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The risk of recession has increased

11 April 2022

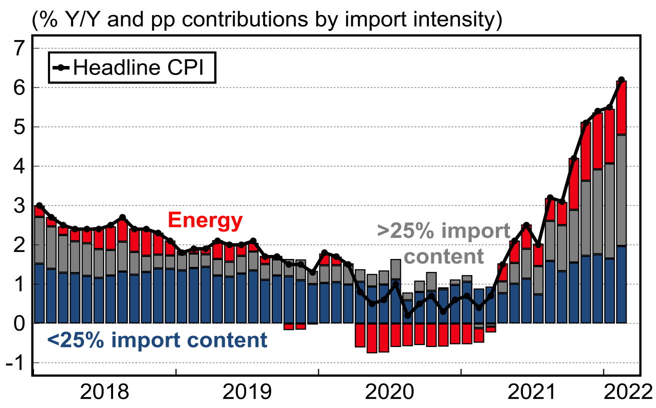
UK monthly growth fell to just 0.1% M/M in February. This slowdown predates the conflict in Ukraine which will add pressure on consumers by intensifying and prolonging inflationary pressures. Households were already faced with the prospect of a serious squeeze to real disposable incomes as energy costs have jumped and government support remains limited. Ordinarily, this would point to a downturn for the UK economy, but post-pandemic rebound effects, especially in services, will provide some support to growth. However, we think it is likely that the UK economy will still experience at least one quarter of contraction in 2022 as consumers are forced to rein in spending.

Inflationary pressures have intensified

UK households are facing soaring living costs. Headline UK CPI has already reached 6.2% in March, the highest rate for three decades, and it will move significantly higher in April. The UK's consumer energy price cap, which is updated every six months based mostly on wholesale energy costs, increased by 54% on 1 April. This means 22 million households are faced with a typical annual increase of 700 GBP.

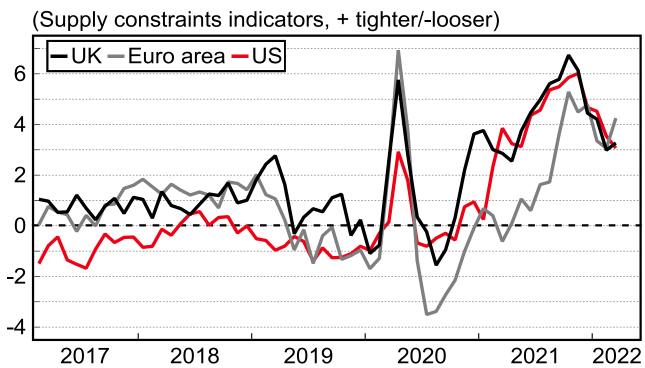
The price cap system means that the April surge in inflation has been long expected (the increase was announced in February based on a 6-month reference period), but the conflict in Ukraine is pushing inflation even higher, most immediately through the energy channel. Brent oil prices have moderated since the beginning of the conflict, yet the spot price remains at around an 8-year high. The effect at UK pumps is clear: petrol prices have increased by around 8.5% since the end of February, even accounting for the 5p/litre reduction in fuel duty announced on 24 March. Food price inflation is also set to move higher, albeit with some lag, on the back of conflict-related disruption and higher fertiliser costs over the coming months.

INFLATION MOSTLY DRIVEN BY EXTERNAL FACTORS



Source: Macrobond, MUFG Bank Economic Research Office

SUPPLY BOTTLENECKS MAY WORSEN AGAIN



Constructed using PMI survey data and methodology used in Chart 2.3 of the November 2021 Bank of England Monetary Policy Report.
Source: IHS Markit, MUFG Bank Economic Research Office

The impact on the CPI from higher wholesale gas prices will also be felt further ahead due to the price cap system. We are currently pencilling in a further 25% increase in the price cap which will come into effect in October. This is not as high as we had previously assumed, but still means a 'twin peaks' scenario of price cap-driven surges in UK inflation this year with energy fanning the flames again in autumn when inflation in other components may just be starting to moderate. **We now expect UK inflation to approach 9% in April and to average around 7% this year**.

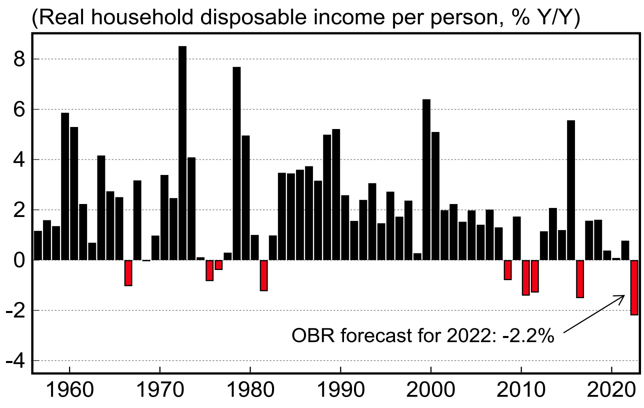
However, unlike in the US, UK inflation remains mostly supply-side driven and there are relatively few signs of second-round effects. Most crucially, there has still been only limited evidence of any wage/price spiral action. CPI inflation has been over 4% since October, but survey data suggests negotiated wages rose by just 3% in the three months to February across the economy as a whole (although pay growth is higher in sectors that have experienced worker shortages, such as hospitality). With the UK economy facing a significant demand squeeze over coming quarters, and tighter monetary policy also working to supress wage growth and employment, the trend towards a tighter labour market seen through 2021 is unlikely to continue. **We expect the unemployment rate will edge higher by the end of the year**.

