UNITED KINGDOM 2021-2023 SCENARIO

STAGFLATION AND A RISK OF RECESSION

April 2022

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WORKING EVERY DAY IN YOUR INTEREST AND FOR SOCIETY

CONTENTS

SUMMARY

UNCERTAINTY AND RISING COST OF LIVING GENERATE STAGFLATION

Economic forecasts deteriorate

The Russian invasion of Ukraine has undermined the global economic outlook. The crisis will negatively impact the United Kingdom, a relatively open economy and net importer of gas and oil. Household consumption will be affected by the rise in the cost of living, private investment will be impacted by uncertainly, surging production costs and monetary and financial tightening, and exports will be hit hard. As such, we have significantly revised our forecasts, upward for inflation and unemployment, and downward for growth. We expect zero growth on average in the second and third quarter 2022, with inflation rising sharply above 8% in spring.

The first quarter should be relatively solid owing to the end of COVID-related restrictions

The year got off to a promising start. GDP grew substantially in January and PMI surveys in March showed a pick-up in business activity and employment. But Russia's invasion of Ukraine shattered optimism in the private sector. According to the composite PMI, corporate optimism, already fragile owing to inflationary pressures and global production chain issues in the past year; has fallen to its lowest level since October 2020.

Inflation forecasts adjusted sharply upward

Russia's invasion of Ukraine will have a strong impact on inflation via energy and commodity prices and heightened tensions across global production chains. And the domestic environment is already inflationary, a result of labour market tensions with nominal wages expected to rise nearly 5% this year. After hitting 7% in February, inflation is expected to top 8% in the second and third quarters, nearly 2 percentage points higher than our January forecast. A further increase in inflation can be expected in October (8.6% year on year) when UK energy regulator Ofgem raises its price caps in step with the trend in natural gas futures. The inflation forecasts are surrounded by significant risks, which appear to be rising.

Expecting a historical decline in purchasing power

The main impact on the British economy of Russia's invasion of Ukraine will be an increase in the cost of living. According to the Gfk index, household confidence has already fallen to its lowest level since November 2020 in response to the decline in real disposable income. Real household income was expected to decline 2% on average in 2022 before the war; it is now expected to contract by almost 4%. Along with lower purchasing power comes the dreaded impact of uncertainty over how the private sector is saving and investing. Households having built up a nest egg during the COVID-19 pandemic will be forced to dip into their savings or take out a consumer loan to support their consumption. Companies will no doubt have to put off their investment plans until the picture clears.

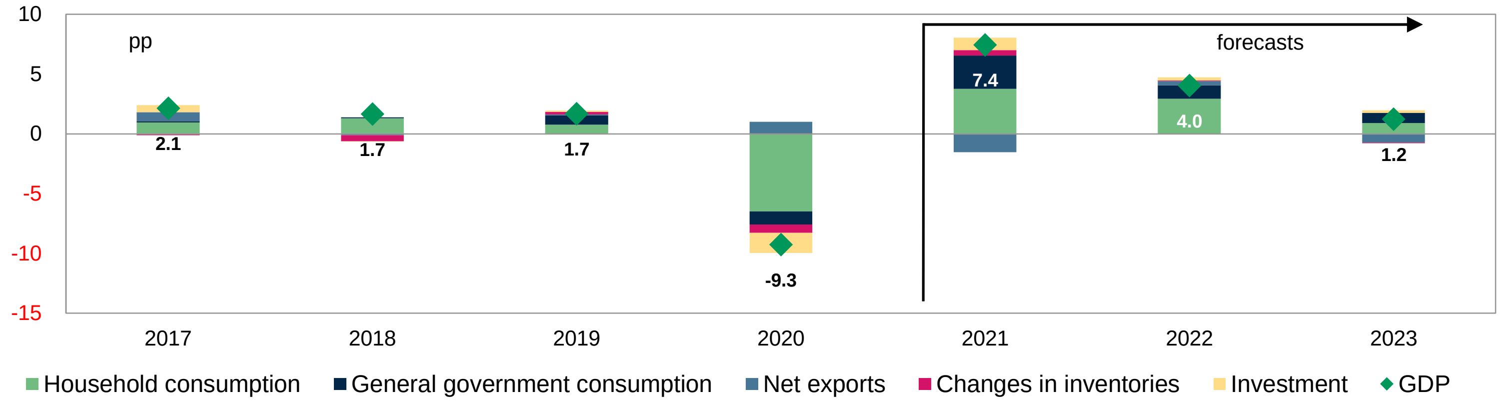
A more dovish BoE

The Bank of England raised its key rate to 0.75% in March but modified its forward guidance. The central bank now says that "some further modest tightening in monetary policy might be appropriate in the coming months" rather than likely, which could mean that the March hike was the last. The voting outcome in March also revealed that a member of the MPC preferred the status quo on rates and voted against the 25 basis point rate hike. Our scenario is for a more gradual tightening in the coming months, with only two additional increases (one per quarter) in May and August (by 25 basis points each). If so, the key policy rate will reach 1.25% in August of this year.

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	4.0	1.2	-1.2	5.6	0.9	1.3	1.2	-0.1	0.1	0.3	0.4	0.4	0.4	0.4
household consumption	6.2	4.9	1.5	-3.4	8.5	2.6	0.5	0.8	0.2	0.3	0.3	0.4	0.4	0.5	0.5
public consumption	14.3	5.4	4.1	1.0	8.5	-0.6	1.5	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
investment	5.9	1.6	1.2	-0.9	1.7	0.4	1.1	1.2	-1.0	-1.0	1.0	0.5	0.5	0.5	0.5
change in inventories*	0.4	0.1	-0.1	-0.8	-0.8	1.0	-0.1	0.0	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
net exports*	-1.5	0.3	-0.7	1.6	0.6	-2.4	1.7	0.3	0.0	-0.2	-0.3	-0.2	-0.2	-0.2	-0.2
Unemployment rate (ILO)	4.4	4.0	4.2	4.8	4.6	4.2	3.9	3.7	4.0	4.1	4.2	4.2	4.1	4.2	4.1
Inflation (CPI, YoY%)	2.6	7.4	4.2	0.6	2.1	2.8	4.9	6.1	7.9	8.0	7.7	7.0	4.5	3.5	2.1
Core CPI (YoY%)	2.4	5.9	3.8	1.1	1.9	2.6	3.9	5.0	6.1	6.2	6.2	5.8	4.4	3.2	2.1
Current account (% GDP)	-2.6	-3.2	-4.0	-2.2	-2.0	-4.9	-1.2	na	na	na	na	na	na	na	na
General gov. balance, % GDP	-10.1	-5.0	-3.9	na	na	na	na	na	na	na	na	na	na	na	na
Public debt % GDP	103.0	104.0	104.7	na	na	na	na	na	na	na	na	na	na	na	na
Bank rate**	0.25	1.25	1.25	0.1	0.1	0.1	0.25	0.75	1.00	1.25	1.25	1.25	1.25	1.25	1.25
Stock of purchased gilts (bn £) **	875	838	803	875	875	875	875	847	847	838	838	838	838	803	803

