

Economics

23 September 2011 | 16 pages

Sterling Weekly

Large QE on the Way Soon

- With deteriorating surveys, strains in the banking system and the intensifying EMU sovereign debt crisis, we are again sharply cutting our UK growth forecasts. We now expect GDP growth of 1.0% this year, 0.7% in 2012 and 1.4% in 2013, versus our previous forecasts of 1.1%, 1.3% and 1.6%, respectively. The jobless rate is likely to rise from 7.9% now to about 9.0% at end-2012.
- The BoE are clearly trying to prepare markets for the resumption of QE in the next month or two, and aiming to dispel worries that they are abandoning the inflation target. We expect QE will start in October or (at the latest) November, with £50bn-£100bn to start with and probably about £300bn more in total. The BoE believes that QE is effective in lifting real and nominal GDP, but that a large amount of QE is needed to achieve even a modest boost to the economy. With fiscal policy constrained and little or no scope to cut rates, the MPC are likely to use the available tool of QE in large size.

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Figure 1. Citigroup Market Forecast

	\$/£	£/€	Base Rate	10 Year Yield	Spread vs. Bunds
End 2011	1.66	0.85	0.50	2.20	20bp
Mid 2012	1.65	0.83	0.50	2.60	20bp

Source: Citi Investment Research and Analysis

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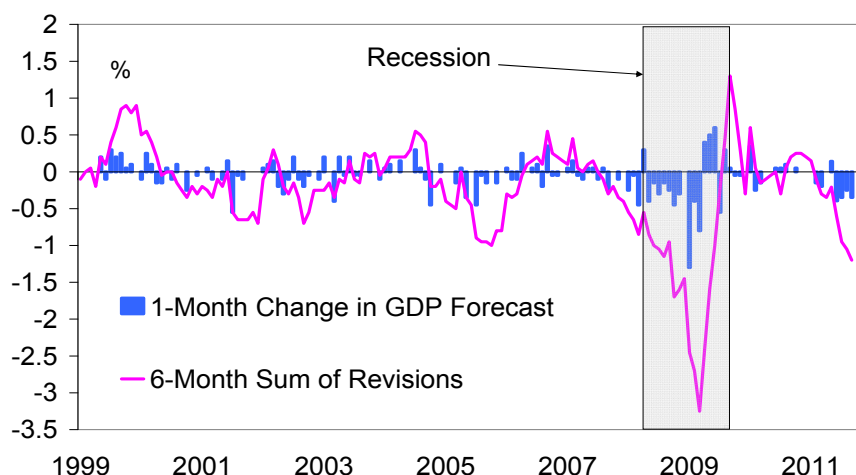
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Figure 2. UK — Revisions to Citi UK GDP Growth Forecast for Current and Following Year, 2001-11



Source: Citi Investment Research and Analysis

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

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Large QE on the Way Soon

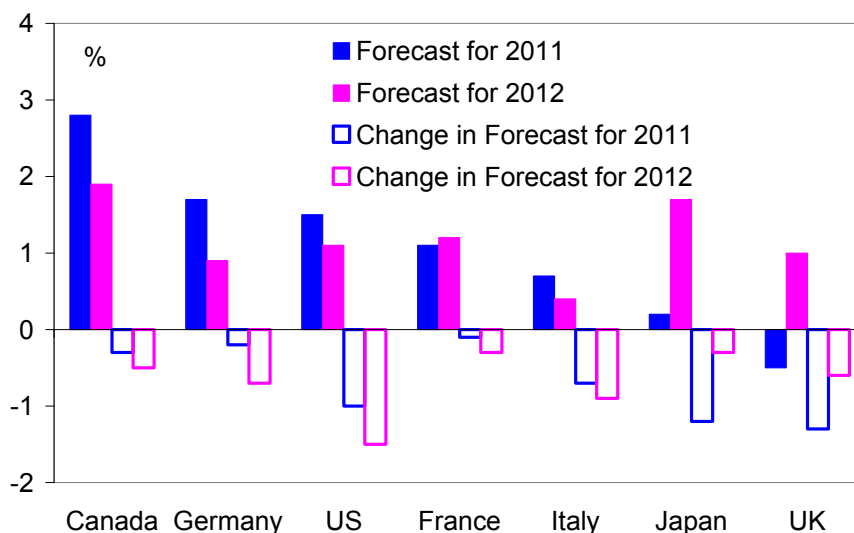
The MPC are likely to implement QE on a large scale soon

Economic prospects are worsening rapidly, with sizeable forecast downgrades from the IMF...

