EY ITEM Club Spring Forecast

Recession fears fade, while prospects brighten for the second half of 2023

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EY

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Foreword

Hywel Ball

UK Chair
Ernst & Young LLP (UK)
LinkedIn

Peter Arnold

UK Chief Economist
Ernst & Young LLP (UK)
LinkedIn

The lighter evenings and warmer days of spring seem to have brought better economic news, and not only because households and businesses will be using less energy! The doom and gloom of the autumn have dissipated slightly, with the government, via successive fiscal events, restoring fiscal credibility and calming down financial markets. The economy has also proved to be more robust than feared – it avoided technical recession by recording modest growth in Q4, retailers had a reasonable Christmas, and the year has started positively with business and consumer confidence improving and the economy again likely to be in positive territory for Q1.

The labour market continues to be robust, which has probably supported consumer spending. There have been some signs of cooling with vacancies falling, but this, combined with some positive trends on inactivity, could helpfully alleviate some of the wage pressure the Bank of England (BoE) is so concerned about.

Due to this perhaps unexpected economic resilience, the EY ITEM Club is no longer forecasting a calendar year decline in GDP for 2023, nor indeed an outright recession. The economy is now expected to grow by 0.2% in 2023 – an upwards revision from a 0.7% decline in the winter forecast – in line with an improving consensus.

Perhaps we shouldn't get too excited, though. The difference between a marginal increase and a marginal decline in activity is insignificant. The economy has effectively stagnated over the last 12 months, and a similar pattern is expected to play out over the first half of 2023. Consumers and businesses will still feel squeezed by inflation and higher interest rates, and we could well see some corporate stress and a slight uptick in unemployment as the labour market cools. The UK economy may not technically enter a recession, but it will feel like one for many.

Better news should await us in the second half of the year, as lower energy prices will lead to falling inflation directly (as the big price rises of early last year drop out of the calculation) and indirectly as energy costs make up a considerable proportion of the costs of other goods and services – most notably food – where a combination of poor harvests and high energy costs drove up prices unexpectedly in February. This decline in inflation should ease the pressure on living standards and likely cause the BOE to pause (or even begin to reverse) the current tightening cycle, setting the scene for a more robust growth of 1.9% in 2024.

However, as has ever been the case, plenty of uncertainty and risk to these forecasts remain weighted to the downside. Alongside the risk of further geopolitical instability and the prospect of another energy crunch next winter, recent events in the US and global financial markets highlight the consequences of higher interest rates. The last 18 months have seen the most significant tightening in rates for a generation in the US, UK and EU. Whilst we can have some confidence that the regulatory measures put in place post-financial crisis mean most banks are better insulated and capitalised, it's what's out of sight that is most concerning – the hidden danger in the depths of the ocean under the complacent swimmer.

Inflation could also be stickier than expected. Whilst the EY ITEM Club forecasts inflation will fall steadily throughout 2023 reaching 3% by the end of the year, this will depend on core inflation (e.g., excluding energy and food) falling neatly and linearly. It could well be stickier and bumpier depending on how embedded higher prices become within business and consumer expectations.

Historically, the housing market has been another risk and weakness for the UK. Whilst mortgage holders look less vulnerable than 15 years ago, when interest rates last rose on a sustained basis, those who recently purchased on short-term fixed rate deals still face a considerable payment shock when they refinance, and perhaps negative equity as house prices are expected to fall some 10% in aggregate. Buy-to-let investors also look exposed – many are highly leveraged and will have to undertake expensive capital investments to meet net-zero obligations on energy efficiency. On the corporate side – as we track in our profit warning publications – insolvencies and stress have been building throughout 2022 and are likely to remain raised throughout 2023.

In summary then, whilst the Spring has brought some improvement in outlook, any optimism does need to be tempered against the reality of a still-weak outlook for 2023 with significant downside risks. As ever, businesses need to think about scenarios and responses to make no-regret decisions on pricing and costs while looking for signs that the green shoots of a recovery are sustainable.

Highlights

- A stronger-than-expected end to 2022, further falls in energy prices and looser fiscal policy mean we now think the UK economy will avoid recession this year and expand slightly. But we still expect a subdued performance, with GDP growth of only 0.2% forecast in 2023, albeit a marked improvement on the 0.7% contraction the EY ITEM Club expected in our last forecast in January. The backdrop remains challenging, including the delayed effect of past interest rate rises, a potential tightening in lending standards and a hit to confidence from strains in the global banking system. As inflation recedes and the BoE starts to cut interest rates, growth is forecast at 1.9% in 2024.
- The three months since the EY ITEM Club's Winter forecast report have seen economic data hold up better than we, and the consensus, had expected. Relatedly, further falls in wholesale energy prices have unwound more of the energy price shock of 2022. This has contributed to a rise in consumer and business confidence, given the government leeway to loosen fiscal policy in the recent Budget, including holding the Energy Price Guarantee (EPG) at £2,500, and mean household energy bills should fall significantly from the summer onwards. Meanwhile, job creation has remained solid and mortgage rates have continued to drop back from post-mini-budget highs, albeit still well above levels in early 2022.
- Falling energy prices, plus the EPG decision, will push inflation down faster this year than we expected in January. CPI inflation is now forecast to end 2023 at just under 3%, taking more pressure off households' spending power and supporting consumption. Developments on the corporate side have been less positive, with business investment continuing to underperform the wider economy. But better prospects for GDP growth, the 100% expensing announced in the Budget and more political stability mean the outlook for business investment over the next few years has improved.
- The outlook is still subject to some big uncertainties. Domestically, these include whether recent signs of economic inactivity reversing some of its pandemic-era rises will persist and the extent to which households continue to draw on 'excess' savings to support spending. Improved macroeconomic prospects should aid both. With job creation remaining solid, we now expect a very modest rise in unemployment, creating less of a disincentive for the currently inactive to enter the workforce, whilst improved sentiment should leave consumers more confident spending rather than saving.
- Internationally, stresses in the global banking sector are another channel of risk between rising interest rates and the real economy. Strong capital and liquidity positions and very different market structures reduce the danger that UK banks will experience turmoil like that suffered by some lenders in the US. But the repercussions of financial volatility for banks' funding costs and lending appetites could see UK credit conditions tighten, creating another headwind for the housing market and reducing consumers' leeway to borrow to use debt to compensate for falling real incomes. Gloomy headlines about the risk of another financial crisis could also hold back the recent rebound in consumer and business confidence.
- The unanticipated consequences of rising interest rates revealed by the LDI pension crisis last year and the implosion of several US banks more recently is one reason why we think the Bank of England (BoE) will implement only one further rise in Bank Rate before hitting pause. More importantly, inflation risks will recede as less expensive energy bears down directly on headline inflation and indirectly on core price pressures. Pay growth should also slow, reflecting falling inflation expectations, the emergence of some slack in the labour market and a fall in job-to-job moves from unusually high levels during and immediately after the pandemic.
- We continue to expect a sustained fall in house prices, although signs of green shoots in the economy, a resilient labour market and the large savings held by households should limit the size of the drop. Falling property prices will weigh on the economy directly via weaker construction activity and indirectly via channels between housing and consumption. But we think the economic damage won't be as severe as in previous price corrections.
- The correlation between home moves and household goods sales has fallen over the last decade. Housing equity withdrawal, which magnified the boost to consumption from rising house prices in the 2000s, has been negative for over a decade. Households' housing equity is starting from a record high, reducing pressure to cut spending to repay debt. And this time, declining housing wealth isn't being compounded by sharp falls in equity and financial wealth.

1 Introduction

It's been a while since the EY ITEM Club forecast for the UK economy has begun on an upbeat note. That certainly wasn't true of our last report three months ago, when the 'r-word' dominated.[1] Then, the expectation was that a combination of very high inflation, expensive energy, falling real incomes and rising interest rates would push the economy into recession, albeit one relatively shallow and short-lived. Indeed, after GDP fell in Q3 2022, we, and many other forecasters, thought that the economy would probably satisfy the definition of a technical recession – two consecutive quarters of falling GDP – by the close of last year.

But reality has proved less gloomy. Q3's contraction was revised smaller, and GDP grew slightly, rather than shrunk, in Q4. And across a range of indicators, the economy's performance in 2023 so far has largely beaten expectations. GDP saw a healthy rise in January, retail sales have rebounded, and tax receipts have come in stronger than anticipated. Job creation has continued at a solid pace, and consumer confidence has picked up, as have other survey indicators. Inflation, the economy's chief bugbear over the last year or so, has fallen back from the peak last autumn, and wholesale energy prices have continued to decline, signalling lower bills ahead. Moreover, mortgage rates have continued to retreat from their post-mini-budget spike. And the fiscal loosening in March's Budget will support activity.

But the economy is not out of the woods. Following January's rise in GDP, output recorded zero growth the following month. Inflation remained in double digits in early 2022, weighing on consumers' spending power. Whilst inflation should quickly fall this year, the uncertain future path of energy prices and the war in Ukraine means this is not guaranteed. Meanwhile, notwithstanding the Budget's announcements, previous fiscal policy decisions mean the tax burden is still headed for a 70-year high. And while we think the BoE will bring the current cycle of rising interest rates to an end soon, stresses from global monetary tightening are emerging, as witnessed by banking sector turmoil abroad. UK banks could tighten lending standards in response, injecting further weakness into an already-soft housing market and reducing consumers' ability to use debt to offset falling real wages.

Bringing these factors together and assuming banking sector turmoil is contained, we now think the economy will flatline, rather than shrink, over the first half of this year, before resuming meaningful growth from the summer. GDP is forecast to rise 0.2% in 2023, a weak performance in isolation but a chunky improvement on our forecast of a 0.7% contraction in the Winter EY ITEM Club report. With less lost ground to make up but domestic demand supported by less expensive energy and investment incentives, the economy is forecast to grow by 1.9% in 2024 (2% previously), followed by 2.3% in 2025.

The significance of reining back our previous recession prediction shouldn't be overblown. There's little meaningful difference between output in a particular period shrinking slightly or growing slightly. But the psychological effects could be powerful. What had been a very negative narrative around the UK economy from much of the commentariat and international bodies, such as the IMF, risked households responding by increasing precautionary savings, lowering demand and negatively affecting company revenues and employment in a vicious cycle. An improvement in the economic mood-music should support confidence and spending, thereby boosting firm revenues and employment in a virtuous cycle. Consequently, the downside risks to our forecast have also eased, as the recent implosion of some banks abroad illustrates, nasty surprises can't be ruled out.

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 the outlook for wages and what that implies for inflation. Section 5 considers the consequences of falling house prices for the wider economy. Section 6 concludes.

1. EY ITEM Club Winter 2023 forecast report. https://assets.ey.com/content/dam/ey-sites/ey-com/en_uk/topics/growth/ey-item-club/ey-item-club-winter-forecast-report.pdf?download

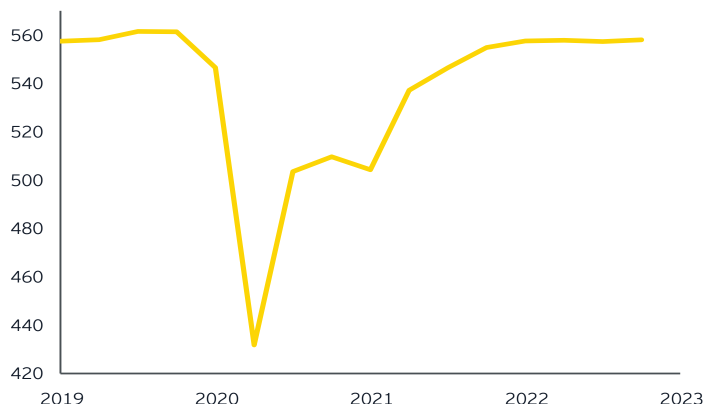
2

Flatlining, not recession, is now likely in the short-term

The economy stagnated in Q4 2022, with industrial action hitting activity at the end of last year ...

