EY ITEM Club Spring Forecast

'Stagnation nation' may be in the past

April 2024

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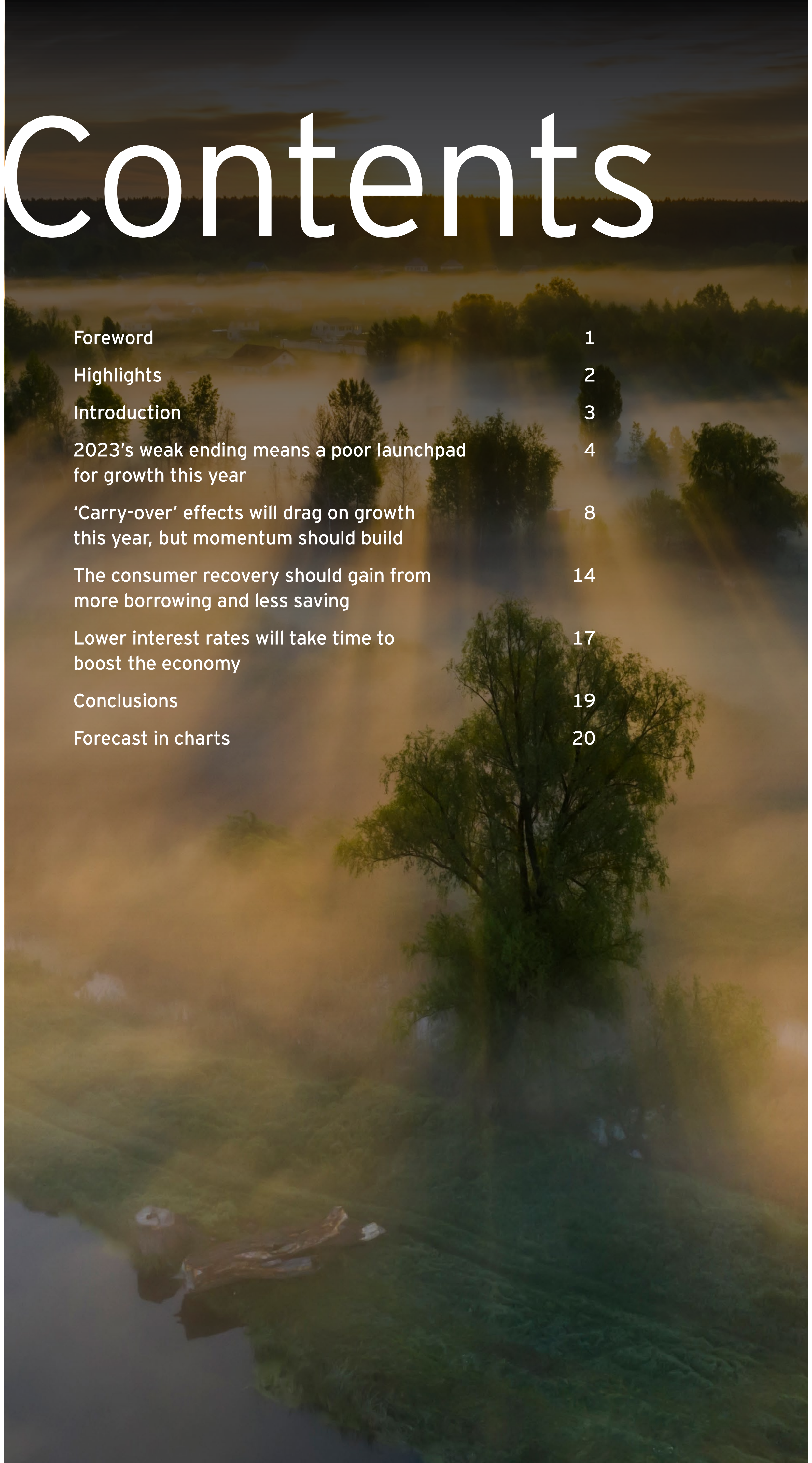

Contents

Foreword

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Recession and recovery

The ups and downs for the UK economy continue, as the much-anticipated recession finally hit in the second half of 2023 – with data released a few weeks ago in March confirming that GDP contracted in both Q3 and Q4 2023. This met the technical definition of a recession, two quarters of negative growth. However, it looks like a recession very much in technical terms only; the fall in output was marginal (0.4% across both quarters), and so could well be revised away in subsequent releases. As other commentators have pointed out – with the labour market remaining robust, unemployment barely shifting and consumer and business sentiment improving in parallel – the term 'recession' may not be that appropriate. In reality, it was a continuation of the stagnation the UK economy has experienced since early 2022.

The dip in activity is also likely to have been short-lived. Monthly GDP grew in both January and February this year, and the forward indicators for March are consistent with positive growth across the whole of Q1 2024, likely bringing any recession to a rapid end.

The EY ITEM Club now expects the economy to grow by 0.7% in 2024 – a slight downward revision from the winter forecast (reflecting a weaker starting point). Otherwise, not much has changed – inflation is still expected to fall steadily and will perhaps dip below 2% in April (reflecting another fall in household energy bills). This should open the way for interest rate cuts by the Bank of England (BoE) – but again, the EY ITEM Club is a little more cautious than in its winter forecast, now expecting three rate cuts this year starting in June, reflecting ongoing stickiness in services and wage inflation.

A combination of lower inflation and lower interest rates should allow for a recovery in consumer spending this year, boosted by some chunky tax cuts (particularly to National Insurance) from the Autumn Statement and March Budget, and a labour market that continues to cool gently preventing any significant rise in unemployment. A stronger demand outlook and a lower cost of capital should allow for continued growth in business investment.

This should be enough to allow the economy to recover properly into 2025 and 2026, with the EY ITEM Club forecasting growth of 1.9% and 2.0% respectively.

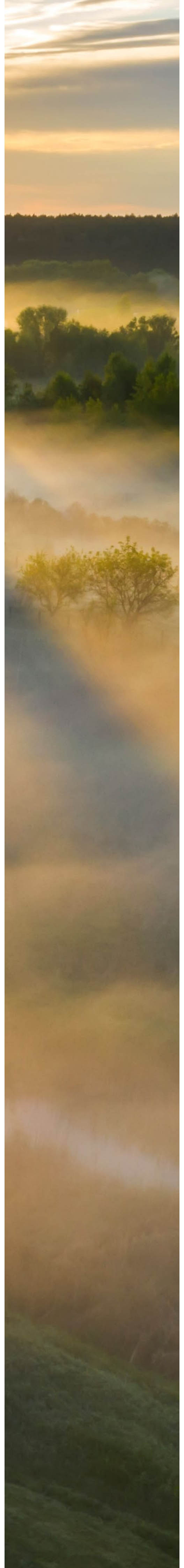
However, as has been the case for the last four years, any optimism should be conditioned by several prevailing risks. Whilst the base rate is expected to fall, higher interest rates will continue to act as a drag to spending – 1.5 million households are due to refinance their mortgages this year and most will end up paying more than on their current fix. In the labour market, economic inactivity remains a problem. There are an extra 700,000 people classified as long-term sick compared to prior to the COVID-19 pandemic and addressing this should be the number one priority of the (new?) government.

More broadly, the geo-political environment is clearly challenging. Tensions in the Middle East continue to build, with recent events raising the spectre of further escalation. Markets are spooked, but perhaps more worryingly from a central banker's perspective, is the impact on the oil price and what that may mean for inflation. The BoE will also look closely at the US experience, where inflation is proving remarkably sticky, and be concerned that the UK faces a similar situation. The EY ITEM Club believes that the first interest rate cut will come in June – but if wage and services inflation remain stubbornly high, the BoE may wait and see till the autumn.

Bringing this all together – the outlook remains uncertain! Although we perhaps shouldn't discount too heavily some of the positives – for example, a brighter outlook for consumers should start helping consumer-facing sectors such as retail – particularly those that sell 'non-essentials', services activity remains strong and a sporting summer (with the Men's Euros and Olympics ahead of us) combined with better weather, could provide a lift to the leisure and hospitality sectors. Businesses should remain agile to take advantage of opportunities as they arise.

Highlights

- A weak starting point this year presented by the recession in the second half of 2023 has caused the EY ITEM Club to downgrade the forecasted economic growth for 2024. But lower inflation, rising real incomes, and actual and prospective cuts in interest rates and taxes mean momentum in activity should build. Indeed, that inflation looks like coming in lower than we'd anticipated three months ago plus April's cuts in National Insurance Contribution (NIC) rates mean the ingredients for a revival in growth have improved. Overall, our new forecast sees the economy expanding 0.7% this year, with growth accelerating to around 2% in both 2025 and 2026.
- The on-off nature of growth during 2023 saw the economy end last year in a technical recession, with GDP contracting in both Q3 and Q4. Reconciling an apparently shrinking economy against job vacancies close to 1m, consumer confidence rising and the unemployment rate not far off a 50-year low means we think there's a good chance last year's recession will eventually be revised away. But any revisions are unlikely to change the story of an economy mired in stagnation for almost two years.
- However, the UK's performance so far this year suggests that stagnation is lifting. Activity surveys have signalled a return to growth, and consumer confidence has improved. More fundamentally, the three big obstacles to economic growth over the last few years – high inflation, high energy prices and high interest rates – have reversed or are in the process of doing so.
- Falling inflation and a return to growth in real wages mean a consumer recovery should take hold this year. We think April's cut in household energy bills took inflation close to the Bank of England's (BoE's) 2% target. The likelihood of another sizeable fall in bills in July, alongside lower food and goods inflation and the impact of a stronger pound on import prices, means inflation should average just below 2% for the rest of 2024. Whilst growth in cash wages is likely to continue slowing, reflecting lower inflation expectations among workers and employers and a looser jobs market, the outlook for real pay is looking increasingly positive.
- Lower inflation will boost real household incomes and raise demand. With unemployment remaining low despite a stagnant economy, employers appear to have hoarded workers. Stronger demand should, therefore, have the effect of boosting labour productivity, helping to keep inflation down. This is a dynamic that has been evident in the US economy and one the UK should start to share in, subject to the BoE relaxing its monetary squeeze.
- Concerns about stickiness in services inflation and pay growth mean the BoE has been wary about signalling the prospect of interest rate cuts. The data for these variables published in mid-April backed that cautious approach. But the MPC has made clear that it's a case of when, not if, rates are cut and the Bank's next set of forecasts in May is likely to show a period of below-target inflation. We think rate cuts will commence in June and expect Bank Rate to fall by a total of 75 basis points this year. But the risks are skewed towards rate cuts coming later and more slowly than our central forecast.
- In addition to taking some of the pressure off households with debt, lower rates should also create a better environment for business investment.
- Still, a revival in consumer spending will be coming from a relatively weak base. Although inflation has fallen significantly, the cost of living for households is still elevated compared with a few years ago. And reflecting the mortgage market structure, the impact of past rises in interest rates has still to come through in full. Meanwhile, although the cut in NICs will support post-tax incomes, it goes only part of the way to offsetting the hit to household finances from the ongoing freeze in income tax allowances and thresholds.
- Along with growth in real incomes, the economy should also be supported by consumers' dissaving. Unsecured lending via credit cards and personal loans has started to rise again in real terms, and relatively low debt levels provide a foundation for consumers to leverage up before confronting balance sheet constraints. Moreover, households still hold much of the 'excess' savings built up during the COVID-19 pandemic. Still, they've so far shown a reluctance to dip into those resources. And after factoring in rising prices over the last few years, that savings firepower is less formidable.
- Cuts in interest rates should reduce the incentive to save rather than spend. However, support to the economy from lower borrowing costs will take time to build. Even factoring in likely BoE rate cuts, the average rate on mortgages is still set to continue rising for most of this year as borrowers on fixed-term loans refinance at what will still be higher rates than their expiring deals. And higher interest rates have so far been a net positive for household incomes, reflecting a much faster passthrough from rate hikes to savers than borrowers. But as rates are cut, that support to incomes will fall. The fruits of lower interest rates are likely to be much more apparent in 2025 than 2024.



