UNITED KINGDOM
2023–2024 SCENARIO

FROM STAGNATION TO RECESSION

January 2023

Slavena Nazarova

WORKING EVERY DAY IN YOUR INTEREST AND FOR SOCIETY

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SUMMARY

DIFFICULT TIMES AHEAD: FROM THE COST OF LIVING CRISIS TO A GREATER FISCAL BURDEN

An economy probably already in recession

Our scenario starting in Q3-2022 includes a four-quarter recession due to the ongoing purchasing power crisis, past and future tightening, monetary and financial conditions, and the government's fiscal turnaround. The government shifted from an ultra-expansionist position in Liz Truss's mini-budget of 23 September (which included significant tax cuts) to a restrictive position in Jeremy Hunt's Autumn Statement of 17 November 2022.

However, the cumulative decline in GDP in our scenario is relatively contained, at -1.3% between Q3-2022 and Q2-2023, driven by a 2.7% decrease in private consumption, lower than what the drop in real disposable income alone would suggest. Indeed, households could further lower their rate of savings and/or draw on their deposits accumulated during the pandemic. They also benefit from an extremely buoyant labour market, although the unemployment rate (currently at 3.7%) is expected to rise in the coming months.

Our annual average growth forecast for 2023 has been revised downwards (to -0.8% versus -0.2% at the beginning of October). In 2024, growth is forecast to return to positive at +1.1%, below potential: 2024 should see the end of the decline in real incomes, but growth would remain constrained by the restrictive fiscal policy stance.

Upward revisions to inflation

Inflation reached 11.1% in October as energy prices rose in line with the government's Energy Price Guarantee (EPG). In the short term, inflation is expected to remain above 10%. In April, the EPG will lead to a further increase in energy prices (+20%) in line with the government's planned energy price cap (GBP3,000 per year for the average household). Our central scenario continues to expect a sharp drop in inflation during 2023 due to base effects becoming favourable, the expected easing of global bottleneck issues, and the anticipated decline in domestic demand. However, on an annual average, the inflation rate is expected to remain very high at 7.3% in 2023, after 9.1% expected in 2022. In our scenario, inflation does not return to the BoE's 2% target until the middle of 2024.

The household standard of living has fallen historically due to inflation

According to the OBR, real disposable income is expected to fall by 7% in total for the 2022 and 2023 period, the largest decline since 1956. This decline will take place despite the anticipated continuation of strong labour income growth and the extent of government aid announced since March in the face of rising costs of living (which we estimate at around GBP114bn, including GBP37bn announced by former chancellor of the exchequer Rishi Sunak in March and May).

The extension of the energy price cap is the top priority among these aid efforts. In his Autumn Statement of 17 November, Chancellor of the Exchequer Jeremy Hunt announced that the measure would last 18 months as a whole but with diminishing support from April. The cap of energy bills is set at GBP2,500 per year on average from October to April and then at GBP3,000 per year for the following twelve months (this is valid for households only, while for businesses the equivalent Energy Bill Relief Scheme will end in April and will be replaced by a targeted support). The government has also announced one-off cost of living payments for low-income households, pensioners and disabled people. However, this support is far from enough to offset income erosion due to inflation. Real disposable income is expected to drop by 3.4% in 2023.

At the same time, the rise in financing costs (the effective mortgage rate reached 2.8% in September, while the two-year fixed rate for borrowers with a 25% down payment reached 6% in October) should lead to a drop in real estate prices in 2023 and further weigh on household investment. Consumer confidence also remains near record lows.

SUMMARY

DIFFICULT TIMES AHEAD: FROM THE COST OF LIVING CRISIS TO A GREATER FISCAL BURDEN

On the threshold of a new era of austerity

Significant fiscal tightening is planned to stabilise public debt over the next five years. The government announced a GBP55bn fiscal consolidation plan over the next five years, split between GBP25bn in tax increases and GBP30bn in spending cuts (both investment and current budget spending).

The tax effort is mainly made up of :

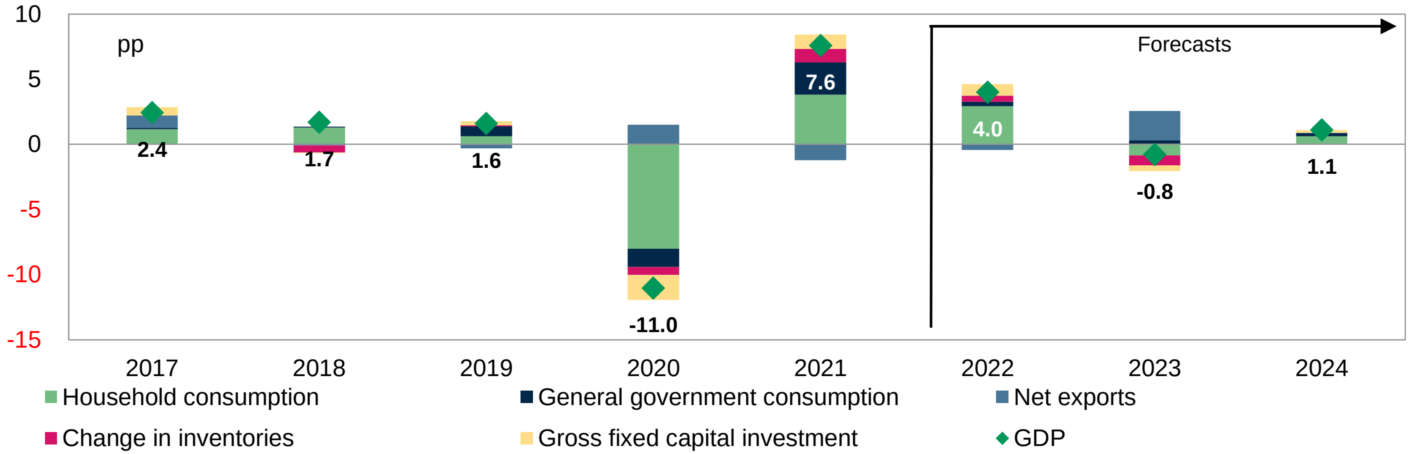
- freezing at current levels the income tax personal allowance, the higher rate threshold, the main national insurance thresholds and the inheritance tax thresholds for a further two years to April 2028;
- lowering the 45p income tax threshold from GBP150,000 to GBP125,140;
- increasing the corporate tax rate from 19% to 25% in April 2023;
- increasing and extending the energy profits levy.

Fiscal tightening (measured by the change in the primary structural deficit) is expected to represent 1.3% of GDP in 2022–2023, 2.5% in 2023–2024, and 0.9% in 2024–2025. The government plans to eliminate the primary structural deficit by 2024–2025 and then run a surplus each year until 2027–2028. The sharp rise in the debt burden resulting in particular from the increase in interest rates and inflation (inflation-linked securities account for a quarter of the public debt) is largely responsible for this tightening of fiscal policy.

SUMMARY

FORECASTS

Contributions to annual GDP growth



Sources: ONS, Crédit Agricole SA / ECO

United Kingdom	2022	2023	2024	2022				2023				2024			
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP (%)	4.0	-0.8	1.1	0.6	0.1	-0.3	-0.3	-0.4	-0.3	0.3	0.3	0.3	0.3	0.3	0.3
household consumption	4.9	-1.4	1.0	0.8	1.2	-1.1	-0.6	-0.6	-0.4	0.3	0.3	0.3	0.3	0.3	0.3
public consumption	1.7	1.5	1.3	-0.6	-1.4	0.5	0.5	0.5	0.5	0.5	0.5	0.2	0.2	0.2	0.2
investment	4.9	-2.5	1.1	4.8	-1.7	1.1	-1.0	-1.5	-0.5	0.0	0.0	0.5	0.5	0.5	0.5
change in inventories*	0.5	-0.8	0.0	1.5	-0.5	-1.5	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
net exports*	-0.4	2.2	0.0	-3.9	1.1	3.9	0.0	0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Unemployment rate (ILO)	3.7	4.1	4.4	3.7	3.8	3.6	3.9	4.0	4.1	4.2	4.4	4.5	4.4	4.4	4.4
Inflation (CPI, YoY%)	9.1	7.3	2.2	6.2	9.2	10.0	10.8	10.2	8.0	6.7	4.6	3.6	2.2	1.7	1.3
Core CPI (YoY%)	5.9	5.0	2.0	5.1	6.0	6.3	6.4	6.0	5.5	4.7	3.9	3.0	2.2	1.6	1.2
Current account (% GDP)	-4.6	-1.6	-0.2	-7.7	-5.7	-3.1	-	-	-	-	-	-	-	-	-
General gov. balance, % GDP	-6.7	-4.8	-3.0	-	-	-	-	-	-	-	-	-	-	-	-
Public debt % GDP	102.5	104.5	106.3	-	-	-	-	-	-	-	-	-	-	-	-
Bank rate**	3.5	4.0	3.25	0.75	1.25	2.25	3.50	4.00	4.00	4.00	4.00	4.00	3.75	3.50	3.25

** Contributions to GDP growth*

*** End of period*

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

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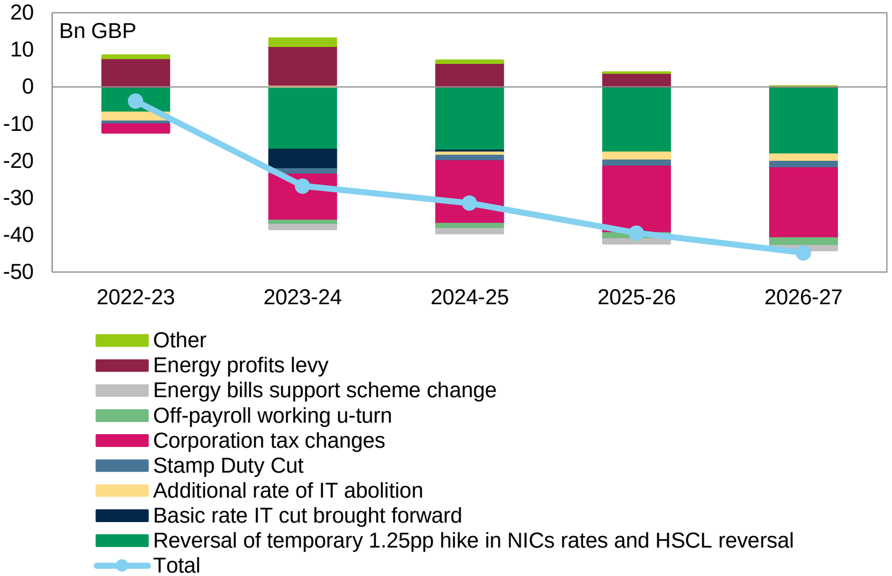
2022 POLITICAL CRISIS AND FISCAL POLICY SHIFTS

