# EY ITEM Club Winter Forecast

Economic gloom for now, but prospects should brighten later this year.

**January 2023**

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# Contents


| | |
|---|---|
| Foreword | 1 |
| Highlights | 2 |
| Introduction | 3 |
| The economy may already be in recession | 4 |
| GDP is likely to continue shrinking in the near term, but growth should return in H2 2023 | 8 |
| Inflation should fall markedly this year | 14 |
| Austerity in the Autumn Statement is pain delayed | 17 |
| Conclusions | 21 |
| Forecast in charts | 22 |


# Foreword

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It is an understatement to say that 2022 was a difficult year for the UK and global economies. It feels like a long time ago now, but we started the year with some optimism; COVID-19 was apparently behind us, and it looked as though both businesses and consumers would face the first 'normal' year since 2019. The Russian invasion of Ukraine quickly ended that optimism. The impact of the invasion on commodity prices, most obviously for oil and gas, fuelled inflationary forces already underway, leading to the worst inflationary crisis in the US and Europe since the 1970s. The consequences – shrinking real incomes, pressure on margins and synchronised and rapid increases in interest rates – brought economic growth to a standstill. We also saw a significant slowdown in mergers and acquisitions alongside a retreat in equity markets, particularly in the tech sector, as promises of future cash flows are more heavily discounted in a high-inflation, high-interest rate environment.

The UK also faced a year of political turmoil. The extended process to force Boris Johnson from power and then find his replacement lasted from spring through to autumn, paralysing political decision-making. This political crisis then became a financial crisis, as the Truss-Kwarteng mini-budget received an allergic reaction in financial markets. It took the UK's third prime minister of the year, and its fourth chancellor, to finally restore apparent order, but at the expense of higher taxes and lower spending.

In that context, that the UK economy managed growth of 4.1% for 2022 sounds surprising, but this still reflects the comparison with the COVID-19-impacted economy of 2021. The quarterly growth figures tell a more accurate story; the economy grew by 0.6% in Q1 before stalling at 0.1% in Q2 and then finally shrinking by 0.3% in Q3. It is possible that the UK may have recorded another quarter of negative growth in Q4 – leaving it in a technical recession as it heads into 2023.

Perhaps unsurprisingly, the EY ITEM Club has downgraded its forecast for 2023 from -0.3% in the autumn to -0.7% in the Winter forecast. This is still a relatively mild recession, with a peak-to-trough fall of just over 1%, and appears optimistic compared with, for example, the recent forecasts from the OBR (-1.4%) and the Bank of England (-1.9%). Importantly, both the OBR and the BoE use market expectations on interest rates in their forecasts – these stood at over 5% in November and have since come down to closer to 4.25%. A further critical input into the forecast models was the futures curves on gas prices. Off the back of a mild winter, strong LNG supplies, and efficiency measures, prices predicted by futures curves are again well below where they were in November. This could lead to deflation in energy costs, easing the burden on both consumers and businesses. One would therefore expect that if the OBR and the BoE reforecast today, they would likely be more optimistic.

More generally, whilst EY ITEM Club does expect a significant squeeze on consumer spending (falling by 1.4% in 2023), inflation is expected to fall rapidly over the course of the year (although it remains above the BoE's 2% target), interest rates are forecast to peak at 4% in the spring, and the labour market will likely remain robust. We may even see some unwind of the current high levels of inactivity, and consumers are expected to dip into their pandemic savings, similar to what we have witnessed in the US and the EU.

However, as we have discovered over the last three years, the 2020s is the gift that keeps on giving when it comes to economic shocks, and I'm afraid the risks remain weighted to the downside. We can't rule out further geo-political or economic shocks – from a further escalation in Ukraine, a 'hard landing' for the US economy, or the challenges China faces in moving on from its zero COVID-19 policies. More parochially, inflation could prove stickier as expectations get embedded, leading to further hikes in interest rates. Whilst underlying structural weakness in the UK economy, including the recent rise in inactivity and weak business investment, could persist, consumers may choose to continue to sit on their savings even as they are inflated away. The only certainty when it comes to forecasting is the lack of certainty – meaning that firms and households need to stress test, build resilience and scenario plan accordingly.

# Highlights

- The UK economy may already be in the most widely anticipated recession in living memory. With 2022 seeing a global energy price shock, inflation at a four-decade high, political turmoil and the sharpest tightening in monetary policy since 1989, a sustained fall in GDP looks inevitable. We think the economy will shrink over the first half of this year, compounding a contraction that may have begun in Q3 2022.
- But the unusual, externally driven nature of the downturn, the prospect of inflation falling back quickly this year combined with the positives the economy still retains, mean we think the recession of 2022–23 should prove less damaging and shorter than downturns in the 1980s, 1990s and 2000s. However, economic growth still faces a near-half lost decade and the balance of risks to our forecast lie to the downside. And longer-term structural challenges remain formidable.
- The economy ended 2022 in a poor state. GDP fell on a quarterly basis in Q3 and its touch-and-go whether output declined again in Q4. Real household incomes have fallen by almost 3% from their mid-2021 peak and look set to drop further as high inflation erodes spending power. With consumer prices still rising quickly, the full impact of 2022's interest rate hikes still coming through, house prices falling, and tax increases taking effect in April, GDP is likely to contract over the next few quarters.
- Output is forecast to shrink by 0.7% in 2023. This would be the first calendar year decline since 2009, excluding the COVID-19 pandemic period. But this leaves us less pessimistic than the OBR and the BoE, mainly reflecting different assumptions around energy prices, interest rates and households' appetite to dissave. The economy is expected to exit recession in the second half of 2023 as inflation drops back, household incomes start to grow again in real terms, the recent rise in inactivity sees some reversal and consumers exploit strong balance sheets by saving less and borrowing more. Growth is forecast at 1.9% in 2024, but this would still mean the economy not regaining its pre-COVID-19 size until the middle of 2024.
- A still very tight jobs market and evidence of worker shortages in some sectors suggest that the recession will translate more into a fall in job vacancies than cuts in headcounts. The unemployment rate is forecast to peak at around 5%. A relatively modest rise in joblessness by the standards of past recessions will reduce the risk of forced home sales and present households with less of a barrier to smoothing consumption by drawing on savings and taking on additional debt.
- We think inflation has already crested and should start to head down this year, absent any further energy price shocks. The surge in energy prices in early 2022 will soon drop out of the annual inflation measure. The disinflationary effects of falling energy and commodity prices and shipping costs have a long way to go; weaker global demand will weigh on price rises, and both market-based and household inflation expectations have recently fallen back. Although a less generous Energy Price Guarantee will push up household energy bills and inflation in April, the recent plunge in wholesale gas futures prices offers hope that bills could start falling from the summer.
- Meanwhile, concerns about a wage-price spiral should recede. Demand for workers is softening, and cost-of-living pressures and a negative wealth from falling house prices should prompt some people to return to the workforce, helping boost the labour supply. Alongside the inflation outlook becoming less worrying, these developments mean the MPC may soon bring the current cycle of rising interest rates to an end, with Bank Rate peaking at 4% early this year.
- Granted, strong growth in cash pay and the lagged effect of sterling's weakness in 2022 means inflation is likely to end this year still above the Bank of England's (BoEs) 2% target. But the weight of disinflationary forces means there's a good chance the MPC will be mulling, or even implementing, rate cuts by the turn of 2023 and 2024. However, an easing in pay growth will be a necessary condition for this to happen.
- November's Autumn Statement tightened fiscal policy further. That most of the tightening was backloaded should limit the short-term hit to activity. And with the OBR's forecast excessively gloomy in our view and a general election likely in 2024, there's a question over whether the new austerity will ever be implemented fully.
- One thing the Autumn Statement didn't address was the impact of rising interest rates in causing losses on the BoE's quantitative easing programme. With the Treasury committed to making the BoE's losses good, covering this cost already adds to government debt. We wouldn't be surprised to see the Chancellor act to curb the additional fiscal impact of the BoE's large balance sheet in March's Budget.



1

# Introduction

Given a new year that has begun with cost-of-living pressures still dominating headlines, widespread industrial action and an NHS seemingly in permacrisis, it would be easy to be enveloped in gloom about the UK economy's prospects. But in some key respects, a snapshot of now and the time of the publication of the EY ITEM Club's last forecast in the autumn reveals no major economic shifts, at least by the standards of the past few years. The market turmoil and plunge in sterling that followed September's 'mini-Budget' have now largely corrected. The economy has been spared any serious new shocks in the last three months from energy prices, COVID-19 or geopolitics. And the chief headwind to activity over the last year — high and rising inflation — may be starting to retreat.

Unfortunately, the short-term prognosis for the economy remains grim. A combination of high inflation, falling real incomes, rising interest rates, depressed private sector confidence, weak business investment and slowdowns in the UK's major trading partners means a recession looks baked in. Indeed, given what we know about the UK economy's performance over the autumn and winter of 2022, the oft-used definition of a technical recession — two consecutive quarters of falling GDP — may have been already satisfied.

The question then turns to how long the downturn will last. In some respects, prospects on that front have deteriorated since the autumn. The government intends to cut the generosity of the Energy Price Guarantee (EPG) in April, labouring households with higher gas and electricity bills. Extra tax rises on high-earners and 'unearned' income were announced in November and will take effect this spring. The housing market is already showing signs of correcting faster than many had anticipated. These developments point to the economy shrinking by more than the EY ITEM Club expected in our last forecast.[1]

A deeper recession, but not necessarily a longer one. We still think GDP will return to growth during the second half of 2023. True, the economy faces serious structural challenges around its capacity to grow at an adequate pace. But unlike some past recessions, the current downturn has not been triggered by imbalances that require a prolonged contraction to purge. Inflation has probably already peaked and, absent further adverse energy shocks, should head down quickly this year. For sure, the rise in the EPG means inflation will be higher than otherwise in the spring. But a combination of factors means inflation is forecast to drop below 4% by the end of 2023. Relatedly, we continue to think that Bank Rate will top out at 4% early this year, less than markets expect.

Meanwhile, although fiscal policy was tightened in the Autumn Statement, the pain was delayed until the middle of the decade. And the economy retains some potential positives. Households, in aggregate, are still sitting on massive 'excess' savings accumulated during the pandemic, although a willingness to dip into those savings has yet to materialise. And that demand for workers still seems to be exceeding supply offers hope that firms will respond to a slowing economy by cutting vacancies more than headcounts.

Overall, after GDP rose a projected 4.1% in 2022, we now expect the economy to contract 0.7% this year, a downgrade from our autumn forecast of a fall of 0.3%. Calendar-year growth should resume in 2024, but the drag from tighter fiscal policy and greater scaring effects from a deeper downturn, particularly on business investment, means we now think the prospect of a strong bounce back has lessened. GDP is forecast to rise 1.9% in 2024, down from a forecast of 2.4% previously, followed by growth of 2.2% in 2025.

Our latest forecast report begins with a discussion of recent economic developments. Section 3 sets out the key elements of our new forecast. Section 4 looks at prospects for inflation. Section 5 considers the fiscal implications of November's Autumn Statement and the BoE selling gilts bought under its quantitative easing programme. Section 6 concludes.

