

**Goldman Sachs Exchanges**

**Is the UK economy finally turning the corner?**

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**Allison Nathan:** Is the UK economy finally on the road to recovery?

**Jari Stehn:** I think it is fair to say that we are now turning the corner. We are tracking first quarter GDP growth now at 0.4%. That's the strongest in a couple of years. And we are also seeing that improvement in some of the survey data, some of the consumer and business surveys that had been extremely weak throughout this period.

**Allison Nathan:** I'm Allison Nathan and this is Goldman Sachs Exchanges.

The UK economy has lagged behind the US and some European economies in recent years, but it's starting to

show signs of growth. To discuss the country's unique economic challenges, its path forward, and the role that small businesses can play in bolstering growth, I'm sitting down with my colleague in Goldman Sachs Research, Chief European Economist Jari Stehn, and Charlotte Keenan, who leads the firm's office of corporate engagements international responsibilities. Jari, Charlotte, welcome to the program.

**Charlotte Keenan:** Thank you.

**Jari Stehn:** Hi, Allison.

**Allison Nathan:** Jari, let me start with you. As I just said, the UK economy has really lagged behind many of its peers. It was actually, if I'm not mistaken, in mild contraction in the second half of last year. But it does look like the country may be starting to turn a corner. Is that right?

**Jari Stehn:** So I think that's right. The economy has been very weak. We've effectively seen real GDP stagnate since the middle of 2022. We saw a mild contraction, as you say, in the second half of last year, which did actually qualify as a technical recession, even though a very shallow

one. We think there are two main reasons behind this weak performance.

One is obviously the energy crisis. We had a huge surge in energy prices, particularly natural gas prices across Europe, including in the UK. That pushed up headline inflation to a peak of about 11% at the end of 2022. And that of course weighed very significantly on real purchasing power and on consumption. And consumption has really underperformed relative to the US over this time period.

And the second is that monetary policy, like in many other places around the world, of course had to tighten a lot. The Bank of England raised interest rates by about 500 basis points. We saw a big increase in mortgage rates, credit volumes contracted, and we think that together with the cost of living squeeze is really responsible for the very weak growth performance that we've seen over the last couple of years.

But I think it is fair to say that we are now turning the corner. We are tracking first quarter GDP, growth now at 0.4%. That's the strongest in a couple of years. And we are also seeing that improvement in some of the survey

data, some of the consumer and business surveys that had been extremely weak throughout this period. And so we have a construct called the Current Activity Indicator, which summarizes the hard data and the survey data, and that has now turned positive.

And we think that improvement has more room to run. We have headline inflation coming down further in the forecast, so there should be continued growth in real incomes this year. And we also expect the Bank of England to cut rates soon. And again, that should provide more mortgage relief for households.

And so when you take the year together, we look for 0.6% growth this year, and that's a bit above the consensus. And I think that's the right place to be as a forecaster.

**Allison Nathan:** So you've touched on inflation. It has been coming down a bit, but we've just had a long conversation with David Mericle, our chief US economist, about the inflation surprises to the upside in the US. So are we also seeing some upside surpass to inflation in the UK?

**Jari Stehn:** We have, but they have been more limited, I would say, than in the US. I think the story in the UK ultimately is a little different in the sense that we have seen a huge decline already in headline inflation. We've gone from about 11% at the peak to about 3%. And we think that will fall further in the near term as more energy effects unwind.

Now, the underlying measures of inflation are still very high and actually higher than in the US. So core inflation is still around 4%. Services inflation is about 6%. And that we think really links back to wage growth, which is still running at about 6%, which is way above normal levels.

But that said, we have seen progress already since the peak, and we are seeing a number of signs that would suggest that this progress will extend, which is mostly that a lot of the remaining strength in services and wages seems to be reflecting the effects of the past energy prices. So when you look at energy intensive parts in services -- so for example, catering or restaurants and pubs and so on -- we think there's very strong evidence that we're going to see a significant amount of cooling in those categories in coming

months.

