KPMG

UK Economic Outlook

March 2024

- After dominating the agenda in recent years, we expect inflation to return to its 2% target by the second half of 2024, with disruptions in the Red Sea and relatively strong wage growth adding some upside risk to our forecast.
- Weakening inflationary pressure should put the Bank of England in a position to begin cutting interest rates from the middle of the year. We expect interest rates to fall by 100 basis points this year and end this cycle at 3% by the second half of next year.
- Falling interest rates could spur partial recovery in liquidity conditions, with accumulated 'dry powder' aiding a bounce-back in private equity deals. However, the deterioration in access to finance pre-dates the current hiking cycle and rates are expected to remain above earlier lows.
- The fall in house prices may have already bottomed out, but expectations of falls in interest rates could depress activity in the short term as borrowers wait for better deals.
- The labour market is softening, with employers hesitant to commit to new hires. However, a larger proportion of the population outside the labour force – due to adverse population trends and lower participation rate – could leave the supply of labour relatively low.
- Nominal pay growth is set to moderate further, notwithstanding the 10% increase in the National Living Wage in April. But it will remain well above inflation, allowing households to continue to recover their purchasing power, while unemployment is also expected to rise only marginally.
- The next Chancellor is set to inherit a difficult fiscal position. Balancing the books against the backdrop of higher spending demands could be achieved either through stronger growth or higher taxes. With a relatively weak prospect for GDP growth, some of the recent tax cuts may therefore need to be reversed after the election.
- A service-led recovery returned the economy back to growth, which is expected to average 0.3% this year, with long-term challenges kerbing real growth to around 1%. We expect improving incomes to bolster consumer spending, while investment should also benefit from easing credit conditions.

Table 1: KPMG forecasts

	2023	2024	2025
Real GDP	0.1	0.3	0.9
Consumer spending	0.3	0.5	1.5
Investment	2.9	-0.1	0.3
Unemployment rate	4.0	4.2	4.5
Inflation	7.3	2.0	1.9
Base interest rate	5.25	4.25	3.00

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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Easing inflationary pressures to pave way for interest rate cuts

Weaker food and energy pricing is expected to see inflation returning to target by the spring.

Disruptions in the Red Sea and strong wage growth present two upside risks to inflation.

The Bank of England could start cutting interest rates in the coming months.

The outlook for inflation is broadly positive, supported by favourable developments in food and energy prices. Ofgem's energy price cap is set to fall by 12% in April, which should lower household utility bills and shave off an extra 0.4 percentage points from headline inflation that month. Gas price futures have continued to fall in recent weeks. Forward-looking indicators, such as producer price inflation and grocery price surveys, also point to a further moderation in food prices. The combined effect of the slowdown in food and a fall in energy prices is expected to lead to inflation falling below the Bank of England's 2% target in the first half of the year (see Chart 1).

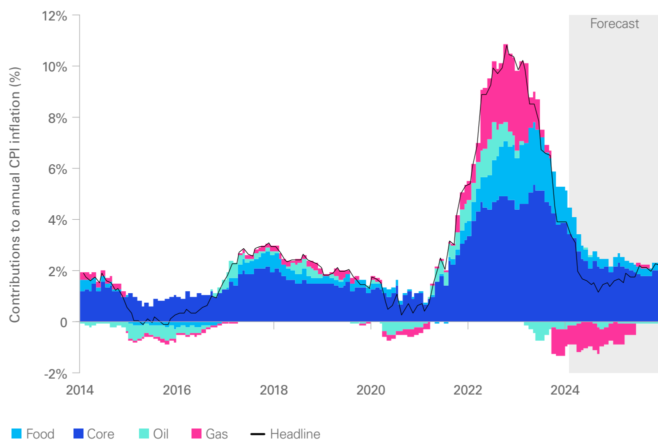
However, there are risks to the outlook, which could cause inflation to remain higher. Strong price increases in the service sector could make inflation stickier. The sector is still absorbing relatively elevated wage growth, including the forthcoming hike in the National Living Wage, which represents a large part of its cost base, and is likely to continue passing some of those additional costs on. Recent disruptions in the Red Sea may also cause inflation to stay higher for longer. Latest Purchasing Managers' Index (PMI) surveys suggest the disruptions are starting to feed through, with firms reporting an increase in input costs in addition to longer waiting times for goods deliveries. However, the weak economic backdrop is expected to make companies more cautious in fully passing on the extra costs.

