# Why the U.K.'s high inflation has global implications

**Goldman Sachs Exchanges**

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**Allison Nathan:** More than any other advanced economy, the UK has been squeezed by sharply higher prices. But new data shows that inflation may be starting to fall, so has British inflation finally turned a corner?

**Jari Stehn:** The UK faces a real confluence of shocks that we've seen in other regions…We have core inflation still close to 6% by the end of the year, which is quite a bit above where we see it in both the US and the Euro area.

**Allison Nathan:** I'm Allison Nathan, and this is Goldman Sachs Exchanges.

To help break down the drivers behind the UK's inflation problem, its implications for the economy and markets, and the impact for consumers and investors, I'm speaking with my colleagues in Goldman Sachs Research, Jari Stehn, our chief European economist, and George Cole, head of European rates strategy. Jari, George, welcome back to the program.

**Jari Stehn:** Hi Allison.

**George Cole:** Thank you.

**Allison Nathan:** So we have talked so much on this podcast about the inflation problem that most of the developed world has been grappling with, but the UK has stood out in terms of the severity of its inflation problem. Why is inflation so high, Jari?

**Jari Stehn:** Well, it's certainly true that the UK stands out here. Headline inflation is at 8%. Core inflation around seven, so that's notably above where both the US and the euro area are now. I would say the big picture reason is effectively that the UK faces a real confluence of shocks that we've seen in other regions. So basically in the US, you have a classic excess demand issue, the tight labor market that's pushed up wage growth and inflation, and the Fed basically needs to lean against that. In the Euro area, you've seen an enormous energy supply shock, which has then started to feed through into wages and into underlying inflation.

And in the UK, you effectively have both of those issues -- excess demand in the labor market and, on top of it, a big energy supply shock. And all of that has been complicated also by constrained labor supply, a drop in labor force participation, changes in immigration patterns, and we think that has really made the UK's inflation problem quite a bit more complicated than elsewhere.

**Allison Nathan:** But the latest UK inflation data was a bit of a surprise. It was better than expected. How much comfort should we take from that? Or was that just a one-off?

**Jari Stehn:** It was a sizable surprise, and I think we should take some comfort in it. So it's pretty clear that surprises have been correlated, certainly on the upside. And we've now also started to see that surprises have been correlated on the downside in other countries. And so we do think it's the start of a more pronounced disinflation process here. But I would say the composition remains worrying.

Essentially, the downside surprises so far have come from energy and have come from core goods prices. And we think those will slow further. You see that wholesale energy prices, at least in gas, have continued to fall. And then indicators of bottlenecks globally that have been important for goods inflation have also continued to ease.

But at the same time, it's really the services side that has continued to look really strong, which is related to wage growth.  And we have not yet seen any signs really that wage growth has started to slow.  And so we think the disinflation process in the UK, as a result of that, is going to be slower.  And we have core inflation still close to 6% by the end of the year, which is quite a bit above where we see it in both in US and the euro area.

**Allison Nathan:** So the Bank of England seems to be in a bit of a bind here with inflation well entrenched.  What do you expected them to do this week?

**Jari Stehn:** Yeah, there's a range of views on the likely outcome of this meeting.  The MPC has really said they want to lean against inflation persistence, and they've set out three criteria that they're watching -- labor market activity, wage growth, and services inflation are basically the indications of inflation persistence they're monitoring.

Now, in June, all of those three indications were to the upside, and that's why they hiked by 50 basis points.  They surprised markets in June.  This time around, the verdict here is somewhat mixed.  On the labor market activity side, things have been softer. Wage growth has still been very firm.  And then on services inflation, things have sequentially eased a bit but are still at a very high level.  A bit of a split verdict here.

Now, there's been very little communication from the Bank of England in terms of how they read the data, and so we think that makes it a close call.  But on balance, we think they're likely to put more weight on the labor market softening that we've started to see and also more weight on these initial signs of disinflation that we talked about.  And we think that's going to tip the balance towards 25 basis points this week.

Now, we then think that will be followed by two more hikes, by two more 25-basis-point steps to a terminal rate of 5.75 in November, which of course would be notably above where the other major central banks are.

**Allison Nathan:** And George, let me bring you into the conversation.  What are markets expecting from the central bank meeting this week?

**George Cole:** Yeah, thanks, Allison. So market is really stuck with the same mixed views, if you like, that Jari just described and is pricing in between a 25-basis-point hike and a 50-basis-point hike, around about 33 basis points' price. So if you think about it in just in rough probabilities, it's about a third chance of a 50-basis-point adjustment and the rest on a 25. And I think the market is in similarly two minds because of the surprise 50-basis-point hike at the June meeting. That really revealed that the Bank of England were willing to surprise the market on the hawkish side and, if you like, over deliver on the expectations at the time. And so the market will retain a little bit of that probability or insurance against that risk.

