UK Economic Outlook

June 2022

- **Just as the UK economy returned to its pre-pandemic size, new shocks hit the global economy.** The invasion of Ukraine and renewed lockdowns in China put upward pressure on commodity prices while keeping supply chains under strain. There are growing concerns that a combination of policy actions to combat inflation and any further fallouts as a result of geopolitical tensions could bring about another recession.
- **Businesses continue to experience difficulties to find staff but also increasingly to pass on costs.** The labour market is very tight, and while 2022 is set to remain an employee's market, staff availability is improving somewhat. Inflation has risen to a 40-year high, and is expected to peak later this year. However, there is growing evidence that consumers are becoming more sensitive to price increases as real incomes get squeezed.
- **We expect GDP growth to more than halve this year to 3.2%, before slowing further to 0.7% in 2023.** The cost of living crisis and the rising tax burden have led to a fall in consumer confidence which is set to drag on discretionary spending. Business investment is expected to be particularly weak next year without any further government support.
- **The risks to our outlook are skewed to the downside.** A sharper deterioration in the external environment – causing a recession in some of the UK's major trading partners – coupled with a stronger fall in consumer spending in the UK, could see the UK economy entering a mild recession next year, with manufacturing and financial services among the worst affected sectors.
- **Following a series of back-to-back increases by the Bank of England, we expect two further interest rate rises this year.** The Monetary Policy Committee will have to weigh the risk of high inflation spilling into pay growth against the risk of a recession. Thereafter, we expect a pause in the tightening cycle to prevent inflation running well below the 2% target further out.
- **Fiscal policy has been loosened again to counteract the cost of living crisis, with a package of giveaways worth 0.4% of GDP.** It leaves very limited room for the Chancellor to spend on some of the government's longer-term priority areas or to cut taxes ahead of the next election.

Table 1: KPMG forecasts

	2020	2021	2022	2023
Real GDP	-9.3	7.4	3.2	0.7
Consumer spending	-10.5	6.2	3.9	0.9
Investment	-9.5	5.9	5.4	-2.5
Unemployment rate	4.5	4.5	4.2	4.6
Inflation	0.9	2.6	8.1	4.1
Base interest rate	0.1	0.25	1.75	1.75

Source: ONS, KPMG forecasts. Average % change on previous calendar year except for unemployment rate, which is average annual rate, while interest rate represents level at the end of calendar year. Investment represents Gross Fixed Capital Formation, inflation measure used is the CPI, and unemployment measure is LFS.

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The global economy: Licking its wounds

The global economy has been recovering from the COVID-19 pandemic, although the bounce-back has been uneven across countries. Overall, GDP across the OECD countries is now 2.4% above its pre-pandemic level, with the US economy 2.8%, the Eurozone 0.8%, and the UK 0.7% higher than in the fourth quarter of 2019. However, a number of countries are yet to reach that threshold, including Spain, Germany, and Japan (see Chart 1).

The lifting of COVID-19 restrictions boosted global growth in 2021 but momentum has slowed into 2022. The US economy contracted by 0.4% in 2022 Q1, while recent PMI data pointed at falls in global manufacturing output, driven by lockdowns in China and renewed pressure on supply chains.

The risk of the Russia-Ukraine conflict escalating further has diminished, but the war has left tangible side-effects on the global commodity markets. For example, global gas prices are now around four times higher than their pre-pandemic average, while oil prices are twice their average levels (see Chart 2).

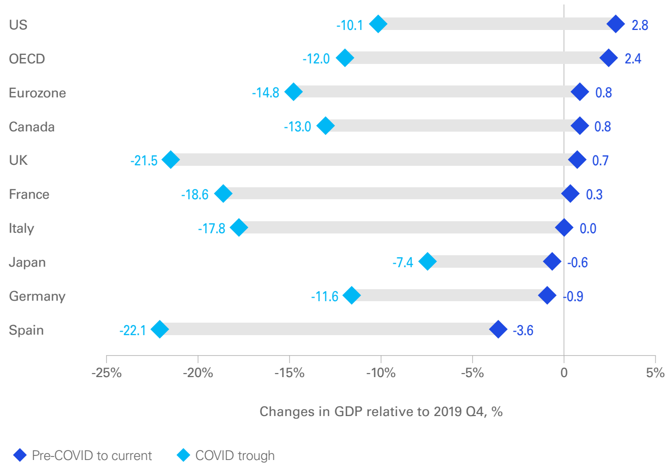
Perhaps the most acute impact is currently being felt on the global food markets, which saw prices rise by 60%. Many low-income countries in the Middle East, Africa and Asia rely heavily on cereal and fertiliser imports from Russia and Ukraine, making them particularly vulnerable to the disruption in food production.

The global supply chain disruption continues to put pressure on suppliers' delivery times. Despite some evidence that lead times improved in May, the New York Fed's global supply chain pressure index remains nearly three standard deviations above its long-run average. Meanwhile, the zero-COVID policy has put a brake on activity in China. With the restrictions mainly centred on Shanghai, the data from ports show a pickup in container waiting times in April and May. Taken together, these suggest a stabilisation rather than easing of global supply chain pressures.

The rise in inflationary pressures has triggered an almost universal tightening in monetary policy. Since the start of the year, at least 29 central banks have raised their policy rates, with 25 doing so in May alone (see Chart 3). With further increases expected throughout the rest of the year – led by the US Federal Reserve – the end of 2022 could see much tighter global financial conditions. Nonetheless, a slowdown in economic growth creates a difficult 'trade-off' for the central banks.

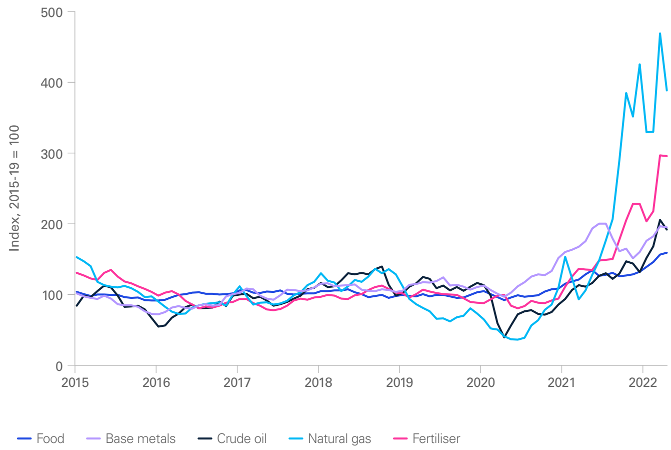
On the fiscal side, policy space has been eroded in many countries by the pandemic. This also creates a trade-off for governments: rising interest rates and the need to protect vulnerable populations against inflation make it more difficult to maintain fiscal sustainability when public debt levels are already high. Policymakers will have to navigate a tricky path to manage often-conflicting economic goals while seeking to minimise market volatility.

Chart 1: Recovery from COVID uneven across countries



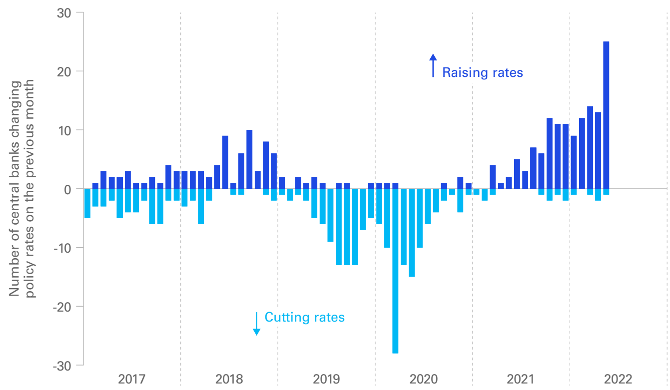
Source: OECD, Eurostat, ONS, Refinitiv Datastream, KPMG analysis.

Chart 2: Global commodity prices have risen significantly



Source: IMF Primary Commodity Price System, KPMG analysis.

Chart 3: Central banks are tightening policy around the globe



Source: Bank for International Settlements, KPMG analysis.
Note: Latest data are for May 2022.

Inflation: Above target

UK CPI inflation has reached a 40-year high. At 9.1% in May, this was its highest rate since March 1982, marking the tenth consecutive month when inflation overshot the Bank of England's target of 2% (see Chart 4). The recent pickup is not dissimilar to the experience of the US and the Eurozone, where headline inflation currently runs at over 8%.

