

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.

Q4 2022: October - December



Quarterly economic highlights

UK economy expected to enter a mild recession, with a 0.7% peak-to-trough fall in output

In our latest forecast, we expect GDP to contract by 0.4% in 2023, as high inflation drags on household incomes and spending. The outlook improves in 2024, when we expect the economy to grow by 1.6%, as inflation falls and the squeeze on household incomes abates.

CPI inflation looks set to fall over the next two years, while remaining above-target

As base effects unwind, global price pressures fade, and a recession takes some of the heat out of price setting, we expect CPI inflation to fall back steadily from its October 2022 peak. Nevertheless, our forecast shows inflation still running above the Bank of England's 2% target by the end of 2024.

Labour market expected to loosen over the coming year

Falling activity should weigh on hiring in 2023, but businesses' experiences of labour shortages may lead them to retain staff to a greater degree than expected. We expect the unemployment rate to peak at 5% by the end of the year, an increase comparable to that seen over the COVID crisis, but much lower than during the 2008/9 financial crisis.



-0.4%

Following growth of 4.5% this year, the UK economy will contract by 0.4% in 2023, according to the latest CBI forecast.



“It’s clear that 2023 will remain a difficult trading environment: the persistent strength in inflation has likely tipped the economy into a recession that will last for most of the coming year”

“We expect the recession to be relatively short-lived, with the economy returning to growth over 2024 – principally as further falls in inflation alleviate the squeeze on household incomes. But longer-term economic challenges remain firmly in place, with both GDP and productivity remaining well below their pre-pandemic trends at the end of our forecast”

- Alpesh Paleja, CBI Lead Economist



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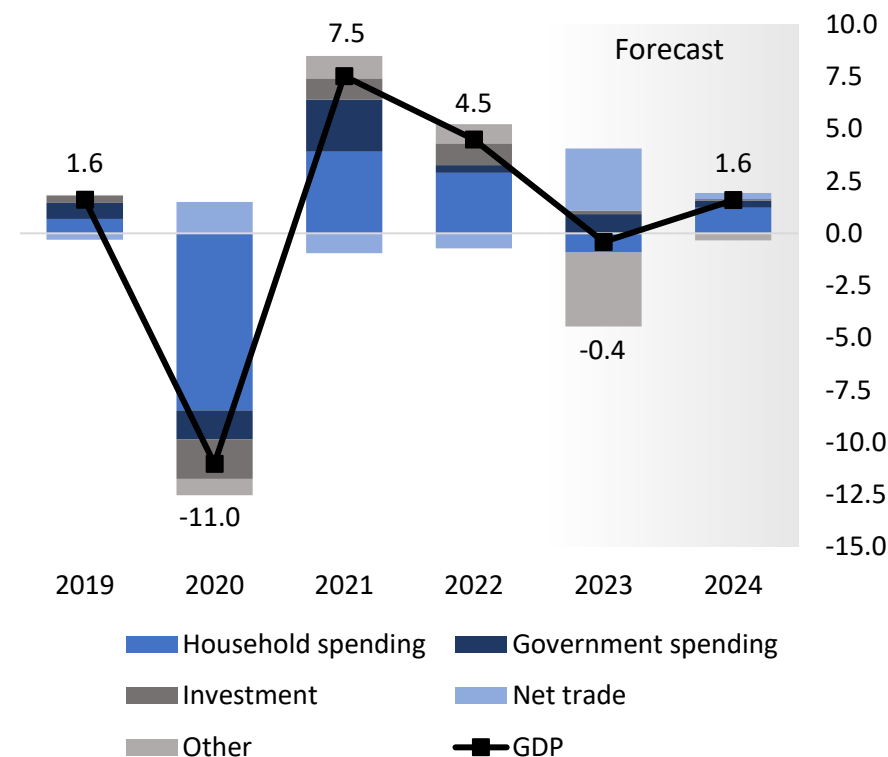
CBI UK economic forecast: darkest before dawn

What does this mean for business?

