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Economic Outlook: Fallout

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Economic outlook: Fallout

- **Transatlantic divergence –** The global outlook remains subdued for 2024. China is struggling to build momentum as structural reform progresses. In the US, the picture looks more resilient – but at risk of high inflation becoming more embedded. Globally, three scenarios are plausible after the supply shocks of recent years: Stagflation, recession or a 'soft landing.' The latter remains plausible, but the path is narrowing. We expect the Euro Area to fall into recession.

- **Tailwinds to headwinds –** For the UK, the economic outlook is a function of 1) supportive terms of trade dynamics; 2) monetary and fiscal tightening and 3) the potential for greater inflationary persistence. We think the former has been the predominant theme through the first half of 2023, with better energy news alongside still generous fiscal support providing a fair economic tailwind. But these effects are now fading. And we see signs that the policy tightening is now beginning to exert itself. Over the year ahead, we expect higher rates to add to the pressure on both households and firms, cramping growth. GDP, we think, will fall by 0.7% in 2024.

- **Slack showing signs of a turn –** Unemployment has already increased by 0.8pp since the trough in mid 2022 – with the UK approaching the historic 1pp 'Sahm' rule. In the months ahead we think the supply picture can continue to improve – with labour hoarding likely to continue to dissipate and reconfiguration ongoing. As demand moderates, we expect unemployment to increase. In contrast to the GFC, we think subsequent adjustment is more likely to come via heads than hours and wages, with a skills intensive recovery limiting scope for a more persistent hoarding effects.

- **Has the Philips Curve really shifted? –** The predominant concern of monetary policy over the past eighteen months has been the shift to a more embedded inflationary regime. Inflation is now falling quickly, but risks remain. For now, we take some comfort from the observation that wage growth 1) still largely consistent with pre-Covid model parameters; and 2) is not obviously facilitating more persistent pricing power. Ill-timed fiscal stimulus would still pose massive risks. But for now we think most of the recent evidence is consistent with a relatively symmetric disinflationary process.

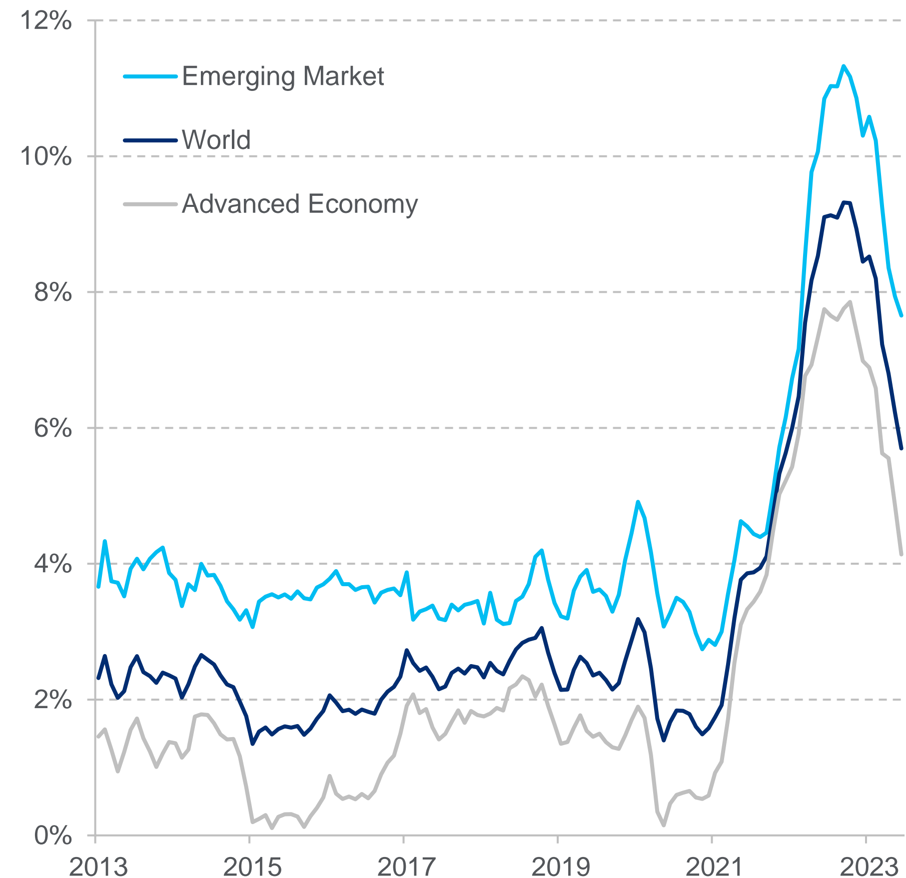
- **Policy: A leap of faith –** Monetary policy has delivered the most aggressive tightening in a generation. We are only now beginning to feel the effects. The core contention of the economic arguments above is that the UK will struggle to live with interest rates that are this high for a sustained period. From here, the lesson of history is monetary policy should not loosen until we have seen the 'whites-in-the-eyes' of disinflation. The issue from a monetary policy perspective is that this almost by definition means waiting too long. In a highly financialised, indebted, economy, the lessons of the 1970s may be at best only a partial guide to the policy challenges to come.

Source: Citi Research. See: Chapter 1 - Global economic outlook: how hard will we land? ; Chapter 2 - UK outlook: fallout

Hard or soft? The global economic landing…

Global inflation has fallen from more than 9% in 2022 to below 6% over the last twelve months. External headwinds – including the energy and supply chain shocks – are fading. However, the path to a soft-landing looks seems to be narrowing as high rates and existing weakness both weigh. **For the UK, the external environment remains unsupportive.**

- After **exceptional supply disruption**, three scenarios are plausible:
  - **Recession** – Weak growth, low inflation
  - **Stagflation** – Weak growth, high inflation
  - **Soft landing** – Resilient growth, low inflation
- Globally, we think **the path to a soft landing is narrowing but is not yet closed**.
  - The **US, the economy seems resilient** to rates, but is at risk of further overheating.
  - In **China, momentum remains poor** as cyclical weakness combine with structural challenges.
  - In the **Euro Area,** weak external demand and tight policy suggest recession.
- **We are now forecasting ex-China world GDP growth of less than 1% in 2024**, fulfilling some definitions of a global recession.
- Weak growth makes **rate cuts most likely from Q2 2024 in Europe**. In the US, the risks are skewed towards higher rates for longer.



