

ECONOMICS: EUROPEAN PERSPECTIVES—AUGUST 13, 2010

Uncertain Outlook Likely to Keep UK Monetary Policy on Hold

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UK economic growth is back at trend, inflation is above target and monetary conditions are still very loose. But the outlook is clouded by key uncertainties. Hence, while we believe the next move in interest rates is likely to be up, policy is unlikely to move in either direction in the near future.

The Bank of England adopted a guarded approach in its latest Inflation Report. While admitting that economic growth has recently been stronger than expected, it reduced its expectations for coming quarters to take account of additional budget cuts, tighter credit conditions and the softer tone of (some) recent survey data. However, the Bank played down the significance of these changes by suggesting that downside risks to growth have started to diminish.

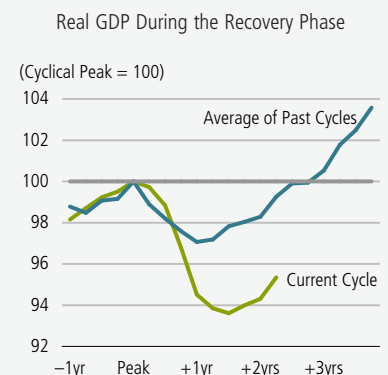
The message on inflation was also carefully balanced. While the Bank believes that temporary factors, such as next January's value-added tax (VAT) hike, will keep inflation above target next year, it expects spare capacity to bring inflation below target in 2012. Nonetheless, it believes that the risks to this forecast are on the upside, largely because persistently high inflation could eventually feed through to an increase in inflation expectations.

It is hard to disagree too much with the Bank's assessment of the growth outlook.

Although the economy expanded by an impressive 1.1% in the second quarter, this should be seen in the context of a weak first quarter—average growth in the first half of the year was 0.7%, close to the historical trend—and the scale of the preceding downturn. Output has risen by a cumulative 1.8% in the last three quarters but is still 4.7% below the peak of the last cycle (**Display 1**).

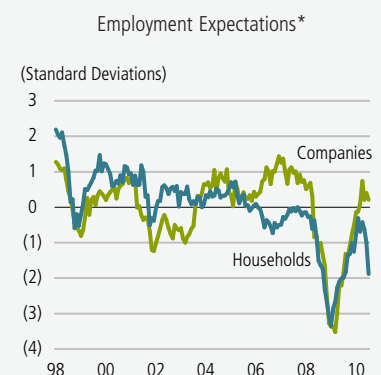
At the Inflation Report press conference, the Bank attached some weight to the weakness of recent survey data. In our view, this should not be exaggerated. For example, the composite purchasing managers' index (PMI) for manufacturing and services fell from 58.8 in February to 54.2 in July, but is still close to its long-run average. Likewise, the Confederation of British Industry's latest quarterly survey showed business sentiment falling from +24 in April to +10 in July. Although this is a big decline, the April reading was the highest since 1994 and the July reading is well above the long-run average for this series.

Display 1
Level of Output Still Depressed



Source: Haver Analytics and AllianceBernstein

Display 2
Divergent Labor-Market Views



*Employment component of the composite PMI versus household unemployment expectations (inverted)
Source: Haver Analytics, Markit and AllianceBernstein

In our view, the only really weak indicator has been consumer confidence. This fell from a high of -2 in February to -17 in July, well below its long-run average. The drop is probably linked to adverse coverage of future government spending cuts. Indeed, the deterioration in sentiment has been driven almost entirely by fears about the general economic outlook and employment prospects. By contrast, households have hardly altered their view of their own financial positions or spending intentions. With job creation strong and employer surveys suggesting that consumers may be too pessimistic about the employment outlook **(Display 2)**, we would not read too much into the drop in consumer confidence.

Overall, recent cyclical indicators do not change our view that the UK economy is on a gradual recovery path. Balance-sheet constraints, weak credit availability and tighter fiscal policy are likely to weigh on growth. But very expansionary monetary conditions represent an important offset to this. It is also important to realize that the private sector has made a huge adjustment in recent quarters—the combined financial surplus of households and nonfinancial companies has risen to over 7% of GDP **(Display 3)**—putting it in a strong position to absorb future fiscal tightening.

With growth only just back to trend, the level of output well below its previous peak, tighter fiscal policy and subdued money and credit growth, it is hard to find a compelling argument for higher interest rates in the near future. But one area the Bank cannot be relaxed about is the recent performance of inflation.

A year ago, the Bank of England expected headline inflation to average 1.8% in the second quarter of 2010. The actual figure was far higher than this (3.4%). Moreover, with sterling having moved sideways over the last eighteen months, it is difficult to blame this on the weakness of the pound. It may be that the Bank has underestimated the impact of sterling's earlier collapse.

Equally, though, the Bank may be overstating the size of the output gap and/or the extent to which this is bearing down on prices. If the latter is true, the Bank's inflation forecast may again be optimistic.

Nor is the latest overshoot a one-off event. Since January 2006, headline inflation has averaged 2.7% and has been above the 2.0% target three-quarters of the time **(Display 4)**. While much of the overshoot can be explained by "special" factors—sterling's fall, higher indirect taxes and rising oil and commodity prices—the longer inflation remains above target, the greater the risk that it will eventually feed through into a costly increase in long-term inflation expectations.

Finally, it is important to remember just how expansionary monetary policy is. Real interest rates currently stand at -2.7%, and nominal GDP growth is now rising at a six-month annualized rate of 4.7%,* close to its historical norm and well above the current level of Bank Rate **(Display 5)**. While the relationship between nominal GDP growth and official rates suggested that monetary policy was too tight a year ago—which is why the Bank resorted to quantitative easing (QE)—the current configuration suggests that QE may have been rather effective and that monetary policy is now too loose.

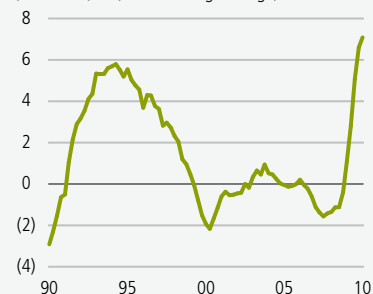
The nuanced approach adopted in the Inflation Report reflects the uncertain environment that the Bank of England is still operating in. Growth has returned to trend, inflation is above target and monetary conditions are loose. But the outlook is clouded by key uncertainties. In our view, the next move in UK interest rates is likely to be up. But the main message from the Inflation Report is that policy is unlikely to move in either direction in the near future. ■

*This is gross value-added at basic prices which strips out the impact of higher indirect taxes. Nominal GDP growth at market prices is currently rising at an annualized rate of 6.6%.

Display 3
Huge Private Sector Adjustment

Net Lending of Households and Nonfinancial Companies

(% of GDP; 4-Quarter Rolling Average)



Source: Haver Analytics and AllianceBernstein

Display 4
Persistent Inflation Overshoot

Consumer Price Inflation

(YoY % Chg.)

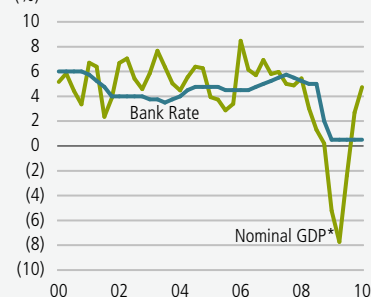


Source: Haver Analytics and AllianceBernstein

Display 5
Monetary Policy Is Very Loose

Bank Rate and Nominal GDP

(%)



*Gross Value-Added at Basic Prices, 6-Mth/6-Mth Annualized
Source: Haver Analytics and AllianceBernstein

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