

Economic Deep Dive

For CEOs, FDs, and Business leaders

Your quarterly guide to the UK economy;
making sense of the key trends and what's
driving them.

Q2 2023: April - June



Quarterly economic highlights

UK economy continues to stagnate, but growth has proved more resilient than expected

UK GDP grew by 0.2% month-on-month (m/m) in April following a 0.3% fall in March, and no growth in February. We expect GDP to fall by 0.1% over Q2 as a whole, before rebounding later this year.

CPI inflation has eased, although not as quickly as the Bank of England had hoped

While headline inflation eased to 8.7% in April and May, measures of domestic price pressures – services and core inflation – remain stubbornly elevated. This prompted the Bank of England to raise interest rates to 5%, their highest level since 2008.

Pay growth accelerated in April, underpinned by the tight labour market

The labour market remained tight in the quarter to April, with the ratio of vacancies to unemployed persons remaining high by historical standards. This helped push average regular pay growth to 7.2%, its the fastest pace on record (outside of the pandemic).



0.4%

The latest CBI forecast shows the UK economy expanding by 0.4% in 2023.



"Our latest forecast [for the UK economy] is a tale of two halves. On the one hand, we now expect a somewhat better outlook for growth – significantly, we no longer expect the mild recession that we were predicting at the end of last year."

"Despite an upgrade to near-term GDP growth, our forecast expects little change in the longer-run challenges plaguing the UK economy. While we see a modest pick-up in productivity growth, it remains below its (already weak) pre-COVID trend, and much lower than the trajectory seen before the 2008 financial crisis."

Alpesh Paleja, CBI Lead Economist



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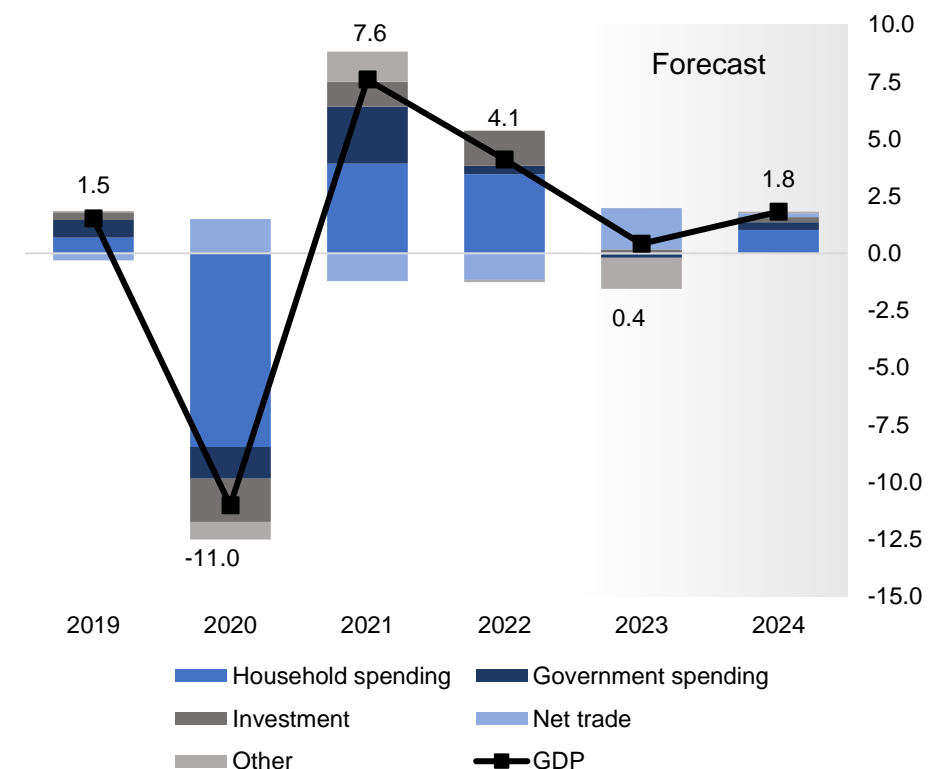
CBI UK economic forecast: Glass half full?

What does this mean for business?

