ABN·AMRO

UK: Fiscal and monetary tightening to drive prolonged recession

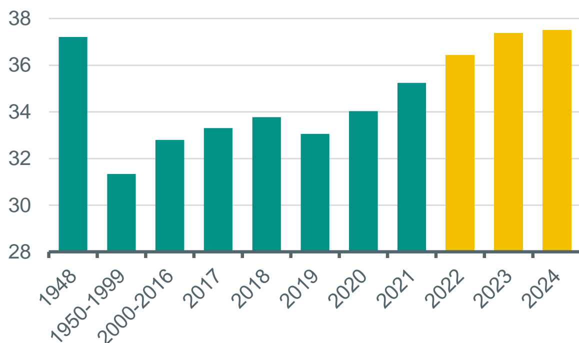
Bill Diviney – Senior Economist | bill.diviney@nl.abnamro.com

- **The new government has staved off a potential crisis, but it cannot prevent a recession**
- **A sharply rising tax burden will compound the challenges faced by households and businesses from high interest rates and energy costs, with the economy set for a year-long contraction**
- **Inflation risks will push the BoE to raise rates even further in the near term, but falling inflation next year combined with weak activity is likely to lead to rate cuts in late 2023 and into 2024**

The infamous 'mini budget' from September now feels like a bad dream, with the new government led by Rishi Sunak moving quickly to unwind proposals that triggered a period of extreme turmoil in UK financial markets. The episode illustrated how financial markets can be a powerful disciplining mechanism, preventing policy mistakes before proposals are implemented. As a result, while the risk of a snap election will remain high over the coming two years, any new (likely Labour) government is likely to be as fiscally hawkish as the current government. For now, though the new government has rescued the UK economy from a potential crisis, it is unable to prevent the unfolding recession. Hobbled by the same energy crisis as the rest of Europe, the UK also faces its own unique challenges from an especially tight labour market (partly stemming from Brexit), and therefore even higher interest rates to fight inflation than in the eurozone. Tighter monetary policy will be compounded over the coming years by increasingly tight fiscal policy. Although the government is stepping in to shield households from the worst of the energy crisis, from next April it will be raising significantly higher taxes on both businesses and workers, with the overall tax burden on the economy expected to reach the highest since the end of WW2. The combined forces of both fiscal and monetary tightening should work to push inflation sharply lower next year. In the meantime, the risk of a wage-price spiral – and high inflation becoming entrenched – remains significant.

Taxes are set to rise significantly…

Tax burden, % GDP; yellow = forecast (OBR)



Source: OBR, ABN AMRO Group Economics

…adding to the burden from higher interest rates

Bank Rate, %; yellow = ABN AMRO forecast

Source: Bank of England, ABN AMRO Group Economics

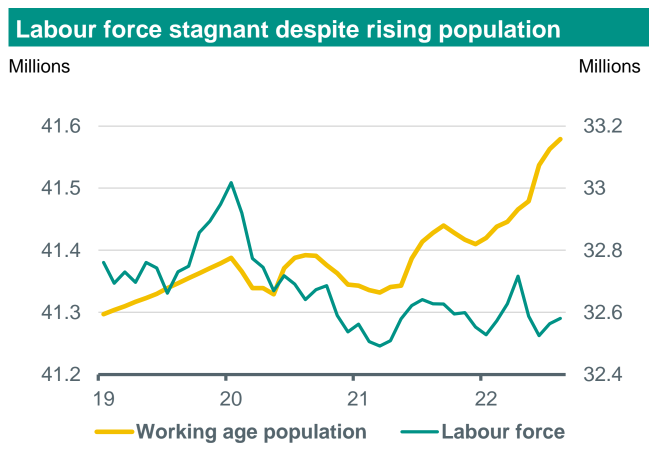
The government's new budget on 17 November contained few surprises, with most changes trailed some weeks before, in order to calm fragile market sentiment. Among the few – albeit most important – policies retained from the previous government was the Energy Price Guarantee (EPG), which caps energy bills for the average household at £2500 per year. This will remain in place until April 2024, with the cap raised to £3000 from next April. Similar to price caps elsewhere in Europe, much of the cost will be funded by the extension of a windfall tax on oil and gas companies, as well as a new tax on low carbon energy producers. The ultimate cost will naturally depend on energy prices, although the surprisingly steep fall in energy demand has kept prices sharply below their August peaks. Assuming wholesale energy prices follow futures pricing, we expect a budget deficit of 6.5% in 2023 – little changed from 2022, but significantly lower than the 13.1% deficit in 2020.

