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Developed Markets
**Western Europe**

# UK Economics Weekly

## Change in Rate View

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- The *Inflation Report* shows a more radical re-think of the MPC's outlook than we expected, with greater optimism over the supply-side as well as the growth outlook. In particular, the MPC judge the medium-term equilibrium unemployment rate (U*) is down to 5.5% (and falling quite rapidly), whereas their prior methodology would have put U* currently at about 6.0%. Hence, even with the jobless rate down to 6.4%, the MPC believe that considerable labour market slack remains.

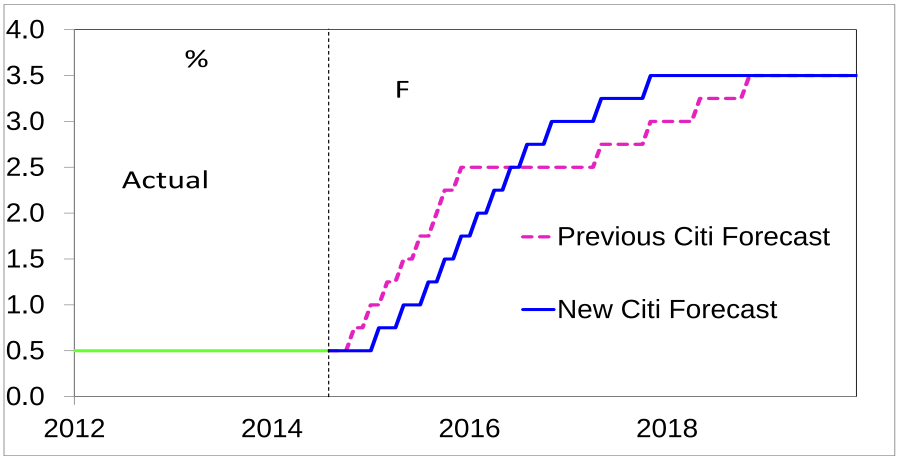
- As a result, we are changing our forecast for the first MPC rate hike from Q4 this year to Q1-2015. We previously judged that the MPC would hike once the jobless rate falls to about 6.0% (which we expect in the next 3-4 months) even if trends in pay and inflation remain benign. But, with the MPC's new view that U* is about 5.5% and falling, a 6.0% jobless figure may no longer be a trigger for action. And, with the MPC's greater emphasis on average earnings growth (which may stay weak for a while amidst the expansion of jobs in low-pay sectors), we also have scaled back our forecast for the initial pace of hiking, and now expect Bank Rate to hit 2.5% around mid-2016 (previously end-2015). This bias to "lower for longer" is likely to reinforce the UK's strong growth outlook and hence raise the likelihood that, over time, tightening proves much less gradual and limited than markets price in.

