CBI Economics

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.

Q1 2023: January - March

Quarterly economic highlights

1

UK economy has held up better than expected even though growth prospects remain dim

GDP was flat in February following growth of 0.4% m/m in January. While the UK economy has avoided slipping into recession, CBI surveys suggest underlying momentum remains fairly weak.

2

CPI inflation continues to run in double digits, but is expected to fall steadily this year

Headline inflation eased to 10.1% in February. We still expect inflation to decline over 2023, as falling wholesale gas prices begin to feed through to lower household energy bills.

3

Labour market is still tight, but pay growth seems to have peaked

Employment continues to grow, while inactivity has eased slightly. Wage growth pressures remain firm in both the public and private sectors.

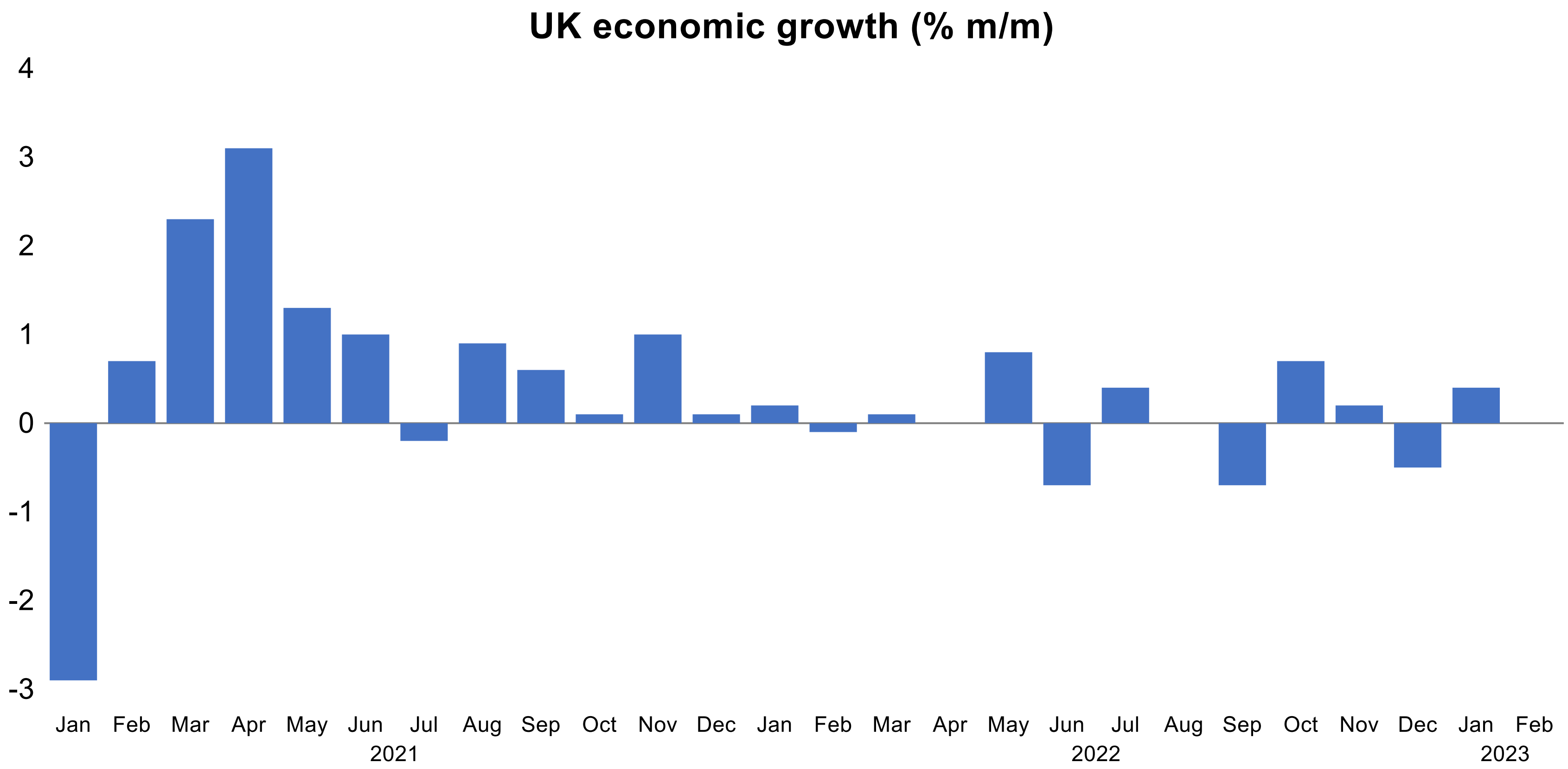
-0.3%

The latest IMF forecast shows the UK economy contracting by 0.3% in 2023.

This quarter at a glance

1. UK economy avoids recession, but growth remains lacklustre →
2. Private sector activity looks set to pick up next quarter →
3. CPI inflation nudges down but remains stubbornly high →
4. Energy prices fall back considerably after surging in 2022 →
5. Labour market shows little sign of loosening →
6. Bank of England hikes while global banking sector shudders →
7. IMF expects global growth slow next year →
8. How are businesses reacting to changes in the UK economy? →

UK economy avoids recession, but growth remains lacklustre