The Bank of England could lower interest rates to 3% by next year, while inflation falls below target.

Overall, the encouraging developments in the inflation outlook will bolster the case for interest rate cuts. The Bank of England is likely to be hesitant to cut interest rates until it sees evidence of a sustained decline in domestic price pressures. But this will have to be weighed against the risk of inflation falling well below target. Monetary policy will also remain restricted for some time even after rates start to fall, and we estimate that a third of the impact from previous rate hikes has yet to feed through to activity. Delaying interest rate cuts could compound the ongoing weakness in the economy.

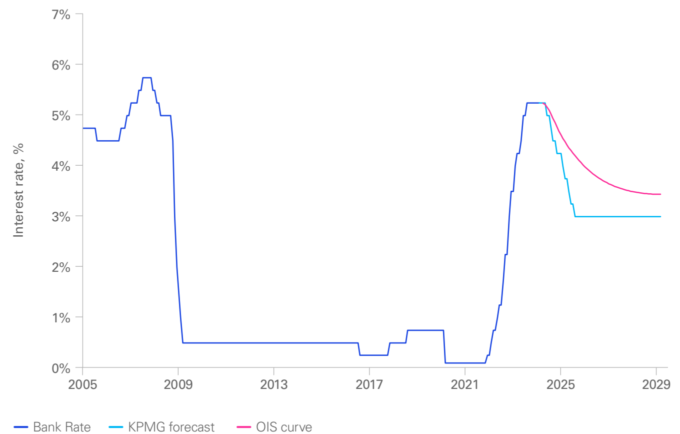
The Bank is therefore expected to start cutting rates this summer, with base rates potentially falling by 100 basis points this year and settling at 3% in the second half of 2025 (see Chart 2).

Chart 1: Outlook for inflation



Source: ONS, KPMG projections.

Chart 2: Outlook for base interest rates



Source: Bank of England, KPMG projections. OIS as of 15 March.

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Short-term recovery in liquidity conditions on the cards, but longer-term issues may be more persistent

Falling interest rates in the second half of the year could spur partial recovery in liquidity conditions.

Deterioration in access to finance pre-dates current hiking cycle by the Bank of England.

Accumulated 'dry powder' could help fuel a near term bounce-back in private equity (PE) investment.

The monetary policy tightening cycle, which began in late 2021, has led to a significant deterioration in access to finance for firms. We expect a partial recovery in access to finance from the second half of this year coinciding with the start of monetary policy easing.

Demand for credit has weakened, with higher borrowing costs raising the cost of credit and other forms of finance. In real terms, the volume of growth finance, which covers bank loans, capital market issuance, and private equity, fell by 16.5% among UK firms between 2022 and 2023, with a more pronounced drop in demand from SMEs (see Chart 3). Meanwhile, larger firms have seen a marked increase in corporate bond yields, in excess of the increase in base rates, signalling a rise in the risk premium. A significant amount of corporate debt is due to be refinanced in 2024 and 2025 across the advanced economies, which could increase refinancing and default risks.

Persistent weakness in business investment can be partly attributed to the decline in access to finance.

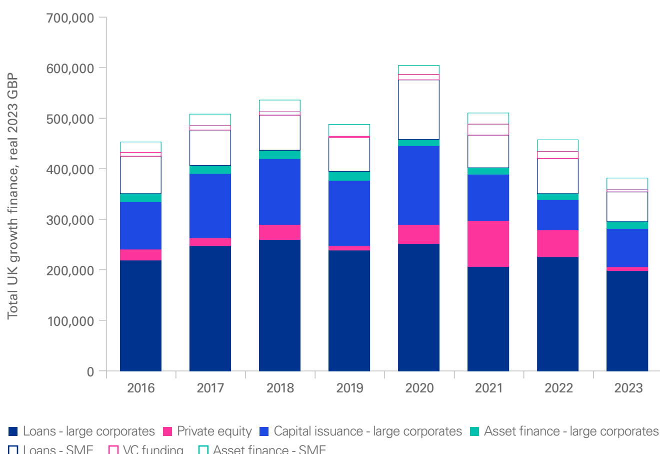
While the current deterioration in access to finance has potentially been driven by higher interest rates and weaker economic conditions, the longer-term trend is also negative and pre-dates the recent hiking cycle by the Bank of England and the start of the global pandemic. Chart 4 shows the index for the overall UK supply of finance in real terms on a per firm basis, which represents the level of financing available to each firm. These indices show a general negative trend, with a steeper decline in access to finance for large corporates, and appear to confirm a similar trend in business surveys also shown in the chart. This apparent trend persists even when accounting for the fall in the business population since 2020.

