

UK Economics Weekly

Will “Low-flation” Persist?

- The UK economy looks rather like the US in terms of real GDP growth and the falling jobless rate. But, in terms of inflation, the UK seems to be more in the European “low-flation” camp, with CPI inflation down to just 1.2% YoY.
- CPI inflation probably will stay low nearterm, with a trough of perhaps 1.0% YoY in December this year. However, we expect that the UK’s flirtation with “low-flation” will ultimately prove to be temporary. Barring new external disinflationary shocks, we expect that CPI inflation will rise close to the 2% target in late 2015 and into 2016.
- The current position is more like 1998 than 2008 in our view, and low inflation will boost real consumers’ incomes and give a further impetus to consumer spending. Moreover, labour market slack is shrinking fast, with a sharp rise in vacancies, and the jobless rate is likely to fall below 5% — and hence below the MPC’s estimate of the equilibrium level (5.1%) — during 2015. We continue to expect that the MPC will hike rates in early 2015, and suspect that markets have now gone too far in pricing in a “low for longer” outlook.

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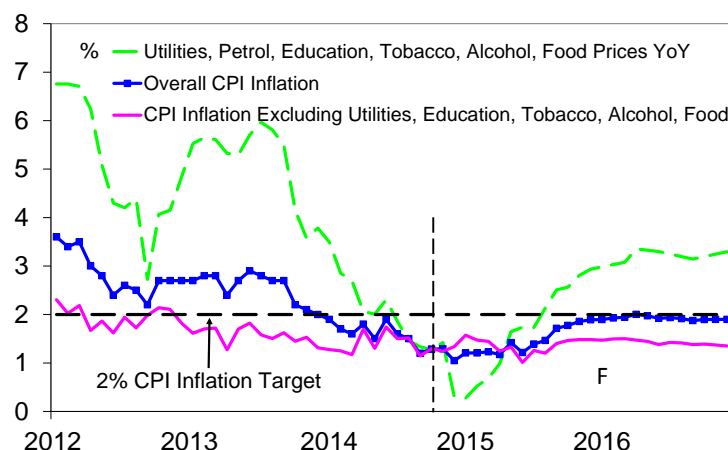
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Figure 1. Citi Market Forecasts

	End-2014	Mid-2015	End-2015	Mid-2016
Base Rate	0.50	1.00	1.75	2.50
QE Target	£375bn	£375bn	£355bn	£310bn

Source: Citi Research

Figure 2. UK — CPI Inflation Data and Forecast, 2012-16



F Citi forecast. Sources: ONS and Citi Research

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

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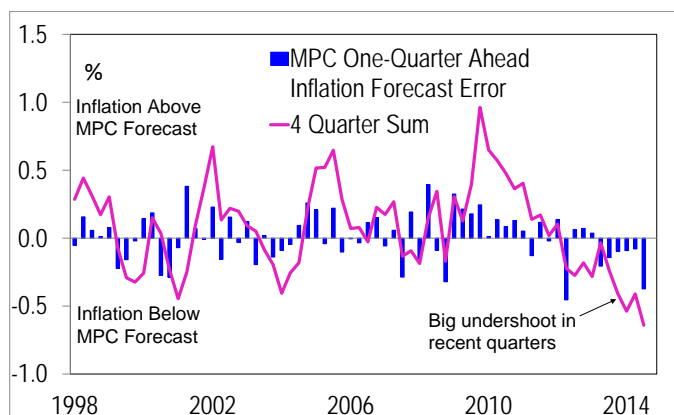
Will “Low-flation” Persist?

In terms of real GDP growth (3.2% YoY) and the falling jobless rate (down to 6.0%), the UK looks a lot more like the US economy than the euro area. But, in terms of inflation, the UK seems to be more in the European “low-flation” camp. CPI inflation has now tumbled to just 1.2% YoY — with CPI inflation excluding tax changes at a 10-year low of just 1.1% YoY. CPI inflation has undershot the MPC’s one-quarter ahead forecasts for six quarters in a row, an unprecedented series of undershoots, and indeed CPI inflation in Q3 (1.4% YoY) was fully 1.0 percent below the MPC’s central forecast for Q3-14 made a year earlier (2.4% YoY, in the August 2013 IR). In turn, consensus forecasts for inflation in the current year and next year have fallen by 0.7 percent over the last 12 months, similar to the decline in the euro area and the biggest drop since 2009.

