EY ITEM Club Autumn Forecast

An economy shifting back into balance

October 2024

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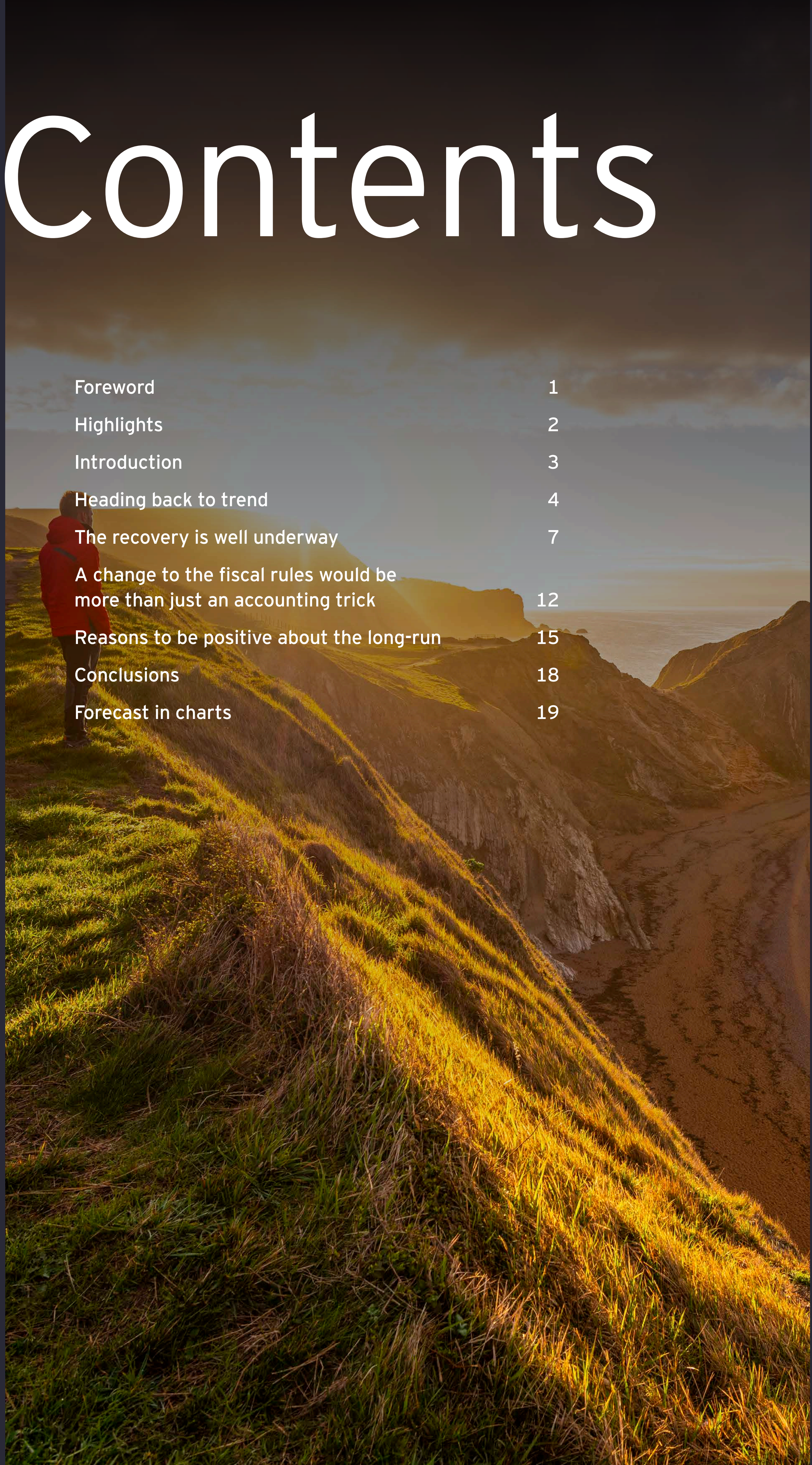

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Foreword

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We thought long and hard about requesting the EY ITEM Club to postpone their Autumn Forecast until after what must be one of the most talked about Budget announcements in history: the first for this new Government, who won with a huge majority but now has a very long to do list. On balance, we decided to stick to our usual October date for the forecast. The reality is that when Government taxes and spends around £1 trillion a year, a few billion here or there on taxes or spending is unlikely to move the dial dramatically from a macro-perspective – however, important it can be for the businesses or households impacted. Hence, we stuck with the date, and may be hostages to fortune!

The health of the macroeconomy is, of course, important to the Government and its fiscal position. Here there has been some (reasonably) good news this year. The economy bounced back in H1 24 from its mini-recession at the end of 2023, and the growth rate has dipped a bit through the summer, the latest EY ITEM Club forecast is for GDP to grow by 0.9% this year – a marked improvement to the 0.3% achieved in 2023. Growth should accelerate further to hit 1.5% in 2025, and 1.6% in 2026 – although this has revised down from our Summer Forecast – reflecting a more cautious outlook on the level of unemployment in the labour market, and from the ONS to the amount of disposable income that households decide to save.

This recovery has been supported by steadily falling inflation – hitting 1.7% in September – below the Bank of England's target of 2%. This opens the way to further reductions in interest rates, following the 0.25 ppts reduction in August. However, with core inflation still at over 3%, the EY ITEM Club remains cautious about the pace of the reduction in rates; with perhaps just one more 0.25 ppt cut this year in November, and with steady reductions in 2025. Healthy real income growth and lower interest rates will ease the pain on household budgets and corporate P&Ls, while lower rates in particularly should get capital markets moving.

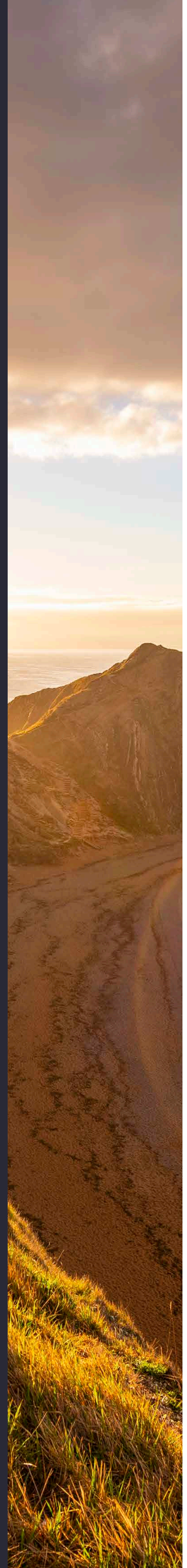
If the Government's macroeconomic inheritance is better than it hoped, in contrast, the challenge facing its fiscal position has not been overstated. The twin hits of COVID-19 and the energy crisis, saw Government borrow an extra £400bn in just over two years. This has taken debt as a percentage of GDP over 100%; the highest it's been since the early 1960s when the UK was still paying down the costs of the Second World War. With interest rates at 5%, Government is paying debt interest service payments of close to £90bn a year – almost 10% of total Government spending. At the same time, there are multiple spending demands from Government departments ranging from Health to Defence to Transport, reflecting the fall-out from COVID-19, a changing global geopolitical environment, and arguably the impacts of the Coalition Government's austerity programme that saw big reductions in capital budgets.

It is in this context that the new Government is looking at revenue raising measures to help fill the coffers, amendments to the fiscal rules to provide some scope for increasing investment spend, and hoping for a more benign economic environment (particularly on inflation and interest rates) as well.

As a thousand economic and political analysts have already commented, the key to solving this set of challenges is faster economic growth, something that has been an issue for the UK really since the global financial crisis. To do this requires recognition of some difficult trade-offs – more Government investment is required, private sector investment should be incentivised through de-regulation, particularly around planning rules, and the long-term challenges in the labour market on skills and participation need to be addressed. There is a growing consensus in the UK as to 'what' is the problem, the number one policy question for the new Government is how to fix it.

Highlights

- After a robust start to the year, the EY ITEM Club continues to think that growth will slow to around trend rates through the latter half of 2024. Following slightly less growth momentum through the middle of the year, we expect growth to be 0.9% in 2024, a touch weaker than the 1.1% we forecast three months ago. Beyond 2024, we see growth improving to 1.5% in 2025 and 1.6% in 2026 on the back of solid real income growth, improved sentiment, and looser financial conditions. We expect growth to track around 1.5% until 2029. That said, with updated data showing households now have less space to dissave, our growth outlook is weaker than in our previous forecast.
- The labour market has loosened in recent months but remains tight. Hiring has slowed, with vacancies back to around pre-COVID-19 levels. However, there have not been large numbers of layoffs, with redundancies tracking below average for most of the year. Softening labour demand is balanced by continued weak labour supply, which is weighed down by the increase in the number of people who are absent from the labour market due to long-term sickness. As a result, pay growth has slowed, but remains above normal rates.
- Inflation clocked 1.7% in September, 0.3ppt below the Bank of England's (BoE's) 2.0% target. We expect inflation to rise above 2.0% again in October and, absent any major geopolitical risk crystalising, we expect inflation to remain around 2% over the next few years. We expect wage growth to slowly head towards 3.0% by the end of next year, as workers push a little less forcefully for pay gains following the loosening of the labour market and lower inflation expectations. Stable inflation and solid pay growth will support household incomes and continue to support consumer confidence, the combination of which will lift consumption as households' saving patterns head back to more normal rates.
- The BoE kicked off its cutting cycle in August but took a breather at its September meeting. With the BoE becoming more confident that it is getting on top of inflation, it's beginning to think more about future growth prospects when setting policy. Nonetheless, it will tread carefully as it adjusts Bank Rate, balancing the risk of re-igniting inflation and weakening the growth outlook. We think that Bank Rate will fall to around 3.5% by the end of next year as pay and inflation pressures fall back to around target consistent rates at the end of 2025.
- Falling interest rates will only have a modest impact on growth over the next couple of years. With core and pay growth still high, the BoE will lower Bank Rate more slowly than it has in previous cycles. While the fact that many UK mortgage holders will fix to higher mortgage rates in 2025 and 2026 will cap some of the effect of a lower policy rate.
- In response to the UK's stretched fiscal position, our base case is that fiscal policy will continue to act as a break on UK growth. The Labour Government inherited a set of fiscal plans where the tax burden is set to rise and spending as a share of GDP fall. The policy measures announced in the Labour manifesto are likely to do little to change this trajectory, while we think that the additional spending identified in the post-election review of the public finances will likely have to be financed by additional tax rises.
- The upcoming Budget adds the greatest uncertainty to our projections. On one hand, remarks made by the Chancellor have led to speculation that she may adjust the UK's fiscal rules from those set out in the pre-election manifesto. Doing so is not just an accounting trick. It could open a lot more scope for Government investment than we have factored into our central case and could boost growth over 2025 and beyond. On the other hand, the Budget could see additional tax rises that may be needed to fund future spending challenges.
- More generally there are reasons to be optimistic about the UK's long-run growth prospects, with the potential improvements in private investment alongside the Government stated goal to hit an ambitious housing policy there is scope for UK potential output growth to improve over the next five years or so.