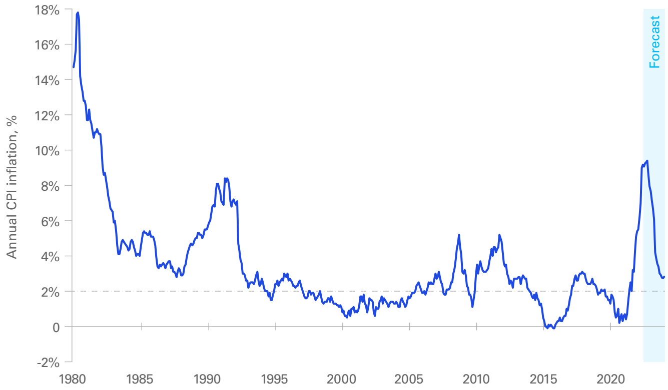
Inflation was already elevated before the outbreak of the Russia-Ukraine conflict, coming in at 6.2% in February. That was driven by the global supply bottlenecks causing shortages of goods, and the upward trend in energy prices which had begun last year. For example, gas stocks were depleted in 2021 following a cold winter in Europe and Asia a year ago – which resulted in greater need for heating – while less wind than normal during the summer meant that countries weren't as able to rely on renewable energy.

The recent geopolitical events have further exacerbated the upward pressure on inflation from global commodity prices. At the time of writing, Brent crude oil was trading at around US$110 per barrel. Since UK consumers purchase petrol at market prices, which are determined internationally, this affects prices at the pump. With average petrol prices exceeding £182p per litre, the cost of filling a 55-litre tank with petrol has now exceeded £100. The current market expectations are that oil prices won't fall below US$100 per barrel until next year.

Food prices have also been affected. The disruption in food production as a result of the war is putting direct upward pressure on prices, while higher cost of fertilisers will impact food prices and production globally. Higher oil prices also affect prices in shops indirectly, as they translate into higher transportation costs, which are then passed on to the prices of final goods.

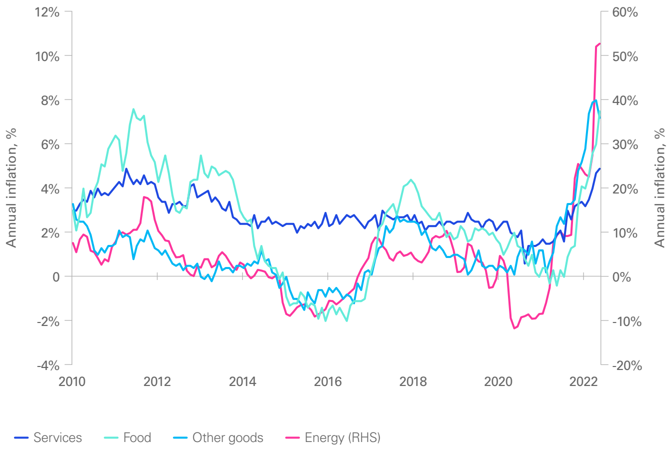
In addition to the external influences, the latest evidence points to an increasing domestic pressure on prices. 'Core goods' inflation (which excludes energy, food, and alcohol & tobacco) has reached its highest level since at least 1989. At the same time, services inflation is double its average level over 2014-19 (see Chart 5). Looking at the distribution of the inflation basket confirms that price pressures are becoming more widespread. The weighted median rate of inflation (price of the middle item in the CPI basket) was 6.8% in May, and prices of nearly two-thirds of all items are now growing at more than 5% compared to a year ago, with a fifth growing at over 10% (see Chart 6).

Chart 4: Inflation is at a 40-year high



Source: ONS, KPMG analysis.

Chart 5: The spike in energy prices is spilling into other components



Source: ONS. Food includes alcoholic beverages and tobacco.

Chart 6: Proportion of items in the CPI basket growing by more than 5% and 10%

Source: ONS, KPMG analysis.
Note: The frequencies are weighted by the items' weights in the CPI.

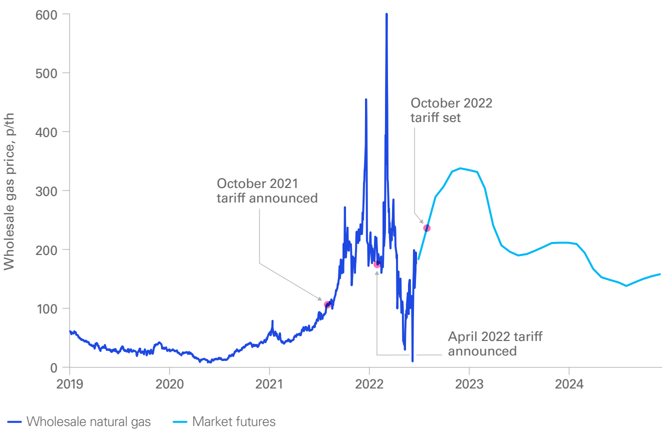
Firms' profit margins have come under pressure. Input price inflation is at its highest level on record but that was not fully reflected in output prices. Companies are further under pressure due to the widespread staff shortages, which require them to consider higher pay awards in order to attract and retain staff.

So far, businesses have been successful in passing on many of the rising costs to consumers. A recent survey by the Bank of England suggested that firms had passed through almost 80% of the increase in non-labour costs to consumer prices. This practice may become more difficult going forward, however, as household incomes get more squeezed, with consumers more likely to balk at price rises and reassess their spending plans.

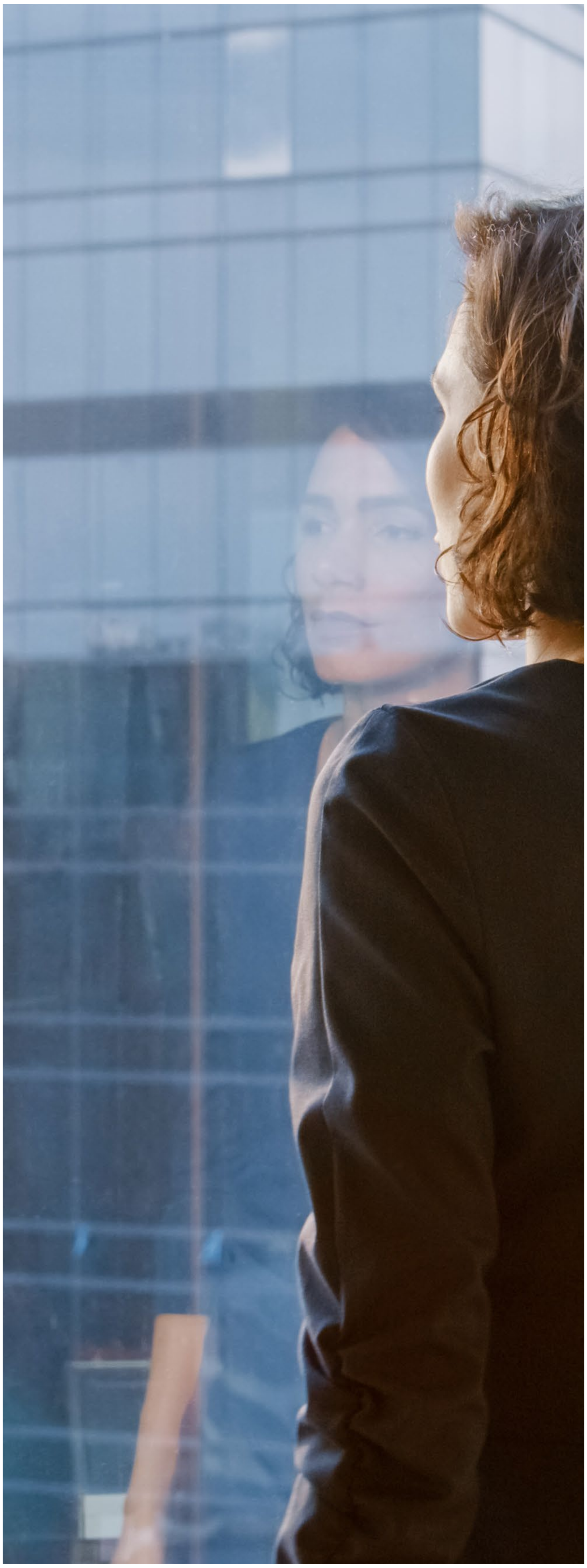
We have revised our forecast for average inflation over 2022 to 8.1%, up from 7.9% in our April report. The peak in UK inflation is likely to lag that in some of the other major economies. Because of regulated energy prices being revised in October (see Chart 7), we expect the full impact on UK inflation to only materialise in the autumn, with the outlook for inflation remaining highly dependent on the evolution of future wholesale gas prices. Latest media reports suggest that Ofgem's next revision could see the utility tariff cap increased to around £2,800, 42% higher than its current level.

