

## 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 2023: July - September



# Quarterly economic highlights

## **The UK economy weathered the pandemic better than previously thought, but momentum has been weak since**

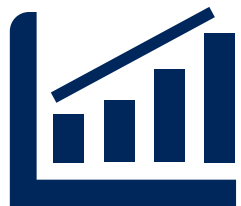
GDP fell 0.5% m/m in July as industrial action and poor weather weighed on activity. While growth has been relatively weak over 2023, ONS data revisions show the UK had a more robust recovery from the pandemic, comparable to the rest of the G7.

## **CPI inflation has fallen back over the summer, but domestic price pressures remain a concern**

Rising interest rates were accompanied by a fall in headline inflation, down to 6.7% in August but still well above the Bank of England's 2% target. Strength in the core and services measures suggest price pressures will unwind slowly.

## **Wage growth in the private sector has so far defied rising unemployment and cooling labour demand**

Employment and vacancies fell in Q3, suggesting firms' hiring intentions have weakened. Even alongside rising unemployment and a gradual improvement in inactivity, wage growth in the private sector has maintained a historic pace.



# 0.3%

The latest OECD forecast shows the UK economy growing by 0.3% in 2023.



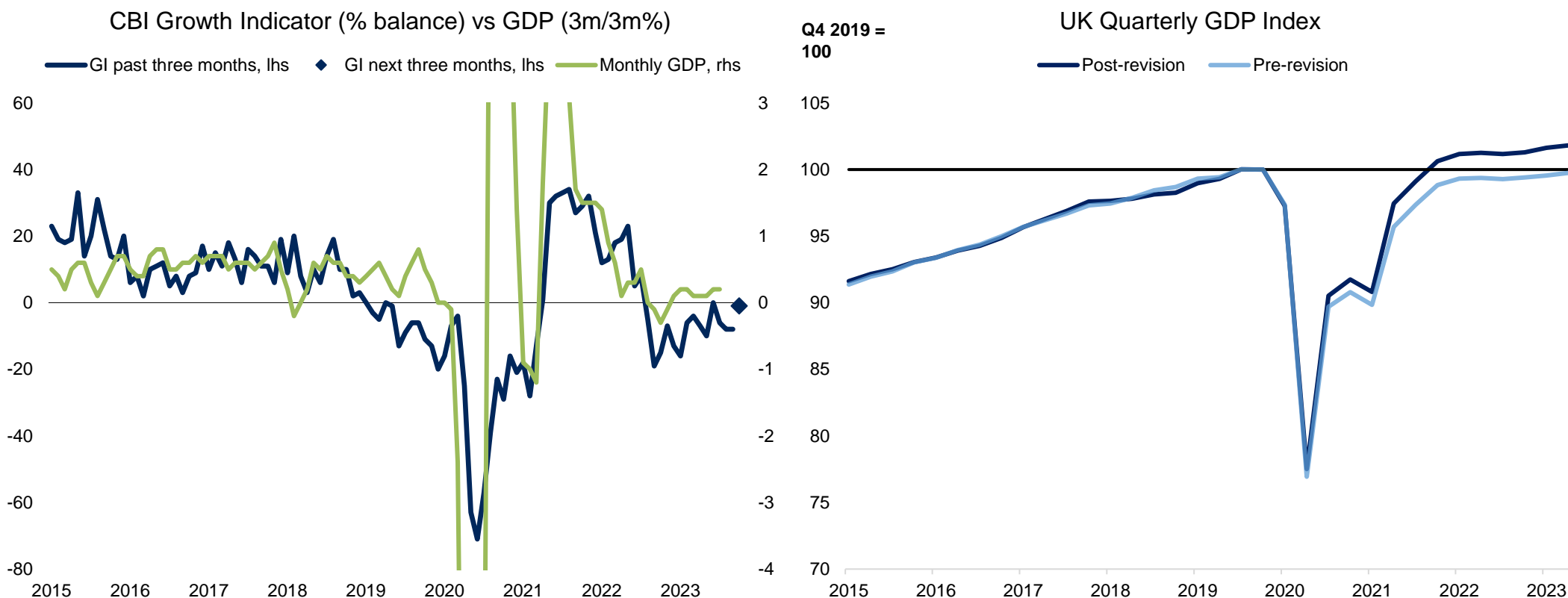


# Quarterly economic highlights

- 1 UK economy has stagnated over the first half of 2023 →
- 2 Private sector unlikely to see growth through year's end →
- 3 CPI inflation cooled steadily over the summer →
- 5 Pay growth defies early signs of labour market loosening →
- 6 Falling inflation gives Bank of England pause for thought →
- 7 OECD expects global growth to remain weak →
- 8 How are businesses reacting to changes in the UK economy? →



