EY ITEM Club Autumn Forecast

A better past, but the future still looks sluggish

October 2023

Building a better working world

Contents

Foreword	1
Highlights	2
Introduction	3
No recession, but bumping along the bottom	4
A further period of sluggishness likely lies ahead	8
Revisions have improved the UK's relative performance, but it still lags the G7's front-runners	14
The Chancellor faces several obstacles in delivering any Autumn Statement 'giveaways'	17
Conclusions	21
Forecast in charts	22

Ernst & Young LLP is the sole sponsor of the ITEM Club, the only non-governmental economic forecasting group to use the HM Treasury model of the UK economy. Its forecasts are independent of any political, economic or business bias.

Foreword

Hywel Ball
UK Chair
Ernst & Young LLP (UK)
LinkedIn

Peter Arnold
UK Chief Economist
Ernst & Young LLP (UK)
LinkedIn

It's a slightly odd event when the most important set of data on the UK economy since our last publication related to events from two years ago. The ONS announced in early September that they had discovered an additional 2% of UK GDP, in effect re-writing the prevailing narrative on the economic performance of the UK post-pandemic. The UK economy is now understood to have surpassed its pre-pandemic size by Autumn 2021 (rather than Spring 2023) – very much a 'v shape' recovery – and it is now no longer the 'worst performing economy in the G7', having outpaced Germany and France, and putting itself firmly in mid-table.

The story was covered widely in the UK media (alongside some caveats – other countries could well do similar) and should hopefully encourage domestic and international investors alike to revise their perceptions of the UK's relative economic performance. However, it doesn't change the fact that the economy has largely flatlined for the last 18 months, nor does it change the current outlook – which remains subdued.

Recession warning lights have been flashing all summer with business surveys in negative territory, and higher interest rates continue to bite on household budgets and corporate borrowing alike. Whilst July's GDP figures (a -0.6% month-on-month (MoM) decline) were affected by strikes and poor weather, more recent data from August confirmed that any momentum from the first half of the year has apparently faded.

However, the prospects of a recession are still finely balanced (as they are in the Eurozone and, to a lesser extent, the US), and even if the economy does experience one, it is likely to be relatively mild. Inflation is falling rapidly, a trend which will be helped by another reduction in household energy prices in October, easing the pressure on wages and margins. Labour markets are cooling, but without (so far) any significant increases in unemployment, and the Bank of England (BoE) took the opportunity in September to pause on rate rises, with market expectations increasingly leaning towards the view that the next rate change will be down rather than up.

Bringing all of that together, the latest forecast from the EY ITEM Club is for growth of 0.6% in 2023 (up from 0.4% in our summer forecast, mainly reflecting the ONS revisions) and 0.7% in 2024 (down from 0.8% in our Summer forecast). That these are relatively small revisions reflects (hopefully) an economic outlook that is beginning to settle after almost three years of constant quarter-on-quarter volatility in outlook.

These are hardly stellar growth figures – for many, it may still feel like a recession. Businesses and consumers alike will need to plan accordingly. In particular, they need to continue to take action to address their exposure to higher interest rates and focus on maximising their operational performance in challenging circumstances.

As an election year looms, there will be plenty of interest in November's Autumn Statement – but perhaps we shouldn't expect too much. The public finances remain challenging despite fiscal drag and inflation increasing the tax take. Any apparent headroom will likely be struck out by a revised set of forecasts from the OBR come November and from higher debt servicing costs – whilst the lessons of 12 months ago from the 'Mini-Budget' and the current heightened tension in global bond markets make a relaxation of any fiscal rules difficult.

The Chancellor, on the lookout for a few fiscal tailwinds heading towards a general election, will be hoping for another mild winter and an economy that proves to be as resilient as it was this time last year. Watch this space.

Highlights

- The previous gloomy narrative around the UK economy's performance in the last few years has been upended by GDP revisions, providing a positive backdrop to the EY ITEM Club's new economic forecast. But while the recovery in 2021 was stronger than thought, the economy has still seen little growth over the past 18 months. And with the effect of a major rise in interest rates coming through, fiscal policy settings tight and the jobs market fraying, sluggishness is likely to remain the story over the rest of this year and into 2024. But the economy's positives mean we continue to think a recession should be avoided.
- The EY ITEM Club forecasts the economy to expand 0.6% in 2023. More momentum than anticipated in the first half of this year means this is an improvement on the 0.4% rise we expected in our summer forecast. But growth in 2024 is nudged down to 0.7% from 0.8%. That inflation has fallen faster and interest rates probably peaked lower than had been feared are positive developments. But these are countered by a lack of momentum going into 2024, higher oil prices and tighter financial conditions. As inflation falls further, growth in real incomes recovers and interest rate cuts kick in, we think GDP will rise 1.7% in 2025.
- Hopes of a decent increase in output in Q3 following a strong end to the previous quarter have dwindled. Official data has been disappointing, and some surveys have been consistent, based on past form, with the economy shrinking. The labour market has deteriorated by more than we'd expected three months ago. And the housing market has remained weak.
- The growing impact of the biggest tightening in monetary policy in over 30 years is an obvious culprit. A rising number of households with fixed-rate mortgages are experiencing a jump in mortgage payments and corporate borrowing costs have risen by even more than mortgage rates. In addition, a combination of still-high inflation and frozen tax brackets means fiscal drag is eroding household spending power.
- However, that interest rates have probably peaked, and at a much lower level than many had expected, should soften the blow. On the assets side of household balance sheets, the boost to interest income from higher rates has, so far, substantially exceeded rises in mortgage payments, helped by still-sizeable pandemic-era savings. With inflation likely to slow more quickly than pay growth, real wages should start to rise more convincingly. And despite the obstacle presented by dearer oil, we think inflation should fall to around 4.5% by the end of this year and to the Bank of England's 2% target in the second half of 2024, helped by drops in energy bills, easing food price inflation and weaker pipeline price pressures. This should prompt the BoE to start cutting rates from May 2024.
- The GDP revisions also show business investment grew strongly in the first half of this year, another break with an earlier narrative of weakness. But headwinds from higher interest rates and a sluggish economy mean we're doubtful this strength will continue. That said, deleveraging by UK companies and relatively limited refinancing needs for market-based debt suggests that UK companies, in aggregate, won't face serious financial stress.
- GDP revisions mean the UK was not the slowest growing economy in the G7 since late 2019, as had been thought. But UK growth has still been well behind the G7's frontrunners. Differences in fiscal responses offers one explanation and a much bigger rise in UK retail energy prices is another. Supply constraints mean the UK has done relatively poorly in translating growth in demand into higher real output rather than inflation. Public sector productivity is still well below pre-COVID-19 levels, while the shortfall in the UK workforce compared with past trends is relatively large, pushing up pay growth. And more expensive energy has also contributed to relatively high inflation.
- But that retail energy prices are now falling offers one source of optimism for the UK's future relative performance. A revival in workforce growth is another. And that the UK has recently lagged some of its peers offers more room for catch-up growth.
- We're doubtful that fiscal policy will provide much near-term support to the economy in making up the gap with the UK's competitors. For sure, the public finances have proved healthier than the OBR expected, thanks to robust growth in tax receipts. But higher government borrowing costs and likely downgrades to growth forecasts mean the OBR may judge in November's Autumn Statement that the government has missed its fiscal rules. It seems unlikely, therefore, that the Autumn Statement will deliver any net 'giveaways', with those more likely in next spring's Budget, the last before the next general election.

1

Introduction

The importance of narratives in shaping economic decision making shouldn't be underestimated. Expectations matter and 'vibes' around the economy's prospects can bear on consumer's appetite to spend or save, firms' willingness to invest and investors' attitudes towards markets and asset classes. For some time, the narrative around the UK has been very negative. Until recently, GDP was thought to still be stuck below pre-COVID-19 levels and the UK the weakest performing economy in the G7 since late 2019.

But developments since the last EY ITEM Club forecast in the summer have triggered something of a vibe-shift. Revisions by the ONS mean the economy is now estimated to have returned to its pre-COVID-19 size by the end of 2021 and recovered more strongly than Germany and France. In terms of growth since late 2019, the UK has moved from the bottom of the G7, pre-revisions, to the middle of the pack.

But a better performance in the past offers only so much cause for celebration. The latest data still shows the economy seeing only modest growth over the last year-and-a-half. Given the shocks which struck over that period, that the recession frequently predicted by forecasters has been avoided suggests a welcome degree of resilience. And the EY ITEM Club thinks a serious downturn should be avoided, as falling inflation, a return to real growth in pay, a growing sense that interest rates have peaked and, more speculatively, some fiscal loosening in next spring's Budget prop up activity.

But the very subdued growth we expect over the rest of this year and into 2024 won't feel much different from a recession. While the ramping up of interest rates by the BoE is now probably at an end, the lag between rate hikes and their effect on the economy means the full impact is still coming through. The labour market is faltering, and a combination of still-high inflation and frozen tax brackets is causing fiscal drag to erode household spending power. Meanwhile, financial conditions have tightened off the back of the recent jump in global bond yields. And the rise in oil prices since the summer, if sustained, risks slowing inflation's descent and delaying the point at which interest rates start to be cut.

Overall, and building on upward revisions in recent ITEM Club forecasts, we expect growth this year of 0.6%, higher than the 0.4% forecast in the summer. But this is a legacy of a stronger-than-anticipated first half of 2023, not increased optimism about the near future. Forecast growth next year is now 0.7%, a little down from 0.8% previously, with inflation falling faster and rates peaking a little lower than we'd anticipated in the summer offset by the negatives of waning momentum in H2 2023, tighter financial conditions and higher oil prices. We've stuck with our expectation for the economy to expand 1.7% in 2025.

Our latest forecast report begins with a discussion of recent economic developments. Section 3 sets out the key elements of our new forecast. Considering the new GDP estimates, Section 4 examines how the UK economy has performed relative to its peers. And with the Autumn Statement due on 22 November, Section 5 looks at the state of the public finances and the options available to Chancellor Jeremy Hunt. Section 6 concludes.

2

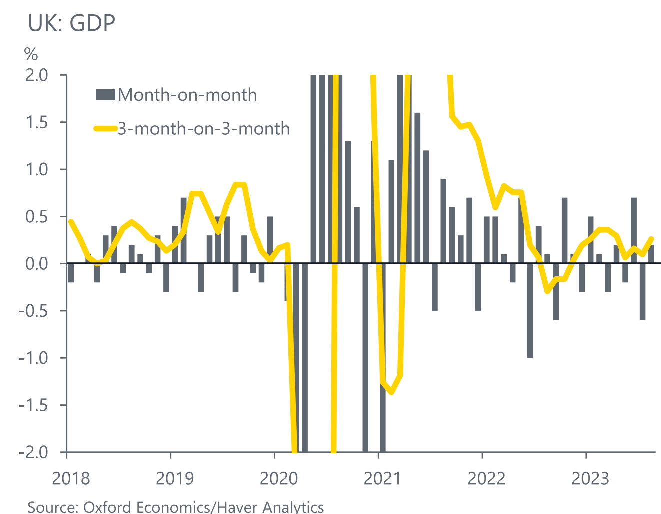
No recession, but bumping along the bottom

The economy grew by more than expected in H1 2023…

The economy's performance in the first half of 2023 proved stronger than anticipated. Growth in Q1 was revised up to 0.3% quarter-on-quarter (q/q) from 0.1% previously. And GDP beat expectations in Q2 by rising 0.2%, a little stronger than the 0.1% rise we, and the consensus, had expected. That the extra public holiday for the King's coronation in May had a smaller-than-expected drag on activity, and one much more modest than previous royal holidays, was a factor behind the outperformance. June delivering a surprisingly robust 0.7% m/m rise in GDP was another.

