



Economics Weekly

16 November 2009

Revisiting the UK inflation outlook

The ONS has outlined some proposed changes to the way mortgage interest payments are captured in the RPI

There have been some important developments on the UK inflation front recently. Firstly, the ONS has published a consultation document outlining proposed changes to the way mortgage interest payments are captured within the RPI. The changes, if implemented, could have important consequences for the volatility and profile of retail price inflation from early next year. Second, the Bank of England (BoE) recently published its latest Quarterly Inflation Report (QIR). The QIR outlines the MPC's updated views on gdp growth and consumer price inflation. In this Weekly, we examine these developments and assess their implications.

absolute difference, however, is 0.4 of a percentage point, largely due to the widening gap that has emerged over the past eighteen months as a result of the sharp fall in the SVR. Had the ONS moved to the new measure in June, annual RPI inflation would have been -0.4% rather than the -1.6% reported.

Looking ahead, if the change is implemented for the February 2010 RPI, the impact will depend on the relationship between the SVR and the AER at that time. At the moment our best guess is that the annual rates of both mortgage payment measures will converge over the coming months, as prior cuts in the SVR drop out of the annual comparison. If so, any change resulting from a move to the AER is likely to be modest, although we suspect there could be a slight upward revision. Further out, the impact will depend on the evolution of Bank Rate, mortgage spreads and swap rates (which are used to price fixed rate mortgages). If the swap curve flattens, as financial market forward rates suggest, the RPI is likely to be slightly lower than would otherwise be the case over the next two years.

The Bank of England Quarterly Inflation Report shows CPI inflation undershooting the 2% target...

Proposed change to RPI mortgage payments

In a recently published consultation document, the ONS's Consumer Price Advisory Committee (CPAC) has recommended that a different measure be used to more accurately capture the mortgage interest payments (MIPS) component of the RPI. Currently, MIPS are calculated solely on the Standard Variable Rate (SVR) and thus exclude the cost of fixed rate and tracker mortgages. To correct for this, the ONS is proposing to use a wider measure of mortgage interest, the Average Effective Rate (AER), which includes tracker and fixed rate mortgages. As chart a shows, the AER has generally been below the SVR in recent years, as the rates paid on fixed and tracker mortgages have tended to be lower than the SVR. Over the past eighteen months, however, the gap has reversed, as the unprecedented fall in Bank Rate has pulled the SVR down sharply.

It is not only the value of the RPI that would be impacted by the proposals, however. RPI inflation is also likely to be less volatile, as MIPS respond to changes in a wider range of mortgage interest rates. The volatility of the SVR is typically far higher than the AER (chart a). This is likely to remain the case over the coming years, particularly once Bank Rate starts to move higher.

...further stimulus cannot be ruled out

So what impact would changes in the way MIPS is calculated have on the RPI? Chart b shows annual RPI inflation and the outturns that would have prevailed if the AER had been used instead of SVR. Since 2005, the average difference between the two measures is relatively small at 0.1 of a percentage point. The average

For companies that have RPI-linked debt and/or receivables, the proposed changes could have important consequences for their cashflows. If the change is implemented from next February, companies could face the prospect of slightly lower, and potentially less volatile, annual RPI inflation over the medium term.

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Chart a: SVR versus AER

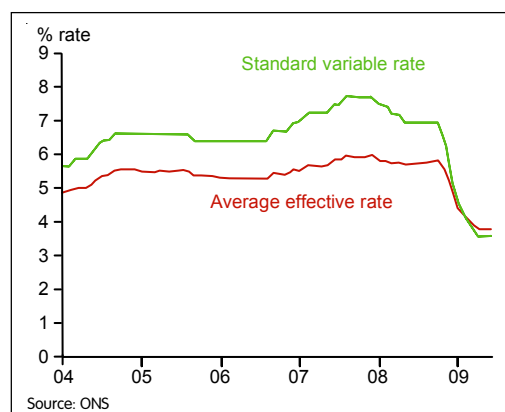
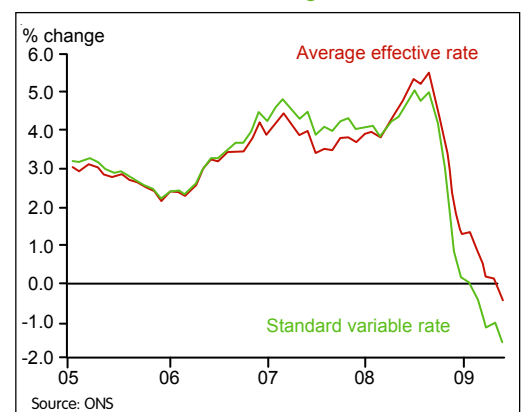


