Economics

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UK Economics Weekly

Options for Extra Stimulus

- At present there seems to be a sense of powerlessness among UK policymakers, faced with the stagnant economy, headwinds from the simultaneous deleveraging of private and public sectors plus the worsening EMU crisis. This week's data confirm that industrial production and construction output both fell in Q1 and have achieved little or no overall growth over the last 10 years. It is not clear if policymakers yet believe that extra stimulus is needed. But we expect the forthcoming *Inflation Report* will signal that further QE is still an option if growth prospects worsen and inflation slows. We continue to expect that QE will be expanded markedly further.

- There also are a range of other policy measures that could be used if the economy continues to disappoint or the EMU crisis escalates rapidly. These include a lower Bank Rate, credit easing, temporary fiscal stimulus and supply-side reform, especially to encourage firms to hire younger people. Some of these could usefully be implemented now in our view, while others are in the toolbox — and may be needed at short notice — especially if the EMU crisis worsens rapidly. However, we believe FX intervention to cap sterling is unlikely unless outright deflation threatens.

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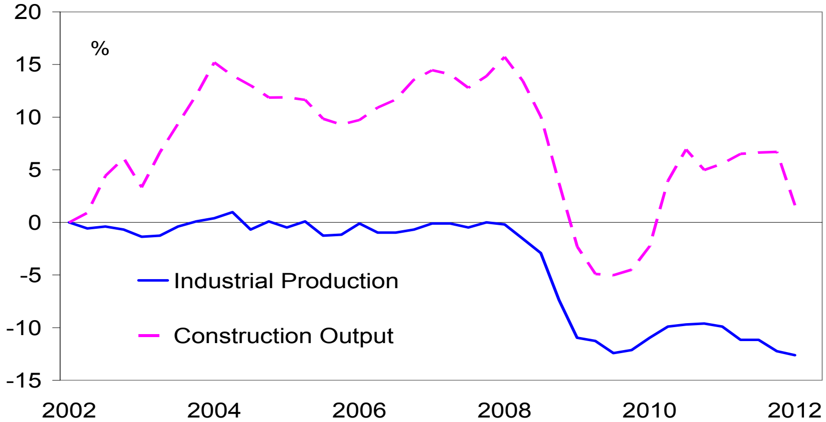
Figure 1. Citigroup Market Forecasts

	Base Rate	QE Target	10 Year Yield	Spread vs Bunds	$/£	£/€
Mid 2012	0.50	£325bn	2.10	35bp	1.57	0.83
End Q1 2013	0.50	£500bn	2.20	40bp	1.54	0.82

Source: Citi Investment Research and Analysis

Figure 2. UK — Cumulative Change in Industrial Production and Construction Output Since Q1-2002, 2002-12



Sources: ONS and Citi Investment Research and Analysis

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

Options for Extra Stimulus

We lay out options for extra stimulus for the UK if the economy continues to disappoint or the EMU crisis escalates

At present there seems to be a sense of powerlessness among UK policymakers, faced with the stagnant economy, worsening EMU crisis, plus headwinds from the simultaneous deleveraging of private and public sectors. It is not clear if policymakers believe that extra stimulus is needed yet, but this note aims to lay out options. These can be divided into measures to slow the pace of private sector deleveraging (QE, lower Bank Rate, credit easing); to support exports (weaker pound); to slow the pace of public sector deleveraging (temporary fiscal stimulus); and to improve the economy's dynamism (supply-side reform). Clearly, there is some overlap (eg QE cuts debt service costs and thus indirectly allows extra public spending within the fiscal targets). Some of these could usefully be implemented now in our view, while others are in the toolbox — and may be needed at short notice — if the economy continues to disappoint or the EMU crisis worsens rapidly[1].

