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Economics

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Developed Markets
**Western Europe**

# UK Economics Weekly

## What Does the "Next Phase of Forward Guidance" Amount To?

- The *Inflation Report* confirms that last year's forward guidance — with the 7% jobless threshold and knockouts — is in effect dead. What the MPC call the "next phase" of guidance aims to prepare the ground for higher interest rates, confirming that the MPC will steer by inflation prospects 2-3 years out and use capacity guides as a key input. The MPC currently expect tightening to be "*gradual*" and "*limited*".
- In our view, the MPC's new approach is not really forward guidance at all. It does not constrain MPC members to act in any particular way. It tells us little about when or how far Bank Rate will rise, or how the MPC will behave if circumstances differ from their forecast. In our view, the new approach would be better described as old-style inflation targeting with enhanced transparency over the MPC's forecasts, judgments and key variables. The MPC's reluctance to over-commit to any particular rate path is sensible given uncertainties over the economic outlook and the degree of slack. But it means that MPC "guidance" provides only a weak anchor for market rate expectations. We continue to expect the MPC will start to hike in Q4 this year. Indeed, we would not be surprised if at least one individual MPC member (probably among the externals) started to vote for a rate hike in the next few months.


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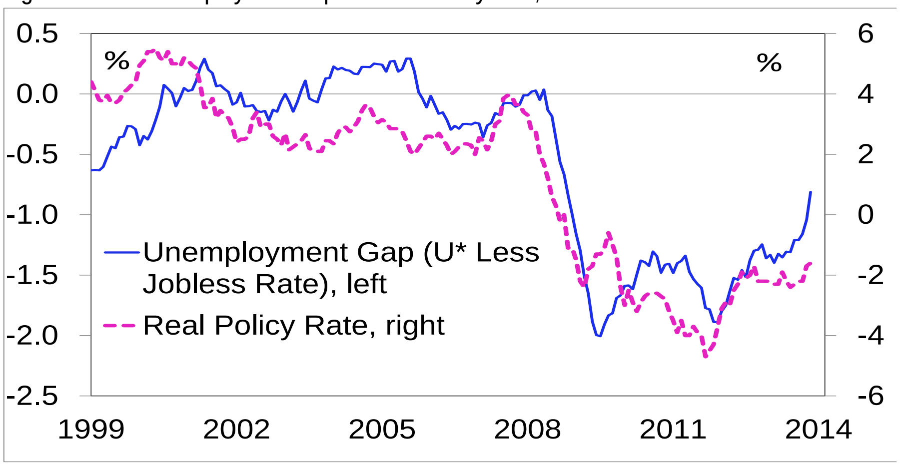
Figure 1. Citi Market Forecasts

| | Base Rate | QE Target | 10 Year Yield | Spread vs. Bunds | $/£ | £/€ |
|---|---|---|---|---|---|---|
| End 2014 | 0.75 | £362bn | 3.60 | 183bp | 1.76 | 0.80 |
| Mid 2015 | 1.50 | £358bn | 3.80 | 194bp | 1.77 | 0.79 |

Source: Citi Research

Figure 2. UK — Unemployment Gap and Real Policy Rate, 1999-2014




Note: Real policy rate deflated by the CPI. Sources: ONS, BoE and Citi Research

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Michael Saunders

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

# What Is "Forward Guidance Phase 2"?

## Goodbye to the Jobless Threshold and Knockouts

**The IR confirms that the existing forward guidance is, in effect, now dead**

The *Inflation Report* effectively signals the end of the MPC's short-lived forward guidance programme. The elaborate framework launched last August, with the 7% jobless threshold as the key guide to capacity use, and the three knockouts, is in effect dead. We expect the coming week's data will show the jobless rate down to 7.0%, but if the threshold is not hit then, it probably will be hit soon after. At that point, the guidance framework will formally end. The fact that the guidance framework has expired so quickly does not necessarily imply that it was a failure or an error, in our view. We believe that guidance did no great harm and had some advantages.

