Prospects

No. 20/336 – 17 December 2022

# United Kingdom– 2021-2022 Scenario

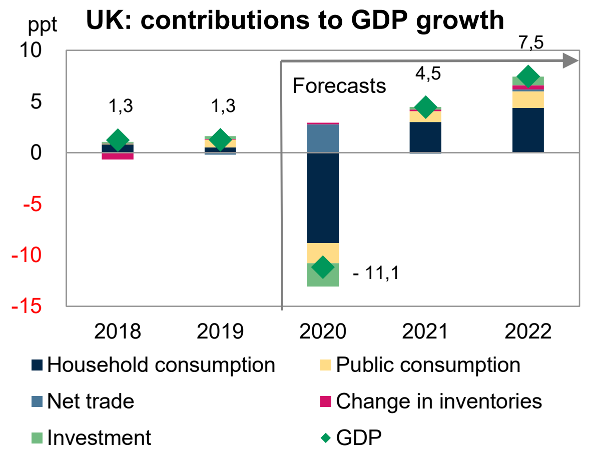
## We are not out of the woods yet

- **After a brief and incomplete rebound in Q3, GDP is expected to fall again in Q4 as the second wave of the Covid-19 pandemic and the November lockdown in England and across the Eurozone interrupted the recovery in the consumer-oriented service sectors. We expect GDP to fall by 2% QoQ in Q4 on a quarterly basis, which would bring the annual contraction this year to a historic -11.1%.**
- **We expect positive, albeit subdued recovery at the beginning of 2021. Two well-known key headwinds will weigh on growth: (1) the persistent risk of a resurgence of the Covid-19 pandemic; and (2) the end of the transition period and the adjustment to the new EU-UK relationship that will come into force on 1 January 2021.**
- **We expect exports and activity to be significantly damaged in Q1 due to the entry into force of new barriers to trade between the UK and the EU at the end of the transition period, leading to controls and delays at the border as well as a disruption to supply-chains. That will likely further weigh on business and consumer confidence.**
- **We expect the recovery to gain steam in H221 only, thanks to progress on the vaccination front and the dissipation of the initial shock of Brexit. However, while one might hope to foresee the end of the pandemic within a year or so, this does not mean a return to the pre-crisis normal. The supply capacity, the labour market, the corporate balance sheets and the public finances will be in a severely damaged situation.**
- **As per our forecasts, at end-2022, GDP would be still around 3.5% below its pre-Covid trend, and more than 8% below its long-term trend prior to the EU referendum.**
- **More stimulus is likely to be needed in order to support the recovery. We expect one rate cut by the BoE to 0% in Q2 and an increase by GBP50bn of the asset purchase target.**

## The economic outlook: no time for relief

### *The recovery interrupted by the second wave*

After a brief and incomplete rebound in Q3, which left the UK economy 9.7% below its Q419 level, GDP is expected to fall again in Q420, reflecting the impact of stricter social distancing measures in October and the introduction of a national lockdown in England in November (from 5 November to 2 December). We expect GDP to fall by 2% QoQ in Q420, leading to annual GDP growth of -11.1% in 2020, before a rebound of 4.5% next year. In 2021, the recovery would be led by the consumers and the government (spending and investment), while in 2022 business investment is assumed to contribute more positively as virus-related uncertainty eases.



Source: ONS, Crédit Agricole S.A.

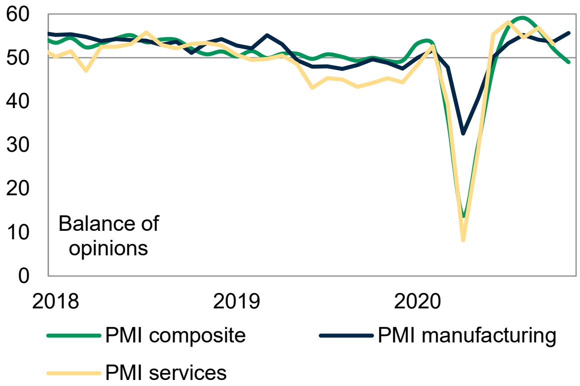
In Q4, the size of the GDP contraction will likely be much lower than the historic fall observed in Q220 (-19.8% QoQ). The recovery looks to have gained

