9 October 2024

Economic Outlook

Navigating the Endgame

Prepared for Benjamin Nabarro

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See Appendix A-1 for Analyst Certification, Important Disclosures and Research Analyst Affiliations
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Economic Outlook: Insecure Recovery

The underlying picture for the UK economy is improving. In the near term a contorted policy inheritance however make it difficult to capitalise. Instead, the balance of risks is we think shifting towards a deficiency in demand. That adds to the upside risks to unemployment. We expect extensive rate cuts through 2025, and a more full-throated growth acceleration through 2026/7.

- **A challenging starting point** – the **UK's economic performance has been poor for two decades.** The UK must now drive an improvement with constrained policy space.
- **Supply improving** – There is good news, with the supply shocks of recent years now either fading or in retreat. **Capacity is improving.**
- **Demand headwinds remain** – Past policy errors – particularly on fiscal – mean some (unnecessary) **headwinds to spending are likely to continue**.
- **Risks shifting** – the implication is the **balance of risks is shifting from inflation to unemployment**.
- **Policy must be responsive** – Poor coordination between monetary and fiscal policy has been a headwind to the recovery. **Monetary policy must now be attentive to the changing balance of risks**.

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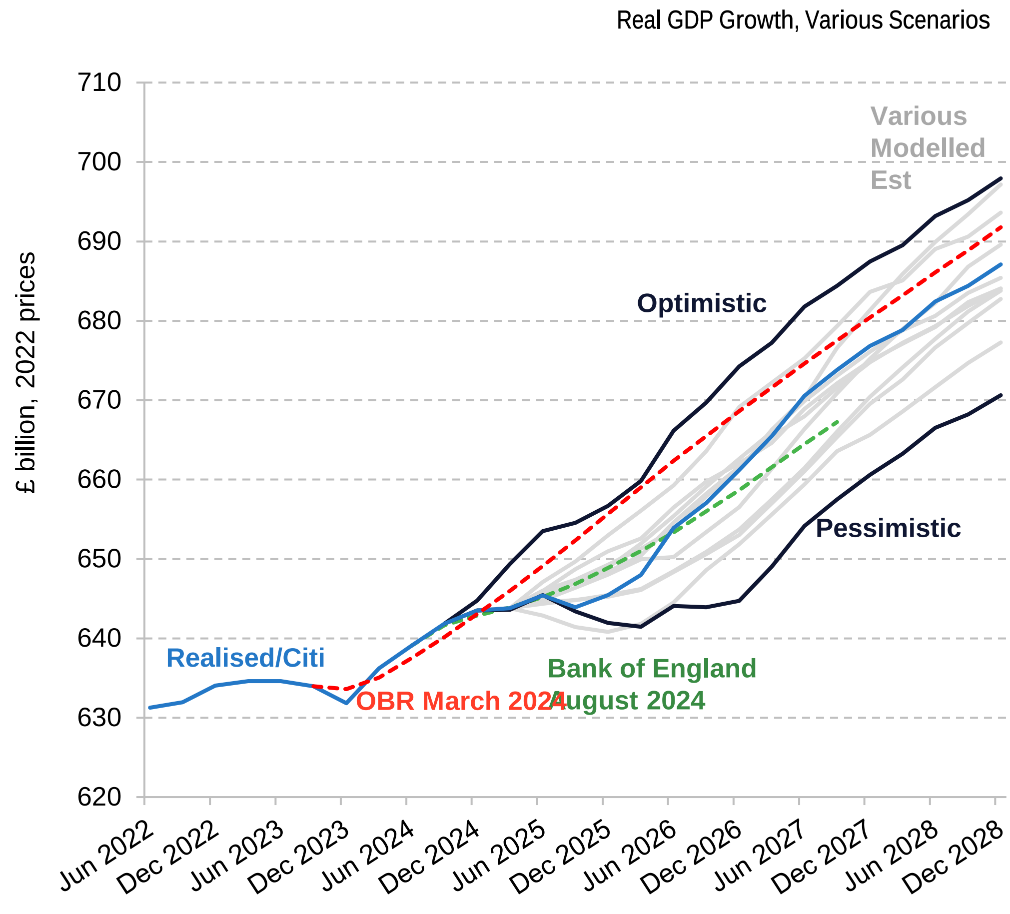
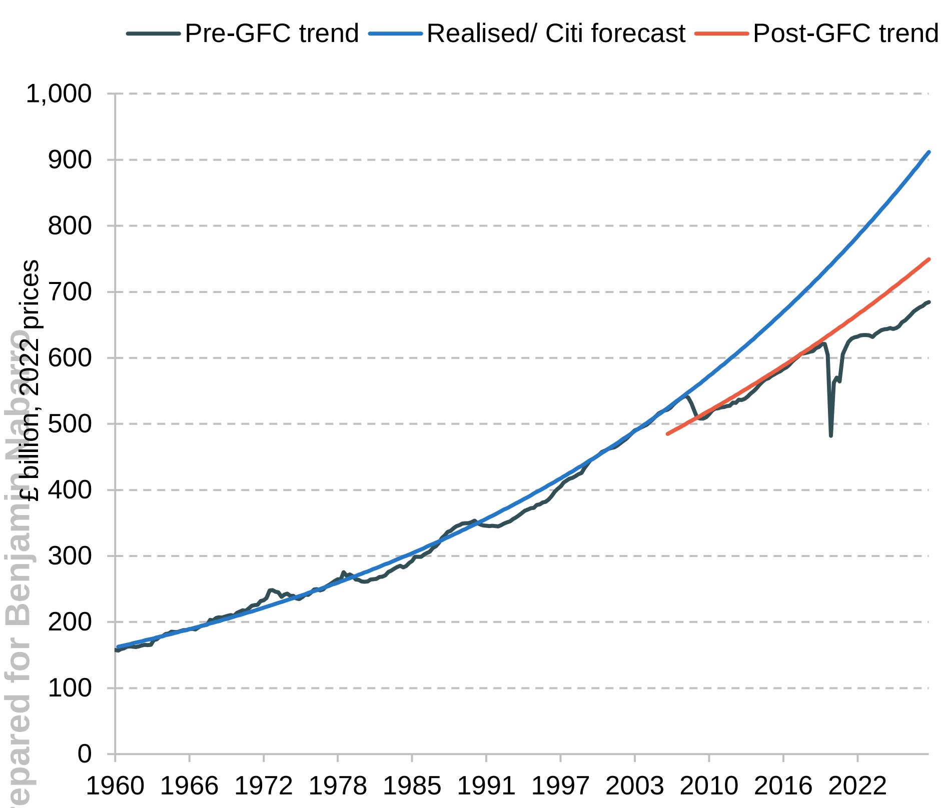


Note: The graph shows our baseline forecast alongside the Bank of England's modal, market-conditioned forecast for August, and our optimistic and pessimistic scenarios. The latter are discussed in Box 1.1 in Chapter 1: Navigating the Endgame. The OBR forecast is taken from the March 2024 economic and fiscal outlook. Historical forecasts in Panel A are indexed back to the last realised data point at the time the forecast was made. Sources: ONS, Bank of England, OBR and Citi Research See: UK Economics: Addressing the 'British Condition'

The Inheritance: No Room for Error

Reeves has argued that her economic inheritance is the worst since the Second World War. We might not go that far, but the challenges are indeed severe. Poor growth in recent decades has meant a growing gap between existing fiscal commitments, and what the economy is able/ willing to support. Tight budget constraints limit room for manoeuvre, while global developments make lifting trend growth more essential.