However, as Jari has said, the data surprises have carried rates lower into this meeting, both in the inflation and on some of the activity numbers coming in a little bit weaker. And so that pricing is lower. That's also true for terminal rate pricing, which is slightly above the 5.75 that we expect, just under 6% but well off the highs which was closer to 6.5% at the peak.

**Allison Nathan:** And just give us some context about those yields relative to where we were historically, relative to where we were during some of the volatility that we saw around the liability-driven investment crisis scenario that we had seen in the autumn of last year.

**George Cole:** Yeah. So I think we've actually been near the 4.5% level, again, in recent weeks. And so if you think about the recent moves in gilt yields, they're in between the 4% to 4.5% range. And apart from that episode you mentioned, September and October 2022, you really do have to go back quite far to the pre-GFC period where yields averaged let's call it 4.5 to 5% at the 10-year point.

Policy rates currently at five, maybe heading against somewhere between 5.5% to 6%. That again, you have to go back to the pre-GFC period for the last time that bank rate was as high as that. And so we are talking about relatively high historical yields and certainly very high contrasting to the previous decade.

But I think what is really interesting is the comparison to the episode you mentioned. So thinking back to September/October where, if you like, an announcement of a fiscally expansionary budget catalyzed a selloff in the gilt market that gained its own momentum because of, as you mentioned, leverage that was deployed in these LDI-type strategies. What it means is essentially buying gilts on leverage. As they sold off, that forced further selling in the market and led to a huge selloff in the gilt market that was predominantly led by longer maturity gilts. So 10-year, 20-year, 30-year gilts.

And in fact, if you look at the very long end of the curve, yields were higher then than they are now. What is quite different this time is that this is a selloff driven by growth in inflation in particular. And that means it's much harder to solve. Back in September/October, the Bank of England were able to short circuit this technical dimension in the market by buying gilts temporarily. This time around, the solution to get inflation under control is actually higher rates itself. And so the fronting, if you think about 2-year yields, are actually higher now than they were back then.

What that means to us is that essentially this time around the repricing is going to be stickier. It's going to be more long lasting and why we don't expect yields to fall much from current levels.

**Allison Nathan:** And so where do you think yields will go from here?

**George Cole:** So we forecast that the terminal rate will probably just undershoot market pricing ever so slightly but that the Bank of England do have more work to do to raise the policy rate from current 5% levels to get the inflation process in hand and under control. For the long end of the curve and thinking about, say, the 10-year point on the gilt curve, which is the global benchmark that we would think about forecasting, we expecting it to reach 4.5% as we go through the peak of the hiking cycle around about Q3, staying around that level, maybe slightly lower to 4.5. by the end of the year but not far from current levels but slightly higher. So we're currently trading around 4.3%. We think it'll be around 4.5% in steady state.

Now, that's also in the context that we do expect yields, for example, in European bond markets to be a little bit higher as well. For example, in German 10-year rates. And so in that sense, it's part of a global picture where we expect rates to remain high. But on the back of the hikes we think the bank need to deliver, gilt yield should be a little bit higher than here.

**Allison Nathan:** And George, what are the broader implications of the UK's inflation problem for yields in the Euro area and globally?

**George Cole:** So we have picked up, if you think about the market pricing over the last several months, that the UK has been, if you like, a kind of bearish source of news for global bond markets. What I mean by that is that, as the inflation problem has worsened in the UK, gilts have sold off. Rates have moved higher. Yields have moved higher. And that has spilled over into other bond markets as well. So in a sense, we know that global bond markets are, in some sense, substitutes -- as the price of one fluctuates that it can affect the prices of others. And we have seen a very significant repricing of gilts, which, again, has had an impact on other markets.

Now, at the same time, we have seen rates spreads move toward, if you like, much wider in favor of the UK. So UK yields moving higher relative to those other economies, but they do leave an imprint on the bond markets of, say, Europe and the US.

In the most recent period, since the Bank of England undertook the 50-basis-point hike in June and around the inflation surprise that we got to the downside in the latest reading, we've noticed that actually the impact on other markets has been much lower. So, if you like, other global bond markets are starting to price the UK as a little bit more idiosyncratic.

