# Can disinflation turn Tory election fortunes?

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- The Conservative Party has suffered two historic by-election drubbings in Tamworth and Mid Bedfordshire, and will be looking to the UK economy to improve its election prospects
- Economic literature demonstrates that GDP, inflation and unemployment outturns all have a significant impact on support for incumbent parties
- While we expect some moderation in inflation by the time of the next election, the price level (which arguably matters more for voters) will be around 25% higher than in 2019
- Moreover, the UK economy is highly likely to experience a recession by the time of the next election
- Finally, our expectation is that house prices will see a peak-to-trough fall of at least 10%
- All of this suggests that the Conservative Party is unlikely to receive a major boost from the economy ahead of the next election

Following two electoral drubbings this week, the Conservative Party will be hoping they can find a way to reverse their fortunes. Could falling inflation be the source of a potential turnaround? UK headline CPI came in at 6.7% last month, down from its peak and getting closer to Rishi Sunak's pledge of 5.3% by the end of the year, though still way above the Bank of England's 2% target. But it is not just consumer prices that matter for voters; and Fathom analysis suggests that, even if inflation is reined in, a weak economy is still likely to weigh on Mr Sunak's popularity.

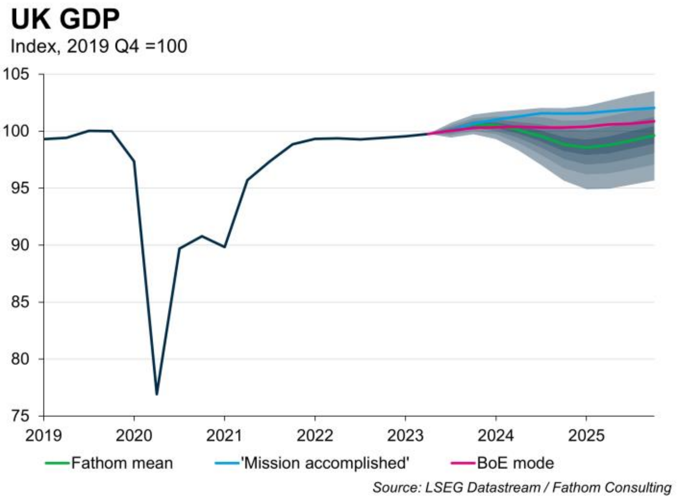
**UK CPI**

Twelve-month percentage change


*Source: LSEG Datastream / Fathom Consulting*

There is a host of economic literature that demonstrates a clear relationship between macroeconomic variables and political outcomes. Many — for example, Kahane (2009), and Dassonneville & Marc Hooghe (2015) — show that GDP, inflation and unemployment outturns all have a significant impact on support for incumbent parties. Separate Fathom analysis supports this conclusion, finding that that these three factors, plus house prices, also have a tangible impact on consumer confidence.[1] This note outlines how these variables are likely to evolve over the months before the next election, and asks what this means for Mr Sunak's prospects.

Fathom's *Global Outlook, Autumn 2023* argued that, with the worst of the cost-of-living crisis behind us, a global recession is unlikely this year. However, it is a case of one bullet dodged, but two bullets still in the chamber. Real wage growth may now be positive again, but we are still waiting for the lagged impact of policy tightening, and there is a risk that inflation turns out to be more persistent than expected. Consequently, the mean path for UK GDP in Fathom's latest forecast shows the UK entering recession next year, something that is unlikely to do the Conservative Party's electoral prospects much good.




The first of those two remaining risks is that the lagged impact of monetary policy tightening already implemented will be enough to cause an economic downturn — so how likely is this. There is international variability on the speed of pass-through from higher interest rates. UK mortgage interest rates tend to be fixed for five years, a shorter time than is usual in the US. This means that, all else equal, UK households will face a bigger and quicker squeeze from higher interest rates their American counterparts. Indeed, Fathom estimates that less than half of the economic impact of the increase in Bank Rate has come through so far.

