Bank of England

Economic Update – is 2023 a time for growth or survival?

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Speaking points

1. The Monetary Policy Committee (MPC) recently published its latest forecast for the UK economy. In the Committee's central projection, aggregate economic activity (as measured by real GDP) is projected to fall slightly over the coming quarters, as high energy prices and the path of market interest rates continue to weigh on spending in an environment of weak potential growth. But the projected decline in output is much shallower than that embodied in the Committee previous forecast (published in November), reflecting the recent decline in wholesale energy prices and the Committee's reassessment of the outlook for consumption on the back of expectations that a slower rise in unemployment will support household confidence. Survey indicators that have become available since the publication of the forecast have surprised to the upside, suggesting that the current momentum in economic activity may be slightly stronger than anticipated. And by the end of the forecast horizon, annual GDP growth reaches nearly 1%.

2. The unemployment rate begins to rise from the second quarter of this year, reaching around 5¼% by end-2025. But, consistent with some hoarding of labour by companies, in its February forecast the MPC took the view that the expected softening of labour demand as economic activity stalls is less likely than usual to be reflected in higher redundancies. With the risk of job loss reduced as a result, the Committee judged that precautionary saving by households would be more modest – and consumption therefore stronger – than had previously been assumed.

3. In the MPC’s February forecast, CPI inflation falls back sharply from its current very elevated level of 10.1% in January to around 4% towards the end of this year. The bulk of this fall reflects base effects as the impact of previous rises in wholesale energy prices on household utility bills that enter CPI inflation drop out of the annual calculation. CPI inflation is projected to fall to below the 2% target by the end of the forecast horizon, as increased economic slack reduces domestic inflationary pressure. However, there are considerable uncertainties around this outlook, and the MPC continues to judge that the risks to inflation are skewed significantly to the upside.

4. These upside risks arise in large part from the possibility that domestic inflationary pressures prove more persistent than anticipated, owing to so-called ‘second round effects’ in price, cost and wage setting behaviour.

5. In our central projection, annual private-sector regular pay growth begins to decline from the second quarter of this year. This already incorporates some ‘catch-up’ in nominal wage growth following the sharp rise in CPI inflation caused by energy price increases. But given the tightness of the labour market and currently elevated level of CPI inflation, there are risks around this projection. For instance, the latest data for private sector regular pay growth – which was published after the MPC’s forecast was finalised – surprised slightly to the upside.

6. Moreover, the strength of corporate pricing power and disrupted supply chains may support firms’ expectations that higher labour costs can be passed through to consumer prices, as well as offering opportunities to build margins.

7. That said, some high-frequency indicators of wages have fallen quite sharply recently, such as the KPMG/REC permanent staff salaries index. The MPC will continue to monitor indications of persistence in domestic inflationary pressures closely, with a focus on developments in the labour market, in wage dynamics, in services price inflation and in measures of underlying inflation and inflation expectations.

8. As always, the MPC will act to meet its price stability mandate through achieving the 2% inflation target on a sustained and lasting basis.

Disclaimer: The views expressed in this speech are not necessarily those of the Bank of England or the Monetary Policy Committee.

I would particularly like to thank Lena Anayi for helpful discussions in the preparation of these speaking notes. The text has also benefitted from helpful comments from Catherine Mann and Silvana Tenreyro, for which I am most grateful.

Opinions (and all remaining errors and omissions) are my own.

UK GDP growth is expected be close to zero in Q1

Sources: ONS and Bank calculations.

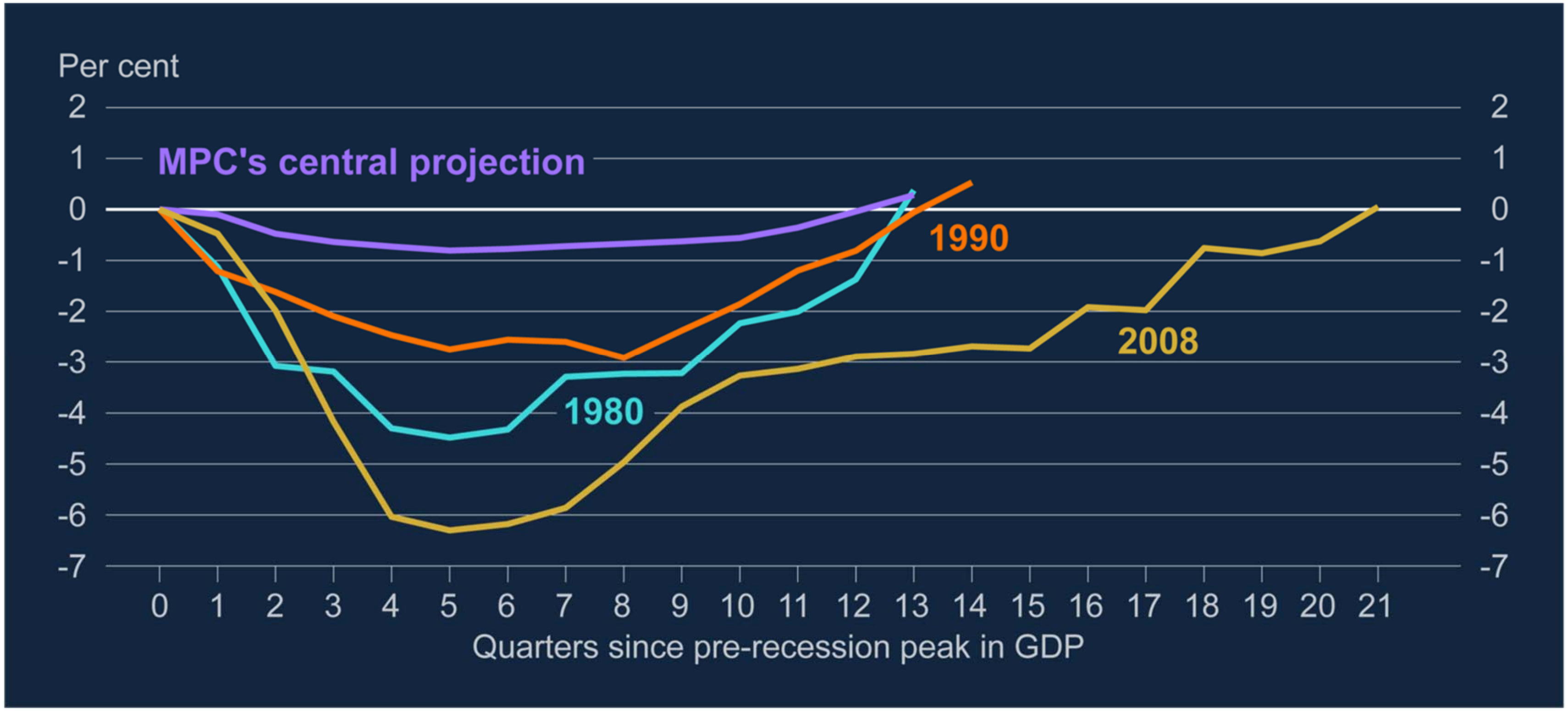
(a) The lighter diamonds show Bank staff's projections at the time of the November 2022 Monetary Policy Report. The darker diamonds show Bank staff's projections at the time of the February 2023 report. Projections for GDP growth show 2022 Q3 to 2023 Q1.