The expenditure breakdown for Q2 showed that household consumption rose 0.5%, building on Q1's healthy 0.7% increase. Business investment increased a strong 4.1%, with spending on aircraft boosting the number. There was also a sizeable contribution from government consumption, but these positives were partly offset by a drag from net trade.

A drag from industrial action in the transport and public sectors and that Q2 had one fewer working day than normal meant the economy's underlying performance was a bit better than the headline numbers suggested. But H1's growth still meant GDP rose only marginally over the previous 18 months.

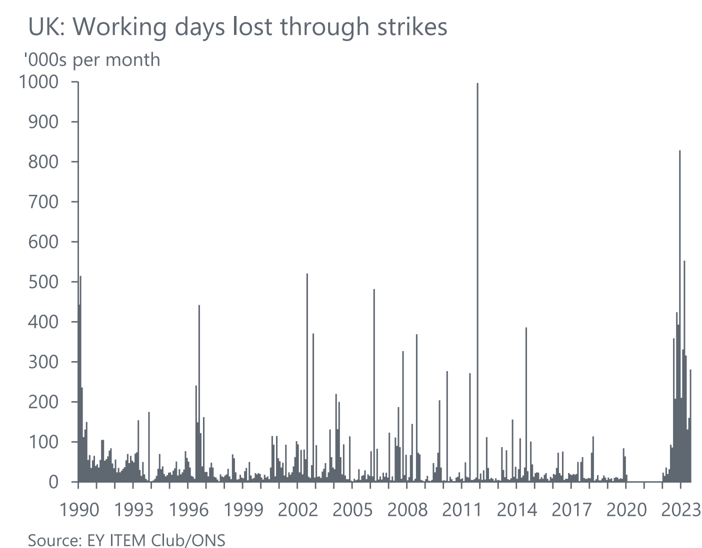


Source: Oxford Economics/Haver Analytics

… but activity looks to have sagged more recently

The strong launchpad for growth in Q3, presented by June's rise in GDP, had seemed to set the quarter up for a decent expansion (official data for Q3 will be published on 10 November). But output fell 0.6% m/m in July, largely cancelling out the previous month's rise. The economy returned to growth in August, but a 0.2% increase in GDP was modest. This left three-month-on-three-month growth at 0.3%, while on a y/y basis, the economy was only 0.4% bigger than 12 months earlier.

Granted, the economy's performance over the summer was affected by erratic factors. Industrial action meant the number of working days lost through strikes was much higher than has been the case for many years. The effect of strikes was particularly marked on health output, which dragged down the wider services sector. And retail and construction activity in July were hurt by unseasonably wet weather (July 2023 was the sixth-wettest July in England since records began in 1891).



Source: EY ITEM Club/ONS

A surprise 0.6% contraction in consumer-facing services in August suggests there's room for a rebound, which could have boosted growth in September. But if recent data and survey evidence are taken in the round, it looks uncertain whether GDP avoided falling in Q3. September's composite Purchasing Managers' Index (PMI) dropped to the lowest level since January, while NHS strikes that month will have dragged on the health sector.

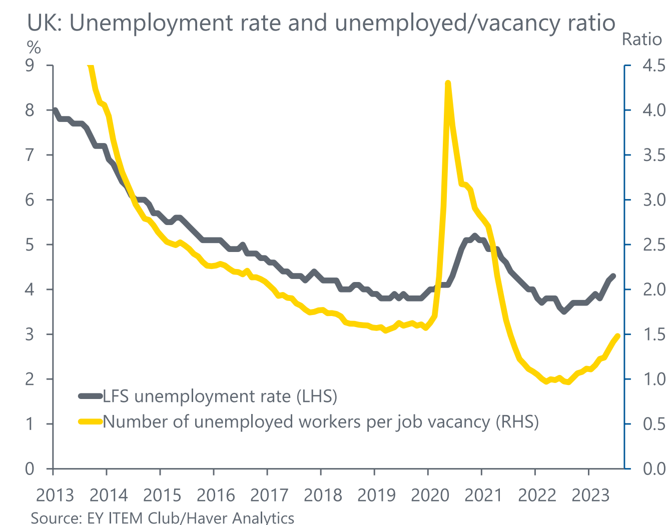
But not all indicators have been so downbeat. Other business survey indicators of activity, including the Lloyds Business Barometer, have remained consistent with positive GDP growth. The weekly ONS Opinions and Lifestyle Survey suggests that household financial distress connected to energy prices, mortgages and rent has seen little move since the spring. Pressure on consumers from high inflation has retreated, and this has helped. The Consumer Prices Index (CPI) measure fell to a 19-month low of 6.7% in August, undershooting consensus and BoE forecasts. Average wages have started to rise again in real terms, helped by continued strength in nominal pay growth and lower inflation. These developments probably contributed to the GfK measure of consumer confidence rising in September to a 20-month high.

However, data on lending to households and house prices has added to signs that the drag from higher interest rates is building. Although net mortgage lending over the summer was in positive territory, it was very low by past standards. Mortgage approvals, which provide an indication of future lending, fell in August to a level close to the low seen after autumn 2022's 'mini-budget'. This left cumulative approvals in the year-to-date almost 30% down on 2022's level. Both the Nationwide and Halifax measures of house prices reported a fall in Q3, the former for the fourth quarter in a row. An average of the two measures in September was 4.5% down on a year earlier.

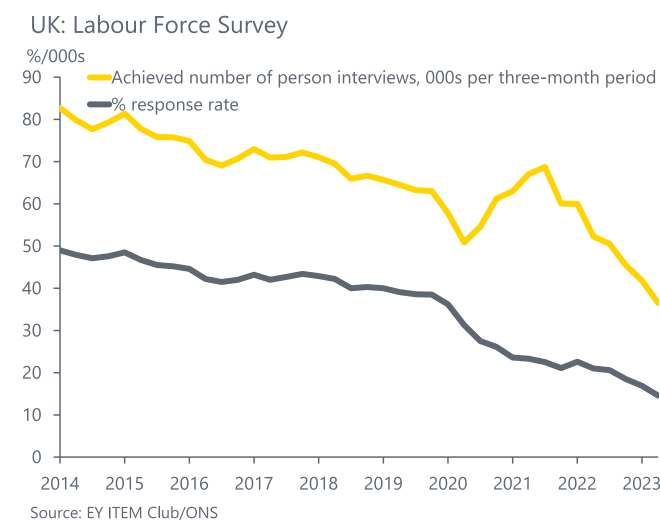
The resilience of the jobs market is eroding, at least on some measures

What had been an apparently 'Teflon' labour market has recently looked less resilient. The Labour Force Survey (LFS) unemployment rate in the three months to July rose to a 23-month high of 4.3%, 0.5ppts up on three months earlier. The employment rate was half a percentage point down over the same period. And job vacancies fell below 1m for the first time since June 2021, lifting the ratio of unemployed to vacancies back to the immediate pre-COVID-19 level.

However, some of the rise in the jobless rate reflects a bigger workforce, rather than being driven wholly by higher redundancies. Although the summer saw an uptick in the number of people classed as economically inactive, the economically active population in Q2 finally exceeded the pre-COVID-19 size in Q1 2020. And not all aspects of recent labour market data have been consistent with the headline story of a deterioration. According to the HMRC data, the number of employees held broadly steady over the summer, while the ONS' single month estimates showed employment and unemployment in July more resilient than the three-month average numbers. And a fall in the response rate to the LFS, down to only 14.6% over the summer from 40% pre-COVID-19, means the accuracy of the LFS numbers has become more open to question.[1]



Source: EY ITEM Club/Haver Analytics



Source: EY ITEM Club/ONS

Nonetheless, a looser jobs market may be starting to influence wages. Year-on-year growth in private sector regular pay slowed in the three months to July for the first time since the start of the year. On a month-on-month basis, the private sector measure barely increased in July. And timelier, if revision-prone, HMRC payroll data showed the median of employee pay growth in August slowing to 6% y/y, an 11-month low.

But in absolute terms, the pace of increase in wages remained very heated. Headline (three-month average of the annual rate) regular pay growth in the three months to July was 7.8%, the same as the previous three months and a joint-record high. And the slowdown in private sector regular pay growth was only modest. At 8.1% y/y, the rise in the three months to July was still close to a historic peak.

1. Office for National Statistics, 'Labour Force Survey performance and quality monitoring report', 15 August 2023. https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/employmentandemployeetypes/methodologies/labourforcesurveyperformanceandqualitymonitoringreport

A pause in rate hikes, while messaging has shifted from the need for more tightening to 'high for longer'

The continued strength of pay growth has been one justification used by the Bank of England's Monetary Policy Committee (MPC) to tighten monetary policy. The committee voted in August to raise Bank Rate by 25 basis points (bps), taking the policy rate to 5.25%. Another rise in September's meeting had initially looked a given.

But growing evidence of the drag on the economy from previous rate hikes and downside surprises for headline, core and services inflation in August left the decision looking more finely balanced. In the event, those dovish developments were enough to convince a narrow majority on the MPC to support keeping Bank Rate on hold, following 14 consecutive rises.

Investors have adjusted rate expectations in response. As recently as mid-July, market pricing had implied Bank Rate peaking at 6.5% by the end of this year. But at the time of writing, markets think it's broadly fifty-fifty whether Bank Rate has already reached a peak or will see one further rise.

That repricing has recently been reflected in a fall in quoted mortgage interest rates. But the decline is happening from a high level. As of August, the average interest rate on all new mortgages stood at 4.84%, 228bps higher than 12 months earlier and the highest since November 2008. Average quoted rates on popular loan to value (LTV) mortgages ranged from 5.52% (two-year, 75% LTV) to 6.92% (five year, 95% LTV).