**Guidance may have helped boost growth…**

- First, by signaling a "low for longer" message, forward guidance may have helped boost business confidence in recent quarters, providing a useful extra stimulus to the economy and encouraging firms to expand hiring and investment. It is notable that job growth, and surveys of firms' hiring and investment intentions, have improved really sharply since guidance was launched. Maybe that would have happened anyway, but guidance may have helped.

**…and was a useful insurance against risks that recovery would have been accompanied by continued inflation stickiness**

- Second, forward guidance was a useful insurance policy against risks that economic recovery might have been accompanied by ongoing inflation stickiness from regulated prices and external costs, plus relatively high unemployment. Had that scenario unfolded, guidance would have helped to clarify that the MPC would steer by capacity use measures rather than the prevailing inflation rate. In practice, inflation has fallen back to target. As a result, the insurance aspect of forward guidance in practice turned out quickly to be redundant. But that does not necessarily mean it was an error to have put it in place.

## "Fuzzy Guidance" — Is It Really Guidance At All?

**The new guidance framework aims to prepare the ground for interest rates to rise…**

In its place, the MPC have unveiled what they call the "*next phase*" of forward guidance. Whereas the first phase aimed to signal that Bank Rate will not rise until recovery is well established, the new phase aims to prepare the ground for higher interest rates. It has three key elements: (1) in judging when to start hiking, the MPC will steer by a range of capacity use guides, including vacancies, unemployment plus under-employment measures; (2) when Bank Rate starts to rise, the MPC's current intention is that tightening will be "*gradual*"; (3) the MPC's current expectation is that the total scale of tightening will be "limited", with the neutral level of rates "*materially below*" the 5% pre-crisis average level of Bank Rate.

**…but is much less clear-cut than the previous framework and also less precise than the frameworks of several other major central banks**

This new guidance framework is much less precise than the prior framework or that used by various other major central banks. For example, unlike the Riksbank, US Fed, Norges Bank and RBNZ, the MPC will not be publishing forecasts for when rates might start to rise or of where rates might be in coming years. Moreover, like those other central banks, the MPC are not committing to any particular reaction function. The MPC have said they will aim to close the output gap over the next 2-3 years, using a range of capacity use guides as a guide to the unobservable output gap. But, they do not explain exactly how their capacity measures are calculated, and some have been changed in this IR from prior IRs. Nor does the MPC spell out what level of capacity use will trigger the first rate hike. Nor do MPC members commit to all treat these capacity guides in the same way: one MPC member may, for example, focus on the jobless rate, while another may focus on wage growth.

**Most of the elements in the new framework were already released in the January MPC minutes**

We have described the MPC's new approach as "fuzzy guidance"[1]. The key elements — no immediate rate hike, "*gradual*" tightening, lower neutral rate — were already disclosed in the January MPC minutes[2]. But, we are still surprised at the lack of extra substance in the February IR. We had expected the Committee to give some sense of what capacity use levels might prompt them to hike rates, or of where they expect interest rates might be 3-5 years ahead (for example, publishing research on the neutral rate, or mimicking the Fed's "scatter plot" charts that show individual committee members' rate forecasts). Instead, the MPC simply noted that the market rate path 2-3 years ahead is well below the pre-crisis norm. They studiously avoided giving their own view on where rates will be under the base case or different scenarios.

**The new framework is really inflation targeting with enhanced transparency rather than forward guidance, in our view**

Indeed, in our view, the MPC's new approach is not really forward guidance at all. It tells us little about when or how far Bank Rate will rise, or how the MPC will behave if circumstances differ from their forecast. Nor does it constrain MPC members to act in any particular way. In our view, the new framework would be better described as old-style inflation targeting with enhanced transparency — ie the MPC are setting policy by their 2-3 year ahead inflation forecast, while providing extra detail regarding their forecasts, main judgments and key variables. The emphasis on aiming to close the output gap over the 2-3 year forecast horizon is not new: the MPC has always acted in this way, judging that (provided inflation expectations are well anchored) a zero output gap is both necessary and sufficient to anchor inflation close to target over time[3]. Likewise, the MPC has (apart from the recent forward guidance period) always focused on a range of capacity use guides. The fact that this emphasis on closing the output gap is now being clearly spelled out is useful, reinforcing the message that the MPC care about stabilising the economy around its potential rather than just stabilizing inflation around the target. But this is more an issue of presentation rather than monetary policy substance, in our view.