Events are moving fast, and we believe the combination of the deteriorating economic outlook plus BoE comments are setting the stage for a big expansion of QE in the next month or two. We expect the MPC will restart QE at the October meeting or, at the latest, in November. We expect they will start with £50bn-£100bn, do a total of £200-400bn, running at £25bn per month or perhaps more. But, rather than the precise numbers, our key conclusions are that QE will be large, soon, and maintained until growth prospects clearly improve.

Economic prospects are clearly worsening further. Recent surveys and data give clear signs that demand is softening in the UK and externally, with extra downside risks. The jobless rate is already rising and corporate liquidity is worsening markedly. Moreover, the latest CBI survey shows a sharp rise in the share of manufacturing firms with excess inventories – a classic signal that further weakness lies ahead. The IMF has cut its UK growth forecast by 0.6% for 2011 and by 0.7% for 2012, and now expects GDP growth of 1.1% this year and 1.6% in 2012¹. The IMF has made similar downgrades to its GDP growth forecasts for a range of advanced economies. However, the UK stands out in terms of the shortfall in domestic demand. The IMF expects final domestic demand to fall 0.5% this year in the UK – the only G7 country for which it expects demand to fall – with a particularly big drop in investment. Moreover, the downgrade to UK final domestic demand growth (1.3%) is the biggest of any G7 country for 2011.

Figure 3. G7 Countries — IMF Forecasts for Final Domestic Demand Growth in 2011-12



Sources: IMF and Citi Investment Research and Analysis

...and we are again taking the axe to our UK GDP growth forecasts

Our previous published GDP growth forecasts (1.1% for 2011 and 1.3% for 2012) already were below the IMF's new forecasts, and we are again sharply cutting our projections². We now expect GDP growth of just 1.0% this year, 0.7% in 2012 and 1.4% for 2013, down from 1.1%, 1.3% and 1.6%, respectively, last month. We have markedly cut our forecasts for investment and exports, and also expect renewed destocking, with a modest downgrade to our consumer spending forecast. Our forecasts imply the economy will be close to recession in the next few quarters. We

¹ See IMF World Economic Outlook, 20 September 2011.

² See "Cutting UK Forecasts Again", Michael Saunders, *Sterling Weekly*, 19 August 2011, Citi.

expect that GDP rose 0.2-0.3% QoQ in Q3 (ie close to zero allowing for the unwind of the temporary adverse effects in Q2) with zero growth in Q4. The jobless total is likely to rise from 7.9% now to about 9.0% in late 2012/early 2013 (from 2.5 million people now to 2.8-2.9 million people).

The recent UK GDP forecast downgrades are among the sharpest we have made in recent years

This is the fourth consecutive month of large downgrades to our UK GDP growth forecasts. In all, we have cut our forecasts for the current and next year by about 1% over the last three months and by 1.2% over the last six months. This is similar to the pace of downgrades we made in late-08, and far greater than seen in any recent period outside recession. Of course, forecasts are fallible. But the key point that we wish to stress is that over the last few months the outlook has darkened very sharply, and it continues to worsen.

