1 June 2012 │ 16 pages

UK Economics Weekly

MPC Likely to Resume QE, Other Easing Also May Follow

- We continue to expect that worsening economic prospects will prompt the MPC to expand QE markedly further — to a total of about £500bn — and that the next installment will occur soon. Timing is uncertain but, on balance, we forecast the MPC will expand QE by another £50bn at the June meeting.
- A delay in expanding QE might give the mistaken impression that the MPC believe they have little or no scope to ease further and are “keeping their powder dry” in order to use the remaining QE if the situation gets even worse. In practice, there is plenty of scope for more stimulus, either via QE or other options, in our view.
- We have some hope that the MPC will soon follow the advice of the IMF and the example of the Danish Central bank and cut rates again. But we do not include such a cut in our forecast at this stage. Other options for stimulus, if QE does reach its limits, include credit easing and temporary fiscal stimulus (or at least, sufficient tax cuts to offset the public spending squeeze for a year or two). If the euro crisis continues to worsen, all these options may quickly come into play, as well as a big increase in QE.

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

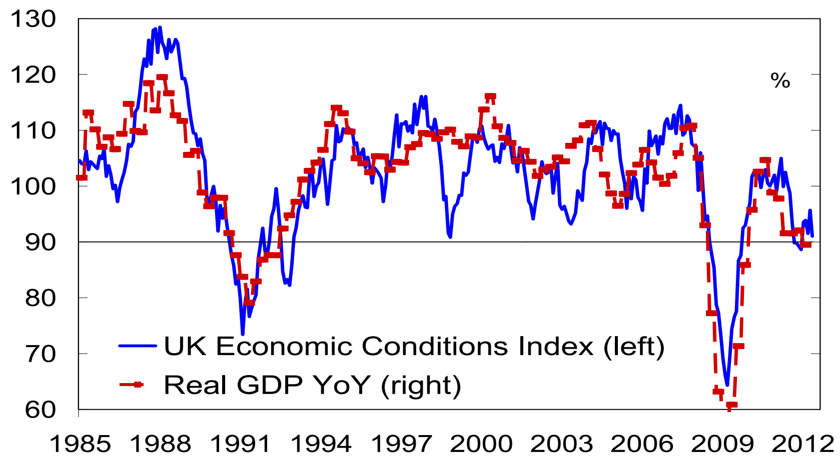
Ann O'Kelly
+44-20-7986-3297
ann.okelly@citi.com

Figure 1. Citigroup Market Forecasts

	Base Rate	QE Target	10 Year Yield	Spread vs Bunds	$/£	£/€
End 2012	0.50	£450bn	1.65	40bp	1.58	0.78
End 2013	0.50	£500bn	2.85	70bp	1.62	0.79

Source: Citi Investment Research and Analysis

Figure 2. UK — Economic Sentiment Index and Real GDP Growth, 1985-2012



Sources: ONS, European Commission and Citi Investment Research and Analysis

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

MPC Likely to Resume QE

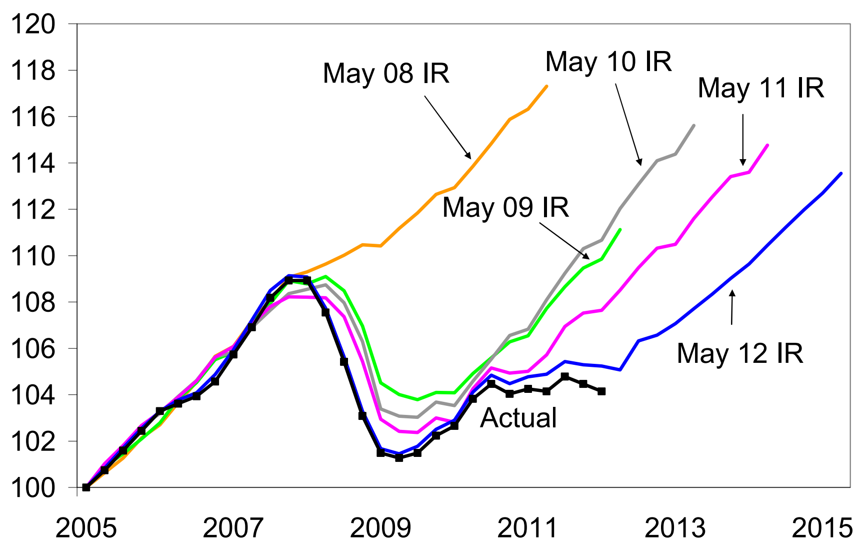
We continue to expect more QE soon, and the next installment may come in June — or soon after

