UNITED KINGDOM
2023-2024 SCENARIO

PERSISTENT INFLATION AND RESILIENT DEMAND DEFY THE BOE

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WORKING EVERY DAY IN YOUR INTEREST AND FOR SOCIETY

GROUP ECONOMIC RESEARCH

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SUMMARY

CRISES THAT FIT TOGETHER LIKE RUSSIAN DOLLS

The UK economy escaped recession over the winter with growth just above zero. Real GDP grew by 0.1% QoQ in both Q422 and Q123. **Household consumption has held up better than expected, with quarterly growth averaging zero over the last 12 months, despite the crisis in purchasing power** (real disposable household income fell by 1.5% last year, despite the energy price cap introduced in October 2022 and extended until the end of June). It has been supported by state aid for the most vulnerable, a more buoyant labour market than expected, and the significant savings surplus accumulated during the pandemic.

Against a backdrop of uncertainty, increasing production costs and rising interest rates, **investment also provided a positive surprise**. Business investment rose by 3.3% in Q123, following annual average growth of over 10% in 2022. While government support measures in the form of capital allowances may have played a role, this is more a case of a post-pandemic catch-up effect because, unlike in other advanced countries, business investment in the UK has just returned to its pre-crisis level. **Even if disaster has been averted, the economy has remained stagnant over the past year, with average growth limited to 0.1% per quarter.** The real GDP data for April did not deviate from this virtually 'flat' trend: GDP grew by 0.2%, following a fall of 0.3% in March.

The resilience of domestic demand has contributed to sticky inflation, with core inflation in particular having surprisingly risen significantly over the last four months. Energy prices are contributing less and less to headline inflation, while food inflation also seems to have peaked in March. **The dissipation of the energy crisis suggests that the purchasing power crisis will soon be resolved, and consumer confidence is improving.** In fact, when we use the monthly data for wages and salaries and the CPIH price index (consumer price index including owner-occupier housing costs), the fall in real wages and salaries appears to be nearing an end. Nominal wage and salary growth reached 7.5% YoY in April, very slightly below CPIH inflation (7.8%), suggesting a fall in real wages and salaries of just 0.3%, whereas they were losing up to 3.5% exactly one year ago. **In the short term, the labour market will remain very tight and conducive to sustained, albeit moderating, wage growth, while inflation is expected to remain on a downward trend.** Nonetheless, the labour market has begun to soften. The fall in the number of vacancies and the decline in inactivity attest to this, while the REC/KPMG surveys suggest a slight contraction in employment over the next six months.

As if to prevent British households from rejoicing too much, the rebound in wage growth has caused interest rate expectations to soar (to almost 6% for mid-2024, close to the peak reached last September following Liz Truss's "mini-budget"), **raising mortgage rates in their wake.** Bad news for the 3.3m households (12% of the total number of households) whose fixed-rate mortgages expire over the next year and who will have to refinance at higher rates. According to the Resolution Foundation, the increase in debt servicing for indebted households is expected to be higher (estimated at around 3% of annual income) than during the periods of rising interest rates in the 1980s and 1990s, mainly because of the higher overall indebtedness of households. So, like Russian dolls, each shock facing households is followed by another one that was previously hidden. The crisis in purchasing power has been followed by a shock to interest rates, which could turn into a crisis in the property market, posing risks to financial stability.

SUMMARY

DOMESTIC INFLATIONARY PRESSURES PERSIST, OBLIGING THE BOE TO CONTINUE ITS MONETARY POLICY TIGHTENING

The BoE changed its tone substantially in May. Taking a more hawkish stance, the central bank made a significant upwards revision to its forecasts on growth (now ruling out the recession from the central scenario) and inflation (with a target reached only at the beginning of 2025, from mid-2024 previously forecast) and revised its unemployment rate forecasts downwards (to under 4% until the end of next year). **The consumer price inflation rate has continued to surprise on the upside since February**, mainly due to rebounds in underlying components (and food products). Relatively resilient domestic demand and persistently tight labour market conditions led the BoE to put its foot down in June with a 50bp rate hike. **This move took the key rate to 5%, the highest since February 2008.**

As external shocks gradually dissipate, UK inflation is increasingly influenced by domestic factors. **Second-tier effects are clearly at play**. There have been significant wage renegotiations in some sectors in response to the increase in inflation. Meanwhile, companies are passing on the rise in production costs to final prices without too much difficulty, since domestic demand is holding up better than expected to the dip in purchasing power and to monetary tightening. The effects of the latter will also be felt less immediately than in past tightening episodes owing to the reduced share of variable-rate property loans.

Leading indicators suggest that wage growth will weaken in the coming months. In addition, short-term household inflation expectations have fallen (to 3.5% in May, the lowest since November 2022, from 3.9% in February, according to the latest IPSOS/BoE survey), which also argues for fewer wage demands in the future. Labour market conditions may remain favourable, but the number of unfilled jobs has decreased in the last several months and the employment participation rate has rebounded – signs that imbalances are beginning to ease, albeit at a snail's pace. **Core inflation, then, appears to have peaked. Though it seems increasingly likely that the peak will look more like a plateau for the rest of the year.** In terms of external pressure, producer costs fell sharply and output price inflation for outgoings decreased in May (to 2.9% from 5.2% in April). But here again, the margin rebuilding trend that appears to be afoot could delay any moderation in the pace of consumer price inflation.

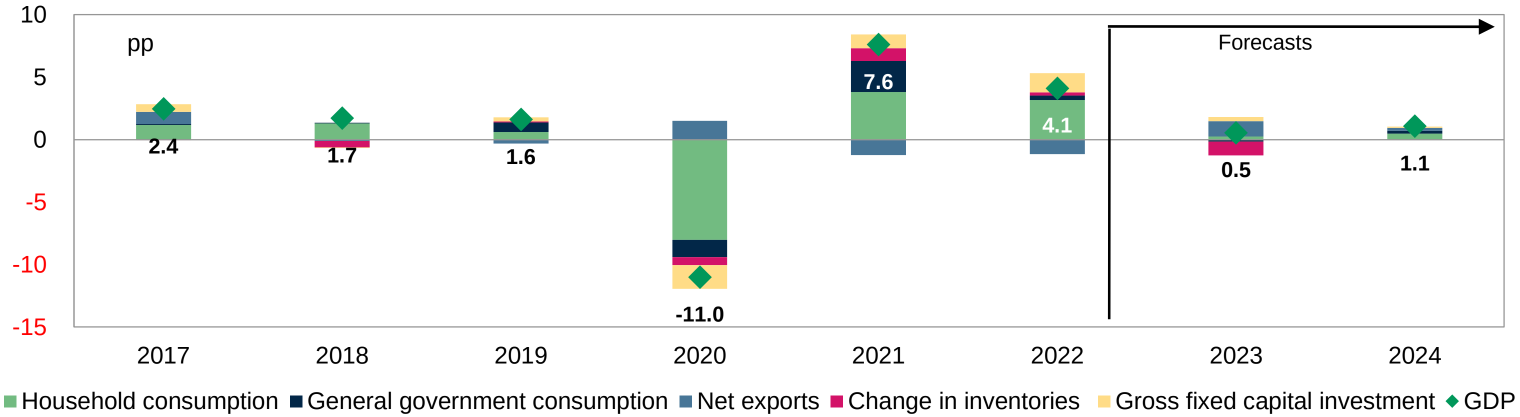
If this outlook proves correct (i.e. with core inflation falling only slightly or not at all in the short term), **the BoE is expected to pursue monetary tightening** in the coming months, no doubt with a fresh rate hike in August. **We expect a 50bp rate hike in August, followed by a further 25bp in September, bringing the key rate to 5.75%.**

On a more positive note, the rise in interest rates should affect fewer households than in the past, as the proportion of households with a mortgage fell sharply during the 2000s, to less than 30%, compared with almost 40% in 1989. Barring an accident, the impact of the rise in interest rates on household consumption therefore looks set to be less significant than in the 1990s (household consumption contracted by 0.4% between Q3 1990 and Q3 1991). It will also likely be more spread out over time, with the majority of loans now at fixed rates (maturing in five years or less) rather than variable rates.

SUMMARY

FORECASTS

Contributions to annual GDP growth



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

United Kingdom	2022	2023	2024	2022				2023				2024			
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP (%)	4.1	0.5	1.1	0.5	0.1	-0.1	0.1	0.1	0.3	0.2	0.1	0.3	0.3	0.4	0.4
household consumption	5.3	0.4	0.8	1.2	0.2	-0.3	0.2	0.0	0.3	0.1	0.1	0.2	0.2	0.3	0.3
public consumption	1.8	-0.7	1.3	-0.4	-1.7	0.8	0.5	-1.8	0.5	0.5	0.5	0.2	0.2	0.2	0.2
investment	8.6	1.9	0.5	8.6	-2.3	1.1	0.3	2.4	-0.3	-0.5	-1.0	0.5	0.5	1.0	1.0
change in inventories*	0.3	-1.1	0.0	1.2	-0.2	-2.1	1.0	-0.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
net exports*	-1.2	1.2	0.2	-4.8	1.3	4.2	-0.4	-1.0	0.1	0.1	0.1	0.1	0.1	0.0	0.0
Unemployment rate (ILO)	3.7	3.8	4.1	3.8	3.6	3.7	3.5	3.6	3.7	3.9	4.1	4.1	4.1	4.1	4.1
Inflation (CPI, YoY%)	9.1	7.8	4.1	6.2	9.2	10.0	10.7	10.2	8.5	7.1	5.5	5.3	4.1	3.9	3.1
Core CPI (YoY%)	5.9	6.7	4.8	5.1	6.0	6.3	6.4	6.1	7.0	7.0	6.8	6.6	5.1	4.3	3.5
Current account (% GDP)	-3.8	-1.8	-1.7	-8.3	-4.6	-2.0	-0.4	-1.7	-	-	-	-	-	-	-
General gov. balance, % GDP	-5.4	-4.5	-3.0	-	-	-	-	-	-	-	-	-	-	-	-
Public debt % GDP	100.7	101.2	100.1	-	-	-	-	-	-	-	-	-	-	-	-
Bank rate**	3.5	5.75	3.25	0.75	1.25	2.25	3.50	4.25	5.00	5.75	5.75	5.75	5.75	5.50	5.25

** Contributions to GDP growth*

*** End of period*

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

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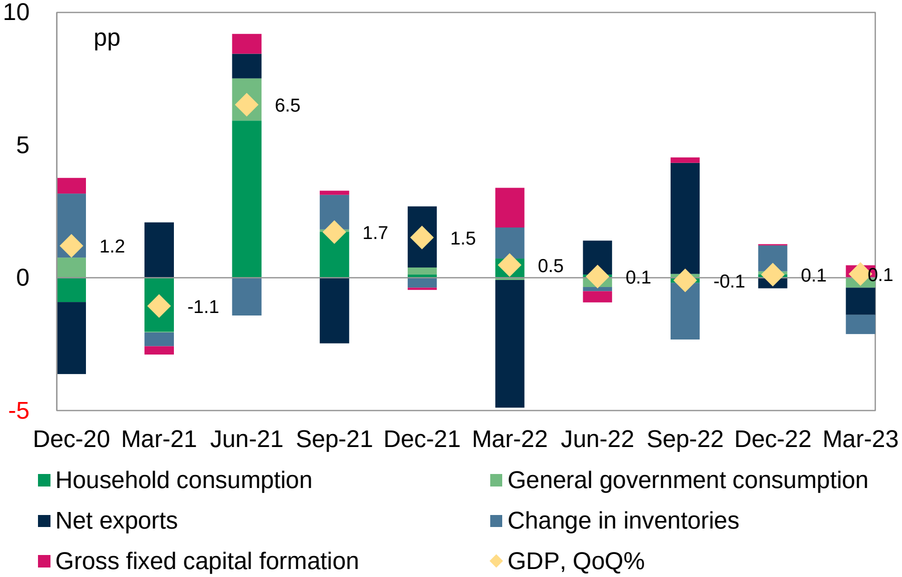
RECENT ECONOMIC TRENDS