- **Stay alert to international developments.** Although commodity prices have generally trended downward and supply chain disruption has eased, an escalation of the conflict in Ukraine or other geopolitical events could provoke a resurgence in energy price volatility.
- **Plan for further rises in interest rates.** We expect the Bank Rate to peak at 4% in early 2023 (up from its current level of 3.5%) and remain at that level through 2024.
- **Think holistically about the employee value proposition.** Continued pressure on household incomes will set the tone for pay negotiations in the year ahead. Anecdotes from our members suggest that businesses are looking to take a wider range of actions to support staff with higher cost of living, such as unconsolidated payments/bonuses.

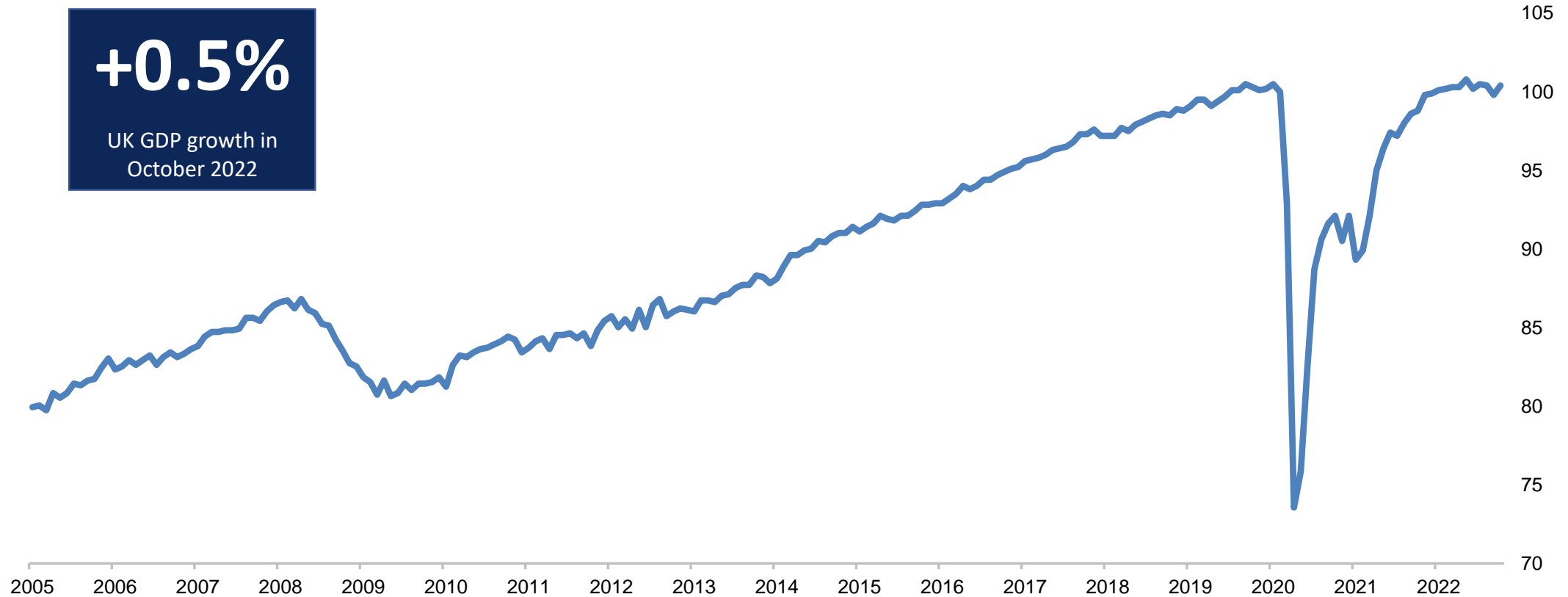
- **We are forecasting a mild recession for the UK economy over the coming year**, with a comparatively shallow peak-to-trough decline in output of 0.7%.
- GDP fell by 0.3% quarter-on-quarter (q/q) in Q3 of 2022, and business surveys suggest a further weakening in underlying activity in Q4. Looking through the volatility in the data caused by an extra bank holiday in September, we believe the UK has effectively entered a recession.
- **We expect the economy to contract by 0.4% year-on-year (y/y) in 2023**, a downward revision from the 1% growth we anticipated in June. After a historic decline in households' real incomes in 2022, price pressures will only gradually recede during 2023, leading to a year-long fall in household spending.
- In our view, we will see inflation ease from its October 2022 peak as global price pressures fade, weaker domestic activity takes some heat out of price setting, and base effects unwind (particularly in energy bills and fuel prices). Nevertheless, inflation remains high by recent historical standards and ends 2023 at 3.9% (almost double the Bank of England's 2% target).
- **The outlook improves in 2024**, by which time inflation has cooled sufficiently so that the squeeze on household incomes eases, which, in turn, supports private-sector investment. As a result, we expect the economy to grow by 1.6% y/y.
- We expect business investment to fall over much of 2023, both due to falling activity and the government's super-deduction coming to an end in Q2. Although the subsequent recovery in GDP and real incomes means that investment begins to grow again in 2024, it remains 9% below its pre-COVID level by the end of the year.
- Much of the structural weakness in the UK economy that persisted before COVID remains. Productivity stays lacklustre, remaining 2% below its (already weak) pre-pandemic trend. GDP is also significantly lower (8%) than the trend seen over the 2010s.
- Our forecast is subject to a number of considerable uncertainties. Most notably, the possibility of further escalation of the war in Ukraine and the recent abandonment of zero-COVID policies in China have the potential to disrupt global supply chains and commodity markets. Additionally, tighter global financial conditions, on the back of higher interest rates, may lead to tough trading conditions for some companies.

