UK Economic Outlook

September 2023

- The UK economy is experiencing renewed signs of stress. While the worries about a deep recession have largely gone away, the prospects of high interest rates, continued uncertainty, and low productivity are set to provide headwinds to growth in the near term. This will likely weigh on investment decisions, sterling, and UK-based assets.
- The post-pandemic imbalances are starting to normalise. Household excess savings are broadly used up, and the housing market is in retreat. We are now seeing the effects of higher interest rates feeding through to investment intentions, transaction volumes, and corporate insolvencies, although the full impact on the household and housing sectors is yet to be felt.
- Inflation remains high. While the resolution of global supply chain bottlenecks and the fall in wholesale energy prices have supported the easing of price pressures, domestic influences – supported by strong pay growth – have kept inflation elevated. This could see inflation returning to its 2% target only by the latter part of 2024, especially if businesses continue to pass on higher costs to rebuild margins.
- Households are finally seeing their incomes grow in real terms, but the outlook for consumption remains weak. Discretionary spending is down and the financial cushion in the form of excess savings has been used up. There are some bright spots, however: the pickup in consumer confidence suggests cautious optimism, and household balance sheets remain healthy.
- The labour market is starting to feel the weight of slowing activity. Hiring is losing momentum, while workers are less confident to switch positions. With the gap between labour demand and supply closing, coupled with improvements in households' purchasing power, we expect to see an easing in pay demands and a gradual fall in pay growth.
- With interest rates potentially at their peak in this cycle, attention will now turn to fiscal policy. The upcoming general election could see new spending pledges to address more immediate demands such as safety concerns around school buildings or authority deficits. However, longer-term headwinds remain, leaving uncertainty around the fiscal outlook beyond the next election.

Table 1: KPMG forecasts

	2022	2023	2024
Real GDP	4.1	0.4	0.3
Consumer spending	5.3	0.7	0.5
Investment	8.6	2.7	0.5
Unemployment rate	3.7	4.2	4.8
Inflation	9.1	7.5	2.7
Base interest rate	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, inflation measure used is the CPI, and unemployment measure is LFS.

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Outlook for GDP: Sluggish momentum

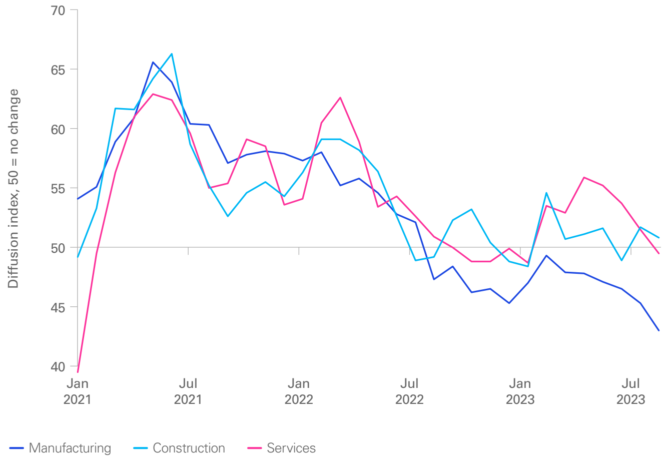
We expect growth to slow over the remainder of this year and into 2024. With the backdrop of weakening global economic conditions coupled with the lagged impact of higher interest rates, the UK economy could struggle to keep its head above water in the second half of the year. Our forecasts show real GDP growth slowing from 4.1% in 2022 to just 0.4% in 2023 and 0.3% in 2024 (see Table 1 for a summary of our key forecasts). With uncertainty around the upcoming general election, strength of demand, and the future trajectory of interest rates, risks to our forecast are skewed to the downside.

The latest data signal a broad-based slowdown in activity. Survey evidence from the Purchasing Managers' Indices increasingly points to a marked deterioration across all the main sectors (see Chart 1). Construction has been weighed down by a fall in housebuilding, services are exposed to the squeeze on household incomes, while manufacturing has been more sensitive to higher energy prices and interest rates. This comes on top of output lost due to industrial action across a range of sectors in recent months.

The outlook for consumption is weak by historical standards. A recent survey from the Bank of England's Agents has found demand to be increasingly driven by discounting, with weaker spending on staycations and eating out. Private car registrations are up 0.9% on a year-to-date basis, with consumers opting for cheaper second-hand alternatives. Retailers and the hospitality sector continue to see sales driven by higher prices, with volumes down as consumers are cutting down on the back of weaker purchasing power. Credit card spending has also been subdued, with a pronounced weakness in delayable purchases. Overall, we expect consumption to grow by 0.7% in 2023 and 0.5% next year.

