Stagflation nation

Special

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Global Economics & Markets
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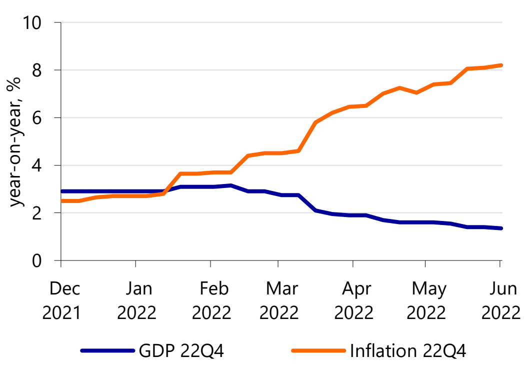
Summary

- We forecast the economy of the United Kingdom to grind to a halt in the upcoming quarters
- It experiences a terms of trade shock: as a net importer of food, energy and manufactured goods, the price of what it sells relative to what it purchases has fallen
- It also experiences a cost of living squeeze: even as the labour market is tight and the government redistributes, real disposable incomes are still set to decline
- The UK has Europe's demand shock but the US's labour shortages: it combines weak growth with the risk of higher-for-longer inflation
- Meanwhile, there is a constant threat of a trade war with the European Union

We forecast the economy of the United Kingdom to grind to a halt in the upcoming quarters, reaching the verge of a technical recession. Recessions attract headlines and stoke fears, but it's not really important whether its technical definition is met or not: the UK faces a negative terms of trade shock and the cost of its energy, food and goods imports rises. The financial pain will be felt. Businesses are forced to raise prices to sustain margins, to be able to pay for wage increases and to compensate for output losses. Households see their living standards falling, their budgets squeezed, and could face financial hardship. They are forced to either save less, to trade down or to cut back spending. The government uses its balance sheet to redistribute some of these effects across sectors and time, **but the next quarters should show there is no escaping the stagflationary consequences of a sudden and deeply negative terms of trade shock.**

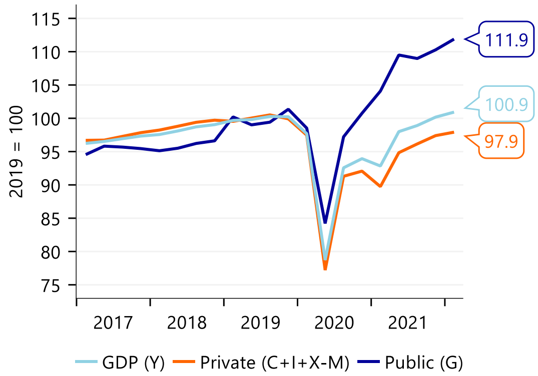
We paradoxically also forecast the economy to grow by 3.2% in 2022, more than double of what we believe to be the UK's trend growth rate (1.25-1.50%). The annual figure is inflated by the so-called 'carry-over' effect, a reflection of the artificially low comparison base due to last year's hit to GDP from the pandemic. Looking at 2022 Q4 versus 2021 Q4, we forecast growth of just 0.3% versus a consensus of 1.4%. Virtually all of this has already been realized in January, when most virus restrictions were lifted and the economy operated near full capacity. Since then, tailwinds were replaced by headwinds and the United Kingdom gradually morphed into a stagflation nation. This primarily shows up in our 2023 forecast: GDP is expected to grow just 0.2%.

Figure 1: The consensus among economists is clear: more inflation and less growth



Source: Bloomberg

Figure 2: Has this *really* been a strong post-pandemic rebound?