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



UK economy expands in October, but momentum remains weak

UK monthly GDP index (February 2020=100)

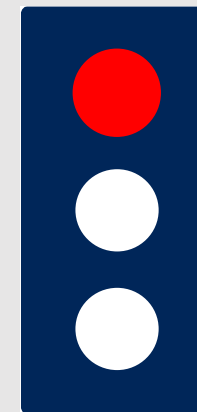


The UK economy rebounded from September's 0.6% month-on-month contraction to post growth of 0.5% in October, marginally exceeding consensus expectations of 0.4% growth. Strong growth this month partly reflects the increased number of working days in October relative to September (due to the extra Bank Holiday for Queen Elizabeth II's funeral). The encouraging headline figure notwithstanding, underlying momentum in the economy remains weak. Over the three months to October, GDP fell by 0.3% compared with the three months to July.

Services seemed to have benefitted most from the unwinding of Bank Holiday impact on the month-on-month comparison, notching up 0.6% m/m growth in October after a 0.8% drop the previous month. Construction activity grew for the fourth month in a row, while industrial production was flat.

In December, the ONS published revised estimates of quarterly GDP showing that the economy shrank by 0.3% quarter-on-quarter in Q3 (revised down from a preliminary estimate of 0.2%). Moreover, it seems that output had been overstated in each quarter since Q3 2021.

Although a prolonged period of industrial action will likely dampen activity through the end of 2022, we expect GDP remain broadly flat in the three months to December due to the bank holiday-driven rebound falling in the fourth quarter. This timing effect aside, business surveys suggest the UK economy has effectively already entered recession, which we expect to last for the rest of 2023.



