Economic activity holds up in Q2

August 2023

UK GDP grew ahead of expectations in Q2 2023, thanks in part to a strong performance in June, underlining the resilience of the economy during the first half of 2023 in the face of rising prices and interest rates. A slowdown in the rate of inflation will support household incomes and spending during the second half of the year, but the economy is likely to remain stuck in a low gear as the impact of the higher interest rates continues to feed through. With wage growth and measures of core inflation high, further rate rises are likely.

Summer's brief appearance boosted activity in June...

GDP grew by 0.5% m/m in June (versus consensus expectations of 0.2%), a surprisingly strong result, which followed a slight contraction in May (-0.1%). The production sector was the main driver of growth, thanks to a 2.4% jump in manufacturing output (-0.1% in May), led by the automotive and pharmaceutical sectors. Construction activity also rebounded (1.6%, from -0.3% in May). Growth in the services sector was more modest (at 0.2%), as rising spending on consumer services (0.5%) was offset by falling output in health services, reflecting the impact of public sector strikes.

A number of one-off factors probably supported activity in June. The return to a normal number of working days following the additional bank holiday in May was cited by businesses in several sectors as a reason for higher output. In addition, the warmest June since records began in 1884 appears to have buoyed activity in the hospitality, tourism and construction sectors (the opposite is likely to be the case in July, which was the sixth wettest on record). However, the strength of the rebound in June suggests that underlying demand in the UK economy also remained fairly resilient.

...and underlying growth proved resilient through Q2

The solid expansion in June lifted GDP growth for Q2 to 0.2% q/q, a slight acceleration compared with Q1 (0.1%). Output data highlighted particularly strong growth in manufacturing (1.6%), which was supported by an ongoing recovery in the automotive sector related to improvements in supply chains. An expansion in construction activity (of 0.3%) was driven by repair and maintenance (0.9%), which offset a fall in new work (-0.1%). Meanwhile, the services sector saw the slowest growth, with output up by just 0.1%. Business-facing sectors were among the weakest within services, with the biggest drag coming from falling output in professional, scientific and technical activities (-1%). Demand for administrative and support services also fell. However, consumer-facing services generally performed better (0.8%).

An improvement in the consumer sector was mirrored in the GDP expenditure breakdown. Household consumption returned to growth in Q2, rising by a robust 0.7%, following zero growth in Q1. Government consumption growth was also strong (+3.1%), despite recent industrial action. Business investment rose for second successive quarter in Q2, though this was driven by aircraft purchases, with other investment categories weakening.

The strong end to Q2 provides a good jumping off point for growth during Q3, which should also be flattered by a return to a normal number of working days within the quarter (following May's additional bank holiday) and less disruption from public sector pay disputes. And with real household incomes set to improve in the second half of the year as inflation falls further, household spending should continue to support growth in the second half of the year.

Wages grew faster than inflation for the first time in almost two years

The latest release of labour market data shows a further acceleration in regular pay growth to 7.8% (y/y) in the three months to June, a new record (the highest growth since records began in 2001, not counting the distortions of the pandemic years). Adjusting for inflation, growth in real regular pay (excluding bonuses) has now turned positive (+0.1%) for the first time since late 2021 according to some measures (i.e. using the ONS' preferred CPIH measure of inflation; deflating by the CPI index, real regular pay was still 0.6% lower than a year earlier, but this was still the highest since 2021).

More interest rate rises to come

Strong pay growth in the latest labour market data (published 15th August) makes another increase in interest rates in September very likely (the next decision will be on the 21st September). The latest snapshot of the labour market data nonetheless provided further signs that the labour market is loosening, with the number of vacancies falling to a two-year low, employment contracting slightly over Q2 and the unemployment rate creeping up to 4.2% (above the Bank of England's forecast). Our recent business surveys point to slowing momentum over the three months to July, underscoring that growth is likely to remain subdued during the second half of the year as the impact of higher interest rates feeds through.

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Further details

- **The main contributor to GDP growth of 0.5% in June was the production sector**, which saw output rise by 1.8%, following a fall of 0.6% in May.
    - Manufacturing output rose by 2.4% (its fastest pace since November 2020), following a slight contraction of 0.1% in May.
- Output in the construction sector grew by 1.6% in June 2023, following a fall of 0.3% in May 2023. Anecdotal evidence from the ONS's Monthly Business Survey for Construction and Trades suggested that warm weather may have supported productivity.
- Services output increased by 0.2% in June 2023, following no growth in May.
    - Output in consumer-facing services rose by 0.5% in June 2023 (following a fall of 0.2% in May). This was driven by a 3.9% increase in the wholesale and retail trade of motor vehicles and a 1.4% increase in food and beverage services (also reflecting warm weather).
    - The largest drag on services output came from lower activity in the human health and social work sector, reflecting industrial action by junior doctors.

