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Europe

UK Economics Weekly

2013 Outlook: Stagnation and Stimulus

- The economy is likely to disappoint again in 2013, with weak growth (and no growth in GDP per head), sticky inflation, persistently large current account deficit (3-4% of GDP) and stubbornly high fiscal deficit (6-7% of GDP in 2013/14). We are cutting our 2013 growth forecast to 0.4% from 0.8% previously (well below the 1.1% consensus) and expect that growth will stay weak in 2014, at only ½%-1%. Even if the economy does not suffer a treble dip recession, we expect that real GDP will not regain its prerecession peak until 2016, with real GDP per head not regaining its precession peak even by the end of this decade. With the public debt/GDP ratio set to surge further in coming years, we think the UK will lose its AAA rating in 2013.

- The MPC probably will keep monetary policy loose and loosen further. We still expect the MPC to expand the QE target to £450bn in the year ahead and to reinvest the proceeds of maturing gilts in order to maintain QE. In addition, we now expect the MPC in 2013 will introduce forward rate guidance, stating that it currently expects rates to stay ultra-low for an extended period, probably to at least 2015. We are pushing back our forecast for the first rate hike from 2016 to mid-2017 — a full 8 years after rates fell to 0.5% in early 2009. Unless sterling dives or inflation expectations surge, real rates will probably be negative throughout 2008-2017, the longest period of negative real rates (outside major wars) for more than 300 years.

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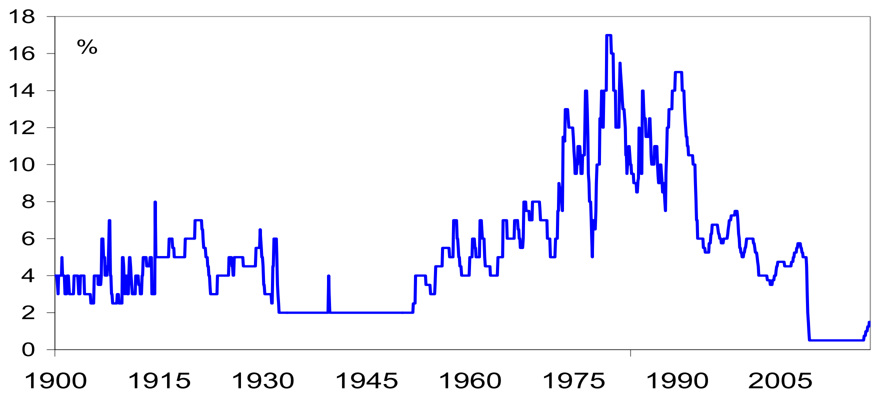
.Figure 1. Citigroup Market Forecasts

	Base Rate	QE Target	10 Year Yield	Spread vs. Bunds	$/£	£/€
Mid-2013	0.50	£400bn	1.95	21bp	1.54	0.79
End-2013	0.50	£450bn	1.80	31bp	1.52	0.79

Source: Citi Research

Figure 2. UK — BoE Policy Rate, 1900-2017F



F Citi forecast. Sources: Bank of England and Citi Research

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

2013 Outlook: Stagnation and Stimulus

The economy is likely to disappoint again in 2013, with little or no growth, sticky inflation, and persistent deficits on both the current account and fiscal balance

It is more than five years since the financial crisis began, and the economy remains stuck in a liquidity trap, with persistent headwinds from private deleveraging, poor credit availability, fiscal policy and the EMU crisis. The economy is likely to disappoint again in 2013, with weak growth (and no growth in GDP per head), sticky inflation, persistently large current account deficit (3-4% of GDP) and stubbornly high fiscal deficit (6-7% of GDP in 2013/14). Even after colossal monetary easing, the level of real GDP in Q3-12 was still 2.9% below the pre-crisis peak, with real GDP per head 6.2% down — making this by far the worst recession/recovery cycle of recent decades. The supply side has worsened, but the key problem is the weakness of demand. Nominal GDP growth is running at just 2.2% YoY, with nominal domestic demand at just 2.5% YoY — far below normal rates of 5% or so.

We are cutting our 2013 growth forecast from 0.8% to 0.4%

It is unclear at this stage if the economy is going into a treble dip recession. Data so far suggest that QoQ growth was around zero in Q4-12, with service sector output roughly flat, weakness in industrial production but a sharp rise in construction output (probably reflecting a rebound in private housebuilding from the weak Q3 figure). But even if the economy does not shrink again, it is likely to continue to underperform in 2013 and 2014. Whereas the consensus expects 2013 growth of about 1.1%, we are cutting our 2013 growth forecast to 0.4% from 0.8% previously and expect that growth will remain weak — at about 0.7% — even in 2014.[1] We expect that real GDP will not regain its prerecession peak until 2016, with real GDP per head not regaining its precession peak (mid-07) even by the end of this decade.

The MPC is likely to expand QE further and use rate guidance to signal a long period of ultra-low rates

With this backdrop, the MPC probably will keep monetary policy loose and indeed loosen further. We still expect the MPC to expand the QE target to £450bn in the year ahead and to reinvest the proceeds of maturing gilts in order to maintain QE. In addition, we now expect the MPC in 2013 will introduce forward rate guidance, stating that it currently expects rates to stay ultra-low for an extended period, probably to at least 2015. We are pushing back our forecast for the first rate hike from 2016 to mid-2017 — a full 8 years after rates fell to 0.5% in early 2009.

