UK FINANCE

MONTHLY ECONOMIC INSIGHT

March 2022

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In February the Monetary Policy Committee voted to raise interest rates to 0.5 per cent, the first back-to-back rate rise since 2004. This month's briefing will look at the latest inflation picture, the factors behind the decision and what might come next.

FEBRUARY MPC DECISION

In line with market expectations the MPC raised Bank Rate by another 25 basis points at its February meeting, coming on the back of an increase to 0.25 per cent in December. While the move was expected, it wasn't an entirely surprise-free event, with four of the nine members voting for a larger increase to 0.75 per cent (that would have been the first time the Committee voted for a 50 bp increase in Bank Rate since the Bank's independence in 1997).

In addition, there was a unanimous vote to reduce the stock of government and corporate bond purchases by ending the reinvestment of maturing assets – a shift from quantitative easing to quantitative tightening.

Alongside the decision, the MPC published its quarterly Monetary Policy Report, with its update forecast for the economy and – importantly – inflation. The outlook for the latter alone provides explanation for the further rate rise (**chart 1**). Compared with the MPC's judgement in the November Report, when the Bank expected CPI to peak at around five per cent in spring 2022, there has been a material shift in the expected path of inflation. CPI is now thought likely to peak at over seven per cent in Q2. While inflation will fall back thereafter, to hit the target at the end of the forecast period, it is notable that in Q1 next year CPI is expected to be in the region of five per cent.

We have previously discussed the drivers underpinning recent rises in inflation – the rebound in demand as the global economy began unlocking from Covid-19; the emergence of some significant supply chain bottlenecks and tightening labour markets. In addition, one of the main factors behind the expectation of a sharper uptick in inflation this year is a larger contribution from household gas and electricity prices – driven by a combination of strong demand and geopolitical tensions.

Chart 1: Inflation surge forecast, CPI percentage based on market expectations of Bank Rate

Source: Bank of England

The Committee also noted concerns about accelerating wage pressures, a consequence of tightness in the labour market. For those members preferring a 50 bp rate rise, signs of a pick-up in pay settlements and firms' intentions to pass this on to customers underlined concerns that this could lead to more persistent inflation.

The minutes of the meeting also noted that, if economic conditions evolve broadly as expected then '*further modest tightening in monetary policy was likely to be appropriate in the coming months*'.

OIL PRICE HEADS ABOVE $100

The rise in energy prices has been substantial as global demand has recovered from pandemic lockdowns in the latter part of 2021. At the end of January 2022 sterling oil prices were almost 90 per cent above their 2020 Q4 level, and UK wholesale gas prices almost 400 per cent higher. This in turn pushed up wholesale electricity prices, which rose by more than 300 per cent over this period.

Further upward momentum on energy prices has been evident in recent weeks due to the escalation of geopolitical tension in Ukraine. At the end of February, the price of a barrel of Brent crude surpassed $100 (**Chart 2**) for the first time since 2014. Ratcheting up of sanctions against Russia has raised concerns about disruptions to global oil supplies. But recent statements for the US on working with other economies on a coordinated reserves release should ease some of the price pressures.

Chart 2: Oil price takes off, Brent crude $pb

Source: Market Insider

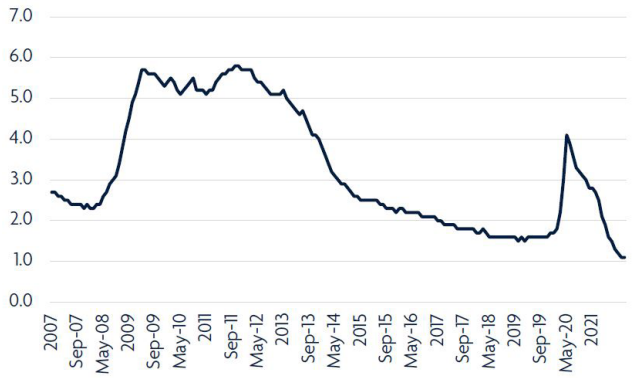
Much of the attention on energy price rises has focused on the impact on households, with the significant increase in the energy price cap that was recently announced by Ofgem. Businesses, however, are not captured by this, nor the offsetting measures that were subsequently announced by the chancellor. The latest wave of the ONS BICS showed that a quarter of businesses (excluding those with fewer than ten employees) have seen an impact on their business from rising gas prices – either directly, through their suppliers or a combination of the two. Manufacturing and accommodation and food service activities were most likely to have been affected, adding further pressure on margins if the full extent of the increase cannot be passed through.

VACANCIES *STILL* AT RECORD HIGHS

In addition to rising gas prices, a tightening UK labour market is being closely watched at the Bank of England. As shown in **Chart 3**, the unemployed-per-vacancy ratio was 1.1 as of November 2021. This is the lowest the ratio has ever been, driven by ever-increasing vacancies, coupled with increased economic inactivity due to long-term illness and more young people entering education. It is expected that a tight labour market will translate into higher wages as firms compete to attract and main talent, which in turn further contributes to inflationary pressures. However, there remains a degree of uncertainty about the path this will take.

