MONTHLY ECONOMIC INSIGHT

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Energy price rises and geopolitical concerns are the backdrop for the latest review. These developments also dominated the recent forecasts from the Office for Budget Responsibility (OBR) and the measures announced in the chancellor's mini-Budget. We take a look at the detail of these and some early signs of how they are being felt in the real economy.

OBR UPDATE AND MINI-BUDGET

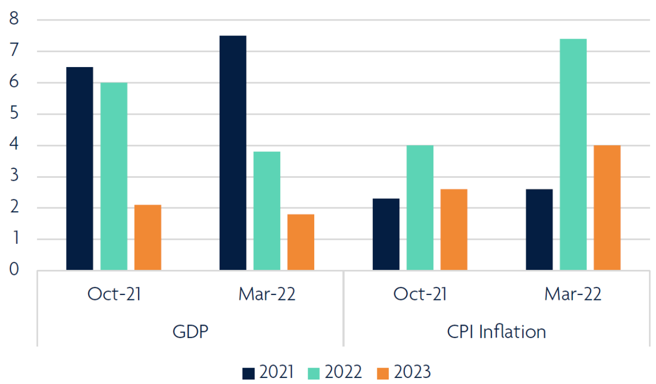
The latest OBR forecasts in March held a gloomier and more uncertain outlook for the UK economy compared with last October. As **chart 1** shows, growth is now predicted to reach 3.8 per cent in 2022 – a drop of more than a third compared with the previous forecast. Meanwhile, inflation expectations have nearly doubled: CPI is now expected to average 7.4 per cent for the year.

Against a backdrop of rising food and energy prices in addition to persistent supply chain disruptions, a further contributor to March's downward revisions to the forecasts was the Russian invasion of Ukraine in February.

As well as the tragic humanitarian consequences, the conflict is going to impose significant inflationary pressures upon the global economy. Despite less than four per cent of the UK's gas supply coming from Russia, the UK is still a net energy importer dependent on gas and oil. Therefore, domestic prices will be subject to rises in the global energy market. If wholesale prices remain in line with market expectations, the OBR forecast energy bills to increase by a further 40 per cent in October, on top of the 54 per cent rise on 1 April.

As a result, inflation is expected to continue outpacing nominal earnings, and when combined with the tax rises this month, real living standards in 2022 are set for the largest fall since the 1950s. It was, therefore, the forecast for household spending this year that saw the largest downward revision, with any continuation of a post-pandemic rebound essentially revised away. Some good news on the consumer-front, however, is that unemployment is forecast to remain low, at around four per cent this year.

Chart 1: Percentage annual forecast change in inflation and GDP



Source: OBR

Given the forecasts, the chancellor took steps to try to alleviate some of the cost of living pressures in his Spring Statement last month. Policies included raising the National Insurance threshold to align with personal allowance for Income Tax, cutting fuel duty by five pence per litre and reducing income tax by one per cent in 2024. These measures, alongside previous commitments such as the £150 council tax rebate and the £200 energy bill rebate, are intended to ease pressure on income for households as they look to cope with rising food and energy prices.

However, the chancellor is also maintaining his position on improving public finances, after public spending was an estimated £167 billion higher for the 2020/21 financial year than was planned due to the pandemic. To ensure this, the government has not reversed its scheduled rise to National Insurance contributions or the freeze to income tax thresholds outlined in the last Autumn Budget. When combined with last month's announcements, the resulting impact looks to be progressive while also maintaining debate about whether further action may be needed. The Resolution Foundation estimates the typical household will gain around £320, whereas the top 50 per cent of households will lose around £170 on average.

Households are expected to see a minimum rise of £693 to their annual energy bill from April, with some economic commentators indicating that the government may need to do more in supporting those on lower incomes, especially regarding benefits. Inflation-linked benefits and tax credits are historically uprated based on a lagged measure of inflation; this is normally not a significant issue, but with inflation up by 3.1 percentage points since October, the result is a substantial real benefits' cut to lower-income households.

