Review of the UK economy in 2023

Steven Proud looks back at the economy in 2023, including how the cost-of-living crisis affected households around the country, and the policies introduced to tackle it

© Iakov Kalinin/stock.adobe.com

SPECIFICATION LINKS

marginal tax rates, housing market, public finances, the role of central banks, inflation, fiscal policy

For over a decade after the global financial crash of 2007–09, the Bank of England (BoE) has maintained a loose monetary policy, with historically low interest rates, and quantitative easing as a way of supporting the economy, while attempting to maintain its target of achieving a 2% inflation rate.

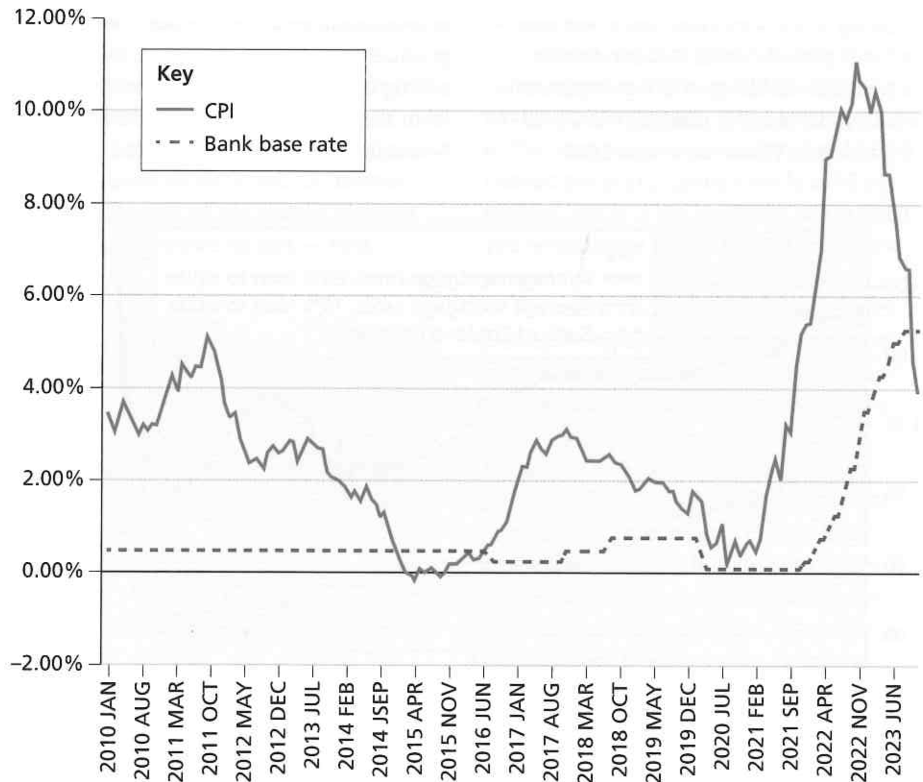
However, 2023 dawned with a spectre looming over it. At the end of 2022, the headline CPI inflation figure had hit over 10%, and so after over a decade of benign inflation rates, and loose monetary policy, the Bank of England reacted by raising interest rates.

For government and policymakers, the economic story of 2023 was one of trying to reduce inflation, while simultaneously not dampening already low levels of economic growth, so much so that on 4 January 2023, prime minister Rishi Sunak pledged to halve inflation in 2023 (although it is worth noting that this is the responsibility of the BoE, not the government). However, the cost-of-living crisis remained a concern throughout the whole of 2023, affecting the economy through inflation, increased interest rates and fiscal drag.

