Economic Perspectives

UK and international economic and financial outlook

prepared for SMPC meeting

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12 October 2021

Mainstream forecasts assume rapid growth in 2022 …

- … and inflation easing back

CONSENSUS FORECASTS: WORLD ECONOMIC ACTIVITY

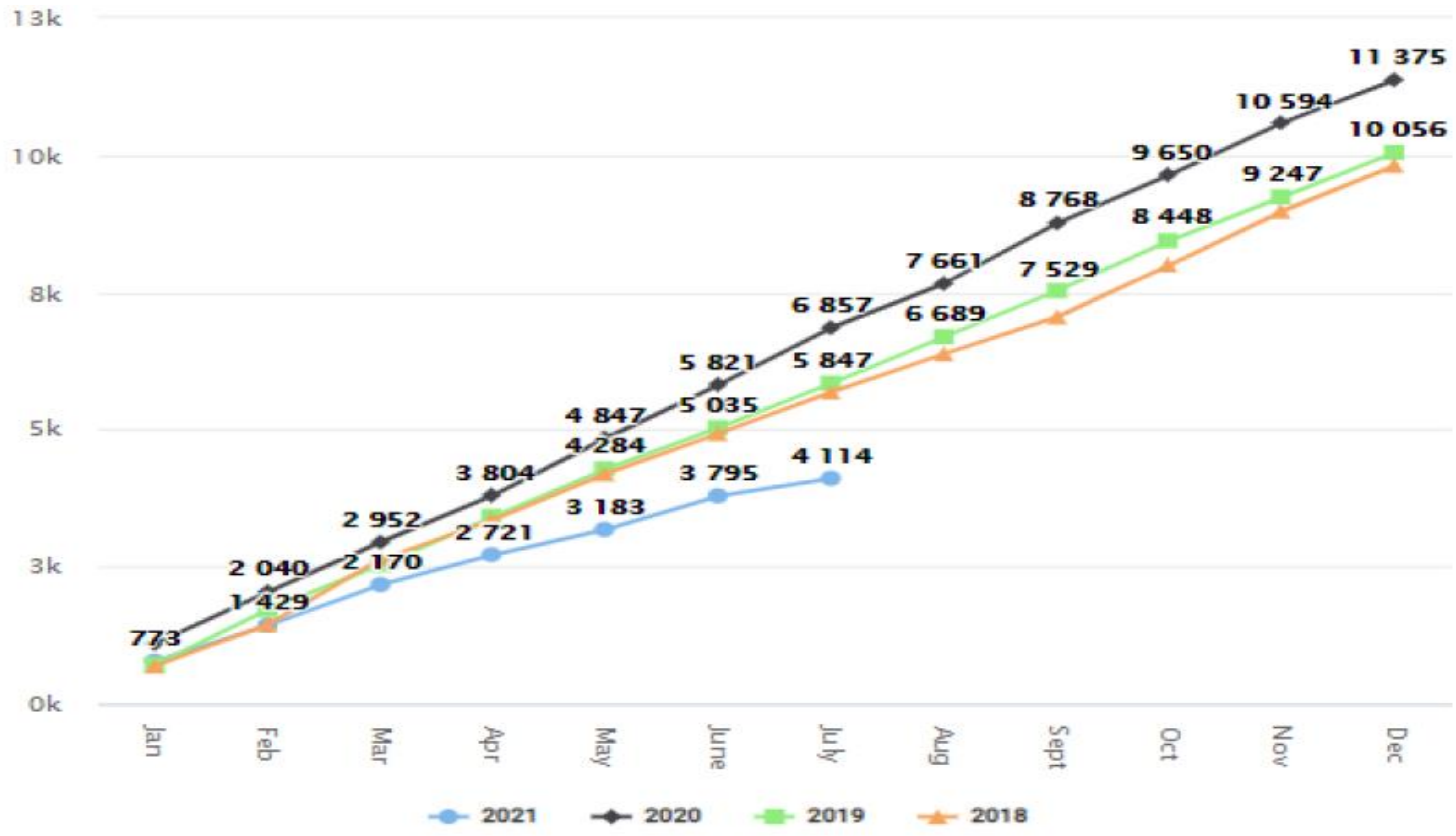
↑ Consensus Forecast **Increase** From Prior Month ↓ Consensus Forecast **Decrease** From Prior Month

September Survey	Real GDP *% increase*			Consumer Prices *% increase*			Current Account *Balance, US$bn*		
	2020	2021	2022	2020	2021	2022	2020	2021	2022
Belgium	-6.3	5.1 ↑	3.4	0.7	1.9 ↑	1.6 ↑	-0.8	-0.4	-2.3
Canada	-5.3	5.4 ↓	4.2	0.7	3.0 ↑	2.5 ↑	-29.9	0.3	-8.4
France	-8.0	6.1 ↑	3.8 ↓	0.5	1.6 ↑	1.5 ↑	-50.0	-40.7	-43.5
Germany	-4.6	3.1 ↓	4.4	0.5	2.9 ↑	2.0 ↑	266.8	291.7	293.0
Italy	-8.9	5.7 ↑	4.3 ↑	-0.2	1.5 ↑	1.4 ↑	66.8	64.9	59.5
Japan	-4.7	2.3 ↓	3.0	0.0	-0.2 ↓	0.5	162.1	181.4	185.2
Netherlands	-3.8	3.7 ↑	3.4	1.3	2.0	1.8 ↑	63.7	93.0	95.8
Norway	-2.5	3.9	3.8	1.3	2.9 ↑	1.8	7.2	32.6	32.2
Spain	-10.8	6.1 ↑	6.0 ↑	-0.3	2.3 ↑	1.5 ↑	8.8	10.9	17.3
Sweden	-2.8	4.3 ↑	3.5	0.5	1.8 ↑	1.6	31.0	34.9	35.7
Switzerland	-2.4	3.5 ↓	3.0 ↑	-0.7	0.5 ↑	0.6	28.6	58.7	62.8
United Kingdom	-9.8	6.7 ↓	5.4	0.8	2.2	2.8 ↑	-94.8	-101.3	-116.1
United States	-3.4	5.9 ↓	4.3 ↓	1.2	4.3 ↑	3.1 ↑	-616.0	-786.7	-814.5
North America[1]	-3.5	5.8	4.3	1.2	4.2	3.1	-645.9	-786.4	-822.9
Western Europe[2]	-6.5	5.0	4.3	0.4	2.0	1.8	341.3	525.6	530.8
European Union[2]	-5.9	4.8	4.3	0.6	2.2	1.8	423.8	547.5	557.7
Euro zone[2]	-6.5	5.0 ↑	4.4	0.3	2.2 ↑	1.7 ↑	282.5	358.2	358.2
Asia Pacific[3]	-0.9	6.3	4.9	2.0	1.6	2.1	782.4	817.0	722.5
Eastern Europe[4,7]	-2.5	4.7	3.8	5.3	6.9	5.4	6.7	43.6	32.1
LatAm ex Venezuela[5,7]	-6.7	6.0	2.9	6.4	9.4	7.2	6.1	-13.4	-38.4
Other Countries[6]	-2.4	3.4	3.9	4.8	5.8	4.9	-24.1	36.5	38.4
Total[7]	-3.3	5.7	4.4	1.9	3.2	2.8			

Economic Perspectives

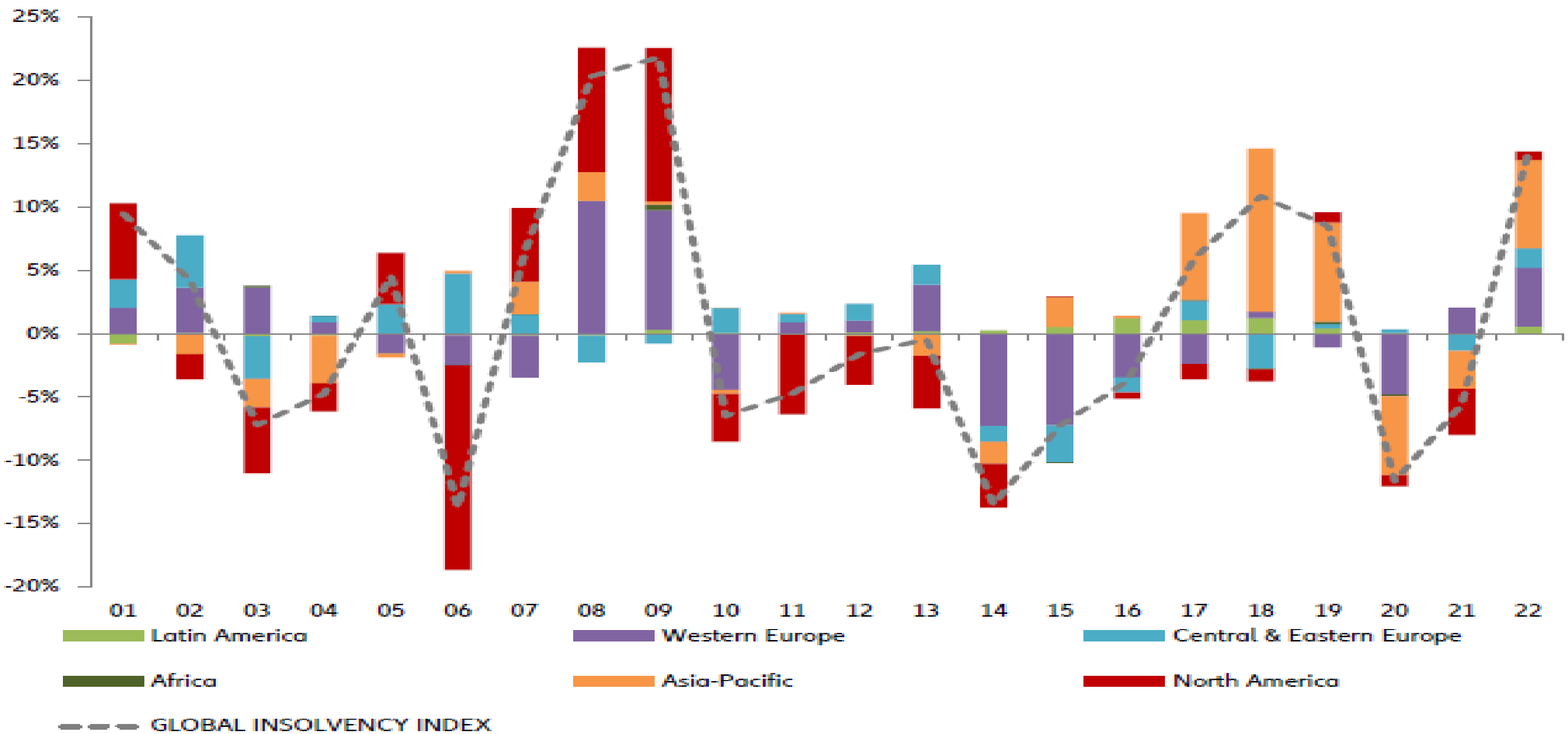
US fiscal and monetary largesse kills off defaults

- Business bankruptcies – cumulative comparisons



But … underlying insolvency pressures are elevated

Figure 2: Euler Hermes insolvency indices by region – contribution to the yearly change in Global Insolvency Index



Sources: Euler Hermes, Allianz Research

Recasting of economic policy objectives

- *Formerly*, the objective of monetary stability required that the cost and access to borrowed money varied to regulate inflationary pressures
- *Formerly*, the objective of financial stability required that financial institutions were regulated to hold sufficient capital to meet bad debts
- *Currently*, monetary policy has been redefined in terms of full/over-employment of the labour force
- *Currently*, financial stability has been redefined in terms of minimising the likelihood of default through zero interest rates and debt forbearance

Nationalisation of credit creation

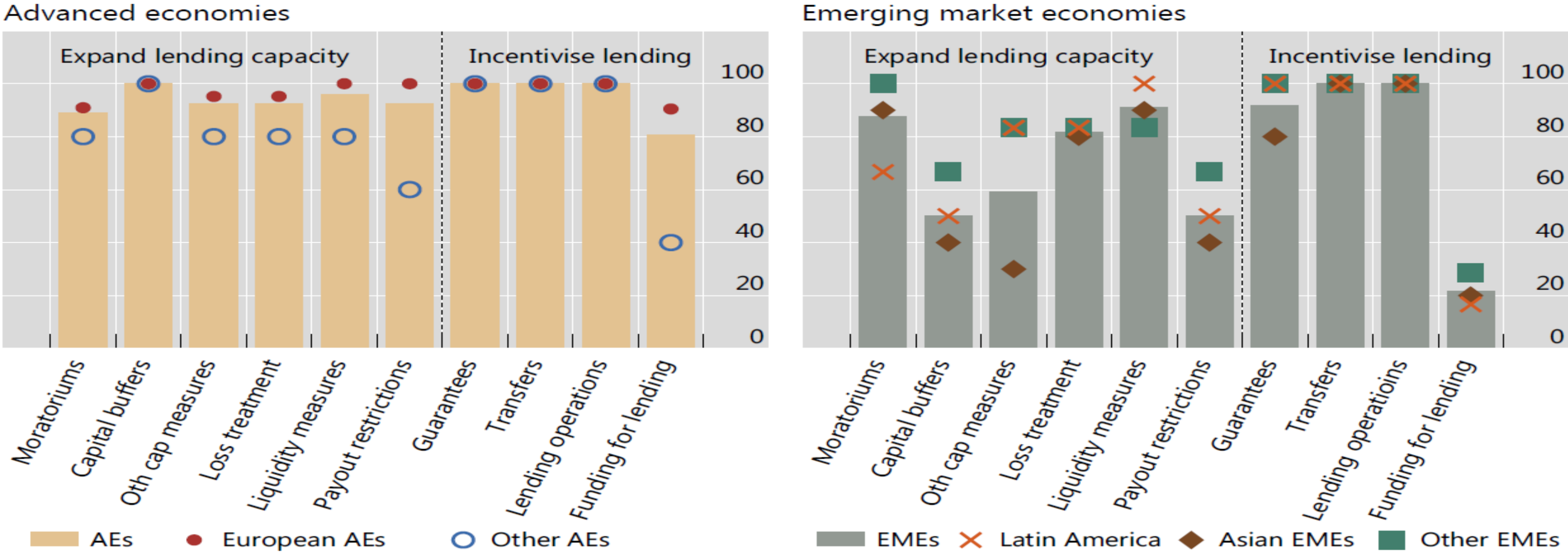
- In response to the pandemic, the state has re-emerged as the dominant economic actor
- When the pandemic struck, government realised that the banks would not provide the support to the private sector that would be necessary
- State effectively nationalised credit creation and weakened bankruptcy/insolvency mechanisms
- State guarantees for ‘crisis’ bank loans
- US Fed’s historic interventions in US corporate credit markets to neuter pricing of default risk

Extensive interference in bank lending decisions

Policy measures implemented during the Covid crisis to support bank lending[1]

Percentage of countries implementing within each region

Graph 1



Asian EMEs = CN, HK, ID, IN, KR, MY, PH, SG, TH and VN; European AEs = AT, BE, CH, DE, DK, EE, ES, FI, FR, GB, GR, IE, IS, IT, LT, LU, LV, NL, NO, PT, SE, and SK; Latin America = AR, BR, CL, CO, MX and PE; Other AEs= AU, CA, NZ, JP and US; Other EMEs = CZ, HU, IL, PL, RU, SA, TR and ZA.

