Special Report 2010/16

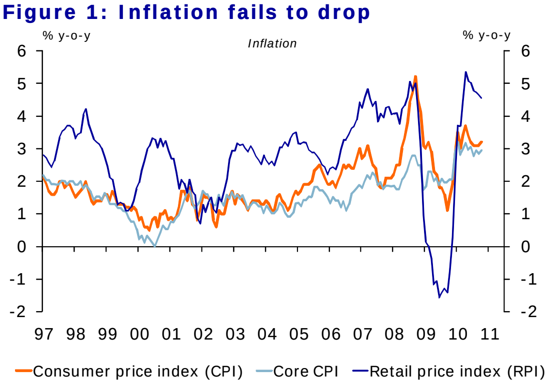
UK: To QE or not to QE?

The pace of economic recovery is slowing before the fiscal squeeze has kicked in. But the BoE is hesitant to launch QE2 given the higher-than-expected inflation (expectations). There are definitely short-term upside risks to inflation, mostly due to the VAT hike in January 2011. However, we believe the risks to inflation in the medium-term to be slightly tilted to the downside owing to the massive slack in the economy. Thus, there is still a chance that the BoE starts purchasing assets in 2011. The exact timing will, of course, depend on the evolution of inflation going forward.

Tit-for-tat or wait-and-see?

The second round of monetary easing in the US – nicknamed QE2 – has put the Bank of England (BoE) in a tight spot. Many market participants –and even former and current BoE governors such as David Blanchflower and Adam Posen– argue that Mervyn King has no option but to follow suit. But that is easier said than done. The UK inflation rate rose from a trough at just above 1% in September 2009 to 3.5% by early 2010 and has remained elevated since. This has caused a split in the Monetary Policy Committee (MPC). In a recent letter to the Chancellor, Mr. King argued that "*the chances of inflation being above or below the target in the medium term are evenly balanced*." In other words, QE2 will only set sail once inflation is on a downward trajectory.

Figure 1: Inflation fails to drop



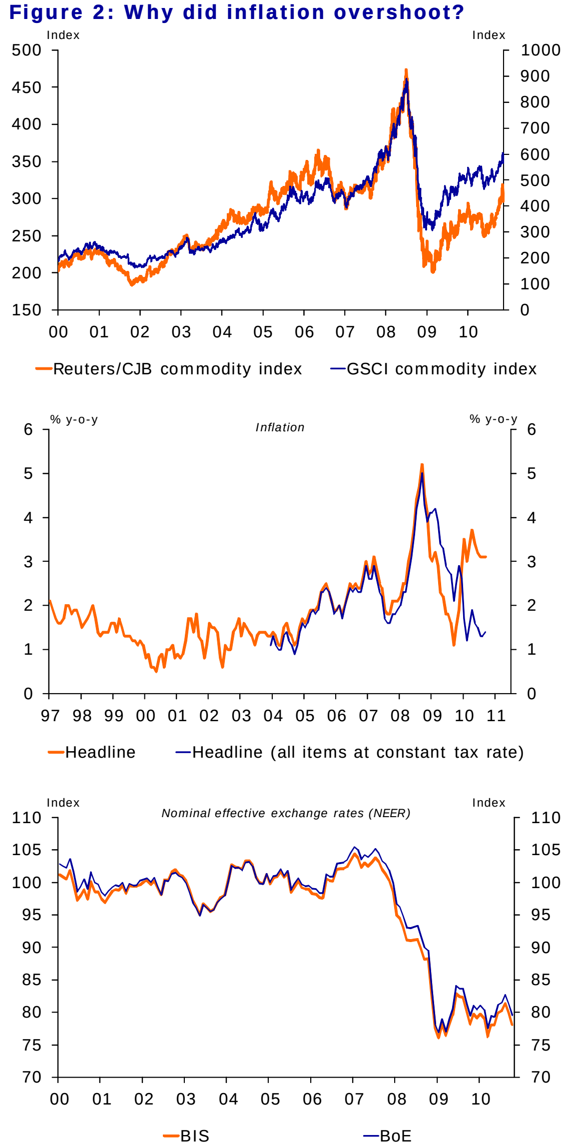
Source: Reuters EcoWin

Why has inflation remained so high?

Much of the rise in the CPI can be attributed to these three factors.

1. The strong rebound of commodity prices since 2009 (figure 2, top panel).
2. The January 2010 VAT rate hike from 15% to 17.5% (figure 2, middle panel).
3. The greater-than-expected exchange rate pass-through (EPT) from past sterling depreciation (figure 2, bottom panel).