We expect inflation to begin to normalise from 2023 Q2 onwards, and to return to the Bank of England's 2% target in 2024 Q2. We see two-sided risks to our forecast. On the one hand, a sudden fall in commodity prices, not factored in our current forecasts, could see a quick reversal of the recent trends. In addition, a sharp slowdown in consumer demand could also limit companies' ability to pass on costs further. On the other hand, a tight labour market could add even more pressure on inflation via 'second-round' effects. That is, if workers use their bargaining power effectively to demand higher wages, knowing that available labour is scarce, and these higher labour costs are then passed on to higher prices.

Chart 7: UK regulated gas prices could rise again in October



Source: Refinitiv Eikon, KPMG analysis. Latest spot data are for 22 June.



Interest rates: A hiking cycle

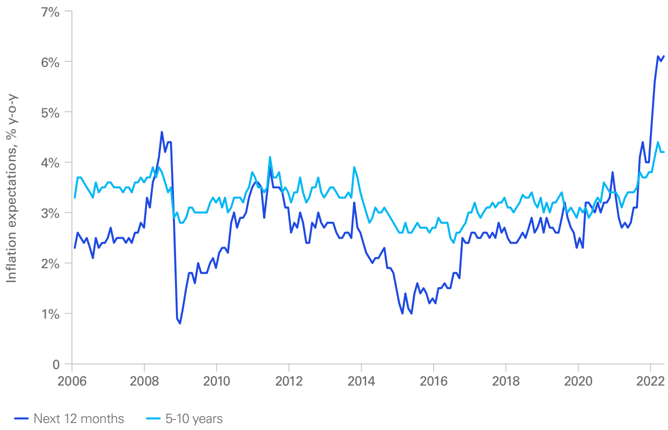
Household inflation expectations – a key indicator for the direction of monetary policy – have picked up sharply (see Chart 8). This is particularly true at shorter horizons: the YouGov/Citigroup measure of one-year ahead inflation was 6.1% in May, and the median Bank of England/Ipsos measure was 4.6% – both at their record highs. Longer-term expectations have also drifted upwards, with the YouGov/Citigroup pointing to 4.2% inflation in 5-10 years' time.

The Bank of England has continued to raise interest rates to anchor longer-term expectations at the 2% level. Taken together, the Bank has now raised rates at five consecutive policy meetings since December 2021, bringing Bank Rate to 1.25% (see Chart 9). This tightening cycle marks the first increase in interest rates since mid-2018, when CPI inflation was 2.4%.

Monetary policy tightening is a global phenomenon. The US Federal Reserve has raised rates by 150bps since March, and the European Central Bank has signalled that it would begin the tightening cycle at its July meeting. Financial markets currently price in a relatively steep path for global interest rates, with multiple increases expected by the end of next year (see Chart 9).

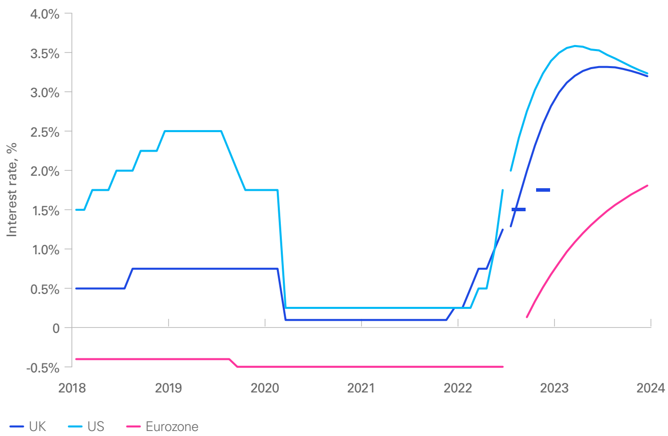
We expect two further increases in Bank Rate this year, in August and November, bringing it to 1.75% (see Chart 9). The Monetary Policy Committee will have to weigh the risk of high inflation spilling into pay growth against the risk of a recession. Facing such a trade-off, we think it is likely that the doves on the Committee could swing the balance towards a more gradual uplift than is currently priced in by the markets, especially in the context of the expected reduction of the Bank's balance sheet that would further tighten financial conditions.

Chart 8: Household short-term inflation expectations are up



Source: YouGov/Citigroup.

Chart 9: Interest rates are set to rise further



Source: BIS, FRED, Refinitiv Datastream, Bank of England, ECB, KPMG analysis.
Note: The dashes represent KPMG's forecast for the UK. Yield curves shown as of 22 June.

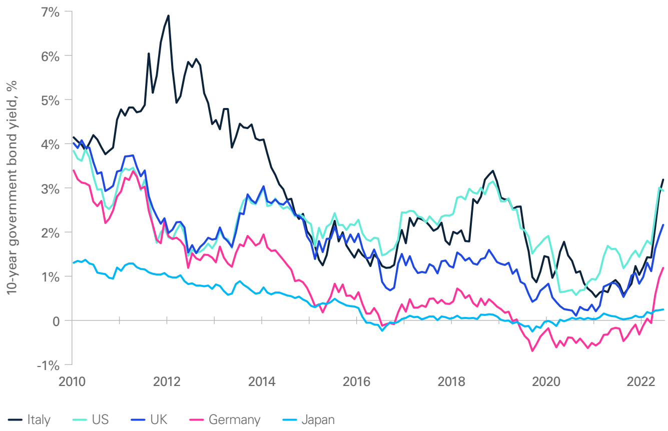
In the UK, we expect a pause in the hiking cycle over 2023. Our forecast is below market expectations for a number of reasons. First, the Bank's latest forecast, which was conditioned on the prevailing market rates, implied a build-up of excess supply at the end of the policy horizon and an undershoot of the inflation target. Second, household inflation expectations may be a poor predictor of future inflation. Our analysis suggests that 12-month ahead expectations instead tend to reflect the current level of inflation, leading it by just a month (rather than a year). And third, it is likely that the equilibrium interest rate in the UK is lower than in the US given the headwinds from the effects of Brexit on trade.

In addition, the Bank has ceased to reinvest maturing assets held within its Asset Purchase Facility, and signalled that it could begin active sales as early as in September. These actions, known as quantitative tightening (QT), will allow the Bank's balance sheet to shrink. Using QT as a monetary policy tool can also play a complementary role to rate hikes, allowing rises to be more gradual. With households more immediately exposed to changes in short-term rates, this may be particularly useful at a time when consumers face headwinds from fiscal policy and rising energy prices.

Government bond yields have risen, reflecting an anticipation of higher short-term rates and inflation in the future. And while changes to policy rates affect interest on shorter-dated debt, QT also acts to raise yields at longer horizons, by increasing the supply of long-term bonds available to private investors. Yields on UK 10-year government bonds are up by over 130bps compared to a year ago, having reached their highest level since 2014 (Chart 10). A similar pattern can be observed across other advanced economies.

