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 2022: January - March

Quarterly economic highlights

1

UK GDP growth remained strong in early 2022

UK GDP grew by 0.8% in January, after falling in December amid rising Covid-19 cases. CBI survey data indicates that the pace of growth remained strong in February and March.

2

Ukraine crisis likely to exacerbate cost pressures

Firms are working to understand the impacts of the tragic events in Ukraine on their business. Most immediately, the crisis has led to even higher and more volatile global energy prices. Prices of key Russian/Ukrainian exports have also risen, including a range of industrial metals and foodstuffs.

3

Firms continue to face labour shortages

Vacancy levels continue to set new records, while a rise in inactivity is adding to labour shortages faced by firms across the economy. Higher inflation is further adding to wage pressures, with expected pay growth continuing to rise.

3.8%

The OBR now expects UK GDP to grow by 3.8% in 2022, a sharp downgrade of 2.2% points from their October forecast.

"The outlook for growth and inflation is pretty bleak. The OBR now expect growth of around 3.8%, falling below 2% next year. The thing that caught everyone's attention was the forecast for inflation, which over the course of this year will average 7.8% and peak around 8.7% in the final quarter.

"Households in the bottom 20% of the income distribution who spend more on food and fuel, where the majority of inflation is coming from, will be more exposed and see inflation rates closer to 10% on average."

- Rain Newton-Smith, CBI Chief Economist

This quarter at a glance

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2. Private sector activity growth accelerates →
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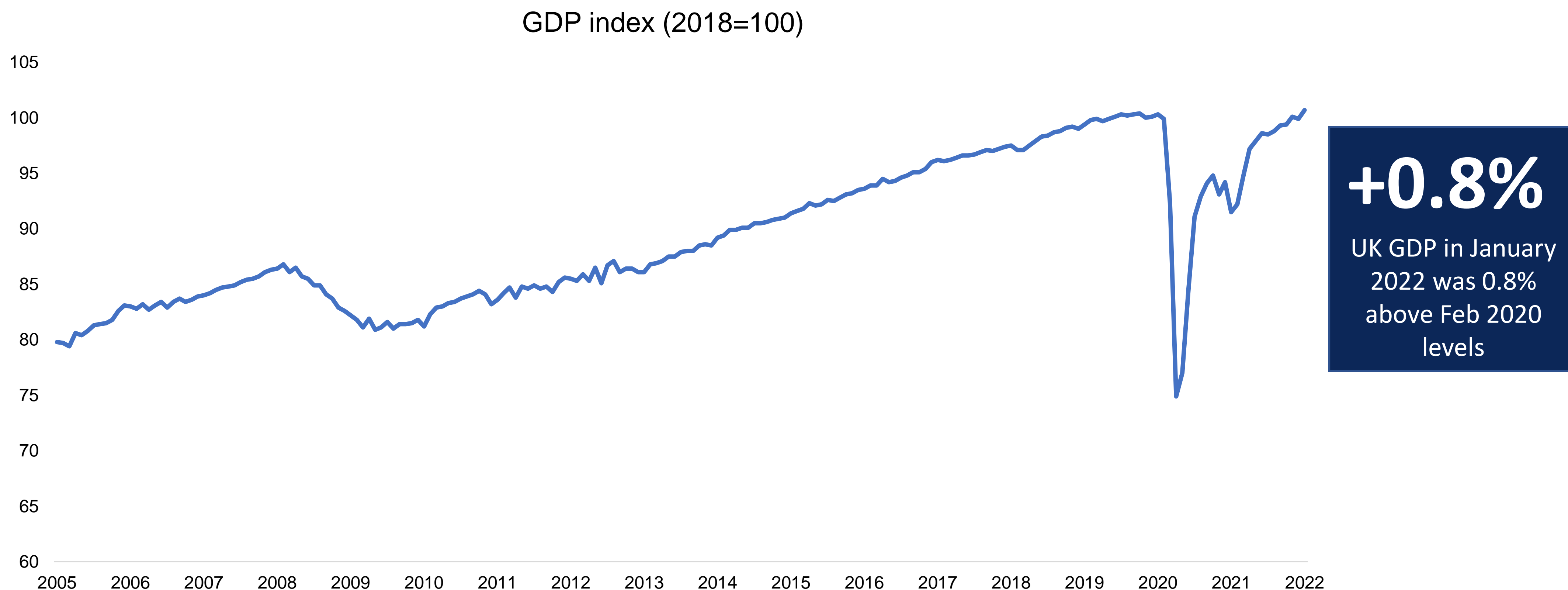
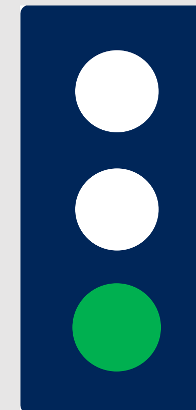
Economic growth rebounded in January



