MONTHLY ECONOMIC INSIGHT

September 2022

There's only one thing on most people's minds this month and that's a winter of unprecedented energy price rises. This month's review takes a look at what this means for inflation, consumers and businesses.

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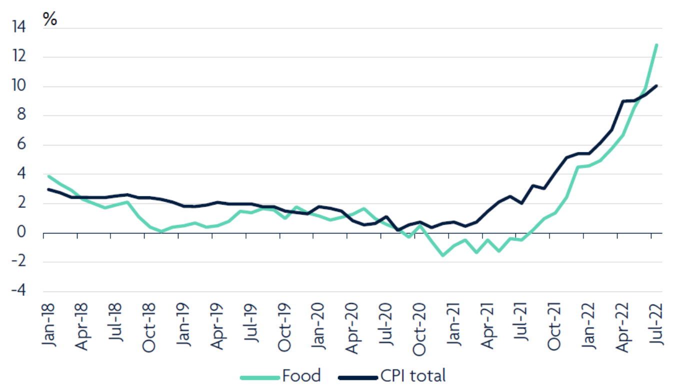
DOUBLE-DIGIT INFLATION

For the first time in over four decades UK inflation hit double digits. CPI rose to 10.1 per cent in July, up from 9.4 per cent in June. The latest data shows that price increases were widespread across the basket of goods and services monitored by ONS.

We're all acutely aware of the hefty contribution higher energy and petrol prices continue to make to price rises, and these continued to be very much evident in July, with likely worse to come now October's energy cap increase has been announced (more on that later).

But the main driver of July's increase came from food prices (**chart 1**). The ONS noted that within food all classes made an upward contribution to higher CPI, but notably bread, cereals and dairy products.

Chart 1: Food and total CPI inflation, percentage change



Source: ONS

Upward pressure on food prices, as with the rise in energy costs, has its roots in the Ukraine conflict. Since the Russian invasion some of the largest increases in global commodity prices can be seen in wheat and corn, where there is a large concentration of production in Russia and/or Ukraine. Despite some shipments leaving Ukraine, distribution challenges will continue to constrain supply and put pressure on prices. In addition, drought across many parts of Northern Europe added to food supply and price pressures.

These pressures were also clear in the latest inflation print from the eurozone, which also showed near double digit rises in July.

ENERGY PRICE CAP AND WHAT TO DO ABOUT IT

And so to energy prices. At the end of August Ofgem announced the forthcoming rise in the energy price cap, which will come into effect in October. The news, given the backdrop of the ongoing war and the gas futures curve, was bad but unsurprising. The cap for dual fuel for an average household will rise to £3,549 in October, an 80 per cent increase on the £1,971 cap that was operating between April and September.

The cap will be in place for three months, with further (likely large) increases hitting households again in January 2023.

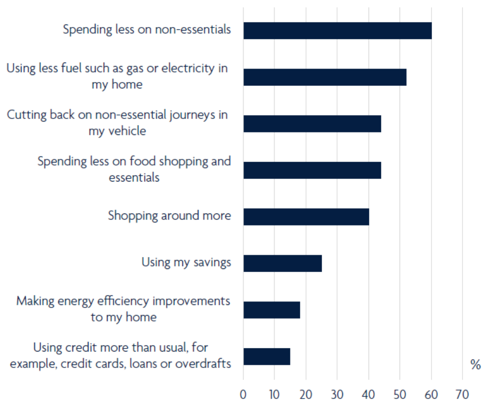
Households are already feeling the strain with the ONS Opinions and Lifestyle survey reporting that nine in ten respondents said that their cost of living had increased over the past month. While almost all those are seeing a cost-of-living impact from their food shopping, people are more likely to be worried about the rising cost of their energy bills.

Chart 2 illustrates the actions that concerned households are already undertaking to manage household budgets, with cutting back on essentials and using less energy in the home being the most common. There are, however, limits to the effectiveness of such moves in the face of the price hikes coming down the track.

Much of the government's current energy support package (outlined in our **June review**), which included an across the board reduction in bills and additional payments to those on means tested benefits and pensions, is yet to land with households. But the scale of the increase in the new cap has increased calls for additional support.

