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Developed Markets
Western Europe

UK Economics Weekly

"Low for Longer" ≠ "Low Forever"

- Economic Forecast
- Fiscal Policy
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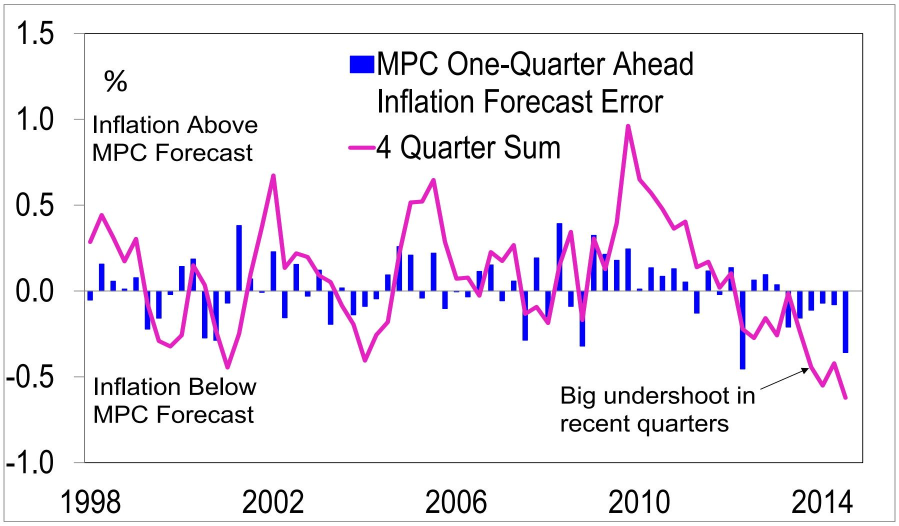
- The upcoming *Inflation Report* (November 12) is likely to endorse a general "low for longer" message for monetary policy, in response to the continued weakness in pay and prices. Inflation has undershot the MPC's one-quarter ahead forecast for six quarters in a row, an unprecedented series of downside inflation surprises. However, this message will probably come with the important caveat that the first rate hike is on the horizon and that it probably will be appropriate to hike rates as labour market slack continues to shrink. In other words, "low for longer" does not necessarily mean "low forever".
- Such a message would be relatively dovish in the sense that it would imply a lower rate path than the MPC's base case in the August IR, despite a lower jobless forecast. But, such a message may come across to investors as a bit less dovish than market pricing (the first hike is not priced in until Sep/Oct 2015).
- We are pushing back our forecast for the first rate hike from Q1-15 to Q2-15, and scaling back our end-15 forecast for Bank Rate to 1.25% (i.e. three 25bp hikes) from 1.75% (i.e. five hikes) previously. The flipside of extended monetary accommodation near term, coupled with weakness in food and energy prices, is that the economy is likely to remain buoyant in 2015-16, and we expect that over time the MPC will hike rates considerably further than markets price in.

Figure 1. UK – CPI Inflation Outturns Compared to MPC One-Quarter Ahead Forecasts, 1998-2014



Note: We compare inflation outturns with the MPC's one-quarter ahead central forecast in successive Inflation Reports, using CPI Inflation since 2004 and RPIX Inflation before then. Sources: ONS, BoE and Citi Research

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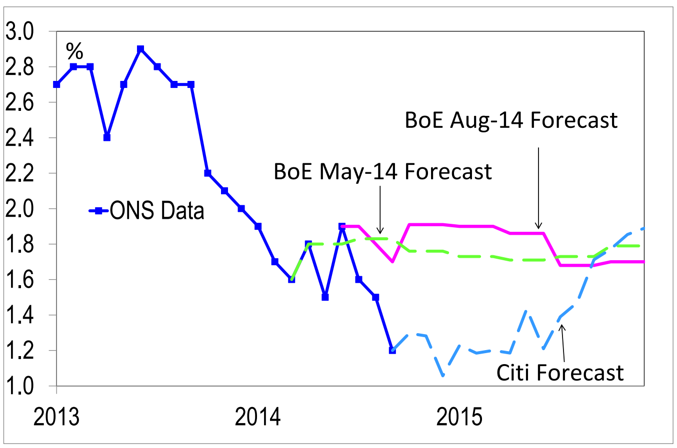
The August IR projected strong GDP growth (3.5% in 2014, 3.1% in 2015, (including some assumed upward revisions to recent GDP growth data) but, with a pickup in productivity growth, forecast the jobless rate to fall more slowly than recently, so that it reaches 5.6% in Q4-15 and 5.3% in mid-2017 (hence never falling below the MPC's 5.1% estimate for the equilibrium jobless rate). In turn, the MPC forecast that inflation would fall slightly below target near term (1.9% YoY in Q4-14 and an average of 1.8% YoY in 2015) but would then level off close to the 2% target 2-3 years ahead. The upcoming IR (Nov 12) will incorporate four major developments:

