

Economics

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UK Economics Weekly

Heading for Extra Stimulus

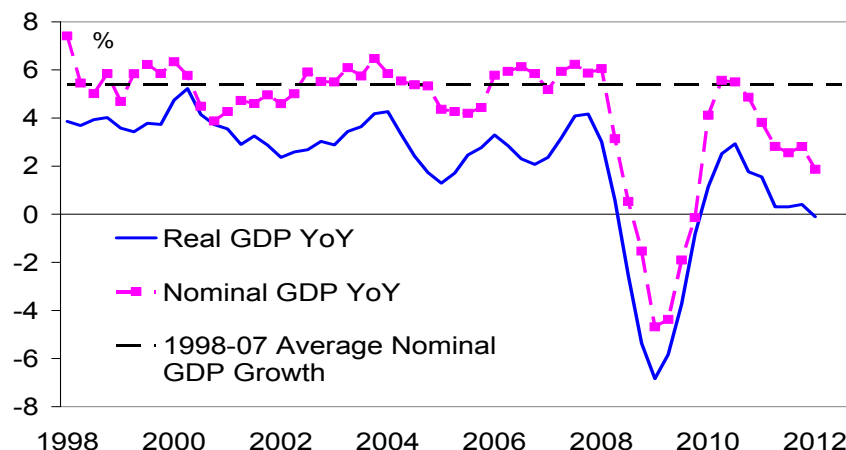
- The case for extra stimulus is rapidly coming together in the UK, reflecting weak economic data, slowing inflation and the escalating EMU crisis. Real GDP has fallen significantly for two consecutive quarters and nominal GDP growth is down to just 1.9% YoY — a woefully inadequate pace and far below the pre-crisis norm of 5-5½% YoY. We expect UK growth to be around zero this year. Moreover, in our view, the long period of inflation stickiness (caused chiefly by the huge overheating in the economy during the boom and the pound's plunge in 2007-09) is now coming to an end. YouGov report that inflation expectations have fallen back and, barring new external cost pressures, CPI inflation is likely to fall below target next year.
- We continue to expect a sizeable further expansion of QE, with the next instalment soon, perhaps even in June. The MPC should also cut Bank Rate, in our view, although we do not include a cut in our central forecast. Other additional options for stimulus — credit easing and temporary fiscal stimulus — also are coming into play, especially if the EMU crisis escalates. The UK's economic position and prospects are sufficiently gloomy that action is more likely and less risky than inaction, in our view.

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 – Real and Nominal GDP YoY, 1998-2012



Sources: ONS and Citi Investment Research and Analysis

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

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Heading for Extra Stimulus

The case for extra stimulus is gathering force and policy moves are likely

The MPC have made it clear they are ready to restart QE if the situation worsens

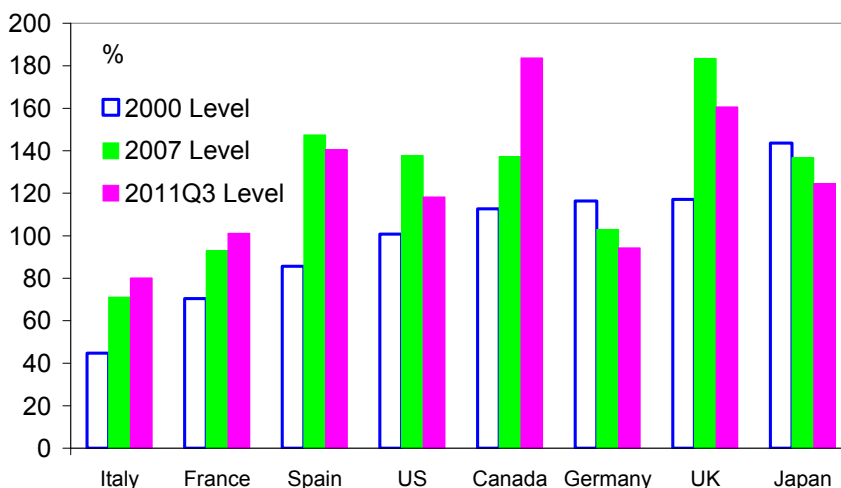
The OECD highlight the drag from high household debt in the UK...

