



# Economics Weekly

1 February 2010

## Will the Bank of England extend Quantitative Easing?

The key decision at the February MPC meeting is not about interest rates, which we expect to remain on hold, but about QE...

...based on the objectives for QE when it started in March 2009 (of helping credit markets, boosting demand and raising money supply), it is not clear that it has been successful so far...

...however, we estimate that it has kept down gilt yields by around 80-90bps and probably prevented the economic downturn from being even worse

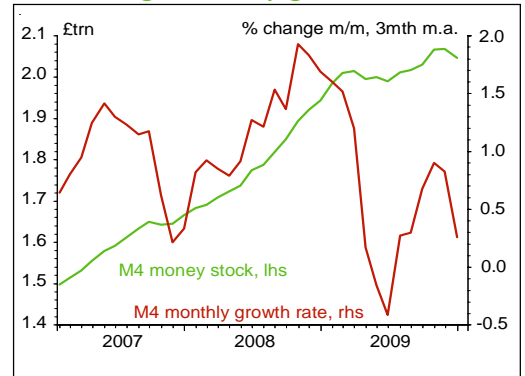
Therefore to withdraw QE when a recovery is not yet assured seems a risk too far

In the period since March 2009, the Bank of England's Asset Purchase Facility (APF) has bought £200bn of UK fixed income securities, £198 of gilts and £2bn of corporate bonds. This programme of asset purchases has now come to an end. Will the central bank renew it this week by asking the Treasury for permission to purchase more and get the balance sheet to do so or will it suspend the programme, arguing that its job is done? Chart a shows that the gilts purchased by the Bank of England amounted to more than the net amount issued by the Debt Management Office (DMO), and not far off the gross amount of £225bn.

That is not the only key decision the Monetary Policy Committee of the Bank of England will have to make this week. The other is to decide on what to do with the Bank Rate. Almost certainly, the decision will be to leave it at the current historic low of 0.5%, especially with the economy having expanded by just 0.1% in Q4 2009. So that is likely to be the easy decision and the financial markets expect no change in the Bank Rate. However, the decision about QE is likely to be much harder (entailing a split vote), as it is difficult to prove what it has done to help the economy and so whether it is still required or not. We look at some of the issues that will affect the MPC decision on QE at the February meeting this week.

First of all, however, what was the original intention of QE? In the May 2009 Inflation Report, this was given as: 'The objective of this policy is to boost money supply in the economy, ease conditions in corporate credit markets and, ultimately, to raise the growth rate of nominal demand and keep inflation on track to meet the inflation target in the medium term'. Let us look at each of those in turn,

Chart b: QE has not been successful in maintaining monetary growth

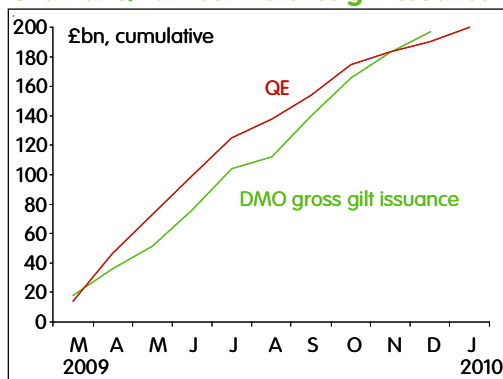


starting with money supply. Chart b shows that money growth is still easing back. Indeed, if securitisations are excluded there have been a few months when money stock has fallen. What about conditions in credit markets? Chart c shows that the cost of borrowing for companies has come down sharply, and that is the case from the lowest rated borrower to the highest. Thirdly, using nominal growth in overall UK gdp shows that demand conditions in the economy are less bad, but still falling in year-on-year terms, see chart d. The MPC noted last year that it expected the stimulus from QE to take many months to appear in published data of final expenditure in the economy but, with only a rise of 0.1% in Q4 gdp, weak demand conditions clearly persist.

The May 2009 Inflation Report also said that: 'The MPC will also continue to pay close attention to measures of inflation expectations, and in particular whether measures of inflation expectations remain consistent with the 2% inflation target.' Interestingly, the index linked gilt yield suggests that inflation expectations remain low and well anchored, despite the rise in annual headline CPI to 2.9% in December 2009 and the widely accepted view that it will accelerate further above 3% in the months ahead before declining later in 2010. In short, despite the worry that QE has injected additional inflation tendencies into the economy, inflation expectations appear not to be troubled. However, headline CPI is well above the 2% target level.

