Citi Research

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Western Europe

UK Economics Weekly

Is the IR Hawkish or Dovish?

- The *Inflation Report* contains a mix of potentially dovish and hawkish signals. On one side, the MPC's economic outlook — strong growth, tightening labour market, prospect of above-target inflation three years ahead — might seem to imply that policy needs to be tightened quite soon. On the other side, the MPC's acknowledgement that 0.5% is no longer the effective lower bound for Bank Rate might seem to open up the possibility of a rate cut.

- In our view, the MPC is firmly on hold near-term, with an expectation to hike over time — but not imminently. Although slack is shrinking, the MPC probably has an asymmetric policy bias — in favour of a low for longer stance rather than pre-emptive tightening. This bias reflects the external environment of weak inflation and falling rates, the possibility that labour market slack is greater than expected, and a sense that it would be easier to cope with a boom than a slump. We still pencil in the first rate hike for early 2016, with rates subsequently rising further than markets expect over time in response to continued solid economic growth.

Michael Saunders
+44-20-7986-3299
michael.saunders@citi.com

Ann O'Kelly
+44-20-7986-3297
ann.okelly@citi.com

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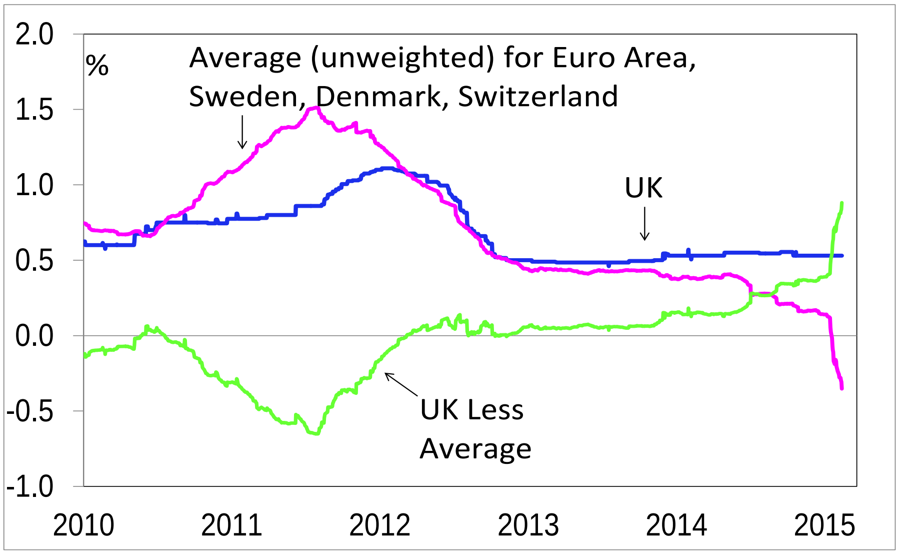
Figure 1. Citi Monetary Policy Forecasts

	Mid-2015	End-2015	End-2016	End-2017
Base Rate	0.50	0.50	1.50	2.50
QE Target	£375bn	£364bn	£265bn	£170bn

Source: Citi Research

Figure 2. Selected Countries – 3-Month Rates, 2010-15



Sources: DataStream and Citi Research

Is the IR Hawkish or Dovish?

The *Inflation Report* contains a mix of potentially dovish and hawkish signals, which potentially could make the case for an early rate hike or signal the possibility of a rate cut.

The Hawkish Case

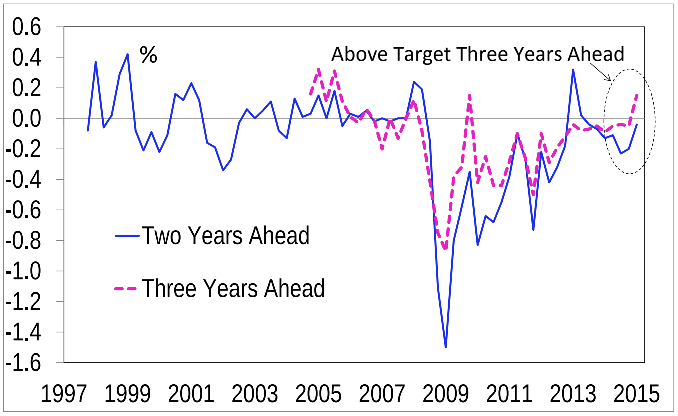
On one side, the MPC's economic assessment implies that monetary policy may need to be tightened sooner than the consensus expects, with strong growth, tightening labour market and — eventually — a tilt to above-target inflation.