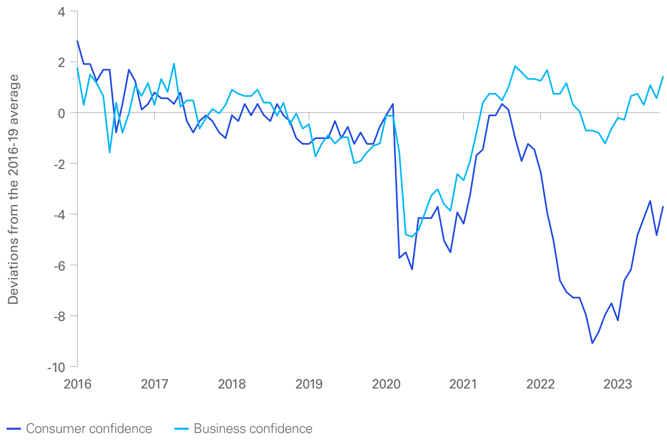
Consumer confidence has picked up but remains well below pre-pandemic levels (see Chart 2). The improvement has been broad based, with consumers feeling more optimistic about their own personal finances as well as the economic outlook over the year ahead. Nonetheless, the balance remains very weak by historical standards. There is also a risk that future consumption may be harder to finance given the erosion of excess savings accumulated during the pandemic (see Chart 3). However, that may also reflect the shifting of funds from deposits into higher paying bonds or paying down debt.

Chart 1: Momentum has weakened across sectors



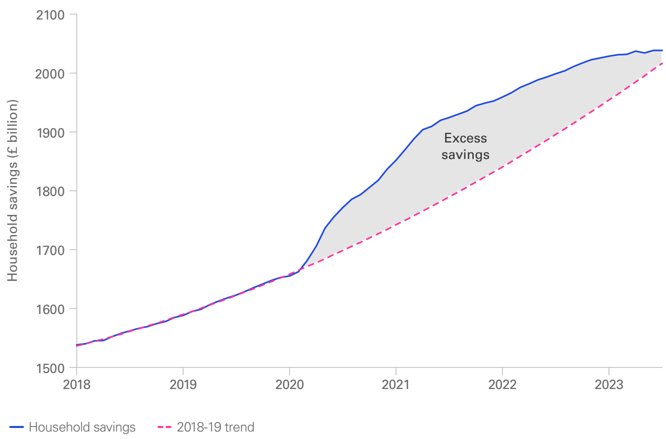
Source: Refinitiv Datastream.

Chart 2: Business and consumer confidence



Source: GfK, Lloyds Business Barometer, KPMG analysis.

Chart 3: Household excess savings have been broadly used up



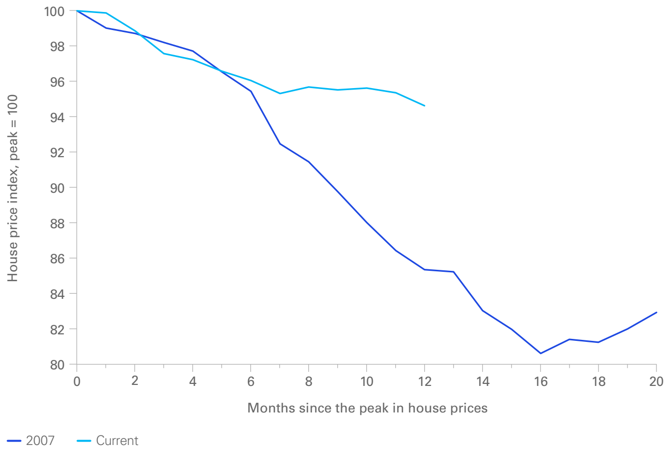
Source: Bank of England, KPMG analysis.

The housing market is gradually adjusting to higher interest rates. Mortgage approval fell by 22% in July on a year ago, while property transactions were down by 16%. This reflects both higher mortgage rates (a cost to borrowers) and a greater risk of defaults (a cost to lenders). According to Bank of England estimates, around 350,000 households will see their monthly mortgage payment increase by over £500 a month by the end of 2023. On the supply side, residential housing completions fell sharply at the start of the year, consistent with the weakness in construction output and residential PMI data. Taken together, our forecasts assume a peak-to-trough drop in nominal house prices of around 8-10%, equivalent to roughly half of the fall during 2007-09 (see Chart 4).

Business investment will be subdued against the backdrop of higher borrowing costs and uncertainty. Corporate bond yields remain close to the peak reached in the aftermath of the mini budget last year, while the Bank of England's Decision Maker Panel survey found that interest rates were expected to reduce business investment by 8% over the coming year. In addition, 17% of businesses surveyed by the ONS attribute the current headwinds to capex to uncertainty about demand or business prospects. Looking ahead, we expect next year to also be partially influenced by uncertainty around the upcoming general election, with investment decisions potentially postponed until there is more clarity on future policy direction. Combined with the weak outlook for residential investment, our forecast envisages total investment growth slowing to 2.7% in 2023 and just 0.5% next year.