1. See EY ITEM Club, 'Autumn 2022 forecast', 31 October 2022. https://assets.ey.com/content/dam/ey-sites/ey-com/en_uk/topics/growth/ey-item-club/ey-item-club-autumn-forecast-october-2022.pdf?download

# 2

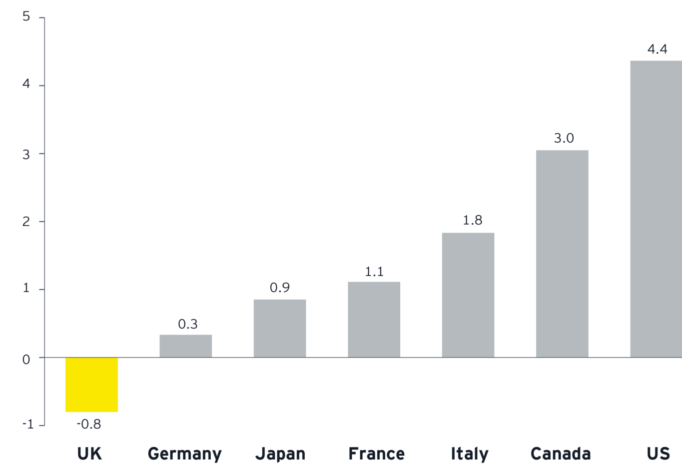
# The economy may already be in recession

### The economy shrank in Q3, then returned to growth in October and November…

After a weak performance from GDP over the summer, the extra public holiday in September for the late Queen's state funeral meant a contraction in the economy that month and in Q3 had seemed likely. Indeed, GDP fell 0.6% month on month (m/m) in September. However, a 0.3% quarter-on-quarter (q/q) decline in Q3 was slightly less than many forecasters, including the BoE and us, had expected.

**G7: GDP**

Percentage points change between Q4 2019 and Q3 2022




Source: EY ITEM club/Haver analytics

But Q3's drop was the first since lockdown afflicted Q1 2021. And the breakdown of GDP by expenditure disappointed on several fronts. Consumer spending fell 1.1% in Q3, compared with a 0.2% rise in the previous quarter. Business investment also declined, although there was a second successive big positive contribution from net trade to GDP after a huge negative contribution in Q1.

Overall, the economy in Q3 was still 0.8% smaller than in Q4 2019, just prior to the COVID-19 pandemic. This left the UK bottom of the league table among G7 economies on that comparison, although methodological changes to measuring GDP made by the ONS last year mean international comparisons aren't necessarily like-for-like. [2]

The effect of September's public holiday muddied the water in assessing the underlying strength of the economy that month. It also complicates interpreting October's 0.5% rebound in GDP. October had an extra working day compared with September, meaning GDP was always on course for a mechanical boost. The economy is estimated to have grown again in November, with GDP expanding 0.1%, beating consensus predictions of a small contraction.

### … but it's still touch-and-go whether GDP fell again in Q4

Notwithstanding growth in output in October and November, it's touch-and-go whether the economy contracted in Q4. Sub-50 readings for the services, manufacturing and construction PMIs in December signalled a decline in private sector activity, albeit at a slightly slower pace than November. And activity that month is likely to have been hampered by widespread industrial action. This will have had both a direct impact on output from the lost working days and an indirect impact, with disruption to the rail network impeding travel and deliveries.

Positively, retail survey results from the British Retail Consortium and the CBI in December came in ahead of expectations, as did Christmas trading results from a number of big retailers, including Sainsbury, Tesco and Next. But high inflation has flattered retail numbers by boosting sales values. Retail sales volumes probably fell by more than 2.5% in 2022. This was partly a story of spending patterns normalising after the end of social distancing restrictions, with consumers switching from goods to previously unavailable services. But it also reflects the squeeze on household spending power from rapid price rises. CPI inflation rose to 11.1% in October from 10.1% in September, the highest rate in over 40 years. An increase in energy prices accounted for almost all of October's pickup. But there was better news in November, with the CPI measure dipping to 10.7%, the biggest month-on-month drop since July 2021. And inflation fell again in December, to 10.5%.

2. See Office for National Statistics, 'Impact of Blue Book 2022 changes on gross domestic product', 22 August 2022. https://www.ons.gov.uk/economy/grossdomesticproductgdp/articles/impactofbluebook2022changesongrossdomesticproduct/2022-08-22



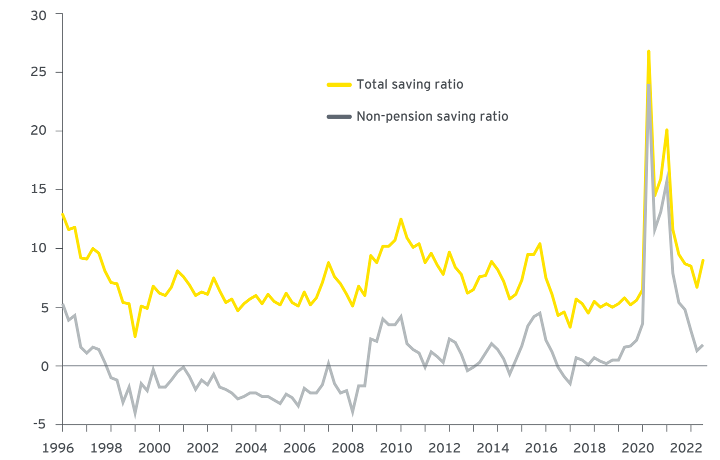
We think falls in inflation at the end of 2022 should prove the start of a steady easing in price rises. But the corrosive effect of high inflation has taken a toll. Real household incomes fell 0.5% q/q in Q3, the fourth successive quarterly drop. And hopes that consumers would be willing to reduce the pace of savings and borrow more to compensate for falling real incomes were seemingly frustrated by a surprise rise in the household saving ratio to 9% in Q3 from 6.7% in Q2.

Granted, the rise in Q3 exaggerated the extent to which households switched to savings mode. Around four-fifths of the increase was accounted for by a rise in investment income payable on pension entitlements, reflecting higher gilt yields over the autumn. Since changes in pension entitlements are a form of deferred income and can only be accessed in retirement, their effect in lifting the saving ratio in Q3 was not reflective of the incomes and saving of households in that period.

But other evidence suggests that households are taking a cautious approach to dissaving. Net unsecured lending via credit cards and personal loans averaged £1bn per month over the three months to November, below the pre-COVID-19 norm (net lending averaged £1.2bn per month over 2018–19). And cash held by households in bank deposits rose by a monthly average of £6.6bn over the same three-month period, well above the £3.9bn per month averaged in 2018 and 2019.

**UK: Household saving ratio**

% of total resources




Source: EY ITEM club/ONS

**UK: Real household disposable income**

Q4 2019 = 100

Source: EY ITEM club/Haver analytics

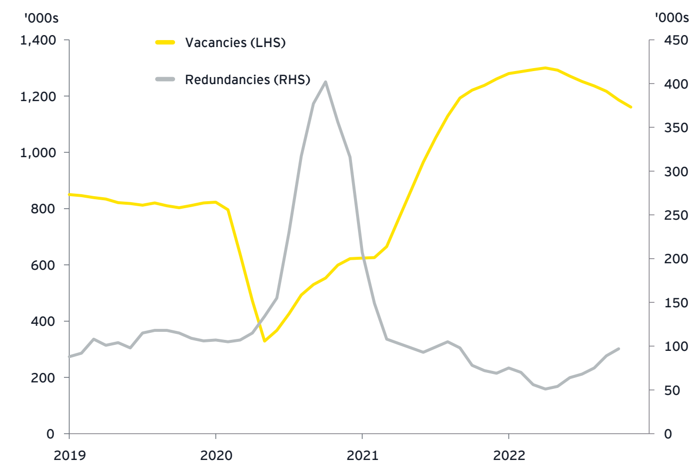
A downbeat mood among consumers meant a cautious approach to personal finances wasn't surprising. Consumer confidence on the GfK measure in late 2022 was at the lowest sustained level in 50 years, whilst the housing market looks to be in the early stages of a correction — average property prices fell in December on both the Nationwide and Halifax measures for the fourth month in a row, the weakest run since 2008.

### The jobs market remains tight, but demand for workers appears to be receding

A decline in job vacancies over last summer and autumn, albeit from very high levels, suggests that demand for workers is waning. Vacancies stood at 1.16m in the three months to December, down 11% from 1.3m in the early summer. And this wasn't the only sign that a weak economy is beginning to impact the jobs market. Redundancies amounted to almost 100,000 in the three months to November, corresponding to 3.4 employees per 1000 losing their job in that period. Whilst still very low by

historical standards, these numbers were significantly up on the early summer when redundancies troughed at 51,000, and the redundancy rate fell to a record low of 1.8 employees per 1,000.

**UK: Job vacancies and redundancies**



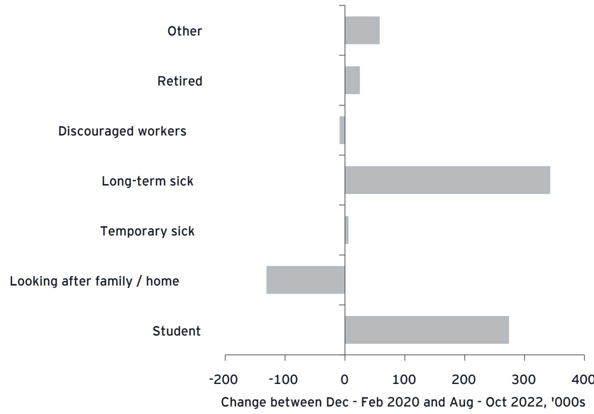

Source: EY ITEM club/Haver analytics

Meanwhile, late autumn saw a noticeable rise in short-term unemployment (albeit from a very low base). Granted, the official Labour Force Survey (LFS) jobless rate stood at 3.7% in the three months to November, only slightly up on 3.5% in the previous three month period and one of the lowest rates since records began in 1971. But a rise in inactivity in the last few years means the jobless rate is a less useful gauge of labour demand than in the past.

Indeed, whilst the number in work picked up a little and the inactivity rate fell slightly in the latest data, both remained some way from their pre-COVID 19 positions. An employment rate of 75.6% in the three months to November was a percentage point (ppt) below where it stood at the start of 2020. And the inactivity rate of 21.5% among those aged 16 to 64 was 1.3 ppts higher, equivalent to an extra 565,000 people either not in work or actively seeking work. This marks the UK as one of the few advanced economies with a higher inactivity rate than just before the COVID-19 pandemic. This development helps to explain why UK GDP has been relatively slow to recover to its pre-pandemic level.

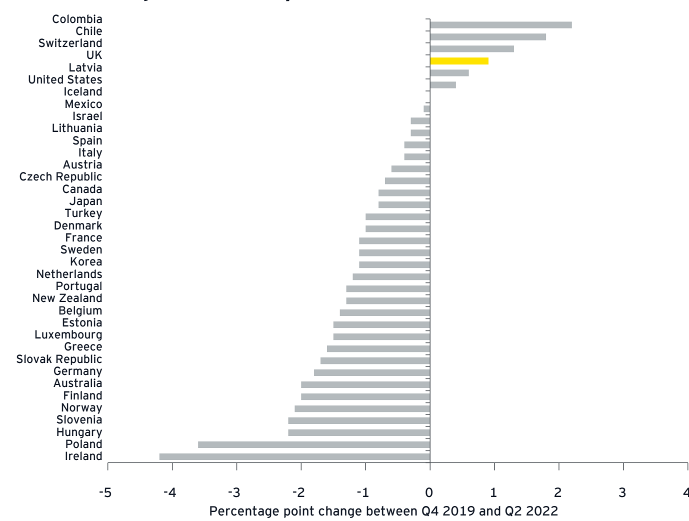
A greater prevalence of long-term sickness has continued to be the biggest driver of higher inactivity, a trend that began before the COVID-19 pandemic, but which has picked up more quickly since early 2020.[3] There is a question mark over whether these people will ever return to the labour force. That said, more young people staying in education has also played an outsized role in pushing up inactivity. That these individuals will eventually enter the workforce (hopefully with improved skill levels) seems more likely.

