

## Warnings over Britain's 'long' and 'deep' recession are exaggerated

Despite a better-than-expected November GDP figure, UK growth prospects look challenging. A recession is likely through the first half of 2023, but predictions that Britain's downturn will eclipse the rest of the developed world look exaggerated



Even by economist standards, this year's [annual FT survey](#) of forecasters made for gloomy reading. A recession in Britain is almost universally expected, although economists disagree on the scale of the downturn and, interestingly, on whether the UK will continue to lag behind its peers. Britain is the only G7 economy not to have returned to pre-Covid activity levels by the third quarter of last year.

The UK outlook undoubtedly looks bad, but we'd caution against overdoing the pessimism. Growth of 0.1% in November means that overall fourth-quarter GDP will most likely come in flat, though this says more about distortions and extra Bank Holidays than economic outperformance. First-quarter data is likely to show a more meaningful decline in output.

Predicting the depth of any recession is difficult – not least because so-called 'non-linearities' tend to kick in when past excesses are exposed or job cuts begin to spread across industries. But for

now, we agree with those looking for a mild recession by historical standards.

We're looking for a peak-to-trough fall in GDP of a little more than 1.5%, which would match closest with the early 1990s recession in terms of scale, if not the surrounding circumstances. And despite the UK's many woes, particularly in the jobs market, we aren't convinced Britain will be a serious outlier from the rest of Europe on the hit to GDP this year, even if it probably does sit in the bottom half of the pack.

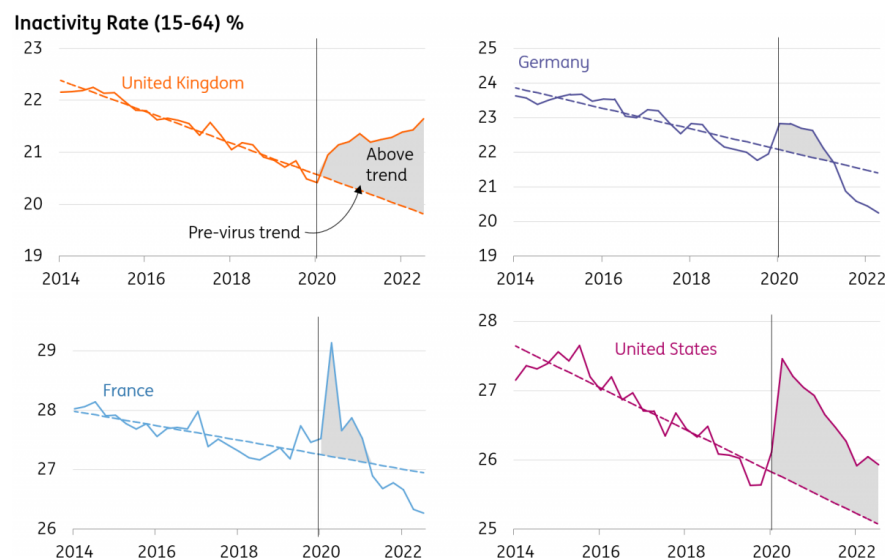
Here we look at four commonly-cited arguments for UK underperformance in 2023, and how they stack up.

## 1 The UK's lack of workers

The jobs market was a commonly cited reason in the FT survey for potential UK underperformance this year, and there's no doubt that Britain's situation looks somewhat unique.

Unlike virtually everywhere else, economic inactivity rates (the proportion of workers neither employed nor actively seeking a job) have continued to trend higher since Covid. Ill health certainly hasn't helped, and there are roughly 400,000 extra people classed as inactive due to long-term illness than pre-pandemic.

### Unlikely virtually anywhere else, UK inactivity rates have trended higher since Covid



Source: Macrobond/OECD data

[ONS data](#) suggests that's partly down to already-inactive or unemployed people being reclassified, but there's still been an impact on employment, particularly in lower-paid, consumer-facing industries. A fall in inward migration of EU workers through the pandemic has also likely contributed to worker shortages.

