EY ITEM Club Summer Forecast

The new government takes the reins of a recovering economy

July 2024

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Contents

Foreword	1
Highlights	2
Introduction	3
The recovery is becoming better entrenched	4
A steady, unspectacular recovery is in prospect	7
The new government will find its room for fiscal manoeuvre limited	12
Tackling the long-running problem of under-investment is key to boosting growth boost the economy	16
Conclusions	19
Forecast in charts	20

Foreword

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An improving outlook

There appears to be increasing grounds for optimism around the state of the UK economy. With GDP expanding by 0.7% in Q1 this year, it's clear that the economy has rebounded rapidly from the minor recession it experienced at the close of 2024. The signs are also positive for Q2, with growth figures for May suggesting that whilst momentum may have slowed slightly, the economy is still on track for growth of around 0.6% in Q2. Consequently, the EY ITEM Club has upgraded its forecast for 2024 as a whole from 0.7% to 1.1% and maintains its view that the economy can grow by 2% in each of 2025 and 2026.

There are also reasons to be positive with respect to monetary policy – with headline inflation now down at the 2% target, the door is open to the Bank of England (BoE) to cut interest rates – although the timing still remains uncertain. The expectation (consistent with the EY ITEM Club forecast) is that we should get two reductions of 25bps each this year, taking rates down to 4.75%. This will be welcome to most households. And also, of course, to businesses, as a lower cost of capital should bring some life back to debt markets, ease the burden on those seeking refinancing and perhaps open the path to increased capital activity and M&A. However, the BoE will closely watch inflation and wages for still-sticky services. June's inflation figures were a little bit disappointing in this regard, and inflation could well temporarily tick up again as the deflationary impact of lower energy costs starts to recede. Lower inflation, lower interest rates and strong wage growth should improve consumer sentiment and spending, which is good news for consumer-facing businesses. However, higher interest rates will have a lagged impact as households continue to roll off fixed deals.

Thus, it could be that our new government benefits from a rather more positive economic inheritance than they perhaps expected. We will have to await an Autumn budget before we hear how the Government will approach fiscal policy. The fiscal position for the Government is likely to remain challenging and require some difficult decisions to be made on spending and, therefore, probably on taxation.

The new government has come to power targeting economic growth as one of its key 'missions'. It has identified planning reform and increasing investment as key levers to drive economic growth. Both of these are sensible areas to target. Still, as ever, the challenge will be in the delivery – the institutional and public barriers to 'building anything anywhere' in the UK should not be understated. It will take real political will to push the necessary reforms through. On investment – again, the diagnosis is sensible – both public and business investment in the UK has lagged at levels seen in comparable countries for many years. There have been some recent successes, as business investment, in particular, has grown reasonably rapidly in the last few years – how to maintain this momentum will be a key policy challenge for the new government.

For business, an earlier election than expected and a new government with a significant mandate – should reduce political and regulatory uncertainty and hence provide some much-needed certainty. This, combined with a recovering economy, should act as a tailwind for business investment and perhaps a return to a more growth-orientated mindset after several years of caution. However, again, this optimism should be tempered by the fact that an economic recovery can take time to feed through into a healthier order book.

Highlights

- Stronger momentum in the first half of this year has caused the EY ITEM Club to revise its forecast for GDP growth in 2024 up to 1.1% from 0.7% three months ago. We still expect GDP growth of 2% in both 2025 and 2026. The boost to household spending power from lower inflation will be the main driver of stronger activity over the next few years, with a less cautious attitude from consumers meaning that solid income growth should translate into a more impressive pickup in spending. However, the lagged impact of past monetary policy tightening and tighter fiscal policy settings will limit the pace of the recovery.
- The recovery in GDP in Q1 more than offset the small fall in output seen in H2 2023, with consumers playing a key role in the upturn. Monthly GDP data suggests the momentum has been maintained in Q2. But we think GDP growth was probably slightly softer in Q2 than Q1 for two reasons. First, the fact that Easter was earlier than normal appeared to boost the output of consumer-facing sectors in March at the expense of April. Second, four days of industrial action by junior doctors at the end of June is likely to have caused output in the health sector to dip that month. Still, the recovery looks to have durability, with consumers in good shape to keep the momentum going in H2 2024.
- In May, CPI inflation dropped back to the 2% target for the first time in nearly three years. However, this landmark was reached slightly later than anticipated, after a big upside surprise for services inflation in April. This partly reflected large increases for goods and services where prices are linked to past inflation rates, such as phone contracts, and regulated prices. The stickiness of services inflation also reflected firms passing on the impact of higher wage costs. And it's services inflation that the Bank of England's (BoE's) Monetary Policy Committee (MPC) is most interested in.
- We expect inflation to remain around 2% over the next few years. Though wage growth should continue to drift downwards, reflecting a looser labour market and lower inflation expectations, our forecast shows real household incomes continuing to grow at a solid pace. The extent to which this translates into stronger consumer spending growth will depend on the mood of consumers. Our forecast assumes that improving confidence translates into a greater appetite for taking on credit and the saving ratio falling back from its current very high level. This would mean that consumer spending growth strengthens over the next couple of years.
- The stickiness of services inflation has prevented the MPC from cutting interest rates so far. But in the minutes of June's meeting, some MPC members signalled a change of tack, moving their focus away from backwards-looking indicators of inflation persistence and adopting a more forward-looking approach. Nevertheless, with another upside surprise for services inflation in June triggering a hawkish reaction from financial markets, we think the MPC will probably delay the first cut until September, with another 25bps rate cut in November, leaving Bank Rate at 4.75% at year-end. However, the extent of the split in the committee means that in the near term, every decision will be on a knife edge. With the MPC having said that policy will remain restrictive even after the committee has started to cut rates, we expect a steady pace of rate cuts through 2025–26 until policy settings are more neutral, likely to be in the 3%–3.5% range.
- Though we expect the MPC to start cutting interest rates soon, for most borrowers, the benefits of looser monetary policy will not be seen for some time yet. Rather, the lagged impact of tighter monetary policy will continue to emerge over the next year, with nearly four million borrowers set to see their mortgage costs rise by the end of 2026. For most homeowners, the increase in debt servicing costs should be manageable. However, this factor will limit the pace of the recovery in GDP growth.
- Another limiting factor will be tight fiscal policy settings. The outgoing administration planned tax increases and spending cuts equivalent to more than 3% of GDP over the next five years. By maintaining the existing net debt rule and presenting a fiscally neutral package of small-scale measures in its manifesto, the new UK government has implicitly committed to implementing the bulk of this tightening. Still, we are sceptical that the government will stick rigidly to its manifesto pledges, particularly when confronted with the realities of what the spending totals mean for departmental allocations. Tax rises or tweaking the fiscal rules to remove the costs of Asset Purchase Facility (APF) losses are plausible methods of creating room for higher spending.
- The government's fiscal challenges would be eased if it could improve on the UK's poor post-global financial crisis growth performance. One of the factors behind the UK's poor performance is persistent under-investment. Though there have been more encouraging signs on business investment of late, public investment remains low by international standards, and current plans suggest it will fall further over the next five years. Moreover, though the decision to exclude investment from the borrowing rule sends a more positive message, the decision to keep the debt rule means there will be no scope to increase investment in this parliament unless savings are made elsewhere or the government opts for a more modest consolidation. Competition for any spare funding will be high, and history suggests that capital spending has rarely won the argument in such circumstances before.

1

Introduction

In our last forecast for the UK economy in April, we argued that the UK economy was finally recovering after two years of stagnation, as many of the obstacles that had hampered activity since 2022 were falling away.[1] Since then, the recovery has become more firmly entrenched, and with growth in Q1 being much stronger than anticipated, we've raised our forecast for GDP growth this year to 1.1% from 0.7%. At the same time, CPI inflation has finally fallen back to the 2% target for the first time in nearly three years. So, it's largely a case of 'so far, so good'.

The one piece of the jigsaw yet to fall into place is interest rate cuts. As has been the case for much of the past 18 months, services inflation has remained frustratingly sticky. With the Bank of England's (BoE's) Monetary Policy Committee (MPC) having closely tied its interest rate decisions to this indicator and private sector regular pay growth, most committee members have felt unable to vote for rate cuts so far. However, the minutes of the June MPC meeting suggested that some committee members are increasingly favouring a more forward-looking approach and putting less weight on backwards-looking measures of inflation persistence. We expect the MPC will start to cut rates in September, and they could even move as soon as August.

But even if the MPC begins to cut interest rates soon, the lagged impact of past tightening of monetary policy will remain a drag on economic growth for some time to come. Fiscal policy is also likely to weigh, given that the new government appears likely to implement the bulk of the tightening planned by the outgoing administration. The drags from tight policy settings will dampen the pace of the recovery, and our forecast that GDP will grow by 2% in 2025 (unchanged from three months ago) is some way short of the rates achieved at equivalent points of previous recoveries. However, the change of government represents a key source of uncertainty for the forecast because of the uncertainty around their approach to fiscal policy. Stronger growth could be possible if the new government opts for a smaller or slower pace of fiscal consolidation.

Our latest forecast report begins with a discussion of recent economic developments. Section 3 examines the key elements of our new forecast. Section 4 looks at how the new government might approach fiscal policy and how this could impact the outlook. Section 5 examines how the UK's investment performance compares with its peers and assesses future prospects. Section 6 concludes.

1. EY ITEM Club, 'Spring 2024 Forecast', 22 April 2024, https://assets.ey.com/content/dam/ey-sites/ey-com/en_uk/topics/growth/ey-item-club/item-club-spring-pdf_final.pdf?download

2

The recovery is becoming better entrenched

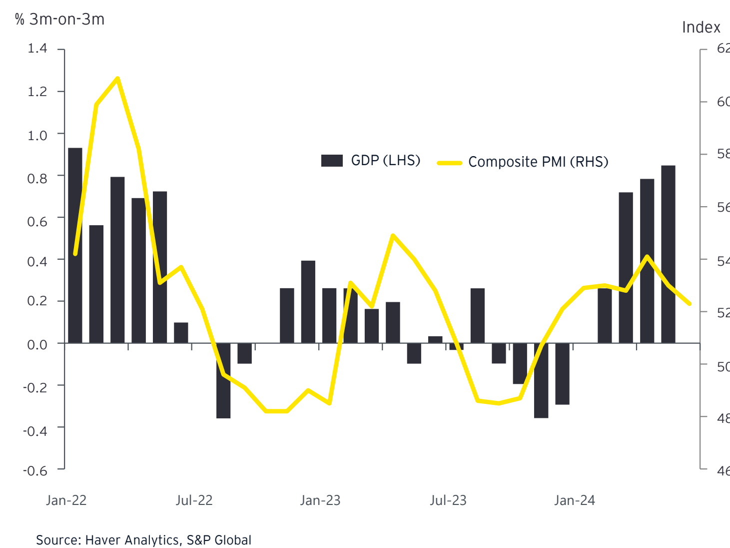
After two years of stagnation, the recovery is finally underway

Once the initial boost from the final post-COVID-19 reopening had worn off in early 2022, the UK economy flatlined for almost two years. But our spring forecast identified some 'green shoots' that were beginning to emerge, and the strength of the recovery in the early months of this year exceeded our expectations. According to the latest Office for National Statistics (ONS) data, GDP rose by 0.7% quarter-on-quarter (q/q) in Q1 2024, more than reversing the small fall in GDP seen in H2 2023.