And so we ultimately don't think that the UK will look that different in terms of the inflation picture come the end of the year and think that, despite some of the recent upside surprises, the disinflation process in the UK is pretty much on track.

**Allison Nathan:** Let's talk about that energy risk for a moment, though, because obviously we are seeing elevated tensions in the Middle East. There's a lot of concern about the Russia-Ukraine trajectory and where that goes from here. So how confident are you that the energy crisis is behind us?

**Jari Stehn:** Well, fairly confident that the very acute phase of that energy crisis, or really the gas crisis, is behind us. I think we've seen a lot of progress in terms of gas supply to Europe in terms of kind of liquid gas flowing into Europe. And so we think these days of very acute risk of shortages, I think, you know, that is behind us. And of course we've seen that in natural gas prices largely normalizing relative to those days where we had the very intense stress.

Now, that said, we're obviously seeing, associated with the tensions in the Middle East, renewed upward pressure on energy prices. But I would say the magnitude at this point is very different from what we saw in 2022. So we're talking about 10-15% on gas and oil prices, and we think the standard kind of mappings and elasticities only point to, you know, limited effect.

So for example, on headline inflation, we think there might be a quarter of a percentage point of an effect. On core inflation, it's probably a lot similar because the magnitude of these shocks at least so far, looks much more limited.

**Allison Nathan:** So that's interesting but setting this energy risk question aside, after that very strong inflation data we saw in the US, the markets are now expecting the Bank of England to cut rates earlier and actually by more than the Fed this year. Just how unusual would that be for the BoE to go before the Fed? Usually we think of other major central banks following the Fed.

**Jari Stehn:** I mean, it's true that the Fed historically has often cut before the European central banks, both the

Bank of England and the ECB. But then historically, the recessions often emanated in the US. So at least if we take the last two, the financial crisis and the early 2000s, those were clearly periods of weakness that started in the US. And so it's natural I think that the Fed would respond to them before the European central banks do once the shock has spilled over. So I don't think that's a hard-and-fast rule that the Bank of England needs to go after the Fed or can't cut ahead of the Fed. I really think it comes down to economic conditions.

And the way we read the economic outlook is that the Bank of England is likely to cut ahead of the Fed. I think that's also consistent with the recent commentary that we've heard from the Bank of England on the one hand and the Fed on the other hand. And so we still think a cut in June is coming, so that would be a month before the Fed. And I think the economic conditions that I described with significantly weaker activity and a disinflation process that's on track, we think that difference is justified by those differences in economic performance.

**Allison Nathan:** And what are you watching to give you confidence in that view? What would make you adjust it?



**Jari Stehn:** Yeah, I think it's really the three criteria that the Bank of England has focused on. That's, first of all, labor market tightness, where we are seeing quite a lot of loosening now. In fact, in the latest labor market report, there is actually quite a sharp contraction in employment, so I think that's one key issue to watch.

The second is wage growth where, as I said earlier, the numbers are still high but we think we're moving in the right direction. I think the speed of the cooling on wage growth is going to be important.

And then the third is services inflation, where I think the unwind of these past energy effects I think is really the most important. So we'll really look out for data around those key indicators in coming months to see whether we're on track with that cut in June.

**Allison Nathan:** Charlotte, let's bring you into the conversation. You and your team recently ran a survey of UK small business owners that participated in the Goldman Sachs *10,000 Small Businesses* program. So give us some context on the role of small businesses in the

economy and how they're coping with some of these economic challenges that Jari had laid out.

**Charlotte Keenan:** Yeah, thank you, Allison. So that's absolutely right. We have recently launched a Small Business Manifesto. To get this, we surveyed just under 600 of our small businesses alumni. And we wanted to know the challenges that they're facing, and we also wanted to know what their priorities were going to be for the next government in the UK. And to put those businesses in context for you, these are some of the fastest-growing small businesses. They represent all sectors. They represent all regions and nations. And as you said, Allison, they're all graduates of our *10,000 Small Businesses* program, which, for those of you that are unaware, is an intensive business leadership program.

