

# Economic activity holds up in Q1

May 2023

***Recent data suggest the UK economy has been more resilient since the start of 2023 than was widely expected just a few months ago. But with high inflation still eating away at household budgets, and worrying signs that inflation may prove more intractable, activity is expected to remain subdued in the near-term. Nonetheless, it now looks increasingly likely that the UK will avoid a recession this year.***

Last week saw the release of GDP figures for March, allowing a preliminary assessment of the strength of activity during the first quarter of the year from official data. Output contracted a little in March, reflecting a broad-based decline in the services sector. Industrial action in the health, education, civil service, and transport sectors contributed to this, as did unseasonably wet weather, which dampened spending in some consumer-facing sectors. However, the economy eked out growth of 0.1% (q/q) in the first quarter as a whole, supported by increases in consumer spending earlier in the year and a solid rise in investment. But momentum weakened steadily over the quarter, from +0.5% in January, to 0 in February, to -0.3% in March. This leaves the size of the economy 0.3% larger than a year ago and 0.1% larger than its pre-pandemic size.

One of the most striking features of the UK economy over the past few quarters has been the relative resilience of the UK consumer. Household consumption was flat during the first three months of 2023 (pretty much in line with the trend in the second half of last year). But this comes against the backdrop of 7 months of double-digit inflation and rising interest rates, which have severely eroded households' spending power: real household disposable incomes fell by 1.7% in 2022 – the sharpest fall since 2011. Recent data suggests a turning point may be at hand. With inflation likely to have peaked in October last year, consumer confidence has been recovering steadily this year. And it was notable that retail sales volumes rose during the first quarter of 2023, following six successive quarterly falls.

Another factor underpinning an improving outlook for consumer spending could be the enduring strength of the labour market. Employment increased by 182k during the first quarter of 2023, the biggest rise since April 2022. With labour supply also improving (reflected in inactivity falling by 212k), strong job creation was not enough to prevent a slight rise in the unemployment rate. However, while the labour market is beginning to loosen up, it remains historically tight: with vacancies still above a million, there remains only one unemployed person per vacancy compared to a series average of 3. As the Bank of England noted in its May Monetary Policy Report, all else equal, a lower-than-expected risk of job losses is likely to lead to lower precautionary saving by households and stronger consumption. Meanwhile, they also note that the greater share of fixed rate mortgages means that the transmission of monetary tightening to households from rising interest rates is likely to operate more slowly than in the past.

None of the above provides a reason to get carried away over the near-term outlook. The latest data on average real wages—which fell by 2% year on year in the first quarter (excluding bonuses and adjusting for inflation)—serve as a reminder that conditions remain difficult for many households and businesses. And while a tight labour market may be good news for consumers, it continues to put pressure on businesses. In our April Industrial Trends Survey, 31% of manufacturers were concerned that shortages of skilled labour could limit output in the quarter ahead, down from a peak of 49% in October (which was the highest % reported since October 1973), but above the series average of 15%. Ongoing industrial action and the additional bank holiday for King's Coronation will also act as a drag on activity in the second quarter and may push growth into negative territory. But we're becoming increasingly confident that the economy will gain momentum during the second half of the year as inflation continues to decline, easing the squeeze on households and businesses alike.

## GDP fell 0.3% in March

- GDP contracted by 0.3% (month on month) in March. This follows zero growth in February and an expansion of 0.5% in January (upwardly revised).
  - Broad-based weakness led to services sector output falling by 0.5% in March, as activity shrank in 9 out of 14 sub-sectors.
  - Industrial action in the health, education, civil service, and transport sectors weighed on activity. The ONS pointed to anecdotal evidence that exceptionally wet weather (with March 2023 being the sixth wettest since 1836) affected some consumer-facing sectors, including retail, hospitality and sports & leisure.
  - Production output expanded by 0.7%, driven by growth of 0.7% in manufacturing.
  - Construction output also grew (0.2%), with a 0.7% increase in new work being partially offset by a 0.6% fall in repair and maintenance.

## The economy expanded slightly over the first quarter

- Q1 saw GDP grow by 0.1%, following an increase of 0.1% in the final quarter of 2022.
  - While household spending expanded by 1.2% in nominal (or cash) terms, high inflation means that it was flat in real terms (i.e., adjusting for price changes).
  - Government consumption fell by 2.5%, reflecting declines in spending on public administration and defence. Spending on education and health also fell, most likely due to industrial action.
  - Gross fixed capital formation increased modestly (1.3%), as business investment increased by 0.7%.
  - Net trade exerted a small drag on quarterly growth (subtracting 0.2% points from GDP growth), though the data remains volatile owing to movements of non-monetary gold.
- Overall, the economy has performed slightly stronger than we expected in our December forecast (when we expected a contraction of -0.1% in the Q1).