We continue to expect that worsening economic prospects will prompt the MPC to expand QE markedly further over time — to a total of about £500bn — and that the next installment will occur soon, in the next few months[1]. We are unsure about the exact timing but, on balance, we forecast the MPC will expand QE by another £50bn at the June meeting. Nevertheless, it is quite possible that they will delay a month or two. Our key point is that QE will resume soon and become very large, not the exact month of the next step. We also have some hope that the MPC will follow the advice of the IMF and the example of the Danish Central bank and cut rates again. But we do not include such a move in our forecast at this stage.

At the May meeting, the MPC expected a solid recovery and worried about inflation stickiness

At the May meeting, the MPC voted 8-1 against further QE, reflecting worries about inflation stickiness and the MPC's forecast that the economy will soon return to its pre-crisis growth trend of about 2¾% YoY. This forecast followed the usual pattern of recent years: the MPC has repeatedly forecast an early return to solid economic growth and then, when recovery fails to materialise, has simply postponed its forecast recovery slightly. Nevertheless, the minutes acknowledged that QE was still an option "*For several members, the decision not to expand the asset purchase programme at this meeting was finely balanced. The Committee would continue to monitor the outlook each month and further monetary stimulus could be added if the outlook warranted it*."

Figure 3. UK — MPC "Backcasts" and Forecasts for Level of Real GDP, Indexed to Q1-2005 = 100, 2005-15



Note: The backcasts include the BoE's estimate for the expected revision to the ONS GDP data. We show the MPC's central forecasts with market rates. Sources: BoE, ONS and Citi Investment Research and Analysis

Recent MPC comments have been mixed

Recent MPC comments have been mixed: Some members have hinted at scope to resume QE soon. For example, Posen acknowledged that he may have been "*premature*" in judging that enough QE was in place[2], Weale argued that the weak Q1 GDP data "*strengthened the case for further support for the economy, for further asset purchases*"[3] and Bean said "*We have the scope to do more asset*

[1] See "Options for Extra Stimulus", UK Economics Weekly, 11 May 2012, and "Heading for Extra Stimulus", UK Economics Weekly, 25 May 2012, Michael Saunders, Citi.

[2] See comments on 18 May 2012.

[3] Comments in BBC interview 24 May 2012.

purchases."[4] By contrast, Dale stressed the stickiness of inflation, while Broadbent argued that investment might rebound if the EMU crisis fades.

Those MPC comments may not fully reflect the recent further marked deterioration in the economy's prospects…

Nevertheless, all these MPC comments may not fully reflect the recent marked deterioration in data and news, with the 2.3% plunge in April retail sales, downward revision to Q1 GDP, nominal GDP growth of just 1.9% YoY and worsening EMU crisis. The past week's data continue the gloomy trend:

…with a large decline in the EC survey for the UK…

- The European Commission reports that their Economic Sentiment Index (ESI) for the UK fell sharply in May, the biggest monthly drop since Aug-11 and the 10th biggest monthly drop of the last ten years. This is by far the widest monthly economic survey in the UK, covering readings from manufacturing, services, construction, retail and consumers. The current level suggests the economy is stagnant, with no sign of the solid H2 recovery expected by the MPC.

…notably gloomy readings for manufacturing and consumers…

- Within that survey, the reading for manufacturing confidence is the lowest since Jan-10, and consumer confidence remains very depressed. The net balance of consumers who intend to spend more on major purchases over the next year is the lowest since Oct-11 and the 12th lowest since the survey began in 1985.

