EY ITEM Club Summer Forecast

UK economy past the worst but challenges remain

July 2020

Building a better working world

Contents

EY is the sole sponsor of the ITEM Club, which is the only non-governmental economic forecasting group to use the HM Treasury model of the UK economy. Its forecasts are independent of any political, economic or business bias.

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Foreword

Reality starting to dawn

A picture starting to emerge …

I have written before about the unprecedented scale and speed of the economic shock caused by the outbreak of COVID-19 and the policy response to it. While the changes were very visible, it has only been in recent weeks that the data allowing us to quantify the impact has started to come through. The data backed up early concerns: UK GDP fell 6.9% in the month of March and 20.3% in April. Unemployment rose and employers lodged claims for over nine million furloughed workers under the Coronavirus Job Retention Scheme, with another 2.5 million self-employed people receiving income support.

… caution replaces optimism …

Unsurprisingly, without hard data, a wide range of views on the performance and outlook for the UK economy emerged. In recent weeks, as the lockdown started to be eased, more optimistic voices could be heard – Andy Haldane, the Chief Economist of the Bank of England, prominent amongst them, suggesting that we might see a 'V' shaped recovery after all.

However, with GDP only growing by 1.8% in May and the public remaining reluctant to return to their normal activity patterns, a more pessimistic outlook appears likely. The EY ITEM Club's latest forecast certainly suggests it is going to take some time before we return to the levels of activity we had achieved at the end of 2019. The EY ITEM Club forecasts that UK GDP will fall by 11.5% in 2020, a significant downgrade to the 8% it forecast in June, which was a downgrade on the 6.8% decline it predicted at the end of April.

And this is not necessarily the worst-case outcome. As the EY ITEM Club notes, there are downside risks from a second wave of the virus breaking out and of a rise in unemployment if the economy remains subdued. In addition, the UK has yet to agree a trade deal with the European Union, with 'no deal' likely to provide a further challenge for the economy.

…. as the reality of living with the virus becomes clearer …

The data on travel patterns, shopping, workplace attendance, visits to hospitality venues and many other measures confirms that the public is not yet willing to return to pre-COVID-19 patterns of behaviour. As in other countries, there was a bounce back when restrictions were lifted, but the pace of change has not been sustained. Worries about contracting the virus appear to be the most important factor shaping behaviour. Sectors in which social distancing can be more easily managed such as construction and some manufacturing are tending to recover faster than those service sectors reliant on person-to-person contact – the arts and entertainment sectors were poorly performing sectors in May even as other industries showed signs of improvement.

The fact is, there is not a choice between controlling the virus and saving the economy: the two are linked. It seems unlikely that the economy can return to its full potential until the virus has been eliminated or a vaccine has been developed, or a mitigating treatment has been shown to significantly reduce the risk from contracting COVID-19. In a consumer-centric economy like the UK, reluctant consumers will limit the level of economic activity even with a shift to activity online.

… putting the spotlight back on economic policy …

In normal times, additional spending of over £30b as announced by the Chancellor on 8 July would be expected to provide a major boost to economic activity. The data since the announcement suggest more might be needed. The Chancellor is rightly concerned about minimising the drain on the UK's resources, but a decline of 11.5% in GDP will put a strain on the economy and society across the country in any case. For now, concerns over an increase in the UK's level of public debt should be secondary to the need to protect and rebuild the economy. After the Second World War, the UK reduced its debt pile primarily through growing the economy, and with borrowing remaining cheap by historic standards, the challenge now is to invest wisely. Difficult as the last few months have been, the Chancellor is now entering into the most difficult part of COVID-19 related policymaking.

… and challenging business

I have tended to overuse 'unprecedented' ever since the crisis began, but it does describe the situation which business finds itself in. This remains a very uncertain environment with the outlook changing regularly with significant downside risks. Businesses must stay close to the emerging data and continue to use scenario planning to develop financial and operational responses for all significant potential outcomes.

Government policy will be a more important influence on business outcomes than we have experienced for some time. Hence, corporates must continue to track policy announcements and proposals to identify how their businesses could be affected. There should be opportunities as the Government proceeds with its agenda in areas such as moving the UK to net zero and levelling up the economy. Working now to identify where these opportunities could be and how policy might deliver them would be a sensible use of time.

COVID-19 is also likely to accelerate changes that were already in progress. Net zero has been mentioned, and other trends include the adoption of digital technologies, a consumer focus on sustainability more generally and the shift from ever more globalisation. All these shifts create opportunities and pose questions for businesses. I recognise how demanding the short-term challenges are, but it is important to devote resources to strategy beyond the immediate crisis in order to ensure long-term sustainability.

Highlights

- The EY ITEM Club Summer Forecast 2020 sees UK GDP contraction of 11.5% in 2020. This is a substantially deeper drop than the 8.0% fall in GDP anticipated in our early June Interim Forecast 2020 and the 6.8% drop that we had projected in our Spring Forecast 2020 which was released at the end of April. June had marked the first time that we had produced an interim forecast between our usual quarterly reports, reflecting the fact that the coronavirus pandemic was having an unprecedented and fast-moving impact on the UK economy.
- The economy's contraction in Q1 2020 has been revised to 2.2% quarter-on-quarter (q/q) from 2.0% q/q, thereby marking the equal largest quarterly decline since Q3 1979. This primarily reflected the economy contracting a record 6.9% month-on-month (m/m) in March with most of the fall occurring after the lockdown to tackle coronavirus was imposed on 23 March.
- We suspect that the economy contracted around 20% q/q in Q2 2020, rather than the 15% q/q drop we had previously estimated. This means that GDP in mid-2020 is seen 21.8% below the Q4 2019 level. The economy suffered a torrid April when GDP contracted 20.3% m/m as the lockdown fully impacted on activity, and it could only then grow a disappointing 1.8% m/m in May following an initial modest easing of restrictions. The economy appeared to take a significant step forward in June as restrictions were further relaxed – notably including non-essential retailers being allowed to open from mid-month – but this is unlikely to have been enough to stop 20% q/q contraction in Q2.
- The economy is expected to return to growth in Q3 2020 with expansion close to 12% q/q. The substantial fiscal and monetary stimulus that has been enacted by HM Treasury and the Bank of England should provide serious support to activity as restrictions are eased. While some of the emergency fiscal measures will wind down over the coming months – such as the jobs retention scheme ending in October – the Chancellor announced further near-term stimulus measures in his Summer Statement on 8 July. There should also be a fair degree of pent-up demand following a collapse in consumer spending in Q2 due to the lockdown, while consumers should also be helped by very low inflation in the near term. Global economic activity should also be markedly stronger from the latter months of 2020 onwards as other economies recover from their coronavirus-related challenges.
- The Bank of England extended its major support for the economy in June when it announced a further £100b in asset purchases, taking the stock up to £745b. We suspect the Bank of England is not yet done on stimulus to support recovery and that it will deliver a final dose of additional asset purchases at the September or November Monetary Policy Committee (MPC) meetings, most likely around £100b. We continue to doubt the Bank will take interest rates down from the current record low level of 0.10%, although it is actively reviewing the case for negative interest rates, having long considered they were not suited to the UK.
- The massive fiscal support that the Government is providing for the economy, businesses and jobs means the budget deficit (measured in terms of Public Sector Net Borrowing excluding banks (PSNBex)) is likely to reach £335b (16.9% of GDP) in 2020/21. PSNBex amounted to £127.9b over the first three months of fiscal year 2020/21, up from £24.0b in April–June 2019. To put this into perspective, it is already £73.1b over the total PSNBex of £54.8n for 2020/21 that the Office for Budget Responsibility (OBR) had forecast in the Budget on 11 March.
- However, a lot of people will have lost their jobs despite the Government's supportive measures (we forecast the unemployment rate to get up to around 9.0% in late 2020/early 2021 from 3.9% in the months to May), while a significant number of businesses will likely go under, and this will have some limiting impact on the economy's recovery. Consequently, despite the economy's expected return to growth in Q3 and then continuing recovery in Q4, it is still seen as contracting by 8.0% over 2020.
- On the assumption that the UK and EU avoid a 'no-deal' outcome at the end of 2020, we expect the economy to grow 6.5% in 2021. Even so, it is not expected to return to its Q4 2019 size until 2024.
- A downside risk to the outlook is the possibility of a significant new coronavirus wave occurring as – or after – restrictions have been eased. Another downside risk to the growth outlook is that even after the Government relaxes the restrictions on activity, people may be cautious in their behaviour for an extended period. A more fundamental and particularly worrying downside risk is that the economy suffers significant scarring in terms of companies going under and jobs being lost, despite the Government's supportive measures, and that this holds back the subsequent recovery.
- Should the UK and the EU fail to reach a free trade agreement by the end of 2020, trade between the UK and the EU will take place under World Trade Organization (WTO) rules from 1 January 2021. If this happens, we suspect growth in 2021, at least, will take a major hit.

Introduction

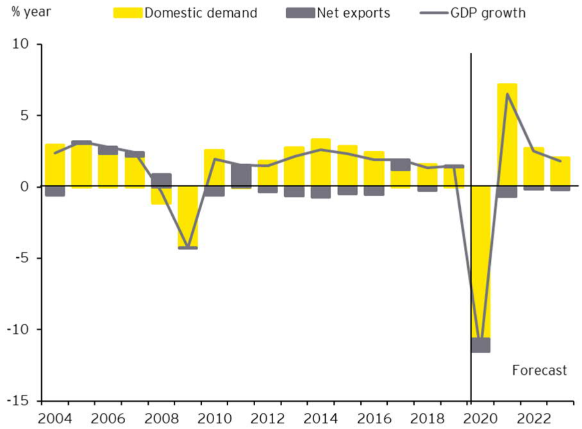
Our Summer Forecast 2020 sees a further substantial downgrading of the outlook for the UK economy in 2020 and this is only partly compensated for by some upgrading of our expectation for 2021. Specifically, we now expect GDP contraction in 2020 to be 11.5%; this compares to the 8.0% drop we expected in our mid-June Interim Forecast 2020[1] and the 6.8% decline we anticipated in our Spring Forecast 2020[2] back in April. GDP is now seen expanding 6.5% in 2021, up from respective growth projections of 5.6% in the June Interim Forecast 2020 and 4.5% in April's Spring Forecast 2020.

There currently continues to be a wide range of forecasts for the UK economy both regarding the depth of the current recession and the likely strength of the recovery. For example, the July edition of Consensus Forecast[3] had a central forecast of UK GDP contraction of -9.2% in 2020 (revised from anticipated 9.0% contraction in the June edition) with the range of projections from the 30 participants being from -6.3% to -13.3%. For 2021, the central GDP forecast was for growth of 5.9% (6.1% in June edition) with a range of +1.5% to +10.3%. It should be borne in mind that most of the July forecasts to Consensus were probably completed before the news that UK GDP rose a much smaller-than-expected 1.8% month-on-month (m/m) in May (the consensus had been for expansion of 5.5% m/m). To this can be added 'plausible scenarios' that have been produced by the OBR and the Bank of England.