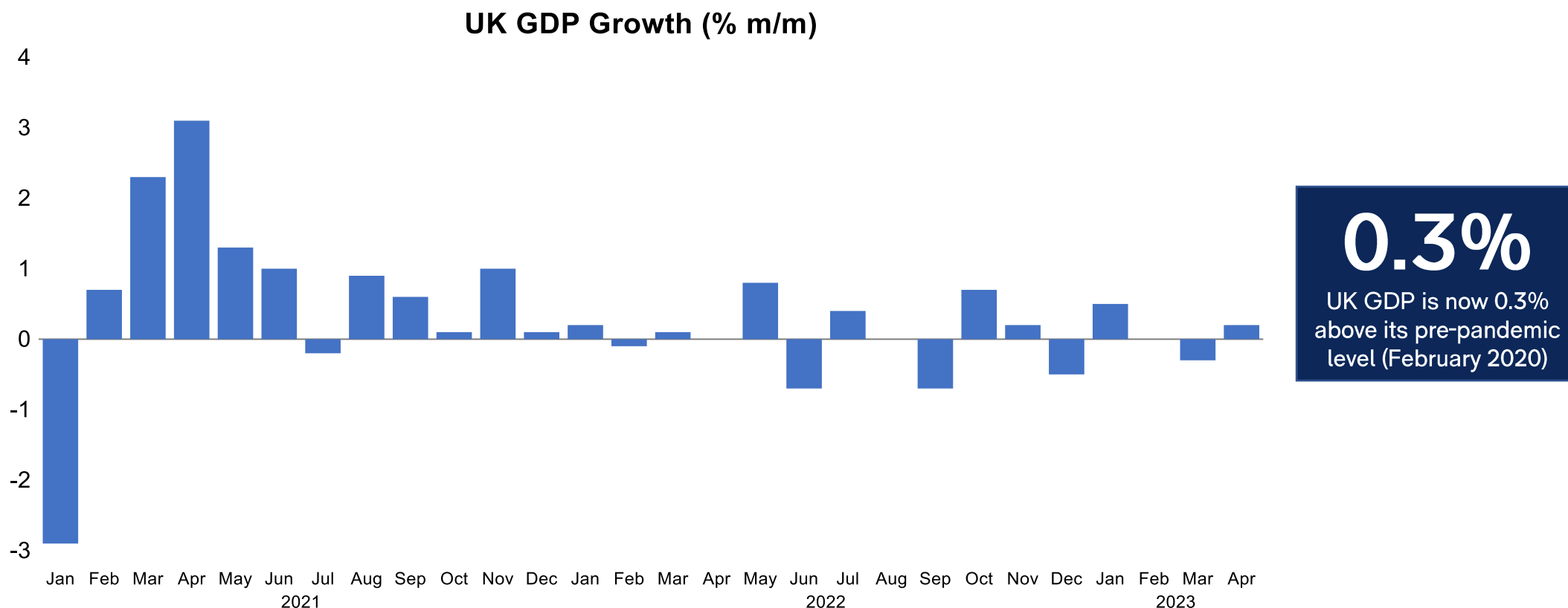
- We expect economic growth to be firmer than in our previous forecast, which all else equal, should translate to more resilient demand **conditions**. However, there may be divergences in sectoral performance, reflecting exposure to cash-strapped consumers and/or higher interest rates.
- **Plan for tighter financial conditions.** Given the stickiness in domestic inflation, we expect further rate rises from the Bank of England. We also predict that the Bank will keep interest rates at a high level for longer to drive down inflation.
- **Think holistically about the employee value proposition.** We expect the labour market to remain tight over our forecast, prompting many firms to focus on areas such as employee propositions and ED&I when formulating recruiting strategies.