See: Chapter 1 - Global economic outlook. For chart notes, see Figure 1.1. Source: National Statistical Offices, Haver Analytics and Citi Research

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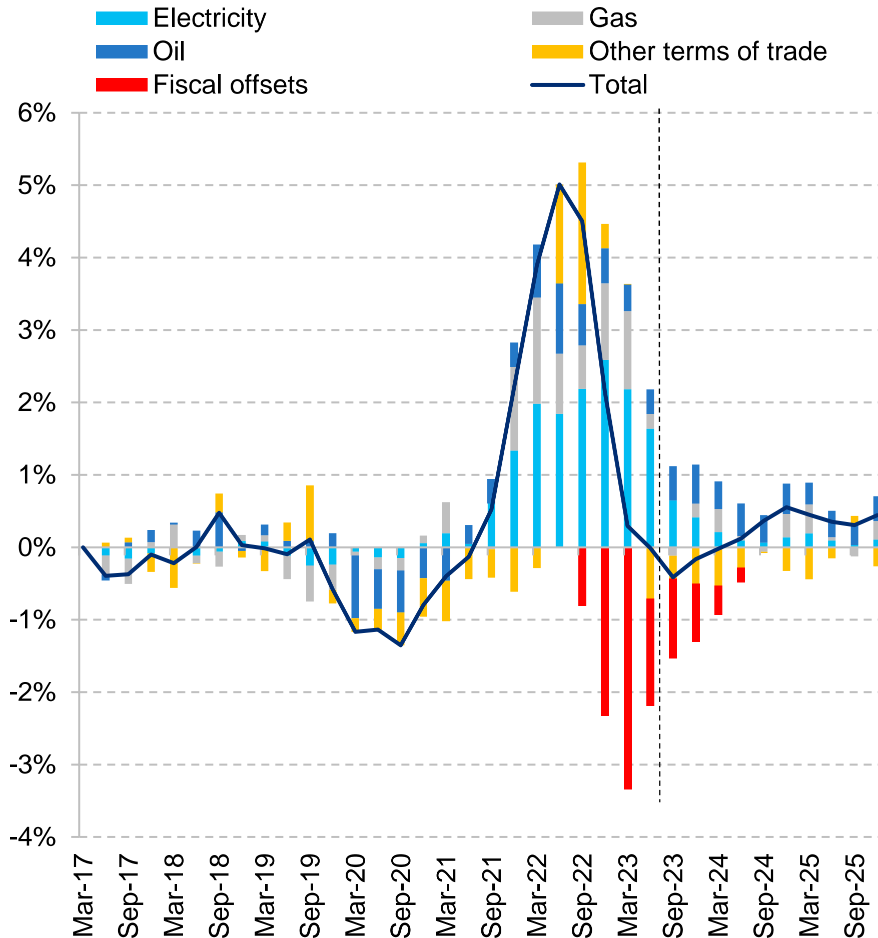
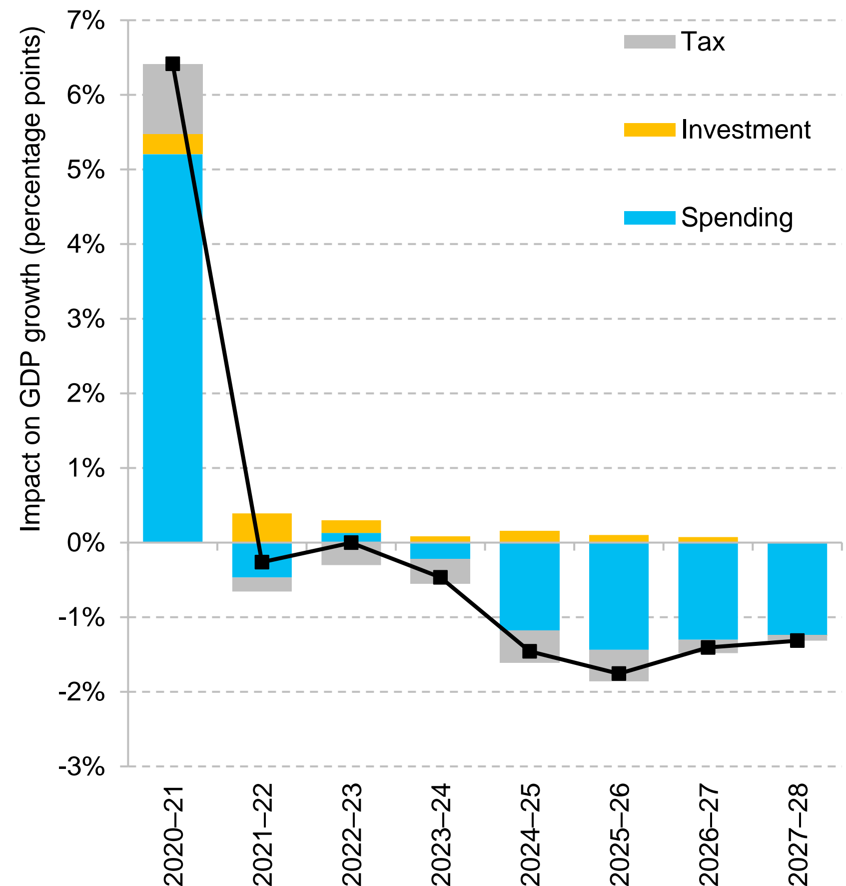
UK: Fading tailwinds, growing headwinds

Activity in recent months has been supported by news around terms of trade (especially energy prices) that has been somewhat better than expected this time last year, and fiscal policy that has remained highly supportive. Increasingly though, many of these effects seem to have run their course, and monetary and fiscal policy headwinds are growing.

Cumulative changes in UK import costs (% of GDP)



Estimated impact of discretionary fiscal decisions on annual GDP growth since Q1-2020



See: Chapter 2 - UK outlook: fallout. For chart notes, see Figures 2.5 and 2.16. Source: ONS, Bloomberg LLP, BEIS, OBR and Citi Research