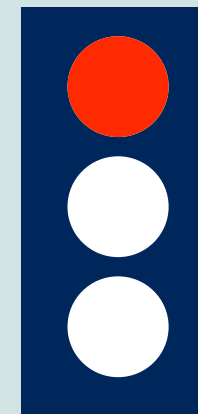
# UK economy has stagnated amid industrial action and poor weather



The UK economy saw a lacklustre start to Q3 2023, with GDP falling by 0.5% month-on-month (m/m) in July following growth of 0.5% in June. July's contraction was broad-based, with services, production, and construction all reporting a fall in activity. Disruption from industrial action and wetter-than-usual weather (with it being the wettest July since 2009) likely played a role in the decline in output over the month. On a rolling 3-month basis, GDP still managed to grow by 0.2%. Taken together with the weak outlook from recent business surveys, these data underscore the anaemic momentum in the UK economy currently.

Looking further back, recent ONS revisions painted a brighter picture of the UK economy's performance during the pandemic. These updated historical estimates showed that GDP fell less sharply in 2020 and rebounded more forcefully in 2021 than previously thought. As a result, the UK economy regained its pre-pandemic size by the end of 2021. Growth was stronger in the first quarter of 2023 too (revised up to 0.3% from 0.1%), leaving GDP in mid-2023 at 1.8% higher than its pre-pandemic level, rather than 0.2% lower previously. These revisions mean the UK no longer exhibits the slowest pandemic recovery among the G7 countries.

September's GDP revisions also revealed that real household disposable incomes grew meaningfully in Q2 2023, chiming with the resilience reported by consumer-facing sectors and the general improvement in consumer confidence. Strong pay growth and cooling inflation may support consumer spending in the near term, but households still face rising interest rates and the prospect of a weakening job market. Tighter financial conditions and an uncertain global outlook will likely weigh on growth more broadly going forward.



**-8%**

**CBI Growth  
Indicator: red**

Private sector activity  
contracted slightly in  
the three months  
to September

## Private sector activity unlikely to see growth through year's end

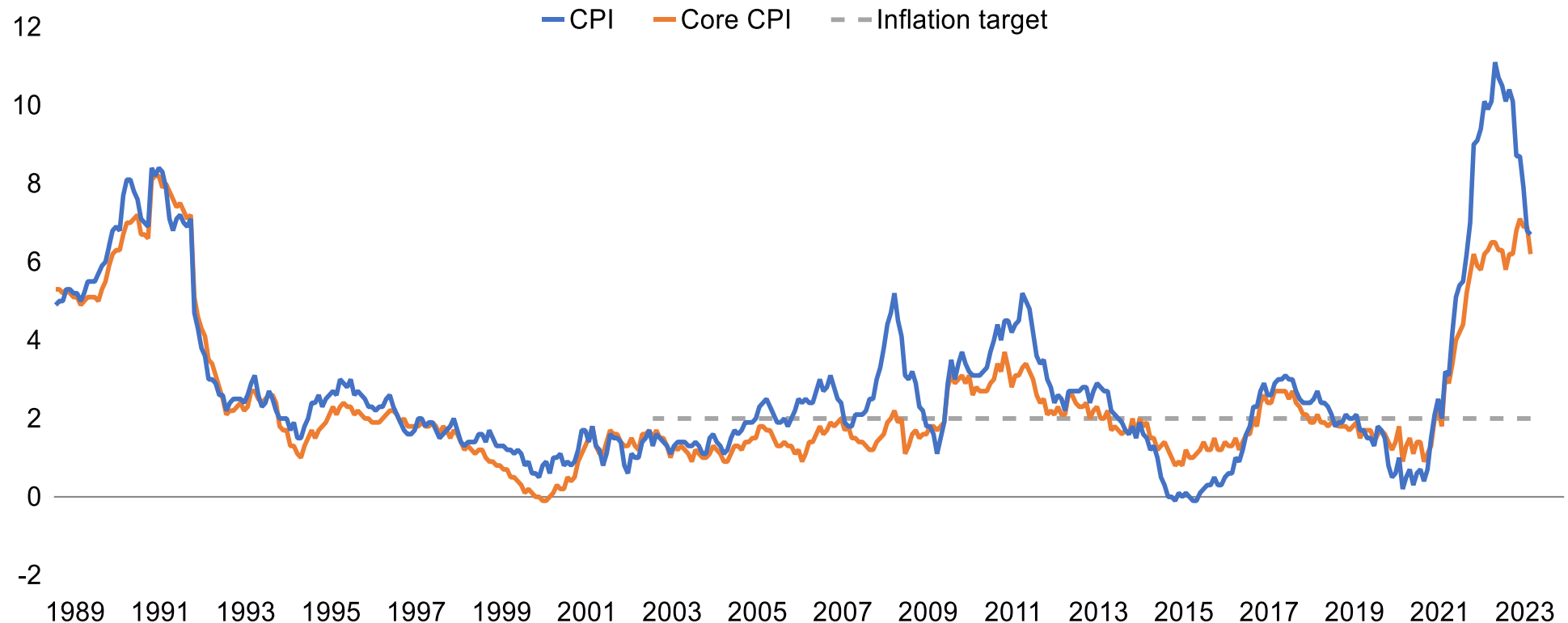
September's Growth Indicator showed that private sector activity fell slightly over the last three months, extending a mild downturn that stretches back more than a year. The services sector reported another fall in business volumes, reflecting contractions across both business & professional services and consumer services. Manufacturing also saw output decline in the quarter to September, while distribution sales were broadly unchanged.