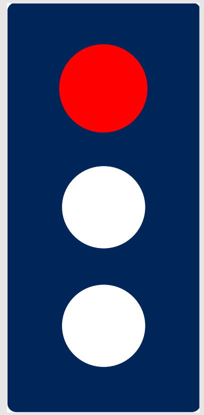
0.3%

UK GDP is now 0.3% above its pre-pandemic level (February 2020)

The UK economy held up better in the second half of 2022 than initial estimates suggested, with GDP growing by 0.1% quarter-on-quarter in the fourth quarter (compared with a preliminary estimate of no growth). This was accompanied by an upward revision to Q3, which showed GDP contracting by 0.1% between July and September (instead of a 0.2% decline). Thus, despite Q3's figure remaining in negative territory, the UK economy narrowly avoided a technical recession in 2022 (defined as two consecutive quarters of falling output).

This weak momentum appears to have carried over into the new year. In January, UK GDP staged a partial recovery from December's 0.5% contraction to record 0.4% growth month-on-month (m/m); however, this recovery stalled in February (0.0% m/m). Services activity fell in February by 0.1% m/m, following growth of 0.7% the previous month. Production output sagged (-0.2% m/m), largely reflecting the ongoing weakness in manufacturing. Meanwhile, the construction activity rebounded from a sharp 1.7% fall in January to post 2.4% growth in February, taking output to its highest level since records began in January 2010.

Alongside the resilience of headline activity data, expanded support for household energy bills and more favourable global economic conditions underpin a slightly brighter outlook than we envisaged at the end of last year. Nevertheless, underlying activity is likely to remain subdued over 2023, due to high inflation and tighter financial conditions.



