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Recession, then stagnation

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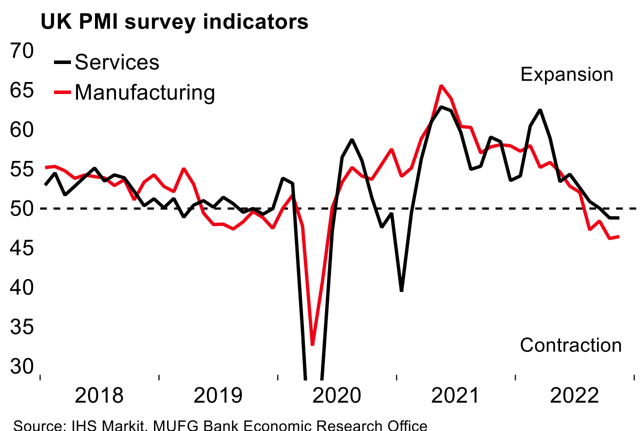
The UK economy continues its slide towards recession. After the negative GDP print in Q3, we expect a further three quarterly declines in activity. The energy support in place should prevent it from being a deep downturn, but the subsequent recovery is likely to be disappointing. Post-pandemic rebound effects have probably been exhausted and significant fiscal tightening is due in two years' time. On top of that, tighter financial conditions are likely to take time to filter through to the real economy. Our base case is a lengthy, but relatively moderate recession, followed by an underwhelming rebound and period of stagnation as the UK economy continues to struggle with the persistent issues of low investment and productivity growth.

Four quarters of contraction

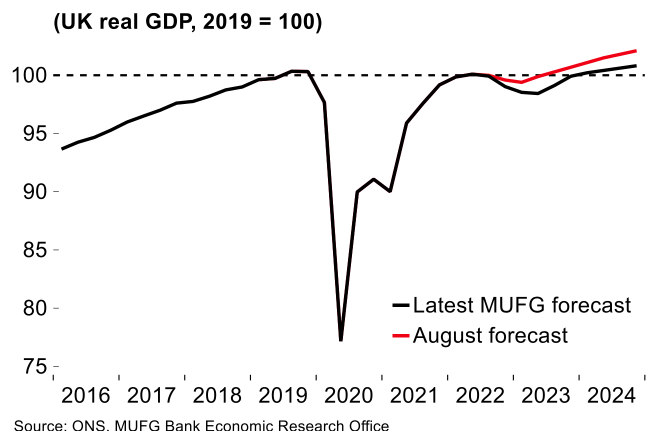
The 0.2% Q/Q fall in GDP observed in Q3 is set to mark the official start of the 2022-23 recession. Q4 will have the usual complement of working days after the extra Bank Holiday for the Queen's funeral but another quarterly decline in activity feels inevitable as energy costs continue to drag on the economy. A range of business surveys are languishing at lows not seen since the last period of national COVID lockdown in early 2021. There has been some stabilisation in the PMIs (Chart 1) since the 'mini Budget' debacle in late September – the new government has steadied the ship with its focus on stability and credibility – but soft data is still clearly signalling contraction as the real income shock continues to hit the UK economy. That said, the stabilisation in the latest figures also supports our view that, in the absence of further shocks, the recession may not be that deep. There has been some better news on the European energy front recently (see here) and, while still tilted to the downside, risks to our outlook now seem slightly more balanced. However, we still expect GDP to fall by 0.7% in 2023 with four quarters of contraction. The subsequent recovery is set to be barely perceptible (Chart 2).

CHART 1: SURVEYS SIGNALLING CONTRACTION



Source: IHS Markit, MUFG Bank Economic Research Office

CHART 2: THE OUTLOOK HAS WORSENED



Source: ONS, MUFG Bank Economic Research Office

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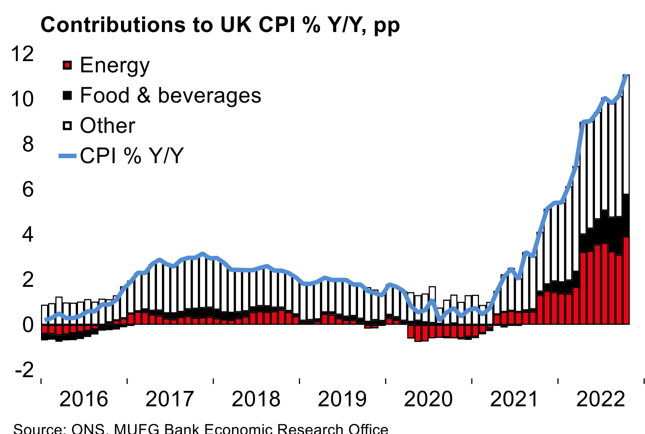
Core price pressures may prove persistent