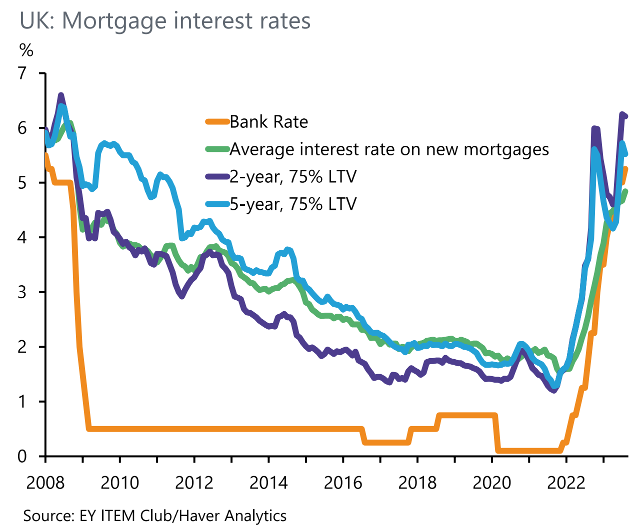
Government borrowing has come in below the OBR's predictions, as Autumn Statement approaches

The gap between public spending and tax receipts has continued to come in lower than the Office for Budget Responsibility (OBR) expected in its last forecast in March. As of August, public sector borrowing over the first five months of 2023-2024 was £69.6b, £19.3b higher than the same period in 2022, but £11.3b less than the £81b forecast by the OBR.

Central government spending has risen more strongly than the OBR anticipated, mainly because of the impact of high inflation on the cost of index-linked government debt. But this has been more than offset by surprisingly robust growth in tax revenues, particularly VAT, corporation tax and income tax (the latter aided by strong wage growth) and downward revisions to past borrowing estimates.

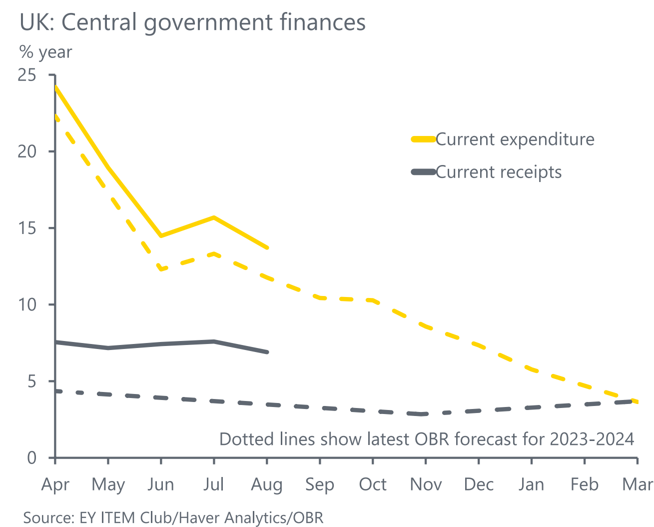
The state of the public finances and options open to the Chancellor in the Autumn Statement are explored in Section 5.

UK: Mortgage interest rates



Source: EY ITEM Club/Haver Analytics

UK: Central government finances



Source: EY ITEM Club/Haver Analytics/OBR

3

A further period of sluggishness likely lies ahead

A modest upgrade to growth this year reflects more momentum in the first half of 2023

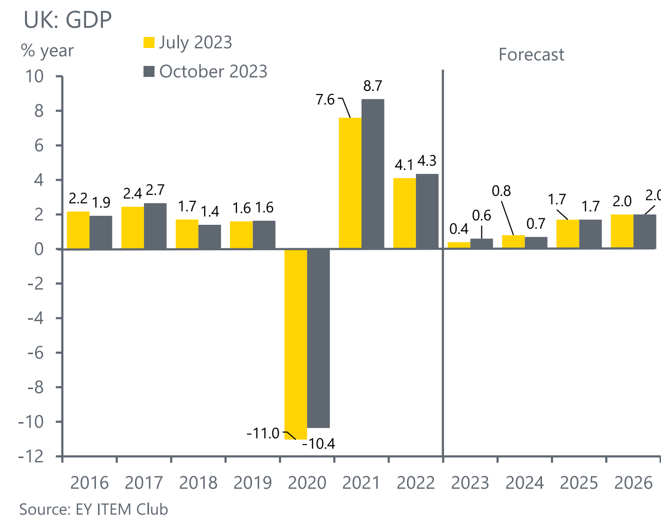
The absence of any significant new economic shocks, positive or negative, since the summer means the EY ITEM Club's forecast isn't greatly changed from three months ago, the first time that's been true in several years. Forecast GDP growth this year has been raised to 0.6% from 0.4% three months ago, reflecting the upward revision to growth in Q1 and a slightly stronger Q2 than we'd anticipated.

That growth in Q3 had initially looked on course to beat expectations would have triggered a bigger upgrade to our 2023 forecast. But the up-and-down pattern of monthly GDP over the summer, plus a disappointing run of activity surveys, have dampened optimism. What's more, industrial action will have continued to weigh on public sector and transport output. Activity in Q3 will have gained from the quarter having one more working day than Q2, and we're wary about reading too much into business surveys, given they haven't been a great guide to the official measure of GDP for some time. Nevertheless, we think it's touch-and-go whether the economy shrank in Q3.

Still-strong growth in cash pay, falling inflation, October's further cut in energy bills and that households continue to hold the bulk of excess savings built up during the Covid pandemic (albeit eroded in purchasing power terms by high inflation) should mean the economy continues to avoid a recession. That interest rates look to have peaked a little lower than we'd expected is another positive.

But the full effect of past rises in borrowing costs is still coming through, fiscal policy settings are tight, and the labour market is weakening. We therefore think the economy is unlikely to break out of a very subdued rate of growth until the second half of next year. GDP is forecast to rise 0.7% in 2024.

As price pressures ease, growth in real incomes recovers, interest rates start to be cut and, more speculatively, fiscal policy is loosened in the run-up to the next general election, growth should pick up in the second half of 2024 and 2025, with the latter year forecast to deliver a 1.7% rise in GDP.



Consumer spending will be supported by strong pay growth and higher savings income…

Strong pay growth, falling inflation and a rise in benefits contributed to real household incomes rising 1.2% in Q2, following zero growth in Q1. This more than offset an increase in consumer spending, pushing the household saving ratio up to 9.1% from 7.9% in the previous quarter.

The outlook for real incomes and consumer spending confronts positive and negative forces. In the former group, we'd identify four sources of support. First, growth in average cash pay has remained unexpectedly robust. Combined with falling inflation, this has meant wages have started to rise again in real terms. We expect nominal pay growth to ease, reflecting lower inflation and inflation expectations, a weaker jobs market and a fall in job-to-job moves from the spike seen during the pandemic.

But pay growth should continue to outpace inflation, thanks to the latter falling faster. Declining wholesale gas prices and cooling food price inflation will help, while the cut in energy bills in October should knock over 1ppt off the CPI measure that month alone. And that pipeline price pressures are now falling outright should gradually pass through to consumer prices. The price manufacturers pay for raw materials and other inputs was in deflationary territory in August for the third successive month, falling 2.3% y/y. And factory gate prices dropped 0.4%, following July's 0.7% fall.

A second positive comes from lower energy bills. The Ofgem Energy Price Cap (EPC) fell to £1,923 in October, a 7% drop from £2,074 previously. This compares with a typical bill of £2,500 (under the now-defunct Energy Price Guarantee) 12 months earlier, although the effective decline is a more modest £200 when previous universal payments of £400 provided under the Energy Bills Support Scheme are factored in. Beyond Q4, the EPC is expected to remain at just under £2,000 through 2024.[2] This would be 50% higher than pre-Ukraine war levels, but only a fraction of the £7000+ some analysts were predicting when wholesale prices peaked in summer 2022.

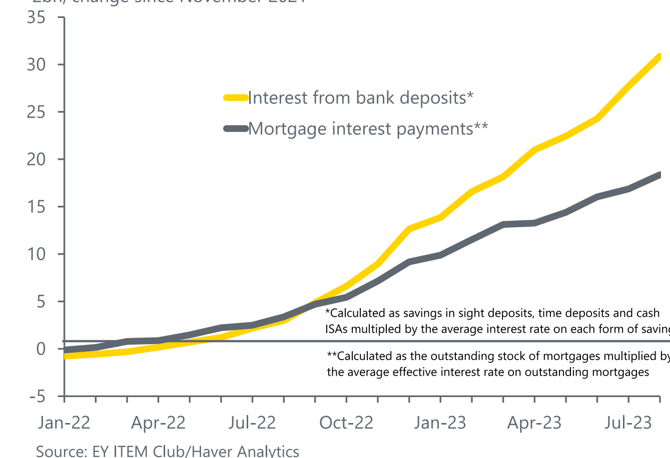
A third positive is savings. The household saving ratio in Q2 remained well above the pre-COVID-19 norm – the saving ratio averaged 6.3% from 2015-2019. Comparing the actual path of household savings over the past few years with what a continuation of pre-pandemic trends would have implied, we estimate that 'excess' savings in Q2 2023 amounted to around £160bn, or 12% of annual nominal consumer spending.

Those savings will provide a buffer to households against pressure from still-high inflation and higher borrowing costs. Their scale has also magnified the boost to savings income from rises in interest rates on bank deposits, the fourth source of support to consumption. Between November 2021 (the month before the MPC began raising Bank Rate) and August 2023, average interest rates on sight deposits, time deposits and cash ISAs rose from 0.1%, 0.3% and 0.3% respectively to 1.8%, 3.2% and 3.0%.

Our calculations suggest that the income boost from higher savings rates has substantially exceeded the extra amount spent on mortgage interest payments. As of August 2023, the net gain since November 2021 was around £12.5bn, or 0.7% of annual household disposable incomes.

UK: Household interest payments and receipts

£bn, change since November 2021



Source: EY ITEM Club/Haver Analytics

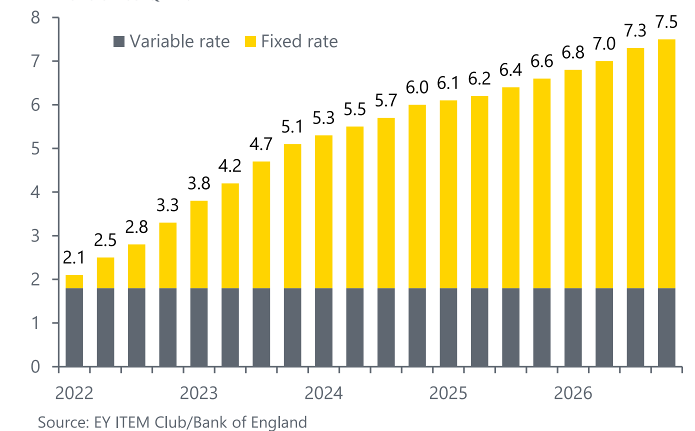
… but hindered by the growing impact of higher mortgage rates, dearer oil and a faltering jobs market

However, savers will generally spend a smaller share of any additional income than borrowers. And interest income accrues disproportionately to the better-off, whose propensity to consume out of extra income is also relatively low. It's estimated that the tenth of households with the most savings wealth will account for two thirds of savings interest income in 2024-25.[3] Any boost to the economy from a rise in household net interest receipts is therefore likely to be smaller than the headline number suggests.