Monetary policy

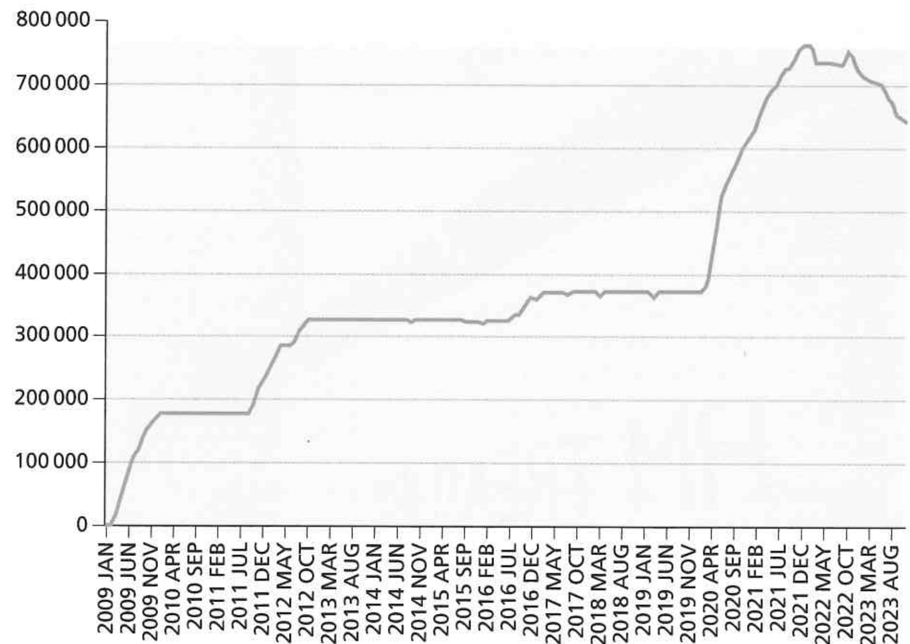
From 2008 until 2022, the Bank of England had maintained the base rate (which influences all lending rates across the economy) at very low (historical) levels of between 0.25% and 0.75%. Through the second half of 2022, and up to August 2023, the BoE gradually increased the base rate up to 5.25%.

There are a number of potential causes of increases in inflation. One of these is the supply of (liquid) money in the economy. When the money supply increases, there is more money competing for goods and services in the economy, causing prices to rise. When the interest rate rises, this increases the cost of borrowing, and increases the returns for saving, leading to a reduction in money supply within the economy, and hence, if the rise in interest rates is sufficient, this should lead to a reduction in inflation. As we can see from Figure 1, the rapid rise in interest rates was



Source: ONS, Bank of England

Figure 1 CPI plotted against the Bank of England base rate from 2010–2023



Source: ONS

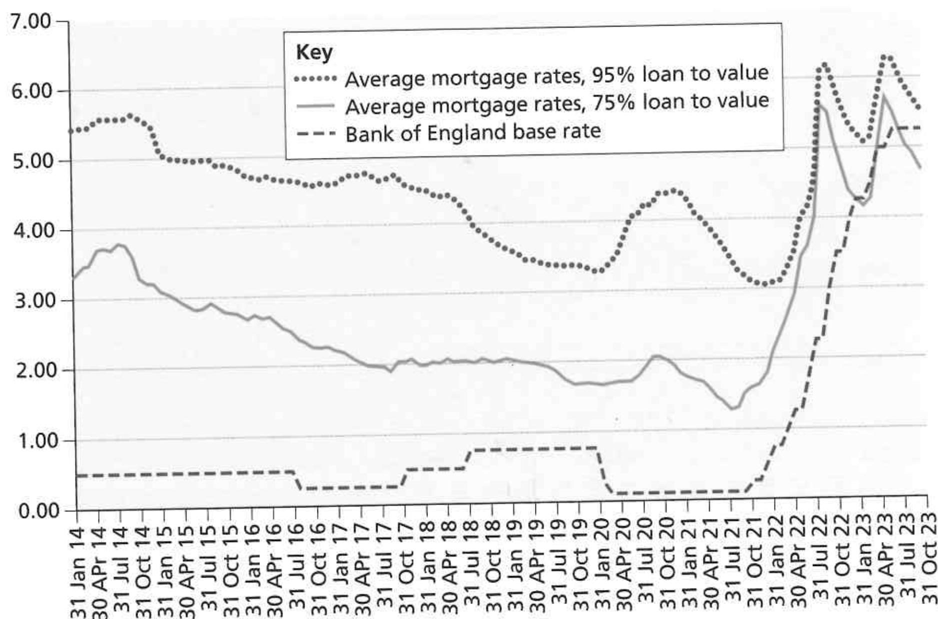
Figure 2 Bank of England holdings of gilts

accompanied, in the second half of 2023, by a significant fall in CPI inflation, down to 3.95% in November 2023.