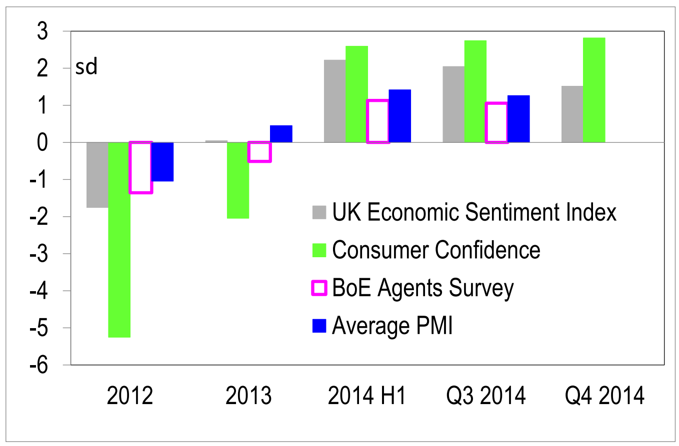
Lower near term inflation profile. CPI inflation in Q3 (1.45% YoY) undershot the August IR forecast (1.81% YoY) by 0.3-0.4 percentage points, the biggest undershoot versus the MPC's one-quarter ahead forecast since Q2-2012. Moreover, the CPI inflation outturns have now undershot the MPC's quarter-ahead forecast for six quarters in a row, an unprecedented series. Such repeated downside surprises probably cannot all be attributed to erratic factors, but suggest that the MPC has repeatedly understated disinflation pressures from the labour market, currency appreciation[1] etc. In addition, global oil and non-oil food and energy prices are weaker, which will help reduce inflation further near term. We expect CPI inflation to average about 1.2% YoY in Q4-14 and H1-15, and 1.5% YoY in 2015 as a whole – and expect the MPC to cut their forecast to around that level.

Figure 2. UK – CPI YoY Inflation Data and Forecasts, 2013-16F



Note: We show the MPC's central forecasts using market rates.
Sources: ONS, BoE and Citi Research

Figure 3. UK – Business and Consumer Surveys, Standard Deviations from 1998-07 Average, 2012-14



Sources: BoE, European Commission, DataStream and Citi Research

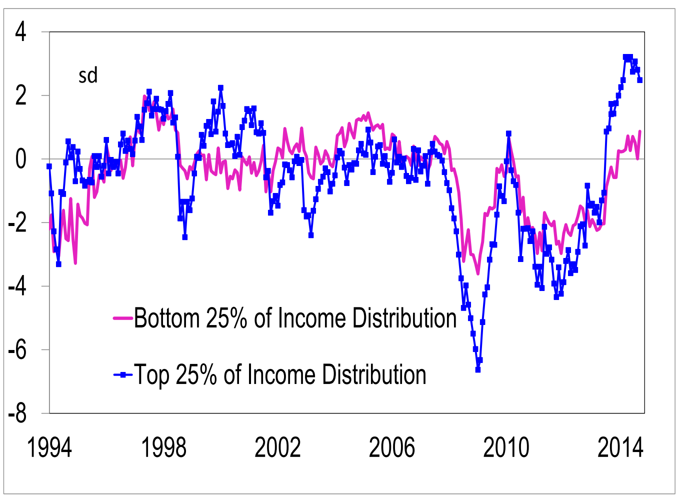
End to Growth Upgrades. The MPC have raised their growth forecasts in the last six *Inflation Reports*, an unprecedented series of upgrades. We suspect that trend will end, with little change or perhaps a mild downgrade to their 2014-15 growth forecasts. The ONS's first release for Q3 GDP growth (0.7% QoQ) was slightly below the MPC's forecast (0.8% QoQ), but the MPC may well not regard that difference as significant given the ONS's tendency to revise GDP growth upwards over time. Indeed, if anything, one could argue that the MPC could validly upgrade their "backcast" estimates for GDP growth in 2013 and H1-2014, i.e. assume bigger upward revisions to the ONS data than previously, given the strength of business surveys and employment in recent quarters, plus the ONS's large upward revisions to the GDP data for 2008-12 (which lifted GDP growth by an average of 0.5 percent per year).