UK GDP growth vs the post-war trend



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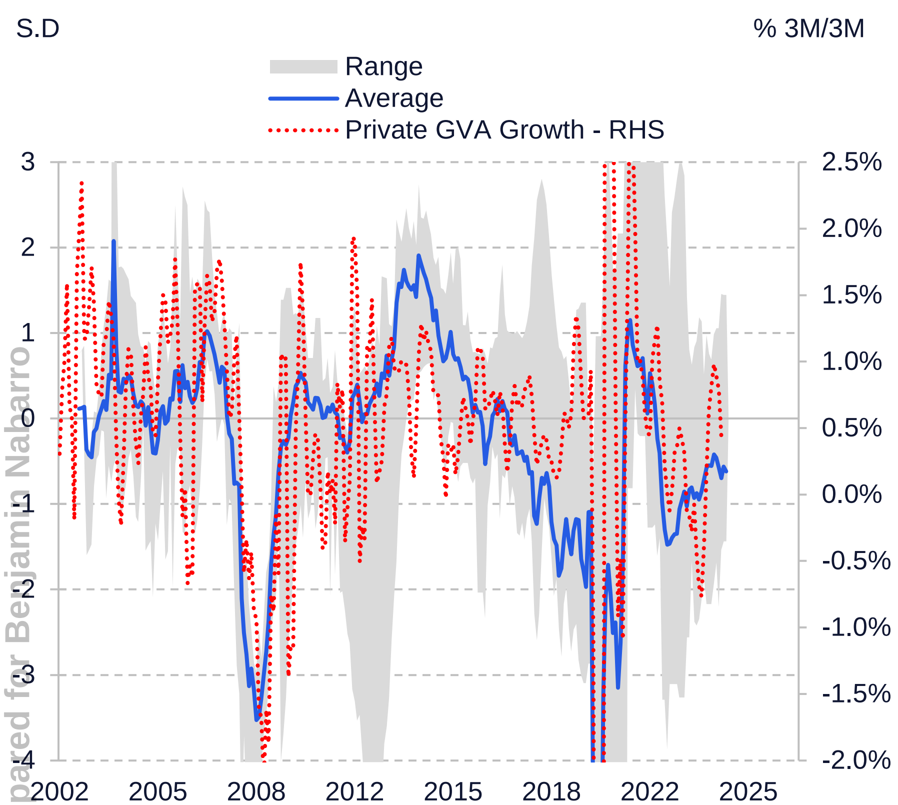
'Global' Nominal Interest Rates (%)

Note: On the left-hand panel, Pre-GFC trend here is calculated between 1960 and 2007 and post-GFC trend is 2010–19, where GFC is Great Financial Crisis. The right-hand side panel shows a cross-national weighted average of two-year and 5-year yields. These are taken for the OECD, BRIC and a handful of South American and east Asian economies. Sources: National Statistical Offices, ONS, Citi Research. See: [UK Economics: Addressing the 'British Condition']

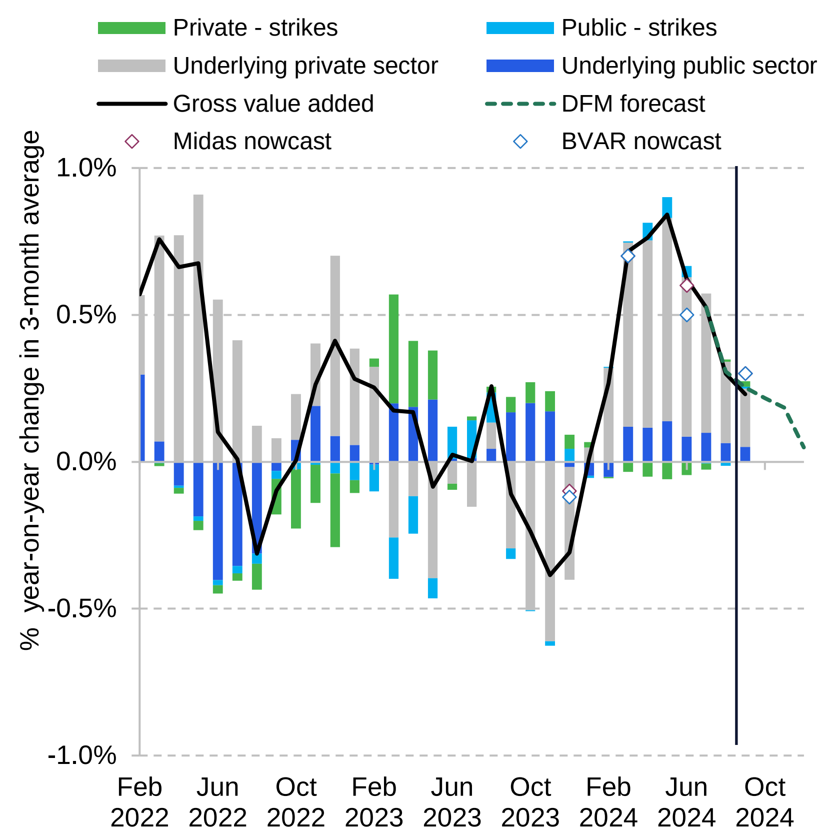
UK Recovery: Soggy, Not Secure

GDP growth has surprised to the upside of late. However, this has primarily reflected downside surprises in 2H-23, and subsequent upside surprises in non-consumer services. This we think primarily reflects 1) the capacity related effects of lower energy prices and 2) more public sector spending. Neither can be expected to drive a more sustained pick up. We expect growth to converge on a 0.3-0.2% QQ trend through 2H-24.

Survey Indicators of Economic Activity



Nowcast of UK Gross Value Added (GVA) (%3M/3M)



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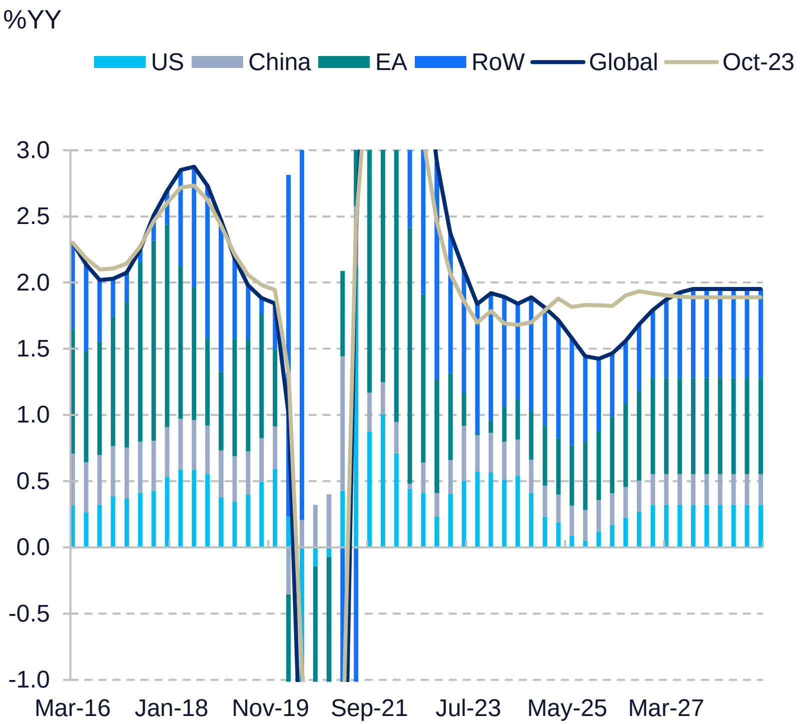
Notes: The left hand side panel shows the correlation weighted average of a range of soft indicators of UK economic activity. The shaded area shows the range of the specific indices. In the right-hand panel, BVAR and Midas nowcasts are products of a Baynesian VAR model and a mixed frequency sampling model respectively. Our main nowcast is based on a dynamic factor model (DFM) of roughly 120 survey indicators. Sources: IHS Markit, CBI, Bank of England, Lloyds, BRC, Deloitte, ONS and Citi Research. See: UK Economics: Addressing the 'British Condition'