Over time, the gap between interest receipts and payments will likely narrow and turn negative. The shift to long-term fixed rate products has been much more prevalent for mortgages than savings accounts and most household fixed rate savings products are fixed for two years or less. As a result, the bulk of rises in deposit rates has probably already happened. But a growing number of fixed-rate mortgages are moving onto higher rates as old deals expire. Around half of mortgages (4.5m) are estimated to have seen increases in repayments since mortgage rates started to rise in late 2021. And higher rates are expected to affect most of the remainder by the end of 2026.

UK: Cumulative number of households facing a change in mortgage rates

Millions since Q4 2021



Source: EY ITEM Club/Bank of England

This movement means the average interest rate on outstanding mortgages has risen from 2% at the start of 2022 to 3.1% in August 2023. We think the average rate will probably increase to over 4% next year, even if Bank Rate rises no further. As things stand, the average household remortgaging in 2024 will see their annual payments rise by around £3,000. Downward pressure on house prices (we continue to expect a peak-to-trough fall of around 10%) will reduce homeowners' wealth, presenting another channel to weaker consumption.

---

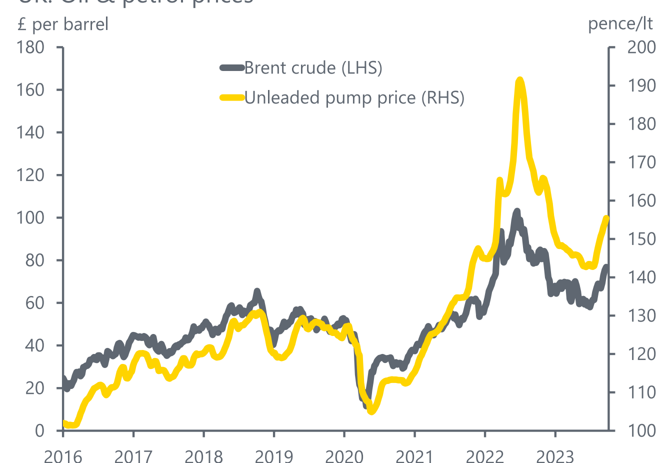
2. Dr Craig Lowrey, 'Cornwall Insight release price cap forecasts for 2024, Cornwall Insight, 29 September 2023. https://www.cornwall-insight.com/press/cornwall-insight-release-price-cap-forecasts-for-2024/
3. Adam Corlett, 'The Living Standards Outlook – Summer 2023 Update', Resolution Foundation, 6 September 2023. https://www.resolutionfoundation.org/publications/living-standards-outlook-summer-2023/

Some renters are also experiencing higher housing costs as landlords with mortgages pass on increased mortgage bills. According to the ONS, private rents in the year to July rose 5.3%, the biggest increase since the data series began in 2016. And data from HomeLet showed average rental prices for new tenancies up 10.3% in the year to August.[4]

A second headwind comes from the recent spike in oil prices. Strength in activity in some oil-consuming economies, notably the US, has pushed up demand for oil. But production and export cuts by Saudi Arabia and Russia have restricted supply. As of mid-October, the price of a barrel of Brent Crude was around $90, a fifth higher than May's recent low. In sterling terms, the increase was around 25%. Relatedly, prices at the petrol pumps have also increased. The average price of a litre of unleaded in October stood at 156 pence, 13 pence higher than the recent low in June.

Higher oil prices, if sustained, could have several adverse consequences. One is inflation falling more slowly than otherwise. For sure, that fuel duties make up over a third of pump prices will cushion the impact of dearer crude on retail petrol prices. And if consumers are compelled to spend more on petrol and so less on non-oil items, downward pressure on the prices of the latter means higher oil prices should have a smaller effect on core inflation than on the headline measure.

UK: Oil & petrol prices



Source: EY ITEM Club/Haver Analytics

But the rise in crude prices will have some impact and mean we've cut our forecast for CPI inflation by less than would otherwise have been the case, given August's downside surprise. We now expect the CPI measure to end this year at just under 4.5% versus 4.9% three months ago. Inflation is expected to fall back to the BoE's 2% target by the autumn of 2024.

All else equal, the rise in oil prices will also reduce real incomes and consumer spending, and could hurt business investment, although a potential boost to capital spending by North Sea firms could mitigate any investment hit.

A third pressure on consumer spending comes from signs that the labour market is deteriorating. Lacklustre GDP growth and the growing drag from higher interest rates mean we now think the official unemployment rate will rise to around 4.8% by the end of this year, up from 3.5% in 2022. While this would leave the jobless rate still relatively low by historical standards, the projected rise would be the biggest since the financial crisis (excluding the pandemic period), risking damage to sentiment and encouraging more cautious behaviour on the part of consumers.

Finally, the freezing of tax thresholds alongside stronger than expected pay growth will increase average tax rates faced by some individuals as they are pushed into higher tax brackets. As discussed in Section 5, the decision not to raise thresholds in line with inflation (in place since 2021 and due to last until 2028) is now projected to raise three times as much revenue as originally estimated.

Overall, and helped by a decent performance in the first half of 2023, we expect consumer spending to rise 0.7% this year, up from a forecast of zero growth in the summer. Growth of 0.7% is also forecast for 2024, but much will depend on just how quickly cash pay growth decelerates, inflation continues to fall and whether oil prices hold on to, extend, or reverse, recent gains.

Interest rates have likely peaked, but we think cuts will have to wait until the late spring of 2024

The EY ITEM Club thinks the odds of September's MPC decision representing a US Fed-style 'skip' before rates rise again are low. Inflation should continue to fall and pay growth decelerate. And the economy has proved weaker than the BoE had anticipated. September's pause should therefore represent an end to the recent cycle of rising interest rates.

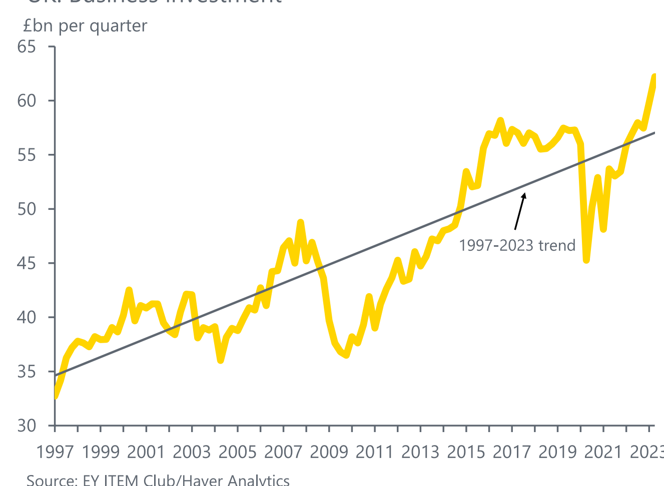
When rates will be cut is more uncertain. The BoE's next economic forecast, due in November, should offer some clues. September's policy statement stuck to the MPC's previous 'high-for-longer' message, repeating language from recent meetings that "monetary policy will need to be sufficiently restrictive for sufficiently long to return inflation to the 2% target sustainably in the medium term".[5]

But it's not implausible that the MPC's messaging proves a poor guide to the actual direction of policy. Were inflation to repeat August's downside surprise and signs that pay growth is on the turn build, the committee could change its stance, with cuts perhaps beginning early next year. Conversely, the recent spike in oil prices, if it's sustained or intensifies, could slow inflation's descent and raise renewed concerns around 'second-round' effects, delaying rate reductions until well into 2024. On balance, we think Bank Rate will start to be cut from May 2024, a little earlier than current market expectations. The policy rate is forecast to stabilise at 3.5% in the second half of 2025.

Business investment has proved much stronger than expected, but sustaining this will a tough order

A substantial 4% q/q rise in business investment in Q1 2023 was probably boosted by firms seeking to take advantage of the super-deduction tax incentive before it ended in April. As a result, we and other forecasters had expected some pay-back in Q2. In the event, the second quarter delivered an even bigger, 4.1%, rise in investment spending. Granted, aircraft purchases boosted growth in Q2. But business investment is looking much healthier than a long-standing narrative of weakness had suggested.

UK: Business investment



Source: EY ITEM Club/Haver Analytics

Q2's rise left business investment almost 40% higher than the recent low in Q2 2020 and 8.6% up on the pre-COVID-19 level in Q4 2019. Growth since the pandemic has been broad-based, with all major categories of investment, bar spending on commercial buildings, now well above pre-COVID-19 levels.

Increased digitisation in response to changes in working and business practices during the Covid pandemic is one factor which may have supported investment recently.[6] Spending on energy efficiency measures in response to high energy prices and net zero commitments is another. Exaggerated fears about the economic consequences of Brexit may be receding. And the tax incentives introduced by the government could be proving more powerful than expected.

Higher borrowing costs pose a threat to investment, although corporate balance sheets are in good shape

But positives for investment face a threat from higher interest rates. Roughly 80% of UK companies' sterling bank debt is floating rate. And the average interest rate on firms' outstanding bank debt has risen by over 400bps since late-2021, a far greater increase than for outstanding mortgages. That higher rates have weighed on corporate demand for bank loans is clear. Year-on-year growth in net lending to non-financial companies was negative in August for the third successive month. And the BoE estimates that the proportion of UK corporations with low interest coverage (ICR) ratios, indicating debt servicing difficulties, will rise from 45% in 2022 to 50% by the end of 2023.[7] Rate rises could pose a particular threat to the private equity sector, given the exposure resulting from leveraged buyouts. Construction, utilities and real estate, all of which have seen relatively large increases in bank debt since the end of 2019, could also be more vulnerable.

However, the UK central bank's estimates were based on balance sheet data from 2021. Companies have reduced debt since then. The BoE also judged that it would require a further significant rise in interest rates beyond current expectations to reach previous peaks in ICRs seen during the global financial crisis (GFC) and the dotcom crash at the start of the millennium. And while higher interest rates raise near-term corporate debt risks, UK banks are better capitalised now, mitigating the risk of credit supply constraints that amplified the economic damage of the GFC.

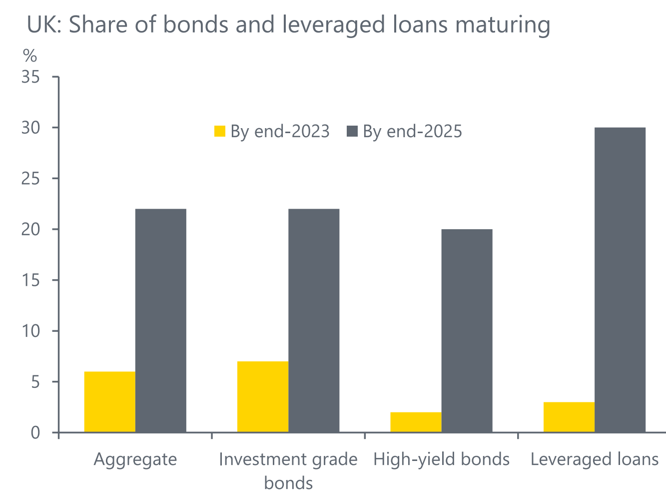
On the other hand, firms have been paying down debt in net terms for most of the period since the financial crisis, bar 2018-2021. As a result, and as we explored in the summer 2023 EY ITEM Club forecast, corporate balance sheets overall are in a relatively healthy state. As of Q2 2023, sterling bank debt as a share of annualised GDP was close to the lowest since records began in 1997. And corporate liquidity (measured by the ratio of non-financial companies' sterling bank deposits to their sterling bank debts) was close to a record high.

