Economic Watch

United Kingdom

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Economic Analysis

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Despite solid growth, spare capacity and the strength of sterling are holding down inflation

Dovish speech presenting the Inflation Report to rein in expectations of interest rate rises this year

- **Growth remains solid and stable in 1Q14, sustained by the strength of domestic private spending …**

  Preliminary GDP data for 1Q14 estimate growth of 0.8% QoQ (similar to that recorded over the last year), with the services sector the main source of growth (up 0.7pp to 0.9% QoQ) and, to a lesser degree, the industrial sector (0.1pp with growth of 0.7% QoQ), and no contributions from either construction or agriculture.

  Although the data breakdown of GDP on the demand side has not yet been released, the above figures, when analysed together with the data available, point to domestic demand being mainly responsible for this robust growth (Figures 5 and 6), in both private consumption (retail sales jumped 1% QoQ) and investment. This is in line with the uptick in intermediate goods production (2.4% QoQ), of capital (1.5% QoQ) and durable consumer goods (3.3% QoQ). Nevertheless, doubts have returned as to the rebalancing of growth, since the major contribution made by the foreign sector in the final quarter of last year (1pp) is likely to have evaporated again at the beginning of this (exports contracted 2.3% QoQ to March), (Figures 6 and 7). Although information for 2Q14 is very scarce, it suggests that GDP might grow at around these rates in the next few quarters (Figures 1 to 4).

- **… and the rapid fall in the unemployment rate, which has surprised with significant employment creation, but without creating inflationary tensions**

  The positive momentum that the economy is experiencing was also visible in the labour market, with employment increasing at rates slightly below GDP (0.7% QoQ on average in the last three quarters), but at a higher rate than the growth in the active population (around 0.4%), which has impacted on a rapid decrease in the unemployment rate (around 1pp in the last year, down to 6.8%), (Figure 9).

  However, the employment created over the last year (2.3% since March 2013) came mainly from the increase in the numbers of self-employed (9%) and, to a lesser degree, in employees. This supports the Bank of England's (BoE) interpretation of slack in the labour market, since many of the self-employed may be underemployed. Independently of the differing opinions within the bank on this point, the robust increase in employment was in contrast to the lower rise in productivity (around 0.2% QoQ or 0.8% YoY over the past year). Even so, wage rises (only just above 1%) were very moderate, also supporting the central bank's interpretation.

Looking forward, unemployment is likely to carry on falling, although more slowly, in line with the Inflation Report's forecasts, dropping to 6.3% and 6% respectively by the end of 2014 and 2015. Nevertheless, the report expects a continued spike in productivity, allowing nominal wages to rise without causing inflationary tensions over the horizon forecast.

- **Slight revision to the upside in our growth forecasts for 2014-15, which will continue to be underpinned by domestic demand, particularly investment**

Somewhat higher growth than forecast at the start of the year, plus the improvement in domestic factors (more employment, less inflation, a notable boost in confidence and improvement in borrowing conditions, all with the commitment of an economic policy which will remain accommodative) have led us to revise slightly to the upside our GDP growth forecast for 2014, by 0.2pp to 2.8%. For 2015, we continue to expect slight moderation in growth, down to 2.4%. These forecasts, although more moderate than those presented by the BoE in its May Inflation Report (3.4% in 2014 and 2.9% in 2015), foresee robust quarterly growth (around 0.6% QoQ on average over the forecast horizon), somewhat higher than our estimate of growth potential.

