UNITED KINGDOM
2024-2025 SCENARIO

A FRAGILE RECOVERY EXPECTED LATER IN THE YEAR

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WORKING EVERY DAY IN YOUR INTEREST AND FOR SOCIETY

GROUP ECONOMIC RESEARCH

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SUMMARY

THE IMPACT OF PAST MONETARY TIGHTENING HAS YET TO PASS THROUGH TO THE ECONOMY

After a slight decline in GDP in the third quarter (-0.1% QoQ), triggered by a sharp drop in private consumption and investment, we expect activity to stabilise in the fourth quarter in light of the improvement in business surveys, followed by positive but weak growth in early 2024. Disinflation surprised positively and government bond yields fell. Although the risk of recession continues to loom over the UK economy, the probability of such a scenario in the short term seems to have diminished.

The main drag on growth is the delayed effect of past monetary policy tightening: according to the Bank of England (BoE), more than half of the impact of past monetary policy has yet to pass through to the real economy. This is a plausible timeframe because the larger share of fixed-rate mortgages relative to past episodes of monetary tightening implies a delayed and protracted impact of mortgage rates' increases on household disposable income. High interest rates will continue to weigh on household consumption, investment and job creation. In turn, weak demand will likely gradually ease domestic inflationary pressures later this year. **According to our scenario, inflation is expected to approach the 2% target in the second quarter of 2024, which should prompt the BoE to begin its rate cuts no later than August 2024.** However, due to the tight domestic labour market and the uncertain geopolitical environment, inflationary risks remain tilted to the upside.

High financing costs are weighing on consumer confidence. Households increased their savings rate (10.3% in the third quarter), despite an increase in real disposable income, probably in anticipation of higher debt service in the coming months. Households are likely to remain cautious in the short term against a backdrop of restrictive monetary (and fiscal) policy. Nevertheless, **continued solid growth in real incomes should enable private consumption to resist and grow slightly in 2024.** Admittedly, with falling inflation expectations and weakening demand for labour, wage growth in the private sector is likely to continue to wane in the coming months. However, upward pressure on wages will remain strong (the BoE forecasts private sector wage growth of around 5% to 6% this year) due to the structural factors that have led to a rise in the equilibrium rate of unemployment: Brexit, *post*-Covid problems such as long-term illnesses among inactive people, and the inadequacy of job seekers' skills to fulfil the needs of the economy. In addition, the tax cuts announced in the Autumn Statement (mainly reductions in social security contributions paid by employees and the self-employed) as well as the 10% increase in the minimum wage planned for April 2024 will partially offset the increase in taxation generated by the freezing of tax thresholds. **What's more, the government will likely announce additional tax cuts in its budget of 6 March 2024 against the backdrop of an election campaign. General elections are expected to be held in the second half of 2024 (probably in the autumn), as recently indicated by Prime Minister Rishi Sunak, although he did not rule out May as a possibility. The Labour Party remains well ahead in voter intentions, with a comfortable advance margin.**

Investment, residential in particular but also productive, will continue to weigh on growth. While tax incentives boosted business investment at the beginning of 2023, the Chancellor's decision to make the full expensing permanent for qualifying plant and machinery investments is likely to result in a short-term decline in investment, as the incentive to anticipate investment has been removed. While inflation is also expected to continue falling over the coming months, real interest rates have started to rise. Finally, business investment will likely suffer from the uncertain global environment with heightened geopolitical risks, elections in the US, a slowdown in global growth and even a possible recession in the US.

SUMMARY

KEY RATES: FIRST RATE CUT EXPECTED IN AUGUST

Prices have moved in the right direction in recent months, supporting the idea that there is no need to raise policy rates further. Inflation (CPI) fell to 4.6% YoY in October and then to 3.9% YoY in November (below BoE forecasts). This positive surprise is mainly due to a sharper-than-expected deceleration in prices of products excluding energy and food, as well as services (down to 6.3% YoY in November).

The labour market continued to gradually ease. Indeed, the unemployment rate has been stable since June at 4.2%. But the number of job offers continued to decline. Wage growth fell more sharply than expected, particularly in the private sector, where it fell from 7.9% YoY in the three months to September to 7.3% YoY in the three months to October. Although wage growth is still too high to be compatible with the 2% inflation target, signs of continued disinflation in the labour market are reassuring.

The BoE expects inflation to fall sharply in 2024, but more slowly than in 2023. According to its central forecasts, inflation is expected to be 4.6% YoY in the fourth quarter of 2023 and 3.1% YoY in the fourth quarter of 2024. It would return to the target of 2% by the end of 2025 and would then fall below this level, due to the emergence of excess capacity. The surprise drop in November's inflation figures should lead the BoE to revise its forecasts downwards at its monetary policy meeting in February.

However, monetary easing seems unlikely in the near term. Monetary policy will have to remain restrictive in order to ensure a sustainable return of inflation towards its target, especially as the risks surrounding inflation are tilted to the upside. Indeed, the labour market remains historically tight, with nominal wage growth too high, and should remain so in the short term (nearly 6% expected in the first quarter of 2024 and 5% in the fourth quarter of 2024). This could lead to persistently high inflation in the services sector. The BoE believes that second-round effects on domestic prices and wages will be slow to absorb. In November, it decided to reconsider its assumptions related to domestic inflationary pressures. In particular, it increased its estimate of the equilibrium unemployment rate in the medium term to 4.5% (it is from this threshold that domestic inflationary pressures disappear), a level which we expect to be reached in the first quarter of 2024. Unless there is a significant and unexpected deterioration in the outlook in the near future (e.g. in the event of a recession), risk management considerations lead us to believe that key rates will have to remain "higher, longer" in order for inflation to move sustainably towards the target.

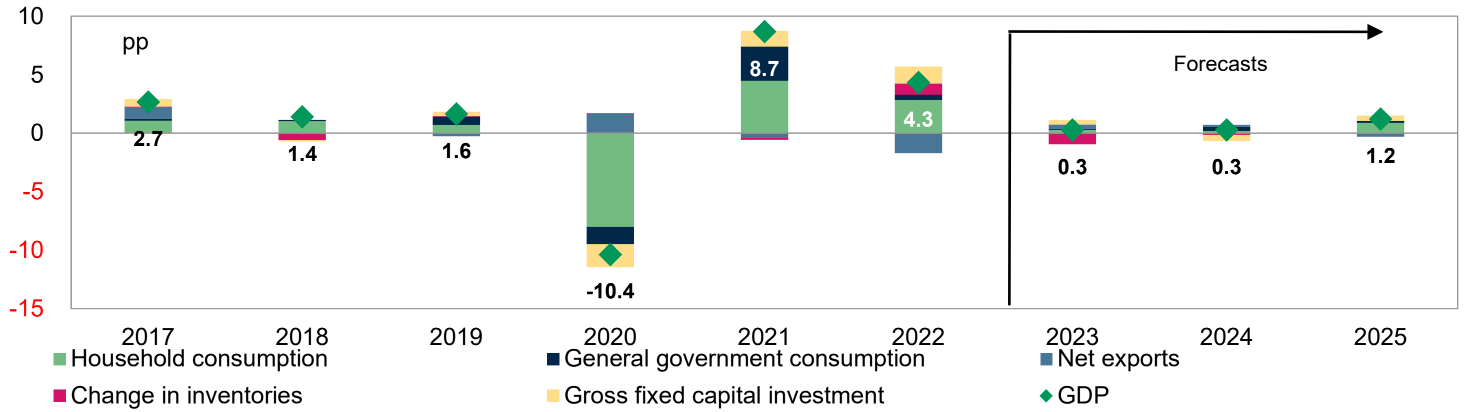
An additional factor reduces the probability of a rate cut in the first half of 2024: the fiscal easing announced in the Autumn Statement of 22 November (around 0.6% of GDP on average per year, i.e. among the most significant since the pandemic). While the main stimulus measures reflect supply policy, the reduction in social security contributions (or NICs for National Insurance contributions) should in the short term give a small boost to demand rather than supply. At the margin, this argues in favour of an extension of the BoE's *status quo*. In addition, in the spring, the government will likely announce additional easing of the 2024 budget (on the 6th of March) in view of the upcoming general elections.

Finally, the BoE should be confident enough to start cutting rates in August 2024, one year after its last hike. This decision would be justified by a context of weak growth, reduced tensions on the labour market and continued deceleration in inflation during the first half of 2024. Our scenario assumes two rate cuts of 25 basis points each in the second half of 2024, then four in 2025.

SUMMARY

FORECAST

Contributions to annual GDP growth



Sources: ONS, Crédit Agricole SA / ECO

United Kingdom	2023	2024	2025	2023				2024				2025			
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP (%)	0.3	0.3	1.2	0.3	0.0	-0.1	0.0	0.1	0.1	0.3	0.3	0.3	0.4	0.4	0.4
household consumption	0.5	0.3	1.5	0.8	0.5	-0.5	0.0	0.1	0.1	0.3	0.4	0.4	0.4	0.4	0.4
public consumption	0.4	1.7	0.8	-1.1	2.6	0.8	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
investment	2.0	-2.8	2.6	2.4	-1.0	-1.6	-1.0	-1.0	-0.5	0.5	0.6	0.8	0.8	0.8	0.8
change in inventories*	-1.0	-0.2	0.0	-0.3	-0.2	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
net exports*	0.4	0.2	-0.3	-1.5	-0.8	0.1	0.2	0.2	0.1	0.0	-0.1	-0.1	0.0	0.0	0.0
Unemployment rate (ILO)	4.1	4.7	5.5	3.8	4.3	4.2	4.3	4.5	4.6	4.8	4.8	4.7	4.6	4.4	4.3
Inflation (CPI, YoY%)	7.3	2.9	1.9	10.2	8.4	6.7	4.2	3.8	2.4	2.6	2.7	2.2	1.9	1.8	1.8
Core CPI (YoY%)	6.2	3.2	2.0	6.1	6.9	6.4	5.3	4.8	3.1	2.5	2.6	2.3	2.0	1.8	1.8
Current account (% GDP)	-2.3	-2.0	-2.4	-2.4	-2.5	-3.5	-	-	-	-	-	-	-	-	-
General gov. balance, % GDP	-5.2	-3.4	-2.6	-	-	-	-	-	-	-	-	-	-	-	-
Public debt % GDP	100.9	103.9	106.6	-	-	-	-	-	-	-	-	-	-	-	-
Bank rate**	5.25	4.75	4.50	4.25	5.00	5.25	5.25	5.25	5.25	5.00	4.75	4.50	4.25	4.00	3.75

** Contributions to GDP growth*

*** End of period*

Source: ONS, BoE, Crédit Agricole S.A.