Consumers played a key role in the Q1 upturn. Output of the consumer-facing parts of the services sector rose by 0.6% q/q, with a particularly strong outturn for March suggesting that Easter being earlier than normal may have played a role. Although the expenditure data showed consumer spending rising by just 0.4% q/q, leaving it down year-on-year, the ONS suggested this softer outturn was largely due to tourism effects and that domestic consumption rose strongly. The expenditure breakdown also showed strong contributions from investment and net trade. However, the latter was again heavily affected by flows of non-monetary gold and appeared to be more noise than signal.

The evidence we have so far for Q2 is consistent with another solid quarter of growth, albeit at a slightly slower pace than was seen in Q1. After three successive strong monthly gains in Q1, GDP was flat in April as the impact of the early Easter unwound. But output then rose by 0.4% month-on-month (m/m) in May, with evidence of strength across the sectors. Business survey results have been volatile from month to month, but the average reading for the composite PMI was slightly higher in Q2 than Q1. Public sector strikes are also likely to have had an impact on quarterly growth. Industrial action was a persistent drag on several sectors in 2023, but the most obvious impact was seen in the health sector, where strikes led to operations and appointments being cancelled, resulting in much lower measured health output during periods of action. There were fewer working days lost to strikes in Q1, but four days of strikes by junior doctors at the end of June is likely to have caused health output to dip that month. On balance, we estimate that GDP grew by 0.6% q/q in Q2, a modest slowdown compared with Q1 but still a big improvement on the experience of the past couple of years.

UK: GDP versus composite PMI

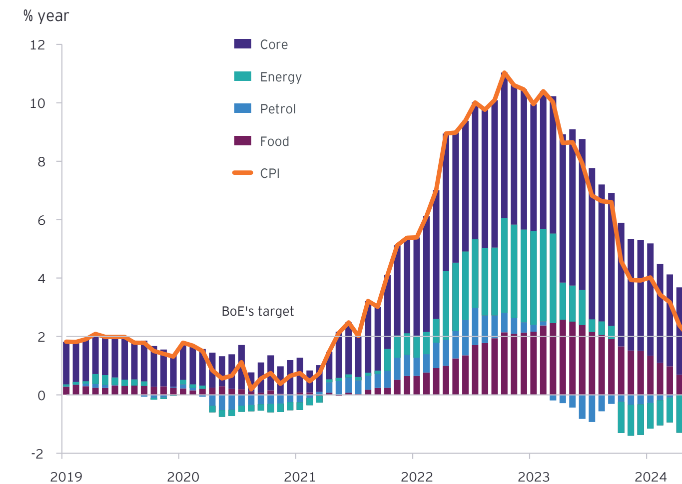


Source: Haver Analytics, S&P Global

Inflation is finally back at the BoE's 2% target

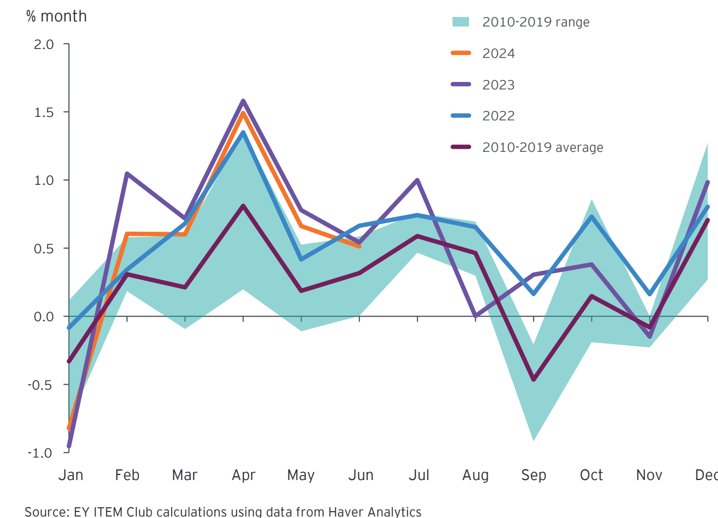
The pickup in activity has coincided with the period of very high inflation drawing to a close. May's reading of 2% for the CPI measure was the first time inflation was back in line with the BoE's target since July 2021, and inflation remained at that rate in June. Falling energy prices have been the key factor behind the fall in inflation, with lower petrol prices and weaker food price inflation also offering support. But core inflation has proved stickier than anticipated due to persistently high services inflation. On a month-on-month (m/m) basis, this year's increases in services prices have only been slightly lower than the unusually large rises seen in 2023 .

UK: Contributions to CPI inflation



Source: EY ITEM Club calculations using data from Haver Analytics

UK: Monthly services inflation



Source: EY ITEM Club calculations using data from Haver Analytics

Some of the recent services' strength reflects the impact of last year's high inflation rates. The prices of some goods and services, such as phone contracts, have an annual inflation uprating built into their user agreements, whilst regulated prices, such as water bills, are similarly linked to past inflation rates. Many of these price rises hit the inflation index in April and, as in 2023, this year's increases were much higher than normal. Furthermore, given that these prices only change once a year, these large increases are now baked into the inflation rates for these categories until early 2025.

However, a bigger factor behind high services inflation is that companies are passing on rapidly rising wage costs. Though all measures of pay growth have cooled in recent months, progress has been relatively slow. This is a double-edged sword. On the plus side, wages are now rising much faster than prices, so consumers are seeing their spending power improve. But on the flip side, headline (three-month average of the annual rate) private sector regular pay growth of 5.6% in May was well above the 3%-3.5% rate that the MPC would consider consistent with achieving the inflation target on a sustained basis.

Sticky services inflation has delayed the rate-cutting cycle

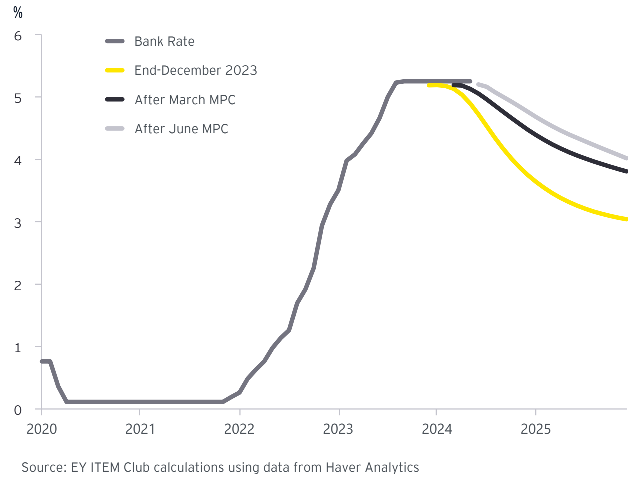
The stickiness of services inflation has stopped the MPC from cutting interest rates so far. As far back as the February meeting, the MPC was suggesting that the next move in interest rates would be down, with the timing of cuts dependent on the evolution of the data. The MPC identified services inflation and private sector regular pay growth as key indicators of inflation persistence. With forecasts by BoE staff for these variables being published in the quarterly Monetary Policy Report, we've had informal benchmarks against which to measure progress. But services inflation has persistently exceeded expectations, even though the BoE staff raised their forecast in May's Monetary Policy Report. Given the importance that the MPC has attached to these series, most members of the committee have been unable to make the case that enough progress has been made to begin cutting interest rates.

However, the minutes of June's MPC meeting hinted at a change of approach for some. An unspecified number of committee members downplayed the importance of recent overshoots for services inflation and instead cited the risk that now inflation was back in line with the target, inflationary dynamics could 'adjust as rapidly on the downside as they had done on the upside'.[2] This switch of emphasis away from backwards-looking indicators of inflation persistence to a more forward-looking approach suggests these committee members feel that they now better understand the inflation generation process and, therefore, that they have greater confidence in their forecasts. This switch will make it much easier to justify cutting interest rates at one of the forthcoming meetings.

But even if – as we expect – the rate-cutting cycle does begin soon, we're likely to see a much slower pace of rate cuts than appeared likely at the turn of the year. At the end of December, financial market pricing implied around 150bps worth of rate cuts by the end of this year, with further loosening next year projected to see Bank Rate fall to 3% by the end of 2025. But since then, market expectations have gradually moved in favour of later and more gradual rate cuts. After June's MPC meeting, market pricing implied just 44bps of rate cuts this year, with Bank Rate at 4% at end-2025.

2. Bank of England, 'Monetary Policy Summary and minutes of the Monetary Policy Committee meeting', 20 June 2024, https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy-summary-and-minutes/2024/monetary-policy-summary-and-minutes-june-2024.pdf

UK: Market interest rate expectations



Source: EY ITEM Club calculations using data from Haver Analytics

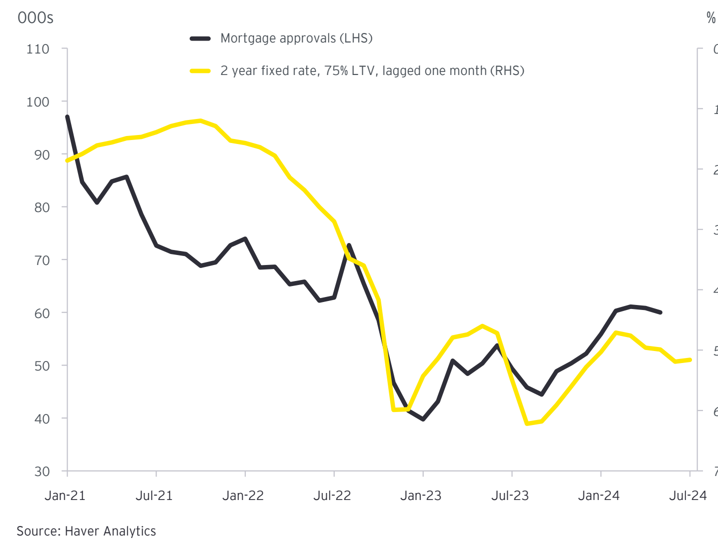
More hawkish market pricing is not just a UK phenomenon. Indeed, markets' view of the likely path of UK interest rates has been heavily influenced by developments in the US, with the Federal Reserve signalling that US rates will remain higher for longer due to its own sticky inflation problem. But we think the link between the UK and the US is overplayed – the US economy has been far stronger than the UK over the past couple of years, whilst there are clear signs that UK labour market conditions are loosening, which should bear down on pay growth. These factors suggest that the BoE should be able to keep inflation under control without needing to keep policy quite as tight as the Federal Reserve.

