Policy error?

Bank of England Preview

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Summary

- The Bank of England's MPC is likely to vote unanimously to keep Bank rate on hold at 0.10%. The asset purchase target looks set to remain at £895 billion, but this vote could be split
- As inflation surges, calls for a relatively early Bank of England rate hike are growing louder
- Yet the increase in inflation has been driven primarily by (global) supply bottlenecks, an unusual consumption bias, and low levels of inventories. This is not a normal business cycle, and it shouldn't be interpreted as such
- Meanwhile, the UK has already achieved peak growth, and fiscal policy turns into a headwind. The transition out of the furlough program comes with new uncertainties too
- Our base case remains that there won't be a rate hike this year or next

The Bank of England's MPC is likely to vote unanimously to keep Bank rate on hold at 0.10%. The asset purchase target looks set to remain at £895 billion, but this vote could be split if Saunders repeats its dissent and/or has inspired others. The central bank's net gilt purchases will end in December nonetheless.

In August, the forward guidance was re-formulated. It now reads: "*The Committee judges that, should the economy evolve broadly in line with the central projections in the August Monetary Policy Report, some modest tightening of monetary policy over the forecast period is likely to be necessary to be consistent with meeting the inflation target sustainably in the medium term.*" (The emphasis is ours).

The minutes of the August meeting revealed that the eight policy makers had differing opinions on changing this guidance. Governor Bailey explained at the Treasury Committee on September 8 that this split was "four-all" and that he was among those supporting the change. With the appointment of Huw Pill as the Bank's Chief Economist –who has been advocating for explicit limits on the use of new or non-standard policy instruments (see Pill, p. 53)– it is reasonable to expect that this new guidance now does have a majority backing. **The minutes will probably reflect this, but that shouldn't be construed as a fresh hawkish signal.**

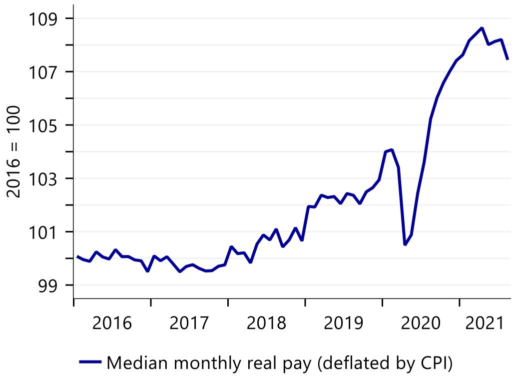
This is not a normal business cycle

The increase in inflation has been driven primarily by global supply bottlenecks, an unusual bias in consumption towards goods instead of services, and low levels of inventories as firms were surprised by the strong policy response of the world's fiscal authorities (facilitated by central bank policies). But even with all the talk of supply disruptions, delays and limitations, the *actual* global trade of merchandise is at record-high levels. Producers only fail to meet the last bit of demand, and therefore ration with some price increases. This, and the physical drawdown of inventories, induces shortages upstream the value chain through so-called bullwhip effects, even when there isn't a structural lack of supplies. With these dynamics in mind, it is not very likely that firms will respond to such exceptionally volatile swings in their supply chains by investing in structural capacity increases – only to have this capacity then sit idle as the fiscal and monetary impulse reverses, consumption habits normalize, and price pressures ease or even reverse.

In short: this is not a normal business cycle, and it shouldn't be interpreted as such.

There is of course genuine uncertainty when normalcy returns and global economic activity starts to synchronize. Meanwhile, the key question for the central bank's policy makers remains the same as it has been in the past months: at what point, and under what conditions, will supply and demand eventually start to balance? Is *aggregate* domestic demand really on a tear, and does it need to be reined in proactively through tighter monetary policy and interest rate hikes? If this is indeed the judgment, and we think it shouldn't be, the MPC accepts the risk of higher unemployment and entrenching lower inflation expectations.