- We have upgraded our forecast for UK growth in 2023 (to 0.4% year-on-year), meaning that the economy avoids the mild recession we expected in our previous forecast (-0.4%).
- The near-term outlook is supported by falling inflation – in part driven by lower wholesale energy prices – and more favourable global economic conditions. Recent indicators of activity and household spending have pointed to a continuation of underlying economic resilience.
- Nonetheless, 2023 will mark another challenging year for consumers and businesses. Real household incomes are set to fall strongly once again due to high inflation and wage growth tailing off. Many businesses will see margins squeezed by high costs and rising interest rates.
- **The outlook improves in 2024**, with growth picking up to 1.8%. Household spending should drive the recovery, spurred by a meaningful easing in inflation. Business and residential investment gain a firmer footing, underpinned by the rebound in activity and real incomes.
- A relatively brighter growth outlook masks longer-term challenges for the economy: with exports and business investment underperforming compared to international peers and productivity growth remaining lacklustre. There are also signs of persistent “scarring” in GDP from the pandemic, with the economy still around 7% smaller than its pre-COVID trend at the end of next year.

GDP growth (y/y%) and contributions (ppts)



UK economy continues to stagnate, but recession fears fade



April's GDP figures met expectations of modest growth (0.2% month-on-month), with output rebounding from March's decline – when activity was weighed down by poor weather and widespread industrial action. While these figures mean that it's increasingly likely that the UK has side-stepped a recession, underlying growth of only 0.1% (as measured on a 3-month rolling basis) was weak in comparison with an average of 0.5% growth in the pre-pandemic decade.

April's rise in GDP was driven by an expansion in services output (0.3% m/m), which only partially recovered from a contraction in the previous month (-0.3%). Within services, consumer-facing output grew by 1.0%, but remains 8.7% below its pre-pandemic level, reflecting long-standing inflationary pressures on household spending. Elsewhere in the economy, activity fell in production (-0.3%) – owing to falling manufacturing output – and construction (-0.6%).

We expect growth to be weak across Q2 as a whole, although the extra bank holiday in May for the coronation is likely to inject volatility into the month-on-month figures. The combination of falling energy prices, easing supply chain pressures, and renewed global growth should support an upturn in domestic activity over the latter half of the year. Our forecast has GDP growing by 0.4% year-on-year in 2023.



0%

CBI Growth Indicator: **Amber**

Private sector activity was broadly unchanged in the three months to June

Private sector activity expected to build momentum

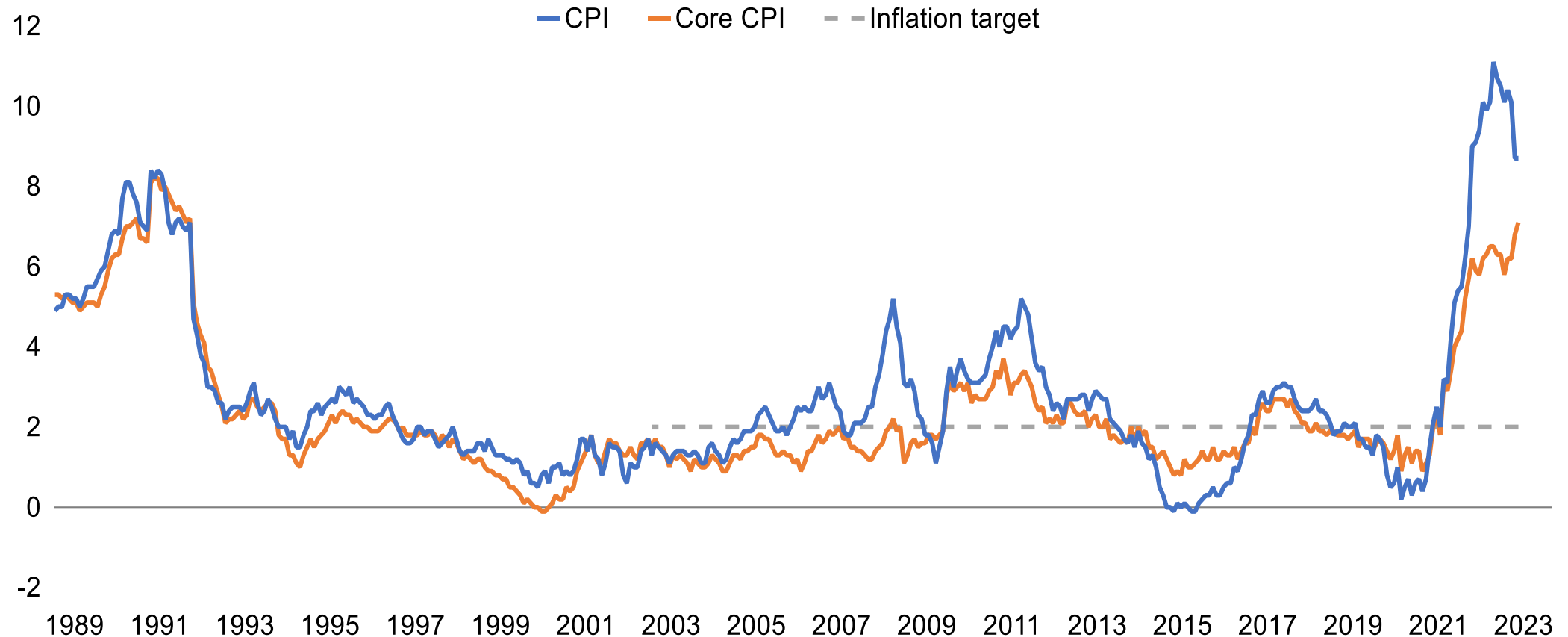
The CBI's latest Growth Indicator reported that private sector activity stabilised in the three months to June, marking the first time that activity has not fallen for ten rolling quarters. Services recorded an increase in business volumes for the first time since July 2022, with growth turning slightly positive in business & professional services and consumer services staying flat. Elsewhere in the private sector, manufacturing and distribution both saw milder contractions than last month.