The MPC's central forecast for 2015 GDP growth remains at 2.9% and they lifted their 2016 forecast to 2.9% (2.6% previously). For both years, these forecasts are clearly above consensus (2.7% for 2015, 2.5% for 2016). The MPC made a sizeable cut to their business investment forecast, reflecting the adverse effects of lower oil prices on the oil sector (which accounts for 7% of business investment). However, the MPC lifted their forecast for consumer spending growth to 3¾% YoY for 2015 — the best since 2003 — and 3½% in 2016 (previously 2½% and 2¾% YoY respectively), reflecting much stronger household real income growth.

In addition, the MPC acknowledge that labour market slack is shrinking fast, and judge the output gap is down to about ½% of GDP (versus 1% of GDP in the Nov-14 IR). The MPC use three measures of labour market slack — the jobless rate gap, participation rate gap and hours gap — comparing each with the MPC's estimate of equilibrium. In the latest IR they lowered slightly their estimate of the equilibrium participation rate (implying less slack than before) and also judge that the hours gap is essentially closed. The MPC still believe the jobless rate (5.8% in Sep-Nov 2014) is a bit above equilibrium (they put the long-term equilibrium jobless rate at 5.1% and the medium-term equilibrium at 5.3%). But, the gap is small. And the MPC believe the jobless rate in real time (ie Feb 2015) is already down to 5.6%, and judge that the output gap will close in mid-2016 (with the jobless rate then at 5.3%).

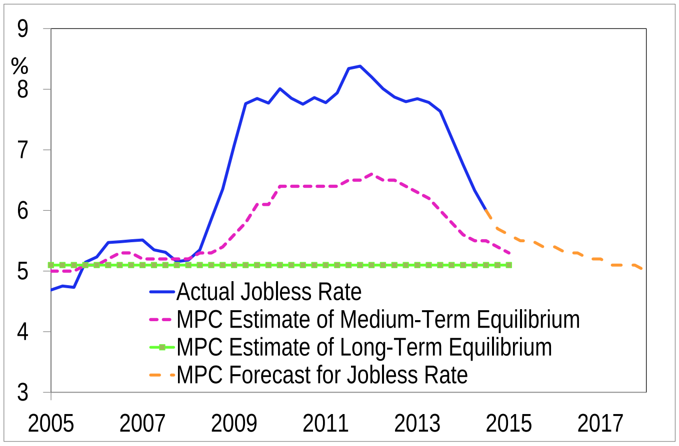
Hence, the MPC — for the first time since Nov-09 — now project that inflation will be a little above target three years ahead, if rates follow the market path. This does not necessarily signal an early hike, but does imply that the MPC believe market pricing for Bank Rate was too low at the time they finished their forecast, a week ago.

Figure 3. UK — MPC Forecasts for Deviation of Inflation From Target 2-3 Years Ahead (With Market Rates), 1997-2015



Note: Figures for forecasts made in 1997 are based on stable rates not market rates. Sources: BoE and Citi Research

Figure 4. UK — Jobless Rate and MPC Estimates of Equilibrium Jobless Rate, 2005-18F



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

The Dovish Case

But, on the other side, the IR and accompanying Open Letter signal that the MPC no longer believe that the current 0.5% level of Bank Rate is necessarily the lower bound. Among MPC options if downside risks materialize, the IR notes that the MPC could "*cut Bank Rate further towards zero from its current level of 0.5%*" alongside expanded QE or a later/more gradual tightening path. This marks a clear shift from the prior MPC view which, since 2009, had set 0.5% as the effective lower bound. As the June-2012 MPC minutes argued: "*a reduction in Bank Rate below 0.5% could have counterproductive consequences, in particular constraining some banks' and building societies' ability to lend. Lenders were, in practice, unable to reduce deposit rates below zero. But they had assets — primarily mortgages — with interest payments contractually linked to Bank Rate. Consequently, a reduction of Bank Rate below 0.5% might squeeze some lenders' interest margins to such an extent that they became even less able to extend new credit*."[1]

With the sharp rise in capital among banks and building societies, the MPC now believe this constraint has faded, and the IR notes "*the United Kingdom's banking sector is operating with substantially more capital now than it did in the immediate aftermath of the crisis. Reductions in Bank Rate are therefore less likely to have undesirable effects on the supply of credit to the UK economy than previously judged by the MPC*." So this appears to open up the possibility that the MPC could follow the general European trend of lower short rates, although the MPC's language ("*cut Bank Rate further towards zero*") appears to rule out a move to negative rates.