Analysis from the Resolution Foundation shows that the bottom half of households will spend more than ten per cent of their budgets on energy over winter 2022/3, even accounting for the £400 discount that has been announced. There is particular concern for those four million households on pre-payment meters. Any additional action from government is expected to be announced imminently, now that Liz Truss has been announced as the new prime minister, taking up her role today.

Chart 2: Action taken due to cost of living increases, percentage of respondents



Source: ONS Opinions and Lifestyle survey

While there will be no shortage of policy options in her inbox, all will come at significant cost, whether these are broad tax cuts, freezing the cap for all or increasing direct payments. The objective, however, will surely be to target hardest hit low/middle income households through a period of peak energy use.

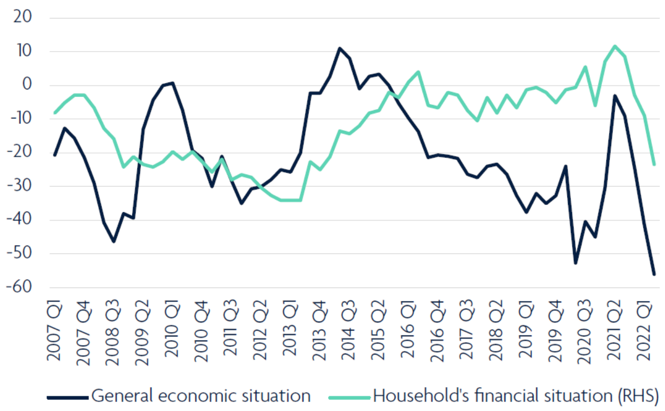
NEW LOWS FOR CONSUMER CONFIDENCE

Given what's just been outlined it is unsurprising that consumer confidence is in a tailspin. GfK's Consumer Confidence index fell to -44 for August, ten points lower than the beginning period of the pandemic during which the economy was under strict lockdown (**chart 3**).

Households were especially pessimistic with regards to their personal financial situation in the coming year, as the cost-of-living continues to dominate the headlines and further increases to the energy price cap. This is also reflected in consumer sentiment surrounding the general UK economy, currently at its lowest since the survey began in 1974.

Despite this, there was a bit of better news coming from the retail sector. ONS retail sales volumes recorded a modest increase in July (up 0.3 per cent month on month) with the value of sales also 1.3 per cent higher compared with June. Both values and volumes remain above pre-pandemic levels, though ONS reports that online retailers benefit from a number of promotions over the month.

Chart 3: Consumer confidence index



Source: GfK

The CBI distributive trade survey was also relatively upbeat in August. However, confidence about the coming quarter remained in the doldrums. This boost to sales over the summer may well be consumers making purchases that may be out of reach in future if, as expected, prices continue to rise.

BUSINESS ENERGY PRICE WOES

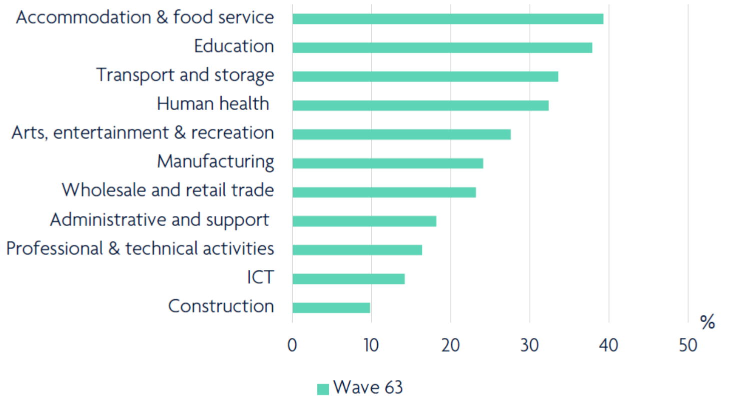
The raging debate around energy costs has been dominated by the impact on the cost of living. But with the outlook for prices and supply looking increasingly challenging, attention is turning to the cost of doing business.

Firms are not subject to any price cap and with many coming off fixed contracts, anecdotal evidence is indicating eyewatering increases in business energy costs for many. This has prompted calls from sectors such as hospitality, corner shops and energy-intensive manufacturers for business-specific support in the face of potentially massive price hikes to come.