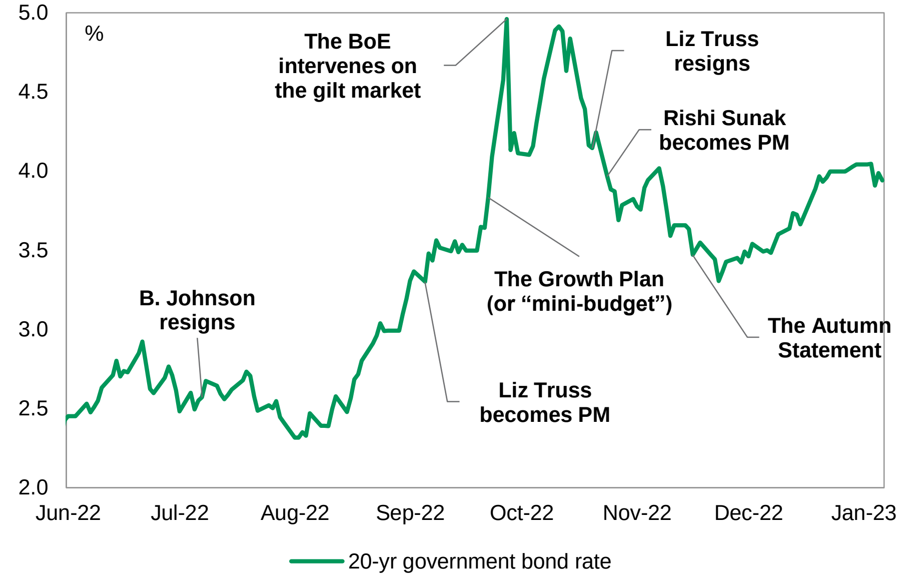
FROM THE KWASI KWARTENG'S 'MINI-BUDGET' TO THE JEREMY HUNT'S AUTUMN STATEMENT

The mini-budget announced tax cuts of GBP45bn per year



Sources: HM Treasury, The Growth Plan 2022, Crédit Agricole SA / ECO

Political crisis and long-term interest rates



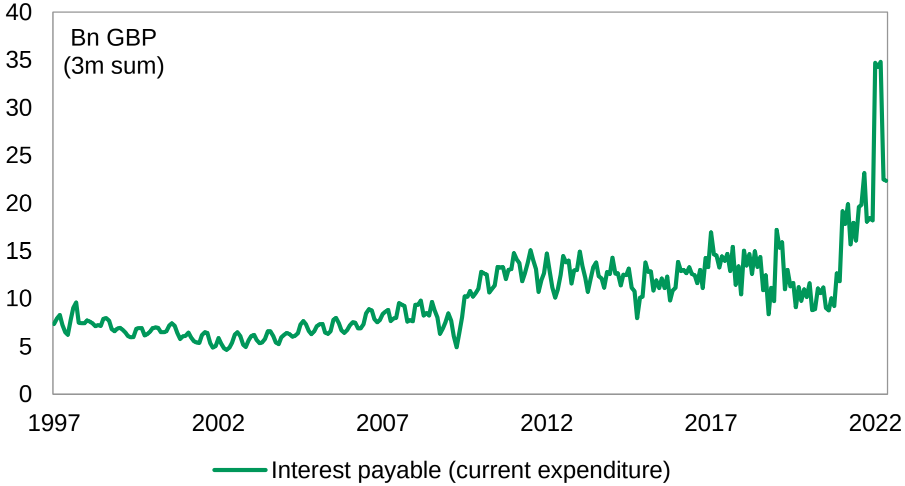
Sources: Datastream, Crédit Agricole S.A./ECO

In 2022, the UK experienced an unprecedented political crisis that threatened the country's financial stability and left its mark on investor confidence. The next sequence of events could be remembered: Boris Johnson's resignation on 7 July, Liz Truss's election in early September, the pension fund debacle caused by her 'mini-budget' (debt-financed growth plan), Liz Truss's resignation after only 44 days in power, the rapid election of Rishi Sunak, the cancellation (on October 17) of most of Liz Truss's tax cuts by Chancellor Jeremy Hunt, and the debt sustainability plan announced in the Autumn Statement of 17 November. These events obviously caused significant volatility in the public debt markets and the pound sterling, with substantial shocks, particularly after the 'mini-budget' of 23 September. The scale of the tax cuts that it contained (GBP45bn per year), not offset by spending cuts, against a backdrop of double-digit inflation, surprised investors and shook their confidence. Debt sustainability was compromised, especially since the OBR did not publish its usual forecasts for public finances. The BoE, which has embarked on a monetary tightening process to curb inflation, had to intervene urgently by targeting purchases of long-dated government bonds on the markets between 28 September and 14 October to avoid a spiral of interest rate increases. In addition, the central bank delayed its gilt sales by one month (the so-called quantitative tightening). However, the still fragile investor confidence was restored only after Liz Truss's resignation and Rishi Sunak's appointment as prime minister and his chancellor's announcement of a fiscal tightening plan to stabilise debt in the medium term.

2022 POLITICAL CRISIS AND FISCAL POLICY SHIFTS

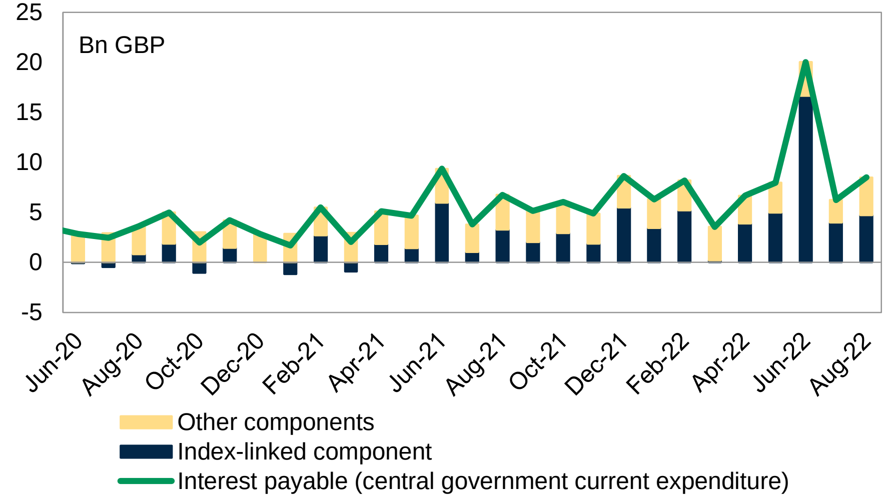
PUBLIC DEBT HAS BECOME MORE EXPENSIVE TO FINANCE

Debt servicing costs reached record highs this summer



Sources: ONS, Crédit Agricole SA / ECO

Inflation plays a significant role in debt servicing costs



Sources: ONS, Crédit Agricole SA / ECO

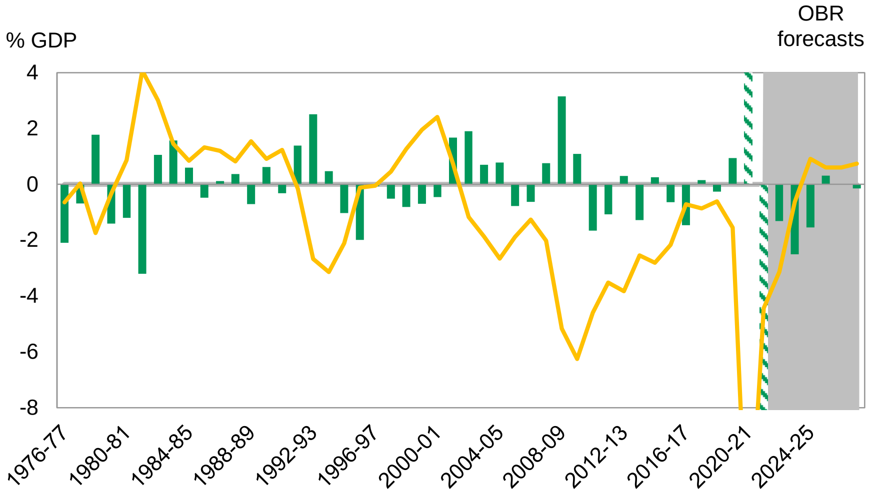
The cost of servicing public debt rose sharply over the past year due to higher interest rates as well as increased inflation since inflation-linked gilts represent a quarter of the government's debt. According to the OBR, each additional percentage point of inflation increases debt servicing costs by GBP6bn. Debt financing is likely to be an even greater concern for the government as the maturity of the debt has declined significantly over time. The average maturity of public debt has decreased from seven years before the start of the BoE's quantitative easing operations in 2008 to less than two years now. The combination of a high debt stock (102% of GDP in 2022), a large share of inflation-linked debt, and a shorter maturity has significantly increased the sensitivity of the debt stock to changes in interest rates and inflation. Each percentage point increase in short-term rates adds GBP13bn of spending in the following year, up from GBP2bn in the early 2000s.

Consequently, in November, on the occasion of the Autumn Statement, the OBR revised its public debt servicing expenditure forecasts significantly upwards: from GBP37.4bn to GBP120.4bn for 2022–2023 and GBP43bn on average per year between 2023–2024 and 2026–2027 (to GBP108.5bn in 2023–2024 and GBP82.4bn in 2024-2025). In addition to these higher interest expenses, there is an increase in short-term social spending due to the energy crisis and declining revenues due to the expected decrease in demand. The result is an anticipated worsening of the public deficit to 7.1% in 2022–2023, after 5.5% in 2021–2022, according to OBR forecasts and an increase in the debt-to-GDP ratio (measured by the public sector net debt excluding BoE, which is the measure targeted by the budget rules) to 89.9% in 2022–2023 and to 95.9% in 2023–2024, compared with 84.3% in 2021–2022.

2022 POLITICAL CRISIS AND FISCAL POLICY SHIFTS

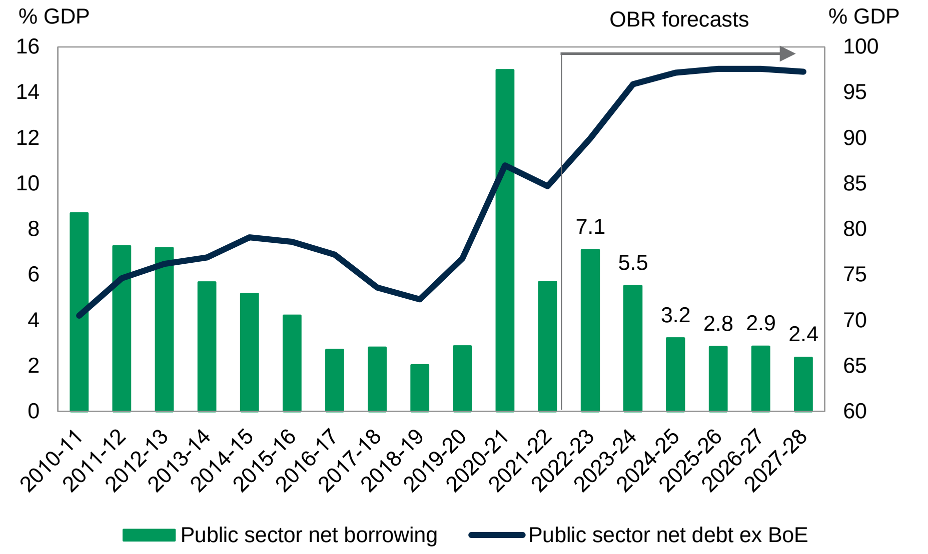
THE JEREMY HUNT'S DEBT SUSTAINABILITY PLAN

Fiscal stimulus: -2.5% of GDP in 2023/24



Sources: OBR, Crédit Agricole SA / ECO

An effort that would stabilise the debt ratio



Sources: OBR

With his Autumn Statement of 17 November, Chancellor Jeremy Hunt's mission was to restore the government's credibility in stabilising public finances and debt sustainability. He managed to strike a difficult balance between the need for economic support in the short term to cope with the energy crisis and the stabilisation of public finances in the medium term. The legal budget rules are no longer respected. The government works on a new, more flexible framework with two new rules: set the debt-to-GDP ratio on a downward trend over a five-year horizon (instead of three years in the legally required target) and have a deficit as a percentage of GDP of less than 3% in the same year (compared with having a balanced current account deficit in the third year of the forecast period). In the short term, due to the energy crisis, the government will continue to support purchasing power this year and, to a lesser extent, next year through a cap on energy prices, as well as increases in social benefits and the minimum wage. However, in the medium term, the chancellor presented a budget consolidation effort of GBP55bn by fiscal year 027–28, split between GBP25bn in tax increases and GBP30bn in budget cuts. The OBR thus anticipates a rapid reduction in the structural primary deficit: it will decrease from 4.4% in FY2021-22 to 3.1% in FY2022-23 and to 0.6% in FY2023-24. The government will then generate primary surpluses each year starting in FY2024-25. The fiscal stimulus (measured by the change in the primary structural deficit) is expected to amount to -2.5% of GDP in 2023–2024 after -1.3% in 2022–2023, which has not been seen since the early 1980s. As a result of this tightening, the budget deficit is forecast by the OBR to be below 3% in 2025–2026, and debt is expected to stabilise the following year.

