UK FINANCE

MONTHLY ECONOMIC INSIGHT

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Written by:

Lee Hopley
Director,
Economic Insight and Research

Charles Cornes
Analyst,
Data and Research

Following last month's focus on the pressure on household incomes from rising inflation, we review the latest measures from government to alleviate cost-of-living challenges and turn to the impact on businesses from higher input costs and the outlook for inflation.

INFLATION ... HIGH AND STILL RISING

Featuring again in our economic review, **chart 1** plots the further rise in CPI inflation in April. As expected, inflation hit a 40-year high of nine per cent on the back of the increase in the energy price cap and rising petrol prices. The average forecast for inflation this year now stands at 7.8 per cent, with further upside risks later in the year as the energy regulator Ofgem has indicated a further significant uplift in the energy price cap in the autumn is likely.

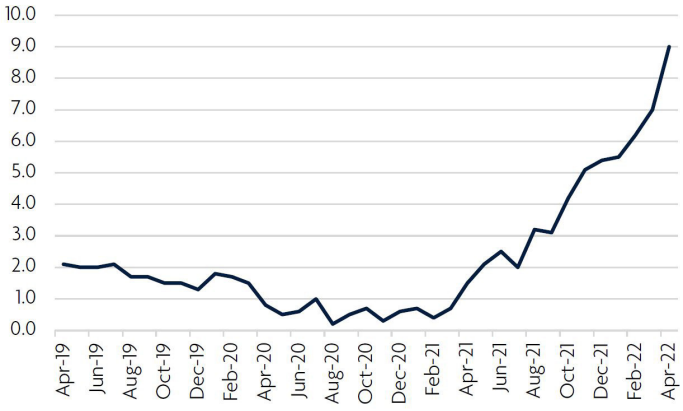
The reality of rising prices, the impact on household budgets and a sustained weakening in consumer confidence all added to pressure on the government to go further than the measures announced at the spring statement, to do more to help households. Last month the chancellor unveiled further measures amounting to an additional £15 billion to ease pressure on incomes.

Measures included: lump sum payments of £650 to over eight million households on means-tested benefits; an additional £300 for pensioner households; a doubling of the discount on all households' electricity bills due this autumn to £400 and £500 million for the Household Support Fund.

This additional spending will, in part, be funded by a new energy profits levy of 25 per cent from now until December 2025, or sooner depending on the path of oil and gas prices.

The structure of the package was more redistributive than that announced in March, with the lowest income households receiving the greatest benefit from the new measures. Analysis from the Resolution Foundation shows that twice as much of the £15 billion package will go to households in the bottom half of the income distribution as the top half. The new measures, together with those announced in March, will offset the real terms fall in, for example, the minimum wage and universal credit.

Chart 1: CPI inflation, percentage annual change



Source: ONS

BUSINESS COSTS ON THE RISE TOO

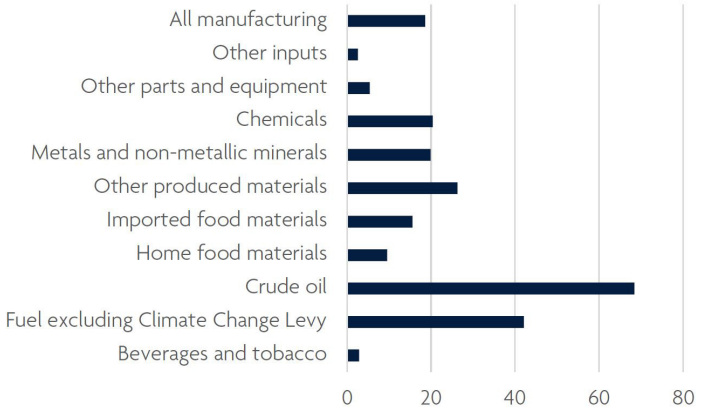
Households are not the only section of the economy feeling the squeeze from higher costs, many businesses have been under pressure from rising input costs since the global economy began to emerge from the pandemic.

The last producer price data, covering input and output prices in the industrial sector, shows another record inflation high with input costs rising at an annual rate of 18.6 per cent. **Chart 2** shows how this breaks down.