The upturn in investment will be the economy's main driver (and our principal revision to the upside after the surprise in 4Q13, to 8.5% in 2014 and 6.5% in 2015), but also the increase in external demand (although doubts persist as to the strength of sterling and the timid recovery of the eurozone). What is more, the above factors will be reinforced by expectations of low interest rates within the forecast horizon and by the extension of the Funding for Lending Scheme to encourage lending to companies, which would encourage investment decisions to be taken, especially when companies' used capacity is at its historical average. On the other hand, job creation, together with wage increases and the moderation in the inflation rate, will impact on an increase in disposable household income, while the reduction in the precautionary savings rate might continue in the future. All this will be reflected in an increase in private consumption of slightly over 2% in 2014 and 2015. The significant moderation in public consumption already seen in 2013 (down to 0.7% from 1.6%) will continue this year and next to comply with the fiscal consolidation process which is underway, although the government maintains its commitment to implement a neutral budget in 2014.

Finally, net exports will again contribute positively to GDP growth (0.2pp in 2014 and 0.1pp in 2015), but less so, since the increase in exports (constrained by the strength of sterling and a higher rise in domestic prices than in the eurozone) will only be slightly higher than purchases from abroad to satisfy domestic demand.

- **Inflation will continue to fluctuate slightly below the BoE's target in the horizon forecast, giving more scope for maintaining an accommodative monetary policy**

Slackening inflation since the middle of last year contributed in 1Q14 to marking an annual rate of 1.6% in March, due fundamentally to the change in prices of energy products and food, while core inflation remained fairly stable at 1.8% YoY. The strength of sterling, in conjunction with the lower price of raw materials, as well as the lack of inflation in wages, suggest that inflation will continue to fluctuate slightly below the BoE's target (1.9%) within the forecast horizon.

- **We still expect the interest rate to stay at 0.50% in 2014, with the first rise in 2Q15**

  At its May meeting, the BoE left its monetary policy unchanged, once the second phase of forward guidance is already underway, and depending on the progress of the economy as a whole. Perhaps because of the latter and the possible market reaction, Governor Mark Carney sent a reassuring message during his presentation of May's Inflation Report, particularly in view of the fact that his updated scenario is virtually unchanged. He was clearly seeking to dispel the uncertainty over a possible imminent interest rate hike (and trying to make the bank's response role more explicit), emphasising once again that in any event the process of normalising monetary policy would be very slow, given the excess capacity in the economy (around 1% to 1.5% of GDP).

  In his speech, he pointed out the strength of sterling (particularly because of the appreciation it has been experiencing in the last year, slightly less than 10% according to effective exchange rates), since this might hinder the growth of exports (with a price elasticity of around 0.4%[1]) and the knock-on effect on investment. He had an obvious incentive to clarify the progress of rates that encourage investment and allow sustained growth of domestic demand, as well as the impact on the moderation of inflation via a reduction in import prices. Since the middle of last year, inflation of energy products has slowed down significantly (from rates of around 5% YoY, going into slightly negative figures in March), reducing their contribution to headline inflation by 0.5pp. As regards the future, we forecast further appreciation, although more moderate, over the course of the forecast horizon.

  Finally, Mr. Carney pointed out that the interest rate is not the best instrument for containing house prices, stressing the importance of macro-prudential policies in this area and the role of the Financial Policy Committee, which implies that he might present a measure of this nature in the near future.

Table 1
BBVA Research GDP and inflation forecasts (May 2014)

YoY rate	2008	2009	2010	2011	2012	2013	2014	2015
Private consumption	-1.0	-3.6	1.0	-0.4	1.4	2.2	2.1	2.1
Public consumption	2.2	0.6	0.5	0.0	1.6	0.7	0.9	-0.3
Gross fixed capital formation	-6.9	-16.7	2.8	-2.4	0.8	-0.6	8.5	6.5
Inventories (*)	-0.2	-1.5	1.2	0.4	-0.6	0.0	0.0	0.0
Domestic demand (*)	-1.6	-6.1	2.1	-0.1	0.8	1.5	2.6	2.3
Exports	1.1	-8.7	6.7	4.5	1.7	1.0	3.5	4.0
Imports	-1.7	-10.7	7.9	0.3	3.4	0.5	2.7	3.5
Net exports (*)	0.9	0.9	-0.5	1.2	-0.5	0.2	0.2	0.1
GDP	-0.8	-5.2	1.7	1.1	0.3	1.7	2.8	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

1: Average elasticity (different from empirical analyses) of exports to their prices. For more information, see Bank of England Quarterly Bulletin 4Q11

United Kingdom

National accounts: solid and stable growth in 1Q14

GDP grew 0.8% QoQ in 1Q14, supported by the services sector and, to a lesser degree, industry. The available data point to strong domestic private spending, while support from the foreign sector is waning. For 2Q14, GDP may grow at similar rates.