The case for extra stimulus is rapidly coming together in the UK, reflecting weak economic data, slowing inflation, and the escalating EMU crisis. We continue to expect a sizeable further expansion of QE, and other additional options — lower Bank Rate, credit easing and temporary fiscal stimulus — also are coming into play. The UK's economic position and prospects are sufficiently gloomy that action is more likely and less risky than inaction, in our view.

First, the MPC minutes and comments confirm that the Committee still believes that QE is a useful tool if inflation seems likely to undershoot the target, and that the MPC was not far from expanding QE further in May. The minutes make it clear that the MPC do not believe QE has exhausted its power to boost activity. Moreover, Deputy Governor Charlie Bean's speech sought to counter the argument that QE cannot be expanded because it harms pension funds, arguing that the boost to equity values from QE roughly offset the QE-induced drop in gilt yields and resultant rise in pension liabilities¹. Nor is QE reserved only for cases where outright deflation threatens. Rather, with the MPC's forecast that inflation will undershoot the target 2-3 years ahead even if the EMU crisis fades, the minutes note: *"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 stimulus could be added if the outlook warranted it."* QE is still very much on the MPC's agenda.

Second, comments and forecasts from the OECD and IMF endorse the case for extra stimulus. The IMF, with a downbeat assessment of the economy's prospects, calls for the early implementation of extra QE, a lower Bank Rate, plus credit easing, with temporary fiscal stimulus as well if the economy remains weak (which it probably would if the EMU crisis escalates)². OECD data show that the UK household debt/income ratio rose by 66 percentage points from 2000 to 2007, the biggest rise among G7 countries and far ahead of the increases in the US (37 percentage points) and the euro area (20 percentage points)³.

Figure 3. G7 (Plus Spain) -- Household Debt/Income Ratios, 2000-2011



Sources: OECD and Citi Investment Research and Analysis

¹ See speech on 23 May 2012.

² See the IMF Article IV Report on the UK, May 2012.

³ In Canada, the household debt/income ratio has continued to rise since 2007 and the total rise from 2000 to 2011 exceeds that in the UK. Source: OECD Economic Outlook, May 2012.

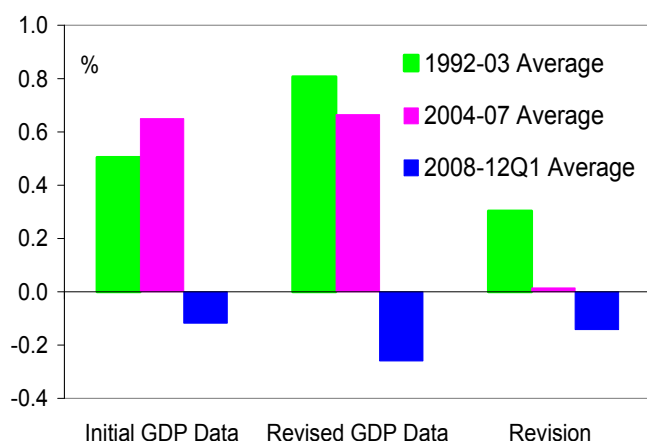
...and warn that the UK may face a decade of deleveraging

Economic data are worsening, with weak Q1 GDP, lower retail sales and softer manufacturing activity

With that debt overhang, the OECD warns that the drag from household deleveraging is likely to be far more protracted than in the US, and that the UK may face a decade of deleveraging: "In the United States, should deleveraging continue at its pace over the past four years, with continued significant write-downs of household debt, the debt ratio would regain its 2000 level in 2015. For households in the United Kingdom, at the speed observed since 2008, the adjustment period would be longer, at around ten years, reflecting the larger debt overhang." As a result, the OECD warns that for the UK "household deleveraging is likely to limit consumption growth over the projection period." In turn, the OECD forecasts that "Unemployment will continue to rise, and will likely reach 9% of the labour force in 2013". With core inflation running at about 1.7% in both 2012 and 2013, the OECD expects CPI inflation to fall a little below target next year.