-13%

CBI Growth
Indicator: **Red**

Private sector activity
contracted in the three
months to December

Private sector activity continued to decline in Q4

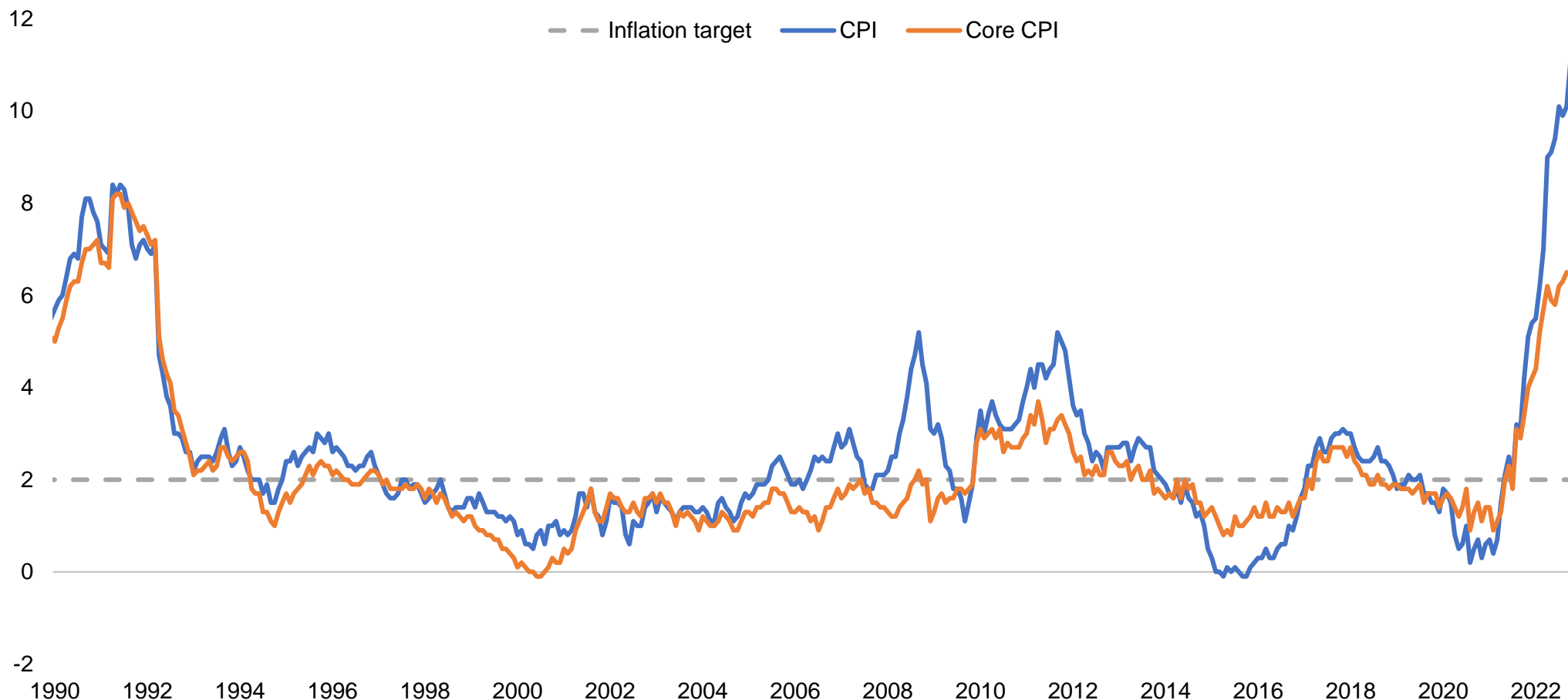
The CBI's latest Growth Indicator showed that private sector activity continued to fall in the three months to December, marking the fifth consecutive rolling quarter of decline. The latest outturn saw volumes falling at a faster pace in consumer services and manufacturing. Meanwhile, business & professional services continued to stagnate, and distribution sales fell at a slower pace.

Businesses do not foresee any change in trend over the next quarter, with private sector activity expected to contract at a faster pace. Specifically, activity in the business & professional services and distribution sectors are expected to decline at an accelerated pace in the coming three months. Consumer services volumes look set to fall at a moderated pace, whilst manufacturing output is expected to contract modestly again.

The weakening momentum in the December CBI Growth Indicator chimes with the latest readings from other economic surveys. The S&P Global/CIPS UK composite output PMI has languished in contractionary territory since August, with December's flash estimate pointing to another month of falling output. Moreover, the consumer spending outlook remains bleak, with consumer confidence – as measured by GfK's headline index – near historic lows in December.