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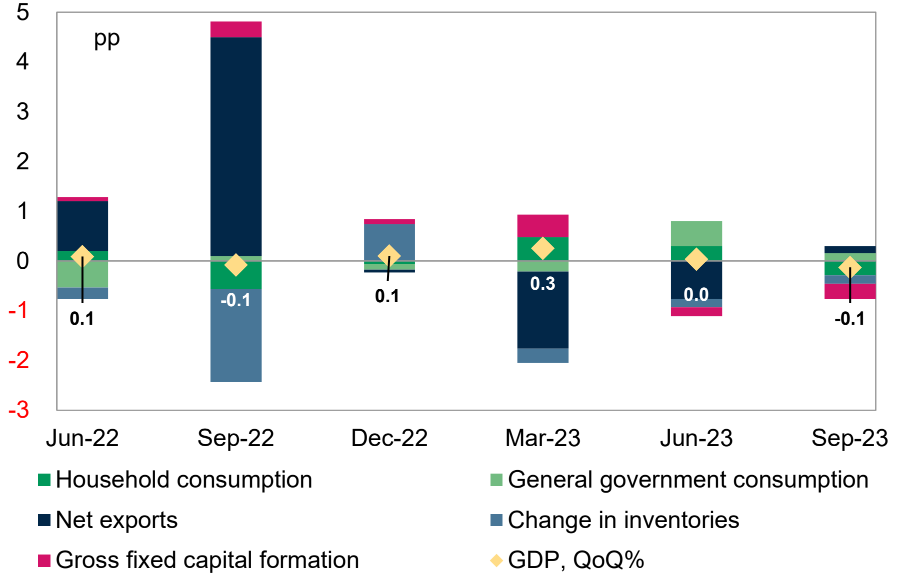
RECENT ECONOMIC DEVELOPMENTS

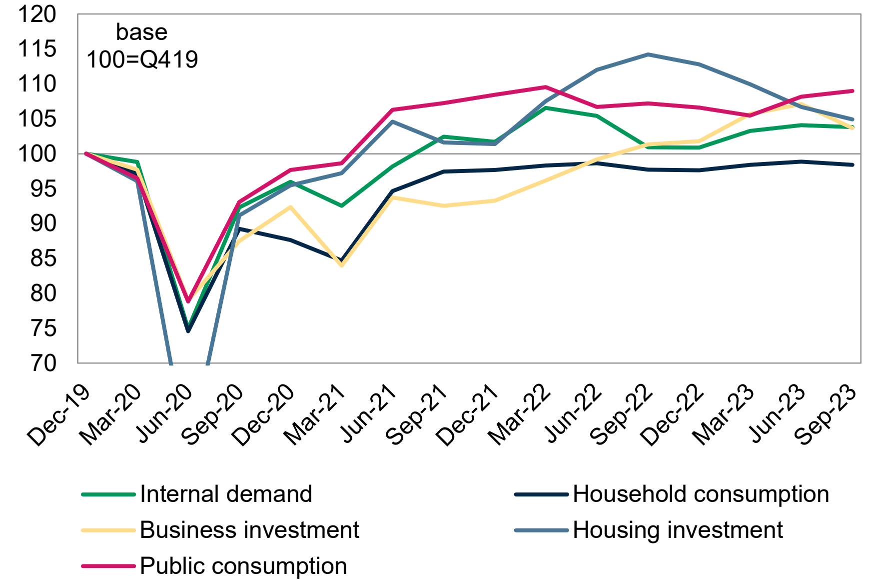
GROWTH WAS NEGATIVE IN Q3-2023 DUE TO A DECLINE IN DOMESTIC DEMAND

Quarterly GDP growth: breakdown in terms of expenditure



Sources: ONS, Crédit Agricole S.A./ECO

Domestic demand: change since Covid



Sources: ONS, Crédit Agricole S.A./ECO

In Q3-2023, real GDP fell by 0.1% QoQ, according to the ONS's second estimate (revised down from the initial estimate of 0%). This slight decline comes after zero growth in Q2 (also revised down from 0.2% QoQ previously).

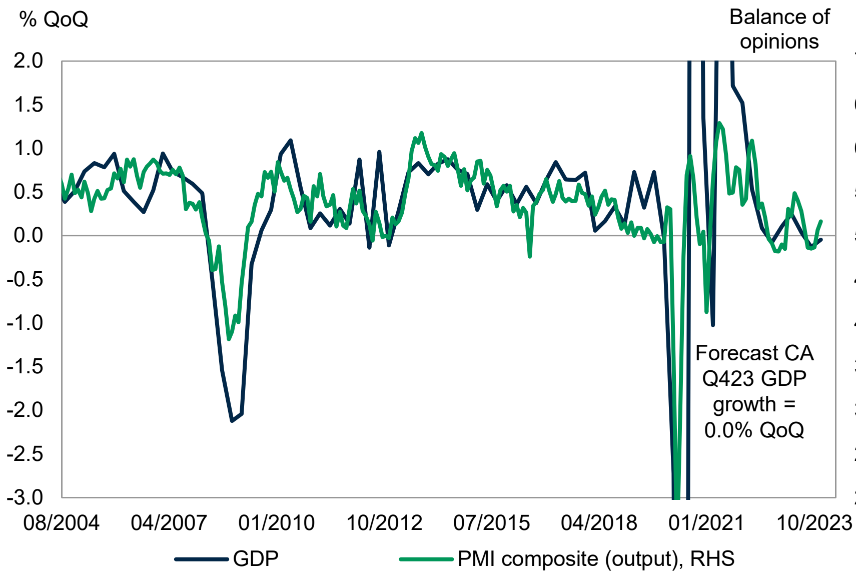
Domestic demand, which so far has been relatively resilient to the various headwinds that hit the economy (inflation eroding real incomes, rising interest rates), was down (-0.3% QoQ) for the first time in a year. This was mainly due to contractions of business investment (-3.2% QoQ) and household consumption (-0.5% QoQ). If GDP managed to limit the decline over the quarter, it was thanks to a more significant fall in imports (-1% QoQ) than in exports (-0.6% QoQ).

The decline in household consumption comes at a time when real incomes are growing again (+3.8% YoY in Q3, after +2.9% in Q2) and seems to be explained by greater precautionary savings behaviour (the savings rate reached 10.3% in Q3, after 9.7% in Q2): indeed, it is quite possible that households are saving in anticipation of increases in the cost of servicing their debt (particularly for households that have to refinance their loans in the coming months) and/or in anticipation of a deterioration in the labour market. On the other hand, the decline in business investment is not surprising. It comes after two quarters of strong growth and seems to be explained in part by the expiry on 1 April 2023 of the "super-deduction allowance" (a tax measure implemented by the government between 1 April 2021 and 31 March 2023 allowing companies to deduct 130% of the amount invested in eligible assets from their taxable profits).