Why has Inflation Undershot So Much?

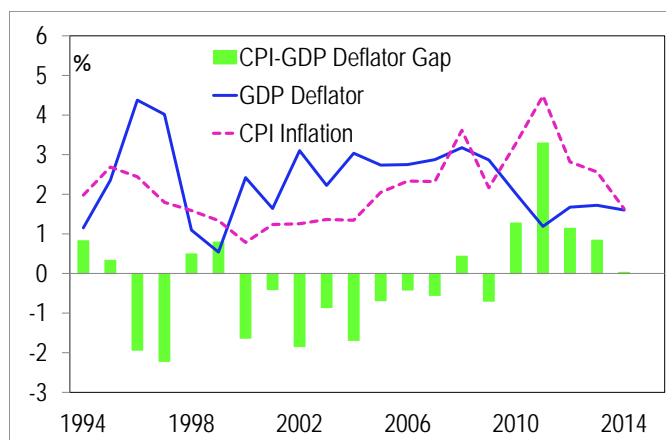
The collapse in UK inflation largely reflects the swing from heavy cost-driven price hikes in 2010-13 to the current position where external costs are now falling. In 2010-13, domestic inflation pressures (eg pay growth, unit labour costs, GDP deflator) were fairly subdued, with slack from the recession providing a powerful disinflationary hangover. However, in that period, UK inflation repeatedly overshot consensus and MPC forecasts, because of strong gains in global commodity prices and currency-driven rises in import prices, plus (especially in 2012-13) a series of regulatory- and tax-driven price hikes. As a result, CPI inflation (which measures inflation for goods and services sold in the UK) averaged 3.3% in 2010-13, whereas the GDP deflator at basic prices (which measures inflation for goods and services produced in the UK but excluding tax effects) averaged just 1.6% YoY.

Figure 3. UK — Inflation Outturns Relative to MPC One-Quarter Ahead Forecasts, 1998-14



Note: We compare the outturns for inflation with the MPC’s median forecast (with market rates) made in the Inflation Report at the start of that quarter. We use CPI inflation since 2004, RPIX inflation before that. Sources: BoE, ONS and Citi Research

Figure 4. UK — GDP Deflator and CPI Inflation YoY, 1994-2014



Note: GDP deflator shown at basic prices, which excludes the direct effects of taxes and subsidies. 2014 shows the average for the year to date. Sources: ONS and Citi Research

The recent trend in domestic costs has remained fairly stable and subdued, with the GDP deflator up 1.8% YoY in 2013 and 1.9% YoY in Q2-14. However, external costs, tax and regulation have swung from adding to inflation to now (as in 2000-07) subtracting from inflation. For example, the government has reined in tax- and regulatory-driven price hikes, global commodity prices have been depressed by disappointing global growth, and sterling’s trade-weighted index is up 7% from the Q1-13 average. Food prices additionally have been dampened by ample supply following this year’s strong harvest. As a result, headline inflation has tumbled back to — and now below — the subdued trend in the GDP deflator. The UK is finally,

getting the ultra-low CPI inflation rates that one would usually expect after the 2008-09 recession and long period of a large output gap.

With hindsight, we suspect that the consensus and MPC (and to an extent ourselves) partly (and wrongly) interpreted the inflation overshoots of 2010-13 as a sign that the UK economy is somehow inflation-prone because of low productivity growth — and hence projected a future of persistently sticky inflation. In addition, the consensus, MPC and ourselves probably failed to forecast the full extent to which sterling would rise and global commodity prices would fall during 2014.

What Will Happen to Inflation in 2015-16?

We do expect that CPI inflation will stay low nearterm, averaging 1.2% YoY in Q4-14 — with a low of perhaps 1.0% YoY in December this year — and staying around 1¼% YoY on average in H1-2015. Our 2014-15 CPI inflation forecasts have been a little below consensus this year and remain so: after the latest data, we have cut our forecasts to 1.5% YoY in both 2014 and 2015 (from 1.6% and 1.8% YoY previously) whereas the consensus before the latest CPI data was for inflation of 1.7% in 2014 and 1.9% in 2015. However, we suspect that the UK's flirtation with “low-flation” will ultimately prove to be temporary. Unless there are new external disinflationary shocks, we expect that stabilization in food and energy prices plus continued gains in utility prices will anchor CPI inflation close to the 2% target in late 2015 and into 2016.