**UK: Economic inactivity by reason**




Source: EY ITEM club/ONS

**OECD: Change in inactivity rate**




Evidence of softer demand for workers has yet to feed through to the price of labour. Annual growth in average total weekly wages stood at 6.4% in the three months to November, close to the fastest rise in at least 20 years, excluding the pandemic period. Strong gains in cash pay have mitigated cost-of-living pressures. But high inflation means the average worker has seen their pay continue to fall in real terms – average inflation-adjusted pay in November was 5% lower than at the start of 2022.

## The BoE has continued to raise rates, but caution is emerging

The last few months have seen the BoE's Monetary Policy Committee (MPC) continue to tighten monetary policy. The MPC's November interest rate decision followed a period of financial market turmoil and a slump in sterling following the mini-Budget, and pressure on UK policymakers to keep pace with large hikes in policy rates in the US and eurozone. The result was a 75bps rise in Bank Rate to 3%, the largest since 1989.

3. Office for National Statistics, 'Half a million more people are out of the labour force because of long-term sickness', 10 November 2022.

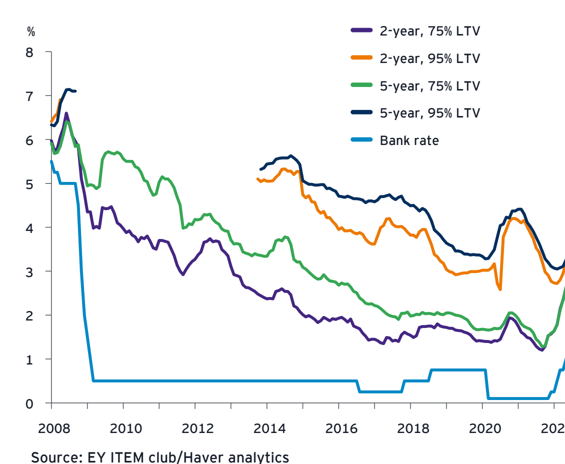


The backdrop to the MPC's next meeting in December was very different. BoE intervention to calm the gilts market and a reversal of course on fiscal policy under a new prime minister and chancellor contributed to market interest rates falling back and sterling strengthening. Further, the mood music emanating from other central banks signalled a slowing in the pace of rate hikes globally. The outcome was a more 'standard' 50bps rise in Bank Rate to 3.5%, with the MPC citing the tightness of the labour market and the risk this would generate inflationary pay rises as justification for another hike in borrowing costs.

December's rise was accompanied by signs that signs that the Committee is prepared to move more cautiously in the future. Only one policymaker voted for a more aggressive 75bp hike. And two of the MPC's nine members voted for no change in rates, arguing that the full impact of previous hikes in borrowing costs had yet to fully feed through.

Granted, the Committee appeared to set the bar low for further rate hikes, stating "further increases in Bank Rate might be required" if the economy evolves in line with the MPC's (very pessimistic) November forecast.[4] Still, as Section 3 explains, we think the peak of the rate-rise cycle is now in sight.

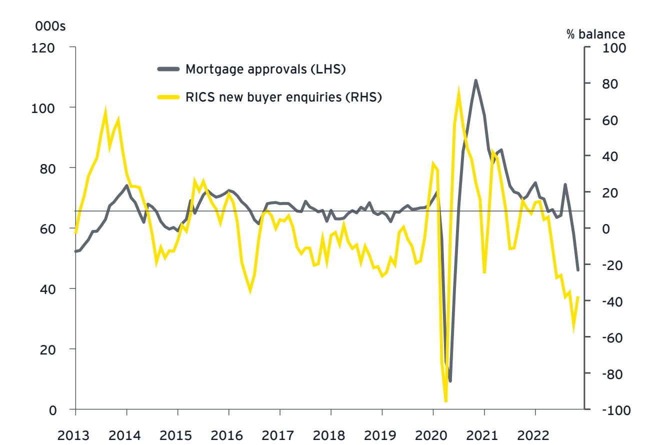
**UK: Interest rates on fixed rate mortgages**




Source: EY ITEM club/Haver analytics

A rise in official interest rates has pushed mortgage rates higher, which was exacerbated in October by a surge in long-term market rates following the mini-Budget. Rates on two- and five-year fixed-rate mortgages across different loan-to-value ratios jumped by almost 2ppts in October alone, leaving rates on some mortgage products up to four times higher than at the start of the year. Mortgage rates have retreated a little since but are still high compared with only a few months ago, and this appears to be impacting housing market activity. Mortgage approvals and interest from new buyers (as measured by the survey from the Royal Institute of Chartered Surveyors (RICS)) have both fallen sharply in recent months.

**UK: Mortgage approvals & new buyer enquiries**




Source: EY ITEM club/Haver analytics

Meanwhile, rising interest rates are only one of the ways that monetary policy is being tightened. Since the start of November, the BoE has been selling some of the £875bn of gilts purchased during its quantitative easing (QE) programme. As Section 5 of this report explores, this action has potentially important implications for the public finances, as well as the stance of monetary policy.

## Government borrowing has been pushed up by the cost of energy support and high inflation

Government measures to hold down households' and firms' energy bills, along with high inflation, resulted in a sharp rise in public sector borrowing in late 2022. November's fiscal deficit of £22bn compared with £8.1bn in November 2021 was the biggest for a November since monthly records began in 1993. Government cost-of-living measures, the EPG for households and the Energy Bill Relief Scheme (EBRS) for businesses added to public spending in November. And the impact of high inflation in raising the cost of servicing index-linked debt meant interest payments came in at £7.3bn, a record high.

It has not been all bad news for the Treasury. Borrowing in 2021-22 was revised down by £7.3bn to £125.4bn. The deficit in the first eight months of 2022-23 of £105.4 billion was £7.6bn less than in the same period last year. And it was £7.8bn below the OBR's latest forecast. But the uncertainty around the future path of energy prices – and, therefore, the cost of energy support for households and firms – means just how high the deficit will reach in the current fiscal year and beyond is hard to predict.

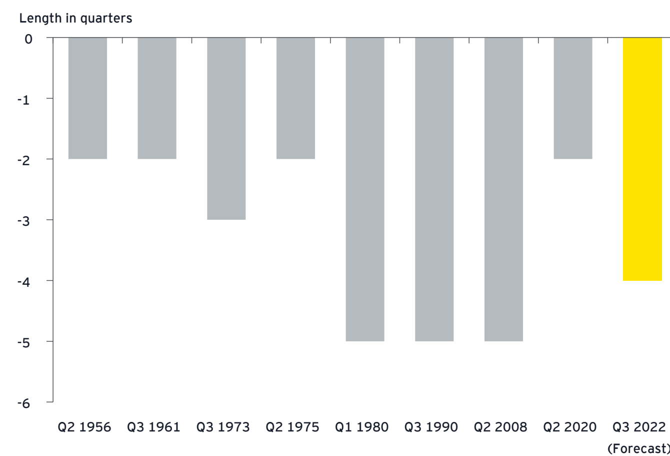
4. Bank of England, 'Monetary Policy Summary and minutes of the Monetary Policy Committee meeting', 15 December 2022. https://www.bankofengland.co.uk/monetary-policy-summary-and-minutes/2022/december-2022

3

# GDP is likely in the near term, but growth should return in H2 2023

The track record of professional economists in predicting recessions is very poor.[5] It's therefore tempting to take a contrary position to what now seems to be a near-unanimous view among UK economy watchers that a recession has already begun or will arrive shortly.[6] But this time, it looks like practitioners of the 'dismal science' will prove accurate.

**UK: Post-war recessions**




Source: EY ITEM club/Haver analytics

Survey evidence and the hard economic data, combined with the impact of industrial unrest over the winter, suggest that the economy's contraction in Q3 may have been followed by another, albeit small, fall in GDP in Q4, satisfying the widely used definition of a technical recession. And output is likely to shrink over the first half of this year. This would result in a recession longer than the average of the post-war period but one quarter shorter than contractions in the early 1980s, early 1990s and during the global financial crisis in 2008–09. And our forecast for a peak-to-trough fall in GDP of around 1.3ppts would be smaller than in those recessions.

Momentum in activity coming into last year and growth over the first half of 2022 means we think GDP expanded by 4.1% in 2022. This is a little slower than our forecast in the autumn, reflecting downward revisions to past GDP data by the ONS. But a likely contraction in 2023 now looks set to be deeper than we had anticipated. GDP is forecast to shrink 0.7% this year, versus a fall of 0.3% predicted three months ago. Declining inflation, real household incomes returning to growth and the possibility of a fall in energy bills from the summer mean the economy is forecast to start growing again from Q3 2023. But tighter fiscal policy is one factor behind the forecast rebound from 2023's contraction being less strong than we had hoped. GDP is seen as rising by 1.9% in 2024, down from our autumn forecast of 2.4%.

Our forecast for this year and next is less downbeat than that of the OBR (which expects a fall in GDP of 1.4% in 2023 and a rise of 1.3% in 2024) and the BoE (which forecasts declines in GDP in 2023 and 2024 of -1.5% and -1% respectively), although broadly in line with the consensus.[7] The difference between our projections and official forecasts largely reflects three factors. One is the recent drop in gas futures prices and the disinflationary impulse this provides. As of early January, the average wholesale price for gas deliveries in 2023 and 2024 stood at around 180 pence per therm. Reflecting the timing of the OBR and BoE's most recent forecasts, both assumed gas prices would average well over 300 pence per therm this year and between 250 pence and 300 pence per therm in 2024. The second is interest rates. We think Bank Rate will peak at 4%, whilst the OBR and BoE's forecasts were both conditioned on the policy rate rising to over 5%. Third, we expect consumers will draw on savings to a greater extent than the official forecasters, particularly the BoE, anticipate, implying a smaller hit to consumer spending.

5. Research by the IMF found that only two of the 60 recessions that occurred around the world during the 1990s were predicted a year in advance, and only one-third seven months before they occurred. See Prakash Loungani, 'The Arcane Art of Predicting Recessions', Financial Times, 18 December 2000. https://www.imf.org/en/News/Articles/2015/09/28/04/54/vc121800
6. As of December 2022, the consensus among professional forecasters was for UK GDP to shrink 0.7% in 2023. See HM Treasury, 'Forecasts for the UK economy: a comparison of independent forecasts', 22 December 2022. https://www.gov.uk/government/statistics/forecasts-for-the-uk-economy-december-2022.
7. See Office for Budget Responsibility, 'Economic and Fiscal Outlook, November 2022', 17 November 2022 https://obr.uk/docs/dlm_uploads/CCS0822661240-002_SECURE_OBR_EFO_November_2022_WEB_ACCESSIBLE.pdf, Bank of England, 'Monetary Policy Report - November 2022', 3 November 2022. https://www.bankofengland.co.uk/monetary-policy-report/2022/november-2022 and footnote 6.

