EY ITEM Club Winter Forecast

Light at the end of the tunnel

January 2024

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Foreword

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As we enter a new year, it's natural that we start to look for signs of that (much-used term) 'green shoots' of recovery. These are few and far between, but there are some. While recent data (particularly December's retail sales) suggests that the UK economy could have experienced a mild technical recession in the second half of 2023, there are some genuine reasons to be (slightly) more positive about prospects for 2024.

This time last year, the consensus was that the UK economy would face a recession in 2023 (indeed, the EY ITEM Club's January 2023 forecast for a contraction of -0.7% for 2023 was slightly more optimistic than the consensus at that time). The economy very much surprised to the upside, posting some robust growth figures in the first half of the year, and whilst activity slowed again in H2, growth for 2023 as a whole is likely to be 0.3% even if it did slip into recession towards the end of the year. This is pretty consistent with what the major European economies appear to have achieved in aggregate – and likely to be much better than some EU member states, for example, Germany, where GDP fell last year.

There have also been recent signs of improving business and consumer confidence in the UK. However, both are more subdued across the EU; therefore, it may be time to start re-pricing the UK economy relative to its peers.

Looking ahead to this year, several tailwinds should support a recovering economy. In particular, the forces that drove the surge in inflation – supply chain constraints and energy market shocks – are receding, with CPI inflation expected to fall to the 2% target by late spring. This will alleviate pressure on business margins and, of course, on consumers, particularly as wage rises are likely to remain robust in the face of a cooler labour market. This should provide a platform for consumer spending to rise by 0.9% this year, which should help consumer-facing businesses and (non-food) retailers, in particular, who have had a challenging few months.

With inflation under control, the Bank of England should be confident to cut rates. The EY ITEM Club now expects 125 basis points of interest rate cuts this year – with the first cut expected in May (if not earlier). This will relieve pressure on mortgage holders and, importantly, lower the cost of corporate borrowing, which contracted for much of 2023 and so, in turn, will support business investment. We should also start to see some recovery in deal markets, which have been subdued for the last 18 months or so due to uncertainty around (and the upward trajectory of) the cost of debt. Finally, falling inflation and lower debt service costs will ease some of the pressures on government finances, leaving scope for pre-election giveaways in the 6 March budget to accompany the already significant measures taken in the Autumn Statement on pensions, benefits, national insurance and the minimum wage.

In this context, the EY ITEM Club has upgraded its forecast for GDP growth in 2024 to 0.9% (up from 0.7% in the autumn) and 1.8% in 2025 (up from 1.7%).

By the end of the year, a new government may well have inherited an economy returning to more 'normal' historical levels of growth and perhaps providing further fiscal headroom for more in the way of tax cuts or additional spending to address the accumulating challenges across the public sector.

However, the optimism does need to be tinged with caution. There are still some considerable downside risks to this outlook. Low unemployment leading to higher wages could cause persistent inflation, central banks may be cautious about rates, whilst geopolitics will remain volatile, with over half the globe's population going to the polls this year. Therefore, although there is general optimism that the UK and, indeed, global economies will achieve a 'soft landing' through 2024 – the uncertainty and volatility will remain, and businesses and households should plan accordingly.

Highlights

- The latest EY ITEM Club forecast shows a UK economy near-stagnant for the last two years but potentially on the cusp of better times ahead. The recent past is more downbeat than envisioned in our last report in the autumn, reflecting downward revisions to growth estimates and a flat performance from GDP over most of 2023. But the future looks more positive, helped by a faster-than-expected fall in inflation, lower energy prices and the prospect of aggressive cuts in interest rates and tax reductions.
- The economy proved much less weak in 2023 than anticipated 12 months ago, avoiding the prolonged contraction predicted by forecasters. But activity has been subdued compared even with downbeat estimates of the UK's potential growth rate. Growth in Q2 was revised down to zero, and GDP fell in Q3, raising the risk of a recession late last year. Improvements in some indicators mean the EY ITEM Club thinks that outcome was narrowly avoided, although we have cut forecast GDP growth in 2023 to 0.3% from 0.6% in the autumn.
- The lagged effect of past rises in interest rates presents a powerful headwind to growth this year. An additional 1.5mn households with fixed-rate mortgages are due to roll on to higher rates by the end of 2024, and increased financing costs for firms will hold back investment. Financial stress will likely grow, leading to more home repossessions and corporate insolvencies. Pensioners and those on low incomes will lose out from the end of government cost-of-living payments. And although real pay may now be rising, most households' purchasing power is still materially lower than before the cost-of-living crisis.
- However, four developments suggest that 2024 should prove to be the year when the economy begins to escape from stagnation. First, inflation has slowed faster than expected and by more than pay growth, implying a better outlook for real household incomes. Second, oil, petrol and wholesale gas prices have fallen significantly in the last few months, despite the conflict in the Middle East, which is a positive for demand and supply.
- Third, markets have moved from expecting the Bank of England's (BoE) Monetary Policy Committee (MPC) to continue announcing a rise in interest rates, to anticipating 100-125 basis points of rate cuts this year. Market interest rates, including mortgage rates, have fallen in response. Fourth, the tax cuts announced in November's Autumn Statement mean the drag from fiscal policy will be less than previously expected. And the Budget on 6 March will likely deliver more on that front. Bringing these developments together, we now think the economy will grow 0.9% in 2024 and 1.8% in 2025, up from 0.7% and 1.7% previously.
- The fall in inflation in the year to December 2023 was the second-biggest of any December-to-December period since 1950. But the major slowdown in economic activity and rise in unemployment that has often been a side effect of rapid disinflation has not so far happened.
- This strengthens the premise that the high inflation of the last few years was a transitory problem driven by temporary supply shocks rather than the fault of structural imbalances in the economy. Inflation is falling rapidly as those shocks have eased, even before much of the impact of higher interest rates has hit. Hindsight, therefore, increasingly suggests that the MPC may have overtightened monetary policy.
- The dominance of fixed-rate mortgages, healthy household and corporate balance sheets and the rise in private sector savings during the pandemic have allowed the economy to absorb that overtightening without the recession and unemployment that a major rise in interest rates may have caused in the past.
- We think the MPC will start to row back from previous 'high for longer' rhetoric when it meets next in February. Our forecast sticks with the first cut in Bank Rate happening in May, but we now expect rates to fall by a cumulative 125 basis points (bps) in 2024, versus 100bps previously. This would leave Bank Rate at 4% by the end of this year.
- Higher interest rates have also yet to trigger the scale of falls in house prices expected at the start of 2023. Property values have declined, but a drop of around 2% in the year to Q4 was surprisingly modest, albeit bigger after adjusting for inflation. Higher borrowing costs have cut demand, evidenced by weakness in mortgage lending and approvals. But demand from cash buyers partly stepped into the breach. Meanwhile, forced sales have been limited by strong household finances, still-low unemployment and greater forbearance by lenders, whilst the supply of properties has also been held back by a fall in new-builds.
- With the jobs market still looking reasonably healthy and mortgage rates heading down, we now think house prices will stagnate this year rather than fall further. This would leave the housing market experiencing the same soft landing we expect for the wider economy.

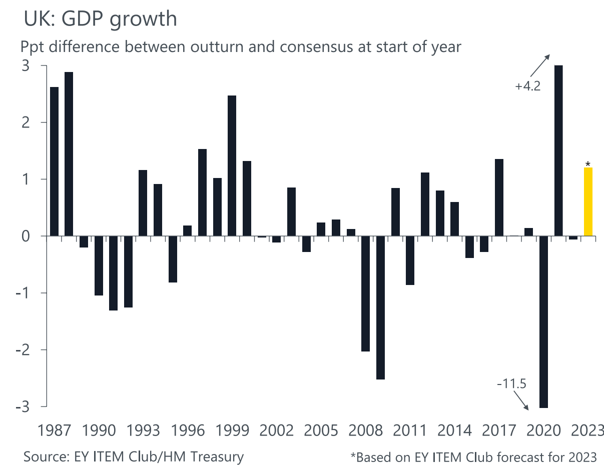
1 Introduction

Talk of the UK being a 'stagnation nation' tallies with a lack of any meaningful economic growth since early 2022, a trend that has continued since the EY ITEM Club's last forecast in the autumn of 2023.

Zero growth in GDP in Q2 2023 (revised down from +0.2% previously) and a small fall in output in Q3 were the latest in a line of disappointing outturns and left the economy in Q3 slightly smaller than at the start of 2022. This was the weakest performance outside a recession since records began in 1955. Judging by high-frequency data, that poor performance may have seen some improvement in the final quarter of 2023. But that the economy fell into a mild recession is now a serious possibility. And the impact of the chief headwind facing the economy — the biggest rise in interest rates since the early 1980s — is continuing to filter through to households and firms.

But before the gloom settles in too much, the economy has performed much less poorly over the last 12 months than forecasters were expecting at the start of 2023. In January of last year, the consensus among professional economists was that GDP would shrink by 0.9% in 2023.[1] We were less pessimistic, but only marginally so. In the event, the economy looks to have grown by 0.3%. This would be one of the largest outperformances relative to the consensus since the late 1990s, excluding 2020 and 2021, when COVID-19 lockdowns muddied the outlook.

The UK's performance has also exceeded expectations relative to those of its European peers. Last January, the IMF predicted that the UK economy would shrink 0.6% in 2023 versus



growth of 0.7% in France, 0.6% in Italy and 0.1% in Germany.[2] But the UK looks to have outperformed Germany, where GDP dropped 0.3%. And whilst the current consensus suggests UK growth fell short of growth in France (0.8%) and Italy (0.7%), the difference is much smaller than predicted a year ago.

Nonetheless, a weak second half of 2023 presents a poor launchpad for growth this year. But four developments since our autumn forecast mean things are looking more positive. First, inflation has slowed faster than expected and more so than pay growth, implying a better outlook for real household incomes. And that rapid disinflation (the year-on-year fall in Consumer Prices Index (CPI) inflation in the 12 months to December 2023 was the second biggest in over 70 years) has occurred, so far, without a serious cost in lost outputs and jobs. Second, oil, petrol and wholesale gas prices have fallen despite the conflict in the Middle East. Third, markets have moved from expecting the BoE to continue raising rates to anticipating 100-125bps of rate cuts this year. This reappraisal has translated into a decline in market interest rates, including mortgage rates. Fourth, the tax cuts announced by the Chancellor in November's Autumn Statement mean the drag from fiscal policy will be less than previously expected.