So, while the conflict in Ukraine is likely to mean higher inflation for longer, a significant upward shift in the longer-term outlook still feels unlikely. Indeed, base effects and a reversal of price rises in energy and commodities are likely to result in headline inflation falling quickly by next year. We currently forecast CPI inflation to average around 3% in 2023 and just 1.5% in 2024.

The big squeeze on households

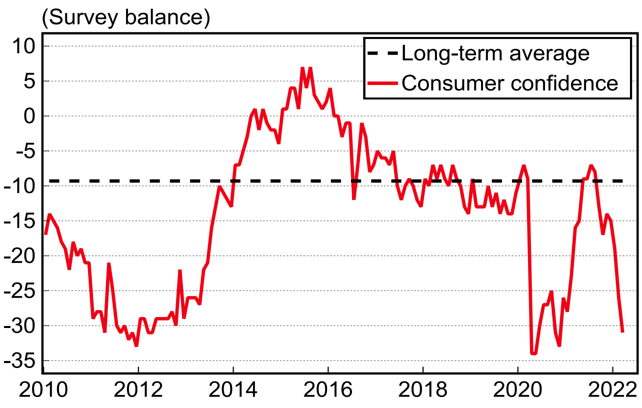
Inflation may eventually moderate but the short-term outlook means that the UK economy is heading into one of the most severe cost-of-living crises seen for many years. The OBR (the UK's independent fiscal watchdog) estimates that per capita real income will fall by 2.2% in 2022. This would be the steepest fall on record. Consumer confidence has already fallen towards the lows seen during the pandemic and we would expect it to deteriorate further as rising living costs begin to bite.

HOUSEHOLDS FACING A HISTORICAL INCOME SQUEEZE



Source: OBR, MUFG Bank Economic Research Office

CONSUMER CONFIDENCE APPROACHING 2020 LOWS

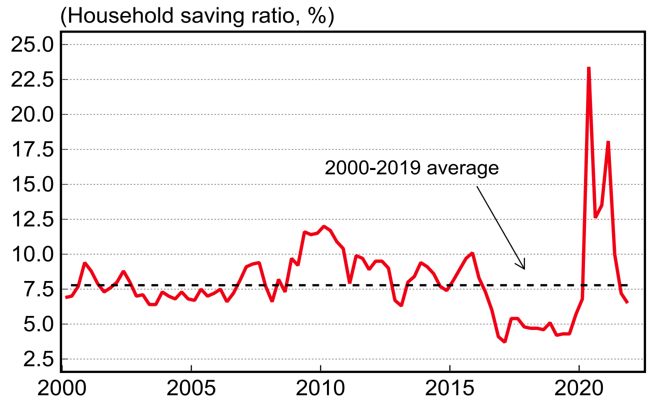


Source: Macrobond, MUFG Bank Economic Research Office

The government response to the surge in living costs has been a little underwhelming so far. Measures include a council tax rebate of 150 GBP for most households and a mechanism in October to spread out 200 GBP of energy costs.

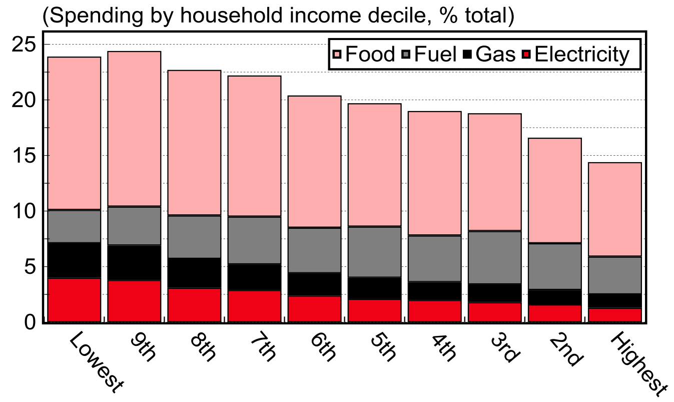
Tax rises announced last autumn also came into effect this month. The most notable change is a 1.25pp increase in National Insurance (NI). The chancellor announced some relief through a higher threshold, which will see a net reduction in NI payments for those earning around the median salary or lower, but this will not come into force until July. Even then, an assessment by the OBR suggests new measures will offset just one sixth of the net tax rises introduced since 2020. The OBR also estimates the tax-to-GDP ratio will rise to 36.3% – the highest ratio since the 1940s – as income tax thresholds are not increased in line with inflation, pushing more workers into higher tax bands.