While interest rates have remained the primary monetary policy lever used by the Bank of England, following the global financial crisis and during Covid-19, the BoE expanded the money supply through quantitative easing (QE). QE worked by the BoE purchasing UK government bonds (gilts) with 'new' money, which acted to increase the overall money supply.

Figure 2 shows the holdings of gilts by the BoE from just before the introduction

of QE up until November 2023. The BoE had four periods where it substantially increased its holdings of UK government bonds, most recently through the Covid-19 pandemic. However, in late 2022 and throughout 2023, the BoE has been gradually reducing its holdings, both by selling holdings, or through transfers from the Treasury. In the 12 months to November 2023, the BoE reduced its holdings from £745 billion to £642 billion. This provided a second lever to reduce the overall money supply, and may have also contributed to the reduction in inflation through 2023.



Source: Bank of England

Figure 3 Cost of borrowing

House prices

The Bank of England's decision to increase interest rates has had knock-on-effects for the rest of the economy. When the base rate increases, this will normally lead to increases in the costs of all other loans as well. In 2023, we saw an increase in the cost of borrowing, shown in Figure 3 in terms of the BoE base rate, the average 5-year fixed-rate mortgage, based upon a 95% loan to value, and the average 5-year fixed-rate mortgage, based upon a 75% loan to value.

The mortgage rates do not move perfectly in step with the base rates, but in general, as the bate rate increases, the mortgage rates similarly rise. But because these rates are fixed for 5 years, banks also include expectations of what will happen to interest rates in the coming years. If they believe that the base rate will fall, then they will lower the interest rate on

© William/stock.adobe.com

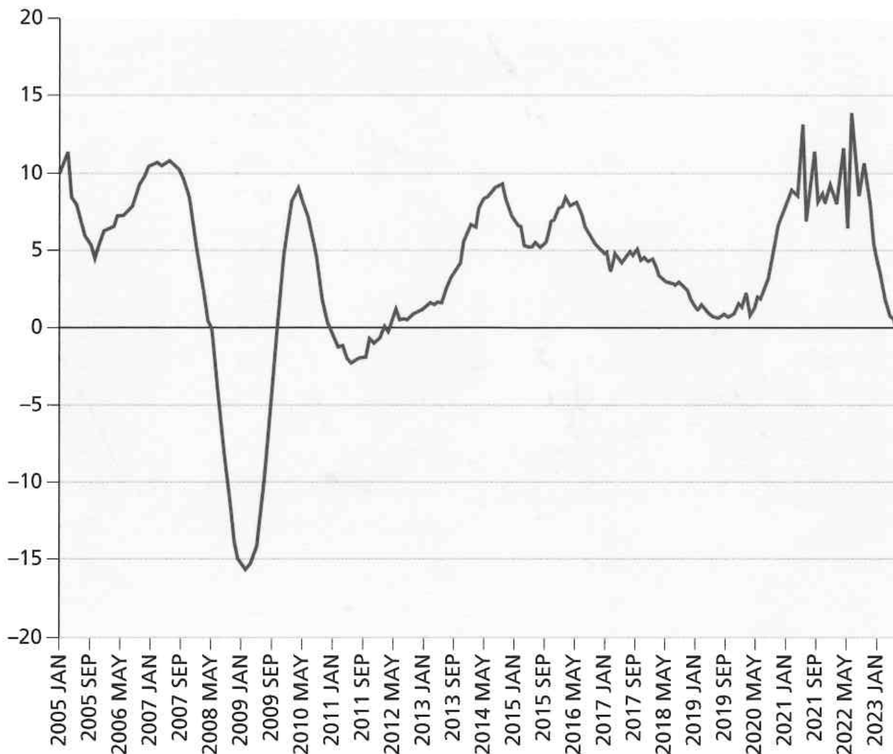
the mortgages they offer. Similarly, if they believe that the base rate will rise, then they will increase the interest rates.

While 2023 has been characterised by relatively high costs of borrowing, towards the end of the year 5-year mortgage rates had started to fall, suggesting that banks expected a reduction in base rates in the coming months, in light of the reduction in inflation.