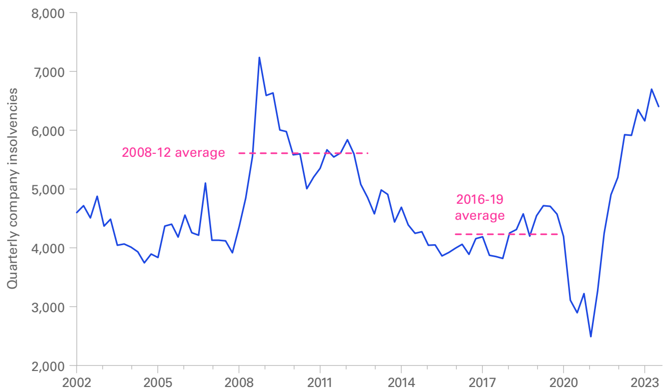
Corporate insolvencies remain elevated. Tighter credit conditions, higher input costs, and the withdrawal of government support have led to a sharp increase in bankruptcies in 2023 Q2, to their highest level since 2008 (see Chart 5). The preliminary estimate for Q3 has been more encouraging, and the fact that most business loans are of floating rate could potentially result in a faster pass-through of distress compared to the household sector. According to a recent survey from the ONS, only 8% of respondents see their business's risk of insolvency as 'severe' or 'moderate', down from over 20% in early 2021. Nonetheless, weaker growth prospects in the household and corporate sectors mean that the risk of further insolvencies remains elevated.

Chart 4: The housing market is cooling only gradually



Source: Nationwide, KPMG analysis.

Chart 5: Company insolvencies remain high



Source: The Insolvency Service, KPMG analysis.
Note: The data for 2023 Q3 is an estimate.

Long-term outlook: Structural headwinds

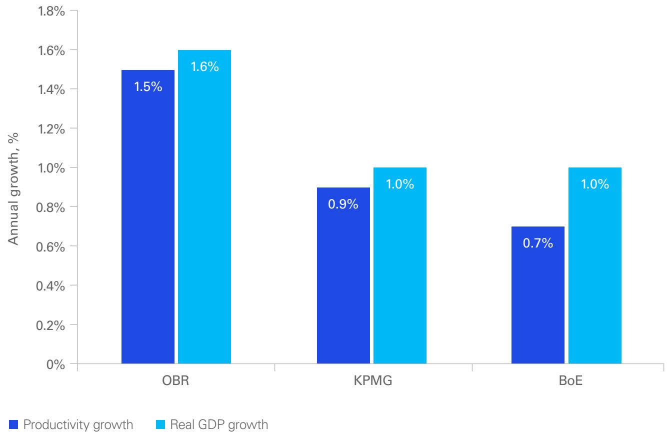
Our long-term assumption is for the UK economy to grow by an average 1%, which is significantly lower than the average GDP growth of 1.9% between 1990 and 2019. It sits between the estimates from the OBR and the Bank of England and is based on productivity growth of 0.9% (see Chart 6). The outlook for economic growth over the medium term and beyond will be determined to a large degree by prospects for labour supply and productivity.[1] As the horizon of longer-term forecasts spans beyond the next economic or political cycle, the focus turns to the slower-moving, structural drivers. These underlying factors are largely driven by demographic trends and other factors affecting the long-run supply potential of the economy.

Productivity remains a headwind to growth. The acceleration of digitalisation could see a rise in productivity over the medium term, as new technologies and working practices are gradually introduced. The rise of remote working may also have the potential to boost productivity by fostering greater flexibility in the labour market and a more efficient use of office space, but the evidence so far is mixed. In addition, the recent increase in input costs could encourage businesses to increase their production efficiency in order to rebuild margins, although that would take time. Set against that, however, we expect business investment growth to be weak, lowering its potential to improve labour productivity, while trade with the EU will likely remain constrained under the new bilateral arrangements, limiting the positive impact through greater access to new products and methods of productions.

UK's population growth is set to slow. The fall in the fertility rate has seen the number of births decline, while previous gains in life expectancy have meant that a greater share of the population is at old age. These trends alone could see the UK's population shrinking by up to 200,000 a year over the next 50 years (see Chart 7). Partly offsetting that, the ONS projects that net migration would settle at 205,000 a year form 2027, after reaching its highest level on record in 2022. This partly reflected the opening of humanitarian routes for people from Ukraine and Hong Kong, but also an increase in overseas recruitment by the NHS and a rise in foreign students. We see the outlook for migration potentially higher than that assumed by the ONS and crucially dependent on the Government's future migration policy.

