

Economic Overview (March 2021) – Provided by Link Asset Services

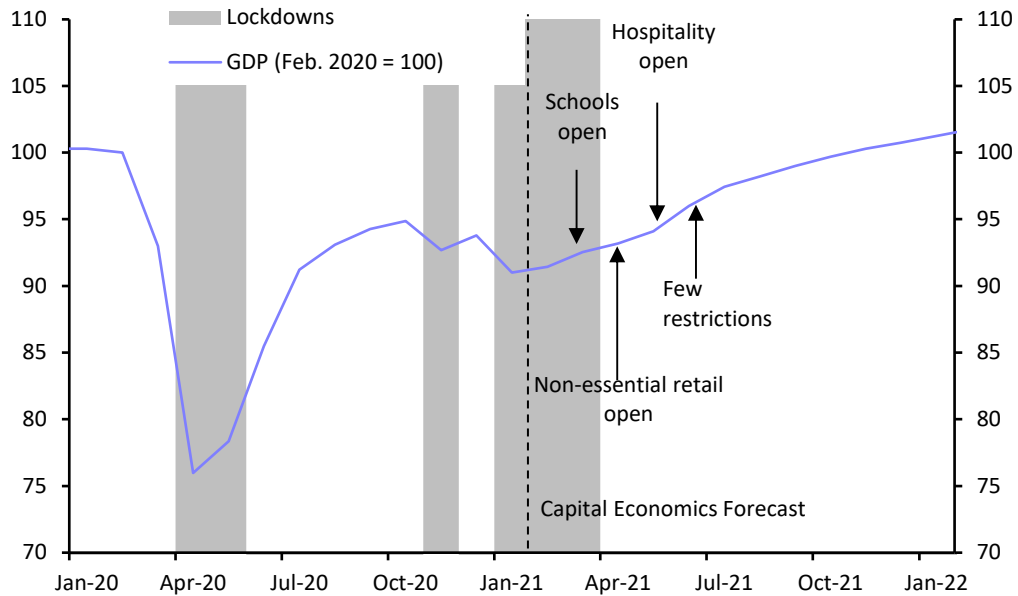
UK. The key quarterly Monetary Policy Report meeting of the Bank of England's Monetary Policy Committee kept **Bank Rate** and quantitative easing (QE) unchanged on 4th February, (as it also did at its 18th March meeting). However, it revised its economic forecasts to take account of a third national lockdown which started on 5th January, which is going to further delay economic recovery and do further damage to the economy. Although its short-term forecasts were cut for 2021 due to the start of a third lockdown in early January, the medium-term forecasts were more optimistic than in November, based on an assumption that the current lockdown will be gradually eased after Q1 as vaccines are gradually rolled out and life can then start to go back to some sort of normality. The Bank's main assumptions were:

- The economy would start to recover strongly from Q3 2021 although it acknowledged there were downside risks from virus mutations etc.
- £125bn of savings made by consumers during the pandemic will give a big boost to the pace of economic recovery once lockdown restrictions are eased and consumers can resume high street shopping, going to pubs and restaurants and taking holidays.
- The economy would still recover to reach its pre-pandemic level by Q1 2022 despite a long lockdown in Q1 2021. **Spare capacity** in the economy would be eliminated in Q1 2022 and there would be **excess demand** in the economy by Q4 2022.
- **CPI inflation** was forecast to rise quite sharply towards the 2% target in the first half of 2021 due to some temporary factors, (e.g. the reduction in VAT for certain services comes to an end) and given developments in energy prices. CPI inflation was projected to be close to 2% in 2022 and 2023.
- The MPC reiterated its previous guidance that Bank Rate would not rise until inflation was sustainably above 2%. This means that it will tolerate inflation running above 2% from time to time to balance out periods during which inflation is below 2%. This is termed **average inflation targeting**. While financial markets are pricing in Bank Rate starting to rise by the end of 2022, this policy could mean that Bank Rate does not rise until as late as 2026.
- The Bank of England removed **negative interest rates** as a possibility for at least six months as financial institutions were not ready to implement them. As in six months' time the economy should be starting to grow strongly, this effectively means that negative rates occurring were unlikely during the current downturn. (**Gilt yields and PWLB rates** jumped upwards after the removal of negative rates as a key risk in the short-term.)

There are two views in respect of Bank Rate beyond our three-year time horizon:

- a. The MPC will be keen to raise Bank Rate as soon as possible in order for it to be a usable tool when the next economic downturn comes along. This is in line with thinking on Bank Rate over the last 20 years; financial markets are currently pricing in Bank Rate starting to rise by the end of 2022.
- b. Conversely, that we need to adjust to the new post-pandemic era that we are now in. In this new era, **the shift to average inflation targeting** has set a high bar for raising Bank Rate i.e. only when inflation has demonstrated that it has risen sustainably above 2%. In addition, many governments around the world have been saddled with high levels of debt. When central bank rates are low, and below the average GDP growth rate, the debt to GDP ratio will gradually fall each year without having to use fiscal tools such as raising taxes or austerity programmes, (which would depress economic growth and recovery). This could therefore result in governments revising the setting of mandates to their national central banks to allow a higher rate of inflation linked to other economic targets. This is the Capital Economics view – that Bank Rate will not rise for the next five years and could then struggle to get to 1% within 10 years.