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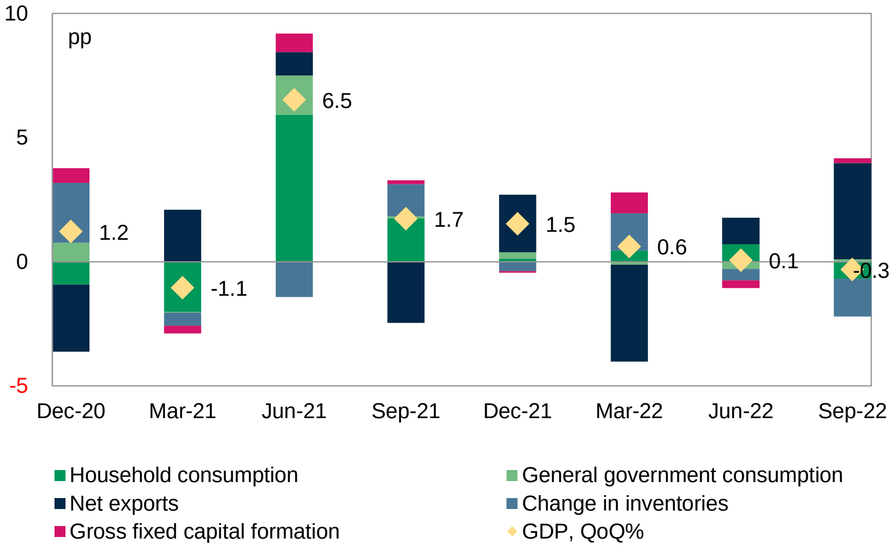
RECENT ECONOMIC TRENDS

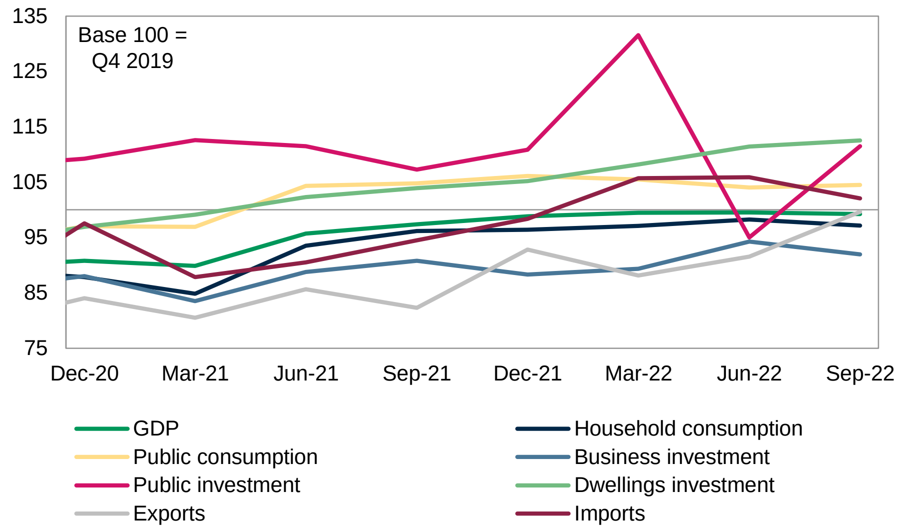
IN Q3-2022 GDP REMAINED BELOW ITS PRE-COVID LEVEL

Quarterly GDP growth: breakdown in terms of expenditure



Sources: ONS, Crédit Agricole SA / ECO

Private consumption and business investment remain depressed



Sources: ONS, Crédit Agricole SA / ECO

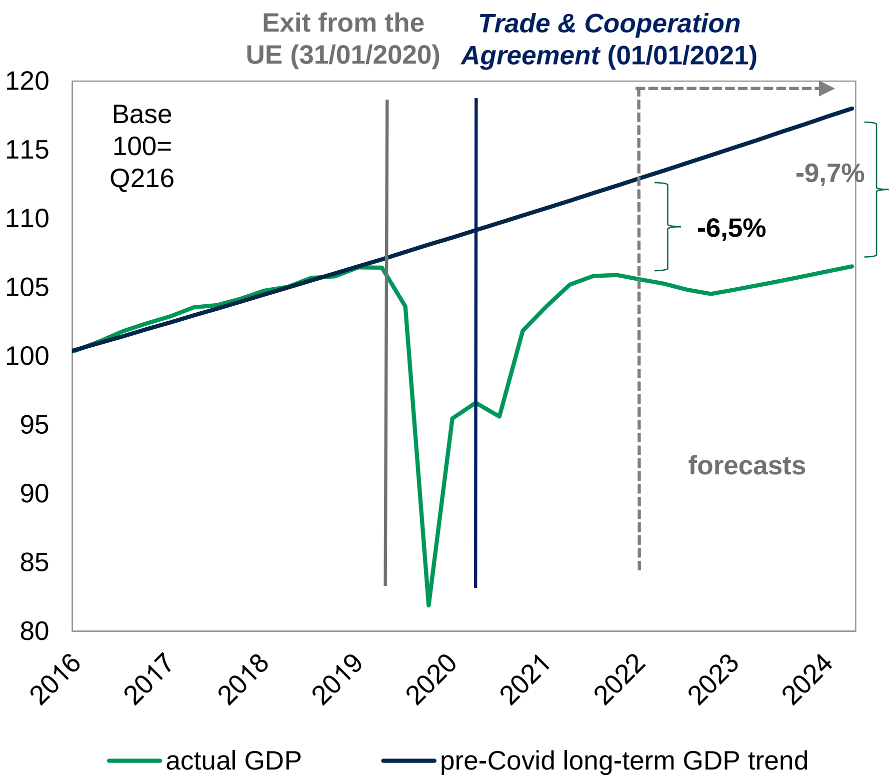
GDP contracted 0.3% QoQ in Q3 (revised downwards from -0.2% QoQ in the first estimate). Growth was dragged down by domestic demand with declines in household consumption and business investment that were larger than initially estimated (-1.1% QoQ and -2.5% QoQ, respectively, for the quarter versus -0.5% QoQ in both cases in the first estimate). **The death of Queen Elizabeth II in September weighed on activity due to the additional holiday granted for national mourning, suggesting that underlying demand is probably stronger than the official figure indicates.** GDP fell 0.6% MoM in September before rebounding 0.5% MoM in October. In Q3, there was also a strong destocking movement: changes in inventories subtracted 1.5 points from the growth rate. Conversely, net exports made a positive contribution of 3.9 points to the quarterly growth rate.

GDP stands 0.8% below its pre-COVID level (Q4-2019). Business investment remains the weak link in the post-COVID recovery, remaining at 8.1% below its Q4-2019 level. Private consumption is also well below its pre-COVID level (-2.9%), suffering from the purchasing power crisis.

In terms of production, the three main sectors slowed down during the quarter. The industrial sector posted its fifth consecutive quarter of decline (-1.6% QoQ in Q3) due to a sharp drop in the manufacturing sector (-2.3% QoQ). Services posted zero growth (after an increase of +0.3% QoQ in Q2), driven down by activities with direct customer contact (-0.8% over the quarter).

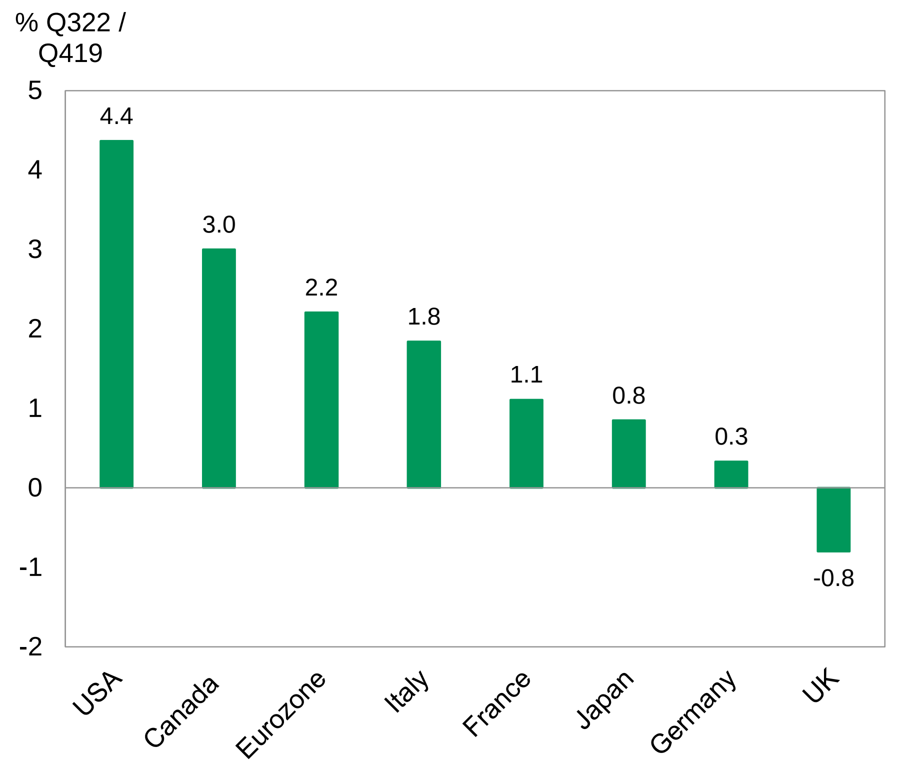
AN ECONOMY FACING MULTIPLE SHOCKS: BREXIT, COVID, TERMS OF TRADE

Shock after shock, real GDP will never regain its pre-COVID potential



Sources: ONS, Crédit Agricole SA / ECO

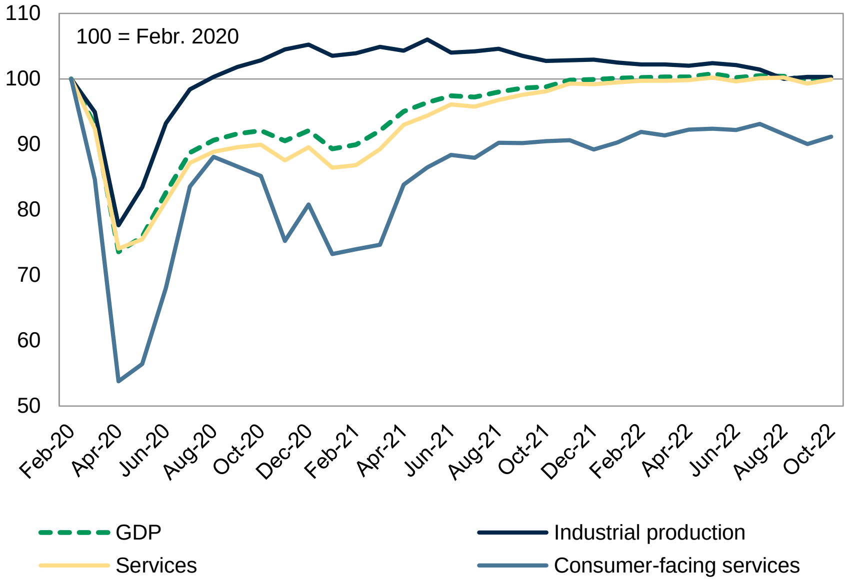
An unflattering international comparison: change in GDP since Q4-19 of the G7 countries