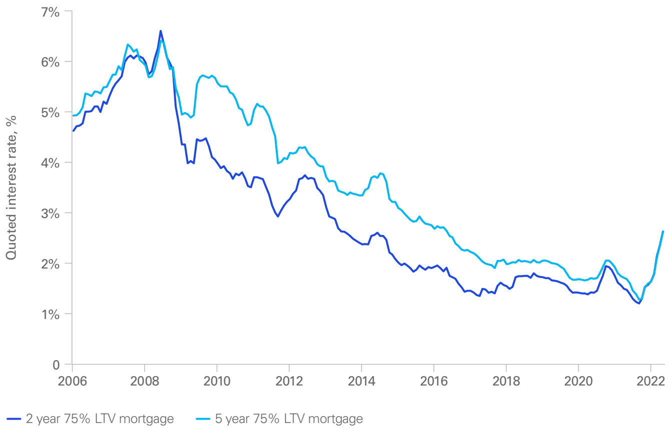
Mortgage rates are also up, as changes in Bank Rate are passed through onto borrowers. Quoted interest rates on two-year and five-year fixed-term mortgages surpassed the 2% mark in March, continuing the upward trend since the second half of 2021 (see Chart 11). Nonetheless, households are still relatively insulated from the immediate impact of higher interest rates on this form of debt than in the past, as the majority of outstanding mortgages have a fixed period of two years or more. This delays any impact of higher interest rates for most borrowers. However, most borrowers will be affected by rising mortgage rates in the medium term, which could mean a significantly higher interest cost if monetary policy tightens by more than our base case.

Chart 10: Government bond yields are rising



Source: Refinitiv Datastream.

Chart 11: Mortgage interest rates are set to rise



Source: Bank of England.

The labour market: Testing the limits

The UK labour market has continued to tighten. The unemployment rate was 3.8% in the three months to April, down 4.9% a year earlier. The redundancy rate fell to its lowest level on record, suggesting that a sharp rise in unemployment appears unlikely in the short term.

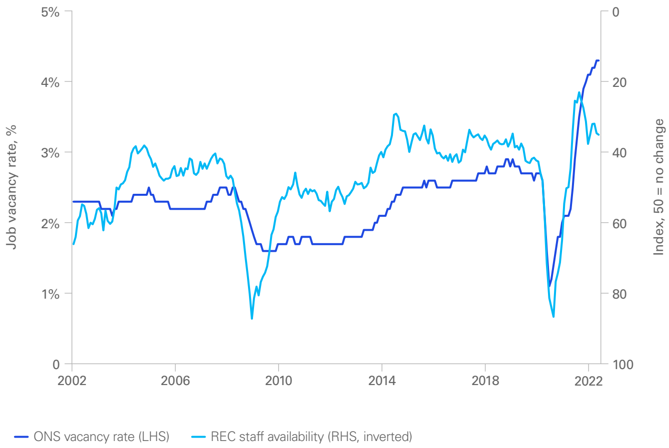
The main challenge remains the ability of firms to hire workers. The demand for staff has been growing since the gradual lifting of COVID-19 restrictions last year, but the availability of workers hasn't kept up pace with the job openings. Recent data show that job vacancies continue to match the number of unemployed people, with the vacancy rate at its record high of 4.3% (see Chart 12).

This mismatch reflects a combination of cyclical and structural drivers in the labour markets globally. In the UK, many foreign workers returned home during the pandemic, while potential skill shortages have made it harder to match workers with jobs. In addition, some workers left the labour market altogether, for reasons ranging from health problems to early retirement. The UK is not unique in experiencing a tight labour market, however – vacancy rates in the US and the Eurozone are also at record highs, with the lack of staff reported as one of the key factors limiting production.

At a sectoral level, the greatest pressure is currently felt in hospitality, followed by ICT and arts & entertainment (see Chart 13). Although accommodation & food services have historically tended to experience higher vacancy rates because of greater churn in the sector, they have also seen the steepest increase in openings since before the pandemic. While this can reflect an exodus of foreign workers as a result of both COVID-19 and Brexit, the high demand for ICT workers is likely related to a growing share of digital products and services within the post-pandemic economy.

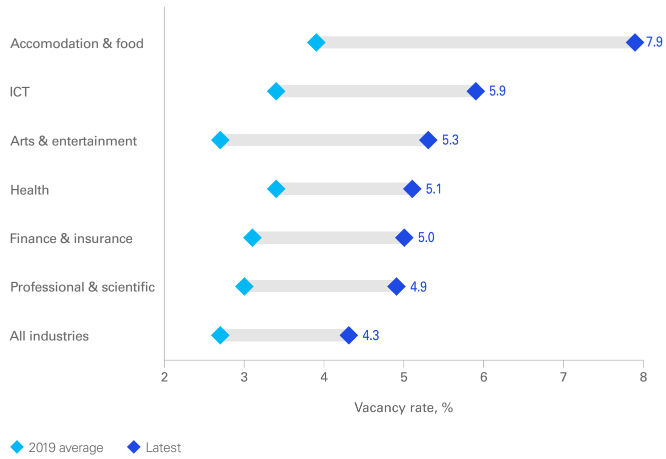
Recent survey data show tentative signs that the labour market could soon begin to cool off. Hiring difficulties have eased since the turn of the year, according to the latest KPMG/REC Report on Jobs, albeit they remain at a high level (see Chart 12). A key question ahead of the summer months will be whether the squeeze on household budgets will result in a lower demand for employees as businesses adjust their hiring needs against the backdrop of weaker activity. Our forecast envisages a gradual pickup in the unemployment rate, averaging 4.2% in 2022 and 4.6% in 2023.

Chart 12: Improving staff availability may signal that vacancy rate is peaking



Source: ONS, REC, KPMG analysis.

Chart 13: Industries with the highest vacancy rates

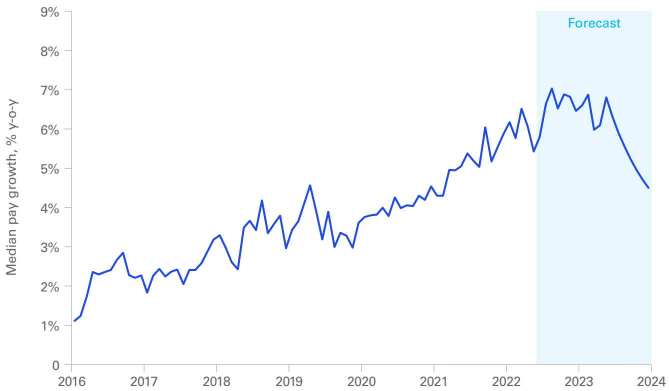


Source: ONS, KPMG analysis.

Nonetheless, the ongoing staff shortages mean that 2022 is likely to continue to be an employee's market. Pay growth has picked up in recent months, reflecting the mismatch between the supply and demand, as well as the efforts by some employers to alleviate the pressure from higher inflation on take-home pay. Permanent and temporary placements fell to their lowest levels since early 2021, driven by shortages of skilled candidates.

Pay growth is likely to stay elevated in the coming months, before moderating next year. Our forecast is for median pay growth to peak at around 7%, averaging 6.3% in 2022 and 5.8% in 2023 (see Chart 14). There is significant uncertainty around this outlook, however. For example, a sharper slowdown in activity could depress hiring more significantly, thus limiting the strong bargaining power currently exerted by employees. Set against that, a continued inflationary environment could lead to escalating pay demands.

Chart 14: Median pay growth is set to peak later this year



Source: ONS, KPMG analysis.

Note: The series has been adjusted to exclude the volatile COVID factors over 2020-21.

The housing market: At a turning point

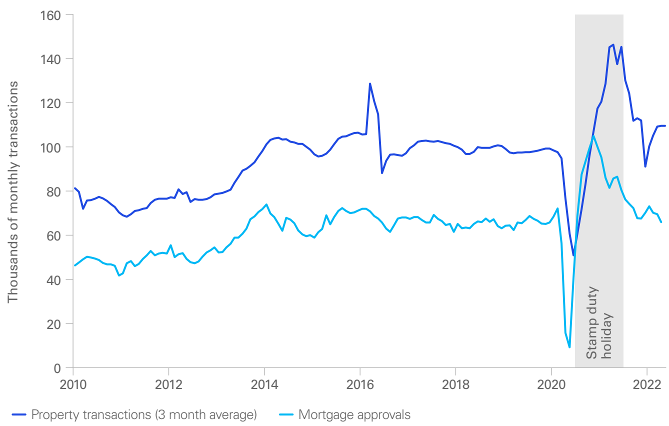
The housing market has remained resilient in recent months. Although activity has moderated following the boost from stamp duty holiday that ended last year, residential property transactions and mortgage approvals both remain around the average levels seen over 2018-19 (see Chart 15). Nonetheless, transactions are expected to fall by around 16% this year due to the high level last year.