While the budget deficit is expected to remain large in 2023, there will be significant increases in taxation, and in the absence of the EPG this would have represented a major fiscal tightening. Specifically, the corporation tax rate is set to rise to 25% from next April, up from 19% at present. The upper rate of income tax will apply at a much lower income threshold, while all other tax thresholds will be frozen until 2028. Coming at a time of high inflation and wage growth, this will push increasing numbers of workers into higher tax brackets, and together with the rise in corporation tax, will raise the tax burden on the economy to 37.4% of GDP next year – sharply higher than the pre-pandemic level of c.33%. The tax rises come on

top of the pressures from high energy prices and interest rates, and will further dampen activity both among households and businesses. As such, we expect declines in real consumption and business investment next year, and only a tepid recovery in 2024, as falling inflation enables the Bank of England to cut interest rates. GDP already declined in Q3, largely due to the additional public holiday related to the Queen's funeral, and our base case sees GDP declining over four consecutive quarters – comfortably meeting the recession definition.

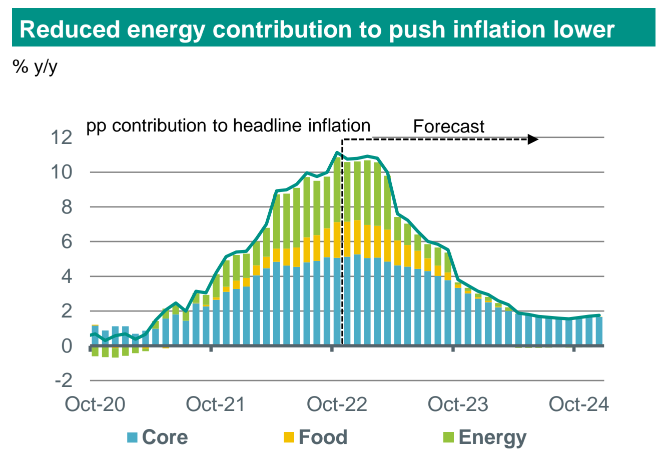
The recession is also likely to fuel the ongoing housing market correction. As of November, house prices are down 3.6% from their August peak. Although mortgage rates have eased following the September surge, rates are still elevated at 5-6%, and UK households are particularly exposed to high rates with most mortgages fixed for relatively short terms (25% of mortgages are on variable rates and 50% on fixed rates due to expire within 2 years). The effect of higher mortgage rates is twofold: first, it lowers housing affordability, pushing down on prices; second, it further reduces the amount of household income available for consumption of goods and services, even for existing home owners.

Labour force stagnant despite rising population



Source: Refinitiv, ONS, ABN AMRO Group Economics

Reduced energy contribution to push inflation lower



Source: Refinitiv, ABN AMRO Group Economics

The silver lining of the unfolding recession is that it should help to bring inflation back to the BoE's 2% target. Inflation is expected to remain near the October reading of 11.1% until April, after which base effects should lead to a steep decline in the energy contribution. Core inflation is likely to remain somewhat elevated, but as 2023 progresses we expect rising slack the labour market to start bearing down on wage growth and in turn broader price pressures. The easing in global supply-side bottlenecks and falls in non-energy commodity prices should also help to significantly dampen goods price inflation.

