

UK outlook: Post QE2

The no growth high inflation safe haven?

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Message

UK economy is an outlier over past

- UK economy has underperformed on growth – too little
- UK economy has underperformed on inflation – too much
- and yet, UK economy is regarded as a “safe haven”

Future is not bright

- Little sign of recovery in domestic demand and
- events across Channel threaten return to depression
- Inflation likely to be too low; not too high in future
- Solution is QE2
- But can the UK economy continue to be perceived as a “safe haven” ?

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Recent history

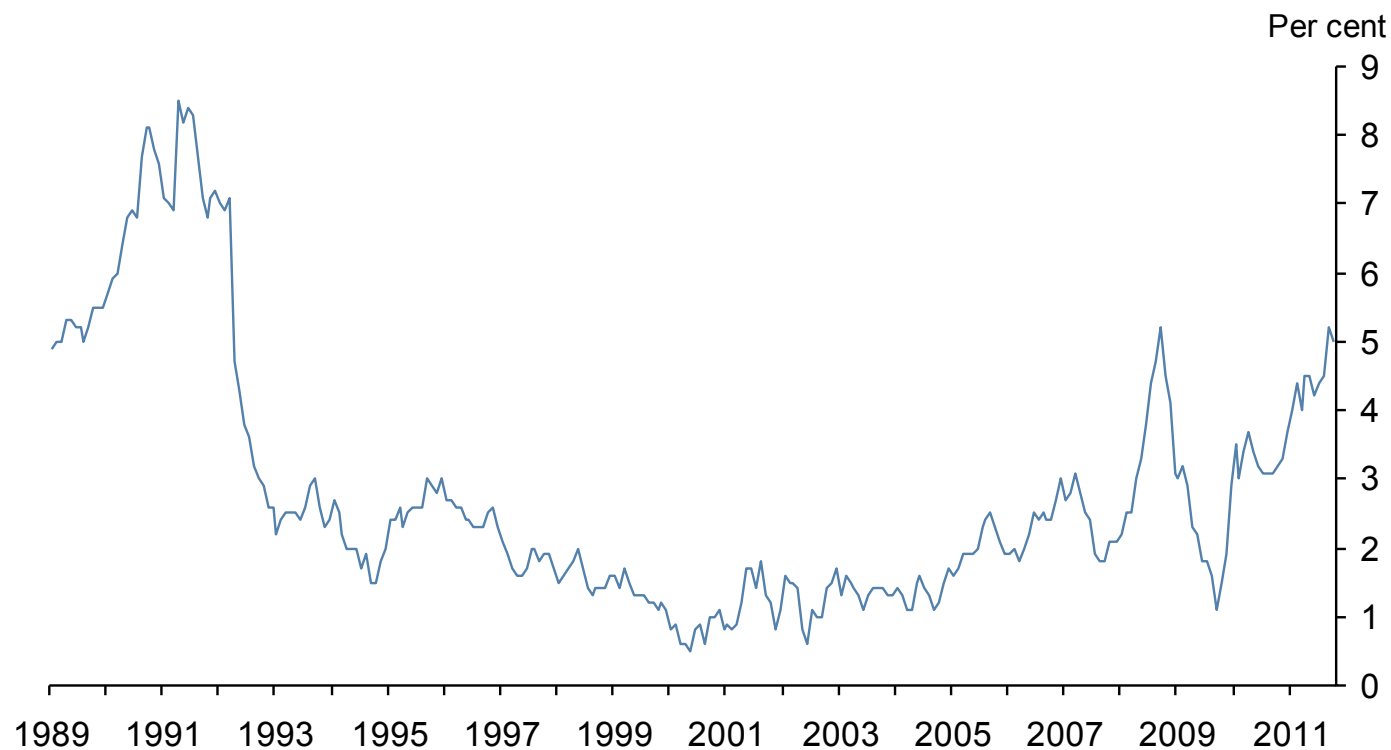
High Inflation, Feeble recovery

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Inflation is high

CPI inflation is 3 percentage points above the target

This will not last.....



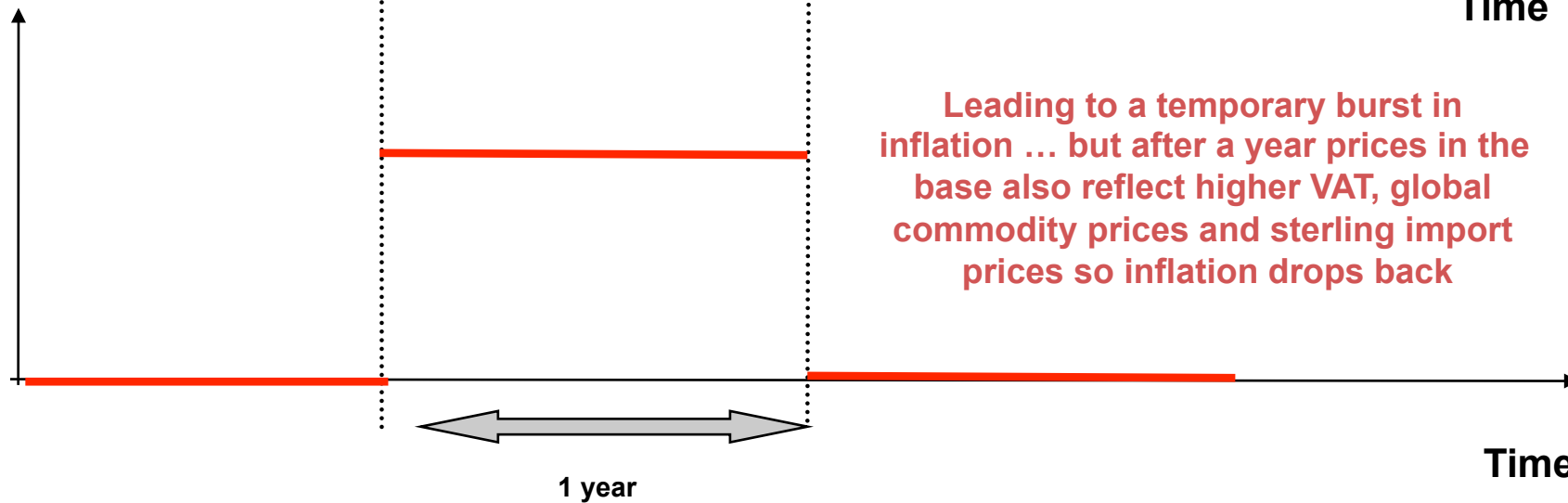
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Why UK inflation will fall back....

