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.

Q3 2022: July - September

Quarterly economic highlights

1

UK GDP contracts in August

UK GDP shrank by 0.3% in August, reflecting a decline in manufacturing output and slightly lower services activity. The size of the economy is now broadly unchanged from its pre-pandemic level in February 2020. Business surveys point to activity falling over Q3 as a whole.

2

Inflation remains near a 40-year high

Headline inflation dipped slightly to 9.9% in August but remains significantly above the Bank of England's 2% target. While the Government's energy package will bring some relief to households and businesses, the broader fiscal stimulus measures announced in September will likely strengthen domestic inflationary pressure over the medium-term.

3

UK labour market remains tight

The unemployment rate sank to its lowest level since 1974, as inactivity remained elevated. However, we expect some softening in the labour market as demand wanes across the economy, pushing up unemployment slightly over the next year.

0.3%

The IMF expects the UK economy to grow by 0.3% year-on-year in 2023, according to its latest projections.

This quarter at a glance

1. UK economy contracts in August, falling back to pre-pandemic size →
2. Private sector activity drops steeply in Q3 →
3. CPI inflation eases slightly in August, but core CPI edges higher →
4. UK labour market remains tight →
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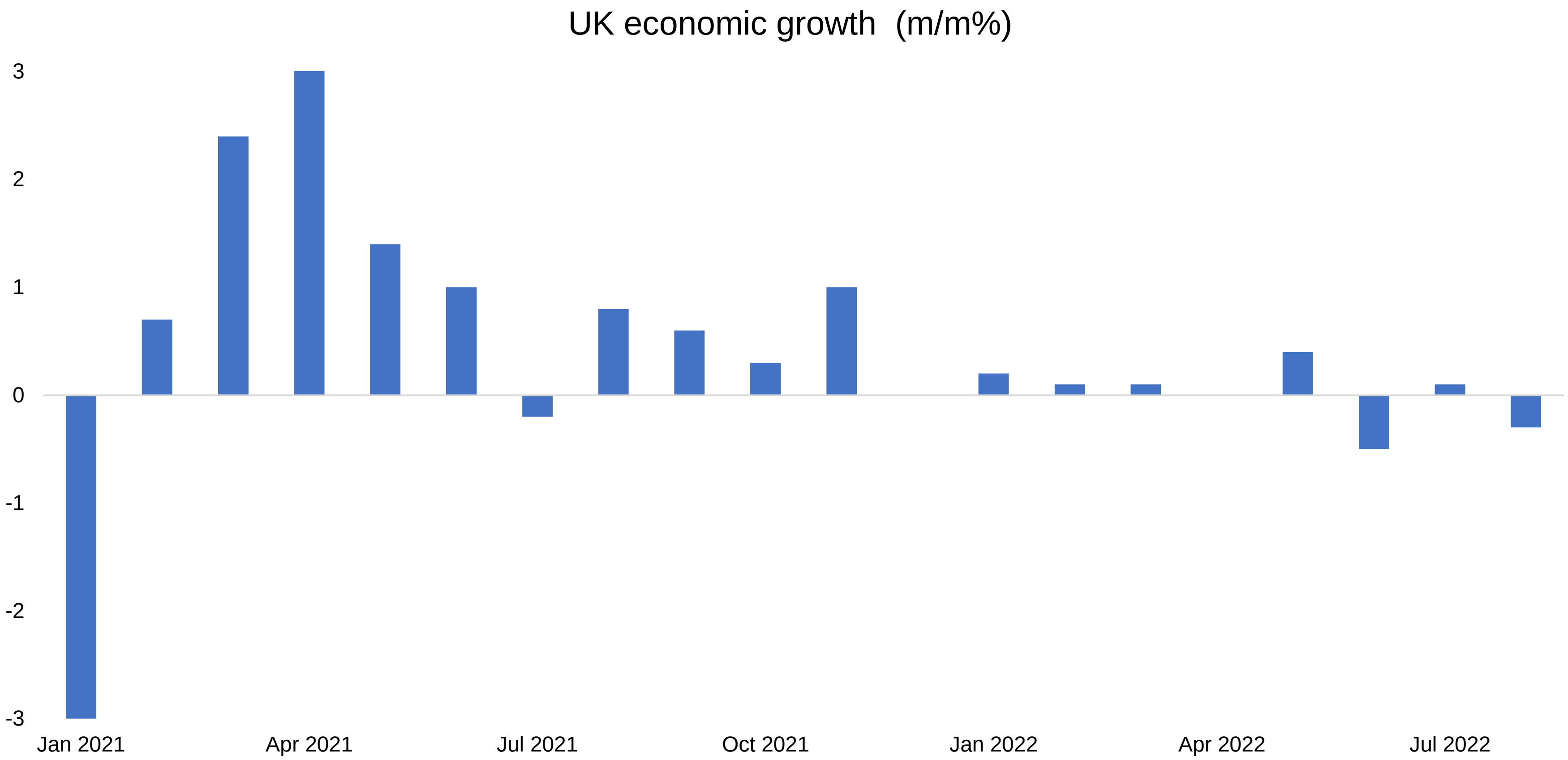
7. Global economy enters a broad-based slowdown →
8. How are businesses reacting to changes in the UK economy? →

