EY ITEM Club Autumn Forecast

Challenges still face UK economy despite strong Q3 2020 bounce back

October 2020

Building a better working world

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Foreword

The end of the summer

All aboard the rollercoaster …

More than half a year since coronavirus (COVID-19) hit the UK, the levels of volatility and uncertainty in the economy are still very high. Whenever it seems that a trend is becoming established, something happens to change the outlook once again. Unsurprisingly, long-term forecasting is almost impossible, but even day-to-day predictions are far from reliable — businesses are being tested like never before.

The EY ITEM Club *Autumn Forecast 2020* illustrates the problem perfectly. The economy performed better than the 12% expected in the July forecast, growing at 17% over the three summer months. The further easing of lockdown restrictions and the boost to the housing market from the stamp duty holiday played their part, and the Eat Out to Help Out Scheme drove a significant amount of incremental spending.

However, just as the green shoots of higher confidence among businesses and consumers started to appear, a surge in new cases of COVID-19 plunged many parts of the country back into lockdown. It does appear that encouraging people to go back to work and to dine out has contributed to an upturn in the number of confirmed cases.

… so hold on tight …

The return of restrictions at a local level adds to the challenges facing the economy in the final quarter of 2020 as the Coronavirus Job Retention Scheme (CJRS) is wound down, and doubts over the likelihood of a UK–EU free trade agreement (FTA) cast a shadow over business investment. As a result, the EY ITEM Club expects the economy to slow significantly during the autumn, with growth of only 1% over the final quarter of 2020.

The 2020 year-end forecast of a 10% fall in GDP appears better on the surface than the 11.5% fall forecast by EY ITEM Club in the summer, but the improvement derives from the faster growth in the second quarter. Although the Chancellor’s Winter Statement provided around £5b of additional support for the economy, all the signs are that the next one or two quarters will be very challenging unless there is a significant medical breakthrough — EY ITEM Club are assuming a vaccine will not be widely available in the first half of 2021.

EY ITEM Club assume a gradual return to growth in 2021 with GDP increasing by 6%. Growth is then forecast to slow to 2.9% in 2022 meaning the economy will not return to its Q4 2019 size until the second half of 2023. It is going to be a long, slow recovery.

… identify and manage risks …

While a vaccine could provide a positive boost, risks are weighted to the downside. A more significant outbreak of the virus during the winter months could plunge us back into lockdown with major implications for the economy. Even if we avoid a second wave, failing to achieve an FTA with the EU is another significant risk. EY ITEM Club forecast that a failure to agree even a bare-bones FTA would reduce GDP growth in 2021 by one-fifth to 4.8% over the year, and to 2.6% rather than 2.9% in 2022. Businesses should ensure that they have contingency plans in case things either improve or deteriorate — flexibility is very important in such a volatile environment.

… watch the labour market …

Businesses have borne the brunt of the shock to date, but pressure is now building on consumers via the labour market. The CJRS is coming to an end and the newly announced Job Support Scheme (JSS) is much less generous. With employers having to contribute a higher share of the payments to employees, the scheme is primarily likely to appeal to companies that want to retain their skilled employees such as in manufacturing or high value-added services. In sectors such as hospitality and retail where output is more directly linked to hours worked, the JSS does not appear likely to be heavily adopted. This will probably lead to a significant increase in unemployment and a corresponding drag on consumer spending as people see their incomes fall. More than ever, managing talent will be critically important.

… and track government policy

The only certainty is that everything is uncertain. This is a very difficult time to be making decisions, especially those with longer horizons such as capital investment. As yet, the UK Government has not communicated any detail of its plan for economic recovery. We know that 'levelling up' and moving towards net zero are priorities, but how these will be achieved remains unclear.

Nevertheless, there is little doubt that Government will play a more significant role in the economy than has been the case over the last three or four decades. While this could create challenges for businesses trying to anticipate policy moves, there will also be opportunities. Difficult as it is to look beyond the immediate challenges, now is the time to begin to think through what opportunities there might be to work with Government to help them achieve their objectives while creating commercial success.

Highlights

- The EY ITEM Club *Autumn Forecast 2020* sees UK GDP contraction of 10.1% in 2020. This is a significantly reduced decline compared to the 11.5% fall in GDP anticipated in our *Summer Forecast 2020* which was released in July. Significantly though, our expectation of a smaller drop in GDP this year than we had previously anticipated is entirely the consequence of the economy bouncing back more than we anticipated in Q3 amid substantially reduced lockdown restrictions, after record GDP contraction of 19.8% quarter-on-quarter (q/q) in Q2 that had been totally in line with expectations.
- We believe GDP grew around 17% q/q in Q3 2020, a significantly stronger rebound than the 12% q/q expansion anticipated in our *Summer Forecast 2020*. The Q3 2020 bounce back was clearly led by consumer demand as pent-up demand was released by the full opening up of the retail sector in June and the progressive opening up of the consumer services sector during July. A temporary cutting of VAT for the hospitality sector in July and the Eat Out to Help Out Scheme in August also supported consumer spending. In addition, the housing sector saw a marked pick-up in activity, supported by a temporary raising of the stamp duty threshold. However, business investment remained weak in Q3.
- Despite the strong Q3 2020 bounce back, our underlying view of the economy in the near term has deteriorated; this is reflected in the fact that our forecast for growth has been reduced for Q4 2020 and for 2021. This primarily reflects the fact that the markedly rising number of COVID-19 cases has led to some renewed tightening of restrictions by the Government. While the direct economic impact of these restrictions looks to be limited, they could well have some dampening impact on business and consumer confidence, and there is the very real possibility of more restrictions to come. Additionally, business caution and reluctance to invest in Q4 2020 may be magnified by the fraught and fractious negotiations between the UK and the EU which have magnified the possibility that the two sides will fail to reach a free trade arrangement (FTA) before the end of the year when the transition arrangement ends.
- Consequently, we suspect the economy is unlikely to grow by any more than 1% q/q in Q4 2020, and could well struggle to achieve even that rate. Activity in Q4 is also likely to be pressurised as unemployment rises appreciably following the ending of the furlough scheme in October (despite the Chancellor's Job Support Scheme having some limiting impact on the increase) and as the boost from pent-up demand wanes.
- We expect the economy to grow 6.0% in 2021, down from the 6.5% expansion previously anticipated. Consequently, the economy is not expected to return to its Q4 2019 size until around mid-2023. Our forecast assumes that the UK and EU will avoid a no-deal outcome at the end of 2020 despite the current heightened tensions. 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. We also assume that COVID-19 will become less of an issue for the economy later on in 2021, and this will be reinforced if a vaccine becomes available during the year — although it currently looks unlikely that this will occur in the first half at least.
- Consumer spending is expected to grow 7.6% in 2021 after contracting 12.8% in 2020, as the labour market gradually recovers from the marked deterioration suffered over the final months of 2020 and the start of 2021. 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. Business investment is expected to only gradually improve as the year progresses, and will likely remain a weak link in the recovery. Exports are expected to benefit from improved global growth and trade.
- Fiscal policy remains orientated to supporting the economy amid the heightened downside risks and uncertainties. The Chancellor has delayed the Budget for 2020/21 from November to Q1 2021 and announced some additional support for businesses, and particularly jobs, in a Winter Economy Plan announced in late September.
- Given the increased risks facing the economy, we suspect the Bank of England will deliver a further dose of asset purchases at the November or December Monetary Policy Committee (MPC) meetings, most likely around £100b which will take the total up to £845b. We remain doubtful that the Bank will cut interest rates below 0.10%. While the Bank continues to review the case for negative interest rates, we suspect the MPC will maintain the view that such a move is not in the best interests of the UK economy.
- Should the UK and the EU fail to reach an FTA 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, the EY ITEM Club believes that without an FTA, growth in 2021, at least, will take a major hit. Specifically, we see GDP growth at 4.8% in 2021 and 2.6% in 2022.

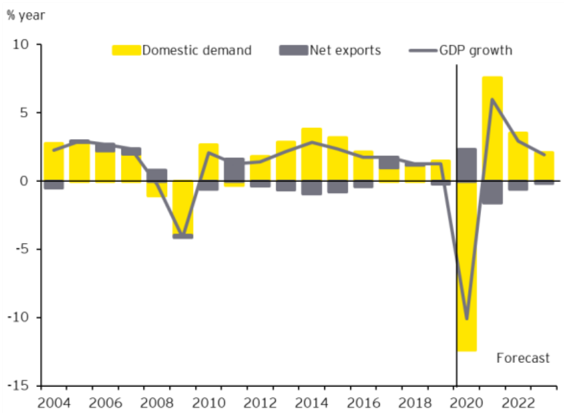
Introduction

The EY ITEM Club *Autumn Forecast 2020* sees an upgrading of the projection for the UK economy in 2020. However, this is hardly a cause for celebration. The reduced contraction now expected for 2020 is entirely due to the fact that the economy seemingly bounced back significantly more than we had expected in Q3 2020 as lockdown restrictions were progressively and markedly eased from mid-May.

