Summary of NIESR Business Conditions Forum July 2021

The National Institute of Economic and Social Research (NIESR) hosted the Business Conditions Forum (BCF) on 7 July 2021. The aim of the BCF is to have informed and analytical discussions of data and surveys to better understand the current state of the UK economy. The discussions are held to the Chatham House Rule to encourage free and open discussion. NIESR is grateful to the ESRC and the Impact Accelerator Award (IAA) for funding the BCF.

Agenda

The discussion at this meeting focused on what insight that can be gleaned from business survey data about the UK post-Covid recovery, and what that means for inflation in the future.

Main discussion points

Business survey data: What can the PMI tell us about post-Covid UK recovery and inflation?

Set against the global backdrop, PMI data suggests the fastest growth spell in 2021Q2 since 2006, with global service sector growth exceeding that of manufacturing. This reflects a slow-down in manufacturing growth, notably in Asia, as countries face rising rates of infections as well as companies in the service sector indicating that they cannot source enough staff to meet rising demand. This recovery continues to be very disparate, led predominantly by developed world services, most notably in the US, UK, and the Eurozone area. By comparison, emerging market services and manufacturing sector growth slowing to stagnation. PMI data suggests the disruption to supply chains and labour shortages are driving input and output prices higher, signaling a peak in global CPI.

In the UK, survey data suggest record growth in goods prices and services charges. The disruption to supply chains has driven prices for intermediate goods to a record high, which in turn is feeding through to both investment and consumer goods. Supplier delays in the UK are more severe when compared to other developed country survey data, reflecting the impact of Brexit in addition to pandemic-related disruptions. Some indicators suggest that supply shortages could be temporary, with manufacturers stock building exacerbating the demand-supply disequilibrium, but the shipping and port delays due to Brexit means that input prices in the UK will remain higher than the global average. There is a concern that the collapse of manufacturing in Asian countries could prolong the effect of high albeit transitory price pass-through.

Increases in UK service sector prices have been broad-based, with businesses passing the cost of higher wages due to labour shortages on to consumers. The employment situation, and the extent to which higher salaries are temporary, depends on labour market participation following the end of the furlough scheme. PMI survey data suggests additional inflationary pressures that could cause CPI to rise above the Bank of England 2 per cent target rate, before base effects and high transitory prices phase out by 2022. There remain significant upside risks to the inflation outlook over the next few months: i) the UK recovery path has been faster and stronger than expected, putting greater pressure on deteriorating supply chains, ii) Brexit-related supply chain disruption unique to the UK, iii) rising commodity prices, particularly the oil price, and iv) the longer higher wages and input costs feed through to consumer goods, the more likely it becomes that the higher prices will impact wage bargaining rounds.

Inflation during and after the pandemic

Officially published statistics indicated that CPI was below 1 per cent from April 2020 until March 2021. Many experts suggested that the official numbers were underestimating the true level of inflation, Professor Huw Dixon amongst those indicating that a shift in expenditure shares and smaller discounts may impact on the calculation of inflation. For that reason, Professor Dixon has published a monthly CPI-Lockdown Weighted (CPILW) blog on the NIESR website during the pandemic.

In the absence of the large drop in CPI in April and May of 2020, headline inflation would likely have remained above 1 per cent until March 2021. The recent media focus on the surge in inflation is partly an effect of a low base, but the outlook for headline CPI remains highly uncertain. Given that month-on-month inflation is known for April and May 2021, it is possible to conduct a simple inflation accounting scenario to represent the range of possible inflation outcomes in the year to May 2022. Assuming month-on-month inflation between 0.17 per cent (equivalent to 2 per cent annual) and 0.25 per cent (3 per cent annually), inflation is expected to peak in February 2022 in a range between 3 to 3.8 per cent before returning to a range of 2 to 3 per cent by May 2022.

During July 2020 there was a temporary reduction of the VAT rate for hospitality, hotel and holiday accommodation to support businesses in these industries. This VAT cut will be reduced in September 2021 and March 2022, representing two positive shocks to the CPI calculation. Given the weight of these categories in CPI, this would represent a 0.6 per cent shock in the event of complete pass-through. Under this assumption, inflation is expected to peak between 4.2 and 5 per cent in March 2022 before moderating to a range of 2 to 3 per cent by March 2023.

Further uncertainty remains for inflation prospects, including the possibility of another Covid-wave and associated lockdowns, the end of the furlough scheme and stamp duty holiday, ongoing supply chain disruptions and labour shortages, which could all affect consumer prices in the near term.