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Is UK monetary policy about to become a whole lot more effective under Mark Carney? asks Rob Wood

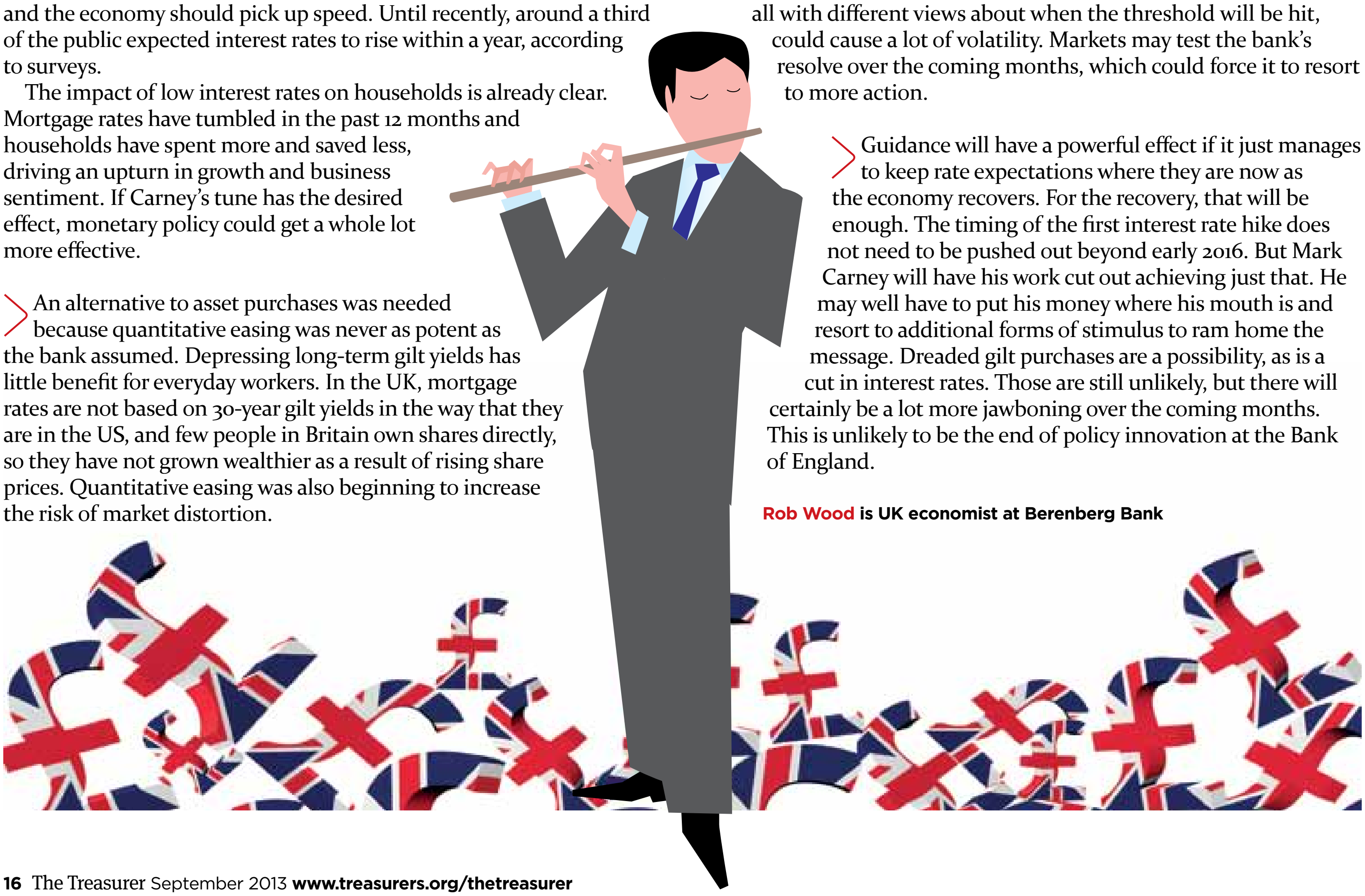
New Bank of England governor Mark Carney wants us all to start dancing to his merry tune. On 7 August he announced the adoption of 'forward guidance', saying interest rates would stay on hold until the UK's unemployment rate falls below 7%. While his jawboning is unlikely to be wholly convincing, it will nevertheless be a helpful tool in securing the country's nascent economic recovery.

Carney's message is that the economy is a long way from home, even if it is now heading in the right direction. Unemployment is high and output is more than 3% lower than it was in 2007. In comparison, Germany and the US have already exceeded their pre-crisis output levels. So the Bank of England has said it will keep rates low until there is a marked improvement.

Guidance is aimed squarely at the borrowing costs of consumers and companies. The idea is that as they will enjoy several years of cheap borrowing, households will keep spending, businesses will invest more and the economy should pick up speed. Until recently, around a third of the public expected interest rates to rise within a year, according to surveys.

The impact of low interest rates on households is already clear. Mortgage rates have tumbled in the past 12 months and households have spent more and saved less, driving an upturn in growth and business sentiment. If Carney's tune has the desired effect, monetary policy could get a whole lot more effective.

An alternative to asset purchases was needed because quantitative easing was never as potent as the bank assumed. Depressing long-term gilt yields has little benefit for everyday workers. In the UK, mortgage rates are not based on 30-year gilt yields in the way that they are in the US, and few people in Britain own shares directly, so they have not grown wealthier as a result of rising share prices. Quantitative easing was also beginning to increase the risk of market distortion.



Nevertheless, the strategy switch to forward guidance is not without its problems. Getting all nine members of the monetary policy committee (MPC) on board has meant an over-engineered set of conditions for guidance and a cautious unemployment threshold that initially disappointed. Unemployment could easily breach 7% earlier than the bank expects. It has already fallen from 8.4% to 7.8% over the past 18 months, but the bank sees it taking another three years to fall below 7%. The risks with that judgement are self-evident.

The turnover of policymakers at the bank also means that the people who are staking their reputation on guidance today may not be making decisions a few years down the line. The terms of seven MPC members expire before 2016, and Mark Carney himself leaves in 2018.

In addition, there is plenty of potential for mangled communication, as the US Federal Reserve and the European Central Bank have shown in recent months. Nine independent policymakers, all with different views about when the threshold will be hit, could cause a lot of volatility. Markets may test the bank's resolve over the coming months, which could force it to resort to more action.

Guidance will have a powerful effect if it just manages to keep rate expectations where they are now as the economy recovers. For the recovery, that will be enough. The timing of the first interest rate hike does not need to be pushed out beyond early 2016. But Mark Carney will have his work cut out achieving just that. He may well have to put his money where his mouth is and resort to additional forms of stimulus to ram home the message. Dreaded gilt purchases are a possibility, as is a cut in interest rates. Those are still unlikely, but there will certainly be a lot more jawboning over the coming months. This is unlikely to be the end of policy innovation at the Bank of England.

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