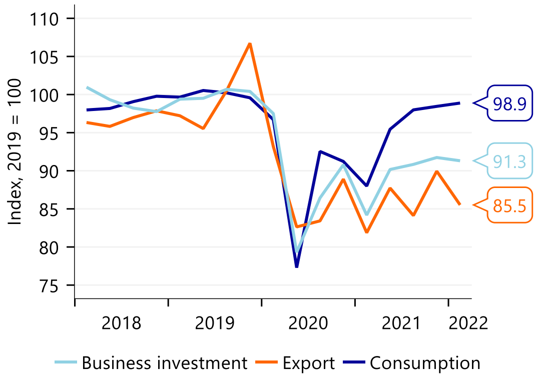


Source: Macrobond, RaboResearch

More unbalanced than strong

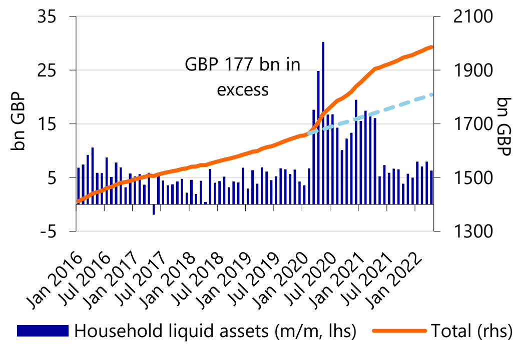
The economy kicked off the year well. Real GDP rose 0.8% q/q in 2022 Q1, defying expectations of yet another quarter marred by virus restrictions. Total output was 0.9% above the 2019 average. This is again much better than feared two years ago, when the economy was confronted with the twin shock of Brexit and the pandemic, but still implies roughly two years of missed growth. It also masks an underlying weakness: government spending on health and pandemic-related measures has been the main driver of this rebound. Private consumption (-1.1%), exports (-14.5%) and, particularly worrying, business investment (-8.7%) haven't returned to the pre-pandemic level. **The rebound from the pandemic was more unbalanced than it was strong.**

Figure 3: Recoveries stalled *way* before the pre-pandemic level was reached



Source: Macrobond, RaboResearch

Figure 4: Liquid household assets have increased sharply; a potentially useful buffer

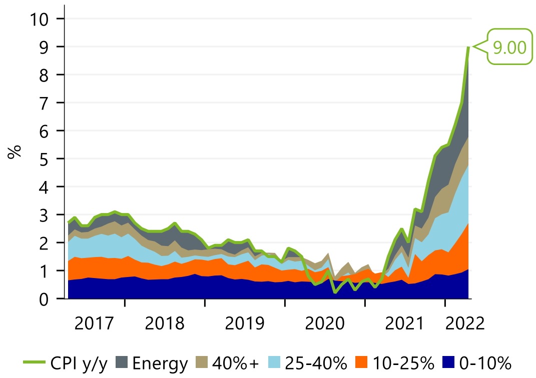


Source: Macrobond, RaboResearch

It's difficult to argue that the economy is 'hot' and that excessive domestic spending has stoked inflation. Spending was curtailed by restrictions while incomes were largely shielded, partially due to the furlough scheme that allowed firms to retain staff even as output was low. Excessive saving has been the result. Household liquid assets have increased by c. £177 billion in excess of the pre-pandemic trend. This accumulation of savings is greater for high-income/high-wealth households and not likely to be spent easily as long as confidence remains low.

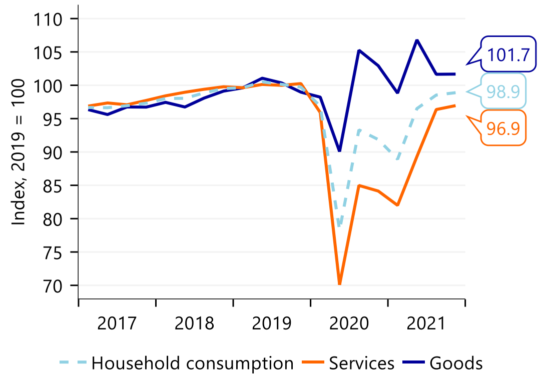
The risk is that the furlough scheme gets tainted by high inflation. However, in the UK, as elsewhere in Europe, **inflation has mostly washed ashore and reflects large increases in global commodity and tradable goods prices**. Some of this is supply-related, but the increase in tradable goods prices is linked to the sudden spike in US demand for durables and the global supply-side's problems in accommodating this. The preferences of British households shifted towards goods consumption, but to a much smaller extent and mostly *within* existing budgets. Real goods consumption in 2021 Q4 was a mere 1.7% above the average level of 2019 (figure 6).

