31.07.2015

MPC MEMBERS

From

PRE-MPC FOLLOW UP: Relating changes in sterling to the macroeconomic outlook

Andy Haldane asked for an update of the various pieces of analysis that link changes in sterling to the broader macroeconomic outlook.

Main Message: **Recent strength in the sterling ERI does not correspond with revisions to survey forecasts of UK domestic demand growth relative to those for its main trading partners, nor by news aggregated across a range of macroeconomic data. However, this does not preclude the importance of particular data outturns in explaining sterling's appreciation, and MI contacts highlight the pick-up in UK wage growth as having been an important driver of increases in UK short rates and sterling in recent months.**

One way of analysing changes in sterling is to look at revisions to domestic demand growth forecasts for the UK relative to its main trading partners. Previous MFAD analysis[1] has explored this, finding that, over certain periods, there has been a fairly close positive relationship between low frequency changes in the sterling ERI and revisions to UK domestic demand growth forecasts relative to its main trading partners. In particular, there was a close correlation during 2013 and 2014. However, the relationship does not hold over the last quarter (**Chart 1**). Recent changes in survey-based relative domestic demand forecasts reflect both negative revisions to UK prospects and positive revisions to the rest of the world (**Chart 2**).

Chart 1: Sterling ERI and revisions to relative domestic demand growth forecasts since 2013

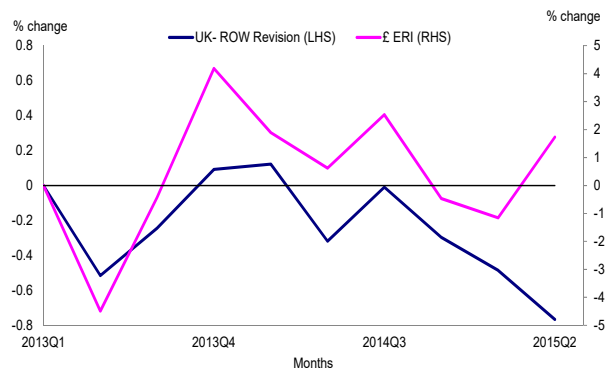
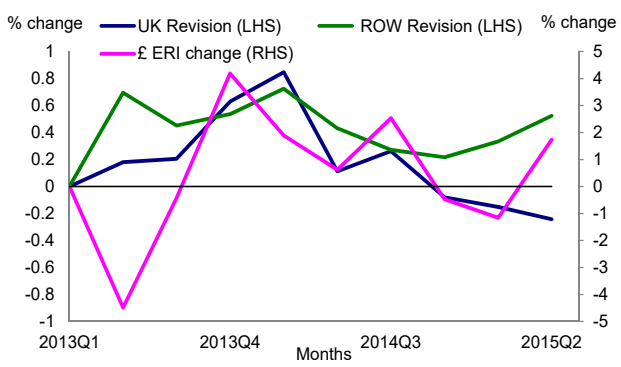


Chart 2: Sterling ERI and revisions to domestic demand growth forecasts since 2013