Figure 4. . UK — Economic Forecast, 2011-2013 F

	2011F		2012F		2013F	
	Aug Citi Forecast	Sep Citi Forecast	Aug Citi Forecast	Sep Citi Forecast	Aug Citi Forecast	Sep Citi Forecast
Real GDP YoY	1.1%	1.0%	1.3%	0.7%	1.6%	1.4%
CPI Inflation	4.4	4.4	3.2	2.9	2.7	2.5
Bank Rate (Yearend)	0.5	0.5	0.5	0.5	1.0	0.5
QE (£bn, Yearend)	200	300	200	500	200	500
Domestic Demand	0.0%	0.0%	0.7%	0.3%	1.0%	0.8%
• Private Consumption	0.0	-0.1	1.5	1.3	1.8	1.5
• Investment	-1.1	-1.1	-1.6	-2.4	-0.8	-2.9
• Business Investment	1.6	1.5	-0.5	-1.5	-0.1	-2.8
• Private Housing	-1.7	-1.6	4.5	2.6	3.9	1.8
• Govt. Investment	NA	NA	NA	NA	-7.8	-7.8
Inventories (Effect on GDP)	0.0	0.1	-0.1	-0.3	0.0	0.0
Net Trade (Effect on GDP)	+1.2	+0.9	+0.6	+0.4	+0.6	+0.6
Employment YoY	+0.8	+0.8	-0.2	-0.4	+0.2	-0.1
LFS Jobless Rate (Q4, Pct)	8.1	8.1	8.5	8.8	8.3	8.7
Fiscal Deficit (fiscal year, £bn)	126	128	111	117	96	107
Current Account (£bn)	-29.9	-33.0	-5.2	-9.1	+11.7	+8.4

Note: Fiscal deficit excludes effects of financial interventions. The August forecasts are as published in [Sterling Weekly](#) of 19 August 2011. F Forecast.
Sources: ONS and Citi Investment Research and Analysis

Headwinds from the sovereign debt crisis are likely to increase...

Moreover, the UK is likely to face increasing headwinds from the interplay between sluggish growth across advanced economies and the worsening euro area sovereign debt crisis. We have warned for a while that several euro area countries will have to make major sovereign debt restructuring with large haircuts, and it seems increasingly likely that this will start in the next 6-12 months³. This could hurt UK growth through several channels, especially banks and exports.

...probably further worsening bank credit availability...

■ Bank credit availability already is poor, and funding strains are escalating again in the UK and EU banking sector. BoE data show that gross capital issuance (commercial paper, programme bonds, stand-alone bonds and equities) by UK banks has fallen sharply in recent months and, allowing for redemptions, net issuance is the most negative seen in recent years. The IMF report that UK banks still have quite substantial wholesale funding needs for the rest of this year⁴. In 2007-08, the BoE was quite slow to appreciate the scale and significance of the deterioration in bank capital and liquidity. But they are very energized on this issue now, and clearly highly worried about the resultant adverse effects on the economy. The latest BoE Quarterly Bulletin warns “*Debt*

³ See recent issues of the “[Global Economic Outlook and Strategy](#)”, Willem Buiter et al, Citi.

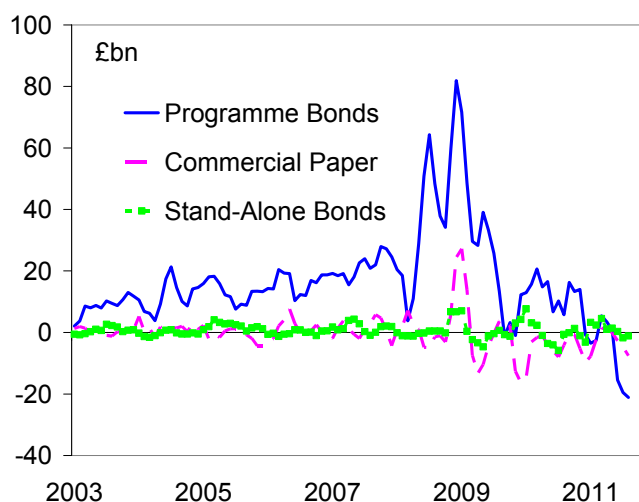
⁴ See “*Global Financial Stability Report*”, IMF, 20 September 2011.

issuance by major UK lenders in public term funding markets fell sharply over the review period. Contacts mainly attributed this change in primary market conditions to the increasing concern about the implications for banks of sovereign default risks in the euro area...A prolonged closure of the market could make it harder for banks to improve the resilience of their balance sheets without reducing lending further to the real economy.”⁵ The latest MPC minutes warn of risks that ongoing funding strains might start to cause a new credit crunch: “While UK banks had already met a significant proportion of their funding needs for the year, if they were unable to access unsecured term funding markets for much longer they might feel pressure to reduce lending.”⁶

