Bad news builds, but a recession isn't baked in yet

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Contents

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Foreword 3
Highlights.. 4
1. Introduction 5
2. The economy has lost momentum this year 5
3. The outlook for growth has deteriorated 9
4. Drivers of UK inflation should encourage MPC caution 14
5. Business investment's struggles are likely to continue........ 15
6. Forecast in charts 19

Foreword

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The list of challenges facing the UK economy continues to grow, with the recent events in Westminster adding to a general sense of perma-crisis. Inflation continues to rise, topping 9% in April and is expected to climb above 11% come October. It's part of a global story that has seen central banks moving quickly and sharply on interest rates, which in turn will squeeze consumers. Meanwhile, businesses face continuing supply chain disruptions, labour shortages and general uncertainty, which, in the UK at least, is dampening down investment.

In that context, there are real concerns about the possibility of a global and UK recession, particularly around the turn of 2022 and into 2023. As a consequence, the EY ITEM Club has cut its GDP growth forecast for 2022 and 2023 for the fourth time in a row. GDP is now expected to grow by 3.7% this year, down from 4.1% predicted in the spring, followed by 1% in 2023, a more significant downgrade from 1.9%. Although, as inflation falls back, the economy is expected to expand 2.4% in 2024, a little faster than previously pencilled in.

However, things may not be as negative as they appear, and there are still some grounds for optimism. Despite the negative UK exceptionalism that so many in our media classes like to indulge in, as of Q1 22, only the US and Canada have outperformed the UK in the recovery from the COVID-19 crisis. Further, whilst headline GDP stagnated between January and April, underlying growth (adjusted for the end of Test & Trace) was positive, and indeed the economy returned to growth in May (0.5%), beating expectations and suggesting that despite the squeeze on consumer incomes, the economy is proving resilient.

Other positives could support activity over the next 12 to 18 months. Firstly, consumers have still yet to tap into the £180bn or so of unplanned savings built up during the pandemic. These savings could support spending in the face of higher inflation, particularly from those on higher incomes, who are responsible for an outsized share of consumer spending and are best able to deal with cost-of-living pressures. Secondly, unemployment is at a near-50-year low, with many industries desperately short of workers; this again should support households for as long as the labour market remains buoyant. Finally, the extra fiscal support announced by the Government in May will go some way to ease the impact of surging energy bills, particularly for those on lower incomes. Regardless of who gains the keys to Number 10, we will likely see further support ahead of the October price cap increase.

However, this slightly more positive narrative relies on major assumptions around the path of energy prices and global economic activity. A gas or oil embargo on Russian energy supplies would see a further surge in energy prices; tightening monetary policy, particularly in the US, risks the creation of a global downturn, and continued and ongoing COVID-19-driven disruptions to supply chains all represent potential downside risks to the latest forecast.

From a UK perspective, the hopes that business investment would bounce back following the relaxation of COVID-19 restrictions are beginning to fade. Business investment continues to lag both pre-pandemic levels and performance in other countries, part of a structural weakness in the UK economy that has been apparent since the 2016 referendum. Greater political certainty would help, but a turnaround looks unlikely in the short term, given subdued growth prospects, rising costs and substantial increases in debt taken on by services sector firms, in particular. The EY Item Club forecast is that it will take to early 2025 before business investment returns to its pre-pandemic level. This has longer-term implications for UK growth and productivity. Addressing this shortfall and the UK's wider productivity challenge will be another job on a substantial 'to do' list for whoever walks into Number 10 come September.

Highlights

- The problems confronting the UK economy have grown since the EY ITEM Club's last forecast report in the spring. Households' real incomes are being squeezed by ever-higher inflation and the prospect of worse to come on that front; supply chains continue to be disrupted by COVID-19 lockdowns in China, borrowers are facing the consequences of a series of unexpectedly rapid interest rate hikes, and the jump in asset prices during the pandemic is subsiding. It's hardly surprising that 'recession' is increasingly on the lips of economic commentators and forecasters.

- But while the EY ITEM Club has cut forecast GDP growth this year and next, we think the economy should narrowly avoid the two consecutive quarters of declining output that define a technical recession or a more protracted contraction. GDP is forecast to grow by 3.7% this year, down from 4.1% predicted in the spring, followed by 1% in 2023, a downgrade from 1.9%. As inflation falls back, the economy is expected to expand 2.4% in 2024, a little faster than previously pencilled in.

- Cost-of-living pressures are already taking a toll on the economy. Real household incomes fell in Q1 2022 for the fourth consecutive quarter, and consumer confidence has plumbed record lows. But activity appears to be slowing, not crashing. GDP in May was 0.4% higher than at the start of the year, and growth would have been stronger but for a fall in spending on COVID-19 testing. And measures of sentiment in the first global economic slowdown of the social media age may be a less accurate guide to reality than in the past.

- The economy probably shrank in Q2, not helped by June's extra bank holiday. Post Q2, GDP should continue to grow, if modestly. For sure, our forecast that inflation will now peak at around 11% in the autumn and average 8.7% over the course of 2022 implies an even more intense squeeze on households' spending power. And that the Bank of England (BoE) is likely to continue raising interest rates will add to the burdens borrowers face. But the consumer sector still enjoys some potentially sizeable supports.

- One is the very healthy state of household balance sheets. In aggregate, consumers have still to tap the £180bn or so of unplanned savings built up during the pandemic, whilst the paying down of unsecured debt over 2020 and 2021 has created space to borrow to maintain spending in the face of rising prices. The job security provided by unemployment being at a near-50-year low and an imbalance between strong demand for workers, but constrained supply, should give consumers more confidence in saving less and borrowing more. Meanwhile, higher-income households are responsible for an outsized share of consumer spending, and that group is best able to deal with cost-of-living pressures. And the extra fiscal support announced by the Government in May will go a long way to protecting those on low incomes from surging energy bills.

- That the economy enjoys some tailwinds means the chances of a 'soft-landing' isn't implausible. But this is dependent on no more energy price shocks and the BoE and other central banks not overreacting to the current bout of inflation by tightening monetary policy excessively. The strong possibility of a Russian gas embargo means that the first assumption is very tentative. And that the BoE and central banks globally seem to be more concerned about inflation than growth risks undermining the second.

- We now think Bank Rate will rise to 2% by the end of this year. But a comparison of the forces driving inflation in the UK versus the US suggests that the BoE should tread more cautiously in tightening policy than the US Fed, which has taken a surprisingly aggressive approach to hiking rates. Evidence of excess demand, whether given by the performance of nominal GDP or wages, is much stronger stateside than in the UK. The case that a recession in the UK is inevitable or even 'necessary' to wring inflation out of the system is weak and certainly weaker than in the US.

- Meanwhile, hopes that business investment would enjoy a strong revival as the economy broke free of COVID-19 restrictions and companies took advantage of the super-deduction tax incentive are looking increasingly in vain. Spending by firms on fixed assets in Q1 2022 was still over 9% below the pre-pandemic level. In the same period, GDP was 0.7% higher. The continued underperformance of business investment is largely a story of services weakness.

- A turnaround looks unlikely in the short term, given subdued growth prospects, rising costs and the substantial increase in debt taken on by services sector firms, notably SMEs, during the pandemic. Our latest forecast suggests it will take until the start of 2025 for business investment to return to its pre-pandemic level on a sustained basis. Whilst current negativity towards the UK economy may be overdone, its long-term prospects remain under pressure from a weak outlook for investment.

1. Introduction

"It never rains, but it pours." A quick internet search shows that proverb was the creation of Jonathan Swift and Alexander Pope in the mid-18th century. But it's hard to think of a better description of the present-day situation confronting the UK (and global) economy. Having emerged from two years of COVID-19-related disruption, the economy is now suffering the consequences of a succession of shocks and associated high inflation, of a magnitude not seen since the 1970s. A run of weak monthly GDP outturns over the spring has offered some early, if not entirely unambiguous, signs that the activity is already sagging in response. And that poor performance likely presages a weaker outlook than the already-downgraded forecast for growth we presented in our last EY ITEM forecast report in the spring.[1]

Inflation is set to be higher for longer than we expected in April, reflecting elevated energy and commodity prices, persistent supply frictions exacerbated by regional COVID-19 lockdowns in China and still-strong global demand for goods. Just where the official inflation measure will peak is uncertain since (at the time of writing) the ONS has yet to rule on how government energy bill rebates to households, due in the autumn, will be treated in the inflation calculation. But it looks increasingly likely that the CPI measure will be in double-digits toward the end of this year. The BoE has raised interest rates an unprecedented five times in successive meetings since last November and will probably be compelled by inflation worries and surprisingly aggressive rate hikes by the US Federal Reserve into tightening more, and to a greater extent than we'd expected a few months ago. And consumer confidence has plunged to record lows.

Given all this, it's not surprising that the prospect of recession intrudes into the predictions of economic commentators and forecasters. That the economy probably shrank in Q2 would seem to reinforce concerns in that direction. But if activity does prove to have contracted in the second quarter, that will be largely a result of temporary factors related to the impact on health sector output from the end of free COVID-19 testing and the loss of output from June's extra Queen's Jubilee bank holiday. Although the risk of two consecutive quarters of declining GDP (that defines a technical recession) later this year and early 2023 is finely balanced, we still think this fate should be avoided.

