KPMG

UK economic update

June 2023

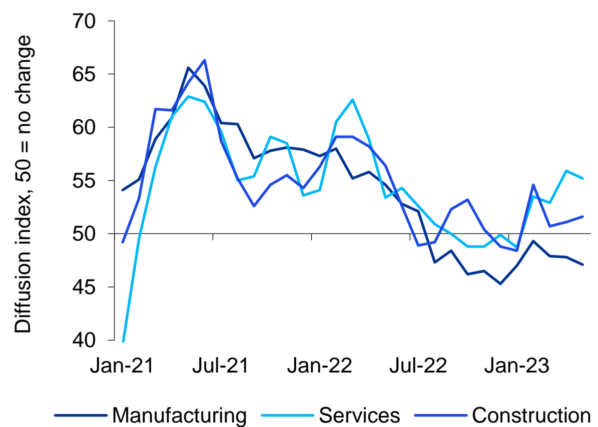
Key points

- The UK economy will likely escape a recession thanks to a better outlook for energy prices, a more resilient global environment, and continued tightness in the labour market. Nevertheless, we expect growth to remain weak by historical standards, and risks are skewed to the downside.
- Inflation continues to fall from its peak, but at a slower pace than implied by movements in energy prices. Elevated core inflation, services price inflation, and pay growth all point to a more persistent underlying price pressure.
- Households and businesses have been adjusting to higher prices and interest rates by curbing consumption and investment. Although inflation is set to continue to fall in the near term, borrowing costs will likely remain higher for longer, depressing activity.

The UK economy has so far avoided a technical recession which was widely expected throughout 2022. The government has provided households and businesses with some support against higher energy prices, including a cap on household utility bills. A tight labour market has kept a lid on unemployment, while excess savings accumulated during the pandemic have been gradually used up, alleviating the squeeze on real incomes. Nonetheless, the impact of monetary tightening is yet to fully feed through to the economy, slowed in part by the stock of fixed-rate debt which hasn't reached maturity.

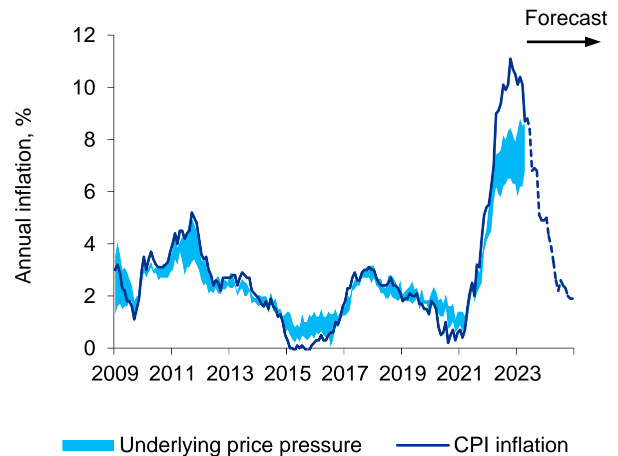
We expect these headwinds to continue to drag on UK activity throughout this year. GDP is still 0.5% below its pre-pandemic level at the end of 2019, with consumption down by 2.3% and business investment 1.4% lower. This lacklustre performance, if sustained, could lead to annual GDP growth averaging 0.3% in 2023, relatively weak by historical standards[(a)]. We see downside risks to this forecast, however, given the ongoing stickiness of UK inflation, recent tensions in the banking system, the uncertain impact of such rapid rise in interest rates on the economy, and worsening geopolitical tensions.

Chart 1: Growth across sectors has been mixed



Source: Refinitiv Datastream.

Chart 2: Underlying price pressure remains elevated



Source: ONS, KPMG analysis.
Note: Underlying price pressure is the range of core CPI inflation, weighted median CPI, and trimmed (10%) mean CPI.

Note (a): See Table 1 below for a summary of our key forecasts.

