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ARBUTHNOT BANKING GROUP PLC

PERSPECTIVES

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MPC August meeting: focus on the inflation forecasts

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Introduction: August's MPC meeting…

The MPC will meet this week, with the monetary policy announcement made on 5 August. There are few expectations of any policy changes but the minutes of the meeting, and the revised economic forecasts, should be of particular interest, not least of all concerning the expected path for inflation and the implications for monetary policy.

For the record, MPC members voted to leave monetary policy broadly unchanged at the June meeting (announcement on 24 June). They voted for:[1-2]

- Maintaining the Bank Rate at 0.1%, unanimously.
- Maintaining the stock of sterling non-financial investment-grade corporate bond purchases, financed by the issuance of central bank reserves, at £20bn, unanimously.
- Continuing with its existing programme of UK government bond purchases, financed by the issuance of central bank reserves, maintaining the target for the stock of these purchases at £875bn. The existing programme of £150bn of UK government bond purchases started in January 2021 and the MPC continued to expect it would be completed by around the end of 2021. 8 of the 9 MPC members voted for this, whilst then Chief Economist Andy Haldane voted to lower the current bond purchases programme to £100bn, reducing the target for the stock of these purchases from £875bn to £825bn, as he had done in May.

Concerning inflation, the June MPC minutes noted that CPI inflation rose from 1.5% in April to 2.1% in May (the June number was 2.5%, released after the meeting), commenting "…while a pickup in CPI inflation had been expected, partly due to higher energy prices, these latest figures represented material upside news to the May *Monetary Policy Report* projections". CPI inflation was expected to pick up further above the 2% target in the months ahead, owing primarily to developments in energy and other commodity prices, and it was likely to exceed 3% for a temporary period. Crucially, however, the MPC's expectation was that the direct impact of rises in commodity prices on CPI inflation would be "transitory". And, as these "transitory effects" faded, inflation was expected to return to around 2% in the medium term. This position was endorsed by the Bank Governor in his Mansion House speech on 1 July.[3]

Since the June meeting, two MPC members have voiced their concerns about inflation, and it will be interesting to see if/how the August MPC minutes and the Bank's revised forecasts reflect these concerns.[4] Deputy Governor Sir Dave Ramsden said "…it is now conceivable that the pre-Covid peak in output in 2019Q4 will be restored in the course of the current quarter, and quite possible that unemployment could

peak lower than our May MPR [*Monetary Policy Report*] forecast. And inflation now looks likely to peak well above 3% and maybe nearer to 4%".[5]

And MPC member Michael Saunders said "…price pressures in global manufactured goods reflect, at least in part, strong global demand for goods, including consumer goods, ICT, and plant and machinery investment. These price pressures may well have some persistent effects on UK CPI inflation. Even once effects from energy prices fade, the closing output gap and possibility of some persistent effects from global cost pressures point to risks that, with the current policy stance, CPI inflation will remain above the 2% target 2-3 years ahead".[6] Moreover, he noted "…even with subdued services inflation, CPI inflation is likely to exceed 3% later this year. It would not be surprising if CPI inflation temporarily reaches 3½%-4% (YOY)." Concerning monetary policy, Saunders said "…if activity and inflation indicators remain in line with recent trends and downside risks to growth and inflation do not rise significantly…then it may become appropriate fairly soon to withdraw some of the current monetary stimulus in order to return inflation to the 2% target on a sustained basis. In this case, options might include curtailing the current asset purchase programme, ending it in the next month or two and before the full £150bn has been purchased, and/or further monetary policy action next year".

But another MPC member, Ben Broadbent, contributed to the inflation debate last week and was altogether more dovish about inflationary pressures.[7-8] He said "…quite a bit of the current rise in inflation is actually coming directly from the higher price of oil, something that is likely to fall away through the early part of 2022. And periods of rapid price rises in other traded goods haven't just been temporary, they've often been followed by below-average rates of inflation. So, while we know it's going to go further over the next few months, I'm not convinced that the current inflation in retail goods prices should…mean higher inflation 18-24 months ahead, the horizon more relevant for monetary policy." In other words, the rise in inflation could still prove to be temporary. And, given several caveats, he said the appropriate monetary policy response to higher inflation "…could well be 'nothing'".

