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.

Q2 2022: April - June

Quarterly economic highlights

1

UK GDP growth surprisingly strong in May

UK GDP grew by 0.5% in May, reflecting a rise in GP appointments and changes to bank holiday dates. Business surveys point to momentum remaining weak.

2

Cost of living crisis set to continue

Inflation hit a 40-year high in June and is set to remain strong for the remainder of the year as price pressures continue to work their way through the supply chain. We expect inflation to peak again in Q4 then begin to ease over 2023.

3

Labour market remains tight

Employment levels continue to rise, with vacancies remaining near their record highs. We expect some softening in the labour market as demand wanes across the economy, pushing up unemployment slightly over the next year or so.

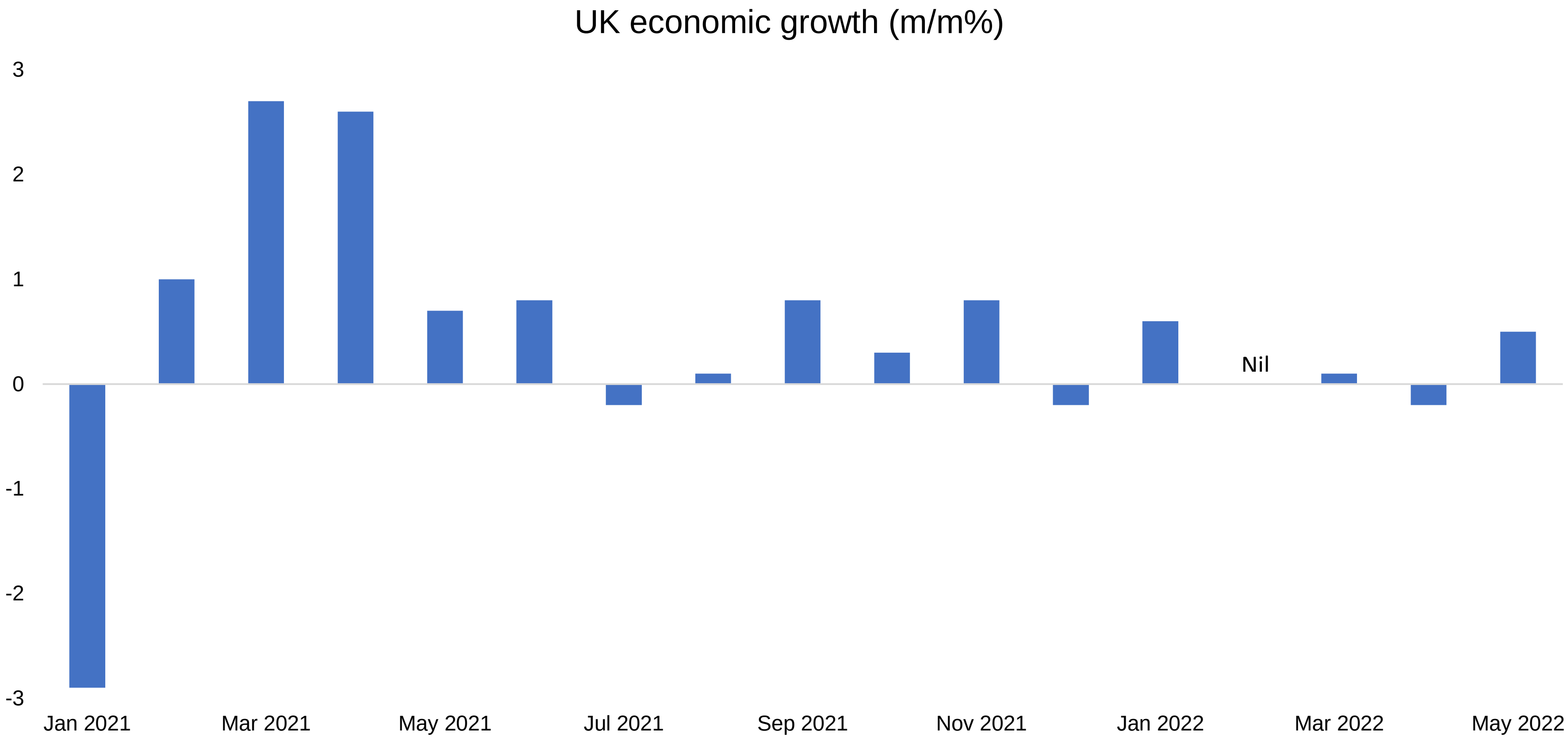
1.0%

The CBI now expects UK GDP to grow by 1.0% in 2023, a sharp downgrade of 2.0% points from our December 2021 forecast.

This quarter at a glance

1. Economy grew in May, but momentum remains weak →
2. Private sector activity growth eases notably →
3. Pipeline cost pressures drive inflation higher →
4. Commodity prices starting to ease →
5. Real pay growth falls rapidly →
6. Bank of England raises rates again in June →
