UNITED KINGDOM

CLOUDS ARE GATHERING

The UK economy shows increasing signs of deterioration. An upturn in unemployment is visible, and the PMI employment data fell sharpy in September. The consequences of monetary tightening are spreading and no sector has been spared; first and foremost, the housing market and even the public sector, recently shaken by the bankruptcy of several councils, including the city council of Birmingham, the country's second largest city. While inflation in the UK is falling, it remains high compared to its European neighbours, notably due to stronger wage increases. However, the Bank of England is not expected to raise the Bank rate again, even though the vote in September (when a hike was expected) was decided by a single vote. The scenario of a recession in H1 2024 remains our central forecast, followed by a slight recovery in activity linked to the start of the cycle of lower interest rates. We expect to see this from Q2 2024 onwards.

The upward revision by the ONS of GDP for 2020-2022 will have given the UK a bit of good news. The contraction of activity in 2020 was revised lower, from -11.0% to -10.4%, while the upturn in 2021 was more significant, up from +7.6% to +8.7%. A full recovery of the activity lost during the pandemic, which had not yet occurred by the summer of 2023 according to previously available data, was actually achieved as early as the last quarter of 2021. However, the economic situation in the UK remains challenging. The country is facing one of the hardest growth-inflation trade off among developed countries.

The reversal of the labour market seems to have begun. After reaching a low of 3.5% in August 2022, the unemployment rate (3m/3m) rose to 4.3% in July 2023. The increase is likely to continue in the second semester. In addition, PMI employment data deteriorated significantly in September: the composite employment index fell by 4 points to 46.4, the biggest monthly drop since the start of statistics in 2007. This indicator for the manufacturing sector had already been significantly below the expansion threshold for several months (46.3 in September). The services index is now falling (-4.8 points, to 46.4 in September), which is consistent with the strong increase in wages in the sector, which is forcing companies to make wage bill adjustments by reducing the volume of jobs.

At 6.3% in August, the one-year increase in the consumer price index (CPI) is now lower than the increase in regular wages in the country (7.9% y/y). Nevertheless, rising interest rates continue to exert pressure on household purchasing power. According to the Retail Price Index (RPI), which includes interest payments on mortgages, these payments were up by more than half within a year (+60.3% y/y in August), accounting for 1.8 percentage points of the increase in the RPI, i.e. nearly half of the gap between the CPI and the RPI, which had posted a rise of more than 9% y/y in August[1]. The CPI, which only takes into account changes in rents, considerably underestimates the drop in purchasing power of UK households who have taken out mortgages, of which the cost of repayment has soared.

These difficulties are not confined to the private sector. Some councils - and not the smaller ones - have had to activate Section 114 in recent weeks for towns and cities that are unable to meet their financial commitments. This is the case in Birmingham, the country's second largest city; but it's not the only one, because councils in Greater London (Croydon, Thurrock and Woking) have had to use this aid mechanism, which could lead to intervention by central government.

GROWTH & INFLATION

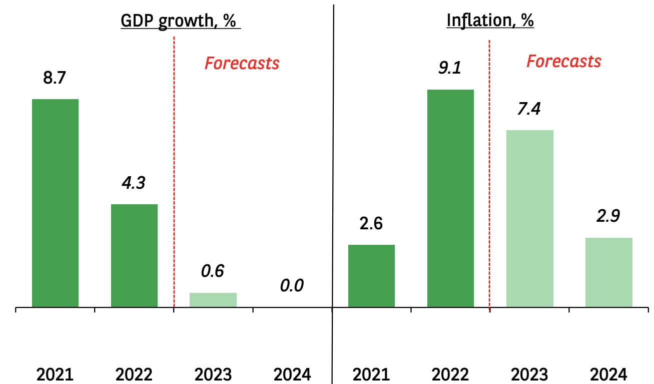

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

The slowdown in inflation and activity played in favour of keeping the Bank rate at 5.25% in September. However, the vote was very close, with four out of ten committee members voting for an increase of 25 bps to 5.5%. While we do not predict any further rate hikes in the future, the pace of a drop in interest rates in H1 2024 should prove slower than previously expected. However, we maintain our forecast that interest rate will be at 4% by the end of 2024. The replacement in early November of John Cunliffe, who was in favour of an increase of 25 bps in September, by Sarah Breeden, could provide more weight to the MPC "doves", thereby confirming our scenario of a terminal rate reached in September.

Guillaume Derrien
guillaume.a.derrien@bnpparibas.com

1 The remainder of the difference between the RPI and the CPI (0.95 pp) can be explained both by the inclusion in the RPI of other housing-related indicators (council tax, home insurance) and differences in data aggregation formulas. This explained, respectively, 0.5 pp and 0.8 of the difference between the RPI and the CPI.