EY ITEM Club Autumn Forecast

A recession is likely, but the gloomiest predictions should be avoided.

October 2022

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Foreword

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After a summer of downbeat news – whether it be heat waves and droughts or rising energy prices – the UK economy enters the autumn facing some material headwinds. The impact of higher energy prices is about to crystallise for consumers as colder, darker nights lead to the heating and lights coming on. Meanwhile, the response in the financial markets to the Government's September 'mini-Budget' has accelerated the upward trajectory of interest rates, which will affect homeowners and buyers and could lead to a significant correction in house prices. The global economy is unlikely to come to the UK's rescue either: the outlook in the rest of Europe and the US is similarly downbeat, with high inflation and the associated monetary response by central banks likely to lead to a global slowdown in economic activity.

In this context, a recession around the turn of the year now feels baked in, with consumers cutting back on discretionary spending and increased stress on businesses in the face of lower demand, squeezed margins and higher borrowing costs.

However, the EY ITEM Club expects any recession to be relatively mild and short-lived, with GDP falling by 0.3% in 2023 and much of the decline concentrated in the first half of the year. The outlook for 2024 is stronger, with a growth of 2.4% forecast as the economy recovers.

What explains this optimism? Firstly, the Government's intervention in energy markets (even in its revised form) will cushion much of the impact of higher energy prices on business and consumers this winter. It also has the added benefit of preventing inflation from reaching the very high peaks that were forecast by some back in the summer. The EY ITEM Club expects inflation to peak at around 11% in October (consistent with the view in the summer forecast) before falling away over 2023.

We are already seeing a widespread fall in commodity prices, and indeed both gas and oil are off their peaks from earlier this year. Further, as the EY ITEM Club has previously highlighted, the finances of most households and businesses are also in better shape than they were before the global financial crisis, while the labour market remains robust, which again should support the economy during the winter.

After a recession, focus will turn to recovery and growth. While the mini-Budget was clearly poorly received by the markets – and indeed, has since been mostly reversed – it did at least highlight the need (and indeed the value) for the UK economy to boost its growth performance. The tax cuts were only one element of the plan for growth – important supply-side reforms have also been proposed, with a focus on accelerating infrastructure projects, tackling planning, and reforming the financial sector post-Brexit. However, these latter ideas may well be challenging to deliver politically, and any benefits would take time to realise.

Looking ahead, businesses need to be cautious as the risk in the forecast is all to the downside, given the ongoing geopolitical uncertainty and the likely transition challenges faced by households and businesses as interest rates return to historically normal levels in the EU and US. In the current environment, there is no high-probability base case, so businesses must carefully plan and stress test worst-case scenarios and prepare their responses accordingly.

Highlights

- A combination of high energy prices, elevated inflation, higher borrowing costs and global weakness means the EY ITEM Club now thinks the UK economy will fall into a recession this winter and that GDP will fall until mid-2023. But we expect a shallow downturn, with the cap on energy bills, and less pressure on the Bank of England (BoE) to aggressively raise interest rates following the government's U-turns on tax cuts averting a more severe outcome. However, much depends on good luck. The centrality of energy prices to the outlook means that economic prospects will continue to hinge on the vagaries of international energy markets and the war's progress in Ukraine, as well as how cold, or otherwise, the winter proves to be.
- GDP probably shrank in Q3, reflecting evidence of stalling activity and the extra bank holiday for the late Queen's state funeral. And falling real household incomes, a rise in market interest rates, and financial market volatility mean we don't think the support on energy bills will be enough to prevent a recession.
- The fall in GDP is forecast to be shallow by past standards, reflecting fiscal support from the Energy Price Guarantee (EPG) and household balance sheets in an even better state than previously believed. As the squeeze on real incomes from high inflation eases, the cheap pound boosts net exports and the tightening cycle for interest rates ends, GDP should return to growth in the second half of next year.
- The sacking of Chancellor Kwasi Kwarteng and the government's U-turn on almost all elements of September's tax-cutting 'mini-Budget' have severely undermined its credibility. The tax burden is now heading to a 70-year high, and the life of the EPG has been cut back. But the drag on the economy from a tighter fiscal policy should be offset by less pressure on the BoE to raise interest rates aggressively, a fall in gilt yields and a lower risk premium on UK assets.
- That said, the recent strength of pay growth, a very tight jobs market and the inflationary impact of the weak pound means borrowing costs are set to still rise to a greater extent than we expected in our last forecast.
- But we don't think current market expectations for Bank Rate to reach around 5% next summer will be realised. Even allowing for any inflationary impulse from what is still set to be a high level of public borrowing this year and next and sterling's fall, inflation is on course to decline next year as base effects, sharp turns in commodity prices, a fall in shipping costs and the cap on energy bills feed into consumer prices. Bank Rate rising to the extent investors expect would risk triggering a deeper recession and inflation falling below the BoE's 2% target. And after recent turmoil in the gilts market, the BoE will be mindful of the financial stability risks of raising rates too quickly after a long period of near-zero borrowing costs.
- We think Bank Rate will top out at 4%. But this forecast depends crucially on the risk-premia investors had recently attached to the UK continuing to retreat. This requires the government to set out a clear medium-term fiscal strategy in the next fiscal event on 31 October and flesh out its supply-side agenda.
- Our expectation for rates would imply a still hefty rise in mortgage payments compared with recent years — reducing how much lenders are permitted to lend. We expect house prices to fall 5%-10% in response. Coming on top of a squeeze in spending power, a correction in property values will make for a gloomier outlook for consumer spending. However, savings built up by households during the COVID-19 pandemic and the scope to take more unsecured debt should provide some support.
- The outlook could prove brighter were the government to realise its ambition of boosting the economy's underlying rate of growth. Economic policy has failed for more than a decade to promote growth in living standards. Reducing obstacles to, and accelerating investment in, new infrastructure, energy provision and housing and seeking to boost participation in the labour force could all help reverse the downtrend in growth. But the government's ability to deliver supply-side reforms is now going to be even harder given the Prime Minister's loss of authority. And economic evidence suggests that it's very hard for public policy to shift an already-rich economy's trend growth rate.
- The weak pound and a big current account deficit have generated chatter about the risk of a balance of payments crisis and a "sudden stop" to capital inflows. We think a floating exchange rate and the make-up of the UK's external assets and liabilities should mitigate imbalances and reduce the risk of sterling falling further. However, US dollar strength will limit any short-term recovery in the pound.

1

Introduction

Sky-high energy bills, a slumping pound, rising interest rates, inflation at a 40-year peak, febrile financial markets, yet more political turmoil … It's not difficult to identify the developments over the few months that have passed since the EY ITEM Club's summer economic forecast that threaten to make 2022, to paraphrase the late Queen, an economic *annus horribilis*.

On the upside, revisions to the GDP data appear to have ruled out predictions that the economy would fall into a technical recession (defined as two consecutive quarters of falling GDP) over the summer. And despite the headwinds facing activity, the risk of a severe downturn has been reduced. Government action on energy bills is the main reason for this. Capping the typical annual household bill at £2,500 for the next six months and curtailing rises in energy costs faced by firms will be potentially very expensive for the public finances. But it will prevent what could have been an economically catastrophic rise in bills and cut the prospective peak for inflation. The remnants of the tax cuts still in place after September's 'mini-Budget' are comparatively very small. But the cut in National Insurance Contributions (NICs) offers some support for household incomes.

Now for the bad news. The market reaction to the mini-Budget's announcements threatened to overwhelm any positives from the fiscal event and eat into support to households from the energy price cap. October's U-turn on almost all elements of the tax-cutting package and signals from new Chancellor Jeremy Hunt of tax rises and spending cuts to come look to have gone some way to placating investors and reducing market turbulence. But the government's backtracking on its fiscal plans has severely undermined its credibility. What's more, at the time of writing, borrowing costs were still significantly higher than before the fiscal event on 23 September. This development has translated into a steep rise in mortgage rates and has caused turmoil in the market for home loans.

Consequently, the risk of a fall in house prices, with all the collateral economic damage that would entail, is very real. But we don't think the prognosis is as grim as that implied by current market expectations for where the BoE policy rate is headed. Base effects, the cap on energy bills and disinflationary forces from falling commodity prices and shipping costs and a weakening global economy are all likely to push inflation down sharply next year, even allowing for upward pressure on prices from fiscal policy and the weak pound. As a result, we think Bank Rate will likely top out at 4% next year, not the 5% or so presently predicted by the markets (itself a drop from investors' expectations of 6% in early October).

Crucially, our rate forecast depends on the government and new Chancellor Jeremy Hunt restoring credibility in fiscal policy. And it still implies a hefty rise in mortgage payments compared with the situation of recent years, adding to the squeeze on consumer spending power. Higher unemployment and continued weakness in business investment are likely by-products of this gloomier consumer outlook, although the cheap pound should boost net exports. Bringing this all together, we now expect the economy to shrink over late 2022 and the first half of 2023 and for GDP to fall 0.3% in 2023, down from our previous forecast of 1% growth.

Our latest forecast report begins with a discussion of recent economic developments. Section 3 sets out the key elements of our new forecast. Section 4 examines the government's recent fiscal actions and what they mean for the economy. Section 5 assesses fears of a sterling or balance of payments 'crisis'. Section 6 concludes.

2

Activity appears to be carrying little momentum

A bank-holiday-induced recession has been avoided ...

Interpreting the economy's performance over the last few months is complicated by distortions caused by changes in the pattern of bank holidays around the Queen's Platinum Jubilee and the extra public holiday in September for her late Majesty's state funeral. GDP rose 0.5% in May, but the traditional late May bank holiday being moved to June for the Jubilee celebrations provided a temporary boost to growth, since May had one more working day than normal.

That move, combined with June's extra jubilee public holiday, contributed to a 0.6% month-on-month (m/m) fall in GDP in June, repeating the pattern of previous jubilee months in 2012 and 2002. That said, the drop in June 2022 was comparatively modest compared with declines of 1.7% and 2.2% in June 2012 and June 2002 respectively, perhaps reflecting structural change in the economy, such as the rise of online shopping.