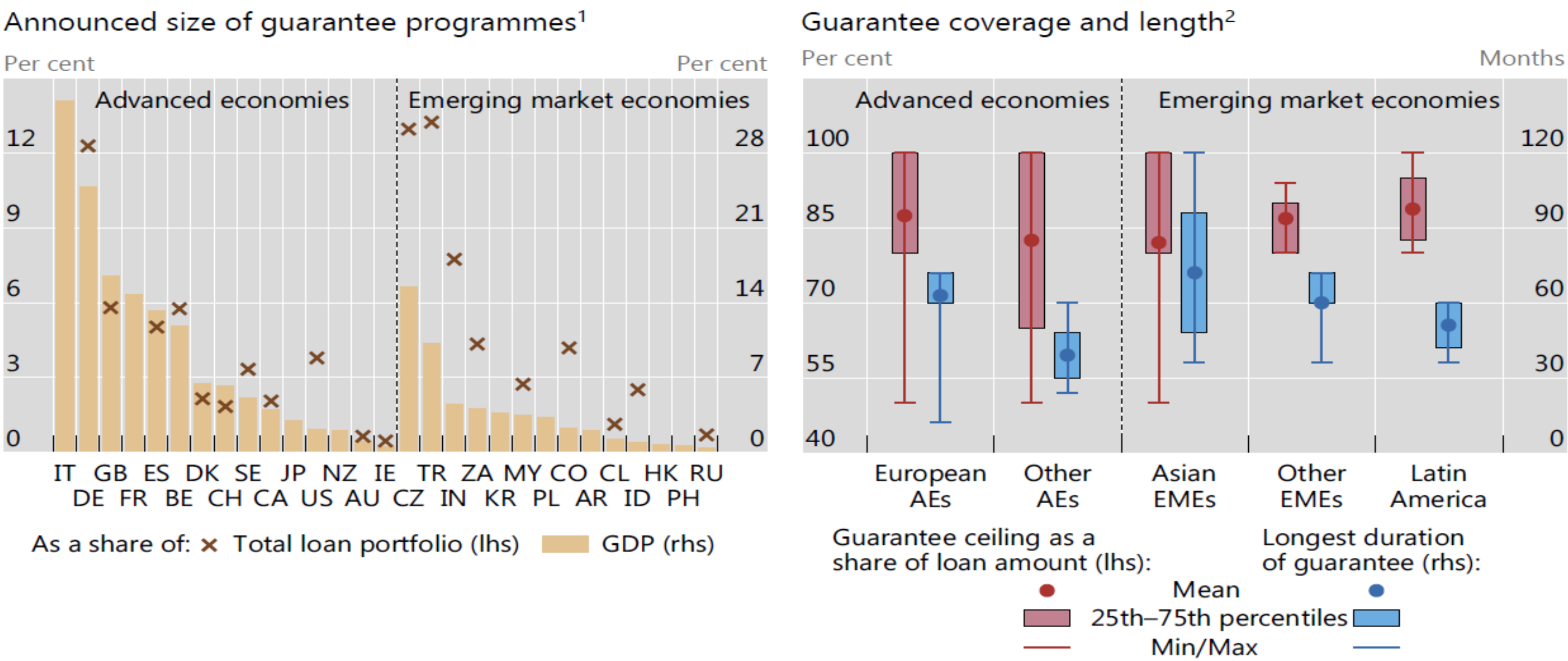
[1] The sample covers 48 countries for prudential policies, 49 countries for monetary policies and 51 countries for fiscal or other policies. For prudential and monetary policies, European Union and euro area-level measures are also counted in individual countries. For instance, the ECB's TLTRO III programme is attributed to each country within the euro area, under funding for lending. The ECB's measures typically apply to the largest banks in the euro area. See Table 1 in the Annex for details on groupings of measures.

Sources: Cantu et al (2021); Asian Development Bank; FSB; IMF; OECD (2020); European Banking Authority; European Systemic Risk Board; national data; authors' calculations.

Phasing-out of measures will have disparate effects

Size and terms of loan guarantee programmes varied across countries

Graph 2



Asian EMEs = HK, ID, IN, MY and PH; European AEs = AT, BE, CH, DE, DK, EE, ES, FI, FR, GB, GR, IE, IT, LT, LU, LV, NL, NO, PT, SE and SK; Latin America = BR, CL, CO and MX; Other AEs = AU, CA, NZ and US; Other EMEs = CZ, HU, PL, TR and ZA.

[1] Size as a share of gross loan portfolio value and GDP in each country. Data on the total loan portfolio were not available for some countries. [2] This panel reports the minimum, maximum, mean and the interquartile range. The left axis shows the maximum share of each loan covered by a guarantee and the right axis shows the maximum maturity of a guaranteed loan in months.

Sources: Asian Development Bank; IMF, *Financial Soundness* Indicators; IMF, *Fiscal Monitor Database*, October 2020; European Banking Authority; European Systemic Risk Board; national data; BIS; authors' calculations.

Nationalisation of credit creation

- Acquiescence of central banks to expansion of state credit creation: acting in concert
- State has subverted the monetary framework to its own ends, declaring *force majeure*
- Colossal budget deficits – largely monetised by CBs
- Post-GFC, bank credit creation has not responded to the cheapness of credit nor to cyclical indicators
- Banking regulation and the extent of likely unrecoverable household and SME debt has dissuaded banks from loan book expansion

Broad money is slowing, but the overshoot is huge

- Policy has validated a richer price structure

Pandemic-related upturns in money growth in leading economies

	Broad money growth, %, in ***two*** years to		
	Jun-19	Jun-21	***Difference***
USA	9.4	34.1	**24.7**
UK	5.8	21.6	**15.8**
Eurozone	8.8	17.9	**9.1**
Japan	4.7	11.3	**6.6**
China	17.8	20.6	**2.8**
India	21.1	23.4	**2.3**

Source: IIMR

Name of country/ jurisdiction	Share of world output		Growth rate of broad money		Comment
	In purchasing-power parity terms, %	In current prices and exchange rates, %	In last three months at annualised rate, %	In last twelve months, %	
USA	15.1	23.3	**7.7**	**6.4**	Possible slowdown indicated by weak June and July money growth.
China	18.7	16.1	**8.8**	**8.5**	Money growth moderate, with authoritarian state clamping down on private sector finance.
Eurozone	10.6	16.4	**5.6**	**8.3**	Money growth boosted by ECB asset purchases, but slowing recently.
Japan	4.2	5.9	**3.3**	**4.5**	Money growth slowing after very high 2020 figures by Japanese standards.
India	7.7	3.3	**10.7**	**11.0**	Money growth close to double digits, as banking system helps to finance budget deficit.
UK	2.2	3.4	**5.9**	**8.8**	Money growth decelerating, despite bank lending surge in June due to buoyant mortgages.

How the credit markets have changed

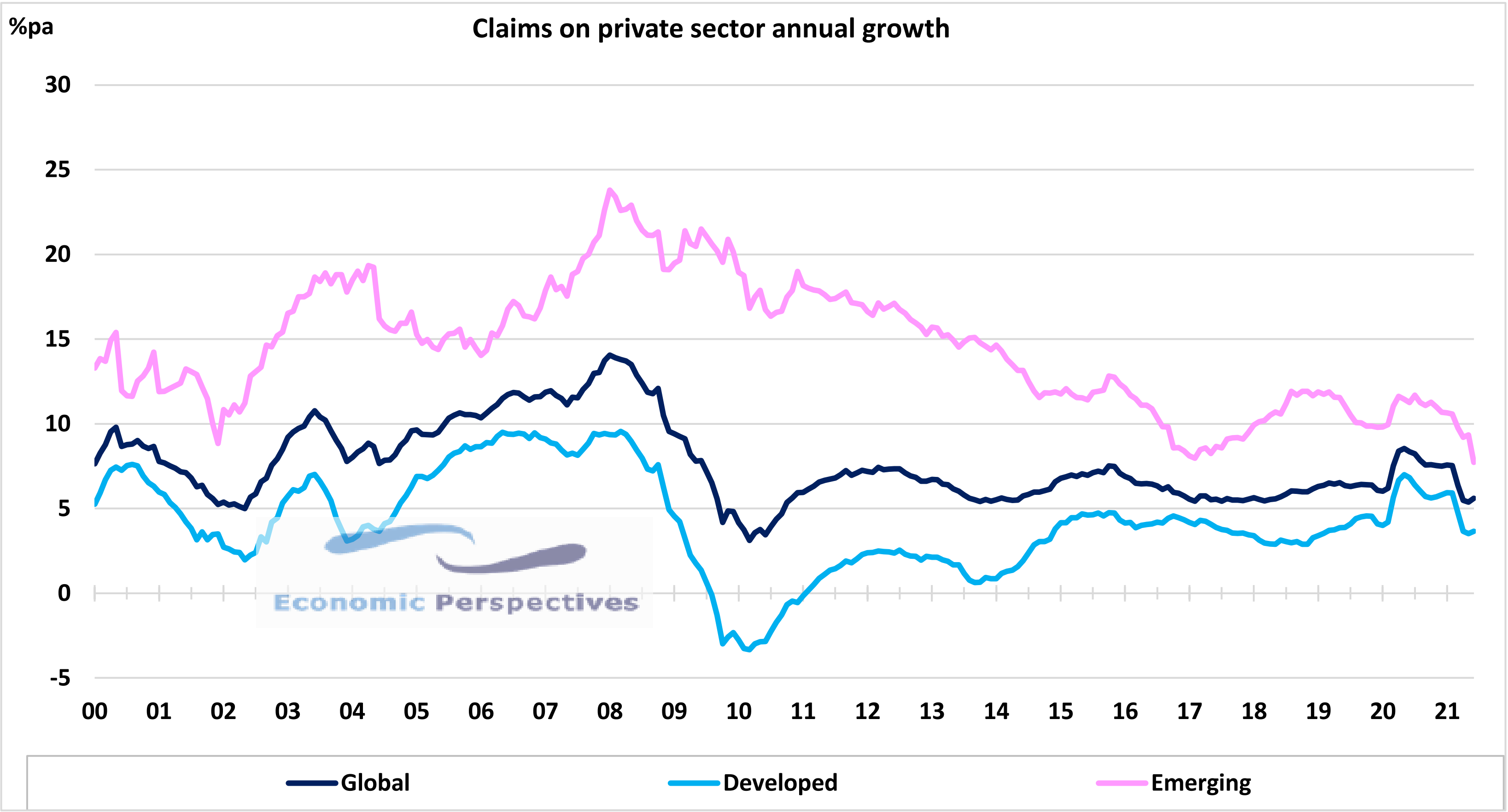
- Despite rock-bottom interest rates, in some ways credit conditions have tightened in recent months
- Bank lending to SMEs has withered since GFC
- SMEs are forced to become self-financing, seek trade credit through their supply chain partners, or use a government-sponsored loan scheme
- Covid-19 lockdowns have depleted the reserves of SMEs, leaving them unable or unwilling to gear up in the re-opening phase.
- Significant implicit business shrinkage, self-employed job losses, rise in voluntary liquidations

Private sector credit creation is weak

- Bias of lending to companies and financial institutions with poor prospects and moderate to weak balance sheets
- In 2020, Fed opened the floodgates to issuance by troubled entities, increasing moral hazard and perpetuating socialistic credit dynamics
- State is on the hook for failed loans and ongoing grants and subsidies to ailing sectors
- Tax revenues are unlikely to rebound strongly as deferred tax will be hard to collect