The economy ended 2022 in contractionary territory, with GDP shrinking 0.5% month-on-month (m/m) in December. But some of the fall was likely a temporary consequence of widespread industrial action that month. A large drop in health output was probably a function of operations being cancelled due to strikes by hospital staff. And lengthy shutdowns across the rail network weighed heavily on output in the transport sector. There was probably also an indirect impact from the transport disruption, both in terms of stopping people from getting to work and compromising their ability to engage in leisure activities. Oddly, the timing of the World Cup also seems to have left a mark in December — delays to Premier League fixtures contributed to output in the recreational sector plunging almost 8%.

GDP growth in October and November was just enough to offset December's contraction, leaving output in Q4 up 0.1% on the previous quarter. Q4 having a normal complement of working days, following the extra public holiday for the Queen's funeral in September, plus the rollout of Covid booster jabs will have flattered the economy's performance and offered some offset to the hit from December's industrial action. But Q4's rise did little to change the picture of a flat economy through 2022.



Source: EY ITEM Club/Haver Analytics

The expenditure breakdown for Q4 showed a 0.2% quarter-on-quarter (q/q) rise in consumer spending. This compared favourably with a fall of 0.3% in Q3, although working-day differences will have exaggerated the rebound. However, business investment dropped 0.2%, despite expectations that firms would ramp up investment to benefit before the 'super-deduction' tax incentive ended in March. Q4's fall left business investment 2.2% below the pre-pandemic level versus a 0.6% undershoot in GDP.

As was the case earlier in 2022, the ONS had significant trouble balancing the various measures of GDP, resulting in a large alignment adjustment. This raises the possibility of large revisions to the Q4 data in subsequent releases.

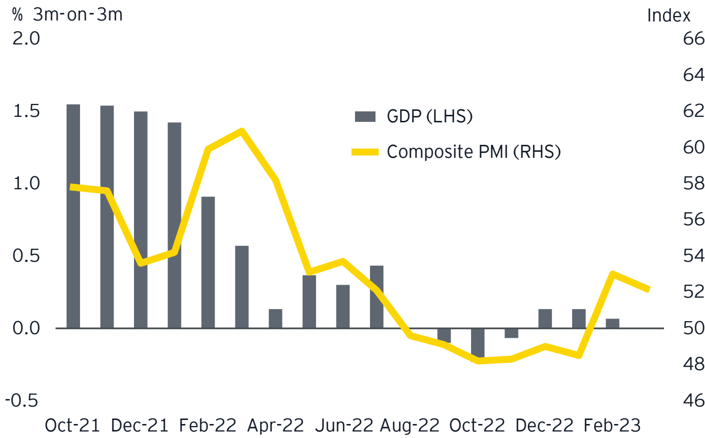
... but 2023 has got off to a better start

Industrial action continued to drag on the economy in January, but GDP grew 0.4% m/m, above consensus predictions. The curtailment of activity in strike-affected areas limited growth in services output to a still-strong 0.7%, with not all erratic factors having a negative impact on the economy's dominant sector. The largest driver of growth in services was education, reflecting school attendance levels returning to normal levels following a big drop in December. A return to the standard schedule for Premiership football matches also helped.

Other sectors turned in weaker performances in the first month of 2023. Manufacturing output declined 0.4%, while the construction sector shrank 1.7%, with bad weather playing a role in the latter. January's rise in GDP was followed by zero growth the following month, although strike action continued to be a notable drag on activity in some sectors, including health, education, and transport. This contributed to services sector output falling 0.1%. Manufacturing was flat, but the construction sector rebounded 2.4%.

Other indicators have been consistent with some turnaround in the economy's fortunes. One upside surprise came from the S&P Global/CIPS activity surveys. February's survey showed the composite PMI jumping to 53.0 from January's 48.5, reflecting rebounds in the services and manufacturing indices. Survey respondents cited lower uncertainty, easing supply shortages and falling inflation as helpful developments.

UK: GDP versus composite PMI



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

The higher PMI signalled rising activity for the first time since July 2022. And the index held on to most of February's gain the following month.

Meanwhile, there's been better news from the retail sector. Retail sales volumes rose 0.9% m/m in January and a further 1.2% m/m in February. Although these gains followed a sizeable fall in December, sales volumes in February were at their highest level for six months. Improved sentiment among consumers may have contributed to the retail revival. GfK's measure of consumer confidence rose over February and March to a 12-month high.

The latest survey numbers are consistent with GDP having expanded in Q1. But as section 3 explores, any increase is likely to prove modest. And the recent run of better data needs some qualifications. GDP in February was still only 0.3% above the pre-pandemic level in February 2020. On the same, pre-COVID-19 comparison, retail sales in February were flat. And the economy has continued to face the adverse consequences of high inflation. Although the CPI measure has fallen from last October's peak, reflecting an easing in both headline and core pressures, it stood at a still very high (by the standards of the last three decades) 10.4% year on year (y/y) in February.

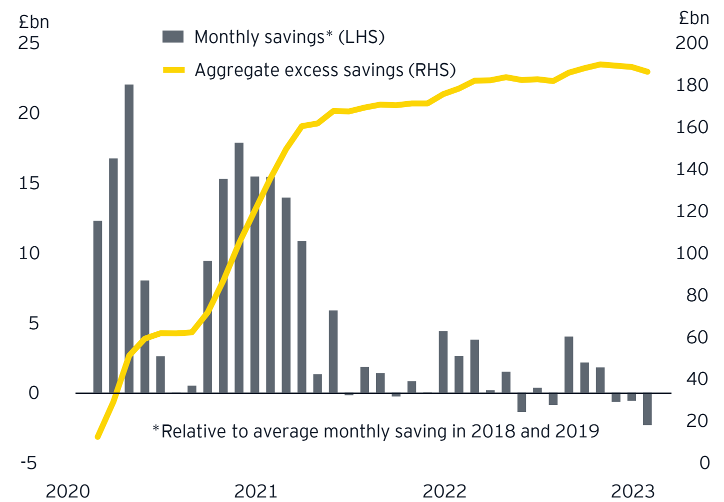
Despite high inflation, real household incomes rose 1.3% q/q in Q4, the first increase in five quarters. But the rise reflected more government energy bill support to households than better fundamentals. The boost to incomes (the biggest, in cash terms, since Q2 1999), alongside a more modest increase in consumer spending, pushed the household saving ratio up to 9.3% in Q4 from 8.9% in the previous quarter, suggesting households have a bigger savings buffer to draw on than had been anticipated.

There have been timelier signs that consumers may be making use of that buffer, perhaps spurred by cost-of-living pressures and a revival in consumer confidence. Net unsecured lending averaged £1.6bn over January and February, up from an average of £1.2bn per month in 2022. And the £1.6bn increase in households' bank deposits in February was below the pre-pandemic norm for the third month in a row and the smallest addition to liquid savings in almost five years.

Housing market activity has remained weak, although the trough may be passed. Mortgage approvals rose to 43,536 in February from 39,647 the previous month, the first increase since last August. But this was still well below the 62,677 per month averaged during 2022. And reflecting the lagged impact of the plunge in approvals at the turn of 2022 and 2023, net mortgage lending fell to only £0.7bn in February, the lowest since April 2016, excluding the pandemic period.

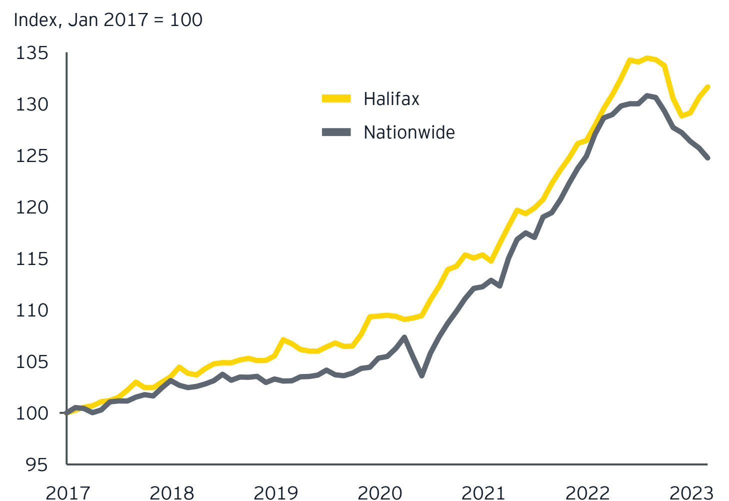
On some measures, house prices have fallen further since our last report, although a divergence has emerged between the widely quoted Nationwide and Halifax measures. The former showed average property values dropping in each of the first three months of 2023, whilst the Halifax index showed growth in the same period, with Halifax citing a fall in mortgage rates and a recovery in consumer confidence as potential reasons. How lower house prices might affect the wider economy is explored in Section 5 of this report.

UK: Household saving in bank deposits



Source: EY ITEM Club/Haver Analytics

UK: House prices



Source: EY ITEM Club/Haver Analytics

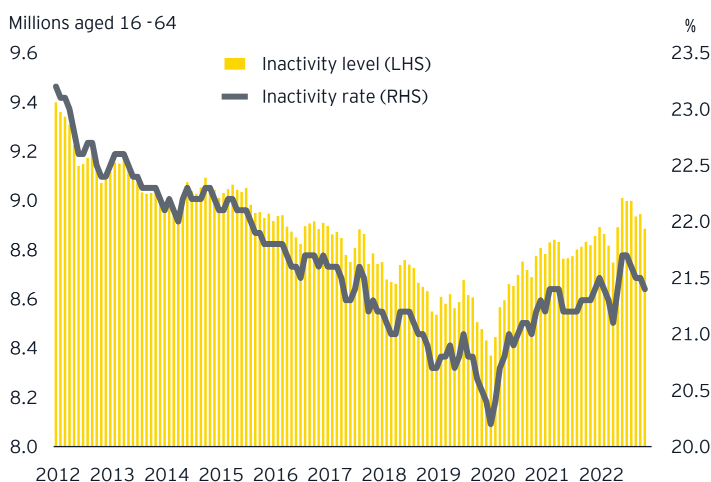
Unemployment has stayed low, and the previous rise in inactivity may be starting to turn

The labour market has remained resilient, despite a stagnant economy. Employment crept up over the winter, rising 65,000 in the three months to January. This pushed the employment rate up 0.1 percentage points (ppts) to 75.7%, although this was still 0.6 ppts short of the pre-pandemic rate.

Growth in the number of people in work was accompanied by a fall in economic inactivity. The share of the working-age population not in work or actively looking for work dipped to 21.3% in the three months to January, a move driven, in part, by an increase in 50-to-64-year-olds returning to the workforce.[2] This was down from a peak of 21.7% last summer, although the lingering effect of a rise in ill-health and early retirement and other factors in depressing participation was evident in the inactivity rate still being over a percentage point above the 20.2% rate at the start of 2020. This corresponded to nearly half a million more inactive people than at the pre-pandemic level. With employment up, but inactivity down, the LFS jobless rate stood a still-very low 3.7% in the three months to January. And redundancies, while higher than early last year, have been in line with pre-pandemic levels.