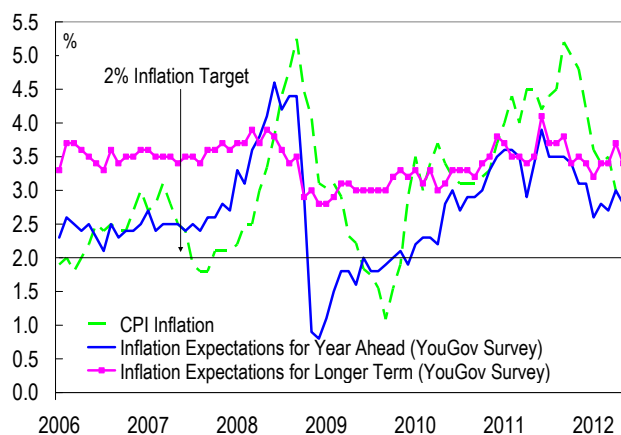
Third, economic data are worsening. The ONS report continued weakness in both real and nominal GDP in Q1, with real GDP down 0.1%YoY and nominal GDP up just 1.9%YoY — a pace that is woefully inadequate to achieve trend growth and hit the inflation target, and far below the pre-crisis norm of 5-5½% YoY. The fact that Q1 growth was revised down matches the recent pattern: GDP growth on average was revised up by 0.3% QoQ from the initial data during 1992-03. But, this upward revision bias disappeared around 2004 and since 2008, revisions so far have been downwards on balance. The dive in April retail sales (down 2.3% MoM) was of course exaggerated by the poor weather, but highlights the extent to which the March surge (up 2.0% MoM) was boosted by good weather. In addition, the CBI report a sharp deterioration in manufacturing industry output expectations and order books in May, reversing recent gains. And of course, the EMU crisis continues to escalate, with worsening economic data, poor credit availability and heightened sovereign risk premia. We now expect UK growth to be about zero this year, with sizeable declines in euro area GDP in both this year and 2013⁴.

Figure 4. UK – Initial and Revised Data for QoQ GDP Growth, 1992-2012



Sources: ONS and Citi Investment Research and Analysis

Figure 5. UK – CPI Inflation and Inflation Expectations, 2006-12



Sources: YouGov, ONS and Citi Investment Research and Analysis

Inflation expectations fell back in May...

To be sure, UK CPI inflation is likely to remain above target near term. However, inflation expectations have not been destabilised by the long inflation overshoot. YouGov report that longterm inflation expectations fell back to 3.4% YoY in May, the same as in March, having blipped up to 3.7% YoY in April⁵. Pay deals and average

⁴ See "Global Economic Outlook and Strategy - May 2012", Willem Buiter et al, 23 May 2012, Citi.

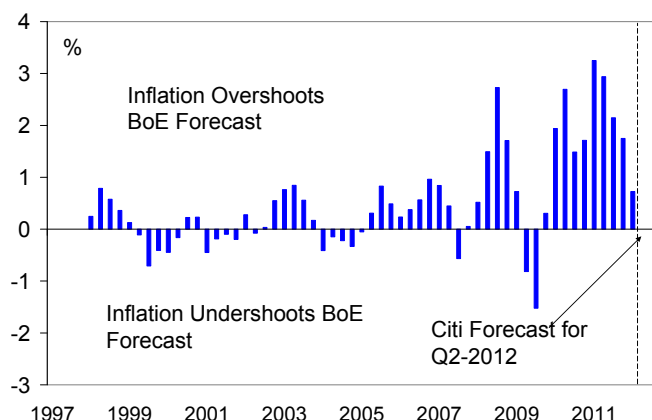
⁵ See "UK – YouGov Reports Lower Inflation Expectations", Michael Saunders, 25 May 2012, Citi.

earnings growth remain extremely weak. IRS report that the median for pay deals fell back to 2.0% in the three months ended April (with a rising number of pay freezes) from 2.5% in Q4-11

...and the long period of inflation stickiness appears to be ending

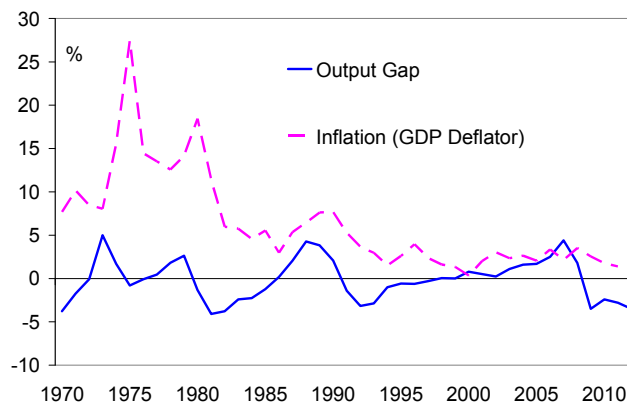
Moreover, the period of inflation stickiness appears to be ending. CPI inflation fell to 3.0% YoY in April, a little below consensus and, with petrol prices falling, we expect that Q2 inflation will be 3.0-3.1% YoY. Our forecast implies that Q2 CPI inflation will undershoot slightly versus the MPC's forecast in the May-12 *Inflation Report* (3.2%), and will roughly match the MPC's forecast of a year ago (May-11 IR forecast 3.0-3.1% CPI inflation for Q2-2012). By contrast, YoY inflation has overshoot the MPC's forecasts made a year earlier in every quarter since Q2-05, apart from one quarter in 1007 and the temporary tax-driven undershoot during 2009.