**There is nothing wrong with central banks retaining flexibility — central banks generally cannot forecast policy rates very well**

We stress that there is nothing wrong with the lack of precision in the MPC's approach. The prior forward guidance framework — which specified no rate hikes at least until certain conditions are met — is no longer appropriate now that the time for the MPC to start to withdraw stimulus is approaching. And we do not believe it is possible for the MPC to provide reliable forecasts for the scale, timing and endpoint of the upcoming tightening cycle, given that their economic forecasts have proved not to be very reliable[4] and there is great uncertainty over the extent of spare capacity. The same point applies to other central banks. For example, since the start of 2007, the average absolute error (ie the average error irrespective of sign) in the Riksbank's forecast for interest rates two quarters ahead has been 50bp, rising to 100bp for rates four quarters ahead and 240bp for rates eight quarters ahead. The correlation between the Riksbank's forecast for rates eight quarters ahead and the outturn has been negative over recent years.

**The MPC's new approach creates only a very weak anchor for market rate expectations**

But, the key point is that, in our view, the MPC's new approach creates only a very weak anchor for market rate expectations. The MPC are aiming to give some sense of where policy is going, but are not constraining themselves or committing to any particular rate path. The MPC will do what is necessary to keep their inflation forecasts close to target 2-3 years out. If the MPC judge that rates must rise earlier or faster than markets currently price in, they will hike accordingly. After the event,

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[1] See "*After Forward Guidance…"Fuzzy Guidance*", UK Economics Weekly, 24 January 2014, Michael Saunders, Citi.

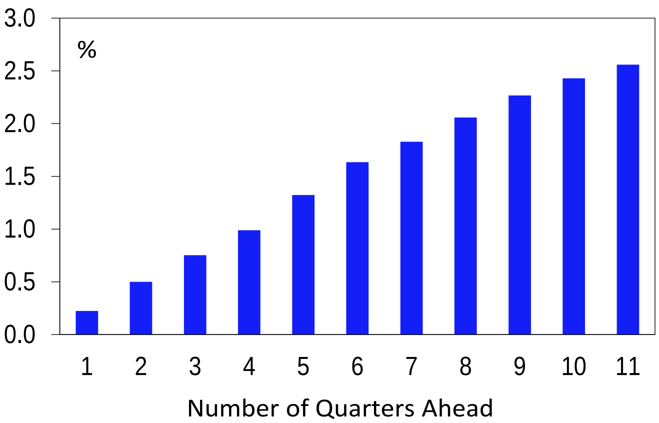
[2] See "*UK - Change of UK Rate View*", 22 January 2014, Michael Saunders, Citi.

[3] See, for example, the speech by then-Governor Eddie George, 24 February 1999.

[4] The Stockton Review, published in 2012 by the BoE, concluded that the MPC's forecast record for growth and inflation has been worse than the consensus in recent years.

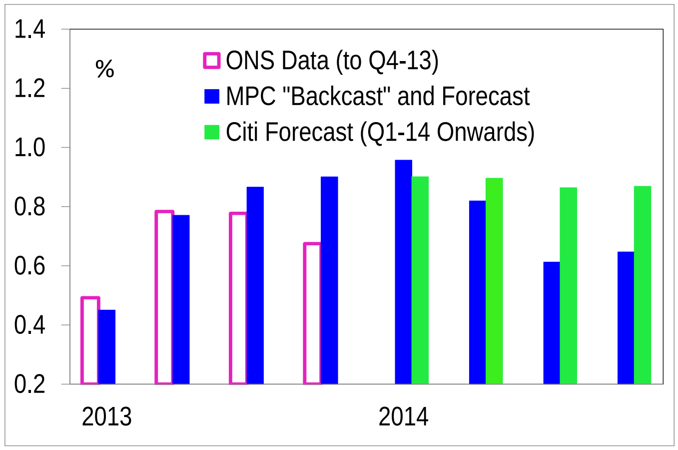
they could justify almost any rate path as being "gradual". If the economy recovers really strongly — even faster than we expect — then in theory Bank Rate could hit 5% or higher 3-5 years out. This is not our base case, but it is not impossible either. Nothing the MPC has said rules it out. It would be totally wrong, in our view, for investors to interpret the MPC's language as a commitment to (for example) not hike rates until 2015, or to hike rates only by 50-75bp per year.