The level of supply remains weaker than its pre-pandemic level

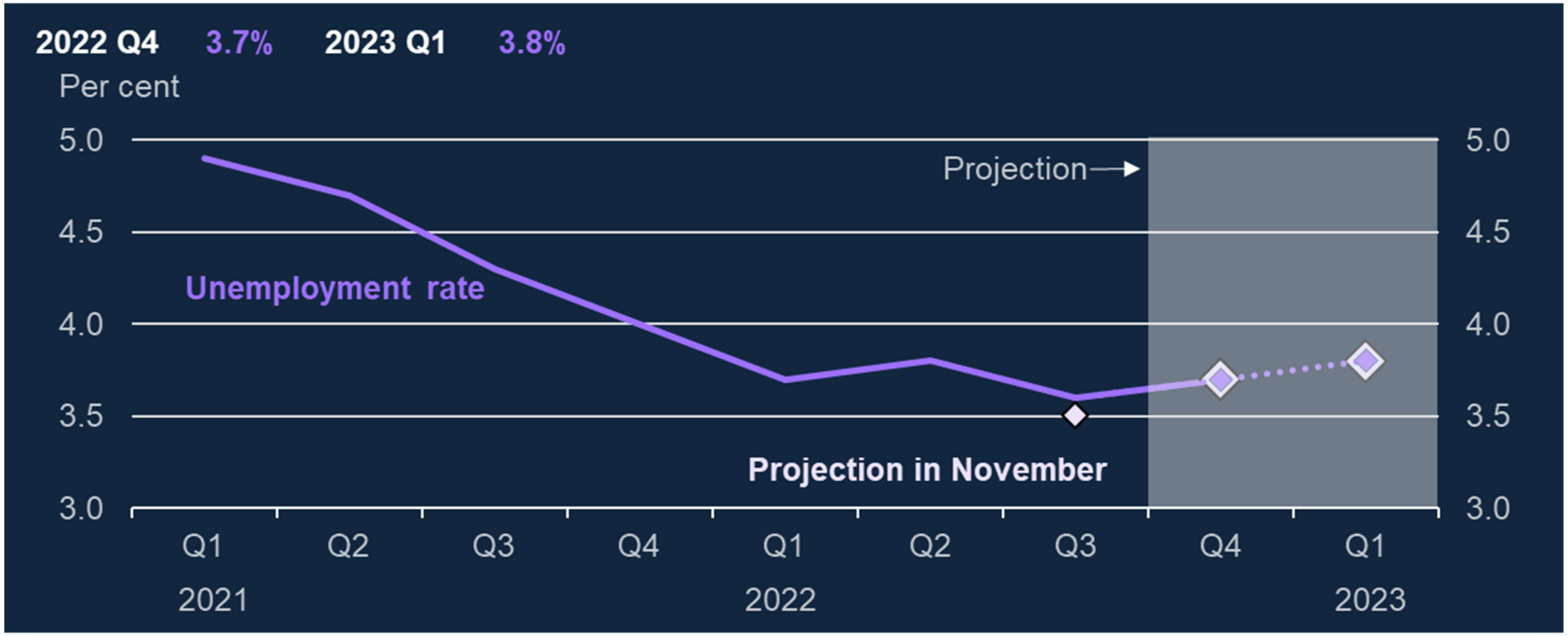
Sources: ONS and Bank calculations.

(a) Diamonds are projections for 2023 Q1, 2024 Q1, 2025 Q1 and 2026 Q1. Diamonds for GDP show MPC projections. GDP in 2022 Q4 is a Bank staff projection incorporating official data to November 2022. Data include the backcast for GDP. Estimated potential supply is derived using the MPC's projection for the level of GDP and the level of excess demand/supply Both GDP and estimated potential supply are indexed to GDP in 2019 Q4

Changes in GDP since pre-recession peak are projected to be smaller than in past recessions