CPI inflation cools after reaching 41-year high in October

CPI inflation (%) vs Bank of England's 2% target



Consumer price index (CPI) inflation in the UK fell to 10.7% in November, easing from the 41-year high of 11.1% seen in October. Transport was the primary drag on headline inflation, mostly reflecting falling prices of fuels and second-hand cars. Partially offsetting upward pressure came from food & non-alcoholic beverages, which rose at the quickest pace since records began in 1988. In addition to the headline rate, core CPI inflation eased slightly to 6.3%, from the 30-year peak of 6.5% seen last month.

The dip in inflation in the year to November is expected to be the start of a steady fall over the year ahead as weaker domestic activity takes some heat out of price setting, monetary and fiscal policy tighten further, and base effects unwind (particularly in energy bills and fuel prices). It should be noted that uncertainty around the inflation outlook is particularly high. Unforeseen global events – including an escalation of the conflict in Ukraine – could push global price pressures higher, and elevated inflation expectations could become more embedded in domestic price and wage setting.

UK labour market defies worsening outlook

The labour market continues to resist the general loss of momentum in the UK economy. In the three months to October, employment and unemployment both increased modestly, compared with the previous three months, due in part to a fall in the number of economically inactive people aged 50 to 64 years old. On the demand side, vacancies declined modestly but the vacancies-to-unemployment ratio (at around one) remains high by recent historical standards.

Pay growth has not relented, likely reflecting the continued tightness of the labour market. Growth in regular nominal economy-wide pay (excluding bonuses) edged up to 6.1% y/y in the three months to October. This was the fastest growth recorded outside the pandemic period, but headline regular pay growth still trails CPI inflation. It is notable, especially in light of ongoing industrial action, that the gap between private (6.9% y/y) and public (2.7% y/y) sector regular nominal pay growth is now among the widest seen by the ONS (since comparable records began in 2001). We expect pay growth to remain around 6% y/y, before slowing from mid-2023, as labour market slack widens.

In our latest forecast, we take the view that the UK labour market has likely passed its peak tightness, even though measures of labour shortages remain elevated by historical standards. This assessment is underpinned by several months of falling vacancies, together with first (slight) reduction in headcounts since February 2021 in December's composite PMI. Furthermore, labour inactivity edged down in the three months to October. However, it would be premature, bearing in mind the noisiness of the data, to take the latest readings as a definitive indication that labour market tightness, and associated pay pressures, are behind us.

Business view

- We continue to hear of recruiting difficulties and skill shortages from many firms, but different industries face different challenges.
- A professional services firm reported an exodus of older employees after the pandemic, meaning that projects have to be led by staff with less management experience than is usual.
- A construction firm saw significant employee churn post-Covid. The business will remain overstaffed, despite lower volumes, in order to avoid facing similar recruitment difficulties when trade improves.
- A manufacturer noted that certain skilled are still very difficult to recruit, but that resignations have dropped off steeply in recent weeks.



Employment rate

(Aug '22 – Oct '22)

75.6%

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



Unemployment rate

(Aug '22 – Oct '22)

3.7%

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



Real wage growth

(Aug '22 – Oct '22 on a year ago)

-2.7%

Real regular pay growth increased by 0.1pp from the previous quarter.



Productivity growth

(Output per hour, Q3 2022 on a year ago)

1.4%

Productivity increased by 1.0pp from the previous quarter.

Bank of England raises rates again

In December, the Bank of England's Monetary Policy Committee (MPC) voted by 6-3 to raise the Bank Rate by 50 basis points to 3.50%. The announcement was in line with our forecast and consensus expectations. The size of the Bank's latest rate hike was matched internationally by both the US Federal Reserve and European Central Bank in the same month.

The Committee's vote produced a three-way split, with the majority judging that tightness in the labour market and persistence in domestic price pressures warranted "a further forceful monetary policy response". Of those in the minority, two preferred to maintain Bank Rate at 3.00% and one preferred to increase Bank Rate to 3.75%. Those in the former camp took the view that monetary policy is already sufficiently restrictive, whereas the lone hawkish dissenting member was concerned that price and wage pressures would prove to be more persistent than previously expected.

