MONTHLY ECONOMIC INSIGHT

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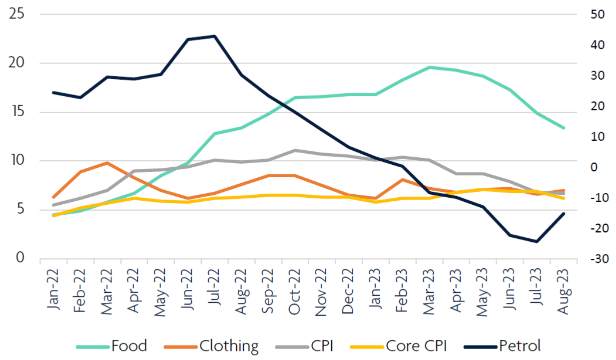
Back to prices this month – somewhat better news on inflation and the Bank of England's decision to keep interest rates on hold in September. The data continues to signal continuing uncertainties ahead on growth and some bumps in the road on inflation with rising oil prices. We round off with the headline from UK Finance's latest report on payments markets.

INFLATION SURPRISE

Good news at last on the inflation front. Against expectations that August data would show a modest uptick in CPI inflation, the headline rate dropped to 6.7 per cent – the third consecutive monthly fall and the lowest level since February 2022.

One of the main drivers of (slightly) lower CPI inflation in August was the continuing decline in food price inflation – this component has been heading lower since March and at 13.4 per cent in August, was the lowest rate of inflation since July 2022 (**chart 1**).

Chart 1: CPI components, annual percentage change



Source: ONS

But a regular reminder that this is still hitting people hard in the wallet. Of those surveyed as part of the ONS public opinions and social trends survey, virtually all respondents that have seen their cost-of-living increase in the past month attribute this to higher food prices. A look at monthly movements shows there's no sign that prices, including of essentials, falling back.

In addition, there were downward contributions to inflation from hotels and restaurants, accommodation services, and recreation. The effects of last year's big hikes in energy costs dropping out of the series and are helping to hold down the headline rate.

However, offsetting these falls was an upward contribution from motor fuels. The ONS noted a 5p per litre increase in petrol prices between July and August, driven by a rise in the oil price (we'll come to this next).

The Bank of England will have taken a couple of other positives away from the data – core CPI and services inflation – both of which were looking sticky, also headed south in August. Ahead of the CPI data release, a further (and perhaps final) 25 basis point increase in Bank Rate had been expected. Though, recent statements from MPC members had stressed that decisions would be finely balanced.

In addition to the inflation news, the Bank also downgraded its expectations for growth in the second half of the year as rate rises so far continue to weigh on activity. Added to this were further signs of labour market loosening and fears of continuing upward pressure from rapid earnings growth have been somewhat assuaged by more recent survey data.

The data and the decision were indeed finely balanced with a narrow majority voting to leave rates on hold at 5.25 per cent, with four members preferring a 25-basis point increase. Is this the end of the tightening cycle? I'm not so sure. Inflation indicators will likely show some volatility in the months to come and the path of growth and the labour market in the near term remain uncertain. The Bank of England, along with other central banks appear to be leaving the door open to further rate rises, should they be warranted.

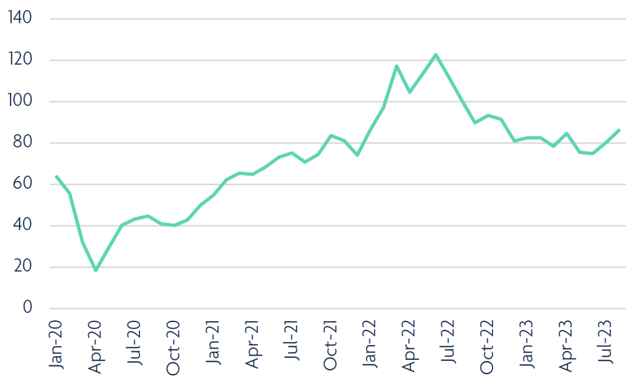
OIL PRICE RALLY

Returning to those rising petrol prices. **Chart 2** shows recent developments in Brent crude oil prices in recent years – from the collapse during the pandemic, the subsequent recovery as the global economy reopened and last year's spike following the Russian invasion of Ukraine.

Oil prices had shown some stability, hovering around $80 per barrel through much of this year, but since the beginning of July oil prices have increased by around 30 per cent.

There are a few factors driving prices higher. Production cuts by Saudi Arabia and Russian, of over one million barrels per day have raised fears of supply constraints. In addition, inventories, particularly in the US, looks tight heading into the winter. While there has been more momentum behind rising prices in recent months, forecasters appear spilt on whether crude prices will rally to over $100 and stay there.