Figure 3. Sweden — Average Absolute Error in Riksbank Policy Rate Forecasts, 2007-13




Sources: Riksbank and Citi Research

Figure 4. UK – QoQ GDP Growth, 2013-14F




F Forecast. Sources: BoE, ONS and Citi Research

## Growth and Productivity

We make two other points.

**The MPC's high growth is actually quite cautious about future growth prospects**

First, although the MPC's growth forecast (3.4% for 2014) is far above consensus (2.6%), this disparity mainly reflects the MPC's assumptions that recent GDP data will be revised up and that Q1 growth will be really high. The MPC assume that the level of GDP in Q4-13 will be revised up by 0.7% from the ONS data, with an upward revision to QoQ growth of 0.1pp for Q3-13 and 0.2pp for Q4-13. And for the current quarter (Q1-14), the MPC expect 1.0% QoQ growth. The MPC actually expect growth to slow sharply in H2 this year, to an average of 0.6% QoQ. At present, there is no sign of such a sharp slowdown. It is quite likely, in our view, that growth in coming quarters will exceed the MPC's forecasts. Our 2014 growth forecast (3.3%) does not assume upward revisions to prior ONS data. If we assumed the same upward revisions as the MPC and mapped forward our forecast for QoQ growth, our 2014 growth forecast would be 3.6%.

**We do not share the MPC's view that a higher productivity path would imply a lower path for interest rates…**

Second, we believe the MPC over-emphasise the extent to which a pickup in productivity growth could imply a lower rate path. The MPC argue (in the latest IR) that "*If the recovery in productivity is more (less) rapid than expected, Bank Rate could rise more (less) slowly*." Their argument is that higher productivity growth would imply lower job growth and hence (all else being equal) a longer period before labour market slack is exhausted and hence a lower rate path. We regard that view as overly simplistic. First, a slowdown in job growth is most likely to occur if real wages are rising or labour supply tightening, and under those conditions the MPC may well become more hawkish, not less. Second, in the event that productivity growth does pick up without (initially) a matching rise in wages, then the result will be a surge in corporate profits that is likely to boost equity prices and feed through to faster gains in jobs and investment: in other words, supply-side improvement would also boost the demand side and yield even faster GDP growth.

**…and the Fed has highlighted the scope for supply-side gains to boost demand…**

This link from the supply side to demand is long-established: For example, Larry Meyer of the US Fed argued in 2000: "*a productivity shock affects aggregate demand as well as potential supply and may initially have an even larger effect on demand than on supply….The demand effects — to the extent that they are directly related to the productivity shock — likely reflect the more favorable investment opportunities, the effect of expected profitability on equity prices and hence household wealth and consumption, and the effect of the increase in expected future labor income on current consumption*." [5]

**…a channel also noted by previous MPC members**

Under those conditions, the MPC might initially delay tightening (because the jobless rate falls more slowly) but the eventual neutral level of rates probably would be higher. A key justification for a lower neutral rate — that potential growth is lower because of weaker productivity trends — would fade away. As a then-MPC member argued in 2000: "*The view that a sustained reduction in the natural rate of unemployment, a sustained fall in margins or a sustained increase in the rate of growth of productivity all unambiguously imply that the path of short-term nominal interest rates can be lower than it would otherwise have been, without this posing a threat to the inflation target, is almost certainly mistaken*."[6]

