UNITED KINGDOM
2022-2023 SCENARIO

SHOCK ON REAL INCOMES, SLOWDOWN IN GROWTH

July 2022

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WORKING EVERY DAY IN YOUR INTEREST AND FOR SOCIETY

GROUP ECONOMIC RESEARCH

CONTENTS

SUMMARY

GROWTH DOWNGRADED AGAIN

Further deterioration in the inflation and growth outlook

We have downgraded our growth forecasts to 3.4% for 2022 and 0.9% for 2023, compared to 4% and 1.2%, respectively, in our April scenario, due to the combination of several headwinds. Firstly, inflation is expected to continue climbing, reaching 11% in October, primarily due to a further 40% increase in energy price caps. Next, financial and monetary conditions have already become much tougher, even though the Bank of England (BoE) has not finished tightening its monetary policy. In addition to this, external demand is softening. We have reduced our growth forecasts for the Eurozone and the United States, which are both key destinations for UK exports. Finally, the fiscal plan. In May, the government announced a support package for low-income households (for a total of GBP 15 billion or 0.6% of GDP) to boost their purchasing power. This plan is likely to provide 0.3 percentage points of support to growth over the next twelve months (according to the BoE), but will likely be insufficient to counter the combined effects of the above-mentioned headwinds.

Short-term volatility due to the Queen's jubilee

The Queen's jubilee in June is likely to drag down Q2 growth figures, as there was one less working day during the month (the opposite effect will be visible in the third quarter). As an illustration, the ONS estimated that the Diamond Jubilee had a 0.3-0.4 percentage point impact on Q2 2012 GDP, while highlighting the uncertainty around these estimates. For its part, the BoE estimates that the jubilee will clip quarterly growth by 0.25 percentage points. We expect GDP to decline by 0.5% in Q2 before experiencing a technical rebound of 0.4% in Q3.

Factors underpinning private consumption are still apparent

With purchasing power expected to plummet this year (-2%, the biggest drop since the 50s, according to the OBR), households will have to dip further into the savings accumulated during the crisis to cover their spending. Although the savings rate (6.8% in Q1 2022) is close to its pre-crisis level, the savings surplus is still considerable at around £230 billion, or 9.6% of GDP. Added to this reserve is the tight labour market: hiring challenges due to persistent shortages in the working population are conducive to wage renegotiations. The BoE expects wage renegotiations averaging 5% this year, well beyond what was observed before the pandemic. Finally, the government's support plan for household purchasing power will come into effect in the second half of this year and will likely help offset the next rise in energy prices in the autumn.

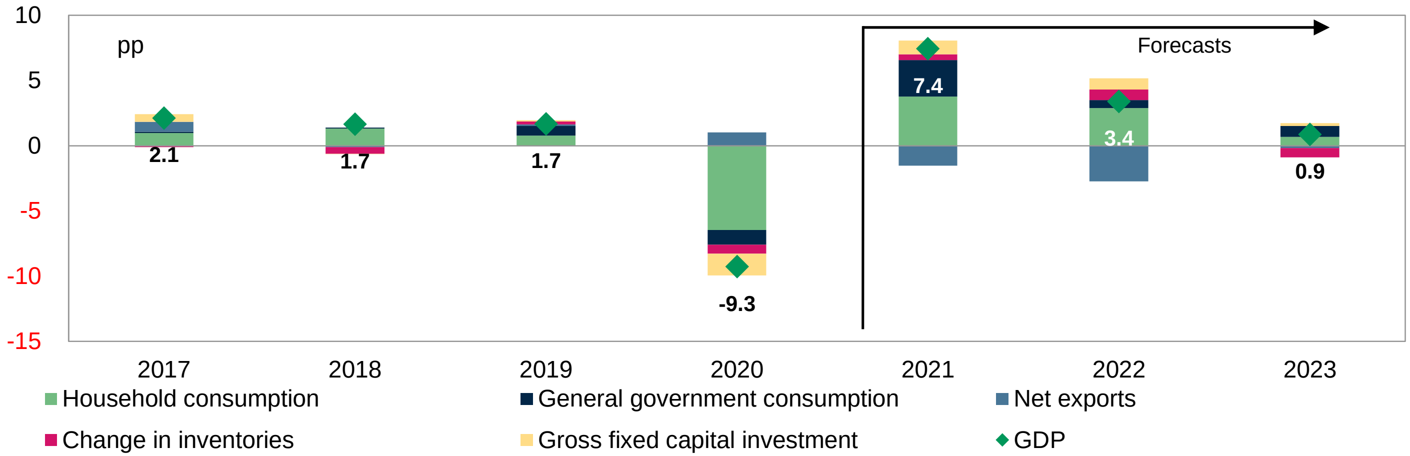
BoE: The comfortable, conditional choice

While the central banks in other advanced economies are stepping up the pace of their monetary tightening, the BoE is taking a more prudent approach and adopting a certain ambiguity in its language which, although not unusual, runs the risk of being inappropriate and even dangerous in the current inflationary environment. Given the labour market situation and the risk that inflation expectations will continue to rise, as well as the Fed's aggressive approach and its implications for the dollar-pound exchange rate, monetary tightening is expected to continue in the UK. We have added three 25 bp hikes to our central scenario, which would bring the Bank rate to 2% in November.

SUMMARY

FORECASTS: GROWTH FORECASTS REVISED DOWNWARDS AGAIN

Contributions to annual GDP growth



Sources: ONS, Crédit Agricole SA / ECO

United Kingdom	2021	2022	2023	2021				2022				2023			
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP (%)	7.4	3.4	0.9	-1.2	5.6	0.9	1.3	0.8	-0.5	0.4	0.1	0.2	0.3	0.4	0.4
household consumption	6.2	4.8	1.1	-3.4	8.5	2.6	0.5	0.6	0.4	0.2	0.2	0.3	0.3	0.3	0.3
public consumption	14.3	3.0	4.1	1.0	8.5	-0.6	1.5	-1.3	1.0	1.0	1.0	1.0	1.0	1.0	1.0
investment	5.9	4.9	1.2	-0.9	1.7	0.4	1.1	3.8	-2.0	2.0	0.5	0.0	0.0	0.5	0.5
change in inventories*	0.4	0.8	-0.7	-0.8	-0.8	1.0	-0.1	2.6	-2.8	0.2	0.0	-0.1	0.0	0.0	0.0
net exports*	-1.5	-2.7	-0.2	1.6	0.6	-2.4	1.7	-4.3	2.2	-0.5	-0.3	-0.1	-0.1	-0.1	-0.1
Unemployment rate (ILO)	4.4	3.8	4.2	4.9	4.6	4.2	4.0	3.7	3.8	3.9	4.0	4.1	4.2	4.2	4.2
Inflation (CPI, YoY%)	2.6	9.0	6.4	0.6	2.1	2.8	4.9	6.2	9.1	9.8	10.8	10.1	6.9	5.6	3.0
Core CPI (YoY%)	2.4	6.2	5.1	1.1	1.9	2.6	3.9	5.1	6.0	6.6	7.1	6.8	5.9	4.6	3.1
Current account (% GDP)	-2.6	-5.6	-5.8	-2.2	-2.0	-4.9	-1.2	-8.3	na	na	na	na	na	na	na
General gov. balance, % GDP	-8.3	-4.5	-2.7	na	na	na	na	na	na	na	na	na	na	na	na
Public debt, % GDP	102.8	100.9	101.2	na	na	na	na	na	na	na	na	na	na	na	na
Bank rate**	0.25	2.00	2.00	0.1	0.1	0.1	0.25	0.75	1.25	1.75	2.00	2.00	2.00	2.00	2.00

** Contributions to GDP growth*

*** End of period*

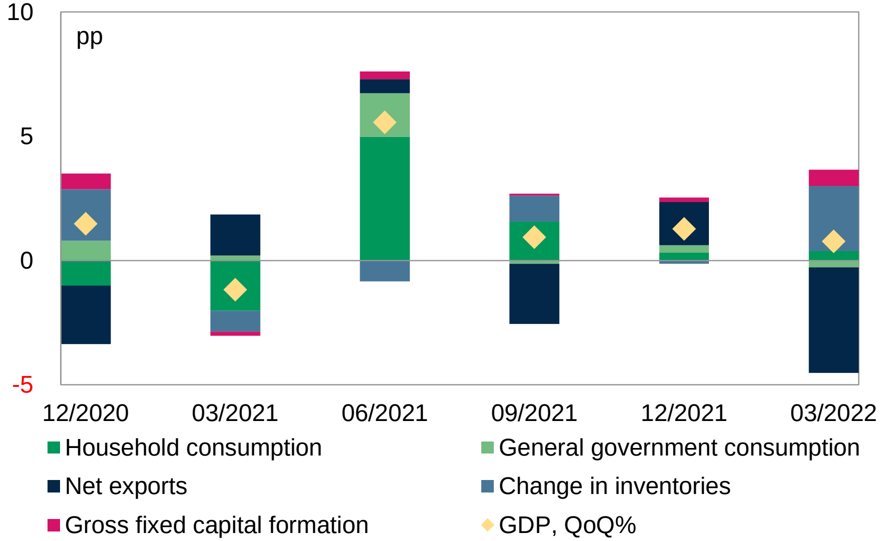
Source: ONS, BoE, Crédit Agricole S.A.