While a stronger-than-expected bounce back in Q3 2020 is obviously welcome news, this is countered by the fact that the outlook for the economy has deteriorated in the near term at least. A marked spike in COVID-19 cases in September led to some renewed tightening of restrictions by the Government on 22 September, and there is a strong possibility of deeper restrictions to come. Additionally, increasingly fraught and fractious negotiations between the UK and the EU have magnified the possibility that the two sides will fail to reach a free trade arrangement (FTA) before the end of the year when the transition arrangement ends.

Specifically, we now expect GDP contraction in 2020 to be 10.1%; this compares to the 11.5% drop we expected in our *Summer Forecast 2020.*[1] We now believe the economy grew by some 17% q/q in Q3 2020 after record contraction of 19.8% q/q in Q2 (that had matched our expectation) amid a marked easing of the lockdown restrictions that had weighed heavily on activity in Q2, especially in April. In our *Summer Forecast 2020*, we had considered growth around 12% q/q was likely in Q3. The Q3 2020 bounce back was clearly led by a strong pick-up in consumer spending fuelled by the release of pent-up demand following record contraction of 23.6% q/q in Q2. There was also a marked pick-up in housing market activity in Q3, although business investment seemingly remained very weak.

UK: contributions to GDP growth



Source: EY ITEM Club

However, we suspect that the economy will see a substantial slowdown in Q4 2020 and may well struggle to grow even 1% q/q. In addition to increased restrictions on activity and heightened UK–EU tensions, it is likely to be hampered by a marked rise in unemployment as the furlough scheme draws to a halt in October. While the Chancellor's Job Support Scheme announced in late September should have some limiting impact on the increase in unemployment in late 2020/early 2021, a significant rise in unemployment still looks more likely than not. There is also expected to be a waning of pent-up demand. The increased restrictions on activity due to the rising number of COVID-19 cases will also probably have some dampening impact on the economy in Q4 while business uncertainty and caution over investment will likely be fuelled by the difficult UK–EU negotiations over their future relationship.

GDP is seen expanding 6.0% in 2021, which is a downward revision from the 6.5% growth anticipated in the *Summer Forecast 2020.* This primarily reflects the fact that the economy is now expected to start 2021 with less momentum than previously expected. Furthermore, economic activity early on in the year will likely continue to be limited by coronavirus-related restrictions. The 2022 growth projection is raised modestly to 2.9% from 2.5%. Nevertheless, the economy is not seen returning to its Q4 2019 size until the second half of 2023.

Fiscal policy remains orientated to growth, with the Chancellor announcing more support for businesses and jobs in his Winter Economy Plan. The Budget for 2021/22 was put back from November to Q1 2021 due to the increased uncertainties and risks facing the economy from COVID-19. The delaying of the Budget also makes it easier for Chancellor Sunak to hold off from giving any indications about how he eventually plans to restore the public finances to a sustainable position over the longer term. This could include outlining potential future tax increases which could have some dampening impact on business and consumer behaviour now.

Meanwhile, we suspect that the Bank of England is not yet done on providing monetary policy support to the economy. We believe the central bank will decide, probably sooner rather than later, that it has a further role to play in helping the economy build a sustainable recovery amid mounting downside risks to the outlook. We expect the Bank of England to announce a further dose of asset purchases, most likely at the November or December MPC meetings and in the region of £100b. This would take the total of asset purchases up to

[1] *EY ITEM Club Summer Forecast 2020: UK economy past the worst but challenges remain*. July 2020. See ey.com/en_uk/growth/ey-item-club/uk-economy-past-the-worst-but-challenges-remain

£845b. However, we remain highly doubtful that the Bank of England will cut interest rates below the current record low level of 0.10%. Despite the Bank of England continuing to review the case for negative interest rates, we suspect that the MPC will maintain the view that such a move is not in the best interests of the UK economy.

Our forecasts assume that the UK and EU will avoid a no-deal outcome at the end of 2020 despite the current heightened tensions. 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.

We also assume that COVID-19 will become less of an issue for the economy in 2021, and this will be reinforced if a vaccine becomes available during the year — although it currently looks unlikely that this will occur in the first half at least. Should this occur during the second half, consumer and business caution should wane.

However, there is clearly a very real risk that the UK and EU will not reach an FTA by the end of the year, and that constitutes a major downside risk to our forecast, particularly for 2021.

Much deeper and extended restrictions on economic activity resulting from a sharply higher number of COVID-19 cases is clearly a very real and serious downside risk to the outlook. Another downside risk to the growth outlook is that even if further coronavirus outbreaks are contained and major restrictions on economic activity are avoided, consumers and businesses are cautious in their behaviour for an extended period.

A more fundamental and particularly worrying downside risk is that the economy will end up suffering significant scarring from COVID-19 in terms of companies ultimately going under and jobs being lost, despite the Government's measures aimed at helping businesses to keep going and to retain workers, and this has an appreciable long-term dampening impact on growth.

COVID-19 impacted on UK economy through several channels

COVID-19 has provided 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 lockdown restrictions occurred in England in mid-May, since when the Government has progressively looked to open up the economy and ease social distancing restraints when considered safe to do so.

On the supply side, the hit to the UK initially came from Chinese economic activity plunging as COVID-19 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 the virus 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 from 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 confidence coming from COVID-19, which was considerable at the outset and clearly led to an initially substantially more cautious approach in behaviour. This most notably weighed down on consumers' willingness to spend, particularly on discretionary items. In addition, consumer demand was hit by people not being physically able to go out and shop or visit the providers of consumer services due to being affected by the virus or being restricted in their movements due to government advice and diktats, although this was partly compensated for by a sharp rise in the volume of online sales.

Of course, there has also 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 both the furlough scheme and support for the self-employed only covering up to 80% of salaries or earnings.

Nevertheless, it should be noted that consumer spending clearly recovered strongly in Q3 2020 as reduced restrictions released pent-up demand after it had suffered record contraction of 23.6% q/q in Q2.

Meanwhile, many businesses facing reduced or even ceased activity as well as major uncertainties, 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."[2]

The Office for National Statistics (ONS) revealed in a late-June bulletin, on COVID-19 and the 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 was higher than normal. For 32.7%, capital expenditure was reported unchanged while the rest were not sure or said it was not applicable.[3] Unsurprisingly, ONS data shows that business investment contracted by a record 26.5% q/q in Q2 2020.

A further demand-side shock to the UK economy has come from reduced tourism, particularly over the summer months. In late August, the World Travel & Tourism Council (WTTC) estimated that the UK could lose up to £22b in 2020 due to the COVID-19 pandemic, as a consequence of visitors being deterred by the relatively high number of cases in the UK as well as uncertainties over travel restrictions due to the Government's quarantine measures.[4] However, this hit to the UK economy needs to be offset by the boost that has come from substantially increased staycations.

Financial conditions also tightened because of COVID-19, and this will obviously have had 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 5,897 on 29 September and the FTSE All-Share closing at 3,291. Gilt yields also rose

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

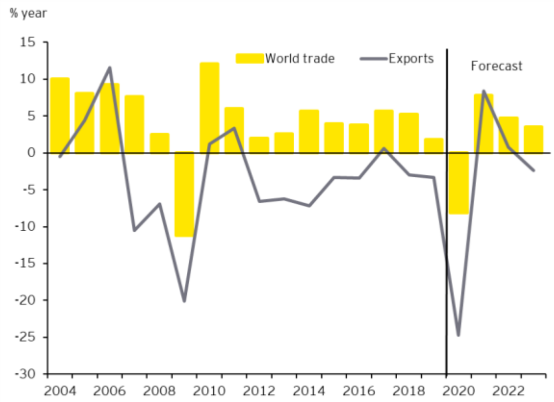
[3] *Coronavirus and the latest indicators for the UK economy and society: 25 June 2020*. Office for National Statistics. 25 June 2020. See ons.gov.uk/peoplepopulationandcommunity/healthandsocialcare/conditionsanddiseases/bulletins/coronavirustheukeconomyandsocietyfasterindicators/25june2020

[4] *Coronavirus: UK "could lose £60m a day" as tourism slumps.* BBC. 26 August 2020. See bbc.co.uk/news/business-53921106#

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.

In addition, COVID-19 took a major toll on global economic activity over the first half of 2020. While matters have since improved, there are still serious uncertainties and concerns about the outlook, including the possibility of second waves. Indeed, a number of countries have recently seen some pick-up in the number of coronavirus cases. Starting with a very substantial downward impact on the Chinese economy in Q1 2020 (where GDP fell 6.8% year-on-year (y/y)), coronavirus spread to take a substantial toll on all major economies — including the US, the Eurozone and Japan. Eurozone GDP contracted 3.7% q/q in Q1 2020, while US GDP declined at an annualised rate of 5.0%. Japanese GDP was down 0.6% q/q.