7. Global growth forecast downgraded across the board →
8. How are businesses reacting to changes in the UK economy? →

Economy grew in May, but momentum remains weak



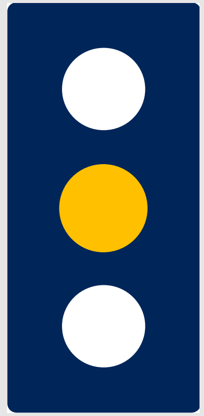
+1.7%

UK GDP in May 2022 was 1.7% above Feb 2020 levels

The UK economy grew by 0.5% in May month-on-month, outperforming expectations by some margin (consensus forecast was for growth of just 0.1%). This strong and broad-based growth, alongside upwards revisions to March and April data, left GDP 1.7% above its pre-pandemic level.

However, the pace of economic growth in May was pushed up by some temporary factors, which may unwind in June. Services growth was largely driven by a sharp rise in GP appointments, which may or may not be sustained. Data was also likely flattered by an extra working day in May, given the shifting of the bank holiday to early June. This, alongside the extra bank holiday for the Queen's platinum jubilee, will likely lead to a fall in GDP over June.

Even accounting for the "noise" in the GDP data over the next few months, the economy is likely to show further signs of weakening. One particular weak spot was output in consumer-facing services, which fell by 0.1% in May – possibly reflecting early signs of households reigning in discretionary spending in the face of a strong cost-of-living squeeze.