Chart 2: Brent crude, $ per barrel



Source: US Energy Information Administration

A US soft landing and continued growth in China would support demand, putting upward pressure on prices. However, neither of these seem certain. US consumer confidence has faltered in recent months and higher interest rates present headwinds for consumers and businesses through the rest of this year and into next. And in China, which is kay as one of the world's biggest oil importers, the post-Covid rebound has clearly faded. The massive shift to electric vehicles in China may also keep a lid on fossil fuel demand.

On the supply side, if a more positive global growth outlook holds, those production cuts could be eased to meet demand together with increased output from non-OPEC members, such as US shale production.

Developments on these demand and supply dynamics develop could further add to the volatility in inflation indicators in the coming months.

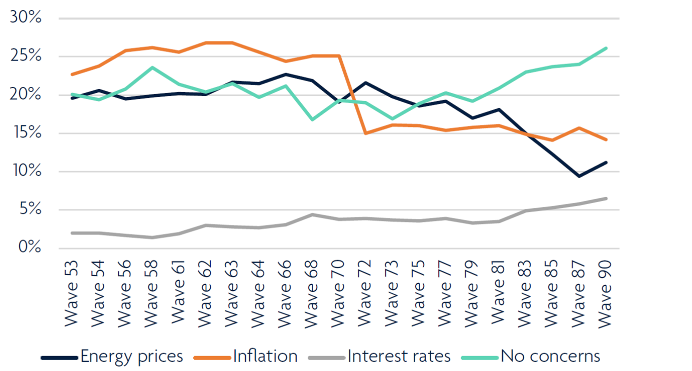
BUSINESS INFLATION WORRIES SUBSIDE

Inflation developments are also providing a bit of relief for businesses. The ONS business insights and conditions survey has been taking the temperature of businesses across a range of trading, employment and pricing indicators since the pandemic.

Similar to the challenges that households have experienced as a result of high energy bills, business have also been under pressure from a range of higher costs in in recent years. For much of the past year energy costs and rising goods and services prices have been the main concerns of businesses. But as chart 3 shows, the proportion of firms citing these as a main concern has started to subside. This is consistent with other surveys such as the PMIs, which point to the slowest rise in private sector business expenses since January 2021.

There are, however, a couple of points worth noting. The first is that not all sectors are feeling this equally. Over a third of businesses in accommodation and food services still feel under the cosh from energy costs. These businesses, together with those in manufacturing and construction are also more likely to cite wider inflationary pressures as an ongoing concern.

Chart 3: Business concerns, percentage of respondents reporting main business concern



Source: ONS Business Insights and Conditions Survey

Secondly, past energy price shocks cast a long shadow over many small businesses as analysis from the **BVA/BDRC SME Finance Monitor** shows. The data shows that over four in five of those businesses that consider themselves to be financially struggling have been and/or continue to be worried about rising costs. This cohort is not immaterial, and these ongoing financial pressures may have implications for future growth and investment.

Chart 3 also notes the gradual increase in the proportion of business noting interest rates (which include mortgages) as a concern for businesses. Unsurprisingly this increase has come from a very low base and continues to be cited as a concern by far fewer businesses than costs or falling demand, but is closing in on the level of taxation as a main business concern. Again, there are significant sector variations. In the most recent wave of the BIC survey over 40 per cent real estate respondents cited interest rates as a concern, with health and transport and storage business somewhat more likely to be feeling the pressure from higher rates.

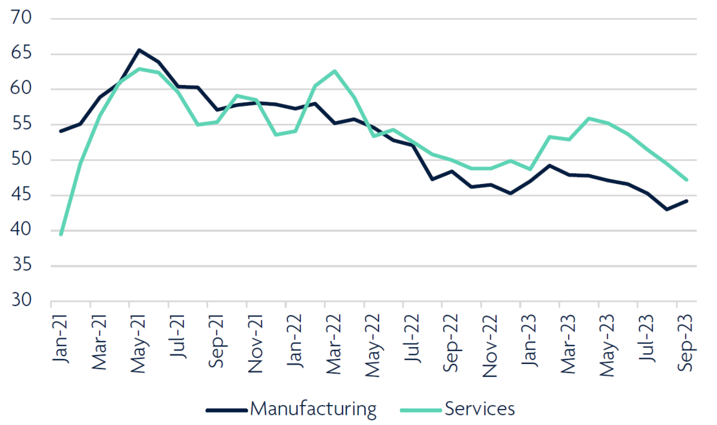
Q3 UK SLOWDOWN ON THE CARDS

Jumping back to that Bank of England decision and the downgrade to expectations for growth in the remainder of this year, the latest round of flash PMIs would support that view.