Figure 6. UK – Outturns for Inflation Compared to BoE Forecasts Made Four Quarters Earlier, 1997-2012



Note: We use RPIX inflation to end 2004, CPI inflation since then. We compare inflation outturns with the MPC's central forecast with stable rates.
Sources: BoE, ONS and Citi Investment Research and Analysis

Figure 7. UK – Output Gap and Inflation, 1970-2012



Note: A positive output gap implies that the economy is overheating, a negative output gap implies the economy has spare capacity. GDP deflator measured at basic prices.
Sources: OECD, ONS and Citi Investment Research and Analysis

In our view, the recent inflation stickiness reflects two major factors, which the MPC and consensus have not allowed enough for, but both of which are now fading:

The MPC and consensus probably have made major errors of output gap mismeasurement in recent years...

- First, the MPC and consensus probably misjudged the extent to which the economy was overheating during the period 2000-07, creating an overhang of domestic inflation pressures. The OECD now believe that output was above potential every year during 2000-07 (ie there was a positive output gap). This persistent positive output gap was reflected to an extent in the relatively high growth of unit labour costs and services inflation in the boom (although the pass-through to CPI inflation was offset by the sharp drop in import prices from the strong pound and globalisation). The OECD judge that the positive output gap hit 4.4% of GDP in 2007⁶, similar to the peak of the 1980s boom (positive output gap of 4.3% of GDP in 1988) and not far below the positive output gap in 1973 (5.0% of GDP). The OECD believes the UK had the greatest overheating (ie biggest positive output gap) among G7 countries in 2007. Output gap estimates are notoriously uncertain and in 2007, the OECD judged the output gap was close to zero. But, even with hindsight, the MPC have not acknowledged that the economy was overheated in the boom. If the OECD's latest output gap estimates

⁶ This was reflected in the low jobless rate but also in the overshoot of productivity growth versus prior trends during the boom. Conversely, the move to a negative output gap has been reflected in lower employment and marked weakness in productivity.

...and also understated the inflationary boost from the low pound

Barring new external inflationary shocks – inflation probably will fall below target next year

We expect more QE soon, and a lot more QE in total...

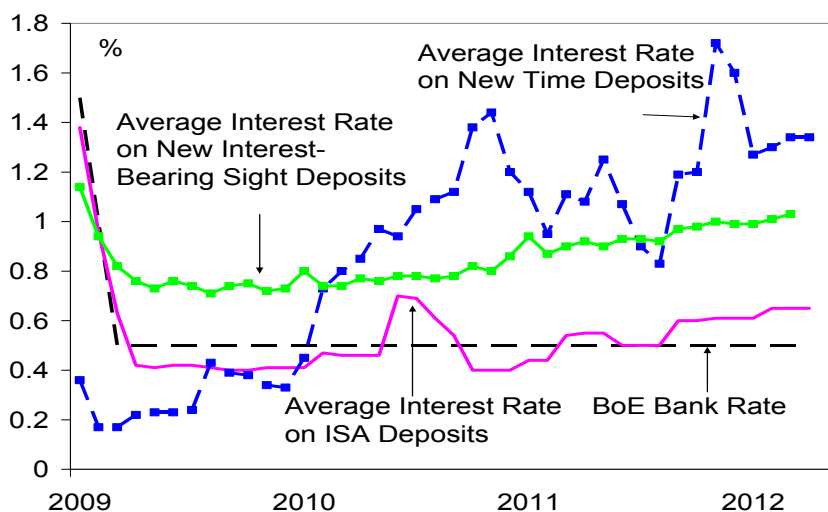
are anything like correct, then the persistent stickiness of services inflation is not so surprising after all, especially given the tendency of inflation to respond only slowly to output gap changes. However, even with recent weakness in potential growth, the OECD believes the UK now has a negative output gap (ie output is below potential) of 3½% of GDP, implying sizeable persistent disinflation pressures that are squeezing margins and gradually pull inflation down over time.