Slavena NAZAROVA
slavena.nazarova@credit-agricole-sa.fr



traction in the industry and construction sectors (as evidenced by the November PMI surveys), boosted by Brexit stockpiling ahead of the end of the transition period and by increased exports, especially towards the EU. In the service sector, surveys point to a lower-than-feared impact from the lockdown on consumer spending in the sectors that are not directly impacted by the lockdown. According to Markit, 30% of service providers have reported a monthly drop in business activity compared to 80% in April.

**UK: PMI surveys were resilient in November**



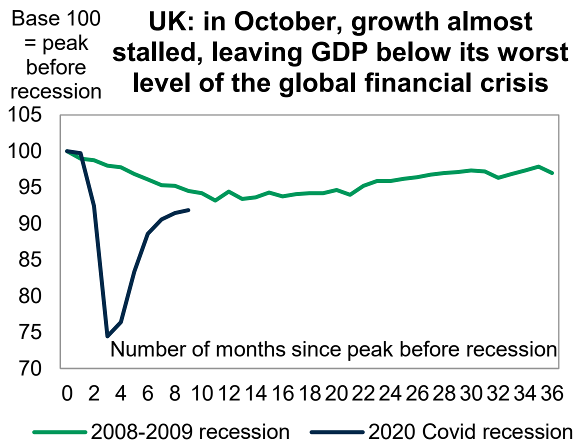

Source: IHS Markit, Crédit Agricole S.A.

### *The current level of social restrictions is planned to continue during Q1*

The lifting of the England-wide lockdown on 2 December is likely to lead to a pick-up in activity. However, much of the country now falls under the stricter Tier-3 restrictions (the highest level of alert). They are tougher than in October and include (1) a closed accommodation and hospitality sector (with the exception of takeaway, drive-through and delivery sales); (2) closed indoor entertainment venues; (3) restrictions on travelling; and (4) a 'rule of six' for people gathering in outdoor public spaces[1]. Therefore, the rebound in December is likely to be weaker than the contraction experienced in November.

We suppose that the risk of the pandemic's resurgence will persist until at least the middle of 2021. Indeed, although Covid-19 vaccination began earlier than expected, it will likely take several months before a sufficient percentage of the population becomes immune to the virus. Social distancing measures are set to continue at their December level until the end of Q1, at which point the government could return to parliament with proposals for further economic and social restrictions. We expect some level of social restrictions will be maintained during Q2, leading to a persistent weakness of growth in the consumer-facing service sectors. From the summer we expect vaccines and improved testing to yield benefits and the need for restrictions to gradually reduce. Towards late 2021 and early 2022 we assume that life will return back to normal across the country.

**UK: in October, growth almost stalled, leaving GDP below its worst level of the global financial crisis**




Source: ONS, Crédit Agricole S.A.

### *Brexit will be a shock to trade and business as the transition ends on 31 December*

Although the UK left the EU on 31 January 2020, the transition period meant that very little changed in practice. Government, individuals and businesses could largely continue to operate as usual. But on 31 December 2020, the UK is set to leave the customs union and single market, whether an agreement is reached or not. **There will be immediate changes to the operations of the UK's border, regulatory barriers to trading with the EU and the end of free movement.** There will also be changes in regulatory regimes. Moving goods across the English Channel will require businesses to comply with new checks, including customs, sanitary, phytosanitary, safety and security checks. Exporting companies will have to comply with rules of origin[2] in order to benefit from the preferential terms of an FTA (otherwise MFN tariffs will be applied to their goods sold to the EU) and will bear the administrative and compliance costs linked to rules of origin (which can be quite high).

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[1] On 2 December the government reimposed a tiered regional approach in England. This is supposed to lapse at end-March, at which point the Government would need to return to parliament with any proposals for further economic and social restrictions. See the government's [Covid-19 Winter Plan](Covid-19 Winter Plan).