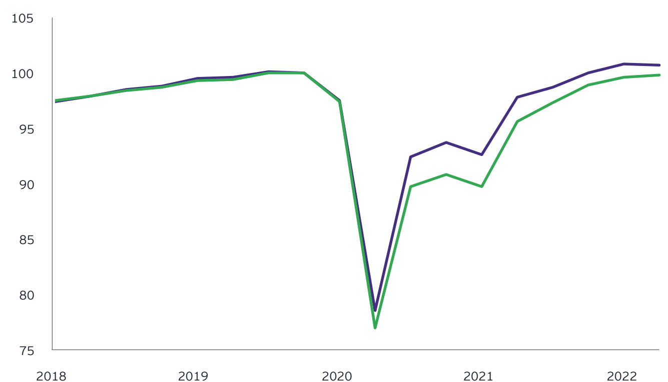
Despite statistical noise related to the Jubilee and a winding down of COVID-19 testing and vaccinations from the late spring, the ONS' latest estimate is that GDP still grew 0.2% in Q2, compared with the preliminary estimate of a 0.1% fall. However, the set of revisions that revised growth up in Q2 painted a weaker picture for the economy before. The fall in GDP in 2020 was revised bigger, from -9.3% to -11%. And a lower level of output versus earlier estimates is judged to have carried through into 2021 and 2022. Consequently, the economy in Q2 2022 is now estimated to have been 0.2% smaller than its immediate pre-COVID-19 size, rather than, as previously thought, 0.6% larger.

UK: GDP
% month

Source: EY ITEM club/Haver analytics

Other, Services, Construction, Production, GVA

UK: GDP
Index, Q4 2019 = 100



Source: EY ITEM club/Haver analytics

Initial estimate, Latest estimate

… but growth looks to have run out of steam

The data we have for the third quarter has generally disappointed. GDP rose 0.1% in July, but then fell 0.3% in August. And with another bank holiday introduced on September 19 to coincide with the Queen's state funeral, Q3 — like Q2 — will have one fewer working day than normal. As a result, we think the economy shrunk again in September and over the third quarter.

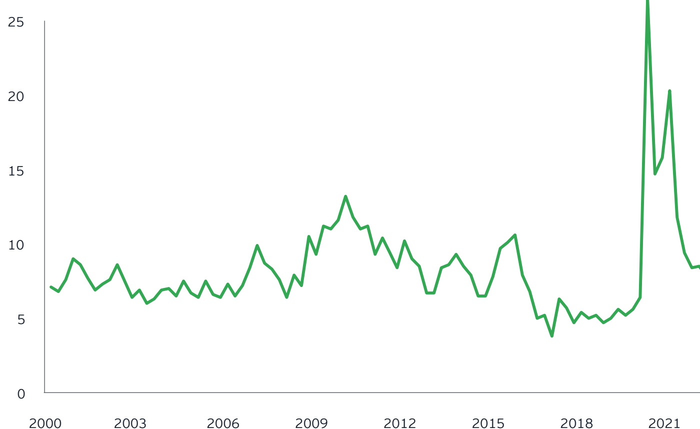
Other evidence has pointed to activity running out of steam as cost-of-living pressures have intensified. September's services PMI fell to 50.0, the lowest reading since February 2021 and signalling stagnation in the sector. And a manufacturing index of 48.5 was in contractionary territory for the third month in a row.

Meanwhile, the downward trend in retail sales volumes, which began at the start of 2022, was interrupted by a surprise increase in July but then resumed in August. Sales rose 0.4% m/m in July but dropped a hefty 1.6% m/m the following month, leaving sales 5.4% down on a year earlier and at an 18-month low. That CPI inflation of 9.9% in August remained close to a 40-year high, if slightly down on July's 10.1%, whilst consumer confidence, on the GfK measure, fell to a record (post-1974) low in the same month, likely contributed to retail's weakness.

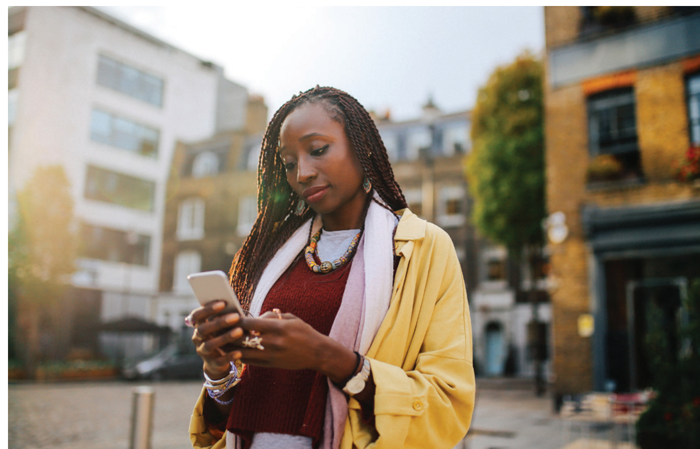
Certainly, the impact of high inflation on consumers' ability to spend is becoming clearer. Real household incomes fell 1.2% q/q in Q2, the fourth successive monthly drop and easily the largest decline of that run. That said, developments in households' finances suggest consumers are making some compensatory efforts to reduce the pace of savings and borrow more to maintain consumption.

UK: Household saving ratio

% of total income



Source: EY ITEM club/Haver analytics



The household saving ratio fell to 7.8% in Q2 from 8.5% in the previous quarter, the lowest since the pandemic began. And net lending to consumers averaged £1.4bn per month in the three months to August, double the amount borrowed in the same period in 2021, whilst the amount of extra cash deposited by households in bank accounts has trended down in recent months. Moreover, not all influences on consumer spending have been negative. Despite a significant rise in mortgage interest rates, the housing market proved resilient over the summer. The official Land Registry measure rose 12% y/y in the three months to July, the fastest since records began in 2006. And the timelier Nationwide and Halifax measures showed annual price rises remaining in, or close to, double digits in August and September.

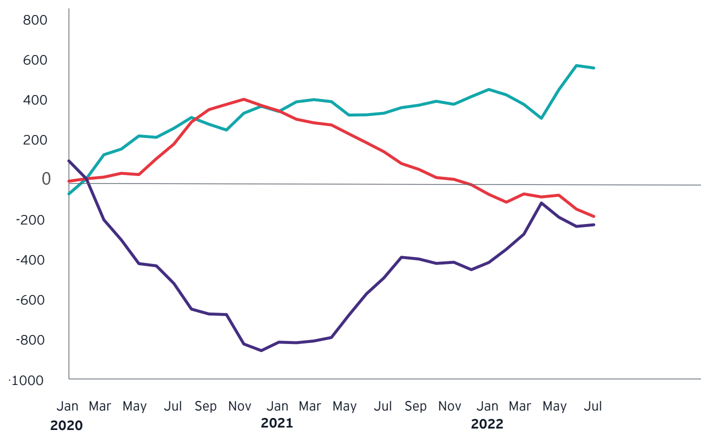
Unemployment is low, but all is not good in the jobs market

Against a backdrop of stagnant GDP over the late spring and summer, that the official Labour Force Survey (LFS) jobless rate dropped to 3.5% in the three months to August, down 0.2ppts from the previous quarter and the lowest since 1974, was ostensibly good news.

But the fall in unemployment was not a consequence of higher employment. In fact, the number in work fell by 119,000 on the previous three month-period and the employment rate declined to 75.5%, a percentage point below where it stood just before the COVID-19 pandemic, both suggesting that the weak economy is starting to weigh on job creation. A rise in inactivity (i.e., those not in work or actively looking for work) was responsible for pushing the unemployment rate down. Concerningly, economic inactivity due to long-term ill health showed the largest quarterly rise since records began in 1992, reaching 2.49mn, also a record.

UK: Labour market indicators

Change in level since February 2020, '000s

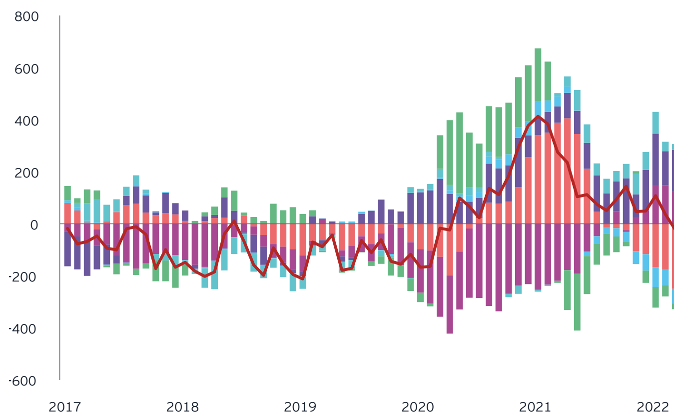


Source: EY ITEM club/Haver analytics

Inactivity Unemployment Employment

UK: Changes in inactivity by reason

Year-on-year, 000s



Source: EY ITEM club/Haver analytics

Other Retired Discouraged Sick Looking after family Students Total

Just why inactivity has gone up is unclear. Delays in NHS treatment for chronic or work-limiting conditions is one possible explanation, and the consequences of 'Long Covid' another (although that a large part of the rise in inactivity related to ill-health is accounted for by mental health conditions makes this explanation more tenuous). Or the experience of furlough may have caused some people to become accustomed to not working (and living on a reduced income), making the option of claiming incapacity benefit, perhaps for spurious reasons, more attractive.

As for the tightness of the jobs market, an increase in inactivity but a drop in job vacancies over the summer, albeit from very high levels, offered mixed messages. Total pay growth accelerated to 6% y/y in the three months to August from 5.5% in July, which errs on the still-very-tight side. And regular pay growth accelerated to 5.4%. Excluding the pandemic period, this was the highest since records began in 2001.

On a positive note, faster pay growth means cost of living pressures have not been as intense as they could have been. But real pay growth has been substantially negative. And relatively rapid growth in cash pay has been one factor prompting the BoE to continue raising interest rates (discussed further below). Hence, for borrowers at least, bigger pay rises have been a mixed blessing.