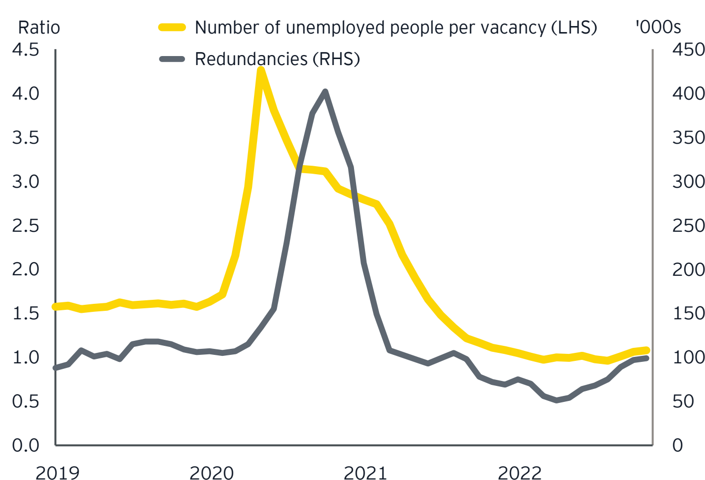
However, demand for labour has not been immune from the economy's sluggishness. Job vacancies have continued the decline that began last summer, falling to 1.1mn in the three months to February, 14% below last year's peak. But they were still one-third higher than before the pandemic, while the number of unemployed people per vacancy remained below pre-COVID-19 levels.

UK: Economic inactivity



Source: EY ITEM Club/Haver Analytics

UK: Unemployment – vacancy ratio and redundancies



Source: EY ITEM Club/Haver Analytics

The Bank of England has continued to raise interest rates, taking Bank Rate to a 15-year high

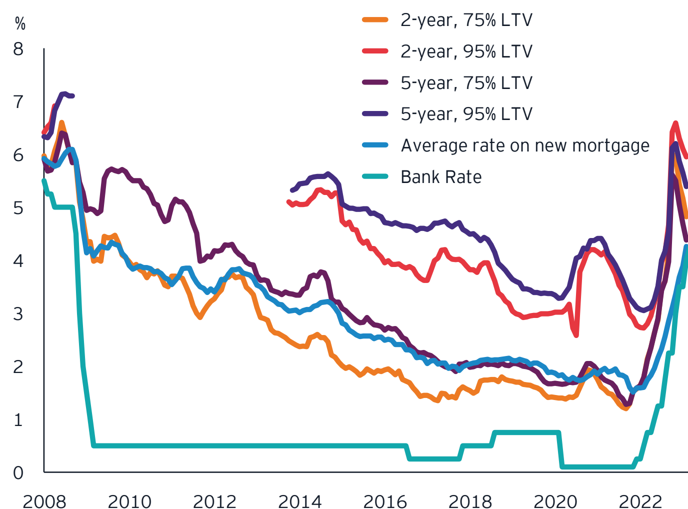
The cycle of rises in official interest rates, which began in late 2021, has continued over the last few months. A majority of 7–2 on the Monetary Policy Committee (MPC) voted to raise Bank Rate from 3.5% to 4% in February's meeting, the first of 2023. This took the policy rate to the highest since 2008.

Still, the wording of February's policy statement suggested that the peak in rates was close, stressing that the full impact of previous rate hikes was still to feed through and removing some hawkish language around responding to inflationary pressures which had appeared in previous statements. But the MPC also continued to argue that the risks to the inflation outlook were large and skewed to the upside.

2. See David Sturrock and Xiaowei Xu, 'New data show signs of over 50s returning to the workforce', Institute of Fiscal Studies, 2 March 2023. https://ifs.org.uk/articles/new-data-show-signs-over-50s-returning-workforce

Notwithstanding early March's financial volatility, the same risk management considerations were a factor behind a further increase in Bank Rate that month. However, a 25 basis points (bps) rise was smaller than previous rate hikes. And while the MPC kept its options open around the future direction of monetary policy, it further dialled back on hawkish rhetoric.

UK: Mortgage interest rates



Source: EY ITEM Club/Haver Analytics

Despite the BoE policy rate rising further in recent months, quoted mortgage rates have continued to retreat from last September's mini-Budget-related peaks. For example, as of February, rates on two- and five-year 75% loan-to-value mortgages were more than 100bps lower compared with last November. But rates on these mortgages were still 250bps–300bps higher than 12 months earlier. And the average effective interest rate on all new mortgages reached 4.36% in February, the highest in over 13 years.

It's still too early to say what effect March's banking sector turmoil may have on the cost of the availability of loans to households and firms. Banks' funding costs have risen in the UK, as in other advanced economies, but how long these rises will persist, whether they will be passed onto borrowers, or the extent to which lending criteria will be tightened, is currently unclear.

March's Budget loosened fiscal policy, aiming to boost long-run growth

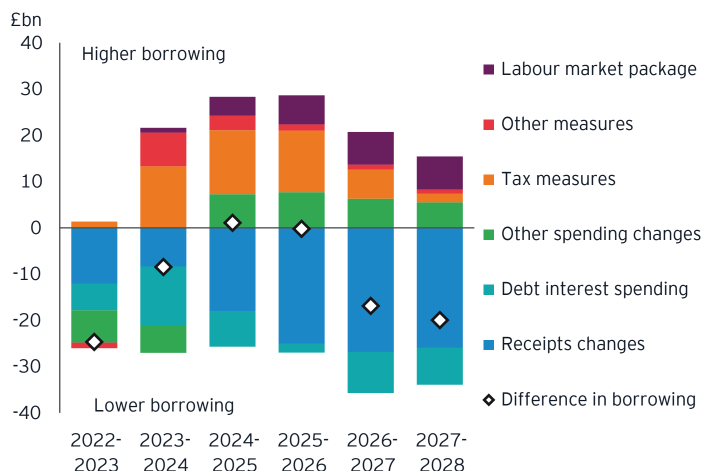
Public sector borrowing has continued to be pushed up by the cost of government energy support to households and firms. Borrowing in the fiscal year to February 2023 of £132.2bn was up £15.5bn (13.2%) on the previous year. But the deficit was a more modest £6.9bn, or 5.9%, higher than the same period in 2021–22 on a like-for-like basis (correcting for student loans figures not yet recorded by the ONS). Unexpected buoyancy in tax receipts has kept borrowing lower than otherwise. And the deficit for 2022–23 looks like it will undershoot the OBR's March Budget forecast of £152.4bn.

March's Budget, Jeremy Hunt's second fiscal event as Chancellor, proved less dramatic but much more positive in tone than the Autumn Statement last November. The latter had majored on tax rises and spending restraint to fill a putative fiscal 'black hole' which had confronted the public finances, to calm market concerns following the short-lived administration of Liz Truss. But the Chancellor used the latest Budget to loosen fiscal policy via a package of measures aimed at supporting the economy in the short- and longer-term while still meeting his self-imposed fiscal rules.

Underpinning this change of approach was a less gloomy set of economic and fiscal forecasts from the OBR. Predictions of a five-quarter-long contraction in GDP in the Autumn Statement forecast became no technical recession at all. And helped by more momentum in activity, the steep fall in wholesale energy prices since the autumn, and a lower expected peak in interest rates, projected public sector borrowing was cut across the OBR's forecast horizon. That most of the recent unexpected strength of tax receipts was expected to persist also helped.

After allowing for the cost of measures announced in the Budget, borrowing will still be around £20bn per year lower than expectations in November. In the short-term, those measures included cancelling plans to raise the Energy Price Guarantee (EPG) in April from £2,500 to £3,000. The economic effect of this is discussed in Section 3.

UK: Changes to public borrowing forecast since November



Source: EY ITEM Club/OBR

The Budget also included several strands of supply-side reforms aimed at boosting long-run growth. One focused on incentivising business investment. For three years, from 2023–24, firms will be able to fully offset investment spending on plant and machinery against taxable profits in the first year. A second strand concerned measures to promote growth in the workforce and correct some of the shrinkage observed since 2020. This included broadening free childcare, imposing greater requirements to look for work and train for those receiving out-of-work benefits, and reforming rules around pension contributions to discourage early retirement.

3

Growth should pick up as 2023 progresses

2023 still looks to be a year of two halves for the economy

The generally positive run of economic data for the early part of this year suggests that the economy should have grown in Q1. But the potential for a q/q expansion faces a headwind from December 2022's fall in GDP and the poor launchpad this presents for growth. Moreover, some sectors have continued to be held back by industrial action. As a result, we think the economy expanded in the first quarter, but by a modest 0.1% q/q.

The economy is likely to hover around stagnation in Q2. For sure, that several of the sectors affected by strikes seem closer to settling their industrial disputes means the drag from this source should fade. And the government's decision to maintain the EPG at £2,500 from April, rather than raise it to the previously planned £3,000, will benefit the typical household by £125 over the April to June period.

On the other hand, Q2 will have an extra bank holiday in May to celebrate the King's coronation. Recent experience of additional public holidays (those for the late Queen's Platinum Jubilee in June and funeral in September) suggests the extra day off could significantly drag on output in several sectors.

But the second half of the year should see the economy return to expansion. A normal complement of working days in Q3 will mechanically boost q/q growth. Wholesale gas prices have continued to decrease, implying that household energy bills should fall from July. Also, the fiscal loosening announced in the Budget will start to take effect. As a result, we now expect GDP to grow 0.2% in 2023, up from our previous forecast of a 0.7% fall.

With futures prices showing the cost of energy remaining well below projections three months ago through this year and next, our forecast for growth in 2024 sits at 1.9%, slightly down on the 2% predicted in January. While cheaper energy will support activity, a better-than-expected performance this year will mean less scope for above-trend growth. The economy then expands a projected 2.3% in 2025, a little faster than we previously anticipated, as the boost to business investment from tax incentives mounts.

The consumer outlook has improved on the back of falling energy prices

The effect of a global energy price shock on the economy was clear last year in very high inflation, real household incomes falling at the fastest pace in decades and an economy flirting with recession. But the energy price shock has receded further since the beginning of 2023, a development that promises to deliver a fillip to the economy.

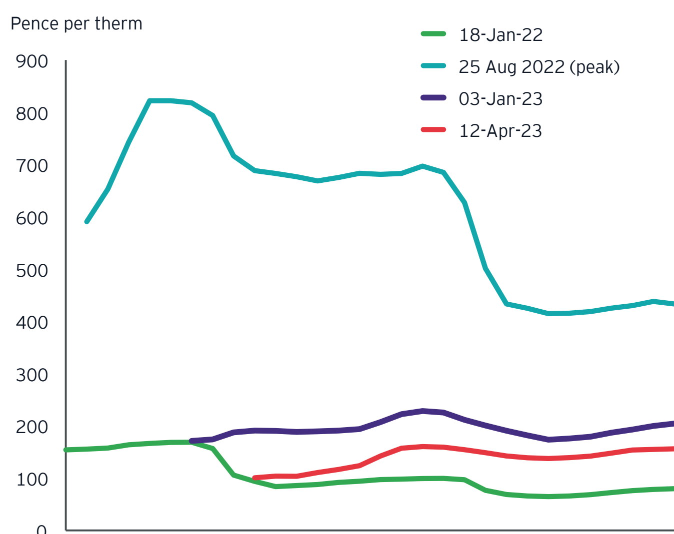
Since last autumn, households have been insulated from the full blast of the earlier surge in wholesale prices by the government's EPG. The EPG currently caps the unit cost of energy, implying a typical annual dual-fuel household bill of £2,500 versus £3,280 under the Ofgem Energy Price Cap (EPC), which previously determined the typical bill. The EPG was due to rise to £3,000 in April, but the government chose in March's Budget to maintain it at the previous level. Meanwhile, firms' spending on energy has been held down by the Energy Bill Relief Scheme (EBRS), which sets a fixed price for gas and electricity used by companies.

Further falls in wholesale energy prices mean these support schemes are likely to drop by the wayside over the next few months. As of early April, spot wholesale gas prices stood at just under 110 pence per therm, 80% lower than last August's record peak.

