UK FINANCE

MONTHLY ECONOMIC INSIGHT

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Written by:

Lee Hopley
Director,
Economic Insight and Research

Charles Cornes
Analyst,
Data and Research

Recent indicators signal tougher economic times ahead, not just for the UK but for the global economy. The IMF's latest read out of the outlook suggests risks are building and surveys point to this being felt in waning business confidence. Big policy decisions lie ahead for the next UK prime minister and central bankers.

GDP – BETTER BUT NOT BRILLIANT

After a slight dip in April, the UK economy rebounded in May, growing by 0.5 per cent overall. For the first time since January, all three sectors registered positive growth.

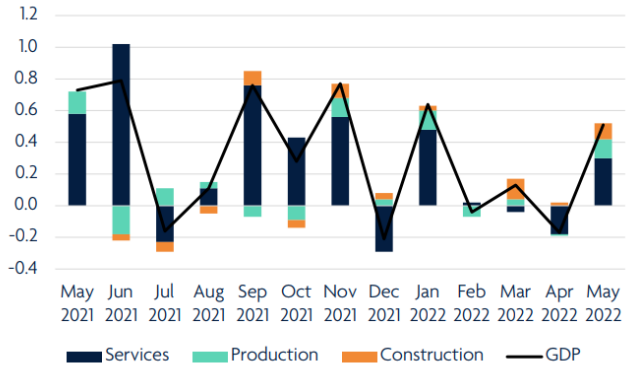
Services was the largest contributor (**chart 1**), driven by a significant rise in GP appointments which more than offset the continued wind down of the NHS Test and Trace and vaccination programmes. This is an indication of a post-Covid-19 return to normal.

However, this expansion was not homogenous across all services. Consumer-facing services contracted in May, amid growing concerns regarding costs of living and a month since the rise in National Insurance contributions outlined by the former chancellor Rishi Sunak. As a consequence, reductions in recreational and retail activity were among the largest drivers for the decline in consumer-facing service output.

There was, however, an 11 per cent rise in travel agency activity, which is defying the squeeze to household disposable income. Though it is important to note this growth is compared to April's activity where – according to the latest ONS overseas travel and tourism data – the number of UK residents visiting abroad remained one third below the same period in 2019. With thoughts turning to the summer holidays, coupled with the end of Covid-19 restrictions, it is expected that there would be a rise in monthly tourism activity despite cost-of-living concerns.

The production and construction sectors registered growth of 0.9 and 1.5 per cent respectively in May, with the latter recording its record monthly level of output of £15 billion. Construction output is now over four per cent higher than pre-pandemic levels, and surveys suggest demand for projects remains elevated despite significant price increases for materials.

Chart 1: Sector contributions to GDP growth, percentage points



Source: ONS

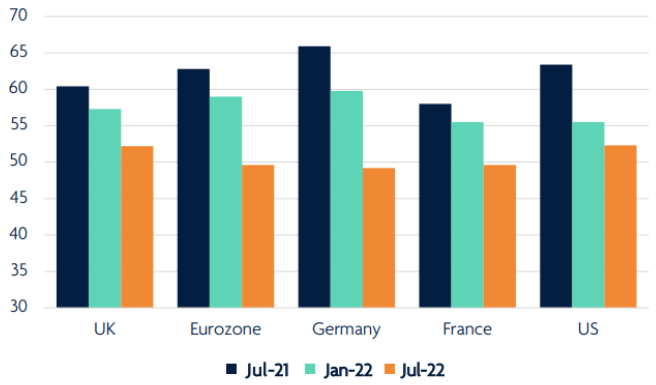
Despite May's somewhat stronger GDP figures, and consistent with our view **last month**, the growth outlook is fragile. The possibility of output posting a decline in Q2 looks finely balanced, ahead of further pressure on households and businesses with more energy price hikes on the cards this autumn.

MANUFACTURING SLOWING

While May's GDP data painted a more encouraging picture for manufacturing, with month-on-month growth of 1.4 per cent and with almost all sub-sectors recording stronger output, survey indicators suggest this may be short-lived.

In the UK, manufacturing has just nudged above pre-pandemic levels, with initial recovery thwarted by supply chain blockages that affected many sub-sectors and persisted for much of 2021.