Sources: ONS, Crédit Agricole SA / ECO

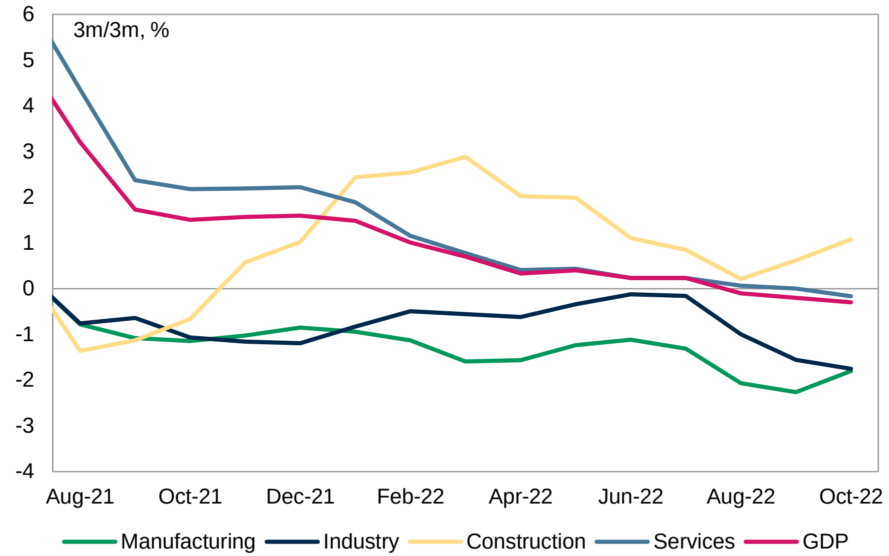
REBOUND IN OCTOBER THANKS TO A NATIONAL POST-MOURNING CATCH-UP EFFECT

Stagnation for most of the past year



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

Continued negative trend in industry and services



Sources: ONS, Crédit Agricole SA / ECO

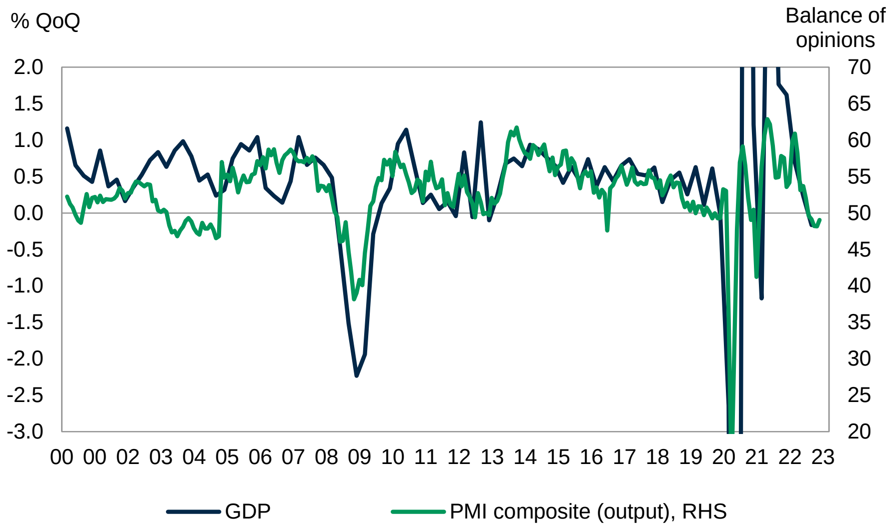
GDP grew 0.5% MoM in October after a 0.6% MoM decline in September when the national mourning of the death of Queen Elizabeth II weighed on activity. The rebound in services activity (+0.6% MoM), driven by the wholesale and retail sector, contributed the most to the increase in GDP over the month, while industry was stable. **Monthly GDP thus managed to reach 0.4% above its February 2020 level.**

On the other hand, momentum is weakening: on average over the past three months, GDP fell 0.3% compared with the three months at the end of July with a 1.7% decline in industry over the period (-1.8% for the manufacturing sector), 0.1% decline in services, and a 1.1% increase in construction. Retail sales, in particular, fell 2.4% over the last three months at the end of October, continuing their downward trend that began in the summer of 2021. Construction stood out with an increase for the fourth consecutive month, thanks to a recovery in new construction sites (+3.1% 3m/3m).

The rebound in GDP in October enabled a carry-over effect of +0.2% for the fourth quarter, suggesting an upward risk on our growth forecast of -0.3% over the quarter. If activity had fallen by 0.2% per month in November and December, GDP would have ended up with zero growth in Q4, narrowly avoiding a technical recession. However, even if this had been the case, what counts is that after stagnation for most of 2022, activity has lost momentum, and the surveys (see next page) remain weak.

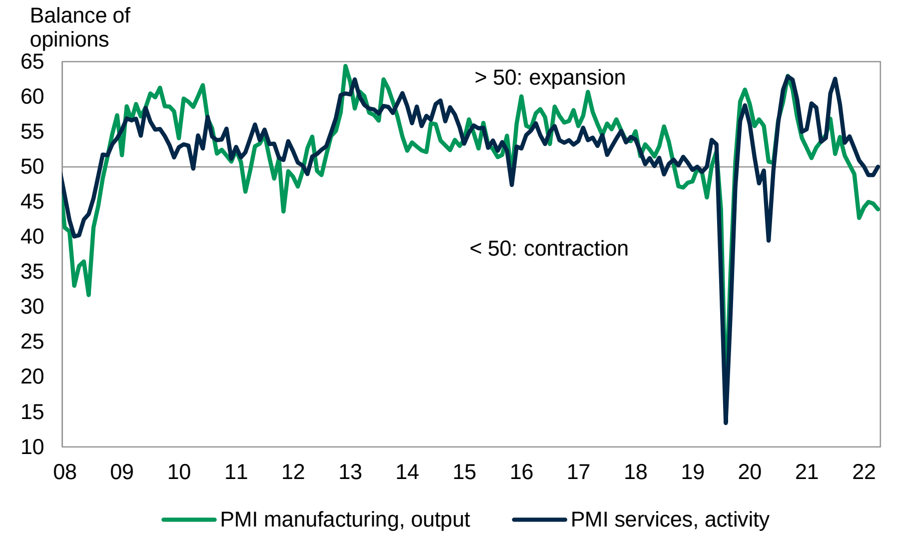
SURVEYS: PMI SURVEYS POINT TO A FURTHER GDP CONTRACTION IN Q4

PMIs suggest a -0.3% QoQ fall of GDP in Q4



Sources: ONS, Crédit Agricole SA / ECO

PMI in contraction territory in industry and stabilisation in services



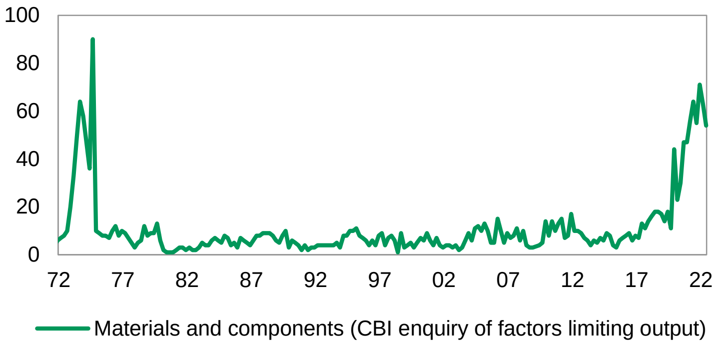
Sources: ONS, Crédit Agricole SA / ECO

The December PMI surveys corroborate the expectations of a further, relatively moderate decline in GDP in Q4. They suggest a 0.3% contraction over the quarter. The composite PMI remained in contraction territory for the fifth consecutive month amid falling demand and still significant, albeit moderate, pressure on costs. That said, the business climate improved very slightly over the month, with a rebound in the composite PMI from 48.2 in November to 49 in December, indicating the lowest contraction rate in three months. This was thanks to a stabilisation of activity in services (index at 50) after two months of decline, while the manufacturing sector contracted at the fastest pace since August (43.9) due to lower demand. New orders fall for the fifth consecutive month in the private sector and for the seventh consecutive month in industry. This has led businesses to reduce their workforce: the employment component shows a decline for the first time since February 2021.

RECENT ECONOMIC TRENDS

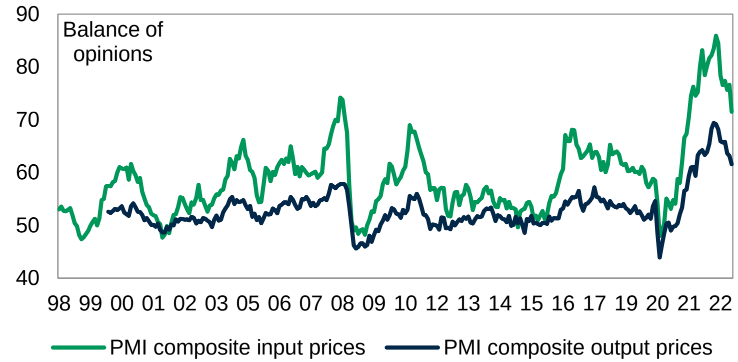
SURVEYS: SUPPLY CONSTRAINTS ARE EASING AS DEMAND DETERIORATES

Shortages of materials are taking a turndown from high levels



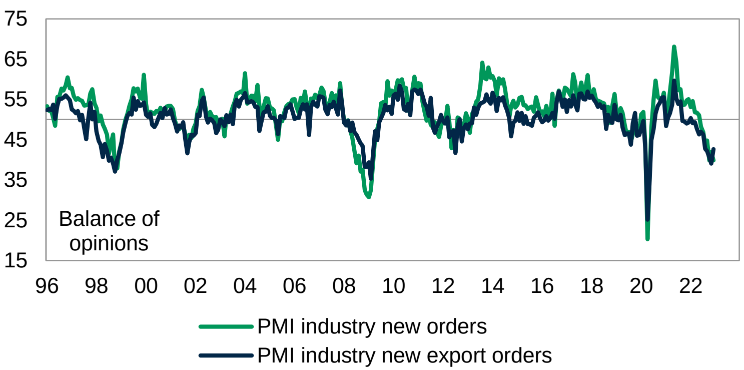
Sources: CBI, Crédit Agricole SA / ECO

Inflationary pressures are easing but remain very high



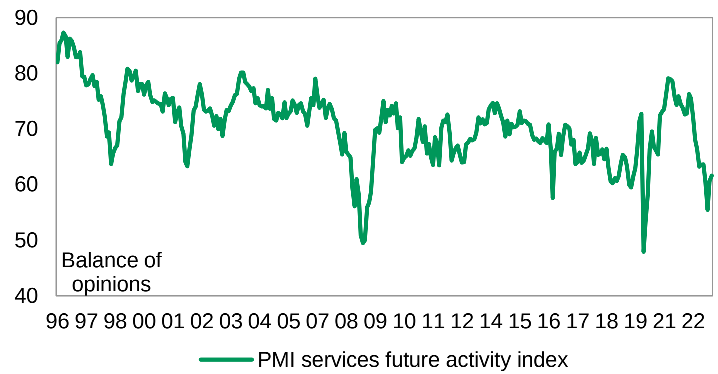
Sources: Markit, Crédit Agricole SA / ECO

Demand is falling in industry (manufacturing PMIs)



