MONTHLY ECONOMIC INSIGHT

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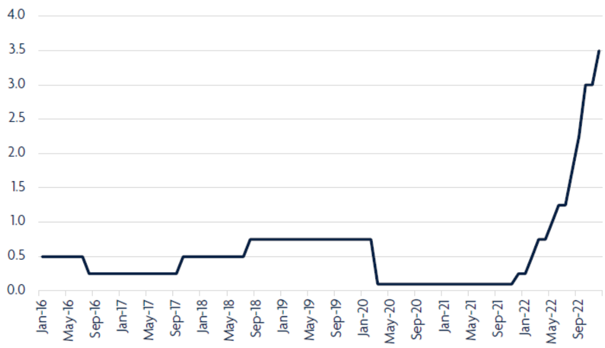
The first briefing of 2023 rounds up key events at the end of 2022 and takes a look at the emerging data for the final months of the year. And as is tradition in the new year, we'll take a look ahead at prospects for the next 12 months.

MONETARY POLICY COMMITTEE (MPC) DIVIDED ON LATEST RATE RISE

The final policy event of note in 2022 was the MPC's last meeting of the year. Coming six weeks after the Committee raised Bank Rate by 75 basis points, a majority voted for a further 50-point rise in December, taking Bank Rate to 3.5 per cent – the highest since 2008 (**chart 1**).

Overall, there had been few significant developments in the economy since the Bank of England published its quarterly forecasts in November. Expectations that the UK economy would enter recession were supported by emerging data. Bank staff expect Gross Domestic Product (GDP) to decline by 0.1 per cent in 2022 Q4, slightly better than the November forecast.

Chart 1: Bank Rate, percentage



Source: Bank of England

Consumer Price Index (CPI) inflation was expected to remain very high in the near term, with the rate currently at 10.7 per cent, although this was slightly below expectations at the time of the November report, but global inflationary pressures remain elevated.

Discussion around labour market developments noted continued tightness, with robust private sector wage growth in the second half of 2022. Domestic price pressures and services inflation in particular remained firm, however, these are expected to moderate quickly from the middle of this year as energy prices abate.

The Committee was split on what policy action was needed, with two members voting for rates to remain at three per cent and one judging a larger rise to be justified at this point. The minutes continue to note that if inflation pressures appear to be more persistent, then the MPC would continue to respond forcefully, as necessary.

INFLATION EXPECTATIONS START TO EASE

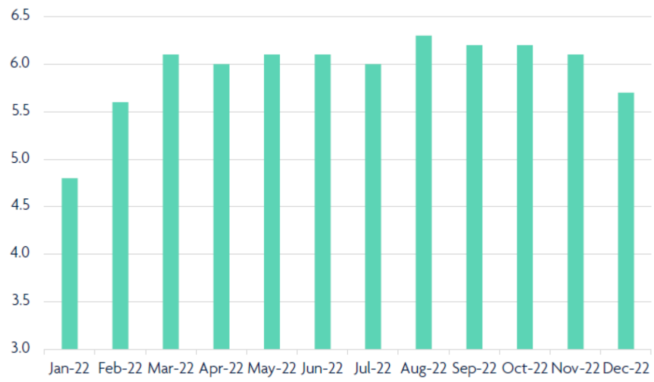
Some potentially better news on the inflation outlook came from the latest Citi/YouGov survey of inflation expectations (**chart 2**). The public's expectations for inflation in the next 12 months eased back to 5.7 per cent in December – still well above average expectations reported before the pandemic but dropping back from highs recorded over the summer. Longer range expectations – over the next five to ten years – have also come off this summer's highs.

This should start to reassure policy makers that the risk of higher inflation expectations becoming entrenched are subsiding.

Other survey indicators would support consumers' views that inflation will subside as the year progresses. Recent manufacturing and services PMIs suggest that while prices remain high, inflationary pressures look to be starting to unwind. The services PMI noted the lowest rate of inflation in 15 months. Global supply chain bottle necks are easing and together with the softer demand outlook, commodity prices have been heading lower.

That said, businesses continue to report concerns about energy prices (ONS BICS) – not least as they await details of any future support for energy prices beyond the current prices guarantee, which comes to an end in March.