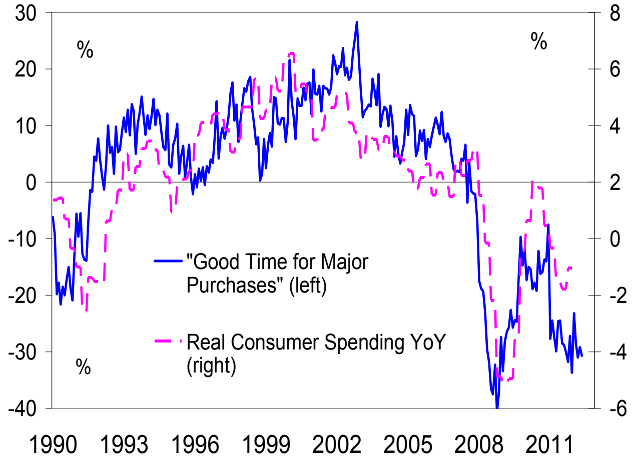
…and the sharp drop in the manufacturing PMI…

- The manufacturing PMI plunged by 4.3 points (second biggest decline since the survey began in the early 1990s) to 45.9 in May, the lowest since early-09. The MPC recently have been putting a lot of weight on the PMIs (which were less weak than other surveys) and hence the sharp drop in this index is likely to have a major effect on their assessment.

…while the rise in deposit rates threatens to tighten monetary conditions further

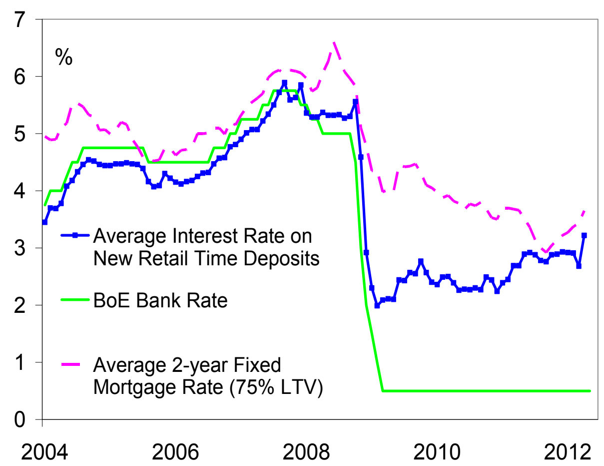
- The BoE report that, with the intense competition among banks for deposits, the average interest rate on new sterling personal time deposits jumped by 54bp in April to 3.22%, the highest since Nov-08 (when the BoE policy rate was 3.0%). The rise in deposit rates is now feeding through to higher mortgage rates, implying that a failure to cut the Bank Rate or expand QE will cause monetary conditions to tighten.

Figure 4. UK — Consumer Confidence and Consumer Spending, 1990-2012



Sources: European Commission, ONS and Citi Investment Research and Analysis

Figure 5. UK — BoE Bank Rate and Average Interest Rate on New Retail Time Deposits, 2004-12



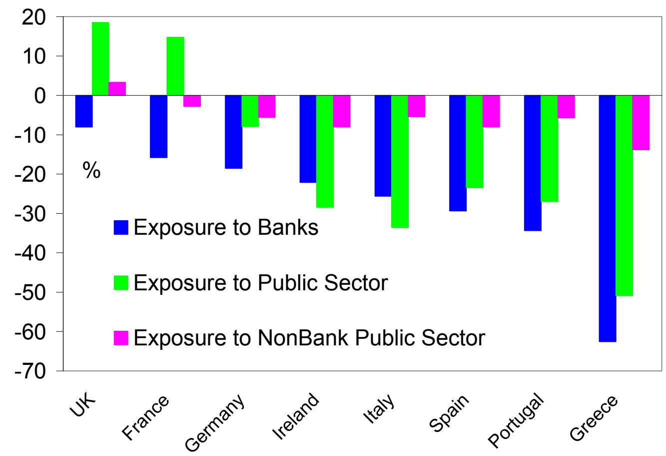
Sources: BoE and Citi Investment Research and Analysis

[4] Interview with the Eastern Daily Press, 31 May 2012.