Figure 3. United Kingdom — Economic Forecasts, 2012-2015F

		2012	2013F		2014F		2015F	
		Citi	Citi	Consensus	Citi	Consensus	Citi	Consensus
Real GDP	YoY	0.1%	0.4%	1.1%	0.7%	1.7%	1.3%	2.0%
Real GDP Per Head	YoY	-1.0	-0.6	NA	-0.1	NA	0.5	NA
Domestic Demand (inc. Inventories)	YoY	1.0	-0.1	1.0	0.2	1.4	1.0	1.6
Private Consumption	YoY	0.8	0.6	1.0	1.0	NA	2.2	NA
Investment	YoY	-0.1	-3.4	2.1	-0.3	NA	-0.8	NA
Government Consumption		2.6	-0.6	-0.9	-1.4	NA	-1.2	NA
Net Trade (Effect on GDP YoY)	%	-0.9	0.5	0.1	0.5	0.3	0.3	0.4
Exports	YoY	-0.4	3.3	2.5	4.7	NA	5.7	NA
Imports	YoY	2.5	1.6	2.1	3.0	NA	4.6	NA
Unemployment Rate	%	8.0	7.8	NA	7.5	NA	7.0	NA
CPI Inflation	YoY	2.8	2.6	2.5	2.2	2.1	1.9	2.2
Current Account	£bn	-58.4	-52.3	-38.5	-47.8	-34.5	-43.3	-31.3
	% of GDP	-3.8	-3.3	-2.2	-2.9	-2.0	-2.6	-1.8
PSNB	£bn FY	86	108	111	107	99	99	84
	% of GDP	5.5	6.8	6.9	6.5	6.0	5.8	4.9
Net Public Debt (Fiscal Yearend)	% of GDP	76.2	80.4	NA	85.0	NA	88.7	NA
General Govt Debt (Cal. Yearend)	% of GDP	89.7	95.0	NA	99.1	NA	101.3	NA
Real Household Disposable Income	YoY	1.8	-0.5	0.8	0.4	NA	1.0	NA
Gross Nonoil Trading Profits	YoY	3.2	6.5	3.1	3.2	NA	4.9	NA
Bank Rate (Annual Average)	%	0.50	0.50	0.53	0.50	0.74	0.50	1.44
QE Target (Yearend)	£bn	375	450	409.5	450	NA	450	NA

Note: Fiscal deficit shown excluding financial interventions. F forecast. YoY Year-to-year growth rate. Sources: ONS, HM Treasury, Consensus Economics and Citi Research

[1] See "*Economy Likely to Underperform Again*", UK Economics Weekly, Michael Saunders, 30 November 2012, Citi for the previous forecasts.

Private Deleveraging — How Far has it Gone? How Far to Go?

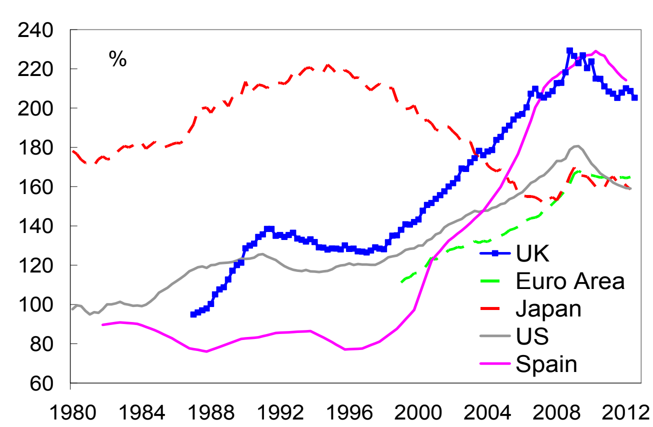
The hangover from the huge credit boom to continue to cap demand…

We expect the hangover from the precrisis bubble economy will continue to cap private sector spending in 2013 and 2014, with an ongoing emphasis on deleveraging and high savings. The ratio of private debt/GDP (combining household and non-financial corporate sectors) surged from 128% of GDP in mid-97 to 229% in Q4-08, with a huge self-fuelling bubble of rapid gains in incomes, jobs, asset prices and debt that spurred extraordinary optimism and easy credit availability. The rise in the private debt/GDP ratio in the UK (91 percentage points from Q1-99 to Q4-08) was far bigger than the US and euro area (53 and 50 percentage points respectively), although a few countries had even bigger rises (eg Ireland, Hungary, Latvia, Spain). The peak in the UK private debt/GDP ratio matched Spain's recent peak (229%) and even exceeded the early 1990s Japan peak (221%).

…and the deterioration in expectations for incomes is likely to extend the bias to deleveraging and higher savings

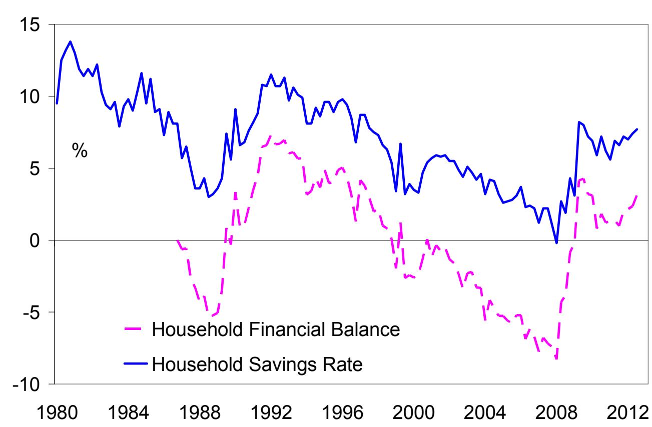
In aggregate, households (and some companies) leveraged up in anticipation that the good times of rapid gains in incomes and asset prices would last more or less indefinitely, and have been left over-indebted as those hopes were disappointed. Real household disposable income per head is unchanged from the 2004 level, and surveys show that households remain gloomy on their financial prospects. The UK is following the typical pattern among extreme boom/bust credit cycle countries, with high private savings, deep recession, weak banking system and weak recovery[2]. Echoing the boom, this stagnation is self-reinforcing: ongoing weakness in incomes and asset prices is prompting both lenders and debtors to reduce future income expectations, hence creating a widespread preference for lower debt ratios and higher savings, with weakness in both credit demand and credit supply.