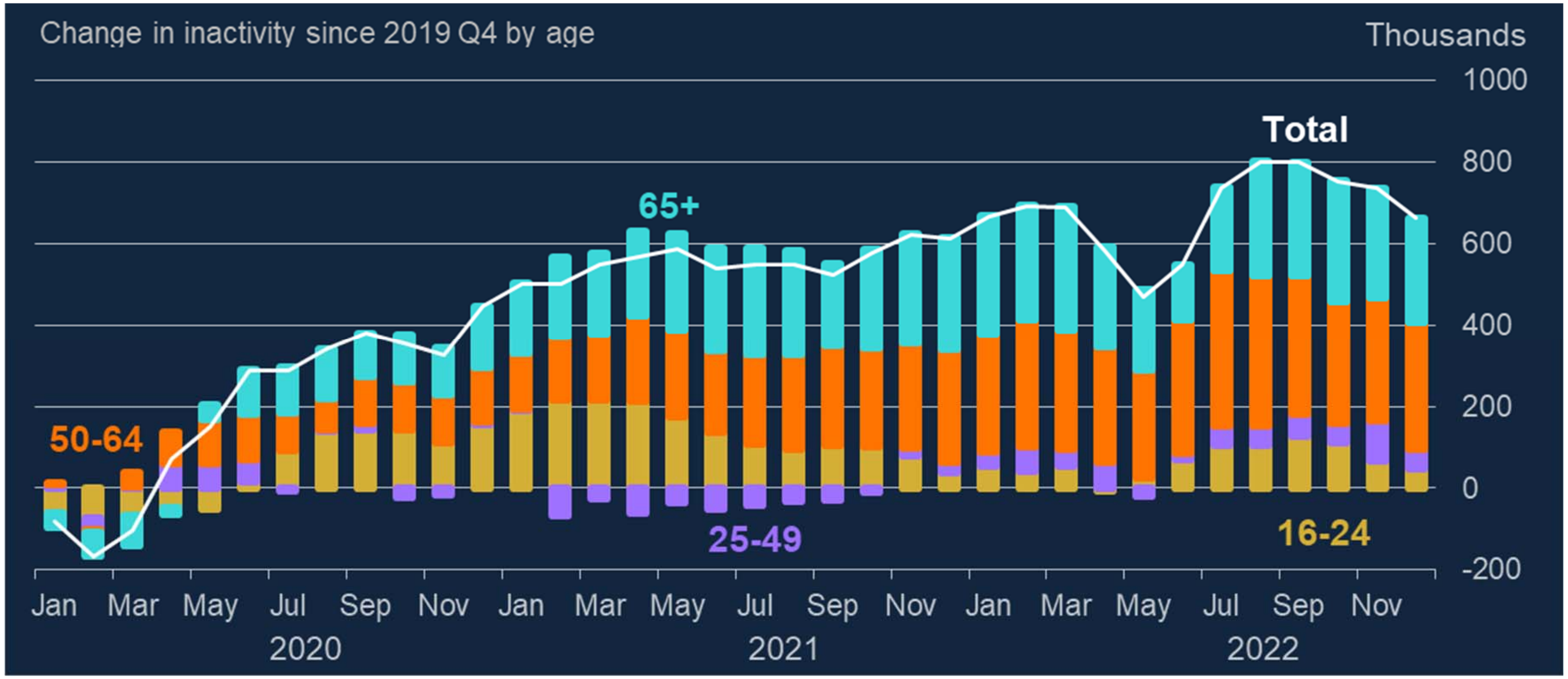
Unemployment is projected to remain very low



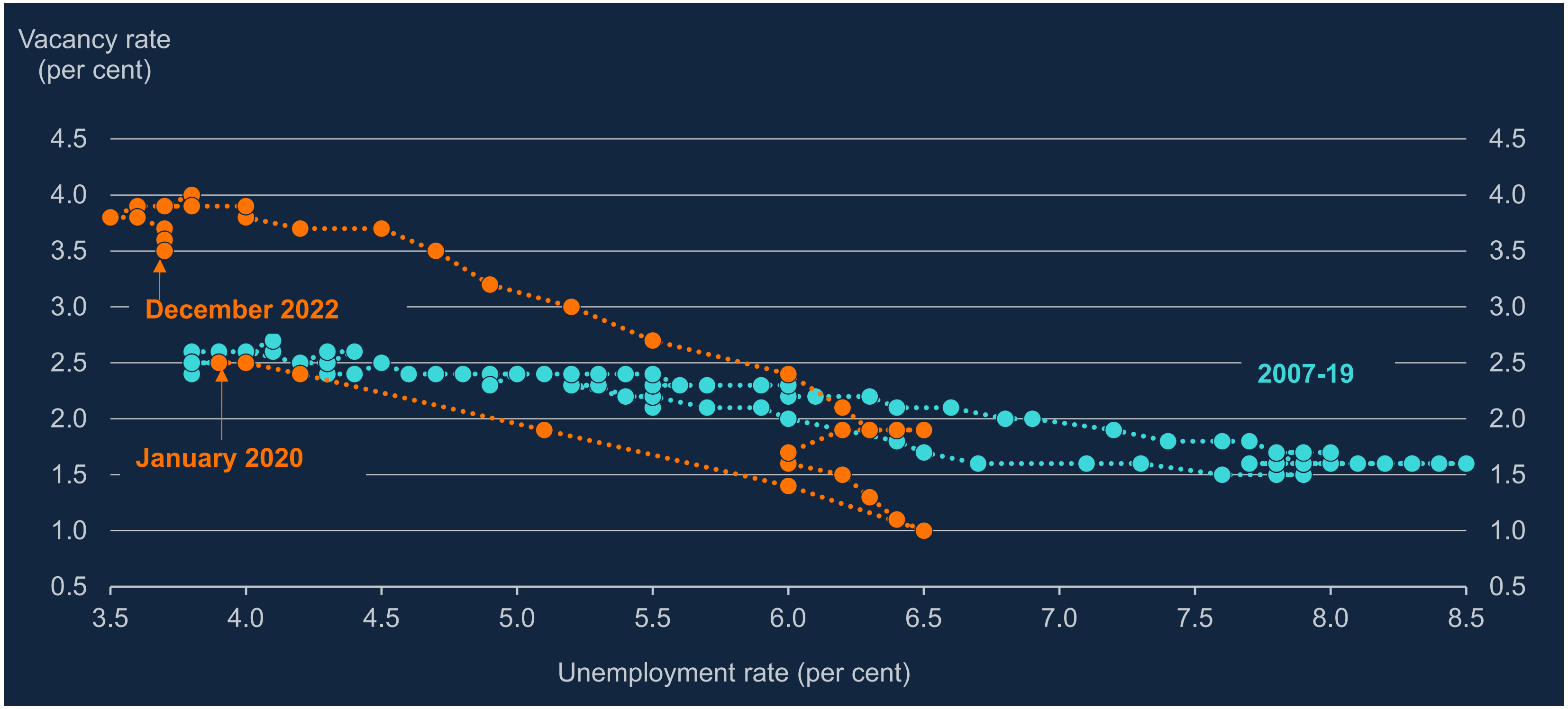
Sources: ONS and Bank calculations.