...and hitting UK exports

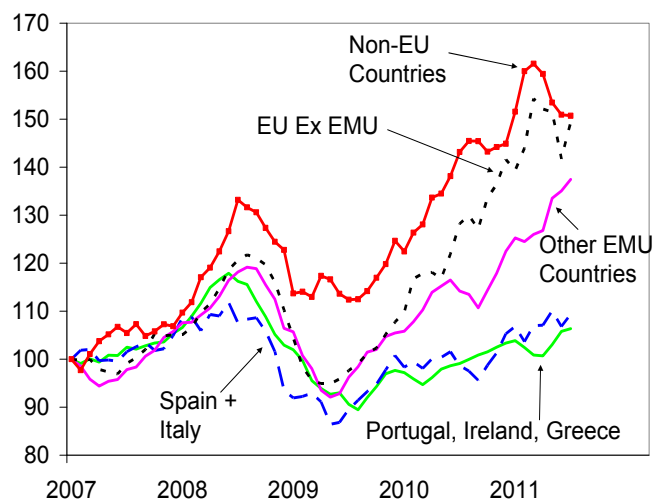
- In addition, weakening euro area growth is likely to further hit UK exports. Exports to Greece, Ireland and Portugal combined account for 7% of exports of goods, and have been roughly flat in nominal terms since early 2007. Exports to Italy and Spain together account for a further 7% of exports and also have been roughly flat. These trends imply substantial declines in volume terms, given that prices for exports to EU countries are up 29% on average since the start of 2007. Exports to non-EU countries account for 45% of total exports but, even with the low pound and strong emerging market growth, these have fallen 6.5% QoQ in May-July (volumes ex oil and erratics). The split shows particular weakness in exports to the US, Japan, Korea and Switzerland. Exports to core EMU countries (defined here as Euro Area excluding Greece, Ireland, Italy, Portugal, and Spain) account for 34% of total exports, and have held up well so far, rising 8.4% QoQ (nominal terms) in May-July. But this remaining source of strength is now likely to fade as the euro slowdown intensifies. Indeed, the latest CBI survey points to a further sizeable deterioration in export order books.

Figure 5. UK – Net Capital Issues By UK Monetary Financial Institutions, 3-Month Totals, £bn, 2003-11



Sources: BoE and Citi Investment Research and Analysis

Figure 6. UK – Exports By Destination, Nominal Terms, 3-Month Averages, Indexed to Jan 2007 = 100, 2007-11



Sources: ONS and Citi Investment Research and Analysis

There are sizeable uncertainties, both technical and economic, in the forecast

We stress the big uncertainties here. The ONS will release GDP revisions on October 5, and these could well alter the recent history and hence the outlook for GDP growth. Historically, UK GDP growth has tended to be revised up, and hence

⁵ See BOE Quarterly Bulletin, issued Monday 19 September 2011.

⁶ See September MPC Minutes, issued 1 September 2011.

there may again be an upside risk to the forecast from this factor. But, aside from this statistical quirk, there are also sizeable downside economic risks even to our gloomy base case, especially unless policymakers act soon to break the vicious circle between the worsening economic outlook and strained financial markets.

Fiscal Policy Remains Constrained

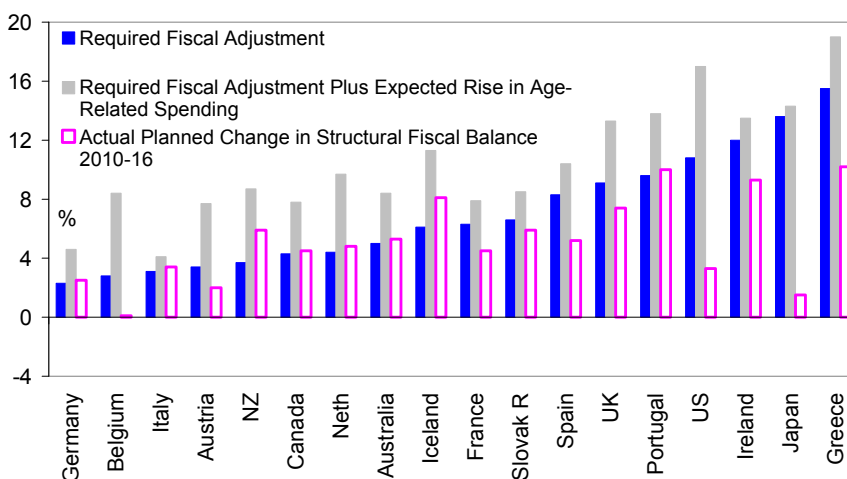
There is a theoretical case for renewed fiscal stimulus...