Figure 2: Why did inflation overshoot?



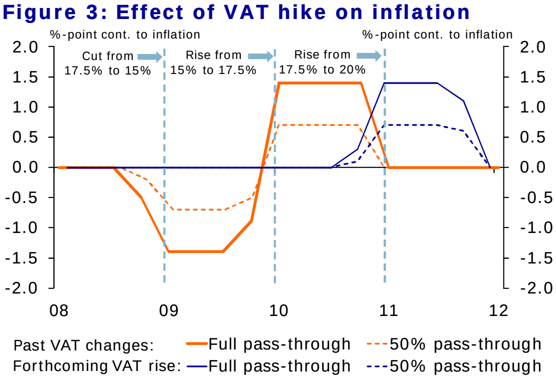
Source: Reuters EcoWin, BoE, BIS

The third factor deserves some extra attention in our view. This is because recent research has generally documented low and declining exchange rate pass-through in advanced economies. Yet the IMF (2010b) finds that much of the variation in inflation across advanced countries over the last three years could be readily explained by EPT on the order of 0.17[1]. That is quite significant indeed.

Where will inflation go from here?

The risks to inflation in the short-term are very much tilted to the upside. In our view, inflation will rise further given the forthcoming rise in VAT and continuing increases in import prices. Regarding the former, the IMF (2010b) expects the Jan. 2011 VAT hike to raise the CPI by around 1.25%-points. This is very much in line with the expectation of the BoE given full-pass through of VAT hike to end consumers. In case of 50% pass-through, the effect on inflation will be more moderate (see figure 3). As a result, the MPC expects inflation to stay above the 2% target throughout 2011.

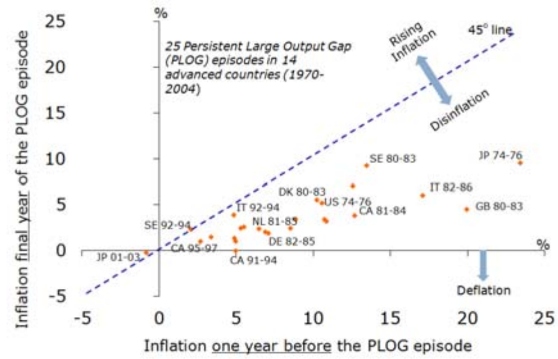
Figure 3: Effect of VAT hike on inflation



Source: BoE

As the short-term impact of these factors on inflation diminishes, however, inflation can start falling below 2% in 2012 –in line with the BoE's expectation. This reflects continuing downward pressure from the persistent margin of spare capacity. Meier (2010) studied inflation dynamics during 25 Persistent Large Output Gap (PLOG) episodes[2] in 14 advanced economies (1970-2004) and found that, in all cases, inflation after PLOG episodes was *equal or lower* than inflation before the PLOG episode. The disinflationary dynamics will be supported by weak labor markets – high unemployment (7.7% in Sept.) and falling real wage growth (-1.1% y-o-y in 10Q3).

Figure 4: PLOG episodes and disinflation



Source: Meier (2010)

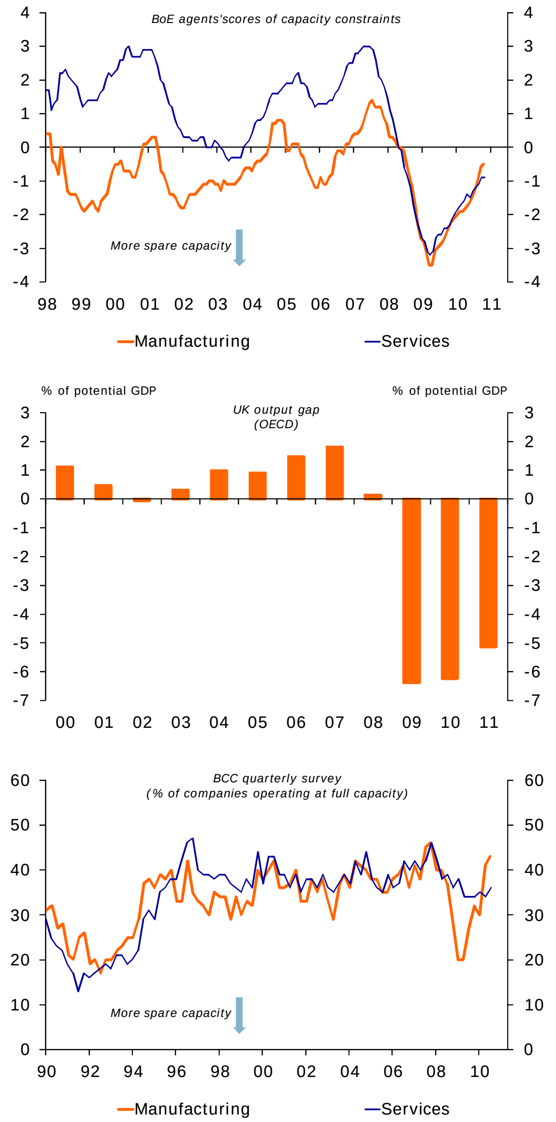
That said, measuring spare capacity remains more art than science. The top and middle panels of figure 5 show that there is still a large amount of slack in the UK economy (based on the BoE agents' survey and the OECD estimate). But the BCC survey gives a rather more optimistic picture, especially in the case of the manufacturing sector (see figure 5, bottom panel). So it is very difficult to judge exactly how much capacity has been destroyed due to the recession.