UK economy contracts in August, falling back to pre-pandemic size



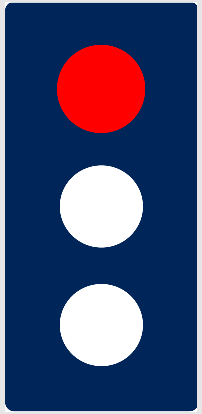
-0.3%

UK GDP contracted by -0.3% in August

The UK economy shrank by 0.3% month-on-month (m/m) in August, falling well short of expectations (consensus forecast expectations were of no growth). Following the subdued 0.1% rebound recorded in July, this month's contraction leaves GDP broadly unchanged from its pre-pandemic level in February 2020.

August's GDP contraction was driven in large part by a 1.6% m/m decline in manufacturing output. The sector has now posted three consecutive months of declining output. Services output fell by 0.1%, with declining COVID-related activity contributing -0.1pp to headline GDP growth. Construction was the only major sector to contribute positively to monthly GDP, recording 0.4% growth in August.

Economic momentum continues to slow as the cost-of-living crisis weighs on household spending. The Energy Price Guarantee will probably mitigate some of the impact of higher energy costs for businesses and households, but the increase in the cost of borrowing following the "mini"-Budget will likely offset some of the support from the government's fiscal stimulus measures. The longer-term economic outlook will depend on the actions of fiscal and monetary policy over the coming months.