** Contributions to GDP growth*

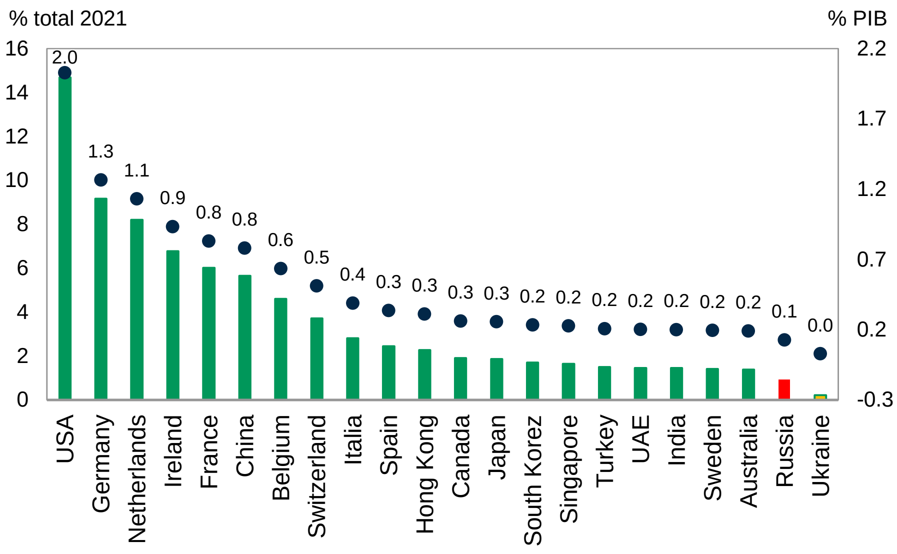
*** End of period*

CONTENTS

FOCUS – EXPOSURE TO THE WAR IN UKRAINE

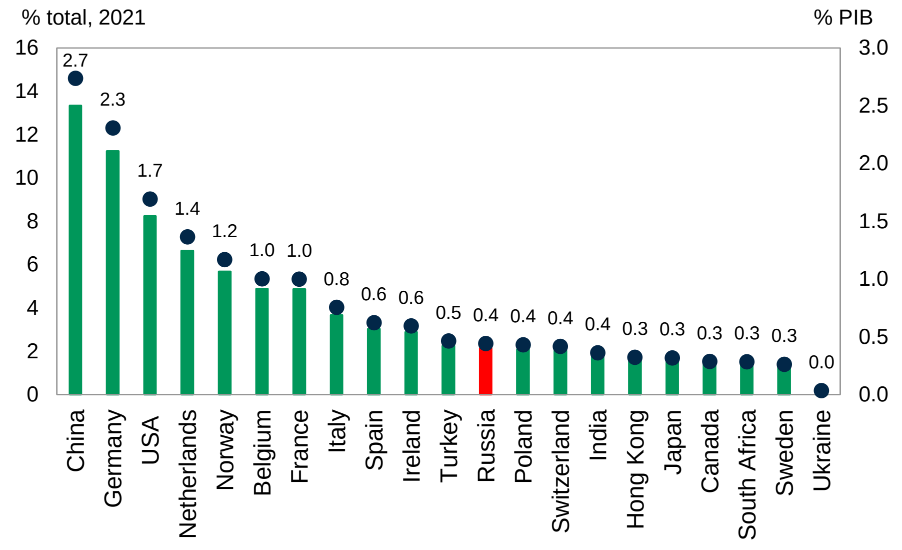
IN GOODS TRADING, THE UK HAS LOW EXPOSURE TO RUSSIA AND UKRAINE

Exports of goods



Sources: ONS, Crédit Agricole SA / ECO

Imports of goods



Sources: ONS, Crédit Agricole SA / ECO

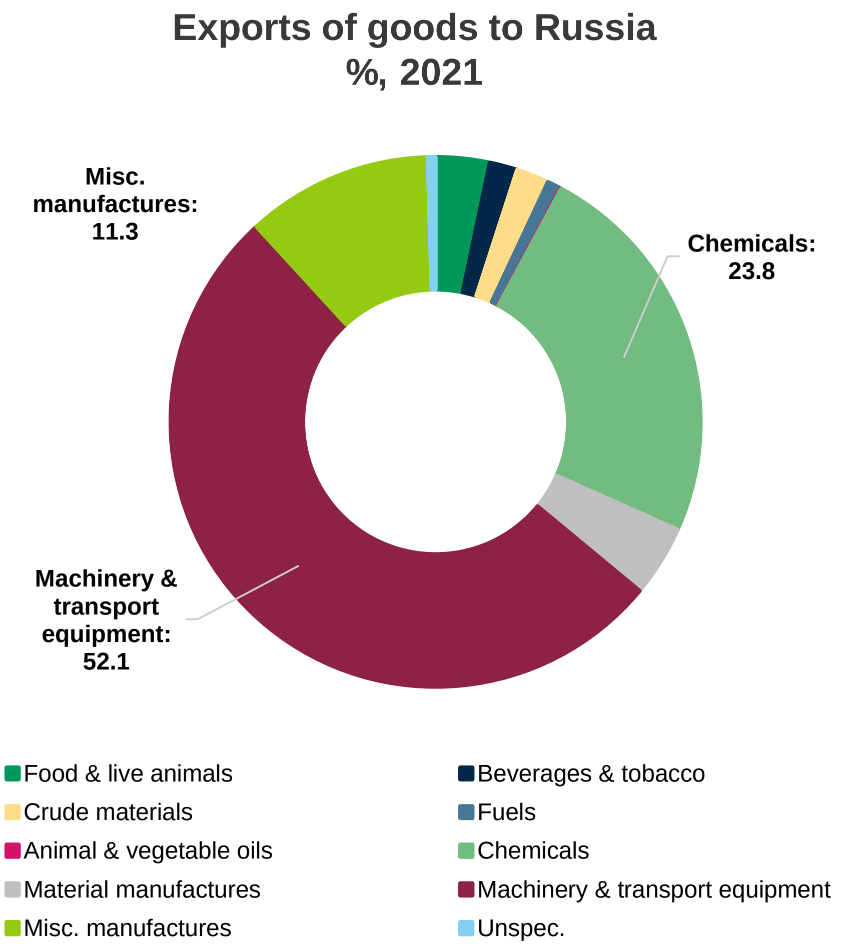
The UK is a net energy importer. Russian oil imports account for 8% of the UK's total demand. The UK decided to phase out these imports in 2022, giving itself time to adjust supply chains and protect consumers.

The main effect of the Russian invasion in Ukraine is a significant inflationary shock through rising energy, food and commodity prices and disruptions in global supply chains. The Russian invasion will accentuate both the peak in inflation and the negative impact on activity by increasing the pressure on household incomes.

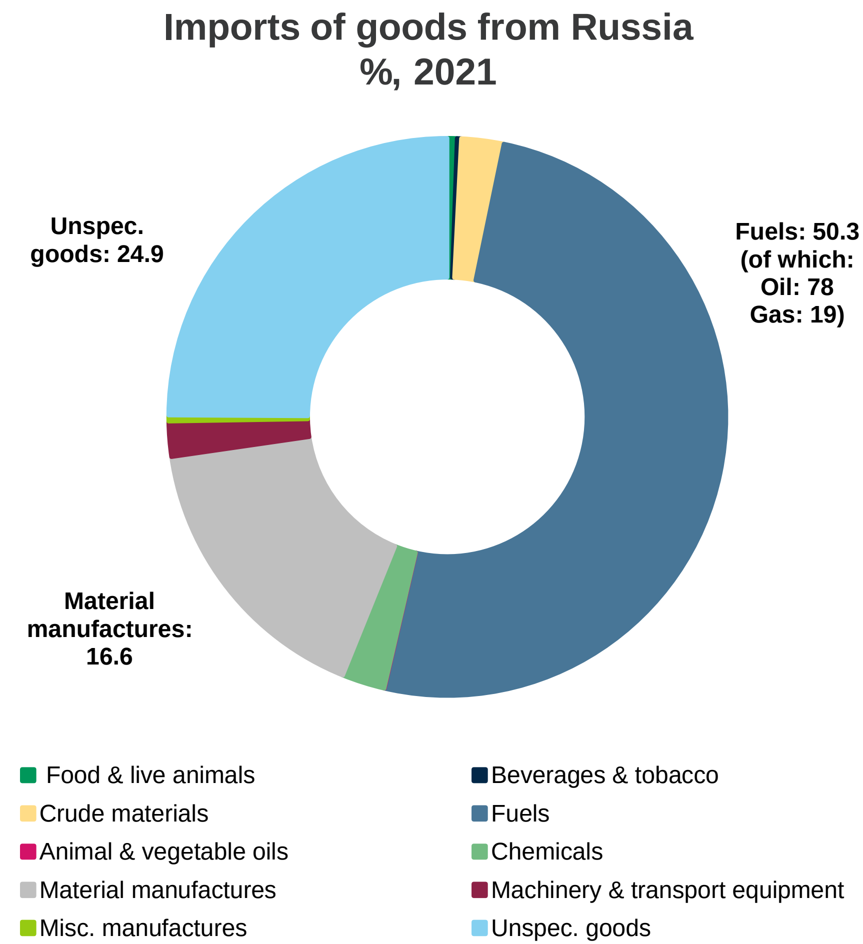
As uncertainty persists, this will weigh on private consumption and business investment. Even before Russia invaded Ukraine, the UK economy was expected to cool off and reach lower growth rates, a result mainly of the compression of real incomes reflecting past increases in tradable goods and energy costs.