Firstly, the supports for the consumer sector highlighted in recent EY ITEM Club forecast reports haven't gone away. We've yet to see households make any serious inroads into the 'excess' savings built up during the pandemic. However, a pick-up in credit card borrowing in recent months suggests a move to support spending by borrowing more in the face of rising inflation. Secondly, the jobs market is, so far, bearing up to economic headwinds with impressive resilience. Unemployment is at a near-50-year low, and job vacancies are at a record high. The job security that implies means consumers should have more confidence to reduce savings or borrow more to support consumption. And thirdly, the extra fiscal support announced by the Government in May offers low-income households meaningful protection against the cost-of-living crisis.

But whilst we think the economy should avoid a recession, we have downgraded forecast growth this year and next. GDP is now expected to rise 3.7% this year compared with 4.1% in May, with momentum coming into 2022 flattering this year's rate. Growth suffers a more serious downgrade in 2023, from 1.9% to 1%, as the effect of more prolonged high inflation bites.

Our latest forecast report begins with a discussion of recent economic developments. Section 3 sets out the key elements of our new forecast. Section 4 looks in more detail at what's driving high inflation. Section 5 considers prospects for what, so far, has been the poor relation of the recovery – business investment. Section 6 concludes.

2. The economy has lost momentum this year

GDP growth was sluggish over the spring, but COVID-19 distortions played a role

GDP recorded a decent start to the year, growing by 0.6% month on month (m/m) in January. But the economy's performance underwhelmed through the spring. February saw output flatline, and GDP grew only 0.1% in March. Although this left growth in Q1 at a reasonable 0.8% quarter on quarter (q/q), the quarter's expansion was almost entirely front-loaded into its first month. Q2 then began on a glum note, with GDP

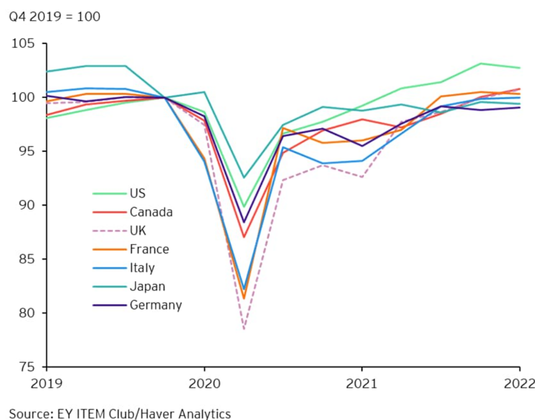
[1] EY ITEM Club, 'Spring 2022 forecast report', May 2022. https://assets.ey.com/content/dam/ey-sites/ey-com/en_uk/topics/growth/ey-item-club/ey-item-club-forecast-may-2022.pdf

contracting 0.2% in April. However, the economy put in a better-than-expected performance in May, expanding 0.5%.

Q1's performance revealed a continued unevenness in the economic recovery. Although GDP was 0.7% above the immediate pre-pandemic level in Q4 2019, consumer spending fell 0.4% short. Admittedly, investment saw a strong revival in Q1, although this was driven by growth in government investment and investment in dwellings, more than offsetting continued weakness in business investment. The picture for trade showed a serious imbalance – exports were almost 20% below the pre-pandemic level, but imports were 3.4% above. Some of this divergence reflected movements in volatile flows of non-monetary gold. At the same time, the ONS's introduction of a new system for collecting trade data means the latest numbers need to be interpreted with caution. On a more positive note, the UK has put in a stronger performance than most G7 economies. Among that group, the UK saw the joint-fastest rate of GDP growth in Q1, whilst the level of UK GDP relative to the pre-COVID-19 position was bettered only by the US and Canada.

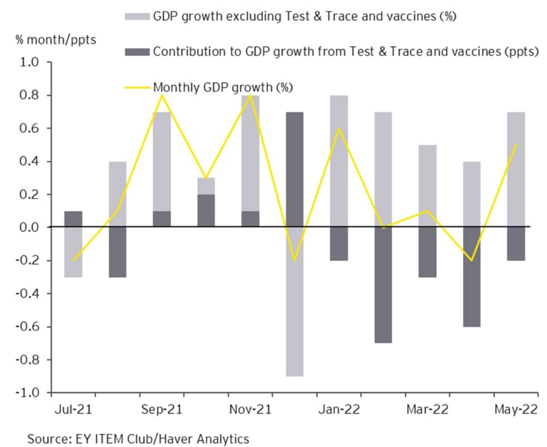
On the output side, a falloff in COVID-19 testing and vaccinations in the early part of this year, following the easing of the Omicron wave and the end of free tests for the general public in April, has been an important factor behind the economy's recent headline weakness. Excluding the drag from this source, GDP grew in each of the first five months of 2022. So, just as COVID-19-related spending exaggerated the scale of the recovery in 2021, it's had the opposite effect in the year to date.

G7: GDP



Source: EY ITEM Club/Haver Analytics

UK: GDP



Source: EY ITEM Club/Haver Analytics

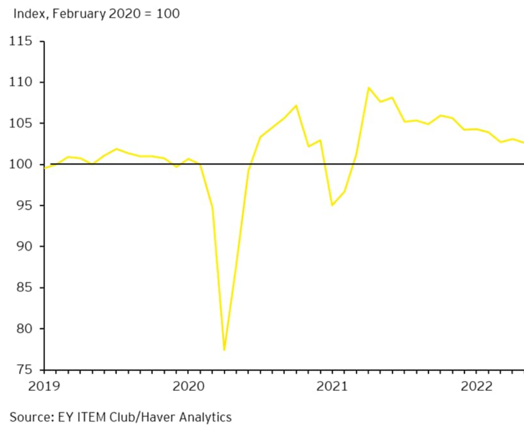
Overall, the economy appears to be slowing but confounding some of the gloom and doom that increasingly surrounds discourse on the subject. A slowdown has been particularly marked in services activity, with three-month-on-three-month (3m/3m) growth in May slowing to 0.1% from 1.3% in January. But growth in industry has held up better (0.5% versus 0.9%), whilst construction's expansion has accelerated, rising on a 3m/3m basis to 3% in May from 1.9% in January.

The cost-of-living crisis has certainly continued to mount in recent months. Ofgem's price cap on the typical household energy bill rose 54% in April to almost £2,000. The same month saw National Insurance Contribution (NICs) rates for employees rise by 1.25% (employers' NICS also increased by the same amount). And petrol prices have continued to climb to new record highs. The consequence was CPI inflation accelerating in each month of the year to date, reaching a 40-year high of 9.1% in May.

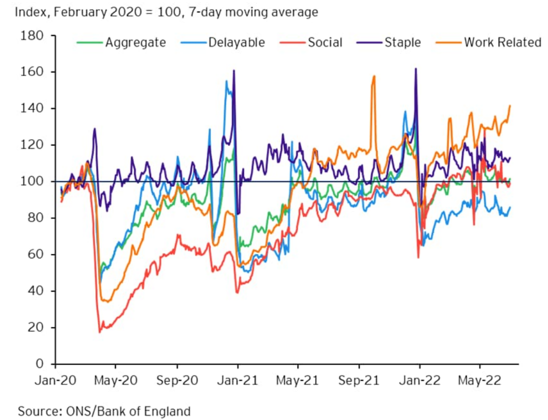
The impact has started to show up in the latest data. That GfK's measure of consumer confidence dropped to a record (post-1974) low in May before falling even further in June was one likely by-product of the squeeze on consumers' spending power from rising prices. And the official measure of retail spending has been weak. Sales volumes fell 0.5% m/m in May, the third fall in four months. A relatively sharp decline in sales of food and household goods in May suggests that the recent jump in food price inflation and cost-of-living pressures, in general, may be causing households to spend less in supermarkets and on discretionary items. And other retail evidence has been downbeat. The British Retail Consortium (BRC) measure of sales values fell 1.1% in May from a year earlier and then a further 0.1% in June.

Admittedly, measures of retail spending won't capture the post-pandemic shift in spending from goods to services, which means they might be overstating consumer weakness. And a conflicting signal was sent by data from Barclaycard, which covers a broader range of spending than the BRC. That reported a 9.3% y/y rise in purchases in May. A jump in the CHAPS measure of credit and debit card spending in late May also cut against the negative media narrative surrounding the consumer sector. However, spending, on this measure, has retreated more recently.

UK: Retail sales volumes



UK: Spending on credit and debit cards



Moreover, the CHAPS numbers are in cash, not real, terms (true also of Barclaycard and the BRC), which means they're flattered by high inflation. And that the CHAPS measure has shown spending on staples, such as food, recently rising faster than spending on social activities offers another clue that consumers may be holding back on discretionary purchases to support spending on essentials.

The household saving ratio in Q1 2022 was unchanged from the previous quarter's 6.8%, suggesting that households' willingness to save less to keep spending may have paused. However, it also implies that they still retain the firepower to spend more. And an increase in debt accumulation has offered support to consumption. Between February and May, individuals borrowed an additional £1.4bn per month on average via credit cards and personal loans, double that of the previous six months. There has been a particularly sharp rebound in credit card lending. Annual growth reached 11.6% in April, the highest since November 2005, before ticking down to a still-strong 11.2% in May.

Meanwhile, the PMI activity surveys have suggested that non-retail private sector activity is holding up better than feared. Although June's manufacturing PMI fell to a two-year low of 52.8, the same month's services index saw a surprise rise to 53.4. And whilst some indicators of business sentiment have weakened, they have so far remained more resilient than indicators of consumer confidence.