Now, big picture, headline, they're very, very optimistic despite the economic challenges, Jari, that you've been talking about. And to give a sense of this, over 90% are expecting both their revenue and their headcount to grow in the next three years. And the vast majority, about 70% still think the UK is a great place to run a small business.

But there are a number of challenges, and this is what we need to drill down into. And to give a sense of what they've told us, number one, they're really struggling with talent. They cannot find the right talent to grow their businesses. And as an anecdote here, only 12% of them think that the UK education system is currently fit for purpose in terms of workplace readiness.

They're struggling to find finance. And to quantify this, 37% can't find the finance that they need at this cycle of their business growth in the UK. They're struggling with business rates. They're struggling with infrastructure, specifically digital infrastructure was called out.

Now, Allison, you asked why this matters for the UK economy. So when we speak about small businesses -- and use the term "small," but their impact is huge. They're 99% of all private sector enterprises. They're 61% of total employees in this country and 53% of total turnover. So a vital group for us to work with and support.

**Allison Nathan:** Interesting. Some of those challenges do seem very cyclical in nature. Obviously, we are dealing with a very high interest rate environment. But some of

them potentially could be more structural in terms of the talent gap that you mentioned, Charlotte. Jari, if we take a step back and think about some of the challenges that you and Charlotte have both mentioned, how much of that relates back to the very transformative moment that the UK economy experienced in the last several years, of course, Brexit? UK leaving the European Union. Has there been a structural shift in the economy post the exit?

**Jari Stehn:** Yeah. I mean, we see very clearly in the data that the UK has underperformed other similar advanced economies since 2016, since the EU referendum. Specifically, around 5%. So in other words, a doppelgänger economy, an economy that's otherwise very similar to the UK, has grown cumulatively 5% more since 2016. And we do think you can trace that back to a number of areas where the UK economy has underperformed. That includes trade. So there's been a significant contraction in trade, particularly with the EU. There's been weak investment and I think quite clear evidence that firms have cited Brexit and Brexit uncertainty as a source of concern and therefore the reason to invest less. We've seen some improvement there recently. Obviously now the arrangement with the EU is clear. For a long time, this was very unclear; the

uncertainty weighed on investment decisions.

And then third, there's been a significant change in the immigration pattern into the United Kingdom. I think what's most interesting here is that it's not so much the total number of people coming into the UK that has fallen. In fact, that's actually gone up. But it's really the composition of the immigration that has changed very much. So we used to have a lot of EU workers come in, people who came to the UK with a specific purpose and objective to work, so had very high labor force participation rates. But now obviously those workers find it much harder to come into the UK, and so there's been a shift in the immigration pattern. And we do think that this has made the supply of labor in the UK less elastic and has been a challenge and has probably contributed, at least in part, to some of the labor shortages that we've seen since COVID.

**Allison Nathan:** And so what are some policy changes that could help these small businesses?

**Charlotte Keenan:** Great question. Bigger picture, there are really four principles that we need to adhere to and we would need a new government to think about. One,

we want them to put small businesses at the heart of all of their policymaking. Two -- and this goes back to some of the earlier points -- they need to think for the long term. Uncertainty has been a really big problem that small businesses have been facing in this country, and we need to give small businesses certainty as to what's ahead. We also need a new government to focus on what works. There are some great initiatives out there in the public sector at the moment, and we need a new government to learn from and take those forward.

And finally, we also know that many small businesses don't know about the support that's available to them. So we need to amplify this, clarify, and help educate small businesses as to what's available for them to help them grow.

**Allison Nathan:** Well, it's interesting because your first point there in terms of small businesses should be at the heart of all policymaking, Jari, I would just appreciate your perspective on that in terms of thinking about what the priorities of government should be at this point, given all of the challenges that the UK faces.

**Jari Stehn:** Yeah, I think measures to support productivity, support long-term growth prospects I think are key. I think we will obviously get some relief as inflation comes down, as rates come down, but that's more of a cyclical nature. And so I think making sure that, from the fiscal perspective, the incentives are set right for medium-term growth to return is I think really the key.