+5%

CBI Growth Indicator: **Amber**

Private sector activity expanded marginally in the three months to June

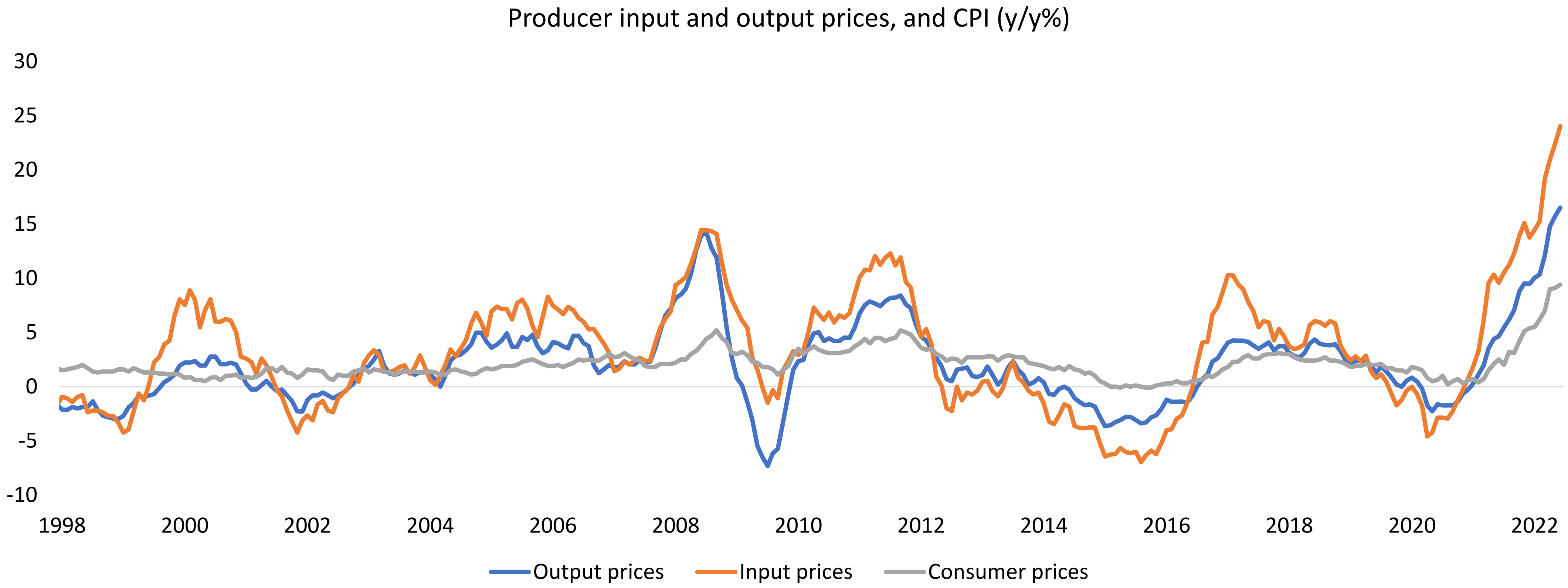
Private sector activity growth eases notably

Private sector activity rose only slightly in the three months to June, representing the weakest growth since April 2021. The deterioration was most marked in consumer services, which saw the sharpest fall in business volumes since February 2021. However, slower growth was also evident across other business & professional services and distribution. Only manufacturing output posted solid growth, albeit easing slightly on the ten-month high seen in the three months to May.

Activity is set to be flat in the next three months, marking the second consecutive survey in which businesses expect no growth. Consumer services firms expect another heavy decline, distribution sales are set to fall slightly and business & professional services firms predict stagnation. Only manufacturing output is set to grow solidly, albeit at a slightly slower pace once again.

Overall, the latest softening in private sector growth chimes with the underlying themes in our economic forecast. We expect much weaker growth ahead, as high inflation leads to a historic squeeze in households' incomes and sparks a full year of falling consumer spending. While we don't expect the economy to fall into a technical recession, it's becoming clearer that businesses will be exposed to a much weaker demand environment in the year ahead.