- Second, the inflation boost from the sharp drop in sterling (the trade-weighted index fell by about 25% between mid-07 and mid-09) is now diminishing. The pass-through from major swings in import prices to consumer prices typically takes several years to complete, affecting services as well as goods. But, this effect now is past its peak - implying reduced inflation pressure.

These pressures were exacerbated by increases in energy prices and indirect taxes in 2010-11. However, we expect that — barring new external cost shocks — CPI inflation will fall back to the 2% target around the end of this year or in early 2013, staying below target in later years.

We share the IMF's view that a multi-faceted approach to easing is appropriate. We expect the MPC will resume QE soon, probably in the next few months, and this could even come at the June meeting if the EMU crisis continues to escalate and data continue to worsen. We continue to expect that QE will reach about £500bn over the next year. The consensus view recently was that the MPC would not expand QE further but, after recent events, we expect the consensus now will quickly swing back in favour of extra QE.

Figure 8. UK – BoE Bank Rate and Key Retail Deposit Rates, 2009-12



Sources: BoE and Citi Investment Research and Analysis

...and there is a good case for the BoE to cut rates in our view

Moreover, as we argued recently, we believe there is a good case for the MPC to cut Bank Rate to 25bp or even lower, perhaps to 10bp or so⁷. In 2009, the BoE decided not to cut Bank Rate below 50bp on the grounds that, with retail deposit rates close to zero, a further cut in Bank Rate would either require banks to set negative retail deposit rates (hence possibly triggering a mass exodus of funds from

⁷ See "MPC Pave Way For Extra Stimulus", UK Economics Weekly, 18 May 2012, Michael Saunders, Citi.

the banking system) or hit banks' margins because variable mortgage rates would fall more than deposit rates. Moreover, the BoE feared that banks' margins would be further squeezed by the requirement to pay negative interest rates on tracker mortgages that had been fixed at below Bank Rate in the boom. These arguments have lost force, in our view. The average interest rate on retail time deposits has risen by 117bp since early 2009 (from 17bp in March-09 to 134bp now), and the rise in retail deposit rates is now beginning to lift mortgage rates. The argument that deposit rates have hit the zero lower bound no longer applies. Moreover, the number of tracker mortgages fixed below Bank Rate must be very small, given that the average spread above Bank Rate on variable rate mortgages is 257p. The BoE can (and in our view should) cut Bank Rate to add stimulus (although we currently do not have a rate cut in our forecast).

Credit easing is back on the agenda...

Credit easing could be done through a variety of means, including BoE purchases of corporate bonds, purchases of securitised new bank loans to SMEs, or an ECB-style LTRO programme. We suspect the first two are more likely, although at present it appears that the BoE and Treasury are both waiting for each other to propose such a scheme. We suspect the BoE would view an LTRO programme as an ineffective means of credit easing, on the not-unreasonable grounds that banks would probably pocket the gains from cheaper long-term funding and fail to pass them on to SMEs in the UK.

...and temporary fiscal easing is possible if the escalating EMU crisis takes a major toll on the UK

Temporary fiscal stimulus is unlikely straight away, being reserved as an option once monetary policy and credit easing have been exhausted. We share the IMF's view that the government was correct to implement in 2010 a credible medium-term plan to regain fiscal sustainability over time. Indeed, the credibility gained by the UK's tough fiscal consolidation plans now creates scope for temporary loosening if the EMU crisis takes a major toll. In terms of the impact on growth, fiscal policy is likely to be more powerful than monetary policy because, with high private debts, even ultra-low interest rates may be unable to remove the ongoing bias to deleveraging. But this ranking of monetary policy before fiscal stimulus reflects the government's high priority on regaining fiscal sustainability.

The government already has a major infrastructure programme underway...