…and the revised forecasts

As already noted, there will be revised Bank forecasts this week (May's forecasts are shown in table 1). It is highly probable the inflation forecasts will be increased in the near-term, but interest will focus on whether the Bank takes the view that CPI inflation will fall back to 2% in the "medium-term", given the assumed path for the Bank Rate (markets are currently factoring in a rate rise in 2022H2). There may also be a modest uplift in GDP growth. In June the MPC noted that GDP data for March and April 2021 had been stronger than anticipated in the Bank's May Report and Bank staff had revised up their expectations for 2021Q2 GDP growth to 5½%, from 4¼% at the time of the May Report. However, the GDP increase in May was disappointing, so 2021Q2 expectations may be revised down from June.

Table 1 Bank of England: forecast, YOY (%), unless otherwise indicated, May 2021

	2020	2021	2022	2023	2024
GDP	-9¾	7¼	5¾	1¼	
Household consumption	-11	5½	9¼	1¾	…
Business investment	-10¼	7	13½	1¼	…
Net contribution of trade (% of GDP)	¾	-2¼	-1¾	0	…
Household saving ratio (%)	15¾	12	6	6	…
Unemployment rate (%, Q4)	5	5	4½	4¼	
Average weekly earnings (%, Q4)	4¾	- ½	2¾	2¾	…
CPI inflation (%, Q4)	½	2½	2	2	…
Bank Rate (%, level), Q2	…	0.1	0.1	0.3	0.6

Source: *Bank of England*, "Monetary Policy Report, May 2021", 6 May 2021.
The path for Bank Rate implied by forward market interest rates.

Record mortgage borrowing in June…

The Bank's latest *Money and Credit* data showed that net mortgage borrowing reached a record high of £17.9bn in June.[9] By comparison, the previous record, in March 2021, was £11.5bn, and borrowing had averaged £5.4bn in the 12 months to May 2021. The Bank commented that the increase was driven by borrowing ahead of the tapering of stamp duty relief from July.[10] Mortgage approvals were, however, not so exceptional. Indeed, approvals for house purchases decreased in June to 81,300, from 86,900 in May. This was the lowest since July 2020, though remaining above pre-February 2020 levels.

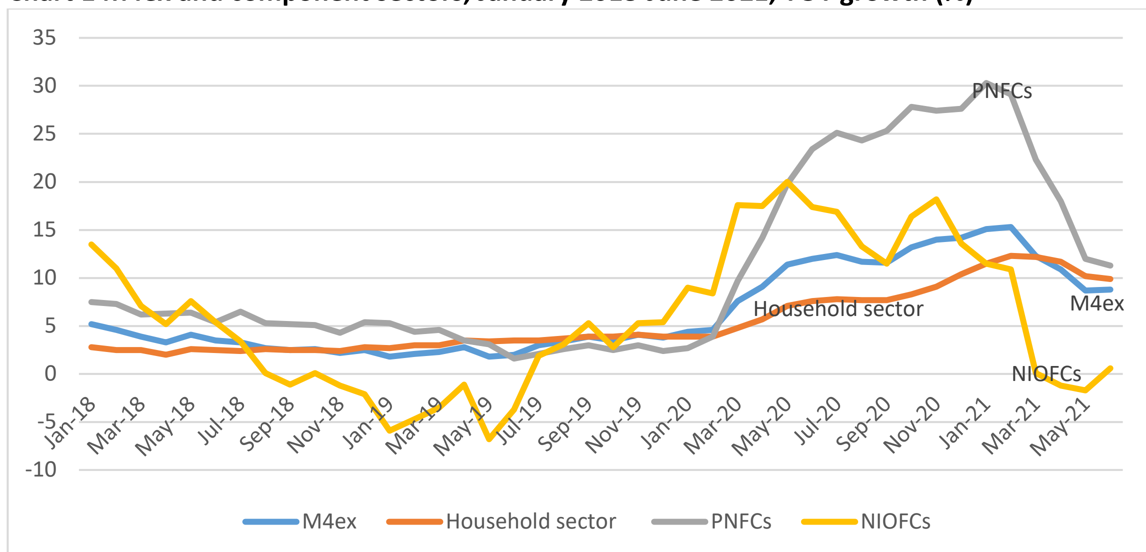
Turning to consumer credit, consumers borrowed a modest £0.3bn (net) in June, after £0.4bn in May. Moreover, the annual growth rate remained weak at -2.2% in June, though it was up from May's -2.9%. The increase in net consumer credit reflected an additional £0.2bn of 'other' forms of consumer credit, such as car dealership finance and personal loans. Credit card lending showed net borrowing of £0.1bn. The annual growth rates of both components have risen from series lows in February 2021 but remained very weak at -0.1% and -7.4%, respectively.

