Presentation to the IEA Shadow MPC

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15 April 2025

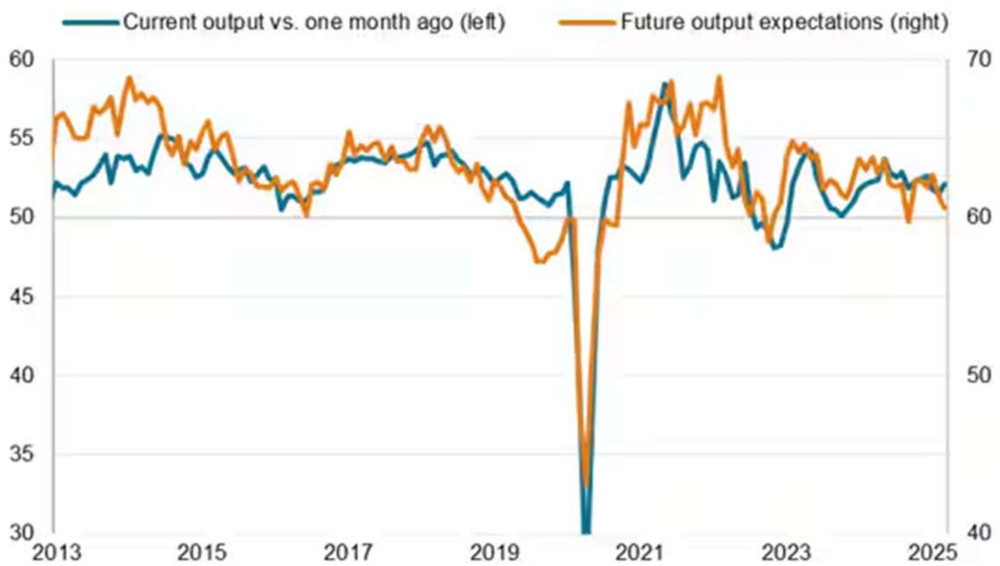
1. Agenda

- The world – before ‘Liberation Day’
- Latest news on the UK economy
- The state of play on tariffs
- The economic consequences of Mr Trump
- How central banks should respond
- The immediate policy decision

2. The world – before ‘Liberation Day’ (2 April)

- The PMI business surveys suggest that the global economy was still growing at a steady pace in March, led by services, but manufacturing continued to lag behind