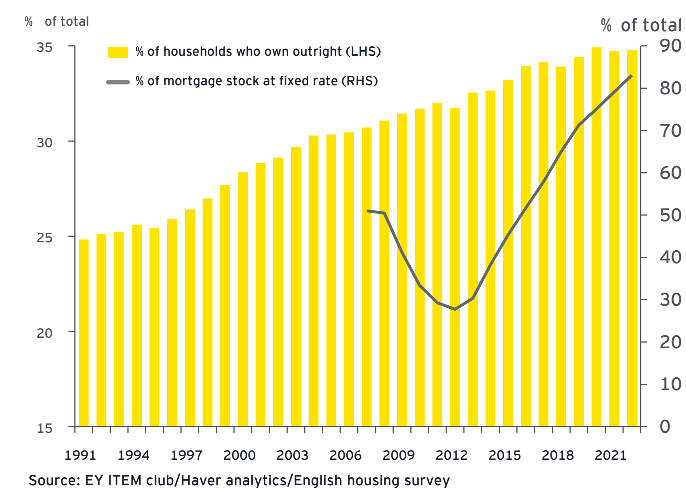
## The economy faces headwinds from falling real household incomes and tighter macro policy

We think inflation has now peaked and should fall back steadily this year. But 2023 is still set to be a year of high inflation by the standards of recent decades, with the CPI measure forecast to average just over 7%. The £500 increase in the energy price guarantee and a likely increase in the weight attached to energy in the consumer spending basket the ONS uses to measure consumer prices will add around 0.7ppts to inflation in April. The pass-through to consumer prices of the remaining impact of 2022's depreciation of sterling will also keep price pressures higher than otherwise. The impact on spending power will be mitigated by strong private sector pay growth and inflation-linked rises in pensions and benefits. But real household incomes are likely to still fall to the greatest extent since the late 1970s.

The squeeze that consumers face from high inflation comes on top of an increase in mortgage costs. Though the market risk premium that emerged during Liz Truss's brief spell as prime minister has now largely disappeared, tighter monetary policy means that swap rates (which feed through to the cost of fixed-rate mortgages) are much higher than they were at the start of 2022. This has been reflected in higher quoted mortgage interest rates, and mortgagees coming to the end of fixed-rate deals face a large increase in debt servicing costs when they refinance. At present, homeowners coming to the end of a two- or five-year fixed-rate mortgage deal are likely to be offered an interest rate 300bps to 400bps higher than their old deal.

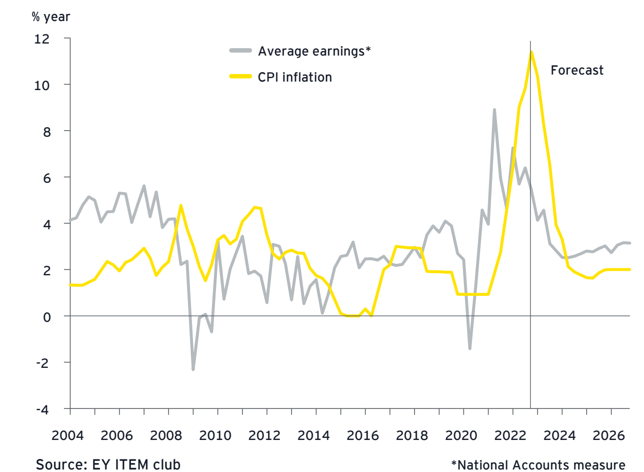
More expensive home loans mean housing transactions are likely to fall sharply in the short term. House prices have also started to decline. However, several factors should limit the extent of forced sales and the decline in prices compared with the last time interest rates rose on a sustained basis. The share of households who own their home outright rose 34.8% in 2021–22, up from 30.3% in 2005. Over the same period, the proportion of households with a mortgage fell to 29.5% from 40.3%.[8] And BoE data suggest more than half of mortgages are five-year fixes, with another quarter on two-year fixes. It's estimated that around half of mortgagees, or just over 4mn households, will face higher interest rates this year. But half will not see their debt servicing costs rise until 2024 or later.[9]

**UK: Fixed rate mortgages and outright ownership**




Source: EY ITEM club/Haver analytics/English housing survey

**UK: Average earnings and inflation**




Source: EY ITEM club *National Accounts measure

Meanwhile, our forecast for a modest peak in unemployment should also reduce the risk of a serious crash in prices. With job vacancies still high and surveys suggesting a shortage of workers in some sectors, employers may choose to hoard, rather than shed, labour during the downturn. As a result, we expect the LFS jobless rate to peak at around 5%. And greater forbearance by lenders, such as switching mortgage holders to interest-only deals, should reduce the prevalence of forced selling.[10] Overall, we think average property prices will drop by around 10% over the next 12 to 18 months.

Typically, policymakers respond to recessions by loosening monetary and fiscal policy, moderating the hit to the economy. But the nature of the shock facing the economy at present — a supply-damaging and inflation promoting jump in energy prices — and the market reaction to efforts to cut taxes in the mini-Budget mean macroeconomic policy is unlikely to come to the rescue this time. If anything, implicit in the BoE's raising interest rates despite forecasting a prolonged recession is the judgement that a downturn is necessary to wring inflation out of the system.

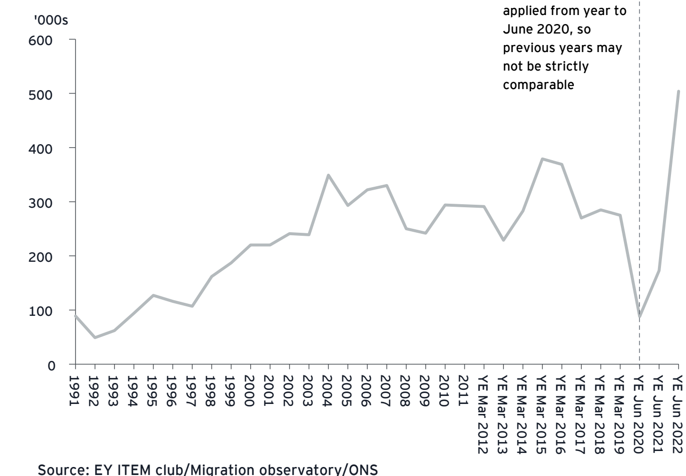
8. Department for Levelling Up, Housing and Communities 'English Housing Survey 2021 to 2022'. 15 December 2022. https://www.gov.uk/government/statistics/english-housing-survey-2021-to-2022-headline-report
9. See Bank of England, 'Financial Stability Report - December 2022', 13 December 2022. https://www.bankofengland.co.uk/financial-stability-report/2022/december-2022
10. Emma Dunkley, 'UK banks to ease pressure on mortgage holders as late payments set to surge', Financial Times, 28 December 2022. https://www.ft.com/content/456b41ec-ae6f-48c5-b4e2-d35c877799e8

Granted, on the fiscal policy front, apart from reducing the generosity of the energy price guarantee by £500 from April, the bulk of the tightening measures announced in the Autumn Statement were backloaded (See Section 5). But the combination of a previously planned withdrawal of pandemic-related support measures, notably the 'super-deduction' tax incentive for business investment, and tax-raising measures inherited from previous Chancellors — including the increase in corporation tax from 19% to 25% and ongoing freeze of most tax allowances — mean that a substantial tightening of fiscal policy (and in a particularly adverse manner for business investment) will come into effect from next April.

## The BoE will probably bring rate hikes to an end early this year

Activity will also be hindered by the sharp tightening in monetary policy since late 2021. Bank Rate rose from 0.1% in November 2021 to 3.5% last December, the biggest increase over an equivalent period since 1989. With changes in interest rates estimated to take 12–18 months to have their full economic effect, the brunt of past rate hikes will appear this year, even if, as we expect, the rate rise cycle is close to peaking.

**UK: Net inward migration**




Source: EY ITEM club/Migration observatory/ONS

Labour market developments will be key to what the MPC does next with interest rates. We think the committee's concerns about a potential wage-price spiral should ease. The downturn in activity means labour demand is weakening. And there are reasons to think growth in the supply of workers will see some revival. Cost-of-living pressures and a negative wealth effect from falling house prices could compel some inactive people to enter or re-enter the workforce. Although NHS backlogs are unlikely to recede quickly, any lingering health effects from COVID-19 should decline thanks to vaccines and natural immunity. And inward migration has proved surprisingly strong since the post-Brexit migration regime was introduced. Net inward migration was over half a million in the year to June 2022, a record high.

We expect one further rate rise of 50bps in February, taking Bank Rate to 4%, and for the MPC to pause at that point. Further ahead, there's a good chance this year will end with the MPC mulling or even implementing rate cuts. Energy price inflation has almost certainly peaked given that prices are now capped. The recent drop in wholesale gas prices and falling prices of food commodities suggest that food inflation is close to a high point, and the inflationary impact of supply chain disruption in goods markets has begun to fade. In addition, some large base effects will increasingly come into play (Section 4 looks at prospects for inflation in more detail). And falling inflation and the interplay of stronger labour supply, but weaker demand, should weigh on pay growth.

Admittedly, inflation is likely to be still above the BoE's 2% target at the close of 2023. But growing disinflationary forces mean inflation will likely drop below 2% in 2024, absent any monetary policy loosening, and the MPC will be mindful of lags between changes in interest rates and their impact on inflation. Rate cuts around the end of the year would also be consistent with precedent — on average, the five rate-cutting cycles since the BoE became independent in 1997 have started just over 10 months after Bank Rate peaked.

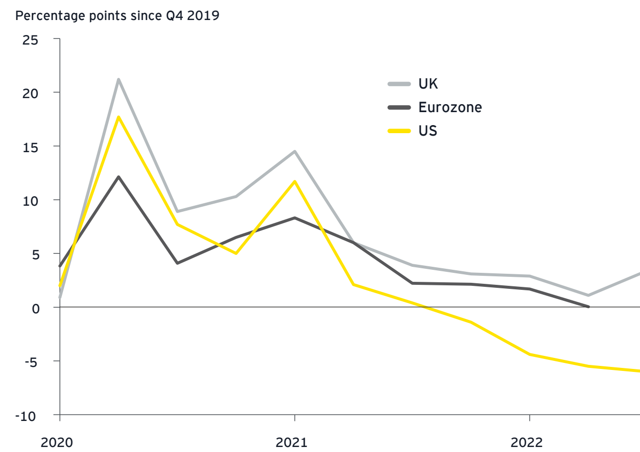
## Savings' 'firepower' is seemingly untouched, but that may change

Overall, we expect real household income to fall by over 4% between the Q2 2021 peak and the forecast trough in Q3 2023. In theory, households drawing on the massive unplanned savings accumulated during the pandemic period could mitigate the impact on consumer spending of such a decline in spending power.

So far, the evidence that this is happening is mixed. The rise in the household saving ratio in Q3 was distorted by pension entitlements. But the non-pension ratio ticked up slightly to 1.8% and was well above the pre-pandemic norm (the saving ratio, excluding pensions, averaged 0.6% over 2017–19), if a long way down from the record 24% ratio reached in Q2 2020. On the positive side, this implies there's still plenty of room for households to save less and tap into the £180bn+ of excess cash accumulated in bank accounts over the last three years. But the apparent reluctance to do so signalled by the latest data suggests that individuals' concerns about their own financial prospects could limit how much changes in savings behaviour compensate for the drag on consumption from falling real incomes.