In theory, there could be a decent case for renewed fiscal stimulus to offset the new slowdown, especially given the weakness in domestic demand, low level of gilt yields and weakness in the banking system. To be sure, the government might make small reallocations of spending between years or from current spending to capital. But, in practice, we continue to believe there is little chance of substantial new fiscal stimulus in the UK⁷.

...but the UK still faces a sizeable medium-term fiscal challenge...

The UK's fiscal position is still far from sustainability. The IMF judges that the UK needs to tighten fiscal policy (in terms of the structural primary balance) by 9.1% of GDP between 2010 and 2020 to return to a 60% public debt/GDP ratio in 2030. The required tightening escalates to 13.3% of GDP allowing for the expected rise in age-related spending. The current fiscal plans, which the IMF judges will tighten the fiscal stance by 7.4% of GDP between 2010 and 2016, will go a long way to matching those requirements, but give no scope for sustained fiscal slippage.

Figure 7. Selected Countries — IMF Estimates for Fiscal Tightening (Pct of GDP) Required to Return to 60% Public Debt/GDP Ratio By 2030



Note: Target debt ratio set at 80% for Japan. Sources: IMF and Citi Investment Research and Analysis

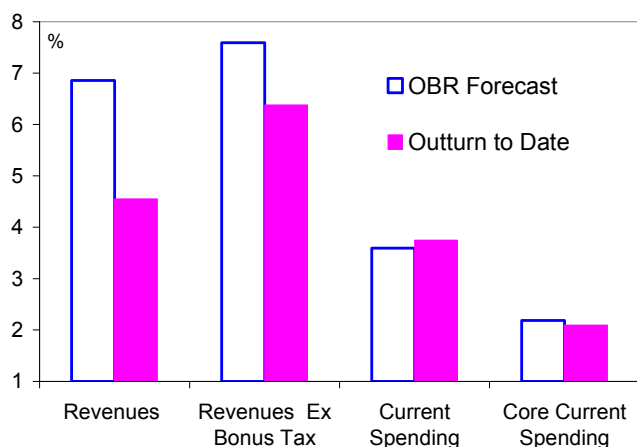
...and the OBR may well produce a less favourable fiscal judgement later this year

Moreover, the government has little or no room for fiscal manoeuvre without risking an adverse OBR verdict or a sovereign ratings downgrade (or negative outlook). And this is something the UK government is very keen to avoid. This year's fiscal deficit is likely to overshoot the OBR's forecast by £6bn or so, because core revenue growth (ie excluding the bank bonus tax) is running about 1% below the OBR's forecast. We expect bigger deficit overshoots for next year (£15bn-£20bn) and 2013-14 (£30bn-£40bn). In addition, the OBR may well come to a more pessimistic judgment on the UK's structural fiscal deficit if it revises down its estimate of the UK's output gap and potential growth to match the IMF's estimate.

⁷ See ["The UK's Long Journey back to Fiscal Sustainability", Michael Saunders, Sterling Weekly, 22 July 2011, Citi.](#)

