UK Outlook

February 2023

Economic Update

Bank of Ireland

Improved outlook, though risks remain

Since our previous forecast, in November last year, the outlook for the UK economy has improved somewhat. The actions of the Bank of England and the Treasury succeeded in calming the financial market turbulence that followed the September mini-budget. In addition, energy prices have fallen significantly, the outlook for world growth has brightened a bit and, after much negotiation, a deal has been struck between the UK and EU in relation to the Northern Ireland Protocol. As such, whereas previously it looked like the economy could well be in recession in the opening months of this year, it now looks like such an outcome will be avoided.

Nonetheless, while the outlook is a little better than previously anticipated, it remains challenging. GDP growth for 2023 as a whole is likely to be around 0% (revised up from -1% in November), with consumer spending held back by wage growth that has lagged inflation, declining investment and a lacklustre export performance - at least partly due to Brexit. Inflation is likely to fall through the course of the year on foot of easing global supply chain pressures and lower energy prices, starting the year at 10% and ending it under 4% (averaging about 6.5%). In this environment we anticipate that the Bank of England will hike rates by a further 50bps - taking Bank Rate to 4.50% - before going on hold. Higher interest rates are likely to continue to weigh on the housing market. However, labour market tightness (elevated vacancies, weak participation) means the sluggish economic growth is unlikely to translate into a significant rise in unemployment.

For next year, we expect GDP growth to pick up to about 1%, close to the economy's slightly lower post-Brexit potential growth rate. Inflation is likely to continue to ease, supporting consumer spending, although it will be a gradual process, while unemployment should remain low. As the year progresses the Bank of England is likely to have scope to reduce interest rates slightly. Fiscal policy, which should be supportive in 2023, will probably be broadly neutral next year.

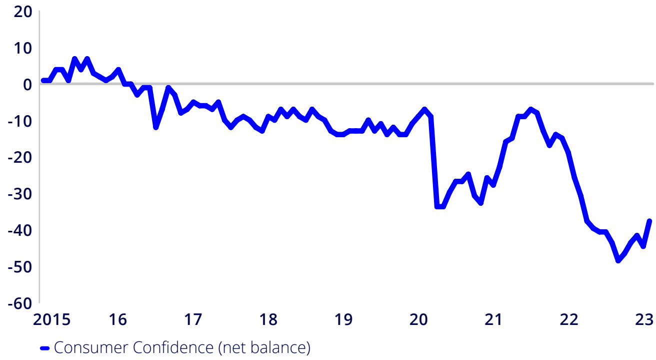
However, there are no shortage of risks to the outlook. Energy and other commodity prices could spike higher again if the Russia-Ukraine war escalates further. In addition, the Bank of England's significant monetary tightening could negatively impact economic activity more than currently expected, while the scarring effects of Covid and Brexit, already evident in subdued labour force and export growth, could prove more acute and/or long lasting than expected.

	2022	2023(f)	2024(f)
Consumer Spending	5.4%	0.0%	1.0%
Government Consumption	1.9%	2.0%	1.0%
Investment	7.7%	-2.0%	0.0%
Exports	10.3%	-1.0%	2.0%
Imports	12.6%	-1.0%	1.5%
GDP	4.0%	0.0%	1.0%
Employment Growth	1.0%	0.4%	0.7%
Unemployment Rate	3.7%	4.0%	3.8%
Inflation Rate	9.1%	6.5%	3.0%

Consumer

Confidence at a low ebb

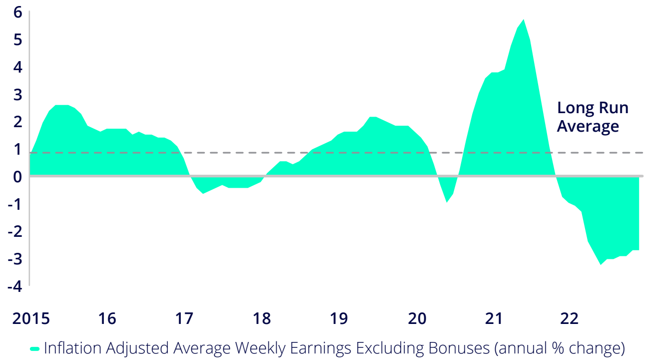
Although consumer spending continued to rise fairly robustly in nominal (i.e. cash) terms through the second half of last year, the sharp rise in inflation meant that consumption actually fell in volume terms and in Q4 it was still 2.3% below pre-Covid levels. In this context it is perhaps no surprise that consumer sentiment has remained close to record lows, although it did improve slightly in February, while the household savings rate, though down significantly from its high point during Covid, remains above normal.