The jobs market remains very tight, although 'peak' tightness may have passed

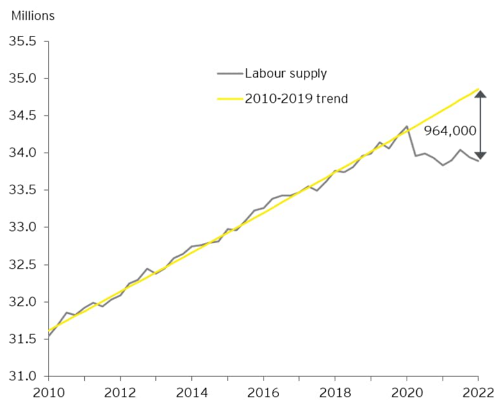
Over the last year or so, the story of the UK labour market has been one of increasing tightness. The latest data at the time of writing, covering the three months to April, was largely consistent with that story but with some caveats. The Labour Force Survey (LFS) jobless rate fell to 3.8% from 4% in the previous three-month period, although reweighting the LFS data meant that the recent history was slightly higher than before. A healthy 177,000 rise in employment helped push the jobless rate down. Job vacancies in the March-to-May period rose to a new record high and matched the number of unemployed, a development unprecedented before this year. And the redundancy rate fell to a record low of 2%, only a third of the long-run (post-1995) average.

Still, there were some tentative signs that labour market conditions had stabilised and maybe even started to loosen. The single-month LFS data showed a sharp rise in unemployment in April. However, the series has been particularly volatile in recent months, and it's unclear whether April's higher outturn or March's much lower one is the aberration. Growth in the stock of vacancies slowed, from 5.4% in the three months to February to 1.6% in the three months to May. And there was a chunky drop in inactivity in the three months to April, although labour supply was still significantly short of pre-pandemic levels. This contributed to an employment rate of 75.6% being still 0.9ppts lower than just before the pandemic began. A shortfall in the

workforce is particularly evident when comparing the actual outturn with the counter-factual of a continuation of the pre-pandemic trend. On that basis, the number of people in work, or actively looking for work, in Q1 was almost 1m, or 3%, lower, driven by a rise in the number of people taking early retirement or claiming long-term sickness.

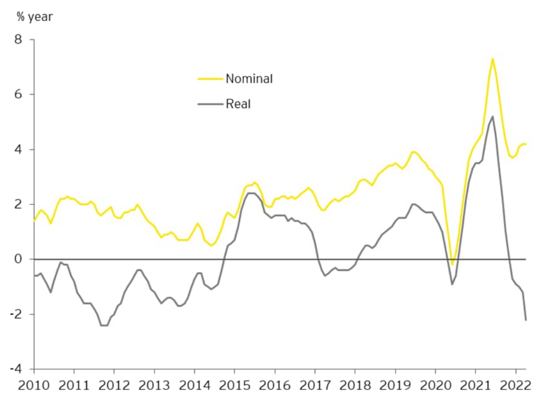
Just how much a tight jobs market is pushing pay up is still not fully clear. Headline (a three-month average of the annual rate) pay growth ran at a strong 6.8% in April (slightly down from 7% in Q1). However, rapid growth in the volatile bonus component was a big driver – headline regular pay rose by a much less heated 4.2%, falling well short of inflation of 7.4% over the same period if a little above the pre-COVID-19 norm. The extent of the decline in real regular pay is far from indicative of a sustainable wage-price spiral developing. However, the risk that higher bonuses will start to be factored in as a permanent feature by workers means the regular pay picture may be misleadingly sanguine.

UK: Labour supply



Source: EY ITEM Club/ Haver Analytics

UK: Headline average weekly earnings - regular pay



Source: EY ITEM Club/Haver Analytics

Interest rates have risen further, and the MPC has left the door open to future hikes

The BoE’s Monetary Policy Committee (MPC) has continued to raise interest rates in the face of rising inflation and a hawkish shift from other central banks. The latest hike was in June when the committee voted 6–3 to raise Bank Rate by 25bps to 1.25%. The vote breakdown repeated the dissent seen in May’s meeting, with a minority of members supporting a more aggressive, 50bps rise.

Information about the MPC's views on the likely path of interest rates over the coming year was sparse in June’s policy statement. This was in marked contrast to the approach taken by the US Fed, which has committed to raising borrowing costs until it sees compelling evidence that inflation is coming down.

What little information there was gave few reasons to think that the BoE will deviate from the prevailing mood among global central banks, dominated by concerns about high inflation and less weight being placed on evidence of slowing activity. The MPC suggested that CPI inflation was now likely to rise to above 11% in October, around 1ppt higher than its May forecast, following the indication from Ofgem’s Chief Executive that the energy price cap could increase by 40% in October.[2] The committee argued that the labour market remained very tight and continued to express concern about the potential for wage growth to take off.

On the growth side, whilst BoE staff expected the economy to contract in Q2, having previously forecast a small rise in GDP, the MPC suggested that the composition of the government's recent fiscal package (see below) could offer a bigger boost to growth than standard modelling implied. The introduction of a vow to "act forcefully" in response to "indications of more persistent inflationary pressures" reinforced the impression that the MPC's focus remains firmly on inflation.

The most surprising feature of the minutes was the lack of comment on market expectations. In May's MPR, the MPC had said that if Bank Rate followed market pricing, it would cause both a recession and inflation to

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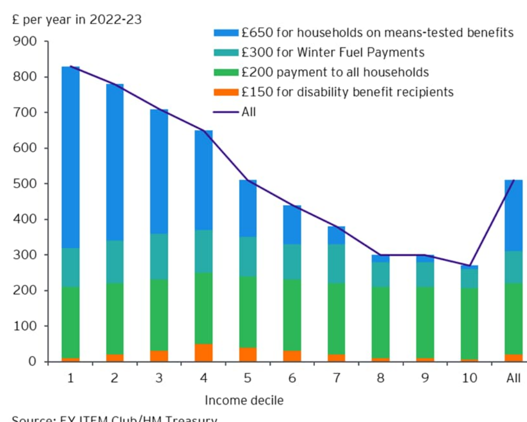
[2] Business, Energy and Industrial Strategy Committee, ‘Oral evidence: Energy pricing and the future of the energy market’, 24 May 2022. https://committees.parliament.uk/oralevidence/10331/pdf/

undershoot the target comfortably.[3] Since then, market pricing has firmed. Before June's meeting, financial markets expected Bank Rate to reach around 2.75% by year-end, up more than 50bps on the market-implied path used in May's MPR.

Extra fiscal support will mitigate the pain of higher energy bills

Pressure had ratcheted up on the Government over the spring to give more fiscal support to households suffering from surging energy bills and inflation at a multi-decade high. The package announced on 26 May amounted to £15bn, or 0.6% of GDP, and consisted of a mix of targeted and universal support.[4] Eight million households on means-tested benefits will have £650 paid straight to their bank accounts in two instalments, in July and the autumn, with a further £150 top-up for the disabled. Pensioner households will receive £300, and all households will receive a £400 discount on their energy bills in October, double the previous amount. Moreover, the original rebate will no longer have to be repaid in future years (which effectively saves households £5bn over the five years from 2023–24, relative to previous plans). About £5bn, or a third, of the package's cost, will come from the proceeds of a temporary 25% energy profits levy on oil and gas companies.

UK: Impact of May's fiscal measures



Source: EY ITEM Club/HM Treasury

The new support builds on measures announced in February and March's Spring Statement and should, all else equal, deliver a small boost to GDP. Whether the windfall tax on energy firms will hurt investment is uncertain, although a new 80% investment allowance should mitigate any damage. As for implications for inflation, the ONS hasn't clarified yet whether it will incorporate the effect of the bill's rebate into the CPI calculation. There's some reason to think it won't – that the rebate is no longer repayable makes it akin to the council tax rebate announced in February, which has not impacted the relevant inflation indices. Any indirect inflationary effects should be modest. Most of the extra cash is targeted at low-income households, which suggests it will be spent largely on more expensive energy, not discretionary purchases, and so not present a positive impulse to the latter.

The cost of the extra help to households will add to public sector borrowing that, so far, this fiscal year, has been running ahead of the OBR's expectations, if declining relative to a year ago. A deficit over March and April of £35.9bn was £6.4bn lower than the same period in 2021–22 but £6.4bn higher than the OBR's most recent projection in March. The weakness of GDP over the spring may have played a role in the overshoot, hurting tax receipts, whilst a jump in debt interest payments on index-linked gilts, as RPI inflation has continued to accelerate, has pushed up government spending by more than the OBR expected.

3. The outlook for growth has deteriorated

The EY ITEM Club now anticipates a weaker GDP growth rate this year and next compared with our spring forecast. In the near term, a poor launchpad for growth in Q2, April's fall in output, a drop in COVID-19 testing, plus the distortionary effect of the additional bank holiday for the Queen's Platinum Jubilee make it very likely that the economy suffered a contraction, albeit small, in the second quarter. With Q3 having a full quota of working days, activity should rebound, meaning the chances of a second successive quarterly decline in GDP – the traditional definition of a technical recession – look low.