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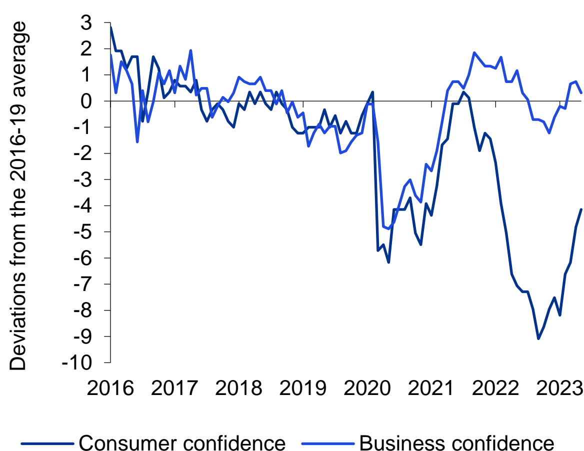
The latest survey evidence paints a mixed picture across UK sectors. The composite PMI has picked up in recent months, with the services sector consistent with relatively robust growth, while manufacturing has been pointing to a contraction (see **Chart 1**). This divergence is not unique to the UK and is likely driven by the more cyclical nature of the demand for goods, as well as particular pressures on the manufacturing sector. Services have been more affected by the pandemic restrictions, leading to a rotation towards goods, while the post-pandemic reconfiguration has likely boosted the demand for services at least in the short term. Manufacturing production has likely been more sensitive to higher energy prices and interest rates compared to services, which rely more on intangible capital. It has also been more sensitive to earlier pressure on supply chains and to worsening trade relations.

Global activity has also been mixed. World GDP grew by 0.6% in 2023 Q1, according to the Bank of England's estimate, with growth of 0.3% in the US. Supply chain pressures have eased materially since the start of the year, supported by faster delivery times and a drop in shipping costs. The price of Brent crude oil is down by 36% year-on-year. Global trade volumes and manufacturing production, although subdued, have both picked up. Set against that, growth in the Eurozone was negative for two consecutive quarters, with Germany and Ireland falling into a technical recession.

Inflation continues to moderate, but at a slower pace than previously expected. Annual headline CPI inflation eased to 8.7% in April, down from 10.1% in March and a peak of 11.1% in October 2022 (see **Chart 2**). The fall in April was predominantly driven by last year's rise in electricity and gas prices falling out of the annual comparison. Nonetheless, inflation was higher than both market (8.2%) and Bank of England's (8.4%) expectations. This surprise came from the underlying (core) components of inflation, suggesting that price pressure could remain elevated for longer. Indeed, core inflation (which excludes energy and food) accelerated to 6.8%, its highest level since 1992, while the weighted median and trimmed mean measures have also picked up (see **Chart 2**). This provides significant risk to our forecast, which sees headline inflation moderating to 5% by 2023 Q4, averaging 7.7% in 2023 and 2.9% in 2024.

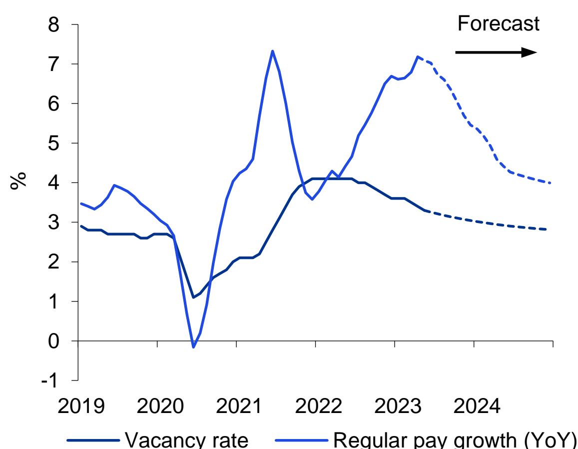
The official energy price cap from Ofgem has been reduced to £2,074 per annum for a typical household. This is down from the current cap of £3,280 and a peak of £4,279 at the start of 2023 and reflects a drop in wholesale gas prices in recent months. However, the fall in actual utility bills is set to be less pronounced because since October 2022 prices have already been capped by the government's Energy Price Guarantee at £2,500, overriding the Ofgem's cap. As a result, from July an average household could expect an effective reduction of 17% in their bills rather than 37% based on the official cap.

