MONTHLY ECONOMIC INSIGHT

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Ahead of the March 6th Budget there has been good news and bad news – the news on the public finances was better than expected. But first estimates of the UK economy's performance at the end of 2023 prompted headlines announcing recession. We'll look at the detail, how sectors have performed since the pandemic, and how the UK stacks up internationally.

RECESSION?

The latest data from the ONS on UK GDP paint a sobering picture, with the economy contracting by 0.3 per cent in the fourth quarter of 2023, continuing the downward trend from the previous quarter. This marks the second consecutive quarter of decline, reflecting the challenges faced by all sectors of the economy and putting the UK into a technical recession. Full year growth for 2023 came in at 0.1 per cent.

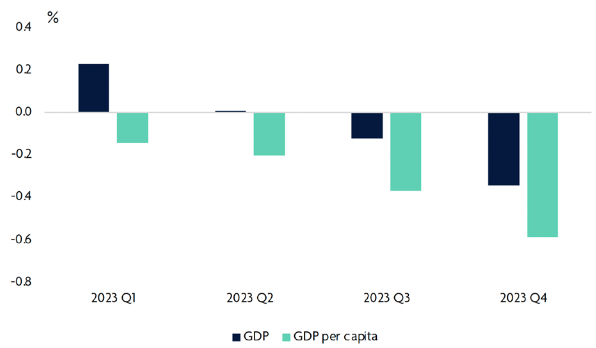
We are slightly cautious in leaning in too much to pronouncements of recession. One or both quarters of falling GDP could yet be revised in future iterations of the data. And, in any case, the contraction is a mild one, with expectations that we'll see signs of gradual recovery through 2024. The narrative of the past year has, nevertheless, been one of stagnation.

Looking at the detail, declines were broad-based across expenditure components. Real household expenditure mirrored the broader economic trends, falling by 0.1 per cent in Q4 2023, driven by reduced spending on recreation, culture, miscellaneous goods, and transport (for more on household finances in Q4 see our **Household Finance Review**). Net trade and government consumption saw reductions, although there was a slight uptick in gross capital formation.

In a breakdown of sectors, all main areas experienced setbacks in output, with services, production, and construction output seeing declines of 0.2 per cent, 1.0 per cent, and 1.3 per cent respectively.

Services sustained a third consecutive quarter of decline, with notable falls in wholesale and retail trade, education, and personal services. Production output decreased primarily due to manufacturing's fall of 0.9 per cent. However, this follows a good run of growth in previous quarters leaving manufacturing output over the year up 1.6 per cent. Construction output falls were driven by a decline in new work, and further subdued by higher rates and a slide in house building.

Chart 1: Quarterly change in GDP and GDP per capita, percentage



Source: ONS

GDP per capita, unlike overall GDP growth, is a better gauge of changes in living standards rather than aggregate economic output. The negative trajectory of GDP per capita, declining consecutively throughout 2023 with a -0.6 per cent dip in Q4 2023, underscores concern about average living standards (**chart 1**). This level of quarterly decline was the largest since Q1 2021, where there were the lingering effects of the Covid era.

With the Office for Budget Responsibility (OBR) set to publish its update view on the economy on March 6th, there's little in recent data releases to change the broad thrust of their commentary on the UK outlook compared with their November forecast.

POST-PANDEMIC LEADERS AND LAGGARDS

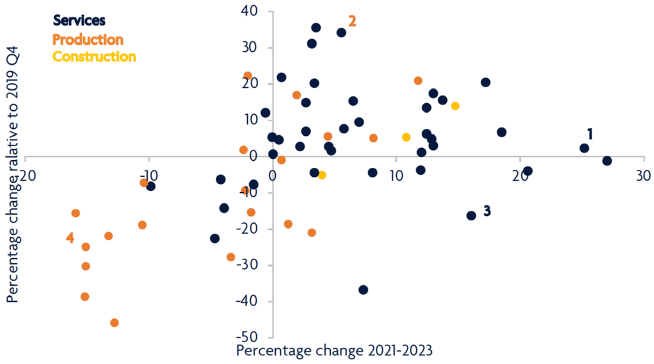
While all three board sectors struggled at the end of 2023, there has been a high degree of variation in performance across sub-sectors since the UK emerged from the pandemic. **Chart 2** compares sectors' (at the 2-digit SIC code level) performance since emerging from the pandemic and where their level of output stands relative to the end of 2019.