Global PMI output and future expectations

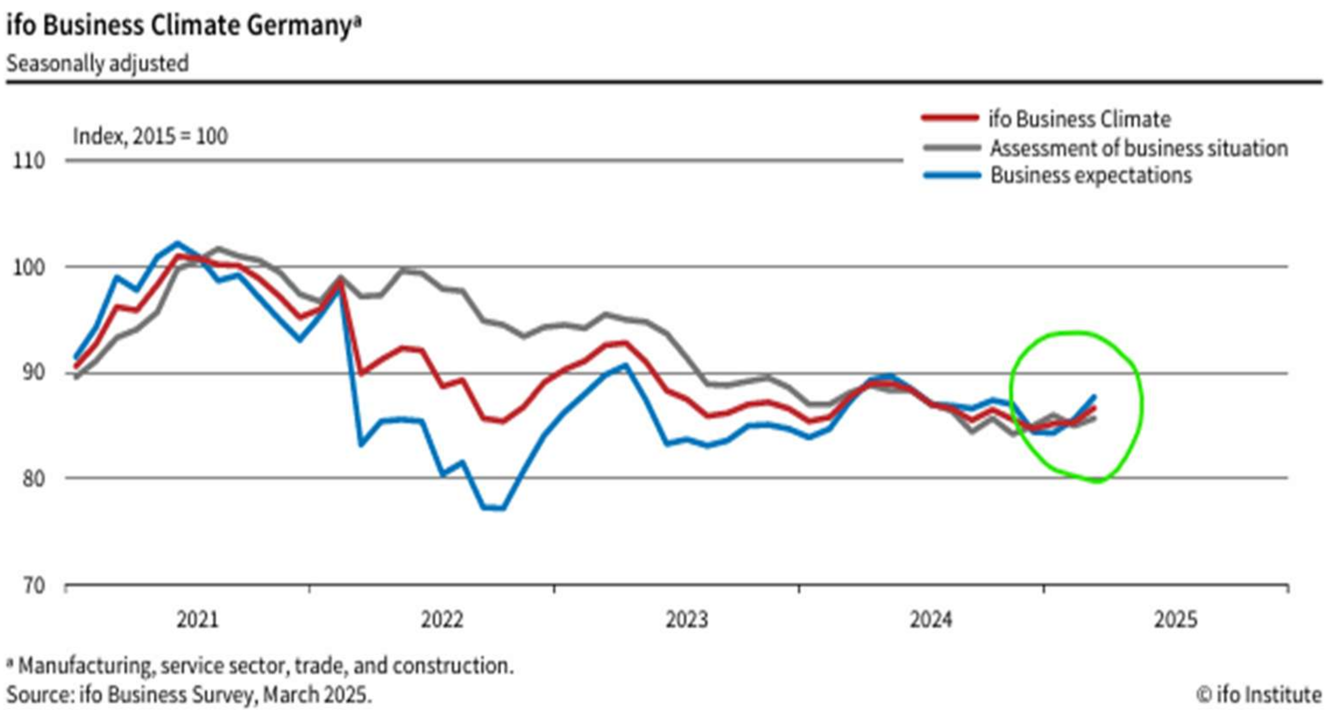


Data compiled April 2025 including PMI data to March 2025.
PMI index value of 50 = no change on prior month/over next 12 months, covers manufacturing and services.
Source: S&P Global PMI with J.P. Morgan.

- Firms’ expectations for their own output over the next 12 months were already faltering, largely due to the rising costs of labour, energy and other inputs

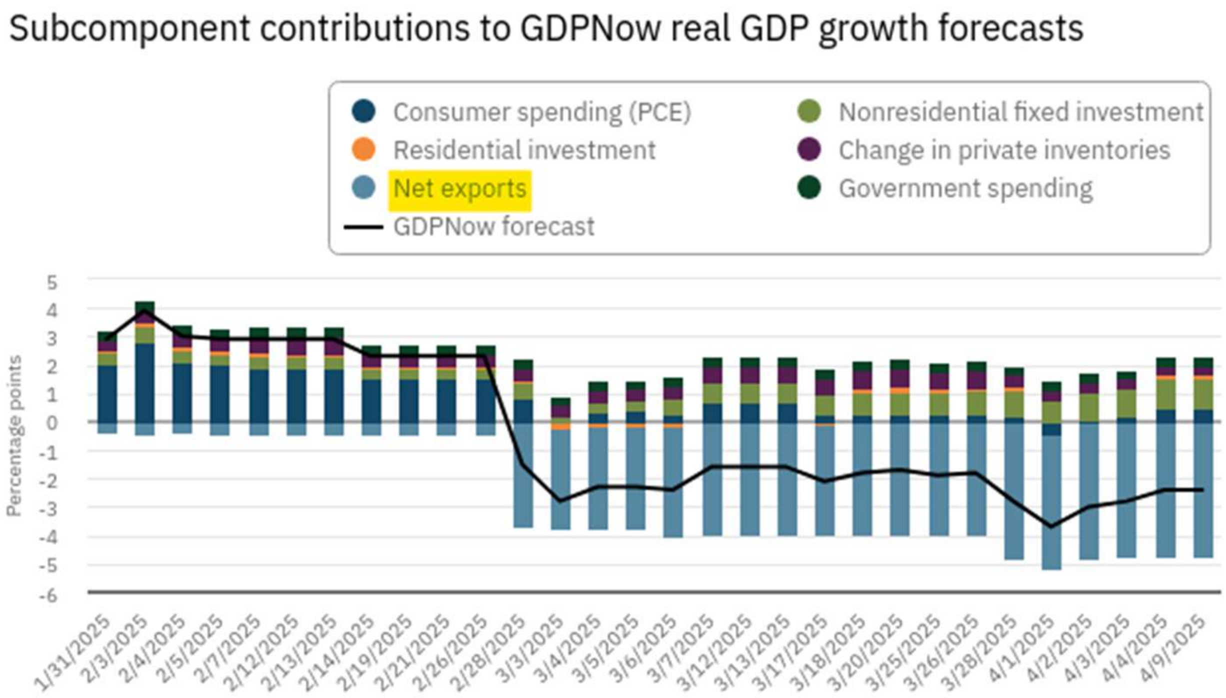
3. Some signs of life in the euro area

- The German economy did at least appear to be bottoming out, with confidence boosted by a reduction in political uncertainty and the planned loosening of the fiscal rules



