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Still in the slow lane

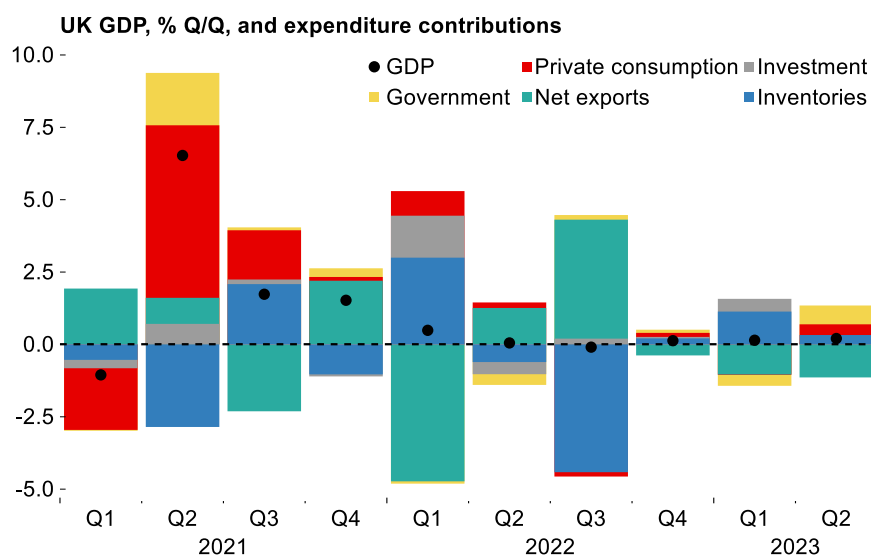
16 August 2023

- Not only has the UK economy avoided recession but the latest growth figures surprised on the upside, supported by resilient domestic spending.
- The longer-term trend is less encouraging: growth is essentially flatlining. Supply-side challenges and the ongoing pass-through of higher interest rates are set to remain headwinds for the UK economy.
- We look for UK GDP growth to average 0.4% this year and 0.6% in 2024, with pass-through from higher interest rates providing the main headwind.

The economy continues to avoid recession

The UK economy continues to show its resilience, eking out 0.2% Q/Q growth in Q2 despite persistent inflation pressures, rapid monetary policy tightening and a working day lost for the King’s coronation. This was above the consensus expectation (0.0%) and is plainly good news.

Chart 1: Resilient domestic demand sees the UK economy evade recession



Source: ONS, MUFG Bank Economic Research Office

By expenditure component, household consumption (0.45% Q/Q) contributed strongly despite CPI averaging 8.4% across the quarter (never underestimate the UK consumer). There was also solid growth in government expenditure (0.65% Q/Q) after increased public sector pay awards. Total investment was flat but there was more encouragement from the business investment component (3.3% Q/Q) which is now, finally, above its 2016 level. It remains well short of the pre-referendum trend however, and was boosted by aircraft deliveries. Nonetheless, the overall picture for domestic demand was encouraging (Chart 1). Net trade developments were less rosy: a 1.1pp

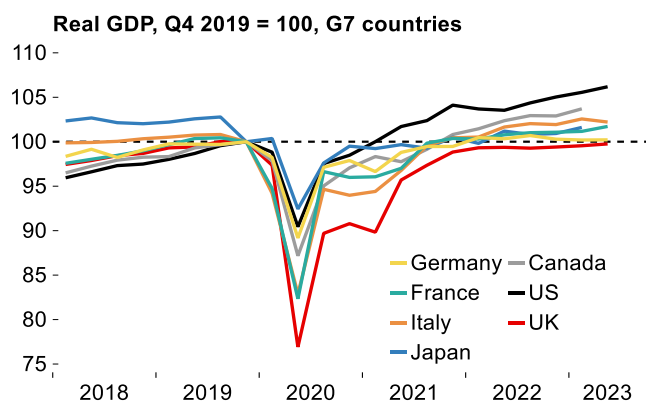
drag on quarterly growth. Services exports slumped by 4.0% Q/Q – the series is volatile but this would be a concern if the strong services trade performance in 2022 (10.1%) were to continue to reverse.

Overall, the Q2 data painted a picture of resilience in the face of clear headwinds as the UK economy continues to dodge recession. In fact, after a gloomy spring we may now be past ‘peak despair’ when it comes to the UK’s economic situation, at least when it comes to short-term data flow. Following a series of upside surprises on inflation and ever-higher interest rate expectations there was very little to cheer about earlier this year. There was finally some better news in the June CPI figures (down to 7.9% from 8.7% in May) and another substantial decline in July (to 6.9%), largely due to the 17% fall in the household energy price limit last month. Services inflation still looks a little too sticky for comfort, rising 0.3pp, but evidence from surveys and the producer price index bodes well for further normalisation of headline price growth. Despite stronger-than-expected wage growth figures this week, forward pricing for the peak BoE rate is still around 60bp lower than in early July after a dovish hike at the August meeting. Taken together, some cautious optimism has returned when it comes to the UK’s situation.