The worsening EMU crisis is likely to hit UK exports further

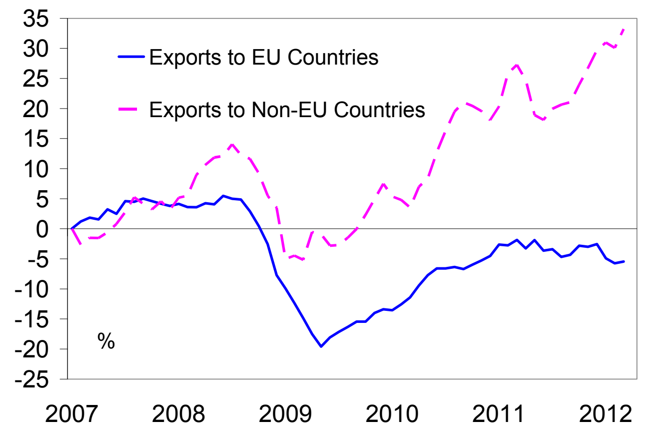
- The EMU crisis has escalated markedly further, with weak activity data and soaring sovereign risk premia. Recent BIS data (released April 25) show that European financial integration continues to unwind, with a further sharp drop in credit from foreign banks to the private and public sectors in EMU periphery countries. The exposure of foreign banks to domestic banks in Ireland, Italy, Spain, Portugal and Greece all fell by more than 20% YoY in Q4-11, In all these five countries, the exposure of foreign banks to domestic banks is down by more than 60% from the 2007-08 peak, hence exacerbating the deterioration in credit availability in periphery countries. Aside from the potential exposure of UK banks, the UK trade data also show early signs of the adverse effect on UK growth. Export volumes (ex oil and erratics) to other EU countries fell 3.7% YoY in Q1-12 and remain 5½% below the level of five years earlier (Q1-07). By contrast, export volumes to non-EU countries have risen by 33% over the last five years.

Figure 6. Selected EU Countries -- YoY Change of Credit to Public and Private Sectors from Foreign Banks, Q4-2011



Sources: BIS and Citi Investment Research and Analysis

Figure 7. UK — Cumulative Growth in Export Volumes Since Jan-2007 (3-month average), 2007-12



Sources: ONS and Citi Investment Research and Analysis

In our view, the MPC need to discard their previous forecast of early recovery and act to lift the economy out of stagnation

To be sure, a decision to resume QE in June would imply a quick turnaround for many on the MPC. But a quick turnaround is warranted, in our view, by the wide gap between the MPC's latest forecast of recovery and the alarming trend of recent data. In our view, there is no valid reason for the MPC to accept ongoing stagnation in the economy. Back in 2007-08, one could argue that the economy needed to slow in order to cool the overheated labour market and housing market, and to end the debt-fuelled boom before balance sheets got even more overextended. Moreover, in 2010 and early 2011, it was possible to believe that the stimulus from QE1 plus the boost to exports from the low pound would overcome the drag of private deleveraging to produce a solid recovery. But now, with the economy having stalled and the worsening EMU crisis, the UK faces an unnecessary further period of economic stagnation and rising unemployment.

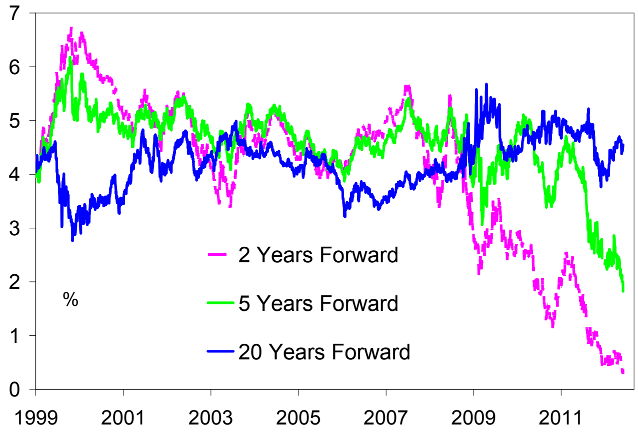
In our view, delay would probably be more risky than early action

There are always valid arguments for waiting a month or two to see how data and events unfold. But there is a cost to delay, in that delayed stimulus would probably imply a more extended period of economic weakness. Moreover, delay might give the mistaken impression that the MPC believe they have little or no scope to ease further and are "keeping their powder dry" in order to use the remaining QE if the situation gets even worse. In practice, there is plenty of scope for more stimulus, either via QE or other options, in our view.