4. US GDP expected to contract in Q1

- The Atlanta Fed's latest NowCast suggests US GDP will fall at an annualised rate of about 3% in Q1, but this is due to a (temporary?) jump in imports (incl. gold) to beat tariffs

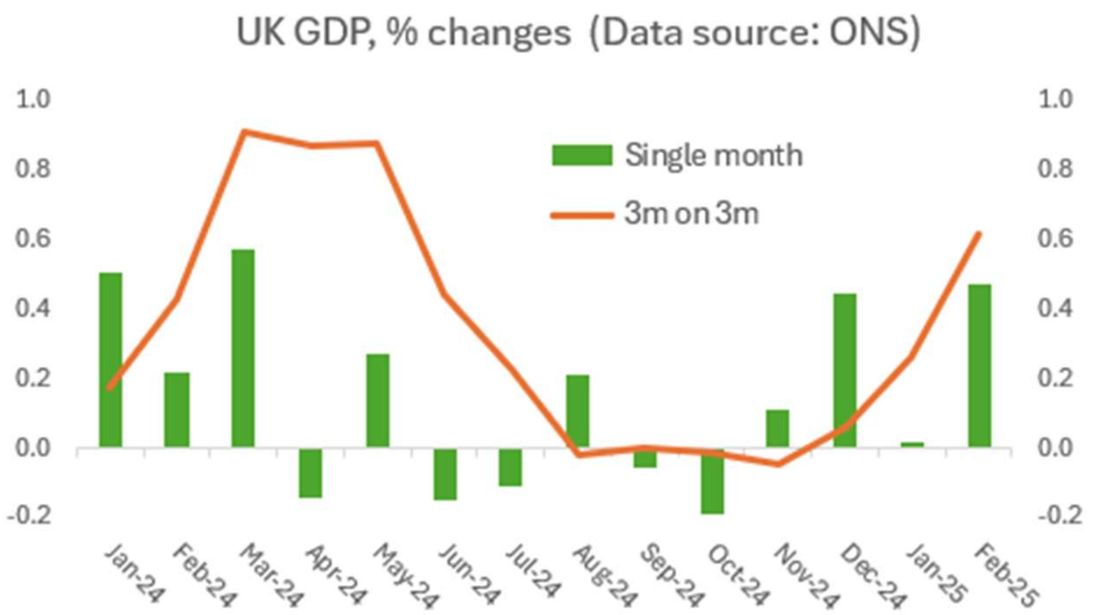


Source: Atlanta Fed

- Other key components are still positive, so this is not (yet) a recession signal
- First official estimate: 30 April