Sources: Markit, Crédit Agricole SA / ECO

Downgraded expectations also in services despite a recent rebound

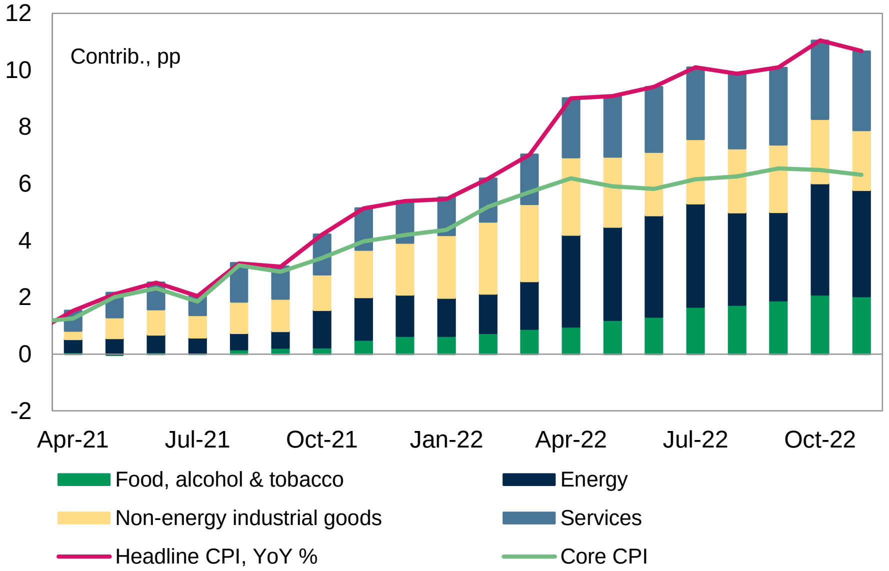


Sources: Markit, Crédit Agricole SA / ECO

RECENT ECONOMIC TRENDS

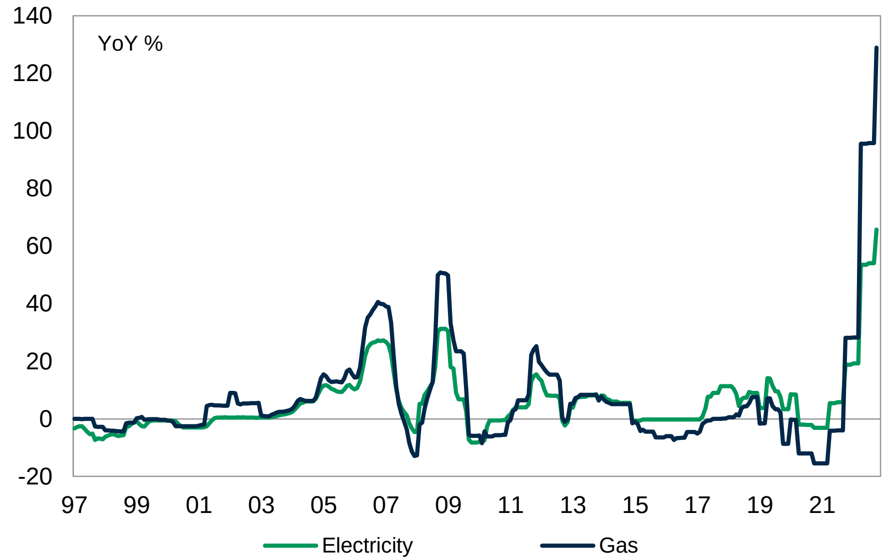
INFLATION EXCEEDED 11% IN OCTOBER DUE TO ENERGY AND FOOD

CPI inflation has exceeded the 2% target since May 2021



Sources: ONS, Crédit Agricole SA / ECO

Gas prices more than doubled in one year



Sources: ONS, Crédit Agricole SA / ECO

The consumer price inflation rate (CPI) reached 11.1% in October before falling slightly to 10.7% in November. The core inflation rate (CPI excluding energy, food, alcohol, and tobacco) was stable at 6.5% in October compared with September and dropped to 6.3% in November.

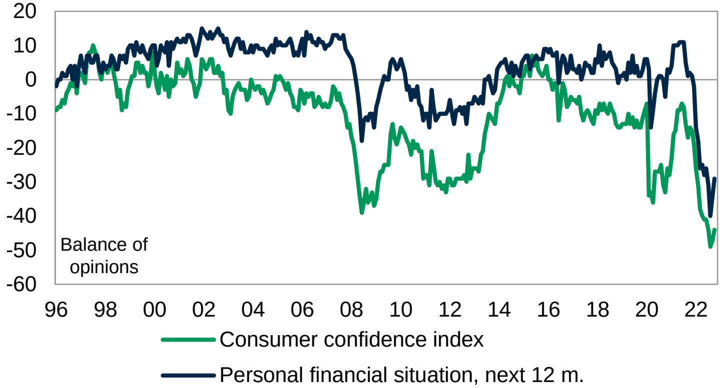
In October, the CPI inflation rate was at its highest since the start of the official series in 1997, while the ONS indicated that, according to its experimental estimates, it is at its highest level since October 1981, when the inflation rate was 11.2%.

Gas and electricity prices were the largest contributors to the rise in the inflation rate in October. They increased in line with the Energy Price Guarantee set up by the government on 1 October. According to this scheme, the average gas price increased from 7.8 p/kWh to 10.3 p/kWh, and electricity increased from 27.2 p/kWh to 34 p/kWh, an average increase of 24% over the month. In the absence of the EPG, electricity, gas, and other fuel oil would have increased by nearly 75% between September and October, which would have led to an overall inflation rate of 11.8%. **A significant increase in food prices (+16.2% YoY) amplified this acceleration in the overall price index.** Their inflation rate continued to rise in November to 16.4% YoY.

CPI inflation has exceeded the 2% target since May 2021. Energy and food prices are responsible for two thirds of this overrun.

