UK Economics Weekly

The Authorities' Dilemma: How to Respond to Stagnation

- The economy remains extraordinarily weak, with the third consecutive negative quarter leaving GDP 4.5% below the pre-recession peak (Q1-08). Technical factors probably exacerbated the drop in Q2 GDP, but the big picture is that the economy has flatlined for two years and, with household deleveraging, poor credit availability, fiscal drag and the EMU crisis, the economy is likely to remain weak for an extended period, in our view.

- With inflation heading below target, options for stimulus are available. However, the authorities face a dilemma over what form of stimulus to use. Further QE is likely, but probably will only give a modest boost given household deleveraging. We believe there is a good case for the MPC to cut Bank Rate further, but the MPC still seem reluctant to act. Fiscal policy is a more powerful tool, and in our view there is a good case for the government to defer the heavy fiscal tightening planned for 2013/14. However, with the fiscal deficit overshooting, the government may be unwilling to defer planned fiscal tightening lest this trigger a sovereign ratings downgrade. It is unclear whether the authorities will be willing to act aggressively enough to lift the UK economy out of stagnation.

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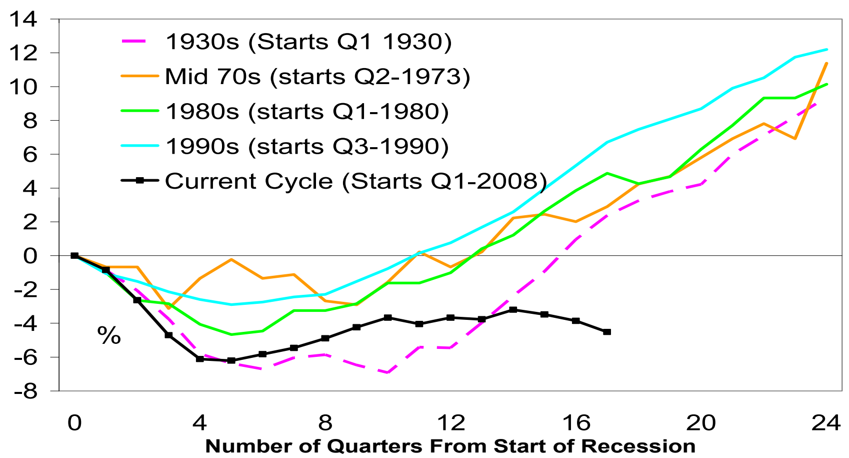
Figure 1. Citigroup Market Forecasts

	Base Rate	QE Target	10 Year Yield	Spread vs Bunds	$/£	£/€
End 2012	0.50	£425bn	1.25	25bp	1.55	0.78
End 2013	0.50	£500bn	2.25	25bp	1.57	0.78

Source: Citi Research

Figure 2. UK — Change in Real GDP from Pre-Recession Peaks, 1973-2012



Sources: NIESR, ONS and Citi Research

The Authorities' Policy Dilemma

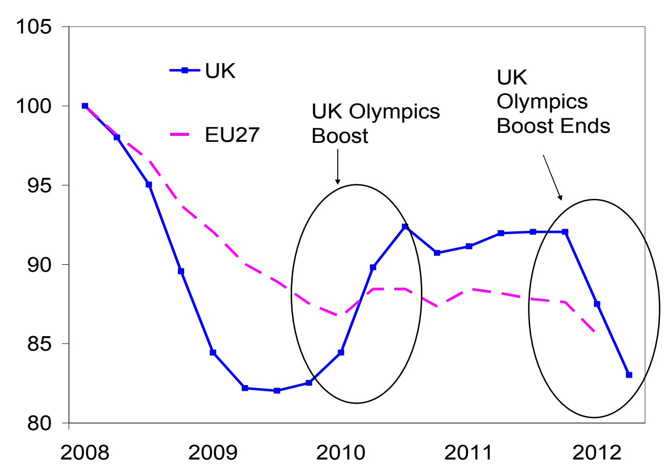
The GDP data highlight the continued weakness of the economy

The GDP data highlight the ongoing weakness of the economy, with the third consecutive negative quarter. The level of real GDP is now 4.5% below the pre-recession peak (Q1-08), whereas in previous cycles the economy at this stage (17 quarters after the pre-recession peak) was recovering strongly. For example, after 17 quarters, real GDP was 2.4% above the pre-recession peak in the 1930s, 2.9% above in the 1970s, 4.9% in the 1980s and 6.7% above in the 1990s.