-7%

CBI Growth Indicator: **red**

Private sector activity contracted slightly in the three months to April

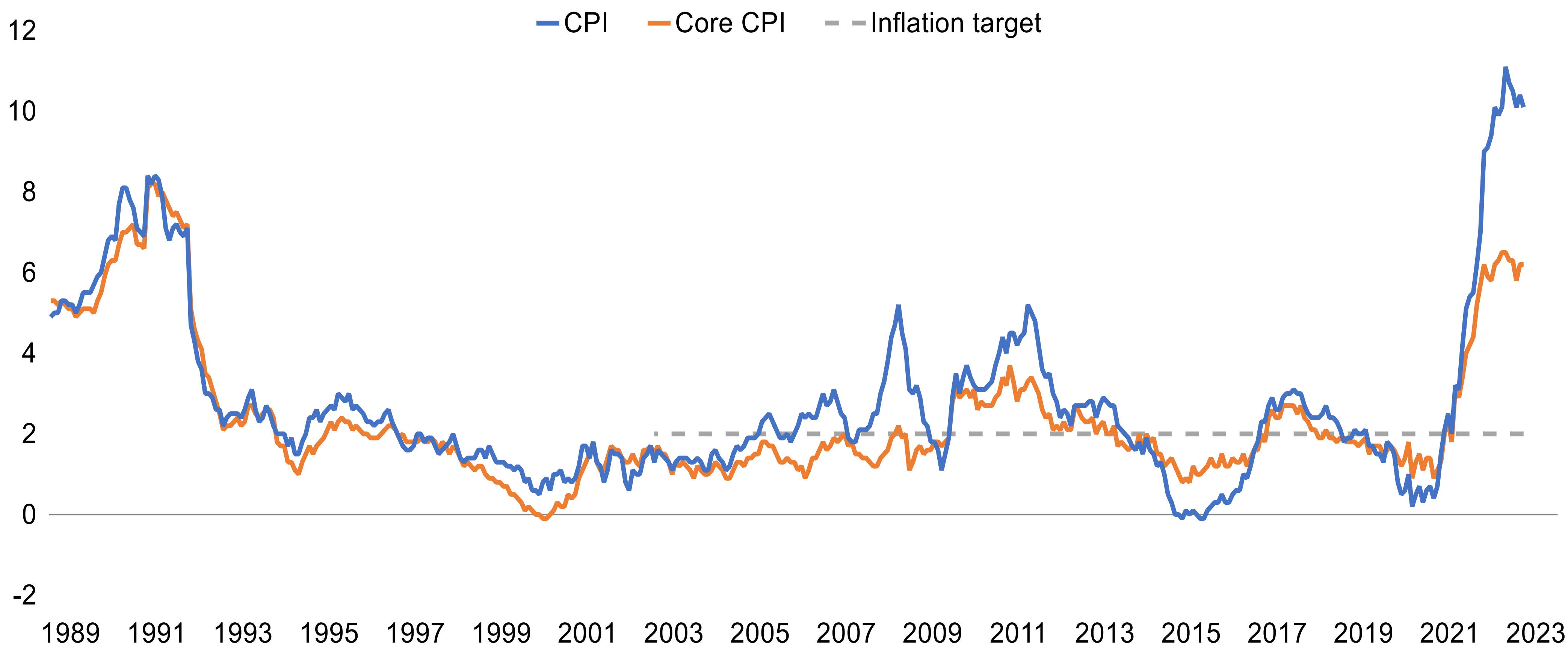
Private sector activity looks set to turn a corner

The CBI's latest Growth Indicator reported that private sector activity continued to fall slightly in the three months to April. Business volumes in the services sector declined at a broadly similar pace to last month, reflecting mild contractions in both business & professional and consumer services. Meanwhile, distribution sales were broadly flat for a second month in a row, whereas manufacturing output fell at a quicker pace than last month.

Private sector activity is set to pick up slightly next quarter, which would mark a return to growth after nine consecutive rolling quarters of contraction. Services volumes are expected to increase marginally in the next three months, with business & professional services growing at a modest pace and consumer services volumes flat. Distribution sales are expected to be broadly unchanged, while manufacturers anticipate a firm recovery in output.

A brighter outlook in our surveys tallies with the steady trickle of better-than-expected economic indicators over the past few months. The latest S&P Global / CIPS Composite Purchasing Managers' Index flash reading – which covers services and manufacturing – points to a third successive month of expansion, while GfK's consumer confidence index rose to its highest in over a year in April. Looking ahead, the extension of the Energy Price Guarantee at the current level of support will likely sustain higher private consumption than anticipated prior to the Spring Budget, but businesses and households will still have to contend with tighter financial conditions in the near term. These headwinds mean that a robust recovery in the private sector remains unlikely over the near-term.