The low realised rate of productivity growth in the UK and elsewhere, potential increases in uncertainty following the Brexit vote and expectations of weaker growth going forward could be responsible for this decline, which may have led to a reduced range of investable opportunities for businesses.

The resulting financing gap may need to be addressed via policy solutions aimed at making the UK a more attractive destination for capital and ultimately arrest the weak trend in productivity growth. A feature of the UK landscape is the presence of highly productive, world-leading firms, which operate alongside a long tail of less productive businesses.[1] Estimates suggest that adopting best practices across the board could boost the level of UK productivity by around 13%.

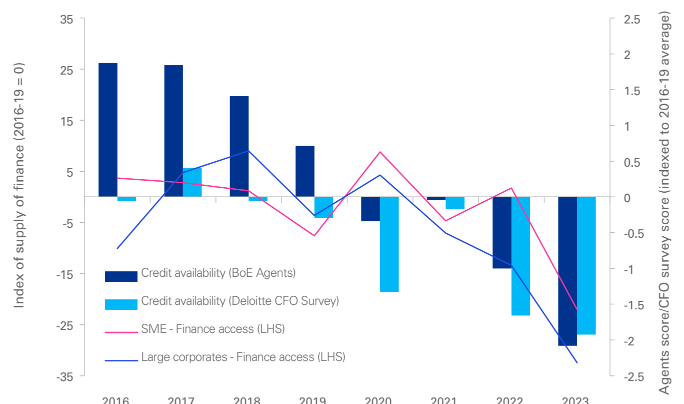
1. Haldane, A (2018), 'The UK's Productivity Problem: Hub No Spokes', speech given at the Academy of Social Sciences Annual Lecture, London.

Chart 3: Supply of growth finance has been weakened by the impact of higher interest rates



Source: Bank of England, UK Finance and Leasing Association, LSEG Eikon, ONS, KPMG analysis.

Chart 4: Decline in access to finance may pre-date the start of the recent hiking cycle



Source: Bank of England, UK Finance and Leasing Association, UK Finance, LSEG Eikon, ONS, Deloitte CFO survey, KPMG analysis.

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Short-term recovery in liquidity conditions on the cards, but longer-term issues may be more persistent

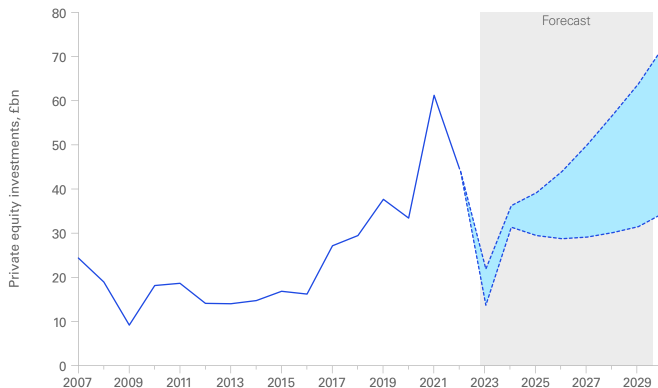
(continued)

After more than a decade of rapid growth in PE investment, the latest data show a fall of nearly 70% between 2022 and 2023, accounting for a large part of the short-term fall in overall supply of finance. Prior to this, PE investments in the UK more than doubled between 2010 and 2021, while funding raised across Europe increased by a factor of five over the same period, according to data from Invest Europe.

Rapid increases in the funding raised have led to an accumulation of dry powder, which could support an initial bounce-back in PE activity during 2024-25. PE funds take time to identify opportunities and deploy their funds towards investment opportunities, which creates a lag between the fundraising and the timing of portfolio investments. The record pace of growth in PE in the lead up to 2023 has created a stock of dry powder that would continue to fuel investments over the course of the next 5-10 years.

Longer-term recovery in PE hinges on the volume of capital directed towards PE funds, with a range of possible outcomes (see Chart 5). A relatively strong recovery could see PE investments return to their pre-2023 dynamics, which would see growth of up to 15% over the five years from 2024 onwards. A more cautious scenario envisages further declines in investment volumes, as existing levels of dry powder become increasingly committed and fresh funding arrives at a much slower pace than before 2023.

Chart 5: Near-term outlook for private equity remains weak



Source: Invest Europe, KPMG projections.

