ARBUTHNOT BANKING GROUP PLC

PERSPECTIVES

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MPC expected to increase Bank rate to 1.0% in May despite recessionary concerns over tighter policy

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Introduction: the MPC expected to raise the Bank Rate again…

At their March meeting (announcement on 17 March 2022), MPC members voted to raise Bank Rate from 0.5% to 0.75%, as expected.[1-2] The vote was 8/1 in favour, with John Cunliffe voting to leave the Bank Rate unchanged at 0.5%. This followed an increase from 0.25% to 0.5% in February and from 0.1% to 0.25% in December.

Significantly, the MPC adopted a more dovish tone concerning monetary tightening in March than in February. In March, based on their current assessment of the economic situation, they "…judged that some further modest tightening in monetary policy may be appropriate in the coming months, but there are risks on both sides of that judgement depending on how medium-term prospects for inflation evolve. The MPC will review developments in the light of incoming data and their implications for medium-term inflation, including the economic implications of recent geopolitical events, as part of its forthcoming forecast round ahead of the May 2022 Monetary Policy Report". In contrast, in February the MPC judged that, if the economy developed broadly in line with the February Report central projections, "some further modest tightening in monetary policy is likely to be appropriate in the coming months", so, in saying that "some further tightening in monetary policy may be appropriate in the coming months" there was a clear change in tone towards the dovish in March.

Moreover, Bank Governor Andrew Bailey has projected a somewhat cautious tone about further rate hikes recently. He was reported as saying on 21 April that the Bank was concerned about triggering a recession by raising rates too quickly in its attempt to control inflation.[3-5] Speaking at the Peterson Institute for International Economics in Washington, Mr Bailey said "…we are in a period of unprecedentedly large shocks. We've had shock after shock after shock – we've come out of the Covid period and now we're faced with the appalling things that Russia is doing in Ukraine. We are walking a very tight line between tackling inflation and the output effects of the real income shock, and the risk that that could create a recession and push us too far down in terms of inflation". Moreover, concerning the inflationary outlook, he said he expected cost pressures (relating, in particular, to high gas prices) driving higher inflation would come back under control in time. He said "…I do expect energy prices will revert to more normal levels, history tells us that".

So there has to be some doubt that the MPC will raise the Bank Rate (from 0.75% to 1.0%) at its May meeting (announcement 5 May). But, on the whole, expectations are still for such an increase.

…and there will be revisions to the economic forecasts

There were no formal revisions to the Bank's forecast at the March meeting, but the MPC minutes did comment on recent economic developments. In particular, they said:

- Developments since the February Report were likely to accentuate both the peak in inflation and the adverse impact on activity by intensifying the squeeze on household incomes. (Note that March's retail sales were disappointing (see below).)
- Regarding inflation, the invasion of Ukraine by Russia had led to further large increases in energy and other commodity prices including food prices. CPI inflation had risen to 5.5% YOY in January and inflation was expected to increase further in coming months, to around 8% in 2022Q2, and perhaps even higher later this year. The projected overshoot of inflation relative to the 2% target reflected global energy prices to an increasing extent. Note that CPI inflation picked up to 7.0% in March.[6-7]
- If sustained, the latest rise in energy futures prices meant that Ofgem's utility price caps could again be substantially higher when they are reset in October 2022. This could temporarily push CPI inflation around end-2022 above the level projected for April, possibly into double-digits, which was previously expected to be the peak.
- Turning to economic activity, they noted that consumer confidence had fallen in response to the squeeze on real household disposable incomes. That impact on real aggregate income was now likely to be materially larger than implied by the projections in the February Report, consistent with a weaker outlook for growth and employment, other things being equal.

There will be revised forecasts for the May meeting, and it can be expected there will be further upward revisions to the inflation forecasts and further downgrades to the GDP forecasts. For the record, the February projections are shown in table 1. It is unlikely the announcements made in the Chancellor's Spring Statement (23 March) would materially affect the forecast.

Table 1 Bank of England: forecast, YOY (%), unless otherwise indicated

	2021	2022	2023	2024	2025
GDP	7¼	3¾	1¼	1	…
Unemployment rate (%), Q4	4	4	4½	5	…
CPI inflation (YOY, %), Q4	5	5¾	2½	1¾	…
Household consumption	5¾	5½	1½	1¼	…
Household saving ratio (%)	10¾	4¾	4	4¼	…
Average weekly earnings (YOY, %), Q4	4	3¾	3	2¼	…
Bank Rate (%), Q1	…	0.4	1.3	1.4	1.3

Source: *Bank of England*, "Monetary Policy Report, February 2022", 3 February 2022. The table includes the path for Bank Rate implied by forward market interest rates.