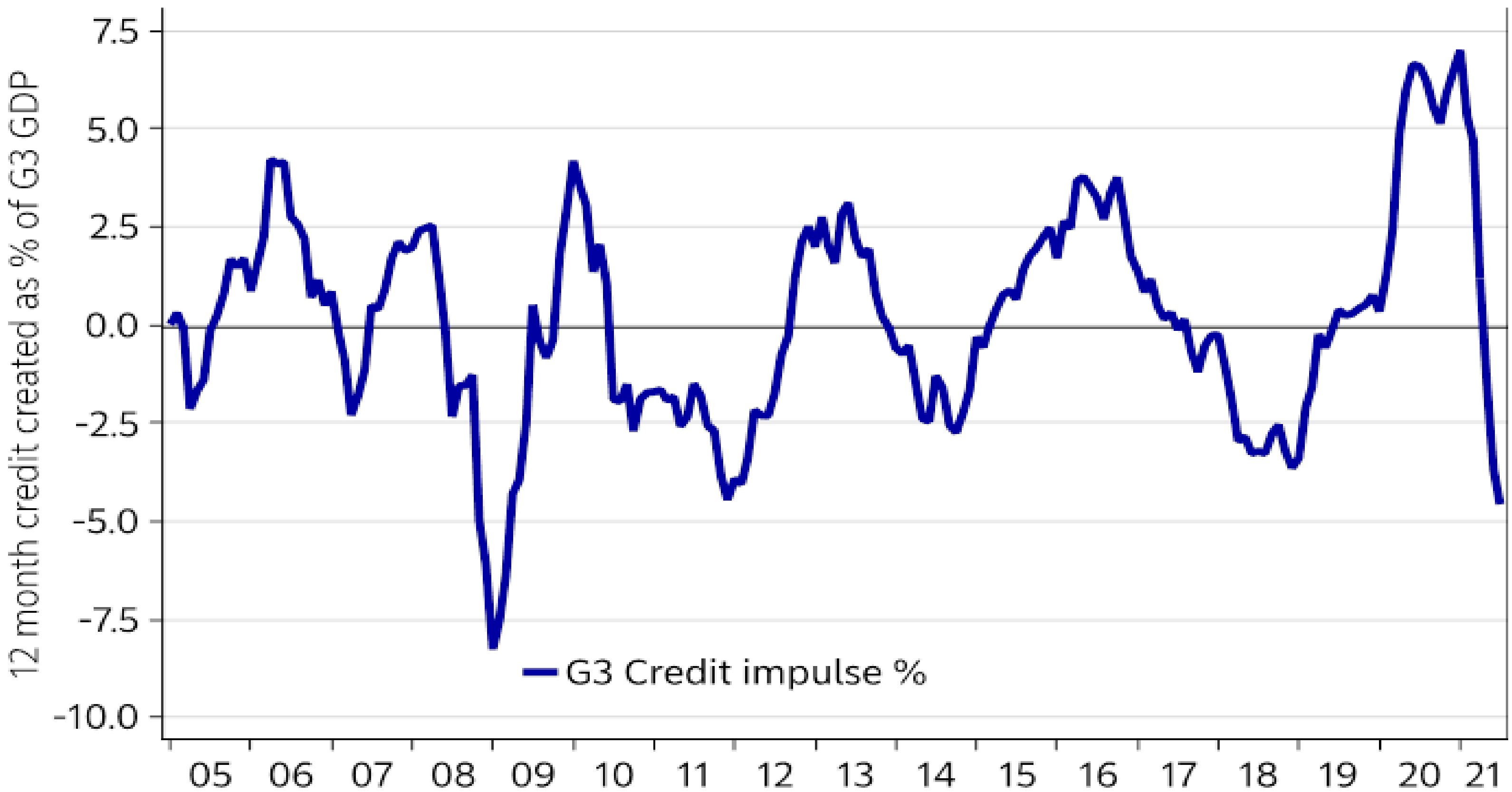
Bank lending spurt is over, the more so in EM

- US: 4.8%; Japan 0.5%; Germany 3.8%; France 4.3%; UK 1.5%; Italy 3.7%; Canada 6.5%



What to make of the G3 private sector credit impulse?

- New credit as % of nominal GDP (US, China & EU)

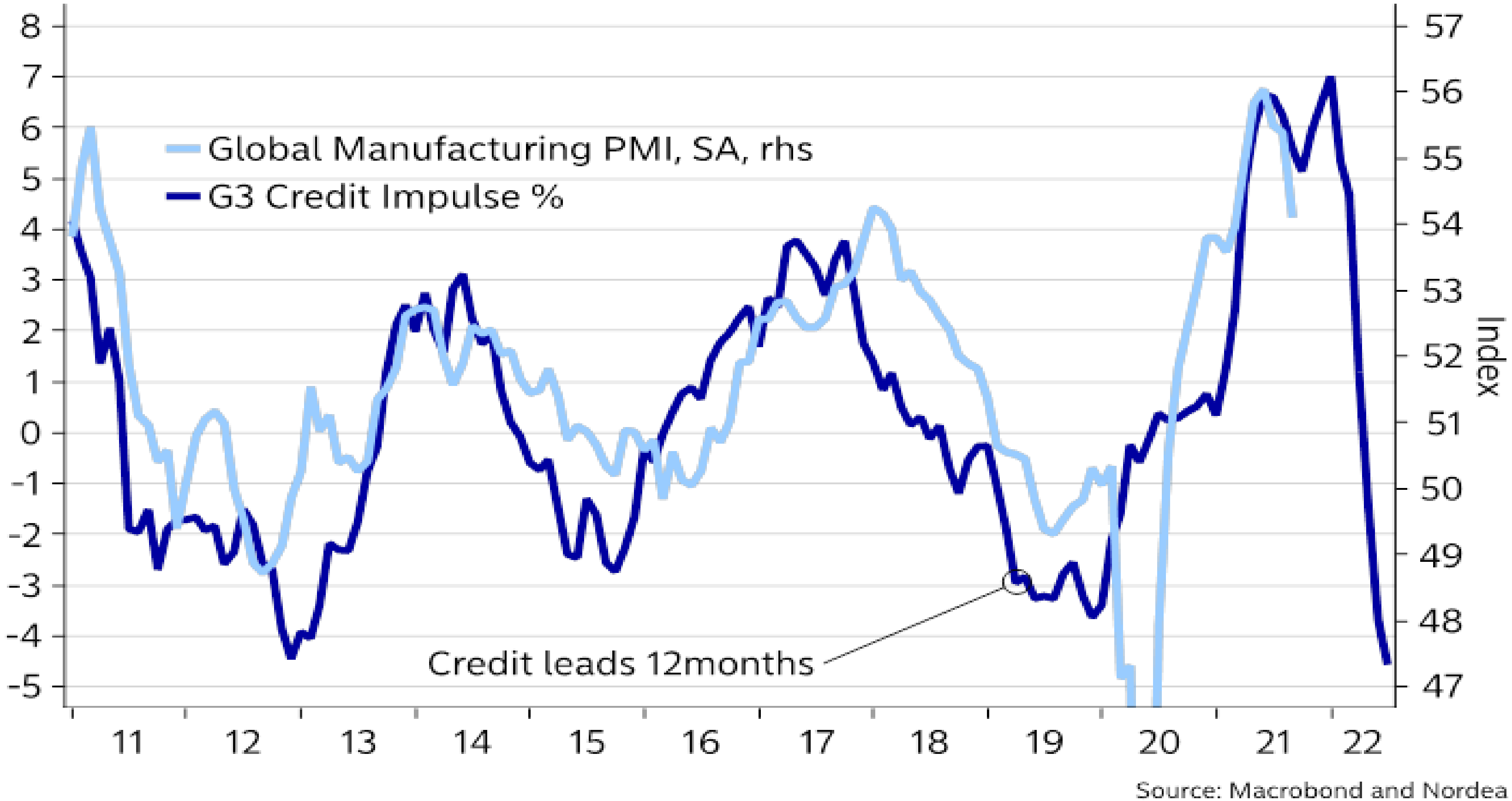


Source: Macrobond and Nordea

Economic Perspectives

Are we headed for an economic recession or depression?

- Is the 2021 rebound a bad joke?



Economic Perspectives

But wait … how should we interpret this impulse series?

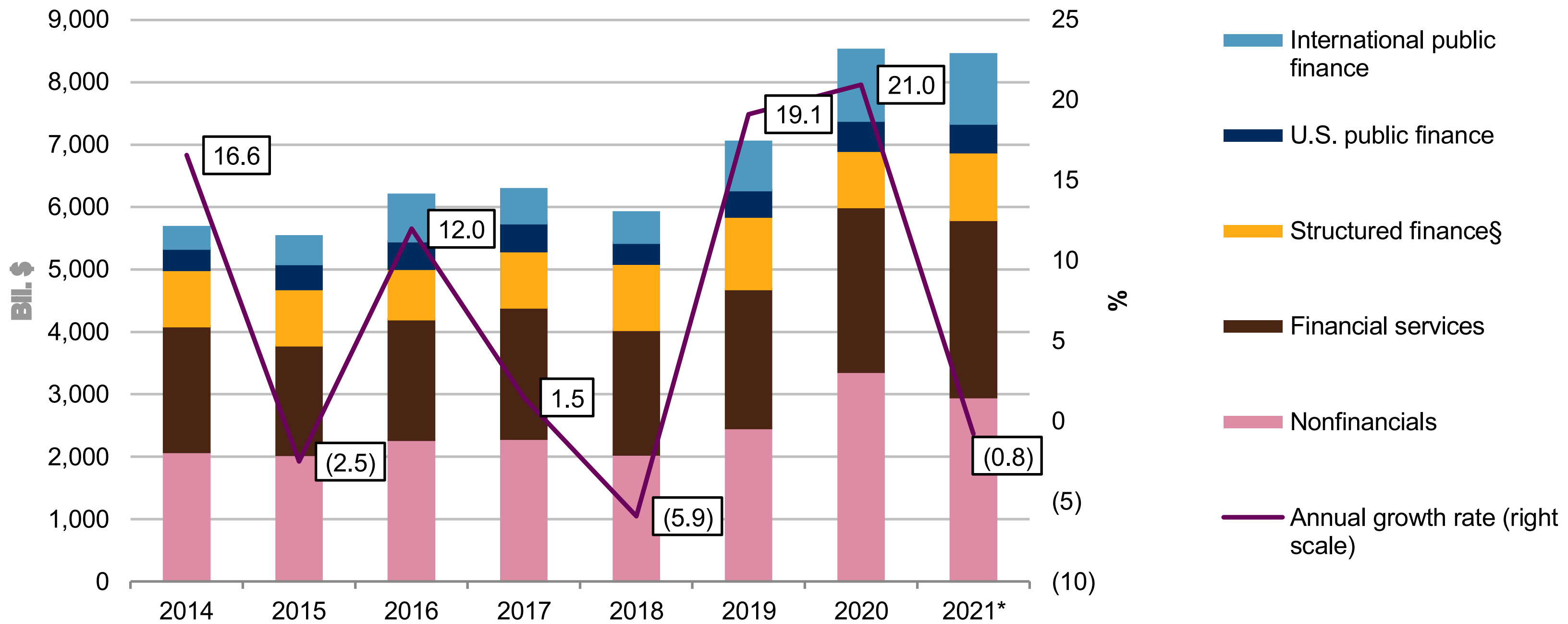
- G3 private sector credit includes state-guaranteed bank loans, which were intended as pandemic bridging finance, to tide businesses over
- Repayment of these loans is *good*, not *bad* news!
- Credit impulse does not capture pandemic-related increases in budget deficits, which have provided a massive boost to nominal GDP – public support is being phased out more gradually
- Strong nominal GDP growth will ease the burden of debt service costs and relieve stress for highly indebted borrowers

Global debt issuance sustains a strong pace

- Credit spreads continue to be unusually suppressed and financial conditions are exceptionally loose
- Investors' hunt for yield pushed speculative-grade bond, leveraged loan, and collateralized obligation totals to multiyear and in some cases record-breaking first-half totals in 2021
- Issuance of high yield bonds and leveraged loans in developed markets has been rapid in 2021 H1, with combined issuance surpassing the investment-grade bond total

Global debt issuance sustains a strong pace

Historical Global Issuance And Forecast

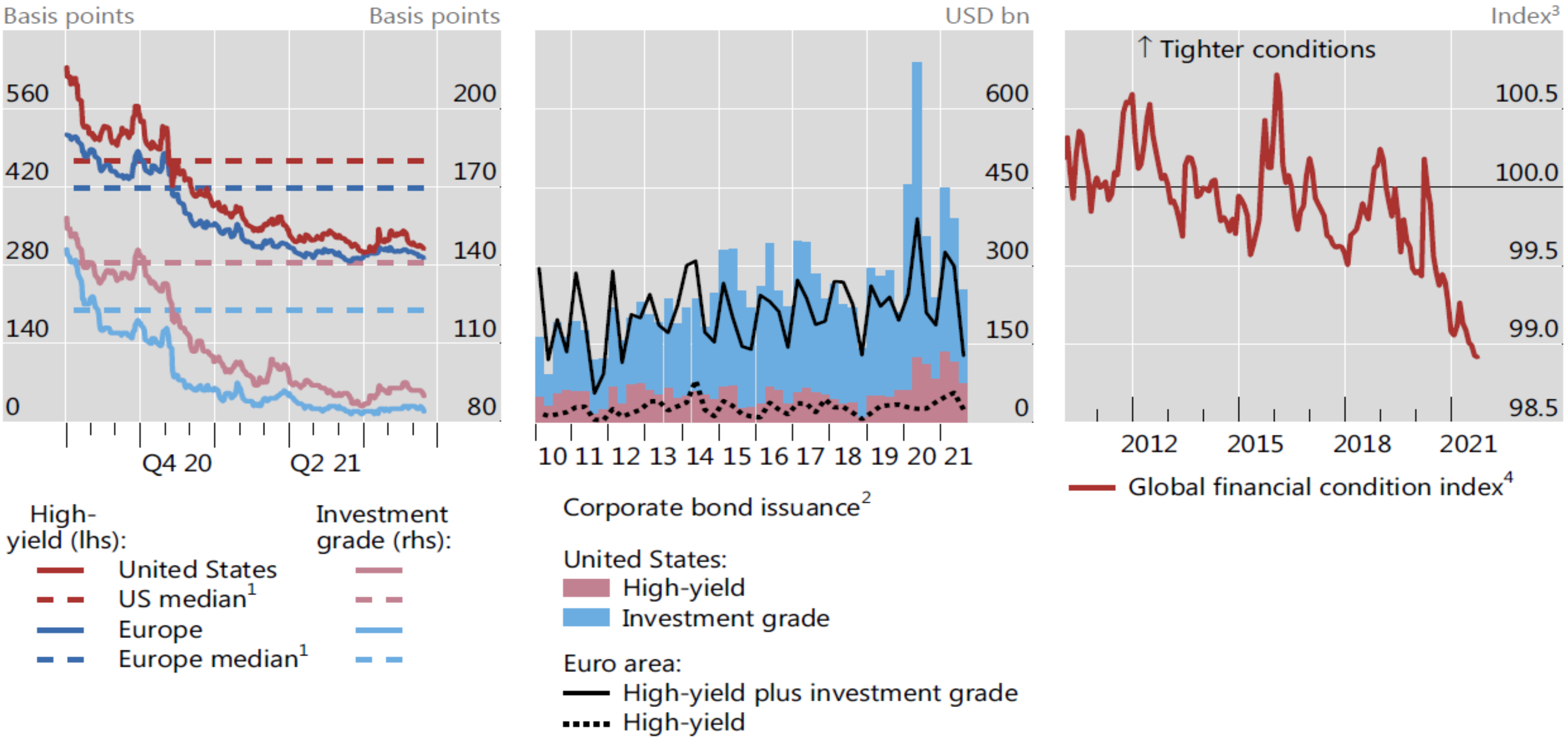


*Full-year forecast. §Structured finance excludes transactions that were fully retained by the originator, domestically rated Chinese issuance, and CLO resets and refinancings. Sources: Green Street Advisors, Refinitiv, and S&P Global Ratings Research.