Pipeline cost pressures drive inflation higher

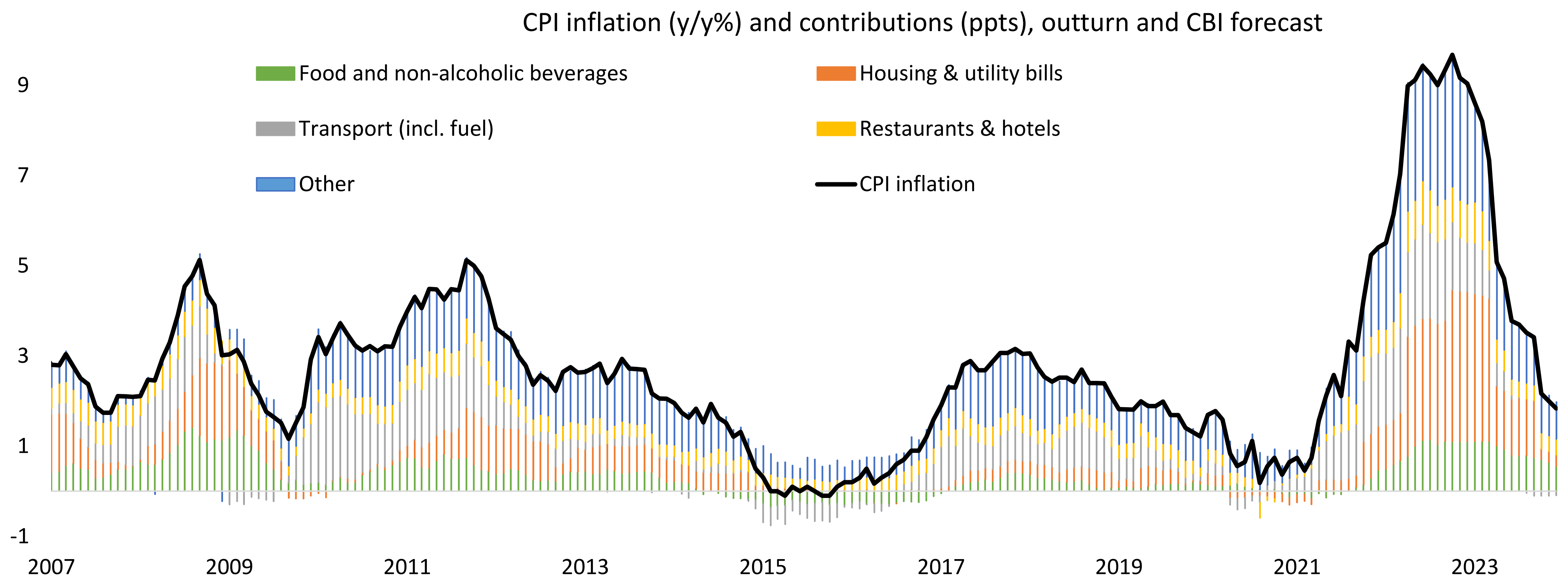


CPI inflation picked up to 9.4% in June, hitting a new 40-year high for the third consecutive month. Core CPI inflation fell for the second consecutive month (5.8% from 5.9% in May), reflecting the increased influence of volatile components such as food and fuel in recent inflation data. The UK continues to have the highest inflation rate in the G7, although inflation is slightly higher for the EU as a whole (9.6%). The latter is driven largely by price pressures in Baltic countries, which rely heavily on imported energy.

Producer input price inflation (i.e. the price paid by manufacturers for raw materials) rose to 24.0% in June, the highest rate since records began in 1985 while producer output price inflation (i.e. the "factory gate" price charged by manufacturers for finished goods) rose to 16.5% in June, the highest rate since September 1977. There are clear signs that inflation pressures, which originally were largely goods-specific, continue to broaden out to other areas of the economy. Services producer price inflation hit 5.4% in Q2, a record high.

Our expectation is for inflation to remain high over the coming months, followed by a second peak in October as Ofgem are expected to raise the energy price cap again. However, inflation should start falling back over 2023, as weaker household demand, softer labour market conditions and the Bank's rate rises take some of the impetus out of price pressures. However, risks also remain to the upside, with pipeline pressures remaining strong and geopolitics threatening to impact gas prices/availability over winter, and food prices/availability over the next year or so.

Some commodity prices starting to ease



Global commodity prices have diverged in the last couple of months. While energy prices generally remain elevated (and quite volatile), non-energy commodity prices have generally fallen back sharply since early June – as rising interest rates, a stronger US dollar and concerns about a slowdown in the global economy have weighed on investor sentiment. Prices for a range of industrial metals, which spiked following Russia's invasion of Ukraine, are now back below their pre-war levels.

Food prices have softened too. For example, wheat is down 36% from its February 2022 peak, with initial concerns over disruption to Russia's food exports diminishing and better-than-expected harvests in other major producers lowering global prices too.

However, global food supply conditions remain tight, thanks in part to high agricultural input costs (especially for fuels and fertilisers, but also labour, transport and packaging). This leaves prices sensitive to poor harvests, with ongoing droughts in several countries still a concern. Food prices are likely to remain a key driver of consumer price inflation in the UK through much of 2023.