Appendix A



- COVID-19 vaccines.** These have been the game changer which have enormously boosted confidence that **life in the UK could largely return to normal during the second half of 2021** after a third wave of the virus threatened to overwhelm hospitals around the start of the year. With the household saving rate having been exceptionally high since the first lockdown in March 2020, there is plenty of pent-up demand and purchasing power stored up for services in the still-depressed sectors like restaurants, travel and hotels. The UK has made fast progress with giving a first job to half of all adults and this programme should be completed in the second half of the year. The big question is whether mutations of the virus could develop which render current vaccines ineffective, as opposed to how quickly can vaccines be modified to deal with them and enhanced testing programmes be implemented to contain their spread.
- The Budget on 3rd March** increased fiscal support to the economy and employment during 2021 and 2022 followed by substantial tax rises in the following three years to help to pay the cost for the pandemic. This will help further to strengthen the economic recovery from the pandemic and to return the government's finances to a balanced budget on a current expenditure and income basis in 2025/26. This will stop the Debt to GDP ratio rising further from 100%. An area of concern, though, is that the government's debt is now twice as sensitive to interest rate rises as before the pandemic due to QE operations substituting fixed long-term debt for floating rate debt; there is, therefore, much incentive for the Government to promote Bank Rate staying low e.g. by using fiscal policy in conjunction with the monetary policy action by the Bank of England to keep inflation from rising too high, and / or by amending the Bank's policy mandate to allow for a higher target for inflation.
- EU exit.** The final agreement on 24th December 2020 eliminated a significant downside risk for the UK economy. The initial agreement only covered trade so there is further work to be done on the services sector where temporary equivalence has been granted in both directions between the UK and EU; that now needs to be formalised on a permanent basis. There was much disruption to trade in January as form filling has proved to be a formidable barrier to trade. This appears to have eased somewhat since then but is an area that needs further work to ease difficulties, which are still acute in some areas.
- US.** The Democrats won the presidential election in November 2020 and have control of both Congress and the Senate, although power is more limited in the latter. This enabled the

Democrats to pass a \$1.9trn (8.8% of GDP) stimulus package in March on top of the \$900bn fiscal stimulus deal passed by Congress in late December. These, together with the vaccine rollout proceeding swiftly to hit the target of giving a first jab to over half of the population within the President's first 100 days, will promote a rapid easing of restrictions and strong economic recovery during 2021. The Democrats are also planning to pass a \$2trn fiscal stimulus package aimed at renewing infrastructure over the next decade. Although this package is longer-term, if passed, it would also help economic recovery in the near-term.

- After Chair Jerome Powell unveiled the **Fed's adoption of a flexible average inflation target** in his Jackson Hole speech in late August 2020, the mid-September meeting of the Fed agreed by a majority to a toned down version of the new inflation target in his speech - that *"it would likely be appropriate to maintain the current target range until labour market conditions were judged to be consistent with the Committee's assessments of maximum employment and inflation had risen to 2% and was on track to moderately exceed 2% for some time."* This change was aimed to provide more stimulus for economic growth and higher levels of employment and to avoid the danger of getting caught in a deflationary "trap" like Japan. It is to be noted that inflation has actually been under-shooting the 2% target significantly for most of the last decade, (and this year), so financial markets took note that higher levels of inflation are likely to be in the pipeline; long-term bond yields duly rose after the meeting. There is now some expectation that where the Fed has led in changing its policy towards implementing its inflation and full employment mandate, other major central banks will follow, as indeed the Bank of England has done so already. The Fed expects strong economic growth this year to have only a transitory impact on inflation, which explains why the majority of Fed officials project US interest rates to remain near-zero through to the end of 2023. The key message is still that policy will remain unusually accommodative – with near-zero rates and asset purchases – continuing for several more years. This is likely to result in keeping treasury yields at historically low levels – **which will also have an influence on gilt yields in this country.**
- **EU.** Both the roll out and take up of vaccines has been disappointingly slow in the EU, at a time when many countries are experiencing a sharp rise in cases which are threatening to overwhelm hospitals in some major countries; this has led to renewed severe restrictions or lockdowns during March. This will inevitably put back economic recovery after the economy had staged a rapid rebound from the first lockdowns in Q3 but contracted slightly in Q4 to end 2020 only 4.9% below its pre-pandemic level. Recovery will now be delayed until Q3 of 2021 and a return to pre-pandemic levels is expected in the second half of 2022.
- Inflation is likely to rise sharply to around 2% during 2021 for a short period, but as this will be transitory due to one-off factors, it will cause **the ECB** little concern. It is currently unlikely that it will cut its central rate even further into negative territory from -0.5%, although the ECB has stated that it retains this as a possible tool to use. The ECB's December 2020 meeting added a further €500bn to the PEPP scheme, (purchase of government and other bonds), and extended the duration of the programme to March 2022 and re-investing maturities for an additional year until December 2023. Three additional tranches of TLTRO, (cheap loans to banks), were approved, indicating that support will last beyond the impact of the pandemic, implying indirect yield curve control for government bonds for some time ahead. The total PEPP scheme of €1,850bn of QE which started in March 2020 is providing protection to the sovereign bond yields of weaker countries like Italy. There is, therefore, **unlikely to be a euro crisis** while the ECB is able to maintain this level of support. The March ECB meeting also took action to suppress the rise in long bond yields by stepping up its monthly PEPP purchases.
- **China.** After a concerted effort to get on top of the virus outbreak in Q1, economic recovery was strong in Q2 and then into Q3 and Q4; this has enabled China to recover all of the