Strong demand for housing has continued to boost house price growth. The official index from HM Land Registry showed overall growth of 12.4% in the year to April, with variation across the regions. The South West saw the highest growth over the past year (14.1%), with London experiencing the weakest growth (7.9%), albeit remaining the most expensive region in the UK. Other indicators, including those by Nationwide and Halifax, corroborate the story of strong growth in house prices (see Chart 16).

Robust demand has been met by a stable increase in supply, but constraints have risen. The stock of dwellings in England rose by 0.9% in 2021, broadly in line with the average since 2014. However, the ongoing supply bottlenecks could impair growth this year due to lower availability and higher prices of construction materials.

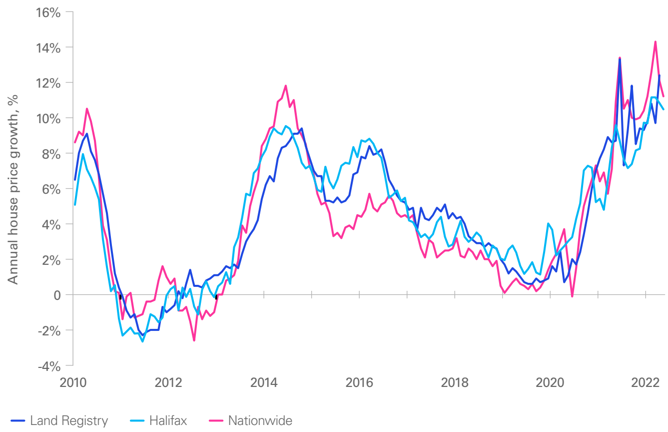
Rapidly falling affordability could be a key driver of a slowdown in the housing market. Since the start of 2020, nominal household incomes haven't kept up pace with house prices. Median pay rose by 12% cumulatively, against growth of 21% in average house prices (see Chart 17). In addition, higher mortgage interest rates will increase the cost of servicing debt, reversing the downward trend seen over the past decade (see Chart 11 above).

Chart 15: Housing activity back to more normal levels after the stamp duty holiday



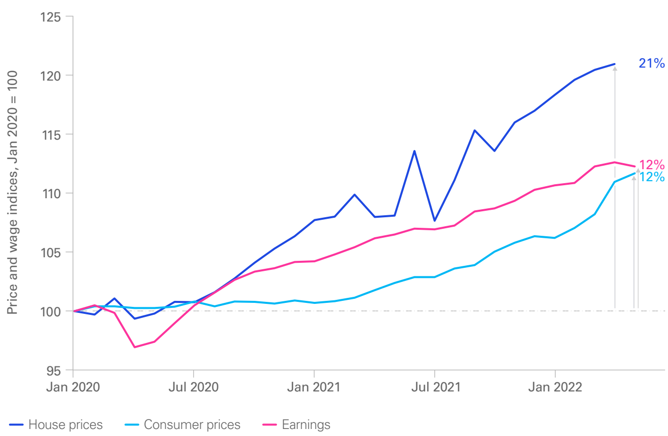
Source: HMRC, Bank of England, KPMG analysis.

Chart 16: Indicators of house price growth



Source: HM Land Registry, Nationwide, Halifax.

Chart 17: House prices are up by more than median pay and inflation



Source: HM Land Registry, ONS, KPMG analysis.

UK consumers: Under pressure

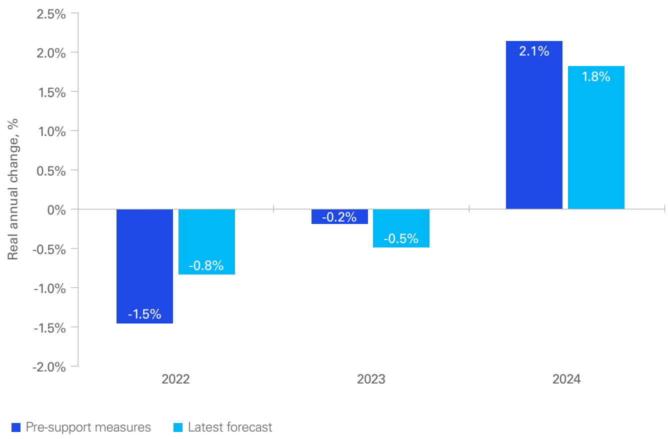
Household budgets have come under pressure as the high and persistent level of inflation erodes their purchasing power. Increases in the cost of living have been driven by higher energy and food costs as a consequence of Russia's invasion of Ukraine in February 2022, and the rising burden of personal income tax and national insurance contributions among other factors. Overall consumption is set to expand by 3.9% in 2022 driven in part by weakness in 2021 and then by a modest 0.9% in 2023.

Support measures announced by the UK Government have helped mitigate the expected impact of higher energy bills for lowest income households. However, despite the support on offer, we expect overall household incomes to fall by 0.8% in real terms this year and 0.5% in 2023 (Chart 18). We expect households to smooth their overall spending by making greater use of savings and lines of credit during the next two years, pushing down on the UK's saving rate during this period.

Consumer confidence has fallen. The combination of falling real incomes and rising costs have pushed consumer confidence to its lowest level on record in June 2022. This could see more pre-cautionary saving by households, and less spending overall over the forecast. However, the collapse in confidence is being offset to some extent by continuing strong labour market performance and the fact that some households were able to accumulate a significant £180bn of savings during the course of the pandemic.

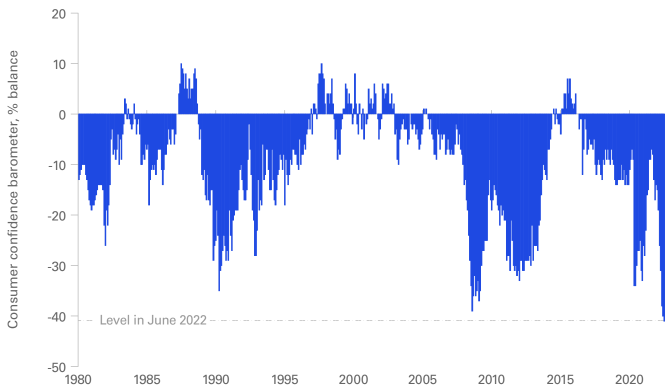
Consumers are expected to shift their consumption patterns away from areas of discretionary spending. Surveys point to a potential fall in non-essential purchases among the 54% of respondents who experienced an increase in their cost of living, while 39% plan to limit their car use. In addition, data on retail sales shows a marked increase in alcohol sales that suggests a switch away from bars and pubs as a way of saving on the cost of going out, although some consumers may prioritise experiences they were not able to have at the height of the COVID pandemic.

Chart 18: Impact of May 2022 support measures on growth in real household disposable incomes



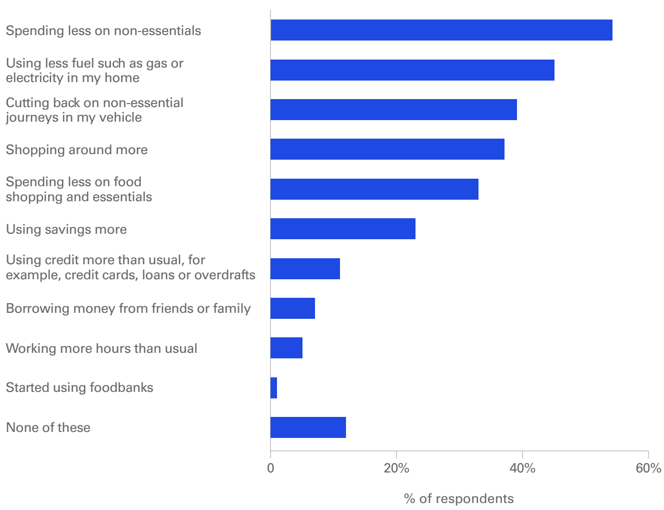
Source: ONS, OBR, KPMG analysis.

Chart 19: UK consumer confidence has fallen to record lows



Source: GfK.

Chart 20: Household responses to increases in the cost of living



Source: ONS.

