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Developed Markets
Western Europe

UK Economics Weekly

CPI Disinflation and RPI Reflation

- CPI inflation — already down to 1.7% YoY, the lowest since 2009 — is likely to fall to about 1.5% during this year, undershooting the MPC's target and consensus expectations in both 2014 and 2015. CPI inflation is likely to be dragged down further by declines in import prices, weaker food price inflation and slower gains in utility prices. Nevertheless, we do not believe the UK is at risk of deflation, or sub-1% CPI inflation rates (unless hit by a major disinflationary shock). The economy is growing strongly, capacity use is rising and pay growth is picking up. CPI inflation is likely to be close to the 2% target in late 2015.
- However, the subdued near-term path for CPI inflation is unlikely to be matched by RPI inflation, which is the relevant measure for index-linked gilts. The RPI-CPI wedge has overshot the pre-release consensus in each of the last four months, rising from 0.4% in Oct-13 to 1.0% in Feb-14. With gains in house prices — and, subsequently, rising Bank Rate — we expect the RPI-CPI wedge will rise to about 1½% in Q4-14 and about 2½% in Q4-15. RPI inflation may edge down to 2.5% YoY in the next month or two from 2.7% in February. But, whereas our CPI forecasts are below consensus, our RPI forecasts are well above consensus, at 3.1% YoY in Q4-14 and 4.4% YoY in Q4-15.

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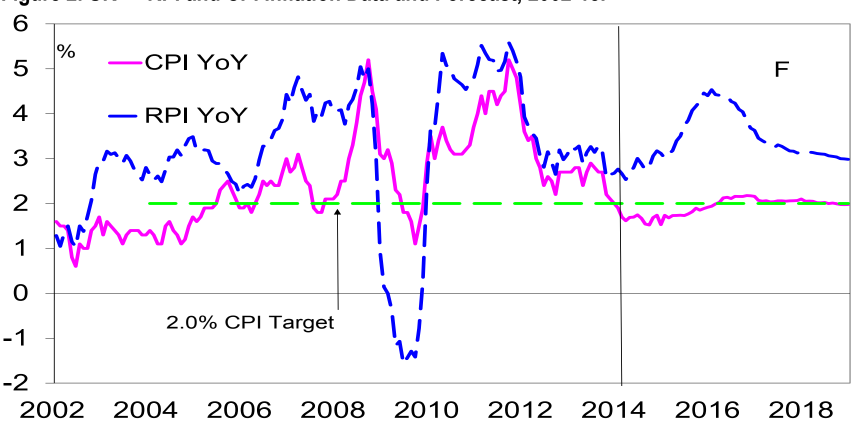
Michael Saunders

Figure 1. Citi Market Forecasts

	Base Rate	QE Target	10 Year Yield	Spread vs. Bunds	$/£	£/€
End 2014	0.75	£375bn	3.40	163bp	1.73	0.81
End 2015	2.50	£351bn	3.70	173bp	1.74	0.81

Source: Citi Research

Figure 2. UK — RPI and CPI Inflation Data and Forecast, 2002-18F



F Citi Forecast. Sources: ONS, BoE and Citi Research

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

CPI Disinflation and RPI Reflation

CPI inflation is likely to stay below the 2% target through this year and 2015

The long CPI inflation overshoot of recent years is giving way to an inflation undershoot that is likely to persist through this year and (barring an inflationary shock) the next[1]. Our near-term CPI forecasts (1.7% YoY in Q4-14 and 1.9% in Q4-15) are a little below consensus which (as of early March) was for CPI inflation of 2.0% YoY in Q4-14 and 2.1% YoY in Q4-15.

