New Year's Outlook 2023

They think it's all over… it isn't now

30 December 2022

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2022 was a truly horrendous year, dominated by the arrival of double-digit inflation that drove a 3.3 per cent (or £800 per household) hit to real disposable incomes, the biggest annual fall in a century. This has left three-quarters of lower-income working families cutting back this Christmas. Against that difficult backdrop, this note considers what 2023 might have in store for policy makers and punters.

The good news is that the new year should see the back of double-digit inflation, as international energy and goods price pressures ease. Combined with anchored inflation expectations and a cooling labour market domestically, this may make for an easier year ahead for policy makers in the Bank of England.

In stark contrast, 2023 will be a groundhog year for families, with household incomes on course for significant further falls. Many families will be helped by benefits and the National Living Wage both rising by around 10 per cent next April. But for the country as a whole this will be swamped by:

- a record £900 energy bill rise as prices increase and government support is scaled back;
- shrinking pay packets, with real wages remaining below current levels well into 2024;
- tax rises amounting to £700 for a typical household; and,
- around 2 million households moving onto more expensive mortgages costing the average fixed-rate mortgagor household £3,000 a year.

Combined these living standards headwinds are set to combine to drive household income falls in 2023 (3.8 per cent or £880 per household) as big as those seen in 2022 For families' living standards, things will get far worse in 2023 before they start to get better.

2022: the year, and living standards squeeze, that was

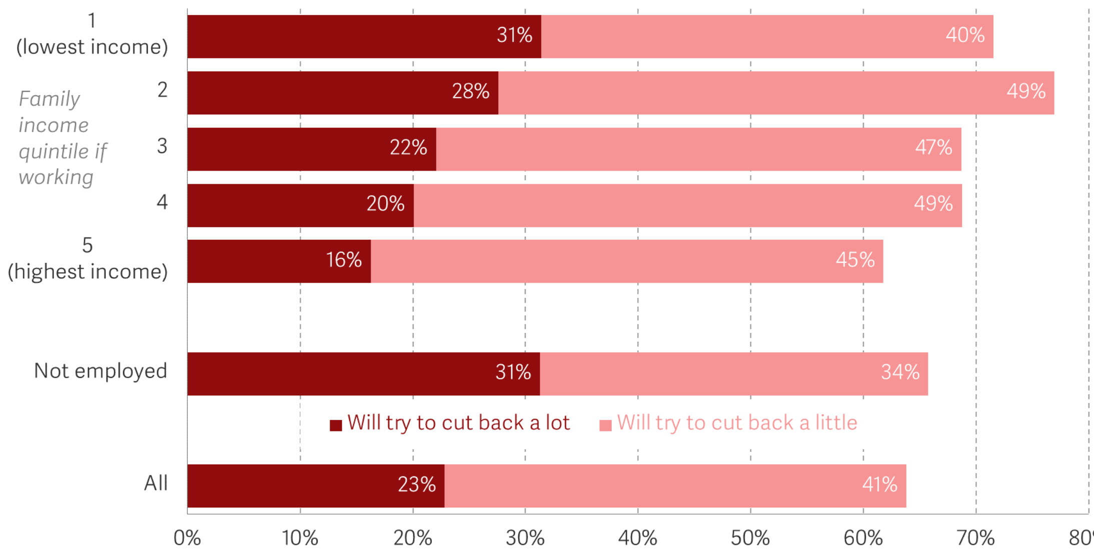
There were good grounds for thinking Elon Musk and Liz Truss might struggle in new jobs during 2022 as Twitter Chief Exec and Prime Minister respectively. Both far exceeded expectations for how bad they'd be. 2022 managed a similar feat: we knew it was going to be grim, but it turned out far grimmer.

This time last year the expectation was that inflation would peak at 6 per cent in the spring, but it actually rose faster and for longer. The 6 per cent barrier was broken as early as February and inflation continued to rise to almost twice that this autumn, hitting 11 per cent in October.

The result has been terrible for British households and challenging for economic policy makers as the first double-digit inflation in four decades prompted interest rates to rise and living standards to tank. Average real household disposable income fell by 3.3 per cent in 2022, or £800 per household – the biggest annual fall in a century.