Figure 4. UK, US and EMU — Private Debt/GDP Ratio, 1980-2012



Sources: ONS, Eurostat, Datastream and Citi Research

Figure 5. UK — Household Savings Rate and Financial Balance (Pct of Income), 1980-2012



Sources: ONS and Citi Research

The private debt/GDP ratio is only back to the level that started the crisis

Private savings have risen significantly: the household financial surplus hit 3% of GDP in mid-09 and remains still high (at 2.2% of GDP) in Q3-2012, with the savings rate at 7.7% of income. But only limited progress has been made in balance sheet repair. The private debt/GDP ratio has edged down to 205% in Q3-12, but this just takes it back to the mid-07 level — when the crisis began. In the US, the household debt/GDP ratio is now back to mid-03 levels (with the private debt/GDP ratio back to Q1-06 levels) and credit sensitive sectors are reviving. In the UK, with a bigger boom and less deleveraging, that upturn probably is still distant.

[2] See "*World Economic Outlook*", IMF, September 2009 and "*Global Economic Outlook and Strategy*", Willem Buiter et al, November 2012, Citi.

Why Is the Current Account Not Improving?

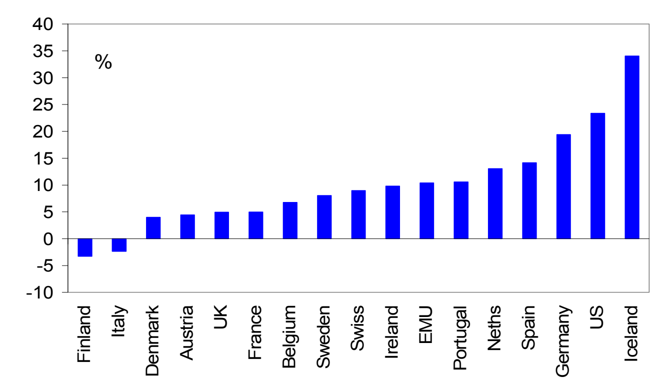
The current account deficit remains stubbornly high, and exports underperformed markedly in 2012

With weak domestic demand and sterling's trade-weighted index 20% below the mid-07 level, one would hope that the UK economy would rebalance to export-led growth with an improving current account (CA) balance. In practice, rebalancing has been disappointingly slow. Export volumes are up by just 5% since Q1-07, underperforming versus the euro area (up 10%) and US (23%). Net trade cut about 0.9% off GDP growth in 2012, the biggest drag since 2002. The CA deficit rose from £20.4bn (1.3% of GDP) in 2011 to about £58bn (3.8% of GDP) in 2012, the highest as a share of GDP since 1989 — in contrast to the improving CAs in other EU boom/bust countries. We expect that rebalancing will remain elusive in 2013 and 2014, with some lift to growth from net trade but a persistently high current account deficit (3-4% of GDP in 2013, about 3% of GDP in 2014).

The UK suffers from over-reliance on exports of financial services and under-exposure to high-growth emerging markets

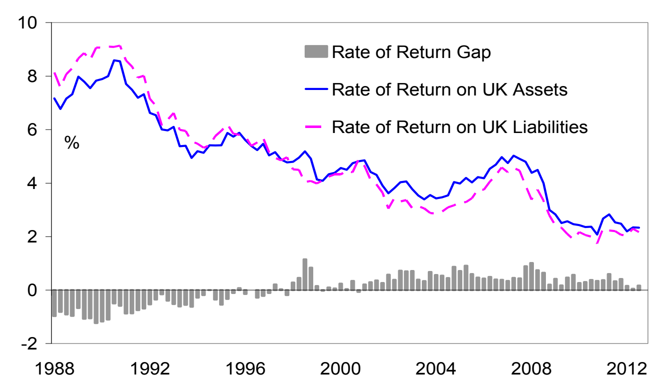
The UK's export performance suffers from a poor geographic mix and poor product mix. Exports of goods to emerging markets account for just 3-4% of UK GDP, the lowest among EU15 countries, and most exports of goods go to low-growth advanced economies. Moreover, the UK's high share of exports of financial services — a big strength in the pre-crisis period — is less helpful now, given widespread deleveraging across advanced economies. Exports of financial services rose by 324% (nominal terms) from Q4-98 to Q4-08, but are down by 28% since then. The UK seems to have no clear policy to redress these structural export weaknesses.

Figure 6. Selected Countries — Percentage Change in Export Volumes (Goods and Services) from Q1-07 to Q3-12



Sources: ONS, Eurostat and Citi Research

Figure 7. UK — Rate of Return on External Assets and Liabilities (4-Quarter Average), 1988-2012



Sources: ONS and Citi Research

The current account balance additionally has suffered from the deterioration in the relative return on the UK's external assets

The CA also has been hit by the plunge in the UK's surplus on investment income from £25.3bn in 2011 (1.7% of GDP) to only £1.8bn (0.2% of GDP) in Q1-Q3 2012. The UK has huge external assets and liabilities, both exceeding 450% of annual GDP. From 1998-2011, the rate of return on the UK's external assets averaged 3.9% per year, whereas returns on the UK's liabilities averaged 3.4%. This gap (0.5%) reflected the high share of FDI (which has relatively high returns) in the UK's external assets, plus the superior return on the UK's overseas FDI versus that on FDI in the UK. As a result, the UK earned a *net income surplus* despite having a *net asset deficit* (ie liabilities exceeding assets) of £324bn (21% of GDP) at end-2011. However, with lower global growth, returns on the UK's external FDI have fallen recently, hence eroding this rate of return gap and largely eliminating the net income surplus. Projections of these flows are uncertain, but we assume that the prior rate of return gap will not recur. In this case, the net income surplus is likely to stay low and (given the UK's liabilities exceed assets) may even flip into a deficit in coming years — hence making it even harder for the UK to achieve current account balance.