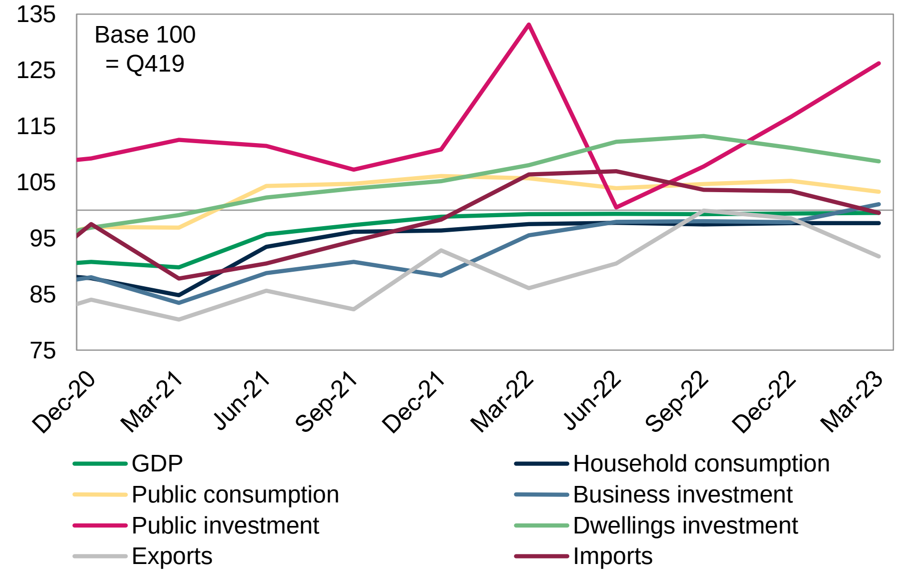
GROWTH BARELY POSITIVE

Quarterly GDP growth: breakdown in terms of expenditure



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

Private consumption and productive investment remain depressed



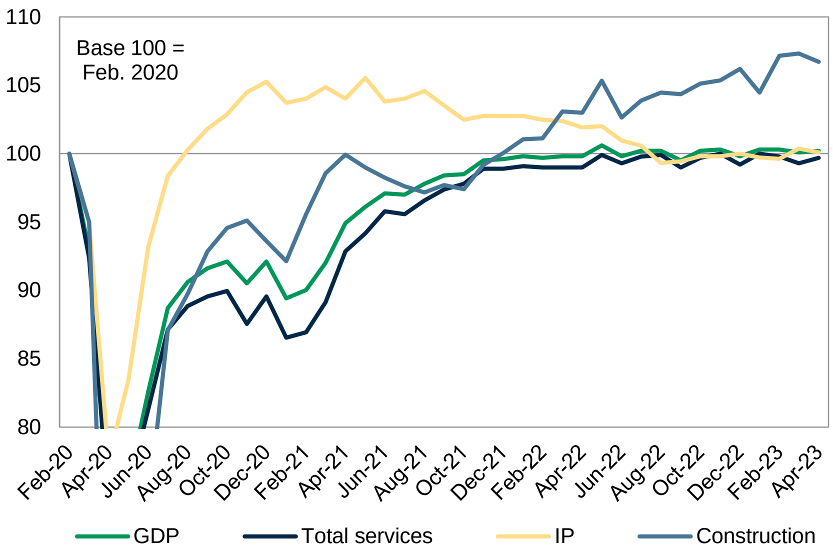
Sources: ONS, Crédit Agricole S.A./ECO

The UK economy dodged a recession over the winter with growth just above zero. Real GDP grew by 0.1% QoQ in both Q422 and Q123. **This resulted from relatively strong growth in domestic demand, with foreign trade proving a hindrance.** Domestic demand increased 0.5% in Q422 and 1.2% in Q123 (according to the second GDP estimate published by the ONS on 30 June). While public spending (particularly investment) remained a solid growth driver, private consumption also surprised on the upside. Despite the continued decline in real incomes, household consumption growth came out at zero for the quarter, after a 0.2% increase in the previous quarter. This resilience was underpinned by the strength of the labour market, as well as the government's financial support. Government aid to protect households from the energy crisis likely enabled the poorest households to get through the winter without eating away at their budgets. Investment also surprised on the upside, with business investment rebounding by a solid 3.3% QoQ in Q1, after a 0.2% QoQ contraction in the previous quarter, and finally recovering its pre-COVID level. **For the second consecutive quarter, foreign trade contributed negatively to growth** (-1pp, after -0.4pp in Q422), with exports (-6.9% QoQ) down more than imports (-3.8% QoQ). Inventory changes also weighed on the growth rate, contributing -0.7 points. Overall **in Q1, GDP was 0.5% lower than before COVID (Q4 2019), the worst performance by a G7 country since the pandemic.** This post-pandemic underperformance can be attributed primarily to household consumption and exports, respectively 2.3% and 8.3% lower than in Q4 2019.

RECENT ECONOMIC TRENDS

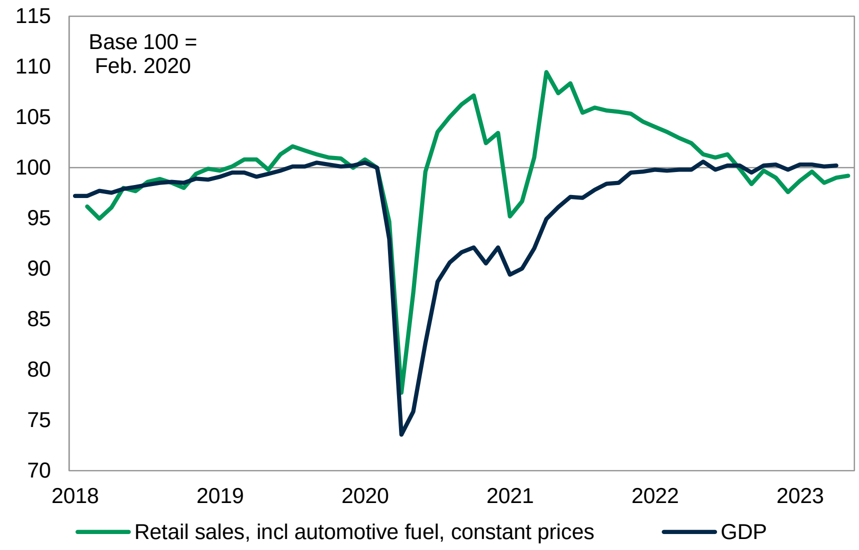
A SLUGGISH START TO Q2

GDP: monthly data and main sectors



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

Retail sales and GDP



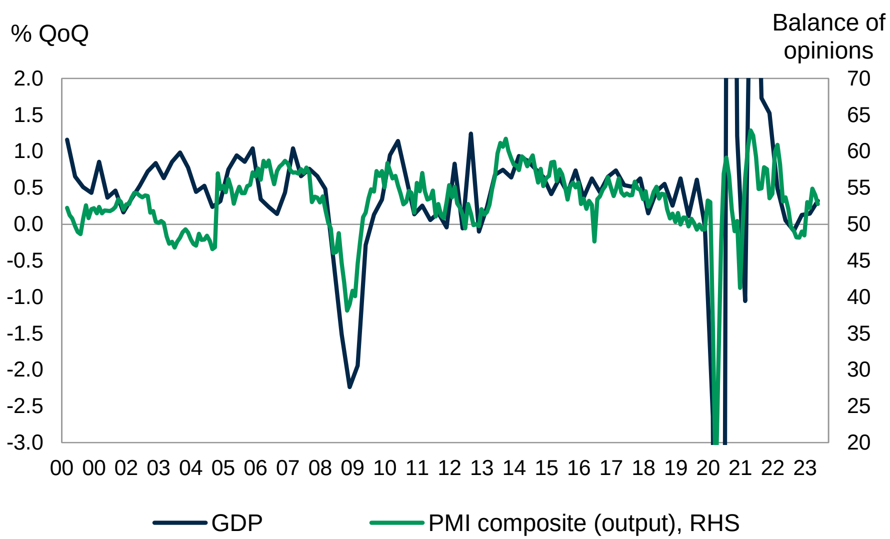
Sources: ONS, Crédit Agricole S.A./ECO

This flatline trend is confirmed by the first hard data for Q223. GDP grew by just 0.2% MoM in April, after a 0.3% decline in March. The performance was fuelled by services, which rebounded 0.3% MoM (after losing 0.5% MoM in March), while industry and construction posted declines (-0.3% MoM and -0.6% MoM, respectively). **The growth carry-over effect for the quarter amounts to zero.** The largest contributions to the rebound in services came from the retail and wholesale and information and communication sectors. Economic activity in sectors with physical contact with customers (retail, restaurants, hotels, travel and transport, culture and leisure) rebounded 1% MoM. Nevertheless, **11 out of 13 sectors remain below their February 2020 level** (-8.7% on average). Impacted by the purchasing power crisis, they have also made little progress over the past year, suggesting that the recovery is likely to remain incomplete. Retail sales by volume grew by just 0.5% MoM in April and 0.2% MoM in May, adversely affected by the additional bank holiday for the coronation of Charles III on 8 May, the decline in in-store sales being more than offset by online sales and petrol sales.

RECENT ECONOMIC TRENDS

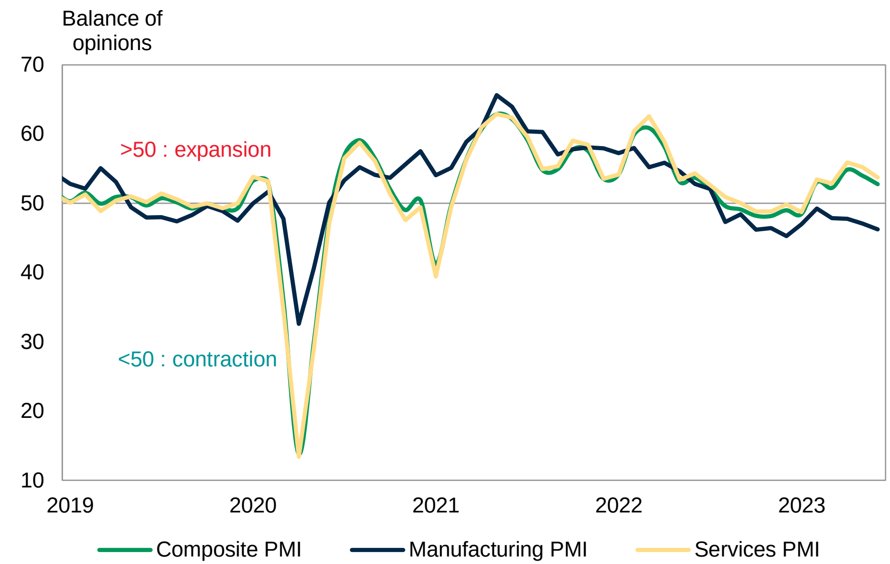
THE BUSINESS CLIMATE HAS WEAKENED SINCE APRIL

PMIs point to a near 0.3% increase in GDP in Q2



Sources: ONS, S&P Global PMI, CIPS, Crédit Agricole S.A./ECO

Loss of momentum in Q2 and a slowdown in services



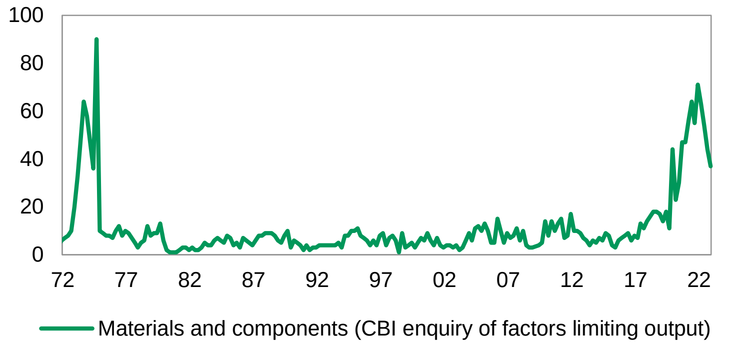
Sources: S&P Global PMI, CIPS, Crédit Agricole S.A./ECO

The composite PMI stayed in expansion territory for the fifth consecutive month, suggesting a moderate rate of growth in economic activity. However, the pace of growth has dipped from its recent peak in April and is below its long-term rate, a trend that appears to be linked to a slowdown in demand. In industry, demand is contracting at its fastest pace since January. In services too, companies are reporting a moderation in consumer spending, with a decline in orders in construction and real estate, while financial services are proving robust. Activity growth in services remains relatively strong but has also slowed down since April. In industry, production volumes have dipped in the last 12 months. **The dichotomy between industry and services is also reflected in price movements.** The prices of outgoing products are falling in industry for the first time in more than seven years, while in services they continue to rise at a steady pace. Companies are reporting an increase in wage costs, which they are passing on to sales prices. In addition, job creations increased at their fastest pace since September on strong recruitment activity in services.