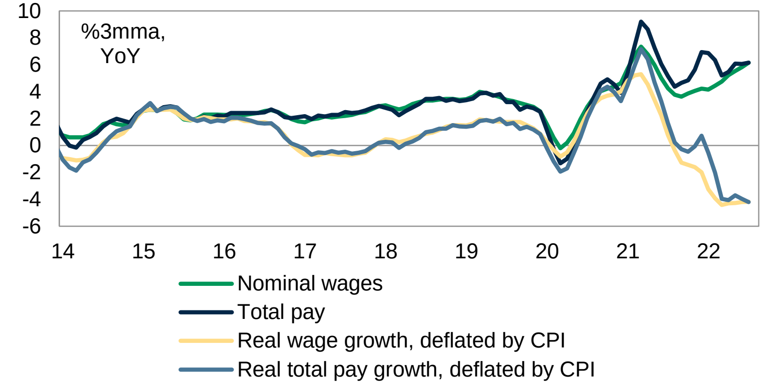
HOUSEHOLD CONSUMPTION INDICATORS REMAIN WEAK

Consumer confidence still at all-time lows



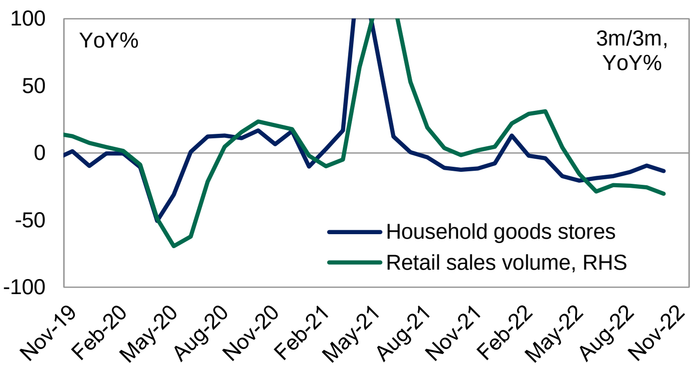
Sources: Gfk, Crédit Agricole SA / ECO

Income falls sharply in real terms



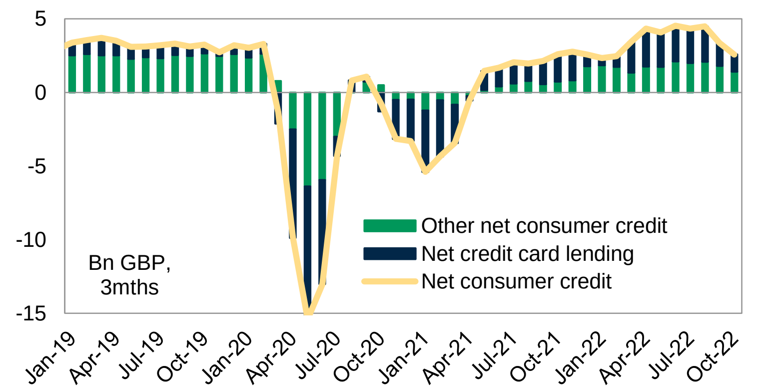
Sources: BoE, Crédit Agricole SA / ECO

Retail sales fall 6% YoY



Sources: ONS, Crédit Agricole SA / ECO

Tighter financial conditions are starting to weigh on consumer credit

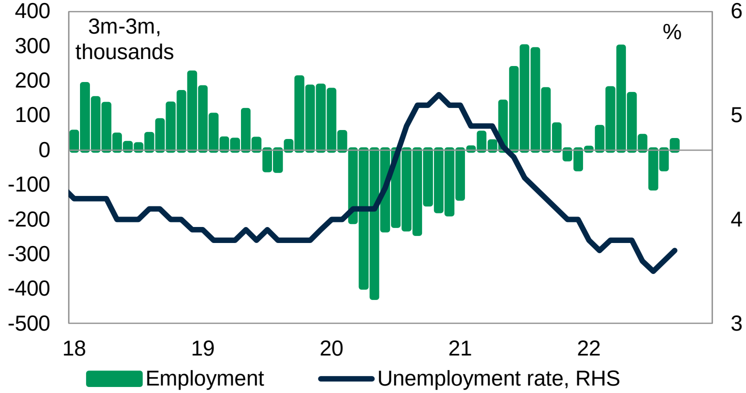


Sources: ONS, Crédit Agricole SA / ECO

RECENT ECONOMIC TRENDS

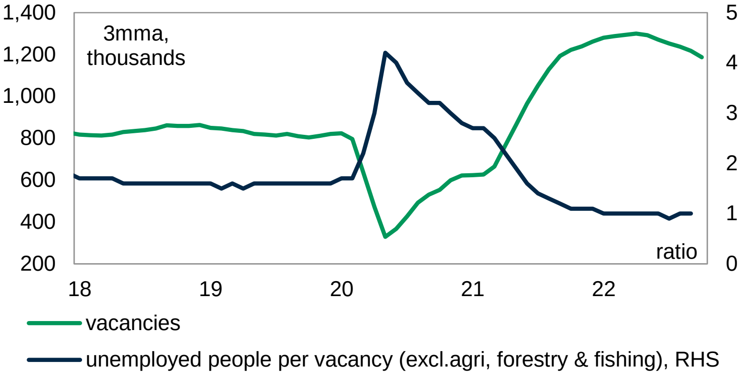
SIGNS OF EASING, STILL TIMID, IN THE LABOUR MARKET

The unemployment rate (3.7%) rises for the second month in a row



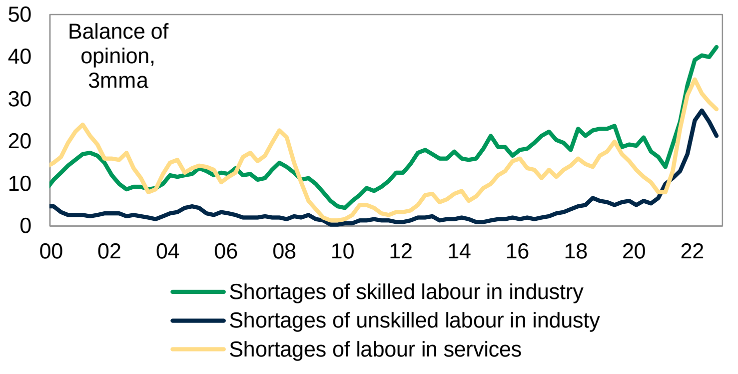
Sources: ONS, Crédit Agricole SA / ECO

The number of vacancies falls from record levels



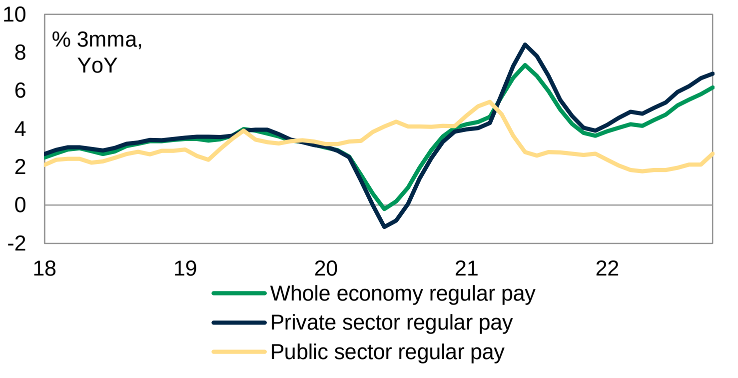
Sources: ONS, Crédit Agricole SA / ECO

Recruitment difficulties remain considerable



Sources: CBI, Crédit Agricole SA / ECO

Wage growth is approaching 7% YoY in the private sector



Sources: ONS, Crédit Agricole SA / ECO

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2023 LOOKS DIFFICULT FOR HOUSEHOLDS AND BUSINESSES

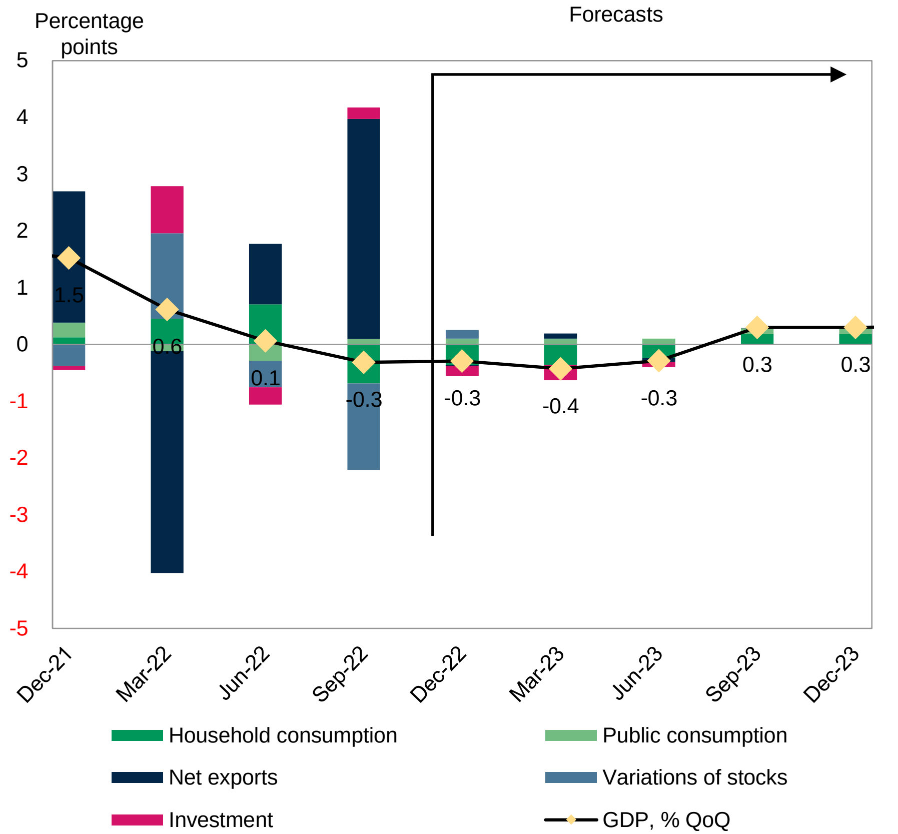
We expect a recession starting in Q3-2022 for four quarters with a cumulative drop in GDP of around 1.5%, driven by a decline in domestic demand. We expect GDP to contract by 0.8% in 2023, followed by a 1.1% rebound in 2023. The inflation rate peak should now be behind us, as well as most of the monetary tightening. However, the outlook for households and businesses remains difficult.

For households, real disposable income is expected to decline significantly again in 2023 before rebounding in 2024. The inflation rate, although slowing, is expected to reach more than 7% on an annual average in 2023, exceeding growth in labour income and government' support. Households will also have to cope with rising mortgage rates and rents, even as many contracts will have to be renewed in 2023. It will therefore be a difficult year for households, but we believe that the savings buffer built up during the pandemic and the potential for a drop in the savings rate should allow private consumption to stand firm in aggregate. We have incorporated only a relatively contained decline of household consumption of nearly 1.5% in 2023 and a 1% rebound in 2024.

For businesses, the increase in corporate tax and the end of the energy cap (both in April 2023) will be new obstacles to productive investment. After stagnating in 2022, it is expected to contract in 2023 on the back of falling domestic and global demand, persistent uncertainties, and rising interest rates.

Foreign trade could finally contribute positively to growth in the coming quarters due to the expected weakness in imports and relatively stronger growth in the Eurozone and the United States than in the United Kingdom, allowing exports to outperform imports.

Contributions to quarterly GDP growth: breakdown by expenditure

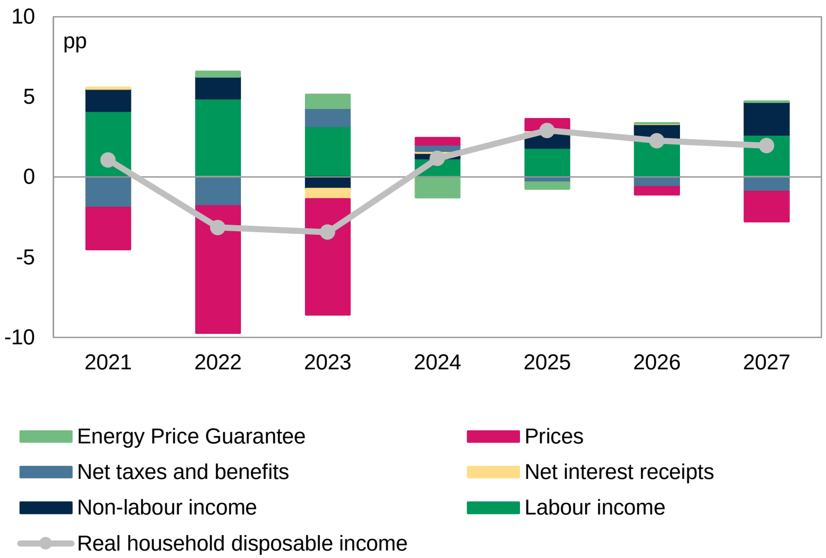


Sources: ONS, Crédit Agricole SA / ECO

OUTLINE OF OUR SCENARIO

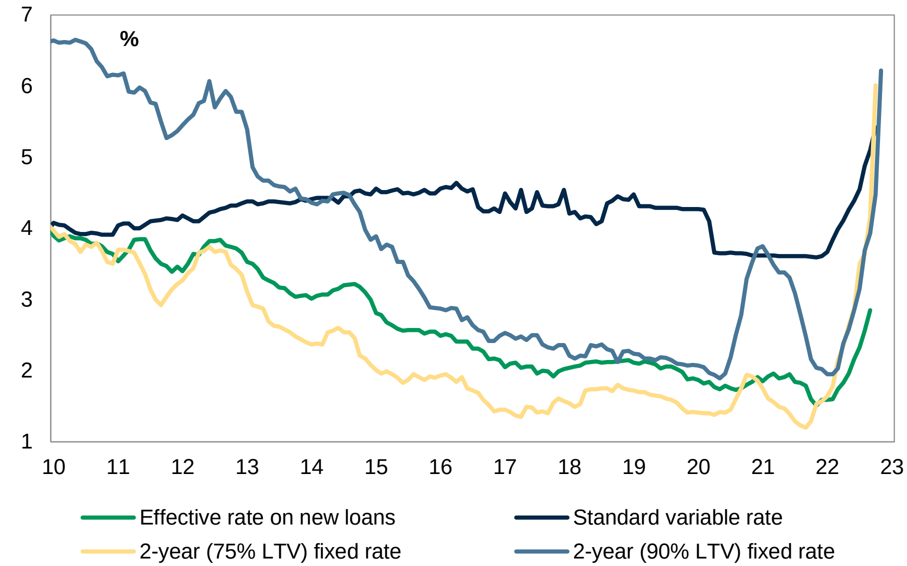
HOUSEHOLDS UNDER PRESSURE BETWEEN INFLATION AND RISING INTEREST RATES

High inflation is expected to lead to a historical decline in purchasing power in 2022 and 2023



Sources: ONS, Crédit Agricole SA / ECO

Rising interest rates: some households will have to refinance their mortgages at rates above 6%



Sources: BoE, Crédit Agricole SA / ECO

Pressure on household finances will increase significantly in 2023 due to the continued fall in real incomes, the rise in mortgage rates, and an anticipated deterioration in labour market conditions.

In terms of purchasing power, the forecasts are alarming: **the OBR forecasts a 3.4% drop in real disposable income in 2023 and 7% cumulatively in 2022 and 2023**, which would offset a decade of purchasing power gains. The decrease in real disposable incomes would have been even greater if the government had not announced the Energy Price Guarantee and support for low-income households. In addition to the Energy Price Guarantee (which will limit the average energy bill for a typical household to £2,500 this winter and to £3,000 from April 2023 for an additional 12 months), the government has planned a 9.7% increase in the minimum wage in April 2023, an increase in social benefits for workers and retirees in line with inflation, and additional payments for the most vulnerable households.

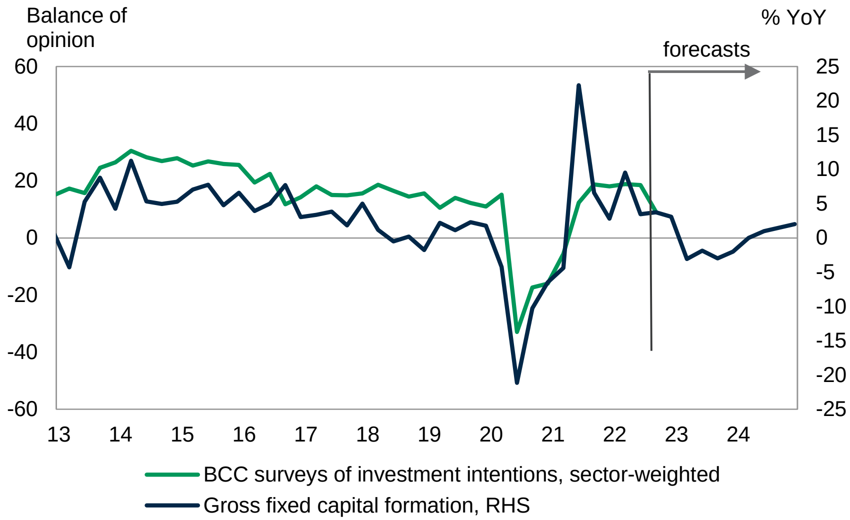
Rising interest rates and rents will also put a strain on household finances. According to the BoE, the monthly payments of nearly 4 million households with mortgages, representing half of those who hold a mortgage, will increase over the next 12 months, as they will have to be refinanced at higher interest rates. The situation is also worrying for the 5 million households in private rentals who will have to face a renewal of their rent in the coming months.