[2] Put in simple terms, rules of origin are thresholds that define how much of a good can come from countries outside a free trade area before it ceases to benefit from the preferential terms of the relevant FTA. Businesses have to be able to prove that their goods contain sufficient 'originating content' in order to retain zero tariff treatment in the EU. For example, in the EU-Canada trade agreement, a car will not qualify for preferential tariffs if more than 50% of the value of its parts comes from outside the EU and/or Canada. The administrative and compliance costs associated with rules of origin could be sizeable, estimated at between 4-15% of the cost of goods sold.

Slavena NAZAROVA
slavena.nazarova@credit-agricole-sa.fr

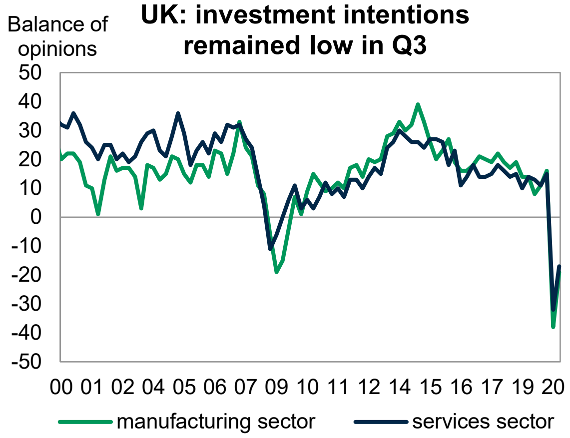

**If there is no deal, the UK will default to trading with the EU on World Trade Organisation (WTO) terms from 1 January 2021.** The EU will impose its common external tariff on its imports of goods from the UK, while the UK on its side, would apply its global tariff regime on imports from the EU. In a no-deal scenario, there will also be a larger and more rapid increase in non-tariff barriers to EU trade as the UK exits the single market without the regulatory equivalence, public procurement and mutual recognition arrangements that are sometimes part of typical trade agreements.

There is considerable uncertainty around the impact of the initial adjustment to the new EU-UK relationship that will take place on 1 January. The Bank of England (BoE) estimates[3] the direct impact on GDP of reduced exports and distorted domestic supply chains at around 1% in Q121 in its central scenario. In its November Economic and Fiscal Outlook, the Office for Budget Responsibility estimated the impact of a no-deal on UK real GDP at 2ppt in 2021.

*The near-term outlook for business investment remains clouded by uncertainty*

**Deal or no deal, a long and unprecedented process of economic disintegration from the EU will only begin on 1 January.** The UK will leave the EU's single market and customs union at the start of 2021. We continue to expect a bare-bones free trade agreement to be found in the coming days and to come into force at the end of the transition period, which would bring a relief to investors and companies. However, there is the risk that some aspects of the deal could take months or even years to implement. Persistent uncertainty, stemming from Brexit and the pandemic, coupled with stress on corporate balance sheets is likely to continue to weigh on investment plans and lead to subdued growth in business investment next year. Business investment fell by 27% in Q2 and in Q3 remained more than 20% below its Q419 level.

Government investment by contrast is set to increase significantly as the government announced large spending plans in March and then in November. According to the OBR, growth of government investment will average 3.5% per year between 2021-25, following 7% growth in 2020. The share of total public spending (including capital investment and government consumption) would reach 56.3% of GDP in the current fiscal year (2020-21), the second largest in the world after Canada, before falling back in 2022-23.




Source: BCC, Crédit Agricole S.A.