Technical factors probably exacerbated the weakness in Q2…

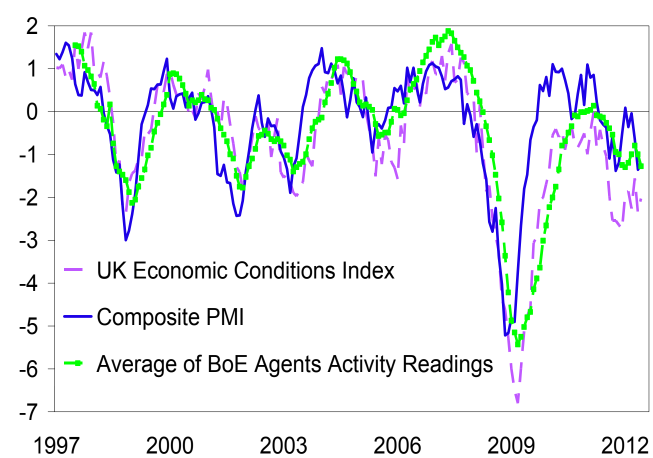
Technical factors probably exacerbated the weakness of Q2 GDP. First, the Queen's Diamond Jubilee holiday may have caused a similar effect to that seen with the June-02 Golden Jubilee holiday, when services output fell 2.0% MoM and industrial production fell 4.7% MoM, hence cutting 0.5-1% off Q2 growth. Moreover, construction output again fell sharply, down by 5.2% QoQ after falling 4.9% in Q1, unwinding the 12.6% surge between Q3-09 and Q3-10. That previous expansion was the biggest among EU27 countries and probably was fuelled by the construction of Olympics facilities. As those faculties have been completed, construction output has fallen back to about the 2009 level. This pattern that growth accelerates 1-2 years before the Olympic Games — and then slows in the immediate run-up to the Games — has been regularly seen in prior host countries[1].

Figure 3. UK and EU27 — Construction Output, Indexed to Q1-08 =100, 2008-12



Sources: Eurostat, ONS and Citi Research

Figure 4. UK — Business Survey Readings, 1997-2012



Note: Shown as standard deviations from the 1997-07 averages. We show the average of the manufacturing and service sector PMIs. For the BoE agents, we average the activity readings.
Sources: BoE, European Commission, Haver Analytics and Citi Research

…but the weakness is not just due to technical factors

But, in our view the economy's weakness is not just due to technical factors. The big picture is that the recovery has stalled, and the economy has been roughly flat since mid-2010, markedly underperforming versus consensus and official forecasts, and compared to prior recovery cycles. After the sharp collapse in output (down 6.2%) from Q1-08 to Q2-09, there was a modest recovery from Q2-09 to Q3-10, followed by stagnation and renewed recession, in contrast to the strengthening recoveries at this stage in prior cycles. Consumption and investment in particular are underperforming and these shortfalls cannot just be attributed to the erosion of real incomes by high inflation, given that spending is weak in both nominal and real terms.

[1] See "Sterling Weekly - 2012 Outlook -- Deleveraging and Stagnation" Michael Saunders, 4 January 2012, Citi.

Nor do we believe the weakness in the economy is just a statistical error

Nor do we share the widely-expressed view that the resilience of the PMIs and employment (up 0.4% QoQ in March-May) proves the economy is much stronger than the GDP data imply. The GDP data will probably be revised a bit, but we doubt that such revisions will alter the broad picture that the economy is not recovering.