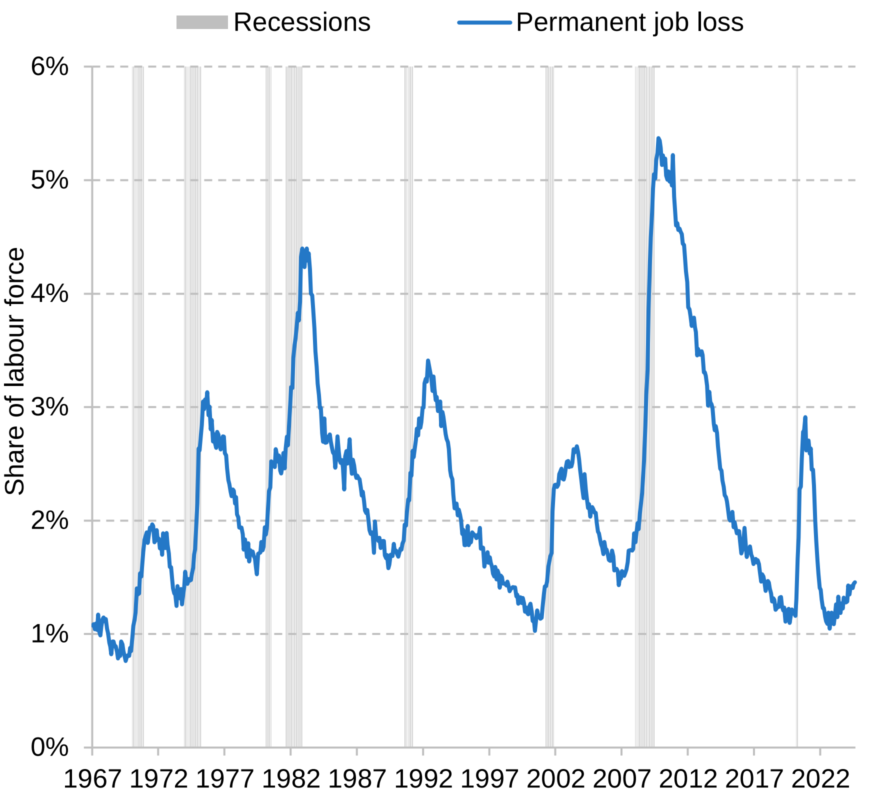
Global Outlook: Fading Tailwinds

The Global Outlook is framed primarily by ongoing structural challenges in China, and growing cause for concern around US demand growth. In the months ahead we expect the associated spillovers into Europe to weigh on external demand for the UK. For now, stimulus in both cases remains a notable risk. But for now the post-Covid impulse is fading...

UK Trade Weighted Global GDP Growth



Recessions and permanent job losses in the US since 1967



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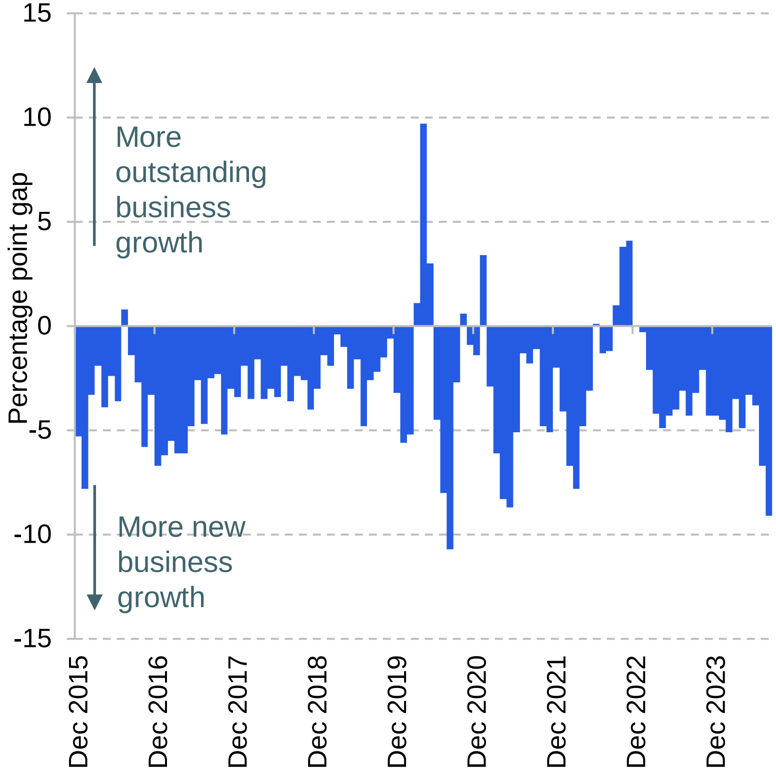
Notes: The left-hand panel is weighted by consumption of UK exported value added from the OECD TiiVA database. Sources: Bureau of Labour Statistics, National Statistical Offices and Citi Research. See: UK Economics: Addressing the 'British Condition

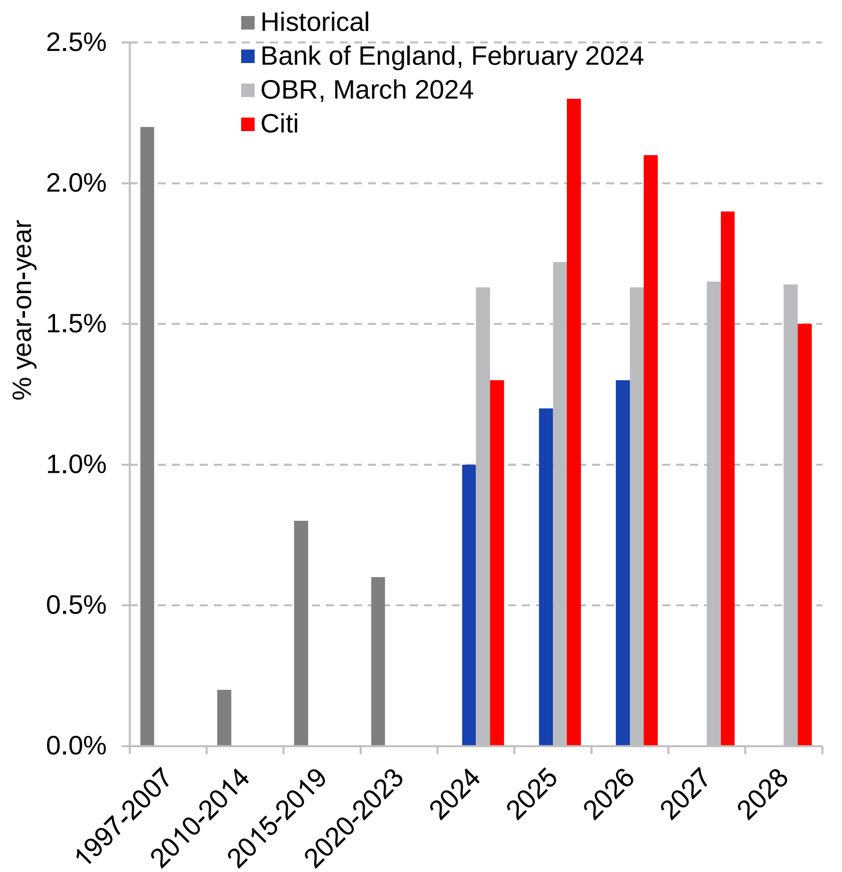
UK Outlook: Reasons to be Cheerful

After several years where growth in economic capacity has effectively stood still, there are now signs things are beginning to improve. The terms of trade shock has come and gone. Capacity seems to be coming back online as input and output prices return to some sort of balance. And production is rebalancing between labour and non-labour inputs. A modest degree of 'catch up' subsequently seems likely.