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Introduction

In our last forecast for the UK economy in January, we argued that a combination of falling inflation, rising real wages, lower energy bills and drops in interest rates and taxes added up to a recipe for a revival in activity in 2024.[1] Those positives are still present and, in some respects, have strengthened over the last three months. A further decline in wholesale gas prices points to energy prices exerting an even stronger disinflationary effect than we'd anticipated. Indeed, reflecting a sizeable cut in household energy bills in April and the growing odds of another double-digit drop in the summer, we now expect Consumer Prices Index (CPI) inflation to have fallen close to the Bank of England's (BoE's) 2% target in April and remain in that region for the remainder of 2024.

Meanwhile, the Budget in March delivered some disposable income-boosting cuts in National Insurance Contributions (NICs), building on the reductions in NICs in last November's Autumn Statement. Revised labour market data showed the unemployment rate began this year at a historically low level, despite an apparent stagnant economy. And house prices beginning to rise again means the risk to household wealth and sentiment from a serious downturn in the property market has faded.

However, a rebound in growth in 2024 faces some new obstacles. One is a weaker launchpad for expansion this year than we'd expected. GDP shrank in Q4 for the second consecutive quarter (so satisfying economists' oft-used definition of a 'technical' recession), and growth earlier in 2023 was revised down. This meant the economy grew only 0.1% last year versus our expectation in the winter of 0.3%. The second obstacle is a tightening in financial conditions caused by markets reining back their expectations of how aggressively the BoE will cut interest rates. In the run-up to our last forecast, investors were pricing in five 25 basis points (bps) cuts in Bank Rate during 2024, a move which had translated into significant falls in market interest rates from last summer's peaks. But at the time of writing, the market interest rate curve implied a more modest two cuts this year.

Several factors have cautioned investors. One is global developments, notably a less dovish tone from the US Federal Reserve towards monetary loosening. Another is the circumspect language used by members of the BoE's Monetary Policy Committee (MPC) towards the prospect of rate cuts in the UK. Consequently, what had been a growth-promoting loosening in financial conditions has been interrupted. Indeed, some lenders raised mortgage rates in March in response to markets' readjustment of the outlook for borrowing costs.

Still, we think the MPC will be compelled to start cutting Bank Rate soon and consider June a likely date for the first move down. And the three big headwinds to economic growth over the last few years– high inflation, high energy prices and high interest rates – have reversed or are doing so. Nonetheless, on balance, the carry-over effect of a weaker-than-expected end to 2023 and less accommodating monetary conditions mean we've cut forecast growth this year to 0.7% from 0.9%. But we still expect a decent rebound in 2025 and 2026, with growth forecast at 2% in those years. As before, a possible change of government and economic policy after the next general election, which must be held no later than 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 scope for consumer spending to be lifted by households borrowing more and saving less. Section 5 considers just how much of a boost prospective interest rate cuts will offer the economy. Section 6 concludes.

1. EY ITEM Club, 'Winter 2024 Forecast', 22 January 2024. https://assets.ey.com/content/dam/ey-sites/ey-com/en_uk/topics/growth/ey-item-club/ey-item-club-winter-forecast-report-2024-final.pdf?download

2

2023's weak ending means a poor launchpad for growth this year

The economy fell into recession in late 2023 …

The on-off nature of economic growth over the first three quarters of 2023 meant we identified a technical recession (two successive quarters of falling GDP) as a serious risk in our winter forecast. And according to the latest data from the Office for National Statistics (ONS), that risk materialised in Q4 2023. Output fell in two out of the three months of Q4. This left the economy in Q4 0.3% smaller than the previous three-month period, a second successive quarterly contraction.

The expenditure breakdown for Q4 showed another drop in consumption, down 0.1% quarter-on-quarter (q/q), compounding Q3's 0.9% decline. Government consumption and net trade also made negative contributions to GDP, although business investment rose at the fastest rate since the start of the year.

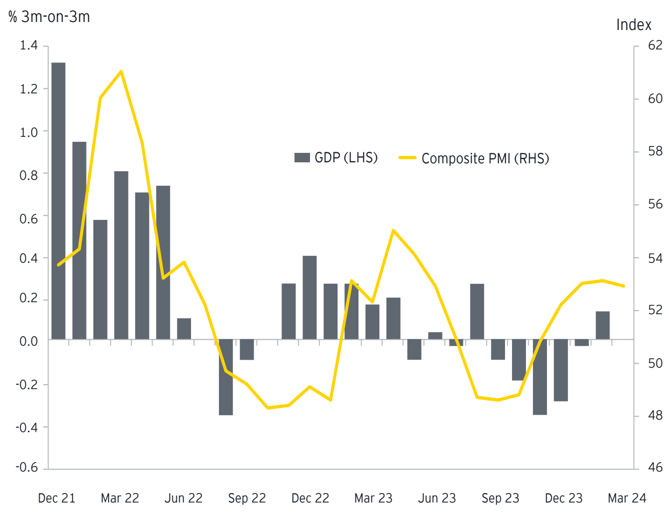
We think there's a reasonable chance that 2023's recession may be revised away in future GDP releases. It's hard to square a contracting economy with job vacancies still close to 1m, consumer confidence rising and the unemployment rate not far off a 50-year low. However, whether future data confirms the economy in Q4 shrank a little, flatlined or grew slightly, the story of broad stagnation, which began almost two years earlier, almost certainly won't change. According to the current vintage of data, the level of GDP in the final quarter of 2023 was slightly smaller than in Q1 2022.

… but the contraction in the economy may already be over

Even in the absence of favourable revisions, last year's recession looks to have proved short-lived. Notably, the monthly Purchasing Managers' Index (PMI) activity surveys have signalled a recovery in momentum in early 2024. March's composite PMI of 53.4 was the fifth successive over-50 reading, signalling growth in private sector activity.

Moreover, a key factor underpinning Q4's weakness was a sharp fall in retail sales. But retail sales volumes rose 3.6% month on month (m/m) in January, making up all the ground lost in the previous month. This made an important contribution to GDP's rising 0.2% in the same month. Retail sales held onto January's gain the following month, setting the first quarter up for a strong performance.

UK: GDP versus composite PMI



Source: EY ITEM Club & S&P Global/CIPS

True, the impact of industrial action in the NHS on health sector output will have held back a revival in economic growth in Q1 (we won't get official GDP data for the quarter until 10 May). But the ingredients are in place for a return to growth. Although what had been a sustained decline in inflation was interrupted in January, it resumed the following month. The Consumer Prices Index (CPI) measure dropped to a 30-month low of 3.2% in March, down from a peak of nearly 11% in late 2022. And indications suggest that pay growth has continued to outstrip price rises, building on the recovery in real wages, which began in mid-2023.

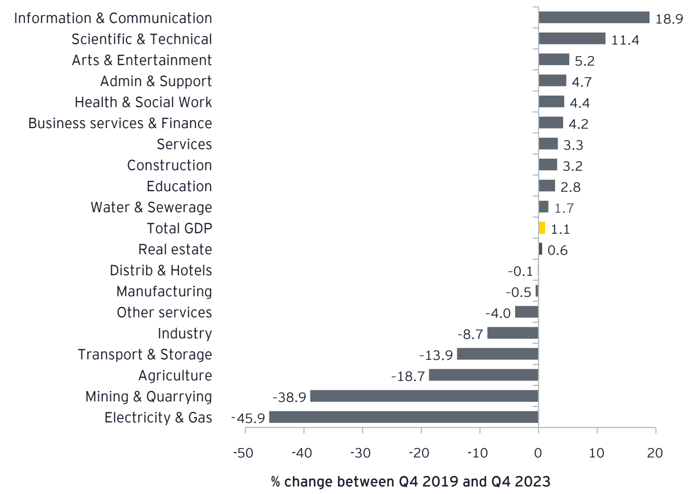
Signs of a revival in housing market activity also bode well. Mortgage approvals in March rose for the fifth successive month to the highest since September 2022, and the Royal Institute of Chartered Surveyors (RICS) survey showed a revival in selling activity and new buyer interest. Meanwhile, house prices on both the Nationwide and Halifax measures increased in Q1 at the fastest pace in almost two years. Recent news on consumer confidence has also been positive. According to the GfK measure, households' confidence in their own financial position in March increased to the highest in over two years.

A flat economy disguises some sectoral differences

As of Q4 2023, total GDP was only 1.1% larger than in Q4 2019, just before the COVID-19 pandemic. However, a flat performance from the economy overall disguises a significant degree of diversity among different sectors, with the consequences of the pandemic and subsequent energy price shock playing an important role in driving sectoral differences.

The energy shock likely contributed to a plunge in electricity and gas output, down by over 45% in the four years to Q4 2023. Some of the fall reflects the shutting down of coal-fired power stations to meet government net zero targets. However, economising by households and firms in the face of higher prices has probably also played a role. Meanwhile, a structural decline in the output of the North Sea sector, also partly net zero related, lies behind the weakness of the second worst sectoral performer, oil and gas. Output here has contracted by almost 40%, and the rise in working from home and decline in commuting helps to explain a slump in transport sector output.