RECENT ECONOMIC TRENDS

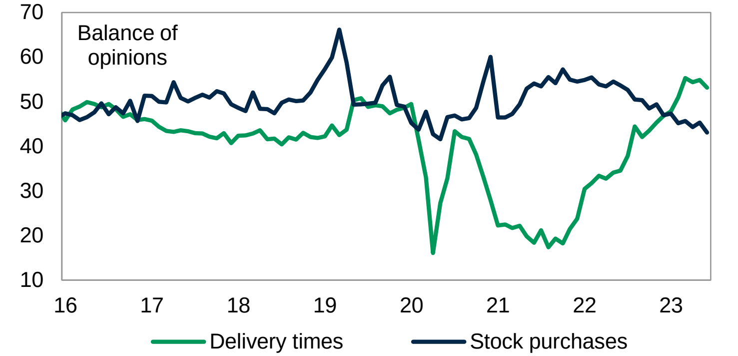
SUPPLY CONSTRAINTS EASE AND PRICE PRESSURES DROP

Shortages of materials are falling from high levels



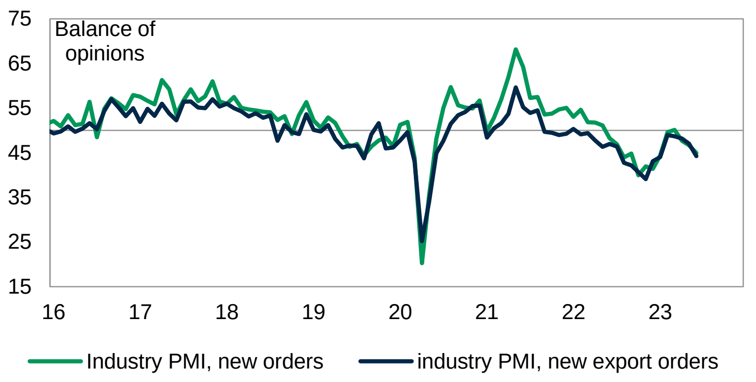
Sources: CBI, Crédit Agricole S.A./ECO

PMIs show an improvement in delivery times and a decline in purchasing stocks



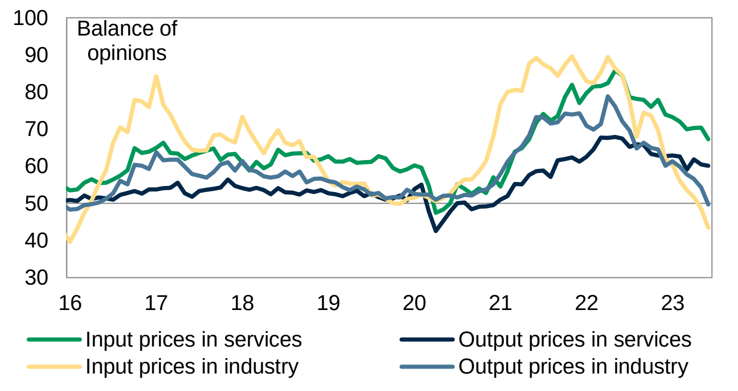
Sources: S&P Global PMI, CIPS-PMI industry, Crédit Agricole S.A./ECO

Decline in demand accelerates in industry



Sources: S&P Global PMI, CIPS, Crédit Agricole S.A./ECO

Prices are finally falling in industry and increasing more slowly in services

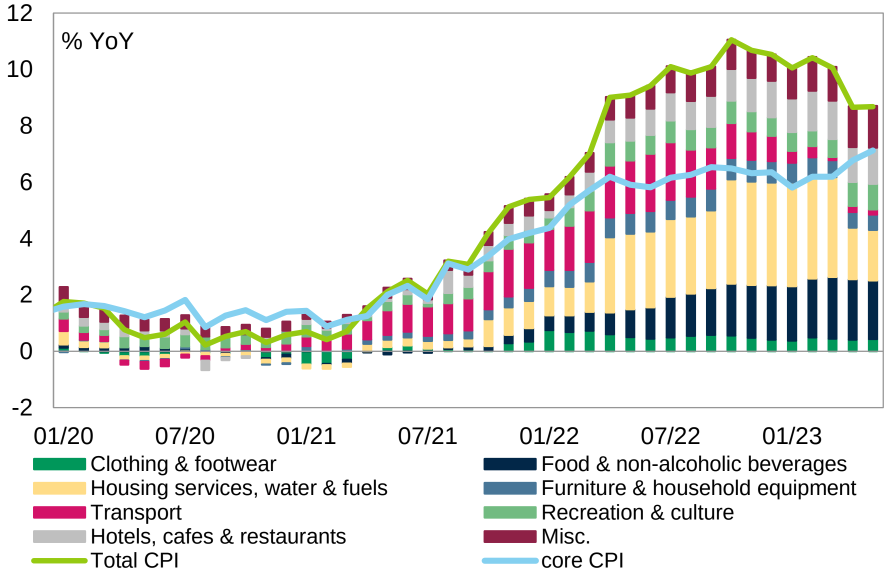


Sources: S&P Global PMI, CIPS, Crédit Agricole S.A./ECO

RECENT ECONOMIC TRENDS

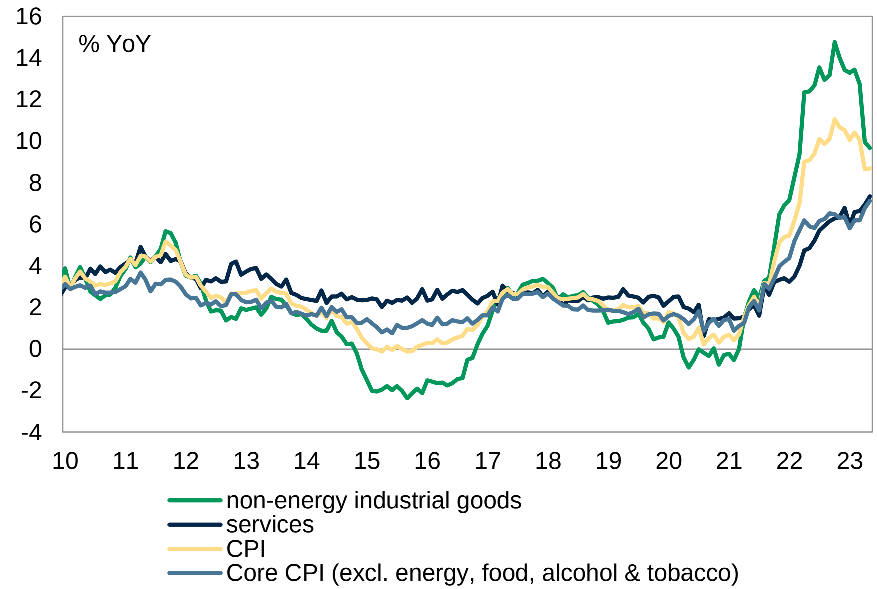
INFLATION IS FALLING TOO SLOWLY

CPI inflation held steady in May at 8.7%



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

Core inflation rose unexpectedly

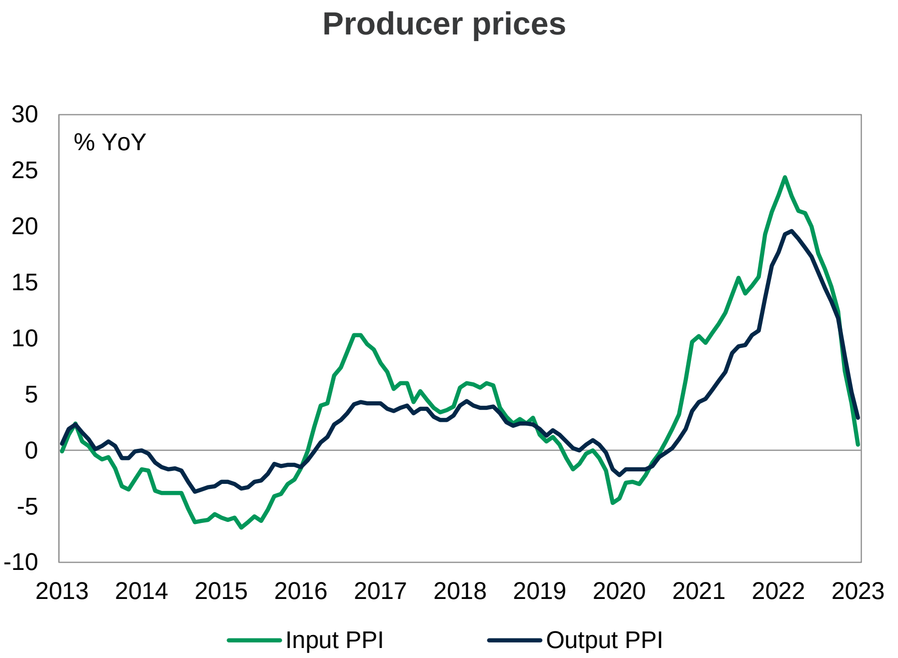


Sources: ONS, Crédit Agricole S.A./ECO

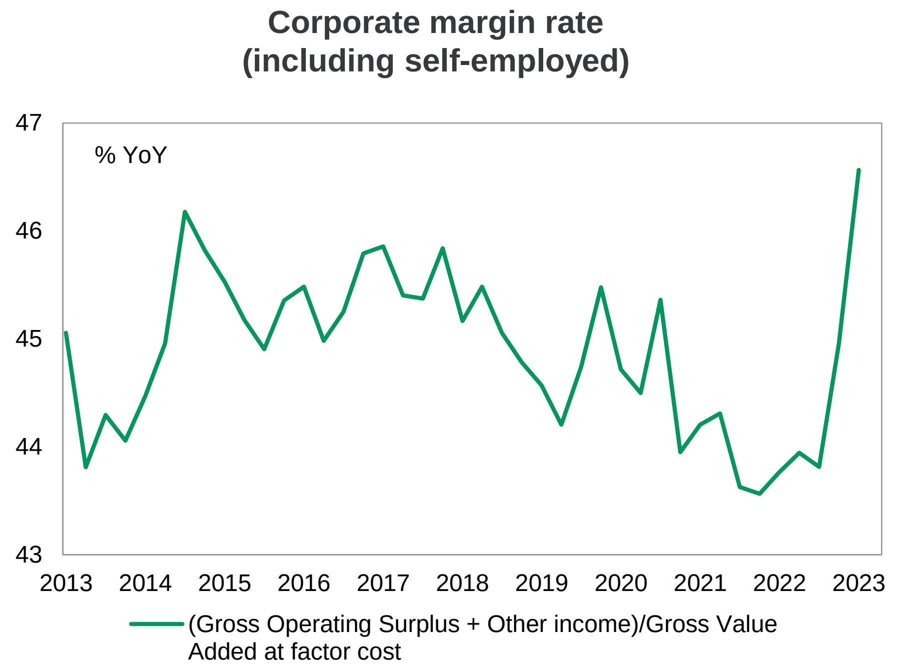
The CPI inflation rate surprised on the upside for the fourth consecutive month. After falling from 10.4% in February to 10.1% in March and 8.7% in April, it remained stable in May at 8.7%, 0.3 percentage points above BoE expectations. Inflation is falling as a result of lower energy prices and favourable base effects (the Ofgem's energy price cap having increased sharply in April 2022). But **inflation is higher than expected owing to the underlying components of the price index**. At 7.1%, core inflation (CPI excluding energy, food, alcohol and tobacco) increased for the second consecutive month in May, after 6.8% in April and 6.2% in March. CPI services inflation came out at 7.4% after 6.9% in April, 0.5 percentage points above the BoE forecast, partly due to temporary factors (including a sharp increase in vehicle excise duty rates). **Inflation in industrial goods prices reached 6.8%, the highest since September 2022.** Food and soft drink price inflation reached 19.1% in March – the highest since data began to be compiled in 1997 – before falling to 19% in April and 18.3% in May. This component of the CPI is the largest contributor to the annual inflation rate, at 2.1pp, followed by housing services (gas, electricity, water and fuel oil) at 1.8pp.

RECENT ECONOMIC TRENDS

PRICES: EXTERNAL FACTORS VS INTERNAL INFLATIONARY PRESSURES



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



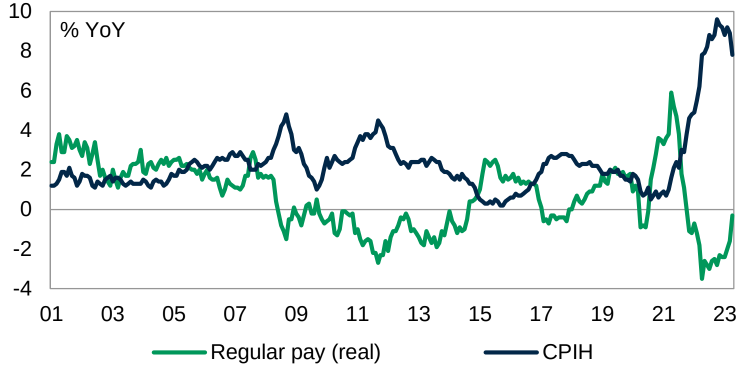
Sources: ONS, Crédit Agricole S.A./ECO

Inflation is higher in the UK than in other advanced countries (6.1% for the Eurozone HICP, 2.7% for the US HICP). In addition, core inflation has been accelerating since February, suggesting an even greater likelihood that elevated inflation will persist once external shocks have dissipated. **Inflation is being fuelled by domestic factors, including the relative resilience of demand and a tight labour market.** Second-tier effects are at play. Wages have been increased substantially in some sectors in response to the increase in inflation, while businesses are passing the rise in production costs onto final prices with no great difficulty since domestic demand is holding up better than expected to lower purchasing power and to monetary tightening. **Corporate margins have rebounded sharply, aided in part by the government cap on energy prices.** External pressures from raw material costs are easing and bottlenecks in global value chains have returned to normal, as have shipping costs. Output PPI inflation continued to fall sharply in May (to 2.9% from 5.2% in April), suggesting an imminent drop in consumer price inflation for goods. But here again, the move to rebuild corporate margins could delay any moderation in the pace of inflation.