Even With Supply Side Deterioration, Inflation Will Eventually Fall

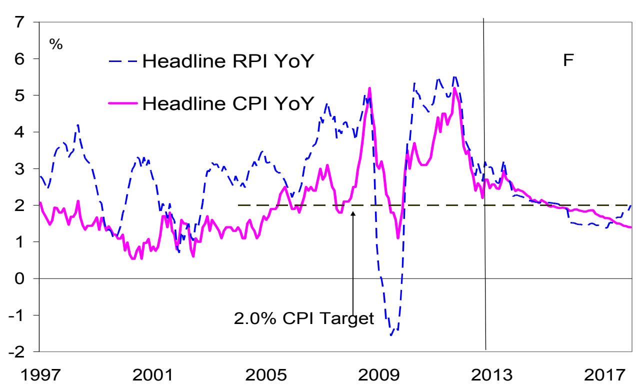
Inflation is likely to remain sticky in 2013, again slightly exceeding the target

CPI inflation has overshot the 2% target for 70 of the last 80 months, and probably will stay a little above target in 2013. The inflation boost from the weak pound is fading, but inflation probably will be kept up by recent and ongoing gains in tuition fees, energy costs, food prices, regulated services (eg postal charges, rail fares) and indirect taxes (eg air passenger duty, insurance premium tax). However, we currently expect that inflation will just stay below letter-writing territory (above 3% YoY), and we believe that (unless external costs keep rising) medium-term risks are tilted towards a sustained undershoot of the 2% target from 2014 or 2015 onwards.

We do not regard weakness in productivity as a major source of inflation stickiness

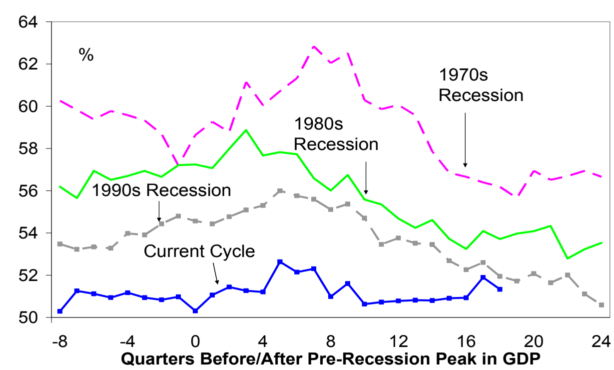
The supply side has worsened in recent years. Productivity (real GDP per hour) in Q3-12 was 3.1% down from Q3-07, whereas productivity gains in the 15 years ended Q3-07 averaged 2.4% YoY. However, we believe the MPC exaggerates the link from stagnant productivity to inflation stickiness. First, real pay is falling alongside productivity, with lower pay deals among full-time employees plus a shift to less well-paid forms of work, such as temporary jobs, part-time work and self-employment. Average earnings ex bonuses are up by only 1% YoY, and the share of wages and salaries in GDP (51.3% in Q3-12) remains below its 20-year average (52.5%) — and indeed is near the lows of recent decades. The notion that wage costs are the source of inflation stickiness is far-fetched, in our view. Second, weakness in productivity probably is partly a side effect of weak demand, and lack of demand also is squeezing margins: aggregate profits have fallen by about 15% in real terms since Q1-08, with notable recent weakness in the financial sector. Third, core inflation guides (eg GDP deflator, inflation expectations, inflation of "shop services", output price inflation for services and manufacturing) are well-contained.

Figure 8. UK — Inflation Profile, 1997-2017F



F Citi Forecast. Sources: ONS and Citi Research

Figure 9. UK — Wages and Salaries as Pct of GDP, 1970-2012



Sources: ONS and Citi Research

We assume that the ONS will reform the RPI to largely eliminate the RPI-CPI wedge

We also disagree with the MPC's view that lower inflation by itself will provide a significant boost to real incomes and spending. This theory of expansionary disinflation probably only applies in cases where inflation is reduced by external factors (eg tax cuts, lower commodity prices). By contrast, the main reason why inflation probably will fall in coming years is because demand and incomes are weak: even with lower inflation, we expect that household real incomes will not grow over 2013 and 2014 combined. Note that, in our forecasts, we assume that forthcoming changes to the RPI (due to be announced on 10 January) will largely eliminate the RPI-CPI wedge from mid-2013. In addition, we assume that the inflation target will continue to be for 2% CPI inflation — although the Chancellor may well switch the inflation target to the new CPIH series (which recently has been slightly lower) at some stage and perhaps also shift to a 1-3% inflation target band.

Fiscal Outlook — Most of the Squeeze Still Lies Ahead

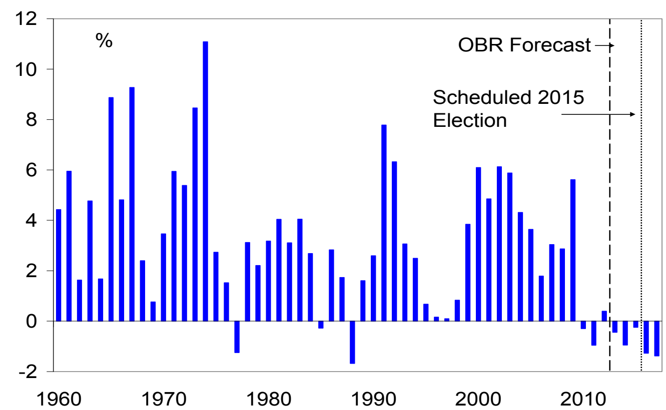
Only limited progress has been made so far in shrinking the structural fiscal deficit…

The UK is still only in the early stages of fiscal austerity. The OBR estimates that by March 2013 (nearly three years after the 2010 election) the structural current deficit will be down by only about 1% of GDP from 09/10. Primary public current spending in 12/13 will actually be about 7% up from the 09/10 level, a drop of only about 1% in real terms. Most of the tightening (about 5% of GDP) still lies ahead, with five years of spending cuts and the biggest cuts (real current primary spending falling by 1-1½% YoY) deferred until 2016/17 and 2017/18 — well after the next election.