[1] For more, see this report, written by Fathom and commissioned by Refinitiv (now owned by the LSEG).



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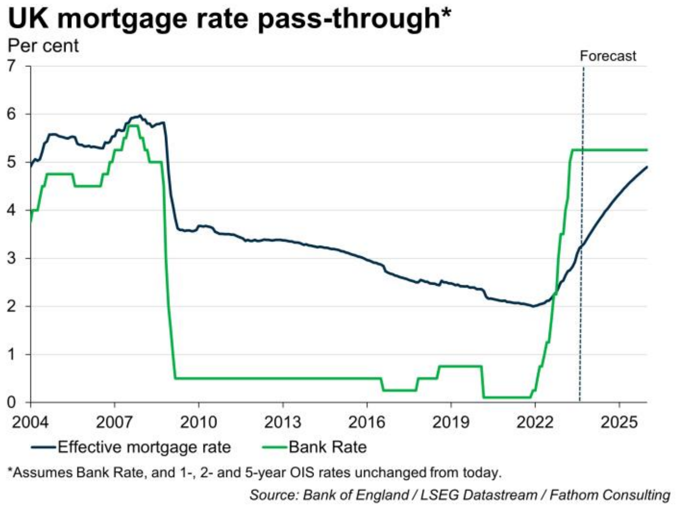
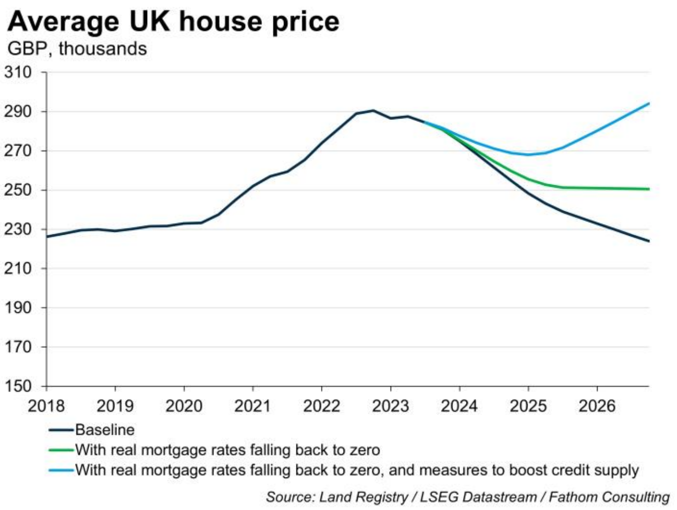
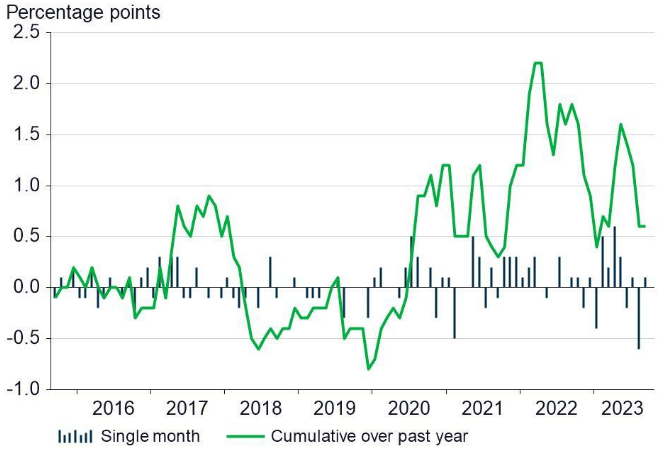



The prospect of higher borrowing costs leading to a recession would, of course, have implications for the housing market. Approvals, often a leading indicator of house price changes, have fallen close to the levels after the Global Financial Crisis, and lenders also expect a reduction in secured credit availability. House prices have already begun to drop and Fathom's expectation is that they will see a peak-to-trough fall of at least 10%, although the risks are skewed to the downside (and with inflation still high, the magnitude of the fall will be larger in real terms).