As a result, whilst a weaker past means we have cut projected growth in 2023 to 0.3% from 0.5% previously, forecast growth in 2024 has been raised to 0.9% from 0.7%, meaning we remain more bullish than the consensus. Still, this would remain an underwhelming performance even by the subdued standards of the decade running up to the COVID-19 pandemic. Although market interest rates have come down from last summer's peak, the impact of the rise in borrowing costs since late 2021 has still not fully hit the finances and budgets of households and companies. Furthermore, the effect of inflation and frozen tax allowances in pushing people into higher tax brackets means fiscal policy is still set to be a net drag on activity.

Looking ahead, we expect growth of 1.8% in 2025, up from 1.7% in the autumn, reflecting a stronger starting point for next year and support from lower inflation and cuts in interest rates. This is followed by 2% in 2026. But a possible government and economic policy change after the next general election, which must be held by January 2025, clouds the outlook beyond this year.

Our latest forecast report begins with a discussion of recent economic developments. Section 3 examines the key elements of our new forecast. Section 4 looks at the role played by higher interest rates versus other factors in bringing inflation down. Section 5 considers the housing market and how much faith should be placed in recent signs of resilience. Section 6 concludes.

1 HM Treasury, 'Forecasts for the UK economy: January 2023', 18 January 2023. https://www.gov.uk/government/statistics/forecasts-for-the-uk-economy-january-2023

2 International Monetary Fund, 'World Economic Outlook: Inflation peaking amid low growth', January 2023. https://www.imf.org/en/Publications/WEO/Issues/2023/01/31/world-economic-outlook-update-january-2023

2

2023 looks to have been a lost year for growth

The economy shrank in Q3 for the first time in a year

GDP fell 0.1% in Q3 compared with the previous quarter, a little weaker than we had expected and the first drop since Q3 2022. The latest estimates from the Office for National Statistics (ONS) also revised down growth in Q2 to zero from +0.2% previously. Domestic demand in Q3 was soft across the board. Consumer spending fell 0.5% quarter-on-quarter (q/q), and business investment was down 3.2%, giving back some of the strong gains in the first half of 2023.

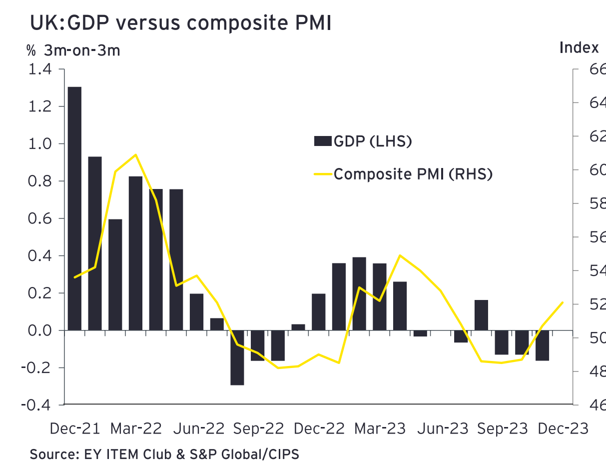
Consumers reined back spending in Q3 despite real household incomes rising 0.4% q/q. This second successive quarterly increase in real incomes reflected a further decline in inflation and still strong pay growth. The net result of higher incomes but lower consumption was an increase in the household saving ratio in Q3 to 10.1%, a nine-quarter high.

On an output basis, activity in some sectors, notably transport and the public sector, was held back by strikes. The number of working days lost to industrial action in Q3 was slightly up on Q2. Hence, the economy's underlying performance was probably not quite as poor as the headline picture suggested.

Q4 offered some positive signs, but a technical recession is a real risk

GDP data for Q4 won't be published until mid-February. But another quarter of growth hovering around zero looks a strong bet. GDP rose 0.2% month-on-month (m/m) in September but then fell 0.3% the following month, with output dropping across services, manufacturing and construction. Excluding the public sector, where activity continued to be impacted by strikes, market-sector output fell to the lowest since December 2022.

However, the tail-end of 2023 also yielded some positive developments. GDP rose 0.3% in November, a little faster than forecasters had expected. Retail sales fell in September and stagnated in October but bounced back in November. The composite Purchasing Managers' Index (PMI) rose above the 50 'no-change' mark in the same month for the first time since July. The PMI climbed further in December to a six-month high of 52.1, a level consistent, given past form, with modest GDP growth. And inflation's downward trend has broadly continued. The CPI measure declined to 3.9% in November, the lowest in over two years, although then ticked up to 4% in December.



Meanwhile, the GfK measure of consumer confidence rose in December to the second highest since January 2022. The ONS's weekly Opinions and Lifestyle Survey has continued to suggest that household financial distress connected to energy prices, mortgages and rent has seen little increase since early 2022. That the household saving ratio rose over 2023 is also a promising signal that most of the population has coped with the cost-of-living crisis.

Signs that weakness in housing market activity may have bottomed out have also emerged, helped by expectations that interest rate rises are now at an end. Whilst mortgage approvals have remained unusually low, they increased in October for the first time in four months and rose further in November. And falls in the Nationwide and Halifax measures of house prices earlier last year reversed a little in late 2023. This left values in December a bit higher than last January, albeit down 3%-3.5% from peaks in autumn 2022.

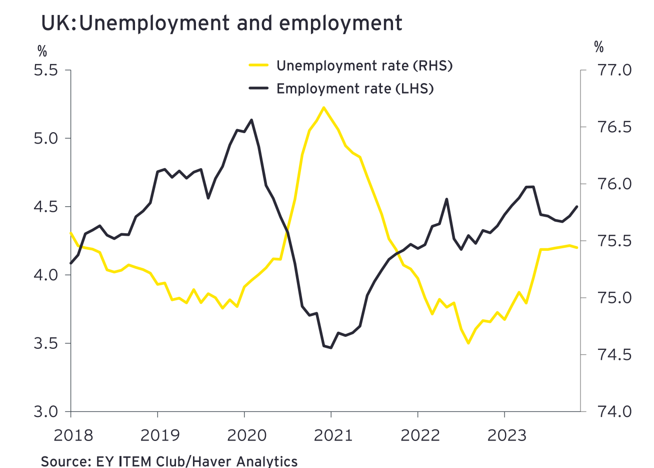
The jobs market has been flat, although data issues cloud the picture

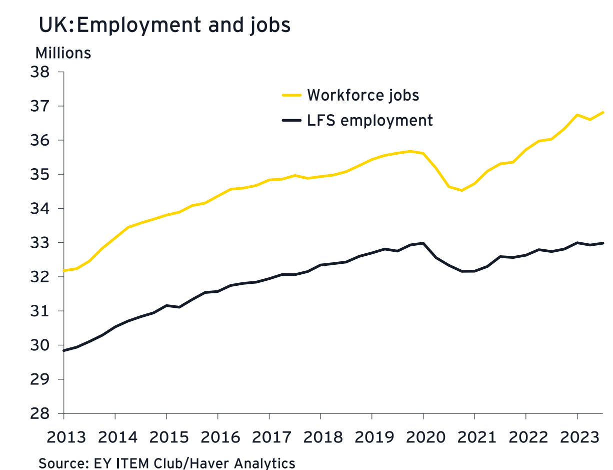
Interpreting the labour market has been complicated by the ONS decision in October to suspend temporarily the Labour Force Survey (LFS) used to produce the official measures of unemployment and employment. The suspension was prompted by concerns over the reliability of the survey following a fall in response rates, which accelerated at the onset of the COVID-19 pandemic but had been underway since much earlier.

In place of the LFS, the ONS introduced experimental labour market data using HMRC PAYE data on payrolled employees to estimate changes in employment and claimant count jobless data to calculate changes in unemployment. Issues with both measures mean the new approach has limitations. Not all unemployed people are eligible for Jobseekers Allowance, which is used to calculate the claimant count measure. Furthermore, the PAYE data is prone to large revisions for several months after publication, implying that recent estimates could be revised to a greater extent than the previous LFS numbers.

According to the new experimental estimates, the key indicators of unemployment and employment have both been broadly stable in recent months. An unemployment rate of 4.2% in the three months to November was unchanged from the three months to July, while an employment rate of 75.8% was a little higher. The inactivity rate for those aged 16–64 fell a little to 20.8%, bringing it back in line with the pre-pandemic 2019 average after rising during the pandemic. But the fact that the ONS stopped measuring inactivity directly after the suspension of the LFS means the latest numbers, and what they tell us about the economy's supply capacity, should be interpreted with caution. The ratio of unemployment to vacancies rose a little in the same period to slightly above levels seen just before the pandemic, accounted for mainly by a fall in vacancies.

Workforce jobs numbers, which are based on employers' surveys and so separate from the LFS, have also been relatively stable. But the gap between the two measures has widened, with the workforce jobs gauge in Q3 2023 3.4% higher than the pre-COVID-19 level in Q4 2019, suggesting a boom in job creation. In contrast, the LFS measure and the recent experimental data showed no change in employment over the same period.





2023 looks to have been a lost year for growth

Meanwhile, momentum in pay growth has cooled, if from a high level. Headline (three-month average of the annual rate) total pay growth slowed to 6.5% in November from 7.2% the previous month and a peak of 8.5% last summer. Some of the slowdown reflected NHS and civil service bonus payments falling out of the calculation period. However, the underlying trend has also been down. Regular pay growth eased to a ten-month low of 6.6% in November.

Interest rates have remained on hold, but the MPC has stuck to hawkish language

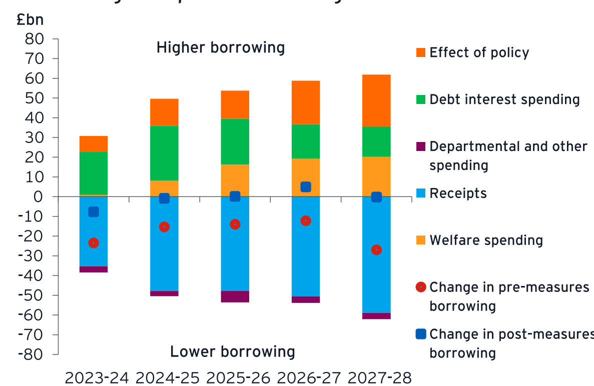
Monetary policy has been on hold since the autumn. December's Monetary Policy Committee (MPC) meeting delivered a 6-3 vote in favour of keeping Bank Rate unchanged at 5.25%, the third such decision in a row. But policymakers continued to push back strongly against any expectations of rate cuts in the near term.