Although gilt yields are low, there is still scope for extra QE to pull forward yields even lower…

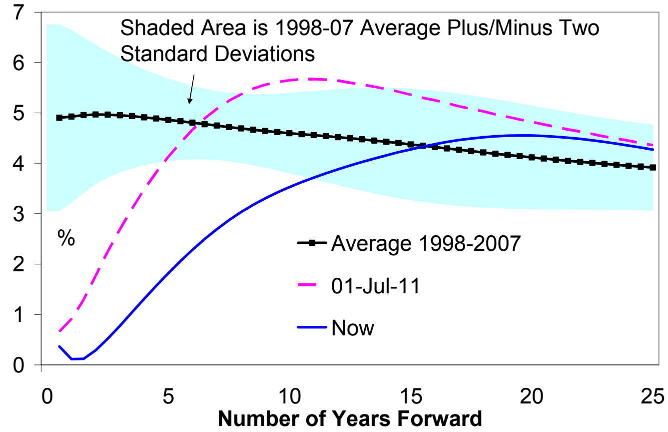
Of course, gilt yields are now extremely low, with 10-year yields at record lows. But forward yields from 10 years onwards exceed 3½% and rise above 4% from about 13 years out. There is ample scope to use QE to pull these longdated forward yields lower. Moreover, even if gilt yields fall so far (ie close to zero) that they cannot be pushed down further, more QE may still have some advantage in keeping yields low and also expanding liquidity and money growth.

Figure 8. UK — Instantaneous Forward Yields (from Gilt Curve), 1999-12



Note: We show instantaneous forward yields.
Sources: BoE and Citi Investment Research and Analysis

Figure 9. UK — Forward Gilt Yield Curve, 1998-2012



Note: We show instantaneous forward yields.
Sources: BoE and Citi Investment Research and Analysis

…and there are plenty of other policy options if the MPC do reach the limits of QE

Moreover, the UK still has plenty of scope to add further stimulus even once QE has been pushed as far as it can go (ie gilt yields close to zero across the whole curve. BoE holds most of the gilt market). The MPC can cut Bank Rate further, and buy high-quality private sector assets instead of gilts. Credit easing can be implemented: the government could recapitalize the state-owned banks and pressure them to lend at low interest rates to UK businesses and households; or the government could authorize the BoE to buy securitized packages of bank loans; or the BoE could do ECB-style LTROs. In addition, the government can introduce temporary fiscal loosening — via tax cuts or capital spending — that aims to neutralize the heavy fiscal retrenchment that currently is planned for 2013. These measures need not be alternatives, but can be combined or done in sequence. If the situation continues to worsen, the UK in coming months may go the whole series: QE, followed by a lower Bank Rate and credit easing, with fiscal loosening (financed by even more QE). In our view, the ultra-low level of gilt yields is practically an invitation to the government to implement temporary fiscal loosening.

The IMF now judges that fiscal tightening should not be more than about 1% of GDP at present

The UK does need to have a credible plan to return to fiscal sustainability over time. But, it is quite reasonable, in our view, to vary the speed of tightening according to external conditions. An important new IMF study argues that fiscal tightening inevitably will lead to weaker growth and, if fiscal tightening is too front-loaded, the resultant weakness in growth may prevent the debt/GDP ratio from falling. The IMF argued: "*The pace at which, on average, advanced economies have adjusted their fiscal accounts in 2011-12 (about 1 percentage point per year) seems to strike the right balance between the need to consolidate the fiscal accounts and the need to avoid an excessively fast withdrawal of fiscal stimulus in the economy.*"[5]

[5] See "*Walking Hand in Hand*", IMF Working Paper, May 2012.

