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ARBUTHNOT BANKING GROUP PLC

PERSPECTIVES

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MPC August meeting: above-target inflation still expected to be 'transitory'

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Introduction: Bank's MPC leaves monetary policy broadly unchanged…

At the meeting ending on 4 August 2021, MPC members voted to leave monetary policy unchanged, voting for:[1]

- 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 had started in January and the MPC continued to expect it to be completed by around the end of 2021. 7/8 MPC members voted for this, whilst Michael Saunders voted to lower the existing programme of bond purchases, reducing the target for the stock of these purchases from £875bn to £830bn (by £45bn). Note that, as of 4 August 2021, the total stock of assets held in the Asset Purchase Facility (APF, corporate and government bonds) had reached £845bn, including £100bn of the £150bn programme of UK government bond purchases announced on 5 November 2020 (see annex table 1).

The minutes commented that the MPC had, since 2020H2, policy guidance specifying that it did not intend to tighten monetary policy at least until there was clear evidence that significant progress was being made in eliminating spare capacity and achieving the 2% inflation target sustainably. In August some MPC members judged that the conditions had not yet been met fully. Other MPC members judged that the conditions had been met fully but noted that the guidance made clear that these were only necessary, but not sufficient, conditions for tightening monetary policy. It can be concluded that the MPC is in no hurry to tighten policy. Nevertheless, the minutes noted "…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".

…as higher inflation is forecast…

Concerning the economy, the Bank's forecasts showed a significant upward revision to the inflation forecast compared with May, as expected.[2] CPI inflation was projected to rise temporarily in the near term, to 4% in 2021Q4 (compared with 2½% in May), owing largely to developments in energy and other goods prices (table 1). However, the MPC maintained the view that above-target inflation was expected to be "transitory", as commodity prices were assumed to stabilise, supply shortages were assumed to ease and global demand to rebalance away from goods and back towards services. As a result, CPI inflation was projected to return to close to the 2% target in the medium term. The minutes said "…the economy was projected to experience a more pronounced period of above-target inflation in the near term than expected in the May Report".

There were few changes to the GDP forecasts, compared with May. GDP was expected to grow by 7¼% in 2021 (unchanged), followed by 6% in 2022 (up from 5¾%) and 1½% in 2023 (up from 1¼%). Specifically, GDP was set to have risen by a better-than-expected 5% in 2021Q2 but would slow to around 3% (weaker than in the May report) in 2021Q3. GDP was then projected to recover further over 2021, reaching its pre-pandemic level in 2021Q4, with demand growth boosted by a waning impact from Covid. Further out, the pace of GDP growth was expected to slow towards more normal rates, partly reflecting the gradual tightening in the stance of announced fiscal policy (as announced in the March 2021 Budget).

Unemployment rates were projected slightly lower. The rate is now expected to be 4¾% in 2021Q4 and 4¼% in 2022Q4 (the rate in the three months to May was 4.8%). The minutes noted that the number of full and part-time furloughed jobs had continued to decline as demand had recovered, but they remained at around 2mn at the end of June. They also noted that the stock of vacancies had increased further, as had indicators of recruitment difficulties. And the minutes commented "…there appear to have been difficulties in matching available jobs and workers. These frictions are for a period reducing effective supply in the economy. Overall, the MPC judges that spare capacity has been eroded over the past couple of quarters, as demand has outstripped growth in effective supply. Frictions in the labour market are judged likely to dissipate over the forecast period, boosting growth in effective supply capacity. There is uncertainty around these judgements, including how the economy will adjust to the end of the furlough scheme."

Finally, note that the "market path" for the assumed Bank Rate has tightened in the near-term since May, see below.