CONTENTS

RECENT ECONOMIC TRENDS

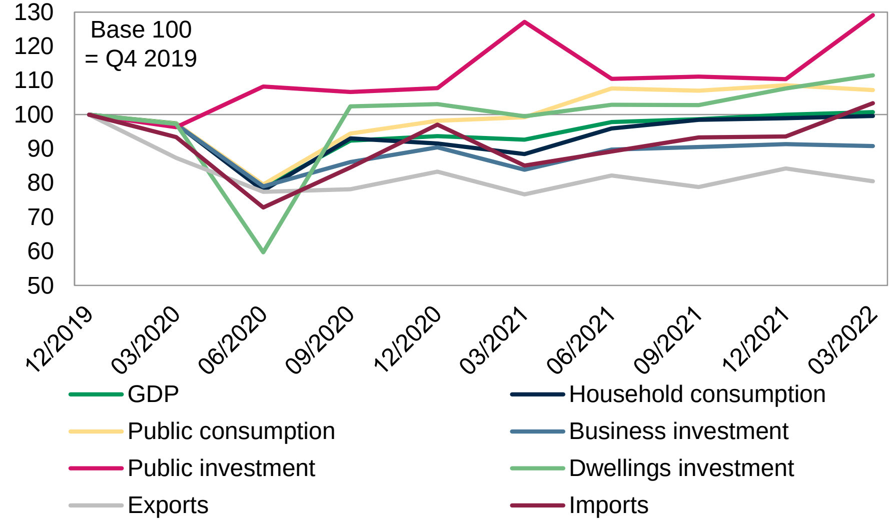
GDP GROWTH IN Q1 2022 WAS SUPPORTED BY CHANGES IN INVENTORIES

Quarterly GDP growth: breakdown in terms of expenses



Sources: ONS, Crédit Agricole SA / ECO

Private consumption has just returned to its pre-Covid level

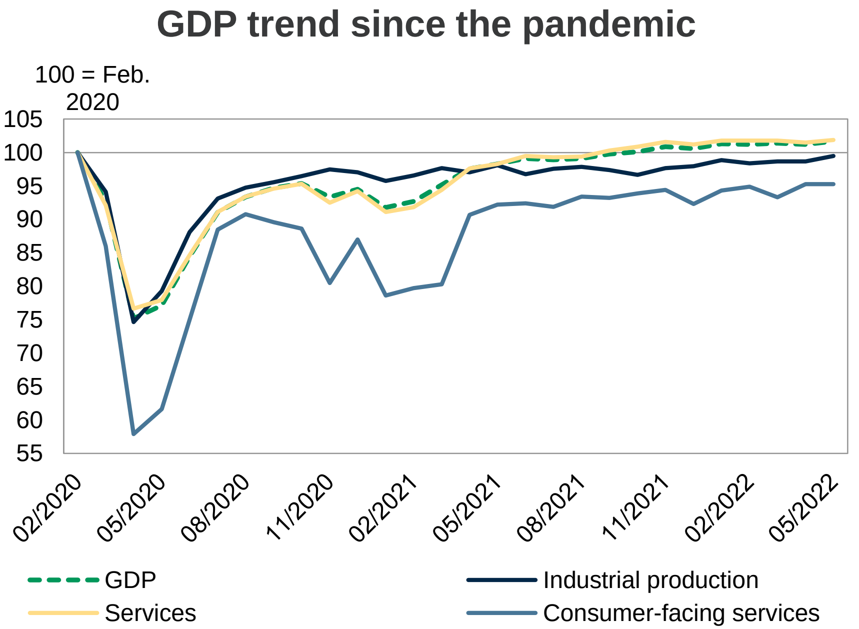


Sources: ONS, Crédit Agricole SA / ECO

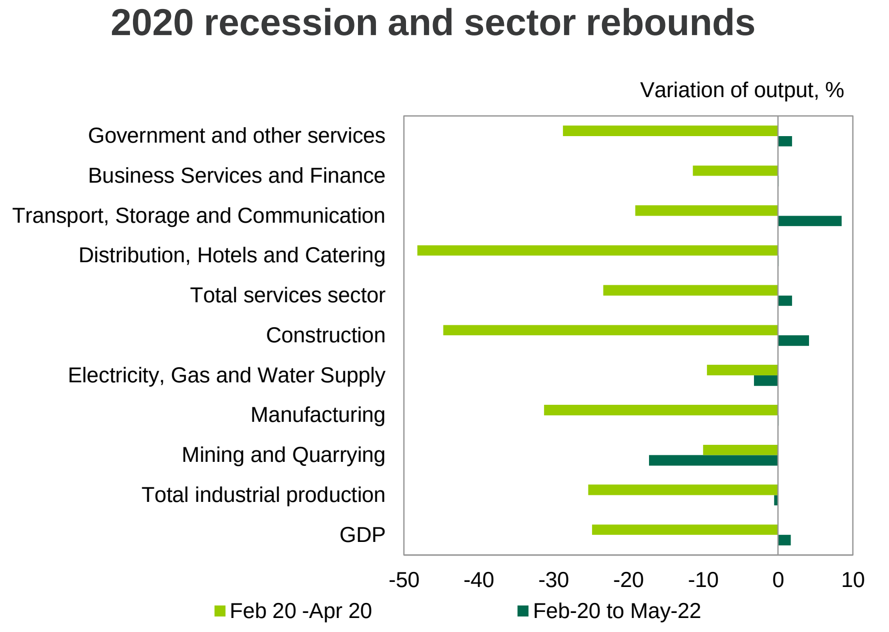
Activity continued to grow in Q1 2022 with a rebound of 0.8% in real GDP over the quarter (after +1.3% in Q4 2021). GDP is 0.7% above its pre-Covid level. This relatively solid performance was mainly concentrated in January when GDP grew 0.7% before stabilising overall in February and March. **It is, to a large extent, the result of strong rebuilding of inventories** (especially in the retail and wholesale sectors), with inventory changes contributing 2.6 percentage points to quarterly growth. Gross fixed capital formation also made a positive contribution of 0.7 percentage points, mainly thanks to public investment, which rebounded by 16.9% over the quarter. **However, productive investment declined over the quarter (-0.6%) and remains more than 9% below its pre-crisis level.** Household consumption grew 0.6% over the quarter and contributed 0.4 percentage points to growth, driven by increases in spending in restaurants and hotels, communication, leisure and textiles. In terms of negative contributions, we note external net trade, which shaved 4.3 percentage points from growth due to a drop in exports (-4.4%) and a sharp rise in imports (+10.4%).