(a) The lighter diamonds show Bank staff's projections at the time of the November 2022 Monetary Policy Report. The darker diamonds show Bank staff's projections in the February 2023 Monetary Policy Report. Projections for Unemployment show 2022 Q3 to 2023 Q1.

Older people have driven the rise in inactivity



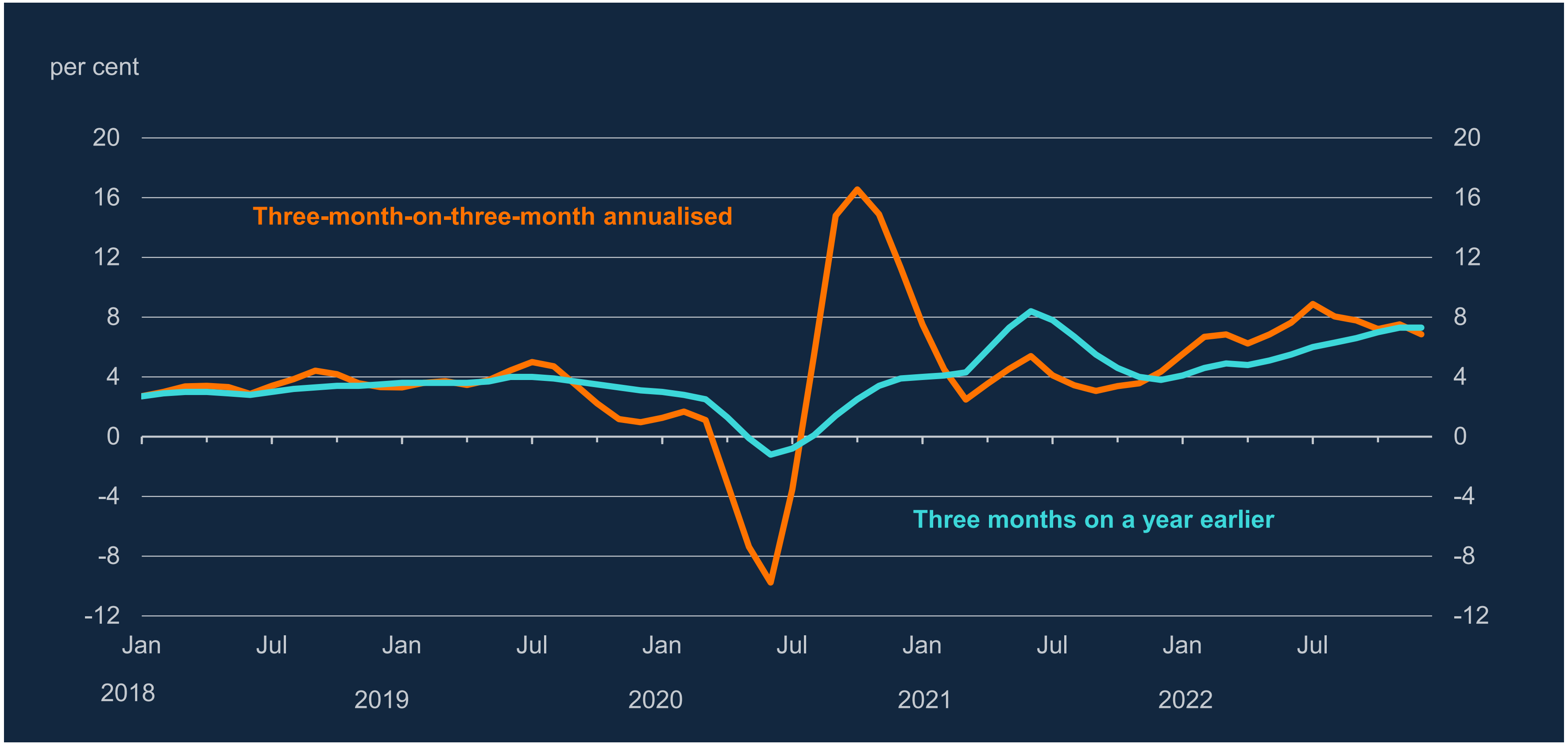
Labour market is even tighter than the unemployment rate would suggest



Sources: HMRC, ONS and Bank calculations.