Percentage point gap between growth in outstanding business and new business



Year-on-year growth in potential GDP, UK



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Notes: The left-hand chart shows the difference between the growth in outstanding and new work indices in the PMI. When the former is high relative to the latter, that suggests that capacity is contracting., The right hand side chart shows various estimates of potential GDP growth. Sources: IHS Markit, ONS, Bank of England, OBR and Citi Research. See: UK Economics: Addressing the 'British Condition

UK Outlook: Reasons to be Cautious

Despite the good news, the UK is poorly positioned to immediately capitalise. That primarily reflects a fiscal strategy that, since the start of 2022, has been heavily procyclical. As inflation has climbed, this has pushed more of the counter-inflationary burden onto monetary policy. This has meant worse trade-offs, and more downside risks.

- Monetary policy has always taken a long time to feed through. **These policy lags have likely elongated further:**
  - Pass through from Bank Rate to financial conditions has been quick
  - But transmission into demand has been slower
  - And the second-round effects into the labour market have been slower still.
- **We think around a third to a half of total transmission as still to come. Fiscal policy also now faces a period of consolidation.**
- The UK's policy mix since the onset of the energy shock has likely **weighed on the UK's medium-term recovery**.

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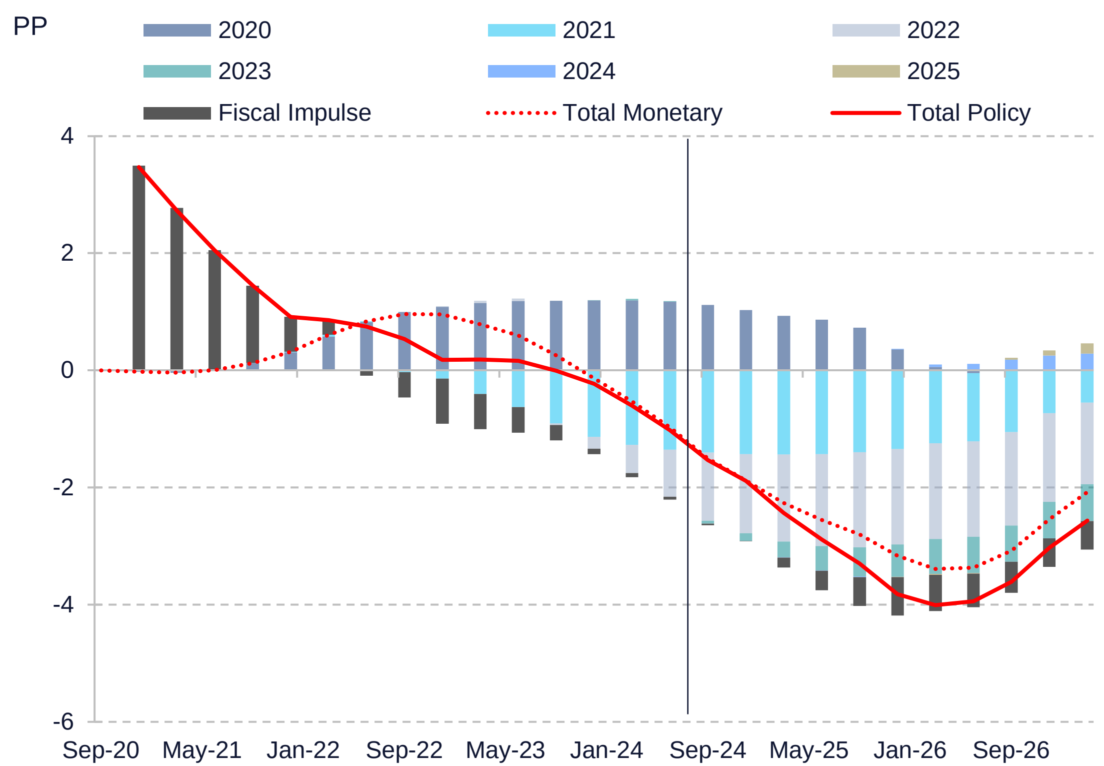
UK – Combined Monetary and Fiscal Impact, GDP Level (% Dev from Trend)

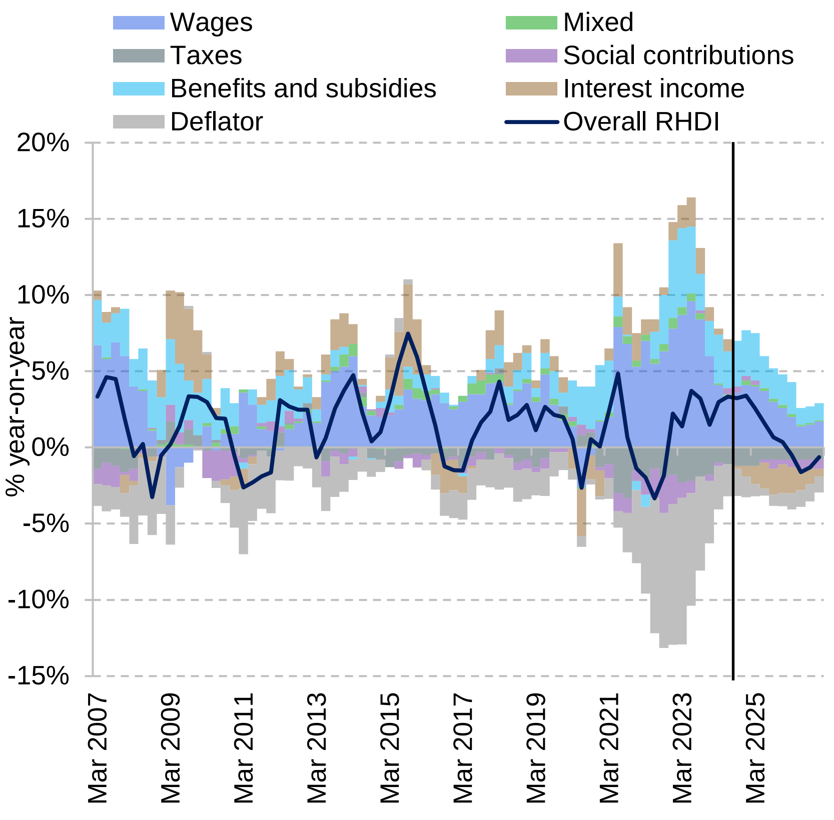


Note: Monetary policy impact here is based on the Bank and associated market rates modelled through a SVAR impulse response. This has been discounted to reflect some of the structural changes listed above. It has also been pushed back by a quarter – reflecting the arguments above. The fiscal impulse is based on the cumulative impact of all discretionary changes since the onset of the pandemic. Here we have excluded the Energy Price Guarantee and the Energy Bill Relief Scheme. Some of the public spending during the height of the pandemic has also been discounted, reflecting reported waste. Source: ONS, Bank of England, OBR, Wolf (2020), Citi analysis. See: UK Economics: Addressing the 'British Condition