[1] See speech by Kristin Forbes of the MPC, 1 October 2014.

But, whether or not the MPC change their "backcast" estimates, they may become slightly less optimistic over growth prospects given the recent deterioration in business surveys – especially for exports. Nevertheless, we do not expect anything more than a marginal downgrade to the MPC's growth forecasts. We have scaled back our 2015 growth forecast to 3.2% from 3.7% three months ago, and look for the MPC to forecast growth of about 3% in 2015.

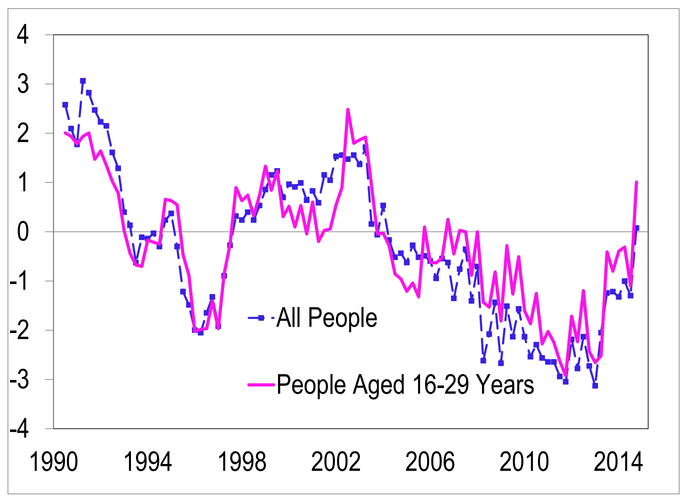
Business surveys (e.g. those by the European Commission and BoE Agents) remain consistent with above-average growth. Moreover, while the recent weakness in equity prices may hit household wealth at the top end, for most people the last couple of months have seen a powerful extra stimulus from lower food and energy prices (lifting real incomes) and lower fixed mortgage rates. For example, the average rate on a 2-year fixed mortgage with a 90% LTV is down by 25bp since June to the lowest for roughly 10 years. It is notable that in October, consumer confidence among the top quartile of the income distribution fell to a six-month low, but confidence among the lowest income quartile rose to the highest level since 2005, Moreover, the net balance of people who intend to buy or build a home in the next 12 months rose to the highest since 2004 (with an especially sharp rise among the 16-29 year age group). Domestic demand has markedly outpaced consensus expectations in 2014 and we suspect the same will hold for 2015 as well.

Figure 4. UK – Consumer Confidence By Income Quartile, Standard Deviations from 94-07 Average, 1994-2014



Sources: European Commission and Citi Research

Figure 5. UK – Net Balance of People Who Believe It Is A Good Time to Buy/Build a House, Standard Deviations from 94-07 Average, 1990-2014



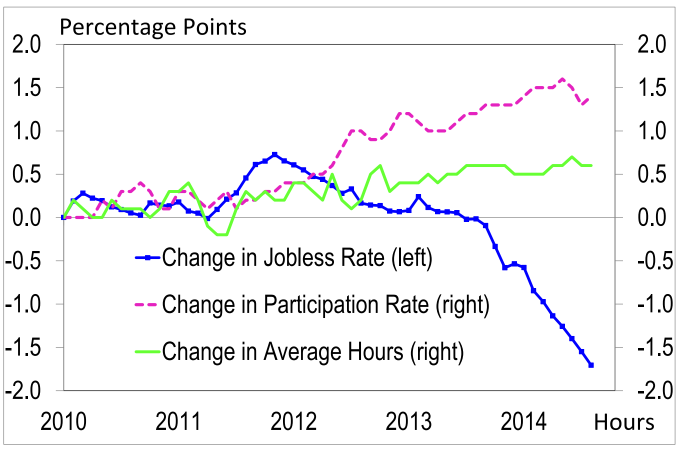
Sources: European Commission and Citi Research