UK data: disappointing retail sales in March…

There have been some interesting UK data releases over the past fortnight. Firstly, retail sales volumes fell, somewhat disappointingly, by 1.4% (MOM) in March, after a fall of 0.5% (revised from 0.3%) in February.[8] Even so, they were still 2.2% above their pre-coronavirus February 2020 levels. And they were 0.9% higher YOY. In 2022Q1 retail sales decreased by 1.0% (QOQ) but were 5.4% higher (YOY).

The largest contribution to the fall came from non-store retailing in which sales volumes fell by 7.9% (MOM) following a fall of 6.9% in February. However, despite these declines, sales volumes were still a robust 20.3% above their pre-coronavirus February 2020 levels. Food store sales volumes fell by 1.1% (MOM) in March and have fallen each month since November 2021. Higher spending in pubs and restaurants linked to reduced coronavirus restrictions, as well as the impact of rising food prices on the cost of living are possible factors for reduced spending in food stores. Automotive fuel sales volumes fell by 3.8% (MOM) in March with other data sources indicating that some non-essential road travel had been

reduced following record high petrol and diesel prices. Non-food store sales volumes rose by 1.3% (MOM) reflecting growth in other non-food stores (2.9%), and household goods stores (2.6%) such as DIY stores.

The proportion of retail sales online fell to 26.0% in March 2022, its lowest proportion since February 2020 (22.7%), continuing a broad downward trend since its peak in February 2021 (37.1%).

…and a slowdown in Markit's April PMIs…

The latest Markit indicators suggested that there was some overall slowdown in activity in April, centred on the services sector, but manufacturing output seemed to improve.[9] The Markit/CIPS flash UK Composite Output Index fell to 57.6 in April, after March's 60.9, a 3-month low. Significantly, there was widespread concern about rising inflationary pressures and survey respondents noted that the cost-of-living crisis and economic uncertainty arising from the war in Ukraine had impacted client demand.

Concerning the component indices:

- The Markit/CIPS flash UK Services Business Activity Index was 58.3 in April, compared with March's 62.6. The loss of momentum in the service economy was the largest in any month since Omicron hit business activity across the sector at the end of 2021. Providers experienced a considerable loss of momentum as the pass-through of escalating costs offset the boost to consumer spending from the ending of COVID19 restrictions.
- The Manufacturing Output Index picked up to 53.8 in April, after March's 51.8. Goods producers suggested that efforts to work through backlogs and fewer supplier delays were the main positive influences on production schedules. The latest lengthening of supplier lead times was the smallest since October 2020, despite widespread reports citing bottlenecks related to the war in Ukraine, ongoing ports congestion and lockdowns in China. Manufacturers faced a headwind to order books from rising output charges, with the latest increase in factory gate prices by far the fastest on record.
- Note the wider manufacturing PMI was little changed at 55.3 in April (after March's 55.2). (The manufacturing PMI is a weighted average of new orders, output, employment, suppliers' delivery times, and stocks of purchases.)

Chris Williamson, Markit's Chief Business Economist, said "…while the start of the year saw businesses in high spirits amid the reopening of the economy, this ebullient mood is being eroded by concerns about the rising cost of living, the Russia-Ukraine war, lingering pandemic disruptions and rising interest rates."

…and public borrowing for full year FY2021

Before looking at the full financial year data, it is worth recording that public sector net borrowing (PSNB-ex, excluding public sector banks) in March 2022 was £18.1bn, the second-highest March borrowing since monthly records began in 1993, compared with £26.8bn in March 2021, £8.8bn (rounding) less borrowing.[10] The PSNB in pre-pandemic March 2020 was, however, only £6.2bn, some £11.9bn less than in March 2022. Borrowing, therefore, remains high by historical standards.

Turning to the full financial year data the PSNB for FY2021 totalled £151.8bn, around 6.4% of GDP and the third-highest FY borrowing since records began in FY1946 (FYE March 1947). This compared with £317.6bn in record-breaking FY2020, some £165.8bn lower.