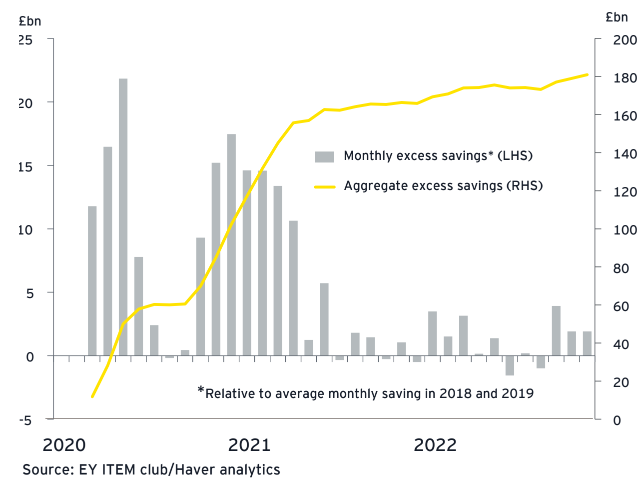
On balance, we still think consumer savings will come to at least the partial aid of the economy. Financial turmoil and a very gloomy media narrative during the autumn may have encouraged greater precautionary saving, but conditions have calmed on those fronts. Survey evidence collected by the BoE just before the mini-Budget found that higher-income households are reducing their monthly savings to cut back spending by less.[11] And other major economies, notably the US, have seen excess savings drawn down to a significant extent. Pandemic-related savings in the US peaked at an estimated $2.5tn at the end of 2021 and are estimated to have fallen $700bn last year, whilst the US saving ratio in Q3 2022 was 6ppts below the pre-COVID-19 ratio.[12] In the UK, it was 3.4ppts higher.

**Change in household saving ratio**




Source: EY ITEM club/Haver analytics

**UK: Excess household saving**




Source: EY ITEM club/Haver analytics

It's not obvious why the UK should follow a different path, at least if inflation starts to fall back and the mood music around the economy becomes less downbeat. But there are big downside risks. In particular, the media narrative looks to have shifted from cost-of-living pressures to other problems. Notably, the crisis in the NHS and the impact of industrial unrest means there's no guarantee consumer sentiment will revive.

A similar story of unused consumer fire power holds for unsecured borrowing by consumers. Lending via credit cards and personal loans picked up in the second half of 2022, but average monthly lending was still below the pre-pandemic average in 2018–19. But the deleveraging that occurred during 2020 and 2021, as consumers cut back borrowing and paid down debt, means households are in a relatively healthy position to take on more debt, should they choose to do so. Total unsecured borrowing stood at £206bn in November, almost £20bn, or 8%, below the level at the start of 2020.

Overall, after consumer spending grew by a projected 5% in 2022, we expect it to fall 1.4% this year. As inflation falls back and household incomes start to grow again in real terms, consumption is forecast to return to growth in 2024, rising 2.3%.

## Business investment will likely remain a relative weak spot, but the trade deficit should narrow further

Although business investment was very volatile from quarter to quarter last year, firms' spending on capital equipment is projected to have grown just over 5% in 2022. But that followed two years of consecutive declines, and we think last year ended with business investment still 7% below the pre-pandemic level in Q4 2019.

Growth in 2022 probably received a boost from the temporary super-deduction tax incentive, with some investment brought forward to benefit from the tax break. But this is likely to be countered by some payback following the super-deduction's end in April, probably only partially offset by the temporary £1mn level of the Annual Investment Allowance, which was due to expire at the end of March 2023, becoming permanent.

Beyond tax effects, the environment for business investment is poor. Recessions typically see business investment fall by more than GDP, as firms faced with weak demand delay or cancel projects. Political turmoil last autumn, ongoing Brexit disputes and the prospect of a change of government next year present further reasons for firms to hold fire on capital spending. And higher interest rates are another obstacle. Private non-financial companies hold debt equivalent to around two-thirds of GDP.

11. Bank Overground, 'How has the increase in the cost of living affected UK households and what does that mean for the economy?', Bank of England, https://www.bankofengland.co.uk/bank-overground/2022/how-has-the-increase-in-the-cost-of-living-affected-uk-households?sf173363926=1
12. See Apricitas Economics, 'The 2022 Economic Year-in-Review', 10 December 2022. https://www.apricitas.io/p/the-2022-economic-year-in-review

Unlike mortgages, most of this debt is at floating interest rates, so rising market rates will quickly translate into a higher cost of capital. Moreover, April's rise in the Corporation Tax rate to 25% could make marginal investment projects unprofitable.

That higher energy prices could encourage investment in energy efficiency or alternative sources of power presents one potential upside. And the weak pound could encourage exporters to invest more to take advantage of their more competitive position. But the scale of headwinds facing business investment means we now expect it to fall 0.8% in 2023, with 2024 seeing a growth of 3.7%.

On the trade front, the trade deficit fell to 1.7% of GDP in Q3 2022 from 4.9% in Q2 and a record 5.8% in Q1. The decline in the gap between exports and imports in Q3 would have been greater absent the impact of high energy prices. Imports of oil and other fuels rose £8.8bn in Q3, taking the total to £38.5bn, a record high.

The fall in gas and oil prices since late 2022 should cause the deficit to continue narrowing, a positive for GDP. A softening in domestic demand should have the same effect by cutting import demand, whilst the weak pound could boost net exports. But a slowdown in the global economy will weigh on UK exports, as might the ongoing effect of UK firms adapting to the changed post-Brexit trading relationship with the EU.

## The EY ITEM Club forecast for the UK economy, Winter 2023

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

| | GDP | Domestic demand | Consumer spending | Fixed investment | Exports | Imports |
|---|---|---|---|---|---|---|
| 2020 | -11.0 | -12.3 | -13.2 | -10.5 | -12.1 | -16.0 |
| 2021 | 7.6 | 8.8 | 6.2 | 6.1 | 2.2 | 6.2 |
| 2022 | 4.1 | 4.5 | 5.0 | 5.8 | 9.8 | 12.7 |
| 2023 | -0.7 | -1.2 | -1.4 | 1.2 | 3.4 | 1.5 |
| 2024 | 1.9 | 2.0 | 2.3 | 2.3 | 2.5 | 2.7 |
| 2025 | 2.2 | 2.3 | 2.4 | 2.6 | 2.1 | 2.3 |
| 2026 | 1.9 | 2.0 | 2.0 | 1.9 | 2.0 | 2.2 |
| | **Net Govt Borrowing(*)** | **Current account (% of GDP)** | **Average earnings** | **CPI** | **Bank Rate** | **Effective exchange rate** |
| 2020 | 15.0 | -3.1 | 1.7 | 0.9 | 0.2 | 78.1 |
| 2021 | 5.3 | -1.5 | 5.8 | 2.6 | 0.1 | 81.5 |
| 2022 | 6.7 | -5.5 | 6.2 | 9.1 | 1.5 | 79.6 |
| 2023 | 5.5 | -5.0 | 3.6 | 7.2 | 3.9 | 78.7 |
| 2024 | 3.1 | -4.4 | 2.6 | 2.3 | 3.4 | 80.2 |
| 2025 | 2.7 | -4.3 | 2.9 | 1.8 | 3.3 | 80.5 |
| 2026 | 2.9 | -4.3 | 3.0 | 2.0 | 3.3 | 81.4 |

Source: EY ITEM Club

* Fiscal years, as % of GDP

## Energy and house prices front-run risks to the forecast

The main uncertainty affecting our latest forecast continues to be the war in Ukraine and the implications for energy prices. An end to the war in a manner that stabilised energy markets and lowered the price of gas presents an upside risk to our projections. The result would be a more rapid fall in inflation, monetary policy being loosened earlier, probably greater consumer dissaving and a stronger post-recession recovery. But a further escalation in the conflict that intensified pressures on energy supplies, inflation and interest rates would have the opposite effect.

A second risk relates to the housing market. Our baseline forecast assumes the high share of fixed-rate mortgages and a low peak for unemployment limit the extent of forced sales and cushions a prospective fall in property prices. But there's a risk of a larger and more abrupt correction. A major housing market crash would have ramifications for the wider economy. Negative wealth effects would exacerbate the consumer downturn, whilst increased losses on housing loans might compel banks to rein in mortgage availability. Still, financial stability risks should be limited given that the Prudential Regulatory Authority (PRA) stress tests banks for a fall in house prices of nearly a third, a scenario we consider unlikely.

That inflation could prove more stubborn is risk number three. The economy might prove more resilient to current headwinds than we expect, meaning disinflationary forces are weaker. Or pay growth may stay heated, aided by strike action becoming more widespread and trades unions succeeding in getting wage demands met. In that world, interest rates would probably rise higher and stay higher for longer, implying a more prolonged recession. The reverse could also be true, with inflation falling faster than expected. In that event, interest rates might start to be cut earlier, and the recovery later this year will prove more vigorous.

The fourth risk relates to China and that country's recent relaxation of COVID-19 restrictions. The boost this might deliver to Chinese consumer demand could prove a useful aid to the global and UK economies this year. But in the short term, disruptions associated with reopening threaten to worsen supply frictions and could prompt political and social turmoil, dragging on Chinese and global economic activity.

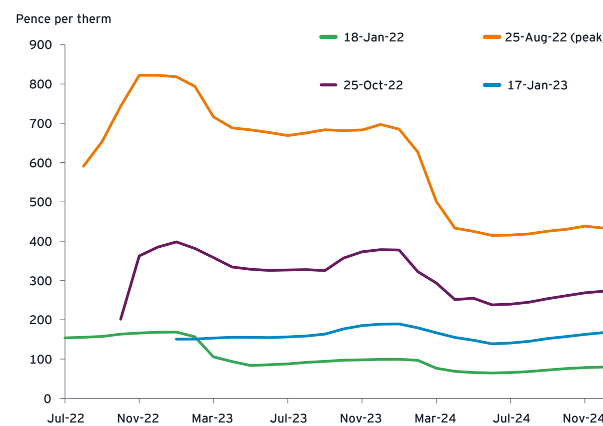
4

# Inflation should fall markedly this year

CPI inflation likely peaked in October at 11.1%, but it remains very high by historical standards. This reflects pandemic-related supply chain disruptions and the fallout from Russia's invasion of Ukraine, which drove energy, food and fuel prices up. In theory, these developments should have resulted in changes in relative, rather than absolute, prices. If the price of an essential, such as oil, rises, consumers are forced to cut spending on other items, resulting in weaker demand for those products and downward pressure on their prices. But a massive QE-related expansion in the money supply at home and abroad over the pandemic period has enabled a rapid rise in the overall price level.

2023 is likely to deliver another high calendar-year reading for inflation by the standards of recent decades. But we think price pressures will ease markedly this year, with CPI inflation falling to just under 4% by the end of 2023.

**UK: Gas futures curves**




Source: EY ITEM club/Haver analytics

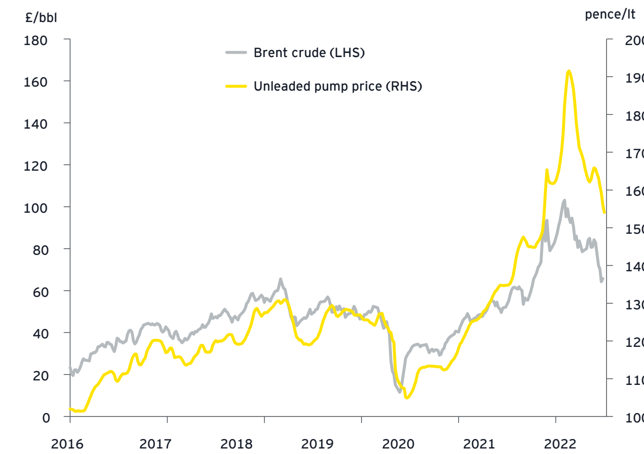
## Large base effects will come into play, particularly for energy prices ...