RECENT ECONOMIC TRENDS

SLOWDOWN IN ACTIVITY



* *Services including retail, catering, tourism, culture and leisure (official ONS data)*



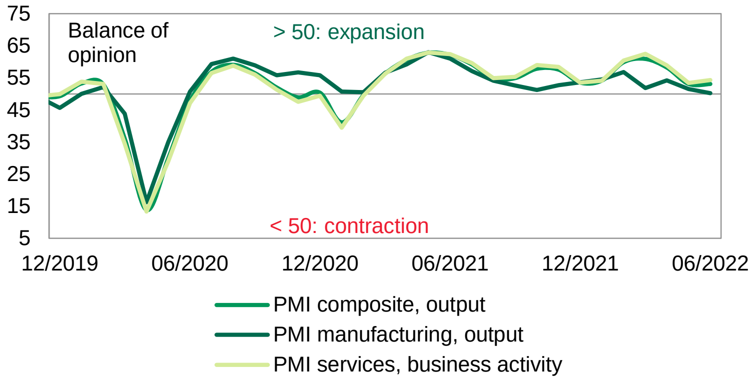
Sources: ONS, Crédit Agricole SA / ECO

GDP increased by 0.5% month-on-month in May (a figure to be taken with caution due to the change in public holidays linked to the Queen's jubilee) and is 1.7% above its pre-Covid level (February 2020). The post-pandemic recovery looks therefore largely behind us and we are naturally seeing a slowdown in activity. **On average over the three months to the end of May, GDP grew 0.4%, compared to double that percentage in March, a slowdown largely due to the services sector, where growth dropped to 0.1% compared to 0.6% in March and 1.3% in January.** A sharp drop in activity in public services related to Covid (vaccination campaign, tests and traceability of Covid cases) seems to have contributed significantly to this slowdown. At the same time, industrial activity posted a better performance with growth of 0.5% over the last three months to the end of May, although this also reflected a sharp slowdown (+1.2% over the three months to end-March). This slowdown is mainly attributable to the manufacturing sector, up 0.2% over the three months to end-May (despite a marked rebound in May of 1.4% over the month) vs. +1.5% in March, and is probably due to a decline in domestic demand. Indeed, foreign trade data showed an acceleration in exports of goods, particularly to the EU (+15.3% over the three months to the end of May), but also in non-EU exports (+9.2%). Finally, the construction sector continued to record strong growth, up 3% over the last three months to the end of May, an increase from March (+2.2% in the corresponding measure).

RECENT ECONOMIC TRENDS

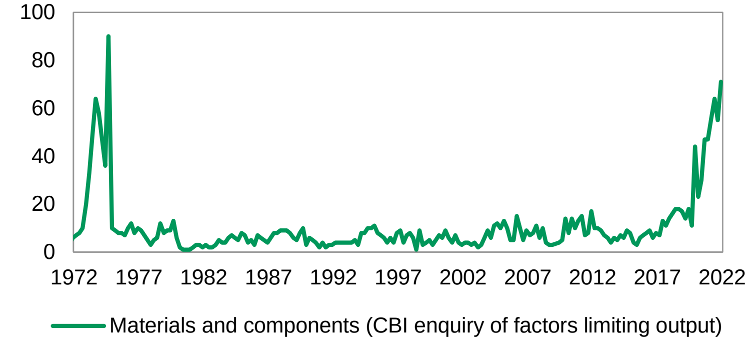
BUSINESS SURVEYS: SUPPLY CONSTRAINTS WORSEN

PMI surveys: industry is slowing, services are accelerating



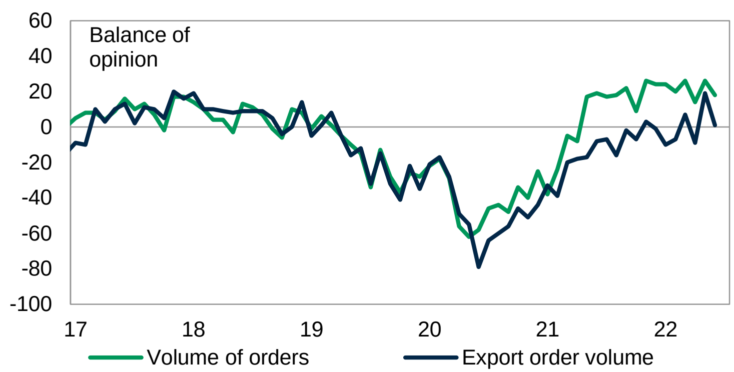
Sources: IHS Markit, Crédit Agricole SA / ECO

Factors limiting production: record shortages of materials and components



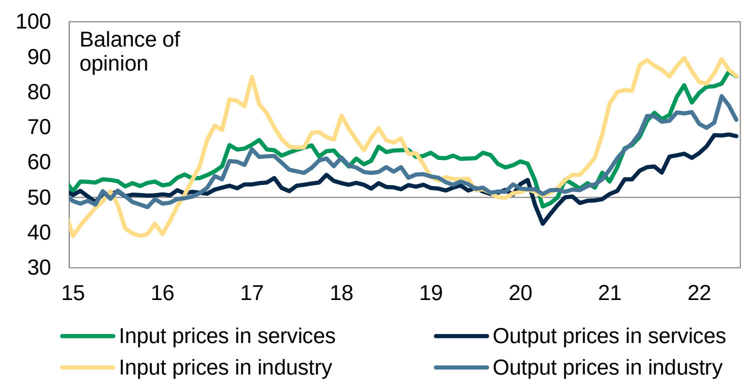
Sources: CBI, Crédit Agricole SA / ECO

Order books stabilise at high levels



Sources: CBI, Crédit Agricole SA / ECO

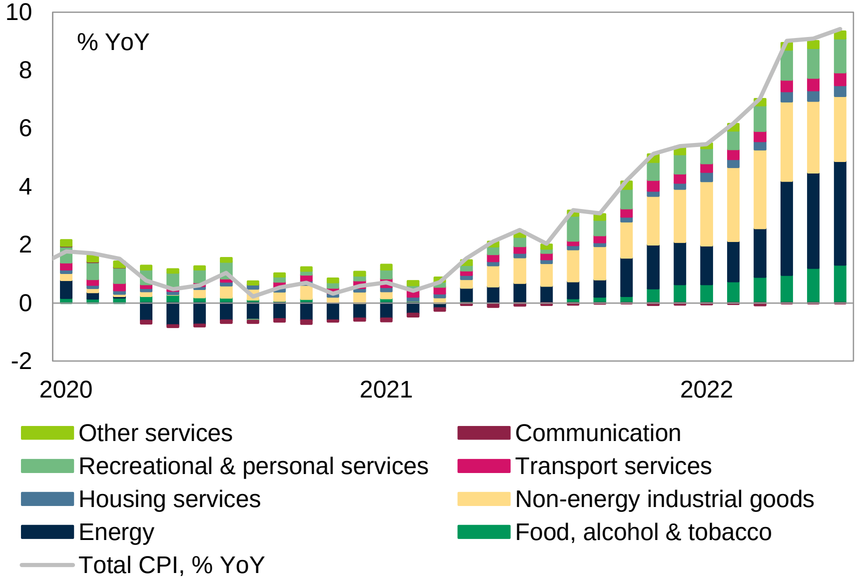
PMI price components seem to have peaked in industry