As it stands, we expect Bank Rate to peak at 4% in March next year. There are risks to our forecast in both directions. On the one hand, rates could move higher if inflation is stickier to come down, but, on the other hand, they may not rise as much as expected if price pressures come off more definitively and/or the economy weakens more than we expect.

What does this mean for business?

- The latest MPC meeting minutes indicate that the majority of members expect further increases in Bank Rate will be required to return inflation to the 2% target.
- We expect the Bank of England to raise rates to 4% in early 2023 – higher than their current level (3%), but lower than markets had expected in the wake of Liz Truss' "mini-Budget".
- Interest rates are expected to stay at 4% through 2024, meaning that businesses will need to plan for the cost of borrowing remaining higher (by recent historical standards) going forward.



	2022	2023	2024
World (PPP)	3.1	2.2	2.7
UK	4.4	-0.4	0.2
US	1.8	0.5	1.0
Eurozone	3.3	0.5	1.4
China	3.3	4.6	4.1
Japan	1.6	1.8	0.9
India	6.6	5.7	6.9

3.1%

Global growth in 2022

2.2%

Projected growth in 2023

Global growth will slow next year, according to the OECD

According to the OECD's latest Economic Outlook, the world economy is on course for a significant slowdown in 2023. World economic growth is forecast to drop to 2.2% in 2023 before a subdued rebound to 2.7% the following year. The major Asian emerging-market economies are expected to account for close to three-quarters of global GDP growth in 2023, whilst the US and European economies slow sharply. Globally, growth prospects have suffered as a result of tighter monetary policy, persistently high energy prices, weak real household income growth, and declining confidence. The OECD considers energy prices, interest rates, and food insecurity to be the most significant downside risks to the forecast.

The outlook is particular bleak for the UK, where output is projected to contract by 0.4% in 2023 and rise by only 0.2% in 2024, reflecting reduced household purchasing power and subdued business investment. Meanwhile, annual growth in the Eurozone in 2023 is projected to be 0.5%, before picking up to 1.4% in 2024 as spending starts to recover. In the US, where tighter monetary policy is expected to weaken spending plans, GDP growth is projected to slow from 1.8% in 2022 to 0.5% in 2023, before picking up to 1.0% in 2024. China, which saw recurring waves of lockdowns disrupt economic activity in 2022, is expected to see growth of 4.6% in 2023 and 4.1% in 2024 – sustained largely by infrastructure investment.



The business view

How are businesses reacting to changes in the UK economy?

Labour market

Firms in some sectors still encounter acute labour & skill shortages when recruiting staff.

- An executive search firm reports that more candidates are renegotiating offers as they will typically have more than one.
- A chemical manufacturer has struggled to recruit experience professionals with technical backgrounds. In addition, the incidence of staff poaching has risen.
- A recruitment agency has found that digital and technology skills are in particularly short supply.
- A private health care provider reports severe labour shortages due to Brexit and related immigration restrictions.
- An industrial manufacturer has had to scale back investment because only 20% of desired staffing could be realised.

Investment & training

Amid a cost-of-living crisis and a tight labour market, firms are finding ways of attracting staff and supporting their workforce.

- A major hospitality firm and other industry groups have jointly undertaken a campaign to promote the industry as one in which it is possible to have a rewarding career.
- A major manufacturer has given all employees and contractors a £1,500 cost-of-living payment.
- An engineering firm has trialled giving employees discretionary time away from work during the daylight hours, which can be made up flexibly.
- A law firm has investing in management training courses for solicitors taking on leadership and project management roles.

Demand outlook

Consumer-facing firms detect faltering retail demand as households cut back on spending.

- A supermarket reports that consumers continue to trade down to basic items, make fewer impulse purchases, and reduce spending on 'big-ticket' items.
- An online retailer has noticed a shift in purchasing trends in lower-income customers. Sales are down overall, but categories such as energy-saving appliances have held up. A greater share of purchases has been made on credit.
- A brewery reports flat sales in pubs and falling sales in supermarkets. Customers downstream in the value chain are putting pressure on the brewery to forgo further price increases.

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