The UK economy grew by 0.8% in January, rebounding from a -0.2% fall in December 2021 as the economic impacts of Omicron subsided. Consumer-facing services saw a strong return to growth (1.7%), mainly driven by food services and retail & wholesale. Other services sub-sectors saw growth of 0.6%.

Manufacturing output expanded by 0.8%, with 10 out of 13 sub-sectors seeing growth. However, pharmaceuticals and transport equipment manufacturing saw sharp declines. Construction output saw robust growth (1.1%), with anecdotes suggesting some easing in materials shortages.

While consumer-facing sectors saw strong growth in January, activity remains 6.9% below pre-pandemic levels, with other services 3.4% above the level in February 2020. Manufacturing activity remained 1.6% below pre-pandemic levels, mainly driven by transport equipment (-29%) and coke & petroleum products (-19%).



+18%

CBI Growth Indicator: **Green**

Private sector activity expanded in the three months to March

Private sector activity growth accelerates

The latest CBI Growth Indicator suggests that growth in private sector activity accelerated in the three months to March compared with the same period one month previously. The pick-up was largely driven by business and professional services, where activity grew at the quickest rate since November 2021. Distribution sales volumes and manufacturing output grew at solid rates in the three months to March, and broadly similar rates to the same period a month earlier. However, consumer services saw activity decline, after a return to growth in the three months to February.

Looking ahead, private sector activity is expected to grow at a faster rate in the next three months. Within this, consumer services firms expect a strong return to growth, while business & professional services and manufacturing expect to maintain the solid growth seen this quarter. In contrast, distribution firms expect volumes to grow at a somewhat slower pace.

The survey field period this month opened the day after Russia's invasion of Ukraine. While the surveys suggest that economic growth generally held up in the three months to March, it's possible that full impact of the conflict in Ukraine is yet to come through. However, the fact that firms still expected growth to accelerate in the next three months may indicate initial expectations that the direct impact from the crisis on demand and output may be limited in the near-term.

The economic impact of the crisis in Ukraine

The shockwaves from the tragic events in Ukraine continue to reverberate around the global economy. The initial priority for CBI members was to support their people caught up in the conflict and the wider humanitarian effort, while the CBI has taken a role in coordinating this activity. Businesses have been fully supportive of the sanctions placed on Russia and have in many instances taken actions that go beyond these by suspending their activities with or within Russia. Some businesses do, however, have complex legal relationships that can't be ended overnight.

Russia's invasion has materially altered the near-term outlook for the UK and global economies, with increased uncertainty over the path ahead. Our initial analysis over the economic impact of the crisis has identified four main transmission channels:

Commodities: Higher energy prices are the greatest concern for the UK economy, which will result in further upward pressure on inflation and a modest hit to GDP growth over the next two years.

Supply chains: Higher prices for non-energy commodities, together with the potential for supply disruption, could exacerbate supply chain pressures in some sectors. Sectors at particular risk include petrochemicals, paper & pulp, automotive, technology and food & drink, given the prominent role of Russia and Ukraine in exports of key inputs/components.

Financial market exposure: Although individual banks and companies with operations in Russia and Ukraine are having to adapt to sanctions and voluntary curbs on business with Russian entities, Russia is a relatively small economy, which should help contain the risk of "contagion" through the global financial system.