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Housing market gradually recovers

Higher borrowing costs and expectation of lower rates to keep housing transactions at low levels.

The contraction in house prices was milder than expected as prices begin to recover.

Regional variations in housing affordability have narrowed as people sought more space.

Last year proved relatively weak for the housing market. Activity was subdued, with mortgage approvals and property transactions both depressed compared to pre-pandemic levels. Monthly mortgage interest payments have doubled since the end of 2021 when the Bank of England began to tighten policy. Although rates on new mortgages have eased in recent months – reflecting expectations of imminent interest rate cuts by the Bank of England – this could actually depress activity in the near term, as potential borrowers delay purchases in anticipation of better deals.

Nonetheless, the fall in house prices turned out milder than expected, at around 4% from peak to trough, and prices have already started to recover (see Chart 6). The staggered nature of fixed-rate mortgage deals means that only around a third of borrowers have rolled onto a new rate since interest rates started to go up. Even though base rates have now probably peaked in this cycle, we estimate that around a third of the pass-through to mortgage rates is yet to come, meaning that households will still face significantly higher borrowing costs when they roll onto a new rate.

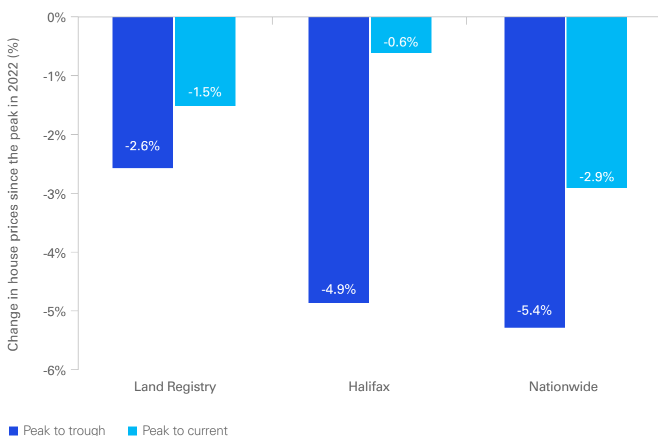
Set against that, with the recent sharp rises in rental prices many households could still see home ownership as a more attractive proposition in the long term, which should support demand and house prices further. In addition, according to Hamptons around 30% of UK homes are bought with cash, while some owners have already paid off their mortgages, making them much less dependent on financing costs.

Affordability, which can be gauged by comparing house prices to average earnings, remains mixed across the regions and nations of the UK. The difference has been narrowing since the pandemic, with less affordable regions experiencing weaker price increases (see Chart 7). This was partly triggered by the increase in remote and hybrid working and people's desire to have more outside green space, causing them to move to more affordable areas.

Recent sharp rises in rental prices underline the attractiveness of home ownership despite higher rates.

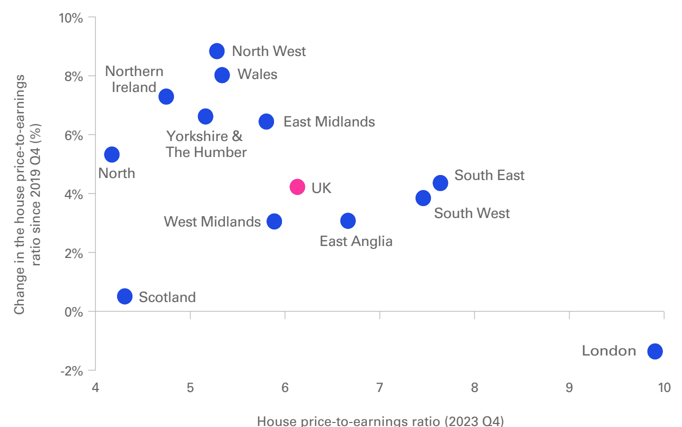
While demand for housing was hit by higher financing costs, the industry has also been grappling with supply-related issues. Housing starts and completions were both down in the latest official data, and more timely survey evidence points to a subdued pipeline of new work. There were reports of bottlenecks in deliveries of construction materials as a result of the disruptions in the Red Sea, and elevated levels of insolvencies in the sector have led to delays in construction. If these persist, that could add to upward pressure on house prices.

Chart 6: House prices may have already bottomed out



Source: LSEG Datastream, KPMG analysis.

Chart 7: Housing affordability variation across UK regions



Source: Nationwide, KPMG analysis.

