TD Securities

Market Musing

Rates, FX and Commodities Research

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IMPLICATIONS FOR UK & CANADA FROM THE APPOINTMENT OF MARK CARNEY AS BOE GOVERNOR

Highlights

- Current Bank of Canada Governor Mark Carney will assume the role of Governor of the Bank of England in July 2013.
- We do not anticipate that the appointment of Mark Carney to the Bank of England will lead to drastic changes at the Bank of England. Carney will not necessarily be as hawkish as the market expects, but will be dovish when conditions warrant.
- We view Senior Deputy Governor Macklem as the presumptive internal candidate to become Governor of the Bank of Canada in July 2013. We do not expect any major shifts in the Bank's mandate with Macklem at the helm. The emergent focus on preserving financial stability will likely lead to a more hawkish central bank, though it remains far too early to position for such a shift given the considerable downside risks that shroud the current outlook.

Chancellor Osborne announced today that Mark Carney, currently the Governor of the Bank of Canada, would become the next Governor of the Bank of England on July 1, 2013. While Carney was rumoured to be a candidate, the announcement was nevertheless a surprise to the market, as Carney had previously stated publically that he would complete his term at the BoC which was set to expire in February 2015. Other organizational changes within the BoE will see Deputy Governor Bean remain in his current position through June 2014 to assist with the transition. Governor Carney will remain at the helm of the Bank of Canada until the end of next June during the recruitment process. We see the current Senior Deputy Governor Macklem as the presumptive candidate to assume the role of Governor, and don't expect Governor Carney to make any radical changes to current Bank of England policy when he arrives.

UK Implications

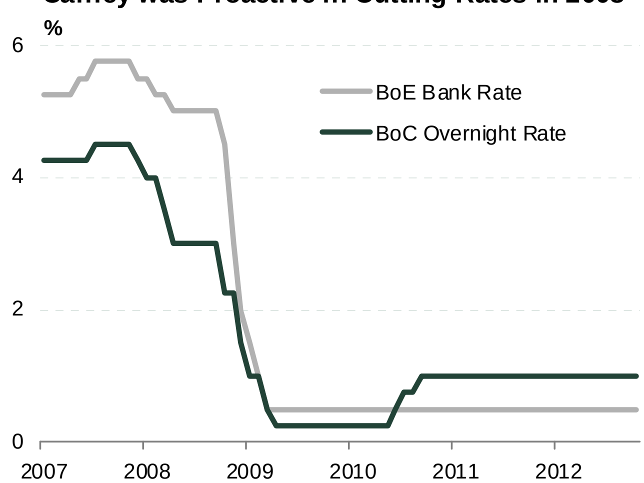
We see four major concerns the market may have over Carney at the helm of the BoE—his views on QE, hawk or dove, communications strategies, and his interaction with the Treasury—which we address below:

Carney and QE

The first question everyone is asking about Governor Carney is how he feels about quantitative easing, since that's something the Bank of Canada has never done. Obviously Canada and UK had two entirely different sets of problems, so whatever policy fit Canada wouldn't have been the ideal one for the UK. But we can glean some insight from some of Carney's comments and the Bank of Canada's publications around the time that markets bottomed in 2009. At that point, with Canada's policy rate at a record low level of 0.25%, there was a lot of uncertainty over what the Bank of Canada could still do, if anything.

In the Bank of Canada's April 2009 Monetary Policy Report, the BoC included an Annex on the Framework for Conducting Monetary Policy at Low Interest Rates. And there, the BoC laid out three alternative instruments available at the lower bound for rates: conditional statements on the future path of policy rates, quantitative easing, and credit easing. So while the BoC only went with the first option, the other two were on the table.

Carney was Proactive in Cutting Rates in 2008



Carney has never been as opposed to QE as some other central banks (like the ECB), and is perfectly open to it if that's the most appropriate thing for the economy at the time. So in our view, the QE outlook continues to be quite data dependent, and having Carney coming the helm will not mean a massive shake-up to BoE policy, with QE still the first go-to easing instrument for the BoE. Furthermore, with Carney not beginning the new role until July 2013, the UK economy may be in a different place, with QE not really up for consideration. So the Carney-QE debate could become increasingly irrelevant by then.

As for FLS, our feeling is that Carney will be an advocate for the program. With his focus on macroprudential regulation, he is clearly in favour of teaming up with other areas of government like the Treasury in order to accomplish the central bank's goals and stabilize the economy. In Canada Carney has had to discuss housing regulations with the Department of Finance in order to help to stabilize household debt. So we don't see why he would be opposed to cooperating with the Treasury in the UK in order to attempt to boost lending activity, since that's what the UK is in need of right now.