1

Introduction

In our last forecast in July[1], we argued that the UK economy was on the road to recovery as real incomes recovered following the 2023 inflation spike. Since then, the recovery has become more firmly entrenched, with growth continuing to run above trend in Q2. We continue to expect growth to pick up materially in 2024 to 0.9% from 0.3% in 2023. At the same time, inflation has remained around its 2.0% target offering continued support to households' real incomes. Overall, in the last three months it looks like the economy has taken a step in the right direction.

The BoE is increasingly more confident that it has got a grip on inflation and so is becoming more focussed on supporting future economic activity. Despite some stickiness in domestic inflation, the BoE cut Bank Rate by 25bp in August and looks likely to deliver another cut in Bank Rate at its November meeting. We expect more to follow through 2025 as pay and inflation fall back towards rates that are consistent with the BoE's 2.0% inflation target. Nonetheless, we expect the adjustment in the policy rate to be slower than has typically been the case in the past, as the BoE balances the risk of re-stoking inflation with exerting too great a drag on economic activity. The steady normalisation of Bank Rate and the continued lagged effects of previous Bank Rate hikes mean looser monetary policy will offer only modest support through 2025 and 2026.

Our base case is that tight fiscal policy will offset some of the support coming from loosening monetary policy. We expect growth to pick up modestly reaching 1.5% in 2025 and settling around that level or a little higher in future years. However, with the upcoming Budget, the exact course of fiscal policy remains uncertain. Our central forecast builds in the tax and capital spending plans outlined in Labour's manifesto and assumes the additional spending identified in the Chancellor's review of the public finances will be funded by higher taxation. However, changes in tax and spending plans beyond these present a two-sided risk to our projections.

Our latest forecast begins with a discussion of recent economic developments. Section 3 examines the key elements of our new forecast. Section 4 previews the upcoming Budget and analyses how the new Government may tackle the UK's fiscal challenges. Section 5 looks at the UK's growth performance over the long-run and how potential output may develop from here. Section 6 concludes.

1. See EY ITEM club Summer Forecast – July 2024.

2

Heading back to trend

A very strong start to the year may fade a little

Looking back to our previous forecast, our key judgement that the UK's recovery had taken hold remains on track. Across the first half of 2024, the economy has grown at an average pace of 0.6% a quarter. The robust start to 2024 means that the economy has already made up the ground lost in the technical recession at the end of 2023, with GDP already having surpassed the pre-recession peak by 0.7%.

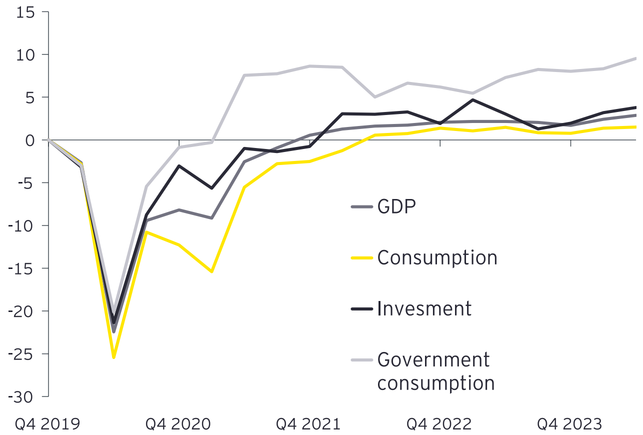
However, consumption remains somewhat weak relative to its key drivers. Falling inflation and a tight labour market have kept real pay growing at a healthy pace and have contributed to a strengthening in consumer confidence, looking past the most recent pre-Budget dip. However, households continue to save more than normal. Albeit, revisions to official estimates of the household savings ratio make this trend less stark than we previously had thought.

Businesses have underpinned the sustained momentum. On the face of it, the trio of a rapid rise in interest rates, a period of soft demand, and elevated labour and non-labour costs presents a challenging backdrop for the corporate sector — corporate insolvencies have risen sharply. However, with the economy looking to have turned the corner and the impacts of the pandemic and energy price shock fading, investment constraints are easing, and firms' capex intentions are beginning to improve. Business investment grew by an average of 1% per quarter over H1.

The signs are that Q3 will likely be another quarter of healthy growth, if a little below the 0.5% q/q recorded in Q2. Across the three months to August, output grew by 0.2%. At the same time, business surveys also point to a slight moderation in growth. September's S&P Global Composite Purchasing Managers' Index was slightly below the average for the first nine months of the year. While some of the strength in GDP over the first two quarters of this year has been focussed in surprisingly strong Government spending, that's likely to reflect the fact there was less industrial action, so this boost will now fade. That said, at this stage in the data cycle the expenditure breakdown of GDP can be prone to revision, and we guard against taking too much signal from that alone.

UK: GDP and components since the pandemic

% change since Q4 2019



Source: EY ITEM Club, Haver Analytics

The labour market has loosened a little, but remains tight

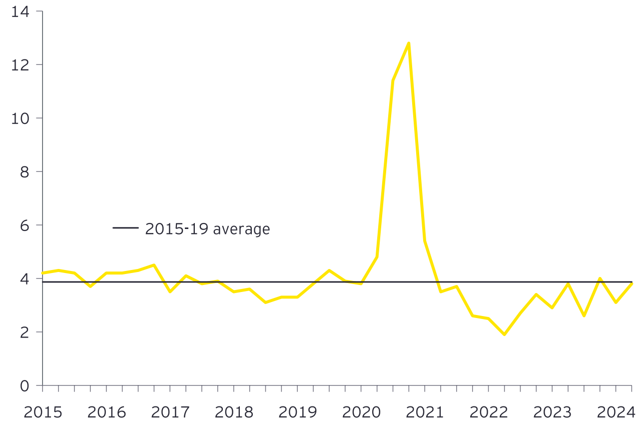
The demand for labour has continued to ease back towards a more normal level over the last few months. Vacancies are now around their pre-pandemic level. However, with activity holding up and corporate balance sheets in quite a healthy position relative to their pay bills, there has not been a wave of layoffs. All told, while the number of people being hired has undoubtedly slowed, firms have yet to really start shedding labour.

Any weakness in the demand for workers continues to be compensated for by the reduced availability of staff. Since the pandemic, the proportion of people who are working or looking for a job has fallen. While this does in part reflect more individuals choosing to stay in or return to education, the main driver is that long-term sickness is keeping more people from participating in the labour market. The net effect is that with a lower participation rate, the softening in demand for workers has not materially reduced the competition for staff, leaving a labour market that now looks to be broadly in balance.

Even though the labour market looks to be in better balance than we've seen in recent years, pay growth has not yet returned to rates that are compatible with inflation reaching the BoE's 2.0% target. Looking at the private sector and excluding the volatility from bonuses, pay

UK: Redundancy rate

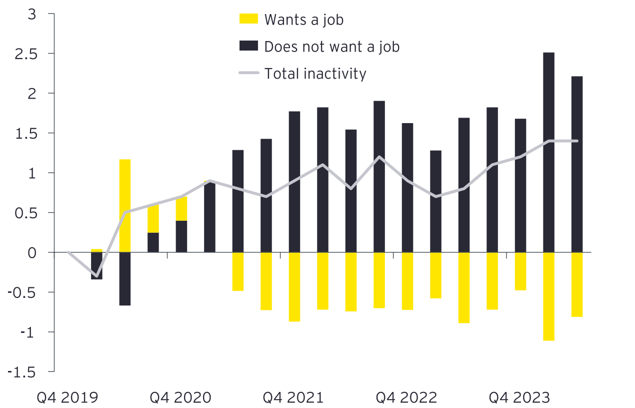
Redundancies per 1000 employees



Source: EY ITEM Club, Haver Analytics

UK: Change in labour market inactivity since the pandemic

pp relative to Q4 2019



Source: EY ITEM Club, Haver Analytics

growth slowed to around 4.5% y/y in August. While that's a sharp slowdown from the close to 8.0% y/y growth we saw in the middle of 2023, it looks like reducing pay growth further will be a more gradual process. To date, earnings growth has fallen as workers' inflation expectations have softened. While expectations have now normalised, surveys of pay settlements remain elevated as workers try to make good losses in real pay seen over the last couple of years.

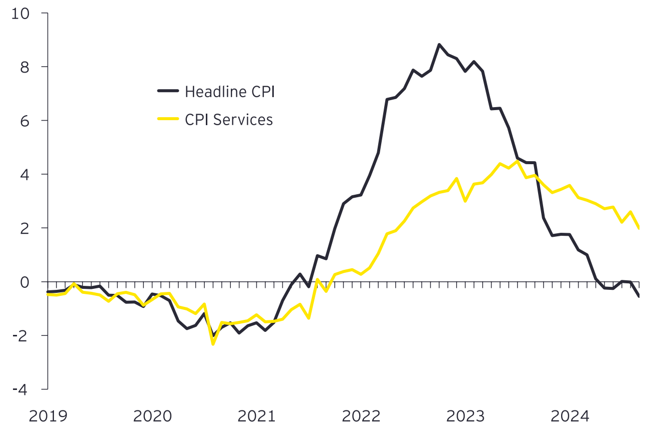
Close to target, but still so far …

Inflation has fallen back below the BoE target, but that does not mean the battle against sticky inflation has been won. Headline inflation printed 1.7% in September, below the BoE 2.0% target. However, inflation looks set to tick back up above 2.0% from next month as September's base effects disappear and the 10% rise in households' energy bills feeds through. While inflation has more than halved since the turn of the year, this hides how sticky inflation has really been. So far, the big drop in headline inflation can be explained by households' paying smaller energy bills than this time last year, a softening in food price inflation and reduced supply chain pressure for goods.