…and the bulk of the spending cuts still lie ahead

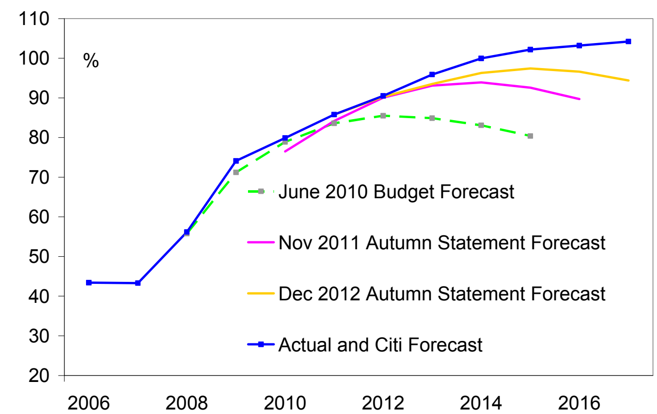
The fiscal stance (primary structural current balance) will tighten by about 1.3% in 2013/14, and real primary current public spending is planned to fall by about ½%, after a roughly neutral stance in 12/13. These spending cuts are big enough to form a significant headwind for the economy, but probably will not be big enough to actually cut the fiscal deficit in 2013. With revenues hit by economic weakness, we expect the deficit will exceed the OBR forecast by about £5bn in 12/13 and £9bn in 13/14, with a headline deficit of £86bn (5.5% of GDP) in 12/13 and £108bn (6.8% of GDP) in 13/14 (implying underlying deficits of 7-8% of GDP in both years excluding oneoff effects such as the Royal Mail and APF transfers). The spring 2013 Budget is unlikely to seek to correct this slippage, given the weak economic backdrop.

Figure 10. UK — Public Sector Primary Current Spending YoY (Real Terms), 1960/61-2017/18F



Note: Figures converted into real terms using the GDP deflator. Primary spending excludes debt interest. F OBR Forecast. Sources: OBR and Citi Research

Figure 11. UK — General Government Debt/GDP Ratio, Fiscal Years 2006/07-2017/18F



F Forecast. Sources: ONS, OBR and Citi Research

With the rising public debt/GDP ratio and trend to deferring fiscal consolidation beyond 2015/16, the UK is likely to lose its AAA rating in the next 12-18 months

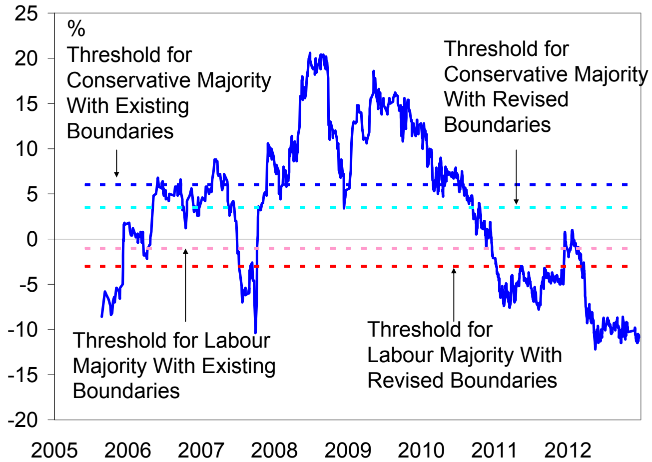
This gradualist approach to fiscal tightening is, we believe, justifiable given the backdrop of ultra-low gilt yields, private deleveraging and weak exports. But, this implies that the general government debt/GDP ratio will surge from 44.2% at end-07 and 85.0% at end-11 to about 90% at end-12 and about 95% at end-13 heading above 100% of GDP in 2015. Moreover, although the OBR projects that the debt/GDP ratio will start falling in 2016/17, in our view the UK lacks credible plans to achieve this. The current spending plans extend only to 2014/15, and there are no proper plans for how to deliver the large cuts planned for later years. In 2013, the government will announce detailed spending plans for 2015/16, but the big cuts penciled in beyond that will remain unspecified. Moreover, with the next election due no later than June 2015, and Labour ahead in the polls, there inevitably are doubts as to whether a new government would actually deliver post-2015 spending cuts unless constrained by market pressure. As a result, we have argued previously that the UK will probably lose its AAA rating in the next 12-18 months — indeed, with the weaker economic outlook, we now expect this downgrade will occur in 2013.

Rising Political Challenges for 2013 and Beyond

Political uncertainties are likely to rise in 2013 and beyond

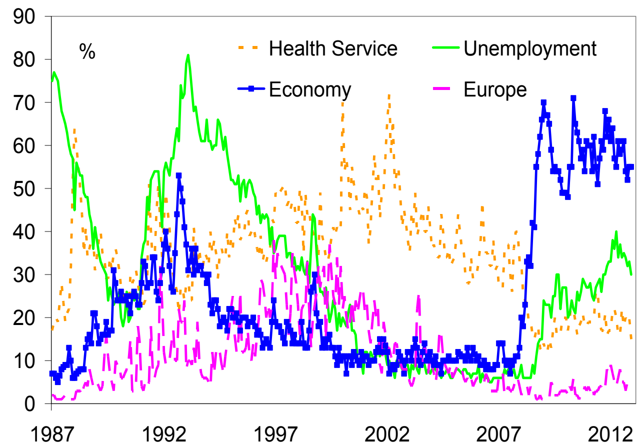
It is still 2½ years to the next election, scheduled for June 2015, but political uncertainties are likely to rise markedly in 2013 and 2014, reflecting four key issues: Will Scotland vote for independence in the referendum scheduled for 2014? Will the coalition fall apart in 2013 or 2014, triggering an early election? Who will win the next election, scheduled for 2015? Is the UK heading on a route that leads to EU exit in coming years?