Chart d: Annual RPI inflation using different MIPS measures



2009/10 calendar of central bank meetings

European ECB (1.00%)

3 December, 14 February, 4 March, 8 April

US FOMC (0-0.25%)

16 December, 27 January, 16 March, 28 April

UK MPC (0.50%)

10 December, 7 January, 4 February, 4 March, 8 April

Rolling calendar of UK data releases and events

CPI inflation (17/11)
RPI inflation (17/11)
BoE MPC minutes (18/11)
Retail sales (19/11)
M4 money supply (19/11)
Public finances (19/11)
Business investment (24/11)

Rolling calendar of US data releases and events

Retail sales (16/11)
Producer prices (17/11)
TIC capital flows (17/11)
Industrial production (17/11),
CPI inflation (18/11)
Housing starts (18/11)
Q3 GDP (24/11)

* All charts are sourced to Lloyds TSB Corporate Markets Economic Research, Bloomberg, Bank of England and Thomson Datastream

Bank of England Inflation Report

From the BoE's perspective, the evolution of the RPI has little direct bearing on monetary policy, as the government's inflation target is the CPI, which excludes MIPS. From a policy perspective, the more important inflation development recently has been the publication of the BoE's latest Inflation Report. The Bank's updated CPI inflation projections are shown in chart c. Based on market interest rate expectations, the Bank expects CPI inflation to rise from 1.1% currently towards 3% early next year, driven higher by a reversal of the 2.5% percentage point VAT cut planned in January and base effects associated with higher petroleum inflation. Thereafter, however, CPI inflation is forecast to drop back, reaching a low of around 1.5% in late 2010, before drifting towards the 2% inflation target in two years' time.

The relatively weak profile of the Bank's CPI inflation rate over the medium term is reinforced by its perception of the balance of risks. The fan chart shows that over the period as a whole the distribution of risk is clearly skewed to the downside. The Bank's benign medium-term inflation assessment reflects its view that a persistent high level of spare capacity – encapsulated in a large output gap – will continue to bear down on price. The degree of spare capacity is already evident in the rise in unemployment and the marked decline in average earnings growth over the past two years.

Although the Bank cites persistent spare capacity as keeping inflation pressures at bay, its CPI projections are predicated on a surprisingly strong recovery taking hold. It expects output to rise by 2% in 2010 and by 4% in 2011. These projections are well above our own and the market consensus estimates, of 1.3% and 1.9%, and 0.7% and 2.3%, for 2010 and 2011, respectively. Although our gdp projections differ, we share the Bank's view that inflation is likely to rise above 2% over the coming months, before falling back towards the 2% target thereafter. Our profile for RPI and CPI inflation are shown in chart d.

Further stimulus cannot be ruled out

We believe that the pass through of the steep fall in sterling's exchange rate and the anticipated pick-up in demand to final prices will be slightly faster than the Bank is projecting. Thus, we arrive at a similar inflation forecast, but with a more modest assessment of the growth outlook. That said, given the Bank's upbeat gdp projections, one might conclude that there is ample scope for gdp growth, and presumably inflation, to undershoot its forecasts, potentially requiring further stimulus. What seems clear is that underlying inflation pressures are likely to remain benign for some time to come. Faced with this likelihood, BoE Governor King is right at this stage not to rule out the possibility of further quantitative easing next year. The financial markets are priced for a rise in UK Base Rate from the third quarter of 2010. Given the Bank's latest Inflation Report, such expectations could well be premature.

Adam Chester, Senior UK Macroeconomist

Chart c: BoE CPI inflation fan chart (based on market interest rates)