## What will happen?

**We expect growth will outpace the MPC's forecasts, with further increases in capacity use…**

Our own view is that the economy will remain buoyant, and we expect QoQ GDP growth will outpace the MPC's forecast during this year, hence pulling the jobless rate markedly lower (and probably lifting the other capacity use guides cited by the MPC). Moreover, like the MPC, we expect growth will be broad-based, including solid pickups in investment plus exports, and with the decline in real wages ending later this year. The policy stance at present is ultra-loose, with real rates at about minus 1.5%, and the QE-adjusted real rate at about minus 5%[7]. With credit availability improving, stimulus is still expanding[8]. Headwinds from balance sheet repair, poor credit availability, and the EMU crisis are receding. Unless there is a big external shock, a major slowdown is rather unlikely, in our view, and a self-fuelling boom is more likely.

**…and we continue to expect the MPC will start to hike late this year**

With this backdrop, we continue to expect that the MPC will start to hike in Q4 this year, with an equal chance that tightening could start a bit earlier (eg August) if the jobless rate keeps falling rapidly or a bit later (eg early 2015) if EM strains intensify or sterling soars. Indeed, we would not be surprised if at least one individual MPC member (most likely among the externals) started to vote for a rate hike in the next few months. By starting to hike before the output gap is fully closed, the MPC would greatly increase the likelihood that tightening can be gradual and limited. Conversely, if the MPC delayed tightening while capacity use continued to rise rapidly, it would become more likely that eventually rates would have to rise a long way. We reject totally any notion that the MPC will keep rates on hold simply because the UK general election will be in Q2-2015. We look for rates to reach about 2% in H2-2015, and a bit higher (maybe 3-4%) over time (ie four or five years out).

[5] See: "*The New Economy Meets Supply and Demand*", 6 June 2000. See also "*Monetary Policy and the Supply Side*", speech by John Vickers (then on the MPC), March 2000.

[6] See "*The new economy and the old monetary economics*", Willem Buiter (then on the MPC), BoE Quarterly Bulletin May 2000.

[7] See " *2014 Outlook — Recovery and the New Normal*", UK Economics Weekly, Michael Saunders, 8 January 2014, Citi.

[8] See "*UK - Household Interest Rates Still Drifting Lower*", Michael Saunders, 11 February 2014, Citi.

## Economic Indicators

| | | | |
|---|---|---|---|
| Tue 18 Feb | *Consumer Prices (Jan)* | Forecast: -0.4% MoM, 2.1% YoY | Prior: 0.4% MoM, 2.0% YoY |
| | *CPI Ex Food, Drink, Tobacco, Energy (Jan)* | Forecast: -0.6% MoM, 1.9% YoY | Prior: 0.1% MoM, 1.7% YoY |
| | *Retail Prices (Jan)* | Forecast: -0.4% MoM, 2.6% YoY | Prior: 0.5% MoM, 2.7% YoY |
| | *RPIX – Excludes Mortgages (Jan)* | Forecast: -0.4% MoM, 2.7% YoY | Prior: 0.5% MoM, 2.8% YoY |

We expect CPI inflation will stay around the 2% target in these figures, although base effects from a fairly weak core CPI reading a year ago may prevent the YoY rate from slipping further. Food price inflation may well slow further, but we factor in a small rise in household gas and electricity prices this month. Looking forward, CPI inflation is likely to remain around the 2% target in coming months, averaging perhaps a little below 2% over the year as a whole.

| | | | |
|---|---|---|---|
| Tue 18 Feb | *Producer Input Prices (Jan)* | Forecast: -0.6% MoM, -2.9% YoY | Prior: 0.1% MoM, -1.2% YoY |

With the stronger pound and slightly weaker commodity prices, we expect to see another decline in input prices (the eighth in the past 10 months), producing the sharpest YoY decline in input prices since 2009. This disinflationary backdrop will, we expect, help cap CPI inflation in the next year or two.