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

	2021	2022	2023	2024
GDP:				
May	7¼	5¾	1¼	…
August	7¼	6	1½	…
Unemployment rate (%), Q4:				
May	5	4½	4¼	
August	4¾	4¼	4¼	
CPI inflation (YOY, %), Q4:				
May	2½	2	2	…
August	4	2 ½	2	…
August forecasts:				
Household consumption	5½	9¼	1½	…
Business investment	3	18¾	¾	…
Net contribution of trade (%, GDP)	-¾	-2½	0	…
Household saving ratio (%)	12¾	5½	5½	…
Average weekly earnings (YOY, %), Q4	2½	1¾	2	…

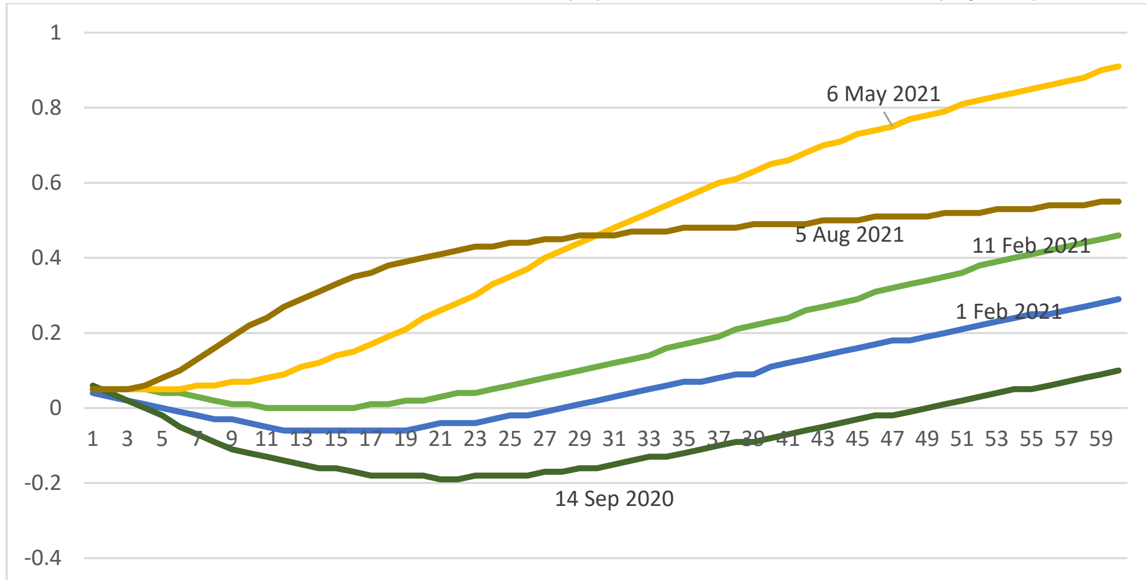
Bank Rate (%), Q3, May in brackets	0.1 (0)	0.2 (0.1)	0.4 (0.4)	0.5

Source: *Bank of England*, "Monetary Policy Report, August 2021", 5 August 2021. The path for Bank Rate implied by forward market interest rates.

...and market interest rates expectations have firmed

As table 1 above notes, the "market path" for the Bank Rate has firmed in the near-term, since the Bank's May *Monetary Policy Report*. Bank Rate was seen at 0.1% in 2021Q3 in the August *Monetary Policy Report* (0% in May) and 0.2% in 2022Q3 (0.1% in May), the markets are clearly anticipating a hike in the Bank Rate in 2022H2.[3] But the rate for 2023Q3 was effectively unchanged at 0.4% and the rate for 2024Q3, at 0.5%, was actually lower than implied by the yield curve data for May (though it was not included in the Bank's May report). The latest yield curve data are shown in chart 1a. The Bank noted that the sterling exchange rate had appreciated a little further since the May Report. The appreciation mainly reflected a stronger pound against the euro, the £/$ rate was little changed overall (chart 1b).

Chart 1a 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, latest data, 5 August 2021.