The largest contributor to rising input costs have been from oil and fuel , which have risen by 68 per cent and 42 per cent respectively over the past 12 months. Chemicals and metals prices are also up by a fifth over the same period.

The similarly rapid rise in output prices indicated that firms are passing much of these price increases on to customers and through the supply chain. Output price inflation, also a series high, registered 14 per cent annual growth in April.

Chart 2: Producer input prices, percentage annual change



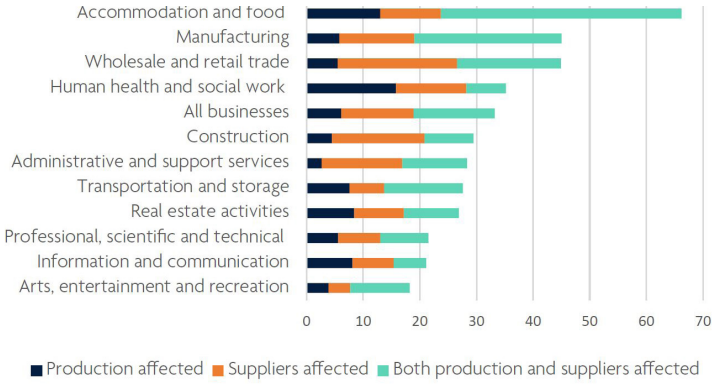
ALL SECTORS FEELING THE IMPACT

While the producer price series covers costs in the industrial sector, the ONS Business Conditions and Insights survey probes the impact of rising energy costs across all segments of the economy. In the last wave of the survey, ONS finds that a third of all businesses have seen some impact from rising energy prices, either directly, through the supply chain or a combination of both. **Chart 3** shows how this breaks down by sector.

The impact is inevitably widespread across industries, but particularly acute in accommodation and food services and wholesale and retail trade, in addition to manufacturing. This is an additional hit to sectors that were already further behind in closing the gap with pre-Covid-19 levels of output.

The response of many, as noted, as been to pass these costs through. However, the survey also shows a higher proportion – over two-fifths – trying to absorb them. This proportion rises to three in five in accommodation and food businesses and 54 per cent of manufacturers. In addition, around one in ten had looked to reduce costs by looking for cheaper suppliers.

Chart 3: Businesses reporting impact from rising energy prices, percentage of respondents by sector



Source: ONS BICS

Thus far, we see little impact on other business areas, for example, only two per cent of all businesses reported that higher costs had led them to make redundancies, which is fairly consistent across sectors.

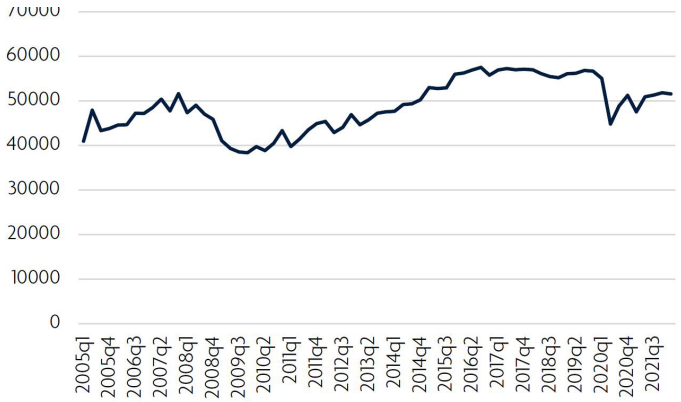
INVESTMENT RECOVERY YET TO MATERIALISE

Forecasters have been expecting business investment to contribute to the UK's continued economy recovery through 2022. The Office for Budget Responsibility, for example, had been predicting investment levels to close in on those seen prior to the pandemic with growth of close to 11 per cent this year.

As **chart 4** shows, the start of this rebound is yet to appear. In 2022 Q2, the ONS first estimates for business investment showed a further 0.5 per cent fall on the previous month, leaving it some nine per cent lower than before the pandemic.

