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Economic Watch
UK

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Economic Analysis

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The Bank of England adapts its forward guidance

Excess capacity limits inflationary pressures

- **Solid 4Q13 growth continued, sustained by domestic demand**

  Preliminary estimates from national accounts showed that GDP grew by 0.7% QoQ in 4Q13 (similar to the 0.8% QoQ from the two previous quarters), bringing the annual average growth in 2013 to 1.9%. Although growth in the fourth quarter has not yet been broken down by demand components, the most recent figures (improvement in confidence and in the jobs market, increased retail sales and sustained growth in industrial production) are in line with our estimates that suggest that (stronger than expected) growth continued to be underpinned by domestic demand (2pp in 2013), with private consumption and investment growing at relatively stable rates at the end of the year. The burden of net exports has slowed (-0.1pp in 2013) as a result of weaker import growth, while exports continued to reflect the negative impact of the stronger pound (over 6% since 2Q13) which cancelled out the benefits of improved global demand, and particularly recovery in the eurozone (45% of total exports). Even so, GDP is still slightly more than 2% below its levels before the crisis.

- **The unemployment rate remained at slightly over 7% in December, but it will probably drop to this threshold in 2Q14**

  The unemployment rate as defined by the ILO crept back up 0.1pp to 7.2% in the three months to December (consensus: 7.1%), after the speedy reduction since the middle of 2013 (over 0.5pp from 7.8%) and in line with our expectations in our previous report as to a more gradual reduction in the next few months. Growth in employment was robust for the second consecutive quarter (0.6% QoQ in 4Q13), thus indicating a meagre degree of progress in productivity (around 0.1% QoQ), although wage rises were limited (around 0.3% QoQ) and continue to be reflected in a controlled increase in labour costs. In general, these figures back up the BoE's vision, laid out in its Inflation Report and in its minutes for February, about the high degree of excess capacity that still exists in the jobs market and the absence of inflationary pressures on the cost side.

- **Inflation slowed to 1.9% YoY in January, giving more room to maintain an accommodative monetary policy**

  After four years above target, inflation slowed again in January, by 0.1pp to 1.9% YoY, somewhat more than expected (2%) and with all the components showing signs of slowdown. The strength of sterling, together with the lower price of raw materials as well as the lack of wage inflation, suggest that inflation will continue to fluctuate slightly under the BoE's target (1.9% YoY) within our forecast horizon.

- ## Solid growth in our forecast horizon, which will continue to be backed by domestic demand and, particularly, in an uptick in investment

Stronger growth than expected at the end of 2013, together with improvement in domestic factors (more employment, less inflation, major improvement in confidence and easier financing conditions, and with no significant changes in economic policy measures) have all led us to revise upwards our GDP growth forecast for 2014 by 0.3pp to 2.6%. For 2015, we expect growth to slacken off slightly to 2.4%. These forecasts, although more moderate than those announced by the BoE in its February Inflation Report (3.4% for 2014 and 2.7% for 2015), anticipate robust quarterly growth (around 0.6% QoQ on average in the forecast horizon), slightly above our potential growth estimation.

The upswing in investment will be the main driver of the economy (6.7% in 2014 and 5.8% in 2015) for dealing both with the acceleration in domestic expenditure and with increased foreign demand. What is more, these improved expectations will be strengthened by the expectations of low interest rates in the forecast horizon and by extension of the Funding for Lending Scheme to help companies get credit, which ought to make it easier to act on investment decisions. On the other hand, job-creation, together with wage increases and the slowdown in the inflation rate will all go towards increasing households' disposable income, while the reduction in the precautionary savings rate may continue in the future. All this will be reflected in an increase in private consumption of somewhat more than 2% in 2014 and 2015. As regards public consumption, the significant slowdown (0.4% from 1.6%) will continue this year and next as part of the current budget adjustments.

Finally net exports will continue to make positive contributions to GDP growth (0.3pp in 2014 and 0,2pp in 2015), but to a moderate degree, since the increase in exports (limited by the strength of sterling and a greater increase in domestic prices compared to the eurozone) will not be much more than the rise in purchases abroad to satisfy domestic demand.

- ## Better economic performance leads the BoE to increase the transparency of its reaction function

Although the same forward guidance strategy that was announced last August is still in place (keeping the interest rate at 0.50% and asset purchase stock at GBP375bn in February), both more robust economic growth and, above all, a better performance of the jobs market than the BoE had anticipated then, has led it to outline how it will adapt this strategy once the threshold of a 7% unemployment rate is reached, which will probably happen during 2Q14.