Sources: IHS Markit, Crédit Agricole SA / ECO

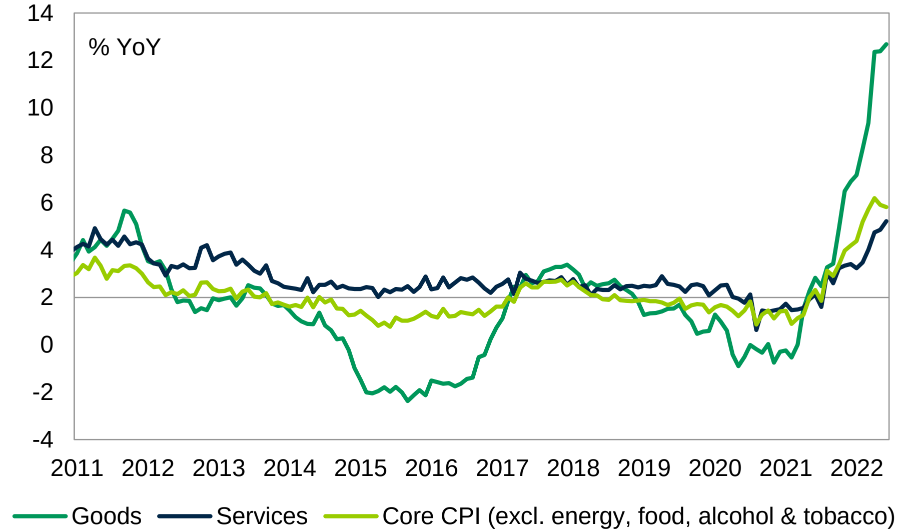
HEADLINE INFLATION CONTINUES TO RISE, DRIVEN BY ENERGY AND FOOD PRICES

CPI inflation reached 9.4% year-on-year in June



Sources: ONS, Crédit Agricole SA / ECO

Core inflation marked two consecutive months of moderation

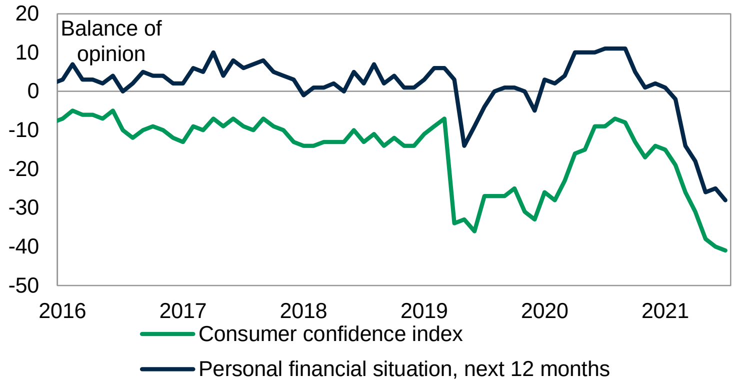


Sources: ONS, Crédit Agricole SA / ECO

The CPI rose 9.4% year-on-year (YoY) in June, versus 9.1% in May, an acceleration due to energy and food prices. Energy inflation saw another record increase to 57.3% YoY (after 52.8% YoY in May), while food prices rose significantly to 8.2% YoY (after 7.5% YoY in May). The rise in energy prices is reflected, on the one hand, in housing services (electricity, gas and other fuel oil) where inflation reached 19.6% YoY, and, on the other hand, in transport, with inflation at 14.9% YoY (due to gasoline prices), both of which have record highs since the start of the statistical series in 1997. Core inflation (CPI excluding energy, food, tobacco and alcohol) fell slightly for the second consecutive month to 5.8% YoY after reaching 6.2% YoY in April. **This moderation is mainly due to a drop in the inflation rate of industrial goods, excluding energy, for the second consecutive month, to 6.5% YoY compared with 8% YoY in April.** Inflation in services, which is more dependent on domestic demand than on global factors, continued to rise, reaching 5.2% YoY after 4.9% YoY in May, an acceleration affecting almost all sectors. In restaurants and hotels, inflation also increased in June to 8.5% YoY, partly due to the restoration of VAT at 20%.

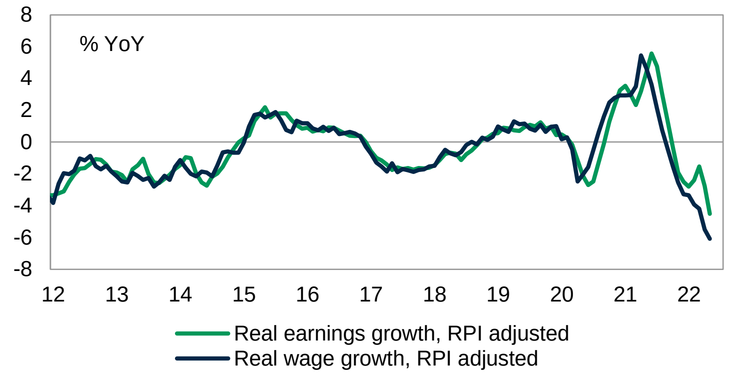
DIMINISHING PURCHASING POWER WEIGHS ON CONSUMER SENTIMENT

Consumer confidence hits record lows



Sources: Gfk, Crédit Agricole SA / ECO

The decline in real incomes has intensified under inflationary pressure

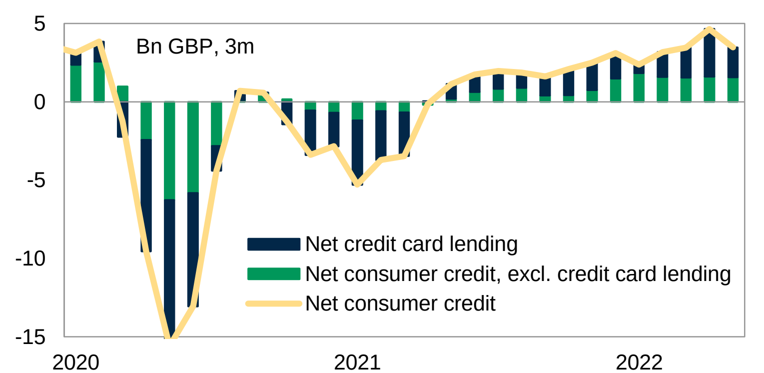


Sources: BoE, Crédit Agricole SA / ECO

Retail sales volumes continue to decline

Sources: ONS, Crédit Agricole SA / ECO

Consumers are borrowing to consume

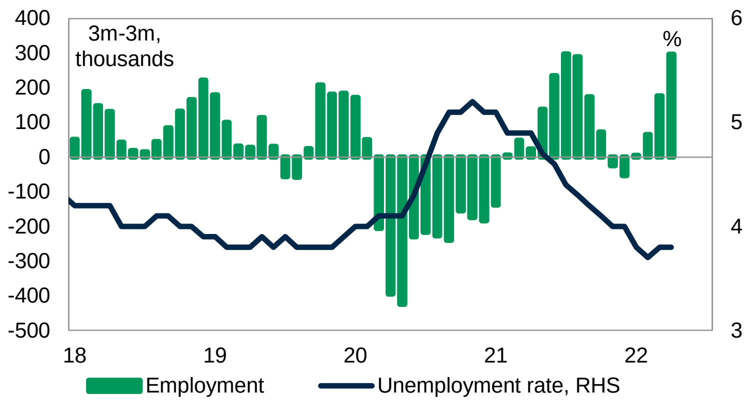


Sources: ONS, Crédit Agricole SA / ECO

RECENT ECONOMIC TRENDS

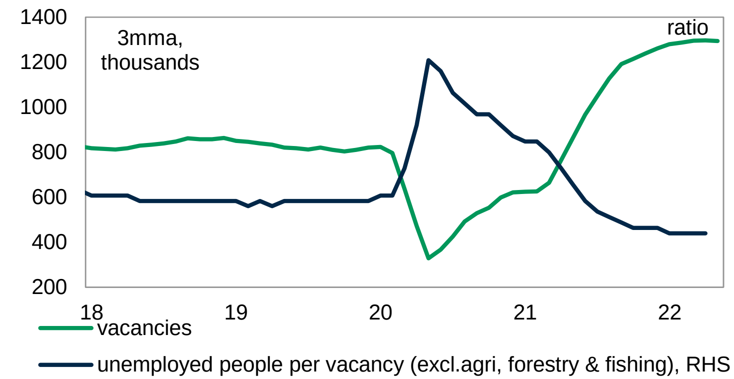
THE LABOUR MARKET REMAINS EXTREMELY TIGHT