Although our surveys suggest that the private sector will narrowly avoid a contraction in the fourth quarter of 2023, no sector anticipates meaningful growth. An anaemic outlook seems to have taken a toll on firms' hiring intentions this month. Overall employment in the private sector is expected to expand slightly over the next three months, but this is driven entirely by anticipated growth in business & professional services. Headcount looks set to fall in consumer services and distribution over the same period, while remaining broadly unchanged in manufacturing.

This month's Growth Indicator also revealed that selling price growth expectations in the private sector have settled at their lowest since March 2021. However, expectations remain slightly firmer than their long-run average. Notably, distribution price growth expectations eased to their weakest in three years.



# CPI inflation cooled steadily over the summer, but remains very high



UK CPI inflation fell to 6.7% in August (down slightly from 6.8% in July), coming in well below consensus expectations of an uptick to 7.0%. A surge in motor fuel prices, coupled with the introduction of new alcohol duties, had been expected to push headline inflation back up in August. However, slower growth in food and accommodation prices, coupled with falling airfares – a first for the month of August outside the pandemic – kept headline inflation on its downward trajectory.

Even more striking than headline fall in inflation was the deceleration in services inflation, a key indicator of domestic price pressures for Bank of England monetary policymakers. In August, the services measure fell back to 6.8% (from 7.4% in July), comfortably below the Bank's forecast of 7.2%. Even though the drop was accounted for in part by volatile categories (airfare, accommodation), underlying momentum appears to be subsiding, which may reflect the impact of tighter monetary policy on domestic demand.

Looking ahead, we expect headline inflation to continue falling over the rest of the year, as base effects in food, fuel, and energy unwind. Cooling pipeline pressures will pass through to lower goods inflation, while emerging labour market slack should exert downward pressure on wage growth and services inflation. However, the recent uptick in global oil and domestic fuel prices suggests that the path back down may be bumpier than previously expected.

# Pay growth defies early signs of labour market loosening

Employment in the UK fell in the three months to July, shedding 207k jobs compared with the previous three months and pushing the employment rate down to 75.5%. The decline, which was concentrated in self-employment, was sharper than typically seen outside a severe economic downturn, but the level of employment remains relatively high. Unemployment increased by 156k over the same period, meaning that the jobless rate reached its highest in almost two years (4.3% from 3.8% in the three months to April). Economic inactivity also picked up against the trend of recent months, rising to 21.1% as student enrolment grew and the number reporting long-term illness climbed to a fresh record high.

Recruitment difficulties, coupled with an uncertain outlook and elevated pay expectations, appear to be convincing firms to cut back on their hiring. Job vacancies continued to fall in the three months to August, slipping below 1 million mark for the first time in two years. With the latest fall, there are 1.44 unemployed persons for each job vacancy in the UK. The gradual increase in the ratio of unemployed to available jobs since its historic low in July 2022 (0.95) suggests the remarkable tightness of the post-pandemic labour market is waning.