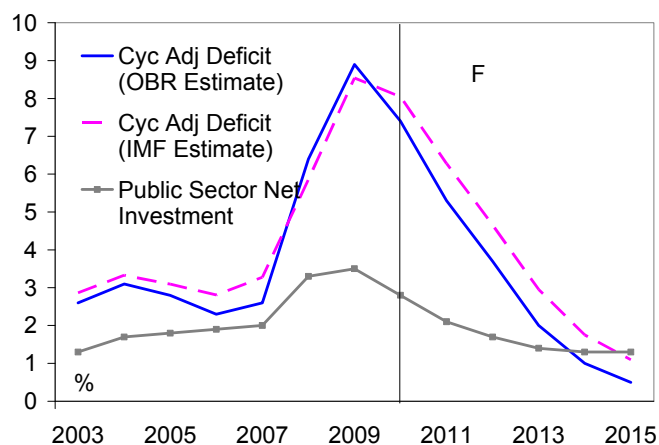
The IMF believe the UK's structural fiscal deficit for 2011 (calendar year) is 6.3% of GDP, well above the OBR's 5.3% figure (for the 2011/12 fiscal year). An interesting analysis by the Financial Times suggests that the OBR's methodology, using updated figures, would produce similar estimates to the IMF figures for the output gap and cyclically adjusted deficit⁸. The IMF's forecast implies that, even with no fiscal loosening, it is roughly 50:50 as to whether the government will hit its key fiscal rule – a cyclically adjusted current surplus (ie deficit excluding investment) five years ahead (currently 2015/16).

Figure 8. UK – Central Government Revenues and Spending YoY, 2011-12 Fiscal Year



OBR Office for Budget Responsibility. Core current spending is current spending excluding debt interest and social benefits. Sources: ONS, OBR and Citi Investment Research and Analysis

Figure 9. UK – Cyclically Adjusted Fiscal Deficit and Net Public Investment, Pct of GDP, 2003-15F



Note: OBR figures and net investment are for the fiscal year, IMF figures are for the calendar year. F Forecast. Sources: IMF, OBR and Citi Investment Research and Analysis

The government is very keen to avoid an adverse fiscal verdict from the OBR and ratings agencies

It would be highly embarrassing in political terms for the government if the OBR judges that the UK will not hit this target. It also could well be the trigger for one or more ratings agency to put the UK on negative outlook, on the grounds that if the coalition cannot put the UK on a sustainable fiscal path now, in the year or two after the election, then it probably never will be able to. A ratings downgrade (or negative outlook) would probably deal a lasting blow to the government's reputation for economic competence. It also might lead businesses and consumers to fear future tax hikes or spending cuts, hence offsetting any hoped-for boost to demand from fiscal stimulus.

The MPC Has Room For Manoeuvre

We expect QE will begin earlier and on a bigger scale than the consensus

With the worsening outlook and fiscal policy constrained, the MPC are likely to restart QE in big scale in October or, at the latest, in November. A Reuters poll suggests that the consensus is for QE to begin in November and to total £100bn (bringing the total to £300bn)⁹. We believe that QE is more likely to start in October and will be bigger, probably starting off with £50-£100bn and totaling a further £300bn or so (bringing the overall total to about £500bn). We stress uncertainties, but the key point is that QE is likely to be earlier and larger than the current consensus.

⁸ As published in the Financial Times on 20 September 2011.

⁹ Survey released 21 September 2011.

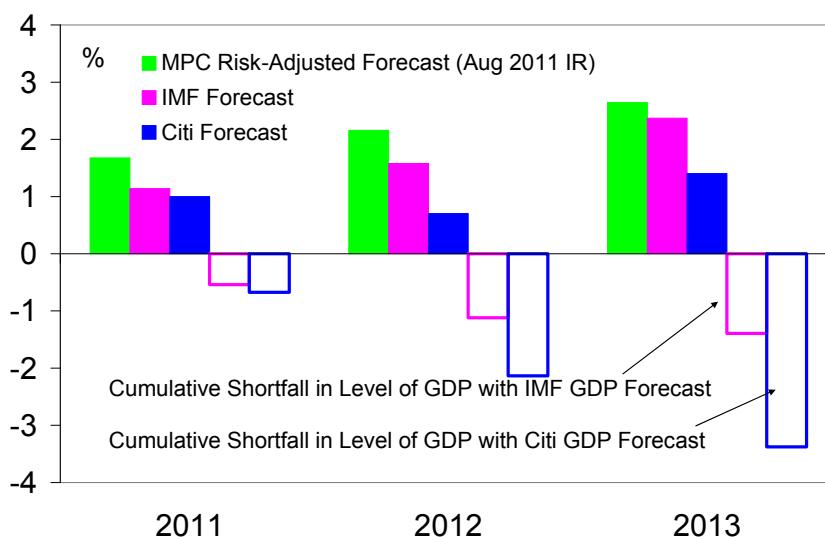
The BoE are clearly trying to soften up sentiment for QE to restart