Divergence in recent guides to labour market slack. The MPC use three main measures to judge labour market slack -- the jobless gap, average hours gap and participation gap – defined for each series as the disparity between the current levels of each measure and the MPC's estimate of where equilibrium is. In the August IR, the MPC judged that slack was falling fast but that some slack remained on each measure - with the most in terms of the participation rate and the least in terms of average hours worked. In theory, one would hope that all three measures show similar trends. In practice, these three measures have diverged in recent months. For example, the drop in the jobless rate during the last three months (0.4 percent QoQ) was twice as fast as forecast in the Aug-14 IR, which implies a sharp decline in labour market slack. However, the participation rate has fallen slightly (implying rising slack), while the level of average hours per person has been stable (imply no change in slack).

In our view, the MPC's estimates of the equilibrium levels for unemployment, hours worked and the participation rate are very uncertain. It may well be that the equilibrium jobless rate is lower than the MPC expect, but that the equilibrium participation rate is not as high. But, the MPC only just revised their equilibrium estimates in August, and we doubt they will change them again this time. Hence, on balance, we expect the MPC to judge that labour market slack has fallen in recent months – especially given the high level of vacancies and rise in survey readings of recruitment difficulties - but has not fallen as fast as the jobless rate alone implies.

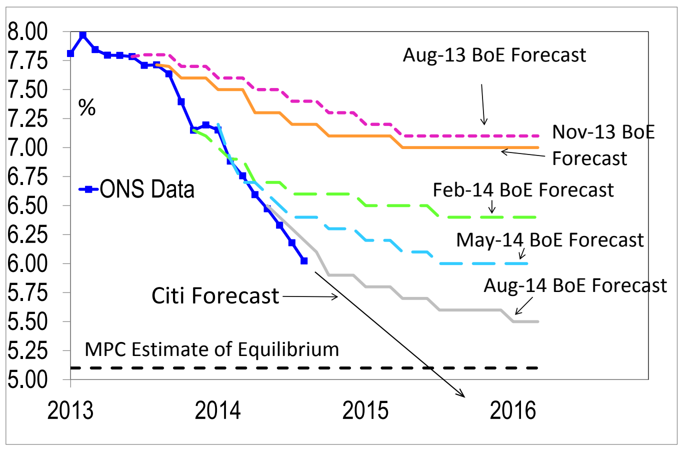
Lower unemployment forecast, again. The MPC only began to publish jobless rate forecasts in Aug-13 and, with the jobless rate falling rapidly, have cut their forecast in every IR since then. However, each IR has forecast that the jobless rate will fall only slightly from the prevailing level. We expect the MPC will again cut their jobless forecast sharply, given the strength in business surveys guides to firms' hiring intentions. And, for the first time, the MPC may well project that the jobless rate will reach their estimate of the long term equilibrium (5.1%) over the next 2-3 years. In turn, the MPC probably will project that the participation rate gap and hours gap will also shrink further from current levels.

Figure 6. UK – Change in Jobless Rate, Average Hours Worked and Participation Rate Since Jan-2010, 2010-14



F Forecast. Sources: ONS, BoE and Citi Research

Figure 7. UK – Jobless Rate Data and Forecasts, 2013-16F



F Forecast. Sources: ONS, BoE and Citi Research

So What Will the MPC Say?

Combining all this, we expect that the IR will forecast that (with market rates) inflation will be very low near term and rise close to target 2-3 years ahead, with the new element that for the first time they will probably project that the jobless rate will reach their 5.1% estimate of equilibrium 2-3 years. Such a forecast would endorse a general sense of "low for longer".

As well as these forecast changes, recent MPC comments hint at a more dovish tilt to the MPC's reaction function, in the sense of being more willing to keep rates low even while the jobless rate falls rapidly given recent weakness in pay and prices.

- In theory, one could still make a case for early MPC hiking on the grounds that recent and near term weakness in inflation and pay are temporary side-effects of currency strength, prior weakness in global commodity prices and the high jobless rates of 2012-13. Unless sterling keeps rising, global commodity prices keep falling or the jobless rate rises again, these disinflationary factors are likely

to fade 2-3 years ahead (which is what the MPC, as a forward-looking central bank, focus on). On this analysis, the most important point is that labour market slack is now shrinking quite fast, which points to a less disinflationary future.