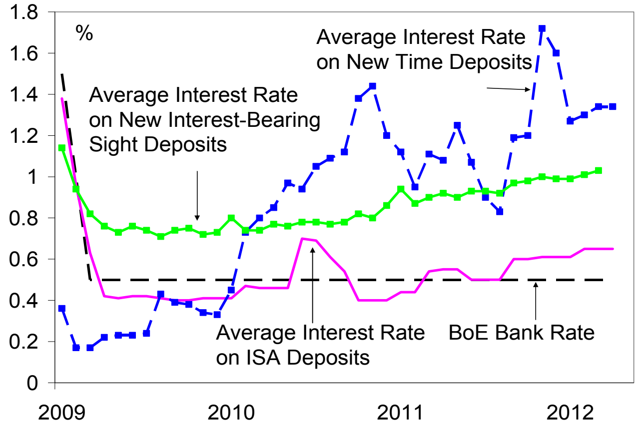
We expect the *Inflation Report* will signal that the door to further QE remains open

More QE. Although the MPC have ended the existing QE programme at £325bn, we believe that extra QE is still likely. Indeed, we expect MPC to signal in the upcoming *Inflation Report* that the door remains open to further QE. The Governor may make this clear in the press conference, or the MPC may signal their thinking indirectly, by forecasting that the current policy stance will probably leave inflation below target 2-3 years ahead. The MPC could then restart QE in coming months (even in June or July) if data or the EMU crisis justify. To be sure, the scale of stimulus from QE is uncertain, but the MPC have been clear that on balance they believe QE does support growth rather than hinder it[2]. Moreover, although gilt yields are the lowest for many decades, they could still be pushed down further by QE.

The MPC believe that setting Bank Rate below 0.5% might produce undesirable negative interest rates or a squeeze on bank profits…

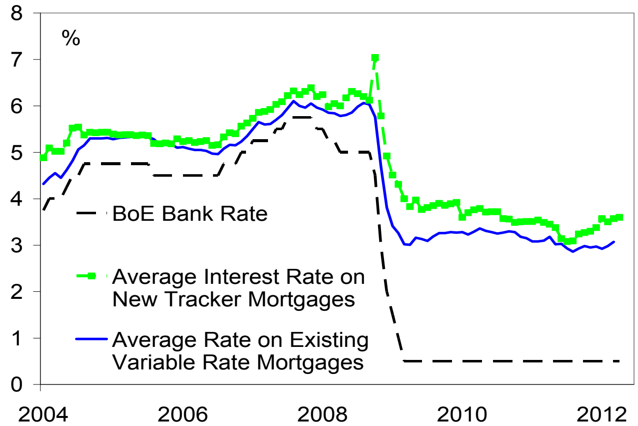
Cut Bank Rate. The MPC's decision to not cut rates below 0.5% in 2009 seemed to reflect worries that a lower Bank Rate would lead to undesirable negative interest rates on household deposits or some tracker mortgages (which were available at below Bank Rate in the boom), and that such negative interest rates would be undesirable. Even if one accepts the premise that negative interest rates are undesirable (and that is debatable in our view), these objections carry less weight now than in 2009.

Figure 3. UK — BoE Bank Rate and Key Household Deposit Rates, 2009-12



Sources: BoE and Citi Investment Research and Analysis

Figure 4. UK — Average Interest Rates on Variable Rate Mortgages, 2004-12



Sources: BoE and Citi Investment Research and Analysis

[1] Some of these options are covered also in "*Global Economics View: What More Can Central Banks Do To Stimulate the Economy?,*" Willem Buiter and Ebrahim Rahbari, 9 May 2011, Citi.

[2] See, for example, the article by BoE Deputy Governor Charlie Bean in the Financial Times, Friday 4 May 2012.

…but in practice retail deposit rates are rising…

- BoE data show that the average interest rate on interest-bearing sight deposits has risen from about 0.7% in 2009 to 1.0% now, while the average interest rate on sterling ISA (ie tax free) deposits is up from 0.4% to 0.65%, and the average rate on sterling time deposits is up from 0.2% to 1.3%. If the BoE cut rates by 25bp and it was fully passed on, none of these deposit rates would go negative. Conversely, rising deposit rates are now being passed on to higher mortgage rates, hence tightening financial conditions.

…and there do not seem to be many sub-Bank Rate tracker mortgages left

- We cannot find data on the number of tracker mortgages fixed below Bank Rate. But, it does not appear that such loans are widespread. BoE data show that the average interest rate charged on the stock of outstanding variable rate mortgages was 3.1% in March, 2.6% above Bank Rate — and this spread has risen markedly in recent years (as spreads on new loans have increased). The issue of negative rates on a few Tracker Mortgages appears trivial in our view.