Higher mortgage rates have slowed the recovery in housing activity

Higher market expectations for Bank Rate have also been reflected in higher swap rates. And banks have responded to the increase in their funding costs by pushing up quoted mortgage rates. In June, the average quoted rate for a 75% LTV fixed for two years was 5.16%, up almost 50bps on the February level. The past couple of years have seen demand for mortgages strongly linked to the level of mortgage rates, so unsurprisingly, the recovery in mortgage demand has petered out in recent months.

But we are increasingly confident that the housing market is over the worst and that the risk of an abrupt price correction has receded. Though they have risen recently, mortgage rates are still well below the levels reached after the 2022 'mini-Budget' and last summer. Along with strong wage growth, lower mortgage rates have made mortgage payments more affordable. That said, housing valuations remain stretched relative to historical norms on all key affordability metrics, suggesting a period of weaker transactions whilst this valuation gap recedes.

UK: Mortgage approvals & interest rates



Source: Haver Analytics

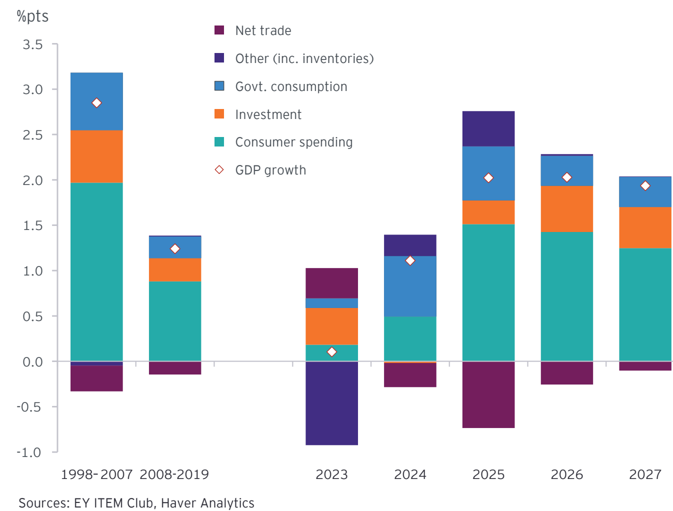
3

A steady, unspectacular recovery is in prospect

The 2024 growth forecast has been upgraded following a strong start to the year

The much stronger-than-expected performance in Q1 and continued momentum in Q2 have led us to upgrade our forecast for GDP growth in 2024 to 1.1% from 0.7% three months ago. We continue to expect growth of 2% in both 2025 and 2026. We expect the consumer will be central to the recovery, with some support from investment growth. Section 5 assesses the outlook for investment and looks at its importance to the supply-side outlook.

UK: Contributions to GDP growth



Sources: EY ITEM Club, Haver Analytics

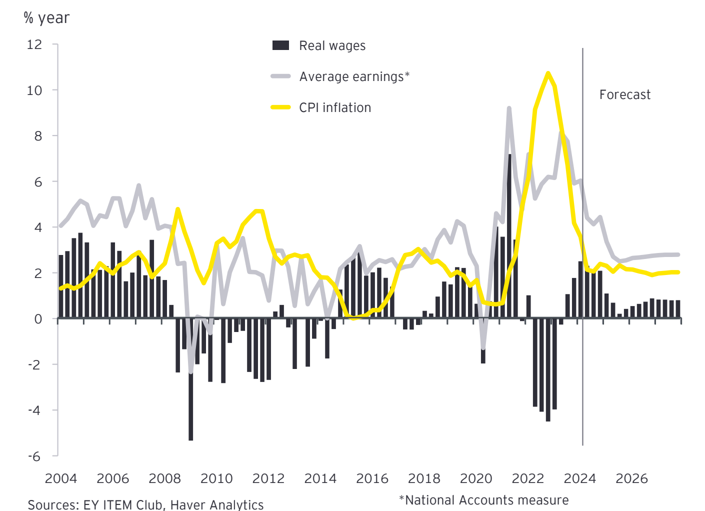
However, the lagged impact of past monetary policy tightening and tight fiscal policy will limit the pace of the recovery. In Section 4, we look at prospects for fiscal policy in greater detail.

We estimate that the two-year period of flat activity has resulted in a small amount of spare capacity emerging. Therefore, we believe that the economy can grow at a slightly above trend pace in 2025-26, without it generating inflationary pressures. Stronger activity growth is likely to be supported by a renewed pickup in employment, with productivity growth likely to continue to underwhelm.

Low inflation should support solid real income growth

Key to the consumer recovery will be a continuation of the solid real income growth seen in recent quarters and a less cautious attitude from consumers. Now that CPI inflation has finally made it back to the 2% target, we expect it to remain around that mark, albeit with some volatility from quarter to quarter. Energy prices will be the main source of volatility. The energy price cap was cut by another 7% on 1 July, but the drag on inflation from the energy category will actually fall that month because there was a larger drop in the cap last July. We then expect the price cap to rise by 7%-8% in October, reflecting the recent rise in wholesale gas prices, which will further reduce the drag on inflation from energy towards the end of the year.

UK: Average earnings and inflation



Sources: EY ITEM Club, Haver Analytics

*National Accounts measure

But we expect downward pressures from other sources to intensify. The indirect impact of lower energy prices should continue to build as firms move off older, more expensive, fixed-price contracts onto cheaper deals, then pass some of the cost savings onto their customers. The slowdown in food price inflation has further to run, partly due to base effects and partly due to

weaker price pressures in the supply chain. The pass-through of high wage costs, particularly in the services sector, should also fade as pay growth softens. We expect CPI inflation to average 2.5% this year and 2.2% in 2025, a far cry from the 7.3% rate seen in 2023.

Solid pay growth and recovering employment will boost household spending power

Given that the ONS is still in the process of implementing the changes it hopes will improve the reliability of its Labour Force Survey, it's hard to assess the current state of the labour market with much confidence. But our reading of other series is that demand for labour has continued to gradually soften, resulting in a steady loosening of labour market conditions. Still, on most measures, labour market conditions remain somewhat tighter than before the pandemic, partly reflecting still-high levels of inactivity.

Given that the recovery in economic growth is becoming more firmly entrenched, and there is little evidence of a sustained improvement in productivity growth, we think we are likely to be close to the peak in unemployment. Rising numbers of people in work will provide further support to aggregate household incomes. However, the extent of that support will partly depend on how successful the new government is in arresting the relentless climb in long-term sickness and improving labour market participation.

Wage growth has remained relatively high in the early months of 2024, partly due to the impact of the near-10% increase in the national living wage (NLW). The large NLW rise has not only boosted the wages of the lowest paid but is also likely to have rippled up the lower part of the pay distribution, increasing pay for roles that typically pay a modest premium over the NLW. Given that the NLW was announced in November, and many companies conducted annual pay reviews before April, we suspect the impact was smoothed over the first four months of the year. Elsewhere, pay pressures appear to be gradually cooling, in line with lower inflation and the reduction in wage bargaining power caused by looser labour market conditions. Both factors should increasingly weigh on pay settlements in H2 2024, dragging pay growth closer to long-run norms. Still, we expect pay to continue to grow in real terms, if not at quite the same rates seen in early 2024.

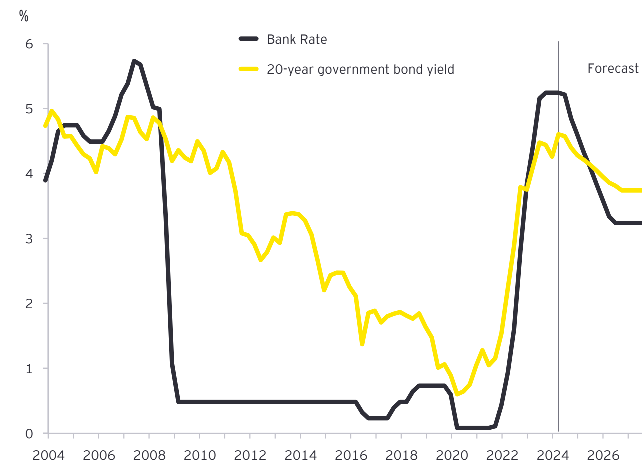
We expect the MPC to loosen monetary policy gradually

We think the June MPC meeting signalled a change of approach for some committee members, with backwards-looking indicators of inflation persistence becoming less relevant to policy decisions and a more forward-looking approach being adopted. However, it was equally clear from the minutes that some committee members don't share this view and remain concerned about the risk of inflation persistently overshooting the 2% target. That there's such a split makes it even harder than normal to forecast the future path of interest rates.

The election period meant that MPC members were unable to give speeches or make on-the-record comments. But now that the election has passed, committee members are beginning to clarify their views. We think the doves narrowly outnumber the hawks. However, following June's inflation data, market pricing moved decisively in favour of rates staying on hold that month. We expect the MPC will be reluctant to surprise markets, so while the August meeting is a possibility, we narrowly favour September for the first rate cut. We then forecast one more 25bps cut in November, leaving Bank Rate at 4.75% at the end of the year.

The BoE has said that policy will still be restrictive even after it has begun to cut rates. We agree with this view, and the neutral interest rate – the rate at which policy is neither stimulating nor restricting the economy – is probably in the region of 3%-3.5%. We think the MPC will continue to loosen policy in 2025 and 2026. However, the chastening experience of the past couple of years, when inflation and pay growth consistently overshot their expectations, is likely to encourage the MPC to tread carefully. So, our forecast assumes a gradual pace of loosening, with Bank Rate cut by 25bps at every other meeting until policy settings are neutral.