Figure 1
GDP (%QoQ) and contribution by component (pp)*

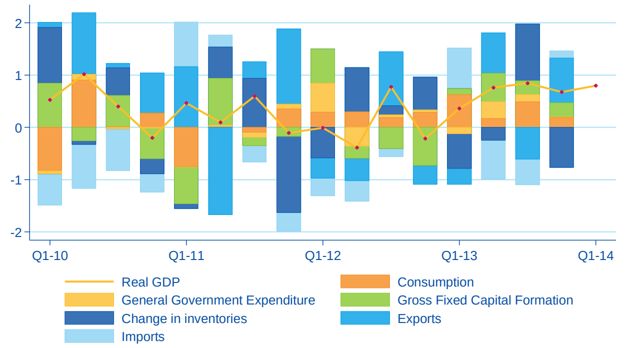
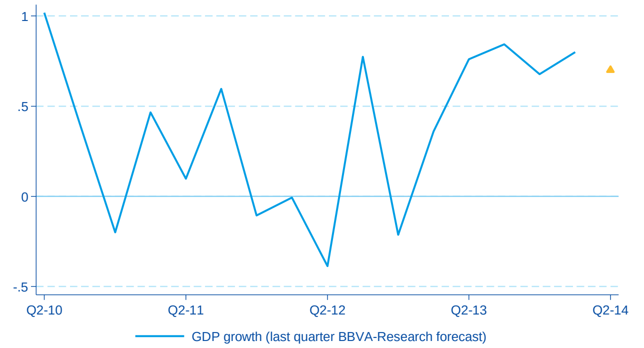


Figure 2
GDP growth (%QoQ) and forecast



Confidence: after the moderation at the beginning of the year, stable at high levels

Confidence stays high (above the historical average), which ought to have a bearing on decision-making by economic agents, particularly in investment, in order to sustain relatively stable growth over the next few quarters.

Figure 3
PMI and GDP growth (%QoQ)*

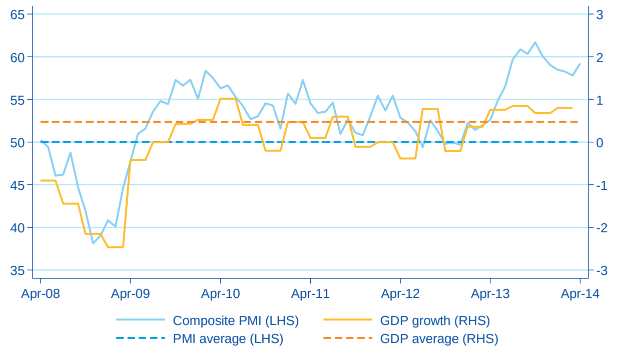
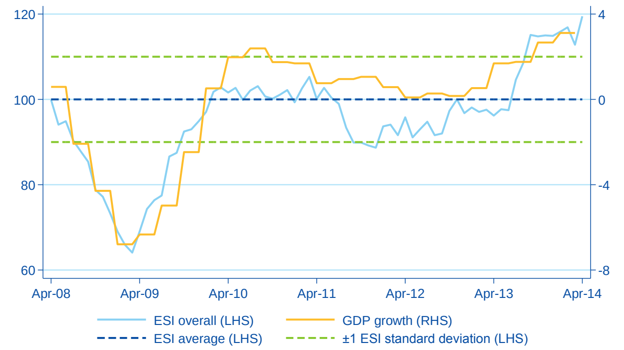


Figure 4
Confidence (ESI) and GDP growth (% YoY) **



Activity: more investment and stable consumption

Industrial production jumped in 1Q14, above all intermediate goods, capital goods and non-durable consumer goods. The improvement in retail sales points to higher private consumption at the beginning of the year.