Lastly, the labour market is expected to be less buoyant in the coming months. The unemployment rate, which has risen by 0.2 points from its record low of 3.5%, is expected to reach 4.5% by the end of 2023.

OUTLINE OF OUR SCENARIO

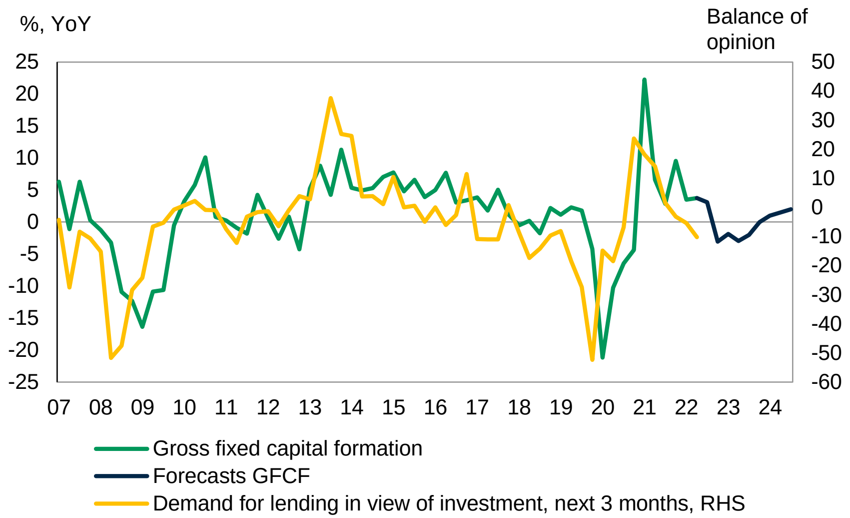
INVESTMENT: WEAKER OUTLOOK

Investment intentions fell in Q3-2022



Sources: BCC, ONS, Crédit Agricole SA/ECO

Demand for credit for investment reasons has continued to decline



Sources: ONS, BoE Credit Conditions Survey, Crédit Agricole SA/ECO

Business investment has increased very little since the pandemic, still standing 8% below its Q4-2019 level. This suggests strong potential for a rebound once clouds darkening the horizon dissipate. In the short term however, we believe this is unlikely given the environment of continued uncertainty and increasing pressure on margins. Investment intentions fell in Q3-2022, as expected, on the back of tighter financial and monetary conditions and a deteriorating demand outlook. In addition, the BoE survey on credit conditions in Q3-2022 shows that demand for credit for investment reasons decreased sharply in Q2 and that a further decrease was expected for Q3. **In 2023, a significant increase in corporate taxation is expected to hi investment hard. The chancellor of the exchequer confirmed that the corporate tax rate would increase from 19% to 25% in April 2023. Similarly, in April, the cap on energy prices for businesses will come to an end and will be followed by targeted aid.** The “super deduction” that allowed eligible businesses to receive an allowance of up to 130% of their investment will end, as will the £1 million capital expenditure allowance. In addition, the tax on profits of oil and gas companies (Energy Profit Levy) will increase from 25% to 35% in January, and their investment allowance will be reduced from 80% to 29%. A 45% temporary tax on electricity producers will also be created in January.

Real estate investment, which has risen steadily since Q3-2020 and is now 12.5% above its Q4-2019 level, is also seeing its outlook deteriorate following the rise in interest rates and is likely to fall in 2023. Only public sector investment is expected to increase in 2023 (forecast at 10.7% by the OBR) thanks to the continuation of Rishi Sunak’s initial spending plan when he was chancellor of the exchequer.

OUTLINE OF OUR SCENARIO

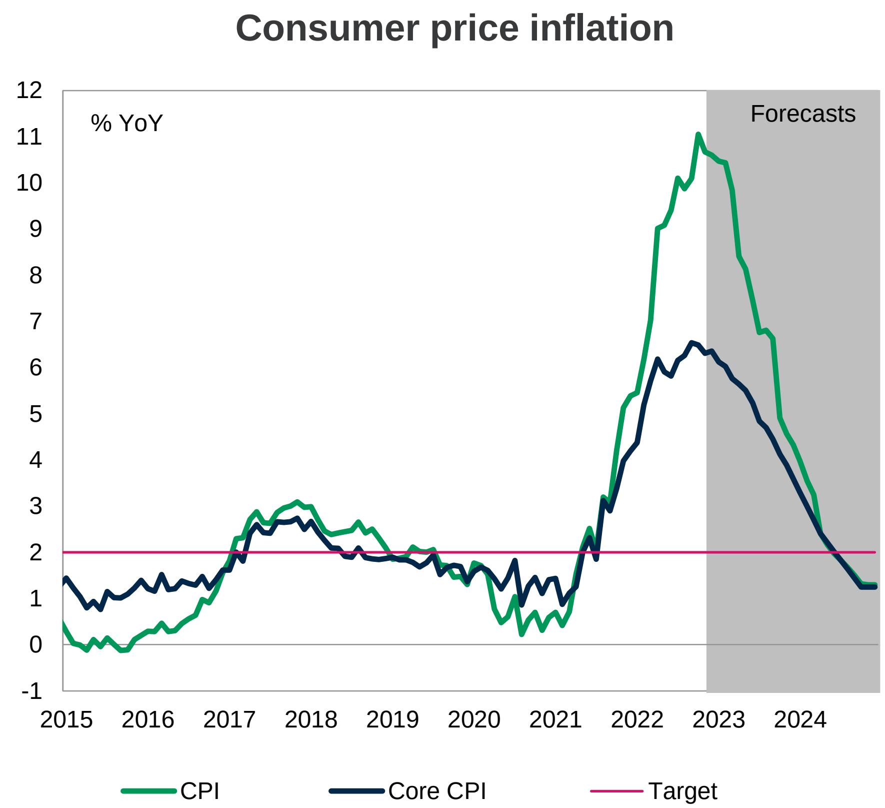
INFLATION: ABOVE 10% IN THE SHORT TERM, FALLING TOWARDS THE TARGET IN 2024.

Finally, good news: the inflation rate likely peaked in October at 11.1% for the CPI and at 6.5% for the core CPI. This is thanks to the decline in energy prices, the implementation of a cap on energy prices (Energy Price Guarantee) by the government, and the moderation of inflation in industrial goods. But it is still (much) too early to declare victory. The road to the BoE's 2% target remains long and fraught with risks. **Inflation in food and services continues to rise.**

In the short term, the headline inflation rate is expected to remain above 10% (10.8% forecast in Q4-2022 and 10.2% in Q1-2023). In April, the EPG will lead to a further increase in energy prices (+20%) in line with the government's planned cap, which will increase from GBP2,500 per year to GBP3,000 per year for a typical annual bill.

Powerful base effects should allow inflation to decline throughout 2023. This trajectory is likely to emerge amid a recession in domestic demand in the near-term, moderating global bottlenecks, and falling – or at least stabilising – commodity prices, especially oil and gas prices. Nevertheless, CPI inflation is expected to remain very high at 4.6% at the end of 2023 (3.6% for core inflation). **In our scenario, CPI inflation returns to the BoE's 2% target in Q2-2024, followed by a drop to 1.3% in Q4-2024.**

Upside risks to inflation remain significant. In particular, the labour market could continue to surprise favourably, leading to wage increases well above productivity growth. The inactivity rate is expected to remain abnormally high due to the large number of those suffering long-term illnesses among the inactive. Migration policy after Brexit s also expected to remain a source of recruitment difficulties for businesses. Lower margins could, in turn, force businesses to raise prices for end-consumers.

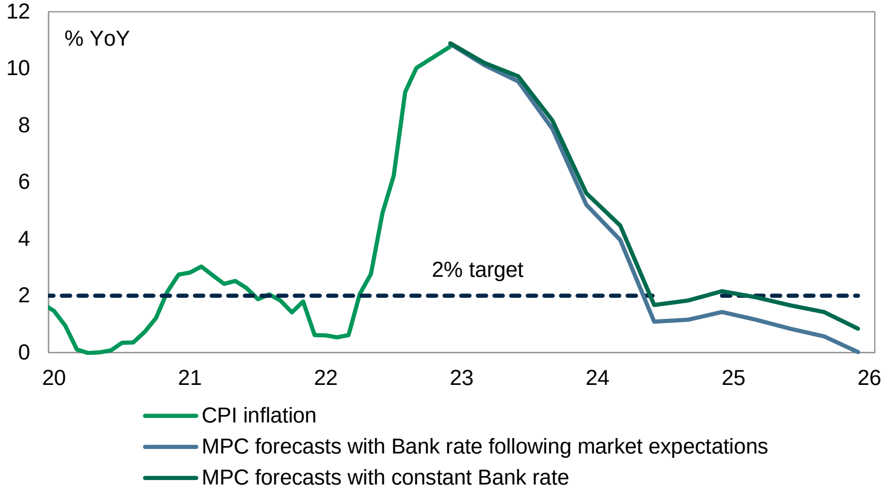


Sources: ONS, Crédit Agricole SA / ECO

OUTLINE OF OUR SCENARIO

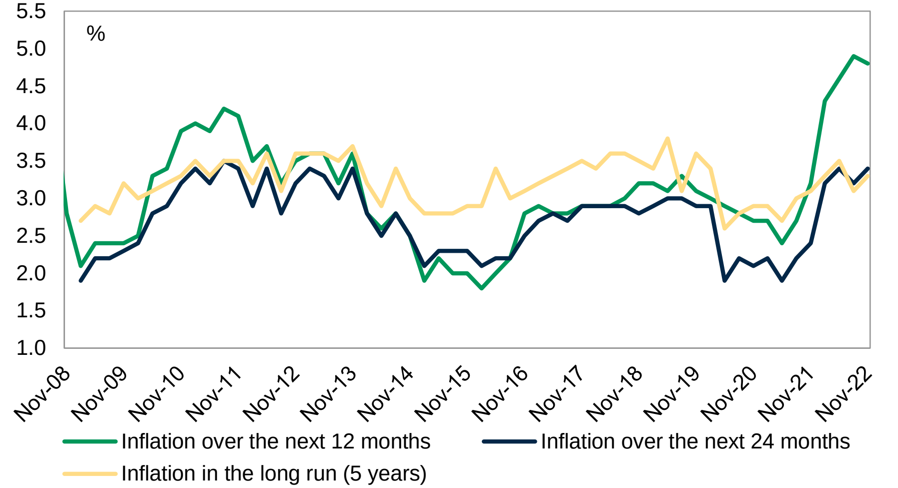
MONETARY POLICY: SLOWER TIGHTENING, STILL ON ALERT

The BoE expects a return to the target in mid-2024, assuming relatively aggressive rate hikes



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

Household inflation expectations remain high, suggesting persistent upside risks to wages



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

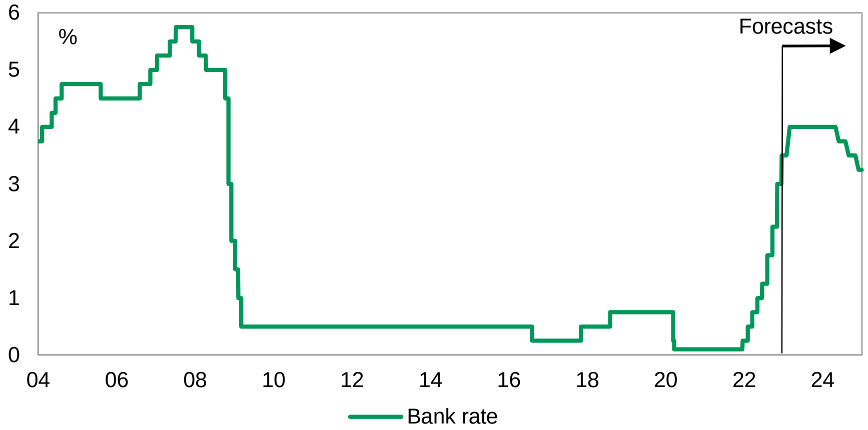
In December, the MPC decided to take its foot off the accelerator slightly amid signs of a weakening economy. The policy rate was raised by 50 basis points (bp) to 3.50%, in line with expectations, after 75bp in November. Two members even voted for the status quo. The majority of the MPC believes that if the economy were to move broadly in line with the projections of the November monetary policy report, further policy rate hikes "*could* be needed" to bring inflation back to the target sustainably.