Figure 12. UK — Conservative Lead Over Labour In Opinion Polls (10-Poll Average), 2005-12



Note: We estimate the leads required in votes cast assuming that smaller parties poll in line with current levels. Sources: UK Polling Report and Citi Research

Figure 13. UK — Share of People Who Cite Various Factors as "Among the Most Important Issues Facing the UK", 1987-2012



Sources: IPSOS/MORI and Citi Research

We doubt that the coalition will split before the 2015 election, and also do not expect that Scotland will vote for independence

Despite rising political divisions between the Conservatives and Lib Dems, we suspect that self-interest will keep the coalition going until close to the scheduled 2015 election. Both coalition parties are lagging badly in opinion polls, and would probably face heavy losses if they trigger an early election. Moreover, with the Fixed Parliament Act, the Conservatives themselves cannot call an early election without support from opposition parties. At the same time, we believe it is unlikely that the 2014 Scottish referendum will produce a vote for independence, given that polls consistently show that only 30-35% of Scottish voters support independence, with 50-60% opposed. The SNP's decision to seek a referendum on independence is, we suspect, aimed more at gaining extra powers for the Scottish Parliament within the UK, rather than a realistic hope of achieving full independence nearterm.

However, at present, it seems likely that the UK will face either a Labour government or another coalition after 2015 election…

However, medium-term political uncertainties are rising. With rising support for UKIP and low public approval ratings for all three mainstream parties, it seems that the UK is not immune from the wider trend towards political fragmentation and rising appeal of NEAPS (New, Extreme or Alternative Parties)[3]. At present, it seems likely that both coalition parties will suffer big losses in the 2015 election, especially the Lib Dems, with the election producing either a Labour majority government, or a coalition (probably Labour-led, but conceivably Conservative-led) that (with low Lib Dem polling) might need support from various smaller parties. The Conservatives have to be 6-7% ahead in votes cast to gain an absolute majority with the current parliamentary boundaries, or 3-4% ahead if boundary changes are implemented. They have not held such a lead on a sustained basis since late-2010.

[3] See "*2013 Global Political Outlook: Another Annus Politicus Ahead*", Tina Fordham, 21 December 2012, Citi.

…and the coalition parties' poor poll ratings casts doubt on the UK's ability to achieve fiscal consolidation

Unlike the Conservative governments of 1979-83 and 1983-87 — which were re-elected despite midterm poll slumps — the current administration will not have the benefit of a buoyant economy and divided opposition. The current government probably will be the first for at least 60 years with little or no growth in average living standards (ie real disposable income per head) over a four or five-year period. Moreover, the Lib Dems' poor polling helps reinforce Labour's lead, while a ratings downgrade would probably hurt the coalition's reputation for competence. Competition for votes in the runup to the election could further delay fiscal consolidation. And either a majority Labour government or another coalition would cast doubt on whether fiscal consolidation will persist beyond 2015 unless market pressures escalate.

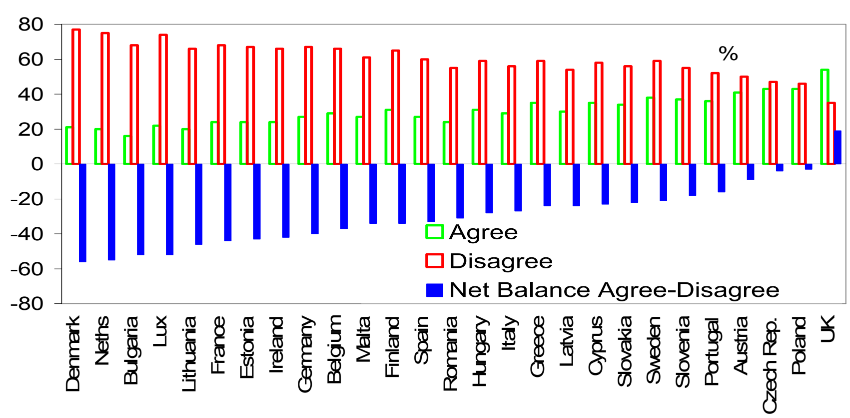
Longer term questions over the UK's place in Europe also are likely to grow…

Longer term, questions over the UK's place in Europe are likely to rise, reflecting rising support for the anti-EU UKIP party and the challenge of whether the UK should join the more integrated EU core that is likely to evolve in coming years. The UK is the only one of 27 EU countries in which a majority of public opinion agrees that "*Our country could better face the future outside the EU*"[4]. We do not expect a referendum on the UK's position in Europe before the 2015 election. The current government does not want to exit the EU and only a small minority of UK voters believes Europe should be a priority for the government. For example, IPSOS/MORI report that only 6% of people believe that "Europe" is among "*the most important issues facing the UK*", and it ranks 12th — behind the economy, unemployment, crime, inflation, health service, racism, education, poverty, housing, low pay and morality (and equal with population ageing).