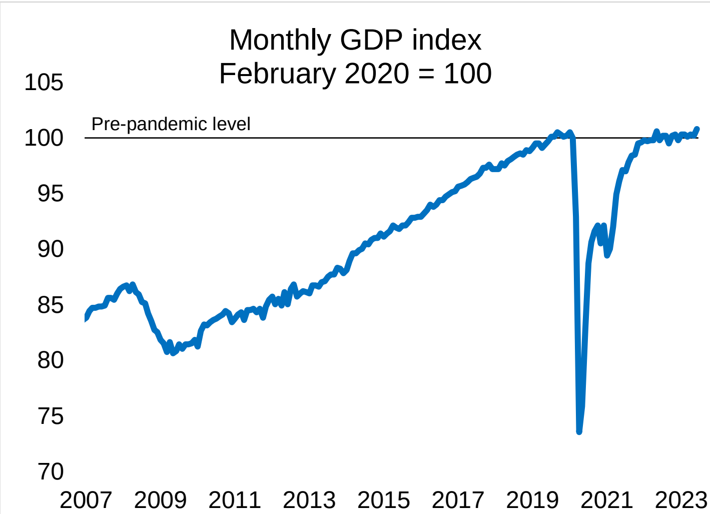
- **GDP in Q2 expanded by 0.2% q/q, following growth of 0.1% in Q1.** In expenditure terms, Q2 GDP growth was driven by rising household and government consumption, which was partially offset by weaker net trade.
    - **Household spending** rose by 0.7% in Q2, following zero growth in the previous quarter. This increase was in line with the rise in spending in consumer-facing services in the output measure of GDP (0.8%, as above).
    - Gross fixed **investment** was flat in Q2, following an increase of 2.4% in Q1. Within this category, government investment fell by 6.7%, but business investment rose by 3.4%, on top of a 3.3% rise in Q1. These back-to-back increases have lifted business investment comfortably above pre-pandemic levels (by 4.5%). Whether this can be sustained remains to be seen. The breakdown shows a large rise in transport investment in Q2 (driven by imports of aircraft, large purchases that are sporadic in nature). Investment in other categories (ICT and other machinery and equipment) fell after a strong Q1, when business investment was likely boosted by the government's super-deduction allowance, which expired at the end of Q1.
    - **Net trade** made a negative contribution to quarterly GDP (subtracting 1.1% points from growth). Export volumes fell by 2.5% in Q1, driven by a fall of 0.8% in goods exports (largely reflecting movements in non-monetary gold) and a 4% drop in services exports. Meanwhile, import volumes increased by 1% in Q2, driven by a 1.7% increase in goods imports (notably cars, other road vehicles and aircraft).

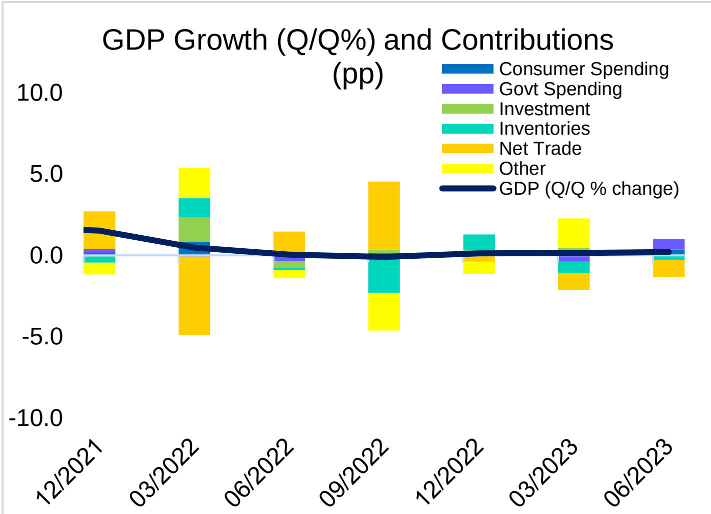
- More than three years on from the onset of the COVID-19 pandemic, real GDP has yet to rise materially above its pre-pandemic level.
    - Using quarterly data, UK GDP was 0.2% below its pre-pandemic level in Q2 (compared with Q4 2019). On this basis, **the UK economy has performed poorly compared with other developed economies**, lagging behind Germany (GDP +0.2% above pre-pandemic levels), France (+1.7%), Italy (+2.2%) and the US (+6.2%).
    - Using monthly data GDP stood just 0.8% above the level in February 2020 in June.

