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A stagnant economy

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The UK economy narrowly dodged a technical recession in Q4 2022. There's not a huge amount to cheer about when it comes to the outlook for this year, however. Momentum into 2023 was weak, households are set to remain under pressure and supply-side issues are weighing on potential output. We expect that quarterly growth will hover around 0% through the rest of this year higher as the economy continues to stagnate.

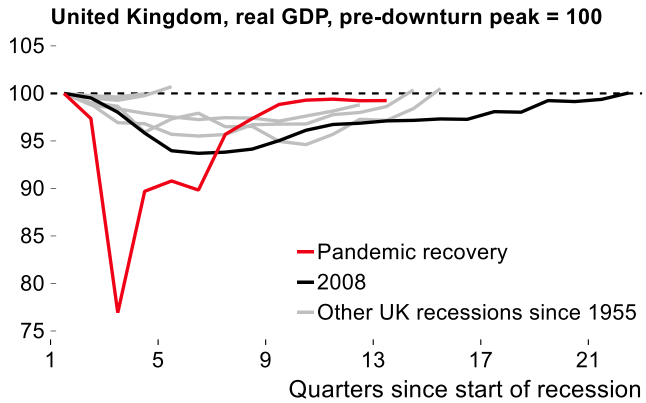
Recession avoided, for now

The UK economy dodged a technical recession by the skin of its teeth at the end of last year. After a negative figure in the previous quarter, growth was flat (0.0% Q/Q) in Q4 2022. Indeed, UK GDP is starting to look quite horizontal (Chart 1).

The effect of the extra bank holiday in the previous quarter for the Queen's funeral and the rollout of COVID boosters in the autumn probably made the difference between expansion and contraction. However, momentum clearly tailed off through the quarter, with monthly GDP falling by 0.5% M/M in December. This was probably related to widespread industrial action (including rail and postal workers) and the suspension of Premier League football games during the FIFA World Cup. There are also signs that cost of living pressures were starting to bite: UK retail sales fell by 1.2% M/M in December.

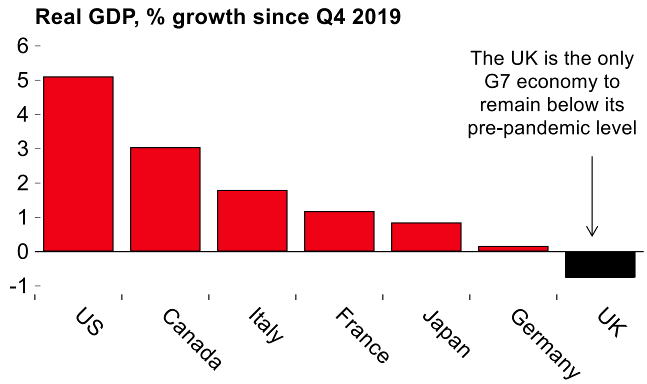
The bottom line is that the UK economy remains weak. GDP is still 0.8% below its pre-pandemic level (Chart 2). On paper that might suggest ongoing scope for catch-up growth, but it still doesn't feel like fertile ground for a strong recovery. While the euro area composite edged back into expansion territory in January, the UK gauge continues to point to a contraction. The carry-over effect from weak December data makes it likely that there will be a negative GDP figure in Q1 2023. We expect that UK growth with likely to hover around 0% for several quarters, with any bounce unlikely to materialise until the end of the year at the earliest.

CHART 1: THE UK RECOVERY HAS TAILED OFF



Source: ONS, MUFG Bank Economic Research Office

CHART 2: GDP STILL BELOW THE PRE-PANDEMIC LEVEL



Note: Q4 2022 data not yet available for Japan (chart shows Q3).
Source: Macrobond, MUFG Bank Economic Research Office