Overall, these indicators suggest that the asset purchase programme has had some impact in improving credit conditions for companies, but has not yet arrested the weakness of domestic

Chart a: QE almost matches gilt issuance



### Editorial comments to:

Trevor Williams  
Chief Economist  
Lloyds TSB Corporate Markets  
Economic Research  
10 Gresham Street  
London, EC2V 7AE  
Tel: +44 (0)20 7158 1748

## 2010 calendar of central bank meetings

**European ECB** (1.00%)  
4 February, 4 March, 8 April, 6 May, 10 June  
**US FOMC** (0-0.25%)  
16 March, 28 April, 23 June  
**UK MPC** (0.50%)  
4 February, 4 March, 8 April, 6 May, 10 June

## Rolling calendar of UK data releases and events

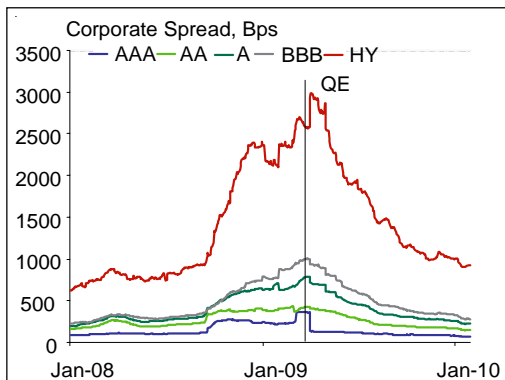
Mortgage approvals (01/02)  
PMI manufacturing (01/02)  
PMI services (03/02)  
Producer prices (05/02)  
Trade balance (09/02)  
Industrial production (10/02)  
BoE Inflation Report (10/02)  
CPI inflation (16/02)  
BoE MPC minutes (17/02)

## Rolling calendar of US data releases and events

Core PCE deflator (01/02)  
ISM manufacturing (01/02)  
ADP employment (03/02)  
ISM services (03/02)  
Factory orders (04/02)  
Non-farm payrolls (05/02)  
Unemployment (05/02)  
Consumer credit (05/02)

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

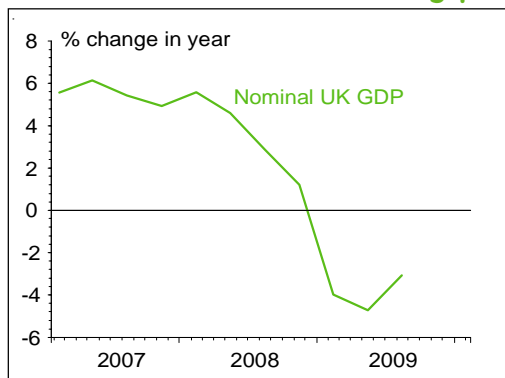
## Chart c: QE has been successful in improving corporate credit conditions



demand or the fall in money supply and is not adversely impacting market inflation expectations. Many argue that for growth in nominal gdp to be stable around its long run trend (5% pa), growth in the broad measure of M4 will have to be between 5-7% a year. The chart shows that growth in M4 is falling sharply.

How do these trends play into the decision at the February MPC meeting on whether to extend QE or not? On balance, only one of the aims of QE identified by the MPC in the May 2009 Inflation Report seems to have improved, corporate credit quality. All of the others appear to be as bad or worsening. What will ending QE do the economy? One way of assessing that is to estimate what impact it has had on the 10-year gilt yield. Our model for this is based on US 10yr treasury yields, UK gdp, UK RPIX, UK 3m Libor, UK debt/gdp ratio and a dummy variable for QE.

## Chart d: QE has not boosted nominal gdp



## Chart e: Our model shows that QE has kept down gilt yields by 80-90bps

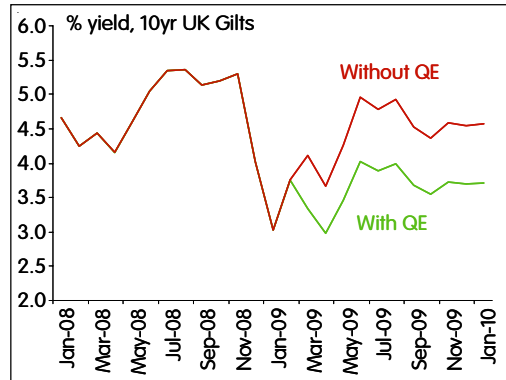


Chart e shows the model's estimate of gilt yield with and without QE. The difference is 80-90bps, i.e. gilt yields would be 80-90bps higher if the BoE had not done QE (this assumes other variables in the equation are unchanged). Moreover, this estimate is likely to be an underestimate of the effect of QE, as it has helped induce confidence in credit markets and in equity markets which is not measured here. Our estimate is in line with recent calculations from the IMF that found QE in the UK had kept down the yield curve by 40 to 100 basis points.