FOCUS – EXPOSURE TO THE WAR IN UKRAINE

TRADE WITH RUSSIA



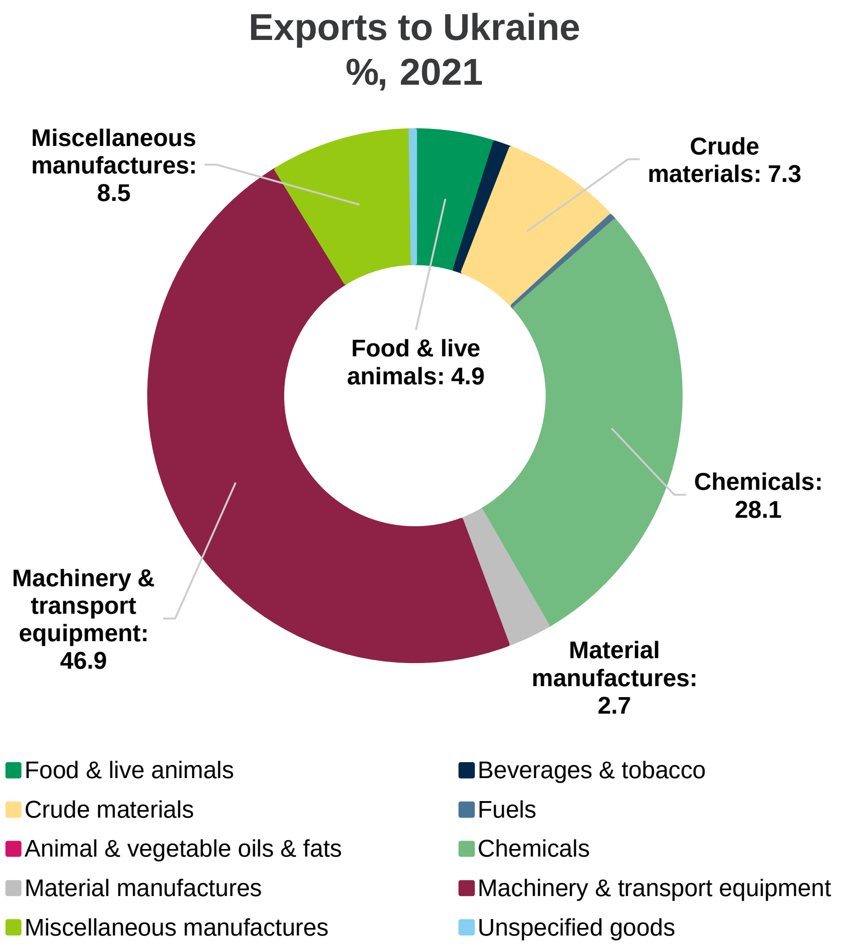
Sources: ONS, Crédit Agricole SA / ECO



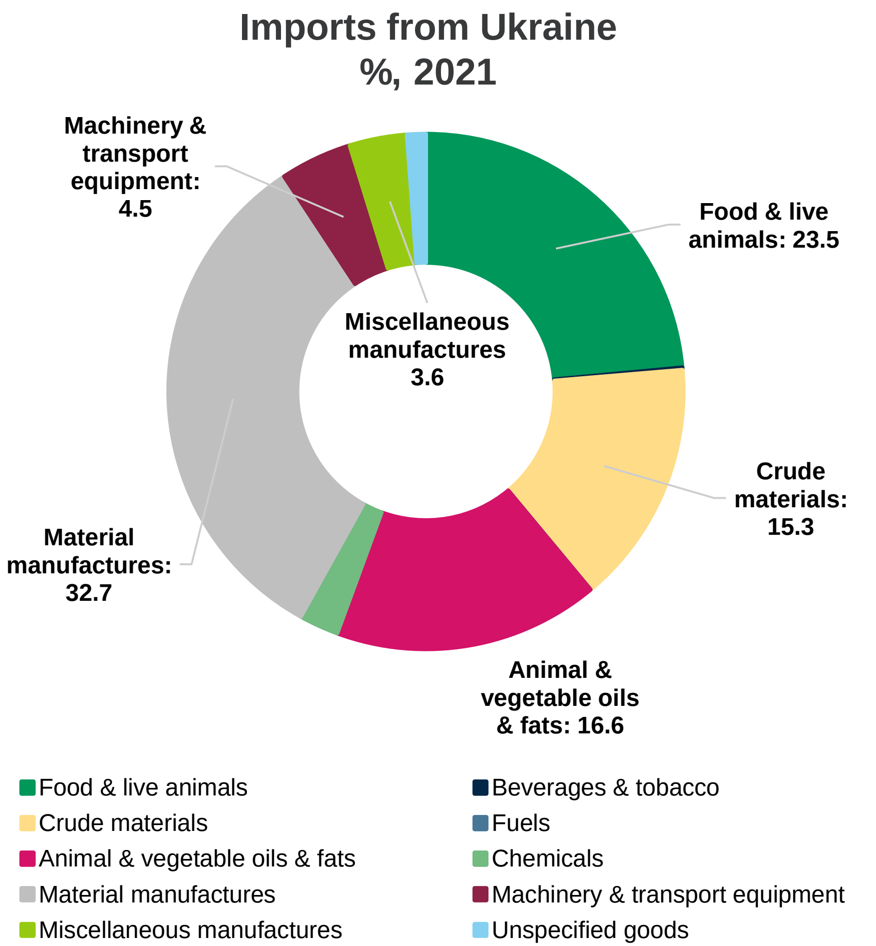
Sources: ONS, Crédit Agricole SA / ECO

FOCUS – EXPOSURE TO THE WAR IN UKRAINE

TRADE WITH UKRAINE



Sources: ONS, Crédit Agricole SA / ECO

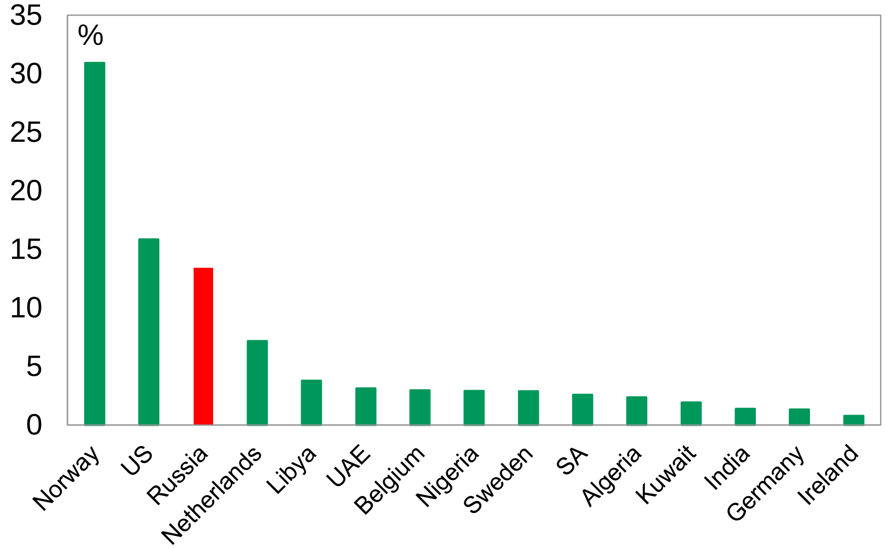


Sources: ONS, Crédit Agricole SA / ECO

FOCUS – EXPOSURE TO THE WAR IN UKRAINE

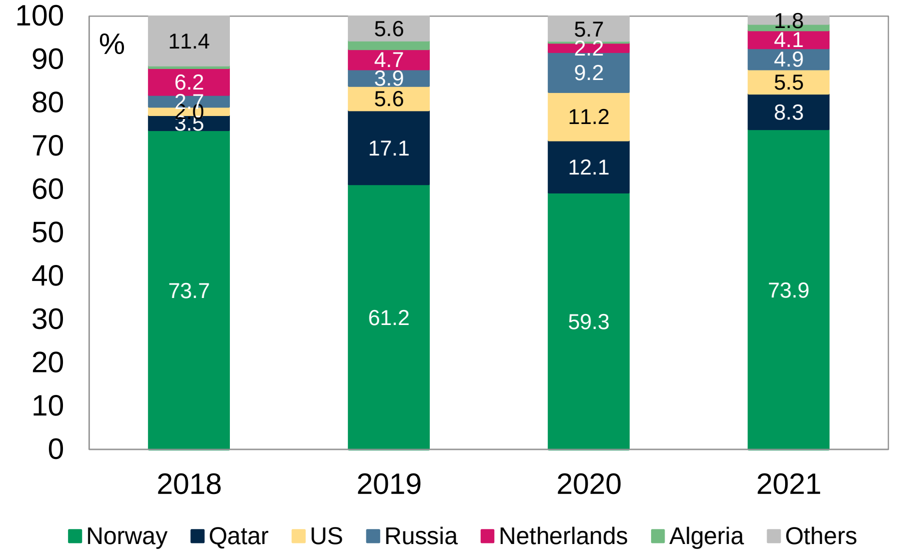
OIL AND NATURAL GAS IMPORTS

Oil imports, 2021



Sources: ONS, Crédit Agricole SA / ECO

Natural gas imports, 2021



Sources: ONS, Crédit Agricole SA / ECO

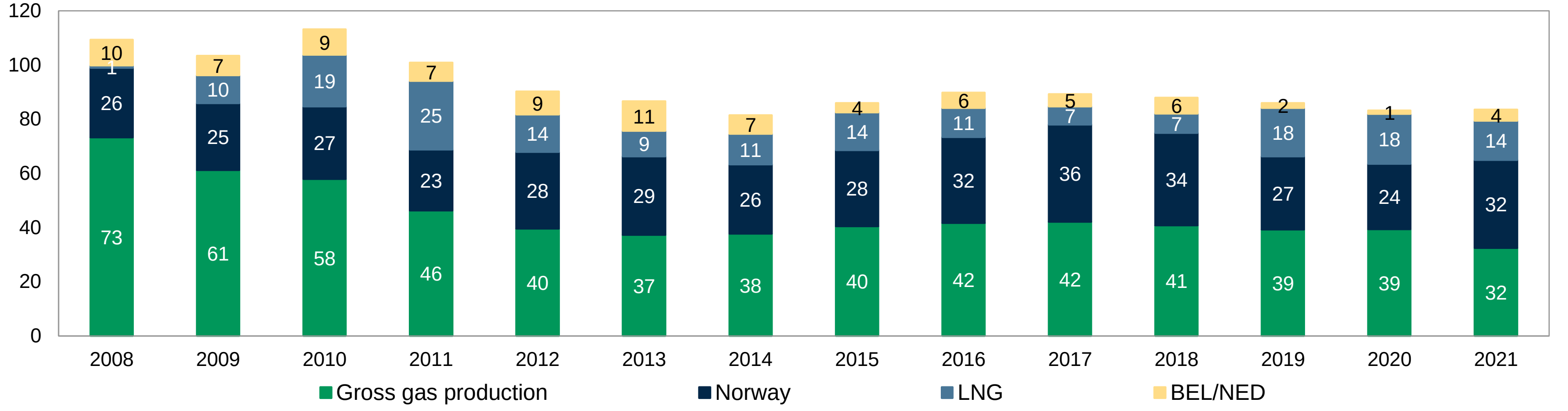
The UK is a major producer of crude oil and oil products. More than two-thirds of UK road fuel comes from domestic production. But as domestic production is unable to cover all the needs of the economy, the UK imports oil from a wide range of suppliers, including Norway and the United States (Russia ranking third, accounting for 13% of oil imports).

Regarding natural gas, nearly three-quarters of natural gas imports come from Norway and only 5% from Russia, in the form of liquefied natural gas.

FOCUS – EXPOSURE TO THE WAR IN UKRAINE

HOW DEPENDENT IS THE UK ON RUSSIAN NATURAL GAS?

UK natural gas supplies by source (bn cubic metres per year)



Sources: ONS, Crédit Agricole SA / ECO

UK gas demand is generally stable at around 80 billion m^3 a year. Natural gas is used widely to generate electricity and heat residential, commercial and industrial premises. Eighty per cent of UK households use gas to heat their homes, making the country highly vulnerable to supply shortages or winter price spikes.

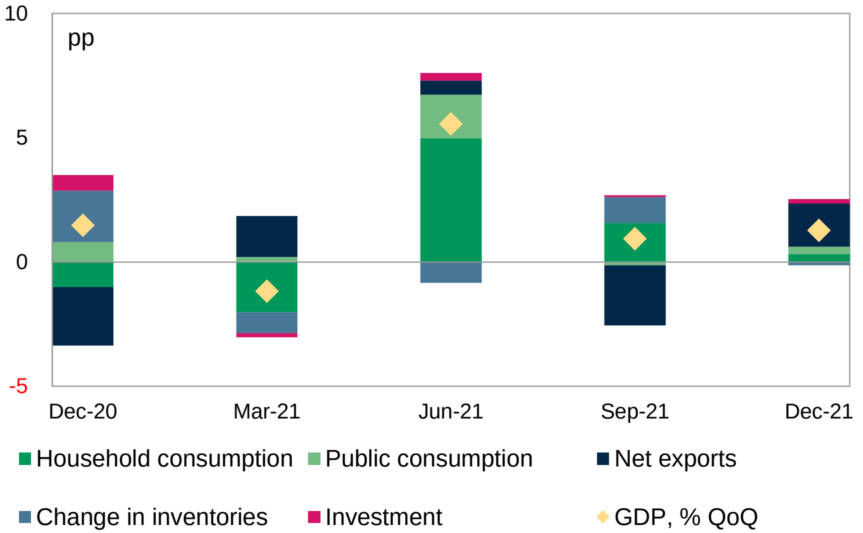
The UK meets this demand via domestic production and pipeline connections with Norway, the country's largest external supplier. However, UK gas production has ebbed over time and continues to decline. The UK would be unable to respond to any physical shortage of import supply. In addition, import capacity from Norway is limited because the country also exports to Belgium, France, Germany and the Netherlands. And with Norwegian production currently at maximum capacity, the UK could receive more Norwegian gas only if exports were diverted from Continental Europe.

The UK's dependence on Russian gas supply is limited. The UK does not have a direct gas pipeline connection with Russia. LNG imports from Russia increased from almost zero in 2017 to 5% of the UK's gas supply in 2021. But any interruption in Russian gas pipeline deliveries to the European market would inevitably lead to price increases in European markets. If European countries were to avoid Russian natural gas, the dynamics of pipeline movements between the UK and Norway and between the UK and Continental Europe could be affected and at the same time influence the dynamics of LNG imports into Europe.

CONTENTS

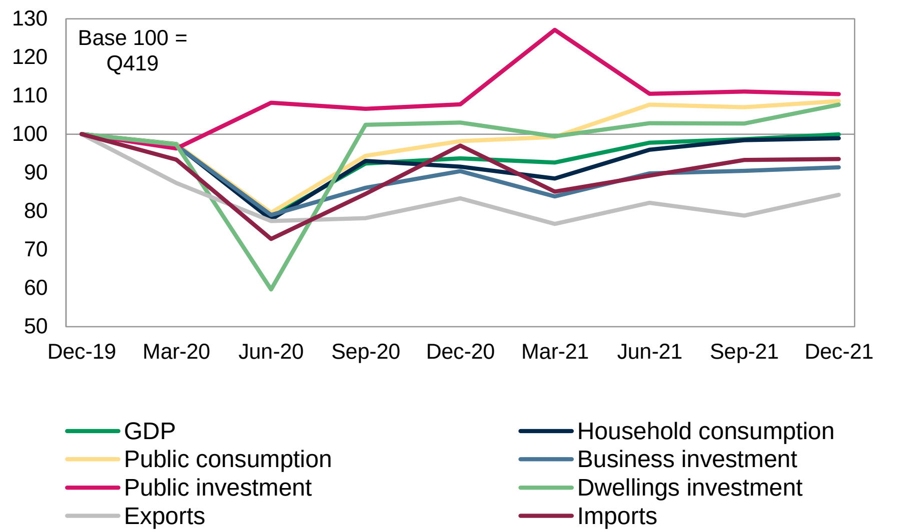
SOLID GROWTH IN Q4, BUT HOUSEHOLD CONSUMPTION IS SLOWING SHARPLY

Quarterly GDP growth: breakdown in terms of expenses



Sources: ONS, Crédit Agricole SA / ECO

Since Q419, the recovery has been driven by the public sector



Sources: ONS, Crédit Agricole SA / ECO

Economic activity increased 1.3% QoQ in Q421, after 0.9% QoQ in Q321. Q421 growth was revised upwards from an initial ONS estimate of 1% QoQ owing to revisions in the services sectors. Over the full year 2021, GDP increased 7.4% on an annual average.

