UNITED KINGDOM

ESSENTIAL BUDGETARY SUPPORT

UK growth contracted slightly in Q2, but the economy should not enter a recession before Q4. On the one hand, the labour market continues to operate at full employment, which will partially absorb the sharp impact of inflation on purchasing power. On the other hand, the new government plan to support households and businesses should mitigate future energy price increases. Faced with persistent inflation, the Bank of England (BoE) is further accelerating its monetary normalisation, at the risk of precipitating a contraction in the economy.

The United Kingdom suffered a slight contraction in its GDP in Q2 2022 (-0.1% q/q), mainly due to the drop in household consumption (-0.2% q/q) and the fall in public spending (-2.9% q/q). According to our forecasts, the UK economy should rebound very slightly in Q3 thanks to Boris Johnson's government's support plan, before experiencing a marked contraction in GDP in Q4 2022, against a backdrop of persistent inflation and rising interest rates. This contraction in GDP could be partially mitigated by the new support measures announced by Liz Truss. For the time being, business climate surveys indicate a contraction in industrial activity and a slowdown in activity on the services side.

PURSUING MONETARY NORMALISATION

Although inflation slowed slightly in August (9.9% y/y), mainly reflecting a drop in fuel prices (86.2% y/y compared to 114.1% in July), it continued to spread, as evidenced by the increase in underlying inflation (6.3% y/y). Inflation should continue to rise to a peak probably at around 13.8% in Q1 2023[1], before slowing down but still staying well above the 2% inflation target.

Furthermore, tensions on the labour market, which is still operating at full employment (3.6% unemployment rate from May to July) are supporting wage growth (+5.5% y/y in nominal terms from May to June, i.e. -2.6% in real terms), which is slightly dampening the impact of inflation for households. Although there is no wage-price spiral at the moment, wage increases in certain sectors (transport, postal services, etc.) should slow down the pace of disinflation in 2023.

Faced with persistent inflation and a robust labour market, the BoE accelerated the hike in its bank rate, with a further hike by 50 basis points at its meeting on 22 September, bringing it to 2.25%. The BoE also announced the start of the sale of UK Treasury debt securities (gilts) held under its Asset Purchase Facility (APF) programme. This reduction from GBP 80 billion over the next 12 months should strengthen monetary normalisation.

" LOW TAX, BIG STATE "

To cope with the energy and cost of living crisis, Liz Truss had no choice but to implement a massive support plan for the economy. With a duration of two years from 1 October, this programme is structured around three measures.

The plan first provides for capping the average electricity and gas bill for households at GBP 2,500 per year, well below the GBP 3,548 estimated by Ofgem (the UK energy regulatory authority). To this end, the government is preparing an "energy price guarantee" at supplier level as well as the temporary abolition of the green levy. This programme is in addition to the household support plan (GBP 37 billion) announced in June, which included targeted aid (GBP 400) for the most vulnerable households.

On the business side, the government proposes to put in place a similar "energy price guarantee" mechanism, for a period of six months, before moving towards a more targeted system, the measures of which have not yet been specified.

GROWTH & INFLATION

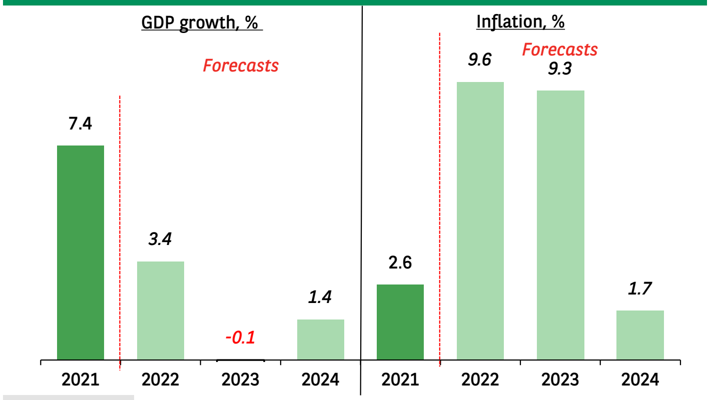

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

The third flagship measure of the support plan aims to guarantee stability in the electricity market by ensuring sufficient liquidity. HM Treasury and the BoE will set up a GBP 40 billion liquidity fund (Energy Markets Financing Scheme) to facilitate the massive margin calls faced by market players.

Although the measures in this plan are necessary to mitigate the impact of inflation, its scale will weigh heavily on the public finances. According to government estimates, this plan would cost between GBP 100 and 200 billion (between 4.5 and 9% of GDP), well above the GBP 80 billion of the household support plan during the Covid-19 crisis. The Debt Management Office (DMO) should soon issue a more detailed estimate of the budgetary impact of this plan on the public finances. So far, no countervailing measures have been announced, so the plan would be financed by increased use of public borrowing.

The fiscal and budgetary policies announced will put pressure on the UK public finances. On the one hand, Liz Truss has announced a support plan without countervailing measures. On the other hand, her campaign promise to prioritise tax cuts for households and businesses (of around GBP 30 billion) could further widen the public deficit. As a direct consequence of this deterioration in the budget outlook, gilts (UK Treasury securities) saw their yield rise sharply across the maturity curve. For the first time since 2011, the yield on 10-year sovereign bonds (10Y gilts) exceeded 3.2%. The other notable development is on the currency market side: despite these higher interest rates, sterling continued to fall, particularly against the dollar. On September 19, GBP fell to 1.1410 USD, its lowest level since 1985.

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1 This figure does not take into account the effects of the new support plan. Recent government measures should significantly reduce inflation.