UK FINANCE

MONTHLY ECONOMIC INSIGHT

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Written by:

Lee Hopley
Director,
Economic Insight and Research

January has been a busy month for economic news, bringing more insight on consumer behaviour over the key Christmas period, what appeared to be a surprise increase in inflation, as well as significant international developments and the latest decision from the Monetary Policy Committee. This month's briefing trots through some of the many headlines.

FESTIVE SPENDING

UK retail sales across 2023 were subdued due to constraints caused by the economic setting as consumers faced higher living costs. The important Christmas period that most retailers bank on to ignite their sales growth for the year was challenging, with a mixed bag of data pointing to diverging fortunes across food and non-food retailers.

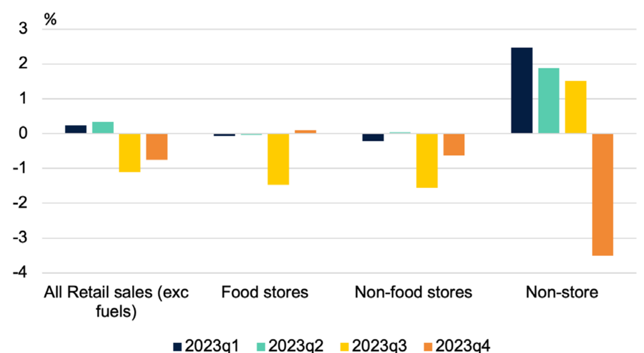
Official retail sales data from ONS show a 0.7 per cent fall in volumes in the final quarter of 2023 (**chart 1**) with a particularly steep drop in December. Consumers did do some early Christmas shopping in November, taking advantage of black Friday discounting, but the boost to sales was more modest than in previous years.

There was a slightly better performance across food retailers, which did see some growth over the quarter. The official data tally with surveys from the December according to the British Retail Consortium (BRC) and trading statements from retailers such as Tesco and Marks & Spencer's which reported food sales growth at around 17 per cent and 11 per cent respectively over the Christmas period. They also noted a good performance across online sales.

Overall, sluggish sales were consistent with ONS survey data that showed around half of consumers were planning to spend less on food and gifts. Given the importance of spending across the festive it's unsurprising that weakness has dented small business confidence. The UK Small Business Index dropped in the final quarter of 2023 to -15 points according to the Federation of Small Businesses' (FSB).

On the outlook heading into the new year, many industry experts expect that 2024 will continue to be a challenging environment for the retail industry. However, with the UK consumer confidence hitting a two-year high in January, according to GfK's Consumer Confidence index, and real terms grow in wages in prospect, the sector may see some green shots emerge later in the year.

Chart 1: Retail sales volumes, percentage quarterly change



Source: ONS

SLOWING LABOUR MARKET

While output has flatlined for the best part of 18 months, labour market indicators have remained reasonably firm. Unemployment edged up a little over the course of 2023, but the latest estimates pointed to an unchanged, and low by historic standards, rate of 4.2 per cent in the three months to November (new labour force survey data will come on stream this month).

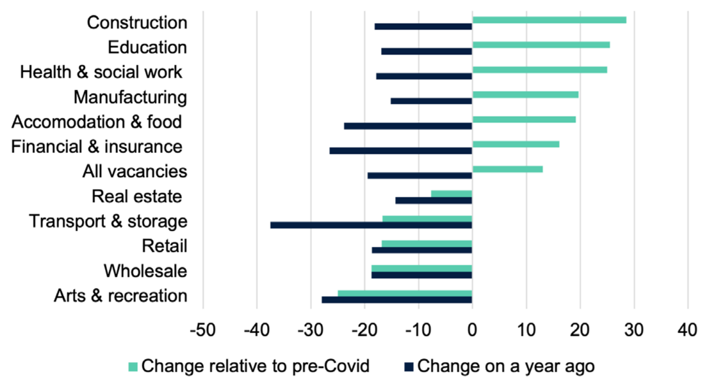
Average earnings growth also continued to moderate from peaks earlier in the year, total pay growth (which includes bonuses) rose by 6.5 per cent in the three months to November – a step in the right direction (as far as the MPC are concerned), but still a punchy rate of growth.

With January a key pay settlement period across most industries (April is another), surveys of pay deals at the start of the year will be closely watched for further signs that pay growth is moderating. Evidence from, for example, the Decision Maker Panel, points to expected wage inflation in the region of five per cent this year – which would be the slowest pace of increase in the post-Covid period.

A slowdown in hiring activity will also take some heat out of pay growth. ONS data has now recorded 19 consecutive months of falling vacancies across the economy. Despite the downward trend, total vacancies are still higher than immediately prior to the pandemic.