The OBR had forecast a total PSNB of £127.8bn for FY2021 for the Chancellor's Spring Statement of 23 March, some £24.0bn lower than the ONS's first estimate.[11-12] But the ONS pointed out that the OBR had made allowance for some policy changes, not least of all the changes to the student finance system in England. These changes are not yet reflected in the public sector statistics but, presumably, will be when there are some firm estimates. They can be expected to lower the borrowing estimate for FY2021 closer to the OBR's projection. The OBR had also estimated that a reduction on calls on the government's coronavirus loan guarantee schemes would reduce net borrowing by £4.4bn in FY2021, which are not yet included by the ONS. The ONS "will include any impact arising from a change in expectations when sufficiently reliable data become available".[13]

The CGNB was £162.2bn in FY2021, compared with £330.5bn in FY2020 (table 2 below):

- CG receipts were £830.0bn in the FY2021, £105.3bn more than in FY2020, of which tax receipts were £619.9bn, an increase of £94.3bn.
- CG current (or day-to-day) expenditure was £893.3bn in the FY2021, £50.3bn less than in FY2020, with a reduction of £67.4bn in subsidies being partially offset by a £30.5bn increase in debt interest payments. The recent high levels of debt interest payments are largely a result of movements in the Retail Prices Index (RPI) to which index-linked gilts are pegged. In FY2021, debt interest was £69.9bn, the highest financial year value on record. The RPI uplift on index-linked gilts was £34.7bn over and above the accrued coupon payments and other components of debt interest.
- Within total CG spending, net investment was £67.0bn (£80.8bn in FY2020).

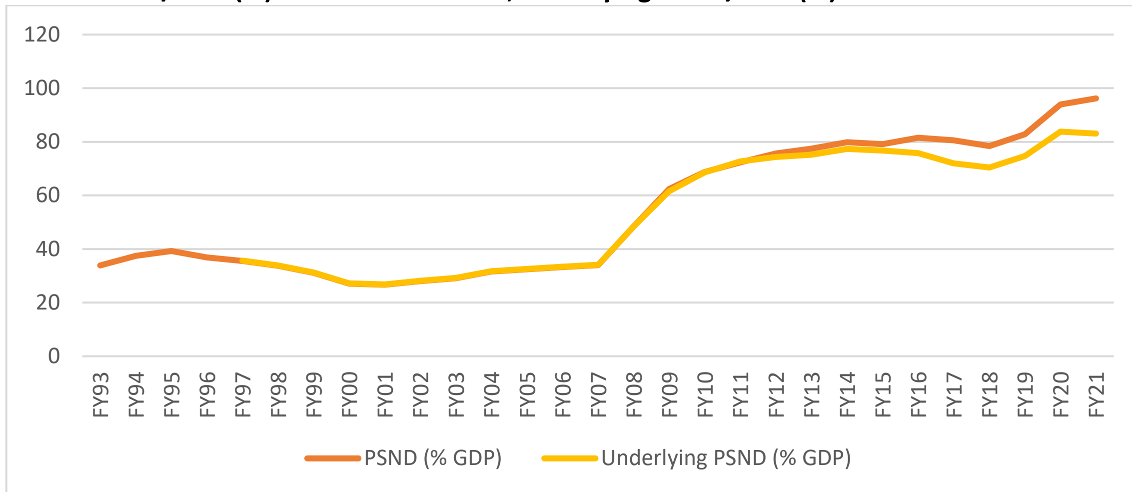
Table 2 PSNB and main components, FY2020 and FY2021 (£bn)

	FY2020	FY2021	Change
PSNB, of which:	317.6	151.8	-165.8
CGNB	330.5	162.2	-168.2
CG receipts, of which:	724.7	830.0	105.3
Tax receipts, of which (selected):	525.6	619.9	94.3
VAT	137.7	162.6	25.0
Fuel duty	20.9	25.9	5.0
Stamp duty	9.5	15.4	5.9
PAYE income tax	168.5	191.0	22.5
Corporation tax	55.1	65.3	10.2
CG spending, of which:	1,055.2	992.2	-62.9
Current expenditure, of which (selected):	943.6	893.3	-50.3
Debt interest	39.4	69.9	30.5
National Insurance Fund Benefits	112.2	114.6	2.3
Social assistance	121.4	119.3	-2.2
Procurement	199.7	198.9	-0.8
Pay	154.3	167.0	12.7
Transfers to local government	149.8	131.2	-18.6
Contributions to EU	10.9	0	-10.9
Subsidies (including CJRS, SEISS, other)	117.9	50.5	-67.4
Depreciation	30.8	32.0	1.2
Net investment	80.8	67.0	-13.8

Source: *ONS*, "Public sector finances: March 2022", 26 April 2022.