…whilst money supply growth steady

M4ex is the Bank's favoured measure of the money supply (defined as broad money, excluding intermediate other financial corporations (IOFCs)). It comprises the money holdings of households, private non-financial corporations (PNFCs) and non-intermediate other financial corporations (NIOFCs); money holdings include notes and coin and deposits with monetary financial institutions (MFIs, including the Bank and the commercial banks). The growth of M4ex and its three constituent component sectors are shown in chart 1.

The annual growth of M4ex has slowed quite significantly in recent months, but it was little changed in June, growing by 8.8% (YOY) after May's 8.7% (YOY). In terms of amounts outstanding, M4ex increased by £18.4bn in June, the strongest since January 2021, after May's £8.3bn. Households' holdings of money continued rising with net flows of £9.8bn, whilst private non-financial companies' (PNFCs') holdings increased by £5.3bn and Non-Intermediate OFCs' holdings rose by £3.4bn.

Chart 1 M4ex and component sectors, January 2018-June 2021, YOY growth (%)



Source: (i) *Bank of England*, "Money and credit: June 2021", 29 July 2021; (ii) Bank's website for time series. Data revisions from March 2021.

Chart 1 clearly shows the rapid growth of money holdings since pre-pandemic February 2020 of the household sector and PNFCs, both of which have been large contributors to the growth of M4ex. As can be seen in table 2 (below), the stock of M4ex increased by over £385bn between February 2020 and June 2021, of which the household sector and PNFCs contributed the lion's share. The household sector's money holdings increased by over £220bn, whilst PNFCs increased their money holdings by over £135bn, reflecting the effects of QE as well as the large increase in bank lending. The net contribution of NIOFCs has been modest by comparison.

Table 2 M4ex and money holdings by sectors, amounts outstanding (£bn)

	Feb 2020	May 2021	June 2021	Change	
				June 2021-Feb 2020 (sic)	June 2021-May 2021 (MOM)
M4ex, of which:	2,256.9	2,624.4	2,643.0	386.1	18.4
• Household sector	1,488.1	1,701.6	1,711.4	223.3	9.8
• PNFCs	431.7	562.7	568.0	136.3	5.3
• NIOFCs	337.1	360.1	363.6	26.5	3.4

Sources: (i) *Bank of England*, "Money and Credit: June 2021", 29 July 2021; (ii) Bank of England website. Data revisions from March 2021. There are rounding errors.