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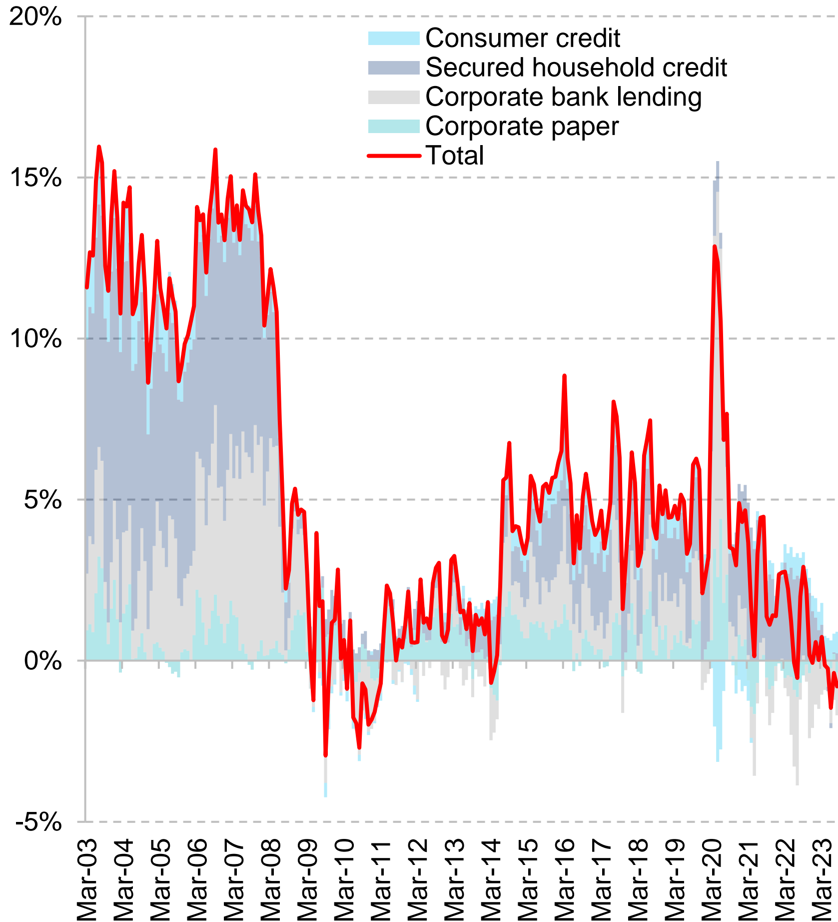
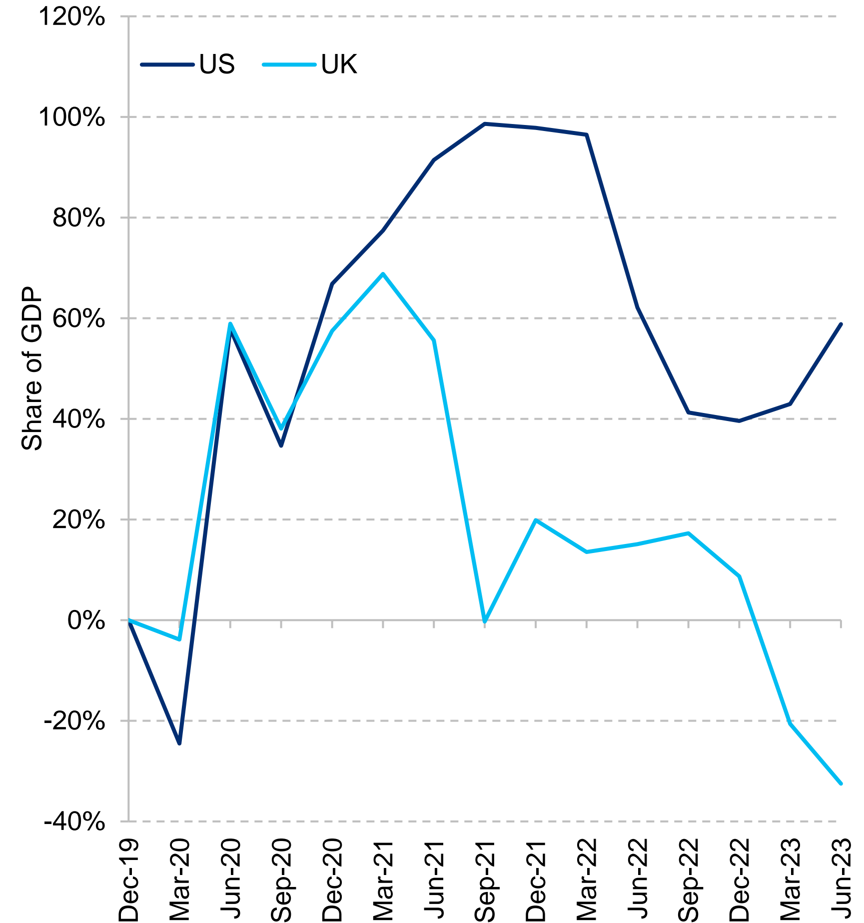
Monetary Policy: Are rate hikes not what they used to be?

Monetary policy in the UK takes around 18-24 months to transmit into activity. Even so, some have argued already that its effect may be less than was the case historically. We disagree. We think a shift away from large floating rate net liabilities means pass through is slower. But sensitivity to asset prices may be somewhat greater.





See: Chapter 2 - UK outlook: fallout. For chart notes, see Figure 2.12 and 2.15. Source: ONS, Bank of England, Federal Reserve and Citi Research