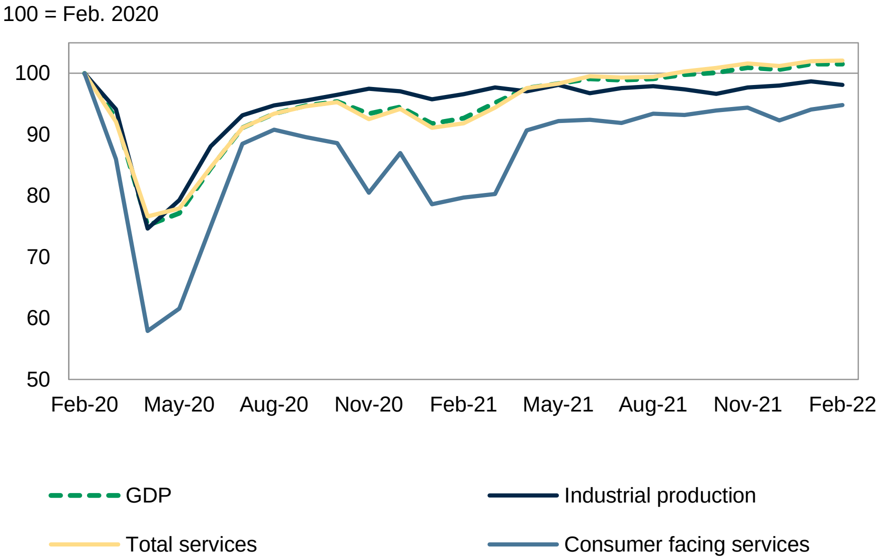
Foreign trade accounts for the bulk of QoQ growth in Q421, contributing 1.7 percentage points. Exports rebounded strongly (+6.9% QoQ), imports were almost stable (+0.3% QoQ). But within domestic demand, private consumption slowed substantially, rising just 0.5% QoQ after 2.6% QoQ in Q321. Lower spending on household goods and services, food, alcohol and tobacco offset a recovery in transport, tourism and clothing spending. Household consumption remains 1% QoQ lower than before the Covid crisis, primarily owing to transport spending, which is a full 15% lower than before the crisis

Business investment surprised on the upside in Q421 with a 1% QoQ rebound and after two consecutive quarters of growth, reflecting higher capital expenditure on transport vehicles. Dwellings investment gained 4.7% QoQ in Q421 and public investment fell 0.6%. However, business investment remains well below its pre-crisis level (-8.6%), while public investment and dwellings investment are, respectively, 10.4% and 7.6% higher than in Q4 2019.

RECENT ECONOMIC TRENDS

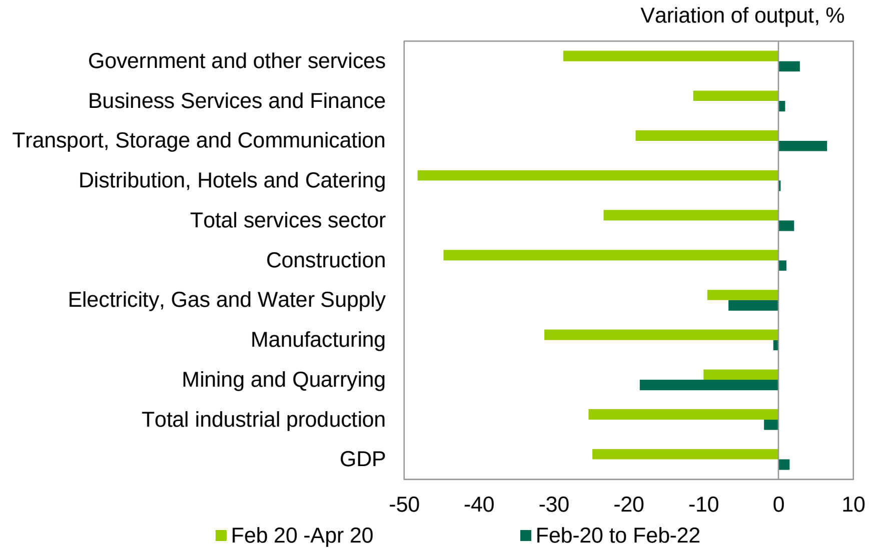
ECONOMIC ACTIVITY STAGNATED IN FEBRUARY

GDP trend since the pandemic



** Consumer facing services refer to retail trade, food and beverage servicing activities, travel and transport, entertainment and recreation (official ONS data)*

State of the post-pandemic sector recovery



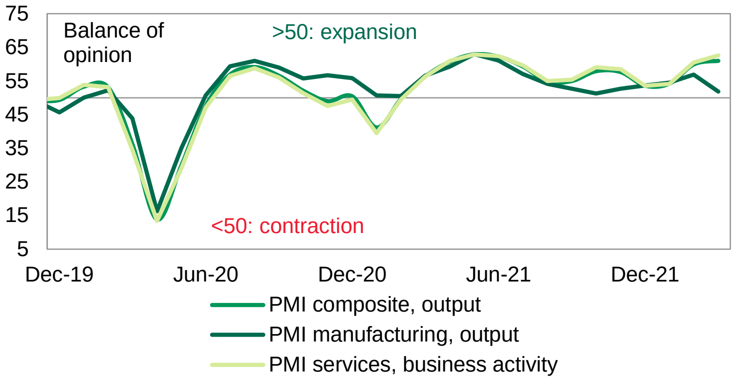
Sources: ONS, Crédit Agricole SA / ECO

After a promising January, when GDP rebounded by 0.8% MoM, economic activity was almost stable in February, rising 0.1% MoM. A slight 0.2% MoM rebound in services was offset by declines in industrial production (-0.6% MoM) and in construction (-0.1% MoM). The four major industrial production sectors contracted, the main negative contributor being the manufacturing sector (-0.4% MoM). In services, growth was driven by a sharp increase in hotel and restaurant activity thanks to the easing of the Omicron wave. Service activities requiring direct contact with the public (retail, catering, travel & transport, entertainment and leisure) rebounded 0.7% MoM thanks to a surge in tourism agency activities (33% MoM), offset in part by a decline in wholesale and retail trade. Two years after the beginning of the COVID-19 crisis, services are 2.1% above their pre-pandemic level. Social and health activities are the key driver, having grown by nearly 10% since February 2020. Service activities requiring direct contact with the public remain 5.2% lower than before the crisis. In monthly terms, GDP is 1.5% higher than before the crisis (February 2020). The disappointing economic activity in February implies a weaker than expected carry-over effect for the quarterly growth rate of GDP in Q1 (+1% QoQ assuming stable activity in March). Therefore, our Q1 growth forecast of 1.2% QoQ is surrounded by downside risks stemming from the conflict in Ukraine.

RECENT ECONOMIC TRENDS

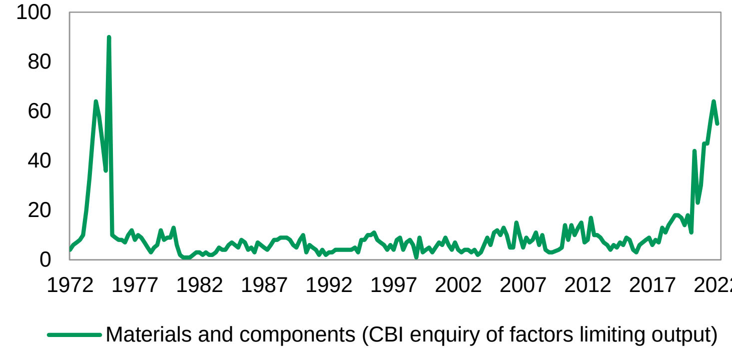
BUSINESS SURVEYS: SUPPLY CONSTRAINTS WORSEN

PMI surveys: manufacturing slowing down



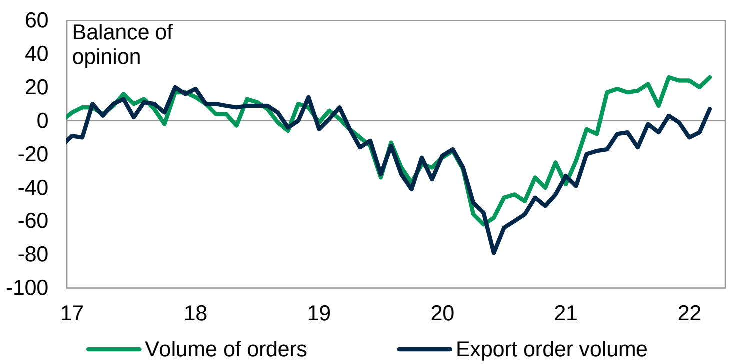
Sources: IHS Markit, Crédit Agricole SA / ECO