Figure 5: The UK's inflation rate, split up by import intensities



Source: Macrobond

Figure 6: British consumers bought some more goods, but only some



Source: Macrobond, RaboResearch

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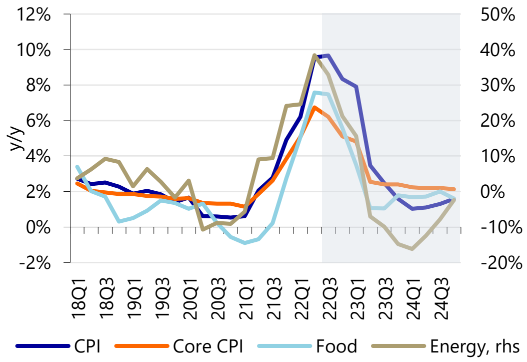
A healthier policy mix

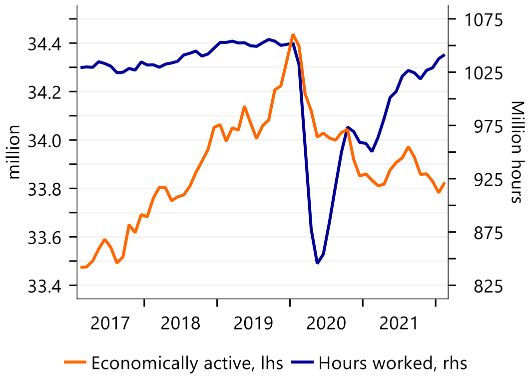
Even as consumer price inflation is a whisker away from a double-digit rate, it did not originate in the domestic economy. It will depress domestic demand, making it tempting to downplay the risk of continued high inflation. It required a political crisis to arrive, but it's why Chancellor Sunak was willing to give each household a GBP 400 discount on their energy bill and to provide significantly more cash support for lower-income households. This GBP 15bn package, in part financed by a windfall tax on energy companies, cushions some of the upcoming GBP 20-25bn blow when regulator Ofgem raises the energy cap again in October. **The fear is that the extra money will only add to inflation**, but most of this is likely to flow into already higher prices for food and energy –which are priced in global markets– and helps low- and middle-income households to sustain demand rather than boost it. We expect high-income households, who aren't cash-constrained, to save a relatively large share of this windfall as long as consumer confidence remains depressed. That said, **the upshot of this healthier policy mix is still that demand may not fall as much as initially feared, giving the Bank of England more space to raise rates.**

Figure 7: Consumer price inflation is only a whisker away from a double-digit rate



Source: RaboResearch

Figure 8: Where are all the workers?

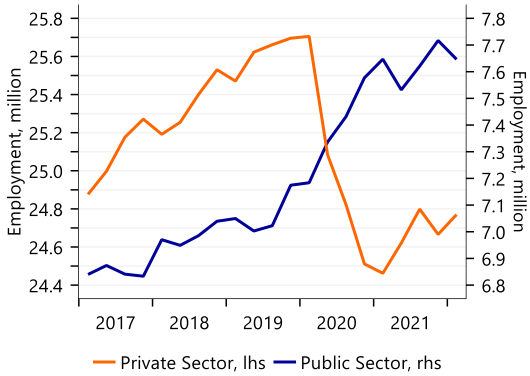


Source: Macrobond, RaboResearch

A tight labour market

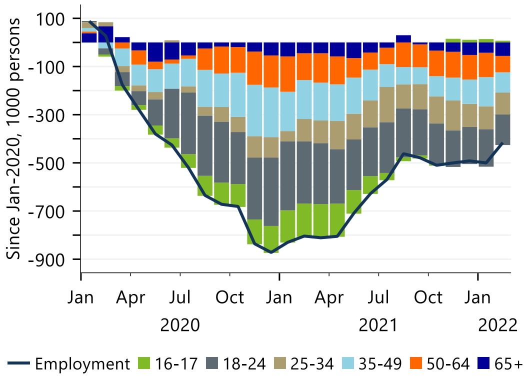
The UK is set to face a 'European' demand shock, but its labour market has many 'American' characteristics: rising inactivity, unemployment falling to as low as 3.8%, a high vacancy rate, recruitment difficulties and elevated pay pressures. The decline in the active workforce in particular makes the labour market tighter and more of a seller's market than one would expect after two years of hardly any GDP growth. After all, total employment is still down over 400,000 people, more than fully driven by the private sector (-3.6% (!) compared to 2019 Q4), whereas public sector jobs grew in line with higher government spending (+6.5%).