We cite three key factors which suggest that the UK's recently disinflationary past is probably not a precursor to a sustained period of “low-flation”.

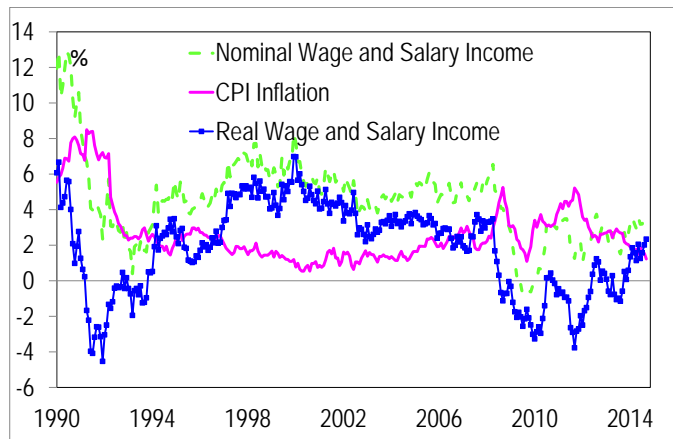
First, the economy is still growing quite strongly and the plunge in inflation will reinforce — rather than dampen — the strength in domestic demand. Data available so far suggest that GDP rose about 0.8% QoQ (3.1-3.2% YoY) in Q3, and overall activity trends in recent business surveys remain above their precrisis averages. Corporate balance sheets are in very robust shape in aggregate, with high liquidity and rapid growth in bank deposits held by non-financial companies (8.9% YoY, highest since 2007), and a range of surveys suggest that firms' hiring and investment intentions remain very strong.

Moreover, for the UK economy as a whole, the current collapse in inflation from prices for food, energy and imported goods is like a tax cut that lifts consumers' real incomes and cushions the economy against the drag from softer external demand. The drop in commodity prices is chiefly a side effect of weaker external growth (especially in emerging markets). So the main losers from these trends are EMs and commodity producers, while the relative gainers are commodity consumers. The UK has relatively light export exposure to emerging markets and commodity producers, but is a major commodity consumer. The UK is a modest oil producer but this is less than 1% of UK GDP. The overall mix of slightly softer global growth and markedly lower commodity prices probably is a plus for UK domestic demand growth and is not that bad for UK GDP growth overall.

For example, with inflation plunging, we estimate that real wage and salary growth (the sum of job growth and average earnings growth ex bonuses, less CPI inflation) is now running at 2-2½% YoY — versus zero a year ago — the highest since the precrisis period and not far below the precrisis average (2002-07 average was 3.1% YoY). With the extra support from income growth among the self-employed, household spending power is now rising quite strongly. In all, we estimate that the “misery index” — ie the sum of inflation and the jobless rate — is now the lowest since 2007 and close to the 2002-07 average. As Figure 6 shows, swings in this

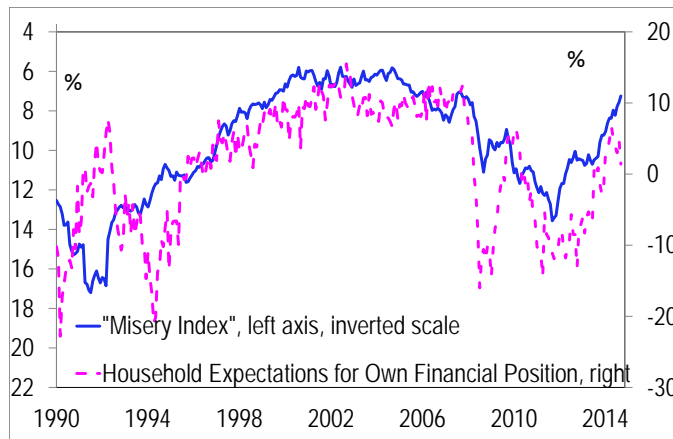
index have tended to be reflected in opposing swings in consumer confidence. A similar effect was seen in the late-90s Asian crisis, as falling import prices crushed inflation and gave consumers massive windfall gains in real incomes which helped fuel a consumer spending surge in the UK. Conversely, the high inflation rates of recent years eroded real incomes and depressed consumer spending.