Factors limiting production: record shortages of materials and components



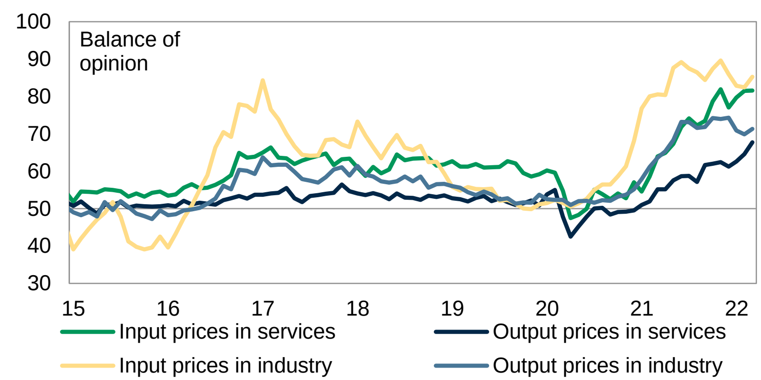
Sources: CBI, Crédit Agricole SA / ECO

Order books still robust



Sources: CBI, Crédit Agricole SA / ECO

PMI price components: accelerating inflation

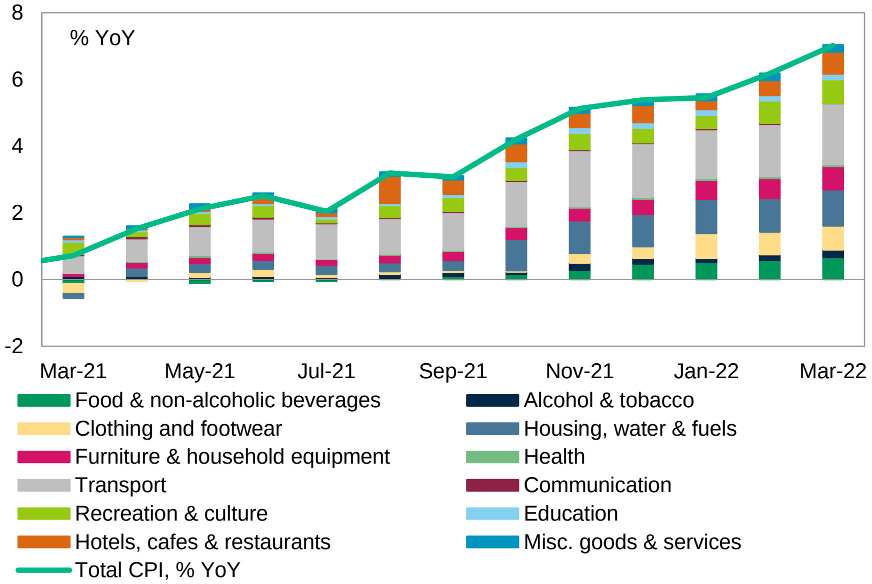


Sources: IHS Markit, Crédit Agricole SA / ECO

RECENT ECONOMIC TRENDS

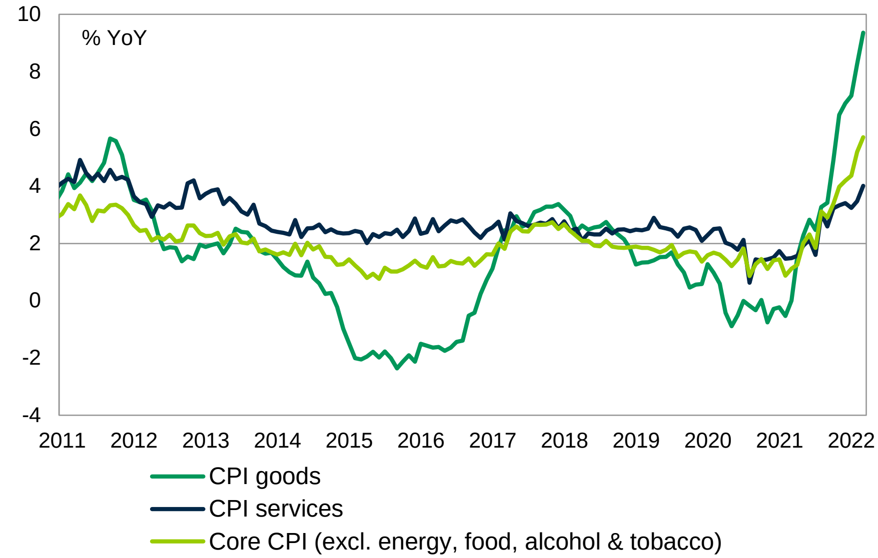
HIGHER AND MORE WIDESPREAD INFLATION

CPI inflation reached 7% year-on-year in April



Sources: ONS, Crédit Agricole SA / ECO

Core inflation has risen to 5.7% year-on-year



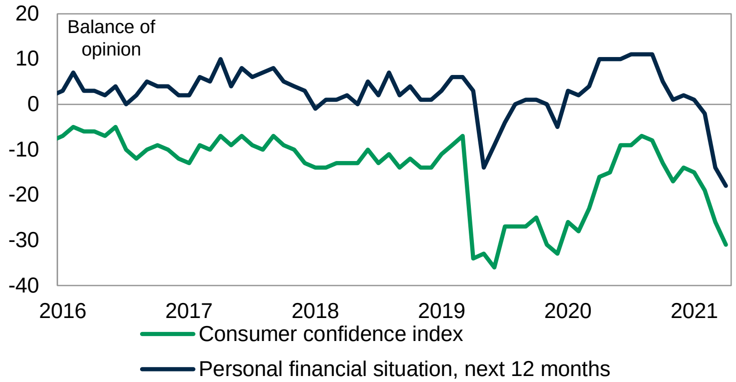
Sources: ONS, Crédit Agricole SA / ECO

CPI inflation reached 7% year-on-year in March after 6.2% in February. Core inflation (CPI excluding energy, food, alcohol and tobacco) rose to 5.7% after 5.2% in February, once again exceeding expectations. Both indices posted strong monthly gains of 1.1% and 0.9%, well above historical averages. While most components contributed positively to the change in the inflation rate between February and March (0.8 percentage points), transport once again contributed the most (by 0.26 percentage points) as a result of higher fuel prices. Petrol prices rose 12.6 pence a litre between February and March (compared to 3.5 pence in the same period last year) in what the ONS considers as the biggest monthly increase since 1990. The rise in energy prices impacted housing services, the price of kerosene used for heating rising 44% over the month. Inflation was also driven upwards in March by the hospitality and catering sectors (which contributed by further 0.22 percentage points to the variation of the annual rate of inflation between February and March) where prices rose 2% MoM, the largest one-month increase since data began to be compiled in 1988. This is mainly due to higher hotel and alcoholic beverage prices. Other sectors bolstering inflation in March included furniture and household equipment goods and food.

RECENT ECONOMIC TRENDS

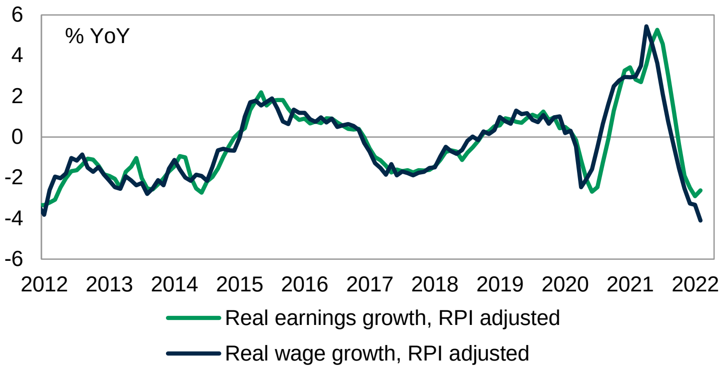
DIMINISHING PURCHASING POWER WEIGHS ON CONSUMER SENTIMENT

Consumer confidence in freefall



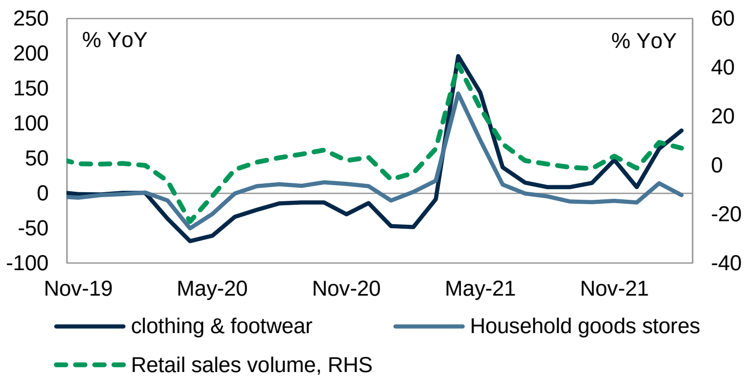
Sources: Gfk, Crédit Agricole SA / ECO

The decline in real incomes is intensifying under inflationary pressure



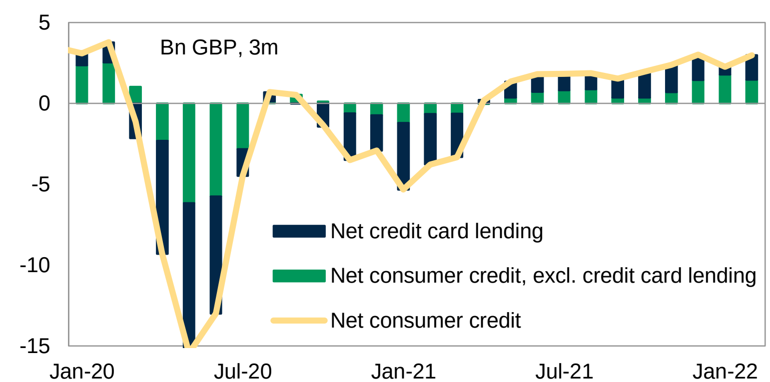
Sources: BoE, Crédit Agricole SA / ECO

Retail sales still relatively strong



Sources: ONS, Crédit Agricole SA / ECO

Consumers are borrowing to consume

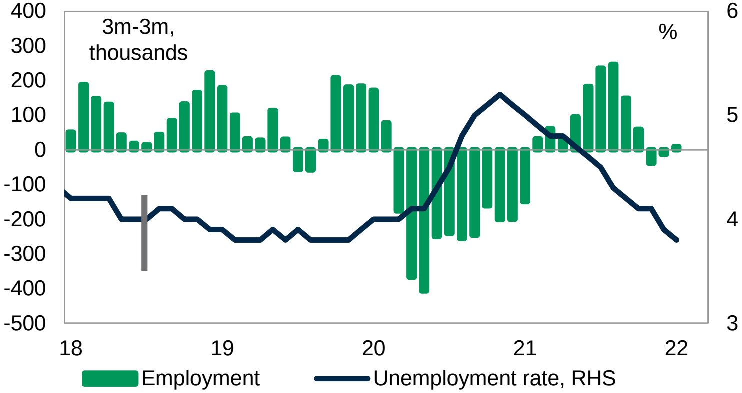


Sources: ONS, Crédit Agricole SA / ECO

RECENT ECONOMIC TRENDS

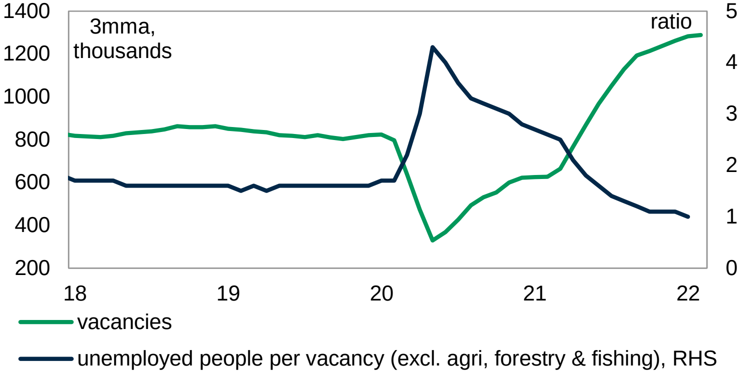
THE LABOUR MARKET REMAINS EXTREMELY TIGHT

Unemployment has returned to pre-crisis levels but employment is weakening



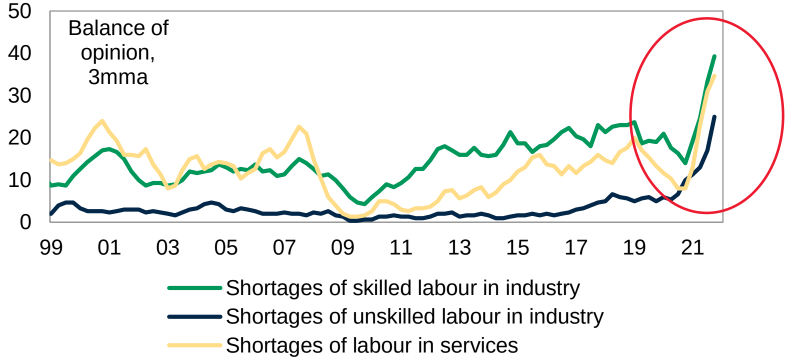
Sources: ONS, Crédit Agricole SA / ECO

The number of vacancies is slowing down slightly



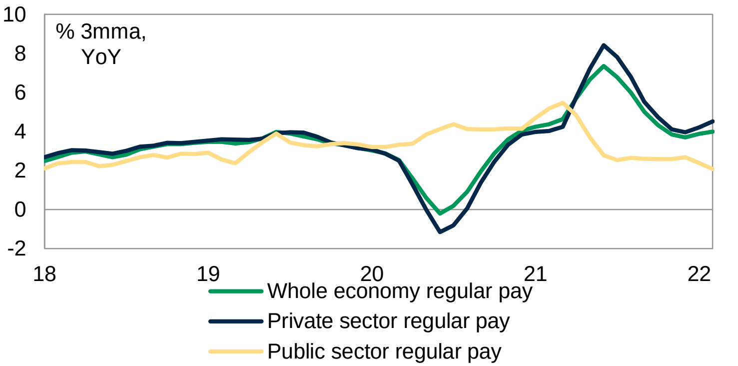
Sources: ONS, Crédit Agricole SA / ECO

Labour scarcity



Sources: CBI, Crédit Agricole SA / ECO

Wage growth is picking up again in the private sector



Sources: ONS, Crédit Agricole SA / ECO

CONTENTS

OUTLINE OF OUR SCENARIO

SHARP SLOWDOWN AND DOWNSIDE RISKS

Rising living costs will have a severe impact on household consumption. We expect real disposable income to fall by 3.5% on average this year (peaking at -4% YoY in Q3) owing to increased inflation and fiscal tightening and a correction in risky financial assets. This magnitude of decline in real income would normally lead to a dip in household consumption and an economic slowdown, but the savings buffer built up during the pandemic should enable household consumption to resist in aggregate terms at close to but slightly above zero. On average, household consumption is expected to grow by 4.9% in 2022 and 1.5% in 2023 after 6.2% in 2021, remaining the main contributor to GDP growth.