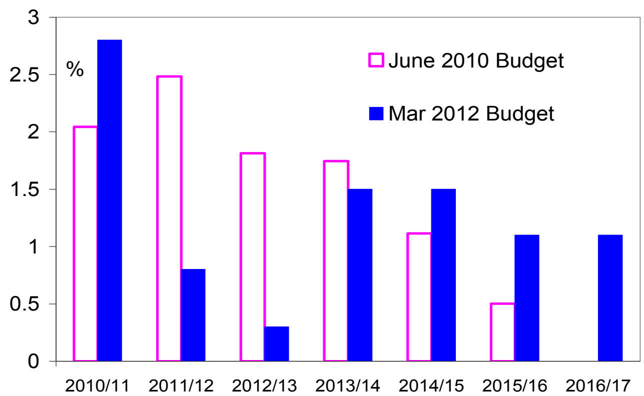
The existing fiscal plans imply fiscal tightening of about 1½% of GDP for each of the next two years

At present, the UK plans fiscal tightening of about 1½% of GDP for both the 13/14 and 14/15 fiscal years (in terms of the cyclically adjusted primary balance) — well above that 1% benchmark — after just 0.3% of GDP in the current year (12/13).

The UK's fiscal framework has clear medium-term targets but allows considerable temporary flexibility

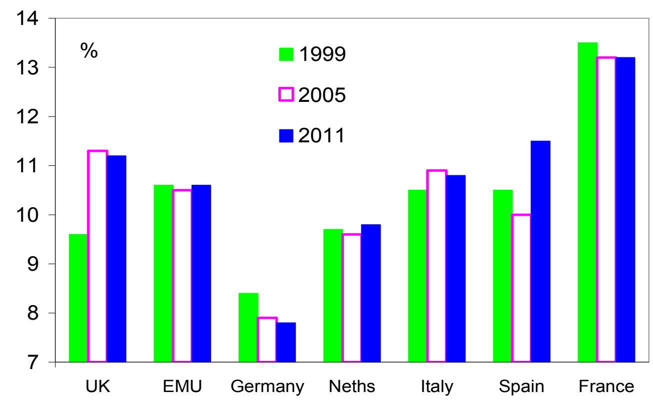
The UK's fiscal framework has clear medium-term targets (cyclically adjusted current balance and falling debt/GDP ratio) but allows ample flexibility over the pace of consolidation. For example, in the June 2010 Budget, the Chancellor aimed to hit both fiscal rules in 14/15. With the weak economy and gloomier view of the structural fiscal balance, the 2012 Budget showed a one-year delay in the planned drop in the debt/GDP ratio (to 15/16) and a two-year delay in the planned elimination of the cyclically adjusted current deficit (to 16/17). The planned fiscal tightening in the current year (12/13) has been reduced from 1.8% of GDP in the June-2010 Budget to just 0.3% of GDP in the March-2012 Budget.

Figure 10. UK — Planned Annual Fiscal Tightening (Pct of GDP), Fiscal Years 2010/11-2016/17F



F Forecast. Note: fiscal tightening measured as change in cyclically adjusted fiscal stance. Sources: HM Treasury and Citi Investment Research and Analysis

Figure 11. Selected Countries — Public Sector Wages and Salaries as Pct of GDP, 1999-2011



Note: Data cover general central, regional and local government, not public corporations. Sources: OECD and Citi Investment Research and Analysis

The Chancellor may limit next year's fiscal tightening to about 1% of GDP if the economy is weak but the EMU crisis does not worsen, with the option of a neutral fiscal stance in 13/14 if the euro area crisis gets much worse

If the economy stays weak but the EMU crisis does not worsen further, the Chancellor may use the Autumn Statement to announce fiscal easing of about ½% of GDP (£8bn) for the 13/14 fiscal year — so that the fiscal stance will tighten by only 1% of GDP rather than the currently planned 1½% of GDP. If the euro crisis quickly gets much worse, then the Chancellor could plausibly implement temporary loosening of 1½% of GDP (£24bn) for 13/14, through tax cuts and capital spending. Combined with the existing restraint of 1½% of GDP (focused mainly on current spending), this would mean a roughly neutral overall fiscal stance in 13/14.