Figure 9: Private sector employment has not recovered from the 2020 shock



Source: Macrobond, RaboResearch

Figure 10: Employment change by age

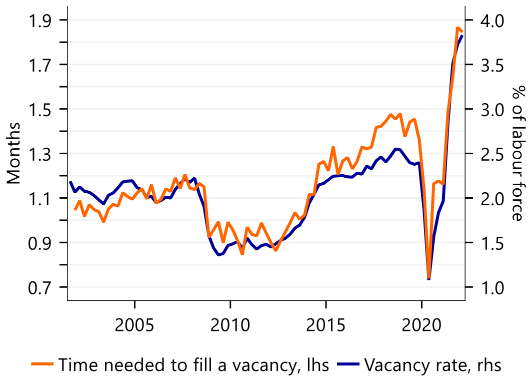


Source: Macrobond, RaboResearch

The impact on inactivity has been larger for young and older workers, low-paid workers, disabled workers and workers from an ethnic minority group. While the cost of living crisis and tighter financial conditions should pull some of these workers back into the labour market, the slow and incomplete recovery suggests these shortages seem to have a persistent component. **Again: the recovery from the pandemic was more unbalanced than it was strong.**

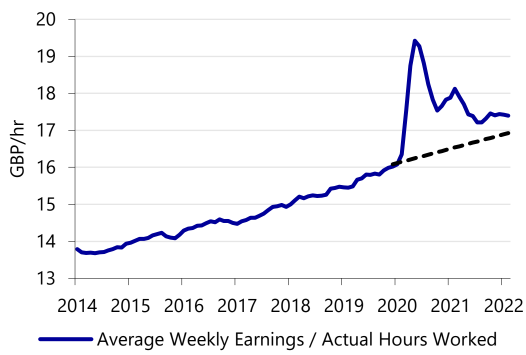
Survey measures of recruitment difficulties have increased to record highs. The time to fill the average vacancy, defined as the ratio of the stock of vacancies to gross hirings, has increased to nearly two months. New openings continued to grow in the first months of this year, but at a markedly lower rate than in 2021. Talent shortages, skills mismatches, and a high level of churn have led to salary inflation for job starters and job switchers. **Regular wages have followed.** The average weekly pay increased by 4.2% y/y in the period between January to March 2022, with pay including bonuses and one-offs increasing 7.0% y/y. Composition effects exaggerates the underlying wage pressure, while the length of the average workweek has increased to 32 from an artificially low 30 hours the same period last year. Correcting for this, the average hourly salary is 2.8% above its pre-Covid trend and seemingly *decelerating* rather than accelerating (figure 12).

Figure 11: It takes much longer to fill a vacancy



Source: Macrobond, RaboResearch

Figure 12: Another way to look at the 'surge' in wages

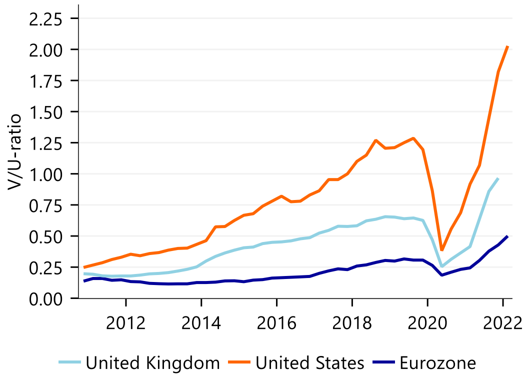


Source: Macrobond, RaboResearch

It suggests that employers, which also face cost pressures and softening demand, may be reaching a limit in terms of being able to raise pay in response to retention and recruitment difficulties, even as survey measures indicate that 4% to 6% pay rises are becoming the norm this year. The alternatives are to upskill staff, to improve job quality, to offer benefits and flexibility, and, crucially, to increase automation. A tight labour market combined with rising wages provides a strong incentive for productivity-enhancing innovation. Surveys of investment intentions did indeed rebound firmly during 2021 when covid restrictions eased, but *actual* growth hasn't been forthcoming since the 2016 referendum. If current labour market conditions do finally induce businesses to increase investment, in spite of the weakening outlook, we may finally see the rise in productivity that has been absent for the past fifteen years. It's long odds this will happen, but it remains the **only sustainable source of growth, prosperity and purchasing power.**