More relevant for energy bills later this year, given the structure of the pricing mechanism, forward prices have also fallen. At the time of writing, prices for the delivery of gas over the rest of 2023 and 2024 averaged around 135 pence per therm. Although still over double the average price in the late 2010s, this is a third down on futures prices at the start of the year and only a third of last summer's high. The price of oil is little changed from three months ago, but prices of agricultural goods and metals have fallen.

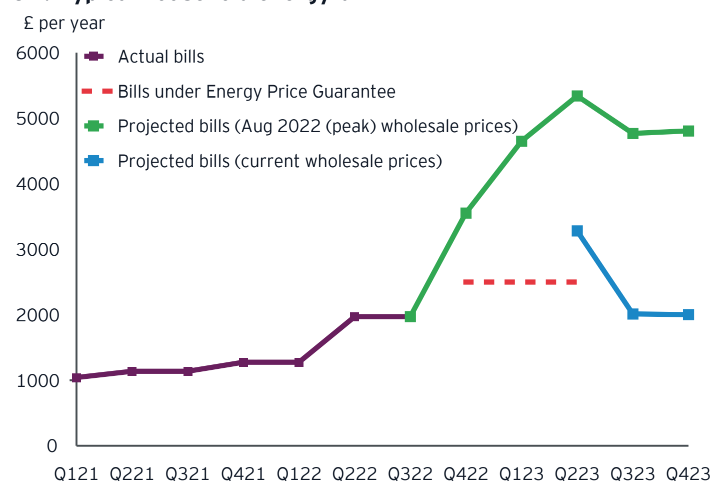
The particularly sharp drop in wholesale gas prices reflects lower European gas consumption, assisted by what was a relatively mild winter. At the same time, the supply of gas from non-Russian sources, following cuts in Russian supply after the invasion

of Ukraine, has been boosted by a surge in Liquefied Natural Gas (LNG) imports from the US and elsewhere and increased Norwegian production.



Favourable demand and supply developments suggest that a renewed spike in prices should be avoided later this year, even if the conflict in Ukraine continues. The size of the cut in European gas consumption signals an ability and willingness to maintain reductions – likely into next winter – so storage levels should remain high. And the rise in LNG flows into Europe should continue as exporting countries, notably the US, expand their infrastructure. That said, the potential for increased competition from a post-zero-Covid China will likely keep prices higher than otherwise.

Current wholesale gas prices mean the Ofgem price cap should drop to around £2,000 in July, below the EPG level.[3] This constitutes a sea change in expectations of where bills are headed compared with last year. Last August, some energy specialists were predicting that household bills could reach as high as £7,700 in spring 2023.[4] The typical bill is now expected to remain at around £2,000 at the end of this year. Although a welcome development, this would still be around 60% higher than in early 2022, when the price cap stood at £1,277.



Source: EY ITEM Club/Ofgem/Cornwall Insight

The drop in energy prices, the decision to keep the EPG at £2,500 in Q2 and the prospect of a fall in bills from the summer mean headline inflation will be lower than otherwise, as will the extent of the squeeze on real incomes. We now expect average household energy bills to fall by around 20% in July. As a result, the direct contribution of the energy category to CPI inflation should decline from 3.2ppts in February to -0.5ppts in Q4 2023.

Energy is an input into almost every form of economic activity. Therefore, less expensive gas and electricity should also feed indirectly into slower price rises across the board, helping to bring down core and headline inflation.[5] Meanwhile, sterling has strengthened since the start of the year, reducing imported inflation. And on balance, China's reopening could prove disinflationary for the UK and other advanced economies, as the easing of supply chain disruption outweighs positive spillovers from stronger demand.

Government policy decisions and energy price moves will add to downward pressure on inflation from other sources. The rapid price increases of early 2022 will soon drop out of the calculation of annual inflation. We expect falling inflation expectations, a reduction in labour market churn and the emergence of slack in the labour market to push down on pay growth (see Section 4). And what had been a rapid rise in the money supply has slowed to almost zero. Overall, we now expect inflation to end this year at just below 3%, down from a forecast of almost 4% three months ago.

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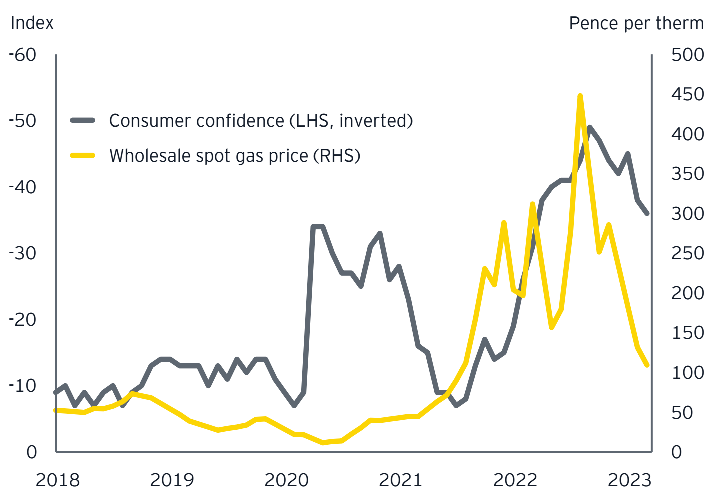
3. Dr Craig Lowrey, 'Cornwall Insight responds to the government's announcement on the EPG', 15 March 2023. https://www.cornwall-insight.com/press/cornwall-insight-responds-to-the-governments-announcement-on-the-epg/
4. Connor Sephton, 'Cost of living crisis: Britons on £45,000 will need help paying energy bills, chancellor says - as experts warn price cap could rise to £7,700', Sky News, 27 August 2023. https://news.sky.com/story/cost-of-living-crisis-britons-on-45-000-will-need-help-paying-energy-bills-not-just-those-on-benefits-chancellor-says-12682533#:~:text=But%20energy%20consultancy%20firm%20Auxilione,consumers%2034.22p%20per%20kWh
5. See 'A cost-of-living crisis: Inflation during an unprecedented terms of trade shock', speech by Swati Dhingra, external member of the Monetary Policy Committee, 8 March 2023. https://www.bankofengland.co.uk/speech/2023/march/swati-dhingra-remarks-on-cost-of-living-crisis-and-inflation-at-the-resolution-foundation

Better economic prospects and low unemployment should bolster consumer confidence

As well as relieving some of the pressure on households' real incomes, less expensive energy should boost consumers' sentiment and make them more confident about spending. Consumer confidence, as measured by the GfK index, had recovered to pre-pandemic levels in early-2021 but was then crushed by the massive surge in the prices of energy and food. Sentiment was initially unresponsive to the fall in gas prices, which began last autumn. But more recently, consumers' spirits have shown signs of making a comeback, which should build if bills start to fall in a few months' time.

So far, there have been limited signs of consumers cushioning the blow to real incomes from high inflation by taking on new credit and saving less. There are reasons why this financial caution may continue. Falling house prices will cut homeowners' wealth, and mortgagors facing a steep rise in debt-servicing costs may choose to save more to try to absorb the higher payments. A high share of fixed-rate mortgages is one factor that should limit the extent of forced sales and, therefore, the fall in prices. Still, we expect average property prices to decline by around 10% peak-to-trough over the next two years.

UK: Gas prices and consumer confidence



Source: EY ITEM Club/Haver Analytics

But improved sentiment should present a counter, as will our expectation of continued resilience in the jobs market. We now expect the official unemployment rate to peak at a little over 4%, down from a peak of close to 5% in the winter forecast. This is mainly due to the improved GDP outlook, while continued recruitment difficulties in some sectors increase the likelihood that firms will choose reduced hours or move to part-time working ahead of cuts in staff numbers. The measures to boost participation in the workforce announced in the Budget may also keep the jobless rate down at the margin.

Still, relatively high inflation (by the standards of recent decades), the freeze in income tax thresholds, and the impact of rising debt servicing costs will likely result in real household disposable incomes falling this year, compounding a 1.3% drop in 2022. But the decline should be less marked than we feared three months ago, and real incomes should start to rise again from the summer onwards as inflation heads lower.

Overall, we have become much less bearish on the likely performance of consumer spending this year, aided by a better-than-expected performance at the end of last year and the positive forces discussed above. Consumption is now expected to drop 0.3% this year, versus a 1.4% fall expected three months ago, with a rise of 1.8% forecast in 2024.

The BoE has left its options open, but we think it'll be a case of one more rate rise and done

In arriving at its most recent monetary policy decision in March, the MPC faced a combination of stronger-than-expected growth and employment, but underlying inflation in line with expectations and pay growth a little less strong than anticipated. This balance between developments suggesting higher rates, and those suggesting the opposite, makes predicting the path of Bank Rate in the short-term difficult.

Financial market turmoil has injected a new source of uncertainty. For sure, combining the risk that banking problems abroad could tighten financial conditions in the UK with the disinflationary impact of falling energy prices, it might be natural to conclude that further rises in the BoE's policy rate are now out of the question.

But the reality isn't so clear-cut. The MPC's policy statement in March suggested that it's confident in the resilience of the UK banking sector and content to focus interest rate policy on the BoE's inflation mandate, leaving financial stability issues to the Financial Policy Committee (FPC).[6] Moreover, lower energy bills will mean a less-weak outlook for consumer spending, all else equal, putting upward pressure on medium-term inflation. Indeed, the MPC has raised Bank Rate by 75bps in its last two meetings, despite projecting that inflation will be closer to zero than the 2% target in two to three years.

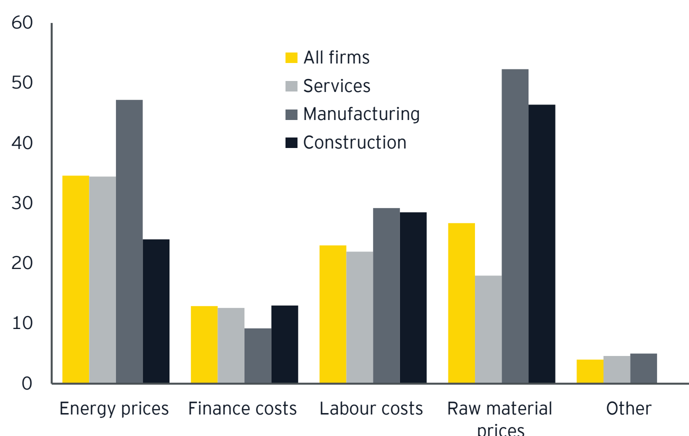
6. Bank of England, 'Monetary Policy Summary and minutes of the Monetary Policy Committee meeting', 23 March 2023. https://www.bankofengland.co.uk/monetary-policy-summary-and-minutes/2023/march-2023
7. Bank of England, 'Monthly Decision Maker Panel data - February 2023', 3 March 2023. https://www.bankofengland.co.uk/decision-maker-panel/2023/february-2023

That said, recent indicators of inflationary pressure have looked more encouraging. The BoE's own survey of corporate CFOs suggests firms are reining back price expectations, while wage growth tentatively appears to have peaked on the measures the BoE tends to focus on.[7] Meanwhile, the indirect effects of the previous rise in energy prices – by lifting firms' costs – has probably pushed up core inflation to a considerable degree.

Consequently, falling energy prices should depress inflation to a greater extent than implied by the category's weight in the consumer spending basket. Consistent with this, survey evidence from the ONS shows that energy has been the most important driver of price rises for services firms and has a significantly bigger influence than labour costs.[8] With energy bills very visible to the average household, if bills start dropping later this year, that could have an outsized effect in bringing down inflation expectations and, consequently, pay demands.