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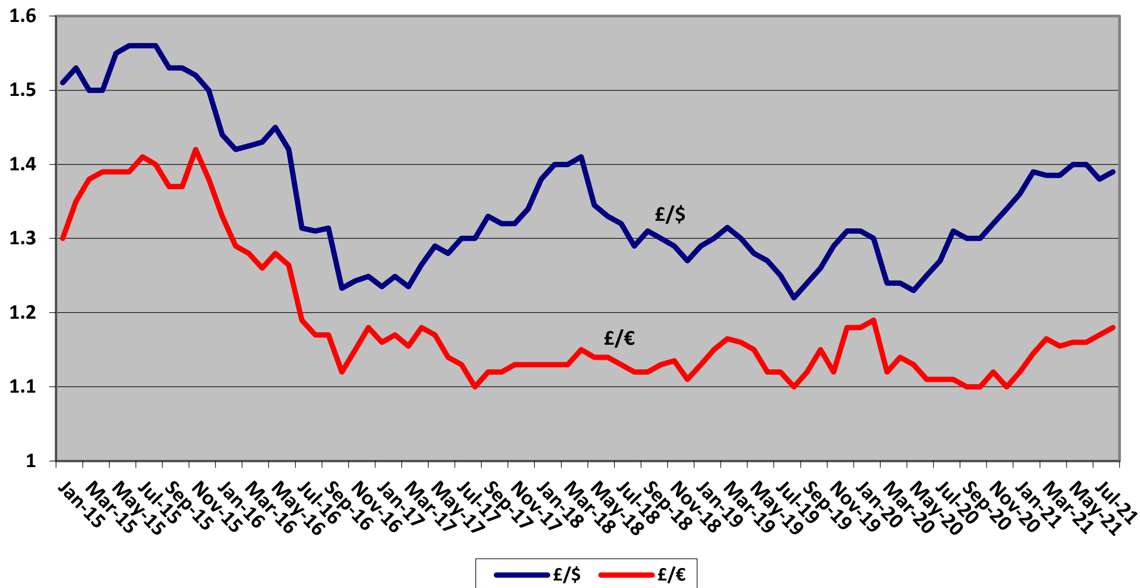
Chart 1b £/$, £/€: January 2015-July 2021, 5 August 2021



Source: Bank of England database for currencies (spot rates): monthly averages, but daily rate for August 2021 (5 August 2021).

The MPC's tightening strategy…

The August *Monetary Policy Report* provided some useful guidance on the MPC's monetary tightening policy.[4]

The report, firstly, considered the factors influencing the MPC's strategy for the sequencing of monetary policy tools to deliver tighter policy. These were:

- The Committee's preference is to use Bank Rate as its active instrument in most circumstances.
- There is uncertainty about the impact of reducing the stock of purchased assets on monetary conditions, but the MPC judges that, when conducted in a gradual and predictable manner and when markets are functioning normally, it is likely to be smaller than that of asset purchases.
- The MPC judges that there are benefits to reducing the stock of purchased assets by initially ceasing to reinvest maturing assets.

The report then considered the MPC's current approach to the sequencing on monetary policy tools. Firstly, the MPC intended to begin to reduce the stock of purchased assets, by ceasing to reinvest maturing assets, when the Bank Rate had risen to 0.5% and if appropriate given the economic circumstances. The markets are expecting 0.5% rates by 2024H2 (see table 1 and chart 1a, above). The 0.5% Bank Rate level for beginning to wind down QE was significantly lower than the MPC's previous assessment. In June 2018, the MPC had stated that it intended not to reduce the stock of purchased assets until Bank Rate had reached around 1.5%. In addition, the MPC intended to reduce the stock of purchased assets by initially ceasing the reinvestment of UK government bonds, rather than corporate bonds.

Secondly, the MPC would consider actively selling some of the stock of purchased assets, but only once Bank Rate had risen to at least 1%. And, finally, the MPC would monitor the impact of the reduction in the stock of purchased assets and may amend or reverse the process if needed to meet its 2% inflation target. It intended to review the unwind process no later than two years after it had begun.

…and the Bank's Agents' latest findings

The August *Monetary Policy Report* also provided a summary of the latest information, gathered in the six-weeks to mid-July, from the Bank's Agents.[5] The key points were:

- Consumer spending remained strong, but continuing supply-chain issues led to long lead times for some goods. In some services, growth was constrained by staff shortages.
- Activity in business services continued to pick up, whilst shortages of materials and labour held back growth in manufacturing and construction output. Output in the automotive sector was specifically being constrained by the shortage of semiconductors. Contacts said they were adapting to the new arrangements for trading with the EU. Export demand was reported to have increased, but there was evidence of some EU customers rotating away from UK suppliers. More UK-based contacts said they were setting up hubs in the EU in order to continue selling to customers there. And there was further evidence of some substitution away from EU imports.
- Housing market activity remained robust even as some transaction tax reductions came to an end. Contacts reported a further tightening in housing supply due to a slowdown in house-building activity and fewer properties being put up for sale.
- Companies expected to increase investment spending over the coming year relative to the previous year, whilst the demand for bank credit was subdued. The Agents' reported that bank credit was readily available in stable and growing sectors, though some smaller businesses and those in sectors that have been most affected by the pandemic continued to report tight credit availability.
- Employment intentions and recruitment difficulties were increasing sharply as activity recovers, whilst pay settlements remain moderate but were beginning to increase.
- Input cost inflation continued to rise and was increasingly being passed through to output and retail prices. Cost increases were attributed to both a robust recovery in global and domestic demand and a loss of supply capacity, most of which was thought to be temporary.

Markit indicators suggest slowing recovery…

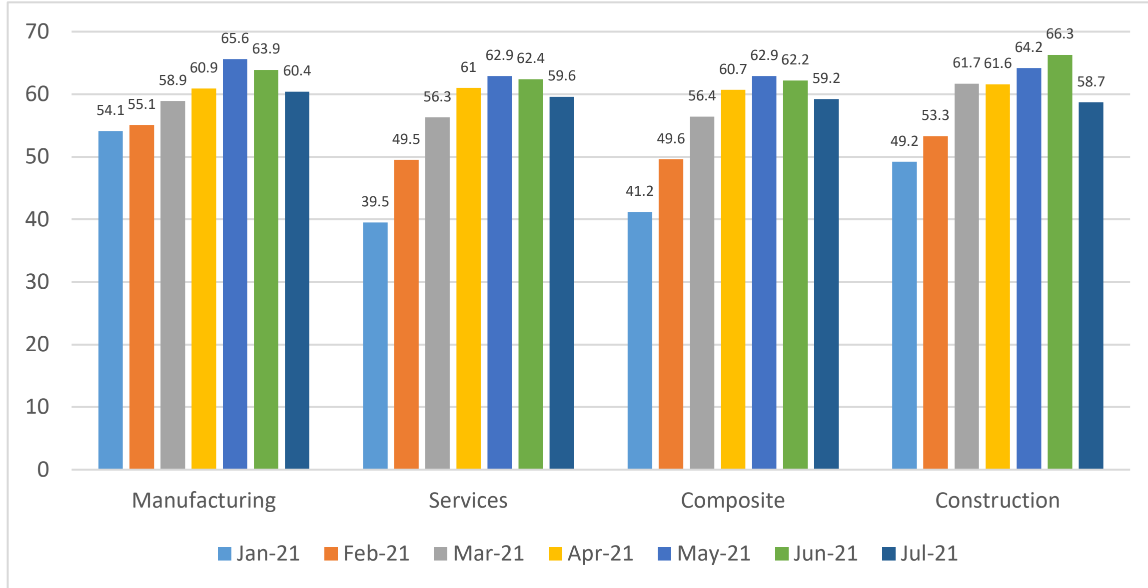
Markit surveys for July suggested manufacturing, services and construction were still expanding strongly, though weaker than in June (chart 2). Inflationary pressures remained a concern in all three sectors.

For the record, the results of the June survey were:

- The Manufacturing PMI slipped to 60.4 in July, after June's 63.9.[6] Although rates of expansion in output and new orders slowed, they were still buoyant. Scarcities remained a prime concern, however, as stretched supply chains and staff shortages were constraints preventing faster growth of output and employment. With demand outstripping supply, price pressures continued to grow during July. Average input costs rose at a near survey-record pace, with over 72% of manufacturers seeing an increase. (The manufacturing PMI is a weighted average of new orders, output, employment, suppliers' delivery times, and stocks of purchases.)
- The Services PMI Business Activity Index slipped 59.6 in July, after June's 62.4, the lowest since March 2021, but still well above the 50.0 no-change level.[7] Staff shortages, supply chain issues and the end of the full stamp duty holiday for residential property sales were cited as factors leading to a slowdown since June. There were also reports that Covid-19 isolation rules had negatively influenced sales volumes.[8] Wage pressures, higher fuel prices and greater transport bills were the most commonly cited factors pushing up input costs in July.
- The seasonally adjusted UK Composite Output Index posted 59.2 in July, down from 62.2 in June, thereby signalling the slowest rate of private sector expansion for four months.[9] (The Composite Output Index is a weighted average of the UK Manufacturing Output Index (not the PMI) and the UK Services Business Activity Index (PMI).)
- The Construction Total Activity Index was 58.7 in July, down sharply from June's 66.3, with slower growth seen in all three main categories of work.[10] Survey respondents often cited difficulties keeping pace with the recent surge in demand for construction projects, especially due to raw material supply

shortages and shrinking sub-contractor availability. A rapid pace of input cost inflation continued in July, fuelled by supply shortages and robust demand for construction items.