So What is the MPC's Message?

In our view, the MPC is firmly on hold near-term, with an expectation to hike over time — but not imminently. The hawkish implications of the above-target inflation forecast is diluted by the fact that monetary conditions already tightened since the IR forecasts were finalized: sterling's trade-weighted index is up 2%, and markets have re-priced the first UK rate hike to Q1-2016 from Q3-16 (the base case in the IR forecasts). Hence, it is not clear if the MPC's forecasts would still show above-target inflation three years ahead using today's market prices. Second, as the MPC's Open Letter stresses, the MPC's focus in setting monetary policy is more on the 2-year horizon than 3-years: "*the MPC judges it appropriate to set policy so that it is likely that inflation will return to the 2% target within two years*". With all the uncertainties in the outlook, a forecast that inflation will slightly exceed the target 3 years ahead does not imply any great urgency to act near-term.

At the same time, we do not interpret the statement that <u>in theory</u> the MPC could cut Bank Rate as a sign that the MPC <u>is likely</u> to cut Bank Rate. The trigger for this re-evaluation of policy options appears to be the Open Letter required after the plunge in inflation below 1% YoY, which requires the MPC to spell out its policy options if the inflation undershoot persists. The MPC are simply making it clear that the option of a rate cut is in their toolbox (alongside QE) if the economy unexpectedly weakens markedly or persistent deflation seems likely. This does not imply that the MPC are close to using this option. Indeed, the MPC's Open Letter states that *"the MPC judges it more likely than not that Bank Rate will increase over the forecast period*".

But, this statement does open intriguing possibilities that the MPC could reassess the optimal monetary policy mix between Bank Rate and QE. For example, the

[1] See also the MPC minutes of March 2009 and the Open Letter from then-Deputy Governor Charlie Bean to the Treasury Select Committee on 16 May 2013.

MPC could in theory do a policy-neutral mix of a rate cut and gilt sales. Or, in considering the exit strategy, the MPC could alter the mix between Bank Rate hikes and QE gilt sales. The May-2014 IR laid out the MPC's current approach: "*in order to be able to use Bank Rate as an active tool in response to adverse shocks to activity, the MPC is likely to defer sales of assets at least until Bank Rate has reached a level from which it could be cut materially, were more stimulus to be required*". The MPC has never formally defined what level of Bank Rate allows scope for it to be cut "*materially*". But, if Bank Rate can be cut to zero and 100bp counts as "*material*", then the threshold for QE gilt sales would be Bank Rate of 1% rather than 1.5% — hence potentially advancing the time of QE gilt sales

Our view: Solid Growth, Patient MPC

We basically agree with the MPC's view that the economy is set for strong growth with buoyant consumer spending, falling unemployment, with inflation around zero near-term but rising further ahead. We look for 3% GDP growth this year and in 2016. Given the strength of labour demand (evident in surveys of firms' hiring intentions and the record level of vacancies), we expect the jobless rate will fall to or slightly below 5% by the end of 2015. Nevertheless, we still expect that the MPC will stay on hold this year, and pencil in the first hike for early 2016 — i.e. roughly the time that data for late-2015 emerge, showing the jobless rate has reached or undershot the MPC's estimate of equilibrium (by then, the MPC's estimate of the medium-term equilibrium will probably have converged down to their 5.1% estimate for the long-term equilibrium).