In particular, the majority in December repeated the mantra of previous policy statements "that monetary policy was likely to need to be restrictive for an extended period of time".[3] There was also an effort to downplay the significance of recent downside surprises for services inflation (which, according to the MPC, was due to "components that might not provide a good signal of underlying trends") and private sector wage growth.

The Chancellor used an improved fiscal outlook to cut taxes in the Autumn Statement

November's Autumn Statement, one of the government's bi-annual fiscal events, was the main source of fiscal interest in the last three months. The accompanying forecast from the OBR showed a better medium-term fiscal outlook than the official forecaster's previous forecast, published alongside the March 2023 Budget. This reflected the boost to tax receipts from higher-than-expected inflation and earnings and the latter's interaction with the ongoing freeze in income tax thresholds.

UK: Changes to public borrowing forecast since March 2023



Source: EY ITEM Club/OBR

The Chancellor took advantage of these improved underlying projections to announce a two-percentage point (ppt) cut in the main rate of employee National Insurance Contributions (NICs), a permanent 100% capital allowance for qualifying business investment, and a package of reforms to welfare and health services designed to increase labour market participation.

The size of 'giveaways' broadly matched the extra fiscal space implied by the OBR's new fiscal forecasts. The OBR cut its forecast for public sector borrowing in 2023–24 to 4.5% of GDP from 5.1% in March. But factoring in the Chancellor's announcements, the predicted deficit in later years saw little change.

However, the Autumn Statement's tax cuts went only part of the way to reversing the much bigger tax rises announced in previous fiscal events, notably the freezing of income tax thresholds. That policy is now forecast to raise almost £30bn in 2025–26, almost four times the sum anticipated when the freeze was first announced in March 2021 and more than three times the size of the cut in NICs.

3. Bank of England, 'Monetary Policy Summary and minutes of the Monetary Policy Committee meeting', 14 December 2023. https://www.bankofengland.co.uk/monetary-policy-summary-and-minutes/2023/december-2023

3 This year should see economic momentum build

Some welcome developments mean we've become less downbeat on prospects for 2024

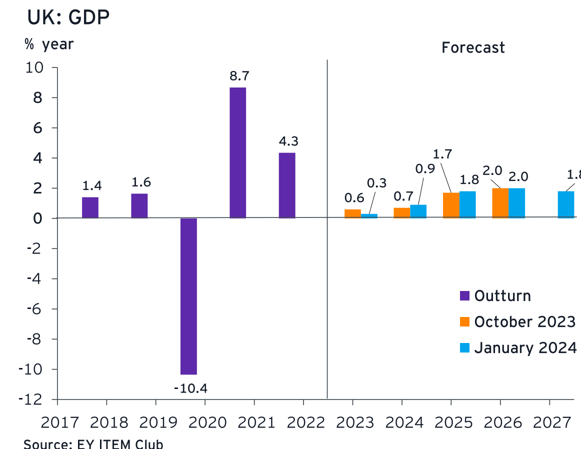
The economy's calendar-year performance this year will be held back by the weak starting point presented by a lack of growth in the second half of 2023. The unexpectedly sharp fall in output in October and more NHS strikes weighing on public sector activity in December suggests a serious revival in activity in Q4, following Q3's small fall in GDP, is unlikely.

That said, the pick-up in the PMI surveys and consumer confidence in late 2023 and what appears to have been a drop in the total number of days lost to industrial action mean we stick with our previous view that the economy eked out marginal growth of 0.1% in Q4.[4] However, Q3's contraction and a downward revision to growth in Q2 means we now think GDP rose only 0.3% last year, down from a forecast of 0.6% previously.

But we have become more positive about the potential for momentum to build moving through 2024. Inflation in 2024 is set to be lower than we'd previously expected, implying a better outlook for real wage growth. The cut in employees' NICs announced in the Autumn Statement, which came into effect on 6 January, along with the reduction in NICs paid by the self-employed due in April, should also offer some support to consumer spending. There's a good chance of more tax cuts in the Budget on 6 March, potentially the last fiscal event before the next general election.

Moreover, markets now anticipate a much more aggressive series of interest rate cuts this year than three months past. This has resulted in drops in quoted mortgage rates and loosened financial conditions, presenting another upside for growth.

UK: GDP



Source: EY ITEM Club

Still, these positives face off against the continued, lagged effect of past interest rate rises. The broader impact of tighter monetary policy will likely keep the housing market subdued and push up corporate insolvencies and unemployment. And tax cuts this year will only offset part of the fiscal tightening already in play, reflecting the end of universal government energy support and the effect of frozen tax allowances in raising the average tax rate faced by some workers.

On balance, we now think the economy will grow 0.9% this year, up from 0.7% in our last forecast. More momentum in activity later this year translates into a stronger base for growth in 2025. This leads us to forecast a rise in GDP of 1.8% (1.7% previously) next year, followed by 2% in 2026, supported by higher employment and investment and a pick-up in productivity growth.

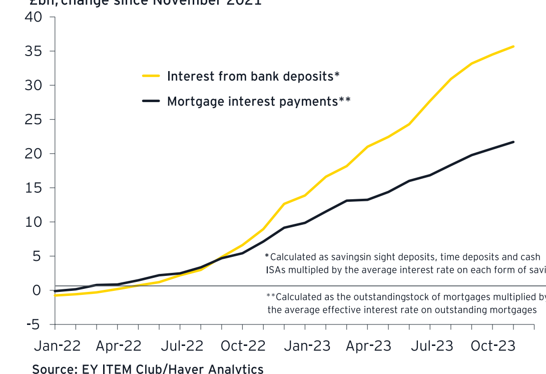
4. According to the ONS, 49,000 workers were involved in labour disputes in October 2023, the lowest number since June 2022.

The pain to households from higher interest rates has still to come through in full

The main driver of our more optimistic view of GDP growth this year is a better outlook for consumer spending. For sure, the pain to borrowers from previous rises in interest rates has yet to reach a peak. Around 5mn or 55% of UK mortgage accounts have repriced since interest rates began to increase in late 2021. Another 1.5mn households (just over 5% of the total) will renegotiate fixed-rate mortgages this year. For the typical borrower rolling off a fixed rate mortgage, monthly mortgage repayments are likely to increase by £150, or around 25%.

The adverse impact of higher rates on the economy has been dampened by the boost to overall household incomes from a rise in interest income on savings. Our estimates suggest that as of Q3 2023, the increase in savings income since the BoE began raising interest rates in late 2021 exceeded the rise in mortgage payments by £15bn, or 0.8% of annual household disposable incomes.

UK:Household interest payments and receipts



Source: EY ITEM Club/Haver Analytics

But support to incomes from higher rates is likely to level off soon, as rate hikes by the BoE have passed through quickly to deposit rates. On the opposing side, a significant number of households with mortgages have still to be exposed to the higher cost of home loans. That savers are likely to have a relatively low propensity to spend interest income will dampen any support to consumption. And our expectation that the BoE will start cutting rates from the spring means interest income is likely to fall faster than interest payments in 2024, the reverse of the situation over the last year or so.

Financial stress among households is likely to increase as a rising number of borrowers refinance. According to UK Finance, the share of owner-occupier and buy-to-let mortgages in arrears by more than 2.5% of the outstanding balance rose in Q3 2023 to a near-eight-year high.[5] At 1% and 0.57% of outstanding mortgages, respectively, these shares were still low by historical standards. But as more borrowers roll off existing deals onto new, more expensive ones, these shares will likely increase. Many borrowers due to refinance also have large mortgages, and the combination of high debt levels and a substantial increase in interest rates threatens to be problematic for some. As of Q3 2023, the average outstanding mortgage was 3.4 times the average household income. This was up from a multiple of three in the global financial crisis of 2008-09 and 1.7 in 2000.

Levels of arrears and repossessions are likely to continue to rise this year, although they should remain well below those seen in the global financial crisis. The buy-to-let sector will remain a particular area of concern – the market expanded strongly in the low-interest rate environment of 2010–19, and the viability of investments in property is likely to be more questionable, with mortgage rates at 5%

5. UK Finance, 'Arrears and Possessions, Q3 2023'. 9 November 2023. https://www.ukfinance.org.uk/data-and-research/data/arrears-and-possessions

This year should see economic momentum build

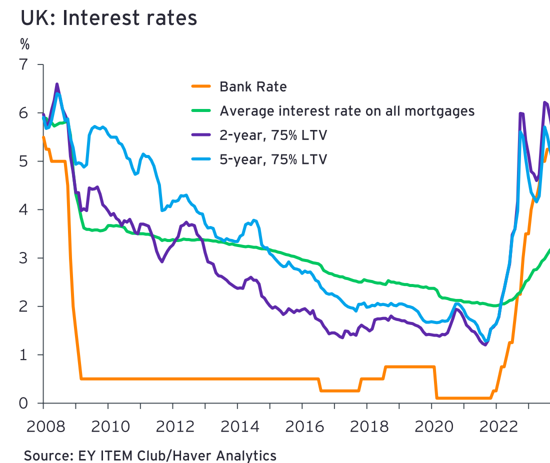
or so. The rise in financial stress among households and buy-to-let investors is also likely to mean more forced sales, putting pressure on house prices. As Section 5 explores, we have become less bearish on how much property values might decline. But, as recent BoE research argued, there's a risk that falling prices could intensify stress by pushing borrowers into higher loan-to-value bands, thus reducing their access to cheaper mortgage deals.[6]

Meanwhile, the boost to household incomes from universal energy support, which added around 3ppts to real household disposable income in both 2022 and 2023, has dwindled as support has been restricted to vulnerable households. And that more targeted support is due to end this spring.