Now, at the same time, of course this needs to be balanced also with ensuring sound public finances, which of course in the UK and in other advanced economies are under pressure. And so I think that's really going to be the key challenge, to try to support the economy from a long-term perspective while, at the same time, also ensuring sustainability and sound public finances.

**Allison Nathan:** Charlotte, let me ask you one more question about your survey results. Of course, everyone is quite focused on AI. How did that come up in your survey? How are businesses using it? And what are they looking at in terms of leveraging that technology?

**Charlotte Keenan:** Yeah, hugely exciting. And look, it's a huge growth opportunity for small businesses. And what I

would say from our survey data and speaking to our businesses is that they broadly fit into three categories. So our early adopters, and I'd say these businesses are excited, self-taught, highly strategic. They see the potential for both generative and non-generative AI. And just under 50% of our businesses are already in this category, and they're already using it for productivity and efficiency gains.

Another group are those that have just started or about to start to use classic generative AI tools, e.g., ChatGPT. And then a tiny group, actually just 7%, that say it's not relevant to their business. So we're hugely encouraged by this.

Look, I think some of the main challenges that they're facing really is a lack of understanding how specifically to go about finding the right tools and products that are available, how to integrate that into their business, what does it look like, and also ensuring that they've got the talent within the business to identify, adopt, and integrate and think through how AI can transform their business models. But the opportunities, as we see it, is very easy for a small business who is often able to be more nimble than



a larger business to integrate and to take advantage of their greater flexibility and to take advantage of AI. And of course those upside productivity gains we think will be huge.

**Allison Nathan:** Right. And over a period of several years, I imagine, but if we think about the topic of the day, which relates back to some of your prior comments, it is a big election year across the globe. It's certainly a big election year for the UK. So Jari and Charlotte, what are some of the key issues at stake that you're watching as it relates to the election that will take place later this year?

**Jari Stehn:** Yeah, maybe I can start from a macro perspective. I would say that the differences between the two main parties, between Labour and the Conservatives, in terms of the economic plans to us look rather limited. And I think the reason really is that fiscal consolidation is really needed under either outcome of the election, and that ultimately somewhat limits the scope for significant deviations in coming years.

Now that said, there are of course a number of important differences. I would highlight on the Labour side people

have talked about a number of tax-raising measures. I would say on the Conservative side, there's been signaling towards further rate reductions, particularly on the national insurance contribution side.

Finally, I would say there are some differences with regard to the future relationship with the EU. I would say the commentary from the Conservative side suggests that there's going to be little change with regard to the relationship. Whereas Labour officials have hinted at areas of closer cooperation so for example, in agriculture or in services, but do not plan to return to the Customs Union or the single market.

**Charlotte Keenan:** I'll leap in just from a small business angle because, as we've talked about, the need to stimulate growth and we know that small businesses are a key driver of this. And reassuringly, what we're seeing from both major political parties is a huge focus on small businesses as agents of creating this growth.

The Conservatives are talking about this is the year of the SME. The prime minister very publicly stated that earlier this month. And Labour is also putting small business at

the heart of how they're thinking about their manifesto. So for us, that's a great place for them to be starting and thinking about.

**Allison Nathan:** Jari, Charlotte, thanks so much. What I'm taking away from this conversation is there's reasons to believe that growth in the UK is turning a corner and inflation, but there's more work to be done on the policy side and we'll see what the election brings.

**Charlotte Keenan:** Thank you.

**Jari Stehn:** Thank you.

**Allison Nathan:** Thanks for joining us for another episode of Goldman Sachs Exchanges, recorded on Friday, April 19th, 2024. I'm your host, Allison Nathan. If you enjoyed this show, we hope you subscribe on your platform of choice and tune in next week for another episode. You can also find a link to the Small Business Manifesto that we discussed in the show notes of this episode. And if you want more insights from Goldman Sachs, make sure to visit GS.com and sign up for Briefings, a weekly newsletter from Goldman Sachs about trends spanning markets,

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