Despite early indications of a cooling labour market, wage growth has maintained its historic pace. Regular wage growth in the private sector rose by 8.1% in the three months to August (from 8.2% in the previous three-month period), while pay growth in the public sector accelerated to 6.6%. Looking ahead, pay growth should begin to slow as hiring becomes more cautious and inflation continues to ease. In July, CBI surveys suggested private sector wage growth would slow from 5.5% to 4.1% over the next 12 months, which broadly accords with the outlook in other pay surveys.

## Business view

- A manufacturer has told us that, although their wage bill has been growing and demand is down, they are reluctant to let staff go because they have invested so much in them.
- A housing provider has seen staff turnover drop, but also report that many entry-level staff have left for competitors that can offer hybrid working. The business still struggles to find surveyors and IT professionals, which has been a long-standing concern.
- A technology services firm has seen salary expectations drop off for software developers, allowing the business to resume hiring to meet demand. This had not been possible for the last year, given local labour market conditions.



### Employment rate

(May '23 – Jul '23)

**75.5%**

The employment rate decreased by 0.5pp from the previous quarter.

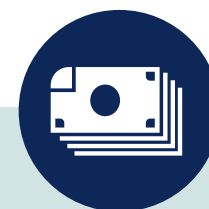


### Unemployment rate

(May '23 – Jul '23)

**4.3%**

The unemployment rate increased by 0.5pp from the previous quarter.



### Real wage growth

(Jun '23 – Aug '23 on a year ago)

**0.6%**

Real regular pay growth increased by 1.8pp from the previous quarter.



### Productivity growth

(Output per hour, Q2 2023 on a year ago)

**+0.1%**

Productivity increased by 0.7pp from the previous quarter.

# Falling inflation gives Bank of England pause for thought

The Bank of England's Monetary Policy Committee (MPC) voted to leave interest rates unchanged in September, holding Bank Rate at 5.25%. In doing so, the MPC halted (at least for now) a tightening cycle that stretches back almost two years. The US Federal Reserve also held rates steady this month (at 5.25-5.50%), while the European Central Bank opted for a 25 basis point hike (to 4.0%). Both signalled that rates were likely at or near their peak.

The MPC's decision to pause was very finely balanced, with the Committee splitting 5-4 in favour of keeping rates on hold. Indications of weaker activity and disinflationary momentum were sufficient to convince the (slim) majority of the MPC to keep interest rates unchanged this month, alongside an explicit acknowledgement that the current policy stance was restrictive.

Four of the Committee voted to raise interest rates by 25 basis points. These members put more weight on more positive forward-looking indicators of output and ongoing wage pressures stemming from a still-tight labour market. In particular, the persistent strength in private sector wage growth was undiminished in the latest data, pointing to the risk that inflation expectations remain undesirably elevated. Many on the MPC see the current pace of wage growth (8.1% in the private sector) as incompatible with a return of headline inflation to the 2% target, so the possibility of further rate hikes cannot be discounted just yet.

## What does this mean for business?

- Most analysts expect that we've now reached the end of the Bank's tightening cycle.
- However, the MPC appear to have left the door open to further rate rises, with their forward guidance largely unaltered.
- Additionally, recent MPC commentary suggests that policy would have to remain restrictive for an extended period of time ("sufficiently restrictive for sufficiently long") to bring inflation sustainably back to its 2% target.
- Taken together, businesses should expect interest rates to remain higher for longer, even if we don't see another hike in the coming months.



# Global growth set to remain weak, according to the OECD

The OECD expects the world economy to grow by 3.0% (revised up from 2.7%) in 2023, supported by lower energy prices and China's reopening. Global growth looks set to slow in 2024 (to 2.7%, revised down from 2.9%) as tighter monetary policy increasingly weighs on business activity and consumer spending.

The OECD forecasts that Asia will be a noteworthy driver of global growth in 2023 and 2024, despite China's sluggish post-pandemic recovery. Euro area growth is expected to be weak, at just 0.6% in 2023 and 1.1% in 2024, while the UK economy is anticipated to expand at a rate of 0.3% and 0.8% over the same years. The US is projected to see growth ease from 2.2% this year to 1.3% in 2024.