When you borrow money through a mortgage, typically for 25 years, you make monthly repayments, consisting of a repayment element and an interest element. The cost of the interest element is determined by two factors — first, how much of the loan you have to repay, and second, the mortgage interest rate. For example, if there is £100,000 left to pay on your mortgage, if the mortgage rate is 2%, then you would need to pay £2,000 interest per year (approximately £167 per month), while if the mortgage rate is 6%, you would need to pay £6,000 in interest per year.

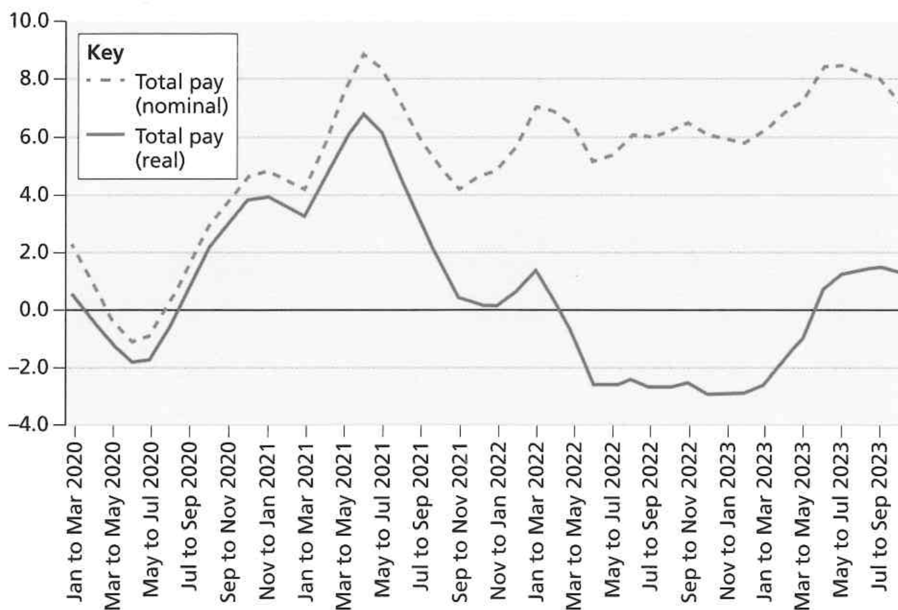
Therefore, increases in mortgage rates makes the repayment of mortgages more expensive, and we would expect it to lead to a reduction in demand for mortgages. Similarly, while many mortgages are fixed for 2 or 5 years, when the fixed period ends, borrowers will either move to a variable rate, or need to negotiate a new fixed rate. With higher mortgage rates, this will increase the monthly costs to borrowers, increasing the risk that the mortgage holder cannot maintain repayments, and increasing the risk of houses being repossessed. Again, this would be expected to exert downward pressure on house prices.

Annual changes in house prices between 2005 and the present are illustrated in Figure 4. When the graph is positive, house prices are increasing, but when the graph is negative, house prices are falling. Other than during the global financial crisis in 2007–09, when house prices fell by over 15% year-on-year, they have maintained a positive growth for much of this period, with particularly robust growth between 2021 and the beginning of 2023. However, this growth reduced substantially during 2023. Although the increase in mortgage rates has not (yet) seen substantial reductions in the prices of properties, the growth of house prices stalled through 2023.



Source: HM Land Registry

Figure 4 Annual percentage house price growth 2005–23, based upon all property types



Source: ONS

Figure 5 Three-month moving average of increase in nominal and real pay, 2020–23

Cost of living and real wages

One of the key mistakes that commentators, politicians and the public often make is to confuse changes and levels. Inflation provides a key example of this, through two mechanisms. First, even though inflation has fallen, this doesn't mean that prices have fallen. The level of inflation measures the speed at which prices increase so unless inflation becomes negative (i.e. becomes deflation), then the increase in prices is effectively 'locked in'; that is, the level of prices is permanently, substantially increased, due to the period of high inflation.

Of course, prices are only one side of the story — we are really interested in the standard of living. Keeping everything else fixed, if wages are increasing faster than prices, then you can afford to purchase more goods and services. Conversely, if prices are increasing faster than wages, then you can afford fewer goods and services. As such, what matters is the increase in real wages.