Chart 3: Business and consumer confidence



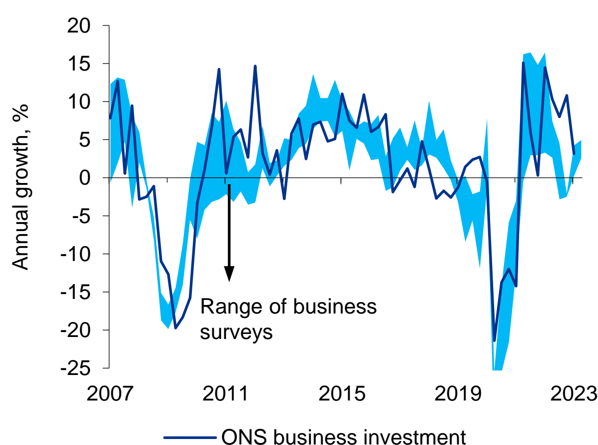
Source: GfK, Lloyds Business Barometer, KPMG analysis.

Chart 4: The labour market tightness is set to ease



Source: ONS, KPMG analysis.

Chart 5: Business surveys are consistent with subdued business investment



Source: ONS, CBI, BCC, Bank of England, KPMG analysis.

Note (b): CPI inflation in March 2022 was 11.7% for the bottom income decile, compared to 8.7% for the top income decile.

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Consumer confidence has bounced back, closing some of the gap relative to business confidence (see Chart 3). The headline index rose for the fourth consecutive month in May, with broad-based improvement across the balances for personal financial situation, general economic situation, and appetite for major purchases. However, the balance is still weak by historical standards and masks the impact of real income squeeze across different income groups. The lower-income group has been affected particularly badly by the cost of living crisis, as it spends a larger proportion of its budget on essential items which have gone up in price, including food, electricity and gas(b). The distributional impact of high inflation matters for our relatively weak consumption forecast, as spending by the lower-income households is more sensitive to changes in real income. We expect real household consumption growth to average 0.2% in 2023 and 0.6% in 2024.

The labour market has stayed remarkably resilient, but hiring is now easing. The unemployment rate was 3.8% in April, close to historical lows, and regular pay growth was 7.2%, its highest level outside of the pandemic. While headline indicators could give an impression of a historically tight labour market, they may also reflect more widespread remote working – which could be keeping the structural rate of unemployment lower, as it becomes easier to match workers with jobs. In addition, the falling cost of digital advertising may be keeping the vacancy rate artificially high. The latest KPMG/REC data are consistent with our view that economic uncertainty is keeping a lid on hiring. This is likely to bring a pivot in the bargaining power enjoyed by employees since the pandemic, driving down pay growth. Our forecasts point to regular pay growth averaging 6.5% in 2023 and 4.4% in 2024, as the vacancy rate continues to moderate (see **Chart 4**).

A higher interest rate environment is set to depress business investment and result in more corporate insolvencies. The Bank of England has raised interest rates for twelve consecutive times, with Bank Rate reaching 4.5% in May. Market interest rates have followed suit. Corporate bond yields are 400 basis points higher than in late 2021, while mortgage rates have risen too. We expect three further increases this year, taking base interest rate to a peak of 5.25%. On the corporate side, the impact of higher borrowing costs has manifested across a range of indicators, including a pickup in corporate insolvencies, a slowdown in M&A activity, and weakening business investment (see **Chart 5**). We therefore expect real investment growth of 0.8% in both 2023 and 2024.

Table 1: KPMG forecasts

	2021	2022	2023	2024
Real GDP	7.6	4.1	0.3	1.1
Consumer spending	6.3	5.3	0.2	0.6
Investment	6.1	8.6	0.8	0.8
Unemployment rate	4.5	3.7	4.1	4.5
Inflation	2.6	9.1	7.7	2.9
Base interest rate	0.25	3.50	5.25	5.00

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 and inflation measure used is the CPI and the unemployment measure is LFS.

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