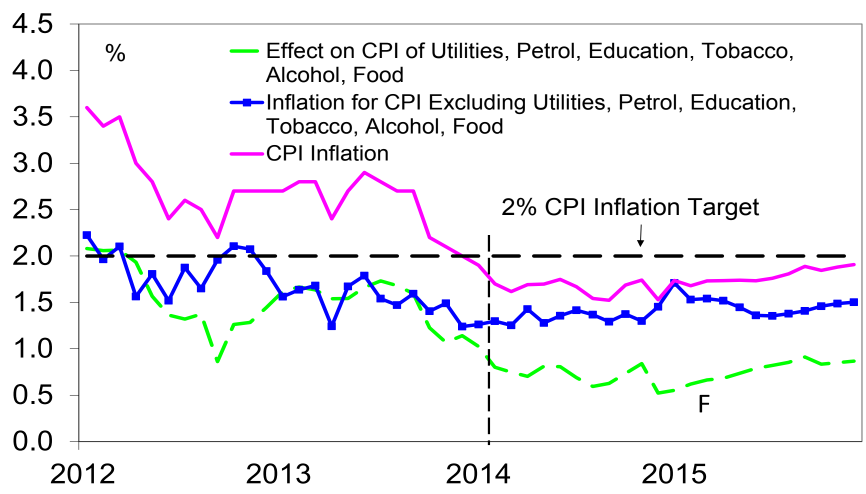
The economy has not become more disinflationary in an underlying sense…

The recent sharp drop in CPI inflation is not really a sign that the UK economy has become more disinflationary than a year ago. Rather, the underlying trend was already disinflationary a year ago, with ample slack, low pay growth and sluggish unit labour cost growth. However, this disinflationary backdrop was masked in the CPI by rapid price gains for specific idiosyncratic items. Food, utilities, education, petrol, tobacco and alcohol have a collective weight of just over 30% in the CPI. Their inflation rates are relatively insensitive to demand. Prices for utilities, drink, tobacco and petrol are heavily influenced by government tax and regulation, while food prices (and to an extent both petrol energy and household energy) are heavily influenced by commodity prices. A year ago (Feb-13), these items had a combined inflation rate of 5.4% YoY — hence adding 1.7% YoY to the overall CPI. Hence, even though inflation of all other goods and services combined was running at just 1.6% YoY in Feb-13, CPI inflation (2.8% YoY) was well above target. This mix of a narrowly-concentrated boost to inflation held as recently as Sep-13, with CPI inflation at 2.7% YoY and underlying inflation (ie CPI excluding food, drink, tobacco, utilities, education) at just 1.6% YoY.

…but last year's inflation stickiness largely reflected tax and regulatory-driven effects, which have not receded

However, with the government action to rein in tax- and regulatory-driven price hikes, plus weaker global food prices, the combined inflation rate of food, drink, tobacco, petrol, utilities and education is down to just 2.6% YoY in Feb-14, hence adding just 0.8% to the CPI over the last year. Hence, even while underlying inflation has fallen only slightly (1.3% YoY), CPI inflation has tumbled to 1.7% YoY.

Figure 3. UK — CPI Inflation Trends and Outlook, 2012-15F



F Citi Forecast. Sources: ONS and Citi Research

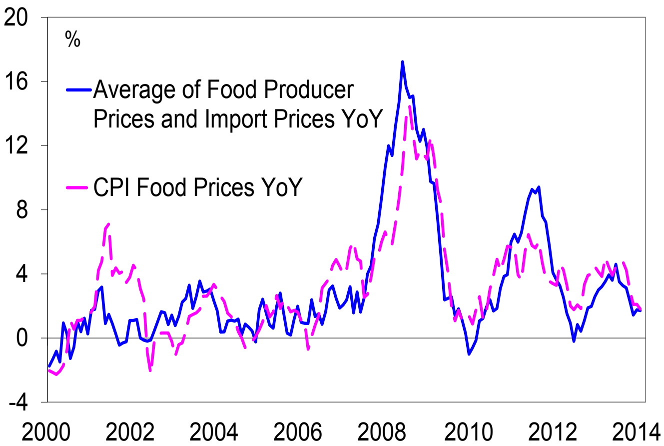
CPI inflation is likely to drop a little further in coming months…

CPI inflation is likely to fall a little further in coming months, with a low of perhaps 1.5% in Q3. Food price inflation probably will drop close to zero YoY around midyear from 1.8% YoY in Feb-14, reflecting recent weakness in import prices, producer prices and commodity prices for the food sector. The YoY gain in tuition

[1] See "Inflation Convergence and Divergence", Michael Saunders, *UK Economics Weekly*, 10 January 2014, Citi.