Confidence: Consumer confidence had already weakened in February to its lowest in 13 months amidst rising inflation concerns. Business confidence and the willingness/ability to invest is likely to suffer—the first indications from CBI business surveys will be published in the coming weeks.

What are members saying?

Sanctions/self-sanctioning

- A car manufacturer has stopped production in Russia and has ceased supplying parts from UK to Russia, with ships turning back.
- A professional services company have stopped all Russian investments and connections. They say they have a significant level of Russian money invested in projects in London which are being put on hold.
- A broadcaster was looking to pull TV shows from Russia but the country's media laws made this difficult to do, while subscription services have already been able to pull out.

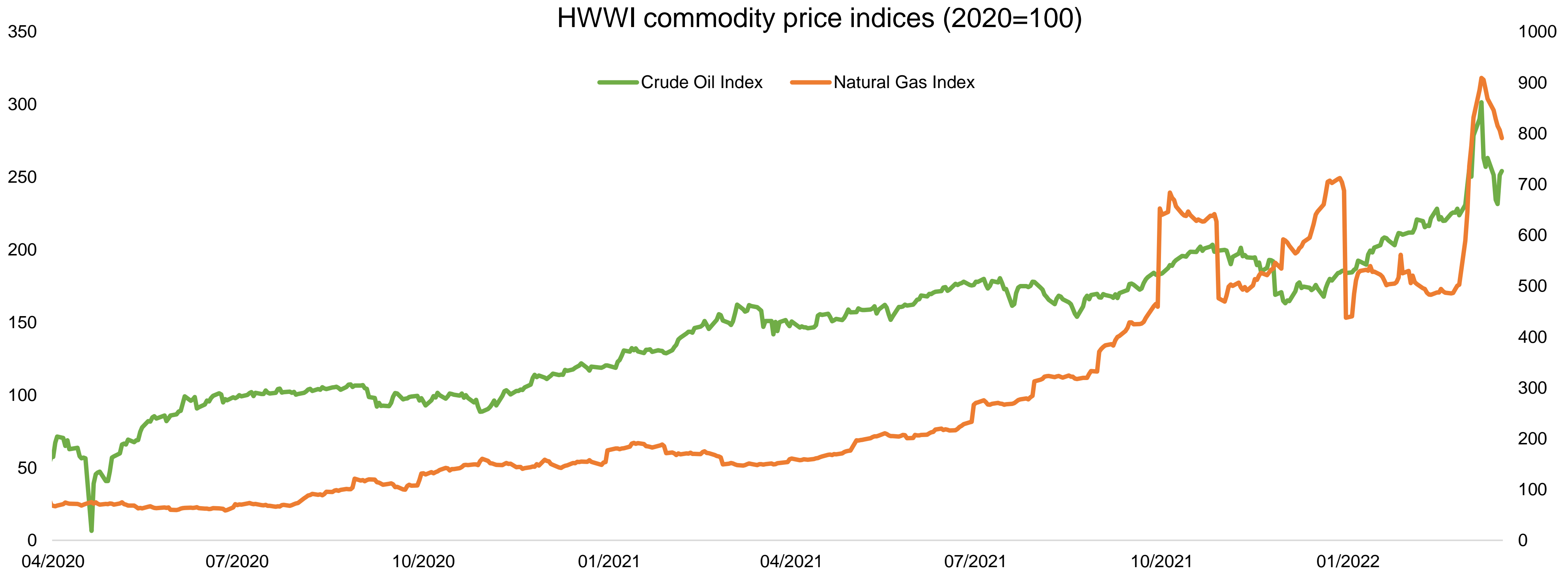
Supply chains

- A logistics firm is expecting an impact on their programme to replace their fleet with electric vehicles as many of the parts come from Ukraine.
- A port has a bioethanol plant which runs off wheat which may be impacted by shortages from Ukraine, with a lack of obvious replacement grains available.
- A machinery manufacturer gets 10% of their steel from Ukraine. While they can source alternative supplies, prices will rise sharply. However, their German factory will likely close as most of their steel came from Ukraine and Russia.