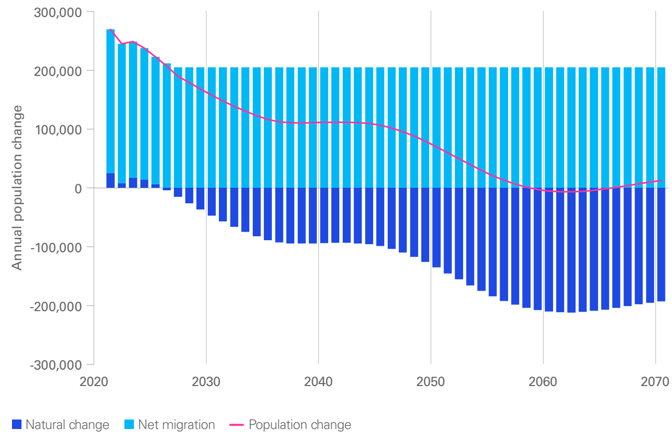
The size of the workforce will depend on the share of the population that is either employed or looking for work. Labour market participation has been recovering but remains at pre-Covid levels (see Chart 8). Inactivity increased sharply with the onset of the pandemic, driven by workers leaving the labour market due to health or early retirement, or by taking up studies. That trend has partly reversed over the past year as inactivity fell by around 200,000. We expect participation rate to continue to rise, as the recent squeeze on real incomes may encourage some to return to work, while greater ability to work remotely has facilitated new opportunities for those who find it harder to commute for work. Nonetheless, there is a wide range of views around how sustained that recovery could be (see Chart 8). Overall, that leaves the outlook for long-term economic growth relatively uncertain.

Chart 6: Long-term growth assumptions



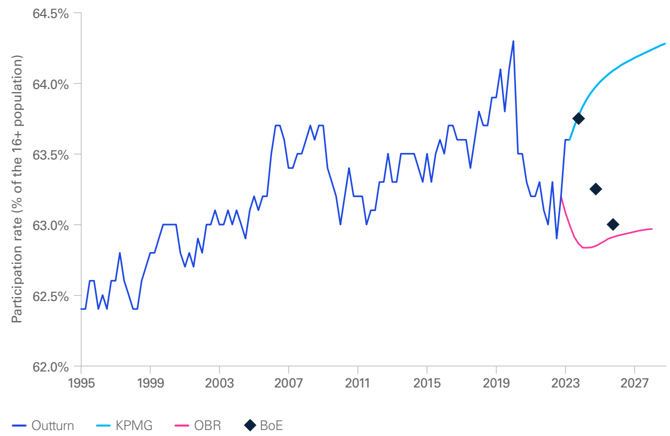
Source: OBR, Bank of England, KPMG analysis.

Chart 7: Population projections for the UK



Source: ONS, KPMG analysis.

Chart 8: Range of forecasts for the labour force participation rate



Source: ONS, OBR, Bank of England, KPMG analysis.

1 A useful way of thinking about long-term growth is given by:
GDP = Labour productivity * Population * Participation rate * (1 – unemployment rate)

Trade and supply chains: A mixed bag

Growth momentum is weakening in the global economy. Interest rates are at multi-year highs across the world's largest economies, acting as a drag on activity. The Eurozone continues to deal with the outfall of the energy shock and has seen lacklustre growth in the first half of the year. Germany faces several headwinds, including sustained weakness in its manufacturing sector. Although economic activity in the US has been relatively strong to date, increasing hopes of a 'soft landing', growth momentum is weakening, with latest PMI data consistent with a sharp slowdown in activity. Despite fears of a slowdown in global growth, oil prices have increased sharply since June. Announcements of production cuts by some OPEC members have fuelled the increase in prices. However, oil futures are suggesting a pull back from the current highs.

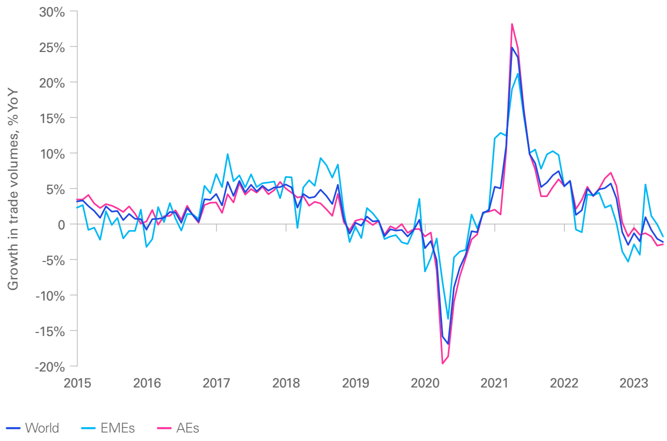
Trade flows have been impacted by the slowdown in global growth. Global trade volumes contracted for the third consecutive month in June, falling by 2.5% on a year earlier (see Chart 9). Trade conditions could worsen further in the second half of the year if the fears of an expected slowdown in China prove correct. UK trade has been particularly weak, underperforming other advanced economies in recent months. Nonetheless, we expect net trade contribution to UK growth to be negligible this year. While exports are expected to contract by 3.5%, this could be offset by a similar drop in imports which are set to fall by 3.7%, constrained by weak consumer spending.

Global supply chains have generally recovered from the post-pandemic shock. After peaking in December 2021, the latest supply chain pressures index remains below pre-pandemic levels (see Chart 10). The improvement in conditions has been broad-based, with shipping costs and container waiting times normalising. In the UK, evidence from the PMIs is pointing towards a recovery in domestic supply chains at an aggregate level, with suppliers' delivery times in the construction sector improving at their second fastest rate since April 2009.