RECENT ECONOMIC TRENDS

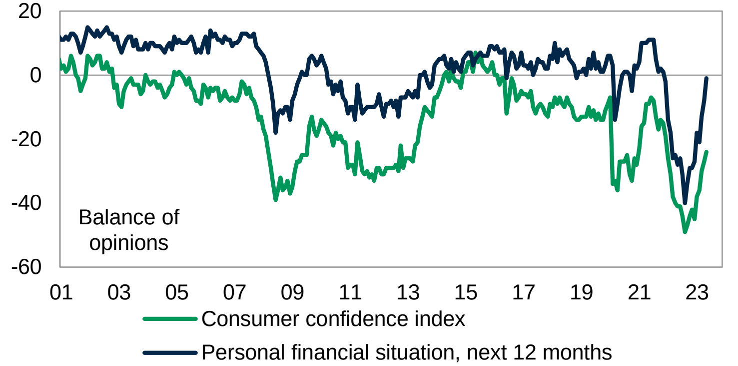
HOUSEHOLD CONSUMPTION: WAGES CATCH UP WITH INFLATION AND CONFIDENCE RECOVERS

The squeeze in real wages has fallen (-0.3% YoY in April)



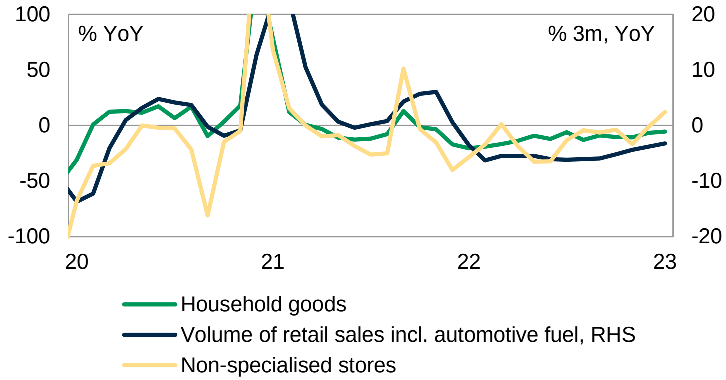
Source: ONS (monthly data as of April 2023)

Households are less pessimistic



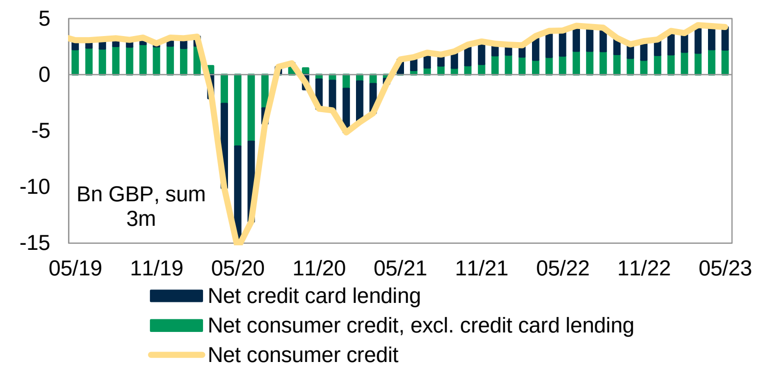
Source: ONS, Crédit Agricole S.A./ECO

Retail sales picked up slightly in May



Source: ONS, Crédit Agricole S.A./ECO

Consumer credit remains strong

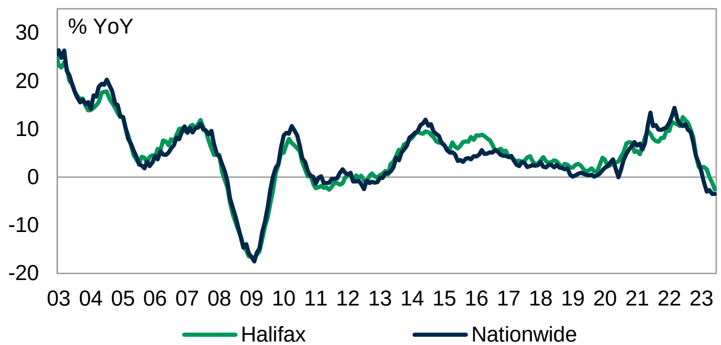


Source: BoE, Crédit Agricole S.A./ECO

RECENT ECONOMIC TRENDS

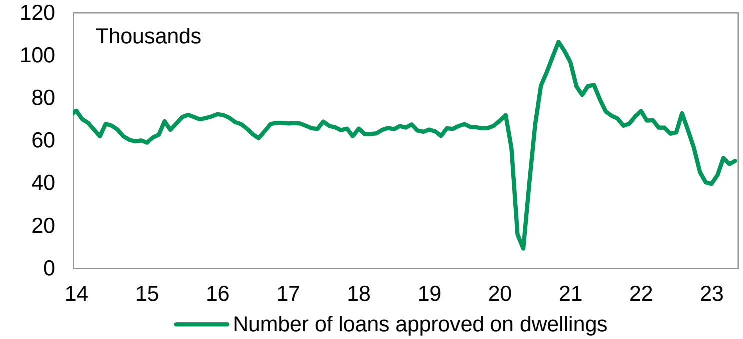
THE REAL ESTATE MARKET CONTINUES TO CORRECT DOWNWARD

House prices down around 4% between Q322 and Q223



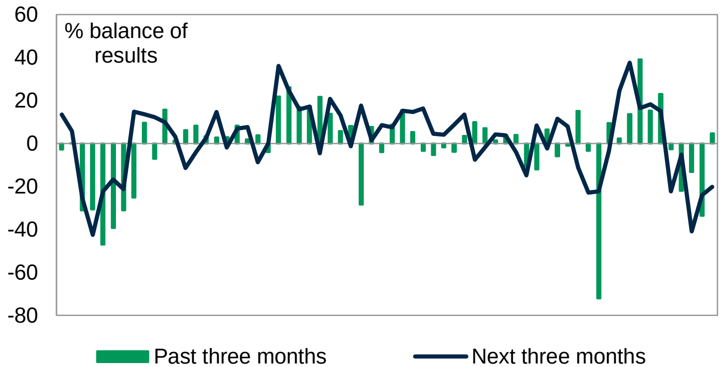
Sources: Halifax, Nationwide, Crédit Agricole S.A./ECO

Mortgage demand 30% lower than before COVID



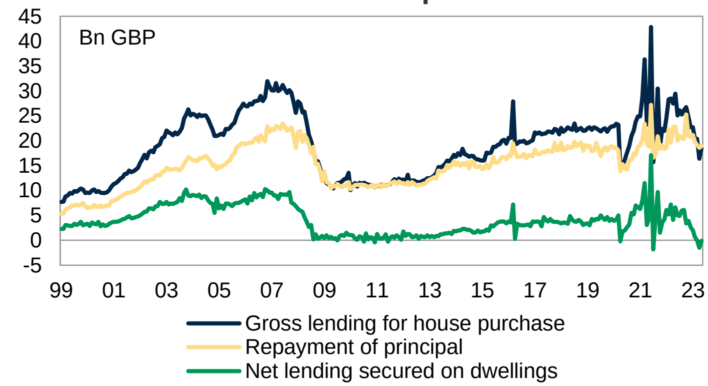
Sources: BoE, Crédit Agricole S.A./ECO

Mortgage availability expected to continue to contract in the next three months



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

Monthly mortgage flows: contraction in net production



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

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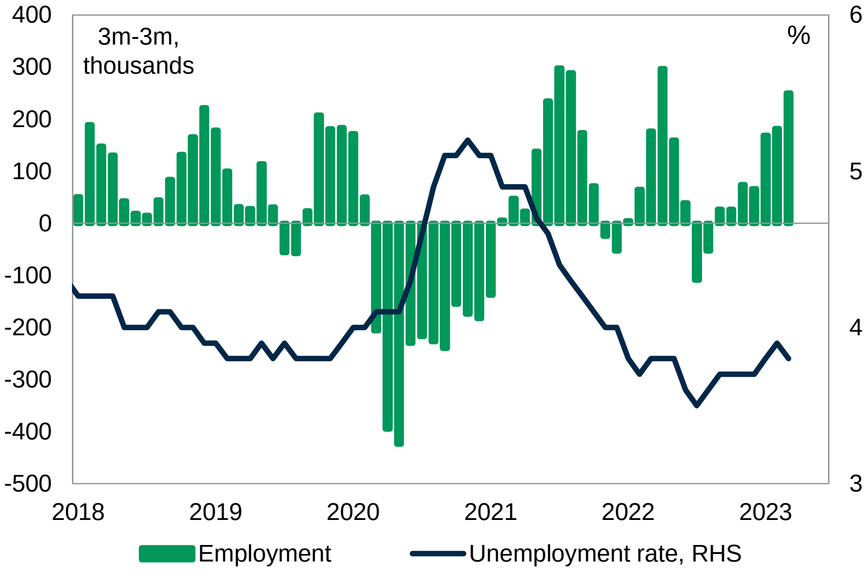
FOCUS: LABOUR MARKET SITUATION

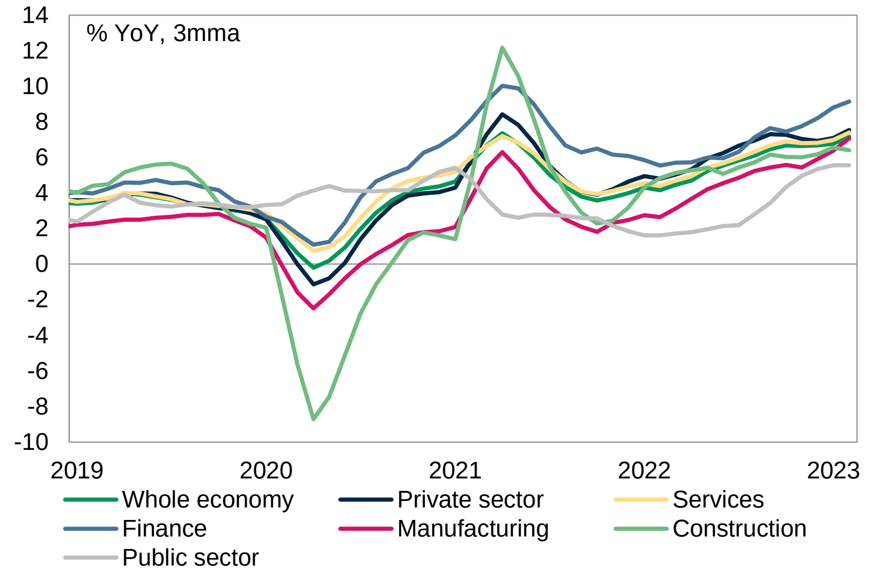
THE LABOUR MARKET REMAINS TIGHT

Unemployment is low and employment creations sustained



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

Wage growth accelerated to 7.5% in the private sector in April



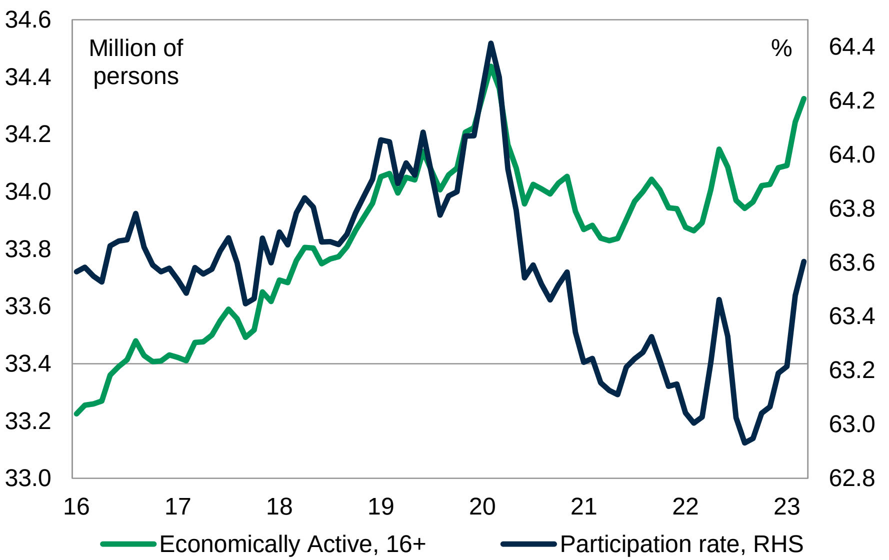
Sources: ONS, Crédit Agricole S.A./ECO

Labour market momentum proved stronger than expected given weak economic activity, with 250,000 net job creations over the three months to the end of April compared with the three months to end of January. Employment has only just returned to its pre-COVID level of more than 33 million people. The unemployment rate increased by just 0.1pp to 3.8% in the last three months and is still below its pre-COVID level of 4%. Unemployment continues to be underpinned by high levels of economic inactivity, though the latter is beginning to decline. **More than half a million people left the working population between early 2020 and mid-2022** (a figure that has since fallen by almost half) pushing down the employment rate and allowing the unemployment rate to remain low. Labour shortages are still high, which favours the bargaining power of employees and job seekers as they seek to neutralise the purchasing power crisis. **Private-sector wage growth hit a record high (excluding the post-pandemic peak resulting from base effects), standing at 7.6% in April after 7.1% in March.** Wages are accelerating the most in the highest-paid sectors, namely finance and business services (9.2%) and manufacturing (7%). They are relatively stable in low-skilled sectors, such as mass retail, hotels and restaurants.

