UK FINANCE

MONTHLY ECONOMIC INSIGHT

July 2022

Written by:

Lee Hopley
Director,
Economic Insight and Research

Charles Cornes
Analyst,
Data and Research

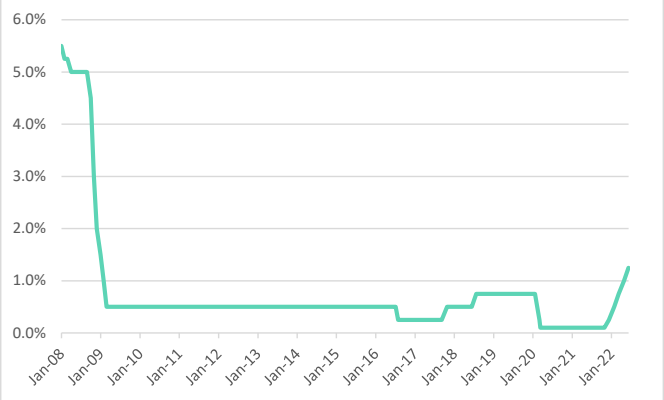
This month we take a look at the detail behind the MPC's latest decision, what's happening underneath the headlines of the softer GDP data and how the UK's growth, inflation and labour market developments compare with developed world counterparts.

MPC HIKES AGAIN

The Monetary Policy Committee (MPC) voted for a fourth consecutive quarter point increase in Bank Rate at its June meeting, taking it to 1.25 per cent – the highest rate since the start of 2009 (chart 1). The decision was not a unanimous one, with three members making the case for a faster pace of tightening and voting for a 50-basis point rise.

The economic backdrop to June's meeting hadn't changed materially since the Bank published its May Monetary Policy Report. Inflation had continued to rise, in line with the Bank's forecast, to nine per cent. The data released subsequently to the meeting showed a continuation of this upward trend to 9.1 per cent in May. As previously discussed, the overshoot is a consequence of rises in global energy and tradable goods prices – partly driven by the post-Covid-19 recovery and exacerbated by the ongoing conflict in Ukraine. The MPC now expects CPI to peak at around 11 per cent in October, when the energy price will be reset in the autumn.

Chart 1: Bank Rate, percentage



Source: Bank of England

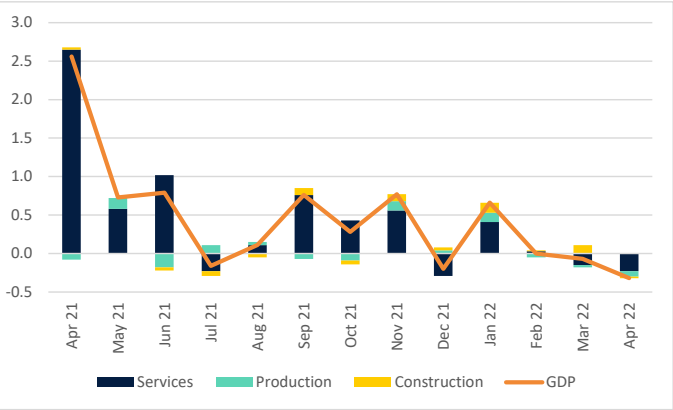
Tight labour market conditions – employment and wages were up and demand indicators remained firm – continue to present risks that price pressures become more persistent and inflation expectations remain elevated. While demand is expected to slow, the Committee judged that action was required to ensure that inflation returned to target over the medium term. There was, again, a slight change in tone on future decisions, with the minutes noting that the Committee 'would be particularly alert to indications of more persistent inflationary pressures, and would if necessary act forcefully in response'.

GDP GROWTH STUTTERS

As noted above, the Bank of England is expecting UK growth to slow and has pencilled in a contraction of 0.3 per cent in the second quarter of 2022. The monthly data from ONS suggest this is more likely than not. Chart 2 shows the overall path of monthly GDP to April 2022 and the sectoral contributions.

GDP fell by 0.3 per cent in April following a 0.1 per cent decline in March and a flatlining in February. While the level of GDP is still nearly one per cent higher than before the pandemic, the post-Covid-19 recovery appears to be petering out. Indeed, all three main industry sectors saw output decline in the month, the first time this has happened since the start of 2021 (chart 2).