Since we released our Interim Forecast 2020, it has been revealed that the economy contracted slightly more than first estimated in Q1 2020. Specifically, the GDP decline in Q1 was revised to 2.2% q/q from the initial estimate of a 2.0% q/q drop, making it the equal largest q/q decline since Q3 1979. Additionally, we now suspect that GDP contraction in Q2 2020 was likely to have been around 20% q/q rather than the 15% q/q drop we anticipated in the Interim Forecast 2020.

Latest data and surveys indicate that the economy troughed in April when GDP contracted an eye-watering 20.3% m/m as it bore the full brunt of the lockdown that was imposed on 23 March to combat coronavirus. It had earlier contracted 6.9% m/m in March. However, the economy could only come slightly off its April lows in May when GDP grew 1.8% as the first marginal easing of the lockdown occurred in England. While the economy appeared to take a significant step forward in June as lockdown restrictions were eased further, the pick-up was unlikely to have been sufficient to keep Q2 2020 contraction under 20% q/q.

UK: Contributions to GDP growth



Source: EY ITEM Club

The Government's approach to easing the lockdown has so far broadly developed in line with our expectations, although the pace is varying across the UK. An initial marginal easing of the restrictions on activity in England was announced on 10 May, and this included telling people who could not work from home to consider travelling to work if their workplace was open (although using public transport was to be avoided if possible). Additionally, restrictions on the English housing market were relaxed in mid-May with properties being able to be viewed by prospective buyers as long as certain conditions were met. Further easing of the lockdown measures occurred in England at the start of June and then again in the middle of that month. Open-air markets and car showrooms were allowed to open from 1 June while non-essential retailers were allowed to open on 15 June, all conditional on guidelines and tests being met.

Further easing occurred on 4 July when pubs, restaurants, hotels and hairdressers were allowed to open conditionally in England along with a number of other leisure facilities and venues such as theme parks, cinemas, museums and galleries. The social distancing rule was also relaxed from two metres to "one metre plus". This was followed by further sectors of the economy being allowed to reopen from 25 July, including

[1] EY ITEM Club Interim Forecast 2020: UK economy likely to take time to fully recover from major coronavirus hit. June 2020. See ey.com/en_uk/growth/ey-item-club/uk-economy-likely-to-take-time-to-fully-recover-from-coronavirus-hit
[2] EY ITEM Club Spring Forecast 2020: UK economy headed for record contraction as coronavirus has heavy near-term impact. April 2020. See ey.com/en_uk/growth/ey-item-club/uk-economy-headed-for-record-contraction
[3] Consensus Forecasts July 2020. Consensus Economics. 16 July 2020. See consensuseconomics.com/

pools, gyms, beauticians and outdoor theatres. Lockdown restrictions have also been eased to varying degrees in Scotland, Wales and Northern Ireland, but at a slower pace so far than in England.

This progressive easing of lockdown restrictions should enable the economy to return to clear growth in Q3 2020 with GDP expanding around 12% q/q. Following this initial bounce back, growth will obviously slow but recovery is expected to become established.

The substantial fiscal and monetary stimulus that has been enacted should provide ongoing support to the economy. While some of the emergency fiscal measures will wind down over the coming months – such as the jobs retention scheme ending in October – the Chancellor announced further near-term stimulus measures in his Summer Statement on 8 July. In addition, the Bank of England announced a further £100b of asset purchases in June which will take the stock up to £745b, and we suspect it will announce a final dose of £100b in September or November. However, we do not expect the Bank to take interest rates below their current level of 0.10%, even though it has said it is actively reviewing the case for negative interest rates.

There should also be some pent-up demand following the sharp reduction in consumer spending in Q2 2020 due to the lockdown, while household purchasing power is being helped by very low inflation. Global economic activity is also now improving as other economies recover from the impact of coronavirus. However, many people will have lost their jobs despite the Government's supportive measures and many incomes will have taken a hit, and this will have some limiting impact on consumption. Indeed, the strength and sustainability of the UK's recovery will clearly be heavily influenced by how well the jobs market holds up. Meanwhile, many businesses have had very difficult times and this will likely limit their willingness to invest or to commit to major new projects for some time to come.

Consequently, despite the economy's expected return to growth in Q3 and a continuing recovery in Q4, the EY ITEM Club still expects GDP to contract by 10.8% over 2020. While we expect GDP growth of 6.5% in 2021, the economy is not seen returning to its Q4 2019 level until 2024.

A downside risk to the outlook is the possibility of a significant new coronavirus wave occurring as, or after, restrictions have been eased.

Another downside risk to the growth outlook is that even with the progressive easing of restrictions on activity, consumers and businesses may remain cautious in their behaviour for an extended period.

A more fundamental and particularly worrying downside risk is that the economy suffers severe near-term damage in terms of companies going under and jobs being lost, despite the Government's measures aimed at helping businesses to keep going and to retain workers, and that this holds back the subsequent recovery.

We assume that the UK and EU will avoid a no-deal outcome at the end of 2020 when the Brexit transition arrangement is due to end (an extension of the transition arrangement was formally ruled out in June). We think it is most likely that the UK and EU will come to a bare-bones free trade agreement by the end of the year and then look to augment this with sector-related deals thereafter. However, this is not certain and the possibility of trade between the UK and the EU reverting to WTO rules from next January is another risk to the 2021 outlook.

Coronavirus impacted on UK economy through several channels

Coronavirus has been a significant supply shock, demand shock and financial shock to the UK economy. It really started to impact on the economy in March, although there were some slight repercussions in February. The maximum negative impact on the economy occurred in late March through to mid-May when full lockdown was in place. The first marginal easing of the lockdown occurred in mid-May, since when the Government has made further moves during June and July in reducing the restrictions. This has allowed economic activity to progressively come off the lows seen from late March through to mid-May.

Even so, the economy is still being affected by coronavirus-related restrictions, and there continue to be uncertainties as to what longer-term repercussions there will be. Much will clearly depend on how effective HM Treasury's and the Bank of England's measures ultimately prove to have been in preventing businesses from going under and in saving jobs. Much will also depend on to what extent consumers and businesses remain cautious in their behaviour once the restrictions on activity have been largely removed. There is also the risk of a second coronavirus wave that necessitates a reimposing of restrictions.

On the supply side, the hit to the UK initially came from Chinese economic activity plunging as coronavirus took hold early on in 2020 with the manufacturing sector suffering in particular. This increasingly affected global supply chains in the manufacturing sector with the UK starting to be affected in February (according to the purchasing managers' surveys). As coronavirus spread, it intensified the impact on supply chains.

The supply side of the UK economy was then significantly affected by people not being able to work due to restrictions on their movements (peaking with the lockdown imposed on 23 March), having coronavirus, being in isolation, or having caring responsibilities. While it is now possible for many people to work effectively at home due to the internet, obviously in some sectors it cannot make up for being in the workplace e.g., in manufacturing, retailing etc. Additionally, the Government shut down certain sectors of the economy, notably including bars, restaurants, hotels, theatres, cinemas, gyms, clubs etc. Non-essential retailers were also closed, and in addition, construction activity was heavily affected by site shutdowns, even though these were not mandatory.

The supply side restrictions started to ease in mid-May when the Government told people who could not work from home to consider travelling to work if their workplace was open (although they were told that using public transport should be avoided if possible). Restrictions on the English housing market were relaxed in mid-May with properties being able to be viewed by prospective buyers as long as certain conditions were met. Further easing of lockdown measures affecting the supply side of the economy occurred in England at the start of June and then again in the middle of that month. Open-air markets and car showrooms were allowed to open from 1 June while non-essential retailers were allowed to open on 15 June, all conditional on guidelines and tests being met. Further easing occurred on 4 July when pubs, restaurants, hotels and hairdressers were allowed to open conditionally in England along with a number of other leisure facilities and venues such as theme parks, cinemas, museums and galleries. This was followed by further sectors of the economy being allowed to reopen from 25 July, including pools, gyms, beauticians and outdoor theatres. In addition, the social distancing rule was relaxed from two metres to "one metre plus". Lockdown restrictions have also been eased to varying degrees in Scotland, Wales and Northern Ireland, but at a slower pace so far than in England.

On the demand side, there has been the hit to consumer and business confidence coming from coronavirus, which has clearly led to a substantially more cautious approach in behaviour. In the case of consumers, this has most notably weighed down on their willingness to spend, particularly on discretionary items. In addition, demand has been hit by people not being physically able to go out due to being affected by the virus or being restricted in their movements due to government advice and diktats.

Of course, there has been a substantial hit to demand from a marked deterioration in consumer fundamentals. Many people have already lost their jobs, despite the supportive government measures, while others will be worried that they may still end up losing their job once the furlough scheme ends in October. Many incomes have also taken a hit with the furlough scheme and support for the self-employed only covering up to 80% of salaries or earnings.

Meanwhile, many businesses facing reduced or even ceased activity as well as major uncertainties, will have cut back on their investment and delayed committing to any new projects. For example, the Bank of England's regional agents reported in their Q2 2020 survey of business conditions that "Companies have mostly cancelled or postponed non-essential investment to preserve cash buffers, and many are uncertain when or whether investment plans will be reinstated. In general, contacts said they had cut investment spending by around half, or more for companies most severely affected by the pandemic. However, some contacts redirected investment to finance social distancing measures and to facilitate remote working, and a few contacts, for example in IT and pharmaceuticals, continued with investment projects. A number of companies said they planned to review their investment plans next year. Decisions will depend on how their finances have been affected by the pandemic, as well as other factors, such as Brexit. Some contacts said they expected to have to streamline their business to adjust to a new normality, though others thought there might be opportunities to make acquisitions. For contacts in hospitality, tourism, leisure and transport, the outlook for investment is particularly uncertain."[4]

The Office for National Statistics (ONS) revealed in a 25 June bulletin on coronavirus and latest indicators for the UK economy that 19.8% of the businesses still trading in their survey had reported that they had stopped capital expenditure, while a further 23.2% said it was lower than normal. Just 5.9% said capital expenditure

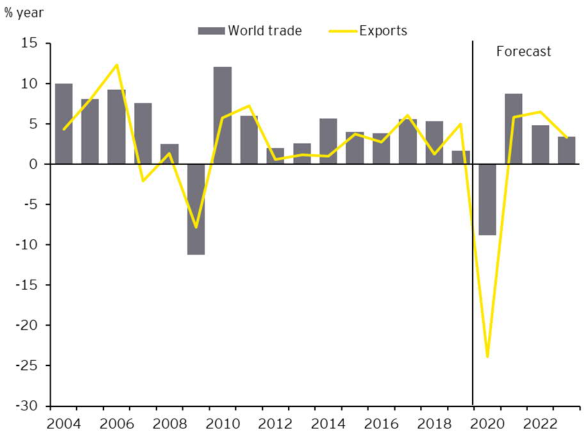
[4] Agents summary of business conditions – 2020 Q2. Bank of England Regional Agents. 18 June 2020. See bankofengland.co.uk/agents-summary/2020/2020-q2

was higher than normal. For 32.7%, capital expenditure was reported unchanged while the rest were not sure or said it was not applicable.[5]

A further demand-side shock to the UK economy will likely come from reduced tourism, particularly over the summer months. As far back as February, the purchasing managers reported that services sector activity was starting to be affected by reduced travel and tourism-related bookings, especially from Asia. This could be partly offset by more staycations in the UK.