Over the next three months, private sector activity is expected to pick up slightly. Services' new-found momentum looks set to build, while manufacturing output is expected to return to (marginal) growth. Distribution is the only sector in which sales performance is expected to deteriorate over the next three months.

Looking at other business surveys for June, the latest S&P Global / CIPS Composite Purchasing Managers' Index (PMI) "flash" reading – which covers services and manufacturing – points to a fifth consecutive monthly expansion. Although headline growth softened compared with May, an expansion in services activity was enough to outweigh a sharper contraction in manufacturing output.

Perceptions of an improving outlook for the economy seem to be lifting consumer confidence, with GfK's headline index for June rising to its highest level since January 2022. Although consumer sentiment has steadily trended upwards since the end of last year, the latest figures remain below the long-run average. Therefore, they should not be taken as heralding a sustained recovery in demand just yet.

Disinflation fails to gain meaningful traction, despite falling gas prices



UK CPI inflation held firm at 8.7% in May, unchanged from the previous month and above consensus expectations of a fall (to 8.4%). The data showed signs of more globally-centric price pressures receding: food price inflation softened (but was still very high, at 18.3%) and fuel prices fell by 13% on a year ago – the largest decline since June 2020. However, core CPI inflation (which strips out volatile price changes in food, fuel, and energy) rose to 7.1% in May (from 6.8% in April), its strongest reading in over 30 years.

The latest inflation data reinforced concerns about the strength of domestically-generated price pressures, which suggests the UK's inflation problem may prove more difficult to shift than previously expected. For example, services price inflation, which is closely watched by the Bank of England as a measure of domestic price pressures, rose to 7.4% in May (up from 6.9% in April). This fuelled fears that higher inflation may become embedded in wage-price setting and that, therefore, the Bank may need to raise interest rates higher to bring inflation back to its 2% target.

Looking ahead, we still expect CPI inflation to fall over the course of this year, despite the upside surprise in May – particularly as base effects from food, fuel, and energy price inflation continue to unwind. Inflation is still set to remain relatively high this year, however, and we expect it to stand at over 4% at the end of 2023 (more than double the Bank's target). Risks to our forecast are firmly to the upside, particularly due to the persistence of domestic price pressures.

Tight labour market fuels firm pay growth

The UK labour market shows little sign of material cooling in Q2, chiming with the broader resilience in activity. In the three months to April, the total number of people employed rose to a record high of 33.1 million, with an additional 250,000 people in work. This was accompanied by signs of an improvement in labour supply, with 140,000 fewer people reported as economically inactive. The increase in labour supply helped push up the unemployment rate very slightly to 3.8%, well below its pandemic peak of 5.2% and not far above its historic lows.