One reason for expecting inflation to fall is favourable base effects, as the huge increase in the price of energy and raw materials over the past year drops out of the annual inflation comparison. The key point to note here is that prices don't need to fall outright for inflation (the rate of change of prices) to decline. The UK experienced two big jumps in energy prices in 2022. The first followed the rise in the EPC in April 2022 after Russia's invasion of Ukraine and the second when consumers transitioned from the EPC to the higher EPG in October. The result was the energy component of the CPI rising a massive 89% y/y in November. We know the EPG will increase by £500 to £3,000 from April this year. But a 20% increase still represents a much smaller rise in energy prices than in 2022. As a result, the contribution of energy in CPI inflation should drop sharply from a peak of just over 3ppts to about 0.5ppts by the end of 2023.

Meanwhile, the spot price of gas fell back significantly in late 2022. More importantly, given the prevalence of energy suppliers buying ahead in the gas market, gas futures prices have plunged from 2022's record high. At the peak, last August, the price of gas for delivery during 2023 averaged 705 pence per therm, compared with a pre-Russian invasion price of around 100 pence per therm. As of the start of 2023, the price had dropped almost 70% to around 180 pence per therm, the lowest in 12 months. This reflects efforts by consumers and businesses to reduce the consumption of natural gas and power, assisted by what has been a relatively mild winter so far. And the supply of gas from non-Russian sources has been boosted by a surge of LNG imports from the US and elsewhere and increased Norwegian production.

As a result, there's now a good chance that the typical household bill could fall below the £3,000 EPG cap in the summer.[13] The implication would be an even bigger drag on inflation from the energy component. On the other hand, there is uncertainty over the energy bills that firms will face this year. Under the EBRS scheme, wholesale gas and electricity prices are fixed for companies until March 2023. From April, a new Energy Bills Discount Scheme (EBDS) will take effect for 12 months. This will be significantly less generous than its predecessor. But the recent sharp fall in wholesale gas prices should soften the blow of a cut back in support. Indeed, gas prices for delivery later this

**UK: Oil & petrol prices**




Source: EY ITEM club/BEIS

year are currently below the threshold at which the EBDS would be triggered. However, some firms will have signed fixed cost contracts when prices were higher, and may seek to pass the rise in costs onto consumers.

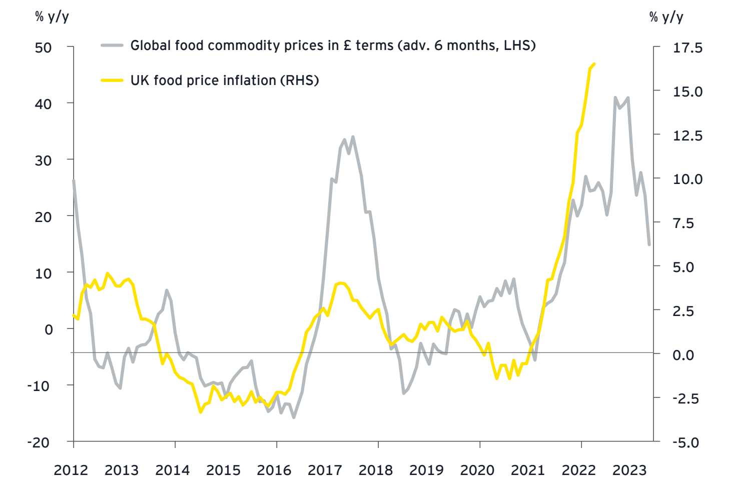
## ... whilst lower oil prices and refinery margins should push petrol prices down

Another important downward pressure on inflation should come from lower petrol prices. Petrol pump prices fell to around £1.50 a litre in early January after averaging almost £1.90 a litre over the summer. That refinery margins appear to have increased significantly last year means prices might now be even lower, at around £1.40, had the historical association between the price of crude oil and petrol prices held.

However, margins have fallen back since the summer. They may come under further pressure depending on the outcome of the ongoing review by the Competition and Markets Authority into the road fuel market.[14] Oil prices are also likely to stabilise lower as concerns around a global recession weigh on demand. The combination of a lower oil price and falling refinery margins should mean that petrol prices decline further. The average contribution of petrol to CPI inflation in 2022 was about 0.8ppts, but that contribution should more than halve from the spring of 2023.

## Falling global food and commodity prices will eventually make their mark on consumer prices

**Domestic and global food price inflation**




Source: EY ITEM club/Haver analytics

There have also been positive developments in the price of non-oil commodities. Food price inflation reached a 45-year high of 16.8% in December. But global food commodity prices peaked over the summer and have fallen since, suggesting that UK food price inflation is likely to be close to its peak.

If the fall in wholesale prices is sustained, it's plausible that the typical household energy bill later this year may come in below the £3,000 annual cap implied by the EPG, putting further downward pressure on inflation.

Meanwhile, the relaxation of COVID-19 restrictions in China at the end of last year may put upward pressure on the price of energy and raw materials (something already evident in a rise in the price of crude in December). But the inflationary effect should be offset by easing global supply bottlenecks reducing goods price inflation. This will build on what has already been a steady normalisation in supply chains. Late 2022 saw a global supply chain pressure measure reach its lowest level in two years.[15] And shipping costs, as measured by the Baltic Dry Index, ended the year twice the pre-pandemic level, down from seven times earlier in 2022.

13. Dr Craig Lowry, 'Drop in wholesale energy prices sees price cap predictions fall below the EPG for second half of 2023', Cornwall Insight, 4 January 2023. https://www.cornwall-insight.com/drop-in-wholesale-energy-prices-sees-price-cap-predictions-fall-below-the-epg-for-second-half-of-2023/

14. Competition and Markets Authority, 'CMA publishes emerging analysis from Road Fuel Market Study', 6 December 2022. https://www.gov.uk/government/news/cma-publishes-emerging-analysis-from-road-fuel-market-study

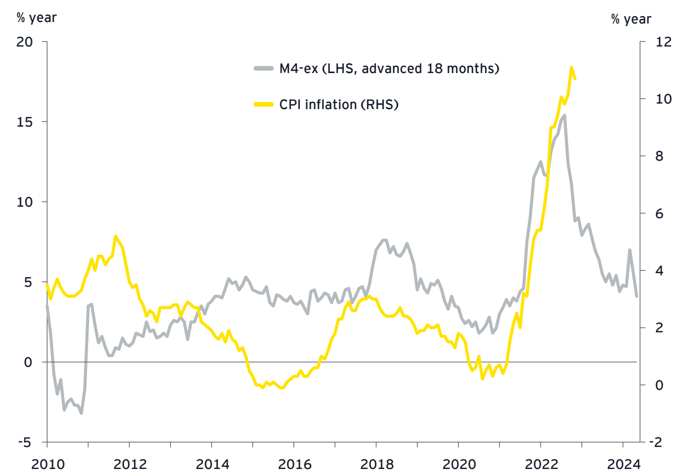
15. See the Federal Reserve Bank of New York's Global Supply Chain Pressure Index (GSCPI). https://www.newyorkfed.org/research/policy/gscpi#/overview

## ‘Structural’ forces affecting inflation are looking less worrying

Drivers of underlying inflation are also looking less concerning. After an extremely turbulent year, market-based measures of medium-term inflation expectations have fallen significantly from their highs last year. They are now back down to their pre-pandemic level. Shorter-term, survey-based measures of expectations, have also dropped back. The BoE’s latest Decision Maker Panel (DMP) survey of UK CFOs showed firms surveyed planning to raise prices by 5.7% over the next 12 months, the joint smallest figure since February 2022.[16] Individuals’ inflation expectations, as measured by the Citi/YouGov survey, also fell at the end of 2022.[17]

Meanwhile, annual growth in the money supply in late 2022 of 3% to 4% was well down on the 15% reached in early 2021. With the BoE now running down its balance sheet and reducing reserves held by commercial banks (see Section Five), money supply growth is likely to decelerate further, ultimately depressing inflation.

**UK: Inflation and monetary growth**




Source: EY ITEM club/Haver analytics

**UK: Inflation expectations five years ahead***

16. Bank of England, ‘Monthly Decision Maker Panel data - December 2022’, 5 January 2023. https://www.bankofengland.co.uk/decision-maker-panel/2022/december-2022
17. David Milliken, ‘UK public’s inflation expectations ease in Nov - Citi/YouGov’, Reuters, 30 November 2022. https://www.reuters.com/markets/europe/uk-publics-inflation-expectations-ease-nov-citiyougov-2022-11-30/



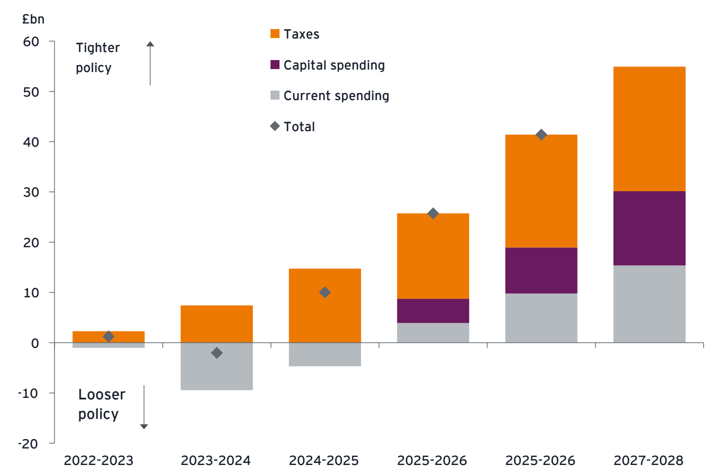
5

# Austerity in the Autumn Statement is pain delayed

Probably the highest profile official economic event since the autumn was the Autumn Statement in November, Jeremy Hunt’s first fiscal event as Chancellor. Given the perceived need to appease the financial markets following the febrile investor reaction to the tax-cutting plans of Hunt’s predecessor, a tightening in fiscal policy in the Autumn Statement was predictable. However, the Chancellor erred towards the latter in facing a trade-off between boosting credibility by seeking to rapidly reduce borrowing and avoiding amplifying a likely recession.

The government opted to give itself additional leeway by extending the timeframe for its fiscal rules from three years to five and by replacing the target of a current budget surplus with the less stretching aim of public sector net borrowing falling below 3% of GDP by the middle of the decade. This allowed the Chancellor to construct a package where the net impact of policy decisions this year and next was close to zero.

**UK: Autumn Statement policy decisions**




Source: EY ITEM club/OBR

As discussed, the major short-term change was to the EPG. The average household will see energy bills fixed at £3,000 a year from April 2023, up from £2,500 previously planned. This April will also see additional tax rises in the form of a larger windfall tax on energy firms and a reduction in the threshold for paying the 45p rate of income tax. However, their macroeconomic impact should be limited, whilst the drag from tax rises will be offset in 2023–24 by further cost-of-living payments to those in receipt of certain benefits, cuts to business rates and additional spending on health and social care and schools.

But fiscal policy will be tightened from 2024–25, with the impact reaching £55bn (1.8% of GDP) in 2027–28. Around 45% of the savings will come from higher taxes, with spending cuts split evenly between current and capital spending. With most of the tightening set to take place after the next general election, there are questions about the extent to which it will happen. The government no doubt hopes that the economic outlook will improve over the next couple of years, encouraging the OBR to take a more optimistic view of the public finances and leaving some of the consolidation measures unnecessary.