Price level



Inflation

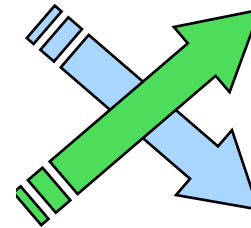
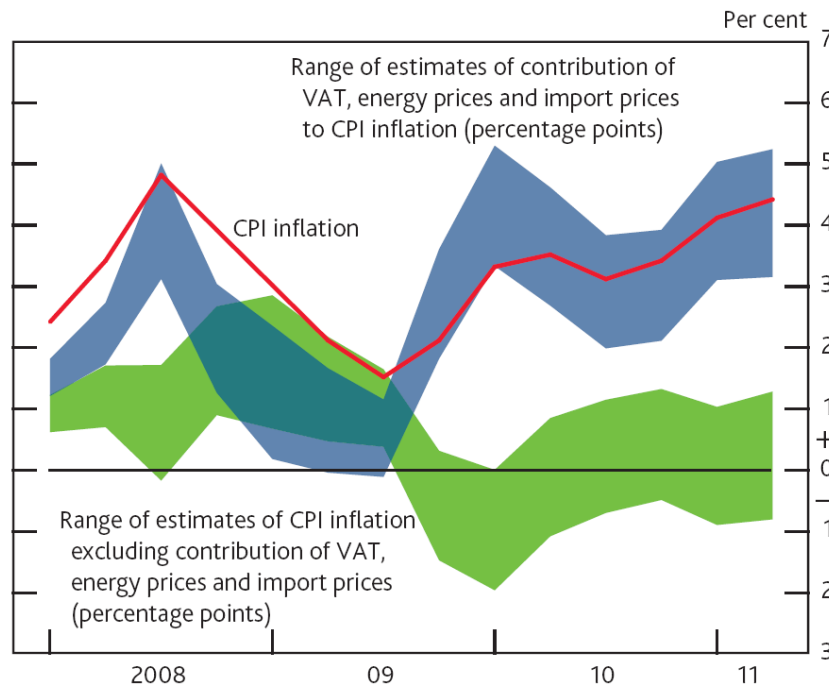


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Fundamental BoE message:

Zero contribution from domestically generated inflation (DGI)

Chart 4.1 CPI inflation and the contribution of VAT, energy prices and import prices^(a)



Story flips round over the forecast:

- VAT flat
- Commodity prices flat
- Exchange rate flat
- only world trade prices