The UK continues to suffer from the terms-of-trade shock with food and energy prices still the main drivers of inflation (Chart 3). Headline inflation rates may have peaked in the US and euro area, and we expect a similar story in the UK with a peak in monthly rates by the end of the year. That said, price pressures in the UK could prove quite sticky into 2023. The manufacturing PMI gauge of input prices has fallen since September as commodity prices have eased yet output prices have hardly budged which suggests that producers are resisting passing price changes onto customers (although margin compression may become relevant later). On the energy front, we know that household bills will increase further from April next year when the typical household bill will increase from 2500 GBP to 3000 GBP as the government reduces its degree of support. That will provide some inflationary pressure at a time when base effects will be working in the other direction on headline rates.

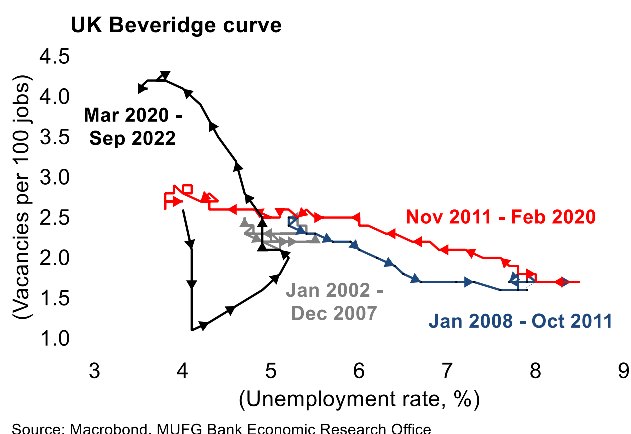
There is also continued evidence of second-round effects on the labour market, which remains very tight (Chart 4). We continue to look for signs of cracks but there are still very few. The number of unfilled vacancies has fallen only slightly from its April peak and remains at a historically high level. The unemployment rate, at 3.6%, is still close to an all-time low. However, employment remains below the pre-pandemic mark as the shrinking UK labour force makes it harder for firms to find workers. Inactivity rates have risen since 2019 (which is in contrast to most other developed countries where rates have fallen since the pandemic). There remain some pandemic-related distortions around student numbers and Brexit has changed immigration flows. However, the main driver of this rise in inactivity is long-term sickness against a background of an overstretched health service. This is unlikely to change any time soon and, while we expect wage growth will soon ease, it could mean that pressures may prove to be relatively 'sticky' compared to economies across the Channel. Overall, we expect UK inflation to average around 7% in 2023.

CHART 3: ENERGY AND FOOD STILL THE KEY DRIVERS



Source: ONS, MUFG Bank Economic Research Office

CHART 4: THE UK LABOUR MARKET IS STILL TIGHT



Source: Macrobond, MUFG Bank Economic Research Office

The BoE will certainly want to see concrete signs that wage growth is moving onto a sustainably lower path before it thinks about ending the current rate hike cycle. Indeed, Governor Bailey said last week that "the expectation is that there will be more to do" on monetary policy tightening. That said, we think the BoE will struggle to raise rates much above 4% (from 3% currently) as the economy slips into recession and base effects start to push down on headline inflation in H1 next year.

One area of potential weakness (and source of downside risk to our forecasts) is the housing market. The house price-to-income ratio is around 30% above the long-term UK average, and there are now signs of house prices falling (the Nationwide gauge

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showed prices fell 1.4% M/M in November) as the market adjusts to higher rates and the gloomy economic outlook. We expect nominal house prices to fall in the region of 10% by end-2023, which would result in a further drag on consumer confidence.

Significant fiscal tightening on the cards

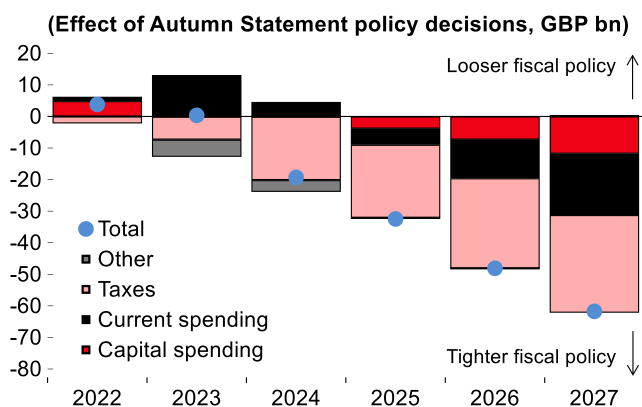
On the fiscal front, the new UK government has been at pains to show its determination to restore credibility and stability in the markets after the debacle of the Truss government. As expected, the Autumn Statement provided a mixture of tax rises and spending cuts, which puts the tax burden on course to reach its highest level since the Second World War. Tax thresholds are to be frozen rather than increased in line with higher inflation (the 'stealth' approach to tax rises), while the budgets of all government departments (apart from education and healthcare) will be squeezed. So far, it has been mission successful for the new chancellor – there is certainly a sense that fiscal risks have greatly diminished under this government.