But the growth outlook has deteriorated. An already serious squeeze on households' spending power is likely to intensify. Another big rise in the energy price cap now looks likely in October. Gas prices have recently jumped from already high levels, continued COVID-19 lockdowns in China are impairing the supply of components for manufacturers, and a weak pound is pushing up import prices (if delivering a boost to the

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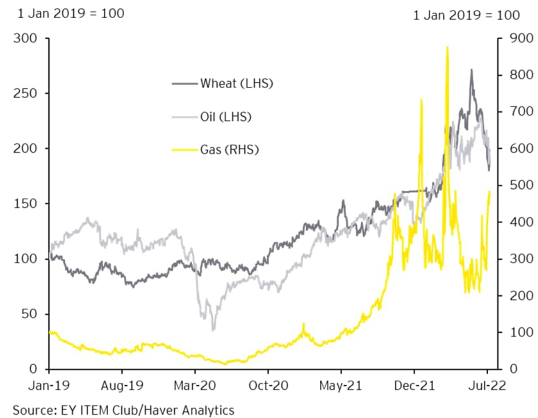
[3] Bank of England, 'Monetary Policy Report– May 2022', 5 May 2022. https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy-report/2022/may/monetary-policy-report-may-2022.pdf

[4] 'Cost of Living Support', Statement by the Chancellor of the Exchequer on Cost of Living Support. 26 May 2022. https://www.gov.uk/government/speeches/cost-of-living-support

tradable sector). Interest rates are likely to continue rising. And an environment of continued economic uncertainty, squeezed margins and rising prices for capital goods is far from conducive to a rebound in business investment (the outlook for business investment is explored in Section 5).

Facing these headwinds is a recent decline in some commodity prices, low unemployment and still-strong demand for workers. Household balance sheets are very healthy, with, on some measures, the £180bn, or 8% of GDP, of excess savings built up during the pandemic still available to be spent, house prices (by far the most important element of non-pension household wealth) have continued to rise rapidly. The Government announced extra fiscal support in May. Moreover, there seems a good chance that, following Boris Johnson's resignation as Prime Minister in July, whoever becomes the new Conservative Party leader and PM will cut taxes.

Commodity prices



Source: EY ITEM Club/Haver Analytics

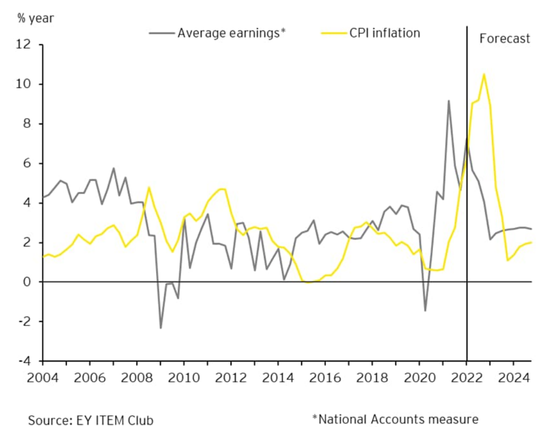
Overall, we have cut forecast GDP growth to 3.7% this year from 4.1% previously, with 2023 seeing a bigger downgrade to 1% from 1.9%. As cost-of-living pressures ease, the economy is expected to make up some lost ground in 2024, expanding 2.4% (2.2% previously). But the props supporting activity mean we do not expect the economy to shrink on a quarter-on-quarter (q/q) basis, bar Q2 of this year.

Several factors should mitigate the hit to consumption from higher-for-longer inflation

With inflation likely to rise to around 11% in the autumn and forecast to average 8.7% this year, the squeeze on households' spending power will be even sharper than we were anticipating in the spring. A higher peak for inflation reflects the recent jump in wholesale gas prices partly. This points to the energy price cap rising a further 50% to 60% in October to over £3,000, a much larger rise than we had previously anticipated.[5] And the recent surge in petrol prices, caused by a sharp rise in refining margins, and the weakness of sterling, particularly against the US dollar, pushing up import prices, will add fuel to the inflationary fire.

We think average earnings will rise by around 5.5% this year, so 2022 remains on course to see the biggest fall in average real pay since the late 1970s. All else equal, this implies a gloomier prognosis for consumer spending. Indeed, we have cut forecast growth in the economy's dominant driver to 4.1% this year and 0.9% in 2023 from 4.9% and 1.5% previously. However, three mitigating factors should give the consumer sector and wider economy a fighting chance of avoiding recession.

UK: Average earnings and inflation



Source: EY ITEM Club
*National Accounts measure

The first is our assumption that households will be willing to save less and borrow more. The household saving ratio remained at 6.8% in Q1 2022, unchanged from the previous quarter. That this ratio was much lower in the run-up to the pandemic (averaging 4.9% over 2017–19) suggests there's room for further dissaving before households save at 'normal' levels.

We expect the revival in households' appetite for unsecured debt, particularly credit card borrowing, since the start of the year to continue, aided by a healthy starting point among consumers for taking on new debt. The ratio of outstanding consumer credit to annualised household income stood at just over 13% in Q1 2022, the lowest share in 25 years. In cash terms, the stock of consumer credit in May 2022 was still £23bn below

[5] Dr Craig Lowrey, 'Default Tariff Cap forecast climbs further as Ofgem announcement looms', Cornwall Insight, 8 July 2022. https://www.cornwall-insight.com/default-tariff-cap-forecast-climbs-further-as-ofgem-announcement-looms/

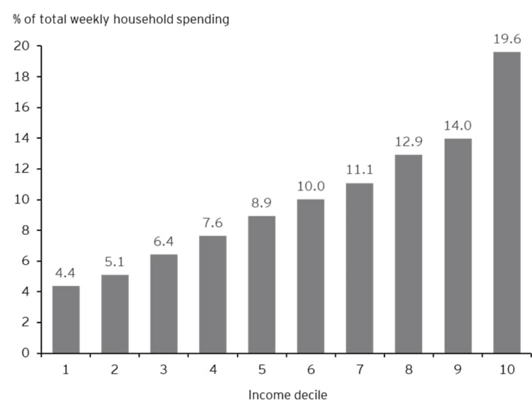
the level in February 2020. Moreover, the ratio of total household interest payments to income (3.3%) was at the joint lowest since records began in 1987.

The ongoing imbalance between the demand and supply of workers should support dissaving. Faced with a shortage of workers, firms are likely to remain reluctant to make redundancies. For sure, our forecast sees unemployment rising. But the jobless rate is seen peaking at a still-historically low 4.5% at the end of this year, a very soft-landing for the labour market by the standards of past slowdowns. This will support job security and mean consumers have more confidence in saving less to support consumption. Admittedly, measures of consumer sentiment currently sit at very depressed levels presenting the risk of consumers hunkering down, even against the backdrop of strong balance sheets and high levels of job security. But the potential for social media 'doomscrolling' to divorce sentiment from reality means consumer confidence gauges may not be providing as good a guide to real-world economic behaviour as in the past.

Second, as we've noted in recent EY ITEM Club reports, low-income households are most exposed to the rising price of food, energy and other essentials since they spend a larger share of their budgets on these items than better-off groups. At the same time, they lack the scope to absorb cost-of-living pressures offered by savings and other forms of household wealth, which are held primarily by the better-off.

But from a macroeconomic perspective, richer households play an outsized role in driving consumer spending, a fact which should help insulate the consumer sector from the cost-of-living crisis. Here, we can apply the terminology of the Harvard Business School professors John Quelch and Katherine Jocz, who examined how different consumer types respond to economic downturns.[6] Using ONS family spending survey data, in 2019–20, households in the top three income deciles accounted for almost half of total weekly household expenditure. These deciles encompass Quelch and Jocz's 'comfortably well-off' and 'pained but patient' households, whose confidence in their financial position and job security means they can broadly carry on spending as normal, at least if a serious rise in unemployment is avoided and asset prices don't crash.

UK: Spending by household income group



Quelch and Jocz describe those most vulnerable and financially hardest hit by downturns as the 'slam on the brakes' group. These lower-income consumers respond to economic troubles by reducing spending across the board, cutting out, postponing or substituting purchases. The nature of the current cost-of-living crisis makes this group's sharp curtailment of discretionary spending a risk. But if the slam on the brakes segment is defined as households in the bottom three income deciles, it's responsible for only 16% of total weekly household spending. Inequality of income and consumption is not lacking in economic costs, but in the context of the headwinds confronting the economy at present, it could bolster consumer spending.

The third factor which offers some protection to the consumer sector is the targeted nature of the extra fiscal support announced in May. Adding that package to previous rounds of fiscal aid in February and March, the effect will be to offset 93% of the rise in household energy costs for households in the bottom three income deciles in 2022–23, compared with 82% for the average household (this assumes the energy price cap rises a further 40% in October).[7] In the BoE's estimation, GDP growth should be around 0.3ppt higher this year due to May's measures alone.[8] With the support targeted at those with the highest marginal propensity to consume, we think the effect could be a bit bigger, particularly when the conversion of the previous bill rebate/loan to an outright grant is factored in.