5. The UK economy appears to be bouncing back

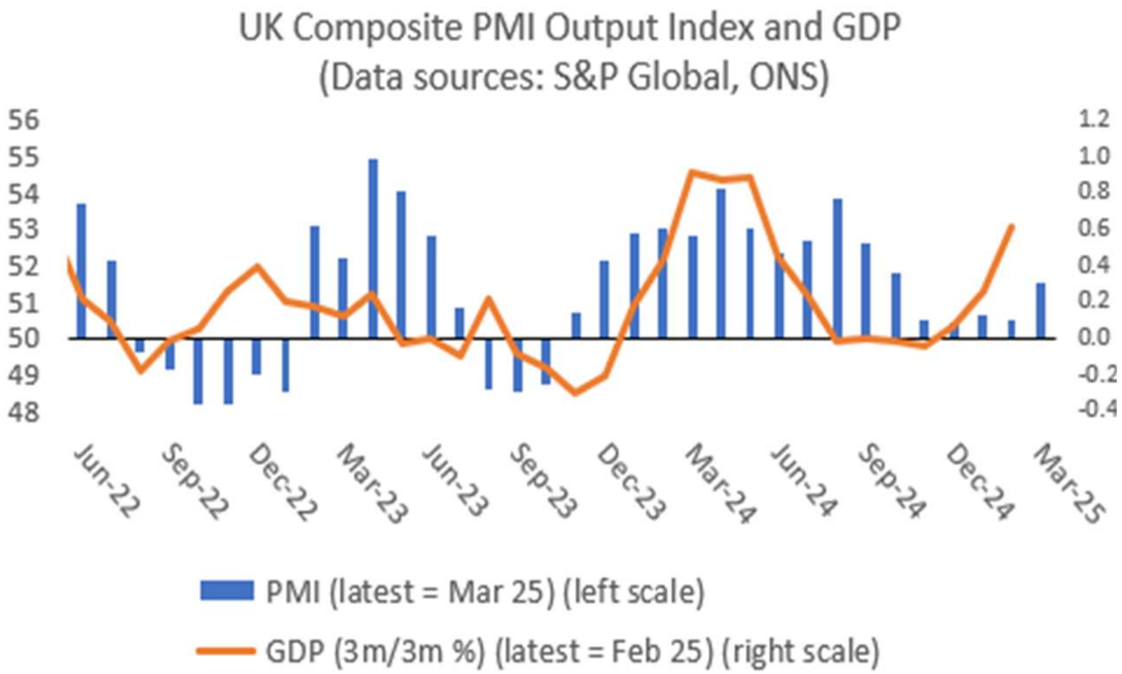
- According to the official data, UK GDP jumped by 0.5% in February and grew by 0.6% on the 3m/3m comparison, but these figures should be plastered with health warnings!
- The monthly GDP data are inherently noisy, with big question marks over the seasonal adjustments…



- Nonetheless, the strength of consumer spending on services is consistent with the decent growth in real wages and ample household savings

6. A few reasons for optimism in the surveys too

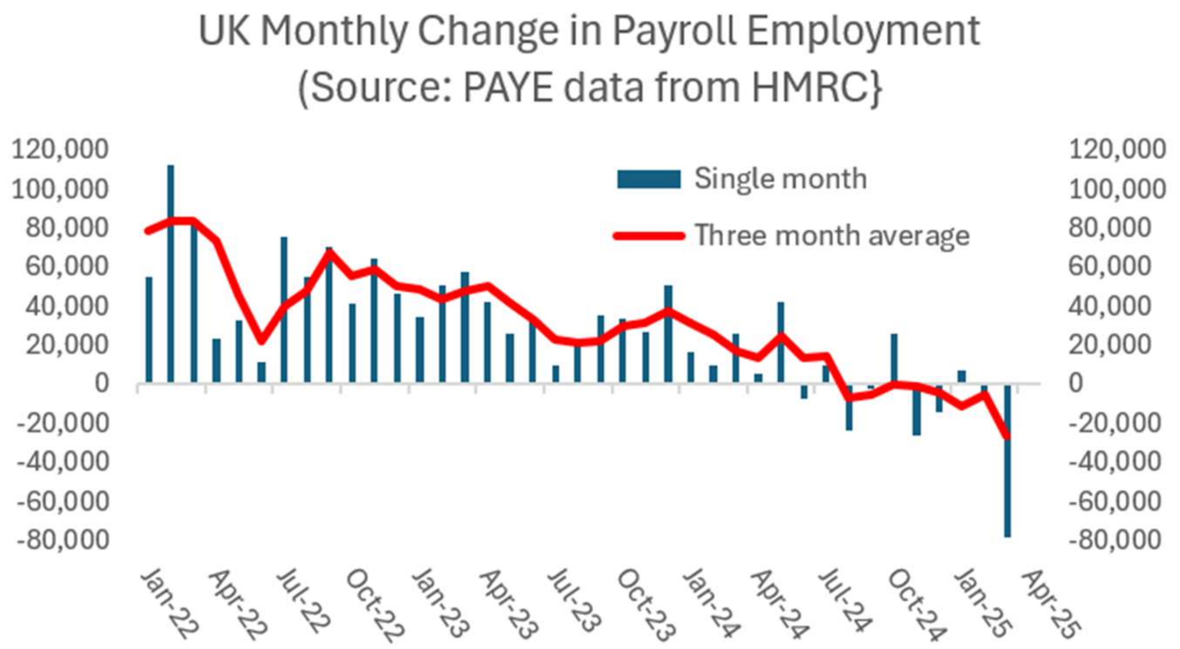
- The latest business surveys do suggest that the economy is picking up – albeit nowhere near as strongly as reported in the official GDP data. Here is the UK PMI, covering private services (excl. retail) and manufacturing…