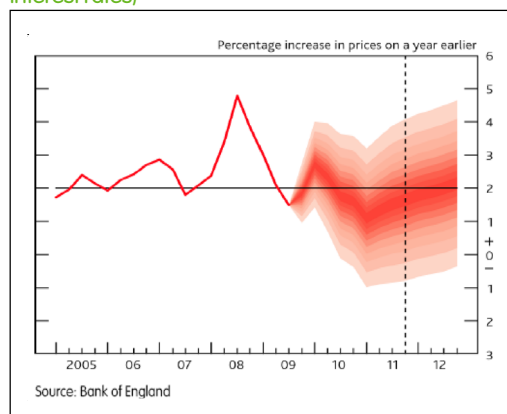
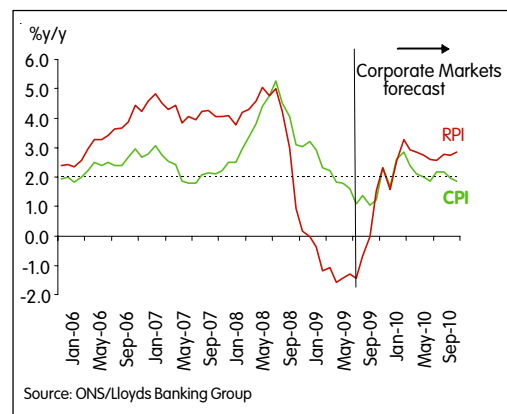


Chart d: CPI & RPI inflation projections



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Weekly economic data preview

16 November 2009

BoE MPC minutes to stay on message with Inflation Report, but watch out for the risk of a split vote

The key focus in the UK will be the publication of the MPC's minutes of the November policy meeting. Although the tone will draw heavily from the points already made in last week's Inflation Report, the debate ahead of the minutes will centre on whether the decision to extend the Asset Purchase Facility by £25bn was unanimous, or whether there was a split on the amount of expansion required. On balance, we think the risks are skewed towards a split vote on QE. On the data flow it's very much an inflation week, with October consumer price inflation figures published in the UK, the euro area and in the US. In terms of policy speeches, the week holds the potential for central bankers to shed more light on how the unwinding of unconventional monetary measures may play out over the coming months. There are three MPC, eight FOMC and seven ECB members scheduled to speak over the week.

- November's BoE MPC minutes are published on Wednesday. Outside of Quarterly Inflation Report (QIR) months, the minutes provide the best distillation of the Committee's views. But being a QIR month, the detail of the minutes usually become a little less important, though not this time. We do expect them to deliver the same message as the QIR, which itself suggested that Bank Rate is likely to remain at its record low for a prolonged period and that the door is far from closed for the prospect of further QE. However, there is the risk of a split vote on the degree of the extension to the Asset Purchase Facility (APF). There could well be a handful of members who voted for a larger extension than the majority vote of £25bn. Recall that on the previous occasion QE was extended (by £50bn in August), the Governor was out-voted on his desire to extend the APF by £75bn to £200bn. Developments since then mean the APF has grown to that level anyway, so it is not clear whether King will have been out-voted in a similar way again, especially as there are signs the economy will exit recession in the current quarter. However, should it transpire that he was out-voted again, the market reaction could be significant. On UK dataflow, the CPI for October is released and the first rise in the headline rate of inflation for eight months (to 1.6% from 1.1% in September) is expected. In a busy week for UK financial markets, other releases include the November CBI industrial trends report and October figures for public borrowing, retail sales and the first estimate of M4 supply.
- US figures this week are characterised by a mix of producer and consumer price data, alongside survey data from the Philadelphia Fed and the Empire manufacturing index. The headline CPI (Wednesday) is forecast to rise one basis point to -0.3% year-on-year in October and it may not be long before pressures further down the price chain gather momentum. Indeed, we expect producer price inflation (Tuesday) to have jumped by three-tenths to a -1.8% annual rate in October, the highest since February. There are eight FOMC members giving speeches, which may provide more colour on how the unwinding of unconventional policy measures could play out.
- In the Eurozone this week, we expect the final inflation reading for the region in October (published today) to be confirmed at -0.1% year-on-year, up two-tenths from the prior month. The German PPI data (Friday) are expected to show a three-tenths rise in factory price inflation to -7.3% year-on-year. In an otherwise light week for European data, ECB rhetoric is therefore taking centre stage, with speeches from seven of the Governing Council.