But consumers will gain from the fading of the inflation shock …

However, the obstacle to activity presented by higher interest rates is easing in some respects. Triggered, in part, by recent below-expectation inflation outturns, investors have reappraised the outlook for borrowing costs. At the time of writing, the market interest rate curve was consistent with the first cut in Bank Rate occurring in May and a total of 100-125bps of rate cuts before the close of 2024. When we published our last forecast in October, investors predicted only one 25bps cut this year, and not until the late autumn.

This more dovish view on rates on the part of investors, also evident in a reining back of high-for-longer expectations in the US and eurozone, has translated into a decline in market interest rates and rates on new mortgages. For example, average two- and five-year fixed rate deals for 75% loan-to-value mortgages fell by 33bps and 13bps, respectively, in November. This took total falls to 94bps and 83bps compared with their July peak.

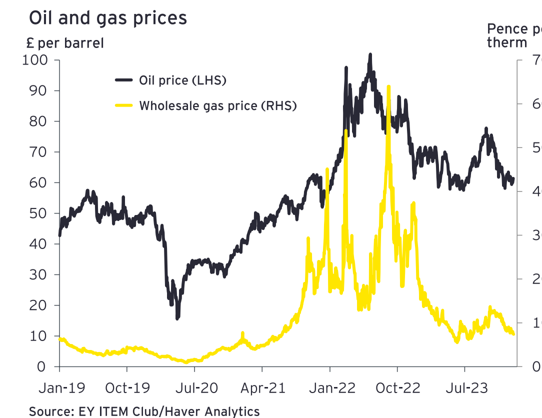


The main factor underpinning this decline in market rate expectations — a steeper-than-expected fall in inflation — implies a better outlook for real household income growth. We now think CPI inflation will return to the BoE's 2% target by May and drop below the target in the second half of this year. Inflation is forecast to average 2.4% in 2024, down from 2.9% in our autumn forecast.

Improved prospects for inflation reflect three factors. The first is the better starting point presented by a surprisingly fast decline in inflation in late 2023. Second, oil prices and wholesale gas price futures have fallen significantly in the last few months.

As of mid-January, oil and gas prices were 20%-25% lower than three months earlier. The price of crude has been pushed down by a combination of slowing global demand, evidence of supply increases from non-OPEC countries, less binding OPEC supply cuts than had been anticipated by market participants, as well as healthy US inventory growth. And nearly full European storage levels going into winter and unseasonably mild weather have put downward pressure on gas prices.

6. Fergus Cumming and Danny Walker, 'Why lower house prices could lead to higher mortgage rates', Bank Underground, 23 November 2023. https://bankunderground.co.uk/2023/11/23/why-lower-house-prices-could-lead-to-higher-mortgage-rates/



Reflecting the fall in crude values, prices at the petrol pumps have fallen to a two-year low. Meanwhile, after the Ofgem energy price cap, which determines the typical energy bill, rose 5% in January, lower gas prices are forecast to result in the cap dropping to £1,660 in the spring, down £268 or 14% from the current £1,928. Another smaller fall is likely in July.[7] After energy bills rose 20% between March and April 2023, the projected cut this April should knock over a percentage point off annual inflation that month, all else being equal.

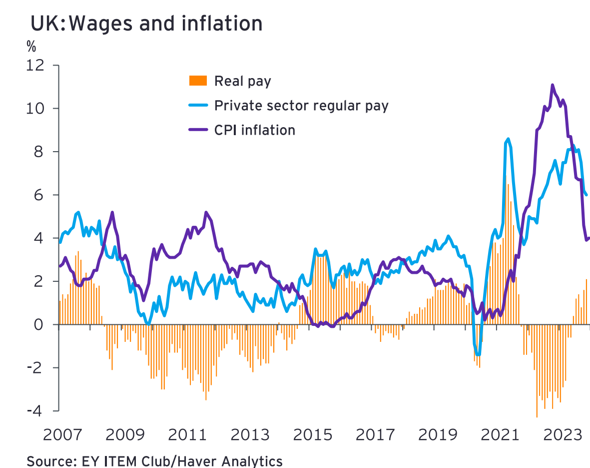
A stronger pound and resulting downward pressure on import prices is a third reason to think inflation will fall faster than previously expected. As of mid-January, the pound was just over 2% higher against the US dollar compared with three months earlier, helped by the US Fed signalling the likelihood of rate cuts this year.

… plus tax cuts and sizeable rises in benefits and the National Living Wage

Households' spending power will also be supported by government action. January saw the 2ppt cut in employee NICs take effect, and a fall in the main self-employed rate from 9% to 8% will follow in April. This will benefit around 30 million workers by an average of around £330 per year. And there's a strong possibility of further tax cuts in the Budget. With the deadline for the next general election approaching, the dictates of the political business cycle point in that direction. And lower market interest rates mean the OBR will probably judge that the Chancellor has a bigger margin of safety against his fiscal rules, giving Jeremy Hunt more room for manoeuvre.

Meanwhile, working-age benefits and pensions in April will rise by 6.7% (reflecting the inflation rate of the previous September) at a point when CPI inflation is likely to be close to 2%. April will also see the National Living Wage (NLW) for those aged 23 and over rise 9.8% from a year earlier. The NLW will be extended to 21- and 22-year-olds for the first time, meaning a 12.4% increase in hourly pay for workers receiving the NLW in this age group.

Granted, we think average pay growth will slow this year compared with 2023's heated pace, mainly reflecting the impact of lower inflation in reining back workers' pay demands and employers' willingness to accommodate big pay claims. However, growth in wages is likely to continue the pattern of the second half of 2023 by outstripping price rises.



7. Cornwall Insight, 'Price cap predicted to fall by 14% in April', 20 December 2023. https://www.cornwall-insight.com/press/price-cap-predicted-to-fall-by-14-in-april/

This year should see economic momentum build

And whilst it's hard to be certain about the state of the labour market given ongoing data problems, most evidence suggests that a stagnant economy has resulted in only a modest rise in unemployment. Labour market conditions have loosened compared with a year ago, but they remain relatively tight by past standards. We expect growing momentum in the economy and the flexibility of the labour market to limit the peak in the unemployment rate to 4.7%.

Overall, nominal household incomes are likely to comfortably outstrip inflation this year. This contributes to an upgrade to our forecast for consumer spending growth to 0.9% from 0.7% in the autumn, followed by 1.8% in 2025, as the fruits of low inflation and falling interest rates build.

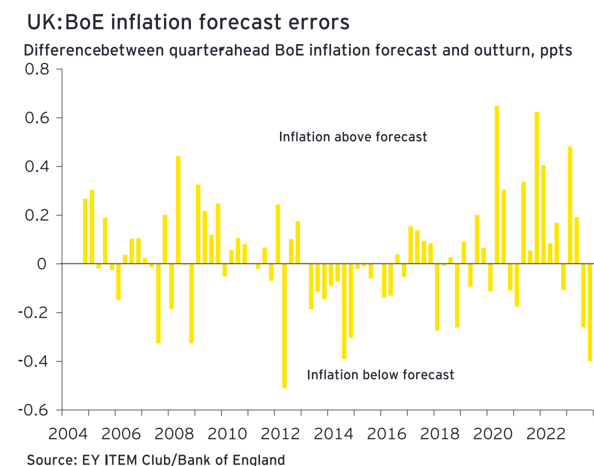
A cut in interest rates in the spring looks increasingly likely

December's MPC meeting was the third in a row to keep Bank Rate at 5.25%. The fact that some members continued to favour higher rates, whilst December's policy statement stuck firmly to the previous high-for-longer rhetoric, implied rate cuts were a distant prospect. But the EY ITEM Club thinks it won't be long before the MPC is compelled to adopt a more dovish tone.

Even before November's downside inflation surprise, a slowdown in pay growth, falls in oil and gas prices and a stronger pound meant the BoE's most recent forecast for inflation had already looked too cautious in terms of the speed at which price pressures would ease. But the extent of the decline in inflation in November means inflation in Q4 undershot the BoE's forecast to a near-record extent. And the economy's recent stagnation suggests the drag from previous interest rate rises is building.

For sure, services inflation and private sector pay growth ended 2023 at levels out of kilter with the BoE's 2% inflation target. However, services inflation has been held up by factors including strong rent growth and mandated price rises in sectors such as telecommunications, which aren't necessarily reflective of underlying economic conditions. Underlying price pressures are easing and should continue, reflecting a sluggish economy and the lagged effect of less expensive energy filtering through to services firms.

UK:BoE inflation forecast errors



On the wages front, growth has slowed from the rapid pace of last spring. On a m/m basis, average growth in the BoE's favoured private sector regular measure fell by more than half from an average of 0.7% from January to May 2023 to 0.3% between June and November. This trend should continue as the jobs market loosens and lower inflation means workers feel less need to demand (and employers accommodate) bumper pay rises.

These developments will likely compel the MPC to change its tone. This should become apparent when it next meets in February. We continue to think that the MPC will go for the first rate cut in May. Our forecast now sees a cumulative 125bps of rate reductions this year, leaving Bank Rate at 4% by the end of 2024. In that event, one of the key headwinds facing the economy will ease.

Business investment has fallen back, and 100% expensing may cause a dip in the short term

A strong performance from business investment in the first half of 2023 went into reverse in H2 2023. After business investment increased 3.8% in Q1 and a further 1.4% in Q3, it fell 3.2% in the third quarter, as previous boosts from the super-deduction tax incentive (which ended in April) and a temporary jump in spending on aircraft faded.

The policy of 100% capital allowances for plant and machinery investment, introduced on a temporary basis for three years in March 2023, was made permanent in the Autumn Statement. Over the medium term, this should result in a higher level of business investment. However, the incentive that existed under the temporary scheme to bring forward investment has now gone. This will weigh on investment growth in the short term versus previous expectations, as will the rise in interest rates faced by firms. This has been reflected in falls in bank lending to firms in late 2023 and signs that rates are becoming a worry to more companies. According to the ONS Business Insights survey, the share of businesses identifying interest rates as their main concern is small but has risen from close to zero in much of 2022 to 7% of businesses in October 2023.[8] Overall, we expect business investment to fall by close to 1% this year.