Source: GfK

Soft outlook for consumer spending

While high street spending started this year on a slightly better footing, with retail sales up 0.5% month-on-month in January, the outlook for household incomes is not particularly supportive - disposable income growth is likely to be offset by inflation leaving households no better off in real terms. As such we expect consumer spending to be broadly flat for the year as a whole. With inflation easing somewhat in 2024 we expect consumption to pick up a bit, with growth of 1% for the year.

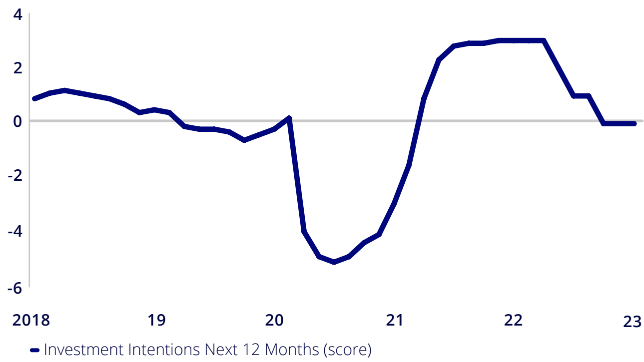


Source: ONS

Investment

Business investment set to fall

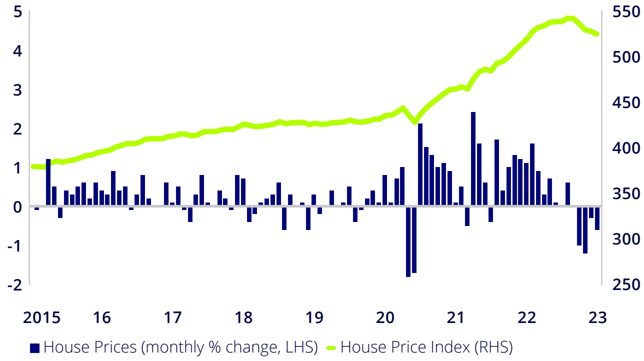
Recent ONS data shows that business investment rebounded more strongly over the past 18 months than previously thought, and is now back at pre-Covid levels. However, the Bank of England's investment intentions survey points to a decline in corporate capital spending this year in an environment of weak growth, rising costs and higher interest rates. Business investment spending is projected to stabilise next year. On the other hand Government fiscal plans point to fairly robust growth in infrastructure spending.



Source: Bank of England

Housing market under pressure

After a strong performance during Covid, with house prices up significantly, the housing market has weakened recently on foot of deteriorating household finances, depressed consumer confidence and increasing mortgage interest rates. House prices declined by 3% between summer 2022 and January 2023 and the market is likely to remain under pressure this year. House building, which proved resilient during the pandemic and actually increased somewhat, is likely to decline both this year and next, with weaker demand and a sharp rise in construction costs weighing on the sector.

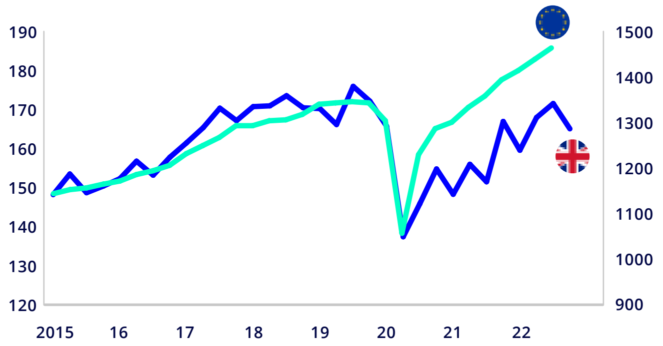


Source: Nationwide

Trade

Disappointing trade performance

Interpreting the latest trends in the exports data is challenging due to methodological and structural changes (partly Brexit related), volatile trade in precious metals and large fluctuations in energy prices. On a headline basis exports of goods and services expanded by a robust 10.3% year-on-year in 2022, although once trade in precious metals is excluded growth was a slightly more modest but still solid 6.7%. However, exports remain below pre-Covid levels, a weak performance which is probably at least partly due to Brexit disruptions to supply chains.