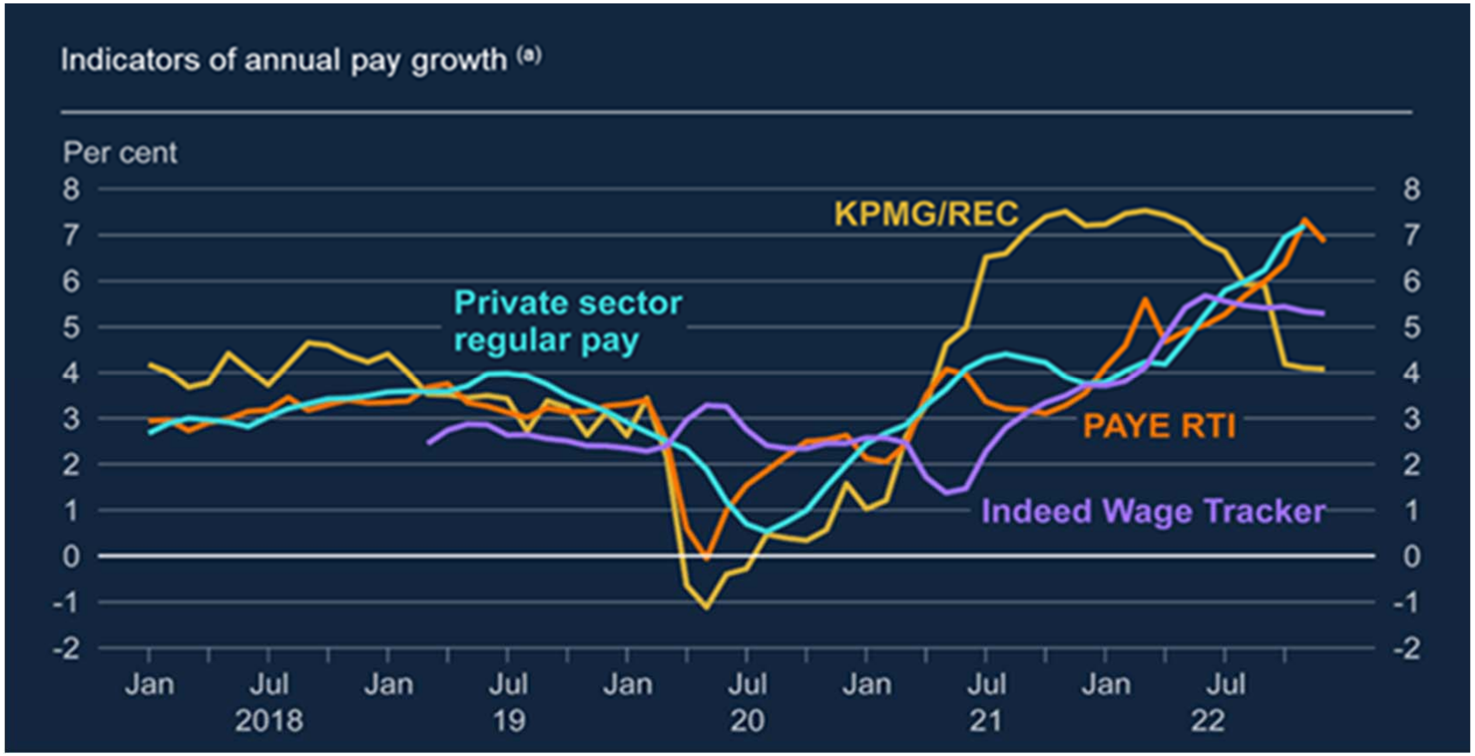
(a) Three-month moving averages. Latest data are for the three months to December 2022. Vacancy rate is the number of vacancies divided by total employment. The unemployment figures have been increased to reflect an MPC judgement that 10% of those furloughed between March 2020 and September 2021 were actively searching for work

Wage growth in the private sector is still high



Sources: ONS and Bank calculations.

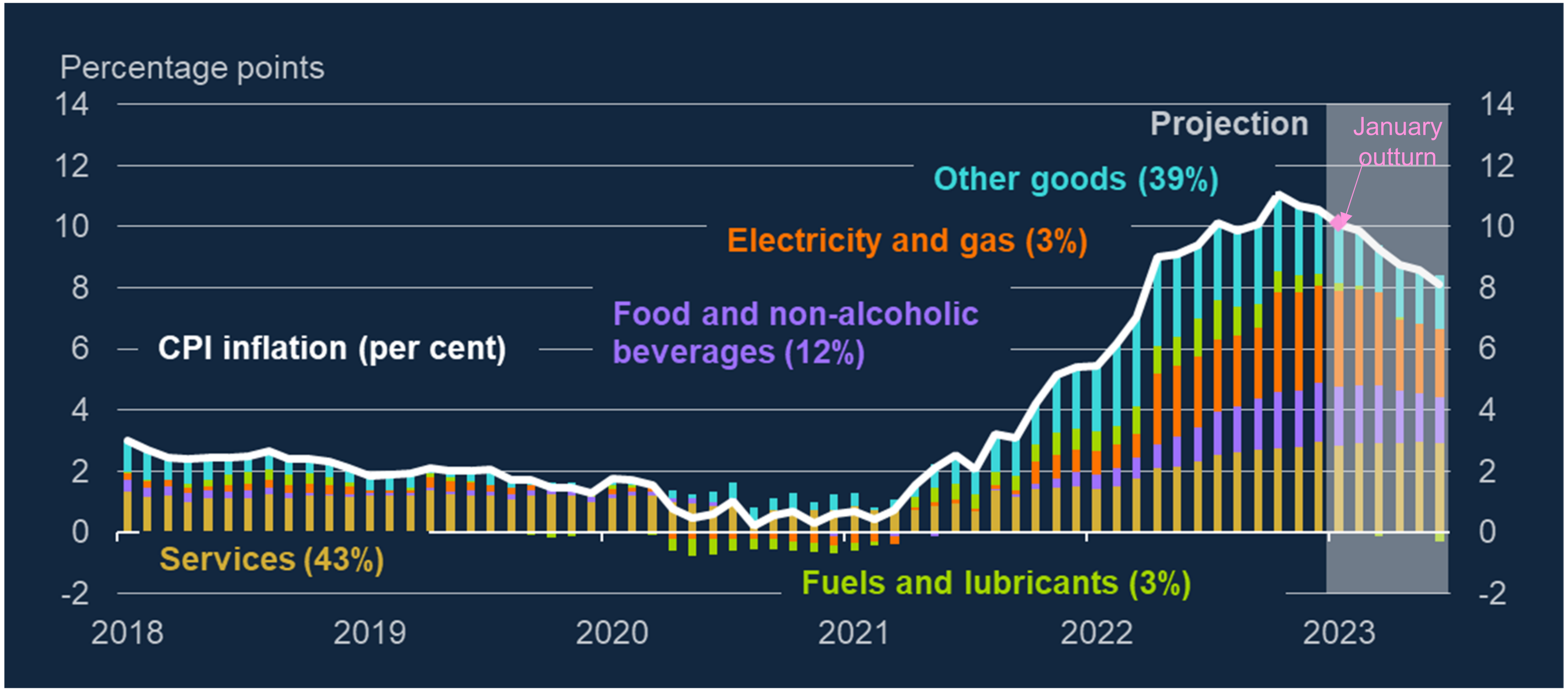
Unemployment is projected to remain very low



Sources: HMRC, Indeed, KPMG/REC UK Report on Jobs, ONS and Bank calculations.