It's not a surprise then that a new Resolution Foundation survey of 10,470 adults found that people are over four times as likely to think that their financial situation has become worse rather than better over the past year. Half of families in work said they were trying to cut back this festive period. Those on the lowest incomes are twice as likely to have been trying to cut back a lot as the highest income working families, with almost three-quarters of lower-income working families cutting back this Christmas.

Figure 1 **Low-income working families are cutting a lot over the festive period**
Proportion of families that have tried to cut spending back a lot or a little on presents, food or treats over the festive period, by income quintile if employed, and by those not employed: UK, 23-30 November



Notes: Base is all those who've cut back a lot on over the festive period and in each of the categories listed. All adults 18+ (n=10,470). In work family income quintiles (n=4456), lowest income quintile (n=988), q2 (n=740), q3 (n=897), q4 (n=703) and highest income quintile (n=1128). No employment (n=1631). These figures have been analysed independently by the Resolution Foundation.
Source: RF analysis of YouGov, Cost of Living Crisis, November 2022 wave.

For the Bank of England, far higher levels of, largely imported, inflation than expected was particularly troubling when combined with a tight labour market – raising fears of domestically generated and longer lasting inflation to come. Interest rates have risen as a result, leaving fiscal policy makers in the Treasury with a different problem: a debt interest bill rising as a share of GDP back to levels not seen since the mid-1980s.

Better news for economists in 2023

Early 2023 is unlikely to feel easy for anyone (oil and gas producers aside), but there are reasons for thinking policy makers focused on avoiding persistently high inflation may have an easier life in 2023.

The peak of inflation looks set to have passed, with its international drivers easing. Annual CPI inflation fell from 11.1 to 10.7 per cent in November – its biggest fall since July 2021, partly reflecting petrol prices no longer rising as they were in Autumn 2021. We've seen petrol price falls more recently, which should drive further inflation reductions in the months ahead.

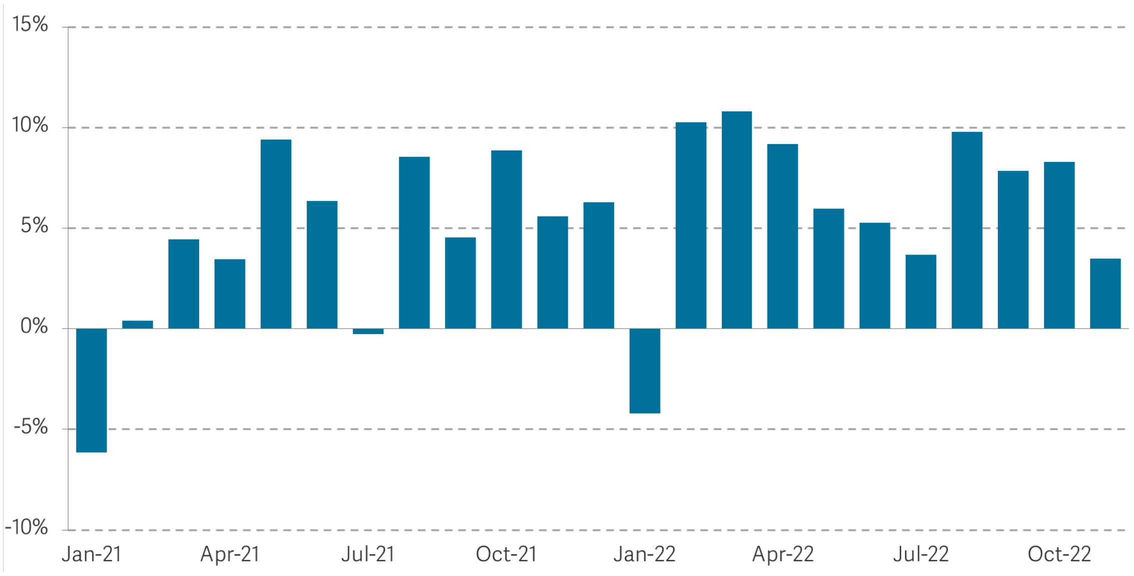
Three-quarters of the rise in inflation since April 2021 is accounted for by just three components: energy, food and other goods. Fortunately, energy prices, the key driver of inflation in Europe, have seen rapid falls with 2023 wholesale gas prices currently 275 pence per therm, 58 per cent lower than the August highs of 620 pence per therm seen for winter 2022 gas contracts.

