May 2020 MACRO BRIEF

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LAST WEEK IN MACRO

A Right Raucous

'BOE WARNS UK SET TO ENTER WORST RECESSION FOR 300 YEARS.'

'BANK OF ENGLAND GIVES DIRE WARNING OF UK RECESSION DUE TO CORONAVIRUS.'

Both eye-catching headlines for sure, but this is the winner…

'BANK OF ENGLAND WARNS CORONAVIRUS CRISIS WILL SEE GDP SLUMP NEARLY 30 PERCENT AND CAUSE WORST RECESSION SINCE THE GREAT FROST IN 1709'.

The Great Frost you say; sensational and educational. You'd think that the boffins at the Bank of England were all running around frantically waving their arms in the air and screaming 'fire'. Or 'frost' or something.

They're not.

Nor, thank goodness, are they engaging in an endless round of alphabetti-spaghetti-nomics… V, W, L, U, I, etc. Instead, the Bank is busying itself with all that it can and should be doing to maintain functioning markets, to encourage the flow of credit to businesses and consumers alike and to assemble the preconditions necessary for as full and as vigorous a recovery as is possible when it is possible.

After years of passive irrelevancy, the Bank of England is back in the game.

Now, let's see what this 30 percent slump stuff is all about…

A Plausible Scenario

Yesterday's headlines were inspired by the publication of the Bank of England's quarterly Monetary Policy Report (née The Inflation Report).

In a break from the usual format, the report focussed on a single 'plausible illustrative scenario' based on 'a set of stylised assumptions about the pandemic and the responses of governments, households and businesses, and … on the prevailing levels of asset prices and the market path for interest rates.'

Stylized conditions - simpler caricatures of various complicated moving parts – represent a useful mechanism for understanding how the disease (Covid-19) and the lockdown response might affect the economy, and which drivers of economic activity might be most affected.

Here are the conditions and the conclusions contained in the report. First, the conditions…

1. Enforced social distancing measures (the lockdown) and government support schemes remain as they are until early June and are gradually unwound by the end of September.
2. The Coronavirus Job Retention Scheme (the furloughs) limits the number of job losses to the extent that unemployment settles at 8 percent (roughly double the pre-pandemic rate) by year end.
3. Most furloughed workers do not seek additional work elsewhere (though 10 percent do).
4. Companies that have ceased or scaled back activities will restart operations gradually as enforced social distancing measures are relaxed.

5. Some of the spending foregone during enforced social distancing is assumed to be made up. A quarter of the recorded fall in consumption and 10% of foregone investment spending is assumed to be recovered gradually rather than lost forever.
6. Low confidence and high levels of uncertainty encourage a voluntary form of social distancing to persist, easing slowly over the course of a full year and damping spending throughout.
7. Falls in asset prices weigh on GDP, with tighter financial conditions making capital market funding (bond issuance) more costly and limiting the availability of mortgages with higher loan-to-value ratios.
8. Monetary policy (the Bank) and fiscal policy (the government/HM Treasury) supports spending.
9. The UK moves to a comprehensive free trade agreement with the EU on 01 January 2021. (I know, that's the bit that raised my eyebrows too).

Number 9 aside, that all seems quite reasonable to me. Now the conclusions…

1. GDP falls 3.0 percent in Q1 and another 25 percent in Q2 before a recovery of sorts in Q3 and Q4 to bring about a full year contraction of 14 percent.
2. GDP increases 15 percent next year before settling a little above trend at 3.0 percent in 2022. Pre-Covid levels of GDP are reached some time in the second half of next year.
3. Lower demand asserts downward pressure on inflation. CPI inflation averages 0.6 percent between now and the end of the year when it drops briefly to zero percent.
4. Inflation rises duriduring 2021 and averages 2.0 percent during 2022.

There's nothing shocking in the conclusions reached by the Bank. Indeed, their illustrative scenario is not far off the average of independent forecasts. Having said that, I think you'll agree instinctively with me that the risks are weighed to the downside.

In that regard, the Bank has laid out what they consider to be some of the 'key sensitives' or changed conditions which might tip the economy further into the red or slow the pace of recovery.

In no particular order…

1. Growth elsewhere in the world might be higher or lower than is assumed (-12 percent in aggregate this year, +15 percent next year). Lower growth will weigh on UK exports, higher growth will support UK exports.
2. The timing of the recovery may be later, and the speed of the recovery may be slower. Enforced social distancing measures might be in place for a longer period or a shorter period, so too might government support measures like the Coronavirus Job Retention Scheme. At the same time, more of the spending which was foregone during the recovery might prove lost for good.
3. Economic 'scarring' might be more severe. The Bank assumes that productivity levels are lower in the post-pandemic economy – reflecting lower investment, lower R&D, work-from-home effects and less on-the-job training – but productivity could turn out to be lower still.
4. Inflation might drift higher or lower.

Point 4, is worth expanding on. Here's what the Bank have to say…

'In the medium term, CPI inflation will depend importantly on how domestically generated price pressures evolve. But the responsiveness of domestic prices to the Covid-19 shock is very uncertain, given the sharp fall and recovery in demand in the scenario, the partial closure of some markets and significant heterogeneity in

Experiences across sectors. There is little evidence from past pandemics to draw upon.'

Indeed, as far as I am aware past pandemics are not unambiguously linked with consequent periods of high inflation.

This one might be, or it might not be.

Notwithstanding the uncertainty over the medium term, it is apparent that inflation expectations (both survey-based and market -inferred) remain 'well anchored' around the 2.0 percent target for now.

Barring something outside of the scope of this report (shenanigans in the Straits of Hormuz for example), CPI inflation is likely to drift lower over the course of 2020.

The more demanding question is what will inflation look like three or four years hence. In that regard, and with a benign near -term inflation outlook, there is little need to act early.

The next 6 months or so - up to and including the US presidential elections - will provide us with an opportunity to gather more information and develop our thoughts.

NOTES.

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