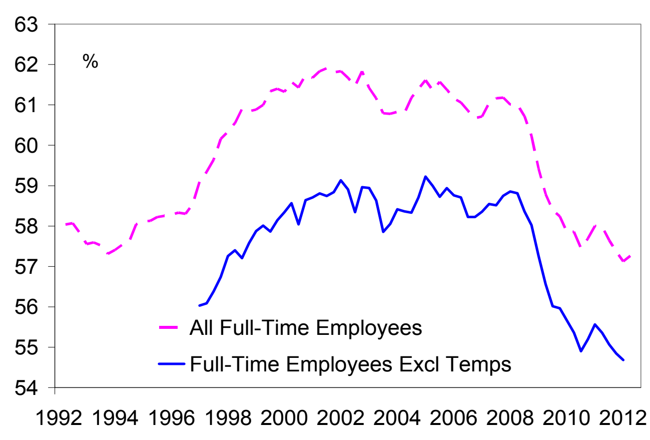
All major business surveys suggest the economy is sluggish

- There are many business surveys for the UK and the general picture is weak. The long-running EU Commission Economic Sentiment index (a composite of a wide range of surveys) is about two standard deviations below average, while the PMI indices (averaged across manufacturing and services) and BoE Agents survey (averaged across the activity components) are about 1¼ standard deviations below average. And one would expect that the PMIs overstate GDP growth, because they exclude the retail sector, which is relatively soft.

Job growth is concentrated in less secure forms of employment, and is sustained by extremely low pay growth

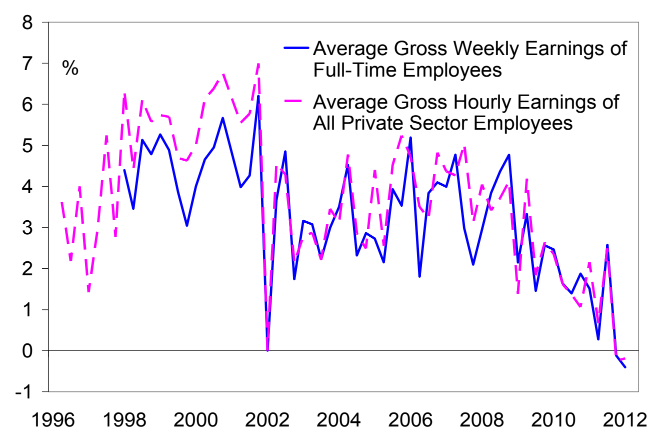
- Job growth is concentrated in lower-paid self-employment, temporary jobs and part-time work, with the numbers of full-time employees down 0.7% YoY. The share of the workforce that are full-time employees (ie not self-employed or working part-time) is down from 61.2% in Q4-07 to 57.3% in March-May this year, close to the early 90s low (57.2% in early 1994). With weak core employment, job insecurity is high (evident in the high share of people who expect unemployment to rise in the next year) and pay growth is very soft. The ONS report that average weekly earnings for full-time employees rose by just 0.3% YoY in Q1 (lowest since data began in 1997), with male earnings down 0.4% YoY (also the weakest on record). With the shift to lower-paid part-time jobs, private sector average hourly earnings fell 0.2% YoY in Q1, with male hourly earnings down by 1.0% YoY. Economic theory implies that in general firms will set staff levels such that labour's marginal productivity equals its marginal cost. Hence, with such low pay growth, firms can afford to have more staff and lower productivity levels — but this is hardly a sign of economic strength.

Figure 5. UK — Full-Time Employees as Pct Workforce, 1992-2012



Sources: ONS and Citi Research

Figure 6. UK — Pay Growth YoY, 1996-2012



Sources: ONS and Citi Research

The economy continues to face major headwinds

In our view, the economy continues to face four major headwinds: household deleveraging, poor credit availability, fiscal drag and weakness in major export markets of the euro area. None of these are likely to fade quickly. The economy probably will grow in Q3, on a technical bounce from the Queen's Jubilee effects, but we expect that the economy will be roughly flat from mid-2010 to end-2013 as a whole: for now, the economy has gone ex-growth. We expect the economy will only regain the pre-recession level of GDP in 2016, eight years after the peak.