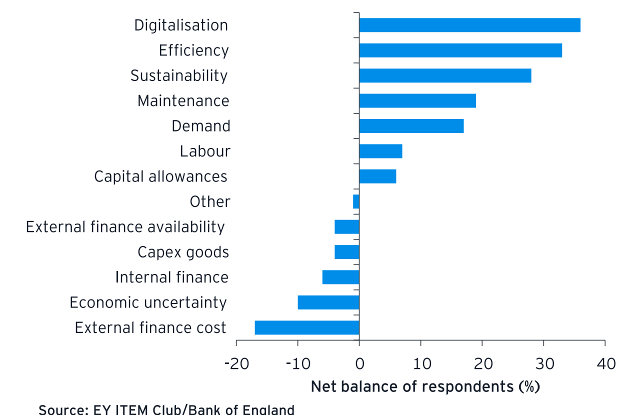
But as with the wider economy, calendar-year weakness is likely to mask a recovery in momentum as this year progresses. Structural factors, including increased digitalisation, investment in artificial intelligence (AI) technologies and a move towards green energy generation and other efficiency measures, should all support investment.

Meanwhile, whilst the cost of finance will be a drag, the recent decline in market interest rates and the prospect of BoE rate cuts mean this headwind should lessen. Healthy corporate balance sheets in aggregate, reflecting strong growth in nominal corporate earnings and a fall in total debt, will also help. For example, the latest data covering Q3 2023 showed UK firms' net debt-to-earnings ratio close to its lowest point in the last 20 years.

Debt and cash holdings are not spread evenly across corporates, so aggregates can mask vulnerabilities for particular firms or sectors. Firms reliant on discretionary consumer spending, such as wholesale trade, or in energy and interest-rate sensitive sectors, such as real estate and construction, are relatively vulnerable to macroeconomic developments. However, the improved outlook means risks from this source have fallen.

Strengthening momentum in the economy and a resulting recovery in business confidence contribute to our forecast of business investment returning to growth in 2025. A rise of 3.2% is forecast for that year, followed by a similar pace in 2026.

UK: Factors affecting investment over the next 12 months



8. Office for National Statistics, 'Business insights and impact on the UK economy, 14 December 2023. https://www.ons.gov.uk/economy/economicoutputandproductivity/output/datasets/businessinsightsandimpactontheukeconomy

This year should see economic momentum build

Global growth looks on course for a soft landing

Despite an aggressive monetary policy tightening across advanced economies over the past couple of years, there's a growing perception that recessions in advanced economies will mostly be avoided and that inflation will ease enough for policymakers to start to cut policy rates this year.

The US economy expanded strongly in Q3 2023, driven by a remarkably buoyant consumer. Since then, there have been signs that the economy has slowed. ISM activity surveys (equivalent to the UK PMI) fell further from their peaks in August and September, whilst retail sales and durable goods orders weakened. The cumulative impact of Fed rate hikes, tighter lending conditions, more restrictive fiscal policy and weakened household finances suggest that the US is likely to face a period of sluggish growth by recent standards. But there's no obvious trigger for a serious downturn.

For the eurozone, the UK's other big trading partner, recent data has shown economic activity to be subdued. Eurozone GDP contracted marginally in Q3. The economy will likely continue to struggle to gain traction in the near term, given headwinds from contractionary monetary policy, the impact of high inflation on consumers' real incomes, weak external demand and an industrial recession. But the consensus is for a gradual recovery to begin in 2024, as lower inflation allows consumers to regain some of their lost purchasing power, the European Central Bank cuts interest rates and financial conditions ease.

Geopolitical risks have increased following events in the Middle East

The main risk to our forecast continues to be external rather than homegrown. Conflict in the Middle East has increased uncertainty around the economic outlook, particularly concerning energy prices. Troubles in the region initially triggered rises in oil and gas prices, but these have since retraced. However, uncertainty around the future cost of energy has risen. Further escalation of geopolitical tensions in the region could cause disruption to oil and gas markets and trade flows. A larger shock to energy prices would lead to higher inflation and increased cost of living pressures on households and businesses.

Domestically, recent developments mean inflation risks have shifted from the BoE continuing to overshoot its inflation target to undershooting it. The danger is that policymakers will be too cautious, or stubborn, in recognising the scale of disinflationary forces and keep monetary policy too tight for too long.

On the upside, falling interest rates and the prospect of the economy beginning to grow again could encourage a faster-than-expected rebound in business investment. That economic data has increasingly undermined the previous narrative of the UK being an outlier among advanced economies in terms of low growth and high inflation could also support a rebound in 'animal spirits'.

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
2021	8.7	9.1	7.4	7.4	4.9	6.1
2022	4.3	4.8	5.0	8.0	9.0	6.1
2023	0.3	0.3	0.6	2.5	-0.1	14.6
2024	0.9	1.1	0.9	0.5	1.4	-1.2
2025	1.8	1.9	1.8	2.4	2.1	2.1
2026	2.0	2.1	2.0	2.6	2.0	2.3
2027	1.9	2.0	2.0	2.4	2.0	2.2
	Net Govt Borrowing(*)	**Current account (% of GDP)**	**Average earnings**	**CPI**	**Bank Rate**	**Effective exchange rate**
2021	5.6	-0.5	6.0	2.6	0.1	81.4
2022	5.6	-3.1	6.2	9.1	1.5	79.6
2023	5.1	-2.4	6.7	7.3	4.7	80.4
2024	3.2	-1.2	3.8	2.4	4.8	81.4
2025	2.8	-1.3	2.5	1.8	3.7	82.1
2026	2.2	-1.5	2.4	2.0	3.3	82.8
2027	1.4	-1.6	2.7	2.0	3.3	83.0

* Fiscal years, as % of GDP

Source: EY ITEM Club

* Fiscal years, as % of GDP

Meanwhile, the next general election, which must be held by January 2025, is looming. The polls continue to point to a Labour Party victory, although as things stand, such an outcome is unlikely to be of much macroeconomic significance, at least initially. Whilst Labour has said that it would raise taxes (via VAT on private school fees and the abolition of 'non-dom' tax privileges), the scale of the proposed increases is very small relative to total revenues. The opposition party has said it would bind itself by fiscal rules that broadly mirror those of the current government, committing to ensuring that tax receipts cover day-to-day spending and that the ratio of public debt to GDP falls by the end of the next parliament.

An initial pledge to spend an extra £28bn on 'green investment' annually until 2030 was postponed until the second half of the next parliament and recent speculation suggests the commitment may be dropped altogether.[9] Labour would also maintain the operational independence of the BoE and the current 2% inflation target. But it's early days, and we have not seen election manifestos. If the polls swung towards a less conclusive election outcome, parties' policy stances could change in more radical directions.

9. Peter Saull, 'Labour denies abandoning £28bn green pledge', BBC News, 5 November 2023. https://www.bbc.co.uk/news/uk-politics-67528894

4 ‘Immaculate disinflation’ raises question marks over BoE rate hikes

To what extent the high inflation of the last two years was a transitory problem or more reflective of underlying structural imbalances in the economy stirred debate among economists during 2023 as well as having real-world implications. Concern that high inflation risked becoming engrained in the economy, rather than being a temporary phenomenon, was what motivated the BoE to raise interest rates 14 times between December 2021 and August 2023.

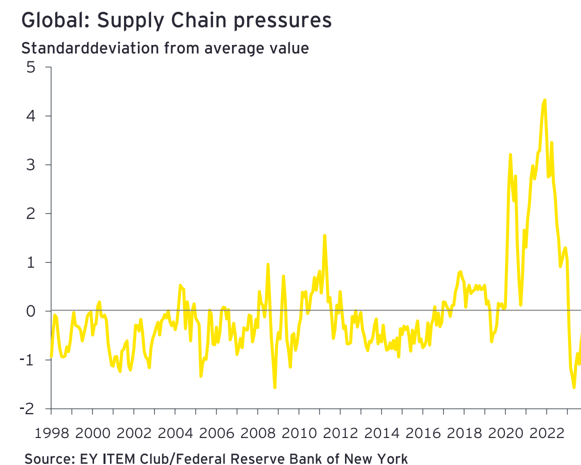
Inflation has fallen faster than expected

But that inflation has tumbled in recent months without the economy and labour market yet suffering serious damage (what some have termed an ‘immaculate disinflation’) has given more weight to the transitory argument and less to the argument that the BoE and other central banks should take the credit for diminishing price pressures.

The UK economy, in common with its peers internationally, was subject to two major external shocks between 2020 and 2022. The first was disruption to supply chains caused by governments’ policy response to the COVID-19 pandemic, which, combined with a shift in global demand during lockdowns to goods from services, drove up the price of goods. The second was a jump in energy prices, which began in 2021 and was then exacerbated by Russia’s invasion of Ukraine the following year.

Both these shocks have faded. A measure of global supply chain pressures developed by the New York Federal Reserve has been at or below its long-run average since early 2023, having been previously multiples above it. And although wholesale gas prices at the time of writing were still double the 2019 average level, they were almost 90% down on the peak in August 2022.

Global: Supply Chain pressures

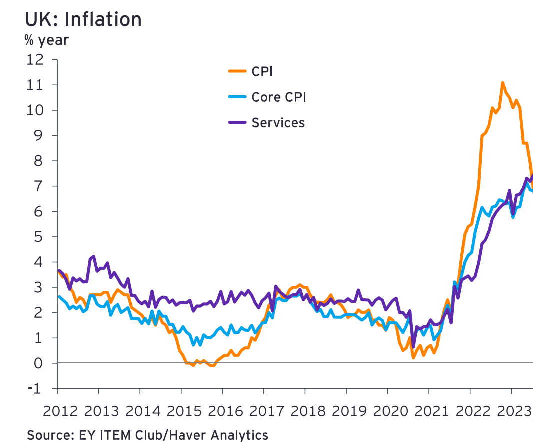


Source: EY ITEM Club/Federal Reserve Bank of New York

Relatedly, the speed at which inflation has fallen has proved much quicker than forecasters expected. In January 2023, the consensus among professional economists was that CPI inflation would average 5% in Q4 2023. We were much less bullish, forecasting a rate of 3.9%.[10] In the event, inflation in Q4 averaged 4.2%. The larger-than-expected fall in November’s CPI measure, to 3.9% from 4.6% in October, proved the trigger for a reappraisal. As recently as November, the BoE was forecasting that inflation would still be 4.4% in the first quarter of 2024 and that it would not return to the Bank’s 2% target until the end of 2025.[11]

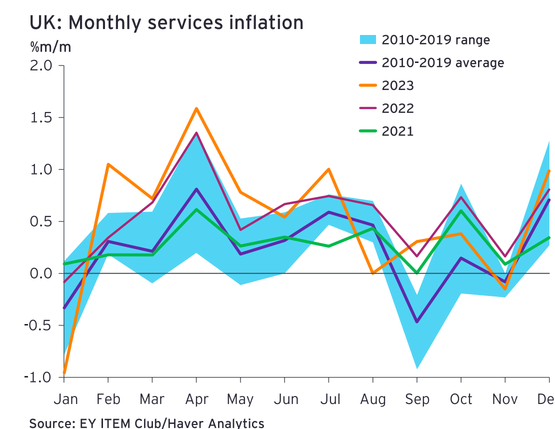
Reassuringly, underlying inflationary pressures have also slowed more quickly than expected. Core inflation, which strips out the volatile fuel and food categories, fell to a 22-month low of 5.1% in November. In the same month, services inflation, which the BoE focuses on as a measure of domestic price pressures, was the weakest since January. Moreover, on a month-on-month basis, services inflation has fallen back into line with the 2010-2019 norm, having previously run well above that norm through most of last year.