The unemployment rate stabilises at its pre-crisis level



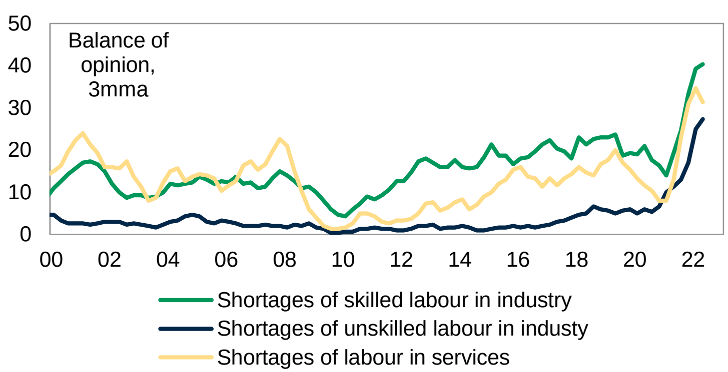
Sources: ONS, Crédit Agricole SA / ECO

The number of vacancies remains at record levels



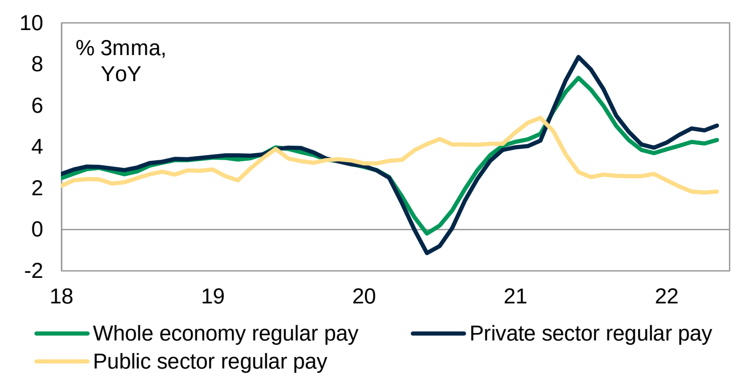
Sources: ONS, Crédit Agricole SA / ECO

Labour scarcity



Sources: CBI, Crédit Agricole SA / ECO

Wage growth in the private sector is picking up again



Sources: ONS, Crédit Agricole SA / ECO

CONTENTS

OUTLINE OF OUR SCENARIO

WE EXPECT GROWTH CLOSE TO ZERO OVER THE REST OF THE YEAR WITH HIGH VOLATILITY

Rising living costs is expected to lead to a slowdown in household consumption. We expect growth of 4.8% in 2022 on average (after 6.2% in 2021), followed by 1.1% in 2023. Nevertheless, the savings buffer created during the pandemic and the government's support package for purchasing power announced in May is likely to allow household consumption to hold up.

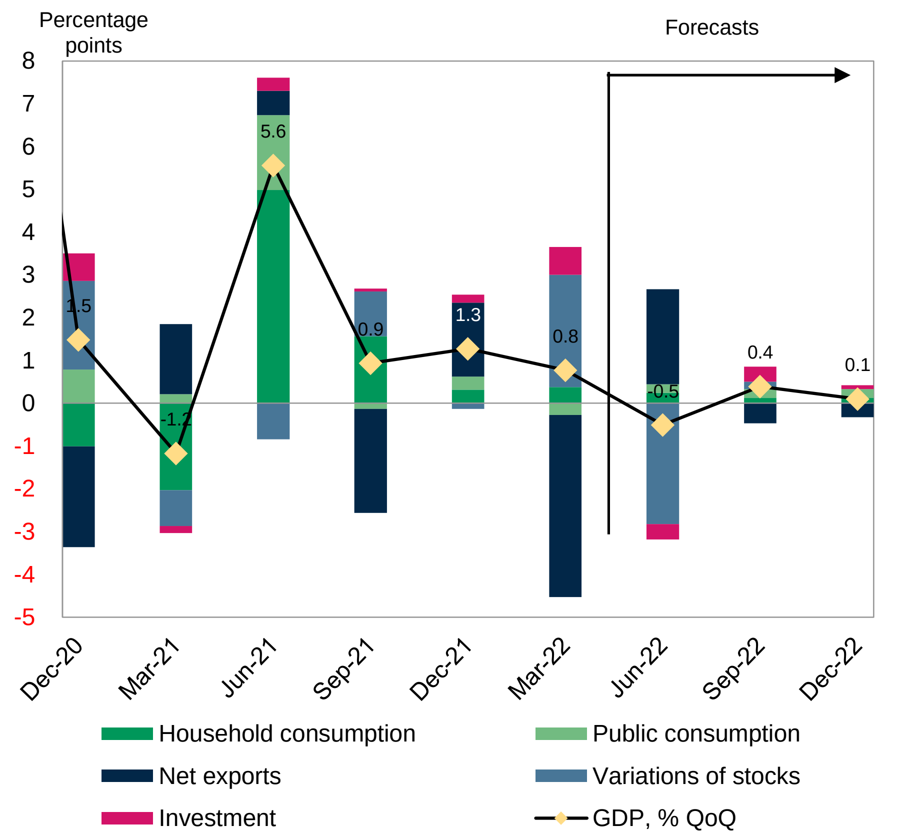
Business investment is expected to remain weak. Rising uncertainties, rising input costs, tighter financial and monetary conditions, material and labour shortages and slowing domestic and global demand should continue to weigh on business investment. In 2023, planned tax rises such as the end of the "super deduction" and the increase in the corporate tax in April 2023 will likely offset any positive effect of a expected end to monetary tightening by the BoE, as well as any improvement in pressure on production costs.

Foreign trade is expected to continue to contribute negatively to annual average growth this year and next year due to persistent weakness in exports.

Volatility linked to Queen Elisabeth II's Platinum Jubilee (decrease in Q2 GDP due to the additional holiday, followed by a catch-up in Q3). For the Diamond Jubilee in 2012, the ONS had estimated the impact at approximately 0.3-0.4 percentage points on Q2 2012 GDP growth. The end of the Covid testing and tracing activity should also weigh on growth in Q2 2022.

A recession is possible. Although the UK has relatively little exposure to the war in Ukraine, it is vulnerable via rising energy prices and supply chain disruptions. Furthermore, the overly aggressive tightening of monetary policies could lead to an unintended deterioration in financial conditions and a more pronounce contraction in demand as a consequence.

Contributions to quarterly GDP growth: breakdown by expenditure



Sources: ONS, Crédit Agricole SA / ECO

OUTLINE OF OUR SCENARIO

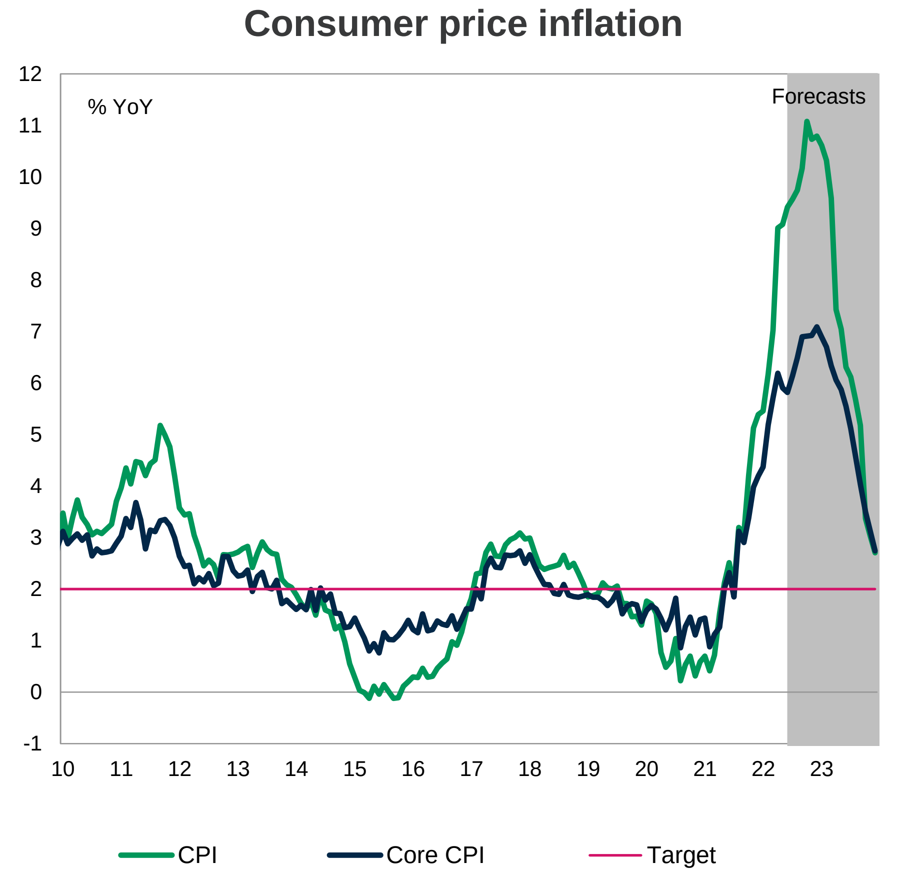
INFLATION IS EXPECTED TO REACH 11% IN OCTOBER

The sharp rise in inflation over the last twelve months is attributable to both global and domestic factors. In terms of global factors, the rise in energy prices, industrial goods and, more recently, food is a direct consequence of the successive shocks of the pandemic and the war in Ukraine. In terms of domestic factors, the tensions in the labour market and the price-setting behaviour of companies has led to a price-wage loop that has not been observed elsewhere in Europe. Finally, another UK specific factor: Brexit remains an inflationary factor due to the barriers to trade with the EU and the more restricted access to the European workforce. These factors should persist at least in the short term and continue to exert an upward influence on prices.