CPI inflation falls to 10.1% in March but remains stubbornly high

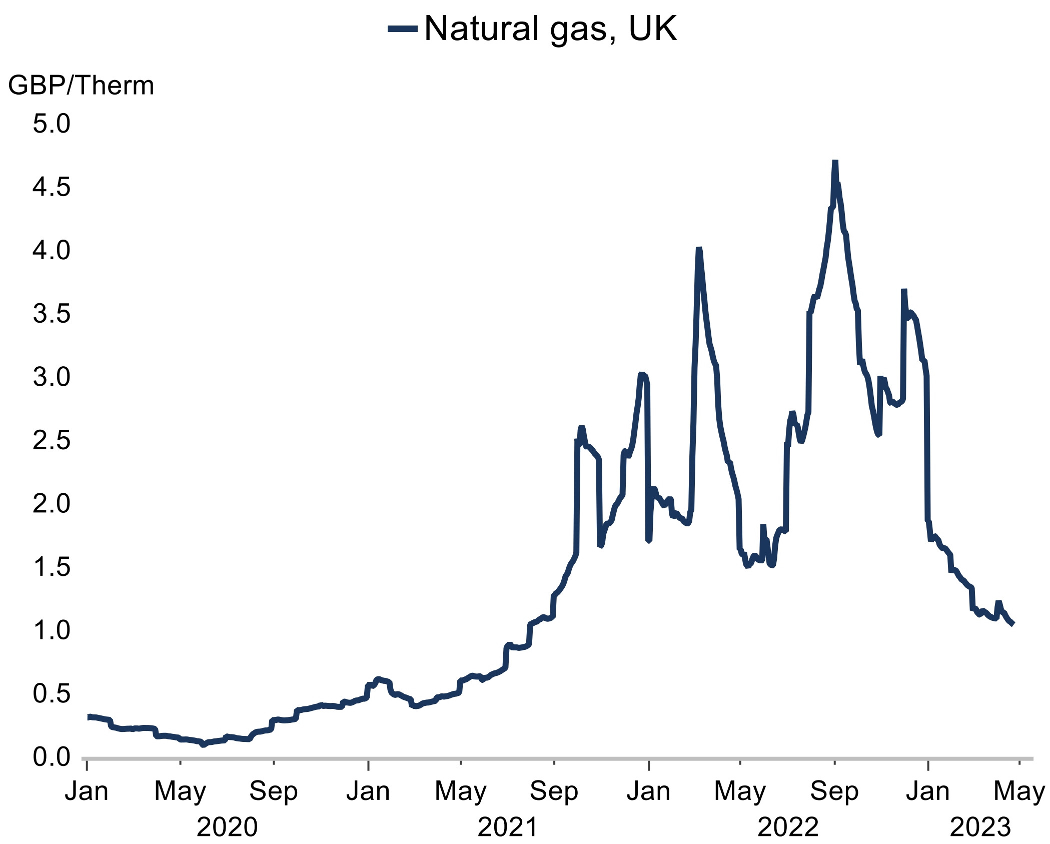


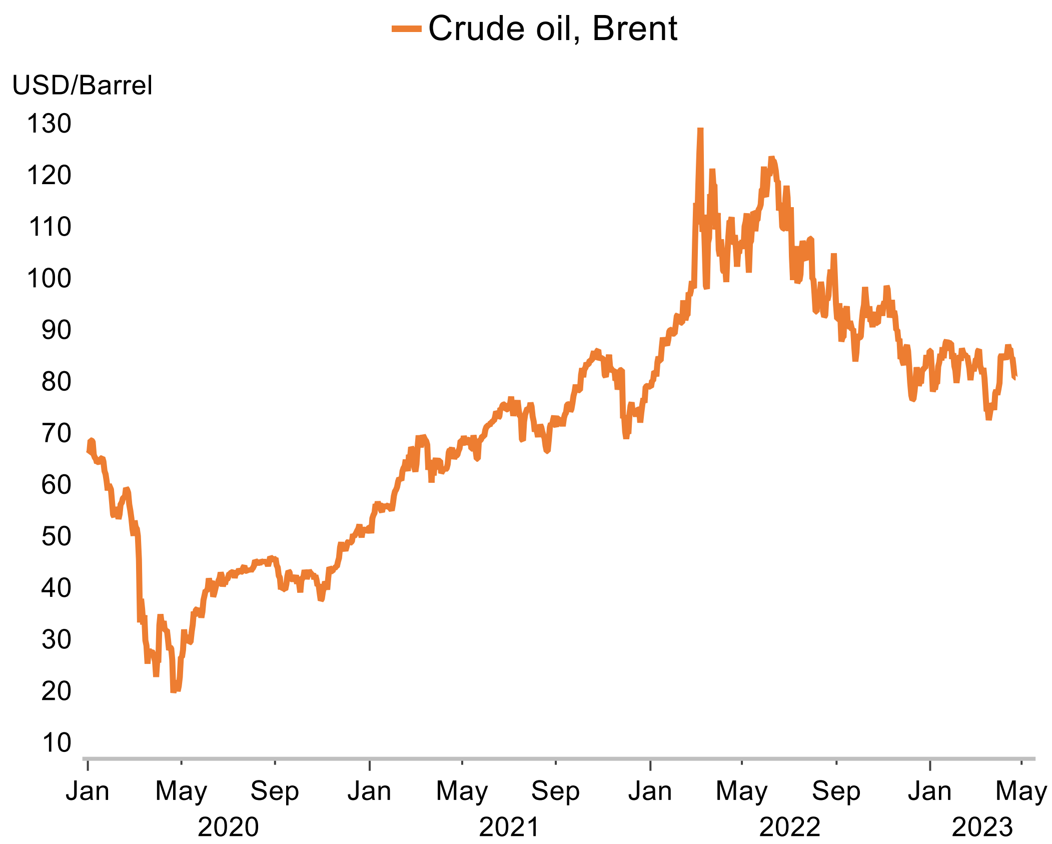
Consumer price index (CPI) inflation eased to 10.1% in March following an unexpected uptick to 10.4% the previous month. Although headline inflation has fallen in four of the five months since its high-water mark in October (of 11.1%), disinflationary momentum has proved weaker than anticipated. In March, transport was the principal drag on the headline rate, reflecting a sharp plunge in the price of motor fuels. This was partially offset by an acceleration of food & non-alcoholic beverages inflation, with prices rising at the fastest pace observed for over 45 years.

Looking beyond the headline figure, two other measures point to the ongoing strength of domestic price pressures. Core CPI inflation (which strips out more volatile components like food and energy) climbed to 6.2% in February and, unlike headline inflation, held steady in March. Likewise, services inflation surged to 6.6% in February and maintained that pace in March. The Bank of England relies on these indicators, among others, to gauge the likelihood of inflation persistence (above its target rate of 2%). This month's readings are unlikely to completely reassure Monetary Policy Committee members that are concerned by the possibility of more persistent inflationary pressures and the knock-on impacts on wage- and price-setting.

Still, despite this month's upswing, we foresee inflation falling steadily over 2023, as falling wholesale gas prices begin to feed through to lower household energy bills and base effects (from last year's price increases) unwind more definitively. Specifically, given the anticipated trajectory of wholesale prices, households should see their energy prices fall below the government's Energy Price Guarantee level starting in Q3. Even so, inflation is likely to remain above the Bank of England's target by the end of the year.

Crude oil and natural gas prices have eased considerably





One of the key factors underpinning the sunnier outlook for the global economy has been the recent decline in energy prices.

Wholesale natural gas prices have plunged by more than 85% from their peak in August 2022, reflecting a combination of reduced demand (partly due to the warm winter) and Europe's remarkable success in diversifying away from Russian gas supply. However, given the near tripling of gas prices over the past couple of years, the recent fall won't immediately feed into lower energy bills. On current trends, households are likely to see prices begin to drop in Q3 2023, while the impact on businesses will feed through with a lag as hedging arrangements roll over. Looking ahead to next winter, Europe finds itself in a relatively favourable position, with gas inventories expected to remain at safe levels even if Russian gas supplies to the continent are completely cut (according to Oxford Economics analysis).