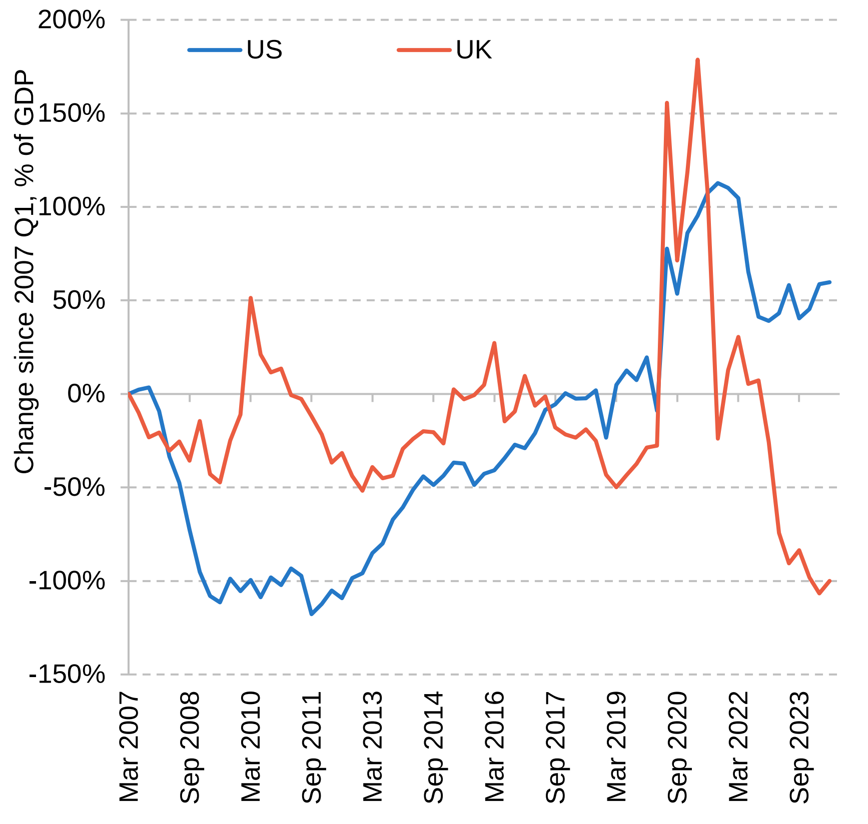
Households: Never Had it So Good?

The rebound in UK real incomes is now largely in. Households have largely responded via saving, rather than spending. Some of this reflects the impact of higher rates. But we think a reasonable portion reflects the deterioration of household balance sheets as asset values have been adversely impacted. We expect savings rates to come down gradually as real income growth moderates.

Real household disposable income growth, UK (% year on year)



Net Worth of the Private Non-Financial Sector, PP Change since Q4-2007 (%GDP)



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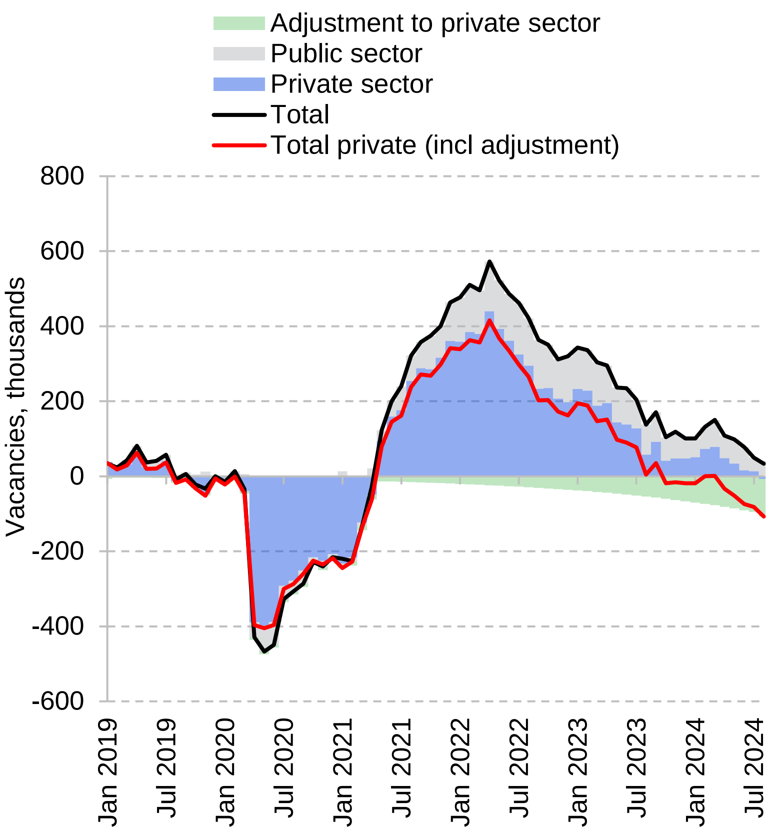
Note: The right hand chart shows the change in net worth of the private non-financial sector since 2007 Q1, measured as a share of GDP. In both the US and UK cases, pension entitlements have been excluded from the calculation on grounds of relevance. In the UK's case, corporate real assets have been calculated by taking the total nominal value of the market sector and multiplying it by the GOS share of non-financial corporates. Housing wealth is calculated via the total number of privately owned dwellings, multiplied by the average house price. UK data are taken from the ONS accumulation accounts; US data are from the Federal Reserve system.

Source: BEA, Federal Reserve, ONS. See: UK Economics: Addressing the 'British Condition

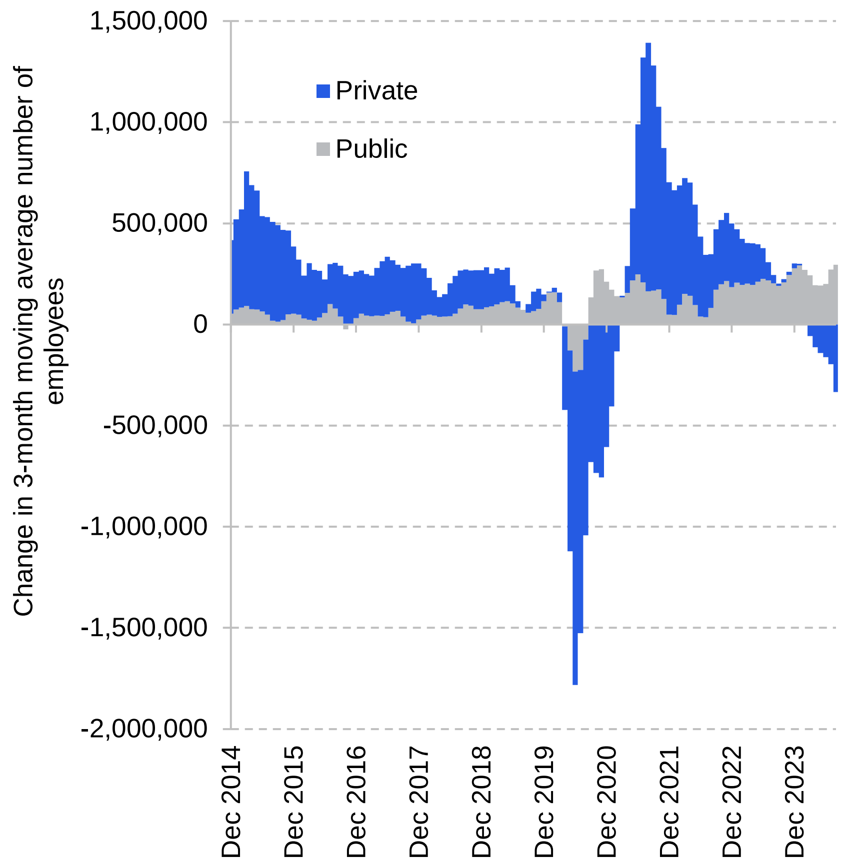
Labour Market: Devil is in the Detail

Even as headline activity has improved, most measures of the labour market have signalled further deterioration. On the vacancies side, adjusting for the change in the relative cost of advertising we think already suggests a looser labour market than in 2019. Private sector payrolls growth has been flat to negative for some time.