Chart 2: Inflation expectation in next 12 months, percentage



Source: Citi Bank/YouGov

SERVICES STABILISE, MANUFACTURING SLIDE CONTINUES

Elsewhere in the latest PMIs for the end of 2022, there has emerged a divergent path for manufacturing and services in December (**chart 3**).

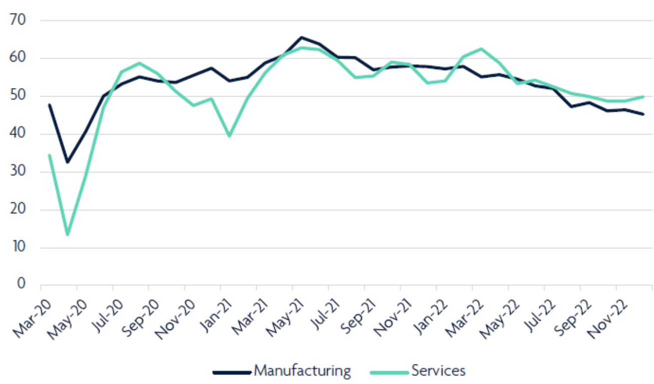
The composite services index pointed to some stabilisation in the sector, coming in at 49.9, a shade under the 50, no change mark, and the best reading since September. While there was a modest pick up in export orders, the survey continues to point to challenging domestic trading conditions, with demand remaining fairly weak.

Other indicators for the services sector, such as footfall on the high street over the Christmas period and reports from retailers, suggest activity appears to have been a bit better than feared, given the backdrop of ongoing cost of living pressures.

Manufacturing activity, on the other hand, continued its slide in December with the PMI ending the year on a particularly weak note. The report notes that outside of the Covid-19 period, the index was at its lowest level since the financial crisis. All components of the index – production, orders and employment – were down in December. This is in contrast to comparable surveys in the eurozone, across which the pace of downturn looked to be easing in December.

In addition to demand weakness, UK firms also noted continued issues with Brexit arrangements – a challenge that looks likely to be with us in the year ahead.

Chart 3: Purchasing managers' index, 50 = no change



Source: S&P Global/CIPS

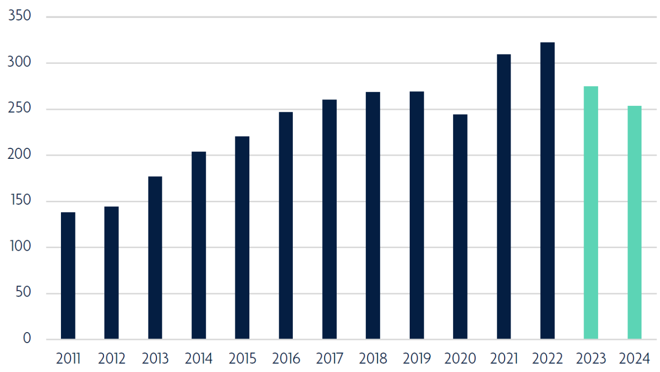
MORTGAGE MARKET OUTLOOK

Turning to the 2023 outlook, we start with the housing market. As forecasts set out their projections for the year ahead, many of the headlines have focused on the prospects for house prices. After bumper price rises in 2022 and amid signs of prices dipping towards the end of the year, most forecasters have pencilled in drops of between five and ten per cent in the year ahead.

While UK Finance does not produce price forecasts, in December we did publish our **forecasts for a range of other mortgage market activity**. **Chart 4** shows that the level of overall mortgage lending is expected to decrease in 2023 and 2024, returning to pre-pandemic levels in the coming year.

Key factors behind the forecast include the ongoing cost of living squeeze, as real wages and disposable income are decreasing, putting a break on consumers' plans to borrow money to purchase property. Rising interest rates will also provide further pressure on affordability for new borrowers and homemovers in the year ahead.

Chart 4: Gross lending, £ billion



Source: UK Finance

And with recession likely, a material increase in unemployment is another downside risk to mortgage market activity this year. However, refinancing is expected to rise in 2023, due to the fixed-rate mortgage deals coming to an end following high levels of activity during the 2021 stamp duty holiday.