The effect of this could be significant. If, as we think, GDP turns out to be almost 1% larger in 2025 than the OBR forecast assumes, public sector borrowing would be around 0.7% of GDP lower, negating the need for almost half the planned consolidation.[18]

18. This calculation applies the ready reckoners used by the OBR to assess the impact of changes in GDP on the fiscal position. See Thora Helgadottir et al. ‘Working paper No.3 Cyclically adjusting the public finances’, Office for Budget Responsibility, June 2012. https://obr.uk/docs/dlm_uploads/Working-paper-No3.pdf

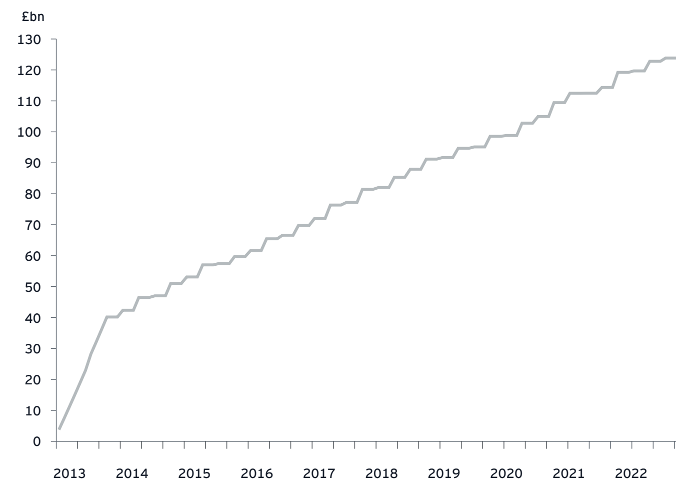
## QE had been a boon to the public finances but will now become a burden

One omission from the Autumn Statement in the short or long term was any effort to reduce what will soon be the ballooning cost of the BoE's QE programme. Between March 2009 and the end of 2021, the BoE attempted to loosen monetary conditions by purchasing a total of £875bn of gilts, along with £20bn of corporate debt, financing those purchases using newly created bank reserves. But as part of the move towards normalising monetary policy, the BoE has, since November 2022, started to sell some of the gilts it holds (quantitative tightening, or QT).

A decision taken in 2009 explains why an ostensibly monetary policy operation has fiscal implications. Then, the Treasury agreed to indemnify the BoE on gilts and corporate bonds bought via the Asset Purchase Facility (APF), a subsidiary of the BoE. Under the indemnity, any financial losses resulting from QE are borne by the exchequer and any gains are owed (and, since 2013, paid) to the Treasury.

Two sources of losses are beginning to appear, with interest rates now rising. The first relates to the interplay between the interest income the APF receives on gilts purchased and the interest paid by the BoE to commercial banks on the reserves the latter hold at the central bank. Most of these reserves were created by the BoE to purchase gilts, and the entire £950bn stock is remunerated at Bank Rate.

**UK: Cumulative cash transfers from APF to HM Treasury**

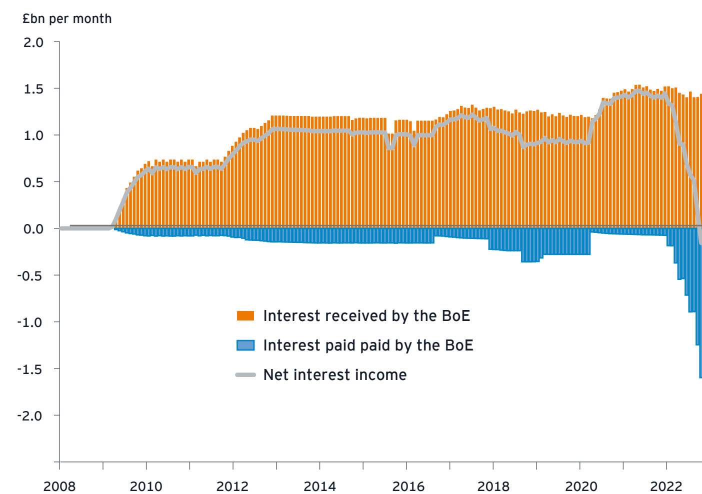



Source: EY ITEM club/Haver analytics

If Bank Rate is below the average yield on the APF's gilts, QE yields a 'profit' paid to the Treasury. Since 2013, when the process for transfers began, ultra-low interest rates have meant the public finances have benefited by £124bn in total. But that fiscal boon is now reversing. The average interest rate on gilts held in the APF is roughly 2%. Since Bank Rate reached 2.25% in September, the APF has been incurring a loss. With Bank Rate increasing further to 3% in November and 3.5% the following month, and likely to head higher still, the loss to the public finances will grow.

Second, rising gilt yields mean that the market value of most of the APF's gilts is now below average purchase prices paid by the BoE. Losses crystallised as gilts redeemed or sold will also have to be made good via transfers from the Treasury. As of November 2022, gilts held in the APF had cost £850bn, but their nominal value stood at £745bn.

**UK: Asset Purchase facility interest flows**




Source: EY ITEM club/Haver analytics

Taking these losses together, the OBR, in its November forecast, predicted that total transfers from the Treasury to the APF will peak at £42.2bn in 2023–24. As the BoE's balance sheet unwinds, transfers decline but are still forecast to total £133bn between the current fiscal year and 2027–28.[19] These transfers won't affect the headline public sector net borrowing figure since they're within the public sector. But they will affect gilt issuance and add to the measure of public sector net debt targeted by the government. Under the government's new fiscal rule, this measure needs to be falling in five years.

The scale of the fiscal transfer to commercial banks also presents a big presentational challenge at a time when the tax burden is climbing to a post-war high, and public spending is being squeezed. Taking the current £950bn total size of the BoE's balance sheet, Bank Rate at 3.5% means commercial lenders will receive almost £35bn in annual transfers from the BoE (and indirectly, taxpayers), up from less than £1bn in late 2021. Every additional 50bps on rates will raise that transfer by over £4.5bn.

## The government could cut the cost of QT

What could policymakers do? A plausible option would involve the BoE paying interest on only part of commercial banks' reserves. Explaining this requires a diversion into why the BoE pays interest on reserves at all. Before the mid-2000s, the BoE raised or lowered interest rates by engineering a shortage or a surplus of reserves, respectively, meaning that banks were willing to pay the rate chosen by the BoE to borrow funds from each other and ensure they had enough reserves to meet their payment obligations. Reforms to the BoE's operating system in 2005–06 resulted in reserves being remunerated at Bank Rate for the first time.

By paying interest on reserves, the BoE creates a floor for market interest rates at the desired level of Bank Rate. This was particularly important post-2009 after QE caused reserves to flood the banking system. Absent paying interest on reserves, an excess supply of reserves would have caused market rates to fall to zero and the BoE to lose traction over monetary policy.

The important point is that it's the rate of interest paid on the marginal pound of reserves held by banks that sets the floor. Hence, a tiered approach to paying interest on only some reserves would mean that rate decisions by the MPC continued to be transmitted to market rates but at a lesser cost to the BoE, requiring lower transfers from the Treasury.

Tiered reserves could be criticised as a tax on the banking sector. Depending on the sector's competitiveness, this 'tax' might be passed on to customers via lower deposit rates or higher borrowing rates. But the BoE's objective is to be able to set monetary policy in a manner that achieves its inflation target. And paying interest on only an element of reserves would allow the BoE to do that at a lower cost to the public purse.

Last autumn, there had been speculation that what proved to be the short-lived administration of Liz Truss would introduce measures to reduce the fiscal cost of QE.[20] But the new prime minister and chancellor chose not to take any steps in that direction. But that doesn't, in our view, rule out the possibility that such a scheme will be announced in the not-too-distant future — perhaps even in this spring's Budget, which is due on 15 March. The case for such a scheme will be greater if interest rates rise faster than expected or the pressure to spend more on public services intensifies.

19. See fiscal supplementary– tables of OBR, 'Economic and Fiscal Outlook', 16 November 2022. https://obr.uk/download/november-2022-economic-and-fiscal-outlook-supplementary-fiscal-tables-receipts-and-other/

20. For example, see Philip Aldrick, 'UK Looks at QE Change to Avert £10 Billion Payout to Banks', Bloomberg UK, 21 September 2022. https://www.bloomberg.com/news/articles/2022-09-21/uk-looks-at-qe-change-to-avert-10-billion-payout-to-banks?leadSource=uverify%20wall

# 6

# Conclusions

The UK, like many of its advanced economy peers, is faced with what is probably the most widely anticipated recession in modern history. The importance of expectations in influencing spending and investment decisions means that widespread predictions of a downturn, as witnessed by consumer and business surveys, make that outcome even more likely.

Those expectations rest on solid foundations. The economy faces a host of adverse forces. But it doesn't enjoy the prospect of policymakers riding to the rescue with fiscal or monetary support. In fact, the BoE's own forecast implies that it judges falling GDP and higher unemployment as necessary to bring inflation back down to target. And faced with a central bank holding that view, there's little that fiscal policy can do to support activity, even were the government minded in that direction.

But whilst a recession may have already begun, the downturn shouldn't prove as long-lasting as recessions in the 1980s, 1990s and 2000s. Unlike those episodes, the economy is not faced with purging the consequences of an unsustainable boom in credit or the housing market. Activity is suffering because of the inflationary consequences of a global supply shock, which initially reflected the repercussions of the public health response to COVID-19 and was then exacerbated by Russia's invasion of Ukraine. But as witnessed by the plunge in gas prices over the last month or so, the severity of this shock is easing, and other drivers of high inflation in the UK and elsewhere have started to retreat. The banking system is well-capitalised and thoroughly stress-tested, cutting the risk of a credit crunch.

Of course, this still leaves the economy faced with big structural challenges. These include the long-term impact of COVID-19 lockdowns and their massive fiscal cost, Brexit and a reorientation of UK trade, resolving what appears to be a distinctly UK problem in the form of a contracting labour force and arresting what has been a decades-long trend of UK companies investing less than their global peers.

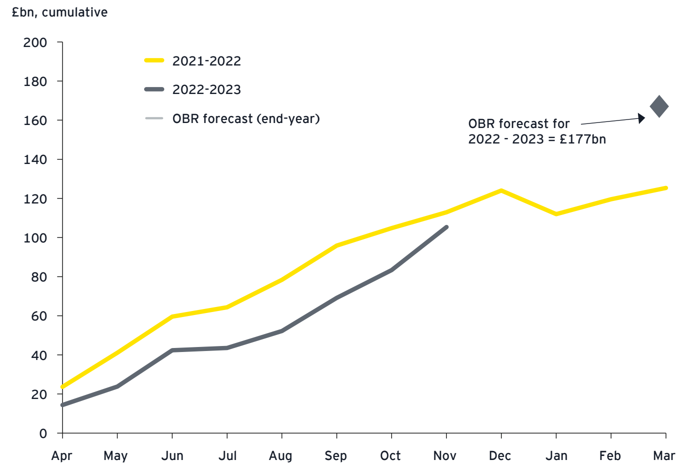
What's more, as with recent forecast reports, the uncertainty surrounding our predictions for the economy shouldn't be underestimated. The outlook for the UK economy hinges crucially on how fast inflation retreats and how much economic pain is required to get inflation back down to normal. If further shocks to energy prices can be avoided, we think that pain should peak during the first half of this year, with growth resuming later in 2023. But just as many events that defined 2022, like the war in Ukraine or the highly restrictive lockdowns in China, were not easy to forecast in 2021, this year could also deliver some big surprises.