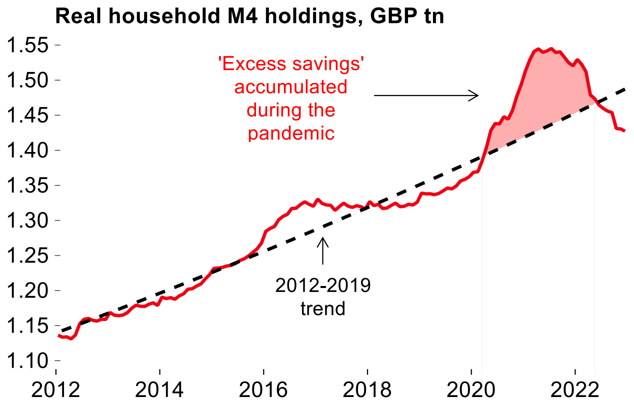
Consumer resilience unlikely to last

The resilience in private consumption in Q4 (0.1% Q/Q) despite soaring inflation was notable in the UK data. There was a contrast to some euro area economies where Q4 probably marked the start of a consumer recession (see here). It is clear that the UK government's generous fiscal support has so far shielded households from the full extent of the wholesale energy price shock.

This is set to change with a significant withdrawal of fiscal stimulus: from Q2, the household energy price cap is due to rise by 20% and universal monthly payments totalling 400 GBP are due to come to an end. Given this, the outlook for consumers looks challenging. Savings buffers accumulated during pandemic lockdowns have been exhausted (Chart 3) and higher borrowing costs will continue to pass through to homeowners as existing mortgage deals expire. At the same time, workers will be dragged into higher income tax bands after the government announced that thresholds will not be uprated with inflation. So it's not surprising to see that consumer confidence is languishing close to all-time lows. There will be some better news from April – the state pension is to increase by 10.1% and the minimum wage (which covers 7% of workers) by 9.7% – but the overall picture will still point to a long period of weak consumer demand.

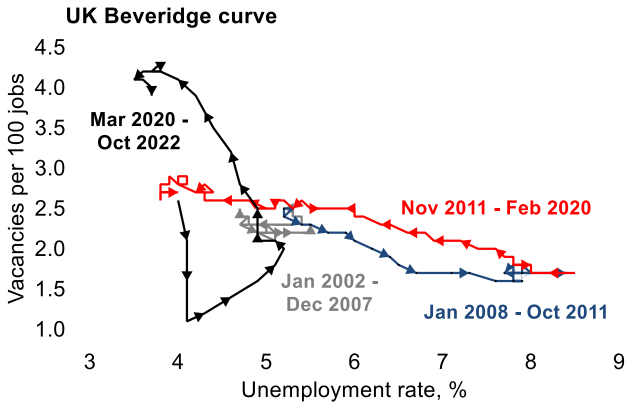
The labour market has remained a bright spot and low joblessness should help to limit the extent of any UK consumer recession. However, the weak growth picture is likely to cause some deterioration through 2023. A few cracks have already started to appear – both vacancy and unemployment rates have deteriorated slightly in recent months (Chart 4). Our models point to the latter reaching around 4.5% by year-end.

CHART 3: SAVINGS BUFFERS HAVE BEEN ERODED



Source: Macrobond, MUFG Bank Economic Research Office

CHART 4: LABOUR MARKET TIGHTNESS MAY TURN



Source: Macrobond, MUFG Bank Economic Research Office

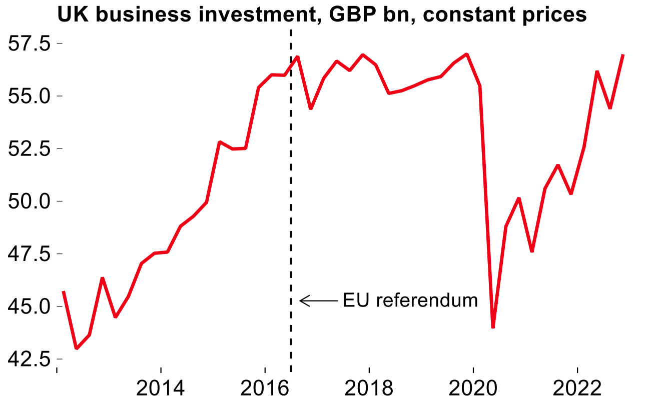
Supply-side issues weigh on the longer-term outlook

It's hard to see much scope for buoyant UK growth, even further down the line. The Bank of England estimates that the rate of potential growth will fall to just 0.7% by 2025, which is 1pp lower than the 2010-19 average.