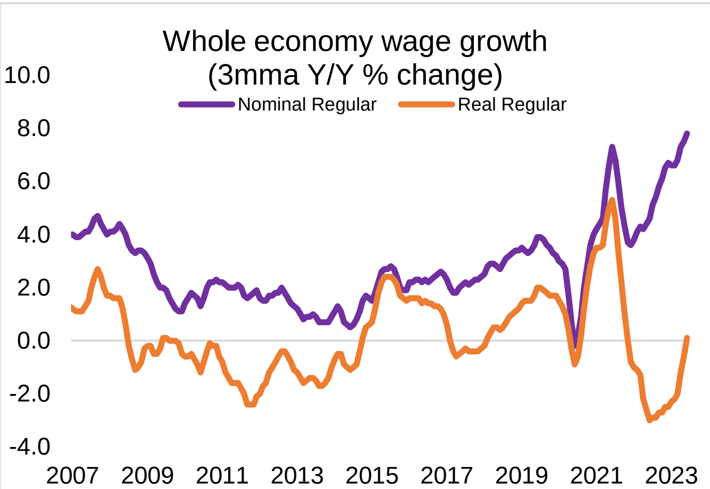
- **Total employment fell by 66,000** in the three months to June, compared with the previous quarter. The employment rate decreased 0.1% points to 75.7%, still some 0.8% points below its pre-pandemic peak in December 2019 to February 2020.
- **The unemployment rate rose to 4.2%**, up 0.3% points on the previous quarter.
- **The number of inactive workers fell by 38,000 to 8.7 million, driven by 78,000 fewer people looking after family/home**. This is still some 323,000 more people inactive than before the pandemic.
    - The main reason for inactivity was long-term sickness, which reached a record high of 2.6 million, up 26,000 on the quarter.
- There are signs that the labour market is loosening with the **number of job vacancies falling by 6% in the three months to July 2023**, to 1,020,000. The number of vacancies has been falling steadily for over a year (though vacancies are still 23% above pre-pandemic levels).

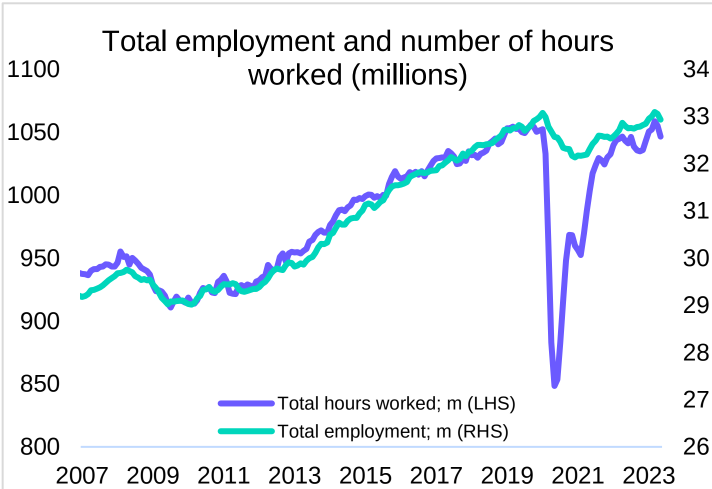
- This also means the ratio of unemployed people per vacancy has risen to 1.38, from a record low of 0.95 in June-August 2022 and the highest in two years.

- **Nominal regular pay (excl. bonuses) rose by 7.8% over the year to April-June** 2023, the highest annual growth figure since records began in 2001.
  - Nominal regular pay growth stood at 8.2% in the private sector, accelerating from 7.9% in the three months to May. Nominal pay growth in the public sector remained at its highest level since August-October 2001 (6.2%).
- Adjusting for inflation using the ONS's preferred measure, **real regular pay across the economy rose marginally by 0.1% in the year to April-June -** the first time real regular pay had increased since the three months to October 2021.









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