A continued squeeze on public sector pay would support medium-term fiscal credibility and allow scope for temporary stimulus

In effect, such a policy would use the squeeze on current spending to finance tax cuts and extra public investment rather than a lower deficit. This is in line with the IMF's recent recommendation, which especially highlighted scope for the UK to cut public sector pay further[6]. The UK's public sector pay bill rose from 9.6% in 1999 to 11.3% in 2005: the rise (1.7 percentage points) matches Hungary's as the biggest rise among EU countries. This ratio remained high in 2011 — at 11.2% of GDP — and exceeds the EMU average (10.6% of GDP in 2011) and Italy (10.8% of GDP). This ratio is well above that in Germany (7.8%), although still some way below France (13.2% of GDP). As the IMF recently argued, provided the government continues to bear down on such current costs, a temporary easing up on overall fiscal consolidation would probably not harm the UK's medium-term fiscal credibility.

[6] See IMF Article IV report, May 2012.

Economic Indicators

Date	Indicator	Forecast	Prior
Thu 7 Jun	***Services PMI (May)***	**Forecast: 52.5**	**Prior: 53.3**
	We expect to see another drop in this index, as the enthusiasm early in the year continues to wane and the EMU crisis takes its toll.		
Fri 8 June	***Producer Input Prices (May)***	**Forecast: -1.6% MoM, 1.1% YoY**	**Prior: -1.5% MoM, 1.2% YoY**
	With declines in oil and nonoil commodity prices, plus the recent appreciation of sterling, we expect these data will show a sizeable MoM decline in input prices. Indeed, a figure in line with our forecast would be the biggest MoM decline since Dec-08 and would put the YoY gain at the lowest since late-09.		
Fri 8 June	***Producer Output Prices (May)***	**Forecast: 0.1% MoM, 3.2% YoY**	**Prior: 0.7% MoM, 3.3% YoY**
	Output Prices Ex Tax (May)	**Forecast: 0.1% MoM, 3.1% YoY**	**Prior: 0.6% MoM, 3.2% YoY**
	Excluding Food, Drink, Tobacco, Energy (May)	**Forecast: 0.2% MoM, 2.3% YoY**	**Prior: 0.6% MoM, 2.3% YoY**
	The sluggish economy and lower commodity prices are likely to pull output price inflation lower again, and a figure in line with our forecast would put the YoY rate at the lowest since late-09. Further weakness is likely in coming months.		
Tue 12 Jun	***Industrial Production (Apr)***	**Forecast: -0.1% MoM, -1.0% YoY**	**Prior: -0.3% MoM, -2.6% YoY**
	Manufacturing Output (Apr)	**Forecast: -0.4% MoM, 0.0% YoY**	**Prior: 0.9% MoM, -0.9% YoY**
	In March, industrial production was depressed by weakness in output of utilities and the energy sector, despite a gain in manufacturing output. For the April data, we expect output of the utilities and energy sectors to rebound a bit, but expect manufacturing to fall back – hence producing another small decline in industrial production. Such a figure would leave industrial production in April a little below the Q1 average.		
Fri 15 Jun	***Trade Balance – Goods & Services (Apr)***	**Forecast: £-3.0 billion**	**Prior: £-2.7 billion**
	Export growth slowed in Q1, with volumes (goods ex oil and erratics) up just 0.3% YoY, after growth of 5.8% YoY in Q4. Exports to euro area countries fell outright, reflecting the weakness of activity in that region, although exports to non-EU countries continue to grow steadily. We expect the trade deficit will continue to drift wider in coming months as the euro area crisis takes its toll on UK exports.		
Tue 19 Jun	***Consumer Prices (May)***	**Forecast: 0.1% MoM, 2.9% YoY**	**Prior: 0.6% MoM, 3.0% YoY**
	CPI Ex Food, Drink, Tobacco, Energy (May)	**Forecast: 0.1% MoM, 2.3% YoY**	**Prior: 0.6% MoM, 2.1% YoY**
	Retail Prices (May)	**Forecast: 0.3% MoM, 3.4% YoY**	**Prior: 0.7% MoM, 3.5% YoY**
	RPIX – Excludes Mortgages (May)	**Forecast: 0.3% MoM, 3.4% YoY**	**Prior: 0.7% MoM, 3.5% YoY**
	The AA report that unleaded petrol prices fell 4.1p/litre in May, the biggest MoM drop since Dec-08 (when prices fell 5.7p/litre). This drop, coupled with base effects from the modest rise in petrol prices a year ago, is likely to take about 0.2% off the YoY CPI inflation rate in May. We expect this will bring the YoY CPI inflation rate just below 3.0%, the first sub-3.0% figure since late-09. We expect CPI inflation will fall back to the 2.0% target around yearend.		
Wed 20 Jun	***Claimant Count Unemployment (May)***	**Forecast: +5,000 MoM, 4.9% Rate**	**Prior: -13,700 MoM, 4.9% Rate**
	LFS Unemployment (Feb-Apr)	**Forecast: -26,000 QoQ, 8.3% Rate**	**Prior: -45,000 QoQ, 8.2% Rate**
	Both the claimant count and LFS measures showed falling unemployment last month, but we expect slight divergences this month with a decline in the LFS measure and slight rise in the claimant count. The labour market has been noticeably less weak than the GDP data recently, and the reasons for this are not yet clear.		
Thu 21 Jun	***Retail Sales Volumes (May)***	**Forecast: 1.2% MoM, 2.1% YoY**	**Prior: -2.3% MoM, -1.1% YoY**
	Retail sales volumes have been volatile recently, with a large weather-related gain in March (up 2.0% MoM) followed by a large weather-related drop in April (down 2.3% MoM). The weather for May has been more mixed, warming up during the month, and sales additionally may be lifted by sales of Diamond Jubilee souvenirs. Hence we expect a partial rebound – but this would still leave the average level of retail sales in April and May 0.7% below the Q1 average.		

