



ARBUTHNOT BANKING GROUP PLC

PERSPECTIVES

By Ruth Lea, Economic Adviser to the Arbuthnot Banking Group



Ruth Lea
Economic Adviser
Arbuthnot Banking Group
ruthlea@arbuthnot.co.uk
07800 608 674

The Spring Statement: focus on the Chancellor's response to the “cost of living crisis”

21st March 2022

Introduction

The Chancellor's Spring Statement is due on 23 March, with popular interest focusing on how he responds to the “cost of living crisis” and the squeeze on household incomes, reflecting the sharp increase in energy prices and the higher tax burden. So far, there have been few hints, albeit much speculation as to possible measures. The OBR's forecasts are expected to be amended significantly, not least of all their inflation forecasts. And, whilst the MPC raised Bank Rate to 0.75% at their March meeting, their tone concerning further tightening was decidedly dovish. As background to the OBR's new forecasts the latest UK data showed a stronger than expected rise in January's GDP, whilst the labour market continued to recover.

The Spring Statement: OBR forecasts to be revised

The OBR's key economic and fiscal forecasts relating to the Autumn Budget and Spending Review (SR) 2021 (announced on 27 October 2021) are shown in tables 1a and 1b.¹⁻² In October the OBR projected a 6.0% increase in GDP for 2022 but, given the impact of the squeeze on household incomes, this can be expected to be revised down significantly. The Bank forecast growth of 3¾% in February (annex table 1), which could now be on the upside (see the report of the March MPC meeting, below). The OBR's October projection of 4.0% for CPI inflation for 2022 now looks significantly too low and could be revised up to around 6-7%.

Turning to the fiscal forecasts, the key finding is that the year-to-date (to January) outturns have been better than expected by the OBR in October. In particular, public sector net borrowing (PSNB) for the first 10 months of FY2021 was £138.5bn, compared with the official forecast of £156.2bn, some £17.7bn (12.8%) lower.³ This gives the Chancellor some leeway, though note that debt interest payments are vulnerable to both higher inflation (given the significant proportion of gilts which are RPI-linked) and higher interest rates.⁴⁻⁶ He could, for example, use this leeway to either “pocket” the improved borrowing figures or cancel/delay some tax rises.

It should be noted that the Chancellor revised his fiscal “rules” in October 2021, and the new fiscal mandate specified that PSND ex BoE as a share of GDP should be falling by the third year of the rolling forecast period (the current target year is FY2024). In addition, there were three supplementary targets: the current budget should be in balance by the third year of the rolling forecast period (target year, FY2024); to ensure that public sector net investment (PSNI) did not exceed 3% of GDP on average over the rolling five-year forecast period; and to ensure that a subset of expenditure on welfare was contained

within a predetermined cap and margin set by the Treasury (the ‘welfare cap’). All of the targets were deemed by the OBR to have been met in October.

Table 1a OBR economic forecast, Autumn 2021

	2021	2022	2023	2024	2025	2026
GDP (%)	6.5	6.0	2.1	1.3	1.6	1.7
Unemployment rate (%)	4.9	4.8	4.3	4.2	4.2	4.2
CPI (%)	2.3	4.0	2.6	2.1	2.0	2.0

Table 1b OBR forecast of key fiscal aggregates, £bn, Autumn 2021

	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026
PSNB	183.0	83.0	61.6	46.3	46.4	44.0
PSNB/GDP (%)	7.9%	3.3%	2.4%	1.7%	1.7%	1.5%
PSND	2,369	2,479	2,561	2,567	2,546	2,567
PSND/GDP (%)	98.2%	97.9%	97.8%	94.7%	90.5%	88.0%
PSND/GDP (ex BoE, %)	85.2%	85.4%	85.7%	85.1%	84.2%	83.3%

Source: *OBR*, “Economic and fiscal outlook”, CP545, October 2021. PSNB=Public sector net borrowing; PSND=Public sector net debt.

The Spring Statement: recap of recent measures to date...

Before looking at any possible measures that may be announced in the Spring Statement, it is salutary to recap recent relevant policy measures.

Firstly, it should also be noted that substantial tax rises were announced in the March 2021 Budget, relating to Corporation Tax (from FY2023) and the freezing of personal tax allowances and thresholds (at FY2021 levels).⁷ The IFS recently commented that when the Chancellor announced a freeze in income tax thresholds in March 2021, he expected it to raise around £8bn. Since then, inflation has been much higher, such that under their latest forecasts it could raise as much as £21bn.⁸ There was also a freeze on the pension lifetime allowance until April 2026. In addition, a 130% super-deduction capital allowance on qualifying new plant and machinery investments was introduced (for FY2021 and FY2022).