Credit conditions: "loose as cooked spaghetti"

Corporate credit markets remained buoyant, financial conditions accommodative — Graph 2

Spreads continued to be unusually compressed… | …and issuance remained robust | Financial conditions were exceptionally loose

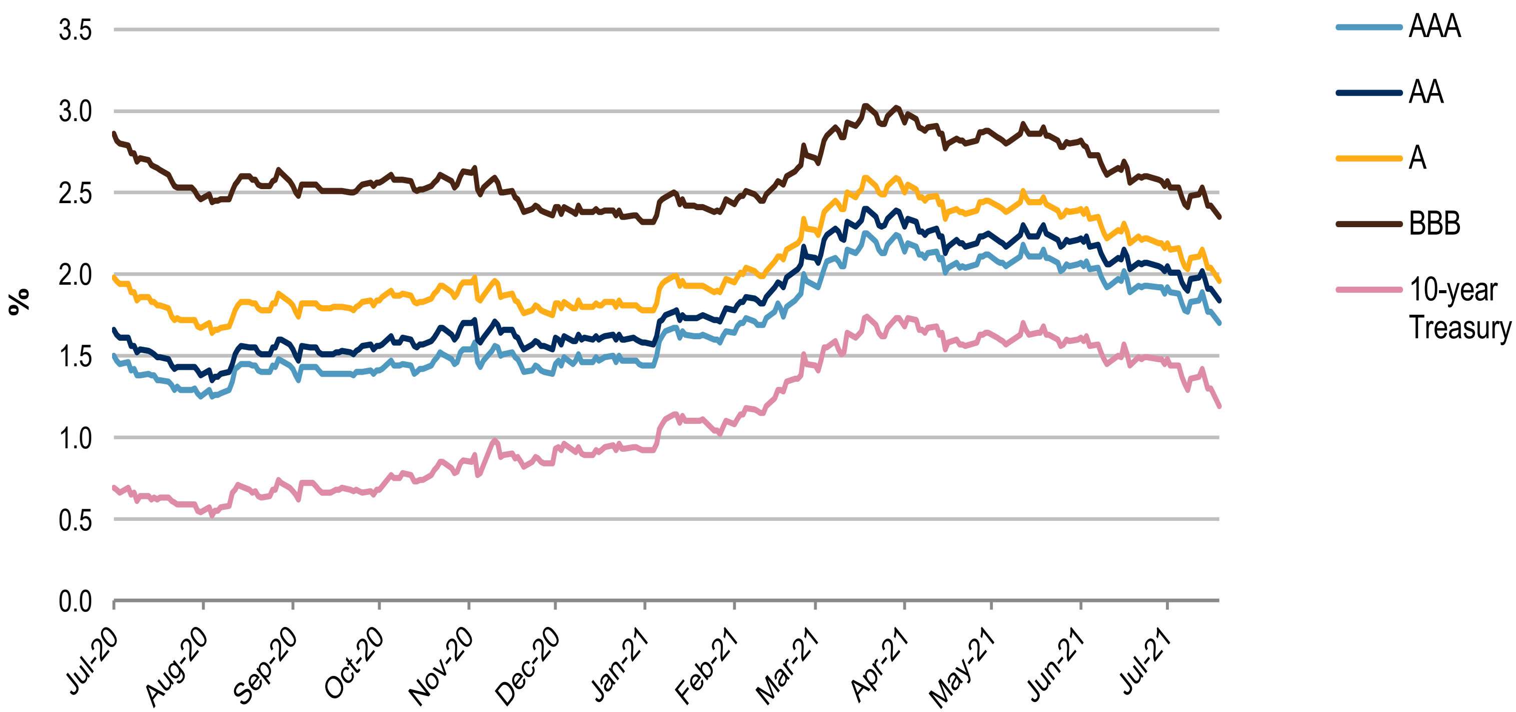


[1] 2010–current. [2] For Q3 2021, issuance data up to 13 September 2021, extrapolated to full quarter. [3] A value of 100 represents average conditions. [4] GDP-weighted average of the financial condition indexes of eight AEs and 13 EMEs. Monthly averages of daily values.

Sources: Bloomberg; Dealogic; Goldman Sachs, Marquee; ICE BofA indices; BIS calculations.

US credit pricing is oblivious to inflationary risks

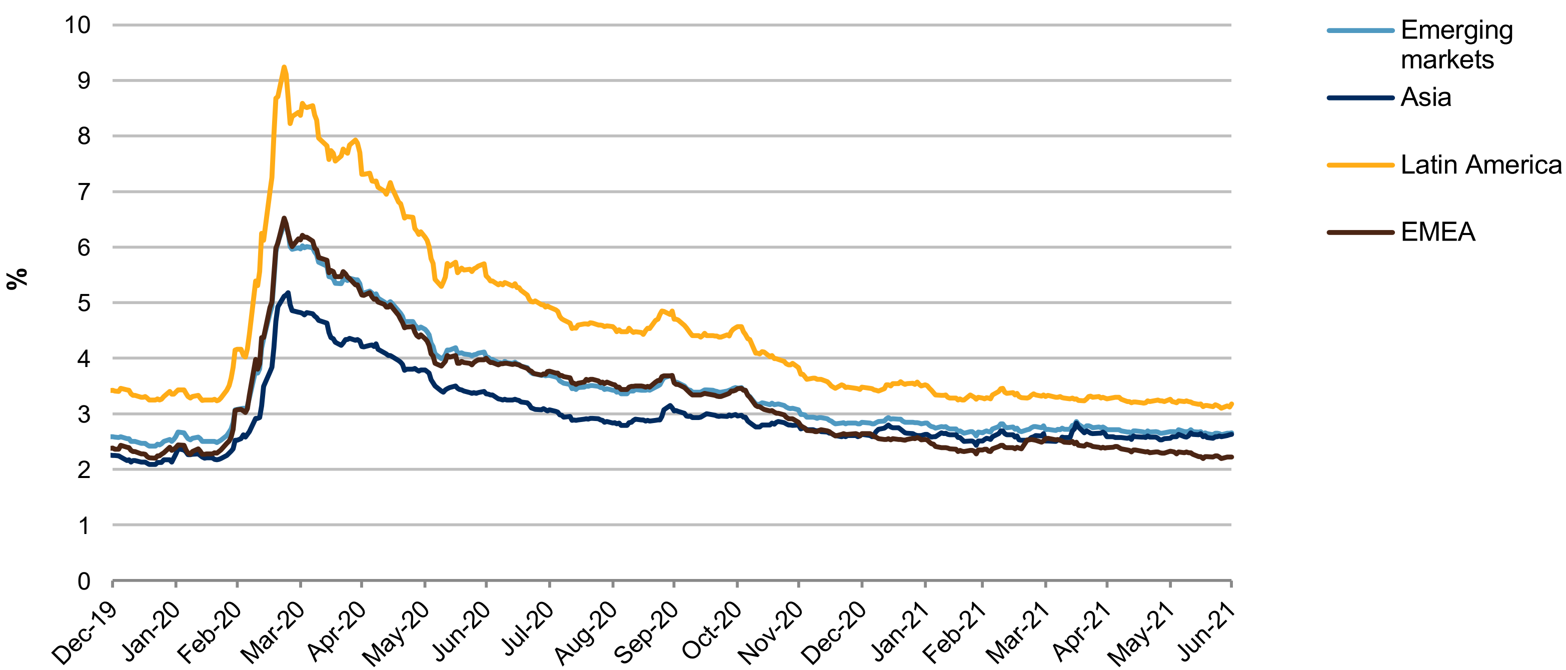
U.S. Investment-Grade Secondary Market Corporate Bond Yields



Source: S&P Global Ratings Research.

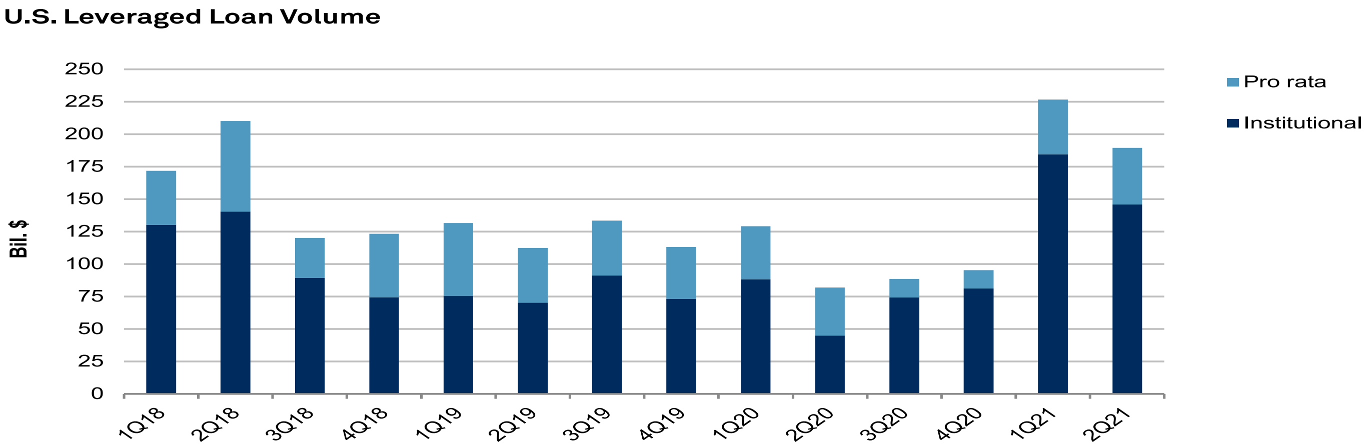
Compression of EM credit spreads is unnerving

Emerging Market Spreads Continue To Tighten

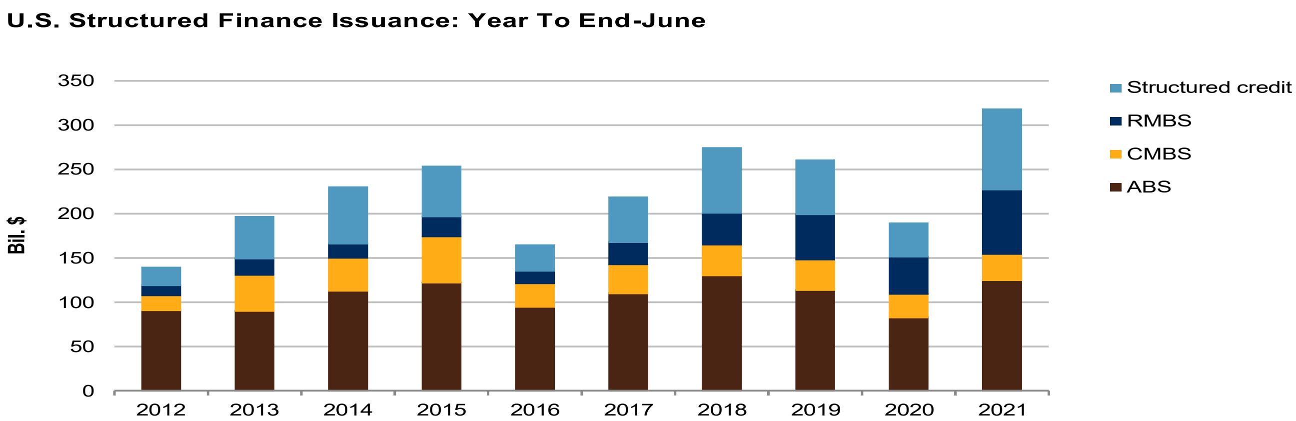


Source: ICE BofA Emerging Markets Corporate Plus Indices Option-Adjusted Spread, retrieved from FRED, Federal Reserve Bank of St. Louis.

Cheap credit is fuelling financial borrowing



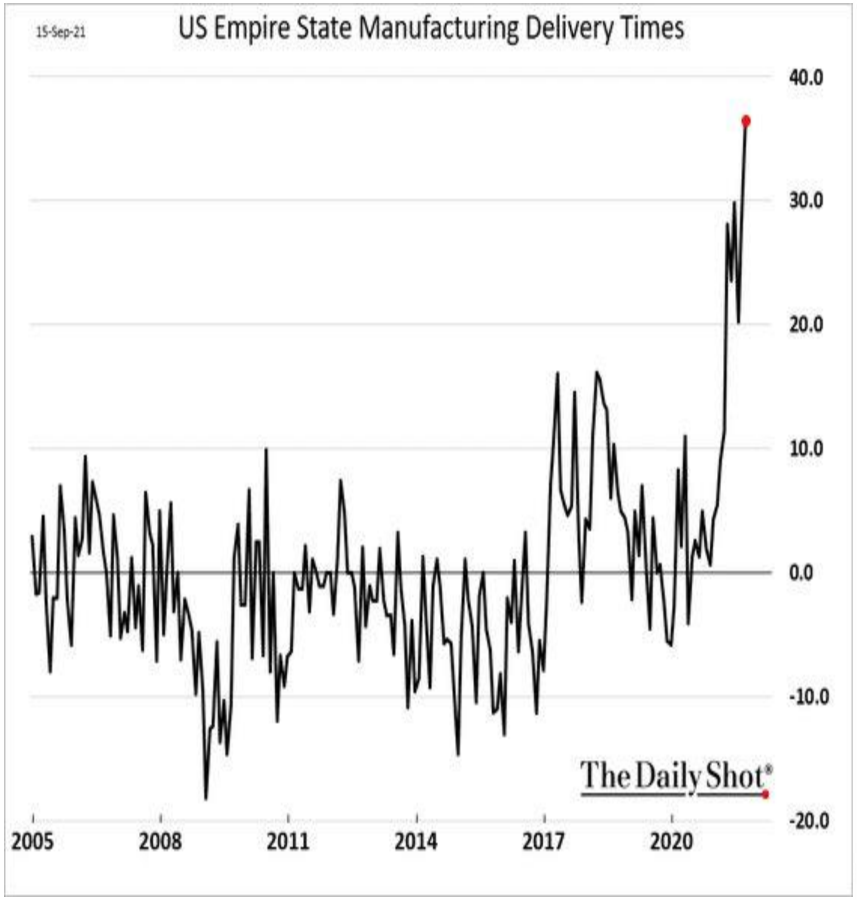
Data through June 30, 2021. Source: LCD, an offering of S&P Global Market Intelligence.