-19%

CBI Growth Indicator: **Red**

Private sector activity contracted in the three months to September

Private sector activity drops steeply in Q3

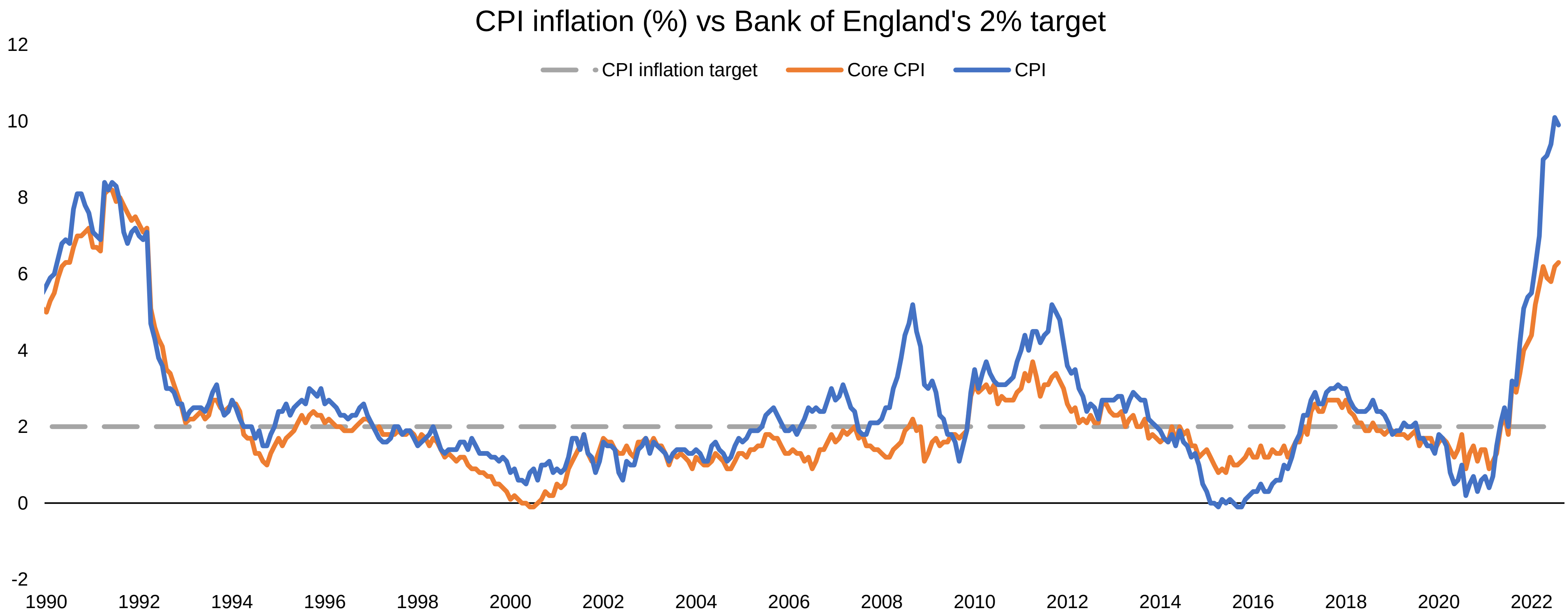
This month’s Growth Indicator paints a bleak picture of recent private sector activity. In the three months to September, activity slumped for a second consecutive month, posting the steepest decline since February 2021. The decline was broad-based across distribution, manufacturing, and services.

Looking ahead to the next three months, the fall in private sector activity as a whole is expected to gather pace. Distribution, manufacturing, and services are all expected to see activity decline at a faster rate in the next three months.

Businesses are contending with challenges on a number of fronts. Household spending has stalled as inflation continues to outstrip pay growth, while high energy costs, recruitment challenges, and supply disruptions still represent considerable headwinds. Higher borrowing costs and a weaker sterling are also likely to weigh on activity.

Nevertheless, there are signs that some cost pressures are beginning to ease. Non-energy commodity prices and shipping costs have fallen as global economic activity weakens. The Government’s Energy Price Guarantee provides valuable support for businesses, but uncertainty remains over which industries will still be covered by the scheme after the initial six month period.

CPI inflation eases slightly in August, but core CPI edges higher



Consumer price index (CPI) inflation in the UK slowed slightly to 9.9% in August, down from 10.1% the previous month (which marked a 40-year high). Falling motor fuel prices accounted for much of the easing in inflation, reflecting the recent fall in global oil prices. This was partially offset by rising prices of food & non-alcoholic beverages, which have now risen for 13 consecutive months and are increasing at the quickest rate since records began in 1988.

Despite the fall in the headline rate, core CPI inflation rose for the second consecutive month to 6.3%, as price pressures from services continue to firm. A 30-year high for core CPI – a measure than excludes food and energy – suggests that wage growth has been spreading price pressures to domestically-oriented sectors.