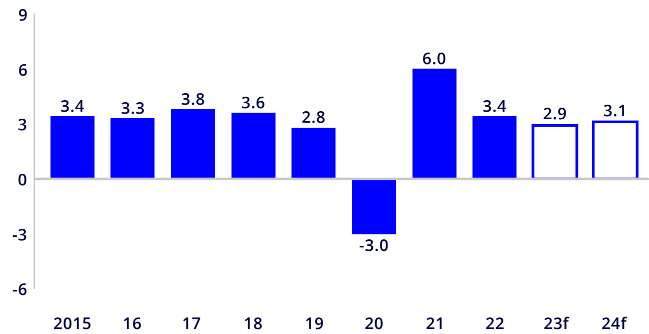


- UK Goods and Services Export Volumes - Excluding Precious Metals (£bn, LHS)
- Euro Area Goods and Services Export Volumes (€bn, RHS)

Source: ONS, Eurostat

Weak outlook for exports

In its January World Economic Outlook Update, the IMF projected that world GDP growth would decelerate somewhat this year before picking up slightly next year, though they emphasised downside risks to this forecast (particularly related to the Russia-Ukraine war). With the UK's major trading partners growing, albeit modestly, UK trade is likely to expand slightly, with exports excluding precious metals rising by about 1%. However, assuming a decline in precious metals exports after a strong reading in 2022, overall exports may fall back slightly.



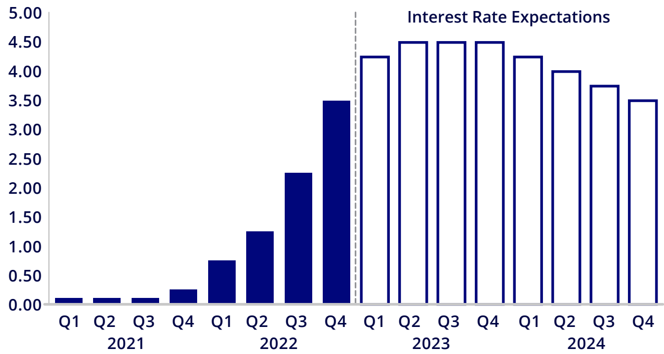
■ Global GDP (annual % change)

Source: IMF

Policy and Markets

Tight monetary policy

The Bank of England has continued to tighten monetary policy in the face of elevated inflation. Although we are probably now near the end of the tightening cycle, the magnitude of the hikes is likely to dampen growth over the next 12-18 months. On the other hand fiscal policy changes have been modestly supportive for the near term – the Bank of England estimates that the measures outlined by Chancellor Hunt in his Autumn Statement will boost GDP growth by roughly 0.3% this year, though will weigh on activity in future years.

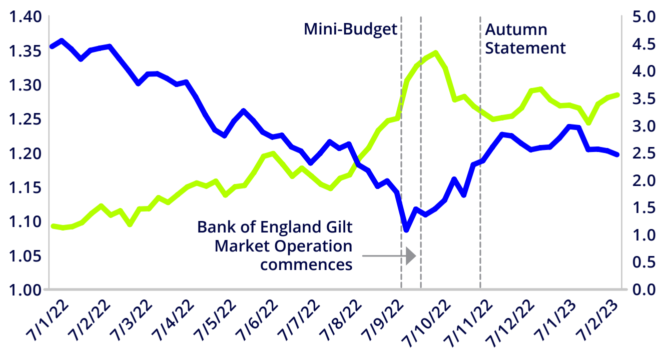


■ Bank Rate (%, end period)

Source: Bloomberg, BOI

Calmer financial market conditions

The turmoil in bond and foreign exchange markets that followed the mini-budget last September has given way to calmer conditions of late, aided by measures from the Bank of England (Gilt Market Operation) and the Treasury (Autumn Statement). UK government 10-year bond yields, which reached a high of over 4.50% in the aftermath of the mini-budget, are now back to 3.70%. Sterling has recovered versus the US dollar over the past six months or so (from an intraday low of $1.04 to just over $1.20 now) and has held fairly steady against the euro.