Some very mixed indicators

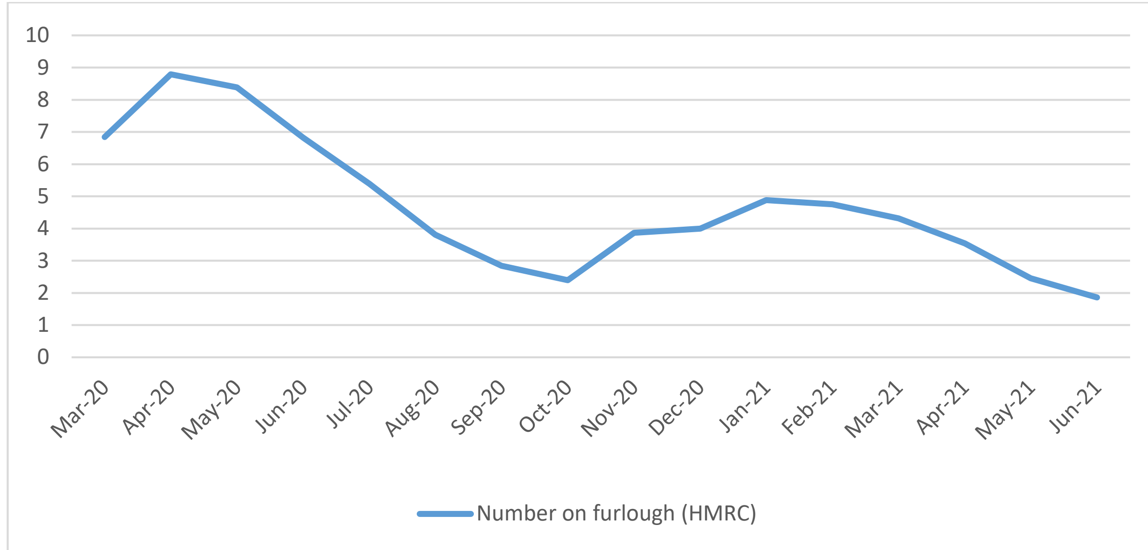
There were other indicators of interest released last week, they were "mixed".

Firstly, the Nationwide's latest house price data showed prices fell 0.5% in the month of July (seasonally adjusted), after June's 0.7% rise.[11] The annual increase eased to 10.5% in July, after June's 13.4%. Nationwide commented "…the tapering of stamp duty relief in England is also likely to have taken some of the heat out of the market. The nil rate band threshold decreased from £500,000 to £250,000 at the end of June (it will revert to £125,000 at the end of September). This provided a strong incentive to complete house purchases before the end of June, especially for higher priced properties". Turning to the near-term outlook for prices, the Nationwide seemed fairly confident, saying "...underlying demand is likely to remain solid in the near term. Consumer confidence has rebounded in recent months while borrowing costs remain low. This, combined with a lack of supply on the market, suggests continued support for house prices".

Secondly, the SMMT reported that, whilst car production in June 2021 was up on Covid-hit June 2020, it was the weakest total since 1953 (bar 2020).[12-13] Production was hit by the global chip shortage and, despite the easing of Covid restrictions, manufacturers were experiencing staff shortages "due to self-isolation arising from notification of contacts outside the workplace". Concerning the year-to-June 2021 data, UK factories turned out nearly 499,000 cars, 38.4% down on the five-year average. 83.4% of the vehicles made so far this year were shipped overseas, with the EU remaining by far the most important overseas destination for British cars, taking 51.7% of all exports, followed by the US (18.8%), China (7.8%), Japan (1.9%) and Australia (1.8%).

Thirdly, the number of employees on furlough continues to fall. According to the latest official (HMRC) around 1.9mn employments (sic) were on furlough on 30 June, compared with 2.4mn on 31 May (chart 2).[14-15] The number had peaked at nearly 9mn in early May 2020. Employees continue to receive 80% of their current salary for hours not worked on the scheme, whilst the employer contribution towards the cost of unworked hours was 10% in July, rising to 20% in August and September. The scheme ends at end-September.

Chart 2 Number of employments on furlough (millions), HMRC data (end-month, to end-June 2021)



Source: *HM Government*, "Coronavirus Job Retention Scheme (CJRS) statistics", 29 July 2021", HMRC data.