FOCUS: LABOUR MARKET SITUATION

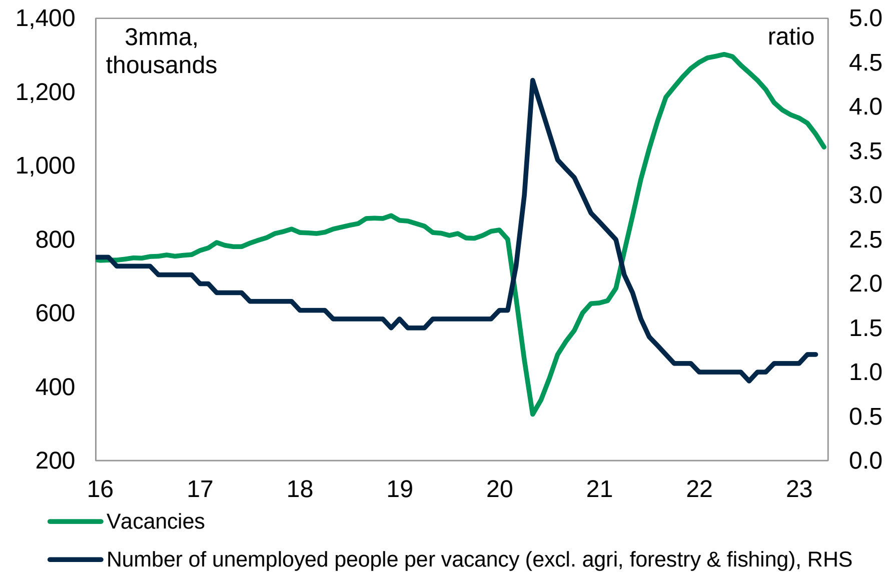
LABOUR MARKET TIGHTNESS BEGINS TO REDUCE

Activity is recovering but remains below its pre-COVID peak



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

The number of vacancies is falling but remains above 1 million



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

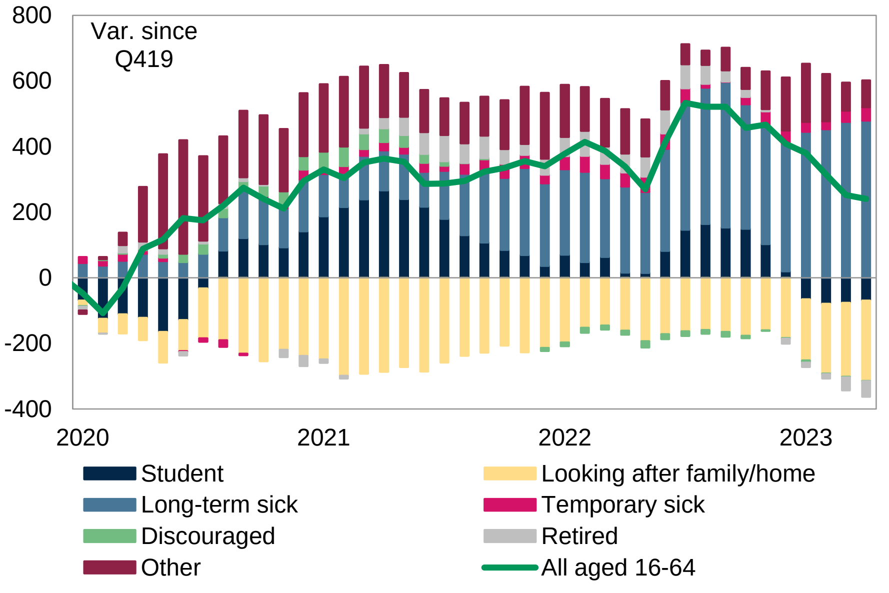
The labour market has begun to ease, as evidenced by the decline in the number of vacant positions for the eleventh consecutive month and the rebound in employment participation (to 63.7% in April, from 63% in October 2022). But this movement is still in a nascent phase. **Excess demand of labour continues to generate upward pressure on wages.** Growth in average weekly earnings (bonuses included) reached 6.5% over the three months to the end of April, compared with 6.1% in March. Wage growth alone rose to 7.2% from 6.8% in March.

An exceptional factor has contributed to this increase: the 9.7% rise in the national living wage in April to £10.42, which concerned 7% of the country's workers. The BoE nevertheless reported that wage growth was 0.5pp higher than expected. **The leading indicators of future wage growth, KPMG/REC and Bank's Agents surveys, point to a deceleration in the second half of the year.** These indicators show a continued improvement in labour supply in May and recruitment difficulties, although these remain more difficult than usual.

FOCUS: LABOUR MARKET SITUATION

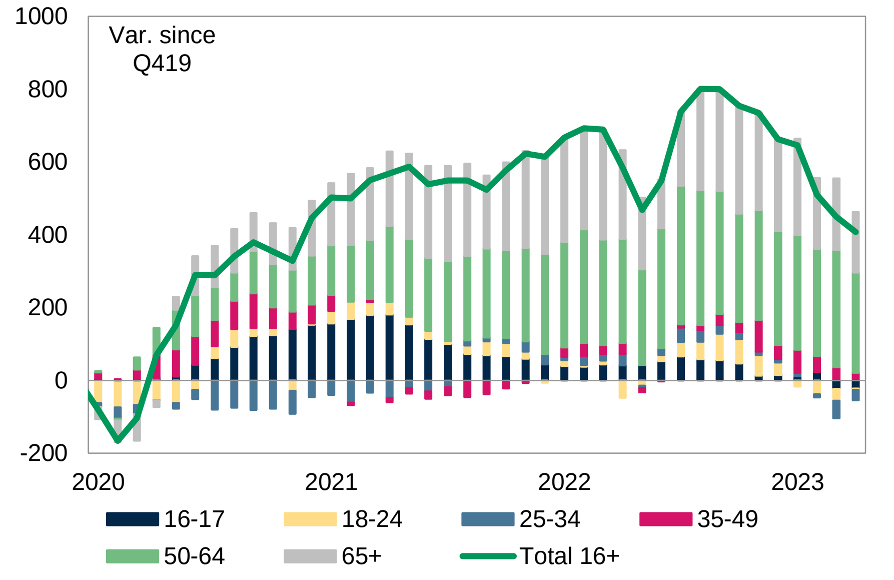
THE NORMALISATION OF ECONOMIC INACTIVITY WILL BE SLOW AND LIKELY INCOMPLETE

Inactivity and reasons for inactivity: more long-term health problems



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

Inactivity by age group: the role of 50- to 64-year-olds



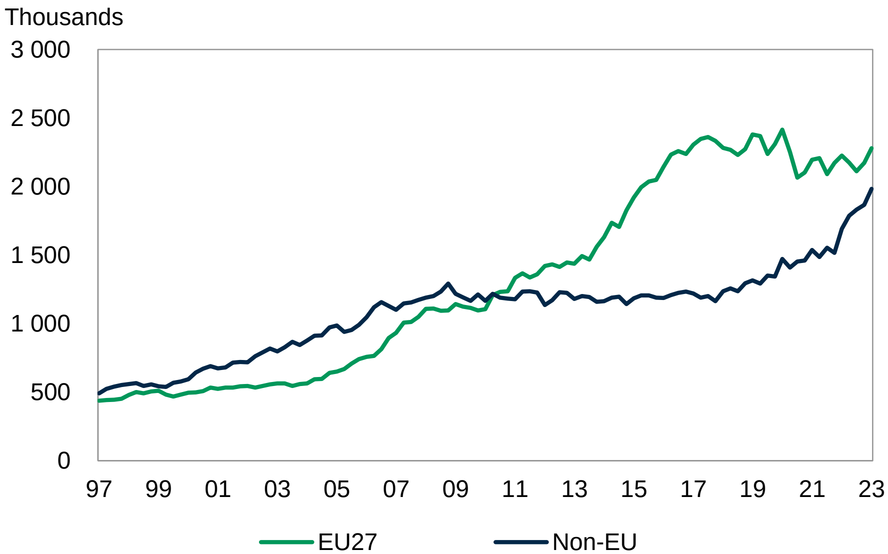
Sources: ONS, Crédit Agricole S.A./ECO

According to ONS data, the main reason for the increase in inactivity since the pandemic is a significant deterioration in the health of the economically inactive. The number of economically inactive people saying that they were suffering from a long-term illness increased by over 400,000 between Q419 and Q322. Their number has continued to grow, reaching a record of over 2.5 million in Q123. Including short-term patients, the number of economically inactive people suffering from sickness is 520,000 higher than in Q419. The increase in the economically inactive population owing to health reasons has mainly affected people between the ages of 50 and 64. **However, the increase in the number of economically inactive people saying they have not integrated labour market owing to health problems does not necessarily mean that this is the reason why they left the labour market.** In an October 2022 study, the Institute for Financial Studies shows that people who are economically inactive owing to health reasons (mainly the 50-64 age group) have not been economically active for the last five years at least. As such, they cannot explain the increase in economic inactivity during the pandemic. **The increase can be attributed to other reasons, including retirements.** But poor health is indeed becoming more widespread among those who have remained unemployed for a long time.

FOCUS: LABOUR MARKET SITUATION

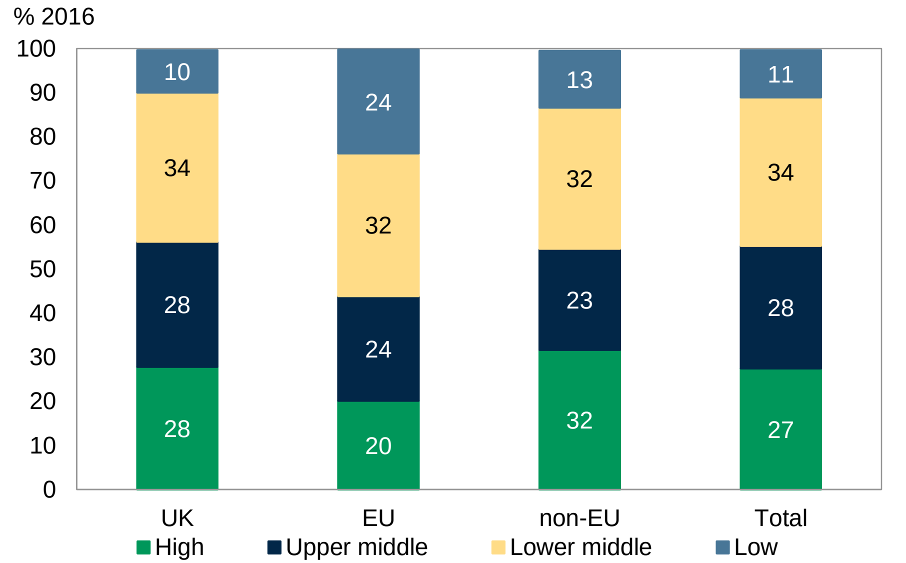
LABOUR MARKET TENSIONS COMPOUNDED BY THE DECLINE IN EMPLOYMENT OF EUROPEAN NATIONALS