Secondly, measures announced in the, expansionary, Autumn Budget and Spending Review 2021 included:⁹⁻¹⁰

- Extra spending throughout the forecast period. When Spending Review 2021 (SR21) was launched in September 2021, there was significant growth pencilled in for public spending. However, this growth was substantially increased in the actual SR21 (October 2021): total DEL spending was increased by around £26bn in FY2022, around £23bn in FY2023 and around £12bn in FY2024. All in all, total departmental spending (excluding depreciation) was set to grow in real terms at 3.8% a year on average over the current Parliament (FY2019-FY2024) – a cash increase of £150bn a year by FY2024 (£90bn in real terms). Since then, higher inflation, of course, will have significantly reduced the real terms estimates. The freeze on public sector pay will end on 1 April 2022.
- The one significant saving was the decision to drop the triple lock on uprating the state pensions, as announced on 7 September 2021. State pensions would be increased by the higher of 2.5% or the CPI inflation rate for September 2021 (which was 3.1%) in April 2022 and not by the total earnings increase for the three months to July 2021 (the outturn was 8.3%, distorted by base effects).
- As announced on 7 September, a Health and Social Care Levy based on National Insurance contributions (NICs) will be introduced from April 2022, when NICs for working age employees, self-employed and employers will increase by 1.25%. From April 2023 (FY2023), once HMRC’s systems are updated, the 1.25% Levy will be formally separated out and will also apply to individuals working above State Pension age, and NICs rates will return to their FY2021 levels. The Government will also increase the rates of dividend tax by 1.25% from April 2022. The government estimated the new measures

would raise an average of £12bn per year: £11.4bn (net) from the levy and £0.6bn from the dividend tax rate increase.

- The Chancellor announced the taper rate for Universal Credit would be reduced from 63% to 55% (as from December 2021).
- The National Living Wage (NLW) will increase by 6.6%, to £9.50 an hour (from April 2022).
- Flights between airports in the UK nations will be subject to a new lower rate of Air Passenger Duty (APD) from April 2023, when a new ultra-long-haul APD band will be introduced.
- The planned rise in the duty on spirits, wine, cider and beer will be cancelled, whilst there will be simplification of alcohol duties. And the planned rise in fuel duty will be cancelled.

Thirdly, since the Autumn Budget, the Chancellor announced support for households in February 2022 to ease the impact of “soaring energy bills”:¹¹

- A non-repayable £150 council tax rebate for most households in England (those in council tax bands A to D) applicable from April 2022, with additional cash for the devolved nations.
- A repayable £200 discount on bills for homes in England, Wales and Scotland from October. This discount will be automatically recovered from people’s bills in equal £40 instalments over a five-year period from 2023.

...and possible measures

Whilst the popular interest is likely to focus on the Chancellor’s possible measures for tackling the “cost of living crisis”, it should be noted that he will probably have other policy objectives and these may include extra measures to stimulate investment and additional funding for the defence budget, in the light of Russia’s invasion of Ukraine. As already noted, so far, there have been few hints of possible measures, albeit much speculation.

Possible measures include:

- Unfreezing tax allowances and thresholds and, say, uprating by the CPI inflation rate for September 2021. Similarly, unfreezing the pension lifetime allowance.
- Cancelling or delaying the NICs increase.
- Recommitting to the triple lock for pension increases.
- Increasing the uprating for Universal Credit, which is due to be uprated by 3.1% (September’s CPI inflation rate) in April 2022. Another option would be to reverse the £20 a month cut in UC; the benefit was uplifted temporarily in March 2020 but was restored to pre-pandemic levels in October 2021.
- Cutting VAT on fuel.
- Cutting VAT on domestic energy bills.

The MPC raises Bank Rate to 0.75%

At the meeting ending on 16 March 2022, MPC members voted to raise Bank Rate from 0.5% to 0.75%, as expected.¹² The vote was 8/1 in favour, with John Cunliffe voting to leave the Bank Rate unchanged at 0.5%.

Concerning the economy, there were no revised forecasts (see annex table 1 for the February forecast). However, the Monetary Policy Summary stated:¹³

- 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.
- Regarding inflation, the invasion of Ukraine by Russia had led to further large increases in energy and other commodity prices including food prices.¹⁴ CPI inflation rose 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.
- 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.¹⁵

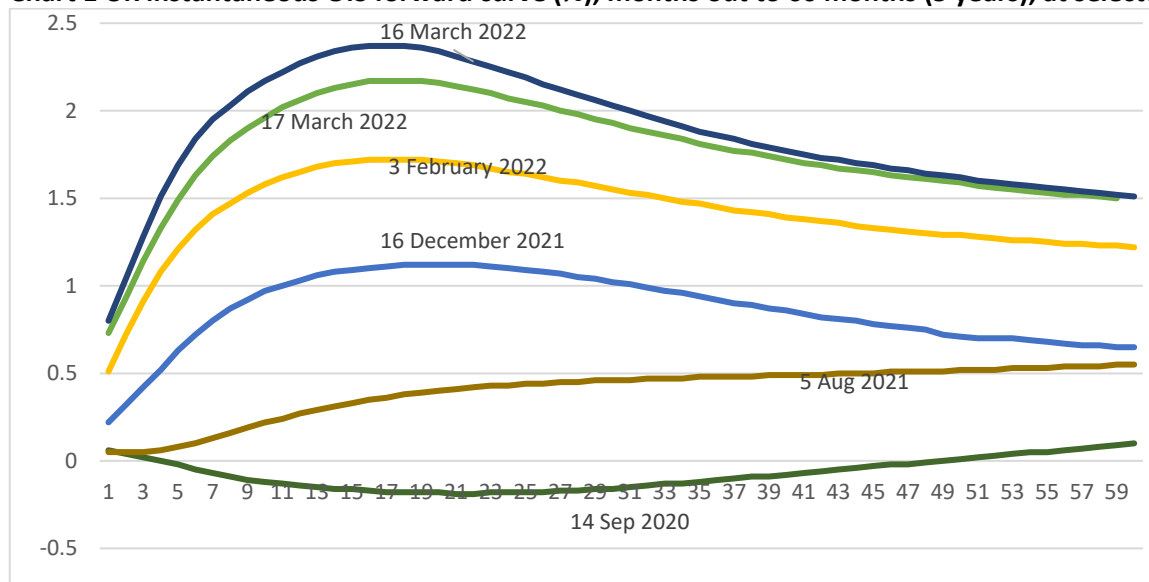
- Turning to economic activity, January's GDP was stronger than expected in the Bank's February Report (see below). Moreover, business confidence had held up and labour market activity data (also see below) had remained robust. Consumer confidence had, however, fallen in response to the squeeze on real 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.