| | | | |
|---|---|---|---|
| Tue 18 Feb | *Producer Output Prices (Jan)* | Forecast: 0.2% MoM, 0.8% YoY | Prior: 0.0% MoM, 1.0% YoY |
| | *Output Prices Ex Tax (Jan)* | Forecast: 0.2% MoM, 0.9% YoY | Prior: -0.1% MoM, 1.1% YoY |
| | *Excluding Food, Drink, Tobacco, Energy (Jan)* | Forecast: 0.1% MoM, 0.8% YoY | Prior: 0.1% MoM, 1.0% YoY |

The output price data are not seasonally adjusted and often record a relatively high gain in January on start-of-year price hikes. So we would focus more on the YoY change than the MoM change as a guide to the trend and expect that base effects from the 0.4% MoM gain seen a year ago will bring the YoY rate a little lower this month.

| | | | |
|---|---|---|---|
| Wed 19 Feb | *LFS Unemployment (Oct-Dec)* | Forecast: -194,000 QoQ, 7.0% Rate | Prior: -167,000 QoQ, 7.1% Rate |
| | *Claimant Count Unemployment (Jan)* | Forecast: -30,000 MoM, 3.6% Rate | Prior: -24,000 MoM, 3.7% Rate |

We expect this release will show the jobless rate falling to the MPC's 7% threshold, with the single month LFS figure for December falling well below 7%. The single month figure for September already fell to 7.1% and, with the LFS based on a rolling 3-month sample, the people surveyed in December will be largely the same as those surveyed in September. Hence, with rapid job growth (Q4 is likely to see record job growth of about 280K QoQ), we expect the single month figure to be down to about 6.7%. The 3-month average is likely to fall below 7% soon.

| | | | |
|---|---|---|---|
| Thu 20 Feb | *CBI Industrial Trends Survey (Feb)* | | |
| | *Monthly Output Expectations Net Balance (Feb)* | Forecast: +24% | Prior: +23% |
| | *Monthly Order Books Net Balance (Feb)* | Forecast: +6% | Prior: -2% |
| | *Monthly Selling Prices Net Balance (Feb)* | Forecast: +10% | Prior: +20% |

This year, as often happens, the January survey showed a dip in order books but price expectations rising. We expect these trends – which seem to be a seasonal norm – to unwind a bit in the February survey. A reading in line with our expectations would put both output expectations and order books about one standard deviation above average, and hence would be consistent with continued rapid output growth.

| | | | |
|---|---|---|---|
| Fri 21 Feb | *Retail Sales Volumes (Jan)* | Forecast: -2.0% MoM, 4.0% YoY | Prior: 2.6% MoM, 5.3% YoY |

The January retail sales data are often quite volatile, producing either a gain of more than 1% MoM, or a decline, in 13 of the last 15 years (the most of any month and compared to an average of seven such readings across all other months). For this year, we expect the January figures to show a large drop, largely reversing the erratic gain in December, although leaving volumes in the last three months up by 0.9% from the prior three months.

| | | |
|---|---|---|
| Fri 21 Feb | *Public Sector Net Borrowing (Jan)* | Forecast: £7.0bn surplus, £86.4 billion deficit fiscal year to date |
| | *(Ex RM, APF and Financial Intervention)* | Year Ago: £6.7bn surplus, £94.3 billion deficit fiscal year to date |

The January figures usually benefit from a seasonal surge in payments of income tax and corporation tax, and we expect another surplus this time. Given seasonal factors, the best comparison is versus a year ago and on that basis we expect a modest improvement of £0.3bn or so.

| | | | |
|---|---|---|---|
| Wed 26 Feb | *GDP (Q4, 2nd Release)* | Provisional: 0.7% QoQ, 2.8% YoY | Prior (Q3): 0.8% QoQ, 1.9% YoY |

We do not anticipate any revision to the headline figures for GDP growth, unless there is a major surprise in the service sector figures published at the same time. The split of the GDP data is likely to show a modest slowdown in consumer spending growth to roughly 0.5% QoQ from 0.8% QoQ in Q3, with another 1-2% QoQ gain in investment and a pullback in stockbuilding after sizeable gains in the prior two quarters.

| | | | |
|---|---|---|---|
| Wed 26 Feb | *Service Sector Output (Dec)* | Forecast: 0.3% MoM, 3.1% YoY | Prior: 0.4% MoM, 2.6% YoY |

Surveys suggest that service sector output is expanding quite strongly, and hence we expect these figures to show another solid gain. A reading in line with our forecast would lift the YoY rate above 3% for the first time since 2008.