- However, while two MPC members have argued for an early hike, other recent speeches (notably those speeches by Haldane and Cunliffe[2]) argue against it, with a notable shift by Haldane from his mid-year hint that it would be better to hike relatively early[3]. This seems to reflect three points. First, repeated weakness in pay and prices may signal that labour market slack is greater than what the MPC believe. Second if, as markets seem to imply, the neutral policy rate has fallen sharply, then the current policy stance is not so far from neutral as previously believed. Third, in conditions of heightened uncertainty (over these and other issues) the costs of policy error probably are asymmetric: it would be easier to deal with the policy consequences of a boom and inflation (by hiking rates) – especially since the neutral rate may not be very high - rather than deal with a slump and deflation (which would require QE, which may be of only limited influence). This argument implies that it is safer for the MPC to wait until trends in pay and prices confirm that slack is largely closed, rather than hike pre-emptively.

Hence, even though the MPC do not forecast the policy rate, we expect the IR press conference to argue there is no urgency to hike rates right now. Nevertheless, we do expect that all this will come with the caveat that the MPC do expect to be hiking rates at some point fairly soon if the economy continues to grow at a fairly solid pace. Of course, it is possible that economic developments could in practice require the MPC to keep rates on hold to end-2015 or even longer (for example, if the economy slows sharply). But it also possible (for example, if wage growth picks up sharply) that the MPC will want to hike in the next few months. We doubt that the MPC will want to rule out such early action. Hence, we expect the Governor to use the IR press conference to give a message similar to those at the last two:

- May 14 IR: "*As time has moved on and the recovery has been sustained, the economy has edged closer to the point at which Bank Rate will need gradually to rise*."

- Aug 14 IR: "*as the economy normalises, Bank Rate will need to start to rise in order to achieve the inflation target*."

Such a message may come across to investors as a bit less dovish than market pricing (the first hike is not priced in until Sep/Oct 2015).

Our Own View

We are pushing back our forecast for the first rate hike from Q1-15 to Q2-15, and scaling back our end-15 forecast for Bank Rate to 1.25% (i.e. three 25bp hikes) from 1.75% (i.e. five hikes) previously. This shift reflects the factors discussed above – slightly softer growth outlook, lower near term inflation, hints that the MPC are reluctant to hike in response to the falling jobless rate given weakness in pay and inflation. Nevertheless, we do still expect that solid economic growth and the tightening labour market will prompt the MPC to hike a bit earlier and faster than markets price in. And the flipside of continued policy stimulus near term is that the economy is likely to remain buoyant for an extended period. By end- 2015, we expect that GDP growth will still be about 3% YoY, the jobless rate will be below 5% and falling, with inflation close to target. In response, the eventual peak in rates (3-4%, 3-4 years out) probably will be significantly higher than markets price in.

[2] Haldane's speech was on 17 October 2014, Cunliffe's speech was 28 October 2014.

[3] See speech of 18 June 2014.