Figure 5. UK — Wage and Salary Income, and Inflation, YoY, 1990-14



Note: Wage and salary income is job growth plus average earnings growth ex bonuses since 1996, including bonuses before that. Sources: ONS and Citi Research

Figure 6. UK — Misery Index and Consumer Confidence, 1990-2014



Note: The "Misery Index" is defined as the jobless rate plus CPI inflation. Sources: European Commission, ONS and Citi Research

Second, although the economy has had ample slack in recent years — helping to cap domestic inflation pressures this year — that slack is shrinking fast and now appears to be quite limited. Even with the boost to the workforce from the rising participation rate and inflows of foreign workers, the jobless rate has fallen by 1.7 percent over the last 12 months (from 7.7% to 6.0%), the fastest drop for 25 years. The share of the working age population in work and the participation rate are both close to record highs. The number of job vacancies is up 24% YoY and is now close to the precrisis peak. Given recent trends, the ratio of vacancies to unemployed people is likely to return to its precrisis average in the next couple of quarters, while the jobless rate probably will hit the MPC's estimate of the equilibrium jobless rate (5.1%) during 2015.

The IMF judges that the output gap has shrunk from 3.0% of GDP (third highest among the G7 countries) in 2012 to 1.2% of GDP on average this year, and (even with a fairly cautious growth forecast) project that the output gap will fall to just 0.4% of GDP in 2015 (smallest among the G7). To be sure, output gap estimates are uncertain, but over the last 15 years UK output gap revisions have almost always been in the direction of higher capacity use (or less spare capacity) than believed in "real time". Given that bias, it is entirely possible that the output gap will close in 2015. All this is a major contrast to the euro area, where the jobless rate is high, the output gap is large and domestic disinflationary pressures probably are powerful enough to create a long period of low-flation.

Third, the continued sluggishness of average earnings growth (which remains around 1% YoY) does not seem to be a sign of renewed disinflationary pressure. A range of surveys (eg BoE Agents Survey) suggest that labour cost trends are gradually picking up. Rather, we suspect that weakness in average earnings is exacerbated by composition effects — in particular the expansion of jobs in low-pay sectors and regions of the economy — which also dampen productivity growth by a roughly similar amount. ONS micro-data also hint at the importance of such composition effects. During 2011-13, hourly pay across the economy rose by 1.2%

YoY on average. However, the growth of hourly pay averaged 3.7% YoY for people who remained in the same job at the same firm from one year to the next, and also averaged 3.7% YoY for people who were at the same firm in a different job from one year to the next. These trends are a little weaker than the precrisis trends, but still imply continued real wage gains. By contrast, among people with a discontinuous employment history from one year to the next¹, pay levels fell by an average of 8% YoY in 2011-13, a far steeper drop than in the precrisis period. These trends hint at a sizeable shift of people into lower-paid jobs, rather than a decline in real pay for those who stayed in the same job.

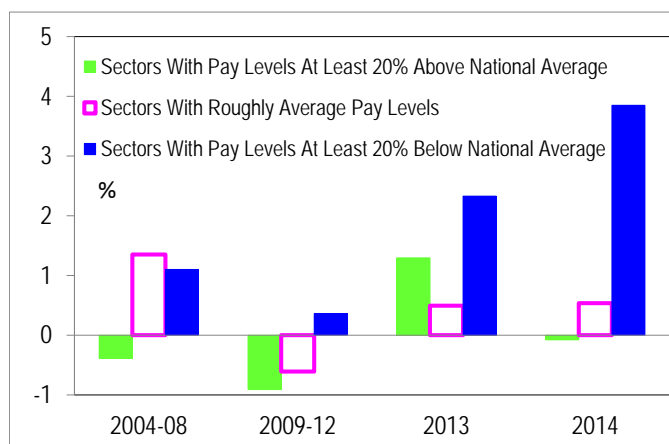
This effect is also evident in the sectoral composition of employment: almost all of the net growth in the numbers of employees (ie in work but not self-employed) over the last year has been in sectors where the level of pay is at least 20% below the national average. Similarly, all of the growth in employment is accounted for by people aged below 35 years or more than 50 years (and people in these age groups also typically earn less than the average), with a continued decline (down 0.7% YoY) in the numbers of people in work aged 35-49 years (who typically earn more than the average).