The ONS business survey (BICS) shows across the board rises in the proportion of businesses citing energy prices as a concern (chart 4) between March and August this year. Nearly four in ten businesses in accommodation and food services see this as a significant business challenge. While the sector has seen relatively robust growth following the end of Covid-19 restrictions, there are inevitably risks around the resilience of these industries.

And while businesses have been (and may continue to be) able to pass on some cost increases to customers, sectors such as education, and health and social work are likely to have less capacity to do so, perhaps reflecting the more significant shift in the proportion of businesses in these sectors, identifying energy costs as a business concern.

Chart 4: Business concern about energy prices, percentage citing as concern by sector



Source: ONS BICS

Like households, businesses await this new government for decisions on what, if any support will be made available to minimise business failures. And in addition, public sector budgets may also need to flex to ensure services are not compromised as a result.

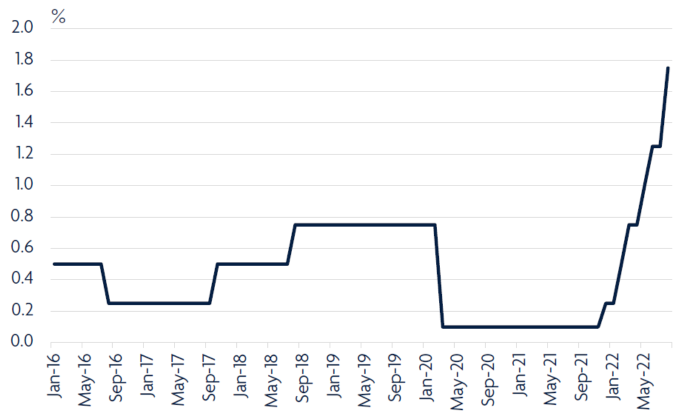
MORE BANK RATE RISES TO COME

In most months, the largest increase in Bank Rate since the MPCs creation would be the lead item ... and yet. But in August, the MPC voted to increase interest rates by half a point to 1.75 per cent.

The Bank further revised up its expectations for the inflation peak this year to 13 per cent in 2022 Q2 and forecasts point to CPI remining elevated through much of 2023. However, it now expects the UK to enter recession at the end of this year and for quarterly GDP to contract through next year. Tight labour market conditions and domestic pricing pressures were also judged to have shown no signs of easing. As a result, eight members backed the 50 basis point interest rate rise in August, noting that a faster pace of policy tightening now would 'reduce the risks of a more extended and costly tightening cycle later'.

That said, markets are expecting the Bank Rate to rise to around four per cent in the second quarter of 2023. This implies that this faster pace of rate rises will continue in the remaining meetings this year.

Chart 5: Bank Rate, percentage



Source: Bank of England

ROUND UP

UK GDP contracted by 0.1 per cent in the three months to June. While services, which fell by 0.4 per cent on the quarter, were behind the fall, this was largely due to the decline in Covid-19 related activity. Manufacturing output was flat, while construction activity continued to expand in the quarter.

Forward-looking indicators, however, confirm more challenging quarters ahead. The latest manufacturing PMI index dropped below the 50 no change mark for the first time since May 2020. Survey respondents reported a sharp fall in demand from both domestic and export customers, leading to a halt in job growth. These trends were mirrored across eurozone manufacturing.

The flash services PMI held in expansionary territory in August, but the rate of new business growth has slowed. With the squeeze on households set to intensify, there are inevitably some significant downside risks to the outlook for services.

As forecasters expect recession for the UK this year and given the building headwinds, the new government won't have the luxury of 100 days to make a difference. Some big decisions will need attention on day one.

Indicator	Period	Value	Change	2022 Forecast*
GDP	Q2 2022	-0.1%	↓	3.6%
CPI inflation	Jul 2022	10.1%	↑	10.6%
Unemployment rate	Jun 2022	3.8%	↔	4.1%
Average earnings	Jun 2022	5.1%	↓	5.9%
Brent crude	Jul 2022	$111.93	↓	-
$ Exchange rate	Aug 2022	$1.20	↓	-
PSNB	Jul 2022	£4.9 bn	↓	£109.1bn

Source: ONS, HM Treasury, Bank of England,