UK: Bank Rate and 20 – year bond yield



Sources: EY ITEM Club, Haver Analytics

But there is a lot of uncertainty around our BoE call. The extent of the split in the committee means that in the near term, every decision will be on a knife edge. Personnel changes could tip the

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

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

	GDP	Domestic demand	Consumer spending	Fixed investment	Exports	Imports
2021	8.7	9.1	7.4	7.4	4.9	6.1
2022	4.3	4.8	5.0	8.0	9.0	6.1
2023	0.1	0.0	0.3	2.2	-0.5	14.6
2024	1.1	1.4	0.8	-0.1	-1.2	-1.5
2025	2.0	2.7	2.5	1.4	2.6	-0.3
2026	2.0	2.3	2.3	2.7	2.4	4.7
2027	1.9	2.0	2.0	2.4	1.8	3.0
	Net Govt Borrowing(*)	**Current account (% of GDP)**	**Average earnings**	**CPI**	**Bank Rate**	**Effective exchange rate**
2021	5.4	-0.5	6.1	2.6	0.1	81.4
2022	5.0	-3.1	6.1	9.1	1.5	79.6
2023	4.5	-3.3	7.0	7.3	4.7	80.4
2024	3.1	-3.3	4.7	2.5	5.1	83.0
2025	2.7	-3.6	2.8	2.2	4.2	83.4
2026	2.3	-3.7	2.7	2.0	3.4	83.7
2027	1.6	-3.7	2.8	2.0	3.3	85.1

Source: EY ITEM Club

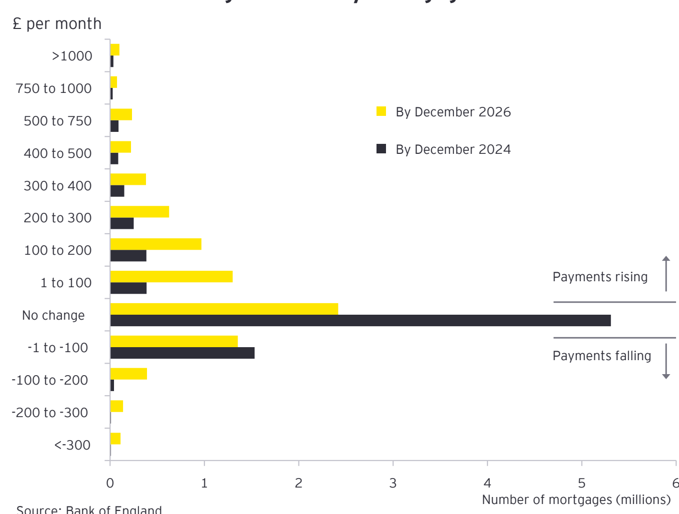
* Fiscal years, as % of GDP

balance (the new Deputy Governor for Monetary Policy, Clare Lombardelli, will replace Ben Broadbent for the August meeting, which will be external MPC member Jonathan Haskel's last one – and his replacement has not yet been announced). The new government's approach to fiscal policy will also be important. If the new administration adopts a less restrictive fiscal approach than the current plans, then monetary policy could be loosened more slowly than we anticipate. Conversely, the government might front-load its fiscal policy tightening, which the MPC might offset with a faster pace of rate cuts.

Tight policy settings will weigh on the pace of the UK recovery

It will take some time for the benefits of looser monetary policy to emerge. Indeed, over the next couple of years, the lagged impact of past tightening of monetary policy will continue to weigh on households. The BoE's latest Financial Stability Report demonstrated how this impact could play out over the next couple of years.[3] Of the 8.3mn owner-occupied mortgages with an outstanding balance of more than £1,000, 3.9mn of borrowers are expected to see their monthly mortgage payments increase before the end of 2026. This reflects the fact that many borrowers who took out five-year fixed-rate mortgages when interest rates were significantly lower will need to refinance at some point over the next two and a half years. Mitigating this impact, 2mn borrowers should see their mortgage costs fall because they have variable rate mortgages or are due to refinance, having taken out shorter fixed rate deals in the period since mortgage rates have been higher.

For most borrowers facing higher mortgage costs, the impact will be manageable. However, 400,000 borrowers will see their monthly mortgage payments increase by 50% or more. The BoE estimates that the net effect will be a modest rise in the aggregate household debt-servicing ratio over the next couple of years. This is consistent with our own forecast and suggests that the lagged impact of tighter monetary policy will weigh on the pace of GDP growth in 2024–25, adding to the drag from tightening fiscal policy settings.



Global conditions should remain supportive, but geopolitical risks are significant

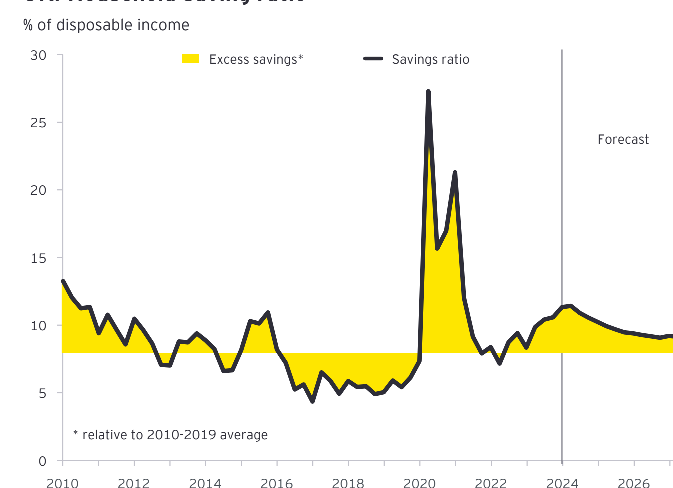
If the BoE does cut interest rates in September, then it will follow on the heels of the European Central Bank, the Bank of Canada, Sweden's Riksbank and the Swiss National Bank. The US Federal Reserve is also likely to follow suit, perhaps as soon as September. As with the BoE, other central banks appear to be shifting to a more forward-looking approach to the appropriate policy stance and are keen to reverse past rate hikes that were designed to contain the risk of inflation expectations becoming unanchored.

Looser financial conditions will offer support to global growth. Lately, some commentators have expressed concerns that the US's relative resilience is fading and that a recession is becoming increasingly likely. But we think those concerns are misplaced. The US labour market remains in good shape, whilst cooling inflation should support real income growth, so any slowdown in US growth should be modest. Meanwhile, the Eurozone outlook is evolving in a similar fashion to the UK, with lower inflation boosting household incomes and enabling a consumer-led recovery. On balance, the global economy looks likely to grow at a similar pace this year to last. However, the stronger performance of the Eurozone suggests that the mix will be slightly more favourable for UK exporters.

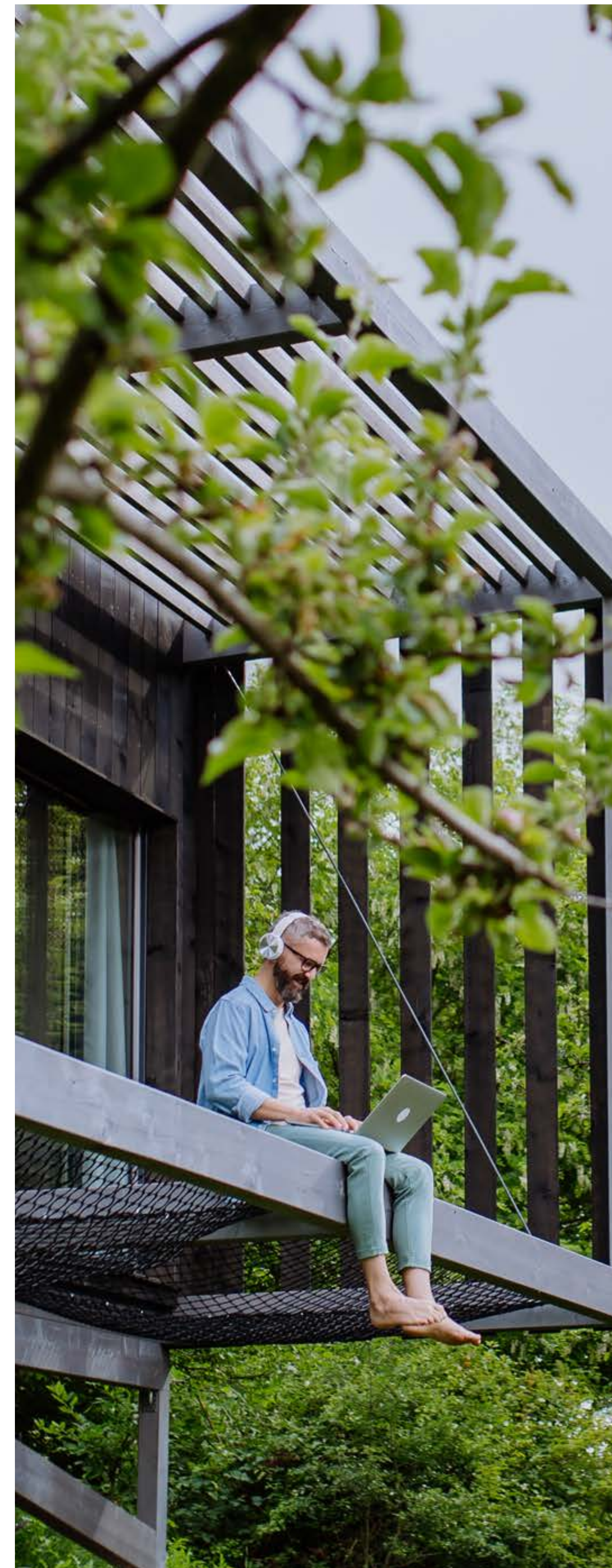
The key risks to the global outlook are geopolitical. Ongoing conflicts in Ukraine and the Middle East continue to present upside risks to energy, oil, food and transportation costs. In addition, more than half of the world's population will vote in national elections this year, with the potential for significant policy change in some of the world's biggest economies.

Consumer behaviour remains a key source of domestic uncertainty

From a domestic macroeconomic perspective, one of the key uncertainties remains the degree to which consumers shed the cautious mood of the past couple of years. Our spring report examined the case for consumers taking on more credit and saving less. The Q1 data showed a further increase in the saving ratio, with another very strong gain in real incomes exceeding the pickup in consumer spending. Given that Q2 saw a large uprating in most state benefits, in line with last year's high inflation rate, and the second cut in the rate of employees' national insurance contributions, there should have been a sharp rise in household income, and we expect the saving ratio to have climbed further that quarter.



But after that, we expect the saving ratio to fall steadily, partly because it starts from such a high level and partly because there's growing evidence that consumers are feeling more positive about the outlook for the economy, their personal finances and the climate for making major purchases.[4] If consumers remain cautious, then the recovery in consumer spending is likely to disappoint. But equally, a quick return to pre-pandemic rates of saving and credit demand could generate a much faster recovery over the next few years.