The BoE has continued to prioritise inflation worries above growth concerns

A renewed surge in gas prices over the summer threatened to worsen the dilemma the BoE's Monetary Policy Committee (MPC) faced in the face of rising inflation and weaker growth. But the government's move to cap household energy bills shifted the backdrop to the MPC's policy decisions. According to the minutes of September's MPC meeting, the EPG means the committee now expects inflation to peak at 11% in October and, by early 2023, be 5ppts lower than if bills had risen in line with the Ofgem price cap and the behaviour of wholesale gas prices.[1] In the MPC's view, this reduces the risk that externally generated inflation will lead to more persistent domestic price and wage pressures.

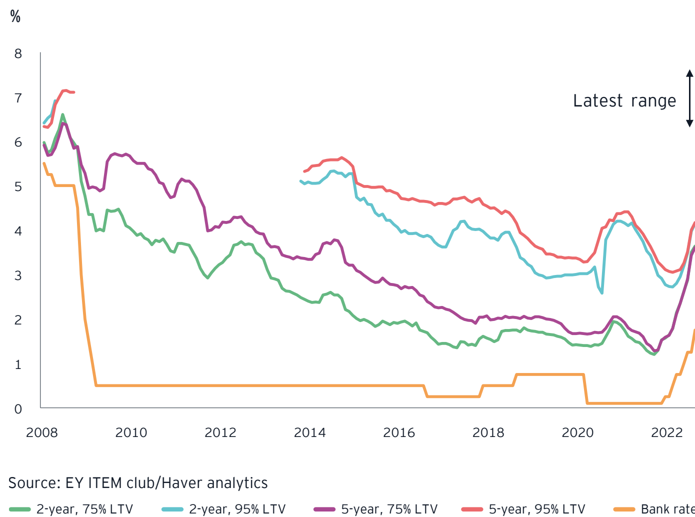
But the committee also concluded that support for disposable incomes offered by the cap points to medium-term inflation being higher than otherwise. Added to continued worries over the impact of a tight jobs market on pay growth and inflation well above the BoE's 2% target, this contributed to the MPC raising Bank Rate by 50 basis points (bps) in September's meeting. September's rise mirrored the increase the previous month and took the policy rate to 2.25%, the highest since 2008.

The rise in Bank Rate has translated into higher mortgage rates. For example, as of August, rates on two- and five-year

1 Bank of England, 'Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 21 September 2022', 22 September 2022. https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy-summary-and-minutes/2022/september-2022.pdf

fixed rate mortgages at 75% loan-to-value ratios were at their highest in a decade, although the increase in borrowing costs on higher loan-to-value mortgages had been more modest. More expensive mortgages may have contributed to a decline in mortgage approvals during 2022, although approvals have remained consistently above the norm in the decade running up to the COVID-19 pandemic. Housing transactions have also been relatively strong in recent months compared with that earlier period. But as Section 3 discusses, market ructions since late September threaten a sharp slowdown in the housing market.

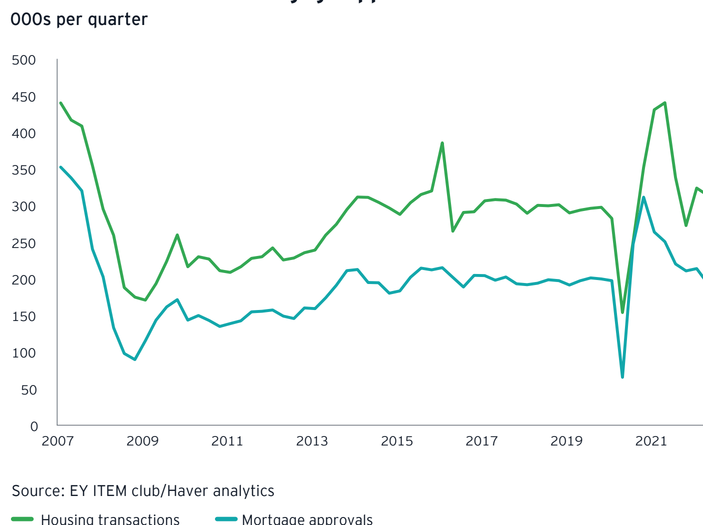
UK: Interest rates on fixed-rate mortgages



Source: EY ITEM club/Haver analytics

UK: Transactions & mortgage approvals

000s per quarter



Source: EY ITEM club/Haver analytics

The public finances have lost and gained from high inflation

The economy's soft performance over the spring and summer does not appear to have made a serious mark on the public finances. The public sector borrowed £58.2bn over the first five months of fiscal year 2022–23, down from £79.7bn in the same period a year earlier and just £0.2bn above the Office for Budget Responsibility's (OBR's) March forecast.

Such a small overshoot represents a positive outcome, given that public spending since the summer has been boosted by the first cost-of-living payments for those receiving means tested benefits, payments which were announced after the OBR's most recent forecast, and by the effect of higher-than-expected inflation in raising the cost of servicing index-linked debt. Debt interest costs averaged £9.8bn per month over April to August 2022, up from an average of £5.9bn in the same period in 2021.

High inflation has probably also had some positive fiscal effects, helping tax receipts by increasing the cash level of consumer spending (good for VAT revenues) and raising pay growth (to the benefit of income tax and PAYE receipts). Tax receipts over April-August were almost exactly in line with the OBR forecast, despite the economy estimated to be smaller than the official forecaster expected. The implication is that GDP may have proved even more 'tax-rich' than expected, aided by fiscal drag, or that the size of the economy has been underestimated, implying the possibility of upward revisions to GDP in the future.

3

Recession now looks likely, as higher interest rates compound existing headwinds

We think the economy almost certainly shrank in Q3. GDP fell in July and August, timelier indicators, such as the PMIs, have been soft and the extra bank holiday on 19 September will have weighed on output. The public holiday meant one fewer working day than normal. And unlike a typical bank holiday, there probably wasn't much of a boost to spending in areas such as eating out and DIY. Q4 having a normal complement of working days will deliver a mechanical boost to quarterly GDP growth. But the weight of adverse forces affecting the economy leads us to suspect output will also fall in that quarter and through the first half of 2023, albeit modestly.

Despite what's likely to be a weak autumn and winter for the economy, GDP growth in 2022 is now forecast at 4.3%, up from 3.7% expected in the summer. This is predominately the consequence of ONS revisions to historical data, which show much more momentum coming into 2022 than previously thought (if a smaller absolute level of GDP). The economy is now estimated to have grown 3.4% in the second half of 2021, versus 2.2% previously. But what is set to be a poor end to 2022, continuing into 2023, means we now expect output to shrink 0.3% next year, down from a rise of 1% expected previously. As falling inflation, a cut in interest rates and rising real incomes allow the economy to make up some ground lost in the previous year, GDP is forecast to expand by 2.4% in 2024 (unchanged from previously).

Interventions on energy bills and personal tax cuts have reduced the risk of a deep downturn

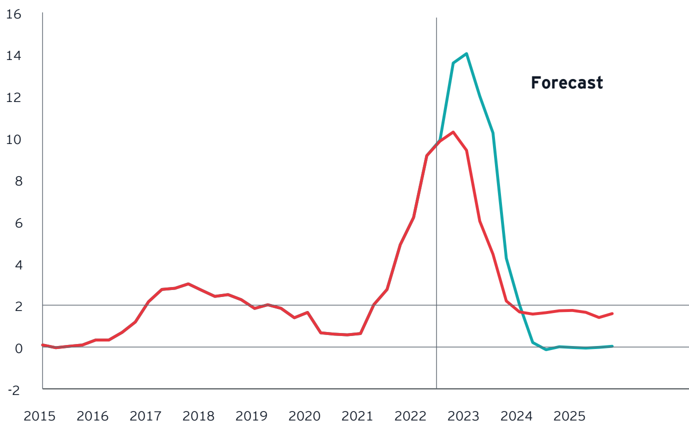
Granted, the government's fiscal interventions significantly reduced the risk of a prolonged and deep downturn. In annualised terms, the EPG has limited the typical household bill to £2,500 for the six months from October, meaning much lower bills than would otherwise have been the case. Ofgem had previously announced that the energy price cap would rise to £3,549 in October. On top of the EPG, all households will still receive the £400 rebate announced last July, due to be paid in monthly instalments from October. And the cut in NICs which takes effect in November will raise households' disposable incomes by around £3.5bn in 2022-23 and a further £8bn or so the following year.

Meanwhile, energy bills for firms will be cut by around half from predicted levels this winter under a package of discounts in place from October until April 2023.[2] This mitigates the risk, in the short-term, of large-scale closures in energy-intensive industries such as steel.

2. Department for Business, Energy & Industrial Strategy, "Government outlines plans to help cut energy bills for businesses", 21 September 2022. https://www.gov.uk/government/news/government-outlines-plans-to-help-cut-energy-bills-for-businesses

UK: CPI inflation

% year



Sources: EY ITEM club/Haver analytics

— Without the energy price guarantee — New forecast

Commodity prices

1 Jan 2019 = 100

Source: EY ITEM Club/Haver Analytics

— Wheat (LHS) — Oil (LHS) — Gas (RHS)

The introduction of the EPG, in its original two-year form, and the cap on energy bills for firms had implied a significantly lower profile for inflation than otherwise. However, the government's decision to reduce the duration of the cap from two years to six month and replace it next April with a more targeted, but yet to be designed, policy means the influence of energy prices on inflation has become much more uncertain. Based on previous plans for a two-year cap, inflation in energy bills would have dropped from around 100% y/y between October 2022 and March 2023 to 27% between April and September next year, then zero next October. That would have cut the contribution of bills to overall CPI inflation from over 4ppt to zero. The decision to curtail the cap after six months means there are upside risks to our inflation forecast. But until we know the form and generosity of support post-April, it's impossible to quantify those risks.

Falls in the price of oil (as of early October, down 30% from June's peak), wholesale gas (spot prices fell 50% between late August and early October) and other commodities, and shipping costs (the Baltic Dry Index dropped 66% in the 12 months to October) will also reduce cost and price pressures and slow inflation.

Granted, the weakness of sterling will mitigate disinflationary pressures. At the same time, the support to spending in the economy from the cut in NICs means inflation in the medium-term will probably be a bit higher than otherwise. Second-round effects from higher wage growth could also slow inflation's fall. But a weaker economy and the prospect of the BoE aggressively raising interest rates suggests that employers may respond to big pay demands more by shedding workers than raising prices. Overall, we expect CPI inflation to peak at just below 11% in October, before falling back to the BoE's 2% target around the turn of 2023/2024.