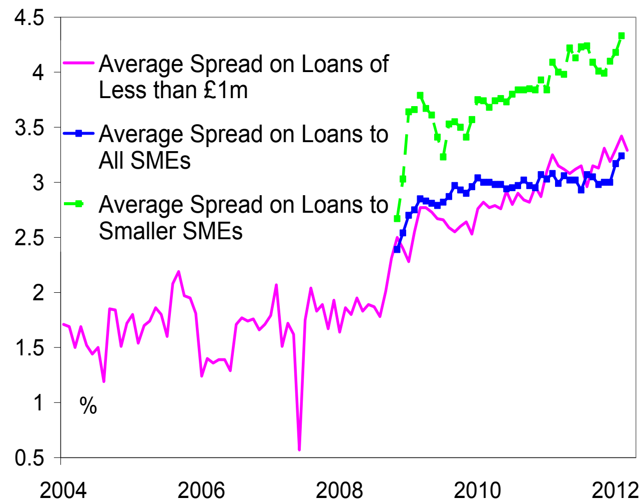
The option of cutting Bank Rate is worth re-examining in our view

To be sure, one could argue that a cut in Bank Rate to 25bp, or even 10bp, would only yield modest stimulus. But, if more stimulus is needed, then every little helps.

Credit availability is poor, with wide lending spreads and tough extra conditions

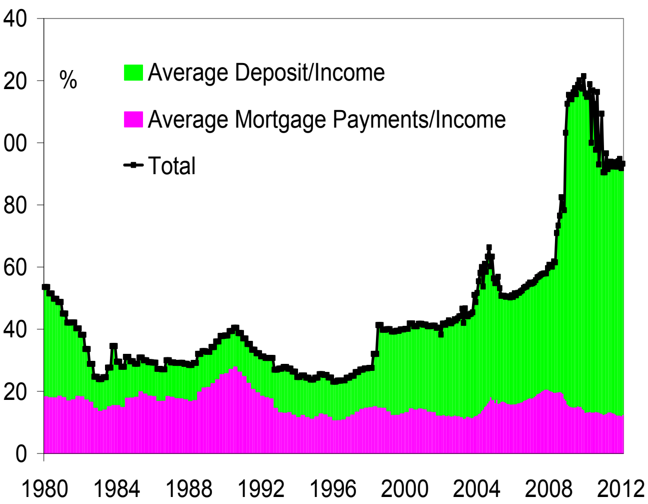
Credit easing. Although riskless rates are ultra-low, many private sector interest rates have wide spreads over riskless rates. For example, over the last six months, average spreads over swap rates on new 2-year fixed mortgages (75% LTV) have risen by 68bp, spreads on 5-year fixed mortgages (75% LTV) have risen by 53bp and spreads on new tracker mortgages have risen by 33bp. Average interest rates on bank overdrafts (a key form of finance for small firms) are 19.5%, the highest since data began in 1995. The average interest rate on a £5,000 unsecured personal bank loan has risen to 15.8% from 8.7% five years ago. The average interest rate on loans to SMEs of turnover below £1million is 4.8% now versus 3.7% in mid-09. Moreover, there are other constraints on credit availability: for example, the average LTV on mortgage loans for first-time buyers is only 80%, versus the pre-crisis norm of 90-95%. As a result, the average deposit among FTBs equals 81% of annual income, versus 10-15% in the mid-90s (the last housing slide).

Figure 5. UK — Average Spreads (Over Bank Rate) on Loans to Small Firms, 2004-2012



Note: Smaller SMEs have turnover of less than £1million per year.
Sources: BoE, Datastream and Citi Investment Research and Analysis

Figure 6. UK — Average Mortgage Payments and Deposit (as pct income) Among First-Time Buyers, 1980-2012



Sources: CML and Citi Investment Research and Analysis

The wide level of lending spreads is unlikely to fade spontaneously soon

Normal market forces are unlikely to produce a significant improvement in credit availability in the year ahead in our view. The wide level of lending spreads is rational from banks' point of view: they are under pressure to lift capital ratios and cut wholesale funding, and face uncertainties over credit quality given the high level of private debt and weak economy. But, the aggregate effect is to reinforce the weakness of the economy. Last year's "Project Merlin" failed to tackle this: the banks in aggregate hit their targets by making credit available at high interest rates and with tough collateral terms — and lending to small firms fell.