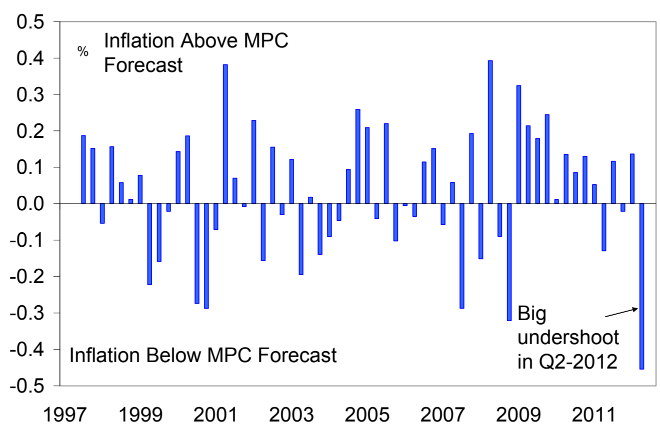
If the UK is to avoid stagnation, policy needs to aim to slow public deleveraging or private deleveraging, or both

For the UK, with the need to deleverage both the public and private sectors, the textbook approach to avoid stagnation is to get sterling down and aim for export-led growth. However, this escape route is probably closed off by the EMU crisis, which is capping UK exports and actually forcing the pound higher again versus the weakening euro. Hence, if the UK is to avoid prolonged stagnation, the authorities probably have to aim to slow private deleveraging (chiefly by monetary loosening) or public deleveraging (ie less fiscal consolidation), or to slow both. But, it remains unclear to what extent the authorities will act, because of their worries about the effectiveness and possible adverse side-effects of policy easing.

The MPC no longer face constraints from inflation, which is undershooting their forecasts…

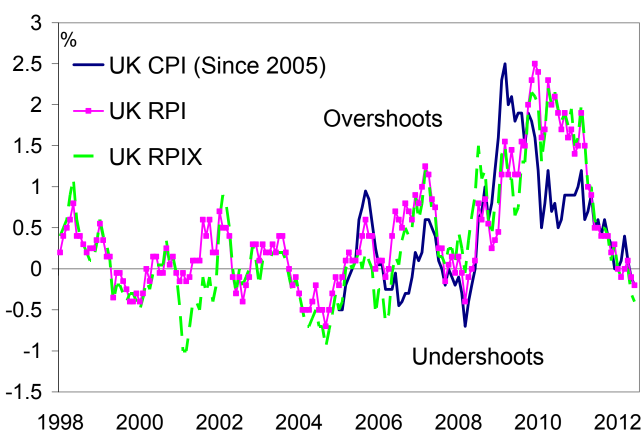
The MPC do not face a major policy dilemma over whether to loosen, given that both real GDP growth and inflation are well below their forecasts. Q2 CPI inflation was 0.3% lower than the MPC expected a year earlier (ie the May-11 forecast), the first undershoot since 2007 (other than the brief tax-driven undershoot in 2009). Compared to the MPC's forecast at the start of the quarter (ie the May-12 forecast), Q2 inflation undershot by 0.45%, the biggest undershoot since MPC independence in 1997. The worries among some MPC members (notably Chief Economist Spencer Dale[2]) that inflation would be sticky in 2012 and 2013 are being overwhelmed by the data. In 2009-11, inflation repeatedly overshot the MPC's forecasts and the target, but now, with the inflationary boost from the low pound fading, inflation is likely to markedly undershoot both the target and MPC forecasts.