What I do think is important, though, is that, demonstrably, if you look at the level of inflation, the level of inflation uncertainty, forecast disagreement, the UK does stand out as having among the worst inflation problems in the G10. If we do indeed find that inflation problem is lessening, it's coming under control both by the central bank's action and then finally through some of the disinflation that's been long awaited in energy and food prices and so on, I think that will go some ways to calm worries in other markets as well about runaway inflation.

Now, the problem, we are getting actually quite a lot more inflation progress out of the US and some in the euro area as well. So those markets are some ways ahead, but it will reinforce a global narrative that inflation, while it might remain well above target, is certainly falling relative to the peaks we saw in 2022.

**Allison Nathan:** And Jari, as you said, inflation is likely to remain high for a while. We're likely to remain well above the BOE's 2% target for some time. And households are still struggling with higher prices. Are you seeing any slowdown in consumer spending as a result of that?

**Jari Stehn:** Yeah. I mean, it's certainly been a tough year for UK consumers. There was a big cost-of-living hit, of course, over the last year with high inflation, higher energy prices, rising interest rates. As a result of that, we've really seen a stagnation in consumption. It's basically gone sideways over the last year. And of course indicators of consumer confidence, for example, have remained very depressed.

Now, when we look ahead, we think it will remain a difficult environment basically because interest rates are going up, and that's feeding into household finances. But at the same time, what's important to realize is that inflation is coming down and wage growth is strong. And so when you think about the real income picture, that's actually improving by quite a lot because you're really looking at a situation where headline, particularly towards the end of the year, is coming down quite rapidly.

Now, on top of that, households still have quite a lot of the pandemic savings, so there's an interesting contrast between UK consumers and US consumers.  US consumers have already wound down most of those savings; whereas, in the UK, households haven't.  And so we think that consumption is likely to show some signs of growing again later in the year and into next year, but, of course, it is going to remain a fairly subdued growth environment, we think.  So we have growth of 0.3% this year and 0.7% next year, so both years clearly below trend.  And weak consumer growth is a key part here.

**Allison Nathan:** And those interest rate increases generally are also quite evident in the housing market. We're seeing monthly mortgage payments rising for millions of homeowners.  And the UK stands out because housing is a big part of the economy.  Talk to us a little bit about the implications of that.

**Jari Stehn:** Yeah, that's right.  That's a key headwind as we look ahead.  UK households are more exposed than households in many other countries. That's basically because the borrowing has a shorter maturity, and households tend to have more mortgage debt than in many continental European countries. So the UK looks a lot more like Sweden or Spain in terms of the exposure to higher interest rates.

At the same time, we've also seen important changes in the mortgage market in the UK over the last 10 to 15 years, which is that the share of floating mortgages has fallen quite significantly. And so it suggests that the refinancing this time around is going to be quite a lot slower than in the past. And so when you look at the effective mortgage rate -- so essentially the rates that households are actually paying on average -- that effective rate has gone up from 2% to 3% so far. And we think it will go to 4.5% by the end of 2024. So it gives you a sense that there's still a significant amount of drag in the pipeline that probably a bit more than half of that drag into housing is still to come.

**Allison Nathan:** And you touched on earlier that the UK's tight labor market has been an important factor behind the wage pressures and the high services inflation that still looks a bit worrying. Your research has shown that post Brexit the change in immigration has contributed to that tight labor market. Give us a little bit more detail there.

**Jari Stehn:** So the interesting thing is that the total immigration numbers are actually higher than they were before the EU referendum but that the composition of immigration has changed quite fundamentally. So essentially, immigration from the EU has fallen sharply. Whereas immigration from other parts of the world has gone up.

Now, we think that change in the composition of immigration has important economic implications because the EU migrants that used to come into the UK used to have very high participation rates. They typically went into lower skilled sectors but effectively came into the UK to work. And so historically, the UK labor market never really overheated because, as soon as labor demand picked up in the UK, you had EU workers flowing in and you effectively had a very elastic labor supply. And we think that Brexit changed this. That the labor supply, as a result of this, has become much less elastic.

And you see that, for example, when you look at the labor market by sector. You see precisely that the sectors that are now most overheated are also the sectors that used to benefit most from the immigration inflows from the rest of the EU. But those are now the sectors also with the highest wage growth. So I think when you look closely, it is clear that the changes in immigration patterns have played an important role here.

**Allison Nathan:** George, we've spoken a lot about the forecast and outlook for gilts. What about sterling? It's been out of favor recently. It's been falling against some of the major currencies, but is that likely to last given all of those moving parts?

