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## PRE-MPC FOLLOW-UP, JUNE 2015: GAP BETWEEN SEF AND MARKET CURVE

- Question**
- Ben Broadbent asked to see a time series of the gap between policy expectations as reported to the Survey of Economic Forecasters and the market curve, and whether the former tends to lag the latter.
- Main message**
- The current gap between the market and SEF remains large even over an extended time horizon; the gaps prior to the commencement of the two previous tightening cycles don't show economists consistently expecting faster tightening than the market; there is some evidence to suggest the SEF lags the market curve, by at least one quarter.

1. We have extended the chart shown in the Financial Markets June 2015 pre-MPC presentation back to the November 1999 SEF for one and two years ahead (Chart 1). The quarterly Survey of External Forecasters (SEF) has collected forecasts of Bank Rate at future points since Q4 1999. Since August 2006 these forecasts have been for Bank Rate at the end of the corresponding *IR* quarter in one, two and three years' time. Hence, after August 2006 (solid lines) the chart shows the gap between the *IR* forecast instantaneous forward OIS curve and the SEF forecasts at one, two and three years ahead as shown in the Financial Markets pre-MPC presentation.

2. Before this, the three forecast points were Q4 of the current year, Q4 of the following year, and the end of the *IR* quarter in two years' time- this means the 3 year ahead forecast is only available from August 2006. Hence, the August 2004 to August 2006 forecasts (dashed lines) show the *IR* forecast (15 day average) instantaneous forward OIS curve less the relevant SEF forecast. Prior to August 2004 (dotted lines), the SEF forecasts are subtracted from a relevant point on the instantaneous forward gilt curve<sup>1</sup>, as the *IR* forecasts during this period were conditioned on a profile of constant rates. The instantaneous forward gilt curves used are for a single day in the middle of the relevant 15 day *IR* average period.

3. The current size of the gap between the SEF and market rates remains large by historical standards, despite the extended time horizon, with the gap between the February 2015 SEF forecast and market at two years ahead only larger on three occasions, only one of which (February 2003 SEF) featured economists forecasting rates above the market, consistent with the current trend observed.

4. Previous tightening cycles (November 2003 and August 2006) are highlighted as black diamonds on Chart 1. At the time of the *IR* prior to the 2003 tightening episode the gap was negative as now, with the SEF forecast from the August 2003 *IR* round 28 and 45 basis points higher than the instantaneous gilt yield 1 and 2 years forward respectively. Conversely, in the May 2006 *Inflation Report* the SEF forecast Bank

<sup>1</sup> Due to the different forecast points in the pre-2007 SEFs, not every forecast is for a point 4 quarters away. To account for this and still give a sufficient quantity of observations the '1y ahead' line refers to forecasts made for a point three to five quarters away subtracted from an equivalent point on the relevant instantaneous curve (e.g the instantaneous rate, nine months forward less the SEF forecast for a point in 3 quarters time). There are sufficient forecasts for the point two years ahead to not require this adjustment.

Rate to be around 30 basis points lower at both one and two years ahead than was implied by the equivalent forward points on the instantaneous forward gilt curve.

5. There is evidence to suggest the market curve tends to lead the economist forecasts, with this gap usually spanning around one quarter. This is shown in Charts 2 and 3 where the time series of one and three year ahead SEF forecasts (solid lines) are plotted against the equivalent instantaneous OIS rate 1 and 3 years forward. By bringing forward the SEF forecast points by one quarter (dashed lines), the SEF forecast is more often in line with the OIS rate, especially at 1 year ahead, and the gap is generally smallest at points where the OIS curve is rising, suggesting SEF economists are slower to react to upside news than UK market rates. Even with the one quarter lag, when OIS rates are falling, economists tend to persist with forecasts similar to their previous, implying they are *even* slower to react to downside news than UK market rates.