Figure 7. UK — Outturns for Inflation Less MPC Forecasts Made One Quarter Earlier, 1997-2012



Note: We use CPI inflation since 2005, RPIX inflation before that. We compare outturns with the MPC's median forecast assuming stable rates.
Sources: BoE, ONS and Citi Research

Figure 8. UK — 12-Month Sum of Gap Between Outturns and Pre-Release Consensus for Inflation, 1998-12



Sources: Bloomberg, Datastream and Citi Research

…but do have a dilemma over whether monetary policy can be effective enough to lift the economy out of stagnation

However, the MPC do face a dilemma of sorts, over what mix of loosening to use, and whether it will be powerful enough to restore normal growth. We still expect that the MPC will expand QE further once the current programme expires later this year. In addition, we believe there is a good case for the MPC to cut Bank Rate below 0.5%, say to 0.25% or 0.1%. The MPC has refused to do this so far, because of fears that banks would have to pass the cut onto variable rate loans but could not pass it onto deposit rates (which in 2009 were close to zero) — and hence would face a margin squeeze. However, as the IMF has argued,[3] this objection is fading,

[2] See speech of 20 March 2012.

[3] See UK Article IV Report, July 2012.

given that retail deposit rates have risen markedly over the last year or two. But, we are unsure if the MPC will opt to actually cut rates, or whether they will limit themselves to QE. In any case, it is unclear how effective QE and rate cuts will be, given the overhang of high household debts and the resultant persistent bias to deleveraging and higher savings. Extra loosening will probably not make things worse, but the scale of the boost to growth may well be modest.

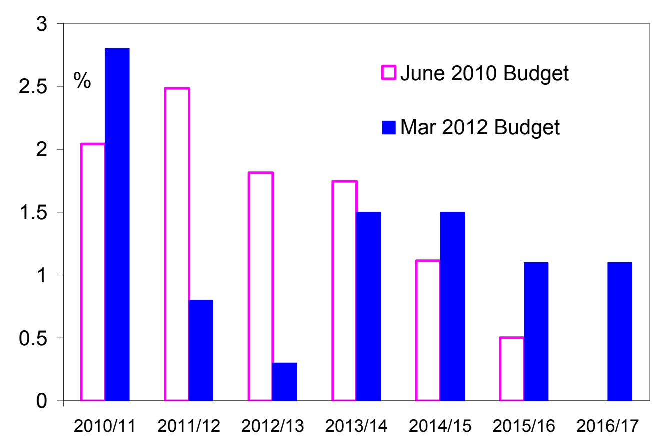
Fiscal policy is more likely to provide a powerful effect on the economy

Conversely, fiscal policy is likely to be a relatively effective tool for stimulus[4], probably more so at present than monetary policy. However, the authorities face a tough dilemma over whether the possible adverse side effects (worries over fiscal sustainability) would outweigh the intended gains from a stronger economy.

There is a good economic case for the government to defer some of the heavy planned fiscal tightening for 2013/14…

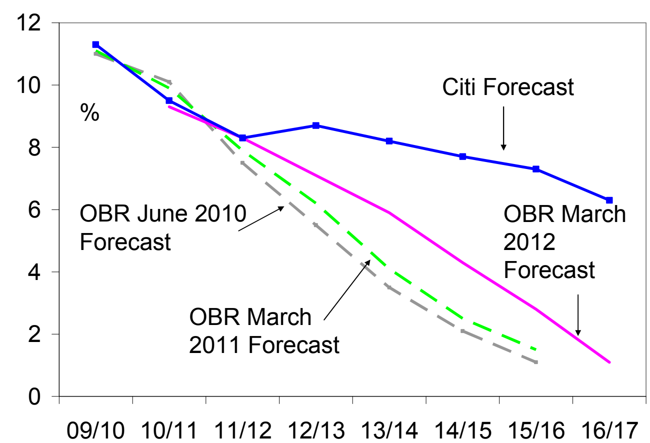
At present, the UK fiscal plans imply fiscal tightening (in terms of the change in the cyclically adjusted primary balance) of 0.3% of GDP in 12/13, rising to about 1½% of GDP in both 13/14 and 14/15. When those plans were set in the Spring 2012 Budget, the government hoped that by 2013 private spending and exports would be strong enough to sustain even greater fiscal restraint. However, those hopes now look misplaced, and in our view there is a good economic case for the government in the Autumn Statement to defer some of the fiscal tightening planned for 13/14 to later years (ie beyond 2015). The ultra-low level of gilt yields is, in our view, practically an invitation for the government to borrow more. For example, the government could implement temporary tax cuts and extra public investment of, say, 1% of GDP (£15bn-£16bn), while maintaining the planned squeeze on current spending, leaving an overall fiscal tightening for 2013/14 of about ½% of GDP. This would be consistent with the IMF's recent advice.