Growth has flatlined since 2022

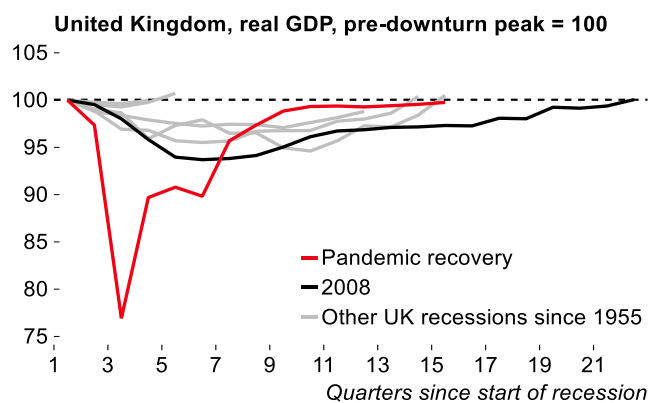
However, zoom out and the trend is less encouraging: growth remains anaemic. UK GDP is still below the Q4 2019 (pre-pandemic) level, unlike all other G7 economies (Chart 2). By our reckoning, this is now the second-slowest post-recession recovery in the UK since the 1950s. Only after the GFC did it take longer for GDP to recover to the pre-downturn level (Chart 3).

Chart 2: UK GDP still lags behind G7 counterparts



Source: Macrobond, MUFG Bank Economic Research Office

Chart 3: Now the second slowest recovery on record



Source: ONS, MUFG Bank Economic Research Office

It’s hard to make a case for any solid acceleration in growth from here. As well as the pandemic-induced supply-chain shock and the European energy crisis, the UK economy has also suffered from two additional supply-side problems: 1) Brexit and 2) higher economic inactivity, the latter of which is at least partly related to health service outcomes. As discussed previously (see [here](#)), both are longer-term issues.

On Brexit, it has been reported recently that the introduction of some import checks on certain food goods from the EU, due to come into force in October, will be delayed again – for the fifth time. Kicking the can down the road again will help the process of disinflation, but a lack of clarity about future policy will continue to hamper businesses (over 20% of firms still cite Brexit as a top-3 source of uncertainty). Our broad view

remains that Brexit trade friction (through extra paperwork, etc.) is set to weigh on UK potential GDP growth for years to come.

On economic activity, over 2.5m people cite long-term sickness as a reason for not participating in the labour force, with the number increasing again in the latest available data for May. There are no signs of improvement in health service bottlenecks: the latest data show that the number of patients waiting for treatment increased to a new record of 7.6m in England. The median wait time from referral to treatment was 14.3 weeks in June, roughly double the pre-pandemic figure.

Chart 4: Economic inactivity remains a challenge

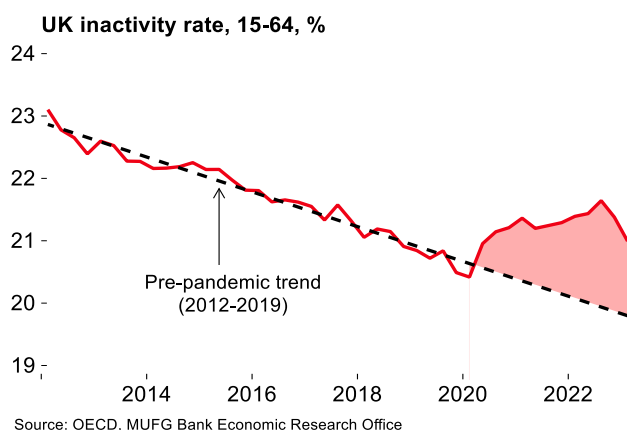
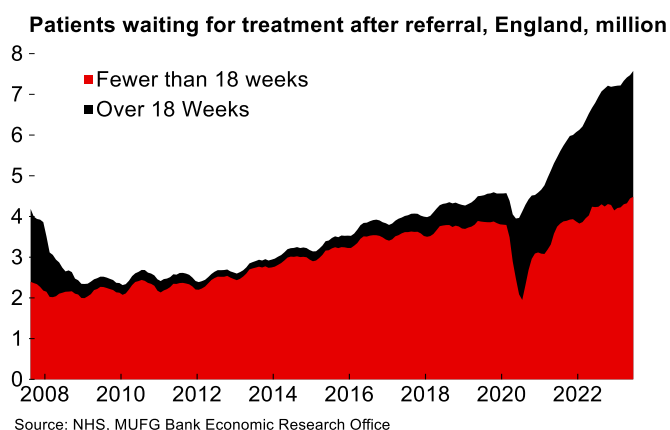


Chart 5: The public health service remains stretched



Signs of resilience to the mortgage shock, but it's not over yet

Household spending (60% of GDP) remains key to the outlook for growth. We mentioned above that consumers have been relatively resilient to the real income/mortgage payment shock. The ongoing strength of the labour market, where a few cracks are now appearing but the unemployment rate remains relatively close to historic lows, will have helped to support confidence. The number of online job adverts is holding steady at 2019 levels – there are still plenty of jobs out there, even though pandemic-related distortions to the labour market have largely faded. Meanwhile, the flipside of BoE rate rises hurting borrowers has been higher interest payments for savers, with UK banks relatively good at passing these on to deposit holders.