UK: exports and world trade



Source: EY ITEM Club

While China returned to growth in Q2 2020 with GDP up 3.2% y/y as it recovered from COVID-19 and restrictions on activity were removed, substantially deeper, record contraction occurred in the US, Eurozone and Japan in Q2 — although it appears that activity highly likely troughed in April. Specifically, US GDP contracted at an annualised rate of 31.4% in Q2 2020, while Eurozone GDP was down 11.8% q/q and Japanese GDP declined 7.8% q/q.

While growth in the US, Eurozone and Japan clearly resumed in Q3 2020, there will obviously 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.

Furthermore, with COVID-19 cases recently seeing renewed increases in many countries, there are serious concerns that the negative impact of the virus on global economic activity is far from over.

Renewed rise in COVID-19 cases has necessitated counteractions and fuelled concerns over the outlook

A recent marked renewed rise in the number of COVID-19 cases in the UK has led to several local lockdowns being imposed, and some heightened restrictions on activity nationwide being introduced. Parts of north-west England, West Midlands, West Yorkshire, Leicester, Scotland, Wales and Northern Ireland have all recently been under local lockdown.

In addition, on 14 September, a new ‘rule of six' was introduced under which a maximum of six people could attend indoor and outdoor gatherings in England and Scotland and indoor groups in Wales.

This was followed by new restrictions on the hospitality sector being imposed on 22 September, with pubs, bars and restaurants ordered to shut at 10p.m., with a requirement to provide table service only. Plans for the return of spectators to sporting events were also put on hold. In addition, the Government urged people to work from home where possible, having in recent weeks previously urged workers to return to their offices where possible amid concern that the economies of cities and major towns were being adversely affected by fewer people being in offices. The Government indicated that these measures are likely to last for six months.

It was also reported in mid-September that scientific advisers had proposed a two-week national lockdown to the Government in October (to coincide partly with the school half-term) to counter the renewed rise in COVID-19 cases. However, the Prime Minister was reportedly strongly against such a measure.

It remains to be seen how large the economic repercussions will be from these latest restrictions on activity and local lockdowns. While they have so far stopped short of any businesses being forced to close, there could be an appreciable negative impact on business and consumer confidence.

There is also the very real possibility that a more substantial tightening of restrictions on activity could occur over the coming weeks/months if cases continue an upward trend.

No-trade-deal Brexit increased threat to UK economic outlook

With the ending of the transition arrangement drawing ever nearer and the UK and EU seemingly still far apart from agreement on a future trading arrangement, there is very real and heightened concern that they will be unable to reach agreement by 31 December and that trade between the UK and the EU will then take place under WTO rules, just as it would have done if the UK had left the EU without a deal on 31 January.

Indeed, latest developments, comments and negotiations occurring between the UK and the EU are hardly encouraging but we suspect that there is a fair degree of public posturing going on.

While it is very far from certain, 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. Undoubtedly though, there will be tortuous twists and turns over the coming weeks.

Furthermore, even a bare-bones FTA is likely to have some dampening impact on UK economic activity in 2021 compared to the current situation, as it will still result in increased non-trade factors in the form of customs bureaucracy and some regulatory barriers.

Should the UK and the EU fail to come to even a bare-bones FTA by the end of 2020, we believe the hit to economic activity in 2021 and beyond will be appreciable. Probable major uncertainty would negatively impact already fragile business sentiment and limited investment plans, and it would 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 even more cautious on employment and pay, with negative repercussions for consumers.

We expect policymakers would react to a no-deal situation by easing both fiscal and monetary policy. In the case of the Bank of England, it would most likely primarily involve more asset purchases. While the introduction of negative interest rates could not be excluded, we believe this would still be unlikely. Meanwhile, there would be pressure on the Chancellor to provide further near-term support to the economy, perhaps with a particularly focus on business investment and assistance for exporters.

Even with additional policy stimulus, we suspect UK GDP growth would be around 1.2 percentage points lower at 4.8% in 2021 without a UK–EU FTA. Growth is also seen modestly weaker in 2022 at 2.6% (instead of 2.9%).

Chancellor has provided further near-term support to economy; Budget delayed until 2021

Fiscal policy remains orientated to supporting the economy amid the heightened downside risks and uncertainties. Indeed, the Chancellor announced a Winter Economy Plan on 24 September which contained additional support for businesses and particularly jobs. In the meantime, the Budget for 2021/22 was delayed from November until Q1 2021.

The Chancellor's Winter Economy Plan is a much-needed response to the increased downside risks to the UK economy, most notably coming from a rise in the number of COVID-19 cases. This threatened to magnify business caution and increase the potential loss of jobs stemming from the ending of the furlough scheme in October. Uncertainties over whether the UK and EU can reach agreement on their future trading relationship by the end of the year is also likely fuelling business caution.

The Chancellor has acknowledged that he cannot save every job and he is keen to target new support measures at jobs that are considered viable. This has been a key factor behind the reluctance to simply extend the furlough scheme. The central strand of the Chancellor's new plans is the Jobs Support Scheme which is orientated towards helping employees to work shorter hours rather than be made redundant. Specifically, the scheme — which will run for six months from 1 November — will directly support the wages of employees who work at least a third of their normal hours. Employees will be paid as normal by their employers for the hours that they work. For the remaining hours not being worked, the Government and employer will each pay up to a third of the wages. The scheme is open to all small and medium-sized companies. Larger companies whose revenue has fallen due to COVID-19 will also be eligible. Companies who did not participate in the furlough scheme can take part in this scheme.

Also important to saving jobs and supporting economic activity is providing support to companies who are struggling to survive due to their business being limited by COVID-19. To this end, the Chancellor announced a number of measures, including extending the temporary VAT cut for the hospitality sector from mid-January until the end of March, giving companies longer to pay back loans from the Government and giving them more time to pay deferred tax bills.

The Chancellor's Winter Economy Plan followed on from the announcement of 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 in the Summer Statement will be up to £30b. The Chancellor took this action as some of the unprecedented major fiscal measures that were enacted from March to support businesses and individuals impacted by COVID-19 were due to increasingly wind down. Most notably, the Coronavirus Job Retention Scheme started to be tapered in August ahead of its planned winding up in October.

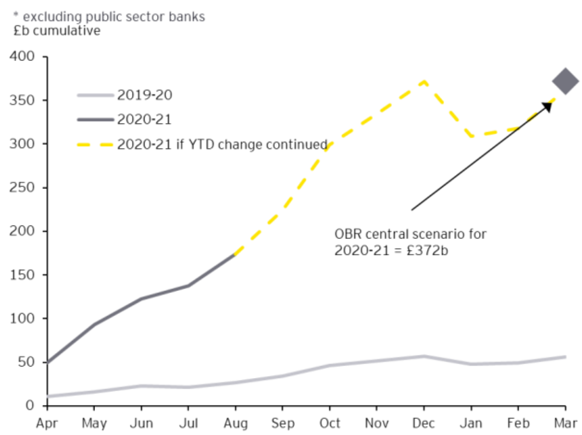
The Chancellor's measures to support jobs in the Summer Statement included a £1,000 bonus per employee to all companies bringing back furloughed workers through to January. In addition, a major initiative was a £2b fund to create six-month work placement jobs for unemployed 16–24-year-olds. The Government also announced associated measures on apprenticeships, training and work coaching.

With the strength of the economy crucial to the jobs outlook, the Chancellor also took a number of measures in the Summer Statement aimed at supporting growth. Most notably, a targeted VAT cut from 20% to 5% for six months from mid-July was aimed at supporting the hospitality and domestic tourism sectors which remain vulnerable as they are still constrained by social distancing. The Government also introduced vouchers for use when purchasing restaurant meals during August. Meanwhile, an immediate increase in the stamp duty threshold from £125,000 to £500,000 lasting through to 31 March 2021 was aimed at getting momentum into the housing market, with hopefully favourable knock-on effects for the economy.

The Government also announced in the Summer Statement that it would 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 more quickly. This will be made up of projects including hospitals, schools and roads.

Back in March, as the COVID-19 pandemic increasingly hit the economy, the Chancellor had announced unprecedented, massive fiscal measures aimed at helping businesses and individuals impacted by the virus, as well as upping resources for the NHS. The March Budget for 2020/21 contained a £12b package to tackle COVID-19 (£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 COVID-10 was going to be substantially deeper than expected when the Budget was being prepared, Chancellor 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).

UK: public sector net borrowing *



Source: EY ITEM Club, Haver Analytics and OBR

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 with some flexibility introduced into the scheme. 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 were asked to start sharing the cost of the scheme on a tapered basis from August.

An additional major step was taken by the Chancellor 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. 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 PSNB ex (public sector net borrowing excluding public sector banks) saw the five largest monthly deficits since records began in 1993 in the first five months of fiscal year 2020/21 (April–August). This meant that PSNB ex amounted to £173.7b over the first five months of fiscal year 2020/21, up from £26.8b in April–August 2019. To put this into perspective, it is already £118.9b over the total PSNB ex of £54.8n for 2020/21 that the Office for Budget Responsibility (OBR) had forecast in the Budget on 11 March.