It will still take time for the impact of past commodity price increases to feed through supply chains, and we do not expect any significant easing in consumer price inflation until early 2023. A key risk to the inflation outlook is the prospect of a renewed surge in energy prices as Russia scales back pipeline deliveries of gas to the Continent, which is a big concern for Europe's economic outlook as Winter 2022 approaches.

Real pay growth falls rapidly

Recent ONS data shows a continued tightening of the labour market, with employment increasing by 296,000 in the three months to May 2022, compared with the previous quarter. The employment rate increased by 0.4pp to 75.9%, while the unemployment rate stood at 3.8%, a drop of 0.1pp on the previous quarter.

While this tightness increases pressure on firms to pay more to retain and attract talent, wage growth continues to trail behind inflation. As a result, real regular pay growth (excl. bonuses and adjusting for CPIH inflation) has fallen by -2.8% on the year to May, which is the lowest since records began.

There are signs that labour market tightness could be nearing or at its peak. The pace of growth in vacancies has slowed to a near-halt in the three months to June according to official data, with indicator data from Adzuna pointing to vacancy levels now beginning to fall. The economic inactivity rate has also fallen recently (0.4pp over the last quarter) and is now at 21.1%. This has been driven mainly by people who were previously not looking for a job but now are. Business survey data also points to expected employment growth starting to ease.

We expect a modest rise in unemployment over our forecast, with the rate hitting 4.1% at the end of 2023 (from its current level of 3.8%). However, this still represents a relatively tight labour market, with the unemployment rate remaining close to historic lows.

Business view

- Labour and skill shortages remain a major issue in a majority of sectors. Recruitment has been reported as a big challenge, while retaining existing employees became harder due to inability to keep up with wage demands.
- Member insight points to firms continuing to face wage pressures due to labour shortages and the cost of living crisis, but they are balancing these against wider cost pressures.

Employment rate

(Mar ’22 – May ’22)

75.9%

The employment rate rose by 0.4pp on than the previous quarter.

Unemployment rate

(Mar ’22 – May ’22)

3.8%

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

Real wage growth

(Mar ’22 – May ’22 on a year ago)

-2.8%

Real regular pay growth decreased by 0.6pp from the previous quarter.

Productivity growth

(Output per hour, Q1 2022 on a year ago, flash estimate)

-0.8%

Productivity fell 0.7% between Q4 (Oct to Dec) 2021 and Q1 (Jan to Mar) 2022.

Bank of England raises rates again in June

The Bank of England's Monetary Policy Committee (MPC) voted to raise its key interest rate by 0.25bps for a fifth successive time in June, bringing the rate to 1.25%.