*The unemployment rate is expected to rise further and to weigh on household consumption*

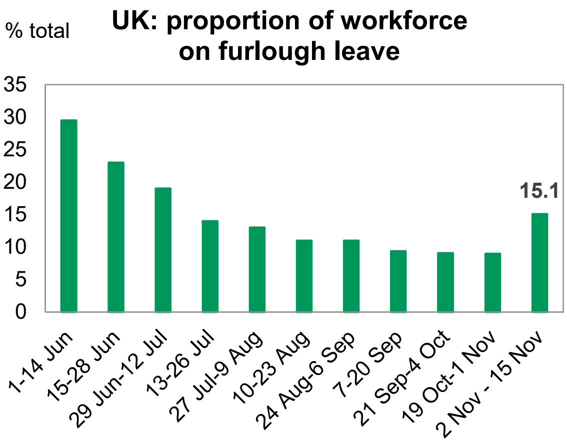
The authorities' aggressive policy response has helped to mitigate the damage of the crisis, containing unemployment and insolvencies. Still, GDP has fallen dramatically and the unemployment rate has started to climb since the summer as companies have increased redundancies massively in response to the previous government's plans to end the Coronavirus Job Retention Scheme (CJRS) on 31 October and to replace it with less generous support measures. The government changed its mind at the very last minute deciding to prolong the CJRS until end-March as the second wave of the pandemic made unavoidable the announcement of a second lockdown in England and that social restrictions would be maintained during the winter.

**Spare capacity is currently very large in the economy.** The unemployment rate rose to 4.9% in the three months to October and employment fell by a cumulative 819k since February (according to PAYE data). In the latest ONS survey, the proportion of employees who were furloughed had jumped from 9% in October to 15.1% in mid-November.

Press reports suggest that massive job losses are planned in the hardest-hit sectors, ie, travel, food and accommodation, and leisure. This is consistent with the PMI composite employment index, which although rebounding, remains well in contraction territory below the 50-threshold.

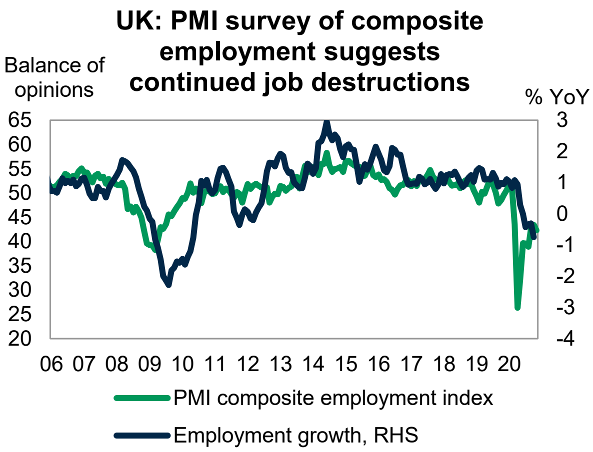
[3] The MPC central projections continue to assume an immediate move to a free trade agreement (similar in scale and depth to the FTA in place between Canada and the EU) on 1 January 2021. However, in November, the BoE appeared less convinced in its long-lasting assumption that the transition would be smooth given evidence of a lack of preparation among firms, in particular small and medium-sized enterprises. The BoE now expects trade and GDP to be lower in the near term due to Brexit, that the adjustment process will concentrate in Q1, but that it will dissipate by the end of Q2. Any implications for slack and inflation are considered to be small.

Slavena NAZAROVA
slavena.nazarova@credit-agricole-sa.fr

Source: ONS - Faster indicators, Crédit Agricole S.A.

**Quite consensually, our central scenario assumes that the unemployment rate will continue to rise, peaking at close to 7.5% in Q2.** Thanks to the CJRS extension, the peak in the unemployment rate is delayed by two quarters relative to our previous scenario in July. We also expect only a gradual decline due to scarring effects in the hardly-hit sectors and difficulties for the unemployed to relocate to other sectors due to inadequacy of skills (from services to the recovering manufacturing sector, for instance). In our scenario, the unemployment rate falls back to 7% at end-2021 and to 6% in Q422.



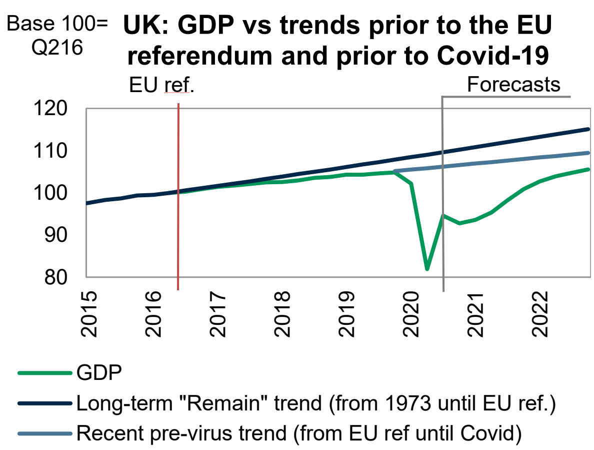
Source: IHS Markit, ONS, Crédit Agricole S.A.

