Economic Watch
United Kingdom

Madrid, January 24, 2014
Economic Analysis

Europe
Miguel Jiménez González-Anleo
Chief Economist
mjimenezg@bbva.com

Agustín García Serrador
Senior Economist
agustin.garcia@bbva.com

Diego Torres Torres
Economist
diego.torres.torres@bbva.com

Pablo Budde
pablo.budde@bbva.com

Massimo Trento
massimo.trento@bbva.com

UK: The BoE to maintain a dovish stance despite recent strength of data

The 7% unemployment threshold is not a trigger to an early exit

- **A strong economic momentum remained in the last quarter of 2013**
  Recent economic data for 4Q13 suggest that the recovery is ongoing at a solid and steady pace (after 0.8% q/q in 2Q and 3Q13). Confidence data from PMIs for the whole quarter were slightly above the 3Q13 average, despite the moderate deterioration registered in November and December, especially in services. In contrast, , hard data, though positive, point to a more moderate outlook than confidence indicators, suggesting that the recovery remained strong but unlikely to gain traction as domestic demand still continues to face headwinds from low real income growth and credit constraints. Industrial production remained flat in November after the slight pick-up in October, resulting in a more moderate increase in these two months over 3Q13 (0.4%, after 0,6% q/q in that quarter), while the average retail sales in October-November increased by a mild 0,3% q/q over 3Q13 (1,6% q/q), despite the marked rebound registered in November. Finally, exports are likely to fall again in late 2013, but a more moderate pace than in 3Q13, and along with a moderate fall in imports could end up resulting in net exports less negative than in the previous quarter, when they substracted 1.2pp from growth.

- **The unemployment rate is close to the threshold set out in BoE, but the monthly figures provide a less optimistic story**
  The ILO unemployment rate fell more than expected to 7.1% on the three months to November (Consensus: 7.3%), continuing the surprising performance of the labour market in recent months and suggesting that the 7% threshold set out by the BoE's forward guidance could be hit well before than what the BoE had projected (in 3Q15). Nonetheless, looking at monthly figures of the labour force survey (not at the smoothed 3 months average), the unemployment rate increased by 0.3pp to 7.4% in November, pointing to a less optimistic outlook that should be consistent with a more gradual reduction in the unemployment rate in coming months.

- **The MPC made every effort possible to curb the hawkish message of activity data**
  The January minutes of the Monetary Policy Committee (MPC) focused again in stressing that the 7% unemployment threshold is not necessarily a trigger of a monetary policy decision. In fact, the MPC seems to think that the Bank's communication framework is working, highlighting the results from a Reuters' poll that shows an increase in the period lag between expected date of unemployment hitting 7% and the first rate hike.

More interestingly were the MPC comments about the *"disappointing"* and *"surprising apparent lack of a significant cyclical improvement in productivity during the recovery"* stemming from better than expected labour market figures, which suggests that *"shifts in the composition of unemployment* (long-term rate also declined) *had suggested that equilibrium unemployment might be lower than previously thought"*, which shows that the MPC will not necessarily see upward pressures on prices. This was consistent with the weakness of pay growth, with the MPC saying that it signals further evidence of *"the continued existence of slack in the labour market"*.

- **Inflation stood at 2% in December, somewhat lower than BoE's projections**

  Inflation slowed significantly over 4Q13, especially in October (2.2% y/y after 2.7% y/y in September), to stand at 2% y/y in December, after hovering around 2.7% y/y in previous quarters. Underlying this significant moderation in inflation was mainly the lower growth in service prices throughout the year (explaining -0.6pp of disinflation) but also the decline in energy inflation by the end of the year (accounting for -0.2pp). This moderation in inflation was somewhat larger than anticipated, while the strength of sterling, combined with lower commodity prices as well as the lack of wage inflation, suggests that inflation should remain hovering slightly below the BoE's target (1,9% y/y) during 2014

- **We see rates at 0.50% throughout 2014, though possibly hiking earlier than in 3Q15 as assumed in our projections**

  Several reasons push us to be cautious and not thinking that the fist hike will be too soon. First, although the January BoE's minutes highlighted that economic momentum could be stronger than Bank's projections for late 2013 and early this year (about 1% q/q GDP growth), we see the pace of the recovery, although robust, losing some steam in coming quarters as the support of public spending should be unwound and the restocking already seen process might be temporary. Indeed, the GDP level in 3Q13 remained still about 2% below the output level before the crisis (1Q08).

