UK FINANCE

MONTHLY ECONOMIC INSIGHT

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Written by:

Lee Hopley
Director,
Economic Insight and Research

This month's review has a focus on growth with an international flavour. We look at what was behind some of the better GDP data in the UK and the resilient US numbers. Some UK labour market indicators continue to surprise, but not in a good way for policy makers; we'll look at what the next MPC meeting might hold for interest rates.

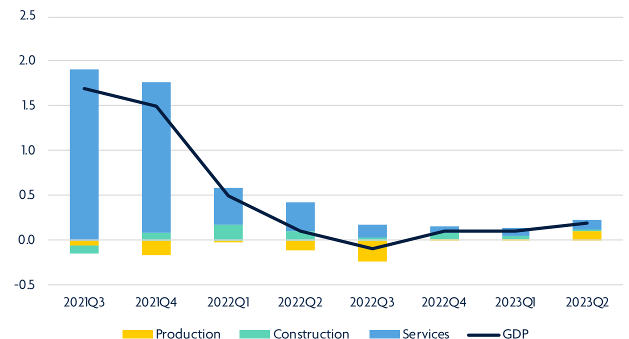
UK GDP CONTINUES TO EXPAND (SLOWLY) IN Q2

Coming in slightly firmer than expected, UK GDP expanded by 0.2 per cent in the three months to June, a touch better than the 0.1 per cent rise in 2023 Q1.

This confirms most forecasters' expectations that the UK will likely avoid recession this year.

Q2 saw all three main sectors of the economy contributing positively to growth (**chart 1**); services output increased by 0.1 per cent, production and construction fared a bit better with output growing by 0.7 per cent and 0.3 per cent respectively.

Chart 1: Contributions to quarterly GDP growth, percentage points by broad sector



Source: ONS

Within services, the sub-sector performance was typically more variable. Good weather and an extra bank holiday in the quarter boosted growth in accommodation and food services. This was the first quarter of growth for this sector in a year, during which cost of living pressures have been weighing on households. A sunny June also helped the high street, with a pickup in retail sales.

Construction saw its seventh consecutive quarter of growth, though the pace of quarterly contraction has slowed in the first half of 2023 compared with that seen through 2022. Decent weather was again a positive of the industry over the quarter, but the Office for National Statistics (ONS) notes that cost of living pressures and the weaker outlook for the economy are depressing new orders together with a slowdown in government spending on larger infrastructure projects.

Turning finally to production, manufacturing had a very strong quarter, growing by 1.6 per cent and marking the third straight quarter of expansion. The ONS data is somewhat at odds with the more downbeat survey evidence from the S&P Global purchasing mangers' index (as we noted in **last month's review**). The majority of manufacturing sub-sectors grew in Q2, aided by a notable easing in input cost pressures. However, there was particular strength in transport equipment, which includes vehicle manufacture.

US ECONOMY PROVES RESILIENT

The Q2 growth news from the UK was OK, but in the US the story was more positive. The latest estimate of GDP growth points to an expansion on 2.1 per cent, on an annualised basis – a shade over 0.5 per cent when comparing with UK numbers.

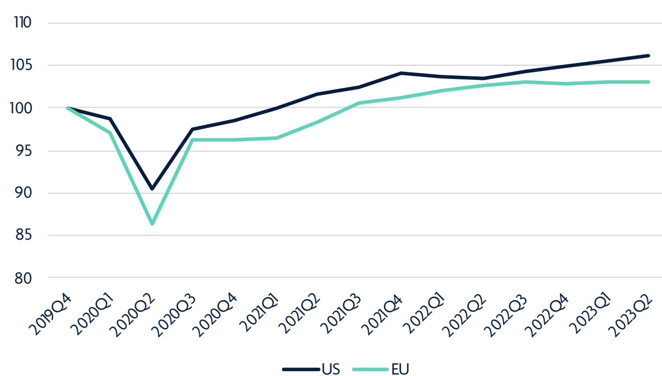
This represented a very modest acceleration in growth on the previous quarter (two percent annualised in Q1). Consumer spending made a positive contribution – through less so than in Q1, with stronger spending on services by households compared with goods. Weak points in the data included declining exports (more on that later) and residential fixed investment.