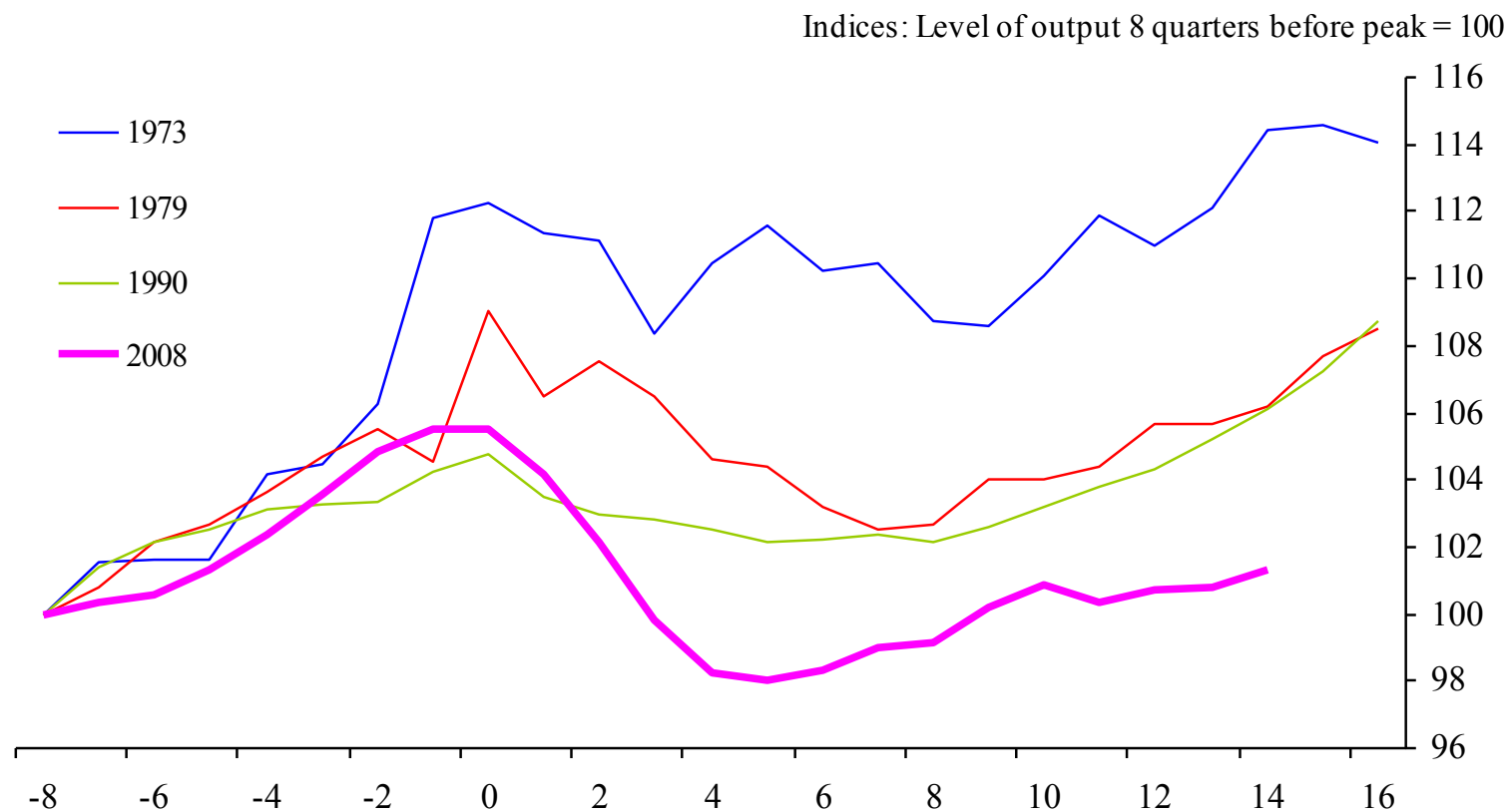
Raises serious questions about why DGI picks up over forecast....

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This recession looks different to recent experience