Crude oil prices have also declined in recent months. Prices had skyrocketed in the wake of Russia's invasion of Ukraine in February 2022, with Brent climbing as high as $129/barrel as geopolitical tensions threatened to destabilise global supply. However, since the summer, the global benchmark has slumped back down as far as $73 amid a deteriorating economic outlook and rapidly building inventories. During this period, the global oil trade was abruptly reconfigured as Russia scrambled to divert seaborne exports previously destined for Europe – principally to China and India – in an effort to circumvent a G7-led price cap and embargo scheme. Oil prices rallied in April, as OPEC+ surprised the oil market with the announcement of a cut to production through the end of 2023. Even with an emboldened OPEC+ looking to support higher prices, the near-term outlook for oil will depend on the strength of global growth prospects and, in particular, on how quickly demand from China ramps up following its reopening.

UK labour market resilience still unshaken

The latest jobs data from the ONS highlights the remarkable resilience of the labour market in the face of economic headwinds. UK employment continued to expand in the three months to February, adding 169,000 workers over this period, which pushed the employment rate up to 75.8%. Notably, the increase in employment was driven entirely by self-employed and part-time workers. Headline employment growth was accompanied by an uptick in unemployment over the same period, which edged up to 3.8% (from 3.7%) because of a further decline in economic inactivity. Lower inactivity was the result of a fall in the number of students, with those reporting as long-term sick rising to a record high.

Even though the headline figures have remained relatively stable, there are signs of a gradual easing in labour demand. Total vacancies have steadily drifted lower since May 2022, decreasing by 47,000 in the three months to February 2023 to 1.11 million. Nevertheless, the level of vacancies remains notably high by pre-pandemic standards (averaging 658,000 between 2010 and 2019).

Labour market tightness continues to sustain considerable pay pressures, which have yet to show signs of turning a corner. Overall, nominal regular wage growth remained strong in the three months to February (at 6.6%). Nominal regular pay in the public sector rose at the fastest rate since December 2005 (5.3% from 4.9% in January), whereas it cooled slightly in the private sector (6.9% from 7.0%), with the result that the public-private gap narrowed somewhat. In real terms, overall regular pay growth remains firmly in negative territory (-2.3%) due to inflation outpacing the recent increases in wages.

Business view

- Our April surveys showed little sign of the labour market slackening ahead, with firm headcount growth expected over the next three months. Even so, anecdotes suggest firms are still finding recruitment difficult.
- A real estate group has struggled to find labour for maintenance and upkeep of properties and are paying considerably more for labour when available.
- A law firm reports that their main challenge remains identifying and retaining good talent. It now takes them 8-9 months to fill vacancies.
- An aerospace manufacturer said that it feels like the rich network of aviation expertise pre-pandemic has been lost. Many people at the peak of their career retired during the pandemic.

Employment rate

(Dec ’22 – Feb ’23)

75.8%

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

Unemployment rate

(Dec ’22 – Feb ’23)

3.8%

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

Real wage growth

(Dec ’22 – Feb ’23 on a year ago)

-2.3%

Real regular pay growth increased by 0.2pp from the previous quarter.

Productivity growth

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

-0.3%

Productivity decreased by 0.2pp from the previous quarter.

