EY ITEM Club Summer Forecast

COVID-19 worries should not blot out a strong economic recovery

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Contents

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Foreword

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A poignant farewell

As many of you will have heard, our chief economic advisor to the EY ITEM Club, Howard Archer, sadly passed away a few weeks ago. Our thoughts and best wishes, from all of us at EY, are of course with his family, friends and colleagues, but we also wanted to reflect on what a significant loss he will be to the economics community, of which he was such a highly regarded and respected member. One can only admire his dedication to a subject he loved.

We also wanted to acknowledge and thank Mark Gregory, who many of you know retired from his role as EY's Chief Economist at the end of June. His 10 years in role saw financial crises globally and in the Eurozone, referendums, and of course pandemics, all of which he took in his stride. He moves on into semi-retirement with a new career as an author and adviser to various governments and think tanks. We're sure he will also continue to entertain on social media with his thoughts on economics, politics, and, of course, his beloved Stoke City.

So now on to what would truly have interested Howard – the forecast …

A significant upgrade to UK growth prospects

In the depths of January, with the UK in the grip of a stringent lockdown in response to the second wave of the COVID-19 pandemic, the EY ITEM Club's view was that the UK economy would grow by 5.5% in 2021, after a record decline of 9.8% in 2020. In April, as the pandemic came under control, and with the impressive success of the vaccination programme in the UK, it upgraded its growth forecast to 6.8% for 2021. Now, as we hit the summer months with restrictions relaxed, and, despite the delays to 'Freedom Day', the EY ITEM Club is more positive still; it now expects the UK economy to grow by 7.6% this year, and 6.5% in 2022 – the fastest annual growth rates since the Second World War.

As a consequence, the UK economy is expected to return to its pre-pandemic peak by the end of 2021, six months sooner than expected in April, and almost three years earlier than appeared likely in last year's 2020 EY ITEM Club *Summer Forecast*.

This upgrade reflects the continuing resilience of the economy and the labour market in the face of the pandemic as businesses and consumers have adjusted and innovated. They were therefore better able to ride the lockdowns in November last year and between January and March this year, which resulted in far less damage to the economy than in March/April 2020. The vaccination programme has also played a key role in both enabling the country to unlock, and also in sustaining consumer confidence. As we progress through the summer, we expect significant pent-up demand, supported by £200b of excess savings stored in the population's bank accounts, to support a strong consumer-led recovery.

As ever there are risks to the forecast

It will come as no surprise that there are significant caveats and risks to this forecast!

Firstly, the growth in cases driven by the 'Delta' variant of COVID-19 remains a cause for concern. It is likely to prevent a return to travel in time for summer (although this could benefit the UK economy if money is spent here rather than on the beaches of the Mediterranean), but it could also result in the reimposition of

restrictions on economic activity. This could prolong the pain for sectors most impacted by the pandemic – the travel industry, hospitality and leisure, and physical retail.

We are also already seeing a spike in inflation driven by tight labour markets, supply chain bottlenecks, and disruptions to trade as the global economy reopens. The EY ITEM Club expects inflation to hit 3.5% by the end of 2021, before falling back, but a sustained increase in prices could see policymakers move to tighten monetary policy, which in turn would throttle back the speed of the recovery.

Finally, questions remain around the strength of business investment. The EY ITEM Club expects business investment to lag economic performance, with growth of 3.1% this year, albeit followed by a much stronger outlook (12% growth) in 2022. The risk is that businesses could well remain cautious even in the face of strong consumer demand – although it could be argued that the time for businesses to move is now.

Time to start thinking about the post-pandemic world

By autumn, we should know more about how the various risks have played out, and therefore attention will start to turn to the future in a post-pandemic world. Key issues will include how to address the social impact of the pandemic, delivering on levelling up, managing the return to the office, and in normalising the relationship with the EU now that the trade agreement has been signed. We suspect, even as the pandemic (hopefully) recedes, the macro-economic environment will remain eventful for many years to come.

Highlights

- The recent surge in COVID-19 infections means that declaring victory over the virus is still some way off. But vaccinations and the removal of most virus-related restrictions have reduced the weight of the pandemic on economic activity. Consequently, with plenty of lost economic ground to make up and strong support from fiscal and monetary stimulus plus the pool of involuntary savings built up households, the EY ITEM Club has upgraded its forecast, predicting GDP growth of 7.6% this year and 6.5% in 2022.