Credit easing can be achieved, if necessary by simply using the state-owned banks

The Chancellor announced plans to subsidise loans to SMEs in the Budget. But, if this does not improve things dramatically, more may need to be done. One option would be to cut bank capital charges for selected loan categories[3], but this cuts against the internationally-agreed Basel standards and the UK's aim of setting capital ratios above those norms. Or the BoE could provide banks with cheap long-term funding, like the ECB's 3-year LTRO programme, although so far the ECB's LTROs have not fed through to lower private sector borrowing costs. Other options — which probably would be more effective in our view — would be for the BoE to buy packages of securitized new SME loans at low yields, or for the government to simply order the state-owned banks to lend to UK SMEs at ultra-low rates. Of course, such measures may have a fiscal cost. But this may be no higher than the fiscal cost if policy inaction prolongs economic weakness.

Although the aggregate UK unemployment rate has risen quite modestly, there is a serious unemployment crisis among younger people

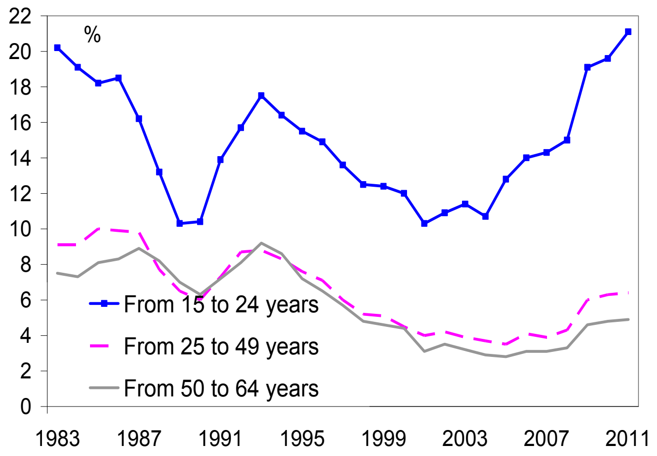
Supply side measures, which may give some nearterm stimulus, but — at least as importantly — may limit the longterm damage from economic weakness. We believe the key issue is to encourage firms to hire younger people. The overall jobless rate (8.3%) is well below the early 90s peak (10.7%), but the jobless rate among people aged 15-24 years (21.1% in 2011 as a whole, 22.2% in early 2012) is the highest since data began in 1983. Conversely, jobless rates among people aged 25-49 years, and 50+years, (6.4% and 4.9% respectively on average in 2011) are far below the early 80s peaks (10.0% and 8.9% respectively) and early 90s peaks (8.8% and 9.2% respectively). A similar pattern is evident in many countries. Academic studies show that extended spells of unemployment among young people cast a long shadow over their lifetime employment and income prospects[4].

The minimum wage bites more heavily among younger workers

The government has cut employment regulations among younger people and this year will freeze the minimum wage for people aged below 21 years. However, in our view, the size of the jobless crisis among younger people demands a far more aggressive response. In our view, one solution (alongside measures to improve education and skills) would be to sharply cut the minimum wage and employment regulations among younger workers — in effect, increasing the age-related tilt in the minimum wage to match the sharper age-related slope of pay levels in the economy. For the overall economy, the adult minimum wage (£6.08/hour in 2011, £6.19 from Oct-12) is only 48% of average hourly earnings (excluding overtime), which was £12.62 in 2011. Among people aged 30-49 years the ratio of minimum wage/average pay is below 45%. For these age groups, the minimum wage does not constrain pay for most workers. But, among people aged 18-21 years, the minimum wage is 71% of average pay, and this ratio has risen from 60% in 1999 (when the minimum wage was introduced at a time of economic strength). Given the disparities in ability between people, it is likely in our view that the minimum wage is stopping some firms hiring some young people (because the pay level that firms would be willing or able to pay is below the minimum wage). A lower minimum wage — implying lower pay — may seem overly harsh to some. But, in our view, the priority must be to get young people into work.