Nevertheless, there are more reasons why inflation may fall below 2% in the medium-term. For one, the fierce fiscal medicine of the government is very likely to pose a downward pressure on domestic prices. The IMF (2010a) claims that a fiscal consolidation equal to 1% of GDP typically reduces inflation by about 0.5%-points within two years when monetary policy rate is constrained by the zero-bound (see figure 6). In other words, the upcoming fiscal squeeze in the UK may act as a huge drag on the headline inflation rate.

[1] That means a 1% depreciation of the sterling will result in a 0.17%-point increase in the CPI inflation.

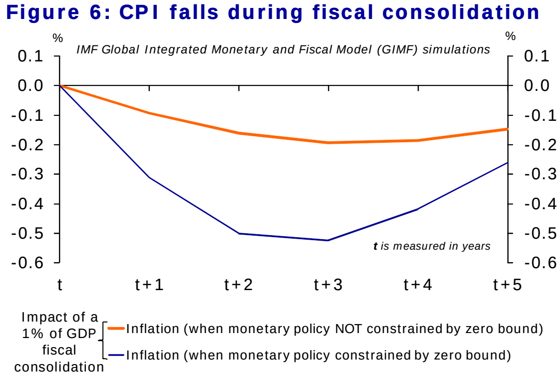
[2] 8 quarters of negative output gaps>1.5%.

Figure 5: A large amount of slack?