UK: Factors causing firms to consider raising prices

% of respondents in week to 30 March



Source: EY ITEM Club/ONS

On balance, we think the improved economic outlook and concerns about inflation persistence will convince the MPC to support another 25bps rise in rates when it meets next in May. But that should prove the end of the current rate rise cycle. Headline inflation should have begun to meaningfully turn down over the summer, and pipeline price pressures should look increasingly benign, indeed to the extent that projected inflation could undershoot the 2% target by an even greater margin than the BoE expected in its last forecast. More gloomily, further stresses in the financial system triggered by a global tightening of monetary policy may emerge in the next few months, necessitating a general change of course by central banks. As a result, there's a good chance the MPC will be mulling rate cuts by the end of this year.

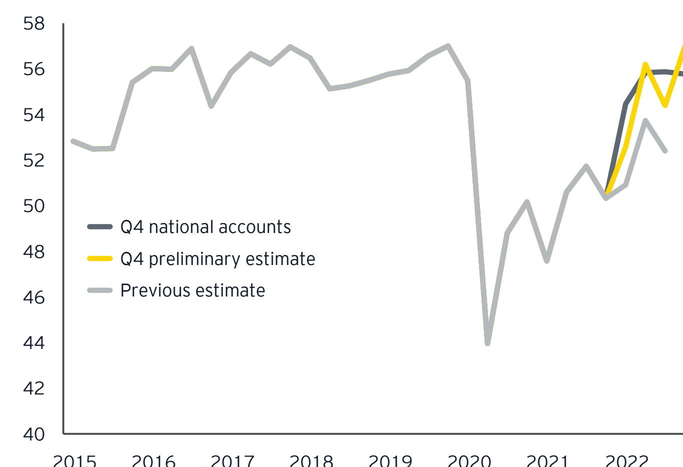
Business investment has continued to underperform but should gain from tax measures

Estimates of business investment are notoriously revision-prone, a point well illustrated recently. The ONS' preliminary estimate of business investment in Q4 saw big upward revisions to historical data and a strong 4.8% q/q gain in Q4, taking investment back to its pre-COVID-19 level at the close of last year. But subsequent revisions in Q4's national accounts changed the picture, showing investment falling 0.2% in Q4, leaving it 2.2% below the level in Q4 2019.

Over a longer timeframe, the performance of business investment has been unimpressive. Firms' spending on capital equipment has stagnated since 2016, with uncertainty surrounding the UK's future trading relationship with the EU, the pandemic, the energy crisis, and rising interest rates all presenting headwinds. But there are now some reasons for optimism around what has been a perennial underperformer in recent years.

UK: Business investment

£bn per quarter



Source: EY ITEM Club/Haver Analytics

One is a better outlook for GDP growth this year. A second is the reduced risk of trade disputes with the EU following the 'Windsor Framework' agreement between the UK and EU, designed to soften the customs and regulatory border between Northern Ireland and Great Britain.[9] Third, and most important, is the effect of the temporary full-expensing capital allowances announced in the Budget. This will enable firms to reduce their taxable profits by 100% of the cost of their investments in plant and machinery for three years from April 2023.

8. Office for National Statistics, 'Business insights and impact on the UK economy', 30 March 2023. https://www.ons.gov.uk/businessindustryandtrade/business/businessservices/bulletins/businessinsightsandimpactontheukeconomy/23march2023
9. UK Government, 'The Windsor Framework: a new way forward', February 2023. https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1138989/The_Windsor_Framework_a_new_way_forward.pdf

This new measure follows immediately from the withdrawal of the previous temporary super-deduction. It should therefore help ensure that firms' incentives to invest do not fall more significantly in the near term from headwinds, including April's rise in the corporation tax rate from 19% to 25%. However, the much weaker end to last year than previously thought means we now expect business investment to shrink 0.3% this year, a little less than the 0.8% fall previously predicted, but then increase 2.3% in 2024 as the effect of investment incentives kicks in.

Export prospects look better thanks to resilience abroad, but Brexit effects may intrude

Meanwhile, the outlook for UK exports will benefit if recent signs of economic resilience in the UK's major trading partners are maintained. Globally, 2023 now looks set to be a year of steady but weak economic growth, with forecasts from international bodies suggesting that the US and eurozone should probably both avoid recessions.

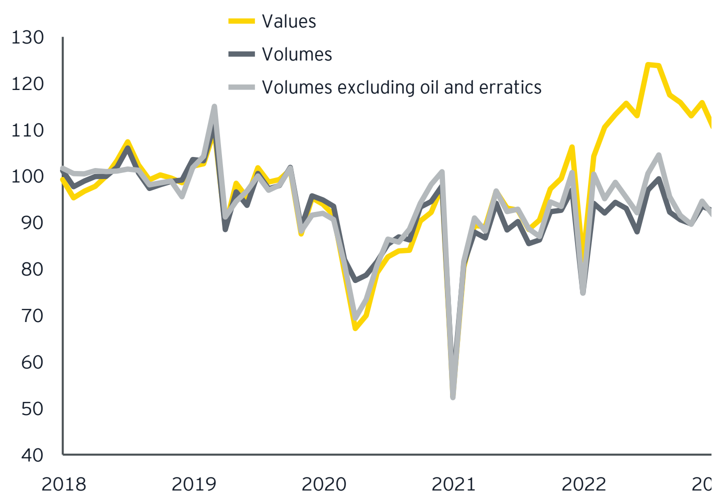
The impact of Brexit continues to occupy discussion of UK trade prospects. Judging the position of trade with the EU relative to the pre-Brexit position depends on which data series is used. In cash terms, UK goods exports to the EU reached a record level last year, and while falling back in the second half of 2022, began 2023 11% above the 2018 average (a comparison that avoids distortions in 2019 due to stockpiling ahead of Brexit deadlines, and in 2020 due to the pandemic).

But UK cash exports to the EU have been inflated by large trans-shipments of gas at high world prices. Exports measured at constant prices or in volume terms go some way to removing this distortion, while the volume series excluding oil and erratic items (mainly shipments of gold) is probably the purest measure. The simple volume series shows that UK exports to the EU in January 2023 were down 7.5% compared with the 2018 average, while UK exports to the EU ex-oil and erratic items fell short by 8.4%. Some of this is related to global factors (for example, the impact of the global shortage of semiconductors on vehicle production), and the monthly trade data can be very volatile. But it also provides some tentative evidence that UK firms are finding the EU market a tougher challenge post-Brexit.

On the import side, a similar divergence has opened between the value and volume of goods bought from the EU. However, the shortfall relative to the pre-Brexit position is smaller. Import volumes in January were 3.1% below the 2018 average and 2.6% smaller on an ex-oil and erratic items basis, perhaps a consequence of the UK continuing to delay the application of full customs checks on goods coming in from EU countries.

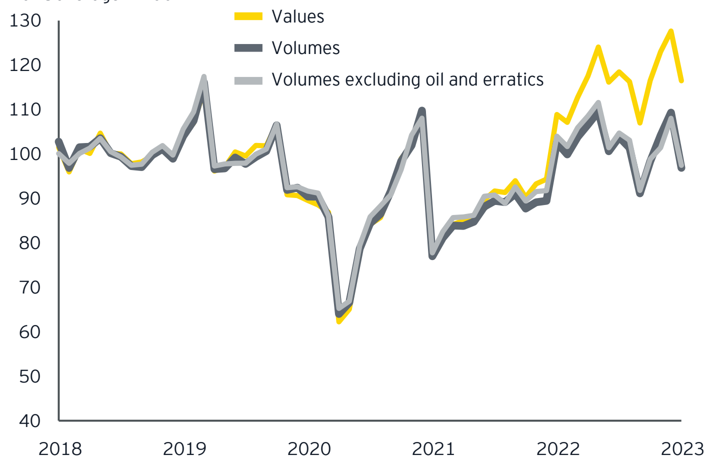
UK: Exports of goods to EU

2018 average = 100



UK: Imports of goods from EU

2018 average = 100



Source: EY ITEM Club/Haver Analytics

Rising interest rates have created a new source of risk to the outlook

Our recent forecast reports have highlighted energy prices, and their interplay with the war in Ukraine, as the chief source of risk to the UK economic outlook. Although movements in prices have recently been favourable, this risk hasn't gone away. The timing of any end to the conflict remains very uncertain, and tensions between Russia and the West, and sanctions, could persist long after any resolution. However, the unseasonably mild winter in Europe and successful efforts to broaden sources of energy supply has significantly reduced the risk of energy shortages or spikes in prices this year.

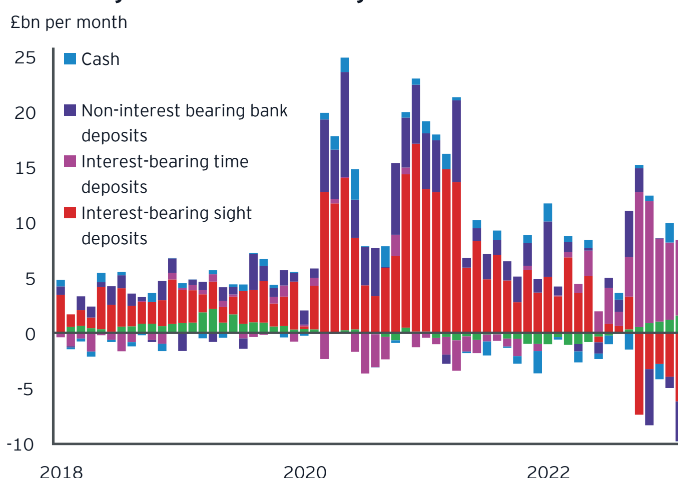
Going by the volume of press coverage, energy price risks have been superseded by turmoil in the banking industry as the next potential crisis in the making. The failure of several mid-tier banks in the US in early March and the near implosion of Credit Suisse have exposed vulnerabilities in the financial system stemming from the rapid tightening of monetary policy globally.

So far, banking stress outside the US has been relatively moderate. And the strong capital and liquidity position of UK banks and the dominant market position of the major players in the UK market suggests that the kind of deposit flight experienced by some mid-tier lenders in the US is very unlikely. Indeed, that UK households have, for several months, been transferring savings from sight deposit accounts on zero, or very low, interest rates to higher-yielding time deposit accounts reduces that risk further.

But there is still the risk of damage to the real economy if banks tighten lending standards in response to asset impairments, leaving consumers with less scope to borrow to support spending. And that risk will grow if central banks continue to raise interest rates, despite a fast-improving inflation outlook, pushing banks' loan losses higher and increasing their cost of capital.

A third risk, but this time to the upside, is that inflation could fall faster than expected. Commodity prices could fall further, particularly if the war in Ukraine is resolved, and global cost pressures might ease more broadly. In this world, a faster pace of disinflation would reassure the BoE and other central banks, resulting in an earlier policy pivot, with interest rates falling sooner and faster than we anticipate.

UK: Change in households savings



Source: EY ITEM Club/Haver Analytics

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

% change 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	4.4	5.6	8.6	9.9	13.3
2023	0.2	-0.5	-0.3	-0.2	1.8	-0.4
2024	1.9	1.4	1.8	1.8	4.7	2.7
2025	2.3	2.4	2.4	3.0	2.1	2.3
2026	2.0	2.0	2.0	2.6	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	78.0
2021	5.2	-1.5	5.8	2.6	0.1	81.4
2022	6.3	-3.8	6.4	9.1	1.4	79.6
2023	5.1	-3.6	4.2	6.2	4.3	78.7
2024	3.2	-2.6	2.8	2.5	3.7	80.2
2025	2.7	-2.6	2.9	1.8	3.3	80.5
2026	2.3	-2.7	3.0	2.0	3.3	81.4

Source: EY ITEM Club

* Fiscal years, as % of GDP

4

The inflationary threat from rapid pay rises should recede

The strength of wage growth over the last year has occupied the BoE as a key risk threatening to keep inflation persistently above target. This is no surprise — excluding the pandemic period, average wage growth has been close to a record high for several months, which, combined with still-sluggish productivity growth, is inconsistent with inflation returning to the BoE's 2% target.