Scratch below the surface and services inflation, which is more exposed to the domestic labour market than headline inflation, has remained stubbornly high. In September, services inflation stood at 4.9% y/y, far in excess of its long-run average of 3.0%, and not much below the 6.0% y/y recorded at the start of the year. While part of this stickiness reflects past elevated inflation, part of it reflects businesses' responses to pay and non-labour cost pressures. While the services sector has benefitted from falling energy prices over the last few months, a tight labour market and elevated wage growth has meant a gradual decline in services inflation. Analysis from the BoE now reports that wages, rather than energy costs has become the key determinant in firms' price setting.[2]

UK: Headline and services inflation

pp deviation from 2010-19 average



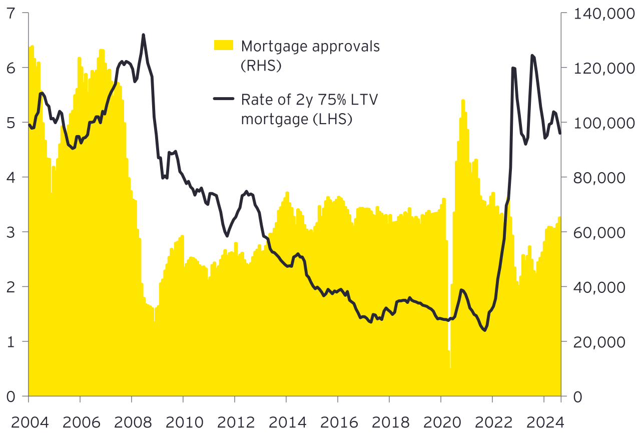
Source: EY ITEM Club, Haver Analytics

With inflation back at target and the labour market starting to loosen, the BoE has set its focus more on where inflation is likely to go, rather than where it is now. With this in mind, the BoE's Monetary Policy Committee (MPC) have judged that it is appropriate to cut Bank Rate, but do so gradually, to ensure that it keeps a lid on inflationary pressures without weakening demand unnecessarily. The MPC delivered the first cut in its cutting cycle in August,

2. See Bank of England "Monetary Policy Report – August 2024"

UK: Mortgage rates and approvals

%, quoted rate on new mortgage   mortgage approvals for home purchase



Source: EY ITEM Club, Haver Analytics

but skipped making any changes at the September meeting, instead setting out that the BoE's November meeting will be the next time it judges whether Bank Rate should be cut further.

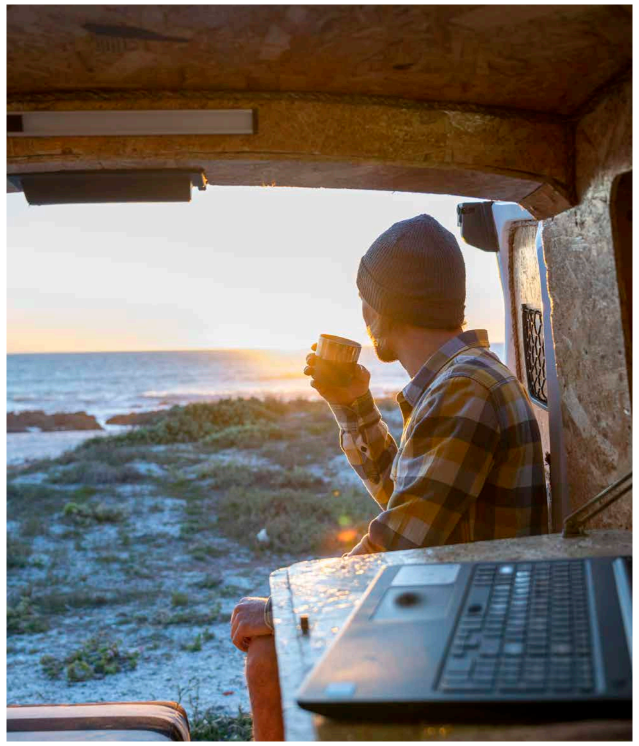
The BoE has not been alone in cutting rates with the European Central Bank (ECB) and the Federal Reserve (the Fed) having cut policy rates by 75bp and 50bp, respectively. With inflation concerns dwindling and more focus turning to the growth outlook, the narrative around international monetary policy has changed. The Fed and ECB have both acted more aggressively than expected a quarter ago. At its September meeting, the Fed opted to deliver a 50bp cut in the Federal Funds Rate to make up the ground lost by not cutting at its July meeting. Meanwhile the ECB having cut at its June meetings, has delivered back-to-back 25bp cuts at its September and October meetings breaking from its previous intention to cut at a pace of 25bp per quarter.

Financial markets have run with the recent change in tone in major central banks' narrative and, zooming in on the BoE, they see a further 25bp cut in November as a near certainty and as of mid-October see a better than even chance of a back-to-back cut in December.

Cutting cycle is starting to stir the housing market

Following the first cut in Bank Rate, financial markets re-priced to expect more cuts over the next couple of years two and five year interest rate swaps fell and this is starting to be passed through to mortgage rates. For example, the average quoted rate for a 75% loan to value fixed two-year mortgage fell to 4.59% in September, 57bp lower than three months ago.

In response, housing activity and prices have picked up through the summer. The recent improvement in mortgage affordability has seen mortgage approvals for new house purchases rise to around their 2019 levels. Despite a period where earnings growth has run ahead of house price gains, most affordability metrics remain stretched relative to historical norms.



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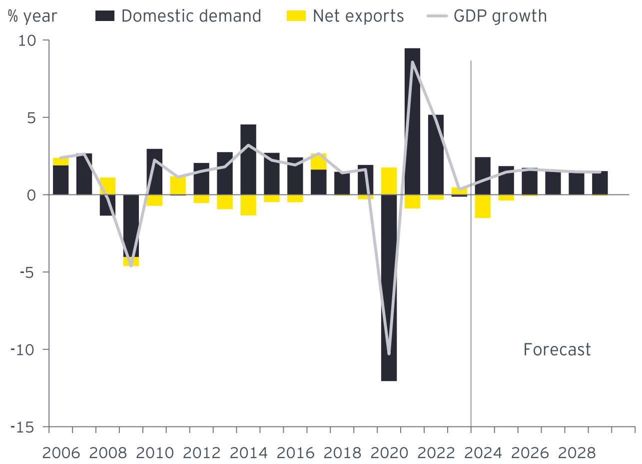
The recovery is well underway

Growth set to slow trend after a strong start to the year

As the recovery beds in, we continue to expect growth to slow a little into H2. Nonetheless, we still expect the growth picture across 2024 as a whole to be far healthier than over 2023. Since the last report, a downwards revision to Q2 and signs growth is heading back towards trend in Q3 has caused us to nudge down our 2024 growth projection to 0.9% from 1.1%. That remains a significant pick up from 0.3% recorded over 2023.

From 2025, we revise down our growth forecasts to reflect the fact that following a large downwards revision to the saving ratio in 2024 the consumer has less space to reduce savings than we previously thought. We now expect growth to clock 1.5% in 2025 and 1.6% in 2026, down from 2.0% in our previous projections. In the face of a tight, but loosening labour market we think that the economy begins in what is a balanced position, with no clear signs of economic slack.

UK: Contributions to GDP growth



Source: EY ITEM Club

A combination of gradually loosening monetary policy and relatively tight fiscal policy is expected to keep growth around trend pace from here. However, the new Government is yet to announce its first Budget, which could change the fiscal landscape. Our base case sticks to the relatively tight set of plans included in the Labour Party's manifesto. This predicts that most of the additional spending identified in the Chancellor's review of the public finances, and the uplift to taxes to fund it, will reoccur beyond this year. Section 4 looks in more detail at the upcoming Budget and sets out how more ambitious plans may impact the growth outlook.

Despite the relatively stable path for growth over the coming years, there is a switching in its composition. Productivity growth is expected to recover a little further, settling just below 1.0%, while employment growth is set to slow towards just over 0.5% per year. Section 5 digs into more detail on the UK's long-run growth and how it might be improved beyond our base case.

The labour market remains in balance as pay gradually normalises

As the shifting policy mix between monetary and fiscal policy broadly offset to keep growth at around roughly trend rates, we expect employment growth to be steady. We think that the unemployment rate will stabilise around current rates.

We project pay pressures will ease back towards rates consistent with 2.0% inflation by the end of next year. Over the last couple of years, high pay growth has helped the consumer regain much of their lost spending power. While the labour market remains in balance, we expect workers to squeeze out a little bit more of an improvement in their real pay as they try to make up for any remaining losses felt during the 2023 energy price shock. But with labour demand now back to more normal levels, we expect less aggressive pay negotiations to take place through the latter half of this year and the start of next, consistent with the softening we have seen in recent pay settlements. Ultimately, now that households' inflation expectations have broadly normalised, we forecast earnings to slow through the latter half of this year and next year, reaching rates that are consistent with 2.0% inflation by this time next year.

Inflation to slowly ease as earnings growth pares back

Inflation begins our forecast below the BoE's target, but is expected to pick up to a little above 2.0% through 2025 and into 2026. But this shallow decline masks a variety of moving parts. Currently headline inflation is being dampened by households' energy bills, which are much lower than at the same time last year. But this effect is set to wane with households' energy bills having increased by 10% in October. This will push up inflation through the end of this year. This boost will be exacerbated by a likely rise in fuel duty towards the start of next year and the imposition of VAT on private school fees, which will also temporarily lift inflation.

Looking past the movements in the more volatile components of the inflation basket, the inflation picture is less benign and suggests that there is still some way to go until it is at rates consistent with the 2.0% inflation target. Currently running at 3.2% y/y, most of the easy progress on core inflation has been made. The sharp decline seen in core inflation to date has reflected very weak growth in goods prices as the post-pandemic supply chain recovery flowed downstream to the prices on the shelves. But we think that has now largely run its course. Further progress on core inflation will largely be driven by easing services inflation, which has been, and we think will continue to be much stickier, reflecting the slow normalisation in pay growth. We forecast core inflation will not fall below 3.0% until the middle of next year.

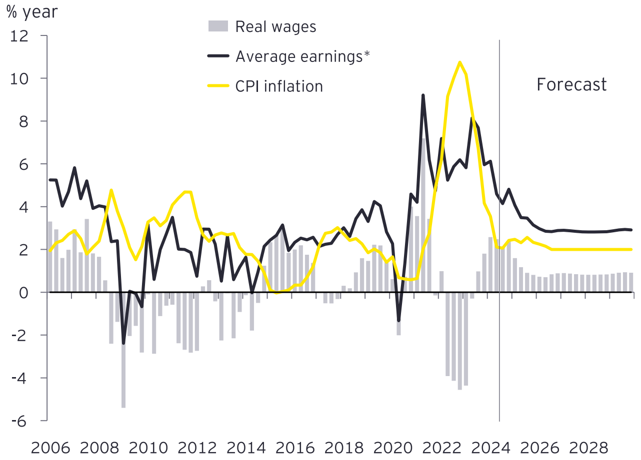
The consumer will carry on spending in the face of sticky inflation

We continue to think that the conditions needed to support consumption will be in place over the next year or so. Albeit, like our wider growth forecast, the pickup in our consumption forecast is less marked than in our last forecast. Since our last forecast, the ONS has undertaken its annual reassessment of the National Accounts data, where one of the largest changes was to the household saving ratio. While the latest data do to continue to show a rise in the saving ratio in recent quarters, it now starts the forecast at a much lower level than in our Summer projections. With less space for households to reduce their savings rates, we now expect consumption growth to rise to 1.9% in 2025, 0.6ppt lower than our previous forecast.