## The UK is lagging behind its peers

- Three years on from the onset of the COVID-19 pandemic, real GDP has yet to rise materially above its pre-pandemic level. Using quarterly data, UK GDP was 0.5% below its pre-pandemic level (compared with Q4 2019), while using monthly data it stands just 0.1% above it (compared with February 2020).
- On this basis the UK economy has performed poorly compared with other developed economies. Compared with Q4 2019, GDP was down by 0.1% in Germany, but comfortably above pre-pandemic levels in France (1.3%), Italy (2.4%), Canada (3.5%) and the US (5.3%).

## The labour market remains tight, but is loosening

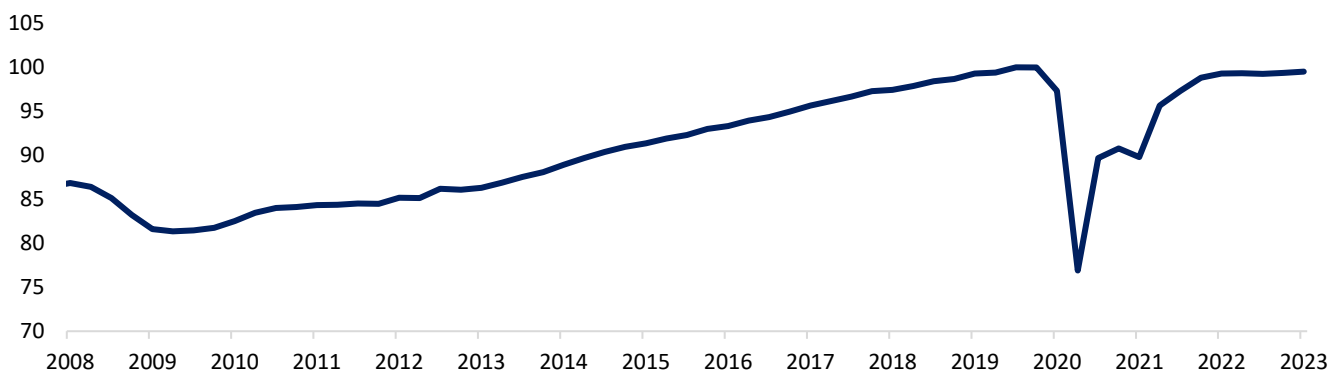
- Total employment rose by 182,000 in the three months to March, compared with the previous quarter. The employment rate increased by 0.2% points, to 75.9%, still some 0.7% points below its pre-pandemic level in December 2019 to February 2020.
- The unemployment rate increased by 0.1% points in Q1 to 3.9%. Unemployment remains near historic lows and comfortably below its pandemic peak of 5.2%.
- In a sign of improving labour supply, the rate of economic inactivity fell by 0.4% points over the quarter, to stand at 21%. This is 0.8% points higher than before the pandemic.
  - The decline in inactivity was driven by a decline in the number of inactive students and in those looking after family/home. Less encouragingly, the number of those inactive due to long-term sickness rose to above 2.5 million.
- An additional sign of loosening conditions was the tenth consecutive monthly fall in the number job vacancies, which were down by 4.9% in the three months to April 2023, to 1,083,000 (but is still 35% above pre-pandemic levels).

## Headline pay growth may have peaked and remains well below inflation

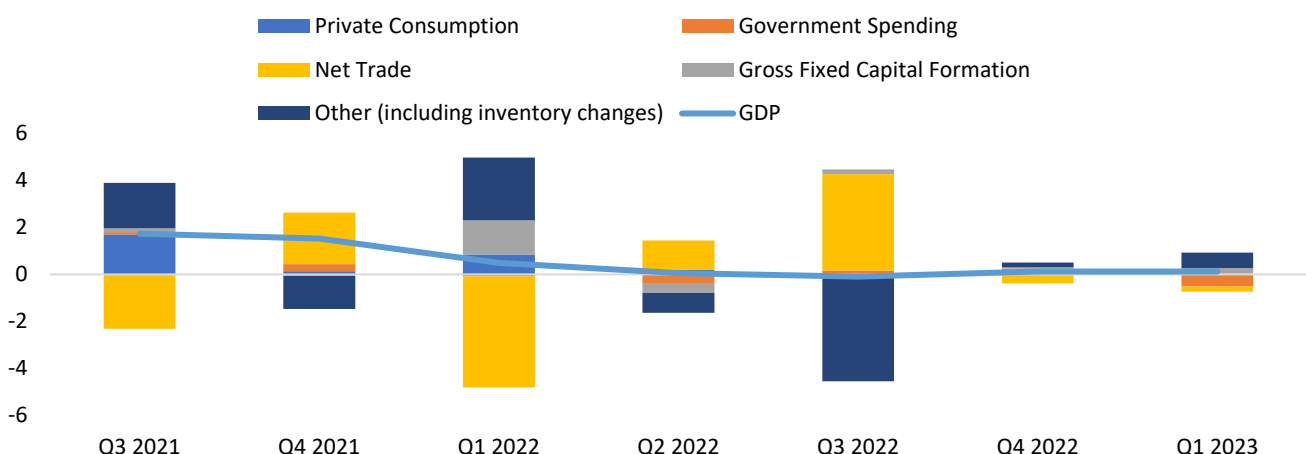
- Nominal regular pay (excl. bonuses) rose by 6.7% over the year in the first quarter, unchanged compared with the final three months of 2022.
  - Nominal regular pay growth stood at 7.0% in the private sector, softening from 7.3% in the fourth quarter of 2022. However, nominal pay growth in the public sector edged up from 4.3% to 5.6%, the highest since December 2005.
- Adjusting for inflation, real regular pay across the economy as a whole fell by 2% over the year in the first quarter, a less steep decline than during the previous quarter (-2.5%).