But there are good reasons to think that pay growth should ease this year, reinforcing our expectation that interest rates have probably peaked and may start to be cut at the turn of 2023 and 2024. One is the prospect of a rapid drop in inflation bearing down on pay demands. Second, labour supply is likely to rise relative to demand. And third, job-to-job moves, often associated with increased pay, are likely to fall back from the elevated level of recent years. That said, structural changes in the jobs market mean that pay rises are unlikely to return to the sluggish pace of the 2010s.

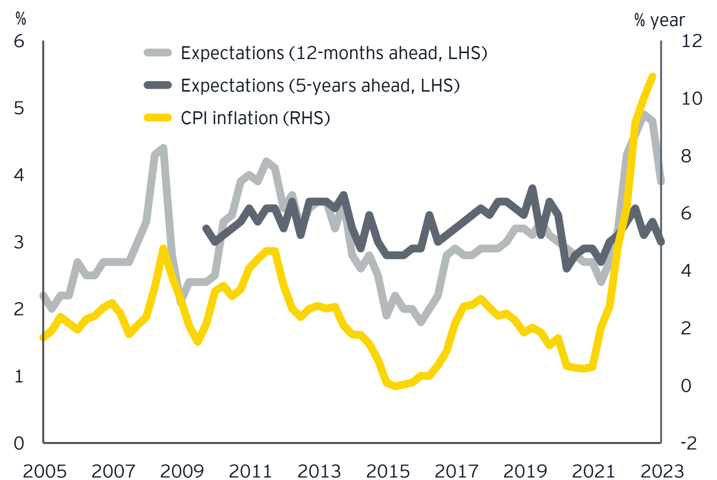
There are already signs that a combination of these factors is starting to weigh on pay growth. Taking private sector regular pay, which the MPC has cited as an indicator of domestic inflationary pressure, a 6.2% y/y rise in January, while strong by historical standards, was a seven-month low. Growth on a three-month annualised basis (another indicator used by the MPC) eased to 5.7%, the weakest in 12 months.

Wage pressures have probably contributed to high inflation, but the situation should now reverse

The recent bout of high inflation primarily reflects external factors, notably massive money creation by central banks during the pandemic, the impact of economies reopening post-COVID-19 and a surge in global energy prices. But domestic factors have also probably played a role. Although cash pay growth over the last 12 months has been substantially outstripped by inflation, it has run ahead of productivity gains, inflating rises in unit wage costs (i.e., the wage cost of producing a unit of economic output).

Rising inflation and inflation expectations are likely to have played an important role in pushing up pay growth. After all, workers care about the purchasing power of their pay, not the cash amount. But inflation now seems firmly on the turn, and the public's inflation expectations are falling fast. We expect CPI inflation to fall from last autumn's peak of 11.2% to under 3% by the end of this year. Meanwhile, the Bank of England/Ipsos latest quarterly Inflation Attitudes Survey showed the biggest drop in inflation expectations for the 12 months ahead since November 2008.

UK: CPI inflation and inflation expectations



Source: EY ITEM Club/Bank of England

Slack is likely to develop in the jobs market as labour supply rises relative to demand

The second influence which should push down pay growth relates to the balance of labour demand and supply. Although the economy is proving more resilient than many feared, sluggish growth in the recent past and, we expect, for the first half of this year, will hold back demand for workers. At the same time, there is cause to think that the recent decline in economic inactivity (discussed in Section 2) may continue. Cost-of-living pressures may compel some currently inactive people to look for a job (for example, in a two-person household where one currently works and one doesn't). And the measures to boost labour supply announced in March's Budget may help at the margin.

An easing of Covid-related health issues may also act in the same direction. The passing of time should diminish the incidence of 'Long Covid', while the backlog of operations and procedures delayed during the pandemic will be worked through. With more people willing to enter the workforce, upward pressure on wages may be dampened even if labour demand picks up later this year on the back of a recovering economy.

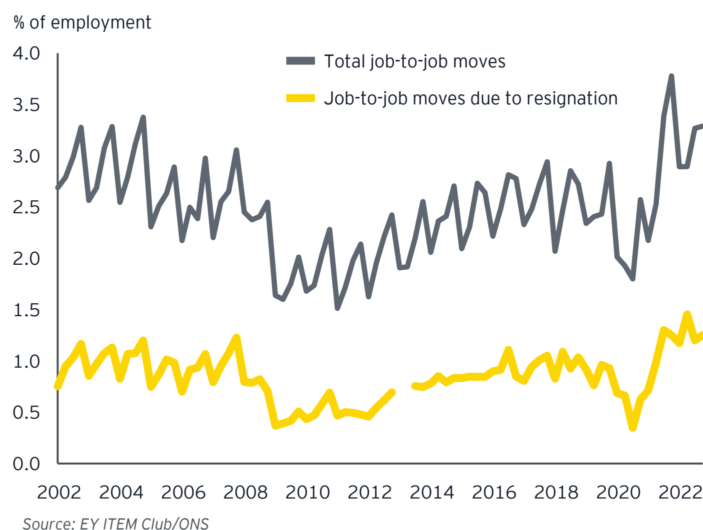
Job-to-job moves are likely to fall back

The quickest way of securing a pay rise is to move job. Hence, a rise in job-to-job moves tends to be accompanied by higher average overall wage growth. And rising quit rates can also boost pay growth indirectly if companies pay higher wages to existing staff, as well as new staff, to encourage them to stay rather than exercise their outside option.

These channels suggest that the jump in job-to-job moves over the last 18 months has pushed pay growth up. Between Q2 2021 and Q4 2022, an average of 385,000 workers, equivalent to 1.3% of people in employment, resigned each quarter to take up another position. This compared with an average of 283,000, or 0.9% of those in work, from 2017–19.

A tight jobs market has probably increased people's willingness to move jobs, as might the COVID-19-era rise of remote working and a reappraisal by some of their relationships with work. But we think there are good reasons why churn in the jobs market should now fall back. One is a fall in demand for workers as the lagged effect of a sluggish economy makes its mark, reducing options for workers considering moving employers. The second is a stabilisation of the structural and psychological shifts triggered by the pandemic.

UK: Job-to-job moves



Source: EY ITEM Club/ONS

That said, job-to-job moves at the end of 2022 were still unusually high, if down from the earlier peak. The experience of the last few years may have permanently changed the way people select positions and whether they stay or go. Elevated levels of resignations may also prove self-perpetuating, to a degree, what some have termed 'turnover contagion'. A colleague resigning puts the idea more firmly in the head of fellow workers and makes leaving appear more doable.

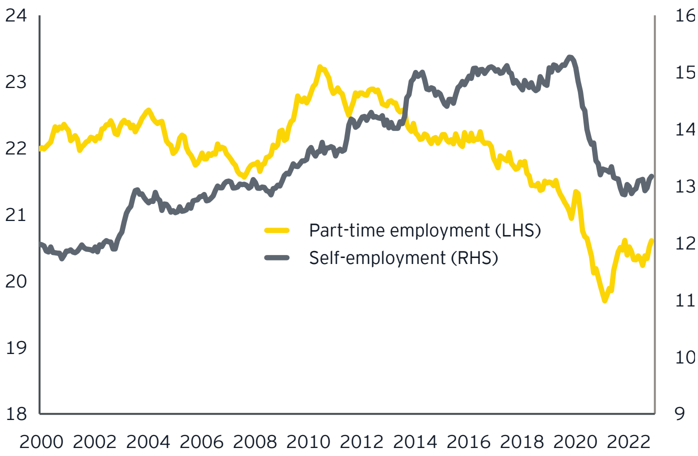
Structural changes may limit how much pay growth slows

That job-to-job moves may stay above pre-COVID-19 levels is one factor that could keep pay growth higher than the very sluggish pace of the 2010s. Another relates to the 'divisibility' of the workforce. A fall in union membership and rise in self-employment and part-time working during the last decade, the argument goes, reduced individual workers' bargaining power and resulted in weaker pay growth for a given level of unemployment.[10]

But there have been several contrary developments in the last few years. One is a revival in the influence of trades unions. To be sure, we haven't seen a return to 1970s levels of union membership. But the increased militancy among employees in some sectors in recent months and that strikes, or threatened strikes, have, in some cases, succeeded in raising pay could have a long-lasting effect, making workers more aware of their collective power and boosting union membership.

10. See 'Pay Power', speech given by Andrew G Haldane, Chief Economist, Bank of England, at the Acas "Future of Work" Conference Congress Centre, London, 10 October 2018. https://www.bankofengland.co.uk/-/media/boe/files/speech/2018/pay-power-speech-by-andy-haldane

UK: Part-time and self-employment



Meanwhile, the share of self-employed workers fell during the pandemic, as did part-time employment, if to a lesser extent. The former may have partly reflected categorisation issues, but the experience of the COVID-19 period may have increased the attractiveness of the perceived security of being an employee. The implication of these shifts is that the labour market has become less divisible, and a previous 'divide and conquer' approach vis-à-vis employers and workers may not now be so straightforward.

5

Will a house price correction crash the economy?

We think a major fall in house prices is unlikely. Granted, the buy-to-let sector looks at a particular risk of distress, with leveraged landlords facing higher interest rates and the cost of complying with net zero energy efficiency targets. But changes in the structure of the overall housing market (a rise in the share of households who are outright owners and a fall in the share with a mortgage) and the mortgage market (the dominance of fixed-rate mortgages) mean higher interest rates should have less of an adverse impact (or at least a less sudden one) than in the past. And the pandemic-related savings held by households, in the aggregate, will act as a buffer against the impact of higher mortgage payments and falling housing wealth.

That said, our forecast sees average property values still declining around 10% peak-to-trough. This would be the first sustained fall in values since the recession of 2008–09, so a new and, no doubt, disturbing development for anyone who bought their first property in the last decade or so. But while hardly helpful to the wider economy, we doubt that the kind of fall in prices anticipated in the EY ITEM Club forecast will do much to knock the economy off balance.

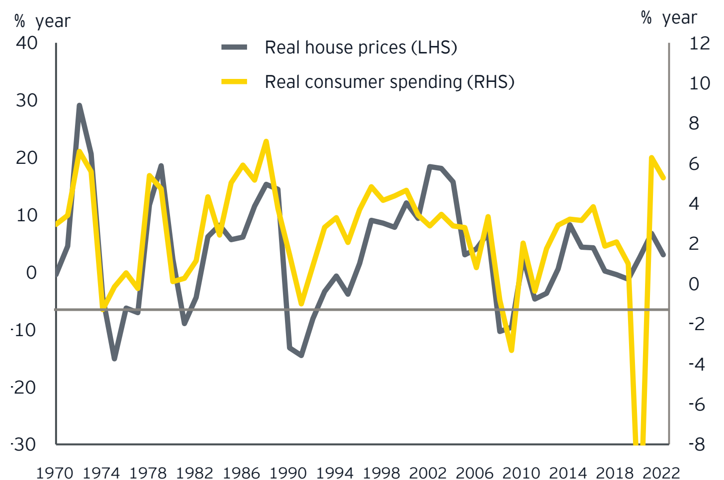
Falling house prices could impact the economy both directly and indirectly

A downturn in the housing market is one factor behind our view that the UK economy will see only negligible growth this year. A weaker housing market will likely directly affect the economy via less construction activity. Lower property prices will squeeze builders' margins, making some projects increasingly unviable — and shelved.