UK: Output by sector



Source: EY ITEM Club/Haver Analytics

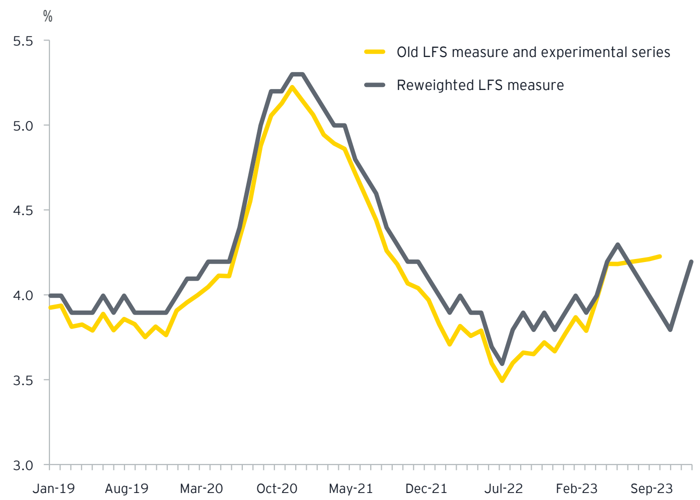
However, the after-effects of the pandemic have also lifted some activities. Among sectoral front-runners, the boost to digitalisation delivered by home working and shifts in consumption patterns of the last few years has been reflected in a near-one-fifth expansion in the information and communication sector. Scientific and technical activities have also substantially outperformed the wider economy.

New jobs data indicates a tighter labour market than previously thought

The ONS's decision last autumn to suspend the Labour Force Survey (LFS), which measures key jobs market indicators such as employment and unemployment, made it difficult to assess the true state of the jobs market. However, the ONS reintroduced LFS data in February and reweighted the results using the latest census estimates on the size and composition of the UK population.

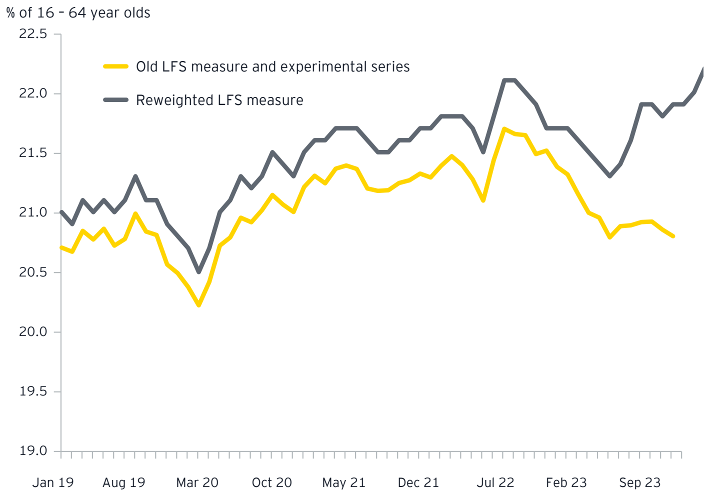
There were marked differences between the reweighted LFS numbers and the experimental measures used in place of the official data during the latter's hiatus. The 'new' LFS findings show the unemployment rate falling over the second half of last year rather than stabilising as the experimental data had suggested. The employment rate dropped over the same period rather than increasing. And inactivity is now estimated to have risen in H2 2023 rather than holding on to the decline of earlier last year.

UK: Unemployment rate



Source: ITEM Club/ONS

UK: Inactivity rate



Source: ITEM Club/ONS

The current numbers don't yet fully reflect what the ONS anticipates will be improvements to survey response levels and rates from the reintroduction of face-to-face interviews and an increase in the number of people sampled. Consequently, the ONS advises 'caution' when interpreting short-term movements in the new headline series. A bigger sample size will be a feature of the ONS's Transformed Labour Force Survey (TLFS), which will appear later in the year.[2] However, with data from the TLFS now not due to be released until July versus the originally planned spring date, uncertainty about the jobs market will persist for some time.

Official data on pay growth, measured using a different survey than the LFS, has shown that wage increases continue to slow. Total average earnings growth was 5.6% year on year (y/y) in the three months to February, the smallest rise since mid-2022. The cooling in headline private sector regular pay growth, the BoE's preferred measure, has been more modest. Growth in the private sector gauge was 6% in the three months to February.

The MPC has dropped hints of further interest rate rises but has been wary about signalling rate cuts

The MPC responded in its February meeting to a big cut in the BoE's forecast for inflation this year by ending hints that it may raise interest rates again. It stuck to the line that policy needs to remain "restrictive" for the time being, a position held to in March's policy statement. But it emphasised that policy would still be restrictive, even after rates have started to be cut.

One member, Swati Dhingra, broke ranks in February by being the first monetary policymaker to vote for a rate cut since March 2020. At the other hand of the hawk-dove spectrum, Catherine Mann and Jonathan Haskel continued to vote for rate hikes in February. But they fell in with the majority in March by supporting keeping Bank Rate at 5.25%.

Overall, the MPC has continued to be circumspect about the prospect of rate cuts. Whilst committing to "keep under review … how long Bank Rate should be maintained at its current level", recent policy statements have kept to previous language that monetary policy will "need to stay sufficiently restrictive for sufficiently long" and that it needs to stay restrictive for "an extended period of time".[3] A less gloomy forecast for demand combined with the BoE's still-downbeat view on the economy's supply capacity has played a role here. In its February forecast, the BoE forecast GDP to grow 0.25% this year and 0.75% in 2025, up from zero and 0.25% three months earlier.

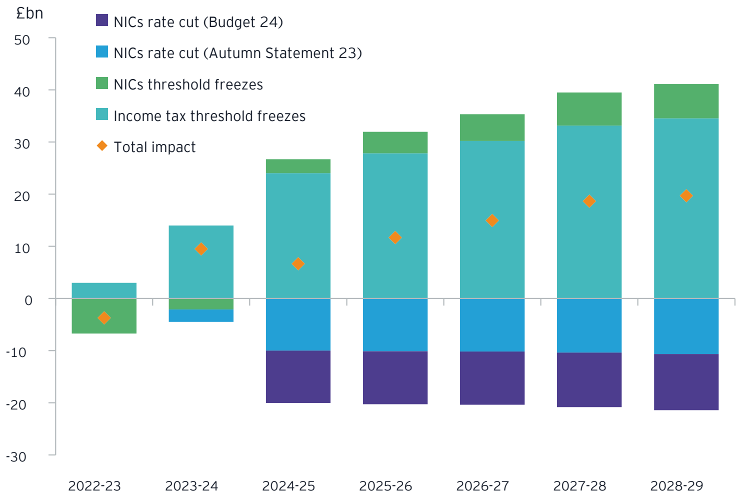
The fact that the BoE thinks inflation will drop to 2% only temporarily before picking up again later this year is another reason behind the committee's reluctance. Moreover, the BoE's risk-adjusted forecast in February showed headline inflation a little above 2% in two years' time were interest rates to fall in line with market expectations, which could be read as the BoE pushing back against the four or five rate cuts investors were then pricing in. The MPC has also argued that geopolitical developments mean risks to inflation remain to the upside, albeit now being more evenly balanced when it comes to domestic wage and price pressures.

The Budget cut taxes, but that only mitigated a general rise in the tax burden

March's Budget delivered a widely trailed cut in personal taxes. Building on the 2p cut in NICs announced last autumn, the Chancellor delivered a further 2p reduction, cutting NIC rates to 8% for employees and 6% for the self-employed from April. All else being equal, this will boost households' post-tax income by £10bn per year, a positive for consumer spending and potentially aiding workforce growth by increasing the number of people returning to work.

However, Jeremy Hunt part-financed the reduction in personal taxes with tax rises due to kick in over the next few years. Notably, the tax regime for non-UK-domiciled individuals will be abolished and replaced with a less generous system from 2025-26, and the windfall tax on oil and gas producers will be extended by a year to 2028-29. As a result, the Budget's net fiscal loosening averaged a modest £8bn, or around 0.3% of GDP, over the five years from 2024-25.

UK: Impact on tax receipts from income tax & NICs policies



Source: EY ITEM Club/OBR

More fundamentally, the Budget's net tax cut will offset only part of the record-breaking increase in tax revenues as a share of national income over the current parliament. The Budget's decisions also left the Chancellor with only a sliver of a margin against his goal of having the ratio of public debt to GDP falling five years out. The predicted £9bn of headroom against the fiscal rule in 2028-29 was down from £13bn in the autumn and compared with an average of £26.1bn that Chancellors have set aside against their fiscal rules since 2010.

2. See Liz McKeown, 'How ONS is improving the Labour Force Survey', Office for National Statistics, 5 February 20024. https://blog.ons.gov.uk/2024/02/05/how-ons-is-improving-the-labour-force-survey/
3. Bank of England, 'Monetary Policy Summary and minutes of the Monetary Policy Committee meeting', 21 March 2024. https://www.bankofengland.co.uk/monetary-policy-summary-and-minutes/2024/march-2024

3

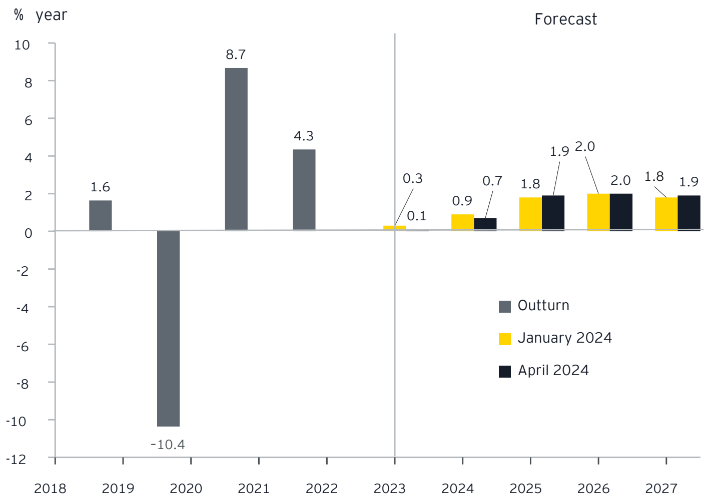
‘Carry-over’ effects will drag on growth this year, but momentum should build

A downgrade to growth this year is more a reflection of the past than the present or future

A quirk of calendar-year growth rates is that developments in the previous year can be just as important a driver as movements in the year in question. Our new forecast for GDP growth this year is a case in point. The economy’s unexpected contraction in Q4 means a lower starting point for the output level in 2024 than we had expected. All else being equal, this mechanically shaves a few tenths of a percentage of GDP growth this year.

However, we still think that on a q/q basis, growth will pick up this year and into 2025. Recent evidence from the PMI activity surveys suggests that the process is ongoing. Granted, a rise in GDP in Q1 is likely to have been held back by the impact of public sector strikes. But the further boost to real incomes from forecast inflation this year being a little lower than we’d previously expected and the effect of the Budget’s net tax cuts mean the revival in GDP growth should be a little stronger than the path outlined in our last forecast.

UK: GDP



Source: EY ITEM Club

However, the economy will be a long way from a boom. The effect of past rises in interest rates on mortgage costs has yet to come through in full. Even allowing for the Budget’s ‘giveaways’, fiscal policy is tightening because of past tax hikes, particularly the ongoing freeze in income tax thresholds and allowances. On balance, and driven by carry-over effects from last year, we now expect the economy to grow 0.7% in 2024, a downgrade from 0.9% three months ago.

But we’ve nudged growth in 2025 up slightly to 2% from 1.8% previously, as the fruits of lower inflation and tax cuts are anticipated to feed through. Growth in 2026 is expected to continue at around 2%, although a potential change of government and economic policy following the next general election makes forecasts for that year and beyond more speculative than normal.