3. Bank of England, 'Financial Stability Report', June 2024, https://www.bankofengland.co.uk/financial-stability-report/2024/june-2024

4. See GfK consumer confidence barometer, June 2024, https://www.gfk.com/press/uk-consumer-confidence-up-three-points-in-june-to-14

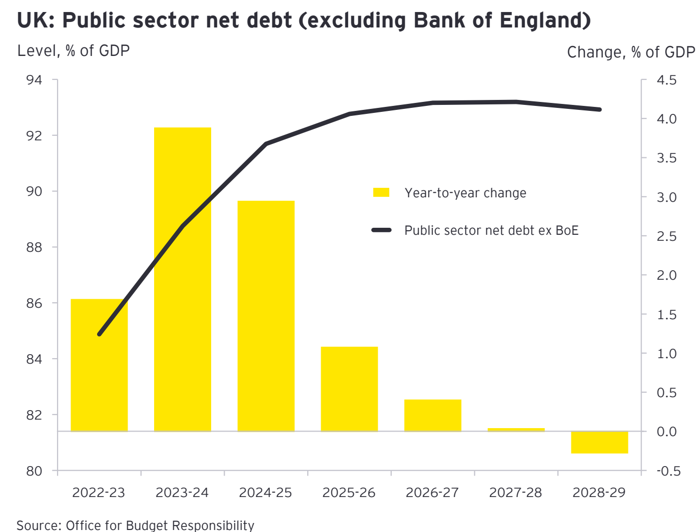
4

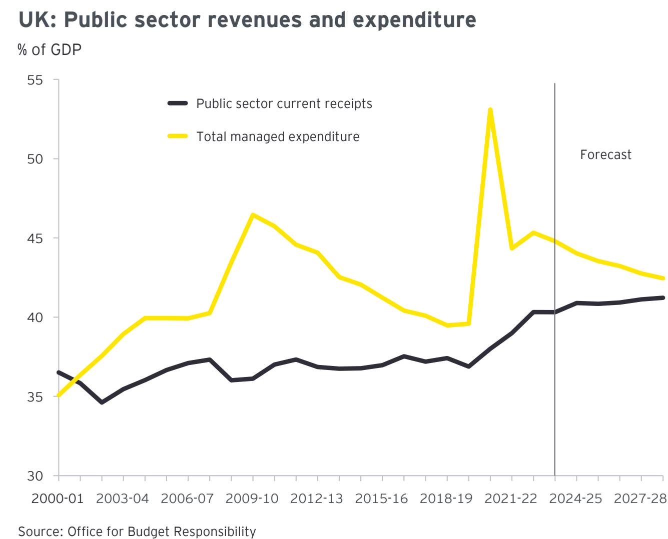
The new government will find its room for fiscal manoeuvre limited

The general election on 4 July yielded a comfortable landslide win for the opposition Labour Party. A parliamentary majority of 174 means that the new government should have no problems passing legislation and can shape the policy agenda as it sees fit. Fiscal policy will be a key part of its policy agenda, not just in terms of its management of the public finances but also in terms of the resources it will have available to fund public services.

We will have to wait until the autumn for the new UK Government's first fiscal event. Parliament will soon rise for its summer recess, and the Charter for Budget Responsibility requires the Chancellor to give the Office for Budget Responsibility (OBR) at least 10 weeks' notice of a major fiscal event to give them time to prepare the economic and fiscal forecasts.

The new government's starting point will be the plans inherited from the previous government. Including the fiscal year that began in April, these plans involve tightening fiscal policy by 3.4% of GDP over the course of the parliament. Despite such a large consolidation, the OBR expects public sector net debt (excluding the BoE) to continue to increase as a share of GDP for the first four years of the parliament before falling marginally in 2028-29.

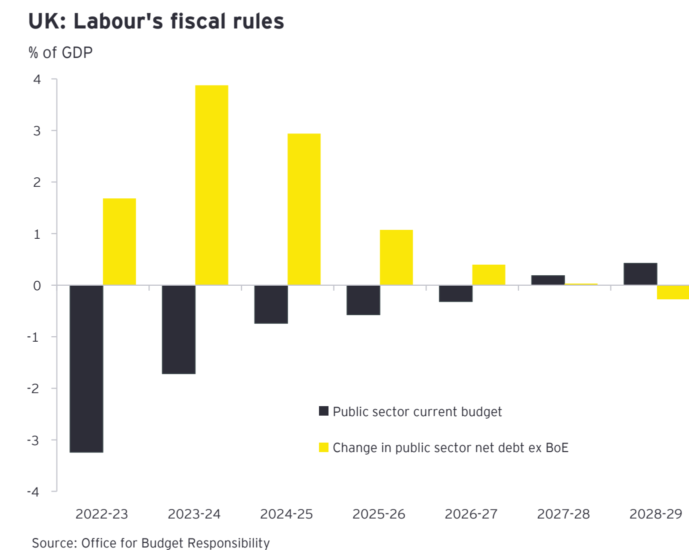




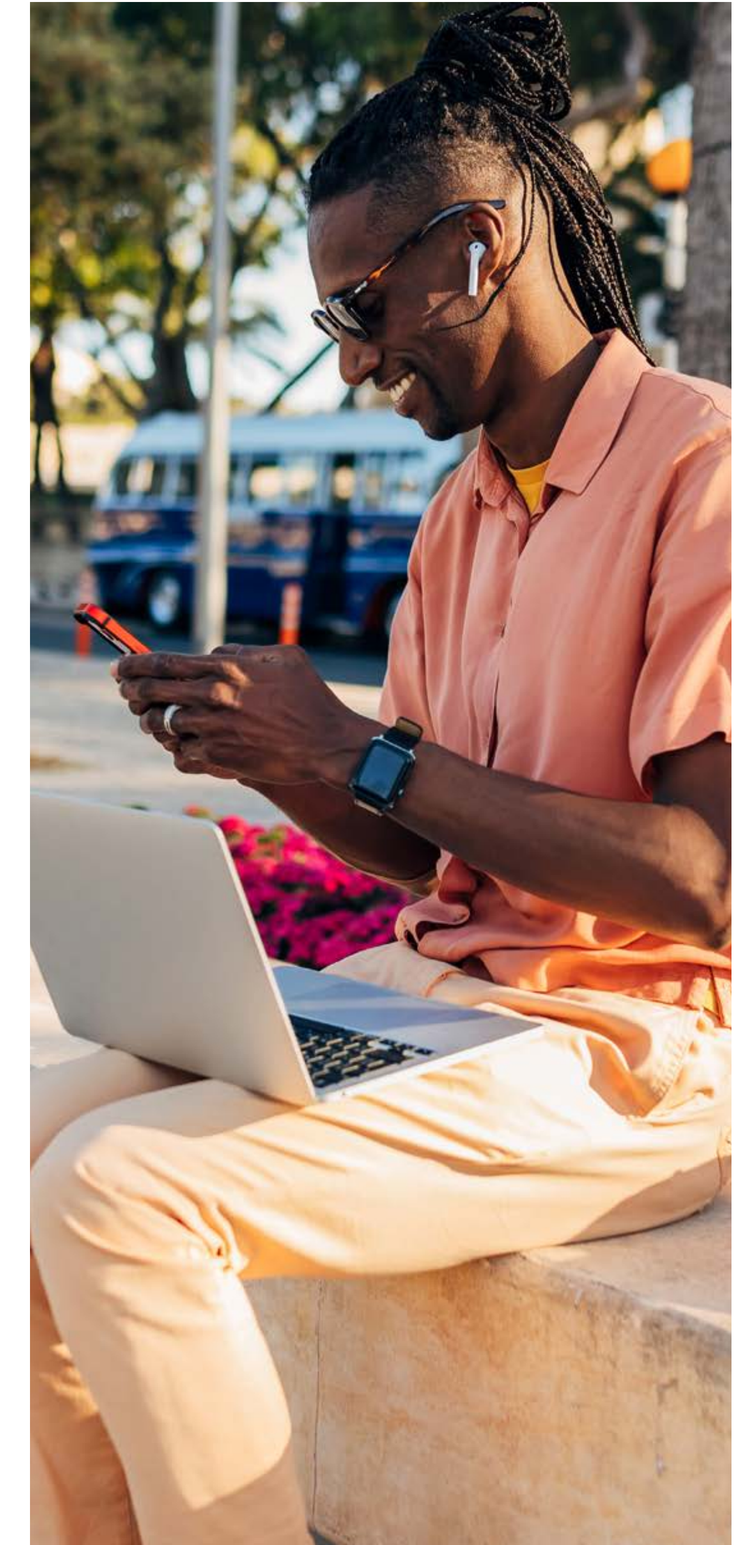
There are two elements to the plans. First the tax burden will be increased via so-called 'fiscal drag', which means keeping most tax allowances and thresholds frozen in cash terms until the fiscal year 2027–28 rather than increasing them in line with inflation. Second, the plans imply a prolonged period of spending restraint. Day-to-day spending by government departments is assumed to rise by just 0.4% a year in real terms over the course of the parliament. There are no departmental spending allocations beyond the current fiscal year. However, the demands of an ageing and more sickly population imply sustained real-terms increases in health spending, whilst education and defence spending have historically enjoyed some degree of protection from spending squeezes. So, the plans imply real terms cuts in day-to-day spending for unprotected departments. Meanwhile, public sector net investment is assumed to fall from 2.5% of GDP in fiscal year 2023–24 to 1.7% in 2028–29.

Labour's proposed fiscal rules will offer similar headroom to the current plans

Labour's manifesto suggested the new government would have two fiscal rules.[5] The manifesto pledged to change the borrowing rule, targeting a balanced current budget (i.e., day-to-day spending matched to government revenue) rather than setting a limit for the broader public sector net borrowing measure. Theoretically, this would allow scope to increase capital spending. However, Labour also committed to keeping the existing debt rule, which says that public sector net debt (excluding the BoE) must fall as a share of GDP in the fifth year of the OBR's forecast.



Due to the impact of the Treasury's indemnity on BoE losses when it sells gilts held in its Asset Purchase Facility (APF), the debt rule will likely be the binding constraint on fiscal policy throughout this parliament. This effectively leaves the new government with the same limited leeway on fiscal policy as the previous administration.