Financial conditions also tightened because of coronavirus, and this will obviously have some negative impact on the UK economy. The FTSE 100 closed 2019 at 7,542 while the FTSE All-Share closed at 4,196. On 23 March 2020, the FTSE 100 closed at an eight-and-a-half-year low of 4,994 (down 33.8% from the level at the end of 2019), while the FTSE All-Share was trading at 2,728 (down 35.0%). Equity markets have since recovered much of their losses, but they are still appreciably down on their levels at the end of 2019, with the FTSE 100 closing at 6,207 on 22 July and the FTSE All-Share closing at 3,439. Gilt yields also rose sharply, although they fell back significantly after the Bank of England announced £200b of new asset purchases on 19 March as part of an emergency stimulus package.

UK: Exports and world trade



Source: EY ITEM Club

Finally, coronavirus took a major toll on global economic activity over the first half of 2020. While there are signs that matters are now improving, there are still serious uncertainties and concerns about the outlook, including the possibility of second coronavirus waves. There had been signs in late 2019 and the start of 2020 that the global economic situation was stabilising after largely deteriorating markedly through 2019, when the manufacturing sector in particular suffered. However, starting with a very substantial downward impact on the Chinese economy in Q1 2020 (where GDP fell 6.8% y/y), coronavirus spread to take a substantial toll on all major economies – including the US, the eurozone and Japan. Eurozone GDP contracted 3.8% q/q in Q1 2020 while US GDP declined at an annualised rate of 5.0%. Japanese GDP was down 0.6% q/q. While China returned to growth in Q2 2020 with GDP up 3.2% y/y as it recovered from coronavirus and restrictions on activity were removed, substantially deeper contraction clearly occurred in the US, Eurozone and Japan in Q2 – although it appears that activity highly likely troughed in April. While growth in the US, Eurozone and Japan is expected to resume in Q3 2020, there will clearly have been a major global recession in 2020, with economic performance set to be one of the weakest for the past 50 years. Additionally, the WTO reported in June that the volume of global merchandise trade fell 3% y/y in Q1 2020, and initial estimates pointed to a record drop around 18.5% y/y in Q2.

Chancellor provided near-term support to economy and jobs in Summer Statement

The Chancellor announced a number of measures to support jobs and the economy in a summer fiscal statement on 8 July. According to the Treasury, the cost of the policies will be up to £30b. Rishi Sunak took this action as some of the unprecedented major fiscal measures that were enacted from March to support businesses and individuals impacted by coronavirus were due to increasingly wind down. Most notably, the Coronavirus Job Retention Scheme will start to be tapered in August and will then come to an end in October. With a number of companies announcing redundancies in late June/early July, concerns have been mounting as to how much unemployment could rise over the coming months.

The Chancellor's measures to support jobs included a £1,000 bonus per employee to all companies bringing back furloughed workers through to January. A major initiative is a £2b fund to create six-month work

[5] Coronavirus and the latest indicators for the UK economy and society: 25 June 2020. Office for National Statistics. 25 June 2020. See ons.gov.uk/peoplepopulationandcommunity/healthandsocialcare/conditionsanddiseases/bulletins/coronavirustheukeconomyandsocietyfasterindicators/25june2020

placement jobs for unemployed 16–24 year-olds. The Government also announced associated measures on apprenticeships, training and work coaching.

Of course, it is the strength of the economy that will be crucial to the jobs outlook and the Chancellor took a number of measures aimed at supporting growth. Most notably, a targeted VAT cut from 20% to 5% for six months from mid-July is aimed at supporting the hospitality and domestic tourism sectors which remain vulnerable as they are still constrained by social distancing. The Government has also introduced vouchers for use when purchasing restaurant meals during August.

An immediate increase in the Stamp Duty threshold from £125,000 to £500,000 lasting through to 31 March 2021 is also aimed at getting momentum into the housing market, with hopefully favourable knock-on effects for the economy.

The Government has also announced that it will step up moves to get infrastructure projects up and running and also liberalise planning rules for approval of housing construction projects. Specifically, Prime Minister Boris Johnson pledged on 30 June to accelerate infrastructure schemes worth £5b. While most of these infrastructure projects had already been announced, the plan is to spend the allocated funds quicker. This will be made up of projects including hospitals, schools and roads.

Back in March, as the coronavirus pandemic increasingly hit the economy, the Chancellor had announced unprecedented, massive fiscal measures aimed at helping businesses and individuals impacted by coronavirus, as well as upping resources for the NHS.

The 11 March Budget for 2020/21 contained a £12b package to tackle coronavirus (£5b extra for the NHS, £7b support for businesses). Less than a week later, on 17 March, with it already becoming clear that the likely hit to the economy from coronavirus was going to be substantially deeper than expected when the Budget was being prepared, Chancellor Rishi Sunak unveiled a further £20b of supportive measures and announced that the Government would guarantee £330b (equivalent to 15% of GDP) of bank lending to businesses (the Coronavirus Business Interruption Loan Scheme).

This was followed on 20 March by the strongest measures of all when the Chancellor announced the Coronavirus Job Retention Scheme, under which the Government aimed to avert massive redundancies in the private sector by making pay grants to companies, which would cover 80% of the salary of retained workers up to a total of £2,500 a month for three months, backdated to 1 March. The Coronavirus Job Retention Scheme was later extended until the end of October, and while the Chancellor indicated that furloughed workers would continue to receive 80% of their monthly salary up to £2,500 a month, some flexibility was introduced into the scheme in an attempt to help furloughed employees back into work and to cut the cost of the scheme to the Government, which Rishi Sunak said was running at around £8b a month. From August, employers using the scheme would be allowed to bring furloughed employees back part-time, something that business groups had been calling for, to allow them to slowly get back up to speed. Employers will also be asked to start sharing the cost of the scheme on a tapered basis from August.

The Chancellor also announced additional measures including increasing the Universal Credit standard allowance for the next 12 months by £1,000 a year, with the working tax credit basic element also rising by the same amount. He also deferred the next quarter of companies' VAT payments until June, and announced that the self-employed would be able to defer the regular payment of income tax due in July 2020 to January 2021. Another initiative was that the Coronavirus Business Interruption Loan Scheme would be interest-free for 12 months, rather than the six months announced initially.

An additional major step by the Chancellor was taken on 26 March, this time aimed at providing support to the self-employed affected by loss of work and income due to the coronavirus outbreak. Specifically, self-employed workers could apply for a grant worth 80% of their average monthly profits over the last three years, up to £2,500 a month for three months, backdated to 1 March. The scheme is open to those with trading profits of up to £50,000. This scheme was extended for a further three months in late May, although the maximum allowed to be claimed was trimmed to £6,750.

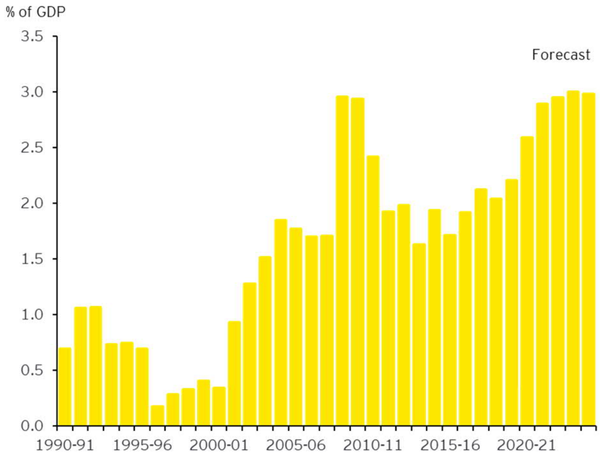
There have since been several other measures from the Chancellor, including a number aimed at making it easier and more attractive for businesses to get loans from banks.

A clear indication of the huge cost of the fiscal measures came when the ONS reported that PSNBex saw the three largest monthly deficits since records began in 1993 in the first three months of fiscal year 2020/21: April (£46.9b), May (£45.5b) and June (£35.5b). This meant that PSNBex amounted to £127.9b over the first three months of fiscal year 2020/21, up from £24.0b in April–June 2019. To put this into perspective, it is already £73.1b over the total PSNBex of £54.8n for 2020/21 that the OBR had forecast in the Budget on 11 March.

In mid-July, the OBR estimated that the cost of the tax and spending measures enacted by the Government to limit the impact of coronavirus on the economy would increase cash borrowing by £192.3b in fiscal year 2020/21. We now suspect that the budget deficit (PSNB ex) will likely come in around £335b (16.9% of GDP) in 2020/21.

The Budget on 11 March had contained sustained fiscal loosening over the five-year period 2020/21 to 2024/25. Indeed, the OBR observed that "the Government has proposed the largest sustained fiscal loosening since the pre-election Budget of March 1992. Relative to our pre-measures baseline forecast, the Government's policy decisions increase the budget deficit by 0.9 per cent of GDP on average over the next five years and add £125b (4.6 per cent of GDP) to public sector net debt by 2024–25".[6]

UK: Public sector net investment



Source: OBR

In particular, the Budget contained an additional £18b of fiscal stimulus for fiscal year 2020/21 rising to some £42b for 2023/24 (accounted for entirely by extra spending). This was essentially split evenly between extra current spending and extra capital spending.

The new fiscal rules that were contained in the Conservative manifesto and adopted in the Budget (although the Chancellor indicated they would be reviewed) were designed to give the Government scope to take advantage of current very low interest rates and to borrow to invest, particularly in infrastructure. This is seen as having a key role to play in the Conservative Party's pledge to 'level up' the economic performance of the least prosperous UK regions. Specifically, the fiscal rule was that the Government will only borrow to invest, and this will be capped at 3% of GDP. Consequently, the Budget sees government investment spending averaging 2.9% of GDP over the five years 2020/21 to 2024/25. This would be up from an average of 2.0% of GDP over the past 10 years, including 2.0% of GDP in 2018/19.

Bank of England provided further stimulus to economy in June but held off from negative interest rates

The Bank of England has responded to the coronavirus threat to the UK economy by enacting several stimulative measures starting on 11 March, with the latest move coming on 18 June.

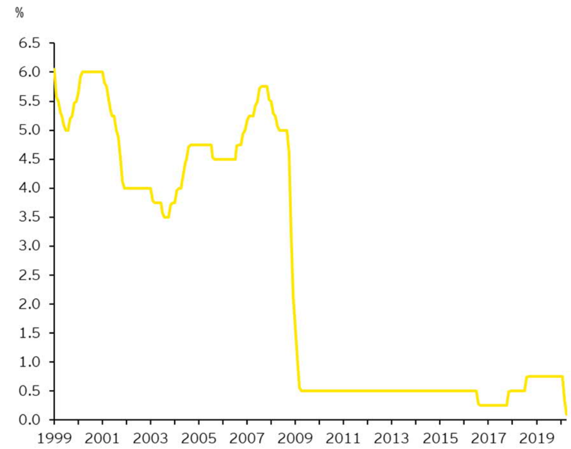
The first move, on 11 March, occurred on the same day as the Budget, highlighting that the central bank and the Treasury were taking coordinated action. Indeed, the action taken by the Bank of England was the consequence of a special Monetary Policy Committee (MPC) meeting, as the next scheduled meeting was not until 25 March. In fact, the MPC held another special meeting on 19 March when further stimulative measures were taken.