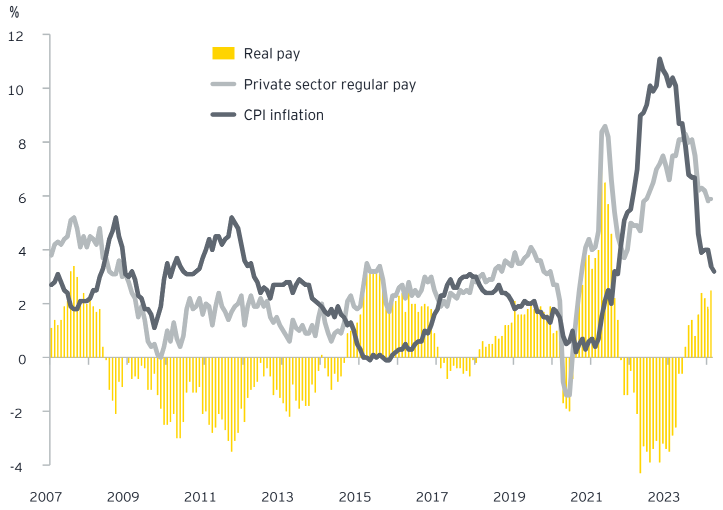
Lower inflation will support a steady recovery in real incomes and consumer spending

Falling inflation means a consumer-led recovery should take hold this year. We think CPI inflation dropped close to 2% in April, reflecting the impact of the new Ofgem Energy Price Cap (EPC). The latest cap implies a typical household energy bill of £1,698, down from £1,920 previously and the lowest since early 2022. And recent moves in wholesale prices, if maintained, point to another double-digit fall in bills in July, when the EPC is recalculated.

Alongside lower food and goods inflation and the dampening effect on import prices of the recent strengthening in sterling, lower wholesale energy prices should push inflation below 2% over the rest of this year via both their direct effect on the energy component of the consumer prices basket and by reducing economy-wide costs. The recent rise in oil prices and disruption to shipping in the Red Sea means inflation will be higher than otherwise. However, the strengthening of sterling against the US dollar, which oil is priced in, and the hefty tax wedge on UK petrol prices will reduce the inflationary impact of pricier crude. And the tiny share of retail goods prices accounted for by shipping costs means the effect of rises in those costs should be small.

Meanwhile, wages have now been growing in real terms since last summer, making up some of the fall in inflation-adjusted terms during 2022 and the first half of 2023. Nominal pay growth is likely to slow due to lower inflation expectations among workers and employers and a looser jobs market. However, recent trends and the tendency for pay to respond with a lag to wider economic developments suggest wage growth will slow less rapidly than prices. Real wages should, therefore, continue to recoup previous losses.

UK: Wages and inflation



Source: EY ITEM Club/Haver Analytics

Wages and broader income growth will benefit from large inflation-linked increases in state benefits and state-mandated wages in April. That month saw the National Living Wage (NLW) rise 9.8%, whilst the age at which workers are covered by the main NLW rate was lowered from 23 to 21 years. Working-age benefits were uprated by 6.7%, and the state pension increased by 8.5%. Overall, we expect real income growth to remain reasonably strong, particularly for those lower down the income distribution.

Cuts in NICs will support post-tax incomes but only go some way to offsetting fiscal drag

On an after-tax basis, incomes have also been boosted by the cuts in NICs announced in the Budget, which came into effect in April. The reduction in NICs will raise post-tax household incomes by £10bn in the current fiscal year, equivalent to around 0.6% of annual disposable incomes.

However, this will go only so far in mitigating the effect of past decisions to raise personal taxes. Most personal tax thresholds and allowances have been frozen in cash terms since April 2021 and, under current plans, will remain so until the end of the 2027–28 fiscal year. As nominal earnings have grown significantly, the freeze has brought more people into higher tax brackets than would have occurred had thresholds continued to rise with inflation. Overall, the OBR estimates that the NICs cuts announced in the Budget and the 2p cut in last November’s Autumn Statement will offset around two-thirds of the impact of fiscal drag this year, falling to around half by the late 2020s.[4]

But the consumer recovery starts from a low base and still faces challenges

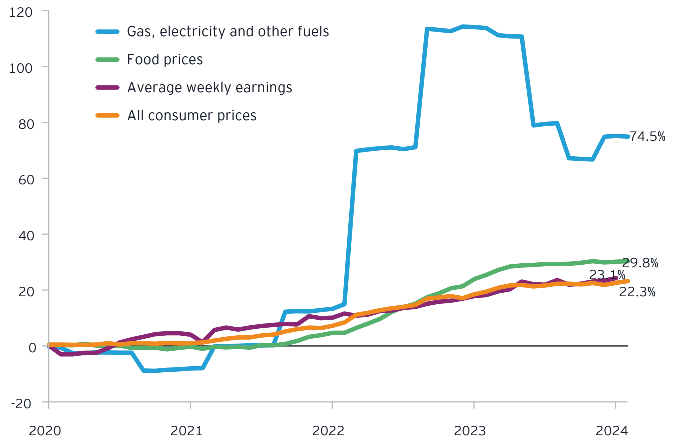
Still, a consumer recovery will be from a relatively weak base. Consumer spending rose just 0.2% in 2023 as a whole and fell by 1% in the second half of last year. As of Q4 2023, consumption in real terms was still 2.1% below the pre-COVID-19- level four years earlier. In comparison, overall GDP was 1% higher.

The potential for a rebound in the dominant driver of GDP still faces some challenges. Whilst inflation has fallen sharply, past rises in the price of energy and other essentials mean the cost of living is still elevated compared to a few years ago.

As Section 4 explores, the prospect of interest rate cuts from the BoE this year may prove to be a net negative for household incomes, at least in the short term, given the boost that higher interest rates have delivered to savers’ interest receipts. That’s not the only factor that will weigh on incomes and spending. Another is the loss of universal energy payments (which contributed 1ppt–1.5ppts to household income growth in 2023).

UK: Prices and wages

Cumulative percentage change



Source: EY ITEM Club/Haver Analytics

A third is the fiscal drag referred to earlier. A fourth obstacle is rising debt servicing costs, as those on fixed-rate mortgages who’ve so far been insulated from rising mortgage rates refinance. The BoE estimates that around one-third of the peak impact of higher interest rates on the level of GDP has still to come through.[5] These factors mean real disposable income growth

4. Office for Budget Responsibility, ‘Economic and Fiscal Outlook’, March 2024. https://obr.uk/docs/dlm_uploads/E03057758_OBR_EFO-March-2024_Web-AccessibleFinal.pdf
5. Bank of England, ‘Monetary Policy Report’, February 2024. https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy-report/2024/february/monetary-policy-report-february-2024.pdf

is still likely to slow on a calendar year basis in 2024 versus the previous year. However, that slowdown will mask a gradual improvement, which should become much clearer in 2025 and 2026.

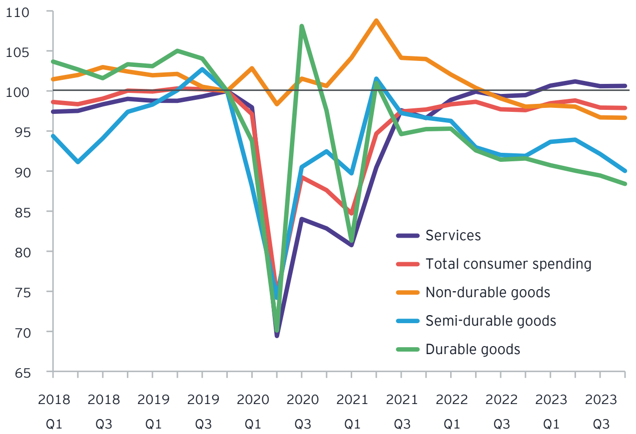
The fact that the jobs market is tighter than the data previously suggested means that whilst the unemployment rate is likely to creep up in response to recent economic weakness, we forecast it to remain very low by past standards. The jobless rate is expected to rise to around 4.3% by the end of this year but then begin to decline again as growth in the economy supports demand for workers.

Overall, we now expect consumer spending to rise 0.7% this year, slower than the 0.9% we forecast in the summer. As with the downward revision to our GDP forecast, the downgrade reflects base effects from a weaker-than-expected second half of 2023 rather than an adjustment to our view of the near-term outlook. Consumption growth is forecast to accelerate to 2.2% in 2025.

Among consumer spending categories, durables (such as cars, home appliances and consumer electronics) and semi-durable goods (including clothing, footwear and jewellery) probably have the greatest scope to benefit from the easing of cost-of-living pressure. As of Q4 of last year, real terms spending in both categories was still around a tenth below pre-COVID-19 pandemic levels.

UK: Consumer spending by category

Q4 2019 = 100



Source : EY ITEM ClubONS

This implies plenty of room for catch-up growth, and these consumption categories are expected to benefit the most from an improvement in consumers' discretionary spending power.

Spending in the other major consumer categories in Q4 — non-durables such as food, energy and services was much closer to levels just before the pandemic. The former category consists largely of essentials, so one wouldn't expect significant swings here. Spending on services may have been supported by a shift in consumer tastes towards 'experiential' spending on things like eating out and entertainment.

The BoE should begin cutting interest rates by early summer

In our winter forecast, a much-improved inflation outlook meant we concurred with investors' new-found bullishness on the likely timing and scope of cuts in interest rates. We anticipated the BoE would begin cutting Bank Rate in May, with a total of 125bps of rate cuts this year.

However, the market's view of prospects for monetary loosening has since become more cautious. At the time of writing, the market rate curve implied the first cut in Bank Rate in the summer and two 25bps reductions by the end of 2024. This move is partly a function of global developments, particularly a less dovish tone from the US Federal Reserve.

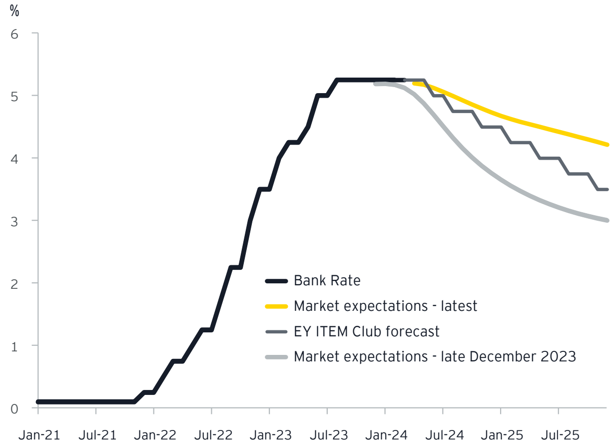
There are reasons why the MPC may want to approach rate cuts cautiously. If the new LFS data is taken at face value, the labour market looks tighter than it did last summer when the MPC was continuing to hike interest rates. And whilst headline wage growth is softer than it was for most of 2023, it's still double the pace that would be consistent with achieving the inflation target.