The price of globally traded goods increased on the back of supply chain disruptions and rampant US goods demand. Both are now easing, with imports of goods to the US having now fallen 5.2 per cent from their peak in March and the cost of shipping (the Baltic Dry Index) falling back from seven to below 2 times its pre-pandemic level.

These trends should make us very confident we are past the worst when it comes to imported inflation. The domestic situation is far less certain, but when it comes to the worst-case scenarios many economists have publicly worried about (accelerating domestic price pressures amidst a wage-price spiral) the warnings signs aren't flashing red.

Core inflation, excluding the likes of energy and food, is not showing signs of accelerating domestic price pressures: it's been flat since April, and month-to-month changes are, if anything, trending downwards (see Figure 2).

Figure 2 **Core inflation is too high but not accelerating**
Annualised monthly core consumer price inflation rate: UK



Notes: Notes: Core inflation is measured as the consumer price index excluding food, alcohol, tobacco and energy. Data are adjusted to account for seasonal patterns by removing the average deviation each calendar month from the average rate over the course of the year between 2021 and 2022.
Source: RF analysis of ONS, Consumer Prices.

One route via which policy makers have worried that an internationally driven inflation spike could translate into sustained domestic price pressure is if it lastingly raised the inflation expectations of households and firms.

On the former, short-term inflation expectations are inevitably elevated alongside actual inflation. But expectations of 2- and 5-year ahead inflation are exactly where they were after the far smaller inflation spike of the early 2010s – which passed without trace. Firms' inflation expectations have been falling back through the Autumn, and financial markets' 3-year ahead implied-inflation rate has now returned to pre-pandemic levels. In short, people expect the Bank of England to do its job and bring inflation down once the current inflation spike has passed.

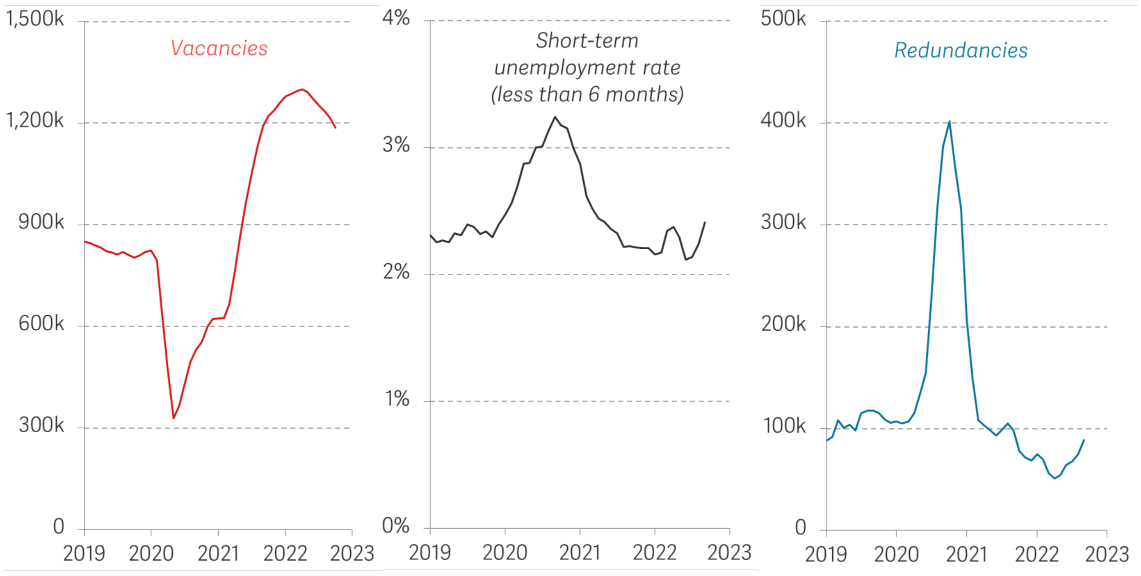
What ultimately determines how difficult that is for the Bank of England is what workers and firms do next. There are signs that firms may not be a source of pent-up domestic inflationary pressure, with profits as a share of GDP broadly flat recently and certainly not falling below historic norms (something which might indicate firms would seek to raise prices in future to rebuild margins).