  Second, monthly data from labour force survey point to a sluggish reduction of the unemployment rate in coming months. In addition, the MPC could end up lowering the unemployment threshold set out in its forward guidance framework to delay a possible rate hike this year if it indeed thinks that the NAIRU is lower than previously anticipated. The advantage of lowering the threshold should be a more efficient implementation in the BoE' forward guidance; however, it would also introduce confusion on the whole concept of forward guidance. Overall, we see unlikely an imminent reduction in the threshold, unless markets priced in an early rate hike in coming months.

  Third, the inflation forecast is likely to be revised down in the next Inflation Report to remain slightly below the BoE's target in 2014. This, along with the lack of price pressures could support a more accommodative monetary policy, even more so with the context of ongoing fiscal consolidation.

  Finally, it is likely that before starting the tightening cycle on Bank Rate, the BoE starts to withdraw the asset purchase programme.

  Still, factoring in the most recent data, we now see a clear bias that the tightening cycle will start earlier than in 3Q15, as we have incorporated in our projections.

United Kingdom

Economic activity: solid GDP growth remains, reducing the unemployment rate faster than expected

GDP growth is likely to have remained strong and steady by end-2013, though domestic demand could face headwinds in coming quarters. Despite the faster fall in the unemployment rate on the three months to November, non-smoothed figures suggest a more sluggish improvement in coming months.

Chart 1
GDP (% q/q) and contribution by components (pp)

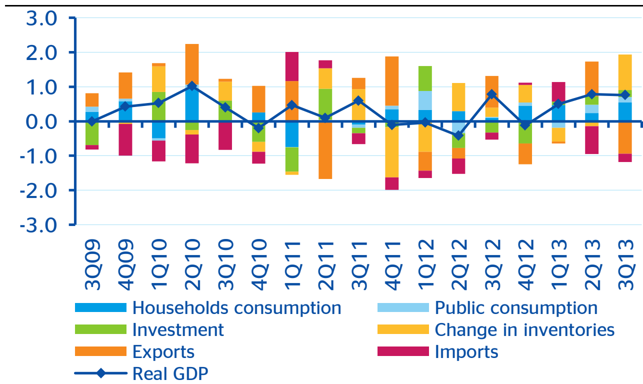


Chart 2
PMI confidence by sectors

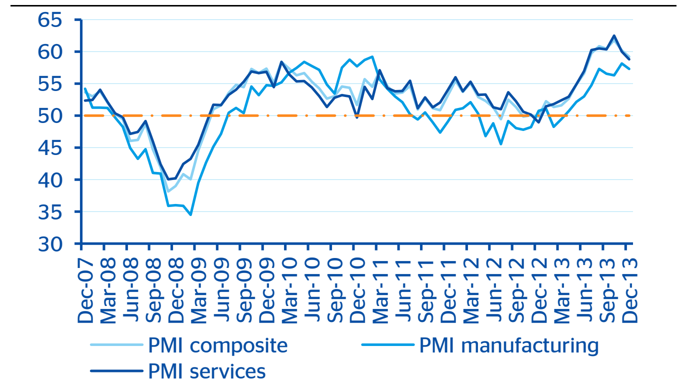


Chart 3
Industrial production and retail sales (% 3mma)