RECENT ECONOMIC DEVELOPMENTS

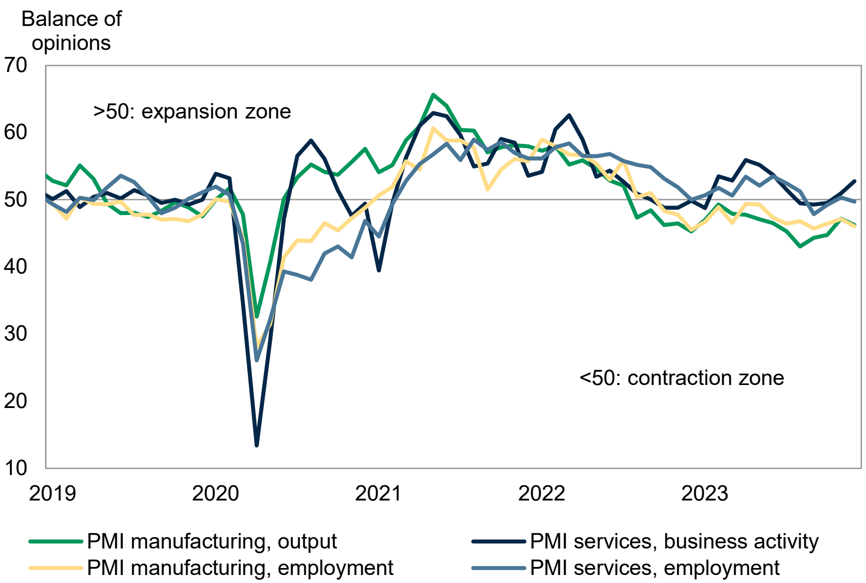
PMI SURVEYS: IMPROVEMENT IN THE BUSINESS CLIMATE AT THE END OF THE YEAR

PMIs suggest zero growth in Q4 after -0.1% in Q3



Sources: ONS, S&P Global PMI/CIPS data at end-December, CA S.A./ECO

An acceleration of activity in December thanks to the services sector



Sources: S&P Global PMI/CIPS data at end-December, CA S.A./ECO

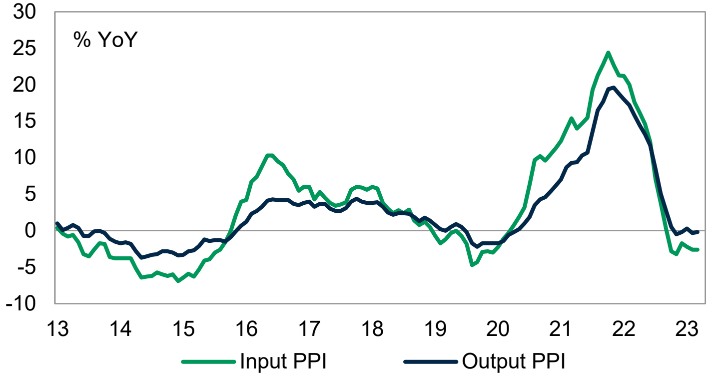
After the ONS's recent revision of the quarterly national accounts, the growth rate in Q3 (-0.1% QoQ) came in line with the pace suggested upstream by the PMIs (surveys of purchasing managers in the private sector). For Q4, the composite PMI suggest a stabilisation of activity (in line with our forecast), while pointing to an acceleration of GDP in December at its highest rate since June. However, the dichotomy between services and industry is still present. While the manufacturing sector remained in contraction territory for the tenth consecutive month (at 46 on average in Q4 after 44.2 in Q3), the services sector seems to be accelerating slightly (to 51.1 after 50.1 in Q3), mainly thanks to professional and financial services.

In general, the status quo on the key policy rate since September and market expectations of rate cuts in 2024 seem to be fuelling hopes of a modest recovery in demand. In services, new orders rose for two consecutive months. In industry, there has also been a slight improvement: new orders are still falling, but less quickly. This improvement in domestic demand seems to be accompanied by a stabilisation in goods prices (after several months of declines) and still-sustained price increases in services (57.8 on average in Q3 and Q4). However, inflationary pressures in services are mainly driven by wage growth (7.3% over the three months to end-October, down from a peak at 7.9% in June-August), the highest rate being in financial services (8.3%).

RECENT ECONOMIC DEVELOPMENTS

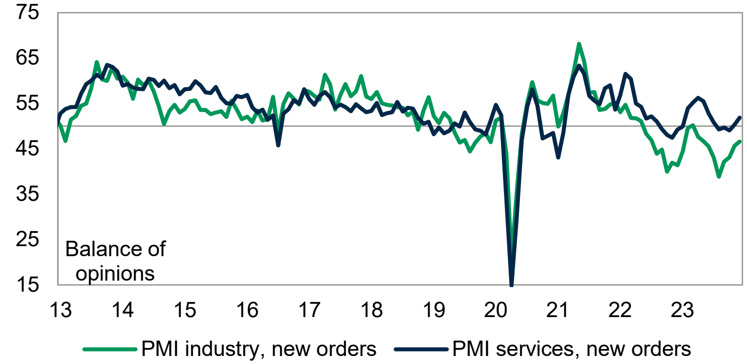
DISINFLATIONARY PRESSURES CONTINUE, BUT ARE BECOMING LESS STRONG

Producer price inflation remains in negative territory



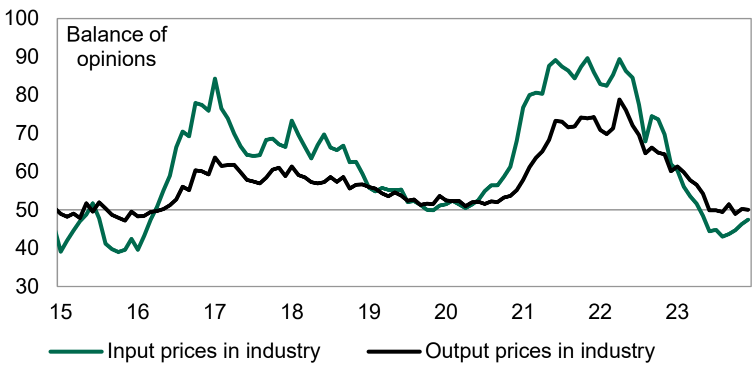
Sources: ONS, Crédit Agricole S.A./ECO

Demand is improving



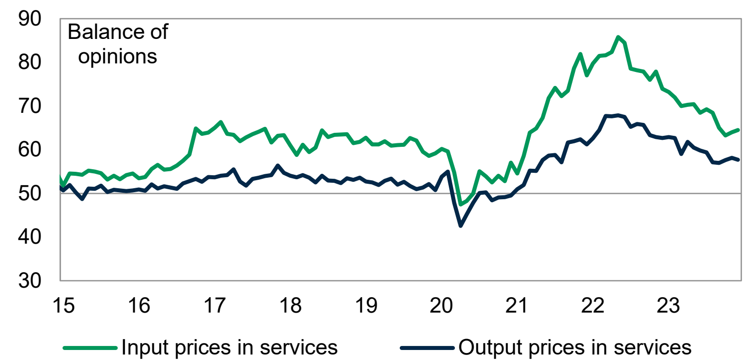
Sources: S&P Global PMI/CIPS-PMI industry at end-December, Crédit Agricole S.A./ECO

Output prices stabilise in industry



Sources: S&P Global PMI/CIPS-PMI industry at end-December, Crédit Agricole S.A./ECO

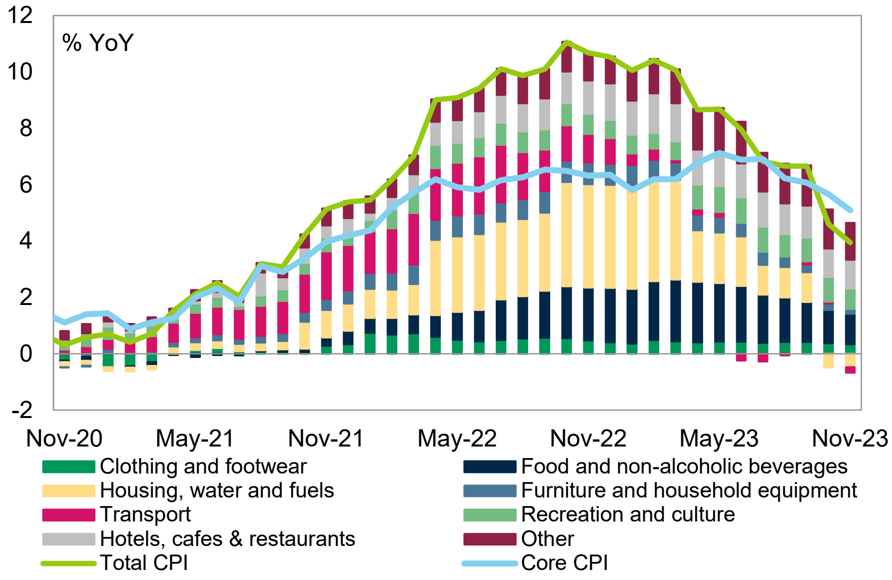
Inflationary pressures remain high in services



Sources: S&P Global PMI/CIPS-PMI services at end-December, Crédit Agricole S.A./ECO

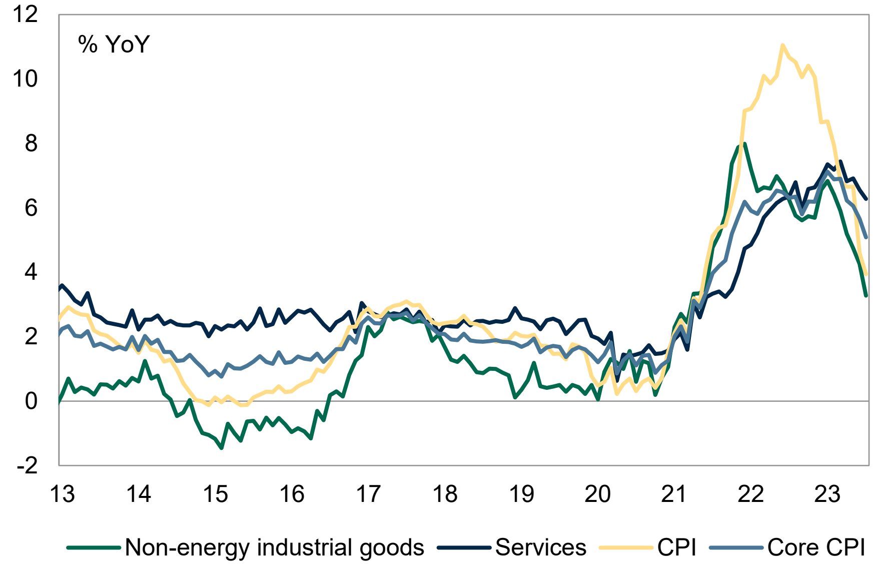
DISINFLATION HAS BEEN SLOWER IN SERVICES THAN IN GOODS

CPI inflation and contributions by main components



Sources: ONS data at end-November, Crédit Agricole SA / ECO calculations

The stickiness of inflation in services supports core inflation



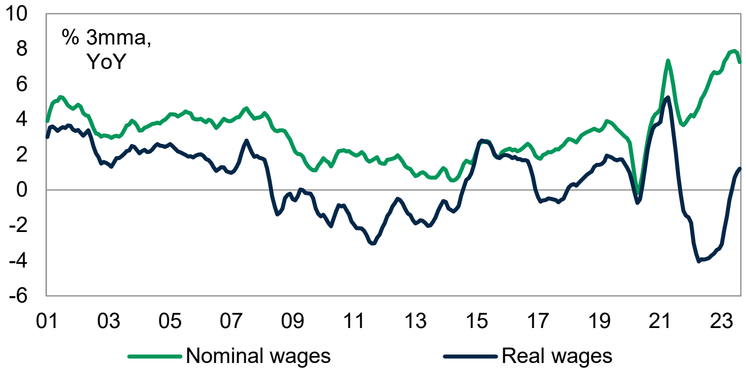
Sources: ONS data at end-November, Crédit Agricole SA / ECO