Nonetheless, supply bottlenecks are still evident in some sectors across the UK. The new trade arrangements with the EU continue to feature as a key source of concern for firms. For example, survey evidence from the ONS shows more than 40% of exporters (and 39% of importers) citing Brexit as a major impediment to trade. With the pandemic-related trade disruptions dissipating, evidence is emerging of persistent weakness in UK trade. This underperformance can be partially attributed to the additional non-tariff barriers firms are facing following the UK's departure from the EU. With the EU accounting for nearly half of UK trade, continued frictions will likely weigh on trade in the near term as businesses adjust.

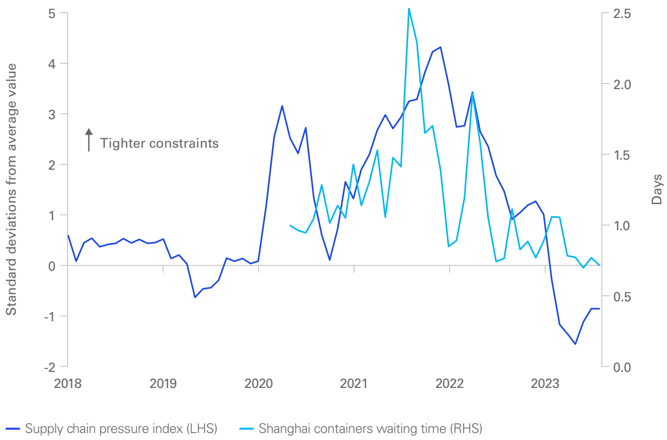
Sterling could lose momentum following appreciation in the first half of the year. The pound has performed strongly against the dollar and the euro in the first half of the year (see Chart 11). Going forward, markets expect a broadly stable outlook for the currency, consistent with growing concerns over domestic economic weakness and the recent easing in CPI inflation, which has decreased market expectations for the peak interest rate.

Chart 9: World trade has stagnated across most regions



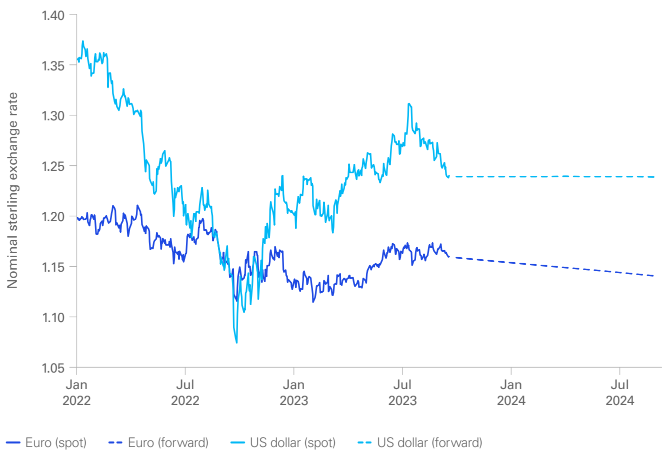
Source: CPB, KPMG analysis.

Chart 10: Supply chain pressures have eased



Source: Federal Reserve Bank of New York, Refinitiv Eikon, KPMG analysis.

Chart 11: Outlook for sterling exchange rate



Source: Bank of England, Refinitiv Datastream, KPMG analysis.

Inflation: Slow improvement

UK inflation continues to ease but remains above the levels in many western economies. Headline inflation fell to 6.7% in August, down from a peak of 11.1% last October (see Chart 12). The latest figure compares to 3.7% in the US and 5.2% in the Eurozone. The decline in inflation in recent months has been supported by the fall in wholesale energy prices, translating into falling household energy bills. The Ofgem price cap was reduced to £2,074 in July and is set to fall further to £1,923 in October. Beyond that, the current market pricing suggests that the impact of energy on inflation could be broadly neutral through 2024, as prices return to the seasonal patterns witnessed prior to the pandemic.

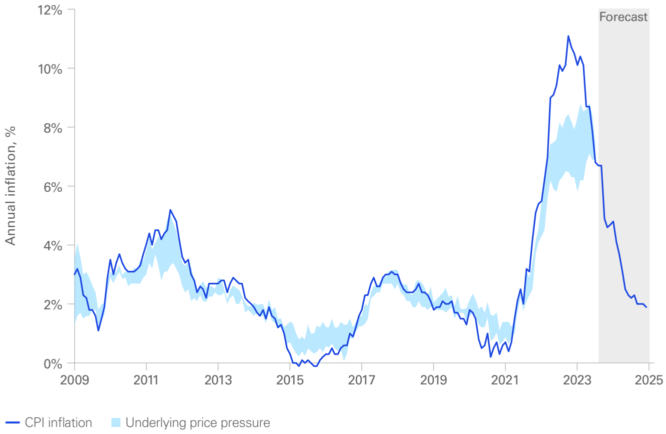
External factors have been favourable for UK inflation. The easing of global supply chain bottlenecks has seen sharp falls in the shipping costs across a range of measures. As a result, goods inflation – which is more sensitive to global developments because of its higher import content – has fallen markedly in recent months. Producer price inflation, which tends to lead goods CPI inflation by around three months, points to further easing in the months ahead (see Chart 13).