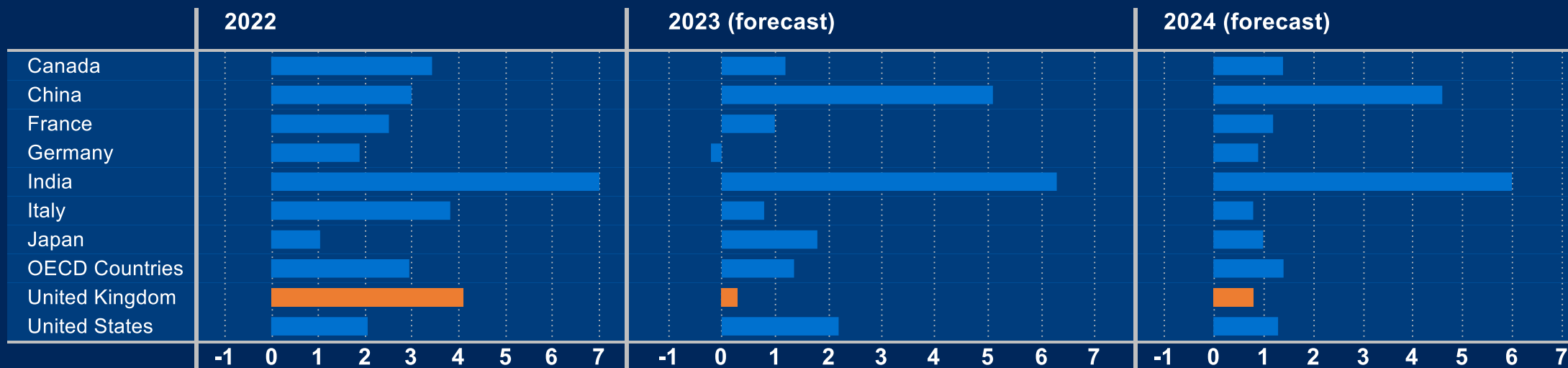
In the OECD's judgement, risks to global growth remain tilted to the downside. Inflation could prove more persistent than expected, which might lead to additional monetary tightening that provokes a more pronounced economic slowdown. Global growth could also be held back by persistently weak growth in China, as well as renewed disruption in commodity markets.

## 3.0%

Projected global growth in 2023

## 2.7%

Projected growth in 2024



# The business view

How are businesses reacting to changes in the UK economy?



## Demand conditions

**Although demand appears to be holding up for now, many businesses say that momentum in the economy feels fragile.**

- A biotech manufacturer reports that a drop in orders is the main constraint on their business, and that demand weakness has affected other firms too.
- An online retailer saw strong sales over the summer, but expects consumers to cut back on spending as savings from the pandemic are depleted and higher interest rates constrain their finances.
- A consumer goods packaging firm told us that sales volumes are down in the last three months due to poor weather conditions and the cost-of-living crisis.
- An aerospace manufacturing firm reports strong demand growth. Many suppliers are experiencing difficulties which are limiting their ability to deliver, so the firm is providing cash support to key partners.

## Cost pressures

**Energy costs are still very burdensome for some firms, while wage growth remains a significant challenge across most sectors.**

- A construction group has seen energy prices fall back somewhat, but still pay three times what they normally would.
- A digital agency still faces difficulties hiring, though these have eased after competitors suffered financial setbacks. Investing in employees' benefits has also shown results.
- A design firm has used one-off bonuses and more generous holiday allowances (5-10% of annual salary) to retain junior staff.
- A professional services firm has given staff a 5% wage increase this year in addition to two one-off, cost-of-living payments.
- A commercial printing company has had to increase salaries twice this year to retain staff. Increases averaged between 7 and 8%.

## Impact of rising interest rates

**Tighter financial conditions have reduced investment, raised costs, and/or held back demand for some businesses.**

- A furniture manufacturer fears that higher mortgage rates will lead to an extended slowdown in the housing market, which will dampen demand for furniture.
- A distillery has seen its loan repayments rise markedly. Higher cash outflows have drained their reserves, leaving the business in a vulnerable position.
- A law firm told us many businesses are running on minimal cashflows, without substantial reserves. Meanwhile, bank finance has become more expensive.
- A global bank reports that its advanced manufacturing clients have deferred investments in automation because funding costs are prohibitively high.

# 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](mailto:SurveyManagementGroup@cbi.org.uk) or call 020 7379 7400.