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 | £307bn |

Source: Citi Research

Figure 2. UK – Previous and New Forecasts for BoE Bank Rate, 2012-19F




Sources: BoE and Citi Research

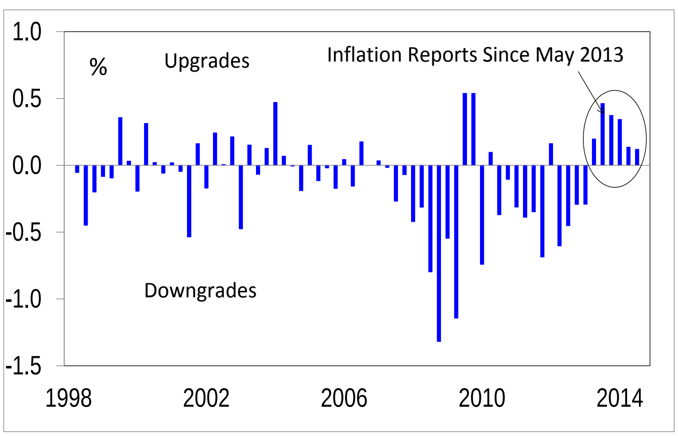
# Change in Our Rate View

### How the MPC's Outlook Has Changed

We had expected the *Inflation Report* to show a fairly radical re-think of the MPC's outlook for the economy[1]. In practice, their rethink was even more radical than we expected, with greater optimism over the supply-side as well as the GDP growth outlook. As we expected, the MPC lifted their GDP growth forecast – the sixth upgrade in a row. The MPC still expect QoQ GDP growth in coming quarters to slow slightly from the recent strong pace. Even so, their central forecast is for 3.5% YoY GDP growth in 2014 (versus 3.4% previously) and 3.1% YoY GDP growth in 2015 (up from 2.9% previously). Moreover, even assuming slower GDP growth and faster productivity growth, the MPC again cut their jobless forecast quite sharply, with the Q4-14 forecast down to 5.9% from 6.3% in the May IR and 6.6% in the Feb-IR. In addition, the MPC acknowledged that slack recently has fallen rapidly, and indeed (taking the average of their three measures of labour market slack[2]) the drop in slack over the last two quarters has been the fastest at any point since their slack measures began in 1990.

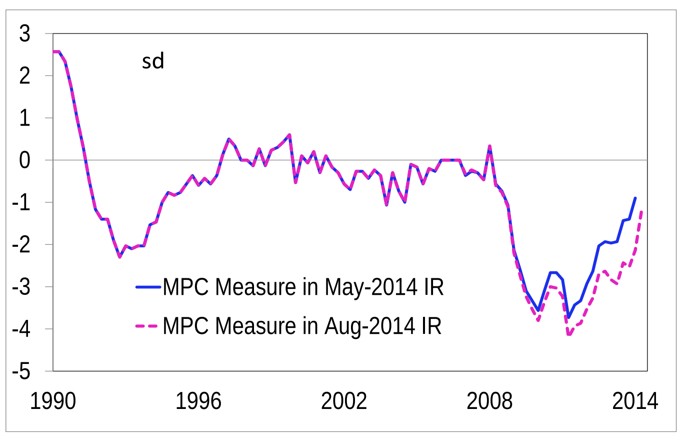
The key surprise, compared to our view, was the extent to which the MPC also judged that the economy in 2013 and early 2014 had significantly more slack than previously expected. The MPC cut their estimate of the current medium-term equilibrium jobless rate (U*) to 5.5% from about 6¼% in the May IR, while also lifting their estimates for the equilibrium levels of the participation rate and average hours worked. Moreover, the MPC believe that U* is falling quite quickly – on their new measure it has dropped by 0.7 percent over the last year (from 6.2% in Q2-13 to 5.5% in Q2-14), so that half of the drop in the actual jobless rate over that period (from 7.8% to 6.4%) has been structural.

Figure 3. UK – Revisions to MPC Forecasts for Average YoY GDP Growth In Next Eight Quarters, 1998-2014




Note: We use the mode forecast with market rates. Sources: BoE and Citi Research

Figure 4. UK – Average of the MPC's Three Measures of Labour Market Slack (standard deviations from neutral), 1990-2014




Sources: BoE and Citi Research

Hence, even though the MPC judge that slack has fallen rapidly, the MPC believe that the *level* of slack in Q3 (aka the output gap) is still about 1% of GDP, similar to their May-14 estimate for Q2 (1-1½% of GDP). As a result, despite the rapid recent rise in capacity use and the MPC's higher growth forecast, the MPC has not advanced their forecast for the date at which slack will be exhausted. As in the May IR, the MPC continues to judge that "*in the central view, the remaining spare*