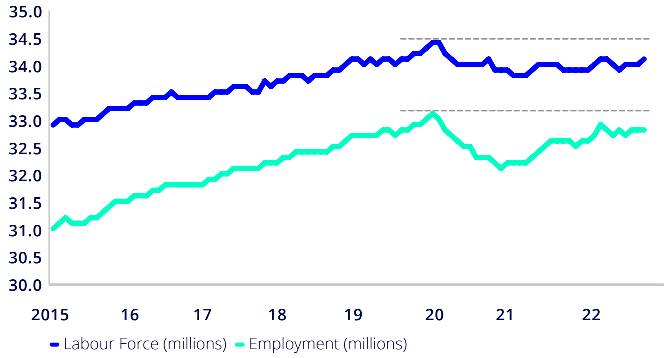
- £/$ (LHS) - 10 Year Gilt Yield (RHS)

Source: Bloomberg

Labour Market

Labour market scarring

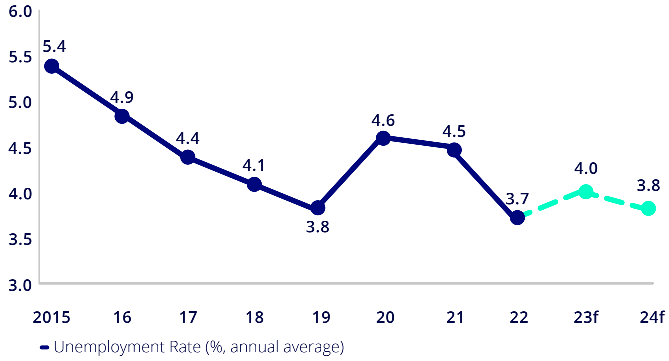
The labour market proved resilient through the pandemic, with employment falling, and unemployment rising, by less than initially feared. However, the recovery remains somewhat incomplete and Covid is casting a shadow in the form of reduced labour force participation (partly due to early retirement as well as increased rates of illness), which has in turn limited the extent of the rebound in employment over the past 6-9 months and led to labour shortages in a range of sectors (vacancies across the economy now exceed 1 million versus a typical range of 500k-800k pre-Covid).



Source: ONS

Unemployment to remain low

However, the latest labour market data, for the last quarter of 2022, offers some hope with both labour force participation and employment picking up slightly – though it is too early to be sure that this is a durable trend. Overall, we expect employment to advance only modestly this year due to weak growth, and with some people coming back to the labour force, unemployment may tick up marginally. This should reverse in 2024 though, with employment growth picking up and unemployment falling back again.

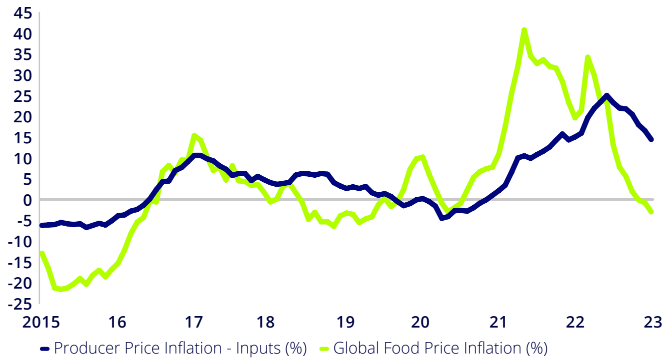


Source: ONS & Bank of Ireland

Inflation

Input cost pressures ease

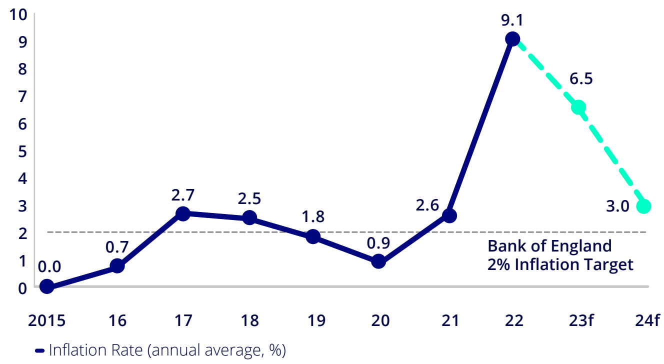
The inflationary cycle observed throughout the course of last year has now finally started to ease. Gas prices in particular have fallen sharply over recent months, though it will take until the second half of the year for that to start to be reflected in household energy bills. Many other commodity prices (oil, food) have also fallen of late, as have shipping costs, and this should eventually feed into consumer prices. However, for services sectors wages are the key input cost and wage inflation remains robust, though there are some early signs it is now starting to ease.