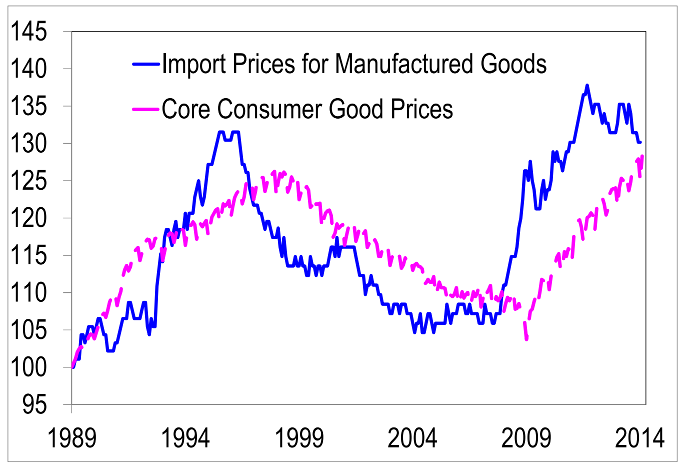
fees is likely to shrink again later this year and again in 2015 as the boost from the 2012 hike in student fees fades. The pace of utility price inflation is likely to slow a little further, given that one energy supplier cut prices at end-February and another has announced a price freeze. We expect the overall contribution to CPI inflation from food, drink, tobacco, utilities, petrol and education to fall from 0.8% YoY in February to about 0.6% in Q3 this year. In addition, import prices for manufactured goods have fallen by 4% since March-13, and this is likely to cap consumer goods prices in coming quarters.

Figure 4. UK — Food Prices YoY, 2000-14



Sources: ONS and Citi Research

Figure 5. UK — Import Prices for Manufactured Goods and Core Consumer Goods Prices, Indexed to Jan 1989 = 100, 1989-2014



Note: Core consumer goods prices exclude food, drink, tobacco and energy.
Sources: ONS and Citi Research

…but we do not believe the UK is at all close to deflation risks

But we do not believe the UK is heading close to deflation, and ultimately the inflation undershoot (1-2 years) is likely to prove far more transitory than the recent inflation overshoot (4 years, covering 2010-13). Nominal GDP has growth by about 1½% QoQ (ie 6% annualized) in the last two quarters, real GDP is growing strongly, a wide range of guides suggest that capacity use is rising rapidly and there are signs that pay deals are picking up. Indeed, the ongoing drop in CPI inflation itself will reinforce the upturn, lifting real incomes and providing extra fuel to consumer spending. As the output gap closes, domestic disinflationary pressures are likely to fade, leaving CPI inflation close to the 2% target on average in 2016-17 — with a chance that external shocks could push it either way.

RPI-CPI Wedge Likely to Expand Further

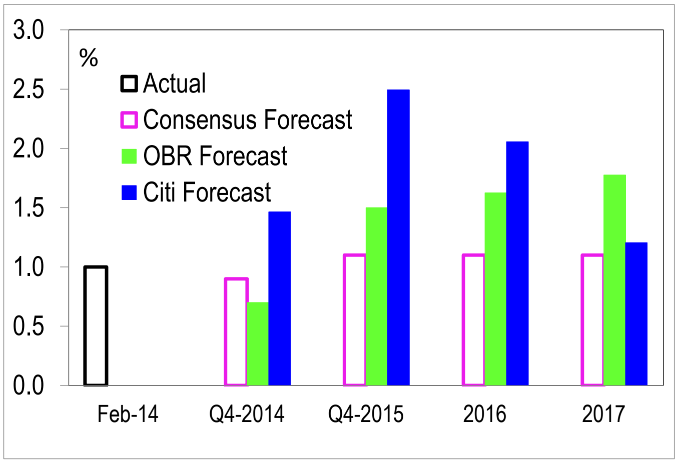
The RPI-CPI wedge has widened recently and repeatedly overshot consensus

Recent weakness in CPI inflation has not been fully reflected in RPI inflation, which is the relevant measure for index-linked gilts. In the last four months, CPI inflation has slowed by 0.5 percentage point (from 2.2% YoY in Oct-13 to 1.7% in Feb-14) but RPI inflation has actually edged up from 2.6% YoY to 2.7%. So the RPI-CPI "wedge" has expanded from 0.4% to 1.0%, the highest since 2011. And this has not been anticipated by the consensus, with the RPI-CPI wedge exceeding the pre-release consensus in each of the last four months. There has been a slight general bias for the RPI-CPI wedge to exceed the pre-release consensus in recent years: since the start of 2009, the wedge has overshot the pre-release consensus twice as often as it has undershot. This bias has become more pronounced recently.