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".[5] 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 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.

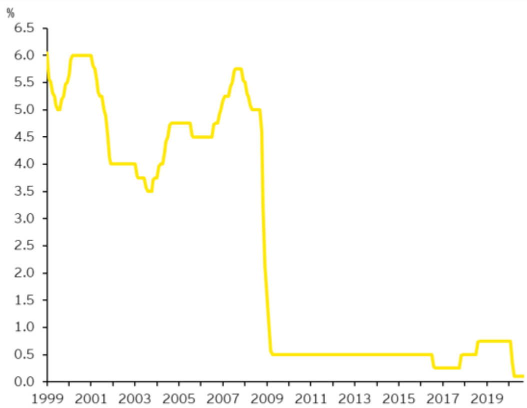
Further Bank of England stimulus likely before long

The Bank of England 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. It has since left monetary policy unchanged at the August and September meetings of the MPC.

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 MPC meeting.

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. Additionally, the Bank of England announced measures

UK: Bank Rate



Source: EY ITEM Club/Haver Analytics

[5] *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/

aimed at supporting bank lending, especially to small businesses (the Term Funding Scheme with additional incentives for Small and Medium-sized Enterprises — TFSME).

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 revived quantitative easing (QE) by announcing that 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, although the Bank of England indicated that it intended to make at least £10b purchases of corporate bonds. This was by far the largest single announcement of asset purchases that the Bank of England had ever made (the previous highest was £75b). The Bank had last undertaken QE in August 2016 in the aftermath of the UK voting to leave the EU. The third strand of the Bank's additional measures on 19 March saw it announce that it would enlarge the TFSME.

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. This type of 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 next acted at its 17 June MPC meeting when it announced a further £100b of asset purchases (taking the stock up to £745b) following an 8–1 vote (Andy Haldane was in favour of keeping the level of asset purchases unchanged at £645b). There was a 9–0 vote to keep interest rates at 0.10%. 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. In fact, the minutes of the June MPC meeting observed "With liquidity conditions having stabilised, purchases could now be conducted at a slower pace than during the earlier period of dysfunction." [6]

The MPC subsequently kept interest rates at 0.10% and the planned stock of asset purchases unchanged at £745b at both its 5 August and 16 September meetings, each time as the result of unanimous 9–0 votes.

With the economy clearly seeing a sharp bounce back in Q3 2020 as it benefitted from much reduced lockdown restrictions, the Chancellor announcing extra support for the economy in his Summer Statement, and planned asset purchases seen as sufficient to last to the end of the year, there was a strong case for the MPC to adopt a 'wait and see' stance on monetary policy at both the August and September meetings.

The minutes of the September MPC meeting revealed that the committee considered that the recent performance of the economy had been modestly stronger than expected in August. Specifically, the minutes observed that "for 2020 Q3 as a whole, Bank staff expect GDP to be around 7% below its 2019 Q4 level, less weak than had been expected in the August Report." In particular, the MPC noted that consumer spending had continued to recover strongly and has recently been doing better than was expected in its August report. However, investment intentions remain weak and the uncertainties facing businesses remain elevated. The MPC also observed that the number of furloughed workers has continued to decline but uncertainty remains around the labour market as the Government's job support schemes are due to unwind.

However, the MPC seemed unconvinced that this necessarily boded well for the economy's performance further out and the members seemed wary of the downside risks to the recovery, particularly stemming from the rising number of coronavirus cases and the possibility of persistently high unemployment. It is also notable that while the MPC did not say anything about the latest developments in the UK–EU negotiations on their future relationship, the minutes commented that: "The MPC's latest central projections were also conditioned on the assumption of an immediate, orderly move to a comprehensive free trade agreement with the European Union on 1 January 2021." The minutes also noted that just under half of respondents in their Decision Maker Panel had ranked Brexit as one of the top three sources of uncertainty for their business. The minutes reported that the MPC would consider economic issues relating to Brexit within the context of its wider forecast discussions ahead of the November MPC meeting.

[6] *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

With the MPC considering that the outlook for the UK economy remains "unusually uncertain", the conclusions of the September MPC meeting made it very clear that the door is open to further Bank of England stimulus, stating "the Committee would continue to monitor the situation closely and stood ready to adjust monetary policy accordingly to meet its remit. The MPC would keep under review the range of actions that could be taken to deliver its objectives." The MPC also indicated that any tightening of monetary policy was some considerable way off as it also commented: "The Committee does not intend to tighten monetary policy until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably."

There was no reporting in the September minutes of the MPC discussing the case for an immediate move to negative interest rates. The minutes did reveal that "the MPC had been briefed on the Bank of England's plans to explore how a negative Bank Rate could be implemented effectively, should the outlook for inflation and output warrant it at some point during this period of low equilibrium rates." The Bank of England is currently holding a review into the case for negative interest rates and other policy instruments open to it. In its August *Monetary Policy Report*, the Bank of England concluded that negative interest rates "at this time could be less effective as a tool to stimulate the economy". It observed that the MPC has other instruments available — for example, asset purchases and forward guidance. However, this would be kept under review.

The EY ITEM Club suspects the odds are now very much tilted towards more Bank of England action to support the economy, given the increased downside risks to the outlook. We believe the MPC will come to the view sooner rather than later that further monetary stimulus is warranted to bolster the UK's recovery. We expect the Bank to announce a further dose of asset purchases, most likely at the November or December MPC meetings and in the region of £100b. This would take the total up to £845b.

However, we remain highly doubtful that the Bank of England will cut interest rates below the current level of 0.10%. Despite the Bank continuing to review the case for negative interest rates, we suspect that the MPC will maintain the view that such a move is not in the best interests of the UK economy.

Economy contracted by record 19.8% q/q in Q2 2020 and by 21.8% over first half

GDP contracted by a record 19.8% q/q and 21.5% y/y in Q2 2020, primarily due to the record fall in activity in April when lockdown restrictions were fully in place. With the economy earlier contracting 2.5% q/q in Q1 2020 (which, at the time, was the sharpest decline since Q3 1979), the economy moved into recession over the first half of the year. Indeed, GDP in Q2 2020 was 21.8% below the level seen in Q4 2019.

After April's fall of 19.5% month-on-month (m/m), which followed a drop of 7.3% m/m in March and essentially accounted for the overall Q2 2020 contraction, GDP grew 2.7% m/m in May when there was a modest first easing of the lockdown restrictions. The economy took a significant step forward in June when GDP expanded 9.1% m/m amid a further easing of lockdown restrictions. This notably included non-essential retailers being allowed to open from the middle of the month. June's marked pick-up in growth was the consequence of decent m/m output growth across all sectors: services (8.2%), industrial production (9.8%) and construction (21.8%). It was notable that services output improved after comparatively limited growth of 1.8% m/m in May that held back overall growth.

Despite June's sharp improvement, there was a substantial q/q contraction across all output sectors in Q2 2020. Output in the dominant services sector fell a record 19.2% q/q following a drop of 2.6% q/q in Q1. The sharpest declines occurred in the accommodation and food services sectors, wholesale and retail trade and repair of motor vehicles, human health and social work activities, and education, as they were impacted by "business closures, shutdowns among clients or shrinking sales due to a slump in non-essential spending".[7]

Industrial production contracted 16.3% q/q in Q2 2020 with manufacturing output declining 21.1% q/q. This followed respective drops of 2.1% q/q and 1.8% q/q in Q1. Manufacturing output was particularly hard hit by a 47.1% drop in the manufacture of transport equipment due to widespread factory shutdowns during the lockdown period. Additionally, construction output fell 35.7% q/q in Q2 2020 after a decline of 2.8% q/q in

[7] GDP first quarterly estimate: UK: April to June 2020. Office for National Statistics. 12 August 2020. See ons.gov.uk/releases/gdpfirstquarterlyestimateukapriltojune2020

Q1. Most notably, private housebuilding fell by 49.5% q/q in Q2 2020. Many manufacturing plants (not just in the auto sector) and construction sites were closed throughout April before starting to reopen from May.

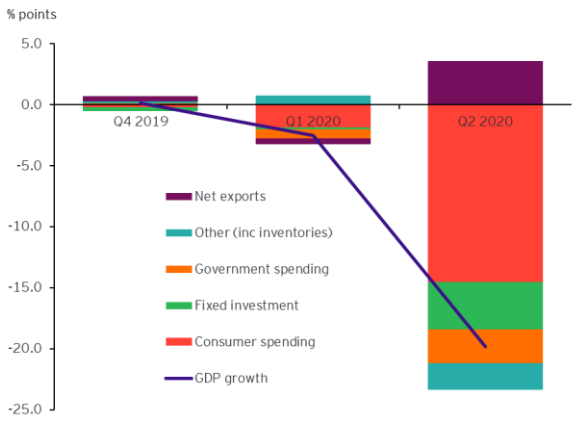
On the expenditure side of the economy, record falls in consumer spending and business investment weighed on the Q2 2020 GDP performance figures, while there were also negative contributions from net trade and government spending. The only positive contributions came from government investment as a consequence of efforts to support the economy and net trade but only because imports fell sharply more than exports.