(a) Private sector regular pay growth is Bank staff's estimate of underlying pay growth between January 2020 and September 2022 and ONS private sector regular pay growth otherwise. KPMG/REC shows permanent staff salaries. Pay as You Earn (PAYE) Real Time Information (RTI) shows median of pay growth. KPMG/REC is mean-variance adjusted to ONS private sector regular pay growth over March 2001–19. Latest data points are January 2023 for PAYE RTI, the Indeed Wage Tracker and the KPMG/REC index and the three months to December 2022 for private sector regular pay.

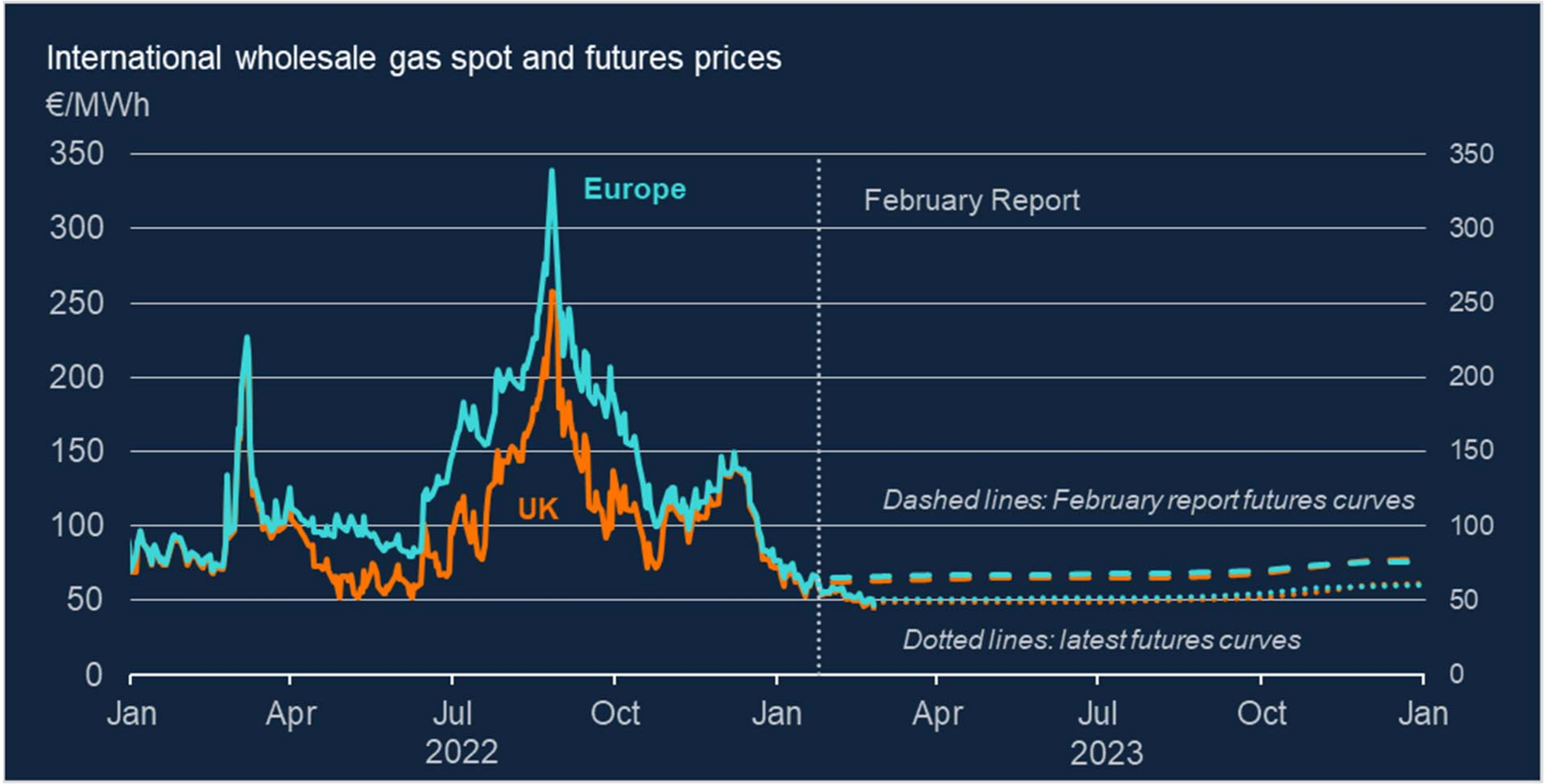
Higher energy and goods prices have pushed inflation higher



Sources: Bloomberg Finance L.P., Department for Business, Energy and Industrial Strategy, ONS and Bank calculations.