- The BRC survey of retail sales (published this morning) also found some 'green shoots' in March, but the recovery here still looks fragile

7. The labour market is continuing to cool

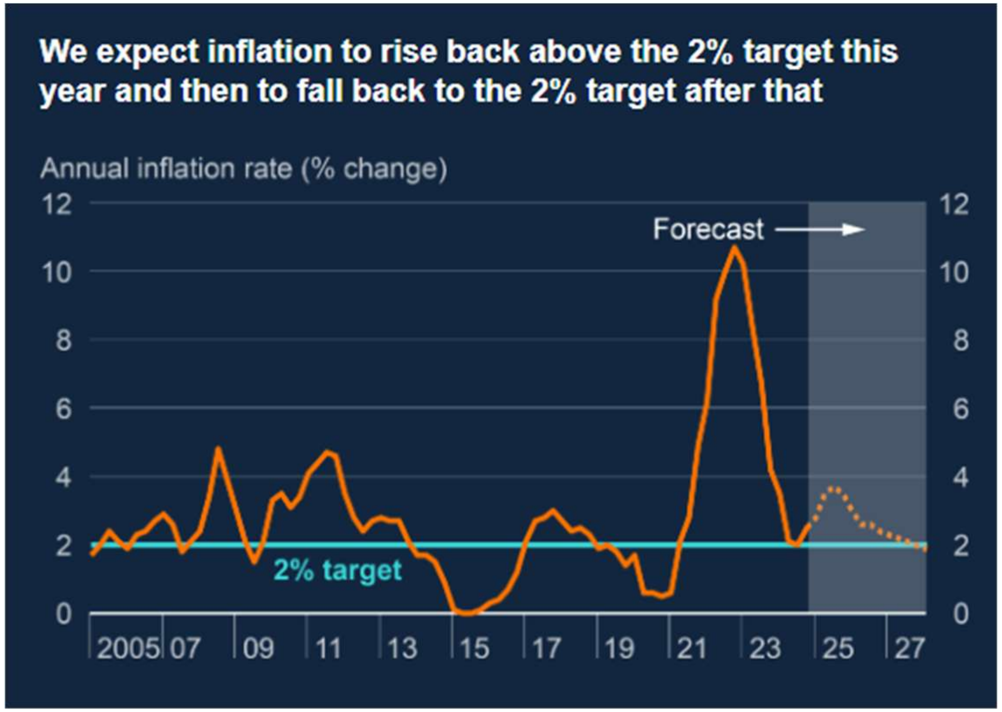
- Early estimates suggest that the number of payrolled employees fell by 78,000 in March, just ahead of the jump in the costs of employing people in April (with vacancies down too)



- Headline pay growth is still strong (just under 6%) but leading indicators are weakening – including surveys of wage expectations

8. Inflation set to jump in April

- Almost everyone already expects inflation to jump in April and to peak at around 3¾% in the summer, reflecting the pass through of higher labour costs and (especially) energy prices



- These are the forecasts from the Bank of England's February MPR, but the latest projections from the OBR and most independent forecasters are similar

9. Money growth not a major inflation threat

- UK broad money growth (M4ex) has picked up to around 4% (still a little too weak for comfort on economic activity, but not strong enough to justify fears of a sustained rise in inflation)

10. The state of play on tariffs

- The US now has a bewildering array of different tariffs for different countries and for different goods:

  1. sector-specific tariffs, notably 25% on cars
  2. punitive tariffs on China as high as 145%
  3. ‘reciprocal tariffs’ on almost everyone else
  4. a wide range of discounts and exemptions, notably on pharmaceuticals, fuels and some electronic goods (even from China), which may or not be temporary…

- Net result is that the average effective US tariff on imports from the rest of the world has risen from around 3% to more than 20% (though this number changes all the time!)