Economic Calendar, 28 May — 15 June 2012

28 May	29 May	30 May	31 May	1 Jun
			GfK Consumer Confidence (May, 00:01) Apr -31 May -29 **Nationwide House Prices (May, 07:00)** Apr -0.3% MoM, -0.9% YoY May 0.3% MoM, -0.7% YoY **Ireland: Referendum on EU Fiscal Treaty**	**Manufacturing PMI (May)** Apr 50.5 May 45.9
4 June	**5 June**	**6 June**	**7 June**	**8 June**
Jubilee Bank Holiday	**Jubilee Bank Holiday** **Bank of Canada: Interest Rate Announcement**	**M&A Involving UK Companies (Q1)** **MPC Meeting Starts** **ECB Meeting:** 12:45 Outcome 13:30 Press Conference	**Services PMI (May)** Apr 53.3 MayE 52.5 **MPC Meeting: Outcome at Noon** *Around Now* **Halifax House Prices (May, 09:00)**	**Producer Input Prices (May)** Apr -1.5% MoM, 1.2% YoY MayE -1.6% MoM, 1.1% YoY **Prod. Output Prices (May)** Apr 0.7% MoM, 3.3% YoY MayE 0.1% MoM, 3.2% YoY **Excluding Tax (May)** Apr 0.6% MoM, 3.2% YoY MayE 0.1% MoM, 3.1% YoY **Ex Food, Drink, Tobacco, Energy (May)** Apr 0.6% MoM, 2.3% YoY MayE 0.2% MoM, 2.3% YoY **BoE/GfK NOP Inflation Attitudes Survey (May)** **New Construction Orders (Q1)** **BoE's Andy Haldane Speaks at Univ. of Edinburg (11:00)**
11 June	**12 June**	**13 June**	**14 June**	**15 June**
	RICS House Price Survey (May, 00:01) **Industrial Production (Apr)** Mar -0.3% MoM, -2.6% YoY AprE -0.1% MoM, -1.0% YoY **Manufacturing Output (Apr)** Mar 0.9% MoM, -0.9% YoY AprE -0.4% MoM, 0.0% YoY		**Swiss National Bank Monetary Policy Assessment (08:30)**	**Trade Balance – Goods & Services (Apr)** Mar £-2.7bn AprE £-3.0bn **Construction Output (Apr)**

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.

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Notes

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Appendix A-1

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