The BoE pointed out the uncertainty associated with measuring and evaluating the excess capacity existing in the economy, particularly after the "disappointing" productivity figures in the last few months. The committee continues to estimate this excess capacity as high (1%-1.5% of GDP), especially in the jobs market (equilibrium unemployment rate of 6%-6.5%) and wants to maintain a monetary policy focused on closing the output gap in the next two to three years, particularly in view of the fact that inflationary pressures are very limited (both on the cost side and on the imported prices side) with inflation outlook slightly under its target throughout the forecast horizon.

As a result, the interest-rate decision will be influenced by how the economy is doing, such that the BoE will closely track a wider set of 18 indexes that include, as well as unemployment, labour market participation, hours worked, part-time employees who could not find full-time work, capacity utilisation, productivity and wage surveys, making its reaction function more explicit. As such, the second phase of forward guidance is rather a return to the normal strategy before the crisis, with the interest rate responding to how the output gap moved and to deviations from target inflation.

The BoE continues to estimate that productivity will increase over the next few quarters, thanks to a better allocation both of capital and of employment in more productive activities. This change will be an important factor in monetary policy, since the more productivity increases, the more room for non-inflationary growth and therefore the slower the normalisation cycle. However, the BoE also highlights that slower productivity gains would have a limited impact on inflation given that labour costs are being contained and as such, in any event, the BoE stresses that this normalisation process will be very slow and gradual in order to guarantee sustained, robust growth (in investment, above all). Finally, the bank also announced that the asset purchase stock will be maintained (as will reinvestment of maturities) at least until the first rise in interest rates.

- **We forecast interest rates at 0.50% throughout 2014, with the first rise in 2Q15**

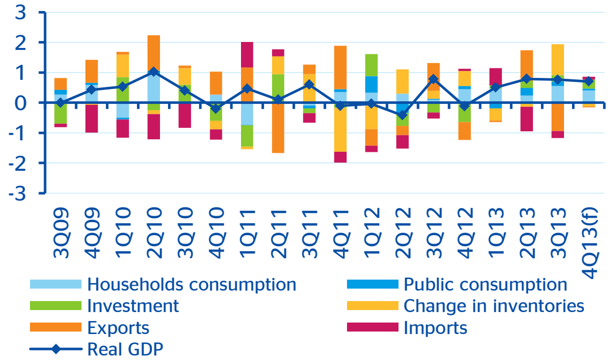
In line with better economic performance over the last three years, we have brought forward by a quarter to 2Q15 our forecast for the beginning of benchmark interest rate hikes vs. our scenario three months ago. Everything indicates that at present, the central bank is expecting the exit strategy to be very slow.

United Kingdom

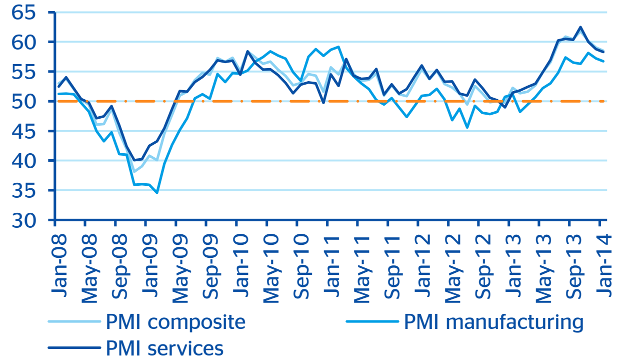
Economic activity: solid growth of GDP and job creation continues, but the reduction in the unemployment rate may slow

GDP growth stood strong and stable at the end of 2013, although internal demand could come into difficulties in the next few quarters. Indexes available for 1Q14 are very limited, but point to a certain moderation in growth.