Concerning the other key metrics, public sector net debt (excluding public sector banks, PSND ex) at end-March 2022 was £2,343.8bn or around 96.2% of gross domestic product (GDP), reaching levels not seen since the early 1960s. The targeted "underlying" public sector net debt excluding public sector banks and the Bank of England (PSND ex BoE) was £2,025.1bn at end-March 2022 or around 83.1% of GDP (chart 1). The Bank of England's (BoE's) contribution to debt is largely a result of its quantitative easing activities via the Bank of England Asset Purchase Facility Fund (APF) and Term Funding Scheme (TFS).

Chart 1 PSND/GDP (%) for FY1993-FY2021, underlying PSND/GDP (%) for FY1997-FY2021



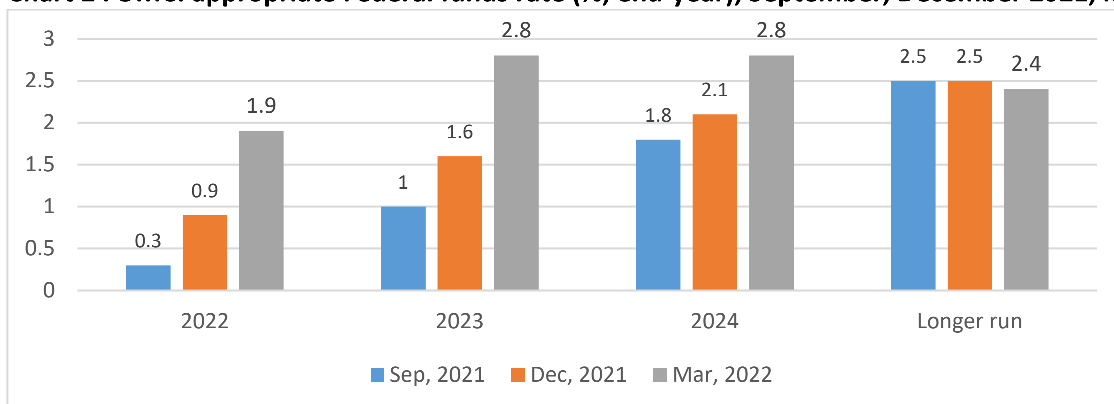
Source: *ONS*, "Public sector finances: March 2022", 26 April 2022, table PSA1 (underlying data available from FY1997). Data revisions from FY2019.

The Fed is expected to raise rates again

The Fed is also expected to raise rates further at their May meeting (announcement on 4 May), though there do not seem to be any of the type of reservations that were expressed by Andrew Bailey (see above). On the contrary Fed Chairman Jerome Powell told an IMF meeting on 21 April that a double rate rise will be under consideration next month. "It is appropriate in my view to be moving a little more quickly" to raise interest rates, Powell said while part of an IMF panel. "I also think there is something to be said for front-end loading any accommodation one thinks is appropriate. ...I would say 50 basis points will be on the table for the May meeting."[14-15] If there is a 50bp increase then the federal funds target range would be lifted to 0.75%-1.0%. It should, however, be noted that GDP contracted 1.4% (annualised) in 2022Q1, but the fall reflected a surge in imports combined with falling exports and, as such, the contraction is unlikely to significantly influence the Fed's May meeting.[16]

At its March (announcement on 16 March) meeting the Fed raised the federal funds target range to 0.25-0.5% (from 0.0%-0.25%).[17-18] Significantly, at the March meeting the Fed increased the projected appropriate policy path for the federal funds rate substantially. The appropriate rate was assessed to be 1.9% by end-2022 in March (0.9% in December), 2.8% by end-2023 (1.6% in December) and 2.8% by end-2024 (2.1% in December), see chart 2. In March 2021 the appropriate federal funds rate was projected to remain at 0.1% until end-2023.

Chart 2 FOMC: appropriate Federal funds rate (%, end-year), September, December 2021, March 2022



Source: *FOMC*, "FOMC projections materials: the summary of economic projections (SEP)", 15 December 2021, and previous, median estimates. See annex table 1. These are the economic projections of Federal

Reserve Board members & Federal Reserve Bank presidents under their individual assessments of projected appropriate monetary policy.

