

UK Economics Weekly

Looking Back...the Economic Surprises of 2013

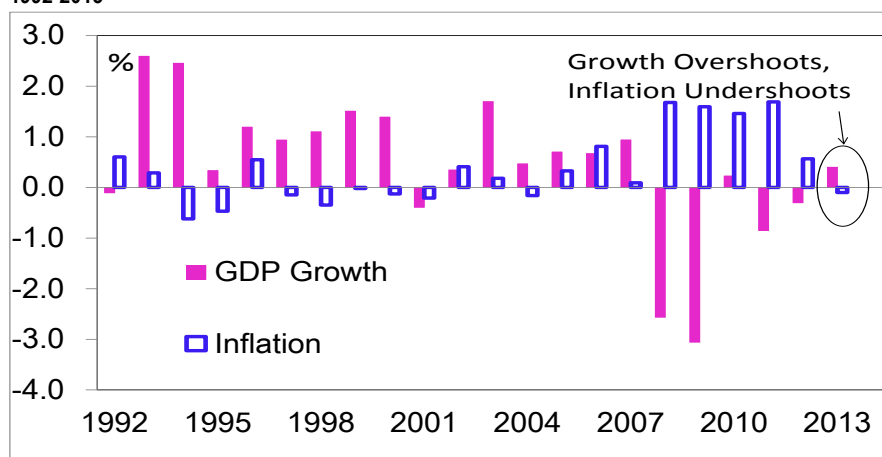
- We usually aim to look forward rather than back in this publication. But, this week we look back to assess how the economy has performed versus consensus forecasts (and our forecasts) at the start of the year, and highlight lessons.
- In contrast to the disappointing growth/inflation mix of recent years, 2013 saw higher-than expected real growth with a slight inflation undershoot compared to the consensus, our forecasts and MPC forecasts. Consumer spending growth markedly overshot consensus for the second year in a row, while — as in recent years — investment and exports undershot. The labour market remains surprisingly flexible, with both wage growth and unemployment lower than expected. We expect some of these themes will carry over into 2014-15, with higher real growth, lower inflation and lower unemployment than the consensus expects but, unlike 2013, a broadening of growth into investment and exports.
- We wish our readers a Merry Christmas and Happy New Year. The next UK Economics Weekly will be published in the week of 6 January 2014.

Figure 1. Citi Market Forecasts

	Base Rate	QE Target	10 Year Yield	Spread vs. Bunds	\$/£	£/€
Mid 2014	0.50	£375bn	3.05	137bp	1.73	0.80
End 2014	0.50	£375bn	3.30	153bp	1.75	0.80

Source: Citi Research

Figure 2. UK — Outturns for Real GDP Growth and Inflation Versus Start of Year Consensus, 1992-2013



Note: Inflation measured by CPI since 2003, RPIX before that. Inflation measured in Q4 since 1997, calendar year before that. Sources: HM Treasury, Consensus Economics, ONS and Citi Research

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Looking Back... Economic Surprises of 2013

We examine the economic surprises of 2013

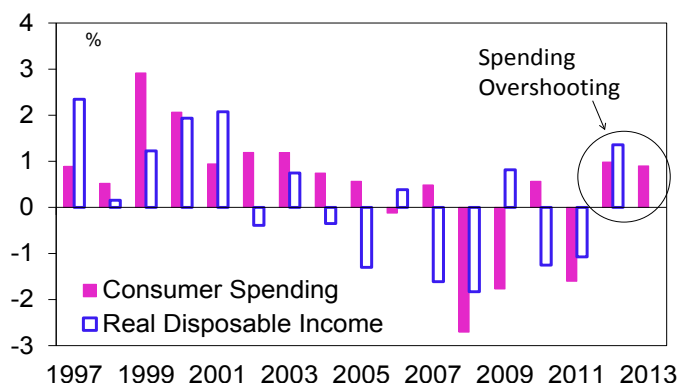
GDP growth overshoot significantly after repeated undershoots in recent years...

...whereas inflation undershot slightly after repeated overshoots in recent years

As 2013 nears its end, this week we look back to assess how the economy has performed versus consensus forecasts (and our forecasts) at the start of the year¹, and aim to highlight lessons from this.