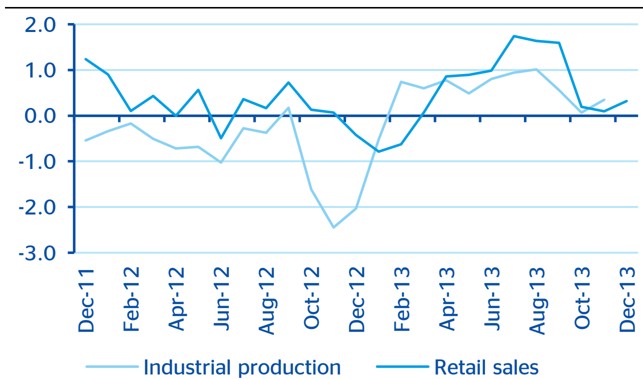
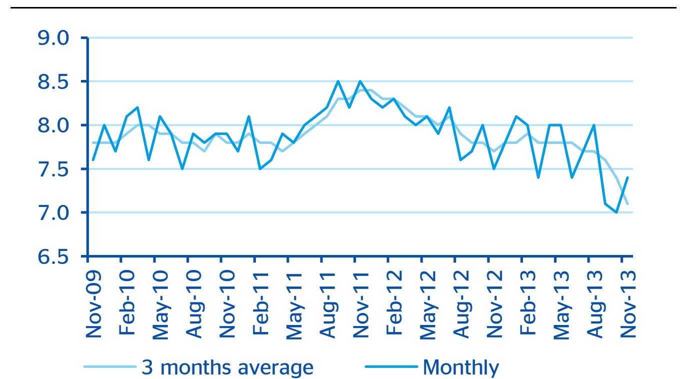


Chart 4
Unemployment rate (%, ILO)



Inflation: Price pressures remain contained

Significant reduction in inflation in 4Q13, to stay at 2% in December, thanks to services, while the strength of sterling and lower commodities prices also pulled inflation down.

Chart 5
Inflation rate, headline and core (% y/y)

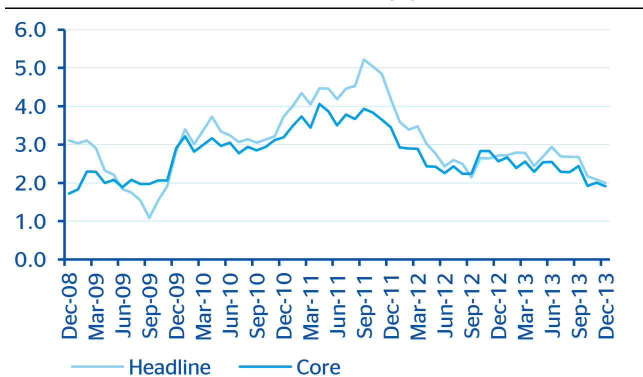
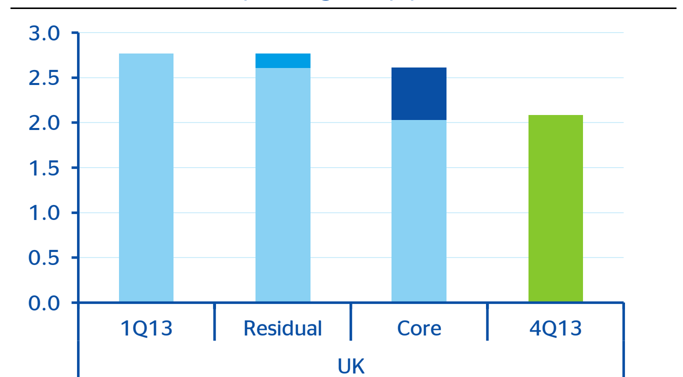


Chart 6
CPI inflation. Quarterly average (% y/y)



* Source: ONS, Markit and BBVA Research

DISCLAIMER

This document has been prepared by BBVA Research Department, it is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

In regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions in the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

The content of this document is protected by intellectual property laws. It is forbidden its reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process, except in cases where it is legally permitted or expressly authorized by BBVA.