The CPI inflation rate fell more sharply than expected in November, to 3.9% YoY from 4.6% YoY in October, driven down by the “transport”, “leisure and culture” and “food and non-alcoholic beverages” components. Core inflation, as measured by the CPI excluding energy, food, alcohol and tobacco, reached 5.1% YoY (vs 5.7% in October and a high of 6.9% in July), its lowest level since January 2022. Inflation in non-energy industrial goods has moderated significantly: it now stands at 3.3% YoY, compared with 6.8% YoY in May, due to lower raw material costs, the stabilisation of freight rates and the decline in activity in the real estate market. The PPI indices show a decline in input costs on annual basis for the sixth consecutive month in November (-2.6% according to the PPI index), driven by metals and chemical inputs and oil. In the food sector, while consumer price inflation has continued to wane since March (from 19.1% YoY to 9.2% YoY), the moderation is mainly due to base effects, with prices continuing to rise on a monthly basis. Inflation in services fell to 6.3% YoY (from 6.6% YoY in October), thanks to transport, recreation and various services. It is also falling faster than expected, but it is clear that disinflation is less rapid than in the goods sector. This is because service prices have a higher wage cost component due to greater labour intensity.

RECENT ECONOMIC DEVELOPMENTS

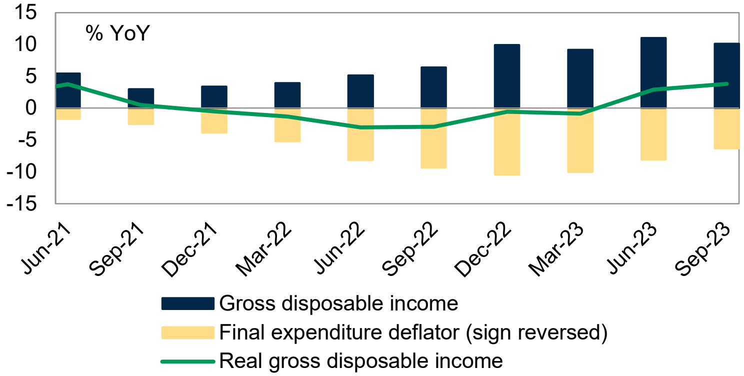
CONSUMERS REMAIN CAUTIOUS DESPITE A RECOVERY IN PURCHASING POWER

Real wages: the end of the great "squeeze"



Sources: ONS, data as of end of October

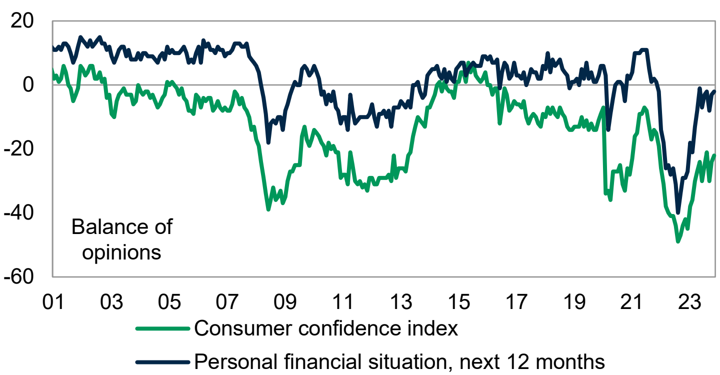
Real disposable income has seen sustained growth over the past two quarters



Note: Real gross disposable income is the gross disposable income adjusted by the expenditure deflator.

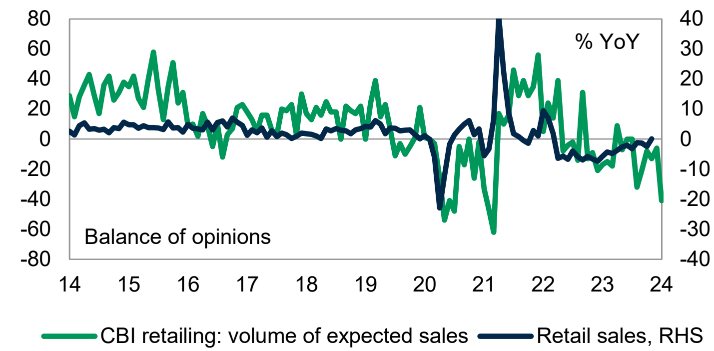
Sources: ONS, Crédit Agricole S.A./ECO

Consumers remain cautious



Sources: GfK, Crédit Agricole S.A./ECO

The start of the year looks gloomy for the retail sector

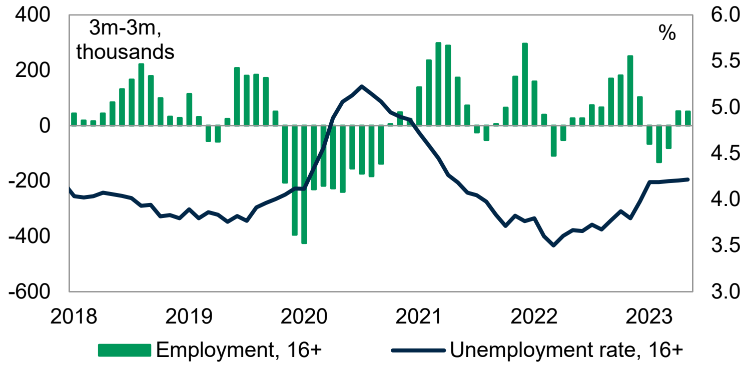


Sources: BoE, Crédit Agricole S.A./ECO

RECENT ECONOMIC DEVELOPMENTS

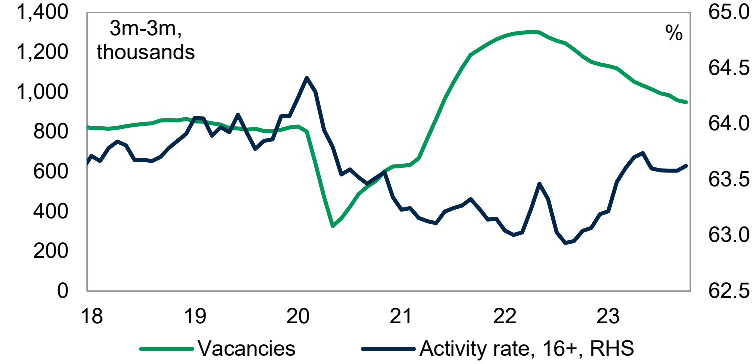
LABOUR MARKET CONDITIONS ARE ONLY SLOWLY EASING

Stabilisation in H2: unchanged unemployment rate at 4.2%, employment creations of 78K



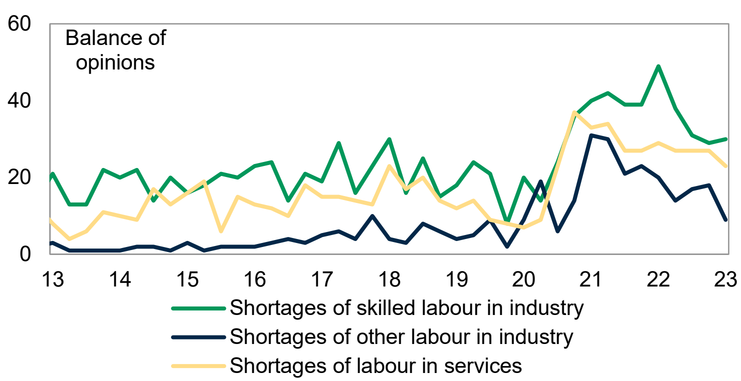
Sources: ONS (experimental data), CA SA / ECO

Reduction of demand/supply imbalances *via* a fall in demand: vacancies versus the participation rate