Overall, this continues a decent run of growth over the past year and shows something of a divergence with the European Union, which has largely flatlined since the early part of 2022.

While the US data was revised down slightly from the initial estimate of growth, it does indicate a good degree resilience in the economy even as the Federal Reserve continued to increase the federal funds rate to 5.5 per cent in July. Like the UK's central bank, the Fed has not declared victory in the fight against inflation, but the pace of rate increases has eased this year.

The US, like other advanced economies has experienced elevated inflation and tight labour conditions following both the pandemic and the impact of the Ukraine conflict. And similar to the UK, policy makers have expressed concerns that these factors were inconsistent with goal of managing inflation back to target.

Chart 2: GDP index, 2019Q4 = 100

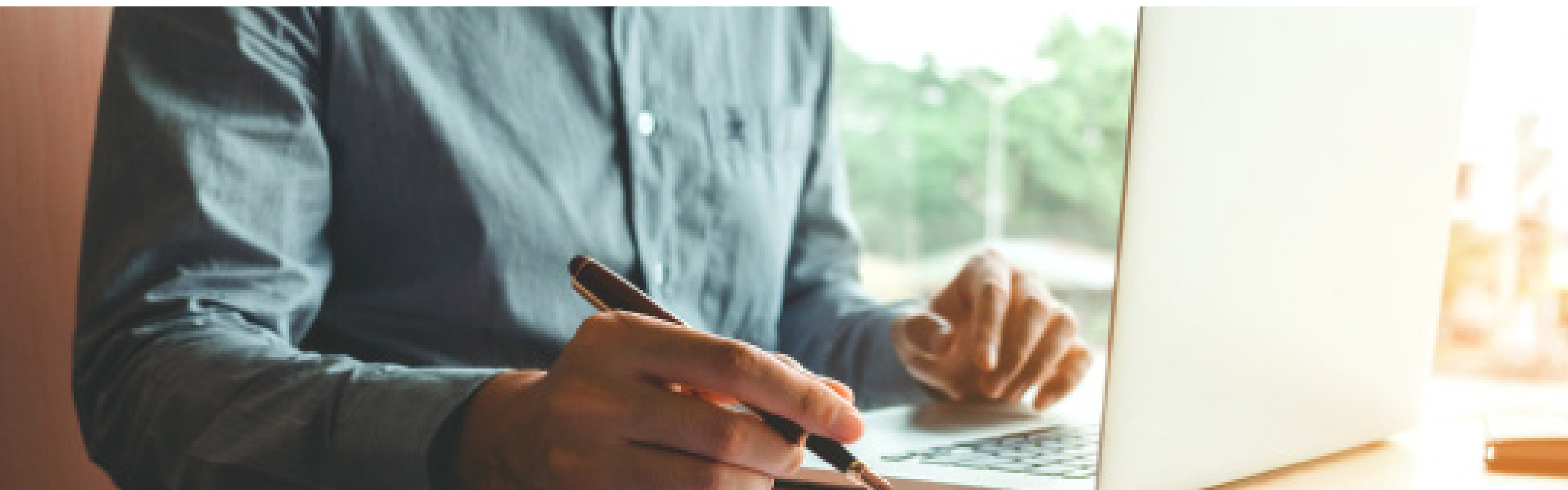


Source: OECD

In addition to the decent news on growth, there are also some positive indicators on inflation and the labour market. Headline inflation stood at 3.2 per cent in July. And there are some signs of normalisation in the labour market, with job openings falling to the lowest level in nearly two and half years.

Forecasters have walked back from predictions of US recession and whisper that a soft-landing could be achievable. Indeed, early indicators for Q3 suggest another quarter of solid expansion in prospect.