The Bank of England slashed interest rates by 50 basis points to 0.25% from 0.75% on 11 March. This took interest rates back down to the record low that the Bank of England had last enacted in August 2016 in the aftermath of the UK voting to leave the EU (they had subsequently been raised to 0.50% in November 2017 and to 0.75% in August 2018). Additionally, the Bank of England announced measures aimed at supporting bank lending, especially to small businesses (the Term Funding Scheme with additional incentives for Small and Medium-sized Enterprises – TFSME).

[6] Overview of the March 2020 Economic and Fiscal Outlook. Office for Budget Responsibility. 11 March 2020. See obr.uk/overview-of-the-march-2020-economic-and-fiscal-outlook/

This was followed by the Bank of England taking interest rates down further to a new record low of 0.10% on 19 March. In addition, the Bank of England revived quantitative easing (QE) by announcing it would buy a further £200b of government and corporate bonds, taking the total up to £645b (the previous mix was £435b gilts; £10b corporate bonds). The majority of this was to be through the purchase of gilts. The Bank of England announced on 2 April that it intended to make at least £10b purchases of corporate bonds and at a significantly faster pace than it had purchased corporate bonds at in 2016. This was by far the largest single announcement of asset purchases that the Bank of England has ever made (the previous highest was £75b). The Bank of England had last undertaken QE in August 2016 in the aftermath of the UK voting to leave the EU. The third strand of the Bank of England's additional measures on 19 March saw it announce that it would enlarge the TFSME.

UK: Bank Rate



Source: EY ITEM Club/Haver Analytics

The Bank of England had also announced on 18 March that a joint Treasury and Bank of England Covid Corporate Financing Facility (CCFF) would provide funding to businesses by purchasing commercial paper of up to one-year maturity, issued by firms making a material contribution to the UK economy. The short-term debt issued by companies needs to be of investment grade, meaning it must have a high credit rating. The scheme will operate for at least 12 months and will be open to firms that can demonstrate they were in sound financial health prior to the coronavirus shock. The Bank of England will create new money to pay the for the scheme, similar to its previous purchases of government and longer-term corporate bonds.

The Bank of England subsequently made no further changes to monetary policy at its regular MPC meetings held on 25 March and 6 May, but it then announced a further £100b of asset purchases (taking the stock up to £745b) on 18 June after the MPC meeting held on the previous day. The June MPC meeting kept interest rates at 0.10%, the decision being the result of a unanimous 9–0 vote within the MPC. There was also a strong 8–1 majority vote in favour of the extra £100b of asset purchases (Andy Haldane was in favour of keeping the level of asset purchases unchanged at £645b). The minutes observed that "The Committee expects that programme to be completed, and the total stock of asset purchases to reach £745b, around the turn of the year." That implied a significant slowdown in the rate of asset purchases compared to its March plans. Indeed the minutes of the June MPC meeting[7] observed "With liquidity conditions having stabilised, purchases could now be conducted at a slower pace than during the earlier period of dysfunction."

The June MPC minutes concluded that "At this meeting, a majority of MPC members judged that a further easing of monetary policy was warranted to support the economy and thereby to meet the inflation target in the medium term. While recent demand and output data had not been quite as negative as expected, other indicators suggested greater risks around the potential for longer-lasting damage to the economy from the pandemic."

Significantly, there was no mention in the June MPC minutes of the case for negative interest rates. The Bank of England has regularly indicated in the past that it sees the lower boundary for interest rates as close to, but just above zero. In particular, the Bank has been concerned about the potential impact of negative interest rates on the profitability of the UK banking sector. Indeed, after cutting interest rates to 0.10% on 19 March, the new Governor, Andrew Bailey, stated that negative UK interest rates are not compatible with attempts to boost the capacity of banks to lend. However, Mr Bailey and several MPC members have recently indicated that the Bank of England is actively reviewing the case for negative interest rates.

Nevertheless, it never looked likely the MPC would opt to go down the negative interest rate route at their June meeting – if at all. In particular, Mr Bailey had told Parliament's Treasury Select Committee in late May

[7] Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 17 June 2020. Bank of England. 18 June 2020. See bankofengland.co.uk/-/media/boe/files/monetary-policy-summary-and-minutes/2020/june-2020.pdf?la=en&hash=494920DA9E8781F0FDE422290F0A6E7FC75A1D68

that the Bank of England needed time to consider taking interest rates below zero before possibly acting.[8] He also stated that the Bank is very keen to see how the economy responds to the interest cuts that had been made in March. Mr Bailey reported that the Bank of England is looking closely at the experience of other central banks that had used negative interest rates. Additionally, he observed that the Bank would have to look how best to use a policy of negative interest rates to best fit in with the UK financial system as well as how to communicate such a move. It is likely that the Bank of England will fully spell out its thinking on negative interest rates on 6 August when it will release the next quarterly edition of its Monetary Policy Report alongside the minutes of its MPC meeting as it announces its next set of decisions on monetary policy.

The minutes of the June MPC meeting observed that the existing evidence suggests that the fall in UK GDP (and in global GDP) will be less severe than was anticipated in the May quarterly Monetary Policy Report when the Bank of England set out its latest views and outlook for the economy. It noted that UK GDP had contracted around 20% in April and that evidence from more timely indicators suggested that GDP had started to recover thereafter. There were signs that consumer spending had picked up in May while the housing market had started to recover. Meanwhile, net trade could benefit from recovering global activity. Consequently, the MPC concluded “Overall, recent developments suggested that the level of GDP in the second quarter might be 20% below its level in the final quarter of 2019, rather than the 27% included in the May Report.” The minutes also observed that UK financial conditions had been fairly stable since the previous MPC meeting, but had remained tighter than prior to the COVID-19 shock.

However, the MPC still has serious concerns and uncertainties about the recovery. The June minutes stated “although stronger than expected, it is difficult to make a clear inference from that about the recovery thereafter”. The MPC considered there is a risk of higher and more persistent unemployment, and also that consumer and business caution may persist despite relaxation of coronavirus-related restrictions on activity. Significantly, it observed “evidence from business surveys and the Bank’s Agents was consistent with a weak outlook for employment in coming quarters. Some households were also worried about their job security.” The MPC also considered that it is unclear “to what extent consumers would be willing to return to shopping physically now that some coronavirus-related restrictions had started to be lifted. Forms of social expenditure were also likely to continue to be held back by social distancing, whether officially mandated or voluntary.”

Consequently, the MPC concluded in the June minutes that “the economy, and especially the labour market, will therefore take some time to recover towards its previous path”.

On the inflation front, the MPC noted that consumer price inflation had fallen to 0.5% in May, which had required Mr Bailey to write an explanatory letter to Chancellor Sunak. The MPC considered that inflation would fall slightly further in the near term, as the drag from the coronavirus-related shock built. Inflation was then expected to rise during 2021, as the direct impact of the recent fall in the oil price dropped out of the annual comparison and the downward pressure from domestic factors waned as demand recovered.

We suspect June’s measures are unlikely to mark the end of Bank of England stimulus as it will probably believe that it has a further role to play in helping the economy build sustainable recovery amid likely still challenging and uncertain conditions. Specifically, we expect the Bank of England to announce a final dose of asset purchases either at its September or November meetings, probably to again be around £100b.

However, we remain highly doubtful that the Bank of England will cut interest rates below the current level of 0.10%. Despite the Bank of England currently actively reviewing the case for negative interest rates, we suspect that the MPC will ultimately decide that such a move is not in the best interests of the UK economy.

Economy contracted 2.2% q/q in Q1

A second estimate from the ONS shows GDP contracted 2.2% q/q in Q1 2020; this was slightly deeper than the preliminary estimate of a 2.0% q/q dip and was the equal sharpest quarterly contraction since Q3 1979. It followed flat q/q GDP in Q4 2019, when economic activity was hampered by particularly heightened domestic political and Brexit uncertainties with the general election occurring on 12 December and the UK’s

[8] BOE says negative interest rates are “under review” for first time. Financial Times. 20 May 2020. See ft.com/content/68ce522a-3587-4cce-9bb2-b5efed5eaeba

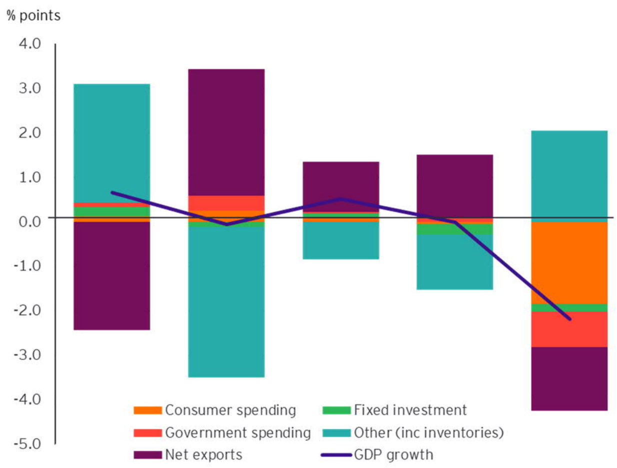
exit from the EU being delayed for a second time. GDP was down 1.7% year-on-year (y/y) in Q1 2020, having been up 1.1% y/y in Q4 2019.

Q1 2020 GDP contraction of 2.2% q/q was primarily the consequence of GDP plunging a record 6.9% m/m in March as economic activity was increasingly hampered by government-imposed restrictions to combat coronavirus, which culminated in the lockdown being imposed on 23 March. The dominant services sector was particularly hard hit by the March restrictions as many consumer-facing activities were completely shut down; output in the sector fell 7.5% m/m. Significantly though, no sector was spared on the output side of the economy as there were also substantial m/m falls in construction output (5.4%) and industrial production (4.3%) including a drop of 4.6% in manufacturing output.

However, while coronavirus only started to significantly adversely affect the economy at the start of March, it should be noted that the economy had previously got off to a disappointingly lacklustre start to 2020. The hope had been that the UK economy would see a decent start to 2020 as reduced uncertainties following December's decisive general election – reinforced by near-term clarity on Brexit with the UK leaving the EU with a deal on 31 January – would lead to businesses and consumers stepping up their activity. There was certainly a marked pick-up in both business and consumer confidence in late December and the start of 2020. However, GDP rose a modest 0.2% m/m in January and was then only flat in February. Consequently, y/y GDP growth slowed to just 0.4% in February from 0.8% in January and 1.1% in December. Furthermore, GDP was only flat on a three-month/three-month basis in February.

Even allowing for construction activity (and retail sales) taking a hit from very wet weather in February, the economy's performance over the first two months of 2020 was very disappointing. There were signs that the coronavirus outbreak was beginning to impact on the economy in February, with the purchasing managers reporting supply chain disruptions affecting the manufacturing sector, with export orders also being affected, especially tourism-related bookings from Asia. In addition, while the ONS indicated that coronavirus had not had a significant impact on February retail sales, it nevertheless observed that some retailers indicated that online orders shipped from China had been reduced.

GDP growth contributions in 2019 and Q1 2020



Source: EY ITEM Club

On the expenditure side of the economy, a substantial drop in consumer spending and markedly negative net trade were the major factors behind the 2.2% q/q GDP contraction in Q1 2020. In addition, there was a significant negative impact from lower inventories – stocks held by UK companies fell by £2.7b over Q1, led by a decline in the holdings of the retail and wholesale trades.