In the labour market, key is what happens to pay. This is where the uncertainty is greatest: history isn't a good guide because this is the first time our modern, flexible labour market has been tight and suffered a large inflation shock. We don't know for sure how it will respond.

Inflation hawks will note that in the three months to October, private sector wage growth was running at 6.9 per cent. One reading of this is that it's unsustainably high for normal times, significantly outpacing productivity growth, pushing up production costs and prices. But when looking ahead to 2023, what this is really telling us is that – unlike in the 1970s and despite the current tight labour market – workers certainly don't have enough power to protect their living standards: this is well below inflation, leaving real private sector pay currently falling at 2 per cent.

Figure 3 **The labour market appears to be cooling**

Number of vacancies, 16+ short-term unemployment rate, number of redundancies: UK

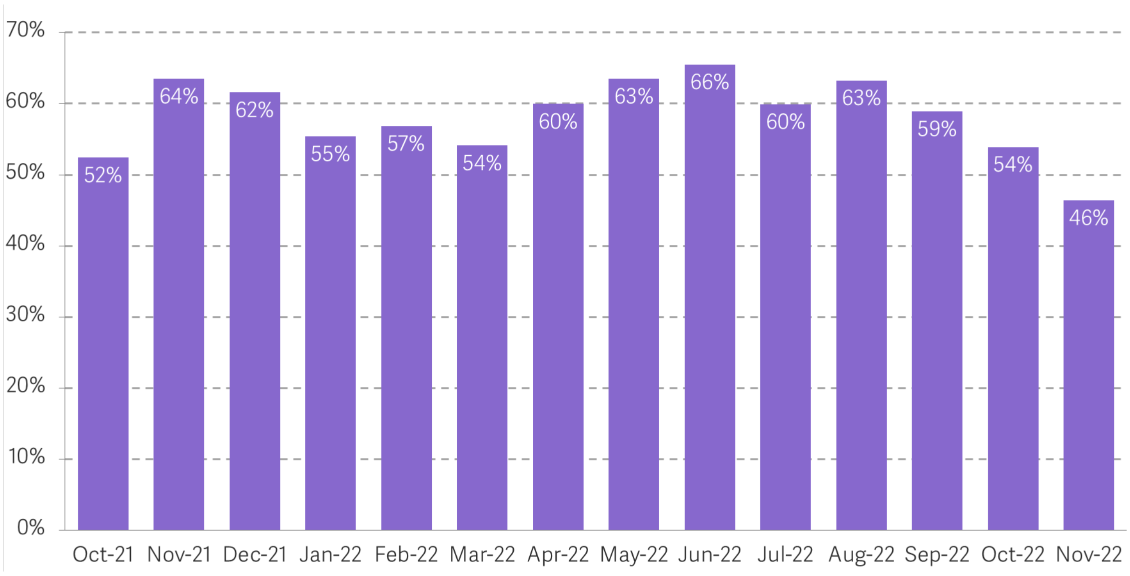


Source: RF analysis of ONS, Labour Market Statistics. Data covers up to the end of October 2022

If workers couldn't protect their living standards in 2022, they are even less likely to be able to in 2023, with signs the labour market is starting to cool. As Figure 3 shows, vacancies are falling (down 9 per cent over the past six months), while short-term unemployment and redundancies are now rising from a low base (redundancies are nearing the 100,000 per three months pre-pandemic norm). Firms are reporting this is feeding through, easing their recruitment difficulties, which are now at their lowest level since at least 2021.

Figure 4 **Labour shortages are easing**

Proportion of businesses reporting recruitment is "much harder" than normal: UK



Notes: excludes businesses with fewer than 10 employees.
Source: RF analysis of Bank of England, Decision Maker Panel.

Falling inflation, anchored inflation expectations, and a cooling labour market don't guarantee easier times for the Bank of England in 2023, but they certainly help.