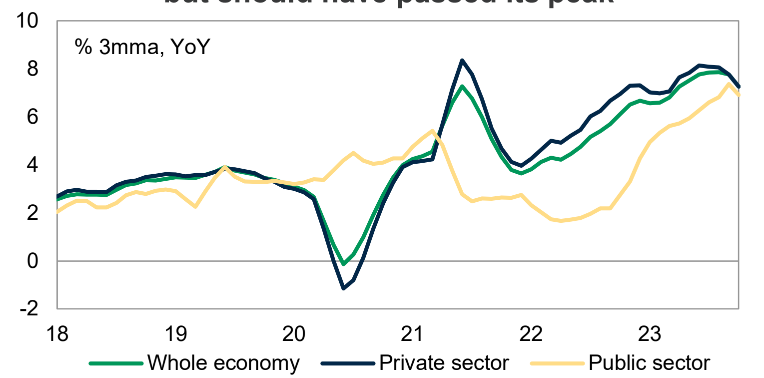
Sources: ONS, Crédit Agricole S.A./ECO

Recruitment difficulties persist



Sources: CBI, Crédit Agricole S.A./ECO

Wage growth remains strong, but should have passed its peak

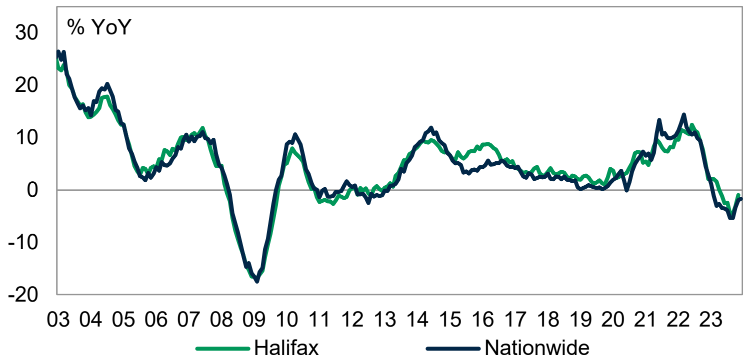


Sources: ONS, data as of end of October, CA SA / ECO

RECENT ECONOMIC DEVELOPMENTS

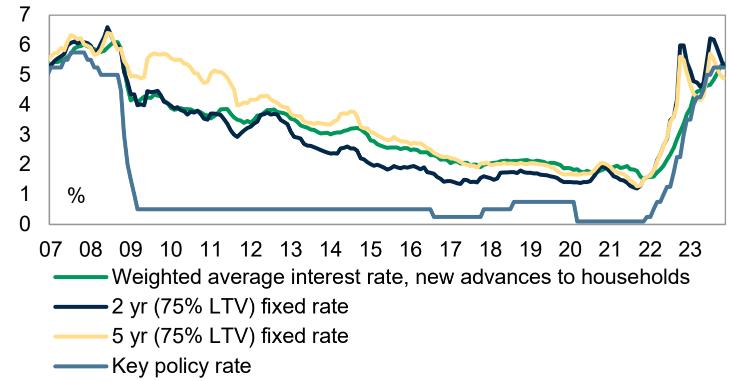
IMPROVED OUTLOOK ON THE REAL ESTATE MARKET

Price declines have slowed in the residential sector…



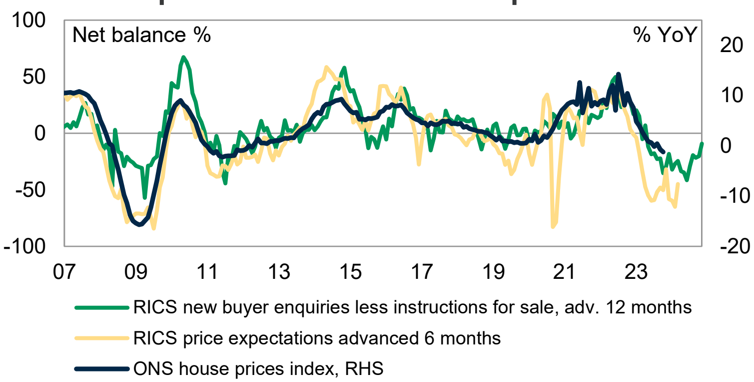
Sources: Halifax, Nationwide, Crédit Agricole S.A./ECO

… thanks to a slight drop in rates on mortgages



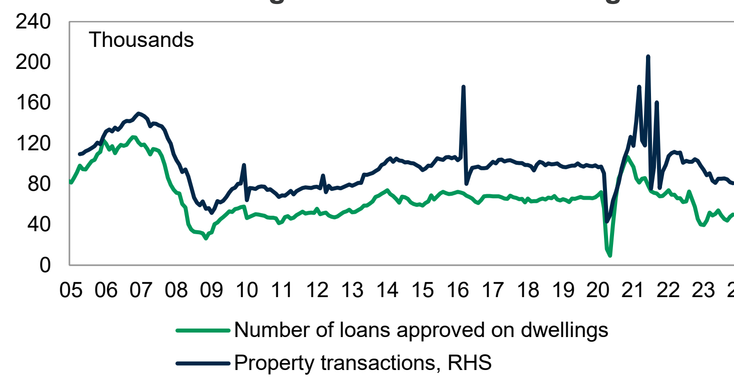
Sources: BoE, Crédit Agricole S.A./ECO

RICS surveys have become less pessimistic on sales and prices



Sources: RICS, ONS, Crédit Agricole S.A./ECO

Transactions have continued to decline but loan agreements are stabilising



Sources: BoE, HM Customs and Excise, data at end-November, Crédit Agricole S.A./ECO

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THE OUTLINE OF OUR SCENARIO

GROWTH IS LIKELY TO REMAIN CLOSE TO ZERO IN THE SHORT TERM

Although Q3-2023 saw a slight decline in activity, **the recession scenario**, which we had anticipated three months earlier for H2-2023, **seems to have diminished in probability** given the recent improvement in business climate surveys. **We now expect zero growth in Q4-2023 and relatively stable activity in early 2024.** However, our 2023 annual growth forecast is revised down to 0.3% from 0.5% previously due to negative revisions by the ONS to quarterly growth in Q2 and Q3. It should remain at a similar level in 2024 (0.3%), before accelerating in 2025 (to 1.2%, below the potential estimated at 1.6% by the OBR). Our scenario remains relatively constructive on household consumption but more pessimistic in the short term on investment than three months previously. Total domestic demand growth is expected to be only 0.2% in 2023. Our scenario then assumes that it will be virtually stable in 2024 before accelerating in 2025.

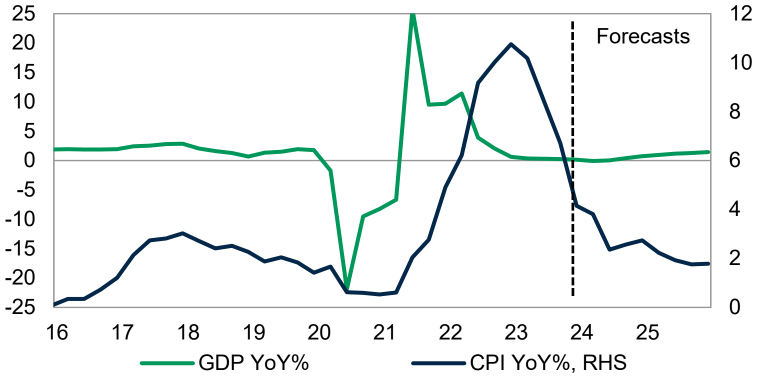
The main characteristics are as follows:

- **Resilience of household spending**. Purchasing power is expected to continue to see solid growth in the coming quarters, although upside risks to inflation, particularly energy prices, remain. The savings rate is higher than its pre-Covid level and the excess savings accumulated during the pandemic remain significant. The good health of household balance sheets on aggregate should enable them to withstand the impact of past monetary tightening on their finances, especially as the BoE is expected to start a cycle of rate cuts in H2-2024.

- **Contraction in private investment in the short term.** Business investment surprised positively in H1-2023, helped by generous government tax measures and benefiting from a late post-pandemic catch-up effect which has probably largely played its part. Gross fixed capital formation is expected to contract in H1-2024 under the increasingly heavy weight of real rates, weakening external demand and less incentive tax credits.

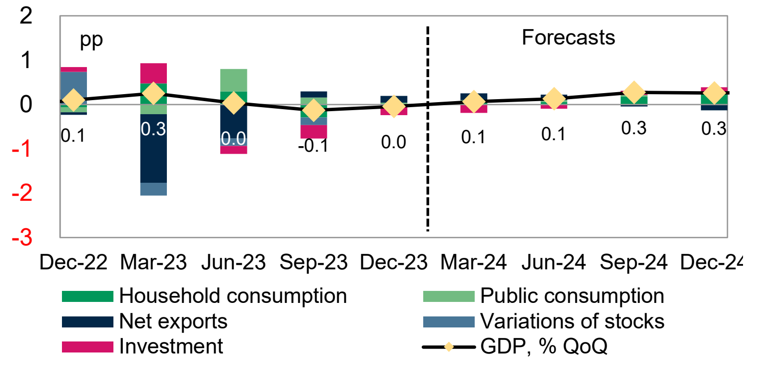
- **Balanced risks.** On the one hand, the uncertain geopolitical climate poses downside risks to growth. On the other hand, the US economy could continue to surprise positively and the recession scenario we expect for H2-2024 may not materialize. On the domestic front, the UK government could also surprise with more fiscal easing ahead of the general election due in May at the earliest and most likely in the autumn.

GDP growth and CPI inflation



Sources: ONS, Crédit Agricole S.A./ECO

Quarterly GDP growth and contributions



Sources: ONS, Crédit Agricole S.A./ECO

THE OUTLINE OF OUR SCENARIO

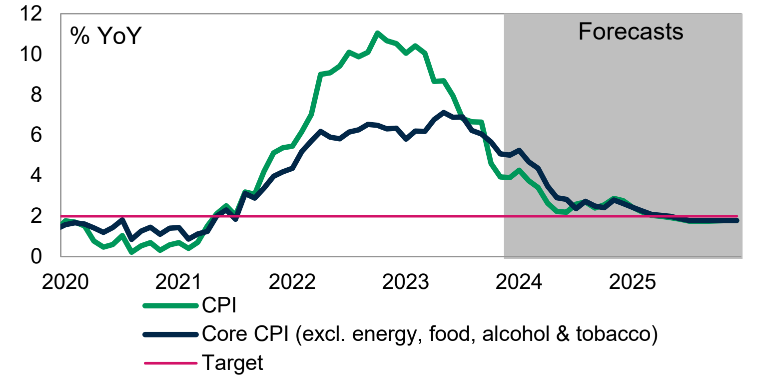
CPI INFLATION CLOSE TO TARGET BY MID-2024, SLOWER DECLINE IN UNDERLYING INFLATION

The drop in consumer price inflation, as measured by the CPI index, was faster than expected over the last year, from 10.2% YoY in Q1 to 6.7% YoY in Q3 and 3.9% YoY in November. The positive surprises reflect a sharper-than-expected deceleration in prices of *core* goods (excluding energy and food), and more recently, of services. Overall, core inflation started to fall only from July (peak at 6.9% YoY) to reach 5.1% YoY in November. Its decline continues to be slowed by domestic pressures still sustained in connection with wage growth. In services, where prices have a strong wage costs component, inflation therefore remains too high (6.3% YoY in November vs 7.4% YoY in July).