contraction in Q1. Policy makers have both quashed the virus and implemented a programme of monetary and fiscal support that has been particularly effective at stimulating short-term growth. After making a rapid recovery in 20/21, growth is likely to be tepid in 21/22.

- **Japan.** A third round of fiscal stimulus in early December took total fresh fiscal spending in 2020 in response to the virus close to 12% of pre-virus GDP. That is huge by past standards, and one of the largest national fiscal responses. The budget deficit is now likely to reach 16% of GDP in 2020/21. Coupled with Japan's relative success in containing the virus without draconian measures so far, and the roll out of vaccines gathering momentum, the government's latest fiscal effort should help to ensure a strong recovery and to get back to pre-virus levels by Q3 2021 – around the same time as the US and much sooner than the Eurozone.
- **World growth.** World growth was in recession in 2020. Inflation is unlikely to be a problem in most countries for some years due to the creation of excess production capacity and depressed demand caused by the coronavirus crisis.
- **Impact on gilt yields and PwLB rates in 2021.** Since the start of 2021 gilt yields and PwLB rates have risen sharply. What has unsettled financial markets has been a \$1.9trn (equivalent to 8.8% of GDP) fiscal boost for the US economy as a recovery package from the Covid pandemic, in addition to the \$900bn support package passed in December. Financial markets have been alarmed that the two packages could cause an excess of demand in the economy which could **unleash inflationary pressures** and force the FOMC to take much earlier action to start increasing the Fed rate from near zero, despite their stated policy being to target average inflation and saying that increases were unlikely in the next few years.
- A further concern in financial markets is **when will the Fed end quantitative easing (QE) purchases of treasuries** and how they will gradually wind it down. These ongoing monthly purchases are currently acting as downward pressure on treasury yields. Nonetheless, during late February and in March, yields rose sharply. As the US financial markets are, by far, the biggest financial markets in the world, any trend upwards there will invariably impact and influence financial markets in other countries. It is noticeable that gilt yields moved higher after the MPC meeting in early February as a result of both developments in the US, and financial markets also expecting a **similarly rapid recovery of the UK economy as in the US**; both countries were expected to make similarly rapid progress with vaccinating their citizens and easing Covid restrictions. They are therefore, expecting inflation to also increase more quickly in the UK and cause the MPC to respond by raising Bank Rate more quickly than had previously been expected.
- **Deglobalisation.** Until recent years, world growth has been boosted by increasing globalisation i.e. countries specialising in producing goods and commodities in which they have an economic advantage and which they then trade with the rest of the world. This has boosted worldwide productivity and growth, and, by lowering costs, has also depressed inflation. However, the rise of China as an economic superpower over the last 30 years, which now accounts for nearly 20% of total world GDP, has unbalanced the world economy. In March 2021, western democracies implemented limited sanctions against a few officials in charge of government policy on the Uighurs in Xinjiang; this led to a much bigger retaliation by China and is likely to mean that the China / EU investment deal then being negotiated, will be torn up. After the pandemic exposed how frail extended supply lines were around the world, both factors are now likely to lead to a sharp retrenchment of economies into two blocs of western democracies v. autocracies. It is, therefore, likely that we are heading into a period where there will be a reversal of world globalisation and a decoupling of western countries from dependence on China to supply products and vice versa. This is likely to reduce world growth rates.

Appendix A

- **Central banks' monetary policy.** During the pandemic, the governments of western countries have provided massive fiscal support to their economies which has resulted in a big increase in total government debt in each country. It is therefore very important that bond yields stay low while debt to GDP ratios slowly subside under the impact of economic growth. This provides governments with a good reason to amend the mandates given to central banks to allow higher average levels of inflation than we have generally seen over the last couple of decades. Both the Fed and Bank of England have already changed their policy towards implementing their existing mandates on inflation, (and full employment), to hitting an average level of inflation. Greater emphasis could also be placed on hitting subsidiary targets e.g. full employment before raising rates. Higher average rates of inflation would also help to erode the real value of government debt more quickly.

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