The forward looking guidance may be the most interesting potential change for the BoE. The MPC has typically relied on their inflation forecasts to communicate to markets on the potential outlook for monetary policy. But just as the BoC used forward-looking language to pre-commit to keeping rates on hold for one year, he could be even more transparent on keeping Bank Rate on hold, and drive a more obvious kink in short sterling depending on the time horizon.

Hawk or a Dove

After the question of whether Carney is for or against QE, the next big query is whether he will be a hawk or a dove. And from there, it's difficult to say as the BoC has always had a very different policy from the Fed, the BoE, or the ECB, since at the BoC the Governor and Deputy Governors all usually sing from the same songsheet. There are not dovish members or hawkish members – they all stick to the same BoC rhetoric.

However, markets seem to have assumed that Carney is going to take a hawkish tone, with gilts selling off in the wake of the announcement, likely because the BoC has maintained a hiking bias for the last two years. However, Carney has been very dovish in the past when he has needed to be. In his first meeting as Governor of the BoC in March 2008, he cut rates by 50bps, and then another 50bps at the next meeting in April. So Canada was actually ahead of most of the G10 in having enjoyed a fair amount of easing by the time the financial crisis came to a climax in the autumn of 2008.

Our best guess at this time is that Carney's going to be somewhere in the middle of the hawk-dove range, especially as he gets his bearings. But since King is considered to be a dove, that does admittedly move the BoE balance marginally to the more hawkish side of the scale. But probably not as far as markets are assuming, as they forget how proactive Carney was on the easing side in the past.

Communications Strategy

The next questions for Carney's new BoE position get more into the nitty-gritty side of things, but could still be important. One is if Carney will want to make any changes to the BoE's communication strategy. For instance, the BoC has never been keen to publish the minutes from its meetings, so it's not clear that Carney will be comfortable with those, although realistically we don't see any way that he could push the BoE to stop publishing them. After all, central banks around the world tend to be leaning toward more rather than less transparency. What he could change though is the fact that the BoE only publishes statements at meetings where it actually makes changes to policy, while the BoC and most other G10 central banks publish a statement at every single decision. If he could implement the publication of a statement at each monthly BoE meeting, that would be a very welcome move in our view, and would give us a much better idea of where the BoE stands in between Inflation Report meetings.

Another area where Carney could dip his toes into current BoE policy is the inflation target, which tends to create some confusion in the UK as the BoE technically targets headline CPI, but tends to look through all sorts of one-off shocks. The Bank of Canada also formally targets headline CPI but uses core CPI as an "operational target," meaning that it's more transparent about which shocks it looks through and which ones it reacts to. While Carney can by no means implement this change on his own, it could be something that he pushes toward, given the success that Canada has had with its own system.

Fiscal Dominance

While this appointment adds certainty as to who will lead the BoE, it obviously increases the uncertainty as to what will follow given Carney's outsider nature may leave him prone to make larger changes than would have an appointment of someone like Tucker. But on paper, Carney's background brings the mix of monetary and financial policy expertise that the BoE is looking to build on. And he has shown no signs of being anything but an inflation targeting central banker, who will not be as hawkish as some in the market may worry given his Canadian experience, or unduly swayed by the Treasury as others may worry. He will work to ensure the greatest chance of hitting the inflation target in the medium-term, and if this means QE, working with Treasury on increasing lending, improving the inflation forecasting track record of the BoE, or anything else that improves growth while maintaining the inflation target, this should be what will emerge and be priced into markets in due course.

Carney's comments in June 2010 display this perfectly:

Given the scale of the fiscal challenge, it is perhaps not surprising that some eminent economists are looking for an "easier" way out. This form of denial is to allow temporarily higher inflation in order to inflate away public debt.

To the Bank, this is a siren call.

Those most in need of fiscal consolidation are often those with debt portfolios of the shortest duration. The "surprise" would have to be very sudden and very large to have a material impact. Of course, if temporary inflation becomes built into expectations, real rates may well increase, rather than fall, thereby exacerbating debt dynamics. Moreover, in the past, it has proven devilishly hard to keep inflation high temporarily. Would it be credible to have a one-off increase in the inflation target?

Central banks have worked for decades to get inflation down to levels consistent with price stability. We should not risk these hard-won gains.