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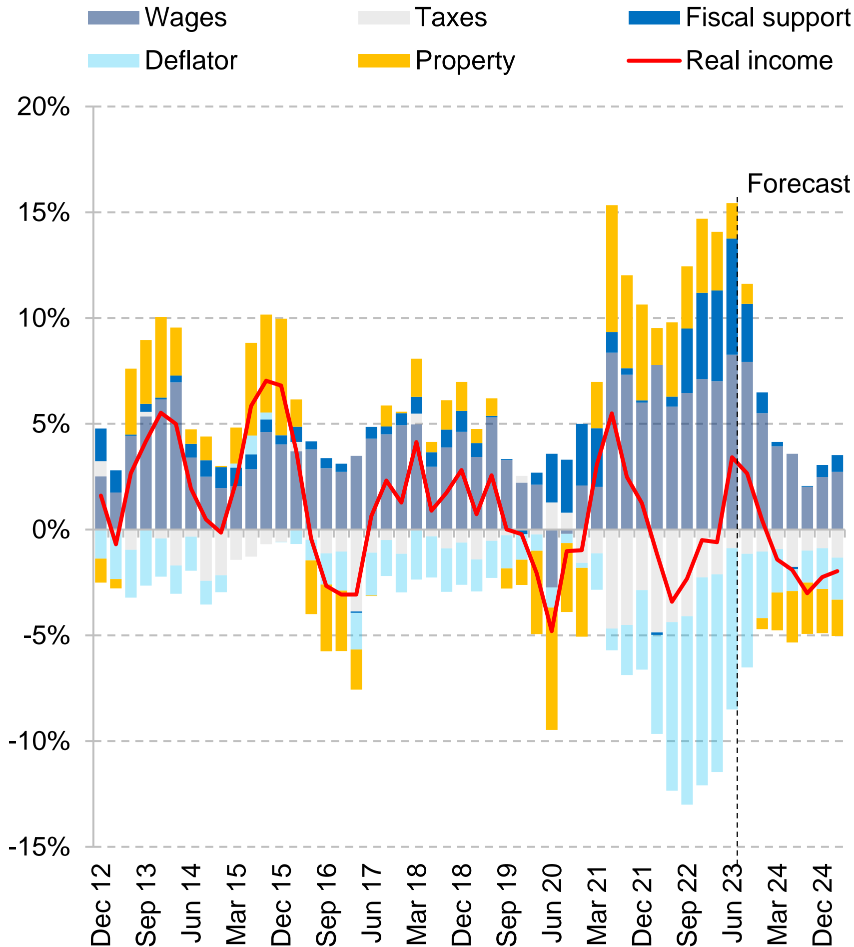
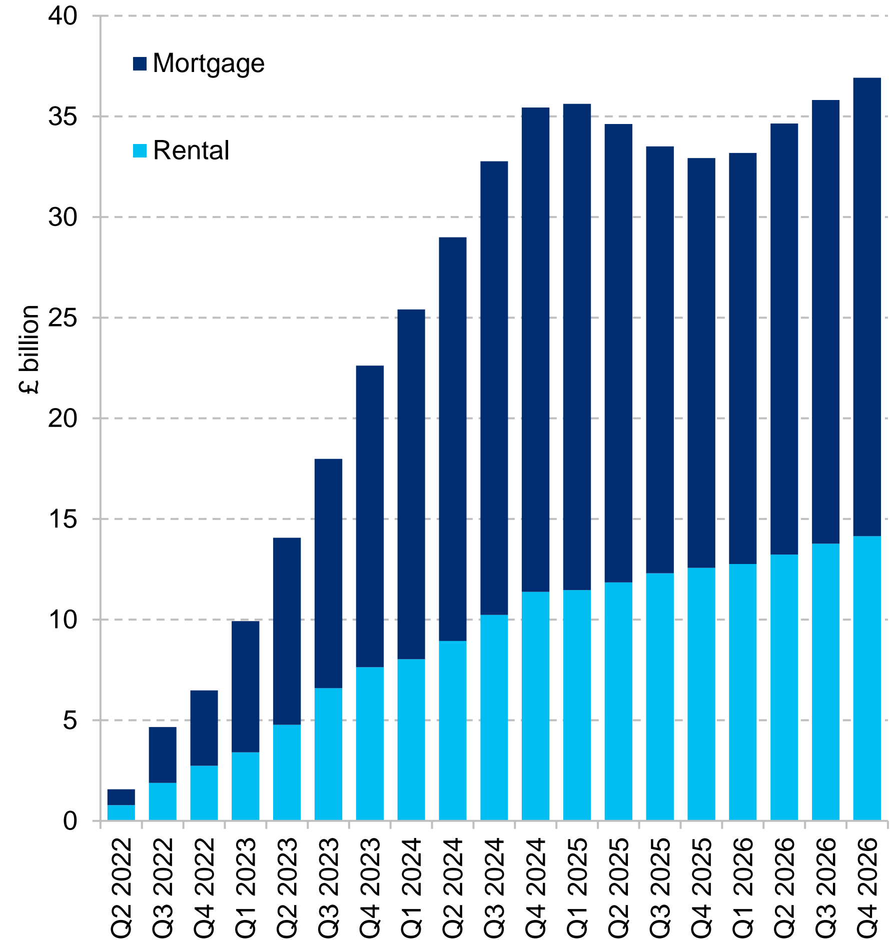
Households: Never had it so good?

As the energy shock as unwound and wage growth has accelerated, real household incomes have grown at a strong rate in very recent quarters. While in the months ahead real wages will accelerate further, aggregate household incomes will, by contrast, suffer a further contraction. The main drivers here are fiscal drag, and a further acceleration in debt servicing.





See: Chapter 2 - UK outlook: fallout. For chart notes, see Figure 2.7 and 2.15 Source: ONS, Bank of England, FCA and Citi Research

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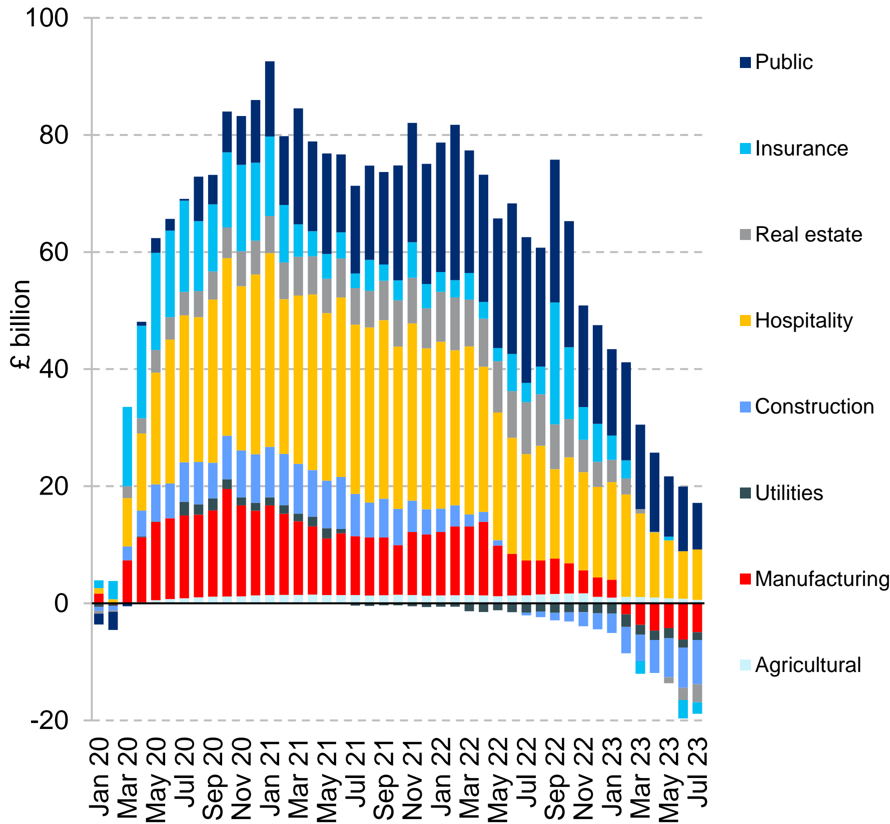
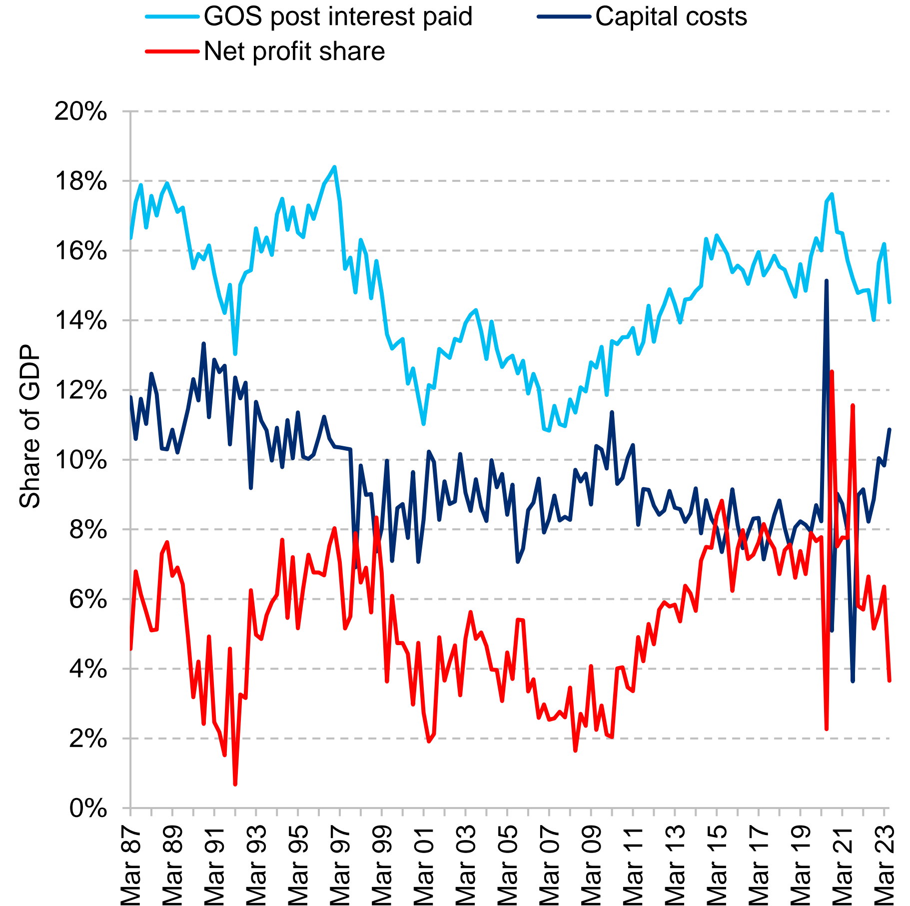
Firms: Also feeling the pinch