Consumer spending declined 23.6% q/q in Q2 2020 and was down 26.2% y/y as it was affected by the restrictions on activity physically preventing people from consuming (particularly in April), worsening consumer fundamentals and weakened confidence. This followed a drop of 3.0% q/q in Q1. Non-essential retailers were shut from 23 March through to mid-June while some parts of the consumer services sector were effectively brought to a halt for much of Q2 by the lockdown, including the closure of theatres, cinemas, gyms, restaurants, pubs and clubs. Meanwhile, jobs were cut, and incomes affected during the quarter, despite the supportive government measures.

A notable feature of Q2 2020 was that the household saving ratio increased sharply to a record 29.1% from 9.6% in Q1. That provides some welcome support to consumers, although analysis indicates that it was the least well-off who have tended to find their finances increasingly squeezed during Q2 as jobs and incomes were negatively affected.

Overall investment fell 21.6% q/q in Q2 2020 after a drop of 1.0% q/q in Q1. Most notably, business investment fell 26.5% q/q in Q2 after a drop of 0.5% q/q in Q1 as companies faced reduced activity, weakened cash flows and uncertainties. There was also substantial contraction of 41.5% q/q in private dwellings investment in Q2. However, government investment rose 19.3% q/q. Government spending, on the other hand, fell 14.6% q/q and 16.9% y/y in Q2 which primarily reflected lower spending on health and education. This followed a fall of 3.9% q/q in Q1.

GDP growth contributions in Q4 2019 and H1 2020



Source: EY ITEM Club

There was a negative impact from lower inventories — stocks held by UK companies fell by £4.0b over Q2 2020. This was led by a fall in the level of stocks held within the wholesale and retail trades, though partially offset by increases in stock levels held in mining and quarrying, which increased as a result of falling oil prices.

Finally, net trade made a major positive contribution to second quarter GDP, but only because imports declined even more sharply than exports. Net trade had previously made a considerable negative contribution in Q1. Exports of goods and services fell 11.0% q/q in Q2 2020 as most countries experienced deep contraction and global trade weakened; this followed a decline of 10.7% q/q in exports in Q1. Imports of goods and services contracted an even larger 22.7% q/q in Q2, reflecting the weakness of UK domestic demand; this followed a decline of 9.2% q/q in imports in Q1.

Economy clearly saw a sharp bounce back in Q3

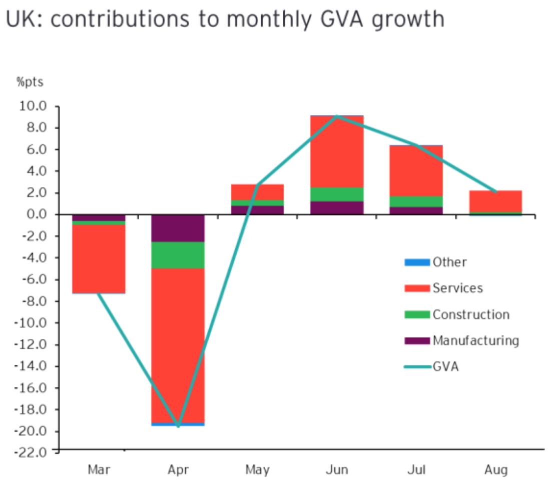
The economy clearly saw a sharp bounce back in Q3 2020 as it benefitted from markedly reduced lockdown restrictions that released pent-up activity, and also some help from stimulative measures, including the Chancellor's temporary raising of the stamp duty threshold for house purchases, the cutting of VAT for the hospitality sector from mid-July, and the Eat Out to Help Out Scheme in August.

Significantly, there will have been a boost to Q3 GDP growth from the education sector. Education was a major drag on GDP in Q2 with output contracting 27.6% q/q and 32.7% y/y as schools were closed. However, with the school holidays occurring in July/August and schools due to reopen in September, there should be a substantial rebound from education output in the Q3 output figures (although much could depend on how the ONS seasonally adjust for the school holidays after the school closures in Q2).

Consumer spending clearly saw a substantial bounce back in Q3 and was healthy through the quarter. The full opening up of the retail sector during June unleashed pent-up demand while the opening up of the hospitality sector and other consumer services from early July further fuelled consumer spending.

Indeed, the rebound in Q3 2020 looks to have been robust and we now suspect that GDP likely grew by some 16-17% q/q in Q3 rather than by around 12% q/q as we had anticipated in our *Summer Forecast 2020* in July.

The UK economy certainly got off to a strong start to Q3 as it built on June's marked improvement in July, helped by the opening up of pubs, restaurants, hairdressers and some other services sectors in England at the beginning of the month, which was followed by a further opening up of services in mid-month as well as restrictions being lifted elsewhere in the UK.



Source: EY ITEM Club calculations using data from Haver Analytics

Specifically, GDP grew 6.4% m/m in July following June's 9.1% m/m expansion; this caused y/y contraction to moderate to 11.3% in July from 16.4% in June and the peak fall of 25.1% in April. The three-month/three-month rate of GDP contraction slowed sharply to 6.8% in July from 19.8% in June.

The dominant services sector saw output expand 5.9% m/m in July. The ONS highlighted that "education grew strongly as some children returned to school, while pubs, campsites and hairdressers all saw notable improvements". Education output actually rose 11.1% m/m in July. Meanwhile, industrial production rose 5.2% m/m in July with manufacturing output climbing 6.9% m/m. All 13 manufacturing subsectors achieved growth in July. Completing the healthy expansion across all output sectors in July, production in the construction sector climbed 17.2% m/m. This was led by the private housebuilding sector.

On the expenditure side of the economy, retail sales volumes rose 3.6% m/m in July and were up 1.4% y/y, which was the first annual gain since January. Furthermore, with July's gain building on healthy m/m gains in May and June, retail sales in July were 3.0% above their February level before they were hit hard in March and, especially, April, by the lockdown imposed to combat coronavirus. Additionally, July saw the first y/y increase in new car sales achieved so far in 2020 (up 11.3%) as pent-up demand since March was released by the progressive opening up of showrooms from early June.

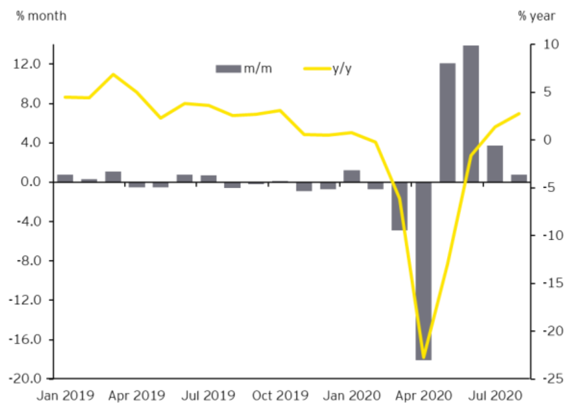
The UK economy continued to recover in August, although GDP growth slowed to 2.1% m/m. The y/y contraction in GDP moderated to 9.3% in August from 11.3% in July, Significantly, the three-month/three-month rate of GDP moved back into positive territory in August as it expanded by 8.0%. August's 2.1% m/m gain in GDP meant that the economy was 21.7% larger than it had been at April's low, although it was still 9.2% below where it was in February, before COVID-19 started to really affect activity.

It was always going to become increasingly difficult for the economy to achieve robust monthly GDP gains as recovery progressed from April's lows, pent-up demand was increasingly exhausted and the easy growth pickings from opening up of sectors were taken. Nevertheless, GDP growth of 2.1% m/m in August was below most expectations.

The services sector grew 2.4% m/m in August but this was expected to be higher due to the support it received from the 'Eat Out to Help' Out scheme and the cutting of VAT for the hospitality sector. Indeed, the food and beverage services activity industry grew 69.7%. Additionally, the accommodation sector grew 76% in August as domestic staycations were boosted by international travel restrictions. Industrial production rose a modest 0.3% m/m in August with manufacturing output climbing 0.7% m/m. Eight out of 13 manufacturing sectors saw growth in output in August. The strongest output growth in August occurred in the construction sector where it climbed 3.0% m/m. The improvement in construction output continued to be led by housebuilding, which is no doubt being helped by the housing market seeing a marked pick-up in activity in recent months, although uncertainties remain about its longer-term outlook.

Consumers seemingly kept on spending at a robust rate in August. Retail sales volumes rose for a fourth successive month as they increased 0.8% m/m and 2.8% y/y; this took them 4.0% above their February level. It is very possible that some consumer spending was diverted away from retail following July's opening up of the consumer services sector and the temporary cutting of VAT for the hospitality sector. Spending on eating out was also clearly lifted in August by the Eat Out to Help Out Scheme (it was reported that the scheme resulted in claims for 100 million meals). Barclaycard reported consumer spending rose 0.2% y/y in August, which was the first annual gain since February. However, new car sales saw a renewed drop in August (5.8% y/y).