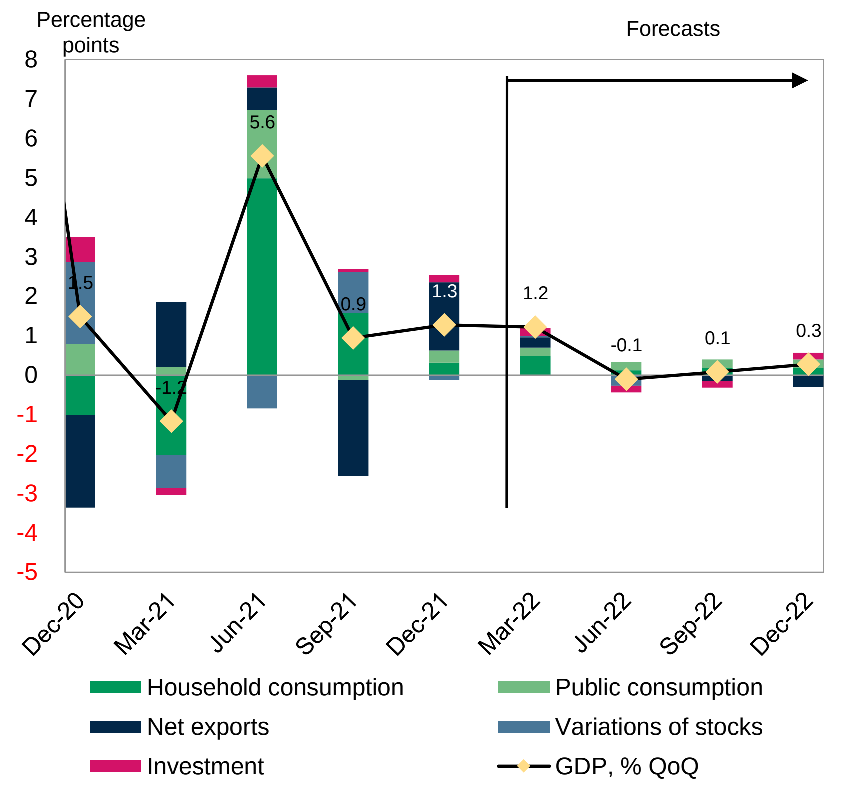
Investment is expected to contract again. Negatively impacted by rising uncertainties, increasing production costs, tighter financial conditions, shortages of labour and materials, and slowing domestic and global demand, business investment will remain far lower than before the crisis. We expect a slowdown in gross fixed capital investment in 2022 and 2023.

Distortions in activity due to the Queen Elisabeth's Platinum Jubilee in June. The additional bank holiday created for the Jubilee celebrations will likely weigh heavily on growth in Q2. In June 2002 and 2012, which also had an extra Bank Holiday, GDP fell 2.2% MoM and 1.7% MoM respectively.

Restrictive policy mix. The BoE will continue to normalise monetary policy, with two additional rate hikes expected for this year, in May and August. Fiscal policy will continue to be tightened.

A recession is possible. The war in Ukraine is a major source of uncertainty and could have greater impact than expected. The worsening of shortages and disruptions in production chains could affect the industrial and construction sectors more than expected. The tightening of monetary policies by central banks could lead to an unintended tightening of financial conditions and a sharper contraction in demand.

Contributions to quarterly GDP growth: breakdown by expenditure



Sources: ONS, Crédit Agricole SA / ECO

OUTLINE OF OUR SCENARIO

INFLATION IS EXPECTED TO MOVE ABOVE 8% IN THE COMING MONTHS

Russia's invasion of Ukraine called for further upward revisions to our inflation forecasts given the following considerations:

1. Upward revisions to oil prices. Our oil expert now expects the Brent price to stand at around $110/barrel in June before moderating slightly in the second half of the year and dipping to $100/barrel in first-half 2023. In consequence, we have made an upward revision to inflation on energy-intensive services such as housing and transport.

2. Increases in gas and electricity prices by Ofgem. In addition to the announcement of a 54% increase in gas and electricity price caps for April 2022, a further update is expected in October this year based on market trends in energy prices in the six months to end-August. Our assumption is that price caps will be increased by 20% in October.

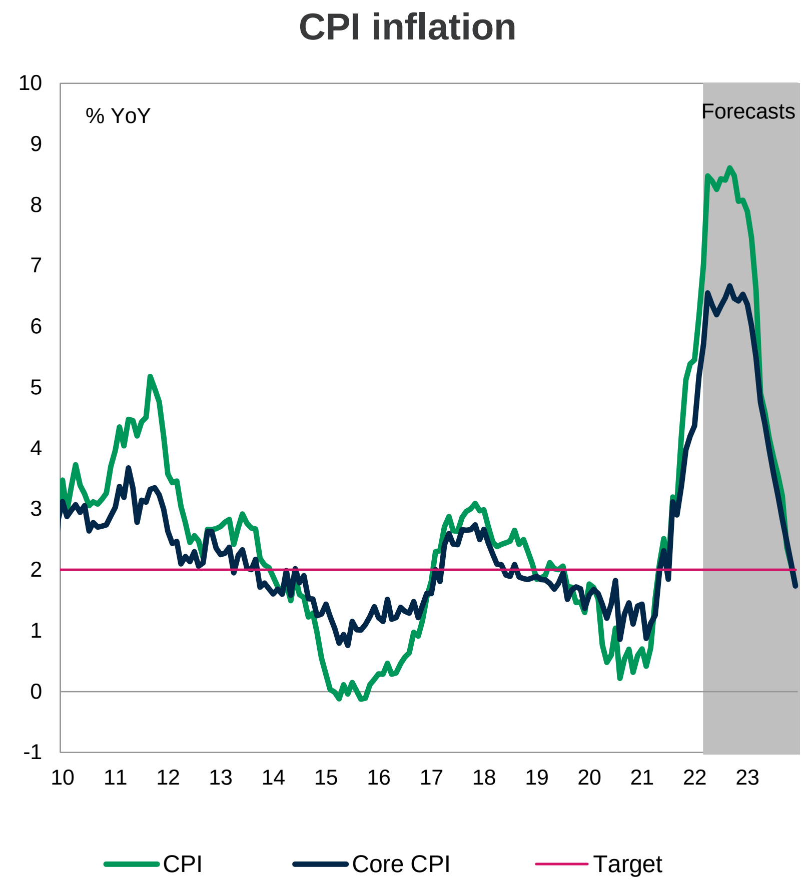
3. Higher inflation in industrial goods and food products. Russia's invasion of Ukraine has also led to a surge in non-energy commodities prices, particularly those of metals and agricultural commodities. Tensions in supply chains and transport disruptions have also worsened.

4. Strong core inflation due to domestic price pressures in the context of a tight UK labour market. Core inflation on a monthly basis has significantly exceeded its historical average in recent months, by 0.3 to 0.5 percentage points. We expect core inflation to remain abnormally high this year before returning to its historical average in early 2023.

After reaching 7% YoY in March, CPI inflation is expected to increase to 8.5% YoY in April. It is expected to remain close to 8.5% for most of the year, with another peak of 8.6% in the autumn. CPI inflation is expected to be slightly above 8% at the end of the year and core inflation to stand at 6.5% YoY.

We continue to expect inflation to moderate considerably in 2023 as base effects on energy become favourable, production chain tensions normalise, and an expected weakening in demand exerts downward pressure on core inflation. We expect total and core inflation to approach the BoE target in Q423.

Given uncertainties over the war in Ukraine, risks relating to inflationary expectations are trending upward.

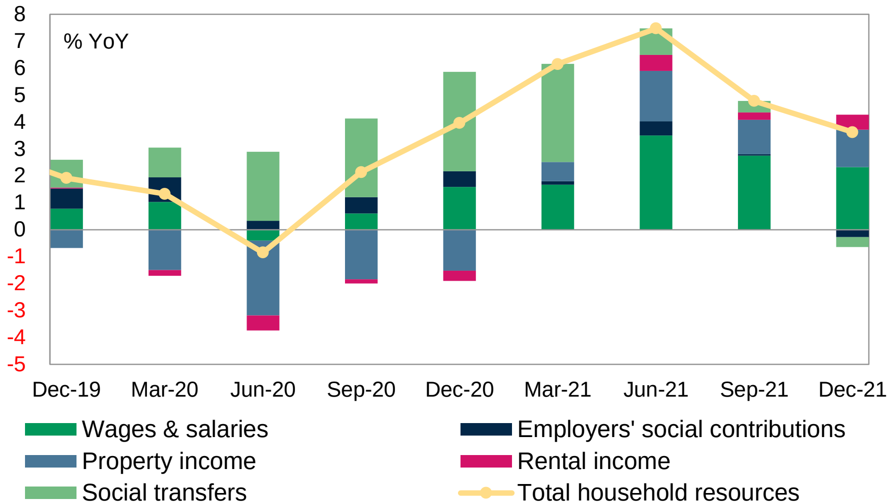


Sources: ONS, Crédit Agricole SA / ECO

OUTLINE OF OUR SCENARIO

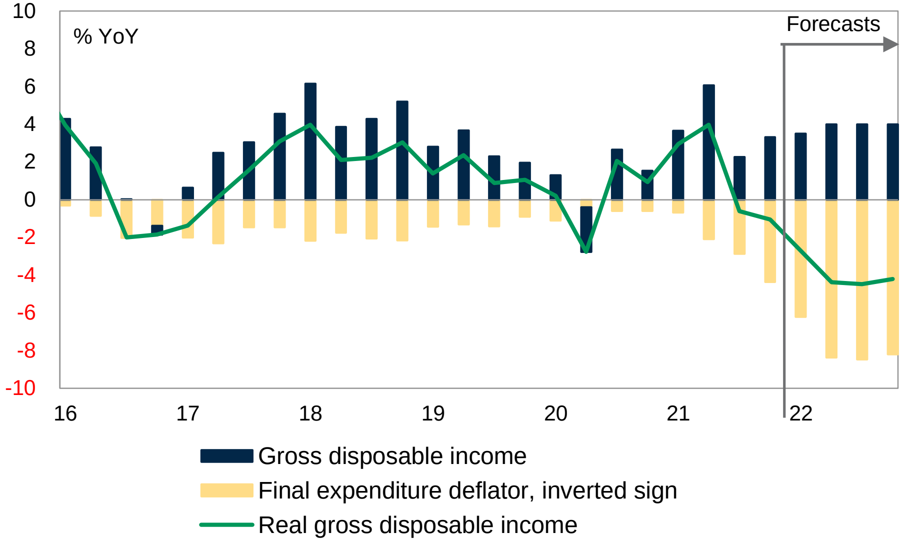
HOUSEHOLD CONSUMPTION UNDER PRESSURE

Household incomes were supported by increases in wages and financial assets



Sources: ONS, Crédit Agricole SA / ECO

The inexorable surge in inflation will lead to a historical decline in purchasing power