**There are downside risks to the forecasts of the unemployment rate.** Firstly, the encouraging news that vaccination is imminent has propelled business optimism towards the 2021 outlook to its highest level in more than five years. This may help limit the near-term increase in closures and redundancies among companies that are financially viable. Secondly, the extension of the government's various support measures until end-March could attenuate the near-term rise in the unemployment rate by more than expected. Progress on the vaccination front may also lead to a sharper-than-expected rebound in the tourism and food and accommodation sectors, especially during the summer period next year.

### *Medium-term scarring would be substantial*

**Growth is expected to strengthen in H221 thanks to the effects of (1) the vaccination; (2) improved treatments and testing; and (3) the dissipation of the initial impact of Brexit.** However, in relation to Covid-19, a degree of caution among certain age and social groups is likely to persist and is likely to continue to weigh on the recovery in the sectors where there is a high degree of physical contact (hospitality, accommodation and travel). More fundamentally, the deterioration in the labour market and the relatively slow decline in unemployment throughout the forecast period means in turn that household consumption is likely to remain weak even after the pandemic disappears. In the corporate sector, impaired balance sheets with high levels of indebtedness will restrain business investment. Productivity growth, which was already among the lowest in the world and a key long-term challenge for the government, will suffer even more.

**In our forecasts, the UK economy reaches its Q419 level by end-2022.** However, the loss in GDP due to the combined effect of Brexit and Covid-19 would be substantial. Our forecast imply a shortfall of close to 8ppt relative to the level implied by the long-term growth trend before the 2016 EU-referendum. Relative to the pre-Covid-19 trajectory, GDP would lie around 3.5% below its implied level at the end of the forecast period[4].



Source: ONS, Crédit Agricole S.A

4 This is consistent with the recent assessment of the IMF in their Article IV review that UK GDP would lie between 3-6% below its pre-pandemic trend through the medium term.

Slavena NAZAROVA
slavena.nazarova@credit-agricole-sa.fr



## The monetary policy outlook: it gets (even more) complicated

### *More stimulus is more likely to be needed than not*

The challenges implied by the Covid-19 crisis and Brexit will continue to necessitate more monetary and budgetary stimulus in the coming quarters, in our view. Our scenario does foresee progress on Covid vaccinations by mid-2021 and a reduction in social restrictions, which will pave the way for a more sustained recovery, but in H221 only. The worst is still to come in the near term in terms of the pandemic's consequences for the economy, especially the labour market, and in terms of Brexit's impact as the transition period ends on 31 December and regulatory changes become effective.

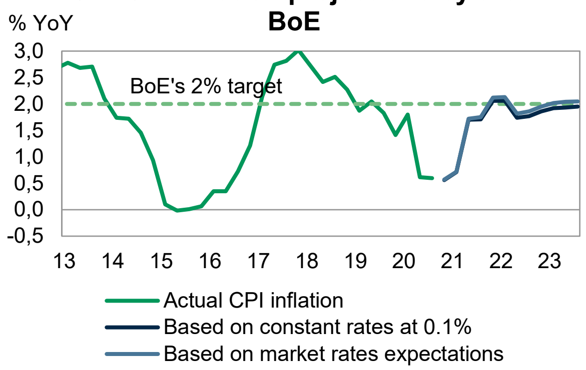
**We expect monetary policy to be loosened again next year.** While positive news on vaccines has reduced the downside risks on the economy, it will take a while before we see a sustained recovery. We expect a rate cut to 0% and an increase by GBP50bn of the asset purchase target in Q221. The economic backdrop would be one with (1) an elevated unemployment rate; (2) expiring government support measures (the Coronavirus Job Retention Scheme is set to expire as of end-March); and (3) a continued adjustment of the corporate sector to the post-Brexit arrangements.