11. What are 'reciprocal tariffs'?

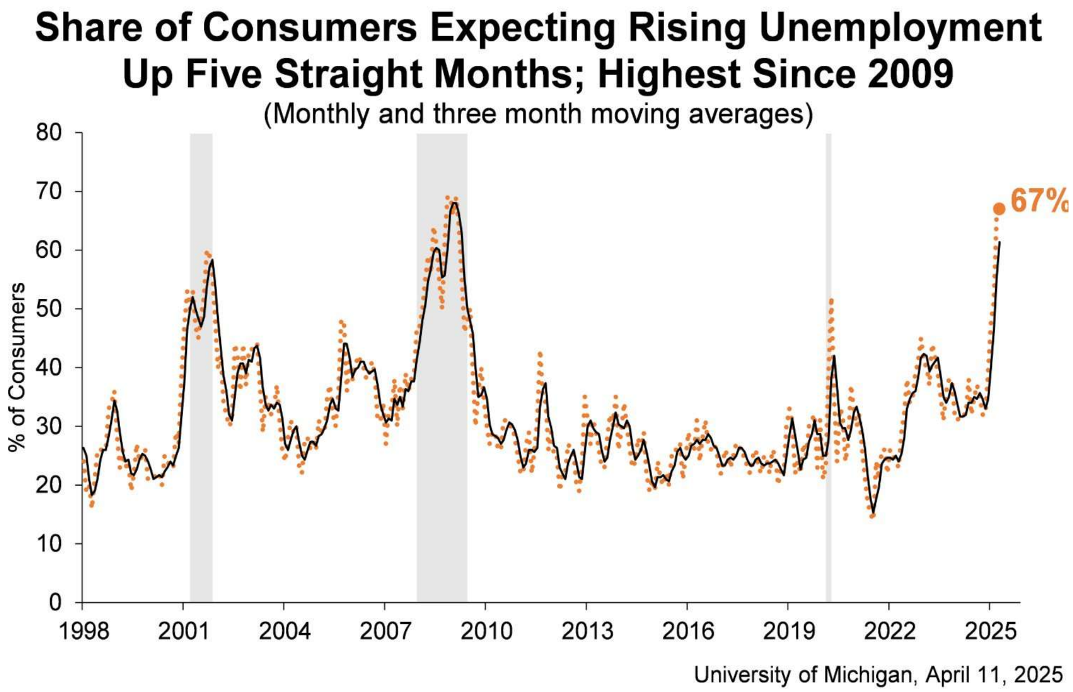
- These new general tariffs on imports from almost all countries, set at half the rate necessary to balance bilateral trade in goods with each one
- Where the US runs a surplus (including the UK), a baseline tariff of 10% would apply
- Where the US runs a deficit, a higher tariff applies
- The larger the deficit (relative to a country's total trade in goods with the US) the higher the tariff
- The higher rates have since been suspended for 90 days, but the 10% is still in place (as well as other sector- and country-specific tariffs)

12. Does this make any sense?

- Of course not…
- The US has assumed that the impact of any non-tariff barriers can be proxied by the size of the bilateral deficit, but there is no world in which you would expect each country to have balanced trade with each and every other country
- Trump supporters say this is just a bargaining tool to bring other countries to the negotiating table
- My own take is that the current US position is simply unsustainable, and that Trump will have to continued to back down (as with electronic goods and components)
- The adverse reaction in equity and (especially) bond markets shows that the policy lacks credibility

13. Even the general public are worried

- Consumer surveys suggest that the average American understands the risks from tariffs far better than Trump, or his advisors - including the threat to US jobs

