, leaving the annual rate of expansion only just above 2%. Likewise, the equivalent measures of bank lending have continued to stagnate or contract, while net new consumer credit was negative (i.e. consumers repaid unsecured debt) for a third consecutive month in October.

CHART 2: M4 EXCLUDING INTERMEDIATE OFCS



Source – Bank of England

£25bn or £50bn?

So taking the recent news on the economy and the evidence on the impact of QE together, it seems very likely that the Monetary Policy Committee will feel the need to take action to increase its policy stimulus at November's meeting.

It is possible that it might yet seek to do so by imposing a lower, or even *negative*, interest rate on commercial banks' reserves in order to encourage them to increase their lending. But the fact that, according to the minutes, that option was not even discussed at last month's meeting suggests that such a move is not imminent.

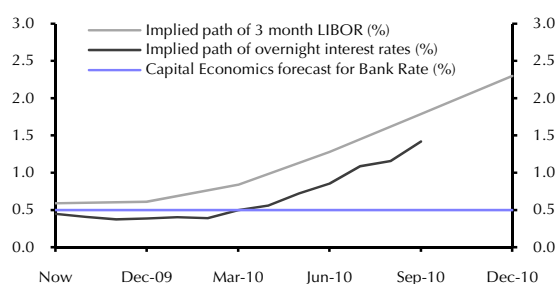
As such, a further extension of the Committee's asset purchases seems the most likely outcome – but of what size? We are not surprised to see that that many forecasters have plumped for a £25bn expansion, given the size of the purchases already made. Assuming that they are spread out evenly over the next three months, that would represent a slowdown in the rate of purchases from the £17bn odd per month seen over the last three months to around £8bn per month.

However, our feeling is that that another £50bn expansion is more likely, and we would not rule out an even bigger amount. Not only did the persuasive Mr King want to do more three months ago, but even those who opposed would probably agree that the risks of doing too little QE still

outweigh those of doing too much. Remember that the MPC has so far been bolder than expected in its decisions on QE, suggesting that it recognises the importance of the impact on confidence. **In that sense, reducing the rate of purchases at a time when, unlike most of its neighbours, the UK economy is stuck in recession, would hardly send out the right signal.**

Whatever the size of the additional asset purchases, however, the fact that the MPC is still increasing them would seem to confirm that any *tightening* of monetary policy - conventional or unconventional - is a long way off. **We still see scope for market expectations of the future path of interest rates to fall.** (See Chart 3.)

CHART 3: INTEREST RATE EXPECTATIONS



Source – Capital Economics, Bloomberg

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TABLE 2: MPC MEMBERS' VOTING RECORD

	King	Bean	Tucker	Barker	Sentance	Dale	Fisher	Miles	Posen
End of term	Jun-13	May-10	May-11	May-10	Oct-11	Jun-13	Feb-12	May-12	Aug-12
No. of meetings	150	110	89	102	37	16	8	5	2
Votes for rate rise	30	8	13	11	8	0	0	0	0
Votes for rate cuts	23	22	10	20	8	6	1	0	0
Votes against maj.	14	5	7	5	5	0	0	0	0
Av. vote (bps)	-1.5	-6.1	-2.5	-5.4	-8.1	-28.1	-6.3	0.0	0.0
Av. abs. vote (bps)	11.5	9.8	9.8	10.8	18.9	28.1	6.3	0.0	0.0
Av. deviation ¹ (bps)	2.3	-1.1	1.4	-0.7	3.4	0.0	0.0	0.0	0.0
Av. abs. deviation (bps)	2.3	1.1	2.0	1.2	3.4	0.0	0.0	0.0	0.0
Hawk ranking ²	2	9	3	8	1	4=	4=	4=	4=
Activist ranking ³	3	6	5	4	2	1	7	8=	8=
Maverick ranking ⁴	2	5	3	4	1	6=	6=	6=	6=

1 From majority. 2 From average deviation of vote from majority (1= most hawkish). 3 From average absolute vote (1= most activist). 4 From average absolute deviation of vote from majority (1= most maverick).