UNITED KINGDOM

THE INTEREST RATE SHOCK CONTINUES TO SPREAD

The economic outlook in the UK is still challenging. After a year 2023 marked by a gradual deterioration in activity (a slowdown in the first half of the year, followed by a contraction in the second half), GDP growth is expected to remain slightly positive in 2024. With the general election, scheduled to be held at the end of the year, Prime Minister Rishi Sunak, who is facing difficulties within the Conservative party, is struggling to reassure households who are bearing the full brunt of rising costs of living and interest rates. Despite a recovery in purchasing power and the resilience of the labour market, private consumption remains depressed. Nevertheless, the drop in inflation should lead to the start of monetary easing in June, which is expected to be modest, with a one-percent reduction (5.25% to 4.25%) expected in 2024.

Between declining inflation and falling business activity, the stance of the hawkish members of the Monetary Policy Committee has softened. Catherine Mann and Jonathan Haskel, who, up until now, were in favour of a further hike in the Bank rates, came back around to the status quo position in March. Inflation in the UK fell below 4% y/y in February and we expect it to drop under the 2% target during the second quarter of 2024, fuelled in particular by the removal of the price cap for electricity and gas. Nevertheless, services inflation, which is more driven by wage trends, is slowing less significantly, remaining above 6% y/y in February. In addition, this rise is identical to the increase in regular pay in the sector (+6.0% y/y in January).

Improving household purchasing power, buoyed by falling inflation and strong wage increases, has helped to buoy UK consumer confidence[1] and is expected to result in slightly increased economic activity over the course of 2024. However, this upturn is not translating into a genuine pick-up in consumption, as households choose, at this stage, to build up additional savings instead. As a result, the savings ratio rose above 10% of gross disposable income in the final quarter of 2023, which was twice as high as the pre-COVID level. This trend may seem counter-intuitive in a context of high inflation, but it is often seen during periods of economic slowdown or recessions. This was the case during the 2008 crisis and during the recession in the early 1990s[2]. This trend, which reflects an increase in precautionary savings, if it continues, will act as a drag on the economic recovery. It could limit the effects of government measures introduced in recent months, which carry a significant cost for the country's public finances. In March, Jeremy Hunt, the Chancellor of the Exchequer, announced a further two percent cut on National Insurance contributions for employees (and the self-employed), following an initial cut of a similar size during the autumn.[3]

Household finances continue to be strained by the increased cost of living and rising interest rates. The share of payment arrears within outstanding home loans hit 1.2% in Q4 2023, the highest level in six years[4]. These figures are still far below the one seen during the 2008 crisis, when the proportion of arrears peaked at 3.6% in Q1 2009. Nevertheless, the increase is underway and there are fears of further deterioration in 2024, as another part British households will have to refinance their loans at higher rates. Mortgage interest payments have continued to rise significantly this winter (+36% y/y in February, according to the Retail Price Index (RPI)) and the Bank of England expects household debt services costs to continue to increase until 2026, as the refinancing phase plays out.

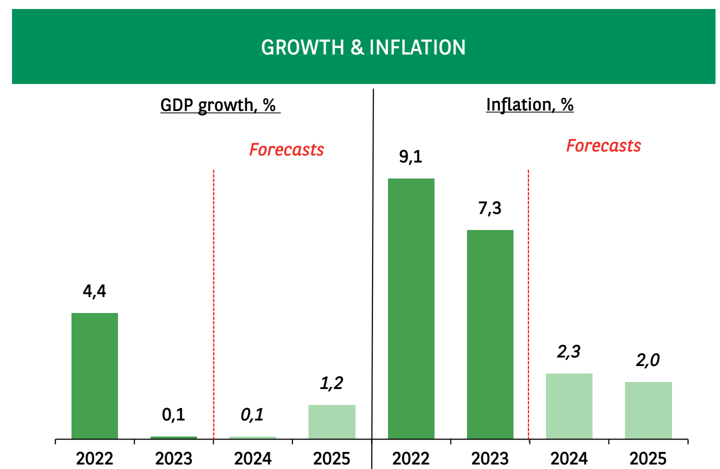

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

Soaring credit costs are also spreading to the buy-to-let rental market, where rents have jumped since the end of the lockdown period. The increase is not abating; it is quite the opposite. According to the CPI, rent inflation hit 6.9% y/y in February 2024, which is its highest rate for exactly 30 years. Despite this, housing activity has recovered as interest rates have stabilised. The volume of mortgages has been increasing for more than a year and property prices are rising again, by more than 1.5% y/y according to the Nationwide index.

Guillaume Derrien
guillaume.a.derrien@bnpparibas.com

1 The GfK 12-month household financial outlook index hit its highest level since November 2021 in March.
2 According to the ONS, the household savings rate jumped from 5.2% in Q1 2008 to 12.5% in Q1 2010. It rose from 6% in Q4 1988 to 13.9% in Q1 1992.
3 The initial cut to the National Insurance Contribution rate for the self-employed, announced in the autumn, was only one percentage point.
4 Data from the Financial Conduct Authority.