Much has been made internationally of 'greedflation' through the recent inflation shock. In certain areas of the UK economy, there certainly is evidence of similar effects. But this is more of a sectoral than aggregate issue. In aggregate, our best estimate of corporate 'bottom lines' is between 2-3pp short of pre-pandemic levels. Signs of stress are growing.

Corporate bank deposits: deviation relative to pre-COVID trend



Adjusted PNFC gross operating surplus



See: Chapter 2 - UK outlook: fallout. For chart notes, see Figure 2.23 and 2.25 Source: ONS, Bank of England, Hall and Jorgenson (1967), Barkai (2020), Piton, Yotzov and Manuel (2023)

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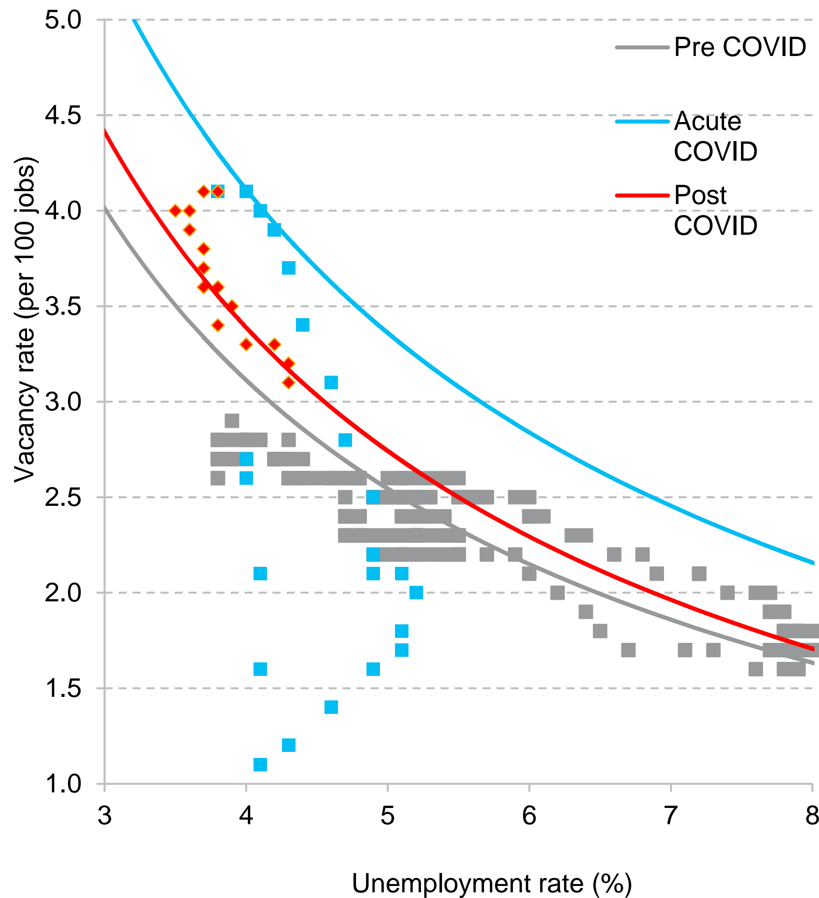
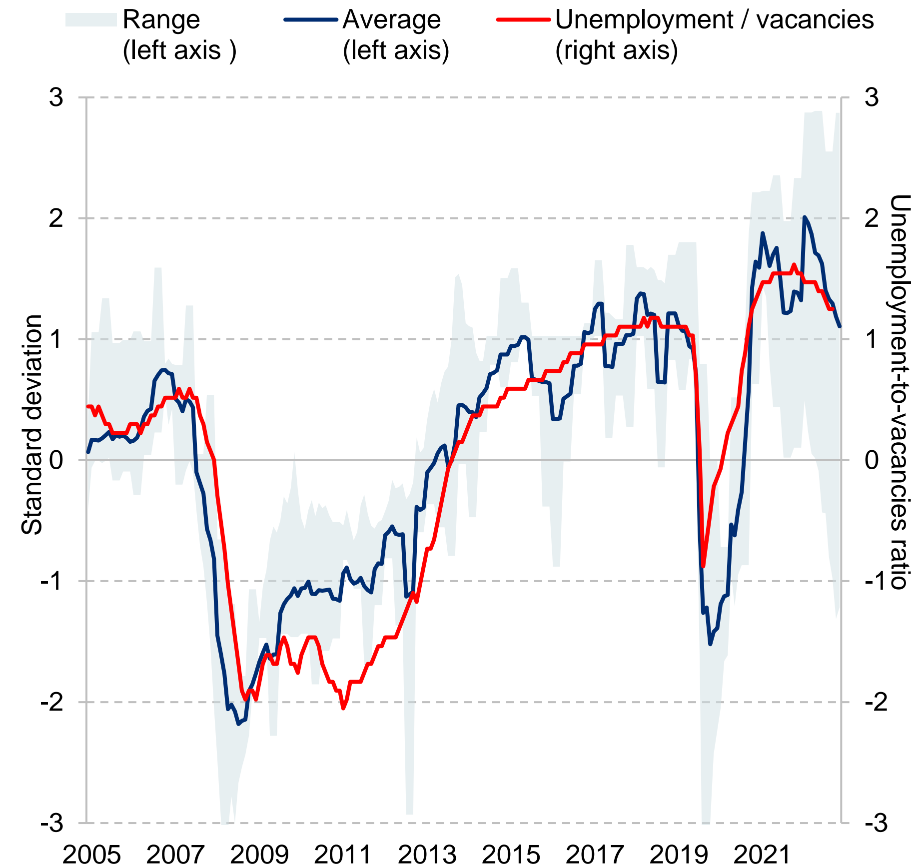
Labour market: Better supply, weaker demand

Over recent years, the UK economy has struggled with weak supply alongside – at least in the labour market – strong demand. In recent months there are signs both sets of dynamics are beginning to change. As the legacy of furlough has faded, labour market matching seems to have improved. Vacancies are also falling sharply, while recruitment difficulties eased.