UK: Inflation



Source: EY ITEM Club/Haver Analytics

UK: Monthly services inflation



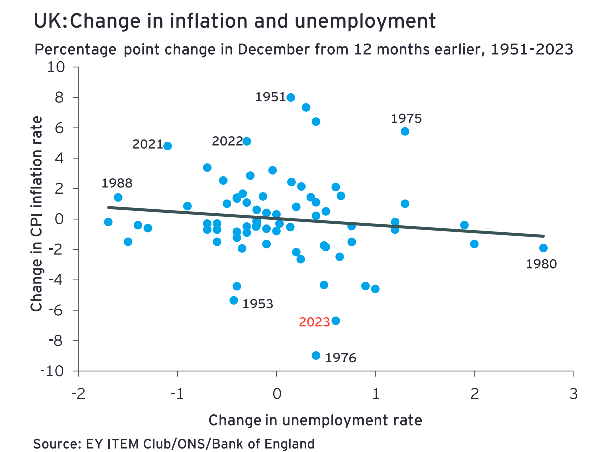
Source: EY ITEM Club/Haver Analytics

Inflation fell significantly in 2023 without a serious economic downturn or rise in unemployment

That the economy’s supply side is healing, and bringing inflation down in the process, is evident from just how much inflation fell during 2023 without being accompanied by a significant rise in unemployment. Over the post-war period, a fall in inflation has typically been accompanied by a rise in joblessness. This makes intuitive sense – if people lose their jobs, spending and demand fall, putting downward pressure on prices.

This lower inflation-higher unemployment link wasn’t absent in 2023. But whilst inflation at the close of 2023 fell by the biggest year-on-year amount of any year since 1951, bar 1976, the rise in the unemployment rate, from 3.7% in December 2022 to a projected 4.3% in the last month of 2023, was only modest and a fraction of what the historical association between inflation and unemployment would have implied. In absolute terms, joblessness ended the year still very low by historical standards.

UK:Change in inflation and unemployment



Source: EY ITEM Club/ONS/Bank of England

One of the main mechanisms of tighter monetary policy to lower inflation is higher unemployment cutting demand. Therefore, unemployment remaining low over the last year makes it hard to argue that rate hikes by the BoE have played a major role in bringing inflation down.

This isn’t to say that higher rates have had no effect. Interest rate rises transfer money from borrowers to savers. By definition, borrowers are more inclined to spend, and savers less so. Raising rates should, therefore, reduce demand. Certainly, the average mortgage borrower rolling off a fixed-rate home loan and who did not take any mitigating action will have seen their post-housing costs income fall relative to a world where rates did not rise.

10. See footnote 1.
11. Bank of England, ‘Monetary Policy Report – November 2023’, 2 November 2023. https://www.bankofengland.co.uk/monetary-policy-report/2023/november-2023

‘Immaculate disinflation’ raises question marks over BoE rate hikes

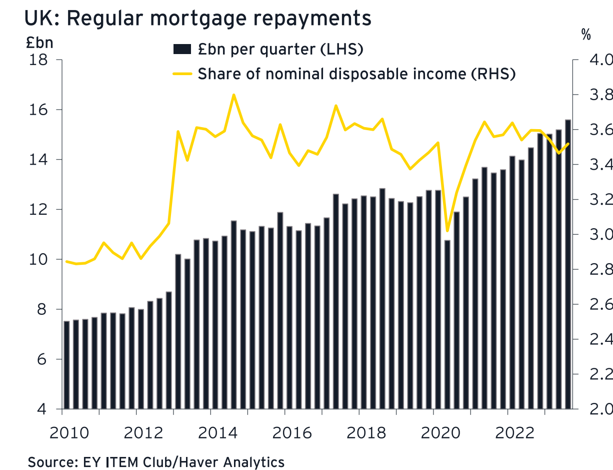
But as section 3 noted, this negative has been mitigated by a rise in households’ net interest income. And a look at spending on mortgage payments suggests that households, overall, have been able to absorb higher mortgage costs without significant financial strain. Strong growth in wages, the boost to some households’ incomes from higher interest receipts and the option taken by some borrowers to extend the duration of their mortgages or move temporarily to interest-only loans have all helped in this regard.[12]

Of course, one could argue that the full impact of previous rate rises has still to come through. But based on the share of households with mortgages who have experienced a rise in borrowing costs, just over half of that impact has occurred, without so far eating seriously into household finances. In cash terms, spending by UK households on regular mortgage repayments in Q3 was 7.7% higher than a year earlier. But this was less than growth in average wages over the same period of 8%. Meanwhile, repayments in Q3 were equivalent to 3.5% of nominal household disposable income. This was unchanged for the third successive quarter and in line with the 2015–19 average, despite the scale of increase in mortgage rates over the last few years.

The ‘great disinflation’ has been a cross-country phenomenon

Less damage from higher rates than feared is the second reason to dispute the suggestion that the BoE should take most of the plaudits for

UK: Regular mortgage repayments

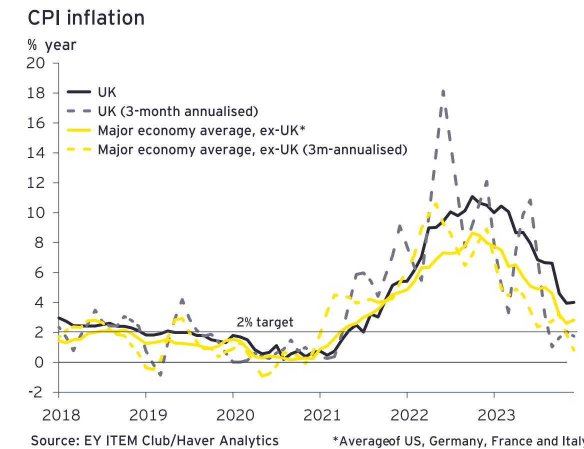


Source: EY ITEM Club/Haver Analytics

lower inflation. A third is that the unexpectedly fast fall in inflation in the UK has also occurred across major economies, also with little impact on unemployment, despite cross-country differences in the timing and extent of rate hikes.

This is particularly clear when looking at inflation on a three-month-on-three-month annualised basis, which picks up recent trends better than the standard year-on-year comparison. On this measure, inflation in December was below 2%, the target set by the BoE, the US Fed and the European Central Bank (ECB) in the UK and across an average of the US, Germany, France and Italy. Arguments made earlier last year that the UK was suffering from a uniquely bad inflation path compared with the rest of the developed world now appear increasingly wide of the mark.[13]

CPI inflation



Source: EY ITEM Club/Haver Analytics *Averageof US, Germany, France and Italy

Recent developments mean it’s no surprise that investors globally have reappraised the likely timing and speed of interest rate cuts. Whether the BoE and other central banks will follow the market view is less clear. Given the reputational damage central banks incurred during the ‘great inflation’ of 2022 and part of 2023, risk-averse policymakers may not cut rates as aggressively as investors expect.

But there seems a good chance that as this year progresses, central banks, including the BoE, will come to recognise that much of the disinflation of the last year would have happened regardless of rate rises and that they over-tightened monetary policy. Criticism of the approach taken by the BoE over the 18 months or so of setting interest rates more based on incoming data and less on the Bank’s inflation forecast (which has generally shown inflation falling back to target, even with interest rates unchanged) is also likely to grow. On that subject, we await Ben Bernanke’s review of the BoE’s forecasting, due to be published this spring, with interest.[14]

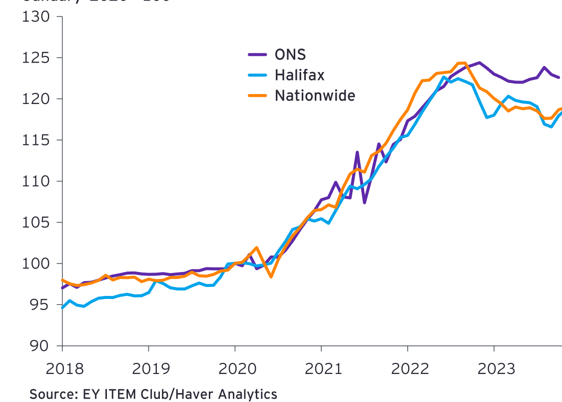
12. For example, according to the housebuilder Taylor Wimpey, 27% of first-time buyers took out mortgages of more than 36 years in mid-2023 compared to 7% in 2021. Among those who had already owned a property, 42% took out mortgages of more than 30 years, compared with 28% in 2021. See BBC News, ‘Housebuilder sees rise in 36-year mortgages’, 2 August 2023. https://www.bbc.co.uk/news/business-66383279
13. For example, see Chris Giles, ‘What can the UK do about its inflation problem?’, Financial Times, 18 August 2023. https://www.ft.com/content/23d87d51-0a9a-485b-bce2-d0ba3b77210c
14. Bank of England, ‘Ben Bernanke to lead review into forecasting at Bank of England’, 28 July 2023. https://www.bankofengland.co.uk/news/2023/july/ben-bernanke-to-lead-review-into-forecasting-at-bank-of-england

5 House prices are likely to stagnate rather than fall further

The correction in house prices has proved unexpectedly modest

2023 began with widespread predictions that property values would see a significant drop during the year, with knock-on and adverse consequences for household wealth, sentiment and consumer spending. In January 2023, the consensus among professional forecasters was that average property values in Q4 2023 would be down 6.5% on a year earlier, with the most pessimistic predicting a drop of almost 10%.[15]

UK: House prices



Source: EY ITEM Club/Haver Analytics

In the event, an average of the Nationwide and Halifax measures was down only 2% y/y in Q4, if a larger 3%–4% below autumn 2022's peak. And with the last few months of 2023 showing a general pattern of m/m rises or flatlining in prices on the two measures, plus a fall in quoted mortgage rates, there seems to be a reasonable chance that the correction in property values may have already come to an end.