Nevertheless, the saving ratio remains high relative to historical norms. So, with consumer confidence normalising — save for a pre-Budget blip — and households' balance sheets in good health, we still see scope for the savings ratio to decline further from here. At the same, the gradual slowing in pay growth over the remainder of this year and next, means real earnings growth will remain solid. Taken together, we think these two factors will continue to support consumption growth.

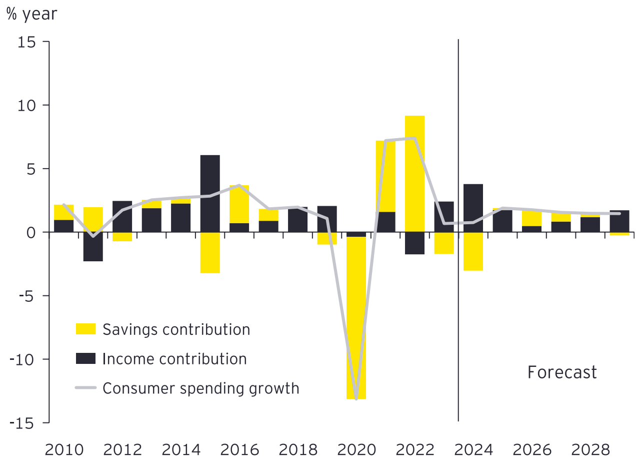
Spending on big ticket items continues to lag other consumption categories. By 2024's midpoint, total consumption was 1% higher than its pre-pandemic level, but durable goods stood more than 7% below. Other major consumption categories have, broadly speaking, now recaptured, or gone past their pre-pandemic levels. With households expected to save less, and durable goods yet to respond to households' greater discretionary spending power, there is some scope for the consumption of durable goods to make up some of the lost ground.

UK: Average earnings and inflation



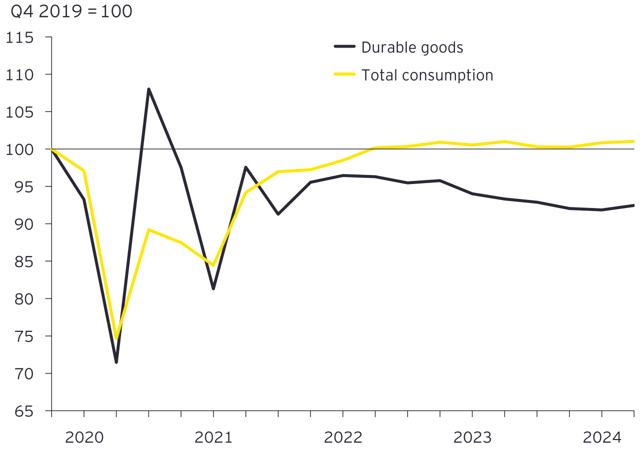
Source: EY ITEM Club *National Accounts measure

UK: Contributions to consumer spending growth



Source: EY ITEM Club

UK: Total and durable goods consumption



Source: EY ITEM Club, Haver Analytics

We expect the Bank of England to cut Bank Rate gradually

We think that the MPC's decision to keep Bank Rate on hold at its September meeting was a skip rather than a pause in its loosening cycle. Having delivered its first cut in August, the BoE made clear that it would adjust policy gradually and would guard against doing too much, too quickly. September's decision to keep Bank Rate on hold was consistent with this. The minutes of the meeting made clear that the November meeting remains 'live' with the MPC identifying it as the right time to update its assessment of the economic outlook.

We continue to think that the BoE will cut again at its November meeting and reduce Bank Rate further into 2025. Bank Rate is at a level where it is clearly restraining

The EY ITEM Club forecast for the UK economy, Autumn 2024

% change on the previous year except borrowing, current account and interest and exchange rates

	GDP	Domestic demand	Consumer spending	Fixed investment	Exports	Imports
2022	4.8	5.1	7.4	5.1	12.6	13.0
2023	0.3	-0.1	0.7	-0.1	-2.2	-3.4
2024	0.9	2.2	0.8	1.2	-0.8	3.7
2025	1.5	1.8	1.9	2.0	3.5	4.3
2026	1.6	1.7	1.8	1.9	2.3	2.4
2027	1.6	1.5	1.5	1.6	1.9	1.8
2028	1.5	1.5	1.5	1.2	1.7	1.7
2029	1.5	1.5	1.5	1.2	1.6	1.7

	Net Govt Borrowing(*)	Current account (% of GDP)	Average earnings	CPI	Bank Rate	Effective exchange rate
2022	4.8	-2.2	6.1	9.1	1.5	79.6
2023	4.4	-1.9	6.9	7.3	4.7	80.4
2024	3.2	-3.0	5.0	2.6	5.1	83.5
2025	2.2	-2.9	3.7	2.5	4.2	84.3
2026	1.5	-2.8	2.9	2.1	3.5	84.5
2027	0.8	-2.7	2.9	2.0	3.5	84.6
2028	0.4	-2.7	2.8	2.0	3.5	84.8
2029	0.4	-2.6	2.9	2.0	3.5	84.9

Source: EY ITEM Club

* Fiscal years, as % of GDP

activity. And while inflationary pressures remain high by historical standards they are easing. With the risk of persistently elevated inflation diminishing, the MPC has started to become more forwards looking as it tries to keep a cap on inflation without unnecessarily weakening the economy. As, if we project, pay and core inflation continue to normalise through the remainder of this year and next, we think the BoE will aim to reduce Bank Rate to the point where it is no longer restrictive by the end of next year — around the time these key gauges of inflationary pressure hit the rates consistent with inflation settling at the 2.0% target.

The point at which Bank Rate is neither boosting nor holding back economic activity is highly uncertain, making it unclear how far the BoE will cut. However, our best guess is that the MPC will cut to around 3.5% before pausing there. At that point, interest rates will be broadly in line with how quickly national income can grow on a sustained basis. That end point also corresponds to the rough rate that the Bank of England's survey of market participants expect Bank Rate to settle[3]. Our forecast is not dissimilar to financial market expectations, which in mid-October, almost fully price a 25bp cut at the BoE's November meeting and a sustained cutting cycle through 2025. As it stands, markets expect Bank Rate to fall to around 3.75% by the end 2025, holding broadly steady thereafter.

Support for growth from lower Bank Rate will take longer than normal

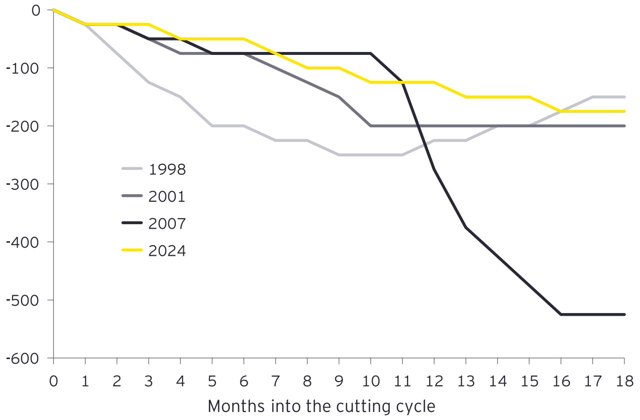
A sustained cutting cycle will support growth, but this time its effect may be a little more delayed than we have seen before.

First, by historical standards, we expect the BoE to adjust rates relatively slowly. The BoE is not reducing Bank Rate in response to a surprisingly weak economy, as it did in response to the global financial crisis, for example. Rather, following numerous shocks that have hurt the UK's supply capacity, it is gradually dialing back restriction as it tries to prevent any spare capacity from gradually appearing. Furthermore, following a period of very high inflation, the BoE has to balance beginning to support the economic recovery with acting too quickly and sparking a re-emergence of inflationary pressures.

Second, the shift towards fixed mortgages mean that many borrowers will not see a cut in mortgage payments for an extended period. Indeed, a significant minority of households will refinance a fixed rate mortgage to a higher rate, even as Bank Rate is being cut. This effect will only likely start to turn around in 2026 once those households who took out five year fixed rate mortgages during the pandemic, when rates were very low, have remortgaged.

UK: Change in Bank Rate over cutting cycles

bp, change in Bank Rate from month before first cut



Source: EY ITEM Club, Haver Analytics

The course of fiscal policy is the greatest uncertainty around the UK outlook

As we have done in previous reports, our base case assumes a tightening of fiscal policy. The Government, inherited a set of fiscal plans from the previous Government, that are set to see the tax burden rise and spending as a share of GDP decrease. As we set out in our Summer Forecast, the Labour Party's manifesto did little to change these plans at an aggregate level, leaving fiscal policy to remain on course for a further tightening. Indeed, the net effect of the tax and spending changes announced in the run up to the election have little impact on the growth outlook in our view and do not make a material difference to our forecast.

Since taking over the reins as Chancellor, Rachel Reeves has undertaken a review of the public finances and HM Treasury analysis has identified the need to spend an additional £21.9bn across this fiscal year. Around half of the shortfall reflects increased pay settlements for public sector workers and so will recur in future years. To date, the Government have announced plans to cover around £8.1bn of the shortfall. And we think that as the Labour has pledged to only borrow to invest, it is likely that the Budget will have to include additional tax rises to makeup the rest of shortfall[4]. Our base case includes £10-12bn of additional tax rises, so we do not expect this additional spending to have a large effect on the growth and inflation outlook.