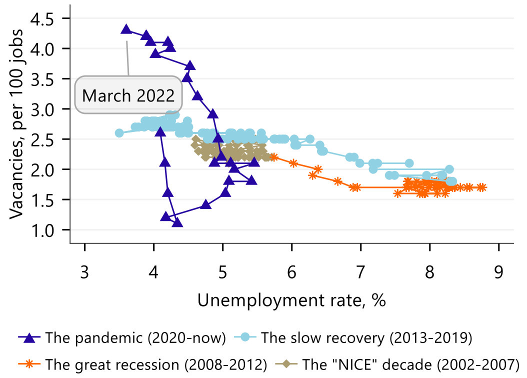
We are sceptical the planned wage rises will materialise if demand indeed softens as sharply as we expect, but it is crucial. The UK is a services-based economy and services have a high labour share of costs. The link between rising wages and services price inflation is stronger than the link between rising wages and goods price inflation. It is also self-sustaining: spending on services generate more domestic labour income, and these additional wages will then be spent on extra services, and so on. If productivity growth can't catch up, and the track record is bad, it is bound to end up in higher-for-longer (core) inflation. **This gives fresh impetus to the Bank of England to cool demand by raising the policy rate well above neutral territory.** The hope is this will merely reduce vacancies, which generate few net hires anyway, from the current rate of 4.2% to a normal rate of c 2.5%. The risk is that it will increase unemployment too, raising the already very substantial likelihood of recession in the next twelve months.

Figure 13: The vacancies-to-unemployment ratio is the highest on record



Source: Macrobond, RaboResearch

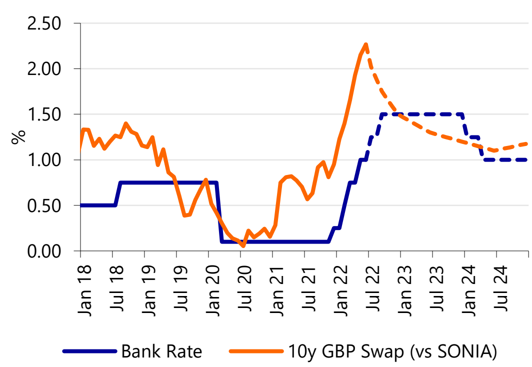
Figure 14: The Beveridge curve is exploring new territories



Source: Macrobond, RaboResearch

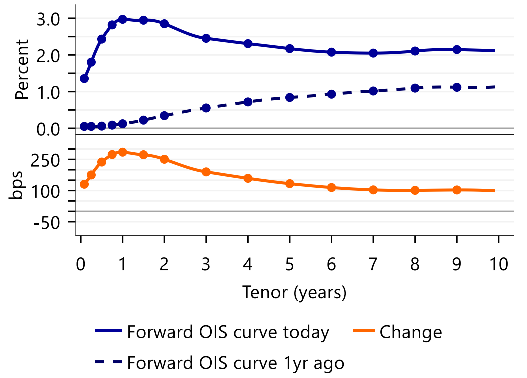
As it stands, we forecast two more 25 bps rate increases to a policy rate of 1.50% before the Bank of England takes a pause. The first rate increase is forecast at the June meeting; the second at the August meeting. The latter could be accompanied by a decision to take the first steps into active selling of gilts. **There is, however, clear upside risk to this forecast, especially if the supply side recovery remains elusive and domestically generated inflation gains traction**. Whilst we expect there will be plenty of evidence of an economic slowdown by this summer, and *hope* the most imminent of price pressures will have eased, the Bank of England may then still decide to hike further into the coming recession in order to stamp out the last sparks of domestically-generated inflation. However, the further the foray into restrictive territory, the bigger the chance these rate hikes will eventually be followed by cuts back to a more neutral rate of 1.00%.

Figure 15: We expect the Bank of England to have to pause – and possibly to revert



Source: Bloomberg, RaboResearch

Figure 16: Investors believe the UK has escaped from the liquidity trap



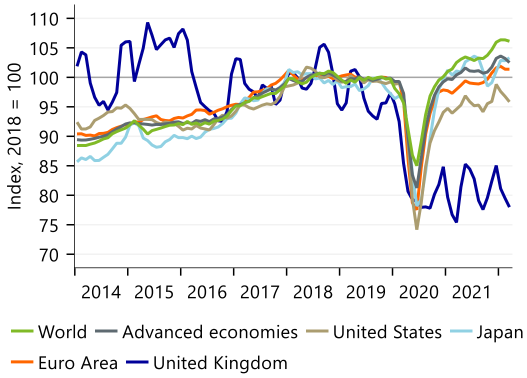
Source: Bloomberg, RaboResearch

Brexit: "It's still complicated"