---

4. 'HomeLet rental index report', August 2023. https://homelet.co.uk/-/media/project/barbon/homelet/homelet-documents/homelet-rental-index/2023-20-august-homelet_dataloft_rental-report_300.pdf
5. Monetary Policy Summary and minutes of the Monetary Policy Committee meeting', 23 September 2023. https://www.bankofengland.co.uk/monetary-policy-summary-and-minutes/2023/september-2023
6. Virgin Media/O2 Business, 'Three Years of Progress How Covid-driven digital change is transforming the way we work and live for the better', 1 September 2021. https://www.virginmediabusiness.co.uk/pdf/RevTheEv/Three-Years-of-Progress_2021-Cebr-Report-VMBusiness%20VMBD_CEDG.pdf
7. Bank Overground, 'How vulnerable are UK companies to higher interest rates?', Bank of England, 22 August 2023. https://www.bankofengland.co.uk/bank-overground/2023/how-vulnerable-are-uk-companies-to-higher-interest-rates

Granted, bank debt is not the only potential source of stress. Bank lending now makes up less than 50% of the total stock of corporate debt, down from around 60% in 2009. Market-based finance (bonds and commercial paper) accounts for the majority. The maturity profile of this type of debt affects the speed with which corporates are exposed to higher interest rates, and the extent to which refinancing pressures could pose risks to the health of the corporate sector. But according to the BoE, in aggregate, refinancing needs for market-based term debt in 2023 are relatively limited. Even by the end of 2025, refinancing needs appear to be modest in aggregate, with 22% of debt estimated to fall due.[8]

UK: Share of bonds and leveraged loans maturing



Source: EY ITEM Club/Bank of England

Consequently, we don't expect UK companies, in aggregate, to face serious financial stress. But it's still hard to see how the recent strength of business investment can continue. Higher borrowing costs raise the hurdle rate faced by investment projects, and continued sluggishness in economic growth is a difficult backdrop to justifying expansion plans. But given a strong first half of 2023, we now expect business investment to rise almost 6% this year, which would be the fastest since 2016, excluding 2022 when the post-Covid recovery kicked in. However, investment is forecast to fall slightly in 2024.

Lacklustre global growth means exports are unlikely to deliver much of a boost

Global economic activity in the first half of this year benefited from the US consumer continuing to spend, Europe shrugging off the energy crisis in a way that surprised even the most optimistic forecasters and China emerging from its zero-Covid restrictions earlier than anticipated, along with a faster-than-expected release of pent-up demand in the initial stages of reopening.

But recent activity surveys have pointed to global growth slowing, including in the UK's two largest export markets. In the US, the adverse impacts from past policy tightening, tougher lending standards, and fiscal drag all look set to take a greater toll on the economy, just as the depletion of households' excess savings buffers leaves a smaller shock absorber. And as with the US, the full impact of lagged policy tightening is yet to be felt in Europe. The IMF forecasts overall global growth to slow to 3% next year, well below the 2000-19 average of 3.8%.[9]

The UK economy is therefore unlikely to be pulled out of continued sluggishness by a pick-up in global demand. On a positive note, the fall in gas and other commodity prices over the last year means that the terms of trade shock which struck the economy in 2022 has continued to unwind, reducing the trade deficit and the drag from this source on GDP growth. But more expensive oil will go same way to offsetting this.

A further rise in oil prices would carry risks for our inflation, interest rates and growth forecast...

Several of the risks we've highlighted in recent EY ITEM Club forecasts continue to stand, including around the future path of gas prices and the economic consequences of developments in the war in Ukraine. On a positive note, the revisions to GDP and the undermining of what had been a very gloomy narrative about the UK economy have probably reduced the danger of talking ourselves into a recession – what some have described as the "nothing to fear but fear itself" risk.

For this report, we'd highlight two additional sources of uncertainty. One, oil prices, has emerged recently and a second, the next general election, is fast approaching.

The recent rise in oil prices may slow the speed at which headline inflation falls and erode gains in real incomes. But as things stand, the impact on the economy shouldn't be that big. The increase in the price of crude is not particularly large compared to the gyrations of the past few years and oil prices are broadly in line with where they were a year ago. But risks would grow if prices were to rise further. The impact on inflation expectations could encourage firms to implement above-normal price increases and workers to push for higher wages. As a result, a serious energy shock might curb the downward path of underlying inflation over and above that caused by the direct impact of higher oil prices and pressure the BoE to delay rate cuts. The outlook for consumer spending would be weaker and 'stagflation' fears would become more pertinent.

8. Bank of England, 'Financial Stability Report', 12 July 2023. https://www.bankofengland.co.uk/financial-stability-report/2023/july-2023
9. International Monetary Fund, 'World Economic Outlook: Navigating Global Divergences', October 2023. https://www.imf.org/en/Publications/WEO/Issues/2023/10/10/world-economic-outlook-october-2023

...but as things stand, a change of government may not have much macro significance, at least initially

A second source of uncertainty is the outcome of the next general election, which must be held no later than January 2025. At present, it's not obvious that a Labour Party victory, which the polls are currently pointing to, would have much macroeconomic significance, at least initially. Labour has said that it would bind itself by fiscal rules that broadly mirror those of the current government, committing to ensuring that day-to-day spending is covered by tax receipts and that the ratio of public debt-to-GDP is falling by the end of the next parliament.

A previous pledge to spend £28bn on 'green investment' has been watered down to an ambition for the second half of the next parliament. And Labour would also maintain the operational independence of the BoE and the current 2% inflation target.[10] But it's early days and we have yet to see sight of election manifestos. Were the polls to swing towards a less conclusive election outcome, parties' policy stances could change in more radical directions.

The EY ITEM Club forecast for the UK economy, Autumn 2023

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

	GDP	Domestic demand	Consumer spending	Fixed investment	Exports	Imports
2020	-10.4	-11.9	-13.2	-10.8	-11.5	-16.0
2021	8.7	9.1	7.4	7.4	4.9	6.1
2022	4.3	4.7	5.2	7.9	8.6	14.1
2023	0.6	0.3	0.7	3.9	-0.1	-0.6
2024	0.7	1.1	0.7	1.4	1.9	3.1
2025	1.7	1.8	1.7	2.4	2.1	2.3
2026	2.0	2.1	2.0	2.6	2.0	2.2

	Net Govt Borrowing(*)	Current account (% of GDP)	Average earnings	CPI	Bank Rate	Effective exchange rate
2020	14.5	-2.8	1.7	0.9	0.2	78.0
2021	5.6	-0.5	5.8	2.6	0.1	81.4
2022	5.6	-3.2	6.3	9.1	1.5	79.6
2023	5.1	-2.4	6.1	7.4	4.7	79.2
2024	3.2	-1.8	3.1	2.9	4.9	80.2
2025	2.8	-1.9	2.6	1.7	3.7	80.5
2026	2.2	-2.1	2.9	2.0	3.5	81.4

Source: EY ITEM Club

* Fiscal years, as % of GDP

10. Matt Bevington, 'What to expect from a first Labour budget: headline choices on fiscal policy', Global Counsel, 25 July 2023. https://www.global-counsel.com/sites/default/files/2023-07/20230717%20Labour%20fiscal%20policy%20%281%29.pdf

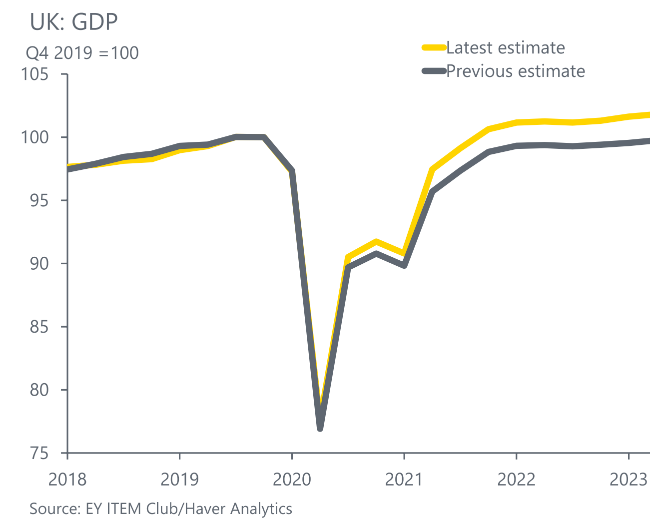
4

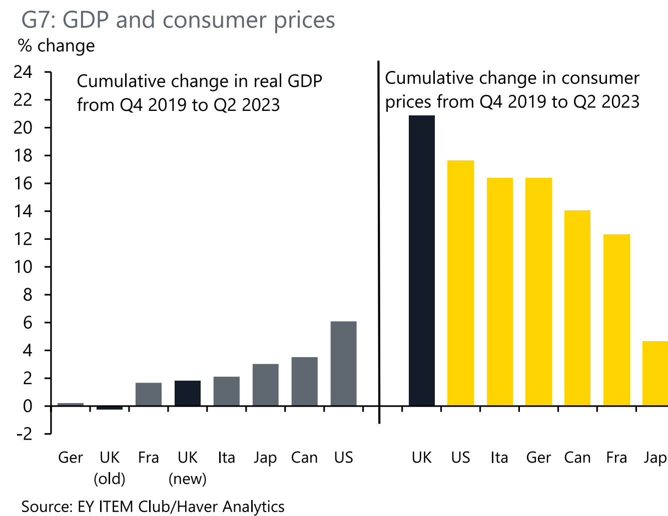
Revisions have improved the UK's relative performance, but it still lags the G7's front-runners

While revisions to GDP estimates are a fact of life, it's not often that they can trigger a major shift in perceptions of an economy's performance. But that's what the updated numbers published by the ONS in early September have done.[11] The new estimates show the UK having a less severe downturn in 2020 than previously thought. And growth in 2021 is thought to have been significantly faster.

The net result is that the economy in Q2 2023 is now estimated to have been 1.8% above its pre-pandemic size in Q4 2019, rather than 0.2% below. Pre-revisions, the UK's growth performance since Q4 2019 left it bottom of the G7 pack. But the latest numbers show the UK in the middle, above Germany and France.[12]

However, this still means that among the G7 grouping, the UK economy has been outperformed by the US, Canada, Japan and Italy over the last three-and-a-half years. True, the difference with the latter two is exaggerated by GDP in both Italy and Japan falling in the last quarter of 2019. But the gap with the other anglosphere economies is significant. And when it comes to inflation, the UK has seen a bigger rise in consumer prices since Q4 2019 than any other G7 economy.