On policy, the Monetary Policy Summary commented:

- Given the current tightness of the labour market, continuing signs of robust domestic cost and price pressures, and the risk that those pressures will persist, the MPC judged that an increase in Bank Rate of 0.25 percentage points was warranted at the March meeting.
- Based on its current assessment of the economic situation, the MPC "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 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. Another 0.25% interest rate hike is still, on balance, expected in forthcoming months, although the timing is not clear. It could be in May or June, and the MPC could pause thereafter. However, such a further rise is not guaranteed and the MPC could signal a pause in May, depending on households' reactions to April's household energy price hikes, and the National Insurance and Council Tax hikes. Market expectations did soften on 17 March but still suggest significant tightening over the next 12-18 months (chart 1).

Chart 1 UK instantaneous OIS forward curve (%), months out to 60 months (5 years), at selected dates



Source: Bank of England, yield curve data, overnight index swap (OIS) rate. Last data, 17 March 2022.

UK data: January's GDP rose by 0.8%...

GDP bounced back by 0.8% (MOM) in January, after the 0.2% fall in December (reflecting tougher pandemic restrictions), and was 0.8% higher than its pre-pandemic February 2020 level.¹⁶ Pandemic restrictions were lifted on 24 February (England).

Concerning the industrial breakdown, all sectors grew in January:¹⁷⁻¹⁹

- The service sector grew by 0.8% (MOM), after a 0.5% decline in December, to be 1.3% above its pre-pandemic level (February 2020). Output in consumer-facing services grew by 1.7% (MOM), mainly driven by a 6.8% increase in food and beverage activities, while all other services also saw growth, by 0.6% (MOM). Within services, consumer-facing services are now 6.8% below their pre-coronavirus levels, while all other services are 3.4% above.
- Output in the production sector increased by 0.7% (MOM) but was still 2.0% lower than in February 2020. Manufacturing grew by 0.8% (MOM), with increases in 10 out of the 13 sub-sectors, partially offset by falls of 23.3% in the manufacture of basic pharmaceutical products and pharmaceutical preparations and of 4.5% in the manufacture of transport equipment both of which increased strongly in December 2021. Mining and quarrying grew by 2.0%, driven by extraction of crude petroleum and natural gas (up 1.0%) and other mining and quarrying (up 7.7%). Electricity et al increased by 1.0% but water supply and sewerage contracted by 1.5%.
- Construction output increased by 1.1% (MOM) in January and the sector was 1.4% above its pre-coronavirus pandemic level. The MOM increase was driven by an increase in repair and maintenance (4.6%) while new work saw a decline, decreasing 0.8%.

...but the trade balance deteriorated sharply in January

The total trade (goods & services, including precious metals) deficit deteriorated sharply to £16.2bn in January 2022 compared with a deficit of just £2.3bn in December (annex table 2).²⁰ Concerning the components (including precious metals):

- The visible (goods) deficit deteriorated to £26.5bn (from £12.4bn in December), as exports fell by 15.8% (MOM) but imports increased by 21.8%. Both the EU and non-EU balances worsened. The deficit with the EU increased to £12.8bn (from £4.5bn), whilst the deficit with non-EU countries increased to £13.7bn (from £7.9bn), the latter reflecting a swing in the balance on precious metals.
- Concerning services, the surplus improved a little £10.3bn (from £10.0bn), as exports increased by 0.9% (MOM), whilst imports slipped by 0.7%.

The balance on precious metals swung to a deficit of £4.6bn in January from a £2.4bn surplus in December (annex table 2). The shift in the balance mainly concerned non-EU trade, where the “underlying” (excluding precious metals) balance actually improved a tad. Excluding precious metals, the goods balance worsened to a deficit of £21.9bn (£14.7bn in December). The deterioration in the precious metals balance, therefore, accounted for about half of the total goods deterioration.