1 See "IR to Signal Shift in the MPC's Outlook", Michael Saunders, *UK Economics Weekly*, 8 August 2014, Citi.

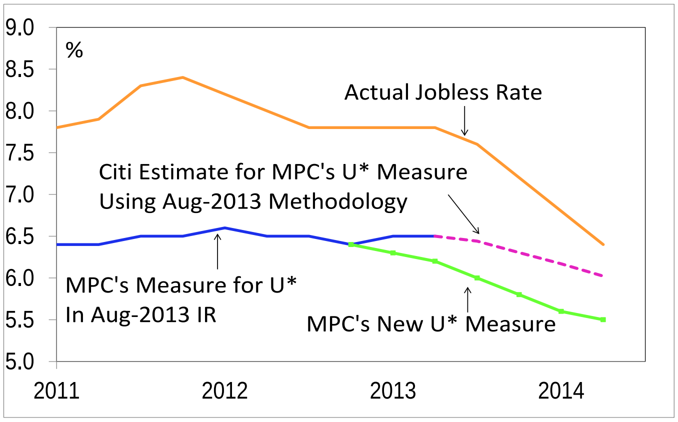
2 These three measures are the unemployment gap, the hours gap and the participation rate gap.

*capacity in the economy is fully absorbed towards the end of the forecast period*." For example, even with their lower forecast for the jobless rate, the MPC do not expect the jobless rate to hit 5.5% (their estimate of the current U* rate) until Q1-2016. Moreover, the MPC expect U* to drift down close to their estimate of the long-term equilibrium unemployment rate (5.1%) over time.

The revisions to the MPC's slack estimates are mainly driven by the recent weakness of average earnings growth and seem to reflect a change in the MPC's approach to estimating labour market slack. The MPC's prior U* measure was a weighted average of the medium-term (6-12 months) and long-term (over 12 months) jobless rates, with the weights based on the typical extent to which the medium-term and long-term unemployed move into employment[3]. That prior methodology would imply that U* currently is 6.0%, not 5.5%. The MPC's new and lower U* measure seems to reflect a downward adjustment based on the view that the extreme weakness of average earnings growth implies that the jobless gap probably has been bigger – and hence U* is lower -- than the MPC believed. A similar process seems to have been at work in the revisions to the MPC's "hours gap" and "participation gap" measures. In other words, rather than using slack measures to forecast pay growth, the MPC now have a two-way process between slack and pay, adjusting their slack measures in light of trends in pay growth.

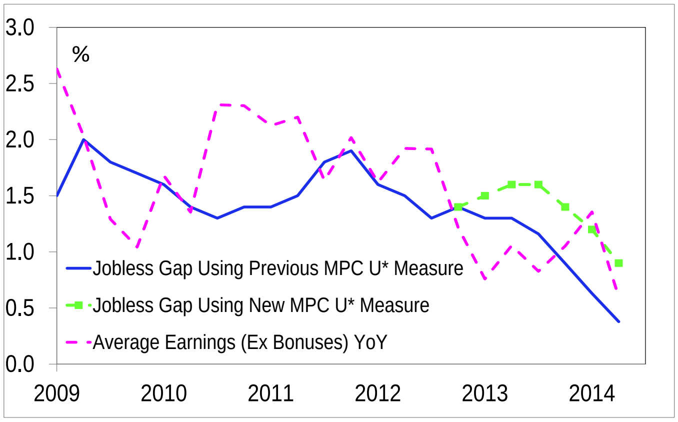
This implies another shift in the MPC's emphasis. The initial phase of forward guidance (Aug-13) focused on the "jobless gap" as the key measure of labour market slack. The second phase (Feb-14) widened the focus to include the "hours gap" and "participation gap". The new approach ranks average earnings growth at least as highly as these gap measures, because the MPC has shown it will rethink its gap measures in light of the earnings data. Average earnings growth tends to lag swings in capacity use, and hence this greater emphasis on earnings growth as a guide to policy also may well imply the MPC will probably be less pre-emptive in withdrawing stimulus as slack shrinks.