In the same time, the MPC has continued to insist on the risk of inflation persistence as suggested by the tightness of labour market conditions and the companies' behaviour of price and wages setting. Low participation rate remains a source of concern as a number of structural factors are at play (ageing population, early retirements, health problems amidst a majority of the inactive persons). For the MPC, the key questions remain the extent to which labour demand will adjust to labour supply and how long this imbalance will continue to put upward pressure on inflation. **If inflationary pressures persist indeed, the MPC stands ready to "respond forcefully".**

OUTLINE OF OUR SCENARIO

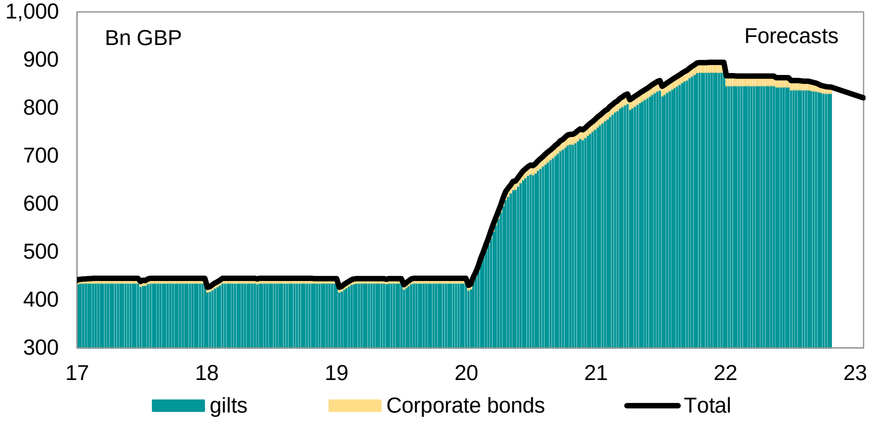
TOWARDS A POLICY RATE PEAK IN Q1-2023. THE BOE CONTINUES ITS BALANCE SHEET REDUCTION

Policy rate: we expect a shift in 2024



Sources: BoE, Crédit Agricole SA / ECO

Very gradual reduction of the stock of securities (quantitative tightening)



Sources: BoE, Crédit Agricole SA / ECO

We expect a final rate hike in February of 50bp to 4%, then stability in 2023 and rate cuts in 2024. The inflation rate is expected to start falling sharply this coming spring, which should reinforce the BoE in its ability to bring the inflation rate back to its 2% target in the medium term. Added to this are the risks to financial stability mentioned by the BoE in its Financial Stability Report of 13 November (see next page).

In 2024, low growth rates and medium-term inflation expectations below target should prompt the BoE to change its course. Fiscal policy will be more restrictive with tax increases and spending cuts.

We therefore forecast three 25bp rate cuts in 2024, bringing the policy rate to 3.25% at the end of 2024. However, risks remain on the upside, mainly due to persistent tensions in the labour market, which are in turn linked to a high inactivity rate that continues to rise.

Quantitative tightening (QT) – On 1 November, the BoE began selling the gilts in its asset purchases facility. In Q4, it sold a total of GBP6bn in short-dated gilts (3 to 7 years) and medium-dated gilts (7–20 years). Due to the pension fund debacle at the end of September, long-dated securities were temporarily excluded from the QT. As a result, at the end of 2022, the total stock of securities included GBP831bn in government bonds and GBP12.9bn in corporate bonds.

In Q1-2023, the BoE plans to sell a total of GBP9.75bn of gilts over the quarter, including long-dated securities (more than 20 years). **Its objective remains to reduce the stock of government securities by GBP80bn over 12 months by the end of September 2023, subject to existing demand.** Only half of this reduction is expected via sales of securities, suggesting a rather gradual decline in the stock of gilts (towards GBP760bn in September 2023).

OUTLINE OF OUR SCENARIO

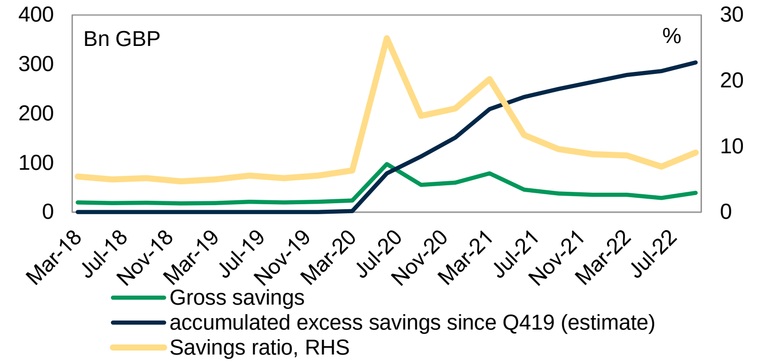
RISKS TO FINANCIAL STABILITY: HOUSEHOLDS

The vulnerability of households and businesses has increased due to the worsening economic situation and tightening financial conditions. This is what the BoE said in its Financial Stability Report of 13 November.

Pressure on household finances will increase significantly in 2023 due to the fall in real incomes, the rise in mortgage rates, and an anticipated deterioration in labour market conditions. Households may struggle to repay consumer loans such as credit cards or other personal loans, especially after the rise in energy and food prices. **The risk of indebted households defaulting on their loans or reducing consumer spending has increased.**

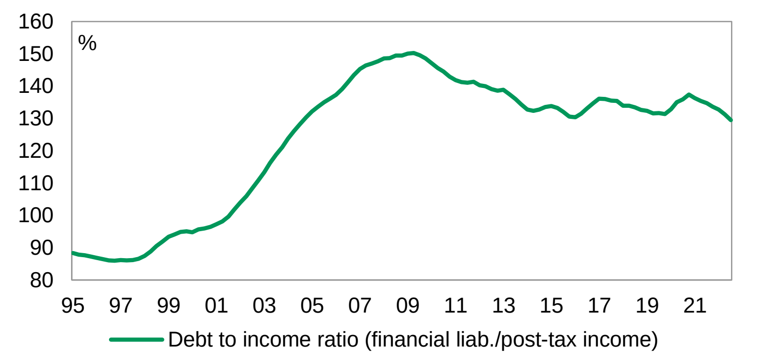
However, the FPC (Financial Policy Committee) **believes that the situation of households is stronger than on the eve of the 2008 financial crisis and during the recession of the early 1990s.** Households are, in aggregate, less indebted: the debt-to-income ratio has fluctuated around 130% in recent years, compared with 150% on the eve of the 2008 financial crisis. Even if the share of mortgage repayments in household income (currently at 5.4%, compared with 10% before the financial crisis) increases, it should remain below the levels reached during these crises. At 9% of disposable income in Q3-2022, the households saving rate is still well above pre-COVID levels. Households can therefore further lower their rate of savings to support their consumption or to service their debt. In addition, the excess savings accumulated since COVID, in aggregate, is still significant (at nearly GBP300bn according to our estimates).

Savings rate and excess savings accumulated since COVID



Sources: ONS, Crédit Agricole SA / ECO

Household indebtedness



Source: ONS, Crédit Agricole SA / ECO

OUTLINE OF OUR SCENARIO

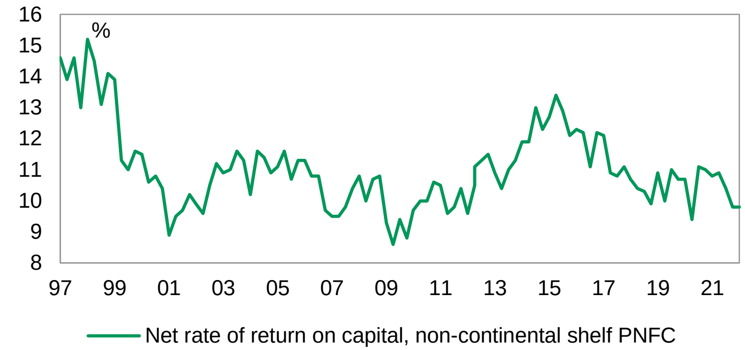
RISKS TO FINANCIAL STABILITY: BUSINESSES

The balance sheets of some businesses are under increasing pressure due to rising production costs, falling consumption, higher interest rates, and the continued disruption of value chains. **These headwinds are expected to put the solvency of the most vulnerable businesses, especially small and medium-sized enterprises with low liquidity and/or high debt, at risk.** There are already signs of stress among corporate borrowers. Bankruptcies have increased, especially among small and medium-sized enterprises. Financing conditions have tightened, and some sources of refinancing have dried up.

Nevertheless, as a whole, businesses are also generally better prepared than at the beginning of the year to face a new stressful situation, thanks to the increase in revenues following the opening of the post-COVID economy and the decrease in debt. Businesses have not yet indicated plans to significantly reduce employment or investment in response to the deteriorating economic environment.

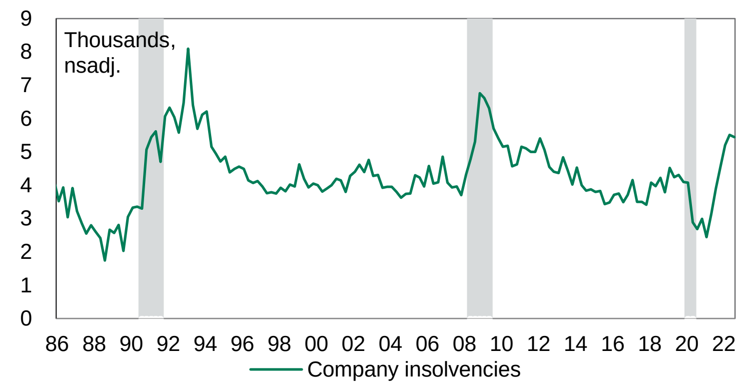
According to the BoE, the banking system has a high capacity to withstand the deteriorating economic environment. The BoE does not expect the increasing pressure on households and businesses to put the banking system in direct trouble, partly due to lower risk on household lending, reflecting healthier lending practices than in previous crises. Liquidity and capital positions are solid, and profitability before provisions is up. Banks are able to absorb shocks and continue to meet the credit needs of businesses and households. Asset quality remains relatively high, although some forms of lending – such as low-down-payment mortgages and loans to highly indebted or low-rated businesses – are more exposed to losses. The observed tightening in credit conditions is seen as normal at this stage, given the weakening economy, and the BoE continues to monitor credit conditions and possible signs of harmful excessive tightening.

Corporate profitability



Sources: ONS, Crédit Agricole SA / ECO

Bankruptcies



Source: UK Government Insolvency Service

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Slavena Nazarova
+33 1 43 23 21 40
slavena.nazarova@credit-agricole-sa.fr

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