UK: retail sales volumes (inc fuel)



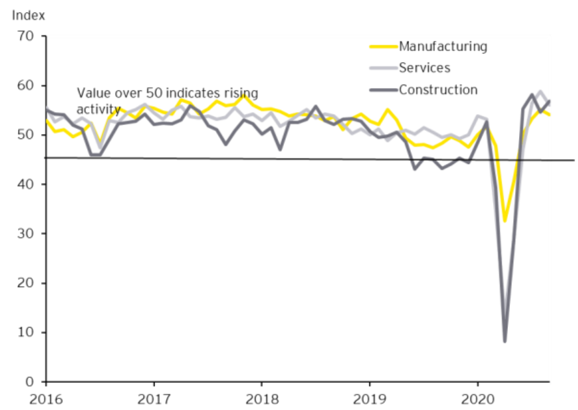
Source: EY ITEM Club/Haver Analytics

It is also notable that housing market activity has picked up markedly since the easing of restrictions across the UK from mid-May through June, reinforced by the Chancellor's raising of the stamp duty threshold to £500,000 from mid-July until 31 March 2021. The pick-up in housing market activity has also led to a firming in prices. Specifically, the Bank of England reported that mortgage approvals for house purchases accelerated markedly for a third month running in August to be at a near 13-year high of 84,715. This was up from 66,288 in July and a record low of 9,285 in May.

The economy clearly continued growing in September, but it may have struggled for momentum. While both sectors remained well in expansionary territory in September, the purchasing managers surveys nevertheless indicated a slowdown in both services (PMI down to 56.1 from August's 64-month high of 58.8) and manufacturing activity in September (PMI down to 54.1 from August's 30-month high of 55.2). On a more positive note, the construction sector regained some momentum in September after August's slowdown with the PMI rising back up to 56.8 from 54.6. Nevertheless, IHS Markit indicated that the all-items PMI fell back to 56.6 in September from a six-year high of 58.7 in August.

On the expenditure side of the economy, the CBI distributive trades survey reported that the balance of retailers reporting a y/y rise in sales volumes rose to +11% in September, which was the strongest level since April 2019 and followed a dip to -6% in August from +4% in July. Less encouragingly, Springboard reported that shopper footfall to all retail destinations fell back for a second week running in the week to 3 October after the Government called on people to work at home, where possible on 22 September in reaction to rising coronavirus cases. Additionally, new car sales suffered a disappointing 4.4% y/y drop in the key month of September.

UK: IHS Markit/CIPS surveys



Source: EY ITEM Club/IHS Markit/CIPS

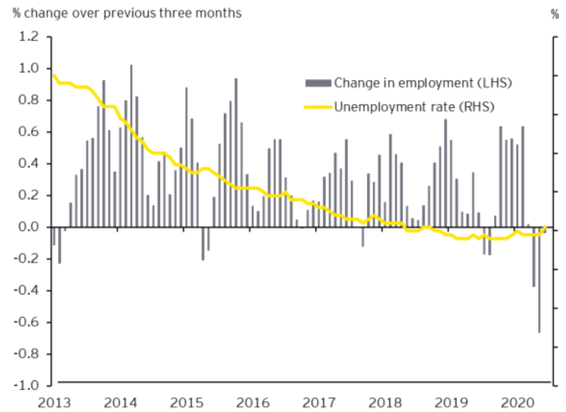
Meanwhile, it is clear that business investment remained a weak link of the economy in Q3. The Bank of England's Decision Maker Panel for August reported that business investment in Q3 would be 32% less than it would otherwise have been because of coronavirus. The food and accommodation sector estimated the biggest drop, at 60%, but it was notable that businesses in all sectors reported falling investment, with retailers predicting a 40% fall and manufacturers 32%. The Panel also reported that overall uncertainty remained high. 70% of firms viewed overall economic uncertainty as high or very high in August, which was slightly lower than 76% in the July survey and 74% in June.[8]

[8] *Monthly Decision Maker Panel data – August 2020*. Bank of England. 3 September 2020. See bankofengland.co.uk/decision-maker-panel/2020/august-2020

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 the Job Support Scheme as the central element of his Winter Economy Plan on 23 September. This followed a number of measures in his Summer Statement in July aimed at supporting jobs.

UK: employment and unemployment



Source: EY ITEM Club/Haver Analytics

The damage to the labour market has undoubtedly been substantially limited so far by companies' ability to furlough workers under the Government's Coronavirus Job Retention Scheme. Treasury data shows that the job retention scheme (which pays 80% of the salaries of employees who are temporarily laid off) has covered 9.6 million workers. When releasing the latest set of labour market data, the ONS reported that the number of people who are estimated to be temporarily away from work (including furloughed workers) had fallen, but it was still more than 5 million in July 2020, with over 2.5 million of these being away for three months or more. There were also around 250,000 people away from work because of the pandemic and receiving no pay in July 2020. The Bank of England's Decision Maker Panel reported that the percentage of employees on furlough extended a downward trend in September. Specifically, businesses reported 7% of employees had been furloughed in September, down from 12% in August, 18% in July and a peak of 36% in April. However, the ONS reported that 9% of staff were fully or partly furloughed during 7-20 September.

The latest labour market data is weak overall but there was some evidence of an impact from the opening up of the economy and an increasing number of workers returning from furlough.

Claimant count unemployment rose 73,700 in August to 2.7373 million. This followed an increase of 94,400 in July. There had been particularly large increases in May (566,400) and, especially, April (852,900). Consequently, claimant count unemployment was up 1.4977 million (120.8%) since March when it stood at 1.2396 million.

Additionally, HMRC and ONS Pay As You Earn Real Time Information data indicate that the number of paid employees in August was down 36,000 from July and was also down 695,000 from March.

International Labour Organization (ILO) data shows that the number employed fell just 12,000 in the three months to July, which was a much smaller drop than 220,000 over the three months to June, which had been the largest three-monthly decline since the three months to July 2009. Furthermore, at 32.979 million in the three months to July, employment was actually up from 32.948 million in the three months to June, although it was still below the record high of 33.114 million in the three months to March. The employment rate rose back up to 76.5% in the three months to July after dipping to 76.4% in the three months to June from a record high of 76.6% in the three months to March.

The number of unemployed rose 62,000 in the three months to July to 1.398 million; this caused the unemployment rate to finally rise to 4.1%, having defied previous expectations of an increase by remaining at 3.9% since the lockdown was imposed in March. It is notable that ONS has indicated that furloughed workers continue to count as employees, while those who claim from the Self-Employment Income Support Scheme will still be classed as self-employed. The ONS has also indicated that the unemployment rate had been kept down as a number of people had given up looking for work and were therefore no longer counted as unemployed. This led to a rise in the inactivity rate, although it dipped in the three months to July.

The number of job vacancies continued to move back up modestly after falling sharply to a record low: it was up to 434,000 in the three months to August from 377,000 in the three months to July and 341,000 in the three months to June, which had been the lowest level since the series began in 2001 and down from 818,000 in the three months to February.

Nevertheless, concerns over the labour market are fuelled by a substantial number of redundancies which were announced in July and August across a number of sectors, and particularly in the retailing sector. It is also notable that the August purchasing managers' surveys reported that employment across the services and manufacturing services fell at the sharpest rate since May in August. It also continued to fall at a sharp rate in August in the construction sector. In addition, a July survey by Make UK revealed that some 46% of manufacturers expect to make redundancies over the next six months, up sharply from 25% in May.

Meanwhile, the decline in annual earnings slowed in July after recent sharp drops, largely reflecting more workers coming off furlough. Many workers who were furloughed only received 80% of their normal pay from March. However, while workers coming off furlough should be being restored to full pay, many companies are looking to freeze or cut pay, and to reduce bonuses.

UK: average weekly earnings

Source: EY ITEM Club/Haver Analytics

Indeed, pay looks set to remain limited. For example, the latest survey by XpertHR released in late September reported that pay deals in the three months to August offered a median annual pay rise of 0%, down from 0.5% in the three months to July and 2.2% in the three months to June. XpertHR further reported that many companies were delaying pay reviews, a practice that a number had introduced in April. Additionally, the Chartered Institute of Personnel and Development (CIPD) reported in August that two-fifths of private sector employers planned to freeze pay for the next 12 months. The median expectation of pay growth was just 1%. 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.

Annual average earnings edged down 0.1% in July itself after drops of 1.6% in June, 1.2% in May and 1.0% in April; they were down 1.2% y/y in the three months to July. Annual earnings figures are also being pulled down currently by 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) rose 0.9% in July, after marginal declines over the previous three months: June (0.2%), May (0.2%) and April (0.1%). Consequently, annual regular earnings growth edged up 0.2% in the three months to July after a drop of 0.2% in the three months to June.

ONS data shows that real earnings fell 1.2% y/y in July itself, which was nearly half the 2.3% drop suffered in June; they were down 1.8% y/y in the three months to July. Regular real earnings fell 0.2% y/y in July itself and were down 0.7% y/y in the three months to July.