Household incomes still face a big squeeze from high inflation, but savings may come to a (partial) rescue

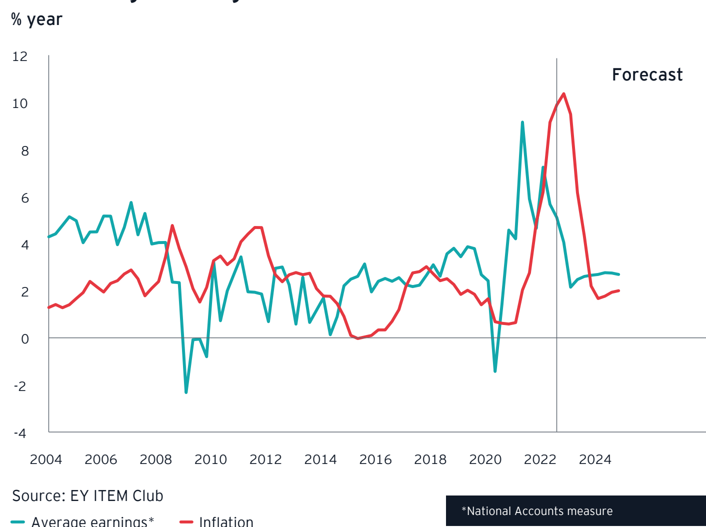
That inflation will remain unusually high over the next 12 months or so implies a still sizeable squeeze on households' spending power. And whilst the cap on energy bills has mitigated, in the short-term, what could have been, for many, an impossible rise in outlays. The average bill between now and next spring will still be more than double its level in early 2022. Hence, households' real incomes are still likely to decline over the next 12 months to the greatest extent since the 1970s.

The damage to consumer spending from lower real incomes might be partially offset by households drawing on unplanned savings built up during the pandemic and higher borrowing via credit cards and unsecured debt. On our calculations, as of Q2, households had yet to draw on any of the 'excess' savings accumulated since early 2020. What's more, revisions made by the ONS to the household saving ratio over the pandemic period, published in Q2's national accounts, imply those unplanned savings are much bigger than previously thought – on our estimate, £230bn, or 17% of annual consumer spending, versus

£180bn (13% of spending) previously. This implies a bigger cushion of savings to support spending, even as real incomes fall.

UK: Average earnings and inflation

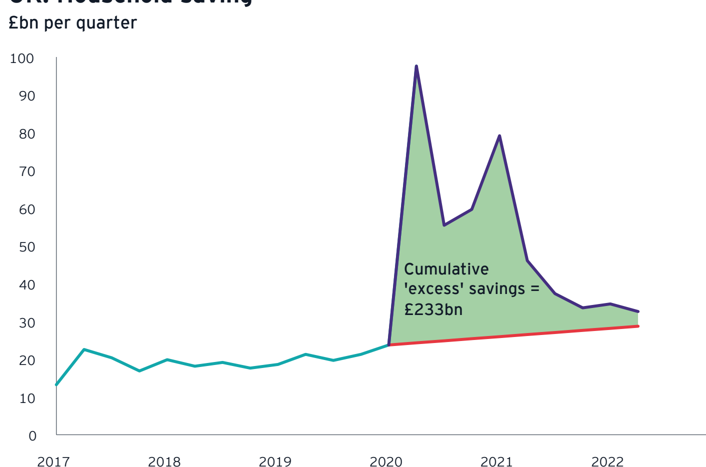
% year



Source: EY ITEM Club

UK: Household saving

£bn per quarter



Meanwhile, following the deleveraging which occurred 2020 and 2021, as consumers cut back borrowing and paid down debt, there's room for unsecured borrowing to pick up before reaching levels that might cause concern. As of Q2, debt from credit cards and personal loans was equivalent to 13.1% of annual household incomes, the joint lowest since 1997.

Interest rates are likely to rise aggressively, but market expectations look too high

A very changed outlook for interest rates presents a new headwind and means the potential for dissaving to support consumption has probably fallen. Even before the financial market turbulence following September's mini-Budget, borrowing costs had risen by more than we had expected. As of October, the official BoE policy rate stood at 2.25%, the highest since 2008.

With inflation well above the BoE's 2% target, the MPC's ongoing concerns about the effect of a tight jobs market on pay growth and the demand-boosting effects of tax cuts, Bank Rate was set to head considerably higher. The government's U-turn on most of its previously announced tax cuts and a subsequent calming in financial markets means the MPC will now be under less pressure to raise rates. But borrowing costs are likely to still increase to a greater extent than we expected in the summer.

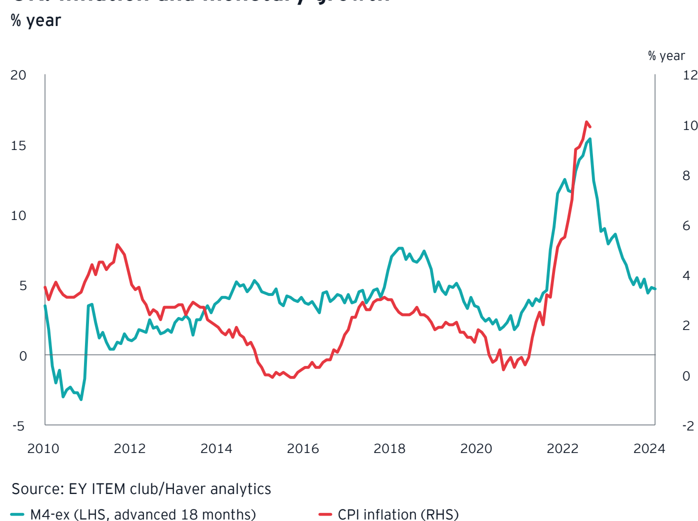
Granted, current market-implied interest expectations, which show the UK policy rate reaching 5% by mid-2023 (down from a peak of 6% during the worst of the market turmoil), strike us as too high. For sure, given the perceived pressure on the BoE to demonstrate its inflation-fighting credibility, an aggressive rise in Bank Rate in the MPC's next meeting in November looks set to happen. We expect a 75bps to 100bps hike. But in our view, that will be followed by a return to more standard-sized rate rises. Bank Rate is forecast to peak at 4% next spring, with the BoE then cutting rates towards the end of 2023 and in 2024.

Our reasoning for the markets getting ahead of themselves is straightforward. Monetary policy works with a lag of 12-18 months, and inflation is likely to fall quickly next year as base effects, deflating commodity prices, sharply decelerating monetary growth and recession or stagnation in many economies all weigh on price rises. Raising rates as aggressively as market expectations imply would risk a more serious recession and a major drop in property prices (many rolling off fixed-rate mortgages would see their mortgage payments almost double overnight). The consequence could be inflation falling well below the 2% target, with a period of deflation a possibility.

Pressure to raise rates aggressively could also ease if the US and eurozone economies slow further and their respective central banks rein back tightening monetary policy in response. And we're doubtful the tax cuts announced in September will prove particularly inflationary. Most of the direct gains will go to better-off households, who have a relatively low propensity to spend income increases. And depending on the ambition of the Government's supply-side reforms and whether those reforms

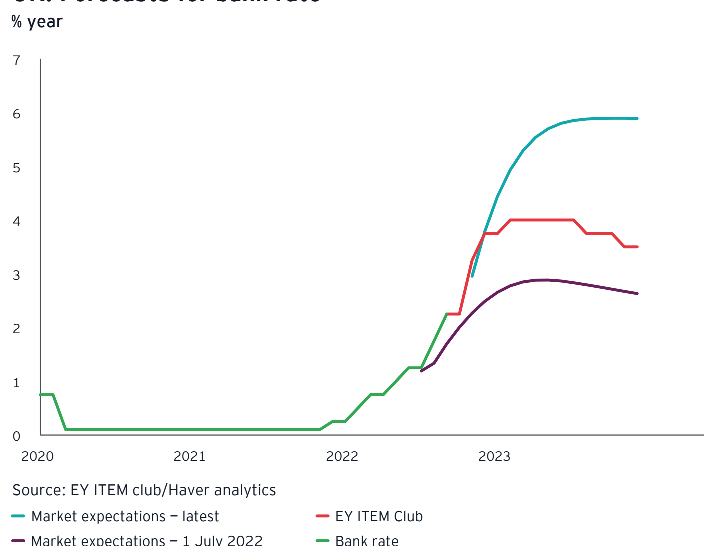
prove deliverable, the BoE may judge that the economy's supply capacity has improved. All else equal, this would depress inflation.

UK: Inflation and monetary growth



Source: EY ITEM club/Haver analytics

UK: Forecasts for bank rate



Source: EY ITEM club/Haver analytics

Moreover, it's clear from recent turmoil in the gilts market that an aggressive rise in interest rates could pose serious financial stability risks beyond consequences for the housing market. The spike in long-term gilt yields in September put many pension funds at risk of insolvency, a consequence of past efforts at financial engineering aimed at generating higher returns in a world of near-zero interest rates.[3] BoE intervention via gilt purchases averted disaster. But the UK central bank will now be more mindful of the risk that pushing borrowing costs up too far, too fast, could have some unintended, and unintendingly damaging, consequences. Tolerating a slower decline in inflation may be a price worth paying to avoid this.

Our rate forecast depends, crucially, on the government acting to boost credibility in its policies, so bringing down the risk premium on UK financial assets. New Chancellor Jeremy Hunt has made a start on that and will have the opportunity to set out his plans in more detail when he presents what is now looking like a full-blown Budget on 31 October. Otherwise, the less significant rise in rates under our forecast would risk triggering a further fall in sterling and adding to imported cost pressures. It may also not prevent long-term market rates, which many mortgages are priced off, from staying at recent elevated levels. In that event, the BoE could feel compelled to raise rates more than the economy's fundamentals require, crashing the housing market and the disposable incomes of borrowers and turning what we expect to be a very shallow downturn into a much deeper recession.