True, in real terms, house prices have seen a bigger decline — on that basis, an average of the Nationwide and Halifax measures in Q4 was just over 6% down on the previous year. But inflation ended the year also lower than expected, implying the size of the real terms fall also undershot forecasters expectations.

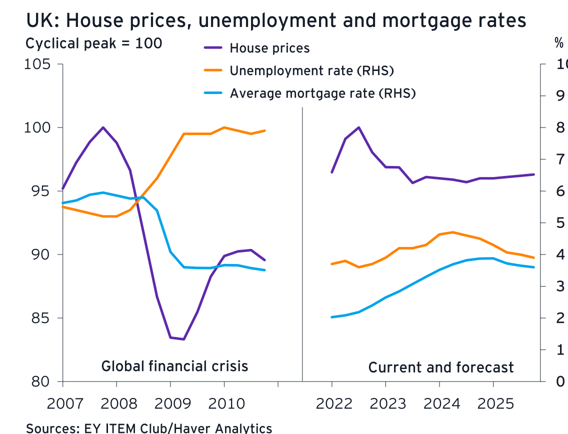
A surprisingly small fall in prices might appear to jar with what has been weak demand for properties. Mortgage approvals in the three months to November were almost a third lower than the average level in 2021–22. But a drop in transactions over the same period of around a quarter wasn't as big, reflecting growth in the share of cash buyers. And lower demand has been offset by a drop in the number of properties for sale. According to the monthly survey from the Royal Institution of Chartered Surveyors (RICS), the flow of new instructions coming onto the market fell in 10 of the 11 months to November 2023.

The economic environment is less threatening than in previous periods of house price falls

Before the present day, the two most recent periods of falling house prices — the global financial crisis and the late 1980s to early 1990s — saw prices falling by 17% and 11% from peak to trough, respectively. Two factors mean the correction this time has been much more modest. First, unemployment has remained low (whilst noting that data issues have hampered our understanding of the labour market). Second, the rise in mortgage interest rates has been much more protracted than in the past, reflecting a shift in the mortgage stock from variable to fixed rate. Both factors have kept forced sales down and limited supply.

The close of 2023 saw some revival in demand for properties, albeit from a low level. This was probably aided by expectations that the latest cycle of rising interest rates had ended and a drop in mortgage rates as investors priced in cuts in Bank Rate this year. We think this recovery should continue as mortgage rates fall further in response to likely BoE rate cuts from the spring, and lower inflation makes for a more predictable macroeconomic outlook. The fact that the ratio of house prices to average earnings is down by

UK: House prices, unemployment and mortgage rates



Sources: EY ITEM Club/Haver Analytics

over 1/10th since the 2022 peak, reflecting a fall in prices alongside strong growth in wages, should also support demand.

On balance, we now think 2024 will be a year of stagnation in house prices rather than further falls, as expected in our autumn forecast. 2025 should then see prices begin to rise again, if slowly. Even if the official BoE policy rate falls in line with our expectations, mortgage rates will still be significantly higher than for much of the last decade. But shifts in the monetary policy outlook mean the key headwind to the housing market should be less onerous than was anticipated only a few months ago.

House price predictions are subject to some big uncertainties

There's considerable uncertainty around our projections. On the upside, the BoE could pivot more dramatically to loosening monetary policy than we have factored in by cutting rates sooner and more aggressively. In that event, mortgage rates could drop faster, reducing the scale of the affordability problem and offering some support to demand.

There's also scope for support from government policy change to underpin prices. Currently, the temporary increase in stamp duty thresholds (initially introduced as a permanent change by the Truss administration in September 2022 but then changed to a temporary concession in the 2022 Autumn Statement) is due to end in March 2025. This would mean the nil-rate threshold falling back to £125,000 from £250,000 and the nil-rate threshold for first-time buyers' relief returning to £300,000 from £425,000.

Though the changes would come into force after the next general election, the current government might see an advantage in delaying this tax increase, abandoning it, or even going further and cutting stamp duty rates or raising thresholds. Although stamp duty is levied on the buyer of a property, the incidence (i.e., who shoulders the burden of the tax) is on the seller. Hence, any moves towards lightening the burden of stamp duty would reduce further the odds of further falls in property values.[16]

A key uncertainty is what's happening in the labour market, with the recent suspension of Labour Force Survey data poking a major hole in our understanding. We expect the flexibility of the UK labour market to cap the rise in unemployment below 5%, which, in turn, should keep a lid on the number of forced sales. But if firms shed jobs more aggressively, this would weigh on house prices by softening demand and increasing the number of forced sales.

The other main downside risk is a larger impact from past monetary policy tightening. If more borrowers get into financial difficulties and are forced to sell their properties, downward pressure on prices will be greater. In that world, lenders might respond by tightening credit conditions, exacerbating the downturn and transmitting weakness in the housing market to the wider economy.

15. See footnote 1

16. Daniel Bentley, 'Stamp duty is a bad tax – but scrapping it will do nothing for first-time buyers', Civitas, 1 July 2019. https://www.civitas.org.uk/2019/07/01/stamp-duty-is-a-bad-tax-but-scrapping-it-will-do-nothing-for-first-time-buyers/

6 Conclusions

Our latest assessment of the UK economy divides between a past gloomier than expected in our last forecast, largely reflecting downward revisions to growth in 2023, but a future which is more positive, mainly thanks to a faster-than-anticipated fall in inflation and its implications for the future path of interest rates.

An easing of the inflationary shocks of the last few years means the economy appears to be on course to achieve an immaculate disinflation — a rapid fall in inflation without serious damage to GDP and employment. That interest rate rises no longer have the powerful economic effect they once had, reflecting changes in the structure of the mortgage market and the deleveraging and extra saving by households and firms during the pandemic, has also helped. Whilst some of the monetary tightening of the last two years has probably been unnecessary, the damage in lost output and jobs has been less than would have followed an equivalent rise in rates a decade or so ago.

Still, the lagged effect of past rises in interest rates, with many households with mortgages still to see the impact on monthly payments, means that a soft landing isn't certain. Indeed, the economy may have fallen into a mild recession at the end of 2023, which, if confirmed, could damage confidence.

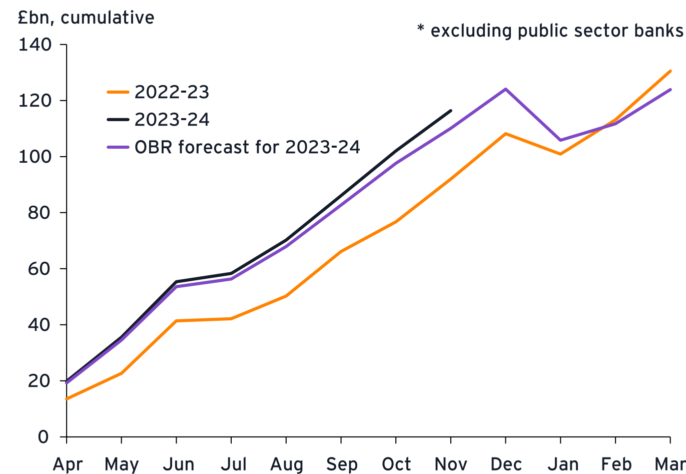
Much depends on whether the BoE recognises quickly enough that it has overestimated the stickiness of inflation and overtightened monetary policy as a result. If, as we expect, it does, a pivot to looser monetary policy in the next few months should avert the risk of a serious downturn and put the economy on a path of gradually increasing momentum.

7

Forecast in charts

Fiscal policy

UK: Public sector net borrowing*

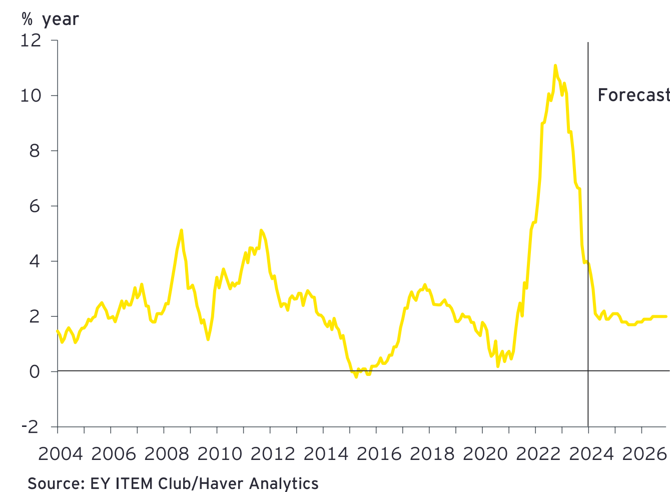


Source: EY ITEM Club/Haver Analytics and OBR

- Public sector net borrowing so far in 2023-24 has come in ahead of the OBR's forecast. Cumulative borrowing in the eight months to November was £116.4bn versus an OBR forecast of £110.1bn.
- However, the gap should narrow over the rest of the fiscal year. Tax receipts continue to be boosted by the interaction of strong wage growth and frozen tax allowances.
- Lower market interest rates should also cut spending on debt interest and give the Chancellor a bigger margin of safety against his fiscal rules in the Budget on 6 March.