We expect the RPI-CPI wedge will markedly exceed consensus in coming years

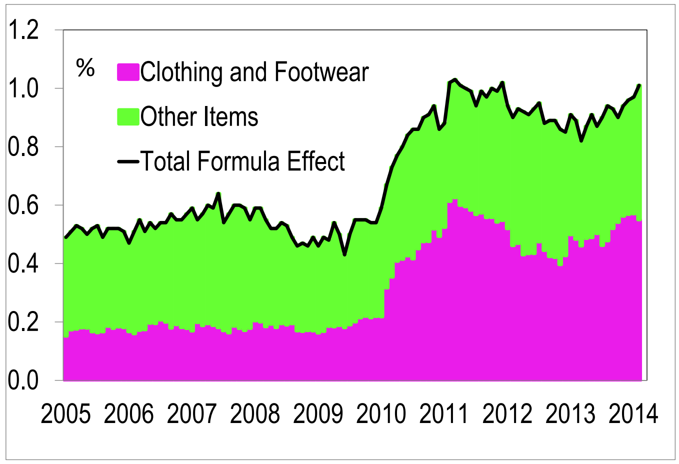
Consensus forecasts for the RPI-CPI wedge have drifted up recently, but in our view remain significantly too low. The consensus projects this wedge at 0.9% in Q4-14, 1.2% in Q4-15 and an average of 1.1% per year in 2016-18[2]. By contrast, the BoE expects this wedge to average about 1.3% per year in the long run[3]. The OBR projects the wedge at 1.2% for 2015, rising to 1.6% in 2016 and 1.8% in 2017[4]. Our view is that the RPI-CPI wedge will rise to about 1.5% in Q4-14 and 2.5% in Q4-15, staying a little above 1½% in Q4-16. Even with a narrower wedge in 2017-18, we expect the RPI-CPI wedge to average 1.5% per year over 2014-18 as a whole. Hence, even though our near-term CPI inflation forecasts are below consensus, our RPI consensus forecasts are well above consensus, at 3.1% YoY for Q4-14, 4.4% YoY for Q4-15 and 4.3% for 2016 (versus consensus forecasts of 3.0%, 3.2% and 3.2% respectively).

Figure 6. UK — Forecasts for RPI-CPI Wedge, 2014-18F



Sources: HM Treasury, ONS, OBR and Citi Research

Figure 7. UK — Contributions to the "Formula Effect" Between RPI and CPI Inflation, 2005-14



Sources: ONS and Citi Research

The recent rise in the RPI-CPI wedge reflects a larger formula effect, rising house prices and other factors

The 0.6pp in the RPI-CPI wedge over the last four months reflects a mix of: (1) a 0.1 rise in the "formula effect"[5] to 1.0pp, related to both clothing and non-clothing items); (2) a 0.1 effect from the housing depreciation index (HDI) — which is in the RPI but not the CPI — and has picked up from 3.2% YoY in Oct-13 to 5.0% YoY in Feb-14; (3) a 0.4 effect from other differences in weights and coverage between the RPI and CPI. For example, financial services charges (in the CPI but not the RPI), fell 1.2% YoY in Feb-14 whereas they rose 1.0% YoY six months earlier, while the YoY rate for the RPI car price series (which only covers used cars) has picked up by a little more than the CPI car price series (which includes both new and used cars). Going forward, we assume that the formula effect will remain around its recent level (1.0%). Our forecast of a widening RPI-CPI wedge reflects two main factors — the HDI and mortgage interest payments (MIPs) — with little effect from other factors.

[2] Source: "*HM Treasury Survey of Independent Forecasts*", monthly.

