THE ABILITY TO PREDICT THE BANK OF ENGLAND'S NEXT INTEREST RATE MOVE ALL DEPENDS ON WHICH SURVEY YOU READ, SAYS **STEVEN BELL** OF DEUTSCHE ASSET MANAGEMENT.

WATCHING THE OLD LADY OF THREADNEEDLE STREET

FIGURE 1
BASE RATE CHANGES CLOSELY LINKED WITH PMI SERVICES SURVEY

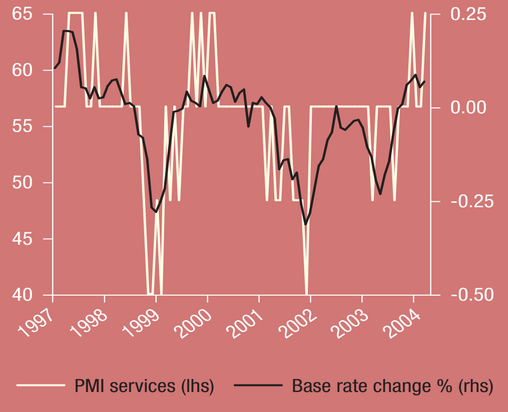
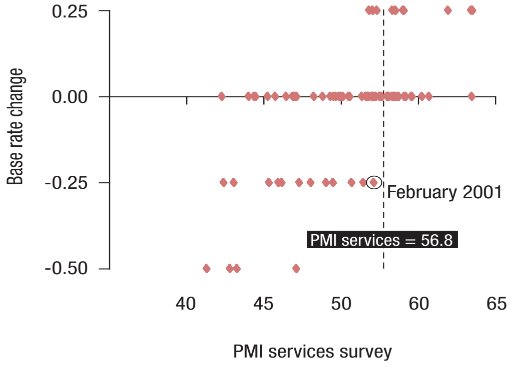


FIGURE 2
PMI=56.8 IS CRITICAL VALUE FOR BASE RATE CHANGES



As noon approached on 6 February 2003, financial markets waited for the Bank of England's Monetary Policy Committee's (MPC) decision with great interest. Two economists were more anxious and interested than most. Ciaran Barr and George Buckley, my colleagues at Deutsche Bank, were the only team out of 38 surveyed by Bloomberg predicting an interest rate cut. The other 37 economists were unanimous in predicting no change. This pattern is not unusual, but what followed was unique. The minority of one was right: the MPC cut rates by 1/4% point.

Media interest in this remarkable result was considerable and profiles of Ciaran and George appeared in numerous newspapers. The obvious question raised by this experience is: what did the other 37 miss? Part of the answer is that Ciaran and George had appreciated the weight that the MPC seems to give to a relatively new survey of purchasing managers in the service sector[1].

IT'S ALL IN THE BASIS POINTS. *Figure 1* shows the close relationship between the services purchasing managers indicator (PMI) and base rate changes. *Figure 2* reconfigures the data and suggests that 56.8 is a critical value. Interest rates are raised only when the PMI exceeds this level, and cut only when it falls below. The exception, which perhaps proves the rule, was on 8 February 2001, when the MPC cut rates by 1/4% despite the PMI being slightly above the critical value. This followed the decision by the US Federal Reserve to slash rates by 100 basis points. With equity markets tumbling and fears of a world recession, this was an exceptional time.

In reality, of course, the MPC looks at a wide range of economic indicators. No sensible central banker would want to pin too much of their credibility on a single economic statistic. But we have been unable to find other economic variables that work as well as the PMI.

The revealed preference for responding to the services PMI is not reflected in either the Inflation Report or the Bank of England's monthly minutes. It is, of course, possible that the PMI just happens to be a very good summary of the range of data the MPC does respond to. That would be quite a coincidence.

But it does raise the question: what is the role of inflation? After all, the Bank of England's primary objective is to target