Specifically, consumer spending declined 2.9% q/q in Q1 2020 (the sharpest q/q drop since Q3 1979) and was down 2.5% y/y as it was particularly hard hit in March by the restrictions on activity, sharply weakening consumer fundamentals and plunging confidence. Non-essential retailers were shut following the lockdown on 23 March while some parts of the consumer services sector were effectively brought to a complete halt by the lockdown, including the closure of theatres, cinemas, gyms, restaurants, pubs, and clubs. Meanwhile, many people had already lost their jobs in March, despite the supportive government measures, while others were worried that they could still end up losing their job once the furlough scheme ends. Many incomes also took a hit. A notable feature of the sharp drop in consumer spending in Q1 was that the household saving ratio rose to a four-year high of 8.6% from 6.6% in Q4 2019.

Overall investment fell 1.1% q/q in Q1 2020 and was down 2.5% y/y. Business investment dipped 0.3% q/q and was up just 0.8% y/y amid economic activity taking a major hit and uncertainties mounting. There was contraction of 3.8% q/q and 10.1% y/y in government investment and 0.9% q/q and 5.1% y/y in private dwellings investment.

Government spending fell 4.1% q/q and was down 1.6% y/y. The q/q drop primarily reflected declines in health and education expenditure – health care consumption fell by 6.2% q/q while education consumption fell by 6.4% q/q. The ONS reported that the initial impact of the coronavirus on government health care consumption was mixed, with increased activity in some areas (calls to NHS 111) and reduced activity in other areas (elective operations and accident and emergency). The fall in estimated education consumption was a result of school closures across the UK, with schools closed to all from 23 March, except for vulnerable pupils or those whose parents or guardians are key workers.

Net trade made a marked negative contribution to Q1 2020 GDP. Exports of goods and services sank 13.5% q/q as global trade weakened substantially as coronavirus impacted widely. Imports contracted by a lesser but still substantial 9.4% q/q. Exports were down 6.6% y/y in Q1 2020 while imports were down 17.4% y/y.

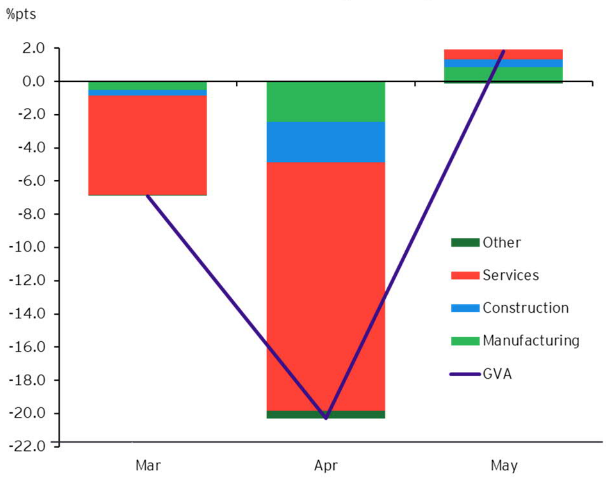
On the output side of the economy, there was widespread marked contraction in Q1 2020. Output in the dominant services sector fell a record 2.3% q/q as it was particularly hit by the lockdown closure on 23 March of many consumer-facing sectors; it was down 1.4% y/y. Output in education contracted 6.0% q/q as schools were closed while the wholesale and retail sector contracted 3.1% q/q. However, the weakness in services activity was widespread. Industrial production contracted 1.5% q/q and 4.1% y/y with manufacturing output declining 1.1% q/q and 5.1% y/y. Construction output fell 1.7% q/q and 2.7% y/y.

Economy likely contracted at least 20% q/q in Q2 with torrid April marking trough in activity

The economy suffered a torrid April as GDP contracted an eye-watering record 20.3% m/m as it experienced the full impact of the lockdown that was imposed on 23 March. April's GDP contraction was nearly three times the previous record monthly decline of 6.9% seen in March when the economy was only affected by eight days of the lockdown. The y/y decline in GDP widened to a record 25.3% in April from 6.6% in March. Additionally, the three-month/three-month decline in GDP widened to 10.5% in April from 1.8% in March. The ONS observed that the economy was 25% smaller in April than it had been in February.

The services sector was markedly affected by the restrictions in April as many consumer-facing activities, as well as education, remained shut down; output in the sector fell 18.9% m/m and 24.2% y/y. It was down by 9.9% in the three months to April compared to the three months to January. Meanwhile, industrial production fell 20.2% m/m and 23.8% y/y in April with manufacturing output down 24.4% m/m and 28.2% y/y. Manufacturing output was particularly hard hit in April by car production essentially coming to a complete halt as plants were shut. Industrial production was down 9.0% on a three-month/three-month basis in April, with manufacturing output down 10.0%.

UK: Contributions to monthly GVA growth



Source: EY ITEM Club calculations using data from Haver Analytics

Construction was the weakest sector in April as many sites closed through the month. Output contracted 40.2% m/m and 44.2% y/y. Construction output was particularly dragged down in April by a drop in housebuilding. Construction output was down 17.3% on a three-month/three-month basis in April.

On the expenditure side of the economy, consumer spending was clearly exceptionally weak in April. Retail sales fell a record 18.0% m/m while new car sales were brought to a virtual halt (they fell 97.3% y/y to just 4,321 vehicles) by the closure of dealerships and restrictions on people's movements amid the lockdown.

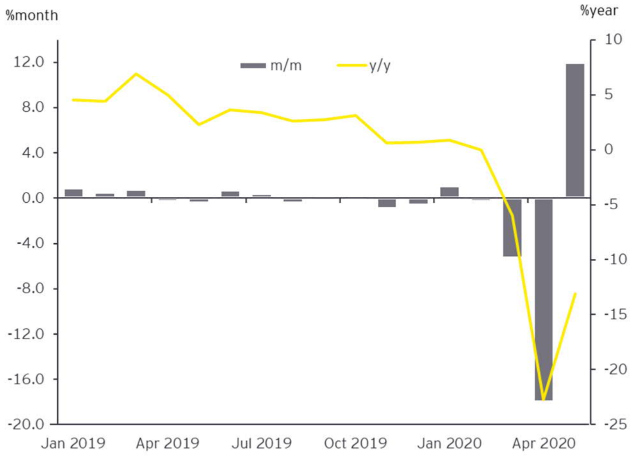
The UK economy came only modestly off its April lows in May when GDP rose 1.8% m/m as there was a modest easing of lockdown restrictions during the month. The y/y decline in GDP narrowed to a still substantial 24.0% in May while GDP was down 19.1% in the three months to May compared to the three months to February.

Construction output rose 8.2% m/m in May following April's particularly sharp drop of 40.2% as some sites reopened. Housebuilding saw particular improvement. The y/y fall in construction output narrowed to 39.7% in May but it was still down 29.8% in the three months to May compared to the three months to February. Industrial production also saw a clear pick-up in May after a large April drop as it rose 6.0% m/m. This was primarily due to manufacturing output increasing 8.4% as some factories reopened. Industrial production was down 20.0% y/y in May and down 18.5% on a three-month/three-month basis. Manufacturing output was down 22.8% y/y and down 18.0% on a three-month/three-month basis.

The most disappointing performance in May came from the services sector where output only rose 0.9% m/m; the y/y drop in services output moderated to 23.6% in May from 24.2% in April. Services output was down 18.9% in the three months to May compared to the three months to February. The ONS observed "In the important services sector we saw some pick-up in retail, which saw record online sales. However, with lockdown restrictions remaining in place, many other services remained in the doldrums, with a number of areas seeing further declines."[9]

On the expenditure side of the economy, there were signs that consumer spending came off its lows in May. Most notably, retail sales volumes rose 12.0% m/m; this followed a huge record drop of 18.0% in April when sales had been hit by the full impact of the lockdown restrictions that were imposed on 23 March. This notably included the closure of the entire retail sales sector except for essential retailers. Retail sales volumes came well off their April lows in May as there was some easing of the restrictions affecting the sector, with garden centres and homeware shops allowed to open in England from the middle of the month. The y/y decline in retail sales narrowed to 13.1% in May from 22.7% in April. The ONS also reported that sales volumes in May were 13.1% below their February level.

UK: Retail sales volumes (inc. fuel)



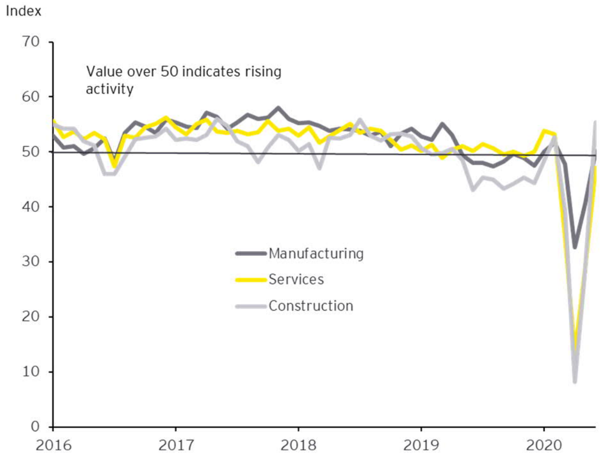
Source: EY ITEM Club/Haver Analytics

Meanwhile, Barclaycard reported that the y/y decline in consumer spending slowed to 27.7% in May from 36.5% in April. GfK reported that consumer confidence was stable at -34 in May. New car sales suffered another huge drop in May as dealerships remained closed. Specifically, the Society of Motor Manufacturers and Traders (SMMT) reported new car sales fell 89.0% y/y in May to 20,247 vehicles from 183,724 in May 2019.

The economy seemingly took a significant step forward in June as it benefitted from a marked easing of lockdown restrictions.

The June purchasing managers' survey for the manufacturing and services sectors indicated that activity picked up appreciably further from April's lows following improvement in May. While the survey still pointed to modestly contracting activity overall, it did little to dilute belief that the UK economy was growing again in June. Indeed, IHS Markit noted that the 17.7 point increase in the composite manufacturing and services output index from 30.0 in May to a four-month high of 47.7 in June was the largest monthly rise since the series started in January 1998. The June purchasing managers survey pointed to services activity contracting at a markedly reduced rate in June as it rose to 47.1 from 29.0 in May.

UK: IHS Markit/CIPS surveys



Source: EY ITEM Club/IHS Markit/CIPS

Meanwhile, the manufacturing Purchasing Managers' Index (PMI) indicated the sector achieved marginal growth in June as it improved to 50.1 from 40.7. IHS Markit reported that that the easing of restrictions related to the coronavirus pandemic had a favourable impact on economic activity in June, with business operations gradually resuming in a number of sectors and staff being brought back from furlough.

[9] GDP Monthly Estimate, UK: May 2020. Office for National Statistics. 14 July 2020. See ons.gov.uk/economy/grossdomesticproductgdp/bulletins/gdpmonthlyestimateuk/may2020

Forward-looking elements of the surveys also showed improvement for a second successive month in June, although they were still far from robust which will likely maintain concern that the recovery could be limited by cautious consumers and businesses. Indeed, Markit reported "there were also widespread reports that underlying demand remained very subdued and cutbacks to client spending had acted as continued drag on overall business activity."[10] Joint new business of work contracted for a fourth month in June, but the rate of decline was reported to have slowed sharply from May. The drop in employment slowed but was still appreciable. Output expectations improved to a four-month high in June.