The other major risk for the UK economy is that the persistence of inflation will be greater than expected. If this proves true, the Bank will probably be forced into further policy tightening which, in turn, is likely to further depress economic growth. Core inflation surprises rose sharply in late 2021 and have remain elevated. Indeed, these surprises have summed to 0.6 percentage points over the past twelve months. Moreover, in August private-sector regular pay was up 7.6% relative to a year prior, suggesting that the labour market is still too tight for inflation to return to its 2% target. In short, Fathom continues to see the risk of sticky inflation as more pronounced in the UK than in either the euro area or US, and only around a one-in-five chance that headline CPI is below its target by the time of the next election.

## UK core inflation surprises




*Surprise relative to consensus of economists, as measured by Reuters poll. *Source: LSEG Datastream / Fathom Consulting*

However, while economists might well celebrate a return of inflation to target, voters may disagree. The wider public tends to evaluate prices through the lens of the price level rather than its rate of change. This is closely related to the cognitive bias that is known as 'money illusion', whereby consumers (at least partly) view the world through a nominal lens as opposed to a real one. To understand this, consider offering an individual the following two options:

1. A 5% increase in inflation coupled with a 5% rise in wages
2. No change in either prices or wages

Both options presented are equivalent in a real sense – either wages and prices rise by an offsetting amount, or they stay the same. Regardless of which option is chosen, the individual would be as well off as they were before. However, the typical consumer would prefer the latter option — no change in either prices or wages. In many cases they would even be willing to make a small financial sacrifice to maintain the status quo.

Given that there is no real prospect of the Bank attempting to get prices to revert to their previous level, Mr Sunak's hope that taming inflation improves his electoral prospects may be premature: prices have risen, and voters have noticed it.

If Fathom's expectation of a UK recession does occur, then it is highly likely that unemployment — the third major predictor of voting patterns — may take a turn for the worse. Thus far, labour markets have remained relatively robust in the face of monetary tightening, although an uptick is noticeable in the labour force survey measure. That said, it should be noted that the UK participation rate is below its pre-pandemic level, and that the potential labour force is lower still, given the outflux of EU citizens during the pandemic. Both of those trends have started to reverse in recent months, however.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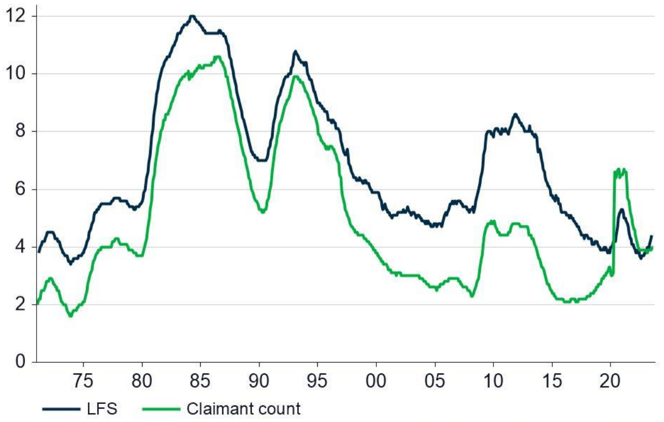
## UK unemployment rates

Per cent of labour force




*Source: LSEG Datastream / Fathom Consulting*

Overall, it seems unlikely the macroeconomic factors are likely to boost Mr Sunak's election hopes next year. Even the best possible economic scenario for his party, a soft landing, would still see the level of prices around 25% higher than it was at the time of the last general election. However, recession is a far more likely outcome for the UK economy, and Fathom attributes a 70% chance of this happening by the end of next year. Given this bearish outlook for the UK, it is unsurprising that the recent Conservative Party conference saw politicians trying to shift focus away from the economy towards other policy areas. Judging by the party's recent performance in by-elections, this strategy has not as yet born much fruit.

### Further reading

Global Outlook, Autumn 2023: fortunes diverging

Why are houses so expensive?

Innovation: the UK's role in a new world order

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