For now, inflation risks continue to be to the upside. The latest BoE decision maker panel of CFOs showed businesses expect to raise prices by 5.7% over the next 12 months, with inflation at close to 4% in three years' time – double the BoE's 2% target (the BoE's consumer survey shows expectations rather better anchored, at around 3%). The labour market is also exceptionally tight, with the number of job vacancies continuing to outnumber the unemployed – a historically unusual situation. Although labour demand appears to have cooled, firms are so far reluctant to implement layoffs, perhaps due to the recent difficulties in finding workers. The worker shortage is partly due to increased long-term sickness, as well as Brexit, with net migration from EU countries persistently negative in recent quarters. This has not yet been alleviated by the influx of refugees from Ukraine – despite a sharp increase in the working age population this year, the labour force has barely grown.

The combination of a still-tight labour market and elevated inflation expectations means the BoE is likely to continue raising rates in the near term. We expect the MPC to hike Bank Rate by 50bp to 3.5% at the December policy meeting, with a further two 25bp hikes at the February and March meetings, taking rates to 4%. From here on, we expect the BoE to keep rates on hold as it assesses the impact of prior rate hikes, as well as the other pressures bearing down on inflation – namely the recession, and the significant fiscal tightening expected from April. We think that by later in the year, the economy will be sufficiently weak to have driven a rise in unemployment, while falling inflation will be driving rises in real interest rates even as nominal rates are unchanged. Given the weakness we are likely to be seeing in the economy at that point, we think this will push the BoE to start cutting rates modestly. Our base case is for two 25bp cuts in Q4 2023, which will likely be followed by further cuts in 2024, ultimately taking Bank Rate back to neutral levels by Q3 2024.

Key forecasts for the UK

	2020	2021	2022e	2023e	2024e
Economic outlook (% yoy)					
GDP	-11.0	7.5	4.3	-1.3	1.0
- Private consumption	-13.2	6.2	4.7	-1.0	0.7
- Fixed Investment	-10.5	5.6	5.7	1.6	1.6
Inflation	0.9	2.6	9.1	6.7	1.9
- Core inflation	1.4	2.3	6.0	5.4	2.3
Unemployment rate (%)	4.6	4.5	3.7	4.3	4.8
Budget balance (% GDP)	-13.1	-8.1	-6.6	-6.5	-3.7
Government debt (% GDP)	98.9	101.5	99.5	103.2	104.2
Interest and exchange rates (eop)					
Bank of England Bank Rate	0.10	0.25	3.50	3.50	2.00
GBP/USD	1.37	1.35	1.15	1.20	1.27
EUR/GBP	0.89	0.84	0.87	0.90	0.88

DISCLAIMER

This document has been prepared by ABN AMRO. It is solely intended to provide financial and general information on economics. The information in this document is strictly proprietary and is being supplied to you solely for your information. It may not (in whole or in part) be reproduced, distributed or passed to a third party or used for any other purposes than stated above. This document is informative in nature and does not constitute an offer of securities to the public, nor a solicitation to make such an offer.

No reliance may be placed for any purposes whatsoever on the information, opinions, forecasts and assumptions contained in the document or on its completeness, accuracy or fairness. No representation or warranty, express or implied, is given by or on behalf of ABN AMRO, or any of its directors, officers, agents, affiliates, group companies, or employees as to the accuracy or completeness of the information contained in this document and no liability is accepted for any loss, arising, directly or indirectly, from any use of such information. The views and opinions expressed herein may be subject to change at any given time and ABN AMRO is under no obligation to update the information contained in this document after the date thereof.

Before investing in any product of ABN AMRO Bank N.V., you should obtain information on various financial and other risks and any possible restrictions that you and your investments activities may encounter under applicable laws and regulations. If, after reading this document, you consider investing in a product, you are advised to discuss such an investment with your relationship manager or personal advisor and check whether the relevant product –considering the risks involved- is appropriate within your investment activities. The value of your investments may fluctuate. Past performance is no guarantee for future returns. ABN AMRO reserves the right to make amendments to this material.

© Copyright 2022 ABN AMRO Bank N.V. and affiliated companies ("ABN AMRO)