Implicitly, we believe the MPC have quietly softened their prior view that monetary policy tightening needs to be pre-emptive, i.e. to begin before the output gap closes. Conceptually, the MPC view inflation targeting with a 2-3 year horizon as akin to output gap targeting a few quarters ahead (or, analogously, aiming to stabilize the jobless rate close to equilibrium). Given lags in monetary policy's impact on the economy, this implies that the MPC usually will start to hike before the output gap closes, and aim to get policy to something like neutral when it does close, in order to slow growth to trend and stabilize the economy around a zero output gap (i.e. jobless rate matching its long-term equilibrium). The MPC gave a classic statement of this pre-emptive approach when they launched forward guidance "*To ensure that CPI inflation remains on track to return to the 2% target, the Committee will need to withdraw some of the monetary stimulus before the unemployment rate falls back to its medium-term equilibrium*."[2]

With the jobless rate now (i.e. Feb 2015 data) probably very close to equilibrium, this approach would usually imply that rates should rise soon. However, in practice there are three asymmetric uncertainties that favour a "low for longer" stance.

Asymmetric uncertainty over the output gap and labour market slack.

The MPC are reasonably certain that the output gap has not yet closed, and probably believes that risks to its estimates still lie on the side of more slack rather than less. In particular, the longterm equilibrium may be below the MPC's estimate (5.1%). The MPC's figure seems to be based on the pre-crisis experience: during 2002-07, the jobless rate averaged 5.1%, average earnings growth (ex bonuses) averaged 3.9% YoY, CPI inflation averaged 1.8% YoY and unit labour cost growth averaged 2.3% YoY. However, both wage growth and the jobless rate have repeatedly undershot consensus and MPC forecasts in recent years[3]. We suspect

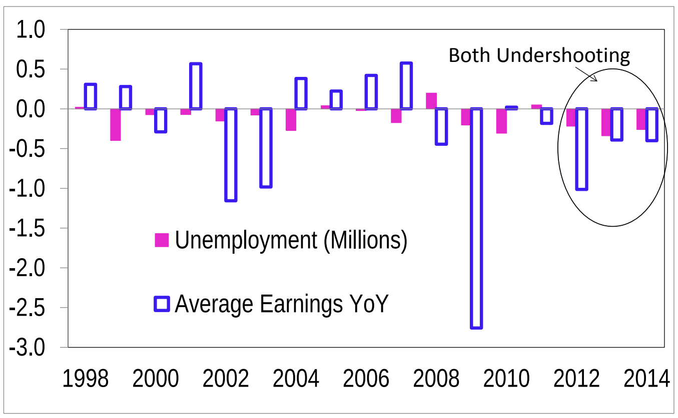
[2] See "*Monetary policy trade-offs and forward guidance*", BoE, August 2013.

[3] See various Inflation Reports.

that labour market flexibility has increased markedly over the last 10 years, reflecting tax and benefit reforms that have lifted labour supply, plus inflows of foreign workers. Hence, rather than the stable equilibrium jobless rate that the MPC seem to assume, we suspect that the equilibrium jobless rate has continued to fall, extending the trend of the last 30 years or so. It may well now be down to 4% or so.

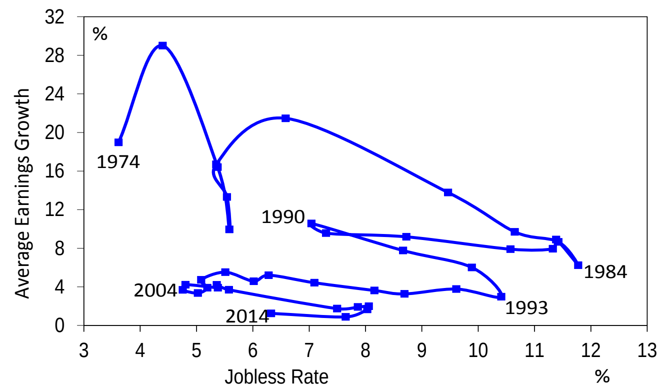
The MPC has already shown its willingness to revise its estimates of slack, having done so several times in the last 18 months. For example, in the May 2014 IR the MPC changed their methodology for the medium-term equilibrium jobless rate, adopting a lower figure, in light of weakness in pay. Again, in Nov-14, the MPC revised up their estimate of the equilibrium participation rate (and hence of the "participation gap"), hence lifting their estimate of overall labour market slack.