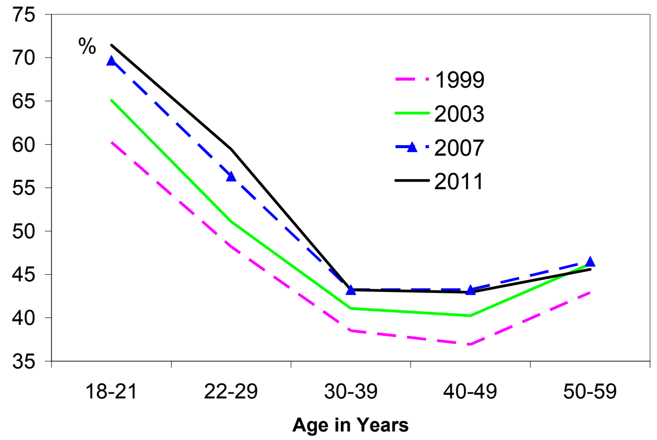
[3] This was suggested by Andrew Haldane of the BoE in a speech last August.
[4] See, for example, "*Young people and the Great Recession*", Bell and Blanchflower, Oxford Review of Economic Policy, 2011.

Figure 7. UK — Unemployment Rates By Age (Years), 1983-2011



Source: Citi Investment Research and Analysis

Figure 8. UK — Minimum Wage As Pct Median Hourly Earnings Excluding Overtime, By Age, 1999-2011



Sources: ONS, Low Pay Commission and Citi Investment Research and Analysis

FX intervention is possible in theory but highly unlikely in practice

FX intervention to cap sterling. The trade-weighted pound has risen by 8% since mid-11 to the highest since mid-09. Versus the euro, sterling has appreciated by 11% since mid-11, to the highest since late-08. MPC members have made it clear that the low pound is a crucial support for the UK economy, given persistent weakness in private spending and fiscal drag. In theory, the MPC can intervene in FX markets for monetary policy purposes, and hence could intervene to sell pounds as an alternative to QE. But, in practice, we regard this as highly unlikely, unless outright deflation threatens or is occurring (as in Japan and Switzerland). As a G20 member, the UK has signed up to support "*greater exchange rate flexibility*" and to "*refrain from competitive devaluation of currencies*"[5] Moreover, as an EU country, the UK has agreed that exchange rates are a matter of "*common concern*".

The UK at present is locked into a tough multi-year fiscal consolidation programme…

Temporary fiscal stimulus. The UK coalition government is locked into a tough multi-year fiscal consolidation programme. The IMF estimates that the fiscal stance (cyclically adjusted primary balance) has tightened by 4.7% of GDP over the last three years and will tighten by a further 4.7% of GDP over the next five years. The major tax hikes are done but, on the government's own estimates, only 18% of the public spending cuts have been made so far (this will reach 29% at the end of the 2012/13 fiscal year). Moreover, the commitment to fiscal consolidation is right at the centre of the coalition agreement: without that, little policy agreement remains.

…but the fiscal rules do allow considerable nearterm flexibility, and fiscal policy could provide a powerful nearterm stimulus

Nevertheless, recent IMF research highlights that fiscal stimulus can provide a powerful boost to growth when the economy has plenty of slack[6]. Moreover, the UK's fiscal rules do allow a 1-2 year delay in fiscal consolidation, provided the commitment to tighten again subsequently is solid: the key rule is for the UK to achieve a cyclically adjusted current balance five years ahead, while the secondary rule is that the debt/GDP ratio must be falling in 2015/16. The government has already used this flexibility a little, responding to the lower growth outlook and lower estimates of potential growth by extending the planned fiscal consolidation beyond 2015. But ample temporary fiscal flexibility remains for 2012, 2013 and even 2014.

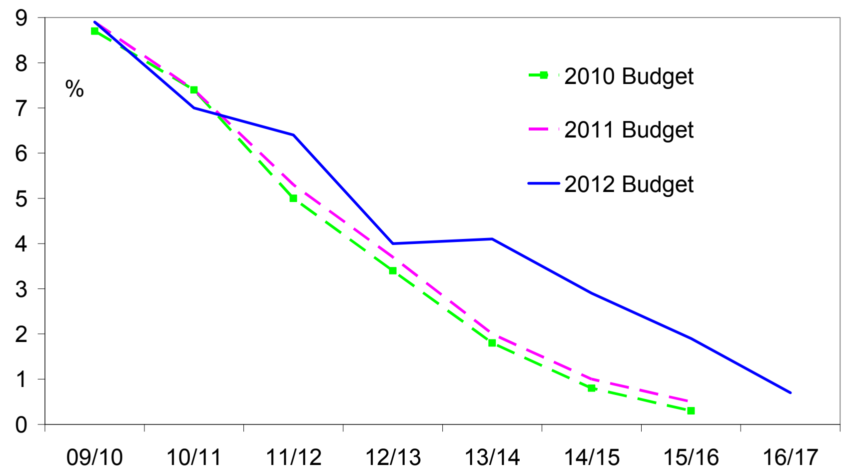
[5] See the G20 Cannes Summit Communiqué, November 4 2011. This could be interpreted as being consistent with a Swiss-style cap on the exchange rate.