Excludes transactions that were fully retained by the originator and CLO resets and refinancings.

Yet, global goods supply chains are creaking

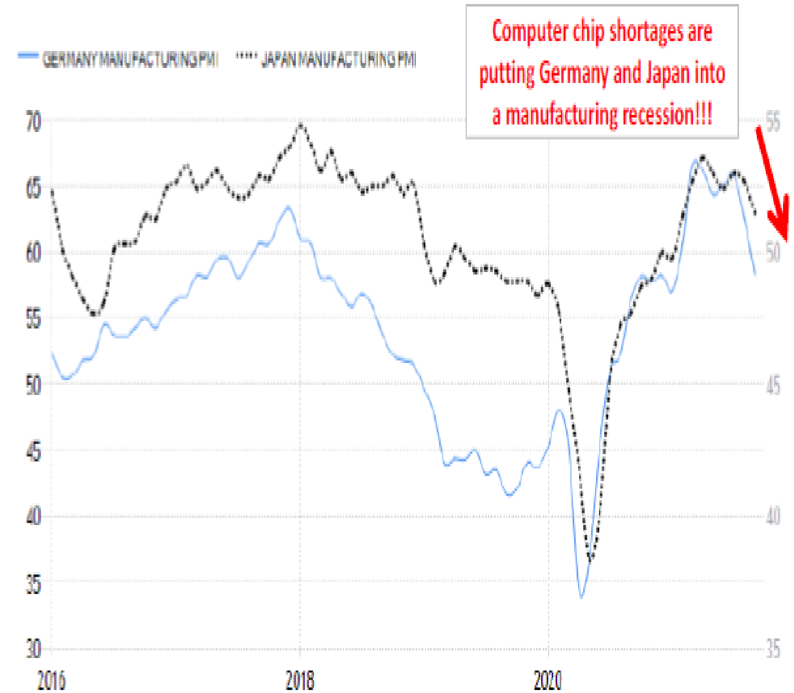
- Delivery times are lengthening, prices rising

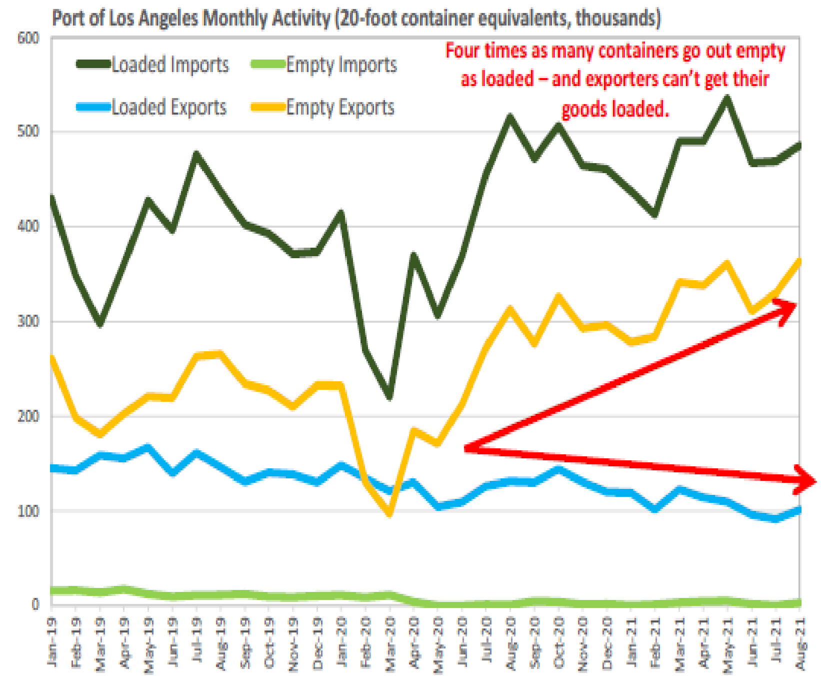


Manufacturing recovery is short of parts, not orders

- Global logistics in disarray

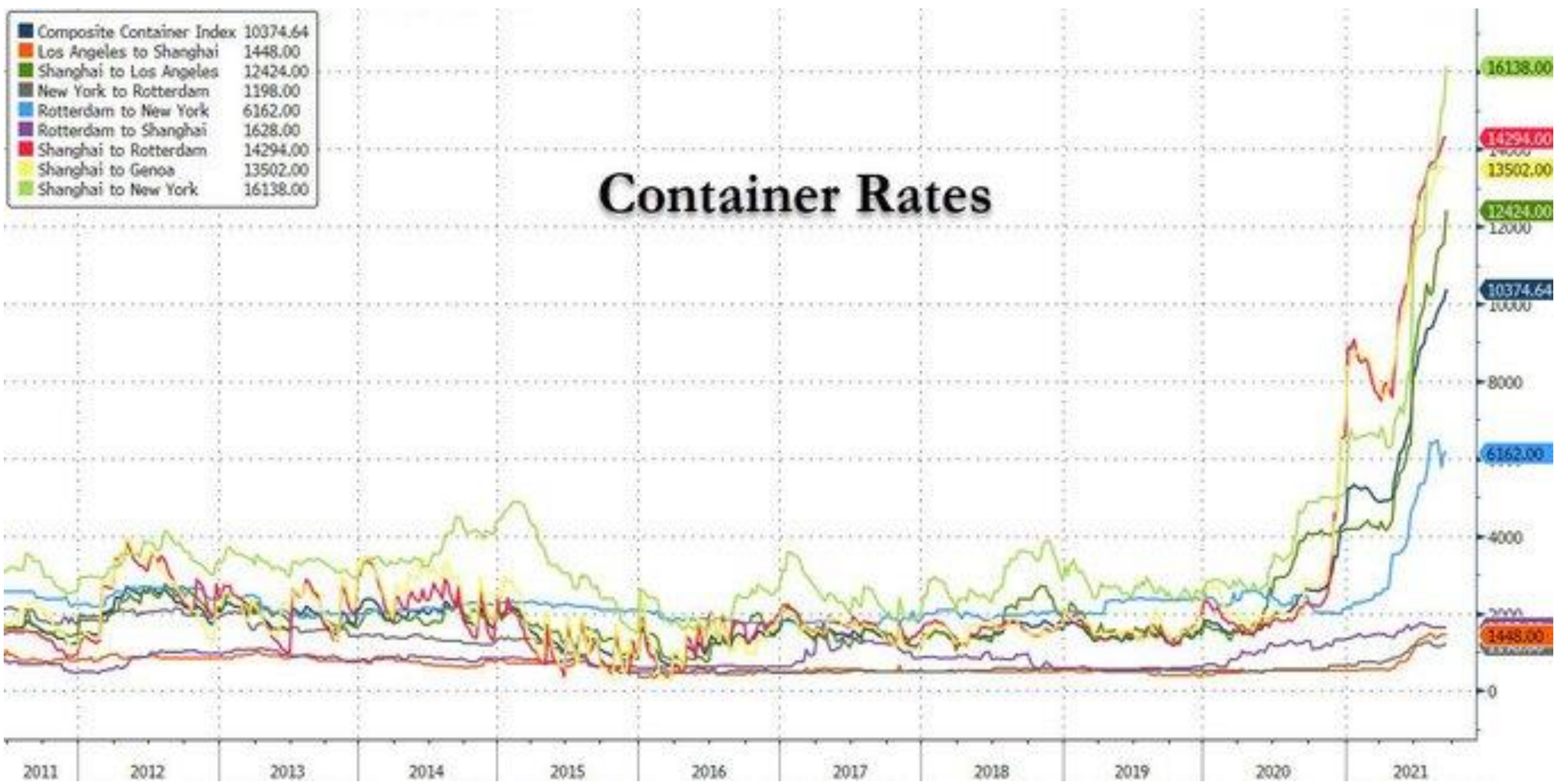
Germany Enters "Bottleneck Recession"





Spiralling container rates

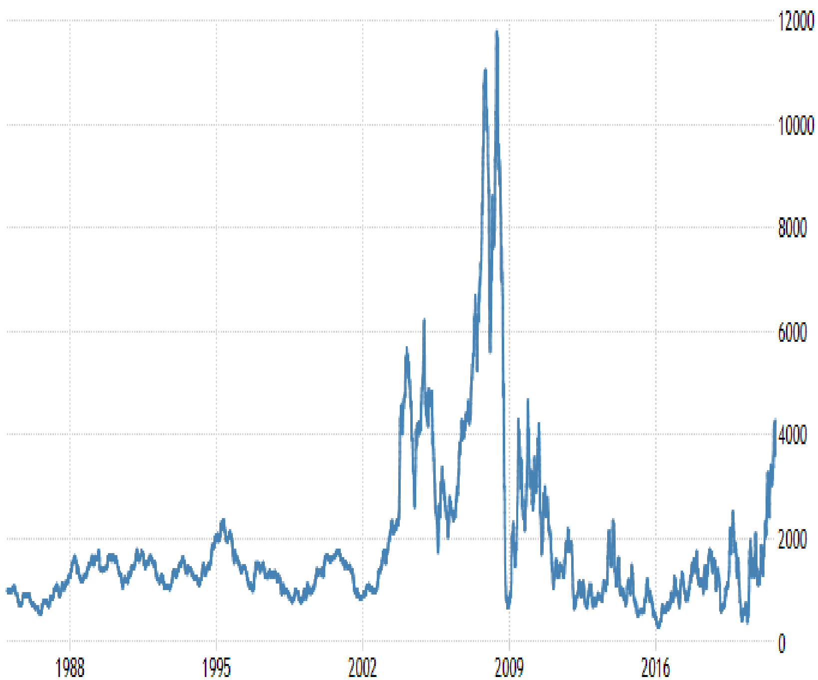
- Strong demand, ships in the wrong place!