The ONS noted that “...in January 2022, there were changes to the way HMRC collect data for both imports from and exports to the EU; because of these changes caution should be taken when interpreting these latest monthly estimates”. They went on to explain:

- As of January 2022, imports from the EU to Great Britain were being collected using custom declarations (as with UK imports from the rest of the world) rather than captured by the Intrastat survey. As a result, the ONS’s EU to Great Britain import statistics from January 2022 were not directly comparable with previous months. HMRC have, however, assessed the impact of this change and were confident that the strong rise in imports from the EU in January was predominantly the result of genuine increases in trade rather than being attributed to the data collection change.
- Concerning exports to the EU, a recent operational change implemented by HMRC had amended the assumed departure period of goods exports from 5 to 15 days. An automated departure would now be triggered if a trader did not submit a departure notification within 15 days (previously five days) of pre-lodging the export with HMRC. There were, therefore, 10 fewer days of EU exports data recorded in January 2022 because of this change, resulting in a break in the time-series for UK exports to the EU. Future months would not be affected as the equivalent number of days moving into the month would also be moved out. Of the £3.0bn (20.7%) decrease in exports (excluding precious metals) to EU countries, HMRC analysis estimated that approximately £2bn was attributed to this change. The ONS added that it was not possible to break down affects to country or commodity level data and caution should be taken when interpreting exports to the EU for periods that include January 2022 data.

The labour market remains robust...

The latest data suggest that the labour market is continuing to recover.²¹ Firstly, early estimates from Pay As You Earn Real Time Information (PAYE RTI, HMRC data) showed the number of payroll employees increased by 275,000 (MOM, January was revised down) to a record 29.7mn in February.²² Interestingly, the number of payroll employees in February 2022 was 662,000 (2.3%) higher than in pre-pandemic February 2020. On the annual comparison, the largest increase in February 2022 was in the accommodation and food service activities sector (a rise of 359,000 employees, YOY), whilst the smallest increase was in the finance and insurance sector (a rise of 4,000, YOY).

Turning to the LFS data, the employment rate (the proportion of people aged 16-64 who were in work) in the three months to January was 75.6%, 0.1 percentage points higher QOQ and 0.9 percentage points higher YOY.²³ The ONS noted that full-time employees had driven the increase in the employment rate during the latest three-month period, adding that, while the number of part-time employees had decreased strongly during the coronavirus pandemic, it had been increasing since April-June 2021. However, the number of self-employed workers remained low following decreases through the coronavirus pandemic. Total actual hours worked increased by 4.7mn hours in the quarter to 1,029.1mn, to be 70.2mn higher YOY. However, this was still 23.1mn hours below pre-pandemic levels (the three months to February 2020).

The unemployment rate (the proportion of the labour force that were unemployed, aged 16+) fell to 3.9%, 0.2 percentage points lower QOQ and 1.2 percentage points down YOY.²⁴ But the inactivity rate (the proportion of people aged 16-64 who were economically inactive) was 21.3%, 0.1 percentage points higher (QOQ), though flat YOY, and it was still 1.1 percentage points higher than pre-pandemic 3 months to February 2020. The ONS commented that, during the coronavirus pandemic, increases in economic inactivity were largely driven by those aged 16 to 24 years. However, the number of economically inactive people aged 16 to 24 years had been decreasing since early 2021, with those aged 50 to 64 years driving the recent increases in economic inactivity. Finally, the number of redundancies fell by 29,000 (QOQ) to 68,000 and was 250,000 down YOY in the three months to January. The redundancy rate decreased to a record low following the end of the Coronavirus Job Retention Scheme.

...whilst vacancies at a record high in the three months to February...

UK vacancies in the three months to February rose to a new record high of 1,319k, an increase of 105,000 (QOQ), with half of the industry sectors showing record highs.²⁵ The ratio of vacancies for every 100 employee jobs reached a new record high of 4.4 in the three months to February, the 12th consecutive period of growth.

The ONS added that, whilst the overall rate of vacancy growth continued to slow, the number of vacancies continued to increase across most industries. The largest increase in vacancy numbers QOQ was in wholesale and retail trade et al (16,800). There were also large increases in human health and social work (15,400), and professional, scientific and technical activities (14,500). It was notable that while 9 of the 18 industry groups posted record numbers of vacancies, only education and public administration, defence and compulsory social security showed higher rates of growth on the quarter.

...but regular annual earnings growth in real terms slips in three months to January

Annual growth in average total pay (including bonuses) was 4.8% and regular pay (excluding bonuses) was 3.8% among employees for the three months to January 2022 (table 2).²⁶ The ONS explained that previous months' strong growth rates had been affected upwards by base and compositional effects, but these initial temporary factors had worked their way out of the annual comparisons. However, they added, they were now comparing the latest period with a period where certain sectors had increasing numbers of employees on furlough as a result of the winter 2020 to 2021 lockdown. Therefore, a small amount of base

effect would be present for these sectors but not to the degree observed when comparing with periods at the start of the pandemic.

In real terms (inflation adjusted) total pay rose by just 0.1%, but regular pay fell by 1.0% (as earnings increases were outstripped by prices increases). Strong bonus payments over the past six months had kept recent real total pay growth positive. Average total pay growth for the private sector was 5.3% in the three months to January 2022, while for the public sector, it was 2.4%. All industry sectors saw pay growth in November 2021 to January 2022, with the finance and business services sector seeing the largest growth rate at 8.6% as well as strong bonus payments.