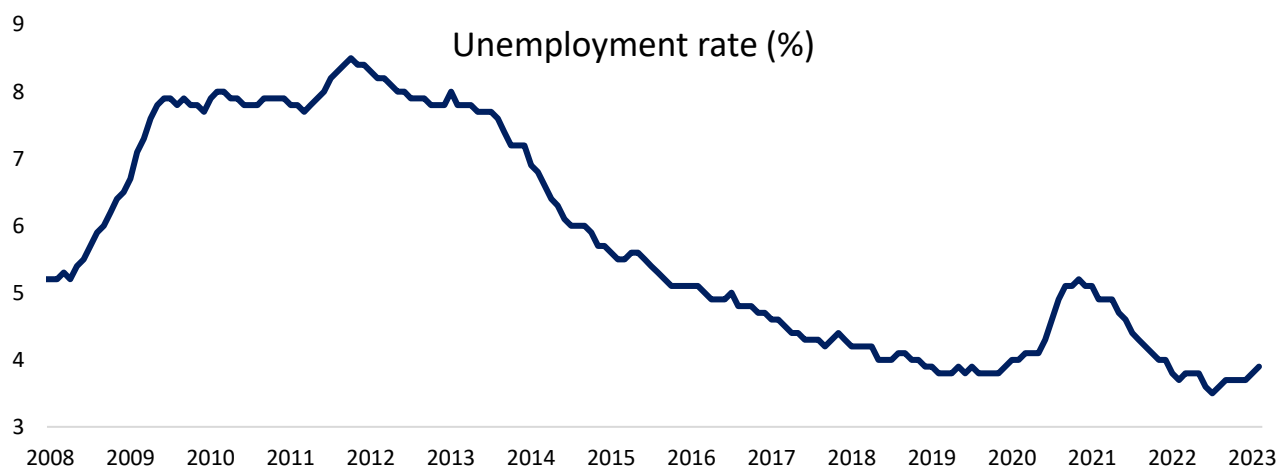
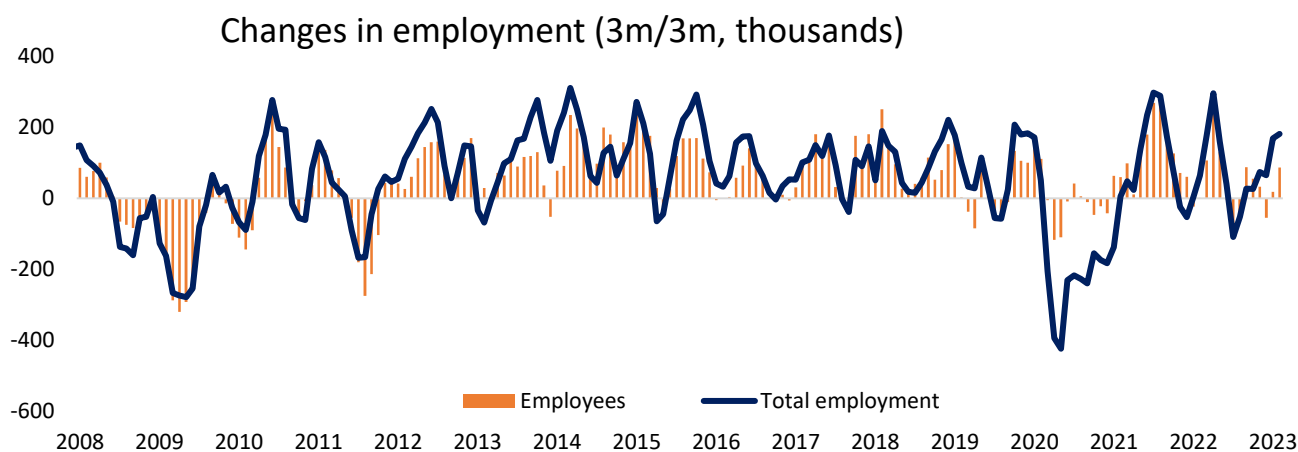
Q4 2019 = 100

UK Quarterly GDP Index



GDP Growth (q/q%) and Contributions (pp)





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