The IMF downgrades prospects…

In their April *World Economic Outlook* forecast, the IMF struck a downbeat tone.[19] They concluded that "…the war in Ukraine has triggered a costly humanitarian crisis that demands a peaceful resolution. Economic damage from the conflict will contribute to a significant slowdown in global growth in 2022. A severe double-digit drop in GDP for Ukraine and a large contraction in Russia are more than likely, along with worldwide spill-overs through commodity markets, trade, and financial channels". The IMF noted that the war will not just reduce growth, it will also add to inflation. "Fuel and food prices have increased rapidly… (whilst) elevated inflation will complicate the trade-offs central banks face between containing price pressures and safeguarding growth. Interest rates are expected to rise as central banks tighten policy, exerting pressure on emerging market and developing economies. Moreover, many countries have limited fiscal policy space to cushion the impact of the war on their economies".

In geo-political terms the IMF commented "…the invasion has contributed to economic fragmentation as a significant number of countries sever commercial ties with Russia and risks derailing the post-pandemic recovery. It also threatens the rules-based frameworks that have facilitated greater global economic integration and helped lift millions out of poverty. In addition, the conflict adds to the economic strains wrought by the pandemic. Although many parts of the world appear to be moving past the acute phase of the COVID-19 crisis, deaths remain high, especially among the unvaccinated. Moreover, recent lockdowns in key manufacturing and trade hubs in China will likely compound supply disruptions elsewhere".

Specifically, global growth is now expected to be 3.6% in 2022, compared with 4.4% in January (table 3).

Turning to country-specific forecasts, the IMF commented that economic links between Russia and the US (and Canada) were limited and the downgrades between January and April were relatively modest. The forecast for the US had already been downgraded in January, largely reflecting non-passage of the Build Back Better fiscal policy package and continued supply chain disruptions. The additional 0.3 percentage point forecast markdown for 2022 in April reflected the faster withdrawal of monetary support than in the previous projection and the impact of lower growth in trading partners because of disruptions resulting from the war.

The hit on the eurozone was significantly greater than in the US, with GDP growth in 2022 revised down to 2.8% (3.9% in January), with the biggest downgrades in economies such as Germany and Italy with relatively large manufacturing sectors and greater dependence on energy imports from Russia. Across the eurozone, the hit to activity was partially offset by increased fiscal support. UK GDP growth for 2022 was revised down to 3.7% (4.7% in January) with consumption projected to be weaker than expected as inflation eroded real disposable income, while tighter financial conditions were expected to cool investment.

Developments in China continued to dominate the outlook for Asia, especially for emerging Asia. The IMF noted that the combination of more transmissible variants and the strict zero-COVID strategy in China had led to repeated mobility restrictions and localized lockdowns that, together with an anaemic recovery in urban employment, had weighed on private consumption.

Both Russia and Ukraine were projected to experience large GDP contractions in 2022. The severe collapse in Ukraine was a direct result of the invasion, destruction of infrastructure, and exodus of its people. In Russia, the sharp decline reflects the impact of the sanctions with a severing of trade ties, greatly impaired domestic financial intermediation, and loss of confidence. The IMF projected a 8.5% fall for Russia's GDP for 2022, whilst Ukraine's GDP could fall by 35% in 2022.

Table 3 IMF GDP forecasts, growth rates (%), April 2022

	April 2022 forecast			January 2022 update		
	2021	2022	2023	2021	2022	2023
World output (GDP)	6.1	3.6	3.6	5.9	4.4	3.8
Advanced economies:						
US (G7)	5.7	3.7	2.3	5.6	4.0	2.6
Eurozone, of which:	5.3	2.8	2.3	5.2	3.9	2.5
Germany (G7)	2.8	2.1	2.7	2.7	3.8	2.5
France (G7)	7.0	2.9	1.4	6.7	3.5	1.8
Italy (G7)	6.6	2.3	1.7	6.2	2.8	2.2
Japan (G7)	1.6	2.4	2.3	1.6	3.3	1.8
UK (G7)	7.4	3.7	1.2	7.2	4.7	2.3
Canada (G7)	4.6	3.9	2.8	4.7	4.1	2.8
EMDEs:						
China	8.1	4.4	5.1	8.1	4.8	5.2
India	8.9	8.2	6.9	9.0	9.0	7.1
Russia	4.7	-8.5	-2.3	4.5	2.8	2.1

Source: *IMF*, "World Economic Outlook, April 2022: War sets back the global recovery", 19 April 2022.