Number of foreign nationals working in the United Kingdom



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

Breakdown of employment by qualification level



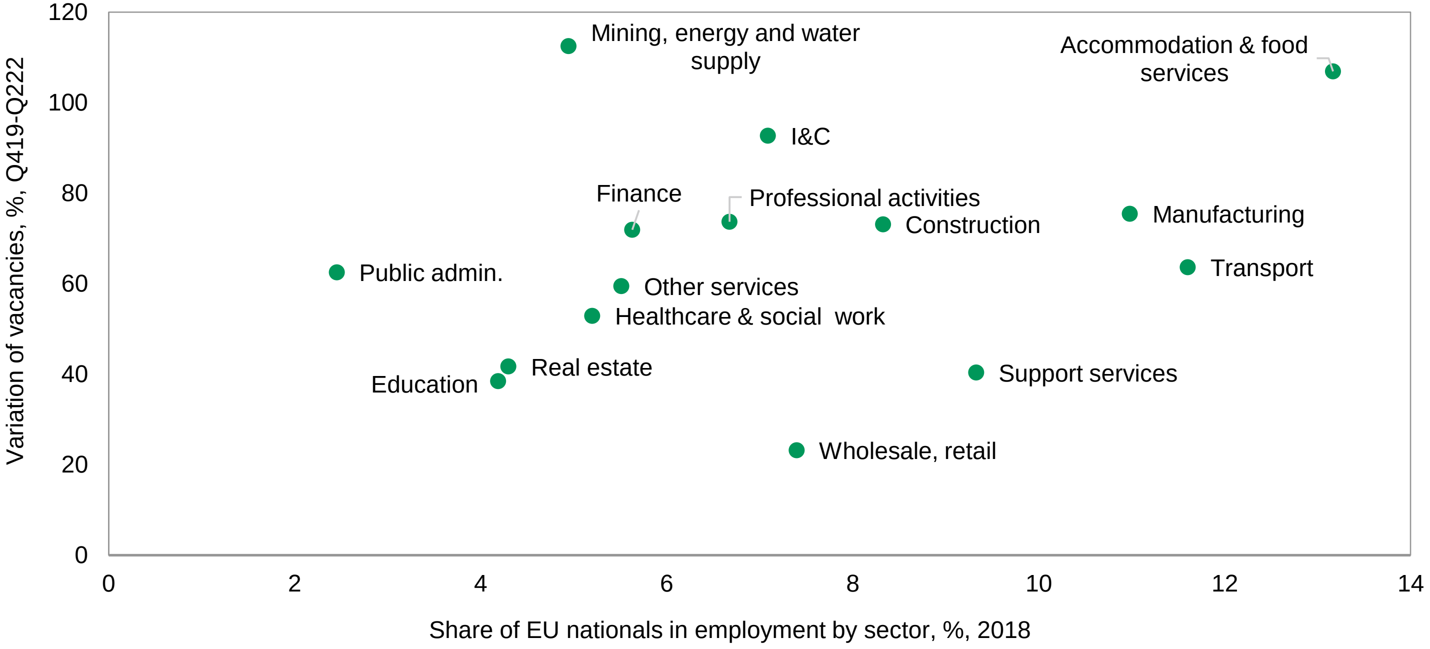
Source: ONS, Crédit Agricole S.A./ECO

While the shortage of supply in the labour market can be explained in part by the low participation rate, Brexit is often cited as the main driver of labour shortages. Yet total immigration flows have risen sharply since the referendum, a considerable increase in non-European immigration more than offsetting the decrease in European immigration. **According to the latest ONS data, total net immigration is estimated at 606,000 in 2022, up from 329,000 in 2015.** Non-European nationals account for the vast majority of people arriving on British soil (925,000), followed distantly by European citizens (151,000). Their occupations are different, however, with the vast majority of Europeans coming to the UK to work, while most non-Europeans do so for reasons of education or asylum. Europeans and non-Europeans also work different jobs. **Europeans held more low-skilled jobs than non-Europeans.** In 2016, 24% of the jobs held by Europeans were low-qualification and just 20% high-qualification (compared with 13% and 32% respectively for non-Europeans).

FOCUS: LABOUR MARKET SITUATION

SECTORS THAT EMPLOYED MORE EUROPEANS BEFORE BREXIT HAVE ENCOUNTERED SOME OF THE GREATEST LABOUR SHORTAGES

Change in the number of vacancies by sector from the start of the pandemic to the peak



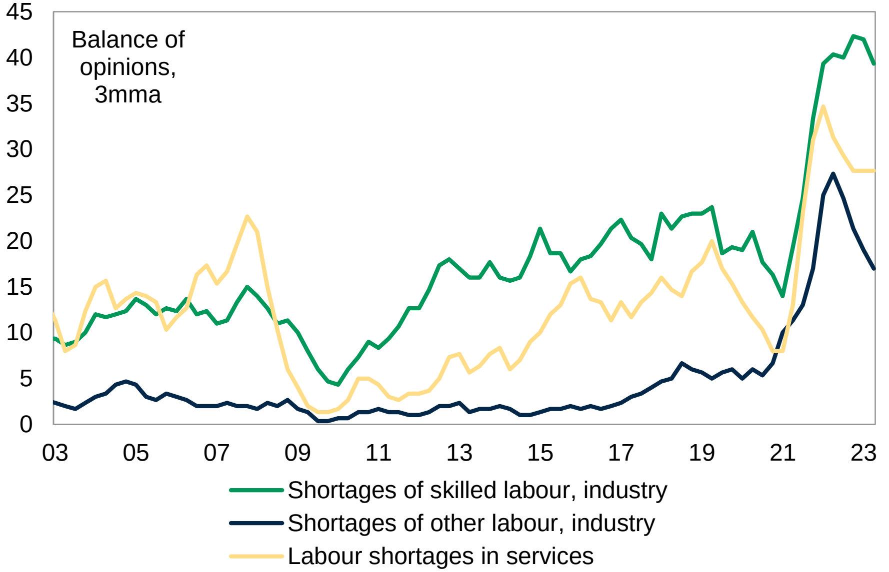
Sources: ONS, Crédit Agricole S.A./ECO

The food and accommodations services, agriculture, manufacturing and transport services sectors employed the most European citizens (particularly from Eastern Europe). These sectors have also experienced some of the greatest labour shortages since Brexit, as the government's new migration policy introduced restrictions on hiring European citizens (minimum wage at £26,200, higher qualification requirements), although it has been relaxed for jobs in the public health system and education. Shortages are slowly receding but remain considerable in healthcare and social work, accommodation and food services, and some manufacturing sectors, with the rise in non-European immigration only partially offsetting the shortage of European labour.

FOCUS: LABOUR MARKET SITUATION

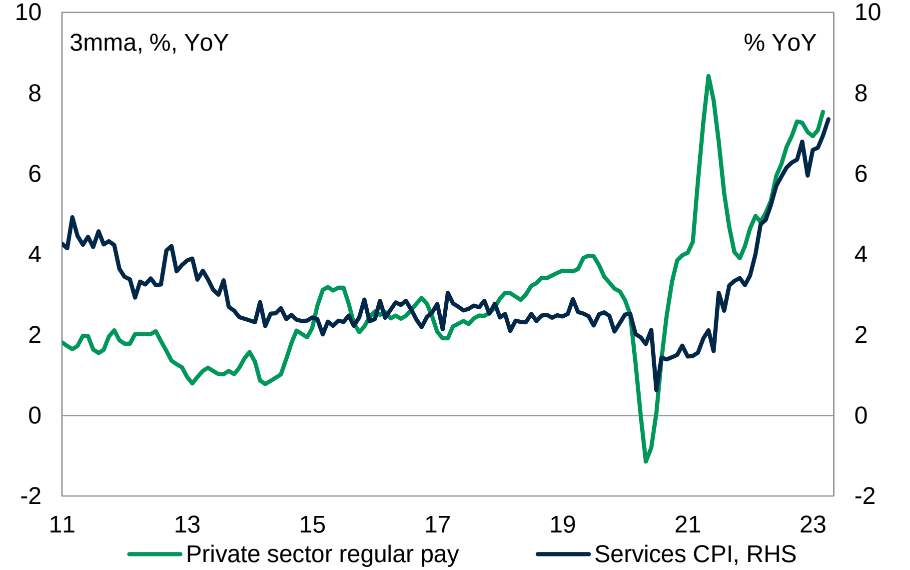
IMPLICATIONS: THE REDUCTION IN IMBALANCES WILL BE SLOW

Recruitment difficulties are likely to remain high for longer



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

Inflationary pressures will likely persist



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

With Brexit, persistent economic inactivity and rising health problems among the economically inactive, the reduction in labour market imbalances will likely be slow and incomplete. Only six out of ten adults having left the labour market since the pandemic are planning to look for a job, and more than half of them have not been looking for work since then. As such, wage pressures will likely persist, serving to perpetuate high core inflation, which the BoE will seek to curb by further monetary tightening. In addition, if the employment participation rate for the 50-64 age group remains low, potential growth will also suffer. In an effort to encourage more people to look for work, the government announced a series of incentives in its Spring budget, including the discontinuation of the lifetime tax-free retirement benefit, free child care for working parents, and more support to help people with disabilities find paid employment. **In a positive aspect, the economically inactive population has relatively small amounts of debt, implying a low risk for banks.** According to the ONS, 66% own their homes, while 61% have no loans. Economically inactive people over the age of 50 are more likely to have repaid a large portion of their mortgage and benefit from a relatively strong appreciation in the value of their wealth, if they have owned their house for a long period. In addition, just under 10% say they have a credit card balance and just under 10% say they have a personal loan.

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OUTLINE OF OUR SCENARIO

OUTLOOK UNDERMINED BY TIGHTER MONETARY AND FINANCIAL CONDITIONS

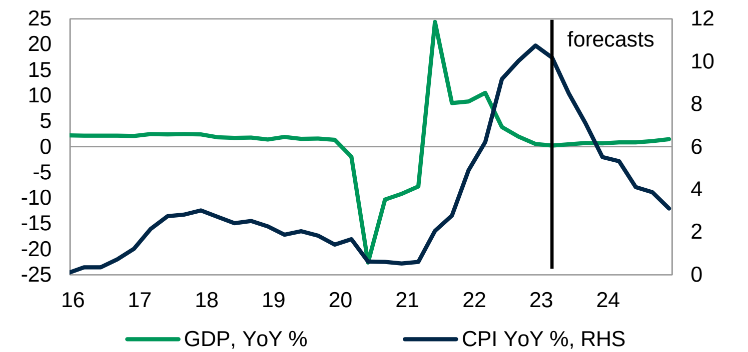
The UK economy has thus far avoided a recession owing to resilient demand, supported by state aid. But this has led to higher-than-expected core inflation and a sharp rise in interest rates. We have revised our inflation forecasts upwards (see *next page*) and our growth forecasts downwards (to +0.5% for 2023 and +1.1% respectively in 2024, vs. 0.6% and +1.4% previously). We expect a slight acceleration of growth in Q2 to 0.3% QoQ as we factor in some catch-up effect after the strikes in Q1. In the second half of the year, growth is expected to slow again. A recession is not part of our central scenario, but we acknowledge that its probability has increased as a result of rising rates and persistent uncertainty.

- **Interest rate increases will weigh on household consumption even though the outlook for purchasing power appears to be improving.** Growth in real household income is expected to rebound in the coming quarters thanks to an expected decline in the rate of inflation (driven mainly by energy prices) which would be more rapid than the expected moderation in labour income growth. However, higher interest rates will put the brakes on spending. Their impact will be more protracted than in previous tightening episodes, as a lower share of mortgages are at variable rate, and is expected to peak in early 2024. As a consequence, private consumption is likely to register weak growth both this year and next (+0.1% in 2023, +0.9% in 2024).

- **We expect private investment to decline this year.** For companies, persistent uncertainty and rising interest rates will slow business investment. But the contraction will be limited by government aid (capital allowances, research tax credits) and solid margins, bolstered by lower production costs. Lower prices in the real estate market are likely to hinder real estate investment.

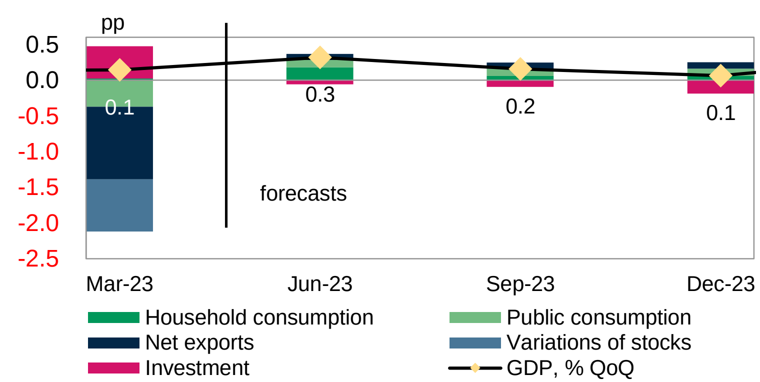
- **Foreign trade is also expected to contribute slightly** to growth in the coming quarters thanks to a stronger recovery in exports than in imports. We still expect a mild U.S. recession in the second half of the year, but the Eurozone, the UK's main trading partner, is expected to see a slight acceleration after two quarters recession thanks to lower energy costs.

GDP growth and CPI inflation



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

Quarterly GDP growth and contributions



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

OUTLINE OF OUR SCENARIO

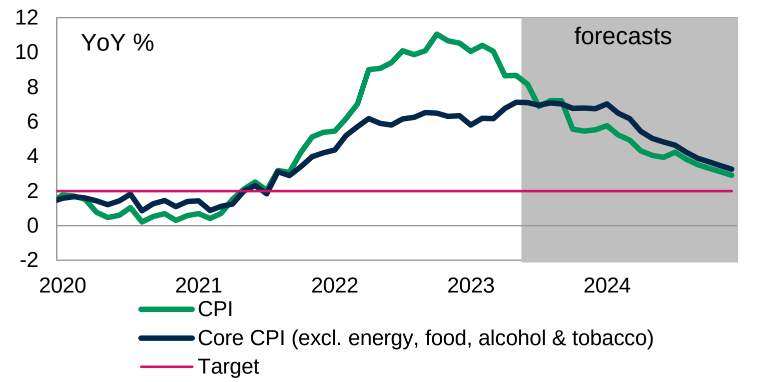
INFLATION: UPWARD REVISIONS TO CORE INFLATION PUSH BACK TARGET

The upside risks to inflation expectations, which we previously highlighted in our April scenario, have become a reality. **Labour market conditions have remained tighter than expected and wage growth has accelerated.** As a result, inflation has increased more than expected in the last four months, with surprises in the underlying components. While temporary factors have played a role, the persistence of inflation can be explained above all by stronger-than-expected domestic demand and second-order effects in the companies' behaviour in prices and wages' setting.