[6] See "IMF Fiscal Monitor", April 2012

A move to temporary fiscal stimulus would need to be presented carefully…

To be sure, temporary fiscal loosening would pose clear reputational and credibility problems for the government. It could easily appear to investors that the government is abandoning its fiscal consolidation programme altogether. In this case, even a modest and temporary fiscal stimulus might trigger such a big rise in gilt yields that there is little or no overall improvement in growth prospects. In addition, the coalition would find it politically very difficult to adopt even a temporary fiscal stimulus package: it would appear to be conceding the debate to Labour (who argued for slower fiscal austerity even when growth prospects were better). The argument that the drag on UK growth from the EMU crisis justifies temporary stimulus (or a delay in fiscal consolidation) may be too subtle to survive heated political debate.

Figure 9. UK — Cyclically Adjusted Fiscal Deficit, Pct of GDP, Fiscal Years 2009/10-2016/17



Sources: HM Treasury and Citi Investment Research and Analysis

…but is an option, especially if the EMU crisis escalates and the UK gains outside endorsement for such a move

Hence, we believe that temporary fiscal stimulus (or, at least, measures which effectively postpone austerity) would only come into play in cases of extreme economic weakness. The same applies to the related option of combining fiscal stimulus with permanent monetization of the extra deficit — ie a “helicopter” drop. Even then, the government would probably need some external endorsement (eg from the IMF) to overcome the political bias in favour of sticking with fiscal consolidation. In order to reinforce the temporary nature of any such move, it probably would be most effective via tax cuts or investment, leaving intact the planned gradual multi-year squeeze on public sector current spending[7].

Conclusion — the policy locker is not empty

All these measures have various disadvantages, in terms of market distortions, or possible erosion of anti-inflation credibility, or lost fiscal credibility, or political difficulties. If the economy improves markedly, then the need for extra stimulus will diminish. But, even if economic conditions do not worsen further, we believe there is a good case for some of these measures (QE, credit easing, lower Bank Rate, measures to cut unemployment among younger workers). That case will strengthen — and the need for a wider range of stimulus measures may grow — if the downside risks from the EMU crisis escalate rapidly.

[7] The IMF has sketched out scenarios in which temporary tax cuts might be justified in last year’s Article IV Report, published June 2011.

Economic Indicators

Tue 15 May	***Trade Balance – Goods & Services (Mar)***	**Forecast: £-2.5 billion**	**Prior: £-3.4 billion**
	The trade deficit has widened out again in early 2012, with an average monthly deficit of £2.9bn in January and February versus £2.4bn per month in Q4-11. Exports are weaker, while imports are stronger. We expect a slightly lower deficit for March but even so a figure in line with our forecast would put the overall Q1 deficit at £8.4bn, up from £7.1bn in Q4-11 and the highest trade deficit since Q4-2010.		
Wed 16 May	***Claimant Count Unemployment (Apr)***	**Forecast: +4,000 MoM, 4.9% Rate**	**Prior: +3,600 MoM, 4.9% Rate**
	LFS Unemployment (Jan-Mar)	**Forecast: -8,000 QoQ, 8.4% Rate**	**Prior: -35,000 QoQ, 8.3% Rate**
	The three-month average for the LFS measure showed unemployment falling in Dec-Feb, but the single month data (for February) showed unemployment rising 81,000 MoM after declines in December and January. We expect another modest rise (18K) in the single month data for March, which would leave the LFS jobless total roughly stable in Q1 as a whole. Both the LFS and claimant count jobless totals are likely to rise further in coming months.		
Tue 22 May	***Consumer Prices (Apr)***	**Forecast: 0.6% MoM, 3.1% YoY**	**Prior: 0.3% MoM, 3.5% YoY**
	CPI Ex Food, Drink, Tobacco, Energy (Apr)	**Forecast: 0.4% MoM, 2.0% YoY**	**Prior: 0.4% MoM, 2.5% YoY**
	Retail Prices (Apr)	**Forecast: 0.7% MoM, 3.5% YoY**	**Prior: 0.4% MoM, 3.6% YoY**
	RPIX – Excludes Mortgages (Apr)	**Forecast: 0.7% MoM, 3.5% YoY**	**Prior: 0.4% MoM, 3.7% YoY**
	Base effects from the very strong rise in the CPI a year earlier (it rose 1.0% MoM, biggest April rise since 1993) probably will bring the YoY CPI inflation rate sharply lower, despite a further rise of about 4p/litre in retail petrol prices. Such a figure would require the BoE Governor to write yet another letter to explain yet another inflation overshoot. With luck, this will be the last such letter, because CPI inflation is likely to drop below the 3% letter-writing threshold in coming months. But inflation has been persistently sticky in recent years.		