Various adjusted vacancy measures, UK



Employee growth in the UK by public and private sector employers, from PAYE data (Diff. 3M/3M)



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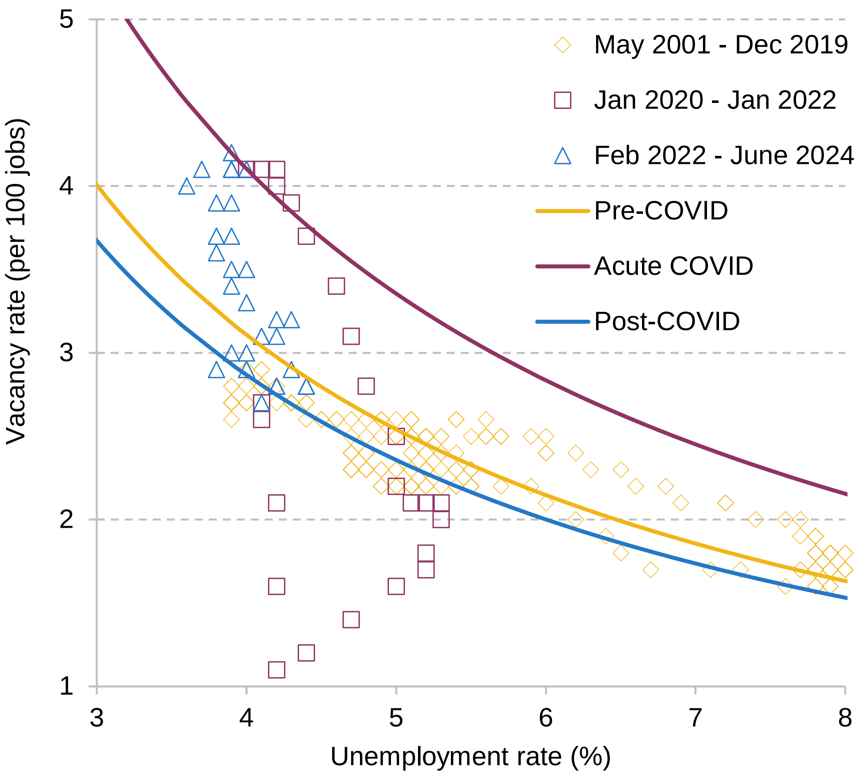
Notes: The adjusted measure on the left hand panel reflects the impact of a 15% drop in the average cost of advertising a vacancy on the headline vacancy rate. Private sector excludes public administration, education and health in both charts. Sources: ONS and Citi Research. See: UK Economics: Addressing the 'British Condition

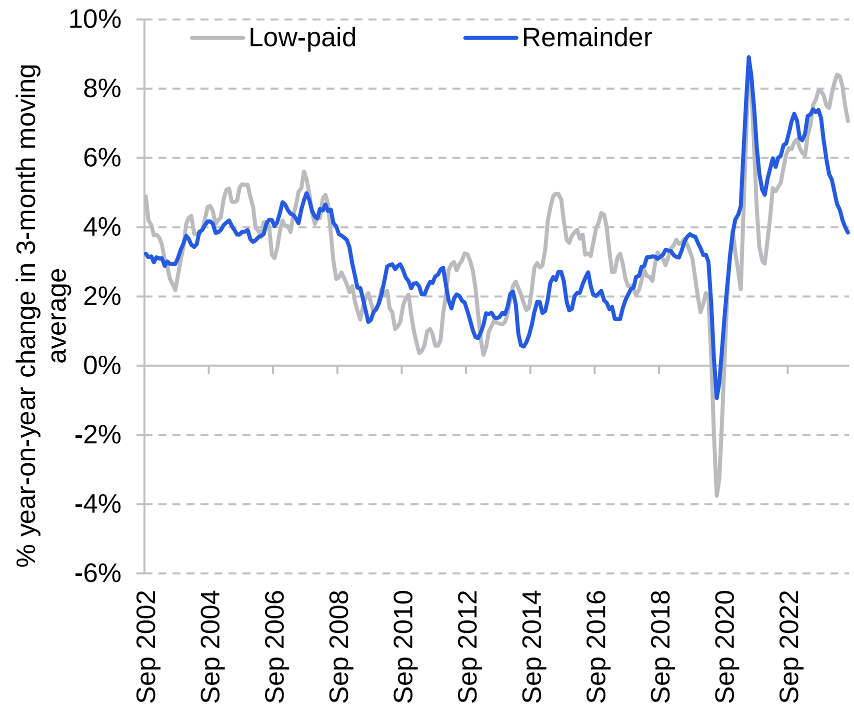
Slack: Watch the Non-Linearity

Judging the overall position of the labour market is made considerably harder by the limitations around the data. Nonetheless, the broad sweep of survey data we think remains consistent with hiring difficulties easing back, and labour market conditions normalising more broadly. We see a growing risk of weaker labour demand feeding into headline unemployment at a growing rate.

UK – Beveridge Curve



Private sector wage growth in the UK, in high- and low-paid sectors



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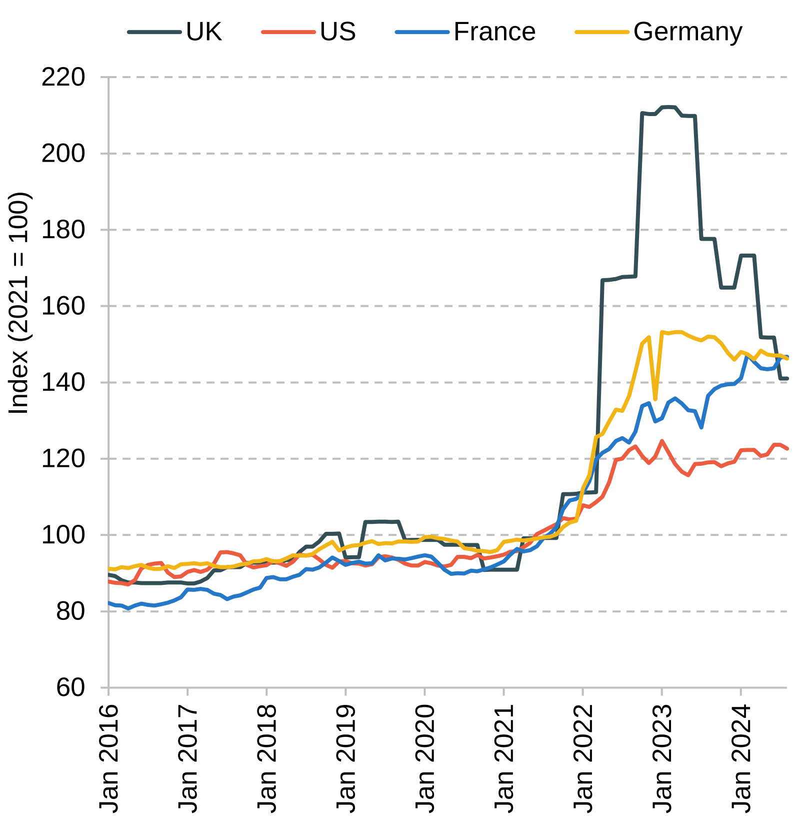
Note: In the left-hand chart, Pre-COVID covers the 2001–19 period. Acute COVID covers 2020 and 2021. Post-COVID covers the post-2021 period. Low-paid sectors here include agriculture, retail, transport, hospitality, administrative services, recreational services and personal services. Data exclude arrears and bonus payments. Seasonally adjusted using X-13. Sources: ONS, Low Pay Commission and Citi Research. See: UK Economics: Addressing the 'British Condition