We have revised our core inflation forecasts upwards, to close to 7% until the end of the year. Headline inflation will fall much more slowly than expected three months ago, to 5.5% in Q423 and 3.1% in Q424 (compared with the previous forecasts of 4% and 1.1% respectively). The 2% target will not be reached until 2025, against mid-2024 expected previously.

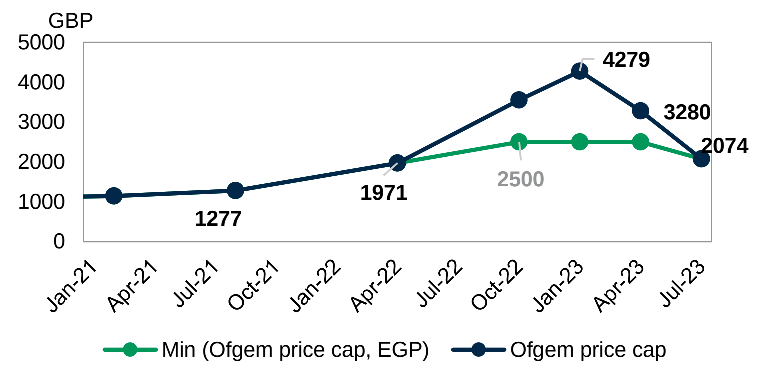
In the short term, the expected decline in inflation is still due to strong base effects in energy prices, amplified by an additional drop in Ofgem's energy price caps. The regulator revised its gas and electricity price caps to £2,074 for the period 1 July - 30 September 2023, compared to the current £2,500 cap based on the government's Energy Price Guarantee in effect until the end of June. From July onwards, the contribution of energy prices to the headline inflation rate is expected to become significantly negative.

CPI inflation and core inflation



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

Typical household energy annual bill (gas and electricity)

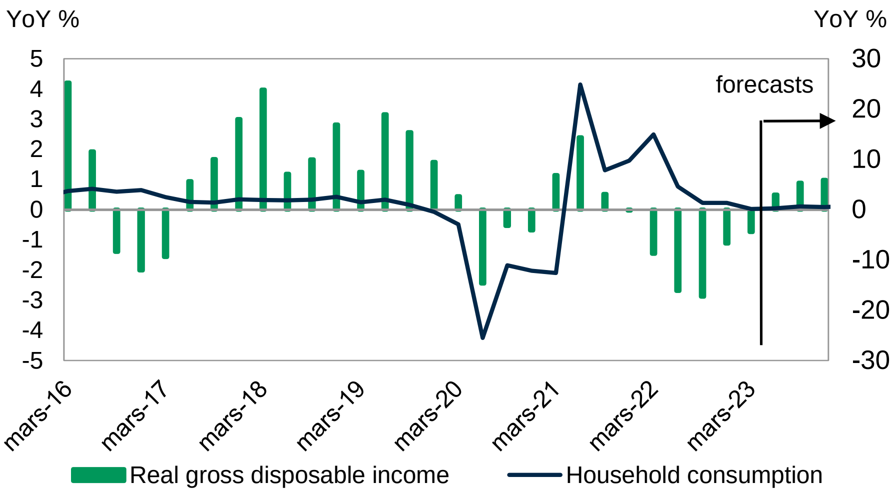


Sources: heattable.co.uk, gov.uk, Crédit Agricole S.A./ECO

OUTLINE OF OUR SCENARIO

HOUSEHOLDS: PURCHASING POWER DECLINE SOON TO BE OVER

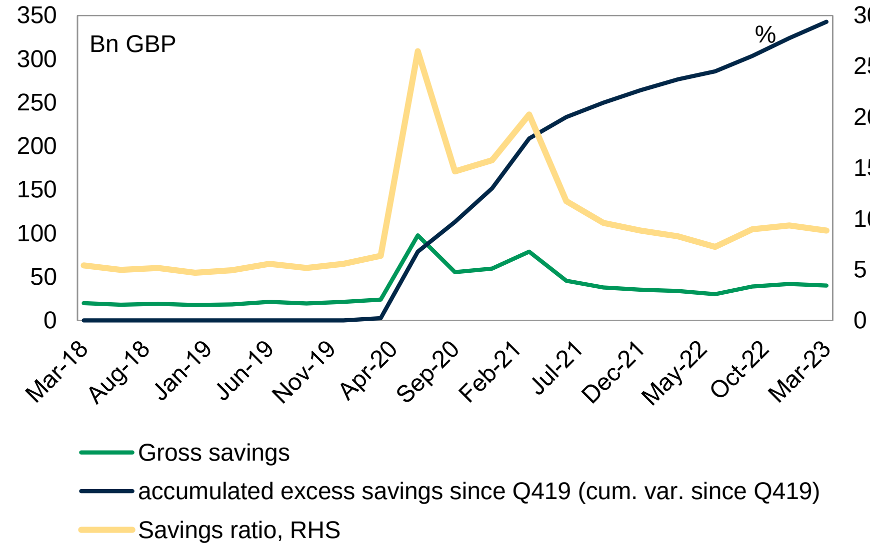
Purchasing power is expected to rebound in the coming months



** Household gross disposable income deflated by the consumer expenditure deflator*

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

Household savings remain a major support buffer for consumption

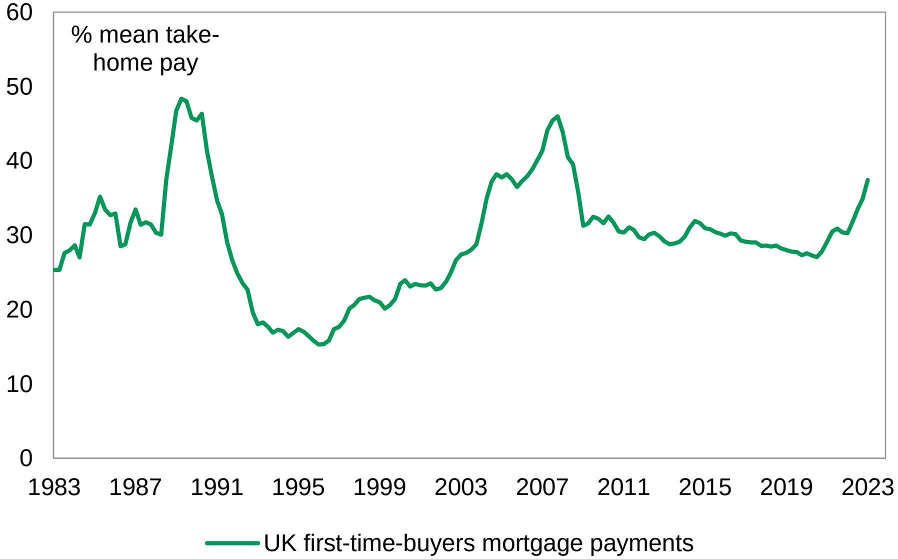


Sources: ONS, Crédit Agricole S.A./ECO

The outlook for household consumption is looking better than three months ago, despite the rise in interest rates. Consumer confidence is recovering from extremely low levels. The labour market remains tight and the unemployment rate is expected to increase only slightly over our forecast horizon (to 4.1% at end-2023). **The erosion of purchasing power is expected to come to an end soon, with the expected decline in inflation, particularly that of energy prices** (in July households will benefit from a £426 decrease in their annualized energy bill), and the continuation of relatively high nominal wage growth over the coming months. Household real disposable income once again contracted, by 0.8% QoQ in Q123, after rebounding 1.3% QoQ in the preceding quarter. But year-on-year it contracted just 0.7%, compared with a 2.9% dip in Q322. Real income growth is expected to return to positive territory in the second quarter. **However, our scenario assumes weaker growth in household consumption than the expected rebound in purchasing power would suggest.** The persistence of uncertainty and the ongoing adjustment of the real estate market should continue to curb household consumption as households build up savings (at 8.7%, the savings rate is still higher than before COVID) and/or pay off loans. The rise in interest rates will continue to impact new loan production and consumer spending by households with variable-rate or short-term fixed-rate mortgages (which account for the majority of home loans).

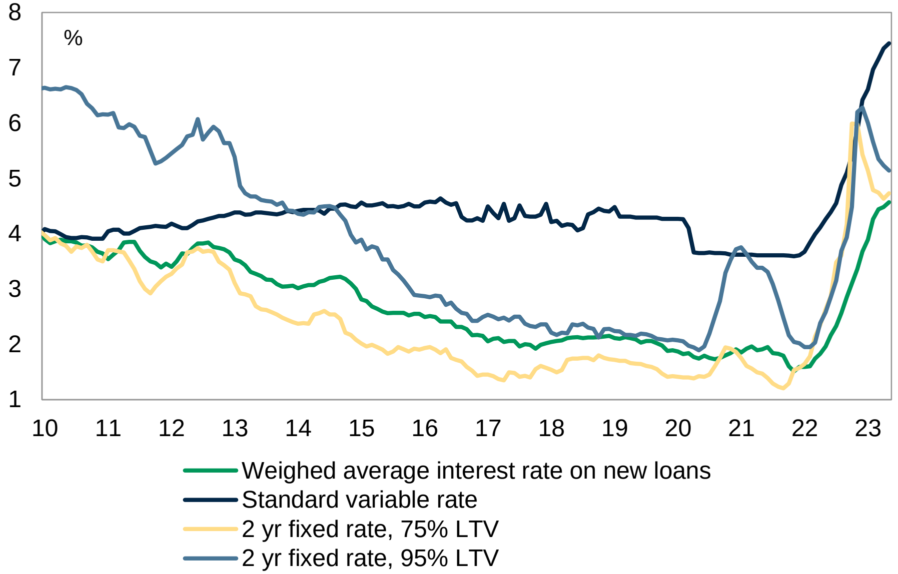
MORTGAGE CRISIS: HOUSEHOLDS WITH DEBT WILL SUFFER FROM THE SHOCK

Mortgage repayments likely to reach their peak in 2007



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

Mortgage rates rise rapidly with inflation surprises



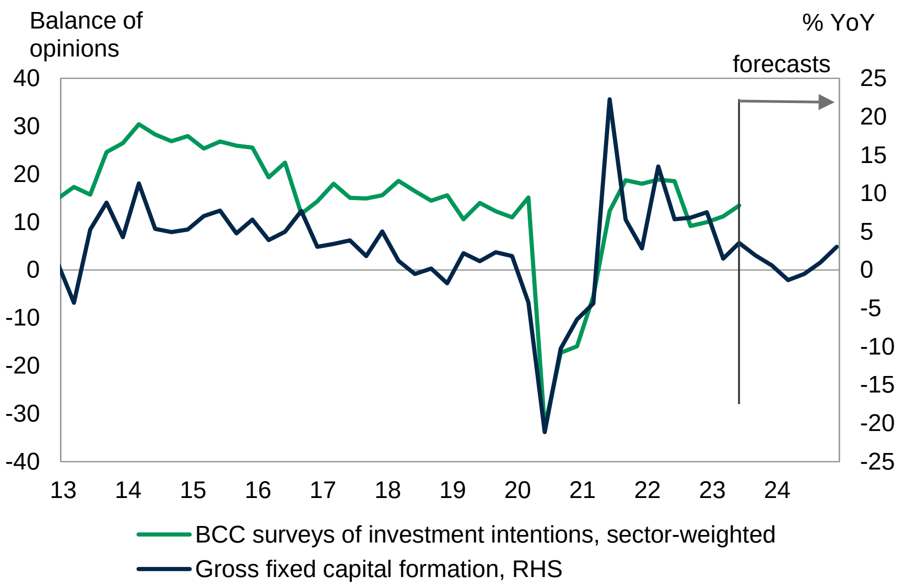
Sources: BoE, Crédit Agricole S.A./ECO

Persistent inflation pushed the BoE's interest rate expectations up to more than 6%, higher than during the pension fund debacle triggered by the Liz Truss budget. After a lull at the start of the year, mortgage rates have picked up again, with the average rate on new loans standing at 7% in May according to the latest BoE data. But according to Citi, the average two-year rate has now reached 6.2% and the five-year rate 5.8%. The impact of rising interest rates is less immediate than in the past, with the majority of loans now at fixed rates (maturing in five years or less) rather than variable rates. The impact on household consumption will therefore be spread out more over time. According to Resolution Foundation, the credit of 56% of households with mortgages expired at the end of June, but 44% of households (3.3 million) will still have to refinance their fixed-rate loans. According to Citi, **mortgage refinancing will peak in Q124, with loan repayments accounting for a full 40% of disposable income of mortgagors.** The expected increase in loan repayments as a result of rising interest rates will account for 3% of disposable income (around £2,000 a year). The impact of rate hikes will hit fewer households than in the past. The ageing of the population means that more households have paid off their mortgages, while fewer young people have accessed home ownership. For example, Resolution Foundation estimates that the share of households with mortgages fell below 30% in the 2000s, down from nearly 40% in 1989. At the same time, households with mortgages are in more debt now than in the past.