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Fragilities under the surface in the labour market

Surveys point to weak labour demand despite robust employment data.

Rising inactivity and smaller working-age population keep a lid on labour supply.

Modest rise in unemployment to coincide with easing nominal wage growth.

We are seeing signs of an ongoing softening in the labour market. Annual employment growth slowed to 0.2% at the start of 2024, and the number of vacancies fell by nearly 400,000 (30%) since the peak in mid-2022. However, recent changes to the ONS data – triggered in part by falling response rates – have made it more difficult to interpret the evolution of unemployment, which was revised down from 4.2% to 3.8% at the end of last year. This low level contrasts with other indicators of labour market activity – such as from the KPMG and REC UK Report on Jobs – and is somewhat hard to square with the technical recession at the end of last year.

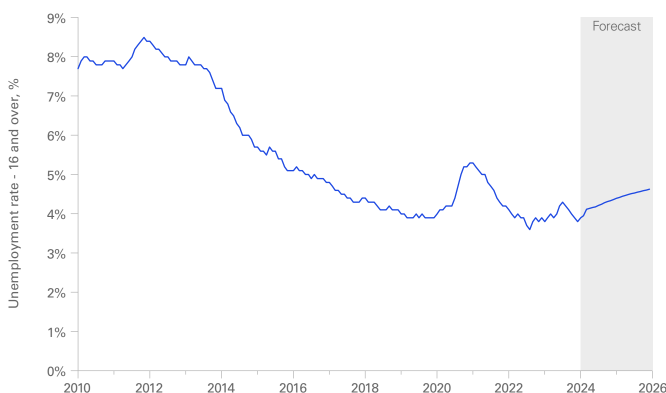
The demand side has been characterised by a cooling of recruitment activity and a pickup in redundancies. The latest KPMG/REC evidence found that employers are hesitant to commit to new hires amid increased uncertainty about the economic outlook. The vacancy rate dropped to 2.9% in February, only a touch higher than the 2.7% registered before the pandemic. The redundancy rate, at 4.6%, is at its highest level since early 2021. In addition, the Bank of England's Agents report that companies have been offshoring certain roles with the aim to cut costs, while at the same time investing in AI and automation.

The outlook for the supply side has been mixed. Labour market participation fell by 170,000 since May 2023, driven by a rise in inactivity. Revised demographic data suggest a greater share of the population outside of working age, and recent immigration has been more concentrated among students and dependants. Set against that, we expect the Government's recent measures on childcare reform and cuts to National Insurance Contributions to boost participation, offsetting some of the structural drag on labour supply. Combined with a weaker outlook for labour demand, we expect the unemployment rate to drift upwards from 4% in 2023 to 4.2% in 2024 and 4.5% in 2025 (see Chart 8).

Despite the expected moderation in nominal pay growth, the recovery in real purchasing power is a bright spot in our projections.

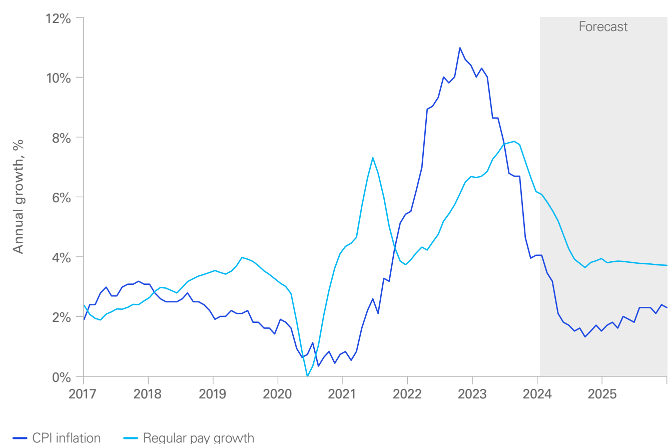
The combination of falling vacancies and gradually rising unemployment could see further moderation in pay growth (see Chart 9). Although regular pay growth is still running at over 6% compared with the previous year, a more timely measure of three-month annualised growth was just 3.5% in January. Despite the planned increase in the National Living Wage of 9.8% in April, further loosening in the labour market, coupled with an ongoing easing in inflation, should lead to a moderation in pay demands. Pay growth could ease from 7.2% in 2023 to 4.5% in 2024 and 3.7% in 2025 according to our latest projections.

Chart 8: Outlook for UK unemployment



Source: ONS, KPMG projections.

Chart 9: Pay growth is expected to outstrip inflation



Source: ONS, KPMG projections.