[6] John Quelch and Katherine E. Jocz, 'How to Market in a Downturn', Harvard Business Review, April 2009. https://hbr.org/2009/04/how-to-market-in-a-downturn-2

[7] Torsten Bell et al., 'Back on target: Analysis of the Government's additional cost of living support', Resolution Foundation, 27 May 2022. https://www.resolutionfoundation.org/app/uploads/2022/05/Back-on-target.pdf

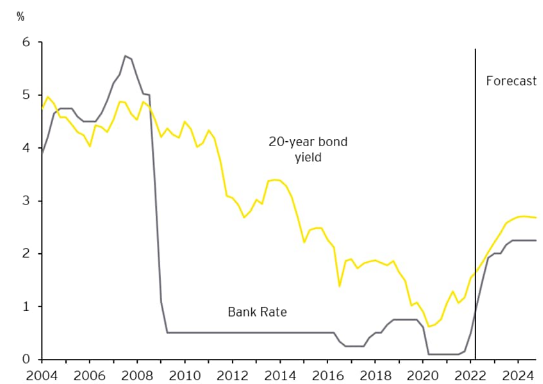
[8] Bank of England, 'Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 15 June 2022', 16 June 2022. https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy-summary-and-minutes/2022/monetary-policy-summary-and-minutes-june-2022.pdf

These factors are unlikely to completely offset the deadening effect of falling real wages on consumption. But they do suggest that the outlook for consumer spending isn't quite as bad as very depressed sentiment and general media angst imply. The key thing will be the jobs market. That unemployment is currently sitting at a near-50-year low, and labour demand, as evidenced by record high job vacancies and record low redundancies, is so strong means there's room for the labour market conditions to deteriorate without pushing joblessness up to the kind of levels associated with past slowdowns in the economy. We think a weaker economy will ultimately leave its mark on employment. But our forecast peak for the jobless rate would still be historically low, aided by the post-financial crisis tendency of the labour market to adjust to weaker demand via prices (i.e. falling real pay), rather than quantities (i.e. rising unemployment).

The BoE will continue to walk a fine line in raising interest rates further

With Bank Rate rising to 1.25% in June's MPC meeting, our expectation in the spring that the policy rate would end 2022 at that level is now looking too dovish. We now think that Bank Rate will increase to 2% by the end of this year, implying three further hikes in 2022. But this is still some way short of market rate expectations, which, at the time of writing, saw rates rising to almost 2.75% by the close of this year.

UK: Bank Rate and 20-year bond yield



Source: EY ITEM Club

The situation confronting the MPC is undoubtedly difficult, with the economy experiencing surging, supply-driven inflation at the same time as demand is weakening. On balance, we think inflation concerns will dominate in the immediate term, and a majority will vote for a 25bps rise in Bank Rate in forthcoming meetings in August, September and November. That the committee increased rates in May and June, despite forecasting two quarters of negative growth over the next year suggests it may not be swayed much by evidence of the economy carrying less momentum. And recent soundings by at least one committee member have highlighted that UK monetary policy may have to be tightened more aggressively to prevent a further, inflationary, fall in the value of the pound against the US dollar.[9]

However, others on the MPC have pushed against this exchange rate argument.[10] And we think uncertainty surrounding the outlook will encourage a more cautious approach than market pricing suggests. One source of that uncertainty is over how much further inflation will climb. The MPC's latest projection is that inflation will peak at around 11% in the autumn. However, if the ONS chooses to incorporate the impact of the energy bills rebate into its calculation of the CPI measure, the committee will probably have to lower that prediction.

A second uncertainty is how fast inflation will fall back. On that front, recent developments have been mixed. The price of Brent Crude rose above $120 per barrel in early June in response to the EU's announcement that it would partially ban oil imports from Russia. But it has since fallen back. And there has been some tentative good news. May's BoE Decision Makers Panel survey of UK firms showed price expectations among firms stabilising.[11] Stability has also been evident in sterling's trade-weighted value in the past few weeks, following a period of depreciation earlier this year. And recent inflation data showed some price pressures which emerged during the pandemic retreating, notably those stemming from a surge in used car prices. In March, a sector representing just 2.5% of the inflation basket accounted for 0.8ppts of that month's 7% inflation rate. But used car prices fell a record 3.1% m/m in April, and a further 1.8% in May so that a corner may have been turned.

[9] 'UK monetary policy in the context of global spillovers', speech by Catherine L. Mann, Market News International Connect event, 20 June 2022. https://www.bankofengland.co.uk/speech/2022/june/catherine-l-mann-speech-at-a-market-news-international-connect-event

[10] David Milliken and Andy Bruce, 'BoE's Pill says rate rises are a blunt tool, cannot fine-tune sterling', Reuters, 21 June 2022. https://www.reuters.com/markets/rates-bonds/boes-pill-says-he-sees-further-rate-rises-ahead-2022-06-21/

[11] Bank of England, 'Monthly Decision Maker Panel data– May 2022', 1 June 2022. https://www.bankofengland.co.uk/decision-maker-panel/2022/may-2022

Whether labour force participation will recover is a third uncertainty and one which is proving a policy headache for the MPC, as several members have stressed.[12] According to BoE Governor Andrew Bailey, the outlook for participation is particularly difficult to judge because a significant share of those who have become inactive report that they are long-term sick, possibly due to "Long COVID". We remain relatively optimistic, expecting that participation will gradually recover as falling real household incomes compel some people to re-enter the workforce and the numbers with Long COVID fall now vaccination rates and the number protected by previous infections are high. Immigration could also rebound, too, now that all pandemic-related barriers have been removed, the number of businesses with sponsor licences has surged over the last year, and more jobs now meet minimum salary thresholds as wages have risen. If we're right, slack should emerge in the labour market, reducing the risk of a wage-price spiral.

As for the economic impact of higher rates, with the majority of mortgagors having fixed-rate deals of two years or more, the effect will feed through slowly.[13] Hence, our new rate call has only a negligible effect on forecast growth this year, with the consequences of higher borrowing costs more marked in 2023.

The EY ITEM Club forecast for the UK economy, Summer 2022

% changes on previous year except borrowing, current account and interest and exchange rates

	GDP	Domestic demand	Consumer spending	Fixed investment	Exports	Imports
2019	1.7	1.6	1.3	0.5	3.4	2.9
2020	-9.3	-10.1	-10.6	-9.5	-13.0	-15.8
2021	7.4	8.5	6.2	5.9	-1.3	3.8
2022	3.7	5.6	4.1	5.3	6.4	13.1
2023	1.0	-0.5	0.8	2.7	7.5	1.8
2024	2.4	2.4	2.9	1.3	2.6	2.6
2025	2.1	2.1	2.2	2.6	2.1	2.2
	Net Govt Borrowing *	**Current account (% of GDP)**	**Average earnings**	**CPI**	**Bank Rate**	**Effective exchange rate**
2019	2.4	-2.7	3.4	1.8	0.8	78.2
2020	14.4	-2.5	1.7	0.9	0.2	78.1
2021	6.0	-2.6	5.9	2.6	0.1	81.5
2022	3.9	-5.4	5.5	8.7	1.2	80.7
2023	1.9	-2.8	2.5	4.2	2.1	80.5
2024	1.3	-2.3	2.7	1.5	2.3	80.4
2025	1.2	-2.2	2.9	2.0	2.3	80.4

* Fiscal years, as % of GDP

Source: EY ITEM Club

Risk of central bank policy mistakes are rising

The ongoing war in Ukraine and continued uncertainty over how and when the conflict will be resolved remain among the chief risks confronting the UK economy. If Russia were to follow recent restrictions on gas flows to some European countries with a full-blown embargo, energy prices and inflation even rise even higher, making recession almost certain. Conversely, an unexpectedly rapid end to the war could trigger a sharp fall in the price of oil, gas and other commodities, boosting consumer spirits and resulting in a faster run-down of household savings and a stronger rate of economic growth.

The unexpected speed at which the BoE and some other central banks have tightened monetary policy over the last few months has brought the risk of going too far, too fast, to the fore. Excessive tightening would unduly squeeze real incomes and could trigger a crash in property and financial markets. Central banks have history here. Research co-authored by former US Fed Chairman Ben Bernanke concluded that a substantial part of the economic damage from spikes in oil prices in the 1970s came not from the change in oil price, but

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[12] House of Commons Treasury Committee, 'Oral evidence: Bank of England Monetary Policy Reports', 16 May 2022. https://committees.parliament.uk/oralevidence/10215/pdf/

[13] For analysis of the effect of rising interest rates on the housing market, see EY ITEM Club, 'Special report on the housing market', June 2022. https://www.ey.com/en_uk/growth/why-uk-house-price-rises-are-continuing-despite-economic-challenges

a subsequent excessive tightening in monetary policy.[14] More recent events reinforce this point. A rapid tightening of monetary policy globally in response to the run-up in oil prices over 2007 and 2008 arguably contributed to the severity of the global recession in 2009.

A third risk relates to a resurgence of the COVID-19 pandemic. As infections have recently risen sharply in the UK and elsewhere, this risk is far from theoretical. The outcome could be renewed restrictions and impaired mobility, hitting demand. Meanwhile, disruption to domestic and global supply chains and the likely continuation of China's "dynamic zero-COVID" policy would prolong supply chain frictions and push prices up.

Finally, our forecast for consumer spending relies heavily on households' appetite to save less and borrow more. Just how long the cost-of-living crisis is expected to persist will bear on this prediction materialising. We have assumed that consumers, in general, will perceive falling real incomes to be a temporary phenomenon. But if people fear a sustained squeeze on their spending power, they may reduce spending permanently. On the other hand, if inflationary pressures recede more quickly than we expect, the appetite to dissave could prove greater than we anticipate.

4. Drivers of UK inflation should encourage MPC caution

CPI inflation reached 9.1% in May, the highest level since March 1982. And a rate over 10% in the autumn is looking increasingly likely. What's driving inflation up has important bearings for both how persistent high inflation might prove and the appropriate policy response. If inflation is primarily an imported problem, reflecting high energy and other commodity prices, it should eventually fall back as the one-off shock to the price level washes out of the inflation calculation. In this world, responding to high inflation by raising interest rates will do little directly to tackle the problem and risks pushing the economy into recession. The case for policy measures aimed at offsetting upward pressure on prices, such as a cut in VAT, would also be stronger.