Figure 5. UK — Outturns for Unemployment (Q4 Each Year) and YoY Average Earnings Growth, Versus Start-of-Year Consensus, 1998-2014



Note: Consensus measured in January each year.
Sources: HM Treasury, ONS and Citi Research

Figure 6. UK — Relation Between Jobless Rate and Average Earnings Growth, 1974-2014



Sources: ONS and Citi Research

The Governor hinted at the possibility of such a reassessment in the IR Press conference: "*one of the things that the MPC has been discussing has been how to update our thinking around potential growth, components on the labour side or with respect to productivity…I think what we're minded to do - and we'll probably start doing this in May - is to set out episodically or periodically update on it, not episodically, periodically update our views - so in terms of the so-called equilibrium variables…So whether it's around participation rate - your question, or around the natural rate of unemployment or the amount of average hours reported. And so we take stock and we're clear and then we hold those for a while*." With pay growth and unit labour cost growth still subdued, the MPC may reasonably anticipate that their slack estimates again will be revised up.

Asymmetric uncertainty over the extent of external disinflationary pressures

With modest global growth, abundant downside risks (e.g. euro area, China, Russia), and falling external policy rates, it seems far more likely that external conditions will be disinflationary rather than inflationary, via weakness in global costs and/or a rising pound. Sterling's trade-weighted index is now the highest level since 2008, and interest differentials have moved sharply in sterling's favour. Import prices have already fallen by 8% since early 2013, and may fall further in coming months.

Under these conditions, UK inflation may remain a little below target even if the output gap is closed and domestic cost growth is consistent with the 2% inflation

target. The MPC do not base their central forecast on the assumption of renewed disinflationary external shocks, but probably are highly sensitive to this risk.

Asymmetric costs of policy error

In the pre-crisis period, most advanced economy central banks usually judged the costs of policy error as being roughly symmetric: i.e. both above-target and below-target inflation were equally undesirable. The MPC's point target and symmetric letter-writing system encourages such a balanced approach. But, at present, it is far easier for the MPC to deal with the costs of policy error if the mistake has been to tighten too late (resulting in an inflation overshoot) rather than too early (leading to a further inflation undershoot).

- If the MPC are too slow to hike and the economy overheats in 2015-16, then they can (if needed) hike rates quite quickly and, with inflation expectations currently low and falling, could probably ensure that inflation expectations are not destabilised to the upside. Conventional monetary policy tools (and QE gilt sales) could do the job.

- Conversely, if the MPC hike too early and the economy nose-dives (for whatever reason), their tools for stimulus (extra QE and lower — perhaps negative — Bank Rate) are of less certain effectiveness. There are some signs that QE's impact is less when (as now) financial markets are working reasonably smoothly[4]. Moreover, it is unclear how far below zero rates can be cut without leading to a destabilising flow of money out of the banking system.

Hence, in our view, it would be far easier to rein in a boom using conventional policy tools (i.e. rate hikes) than to pull the economy out of renewed slump with unconventional policy. In turn, this probably gives the MPC another reason to err on the side of leaving rates "too low for too long". Of course, the flipside of this approach is that the economy is likely to continue to grow strongly, and that rates over time may rise more than markets price in. But, in our view, such a scenario — whereby the economy grows strongly enough to allow a sustained return to positive real interest rates rather than the semi-permanent negative real rates projected by markets — would be regarded by the BoE and investors as a policy success rather than failure.

[4] See speech by David Miles of the MPC, June 2013.