Nonetheless, inflation has been more persistent than initially expected, driven by domestic influences. Tightness in the labour market has fuelled pay demands across many sectors, while rising costs have led businesses to pass them onto consumers. Survey evidence from the Bank of England's Decision Maker Panel shows that firm expectations of future price growth are particularly elevated in the labour-intensive sectors. Similarly, the latest PMI shows that higher wages were the most frequently cited rising input cost by firms.

The outlook for core inflation will be shaped by the extent to which domestics price pressures normalise. There has been encouraging evidence of easing in inflation expectations. Households' short-term expectations fell sharply to a 19-month low in July, while longer-term expectations have also trended down, according to YouGov/Citigroup. Financial market expectations, including RPI swaps, are also down on a year earlier. As the impact of higher interest rates is gradually reflected in weaker activity, we expect inflation to average 7.5% this year, before falling to 2.7% in 2024 (see Chart 12).

Despite the tightening cycle reaching its peak, monetary policy will remain restrictive for some time. The Bank of England voted to hold interest rates unchanged at 5.25% in September. Market expectations for a peak in interest rates have fallen back from 6.5% in early July (see Chart 14). Some Bank of England officials expressed preference for keeping interest rates around the current level in the medium term, rather than raising them even higher before subsequently cutting them next year. Nonetheless, given the already fragile state of the economy and the full impact of past tightening yet to feed through to activity, we would expect the Bank to start contemplating cuts potentially from November 2024 onwards, especially if the US Fed loosens policy next year.

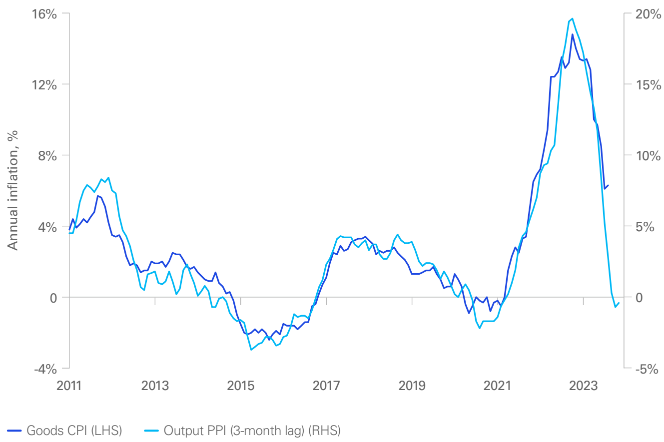
Chart 12: Underlying price pressure remains elevated



Source: ONS, KPMG analysis.

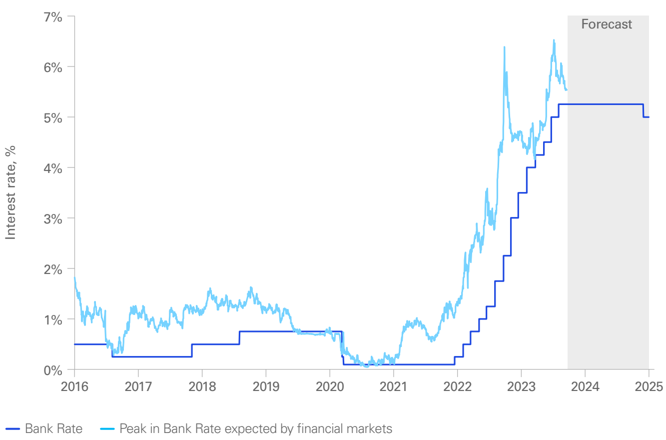
Note: Underlying price pressure is the range of core CPI inflation, weighted median CPI, and trimmed (10%) mean CPI.

Chart 13: Output prices signal further moderation in goods CPI inflation



Source: ONS, KPMG analysis.

Chart 14: Base interest rates have probably reached the peak in this cycle



Source: Bank of England, BIS, KPMG analysis.

The labour market: Precarious state

The slowdown in activity is gradually being reflected in the labour market. The unemployment rate was 4.3% in July, 0.7 percentage points higher than a year earlier, while the vacancy rate has dropped to 3.1%, its lowest level since mid-2021. Annual employment growth has slowed from around 1% at the start of 2023 to 0.5% in recent months. Participation rate has also recovered somewhat from the earlier depressed levels. As a result, the gap between labour demand and supply that has opened post-Covid is now broadly closed (see Chart 15).