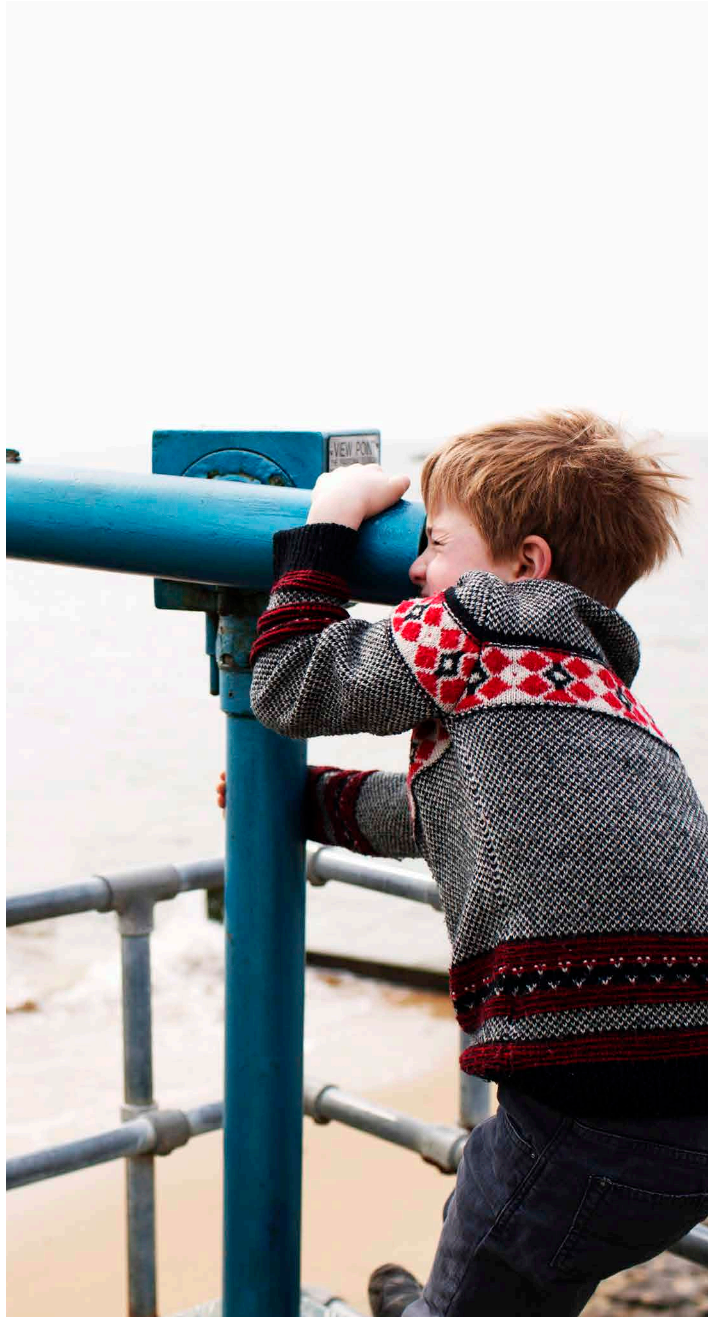
3. See Bank of England Market Participants Survey — September 2024.
4. See Labour Party Manifesto 2024.

Nonetheless, the course of fiscal policy presents the greatest uncertainty around our forecast. On one hand, the Chancellor's pledge to "invest, invest, invest" presents an upside risk to our autumn growth and inflation projections and depends on the extent to which the Government adjusts the UK fiscal rules. On the other hand, the Budget may set out additional tax rises beyond those factored into our forecast that could be used to fund additional spending needs beyond those identified in Labour's audit of the public finances. Section 4 previews the 30 October Budget in more detail and looks at how changes in public investment might impact on the growth outlook.

Global economic backdrop could weigh on UK growth

On the other side of the coin, the global economic recovery looks more fragile than three months ago. The economic data coming out of the US and eurozone has been mixed, with indicators of European activity having been particularly soft in the last month or so. This could presage one of two downside scenarios for the UK. A harder landing in the US and eurozone, could weaken the narrative around the global economic recovery and weigh on UK sentiment and domestic demand. The second, perhaps more concerning scenario is if that economic weakness in the US and eurozone is a sign of things to come in the UK, where the lagged effects of interest rate hikes are likely to take longer to be felt by the real economy. If the first risk were to play out, the BoE would likely cut Bank Rate towards neutral a little more quickly than in our base case, probably arriving there in mid-2025. In the case of the second risk, it could even cut Bank Rate below neutral.

As we flagged in our last report, broader geopolitical risks also continue to pose a risk to the outlook. Continuing conflicts in Ukraine and the Middle East remain an upside risk to energy, oil, food and transportation costs. In addition, the US election on 5 November, which could result in material policy changes in the world's largest economy.



4

A change to the fiscal rules would be more than just an accounting trick

Following the Labour Party's landslide victory in the July general election, it will deliver its first Budget on 30 October. Fiscal policy changes announced in both the pre-election manifesto and the Chancellor's review of the public finances are unlikely to have a material impact on the broad macroeconomic outlook. However, the UK's wider fiscal challenges means the Budget could have wider implications for fiscal policy. We see the risk as two sided. On the upside, the mood music since the Labour Party conference has suggested a tweak to the fiscal framework to allow more public investment. On the downside, the Government faces the challenge of putting in place funding for potential future spending increases, which may require additional tax rises to be announced at the Budget. In this section, we look ahead at the fiscal challenges that face the Government and how it may tackle them at the Budget.

Keeping the UK's public finances on a sustainable footing

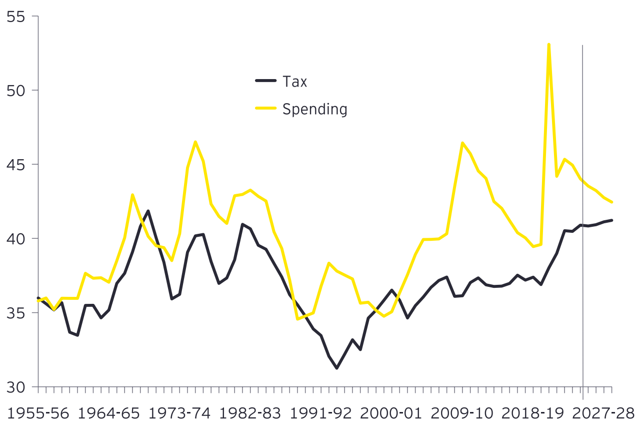
UK public debt increased through the COVID-19 pandemic and energy price crisis as the Government put in place emergency measures such as the furlough scheme and the energy price guarantee. With the effects of these shocks fading, the previous Conservative Government looked to ensure the sustainability of the public finances by putting in place a set of policies that would put the UK's public debt position on a downwards trajectory within five years. The result was reduced public spending, relative to the size of the economy, and an increased tax burden.

In its pre-election manifesto, the Labour Party committed to continued fiscal prudence through two fiscal rules:

- Retaining the Conservative Government's primary fiscal rule, by continuing to set fiscal policy so that the UK's debt position would be on a downwards trajectory within five years.
- Supporting the UK's growth outlook by only borrowing to invest.

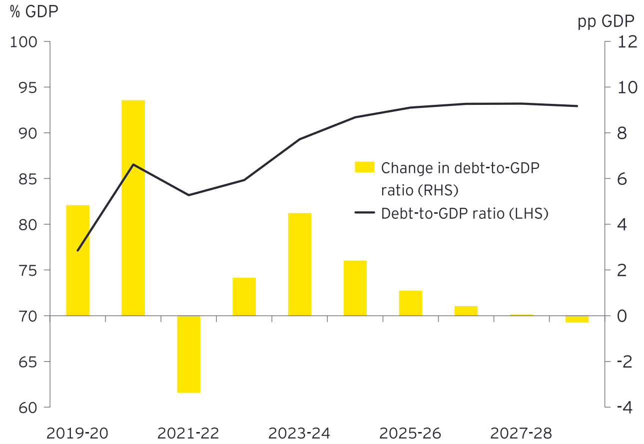
As we set out in our Summer Forecast, the fiscal rules in the Labour manifesto gave the Government little wiggle room when it came to changing the overall fiscal position. The starting point for the new Government are the tax and spending plans it inherited from its predecessor. And these were judged to only just get the debt-to-GDP ratio falling. At the March 2024 Budget, the Office for Budget Responsibility (OBR) forecast that in 2028-29 the target would be met by only £9bn. This tiny amount of headroom translates to the OBR estimating that these plans have nearly as good a chance of working (54%) as they do at failing against the debt target. Therefore, while Labour never formally signed up to the Conservative Party's fiscal plans, by sticking to its debt rule, it effectively committed to any policy changes it implemented being fiscally neutral.

UK: March 2024 Budget tax and spending plans



Source: EY ITEM Club, OBR

UK: March 2024 Budget debt-to-GDP projection



Source: EY ITEM Club, OBR

The fiscal rules could be changed to free up more fiscal space

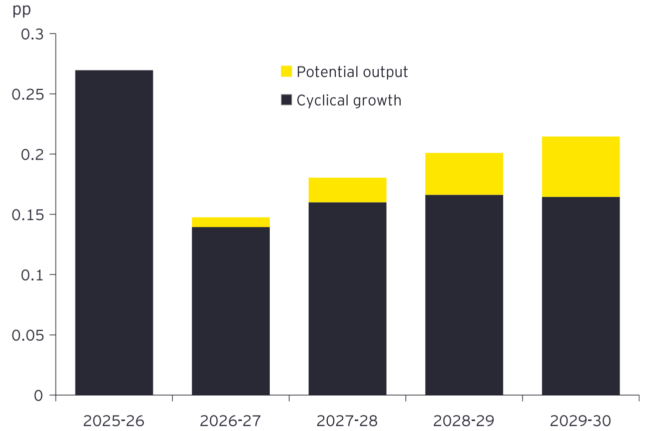
Despite the relatively little scope within Labour's rules to adjust tax and spending plans, the Chancellor has been clear the Government would like to increase public investment. In fact, remarks in her Labour Party conference speech that the Government would like party assets to play a greater role in the assessment of the health of the public finances has led some commentators to speculate that the Government may tweak the definition of debt used in its debt rule.[5]

A technical tweak could open much more fiscal headroom. The debt rule inherited from the Conservative Government focuses on public sector net debt excluding the BoE balance sheet. The most conservative change to the fiscal rules would be to revert to using public net debt as the key metric, a measure previously used in the UK and still used around the world to judge the condition of the public finances. The way the balance sheet of the BoE is accounted for means that once included, public debt would fall more quickly in five years' time, opening around an additional £16bn of headroom.

A more significant shift would be to consider not only Government debt, but also include a broader range of public assets when considering fiscal sustainability. While public sector net debt includes only liquid financial assets, the inclusion of more illiquid financial assets like unpaid student loans (Public Sector Net Financial Liabilities, PSNFL) or all assets (Public Sector Net Worth, PSNW) could generate an even more pronounced drop in the debt-to-GDP ratio. Opting for one of these two metrics could increase the amount of headroom to around £50-60bn.