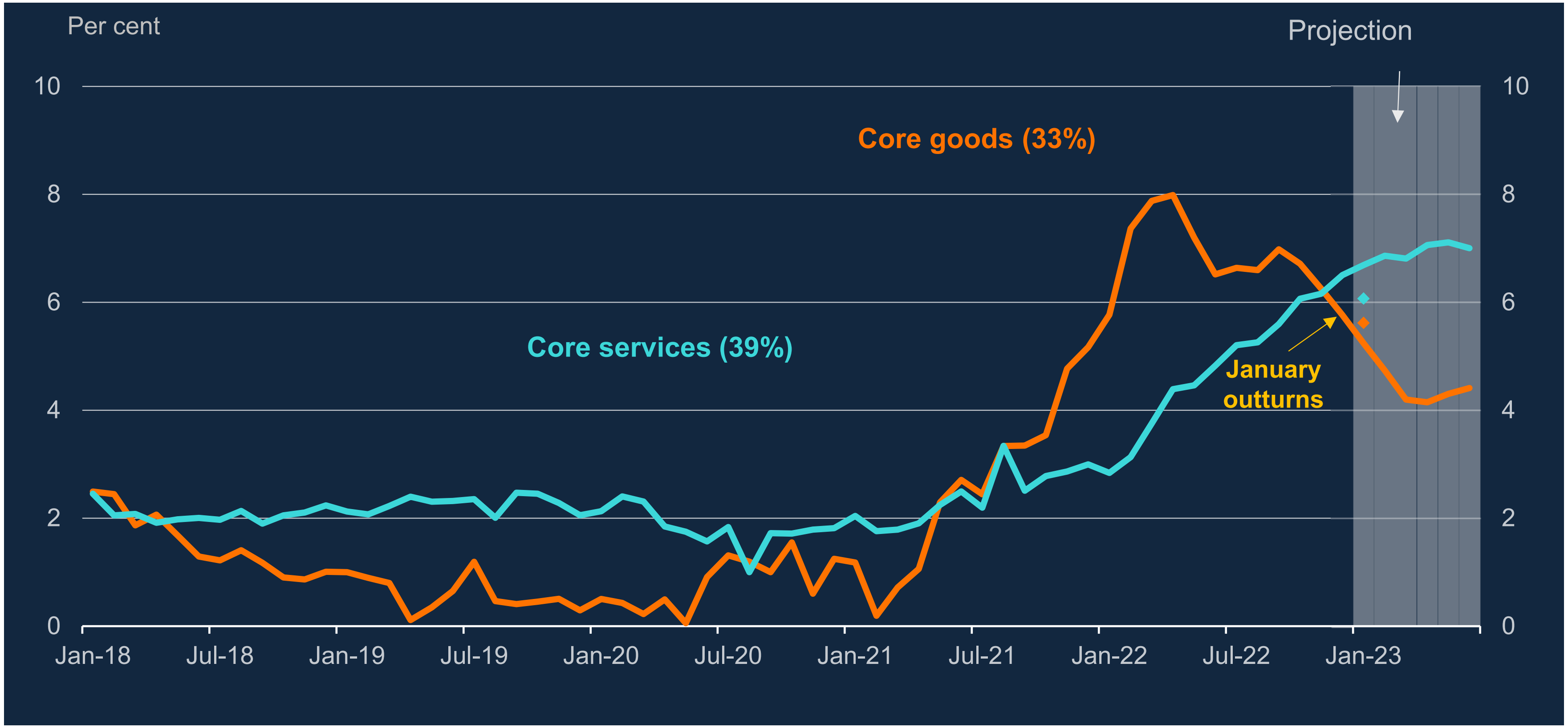
[1]Figures in parentheses are CPI basket weights in 2022. Data to January 2023. Bank staff projections from January to June 2023. Fuels and lubricants estimates use Department for Business, Energy and Industrial Strategy petrol price data for January 2023 and then are based on the sterling oil futures curve. Other goods is the difference between CPI inflation and the other contributions identified in the chart.

Gas spot and futures prices have fallen since November



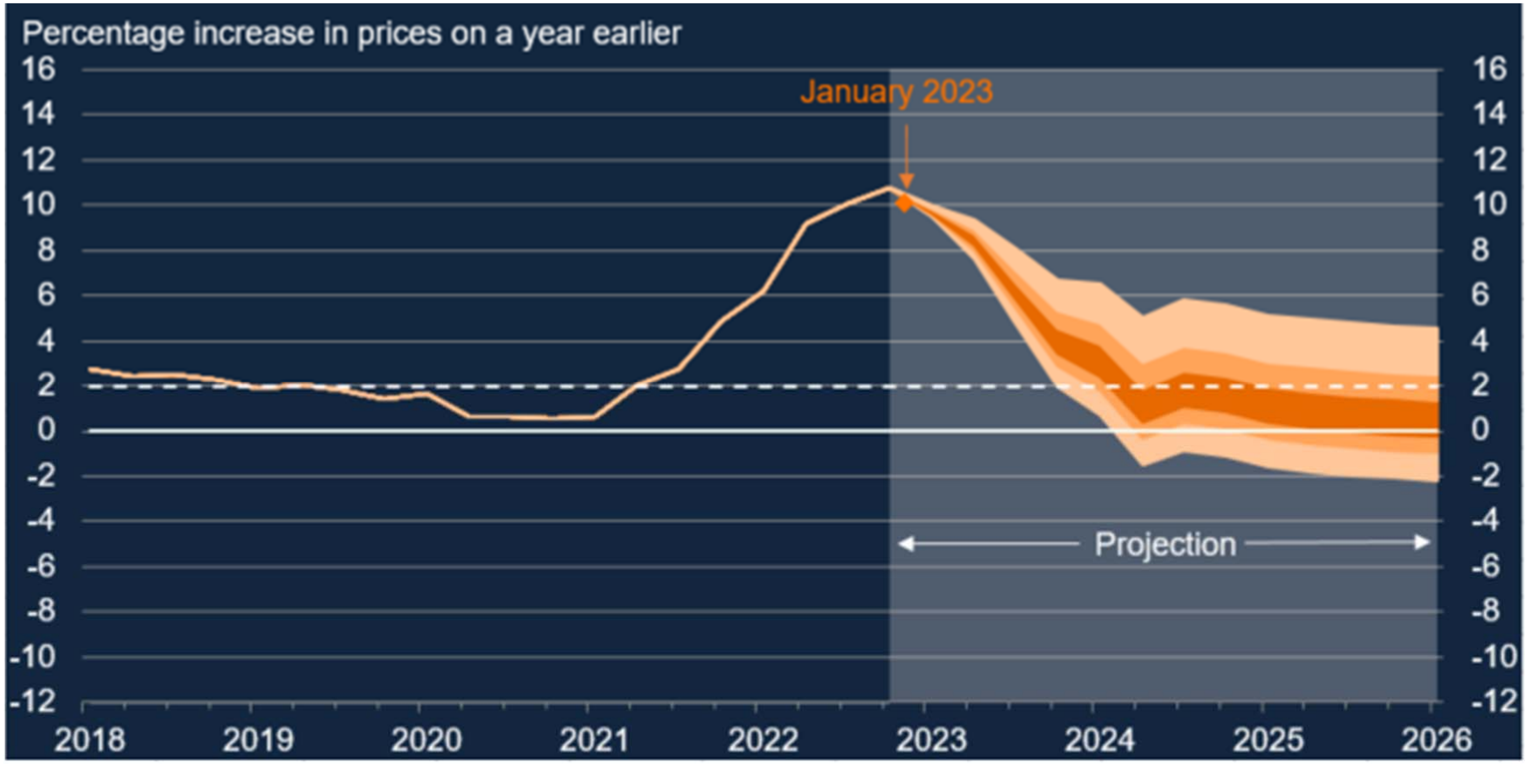
Sources: Bloomberg Finance L.P., Bank calculations.