Table 2 Growth in employee earnings (YOY, %), 3 months to January 2022

	Nominal	Real
Actual:		
Total pay (including bonuses)	4.8%	+0.1%
Regular pay (excluding bonuses)	3.8%	-1.0%

Sources: (i) ONS, "Labour market overview: March 2022", 15 March 2022; (ii) ONS, "Average weekly earnings in GB: March 2022", 15 March 2022.

The Fed raises interest rates as expected...

As expected, the Fed increased interest rates by 0.25% their March meeting (announcement 16 March) and, moreover, indicated more rate increases to come. The FOMC statement said:²⁷

- The Committee (FOMC) seeks to achieve maximum employment and inflation at the rate of 2% over the longer run. With appropriate firming in the stance of monetary policy, the Committee expects inflation to return to its 2% objective and the labour market to remain strong. In support of these goals, the Committee decided to raise the target range for the federal funds rate to 1/4 to 1/2 percent and anticipates that ongoing increases in the target range will be appropriate (see the forecast below).
- In addition, the Committee expects to begin reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities at a coming meeting.
- In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals. The Committee's assessments will take into account a wide range of information, including readings on public health, labour market conditions, inflation pressures and inflation expectations, and financial and international developments.

On the economy, the FOMC statement commented "...indicators of economic activity and employment have continued to strengthen. Job gains have been strong in recent months, and the unemployment rate has declined substantially. Inflation remains elevated, reflecting supply and demand imbalances related to the pandemic, higher energy prices, and broader price pressures. The invasion of Ukraine by Russia is causing tremendous human and economic hardship. The implications for the US economy are highly uncertain, but in the near term the invasion and related events are likely to create additional upward pressure on inflation and weigh on economic activity". The US CPI inflation rate rose to 7.9% (YOY) in February, the highest since January of 1982; energy remained the biggest contributor (25.6% versus 27% in January), with gasoline prices surging 38% (40% in January).²⁸

...and revisions to the forecast

Turning to the forecast, the GDP annual growth projection was, unsurprisingly, revised down to 2.8% for 2022 (4.0% in December) (chart 2a).²⁹ There were, however, no changes thereafter. The projections for PCE (personal consumption expenditures) inflation were revised up again, again unsurprisingly, with PCE inflation expected to average 4.3% in 2022Q4 (2.6% in December), before falling to 2.7% in 2023Q4, and 2.3% in 2024Q4 (chart 2b).

Finally, the projected appropriate policy path for the federal funds rate was further increased significantly. The appropriate rate is now assessed to be 1.9% by end-2022 (0.9% in December), 2.8% by end-2023 (1.6% in December) and 2.8% by end-2024 (2.1% in December), chart 2c. In March 2021 the appropriate federal funds rate was projected to remain at 0.1% until end-2023.