Figure 5. UK – MPC's Measures of U* (Medium-Term Equilibrium Unemployment Rate), 2011-14




Sources: BoE and Citi Research

Figure 6. UK – Average Earnings Growth and MPC's Measures of Jobless Gap, Pct of Workforce, 2009-14




Sources: BoE and Citi Research

**Where We Agree, and Disagree, With the MPC**

We agree with the MPC's view that the economy will be pretty strong, with GDP growth above the consensus (3.0% for 2014, 2.6% for 2015), and unemployment

[3] For example, a weighted average of the medium-term and long-term jobless rates (plus a constant) has a 99.9% correlation with the MPC's previous U* estimates over 2005-13.

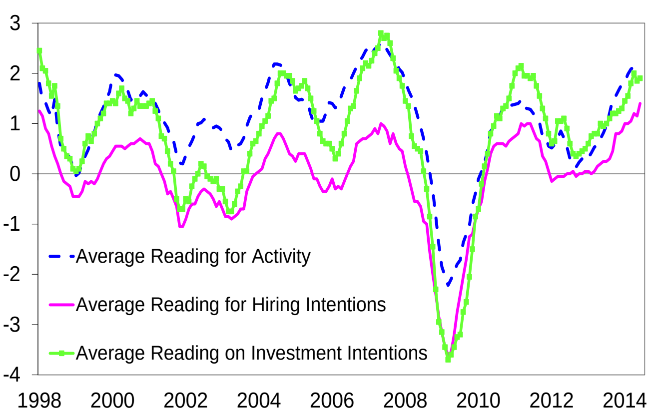
well below consensus (6.2% in Q4-14, 5.8% in Q4-15). In addition, we believe the MPC are right to put more weight in their forecasts on the expansion of labour supply and increased labour market flexibility, reflecting the rising participation rate and inflows of foreign workers. Moreover, while estimates of slack are very uncertain, the MPC's latest estimate (1% of GDP) is fairly similar to the OECD and IMF output gap estimates for the UK. And it is clear from a wide range of measures (eg job vacancies, BoE Agents survey) that labour market slack is shrinking fast.

However, we disagree with the MPC's forecasts for the economy and job growth, and expect that (as in recent quarters) GDP growth will turn out a bit stronger and job growth a lot stronger (with the jobless rate a lot lower) than the MPC's base case. Our base case is for real GDP growth in 2015 to be similar to this year, at about 3½% YoY, with the jobless rate falling to 5½% by mid-2015 and to 5% or lower by end-2015.

The MPC's slowdown forecast is based on two assumptions: (1) consumer spending growth will be capped by modest real income growth (which the MPC expect to slow from 1¾% YoY this year to 1½% YoY in 2015). (2) business investment and housebuilding will slow from the recent strong growth rates: "*The Committee's latest projections assume that the near-term outlook for approvals, and hence housing investment, is a little less buoyant than previously thought… Overall, the central path for business investment growth is a little weaker than in May*".

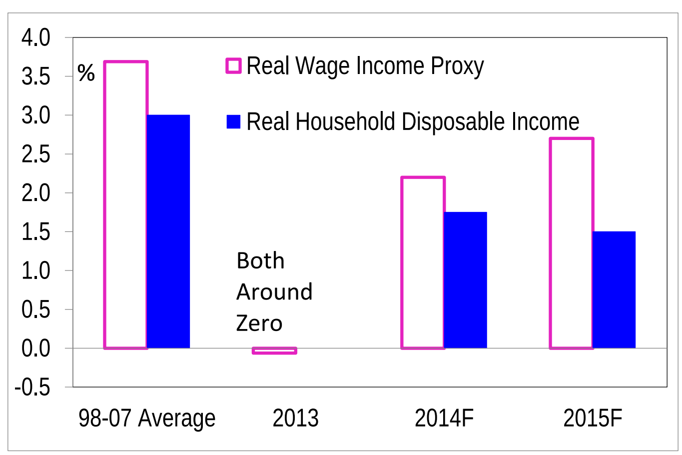
In practice, business surveys remain elevated and at levels consistent with GDP growth well above 0.7-0.8% QoQ. Monetary policy remains very loose, credit availability is improving, headwinds from private deleveraging and fiscal drag have receded, and economic uncertainties have shrunk markedly compared to the extremes of 2011-12. The ONS business investment data can be volatile, but we expect continued rapid growth. Even after the recent pick up, there is probably still considerable pent-up business investment demand: investment remains low as a share of GDP, capital stock growth is meagre, corporate balance sheets are in excellent shape, and various surveys imply that capacity use in firms is quite high. Indeed, surveys suggest that firms' investment intentions remain extremely strong.