In the days after the conclusion of the EU-UK Trade and Cooperation Agreement (TCA), we argued it would mark the start of a complicated relationship in which the UK and the EU would have to learn to live together separately. As with any messy divorce, there would be frictions. **We particularly doubted the government's ability to provide domestic and international investors with long-term reassurances on continued tariff-free access to European markets.** But even then, goods traders still face costly and lengthy custom checks or complicated rules of origin requirements, which demand a certain proportion of a good needs to be produced in the UK in order for it to qualify for the preferential tariff. This is particularly difficult to prove for intermediates or final products which are part of long cross-border supply chains. Just as well, trade in (agri-)food and drink products would involve costly and time-consuming health checks and/or extensive labelling requirements. The additional costs of exporting these affected products to EU countries could soon be prohibitive, in particular for smaller traders.

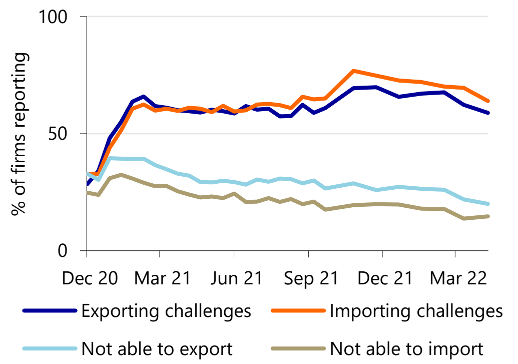
While volatile, trade figures indeed show that UK exporters are feeling the pinch. In March 2022, goods export volumes were down more than 20% relative to the 2018 average. The UK fully missed out on the global post-pandemic rebound in goods trade; volumes from advanced economies were 2.5% above the 2018 average. The declines are concentrated in clothing and footwear, food, vegetable and live animal exports, and vehicles. **These declines are a feature –not a bug– of the TCA.**

Figure 17: Exporters have fallen behind global competitors since Brexit



Source: Netherlands Bureau for Economic Policy Analysis

Figure 18: The UK is at a trade war with itself; its businesses experience challenges



Source: ONS

What's next?

In spite of the repeated threats to torpedo the TCA, and already doing away with any remaining reassurances, **Brexit has nevertheless faded from investor radars**. We see several explanations for this. First of all, the current risk is not as binary as the "deal or no deal"-frame that shaped thinking in 2019 and 2020. There is also no explicit deadline to focus on. Finally, past experience suggests it culminates in a climb-down on the part of the UK government anyway. This calculation is straightforward: threats to walk away from the deal are mostly for domestic political consumption and divert attention from prime minister Johnson's ongoing leadership struggles. The electoral benefits of picking fights with "Brussels" will never be fully consumed either. But ultimately, the economic impact of a conflict with the biggest trading partner would be too adverse, especially at a time when policy credibility is already eroded by high inflation and a rather wide variety of scandals.

That said, we do not fully subscribe to this view. Brexit is not just about economics –far from it– and political decisions shouldn't be analysed solely through an economic lens. In the run-up to the referendum and to the key votes in Parliament, virtually every economist warned Brexit would have a negative impact on export, investment and productivity, especially if the departure wasn't accompanied with a 'grand strategy' that wouldn't be possible within the confines of the European Union. This strategy still remains absent today, but Brexit still happened.

Last year, we argued that freed from Single Market obligations and a strict interpretation of European state aid rules, the UK could still revitalize its industrial policy. The government could explicitly allow the labour market to run hot in order to spur investment in labour-saving innovation, while at the same time channelling funds 'DARPA-style' to new (green) technologies. There has been some movement on this front, but the government relies on support of Thatcherites, who believe that Global Britain implies a free-trading, low-taxed, deregulated economic powerhouse with an atomized labour market. **These two views can't be reconciled: as such, businesses postpone their investment, export flows gradually dry up and productivity growth suffocates.**

This isn't likely to improve much before the next election. **The Conservative party fails to ask itself important questions**: is it a party of Thatcherites, or does it want the state to intervene in its markets? Is Brexit about free trade, or about protectionism? Is a price a signal, or something that needs to be controlled? Is unemployment a market outcome, or a political decision? Is the one nation tradition still running deep, or are regional divisions to be exploited for electoral gains? Is it worth breaking international law to seek leverage, or should the government lead by example? As long as these fundamental questions remain unanswered, the UK will have difficulties moving forward and to find its new position in the increasingly fragmented world. Worryingly, as last week's vote of no confidence showed, this political rot feeds on itself and the focus on tactics sucks oxygen out of any debate on the country's long-term strategy. **Stagnation is the result.**

And on Brexit?