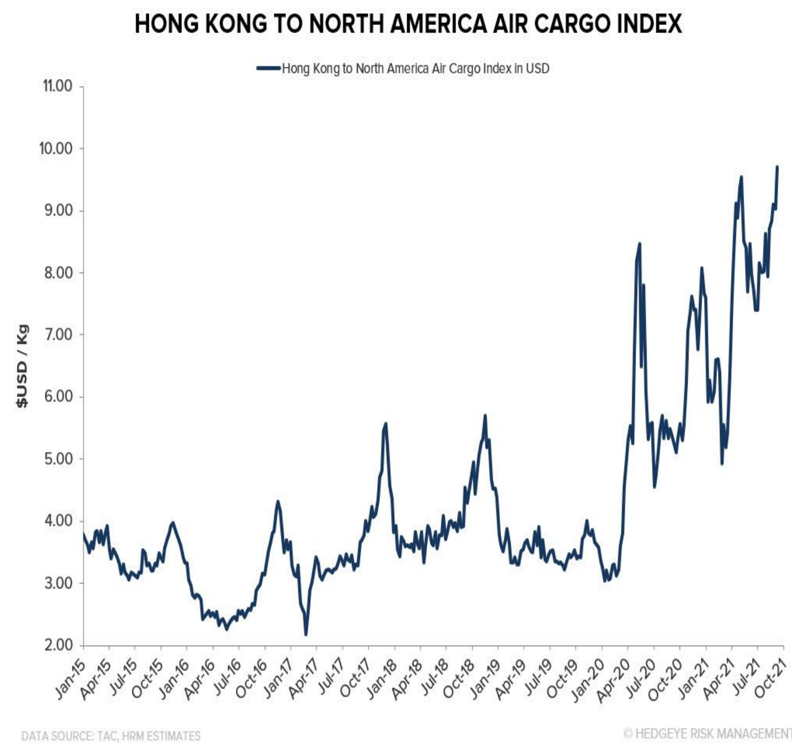


Signs of supply bottlenecks in shipping and air freight

- Baltic Dry Index: cost of moving raw materials

Baltic Dry Index

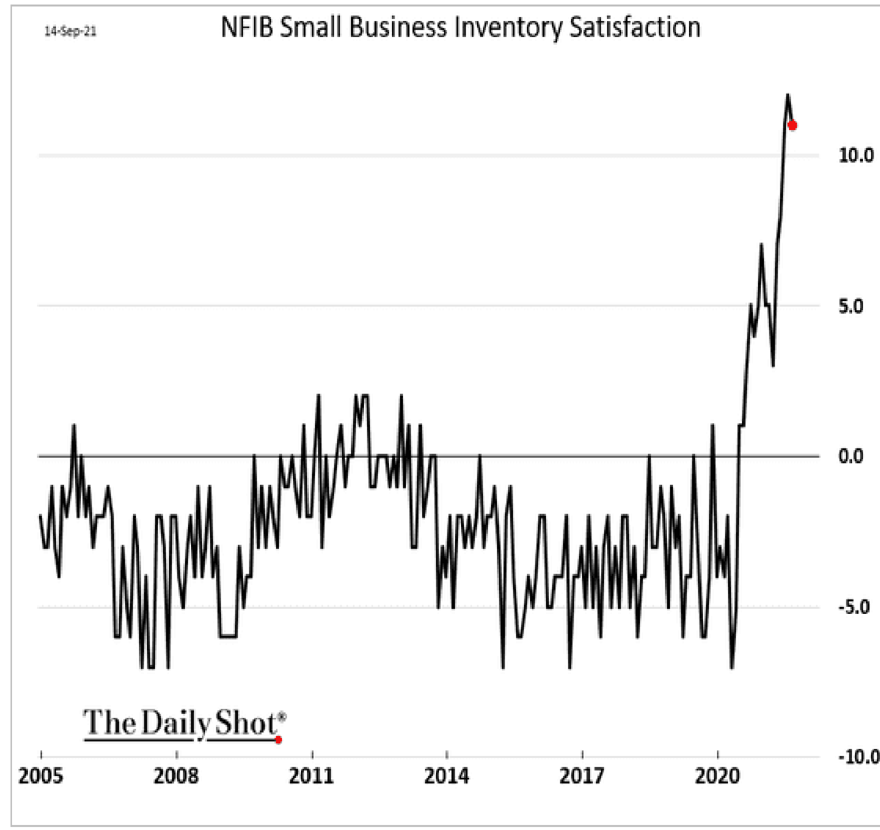




Source: Baltic Exchange

Tight inventory conditions unalleviated as …

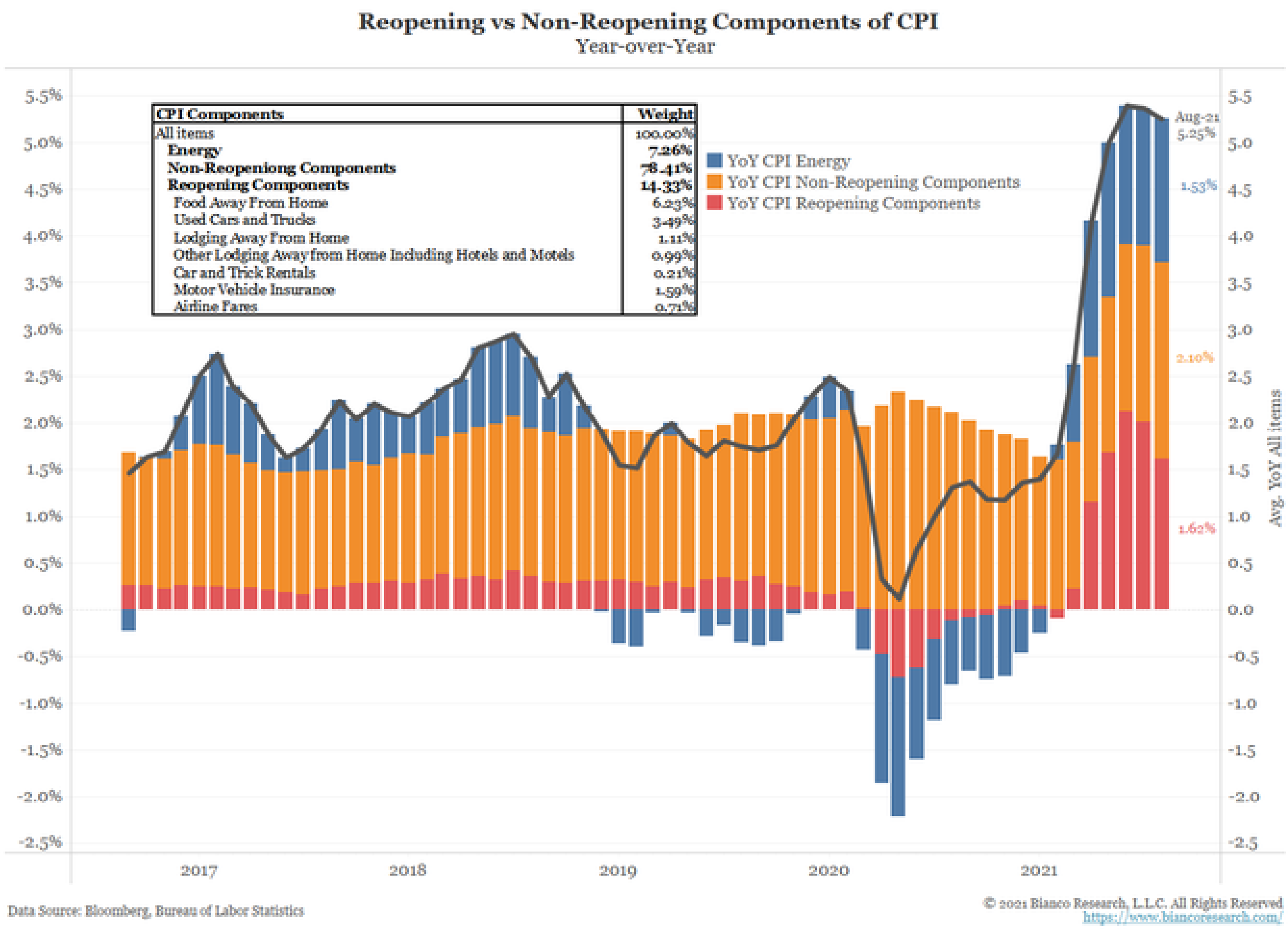
- … consumer demands remain intense



Data sources: FRED, NFIB

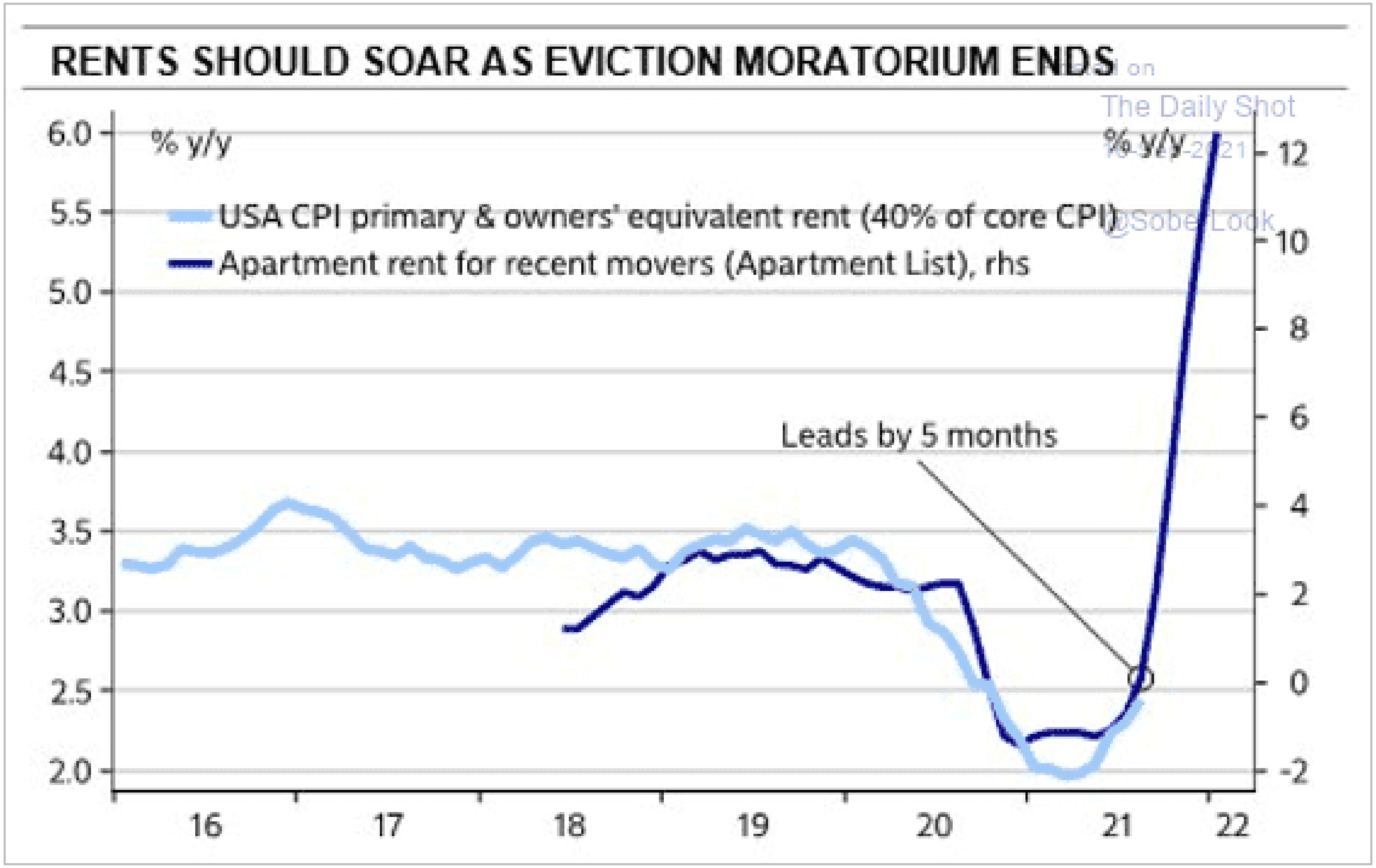
US CPI inflation: transitory components are softening

- But non-transitory items are hardening



US single family rental market is tightening

- Scope for rental inflation to set OER on fire



Pricing in the coming inflation – even in Germany

- Market-implied inflation compensation

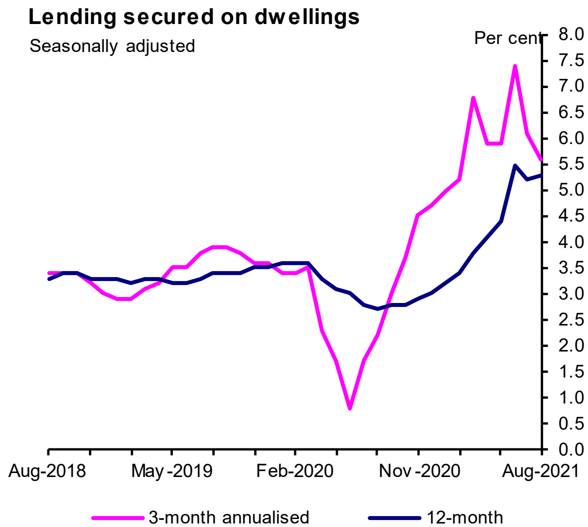
UK economic outlook clouded by inflation and policy exits

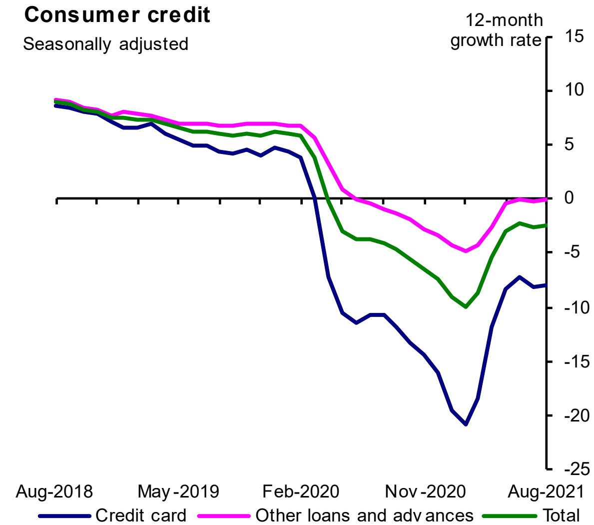
- Overlay of a regional supply crisis in energy on a global supply crisis in goods.
- Trying to force more demand through a broken supply chain brings frustration and inflation
- UK – as with US and Canada – turned a firehose on the health and social problems created by Covid: the problem now is how to turn it off
- Removal of spending largesse will drag UK growth back to 1%-2% even as inflation remains elevated
- Enormous political pressure on BoE to postpone QE taper and delay raising rates

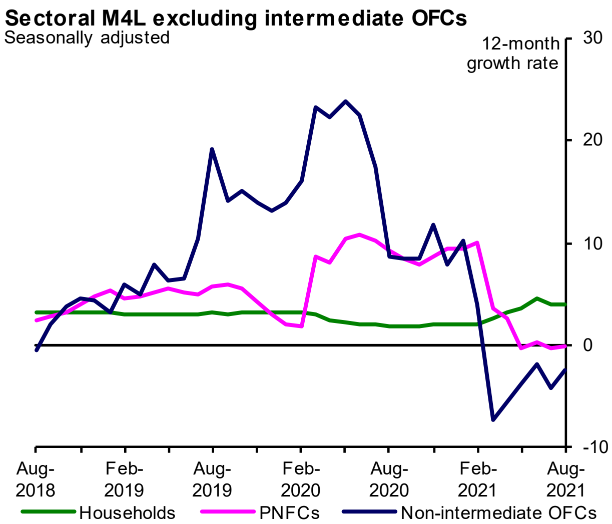
UK economy has a different shape in 2021 to 2019

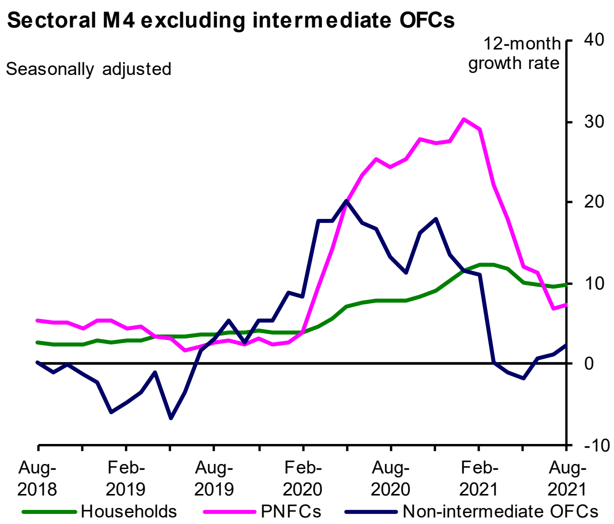
Composition of UK economic recovery		
	2018 weights	Jul21/Jul19
	%	%
Human health and social work activities	75	6.3
Wholesale and retail, vehicle repairs	104	4.4
Water supply, sewerage etc.	13	4.3
Public administration and defence	49	3.7
Electricity gas, steam and air	14	2.0
Professional, scientific and technical activities	77	1.0
Real estate activities	135	-1.9
Total service industries	*790*	*-2.2*
Financial and insurance activities	68	-2.3
Total GVA at basic prices	***1000***	***-2.6***
Information and Communication	66	-2.6
Total production industries	*139*	*-3.1*
Manufacturing	101	-3.4
Construction	64	-5.1
Education	57	-5.4
Accommodation and food service activities	29	-7.2
Agriculture, forestry and fishing	6	-10.3
Transport and storage	40	-10.4
Administrative and support service activities	53	-11.3
Mining & quarrying	11	-16.6
Arts, entertainment and recreation	16	-18.1
Activities of households as employers	3	-20.7
Other service activities	18	-22.7