# 7

# Forecast in charts

## Fiscal policy

**UK: Public sector net borrowing***



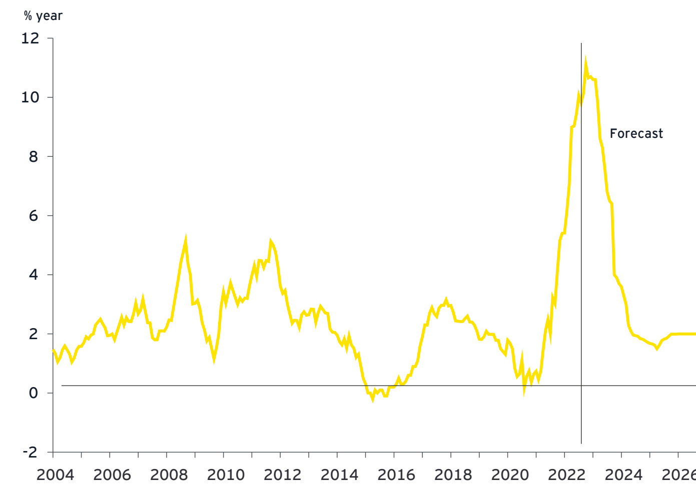

Source: EY ITEM club/Haver analytics and OBR

* excluding public sector banks

- The public sector borrowed £105.4bn over the first eight months of fiscal year 2022-23, £7.6bn less than at the same point in 2021-2022 and £7.8bn lower than the latest OBR forecast.
- Borrowing is likely to rise sharply in the coming months, reflecting the cost of energy support. The deficit will be influenced by the uncertain path of energy prices.
- The change in the EPG from April and the government's decision not to continue universal support for firms means that the cost of the energy support schemes should be much lower in fiscal year 2023-24.

## Prices

**UK: CPI inflation**




- CPI inflation has been very high in recent months, although the CPI measure dipped to 10.5% in December from a peak of 11.1% in October.
- We think October was likely the peak for inflation. Falling commodity prices suggest food price inflation is close to its peak, large base effects are likely to come into play for energy prices next year and weaker activity should cool core inflation.
- Our forecast sees CPI inflation falling to just under 4% by the end of this year. But the risk of further energy price shocks means the outlook for inflation is very uncertain.

## Monetary policy

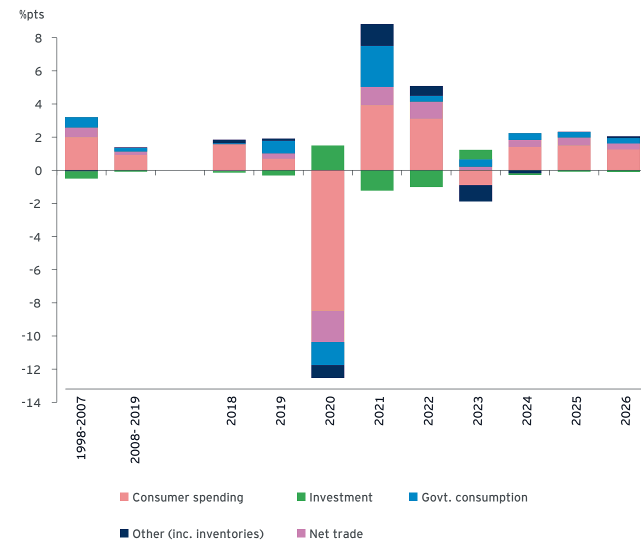
**UK: Bank rate and 20-year bond yield**

Source: EY ITEM club

- Bank Rate rose to 3.5% in December, the highest level since 2008. The rise from 0.1% in late 2021 was the biggest increase in rates over an equivalent period in over 30 years.
- The MPC's concerns about the inflationary risks of a tight jobs market mean the rate-hiking cycle is probably not at an end yet.
- But growing disinflationary forces and the economic slowdown mean monetary policy tightening should end early this year. We expect Bank Rate to peak at 4% in February.

## Activity

**UK: Contributions to GDP growth**

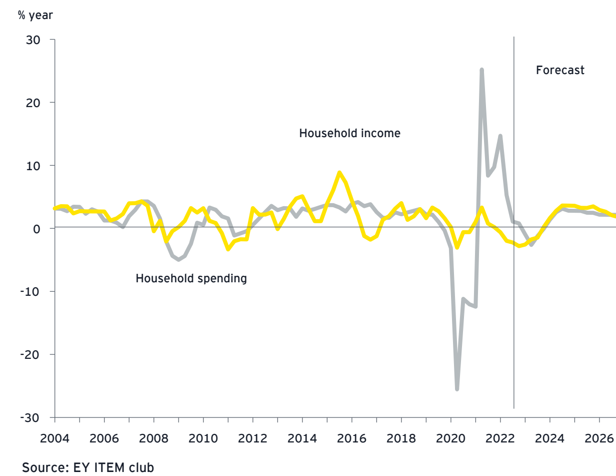



Source: EY ITEM club

- The economy shrank 0.3% q/q in Q3. Although the extra public holiday for the late Queen's state funeral played a role in the drop, a soft performance from GDP over the summer points to underlying weakness.
- Although GDP rose in October and November, the economy may have still shrunk in Q4, although an extra working day compared with Q3 means the fall in GDP should be modest.
- GDP is forecast to drop over the first half of 2023. We expect the economy to shrink 0.7% this year, before growing 1.9% in 2024.

## Consumer demand

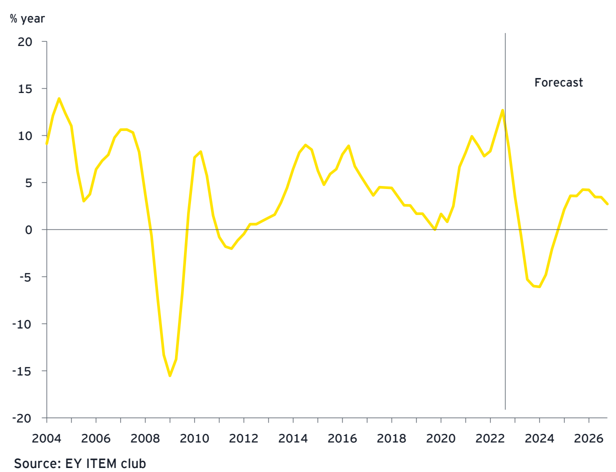
**UK: Real household income and spending**




- Consumer spending fell 1.1% q/q in Q3 2022. This compared with growth of 1.2% in Q2 and was the first decline in consumption since Q1 2021.
- High inflation, rising interest rates, tax increases and falling house prices mean consumer spending is likely to continue falling outright over the next few quarters.
- But expectations of a modest rise in unemployment, support to households from the EPG and scope for consumers to dissave should moderate the downturn. Consumer spending is forecast to drop 1.4% this year, with growth of 2.3% in 2024.

## Housing market

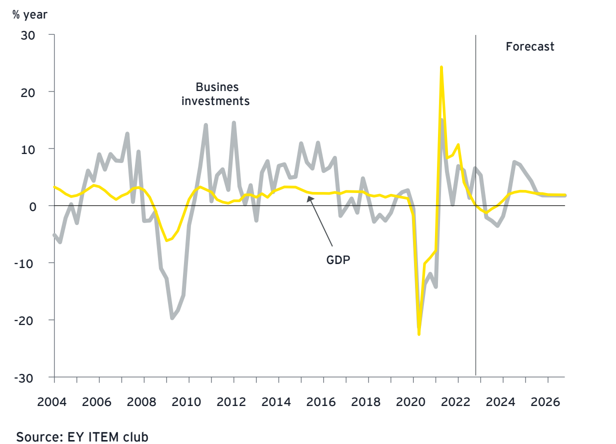
**UK: House prices**




- House prices fell in late 2022, with the Nationwide and Halifax measures both dropping in each of the four months to December.
- Values are likely to fall further, reflecting the impact of significantly higher mortgage rates and the wider economic downturn.
- After average house prices rose a projected 10.5% in 2022, we forecast a decline of 2.4% this year, with another fall of around 3% in 2024.

## Company sector

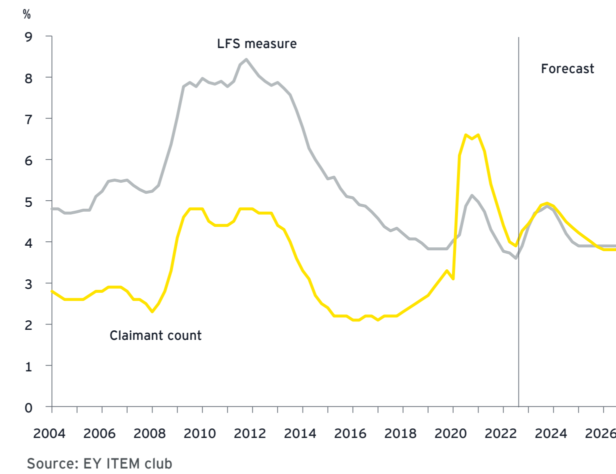
**UK: Business investment and GDP**




- Business investment fell 2.5% q/q in Q3, ending two successive quarters of growth. This left investment 8.1% below the pre-pandemic level in Q4 2019.
- Firms taking advantage of the super-deduction tax incentive, which ends in April, may deliver a boost to investment at the end of 2022 and in early 2023. But this will be countered by a rise in long-term real interest rates, higher input costs and elevated uncertainty.
- After business investment grew a projected 5.2% in 2022, it is forecast to fall 0.8% this year.

## Labour market and wages

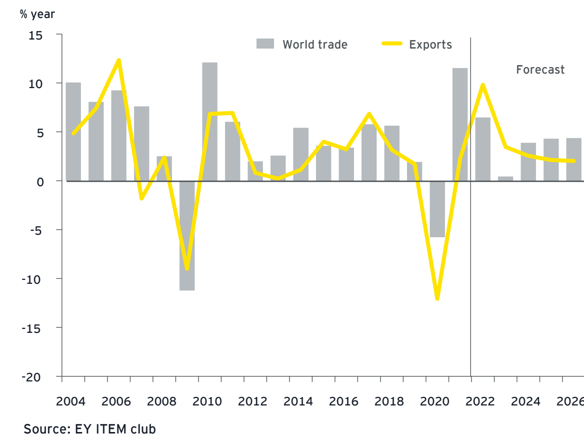
**UK: Unemployment rate**




- The LFS unemployment rate stood at 3.7% in the three months to November close to a 40-year low. However, the jobless rate has been depressed by a rise in inactivity.
- There have been signs of labour demand weakening, including a drop in job vacancies. But openings remain high in absolute terms, and other measures, such as the redundancy rate, still point to a tight jobs market.
- With a further drop in vacancies likely to absorb much of the impact of a weaker economy, we expect the unemployment rate to rise modestly, peaking at around 5%.

## Trade and the balance of payments

**UK: Exports and world trade**




- Trade flows have continued to be volatile, driven by movements in non-monetary gold and changes in the method the ONS uses to measure imports from the EU.
- The current account deficit narrowed to 3.1% of GDP in Q3 2022 from 5.7% in Q2 and a record 7.7% of GDP in Q2.
- Slowing global GDP growth is likely to weigh on export growth, albeit mitigated by sterling's weakness, whilst a softer outlook for consumption and investment will hold back imports.

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