Chart 2a FOMC: US GDP growth (%), Q4 (YOY), September, December 2021, March 2022

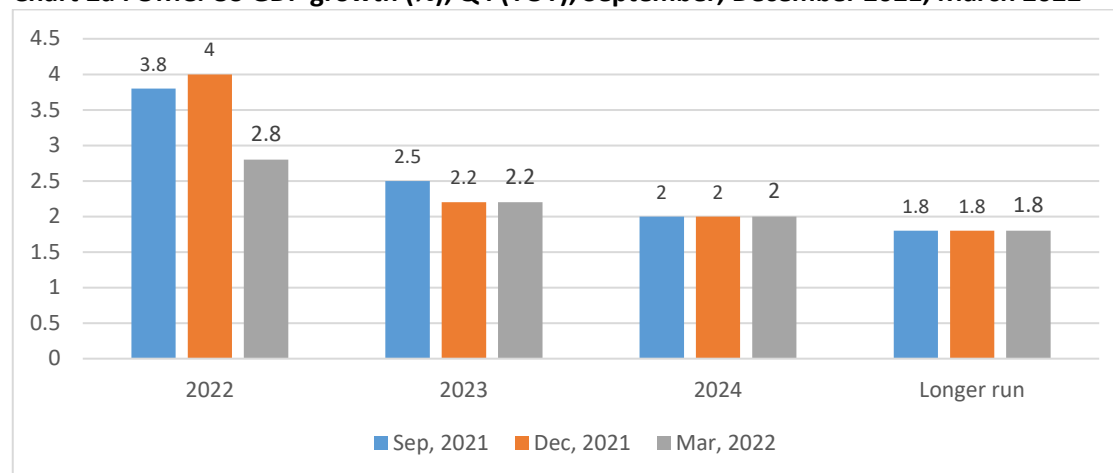


Chart 2b FOMC: PCE inflation (%), Q4 (YOY), September, December 2021, March 2022

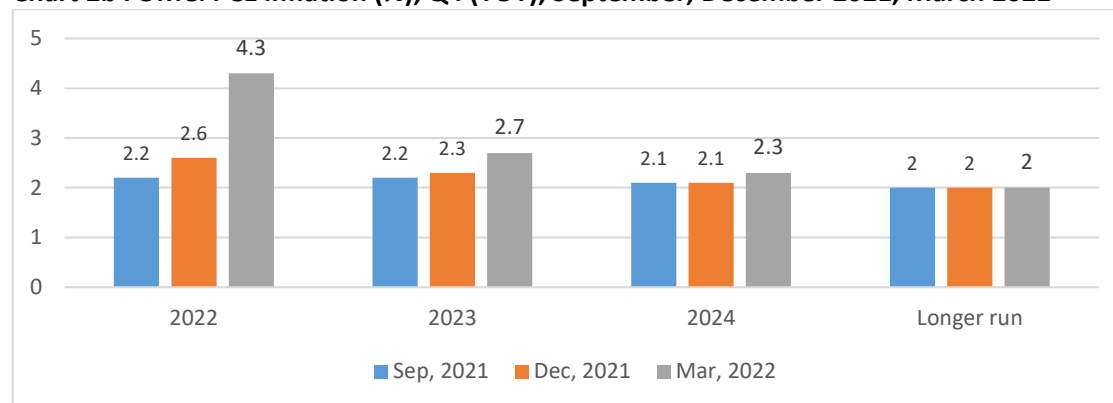
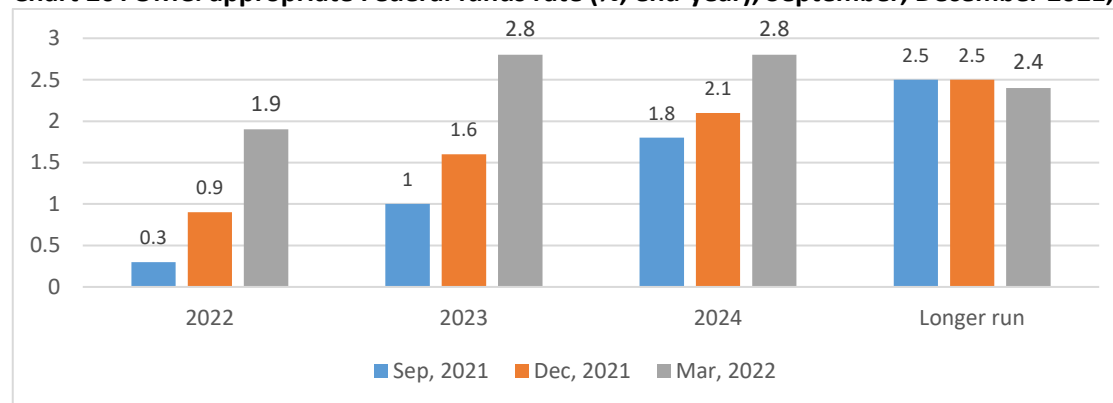


Chart 2c FOMC: appropriate Federal funds rate (% end-year), September, December 2021, March 2022



Source: *FOMC*, “FOMC projections materials: the summary of economic projections (SEP)”, 15 December 2021, and previous, median estimates. See annex table 3. These are the economic projections of Federal Reserve Board members & Federal Reserve Bank presidents under their individual assessments of projected appropriate monetary policy.

The ECB speeds up tapering asset purchases...

The ECB, somewhat unexpectedly, speeded up the tapering of its asset purchases at its March meeting (announcement 10 March).³⁰ At its February meeting, the ECB confirmed that the monthly net purchases under the APP (Asset purchase programme) would amount to €40bn in 2022Q2 and €30bn in 2022Q3.³¹ And, from October 2022 onwards, the Governing Council would then maintain net asset purchases under

the APP at a monthly pace of €20bn for “as long as necessary to reinforce the accommodative impact of its policy rates”. However, in March, however, the ECB announced that monthly net purchases under the APP would amount to €40bn in April, €30bn in May and €20bn in June and it planned to end APP purchases in 2022Q3. But note the ECB remains in no hurry to raise rates.³²

Specifically, the ECB’s March decisions were:³³

- The Governing Council today revised the purchase schedule for its APP for the coming months. As already noted, monthly net purchases under the APP will amount to €40bn in April, €30bn in May and €20bn in June. The calibration of net purchases for 2022Q3 will be data-dependent and reflect its evolving assessment of the outlook. If the incoming data support the expectation that the medium-term inflation outlook will not weaken even after the end of its net asset purchases, the Governing Council will conclude net purchases under the APP in 2022Q3.
- The interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will remain unchanged at 0.00%, 0.25% and -0.50% respectively.
- Any adjustments to the key ECB interest rates will take place “sometime after” the end of the Governing Council’s net purchases under the APP and will be gradual.
- “The path for the key ECB interest rates will continue to be determined by the Governing Council’s forward guidance and by its strategic commitment to stabilise inflation at 2% over the medium term. Accordingly, the Governing Council expects the key ECB interest rates to remain at their present levels until it sees inflation reaching 2% well ahead of the end of its projection horizon and durably for the rest of the projection horizon, and it judges that realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at 2% over the medium term.”