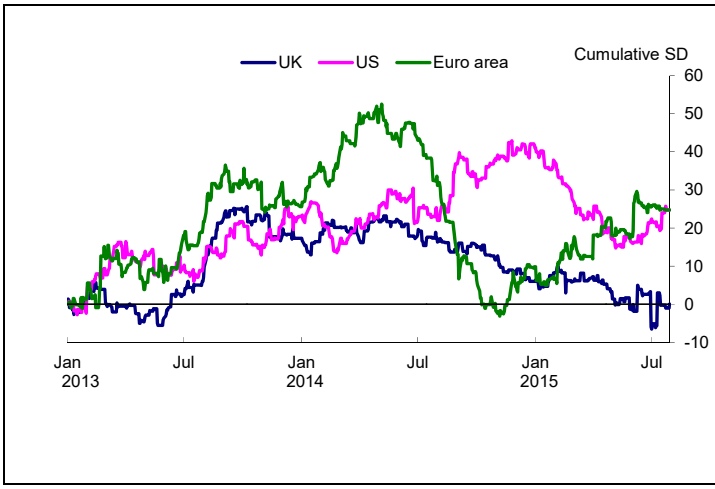


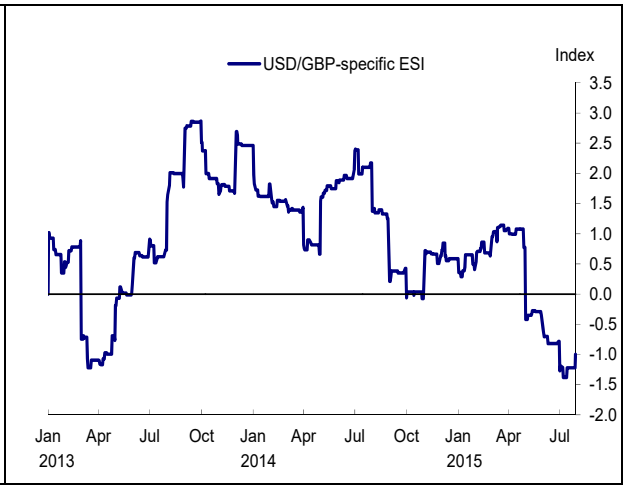
However, this analysis isolates near-term expectations of demand growth. It could be that other economic news lies behind sterling's recent appreciation. For example, MI has highlighted the importance of the pick-up in UK wage growth, which would not necessarily be reflected in recent changes in demand growth forecasts. One way to consider a wider range of economic data is by aggregating macro news in an economic surprise index (ESI). This has also been explored previously at the Bank[2].

Chart 3: Equally weighted ESIs since 2013

Chart 4: Historically weighted ESIs since 2013

[1] See, for example, .
[2] See, for example,





Charts 3 and 4 show that our two preferred measures of ESIs[3] have also been falling recently. Again, this is not to say that specific macroeconomic news, such strong UK wage growth, have not underpinned the rise in sterling to a certain extent. Instead, these charts only suggest that sterling's latest upward trend has not been driven by a broad-based upward impetus from a wide range of macro data.

In addition, an update of past analysis shows that, although the sensitivity of sterling to macro news appears to have gone up over the past year (**Chart 5**), the explanatory power of these regressions remains quite low (**Chart 6**)[4]. Of course, even if news to the broad macroeconomic outlook (as captured in the ESIs) does not fully explain daily changes of sterling, it could still be the case that certain macro releases are behind particularly large FX moves. Moreover, this effect could be amplified on the days following the release by MPC communication on the back of the news, which would not be captured by this methodology.

Chart 5: Sensitivity of £/$ to macro data news

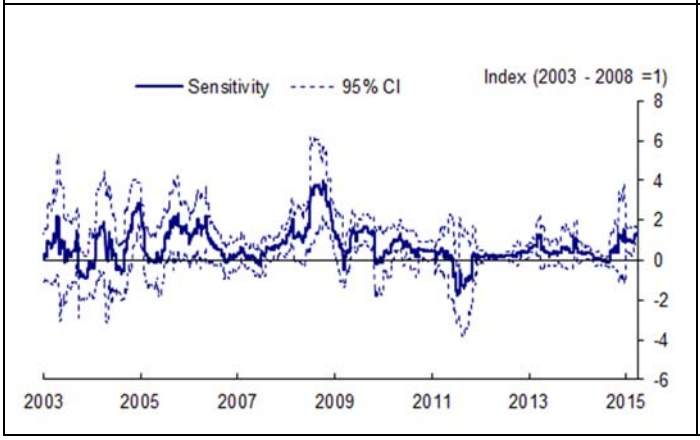
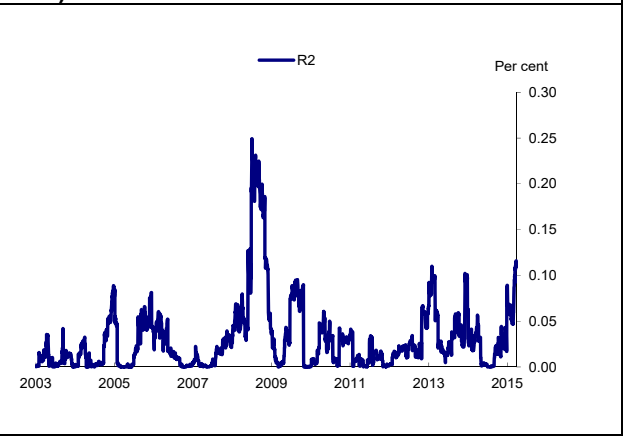


Chart 6: Explanatory power of regressions of $/£ on macro data news (historically weighted ESIs)



[3] The equally weighted ESI treats all macro releases in the same way, while the historically weighted alternative weights each release according to its impact on the exchange rate over the sample.

[4] The results are broadly similar for £/$ and £/EUR (not reported), and for historically and equally weighted ESIs (not reported).

In summary, recent strength in the sterling ERI does not seem to be explained by revisions to UK domestic demand growth forecasts relative to its main trading partners, nor by news aggregated across a range of macroeconomic data. However, recent MI has highlighted the importance of specific releases, such as the pick-up in UK wage growth (and the MPC communications resulting from it), for explaining sterling's appreciation (and the corresponding rise in short-term interest rates).

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31 July 2015

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