UK credit and money trends are softening







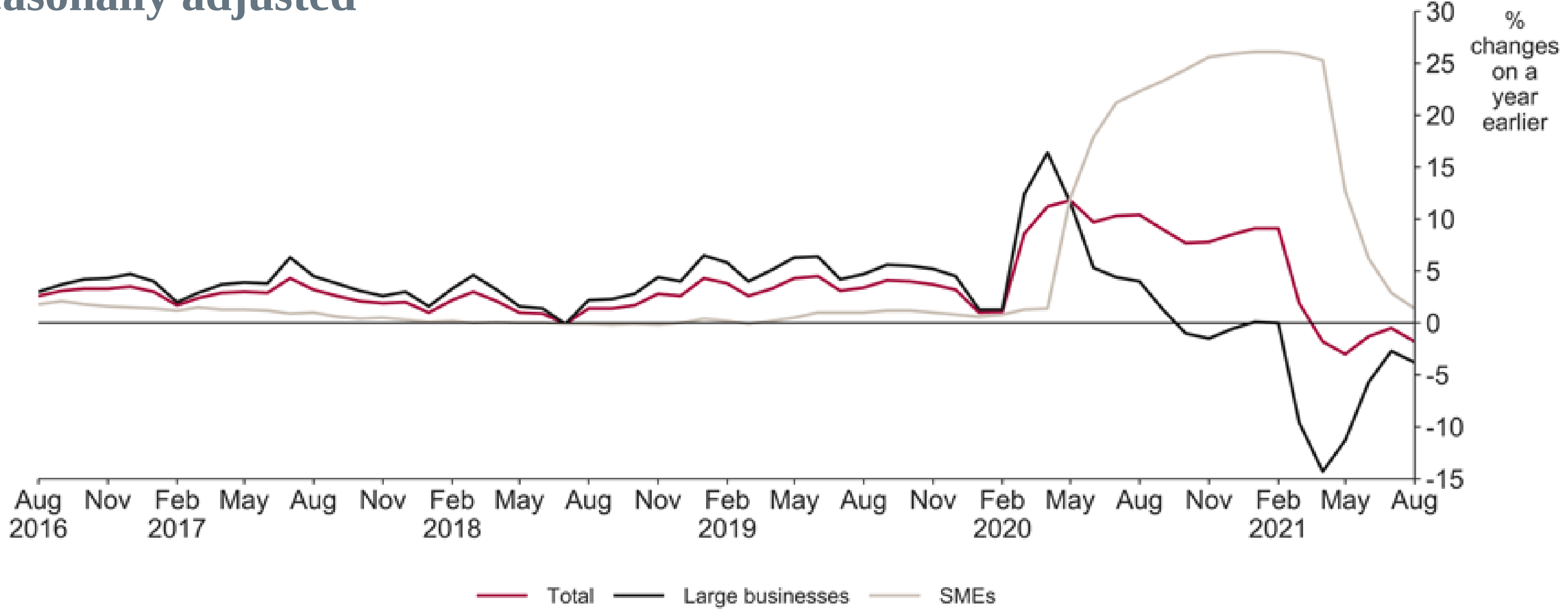


Lending to corporate sector has tanked …

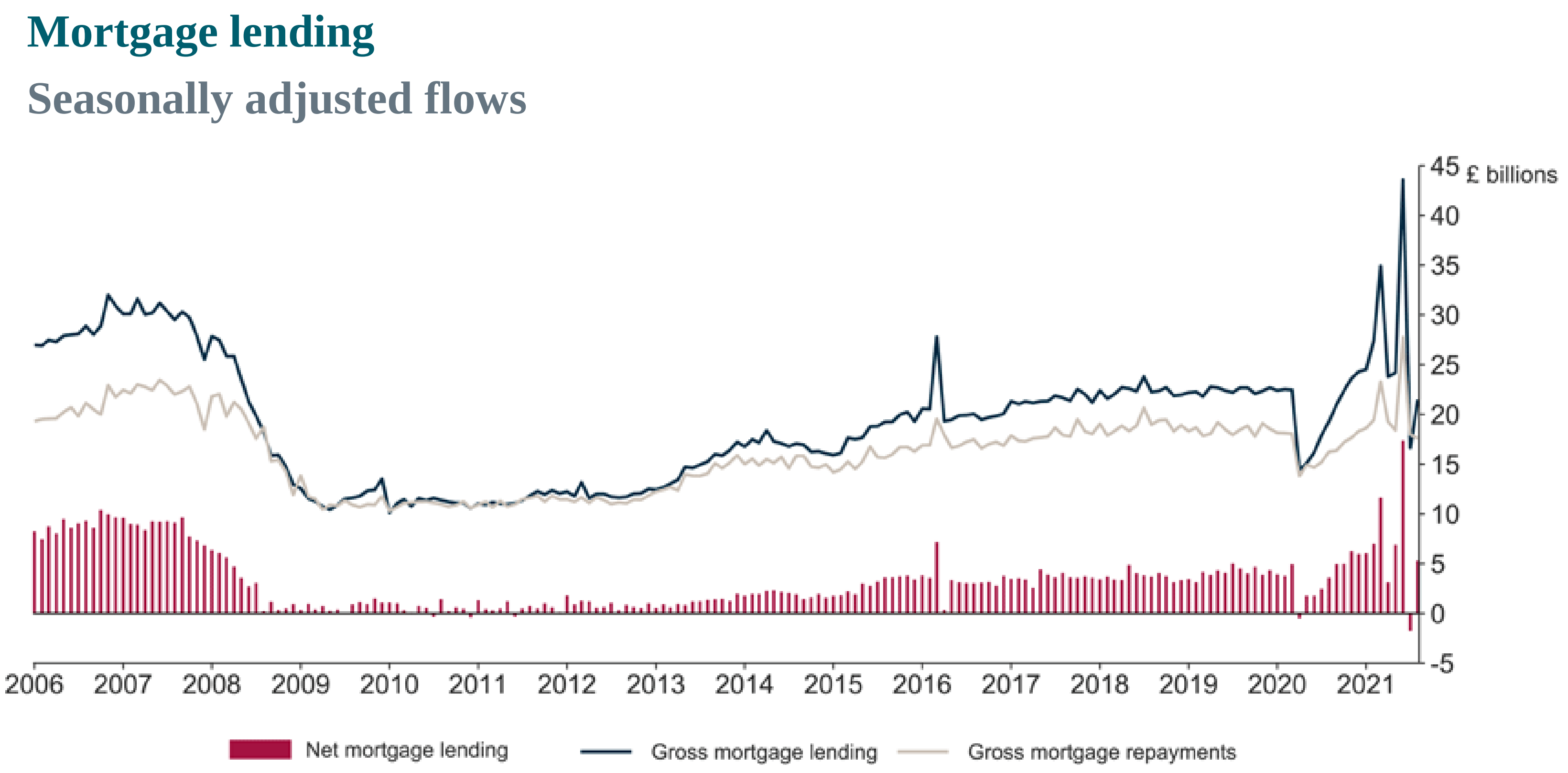
- … as government guarantees are withdrawn

Annual growth of lending to SMEs and large businesses

Seasonally adjusted



Mortgage lending: back to earth after SD holiday

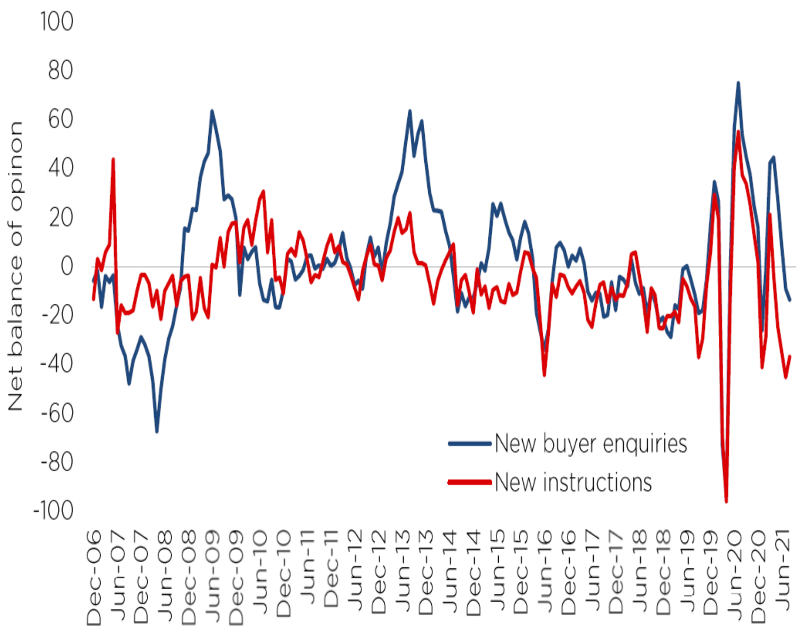


Economic Perspectives

But UK housing market still tilted to appreciation

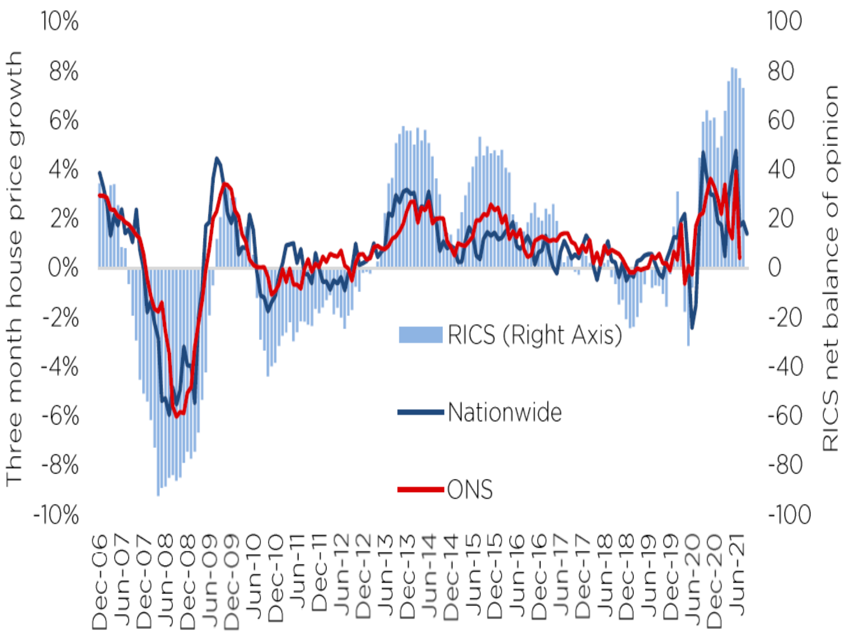
- Potential vendors scared of selling too cheaply

Figure 3 First reduction in the gap between supply and demand since March



Source RICS (seasonally adjusted)

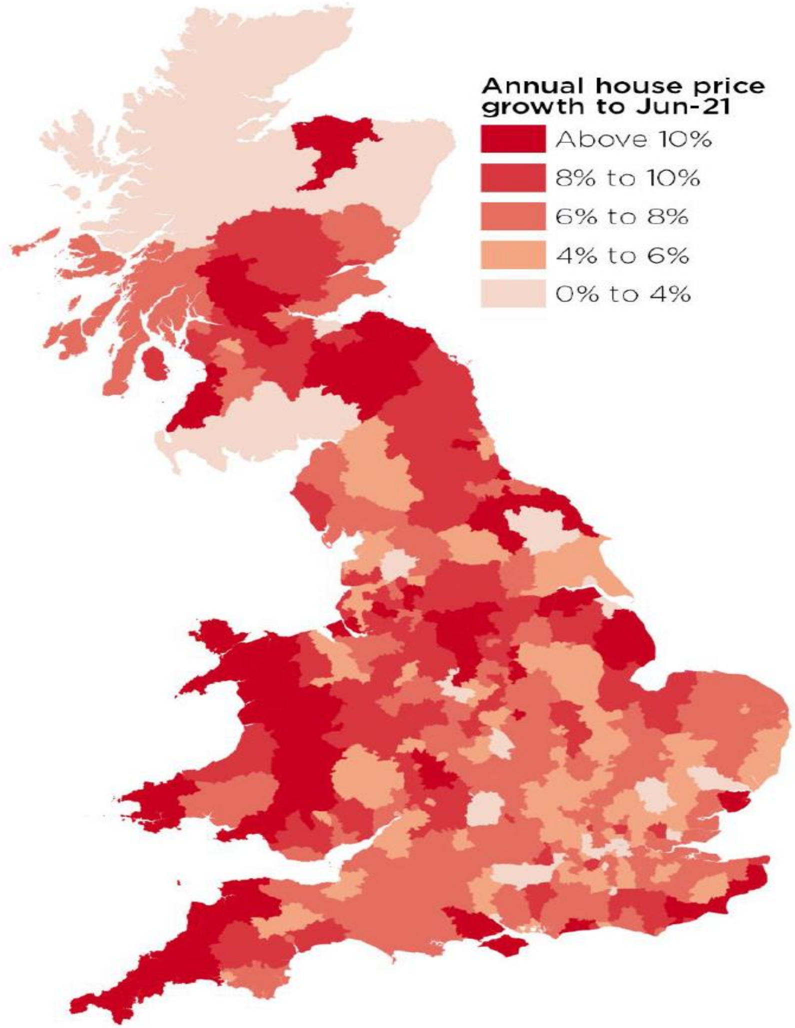
Figure 4 Price growth has eased but remains strong