Further Fed action remains on the table, according to Chair Jerome Powell's recent Jackson Hole speech. The next move, whether it be hike or hold, will be data driven. But the message for markets was clear 'we will keep at it until the job is done.'



WOBBLY WORLD TRADE

While the recent headline growth numbers in the UK, US and indeed Europe have shown a bit of divergence this year, one common theme is a weak trade performance.

Early this year, the World Trade Organisation (WTO) warned of a subpar world trade performance this year, weighed down by the war in Ukraine, high inflation, tighter monetary policy and financial market uncertainty. The erection of barriers and trade fragmentation presented further risks to the outlook.

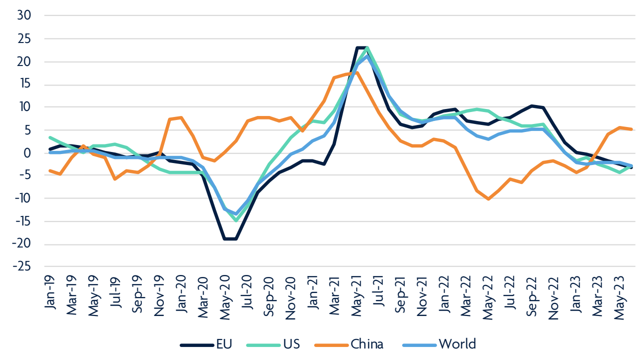
Thus far the data would appear to support that view. Import demand from major economies has been deteriorating over the past year (**chart 3**). However, there were signs that a recovery in Chinese demand may come good.

China has seen four quarters of GDP growth with the expansion in the most recent quarter beating expectations. But at 0.8 per cent, it nevertheless points to some loss of momentum and risks remain from the ongoing property downturn and high unemployment.

The WTO's recent barometer for confirmed a challenging start to 2023 for world trade, with forward looking indicators on export orders running below trend. As such, there appears little momentum for trade growth going into the second half of the year, posing downside risks to the WTO forecast of 1.7 per cent growth this year.

The growth benefits of buoyant world trade for the UK and other advanced economies look like they will be largely absent this year. While most forecasters are predicting strong global GDP growth next year, risks to the trade outlook remain in 2024 with the addition of geopolitical tensions and potential further supply shocks.

Chart 3: Merchandise imports, percentage change three months on a year ago



Source: CPB World Trade Monitor

LABOUR MARKET LOOSENING?

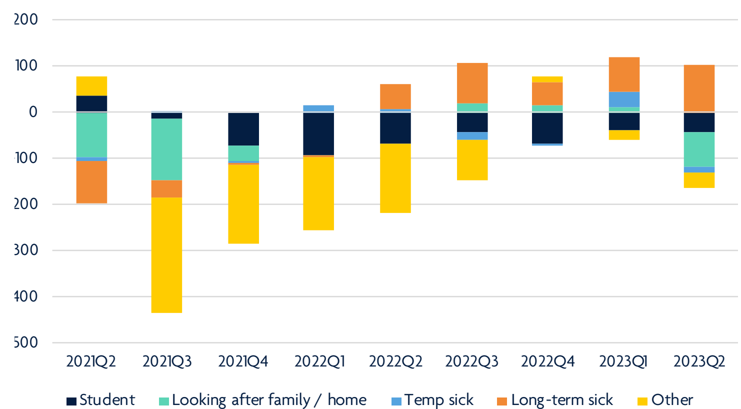
Back to the UK data ... there were a few notable labour market developments in the latest ONS release. Making the headlines was the further acceleration in wage growth.

Total pay growth in the three months to June came in 8.2 per cent higher than the same period a year ago – up from 7.2 per cent in the three months to May (and higher than CPI inflation for the first time since October 2021).

While total pay growth was impacted to a significant degree by payments of one-off bonuses to NHS staff in June, excluding bonuses, regular wage inflation was the highest since comparable records began (7.8 per cent). This was not the news the Bank of England wanted, noting in the minutes of the recent MPC meeting that this provided some evidence that 'some of the risks from more persistent inflationary pressures may have begun to crystallise.'