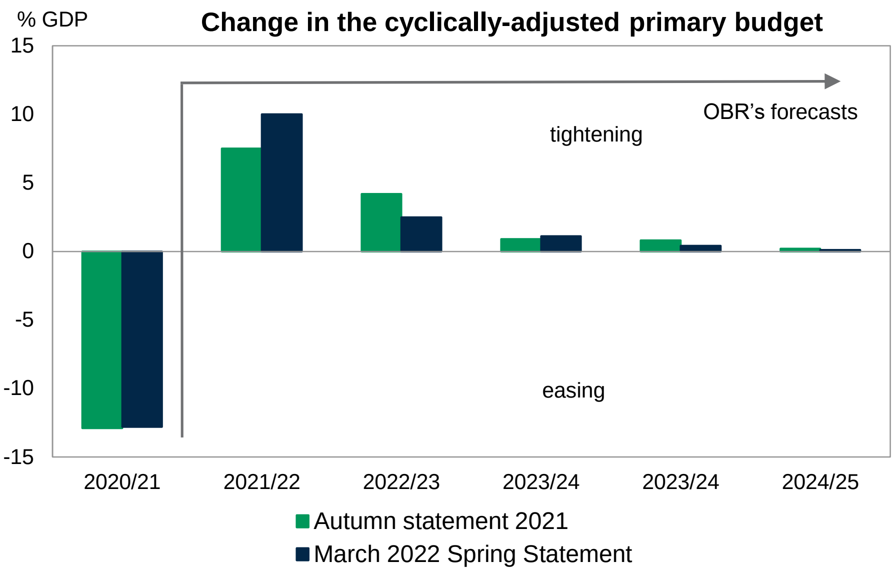
Sources: ONS, Crédit Agricole SA / ECO

Household consumption slowed sharply in Q4 (+0.5% QoQ after +2.6% QoQ in Q3). The Omicron variant of COVID-19 is not the only cause. Government pandemic financial support ended on 30 September: the furlough scheme (Coronavirus Job Retention Scheme) expired, VAT rates were raised from 5.0% to 12.5% in the food and accommodation sectors, and the temporary £20 weekly increase to the Universal Credit was suspended. True, increases in nominal wages have fuelled a relatively strong growth in gross disposable income (+3.3% YoY in Q4) but have failed to offset the erosion in real incomes caused by rising prices. Purchasing power contracted in the last two quarters of the year (-1% YoY in Q4 and -0.6% YoY in Q3) as inflation picked up (+4.4% YoY in Q4 according to the household consumption expenditure deflator). In the coming months, both tax and inflationary pressures will heighten. From April the rate of National Insurance Contributions (NIC) will increase by 1.25%. April will also mark the start of a four-year freeze on income tax and allowance thresholds. The VAT rate for hotels and restaurants will return to the normal rate of 20%. The Autumn Budget and Spending Review in October 2021 announced some welcome compensation measures, including a 6.6% increase in the national living wage from April 2022 and changes to the Universal Credit allowance. It was followed by additional measures in March 2022 aiming to support the households purchasing power. Those included an increase in the threshold for NIC from £9,880 to £12,570 in July 2022 and lower taxes on petrol and fuel. But according to the OBR, these measures are largely insufficient to prevent a strong fall in real disposable income. The savings surplus built up during the crisis (close to GBP250bn) remains the main supporting factor for our household consumption forecasts. We expect a sharp slowdown but no contraction over our forecast horizon.

OUTLINE OF OUR SCENARIO

RESTRICTIVE BUDGETARY POLICY

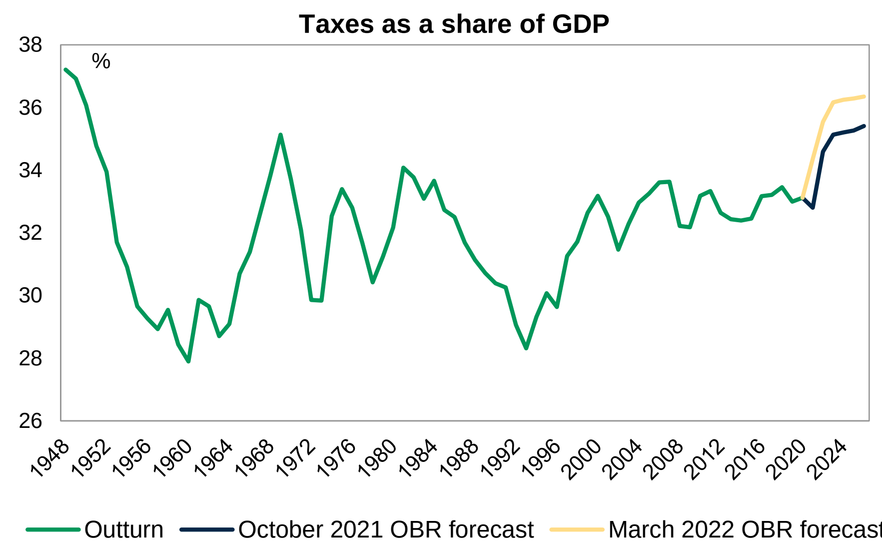
Negative fiscal impulsion



Sources: OBR, Crédit Agricole SA / ECO

In response to the rising cost of living, the UK government introduced fiscal measures in March to support household purchasing power, including a tax support plan. The support measures are possible because public finances were better than expected at the end of the pandemic, tax revenues in particular. The main measures include an immediate five-pence-per-litre reduction in petrol and diesel taxes through March 2023; an increase in the NIC threshold, from £9,880 to £12,570 in July 2022; a 5% to 0% reduction of VAT on energy-saving facilities; the doubling of the Support Fund for low-income households of local authorities; and a one-point decrease (from 20% to 19%) in the basic income tax rate from April 2024.

Rising tax burden



Sources: OBR Economic and Fiscal Outlook March 2022

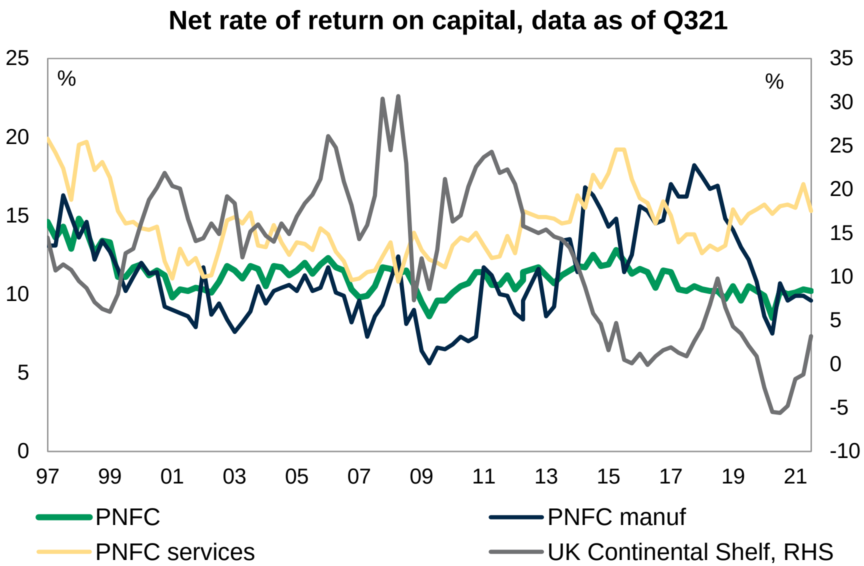
According to the OBR, the government support plan will offset just one-third of the loss in real income this year and cancel only one-sixth of the tax increases introduced by the Chancellor of the Exchequer over the past two years. The tax burden will continue to increase in the coming years as a result of the measures discussed above. According to the OBR, tax revenue as a percentage of GDP will reach its highest level since 1949.

The UK looks set to swiftly complete fiscal consolidation, with its structural primary budget deficit expected to improve from 4% of GDP for the 2021-22 fiscal year (which ended in March 2022) to 0% of GDP for 2023-2024.

OUTLINE OF OUR SCENARIO

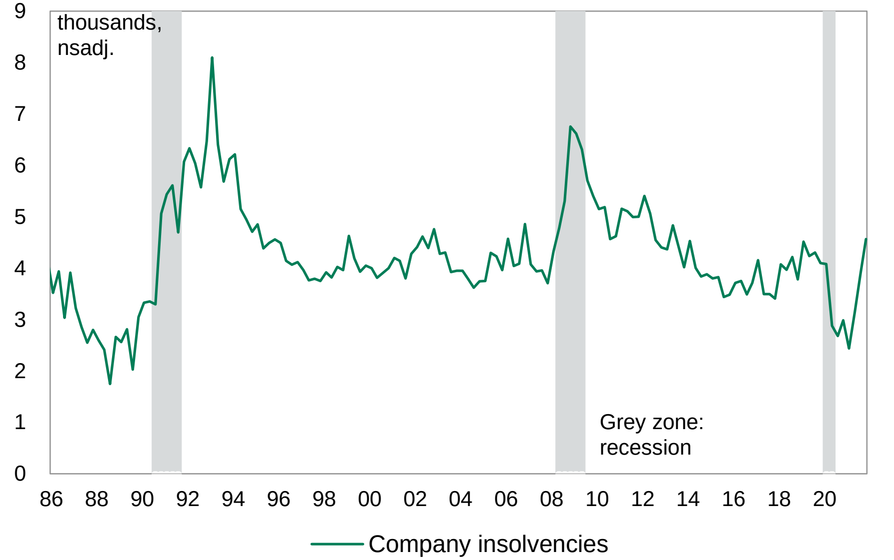
BUSINESS FINANCIAL SITUATION LOOKS HEALTHY OVERALL

NFC profitability is relatively solid



Sources: ONS, Crédit Agricole SA / ECO

Corporate bankruptcies: normalisation after the discontinuation of support measures