Figure 7. UK – BoE Agents' Survey Readings Among Firms on Activity, Investment Intentions and Hiring Intentions, 1998-2014




Note: We show the average of the activity readings for retail, consumer services, business services, manufacturing and construction. Sources: BoE and Citi Research

Figure 8. UK – Data and BoE Forecasts for Real Wage Income and Real Disposable Income, 1998-2015F




Note: Real wage income proxy is average earnings growth plus job growth less CPI inflation. Sources: BoE, ONS and Citi Research

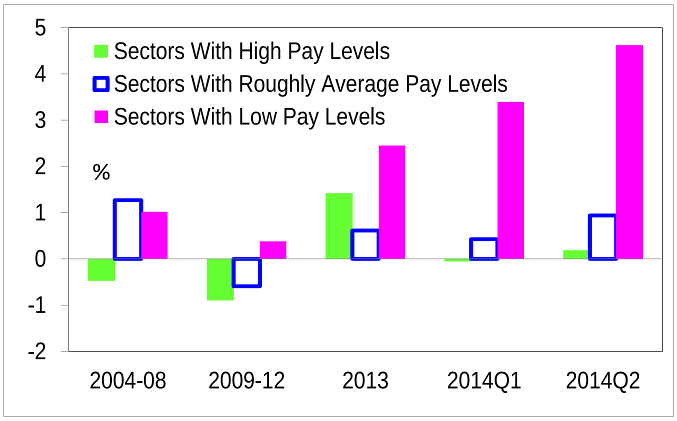
In addition, we are somewhat puzzled by the MPC's forecast that real household disposable income (RHDI) growth will slow next year, especially given that their

forecast implies that real wage growth (i.e. job growth plus average earnings growth less CPI inflation) will rise from 2.2% YoY in 2014 to 2.7% in 2015. To be sure, RHDI growth often lags this real wage growth measure slightly, and can be affected by tax changes and so forth. However, no major tax changes are currently planned for 2015. We expect that if real wage growth matches the MPC's forecast (which looks reasonable in our view) then real household income growth in 2015 probably will be 2-3% YoY– hence supporting a somewhat stronger consumer outlook than the MPC's base case.

Moreover, there is no sign of the productivity rebound and slowdown in job growth expected by the MPC. Rather, business surveys suggest that firms' hiring intentions remain extremely strong. In our view, the recent weakness in productivity is a side-effect of the same factors depressing wage growth (i.e. greater labour supply and labour market flexibility), with an ongoing shift to lower-paid (and, on average, less-productive) jobs, reflected in the rapid expansion in employment in low-pay regions, low-pay sectors and among low-pay age groups.

- In sectors with pay levels at least 20% *below* the national average, the number of employees rose by 4.6% YoY in Q2. Conversely, in the sectors with pay at least 20% *above* the UK average, the number of employees grew by just 0.2% YoY[4].
- The number of people in work aged 18-34 years rose 4.1% YoY in Q2, while the numbers in work aged 50+ years rose 3.9% YoY, but the number in work aged 35-49 years rose just 0.7% YoY. This surge in employment among younger and older workers depresses average pay levels, given that typical hourly pay among full-time employees is 10-15% above average among people aged 30-49 years, but is well below average among people aged below 30 years and 60+ years.
- In the four UK regions with the lowest pay levels (Northern Ireland, Wales, NE England, E Midlands) job growth has picked up from 0.5% YoY in 2013 to 2.9% YoY in H1-2014 (and 3.2% YoY in Q2-14). Job growth remains strong in London (which has the highest average pay level in the UK) but, at 3.3% YoY in H1-2014, is the same as last year.