In early 2024, inflation is expected to rebound temporarily again. On the one hand, base effects are becoming unfavourable again (less significant decrease expected for January 2024 than in January 2023) and, on the other hand, the energy price cap levels increased by 5% on average on 1 January to £1,928 for Q1-2024 (annualised bill for the typical household) compared to Q4-2023. Core inflation is expected to continue to fall very gradually. It is now above the headline inflation and is expected to remain so for most of next year.

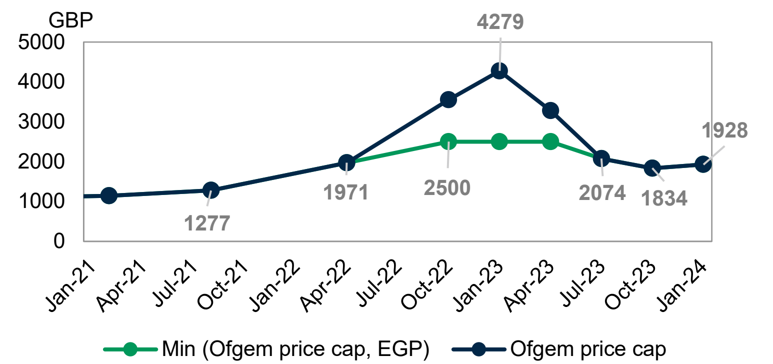
Due to the downside surprises over the past few months, our scenario is now more optimistic about the ability of inflation to reach the target. Indeed, we anticipate a sharp fall in Q2-2024, when inflation approaches the 2% target, but remains above it (2.4% on average over the quarter). The emergence of excess capacity in the labour market should contribute to the easing of pressure on prices: we anticipate an increase in the unemployment rate in the coming months, which would surpass its equilibrium unemployment rate in Q2-2024 and would continue to rise in the second half of the year towards a peak of 4.8% at the end of 2024.

CPI inflation and core inflation



Sources: ONS, Crédit Agricole S.A./ECO

Typical household annual energy bill (gas and electricity)

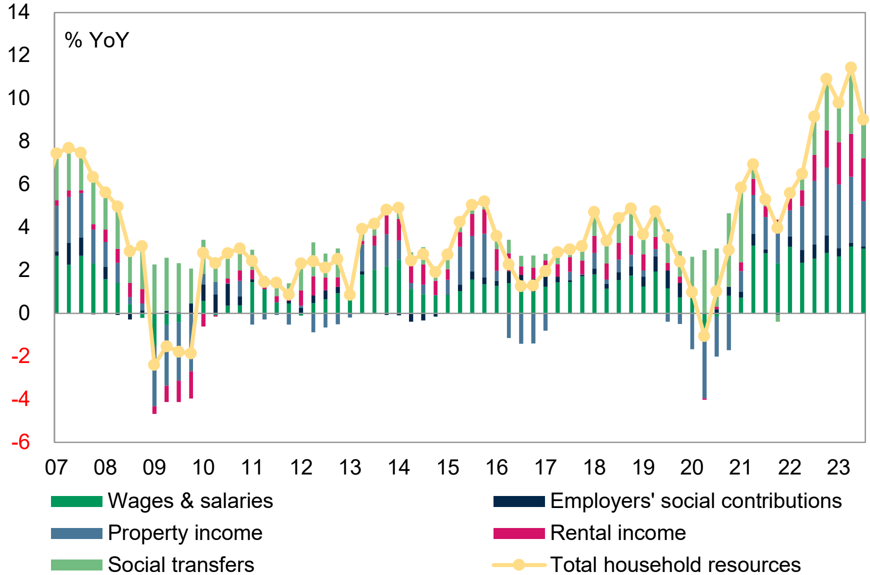


Sources: Ofgem, gov.uk., heattable.co.uk, Crédit Agricole S.A./ECO

THE OUTLINE OF OUR SCENARIO

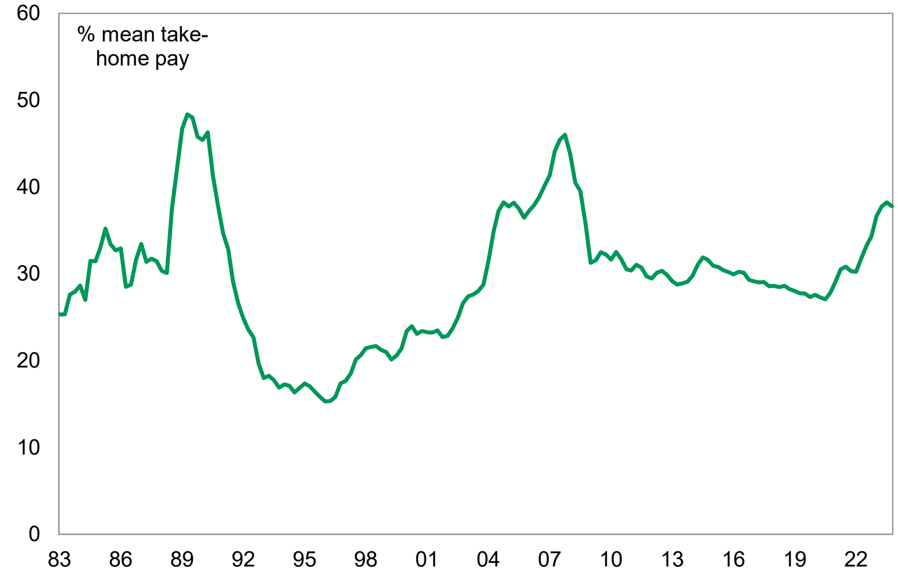
HOUSEHOLDS: AN INCREASE IN PURCHASING POWER, BUT ALSO IN DEBT SERVICING

Growth in household income: moderation from very high rates



Sources: ONS, Crédit Agricole S.A./ECO

Mortgage repayments for first-time buyers: the debt burden is increasing

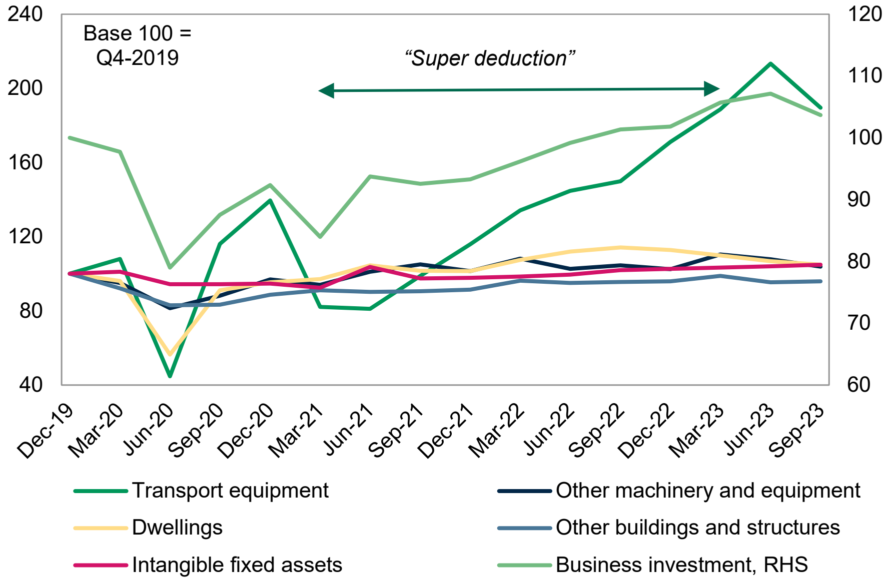


Sources: ONS, Crédit Agricole S.A./ECO

Household consumption held up fairly well in H1-2023, rising 1.3% (Q2-2023 relative to Q4-2022), before falling 0.5% QoQ in Q3. This resilience is explained by the government's financial aid to households and businesses to cope with the energy crisis (a cap to energy prices from October 2022 to June 2023), the tight labour market conditions, as well as high growth in financial and rental income. Gross disposable income grew by 11% YoY in Q2, a record pace since the early 90s. Moreover, the fall in inflation enabled real disposable income to grow again: the purchasing power recorded two consecutive quarters of positive growth, reaching 3.7% YoY in Q3. It is now above its peak in Q2-2021 and is expected to continue to see solid growth in the coming months, boosted by wage growth that is expected to remain high again this year in the private sector and by continued disinflation. From January, households will also benefit from the 2 pp reduction in NICs paid by employees (i.e. an annual reduction of £450 for an employee earning an average of £35,400 per year) and, from April, the 1 pp reduction to 8% for self-employed workers. In addition, a 9.8% increase in the minimum wage will take effect in April. However, consumers remain cautious and are increasing their savings rate (10.3% in Q3 vs 7.9% in Q1). There are plenty of reasons for caution: inflation remains high and geopolitical conflicts pose the risk of a new shock to energy prices. But the excessive precaution is probably mainly due to the desire to build up reserves ahead of an increase in debt service (for indebted households that have not yet refinanced their loans) or in anticipation of a deterioration in the labour market. Growth in household consumption is expected to be only 0.5% on an annual average in 2023 and to remain weak in 2024 (0.3%), before accelerating in 2025 (1.5%). We therefore do not foresee a collapse: the overall good health of household balance sheets and a relatively resilient labour market should allow them to withstand the rise in rates, especially as the BoE is expected to start cutting rates later this year.