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to come

FIGURE 3
NO LINK BETWEEN RPIX AND BASE RATE CHANGES

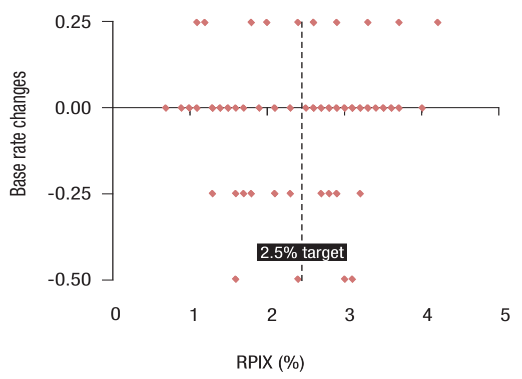


FIGURE 4
54.7 TO 57.7 FOR THE PMI SURVEY ARE THE CRITICAL VALUES FOR ECB INTEREST RATE DECISIONS

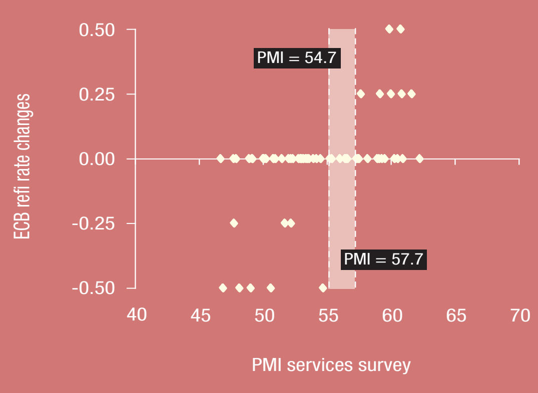
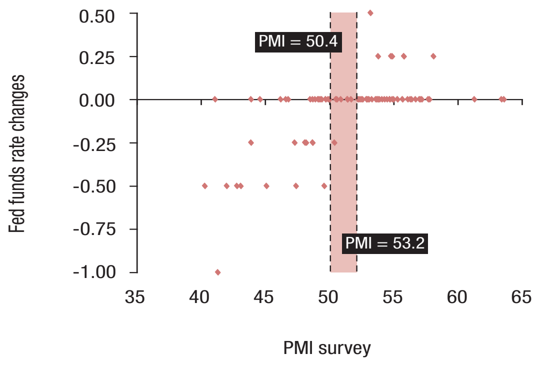


FIGURE 5
50.4 TO 53.2 FOR THE PMI SURVEY ARE THE CRITICAL VALUES FOR US FED INTEREST RATE DECISIONS



inflation, albeit over a two-year horizon, with a tolerance range of plus or minus 1%. *Figure 3* shows there is no relationship between the MPC's decisions and observed inflation relative to the target. The MPC would, no doubt, retort that it is prospective rather than actual inflation that matters and that any apparent relationship between the PMI and its decision-making is explained entirely by its influence on prospective inflation.

There is undoubtedly some merit in this argument. But neither the MPC nor anyone else is able to make accurate forecasts of inflation two years ahead. It often seems the MPC devises its inflation forecast to suit its interest rate decision, rather than the other way round. Even though I believe the MPC has been a great success, I think the experience is that it is too ready to pursue a counter-cyclical monetary policy, focusing on economic activity, rather than its principal goal of inflation itself.

A CLOSE RELATIONSHIP. This has been brought into particularly sharp focus by the recent switch in the inflation target from the Retail Prices Index (RPIX) to the Consumer Price Index (CPI). When the announcement was made in July 2003, the RPIX was above its 2½% target and rising, while the CPI was below its 2% target and falling. Cynics observed at the time that this was no coincidence. By making the switch when he did, Chancellor Gordon Brown was, in effect, putting pressure on the Bank of England to pursue an easier monetary policy. This may explain Governor of the Bank of England and Chairman of the Monetary Policy Committee Mervin King's apparent irritation when the move was announced last June.

When the Bank of England raised rates in November, it could reasonably argue that since the new target had not been formally confirmed, it should ignore it. The more recent interest rate increase falls into a different category, however, since the new target had been announced and the MPC had time to prepare its new inflation forecasts. Indeed, on the four occasions each year when the Inflation Report is compiled, the Bank of England is twice as likely to move interest rates.

I was very surprised when I first saw the close relationship between the PMI and base rate decisions. I guessed it might reflect the peculiarities of the UK. I was even more surprised that the results also apply to the European Central Bank (ECB) and the US Federal Reserve (see *Figures 4 and 5*). Indeed, the fit is even better: there are no exceptions to the rule and the ECB and Federal Reserve seem to have a 'no-man's-land', where rates neither rise nor fall.

What conclusions should treasurers draw from all this? First, and most obviously, you should watch these surveys closely and give them more weight than other economic variables. Second, do not assume that the MPC will be swayed by reported inflation. I personally believe that it should be, given the vagaries of economic forecasting, but, on the basis of the results presented here, it appears it is not.

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[1] The UK PMI Report on Services *is produced on a monthly basis by NTC Research on behalf of the Chartered Institute of Purchasing and Supply and Reuters. It is based on a survey of more than 700 business executives in UK private sector service companies and goes back only to July 1996. See http://www.ntc-research.com/Information/UKServInfo.asp.*