Figure 9. UK – Job Growth By Average Sectoral Pay Level, YoY, 2004-14




Sources: ONS and Citi Research

Figure 10. UK – YoY Job Growth By Region, 2012-14


Note: The regions with the lowest pay levels are Northern Ireland, Wales, NE England, and the E Midlands. Sources: ONS and Citi Research

[4] The low pay sectors are agriculture, retailing, accommodation and food services, administrative and support services, arts and entertainment and miscellaneous services. The high pay sectors are mining and quarrying, engineering, chemicals manufacturing, information and communication, finance, professional, scientific and technical activities and public administration.

These compositional effects are likely to depress average earnings growth. The size of this effect is uncertain. The ONS judge that the shift in the sectoral composition of employment is cutting about ½% off average earnings growth at present, but do not provide estimates for the effects of changes in age and regional composition. The weakness in average earnings growth from composition effects is not really a sign that inflation prospects are weaker: these composition effects are likely to depress both pay and productivity growth by roughly equal amounts, leaving unit labour cost growth and inflation prospects unaffected.

We suspect this expansion of low-pay and low-productivity jobs will continue, given that labour market slack is increasingly concentrated in younger (below 35 years) and older (50+ years) people: the jobless rate among people aged 35-49 years is already down to 4.3% (not far from the 1998-07 average of 3.6%). This implies that strong GDP growth will probably be accompanied by very high job growth and a sharp drop in the jobless rate (and other measures of labour market slack).

**Where Does This Leave the Interest Rate Outlook?**

But, whether or not our above-consensus forecast for GDP growth and job growth over 2014-16 proves correct, the MPC's re-think probably puts a major dent in our case for a nearterm rate hike (i.e. Q4 this year).

- Our previous forecast of a hike in November this year was based on our forecast that at that point, the latest data (which would be for Q3) would show the jobless rate down to about 6% (i.e. roughly matching the MPC's prior U* measure[5]. The MPC has previously said that they would expect to start hiking rates before the jobless rate hits U*[6]. Hence, we believed that a jobless rate of about 6% would prompt the MPC to start hiking even if, at that stage, average earnings growth remains weak and CPI inflation is close to target.
- However, the drop in the MPC's U* estimate to 5.5% changes the picture. Even with our relatively high growth forecast, we do not expect the jobless rate to hit 5.5% until Q1 or Q2-2015 (for which data will be published in Q2 and Q3).

The MPC could still choose to hike in Q4 this year, especially if they want to increase the chance that tightening is "*gradual and limited*" by acting before labour market slack is exhausted. But the case for a Q4 hike is much less clearcut than we previously judged, especially given that average earnings and CPI data are unlikely to provide a trigger for action.

As a result, we are shifting our forecast for the start of tightening from Q4-2014 to Q1-2015, with Feb-15 (*Inflation Report* month) the most likely single date – although it is not inevitable that the MPC will start to hike in an IR month. With a later start, and slower initial trajectory, we are also trimming our forecast for the Dec-2015 level of rates to 1.75% from 2.5%, with rates reaching 2.5% around mid-2016. We stress that this shift in our rate forecast reflects the assumption that the MPC will be less pre-emptive as slack shrinks, and influenced more by the sluggish trend in average earnings growth, rather than any sense that the outlook for growth and inflation is weaker than before. In turn, this bias to "low for longer" increases the likelihood that real GDP growth in 2015-16 will again outpace the consensus, and reduces the likelihood that tightening will be anything like as gradual and limited as markets currently expect. We still expect that Bank Rate will rise to 3-4% three to four years ahead without derailing the expansion.