- The big development since our last forecast in April has been the reopening of previously shuttered parts of the services sector. Following an unexpectedly modest, lockdown-driven, fall in GDP in Q1, a relaxation of social distancing restrictions has triggered a strong, consumer-led, recovery. The shortfall in GDP relative to pre-pandemic levels narrowed from 8% in February to a little over 3% in May.

- Granted, the pace of growth has cooled as the summer has progressed. And a rise in the number of COVID-19 infections related to the more transmissible 'Delta' variant caused a four-week delay to the removal of most remaining domestic restrictions in England. But the postponement of 'Freedom Day' is unlikely to have thrown the economic recovery off track to any great degree.

- Thanks to the furlough scheme and businesses adapting to life under lockdown, the jobs market is emerging from the crisis in a remarkably little-damaged state. Although unemployment is higher than just before COVID-19 struck, the increase in joblessness has been much smaller than most forecasters feared and a shadow of that seen during past economic downturns, despite a comparatively significant hit to output.

- The highlight of the EY ITEM Club's new forecast is a stronger performance from GDP this year and next. We think the economy will expand 7.6% in 2021, up from 6.8% forecast in April, and by 6.5% in 2022 (previously 5%). Forecast growth in 2021 would be the fastest since 1941. Output is predicted to regain its pre-COVID-19 level by the end of this year. And while the unemployment rate may creep up in the second half of this year, we expect the Labour Force Survey (LFS) rate to peak at only a little above 5%.

- Now that people are returning to working, shopping and socialising, the UK is well-placed to reap a strong bounce-back in growth. That the economy shrank so much compared to most of its peers means there's more lost ground to make up. UK consumers are particularly big spenders on consumer services, which should magnify the economic boost from life returning to normal. And the UK's approach to measuring public sector output will go from being a drag on GDP to a positive. Moreover, a deficit in tourism with the rest of the world means growth should, perversely, gain from continued obstacles to international travel.

- Support from macroeconomic policy will also fuel a strong expansion this year and next. Fiscal policy remains in loosening mode, while the Chancellor may be able to rein back planned future tax rises and spending cuts if, as we think, the economy recovers more strongly than the Office for Budget Responsibility (OBR) expects. Meanwhile, the Monetary Policy Committee (MPC) is predicted to keep the Bank Rate at the current record low until late 2022.

- Another powerful impetus to growth should come from households' savings dropping back from the very elevated levels reached during the pandemic. Involuntary saving contributed to 2020 seeing the biggest rise in households' net worth since 2016. A return to the typical, pre-pandemic, household saving ratio would be enough to fuel a strong rebound in consumer spending. Households going further and spending some of the £200b of excess savings built up since early 2020 would make that rebound even stronger.

- Technical factors, combined with supply disruption connected to the reopening of economies globally, will push inflation up further during the rest of this year and into 2022. We think the CPI measure will peak at around 3.5%. But other influences, including the stronger pound, will keep a lid on price pressures. And the ingredients needed to support sustained high inflation appear to be lacking.

- The recovery will not be uniform. Spending in areas such as household goods, which benefitted from diverted spending during lockdowns, will fall back. And there are plenty of risks to the forecast. On the upside, the end of remaining restrictions could fuel an unexpectedly strong surge in sentiment. But a sufficiently large rise in infections risks restrictions being reimposed. Consumers might keep savings levels up. Even a temporary period of high inflation could trigger a hawkish shift from the MPC, causing financial conditions to tighten. And the departure of foreign-born workers during the pandemic threatens to weigh on the economy's capacity to grow without running into inflationary bottlenecks.

1. Introduction

The economy's path out of the COVID-19 crisis has been far from smooth. And even now, with activity enjoying a strong recovery since the spring and almost all remaining domestic restrictions on social activity lifted in England on 19 July, and relaxed in other parts of the UK to a lesser extent around the same time, the outlook still has an element of looking though a glass, darkly. Some of this uncertainty is more for epidemiologists than economists to resolve – for example, whether COVID-19 will become an endemic virus with – thanks to vaccinations – hospitalisations and deaths kept at a low level, or whether the virus could mutate in a manner which evades vaccines and brings the prospect of new lockdowns back to the table.