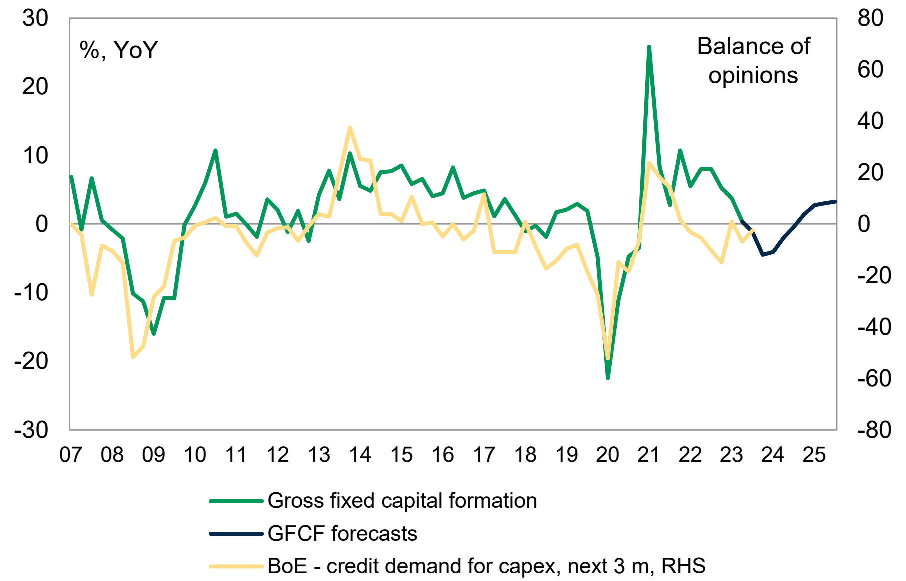
INVESTMENT: CONTRACTION IN 2024 BEFORE A REBOUND IN 2025

Business investment grew sharply during the period of the “super deduction allowance”



Sources: ONS, Crédit Agricole S.A./ECO

Demand for corporate credit continues to decline



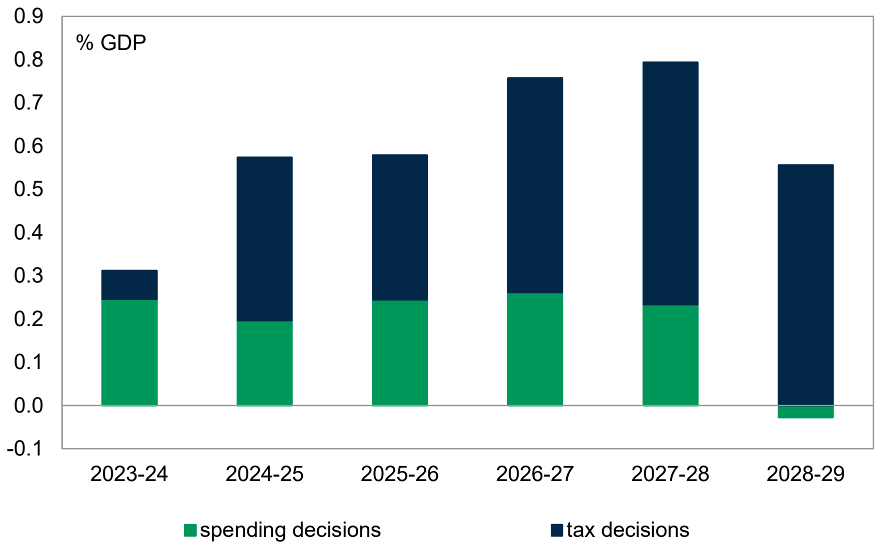
Sources: ONS, BoE Credit Conditions Survey T3-2023, Crédit Agricole S.A./ECO

Over the past three years, business investment has been impacted by significant changes in corporate taxation introduced by Rishi Sunak’s government. These include: 1) the implementation, between 1 April 2022 and 31 March 2023, of a tax relief of 130% of investments in installations and machines during the first year of expenditure (a “super-deduction” which offered a tax reduction of 25 pence for each pound of qualifying asset capex); 2) the increase in the main corporate tax rate (from 1 April 2023) from 19% to 25% for companies with an annual profit in excess of £250,000; 3) the “temporary full expensing” which granted a 100% tax deduction for investments in plants and equipment between April 2023 and March 2026; 4) the decision to make permanent this last measure in the Autumn Statement of November 2023 (“permanent full expensing”). It seems that these tax changes had a certain positive effect on business investment during the two years of the implementation of the “super-deduction,” particularly in transport assets, IT equipment and machinery, but that the impact was not significant (less than 5% according to the OBR). Nevertheless, we note a solid increase of more than 25% in business investment over the period between Q1-2021 and Q2-2023 despite the difficult context (Brexit, energy crisis, announced increase in corporate tax). This strong growth could reflect reasons for investing such as digitisation, efficiency, sustainability and maintenance. Finally, volatile components, such as investment in aerospace assets, supported investment in Q2-2023. We expect investment to decline in 2024, reflecting the impact of rising real interest rates and volatility of investment in the transport sector. Moreover, in Q3-2023, business investment was 3.7% above its level in Q4-2019, suggesting less scope for a cyclical recovery. In addition, the “permanent full expensing” will probably result in a decline in business investment in the short term, as the incentive to anticipate projects is no longer there. Finally, residential investment is expected to continue to contract sharply this year and next.

THE OUTLINE OF OUR SCENARIO

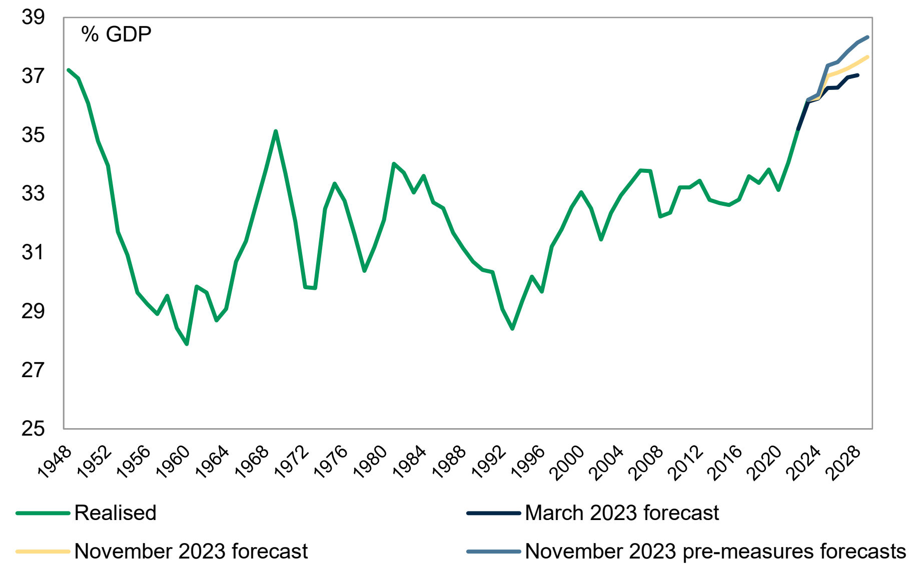
FURTHER EASING OF FISCAL POLICY

Discretionary measures of the Autumn statement in terms of budgetary cost



Sources: OBR Economic and Fiscal Outlook – November 2023, CA SA

Taxes as a share of GDP: towards a post-war record despite the reductions



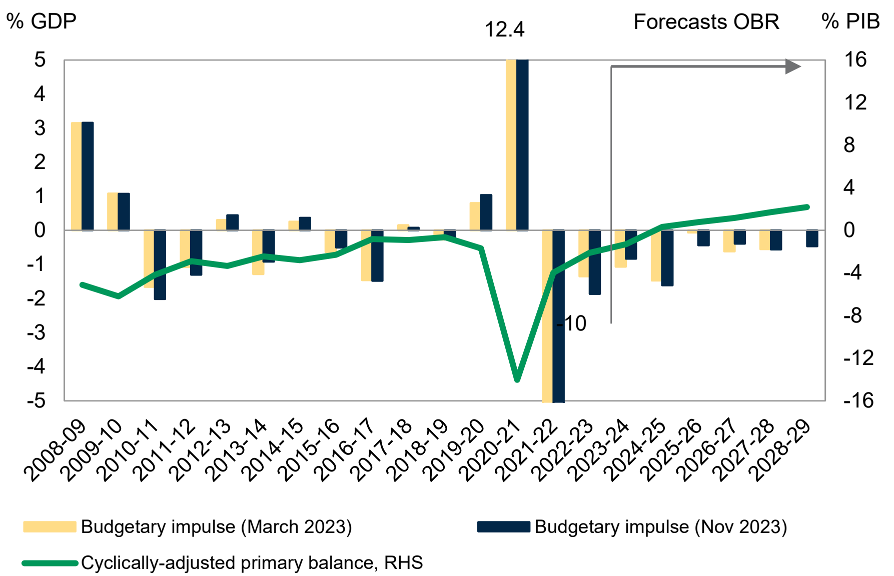
Sources: OBR Economic and Fiscal Outlook – November 2023, OBR forecasts

After the fiscal easing announced in March 2023, the Chancellor of the Exchequer announced additional and similar of size fiscal easing (around 0.6% of GDP), in his Autumn Statement of 22 November 2023. This is the third most significant discretionary easing since 2010, surpassed only by those in 2020. This is made possible by improving budget deficit forecasts thanks to upward revisions of past and future growth. While the government's objective remains to stimulate supply (including encouraging investment and increasing the labour force and employment), the main measures announced are tax cuts, rather than increases in budgetary spending. The flagship measures consist of a significant reduction in social security contributions (National Insurance contributions) on employees from 12% to 10% from January 2024, i.e. an annual reduction of £450 for an employee earning an average of £35,400 per year, and the decision to make permanent the full expensing deduction for eligible investments in new installations or new machines, up to 25 pence for each pound invested. Other, less expensive measures include extending the 75% tax reduction for businesses in the retail, hospitality and leisure sectors until 2025; a 6.7% increase in social benefits in April 2024 for people of working age and an increase in housing benefits. The government also confirmed its commitment to raising the minimum wage by 9.8% to £11.44 an hour in April. The new measures bring total support for purchasing power to £104bn over the period 2022-25, i.e. £3,700 per household on average. In the short term, they should give a small boost to demand relative to supply (which, incidentally, argues for an extension of the *status quo* by the BoE), but in the long term they should have a beneficial effect on supply with an increase in the level of potential GDP estimated at 0.3%.