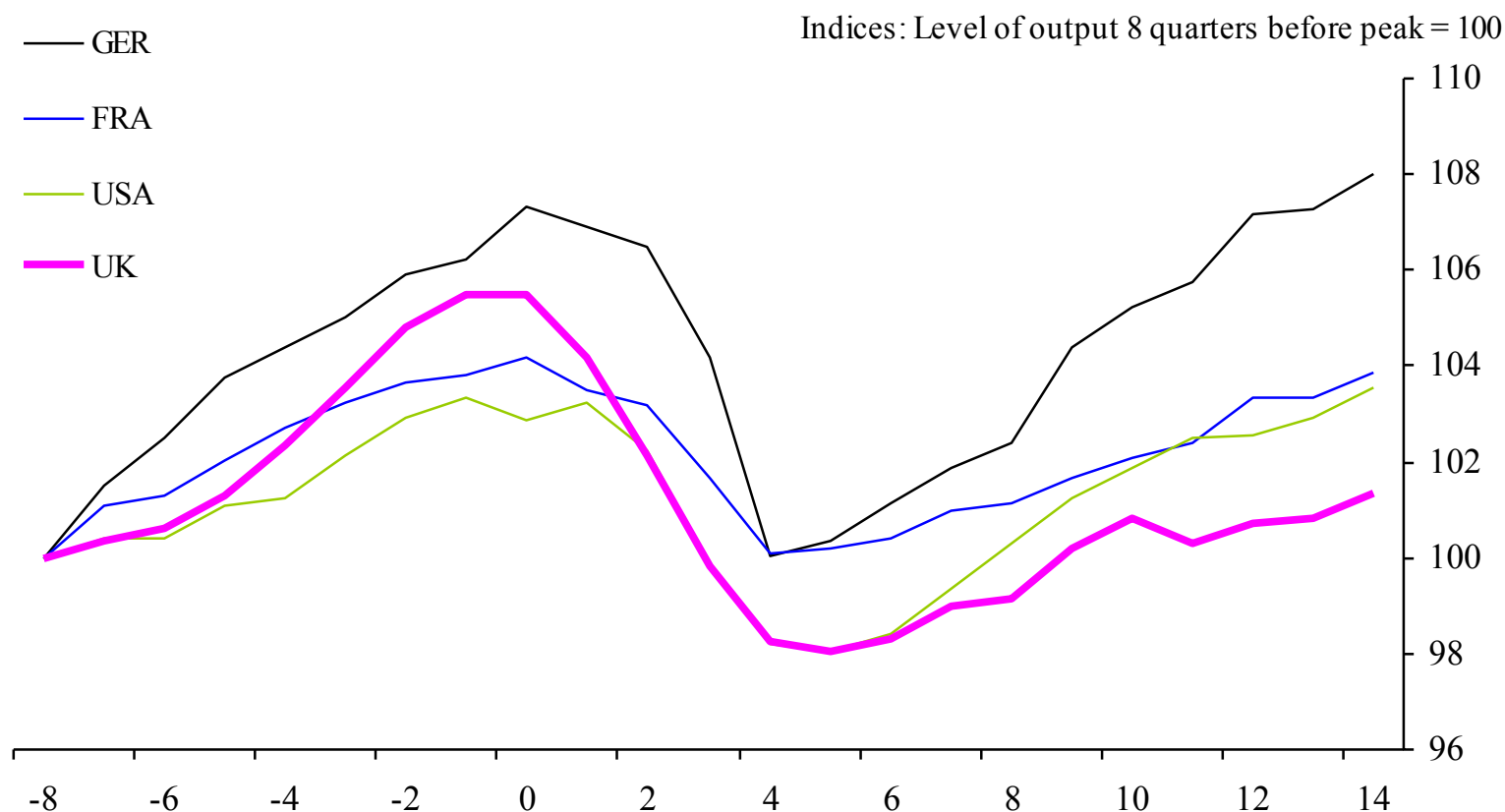
..... Was pretty feeble to begin with

..... Is grinding to a complete halt



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This recession looks different to recent experience And is pretty feeble by historical comparison too

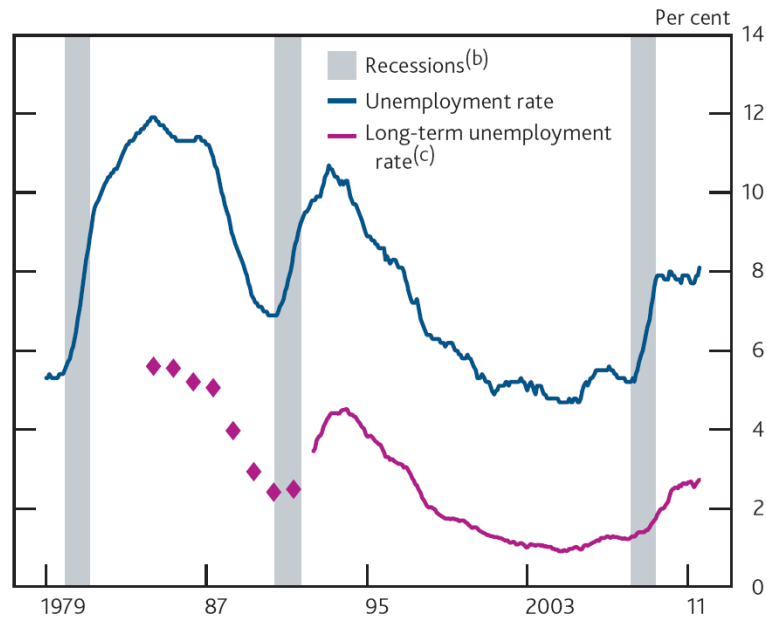


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Slack in the labour market

More people out of work; public sector demand set to shrink

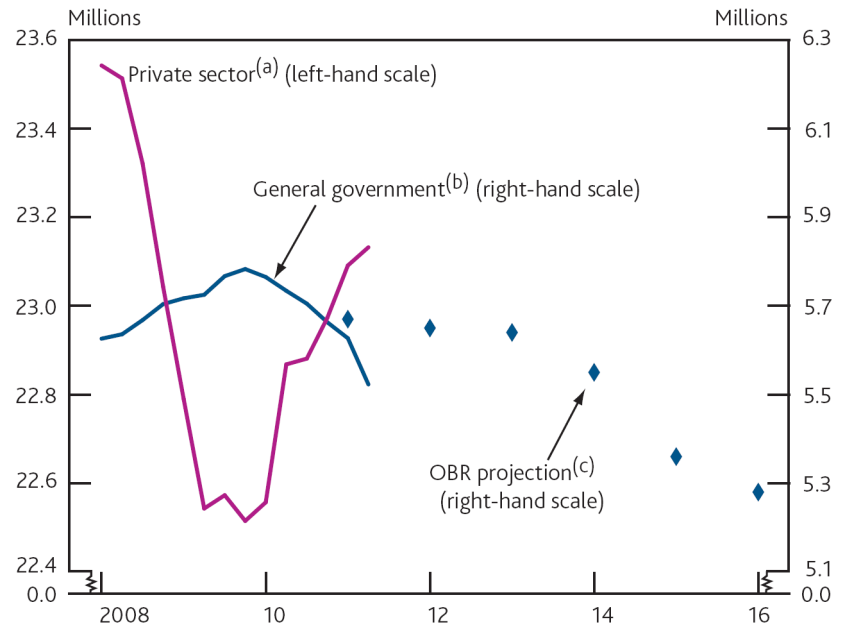
Chart 3.6 Unemployment rates^(a)



Source: ONS (including the Labour Force Survey).

- (a) Rolling three-month measures unless otherwise stated.
- (b) Recessions are defined as in **Chart 3.2**.
- (c) Defined as those people who have been unemployed for more than twelve months divided by the economically active population. Data prior to 1992 are based on non seasonally adjusted, annual LFS microdata. These annual observations correspond to the March-May quarter.

Chart 3.4 Public and private sector employment



Sources: Office for Budget Responsibility (OBR) and ONS (including the Labour Force Survey).

- (a) Private sector employment is calculated as the difference between LFS whole-economy employment and total public sector employment from the ONS' public sector employment release.
- (b) General government employment (excluding public corporations) data are from the ONS' public sector employment release.
- (c) The OBR's projection is from the March 2011 *Economic and Fiscal Outlook* and is for the end quarter of each financial year.