[5] We initially made this forecast in January 2014. See "Change of UK Rate View", Michael Saunders, 22 January 2014, Citi. We have repeated it several times since then.

[6] See comments by then-Deputy Governor Charlie Bean at the Feb-14 IR press conference.

Figure 11. Economic Indicators

| | | | |
|---|---|---|---|
| Tue 19 Aug | *Consumer Prices (Jul)* | Forecast: -0.1% MM, 1.8% YY | Prior: 0.2% MM, 1.9% YY |
| | *Ex Food, Drink, Tobacco, Energy (Jul)* | Forecast: -0.1% MM, 2.0% YY | Prior: 0.2% MM, 2.0% YY |
| | *Retail Prices (Jul)* | Forecast: -0.1% MM, 2.5% YY | Prior: 0.2% MM, 2.6% YY |
| | *RPIX – Ex Mortgages (Jul)* | Forecast: -0.1% MM, 2.6% YY | Prior: 0.2% MM, 2.7% YY |
| | Renewed weakness in food prices (with this component of the CPI likely to be down YY) is likely to pull CPI inflation a little lower in July. Nevertheless, the big picture is that inflation is likely to remain close to the 2% target in this month and (barring unexpected shocks) in the rest of the year. | | |
| Tue 19 Aug | *Producer Input Prices (Jul)* | Forecast: -1.4% MM, -6.9% YY | Prior: -0.8% MM, -4.4% YY |
| | The continued appreciation of sterling, plus slightly lower global commodity prices, are likely to produce another decline in input prices, and a figure in line with our forecast would imply the sixth MM drop in the last seven months. This decline is likely to help cap CPI inflation in coming quarters. | | |
| Tue 19 Aug | *Producer Output Prices (Jul)* | Forecast: 0.1% MM, 0.0% YY | Prior: -0.2% MM, 0.5% YY |
| | *Output Prices Ex Tax (Jul)* | Forecast: 0.1% MM, 0.2% YY | Prior: -0.2% MM, 0.3% YY |
| | *Ex Food, Drink, Tobacco, Energy (Jul)* | Forecast: 0.1% MM, 1.0% YY | Prior: 0.0% MM, 1.0% YY |
| | Output price inflation has weakened recently, with the YY rate at the lowest since 2009, and we expect another soft figure this month. UK manufacturers' expectations for their selling prices turned negative in July and were the weakest since 2009. | | |
| Wed 20 Aug | *CBI Industrial Trends Survey (Aug)* | | |
| | *Output Expectations Net Bal. (Aug)* | Forecast: +28% | Prior: +26% |
| | *Order Books Net Balance (Aug)* | Forecast: +5% | Prior: +2% |
| | *Selling Prices Net Balance (Aug)* | Forecast: 0% | Prior: -4% |
| | The July survey was a little softer than the June reading, but still suggests that order books and output expectations are about one standard deviation above their longrun averages. We expect another strong reading this time, consistent with above-average manufacturing output growth. | | |
| Thu 21 Aug | *Public Sector Net Borrowing (Jul)* | Forecast: £0.0bn deficit, £36.1 billion deficit fiscal year to date | |
| | *(Ex RM, APF and Fin. Intervention)* | Year Ago: £1.6bn deficit, £35.2 billion deficit fiscal year to date | |
| | Over April-June, the underlying fiscal deficit has risen by £2.5bn from a year ago, reflecting weakness in income tax revenues (due to the expansion of low-pay jobs and income shifting a year ago around the top rate tax cut) plus stronger public investment. For the July figures (a seasonally strong revenue month), we expect better revenue growth to produce a deficit close to zero, somewhat better than a year ago. | | |
| Thu 21 Aug | *Retail Sales Volumes (Jul)* | Forecast: 0.5% MM, 3.1% YY | Prior: 0.1% MM, 3.6% YY |
| | After a couple of sluggish figures (down 0.5% MM in May, up 0.1% in June), we expect a stronger reading this month. Consumer confidence is high, housing activity remains fairly strong, and the CBI survey suggests that sales growth increased in July. | | |