However, the latest figures point to increasing divergence across economic sectors (**chart 2**). While all parts of the economy have seen vacancies fall to below the levels reported a year ago, in some (mainly consumer facing sectors), vacancies are now lower compared with the start of 2020. This is a consequence of consumers' response to cost-of-living pressures and uncertainty for businesses about demand prospects. It is also a sign of a cooling labour market which should help ease domestic inflationary pressures that the Bank of England is keeping a close eye on.

Chart 2: Change in vacancies by sector, percentage



Source: ONS

INFLATION SURPRISE AND THE BANK

CPI inflation started 2023 at 10.1 per cent, but at the start of Q4 the rate dropped markedly to 4.6 per cent in October and then 3.9 per cent in November. There was (what appeared to be) an upside surprise in the December inflation print, with the headline rate picking up again to four per cent. Cue speculation that the move would delay cuts to interest rates.

In fact, the data release was more noise than news, with some calculation changes (reweighting of air fares) and volatile components (e.g. computer games and live events) making upward contributions. Tax changes in the Autumn statement on tobacco tax also pushed the rate higher.

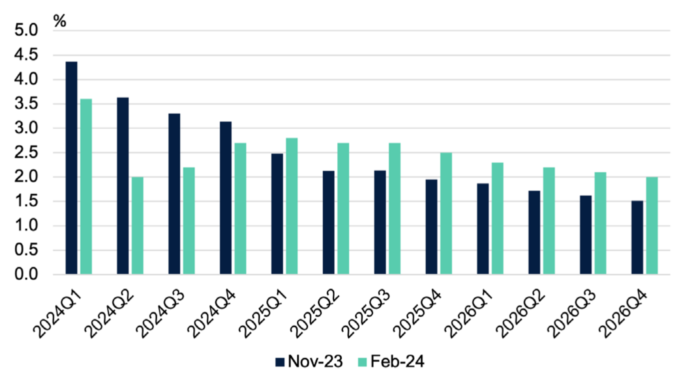
December moves didn't worry policy makers, with Q4 CPI coming in lower than forecast and growing signs that global inflationary pressures are easing. Moreover, the Bank of England's latest forecast in February now expects a much more rapid near-term fall in inflation than was the case in November (**chart 3**).

CPI will hit target in Q2, but temporarily, thanks to a reduction in energy prices. However, it is predicted to rise thereafter ending 2024 at around 2.7 per cent (compared with its previous forecast of 3.1 per cent) and remaining above the two per cent for the remainder of the forecast period. Forecasts are conditioned on market expectations of interest rates, which the Monetary Policy Report notes are around 100 basis points lower than assumed in November.

Essentially the battle has not yet been won on inflation. The Bank notes the continued presence of domestic inflationary pressures and elevated wage growth but sees the risks on this front more evenly balanced than previously. However, there are upside risks to the forecast profile in the near term, predominantly from geopolitical factors (we'll come to that next).

A quick word on the growth forecast – revisions for 2024 GDP growth were modest with a bit more of a pickup in activity expected at the start of this year, but the resulting expectation of 0.25 per cent growth this year (against no growth in November) continues to indicate another stagnant year.

Chart 3: CPI forecast, percentage rate (based on market interest rate expectations



Source: : Bank of England

The decision to hold was largely expected but split once again with two members voting for a quarter point rise and one voting for a quarter point cut. The Monetary Policy Report reiterated that policy would need to remain restrictive for sufficiently long to get inflation back to target sustainably, and in the medium term. More evidence that this is in train was, therefore, required. Given some of the uncertainty around, particularly the near-term, path of inflation, it may take some months for a majority on the committee to be convinced that there is sufficient evidence that domestic price pressures will not persist before voting to ease monetary policy.

SUPPLY CHAIN DISRUPTION

Returning to those near-term upside risks to inflation ... these stem largely from the geopolitical tensions in the Middle East, which have led to disruptions to shipping through the Red Sea and Suez Canal.

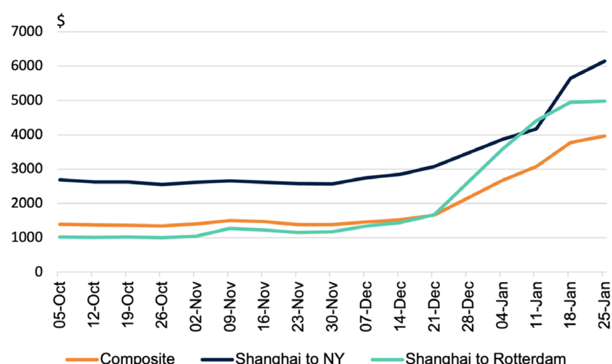
Recent attacks on commercial shipping have led to the re-routing of trade away from the Red Sea and around the south of Africa – adding time and cost to freight (**chart 4**). We have recent experience of the impact of post-Covid supply chain disruptions on inflation, the question is what impact these latest geopolitical developments may have.