Figure 7. UK — YoY Growth in Hourly Pay, 2005-13



Sources: ONS and Citi Research

Figure 8. UK — Split of Employment Growth By Pay Level, 2004-14



Sources: ONS and Citi Research

As well as these three factors, the economy is backstopped by the MPC, who can — if necessary — be flexible over the timing and pace of any tightening. We have been expecting the MPC will start to hike rates in Q1-2015, with rates to rise by 125bp by yearend, and to rise further in 2016. If downside risks to growth expand, the MPC could simply prolong stimulus, by hiking later or slower than we expect. We doubt that the economy will need as much stimulus in 2015-16 as markets price in. We still expect that the MPC will start to hike rates in 2015, and hike more than markets price in for 2015-16. But, our confidence in the economy's prospects is reinforced by the MPC's ability — especially with inflation below target — to maintain as much stimulus as needed to ensure the economy continues to grow solidly.

¹ People with a discontinuous employment history did not work at the same firm across two years. There are several reasons why people might have a discontinuous employment history, including non-response, moving from one job to another one, or moving from unemployment into employment.

Figure 9. Economic Indicators

Tue 21 Oct	Public Sector Net Borrowing (Sep) (Ex Public Sector Banks)	Forecast: £10.5bn deficit, £55.9 billion deficit fiscal year to date Year Ago: £10.4bn deficit, £53.1 billion deficit fiscal year to date	
	The fiscal deficit in the first five months of the fiscal year was a little above last year's levels, in contrast to the OBR's forecast that the deficit will fall by £12.7bn this year, with revenue growth running well below target. We expect revenues will remain soft this month, with the deficit likely to overshoot by about £10bn versus the OBR's forecast over the full fiscal year.		
Thu 23 Oct	Retail Sales Volumes (Sep)	Forecast: 0.4% MM, 3.4% YY	Prior: 0.4% MM, 3.9% YY
	Surveys suggest that retail sales continue to grow at a fairly solid pace, and we anticipate another gain. Such a figure would leave Q3 volumes up 0.5% QoQ, the seventh consecutive quarterly gain.		
Thu 23 Oct	CBI Quarterly Industrial Trends Survey (Oct)		
	Quarterly Industrial Confidence, Oct	Forecast: +10%	Prior (Jul): +19%
	Monthly Output Expectations Net Bal. (Oct)	Forecast: +20%	Prior (Sep): +27%
	Monthly Order Books Net Balance (Oct)	Forecast: -14%	Prior (Sep): -4%
	Monthly Selling Prices Net Balance (Oct)	Forecast: +0%	Prior (Sep): +1%
	The October CBI survey has often shown weakness, with an average deterioration in the monthly order books of 10 percentage points between the September and October surveys over the last 10 years. The average deterioration in the quarterly business index is four points from July to October. Given those trends, plus the likelihood that there is a genuine slowdown in manufacturing underway, this survey is likely to show a fairly sizeable deterioration in the main activity gauges.		
Fri 24 Oct	Service Sector Output (Aug)	Forecast: 0.3% MM, 3.4% YY	Prior: 0.3% MM, 3.4% YY
	Surveys suggest that service sector output is growing strongly and we expect these figures will show continued solid growth. Note that the ONS will revise previous data as part of the shift to the ESA system.		
Fri 24 Oct	GDP (Q3, Preliminary Estimate)	Provisional: 0.8% QQ, 3.1% YY	Prior: 0.9% QQ, 3.2% YY
	The available data show modest growth in industrial production and flat construction in July-August, with a modest gain in service sector output for July. Our forecast assumes a further gain in services output in August (data released at the same time), and we are torn between forecasting a gain of 0.7% and 0.8% QoQ. We expect that the ONS will, as usual, revise up recent GDP growth rates at some stage.		
Wed 29 Oct	Mortgage Approvals (Sep)	Forecast: 64,500 MM, -3.6% YY	Prior: 64,200 MM, 1.0% YY
	The number of mortgage approvals for house purchase has flattened off since late 2013 and we expect these figures will show a slight YoY decline – the first such reading since Jan-2013. Nevertheless, there is still substantial pent-up demand for housing, which is likely to keep the housing market reasonably buoyant in coming months.		