Particularly encouraging news from the purchasing managers saw the construction PMI spike to a 23-month high of 55.3 in June from 29.9 in May. By rising well above 50.0, the PMI pointed to clear expansion in the construction sector in June and this was reinforced by the housebuilding, commercial and civil engineering sectors all reportedly returning to growth. In addition, new business saw marginal growth in June after contracting markedly over the previous three months.

The Bank of England's Decision Maker Panel for June found that businesses expected their sales in Q2 2020 to be 38% lower than they would otherwise have been, employment to be 8% lower and investment to be 38% lower. In the May survey, sales had been expected to be 42% lower, employment to be 6% lower and investment to be 43% lower. Overall uncertainty fell slightly in June, but remained well above the level recorded in February and March. Specifically, 74% of firms viewed overall economic uncertainty as high or very high in June, down from 76% in May and 84% in April.[11]

An early July ONS survey found 88% of businesses were trading over the period 15–28 June, with 85% trading for more than two weeks. However, 57% said that their turnover was below normal expectations for the time of year. Only 12% said their turnover was higher than normal while 25% said it had not been affected.[12]

On the expenditure side of the economy, the British Retail Consortium reported that retail sales values rose 3.4% y/y in June, which was the largest increase since March 2018 although the comparison was helped by particularly weak sales in June 2019. Additionally, Barclaycard said that the y/y fall in consumer spending moderated to 14.5% in June from 27.7% in May and was the smallest decline since the lockdown began. Meanwhile, new car sales saw a much reduced decline of 34.9% y/y in June as the reopening of showrooms in England at the beginning of the month allowed 145,377 vehicles to be sold.

Consumer confidence picked up over June, according to GfK with consumers more optimistic about prospects for the economy and their personal finances, and also seeing it as an improving time to make major purchases. However, while the GfK confidence balance picked up to -27 at the end of June from -36 at the end of May (the lowest since January 2009) and was at the highest level since March, it was still 20 points below the February level of -7.

Despite the economy seemingly taking a significant step forward in June, we suspect GDP likely contracted around 20% q/q in Q2 2020 following the 2.2% q/q decline suffered in Q1. This means that GDP in mid-2020 is seen 21.8% below the Q4 2019 level.

Performance of labour market key to outlook

Key to the economy's prospects over both the short term and further out, is how the labour market performs. This was reflected in the Chancellor announcing a number of measures in his Summer Statement aimed at supporting jobs. The latest labour market data is not as bad as had been feared and indicated overall that the rate of decline slowed. However, this should not mask the fact that unemployment poses a major threat to UK recovery prospects.

The damage to the labour market has been substantially limited by companies' ability to furlough workers under the Government's Coronavirus Job Retention Scheme. Data from the Treasury show that the scheme

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[10] IHS Markit/CIPS Flash UK Composite PMI. IHS Markit. 23 June 2020. See markiteconomics.com/Public/Home/PressRelease/31975bdd766349268b37c9856621dcea

[11] Monthly Decision Panel data – June 2020. Bank of England. 2 July 2020. See bankofengland.co.uk/decision-maker-panel/2020/june-2020

[12] Coronavirus and the latest indicators for the UK economy and society: 9 July 2020. Office for National Statistics. 9 July 2020. See ons.gov.uk/peoplepopulationandcommunity/healthandsocialcare/conditionsanddiseases/bulletins/coronavirustheukeconomyandsocietyfasterindicators/9july2020

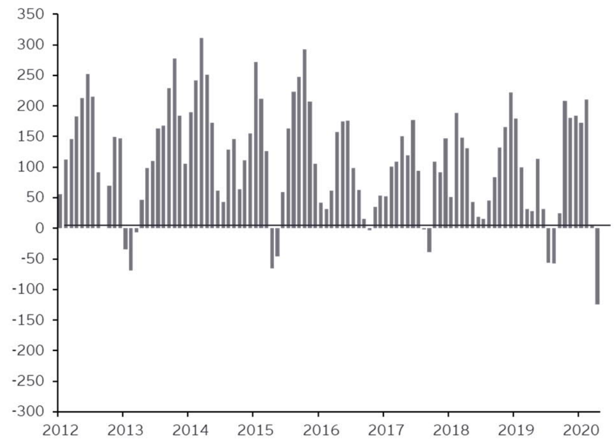
covered 9.4 million workers as at mid-July, costing £28.7 billion so far. Fuelling concerns over the labour market, a substantial number of redundancies have been announced so far in July across a number of sectors, and particularly in the retailing sector. These include cuts by John Lewis, Boots and Marks & Spencer. Furthermore, a survey by Make UK in mid-July revealed that some 53% of manufacturers expect to make redundancies over the next six months, up sharply from 25% in May.

Claimant count unemployment fell by 28,100 in June to 2.6308 million from a high of 2.6589 million in May. This followed large increases in May (566,400) and, especially, April (852,900). Consequently, claimant count unemployment was still up 1.3912 million (112.2%) since March. In addition, HMRC and ONS Pay as You Earn Real Time Information data indicates that the number of paid employees in June were down 649,000 (2.2%) from March. The ONS observed that the largest falls were seen at the start of the pandemic and, while the number of payroll employees is still falling, the decline is slowing.

Labour market weakness is now increasingly showing up in some of the International Labour Organization (ILO) jobs data which had previously continued to show resilience – largely reflecting that this covers a three-month period and up to March had only included one week of the lockdown period. Having said that, the ILO data up to March had still looked surprisingly resilient given that the economy had contracted 2.2% q/q in the first quarter with economic activity disappointingly lacklustre over the first two months of the year and then plunging 6.9% m/m in March.

UK: Change in employment

'000s over previous three months



Source: EY ITEM Club/Haver Analytics

The ILO data show that the number employed fell 126,000 in the three months to May, which was the largest three-monthly decline since 2011. This took the number employed down to 32.948 million from a record high of 33.114 million in the three months to March. The number employed had previously risen just 6,000 in the three months to April, which was down from 211,000 in the three months to March. The employment rate dipped to 76.4% in the three months to May from a record high of 76.6% in the three months to March.

The number of unemployed fell 17,000 in the three months to May to 1.347 million; the unemployment rate remained at 3.9% in the three months to May. It is notable that ONS has indicated that furloughed workers will continue to count as employees, while those who claim from the Self-Employment Income Support Scheme will still be classed as self-employed. The fact that employment fell 126,000 but unemployment also dipped by 17,000 reflected the fact that the number of economically active people fell by 142,000 in the three months to May, taking the activity rate down to 79.6% from 79.8% in the three months to February.

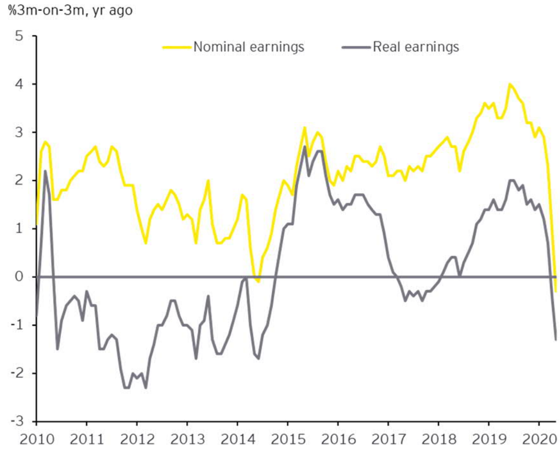
The number of job vacancies fell sharply further to 333,000 in the three months to May – this was the lowest level since the series began in 2001 and was down from 476,000 in the three months to May, 642,000 in the three months to April and 818,000 in the three months to February.

The ONS also reported that between March to May 2019 and March to May 2020, total actual weekly hours worked in the UK decreased by 175.3 million, or 16.7%, to 877.1 million hours. This was the largest annual decrease since estimates began in 1971, with total hours dropping to its lowest level since May to July 1997.

Meanwhile, annual earnings saw a further marked weakening in May and they look set to suffer further over the coming months. Many workers who were furloughed took only 80% of their normal pay from March. Looking ahead, many companies are looking to freeze or cut pay, and to reduce bonuses. Even before the downward impact on earnings from the coronavirus hit to the labour market, earnings growth had come well off the highs seen in mid-2019.

For example, a survey by XpertHR released in late July reported that 16% of pay deals in the three months to the end of June offered no increase in wages, which was up from 15% in the three months to May and almost double the proportion in the three months to April. XpertHR observed “Many organizations are deferring a decision on their April pay award until later in the year, but indications are that many of these will come back and implement a pay freeze.” Additionally, the June REC Report on Jobs reported that “Starting pay for both permanent and short-term staff fell further in June as demand for workers remained weak and labour supply continued to increase. Though not as severe as in May, rates of reduction remained sharp for both starting salaries and temp wages." In addition, the IHS Markit Household Finance survey for May reported that "Incomes from employment fell drastically and at an accelerated rate during May. Overall, the decline in incomes was the sharpest ever seen since data collection began in February 2009."

UK: Average weekly earnings



Source: EY ITEM Club/Haver Analytics

Annual average earnings were down 0.3% in the three months to May; this was down from growth of 1.0% in the three months to April, 2.3% in the three months to March and 3.1% in the three months to January. It has come down from a peak of 3.9% in the three months July 2019, which had been an 11-year high. Annual earnings fell 1.2% in May itself after a drop of 1.0% in April; growth had previously slowed to 1.2% in March from 2.7% in February and 3.1% in January. It peaked at 4.0% in May 2019. Annual earnings are also being pulled down at the moment by sharply reduced bonus payments compared to a year ago. Annual regular earnings growth (which strips out bonus payments which can be erratic and distort the overall figures) slowed to 0.7% in the three months to May; this was down from 1.7% in the three months to April; 2.7% in the three months to March and 3.1% in the three months to January. It has come down from an 11-year high of 3.9% in both the three months to July and June 2019. Annual regular earnings were flat in May itself, having edged down 0.1% in April; this is down from growth of 2.4% in March, 2.8% in February and January. It had peaked at 4.0% in June 2019.

ONS data show that real earnings fell 1.9% y/y in May itself and were down 1.3% y/y in the three months to May. This contrasts with growth of 1.5% in the three months to January. Growth peaked at 2.0% in the three months to June 2019. Regular real earnings fell 0.7% y/y in May itself and were down 0.2% y/y in the three months to May.

Economy expected to see reasonable but not sharp recovery develop from Q3 2020

We estimate the economy contracted around 20% q/q in Q2 2020, even allowing for a significant pick-up in activity in June. Consumer spending clearly took a huge hit in Q2 2020 from the major restrictions on people's movements that existed for most of the quarter, the fact that all non-essential shops were shut until mid-June, and that much of the consumer services sector was essentially closed through the quarter with restaurants, pubs, gyms, clubs, salons, etc. banned from opening by the Government.

Consumer spending was clearly also hurt in Q2 2020 by a sharp rise in unemployment and a substantial number of people taking a hit to their income. Consequently, we suspect that consumer spending likely contracted by around 18.5% q/q in Q2.