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Difficult choices ahead for the public finances

Government borrowing is set to fall thanks to lower borrowing costs and higher tax take.

Public sector debt may barely improve, making it hard for the Chancellor to meet his target.

Spending plans to be unveiled by the next government may involve difficult trade-offs.

The state of public finances has proved marginally better than expected, with net borrowing now expected to end 2023-24 with a deficit of £114 billion, down from £129 billion in 2022-23 and £10 billion below the Office for Budget Responsibility's (OBR) forecast published in November (see Chart 10). The lower RPI inflation meant that the forecast for debt interest spending was revised down by £11.5 billion in 2023-24, and – combined with a lower path for market interest rates – pushes down financing costs by an average of £13 billion by 2028-29.

The flipside to lower inflation comes from a weaker boost to cash receipts, which tend to benefit from an inflationary environment due to stronger nominal pay and corporate profits. This means that by 2028-29 lower debt interest spending is virtually offset by weaker tax revenues.

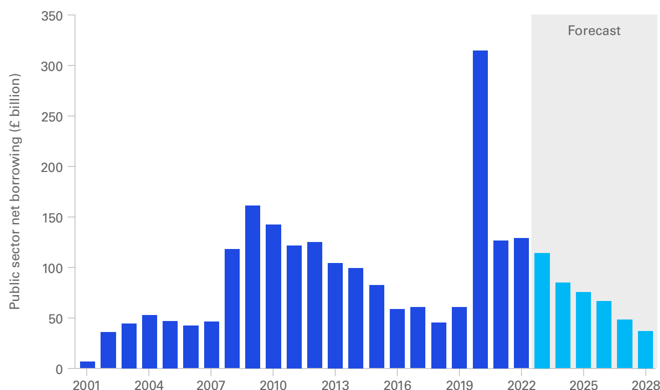
In his March Budget, the Chancellor announced net fiscal loosening of £40 billion between 2024 and 2028 (£8 billion a year). Most of that is accounted for by a further 2% cut to National Insurance Contributions (NICs), costing £10 billion a year. The main revenue-raising measure is a new tax on non-doms, expected to raise around £3 billion a year. The remaining gap is largely covered by the previously announced freezes for income tax and NICs, and the increase in corporation tax from 19% to 25%.

The overall spending plans pencilled in by the Government assume an increase in its key commitments on health and defence, which implicitly constrains spending on other public services. According to the OBR, if spending on defence and overseas aid grows in line with the Government's ambitions, funding for 'unprotected' departments would need to fall by 3.6% a year in real terms. It is quite possible that, as in previous years, spending on public services will be higher than originally planned, and capital spending would be cut in order to lower the pressure on public finances.

The Government's plans for the overall spending envelope imply that funding on unprotected departments would have to fall by over 3% a year in real terms, which is unrealistic in the absence of sustained productivity growth.

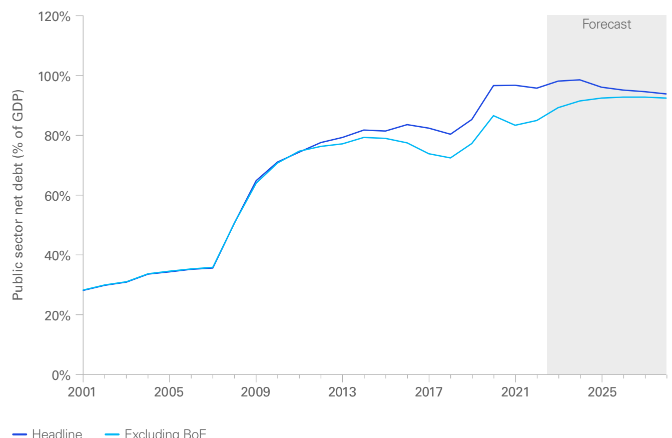
The next Chancellor is set to inherit a difficult fiscal position. Under the latest projections, the underlying measure of debt (which excludes the Bank of England) is expected to fall by just 0.3% of GDP in 2028-29, leaving a historically low headroom of £8.9 billion (see Chart 11). Balancing the books against the backdrop of higher spending demands could be achieved either through stronger growth or higher taxes. With a relatively weak prospect for GDP growth, some of the recent tax cuts may therefore need to be reversed after the election.

Chart 10: Outlook for government borrowing



Source: ONS, KPMG projections. Fiscal years shown.