It is true firms are struggling to recruit: the latest Decision Maker's Panel data for January shows 55 per cent of businesses are finding it much harder to recruit employees compared with normal, and this has contributed to a sharp rise in the pay of new hires. Furthermore, pay growth has been attributed to a rise in inflationary expectations, as well as a rising number of people moving jobs who are being rewarded with higher pay.

Chart 3: Unemployed per vacancy ratio



Source: ONS

The latest official measure of earnings growth showed a slight pick up in wages, with further rises forecast. However, some businesses also note challenges in meeting higher pay expectations. Turning again to the latest ONC BICS, around three in ten businesses point to an inability to offer attractive packages to applicants as one of the factors behind their struggle to fill vacancies. This rises to 45 per cent amongst firms in the accommodation and food sector. Though it should also be noted that the most common problem is simply a lack of applicants. Nevertheless, this could become more of an issue when higher employer NIC contributions kick in later this year.

'MISERY INDEX'

The misery index is an indicator used to measure the degree of economic stress felt by the average citizen and is calculated by summing the unemployment rate and the inflation rate.

For the UK (**Chart 4**), 'misery' for the average citizen looks to be similar to the beginning of the GFC. In the short term at least, we'll see a further rise in the misery index, as costs of living are set to rise in the coming quarter.

This is borne out in the latest consumer sentiment data from GfK. February saw a seven-point fall to the lowest level since last January. There were particularly marked falls in confidence about households' financial situation in the next 12 months, the general economic outlook and plans for major purchases. All indicate that concern about inflation and upcoming energy price hikes are starting to bite.

Chart 4: Misery index

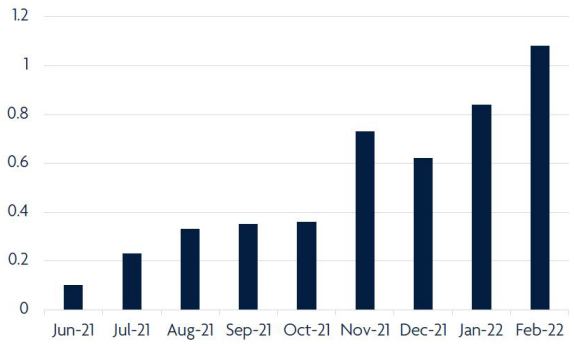
Source: ONS

'MISERY INDEX'

So, with further rises in inflation in the pipeline, but heightened uncertainty due to escalating geopolitical tensions, what's the Bank's next move. At the last meeting, the Committee signalled that further increases were most likely on the cards, which suggests it's a question of when rather than if, as things currently stand.

While there is an expectation that the rate of GDP growth will ease this year as consumers rein in spending, the latest business indicators, from the 'flash PMIs', point to the private sector shaking off the temporary wobble from the Omicron variant, with the service sector looking especially buoyant as activity rose to an eight-month high in February. This could keep rates on track for another rise in the coming months. Certainly, economic forecasters' expectations have shifted significantly since the middle of last year, when many thought 2022 rate rises unlikely. Now the average expectation is for Bank Rate to end the year at around one per cent.

Chart 5: Bank Rate forecast at 2022 Q4, percentage



Source: HM Treasury

ROUND UP

As anticipated, activity in the UK economy seems to have shaken off the temporary disruption caused by the Omicron variant. Business surveys are firmly in positive territory, indicating that GDP will resume its growth trajectory during 2022 Q1. The government also recently announced the path to the removal of all remaining Covid-19-related restrictions, replacing these with guidance. This may provide a further small fillip to activity, but this will be limited as much of the private sector is operating as normal.

However, we move from one challenge into the path of another. The cost-of-living storm is rolling in and households' concerns about their future financial position is becoming more evident. Will they batten down the hatches or succeed in securing sufficient pay increases in a tight labour market to offset the squeeze? This is some of the uncertainty facing policy makers and where judgements and the appetite for further evidence may dictate timings on the next policy move.

Coming up in the next month, is an updated outlook for the economy and the public finances from the Office for Budget Responsibility – we'll bring you the headlines in next month's review.

Indicator	Period	Value	Change	2022 Forecast*
GDP	Q4 2021	1.0%	↔	4.4%
CPI inflation	Jan 2022	5.5%	↑	4.7%
Unemployment rate	Dec 2021	4.1%	↔	4.1%
Average earnings	Dec 2021	4.3%	↑	4.2%
Brent crude	Jan 2022	$86.51	↑	-
$ Exchange rate	Jan 2022	$1.36	↑	-
PSNB	Jan 2022	-£2.9bn	↓	£92.7 bn