UK Post-Covid Beveridge curves



Survey indicators of labour market tightness



See: Chapter 2 - UK outlook: fallout. For chart notes, see Figure 2.33 and 2.34. Lines on the left hand figure taken from a structural Beveridge curve model. Source: CBI, KPMG–REC, ONS and Citi Research

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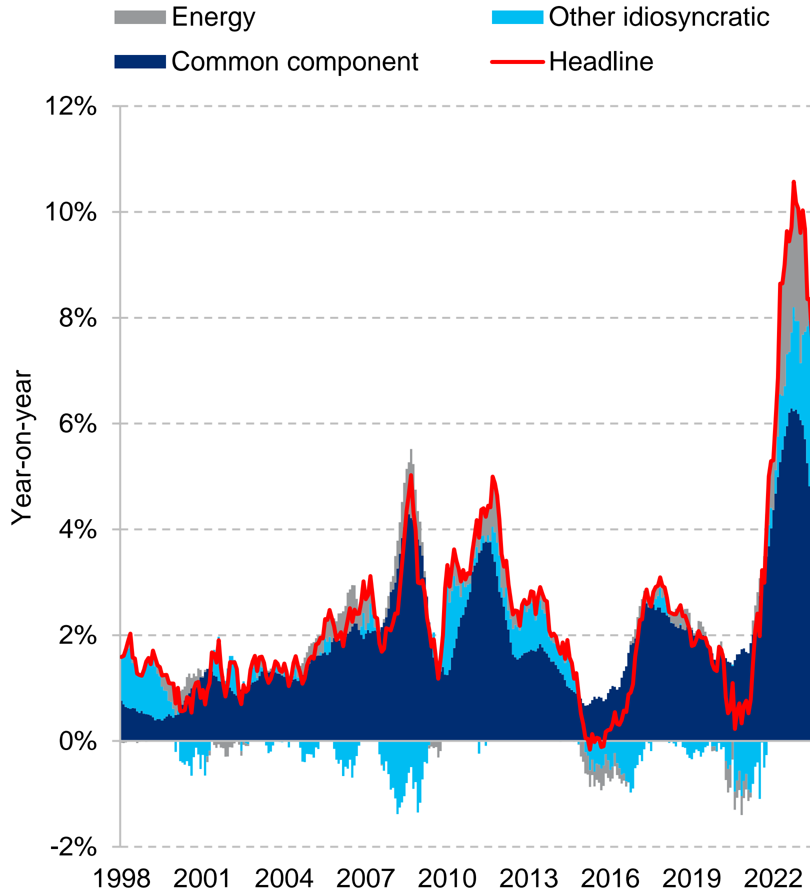
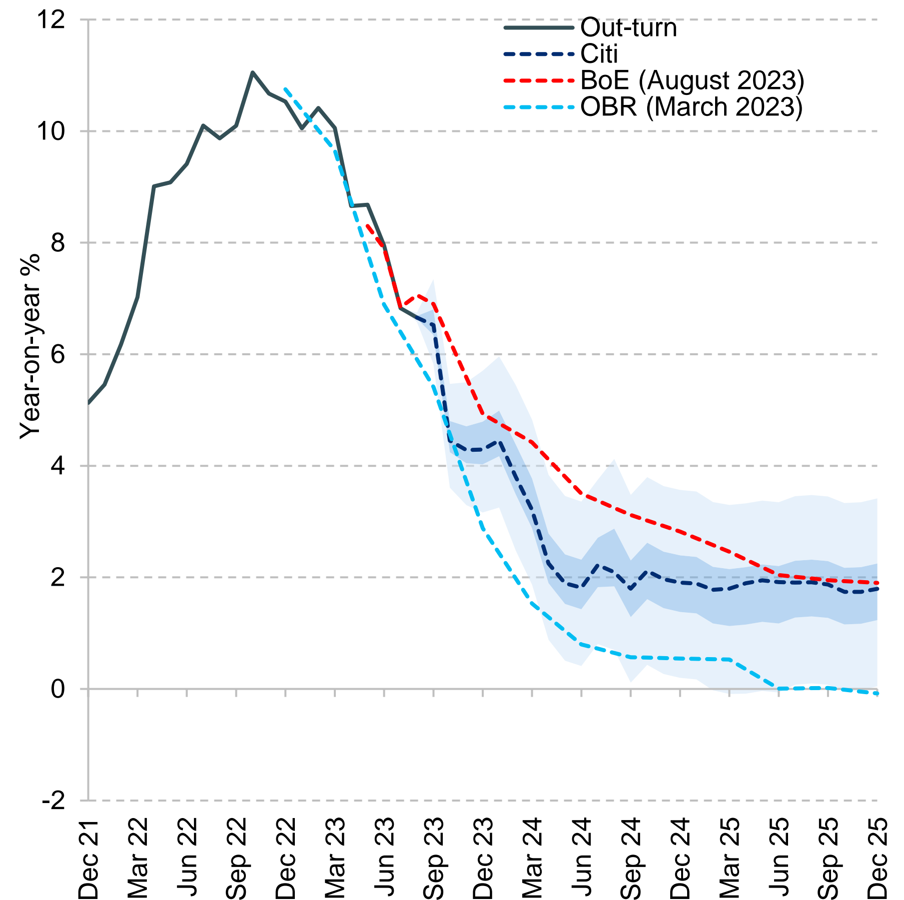
Inflation: Symmetry the key question

UK inflation has been somewhat higher than comparable economies. This reflects an especially challenging constellation of supply issues, rather than a qualitatively different inflation challenge. The question now is whether as cost shocks ease, this feeds through relatively symmetrically into domestic price growth, or whether firms find a way of repairing margins.