Labour demand continues to cool slightly but remains high by historical standards. Job vacancies fell by 7% in the three months to May 2023 to 1.1 million (the 11th consecutive monthly fall), but remained 27% above pre-pandemic levels. This left the ratio of unemployed persons to job posting around one, compared with a pre-pandemic average of 3.3. This suggests that labour demand is still outstripping supply.

The tightness of the labour market continues to put upward pressure on wages. Average regular pay growth in the three months to April rose to 7.2%, the fastest pace on record (outside of the pandemic), with a particularly large jump in private sector pay growth (to 7.6%) over the same period. This partly reflected a large increase in the National Minimum Wage in April, but also strong wage pressures in higher-paid roles.

Business view

- Our June surveys showed hiring intentions are still firmly positive in the services sector. Elsewhere, distribution employment expected to grow slowly over the next three months, while manufacturing headcount looks set to remain broadly unchanged.
- A wholesale distributor still struggles to fill vacancies. Hiring difficulties are not limited to a specific job function, which has meant the business has had to be selective about which roles need to be filled and which can be performed by technology or existing staff.
- In contrast, a construction company has found some supply chain roles – e.g. bricklaying, plumbers – have become easier to recruit. Employee churn has eased recently as the economic climate has become less favourable.



Employment rate

(Feb '23 – Apr '23)

76.0%

The employment rate increased by 0.2pp from the previous quarter.



Unemployment rate

(Feb '23 – Apr '23)

3.8%

The unemployment rate increased by 0.1pp from the previous quarter.



Real wage growth

(Feb '22 – Apr '23 on a year ago)

-1.3%

Real regular pay growth increased by 0.9pp from the previous quarter.



Productivity growth

(Output per hour flash estimate, Q4 2022 on a year ago)

-0.6%

Productivity decreased by 0.6pp from the previous quarter.

Bank of England opts for aggressive response to sticky inflation

The Bank of England's Monetary Policy Committee (MPC) voted by a majority of 7-2 to increase interest rates by 50 basis points in June, bringing the Bank Rate to 5.00%. This was more forceful than most analysts expected (predicting a smaller 25 basis points hike), and it was a larger rate increase than was delivered in the last two MPC meetings.

The decision to raise rates by 50bp was driven by concerns about the strength of recent inflation and labour market outturns. Headline CPI inflation has surprised to the upside in each of the last four months, while services and core inflation continue to outpace the Bank's forecasts. Considered in conjunction with firm pay growth, the recent data was taken to imply resilience in domestic price pressures that warranted a firmer monetary policy response.

The MPC reiterated that "further tightening in monetary policy would be required" if there was evidence of more persistent inflationary pressures. The extent of further rate rises will largely be dependent on how long data around inflation and domestic price pressures continue to run ahead of the MPC's expectations. At the time of writing, financial markets are expecting rates to peak at around 6% next year, before falling thereafter.

Elsewhere, other central banks moved more cautiously this month. The US Federal Reserve decided to forgo a rate hike, while the European Central Bank stuck to a 25 basis points rise. This left the Federal Funds Rate target range at 5.00-5.25% and ECB deposit rate at 3.5%. Both the Fed and the ECB clearly signalled that further monetary tightening was to be expected.

What does this mean for business?