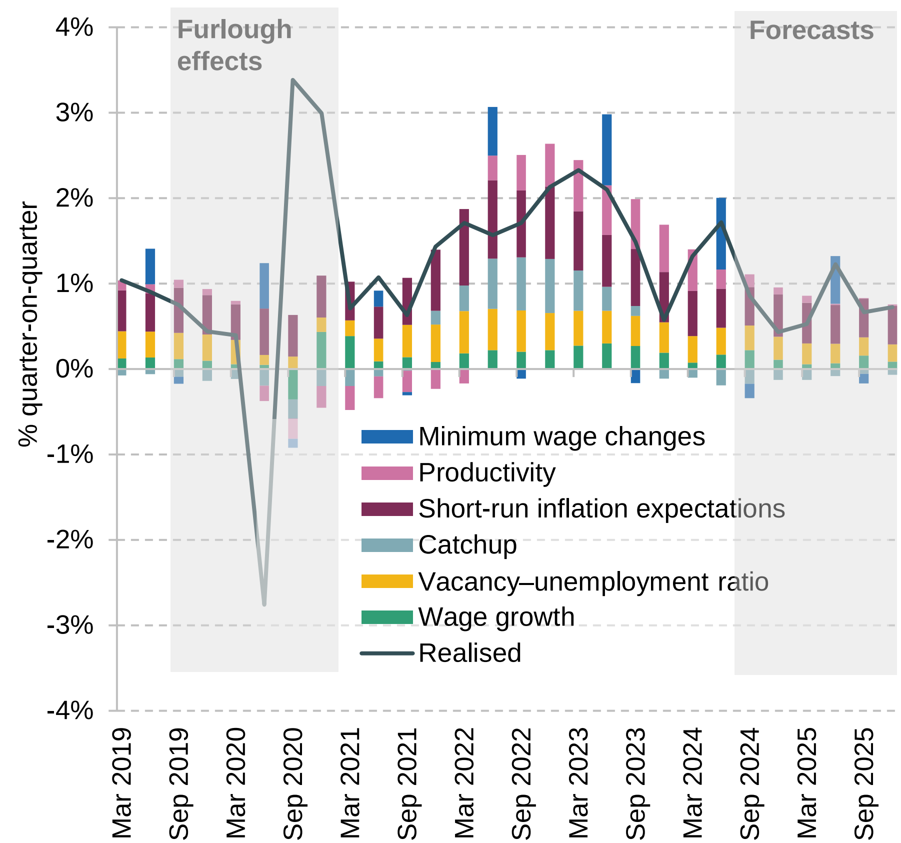
Inflation: A Three-Part Saga

The UK inflation shock can be broadly thought of as a three-part process. First have been the direct effects of a succession of large cost shocks. Second has been second round ‘adjustment’ effects as these impacts have fed through. And third has been a period of more persistent ‘conflictual’ inflation as workers and firms have resisted the associated real income shock. Importantly, there is little evidence in our view of a material ‘inflationary break.’

CPI Household Energy Inflation Across Countries



Realised and forecast private sector regular pay growth



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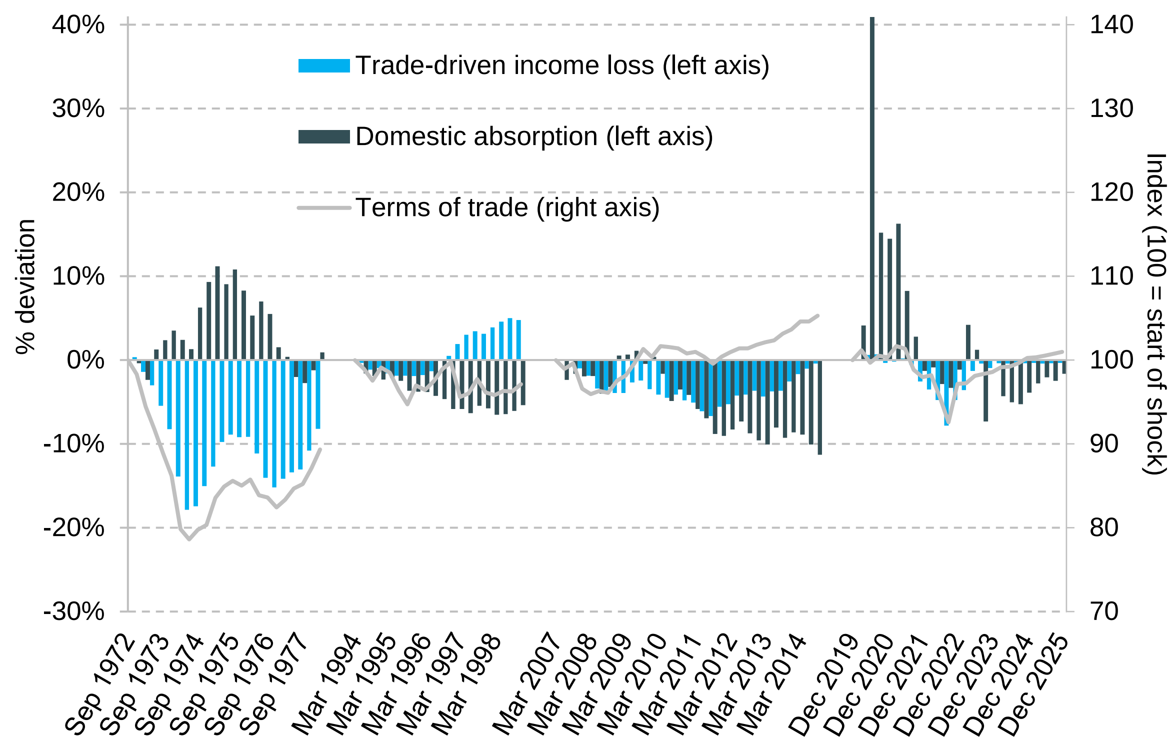
Note: The bars show the modelled contributions based on the period 1992–2019. The line shows the realised out-turn, and a forecast from 2024 Q3. Model equation is an auto-regressive distributed lag on the quarterly data, measured with four lags. Variables include: productivity – measured as output per worker; wage growth – using a combination of Average Weekly Earnings (private sector regular pay) and the Average Earnings Index; the vacancy to unemployment ratio; short-run inflation expectations – measured via an average of the Citi/YouGov and Bank of England / Ipsos survey for inflation 12 months ahead (pre-1997 this is measured via NIESR professional forecast expectations); minimum wage changes – measured as the quarterly change in the headline rate; and catchup – measured as the gap between realised and expected inflation 12 months prior. Model is estimated over the period 1992–2019. Source: National Statistical Offices, ONS, NIESR, Bank of England / Ipsos, YouGov, Bernanke and Blanchard (2023), Citi analysis. See: UK Economics: Addressing the ‘British Condition

Inflation: Cessation of Hostilities?

The key question of course is when this 'conflictual' inflation process can be said to have run its course. For now, we think that is increasingly consistent with the data. In comparison with the 1970s sustaining conflict is meaningfully more costly. That creates a natural process of decay. Those areas that are seeing more persistent conflict are generally exceptions that prove the rule.

- Three conditions are needed for 'conflictual inflation' to conclude:
  - The real loss should be fully absorbed.
  - No evidence that either workers or firms are trying to agitate away from the associated distribution.
  - Both firms and workers must jointly expect both wages at broadly target consistent levels.
- **We see these conditions as increasingly satisfied.**

'Loss Absorption' of UK terms of trade shocks



Note: The dark grey blur (domestic absorption) show post-tax income of the private sector, de-trended for labour force and productivity growth. The light blue bars (trade-driven income loss) show the change in the relative cost of imports, multiplied by the import intensity. Sources: ONS, Rowthorn (1977) and Citi Research. See: UK Economics: Addressing the 'British Condition