This then raises the question of whether the MPC would want to see the cost of longer term funding rise by this amount at this time. Our view is that they will want to avoid this eventuality. The DMO will be selling a gross £213bn of gilts in 2010/11 and £195bn in 2011/12. This is a lot for the private sector to absorb at a time when recession is not yet conclusively over. As a result, the MPC is likely to continue QE and ask for permission from the Treasury to do so. This may not entail buying bonds in exactly the same amounts or manner as in recent months, but to give up this source of monetary flexibility at this stage of the economic cycle seems to us to be very risky, and could possibly lead to the very 'double-dip' that the monetary authorities want to avoid.

**Trevor Williams, Chief Economist  
Corporate Markets**

### Customer sales

**Andrew Willett**

+44 (0)20 7158 1616  
andrew.willett@lloydstsb.co.uk

**Kathryn Ball**

+44 (0)20 7158 1672  
kathryn.ball@lloydstsb.co.uk

### Credit Distribution

**Martin Bates**

+44 (0)20 7158 1983  
martin.bates@lloydstsb.co.uk

### Commercial sales

**Matt Lawrence**

+44 (0)20 7158 1661  
matthew.lawrence@lloydsbanking.com

### Wealth product sales

**Andrew Evans**

+44 (0)20 7158 1691  
andrew.evans@lloydstsb.co.uk

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## Weekly economic data preview

1 February 2010

### Knife-edge MPC decision to take centre stage

- The MPC makes its announcement on whether or not to extend the Bank of England's Asset Purchase Facility (APF) this Thursday. Since the quantitative easing programme was implemented in March last year, changes to the size of the APF have only been made in quarterly Inflation Report months when a comprehensive assessment is conducted. Financial markets therefore see this week's decision as pivotal. Since the MPC's November assessment, GDP has been significantly weaker than expected, with 0.1% growth in Q4 four times smaller than the expectation implied by the Inflation Report projection. The composition of growth was also disappointing, driven predominantly by a boost from government services output and the car scrappage scheme, rather than underlying private sector strength. The lower starting point for the growth projections in February's Inflation Report will increase the chances of an undershoot of the 2% inflation target at the two-year horizon, assuming Bank Rate and the APF are unchanged. Although Q4 CPI inflation was 0.2 percentage points higher than the Bank's forecast, this is more a reflection of unfavourable energy base effects and the impact of past sterling weakness on imported inflation. More significant is the sheer magnitude of the output gap which has opened up during the recession, which will put substantial downward pressure on domestically generated inflation. The MPC is therefore likely to look through a temporary inflation spike in Q1 and remain focused on the potential for a medium-term undershoot of the inflation target. Our central view is therefore that the MPC will vote for a £25bn extension to the APF, but we would not rule out the possibility of further increases over the course of the year. It's likely to be a close call, with a split vote. Ahead of the MPC decision, there is plenty of UK data to pore over, with the release of personal borrowing figures, the PMIs (which are expected to be broadly unchanged) and PPI data, where factory gate price inflation is expected to tick higher on import price pressures.
- This week sees a very busy US economic data calendar, with January's non-farm payrolls topping the bill. Last month's December payroll data was disappointing (-85k), while the Federal Reserve has noted that although the pace of lay-offs seems to be slowing, few firms are actually hiring. Our own forecast stands at +30k, with an unemployment rate of 9.9%, down from 10% in December. The ADP employment survey for January is also released this week (on Wednesday). January's ISM surveys are also published, where we look for a pick-up in the pace of manufacturing expansion to 55.5 from 54.9 previously. Within services, we expect a return to growth with a reading of 51.5 from 49.8. Finally, on Thursday, we get an indication of unit labour cost pressures. These have been declining recently reflecting the productivity gains associated with economic growth. Our projection stands at -2.2% in the year to Q4.
- In many ways, recent euro-zone economic data releases have been superseded by continuing concerns in financial markets about public finances in the so-called peripheral euro-zone countries, especially Greece and Portugal. Greece needs a decisive, durable, fiscal consolidation plan together with far greater transparency in the publication of official data. Importantly, there will be a review of Greece's fiscal plans at February's Ecofin meeting. Highlights in the euro-zone this week include final January PMI readings for manufacturing and services, along with December retail sales and producer prices. For the manufacturing PMI, we look for a small upward revision to 52.1, partly reflecting an improvement in the Italian index, to 51.5 from 50.8 previously. In services, we look for an unchanged reading of 52.3. In terms of national economic data releases, German December factory orders data are scheduled for Thursday, while industrial output figures are published on Friday, where we look for an outturn of +0.5% month-on-month.