One consequence of the earlier tightness in the labour market has been strong pay growth. Annual regular pay growth was 7.8% in July, with growth of 8.1% in the private sector. At a disaggregated level, sectors with higher vacancy rates have generally experienced stronger pay growth this year (see Chart 16). The hospitality sector has been an exception, with the highest vacancy rate and one of the weakest rates of pay growth. This may reflect the relatively low margins the industry tends to operate in, giving it less room to increase wages, although its average pay growth has picked up to around 7% in the latest data.

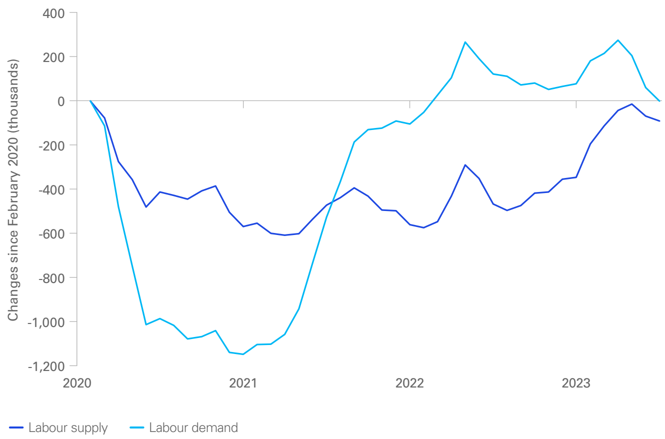
Job-to-job flows have moderated, suggesting that workers are less confident to switch positions. While the period immediately post-Covid has been characterised by an employee market, facilitated by ample job opportunities, the latest trends point to uncertainty about the future, limiting their bargaining power. Although the rate of job-to-job flows has dropped below 3%, it nonetheless remains above the pre-pandemic average of 2.5%, which continues to put upward pressure on wages.

Demand for staff is now losing momentum. The number of vacancies has dropped by 313,000 (24%) since the peak in the middle of last year. The latest evidence from the KPMG/REC survey points to ongoing moderation in demand for permanent workers. While some of that is driven by the seasonal nature of many jobs during the summer, where temporary placements are preferred, it could also reflect hiring freezes across businesses, preventing them from offering permanent positions. As activity slows in the coming months, it could see the unemployment rate increasing from an average of 4.2% in 2023 to 4.8% in 2024.

Skills shortages remain an issue in some sectors. Survey evidence from the Bank of England points to challenges in recruiting skilled staff in the IT, engineering and finance sectors. Indeed, the recent loosening in labour demand has been mainly reported for less skilled workers. Although many foreign workers have left the UK during the pandemic, the recent pickup in the participation rate has been more encouraging.

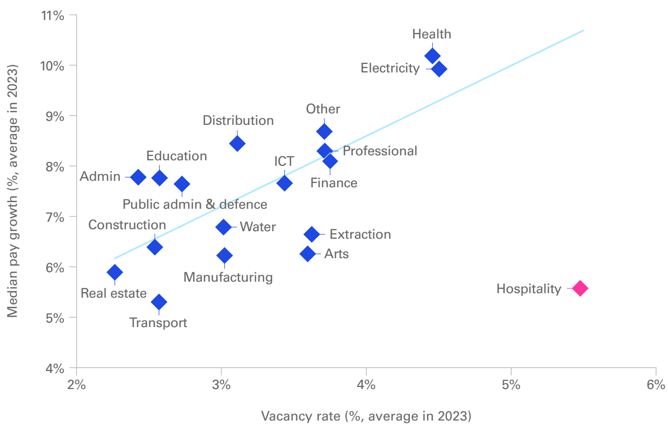
We expect pay growth to ease over the coming months. As economic activity remains weak and participation rate continues to recover, nominal pay growth should ease. The expected easing of inflation, coupled with earlier pay awards and the increase in the National Living Wage, should provide further improvements in households' purchasing power and help alleviate pay demands. Our forecast points to regular pay growth averaging 7.2% in 2023 and 4.8% in 2024 (see Chart 17).

Chart 15: The gap between labour demand and supply has largely closed



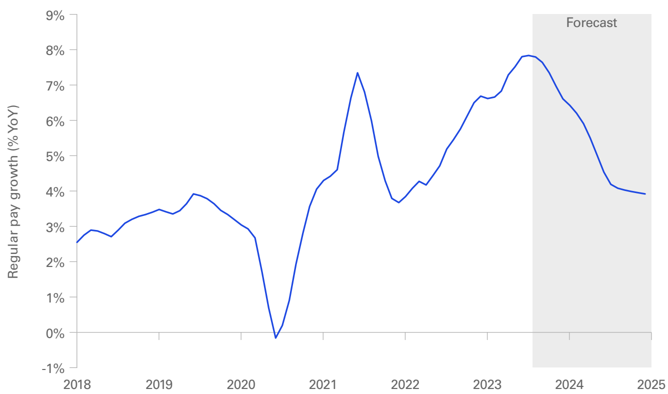
Source: ONS, KPMG analysis.
Note: Supply is total workforce participation. Demand is the sum of employment and vacancies.