Figure 9. UK — Annual Fiscal Tightening (Change in Cyclically Adjusted Primary Balance), Pct of GDP, 2010/11-2016/17



Sources: OBR and Citi Research

Figure 10. UK — Fiscal Deficit as Pct of GDP, 2009/10-2016/17F



F Forecast Sources: OBR and Citi Research

…but there are risks, especially if deferred fiscal consolidation leads to a sovereign ratings downgrade

However, such a policy does carry risks. A decision to defer much of the fiscal tightening planned for next year might well trigger one or more ratings agency to quickly put the UK on Negative Ratings Watch or move straight to a downgrade of the UK's AAA rating. The UK's fiscal consolidation programme already has slipped considerably. The OBR has already revised up its 2012/13 deficit forecast from £89bn (5.5% of GDP) in the June-10 forecast to £120bn, 7.1% of GDP (excluding the £28bn impact from the assets of the state postal service), in the Mar-12

[4] See IMF Fiscal Monitor, April 2012.

forecast. With the economy undershooting official forecasts, we expect this year's underlying deficit will be about £134bn (8.6% of GDP), with the headline deficit (including assets from the state-owned postal service) at £106bn — £14bn above the OBR forecast. With further deficit overshoots in subsequent years, we expect the debt/GDP ratio will continue rising well beyond the OBR's forecast (which is for this ratio to fall in 2015/16), implying the government is likely to miss its secondary fiscal rule of a falling debt/GDP ratio in 15/16. Moody's and Fitch already have the UK on negative Ratings Outlook and, even with the current fiscal consolidation plans, we believe there is a high chance that S&P also will put the UK on Negative Outlook in the next 2-3 quarters, with a probable downgrade by one or more ratings agency over the next 2-3 years[5].

We suspect a one-notch ratings downgrade — if it happens — would not have major market implications, but it would be a big political problem for the government

A deferred fiscal consolidation path is sensible in economic terms, we believe, but implementation inevitably would be less certain given that much of the planned consolidation would be deferred until after the next General Election (due no later than mid-2015). We doubt that a ratings downgrade would have major market implications, given the weak economy, EMU crisis and high private savings. But, even if markets do not react much, a ratings downgrade probably would be a huge political blow for the coalition, which has put the aim of restoring fiscal sustainability at its core. There are widening fissures in the coalition from policy disagreements and poor poll ratings. For the next election, the coalition partners hope to have established a political narrative that by their tough actions, they have returned the UK to fiscal sustainability. A ratings downgrade would eat away at that narrative, making it even harder to keep the coalition together in 2013-15.

It is unclear how the government will respond to this fiscal dilemma

It is unclear how the government will react to this dilemma: heavy fiscal restraint in 13/14 and 14/15 could lead to continued economic stagnation, while a deferred fiscal tightening programme might cast doubt on the UK's commitment to fiscal sustainability and produce an earlier ratings downgrade. Either route might well undermine the electorate's confidence in the government's economic policies. The choice is likely to come to a head in coming months, ahead of the Autumn Statement, and will probably rest on the extent of economic weakness and the scale of the euro crisis in coming months.