Under the assumption that that second, grim, scenario is avoided, the new EY ITEM Club *Summer Forecast* (2021) sets out a more upbeat prognosis for the economy than at any point since before the 2008–09 financial crisis. The speed at which activity has resumed across previously shuttered parts of the services sector and the strength of forces supporting the recovery mean that GDP growth in 2021 is forecast at 7.6%, a post-war high and up from the 6.8% expected in our last forecast in April.[1] The economy should regain its pre-pandemic size during the final quarter of this year. And thanks to the furlough scheme and a jobs market which has sprung back to life, the unemployment rate probably reached its pandemic-related peak in late 2020. Granted, joblessness is likely to remain elevated compared to where it stood just before COVID-19 struck. But the labour market should emerge from the crisis in a remarkably little-damaged state, which is good news regarding minimising any virus-related 'scarring' to the economy's capacity to produce goods and services.

However, as the experience of the last year and a half demonstrates, unprecedented times make economic forecasting even trickier than usual. And there are two key sources of economic uncertainty surrounding the forecast. The first is to what extent, and how quickly, households will return to more normal savings habits, or go further by dipping into the £200b or so of 'excess' savings accumulated during lockdowns. Greater than expected dissaving could fuel an even stronger rebound in consumer spending than we anticipate. Conversely, if households prove unexpectedly prudent, an anticipated consumer boom might underwhelm.

The second big area of uncertainty relates to what has been a long dormant bugbear of economic policymakers – inflation. Technical factors mean inflation will almost certainly rise over the remainder of this year and into 2022. We expect the CPI measure to reach 3.5% around the turn of 2021 and 2022, a pace of price rises rarely seen in the last decade. There are good reasons to think that higher inflation will be temporary. But were it to prove persistent, the Bank of England (BoE) could press on the policy brakes earlier than anticipated, undermining the recovery.

Before considering these two issues, we begin by examining how the economy has fared in the three months since the EY ITEM Club's *Spring Forecast* was published. Section 3 discusses our new forecast and Section 4 considers prospects for household savings. Section 5 addresses risks around inflation, before Section 6 concludes the report.

2. Liberation from virus restrictions has triggered a strong, consumer-led, recovery

The COVID-19 pandemic and efforts to control the spread of the virus caused an extraordinary contraction in the economy. GDP fell 9.8% in 2020, the biggest decline in over 300 years, and output dropped further during the recent lockdown in early 2021. The main development since our last forecast has been the relaxation of restrictions on social contact, following the 'road map' for reopening the economy in England published by the UK Government on 22 February, and plans set out by the devolved administrations in Scotland, Wales and Northern Ireland during March.[2] Reopening has been facilitated by a speedy roll-out of

[1] EY ITEM Club. *Spring Forecast*. April 2021. assets.ey.com/content/dam/ey-sites/ey-com/en_uk/topics/growth/ey-item-club/ey-item-club-spring-forecast-april-2021.pdf

[2] See HM Government. *COVID-19 Response – Spring 2021*. February 2021. assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/963491/COVID-19_Response_-_Spring_2021.pdf,

vaccinations. Vaccines have kept COVID-19-related hospitalisations and deaths at relatively low levels, despite a recent sharp rise in people infected with the more transmissible 'Delta' variant of COVID-19.

The Government's February plan set out a four-stage process for reopening in England. As of late July, all four of those stages had passed – schools reopened on 8 March, non-essential retail shops resumed operation on 12 April, indoor hospitality and entertainment venues followed suit on 17 May and remaining legal limits on social contact were ended on 19 July. Other parts of the UK have also relaxed virus-related restrictions, albeit taking a more guarded approach.