The MPC minutes noted that it had sight of the flash PMI data ahead of the meeting and Bank staff now expected GDP to rise only marginally in 2023 Q3, compared with the 0.4 per cent rise set out in the August monetary policy report. Underlying growth in the second half of 2023 was therefore likely to be weaker, overall, than had been expected.

Chart 4 shows the marked weakening in the services PMI over the past couple of quarters, with activity in contractionary territory for the past two months with service sector respondents reporting the fastest rate of decline in business activity since the start of 2021. The survey noted ongoing cost of living pressures, higher borrowing costs, cutbacks to spending, particularly in real estate and construction, and a downturn in export demand. Meanwhile, the manufacturing index remains very much in the doldrums, having been below the 50, no change mark since August 2022.

Chart 4: Purchasing managers' indices, 50 = no change



Source: CIPS/S&P Global

A further new development in the flash survey is an 'abrupt turnaround in employment numbers'. Respondents across the private sector reported the fastest pace of job shedding, outside of the pandemic, since 2009. Again, this further supports the Bank of England's view that tightness in the labour market is easing – but the pace will be closely watched in the context of future rate decisions.

While the PMI data would appear to signal a weaker outlook for the UK in the near term, we're not alone. The US flash services indicator fell to an eight-month low in September and although the eurozone index picked up slightly, it nevertheless pointed to contraction again.

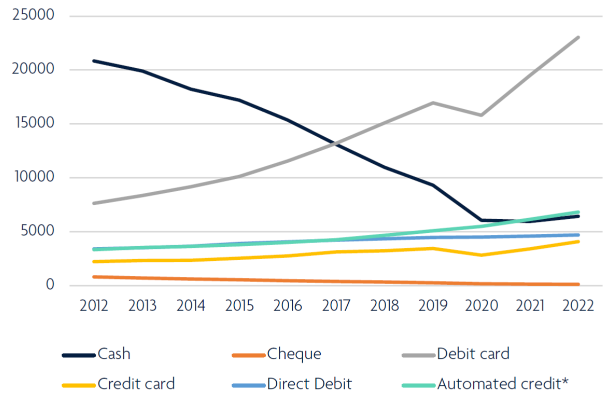
A DECADE OF PAYMENTS TRENDS

And on to something completely different. Last month saw the publication of UK Finance's annual UK Payments Markets report – rounding up developments on all forms of payments in the UK over the past decade.

Chart 5 shows how the volume of transactions across the main payment methods in the UK has evolved in the past ten years. And the key take-aways for 2022 include:

- Total number of payments increased to 45.7 billion, up from 40.4 billion in 2021.
- For the first time, half of all payments (50 per cent) in the UK were made using debit cards.
- The number of cash payments increased to 6.4 billion payments (6 billion in 2021) although the proportion of payments made using cash fell slightly from 15 per cent to 14 per cent.
- The number of contactless payments increased by 30 per cent to 17 billion.
- Continued growth in the use of Faster Payments by both consumers and businesses.

Chart 5: Payment transaction volumes, millions



Source: UK Finance

** Includes Bacs Direct Credits, Faster Payments Service, CHAPS and in-house standing orders and remote banking payments*

In the context of the inflationary pressures already discussed, the analysis in the report suggests that there has been a shift towards an increasing number of transactions that are each worth a lower amount, without necessarily increasing the overall amount spent.

Anecdotal evidence suggests that people are, for example, making more smaller visits to supermarkets rather than doing one large shop. In addition, as more people work from home, purchases of travel cards have fallen significantly as people instead pay for individual journeys – therefore increasing the number of travel payments.

However, the data that attracted the most attention was the increase in the number of cash transactions (though still on a declining trend in terms of the share of all payment methods). The increase in cash transactions is a rarity, but generally coincides with periods of economic downturns as some people are make greater use of cash as a way of managing budgets – a factor again at play during last year's cost of living pressures.

Over the next decade, we expect to see a continuation of current trends, with debit cards becoming ever more popular and cash usage continuing to decline in importance and lose its top three podium spot in 2026. UK Finance members can access the report on the My UK Finance portal, non-members can find more information **here**.

Indicator	Period	Value	Change	2023 Forecast*
GDP	Q2 2023	0.2%	↑	0.4%
CPI inflation	Aug 2023	6.7%	↓	6.1%
Unemployment rate	Jul 2023	4.3%	↑	4.3%
Average earnings	Jul 2023	8.5%	↑	6.5%
Brent crude	Aug 2023	$86.15	↑	-
$ Exchange rate	Aug 2023	$1.27	↓	-
PSNB	Aug 2023	£11.6 bn	↑	£129.3bn

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