HOUSEHOLD SAVINGS ACCUMULATED DURING THE PANDEMIC WILL PROVIDE SOMETHING OF A BUFFER



Source: ONS, MUFG Bank Economic Research Office

LOWER INCOME HOUSEHOLDS MOST AFFECTED BY FOOD AND ENERGY INFLATION



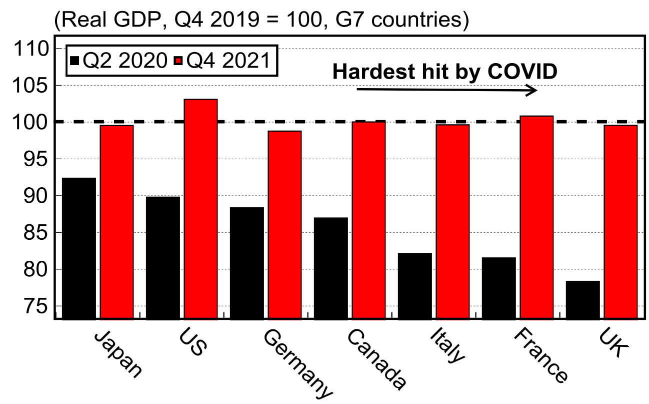
Source: ONS, MUFG Bank Economic Research Office

Other policy changes will support the economy: the minimum wage has increased by 6.6% in April which means an automatic income boost for around 2m employees. However, lower-income households are still the ones most likely to feel an acute pinch on disposable as they have most exposure to price pressures on food and fuel, and are less likely to have accumulated savings buffers during the pandemic.

Will there be a recession?

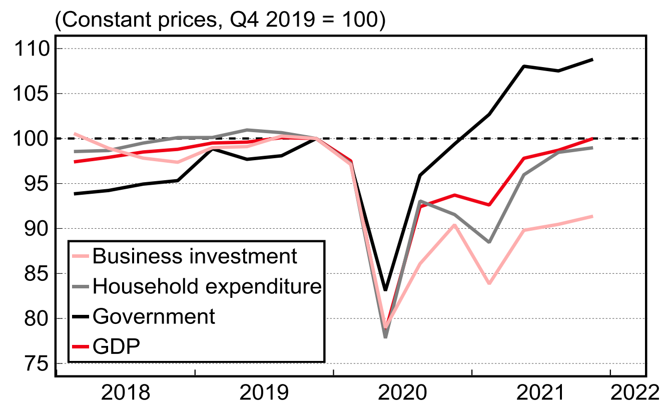
Consumer spending accounts for around two thirds of the UK economy and this squeeze on household finances would ordinarily point to a downturn for the UK economy. On this occasion, the picture is muddied by pandemic rebound effects. The UK economy suffered more than others from COVID, but the recovery has been sharp: activity is now more or less back to where it was before the pandemic.

UK ECONOMY HAS BOUNCED BACK FROM COVID LOWS



Source: National sources, MUFG Bank Economic Research Office

GOVERNMENT MEASURES HAVE SUPPORTED UK GDP



Source: ONS, MUFG Bank Economic Research Office

However, GDP remains well short of its trend established before the pandemic and so there should be scope for the rebound effect to continue. The services PMI for March increased to 62.6, a 10-month high, which suggests a degree of momentum.

ONS survey data shows around one third of adults still remain worried about the effect of COVID-19 on their lives. This is down from 66% during the Omicron wave and, if it continues to improve, it would bode well for activity in customer-facing service industries.

The trouble is that the components of GDP with most ground to catch up, such as consumer spending and business investment, are likely to face headwinds over the coming months (with the latter exposed to geopolitical uncertainty and ongoing Brexit-related disruption). At the same time, government spending on COVID measures will provide less support. The Q4 GDP figures were boosted by high volumes of testing and the vaccination drive during the Omicron wave, but these have been wound down since the start of the year. There is already evidence that this is weighing on activity growth: human health and social work activities provided a sharp drag of 0.35pp to the February monthly growth figure (+0.1% M/M).

Our current forecast is for UK GDP growth of 3.9% in 2022. This would be hugely flattered by the carry-over effect of 2.8pp from last year. The reality is likely to be very low quarterly growth (<0.3% q/q). Our view is that **the UK economy would be fortunate to get through this year without at least one quarter of contraction.** Q2 could be the most likely candidate at this stage. As well as the sharp increase in energy costs from April, the ONS estimates that COVID-19 is now more prevalent than ever in the UK population which makes it likely that activity will be affected by sickness and self-isolation effects. There will also be an extra drag on Q2 GDP this year from the extra Bank Holiday in June for the Queen's 70th Jubilee.

But while the COVID rebound effect means that a technical recession (two consecutive quarters of contraction) may be avoided, it will certainly feel like a recession for many households as the pressure on disposable income is set to intensify over coming months.

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