While there has been some growth over the pandemic period in ICT equipment, largely in support of hybrid working, spend on transport equipment has been hampered by supply chain problems and investment in buildings also remains below 2019 Q4 levels.

Chart 4: Business investment, £ millions



Source: ONS

While investment was inevitably put on hold during Covid-19, growth has been pretty stagnant since the 2016 Brexit referendum. A fairly hefty tax incentive, in the form of a super-deduction, has been in place since April 2021, but it is unclear whether this has materially changed the outlook for investment plans.

The ONS Business Conditions and Insights survey reveals that just over one in ten firms plan to raise capex in the next three months compared with a third saying it will stay the same or decline.

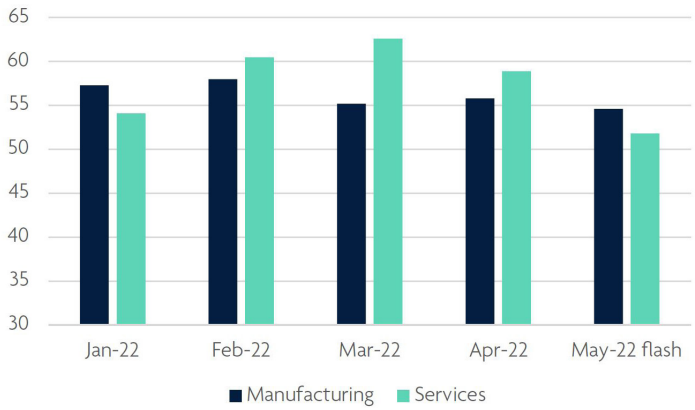
The main limiting factor in investment is uncertainty about demand or business prospects, with just four per cent citing challenges raising external finance – a proportion that is consistent across size brackets.

SERVICE SECTOR ACTIVITY SLOWS

The challenges facing businesses discussed here as well as the build up of worry about the consumer outlook (see last month's review) are starting to become apparent in business activity and sentiment. The flash purchasing managers' indices covering services and manufacturing, released at the end of last month, have come down from post-Covid-19 highs at the start of the year.

As **chart 5** shows, the softening in service sector activity was particularly marked in May with the index falling to a 15-month low. The survey notes that inflation and geopolitical uncertainty constrained consumer demand. Though it also points to still solid activity in travel-related services.

Chart 5: Purchasing managers' index, 50=no change



Source: S&P Global/CIPS

As a consequence of more subdued activity and a bit more pessimism about the next 12 months, the rate of reported job creation slowed, with some respondents indicating that some leavers were not being replaced to manage costs. Official labour market data on vacancies will be one to watch in the coming months.

Manufacturers also faced a drop in export demand, much of which is attributed to trade frictions related to Brexit.

ROUND UP

Overall, this points to a bumpy ride for the economy in the coming quarters. The average forecast for growth in Q2 is for GDP to remain unchanged following a rise of 0.8 per cent in Q1 (in which the economy only expanded in January). Forecasts were taken before the announcement of the government's additional support for households; whether this moved the dial at all on confidence is yet to be seen.

As ever in this section it's over to the Bank of England, with monetary policy makers due to meet again this month. The recent jump in inflation will have come as no surprise. In May, Bank Rate rose by another 25 basis points to one per cent, nevertheless, three members voted for a larger increase of 50 basis points. Price increase and labour market tightness risked above target inflation becoming more persistent, justification for further policy tightening. There were, however, some worries about risks to demand in the economy.

The government's additional spending on household support will take some of the pressure off and could clear the path for another rate rise this month – thus delivering a better balance between monetary and fiscal policy at the current time.

Indicator	Period	Value	Change	2022 Forecast*
GDP	Q1 2022	0.8%	↓	3.9%
CPI inflation	Apr 2022	9.0%	↑	7.8%
Unemployment rate	Mar 2021	3.7%	↓	4.0%
Average earnings	Mar 2021	7.0%	↑	4.9%
Brent crude	Apr 2022	$104.58	↑	-
$ Exchange rate	May 2022	$1.24	↓	-
PSNB	Mar 2022	£18.6 bn	↑	£100.2 bn

Source: ONS, HM Treasury, Bank of England