UNITED KINGDOM

STRIKING THE RIGHT BALANCE BETWEEN GROWTH AND FISCAL CONSOLIDATION

The presentation of the budget on 30 October will be the first real test for Rachel Reeves. The deteriorating situation of the public accounts and the September 2022 *mini-budget* crisis, which is on everyone's minds, are leaving the Chancellor of the Exchequer with little room for manoeuvre. UK growth is expected to slow in the second half of 2024 (+0.3% quarter-on-quarter). The two policy rate cuts by the Bank of England (BoE) that we expect in 2024 (August and November) would enable growth to come close to its potential level during this year and in 2025.

The British economy is improving timidly. Domestic activity (consumption, investment) remains weak, despite the decline in inflation. The fall in inflation since the start of 2024 has come mainly from industrial goods, while deflation in energy, fuelled by decreases in the cap on regulated gas and electricity tariffs, has remained above 10% year-on-year. These two effects are expected to dissipate. While it remains limited at this stage, disinflation in services should continue over the course of 2025, allowing headline inflation to stabilise around the 2% target over time[1].

The upturn in housing activity is seemingly well underway, with sales prospects at their highest since the health crisis (RICS survey) and price indices (Halifax, Nationwide) rebounding by an average of 2.5% in the first half of 2024. However, the foundations of this recovery are fragile. The effects of the rise in interest rates have not yet been fully felt, with fixed-rate loans seeing their rates continue to rise this summer, in particular. The rise in mortgage arrears also continued in the second quarter (standing at 1.32%, the highest level since 2016). Furthermore, future rate cuts will not solve the fundamental problem of rising household debt in the United Kingdom. As a share of GDP, it reached 91.9% in Q1 2024, 10 percentage points higher than the peak before the 2008 financial crisis. Unlike the United States and many euro zone countries, where this aggregate ratio has plummeted over the past fifteen years, British households continue to rely quite heavily on credit, not least to cope with the high housing costs in the country.

In terms of fiscal policy, the road ahead is narrow for the Chancellor of the Exchequer, who will be looking to reassure the markets about Labour's ability to preserve the sustainability of public finances, while delivering the increased investment and spending promised during the election campaign. An in-between solution could involve making changes to the government's targeted measures for budget balance and public debt. This could involve removing specific investments from government spending, particularly investments linked to programmes created by the Labour Party (the National Wealth Fund and GB Energy). The public debt measure could also be amended to remove the BoE's losses on its asset portfolio, which are covered by the UK Treasury. In March, the OBR forecasted that the deficit would fall to 3.1% of GDP over the 2024-25 fiscal year (April 2024-March 2025), from 4.4% during the previous year[2]. This improvement would be partly due to a fall in debt interest payments, which had risen with the surge in interest rates and inflation in 2022-2023, as a result of the large proportion of UK government securities indexed to the price index (RPI)[3].

GROWTH AND INFLATION

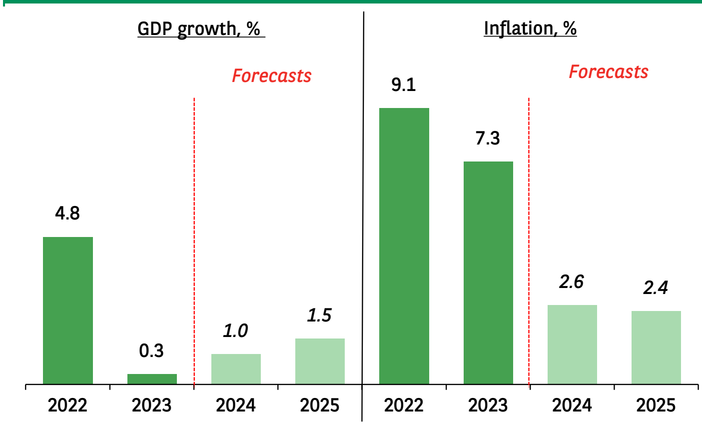

CHART 1

SOURCE: BNP PARIBAS GLOBAL MARKETS

THE DRAGHI REPORT ALSO RESONATES ACROSS THE CHANNEL

The Draghi Report on the future of European competitiveness has prompted a number of reactions within the EU, but the findings of the former ECB President apply equally to the United Kingdom. With a productive investment rate (excluding investment in housing) that is almost 4 GDP points lower than in the United States, productivity gains standing at around 25 percentage points lower since the early 2000s[4], and a less buoyant demography, the drivers for growth seem more limited than on the other side of the Atlantic.

While the EU-UK Trade and Cooperation Agreement, which entered into force in January 2021, has not resulted in a decline in foreign investment in the United Kingdom[5], it has led to it levelling off. Brexit has also reportedly reduced opportunities in sectors with lower value added and high exposure to international competition (textiles and agriculture)[6]. UK exporters are also suffering as a result of a slowdown or even a decline in activity among some of their major trading partners (Germany, the Netherlands, France and China). In volume terms, UK exports of goods are down by nearly 20% from their pre-pandemic levels. However, the picture is not completely bleak: while some parts of the manufacturing sector do indeed seem to be struggling, the UK retains major strengths in certain industries (aerospace and pharmaceuticals) and, above all, in high value-added services, such as finance and information and communication services.

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1 The PMI index for sales prices in services fell in September to its lowest level since February 2021.
2 New forecasts will be released on 30th October.
3 In September 2024, 17% of the total Gilts stock was indexed to the RPI (UK Debt Management Office).
4 In purchasing power parity terms, between 2020 and 2023, hourly productivity increased by 19% in the UK, compared with 43% in the US (OECD).
5 See UK Attractiveness survey, EY, July 2024.
6 A report by Aston University (Birmingham) estimates that between January 2021 (the end of the transition period and the entry into force of the new trade treaty) and December 2023, Brexit resulted in a 27% fall in UK exports to the EU and a 32% fall in imports. See Unbound: UK Trade Post Brexit | Aston University.