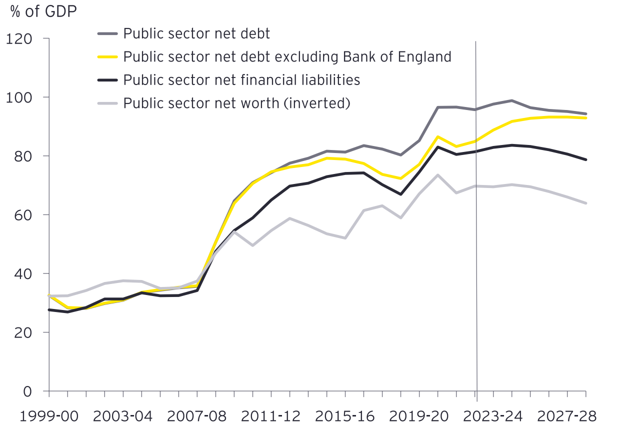
If there were to be a change in the debt to rule to be measured on a PSNFL or PSNW basis, it seems unlikely the Government would use all of the additional fiscal space. Firstly, increased debt service costs would begin to impact on already stretched day-to-day spending. Secondly, it returns the Government to a situation where they are again left with very little space against the debt-target. Instead, a more likely upper bound would be an increase in investment of around £25bn, which would, based on the OBR's March forecasts, keep investment as a share of GDP from now until 2028-29 broadly flat. Even then, while this would be a step up on previous plans, it would, as we set out in our summer report, still leave the UK lagging some of its international peers.[6]

UK: Impact on growth of holding public investment flat



Source: EY ITEM Club, OBR

UK: Alternative measures of the public sector balance sheet



Source: EY ITEM Club, OBR

5. See Chancellor Rachel Reeves speech at Labour Conference 2024.
6. See EY ITEM club Summer Forecast – July 2024.

If the Government were to increase annual investment by around £25bn by 2029-30 that could boost growth by up to 0.3pp at its peak impact. This is a material effect and could be larger if investment plans were brought online more quickly or were more ambitious than our simple experiment. Nonetheless, it illustrates how important changes in the Government stance on investment will be for growth over not only next year, but for years after that.[7]

Tweaking the fiscal rules would still leave the Government facing day-to-day spending challenges

Since taking office, the Rachel Reeves' audit of the public finances suggests that the fiscal position may be more challenging than previously thought. HM Treasury has identified an overspend of £21.9bn over the rest of the year is likely. Around half of this uplift reflects the Government's signing up to higher than budgeted for public pay deals and, therefore, will persist beyond this fiscal year. Previously, public sector pay deals had been budgeted to rise by between 1 and 3% as set out in the 2021 Spending Review. But in response to recent high inflation, the Government has agreed to public pay boards' recommendations to raise pay in some parts of the public sector by 5.5%.

Beyond this fiscal year, the departmental spending plans the Government has inherited look difficult to deliver. As it stands, across 2025-26 to 2028-29 day-to-day departmental spending is expected to grow by 1.0% each year in real terms. Given spending on some public services is protected, the Institute for Fiscal Studies (IFS) estimate that funding for unprotected services will be cut by around 3.3% per year under the current spending arrangements.[8] We think it unlikely that the Government would want to see some services reduced to this extent, which would require it to increase spending further in coming fiscal years. But that would come at a cost. The IFS Green Budget estimates that the Government would have to increase spending by £30bn in 2028-29 to fund current spending pressures that reoccur, manifesto promises and prevent real-term cuts to unprotected departments.[9]

However, any changes to the debt rule would do little to ease the challenge of funding day-to-day spending. Even in a scenario where a change to the debt rule opened a lot more fiscal space, day-to-day spending would still be restricted by the Government pledge to only borrow to invest. Looking back to the March Budget, the OBR already judged there to be very little wiggle when it came to hitting this goal, with revenue only covering day-to-day spending by £13.6bn.

A tax rising Budget

Therefore, it seems likely that taxes will have to rise at this Budget if the Government are to stick to the fiscal framework it set out in the run up to the general election. As a starting point, the public finances are already off track across the year-to-date. By September, borrowing was already running £6.7bn above the March Budget projection leaving the Chancellor no wiggle room with which to fund the £21.9bn shortfall she has identified. While to date, the Government have identified around £5bn of savings this year growing to £8.1bn next year, additional funding will be required to meet these spending commitments. Therefore, it seems likely that at least around £10-12bn of additional tax revenue may need to be raised. And these taxes rises will need to be permanent to fund overspend in 2024/25 that will roll through to later years.

The Chancellor has committed to provide updated spending totals for the remainder of the Parliament at this Budget, with a more comprehensive Spending Review to be delivered by the spring. Therefore, this Budget may need to put in place tax rises today, to fund additional future increases in day-to-day spending. We have not built these tax rises into our base case, but on their own they clearly present a downside risk to the growth outlook.

7. See Office for Budget Responsibility "Public investment and potential output".
8. See Emerson et al "Fiscal rules and investment in the upcoming budget"
9. See IFS "Green Budget 2024"

5

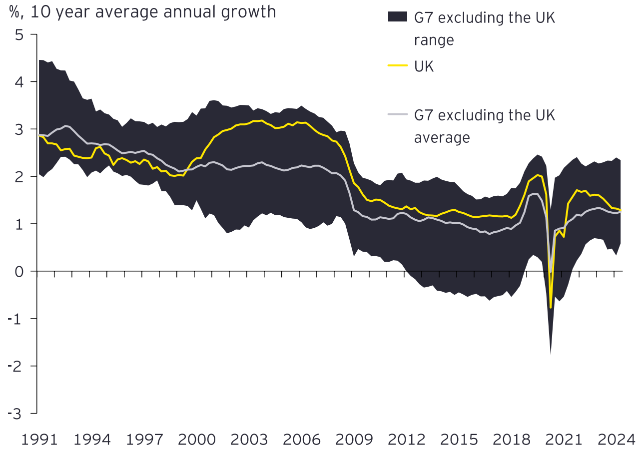
Reasons to be positive about the long-run

The latest data have shown that the UK economy grew modestly across 2022 and 2023. However, the prospects for the UK are looking up from here. And while growth over the next couple of years will be driven to some extent by changing demand conditions, where growth settles after that will be determined by the UK economy's ability to efficiently deliver goods and services.

Looking back over recent history, it's clear that trend growth has slowed across major developed economies and the UK has been no different in this regard. In the decade before the global financial crisis, UK growth averaged around 2.75% each year. Likewise, the rest of the G7 – the US, Canada, France, Germany, Italy and Japan – grew annually by more than 2.00%. At the end of 2019, just before the onset of the COVID-19 pandemic, the UK's growth trend had slowed to less than 2.00%. A fall mirrored in the other large developed economies.

G7: Trend GDP growth

%, 10 year average annual growth

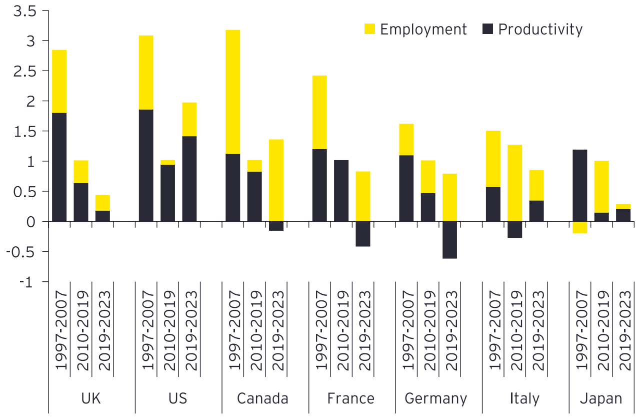


Source: EY ITEM Club, Haver Analytics

The widespread slowdown in economic growth can largely be accounted for by softer productivity growth. And this drop off is particularly notable in the UK. In recent years, the UK like many other economies was heavily disrupted by two large shocks: the global financial crisis and the COVID-19 pandemic. But the UK has also undergone a change in its trading arrangements as well as a sustained period of relatively weak investment from both the private and public sectors. As the EY ITEM Club pointed out in

G7: Drivers of GDP growth

%, average annual growth



Source: EY ITEM Club, Haver Analytics

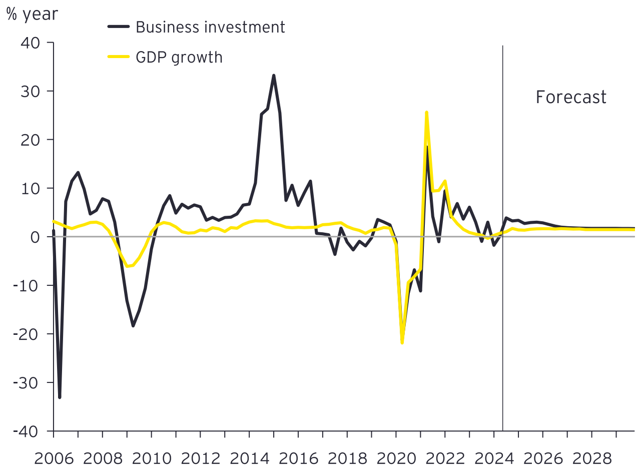
its Summer Forecast 2024 report, over the last couple of decades investment in the UK has typically lagged its international peers, which has limited the improvements to the UK's infrastructure and capped innovation.

There are a few bright spots on the horizon

Broadly speaking, there are two ways to improve the UK economy's productive capacity. Firstly, individuals can be provided with more or better tools – including skills and education – to do their job. Secondly, it can innovate to use its workforce and the tools available to it to become more efficient. The key to unlocking both will be continued investment and economic reform, and on both fronts there are reasons to be positive.

Private investment conditions are improving, which, when realised, will boost the UK's long-run supply potential. Firms across the industrial, consumer services and business services sectors have all identified staff shortages and the cost of finance as constraints on investment. However, with Bank Rate being cut and the labour market moving closer into balance these limits have eased. And we expect them to loosen back further with Bank Rate being cut further through 2025. More investment will directly support productivity by improving the tools available to workers. But it also helps to promotes innovation, which will often have larger, but more delayed benefits to productivity and overall long-run growth.

UK: Business investment and GDP



Source: EY ITEM Club

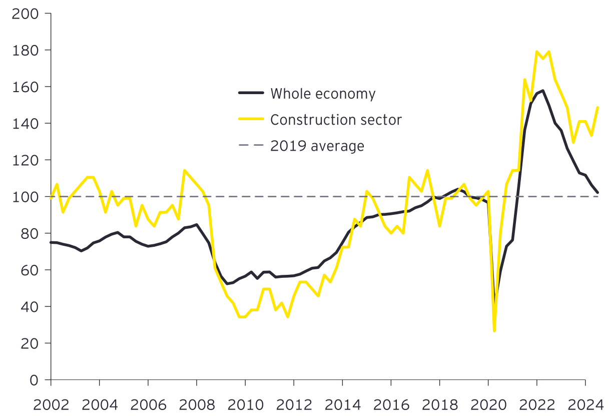
The outlook is also bright when it comes to UK innovation and technological adoption. Typically, the level of UK productivity has lagged the US and some other major European economies on a per worker basis. In part, this reflects the UK's specialism in services provision, which in many cases can be harder to scale than industrial output. However, even allowing for this, the UK still falls short of some of its international peers. But as the EY [UK Attractiveness Survey] shows, the UK remains a top choice for foreign direct investment in Europe. And this presents the UK with an opportunity to innovate and adopt more efficient delivery techniques and and catch up to the productivity frontier. Much of the recent foreign direct investment into the UK comes from US investors, interested in advanced engineering and supply chain projects. And given the UK is one of the countries better able to exploit new technologies, particularly Artificial Intelligence[10], we see scope for new innovation supporting productivity growth over the coming years.