The outlook for inflation has become more complicated following the Government's fiscal policy announcements in September. While the Energy Price Guarantee, which subsidises energy costs for households and businesses, should put downward pressure on inflation in the near-term, this will likely be offset to some extent over the medium-term by the significant tax cuts announced in the "mini"-Budget. As a result, the Bank of England is expected to keep interest rates higher for longer in order to meet their 2% inflation target.

UK labour market remains tight

The unemployment rate in the UK dropped to 3.5% in the three months to August, its lowest since 1974. The employment rate also declined, slipping to 75.5%. Despite fewer people working than last quarter, the unemployment rate has fallen because of an uptick in inactivity, with growing numbers not looking for work due to study or long-term sickness.

There are signs of some slight slackening of the labour market as demand begins to cool, however. Vacancies fell in the three months to August, although the number of vacant posts remains high by historical standards. The ONS notes that the number of employers imposing a freeze on recruitment has increased, suggesting that businesses are becoming more cautious about expanding their workforce as wages rise and the economic outlook worsens.

Pay pressures continue to mount, with nominal regular pay growing by 5.4% year-on-year in the three months to August. Still, with consumer prices rising apace, real regular pay growth stands at -2.9%, just off the lowest rate of growth since records began in 2001. Since year-on-year growth rates no longer reflect the pandemic's furlough scheme, these figures could be seen as more representative of the wage pressures businesses are facing.

Business view

- The CBI's latest Employment Trends Survey found that three quarters of UK companies have been hit by labour shortages in the last 12 months.
- Nearly half of those firms facing labour shortages have been unable to meet demand and a quarter have reduced capital investment.
- In response, more than half of firms are investing in training and base pay, while 40% are investing more in technology.

Employment rate

(Jun '22 – Aug '22)

75.5%

The employment rate decreased by 0.4pp from the previous quarter.

Unemployment rate

(Jun '22 – Aug '22)

3.5%

The unemployment rate decreased by 0.3pp from the previous quarter.

Real wage growth

(Jun '22 – Aug '22 on a year ago)

-2.9%

Real regular pay growth decreased by 0.3pp from the previous quarter.

Productivity growth

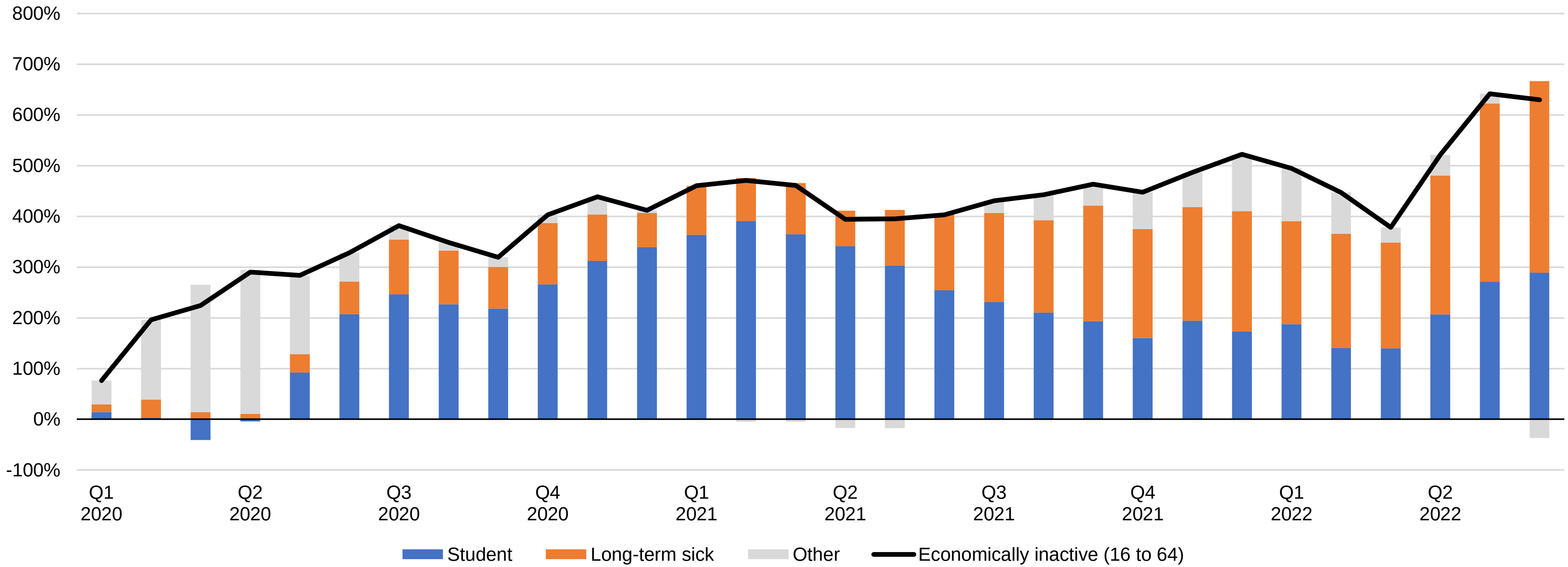
(Output per hour, Q2 2022 on a year ago)