An outright fall in house prices now looks odds on

Even with Bank Rate reaching no more than 4%, our previous prediction for a soft-landing for the housing market has shifted to an outright fall in prices. We expect average property prices to drop 5–10% over the next year or so. This wouldn't be a particularly big fall in the context of average prices rising almost 25% since the start of 2020 alone. The affordability stress tests applied by lenders between 2017 and the summer of 2022 mean mortgagors should be better able to deal with higher mortgage rates. And the cost to households of servicing debt is rising from a very low level. As of Q2, interest payments absorbed 3.6% of total household incomes, up from 3.4% in Q1, but still well below the long-run (post-1987) average of 6% and a fraction of the peak of 13% reached in 1990.

Moreover, previous large corrections in house prices and periods of financial stress for households have tended to be triggered by steep rises in unemployment. We think the unemployment rate will rise. But that prospects for the jobs market are beginning from a situation of excess demand for workers (if the ratio of unemployed to vacancies sitting at a record low of just under 1 over the summer is any indication) implies that softer demand for workers may not translate into a major increase in joblessness.

3. A comprehensive explanation of developments which nearly blew up the pensions market is given in Alexandra Scaggs and Louis Ashworth, 'LDI: the better mousetrap that almost broke the UK', FT Alphaville, 29 September 2022. https://www.ft.com/content/f4a728a5-0179-48bd-b292-f48e30f8603c

The LFS rate is forecast to peak at around 5%, a modest rise by the standards of past recessions.

But the outlook for property owners is still grim. Bank Rate at 4% would imply typical mortgage rates of 5%+. In comparison, the average interest rate on a new mortgage averaged 2.7% over the last decade. One could argue that mortgage rates of 5% would still pale in comparison with rates of 10%–15% that property buyers in the 1980s and early-90s had to deal with. But the comparison is not like for like. Mortgages today are at much higher multiples of income. They are not (unlike the pre-2000 situation) tax-deductible, whilst a bigger share of home loans is now repayment rather than interest only.

Coming on top of a severe squeeze in spending power, a correction in house prices makes for an even gloomier outlook for consumer spending. Even those mortgagees who are protected from the immediate consequences of higher rates by fixed-rate deals may now decide to save more and spend less in anticipation of a steep rise in mortgage outlays, or direct savings and the proceeds of tax cuts into early repayment. After consumer spending is forecast to grow 4.9% this year, we expect a 0.7% contraction in 2023, a similar-sized drop to that in 2008, during the global financial crisis.

Investment recovery faces even more challenges

Meanwhile, on the business investment front, the recovery in capital spending has disappointed, with business investment in Q2 2022 still 8% below its pre-pandemic level. Whilst the 'super deduction' tax incentive has been relatively successful in spurring investment in machinery over the past year, the performance of the services sector has been very weak.

There's still large scope for a catch-up, and the government's decision in September's 'mini-Budget' to cancel the planned rise in the corporation tax rate from 19% to 25% and maintain the Annual Investment Allowance at £1mn makes for a better tax environment for investment. But a very uncertain economic climate, the prospect of a period of weak growth for the UK and global economies, the rising cost of capital goods and a world of much higher interest rates than we expected only a few months ago will hold back the pace at which investment recovers. Therefore, whilst we forecast decent calendar-year growth rates for business investment in the near term, we expect it will take until late 2024 for the investment to return to its pre-pandemic level on a sustained basis.

Energy prices still dominate risks, but sterling and gilt yields present new avenues of uncertainty

The centrality of energy prices to the economic outlook means that moves in those prices continue to be the chief source of risks to our forecast. If sustained, the fall in wholesale gas prices since August presents upside and downside risks to growth and inflation, respectively. But the impossibility of predicting the vagaries of international energy markets and how the war in Ukraine will progress mean another spike in prices can't be ruled out.

One consequence of the government's open-ended commitment to cap bills for households is that changes in energy prices carry risks for more than just growth and inflation. If energy prices were to come in lower than expected, the EPG would cost less, combining with a stronger economy to deliver a better-than-expected fiscal position and potentially a stronger pound and lower gilt yields. Conversely, were energy prices to spike again, concerns about the sustainability of the UK's public finances would intensify, raising the prospect of higher interest rates and weaker sterling or a further U-turn from the government on the level of support.

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

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

	GDP	Domestic demand	Consumer spending	Fixed investment	Exports	Imports
2019	1.6	1.7	1.1	1.9	1.7	2.6
2020	-11.0	-12.2	-13.2	-10.5	-12.1	-16.0
2021	7.5	8.2	6.2	5.6	-0.3	2.8
2022	4.3	6.2	4.9	5.1	6.7	13.2
2023	-0.3	-1.7	-0.7	1.7	5.3	0.2
2024	2.4	2.4	2.9	1.3	2.6	2.5
2025	2.3	2.3	2.4	2.7	2.1	2.2

	Net Govt Borrowing(*)	Current account (% of GDP)	Average earnings	CPI	Bank Rate	Effective exchange rate
2019	2.4	-2.7	3.4	1.8	0.8	78.2
2020	15.0	-2.5	1.7	0.9	0.2	78.1
2021	6.2	-2.6	5.9	2.6	0.1	81.5
2022	6.6	-5.9	5.5	8.9	1.6	79.0
2023	4.5	-3.5	3.3	5.5	3.8	78.2
2024	2.4	-2.4	2.7	1.8	3.3	80.2
2025	1.9	-2.3	2.9	2.0	3.3	80.4

Source: EY ITEM Club

* Fiscal years, as % of GDP

Our forecast for consumer spending depends on cost of living and interest rate pressures being partly offset by households saving less and borrowing more. That consumers have more unplanned savings to draw on than previously believed means dissaving could, in theory, play a bigger role in supporting consumption.

On the other hand, financial market turmoil and the drum roll of bad news stories about the economy's prospects could prompt a much more cautious attitude among consumers, meaning an even weaker performance from consumer spending.

4

Has the government's policy activism failed before it's even begun?

In a turbulent period for the economy since our summer forecast, a shift toward a more activist fiscal policy and away from the focus on reducing of the previous decade stands out. Given the potentially disastrous economic consequences had household energy bills risen to the £5,000+ levels previously predicted for next year, large-scale support to households via the EPG was probably inevitable. But the government under new Prime Minister Liz Truss went further, announcing a package of tax cuts and supply-side reforms in September's mini-Budget, framed around raising the economy's rate of trend growth.

The immediate market reaction to all the fiscal largesse was not pretty, with the Chancellor's statement on 23 September immediately followed by the pound dropping sharply and gilt yields spiking. Although markets initially calmed, the speed at which gilt prices fell – and yields rose – forced pension funds that had engaged in so-called 'Liability-driven investment', or LDI, strategies to inject fresh capital to meet margin calls, resulting in a further sell-off in gilts and triggering emergency intervention by the BoE. That intervention calmed the markets, but the time-limited nature of BoE support left the government's plans for major borrowing-funded tax cuts exposed to investors' worries about the public finances. The result was a U-turn on almost all elements of the tax cuts, the sacking of Chancellor Kwasi Kwarteng and the prospect now that fiscal policy may be tightened via more tax rises and tighter control on public spending.

The cap on energy bills is a potentially very costly but necessary, evil

The EPG was originally intended to cap the unit price of energy for households for two years, starting in October, with energy suppliers compensated for any additional costs. Similar support has been offered to businesses and other energy users (such as schools) for an initial period of six months. The duration of the EPG has now been limited also for six months, with the Treasury charged with coming up with a more targeted form of support post-April 2023. Even with the shorter duration, applying the EPG to all households will be expensive and puts the government on the hook for a potentially open-ended commitment.

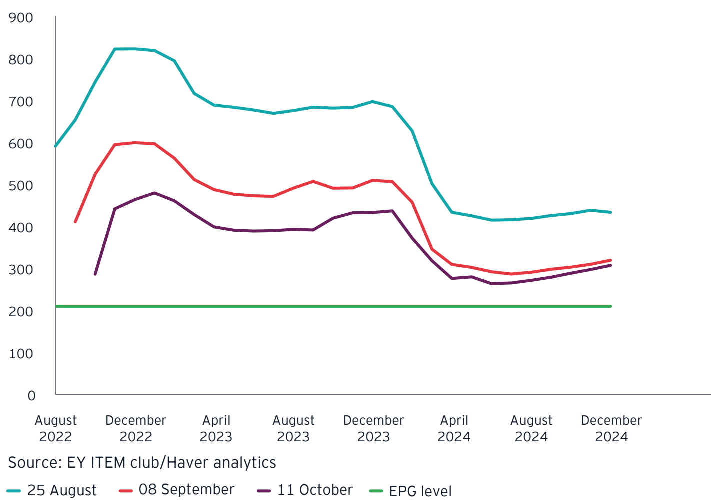
But that cost needs to be weighed against the collapse in tax receipts and rise in spending had energy bills risen over the autumn and winter in line with wholesale gas prices and a deep recession followed. The EPG is simple and easy to communicate. Targeting support to more vulnerable groups would have been complicated by a lack of homogeneity among households (for example, a threshold based on subsidising a given amount of energy use would have penalised low-income households with high energy needs, such as those with lots of children or living in badly insulated homes) and risked big 'cliff-edge' effects. A support threshold based on income would have resulted in households sitting just above the threshold but still very vulnerable to rising bills with no support.

As to how much the price cap will cost, an honest answer would be that no one knows. The Treasury puts the cost of the cap on household and corporate energy bills combined at £60bn over the six months from October.[4] But this number is very speculative. The eventual cost will depend upon movements in wholesale gas prices and how cold, or otherwise, the coming winter proves. Neither is forecastable. But as things stand, the burden to the public finances might be less than feared.

4. HM Treasury, 'The Growth Plan', 29 September 2022.
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1105989/CCS207_CCS0822746402-001_SECURE_HMT_Autumn_Statement_2022_BOOK_Web_Accessible.pdf

UK: Gas futures curves

Pence per therm



At the time of writing, wholesale gas futures prices over 2023 and 2024 had dropped by an average of 13% compared with their level on 8 September, when the EPG was announced, and by almost 40% from the peak in late August. The spot price (the outcome of a much more liquid market than futures prices) had fallen by 60% to below 250 pence per therm (for reference, the price implicit in the cap on household bills is around 210 pence per therm).