Bank of England hikes while global banking sector shudders

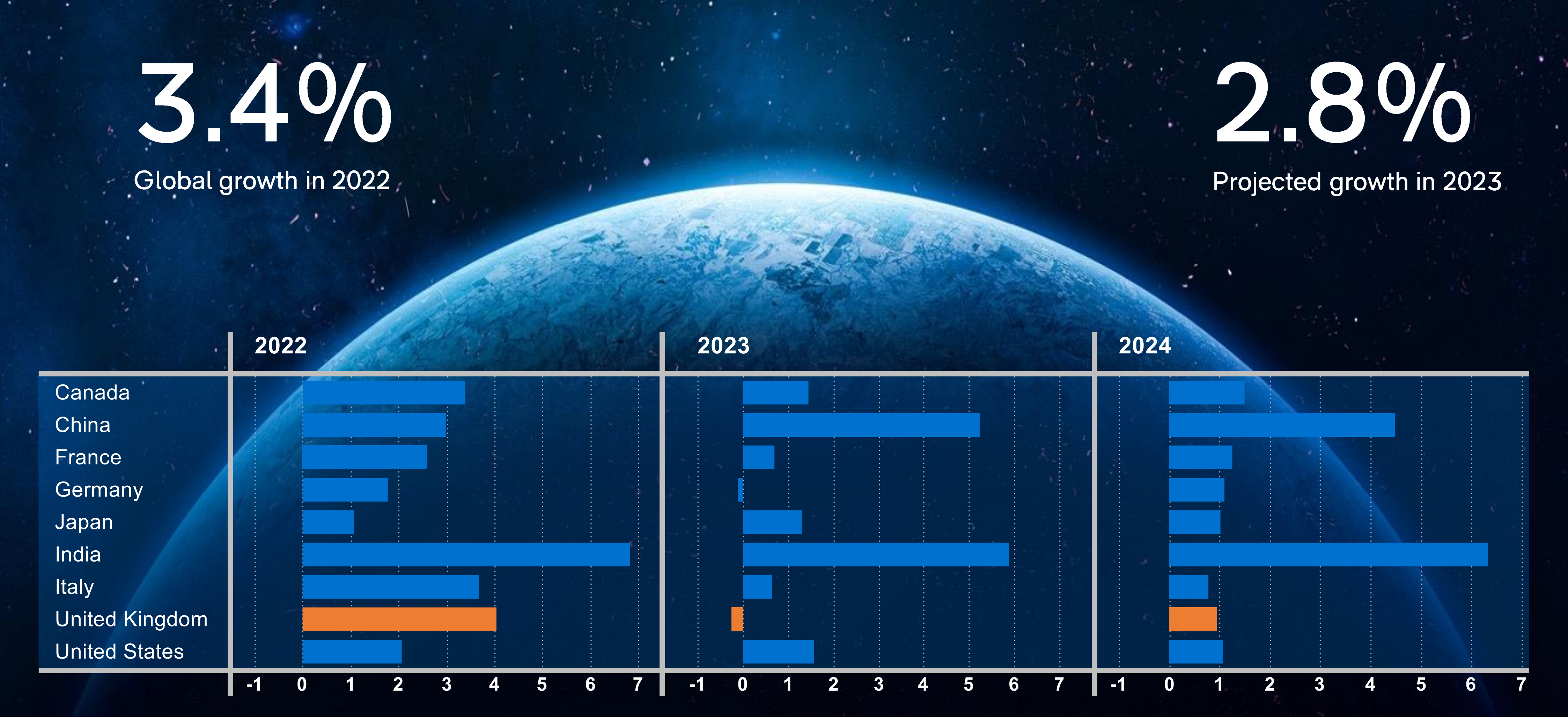
The Bank of England's Monetary Policy Committee (MPC) voted to increase benchmark interest rates by 50 basis points in February and a further 25 basis points in March, bringing Bank Rate to 4.25%. The latest interest rate hike rise mirrored the recent decisions of the European Central Bank and the US Federal Reserve to press ahead with rate increases (of 50bp and 25bp, respectively), undeterred by the banking turmoil caused by the collapse of Silicon Valley Bank (SVB) and UBS's buyout of Credit Suisse.

The MPC's decision to raise rates reflected the improvement in near-term outlook for UK and global activity and the continued strength of headline (as well as core goods and food) inflation. Notably, the MPC no longer anticipates that the UK will enter a technical recession this year. The Bank now expect GDP to increase slightly in the second quarter, compared with the 0.4% decline anticipated in their February forecast.