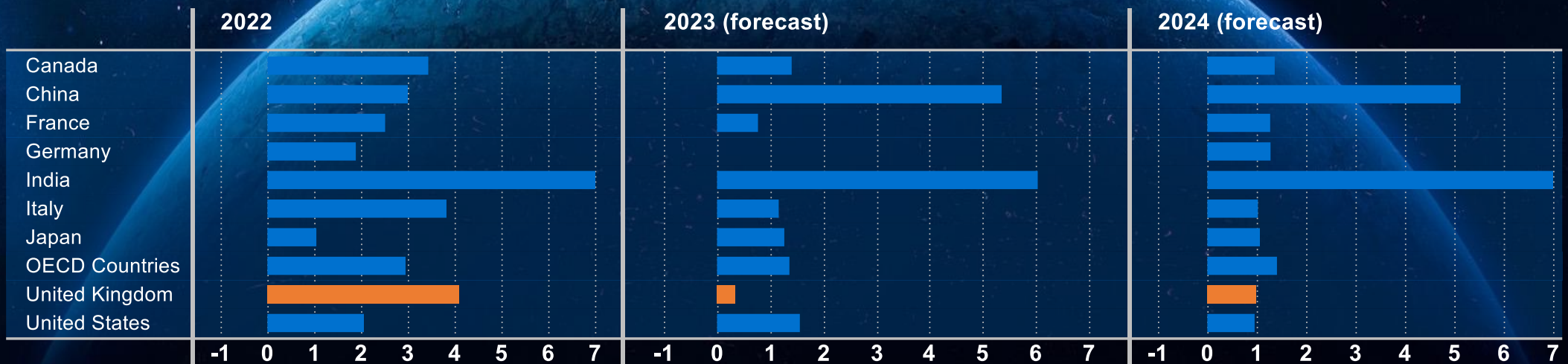
- Financial conditions will likely become more restrictive. Given the stickiness in domestic inflation, we expect further rate rises from the Bank of England this year. Financial markets currently expect rates to peak around 6%.
- Firms should consider the possibility that the cost of borrowing will remain higher for longer. We predict that interest rates will need to stay at or near their peak level through 2024 to sustainably drive down inflation.
- Higher interest rates will put additional pressure on public finances by increasing the burden of debt servicing costs (which already accounted for 10% of total government spending in FY 2022/2023).

2.7%

Projected global growth in 2023

2.9%

Projected growth in 2024



Global growth remains fragile despite improved outlook

According to the latest forecast from the OECD, global GDP growth will ease to 2.7% in 2023 (from 3.3% last year), before accelerating slightly to 2.9% in 2024. Although this forecast includes a slight upgrade for growth in 2023 (from 2.6% in the OECD's March 2023 forecast), this would still fall short of the 3.5% annual growth in global output seen on average over the last two decades.

Improved expectations for global activity in 2023 reflect the anticipated fall in headline inflation due to lower energy prices and the boost from the reopening of China's economy. Restrictive monetary policy in advanced economies is expected to constrain demand, however, with the full impact of accumulated tightening appearing in late 2023 and early 2024.

Despite the relatively improved outlook, uncertainty about economic prospects remains and risks to the forecast are tilted to the downside. Rapid monetary tightening raises the likelihood of abrupt asset repricing and financial market stress. Global growth remains highly dependent on a robust rebound in China, which seems to have lost steam in recent months. Furthermore, the ongoing war in Ukraine risks renewed disruptions in global energy and food markets.



The business view

How are businesses reacting to changes in the UK economy?

Demand outlook

Demand seems to be holding up in consumer-facing sectors, but is still uneven elsewhere.

- A chemical manufacturer has seen trade soften over the last couple of months, with volumes down 10-20%. Seasonal factors as well as cost-of-living pressures are thought to be driving the downturn.
- A train operator reports that passenger volumes are trending upward, due largely to demand for leisure travel. Customer numbers are growing even compared with pre-pandemic levels.
- A business park developer reports that demand for their office buildings has held up, but that other businesses in the same space have paused new development until the economic outlook becomes clearer.

Staff recruitment

Labour shortages are easing in some sectors, while pay growth remains a serious concern.

- A port operator settled on an 8% pay increase for most of their workforce, with a higher settlement for certain staff with training that is in short supply.
- A recruiter confirms that there has not been a meaningful drop off in hiring yet, with vacancies across sectors still well above their 2020 level.
- A consumer health products company has seen key staff poached by competitors offering significantly higher pay packages. Salary expectations remain unsustainably high.
- A housing provider reports that staff turnover has cooled somewhat from its peak during the pandemic, falling to single digits. Shortages in property services & trades have eased too.

Financial conditions

Rising interest rates beginning to put pressure on profit margins and investment in some sectors.

- A business association reports that higher interest rates are beginning to affect activity in their region, with greater impact ahead.
- A wholesale distributor is facing a massive increase in debt service costs this year, as interest rates have risen sharply. Tighter financial conditions are threatening the viability of some suppliers' businesses too.
- A multinational conglomerate sees higher interest rates as a major risk to their business at the moment, with a high stock of short-term debt outstanding and additional credit needed to finance expanded operations.

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