Chart 2: Sector contribution to growth, percentage points



Source: ONS

There were a number of one-off factors at play in April. The main contribution to the decline in services output, which also fell by 0.3 per cent on the month, was the ongoing drag from the wind down in 'Track and Trace' activity. The ONS reported that this detracted 0.5 per cent points from total GDP growth in the month. There was better news from other parts of the sector – consumer facing services continued to post robust growth (up 2.6 per cent on the month).

Manufacturing continued to struggle at the start of Q2, with most sub-sectors declining. Cost pressures and supply chain issues continue to plague the industry. Construction also declined, but this follows a strong run and record levels of output in March – boosted by repair work after storms in February.

While there were clearly a number of exceptional factors at play in April, the data nevertheless suggest that the underlying picture has deteriorated and it isn't taking much to push GDP into the red. With cost-of-living headwinds likely to become increasingly evident in the coming months, the outlook for growth in the remainder of this year looks challenging.

RETAIL SALES SHOW COST OF LIVING IMPACT

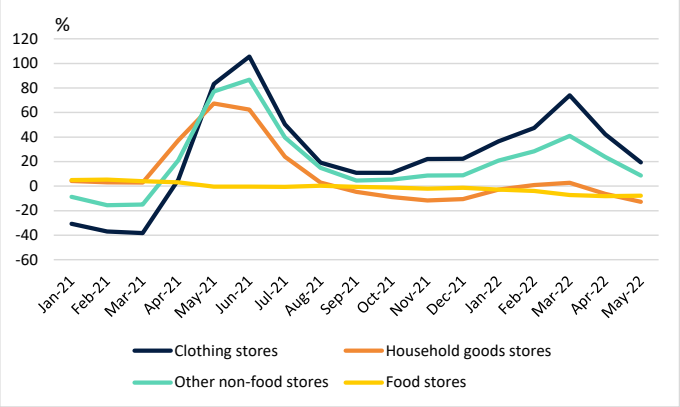
Speaking of cost-of-living pressures, there are some signs that may be evident in the retail sales data. While consumers continue to hit the hairdressers (one of the sectors boosting consumer facing services output), retail spending is looking rather weaker. Volumes fell by 0.5 per cent in May after a downgraded rise of 0.4 per cent April.

Chart 3 shows how this breaks down by category. There was a notable decline in sales volumes in food stores in May, continuing the trend seen since the latter part of 2021. ONS commentary attributes some of this decline to affordability, linked to the sharp rise in food prices in recent months. The ONS opinion and lifestyle survey notes that more than two-fifths of consumers reported buying less when food shopping, up from under a fifth at the start of the year.

Declining sales volumes were also seen across household goods and department stores. However, bucking the trend was growth in clothing stores, which reported a two per cent month-on-month increase.

While these data do point to some cost-of-living effects following April's energy and tax increases, they don't indicate a rout on the high street. Nevertheless, the news on consumer confidence in the past month suggests that households will continue to be cautious about discretionary spending, in the coming months.

Chart 3: Retail sales volumes by category, percentage change three months on a year ago



Source: ONS

GLOBAL TRENDS

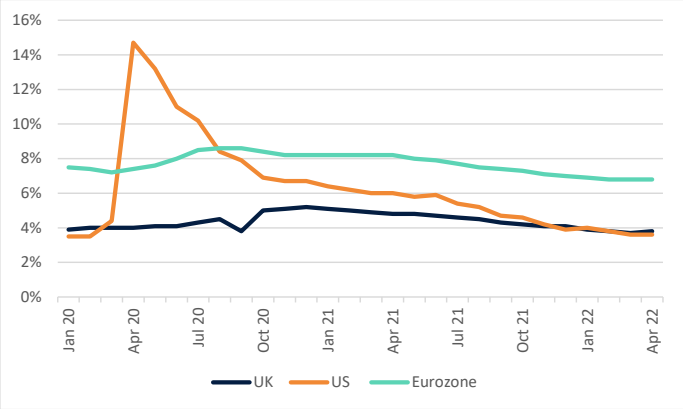
Our briefings have had a distinctly UK flavour in recent months – how are we staking up against developments elsewhere?