0.4%

Productivity increased by 0.3pp from the previous quarter.

Record levels of long-term sickness drive economic inactivity higher

Inactivity by reason, cumulative change from December to February 2019, seasonally adjusted



In the three months to August, economic inactivity – the proportion of people aged 16 to 64 that are unemployed and unable to start work within the next two weeks – leapt to 21.7%, well above pre-pandemic levels. The increase in inactivity since the start of the pandemic has been led by people aged 50-64 years.

Long-term sickness climbed to record highs in the three months to August, becoming the most important factor pushing the inactivity rate higher since the beginning of the COVID-19 pandemic. Chronic pain (back, legs, etc.) and mental health issues are the main drivers of this increase in long-term illness. An increase in the number of economically inactive students recently has also contributed noticeably to the headline rise in inactivity.

This development may have implications for monetary policy. Firms continue to face persistent labour and skills shortages, but the fall in labour supply (due to rising inactivity) has meant that businesses are competing for a smaller pool of available workers. A tight labour market serves to amplify wage pressures, which explains why the Bank of England may choose to pursue more aggressive monetary tightening that it otherwise might have.

Bank of England raises rates again

The Bank of England's Monetary Policy Committee (MPC) voted to raise its benchmark interest rate by 50 basis points, bringing Bank Rate to 2.25%. September's hike marks a seventh successive rate increase.

Markets had been expecting a larger increase, pricing in a significant chance of a 75 basis point rise. Although the vote produced a three-way split, the first since mid-2008, the MPC ultimately declined to match the more aggressive tightening of the US Federal Reserve and the European Central Bank.

Although four of the nine members dissented from majority vote on the size of the rate increase, the MPC was unanimous in seeing the case for higher interest rates, with CPI inflation still well above the 2% target (inflation was 9.9% in August). They expect the Energy Price Guarantee (EPG) to moderate inflation in the near term (revising down their estimate of peak CPI inflation to just under 11% in October). Even so, by shielding household incomes from the full brunt of the energy price spike, the EPG is likely to prove inflationary in the medium term.

September's decision only took into account the impact of the EPG, with full consideration of the Government's fiscal measures announced in the "mini"-Budget deferred to the November meeting. At the time, the MPC stated that it would act "forcefully" to counteract persistent inflationary pressure, "including from stronger demand". Later in the month, the Bank reiterated that it "will not hesitate to change interest rates by as much as needed" to bring down inflation, language that most economists interpret as presaging an even larger hike to come.

What does this mean for business?

- The market turmoil following the "mini"-Budget has resulted in a sharp rise in borrowing costs and fuelled expectations that the Bank of England will be forced to raise rates higher than previously anticipated. Market expectations currently point to a peak in the Bank rate of just under 6% in 2023, up from around 5% ahead of the "mini"-Budget.
- As a result, UK businesses will need to incorporate the materially higher cost of borrowing and lower sterling into their strategic planning.