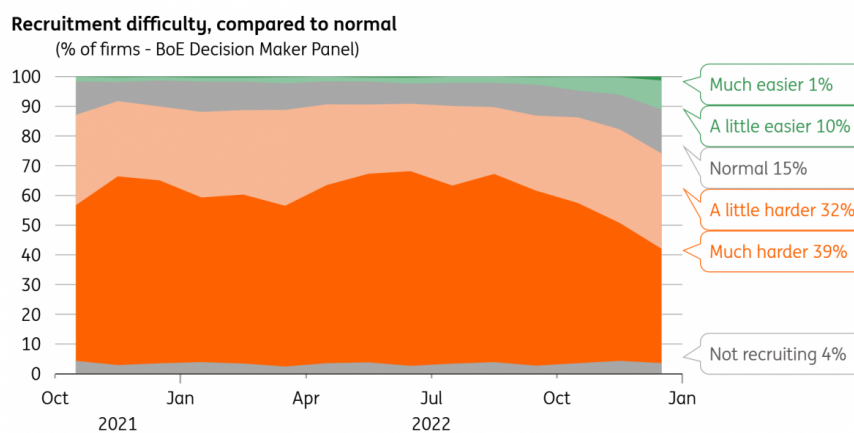
The good news is that the proportion of firms reporting that it's "much harder" to recruit has tumbled over recent months, from roughly 60% last summer to 38% now, according to the latest Bank of England survey data. Nevertheless, the root causes of the challenge look increasingly

structural and long-lasting. Healthcare waiting lists are projected to rise further, while urgent care is crumbling too. The average ambulance response time to 'category II' 999 calls (strokes/severe chest pain) doubled through the autumn and now stands at 92 minutes.

But concerning as this story increasingly looks, does the UK's jobs market situation point to economic underperformance this year?

Conceptually that might make sense, for two reasons. First, on a basic level, if the UK can't as easily source workers as its competitors, then its productive capacity is inherently lower. The jury's out on whether that by itself will make the UK stand out this year, but it points to lower medium-term growth if the UK remains an outlier.

## The UK's recruitment challenges appear to be easing



Source: Macrobond (Bank of England Decision Maker Panel)

Second, it could prompt a more aggressive response from the Bank of England. More persistent labour shortages risk keeping core inflation higher for longer, and BoE hawks may see that as a reason to hit economic demand more aggressively. This was roughly the argument being put forward by BoE Chief Economist Huw Pill in a [recent speech](#).

In reality, we think the Bank is only one or two rate hikes away from the end of its tightening cycle now, and that was evident from the noticeably dovish shift among voters at the December meeting. The question we need to ask ourselves is what happens if core inflation falls back, but settles a little way above target – will policymakers feel the need to keep acting forcefully to keep a firm lid on demand?

In practice, we think they will become more relaxed about inflation as the year wears on, partly because, as the BoE has itself emphasised, much of the impact of past rate hikes are still largely to come. That said, we do think the UK could be less quick to cut rates than the US, for example.

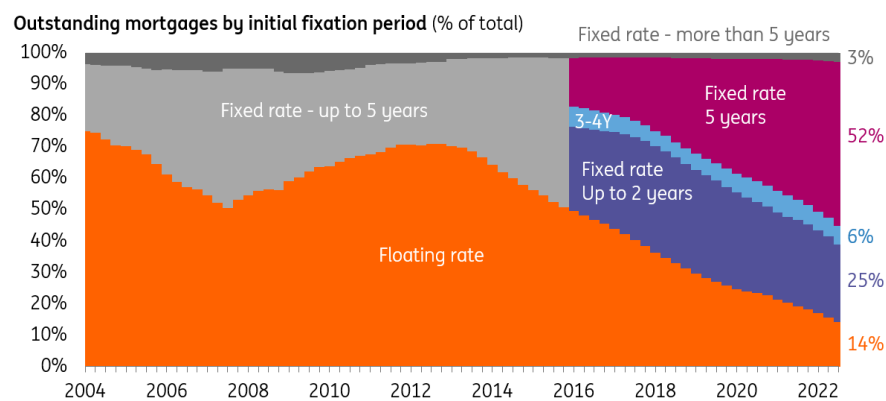
The flip side of a persistently tight jobs market is that it incentivises firms to avoid layoffs, amid concern about rehiring when conditions improve. For now, redundancies are low by historical standards. That will undoubtedly change, but assuming firms first look to reduce hours as opposed to workforce numbers, we think there's only so far consumer spending can fall over the coming months. That, in a nutshell, is why we think this recession will prove mild by historical standards.

## 2 The UK's vulnerability to the housing market correction

UK house prices are already down by 3.4% from the peak last August, and the sharp rise in mortgage rates through the autumn suggests steeper falls are likely. For now, surveys suggest the ratio of sales to unsold properties isn't adversely low (albeit falling), and the jury's out on how much selling pressure will emerge as a result of higher interest rates.

On a comparative basis at least, the UK doesn't look unduly exposed. Ninety percent of mortgages are on fixed rates, among the highest proportion in Europe and compares to roughly 50% in 2007. Admittedly, fixing terms are often shorter than in other parts of Europe and certainly the US, and the result is 25% of loans will be refinanced by the end of this year according to the Bank of England. That's still a decent proportion, but on a comparative basis, it's a slower pass-through than in many other countries.