OUTLINE OF OUR SCENARIO

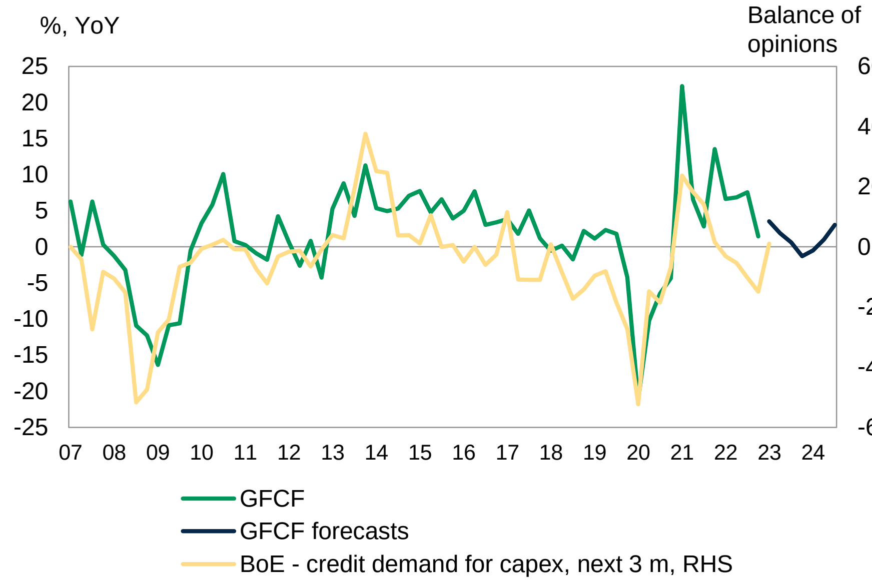
INVESTMENT: RISING RATES WEIGH ON THE OUTLOOK

Investment intentions and gross fixed capital formation (GFCF)



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

Investment and demand for credit for investment purposes



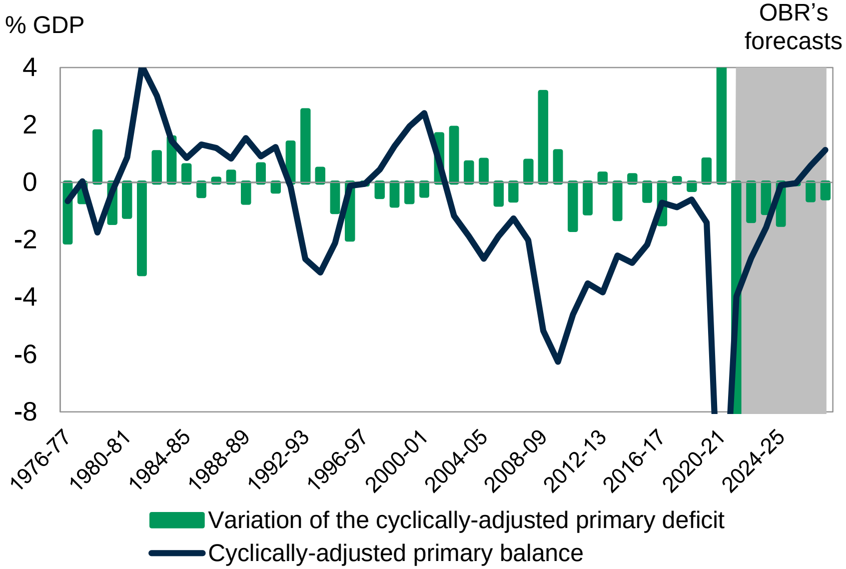
Sources: ONS, BoE Credit Conditions Survey, Crédit Agricole S.A./ECO

With the exception of housing investment, which declined for the second consecutive quarter (-2.2% QoQ, after -1.9% QoQ in Q422), **the tightening of monetary and financial conditions has thus far had little impact on investment**. Gross fixed capital formation even accelerated in Q1 (2.4% QoQ after 0.3% QoQ in Q4) on a significant rebound in business investment (3.3% QoQ, after -0.2% QoQ in Q4) and continued strong growth in public investment (8.2% QoQ, after 8.3% QoQ in Q4). The rebound in business investment might have been amplified by the headway made by companies on investment projects before the “super deduction” expired on 31 March 2023. We continue to expect a contraction in investment over the rest of the year on tighter financial conditions and persistent uncertainty over the outlook. Investment intentions remain low. **The average cost of new loans to non-financial companies increased sharply, to 6.32% in May, 429bp higher than in December 2021.** But the contraction will be limited by government aid (capital allowances, research tax credits) and solid margins, bolstered by lower production costs. The BoE’s Q2 credit conditions survey shows a pick-up in demand for investment-related credit over the next three months, confirming our expectations of relatively resilient investment.

OUTLINE OF OUR SCENARIO

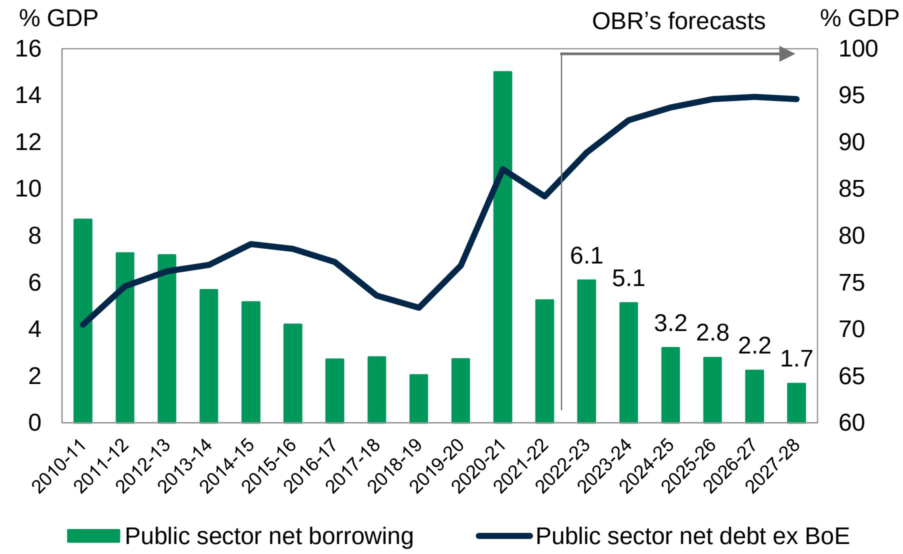
FISCAL POLICY WILL REMAIN RESTRICTIVE DESPITE AN EASING IN MARCH

Fiscal stimulus will be negative in the coming years



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

An effort to stabilise the debt ratio on GDP in the next five years



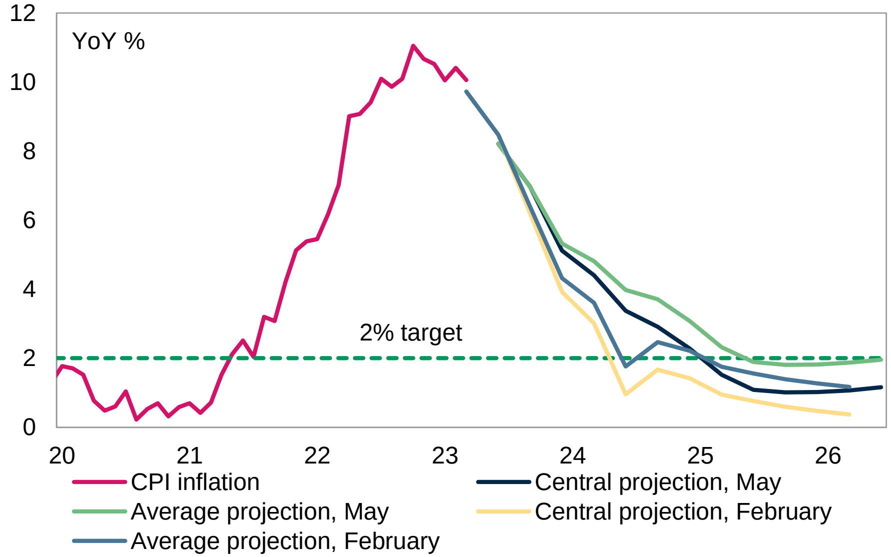
Sources: OBR

The Chancellor of the Exchequer announced an easing of fiscal policy in his Spring Budget, made possible by a lower-than-expected government deficit and upward revisions to the OBR's economic forecasts. The Chancellor has decided to use two-thirds of the room for manoeuvre, i.e. £20bn per year over the next three years (0.8% of 2022 GDP), to give a small boost to both supply and demand. The extension of the energy price guarantee to £2,500 until the end of June was one of the key measures to support households in the energy crisis. Between its implementation in October 2022 and the end of June 2023 it has made it possible to lighten the bill of the typical household by £1,100 relative to the Ofgem price caps. The key thrust of the budget consists of measures to accelerate investment, including generous but temporary tax credits (with a duration of three years) for companies investing in eligible assets. The government has also frozen the fuel tax for another year and increased defence spending (from £2bn to £3bn per year). A package of measures to increase the supply of labour, the key measure of which is 30 hours of free childcare, is part of the government's objective to improve activity. Despite these support measures, fiscal policy will remain restrictive in the coming years, with a fiscal stimulus (change in the primary structural deficit) of -1.3 percentage points on average over the next two years. We could expect some additional fiscal easing in the autumn thanks to a lower-than-expected fiscal deficit so far for the current fiscal year (£18.3bn less than the March OBR forecast).

OUTLINE OF OUR SCENARIO

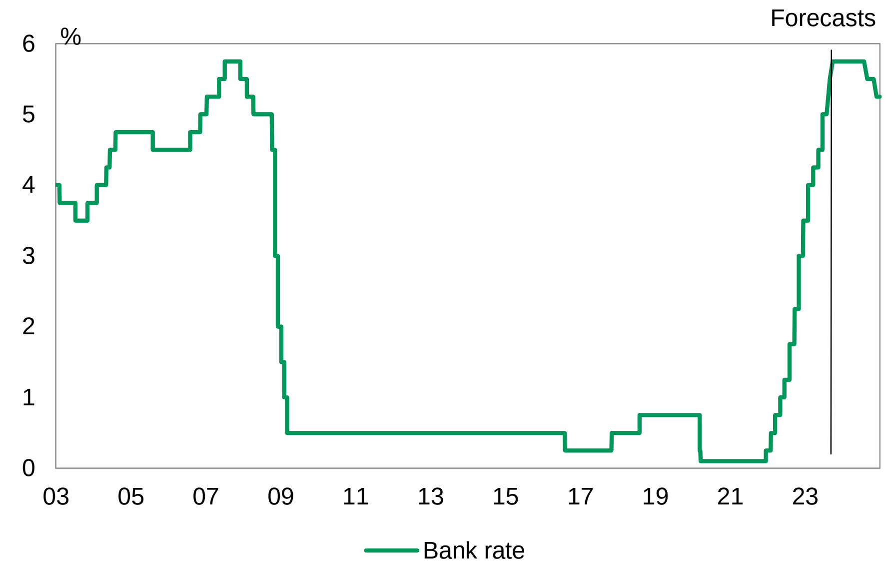
THE BANK OF ENGLAND KEEPS AN EYE ON PERSISTENT INFLATION

BoE's upward revisions to inflation expectations. Target achieved in 2025



Sources: BoE Monetary Policy Reports, Crédit Agricole S.A./ECO

Key rate forecasts peak at 5.75% and dip in 2024



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

After slowing the pace of tightening to 25bp in April, the BoE shifted its stance significantly in May. More hawkish, the central bank made substantial upward revisions to its forecasts of growth (now ruling out the recession from the central scenario) and inflation (with a target reached only at the beginning of 2025, versus mid-2024 previously forecast). The central bank also revised its unemployment rate forecasts downwards (set to remain under 4% until the end of next year). **In June, after inflation surprised four months in a row, the BoE finally stepped on the gas, voting for a 50bp rate hike.** This move took the key rate to 5%, the highest since February 2008. The BoE commented: "There has been significant upside news in recent data that indicates more persistence in the inflation process, against the background of a tight labour market and continued resilience in demand." The indicators monitored closely by the BoE to assess the persistence of inflationary pressures, namely labour market conditions, inflation in services and wage growth, have generated substantial surprises. We expect monetary tightening to continue in the coming months. **We expect a further 50bp rate hike in August and a 25bp hike in September, bringing the key rate to 5.75%.** The BoE seems to have slowed down tightening too soon, which means it now has to raise rates higher. But a stronger tightening of monetary conditions increases the probability of inflation falling below the target of 2% over the next three years. This should lead the BoE to reverse in 2024. In our scenario, an initial rate cut will come in Q324.

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