UK investment: Delayed recovery

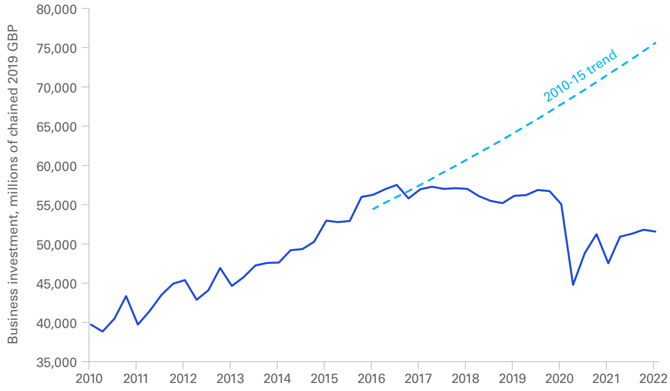
UK business investment has underperformed since the Brexit referendum in 2016 and following the COVID pandemic. Latest data shows the level of business investment in Q1 2022 was 9.1% below the level in 2019 Q4. The level of underperformance becomes even more pronounced if levels of investment are compared to those implied by pre-2016 trends (see Chart 21).

Russia's invasion of Ukraine increased geopolitical uncertainty, although that has moderated somewhat recently (see Chart 22). Higher uncertainty could hinder investment over the course of our forecast, which in turn could lead to lower overall economic growth.

Tighter monetary policy has raised borrowing costs for businesses. Higher costs of borrowing are likely to further dampen investment this year. Yields on investment grade corporate bonds increased by 2.4% between the start of the year and June 2022 (see Chart 23). The extent of further tightening of monetary policy could further raise the cost of borrowing for businesses in our forecast.

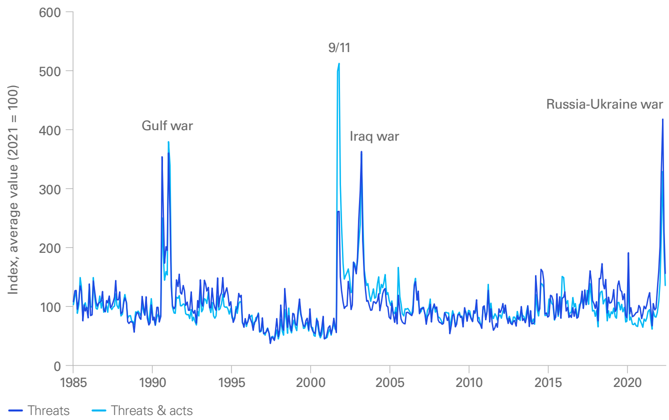
Investment growth is supported by government policy incentives. We expect overall investment to grow by 5.4% during 2022, driven in part by the incentives provided by the government's super-deduction scheme, which focus on investment in plant and machinery. This scheme is currently set to expire at the end of the first quarter of 2023, which could see investment decline by 2.4% during that year. The government is likely to prioritise the support for business investment in an attempt to boost long term productivity. A potential replacement for the scheme may therefore be announced later this year to help support investment next year.

Chart 21: UK Business investment has underperformed



Source: ONS.

Chart 22: Measures of geopolitical uncertainty have increased



Source: Dario Caldara and Matteo Iacoviello (2021), *Measuring Geopolitical Risk*, working paper, Board of Governors of the Federal Reserve Board, November 2021.

Chart 23: Yields on corporate lending have risen

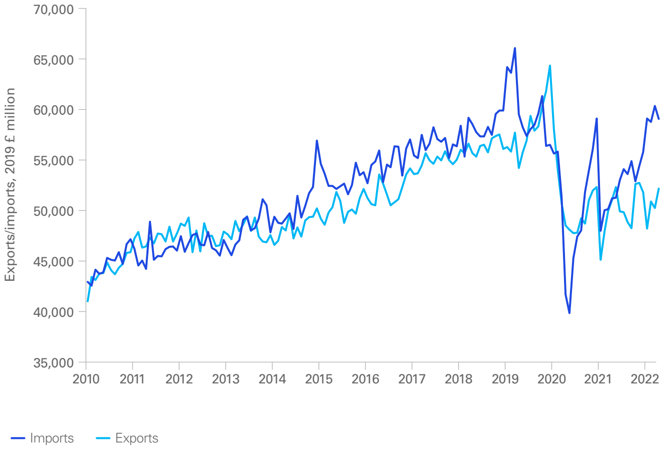
Source: S&P Global.

Trade outlook: Persistent underperformance

Export performance has been weak and further deterioration is possible. UK export volumes have not yet reached pre-pandemic levels, suggesting the possible long-term impact of changing in trade relations after Brexit may play a role, since UK exports performance has been relatively poor compared to other western economies in recent months. Latest data shows that total exports for Q1 2022 were still 20% below their 2019 Q4 levels (see Chart 24). Weakening global demand could weigh on UK exports further, especially if some of the UK's main trading partners experience a sharper slowdown next year.

The direct impact of the invasion of Ukraine and the associated sanctions is likely to be small. UK's direct trade with Russia is relatively small. Imports to Russia made up 1.7% of UK total in 2021, and exports just 0.7%. Nevertheless, the rising cost of energy imports due to the conflict has been partially responsible for the sharp increase in UK imports in the first four months of 2022, as fuels make up around 14% of UK imports.

Chart 24: UK exports have yet to recover to pre-2020 peak



Source: ONS.

Sector outlook: Slowing momentum

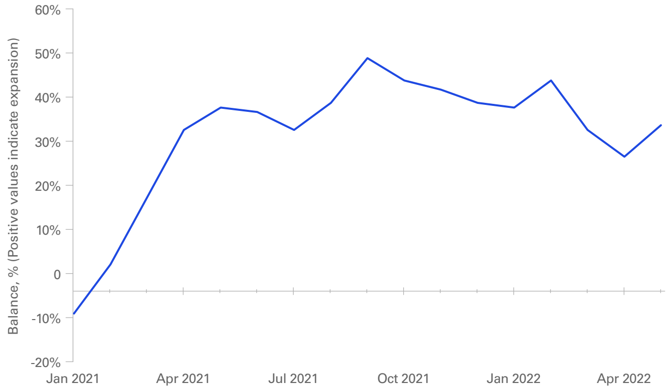
Overall business confidence remains at high levels, albeit with an anticipation of a slowing pace of expansion in the near term. Some measures, such as the Lloyds business barometer remain buoyant, with a majority of businesses reporting an improvement in economic conditions in May this year (see Chart 25). Agent surveys conducted by the Bank of England also point to key bottlenecks arising from supply chain issues and labour shortages rather than a shortfall in demand. These difficulties are particularly pertinent in manufacturing. We expect supply issues to gradually ease during the course of this year, although headwinds in the form of a potential deterioration in Russian energy supply or further lockdowns in China as a result of its zero COVID policy could worsen the outlook.

Growth is expected to slow across all sector groups. PMI readings showed a fall across the three main groupings of economic sectors, yet all three remained above 50 in May and June 2022, indicating continuing growth in the near term (see Chart 26). The sharpest fall was recorded in the service sectors, which in May this year saw its weakest performance since February 2021, with survey respondents raising concerns about the fallout of high inflation on consumer demand. We anticipate a gradual rotation of the main headwinds to economic activity to change from supply factors such as supply chain frictions and labour shortages towards demand pressures resulting from the squeeze on household income.

Manufacturing performance could see an incomplete recovery. The sector could see relatively subdued growth during this year as production is held back by lingering disruptions to supply chains, while weakening of export demand could impact it next year.

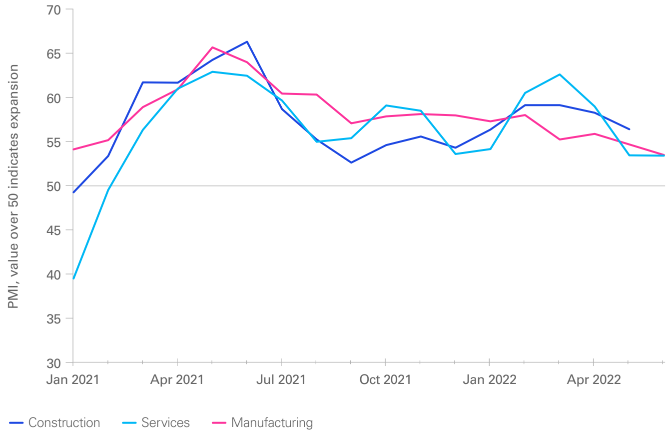
Consumer facing sectors to see a slowdown over 2023. Meanwhile, consumer-facing service sectors, such as transport and hospitality are expected to see relatively stronger growth during 2022, driven by consumers returning to experiences they couldn't do during the pandemic. However a shortfall of domestic demand could dampen output in these sectors next year (see Table 2).