Figure 1: Real wages have increased sharply in 2020, but are now being squeezed



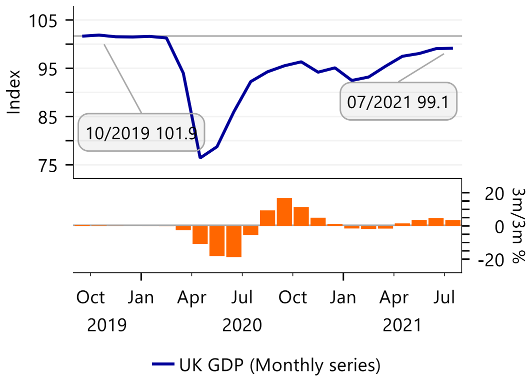
Source: ONS (HMRC PAYE data)

And what about the **imminent surge in retail gas and electricity prices**, which comes on top of the £20 cut in Universal Credit, of the 1.25% rise in National Insurance, and of the uncertain transition out of furlough? Unless pay growth re-accelerates, which PAYE data suggest doesn't appear to be happening, the incomes of those with the highest propensity to consume will be squeezed. This will have a significant negative impact on demand. **If the Bank of England indeed decides to tighten next year, both fiscal and monetary policy are hitting the brakes on the economy. That's an "ECB 2011"-policy error in the making.**

Weaker growth, higher inflation

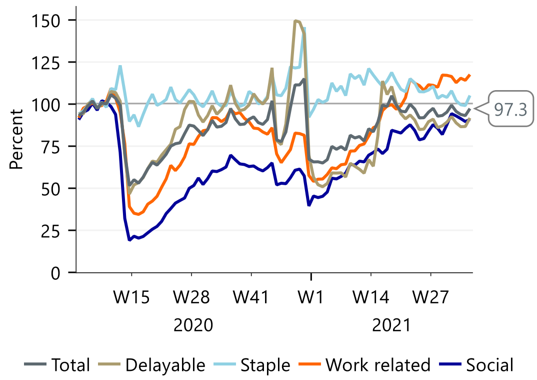
The recent slew of economic data for the UK seems to indicate that the adjustment takes place through a combination of weaker volume growth and higher prices, providing more evidence **that sectoral shortages in terms of materials, products, logistics, and qualified workers are acting as a brake on the recovery of output**. Other developed economies face similar difficulties, but Brexit works as an idiosyncratic amplifier (e.g. the shortage of lorry drivers).

Figure 2: Still 2.8%-points to go before GDP is back at pre-pandemic highs



Source: Macrobond

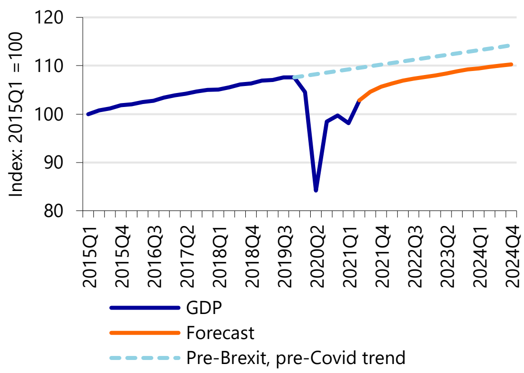
Figure 3: Card spending remains below the baseline; growth has nearly stalled



Source: Macrobond, Bank of England CHAPS data

In July, the economy expanded by only 0.1% m/m. This was the slowest pace since January and also reflects the spread of the delta variant and greater consumer caution. Output in the services sector stagnated due to a sharp drop in high street spending. While it is generally expected that growth should pick up again in August, this morning's retail sales report and the timely CHAPS card payment data don't suggest another sharp upturn is coming. **We project the three-month growth rate of GDP to level off quite rapidly, as the low-hanging fruit from reopening has long been picked. Meanwhile, we note that the size of the UK's economy in July was still 2.8% below its pre-pandemic peak of October 2019.**

Figure 4: We are not convinced that the UK's GDP is able to catch its old trend path