The fiscal savings from curtailing the cap after six months are also very uncertain. Limiting the scheme's life gives the Chancellor a degree of conditionality. If the recent fall in wholesale gas futures prices is sustained, the cost of the EPG beyond six months would likely have been much less than initially projected, and the need to replace it with any particularly expansive support will be lessened. But if prices spike up again, the government will probably end up extending the life of the cap beyond next April.

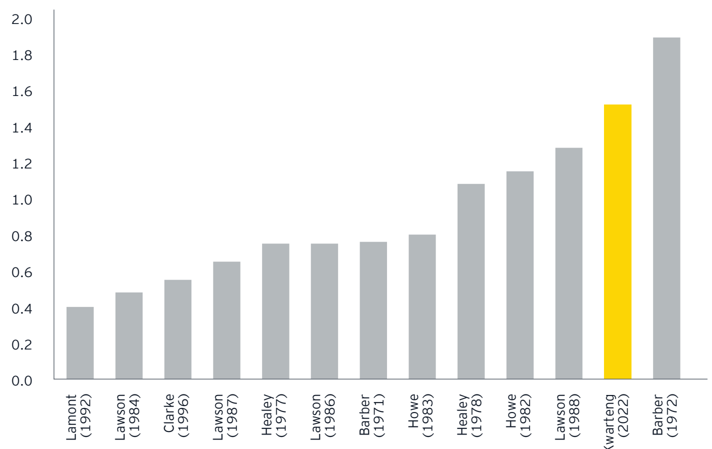
U-turns on tax cuts present a mixed blessing for the economy …

The tax reductions announced by now-former Chancellor Kwarteng were sizeable, amounting to £45bn per year or around 1.5% of GDP by the middle of the decade. This would have represented the biggest package of reductions, in GDP terms, since the Budget of 1972.

But the passing of only a few weeks saw the near-complete reversal of the mini-Budget's announcements. New Chancellor Jeremy Hunt began by announcing that next April's rise in the corporation tax rate would itself be cancelled. He then went further, scrapping plans to reduce income tax (and putting any future cut on hold) and abandoning September's smaller tax reductions. This leaves the cuts in NICs (at a fiscal cost of £13bn per year) and stamp duty as the only parts of September's initial £45bn of tax reductions that will go ahead.

UK: Net reduction in tax burden by fiscal event

% of GDP



Source: IFS

The market reaction to the Chancellor's announcements was positive, with sterling strengthening and gilt yields falling across the curve. The latter was particularly reassuring given the risk that the end of BoE intervention in the gilts market would trigger a rise. With the fiscal stance now set to be less loose than previously planned (the tax U-turns alone equate to a tightening of around 1.3% of GDP) and the risk premia on UK assets falling, the BoE will be under less pressure to take an aggressive approach to raising interest rates.

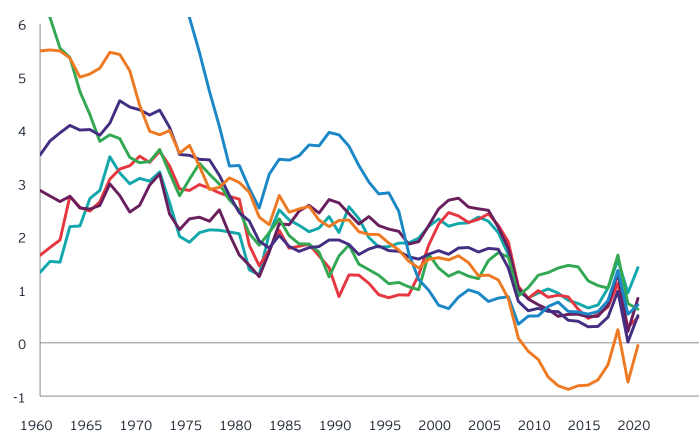
All else equal, this is good news for the economic outlook. But that the tax burden will now be higher than planned will add to already significant financial pressure on households, something true even for the rise in corporation tax, which investors will bear through lower dividends, consumers via higher prices, and workers through lower wages. All else equal, it will also increase the cost of capital for firms, a negative for business investment.

… while the delivery of supply-side reforms now looks like an even tougher challenge

The government's framing of its tax measures, as well as accompanying reforms to accelerate planning approval for key infrastructure, encourage domestic energy production and increase participation in the labour force, was not to provide a short-term boost to demand but to raise the economy's sustainable rate of growth. Former Chancellor Kwarteng had set a goal of achieving GDP growth of 2.5% a year over the longer term. This would be in line with the average rate between 1948 (when the official GDP series begins and 2019, but a major step up from the 1.5% a year recorded since the global financial crisis.

That economic policy has, for some time, failed to achieve the aim of healthy growth in living standards is undeniable. In common with most other major economies, the UK has seen underlying GDP growth, particularly in per capita terms, decline significantly over the past few decades, notably since the global financial crisis. Hence, the argument that a different approach might be worth trying is a strong one.

But whether the Government's policies would have been sufficient to shock the economy out of sluggish growth, even if they had been implemented in full, is another question. The evidence that tax reductions boost trend growth is mixed. Some research finds that lower taxes can have a significantly positive effect. But other analysis finds no boost to growth.[5] More generally, research suggests that it's very hard for public policy to shift an already-rich economy's trend growth rate, whether via changes to R&D, education, public investment or tax.[6]



That said, the relatively free market US has tended to outperform more social-democratic economies – US GDP growth averaged 2.6% between 1980 and 2021 vs 2.2% for Sweden, a country arguably at the opposing end of the mixed capitalism spectrum. And the UK's government 'Growth Plan' had extended to more than just tax cuts. Reducing obstacles to and accelerating investment in new infrastructure, energy provision and housing and seeking to boost participation in the labour force are at least steps in the right direction. But delivering those plans was already going to be difficult in the face of NIMBYism, institutional inertia and the power of special-interest lobbies. The current prime minister's loss of authority and a Conservative Party riven with divisions will make the task even harder.

5. See Torsten Bell et al. 'Blowing the budget: Assessing the implications of the September 2022 fiscal statement'. Resolution Foundation, 24 September 2022. https://www.resolutionfoundation.org/publications/blowing-the-budget/
6 For an example of analysis supporting the proposition that lower taxes boost growth, see Karel Mertens, 'The Near-Term Growth Impact of the Tax Cuts and Jobs Act', Federal Reserve Bank of Dallas Research Department Working Paper 1803, 23 March 2018. https://www.dallasfed.org/-/media/documents/research/papers/2018/wp1803.pdf. For a contrary view, see Sebastian Gecherta and Philipp Heimberger 'Do corporate tax cuts boost economic growth?', European Economic Review. Volume 147, August 2022. https://www.sciencedirect.com/science/article/pii/S0014292122000885?via%3Dihub

5

Current account worries and fears of a sterling 'crisis' are overdone

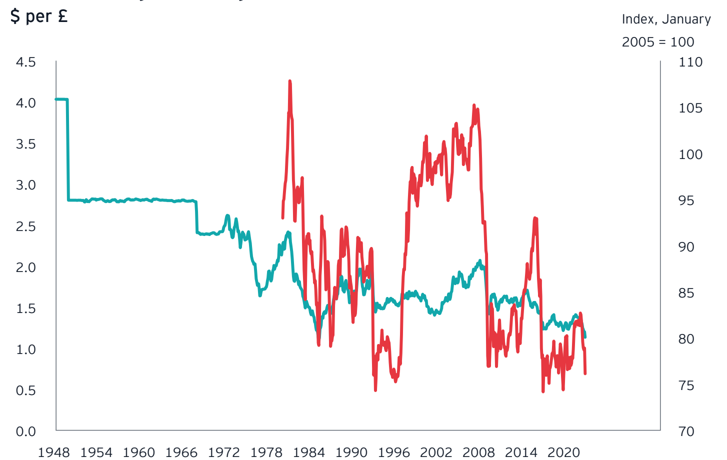
With the pound sinking against the US dollar in September to a record low and the UK running a historically large current account deficit, worries of a potential sterling or balance of payments 'crisis' have emerged. But these concerns need to be qualified. A weaker currency should help to stabilise the UK's external position. And most economies are in the same boat as the UK regarding the impact of high energy prices. These factors should hold back a further widening in the current account deficit and limit the odds of sterling falling more.

A floating pound rules out a 'traditional' sterling crisis, but crises can take different forms

Sterling crises were a feature of the first half of the post-war period because of ill-fated attempts to keep the pound fixed against the dollar. A combination of a domestic economy losing competitiveness and unsustainable external commitments (stemming from a desire to maintain the UK's economic and military world role) meant sterling came under repeated pressure. With the BoE's foreign exchange reserves unable to offset the volume of selling, the pound was devalued in 1949 and 1967. That sterling has floated freely since 1971 (apart from the period of ERM membership in 1990–92) means a sterling crisis, in the traditional sense of the term, can't happen.

That doesn't mean a different type of crisis can't occur under a floating regime. The pound could fall to the extent that it threatens to raise inflation to unacceptably high levels, undermining confidence in the currency and risking a downward spiral. It was this concern (not helped by Treasury forecasts for government borrowing, which proved far higher than the reality) that resulted in the Labour government's request for a loan from the IMF in 1976.

UK: Sterling exchange rate



Source: EY ITEM club/Haver analytics

— £/US$ (LHS) — Trade-weighted index (RHS)

Certainly, the pound is currently very weak. As of the start of October, sterling had dropped 18% against the US dollar since the start of the year, whilst measured against a basket of currencies weighted by the importance of UK trade, the fall stood at 7.5%. In both dollar and trade-weighted terms, the pound was close to a record low.

But comparisons with the IMF crisis of 1976 are overblown. Whilst inflation averaged around 10% this summer, the UK is still far from 1976-style inflation levels or persistence. The CPI measure peaked at 21% at the start of 1976, having been above 10% in each month since late 1973. And inflation then was much more a result of structural domestic pressures than is the case now. Growth in average weekly wages averaged almost 17% in 1976, after running at an average of close to 21% y/y over the previous three years. Pay growth is currently running at a much less heated 5% y/y.