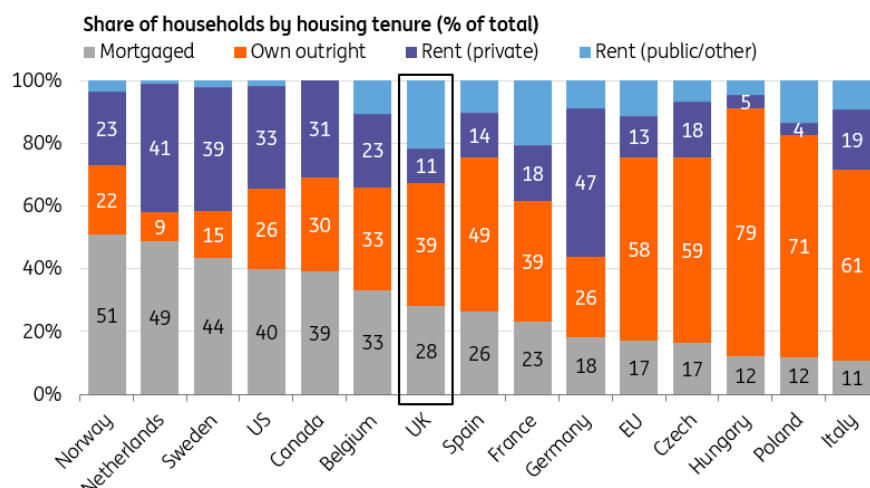
### The vast majority of UK mortgages are fixed, albeit not always for that long



A little more than a quarter of UK households have a mortgage, which puts the UK in the middle of the pack among OECD countries, and there are now more UK dwellings owned outright than mortgaged. Similarly, the UK doesn't stand out when looking at changes in price-to-income ratios since 2015.

That's not to say lower house prices won't weigh on the UK economy, and we also need to consider the recent acceleration in rent growth. Both factors will add to the consumer spending squeeze, and the combination of that and higher interest rates for real estate developers point to a poor year for construction, a sector that outperformed the overall economy in 2022.

## Just over a quarter of UK households have a mortgage

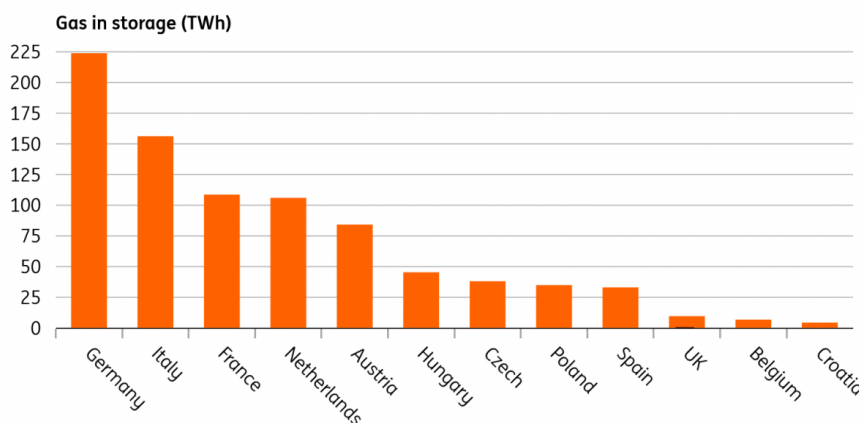


Source: OECD

### 3 Britain's exposure to Europe's energy crisis

Tentative optimism has crept back into the European outlook over recent weeks as energy prices have continued to tumble and gas storage levels appear unseasonally healthy. That's also good news for the UK, which is one of Europe's heaviest gas users as a proportion of total energy consumption. In the short-term, Britain arguably remains more exposed during cold snaps, owing to a level of gas storage that is several orders of magnitude lower than its larger (and in some cases, much smaller) European neighbours. The counterpoint is that the UK scores well on liquefied natural gas (LNG) regasification capacity.

## The UK's gas storage capacity is low compared to much of Europe



Source: Macrobond

Short-term disruption aside, there's no clear reason why the UK should benefit less from the recent fall in gas prices – and instead, it will come down to relative support from the government.

The UK is poised to increase unit gas and electricity prices for consumers from April, so that the

average bill will hit £3,000, up from £2,500 currently (or £2,100 if subsidies are included). But if lower gas prices hold, then regulated prices should fall below that level by the third quarter. That should enable the government to either lower unit prices, or scrap April's planned increase altogether at minimal cost – although our [house view](#) is for a renewed increase in wholesale gas prices later this year.