Chart 2 UK Markit/CIPS PMIs, January-July 2021



Sources: (i) Markit releases for manufacturing, services and construction PMIs for July 2021; (ii) previous releases for previous data.

…and two other indicators

There were two other indicators of note released last week.

Firstly, The SMMT reported that July's new car registrations were 29.5% (YOY) lower, but the annual decline was exaggerated by the fact that sales had been boosted in July 2020 by showrooms fully opening after the first lockdown.[11] However, July's registrations were 22.3% lower than the average recorded over the past decade, as the ongoing semiconductor shortage and the 'pingdemic' impacted on both supply and demand. Sales in July 2021 were the weakest since 1998, prior to the introduction of the two-plate system. Year-to-date data suggested that sales were some 24.7% higher (YOY), but last year's sales were distorted by the first lockdown and closed showrooms. The SMMT commented "…while the UK's economic outlook continues to strengthen, with most consumer indicators suggesting a greater appetite for spending, including on so-called 'big ticket' items, supply challenges continue to throttle growth with the weaker market conditions expected to continue in August, traditionally a quiet month for registrations, before modest growth returns in 2021Q4".

Secondly, the Halifax reported that the average UK house price picked up by 0.4% (MOM) in July, after slipping in June. But the annual growth eased to 7.6% (after June's 8.7%), the lowest since March.[12] However, the YOY data were distorted by base effects, as the housing market started to recover in July 2020 from the first lockdown and began to benefit from the introduction of the stamp duty holiday. The Halifax commented "…recent months have been characterised by historically high volumes of buyer activity, with June the busiest month for mortgage completions since 2008. This has been fuelled both by the 'race for space' and the time-limited stamp duty break. With the latter now entering its final stages, buyer activity should continue to ease over the coming months, and a steadier period for the market may lie ahead. Latest industry figures show instructions for sale are falling and estate agents are experiencing a drop in their available stock. This general lack of supply should help to support prices in the near-term, as will the exceptionally low cost of borrowing and continued strong customer demand."

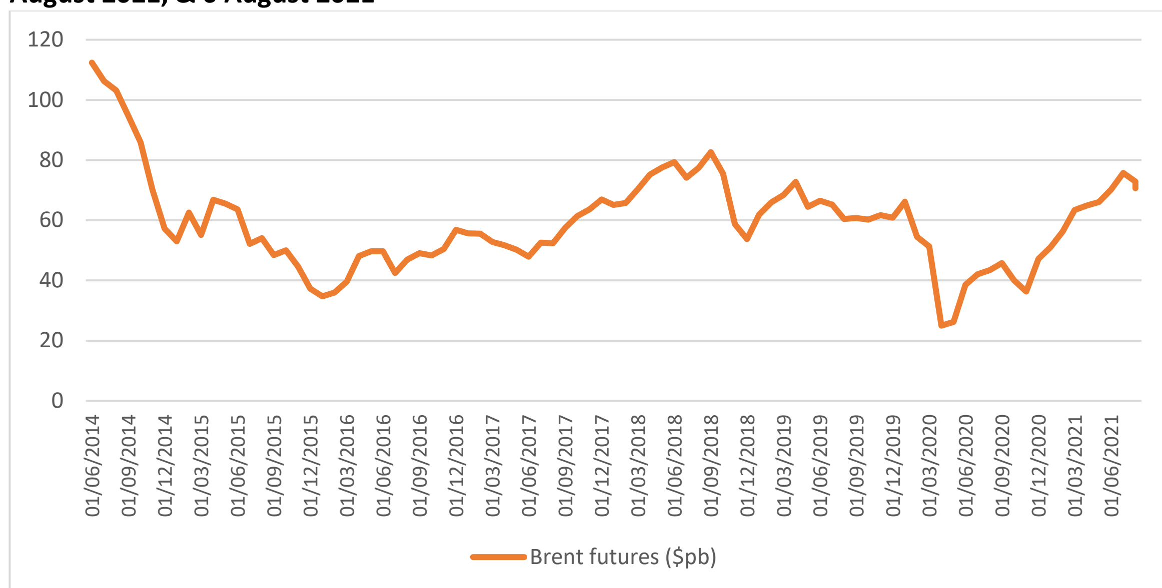
By comparison, the Nationwide reported last week that house prices fell 0.5% in the month of July (seasonally adjusted), after June's 0.7% rise, whilst the annual increase eased to 10.5% in July, after June's 13.4%.[13-14] For the record, the SDLT nil rate threshold (for England and Northern Ireland) was reduced from £500,000 to £250,000 on 1 July and will revert to £125,000 on 1 October. The tax holiday ended on 31 March 2021 in Scotland and on 30 June 2021 in Wales.