The IMF's July update…

In their July update, the IMF forecast global growth of 6.0% for 2021, unchanged from the April forecast but with "offsetting revisions", whilst growth for 2022 was modestly revised higher to 4.9% (4.4% in April).[16] Their key message was that "…economic prospects have diverged further across countries since the April 2021 WEO forecast. Vaccine access has emerged as the principal fault line along which the global recovery splits into two blocs: those that can look forward to further normalisation of activity later this year (almost all advanced economies) and those that will still face resurgent infections and rising Covid death tolls. The recovery, however, is not assured even in countries where infections are currently very low so long as the virus circulates elsewhere". Global recovery was, therefore, still dependent on developments in the Covid pandemic.

More specifically, prospects for emerging market and developing economies (EMDEs) had been marked down for 2021, especially for Emerging Asia. By contrast, the forecast for advanced economies was revised up, reflecting "improved health metrics more broadly across the group", as well as the fiscal boost in 2021H2 in the US.

Turning to country-specific forecasts, US GDP was projected to rebound by 7.0% in 2021 (6.4% in April), followed by growth of 4.9% in 2022 (3.5% in April), reflecting the aforementioned additional fiscal stimulus "…in line with the overall cumulative size of the current administration's proposed American Jobs Plan and American Families Plan".[17] Concerning the Eurozone, the IMF modestly raised growth expectations for 2021 to 4.6% (4.4% in April) and for 2022 a bigger boost to 4.3% (3.8% in April) (chart 3, annex table 1). Concerning the UK, the IMF significantly revised up the UK growth projection to 7.0% for 2021 (5.3% in April), followed by a downgrade to 4.8% for 2022 (5.1% in April). Of the EMDEs, China was expected to grow by a buoyant 8.1% in 2021 and India by 9.5% (after a significant 7.3% fall in 2020).

Chart 3 IMF GDP growth forecasts (%), July 2021, selected economies, 2020-2022

Source: *IMF*, "Fault lines widen in the global recovery", 27 July 2021. See annex table 1.

…and some GDP estimates for 2021Q2

The first GDP estimates for 2021Q2 for the US and the Eurozone (and the EU27) were released last week. (The UK data will be released on 12 August.) The main data are shown in table 3 below.

The US economy grew 6.5% in 2021Q2 (QOQ, annualised, about 1.6% non-annualised), which was below market expectations of 8.5% and thus regarded as disappointing, after growing by 6.3% in 2021Q1.[18-19] But personal consumption showed very strong growth of 11.8% (QOQ, annualised), whilst non-residential fixed investment (+8%), exports (+6%) and state and local government spending (+0.8%) were all higher. GDP growth in the quarter was, therefore, arguably more "robust" than the headline figure suggested. The negative contributions came from inventories, residential fixed investment (-9.8%), federal government spending (-10.4%) and imports (+7.8%).

Eurozone GDP rose by 2.0% (QOQ) in 2021Q2, after slipping 0.6% in 2020Q4 and a further 0.3% in 2021Q1 (thus having experienced a "double dip recession").[20] Growth in Germany was a disappointing 1.5% (2% was expected), whilst French growth was a subdued 0.9%, with manufacturing affected by supply bottlenecks and shortages.[21] Growth was more buoyant in the Mediterranean countries.

Table 3 GDP quarterly growth (%), 2021Q1 and 2021Q2, for the US, the Eurozone, EU27, key EU countries

	2021Q1	2021Q2
US	6.3% annualised (about 1.5%)	6.5% annualised (about 1.6%)
EU27	-0.1%	1.9%
Euro area (EU19)	-0.3%	2.0%
Germany	-1.8%	1.5%
France	0	0.9%
Italy	0.2%	2.7%
Spain	-0.4%	2.8%
Sweden	0.8%	0.9%

Sources: (i) Trading Economics website; (ii) *Eurostat*, "GDP up by 2.0% in the euro area and by 1.9% in the EU", 30 July 2021.

No policy change from the Fed

As expected, the Fed made no policy changes at its July meeting (27-28 July).[22] Moreover, the Fed appeared to be in no hurry to tighten policy. There were no revised forecasts accompanying the July meeting; the next set of revisions will be in September.