Forward guidance from the March meeting consisted of a commitment to further tightening "if there were to be evidence of more persistent [inflationary] pressures". Given that inflation is set to fall significantly this year, especially off the back of an unwinding of energy price base effects, we take the view that Bank Rate is nearing its peak for this tightening cycle.

What does this mean for business?

- The latest MPC meeting minutes suggest that, barring additional upside surprises, further increases in Bank Rate may not be required to return inflation to the 2% target.
- The MPC did note that bank wholesale funding costs rose in the wake of SVB's collapse and UBS's purchase of Credit Suisse, which could affect the credit conditions faced by businesses and households.
- As things stand, we don't expect the recent bank failures to spark a 2008/9-style financial crisis, given the UK system's strong capital positions as well as central banks' expanded set of policy tools for managing liquidity strains. For a more detailed discussion of these developments, see our recent member note.



Global growth will slow this year, according to the IMF

The IMF estimates that global GDP rose by 3.4% in 2022, and forecasts growth of 2.8% in 2023 (upwardly revised by 0.2 percentage points) and 3.0% in 2024 (downwardly revised by 0.1 percentage point). The Fund notes that stubbornly high inflation, rapidly tightening monetary policy, banking sector vulnerabilities, and high debt levels will all weigh on global growth going forward.

GDP growth in advanced economies (including the UK) is set to ease considerably (from 2.7% in 2022 to 1.3% in 2023), with the IMF's growth forecast for this bloc at the lowest since 2001 (not including the early COVID-19 crisis in 2020 and the global financial crisis of 2008-09). This slowdown reflects the tight monetary policy stance, financial stress, and ongoing effects from the war in Ukraine.

Peak inflation seems to be behind the world economy due to the recent fall in fuel and commodity prices, but it is proving stickier than previously expected. Therefore, the IMF now expects global inflation to fall more slowly, from 8.7% in 2022 to 7.0% in 2023 (upwardly revised by 0.4 percentage points) and 4.9% in 2024 (upwardly revised by 0.6 percentage points).

The business view

How are businesses reacting to changes in the UK economy?

Demand outlook

Firms' experience of current demand conditions varies to some extent by industry, but many report improving confidence.

- An industrial engineering firm has seen their order book grow at record pace, bolstered by demand from China following the country's reopening.
- An aerospace manufacturer reports that they've has seen robust growth due to the increased defence spending and higher passenger traffic numbers.
- A law practice reports that their project pipeline has stabilised compared with a year ago when they struggled to keep up with work.
- A consultancy has seen strong demand across all of its business areas: data-led projects, management & automation, and cloud & cyber.

Staff retention

Many firms report firm wage growth, but there have been higher settlements for specific groups.

- A food manufacturer settled their annual pay review just before Christmas at just over 5%, alongside temporary supplements. But the pay reward was closer to 10% for factory level staff.
- A wholesale distributor has seen wages rise by 6-7% in 2022, and hopes to offer staff a one-off, cost-of-living bonus later in 2023. Pay remains a significant challenge for recruitment.
- A consultancy expects to provide a 6% rise in wages for 2023. But this comes after some of their staff have left after being offered 40-60% increases in salaries by larger international organisations.
- An aerospace manufacturer has raised wages at a record pace (6-7% for 2022).

Investment

Economic uncertainty still represents a headwind for businesses' investment plans, but there is a sense of confidence returning.

- A bank reports that economic uncertainty has meant that they are sitting on a lot of capital waiting to be deployed.
- An international logistics company has taken a more cautious approach to investment given weaker volumes, but green tech investments continue at pace.
- A law firm has noticed that banks are doing more due diligence, and investors are slower to commit capital.
- A consultancy firm sees large companies investing in "no regret" assets and technology for efficiency. Mid-market firms are investing for innovation, while SMEs are monitoring developments in R&D tax credits.

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