See: Chapter 2 - UK outlook: fallout. For chart notes, see Figure 2.37 and 2.2. Source: ONS, Luciani (2020), Bank of England, OBR and Citi Research

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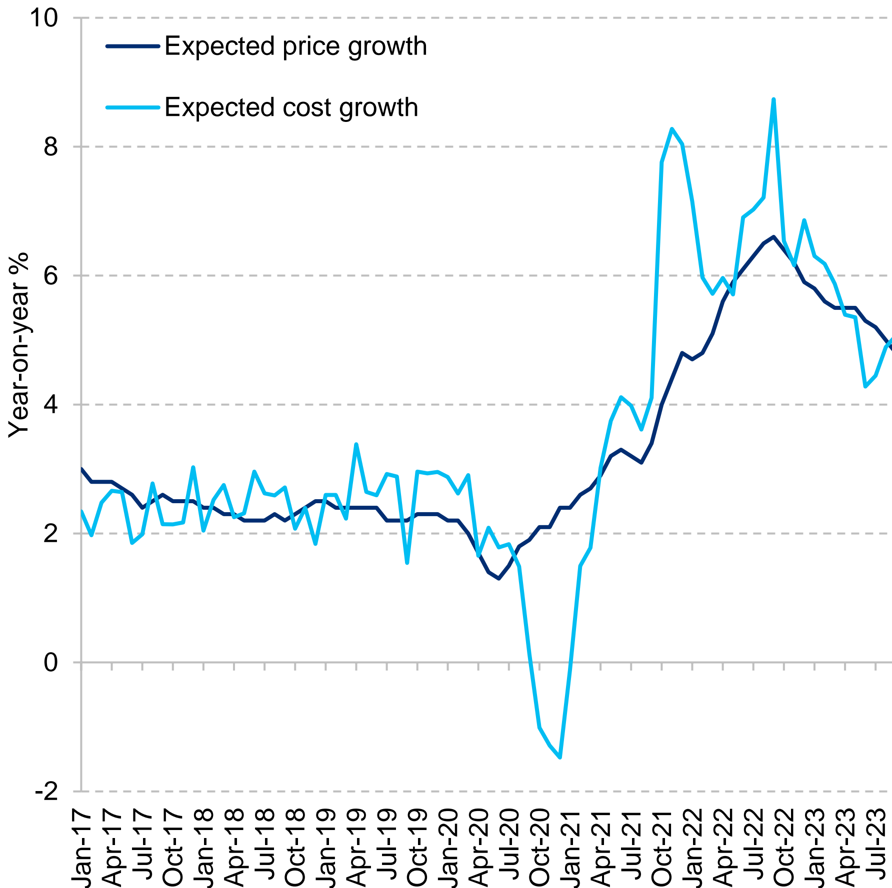
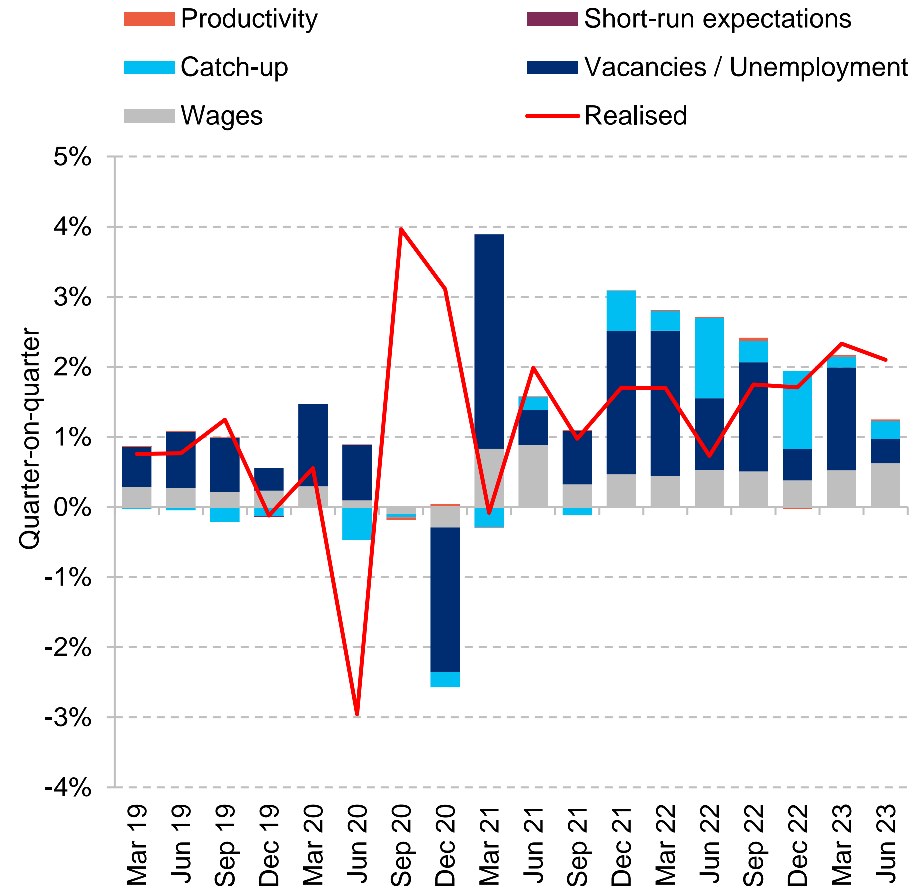
Inflation: Is inflation already embedded?

It is possible we have already transitioned to a high wage, high price growth equilibrium. But there is little sign of such a change in the expectations data. Crucially, we are also not convinced that is evidenced in the behaviour of wage growth. While strong, we think this primarily reflects 1) extreme labour market tightness through 2022; and 2) several post-Covid level adjustments.





See: Chapter 2 - UK outlook: fallout. For chart notes, see Figure 2.39 and 2.40. Source: Bernanke and Blanchard (2023), YouGov, Decision Maker Panel, ONS and Citi Research