Source: Citi Research

Figure 10. Economic Calendar, 13 October — 2 November 2014

13 October	14 October	15 October	16 October	17 October
	Consumer Prices (Sep) Aug 0.4% MM, 1.5% YY Sep 0.0% MM, 1.2% YY CPI Ex F, D, T, E (Sep) Aug 0.5% MM, 1.9% YY Sep 0.1% MM, 1.5% YY Retail Prices (Sep) Aug 0.4% MM, 2.4% YY Sep 0.2% MM, 2.3% YY RPIX – Ex Mortgages (Sep) Aug 0.4% MM, 2.5% YY Sep 0.2% MM, 2.3% YY Producer Input Prices (Sep) Aug -1.2% MM, -7.7% YY Sep -0.6% MM, -7.4% YY Prod. Output Prices (Sep) Aug -0.1% MM, -0.3% YY Sep -0.1% MM, -0.4% YY Ex F, D, T, E (Sep) Aug 0.1% MM, 0.9% YY Sep -0.1% MM, 0.8% YY EcoFin Meeting (Luxembourg)	LFS Unemployment (Jun-Aug) May-Jul -146K QQ Jun-Aug -154K QQ LFS Unemployment Rate, 3-Month Avg (Jun-Aug) May-Jul 6.2% Jun-Aug 6.0% LFS Unemployment Rate, Single Month (Aug) Jul 5.9% Aug 5.9% Claimant Count Unemployment (Sep) Aug -33.2 K MM, 2.9% Rate Sep -18.6K MM, 2.8% Rate Average Earnings Ex Bonus, 3-Month Avg (Aug) Jul 0.8% Aug 0.9%		EU Government Debt and Deficit Returns
Informal Eurogroup (Luxembourg)				
US: Columbus Day Holiday				
20 October	21 October	22 October	23 October	24 October
	Public Sector Net Borrowing (Sep) Sep13 £10.4bn Sep14E £10.5bn Fiscal Year To Date (Apr-Sep) Apr-Sep13 £53.1bn Apr-Sep14E £55.9bn	MPC Minutes (9 Oct) BoE Agents' Summary of Business Conditions (Oct) Bank of Canada Meeting: (Outcome at 15:00)	Retail Sales Volumes (Sep) Aug 0.4% MM, 3.9% YY SepE 0.4% MM, 3.4% YY Norges Bank: Interest Rate Decision (09:00) CBI Quarterly Industrial Trends Survey (Oct, 11:00) Qrtly Industrial Confidence Jul +19% OctE +10% Mthly Output Expect'ns Sep +27% OctE +20% Monthly Order Books Sep -4% OctE -14% Monthly Selling Prices Sep +1% OctE 0% European Council (Brussels)	Service Sector Output (Aug) Jul 0.3% MM, 3.4% YY AugE 0.3% MM, 3.4% YY GDP (Q3 Preliminary) Q2 0.9% QQ, 3.2% YY Q3E 0.8% QQ, 3.1% YY European Council (Brussels)
				Sun 26 October Clocks Go Back One Hour in UK and Europe (02:00) ECB Releases Final Results of Comprehensive Assessment of 130 Banks (11:00)
27 October	28 October	29 October	30 October	31 October
CBI Retail Survey (Oct, 11:00) During The Week Nationwide House Prices (Oct, 07:00)	Riksbank Meeting (Outcome at 08:30) FOMC Meeting	Mortgage Approvals (Sep) Aug 64.2K MM, 1.0% YY SepE 64.5K MM, -3.6% YY Insolvencies (Q3) FOMC Meeting (Outcome at 18:00)		GfK Consumer Confidence (Oct, 00:01) National Accounts "Blue Book" 2014 Balance of Payments "Pink Book" 2014 Sun 2 Nov Clocks Go Back One Hour in N. America (02:00)

E Citi estimate. B Billion. P Provisional. R Revised. Note: All data are released at 9.30 a.m., except those marked otherwise.
Sources: BoE, CBI, ONS, national sources and Citi Research.

Appendix A-1

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