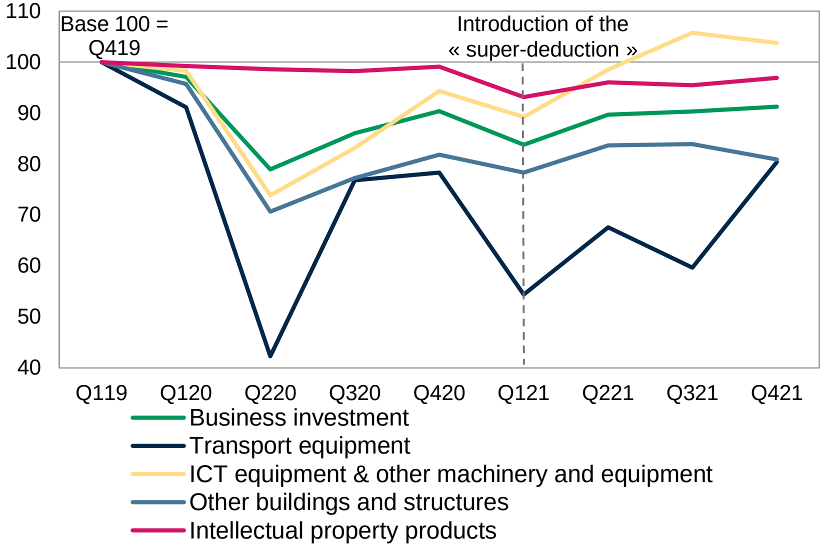


Sources: ONS, Crédit Agricole SA / ECO

Data on the financial health of private companies show no significant deterioration despite the end of public support measures, suggesting that investment should withstand the mounting headwinds. The profitability of NFCs continued to improve gradually in the first three quarters of 2021, returning to Q419 levels on an aggregate basis. This is confirmed by better-than-expected government revenue from corporate tax levies. However, profitability continues to deteriorate in the manufacturing sector. In the coming months, the combination of the expected slowdown in household consumption and the rise in production costs, including wages, will inevitably erode corporate profitability. The number of bankruptcies has increased since the discontinuation of government pandemic support measures. But this is more about catch-up after exceptionally low levels during the pandemic. According to the BoE, the cost of servicing debt remains affordable. The rise in current and future interest rates poses risks for companies, particularly small companies that finance themselves from banks. According to the OBR, the government's "Bounce Back Loans" protect small businesses, which have largely been able to borrow at low fixed rates.

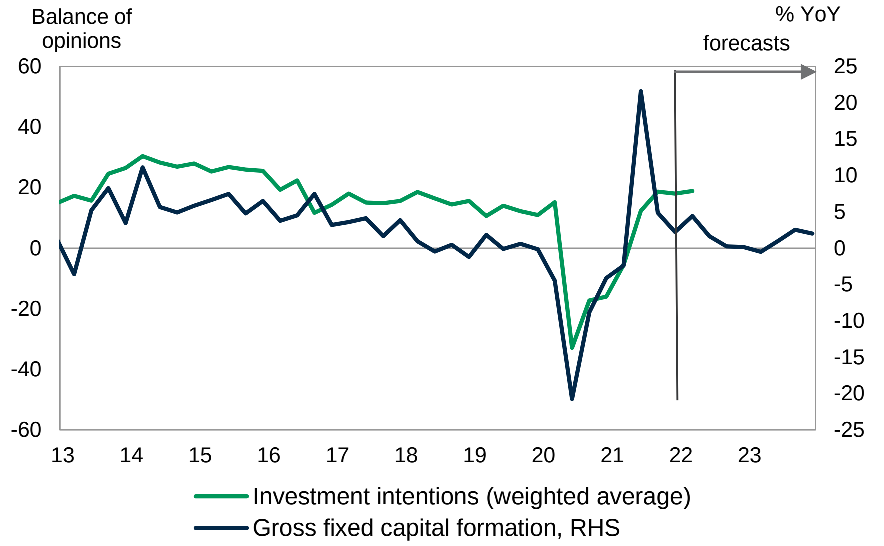
INVESTMENT: SUPPORTING FACTORS AND HEADWINDS

Business investment remains below pre-pandemic levels overall



Sources: ONS, Crédit Agricole SA / ECO

Investment intentions were still elevated in Q122



Sources: BCC, ONS, Crédit Agricole SA / ECO

The war in Ukraine and its attendant uncertainties have followed the pandemic crisis, further deteriorating the investment outlook. Before the war, we were moderately optimistic about the outlook for business investment. The end of the pandemic suggested the possibility of a strong rebound which surveys of investment intentions and business confidence tended to confirm. The government's tax incentive “super-deduction" (a 130% one year capital allowance for plant and machinery assets in place until April 2023) was expected to contribute to this. Moreover, the size of the gap to be closed in relation to pre-crisis levels remains substantial : in Q421 business investment was still nearly 9% below its level at the end of 2019, after a year of quasi-stagnation in 2021. Some sectors, such as transport equipment and other buildings and structures, even lag behind their pre-crisis levels by almost 20%.

In Q122, investment intention surveys stabilised at relatively high levels. The BoE's first business survey, conducted in March, on the impact of the Russian invasion of Ukraine also shows reassuring results. While almost half (49%) of businesses expect the war to have a negative impact on their turnover, a significant proportion (45%) do not expect any impact and only 11% of businesses see it as a major source of uncertainty, while 37% put it in the top three sources of uncertainty. The overall level of uncertainty has increased only modestly, as both Covid uncertainty and Brexit uncertainty fell sharply in March. We expect a slowdown in business investment in 2022 but not a sharp fall, followed by a small recovery in 2023, against the backdrop of an end of the “super deduction” and an increase in the main rate of corporation tax in April 2023 (from 19% to 25%).

OUTLINE OF OUR SCENARIO

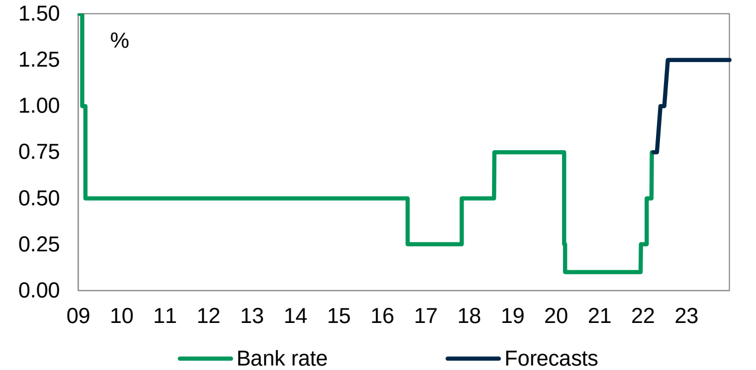
MONETARY POLICY: TWO MORE RATE HIKES THIS YEAR

Since December 2021, the BoE has raised its key policy rate three times, by a total of 65 basis points. The Bank rate reached 0.75% in March, back to its pre-pandemic level. We expect the tightening to continue in the short term as inflation accelerates sharply. **We maintain our scenario of two additional hikes, one in May and one in August, of 25 basis points each. The policy rate will thus reach 1.25% in August this year.** Our expectations are well below market expectations of a policy rate above 2% by 2023, which the BoE sees as too hawkish. We believe that the uncertainty from the war is likely to make the BoE more cautious, as it did in March, and its action more uncertain against the backdrop of an anticipated slowdown in demand. The BoE expects a historic shock to real household incomes, exacerbated by the Russian invasion of Ukraine, a shock that monetary policy cannot prevent.

BoE's dovish turn. The voting results of the March Monetary Policy Committee (MPC) meeting showed that one MPC member voted against the 25 basis points rate hike, preferring the status quo. The BoE also changed its forward guidance: some further modest tightening is possible in the coming months rather than likely, which could mean that the March hike was the last. Nevertheless, the labour market is not showing signs of deterioration, contrary to what the BoE had anticipated. Wage growth remains above its pre-pandemic pace and the BoE expects strong wage increases this year (of close to 5% based on its Agents survey). Against this backdrop of tight labour market conditions and strong upward revisions to both headline and core inflation forecasts, the BoE is expected to continue to tighten monetary policy in the near term in order to anchor inflation expectations.

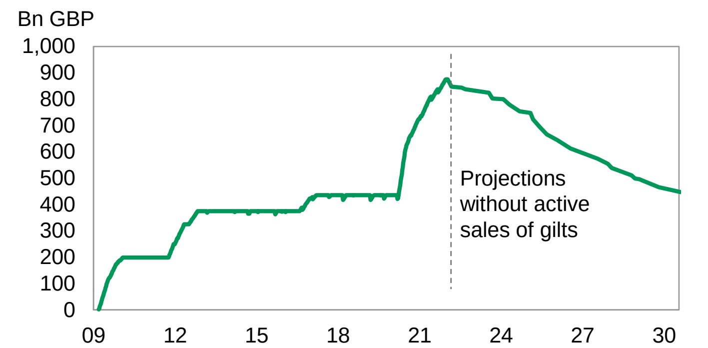
Quantitative tightening. The BoE has decided to start reducing its stock of purchased securities by no longer reinvesting maturing gilts. As such, in March, 28 bn maturing gilts were not reinvested. By the end of the year, only 3 bn of gilts will mature in July and 6 bn in September, followed by 18 bn during 2023. According to its forward guidance, the BoE could start actively selling gilts once Bank rate has reached 1% (in May according to our forecasts) and "if economic conditions require it". However, the BoE has already indicated that the policy rate will remain its preferred tightening tool. If growth slows down as expected and the BoE stops tightening in August, as we expect, a decision to actively sell gilts is likely to be avoided.

UK key policy rate



Sources: Thomson Reuters, Crédit Agricole SA / ECO

BoE's stock of *gilts*



Sources: BoE, Crédit Agricole SA / ECO

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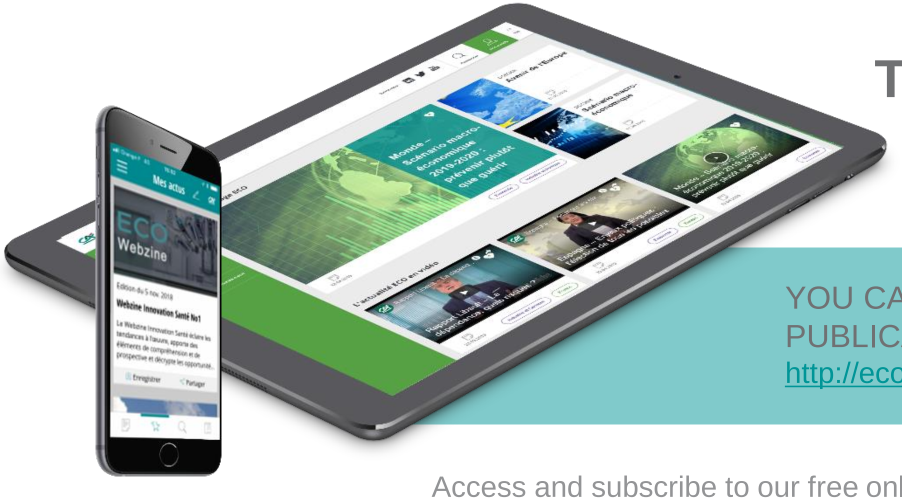

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