As we mentioned in our preview of the Budget, there is a chance that the Government will increase public investment materially relative to existing plans. These investment plans would be not only important for the near term, but for the medium-term as well. Recent analysis from the OBR suggests public investment today would still have a positive effect on growth in five years' time.

Beyond direct spending, the Government can also help to support productivity through planning reform. In particular, its goal to hit ambitious housing targets could help increase productivity growth. If increased housing gives individuals greater scope to relocate to parts of the country where they can access more productive jobs, then overall productivity will benefit. In addition, academic research identifies the benefits of cities and the 'agglomeration effects' that come with them as being supportive of individual productivity. So, if implemented successfully, with these goals in mind, the Government's housing agenda would also be supportive of productivity growth.

UK: Vacancies in the construction sector and wider economy

2019 = 100



Source: EY ITEM Club, Haver Analytics

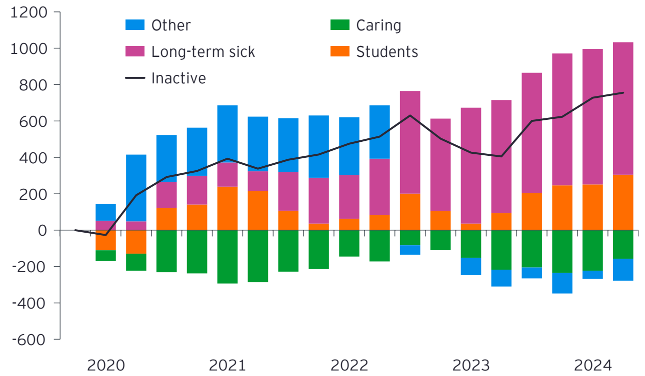
Boosting long-run growth takes time

There is no quick fix to boosting productivity growth. While conditions are supportive for improving productivity and long-term growth, the EY ITEM Club expect only a modest pickup in productivity growth over the next five years to 0.9% in 2029, a slight improvement on the 0.7% average of productivity growth over 2011-2019. Investment is small relative to the capital stock, so investment from both the private and public sectors needs to be sustained for it to have a meaningful effect on productivity. At the same time, innovations take time to feed through firms and gain sufficiently wide adoption to boost firms' efficiency. For example, rapid improvements in computer power and technology spending during the later 1970s and 1980s provided a large boost to productivity in the 1990s .

There's also limits to how quickly the Labour Government housing target will be able to boost growth. The current target is ambitious by historical standards. However, the labour market is tight. And the construction sector faces a skills shortage: vacancies in the sector are still well above their pre-pandemic level, in contrast with the wider economy. In addition, the Resolution Foundation's research argues that the current housing policy might not be sufficiently focussed on building housing around cities and not be totally optimised in terms of providing access to higher productivity roles.

UK: Reason for change in labour market inactivity since the end of 2019

000s of 16-64s not participating in the labour market



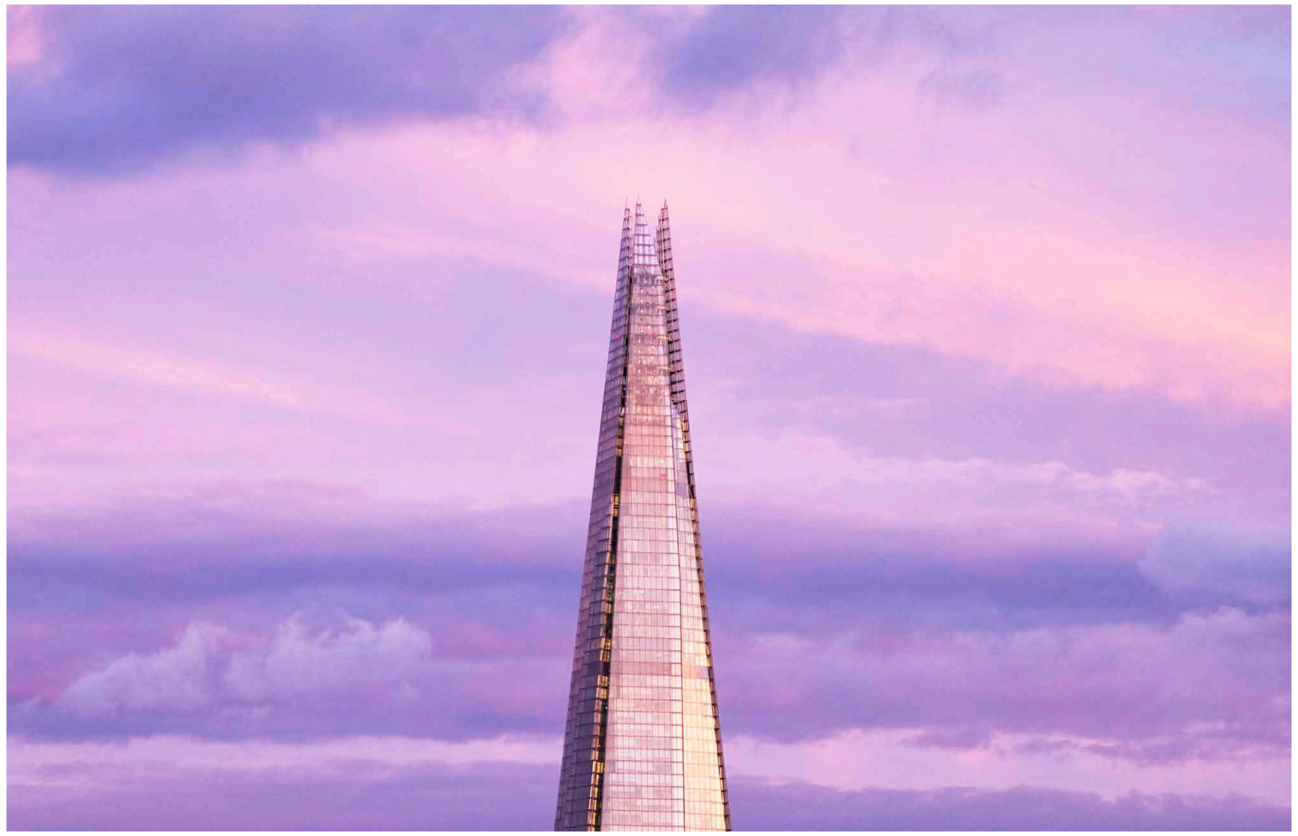
Source: EY ITEM Club, Haver Analytics

Improving health outcomes may help in the short-term

Since the pandemic, labour force participation has dropped sharply on the back of more people being unable to seek work due to long-term sickness. Going forward, an aging population will further drag down the number of people looking to work. Therefore, a more immediate boost to long-run growth could be policies that result in immediate improvements in the health outcomes of the working age population.

6

Conclusions



The UK recovery looks to have bedded-in and the economy moved into better balance. We expect the economy to remain around trend as interest rates start to weigh a little less on activity and fiscal policy continues to tighten. With the labour market returning to normal, we expect pay pressures and core inflation to ease back towards the rates consistent with inflation at the 2.0% target by the end of next year.

The BoE kicked off its loosening cycle in August and after taking no action in September, we expect them to cut again in November. From there we expect a relatively gradual cutting cycle as the MPC balance the need to support economic growth against the risk of re-emerging inflation. With the economy growing roughly at trend we think that the MPC will not need to cut rates too much and expect Bank Rate to fall to 3.50% by the end of 2025, where we expect it to remain.

With the new Government yet to deliver its first Budget, the key uncertainty around the outlook remains the stance of fiscal policy. At the Budget, the Chancellor has hinted that the Government could tweak the fiscal rules set out in its manifesto to allow more public investment. Funded by more borrowing a larger investment plan than set out in the pre-election manifesto would provide an upside risk to our growth outlook. However, set against that risk, the Government faces the challenge of putting in place funding for potential future spending increases, which may require additional tax rises to be announced at the Budget. On their own they clearly present a downside risk to the growth outlook.

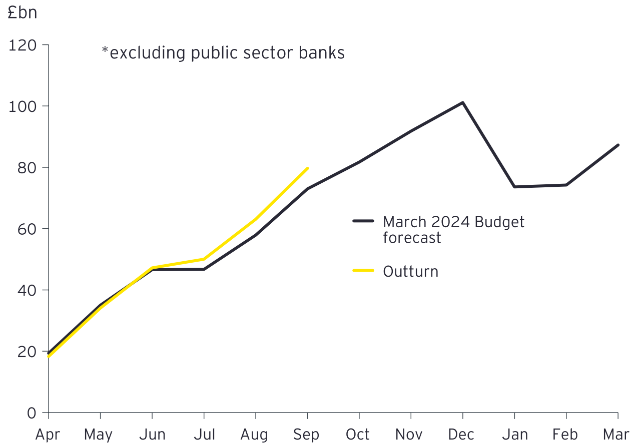
There are some bright spots on the horizon when it comes to the UK's long-run growth outlook. But the conditions for investment, innovation and enterprise need to be fostered for a sustained period of time for the UK to really feel the benefits. The UK remains an attractive location for foreign investment and has the ability to leverage new technologies to move closer to the productivity frontier, particularly if supported by public investment and a well-targeted programme of house building. One possibly of a more short-term gain to growth would be to improve health outcomes for working-age people returning to the workforce particularly for those that left due to ill health.

7

Forecast in charts

FISCAL POLICY

UK: Public sector net borrowing *

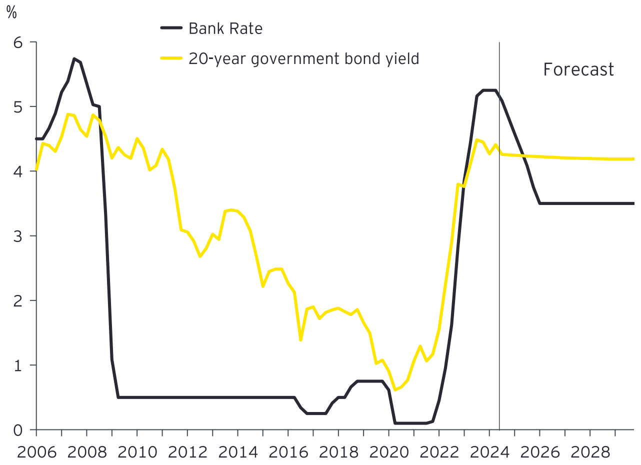


Source: Haver Analytics, OBR

- Over the first half of the current fiscal year, borrowing has run ahead of the March 2024 Budget forecast.
- This looks set to continue through the remainder of this fiscal year, as since taking office, Chancellor Rachel Reeves has identified £21.9bn of additional spending.
- Beyond this year, fiscal policy is the greatest uncertainty around our forecast. If the new Labour Government sticks to its pre-election plans fiscal policy will remain tight. Pursuing a more ambitious investment plan would loosen the fiscal stance somewhat, but further tax rises could hold back growth.