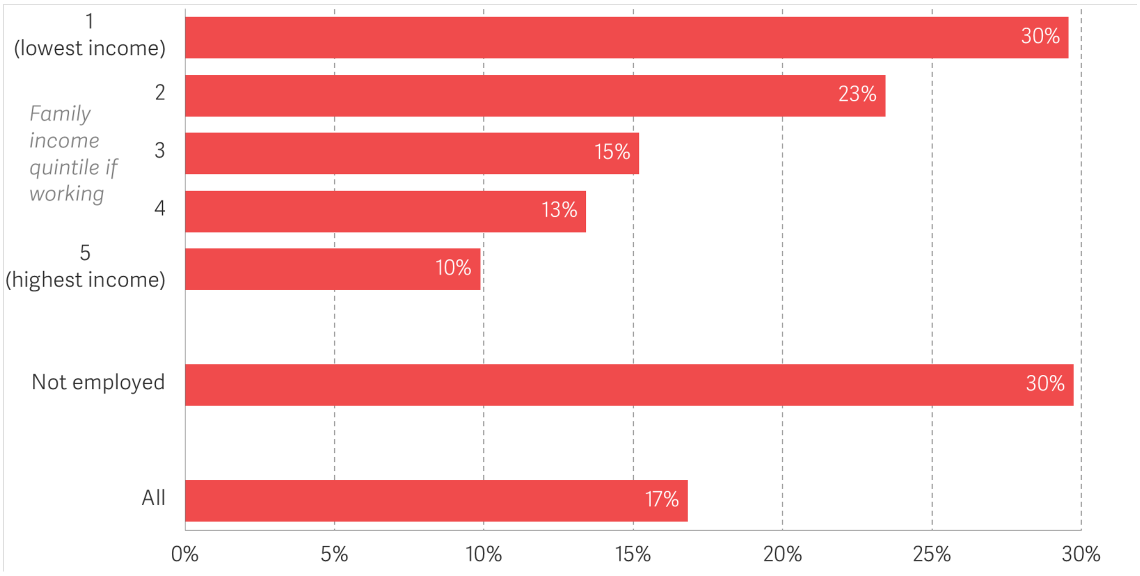
Groundhog day for households

While double-digit inflation passing into the history books may mean life gets easier for economic policy makers in 2023, that will not be the case for households. Lower inflation means smaller price rises, not lower prices. Still-high inflation, combined with new headwinds as mortgages and taxes rise, mean 2023 will be a groundhog year for families: their finances face a further round of hits similar in scale to 2022 all over again.

This comes despite benefits and the National Living Wage being set for rises of 10.1 per cent and 9.7 per cent respectively in April. How necessary those steps are is demonstrated by the fact that low-income working families are three times as likely to not feel confident about their financial situation over the coming months as those on higher incomes. It is simply a far harder to navigate a cost-of-living crisis on lower incomes.

Figure 5 **Low-income families are concerned about their 2023 finances**

Percentage of respondents who are not confident about their financial situation over the next three months (i.e. end of November 2022 to end of February 2023): UK, 23-30 November