Economic Calendar, 7 May — 25 May 2012

7 May	8 May	9 May	10 May	11 May
Bank Holiday in UK	**RICS House Price Survey (Apr, 00:01)**	**MPC Meeting Starts**	**Industrial Production (Mar)** Feb 0.4% MoM, -2.3% YoY Mar -0.3% MoM, -2.6% YoY **Manufacturing Output (Mar)** Feb -1.1% MoM, -1.5% YoY Mar 0.9% MoM, -0.9% YoY **MPC Meeting Ends: Rates Unchanged at 0.5% QE Unchanged at £325bn** **Norges Bank Outcome: Rates Unchanged at 1.50%**	**Producer Input Prices (Apr)** Mar 1.7% MoM, 5.6% YoY Apr -1.5% MoM, 1.2% YoY **Prod. Output Prices (Apr)** Mar 0.6% MoM, 3.7% YoY Apr 0.7% MoM, 3.3% YoY **Excluding Tax (Apr)** Mar 0.5% MoM, 3.5% YoY Apr 0.6% MoM, 3.2% YoY **Ex Food, Drink, Tobacco, Energy (Apr)** Mar 0.1% MoM, 2.5% YoY Apr 0.6% MoM, 2.3% YoY **EU Commission Spring Economic Forecasts** (10:00)
14 May	**15 May**	**16 May**	**17 May**	**18 May**
EuroGroup Meeting (Burssels)	**Trade Balance – Goods & Services (Mar)** Feb £-3.4bn MarE £-2.5bn **EcoFin Meeting (Brussels)**	**Claimant Count Unemployment (Apr)** Mar +3,600 MoM, 4.9% Rate AprE +4,000 MoM, 4.9% Rate **LFS Unemployment (Jan-Mar)** Dec-Feb -35K QoQ, 8.3% Rate Jan-MarE -8K QoQ, 8.4% Rate **BoE *Inflation Report*** (10:30)		*During The Weekend* **G-8 Summit Meeting of Heads of State & Gov't** (Camp David, Maryland, US, May 19-20) **2012 Nato Summit** (Chicago, May 20-21)
21 May	**22 May**	**23 May**	**24 May**	**25 May**
	Consumer Prices (Apr) Mar 0.3% MoM, 3.5% YoY AprE 0.6% MoM, 3.1% YoY **CPI Ex Food, Drink, Tobacco, Energy (Apr)** Mar 0.4% MoM, 2.5% YoY AprE 0.4% MoM, 2.0% YoY **Retail Prices (Apr)** Mar 0.4% MoM, 3.6% YoY AprE 0.7% MoM, 3.5% YoY **RPIX – Ex Mortgages (Apr)** Mar 0.4% MoM, 3.7% YoY AprE 0.7% MoM, 3.5% YoY **Public Sector Net Borrowing – Ex Costs of Financial Intervent'n (Apr)**	**Retail Sales Volumes (Apr)** **CBI Industrial Trends (May)** (11:00) **MPC Minutes (May 10)** **BoE Agents' Summary of Business Conditions (May)** **Informal Meeting of European Council of EU Heads of State & Gov't** (Brussels)	**GDP (Q1, 2nd Release)** **Service Sector Output (Mar)** **Business Investment (Q1, Provisional)** **Migration Statistics Quarterly Report (May)**	

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, CML, ONS, national sources and Citi Investment Research and Analysis.

Appendix A-1

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