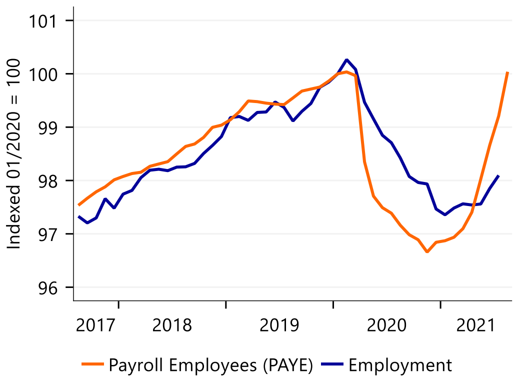
Source: Macrobond, RaboResearch

The MPC currently forecasts GDP to rise by 2.9% q/q in 21Q3. This seems to be out of reach following the weak figures for July. We expect an increase in GDP of 1.7% this quarter, which already seems to be optimistic. We forecast growth to then moderate to 1.0% q/q in 21Q4 (vs. an MPC projection of 2.0% q/q), before slowing down further over the course of 2022. We continue to project GDP to remain below its pre-virus, pre-Brexit trend path. **As a relatively larger share than we initially expected of nominal spending ends up in higher prices, we view the risk to our forecast as to the downside**.

Back to work!

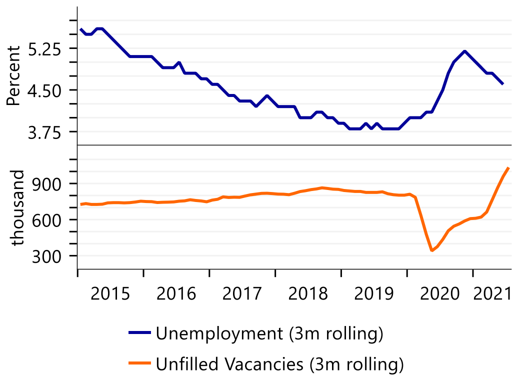
The labor market recovery shifted into higher gear after most of the national Covid-19 restrictions eased, leading up to **strong official employment figures for July**. The payroll statistics from the PAYE system indicate that the bounce-back continued into August. It appears that younger people in particular have benefited the most from reopening: almost all of the employment growth in the Q2 was due to 16-24 year olds, who stayed in education rather than looking for work in the Covid-hit labor market of last year, and in customer-facing parts of the service sector.

Figure 5: The employment recovery accelerates



Source: Macrobond

Figure 6: *"We're hiring!"*

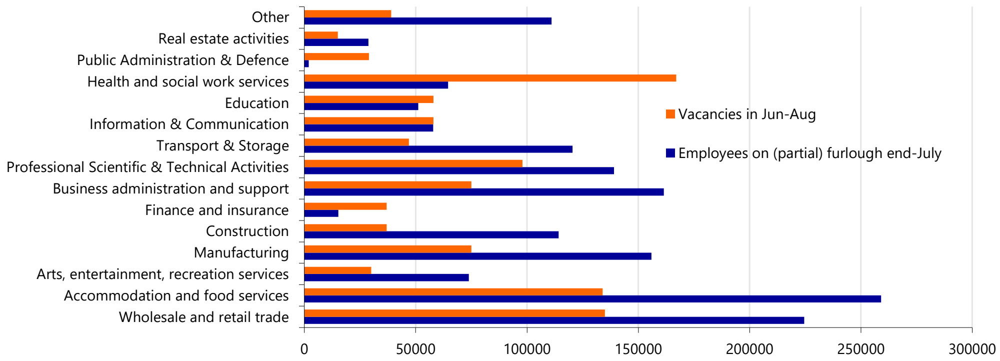


Source: Macrobond

Job openings rose sharply too, reaching above one million, and unemployment fell to 4.6% in the three months to July. Clearly, labor demand exceeds supply in various segments of the market, in particular the ones that relied heavily on EU workers. The combination of Brexit and Covid-19 has driven many of them away. Secondly, economic inactivity has increased markedly for reasons such as early retirement, health concerns or education. It suggests that employers need to pay extra to lure them back to the job market. While the reported average hourly earnings growth of 6.8% y/y is the result of a statistical artifact, the ONS does estimate underlying regular earnings growth between 3.6% and 5.1% y/y. These should be taken with caution, however, the ONS notes.