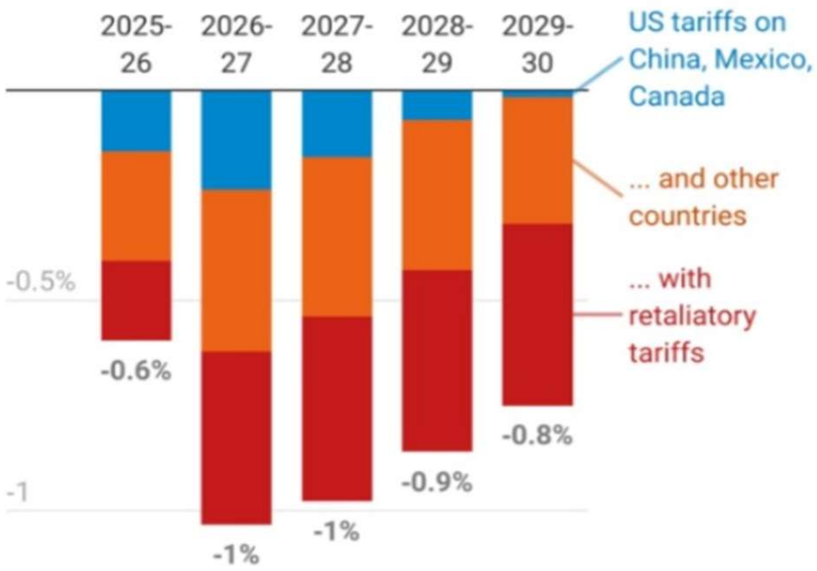


- Household, business and financial market expectations for US inflation have also jumped, making it harder for the Fed to cut rates

14. What does this mean for the UK?

- OBR modelling suggests a global trade war - with US tariffs 20pp higher than before - could reduce the level of UK GDP by as much as 0.6% this year, with a peak hit of 1.0% next year

OBR modelling for the impact of tariffs on its GDP forecast, in different scenarios



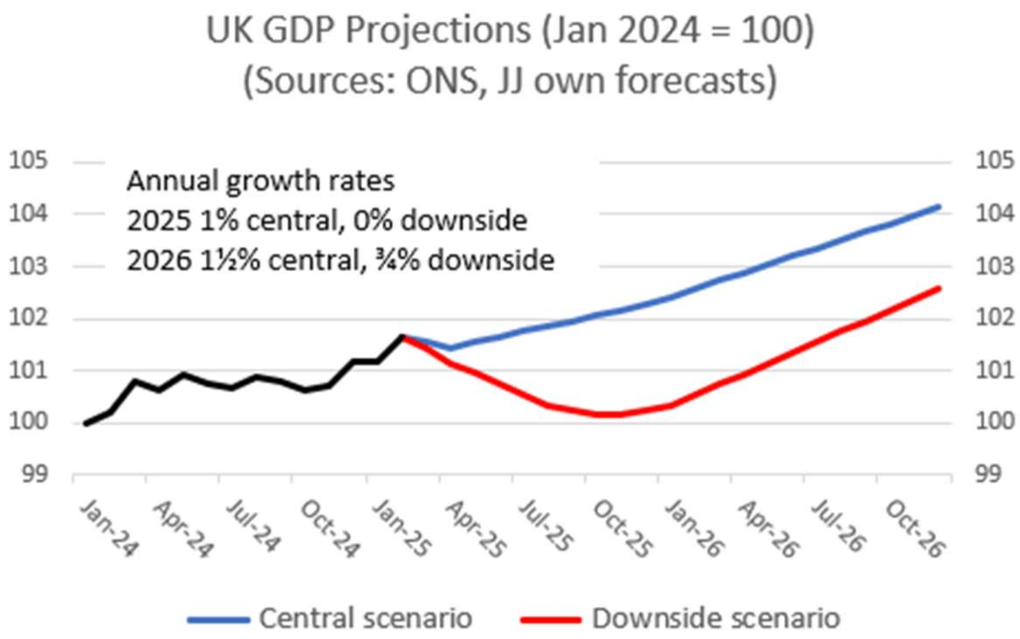
Assuming 20 percentage point increase in tariffs

Chart: The Spectator (Q4uWk) • Source: OBR EFO Mar '25 chart C

- However, this is a worst case assuming that other countries (including the UK) retaliate, and that this should still not enough (on its own) to drag the UK into full-blown recession

15. Two illustrative scenarios for UK GDP

- In my central scenario, the trade war is largely contained to the US and China, UK consumer spending continues to recover as real incomes rise, higher public sector investment finally kicks in, and taxes are not raised any further (a lot to go right!)



- But the main risks to growth are clearly skewed to the downside, including a wider and more protracted trade war

16. How should central banks respond?

- This table from the Bank of England's February MPR shows why the impact of a trade war on the UK interest rate decision is not as straightforward as many assume!