…whilst Markit's international indicators for April were mixed

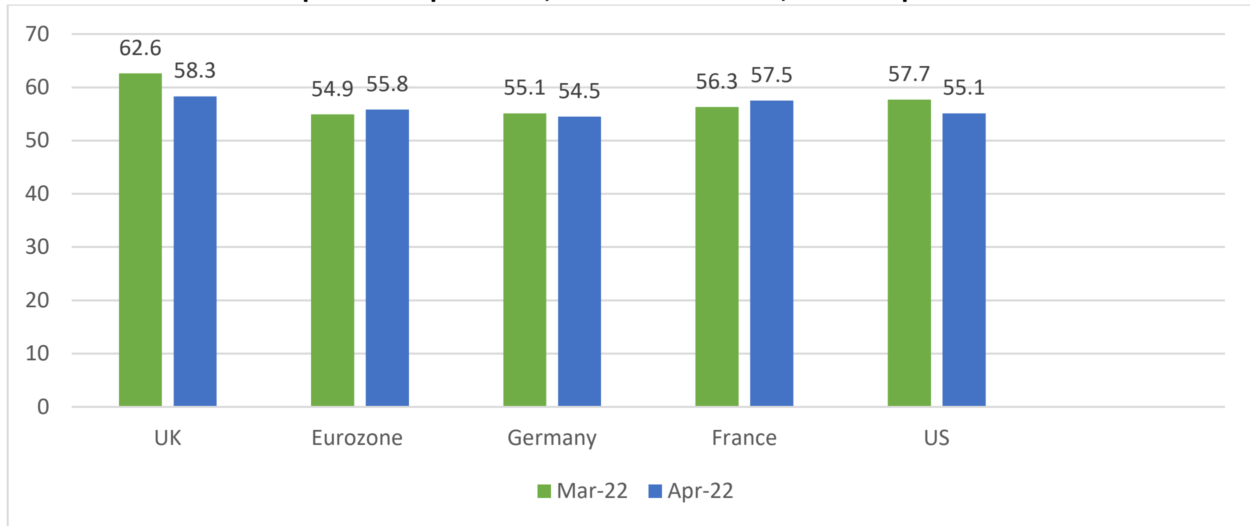
Markit's flash indices for April have also been released for the Eurozone and the US (chart 3) and they show a mixed picture.

Eurozone economic growth accelerated in April as a rebounding service sector, benefitting from loosened COVID-19 restrictions, helped compensate for a near stalling of manufacturing output.[20] But confidence remained subdued by recent standards as concerns over the Ukraine war, rising prices and the lingering effects of the pandemic continued to dampen optimism, especially in manufacturing. Prices charged for goods and services meanwhile rose at an unprecedented rate in April amid another near-record rise in firms' costs, hinting that inflation has further to rise.

Germany, with its large manufacturing sector, was noticeably less buoyant than France.[21-22] Germany's Composite PMI slipped as the survey signalled a downturn in manufacturing production in April amid reports of severe supply disruption and a drop in demand for goods. Services were, however, firmer, continuing to benefit from the waning influence of the pandemic. The French economy enjoyed a strong start to the second quarter of 2022, with the service sector the main driving force as fewer COVID-19 restrictions continued to support demand. Manufacturing was little changed.

Overall growth in the US was dampened by a softer rise in service sector output following pressure on customer spending as prices continued to increase markedly.[23] Manufacturers, on the other hand, indicated a stronger expansion in production on the back of rising demand. The headline Flash US PMI Composite Output Index registered 55.1 in April, down from 57.7 in March.

Chart 3 Markit PMI Composite Output Index, selected countries, March-April 2022



Sources include: (i) *Markit, Flash Eurozone PMI*, "Eurozone growth accelerates as reviving services demand offsets near stalling of manufacturing, but prices rise at record rate", 22 April 2022; (ii) *Markit, Flash US PMI,* "US economic upturn eases in April amid survey record inflation pressures", 22 April 2022.

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22. *Markit, Flash France PMI*, “French business activity rises at fastest pace since January 2018”, 22 April 2022.
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Annex

Table 1 Federal Reserve: economic projections, March 2022 median estimates

	2022	2023	2024	Longer run
GDP % change, Q4 (YOY)	2.8	2.2	2.0	1.8
Unemployment rate, Q4 (%)	3.5	3.5	3.6	4.0
PCE inflation (%), Q4 (YOY)	4.3	2.7	2.3	2.0
Core PCE inflation (%), Q4 (YOY)	4.1	2.6	2.3	Na
Projected appropriate policy path, Federal funds rate (%), end-year	1.9%	2.8%	2.8%	2.4%

Source: *FOMC*, "FOMC projections materials", 16 March 2022.PCE = personal consumption expenditures, core excludes food & energy. The Federal funds rate is the midpoint of the targeted range. These are the economic projections of Federal Reserve Board members & Federal Reserve Bank presidents under their individual assessments of projected appropriate monetary policy.