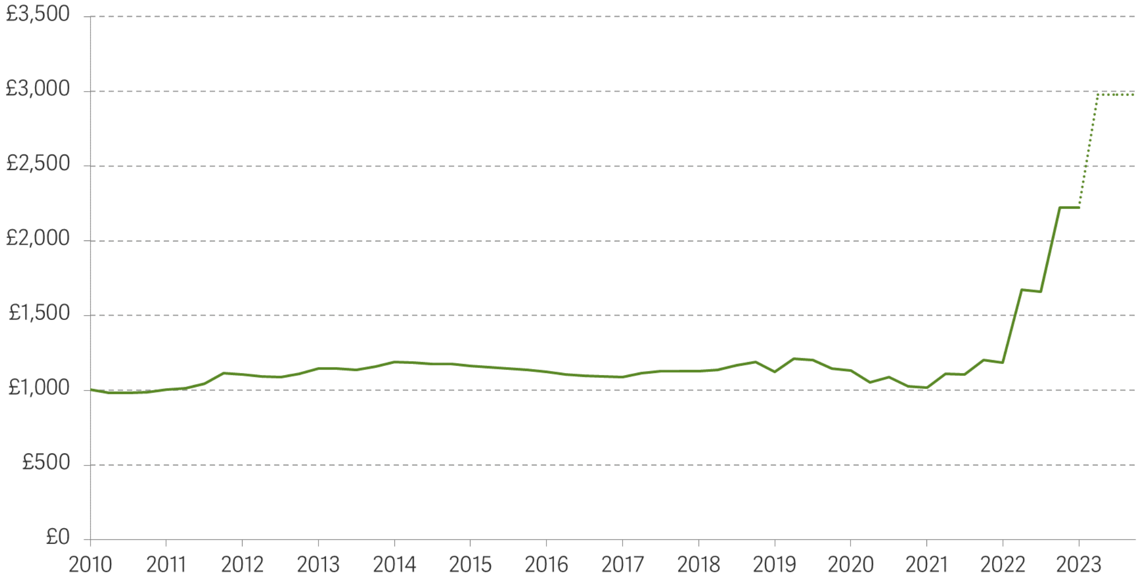


Notes: Base is all those answered how confident they feel about family or personal financial situation and in each of the categories listed. All adults 18+ (n=10,470). By employed income quintile (n=4456), lowest income quintile (n=988), q2 (n=740), q3 (n=897), q4 (n=703) and highest income quintile (n=1128). Not employed (n=1,630). These figures have been analysed independently by the Resolution Foundation.
Source: RF analysis of YouGov, Cost of Living Crisis, November 2022 wave.

For the population as a whole, however, those welcome policies will be more than wiped out by huge tailwinds for household finances. Energy bills will continue to dominate in 2023. While wholesale energy prices have fallen, household spending on energy bills is set to reach a record high as retail prices rise further and government support is scaled back. The typical energy bill households pay is set to rise by £900 to £2,650 in 2023, up from £1,750 in 2022, and £1,170 in 2019. We have spent the past year talking about higher energy costs, but for consumers a record energy bill rise actually lies ahead of us. This will be felt by consumers from April when the Energy Price Guarantee rises to £3,000 for a typical energy user, as Figure 6 shows.

Figure 6 **Household energy spending will hit record highs in 2023**

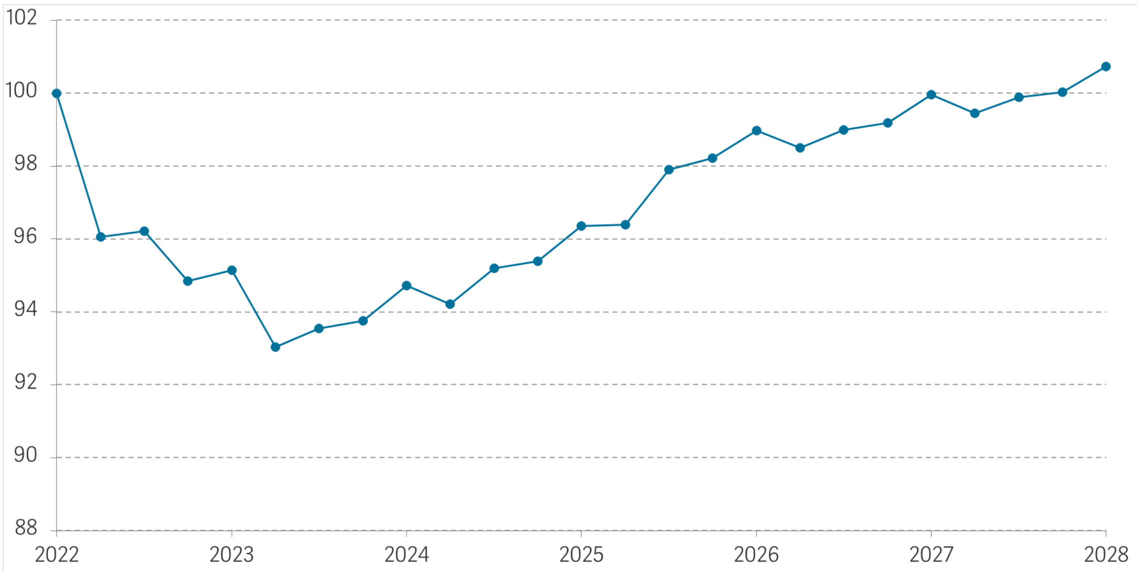
Historical and forecast annual household expenditure on gas and electricity, real terms, 2010-2023



Notes: Assumes constant per-households use of 2,900 kWh for electricity and 12,000 kWh for gas, in line with current typical domestic consumption values (TDCV). Includes £400 universal discount for energy costs spread over the October 2022 – March 2023 period.
Source: RF analysis of BEIS Energy Price indices, Energy Price Guarantee, Ofgem Price Cap methodology.