What's clear is that there are multiple stories about how sectors have evolved in the past two years when looking through this more granular sector lens.

A majority of sectors have both grown and surpassed pre-pandemic levels of output (the top right-hand quadrant of the chart). And with a few exceptions these are mostly sectors in the service industry and construction – the latter seeing a strong and early recovery after Covid-19.

One of the strongest rebounds in activity was in sports activities, amusement and recreation activities (1), however, even as one of the stronger performers, output has only just regained pandemic related losses. In addition, more recent cost-of-living pressures may have limited the bounce back, given this sector is likely more reliant on discretionary spending.

Chart 2: Change in output 2021-2023 and 2023 Q4 relative to 2019 Q4, percentage



Source: ONS

One of the production-related exceptions is pharmaceuticals manufacture (2). This sector was boosted by production of Covid-19 vaccines during the pandemic but has also sustained modest levels of growth in recent years.

The longer terms effects of the pandemic are clear when looking at the performance of land transport (3) – strong growth since the pandemic as people returned to bus and train travel, but still some way from normal as a result of changes in working and commuting patterns.

The sectors in the bottom left-hand quadrant of the chart are the most challenged – posting no growth between 2021 and 2023 and output continuing to lag pre-pandemic levels. These are concentrated in production sectors, for example the manufacture of electrical equipment (4). This likely reflects subdued public and private investment in recent years. However, this sector (and others like it, which include industries in the construction supply chain) are still important in sustaining growth in power generation and the net zero transition.

Understanding these dynamics will be important in considering future economic priorities and how a broad-based recovery is sustained in the coming years.

UK GROWTH COMPARED

Turing to the international picture (**chart 3**); while recent growth in the UK has disappointed it is not out of line with that seen across parts of the eurozone. The German economy saw growth only in the first three months of 2023, followed by two quarters of stagnation and a 0.3 per cent contraction in the final months of last year. Facing the same challenges as the UK – high energy and borrowing costs – the impact on German GDP is most evident in weakness in construction and manufacturing activity.

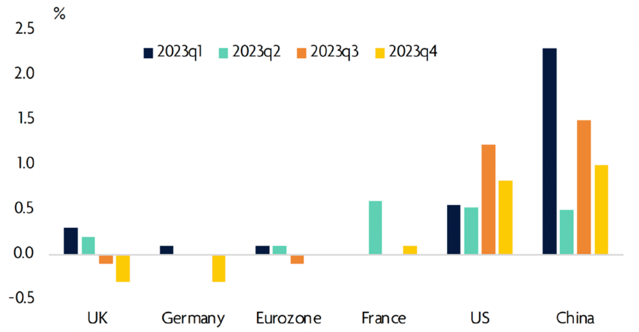
There was a similar story of stagnation in France across much of last year with shaky consumer demand and weak investment holding back growth.

The US, in contrast, is something of a G7 outlier. Unlike the UK's broad-based decline in most GDP components, the US saw growth across most segments of the economy. Personal consumption expenditure rose by 0.8 in both Q3 and Q4. While growth slowed in other areas (namely private and residential investment, and federal government spending) contributions were nevertheless positive. The apparent resilience of the economy, while seemingly doing little to influence the polls ahead of the election, has led forecasters to push back their expectations of when the Fed's first interest rate will come.

And turning finally to China, an important driver of global growth in the decade before the pandemic, which continues, on the face of it, to register fairly robust growth rates. GDP expanded by more than five per cent in 2023 and just about hit the government's target, but this growth rate is flattered by pandemic restrictions that continued to linger in 2022.

Double-digit growth rates are likely a thing of the past for China and in the short-term policy makers need get a handle on the crisis in the property sector, deflation, and a struggling manufacturing sector. March's national peoples' congress provides government with an opportunity to outline reforms and stimulus to stabilise the economy.