Conversely, if inflation is more a consequence of excess demand, it risks becoming engrained in the economy via a classic wage-price spiral. In this case, a tighter monetary policy to cut demand is an appropriate response. And efforts to support spending via tax cuts could prove self-defeating, pumping up demand and price rises further.

That UK inflation is now more than just an energy price issue is clear. For example, according to Bank of England estimates, the inflation rates of around 90% of the 85 class level categories by weight in the CPI basket were above their pre-pandemic averages in May, up from around half in the summer of 2021.

On the other hand, core inflation, which strips out the volatile fuel and food components, stood at 5.9% in May, significantly lower than the headline rate and revealing the effect of those volatile categories in pushing up overall prices. The core measure was still elevated by recent standards – May's rate hadn't been exceeded since 1992 – but was down from 6.2% in April, the first decline since October 2021.

The gap between headline and core inflation in May, the largest since the core measure series began in 1989, is one indication that the UK economy is suffering significantly from imported inflation. The performance of nominal GDP points in the same direction. Nominal GDP is the cash value of goods and services produced in the economy, so equivalent to aggregate demand. As of Q1 2022, total UK-economy demand was almost exactly in line with the level implied by the pre-COVID-19 trend (taken as average year-on-year nominal GDP growth from Q1 2010 to Q4 2019 of 3.8%).

This contrasts with the US, where the economy in Q1 was operating around 3% in excess of its supply potential, measuring the latter using a continuation of US pre-pandemic trend growth (4% y/y from 2010-19). On this measure, excess demand is of limited blame for rising inflation in the UK, implying the fault lies more with global supply shocks. The opposite conclusion holds in the US, where headline inflation reached 8.6% in May, and fiscal policy has continued to deliver a powerful impetus to growth. As a net energy exporter, higher energy prices have been a positive for headline US GDP.

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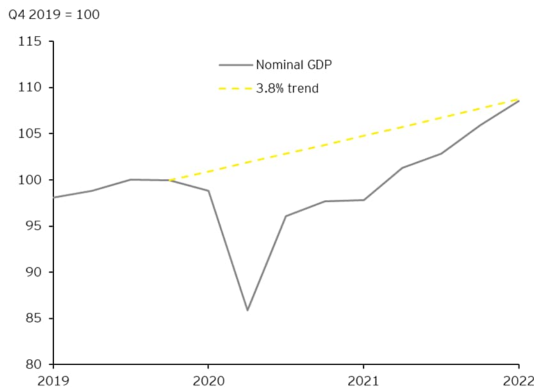
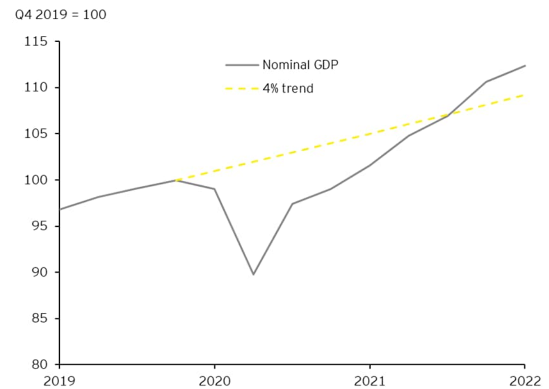
[14] Ben S. Bernanke, Mark Gertler and Mark Watson, 1997, 'Systematic Monetary Policy and the Effects of Oil Price Shocks', Brookings Papers on Economic Activity, Economic Studies Program, The Brookings Institution, vol. 28(1), pages 91-157. https://www.brookings.edu/wp-content/uploads/1997/01/1997a_bpea_bernanke_gertler_watson_sims_friedman.pdf

UK: Nominal GDP



Source: EY ITEM Club/Haver Analytics

US: Nominal GDP



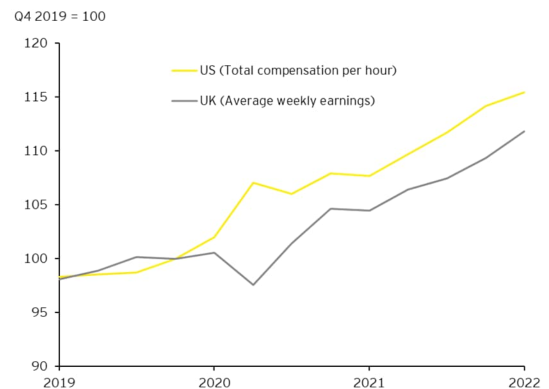
Source: EY ITEM Club/Haver Analytics

Granted, one could argue that the pandemic's repercussions have cut trend growth, so a simple comparison of the pre-pandemic norm with the actual path of GDP gives a false picture. But the success of government measures to support the economy in keeping unemployment and business insolvencies low suggests that COVID-19-related scarring should be small.

Another objection relates to developments in labour supply. The number of people in work or looking for work has shrunk, relative to the pre-COVID-19 trend, to an even greater degree in the UK than in the US, potentially holding back the economy's capacity to produce goods and services. But this has been mitigated by stronger growth in output per worker (which may continue, given the impetus to digitisation and more effective working practices delivered by the pandemic). And as discussed earlier, there are good reasons to expect inactivity to fall back. In any case, it's not clear that fewer people in work is necessarily inflationary. A fall in the number of wage-earners means lower spending in the economy, which should lead firms to reduce labour demand.

Moreover, that wages in the US have also risen more strongly than in the UK offers another indication that demand-side factors have played less of a role in the UK in pushing up inflation. As of Q1 2022, average wages in the US were 15% above their level in Q4 2019, versus a rise of 12% in the UK.

Nominal wages



Source: EY ITEM Club/Haver Analytics

Against this backdrop, it's unsurprising that the BoE has pursued a more cautious approach to raising interest rates than the US Fed. Although the BoE was the first major central bank to start hiking rates last November, the magnitude of the move since then, from 0.1% to 1.25%, has been smaller than in the US, where the official policy rate has risen from a range of 0% to 0.25% to 1.5% to 1.75%. Moreover, the Fed's June decision raised rates by 0.75ppt in one move, the largest rise since 1994. It's presently hard to see the BoE pursuing such an aggressive hike.

The weaker aggregate demand picture in the UK should caution the BoE from feeling compelled to play 'catch-up' with its US peer. The case that a recession in the UK is inevitable or even 'necessary' to wring inflation out of the system is weak and certainly weaker than in the US.

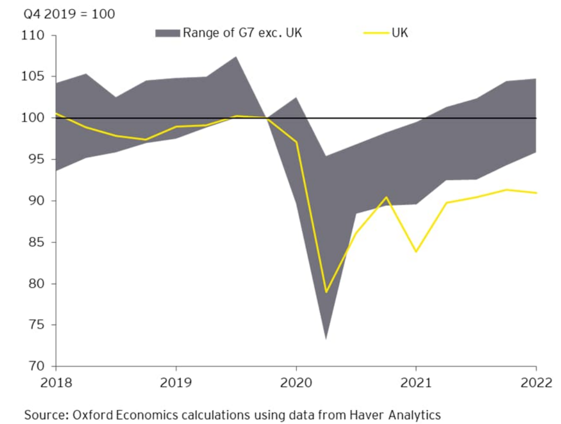
There is a risk that the MPC could be distracted from this point. As mentioned in Section 3, some MPC members have argued that the risk of importing more inflation via a weaker exchange rate means more weight should be placed on the actions of the Fed in setting UK monetary policy. The implication is that aggressive hikes stateside would be followed suit at home. But combined with the likelihood that high commodity prices will ultimately prove disinflationary by depressing demand, that would threaten the risk of 'too far, too fast' and increase the odds of the economy falling into recession.

5. Business investment's struggles are likely to continue

The underperformance of business investment during and after the COVID-19 pandemic is nothing new – between the Brexit referendum in the summer of 2016 and the start of the pandemic, spending by firms on fixed assets like machinery, vehicles and intellectual property flatlined. But the extent of the underperformance over the past two years or so has been striking. In Q1 2022, business investment was still 9.2% below the pre-pandemic level in Q4 2019.

This left the UK as a clear outlier among the G7 economies – the next worst performer, Canada, reported a business investment shortfall of 4% in Q1. At the same time, capital spending had rebounded above pre-pandemic levels for three G7 members, the US, Italy and France.

G7: Business investment

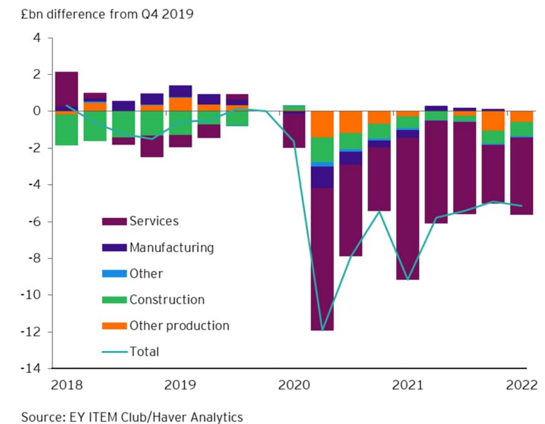


Source: Oxford Economics calculations using data from Haver Analytics

The sectoral breakdown suggests the shortfall is almost entirely a story of services sector weakness. Services sector investment (which, pre-COVID-19, typically accounted for around two-thirds of total business investment, a little below the sector's weight in GDP) was still £4.2bn, or 11.7%, below its pre-pandemic level in Q1. The weakness was relatively broad-based, with all major sub-sectors, except distribution, lagging the position in the last quarter of 2019. But several sectors stand out as underperformers. Accommodation, food, and other services (including art and recreation) reported shortfalls of more than 35%, likely to reflect the damage to activity in social consumption sectors during periods of pandemic-related restrictions.