April's energy price rise will drive a pick-up in inflation, extending the period of falling real wages into the second half of 2023 on the basis of the OBR's forecasts. Although the damage to our pay packets will start to be undone in the second half of the year, the scale of that damage means real earnings won't return to today's levels until well into 2024 (Figure 7) and aren't forecast to return to 2008 wage levels until 2027. Britain's wage stagnation is now a two-decade long phenomenon. While falling real wages are a widespread form of economic pain, there is a danger that contributing to income falls next year could be a more concentrated income shocks: rising unemployment. The OBR and Bank of England respectively expect 340,000 and 440,000 more people to be out of work by the end of 2023.

Figure 7 **Earnings aren't expected to rise in real-terms until the second half of 2023**
Index of average earnings (Q1 2022=100) in real-terms, 2022 prices: UK



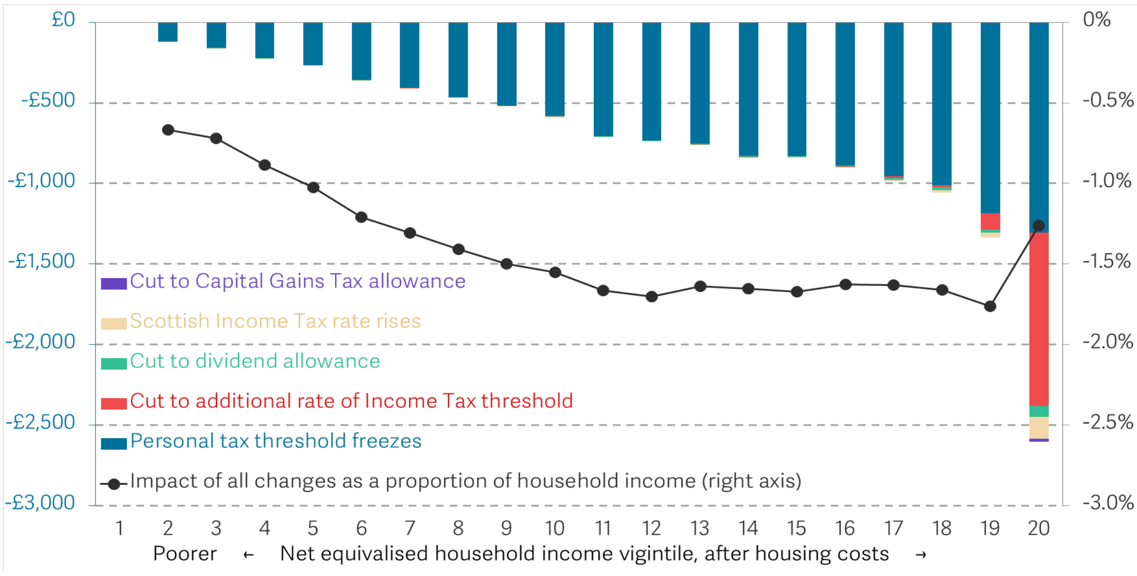
Source: RF analysis of ONS; OBR, Economic and Fiscal Outlook, various.

While wages will be falling for much of 2023, taxes are on the up. Specifically, from April a typical middle-income household will see their personal tax bills rise by around £700 compared to a world where the Government had indexed all threshold with prices as usual. The overwhelming majority of this is driven by the decision to freeze almost every threshold in our tax system at a time of high inflation. This isn't the first year many of those thresholds have been frozen, with Chancellors Sunak and Hunt's decisions cumulatively increasing personal tax bills from April 2023 by almost £1,000 higher for a middle-income household.

The package of measures coming into effect in April is progressive, broadly falling on the shoulders of middle- and higher-income households, as Figure 8 shows. However, the decision to raise most of the additional tax revenues from freezing personal tax thresholds rather than raising tax rates means middle-income households will actually face a bigger income hit than the richest five per cent of households (1.6 and 1.3 per cent of income respectively).