Chart 11: Outlook for government debt



Source: ONS, KPMG projections. Fiscal years shown.

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Narrow path to recovery in consumption and investment

Improving household incomes and wealth levels could help restore confidence and fuel growth in consumption.

Easier credit conditions and recovering growth prospects herald an eventual return to investment growth.

Geopolitical risks and potential for trade frictions could hamper investment plans.

Household consumption could return to a modest pace of growth in 2024, after declining in the second half of 2023. We expect steady increases in spending in every quarter of our forecast, with household consumption rising by 0.5% in 2024 and 1.5% in 2025 in real terms.

The main tailwind driving the expansion in consumer spending is the recovery in household income growth as pay growth outpaces the rapidly falling rate of inflation. Cuts to the National Insurance, pencilled in the 2024 Budget, offer an additional boost this year. The fall in inflation has come hand-in-hand with partial recovery in consumer confidence, which may point to greater willingness to increase spending going forward.

Furthermore, after a fall of around 4% during 2022-23, a return to growth in house prices could help support the housing wealth of homeowners. A potential rebound in housing transactions could also lead to more spending on related areas, such as furnishings, which fall into the category of delayable spending. This category of spending has seen nearly a 25% fall since January 2020 (see Chart 12) as consumers prioritised staples and work-related spending during the cost-of-living crisis.

Headwinds for consumers come in the form of a continuing pass-through of a higher base interest rate to mortgage payments and increases in unemployment expected in 2024 and 2025. These could raise the levels of precautionary savings by around 3% over the next two years, allowing for only a modest pace of consumer spending growth in our projections.

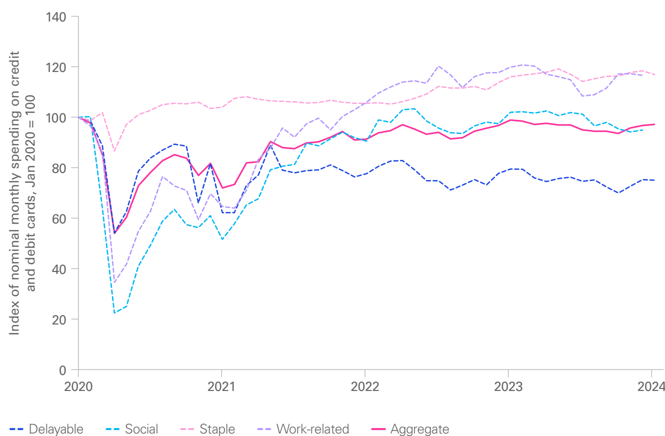
Looser financial conditions and lower interest rates are the main factors driving stronger investment growth in 2025

We also expect a minor fall in investment of 0.1% during 2024, before a recovery takes hold in 2025, reversing this decline with growth of 0.3% that year. Increases in business investment have been offset by lower investment in housing in 2023, with investment volumes during the year failing to match the high point in 2023 Q1 (see Chart 13).

For much of 2024, businesses are expected to continue to face higher cost of borrowing and tighter access to finance, acting as a drag on investment. As financial conditions start to ease, improving access to finance, this should hopefully lead to stronger investment growth in 2025.

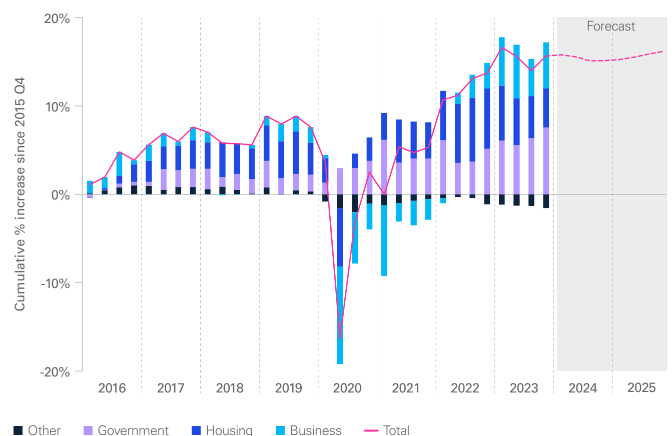
However, greater uncertainty – ranging from policy uncertainty due to upcoming elections across a number of key countries, to the effects of a more fraught geopolitical environment – could hamper investment plans for some businesses, especially those significantly exposed to trade.

Chart 12: Consumers have shifted spending away from delayable purchases



Source: Bank of England via ONS, KPMG analysis.