The further Treasury support for the labour market and businesses that was announced in the Winter Economy Plan has led us to trim our expectation of how much unemployment will rise over the coming months. Nevertheless, we still suspect that given the vulnerable position of many companies and a highly uncertain outlook, plus the fact that employers will have to contribute significantly to the pay of the workers that are working part-time, unemployment will rise substantially when the furlough scheme ends in October. It could also see a further, albeit less marked increase when the Job Support Scheme concludes at the end of April 2021. Specifically, we suspect the ILO unemployment rate will get up to around 7.0% at the end of 2020, and reach a peak of 7.7% in mid-2021 before stabilising and then starting to fall back. The unemployment rate is also likely to be lifted by a significant number of workers starting to look for jobs again as the economy recovers. Employment is seen falling from 32.979 million in the three months to July to a low of 31.564 million in Q2 2021 before starting to move back up.

Meanwhile, we forecast average earnings to gradually pick-up from a peak drop of 1.2% y/y in the three months to June. Earnings will be lifted by employees coming off furlough, which paid up to 80% of their salaries. However, we suspect that the pick-up in earnings growth will be limited by many employers looking to freeze pay or give very low pay awards in the near term at least. Consequently, we only see earnings growth rising by 2.4% over 2021 after a drop of 0.3% over 2020.

Economy expected to find life much harder after sharp Q3 2020 bounce back

The economy clearly saw a considerable bounce back in Q3 2020 as it benefitted from sharply reduced lockdown restrictions. Indeed, we now estimate GDP expanded around 17% q/q following the record Q2 contraction of 20.4% q/q. Consumer spending clearly played the leading role in the Q3 recovery, but business investment seemingly remained weak.

We suspect that the economy will find life a lot more challenging during Q4 2020 than it did in Q3, and that it will struggle to grow more than 1% q/q. Activity in Q4 is likely to be pressurised by a marked rise in unemployment as the furlough scheme draws to an end in October. While the Chancellor's Job Support Scheme announced in late September should have some limiting impact on the increase in unemployment in late 2020/early 2021, a significant rise in unemployment still looks more likely than not following the ending of the furlough scheme in October. There is also expected to be a waning of pent-up demand in Q4.

On top of this, markedly rising numbers of coronavirus cases led to some renewed tightening of restrictions by the Government on 22 September. While the direct impact of these restrictions looks to be limited, they could well have some dampening impact on business and consumer confidence, and there is the possibility of more restrictions to come, with the risk of a two-week lockdown being cited. Additionally, business caution and a reluctance to invest in Q4 2020 may be magnified by the increasingly fraught and fractious negotiations between the UK and the EU, which has magnified the possibility that the two sides will fail to reach a free trade arrangement before the end of the year when the transition arrangement ends. 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.

The Bank of England's regional agents reported in their Q3 2020 survey of business conditions that "Investment intentions remained significantly weaker than a year ago, and there were widespread reports of investment being postponed or cancelled to preserve cash. Most contacts remained cautious about the economic outlook and their cash positions. As a result, investment tended to be limited to essential equipment or maintenance, rather than discretionary or strategic projects. Contacts in the automotive, aviation and oil and gas extraction sectors were particularly cautious about investment due to the uncertain outlook for demand. And companies generally reported delaying investment in office relocation, workplace expansion and replacement of machinery."[9]

On the positive side, while some of the emergency fiscal measures will wind down over the next few months, there will still be appreciable near-term fiscal support for the economy. This includes the temporary VAT cut for the hospitality sector that will last through to the end of March as well as the raised stamp duty threshold through to the end of March. Monetary policy is also hugely supportive to growth and we doubt the Bank of England is fully done yet on providing help for the economy. We expect it to announce a final dose of £100b of asset purchases in November or December. 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 (it fell to 0.2% in August and is likely to hover around 0.5% over Q4). Also on the positive side, four months of net repayment of unsecured consumer debt totalling £15.7b over March–June improved many households' balance sheets which will enhance some consumers' purchasing ability.

Meanwhile, global economic activity has picked up overall in recent months, and this should help UK exports.

There may well be significant stockbuilding in Q4 2020 as a consequence of heightened concerns that the UK–EU may not come to an FTA agreement as well as appreciable front-loading of exports and imports (including raw materials and intermediate goods). This may well occur even if agreement on an FTA is reached during Q4, due to the increased bureaucracy on UK–EU trade that will occur after 31 December.

[9] *Agents summary of business conditions – 2020 Q3.* Bank of England Regional Agents. 17 September 2020. See bankofengland.co.uk/agents-summary/2020/2020-q3

EY ITEM Club forecast for the UK economy, autumn 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	1.2	1.4	0.4	3.0	2.7
2019	1.3	1.4	0.9	1.5	2.8	3.3
2020	-10.1	-12.3	-12.8	-17.2	-11.5	-18.1
2021	6.0	7.7	7.6	3.4	10.6	16.3
2022	2.9	3.5	3.0	9.0	5.5	7.3
2023	1.9	2.1	2.0	2.9	3.4	3.8
2024	1.7	1.9	1.8	2.6	3.4	3.7
	Net government borrowing*	**Current account (% of GDP)**	**Average earnings**	**CPI**	**Bank Rate**	**Effective exchange rate**
2018	2.0	-3.7	3.0	2.5	0.6	78.5
2019	3.0	-4.3	3.5	1.8	0.8	78.2
2020	17.4	-2.8	0.5	0.8	0.2	77.6
2021	7.5	--4.3	2.2	1.4	0.1	77.9
2022	4.1	-4.4	3.1	2.2	0.2	80.1
2023	3.0	-4.5	3.5	2.0	0.5	81.3
2024	2.7	-4.5	3.5	2.0	1.0	79.5

*Fiscal years, as % of GDP

Source: EY ITEM Club

With the economy expected to grow around 1% q/q in Q4 2020 following an estimated expansion of 17% q/q in Q3, GDP is forecast to contract 10.1% over 2020.

Consumer spending is forecast to contract by 12.8% over 2020, while fixed investment is seen plunging 17.2%, with business investment declining 21.9%. Government investment is seen rising 10.5%, but public spending is projected to fall by 7.6%. Net trade is seen making a positive contribution of 2.0 percentage points to GDP as exports of goods and services fall by 11.5% while imports decline by a greater 18.1%.

On the assumption that the UK and EU avoid a no-deal outcome at the end of 2020 when the transition arrangement ends, and that the negative impact from coronavirus wanes, we expect the economy to grow 6.0% in 2021. Even so, the economy is not expected to return to its Q4 2019 size until the second half of 2023.

After contracting 12.8% in 2020, consumer spending is expected to rebound 7.6% in 2021 as the labour market gradually recovers from the marked deterioration suffered over the final months of 2020 and start of 2021. 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 as the Chancellor favours ensuring that the economy is on a firm footing ahead of early action to start restoring the public finances to a sustainable state. Indeed, government investment is seen increasing 10.7% in 2021 contributing to fixed investment growth of 3.4%. Business investment is forecast to contract 3.5% over 2021 but this overall decline masks q/q growth as the year progresses 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. Productive business investment may also continue to be limited by the amount of resources that companies have had to devote to making their facilities compatible with social distancing guidelines.

Net trade is seen as significantly negative in 2021 as exports (up 10.6%) are forecast to be markedly outgrown by imports (up 16.3%).

Risks and uncertainties to forecast

The risks to the forecast currently seem primarily loaded to the downside.

Much deeper and extended restrictions on economic activity resulting from sharply higher numbers of COVID-19 cases is clearly a very real and serious downside risk to the outlook. Another downside risk to the growth outlook is that even if further coronavirus outbreaks are contained and major restrictions on economic activity are avoided, consumers and businesses are cautious in their behaviour for an extended period

A more fundamental and particularly worrying downside risk is that the economy suffers appreciable scarring 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 and limits growth over the medium term.

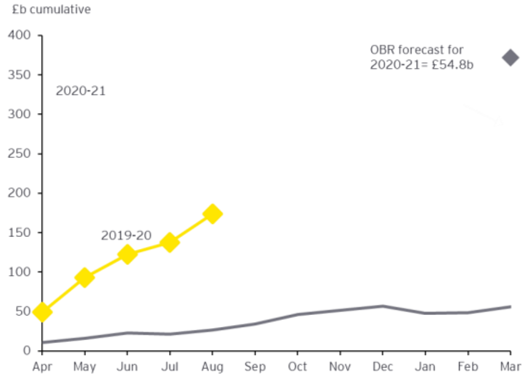
A very significant and currently heightened downside risk to the forecast stems from the very real possibility that the UK and the EU could fail to reach a free trade agreement by the end of 2020, causing trade between the UK and the EU to take place under WTO rules — just as it would have done if the 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.

An upside risk to the forecast is that unemployment does not rise as much as we expect in late 2020/early 2021 and this allows the economy to see stronger recovery over 2021 and beyond.