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Consumption?

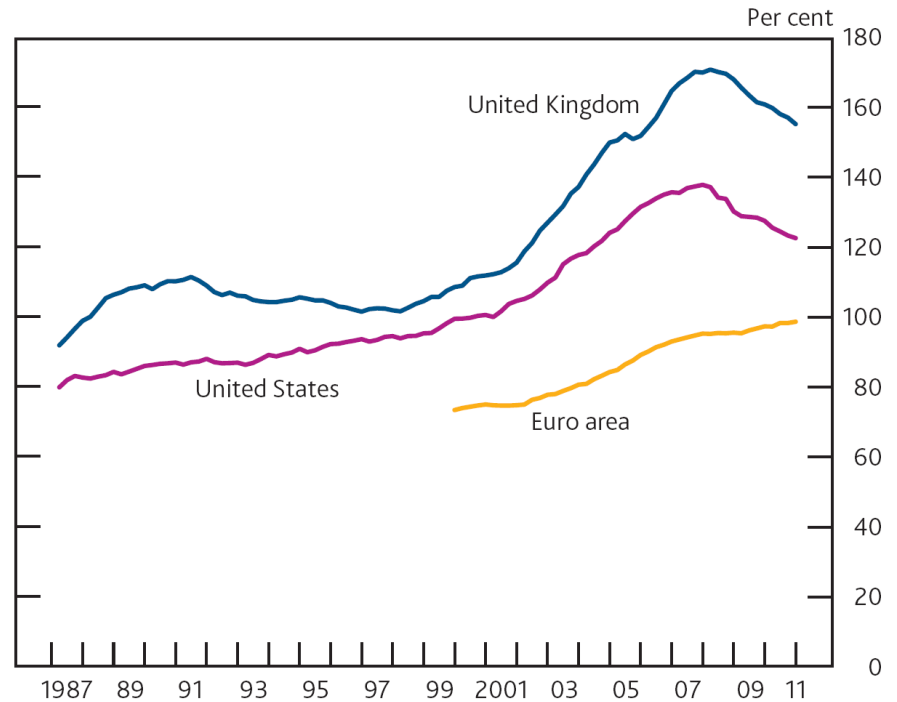
Households' disposable income squeezed; debts still substantial

Growth in nominal labour income weak relative to prices, support from benefits dissipates



- (a) General government benefits minus employees' National Insurance contributions.
- (b) Wages and salaries plus mixed income.
- (c) Household taxes include income tax and Council Tax.
- (d) Calculated as a residual.
- (e) Nominal post-tax labour income divided by the consumer expenditure deflator (including non-profit institutions serving households).

Chart 2.18 Household debt relative to income(a)



Sources: ECB, Thomson Reuters Datastream and Bank calculations.

- (a) Households' gross debt as a percentage of a four-quarter moving sum of their disposable income.

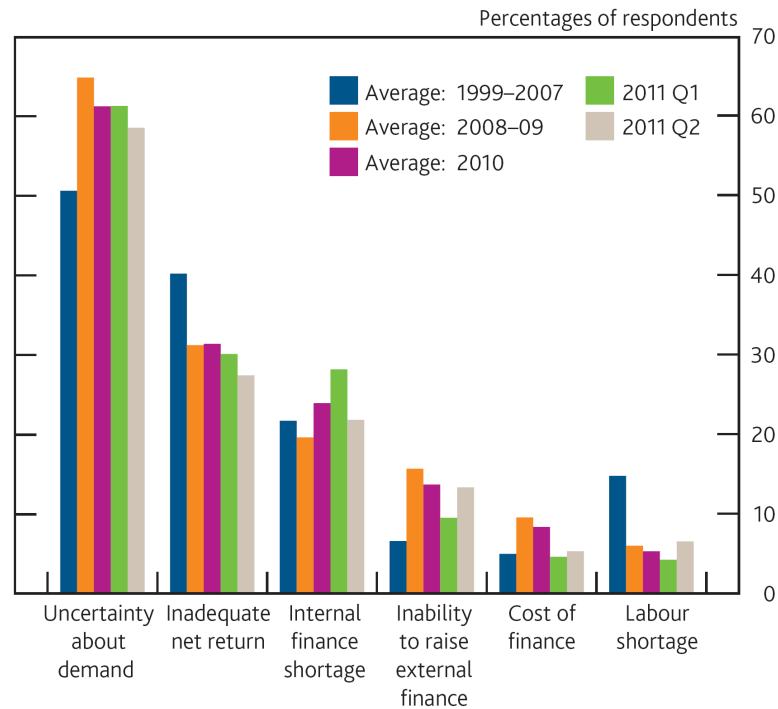
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Business Investment

Uncertainty key; credit conditions still an issue for SMEs

Investment by company size

Chart 2.6 Factors likely to hold back investment^(a)



Sources: CBI, CBI/PwC and ONS.

(a) Manufacturing, financial services, consumer/business services weighted by shares in real business investment. Companies are asked for their twelve-month forecast of factors likely to limit capital expenditure authorisations. Financial services companies are not asked to distinguish between a shortage of internal finance and the availability of external finance, so their single response is used for both questions.