Source: ONS, United Nations

Inflation set to fall

Consumer price inflation has declined somewhat over recent months (from 11.1% in October to 10.1% in January), primarily on foot of declining petrol and diesel prices. While inflation may remain elevated over coming months it is likely to fall to 4% or below by year end as energy bills decline and price pressures ease in a range of other sectors (food, durable goods, hospitality). For the year as whole inflation is forecast to average 6.5%, declining to about 3% in 2024, though it must be acknowledged that there is a significant amount of uncertainty regarding the future path for prices.

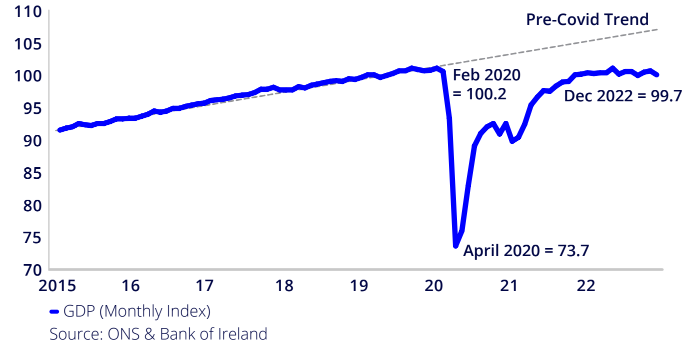


Source: ONS & Bank of Ireland

Outlook for Growth

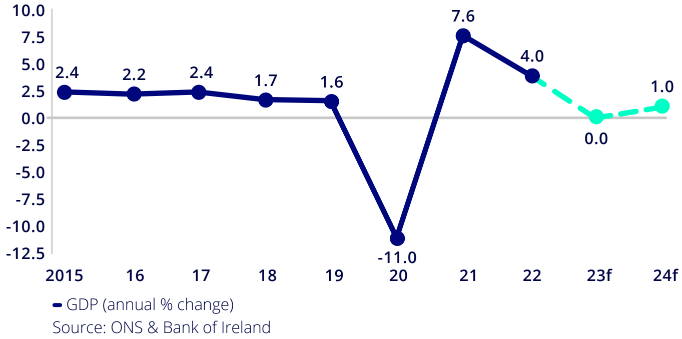
The recovery has stalled

Following a strong rebound from Covid through 2021 and early 2022, the recovery stalled on foot of the sharp rise in energy and other commodity prices which negatively impacted both the demand (consumer spending) and supply (business costs) sides of the economy. GDP was down 0.2% quarter-on-quarter in Q3 last year, and was flat in Q4. As of December 2022 economic activity remained 0.5% below pre-Covid levels – both industrial and services sector output remain below their Feb 2020 levels, by 1.4% and 0.7% respectively, though construction output is actually up 4.5% over this period.



Subdued outlook for growth

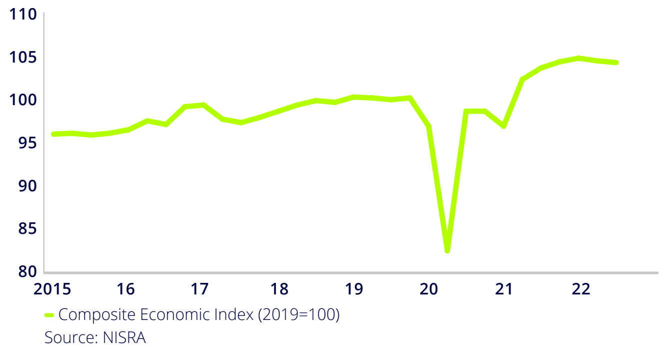
Much of this year is likely to be similar to last year, with negligible growth in output as the economy continues to adjust to multiple headwinds including higher energy prices and interest rates, the negative impact of Brexit on investment and trade, a slowing housing market and sluggish growth in key trading partners. Overall, for the year as whole we are forecasting 0% GDP growth. However, the economy should pick up towards the end of the year and into next year, led by a recovery in consumer spending as inflationary pressures ease. We expect output growth of 1% in 2024.



Northern Ireland

UK-EU Deal on the NI Protocol

The latest data on the Northern Ireland economy points to subdued economic conditions and low unemployment – though as elsewhere inflation remains elevated. After much negotiation the UK and EU have finally agreed a deal on the Northern Ireland Protocol. It is hoped this deal will usher in greater political stability, which in turn could provide support to the economy this year and next.



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