[3] See "*Inflation Report*", February 2014, BoE.

[4] See "*Economic and Fiscal Outlook*", March 2014, OBR.

[5] This reflects the use of arithmetic means to aggregate in the RPI and geometric means in the CPI, and the difference between these two methods has expanded in recent years due to changes in the method of measuring clothing and footwear prices.

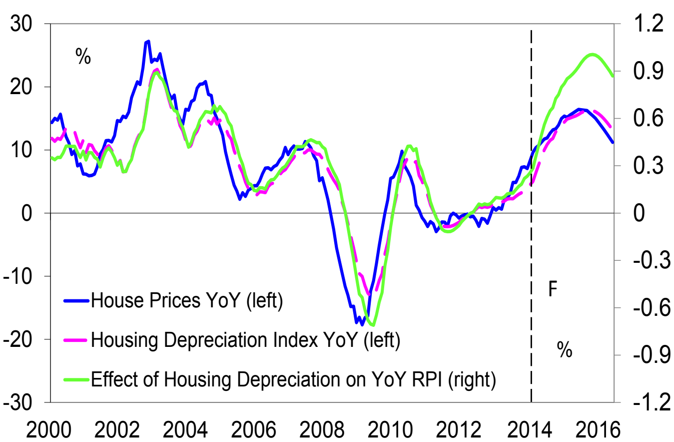
The house price boom will probably add materially to the RPI-CPI wedge during 2014

The HDI is calculated as a lagged average of actual house price inflation trends, and its RPI weight has risen to 5.8% now from 4.7% ten years ago and 3.0% 15 years ago — hence making the RPI-CPI wedge markedly more sensitive to house prices. House price inflation already is about 10% YoY on the main two monthly indices (and an annualized pace of 12-13% over the last three months), and probably will reach about 15% YoY later this year and a similar pace in 2015, reflecting the boost from low mortgage rates and limited housing supply. In turn, this implies that the HDI is likely to pick up markedly further in coming months, with its YoY rate also reaching about 15% later this year and in 2015. This would expand the RPI-CPI wedge by a further 0.6% from recent levels (with the HDI's effect on the RPI rising from 0.3% YoY now to about 0.9% YoY at end-14). The HDI recorded similar growth during the pre-crisis boom, rising by 14.4% YoY on average in 2002-04, but it's effect on the RPI-CPI wedge would be greater now because its weight on the RPI is higher.

The MIPS component recently has not been contributing to the rise in the RPI-CPI wedge

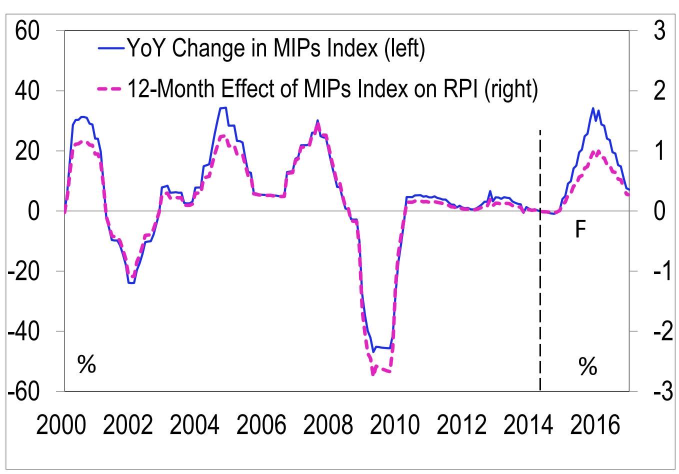
The MIPs index in the RPI is calculated as the product of the average rate on outstanding mortgage debt and average mortgage debt per household. Since average debt changes only slowly, the key variable is the average mortgage rate which, in turn, is a weighted average of floating rates (weight of 67%) and fixed rates (33%). Note that even though Bank Rate has been stable for 5 years, the average *outstanding* mortgage rate is down by about 10bp YoY as the result of lower lending spreads on new mortgages: the average *new* mortgage rate (across fixed and floating rates) is down by about 50bp YoY. So far, therefore, the MIPs component has not been expanding the RPI-CPI wedge.