Bottom Line – No Radical Changes

The bottom line is that there will be no seismic change in policy once Carney takes the helm of the BoE in July 2013. All things equal, having Carney replace King could make the MPC marginally less dovish, but not as much as markets are thinking. We may also see some attempts to tweak BoE communication policy, with perhaps a little more transparency between Inflation Report meetings, which would be welcome. And on QE, with two Inflation Reports to go before Carney takes over as BoE Governor, the chances of further QE over the next quarter or two are as high as ever, and the decision remains a data dependent one. And even after Carney takes over in July, if there are negative shocks then we think that he is just as likely to conduct QE as King would have been. He has always leaned toward being proactive, and there's no reason for that to change now.

Canada Implications

On the other side of the Atlantic, the Board of Directors of the Bank of Canada will undertake a recruitment process to select the next Governor for a seven year term beginning July 1, 2013. For the role of Governor, the Bank has a tendency to promote from within (Carney was a Deputy Governor in 2003-2004 and Thiessen was a lifelong Bank employee) or recruit from elsewhere in the civil service, ideally someone who has spent a significant amount of time at the Department of Finance (David Dodge).

We would view Senior Deputy Governor Tiff Macklem as the presumptive internal candidate to assume the role of Governor. Macklem has spent basically his entire career at the Bank of Canada including a secondment to the Department of Finance (his bio can be found here). Macklem is closer to a pure economist in his training and experience versus Carney's financial markets & global focus. He is well versed in the models that underpin the Bank's forecast presented in the Monetary Policy Report (MPR). From the perspective of maintaining the inflation target & communication strategy, we see Macklem as maintaining the status quo. It is also likely the case that Macklem would not stray as far from the Bank's key message as Carney did in the middle of October.

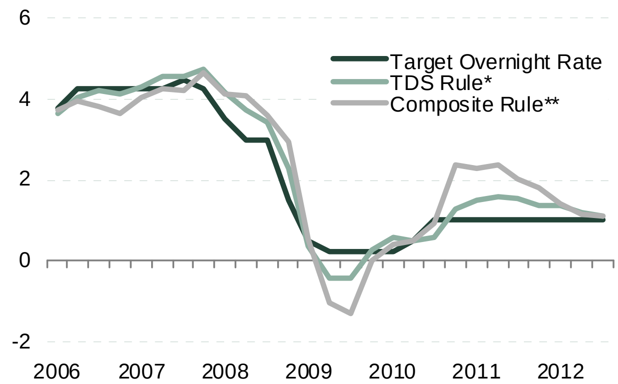
In weighing in on the lean/clean debate over asset bubbles and preserving financial stability—with a particular relevance to Canada's housing market—Macklem reflects the Bank's thinking on the three lines of defence (sound regulation, macroprudential regulation, and then monetary policy). In a speech in October 2010, Macklem noted that there were instances where financial imbalances in a specific sector would spill over to the entire economy that monetary policy would have a role to play.

In our view, the Bank is still judging the impact of the last round of mortgage regulations that took effect in July and if they do not effectively curtail the increase in household debt, the Bank may feel forced to take the overnight rate higher. Some of the work we have done suggests that as long as interest rates remain exceptionally accommodative, tighter mortgage regulations only have a temporary impact on slowing housing market activity (see the Canada Macro Focus chapter here). The view towards higher rates also depends on the international backdrop improving (in particular navigating around the fiscal cliff in the US) to the point where net exports and business investment can adequately compensate for the growing drag on consumer spending and the housing market.

Canadian Market Reaction and Outlook

The market reaction has been fairly muted—BAXs and 2s rallied by a basis point or so—but the move in the Canadian short-end was in keeping with the broader risk-off tone on the day, and 2s still underperformed versus the belly. On the margin, this move points to a more dovish central bank with Carney heading for the exit. Still, the Bank of Canada as an institution is greater than a single individual, and the July changeover will allow for an orderly transition; we see the Bank as maintaining its credibility in maintaining the 2.0% inflation target and becoming more focused on issues unique to the Canadian economy. This extends to the emergent risk posed to financial stability from rising household leverage, which many non-crisis economies are grappling with. Insofar as Macklem is more in line with the Bank's forecasting staff, our collection of simple rules for monetary policy suggests the overnight rate should currently sit at 1.10%. This again is predicated on the view that the key risks facing the US and Europe are not realized and growth recovers heading into 2013. If this healing can take place the more advanced recovery in the Canadian economy will make the new Governor's first year on the job very interesting though it remains far too soon to position for a more hawkish central bank.

Monetary Policy Rules for the Overnight Rate (Percent)



*Estimated based on output gap, CPI, and financial conditions.
**Median of 19 simple rules;
Source: Bloomberg / TD Securities

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