Prices

UK: CPI inflation

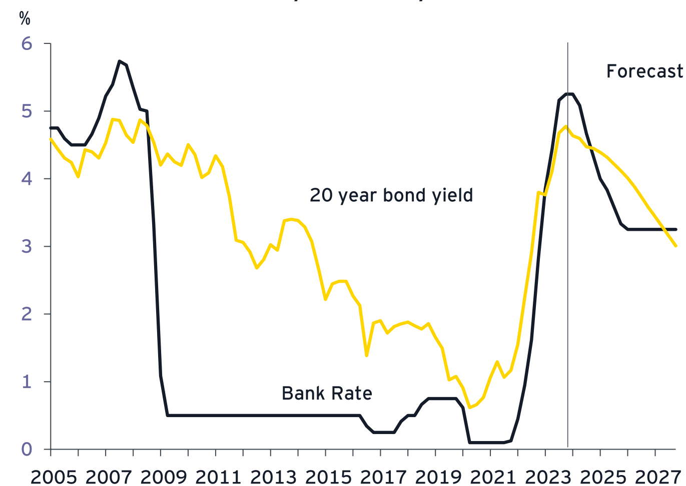


Source: EY ITEM Club/Haver Analytics

- Inflation has generally fallen faster than expected since the autumn. The CPI measure dropped to 3.9% in November, the lowest in over two years, then rose to 4% the following month.
- Most of the decline in headline inflation in 2023 was driven by falling energy prices, which are now largely in the past. However, the broad-based nature of the recent fall in inflation suggests disinflationary forces are becoming more widespread.
- We now expect inflation to fall to the BoE's 2% target by May and end this year slightly below the target.

Monetary policy

UK: Bank Rate and 20-year bond yield

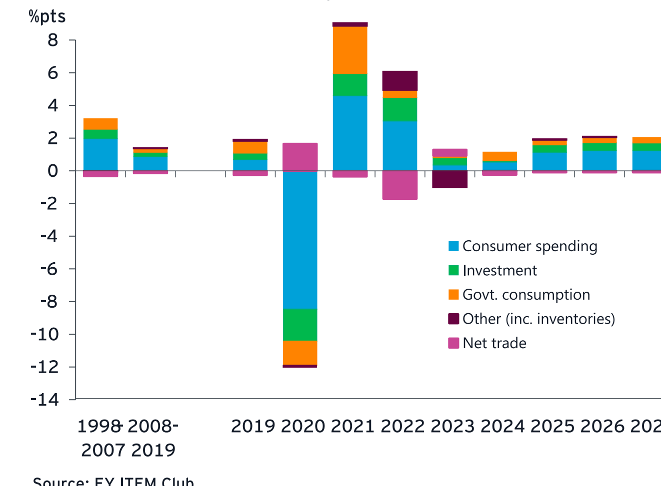


Source: EY ITEM Club

- The MPC has kept Bank Rate unchanged at 5.25% in recent meetings, although three members voted to hike, and the committee stuck to high-for-longer messaging.
- Inflation falling faster than expected while the economy has stagnated is likely to cause policymakers to pivot towards loosening monetary policy.
- We continue to think that the MPC will start cutting interest rates from May, although continued inflation undershoots could bring that date forward. A cumulative 125bps of rate cuts is expected this year.

Activity

UK: Contributions to GDP growth

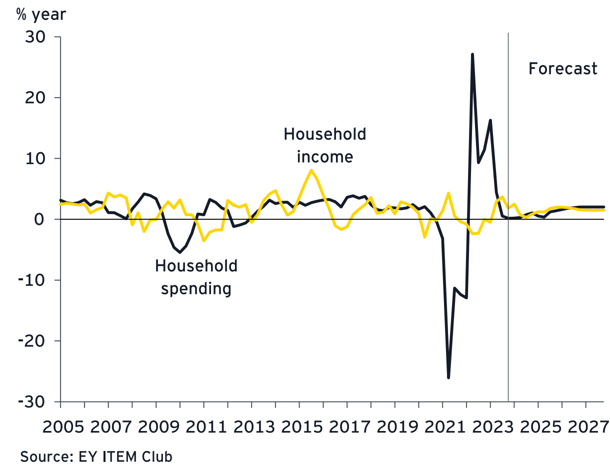


Source: EY ITEM Club

- A downward revision to GDP growth in Q2 2023 and a flat performance in Q3 mean we think the economy grew only 0.3% last year.
- High-frequency data suggests activity may have picked up a little at the end of 2023. However, the lagged effect of interest rate rises means broad stagnation is likely to have characterised the economy at the turn of 2023 and 2024.
- But falling inflation, lower energy bills and interest rates, and tax cuts mean momentum in activity should build as this year progresses. Growth in 2024 is forecast at 0.9%, followed by 1.8% in 2025.

Consumer demand

UK: Real household income and spending

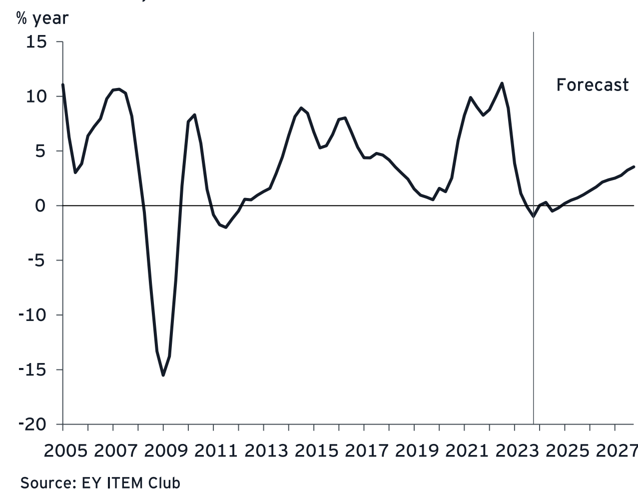


Source: EY ITEM Club

- Consumer spending fell 0.5% in Q3 2023, the biggest drop in four quarters. This was despite real household incomes rising in the same period.
- The outlook for consumption still faces a headwind from the lagged effect of past rises in interest rates.
- But inflation slowing faster than pay growth is boosting real wages. And tax cuts and the prospect of falls in energy bills and interest rates this year should support a forecast 0.9% rise in consumption in 2024.

Housing market

UK: House prices

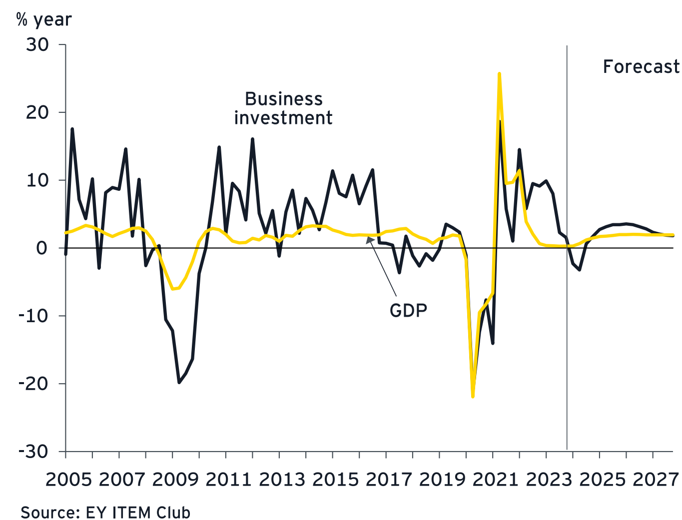


Source: EY ITEM Club

- House prices were broadly flat over the latter part of 2023, having fallen earlier last year. An average of the Nationwide and Halifax measures in December was around 2% down on a year earlier.
- Although mortgage rates are now three times higher than the low reached during the pandemic, we now think 2024 will be a year of stagnation in house prices rather than further falls.
- Quoted mortgage rates have fallen back as investors have become more optimistic that the BoE has already raised rates far enough. And unemployment is likely to remain low.

Company sector

UK: Business investment and GDP

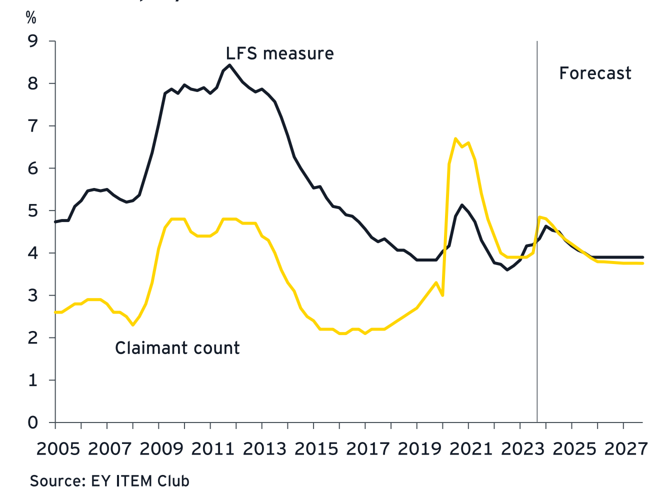


Source: EY ITEM Club

- A strong rise in business investment in the first half of 2023 looks to have gone into reverse in H2 2023. Business investment fell 3.2% in Q3, the first decline in eight quarters.
- A sluggish economy and higher financing costs suggest investment will remain weak in the near term. And that 100% expensing is now permanent has removed the incentive for firms to bring forward capital spending.
- But the incentive should mean higher investment in the medium term. And lower interest rates and a better macro-outlook should help. Business investment is forecast to fall 1% this year but rise 3.2% in 2025.

Labour market and wages

UK: Unemployment rate



Source: EY ITEM Club

- The suspension of the Labour Force Survey has made it harder to assess the state of the jobs market.
- Experimental measures from the ONS suggest that unemployment and employment were very stable in the second half of 2023.
- We expect the labour market to loosen in response to a sluggish economy. The unemployment rate is forecast to rise to 4.7% next year, before falling back as economic momentum improves.

Trade and the balance of payments

UK: Exports and world trade

Source: EY ITEM Club

- Excluding trade in precious metals, the current account deficit narrowed to 2.8% of GDP in Q3 2023 from 4.2% of GDP in Q2, reflecting a smaller trade and investment income deficit.
- Sluggish growth in the UK's major export markets, mainly reflecting the impact of higher interest rates, has held back exports. But the prospect of looser monetary policy globally should improve prospects this year.
- Lower prices for energy and food imports should also cause the trade and current account deficits to narrow.

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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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