Chart 13: Investment growth held back by tight credit conditions



Source: ONS, KPMG projections.

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UK economy emerging from stagnation

GDP growth back to positive after a technical recession in the second half of 2023.

Recovery led by service sector, with weaker growth in construction and manufacturing.

Longer-term economic growth expected to reach just 1% this decade.

The UK economy staged an early recovery from a technical recession in the second half of 2023, with real GDP growth expected to be 0.3% in 2024, and to accelerate to 0.9% in 2025. Since the start of the global pandemic, UK GDP growth has been disappointing by international standards, with the level of real GDP at the end of 2023 up by just 1% compared to the end of 2019. This is only ahead of Germany over this period, among G7 economies (see Chart 14).

While global growth conditions are expected to remain subdued, the likely cuts in base interest rates in advanced economies could deliver a tailwind to external demand. We anticipate a partial recovery in export volumes during 2024, following consistent declines throughout the course of the past year. However, due to an expected increase in import demand of similar size, the contribution from net trade to overall economic growth may prove minimal. Furthermore, rising geopolitical tensions and election outcomes in some of the UK's key trading partners in 2024 could increase trade frictions going forward.

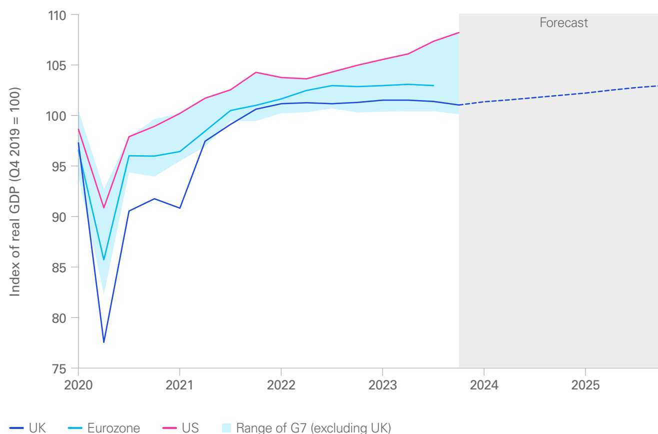
Survey evidence suggests that the recovery in UK growth is being led by the service sector, with manufacturing and construction lagging behind (see Chart 15). Lower interest rates and a recovery in the UK housing market could see an acceleration in output growth of the construction sector this year, while latest data from the ONS point to an early and tentative recovery in the manufacturing sector in Q1 2024.

A lower share of manufacturing industry in the capital contributed to a widening gap in performance between London and other regions and nations of the UK. This was due to services overall outperforming other sectors of the economy.

Since the start of the global pandemic, UK GDP growth has been disappointing by international standards, with the level of real GDP at the end of 2023 up by just 1% compared to the end of 2019.

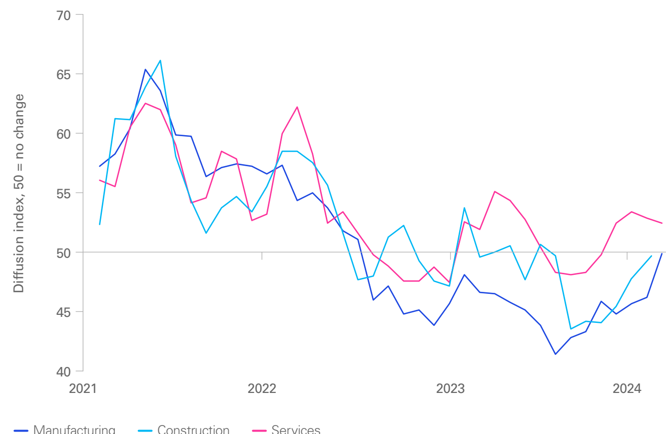
Looking at the longer term, we expect the UK's potential growth this decade to be around 1% per year. This will crucially depend on the pace of productivity growth, which we currently expect to contribute 0.6 percentage points to annual GDP growth, with an increase in labour supply accounting for the remaining 0.4 percentage points. This relatively downbeat assessment assumes a continuation of the recent trends in weak investment and productivity growth, which could be reversed if adoption of new technologies, such as AI, drives a significant acceleration in productivity growth.

Chart 14: UK GDP has stagnated since the post-pandemic recovery



Source: ONS, Eurostat, FRED, Government of Japan Cabinet Office, Statistics Canada, KPMG projections.

Chart 15: PMI surveys point to a recovery in 2024



Source: LSEG Datastream.

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