THE OUTLINE OF OUR SCENARIO

FISCAL POLICY REMAINS RESTRICTIVE

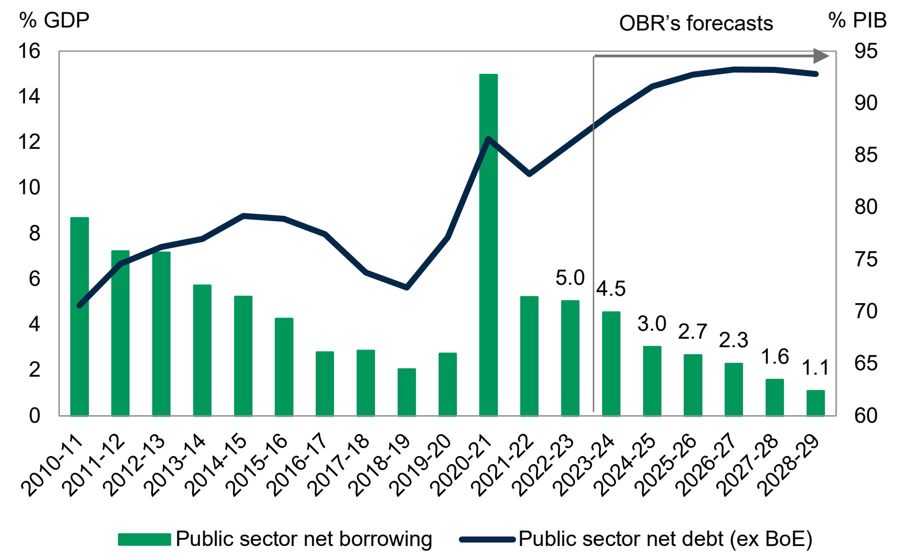
Fiscal stimulus will remain negative in the coming years



Sources: OBR Economic and Fiscal Outlook – November 2023, CA SA

Note: The budgetary impulse is the annual variation of the cyclically-adjusted primary deficit.

Fiscal rules: public debt down over five years & budget deficit < 3%



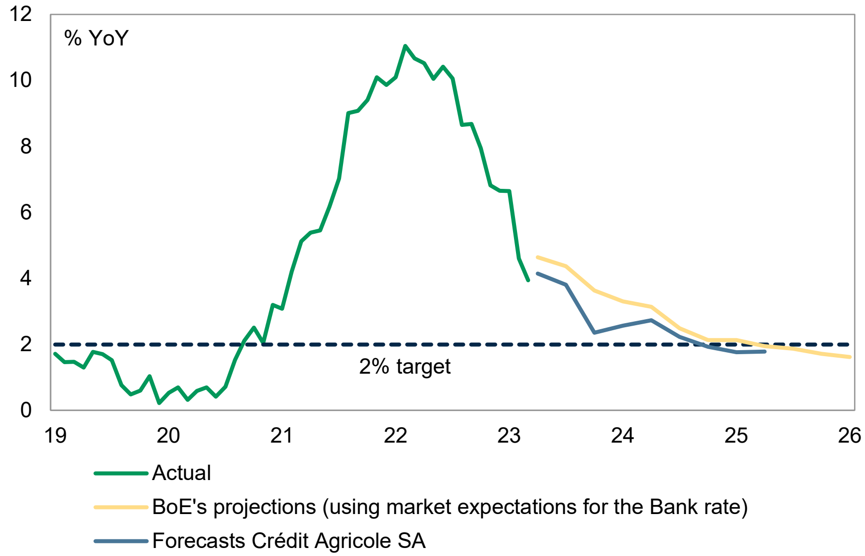
Sources: OBR Economic and Fiscal Outlook – November 2023

Despite the successive easing measures, fiscal policy will remain restrictive in the coming years with a structural primary balance expected to return to surplus this year (0.3% of GDP) after more than twenty years of deficit, and to continue to grow in the coming years. This fiscal consolidation effort would enable the government to fulfil its mandate of bringing public net debt on a downward trajectory over the next five years with a peak expected of 93.2% of GDP in FY2026/27, according to OBR forecasts, and a leeway of £13bn (0.4% of GDP). The public sector net borrowing is forecast to be reduced to 3% as soon as in FY2024/25, down from 4.5% in FY2023-24. The overall government gross debt to GDP ratio (central and local government debt including liquid assets) is expected to reach 103.8% in FY2026/27. Despite the measures announced in November, the OBR estimates that the tax burden (measured by the ratio of national tax revenues to GDP) would reach a new all-time high since 1945 at 37.7% in FY2028-29. This partly reflects the measures announced between March 2020 and 2022 such as the freezing of income tax thresholds until FY2025/26, the introduction of a tax to finance the healthcare system (Health and Social Care Levy) and the maintenance of the corporate tax at 19% (instead of lowering it to 17% as initially promised), then its increase to 25% on 1 April 2023.

THE OUTLINE OF OUR SCENARIO

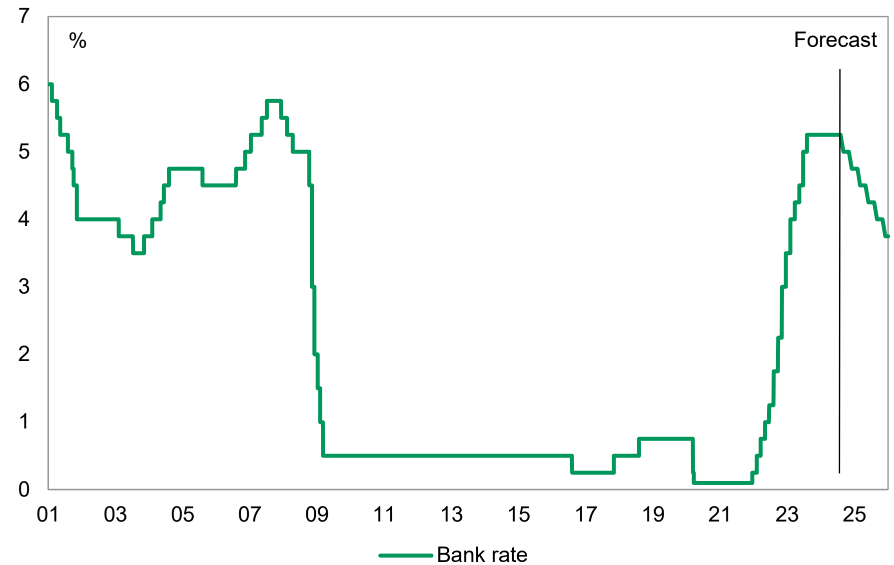
MONETARY POLICY: “RESTRICTIVE FOR AN EXTENDED PERIOD”

CPI inflation: the BoE could reach its target earlier than expected



Sources: ONS (monthly data at end-November), BoE (monetary policy report of November 2023), CA S.A.

Bank rate: peak reached in August 2023 at 5.25% and cuts expected one year later



Sources: ONS, Crédit Agricole S.A./ECO

The BoE is expected to have reached the peak of its monetary tightening with a final tightening in August 2023, bringing the key rate to 5.25%, its highest level in fifteen years. It then surprised on the whole with a hawkish tone, contrary to market expectations. Any rate cut in the short term seems unlikely. According to the BoE, “*monetary policy should remain restrictive for an extended period*” in order to bring inflation back to its 2% target in a sustainable manner over the medium term. The Monetary Policy Committee (MPC) considers that “*key indicators of persistence of inflation remain high*” and still does not rule out the possibility of further rate hike if inflationary pressures persist. In this regard, “*the MPC will continue to closely monitor indicators of inflation persistence and resilience of the economy as a whole, including a set of measures of tighter labour market conditions, wage growth and the rate of price inflation in services*”. The majority of the MPC continues to believe that risks around CPI inflation in the medium term are tilted to the upside, first domestic, in connection with a still-tight labour market and the upcoming increase in the minimum wage, and then external, due to the war in the Middle East. The MPC wants to see, above all, a more pronounced downward trend in wage growth and inflation in services. Recent data showing a sharper-than-expected decline in inflation, including core inflation, and a continued waning of wage growth are reassuring, reducing the need for further rate hikes. Nevertheless, we have postponed the first rate cut from May to August. Indeed, the tax cuts announced by the government in its Autumn statement in November have tilted the balance more in favour of keeping rates high for longer. In addition, as part of an election campaign, it is possible that the government will announce additional fiscal easing in its budget on 6 March 2024.

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