The UK has suffered from a period of chronically low investment, both public and private. There's not much in the pipeline when it comes to government capital spending. There was better news for business investment, which is now back to its pre-pandemic level after 4.8% Q/Q growth and some revisions to the historical data. Limited worker availability (see below) may have prompted the investment of cash accumulated during the pandemic. However, the overall lack of growth in capital expenditure since the EU referendum remains stark (Chart 5), which points to an ongoing headwind for UK productivity growth.

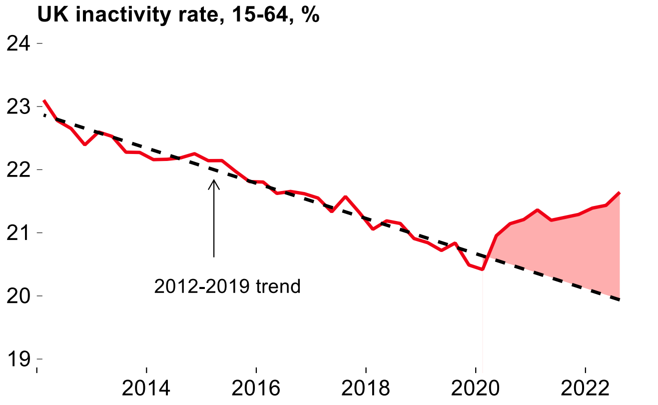
Focus is also turning to UK labour participation. The latest data from October showed that there were 400,000 people outside of the labour force compared to the 2019 average. Other European economies experienced a similar rise in inactivity following the pandemic, but this has been followed by normalisation. This is not the case for the UK (Chart 6). Lower availability of EU workers is part of the issue, but the rise has been mostly driven by an increase in workers citing long-term sickness. Data points to structural problems with the UK health service – e.g. median wait times for treatment have doubled from 7 weeks in 2019 to around 14 weeks currently – which suggests that this withdrawal of labour due to health issues will continue to weigh on UK potential output over the medium term.

CHART 5: BUSINESS INVESTMENT STILL AT 2016 LEVELS



Source: ONS, MUFG Bank Economic Research Office

CHART 6: WORKERS HAVE LEFT THE LABOUR FORCE



Source: OECD, MUFG Bank Economic Research Office

The BoE may have reached the terminal rate for this cycle

The BoE hiked by 50bp last week, taking rates to a 14-year high of 4%. However, we're probably now at, or at least close to, the terminal rate of this cycle. The BoE no longer said that it will "respond forcefully, as necessary" if there are signs of more persistent inflationary pressures. It also dropped the note that "further increases in Bank Rate may be required for a sustainable return of inflation to target". There may be another hike in March (perhaps at a slower 25bp increment if so) but there are clear signs that the BoE is ready to ease off the brakes if conditions allow.

Headline inflation has probably now peaked in the UK, following the trajectory seen in other developed economies. The sharp slide in wholesale energy costs (UK natural gas front-month prices are now back to September 2021 levels) suggests that UK inflation could fall quite quickly through to H2 this year.

However, the BoE will also want to see evidence that private sector wage growth is cooling from the current rate of around 7% Y/Y in nominal terms. The persistent labour shortages and other supply-side concerns mentioned above could delay this process and result in core price pressures remaining stubbornly high.

Market participants are now pricing in BoE rate cuts by H2 this year. While the economic outlook looks challenging and inflation will have fallen considerably, it still looks too soon for rate cuts. Our general view has been that central banks will err on the side of caution when it comes to moving to a less restrictive monetary policy stance. After decades of falling inflation, policymakers will not want to be held responsible for ushering in a protracted period of persistently higher price growth. This means that monetary policy could remain restrictive for some time yet.

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