The Fed's statement reported:

- "The Committee (the Federal Open Market Committee (FOMC)) seeks to achieve maximum employment and inflation at the rate of 2% over the longer run [the "dual mandate"]. With (PCE) inflation having run persistently below this longer-run goal, the Committee will aim to achieve inflation moderately above 2% for some time so that inflation averages 2% over time and longer-term inflation expectations remain well anchored at 2%. The Committee expects to maintain an accommodative stance of monetary policy until these outcomes are achieved". It should be noted that PCE (core personal consumption expenditures, excluding food and energy) inflation nudged up from 3.4% in May to 3.5% in June.[23] But the Fed appears content for PCE inflation to run above 2% for some time.
- "The Committee decided to keep the target range for the federal funds rate at 0 to ¼% and expects it will be appropriate to maintain this target range until labour market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2% and is on track to moderately exceed 2% for some time.
- Significantly, in a nuanced change of tone, the statement said "…last December, the Committee indicated that it would continue to increase its holdings of Treasury securities by at least $80bn per month and of agency mortgage-backed securities by at least $40bn per month until substantial further progress has been made toward its maximum employment and price stability goals. Since then, the economy has made progress toward these goals, and the Committee will continue to assess progress in coming meetings".

Fed Chair Powell warned in his press conference "…the effects of the pandemic on the economy have continued to diminish, but risks to the economic outlook remain. Progress on vaccinations has limited the spread of COVID-19. However, the pace of vaccinations has slowed, and the 'delta' strain of the virus is spreading quickly in some areas."[24] On inflation, he noted "…inflation has increased notably and will likely remain elevated in coming months before moderating. As the economy continues to reopen and spending rebounds, we are seeing upward pressure on prices, particularly because supply bottlenecks in some sectors have limited how quickly production can respond in the near term. These bottleneck effects have been larger than anticipated, but as these transitory supply effects abate, inflation is expected to drop back toward our longer-run goal. Very low readings from early in the pandemic as well as the pass-through of past increases in oil prices to consumer energy prices also contribute to the increase, although these base effects and energy effects are receding". In other words, higher inflation is still (broadly) seen as temporary.

Concerning the tapering of the securities buying stimulus programme, Powell was noticeably non-committal on its timing, though the issue of tapering is clearly moving up the agenda. There are some expectations that Powell will lay the foundations for tapering in September, with an announcement on tapering in December.[25]

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Annex

Table 1 IMF GDP forecasts, growth rates (%), July 2021

	July 2021 update			April 2021 forecast		
	2020	2021	2022	2020	2021	2022
World output (GDP)	-3.2	6.0	4.9	-3.3	6.0	4.4
Advanced economies:						
US (G7)	-3.5	7.0	4.9	-3.5	6.4	3.5
Eurozone, of which:	-6.5	4.6	4.3	-6.6	4.4	3.8
Germany (G7)	-4.8	3.6	4.1	-4.9	3.6	3.4
France (G7)	-8.0	5.8	4.2	-8.2	5.8	4.2
Italy (G7)	-8.9	4.9	4.2	-8.9	4.2	3.6
Spain	-10.8	6.2	5.8	-11.0	6.4	4.7
Japan (G7)	-4.7	2.8	3.0	-4.8	3.3	2.5
UK (G7)	-9.8	7.0	4.8	-9.9	5.3	5.1
Canada (G7)	-5.3	6.3	4.5	-5.4	5.0	4.7
EMDEs:						
China	2.3	8.1	5.7	2.3	8.4	5.6
India	-7.3	9.5	8.5	-8.0	12.5	6.9
Russia	-3.0	4.4	3.1	-3.1	3.8	3.8
Brazil	-4.1	5.3	1.9	-4.1	2.7	2.6
Memo: world trade	…	…	…	-8.5	8.4	6.5

Source: *IMF*, “Fault lines widen in the global recovery”, 27 July 2021.
There are four forecasts a year: Jan update, April forecast, July update, October forecast. EMDEs = Emerging market & developing economies.