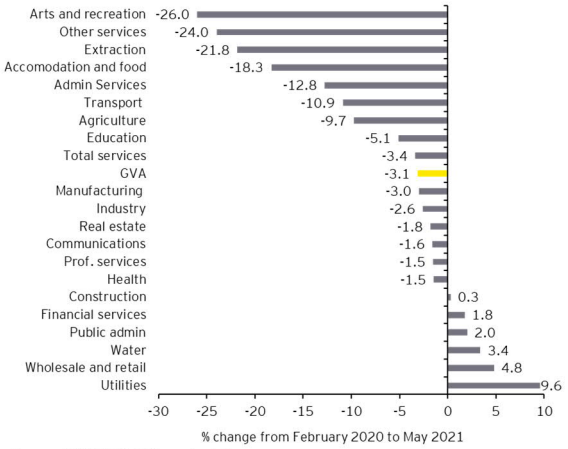
GDP has steadily narrowed the gap with pre-pandemic levels

A chunky 2.4% month-on-month (m/m) rise in GDP in March pointed to economic momentum building even while most social distancing measures remained in place. The reopening of schools that month boosted the output of the education sector. But growth was broad-based, with consumer-facing activities benefitting from more spending taking place online. March's performance meant the fall in GDP in Q1 was limited to -1.6% quarter-on-quarter (q/q). This was a far cry from the 19.5% q/q plunge during the first lockdown in Q2 2020 and much smaller than forecasters had expected. As recently as March, the Office for Budget Responsibility (OBR) anticipated GDP would fall 3.8% q/q in Q1, while the BoE's February *Monetary Policy Report* predicted a 4.3% q/q decline. Adaptation by households and firms to life under lockdown helped. GDP in Q1 was also bolstered by higher government spending on COVID-19 testing and vaccinations. The two categories accounted for 1.5% of GDP in the quarter.

Since March, the liberation of swathes of the services sector has triggered a strong, consumer-led recovery. April's reopening of non-essential retailers translated into a 9.2% m/m leap in retail sales volumes that month. The gain was particularly impressive given that retail sales had exited the third lockdown already above pre-pandemic levels. The strength of the retail sector, along with growth in other areas, such as new car sales, contributed to GDP in April rising 2% m/m.

However, growth eased to 0.8% m/m in May. While this narrowed the GDP gap with February 2020's pre-COVID-19 peak to 3.1%, the smallest since the pandemic began, May's expansion was below forecasters' expectations. The fact that retail sales volumes slipped back by 1.4% m/m pointed to consumers switching some spending from shopping to socialising, following the easing of restrictions on indoor hospitality. And the sectoral position remained very dispersed. At one extreme, utilities output in May was almost 10% higher than in February 2020. But other sectors remained depressed – notably, the output of the arts, entertainment and recreation sector was still a quarter smaller than in early 2020.

UK: Change in GVA by sector



Source : EY ITEM Club/Haver Analytics

And the last few months have not been all plain sailing. A rise in the number of people infected with COVID-19's 'Delta' variant caused the Government to delay the removal of remaining domestic restrictions in England by four weeks from 21 June to 19 July. There is tentative evidence that rising infections have had some adverse effect on the economy – high-frequency indicators for late June pointed to a plateauing in job vacancies, spending on credit and debit cards and retail footfall. But the postponement of 'Freedom Day' is unlikely to have thrown the economic recovery off track to any great degree. While painful for affected sectors, the economic impact of nightclubs staying closed and hospitality being restricted to table service for a further four weeks should have proved small. And the postponement pushed back the boost from the final lifting of domestic restrictions by only a

See Scottish Government. *Timetable for further lockdown easing*. 16 March 2021. gov.scot/news/timetable-for-further-lockdown-easing

See Welsh Government. *Coronavirus Control Plan: Revised Alert Levels in Wales*. March 2021. gov.wales/sites/default/files/publications/2021-05/coronavirus-control-plan-revised-alert-levels-in-wales-march-2021.pdf and

See Northern Ireland Executive. *Moving forward: The Executive's pathway out of restrictions*. 2 March 2021. executiveoffice-ni.gov.uk/sites/default/files/publications/execoffice/executives-pathway-out-of-restrictions.pdf

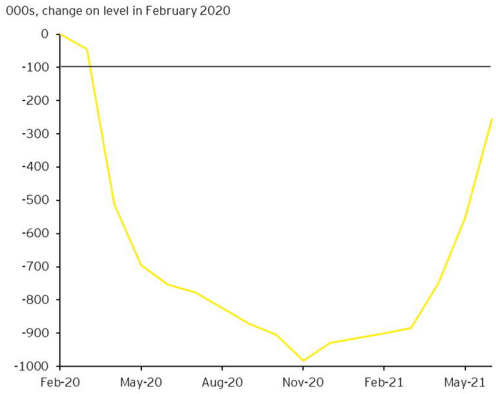
month. The fact that June's Purchasing Managers' Index (PMI) for services slipped only slightly from the previous month's 24-year high offered some early evidence that the sector was little damaged by the delay.