Chart 16: Sectors with higher vacancy rate have typically seen stronger pay growth



Source: ONS, KPMG analysis.

Chart 17: Pay growth is set to ease



Source: ONS, KPMG analysis.

Public sector finances: Under pressure

The UK public finances remain vulnerable to fragile economic outlook and tighter financing conditions. The upcoming general election could see new spending pledges to address more immediate demands, such as safety concerns around school buildings, addressing local authority deficits, and public sector pay. State pensions could also rise by around 10 billion (8.5%) next year under the triple-lock guarantee. That would leave less money for the Government to finance critical investment projects and less room to balance the books in the medium term.

Longer-term headwinds remain, leaving uncertainty around the fiscal outlook beyond the next election. These include an ageing population (putting upward pressure on health and pensions spending), slowing growth in workforce participation (keeping a lid on tax receipts), higher defence spending, and the cost of tackling climate change.[2] That will leave the Government facing a trade-off between higher taxes or lower spending, neither being a popular option.

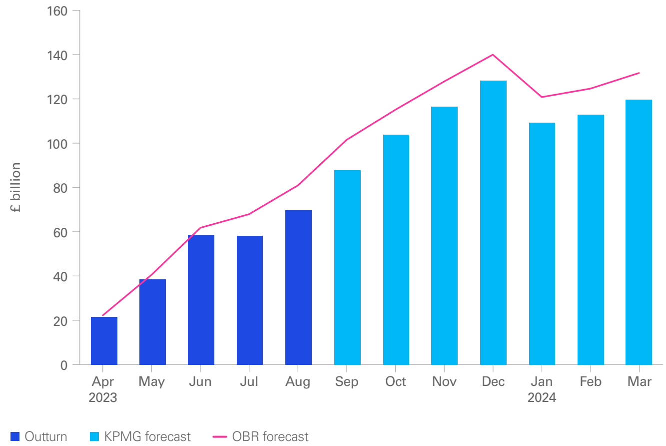
The latest public finances data has been better than expected, however. Government borrowing in the first five months of 2023-24 came in at £69.6bn, 14% less than the £81bn expected by the Office for Budget Responsibility (OBR) in March (see Chart 18). This was thanks to stronger tax receipts and lower borrowing by local authorities. In addition, borrowing has so far this year been revised down by £10.3bn relative to preliminary data, largely on account of stronger corporation tax and VAT receipts than initially assumed.

Central government tax receipts have continued to grow strongly. Against the backdrop of high inflation, pay growth and corporate profits have both supported stronger nominal tax base, while a robust labour market facilitated growth in income tax via higher employment. However, government spending has also increased (see Chart 19). Central government non-interest spending was up by £33.9bn on a year-to-date basis in August, reflecting increased outlays on energy and cost of living support.

Debt interest spending has moderated. Following the spike in RPI inflation – used to uprate payments on the index-linked part of government debt – as well as the rise in government bond yields, debt interest reached £112bn in the 12 months to April 2023 (see Chart 20). The latest figures for RPI inflation have been more positive, however, suggesting further easing in debt interest spending. We expect the government interest bill to total £77bn in 2023-24, down from £108bn in 2022-23.

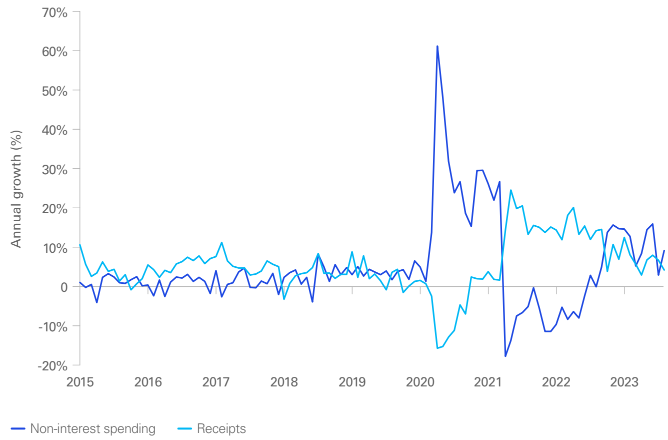
Public sector net borrowing is expected to reach around £120bn in 2023-24. This would be the lowest level since 2019-20, although it would still amount to 4.6% of GDP, compared to the Government's medium-term target of 3% (intended to be reached by the fifth year of the rolling forecast period according to the current fiscal rules). Borrowing may then fall further to £89bn (representing 3.4% of GDP) in 2024-25.

Chart 18: Cumulative public sector net borrowing in 2023-24



Source: ONS, OBR, KPMG analysis.

Chart 19: Central government receipts and spending growth



Source: ONS, KPMG analysis.

Chart 20: Outlook for debt interest spending

Source: ONS, KPMG analysis.
Note: The dashed line shows KPMG forecast for debt interest.

2 For further detail, see our recent report '*Budgets under pressure: Long-term fiscal challenges in Europe*'.

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