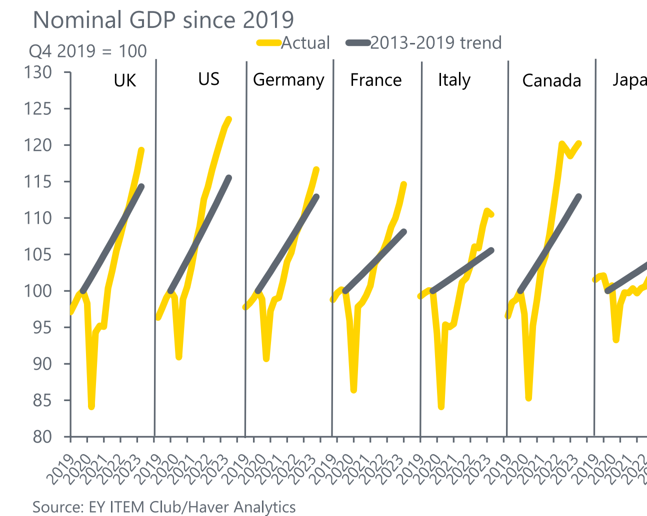


The UK has seen a smaller rise in demand relative to pre-COVID-19 trends than other anglosphere economies

In accounting for why the UK economy's performance has fallen short of some of its peers but suffered a bigger burst of inflation, we can separately examine demand and supply, which interact to determine how quickly GDP grows and how much inflation is generated in the process. Nominal, or cash, GDP provides a proxy for aggregate demand.

As of Q2 2023, UK demand was just over 4% above the level implied by a continuation of the pre-COVID-19 trend (using 2013-2019 to avoid contamination from the eurozone debt crisis in the early 2010s). But demand in the US was 7% above trend, while Canada, Italy and France had also seen bigger rises relative to trend than the UK.

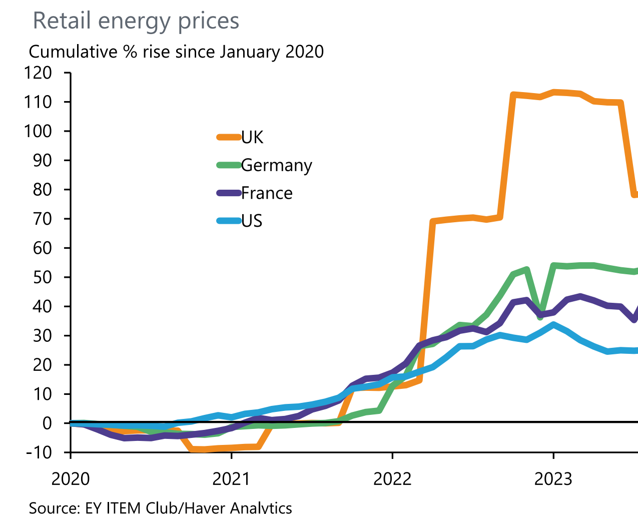
Different fiscal responses go some way to explaining why demand growth has been comparatively less strong in the UK compared to past trends. UK fiscal policy during the pandemic was aimed largely at preserving jobs. The furlough scheme was successful in that aim, but affected workers had to take a substantial pay cut. The US response was focused much more on protecting household incomes via more generous unemployment insurance and stimulus cheques. This contributed to US nominal GDP at the end of 2020 being back at the Q4 2019 level after slumping earlier in that year. In contrast, UK nominal GDP was still almost 5% lower.



A second factor which held back UK demand was a much bigger rise in the retail price of electricity and gas than in the US or Europe, resulting in a larger hit to real incomes and consumer spending. At the peak in January 2023, UK energy prices were 113% higher than in January 2020. In Germany, France and the US, peak rises were much lower at 54%, 43% and 34% respectively.

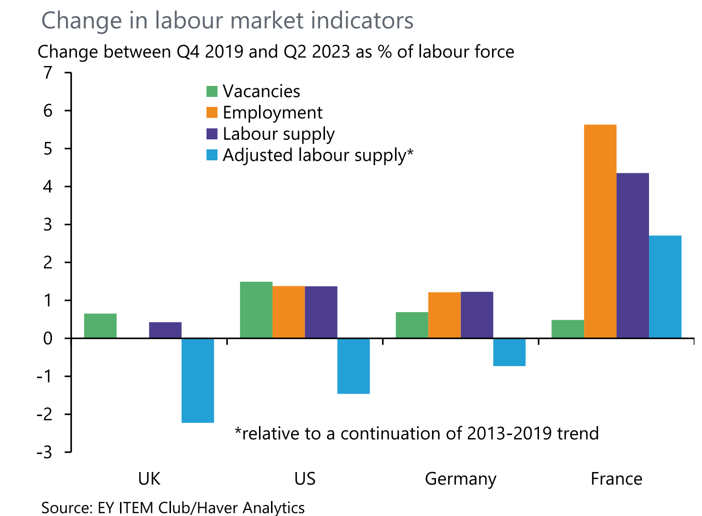
The UK's supply-side has been hurt by weak workforce growth and a fall in public sector productivity

The UK has been less successful than other major economies in translating growth in demand into higher real output rather than higher inflation. In theory, the explanation for this could lie with one, or a combination, of two factors – a relative deterioration in the supply capacity of the UK economy, or idiosyncratic developments. In practice, both have probably played a role.



Certainly, labour market constraints appear to have been more marked in the UK than elsewhere. As of Q2 2023, the number of people in work or actively looking for work in the UK had finally exceeded the Q4 2019 level.

But the economically active population was only 0.4% bigger, versus rises of 1.2% in Germany, 1.4% in US and a whopping 4.4% in France (the latter boosted by the very generous state aid for apprentices and trainees introduced in 2020). Comparing the actual size of workforces with that implied by pre-COVID-19 trends, the UK, US and Germany have all seen falls. But the UK has had the largest drop.



Weakness in public sector productivity also appears to have damaged the UK's supply-side. As of Q1 2023, output per worker in the market sector was around 1% above the level in Q4 2019. But output per job in government services was still almost 9% lower (although that these estimates have yet to go through the ONS's "Blue Book" revisions could narrow the gap).

Lower public sector productivity is not directly inflationary since public services are free at the point of delivery. But it has contributed to the need for higher taxes, which have added to firms' costs and arguably depressed growth. And there may have been other side-effects from a fall in public sector efficiency. The rise in NHS waiting lists has probably contributed to economic inactivity being higher than otherwise and slower responses from customer-facing parts of the civil service, such as the Passport Office and the Land Registry, has arguably injected some grit into the wheels of the economy's general functioning.

Meanwhile, an unusually tight jobs market by international standards has held back the UK economy's capacity to grow and resulted in pay growth strong by international standards. For example, in the year to Q2 2023, average UK wages were over 8% higher than a year earlier, versus rises of 4%-5% in the US, Germany and France.

11. Office for National Statistics, 'Impact of Blue Book 2023 changes on gross domestic product', 1 September 2023. https://www.ons.gov.uk/economy/grossdomesticproductgdp/articles/impactofbluebook2023changesongrossdomesticproduct/2023-09-01
12. At the time of writing, among G7 economies, the US, France and Italy had also made revisions to GDP estimates for 2020 and 2021, with Germany, Canada and Japan still to come. So international comparisons need to be treated with some caution.

The impetus to wage rises from a lack of slack in the jobs market has probably contributed to the UK's relatively high inflation rate. And the comparatively large rise in energy prices fits the bill as an idiosyncratic factor in helping to drive UK inflation up by more than elsewhere. For sure, energy bills are only a small part of the consumer spending basket the ONS uses to measure inflation (the weight of this component ranging from 3.3% to 4.9% over the last few years).

But with energy directly or indirectly an input to all economic activities, the relatively big rise in energy prices in the UK has likely translated into a stronger inflationary impulse across a broad range of goods and services categories, a proposition supported by research by the MPC.[13] With wages in some sectors explicitly or implicitly indexed to inflation, dearer energy has probably also played a role in the recent strength of wages growth, irrespective of the tightness of the jobs market.

We think the UK should narrow the gap with better-performing economies over the next few years

We think the UK should narrow the growth gap with the better-performing G7 economies over the next few years, while inflation should fall more into line with the advanced economy norm. Energy prices will be the most important driver of this.

The EPG, which fixed household bills between September 2022 and June 2023, and the lagged nature of the Ofgem price cap delayed the response of retail energy prices to the drop in wholesale prices since last autumn. But that response is now happening – the typical household bill fell by almost 20% in July and then by 7% in October.

Less expensive energy will boost households' discretionary spending power and help to push down inflation both directly and indirectly. And there have been some promising developments on the supply-side. After the workforce shrank during the pandemic, growth returned late last year, with inward migration and falling inactivity contributing to the economically active population rising recently at the fastest pace since 2016.

On the other hand, the UK's supply-side continues to face challenges from the repercussions of Brexit and an ageing population (the latter admittedly one shared across the developed world). And while the UK's underperformance compared to some of its peers, particularly the US, implies more room for 'catch-up', that catch-up is not automatic. In practice, copying what's worked elsewhere in delivering growth may entail a degree of disruption to the status quo and/or political risk which politicians, or the electorate, may not be willing to stomach.

13. 'A cost-of-living crisis: Inflation during an unprecedented terms of trade shock', speech by Swati Dhingra at the Resolution Foundation, 8 March 2023. https://www.bankofengland.co.uk/speech/2023/march/swati-dhingra-remarks-on-cost-of-living-crisis-and-inflation-at-the-resolution-foundation

5

The Chancellor faces several obstacles in delivering any Autumn Statement 'giveaways'

We'll get a better idea of whether the economy's performance will be helped or hindered by fiscal policy when the Chancellor delivers his Autumn Statement, one of the biannual fiscal events, on 22 November. But the likelihood is that Hunt will find himself boxed in, with aspirations for any major fiscal action postponed to the Budget next spring. Indeed, the Chancellor has been at pains to dampen expectations of 'giveaways'.[14]

On the face of it, the recent performance of the public finances might suggest otherwise. Public sector borrowing was below the OBR's March Budget forecast in each of the first five months of 2023-2024. Were this undershoot to continue over the rest of the fiscal year, borrowing in 2023-24 would come in a chunky £20b under the £131.6b forecast by the OBR.