Business investment also clearly suffered markedly in Q2 and it will probably continue to do so beyond then as it is pressurised by several factors. With many companies facing sharply reduced or even non-existent near-term business in Q2, and with cash flows suffering, they are currently focused on getting through the near-term crisis rather than planning for the future.

Meanwhile, UK exports were hit hard in Q2 by sharply contracting key overseas markets, notably including the EU and the US. Furthermore, some exports have likely been impacted by production problems in the UK resulting from coronavirus affecting workforces.

We expect the economy to return to growth in Q3 with GDP expanding close to 12% q/q. The economy should benefit from a further significant easing of lockdown restrictions in early July with pubs, restaurants, hotels and hairdressers allowed to open conditionally in England along with a number of other leisure facilities and venues such as theme parks, cinemas, museums and galleries. This was followed by further sectors of the economy being allowed to reopen in mid-July, including pools, gyms, beauticians and outdoor theatres, and the social distancing rule was also relaxed from two metres to "one metre plus". A progressive easing of lockdown restrictions also took place in Scotland and Wales.

Early news on the economy for July indicates there has been some pick-up in activity but consumers remain cautious amid heightened job insecurity. The IHS Markit household finance index rose to a four-month high of 41.5 from 40.7 in June (and an eight-and-a-half year low of 34.9 in April); the spending index improved to 41.6 from 37.8, but this was reported "still much lower than at any time in 11 years of survey data prior to the coronavirus disease 2019 (COVID-19) pandemic. Households appeared focussed on reining in debt and supporting their savings where possible, according to the latest survey data. As a result, the index measuring demand for unsecured credit fell to 49.3 in July, from 50.1 in June, to signal an overall drop in households' appetite for unsecured borrowing for the first time since the survey began in February 2009." [13]. Additionally, Springboard report shopper footfall rose 4.5% in the week to 18 July from the previous week, which was less than half the rise of 10.6% that occurred during the first week following the reopening of hospitality and leisure businesses in England on 4 July. Nevertheless, the y/y drop in shopper numbers slowed to 40.2% in the week to 18 July, which was the smallest annual decline since the lockdown was imposed.

Meanwhile, an ONS survey found 92% of businesses were trading over the period 29 June -12 July, up from 88% over the previous two weeks. However, 57% said that their turnover was below normal expectations for the time of year. Only 10% said their turnover was higher than normal while 26% said it had not been affected.[14]

EY ITEM Club forecast for the UK economy, summer 2020

% changes on previous year except borrowing, current account, and interest and exchange rates

	GDP	Domestic demand	Consumer spending	Fixed investment	Exports	Imports
2018	1.3	1.3	1.6	-0.2	1.2	2.0
2019	1.5	1.5	1.0	0.7	5.0	4.6
2020	-11.5	-10.5	-11.6	-17.5	-23.9	-20.3
2021	6.5	7.0	6.6	2.7	5.9	7.7
2022	2.5	2.6	2.1	7.6	6.5	6.5
2023	1.8	2.0	1.8	2.4	3.4	3.8
2024	1.6	1.7	1.7	2.2	3.4	3.7
	Net government borrowing*	**Current account (% of GDP)**	**Average earnings**	**CPI**	**Bank rate**	**Effective exchange rate**
2018	1.8	-3.9	3.0	2.5	0.6	78.5
2019	2.9	-4.0	3.5	1.8	0.8	78.2
2020	16.9	-5.1	-0.4	0.7	0.2	78.3
2021	6.3	-5.0	2.4	1.3	0.1	80.3
2022	3.9	-4.7	3.1	2.2	0.5	82.1
2023	3.1	-4.8	3.5	C2.0	1.0	82.1
2024	2.7	-4.9	3.5	2.0	1.5	79.7

*Fiscal years, as % of GDP

Source: EY ITEM Club

[13] Pressure on household finances eases in July, but spending remains very subdued. IHS Markit UK Household Finance Index 20 July 2020. See https://www.markiteconomics.com/Public/Home/PressRelease/60f7625251c44079aa4757dae427e8ad

[14] Coronavirus and the latest indicators for the UK economy and society: 23 July 2020. Office for National Statistics. 23 July 2020. See https://www.ons.gov.uk/peoplepopulationandcommunity/healthandsocialcare/conditionsanddiseases/bulletins/coronavirustheukeconomyandsocietyfasterindicators/23july2020

The substantial fiscal and monetary stimulus that has been enacted has undoubtedly helped to limit the extent of the downturn, and many measures should provide ongoing support to activity as the coronavirus impact wanes and recovery develops. While some of the emergency fiscal measures will wind down over the coming months (such as the jobs retention scheme ending in October), the Chancellor announced further stimulus measures in his Summer Statement on 8 July. Additionally, the Bank of England announced a further £100b of asset purchases at the June MPC which will take the stock up to £745b. We doubt the Bank of England is fully done yet on providing help for the economy and expect it to announce a final dose of £100b of asset purchases in September or November. However, we do not expect the Bank to take interest rates below their current level of 0.10%.

Consumer purchasing power should benefit from very low inflation (we believe consumer price inflation could fall as low as 0.1% over the summer). There should also be a fair degree of pent-up demand following the collapse in consumer spending in Q2 due to the lockdown. Also on the positive side, three months of net repayment of unsecured consumer debt totalling £15.8b over March–May has improved many households' balance sheets which will improve some consumers' purchasing ability. Meanwhile, global economic activity should also be markedly stronger in the latter months of 2020 and during 2021 as other economies recover from their 2020 coronavirus-related woes, and this should help UK exports.

However, a lot of people have lost their jobs despite the Government's supportive measures and more will do so (we forecast the unemployment rate to get up to around 9.0% in late 2020/early 2021 from 3.9% in the months to May), while a significant number of businesses will likely go under, and this will have some limiting impact on the economy's recovery. Business caution over investment and committing to new projects may also be affected over the latter months of this year by uncertainty over what will happen on the UK–EU relationship once the transition arrangement ends on 31 December – especially as any extension of the transition arrangement has been ruled out. Productive business investment may also be limited by the amount of resources that companies have had to devote to making their facilities compatible with social distancing guidelines.

Despite the economy's expected return to growth in Q3 and then continuing recovery in Q4 with, hopefully, coronavirus having little impact, GDP is seen as contracting by 11.5% over 2020. Consumer spending is forecast to contract by 11.6% while fixed investment is seen plunging 17.5%, with business investment declining 22.3%. Government investment is seen rising 4.3%, while public spending is projected to increase by 2.5%. Net trade is seen making a negative contribution of 1.1 percentage points to GDP as exports of goods and services fall by 23.9% while imports decline by a lesser 20.3%.

On the assumption that the UK and EU avoid a no-deal outcome at the end of 2020 when the transition arrangement ends, we expect the economy to grow 6.5% in 2021. Even so, the economy is not expected to return to its Q4 2019 size until 2024.

After contracting 11.6% in 2020, consumer spending is expected to rebound 6.6% in 2021 as the labour market recovers from the sharp deterioration suffered over the second half of 2020. Low inflation for much of the year should also support consumer spending (although inflation is expected to trend up during the year). However, the labour market is not expected to recover all the job losses suffered in 2020 and that will have some limiting impact on consumer spending.

Government spending and investment should contribute significantly to growth in 2021. Indeed, government investment is seen increasing 13.5% in 2021 contributing to fixed investment growth of 2.7%. Business investment is forecast to pick up modestly in 2021 as companies become more confident in the recovery. However, the upside for business investment is likely to be limited by the hit that many companies will take to their profitability in 2020. Consequently, business investment is seen as only rising 1.3% over 2021, although this masks a significant q/q pick-up as the year progresses.

Net trade is seen significantly negative in 2021 as exports (up 5.9%) are forecast to be outgrown by imports (up 7.7%).

UK economy facing significant Brexit uncertainties as ending of transition arrangement on 31 December looms

The UK's exit from the EU avoiding a no-deal outcome on 31 January reduced immediate uncertainties over Brexit – but it far from ended them. The transition agreement between the UK and the EU that came into effect after 31 January preserved the status quo but it will only last until 31 December 2020.

Now that the transition arrangement has not been extended – as the UK Government had repeatedly made clear it would not agree to do – if the UK and EU have not reached agreement on their long-term relationship by the end of this year, trade between the UK and the EU will take place under WTO rules, just as it would have done if the UK had left the EU without a deal on 31 January.

There is considerable uncertainty as to whether the UK and EU can come to an agreement over their long-term relationship by the end of 2020. The history of trade agreements between countries and groups of countries suggests that it takes several years to reach a successful conclusion.

Furthermore, the massive task of UK and EU policymakers in trying to deal with the impact of coronavirus on their economies and populations, as well as the need for social distancing, has made Brexit negotiations more difficult to conduct. Adding to concerns, the UK and the EU currently seem very far apart in their negotiating stances, with relations not exactly being convivial.

Boris Johnson has regularly argued that the UK and the EU can negotiate a free trade agreement that will be ready to come into effect on 1 January 2021. Of course, one major difference between the UK and the EU's negotiations and the usual negotiations between countries is that the UK and EU are looking to come to an agreement on a trade relationship that is less close than they had before Brexit.

Consequently, there is a very real possibility that the latter months of 2020 could see another Brexit cliff edge developing – with the risk of the UK ending the status quo with no deal.

Our assumption is that the UK and the EU will avoid a no-deal outcome at the end of 2020. We think it is most likely that the UK and EU will come to a bare-bones free trade agreement by the end of the year and then look to augment this with sector-related deals thereafter.

However, even a bare-bones trade agreement by 31 December is likely to prove difficult to achieve and certainly cannot be taken for granted, so there may well be tortuous twists and turns over the second half of the year, as occurred with the UK actually leaving the EU on 31 January.

Furthermore, a concern for many businesses regarding the long-term UK–EU relationship is that the Johnson government is aiming for a free trade agreement with the EU with less regulatory alignment. This is seen as making a frictionless border between the UK and the EU less achievable. Indeed, in setting out its negotiating position ahead of talks with the EU, the Government stressed that it wants full economic and political independence and that self-determination must trump economic concerns.

Risks and uncertainties to forecast

The risks to the forecast currently seem very much loaded to the downside. The most obvious downside risk is the possibility of a significant new coronavirus wave occurring as, or after, restrictions have been eased.

Another downside risk to the growth outlook is that even after the Government has significantly relaxed the restrictions on activity, people and businesses may be cautious in their behaviour for an extended period.

A more fundamental and particularly worrying downside risk is that the economy suffers severe near-term damage in terms of companies going under and jobs being lost, despite the Government's measures aimed at helping businesses to keep going and to retain workers, and that this holds back the subsequent recovery.