However, there were some data points that suggest that some loosening labour market conditions may be underway. The number of vacancies fell again, and there was a decline in economic inactivity.

Chart 4: Economic inactivity amongst those wanting a job, change on quarter thousands



Source: ONS

Chart 4 shows quarterly changes in the economically inactivity population (those inactive but wanting a job). There were notable declines across those looking after family and students. However, offsetting this was a further rise in long-term sickness.

The softening in demand combined with an increase in the supply of labour led to a further increase in the unemployment rate to 4.2 per cent. These factors (as well as signs that inflation may be on its way down) should start to take the pressure of pay growth in the latter part of this year.

INTEREST RATES ... THE FINAL COUNTDOWN?

The Bank of England's Monetary Policy Committee (MPC) voted to raise Bank Rate by 0.25 percentage points to 5.25 per cent at its August 2023 meeting. The decision, supported by a majority of 6-3, continued to be driven by concerns over persistent inflationary pressures and the importance of maintaining both price stability and sustainable economic growth.

The MPC's projections, outlined in the accompanying August Monetary Policy Report, showed inflation falling to around 5 per cent by year-end, driven primarily by lower energy and gradually diminishing food and core goods price inflation and only returning to the 2 per cent target by Q2 2025.

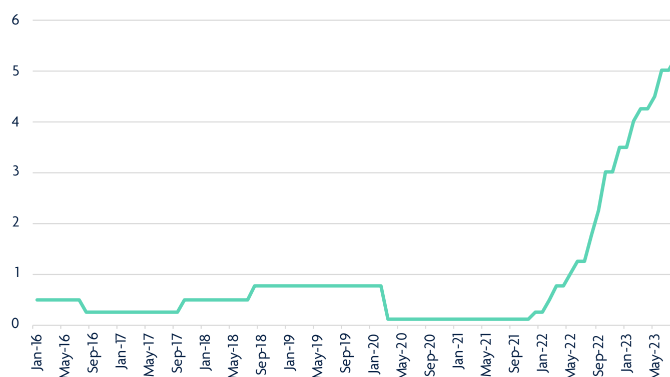
On growth, the MPC expects subdued growth, similar to that in 2023 H1, to persist in the near term due to resilient household spending reflected in recent business surveys. However, further weakening pointing to lower consumer confidence, the Bank's Agents had reports of a slowing in the outlook for activity in the most recent period. In addition, recent increases in market interest rates, and the subsequent media coverage of increasing mortgage costs, could have also contributed to weaking in some indicators.

In line with the labour market developments outlined above, the tightness of the labour market is expected to ease, with the unemployment rate forecast to increase more than previously projected, reflecting weaker GDP growth.

The MPC notes it remains vigilant about persistent inflationary pressures, particularly regarding wage growth. The current monetary policy stance is considered restrictive due to the cumulative Bank Rate increases. However, the MPC will closely monitor inflationary signals and if persistent pressures arise, further tightening of monetary policy may be necessary.

A recent Reuters poll suggests that a majority of economist expect the MPC to think further tightening will indeed be necessary and vote for another quarter point rise when it meets in September. But most expect the Committee to hit pause at that point.

Chart 5: Bank Rate, percentage



Source: Bank of England

Indicator	Period	Value	Change	2023 Forecast*
GDP	Q2 2023	0.2%	↑	0.3%
CPI inflation	Jul 2023	6.8%	↓	6.1%
Unemployment rate	Jun 2023	4.2%	↑	4.1%
Average earnings	Jun 2023	8.2%	↑	5.4%
Brent crude	Jul 2023	$80.11	↑	-
$ Exchange rate	Jul 2023	$1.29	↑	-
PSNB	Jul 2023	£4.3 bn	↓	£132.7bn

Source: ONS, HM Treasury, Bank of England, EIA