George Johns, UK Macroeconomist

Chart 1: Increases in CPI inflation on the cards across the regions

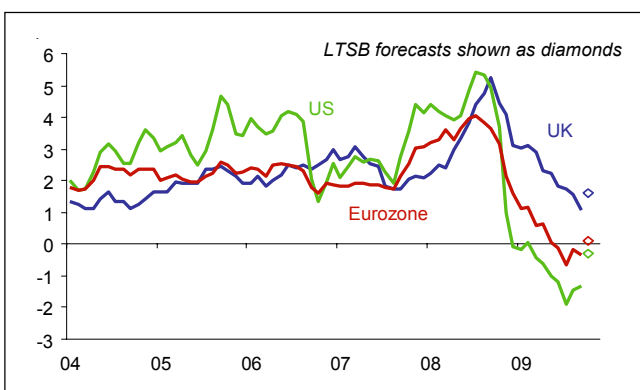
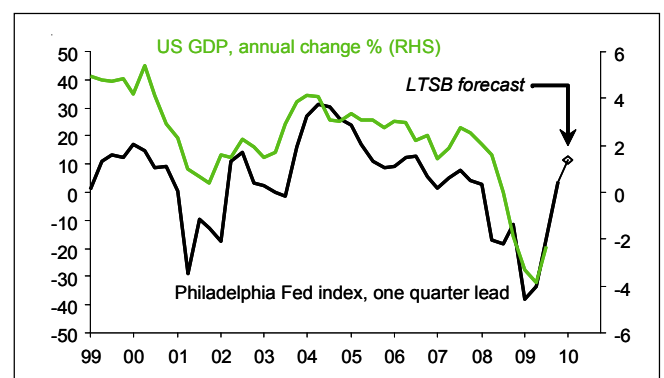


Chart 2: Philly Fed survey to signal a stronger US pick-up in Q4



16 - 20 November 2009

Country	Time	Event	Consensus	Forecast	Previous
Monday 16th					
UK	00:01	Rightmove House Prices (Nov)	n/a	n/a	2.8% (0.2%)
EC	10:00	Euro-Zone CPI (Oct)	0.3% (-0.1%)	0.3% (-0.1%)	0.0% (-0.3%)
CA	13:30	Manufacturing Sales (Sep)	1.3%	1.1%	-2.1%
US	13:30	Advance Retail Sales (Oct)	0.9%	1.0%	-1.5%
US	13:30	Retail Sales Less Autos (Oct)	0.4%	0.5%	0.5%
US	13:30	Retail Sales Ex Auto & Gas (Oct)	0.2%	n/a	0.4%
US	13:30	Empire Manufacturing (Nov)	28.50	29.00	34.57
US	15:00	Business Inventories (Sep)	-0.6%	-0.6%	-1.50%
JP	23:50	Tertiary Industry Index (Sep)	0.1%	0.1%	0.3%
Tuesday 17th					
UK	09:30	CPI (Oct)	0.1% (1.4%)	0.2% (1.6%)	0.0% (1.1%)
UK	09:30	Core CPI (Oct)	(1.8%)	(1.7%)	(1.7%)
UK	09:30	RPI (Oct)	0.1% (-1.0%)	0.4% (-0.7%)	0.4% (-1.4%)
UK	09:30	RPI Ex Mort Int.Payments (Oct)	(1.7%)	(1.6%)	(1.3%)
EC	10:00	Euro-Zone Trade Balance (Sep)	n/a	-5.0bn	-4.0bn
US	13:30	PPI (Oct)	0.5% (-1.7%)	0.4% (-1.8%)	-0.6% (-4.8%)
US	13:30	PPI Ex Food & Energy (Oct)	0.1% (1.4%)	0.1% (1.4%)	-0.1% (1.8%)
US	14:15	Net Long-term TIC flows (Sep)	n/a	n/a	28.6bn
US	14:15	Industrial Production (Oct)	0.3%	0.5%	0.7%
US	14:15	Capacity Utilization (Oct)	70.8%	70.8%	70.5%
US	18:00	NAHB Housing Market Index (Nov)	19	n/a	18
US	22:00	ABC Consumer Confidence	n/a	n/a	-46
Wednesday 18th					
AU	00:00	Westpac Leading Index (Sep)	n/a	n/a	1.1%
AU	00:30	Wage Cost Index (QoQ Q3)	0.7% (3.6%)	n/a	0.8% (3.8%)
EC	09:00	ECB Euro-Zone Current Account (Sep)	n/a	-0.3bn	-1.3bn
UK	11:00	U.K. CBI November Industrial Trends Total Orders (Nov)	n/a	n/a	-51
CA	12:00	CPI (Oct)	0.1% (0.2%)	0.1% (0.2%)	0.0% (-0.9%)
CA	12:00	Bank Canada Core CPI (Oct)	0.1% (1.8%)	0.1% (1.8%)	0.3% (1.5%)
US	12:00	MBA Mortgage Applications (Nov-13)	n/a	n/a	3.2%
US	13:30	CPI (Oct)	0.2% (-0.3%)	0.1% (-0.3%)	0.2% (-1.3%)
US	13:30	CPI Ex Food & Energy (Oct)	0.1% (1.6%)	0.1% (1.6%)	0.2% (1.5%)
US	13:30	Housing Starts (Oct)	598K	600k	590K
US	13:30	Building Permits (Oct)	580K	580k	573K
Thursday, 19th					
JN	04:30	All Industry Activity Index (Sep)	-0.1%	0.0%	0.9%
JN	05:00	Leading Index CI (final Sep)	n/a	n/a	86.4
JN	05:00	Coincident Index CI (final Sep)	n/a	n/a	92.5
UK	09:30	BoE Mortgage Approvals (Oct)	n/a	n/a	56K
UK	09:30	Retail Sales (Oct)	0.5% (2.9%)	0.6% (3.0%)	0.0% (2.4%)
UK	09:30	M4 Money Supply (Oct)	1.0% (9.9%)	1.5% (10.2%)	0.8% (11.6%)
UK	09:30	PSNCR (Oct)	4.0bn	4.0bn	19.4bn
UK	09:30	PSNB (Oct)	6.8bn	7.0bn	14.8bn
CA	13:30	Int'l Securities Transactions (Sep)	4.1bn	3.5bn	5.08bn
CA	13:30	Wholesale Sales (Sep)	0.4%	1.0%	-1.4%
CA	13:30	Leading Indicators (Oct)	n/a	n/a	1.1%