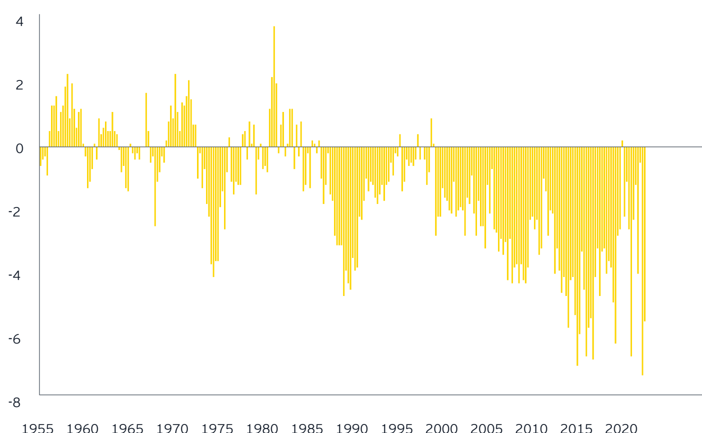
Moreover, high inflation is hardly a UK-specific problem. On a harmonised basis, inflation in the UK in August (9.9%) was lower than in 14 of the 27 EU member states and the EU average of 10.1%, although higher than in some of the big EU economies (France: 6.6%, Germany: 8.8% and Italy: 9.1%).

The current account deficit has widened, but the weak pound should keep it in check

The UK's current account (a summary of imports and exports of goods and services, payments made to foreign investors, and transfers such as foreign aid) showed a deficit of 7.2% of GDP in Q1, the biggest since records began in 1955. It narrowed to 5.2% of GDP in Q2, although this still dwarfed a long-run average deficit of 1.4% of GDP.

UK: Current account

% of GDP



Source: EY ITEM club/Haver analytics

With the cost of mainly imported energy soaring, it's not surprising that the UK's external deficit has widened. The trade deficit in fuels alone reached a record of 2.2% of GDP in Q2 2022, compared with a position of balance only two years earlier. In the parlance of the more alarmist narratives, a current account deficit means a country is 'living beyond its means' and must be 'funded' by a surplus on the financial account – in words, more capital flowing into the UK from abroad than vice versa. A bigger deficit means more funding is required, but if holders of overseas capital lose confidence, inflows could dry up, leading to a collapse in imports (and so living standards) and sterling.

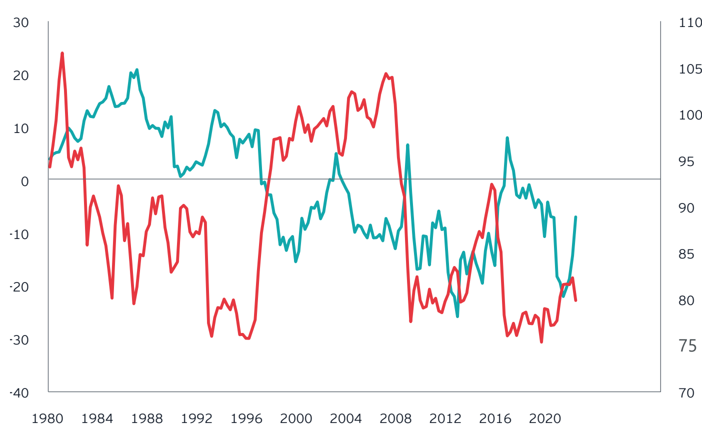
But this story's not quite the full picture. The balance of payments must balance. A deficit on the current account must be matched by a surplus on the financial account. But there's no a priori reason to think that the chain of causation runs from current account deficit – borrowing from abroad – financial account surplus. Financial flows into the UK, attracted by factors like institutional strength and the rule of law, can equally be a cause, not a consequence, of the deficit on the current account.

Granted, there's no doubt that the nation's higher energy bill means an excess of imports over exports is driving the wider deficit at present, rather than the appetite of overseas investors for UK assets. That's consistent with the recent fall in sterling. But that fall should prove an automatic stabiliser as far as the external accounts are concerned, mitigating the risk of a further sharp decline in the currency's value.

There are two reasons for this. One is the effect of a weaker currency on exports and imports. The pound's fall should be positive for the UK's net trade position, boosting exports and reducing imports, even allowing for evidence that the demand for UK exports is fairly price insensitive.

UK: Net international investment position and sterling

% of GDP



Source: EY ITEM club/Haver analytics

— NIIP (LHS) — Trade-weighted exchange rate (RHS)

The second reason concerns the UK's external balance sheet. Most assets held by foreign investors in the UK are denominated in sterling, but the overwhelming share of assets owned by UK investors overseas are denominated in foreign currencies. This currency mismatch means that, all else equal, the weaker pound should raise net investment income from abroad. It should also improve the UK's net international investment position (NIIP), the difference in the sterling value of the stock of UK assets held abroad and foreign-owned assets in the UK.

Indeed, whilst the UK's NIIP was substantially negative in Q2 at -7% of GDP, it had narrowed from -22% of GDP a year earlier, despite a succession of big current account deficits, and was the least negative since Q2 2020. Precedent suggests the NIIP should narrow further. The fall in sterling around the Brexit referendum was accompanied by the NIIIP narrowing by over 20% of GDP in the space of a year. An improvement in the NIIP should help calm concerns about imbalances and be supportive of sterling. We expect a gradual appreciation in sterling, with the pound rising above $1.25 by the end of next year.

6

Conclusions

Regardless of domestic developments, the UK economy would have had a hard time avoiding recession in the coming months, not least due to a very weak global situation. The US economy contracted over the first half of 2022. Whilst it's widely expected to return to growth in H2 of this year, many forecasters predict another US recession in 2023 as very hawkish Fed policy leaves its mark. And the demand-sapping effects of high energy prices mean the eurozone economy is widely expected to shrink later this year and into 2023.

But have recent financial and political developments in the UK made a bad situation even worse? On the side of those saying 'no', the cap on energy bills, even in its now-truncated form, will likely prove a game changer in ensuring what could have been a deep slump over the coming winter is instead a mild recession. And the U-turns on the mini-Budget appear to have calmed investors' worries about the UK's public finances and led to some reversal in what had been a frightening rise in market interest rates.

But households now face the prospect of the highest tax burden since Clement Atlee was PM and the prospect, given recent soundings from the new Chancellor, that more taxes could rise and public spending cut. The big question is the extent to which a tighter fiscal policy and a calming in financial markets will give the BoE leeway to keep interest rates lower than otherwise. On that count, we're confident that market expectations for rate hikes are still too aggressive.

Falling inflation next year, an appreciation that the UK will be far from alone in having to loosen fiscal policy (witness the recent announcement in Germany of €200bn of energy support for households and firms) and, hopefully, a calming down of political turmoil, suggests to us that interest rates will peak well below where investors currently expect. But the 4% rate we forecast will still add considerably to the challenges faced by households with mortgages (if good news for those with savings) and probably trigger an outright fall in house prices.

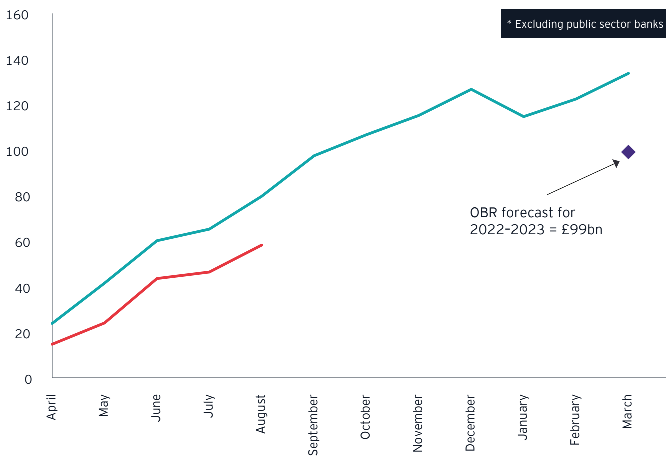
In an ideal world, by this time next year, gas prices will have returned to some semblance of normality, inflation will be back down to 2% or so, government borrowing will prove much lower than expected and tax and supply-side measures will be having the desired effect in boosting growth. An idle fantasy? Not necessarily. But outside forces, beyond the control of UK policymakers, will be the ultimate determinant of whether this benign scenario materialises or if the recent bout of 'Shriekonomics' among markets and some commentators and elements of the media proves accurate.

7

Forecast in charts

Fiscal policy

UK: Public sector net borrowing*
£bn, cumulative

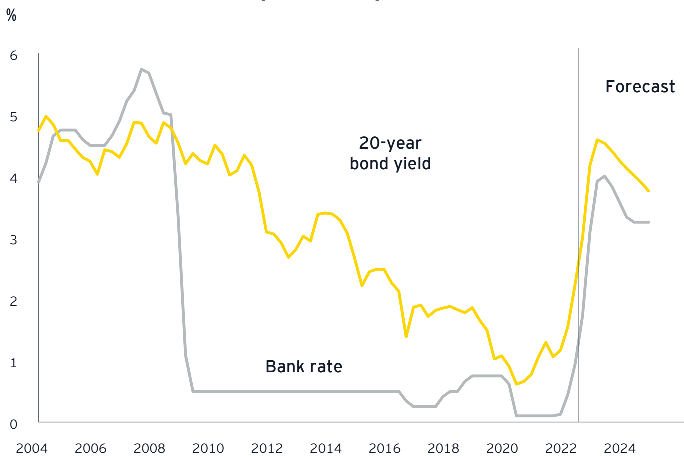


Source: EY ITEM club/Haver analytics
— 2021-2022 — 2022-2023 ◆ OBR forecast (end-year)

- Borrowing in the first five months of fiscal year 2022-23 came in at £58.2bn, about a quarter lower than the same period a year earlier and in line with the OBR's March forecast.
- The deficit in the second half of the year is set to widen considerably, reflecting the cost of the energy price cap and support payments to households. Tax cuts will further add to borrowing in 2023-24.
- That said, actual borrowing is highly dependent on movements in wholesale gas prices. So, while a deficit of well over £100bn in both this year and next is plausible, any prediction is highly speculative.