An estimated 12 per cent of world trade goes via the Suez Canal making it a key trade route mainly between Asia and Europe. On the one hand, subdued demand across may dampen the effect of shipping delays and retailers may be more likely, therefore, to absorb cost increases rather than pass through to stretched consumers.

There are emerging signs that delays and additional costs are being felt in the manufacturing sector, with January's purchasing managers' index reporting higher costs and increased lead times as a result of the disruptions.

This could prove fleeting if there is no escalation in tensions and the easing in global export prices resumes. However, the Bank of England note that prolonged disruption presents an upside risk from higher logistics costs, rising energy prices, potential shortages and second round effects through uncertainty in financial markets.

Chart 4: Container cost index, $ per 40ft container



Source: Drewry's World Container Index

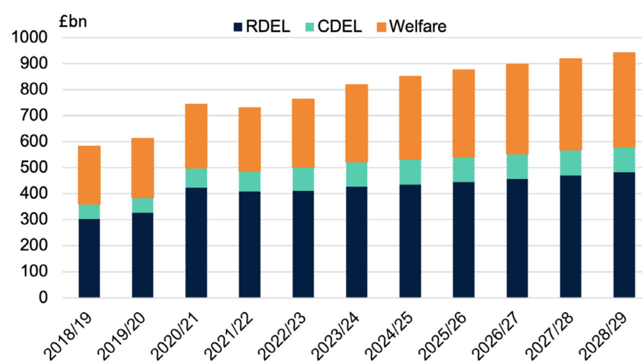
ANOTHER FISCAL EVENT

It was only a few months ago when we reported on the detail of the chancellor's autumn statement and forecast update from the Office for Budget Responsibility (OBR), but we're already looking ahead to the next one on March 6th.

There's hasn't been a great deal of new news on fiscal situation since November – data on borrowing in December was around £5 billion lower than forecast, largely due to lower debt interest. However, receipts were also lower than the OBR's forecast profile. But January data, which includes the lump of self-assessment receipts will provide a clearer indication of how much, if any, room for manoeuvre the chancellor with have for any new tax or spending measures.

While the government's ambition for tax cuts is no secret, in recent statements the chancellor has walked back from suggesting personal tax cuts of a magnitude seen in the autumn statement will be forthcoming in March.

Chart 5 Public sector expenditure, £ billion



Source: OBR

This chimes with the views of the International Monetary Fund (IMF). Its Chief Economist recently advised against further discretionary tax cuts given spending pressure from health and social care, and the transition to net zero. In addition, one doesn't have to dig too deep to uncover the problems with local government finances, most often described as in crisis.

The spending side of the equation (as we alluded to in December) is the trickier side of the budget equation. Recent increases in RDEL (department resource spending), (**chart 5**), have been modest across the last spending review and the forecast spending envelope for the next five years points to similar rates of growth – presenting some tough trade-offs across departments in the next parliament.
The lack of detail on priorities was a point highlighted by the head of the OBR at a recent House of Lords economic affairs select committee – "At the moment, the Government have them (department expenditure limits) falling as a share of GDP, but they provide almost no detail about how that will be delivered."

In usual times, the government sets out detailed three-year spending plans at each spending review. The absence of this detail does make it more challenging to see the full fiscal picture. We can be fairly certain this won't be resolved at the spring budget.

What we might see is policies targeted towards the housing market and ISA reform, which were expected before the autumn statement, but didn't feature in the speech. But a lot of politics can happen between now and the Budget speech on March 6th and the chancellor may well find the means to pull a (tax cutting) rabbit out of the hat.

Indicator	Period	Value	Change	2024 Forecast
GDP	Q3 2023	-0.1%	↓	0.4%
CPI inflation	Dec 2023	4.0%	↑	2.2%**
Unemployment rate*	Nov 2023	4.2%	↔	4.7%**
Average earnings	Nov 2023	6.5%	↓	3.8%
Brent crude	Dec 2023	$77.63	↓	-
$ Exchange rate	Jan 2024	$1.27	↑	-
Bank Rate	Feb 2024	5.25%	↔	4.5%**

Source: ONS, HM Treasury, Bank of England, EIA
** New ONS experimental series*
*** Q4 2024*