Chart 25: Business confidence has stayed resilient so far



Source: Lloyds Bank Business Barometer, BVA BDRC. Respondents' perception of the economy compared to three months ago.

Chart 26: Purchasing managers indices have fallen



Source: CIPS/S&P Global.

Table 2: Sector real GVA growth in main scenario

	2021	2022	2023	2024
Agriculture	4.0%	6.3%	1.5%	0.1%
Mining and quarrying	-11.3%	6.4%	5.7%	2.1%
Manufacturing	7.2%	1.2%	-1.9%	-1.1%
Utilities	3.2%	-0.6%	-2.1%	-1.7%
Construction	12.9%	4.9%	-1.7%	-0.8%
Retail and distribution	8.0%	-0.4%	0.2%	0.2%
Transport	9.5%	11.9%	-4.1%	-0.2%
Hospitality	37.2%	31.6%	0.4%	1.1%
IT and Media	5.5%	9.3%	12.9%	11.4%
Financial services	1.7%	-2.4%	-6.1%	-1.6%
Real estate	-0.2%	-0.2%	2.5%	1.5%
Business services	9.0%	2.4%	-0.1%	1.0%
Public services	11.9%	-0.8%	1.0%	1.5%
Arts and recreation	20.7%	14.0%	1.7%	1.3%
Other services	7.1%	13.8%	3.1%	2.4%

Source: ONS, KPMG analysis.

Outlook for GDP: Rising risk of recession

The UK economy faces a number of global and domestic risks. These could lead to a significant deceleration in economic growth and potentially to a mild recession (see Chart 27). In our main scenario, we assume a gradual increase in interest rates in the UK, US and Eurozone alongside an increase in long-term interest rates leading to tighter financial conditions for firms and households. This could see GDP growing by 3.2% in 2022 and by 0.7% in 2023.

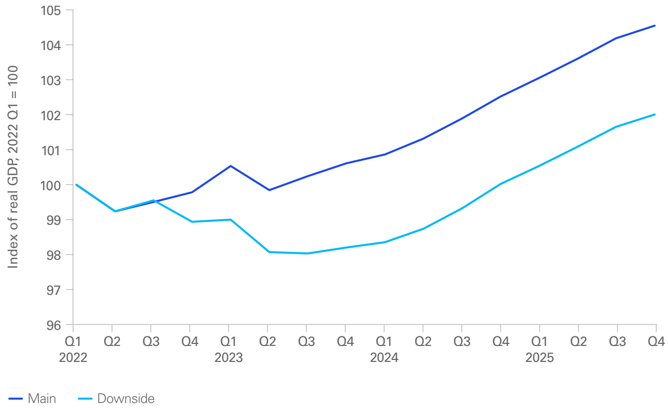
A weaker scenario, depicted in our downside forecast could see the economy entering a mild recession. Given the weak outlook, a more severe scenario is a distinct possibility, although a lower likelihood than our main scenario. It captures a potential deterioration across three main headwinds facing the economy, with the main impacts falling on the fourth quarter of 2022. These include:

- A potential US recession arising from a significant monetary tightening by the US Fed;
- A potential Eurozone recession due to interruptions of gas supplies from Russia, as well as a significant additional shock to global wholesale gas and oil prices;
- An ongoing and worsening squeeze on UK household incomes leading to a sharp decline in household consumption.

The recession modelled in our downside scenario involves a 1.5% fall in GDP in the year between 2022 Q3 and 2023 Q3. This is less severe than other recessions the UK experienced in the past, especially compared to the Great Recession, which saw a nearly 6% fall in GDP in the five quarters following Q1 2008 (see Chart 28). The UK economy is expected to contract by 1.1% next year in our downside scenario following 3% growth this year, with consumer spending falling by 1.9% in 2023.

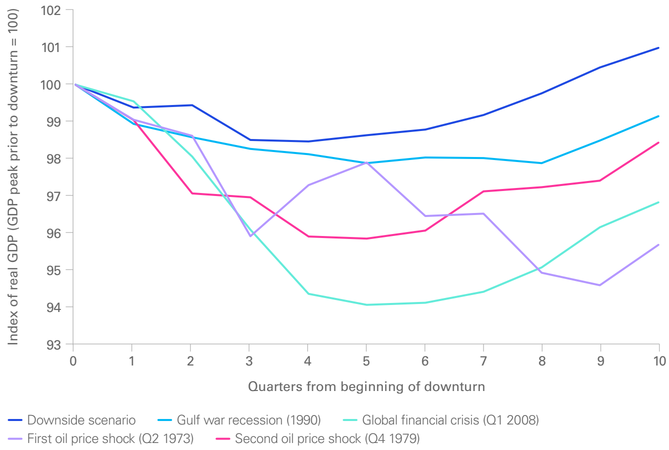
We expect manufacturing and financial services to be among the worst affected sectors in our downturn scenario. Manufacturing GVA growth could be down by 3.2% in 2023 and 1.7% in 2024 compared to our main scenario as the sector tends to be more export intensive, and more vulnerable to a fall in external demand arising from US and Eurozone recessions. Meanwhile financial services could also see significant losses from a downturn as it negatively affects UK's household incomes and raises the potential for significant loan losses and write-offs (see Table 3).

Chart 27: KPMG scenarios for the UK economy



Source: ONS, KPMG analysis.

Chart 28: Recession in our downside scenario may be relatively mild



Source: ONS, KPMG analysis.

Table 3: Sector GVA growth forecasts in our downside scenario

	2021	2022	2023	2024
Agriculture	4.0%	6.0%	-2.3%	-1.9%
Mining and quarrying	-11.3%	6.1%	2.1%	-0.1%
Manufacturing	7.2%	0.8%	-5.1%	-2.8%
Utilities	3.2%	-0.9%	-5.0%	-3.4%
Construction	12.9%	4.8%	-3.5%	-1.8%
Retail and distribution	8.0%	-0.6%	-2.0%	-0.3%
Transport	9.5%	11.7%	-5.8%	-1.1%
Hospitality	37.2%	31.5%	-0.2%	1.0%
IT and Media	5.5%	9.0%	10.4%	11.1%
Financial services	1.7%	-2.7%	-8.8%	-2.5%
Real estate	-0.2%	-0.3%	1.6%	1.5%
Business services	9.0%	2.3%	-1.7%	0.3%
Public services	11.9%	-0.9%	0.1%	1.3%
Arts and recreation	20.7%	13.8%	0.7%	1.2%
Other services	7.1%	13.5%	1.6%	2.0%

Source: ONS, KPMG analysis.

UK regions: Calm before the storm

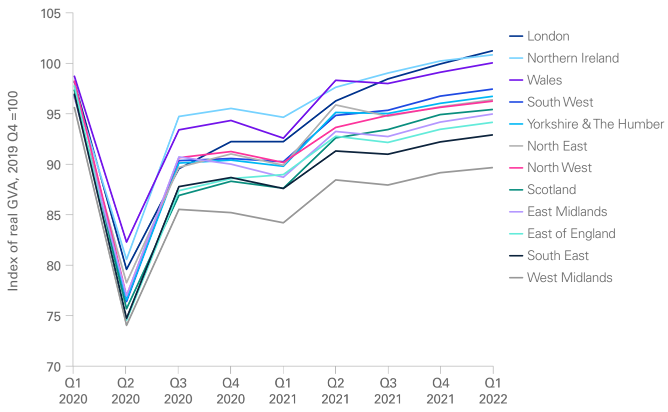
Post pandemic recovery has been uneven across the UK. Early estimates of regional GDP suggest that of the 12 regions and countries of the UK, only three – London, Northern Ireland and Wales – have so far exceeded their pre-pandemic levels of output (see Chart 29). While this is based on preliminary estimates and is likely to see some revisions, it points to a substantial level of scarring inflicted by the pandemic on the majority of the UK's regional economies.

Supply chain issues have held back some local economies reliant on manufacturing sectors. The underperformance of the West Midlands is notable in this case, as in Q1 2022, the level of real GDP was more than 10% below its pre-pandemic level of output. A gradual recovery in supply chains could support growth in these regions, causing them to potentially outperform the wider UK economy over the next year.