Figure 8. Economic Indicators

Mon 3 Nov	***Manufacturing PMI (Oct)***	**Forecast: 51.0**	**Prior: 51.6**
	After three consecutive declines – and with continued weakness in euro area guides – we look for another soft reading this month. A figure in line with our forecast would bring this index to the lowest since early 2013, and put it a little below its longrun average.		
Wed 5 Nov	***Services PMI (Oct)***	**Forecast: 58**	**Prior: 58.7**
	The services PMI has oscillated around an average level of 58-59 so far this year and we expect a figure close to that level this time. Such a reading is consistent with service sector output growth that is well above its longrun average.		
Thu 6 Nov	***Industrial Production (Sep)***	**Forecast: 0.2% MM, 2.0% YY**	**Prior: 0.0% MM, 2.5% YY**
	Manufacturing Output (Sep)	**Forecast: 0.4% MM, 2.9% YY**	**Prior: 0.1% MM, 3.9% YY**
	Surveys suggest that manufacturing output growth is slowing, but we suspect that recent data have overstated the slowdown and look for a stronger figure this month. Such a figure would leave Q2 manufacturing output up 0.5% QoQ, the fifth consecutive quarter of growth.		
Fri 7 Nov	***Trade Balance – Goods & Services (Sep)***	**Forecast: £-2.5 billion**	**Prior: £-1.9 billion**
	The trade deficit fell sharply in August because of a marked decline in imports of aircraft, and we look for a higher deficit this month. Levels of both imports and exports have been depressed in recent months by the unwinding of transactions related to VAT fraud.		
Wed 12 Nov	***LFS Unemployment, 3-M Avg (Jul-Sep)***	**Forecast: -138,000 QQ, 5.9% Rate**	**Prior: -154,000 QQ, 6.0% Rate**
	LFS Unemploym't, Single Month (Sep)	**Forecast: 5.9% Rate**	**Prior: 5.9% Rate**
	Claimant Count Unemployment (Oct)	**Forecast: -20,000 MM, 2.8% Rate**	**Prior: -18,600 MM, 2.9% Rate**
	Average Earnings Ex Bonus, 3-M Avg (Sep)	**Forecast: 1.0% YY**	**Prior: 0.9% YY**
	Surveys suggest that firms' hiring intentions remain very strong and, with the participation rate stalling in recent months at close to a record high, we expect the jobless rate will continue to fall rapidly. The MPC judge that the UK's equilibrium unemployment rate is 5.1% and we expect that threshold to be reached during 2015. Surveys suggest that labour cost growth is picking up, but we expect that composition effects from the expansion of low-cost employment will keep average earnings growth subdued for now.		

Source: Citi Research

Figure 9. Economic Calendar, 27 October — 14 November 2014

27 October	28 October	29 October	30 October	31 October
CBI Retail Survey **(Oct, 11:00)** Sep Sales +31% YY Oct Sales +31% YY	**Riksbank Meeting:** Repo Rate cut by 25bp to 0.00% **FOMC Meeting**	**Mortgage Approvals (Sep)** Aug 64.1K MM, 1.0% YY Sep 61.3K MM, -8.7% YY **Insolvencies (Q3)** **FOMC Meeting** QE Ended	**Nationwide House Prices** **(Oct, 07:00)**	**GfK Consumer Confidence** **(Oct, 00:01)** **National Accounts** **"Blue Book" 2014** **Balance of Payments** **"Pink Book" 2014** **Sun 2 Nov** **Clocks Go Back One Hour in N. America (02:00)**
3 November	**4 November**	**5 November**	**6 November**	**7 November**
Manufacturing PMI (Oct) Sep 51.6 OctE 51.0 *During The Week* **Halifax House Prices** (Oct, 08:00)	*During The Week* **EU Commission's Autumn Economic Forecasts** (c.10:00) **US Mid-Term Elections**	**Services PMI (Oct)** Sep 58.7 OctE 558.0 **MPC Meeting Starts**	**Industrial Production (Sep)** Aug 0.0% MM, 2.5% YY SepE 0.2% MM, 2.0% YY **Manufacturing Output (Sep)** Aug 0.1% MM, 3.9% YY SepE 0.4% MM, 2.9% YY **MPC Meeting Ends: Outcome at Noon** **ECB Meeting:** **12:45 Outcome** **13:30 Press Conference** **EuroGroup Meeting** (Brussels)	**Trade Balance – Goods & Services (Sep)** Aug £-1.9bn SepE £-2.5bn **EcoFin Meeting** (Brussels)
10 November	**11 November**	**12 November**	**13 November**	**14 November**
		LFS Unemployment (Jul-Sep) Jun-Aug -154K QQ Jul-SepE -138K QQ **LFS Unemployment Rate, 3-Month Avg (Jul-Sep)** Jun-Aug 6.0% Jul-SepE 5.9% **LFS Unemployment Rate, Single Month (Sep)** Aug 5.9% SepE 5.9% **Claimant Count Unemployment (Oct)** Sep -18.6K MM, 2.9% Rate Oct£ -20.0K MM, 2.8% Rate **Average Earnings Ex Bonus, 3-Month Avg (Aug)** Aug 0.9% YY SepE 1.0% YY **BoE Inflation Report** (10:30)	**Scottish National Party Conference** **(Perth, Scotland, Nov 13-15)** **G-20 Finance Ministers' Mtg (Brisbane, Nov 13-15)**	**Profitability of UK Companies (Q2)** **Construction Output (Sep)** **EcoFin Meeting – Budget**

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

Appendix A-1

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