Chart 2: Manufacturing purchasing managers' index, 50 = no change



Source: S&P Global

The latest flash PMI for the UK points to more challenging demand conditions for industry with the overall composite manufacturing index having declined to a 25-month low (**chart 2**). Underneath the headline was a decline in both output and the biggest fall in new work for two years, with the latter attributed to subdued confidence and weakening demand conditions. The silver lining, if it can be described as such, is that inflationary pressures in the sector appear to be easing with some softening in raw materials prices and stabilising energy costs.

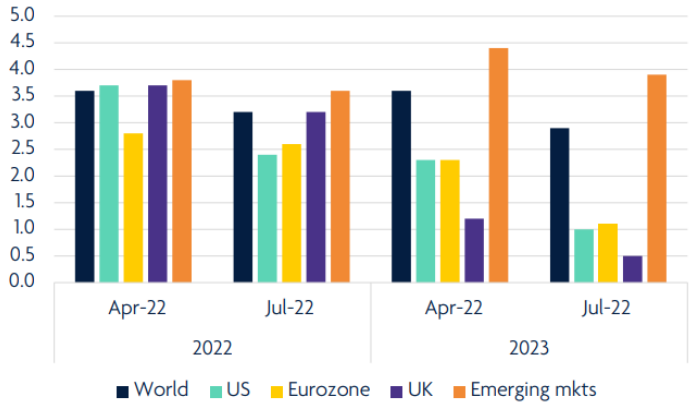
This picture is by no means unique to the UK, global demand for industrial goods is softening globally. All major industrial countries have seen the manufacturing PMI come off the boil over the course of this year. France and Germany posted a flash PMI in contractionary territory (a value below 50). Specifically, the PMI reports eurozone manufacturing output contracting for two consecutive months with the decline accelerating in July – a trend noted in both France and Germany and with businesses in the latter particularly noting concerns about the ongoing Ukraine conflict and energy security. The export demand picture has also softened. In contrast, it is domestic weakness bearing down on US manufacturing activity – a result of severe inflationary pressures and recent interest rises.

GLOBAL OUTLOOK DETERIORATING

The manufacturing PMIs are a microcosm of wider global challenges reported in the IMF's recent forecast update. The Fund has become more pessimistic about the global outlook since its last tranche of forecasts in the spring.

It now expects the world economy to expand by 3.2 per cent, compared with 3.6 per cent in April and the much more buoyant prediction of 4.9 per cent growth made this time last year. Virtually all economies have seen 2022 and 2023 growth prospects downgraded, with the US, Germany and China seeing some of the largest downward revisions for 2022 (**chart 3**).

Chart 3: Annual change in GDP, percentage



Source: IMF

The factors behind the forecast revisions will be familiar and reflect the build up of challenges to growth in the world economy, and developed markets in particular, through 2022. These include weakening consumer demand in the US; the war in Ukraine and levels of inflation not seen in four decades; and multiple challenges in China, including a resurgence of Covid-19 and a deepening real estate crisis.

There is little expectation that these challenges will abate in the latter part of this year and into next. Global inflation has been revised up by nearly a percentage point this year and next to 8.3 and 5.7 per cent respectively. In response, action from central banks, which is already underway, is expected to bite next year, with an expansion in global output of just 2.9 per cent pencilled in for the year. Moreover, with the exception of Japan and Canada, most advanced economies are expected to grow by a paltry one per cent in 2023.

The IMF very much sees the risks to the global economy skewed to the downside. The list of things that could go wrong is long – protracted conflict in Ukraine and further energy supply disruptions; inflation remaining stubbornly persistent; tighter financial conditions leading to debt distress in emerging markets; and political trade disruptions. In addition, Covid-19 remains ever-present on the list of risks.