Source: Reuters EcoWin

Figure 6: CPI falls during fiscal consolidation

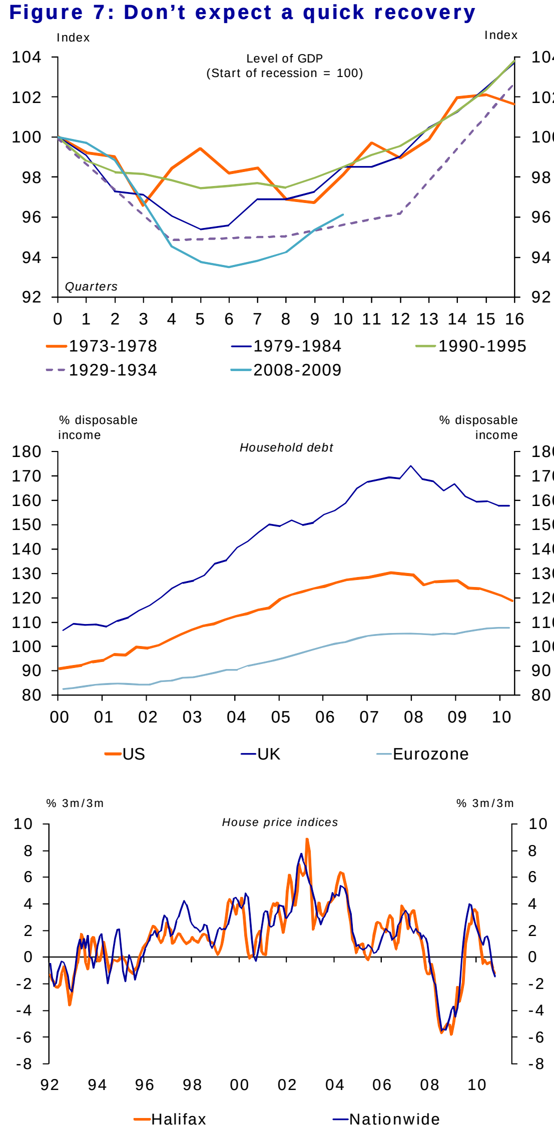


Source: IMF

Mind you that this sharp fiscal contraction comes at a time when economic growth is very weak given the collapse of output (figure 7, top panel). The highly indebted consumers are still busy deleveraging (figure 7, middle panel) and, therefore, are in no mood of spending. The negative wealth effect amid a double-dip in the housing market (figure 7, bottom panel) will probably dent consumer spending even more. Firms, in turn, will not go on an investment spending binge even if capacity utilization rates are higher than currently estimated. Net trade is equally unlikely to pull the economy forward amid troubles in the eurozone.

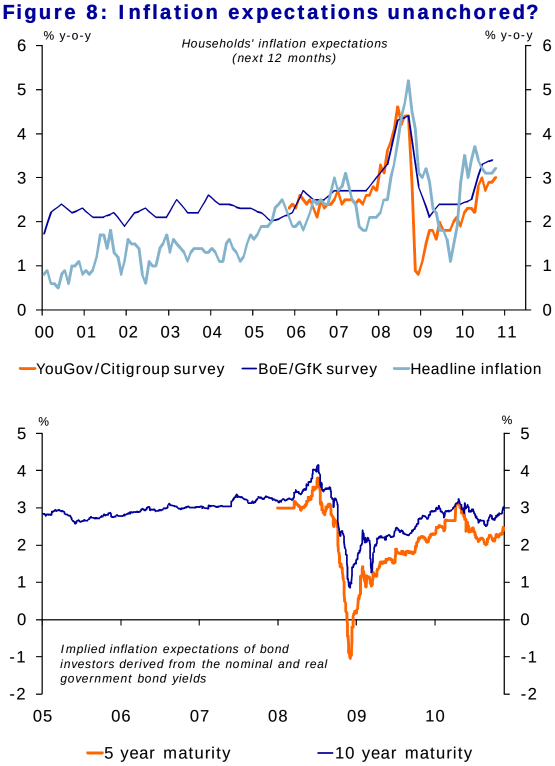
Of course, there are also upside risks to the inflation outlook in the medium-term. The most

Figure 7: Don't expect a quick recovery



Source: Capital Economics, Reuters EcoWin important one is if an extended series of above-target inflation outturns result in a further rise in households' inflation expectations (figure 8, top panel), which might start feeding back into wage and price-setting. We must stress, however, that households' inflation expectations act more as a coincident – rather than as a leading – indicator. Phrased differently, inflation expectations are likely to drop when headline inflation starts falling. The good news is that investors' inflation expectations have remained well-anchored after falling sharply in the peak of the crisis (figure 8, bottom panel).

Figure 8: Inflation expectations unanchored?



Source: Reuters EcoWin, Bloomberg

To sum up, there are significant uncertainties around the outlook for inflation. But we believe the risks to the outlook is slightly tilted to the downside and not evenly balanced as viewed by the BoE. This means the MPC is very likely to launch its QE2 program in 2011 to sustain the recovery once the fiscal squeeze kicks in. But the timing of the move is subject to a great degree of uncertainty. On the one hand, advocates of 'move quickly' policy such as Adam Posen believe QE2 should be launched faster given the long lag in which monetary policy affects the economy. On the other hand, Mr. King does not wish to launch QE2 and then write another letter to the Chancellor explaining why inflation stubbornly remains above the target. That makes it politically difficult to sell. This means the evolution of headline CPI inflation will very much determine the timing of QE2. As soon as signs of falling inflation (expectations) become visible, the MPC will not hesitate to purchase more assets in the hope of pushing yields even lower.

Conclusion

The BoE is stuck between a rock and a hard place. On the one hand, the expected weakening of economic growth amid a harsh fiscal squeeze calls for a second round of monetary stimulus. On the other hand, the MPC is afraid to move given that inflation (expectations) have moved above their comfort zone due to higher commodity prices, the VAT hike in 2010 and the greater-than-expected exchange rate pass-through. What's more, the VAT hike in Jan. 2011 may result in a sharp pickup in inflation (expectations). But in our view, the weak economic backdrop will continue to pose downward pressure on domestic prices and this will result in lower inflation in the medium term. Overall, the MPC is very likely to remain in a wait-and-see mode (to avoid writing more embarrassing letters to the Chancellor) until signs of falling inflation becomes more apparent.

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