Economic Calendar, 10 February — 28 February 2014

| 10 February | 11 February | 12 February | 13 February | 14 February |
|---|---|---|---|---|
| | | BoE *Inflation Report*<br>(10:30) | RICS House Price Survey<br>(Jan, 00:01)<br><br>Riksbank Outcome:<br>Rates Unchanged at 0.75% | Construction Output (Dec)<br>Nov -4.0% MoM, 2.0% YoY<br>Dec 2.0% MoM, 6.3% YoY |
| **17 February** | **18 February** | **19 February** | **20 February** | **21 February** |
| Eurogroup Meeting<br>(Brussels, Afternoon) | Consumer Prices (Jan)<br>Dec 0.4% MoM, 2.0% YoY<br>JanE -0.4% MoM, 2.1% YoY<br>CPI Ex F, D, T, E (Jan)<br>Dec 0.1% MoM, 1.7% YoY<br>JanE -0.6% MoM, 1.9% YoY<br>Retail Prices (Jan)<br>Dec 0.5% MoM, 2.7% YoY<br>JanE -0.4% MoM, 2.6% YoY<br>RPIX – Ex Mortgages (Jan)<br>Dec 0.5% MoM, 2.8% YoY<br>JanE -0.4% MoM, 2.7% YoY<br>Producer Input Prices (Jan)<br>Dec 0.1% MoM, -1.2% YoY<br>JanE -0.6% MoM, -2.9% YoY<br>Prod. Output Prices (Jan)<br>Dec 0.0% MoM, 1.0% YoY<br>JanE 0.2% MoM, 0.8% YoY<br>Ex F, D, T, E (Jan)<br>Dec 0.1% MoM, 1.0% YoY<br>JanE 0.1% MoM, 0.8% YoY<br><br>EcoFin Meeting<br>(Brussels) | LFS Unemployment (Oct-Dec)<br>QoQ Rate<br>Sep-Nov -167K 7.1%<br>Oct-DecE -194K 7.0%<br>Claimant Count<br>Unemployment (Jan)<br>MoM Rate<br>Dec -24K 3.7%<br>JanE -30K 3.6%<br><br>MPC Minutes<br><br>BoE Agents' Summary of<br>Business Conditions (Feb) | CBI Industrial Trends<br>Survey (Feb, 11:00)<br>Output Expectations (Feb)<br>Jan +23%<br>FebE +24%<br>Order Books (Feb)<br>Jan -2%<br>FebE +6%<br>Selling Prices (Feb)<br>Jan +20%<br>FebE +10% | Retail Sales Volumes (Jan)<br>Dec 2.6% MoM, 5.3% YoY<br>JanE -2.0% MoM, 4.0% YoY<br><br>Public Sector Net<br>Borrowing (Jan)<br>Jan13 £-6.7bn Surplus<br>Jan14E £-7.0bn Surplus<br>Fiscal Year To Date<br>Apr12-Jan13 £94.3bn Deficit<br>Apr13-Jan14E £86.4bn Deficit |
| **24 February** | **25 February** | **26 February** | **27 February** | **28 February** |
| | EU Commission:<br>Winter Economic Forecasts<br>(c. 10:00) | GDP (Q4, 2nd Release)<br>Q3 0.8% QoQ, 1.9% YoY<br>Q4P 0.7% QoQ, 2.8% YoY<br><br>Service Sector Output (Dec)<br>Nov 0.4% MoM, 2.6% YoY<br>DecE 0.3% MoM, 3.1% YoY | Migration Statistics Quarterly<br>Report | GfK Consumer Confidence<br>(Feb, 00:01)<br><br>*Around Now*<br>Nationwide House Prices<br>(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.

## Notes

# Appendix A-1

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