Figure 5
Industrial prod.(%YoY) and output PMI*

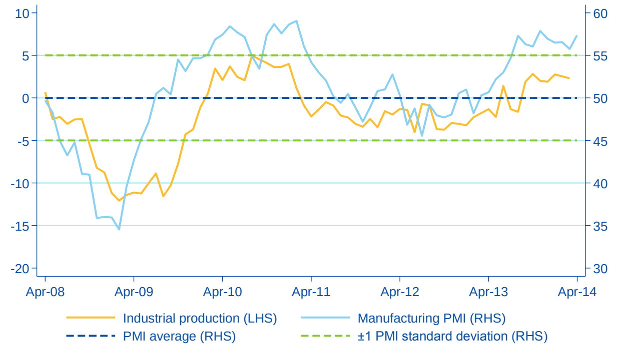
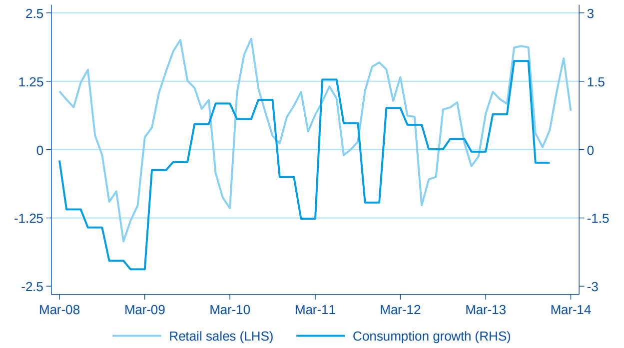


Figure 6
Retail trade (% 3m/3m) and consumption growth (%QoQ)*



*Sources: HAVER y BBVA Research

Foreign sector: doubts continue about the greater role being played by exports

The contribution of net exports may have been lost in the first quarter of 2014 (from 1pp in 4Q13).

Figure 7
Trade balance (% of GDP)*

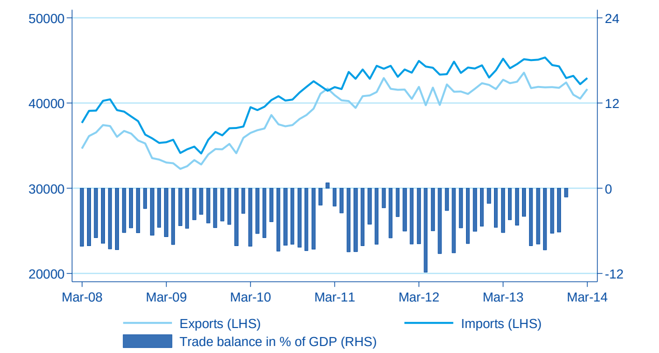
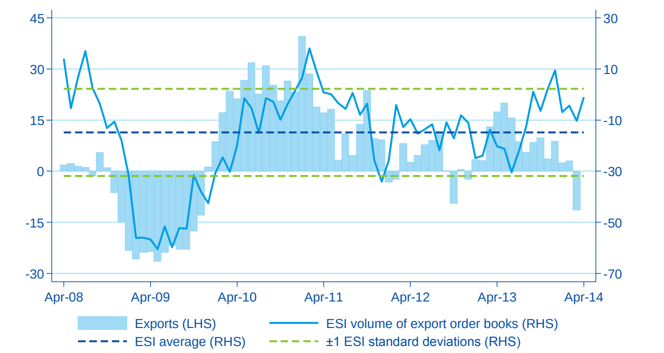


Figure 8
Export growth (%YoY) and volume of export order books*



Labour market: continues to improve, underpinned by strong growth in the number of self-employed

Despite the moderate rise in productivity, wage growth was moderate and labour costs remain contained. No inflationary pressure.