The other sub-sector in which investment remains well below pre-pandemic levels is transport (-47%). This likely reflects a plunge in demand for aircraft in response to the collapse of tourism during the pandemic and a lack of availability of vehicles for purchase because of the global shortage of semiconductors. This idea is corroborated by the breakdown of investment by asset, which shows transport equipment accounts for around a quarter of the shortfall in total business investment relative to pre-pandemic levels. In contrast, investment in ICT and other machinery has rebounded above its Q4 2019 level. This coincides with the introduction of the 'super-deduction' tax incentive, which offers enhanced capital allowances on qualifying plant and machinery investments.

UK: Business investment



Source: EY ITEM Club/Haver Analytics

Sectoral trends are unlikely to change much in the short term

The super-deduction should support investment in plant and machinery over the rest of this year and early 2023, encouraging firms to bring forward capital spending plans. Furthermore, internal funding for investment appears plentiful. Since the pandemic hit, private non-financial corporations have accumulated substantial excess cash deposits – £124bn (5.4% of GDP) above the level had the 2018-19 trend continued.

But the super-deduction has a relatively narrow focus, so only a portion of firms' excess savings are likely to flow into investment due to the tax break. Moreover, at the time of writing, the scheme had just nine more months to run and was organised so that the plant and machinery not only needed to be ordered but also delivered to qualify. Factoring in lead times, which in many cases will be longer than normal because of supply chain disruptions, there's little time left for firms to place their orders. So, whilst the super-deduction appears to have been effective in spurring investment in its field over the past year, it will not be the silver bullet that powers a wider recovery. That a new Chancellor might extend the tax break or even make it permanent is a possibility, which presents some upside risk to our investment forecast.

Prospects for a recovery in investment in transport equipment are mixed. The global resurgence in tourism, following a hopefully permanent relaxation of COVID-19 travel restrictions in many countries, should boost investment in aircraft; although staff shortages in the aviation sector mean recovery there won't be plain-

sailing. However, lockdowns in China and Russia's invasion of Ukraine have brought new disruption to supply chains, which is likely to last into 2023. So, supply shortages are likely to remain a constraint on investment in new vehicles.

Meanwhile, relatively little of the investment made by firms in the services sector is likely to qualify for the super-deduction. And although activity has rebounded strongly in most sub-sectors since COVID-19 restrictions were lifted – suggesting scope for investment to recover – two factors temper that good news. First, consumer-facing parts of the services sector face a tough year. A squeeze on household spending power is likely to trigger a sharp decrease in consumer spending, with discretionary purchases being particularly badly hit. Even outside these sectors, weak economic growth will make firms hesitant about committing to long-term capital projects. Second, many firms have had to contend with a hefty increase in input costs following sharp rises in oil and gas prices and inflation in capital goods. On the other hand, labour shortages could encourage some firms to substitute capital for labour, presenting one upside.

A rise in corporate debt repayments may also weigh on investment

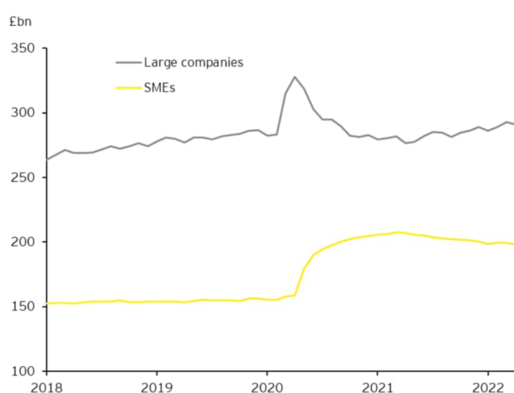
Another area where firms face higher costs is in servicing debt. Three-quarters of corporate bank debt has a floating interest rate, so recent rises in Bank Rate have quickly passed through to firms. BoE data suggest the weighted average interest rate on loans to non-financial companies has risen by more than 70bps since the start of last year. With Bank Rate forecast to rise by another 75bps this year, corporate borrowing costs are set to increase further.

In some respects, SMEs are relatively vulnerable to the impact of higher interest rates. As of April 2022, SMEs' stock of outstanding bank loans was 27% higher than immediately before the pandemic. This reflects the expansion of state support to businesses during the pandemic and that smaller businesses were most likely to operate in sectors affected by the pandemic.

On the positive side, large firms saw only a very small rise in their debt burden (up by less than 3%). And the government's Bounce Back Loan Scheme, which accounts for the bulk of extra debt taken on by SMEs, has a fixed interest rate of 2.5% so that it will be unaffected by changes in Bank Rate. Nonetheless, with firms overall bearing an additional £51bn of bank debt on their balance sheets compared with the start of 2020, the result may be cutbacks in investment, particularly at a time when the economy is subject to external shocks.

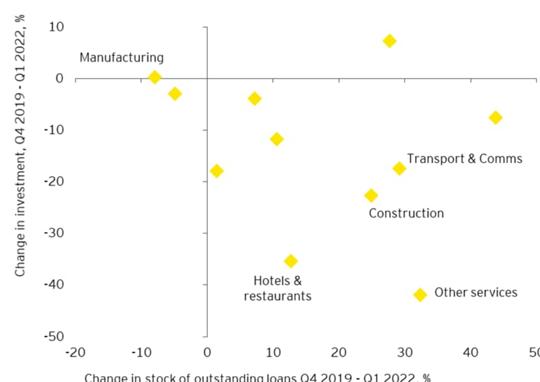
Drilling down to a sectoral level, those that have tended to suffer the biggest shortfall in investment relative to the pre-pandemic level have also increased their debt levels the most. 'Other services' (which includes art and recreation) is the sector that stands out most in this respect. At the other end of the spectrum, the manufacturing sector was less affected by lockdown restrictions, so firms had less need to borrow to keep their businesses afloat.

UK: Non-financial corporate bank debt



Source: EY ITEM Club/Haver Analytics

UK: Changes in investment and debt by sector



Source: EY ITEM Club/Haver Analytics

Overall, whilst there might appear to be plenty of scope for investment to rebound strongly in many parts of the services sector, higher debt burdens may limit the ability of some firms to finance greater capital spending. The rise in the main corporation tax rate from 19% to 25% will also constrain the availability of internal funding from next year.

Alongside a wide range of cost pressures, the prospect of a squeeze in profit margins may also hold back investment. Firms are increasingly experiencing a slowdown in demand that will limit their pricing power. In this context, companies are likely to cut costs in a bid to avoid falling margins, and a cautious approach toward capital spending would be an obvious way to achieve this.

Investment may not get sustainably back to pre-COVID levels until 2025

The combination of renewed supply chain challenges, the fragile economic outlook, rising costs and the debt overhang in many parts of the services sector mean we have become more cautious about the likely strength of the recovery in business investment. It now looks like the catch-up to pre-COVID-19 levels of investment will take longer than expected, whilst the impact of the super-deduction looks likely to be smaller, given the tax incentive's narrow focus.

We now forecast capital business investment to grow by 6.4% this year and 3.9% in 2023, down from 9.5% and 4% in our spring forecast. We expect it will take until early 2025 for business investment to return to its pre-pandemic level on a sustained basis.

6. Conclusions

Given the breadth and depth of the headwinds facing the UK economy, it's not hard to be pessimistic about the outlook. And the strong possibility that there could be more external shocks, whether from a Russian oil and gas embargo, a US recession or a trade war with the EU, means that pessimism may prove fully justified. But as things stand now, the very bearish and recessionary language of many economic commentators strikes us as a little downbeat. The job security implied by very low unemployment and an imbalance between labour demand and supply, households' healthy balance sheets and the outsized importance of higher-income groups for consumer spending all offer some insulation to the consumer sector in the face of falling real incomes. Hence, whilst we see the economy experiencing distinctly tardy growth over the rest of 2022 and much of 2023, a protracted contraction is still not baked in.

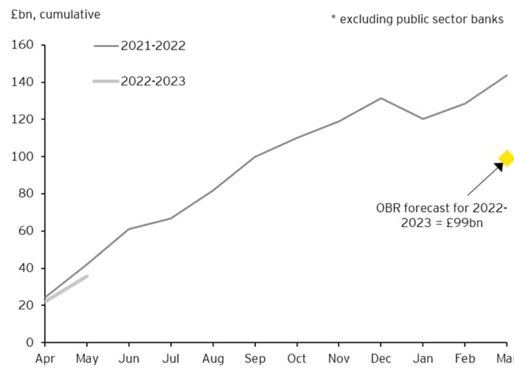
But some modesty is in order. No one under the age of 60 has lived, as an adult, through the kind of supply shocks that the UK and the rest of the world are currently experiencing. By their nature, supply shocks are unpredictable; a point exacerbated in the present day by the role of geopolitical and economic forces in driving up energy and commodity prices. Our relatively bullish forecast could quickly prove out of date if the economy were to experience another surge in energy prices or were interest rates to rise faster and to a higher level than we expect.

On an optimistic view, the BoE and other central banks could prove adept enough to cool demand just enough to bring down inflation, but no more. At the same time, the market-driven response to high commodity prices, namely efforts to increase supply, could also continue to bear down on price rises. And with most of the candidates in the Conservative Party leadership election pledging tax cuts, a looser UK fiscal policy may also help. Hence, it's possible to envisage a 'goldilocks' scenario, where the UK and world economies escape from their current tribulations with the worst of fears not realised.