Chart 3: Quarterly change in GDP, percentage



Source: : ONS, Eurostat, Bureau of Economic Analysis, National Bureau of Statistics China

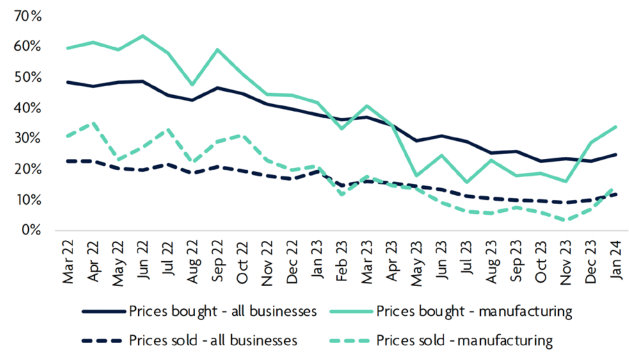
SUPPLY CHAIN DISRUPTION REVISITED

In **last month's briefing** we discussed the implications of Middle East tensions and disruption to Red Sea trade routes. Since then, we continue to see evidence of this impacting on businesses with the potential to add to inflationary pressures.

The Drewry container index, that we reported on last month, has edged down from the end-January highs. However, other survey indicators from businesses suggest higher costs and shipping delays are starting to filter through.

Chart 4 shows the percentage of all businesses and manufacturers that have seen an increase in prices bought and are in turn passing those on the customers. After steadily declining through last year there has been an uptick in businesses seeing higher prices – particularly in manufacturing. Over a fifth of manufacturers said higher transport costs contributed to the rise.

Chart 4: Businesses reporting monthly change in prices bought and sold, percentage



This tallies with a new survey from the British Chambers of Commerce, which reported that more than half of UK exporters have been impacted by disruption to shipping in the Red Sea. And February's manufacturing purchasing managers' index (PMI) which said 'by far the biggest impact on supplier performance was the effects of the Red Sea crisis. This also contributed to a further increase in average purchase prices, which rose for the second month in a row.'

The feedthrough to consumer prices should be limited unless the disruptions escalate. Nevertheless, upside risks to inflation create more uncertainty about the timing of a cut in Bank Rate.

BUMPER JANUARY RECEIPTS

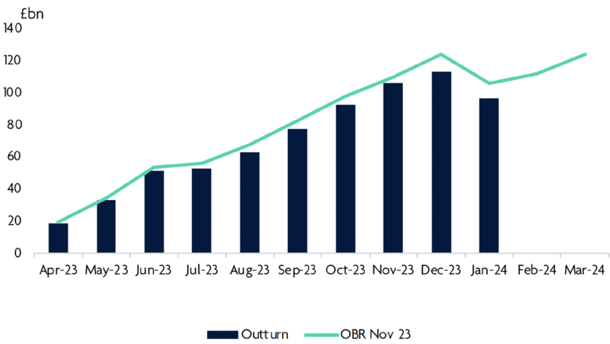
And finally, some better news, for the Chancellor at least, ahead of the March 6th Budget. Public sector net borrowing recorded the largest ever surplus in January (£16.7 billion) helped by an inflow of receipts from self-assessed income and capital gains tax.

While this was a shade lower than the OBR were predicting, overall borrowing in on track to be around £10 billion lower than forecast for the year (**chart 5**).

Is this the 'fiscal headroom' the government needed to announce a package of tax cuts? Maybe. But as more and more commentators are alluding to, these month-to-month developments are perhaps not the soundest basis for fiscal policy.

The focus on where there might be space for personal tax cuts is understandable, given the rise in the tax burden in recent years and the effects of fiscal drag, but attention will equally be paid to indications on the shape of spending plans beyond 2024/25.

Chart 5: Public sector net borrowing, £ billion



Source: OBR and ONS

Indicator	Period	Value	Change	2024 Forecast
GDP	Q4 2023	-0.3%	↓	0.4%
CPI inflation	Jan 2024	4.0%	↔	2.2%*
Unemployment rate	Dec 2023	3.8%	↓	4.7%*
Average earnings	Dec 2023	5.8%	↓	3.8%
Brent crude	Jan 2024	$80.12	↑	-
$ Exchange rate	Feb 2024	$1.27	↑	-
Bank Rate	Feb 2024	5.25%	↔	4.5%*

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

** Q4 2024*