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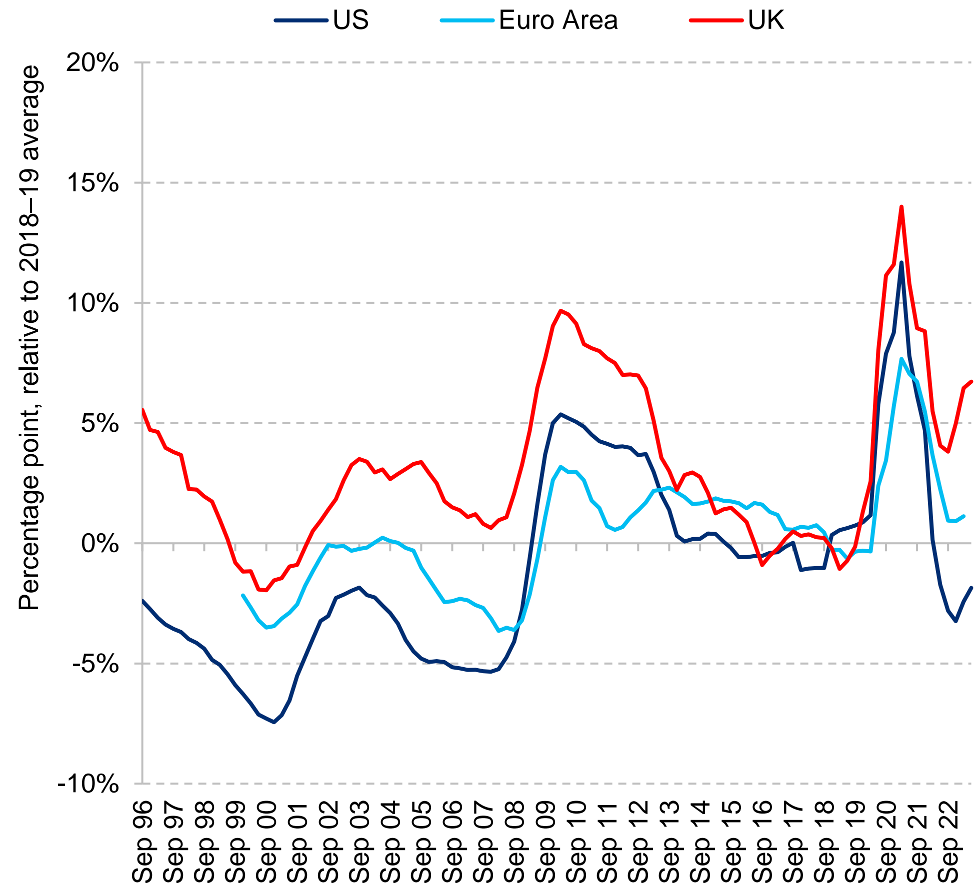
Monetary policy: An impossible trade-off

The MPC have concluded '…risks from more persistent inflationary pressures may have begun to crystallise.' That means weakening growth, or even increasing unemployment, is insufficient to cut rates. Instead, only manifest disinflation will do. However, keeping rates tight increases the risks around asset prices. That could mean a protracted downturn.

- Policy has for some time been **focused on managing risks:**
  - Significant uncertainty
  - Asymmetric 'cost of error'
  - Dividend in being proactive
- Inflationary risks remain, but **the cost of error is no longer obviously skewed**.
- **Balance sheets are of increasing concern**:
  - So far, policy **transmission has been slow** as cashflow effects have been muted
  - But **pass through into asset prices can be discontinuous**.
  - Feedback effects into demand and unemployment mean hard to reverse.
- The risk here is that policy is forced to cut quickly to stop this process accelerating further.
- We expect cuts from May 2024, although there is a risk cuts come later, but are forced to be more aggressive.



See: Chapter 2 - UK outlook: fallout. For chart notes, see Figure 2.43. Source: National Statistical Offices, ONS and Citi Research

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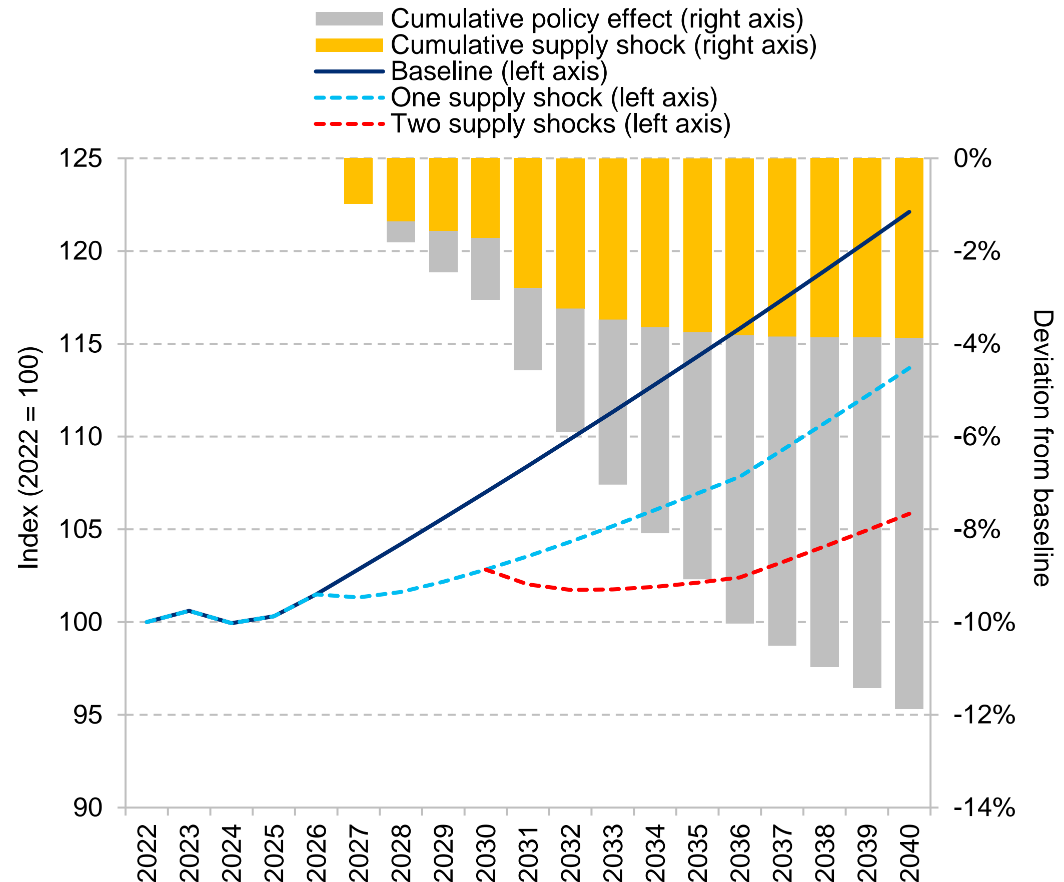
Keep calm and carry on? Monetary policy and supply shocks

Economic institutions are always specific to a given time and place. Over the last thirty years, stable supply and high nominal rates mean monetary policy has been a relatively robust mechanism for delivering macroeconomic stability. In an era of supply shocks, we think that no longer holds. Protecting 'monetary dominance' likely necessitates reform.

- In a context of **supply driven inflation**, monetary policy faces worse trade-offs:
  - This relates to **long lags**, which leaves policy unable to reduce the risk of inflationary embeddedness.
  - It also reflects the **blunt nature of the tool**, which weighs especially on investment and sometimes slows reconfiguration.
  - And last, rates volatility is especially **risk prone** in a context of high indebtedness – with a greater risk of financial volatility.
- These **risks are greater when fiscal policy is expansive**, with monetary policy then forced to trade off optimal domestic policy against the need to maintain credibility.
- The likely weakness associated with continuing with the same strategy means a **different approach is likely to be required.** In the UK that means **fiscal reform**.



See: Chapter 2 - UK outlook: fallout. For chart notes, see Figure 2.45. Source: Jordà, Singh and Taylor (2023), Uhlig (2005), Thomas and Dimsdale (2016), ONS and Citi Research.

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