Figure 7. Economic Indicators

Tue 17 Feb	*Consumer Prices (Jan)*	Forecast: -0.8% MM, 0.3% YY	Prior: 0.0% MM, 0.5% YY
	Ex Food, Drink, Tobacco, Energy (Jan)	Forecast: -0.8% MM, 1.4% YY	Prior: 0.2% MM, 1.3% YY
	Retail Prices (Jan)	Forecast: -0.9% MM, 1.0% YY	Prior: 0.2% MM, 1.6% YY
	RPIX — Ex Mortgages (Jan)	Forecast: -1.0% MM, 1.0% YY	Prior: 0.2% MM, 1.7% YY
	The sharp drop in petrol prices is likely to pull CPI inflation down to a new record low, with the prospect of a further decline in coming months. The AA report that petrol prices fell 6.4% MoM in January, the biggest MoM decline since 2008, and such a figure would cut 0.2% off the CPI. In addition, both food and household energy prices are likely to remain down from a year ago.		
Tue 17 Feb	*Producer Input Prices (Jan)*	Forecast: -3.1% MM, -12.7% YY	Prior: -2.4% MM, -10.7% YY
	Declines in prices for oil and nonoil commodities are likely to produce another large drop in input prices – indeed, a figure in line with our forecast would represent the biggest MoM drop since late-2008. Recent trends in commodity prices, however, suggest that the recent sharp decline in input prices may be ending, with a rise likely in February.		
Tue 17 Feb	*Producer Output Prices (Jan)*	Forecast: -0.3% MM, -1.4% YY	Prior: -0.3% MM, -0.8% YY
	Output Prices Ex Tax (Jan)	Forecast: -0.3% MM, -1.1% YY	Prior: -0.3% MM, 0.6% YY
	Ex Food, Drink, Tobacco, Energy (Jan)	Forecast: 0.0% MM, 0.3% YY	Prior: 0.0% MM, 0.8% YY
	Surveys suggest that manufacturers' selling prices remain weak and, with the extra effect from falling oil prices, we expect that output prices will record another sharp drop this month. A figure in line with our forecast would imply the biggest YoY decline since 2009, when the low point was minus 1.6% YoY.		
Wed 18 Feb	*LFS Unemployment, 3-M Avg (Oct-Dec)*	Forecast: -83,000 QQ, 5.7% Rate	Prior: -58,000 QQ, 5.8% Rate
	LFS Unemployment Rate, Single Month (Dec)	Forecast: 5.7%	Prior: 5.6%
	Claimant Count Unemployment (Jan)	Forecast: -30,000 MM, 2.5% Rate	Prior: -29.7 MM, 2.6% Rate
	Average Earnings Ex Bonus (Dec)	Forecast: 1.6% YY, 1.8% 3-M YY	Prior: 1.7% YY, 1.8% 3-M YY
	With vacancies at a record high and survey evidence that demand for staff remains strong, we expect that the jobless rate will continue to fall rapidly. Base effects from a relatively large rise in average earnings ex bonuses a year ago (+0.4% MoM) may cap the YoY rate this month, but a further pickup in average earnings growth seems likely in coming months.		
Thu 19 Feb	*CBI Industrial Trends Survey (Feb)*		
	Monthly Output Expectations Net Bal. (Feb)	Forecast: +18%	Prior: +13%
	Monthly Order Books Net Balance (Feb)	Forecast: +6%	Prior: +4%
	Monthly Selling Prices Net Balance (Feb)	Forecast: -6%	Prior: -6%
	The January survey showed solid order books and very weak selling prices For the February survey, we expect prices to remain very weak, reflecting disinflationary global pressures, with a pickup in output expectations driven by the healthy trend in orders and low level of inventories.		
Fri 20 Feb	*Public Sector Net Borrowing (Jan)*	Forecast: £7.0bn surplus, £79.3 billion deficit fiscal year to date	
	(Ex Public Sector Banks)	Year Ago: £6.5bn surplus, £80.0 billion deficit fiscal year to date	
	The January figures usually produce a sizeable surplus, thanks to payments of income tax and corporation tax, and the same pattern is likely this year. Over the first nine months of the fiscal year, the cumulative deficit has been roughly stable from a year earlier.		
Fri 20 Feb	*Retail Sales Volumes (Jan)*	Forecast: -0.3% MM, 5.9% YY	Prior: 0.4% MM, 4.3% YY
	The January retail sales figure is often quite volatile – over the last ten years the standard deviation of the MoM changes for January is the highest for any month. Given that, and the strength of sales in recent months, we would not be surprised to see a slight drop in retail sales this month. A figure in line with our forecast would still, however, leave sales volumes 0.6% above the Q4 average and hence imply a continued solid trend.		
Thu 26 Feb	*Service Sector Output (Dec)*	Forecast: 0.4% MM, 3.5% YY	Prior: 0.1% MM, 3.2% YY
	The growth in services output slowed in November, with unusual weakness in the transport and communication sector plus a relatively low gain for financial and business surveys. Given the elevated level of survey readings for service sector growth, we anticipate a stronger gain this month, and a figure in line with our forecast would leave Q4 output up 0.8% QoQ.		
Thu 26 Feb	*GDP (Q4, 2nd Release)*	Provisional: 0.5% QQ, 2.7% YY	Prior: 0.7% QQ, 2.6% YY
	The headline figure for Q4 GDP growth (0.5% QoQ) already has been released and we do not anticipate major revisions at this stage (although historically the GDP growth data usually have been revised up). The split is likely to show strong gains in consumer spending and investment (we expect gains of roughly 1% QoQ and 2% QoQ respectively), offset by a marked reduction in stockbuilding (which appears to have hit imports of intermediate goods as well).		