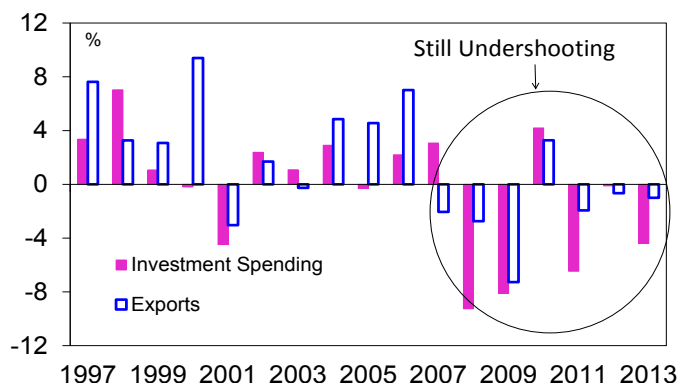
- GDP growth in 2013 (outturn of about 1.4% YoY) overshoot the start of year consensus (1.0%), the first significant overshoot since 2007. The UK was near the top of economic outperformers versus the consensus in 2013: growth undershot in most major economies, and among the main advanced economies, only Switzerland and Japan posted bigger upside surprises than the UK. This follows a string of undershoots in four of the last five years. By contrast, in the period from 1993-07, UK growth beat the consensus in 14 out of 15 years.
- CPI inflation in Q4 (2.2% YoY on the OBR forecast, 2.1% on our forecast) marginally undershot the start of year consensus (2.3%), and the consensus for Q4 reached as high as 2.6% YoY in May. To be sure, inflation undershot consensus by more in the euro area and US in 2013. But, even to have a modest undershoot is a marked change for the UK compared to previous years: UK CPI inflation overshoot the consensus every year from 2005-12, with exceptionally large overshoots (around 1½% per year) in 2008-11 and another large overshoot (0.6%) in 2012. No other major advanced economy had such a persistent trend of upside inflation surprises in those years.

Figure 3. UK — Outturns for Real Consumer Spending and Household Disposable Income, YoY, Versus Start of Year Consensus, 1997-2013



Sources: HM Treasury, ONS and Citi Research

Figure 4. UK — Outturns for Real Investment Spending and Exports, YoY, Versus Start of Year Consensus, 1997-2013



Sources: HM Treasury, ONS and Citi Research

Consumer spending overshoot even though real income growth remained sluggish...

- Consumer spending growth in 2013 (about 1.9% YoY) overshoot the consensus (1.0%) by nearly 1%, similar to the 2012 overshoot and the first sizeable back-to-back consumer overshoots since 2002-03. Note that this overshoot in consumer spending was not caused by higher-than-expected real income growth which, at about 0.5%, was in line with the start of year consensus. Rather, it was mainly a story of a lower-than-expected savings rate. This apparent short-term disconnect between spending and incomes is not that unusual, and reflects volatile elements in the income figures as well as the role of swings in savings in driving spending: over the last 10 years, the correlation between the surprises (versus consensus) in consumer spending growth and real income growth is low, at 20-25%.

¹ To be precise, we compare the OBR's estimate of the outturns (or, for average earnings growth, the actual average for Jan-Sep) with the consensus and our forecasts published in January.

...while investment undershot again...

■ Investment spending undershot for the fifth year out of the last six; falling by about 2½% in 2013, whereas the consensus expected a gain of 1.9%. Investment spending has also repeatedly undershot the OBR's forecasts in recent years. Data on investment are often revised quite markedly, and it is, of course, possible that recent investment data will be revised up (with stockbuilding revised down). But, so far, the picture is of repeated disappointment.

...and export growth also undershot again

■ Export growth undershot for the sixth year out of the last seven, with export volumes (goods and services) rising by about 1.2% YoY versus the consensus forecast of 2.2% growth.