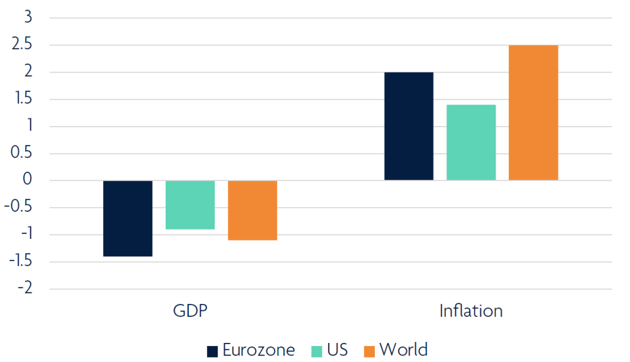
Overall, the chancellor's policies remain focused on improving the public finances despite the promise of tax cuts in the Spring Statement. The rise to National Insurance contributions, coupled with the fiscal drag caused by freezing the income tax thresholds during a period of high inflation, will aid in reducing the debt. The OBR predicts that government borrowing will fall from around 15 per cent of GDP in 2020/21 to around 1.5 per cent in 2024/25.

GROWTH DOWN, INFLATION UP, EVERYWHERE

The UK is not alone is experiencing growth and inflation consequences of the conflict in Ukraine. As noted above, the invasion of Ukraine has led to significant increase in wholesale gas prices, the potential for disruption to supplies, particularly into Europe and steep rises in a basket of commodity prices. This comes on the heels of rising prices and production bottlenecks that followed the post-pandemic reopening of the global economy last year.

Russia's dominance in oil and gas production – it accounts for around a fifth of global gas supply and a tenth of world oil production – has led to the spike in prices. In addition, both Russia and Ukraine are important producers of wheat, fertilisers, metals, and neon (used in semi-conductor manufacture), which has added further to inflationary pressure and the risk of supply shortages.

Chart 2: Simulated impact of Ukraine conflict on growth and inflation



Source: OECD

A recent interim forecast from the OECD (**chart 2**) looks at the potential impact of these factors on the global economy outlook this year. The simulation points to the eurozone's relatively higher exposure to Russian energy supplies and estimates that the conflict could shave 1.4 percentage points off growth this year. But the effects are global with world GDP set to be one percentage point than previously forecast.

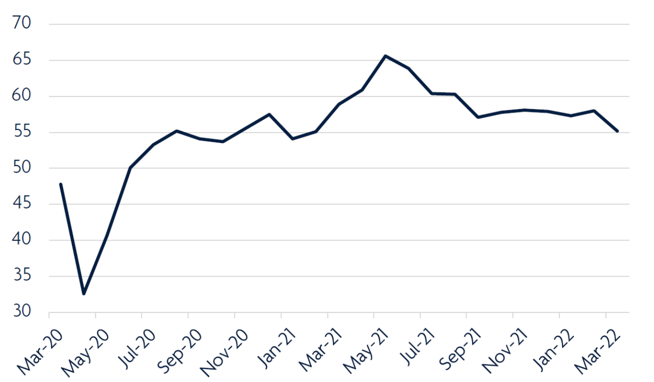
The inflationary impacts are stark. Inflation was already on the rise before the conflict, with US inflation accelerating to over seven per cent at the start of the year. Geopolitical tensions look set to add a further 1.4 percentage points to that this year, with global inflation around 2.5 per cent higher. None of this makes the task of central banks easier as they walk the tightrope of trade offs between anchoring inflation and the risks to growth.

While the global growth outlook is once again on shaky ground, these numbers are small beer compared with the direct impact on the Ukrainian economy. Focus Economics latest consensus forecast report points to a collapse of GDP of around 27 per cent as infrastructure is decimated and working-age people have fled the country.

BUSINESS CONFIDENCE STARTING TO WOBBLE

The challenges outlined above appear to be starting to bite in the real economy. Manufacturing activity, as measured by the PMI, while positive fell to a 13-month low in March (**chart 3**).

