UNITED KINGDOM

A WAVE OF INFLATION MAY WELL BE HIDING A SECOND ONE

GDP in the United Kingdom rose by 0.1% q/q in Q1 2023. The winter recession heralded in autumn 2022 did not materialise thanks to public investment, the momentum of services and the resilience of industry. This resilience is good news, but is likely to make inflation more persistent in the medium term, while the latest figures once again surprised on the upside. The Bank of England (BoE) will have to continue to raise interest rates. This will impact growth, which is likely to be zero in 2024, after already reaching just 0.4% in 2023.

Q1 GROWTH WEATHERED THE STORM

The UK will not be hit by recession in H1 2023, with growth having held up in Q1 according to current estimates (+0.1% q/q). Public finance support, through various support schemes (the Energy Price Guarantee, support for private investment) as well as through direct public investment (+9.7% q/q in Q1 2023), contributed positively to growth. Private consumption (-0.0% q/q) and corporate investment (+0.7% q/q) have not fallen as expected, benefiting from a catch-up effect in relation to the stalling seen post-Brexit. From a production point of view, services primarily supported growth (by 0.06 points), while construction (0.04 pt) and industry (0.02 pt) also contributed positively, although to a lesser extent. This resilience has spread to the majority of sub-sectors, despite signs of a slowdown for some. Retail sales held up in Q1 (+1.1% q/q), but household services fell (-0.4% q/q).

However, the United Kingdom faced headwinds this quarter. The household consumption deflator only slowed slightly to 9.4% y/y in Q1 2023, after reaching 10.3% in Q4 2022. At the same time, interest rates continued to rise, with the BoE bringing its key rate to 5% in June, and with the borrowing rate for lending to non-financial businesses standing at 6% in April (2.4% in April 2022). Households also suffered from monetary tightening as the interest charge as a percentage of their gross disposable income went from 1.5% in Q4 2021 to 3.6% in Q4 2022[1]. For the time being then, the private sector has weathered this double rise in the cost of living and in borrowing.

THE SECOND WAVE IS ALREADY HERE

Our scenario forecasts growth of +0.1% q/q in Q2 2023, then +0.2% in Q3 and +0.0% in Q4. Recession would therefore be avoided this year thanks to the favourable momentum driven by Q1 performance. Buoyed by this positive momentum in the short term, the UK economy has weathered the storm but headwinds are keeping it out at sea.

Firstly, the latest inflation figures are still generating fears of greater persistence and should force the BoE to continue its monetary tightening cycle for longer than expected a few months ago. Core inflation (excluding food and energy) continued to rise in May, reaching a 40-year high (7.1% y/y). Inflation seems to be affecting components which had been relatively spared to date, such as communication (+9.1% y/y in May) and leisure (+6.7% y/y). Similarly, inflation on the services sector (+7,4 %) - closely monitored by the BoE as an indicator of domestic inflation - rose above its record high seen in December 2022.

Secondly, the labour market is showing signs of a slowdown but remains relatively tight. The UK economy created only 7,000 jobs in April. Employment has now fallen in some sectors since April 2022, such as construction (-5,000 jobs) and retail (-50,000 jobs). These job losses can also be weighed against the sharp rise in corporate defaults in Q1 (+17.7% y/y), which was particularly marked in the retail sector (+35.3% y/y).

GROWTH & INFLATION

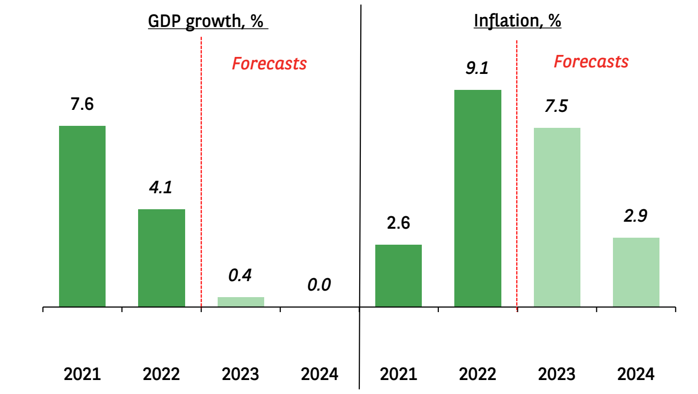

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

The unemployment rate is up y/y in Q1 2023 (to 3.9% compared to 3.7% in Q1 2022), which is a recession indicator according to the Sahm Rule[2], confirmed 7 out of 11 times in the United Kingdom over the last 50 years. The inflows of non-European workers (+6.2% q/q in Q1 2023) are also beginning to offset Brexit-related departures of workers from the European Union. However, these factors remain too piecemeal, and cannot be considered as a trend for the time being. Wage growth, another indicator of persistent inflation, is the highest among G7 countries (+7.2% y/y in April). Recent surprises on the upside around inflation should be passed on to wages via inflation expectations. These expectations rose in May for the first time since December 2022, to 5.9% on a one-year horizon, increasing the risk of a wage-price spiral.

Inflation could therefore have an impact for longer on household purchasing power and, at the same time, push, if not force, the BoE to tighten the terms of lending once again. We expect two additional hikes and a terminal rate of 5.75% in November. These factors would prevent the recovery of UK activity in 2024 (+0.0% as an annual average). We also expect a technical recession at the beginning of next year, with -0.2% q/q in Q1 2024 then -0.1% in Q2, while inflation should not fall below its target of 2% by the end of 2024.

Stéphane Colliac (with Louis Morillon, intern)
stephane.colliac@bnpparibas.com

1 Normalisation of monetary policy in the United Kingdom: the impact on mortgages (bnpparibas.com)
2 Real-time Sahm Rule Recession Indicator (SAHMREALTIME) | FRED | St. Louis Fed (stlouisfed.org)