Unemployment and pay growth both undershot again

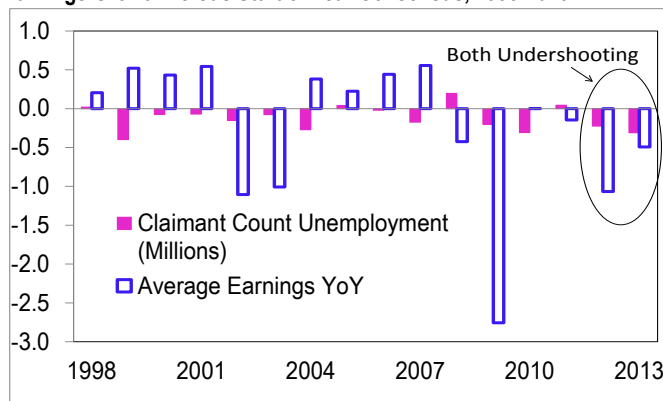
■ Claimant count unemployment undershot the consensus by roughly 300,000 people, the fourth undershoot in the last five years². Average earnings growth also undershot again, rising by roughly 1.1% YoY versus the consensus of 1.6% growth, the third consecutive undershoot and the fifth undershoot in the last five years. By contrast, earnings growth overshot consensus each year during 05-08.

Compared to our start of year forecasts, growth was notably stronger with inflation notably lower

■ Compared to the start-of-year Citi forecasts, real GDP growth was markedly higher (overshoot of 1.0%, we forecast 0.4% growth) and inflation was markedly lower (undershoot of 0.5%, we forecast 2.7% YoY for Q4)³. Our forecasts missed by more than the consensus on both counts. Indeed, 2013 saw the biggest overshoot in GDP growth versus the Citi start of year forecast since 2003. Over the 14 years from 2000-13 inclusive, the Citi forecast has been closer than the consensus to the outcome ten times, although in some cases the differences are small and reflect revisions long after the event. For inflation, one notable feature is that over the last six years we have recorded three undershoots and three overshoots, whereas the consensus recorded five overshoots.

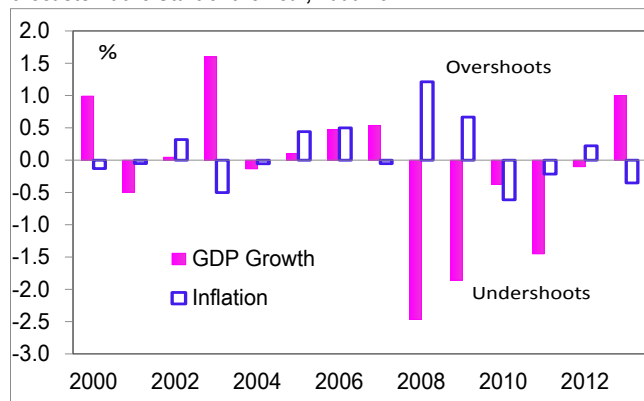
■ The story of better-than-expected growth and lower-than-expected inflation is similar compared to the MPC's forecasts, although their growth forecasts were closer to the probable outcomes for 2013 than both our forecasts and the consensus. At end-2012, the MPC forecast GDP growth of 1.2% in 2013 (about 0.2% too low) and CPI inflation of 2.3% YoY in Q4-13 (0.1-0.2% too high). As recently as Aug-13, the MPC forecast CPI inflation in Q4-13 at 2.9% YoY. By contrast, inflation has repeatedly overshoot MPC forecasts in recent years.

Figure 5. UK — Outturns for Unemployment (Millions) and YoY Average Earnings Growth Versus Start of Year Consensus, 1998-2013



Note: Unemployment measured by the claimant count.
Sources: ONS and Citi Research

Figure 6. UK — Outturns for GDP Growth and Inflation Versus Citi Forecasts At the Start of the Year, 2000-13



Note: Forecasts and outturns both measured for the calendar year. Inflation measured by CPI inflation since 2004, RPIX before then. Sources: ONS and Citi Research

² Until recently, consensus surveys have not covered the LFS jobless rate. However, the LFS jobless rate also undershot compared to forecasts available from the IMF, EC and OECD.

³ See "Global Economic Outlook and Strategy", January 2013, Willem Buiter et al, Citi.

Consensus forecast errors are often serially correlated for several years

Several points stand out from this.

First, although one might expect that forecast errors are more or less random, in practise they often are serially correlated: in other words, the consensus often makes a similar error for several years. Such repeated forecast errors may be a sign that the consensus is not allowing enough for a key factor, for example the headwinds from deleveraging and poor credit availability in recent years. We believe that analysis of forecast errors is a useful part of the forecast process, and suspect that the repeated overshoots in consumer spending are a sign that headwinds from deleveraging are easing.