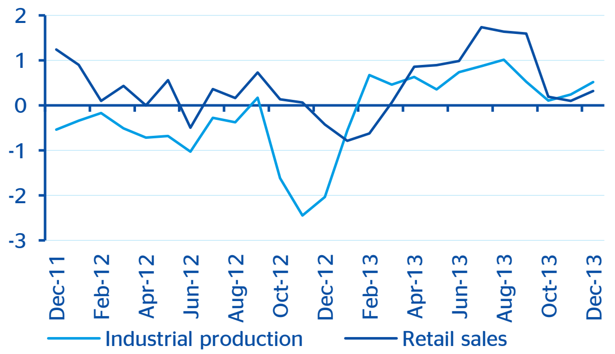
GDP (% QoQ) & contribution by components (pp)



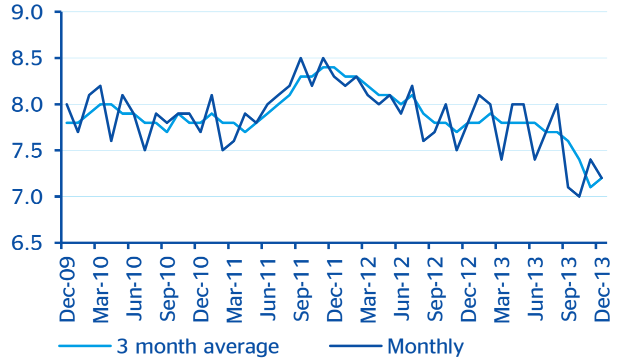
PMI confidence by sectors



Industrial production & retail sales (quarterly mobile average %)



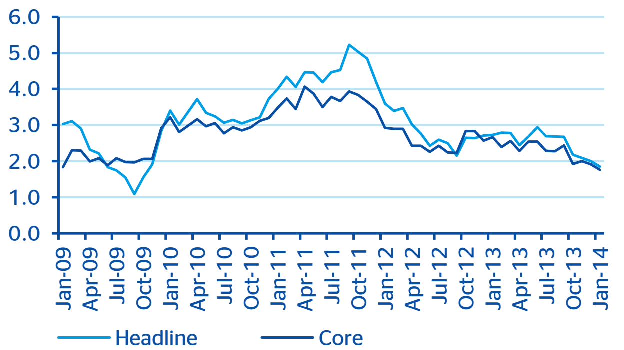
Unemployment rate (%, ILO)



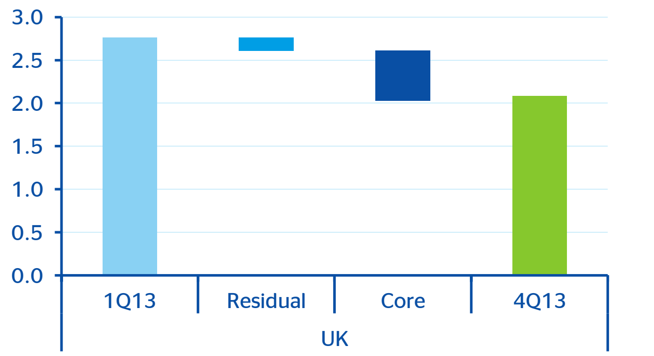
Inflation: pressure on prices continues to be contained

Inflation again slowed in January to come in at 1.9% YoY. The strength of sterling, together with lower prices of raw materials, as well as the lack of wage inflation suggests that inflation will continue fluctuating slightly below the BoE's target in the forecast horizon.

Inflation rate, headline & core (%, YoY)



Consumer Price inflation. Quarterly average (% YoY)



* Source: ONS, Markit & BBVA Research

Table 1

United Kingdom: GDP and inflation growth forecasts

Rate YoY	2008	2009	2010	2011	2012	2013	2014	2015
Private consumption	-1,0	-3,6	1,0	-0,4	1,5	2,3	2,2	2,1
Public consumption	2,2	0,6	0,5	0,0	1,6	0,4	0,5	-0,2
Gross Fixed Capital Formation	-6,9	-16,7	2,8	-2,4	0,7	-2,0	6,7	5,8
Inventories (*)	-0,2	-1,5	1,2	0,4	-0,5	0,7	0,0	0,0
Domestic Demand (*)	**-1,6**	**-6,1**	**2,1**	**-0,1**	**0,9**	**2,0**	**2,4**	**2,2**
Exports	1,1	-8,7	6,7	4,5	1,1	0,5	2,7	4,2
Imports	-1,7	-10,7	7,9	0,3	3,1	0,9	1,8	3,4
Net exports (*)	**0,9**	**0,9**	**-0,5**	**1,2**	**-0,7**	**-0,1**	**0,3**	**0,2**
GDP	**-0,8**	**-5,2**	**1,7**	**1,1**	**0,3**	**1,9**	**2,6**	**2,4**
Inflation	**3,6**	**2,2**	**3,3**	**4,5**	**2,8**	**2,6**	**1,9**	**2,0**

(*) Contributions to growth
Source: BBVA Research