Despite strained household budgets in the year ahead, we expect the vast majority of borrowers to still be able to keep up with their mortgage payments. The number of customers in arrears is forecast to rise from the 80,000 seen at the end of September 2022 to a little under 100,000 by the end of 2023. This will still be considerably lower than levels seen during the 2008/9 recession.

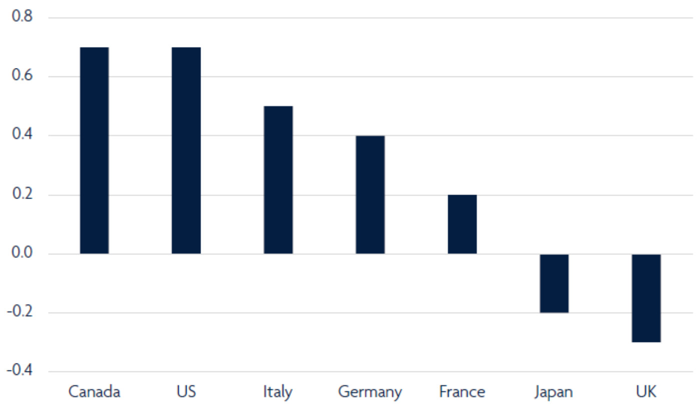
ROUND UP

2022 started with expectations of a post-pandemic return to normal and hopes of a strong rebound after the stop-start activity of 2020/21. But what materialised was a protracted war in Ukraine, the highest inflation in four decades and a slowing economy. 2022 also marked the end of an era of low interest rates. Other developments that weren't foreseen at the start of the year were autumn's shenanigans at Westminster and England's men failing to lift the football World Cup (maybe not the last one).

Last month's briefing went through the Office for Budget Responsibility's (OBR) assessment of the 2023 outlook, which pointed to the continuation of weak growth, high inflation trends that dominated the second half of last year.

According to the FT's poll of economists, this rather gloomy outlook is held by the majority of economists. Indeed, respondents to the poll, on balance, expect inflation to be higher and growth to be lower in the UK compared with its developed world counterparts. **Chart 5** shows that the UK already appears to be struggling more than most G7 countries, and the factors weighing on growth at the end of last year – income squeeze, weak investment intentions and struggling exports – seem unlikely to unwind quickly.

Chart 5: Quarter-on-quarter GDP growth, percent change in three months to September 2022



Source: ONS

There was, however, a broader spread of views on the labour market, notably whether the UK would see more of the currently inactive population returning to address skills shortages and bottlenecks in key sectors and occupations.

While markets continue to price in further increase in Bank Rate this year, a minority of economists responding to the FT poll are not ruling out the MPC cutting rates later in the year, as inflation falls back to target, and the economy remains in the doldrums.

Some of the key uncertainties from last year are very much present at the start of 2023 – how the conflict in Ukraine will evolve, the continuation of industrial action in the UK, and the fact that we continue to live with the presence of Covid-19.

A couple of other not-so-wild predictions might include that 2023 will feel like an election year, with the leaders of both main parties setting their policy stall out already in January. But we're unlikely to go to the polls in a general election. On the upside, progress towards shifting from fossil fuel dependence – globally – could accelerate this year, helping make much needed progress towards net zero goals.

Businesses in the UK have had their resilience tested in recent years and that will be tested again in 2023, navigating the challenges outlined above. Maintaining some support around energy prices and progress on the levelling up agenda will help see the private sector through to what is expected to be a better 2024.

Indicator	Period	Value	Change	2023 Forecast*
GDP	Q3 2022	-0.3%	↓	-0.8%
CPI inflation	Nov 2022	10.7%	↓	7.4%
Unemployment rate	Oct 2022	3.7%	↑	4.6%
Average earnings	Oct 2022	6.1%	↑	4.4%
Brent crude	Dec 2022	$80.92	↓	-
$ Exchange rate	Dec 2022	$1.22	↑	-
PSNB	Nov 2022	£22.0 bn	↑	£124.6bn

Source: ONS, HM Treasury, Bank of England, EIA