The last year's experience suggests that the UK is not inevitably set for a disappointing growth/inflation tradeoff

Second, the 2013 outturns suggest that the UK is not inevitably locked into an adverse growth/inflation tradeoff. We suspect the consensus has drawn the wrong conclusions from the experience of recent years, interpreting it as in part a symptom of supply-side limitations connected to weakness in capital stock growth and productivity that will keep inflation sticky as growth revives. In our view, the inflation stickiness of recent years mainly reflects a series of one-off factors — overheating at the peak of the boom, lagged effects of cost pressures from sterling's sharp depreciation in 2007-09, plus persistent increases in indirect taxes, utilities and regulated prices in 2012-13. UK cost growth has been subdued for several years, while the inflation pressures from the weak pound are over. Underlying CPI inflation (excluding utilities, food, drink, tobacco, energy and petrol) has been running at about 1½% YoY for a couple of years. With the government now acting to reduce the boost from regulated prices, taxes and utilities — and food price inflation slowing — headline CPI inflation is likely to fall further towards that subdued underlying path.

It is not that unusual for inflation and growth to surprise in opposite directions

Third, although our forecast that in 2014-15 real growth will overshoot consensus and inflation will undershoot⁴ might sound contradictory, in practice the correlation between undershoots/overshoots in growth and inflation has been markedly negative over the last 20 years. In other words, upside growth surprises tend to go alongside downside inflation surprises (and vice versa). Upside growth surprises might well boost future inflation pressures, but (especially if the economy has a sizeable output gap) not necessarily in the same year or even in the next year. Indeed, in so far as inflation surprises reflect cost pressures, the causality in any particular year may in part go from lower inflation to higher real growth in incomes and GDP. In 2014, we expect that the reduced drag on real incomes from taxes and regulated prices will actually help the growth outlook, and the economy has enough slack to allow faster growth without immediate cost and capacity pressures.

The economy is not really rebalancing yet

Fourth, this year's upside surprise in growth mainly reflects consumption rather than rebalancing towards exports and investment.

The labour market remains surprisingly flexible

Fifth, the labour market remains surprisingly flexible, with both wage growth and unemployment lower than generally expected. To an extent, we regard the weakness in productivity and pay amidst modest GDP growth as a positive sign of supply-side flexibility: it probably is better for the economy's longrun prospects to have had a general drop in real wages and rising employment rather than rising real wages and much higher unemployment (as seen in the early 90s recovery) with resultant hysteresis worries. We suspect that productivity growth will gradually pick up as the economy strengthens and, with lower unemployment, real wages stop falling. There are hints of this more benign supply side view in BoE Governor

⁴ See "[The Opposite of Stagflation](#)", *UK Economics Weekly*, Michael Saunders, 8 November 2013, Citi.

Carney's latest speech⁵: "With the sharp fall in real wages during the recession, employees effectively priced themselves into low-productivity work at a time of weak demand. To the extent that this allows skills to be retained and reduces costs of replacing particularly skilled employees as the recovery takes hold, the recovery could generate greater supply capacity and real wage growth as it proceeds."

We expect some of these themes to carry over into 2014

We expect that many of these themes will carry over into 2014, with stronger GDP growth and lower inflation than the consensus (and MPC) expects, but - unlike 2013 - a broadening of recovery to exports and investment as well. We will discuss the outlook in more detail in the New Year.