But the case for cutting rates soon remains strong. Part of that case is the unexpected speed at which the inflation threat has receded. Given recent moves in wholesale energy prices, the Bank's most recent forecast for inflation to average 2.7% in Q4 2024 looks too high and is ripe for a significant cut when the BoE publishes its new forecasts in May.

On the wages front, the large month-on-month rises in pay in the first half of 2023 will soon drop out of the annual measure, suggesting that headline wages growth will come down quickly over the next few months. And timelier measures of pay growth have already slowed to a pace broadly consistent with the inflation target. On a 3m/3m annualised basis, growth in private-sector pay in February stood at 4.4%.

UK: Forecasts for Bank Rate

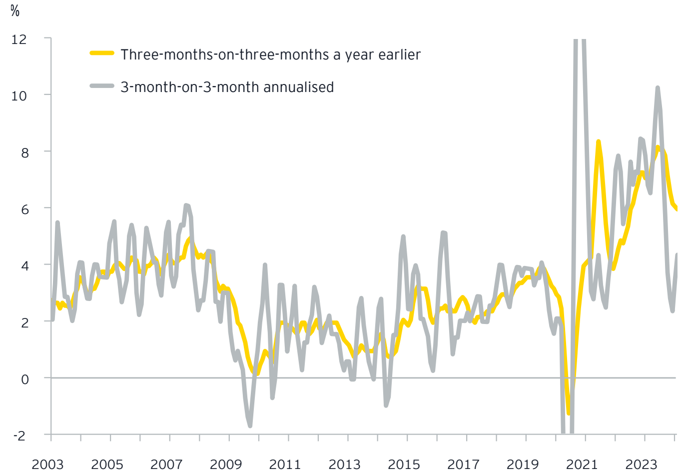
%



Source: EY ITEM Club/Haver Analytics

UK: Average private sector regular pay

%



Source: EY ITEM Club/Haver Analytics

Overall, we think it's likely that the MPC will go for the first rate cut in June. Following March's MPC meeting, BoE governor Andrew Bailey said, "We don't have to actually get inflation all the way back to target … to cut rates, for instance, what we have to do is be convinced that it is going there".[6] The Bank will publish its next economic forecast alongside May's interest rate decision. If, as is likely, that forecast shows inflation falling below 2% in April and remaining sub-target for the rest of this year, it's hard to see how the MPC could justify waiting much longer.

A June date would give the committee sight of April's inflation outturn (which won't be released until after the May MPC meeting), as well as the impact of April's big rise in the national living wage on overall pay growth, before pressing the 'cut' button. However, regardless of the precise timing, we think the current market view is a little too cautious. We now expect a total of 75bps of rate reductions in 2024, leaving Bank Rate ending this year at 4.5%. That said, the MPC's caution does mean that the risks are skewed towards rate cuts coming later and more slowly than our central forecast.

Business investment should be aided by lower interest rates and a more predictable macro environment

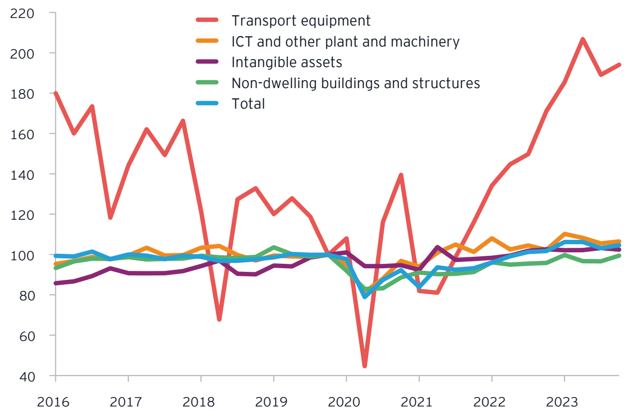
A 1.4% q/q rise in business investment in Q4 2023 capped off a reasonably strong year. Calendar-year growth came in at 5.5%, and the level of investment at the close of 2023 was 4.7% higher than the pre-COVID-19 pandemic position in Q4 2019, which was a better performance than the overall GDP. Investment in transport equipment has been particularly strong, with spending on passenger aircraft and a shift in company car fleets towards electric vehicles likely playing a role in that strength.

However, as the effect of higher interest rates on firms' cost of capital builds, we think investment growth will be slower this year. Net bank lending to companies continued to contract on a y/y basis in early 2024, and surveys such as the BoE's Decision Makers Panel Survey and intelligence from the Bank's regional Agents point to relatively subdued expectations for business investment during 2024.

Moreover, increased financial stress among companies may dampen firms' appetite to invest. The corporate insolvency rate increased to 53.7 per 10,000 active companies in 2023, the highest level since 2014 Q3. Construction, retail, and hospitality were the sectors experiencing the highest numbers of insolvencies.[7]

UK: Business investment

Q4 2019 = 100



Source: EY ITEM Club/Haver Analytics

However, the 2023 insolvency rate remained much lower than the peak rate of 94.8 insolvencies per 10,000 active companies during the global financial crisis. And we think growth in investment should remain in positive territory this year, with forecast growth of 0.6%, an improvement on the modest fall we expected in our winter forecast.

A stronger-than-expected end to 2023 will help. With around 80% of corporate bank debt at variable interest rates, the prospect of interest rates falling this year should pass relatively quickly into the bottom lines of companies with bank debt. A more predictable macroeconomic environment, with the outlook for inflation and borrowing costs more benign than for some time, should also give corporate decision-makers more confidence to invest. Structural factors, including a tight jobs market, increased digitalisation and investment in artificial intelligence (AI) technologies, and a move towards green energy generation and other efficiency measures, should all support investment. And regardless of which party wins the next general election, if the new administration comes in with a solid mandate, greater political certainty should be a positive.

6. Michael Race & Faisal Islam, 'UK interest rates: Bank boss says cuts 'on the way'', BBC News, 21 March 2024. https://www.bbc.co.uk/news/business-68618436
7. The Insolvency Service, 'Commentary — Company Insolvency Statistics October to December 2023', 30 January 2024. https://www.gov.uk/government/statistics/company-insolvency-statistics-october-to-december-2023/commentary-company-insolvency-statistics-october-to-december-2023

We think these factors will contribute to growth in business investment, picking up to just over 3% in 2025. However, achieving a sustainable uplift in investment by firms will likely require more than just an exit from the economic stagnation of the last few years and a drop in interest rates.

Investment is a driver of GDP growth, but it's also a consequence of how easy regulatory systems and planning laws make it to build and start enterprises providing what consumers want. The significantly higher cost of infrastructure projects in the UK versus most of its international peers (high-speed rail being a classic example) suggests the environment for investment in the UK compares poorly with elsewhere. This is a problem that won't be addressed simply via a better outlook for demand.

There have been more positive signs across the UK's major export markets.

Evidence from the last few months suggests the low point for global growth has passed. Activity data from the US, China and the eurozone have recently surprised economists to the upside simultaneously for the first time in almost a year.

Taking the UK's major export markets, eurozone GDP was nearly stagnant over the past year, with activity now reported to have been flat in Q4 2023 after a marginal drop in Q3. Recent surveys suggest a swift change is unlikely in the short term, but economic activity should improve in the second half of 2024 as real disposable income and financial conditions improve.

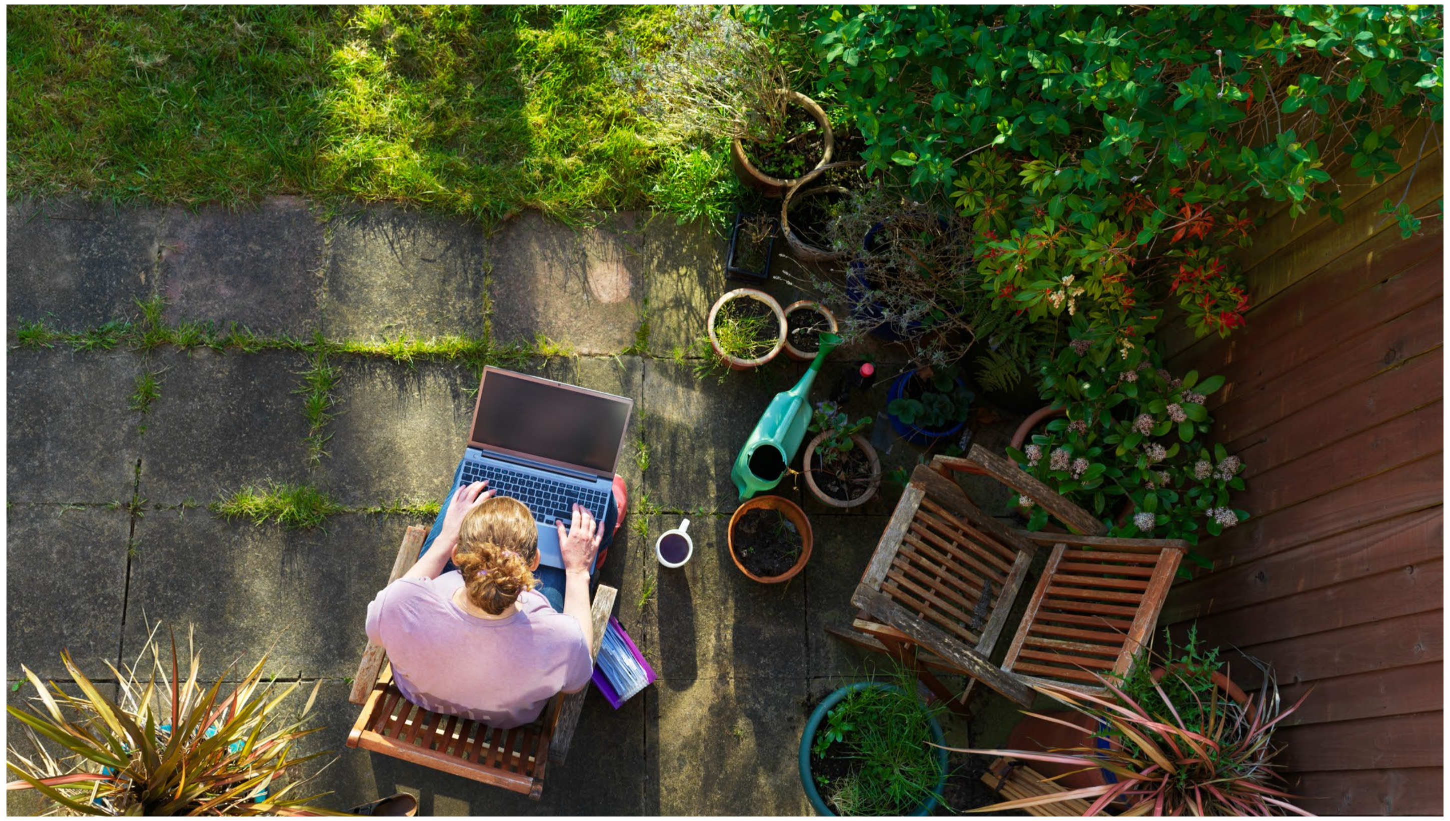
The US has remained the star performer among major economies. A strong labour market, easing financial market conditions and solid household and non-financial corporate balance sheets suggest that outperformance will continue.