As such, CPI inflation should continue to rise, reaching a peak of 11% in October (6.9% for core inflation). The rise in October mainly reflects the upcoming change in gas and electricity price caps by Ofgem, the UK regulator.

We continue to expect inflation to moderate considerably in 2023 thanks to base effects becoming favourable, global chain value issues starting to normalise and an expected weakening in demand. However, both headline and core inflation will remain above the BoE's target for the horizon of our forecast: close to 3% in Q4 2023 (i.e. 1 percentage point above our previous forecast).

Given uncertainties over the war in Ukraine and pressure on commodity prices, risks relating to inflationary expectations continue to trend upward. Domestic inflationary pressures could also continue to surprise on the upside due to the persistence of recruitment difficulties, to which employers are responding with pay increases.

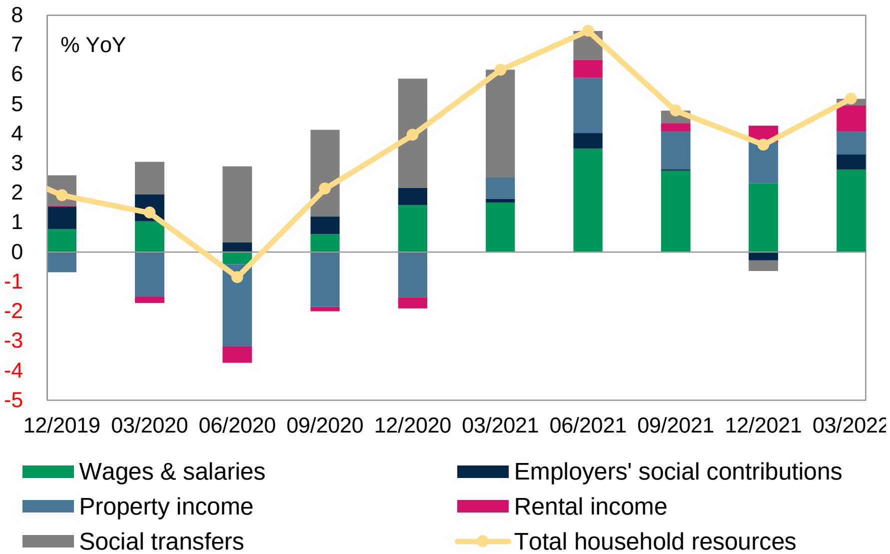


Sources: ONS, Crédit Agricole SA / ECO

OUTLINE OF OUR SCENARIO

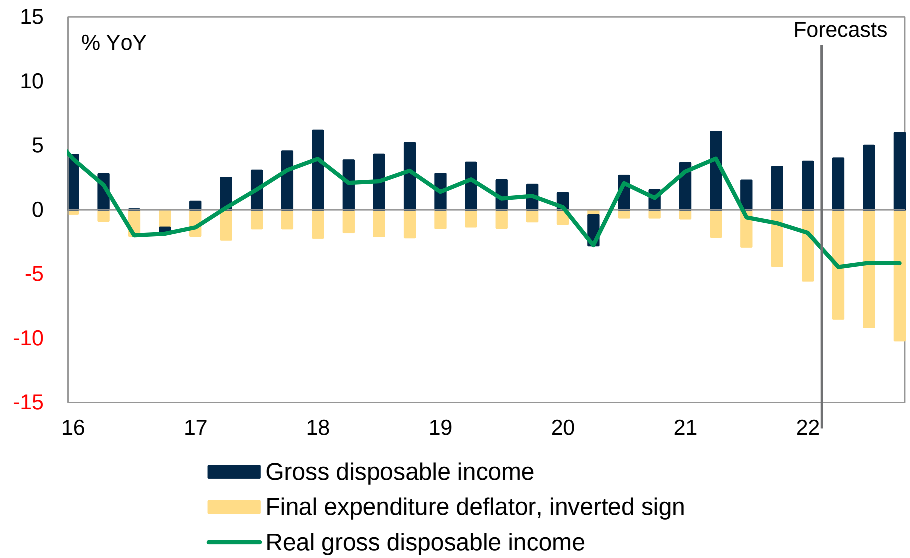
HOUSEHOLD CONSUMPTION: EXPECTED RESILIENCE THANKS TO NEW STATE AID

Household income will be supported by wages and recently announced state aid



Sources: ONS, Crédit Agricole SA / ECO

Inflation will nevertheless lead to a significant drop in purchasing power this year



Sources: ONS, Crédit Agricole SA / ECO

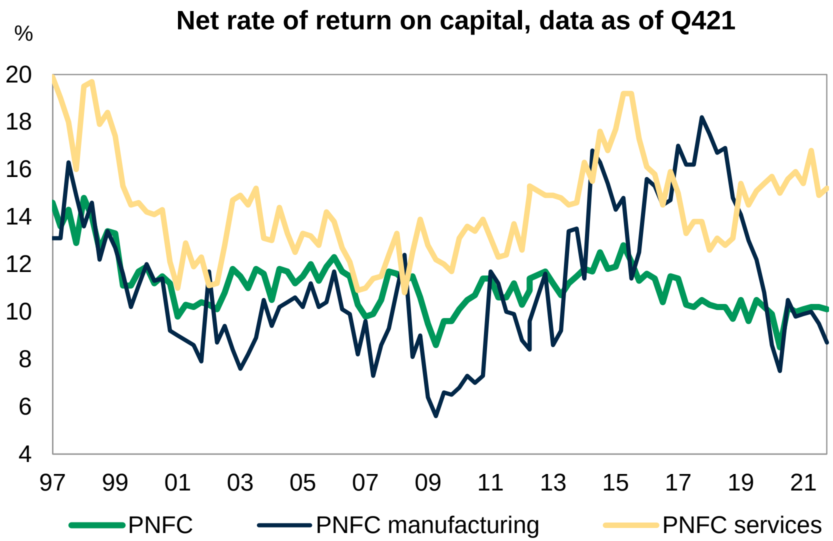
The household purchasing power, measured by real disposable income, contracted in the first quarter (-1.8% YoY), driven by inflation well above nominal disposable income growth. **A stabilisation in purchasing power is likely from Q3 thanks to the recently announced state aid.** On 26 May, ex-chancellor Rishi Sunak announced a £15bn support plan (0.6% of GDP) for purchasing power *(Cost of Living Support Package*), focused on low-income people. This plan includes direct payments of £650 to households receiving resource-based benefits, £300 for retirees and £150 for disabled people. In addition, the energy bill support programme will provide an additional £200 for households. The government also announced that the initial £200 aid would no longer have to be repaid in subsequent years. The measures announced will come into effect in the second half of this year, with additional payments to households receiving resource-based benefits starting in July. According to the BoE, these measures should support GDP growth by 0.3 percentage points in the coming year and increase inflation by 0.1 percentage points.

The excess savings accumulated during the crisis also remain a major factor in supporting household consumption in our scenario. The savings rate stabilised at 6.8% in Q1 2022, slightly above its pre-crisis level.