Source: Citi Research

Figure 8. Economic Calendar, 9 February — 27 February 2015

9 February	10 February	11 February	12 February	13 February
G-20 Meeting of Finance Ministers & Central Bank Governors (Istanbul, Feb 9-10)	Industrial Production (Dec) Nov 0.0% MM, 1.1% YY Dec -0.2% MM, 0.5% YY Manufacturing Output (Dec) Nov 0.8% MM, 3.0% YY Dec 0.1% MM, 2.4% YY	Extraordinary Eurogroup Meeting on Greece	RICS House Price Survey (Jan, 00:01) Riksbank Outcome: 10bp Repo Rate Cut to -0.10%, QE Announced Bank of England's *Inflation Report* (10:30) Informal Meeting of EU Heads of State & Government (Brussels) (Feb 12-13)	Construction Output (Dec) Nov -1.8% MM, 5.8% YY Dec 0.4% MM, 5.5% YY
16 February	**17 February**	**18 February**	**19 February**	**20 February**
Eurogroup Meeting of EA Finance Ministers (14:00, Brussels)	Consumer Prices (Jan) Dec 0.0% MM, 0.5% YY JanE -0.8% MM, 0.3% YY Ex F, D, T, E (Jan) Dec 0.2% MM, 1.3% YY JanE -0.8% MM, 1.4% YY Retail Prices (Jan) Dec 0.2% MM, 1.6% YY JanE -0.9% MM, 1.0% YY RPIX – Ex Mortgages (Jan) Dec 0.2% MM, 1.7% YY JanE -1.0% MM, 1.0% YY Producer Input Prices (Jan) Dec -2.4% MM, -10.7% YY JanE -3.1% MM, -12.7% YY Producer Output Prices (Jan) Dec -0.3% MM, -0.8% YY JanE -0.3% MM, -1.4% YY Ex F, D, T, E (Jan) Dec 0.0% MM, 0.8% YY JanE 0.0% MM, 0.3% YY EcoFin Meeting of EU Finance Ministers (08:00, Brussels)	LFS Unemployment (Oct-Dec) Sep-Nov -58,000 QQ Oct-DecE -83,000 QQ LFS Unemployment Rate, 3-Month Avg (Oct-Dec) Sep-Nov 5.8% Oct-DecE 5.7% LFS Unemployment Rate, Single Month (Dec) Nov 5.6% DecE 5.7% Claimant Count Unemployment (Jan) Dec -29,700 MM, 2.6% Rate JanE -30,000 MM, 2.5% Rate Average Earnings Ex Bonus (Dec) Nov 1.7% YY, 1.8% 3-M YY DecE 1.6% YY, 1.8% 3-M YY MPC Minutes (Feb 5) BoE Agents' Summary of Business Conditions (Feb)	CBI Industrial Trends (Feb) Output Expectations (Feb) Jan +13% FebE +18% Order Books (Feb) Jan +4% FebE +6% Selling Prices (Feb) Jan -6% FebE -6%	Public Sector Net Borrowing ex Banks (Jan) Dec £6.5bn Surplus JanE £7.0bn Surplus Fiscal Year To Date Apr-Dec £80.0bn Deficit Apr-JanE £79.3bn Deficit Retail Sales Volumes (Jan) Dec 0.4% MM, 4.3% YY JanE -0.3% MM, 5.9% YY
23 February	**24 February**	**25 February**	**26 February**	**27 February**
CBI Distributive Trades Survey (Feb, 11:00)		BBA Loans for House Purchase (Jan)	Service Sector Output (Dec) Nov 0.1% MM, 3.2% YY DecE 0.4% MM, 3.5% YY GDP (Q4, 2nd Release) Q3 0.7% QQ, 2.6% YY Q4P 0.5% QQ, 2.7% YY Migration Statistics – Quarterly Report	*(Around Now)* Nationwide House Prices (Feb, 07:00)

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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