Energy and commodities

- In the farming industry, soaring gas prices are harming greenhouse growers. Cucumbers, aubergines and tomatoes are at risk and forcing farmers to downsize.
- A manufacturer said that a key supplier from Europe shut down production due to gas price increases.
- A grocer said higher prices for wheat and oil have added £100m of cost within 10 days, which was driving the need to look for alternatives.

Commodity prices pick up and become increasingly volatile

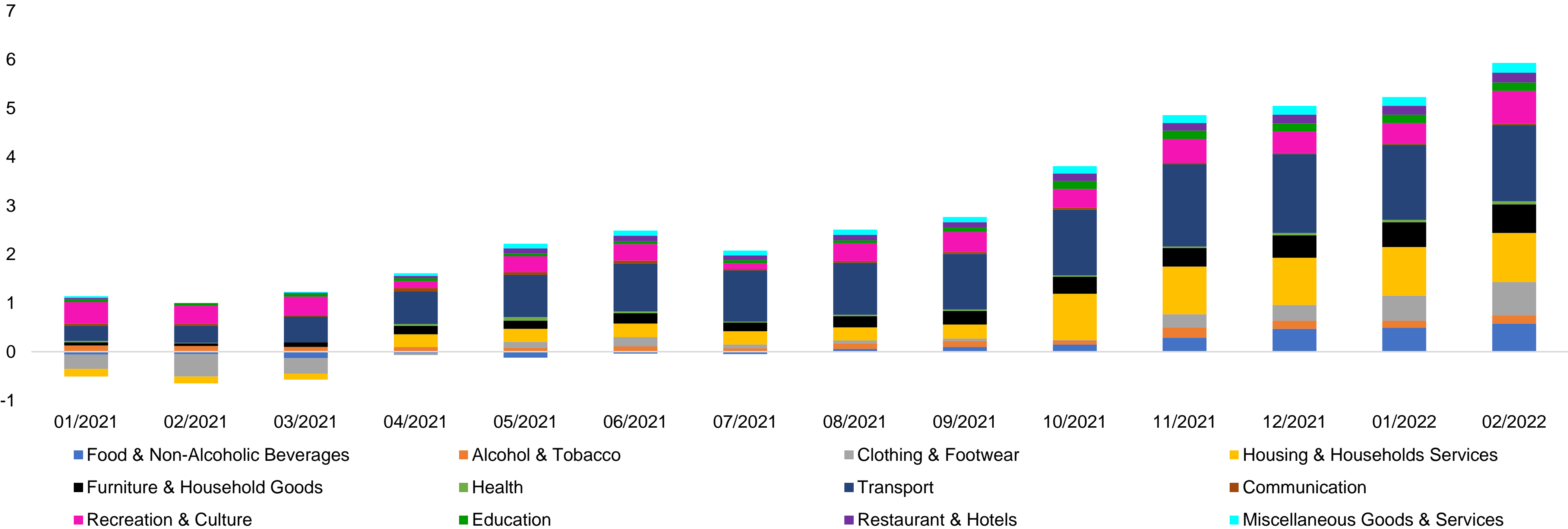


Initial reflections from CBI members appear to confirm that higher global commodity prices will be the most important of the four transmission channels from the Ukraine crisis. The UK gets only a small share of its energy from Russia, but the prices that companies and households pay are closely linked to developments in European markets. Russia is the biggest provider of gas to mainland Europe, as well as a major exporter of crude oil and refined petroleum products. So far, direct oil and gas flows via pipelines from Russia to Europe have continued, but seaborne trade of Russian oil, metals and grains is declining as traders struggle to secure insurance or letters of credit or voluntarily seek alternative suppliers.

With Russian supply effectively curtailed, commodity markets have been extremely volatile, with international oil prices moving sharply higher and Russian oil trading at a heavy discount. There has also been a broad-based rally in global prices for a range of commodities in which Russia and Ukraine specialise, notably including foodstuffs and a host of industrial metals.