Granted, construction accounts for only 6% of GDP, with housebuilding a third of this. But volatility in construction output means it often plays an outsized role in influencing growth in the wider economy. This has been evident recently — while GDP grew 0.1% q/q in Q4 2022, construction output related to the building of new housing fell 2.8%. Though the Q4 fall was probably exaggerated by very strong growth earlier last year, it was the first decline in five quarters and the biggest since mid-2015, excluding periods of COVID-19 restrictions.

There are also indirect links between the housing market and the economy. Traditionally, the correlation between movements in real house prices and real consumer spending has been strong. A complication here is that both the housing market and consumer spending are influenced by common factors, such as income expectations and unemployment. So, a close relationship need not necessarily be evidence that housing directly influences consumption.

UK: House prices and consumer spending



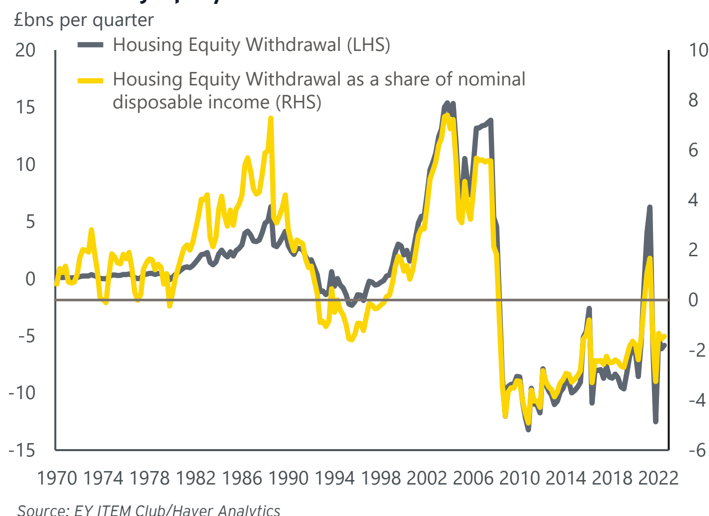
Source: EY ITEM Club/Haver Analytics

But there are reasons to think a weak housing market will weigh on consumer spending. Housing accounts for around half of household wealth, so falling prices could adversely affect spending as households feel poorer. And sales of goods such as furniture and carpets are influenced by the number of people moving house, so should, in theory, have a relationship with housing market activity.

Certainly, the large drop in housing transactions in the early stages of the 2008-2009 recession was followed by household goods sales falling sharply. However, the correlation between the two series from 2010 and 2019 was weak, running at around 0.2, using transactions advanced six months. This was probably a consequence, in part, of a persistently lower level of home sales post-financial crisis. And household goods sales account for only around 6% of total consumer spending, so even if the housing market started having a larger effect on this consumption element, the total impact might not be big. Moreover, unlike the last time house prices fell on a sustained basis in the late 2000s, the impact on households' wealth isn't being compounded this time by falling equity prices and financial wealth.

Developments in another potential channel from the housing market to consumer spending – housing equity withdrawal (HEW) – also suggest a more muted effect than in the past. HEW involves homeowners using rising house values as collateral for personal loans or freeing up cash by trading down their property. This was an important prop to consumption during the UK economy's expansion in the 2000s, with HEW peaking at the equivalent of 7.5% of nominal household incomes in 2003.

UK: Housing equity withdrawal



Source: EY ITEM Club/Haver Analytics

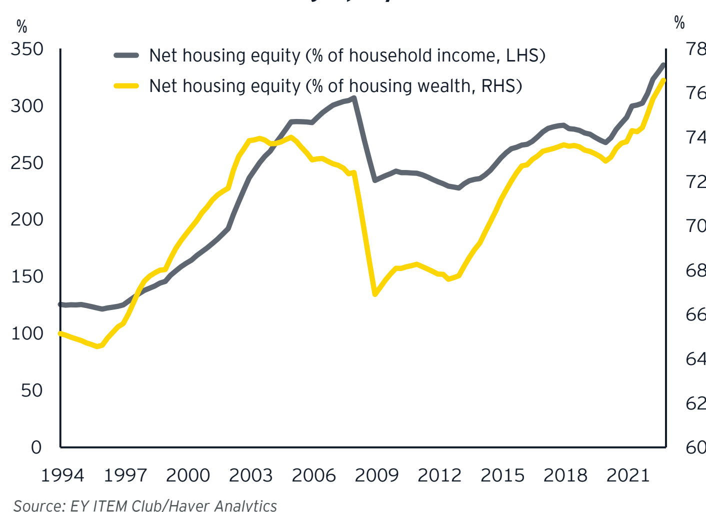
But HEW has been heavily negative since the financial crisis, bar a few quarters during the pandemic, despite a strong rise in house prices. In other words, households have put more money into the housing market, for example, through house deposits or overpaying mortgages, than they have taken out through re-mortgaging. This probably reflects tighter, post-crisis mortgage regulation, a sharp decline in interest-only home loans and more financially cautious households.

A housing market downturn is likely to result in HEW becoming more negative, as structural factors that have held it down are magnified by a fall in house prices. But that HEW has offered no sustained positive impulse to consumption for over a decade means a drag from this source should be much less than during the last downturn in the late 2000s and early 2010s.

Homeowners' equity is unusually high, providing a cushion of safety for consumption

Homeowners have entered the current downturn with an unusually high level of housing equity. This should also soften the impact of falling prices on consumption compared with previous cycles by reducing pressure on some households to reduce their spending to repay some debt. As of Q4 2022, households' aggregate housing equity (i.e., housing wealth net of mortgage debt) stood at a record high relative to both gross housing wealth and incomes.

UK: Households net housing equity



Source: EY ITEM Club/Haver Analytics

This reduces the risk of negative equity and should limit the number of households who, faced with an expiring fixed-rate mortgage and little or no equity in their home, are forced to revert to their lender's – typically more expensive – standard variable rate.

Higher equity levels may also give some borrowers more flexibility to switch temporarily to interest-only mortgages. Of course, this shouldn't disguise the fact that mortgagees are experiencing, or set to experience, a major rise in debt-servicing costs. But the backdrop to this could have been a lot worse if equity levels had begun at a much lower level.

Still, a sustained fall in prices has consequences for the banking sector and, consequently, the wider economy. But will it outweigh the mitigating factors above? For sure, falling property values risk initiating a negative feedback loop in which lenders respond by tightening credit supply, reinforcing the housing market downturn, and eroding borrowers' confidence and credit worthiness. Even before the latest volatility in the banking sector, the BoE's credit conditions survey showed the balance of lenders at the close of 2022 reporting the biggest fall in the availability of secured credit to households since Q3 2008, excluding the pandemic period. [11]

However, the UK banking sector is far better capitalised now than in the run-up to the financial crisis.[12] And lenders have been stress tested by the BoE against a much bigger — 31% — peak-to-trough fall in prices than we're forecasting.[13] What's more, our expectation of a very modest rise in unemployment should keep forced sales down. In sum, several factors suggest that while the housing market downturn is another headwind to consumer spending, it may not be as powerful a drag as in the past.

11. Bank of England, 'Credit Conditions Survey - 2022 Q4', 19 January 2023. https://www.bankofengland.co.uk/credit-conditions-survey/2022/2022-q4
12. Bank of England, 'Financial Stability Report - December 2022', 13 December 2022. https://www.bankofengland.co.uk/financial-stability-report/2022/december-2022
13. Bank of England, 'Stress testing the UK banking system: key elements of the 2022 annual cyclical scenario', 26 September 2022. https://www.bankofengland.co.uk/stress-testing/2022/key-elements-of-the-2022-stress-test

6

Conclusions

Catastrophising, the tendency to focus on the worst-case scenario, has been a noticeable feature of UK economic commentary since at least the Brexit referendum in 2016. Predictions only a few months ago of energy bills rising to levels this spring unaffordable for most households, accompanied by a deep recession, are recent examples. Forecasts from the IMF and OECD in the last few months that the UK will be the only major economy, apart from Russia, to shrink this year strike us as another.[14]

The reality is that recent indicators suggest that the economy is starting to turn a corner, with the risk of recession, even a mild one, receding. Given that wholesale gas prices are down 80% from last summer's peak, an improved outlook isn't surprising. Less expensive energy means inflation will fall faster than previously thought, reducing the risk of a wage-price spiral, calming labour unrest and meaning monetary policy is likely to loosen sooner than otherwise. An unwinding of the energy price shock is also translating into a strengthening in consumer and business sentiment, while the positives of lower gas prices and a less weak economy for the public finances gave the government room to loosen fiscal policy in the Budget.

We wouldn't want to overdo the prospect of sunlit uplands. Gas prices are still well above historically 'normal' levels. And the cost of energy could rise again as China reopens and the global economy rebounds. Although our forecast has brightened relative to three months ago, a year of almost no growth is nothing to shout about. Moreover, a risk we've highlighted in the past – that the BoE and other central banks could continue to raise rates despite the inflation genie heading back into its bottle – carries potentially more ominous consequences, given the stresses in the financial system revealed by the implosion of Silicon Valley Bank and other lenders.

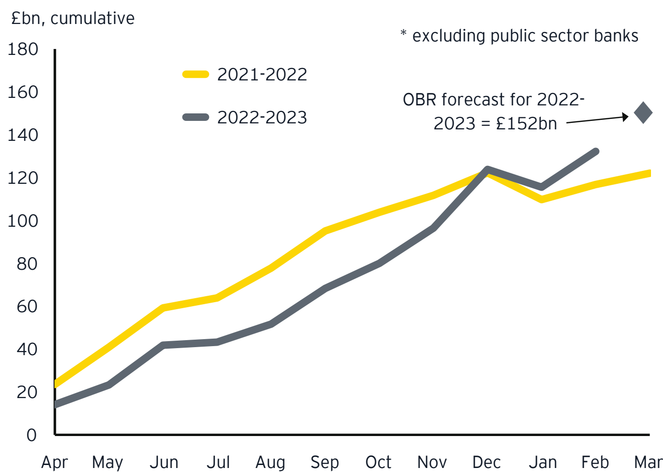
In a worst-case outcome, a significant tightening in credit conditions could hinder the economy just as households and firms are escaping from the 'tax' created by the energy price shock. The optimistic view is that the capital and liquidity strength of UK banks means there's little effect, and lending to the private sector carries on broadly as before. The recent recovery in banks' equity prices and a slowdown in deposit outflows in the US strengthens hope that the latter will win out. But whether that proves true, only time will tell.