Economic Indicators

Tue 17 Dec	Consumer Prices (Nov) CPI Ex Food, Drink, Tobacco, Energy (Nov) Retail Prices (Nov)	Forecast: 0.1% MoM, 2.1% YoY Forecast: 0.1% MoM, 1.7% YoY Forecast: 0.1% MoM, 2.6% YoY	Prior: 0.1% MoM, 2.2% YoY Prior: 0.2% MoM, 1.7% YoY Prior: 0.0% MoM, 2.6% YoY
	There are slightly conflicting effects for this month, with the initial part of the recently-announced hikes in home energy prices but also a further slight drop in petrol prices. On balance we expect that CPI inflation will edge down, reaching the lowest since late-2009. Inflation is likely to fall a little further in the December data.		
Tue 17 Dec	Producer Input Prices (Nov)	Forecast: -0.6% MoM, -1.2% YoY	Prior: -0.6% MoM, -0.3% YoY
	We expect input prices to fall for the fourth consecutive month, and for the seventh month out of the past eight. Global commodity prices have continued to drift lower, while the pound has continued to appreciate. All this provides a helpful disinflationary backdrop for 2014.		
Tue 17 Dec	Producer Output Prices (Nov) Output Prices Ex Tax (Nov) Excluding Food, Drink, Tobacco, Energy (Nov)	Forecast: 0.0% MoM, 0.3% YoY Forecast: -0.1% MoM, 1.0% YoY Forecast: -0.1% MoM, 0.9% YoY	Prior: -0.3% MoM, 0.8% YoY Prior: -0.2% MoM, 1.1% YoY Prior: 0.1% MoM, 0.9% YoY
	With continued weakness in global commodity prices, and subdued trends in surveys of firms' pricing intentions, we expect that output price inflation will remain weak.		
Mon 17 Dec	CBI Industrial Trends Survey (Dec) Monthly Output Expectations Net Balance (Dec) Monthly Order Books Net Balance (Dec) Monthly Selling Prices Net Balance (Dec)	Forecast: +30% Forecast: +10% Forecast: +5%	Prior: +24% Prior: +11% Prior: -2%
	After the weaker October survey (a regular pattern of recent years), the November CBI survey bounced back to show broadbased strength – with order books at the highest since the mid-90s. We expect similar strength in the December survey, and recent IP data suggest that the official data are broadly validating the bullish message from recent surveys.		
Wed 18 Dec	LFS Unemployment (Aug-Oct) Claimant Count Unemployment (Nov)	Forecast: -42,000 QoQ, 7.5% Rate Forecast: -40,000 MoM, 3.8% Rate	Prior: -48,000 QoQ, 7.6% Rate Prior: -41,700 MoM, 3.9% Rate
	The single month data for September showed the jobless total falling by 63K relative to three months earlier, and we expect a similar decline in the October single month figures, hence leaving the three-month average decline at 42K and bringing the jobless rate down to 7.5% – the lowest since early 2009.		
Thu 19 Dec	Retail Sales Volumes (Nov)	Forecast: 0.9% MoM, 2.8% YoY	Prior: -0.7% MoM, 1.8% YoY
	We expect these data to show a snap back in retail sales growth, as the adverse effect on sales of the relatively warm October fades. The average daily temperature in November fell below average, and indeed it was the biggest drop between October and November since 2006. This is likely to boost sales of winter clothing, reversing the weakness in clothing sales in the October data.		
Fri 20 Dec	Public Sector Net Borrowing (Nov) (Ex RM, APF and Financial Intervention)	Forecast: £15.0bn deficit, £108.7 billion deficit fiscal year to date Year Ago: £15.5bn deficit, £121.9 billion deficit fiscal year to date	
	We expect the underlying deficit will continue to fall slightly, keeping the UK on course for a slight undershoot even compared to the OBR's updated forecast (£111.2bn).		
Fri 20 Dec	Balance of Payments (Q3)	Forecast: £-13.0 bn	Prior: £-13.0 bn
	Recent figures already have shown that the deficit on goods and services trade widened slightly in Q3, but we expect this will be balanced by a slight drop in transfer payments after a high figure in Q3. Such a figure would keep the full-year total deficit on course for about £60bn, 3.7% of GDP, a record high in cash terms and as a share of GDP similar to the 22-year high seen in 2012.		
Fri 20 Dec	GDP (Q3, 3rd Release)	Provisional: 0.8% QoQ, 1.5% YoY	Prior (Q2): 0.7% QoQ, 1.3% YoY
	It is possible that the ONS will revise Q3 growth up by a tenth following the upward revision to the Q3 construction output data. The split is likely to show a slight drop in the savings rate to about 5.1% from 5.9% in Q2.		
Fri 20 Dec	Service Sector Output (Oct)	Forecast: 0.3% MoM, 2.4% YoY	Prior: 0.2% MoM, 2.2% YoY
	Surveys suggest that service sector output is growing rapidly, and we expect these figures will show another solid gain. A figure in line with our forecast would put output already 0.6% above the Q3 average, hence setting the stage for a strong Q4 GDP reading.		