…and the key issue will probably will be whether the UK can stay in the EU but out of the more integrated core that is likely to form in coming years

The Conservatives probably will commit in the next year or two to hold a referendum on Europe after the 2015 election, aiming to reclaim voters lost to UKIP. But, any such referendum probably will only be held once a clear choice has to be made over whether to join an integrated core EU. If the UK can stay in the EU and out of the integrated core then — given the risk that EU exit might hurt the economy (which voters put as the main priority) — we believe there would be a clear majority to stay in the EU. But if the UK has to choose between joining an integrated core EU and EU exit, then the outcome would be uncertain. And, even though any such choice is still some years away, anti-EU rhetoric among UK politicians in the months ahead may add to longer term uncertainties in 2013.

Figure 14. EU Countries — Pct of People Who Agree or Disagree With the Statement "Our Country Could Better Face the Future Outside the EU", Autumn 2012



Sources: European Commission and Citi Research

[4] See "Eurobarometer survey", European Commission, Autumn 2012

Policy Outlook — Monetary Policy to Stay Loose — and Loosen Further

The MPC is likely to expand QE a bit further…

Monetary policy is likely to stay loose in 2013 and indeed probably will loosen further. The continued underperformance of the economy is likely to persuade the MPC that more stimulus is needed, and the MPC also will probably reject the argument that stimulus is futile. Monetary policy's traction on the economy is modest given the headwinds from fiscal policy, the EMU crisis and private deleveraging. But, QE has helped to support money growth and asset prices, while the FLS has helped ease banks' funding strains — hence reducing risks of an even greater implosion in demand. Recent gains in money growth and asset prices suggest that the traction from these measures — while limited — has not faded away. We expect that the MPC will resume QE on a modest scale during H1, with the exact timing depending on data and market conditions, and still expect that the QE target will eventually rise to £450bn (from £375bn now) or even higher.

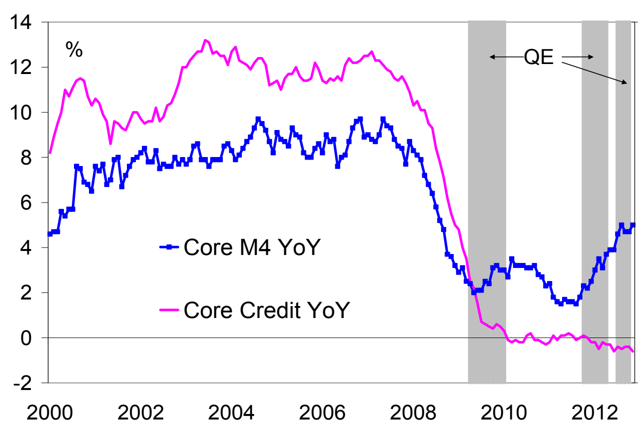
…and give more clearcut guidance that rates are likely to stay low for an extended period…

In addition, we suspect that, from midyear, the new Governor Carney will introduce a clearer role for rate guidance in monetary policy, with the MPC stating that — under its current outlook — it does not expect to tighten policy for a long period, for example before 2015 or so. The MPC's inflation forecasts occasionally have provided a very limited amount of implicit rate guidance. But, in general, the MPC has sought maximum flexibility by giving little or no explicit rate guidance, and taken the view that "we take each meeting as it comes"[5].

…hence magnifying the effect of policy stimulus while retaining flexibility to shift policy if the outlook changes significantly

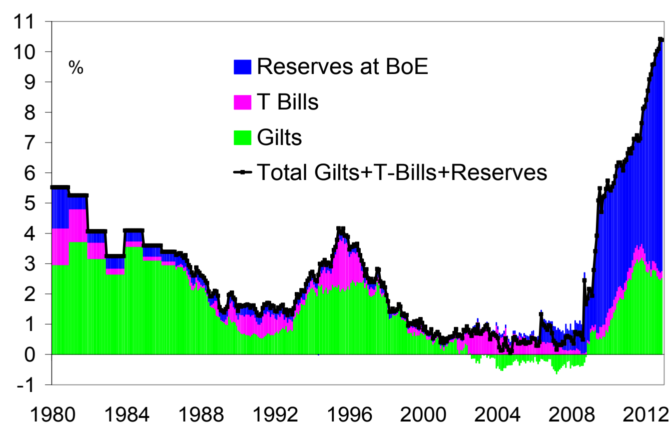
However, the Fed, BoC, Riksbank and Norges Bank have all shown that useful rate guidance is possible without losing policy flexibility. The Fed and BoC have used statements that, based on the current outlook, they expect rates to remain stable for a certain period, while the Riksbank and Norges bank publish forecasts of their expected rate path. Such statements can help anchor market rate expectations, reduce uncertainty about the central bank's reaction function and hence magnify the desired policy stimulus. Flexibility is retained by making the rate guidance conditional on the forecast, and hence subject to change if the economic outlook changes. In practice if, as we expect, the economy remains sluggish, any UK rate guidance for stable rates is more likely to be rolled forward rather than truncated.

Figure 15. UK — Core M4 and Credit YoY, 2000-12



Note: Data exclude transactions of non-bank financial companies.
Sources: BoE and Citi Research

Figure 16. UK — Banks' Holdings of Gilts, Treasury Bills and Reserves as Pct Sterling Assets, 1980-2012



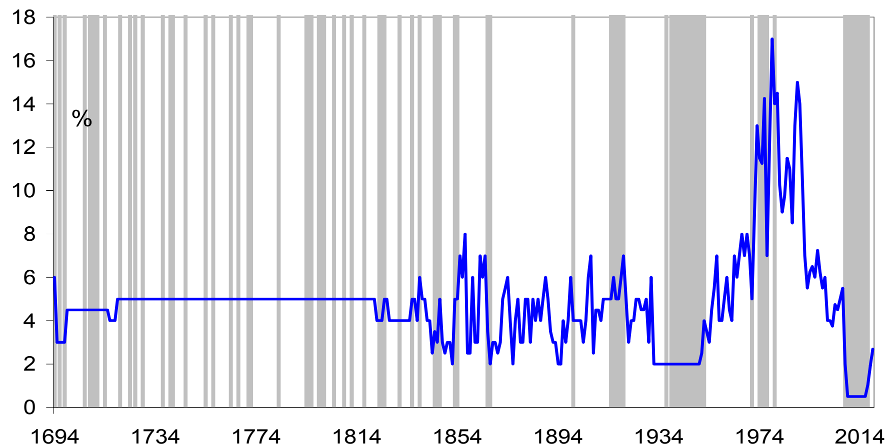
Sources: BoE and Citi Research

5 See "*The MPC Ten Years On*", Speech by Mervyn King, May 2007.

The UK is only partway through an unprecedented period of ultra-low nominal rates and negative real rates