	2021	2022(F)	2023(F)
World (PPP)	6.0	3.2	2.7
UK	7.4	3.6	0.3
US	5.7	1.6	1.0
Eurozone	5.2	3.1	0.5
China	8.1	3.2	4.4
Japan	1.7	1.7	1.6
India	8.7	6.8	6.1

6.0%

Global growth in 2021

3.2%

Projected growth in 2022

Global economy enters a broad-based slowdown

The IMF expects the global economy to remain on track for 3.2% output growth in 2022, before slowing in 2023 to an annual rate of just 2.7% (a downward revision of 0.2pp from July). Over this period, more than a third of the global economy is projected to fall into “technical” recession (i.e., two or more consecutive quarters of falling output). The Fund warned that risks are skewed firmly to the downside, with a 25% chance of global growth falling below 2.0% in 2023.

Turning to some the major world economies, the Fund expects UK GDP growth to slow to 3.6% in 2022 and 0.3% in 2023 due to high inflation and tighter monetary policy. Likewise, US growth is projected to ease to 1.6% in 2022 and 1% in 2023, primarily as a result of higher inflation weighing on consumer demand and aggressive monetary policy tightening taking a toll on spending, especially residential investment. The Eurozone is also expected to see a growth slowdown, with the war in Ukraine and tighter monetary policy weighing on activity. China is forecasted to see its lowest growth for four decades (excluding the initial COVID-19 impact in 2020) at 3.2% in 2022, driven by lockdowns as well as a worsening property crisis, before edging up to 4.4% in 2023.

Inflationary pressures continue to percolate through most economies, as higher energy, transportation, and labour costs have translated into rising consumer prices for most goods and services. The Fund expects inflationary pressures to remain high during the remainder of 2022, with global headline consumer price inflation forecasted at 8.8% (an upward revision of 0.5pp from July). Global inflation is expected to gradually ease to 6.5% in 2023 and 4.1% in 2024.

The business view

How are businesses reacting to changes in the UK economy?

Energy prices

Energy support measures will give firms some breathing space in the short term.

- A manufacturer was facing the prospect of their energy bills increasing by more than 400%. Even with the support package, rough estimates have bills doubling.
- A business solutions firm has hedged energy prices until mid-2023, but will begin investing in a solar farm to reduce future gas usage.
- A manufacturer has already reduced gas usage by 30% in one facility by investing in more efficient capital equipment, and will seek further reductions through operational improvements.
- A water services firm is accelerating plans for development of solar and renewable power generation on-site, even though cap has temporarily shielded them from gas prices.

Demand weakening

Many firms detect faltering demand as the cost-of-living crisis weighs on households.

- An enterprise software company has seen their customers cut back on investment in response to a slowdown in household spending.
- A shipping business reports a double-digit decline in volumes in the UK as activity slows. Volumes in Europe have held up better.
- A food retailer is concerned by a pronounced shift in consumer purchasing behaviour, away from higher-end products towards basic items.
- A marketplace has registered a considerable uptick in traffic, with consumers increasingly seeking out cheaper, second-hand products.
- An industrial goods producer has seen their order book shrink over the last quarter as consumer-facing businesses cut back on spending.

Labour market

Many firms continue to face difficulties recruiting and retaining staff.

- An aerospace engineering firm has been forced to turn down multiple projects due to lack of staff. Recruiting has been difficult at all levels, but the shortage is especially acute for mid-career technical leads.
- A university has struggled to recruit information technology staff in particular, amid record levels of turnover. As part of their renewed recruitment efforts, they have become a Living Wage employer.
- A retailer is already planning further pre-emptive wage increases for warehouse staff to avoid losing them to competitors during the December holiday season.
- A restaurant chain has raised wages, but still faces churn twice as high as pre-pandemic levels. Margins are already very slim.

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