While core goods inflation has eased, core services inflation has strengthened



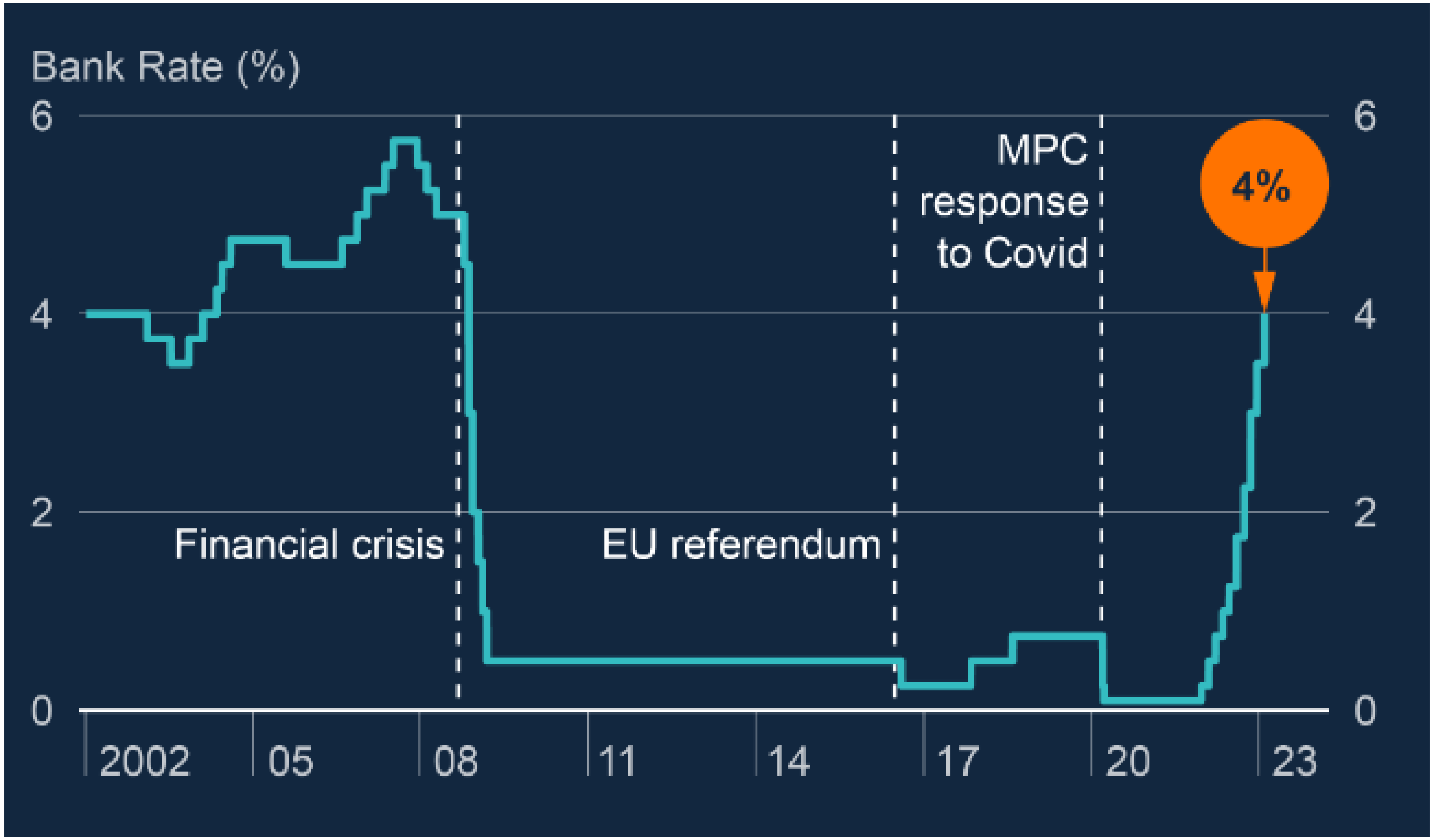
Sources: ONS and Bank calculations.

CPI inflation projection based on market interest rate expectations, other policy measures as announced



Sources: ONS and Bank calculations.

MPC raised interest rates by almost 400bps in the last year



Source: Bank of England