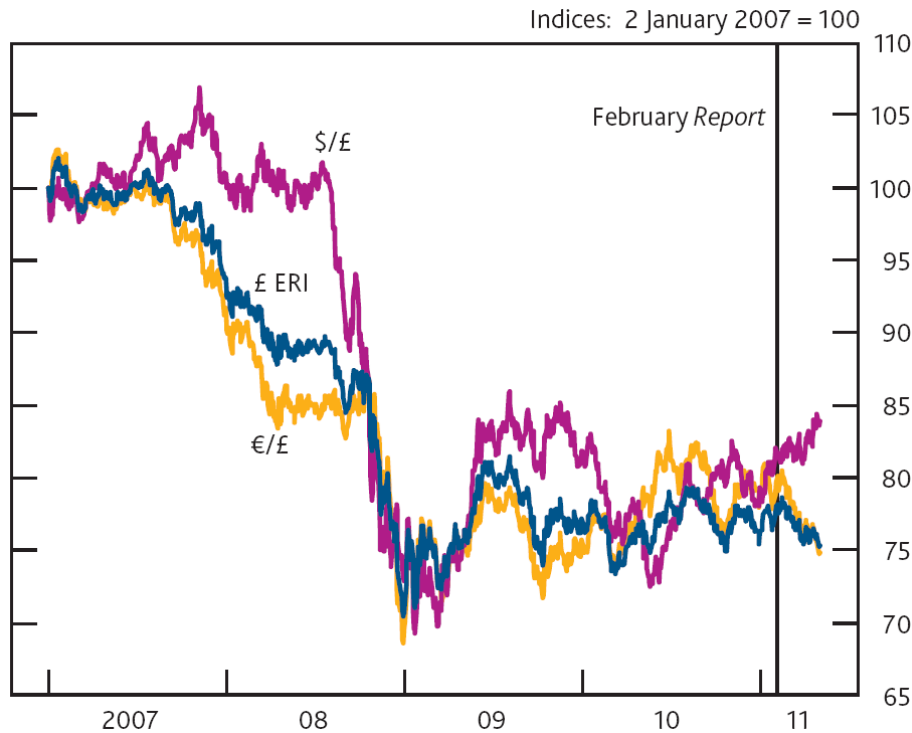
Many small and medium-sized firms remained frustrated with their current banking relationships, and some were planning under the assumption that they would not make use of bank finance in the medium term

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Net trade

The currency is cheap BUT expenditure switching sluggish and UK holds comparative

Trade weighted and key bilaterals



UK exports as a share of total imports by USA, JAP, CAN, GER, FRA, ITA



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The future

UK flirts with recession, Europe threatens worse.....

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Europe

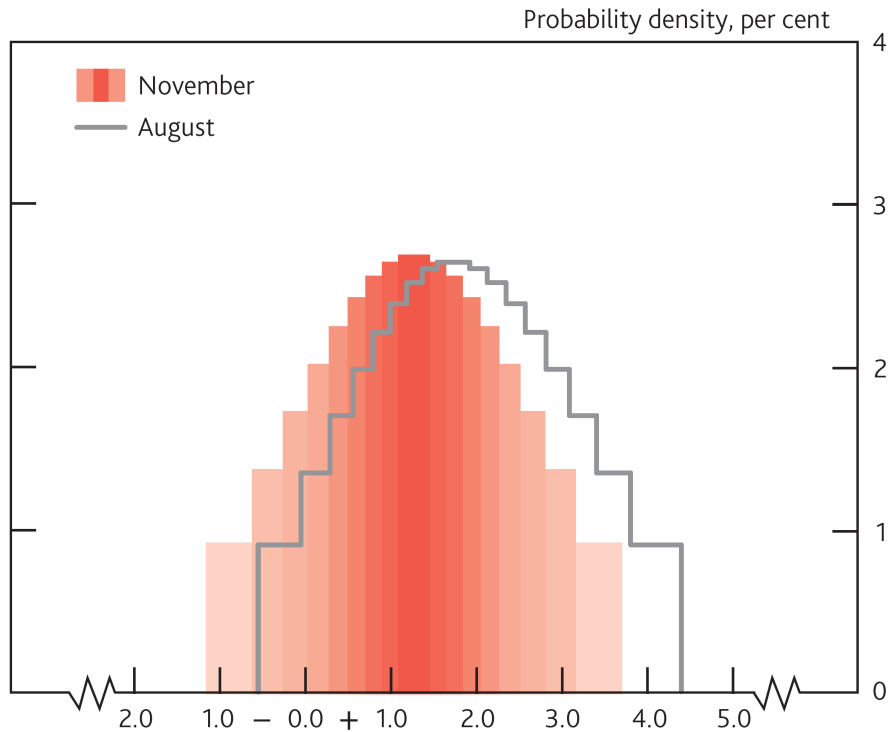
- **Recession looks inevitable in Europe – the question is simply whether we get full blown financial crisis**
- *Solution (i) – Monetary solution : ECB as permanent lender of last resort*
- *Solution (ii) – Fiscal solution : Strong shoulder the burden of the weak in return for..*
- *Solution (iii) – Write-down solution : Restructure the debt (and exit....)*
- Solutions (i) and (ii) are unpopular and require the rule book to be re-written, while Solution (iii) could be economically devastating
- **We are massively exposed to Europe**
 - (i) Direct trade channels – Europe is our number one trading partner
 - (ii) Financial markets contagion – primarily via banks, and asset prices
 - (iii) Fear / confidence
- **Worst case scenario very bad for us too.....**