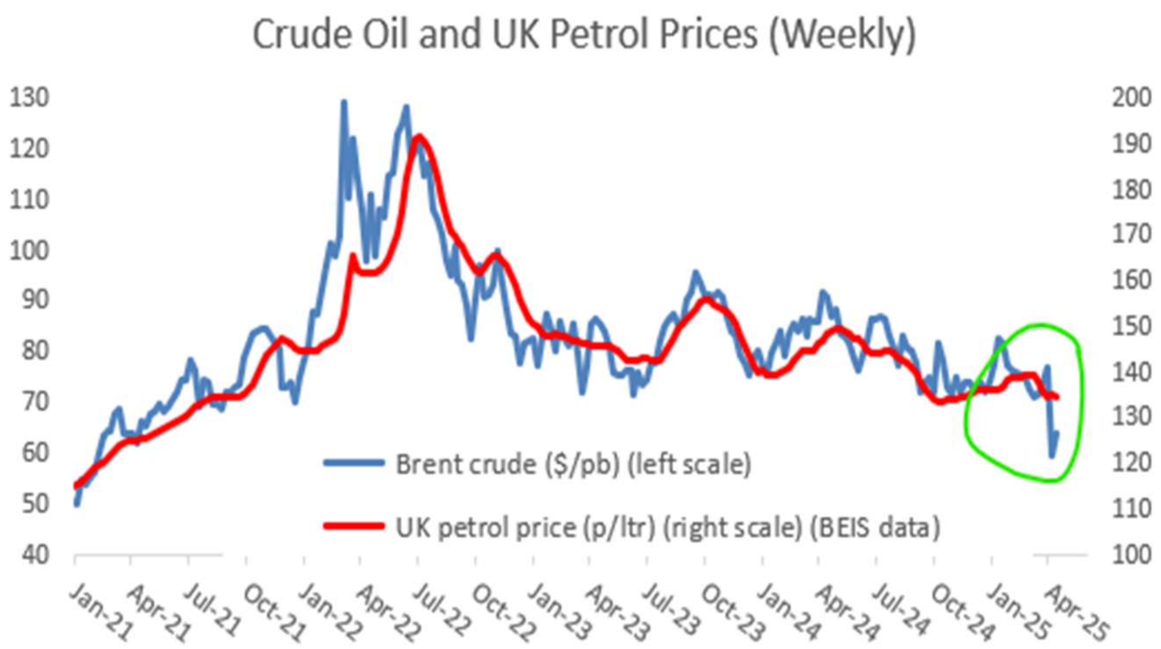
Table 1: Potential effects of US tariffs on the UK

Channel	UK activity	UK inflation	Explanation
Expenditure switching	↓	↓	US demand for UK exports weakens.
Weaker global demand due to counter-tariffs	↓	↓	Additional trade distortions weigh on global demand, weakening demand for UK exports.
Supply chain disruptions	↓	↑	Supply chain disruptions due to missing components could lead to short-term price spikes.
Trade diversion	↔	↓	Other countries lower prices of exports previously destined for US.
Exchange rate movements	↑ ↓	↑ ↓	Sterling could appreciate or depreciate depending on other countries' trade policies and changes in global risk sentiment.
Long-term supply chain reconfiguration	↓	↑	Reorganisation temporarily reduces global supply capacity and increases price pressures.
Lower competition and knowledge transfers	↓	↔	Reduced trade openness weighs on global potential supply growth.

- Key takeaway: a global trade war could have many different effects on both UK demand and supply and in ways that could either reduce or increase UK inflation…

17. … but one effect does already seem clear

- Global oil prices have recovered a little in the last few days, but UK pump prices should still fall over the coming weeks (reflecting the usual lags). At least as importantly, natural gas futures remain much lower too.



- Key takeaway: energy prices will not push up headline inflation as much as many fear, meaning the CPI should peak nearer 3% than 4%

18. The immediate policy decision

- Subject to the discussion we are just about to have, I would vote (again) for an immediate half point cut in Bank rate, to 4%, to return official interest rates to a ‘neutral’ level
- Thereafter I would have no bias
- This is based on my long-held view (regardless of the threat of a trade war) that interest rates are still higher than they need to be to continue bearing down on inflation
- The impact of a trade war on inflation is too uncertain to justify a rate cut on its own, but on balance I do think this adds to the downside risks both to growth and inflation
- I would also pause QT pending a wider review of the treatment of the APF in the Bank’s balance sheet and of the amount of interest paid on QE reserves

Questions and discussion