Monetary policy

UK: Bank Rate and 20-year bond yield
%

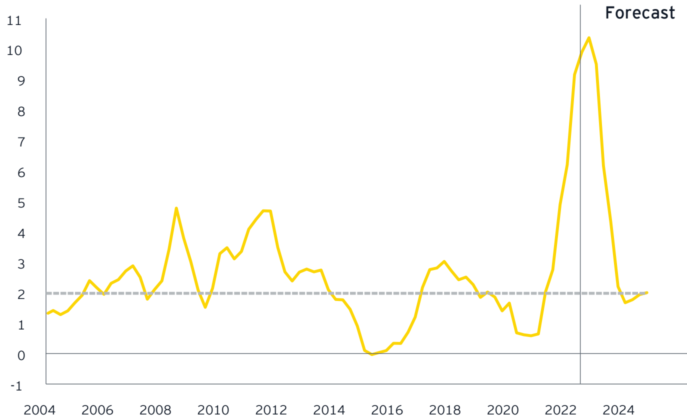


Source: EY ITEM club

- Bank Rate rose to 2.25% in September, the highest level since 2008.
- High inflation, a tight jobs market and aggressive rate hikes by other central banks meant the MPC was already on course to continue tightening monetary policy.
- But September's fall in sterling, looser fiscal policy, and a perceived need to appease investor concerns are likely to accelerate the rate hikes. We expect Bank Rate to rise to 4% by next spring.

Prices

UK: CPI inflation
% year

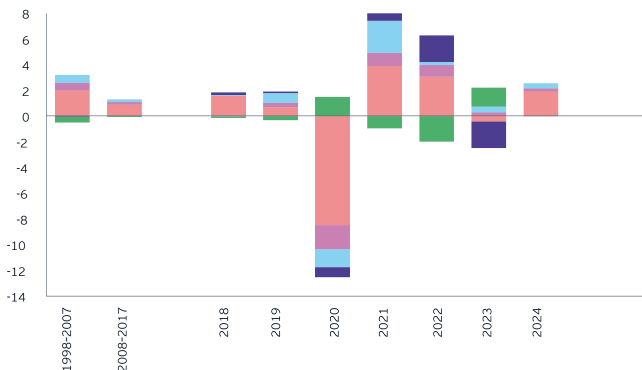


Source: EY ITEM club

- Inflation dipped to 9.9% in August, from 10.1% a month earlier, reflecting downward pressure from a fall in petrol prices.
- We expect the CPI measure to rise close to 11% in October, as the typical household energy bill rises 25%. But the cap on bills will substantially reduce what could have been a peak in inflation of around 15%.
- Price pressures should fall back rapidly next year, reflecting base effects, the consequence of recent declines in commodity prices and shipping costs and weaker economic activity at home and abroad.

Activity

UK: Contributions to GDP growth
%pts

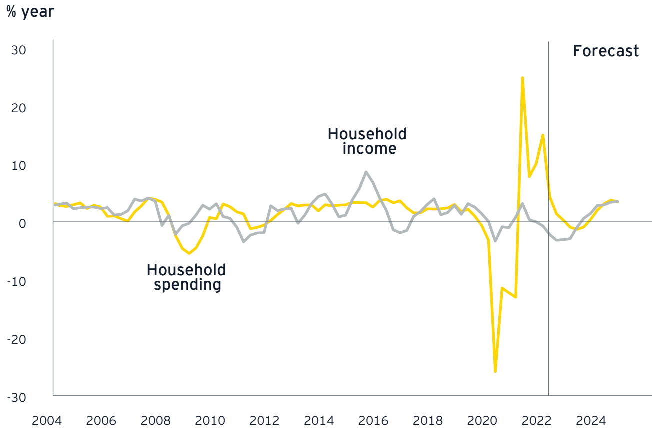


Source: EY ITEM club
Consumer spending
Govternment consumption
Net trade
Investment
Other (inc. inventories)

- The economy stagnated between April and July, although this partly reflected a fall in spending on Covid testing and vaccinations and the bank holiday for the Queen's Jubilee.
- Public holiday effects are likely to have weighed on growth in September and pushed the economy into a contraction in Q3.
- GDP is forecast to shrink further in Q4 and over the first half of 2023, with activity weighed down by high inflation, rising interest rates and global economic weakness. We forecast GDP to rise 4.3% this year and fall 0.3% in 2023.

Consumer demand

UK: Real household income and spending
% year

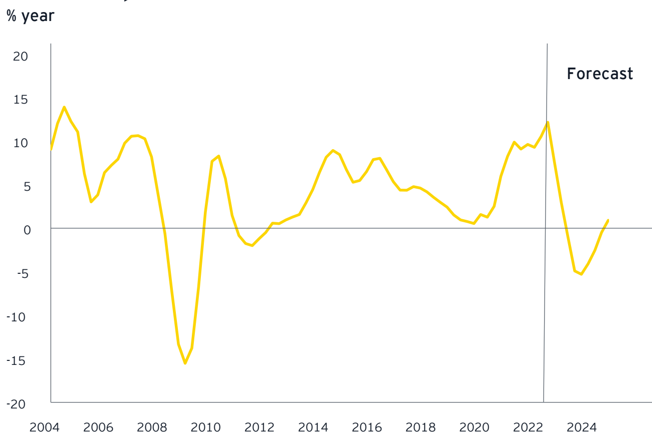


Source: EY ITEM club

- Consumer spending rose 0.1% in Q1 2022, down from 0.6% in the previous quarter and the weakest expansion since Q1 2021.
- High inflation, rising interest rates and depressed consumer sentiment are likely to cause consumer spending to fall outright over the next few quarters.
- But the sizeable savings held by households, scope to take on more unsecured debt, and tax cuts should moderate the decline. Consumer spending is forecast to rise 4.9% this year, followed by a 0.7% contraction in 2023.

Housing market

UK: House prices
% year

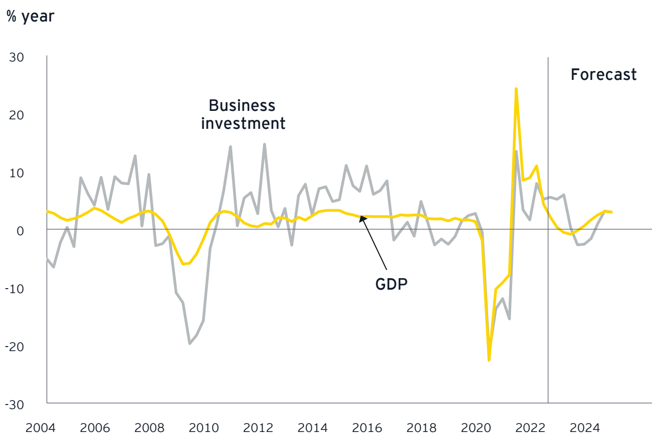


Source: EY ITEM club

- House prices continued to rise rapidly over the summer, with growth reaching a record high on the Land Registry measure, despite the weaker economy and rising mortgage rates.
- But the recent jump in market interest rates, reduced mortgage availability and the likelihood of more aggressive rate rises from the BoE point to a period of falling house prices ahead.
- We expect prices to rise by an average of 9.1% this year. But as pressures on the housing market build, a drop of 4% is forecast in 2023.

Company sector

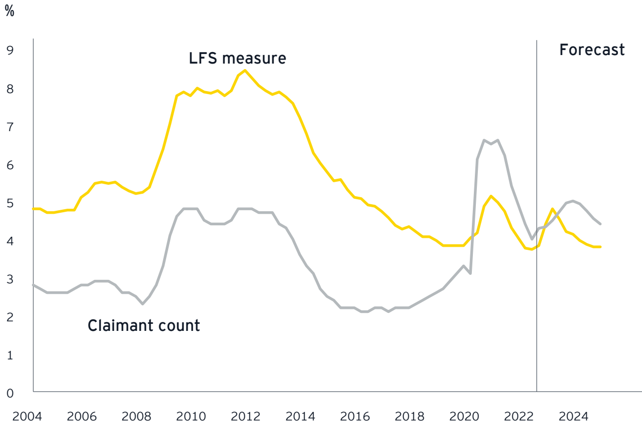
UK: Business investment and GDP
% year



Source: EY ITEM club

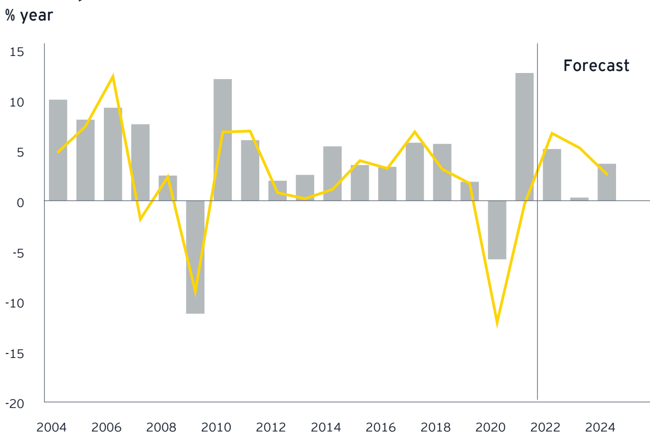
- Business investment returned to growth in Q2, expanding 3.7% q/q, the fastest pace for four quarters.
- But in level terms, this left capital spending by firms still 8% below that in Q4 2019. The looming end of the 'super-deduction' tax incentive should support investment growth over the rest of this year and in early 2023.
- But a weak economy, rising interest rates and inflation in the cost of capital goods are likely to hold back growth. We forecast business investment to rise 5.5% this year, but barely grow in 2023.

Labour market and wages



- The unemployment rate stood at 3.6% in the three months to July, the lowest since 1974. But with employment growth recently slowing, a rise in inactivity has depressed the jobless rate.
- Still-strong demand for workers, as evidenced by high vacancy numbers and robust pay growth, should mean that a weaker economy does not translate into a major rise in unemployment.
- The LFS rate is expected to peak at just below 5%, which would represent a very soft landing by the standards of past downturns.

Trade and the balance of payments



- Trade flows have remained particularly volatile, driven by flows of non-monetary gold and changes in the method the ONS uses to measure imports from the EU.
- The current account deficit rose to a record high of 7.1% of GDP in Q1 2022, reflecting more expensive energy imports, but narrowed to 5.5% of GDP in Q2.
- A sluggish global economy is likely to hold back UK export growth. But this should be countered to a degree by the cheap pound.

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