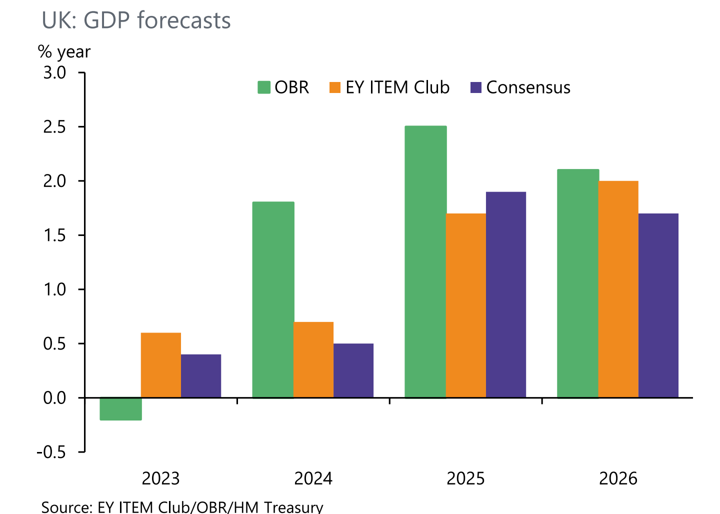
The undershoot so far this year has been driven by unexpected buoyancy in tax receipts. Income tax revenues have benefited from strong pay growth, and VAT revenues have been boosted by real consumer spending proving more resilient than anticipated and high inflation increasing the size of the nominal tax base. Public spending has also exceeded the OBR forecast, but to a lesser extent. The effect of inflation on the cost of index-linked government debt and spending on public sector pay agreements has been the main drivers of the spending overshoot.

But better news in recent months does little for the Chancellor's room for manoeuvre. The government's fiscal rules require that both public sector net debt is falling and public sector net borrowing does not exceed 3% of GDP by the fifth year of the OBR's forecast period (2027-28 in the March Budget). Short-term movements in the public finances have therefore little bearing on the overall stance of fiscal policy, unless those movements are judged to have permanent drivers.

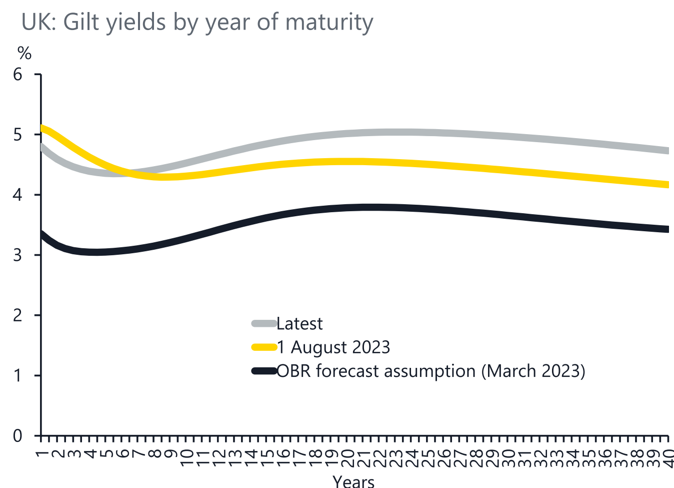
In March, the OBR forecast that the government would meet its fiscal rules, but only by narrow margins (the debt target by 0.2% of GDP and the borrowing goal by 1.3% of GDP). But for the autumn fiscal event, there's a good chance that, based on current policy, the OBR will deem the government in breach of its fiscal rules.

For one, although real GDP growth this year is on course to beat the OBR's forecast of a 0.2% contraction by a substantial margin, its projections for growth of 1.8% next year and 2.5% in 2025 are now looking too optimistic. We expect an expansion of 0.7% and 1.7%, respectively, while the consensus of 0.6% and 1.6% is weaker still. Taking the consensus view, and applying the OBR's ready-reckoners, weaker growth could increase government borrowing by around 1% of GDP by 2026-2027.

Higher-then-expected interest rates represent a second adverse development since the Budget. The OBR's forecast for debt interest payments is conditioned on market expectations for Bank Rate and gilt yields prevailing at the time of its projections. In March, market pricing implied that Bank Rate would peak at 4.3% in Q3 2023 before falling back to 3% by 2027. But rates have risen to a much greater extent than the OBR assumed. Bank Rate has probably peaked at its current 5.25%, and investors expect it to fall to 3.7% by 2027.



14. Christy Cooney and Nick Eardley, 'Tax cuts 'virtually impossible' at present, says Jeremy Hunt', BBC News, 22 September 2023. https://www.bbc.com/news/uk-politics-66886514



Source: EY ITEM Club/OBR/Bank of England

Meanwhile, as of mid-October, gilt yields were over a percentage point higher across the maturity spectrum compared to levels in March. Overall, we think the OBR's next forecast could show spending on servicing public debt around £20bn or 0.7% of GDP in 2027-28. The spending side of the ledger also faces other pressures, including dealing with an ongoing rise in hospital waiting lists, the cost of making safe public buildings identified at risk from the use of potentially collapse-prone lightweight concrete and, if the pensions 'triple-lock' is maintained, an 8.5% rise in the state pension next April.

For sure, changes to the OBR's forecast are unlikely to be all bad news. Inflation this year and next is set to be higher than OBR projected, and the official forecaster is likely to assume that the effect on the price level, and hence the size of the cash economy, will be permanent. This should feed through to structurally higher forecasts for income tax, VAT and corporation tax receipts. The freezing of the personal allowance and higher-rate thresholds of income tax provides an illustration of the fiscal boon high inflation has provided, in some respects. When this policy was announced in March 2021, it was projected to raise just over £8bn in 2025-26. The OBR's most recent forecast is that it will raise almost £24bn in that year.

Meanwhile, that the target year for the fiscal rules will roll on by one year to 2028-2029 might give the Chancellor a little more wiggle room. Furthermore, even if the medium-term fiscal forecasts deteriorate, this will not automatically preclude the government from loosening policy in the short term. It's plausible that the government could loosen policy in fiscal year 2024-2025, then pencil in more austerity for the four years after the election. Granted, the degree of spending restraint already planned for future years looks very hard to deliver in practice. But with the Conservative party so far behind in the opinion polls, the government will likely take the view that implementing post-election plans is either an issue to be tackled when the time comes or a problem for a future Labour government to deal with.

From a macroeconomic perspective, probably the most important constraint on fiscal policy is not the OBR's next forecast but the BoE's judgement, whether right or wrong, that the economy currently has little or no spare capacity. This means the BoE could respond to any significant fiscal loosening by tightening monetary policy further or signalling that interest rates will stay high for longer. Of course, the prospect of a different balance between fiscal and monetary policy isn't an insuperable obstacle to the Chancellor choosing to go for significant tax cuts or spending increases. But with memories of the fate of the Truss government still fresh and the media already full of bad news stories about the pain of higher mortgage rates, Hunt is unlikely to want to take that risk.

This leaves the Chancellor with the option of taking with one hand and giving with the other, while keeping the overall fiscal stance unchanged. One option which ministers have reportedly considered is to reduce working age benefits in real terms.[15] Using some of the £36b saved from axing the northern leg of the HS2 high-speed rail line to Manchester is another. Meanwhile, the tax system isn't short of tax breaks and allowances for businesses.[16] Curtailing or abolishing these could raise several billions for headline tax cuts. And tax breaks for firms are dwarfed by those aimed at individuals.[17]

But overall, we think the Autumn Statement will probably prove an unusually headline-free fiscal event. With the next general election approaching, the government will no doubt be hoping that the economic and fiscal backdrop to next spring's Budget proves more favourable. And given the needs of the political business cycle, it's hard to see how the Budget won't deliver some form of fiscal loosening.

15. 'George Parker and Chris Giles, 'UK ministers explore cutting working-age benefits in real terms', Financial Times, 8 September. https://www.ft.com/content/87954077-da72-4977-aed7-ac264dafe9af
16. OECD, 'Quantifying Industrial Strategy: United Kingdom Factsheet'. https://www.oecd.org/industry/industrial-policy-and-strategies/quantifying-industrial-strategies/QuIS_UK_Factsheet.pdf
17. HMRC, 'Non-structural tax relief statistics', 1 August 2023. https://www.gov.uk/government/statistics/main-tax-expenditures-and-structural-reliefs/non-structural-tax-relief-statistics-january-2023

6

Conclusions

In a sense, September's narrative-shifting revisions to GDP have changed everything and nothing. The economy enjoyed a much stronger recovery in 2021 than we'd believed, but that acts to cast the recent period of weak growth in a gloomier light. And it's hard to see how 'bumping along the bottom' won't continue to characterise the UK's performance for the rest of this year and into 2024.

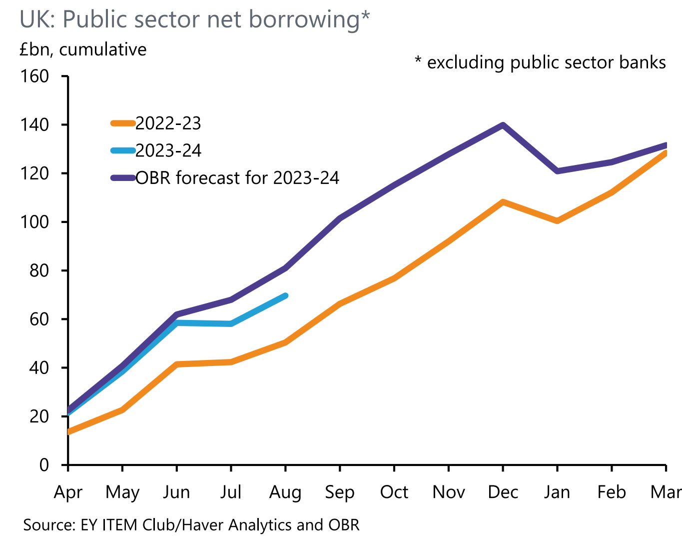
While interest rates look to have peaked well below what many had expected, the lagged impact of previous rate hikes continues to come through to the detriment of activity, employment and the housing market. The global rise in long-term interest rates, if its sustained, could exacerbate this. Meanwhile, the recent fall in inflation is vulnerable to overseas developments over which the UK has little influence; higher oil prices are a case in point. And current fiscal policy settings are imposing more pain on taxpayers than had been anticipated, something which the Autumn Statement is unlikely to do much to relieve.

But we continue to think that the positives enjoyed by the UK should keep recession at bay and prompt a return to more meaningful growth in the second half of 2024. Inflation should continue to head down, average wages are rising again in real terms, household and corporate balance sheets remain unusually healthy, and we think monetary and fiscal policy will likely loosen next year. The UK's post-pandemic performance remains weaker than some of its peers, suggesting that UK GDP still has the potential to catch up. And the recent strength of business investment signals that the economy's growth potential may be reviving.