But the opposite could happen. A prolongation of the war in Ukraine risks developments that could increase energy prices. A Russian embargo on gas exports is a case in point. Central banks could push the lever of tighter monetary policy too hard, overwhelming fragile household and corporate borrowers and repeating mistakes that helped trigger recessions in the 1980s, 1990s and 2000s. Any short-term boost to the economy from tax cuts would be negated if public spending were to be cut as well or if the MPC responded by raising interest rates faster. And as the recent spike in COVID-19 infections reveals, the issue that bedevilled the UK and the global economy in 2020 and 2021 hasn't necessarily gone away. All in all, the macroeconomic outlook has probably never been more uncertain.

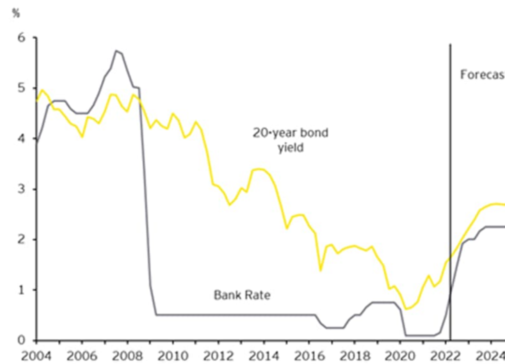
Forecast in charts

Fiscal policy



- The budget deficit continued to fall in the first two months of 2022–23, with year-to-date borrowing of £35.9bn down £6.4bn on last year. The OBR expects a full-year deficit of £99.1bn.
- Borrowing could well come in higher. Growth in tax receipts may suffer from faltering activity. And government spending will be pushed up by higher inflation and interest rates and the cost of the government's May support package.
- But the bulk of the upward pressures on borrowing this year will be temporary, so the implications for medium-term fiscal policy choices should be limited.

Monetary policy



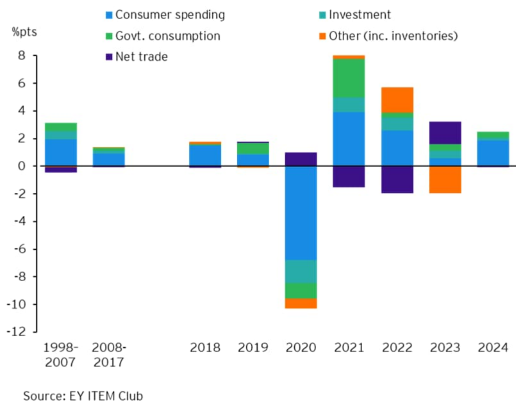
- June saw Bank Rate increase by 0.25ppts to 1.25%, the fifth successive hike.
- That the MPC appears to prioritise fighting inflation over supporting activity, plus the US Fed's more aggressive approach, mean we now expect three more 25bps rate hikes this year, leaving Bank Rate at 2% by the end of 2022.
- With most mortgagors having fixed-rate deals of two years or more, the economic impact of higher interest rates will feed through slowly.

Prices

- Inflation reached a 40-year high of 9.1% in May, advancing further on April's 9% reading.
- Recent moves in wholesale gas prices suggest that the energy price cap could rise 50% to 60% in October. Inflation will also be pushed up by higher petrol prices and sterling weakness.
- CPI inflation is forecast to peak at around 11% in October. However, there's some uncertainty surrounding this call since the ONS has yet to say whether it will incorporate the impact of the Energy Bills Rebate in the CPI calculation.

Activity

UK: Contributions to GDP growth

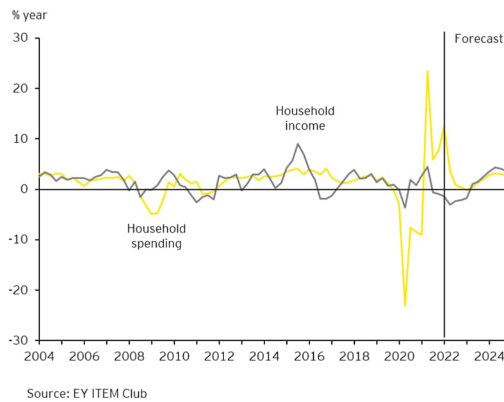


Source: EY ITEM Club

- The economy put in a weak performance over the spring, with GDP falling 0.4% between February and April.
- Excluding the impact on health sector output of a fall in COVID-19 testing, GDP grew each month from January to April. But cost-of-living pressures are biting.
- The economy is likely to have shrunk in Q2, and growth over the rest of this year and into 2023 will be held back by high inflation, rising interest rates and headwinds to investment. We forecast GDP to rise 3.7% this year and 1% in 2023.

Consumer demand

UK: Real household income and spending



Source: EY ITEM Club

- Consumer spending rose 0.6% in Q1 2022, a little faster than the previous quarter, aided by the lifting of COVID-19 measures and fading concerns about the virus.
- Inflation rising to levels not seen since the early 1980s and depressed consumer confidence will hold back consumption in the near term.
- But healthy household balance sheets and the boost to job security from low unemployment and strong demand for workers will mitigate headwinds. Consumer spending is forecast to rise 4.1% this year and 0.8% in 2023.

Housing market

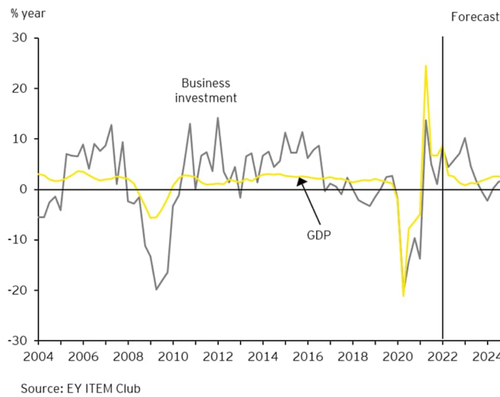
UK: House prices

Source: EY ITEM Club

- The recent performance of the housing market has been detached from the wider economy's troubles. House prices have continued to grow at double-digit rates, and mortgage lending has been strong.
- Falling real incomes and rising mortgage rates point to a slowdown in activity and price rises this year, although a serious correction is unlikely.
- After a forecast 9% rise in house prices this year, we expect prices to gain by a muted 1.1% in 2023.

Company sector

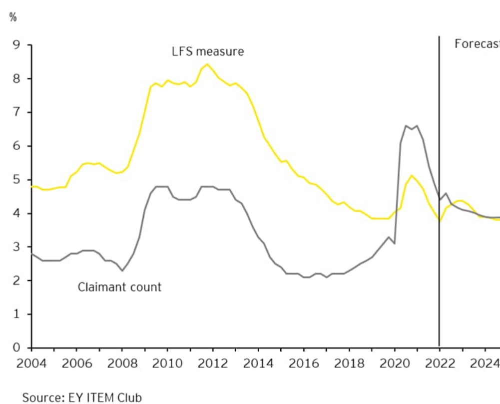
UK: Business investment and GDP



- Business investment has continued to miss out on the recovery seen in the wider economy. As of Q1 2022, spending by firms on fixed assets was still 9.2% below the pre-pandemic level.
- The impact of the temporary super-deduction tax incentive has so far been underwhelming. And positives from this source face off against geopolitical uncertainty, continued supply frictions and inflation in capital goods' prices.
- We forecast business investment to rise 6.4% this year and a further 3.9% in 2023.

Labour market and wages

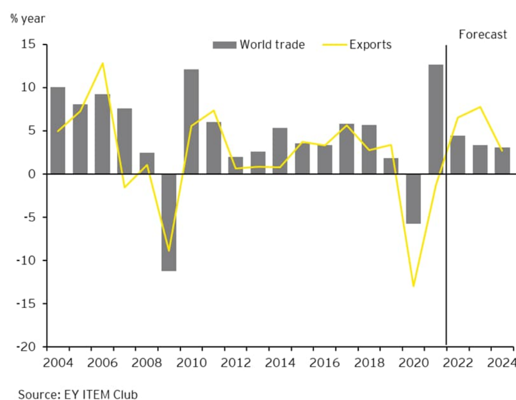
UK: Unemployment rate



- The unemployment rate stood at 3.8% in the three months to April, a near-50-year low. And demand for workers has remained strong, as evidenced by record high vacancies.
- A weaker economic outlook may weigh on labour demand, but we expect the labour market to adjust to this more via lower real wages than higher joblessness.
- Growth in average real regular pay has increasingly fallen behind inflation, although the picture including bonuses has been less bad.

Trade and the balance of payments

UK: Exports and world trade



- Trade flows have become particularly volatile, driven by flows of non-monetary gold and changes in the method the ONS uses to measure imports from the EU.
- Expensive energy means that the UK's import bill will likely remain unusually high. At the same time, a slowdown in the global economy will weigh on export growth.
- The current account deficit rose to a record high of 8.3% of GDP in Q1 2022, reflecting more expensive energy imports and a jump in imports of precious metals.

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About EY ITEM Club

EY ITEM Club is the only non-governmental economic forecasting group to use the HM Treasury's model of the UK economy. ITEM stands for Independent Treasury Economic Model. HM Treasury uses the UK Treasury model for its UK policy analysis and Industry Act forecasts for the Budget. EY ITEM Club's use of the model enables it to explore the implications and unpublished assumptions behind Government forecasts and policy measures.

Uniquely, EY ITEM Club can test whether Government claims are consistent and can assess which forecasts are credible and which are not. Its forecasts are independent of any political, economic or business bias.

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