Chart 3: Manufacturing PMI, 50=no change



Source: S&P Global, CIPS

As we noted in February manufacturing was plagued with supply chain issues through much of last year, particularly affecting sectors such as automotive. In addition, we've already seen sharp rises in producer prices. While there had been expectations that these issues would right themselves this year, the Ukraine conflict has intensified concerns across the sector.

The survey reports that '*ongoing supply shortages, greater caution among clients, escalating inflationary pressures and geopolitical tensions had all hampered the upturn.*'

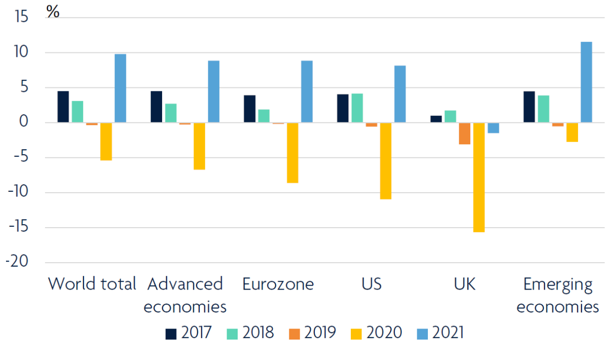
Manufacturers, which have been reporting rising input costs for more than two years, saw prices accelerate to a three-month high in March, with reports of pass through in higher selling prices. In addition, future optimism declined to rates not seen since the beginning of 2021. Despite this, businesses continue to recruit to address labour shortages and fulfil incoming orders. This will be a key component to watch in the survey given confidence is wavering against an ongoing uncertain outlook.

TRADE CATCH-UP?

There were no surprises in the OBR forecast update around the outlook for UK trade. Expectations are for net trade to drag on GDP growth this year, but, if anything, the drag is a bit less than assumed in the October forecast as softer domestic demand will translate into lower import growth.

Chart 4 does suggest that there is something going on with the UK's export performance. All countries – advanced and emerging – experienced a hit to exports during the pandemic, but the UK has not capitalised on the recovery in world trade through 2021. Indeed, the OBR commented that by the fourth quarter of 2021 total advanced economy trade volumes had rebounded to three per cent above their pre-pandemic levels while UK exports remain around 12 per cent below, leading to a less trade intensive economy.

Chart 4: Percentage annual change in merchandisexports



Source: CPB

In addition to the PMI signalling a recent contraction in export orders, the weaker outlook for the world economy will add to the challenge for exporters and the government's ambitions to significantly increase UK exports to £1 trillion by 2030 (though one of the contributors to this review is old enough to remember the last outing of this particular target).

ROUND UP

Another new forecast and another new reminder that the global economy has shifted from managing one shock to navigating a new source of uncertainty. The outlook for the UK and global economy has deteriorated in recent months. Inflationary pressures look more concerning as a result of the conflict in Ukraine.

While we're focused here on the impact on the broader economy, and specifically on manufacturing, clearly households have become more nervous about the outlook and their own finances, with the GfK consumer confidence barometer recording another sharp fall in March.

Balancing the risks, the MPC increased the Bank Rate by another quarter point in March, but there was one dissenter, this time preferring no change. There was a subtle change in language that accompanied the decision as the Committee indicated that further rises may be necessary (as opposed to would be necessary) in managing inflation over the forecast period. Forecasters still expect the Bank Rate to end the year at over one per cent, which implies at least one more increase. Whether that comes in May looks as uncertain as almost everything else.

Indicator	Period	Value	Change	2022 Forecast*
GDP	Q4 2021	1.3%	↑	4.1%
CPI inflation	Feb 2022		↑	6.4%
Unemployment rate	Jan 2021	3.9%	↓	4.1%
Average earnings	Jan 2021	4.8%	↑	4.9%
Brent crude	Mar 2022	$117.70	↑	-
$ Exchange rate	Mar 2022	$1.32	↓	-
PSNB	Feb 2022	£13.1 bn	↓	£92.4 bn

Source: ONS, HM Treasury, Bank of England