7

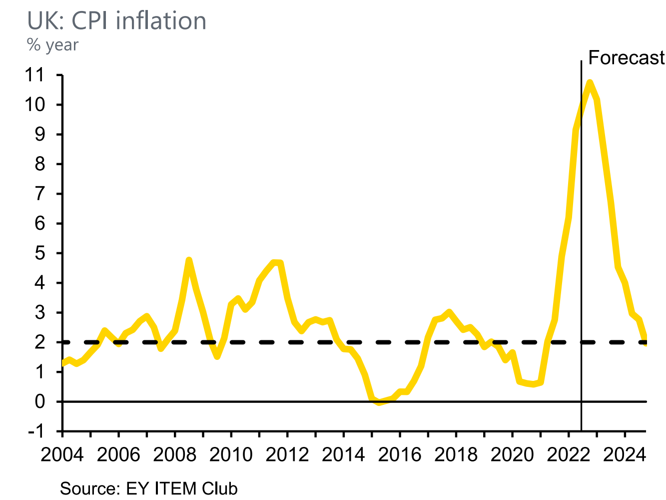
Forecast in charts

Fiscal policy



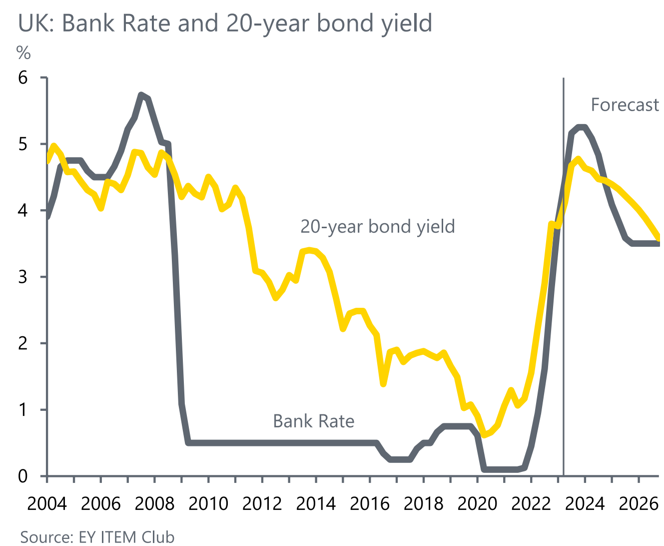
- Public sector net borrowing has continued to undershoot the OBR's forecast. As of August, borrowing in the fiscal year-to-date was £11.3b less than the OBR expected.
- Tax receipts have been boosted by the economy's resilience and the effect of high inflation. This has more than offset higher-than-forecast public spending.
- But that the OBR is likely to turn gloomier on the economic outlook, plus higher interest rates, mean the Chancellor will struggle to meet his fiscal rules.

Prices



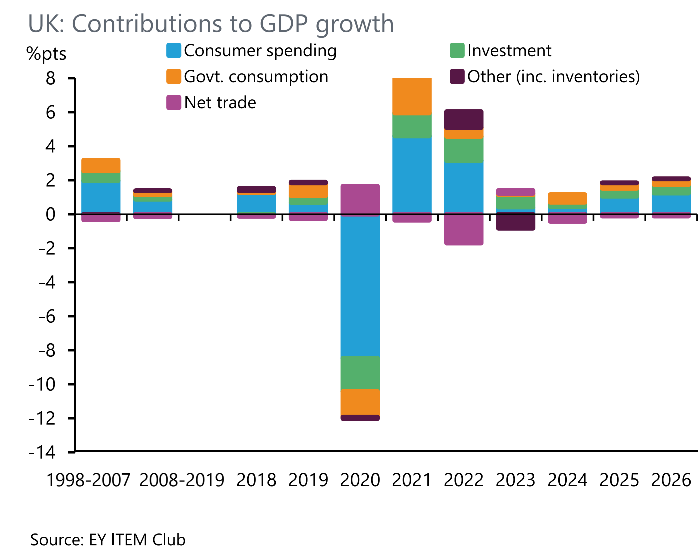
- Inflation declined faster than expected over the summer. The CPI measure fell to 6.7% in August, the lowest since February 2022.
- Inflation should continue to fall, reflecting a cut in energy bills in October, easing food price inflation and the lagged effect of outright falls in producer prices.
- However, the recent jump in oil prices, if sustained, may slow the descent. Overall, we expect the CPI measure to drop to around 4.5% by the end of this year and fall to the BoE's 2% target by autumn 2024.

Monetary policy



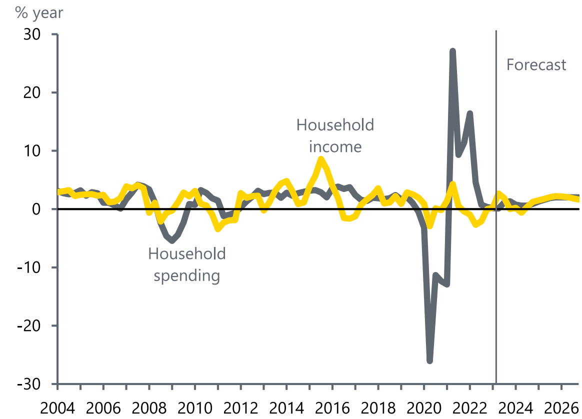
- After 14 consecutive rises in Bank Rate, the MPC voted to hold the policy rate at 5.25% in September's meeting.
- We think this should prove the peak. Inflation is likely to continue falling, helped by lower energy bills and easing food price inflation. And the drag from past rate hikes is building.
- But rate cuts are likely to have to wait until towards the middle of 2024. Pay growth remains strong and a data dependent MPC will probably want consistent evidence this is slowing before loosening policy.

Activity



- Revisions to past GDP numbers mean that the economy in Q2 2023 is now estimated to have been 1.8% larger than its pre-COVID-19 size versus 0.2% smaller previously.
- But GDP has still seen only modest growth since early 2022. And we expect that to remain the case for the next few quarters.
- More people are seeing large rises in mortgage payments, fiscal policy settings remain tight and the labour market is weakening. The economy still has some positives, but we forecast growth of only 0.6% this year and 0.7% in 2024.

Consumer demand

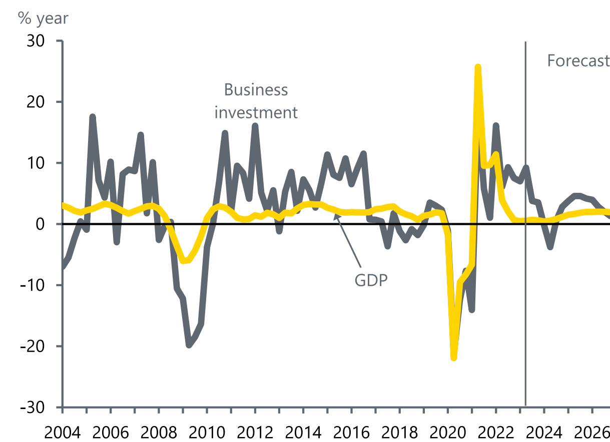


- Consumer spending rose 0.5% in Q2 2023, helped by a surprisingly strong rise in real household incomes.
- Falling inflation, lower energy bills, a return to growth in real wages and a rise in interest income on savings all present positives for consumption.
- But a rise in mortgage payments for many households, higher petrol prices and a weaker jobs market will counter these upsides. We expect consumer spending to rise 0.7% this year and by the same amount in 2024.

Housing market

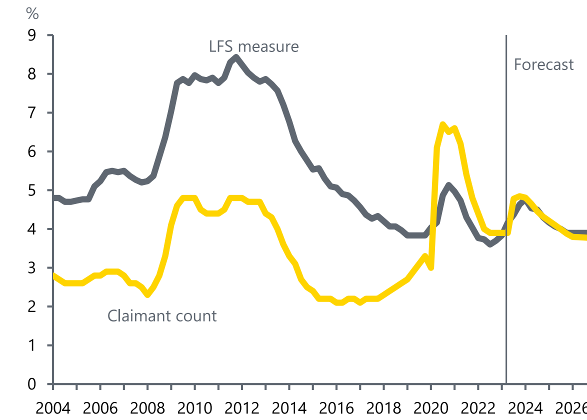
- House prices declined over the summer and early autumn. An average of the Nationwide and Halifax gauges showed prices in September 4.5% down on the peak last autumn.
- Quoted mortgage rates have eased recently but are still very high by the standards of the past decade. And a weaker jobs market is another headwind to housing activity.
- On the other hand, the ratio of house prices to average incomes has fallen. And lender forbearance should reduce forced sales. We expect average house prices to broadly flatline this year, before falling by around 4% in 2024. This implies a peak-to-trough drop of around 10%.

Company sector



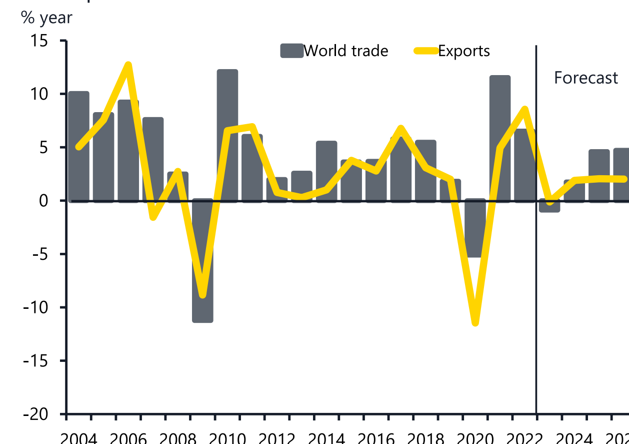
- Business investment rose 4.1% q/q in Q2, building on the first quarter's strong gain. This left the level of investment 8.5% above the pre-COVID-19 level in Q4 2019.
- Increased digitisation, measures to improve energy efficiency and government tax incentives offer positives for investment growth going forward.
- But a steep rise in corporate borrowing costs and continued sluggishness in the economy mean we're doubtful recent strong growth will continue. Business investment is forecast to rise 5.9% this year but fall modestly in 2024.

Labour market and wages



- The labour market has recently shown more signs of weakening. The unemployment rate rose to a 23-month high over the summer and employment and job vacancies fell.
- Headline wages growth has remained strong, but other measures have suggested that strength may be on the turn.
- We expect the unemployment rate to continue increasing, peaking at around 4.8% early next year.

Trade and the balance of payments



- Trade flows have continued to be volatile, driven by movements in non-monetary gold and changes in the method the ONS uses to measure imports from the EU.
- Excluding trade in precious metals, the current account deficit widened to 4.2% of GDP in Q2 2023 from 3.2% in Q1, reflecting a fall in net investment income.
- Sluggish growth in the UK's major export markets, mainly reflecting the impact of tighter monetary policy, will hold back exports. But the recent weakening in sterling should support net trade.

EY | Building a better working world

EY exists to build a better working world, helping to create long-term value for clients, people and society and build trust in the capital markets.

Enabled by data and technology, diverse EY teams in over 150 countries provide trust through assurance and help clients grow, transform and operate.

Working across assurance, consulting, law, strategy, tax and transactions, EY teams ask better questions to find new answers for the complex issues facing our world today.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via ey.com/privacy. EY member firms do not practice law where prohibited by local laws. For more information about our organization, please visit ey.com.

© 2023 EYGM Limited.
All Rights Reserved.

EYSCORE 009488-23-UK
ED None

UKC-031015.indd (UK) 10/23. Artwork by Creative UK.

In line with EY's commitment to minimize its impact on the environment, this document has been printed on paper with a high recycled content.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax, legal or other professional advice. Please refer to your advisors for specific advice.

ey.com/uk/item