This has already led to fuel price rises in March and raises the spectre of a further Ofgem price cap increase in October, while also adding to cost pressures throughout the supply chain (with this pressure increasing over time as fixed energy hedging contracts expire). Higher energy prices also have the potential to curb production in the most energy-intensive sectors, with member anecdotes already pointing to multiple examples where this is happening across Europe.

Cost of living squeeze continues



CPI inflation rose to 6.2% in February, the highest rate of price growth for 30 years. Inflation has broadly been driven by three major factors: Global energy price increases, particularly oil and natural gas (alongside associated changes to Ofgem's energy price cap); goods price inflation, driven by supply chain disruptions and high demand; and base effects, with price movements compared to those in last year's lockdown.

Producer input and output price growth picked up to 14.7% and 10.1% in the year to February, respectively. Considering global energy and commodity price movements following Russia's invasion of Ukraine, alongside a 54% increase in the Ofgem energy price cap in April, consumer price inflation is now expected to peak at around 8% in April (in line with the Bank of England's revised assumptions).

On the assumption that supply chain disruption eases (partly reflecting a recovery in spending on consumer services and softening in demand for goods), inflationary pressure should soften from mid-2022 onwards, although inflation is likely to remain above the Bank of England's 2% target well into 2023. Moreover, this is subject to a great degree of uncertainty: another large rise in Ofgem's price cap in October could lead to a further substantial rise in inflation later this year.

Labour market conditions remain tight

The number of people in work fell in the three months to January, as declining levels of self-employment more than offset continued growth in employee numbers. However, the employment rate actually rose in the three months to January, as more individuals left the labour force to become economically inactive, with the unemployment rate falling further to 3.9%. This chimes with member anecdotes of more resignations as people reflect on their career and life goals during the pandemic.

It is clear that the labour market is tight. Vacancies continued to grow in the quarter to February to a new record high, with member anecdotes continuing to point to firms across the economy struggling with labour shortages. Indeed, CBI survey data for Q1 found that the number of manufacturers/services firms expecting labour shortages to impact output/investment respectively remained at historically high levels.

One result of this has been to increase pressure on firms to increase wages. CBI survey data for Q1 points to mean expected wage growth for the year ahead picking up to around 3.5-4%. Inflation has also been providing a motivation to pay higher than usual wage increases, while simultaneously inhibiting the ability of many firms to do so due to their own cost pressures.

This rate of wage growth will not keep up with inflation, so real wages are likely to fall this year, and may not return to growth until some time in 2023. Alongside increasing mortgage repayments due to interest rate rises and upcoming personal tax changes, consumers will face a big hit to their purchasing power this year, which will feed through to weaker consumption growth.

Business view

- Many firms are struggling with labour shortages across the UK economy. Some of the issues that have been highlighted by businesses include higher levels of resignations, skills shortages, and the impact of EU migration flows.
- Labour shortages seem to be leading to wage inflation in certain in-demand roles, such as driving and lawyers. Wider pay awards are largely below expected inflation.

Employment rate

(Nov '21 – Jan '22)

75.6%

The employment rate rose by 0.1pp on than the previous quarter.

Unemployment rate

(Nov '21 – Jan '22)

3.9%

The unemployment rate decreased by 0.2pp from the previous quarter.

Real wage growth

(Nov '21 – Jan '22 on a year ago)

-1.0%

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

Productivity growth

(Output per hour, Q4 2021 on a year ago, flash estimate)

0.5%

Productivity rose by 1% from the previous quarter.

Bank of England raises rates amidst Ukraine uncertainty

The Bank of England's Monetary Policy Committee (MPC) voted 8-1 to raise its key interest rate for a third time in the current tightening cycle in March – to 0.75% (a rise of 25 basis points), bringing it back to the level before the pandemic.

Those voting for a rate rise were swayed by continuing signs of robust domestic cost and price pressures, and the risk that these would persist. In particular, tightening monetary policy was seen as reducing the risk of pressures on pay, domestic pricing and inflation expectations strengthening further, and becoming embedded.

However, there was explicit acknowledgement of the current trade-off in setting monetary policy; with Russia's invasion of Ukraine likely to both accentuate the peak in inflation, and the adverse impact on activity by intensifying the squeeze on household incomes. Jon Cunliffe – the one member who voted to keep rates on hold – placed much more weight on this trade off, requiring a "fuller assessment" of the balance between these pressures.