Oil prices off their recent highs

Oil prices continued to firm in June and early July reflecting the continuing global recovery. There were also indications that an apparent stand-off in early July between Saudi Arabia (which favoured increasing oil production gradually) and the UAE (which favoured a more rapid increase in production) was pushing up prices.[15-17] However, OPEC+ agreed production increases at their last meeting (ending 18 July), which has led to some easing oil prices. Specifically, OPEC+ agreed to increase their overall production by 0.4mbd on a monthly basis, starting August 2021.[18-19] Moreover, they aim to fully phase out the production cuts ("adjustments", introduced in 2020) by the end of September 2022, subject to market conditions.

Reflecting the OPEC decision to increase production, oil prices (Brent Crude), having exceeded $77pb in early July, have since slipped back (chart 3). By 6 August, Brent Crude had fallen to $70.7pb. But, having said that, oil prices remain significantly above pre-pandemic levels.

Chart 3 Brent oil futures, $ per barrel ($pb), monthly prices (1st of month, or nearest), 1 June 2014-1 August 2021, & 6 August 2021



Sources: Brent crude historical prices, www.uk.investing.com; BBC website 1 January-1 August 2021 and 6 August 2021.

References

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15. *Daily Telegraph*, "Oil prices surge amid OPEC dispute over production rises", 7 July 2021.
16. *BBC*, "The growing Gulf rivalry that's pushing up oil prices", 8 July 2021.
17. *BBC*, "Oil producing nations agree deal to control prices", 18 July 2021, reported that Abu Dhabi had blocked a proposal by Riyadh and Moscow to extend output curbs to 2022 after they rejected its demand to produce more oil.
18. *OPEC*, "19th OPEC and non-OPEC Ministerial Meeting concludes", 18 July 2021.
19. *Reuters*, "OPEC+ agrees oil supply boost after UAE, Saudi reach compromise", 19 July 2021.

Annex

Table 1 Bank's actual/proposed asset purchases (QE), cumulative totals

Date		Assets (£bn)		
		Government bonds	Corporate bonds	Total
Mar 2009	Introduced to help economy through financial crisis	75	0	75
May 2009	Increased to help economy through financial crisis	125	0	125 [+50]
Aug 2009	Ditto	175	0	175 [+50]
Nov 2009	Ditto	200	0	200 [+25]
Oct 2011	Increased to support economy	275	0	275 [+75]
Feb 2012	Ditto	325	0	325 [+50]
Jul 2012	Increased to meet inflation target in medium-term	375	0	375 [+50]
Aug 2016	Increased to help economy after EU referendum	435 [+60]	10	445 [+70]
Mar 2020	Increased to help economy during COVID-19 pandemic	625 [+190]	20 [+10]	645 [+200]
Jun 2020	Ditto, to be completed by "turn of year", 2020-2021	725 [+100]	20	745 [+100]
Nov 2020	Increased to meet inflation target in medium-term, to be completed by around end-2021	875 [+150]	20	895 [+150]
4 August 2021	Purchased to date, including £100bn of November 2020's £150bn	825	20	845

Main source: Bank of England website.