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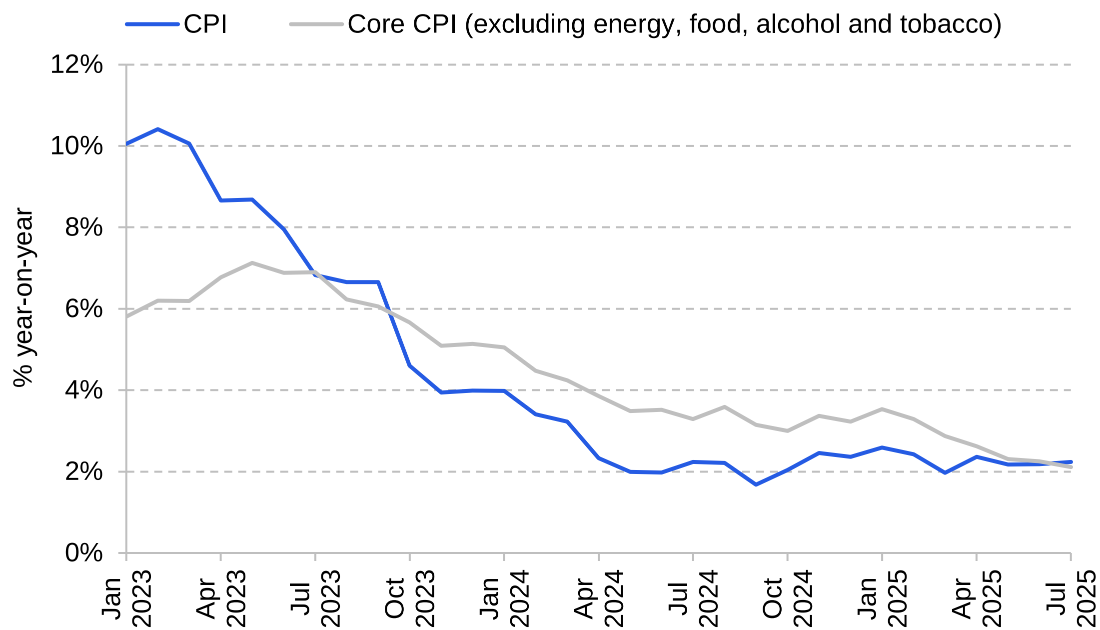
Monetary Policy: When is Enough, Enough?

Monetary policy must always be as loose as possible, but as tight as necessary. In recent years monetary policy has been forced to take out substantial insurance against embedded inflation as 1) supply shocks have accumulated and 2) fiscal policy has stimulated. The balance of risks are now fading quickly. A continued margin of inflationary-aversion is increasingly inappropriate.

- The MPC are currently still operating with an **'inflation averse' state of mind.**
- With uncertainty falling, and the risks in better balance, that is likely **increasingly inappropriate.**
- For now, we think a cautious approach implies **cutting rates once a quarter** into 2025.
- We expect the MPC to be stopped into a **consecutive cycle from May 2025** as the labour market loosens.
- Followed by **rate cuts into accommodative territory** as slack emerges.
- By waiting too long, the MPC risk **further scarring of investment.**
- **While the MPC should of course remain primarily focused on their mandate, growth concerns – including structural concerns, cannot be ignored.**

Annual UK CPI Inflation (%YY)



Sources: ONS and Citi Research

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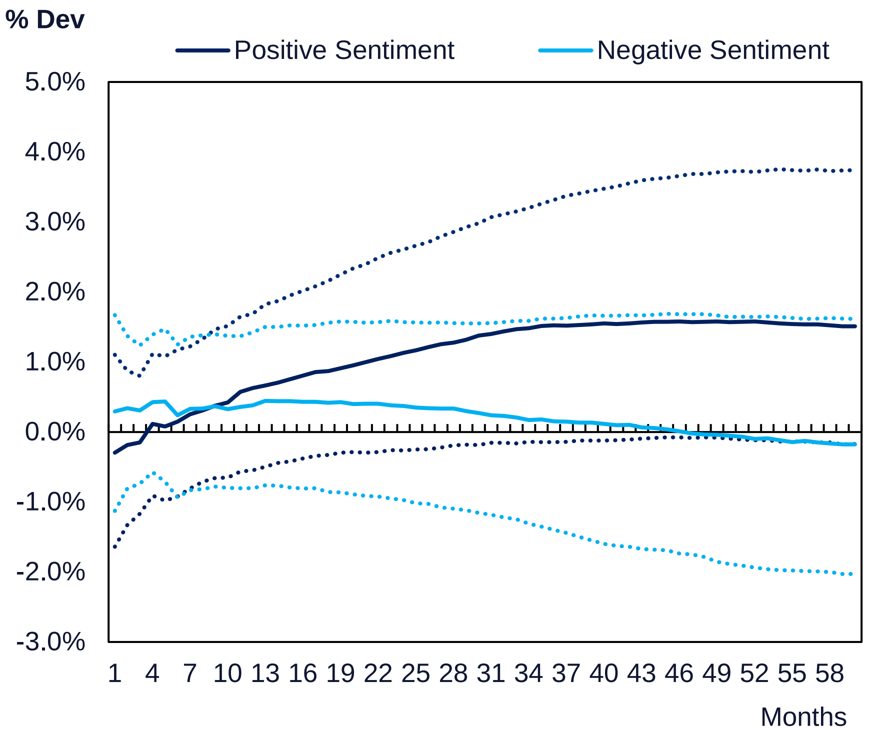
Supply Shocks: Getting the Balance Right

To some extent, we have got lucky when it comes to the recent supply shocks, many of which have at least partly reversed. In future, we may not be so fortunate. Monetary policy feels like a deeply suboptimal way of addressing these shocks. A different approach may be increasingly required to achieve price stability at a tolerable cost. **This will require better coordination of monetary and fiscal policy, alongside the protection of monetary dominance.**

CPI Household Energy Inflation Across Countries



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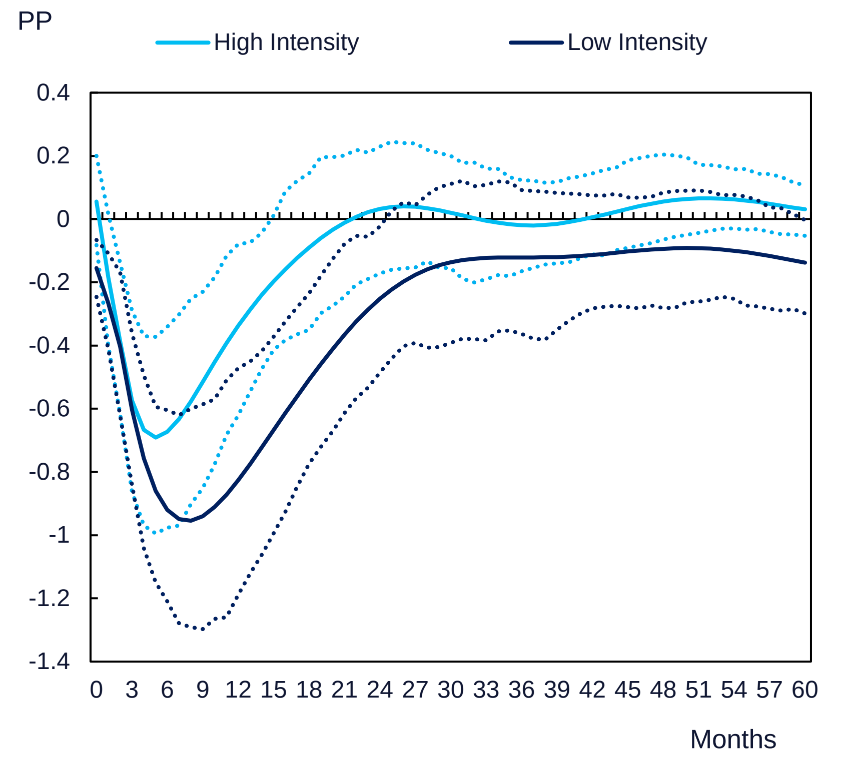

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Notes: The left hand panel here is the product of a SVAR model looking at the response of wage growth to the change in the v/u ratio when accompanied by falling unemployment expectations, and increasing expectations. The right hand side chart shows the response of the labour share to a tightening labour supply shock – modelled here using a Proxy-SVAR approach from Stock and Watson (2018). Here the effect is broken down across more and less energy and food intensive sectors. Sources: ONS, GfK Bank of England, OBR Stock and Watson (2018) and Uhlig (2005) and Citi Research

See: UK Economics: Addressing the 'British Condition'

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