Looking overseas, recent economic data show how the UK compares with the eurozone and the US in the first quarter of 2022. The former experienced similar growth to the UK: the eurozone expanded by 0.6 per cent in Q1, driven in part by an improvement in net trade. But this was offset by falls in household consumption and public expenditure. In the US, the first quarter was bleaker; GDP contracted by 1.6 per cent – the first quarterly contraction since the start of the pandemic. Unlike the eurozone, the US trade deficit deteriorated in Q1 as the dollar appreciated. Household consumption rose in the quarter, driven by increased expenditure on services such as utilities, however, this rise was dampened by decreases in food and petrol spending as global commodities prices continue to increase.

These rises in food and energy prices are exacerbated by the Russian invasion of Ukraine, coupled with sustained supply chain disruptions that have significantly contributed to the inflationary pressures faced by these developed economies. In the eurozone, inflation reached a record level of 8.1 per cent in May – four times higher than the same period a year prior. This varied significantly across countries, with France recording a five per cent annual rise, while Estonia is currently experiencing inflation of 20 per cent. The US has experienced high inflation over the past year; an estimated $5 trillion in stimulus funding throughout the pandemic contributed to high domestic demand, unique to the US. Recent global pressures have only further added to US inflation, now reaching 8.6 per cent across the pond.

As seen in chart 4, the contrasting labour market policies adopted by the US and the eurozone led to a divergence in unemployment trends throughout the pandemic. Similar to the UK, countries across the eurozone implemented furlough schemes to moderate rises in unemployment. Conversely, the US expanded unemployment benefits, while also providing stimulus cheques. This policy provided important liquidity to US households, however, the lack of job protection led to significant spikes in unemployment in the months immediately following the Covid-19 outbreak.

Chart 4: Unemployment rates, percentage



Source: ONS, US Bureau of Labor Statistics, Eurostat

Chart 4 also shows the unemployment rates for both economies are approaching pre-pandemic levels, as demand for labour has risen following the gradual easing of lockdown restrictions over the past year. However, vacancies remain high across both the US and eurozone, signalling tight labour markets across the two economies.

In reaction to tightening labour markets and persisting inflationary pressures, the Federal Reserve and European Central Bank (ECB) have decided to raise their respective interest rates. In June, the US central bank rose its interest rate to a range of 1.5-1.75 per cent– a 0.75 percentage point rise. The ECB have announced that it will raise interest rates in July for the first time in 11 years, increasing by 0.25 percentage points. As of June, the OECD predicts the eurozone to expand by 2.6 per cent in 2022, and the US to grow by 2.5 per cent.

ROUND UP

Good economic news has been thin on the ground recently. Growth is faltering, confidence amongst households has slumped and business sentiment has softened, and inflation remains far from the Bank's target. Cost-of-living pressures are only tentatively making themselves known in the aggregate data, but calls for wage restraint are being drowned out by employees looking to minimise the hit to real income growth – particularly in public sector where earning growth is lagging.

In some more encouraging news for rate setters at the Bank of England, inflation expectations over the medium term have edged down somewhat – if this downward drift continues the MPC may step back from more substantial rate increases when it meets again in August.

The key developments to look out for in the coming months will be whether pressure on wage increases translate into more substantive earning growth across the economy; metrics on the consumer side which point to more rapid retrenchment in spending; and additional upward pressure on prices from developments in global commodity prices and sterling exchange rate movements.

Indicator	Period	Value	Change	2022 Forecast*
GDP	Q1 2022	0.8%	↓	3.6%
CPI inflation	May 2022	9.1%	↑	9.2%
Unemployment rate	Apr 2022	3.8%	↑	3.9%
Average earnings	Apr 2022	6.8%	↓	5.4%
Brent crude	May 2022	$113.34	↑	-
$ Exchange rate	Jun 2022	$1.23	↓	-
PSNB	May 2022	£14 bn	↓	£110.1 bn

Source: ONS, HM Treasury, Bank of England