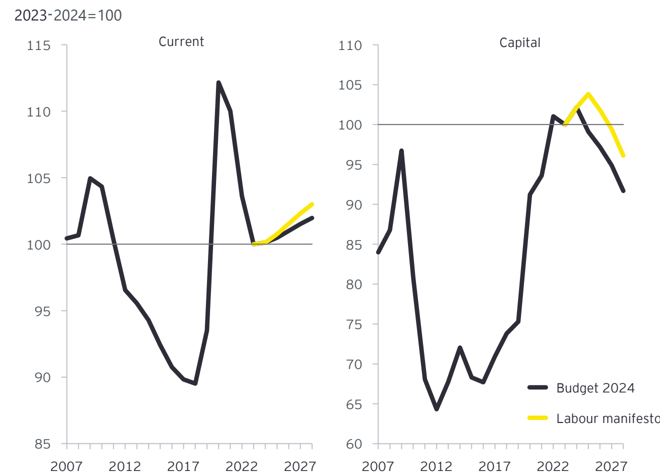


5. See 'My plan for change', Labour Party Manifesto, June 2024. https://labour.org.uk/change/my-plan-for-change/

Indeed, the government could find that the OBR's next forecast implies less headroom than its March vintage. The March forecast was based on financial market pricing in mid-January when markets were much more bullish about the pace of interest rate cuts. Updating these forecasts for current market pricing implies that the already slim £9bn headroom that the government had against the net debt rule would be halved. Similarly, the OBR's current forecasts assume a rebound in productivity growth that's stronger than most other forecasters anticipate. The OBR pared back its optimism a little in its March forecast, but there's a danger that it will cut its productivity assumption further in a future forecast. All else being equal, such a revision would increase the OBR's borrowing forecast and, therefore, require the government to tighten policy more to comply with the fiscal rules.

The manifesto pledges were fiscally neutral and small-scale

Labour's manifesto did not acknowledge the fiscal plans it inherited from the previous government. But with its new pledges on tax and spending being fiscally neutral and small in scale, it has implicitly committed to implementing the bulk of the fiscal consolidation planned by the previous government. Moreover, though the manifesto pledges implied slightly higher taxation and spending than the existing plans, the bigger picture is that past fiscal choices play a bigger role than new policies.



Source: EY ITEM Club calculations using forecasts from OBR and Labour party manifesto

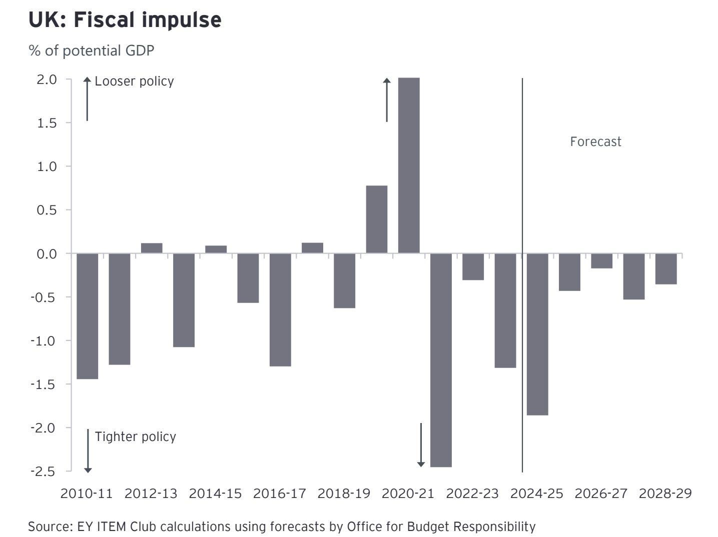
This analysis assumes that Labour's manifesto is implemented in full. However, experience suggests that governments often pursue slightly different approaches once in government. With a spending review likely to run in parallel with preparations for the autumn fiscal event, we suspect the government will be keen to increase the spending envelope to provide better public services and investment funding.

During the election campaign, Labour ruled out increases to National Insurance, the basic, higher, or additional rates of Income Tax, or VAT. These taxes account for the bulk of tax revenues, leaving relatively few options for raising taxes to finance higher spending. Remaining options include increasing Capital Gains Tax, or reforming Council Tax in a way that raises additional revenue.

The government might also look at the influence of the BoE's APF on the fiscal rules. When the BoE engaged in quantitative easing, it financed its purchases of gilts by issuing central bank reserves. The BoE pays interest on those reserves at Bank Rate, so the cost has risen sharply over the past few years. Furthermore, though the debt measures used in the fiscal rules exclude the BoE's balance sheet, they include the cost incurred by the Treasury indemnifying the BoE for losses when it sells gilts held in the APF. The OBR's latest forecast assumes just over £20bn of losses on gilt sales in the final full fiscal year of the next parliament (2028-29). But, as soon as the BoE finishes selling gilts, currently assumed to be 2032-33, these costs will cease. So, the amount of fiscal headroom is materially affected by a one-off effect that is largely outside the government's control.

Excluding the cost of APF losses from the net debt measure might be an attractive option for the government, given it would generate an extra £20bn of headroom in 2028-29. Introducing tiering on bank reserves might also be considered. This change, which would mirror the system used in many other countries, would involve only paying interest on a portion of bank reserves. But BoE Governor Andrew Bailey has previously expressed his opposition to this idea, whilst the potential cost savings will fall as Bank Rate is cut.[6]

The other uncertainty is the speed and timing of the consolidation. The OBR's forecasts imply a major policy tightening in the current fiscal year, followed by more modest tightening in subsequent years. The OBR adds an extra year to the forecast horizon in the autumn, so there may be a temptation to spread consolidation measures over a longer period to try to lessen the damage on activity. The government might also hope that by the second half of the parliament, their planning reforms may have borne fruit, convincing the OBR that a persistently stronger growth environment means less tightening is needed. But equally, front-loading tax rises and spending cuts would allow the government to get the bad news out of the way early whilst still having substantial political capital, providing time to rebuild later on. The timing of fiscal consolidation is likely to be influenced as much by political considerations as by economic arguments.



Source: EY ITEM Club calculations using forecasts by Office for Budget Responsibility

6. 'Corrected oral evidence: Governor of the Bank of England—annual scrutiny session', House of Lords Economic Affairs Committee, 14 February 2024, https://committees.parliament.uk/oralevidence/14282/pdf/

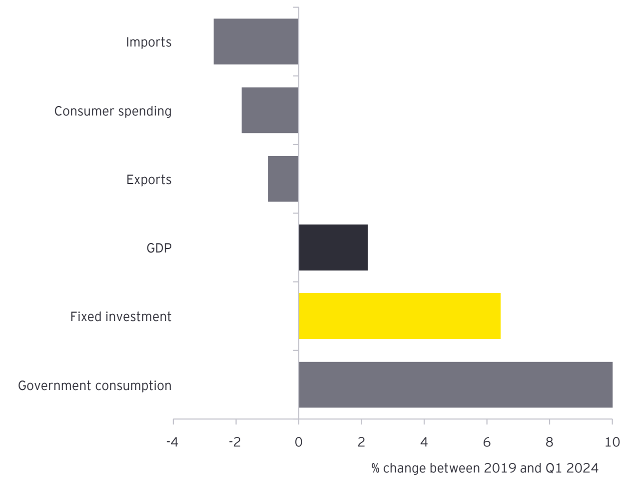
5

Tackling the long-running problem of under-investment is key to boosting growth

Investment has rebounded strongly since the pandemic

The strength of capital spending was one of the few bright spots for the economy in 2023. Fixed investment only accounts for just under a fifth of the economy. But last year, capital spending more than accounted for all of the growth in the economy. Moreover, this continued a strong post-pandemic recovery. In Q1 2024, investment was 6% above the average level in 2019. Across the main GDP components, only government consumption had risen more. All three of the major sub-sectors — business, government, and private dwellings — have recovered strongly, with the increase in public investment particularly striking, contributing around two-thirds of the overall rise.

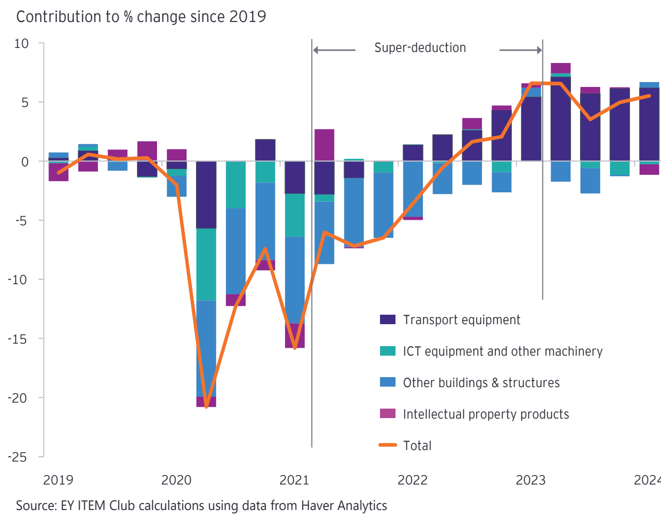
UK: GDP components compared with pre-pandemic level



Source: EY ITEM Club calculations using data from Haver Analytics

Looking specifically at business investment, the news is more mixed. The breakdown by asset type suggests the rebound has been heavily dependent on investment in transport equipment, particularly aircraft. Some of this strength is likely to be a case of catch-up following a pause in capital spending during the pandemic when the sector was one of the hardest hit by social distancing restrictions. Indeed, spending has been broadly flat over the past few quarters after a strong pickup in 2022 and H1 2023.

UK: Change in business investment since 2019



Source: EY ITEM Club calculations using data from Haver Analytics

A year ago, we were concerned that the end of the super-deduction — a temporary 130% capital allowance for investment in plant and machinery available from Q2 2021 to Q1 2023 — might trigger a softer patch, with firms bringing forward investment to qualify. However, the latest data suggests that the super-deduction was a small piece in the jigsaw, with no material increase in investment in ICT equipment and machinery when the incentives were active.

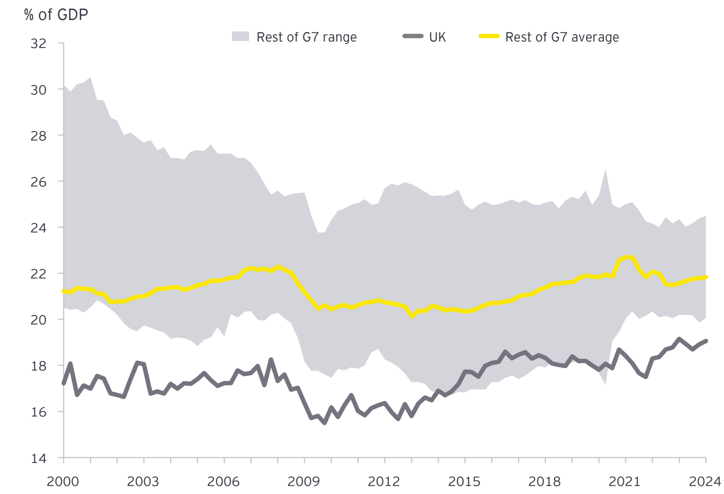
But the long-run picture looks more troubling

The recent investment strength is welcome, but it's only had a modest impact on the UK's long-running underperformance in this area. OECD data suggest that apart from a brief period in the second half of the last decade, since 2000, fixed investment has consistently accounted for a lower share of GDP in the UK than in any other G7 country. And despite the strong rebound in capital spending from 2021 to 2023, investment was still only 19% of GDP last year, 1ppt below the next worst in the G7 and 2.8ppts below the median.