Figure 5 illustrates the growth of both nominal and real pay between 2020 and 2023. Throughout 2022 and 2023, nominal wages (i.e. the cash value of pay) increased between 6% and 8% per year. However, because inflation was approximately 10% for much of this period, the purchasing power of people's salaries reduced. This is illustrated by the total real pay — the growth in real pay adjusted to take account of inflation. That is, when real pay increases, the quantity of goods and services that consumers can purchase increases, but when real pay decreases, the quantity of goods and services consumers can purchase decreases. Between April 2022 and April 2023, real pay fell, but in the second half of 2023, pay growth outstripped inflation.

Of course, we cannot keep everything else constant — increasing mortgage interest rates mean that homeowners may need to devote a greater proportion of their income to paying interest on their mortgages.

The fiscal position

Following the global financial crisis, UK public sector debt increased substantially from 35.6% of GDP in 2007-08 to 83.5% in 2016-17, as illustrated in Table 1. This was reduced marginally until 2019-20, when the pandemic exerted a significant negative impact on public sector finances, with debt increasing to 97.1% of GDP in 2022-23.

Possibly the most notable figure, however, is not the total level of debt, but rather the level of government receipts. This represents the total tax take from the government. That is, in 2022–23,

Table 1 UK government receipts and spending

Year	UK government receipts	Total government spending	Public sector net borrowing	Public sector net debt
2007–08	37.3	40.3	3.0	35.6
2008–09	36.0	43.5	7.5	50.6
2009–10	36.2	46.5	10.2	64.7
2010–11	37.1	45.7	8.7	70.9
2011–12	37.3	44.6	7.2	74.3
2012–13	36.9	44.1	7.2	77.5
2013–14	36.8	42.5	5.7	79.2
2014–15	36.8	42.0	5.2	81.6
2015–16	37.0	41.2	4.3	81.3
2016–17	37.6	40.4	2.8	83.5
2017–18	37.2	40.0	2.9	82.3
2018–19	37.4	39.5	2.0	80.3
2019–20	36.8	39.6	2.7	85.2
2020–21	38.1	53.1	15.0	96.5
2021–22	39.0	44.2	5.2	96.6
2022–23	40.1	45.1	5.0	97.1
2023–24 (projected)	40.3	44.8	4.5	97.9

Source: OBR. Note that all figures represent percentages of GDP

© Alfan Subekti/stock.adobe.com

The growth of house prices stalled through 2023

© moodboard/stock.adobe.com

the government received tax income equivalent to 40.1% of UK GDP.

In part, this increase in tax receipts has been driven by fiscal drag. Since 2021, the thresholds that determine when people pay income tax have been frozen. The marginal income tax and national insurance rates for employees are illustrated in Table 2.

As we saw earlier, average nominal wages were increasing by 6% and 8% in 2023. As such, average pay is increasing compared with the earnings thresholds. This means that, as pay increases, more workers will move into a range where they need to pay tax, and on average, an increase in nominal wages leads to a higher proportion of wages being paid in taxes. An increase in nominal wages would mean that some workers are pushed into the taxable bracket, while others are moved into the higher rate of tax. This increase in the number of workers paying tax (and an increase in the number paying higher rates of tax) is known as fiscal drag.

To ameliorate this effect, the government announced a reduction in the headline rate of national insurance from 12% to 10%, taking effect in January 2024.

Table 2 Earnings thresholds for tax and national insurance for a single worker with no children

Earnings	Effective income tax (marginal rate)	National insurance (marginal rate)
£0–12,570	0%	0%
£12,571–50,270	20%	12%
£50,271–100,000	40%	2%
£100,000–125,140	60%	2%
Over £125,141	45%	2%

Notes:
1. Between £100,000 and £125,140, the personal allowance (£12,570) is reduced by £1 for every £2 that your earnings increase. This is equivalent to increasing the marginal income tax level to 60%.
2. This ignores any benefits that workers may be in receipt of. Benefits are means tested and are reduced as income increases.

Summary

Just as with 2022, the headline story of 2023 was increasing pressures on the cost of living. While inflation may be reducing, the levels of prices remain substantially higher than pre-pandemic. Further, the policy instruments of higher interest rates used to reduce inflation placed additional cost-of-living pressure on households, through increased mortgage interest costs.

Steven Proud is a member of the Economic Review editorial board and a reader in economics education at the University of Bristol.