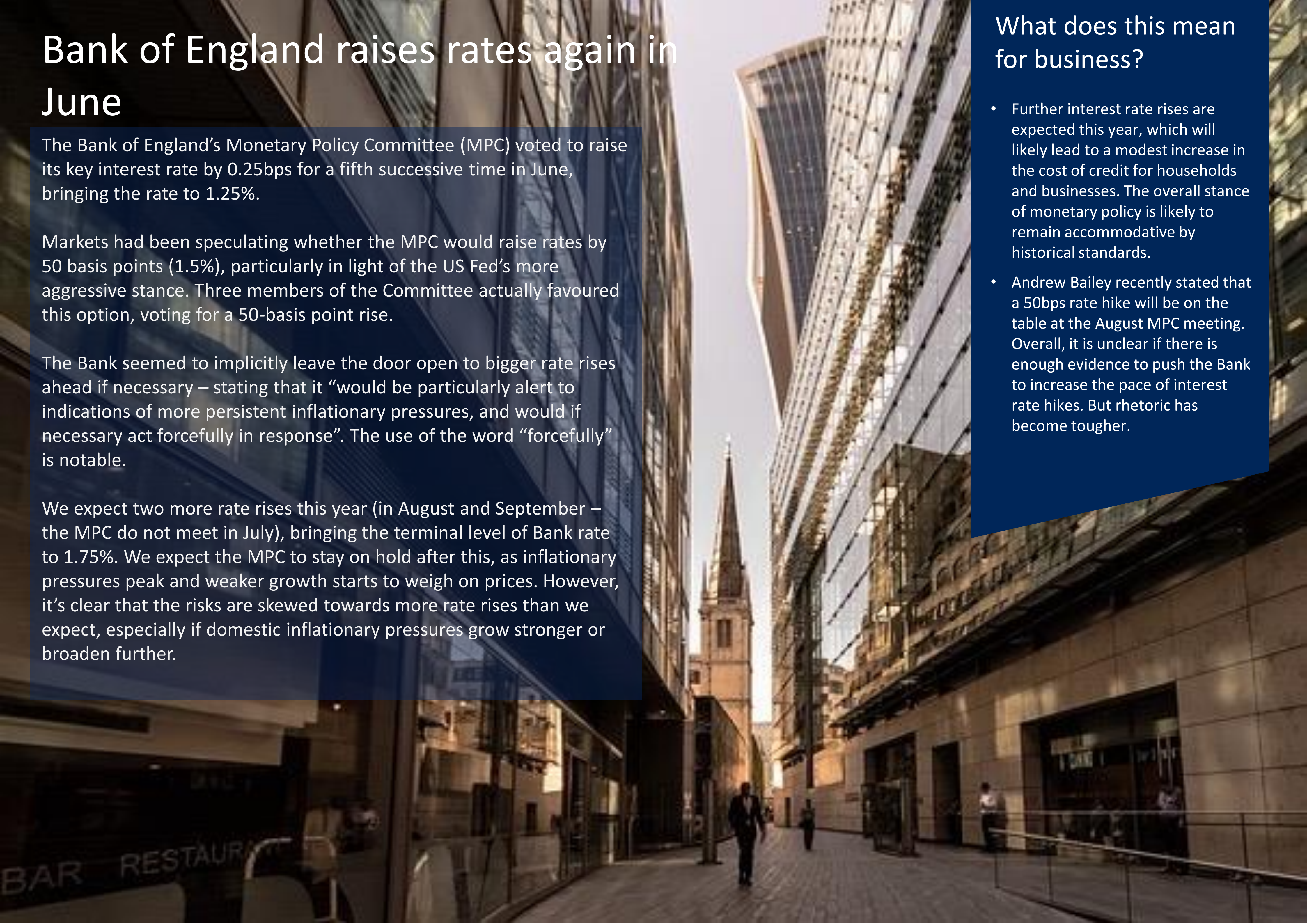
Markets had been speculating whether the MPC would raise rates by 50 basis points (1.5%), particularly in light of the US Fed's more aggressive stance. Three members of the Committee actually favoured this option, voting for a 50-basis point rise.

The Bank seemed to implicitly leave the door open to bigger rate rises ahead if necessary – stating that it "would be particularly alert to indications of more persistent inflationary pressures, and would if necessary act forcefully in response". The use of the word "forcefully" is notable.

We expect two more rate rises this year (in August and September – the MPC do not meet in July), bringing the terminal level of Bank rate to 1.75%. We expect the MPC to stay on hold after this, as inflationary pressures peak and weaker growth starts to weigh on prices. However, it's clear that the risks are skewed towards more rate rises than we expect, especially if domestic inflationary pressures grow stronger or broaden further.

What does this mean for business?

- Further interest rate rises are expected this year, which will likely lead to a modest increase in the cost of credit for households and businesses. The overall stance of monetary policy is likely to remain accommodative by historical standards.
- Andrew Bailey recently stated that a 50bps rate hike will be on the table at the August MPC meeting. Overall, it is unclear if there is enough evidence to push the Bank to increase the pace of interest rate hikes. But rhetoric has become tougher.