14. See IMF World Economic Outlook update, January 2023, https://www.imf.org/ /media/Files/Publications/WEO/2023/Update/January/English/text.ashx and OECD Economic Outlook, Interim Report, March 2023 https://www.oecd-ilibrary.org/sites/d14d49eb-en/index.html?itemId=/content/publication/d14d49eb-en

7

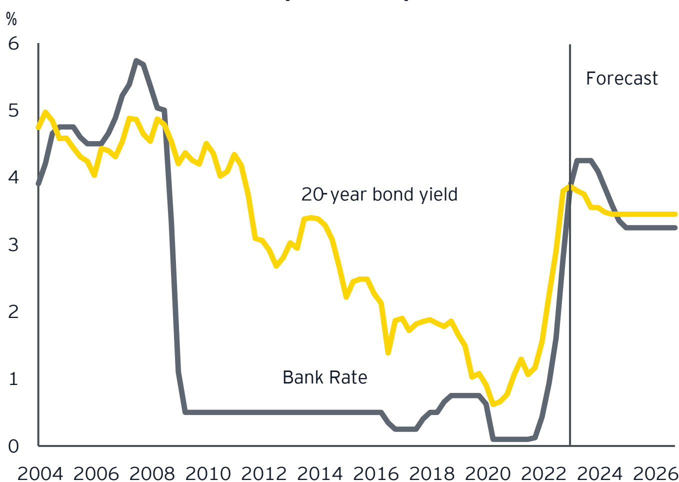
Forecast in charts

Fiscal policy



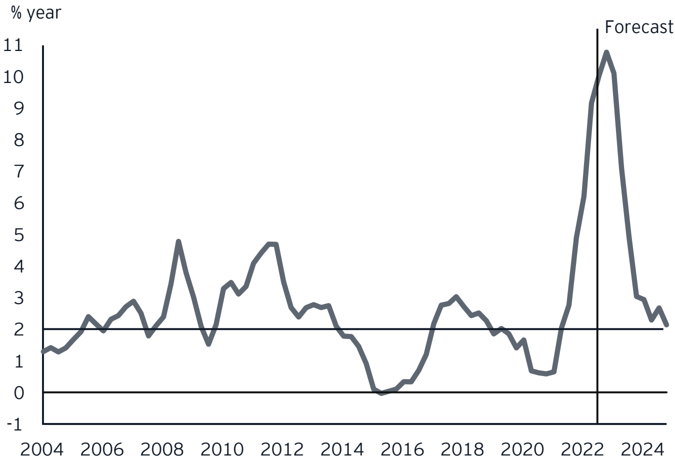
- Public sector net borrowing (excluding public sector banks) over the first eleven months of fiscal year 2022-2023 came in at £132.2bn. This points to a substantial undershoot of the OBR's full year forecast of £152.4bn
- Borrowing is likely to fall by more in the next fiscal year than previously expected, reflecting a stronger GDP performance and the impact of lower energy prices.
- The Budget delivered a loosening of fiscal policy worth 0.8% of GDP in each of the next three fiscal years. However, factoring in changes previously announced, there will still be a significant medium-term tightening.

Monetary policy



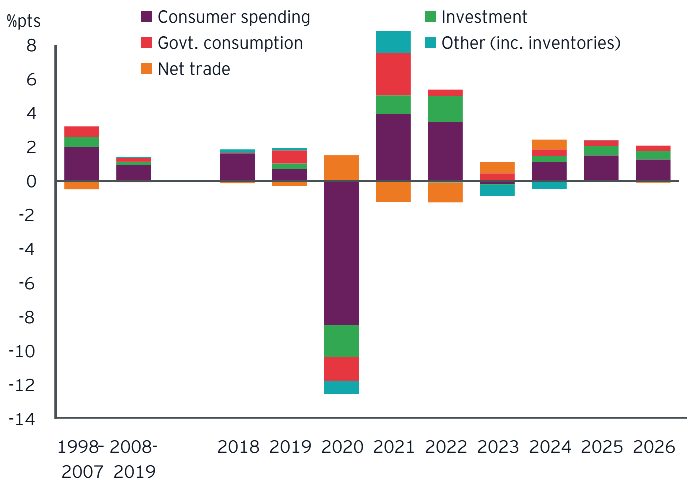
- Bank Rate rose to 4.25% in February, the highest since 2008. The increase from 0.1% in late 2021 represents the biggest tightening of monetary policy over an equivalent period since 1989.
- In the near term, the MPC faces having to juggle a stronger-than-expected economy, against the likelihood of rapidly falling headline inflation.
- We think the former will win out, with Bank Rate rising to 4.5% in May. But the MPC is likely to start cutting rates at the turn of 2023 and 2024.

Prices



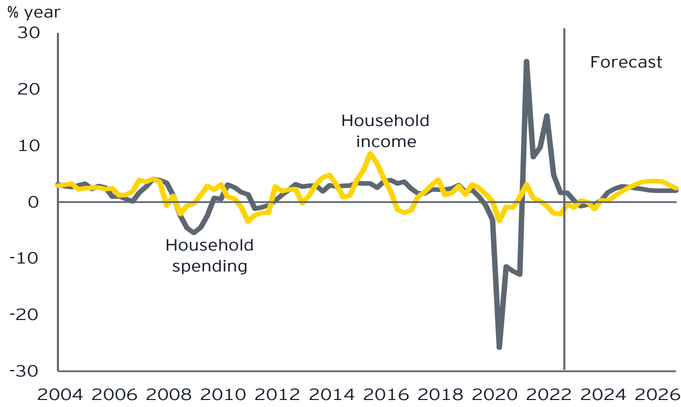
- CPI inflation has fallen back from last autumn's peak but was still in double digits in the first two months of this year.
- Inflation should start to fall quickly over the next few months, as the big price rises in early 2022 fall out of the annual comparison, and cheaper energy feeds into household bills and a lower cost of production for firms.
- We think inflation should drop below 3% by the end of this year, with an easing in wage pressures helping to push down the core measure.

Activity



- The economy grew 0.1% q/q in Q4, meaning it escaped the recession that many forecasters had expected in the second half of 2022.
- Hard data and survey evidence for early 2023 point to growth continuing. But still sizeable headwinds and the effect of an extra public holiday in May suggest expansion in H1 2023 will be negligible.
- Growth should accelerate in the second half of this year as inflation and energy bills fall. We expect the economy to expand 0.2% in 2023, before growing 1.9% in 2024.

Consumer demand

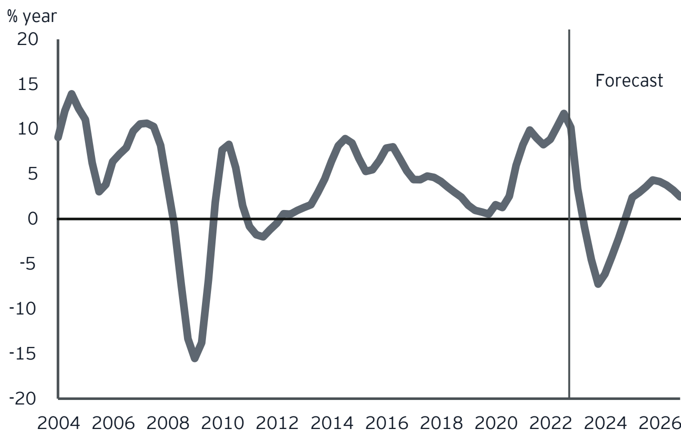


Source: EY ITEM Club

- Consumer spending rose 0.2% q/q in Q4 2022, an improvement on Q3's 0.3% decline, although an extra working day flattered the performance.
- Still-high inflation and the lagged effect of previous rises in interest rates will hold back consumption growth in the short-term.
- But as energy bills start to come down, inflation drops and households draw on their savings, consumer spending should put in a better performance as the year progresses. Consumer spending is forecast to drop 0.3% this year, with growth of 1.8% in 2024.

Housing market

UK: House prices

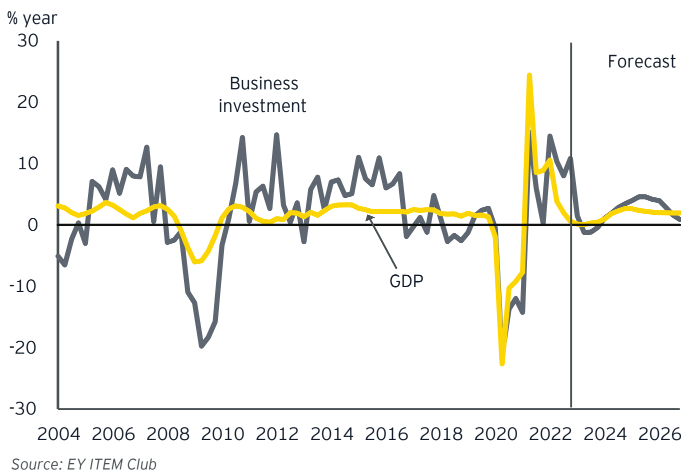


Source: EY ITEM Club

- House prices continued to fall early this year on most measures, although the Halifax index has painted a less weak picture than other indices.
- The significant rise in mortgage rates since early 2022 and negative mood music around prospects for house prices point to values continuing to drop. But low unemployment and high household savings should cushion the extent of the decline.
- We expect average prices to fall 2.4% this year, followed by another decline of 3.1% in 2024.

Company sector

UK: Business investment and GDP

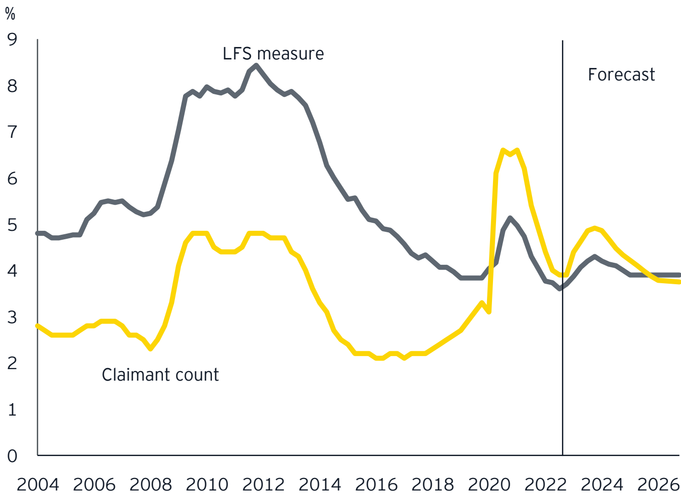


Source: EY ITEM Club

- The recent performance of business investment has seen sizeable revisions by the ONS. The latest estimate showed business investment falling 0.2% q/q in Q4 2022.
- This left business investment 2.2% below the pre-pandemic level. The introduction of 100% expensing for investment in plant and machinery in April 2023 should support investment spending.
- But this faces off against headwinds from higher interest rates and a potential tightening in lending standards. Overall, business investment is forecast to fall 0.3% this year and grow 2.3% in 2024.

Labour market and wages

UK: Unemployment rate

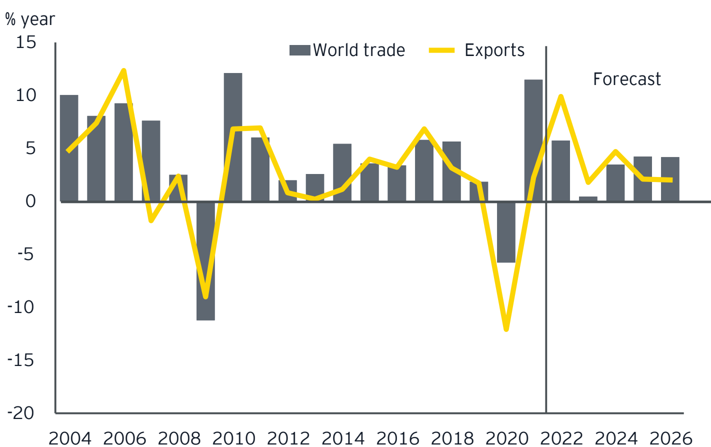


Source: EY ITEM Club

- The LFS unemployment rate has remained very low, standing at 3.7% in the three months to January. Employment has increased, while inactivity has started to fall back.
- A further drop in job vacancies and a rise in redundancies in the last few months suggests the jobs market is loosening at the edges.
- But vacancies are still a third higher than pre-COVID-19 levels and a better GDP performance should support demand for labour. We expect the unemployment rate to rise only modestly, peaking at just over 4%

Trade and the balance of payments

UK: Exports and world trade



Source: EY ITEM Club

- Trade flows have continued to be volatile, driven by movements in non-monetary gold and changes in the method the ONS uses to measure imports from the EU.
- Excluding trade in precious metals, the current account deficit narrowed to 3.3% of GDP in Q4 2022 from 4.2% in Q3, aided by a recovery in income on UK investment abroad.
- A better-than-expected global economy will support UK export growth, but imports will also be supported by stronger UK GDP growth and the boost to (import-intensive) investment from the temporary 100% capital allowances.

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