Regarding the impact on the economic outlook, the key point is that most of the pain has been 'backloaded'. The UK faces fiscal tightening of around 1.8% of GDP over the next five years – but all of this is due to come in the second half of that period (Chart 5). We had been worried that sudden fiscal tightening would worsen the impending downturn, so this can be seen as a positive policy choice (even if it's probably a political decision with the next election due in 2024). With the can kicked down the road, it remains to be seen how much of the planned tightening actually materialises – if the UK economy does deteriorate as we expect then the chances of the government proceeding with tax rises and spending cuts would seem slim.

The chancellor also announced additional cost of living payments for the most vulnerable and stated that benefits and pension payments will be uprated in line with inflation. Despite this, it's still set to be a very tough period for UK households in aggregate. On average, households are paying around 90% more for energy than this time last year, according to the ONS. As mentioned above, costs will increase further from April next year, while the universal annual subsidy of 400 GBP will also end. The OBR (the UK's independent fiscal watchdog) now forecasts real per capita household disposable income to fall by 4.3% this fiscal year (Chart 6).

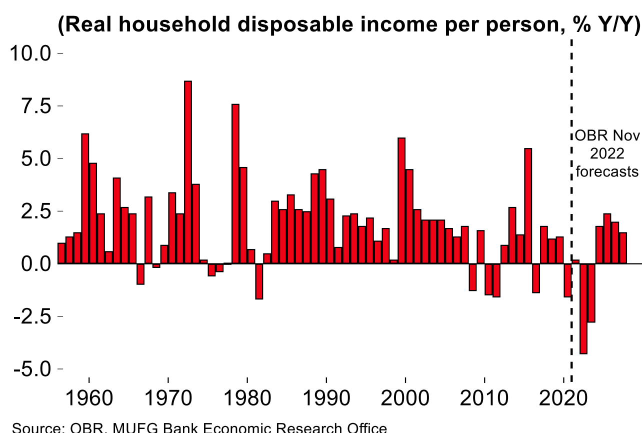
Looking further ahead, there was nothing in the Autumn Statement to jump start the economy after the recession. The chancellor spoke of boosting productivity but there was little of substance with capital spending set to fall in real terms. Meanwhile, the post-referendum trend of anaemic business investment may continue given uncertainty around energy support for businesses beyond March and the increased likelihood of a change in government (and hence policy) at the next election.

CHART 5: 'BACKLOADED' FISCAL TIGHTENING



Source: OBR, MUFG Bank Economic Research Office

CHART 6: A HISTORIC FALL IN HOUSEHOLD INCOMES



Source: OBR, MUFG Bank Economic Research Office

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A gloomy outlook

The UK recession has probably already started as the economy continues to reel from the large real income shock. The subsequent recovery is likely to be unspectacular. The latest PMI release suggests that Brexit-related problems for exporters of manufactured goods are not getting any better (perhaps it is easier for firms to notice the drag now that pandemic distortions have faded). The effects of tighter monetary policy will also continue to pass through to the economy. It could be a painful period of adjustment following the end of ultra-low interest rates – in particular for the housing market. At the same time, a potential period of significantly tighter fiscal policy will continue to loom over spending and investment decisions across the economy.

Taken together, there's not a great deal of optimism around the UK economy at the moment. To our minds, it seems likely that the recession could be followed by a period of stagnation with low investment and low productivity set to remain longer-term problems for the UK.

TABLE 1: UK MACRO FORECASTS

% Y/Y unless otherwise stated	2019	2020	2021	2022F	2023F
GDP	1.6	-11.0	7.5	4.2	-0.7
Household spending	1.1	-13.2	6.2	4.6	-0.6
Government spending	4.1	-7.3	12.6	1.4	1.8
Fixed investment	1.9	-10.5	5.6	5.5	-0.1
Net exports (contrib.)	-0.3	1.5	1.0	-1.0	-0.1
Unemployment rate (%)	3.8	4.6	4.5	3.7	4.7
CPI	1.8	0.9	2.6	9.1	6.8
Average weekly wages	3.5	1.7	5.9	5.9	4.4

Source: ONS, MUFG Bank Economic Research Office

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