Recent government comments have highlighted the scope for a growth boost via increased infrastructure spending. However, these comments just appear to refer to the substantial programme that already is underway, largely through privately funded projects but with some use of public guarantees on privately funded debt⁸. There is a good case for such projects given the ultra-low level of long yields and poor state of much of the UK's transport infrastructure. However, the existing programme does not appear large enough to provide a significant near-term fiscal boost, especially given the long lead time that is typical for infrastructure spending.

...and we expect that if there is temporary fiscal loosening, it will come via tax cuts or investment spending

If the government does implement extra fiscal stimulus, it is likely to come through temporary tax cuts or a temporary boost to investment, while leaving intact or even accelerating the planned squeeze on current public spending. Any such tax cuts probably could be done through VAT, or national insurance or income tax. The existing Budget plans already include a 1% cut in the main corporation tax rate next year, on top of the 2% cut made earlier this year. If temporary fiscal stimulus is going to be implemented, it is unlikely to come before the late-2012 Autumn Statement, and even then probably would only occur if the EMU crisis — and adverse effects on the UK — have escalated markedly further. But these conditions could fall into place very quickly.

⁸ See National Infrastructure Plan 2011, November 2011, HM Treasury.

Economic Indicators

Fri 1 Jun	Manufacturing PMI (May)	Forecast: 49.8	Prior: 50.5
We expect to see a further drop in this index as the EMU crisis hits euro area growth. A figure in line with our forecast would put this index below 50 for the first time since last November.			
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: % MoM, % YoY	Prior: -1.5% MoM, 1.2% YoY
Fri 8 June	Producer Output Prices (May)	Forecast: % MoM, % YoY	Prior: 0.7% MoM, 3.3% YoY
	Output Prices Ex Tax (May)	Forecast: % MoM, % YoY	Prior: 0.6% MoM, 3.2% YoY
	Excluding Food, Drink, Tobacco, Energy (May)	Forecast: % MoM, % YoY	Prior: 0.6% MoM, 2.3% YoY
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.			

: BoE, CBI, CML, ONS, national sources and Citi Investment Research and Analysis.

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Economic Calendar, 21 May — 8 June 2012

21 May	22 May	23 May	24 May	25 May
MPC's Adam Posen speaks At Columbia Business School Conference on "Tensions in Global Financial Regulatory Environment", Tokyo (08:00)	Consumer Prices (Apr) Mar 0.3% MoM, 3.5% YoY Apr 0.6% MoM, 3.0% YoY CPI Ex Food, Drink, Tobacco, Energy (Apr) Mar 0.4% MoM, 2.5% YoY Apr 0.6% MoM, 2.1% YoY Retail Prices (Apr) Mar 0.4% MoM, 3.6% YoY Apr 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) Apr 11 £9.1bn Deficit Apr 12 £16.5bn Surplus OECD Economic Outlook Released (09:00)	Retail Sales Volumes (Apr) Mar 2.0% MoM, 3.1% YoY Apr -2.3% MoM, -1.1% YoY MPC Minutes (May 10) BoE Agents' Summary of Business Conditions (May) CBI Industrial Trends (May) (11:00) Output Expectations (May) Apr +24% May -3% Order Books (May) Apr -8% May -17% Selling Prices (May) Apr +7% May +12% Informal Meeting of European Council of EU Heads of State & Gov't (Brussels) MPC's Charlie Bean Speaks at NAPF Local Authority Conference (Cirencester, 10:15)	GDP (Q1, 2nd Release) Q4 -0.3% QoQ, 0.5% YoY Q1 -0.3% QoQ, -0.1% YoY Service Sector Output (Mar) Feb -0.6% MoM, 0.6% YoY Mar 0.5% MoM, 0.8% YoY Business Investment (Q1, Provisional) Migration Statistics Quarterly Report (May) FPC's Alastair Clark speaks at Society of Business Economists Annual Conference (London, 09:10) BoE's Andrew Bailey speaks at Westminster Business Forum (London, 09:20) MPC's David Miles speaks at Society of Business Economists Annual Conference (London, 12:15)	
28 May	29 May	30 May	31 May	1 Jun
			GfK Consumer Confidence (May, 00:01) Nationwide House Prices (May, 07:00) Ireland: Referendum on EU Fiscal Treaty	Manufacturing PMI (Jun) Apr 50.5 MayE 49.8
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	Producer Prices (May) New Construction Orders (Q1) <i>Around Now</i> Halifax House Prices (May, 09:00)

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

Appendix A-1

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