OUTLINE OF OUR SCENARIO

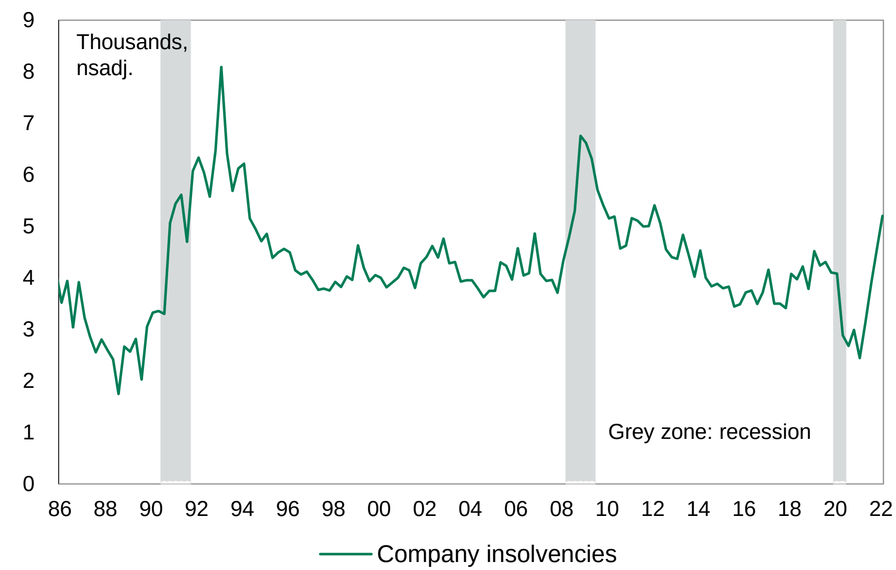
FINANCIAL HEALTH OF NON-FINANCIAL COMPANIES: CHALLENGES IN INDUSTRY WEIGH ON MARGINS

NFC profitability: stabilisation in 2021



Source: ONS, Crédit Agricole SA / ECO

Corporate bankruptcies on the rise

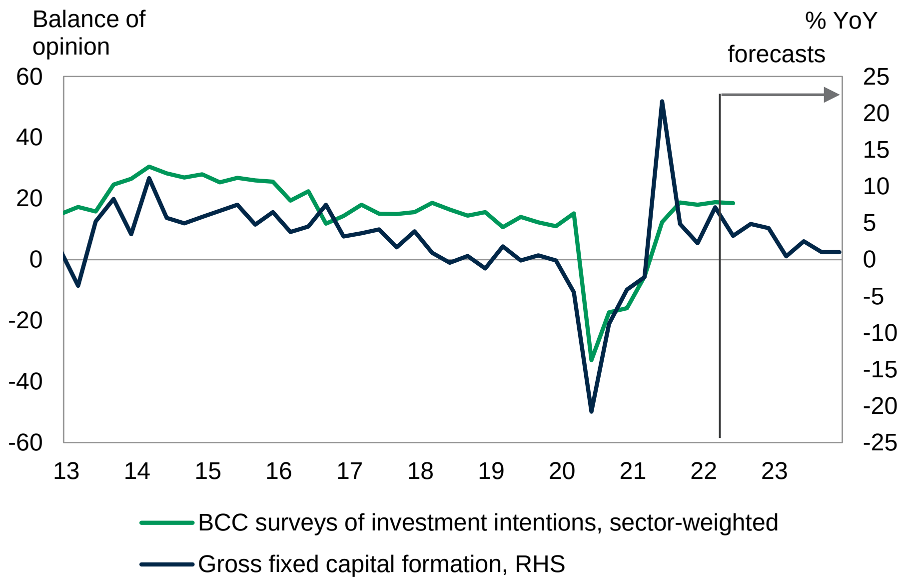


Source: ONS, Crédit Agricole SA / ECO

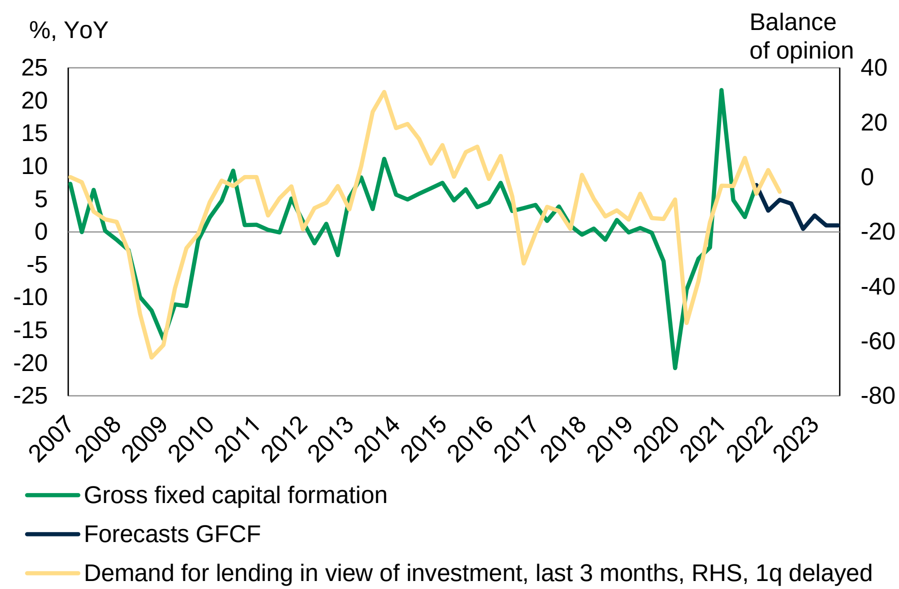
Data on the financial health of private companies show no significant deterioration despite the end of public support measures linked to the pandemic. After returning to its Q4 2019 level, NFC profitability stabilised in 2021. However, it continues to deteriorate in the manufacturing sector. In 2022, the combination of the expected slowdown in household consumption and the rise in production costs will inevitably erode corporate profitability. The number of bankruptcies has increased since the withdrawal of the government's pandemic support measures. In Q1 2022, it exceeded its level at the end of 2019 but remains far from the peak observed during the 2008 financial crisis. The rise in interest rates of course presents risks for companies, particularly small companies that finance themselves from banks. In addition to this, the corporate tax rate is scheduled to increase significantly in April 2023 (from 19% currently to 25%).

INVESTMENT: THE OUTLOOK REMAINS GLOOMY

Investment intentions were stable in Q2 2022



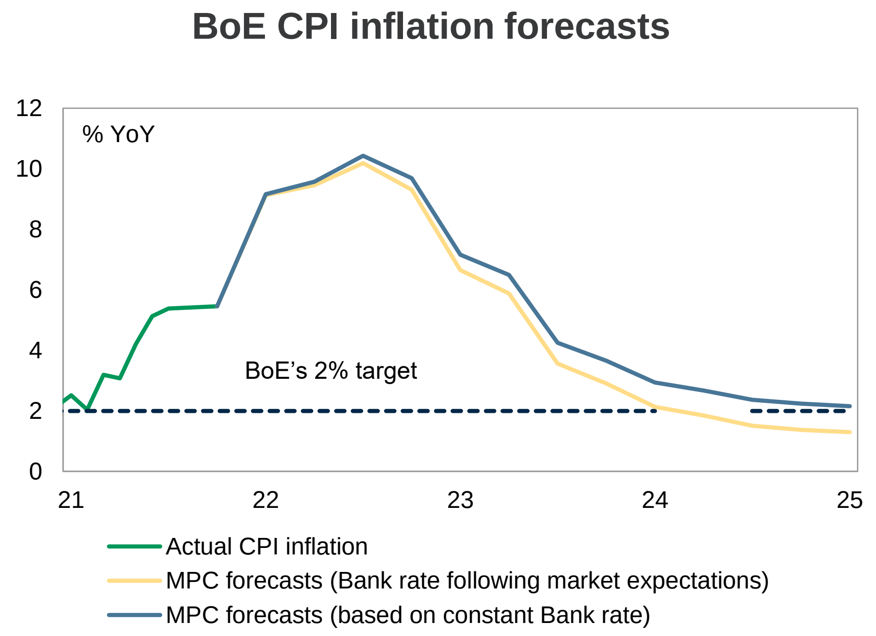
Fixed capital formation and credit demand for investment purposes