Survey data points to a widespread expansion. More timely data from surveys of purchasing managers shows all regions and countries of the UK undergoing an expansion in output during May (see Chart 30), although national data suggests this pace of expansion is likely to slow and could see a brief contraction during the second quarter of this year.

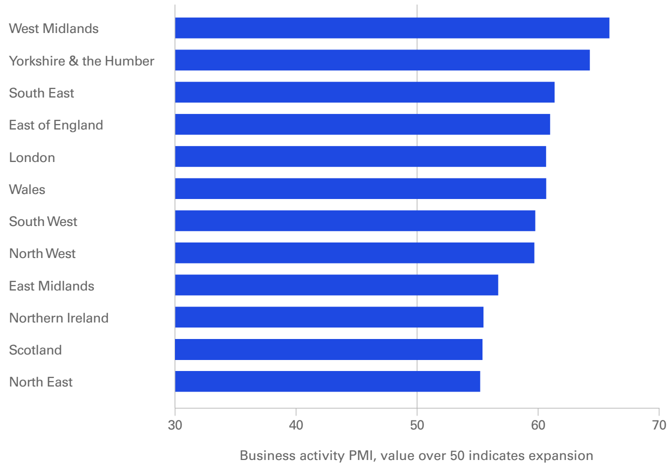
However, demand appears to be falling in the majority of UK regions and countries. Evidence is also emerging that firms are starting to experience a gradual fall in demand, likely as a result of the slowdown in consumer spending. A survey conducted by the ONS shows that in all but four regions and countries of the UK, a greater share of businesses reported a fall in demand for their goods and services rather than increases (see Chart 31). This suggests that as with the wider UK economy, a weakening of demand could bring slower growth in these locations over the next year.

Chart 29: Most UK regions have not yet recovered to pre-pandemic output levels



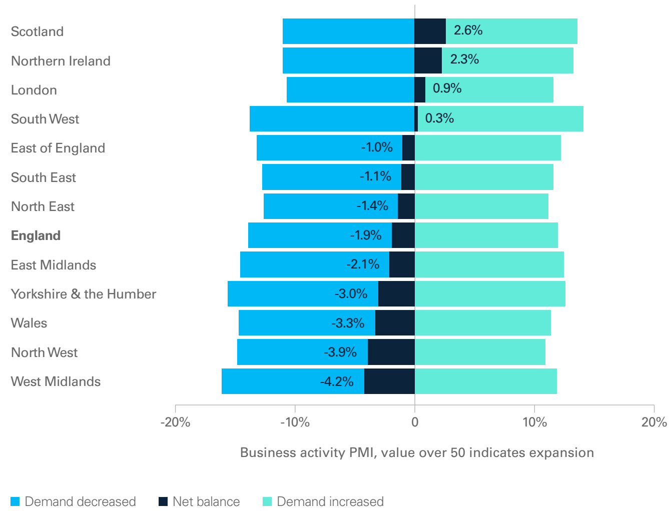
Source: ONS.

Chart 30: PMI surveys point to expansion in all regions and countries of the UK



Source: Natwest.

Chart 31: Majority of regions report falls in demand



Source: ONS BICS survey, 1 June 2022.

Public sector finances: Easing the squeeze

Public finances have continued to recover from the COVID-19 shock. Public sector net borrowing more than halved in 2021-22 compared to a year earlier, reaching 6.1% of GDP (see Chart 32). In contrast, it took five years for the deficit to halve from its peak following the global financial crisis.

The phasing out of the government's COVID-related packages has eased much of the burden on borrowing going forward. In 2021-22 alone, the Coronavirus Job Retention (CJRS) and the Self-Employment Income Support (SEISS) schemes together cost the taxpayer £17bn, while NHS Test & Trace added a further £16bn.

Nonetheless, rising inflation continues to put pressure on debt interest payments. Although inflation pushes people into higher tax brackets as their nominal incomes rise, a quarter of UK debt is financed by index-linked gilts, the liability on which increases with RPI inflation. Following the latest spike in RPI inflation, we now expect monthly interest spending to reach £16bn in June, exceeding the annual day-to-day budget of the Home Office.

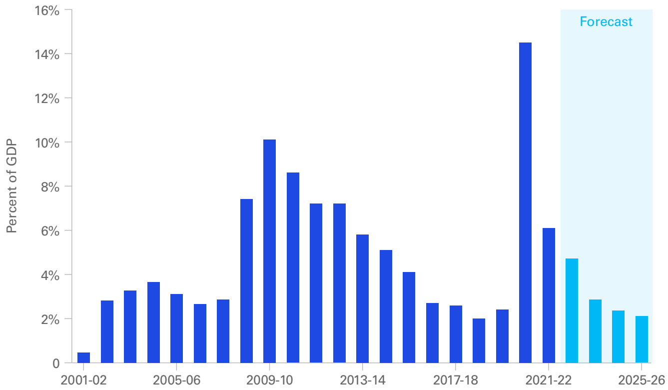
Higher receipts will drive a further reduction in borrowing in 2022-23. We expect the overall tax take to rise by £63bn this year, thanks in part to a strong labour market and pay growth (see Chart 33). This improvement is set to be partly offset by higher government spending plans consistent with the March 2022 Spring Statement. The £26bn planned increase in spending this year includes the earlier package of energy support measures worth £11bn to help households with the cost of living crisis.

On top of the help announced earlier this year, the government set out a further package of support in May, worth £15bn. These new measures, addressing the ongoing cost of living crisis, have been targeted at those with the greatest need – including those on means-tested benefits, pensioners, and in receipt of disability benefits.

Part of the increase will be offset by a new Energy Profits Levy. Known as the 'windfall tax' on energy companies, it comprises a 25% surcharge on the profits made by the oil and gas sector. The levy is expected to raise around £5bn over the next year. In conjunction with the latest package of cost of living measures, this constitutes a £10bn fiscal loosening this year, equivalent to 0.4% of GDP.

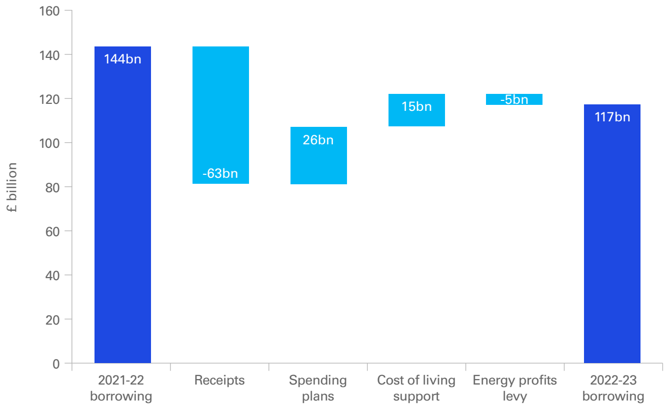
We forecast debt-to-GDP ratio to peak two years later than the OBR. The latest fiscal giveaways and weaker economic outlook mean that debt will likely continue to rise this year and next, peaking at 98.3% in 2023-24 (see Chart 34). This would be its highest level since 1962-63.

Chart 32: Public sector net borrowing



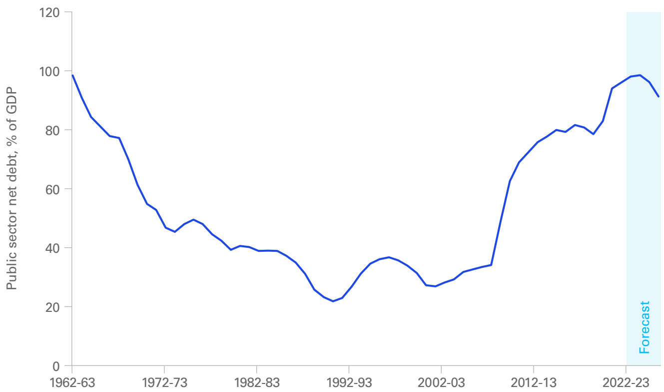
Source: ONS, KPMG analysis.

Chart 33: Sources of changes to public sector net borrowing in 2022-23



Source: ONS, OBR, Gov.uk, KPMG analysis.

Chart 34: The outlook for government debt



Source: ONS, OBR, KPMG analysis.

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