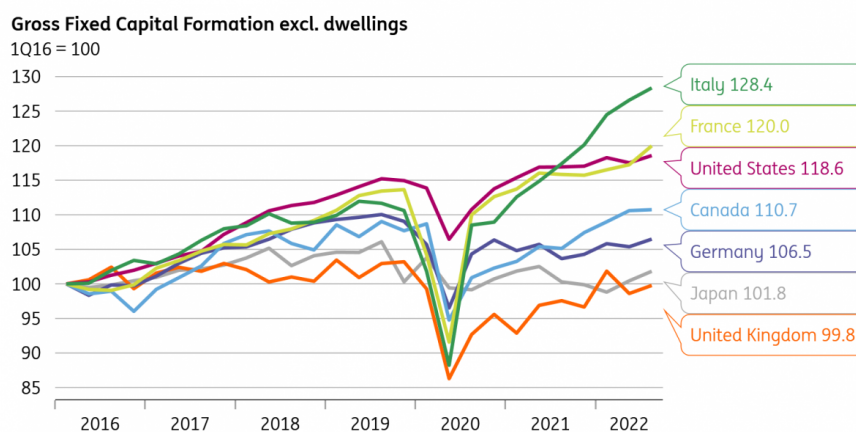
The bigger concern surrounds businesses. Support will [reportedly](#) be cut back from April for all companies, with caps on unit prices replaced with fixed discounts on bills when wholesale costs rise above a certain threshold. Recent declines mean that wholesale gas prices are now trading below the government's existing price cap. On paper, that means the change shouldn't have a huge impact, though what's less clear is how many firms fixed their bills in the autumn when unit prices were much higher (and therefore will be left with higher costs when government support is scaled back).

How does that compare to the rest of Europe? The varying structure of government support makes direct comparisons difficult. But if wholesale gas prices do indeed rise further, then as it stands UK firms may be left with less support than elsewhere.

#### 4 The UK's underperformance on investment

That neatly leads to where the UK outlook undoubtedly stands out: investment. The level of quarterly non-residential investment is below pre-Brexit levels and has lagged every other G7 economy since the EU referendum. Consistent under-investment has lowered productivity growth and points to weaker medium-term growth than other developed economies.

### The UK has been a clear underperformer on investment



Source: Macrobond, ING calculations

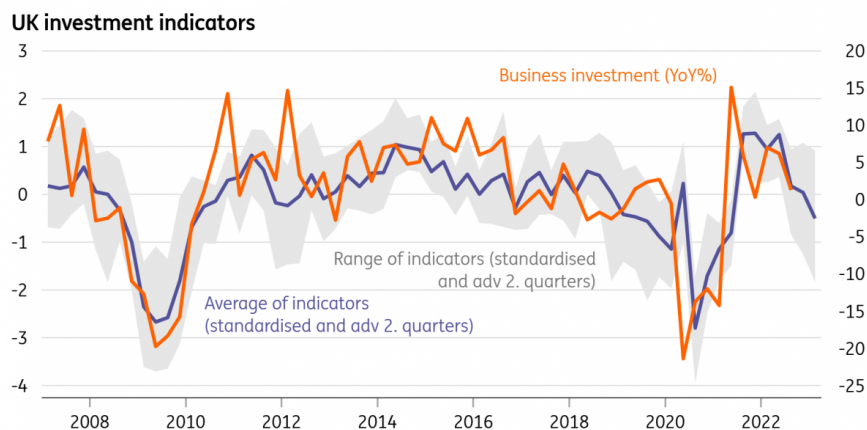
Calculated using OECD National Accounts data, and excluding dwellings investment from total gross capital formation

Where 2022 had initially been shaping up as a brighter year, investment intentions have unsurprisingly turned lower. That's partly because higher interest rates are hitting businesses much more rapidly than consumers, a function of 70% of outstanding small and medium-sized enterprise lending being on a floating rate product.

While much of the focus is on the consumer spending squeeze, the combined impact of higher

rates and risks from gas prices suggest that investment is likely to be a key area of weakness during the forthcoming recession. Alongside construction, manufacturing looks set to underperform against a backdrop of slowing global demand, gradually improving supply chains and rising inventory levels.

## UK investment intentions are turning south



Source: Macrobond

Range of indicators includes investment-related survey questions from the CBI and Bank of England

### Where does that leave the UK outlook?

Our [forecasts](#) show the UK is likely to be towards the bottom of the pack this year when it comes to growth, for many of the reasons discussed here. But we'd emphasise that it doesn't look like an extreme outlier either. Our growth projections for later in 2023 – measured by 3Q23/3Q22 year-on-year growth – show Britain (-1.4%) underperforming the eurozone as a whole (-0.7%) but with a lower hit than Germany (-1.8%).

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