May's Stormont election has added another layer to this. The Democratic Unionist Party refuses to nominate ministers to the new power-sharing executive, which Sinn Féin will be entitled to lead, insisting there should at least be "decisive action" on the Northern Ireland Protocol first. The DUP has never supported the Protocol, but their desire to rewrite it is now shared in Westminster. The Conservatives use the blockade to argue the Protocol risks peace and security in Northern Ireland. If the EU is not willing to change it through consensus agreement, the UK government feels justified to implement the required changes unilaterally. **If so, this will create a trade conflict.**

The main changes relate to the treatment of goods that cross from Great Britain to Northern Ireland and remain there. The UK government wants these goods to be fast-tracked through 'green lanes', which should ensure they are not subject to the same checks as goods ultimately destined for Ireland or another EU country. The burden of proof needs to be reversed in order to achieve this: **a good should always be seen as destined for Northern Ireland, unless there is reason to suspect it moves on towards the Single Market**. This would probably require an expansion of the trusted trader scheme, an expansion of the not-at-risk regime, and a reduction of the amount of information that needs to be provided for each transaction. Other UK demands are, reportedly, permanent grace periods for certain products (e.g. the sausages that were the protagonist of last year's phoney trade conflict), a dual regulatory system that gives Northern Ireland businesses a choice between conforming with UK (for domestic sellers) or EU regulations (for exporters). Crucially, and most contentiously, the UK government also wants to replace the EU's state aid rules with the looser subsidy controls included in the TCA, while also seeking to end the role of the European Court of Justice as the sole arbiter of disputes with the EU over the functioning of the Protocol.

An asymmetric trade war?

The Protocol was proposed, studied, negotiated and signed by this British government, so it is not a surprise that Brussels (and Washington) is agitated. Even as there is plenty of room for practical compromises, there is a serious risk of this 'unilateral renegotiation' eventually culminating into a trade war, **with Brussels threatening to impose tariffs on <u>all</u> of the EU's imports from the UK.**

For three reasons, it is not a foregone conclusion that the British will then pay back with equal currency. First, the Thatcherites see themselves as advocates for free trade. This is an opportunity to put money where the mouth is and to demonstrate they are the side with good intentions. Secondly, the UK already lacks the capacity to control its imports without causing empty shelves, let alone if import tariffs have to be imposed too. And thirdly, inflation is already running at 9% and rising. Additional import tariffs will only add to the cost pressures faced by consumers/voters.

The United Kingdom is more dependent on the European market than the other way around. Such an asymmetric trade war creates opportunities for European companies, just as Brexit did. For British exporters, it is a completely different story. **However, it has been a long time since the British government has really cared about their plight…**

Forecasts

Table 1: Economic forecasts

	2021	2022	2023	2024	22 Q2	22 Q3	22 Q4	23 Q1
GDP	7.4	3.2	0.2	1.3	-0.4	0.1	-0.1	-0.1
Private consumption	6.2	4.2	0.1	1.5	0.2	0.0	-0.2	-0.2
Business investments	0.8	2.5	2.9	3.2	0.0	0.0	0.5	0.8
Government consumption	14.3	0.5	-0.2	0.4	-0.7	0.0	0.0	0.0
Export volume	-1.5	1.9	3.5	2.0	2.0	0.8	0.8	0.8
Import volume	3.7	8.0	0.8	2.0	-6.8	0.0	0.8	0.8
Inflation	2.6	8.2	5.9	2.0	9.0	9.0	8.6	9.0
Unemployment	4.5	3.9	4.3	4.0	3.8	3.8	4.0	4.1
Bank rate	0.10	1.40	1.50	1.1	1.25	1.50	1.50	1.50
10y GBP Swap	0.70	1.80	1.30	1.15	1.90	1.90	1.60	1.40

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