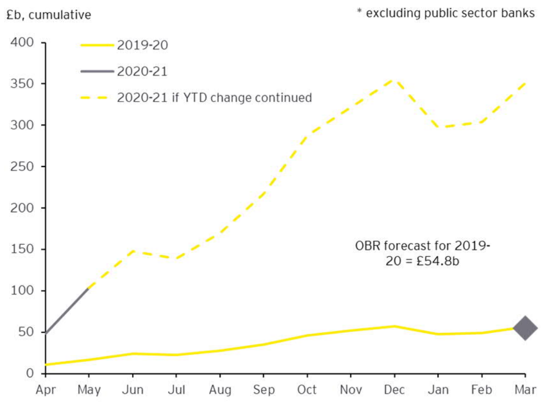
A very significant downside risk to the forecast stems from the very real possibility that the UK and the EU could fail to reach a free trade agreement by the end of 2020, causing trade between the UK and the EU to take place under WTO rules – just as it would have done if the UK had left the EU without a deal on 31 January.

If this happens, we suspect that growth in 2021 – at least – will take a major hit. Probable major uncertainty would negatively impact business sentiment and investment, and also affect consumers (albeit to a lesser extent). Trade would be substantially affected as non-tariff barriers kicked in. The impact of changes in tariffs is harder to judge as the Government has indicated in the past that, under a temporary scheme, 88% of imports by value would be eligible for zero-tariff access compared to 80% of imports which are currently tariff-free. Meanwhile, supply chains would be affected by any disruption at ports. While a likely sharp fall in sterling would help UK exporters, it would also raise import prices, pushing up businesses' costs and consumer price inflation, thereby hitting households' purchasing power. As well as limiting their investment, businesses would probably be more cautious on employment and pay, with negative repercussions for consumers. We expect policymakers would react by easing both fiscal and monetary policy.

Forecast in charts

Fiscal policy

UK: Public sector net borrowing *

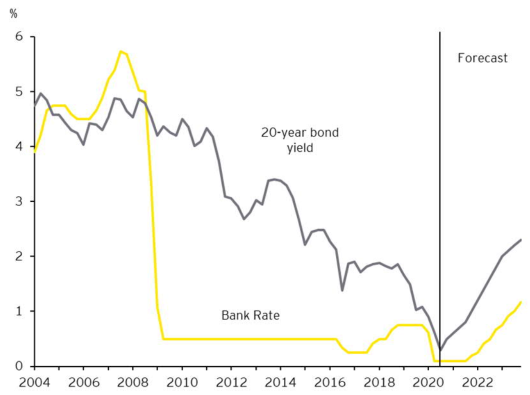


Sources: Oxford Economics, Haver Analytics and OBR

- ► Fiscal policy is playing a major role in aiming to limit the long-term damage to the economy from coronavirus.
- ► The cost of fiscal packages to support the economy is likely to see the budget deficit (PSNBex) reach £335b (16.9% of GDP) in 2020/21.
- ► OBR observed of the March Budget for period 2020/21 to 2024/25: "the Government has proposed the largest sustained fiscal loosening since the pre-election Budget of March 1992".

Monetary policy

UK: Bank Rate and 20-year bond yield

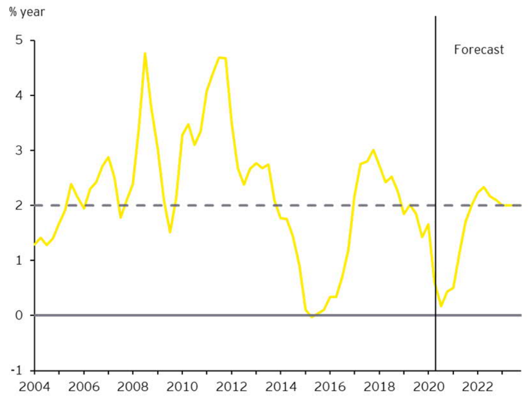


Source: EY ITEM Club

- ► Bank of England set to keep interest rates at record low of 0.10% until late 2021 at least.
- ► We do not expect the Bank of England to take interest rates any lower despite the Bank currently reviewing the case for negative interest rates.
- ► More Bank of England stimulus is probable, most likely through more asset purchases. A final £100b is likely to be announced at September or November MPC meeting.

Prices

UK: CPI inflation

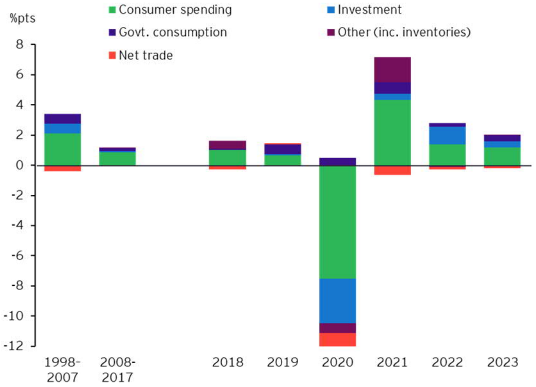


Source: EY ITEM Club

- ► Consumer price index is seen dipping in near term despite edging up to 0.6% in June from 47-month low of 0.5% in May, which will provide much-needed help for consumers.
- ► Relatively low oil prices and weak economic activity could well see inflation fall as low as 0.1% over the summer.
- ► Inflation is expected to start edging up in late 2020, then heading towards 2% in 2021. Seen as averaging 1.3% in 2021 after 0.7% in 2020.

Activity

UK: Contributions to GDP growth



Source: EY ITEM Club

- GDP seen contracting 11.5% in 2020 with short but very deep recession over first half. GDP estimated to have declined in vicinity of 20% q/q in Q2 after 2.2% q/q drop in Q1.
- Economy seen returning to growth in Q3 with GDP expanding around 12% q/q. Assumes gradual easing of lockdown restriction continues.
- GDP growth seen at 6.5% in 2021 but will not return to Q4 2019 size until 2024.

Consumer demand

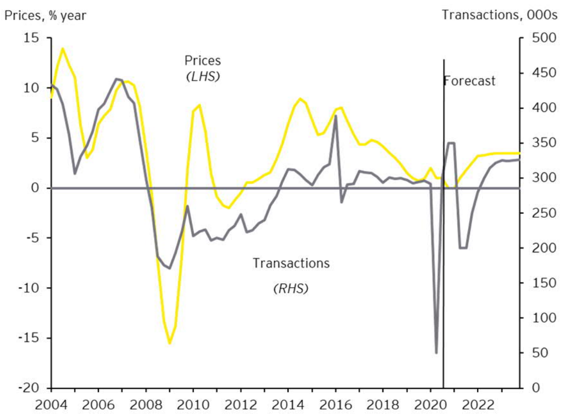
UK: Real household income and spending

Source: EY ITEM Club

- Consumer spending has taken a major hit from the lockdown, weakened consumer fundamentals and sharply reduced confidence.
- Consumer spending seen contracting 11.6% over 2020 despite some pick-up anticipated in second half of the year.
- Consumer spending seen growing 6.6% in 2021, making up for a lot of the fall in 2020. Likely to be some limiting impact from labour market not fully recovering from the 2020 hit.

Housing market

UK: House prices and transactions

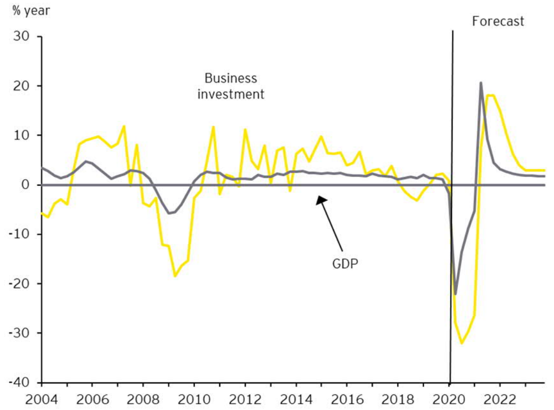


Source: EY ITEM Club

- Easing of lockdown restrictions led to an initial surge in activity and buyer interest but there are major uncertainties over longer-term outlook, given current pressure on jobs and incomes.
- Near-term support to housing market will come from Stamp Duty threshold being raised to £500,000 through to 31 March 2021.
- House prices expected to be essentially flat in near term. Seen as gaining 2%–3% in 2021.

Company sector

UK: Business investment and GDP

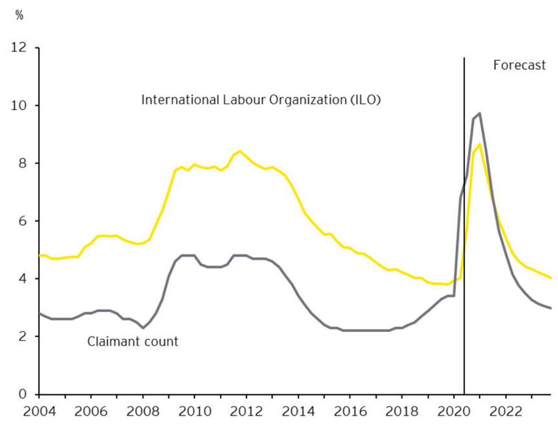


Source: EY ITEM Club

- Impact of coronavirus on economy and businesses is weighing heavily on investment. Business investment expected to have contracted sharply in Q2 after 0.3% q/q drop in Q1.
- Business investment may be adversely affected over latter months of 2020 by uncertainties over UK–EU relationship.
- Business investment seen declining 22.3% in 2020. Seen up 1.3% in 2021 and 8.7% in 2022 as economy and confidence are firmer.

Labour market and wages

UK: Unemployment rate

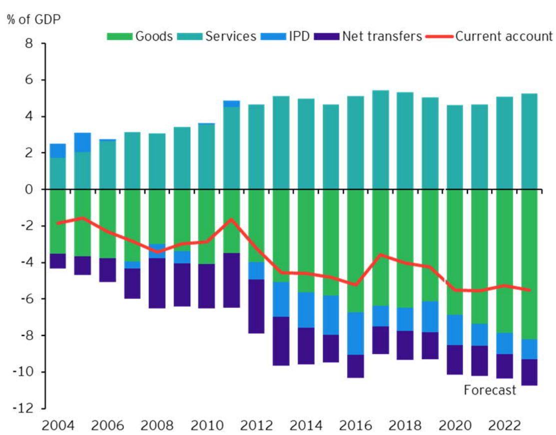


Source: EY ITEM Club

- The labour market is taking a major hit from sharp weakening of economic activity and several businesses going under due to coronavirus, despite the Government's supportive measures.
- We suspect the unemployment rate could rise as high as 9.0% in Q4 2020 and Q1 2021 from 3.9% in the three months to May.
- Earnings growth taking a marked hit from weakened jobs market. However, the labour market and earnings should see some recovery in 2021.

Trade and the balance of payments

UK: Current account



Source: EY ITEM Club IPD= interest, profit and dividends

- Net trade made a markedly negative contribution to GDP in Q1 2020 as real exports fell 13.5% q/q and imports declined by 9.4% q/q.
- Net trade expected to make appreciable negative contributions to GDP in both 2020 and 2021.
- Current account deficit forecast to widen from £88.8b (4.0% of GDP) in 2019 to £101.7b (5.1% of GDP) in 2020. Seen at £109.0b (5.0% of GDP) in 2021. Trade deficit seen increasing.

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About EY ITEM Club

EY ITEM Club is the only non-governmental economic forecasting group to use the HM Treasury's model of the UK economy. ITEM stands for Independent Treasury Economic Model. HM Treasury uses the UK Treasury model for its UK policy analysis and Industry Act forecasts for the Budget. EY ITEM Club's use of the model enables it to explore the implications and unpublished assumptions behind Government forecasts and policy measures.

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