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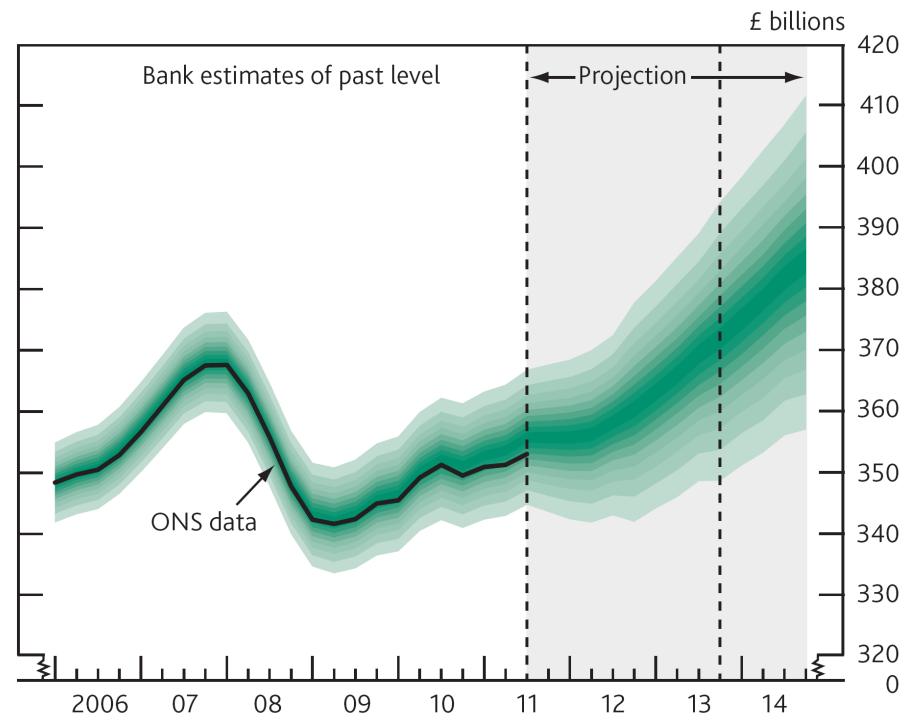
The future for the UK

Inflation will fall, and there is a risk of a big undershoot
but GDP will take until 2013/14 before we get back to where we started

My best guess is this is still too optimistic



Distribution of outcomes for inflation in medium term (2013 Q4)



Distribution of outcomes for output

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QE works

- **QE is more like conventional monetary policy than it is made out to be**

Conventional policy influences market yields via control over overnight rates and expectations of future overnight. QE hits market yields directly

- **Consensus that QE moves asset prices; debate around real economy**

This is the **wrong way round**. If you are convinced that QE moves bond yields then all the other channels of monetary policy should kick in ...higher asset prices (wealth and funding effects); lower exchange rate; lower real interest rates; confidence channels

- **The fact that the economy is not back on its feet does not prove QE doesn't work**

It tells you that the BoE didn't buy enough bonds (with 20:20 hindsight)

- **... the fact that retail lending rates didn't fall 1:1 with Bank Rate tells you nothing**

Spreads were bound to expand – in the absence of QE (lower yields) rates would have been even higher

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QE works.... and we are going to get more of it

- MPC announced a second round of asset purchases in October

... takes stock from 200 to 275 bn.

- Signalled a more aggressive MPC looking to get ahead of the curve

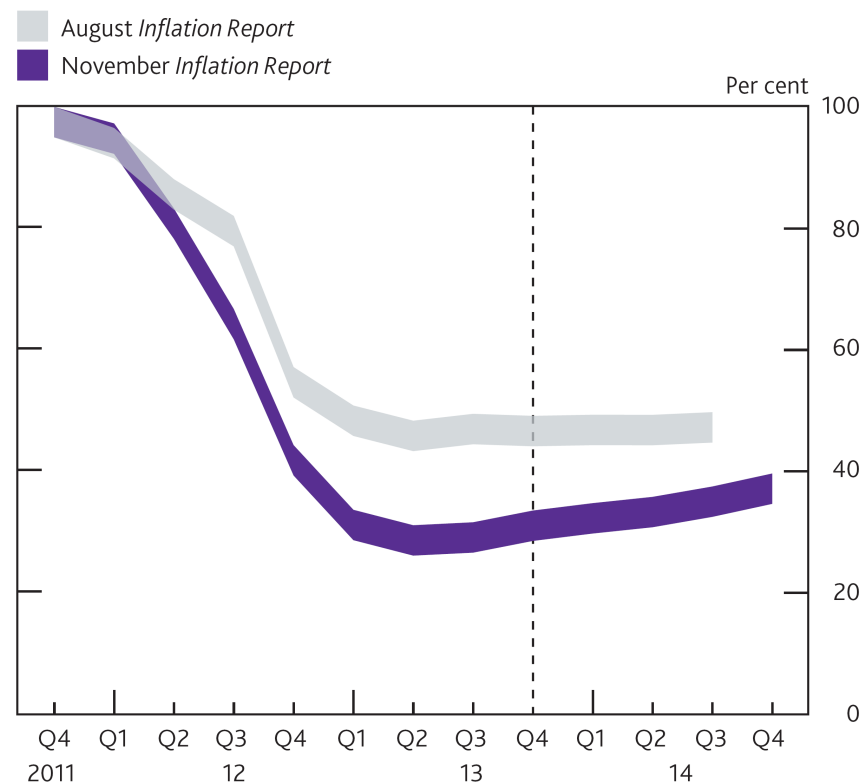
... more than market expected and a little earlier; unanimous decision