### *Increasingly divided MPC*

**The monetary policy decision will be complicated by the prospects of rising CPI inflation during 2021.** The BoE (and we) expect a sharp rebound in CPI inflation in the course of 2021 (it is actually expected to return back to the 2% target by end-2021), as the temporary factors that weighed on inflation in 2020 dissipate. Energy prices will rise as demand recovers, and the 20% VAT rate in the hospitality sector will be restored in Q2. Meanwhile, the medium-term equilibrium rate of unemployment will likely increase due to the skills mismatch of the labour force that has been made redundant, meaning that the downside pressure on prices would likely be more modest than implied by the official unemployment figures. While this configuration will increase the divergence of views within the monetary policy committee (MPC), a majority of members will likely judge that, given the high level of unemployment, more monetary policy would be needed to ensure that inflation is maintained close to target in the medium term.

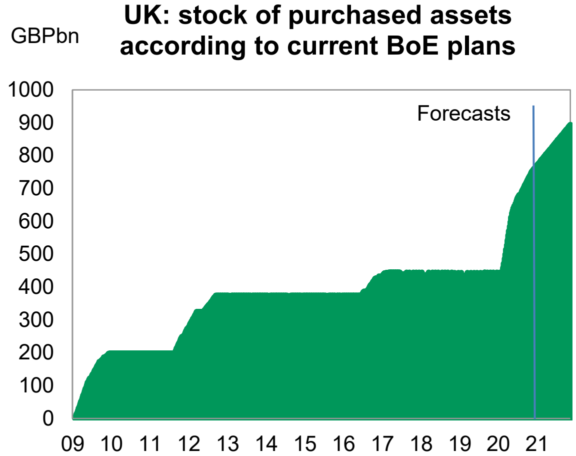
**Quantitative easing (QE) has become the BoE's marginal tool.** In November, the BoE expanded its asset purchase target by an additional GBP150bn, on top of the GBP300bn announced earlier this year, taking the total stock of government bond purchases to GBP875bn. Alongside purchases of corporate bonds, assets held by the BoE are due to reach GBP895bn by end-2021. According to the BoE's current plans and based on the November OBR forecasts for the nominal value of outstanding conventional gilts, the BoE is likely to hold close to 60% of the conventional gilts in free float by early 2022, against its self-imposed limit of 70% of the free float (implying a QE headroom of around GBP170bn in cash terms).

**UK: CPI inflation projections by the BoE**




Source: BoE, Crédit Agricole S.A.

**UK: stock of purchased assets according to current BoE plans**




Source: BoE, Crédit Agricole S.A.

MPC members have become more vocal about the state contingency of the various transmission channels for asset purchases. In a speech in late August, BoE Governor Andrew Bailey concluded that (1) "the effect of QE can be state contingent"; and (2) "the pace of QE purchases may be more important during a period of market dysfunction associated with a widespread shock to liquidity demand". He also raised the question about "the need to ensure that we have enough headroom in future to repeat it".

**Negative interest rates are now a part of the BoE's toolbox, but a majority of the MPC is reluctant to use them, at least in the near future.** In August, the MPC concluded that "implementing negative policy rates might be less effective in providing stimulus to the economy at the current

Slavena NAZAROVA
slavena.nazarova@credit-agricole-sa.fr



juncture than at a time when banks' balance sheets are improving." While the majority of the MPC continues to see negative interest rates as counterproductive, it is increasingly split regarding this possibility with external members including Michael Saunders and Silvana Tenreyro favouring the idea. Early in December, Michael Saunders argued that a further expansion of asset purchases was less likely to provide "much extra stimulus from current levels unless accompanied by a cut in Bank rate (or guidance that such a cut is likely)". He saw "a modest scope to cut Bank Rate further, but if we do, it may be preferable to move in a relatively small steps". If the BoE is right about its central scenario of strengthening recovery beyond the near-term weakness and rising CPI inflation, negative interest rates are likely to remain a hypothetical tool for most MPC members. However, when/if more stimulus is needed (and we believe it will be), questions regarding the QE headroom and the state contingency of the effectiveness of asset purchases will increase the odds for a (at least a small) cut in the key policy rate. ■