Figure 8. UK — House Prices and RPI Housing Depreciation Index, YoY, 2000-2016F



F Citi forecast. Sources: ONS and Citi Research

Figure 9. UK — MIPs Component of RPI, 2000-16F



F Citi forecast. Sources: ONS and Citi Research

The MIPs component will probably add markedly to the RPI-CPI wedge once Bank Rate starts rising

The average *new* fixed mortgage rate (3.1%) is now well below the average *outstanding* fixed rate (3.8%). Hence, the average *outstanding* mortgage rate probably will continue to fall in the next few months even if *new* loan rates are stable, as maturing 2-, 3- and 5-year fixed mortgages are replaced by new loans (the "vintage effect"). If and when Bank Rate starts to rise (which we expect will be in Q4-14), variable mortgage rates are likely to rise almost one-for one with Bank Rate, but the "vintage effect" will probably — for a while — keep the average outstanding fixed mortgage rate rising more slowly than new mortgage rates. Allowing for this, our forecast of a 200bp rise in Bank Rate from late 2014 to end-2015 translates into a rise of only about 100bp in the average outstanding mortgage rate over that period, with a further upward drift subsequently even if Bank Rate

then levels off. Even so, a 100bp rise represents a rise of roughly one third in mortgage rates, hence adding roughly 1% to the RPI over that period.

Council tax hikes probably will remain low near term, but may pick up post-election

A third key potential driver of the RPI-CPI wedge is the Council Tax (which is in the RPI with a 4.2% weight, but not in the CPI). We assume this will rise by just 0.6% this year[6] (after a 0.9% rise in 2013) and then by 2% YoY from 2016 onwards (once the election is past). However, if the election produces a Labour majority or Labour-led coalition, then the Council Tax may rise more markedly from 2015 onwards: the Council Tax rose by an average of 6.1% YoY under Labour from 1998-2009. A replay of that would add roughly 0.2% per year to the RPI-CPI wedge above our forecast from 2015 or 2016 onwards. Notice that if instead there is a “Mansion Tax”, applying to the very top end of the housing market, then the RPI effect would be much smaller, because the RPI excludes the top 5% of income earners (and hence probably would largely exclude those most affected by a “Mansion Tax”).

We find it striking that the consensus for the RPI-CPI wedge is so low

Of course, these forecasts inevitably are uncertain. Nevertheless, we find it striking that the consensus expects the RPI-CPI wedge to stay around current levels (ie close to 1%) in coming years, despite the likelihood that the HDI and MIPs components of the RPI will both rise sharply in the next year or two. Hence, we believe risks for the wedge lie markedly to the upside of the consensus.

Economic Indicators

Tue 1 Apr	***Manufacturing PMI (Mar)***	**Forecast: 57.0**	**Prior: 56.9**
	The PMI edged up last month after two months of declines, but in broad terms the PMI has been roughly stable at very high levels since last August. We expect little change either way this month and such a figure would be consistent with continued rapid output growth.		
Thu 3 Apr	***Services PMI (Mar)***	**Forecast: 58.4**	**Prior: 58.2**
	The services PMI has weakened for four months in a row, although it remains at a very high level. We suspect that this downtrend will end soon, perhaps this month, and look for the index to be broadly stable in coming months.		
Tue 8 Apr	***Industrial Production (Feb)***	**Forecast: 0.3% MoM, 2.2% YoY**	**Prior: 0.1% MoM, 2.9% YoY**
	Manufacturing Output (Feb)	**Forecast: 0.3% MoM, 3.2% YoY**	**Prior: 0.4% MoM, 3.3% YoY**
	Surveys suggest that manufacturing output continues to expand quite rapidly and so we expect another solid gain. Figures in line with our forecast would leave industrial production in Jan-Feb up by 0.5% from the Q4 average, and signal continued strong Q1 GDP growth.		
Wed 9 Apr	***Trade Balance – Goods & Services (Feb)***	**Forecast: £-2.3 billion**	**Prior: £-2.6 billion**
	The trade deficit fell significantly in 2013, helped by a marked rise in the surplus on services and softer import prices. We expect that import prices will fall a little further in the February data		

[6] See report by CIPFA, 4 March 2014.