Low levels of investment are a key factor behind the UK's poor growth performance over the past 20 years. Weak business investment growth tends to be associated with low levels of innovation and poor productivity growth. Meanwhile, failure to invest in the UK's infrastructure has undermined the existing road and rail network's performance and prevented firms from taking advantage of the benefits that improved connectivity would bring. These factors have contributed to the UK's poor supply-side performance, and it's crucial that the UK builds on the more promising experience of the past couple of years and makes strides towards closing the investment gap with its G7 peers.

Labour's manifesto and the new government's early announcements around planning reform and the creation of a National Wealth Fund suggest that the new administration understands the need to boost investment levels. Having recognised the problem, the onus is now on the new government to identify solutions that will arrest the UK's long-running under performance.

G7: Gross fixed capital formation as a % of GDP



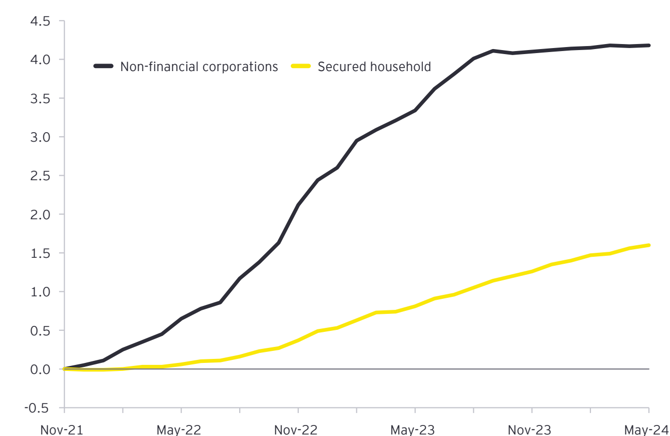
Source: EY ITEM Club calculations using data from OECD

Prospects are mixed, with plans to cut public investment a key concern

We remain relatively upbeat about prospects for business investment. Likely reflecting the popularity of non-bank financing, capital spending has shown impressive resilience in the face of a significant increase in interest rates over the past couple of years. The average interest rate on outstanding loans to companies has risen by more than 400bps since the BoE began to tighten monetary policy in late 2022, more than double the increase in average household mortgage rates. So, with the BoE likely to begin cutting interest rates shortly, we are probably now past the peak squeeze from higher debt servicing costs.

UK: Change in average interest rate on outstanding loans

%pts change since BoE started to increase Bank Rate



Source: EY ITEM Club calculations using data from Haver Analytics

From a cost perspective, full expensing — the permanent successor to the super-deduction, offering 100% capital allowances — should also be a positive. However, the limited impact of the super-deduction suggests we should have modest ambitions about the scale of the boost we can expect to see from full expensing.

The promise of a more stable political climate should also be a positive for capital spending. The previous government's frequent changes of Prime Minister and Chancellor, with associated swings in policy priorities, made business planning more challenging, particularly given this came on top of the disruption caused by Brexit and the pandemic. International perceptions of the UK as a place to do business have also suffered in this period, so the change of government provides the opportunity for a reset. In this respect, the government's commitment to pursuing a more constructive relationship with the European Union is a good start, although its reluctance to been seen to be watering down Brexit is likely to limit its ability to reduce trade frictions.

Furthermore, if the government can follow through on its pledges to overhaul the planning system, this could also potentially improve the climate for residential investment. The potential benefits in this area are significant. In addition to directly boosting demand, building houses in the right places could boost supply-side prospects by improving labour mobility. Still, achieving a material improvement will be far from easy, particularly given long-running skills shortages in the construction sector.

The biggest constraint on tackling under-investment will likely be capital spending by the public sector. In this respect, the UK starts from a poor position. Over the period from 2000–21, only three OECD countries reported a lower average ratio of government investment to GDP. The UK's average share of 2.7% was well below the OECD average of 4%. As we established in Section 4, lower capital spending was a key part of the fiscal consolidation planned by the previous government, so the UK could fall further down the OECD league table if the new government implements these investment cuts.

OECD: Government investment as share of GDP, 2000-2021

Source: EY ITEM Club calculations using data from Haver Analytics

Academic evidence provides a strong case for boosting public investment because of its positive impact on potential output growth. And the decision to remove investment from the borrowing rule is a step in the right direction. But as we established in section 4, keeping the existing debt rule is likely to prevent any practical benefit from the change in the borrowing rule in this parliament. Competition for any spare funding will be high, and history suggests that capital spending has rarely won the argument in such circumstances before.

7. See for example, 'The Positive Effect of Public Investment on Potential Growth', OECD Working Paper, 2016, https://www.oecd-ilibrary.org/economics/the-positive-effect-of-public-investment-on-potential-growth_15e400d4-en;

6 Conclusions

Lower inflation has kick-started a recovery in UK activity, ending two years of stagnation. Over the next couple of years, we expect a steady but unspectacular recovery to develop. Whilst prospects for consumer spending and investment look reasonably good, the pace of the recovery will be limited by the lagged impact of past monetary policy tightening and tighter fiscal policy settings.

With inflation now back at the 2% target, some MPC members have signalled a shift of emphasis away from backwards-looking measures of inflation persistence, instead adopting a more forward-looking approach. We expect this to open the door to rate cuts from the September meeting, with Bank Rate cut at a pace of 25bps per quarter until the policy settings are more neutral. An August cut is possible, but it would require the MPC to go against current market expectations.

A key uncertainty around our forecast is how the new government will approach fiscal policy. We're sceptical that the new administration will stick rigidly to its election manifesto, particularly given the degree of spending restraint it implies. So, a more expansionary approach looks possible, with a tweak of the fiscal rules to remove the distortionary impact of APF losses being a possible way to create extra headroom.

It would also be desirable if the government could find a way of boosting public investment. The UK already has one of the lowest ratios of government investment to GDP in the OECD, and the current plans imply that the UK could fall further down the OECD league table over the next five years. If higher public investment could be allied with a continuation of the recent strength in business investment, it could go a long way toward improving the UK's poor post-global financial crisis growth performance.

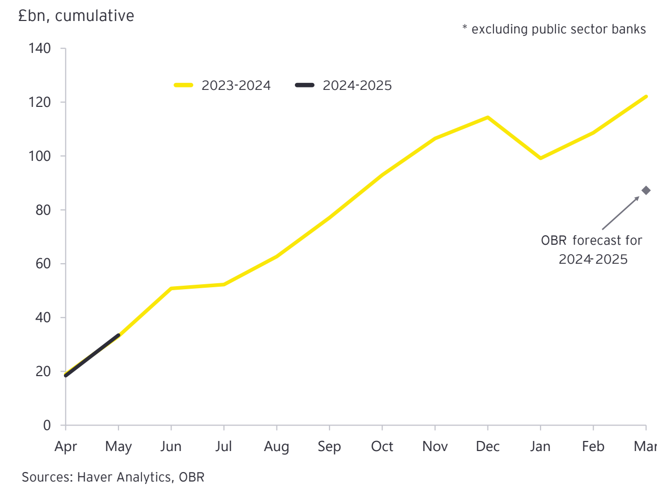
The government also has a key role to play in improving the investment climate for businesses. In recent years, the combination of political instability and policies that have increased trade barriers have made it difficult for businesses to plan and damaged the UK's reputation as a place to do business. The change of government offers an opportunity for a reset. A more stable political backdrop and pro-growth agenda would do a lot to repair the damage and promote investment.

7

Forecast in charts

Fiscal policy

UK: Public sector net borrowing*

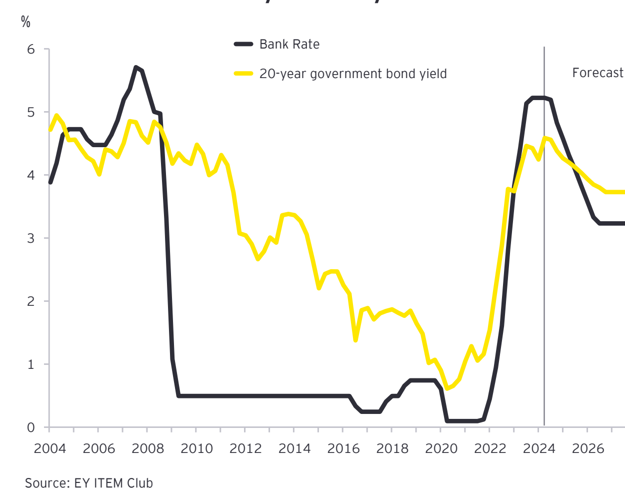


Sources: Haver Analytics, OBR

- In the first two months of fiscal year 2024-2025, public sector net borrowing has come in very close to the 2023-2024 figures.
- We expect this pattern to continue for the rest of the year, causing a sizeable overshoot of the OBR's forecast. Higher-than-expected Bank Rate and gilt yields are likely to mean debt servicing costs are higher than the OBR forecasts.
- Beyond this year, the fiscal outlook will be heavily influenced by the approach of the new government. Their manifesto implied it would largely follow the tax rises and spending restraint in the current plans. But we think it will be keen to increase the size of the spending envelope.

Monetary policy

UK: Bank Rate and 20-year bond yield

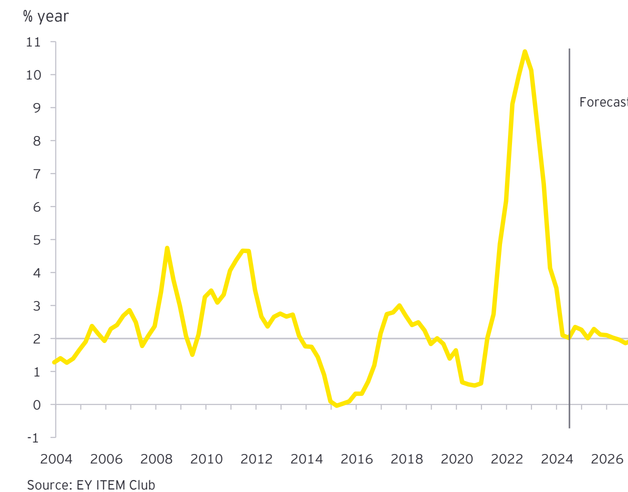


Source: EY ITEM Club

- The MPC has continued to vote to keep Bank Rate at 5.25%. But June's minutes signalled that some members had shifted their focus away from backward-looking measures of inflation persistence in favour of a more forward-looking approach.
- The change of focus is consistent with the MPC beginning to cut interest rates soon. The August meeting may come to soon given market pricing, But a 25bps cut in September and another in November would see Bank Rate end this year at 4.75%.
- The MPC has said policy would still be restrictive even after it has started to cut rates. We expect a steady pace of rate cuts until Bank Rate has reached more neutral settings in the region of 3-3.5%.