MONETARY POLICY

UK: Bank Rate and 20-year bond yield

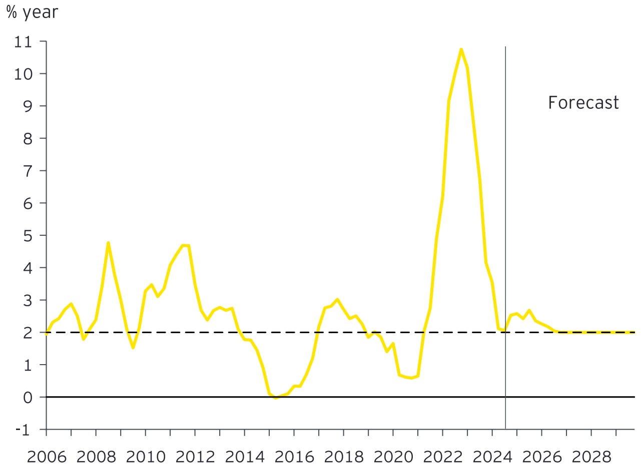


Source: EY ITEM Club

- The MPC has cut Bank Rate to 5.00% and will likely cut Bank Rate to 4.75% at its November meeting.
- With the MPC's focus turning more towards the growth outlook and away from current inflation we expect the BoE to cut rates to 3.50% by the end of next year.
- Rate cuts will be steadier than in previous cutting cycles and the popularity of fixed rate mortgages will make the growth impact of cutting rates relatively modest.

PRICES

UK: CPI inflation

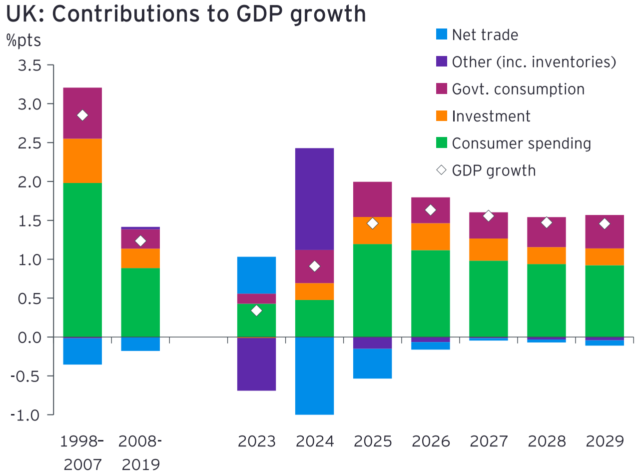


Source: EY ITEM Club

- Consumer Price Index (CPI) inflation has dipped below the BoE's 2% target in September, recording 1.7%, but is expected to rise back above 2.0% in October.
- Energy prices are currently weighing on headline inflation, but core inflation which looks past some of the more volatile prices in the inflation calculation remains elevated at 3.2%.
- We forecast that inflation will remain a little above 2.0% in 2024 and 2025, before returning to target in 2026. We expect domestic inflationary pressures to normalise gradually with core inflation falling below 3.0% in mid-2025.

ACTIVITY

UK: Contributions to GDP growth

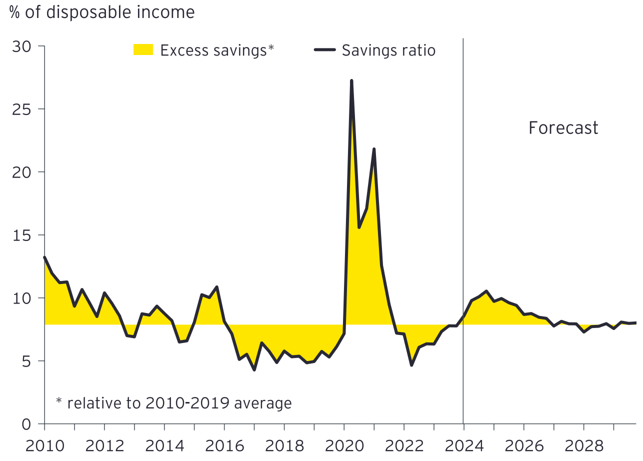


Source: EY ITEM Club

- On the back of a strong Q1, output grew by 0.5% q/q in Q2 2024. The economy has now returned to the level seen before H2 2023's technical recession. We think that growth will slow to around trend rates in Q3 2024.
- A little less growth momentum has led us to mark down our 2024 growth forecast to 0.9%, which, nonetheless, marks a sharp improvement from the 0.3% recorded in 2023.
- We now expect growth to settle at around 1.5% over the coming years.

CONSUMER DEMAND

UK: Household saving ratio

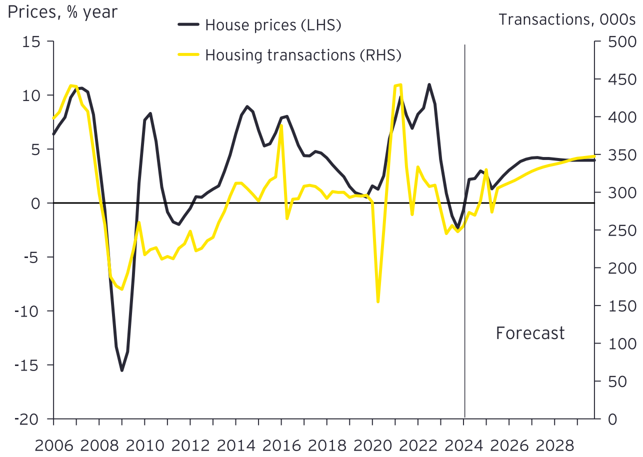


Sources: EY ITEM Club, Haver Analytics

- Consumer spending slowed to 0.2% q/q in Q2 2024, from 0.6% in Q1. Real household income has sustained strong growth, and consumer caution has led to the saving ratio edging up.
- We expect decent pay growth and roughly at target inflation to leave household income growing solidly over the next year or so.
- Combined with greater confidence, we expect consumption to run ahead of spending as households normalise their saving ratio over the next few years.

HOUSING MARKET

UK: House prices and transactions

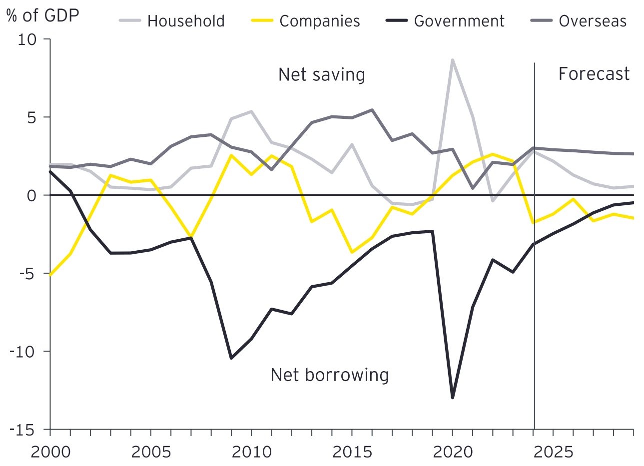


Source: EY ITEM Club

- The housing market has picked up over the summer as the first cut in Bank Rate has led to falling mortgage rates.
- Nonetheless, despite improving mortgage affordability house prices continue to look stretched on most affordability metrics.
- We expect a steady increase in house prices as real pay growth remains solid and mortgage rates are expected to fall further.

COMPANY SECTOR

UK: Sectoral balances

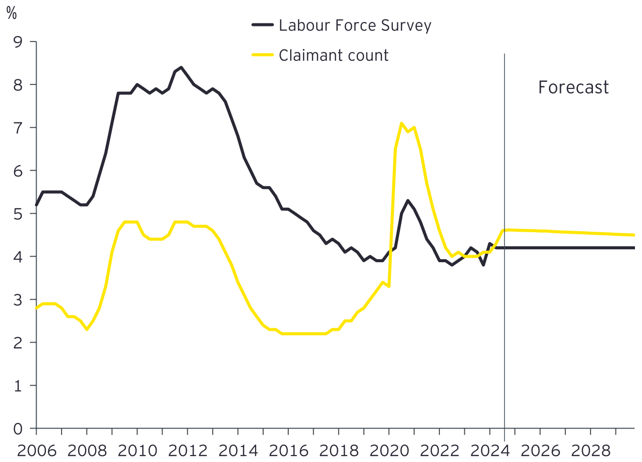


Source : EY ITEM Club

- Business investment has picked up strongly in the last couple of quarters growing 1.4% q/q in Q2 alone.
- Corporate liabilities respond much more quickly than household liabilities to changes in financial conditions, so we expect interest rate cuts to boost private investment over 2024 and 2025.
- The UK remains an attractive place to invest, so we expect firms to continue using overseas funding to support investment.

LABOUR MARKET AND WAGES

UK: Unemployment rate

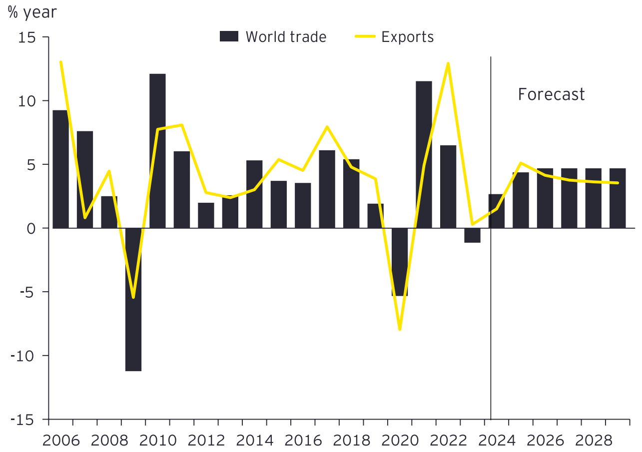


Source: EY ITEM Club

- Ongoing methodological challenges with the ONS's Labour Force Survey make understanding the true position of the labour market difficult.
- However, it looks like the labour market has loosened and has moved into a better-balanced position. Vacancies have normalised to around pre-pandemic levels without a large increase in layoffs. Softening labour demand has been matched by weak labour supply as poor health keeps people from entering the labour market.
- We expect pay growth to slow to around 3.0% by the end of 2025 as the effects of a period of high inflation wanes.

TRADE AND THE BALANCE OF PAYMENTS

UK: Exports and world trade



Source: EY ITEM Club

- Recent data on the UK's trade position have been mixed with any signal masked by the large volatility.
- We expect export growth to match import growth as UK domestic demand recovers from the twin shocks of the COVID-19 pandemic and 2022 energy price spike alongside the global economic recovery.
- Nonetheless, some fragility in the global recovery is emerging. A period of possible weakness in the UK's major trading partners is a downside risk to our forecast and would attenuate some of the UK's economic recovery.

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