- We thought that they would have to do more

.... we had pencilled in 50 bn more in FEB

- Latest IR signals we may get more sooner

... with extra 75 bn inflation still too weak



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Threats to AAA UK

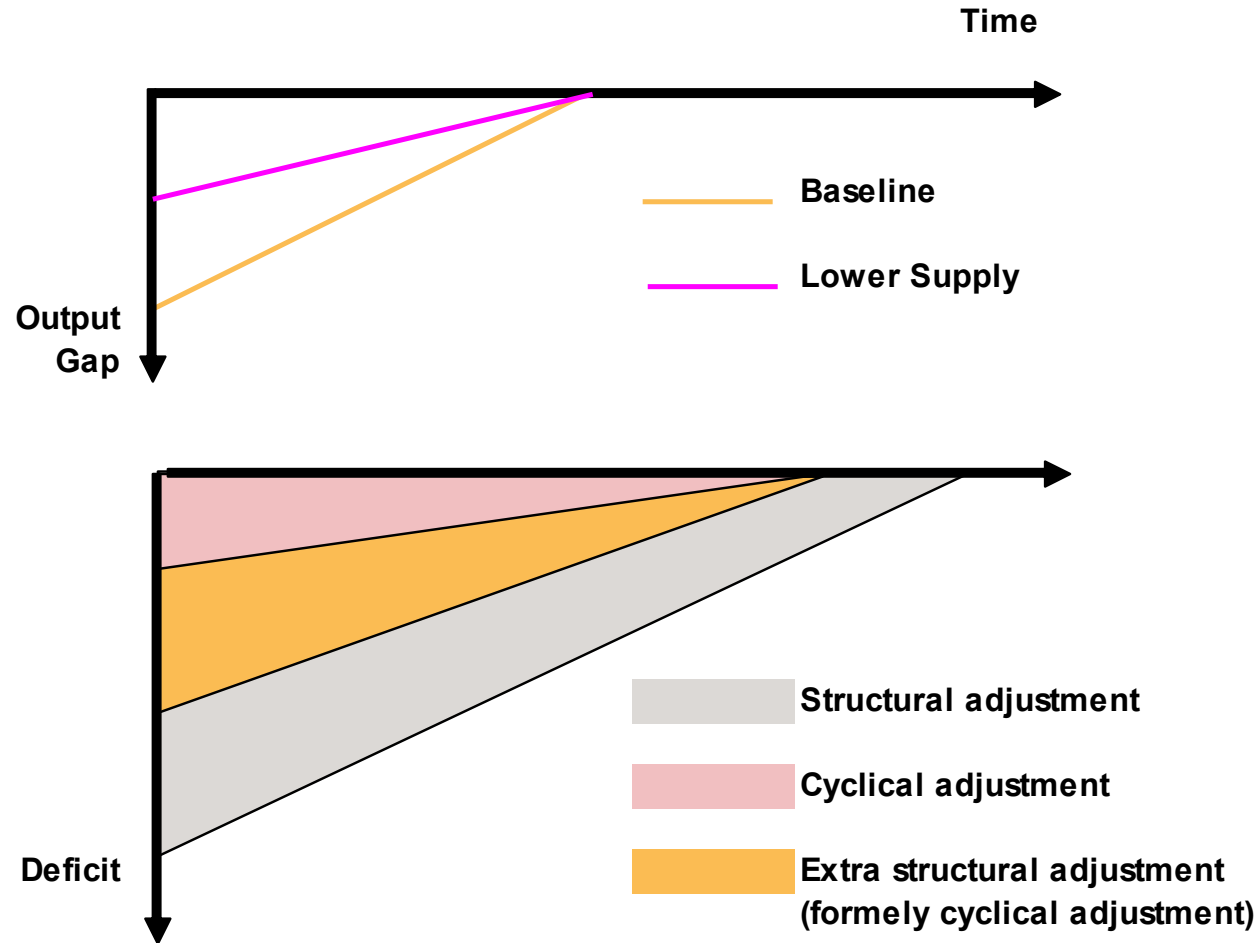
- We cannot take our safe haven status for granted
- Countries don't want to be downgraded – we will do something about it if we can
- **A credible downgrade scenario therefore requires circumstances in which authorities are unwilling or unable to take corrective action**
- We can ride out a demand-driven modest recession – monetary policy should be able to respond, and no need for Plan B
- One obvious risk to AAA – catastrophe on the Continent, driving us into a depression with massive and sustained damage to the public finances, which overwhelm policy response
- Hidden risk to AAA – the crisis has done more damage to the UK supply side so (i) less deflationary pressure than MPC thinks (ii) underlying public finances less sound than Chancellor thinks

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The implications of a reassessment of the supply side

Chancellor would need to announce additional consolidation measures

If authorities revise down their estimate of the 'output gap' – how much GDP will recover without stoking inflation



Implies less of the deficit can be written off as cyclical, and therefore more austerity is required to balance the books

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