	2021	2022(F)	2023(F)
World (PPP)	6.0	3.1	3.4
UK	7.4	3.7	1.0
US	5.7	2.4	2.3
Eurozone	5.3	2.5	2.4
China	8.1	4.0	4.8
Japan	1.7	2.4	1.7
India	8.1	7.2	6.5

3.1%

We forecast that global growth in 2022 will be 3.1%, before rising slightly to 3.4% next year.

-1.6pp

Our June economic forecast saw a 1.6pp downgrade to growth compared to our previous forecast from December 2021.

Global growth forecast downgraded across the board

We've downgraded our global growth forecast across the board for 2022, reflecting a weak start to the year (partly due the Omicron wave), and high inflation hitting household incomes and spending across the world.

There is a growing recessionary risk for the US economy as the Fed raises interest rates more quickly than many other advanced economies, adding a stronger headwind to growth. US interest rate rises also have implications for emerging markets, which are likely to see capital outflows as a result, at the same time as they face high food price inflation and food security concerns given the war in Ukraine and a heatwave in India and across Europe.

Our forecast for growth in the EU saw a particularly large downward revision as certain member nations (such as the Baltics and Germany) are more reliant on Russian fuel than most and face a greater economic risk from reduced supply of energy from Russia. Some EU countries (such as Italy and Greece) continue to hold a high level of debt in comparison to GDP so may face greater financial strain as interest rates begin to rise.

The situation in China is more unique, as the economy has not been facing the same rate of inflation as many other countries (CPI inflation hit 2.5% in June). However, consumers still suffer from a lack of confidence, leading to a reduction in spending. One primary source of this weakness is the fallout from the Evergrande crisis, which has rippled through the real estate sector and hit disposable incomes. On top of this, China's continued 'zero covid' policy has led to strict lockdowns and a large degree of uncertainty around the near-term outlook, causing many consumers to build precautionary savings.

We do expect global growth to recover somewhat in 2023 to 3.4%, as inflationary pressures begin to wane, however risks remain weighted to the downside, largely reflecting ongoing supply chain disruptions and price pressures, with the Covid pandemic still having the potential to cause disruption.

The business view

How are businesses reacting to changes in the UK economy?

Demand

Some firms have seen demand negatively affected by increased cost of living.

- A transport firm is planning for a downturn in demand from October but there are no signs of a slowdown at the moment
- A manufacturer is seeing the chemicals industry de-stocking generally, with many running at 50-70% capacity. Demand is low overall while margins remain paper thin.
- A retailer has seen the cost of living start to bite since Easter, as consumers tighten their belts.

Supply chain disruptions

Many firms are still affected by cost pressures caused partially by supply chain disruptions.

- A manufacturer is challenged by the 150-180% increase in steel costs due to invasion of Ukraine. They are planning to adapt their operations by sourcing steel from China to mitigate costs.
- An alcoholic drinks manufacturer has seen 7% inflation across the board, they have increased prices by 8% in January and hoping to delay any more price rises until the Autumn.
- FMCG and food manufacturers have separately pointed to sharp increases in costs, but are mostly taking the hit to margins as retailers are aggressively pushing back on price rises.

Labour market

Many firms continue to face recruitment difficulties.

- A regional airport has reduced flights by 10% due to staff shortages, they have done this early to try and reduce issues over the summer.
- A manufacturer is seeing demand for hours changing, over-time is becoming less appealing and staff are wanting to work 8-hour days. This is causing issues for their sites as they operate 24/7.
- A distribution firm continues to struggle to hire warehousing staff. They have done all they can to make themselves an attractive employer and are paying above the Living Wage. The supply chain continues to be under immense stress due to the shortage of seasonal workers.

CBI Economics

Powered by CBI Economics surveys

To benefit from the full survey results, participate in the next survey and you’ll receive the results for free.
If you don’t want to participate, you can also pay a subscription fee.
For more information, email SurveyManagementGroup@cbi.org.uk or call 020 7379 7400.