Figure 9
Unemployment rate (%) and employment expectations*

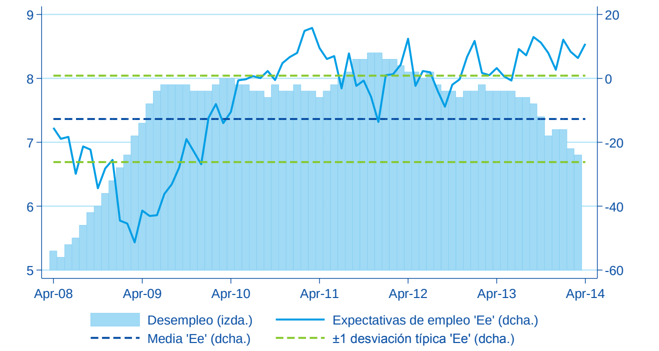
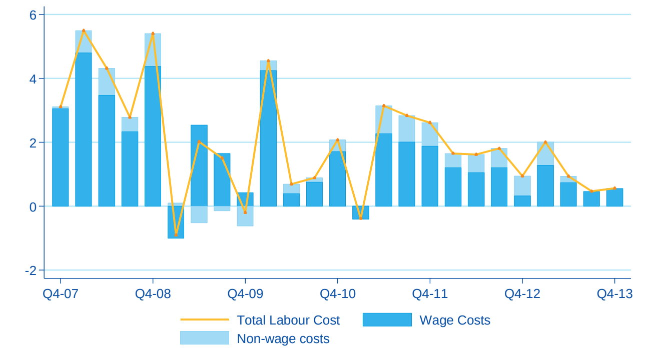


Figure 10
Labour cost in the business sector (%YoY)*



Prices: inflation will continue to fluctuate slightly below 2%

Inflation slowed in 1Q14, affected by price changes in energy products and food. The strength of sterling, lower raw materials prices and the lack of wage inflation suggest that inflation will oscillate slightly below 2% within the forecast horizon.

Figure 11
Inflation rate, headline and core (%YoY)*

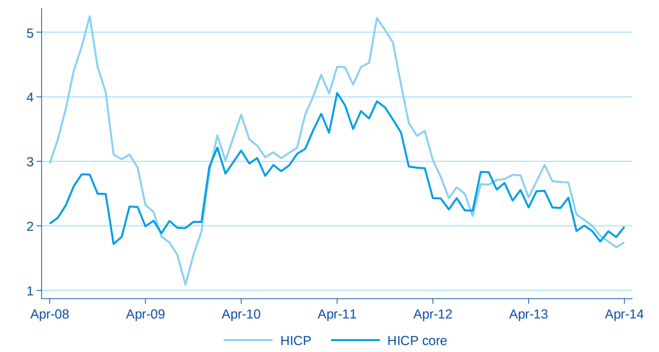
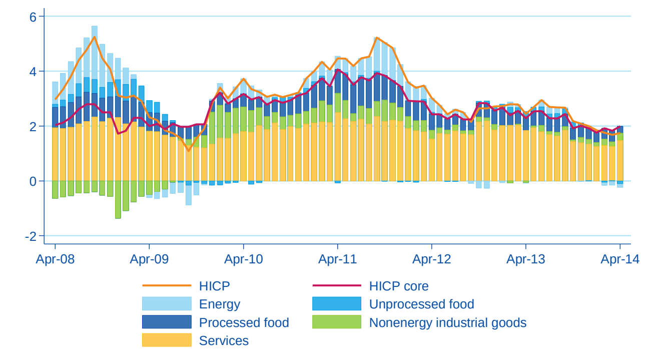


Figure 12
Inflation by components (contribution in %)*



* Sources: HAVER y BBVA Research

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