...and revisions to the forecasts

The ECB released its latest forecasts, commenting that “...the outlook for euro area activity and inflation has become very uncertain and depends crucially on how the Russian war in Ukraine unfolds, on the impact of current sanctions and on possible further measures. Soaring energy prices and negative confidence effects imply significant headwinds to domestic demand in the near term, while the announced sanctions and sharp deterioration in the prospects for the Russian economy will weaken euro area trade growth. The baseline projections are built on the assumptions that current disruptions to energy supplies and negative impacts on confidence linked to the conflict are temporary and that global supply chains are not significantly affected. Based on these assumptions, the baseline projections foresee a significant negative impact on euro area growth in 2022, from the conflict. Nevertheless, given the starting point for the euro area economy, with a strong labour market and headwinds related to the pandemic and supply bottlenecks assumed to fade, economic activity is still projected to expand at a relatively strong pace in the coming quarter.”³⁴

Specifically, GDP growth has been revised down to 3.7% for 2022 (from 4.2% in December), with a very minor revision to 2023 (table 3). HICP inflation is now expected to average 5.1% in 2022 (3.2% in December) before falling to 2.1% in 2023 and 1.9% in 2024. Note that euro area HICP inflation rose to 5.9% (YOY) in February from 5.1% in January.³⁵ In February, the highest contribution to the annual euro area inflation rate came from energy (+3.12 percentage points), followed by services (+1.04 pp), food, alcohol & tobacco (+0.90 pp) and non-energy industrial goods (+0.81 pp). There were modest upward revisions to the ECB’s unemployment forecasts for 2023 and 2024.

Table 3 ECB: economic projections, December 2021, March 2022

	2021	2022	2023	2024
GDP % change (YOY):				
Dec 2021	5.1	4.2	2.9	1.6
Mar 2022	5.4	3.7	2.8	1.6
HICP inflation (%), annual averages (YOY):				
Dec 2021	2.6	3.2	1.8	1.8
Mar 2022	2.6	5.1	2.1	1.9
Unemployment rate, annual averages (%):				

Dec 2021	7.7	7.3	6.9	6.6
Mar 2022	7.7	7.3	7.2	7.0

Source: ECB, “Eurosysteem staff macroeconomic projections for the euro area”, 16 December 2021, and 10 March 2022. The data are annual averages.

The OECD latest economic assessment: weaker growth and higher inflation

The OECD’s March Economic Outlook specifically focussed on the economic and social impacts and policy implications of the War in Ukraine.³⁶

The OECD concluded that, although Russia and Ukraine were relatively small in output terms, they are large producers and exporters of key food items, minerals and energy. And the war had already resulted in sizeable economic and financial shocks, particularly in commodity markets, with the prices of oil, gas and wheat soaring. Moreover, the moves in commodity prices and financial markets seen since the outbreak of the war could, if sustained, reduce global GDP growth by over 1% in the first year, with a deep recession in Russia, and push up global consumer price inflation by approximately 2½%. In their December forecast the OECD had forecast world growth of 4.5% for 2022.³⁷

On policy the OECD said that, faced with a new negative shock of uncertain duration and magnitude, monetary policy should remain focused on ensuring well-anchored inflation expectations. Most central banks should continue their pre-war plans, with the exception of the most affected economies, where a pause may be needed to fully assess the consequences of the crisis. And they added that, in the near term, many governments would need to cushion the blow of higher energy prices, diversify energy sources and increase efficiency wherever possible. Specifically, the war had underlined the importance of minimising dependence on Russia for key energy imports.