The labour market is emerging from the crisis in a remarkably little-damaged state

The introduction of the Coronavirus Job Retention Scheme (CJRS) in March 2020 and the Government's willingness to prolong the scheme in the face of new lockdowns have proved their worth during the pandemic, cushioning employees from a historically huge drop in GDP. That protection has continued to be evident in recent months. The official LFS unemployment rate stood at 4.8% in the three months to May, down from 5% in the previous quarter and a pandemic peak of 5.2% in late 2020. Unemployment declined in early 2021, despite the economy shrinking over the same period. Without doubt, the latest jobless rate was a rise on the 4% seen at the start of 2020. But the increase in unemployment during the pandemic has been much smaller than most forecasters feared earlier in the crisis. Last summer, the EY ITEM Club predicted the jobless rate would reach almost 8.5% by the end of 2020. The most bearish of economic forecasters were anticipating a double-digit unemployment rate.[3] The damage to the labour market also fell well short of that seen during past economic downturns, despite COVID-19 and the public health response inflicting a much bigger hit to GDP. Compared with a rise in unemployment of less than 1ppt since the pandemic began, the jobless rate increased by 3.3ppts following the financial crisis in 2008, 3.8ppts after the recession of the early 1990s, and by over 6ppts in the aftermath of the early 1980s downturn.

Evidence has built that the reopening of the economy prompted a strong revival in demand for workers. HMRC PAYE data showed the number of paid employees climbing by almost 200,000 in May, the biggest gain since the series began in 2014. This meant that half the damage to payroll numbers during the pandemic had been undone. May's numbers also offered early signs that sectors previously shut down were starting to fuel job creation – accommodation and food services accounted for about a quarter of May's increase in jobs.

UK: Payrolled employees



Source: EY ITEM Club/ONS

What's more, HMRC data on flows of employees revealed 828,000 people started a new job in May, another record. In the same month, the measure of job vacancies from the Office for National Statistics (0NS) reached one of the highest levels since the series began in 2001. And data on online job adverts from Adzuna suggest more may be to come. In early July, online vacancies were 129% of the February 2019 average.[4]

Meanwhile, the number of people furloughed via the CJRS has already fallen sharply. The latest hard data from HMRC reported that 2.4m jobs were still furloughed as of 31 May, down from a peak of 5m in January. But more timely survey estimates from the Office for National Statistics (ONS) suggest that the proportion of the UK workforce on furlough had fallen to about 6% in early June, equivalent to around 1.5m people. And survey evidence commissioned by the Resolution Foundation found that in the first week of June, 80% of those furloughed during the first and second lockdowns had returned to work. 69% of those furloughed in October 2020 (the low point for furlough rates in between lockdowns) had also returned.[5]

That said, the labour market is still some way from 'normal'. As of May, total hours worked in the economy remained 4.9% below the level in February 2020. Long-term unemployment (defined as more than 12 months of unemployment for those aged over 25, and more than six months for those aged 16–24) in the three months to May rose to the highest level since early 2016. Despite rising job openings, the number of unemployed people per vacancy stood at well over 2, compared with around 1.6 before the crisis. And even as the number on furlough has fallen, the scheme has remained an important prop for some sectors. In the

[3] HM Treasury. *Forecasts for the UK economy*. August 2020. assets.publishing.service.gov.uk/goverment/uploads/system/uploads/attachment_data/file/910534/Forecomp_August_2020_new.pdf

[4] Office for National Statistics. *Economic activity and social change in the UK, real-time indicators*. 15 July 2021. https://www.ons.gov.uk/economy/economicoutputandproductivity/output/bulletins/economicactivityandsocialchangeintheukrealtimeindicators/15july2021

[5] Torsten Bell et al. *Understanding the labour market: pandemic not pandemonium*. Resolution Foundation. 28 June 2021. resolutionfoundation.org/app/uploads/2021/06/Understanding-the-labour-market.pdf

second half of June, 15% of jobs in the arts, entertainment and recreation sector were still furloughed, as were 10% of accommodation and food services jobs.