Paradoxically, there is also a lot of slack in several segments of the labor market. At the end of July, there were still 1.55 million jobs (partially) furloughed, mostly by relatively small firms in sectors that were hit hard by the pandemic. Moreover, in some other sectors, such as construction, furlough usage remains high even as activity has already returned to pre-Covid levels. The sectoral mismatch between where the vacancies are (e.g. health services) and where employees were on furlough at the end of July (e.g. manufacturing, hospitality, retail) suggests a difficult transition once the CJRS ends late this month.

Figure 7: Lots of furloughed employees + lots of unfilled vacancies = sectoral mismatch



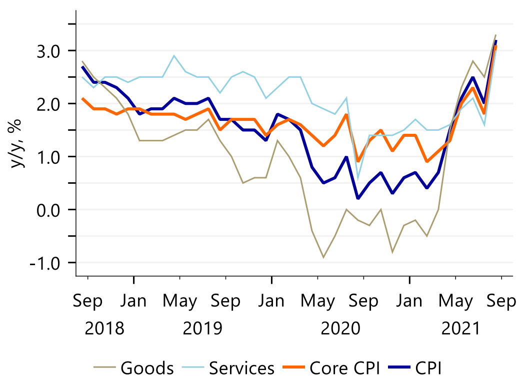
Source: Macrobond, RaboResearch

The Bank of England, however, is no longer forecasting a rise in unemployment. In our view, that is too optimistic: with Covid-19, there's no guarantee that autumn and winter will be easy, whilst the best part of the demand recovery is behind us. This deceleration has also been flagged by the August PMI survey, which indicated that the rate of expansion seen in Q2 has been unsustainable, reflecting a "reboot" of the economy rather than the start of a strong upward trend.

A policy error?

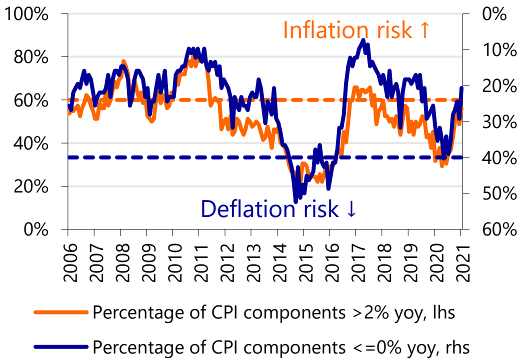
Much has already been written on the biggest jump on record of the UK's inflation rate, which rose from an artificially low reading of 2.0% in July to an artificially high reading of 3.2% in August. Both numbers show that narrowly based inflation has the potential to quickly reverse if base effects –such as the one stemming from the sharp fall in the cost of a restaurant meal in August 2020– suddenly start pointing in the other direction. Inflation is projected to rise further, to around 4% at the turn of the year, as the temporary cut in hospitality VAT will be unwound and household energy bills rise sharply. Meanwhile, the pressure on global supply networks isn't likely to abate as quickly as hoped.

Figure 8: A record 1.2 point leap in UK inflation



Source: Macrobond, RaboResearch

Figure 9: The rise in inflation is concentrated: only 56% of the 85 items are >2% y/y



Source: Macrobond, RaboResearch

Inflation is driven by global supply constraints and an unusual composition of demand – *not* the level of aggregate demand. Domestic factors, which include Brexit, aggravate this imbalance. Meanwhile, fiscal headwinds have started blowing. **This is why we remain reluctant to forecast an increase in the Bank's policy rate this year or next. It is also why we don't see any urgency for the MPC to spell out the exact conditions under which it would contemplate such a move.**

It may, however, still decide to do so. After last year's accusations of fiscal dominance, they might have a particular interest in convincing the public that it is still, after all, a central bank determined to fight off above-target inflation. **The risk of a policy error is therefore elevated**.

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