The continued strength of US activity implies that the Fed will not be in a hurry to lower the US policy rate. But policy rates in the US and other advanced economies are comfortably within restrictive territory, so there's a good chance that alongside the BoE, other major central banks will gradually lower rates into less restrictive territory from the middle of this year, supporting global demand.[8]

Risks around energy prices remain the biggest source of uncertainty

By pushing down inflation and raising consumers' discretionary spending power, lower energy prices are an important driver of our expectation of an improved performance from the UK economy this year. But the positives from this source could be undone were the conflict in the Middle East to widen and a surge in energy prices to follow.

Domestically, a different path for interest rates than we expect would have implications for household incomes, residential housing transactions and house prices. The BoE has been more



The EY ITEM Club forecast for the UK economy, Spring 2024

% change on the 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	0.1	0.0	0.3	2.2	-0.5	14.6
2024	0.7	0.9	0.7	0.7	0.5	-1.5
2025	2.0	2.1	2.2	2.3	2.0	1.0
2026	2.0	2.1	2.1	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	5.2	-0.5	6.0	2.6	0.1	81.4
2022	5.3	-3.1	6.2	9.1	1.5	79.6
2023	5.0	-3.3	6.5	7.3	4.7	80.4
2024	3.1	-2.8	3.9	2.2	5.0	82.5
2025	2.7	-2.7	2.8	2.1	4.0	83.0
2026	2.3	-2.9	2.6	2.0	3.3	83.5
2027	1.5	-2.9	2.7	2.0	3.3	83.7

Source: EY ITEM Club

* Fiscal years, as % of GDP

cautious so far than we'd anticipated in signalling a willingness to cut interest rates. Were policymakers to be over-cautious, rates could stay higher for longer, to the detriment of growth. Alternatively, a run of better-than-expected data on inflation and pay could trigger a more aggressive monetary loosening than we've factored in.

Meanwhile, the next general election, which must be held no later than January 2025, is coming closer. The polls continue to point to a Labour Party victory, although the similarity of the two main parties' platforms suggests that any macroeconomic implications would be limited. In Shadow Chancellor Rachel Reeves' Mais Lecture in March, she confirmed that a Labour government would stick to the current administration's primary fiscal rule of setting policy to ensure debt is falling as a share of GDP in the fifth year of the forecast.[9] Reeves did say that a Labour government would move to ensuring current (i.e. day-to-day spending) budget was funded by taxation, rather than limiting total borrowing as under the current rules. However, the scope this could deliver for a future government to borrow more to finance higher investment will be restricted by what is currently projected to be a very small margin of safety against the debt target.

Differences in the two big parties' fiscal platforms are even narrower following March's Budget when the Conservative government adopted two of Labour's planned tax policies — the abolition of the current tax regime for non-domiciled residents and the extension of the windfall tax on oil and gas producers for an extra year. Of course, economic policy is not just fiscal policy. Were the Labour Party to take power and implement its plans around planning reform and facilitating infrastructure projects, there could be a boost to the economy's supply-side, albeit a slow-moving one. Assuming a new government had a clear majority and sense of direction, this could prove positive for investors' perceptions of the UK, both domestic and foreign.

8. See Sam Dumitriou and Ben Hopkinson, 'Britain's infrastructure is too expensive', Notes on Growth, 23 August 2023. https://www.samdumitriu.com/p/britains-infrastructure-is-too-expensive

9. Rachel Reeves, 'Mais Lecture 2024', 19 March 2024. https://labour.org.uk/updates/press-releases/rachel-reeves-mais-lecture/

4

The consumer recovery should gain from more borrowing and less saving

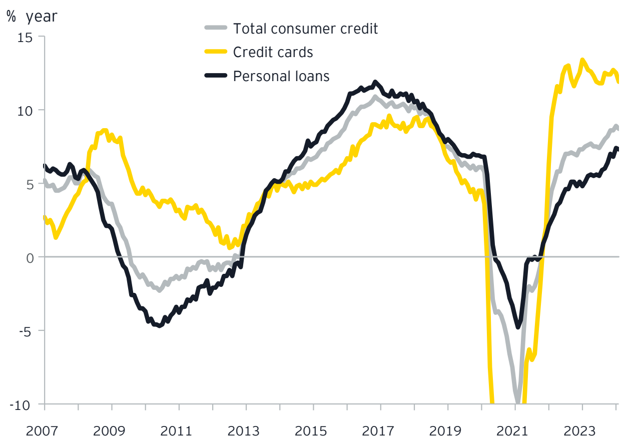
Growth in real household incomes, helped by falling inflation, is the main driver of the consumer recovery we expect this year. But we also think two other influences on spending – households' appetite to take on unsecured debt and to save less – will offer some support. However, there are reasons to be cautious about just how much of a positive impulse dissaving will provide.

Unsecured lending has begun growing again in real terms

Growth in consumer credit, which includes lending via credit cards and personal loans, appeared to have been a tailwind to consumer spending in 2023 – at least on the surface. In net terms, lending rose by 6.1% last year, the fastest increase since 2017 and well above the growth of 2.4% averaged between 2010 and 2019.

However, the rise in consumer credit in 2023 was boosted by the effect of high inflation in pushing up the average spend per transaction. After adjusting for inflation, net lending to consumers fell 1.2% in 2023, the fourth successive annual real terms drop.

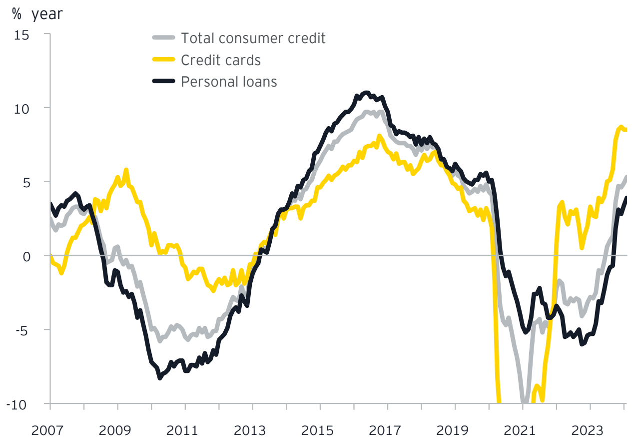
UK: Nominal consumer credit



Source: EY ITEM Club/Haver Analytics

Still, 2023's real terms decline was the smallest over that four-year period. On a monthly basis, y/y growth in real consumer lending returned to positive territory in the second half of 2023 for the first time since early 2020, a trend that continued at the start of this year.

UK: Real consumer credit



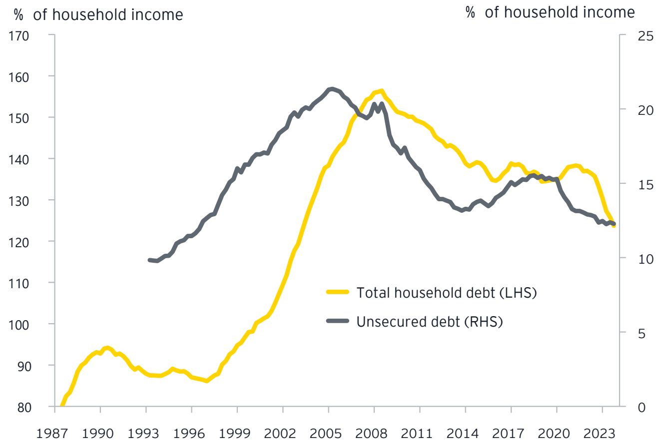
Source: EY ITEM Club/Haver Analytics

According to the BoE, this recovery may have been supported by an increasing proportion of credit cards issued in short-term teaser deals at 0% interest.[10] A better financial outlook for households could also have played a role. The inflationary shock of the last few years has been receding, pay growth is now outstripping price rises and pressures on households from energy and food prices – the most tangible elements of the recent cost-of-living crisis – have dropped back. There may also be a compositional effect at play. Surging energy bills, which tend not to be paid with credit cards, have squeezed discretionary spending, so using credit cards has become more common in recent years. This effect is now reversing as energy bills fall.

Meanwhile, an improved financial outlook has underpinned a recovery in consumer sentiment, another factor that may have translated into a greater willingness to take on unsecured debt. Though GfK's measure of consumer confidence remains some way below the long-run average, it's bounced back from the historically low levels in 2022 and 2023.

A third support to credit demand is the relatively healthy aggregate financial position of households, meaning consumers should have fewer concerns about taking on more debt. Deleveraging during the pandemic plus strong wage growth in recent times resulted in the stock of unsecured debt falling to 12.3% of annualised household income in Q4 2023, the lowest since 1996.

UK: Household debt



Source: EY ITEM Club/Haver Analytics

Relatively low debt levels provide a foundation for households to leverage up before confronting potential balance sheet constraints. However, the recent direction of travel in household debt may also indicate that households want to hold fewer financial liabilities than in the past. The higher cost of unsecured borrowing could be one motive for such a shift in attitudes. As of February 2024, borrowing rates on personal loans were 330bps–400bps higher than the recent lows of 2021, though a less significant 150bps or so higher than the 2010–19 average.

Borrowing on credit cards has become particularly expensive. Unlike the cost of personal loans, average rates on credit cards rose during the pandemic, despite interest rate cuts by the BoE, and reached a record high of 24% in December, a rate repeated in the first two months of this year. This was around 600bps higher than the 2010–19 average.

The higher cost of credit card lending may help to explain a big rise in the rate at which credit card debt is repaid. From 2013 to 2019, monthly repayments of credit card debt averaged the equivalent of 23% of the stock of credit card borrowing outstanding in the previous month, with the share rising modestly over that period. However, the repayment rate jumped during 2021 and has settled at just over 30% since early 2022. The repayment rate for personal loans also increased but to a much more modest extent. Since it's the net addition to unsecured lending that adds to household resources and spending power, what appears to be a persistently higher repayment rate could blunt any boost to consumption from credit growth.

Savings 'firepower' remains significant in nominal terms, less so in real terms

A further potential reason for the rise in repayments is that consumers, in aggregate, are in a better position to repay credit card balances quickly because of the pandemic-era rise in savings.

In cash terms, households appear to be still sitting on substantial excess savings. Alongside a recovery in consumer credit, the scope to draw on these savings offers another channel through which dissaving could support consumption. In nominal terms, households' holdings of cash and money in bank accounts in February 2024 stood at £1.85tn. This was £116bn above what a continuation of the pre-COVID-19 2010–19 trend would have implied, an apparently hefty war chest. Moreover, the household saving ratio stood at over 10.2% in Q4 2023, still well above the 2015–19 average of 6.3%.