Source RICS, Nationwide, ONS (seasonally adjusted)

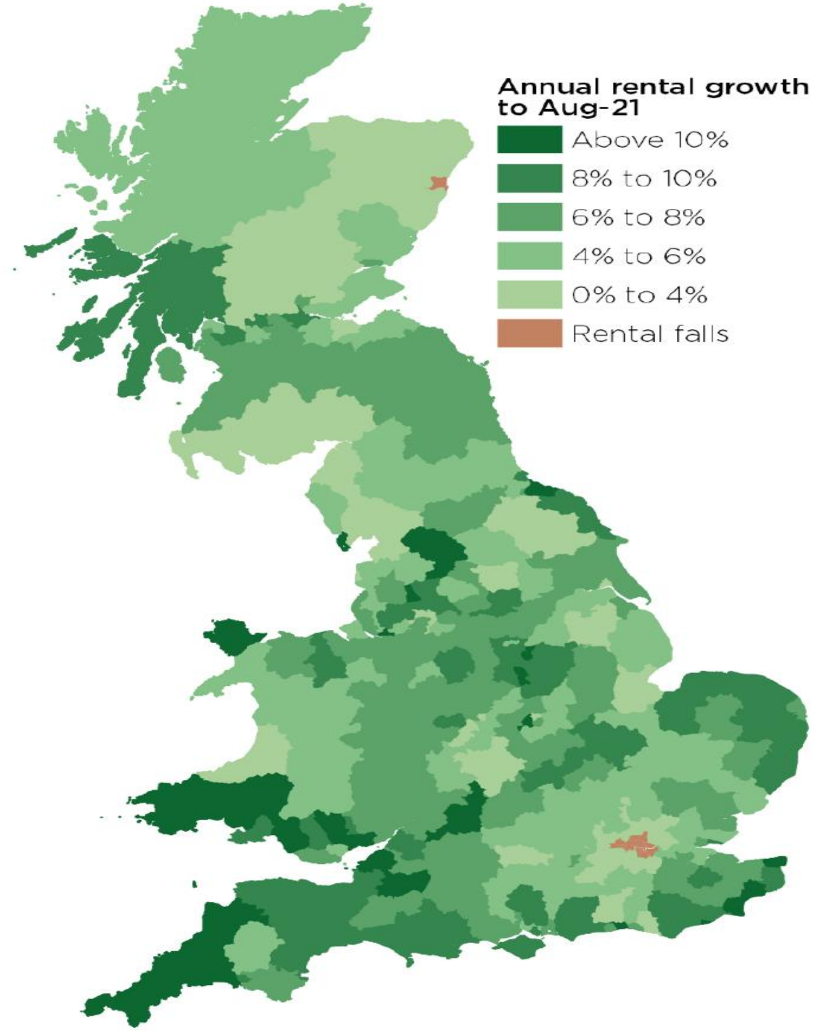
Regional housing and rental markets are on fire

Figure 1 Annual house price growth to Jun-21



Source Savills using HM Land Registry and Registers of Scotland (6 month smoothed)*

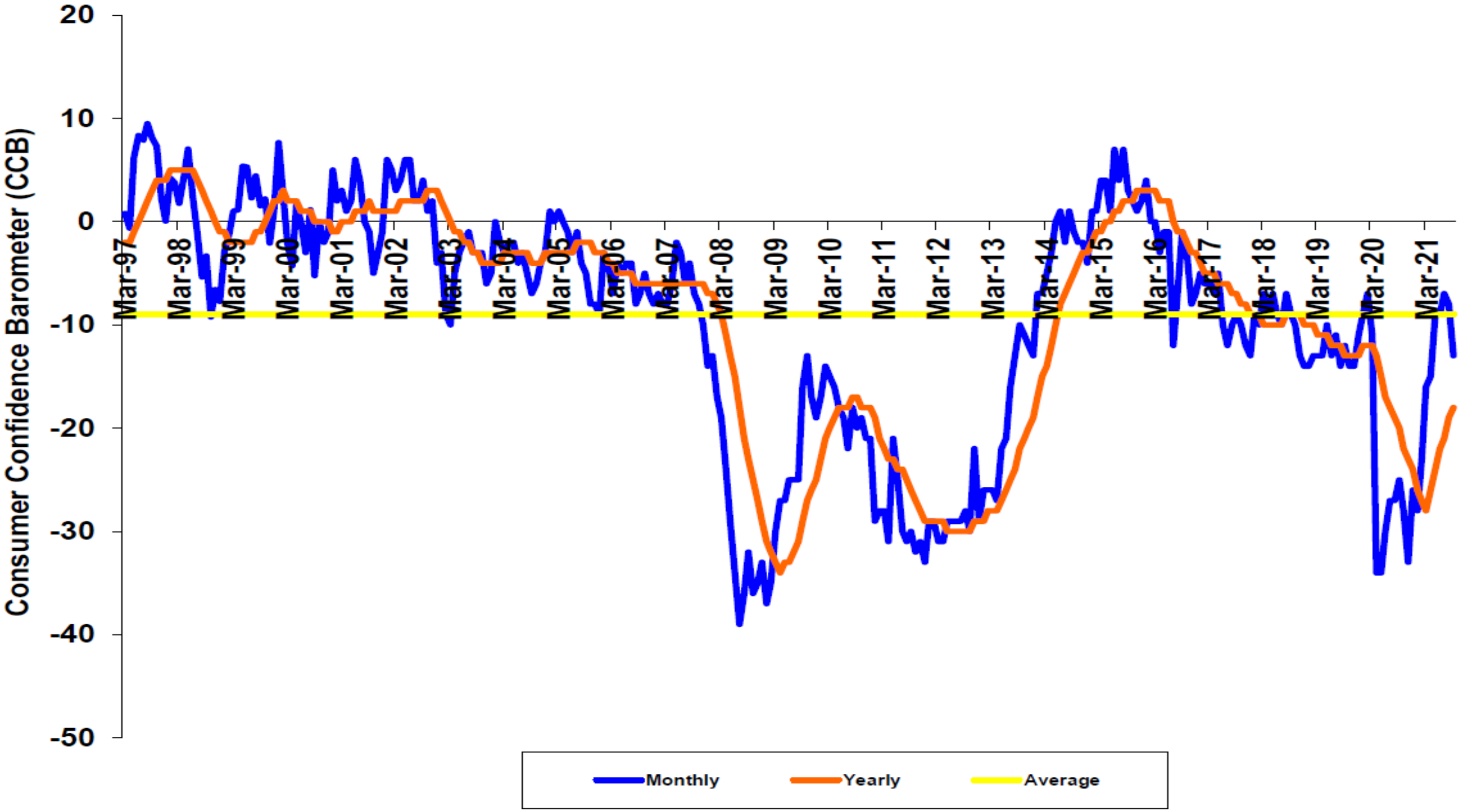
Figure 2 Annual rental growth to Aug-21



Source Zoopla Rental Index – Powered by Hometrack

UK consumer recovery: fading momentum

Chart 1: UK Consumer confidence January 1997 – September 2021

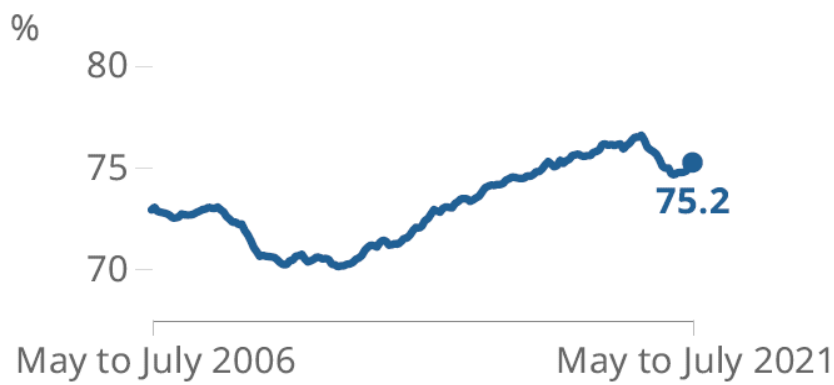


Source: GfK / JGFR

UK labour market is showing signs of strain

- Skills shortages and mis-matches are rife

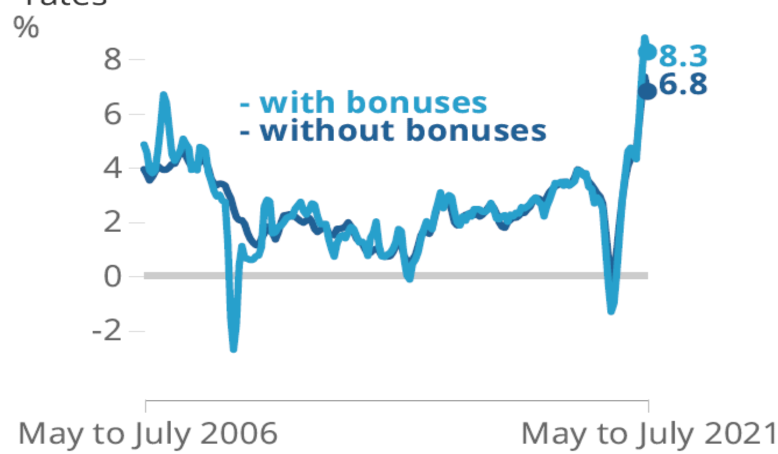
Employment rate (all aged 16 to 64)



Number of job vacancies

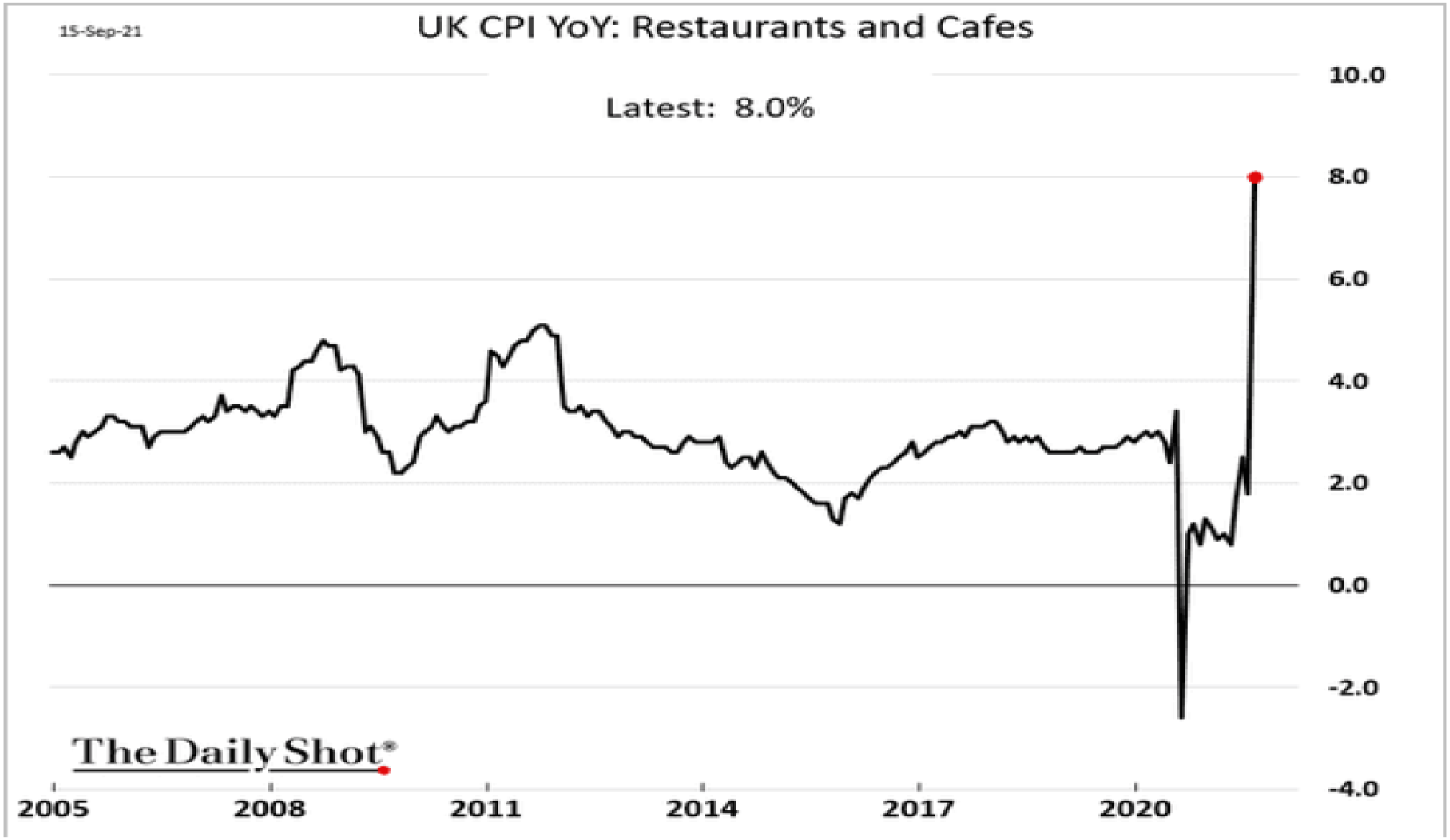
Economic inactivity rate (all aged 16 to 64)

Average Weekly Earnings annual growth rates



Withdrawal of services capacity remains an issue

- Survivors find a firmer pricing environment



Inflation: a richer narrative

- Covid has provided a credible inflationary trigger
- Public sector budget deficit reduction will squeeze the private market sector – lurch toward a command economy and smaller SME sector
- Public sector pricing of labour and materials is driving up the aggregate price level
- Impending market-led credit tightening will weaken private sector activity but raise costs
- Semi-permanent contraction of supply will keep inflation strong even when the sugar-high is over

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