Figure 8 **Tax rises will hit middle-income households in 2023**

Average impact of tax changes taking effect in 2023-24 by income vigintile, in 2023-24 prices: UK



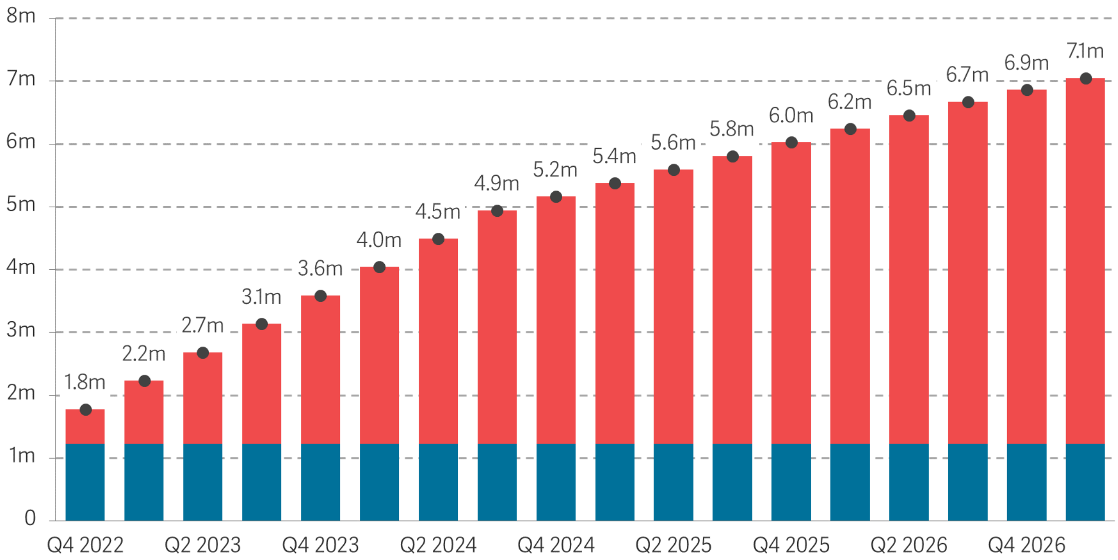
Notes: Capital Gains Tax change reduces the annual exempt amount from £12,300 to £6,000 from 2023-24, then to £3,000 in 2024-25. We assume Capital Gains Tax changes affect the top vigintile only. Dividend allowance change reduces the threshold from £2,000 to £1,000 in 2023-24, and £500 in 2024-25. Additional rate of income tax threshold reduced from £150,000 to £125,140 in 2023-24. Personal Tax Threshold Freeze refers to Income Tax and National Insurance thresholds freeze (excluding employer NI).
Source: RF analysis of DWP, Family Resources Survey using IPPR tax-benefit model; DWP, Households Below Average Income.

While wage falls and tax rises are things British households have got painfully used to, a new squeeze on their living standards will take centre stage in 2023. 2022 saw rapid interest rate rises announced, but 2023 is when they rapidly turn into pain for borrowers. Next year will see the biggest cohort of households facing the mortgage bill shock of being newly affected by the new higher rate regime, with around 2 million fixed-rate mortgages set to be renewed. A further 1 million plus floating-rate mortgages face the impact of continued rises in the Bank of England's policy rate.

Of course, there are winners from higher interest rates (principally richer and older households with significant savings) but the hit for mortgagor households will be very significant indeed. The Bank of England estimate that the average fixed-rate mortgagor household renewing in 2023 faces a £3,000 a year increase in interest costs, with total monthly mortgage payments rising from £750 to £1,000. While 2022 will be remembered as the year of two-digit inflation, 2023 will be remembered by many as the year of four-digit mortgage bill increases.

Figure 9 Around 2 million mortgagor households will roll over onto higher rates in 2023

Estimated number of households facing rising mortgage payments, relative to Q3 2022: GB



Notes: Only includes one owner occupier mortgage per household, additional mortgages (where applicable) are excluded.
Source: RF analysis of ONS, Wealth and Assets survey; Bank of England, Bankstats and Yield Curve.

Conclusion

For families looking at what 2023 has in store, the dominant feature is that tomorrow will be worse than today. The fact that it isn't quite as bad as economists previously feared will offer little comfort.

To see the combined effect of falling real wages, and higher energy, mortgage and tax bills, we can look at the outlook for household incomes overall. Analysis of the Office for Budget Responsibility's (OBR's) forecasts shows they are set by to fall by another 3.8 per cent (equivalent to £880 per household) in 2023. How exactly things will play out is uncertain, but were that to come to pass it would amount to an even bigger income hit than in 2022.

2023 should see the back of double-digit inflation, but it also looks set to be a groundhog year for family finances: things will get far worse before they start to get better.