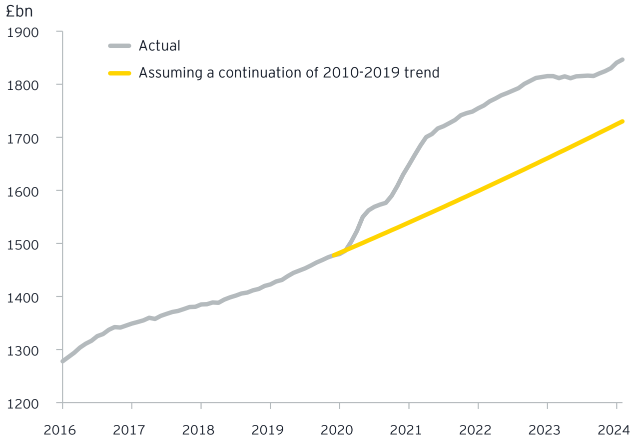
10. Bank of England, 'Financial Stability Report', December 2023. https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2023/financial-stability-report-december-2023.pdf

However, these are nominal measures of savings, and the high inflation of 2022 and 2023 has eroded their value in terms of purchasing power. Expressed as a share of nominal consumer spending, households' liquid assets surged during 2020 and early 2021, rising from the equivalent of 107% of annualised consumption in Q4 2019 to a peak of 145% in the first quarter of 2021. But the ratio has since fallen, dropping to 114% in Q4 2023.

Still, the ratio is a little above both pre-COVID-19 pandemic levels and what a continuation of the pre-COVID-19 trend would imply, indicating some room for dissaving versus past norms. What's more, there are reasons why households may want to hold fewer liquid assets than past patterns would suggest. The prospect of interest rate cuts this year will reduce the opportunity cost of spending rather than saving. It may also mean some borrowers, who had anticipated that the BoE rate would stay higher for longer, feel less need to save more to try and absorb the higher payments due when their previous fixed-rate mortgage deals expire.

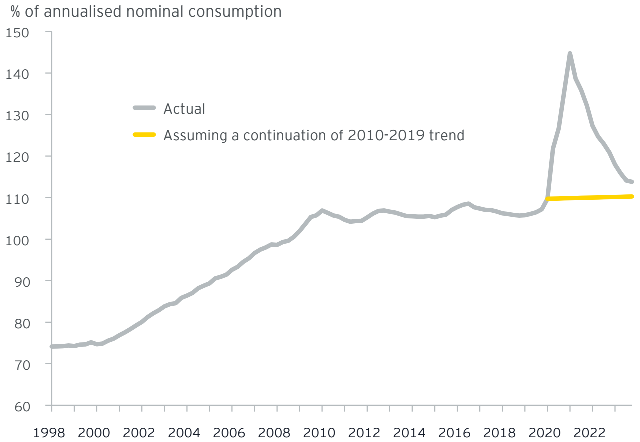
A return to low inflation and a more stable macroeconomic environment following the shocks of the last few years also means some households may feel less need to save for precautionary reasons. That the housing market has avoided the sharp correction some were predicting could work in the same direction, at least for those with mortgages.

UK: Household liquid assets



Source: EY ITEM Club/Haver Analytics

UK: Household liquid assets relative to consumer spending



Source: EY ITEM Club/Haver Analytics

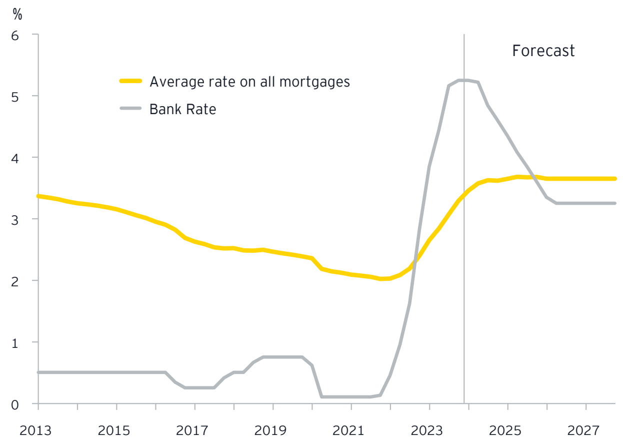
5

Lower interest rates will take time to stimulate the economy

The prospect of a significant cut in interest rates this year won't be a game-changer yet

Whilst we've become more cautious about the prospect of when and how much monetary policy will be loosened in 2024, we think that the outlook for inflation and pay growth means markets have turned too cautious in the last few months. Our forecast sees Bank Rate ending this year at 4.5%, with another 100bps of rate cuts to follow in 2025.

UK: BoE rate and average mortgage rate



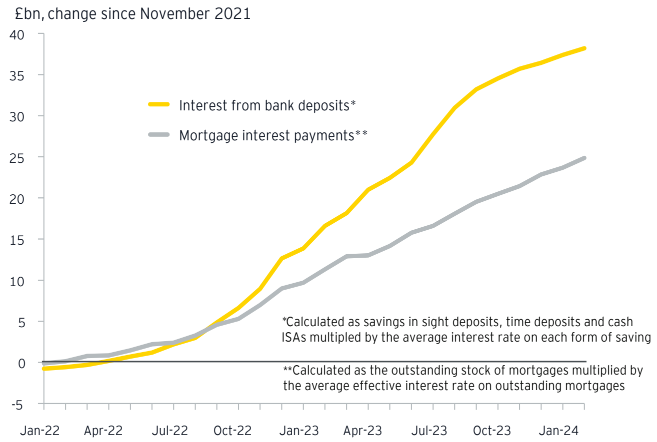
Source: EY ITEM Club/Haver Analytics

Given the emphasis placed on higher rates in holding back the economy over the last two years, the prospect of such a significant reduction in borrowing costs might be expected to prove a game-changer. Interest rate cuts transfer money from borrowers to savers. By definition borrowers are more inclined to spend and savers less so. Therefore, the scale of rate cuts we're expecting should increase demand.

However, in practice, two reasons suggest the boost will likely be a slow burner. The first is the structure of the UK mortgage market. Just as the dominance of fixed-rate over variable-rate home loans slowed the passthrough from rising interest rates to average mortgage rates during 2022 and 2023, the same factor will also slow the transmission of cuts in the BoE rate to the average cost of home loans. Indeed, our forecast shows the average rate on all mortgages continuing to rise through most of this year, even as Bank Rate is cut.

The second obstacle to a short-term boost from rate cuts relates to the effect on households' net interest income. BoE rate hikes from late 2021 onwards passed through more quickly to savings rates (around 80% of household savings are sight deposits) than borrowing rates. Meanwhile, households' net financial wealth rose during the COVID-19 pandemic due to a jump in savings and the paying down of unsecured debt.

UK: Household interest payments and receipts



Source: EY ITEM Club/Haver Analytics

The combination of these factors means higher interest rates have so far been a net positive to overall household incomes. However, net interest income is likely to fall this year as looser monetary policy causes interest rates on savings to fall relatively quickly, whilst mortgage bills take longer to come down.

But whilst rate cuts may be slower to have an effect than in the past, they should still have a powerful effect …

Although the transmission from changes in monetary policy to the wider economy has been reduced in speed and scale, it has not been curtailed. Movements in interest rates work partly through a household cashflow channel, whereby higher debt service payments constrain the finances of indebted households, forcing them to cut spending, especially if they are credit-constrained. However, that channel will have less of an adverse effect on consumer spending in the short term than expected during much of 2023 since fixed-rate mortgages will be refinanced at lower rates than feared. To the extent that some households have cut spending in advance of mortgage resets, the headwind to consumption from this source should lessen as those households realise the outlook is not as bad as they'd previously anticipated.

Meanwhile, looser monetary policy will quickly support activity through a cashflow effect on indebted companies, lower interest rates on new loans, the pound's lower value and support for house and asset prices. For example, we now think property prices will rise modestly this year versus a further drop expected in our winter forecast. However, support for activity from rates is likely to be much more evident next year than this.

… as well as potentially creating some space for further tax cuts before the election

A more contingent channel by which rate cuts could lead to stronger activity is the link to fiscal policy. If interest rates fall more aggressively this year than markets currently expect, the effect would be lower interest rate expectations further out, a push down on the cost of government debt and lower projected government spending on debt interest. All else being equal, this would mean a bigger margin of safety against the Chancellor's fiscal rules.

If this situation were to arise, the prospect of another fiscal event before the next general election would become much more attractive to the chancellor since he would have more leeway to deliver further growth-boosting tax cuts in advance of the national vote.

6

Conclusions

The legacy of the economic shocks of the last few years will continue to make its presence felt in what we expect will be an insipid rate of GDP growth for the calendar year 2024. But weak growth this year will be more a consequence of the economy's frailty in 2023 than the prognosis for the present or near future. The ingredients are in place for growth to steadily pick up and for the economic stagnation that began in early 2022 to come to an end.

Having been consistently above the BoE's 2% target for over two years, inflation has fallen back fast and will likely undershoot the target in the second half of 2024. Real wages are rising as a consequence, and April's significant fall in energy bills and the prospect of more to come on that front will boost discretionary spending power, particularly for those on low incomes. And the BoE is likely to start cutting interest rates soon. Rate cuts are likely to be a slow burner in supporting the economy. However, their gradual effect reinforces our view that growth in 2025 should pick up to a respectable pace, at least by the standards of the 2010s, if not most of the post-war period.

The importance of lower energy prices as a driver of this brighter outlook reveals some of its potential fragilities with the risks posed by geopolitical developments abroad and the potential cost and disruption of net zero ambitions at home.

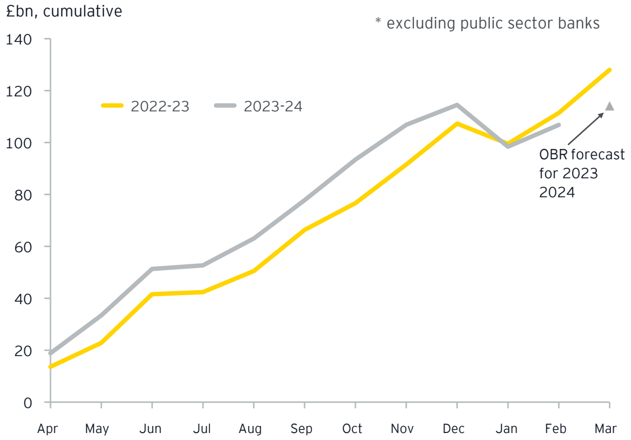
Domestically, whoever forms the next government faces a tricky balancing act between supporting public services and avoiding an even bigger tax burden. The economy should enjoy a sugar rush this year and next from the reversal of the high inflation, high energy prices and high interest environment that has hindered growth in the recent past. However, ensuring growth continues at a reasonable pace will mean tackling the structural obstacles to expansion posed by rules and attitudes that make the UK such an expensive place to build and invest.