| United Kingdom | 2019 | 2020 | 2021 | 2022 | 2020 | | | | 2021 | | | | 2022 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| GDP (%) | 1,3 | -11,1 | 4,5 | 7,5 | -2,5 | -19,8 | 15,5 | -2,0 | 0,9 | 1,9 | 3,0 | 2,7 | 1,8 | 1,2 | 0,8 | 0,8 |
| household consumption | 0,8 | -14,2 | 5,0 | 7,3 | -3,0 | -23,6 | 18,3 | -3,0 | 3,0 | 1,0 | 3,0 | 3,0 | 2,0 | 1,0 | 0,5 | 0,5 |
| public consumption | 4,1 | -10,4 | 5,5 | 8,2 | -3,9 | -14,6 | 7,8 | 1,0 | 2,0 | 2,0 | 2,0 | 2,0 | 2,0 | 2,0 | 2,0 | 2,0 |
| investment | 1,5 | -12,8 | 1,4 | 5,0 | -1,0 | -21,6 | 15,1 | -4,0 | 2,0 | 1,5 | 1,0 | 1,0 | 1,0 | 1,0 | 2,0 | 2,0 |
| change in inventories* | 0,1 | 0,2 | 0,2 | 0,4 | -0,5 | -0,7 | 1,6 | 0,8 | -1,6 | 0,4 | 0,6 | 0,0 | 0,0 | 0,0 | 0,0 | 0,0 |
| net exports* | -0,2 | 2,8 | -0,1 | 0,2 | -0,5 | 3,6 | -2,1 | -0,4 | -0,1 | 0,2 | 0,0 | 0,3 | 0,1 | 0,1 | -0,3 | -0,3 |
| Unemployment rate (ILO) | 3,8 | 4,8 | 7,3 | 6,3 | 4,0 | 4,1 | 4,8 | 6,5 | 7,3 | 7,5 | 7,2 | 7,0 | 6,7 | 6,4 | 6,2 | 6,0 |
| Inflation (CPI, YoY%) | 1,8 | 0,8 | 1,5 | 2,3 | 1,7 | 0,6 | 0,6 | 0,5 | 0,5 | 1,5 | 1,7 | 2,3 | 2,4 | 2,3 | 2,2 | 2,2 |
| Core CPI (YoY%) | 1,7 | 1,4 | 1,6 | 2,2 | 1,6 | 1,4 | 1,3 | 1,2 | 1,1 | 1,6 | 1,8 | 2,1 | 2,2 | 2,2 | 2,2 | 2,4 |
| General gov. balance, % GDP | -2,3 | -18,8 | -8,5 | -4,1 | na | na | na | na | na | na | na | na | na | na | na | na |
| Public debt % GDP | 85,4 | 108,0 | 113,7 | 109,3 | na | na | na | na | na | na | na | na | na | na | na | na |
| Bank rate** | 0,75 | 0,10 | 0,0 | 0,0 | 0,1 | 0,1 | 0,1 | 0,1 | 0,1 | 0,0 | 0,0 | 0,0 | 0,0 | 0,0 | 0,0 | 0,0 |
| Target of BoE's asset purchases (bn £) | 435 | 895 | 945 | 945 | 645,0 | 745,0 | 745,0 | 895,0 | 895,0 | 945,0 | 945,0 | 945,0 | 945,0 | 945,0 | 945,0 | 945,0 |

** Contributions to GDP growth*

*** End of period*

*Sources: ONS, BoE, Crédit Agricole S.A.*

Slavena NAZAROVA
slavena.nazarova@credit-agricole-sa.fr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**Crédit Agricole S.A. — Group Economic Research**
12 place des États-Unis – 92127 Montrouge Cedex

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Contact: *publication.eco@credit-agricole-sa.fr*

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