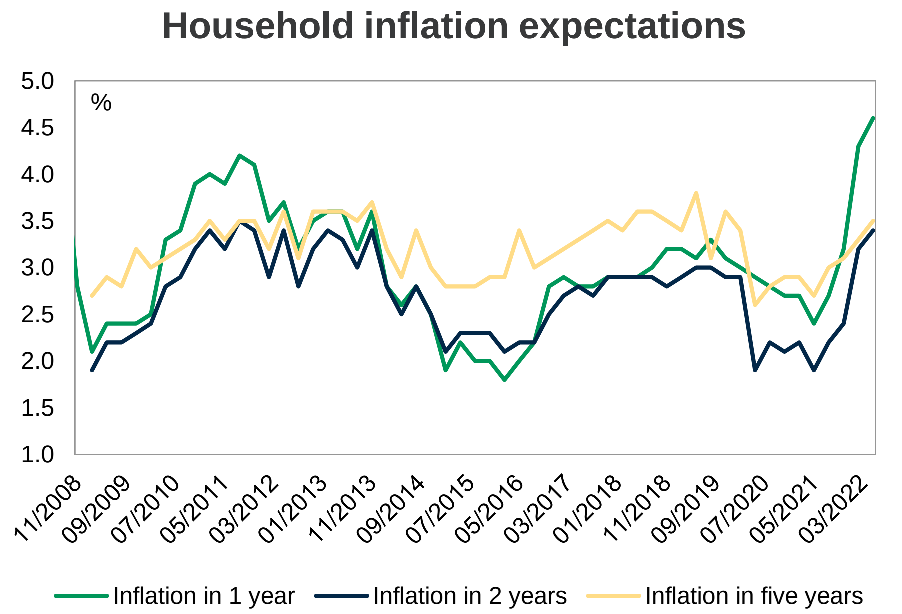
In Q2 2022, surveys on investment intentions stabilised at relatively high levels but, going forward, the tightening of financial and monetary conditions and the anticipated slowdown in domestic and global demand should ultimately weigh on investment projects. The BoE survey on credit conditions in Q2 2022 shows that demand for credit for investment reasons decreased in Q2 2022 and that a slight deterioration was expected for Q3. In 2023, the end of the "super deduction" introduced in April 2021 for a period of two years (offering aid to cover 130% of equipment purchases to companies) and the increase in corporate tax in April (from 19% currently to 25%) should offset any positive effect of a likely end to monetary tightening by the BoE and any improvement in pressure on production costs. Corporate tax cuts could emerge in the autumn budget, but their contours remain uncertain. Ex-chancellor Rishi Sunak promised new business aid for the autumn budget, but did not consider a cancellation of the corporate tax hike, while his successor Chancellor (Nadhim Zahawi) confirmed these intentions. The direction of fiscal policy will also depend largely on the next Prime Minister. Rishi Sunak and Liz Truss are currently in the final phase of the leadership race, and Ms Truss is in favour of cancelling the corporate tax hike. In any case, the effectiveness of any measures to boost investment should depend primarily on the degree of uncertainty surrounding the demand outlook.

OUTLINE OF OUR SCENARIO

MONETARY POLICY: TOWARDS A KEY INTEREST RATE OF 2% IN THE AUTUMN



Sources: BoE Monetary Policy Reports, Crédit Agricole SA/ECO



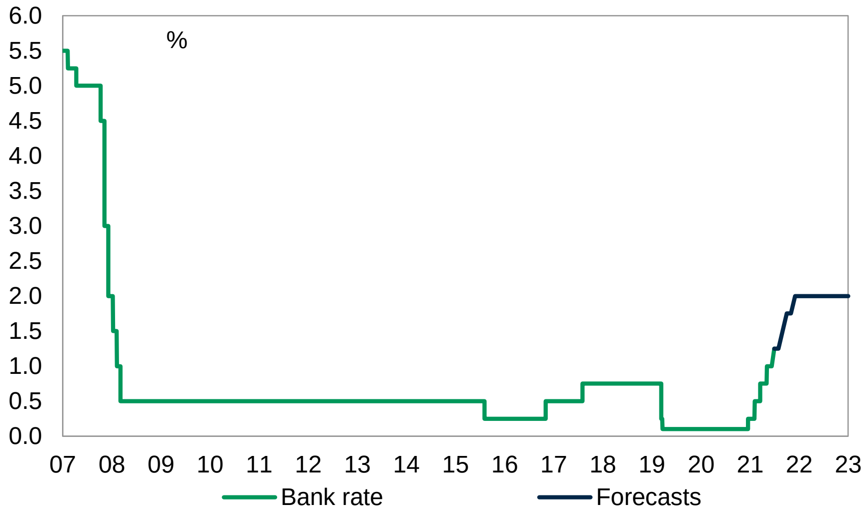
Sources: BoE/Ipsos Inflation Attitudes Survey, Crédit Agricole SA/ECO

Since the start of its tightening cycle, despite an earlier start than the Federal Reserve (December 2021 vs. March 2022 for the Fed), the BoE has made a total increase in its Bank rate of 115bp, with incremental rate hikes of 25bp, contrasting with the more aggressive stance taken by the Fed (75bp per hike). BoE Governor Andrew Bailey justified this relatively gradual pace of tightening by pointing to the trade-off between high inflation and economic slowdown. In its May monetary policy report, the BoE expected that if the key policy rate follows the aggressive market expectations, CPI inflation should fall below its 2% target over the next three years.

In the short term, taking into account the UK labour market situation and the risk that inflation expectations will continue to rise, as well as the Fed's aggressive approach and its implycations for the exchange rate of GBP, monetary policy tightening will likely continue. We have added three 25 bp hikes to our central scenario, which would bring the Bank rate to 2% in November, a forecast that comes with upside risks. UK inflation is higher than in the US and is expected to rise to over 11% by the autumn. More importantly, labour market conditions, which are key determinants of monetary policy choices, are very tight, with no sign of an easing of these tensions in the very short term: record demand for labour, persistence of "severe" recruitment difficulties, strong wage negotiations.

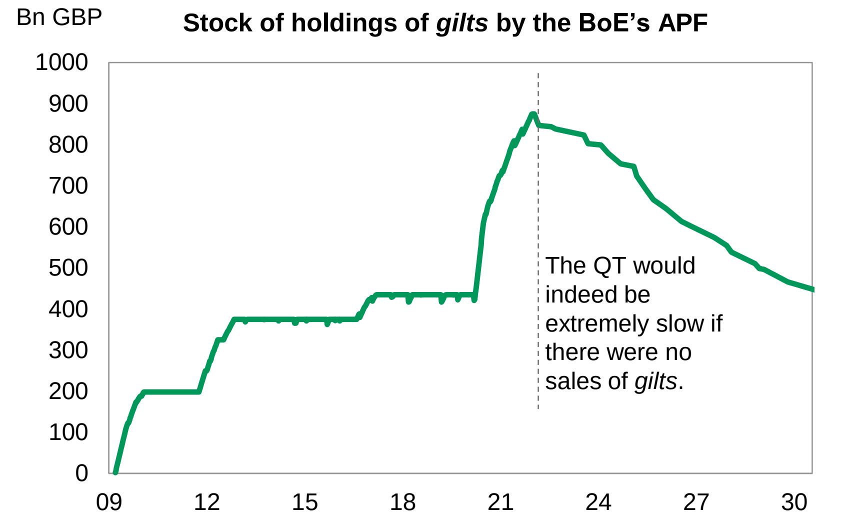
MONETARY POLICY: "ACTING WITH FORCE IF NECESSARY"

Key interest rate: the door is open to an increase of 50bp in August



Sources: BoE, Crédit Agricole SA / ECO

BoE to accelerate its quantitative tightening (QT) through government bond sales



Sources: BoE, Crédit Agricole SA / ECO

A 50 bp rate hike in August is becoming increasingly likely at the 5 August meeting when the BoE updates its new inflation and growth forecasts. In June, the BoE made two notable changes to its forward guidance, making it more ambiguous.

1/ The end of the commitment to continue tightening. The BoE removed the sentence "some degree of further tightening in monetary policy may still be appropriate in the coming months" and introduced less explicit forward guidance indicating that the "scale, pace and timing of any further increases in Bank Rate will reflect the Committee's assessment of the economic outlook and inflationary pressures".

2/ Determination in the face of inflation. The BoE said it would be "particularly vigilant" with regard to any indication of **persistent inflationary pressures** (particularly in terms of price-setting and wage-setting behaviour) and said that it would act "with force if necessary".

In August, the BoE will also publish its plan to reduce its stock of government securities (totalling GBP844bn currently). Governor A. Bailey has signalled it is likely to be reduced by GBP50bn to GBP100bn in the first year through sales of securities and gilt redemptions. Without selling securities, the pace of reduction would indeed be too slow, with only GBP41.3bn in gilts maturing between September 2022 and September 2023.

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