7

Forecast in charts

Fiscal policy

UK: Public sector net borrowing*



Source: EY ITEM Club/Haver Analytics and OBR

- Public sector net borrowing has fallen year-on-year in recent months and is broadly consistent with the OBR's forecast for a deficit of just over £114bn in 2023–24 as a whole.
- Public spending has grown more slowly than tax receipts, reflecting the end of energy support to households and a fall in the cost of inflation-linked government debt.
- Beyond this year, the fiscal outlook is clouded by a potential change of government. The Labour Party has said it would maintain the current fiscal rule of setting policy to ensure debt is falling as a share of GDP in the fifth year of the forecast.

Prices

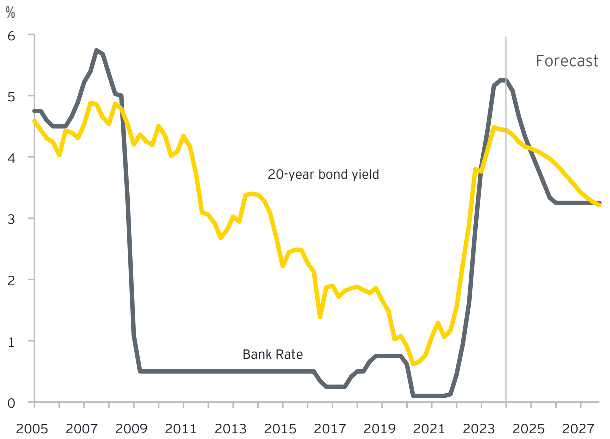
UK: CPI inflation

Source: EY ITEM Club/Haver Analytics

- A 12% cut in household energy prices in April probably pushed CPI inflation close to the BoE's 2% target that month.
- The prospect of another sizeable drop in energy bills in July, fast-falling food prices and goods inflation as well as the effect of a stronger pound in holding down import prices will probably keep inflation below 2% for the rest of this year.
- We expect inflation to average 2.2% in 2024, followed by a similar rate next year.

Monetary policy

UK: Bank Rate and 20-year bond yield

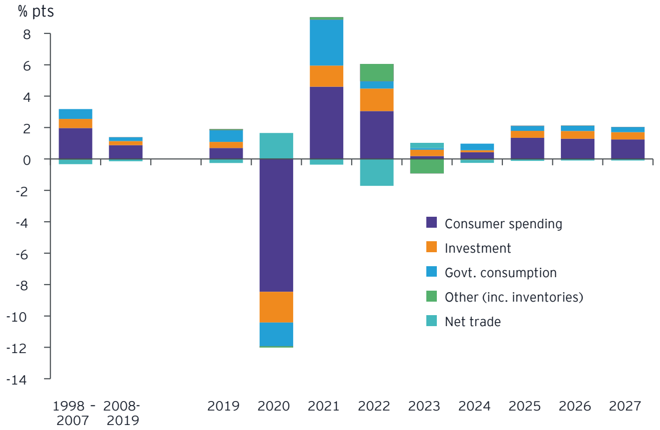


Source: EY ITEM Club

- The MPC has continued to vote to keep Bank Rate at 5.25%. However, the committee has ceased hinting that it may raise rates further and the two members who voted for rate hikes in February have fallen in with the consensus.
- Concerns about stickiness in services inflation and private sector pay growth mean policymakers have been cautious in signalling the prospect of rate cuts.
- Progress on both fronts and the likelihood of a prolonged period of below-target inflation means there's still a good chance policy will begin to be loosened in June and we expect 75bps of rate cuts in total in 2024. But the risks are skewed towards rate cuts coming later and more slowly.

Activity

UK: Contributions to GDP growth

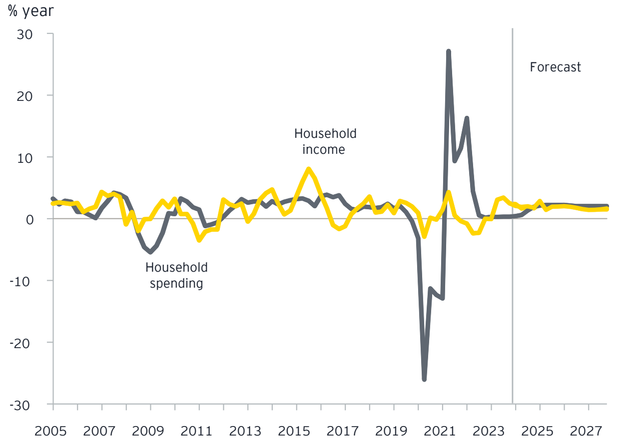


Source: EY ITEM Club

- A pick-up in activity surveys and a recovery in retail sales in early 2024 suggest that the economy's contraction in the second half of 2023 was short-lived.
- Growth in Q1 2024 will have been held back by the impact of continued industrial action in the public sector. But falling inflation, rising real wages and lower energy bills should support a recovery in momentum this year.
- We think the weak end to 2023 will restrict calendar-year growth this year to 0.7%. However, rising momentum means the GDP is forecast to rise by around 2% in both 2025 and 2026.

Consumer demand

UK: Real household income and spending

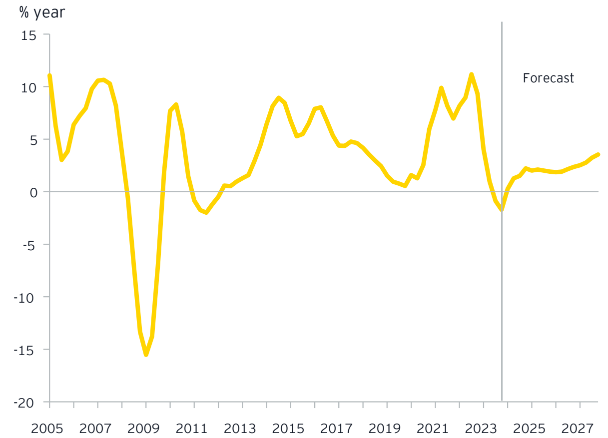


Source: EY ITEM Club

- Consumer spending fell in Q4 2023 for the second successive quarter despite another rise in real household income.
- But consumption looks to have returned to growth in Q1 2024. Retail sales are on course to have rebounded strongly and consumer sentiment has picked up.
- Lower inflation, falling energy bills and rising real wages should see a consumer recovery take hold this year. Growth is forecast at 0.7% in 2024, followed by 2.2% next year.

Housing market

UK: House prices

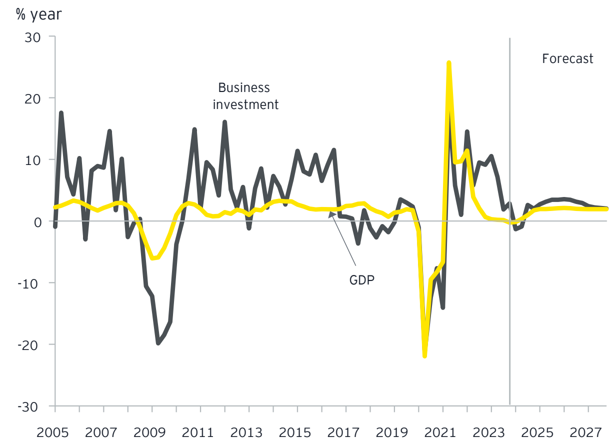


Source: EY ITEM Club

- A fall in quoted mortgage rates and a more predictable macroeconomic outlook looks to have brought the previous correction in house prices to an end and triggered some recovery in transactions.
- An average of the Nationwide and Halifax house prices measures in March was around 1% higher than last December and only 3% lower than the peak in summer 2022.
- The boost to sentiment from likely BoE rate cuts and an improving economy means we expect property prices to continue rising modestly, increasing by 1.3% this year and 2% in 2025.

Company sector

UK: Business investment and GDP

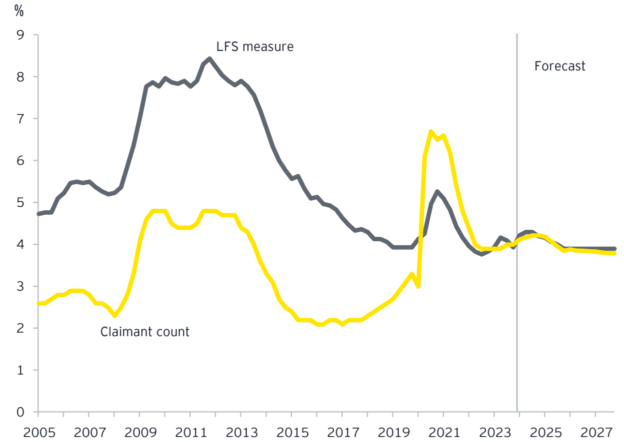


Source: EY ITEM Club

- A 1.4% q/q rise in business investment in Q4 2023 capped off a reasonably strong year. Growth came in at 5.5% in 2023, and the level of investment at the close of last year was 4.7% higher than in pre-COVID-19 pandemic Q4 2019.
- Higher financing costs will drag on investment growth this year. However, prospective cuts in interest rates will reduce this headwind and a more predictable macroeconomic outlook should also help.
- Business investment is forecast to grow 0.6% this year, followed by 3.2% in 2025.

Labour market and wages

UK: Unemployment rate

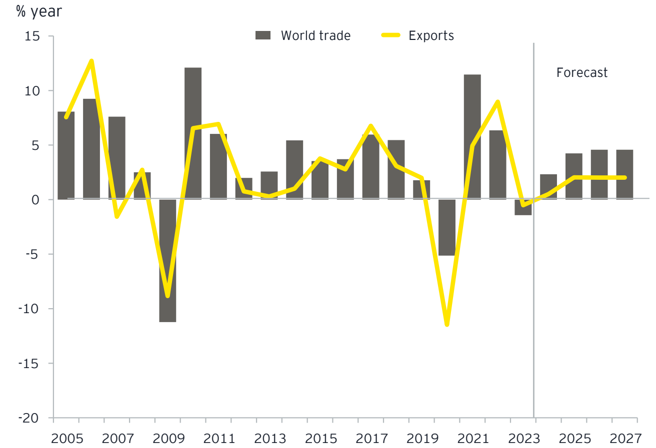


Source: EY ITEM Club

- The introduction of new Labour Force Survey data has signalled a jobs market tighter than previously thought, with unemployment lower and inactivity higher.
- ut in advance of the 'Transformed LFS' due later this year, the ONS has advised caution in interpreting short-term movements in the new headline series.
- Falling job vacancies point to the jobs market loosening in response to a sluggish economy.

Trade and the balance of payments

UK: Exports and world trade



Source: EY ITEM Club

- Recent trade data has been volatile and prone to revisions. The trade deficit, excluding precious metals, widened to 1.8% of GDP in Q4 2023, contributing to a current account deficit of 3.9%.
- The prospect of looser monetary policy globally and the impetus this gives to demand should boost spending on UK exports.
- We think lower prices for energy and food imports should also cause the trade and current account deficits to narrow modestly.

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