George Johns (UK Macroeconomist), Mark Miller (Global Macroeconomist)

Chart 1: US labour market on the turn...

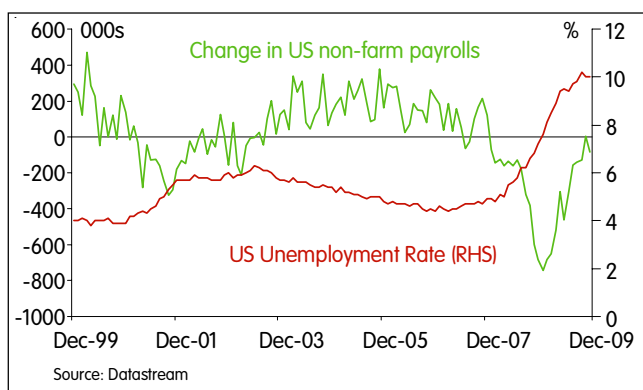
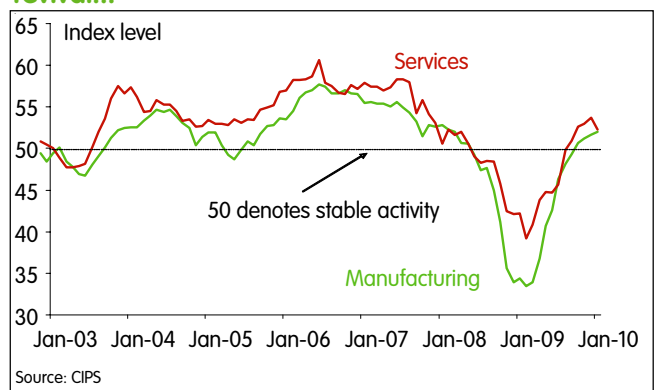


Chart 2: Euro PMI surveys still suggest economic revival...





## 1 - 5 February 2010

Country	Time	Event	Actual	Consensus	Forecast	Previous
<b>Mon 1st</b>						
00:30	AU	House price index (Q4)		3.50% (11.00%)	n/a	4.20% (6.20%)
01:00	CH	PMI manufacturing (Jan)		56.5	n/a	56.6
07:45	FR	Producer prices (Dec)		0.1% (-3.0%)	0.0% (-3.1%)	0.20% (-4.50%)
08:50	FR	PMI manufacturing (Jan F)		54.7	54.7	54.7
08:55	GE	PMI manufacturing (Jan F)		53.4	53.4	53.4
09:00	EC	PMI manufacturing (Jan F)		52.0	52.1	52.0
09:30	UK	Net consumer credit (Dec)		-0.5B	-0.4B	-0.4B
09:30	UK	Net lending sec. on dwellings (Dec)		1.5B	1.6B	1.5B
09:30	UK	Mortgage approvals (Dec)		61.4K	62.0k	60.5K
09:30	UK	M4 money supply		n/a	n/a	-1.10% (6.40%)
09:30	UK	PMI manufacturing (Jan)		53.9	54.0	54.1
13:30	US	Personal income (Dec)		0.30%	0.30%	0.40%
13:30	US	Personal spending (Dec)		0.30%	0.20%	0.50%
11:30	US	PCE core		0.10% (1.50%)	0.10% (1.50%)	0.00% (1.40%)
15:00	US	ISM manufacturing		55.6	55.5	55.9
23:50	JN	Monetary base (Jan)		n/a	n/a	(5.20%)
<b>Tue 2nd</b>						
01:30	JN	Labor cash earnings (Dec)		n/a	n/a	(-2.80%)
03:30	AU	RBA cash target (3 Feb)		4.00%	4.00%	3.75%
07:00	GE	Retail sales (Dec)		1.00% (-2.40%)	0.80% (-2.60%)	-1.10% (-2.80%)
09:30	UK	PMI construction (Jan)		47.2	47.0	47.1
10:00	EC	PPI (Dec)		0.00% (-3.10%)	0.00% (-3.10%)	0.10% (-4.40%)
15:00	US	Pending home sales (Dec)		0.60%	2.00%	-16.00%
22:00	US	ABC consumer confidence (31 Jan)		n/a	n/a	-48
<b>Wed 3rd</b>						
00:01	UK	Nationwide consumer confidence (Jan)		70	70	69
00:30	AU	Trade balance (Dec)		-2400M	-2400M	-1700M
08:50	FR	PMI services (Jan F)		57.0	57.0	57.0
08:55	GE	PMI services (Jan F)		51.2	51.2	51.2
09:00	EC	PMI services (Jan F)		52.3	52.3	52.3
09:30	UK	PMI services (Jan)		56.5	56.5	56.8
09:30	UK	Official reserves (changes) (Jan)		n/a	n/a	-\$1603M
10:00	EC	Retail sales (Dec)		0.40% (-2.40%)	0.20% (-2.60%)	-1.20% (-4.00%)
12:00	US	MBA mortgage applications (29 Jan)		n/a	n/a	-10.90%
12:30	US	Challenger job cuts (Jan)		n/a	n/a	(-72.90%)
13:15	US	ADP employment change (Jan)		-40K	-25k	-84K
15:00	US	ISM non-manf composite (Jan)		51.0	51.5	50.1
<b>Thur 4th</b>						
00:30	AU	Retail sales (Dec)		0.20%	0.20%	1.40%
11:00	GE	Factory orders (Dec)		0.00% (9.50%)	n/a	2.80% (4.50%)
12:00	UK	BoE interest rate decision		0.50%	0.50%	0.50%
12:00	UK	BoE asset purchase target		200B	225B	200B
12:45	EC	ECB announces interest rates		1.00%	1.00%	1.00%
13:30	CA	Building permits (Dec)		3.00%	3.50%	-4.60%
13:30	US	Nonfarm productivity (Q4 P)		5.20%	5.50%	8.10%
13:30	US	Unit labor costs (Q4 P)		-2.10%	-2.20%	-2.50%
13:30	US	Initial jobless claims (30 Jan)		460K	460k	470K