Prices

UK: CPI inflation

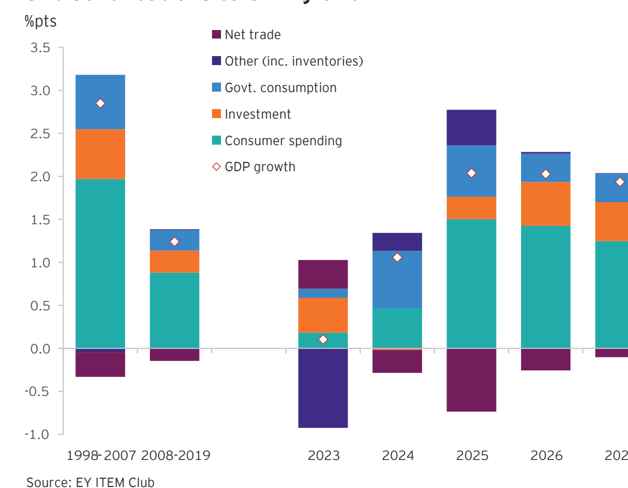


Source: EY ITEM Club

- In May, CPI inflation finally returned to the 2% target for the first time in nearly three years.
- The drag from the energy category will fall due to base effects and a likely increase in the price cap in October. But we expect additional downward pressure from firms passing on the impact of their falling energy costs and a further cooling in food price inflation.
- Our forecast shows inflation averaging 2.5% in 2024 and 2.2% in 2025. But the energy category is likely to ensure there is volatility in headline inflation from quarter-to-quarter.

Activity

UK: Contributions to GDP growth

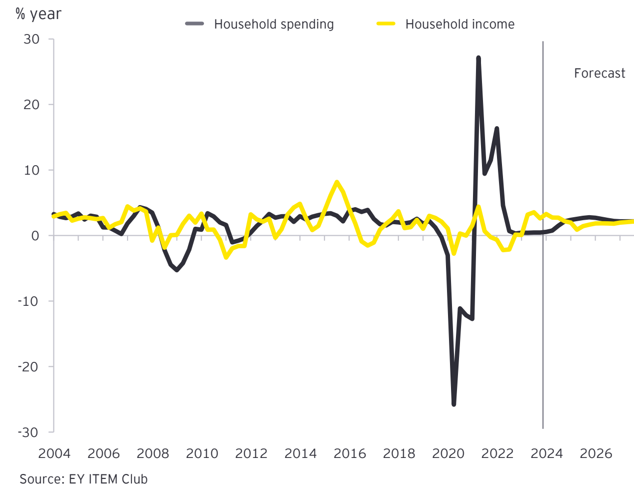


Source: EY ITEM Club

- A 0.7%.q/q increase in GDP in Q1 2024 more than offset the small falls in output seen in H2 2023. We estimate there was another solid increase in GDP in Q2, but at a slightly softer pace than in Q1.
- The stronger-than-expected rebound in Q1 and solid momentum in Q2 have led us to revise up our forecast for GDP growth in 2024 to 1.1%, from 0.7% three months ago. We still expect growth of 2% in both 2025 and 2026.
- The upturn will be founded on stronger consumer spending growth. But the lagged impact of tighter monetary policy and tighter fiscal policy will mean the recovery is steady rather than spectacular.

Consumer demand

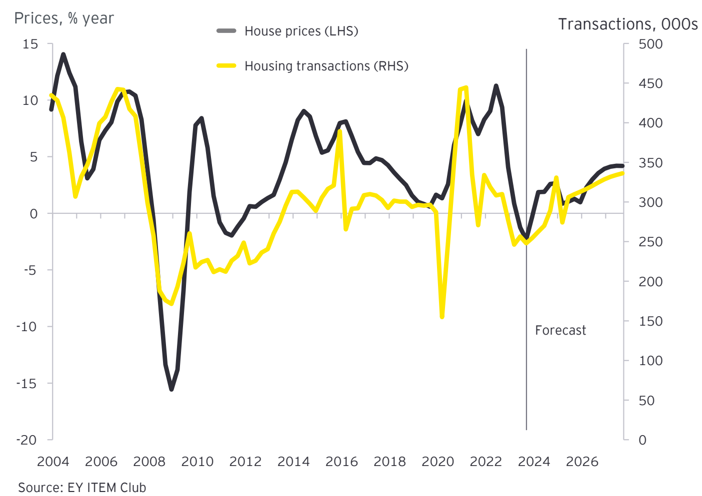
UK: Real household income and spending



- Consumer spending rose by 0.4% q/q in Q1 2024, after falling in H2 2023. Real household income has grown strongly over the past few quarters, but consumer caution means this has translated into a sharp rise in the saving ratio.
- Lower inflation should ensure solid real household income growth over the next couple of years.
- We're optimistic that improving confidence should mean that consumers adopt a less cautious approach moving forwards, meaning that solid income growth translates into a stronger pickup in consumer spending. Growth is forecast at 0.8% in 2024, followed by 2.5%. next year.

Housing market

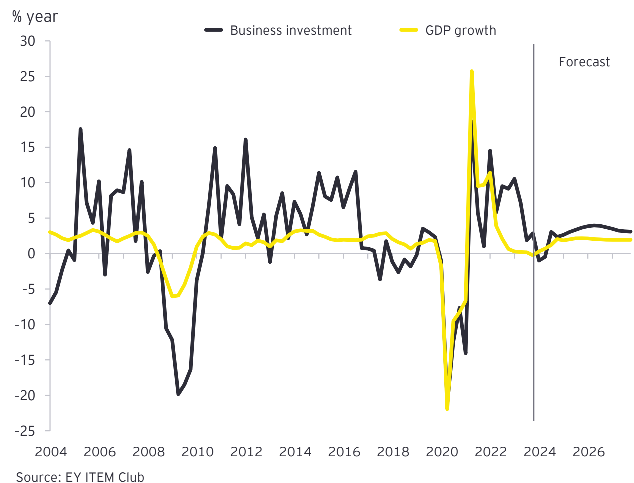
UK: House prices and transactions



- The strong recovery in housing demand seen in early-2024 has petered out in recent months in response to an increase in quoted mortgage rates. Prices have been broadly flat so far in 2024 according to the lenders' indices.
- Mortgage affordability looks less stretched than in late-2022 or last summer. But valuations are still much higher than historical norms, suggesting strong recoveries in prices or activity are unlikely.
- But with unemployment remaining low and mortgage rates likely to drift lower over the next few years, the risk of a sharp correction in property prices has receded significantly.

Company sector

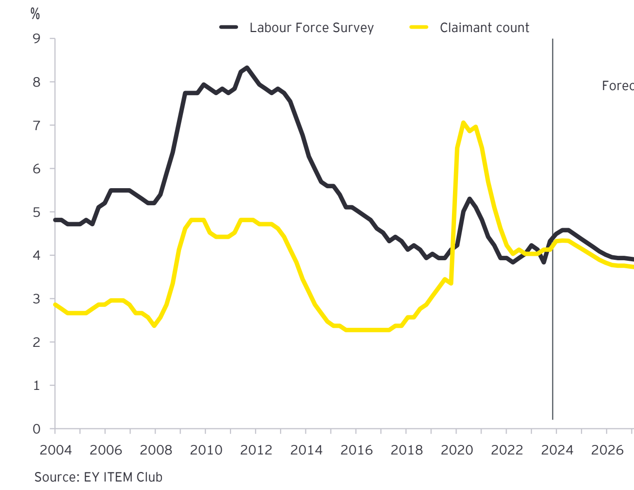
UK: Business investment and GDP



- The post-pandemic recovery in business investment has been much stronger than the upturn in the wider economy.
- Tighter monetary policy has fed through to the debt servicing costs of companies much more quickly than for households. But so far investment has been resilient to these pressures, and the company sector should now start to benefit from interest rate cuts. Greater stability in the macroeconomic and political backdrops should also help.
- Business investment is forecast to grow 1% this year, followed by 3.2% in 2025.

Labour market and wages

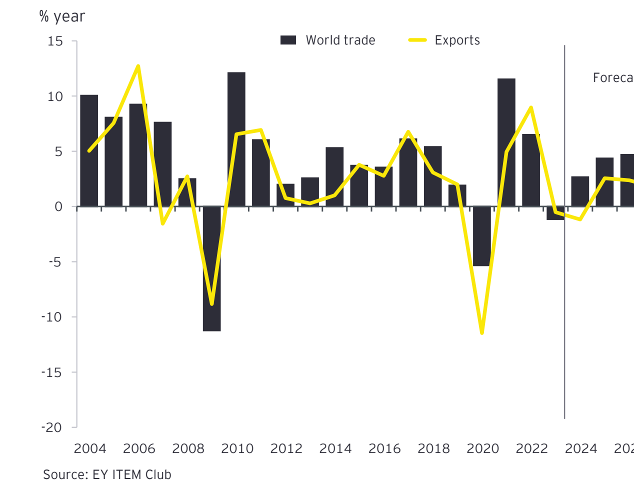
UK: Unemployment rate



- The Labour Force Survey data remains beset by volatility, with the ONS still to fully implement its methodological improvements. It's hard to gauge the true state of the labour market.
- Most evidence suggests labour market conditions have loosened slightly compared with last year, reflecting softening labour demand, but that they remain tighter than before the pandemic.
- Stronger activity should boost demand for labour, so we're probably close to the peak in unemployment. We expect wage growth to gradually soften due to looser labour market conditions and the influence of lower inflation on workers' pay expectations.

Trade and the balance of payments

UK: Exports and world trade



- Recent data has shown large falls in both exports and imports, though flows of non-monetary gold have caused sizeable distortions. The current account deficit was 3.1% of GDP in Q1 2024, slightly narrower than the 2023 average of 3.3% of GDP.
- We expect the global economy to grow at a similar pace this year to last. But with the Eurozone accelerating, the cross-country mix should be more favourable to UK exporters.
- But import growth should also pickup, reflecting stronger consumer demand. We expect the rise in import demand to be slightly stronger than the pickup in exports, so the current account deficit is forecast to widen modestly, reaching 3.6% of GDP next year.

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