**George Cole:** It's a really interesting question, and we certainly pick up very strong views on the prospects for the currency. And certainly I think there's been a link that the prospects of recession -- were they gas driven from last year or perhaps because of Bank of England action -- would be a headwind for sterling. But we're actually a little more positive on the pound. We think that ultimately the Bank of England do have more work to do to hike rates to stabilize inflation. Again, thinking about the action delivered in June did go some ways to restoring a little bit of resolve for the Bank of England to get on top of that inflation issue.

And if you think about the context here, currencies and FX always need the second leg, if you like.  If you think about what's happening in the US and in Europe, we've just had meetings from the Fed and the ECB where they were ever just slightly dovish and perhaps receding a little bit back away from the hikes that have been delivered quite spectacularly through 2022 and much of this year and seem is to be closing in toward the end of their cycle.

Now, of course, it will depend on what the bank ultimately delivers, but, if we are right, that there are more hikes to come from the Bank of England, that will come at a time where the Fed will be on hold from here.  The ECB might deliver just one final hike.  I mean, there's of course risks around each of those forecasts, but our baseline view is that the Bank of England will be hiking for longer, and typically those higher yields will go some ways to support the currency.

Now, I think there's another positive for sterling, which is that, last year in 2022, both the pound and in euro were suffering from a very substantial negative terms of trade shock as gas prices increased. So if you think about just the aggregate terms of trade of those economies as the cost of those gas imports went up, then those terms of trade deteriorate. And that's a long run driver, if you like, of FX returns. And so if you couple that against an environment where the Fed were hiking and the US economy didn't have such a negative terms of trade impact, that was a recipe for quite weak currencies.

Now, we may not be totally out of the woods on the gas situation in Europe, but it certainly looks like gas prices have stabilized much lower than expected at the earlier part of the year. And that is going to be a tailwind, not only for the macro fundamentals, including growth, improving purchasing power of the consumer, but also should be a support for the currency as those terms of trade improve. So we expect sterling against the US dollar at 1.33 in 12 months and expect a similar margin of appreciation against the euro about to 0.84 on euro sterling.

**Allison Nathan:** And Jari, let's just go back to policy for a moment. So much focus on central bank policy heading into the BOE's meeting this week and of course off the back, as George just said, of the Fed and ECB last week. But with the rise in borrowing costs and of course with public finances already being strained, what does that mean for near- and long-term fiscal policy in the UK?

**Jari Stehn:** Yeah, we basically think it means that fiscal policy needs to turn from a supportive role for growth over COVID and during the energy crisis into a drag as debt has risen, as interest payments are due to rise. And so our estimates here are that fiscal policy is already deducting from growth this year to the tune of about half a percentage point. And then we think the drag will go up in 2024 to a bit more than one percentage point.

Now, of course there is uncertainty around the fiscal outlook. We also have an election and so on. But we do think bottom line here is that fiscal policy is turning from a supportive role really to more of a headwind to the economy going forward.

**George Cole:** Maybe just to add, there is, of course as Jari mentioned, a connection between the interest rate movements we've seen and the inflation repricing that we have seen because, ultimately, they have a fiscal impact. And if we think about the moves over the last few months of interest rates higher -- now, they've come down a little bit, but they represent relative to, for example, the last time that the government provided an update on the finances, on how much might need to be issued this year -- there is a pretty significant impact both from the higher interest build, the higher inflation build, given the inflation -- I mean, debt -- that the government has already issued.

But then also importantly, from quantitative tightening. Now, that is something that other central banks are doing as well, which really is about shrinking the portfolio of assets bought under the quantitative easing programs over the last decade or more.  But the UK is a little bit unusual in that the Bank of England are selling those assets.  And now that interest rates are higher, when you sell them, they actually incur a capital loss.  That also has a fiscal cost that is constraining the finances to some degree.

**Allison Nathan:** So with all of these pressures on the UK economy, what's the chance that it actually could fall into recession again this year or into 2024?

**Jari Stehn:** Yeah, I mean, base case for us is that the UK can avoid a recession. That basically falling headline inflation supports the consumer enough that households can absorb higher interest rates, can absorb the fiscal drag that we talked about. But we're talking about pretty low growth. We have barely positive growth in the second half. Then growth picks up a little bit in 2024. And so we do think the risk of recession remains. We have put a probability of about 40% on this over the next year, which is about twice as high as it is in the US because the UK, as we've talked about, is struggling with this combination of shocks that still makes it a more challenging macro outlook, we think.

**Allison Nathan:** Jari, George, thanks for joining us again and sharing all of your insights.

**George Cole:** Thank you very much.

**Jari Stehn:** Thank you.

**Allison Nathan:** Thanks for listening to another episode of Goldman Sachs Exchanges, recorded on Monday, July

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