It was acknowledged that there was little evidence available yet on the impact of the Ukraine conflict on activity, though it has increased uncertainty around the economic outlook significantly. But reinforcing the nature of the trade-off facing the MPC, they now expect a much larger impact from energy prices on real aggregate incomes. How households react to this – i.e. by cutting real spending, or reducing their savings – was flagged as a key thing to watch further ahead.

What does this mean for business?

- There was a subtle change in language around guidance for future rate rises: the MPC now flag that some further modest tightening in monetary policy "might be" appropriate in the coming months, compared to the use of "likely to be appropriate" in previous meetings.
- Nonetheless, 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.

OECD estimate that the Ukraine conflict will lower global growth by just over 1% point in the first year

+2.5pp

OECD estimate that the Ukraine conflict will raise global inflation by around 2.5% point in the first year

OECD points to global growth impact of Ukraine crisis

The OECD provided an initial assessment of the global economic impact from the Ukraine conflict in March. This was based on simulations that considered the initial shocks seen to commodity and financial markets in the first two weeks since the invasion, plus the large declines in domestic demand in Russia and Ukraine. They do not incorporate many other factors that could intensify the impacts, such as further sanctions and consumer/business boycotts of Russia, while the outlook for commodity prices and the conflict itself is still highly uncertain.

The OECD expects the impact of the Ukraine conflict on global growth to be over 1% point in the first full year (their December forecast was for 4.5% growth in 2022 and 3.2% in 2023). Just under half of this impact comes from higher commodity prices, with the rest attributed to a decline in Russia's domestic demand (of over 10%) and financial shocks. The Euro area is expected to see a larger than average impact of 1.4% points, highlighting its reliance on Russian energy imports.

The OECD also expects the crisis to raise global inflation by around 2.5% points in the first full year (their December forecast was for 4.2% inflation in 2022 then 3.0% in 2023). Around 2% points comes from higher commodity prices, with the rest from Russia's domestic demand and financial shocks.

The crisis is creating additional fiscal pressures at a time that many governments were looking to tighten fiscal policy following . The OECD simulated the economic impact of well-targeted rises in government spending of 0.5% of GDP for one year to cushion the blow of commodity and food price increases and found it would reduce the impact of the crisis on GDP for OECD economies by around a half.

The business view

How are businesses reacting to changes in the UK economy?

Demand

Demand seems to remain firm, but concerns around the impact of inflation are growing.

- Some retailers have noted a shift in consumer behaviour, such as looking towards refurbished rather than brand new electronics or buying more budget range food.
- A machinery manufacturer usually has a 1-2 month order book but right now it is 9. Demand for capital equipment is exceptionally strong and the problem for them is meeting this demand.
- An airport is seeing a stronger than expected recovery, driven by leisure. They are looking at their busiest summer season ever, although due to low business travel numbers, it may take till 2025 to return to 2019 passenger numbers overall.

Supply chain disruptions

Many firms are experiencing ongoing supply chain disruptions.

- A construction and engineering firm is currently being quoted six weeks for deliveries, with a supplier blaming high demand and panic buying rather than supply issues.
- A gas products manufacturer's largest supply issue was a driver shortage, and while this had more or less recovered, they are still dealing with some of the backlog it caused.
- A manufacturer is currently waiting 12 weeks to get products shipped into the UK, after a period of improvement where it had fallen from 8 weeks during the pandemic to 6. The problem seems to be delays at ports in both the UK and US.

Labour market

A majority of firms are facing some form of labour shortage, most commonly related to hiring new workers.

- A technology company said that the skills shortage is a major barrier to investment. They are successfully recruiting graduates but having a hard time locating experienced staff.
- A law firm believes there is latent demand within the industry but they are being held back by the lack of skills.
- A manufacturer is concerned about the rise in economic inactivity, as people are choosing to retire or not to work. They are trying to grow but losing 20% of staff to churn, not helped by competitors who can offer higher salaries.

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