The BoE believe that QE works, but is less powerful in lifting nominal GDP than they thought in early 2009

The last week has seen what appears to be a concerted effort by the MPC to prepare markets for the restart of QE in the next month or two. First, the Quarterly Bulletin argued that QE is an effective tool to lift nominal GDP growth and reduce risks of an inflation undershoot. Looking back at the £200bn QE programme of 2009 and early 2010, the QB concludes that *"the effect of QE was equivalent to a 150 to 300 basis point cut in Bank Rate, a significant reduction."* Second, the MPC minutes showed a clear acceptance by the majority on the MPC that extra QE is likely: *"it was increasingly probable that further asset purchases to loosen monetary conditions would become warranted at some point."* The MPC appear far more willing to implement QE than the Fed or ECB.

But, while the BoE believe QE was effective, they also believe it is much less powerful than initially expected. When the MPC began QE in early 2009, there was huge uncertainty as to the scale of its effect: was it like rocket fuel, and a modest amount of QE would lead to hyper-inflation? Or was it totally ineffective? At the time, the MPC assumed that QE would boost nominal GDP roughly one for one. As the minutes of March 2009 noted *"the increase in the level of money balances should be of a similar magnitude to the required increase in nominal GDP."* Hence, facing what they judged to be a 5% shortfall in nominal GDP growth, the MPC initially began with £75bn of QE (about 5% of GDP). In practice, QE reached £200bn (14% of GDP) eventually by early 2010. The BoE now estimate that the £200bn QE programme lifted real GDP by 1½%-2% and lifted the CPI by ¾% to 1½%, implying a total boost to nominal GDP of 2¼%-3½%. So the BoE now believe the impact of any given amount of QE is between one sixth and one quarter of what they had initially assumed. This implies that if the MPC face the same shortfall in demand as they did in early 2009, they will restart QE on a far bigger scale than before. They may even start QE on a bigger scale even if they face a smaller prospective shortfall in demand than in 2009.

Figure 10. UK — Forecasts for Real GDP Growth, and Cumulative Shortfall in Level of GDP Versus MPC Forecast, 2011-13F



Note: We show the MPC's risk-adjusted forecast with market rates.
Sources: IMF, BoE and Citi Investment Research and Analysis

The QB implies it will probably take more than £100bn of QE to reverse the probable shortfall in GDP growth versus the MPC's forecast

The BoE's estimates of QE's impact are highly uncertain, but can be used to roughly calibrate the required amount of QE for a given prospective shortfall in GDP. The IMF's forecast implies a cumulative shortfall of real GDP growth in 2011-13 of 1.4% versus the MPC's base case, a significant and undesirable expansion of the output gap. The QB conclusion that £200bn of QE lifts real GDP by 1½%-2% implies that it would take £140bn-£190bn of QE to reverse this shortfall in the 2013 level of GDP. Our own forecast implies that the shortfall in the level of 2013 GDP versus the MPC's forecast will be even greater, at about 3½%. Using the BoE's ready reckoner, it would take about £350bn-£450bn of QE to reverse this shortfall.

And so we expect the MPC to restart QE on a big scale soon

These are very approximate figures. The MPC GDP forecasts assume some upward revisions to recent GDP data, whereas we and the IMF do not. But, the key point is that even if the MPC just come into line with the IMF's base case – which is by no means a worst case – they are likely to conclude that more than £100bn of QE will be needed. And if they reach that view, they are unlikely to hang around, given the urgent need to break the intensifying downward spiral.