References

1. OBR, "Economic and fiscal outlook", CP545, 27 October 2021.
2. HM Treasury, "Autumn Budget and Spending Review 2021: A stronger economy for the British people", HC822, 27 October 2021.
3. Ruth Lea, "Surging oil and gas prices, as Central Banks due to meet", *Arbuthnot Banking Group*, 7 March 2022, discussed the public finance data for January.
4. OBR, "Economic and fiscal outlook", CP387, March 2021, reported that "...if short- and long-term interest rates were both 1 percentage point higher than the rates used in our forecast...it would increase debt interest spending by £20.8bn (0.8% of GDP) in FY2025.
5. OBR, "Economic and fiscal outlook", CP387, March 2021, reported that "...the Government's debt interest spending has also become more sensitive to higher inflation due to the share of index-linked debt rising from 14% of all gilts in FY1989 to 24% gilts in FY2020".
6. Roger Bootle, "War means Sunak must rethink his plan to boost Government spending", *Daily Telegraph*, 14 March 2022, reported that each 1% on inflation increases the debt interest bill by about £5bn, whilst an increase of 1% in Bank Rate adds £11bn. Moreover, a 1% reduction in GDP adds £17bn to PSNB. The total PSNB in FY2021 could be £13bn lower than forecast in October 2021.
7. Ruth Lea, "A Budget of two halves: a big boost for FY2021, but large tax increases pencilled in for FY2023, FY2024 and FY2025", *Arbuthnot Banking Group*, 8 March 2021, discussed the March 2021 Budget.
8. IFS, "Boris Johnson and Rishi Sunak have announced tax rises worth 2% of GDP in just two years – the same as Tony Blair and Gordon Brown did in ten", 17 March 2022.
9. HM Treasury, "Autumn Budget and Spending Review 2021: A stronger economy for the British people", HC822, October 2021.
10. Ruth Lea, "Autumn Budget and Spending Review 2021: improved economic forecasts and significantly higher spending", *Arbuthnot Banking Group*, 1 November 2021, discussed the Autumn Budget.
11. BBC, "Most homes to get energy bill relief of £350", 3 February 2022.
12. Bank of England, "Monetary policy summary and minutes of the MPC meeting ending 16 March 2022", 17 March 2022.
13. Bank of England, "Monetary policy summary and minutes of the MPC meeting ending 16 March 2022", 17 March 2022.
14. Ruth Lea, "Surging oil and gas prices, as Central Banks due to meet", *Arbuthnot Banking Group*, 7 March 2022, discussed the surging oil and gas prices.
15. *Daily Telegraph*, "Prepare for double-digit inflation, warns Bank", 18 March 2022.
16. ONS, "GDP monthly estimate: January 2022", 11 March 2022.
17. ONS, "Index of Production, UK: January 2022", 11 March 2022.
18. ONS, "Index of Services, UK: January 2022", 11 March 2022.
19. ONS, "Construction output in GB: January 2022", 11 March 2022.
20. ONS, "UK trade: January 2022", 11 March 2022.
21. ONS, "Labour market overview: March 2022", 15 March 2022.
22. ONS, "Earnings and employment from Pay As You Earn Real Time Information, UK, March 2022", 15 March 2022.
23. ONS, "Employment in the UK: March 2022", 15 March 2022.
24. ONS, "Employment in the UK: March 2022", 15 March 2022. Unemployment measures people without a job who have been actively seeking work within the last four weeks and are available to start work within the next two weeks. The unemployment rate can be defined as the proportion of the economically active population (those in work plus those seeking and available to work) who are unemployed.
25. ONS, "Vacancies and jobs in the UK: March 2022", 15 March 2022.
26. ONS, "Average weekly earnings in GB: March 2022", 15 March 2022.
27. Fed, "Federal Reserve issues FOMC statement", 16 March 2022.
28. Trading Economics website, data released on 10 March 2022.
29. FOMC, "FOMC projections materials", 16 March 2022.
30. ECB, "Monetary policy decisions", 10 March 2022.

31. Ruth Lea, "The MPC raises the Bank Rate to 0.5% in February: and more increases to come", *Arbuthnot Banking Group*, 7 February 2022, discussed the ECB's February meeting.
32. *Reuters*, "ECB has 'extra space' before the first rate hike, Lagarde says", 17 March 2022.
33. *ECB*, "Monetary policy decisions", 10 March 2022.
34. *ECB*, "Eurosystem staff macroeconomic projections for the euro area", 10 March 2022.
35. *Eurostat*, "Annual inflation up to 5.9% in the euro area", 17 March 2022.
36. *OECD*, "Economic Outlook, Interim Report, Economic and Social Impacts and Policy Implications of the War in Ukraine", 17 March 2022.
37. *OECD*, "Economic Outlook, December 2021: A balancing act" 1 December 2021

Annex

Table 1 Bank of England: February 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.

Table 2 Trade (goods and services) in January, balances (£bn), exports and imports (% change)

	Monthly balances (£bn)			Exports and imports (Jan, MOM, %)	
	December 2021	January 2022	Change	Exports	Imports
Total balances:					
Goods (total):	-12.4	-26.5	-14.1	-15.8%	+21.8%
of which EU/non-EU:					
• EU	-4.5	-12.8	-8.3	...	...
• Non-EU	-7.9	-13.7	-5.8	...	...
Services	10.0	10.3	+0.3	0.9	-0.7
Goods and services	-2.3	-16.2	-13.9	...	...
Precious metals	+2.4	-4.6	-7.0	...	...
“Underlying” balances:					
Goods (excluding precious metals): of which EU/non-EU:	-14.7	-21.9	-7.2	...	...
• EU	-4.8	-12.5	-7.7	...	...
• Non-EU	-10.0	-9.4	+0.6	...	...

Source: *ONS*, “UK trade: January 2022”, 11 March 2022. There are rounding errors in the table.

Table 3 Federal Reserve: economic projections, December 2021, March 2022 median estimates

	2022	2023	2024	Longer run
GDP % change, Q4 (YOY):				
Dec 2021	4.0	2.2	2.0	1.8
Mar 2022	2.8	2.2	2.0	1.8
Unemployment rate, Q4 (%):				
Dec 2021	3.5	3.5	3.5	4.0
Mar 2022	3.5	3.5	3.6	4.0
PCE inflation (%), Q4 (YOY):				
Dec 2021	2.6	2.3	2.1	2.0
Mar 2022	4.3	2.7	2.3	2.0
Core PCE inflation (%), Q4 (YOY):				
Dec 2021	2.7	2.3	2.1	Na
Mar 2022	4.1	2.6	2.3	Na
Projected appropriate policy path, Federal funds rate (%), end-year:				

Dec 2021	0.9%	1.6%	2.1%	2.5%
Mar 2022	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.