## 1 - 5 February 2010

Country	Time	Event	Actual	Consensus	Forecast	Previous
13:30	US	Continuing claims (23 Jan)		n/a	n/a	4602K
15:00	CA	Ivey purchasing managers index (Jan)		51.8	52.0	48.4
15:00	US	Factory orders (Dec)		0.90%	1.20%	1.10%
<b>Fri 5th</b>						
05:00	JN	Leading index CI (Dec P)		93.5	93.5	90.7
05:00	JN	Coincident index CI (Dec P)		97.3	97.3	96
07:45	FR	Trade balance (euros) (Dec)		n/a	n/a	-5.3B
09:30	UK	PPI input (Jan)		0.80% (6.60%)	0.80% (6.50%)	0.10% (6.90%)
09:30	UK	PPI output (Jan)		0.30% (3.70%)	0.30% (3.70%)	0.50% (3.50%)
09:30	UK	PPI output core (Jan)		0.30% (2.60%)	0.20% (2.50%)	0.70% (2.60%)
11:00	GE	Industrial production (Dec)		0.40% (-3.80%)	0.50% (-3.70%)	0.70% (-8.00%)
12:00	CA	Unemployment rate (Jan)		8.50%	8.50%	8.50%
13:30	US	Change in nonfarm payrolls (Jan)		20K	30k	-85K
13:30	US	Unemployment rate (Jan)		10.00%	9.90%	10.00%
13:30	US	Change in manufact. Payrolls		-23K	-20k	-27K
13:30	US	Average hourly earnings (Jan)		0.20% (2.20%)	0.20% (2.20%)	0.20% (2.20%)
20:00	US	Consumer credit (Dec)		-\$9.5B	-\$12.0B	-\$17.5B

**Key events of the week**

<b>Mon 1st</b>	US	Treasury's Geithner testifies to Senate Fin. Committee (15:00)
<b>Tue 2nd</b>	JN	10-year bond auction (03:45)
	UK	GBP3.75bn 5.25% 2012 gilt auction (10:30)
	PO	ECB's Constancio, Portugal's Teixeira dos Santos at Conference (09:00)
<b>Wed 3rd</b>	GE	EU6bn 5-year bond auction (10:15)
	UK	GBP3.0bn 5% 2018 gilt auction (10:30)
	CA	10-year note auction (17:00)
	US	Fed's Warsh speaks to N.Y. Association for Business Economics (17:00)
<b>Thu 4th</b>	UK	BoE announces rates (12:00), BoE monetary policy committee decision (12:00)
	EC	ECB announces interest rate decision in Frankfurt (12:45), Trichet speaks at ECB monthly news conference (13:30)
	CA	Bank of Canada Governor Mark Carney Speaks in Winnipeg (18:30)
<b>Fri 5th</b>	AU	Reserve Bank quarterly monetary policy statement (00:30)
	US	Treasury's Geithner attends G-7 meeting in Iqaluit, CA (17:00), Fed's Bullard speaks at Washington Uni. in St. Louis (22:15)

Source: Bloomberg

NB: Data in brackets denote YoY. Market consensus estimates are taken the preceding Friday.