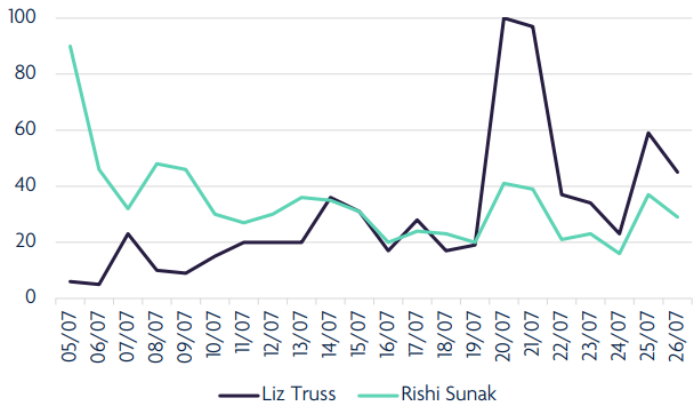
In response, the IMF proposes a range of policy remedies. For economies like the UK, the answer is tighter monetary conditions while increasing support for vulnerable households and structural reforms, which will pay off in the longer term – raising labour market participation and action to improve productivity; continuing vigilance on Covid-19 and continuing the focus on transition to a low-carbon economy.

DOMESTIC REMEDIES?

While the IMF has set out its recommendations for the best course of action for policy makers to manage potential risks to growth, there is fierce debate at home about who should lead the next government and what the priorities of the next prime minister will be. Readers have likely seen the polling and (maybe) the read out from betting markets, **chart 4** looks at interest in the two candidates of 'googlers'. While Rishi Sunak's resignation (less than a month ago at time of writing) led to a surge in searches, Liz Truss's announcement that she would also stand prompted a peak in searches and she has held a lead in searches and in polling with Conservative members in recent weeks.

This isn't the vehicle to review the candidate's commitments to date. However, while debates and hustings continue in the run up to the announcement in September, it is worth reflecting on some of the key questions that the next prime minister will need to address – some with a degree of urgency this autumn.

Chart 4: Google searches of Conversative leadership candidate, 100 = peak interest in period



Source: Google Trends

- Ever-increasing estimates of the forthcoming rise in the energy price cap and the implications for households, particularly lower income ones, this winter. Key questions are the extent to which additional support is needed (almost certainly) and how it can be best targeted.
- The curse of low productivity, which has weighed on the UK economy since the financial crisis. This has to be the core plank of a new economic policy with a focus on longer-term economic growth. While there is a wealth of research pointing to the role of skills, innovation and investment (among others) in moving the productivity needle, post-Covid policy thinking on these issues needs to come back on the agenda. Linked to this will be the resolution of outstanding trade frictions with the EU.
- The IMF recommendation to press on with net-zero objectives is pertinent to the UK. Businesses facing a host of ongoing uncertainties will need a sense of long-term signals about how the UK plans to manage this transition in order to align their own strategic decisions in this area.
- The next Spending Review will need to balance longer-term trade offs on tax and investment in public services with the immediate pressure on budgets driven by rising input costs and increasing wage demands.

ROUND UP

Activity indicators are softening at home and abroad. With early estimates suggesting that cost-of-living pressures in the UK will intensify in the autumn with a further substantial hike in the energy price cap, fiscal and monetary policy will have to navigate a difficult balancing act in the months ahead.

The backdrop for August's MPC meeting is inflation at 9.4 per cent, with further increases on the cards and faltering GDP growth. However, inflation expectations, while still elevated, do appear to have stabilised and survey indicators of business cost pressures are showing signs of some moderation.

Economic commentators are split on their expectations for this month's decision, with a 25 or 50 basis point increase seen as equally likely. The global interest rate setting climate has become more hawkish, with both the US and eurozone policy makers pushing ahead with rises of 75 and 50 basis points respectively over the past month as they seek to prevent higher inflation from becoming embedded. MPC minutes have indicated that the Bank is prepared to 'act forcefully' if needed in its fight against inflation, which could prompt the first half point rise in Bank Rate since Bank of England independence.

Indicator	Period	Value	Change	2022 Forecast*
GDP	Q1 2022	0.8%	↓	3.6%
CPI inflation	June 2022	9.4%	↑	9.6%
Unemployment rate	May 2022	3.8%	↔	3.8%
Average earnings	Apr 2022	6.2%	↓	5.8%
Brent crude	Jun 2022	$122.71	↑	-
$ Exchange rate	Jun 2022	$1.23	↓	-
PSNB	Jun 2022	£22.9 bn	↑	£85.7bn

Source: ONS, HM Treasury, Bank of England,