Any eventual move to policy tightening is distant in our view. As stated previously, we are postponing our forecast for the first MPC rate hike from 2016 until 2017. Hence, we expect that this episode from 2009 will match or even slightly exceed the seven-year rate trough (at 0.5% Bank Rate) from 1932-39 as the longest period of rock-bottom rates (outside wartime) for at least 100 years. We expect that real rates (versus CPI inflation) will remain negative until about 2018, unless sterling falls sharply or inflation expectations surge. Real rates went negative in 2008, and so we expect a full 10 years with negative real rates — the longest such period (outside major wars) since Bank Rate was introduced in the late 17th century.

Figure 17. UK — BoE Policy Rate (Shaded Periods Show Episodes With Negative Real Rates), 1694-2019F



Sources: Bank of England, ONS and Citi Research

The eventual unwind of QE is probably distant and in any case may be roughly matched by increased demand for gilts from UK banks

Indeed, it is worth noting that if and when the MPC eventually does seek to unwind QE — selling gilts and draining reserves — UK banks would probably need to buy a roughly similar amount of gilts in order to meet their required holdings of high quality liquid assets. The BoE reports that — even after the huge QE-induced rise in banks' reserves — major UK banks liquid asset holdings (which are largely made up of gilts, treasury bills and reserves at the BoE) on average are only 110-115% of the required levels[6]. At present, UK banks hold £385bn in high quality sterling liquid assets (£94bn in gilts, £8bn in treasury bills and £283bn in reserves, equal to just over 10% of banks' sterling assets), plus limited holdings of foreign government bonds. So, if the MPC does ever sell the APF gilts and drain reserves on a major scale, then banks will need to further expand their gilt holdings to hit their overall liquidity targets. We doubt this issue will stop the MPC unwinding QE if and when it is needed, but it should help limit the adverse effect on the gilt market (but hence probably also putting more burden on interest rates to tighten monetary conditions).

Any changes to the inflation target are likely to reinforce the MPC's bias to a loose policy stance

At this stage, we have not included possible changes to the MPC's target, for example to a 1-3% band. If such a change is made — and we consider this desirable and distinctly possible[7] — it will establish a framework of greater inflation tolerance, hence reinforcing the MPC's nearterm bias to stimulus and defer even further any eventual move to tightening.

[6] See Financial Stability Report, Bank of England, November 2012.

[7] See "UK - New Year, New Governor – and New Targets?, *UK Economics Weekly,* Michael Saunders, Citi, 19 December 2012

Economic Indicators

Wed 9 Jan	***Trade Balance – Goods & Services (Nov)***	**Forecast: £-3.0 billion**	**Prior: £-3.6 billion**
	These data are likely to keep the trade balance on a deteriorating trend, with the cumulative deficit for January-November in 2012 up to £32.4bn, versus £22.5bn in the same period of 2011. Exports have been badly hit by the renewed EMU recession, and this headwind is likely to persist in the year ahead.		
Fri	***Industrial Production (Nov)***	**Forecast: 0.6% MoM, -2.1% YoY**	**Prior: -0.8% MoM, -3.0% YoY**
11 Jan	***Manufacturing Output (Nov)***	**Forecast: 0.3% MoM, -1.6% YoY**	**Prior: -1.3% MoM, -2.1% YoY**
	Manufacturing output fell sharply in October, a steeper plunge than implied by surveys, and we look for some of that lost ground to be regained in November. Even so, a figure in line with our forecast would leave the average level of industrial production in October and November down by 2.1% from the Q3 average, hence setting the stage for a weak Q4 figure.		

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Economic Calendar, 31 December 2012 — 18 January 2013

31 December	1 January	2 January	3 January	4 January
Housing Equity Withdrawal (Q3) *(During The Week)* **Nationwide House Prices (Dec, 07:00)**	**New Year's Day Holiday**	**Manufacturing PMI (Dec)** Nov 49.2 Dec 51.4	**Labour Productivity (Q3)** **Personal Borrowing (Nov)**	**Services PMI (Dec)** Nov 50.2 Dec 48.9
7 January	**8 January**	**9 January**	**10 January**	**11 January**
(During The Week) **Halifax House Prices (Dec, 09:00)**		**Trade Balance – Goods & Services (Nov)** Oct £-.3.6Billion NovE £-3.0Billion **Profitability of UK Companies (Q3)** **MPC Meeting Starts**	**MPC Meeting Ends: Outcome at Noon** **ECB Meeting:** 12:45 Rate Announcement 13:30 Press Conference	**Industrial Production (Nov)** Oct -0.8%MM; -3.0% YY NovE 0.6%MM; -2.1% YY **Manufacturing Output (Nov)** Oct -1.3%MM; -2.1% YY NovE 0.3%MM; -1.6% YY **Construction Output (Nov)**
14 January	**15 January**	**16 January**	**17 January**	**18 January**
	Producer Prices (Dec) **Consumer Prices (Dec)** **Retail Prices (Dec)**			**Retail Sales Volumes (Dec)**

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 Research.

Appendix A-1

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