Economic Indicators

Mon 3 Oct	Manufacturing Purchasing Managers' Index (Sep)	Forecast: 47.0	Prior: 49.0
	The manufacturing PMI has weakened for seven months in a row and probably will record another deterioration this month. This 7-month losing streak already is the longest run of worsening PMI readings since the index began 20 years ago, and we expect that dismal record to be extended again this month.		
Wed 5 Oct	Services PMI (Sep)	Forecast: 49.0	Prior: 51.1
	The services PMI fell sharply in August, falling by 4.4 points – the second biggest monthly drop on record. We expect another deterioration this month, taking the services PMI below 50 for the first time since April 2009. This, we expect, will be a decisive trigger for the expansion of QE.		
Wed 5 Oct	GDP (Q2, 3rd Release)	Provisional: 0.2% QoQ, 0.7% YoY	Prior (Q1): 0.5% QoQ, 1.6% YoY
	This release will include substantial revisions to the GDP data over many years, probably affecting both overall GDP growth and also the split of activity. These revisions are likely to be substantial, because this release will include the annual "Blue Book" revisions as well as the rebalancing of the data for recent years. Historically, GDP growth has been revised up more often than down, and revisions can often be quite large.		
Wed 5 Oct	Balance of Payments (Q2)	Forecast: £-11.8bn	Prior: £-9.4bn
	The trade deficit worsened in Q2, rising to £11.3bn from £8.5bn in Q1, and hence we expect that the overall current account balance also worsened. A word of caution, however: this release will include sizeable revisions to the current account data of recent years, which may well change the recent trend quite markedly.		
Thu 6 Oct	Service Sector Output (Jul)	Forecast: 0.0% MoM, 2.9% YoY	Prior: -0.1% MoM, 1.6% YoY
	Surveys suggest that service sector output growth has slowed sharply in recent months, and hence we expect that the ONS data will show output flat this month. Such a figure would still leave output in the last three months up by 1.0% from the previous three months, with a further slowdown likely in coming months.		

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Economic Calendar, 19 September — 7 October 2011

19 September	20 September	21 September	22 September	23 September
BoE Quarterly Bulletin		Public Sector Net Borrowing – Ex Costs of Fin. Intervention (Aug) Aug 10 £14.2bn Deficit Aug 1E £15.9bn Deficit Fiscal Year To Date Apr-Aug 10 £55.3bn Deficit Apr-Aug 11 £51.5bn Deficit MPC Minutes (Sep 8) Agents' Summary of Business Conditions (Sep) Norges Bank Outcome: Rates Unchanged at 2.25%	CBI Industrial Trends Survey (Sep, 11:00) Output Expectations (Sep) Aug +13% Sep +9% Order Books (Sep) Aug +1% Sep -9% Selling Prices (Sep) Aug +9% Sep +13%	BBA No. of Mortgage Approvals for House Purchase (Aug) Jul 33,734 MoM, 0.4% YoY Aug 35,226 MoM, 14.0% YoY IMF and World Bank Annual Meetings (Washington, DC)
	FOMC Meeting Starts	FOMC Outcome (19:15)		
26 September	27 September	28 September	29 September	30 September
Labour Party Conference (Liverpool, Sep 25-29)	CBI Retail Survey (Sep, 11:00)		Personal Borrowing (Aug)	GfK Consumer Confidence (Sep, 00:01) Around Now Nationwide House Prices (Sep, 07:00) Deficit & Debt under Maastricht Treaty (FY 2010-11)
3 October	4 October	5 October	6 October	7 October
Manufacturing PMI (Sep) Aug 49.0 SepE 47.0		Services PMI (Sep) Aug 51.1 SepE 49.0 GDP (Q2, 3 rd Release) (Incorporating Annual Blue Book Revisions) Q1 0.5% QoQ, 1.6% YoY Q2P 0.2% QoQ, 0.7% YoY	Service Sector Output (Jul) Jun -0.1% MoM, 1.6% YoY JulE 0.0% MoM, 2.9% YoY BoE Housing Equity Withdrawal (Q2) MPC Meeting: Outcome at Noon	Around Now Halifax House Prices (Sep, 09:00) Producer Prices (Sep)
Conservative Party Annual Conference (Manchester, Oct 2-5)				
Eurogroup Meeting (Brussels)	ECOFIN Meeting (Brussels)	Balance of Payments (Q2) Q1 £-9.4bn Q2E £-11.8bn MPC Meeting Starts	ECB Meeting: 12:45 Outcome 13:30 Press Conference	(During The Weekend) Poland: General Election (Oct 9)

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.

Notes

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Appendix A-1

Analyst Certification

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