16 - 20 November 2009

Country	Time	Event	Consensus	Forecast	Previous
US	13:30	Initial Jobless Claims (w/e 14-Nov)	502k	504k	502k
US	13:30	Continuing Claims (w/e 7-Nov)	5620k	n/a	5631k
US	15:00	Leading Indicators (Oct)	0.4%	0.5%	1.0%
US	15:00	Philadelphia Fed. (Nov)	12.0	11.8	11.5
Friday 20th					
JN	-	BOJ Target Rate Decision	0.10%	0.10%	0.10%
GE	07:00	Producer Prices (Oct)	0.1% (-7.5%)	0.3% (-7.3%)	-0.5% (-7.6%)
Key data and events of the week					
Mon 16th	JN	BOJ Governor Masaaki Shirakawa to speak in Tokyo (00:30)			
	EC	ECB's Noyer speaks in Tokyo (08:15), Weber speaks at Euro Finance Weekl, Frankfurt (08:50), Tumpel-Gugerell speaks in Vienna (10:30), Quaden Speaks at Belgian Finance Forum Conference (16:00)			
	US	Fed Chairman Bernanke speaks to Economic Club of New York (17:15), Fed's Fisher speaks in Texas on U.S. Economy (18:15), Fed's Kohn speaks on Policy Challenges (23:15)			
	UK	BoE's Tucker speaks (08:15), Sentance speaks in London (18:00), DMO to Sell IL gilts 1.125% due 2037 (16-20 Nov)			
Tue 17th	EUR	ECB's Stark speaks on Financial Stability in Frankfurt (14:30), ECB's Tumpel-Gugerell speaks in Hamburg (16:00), ECB President Trichet speaks in Frankfurt (17:00)			
	US	Fed's Yellen speaks in Hong Kong (10:30), Lacker speaks on Economy in Virginia (15:15), Pinalto speaks in Ohio (17:30)			
	AUS	RBA publishes minutes of November monetary policy meeting (00:30)			
Wed 18th	EUR	Germany to sell EUR6bn 2-year bonds due 2011, ECB President Trichet Speaks in Frankfurt (08:40)			
	UK	Bank of England Releases Minutes of Interest Rate Decision (09:30)			
	US	Fed's Bullard to Speak on Economy in Missouri (14:15)			
Thu 19th	US	Fed's Plosser speaks in Singapore (04:45), Fed's Fisher Speaks at Cato Conference in Washington (21:45)			
	UK	BoE's Fishers speaks (09:20), Bank of England releases Trends in Lending Report (09:30),			
	EUR	France to sell up to EUR7.5bn Notes (10:00) & EUR1.2bn IL Bonds (11:00), ECB President Trichet speaks in Paris (16:00), Gonzalez-Paramo speaks in Berlin (18:00)			
	CA	Bank of Canada Governor Carney Speaks in New York (22:50)			
Fri 20th	JN	BOJ Target Rate Decision			
	EUR	ECB's Weber speaks in Frankfurt (08:00), ECB's President Trichet speaks in Frankfurt (10:30)			

Source: Bloomberg

NB: Data in brackets denotes YoY. Market consensus are as of preceding Friday.