Forecast in charts

Fiscal policy

UK: public sector net borrowing*

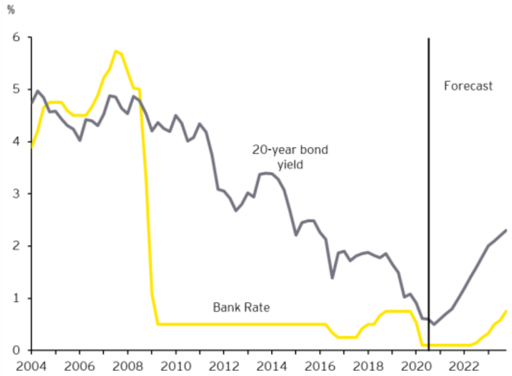


Source: Haver Analytics and OBR

- Major fiscal measures have played a key role in aiming to limit the damage to the economy from COVID-19. Winter Economy Plan is the latest move.
- The cost of fiscal packages to support the economy is likely to see the budget deficit (PSNB ex) reach £365b (17.4% of GDP) in 2020/21.
- Chancellor expected to prioritise getting economy on firmer footing in delayed 2021/22 Budget, rather than taking initial steps to get public finances to a sustainable position.

Monetary policy

UK: Bank Rate and 20-year bond yield

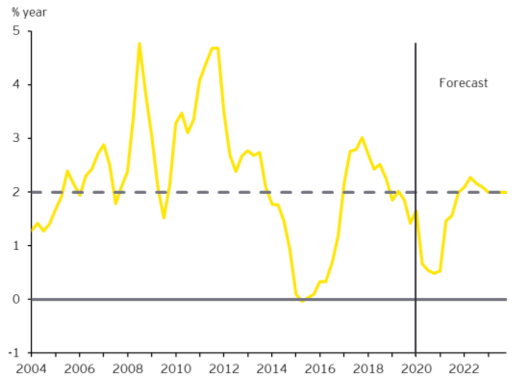


Source: EY ITEM Club

- Bank of England set to keep interest rates at record low of 0.10% through 2022 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 the November or December MPC meetings.

Prices

UK: CPI inflation

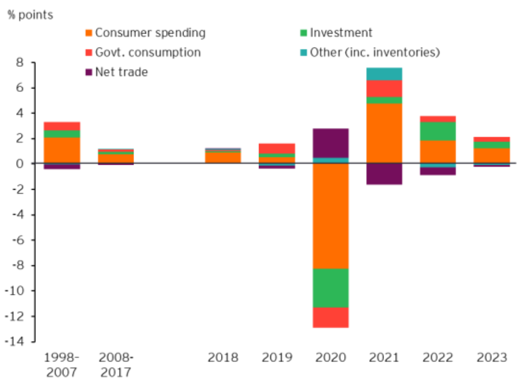


Source: EY ITEM Club

- Annual consumer price inflation of 0.2% in August (lowest since January 2016) seen as trough; brought down by Eat Out to Help Out Scheme and VAT cut for hospitality sector.
- Inflation seen hovering just under 0.5% over rest of 2020; will start rising gradually early in 2021 as temporary VAT cut is withdrawn at end of March and base effects are unfavourable due to sharp fall in oil prices in early 2020.
- Inflation seen rising towards 2% in late 2021. Averaging 1.3% over 2021.

Activity

UK: contributions to GDP growth



Source: EY ITEM Club

- GDP seen contracting 10.1% in 2020. GDP estimated to have grown around 17% q/q in Q3, led by consumer spending, after contraction of 19.8% q/q in Q2 and 2.5% q/q in Q1.
- Growth seen slowing to no more than 1% q/q in Q4 2020 as unemployment rises markedly, impact of pent-up demand wanes and coronavirus-related restrictions impact.
- GDP growth seen at 6.0% in 2021 but will not return to Q4 2019 size until second half of 2023.

Consumer demand

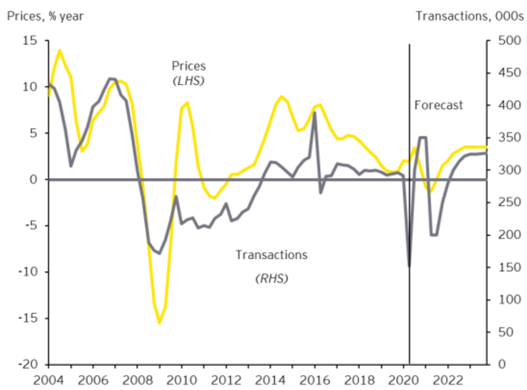
UK: real household income and spending

Source: EY ITEM Club

- Consumer spending bounced back strongly in Q3 2020 after record contraction of 23.6% q/q in Q2. Pent-up demand released by opening up of retail sector in June and consumer services in July.
- Consumer spending seen constrained after Q3 2020 by cautious consumers and markedly higher unemployment.
- Consumer spending seen growing 7.6% 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

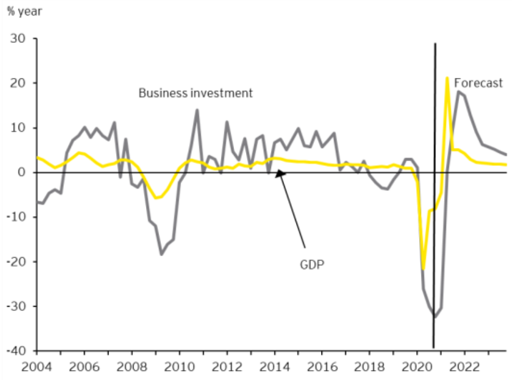


Source: EY ITEM Club

- Easing of lockdown restrictions led to an initial surge in activity and buyer interest. Reinforced by temporary raising of stamp duty threshold to £500,000 in mid-July through to 31 March 2021. Prices firmed markedly.
- Housing market seen coming under pressure over late 2020/early 2021 when there will probably be a significant rise in unemployment. Also likely to be a fading of pent-up demand in the near term.
- House prices seen around 5% lower than now by mid-2021, then stabilising as activity starts to gradually pick up.

Company sector

UK: business investment and GDP

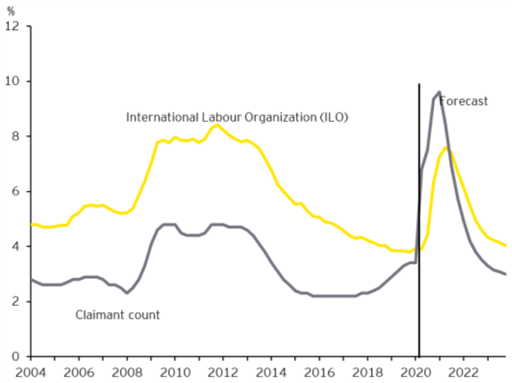


Source: EY ITEM Club

- Impact of COVID-19 on economy and businesses has weighed heavily on investment. Business investment contracted by a record 26.5% q/q in Q2.
- Business investment may be adversely affected over final months of 2020 by uncertainties over UK-EU relationship and renewed coronavirus concerns.
- Business investment seen declining 21.9% in 2020. Seen falling by 3.5% over 2021 but this masks a q/q pick-up over the year as economy and confidence are firmer. Seen rising 8.7% in 2022.

Labour market and wages

UK: unemployment rate

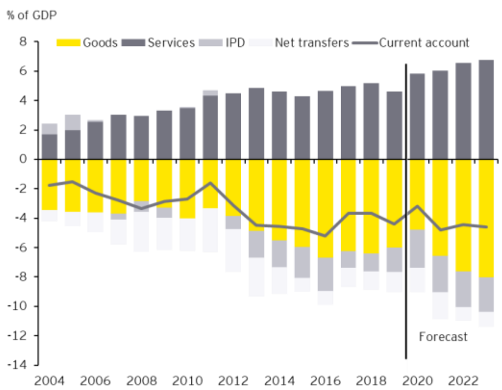


Source: EY ITEM Club

- Rise in unemployment has been limited by furlough scheme, which finishes at the end of October. Unemployment rate has only risen to 4.1% in the three months to July from 3.9% at start of year.
- We suspect unemployment rate could rise as high as 7.7% in mid-2021 despite the Job Support Scheme.
- Earnings have taken a marked hit from workers being furloughed and companies looking to limit pay. Labour market and earnings should see some recovery as 2021 progresses.

Trade and the balance of payments

UK: current account



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

- Net trade made a positive contribution to GDP in Q2 2020 as real exports fell 11.0% q/q and imports declined by 22.7% q/q. It had made a negative contribution in Q1.
- Current account deficit narrowed sharply in Q2 as rare trade surplus.
- Current account deficit forecast to narrow sharply to £58.4b (2.7% of GDP) in 2020 from £88.8b (4.0% of GDP) in 2019. Seen widening back out to £85.9b (3.9% of GDP) in 2021 as trade deficit widens anew.

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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.

Uniquely, EY ITEM Club can test whether Government claims are consistent and can assess which forecasts are credible and which are not. Its forecasts are independent of any political, economic or business bias.

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