However, housing costs will likely dominate as the mortgage shock continues to pass through to the real economy. The majority (75%) of UK mortgage holders fix rates for two or five years. To illustrate the shock from BoE tightening, consider that the average quoted rate (on a 75% loan-to-value mortgage) for both terms has increased from 1.3% in October 2021 to around 6% currently (Chart 6). This shift would see monthly repayment costs on a typical 25-year mortgage for an average priced house in England increase by around 580GBP – or over 20% of median household disposable income (FY 2022).

Recent data are somewhat encouraging that households, in aggregate, are managing to navigate the extra mortgage burden. The ONS social trends survey shows that the proportion of adults finding paying rent or mortgage payments 'difficult or somewhat difficult' has fallen from 46% in early July to 38% currently. This is still high, but the fall could reflect some easing in real pay conditions – CPI-adjusted average weekly earnings growth is now back in positive territory, recovering from a low of -5.7% Y/Y at the end of 2022 to +0.7% Y/Y in the latest figures for June.

There has also been a clear trend for homeowners to extend the term of their mortgage when renewing the deal in order to decrease monthly payments (the government has tweaked regulation and promoted this as a possible approach for struggling households). However, the latest data from UK Finance suggest that we could be approaching the limit of term-extension – the proportion of new house purchase mortgages with terms of 30 years or more has plateaued in the last few months. Meanwhile, the rate shock will continue to pass through to the economy. Over 1.4m homeowners will re-mortgage from previous deals fixed which were fixed below 2.5% over the next five quarters (Chart 7).

Chart 6: Mortgage rates have soared to around 6%

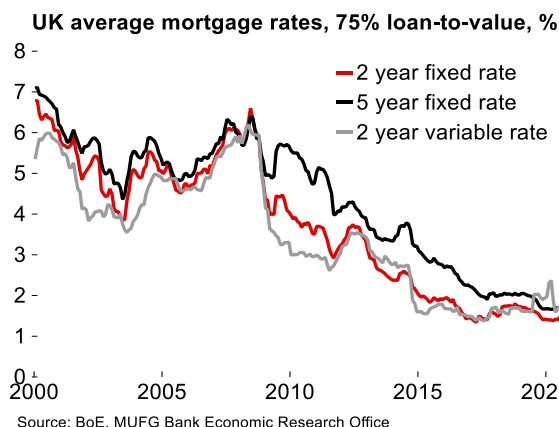
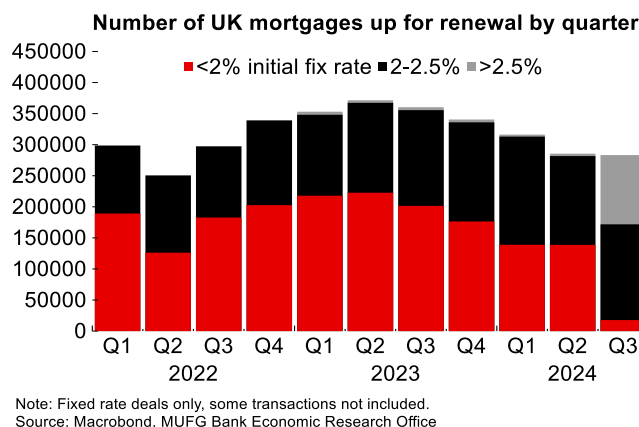


Chart 7: The lagged pass-through to mortgage holders



Weak expansion remains our base case

The resilience shown in the Q2 data is encouraging. Our base scenario remains that the UK economy will avoid a recession, but growth will remain muted over the next 18 months or so. That is, quarterly growth will be flat or slightly positive. We look for UK GDP growth to average 0.4% this year and 0.6% in 2024, with pass-through from BoE tightening, and higher mortgage rates in particular, as the main headwind. We also expect that deterioration in the labour market will increasingly weigh on confidence over the next year.

So, short of a synchronised global upswing scenario to drag the UK along – perhaps prompted by relief of a Fed soft landing in the US – it’s hard to make much of a case for an upside surprise for the UK economy from here. There could be *some* pre-election fiscal giveaways from the UK government (the next election is likely to be held in autumn next year). However, stretched public finances after the pandemic, energy crisis and interest rate shock will not allow for a great deal of fiscal support. The bottom line is that it’s likely to be a slow grind ahead for the UK economy – a recession may be avoided, but growth figures are unlikely to provide much to cheer about.

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