Economic Calendar, 24 March — 11 April 2014

24 March	25 March	26 March	27 March	28 March
	Consumer Prices (Feb) Jan -0.6% MoM, 1.9% YoY Feb 0.5% MoM, 1.7% YoY **Ex F, D, T, E (Feb)** Jan -0.9% MoM, 1.6% YoY Feb 0.7% MoM, 1.7% YoY **Retail Prices (Feb)** Jan -0.3% MoM, 2.8% YoY Feb 0.6% MoM, 2.7% YoY **RPIX – Ex Mortgages (Feb)** Jan -0.4% MoM, 2.8% YoY Feb 0.7% MoM, 2.7% YoY **Producer Input Prices (Feb)** Jan -0.9% MoM, -2.9% YoY Feb -0.4% MoM, -5.7% YoY **Prod. Output Prices (Feb)** Jan 0.3% MoM, 0.9% YoY Feb 0.0% MoM, 0.5% YoY **Ex F, D, T, E** Jan 0.5% MoM, 1.2% YoY Feb 0.1% MoM, 1.1% YoY **CBI Retail Survey** **(Mar, 11:00)**		**Norges Bank Monetary Policy Outcome & MPR:** Rates Unchanged at 1.50% **Retail Sales Volumes (Feb)** Jan -2.0% MoM, 3.9% YoY Feb 1.7% MoM, 3.7% YoY **Financial Policy Committee Statement** (from 19 Mar Policy Meeting)	**GfK Consumer Confidence** (Mar, 00:01) **Balance of Payments (Q4)** Q3 £-22.8bn, 5.6% of GDP Q4 £-22.4bn, 5.4% of GDP **GDP (Q4, 3rd Release)** Q3 0.8% QoQ, 1.8% YoY Q4 0.7% QoQ, 2.7% YoY **Service Sector Output (Jan)** Dec 0.3% MoM, 3.1% YoY Jan 0.4% MoM, 3.2% YoY **During the Weekend:** **France: Municipal Elections** (Mar 30: Run-Off) *During The Weekend* **Clocks go forward one hour** (Night of Mar 29/30)
31 March	**1 April**	**2 April**	**3 April**	**4 April**
Informal EcoFin Meeting Of EU Finance Ministers (Athens, Apr 1-2)	**Manufacturing PMI (Mar)** Feb 56.9 MarE 57.0 **Record of Financial Policy Meeting of 19 Mar**	**Nationwide House Prices** (Mar, 07:00)	**Services PMI (Mar)** Feb 58.2 MarE 58.4 **Housing Equity Withdrawal (Q4)** **Government Debt & Deficit Returns to EU Commission (Mar)** **ECB Meeting** 12:45 Outcome 13:30 Press Conference	*Around Now* **Halifax House Prices (Mar)** (08:00) **Informal Meeting of EU Foreign Ministers** (Greece, Apr 4-5)
7 April	**8 April**	**9 April**	**10 April**	**11 April**
IMF/World Bank Spring Meetings – Seminars & Events Throughout the Week (Washington, Apr 8-13)	**Industrial Production (Feb)** Jan 0.1% MoM, 2.9% YoY FebE 0.3% MoM, 2.2% YoY **Manufacturing Output (Feb)** Jan 0.4% MoM, 3.3% YoY FebE 0.3% MoM, 3.2% YoY **IMF's *World Economic Outlook*** Released (c. 15:00)	**Riksbank Monetary Policy Outcome (08:30)** **Trade Balance – Goods & Services (Feb)** Jan £-2.6bn FebE £-2.3bn **Profitability of UK Companies (Q4)** **MPC Meeting Starts** **IMF's *Global Financial Stability Report*** Released (c. 15:00) **IMF's *Fiscal Monitor Report*** Released (c. 17:30)	**MPC Meeting Ends: Outcome at Noon**	**Construction Output (Feb)** **G-20 Ministerial Meeting** (Washington)

E Citi estimate. B Billion. P Provisional. R Revised. Note: All data are released at 9.30 a.m., except those marked otherwise.
Sources: BoE, CBI, ONS, national sources and Citi Research.

Notes

Appendix A-1

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