⁵ See speech of 9 December 2013.

Economic Calendar, 9 December 2013 — 10 January 2014

9 December	10 December	11 December	12 December	13 December
	Industrial Production (Oct) Sep 0.9% MoM, 2.2% YoY Oct 0.4% MoM, 3.2% YoY Manufacturing Output (Oct) Sep 1.2% MoM, 0.7% YoY Oct 0.4% MoM, 2.7% YoY Trade Balance – Goods & Services (Oct) Sep £-2.6bn Oct £-2.6bn EuroGroup Meeting (afternoon)		Swiss National Bank Monetary Policy Assessment (08:30) Target Range for 3-M Libor Unchanged at 0.00%-0.25% Swiss Franc Cap Unchanged At CHF1.20/€	Construction Output (Oct) Sep -0.5% MoM, 8.2% YoY Oct 2.2% MoM, 5.3% YoY
16 December	17 December	18 December	19 December	20 December
	Consumer Prices (Nov) Oct 0.1% MoM, 2.2% YoY NovE 0.1% MoM, 2.1% YoY CPI ex F, D, T, E (Nov) Oct 0.2% MoM, 1.7% YoY NovE 0.1% MoM, 1.7% YoY Retail Prices (Nov) Oct 0.0% MoM, 2.6% YoY NovE 0.1% MoM, 2.6% YoY RPIX – Ex Mortgages (Nov) Oct 0.0% MoM, 2.7% YoY NovE 0.1% MoM, 2.7% YoY Producer Input Prices (Nov) Oct -0.6% MoM, -0.3% YY NovE -0.6% MoM, -1.2% YoY Prod. Output Prices (Nov) Oct -0.3% MoM, 0.8% YY NovE 0.0% MoM, 0.3% YoY Ex F, D, T, E (Nov) Oct 0.1% MoM, 0.9% YY NovE -0.1% MoM, 0.9% YoY CBI Ind. Trends (Dec, 11:00) Output Expectations (Dec) Nov +24% DecE +30% Order Books (Dec) Nov +11% DecE +10% Selling Prices (Dec) Nov -2% DecE +5%	LFS Unemployment (Aug-Oct) Jul-Sep -48K QoQ, 7.6% Rate Aug-OctE -42K QoQ, 7.5% Rate Claimant Count Unemployment (Nov) Oct -41.7K MoM, 3.9% Rate NovE -40.0K MoM, 3.8% Rate MPC Minutes CBI Retail Survey (Dec) (11:00)	Retail Sales Volumes (Nov) Oct -0.7% MoM, 1.8% YoY NovE 0.9% MoM, 2.8% YoY	Public Sector Net Borrowing – Ex RM, APF & Fin. Interventions (Nov) Nov 12 £15.5bn Deficit Nov 13E £15.0bn Deficit Fiscal Year To Date Apr-Nov12 £121.9bn Deficit Apr-Nov13E £108.7bn Deficit Balance of Payments (Q3) Q2 £-13.0bn Q3E £-13.0bn GDP (Q3, 3rd Release) Q2 0.7% QoQ, 1.3% YoY Q3E 0.8% QoQ, 1.5% YoY Service Sector Output (Oct) Sep 0.2% MoM, 2.2% YoY OctE 0.3% MoM, 2.4% YoY
23 December	24 December	25 December	26 December	27 December
	Christmas Eve	Christmas Day Holiday	Boxing Day Holiday	
30 December	31 December	1 January 2014	2 January	3 January
(During The Week) Nationwide House Prices (Dec, 07:00)		New Year's Day Holiday	Manufacturing PMI (Dec)	
6 January	7 January	8 January	9 January	10 January
Services PMI (Dec)			Trade Balance – Goods & Services (Nov)	Industrial Production (Nov) Manufacturing Output (Nov)
(During The Week) Halifax House Prices (Dec) (08:00)		MPC Meeting Starts	Profitability of UK Companies (Q3) MPC Meeting Ends: Outcome at Noon ECB Meeting 12:45 Outcome 13:30 Press Conference	Construction Output (Nov)

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

Notes

Appendix A-1

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