Economic Indicators

Wed 1 Aug	***Manufacturing PMI (Jul)***	**Forecast: 46.0**	**Prior: 48.6**
	The manufacturing PMI bounced by 2.7 points in the June survey, but we expect renewed weakness in the July index, reflecting sluggish domestic demand plus the drag on UK exports from the EMU crisis. Such a figure would mark the third consecutive sub-50 reading for this index.		
Fri 3 Aug	***Services PMI (Jul)***	**Forecast: 50.5**	**Prior: 51.3**
	The service sector PMI weakened by 2.0 points in the June survey, falling to the lowest since last October, and we expect a modest further deterioration in the July index, taking it to the lowest since Dec-2010.		
Tue 7 Aug	***Industrial Production (Jun)***	**Forecast: -4.5% MoM, -6.0% YoY**	**Prior: 1.0% MoM, -1.6% YoY**
	Manufacturing Output (Jun)	**Forecast: -5.0% MoM, -6.3% YoY**	**Prior: 1.2% MoM, -1.7% YoY**
	We expect that industrial production and manufacturing output will fall sharply in June, because of the extra bank holiday around the Queen's Jubilee. Our forecasts are for something like a rerun of the last such event, in June 2002, when manufacturing output fell 5.6% MoM with industrial production down 4.7% MoM.		
Wed 9 Aug	***Trade Balance – Goods & Services (Jun)***	**Forecast: £-4.0 billion**	**Prior: £-2.7 billion**
	These data will probably show a fairly sharp drop in exports, because of disruptions around the Queen's Jubilee. The last such event, in June 2002, saw exports fall 6% MoM with the deficit on goods and services trade rising to £2.4bn from £2.0bn in the prior month.		

[5] See "Sovereign Ratings Outlook - July 2012", Michael Saunders, Mark Schofield and Peter Goves, 25 July 2012. Citi.

Economic Calendar, 23 July — 10 August 2012

23 July	24 July	25 July	26 July	27 July
	BBA Mortgage Advances (Jun)	**GDP (Q2 Preliminary)** Q1 -0.4% QoQ, -0.2% YoY Q2 -0.7% QoQ, -0.8% YoY **Service Sector Output (May)** Apr -0.2% MoM, 1.8% YoY May 0.9% MoM, 1.3% YoY **CBI Industrial Trends Survey (Jul, 11:00)** **Qrtly Business Conf. (Jul)** Apr +22% Jul -6% **Monthly Output Expect'ns** Jun +7% Jul +11% **Monthly Order Books (Jul)** Jun -11% Jul -6% **Monthly Selling Prices (Jul)** Jun +2% Jul -3%		**2012 Olympic Games start** (London)
30 July	**31 July**	**1 August**	**2 August**	**3 August**
Personal Borrowing (Jun) **CBI Retail Survey (Jul)** (11:00)	**GfK Consumer Confidence (Jul, 00:01)** **UK National Accounts "Blue Book" released** **UK Balance of Payments "Pink Book" released**	**Nationwide House Prices (Jul, 07:00)** **Manufacturing PMI (Jul)** Jun 48.6 JulE 46.0 **MPC Meeting Starts** **FOMC Outcome** (19:15)	**MPC Meeting Ends: Outcome at Noon** **ECB Outcome** 12:45 Announcement 13:30 Press Conference	**Services PMI (Jul)** Jun 51.3 JulE 50.5
6 August	**7 August**	**8 August**	**9 August**	**10 August**
During the Week **Halifax House Prices (Jul)** (09:00)	**Industrial Production (Jun)** May 1.0% MoM, -1.6% YoY JunE -4.5% MoM, -6.0% YoY **Manufacturing Output (Jun)** May 1.2% MoM, -1.7% YoY JunE -5.0% MoM, -6.3% YoY	**BoE *Inflation Report*** (10:30)	**Trade Balance – Goods & Services (Jun)** May £-2.7bn JunE £-4.0bn	**Producer Prices (Jul)** **Construction Output (Jun)**

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.

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