Source: Citi Research

Figure 12. Economic Calendar, 11 August — 30 August 2014

| 11 August | 12 August | 13 August | 14 August | 15 August |
|---|---|---|---|---|
| | | LFS Unemployment, 3-Month Avg (Apr-Jun)<br>Mar-May -121K QQ<br>Apr-Jun -132K QQ<br>LFS Unemployment Rate<br>Mar-May 6.5%<br>Apr-Jun 6.4%<br>LFS Unemployment Rate – Single Month (Jun)<br>May 6.3%<br>Jun 6.4%<br>Claimant Count Unemployment (Jul)<br>Jun -39.5K MM, 3.1% Rate<br>Jul -33.6K MM, 3.0% Rate<br>Avge Earnings ex Bonus (Apr-Jun)<br>Mar-May 0.7% YY<br>Apr-Jun 0.6% YY<br><br>BoE *Inflation Report* (10:30) | RICS House Price Survey (Jul, 00:01) | Services Output (Jun)<br>May 0.3% MoM, 3.2% YoY<br>Jun 0.3% MoM, 3.6% YoY<br><br>GDP (Q2, 2nd Estimate)<br>Q1 0.8% QoQ, 3.0% YoY<br>Q2 0.8% QoQ, 3.2% YoY |
| **18 August** | **19 August** | **20 August** | **21 August** | **22 August** |
| | Consumer Prices (Jul)<br>Jun 0.2% MM, 1.9% YY<br>JulE -0.1% MM, 1.8% YY<br>CPI ex F, D, T, E (Jul)<br>Jun 0.2% MM, 2.0% YY<br>JulE -0.1% MM, 2.0% YY<br>Retail Prices (Jul)<br>Jun 0.2% MM, 2.6% YY<br>JulE -0.1% MM, 2.5% YY<br>RPIX – Ex Mortg. (Jul)<br>Jun 0.2% MM, 2.7% YY<br>JulE -0.1% MM, 2.6% YY<br>Prod. Input Prices (Jul)<br>Jun -0.8% MM, -4.4% YY<br>JulE -1.4% MM, -6.9% YY<br>Prod. Output Prices (Jul)<br>Jun -0.2% MM, 0.5% YY<br>JulE 0.1% MM, 0.0% YY<br>Ex F, D, T, E (Jul)<br>Jun 0.0% MM, 1.0% YY<br>JulE 0.1% MM, 1.0% YY | MPC Minutes (7 Aug)<br><br>BoE Agents' Summary of Business Conditions (Aug)<br><br>CBI Industrial Trends Survey (Aug, 11:00)<br>Output Expectations (Aug)<br>Jul +26%<br>AugE +28%<br>Order Books (Aug)<br>Jul +2%<br>AugE +5%<br>Selling Prices (Aug)<br>Jul -4%<br>AugE 0% | Public Sector Net Borrowing – Ex RM, APF & Financial Intervention (Jul)<br>Jul13 £1.6bn Deficit<br>Jul14E £0.0bn Deficit<br>Fiscal Year To Date<br>Apr-Jul13 £35.2bn Deficit<br>Apr-Jul14 £36.1bn Deficit<br><br>Retail Sales Volumes (Jul)<br>Jun 0.1% MoM, 3.6% YoY<br>JulE 0.5% MoM, 3.1% YoY | |
| **25 August** | **26 August** | **27 August** | **28 August** | **29 August** |
| Bank | | | Migration Report (Q2)<br><br>CBI Retail Survey (Aug) (11:00) | GfK Consumer Confidence (Aug, 00:01)<br><br>*Around Now*<br>Nationwide House Prices (Aug, 07:00)<br><br>**Saturday 30 August**<br>European Council (Brussels) |

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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