The fiscal cost of COVID-19 has been startling, but less than originally anticipated

Another area which has confounded some of the gloomier predictions of economists is the public finances. In the OBR's forecast published alongside the November 2020 Spending Review, the deficit in 2020–21 was expected to be £394b or 19% of GDP. At that time, private sector forecasts for government borrowing of well over £400b were not uncommon.[6] By the time of the March 2021 Budget, the OBR's prediction had been revised down to £356b or 17% of GDP. The latest estimated outcome for 2020–21 was lower still at £299b or 14% of GDP. This improving trend has continued with monthly deficits in April and May 2021 coming in well below OBR forecasts, reflecting lower-than-expected public spending and higher-than-expected tax receipts. Admittedly, the ONS' figures do not yet include estimates of the future costs of write-offs against the Government's loan guarantee schemes. In the OBR's March forecast, these costs were assumed to amount to £27.2b. But even allowing for this still implies a substantial undershoot of borrowing relative to expectations.

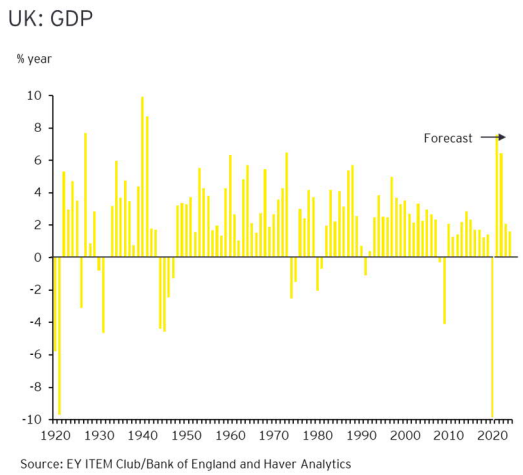
Brexit appears to have impeded trade, but not quite in the manner expected

Although the UK and EU arrived at a free-trade deal in the final days of 2020, disruption related to new non-tariff barriers between the two parties was expected to hold back the UK's recovery. In practice, UK trade with the EU was weak in early 2020. But that weakness was mainly on the import side. March saw UK goods imports from the EU fall below imports from non-EU countries for the first time since records began in 1997. And goods imports (excluding precious metals) from the EU in May were still almost 9% below the average level in the second half of 2020. This may have been partly related to disruption, or fear of disruption, following the end of the Brexit transition period on 31 December. But the fact that the UK has chosen to delay post-Brexit checks on most goods imports from the EU until March 2022 suggests the effects of leaving the EU were not the whole story. Problems in the car sector, including a global shortage of semi-conductors, and the relative weakness of demand for cars, imports of which mainly come from the EU, likely also contributed.

However, as of May, exports of goods (excluding precious metals) to the EU were 11% above pre-Brexit levels in H2 2020. So in net terms, changing trade patterns with the EU look to have boosted GDP in early 2021. In contrast, we, and forecasters generally, had expected exports to fall by more than imports in early 2021, weighing on GDP growth.

3. The forecast sees two years of very strong growth

The highlight of the EY ITEM Club's new forecast is an upgrade to expected GDP growth this year and next. We now think the economy will expand 7.6% in 2021, up from 6.8% forecast in April, and by 6.5% in 2022 (previously 5%). Using long-run economic data collated by the BoE, forecast growth in 2021 would be the fastest since 1941.[7]



The fact that the economy shrank so much in 2020 means it's more appropriate to look at levels than growth rates in assessing the strength of the recovery. But here the outlook is also much brighter. We now forecast output to regain its Q4 2019 (the quarter before the pandemic struck) level during Q4 of this year. The transformation this implies in expectations for the economy is clear when considering what forecasters were

[6] See Office for Budget Responsibility. *Economic and fiscal outlook – November 2020*. 25 November 2020. obr.uk/efo/economic-and-fiscal-outlook-november-2020/ and HM Treasury. *Forecasts for the UK economy.* November 2020. gov.uk/government/statistics/forecasts-for-the-uk-economy-november-2020

[7] Bank of England. *A millennium of macroeconomic data*. (Excel spreadsheet.) bankofengland.co.uk/-/media/boe/files/statistics/research-datasets/a-millennium-of-macroeconomic-data-for-the-uk.xlsx?la=en&hash=73ABBFB603A709FEEB1FD349B1C61F11527F1DE4

predicting only a few months ago. At the start of 2021, most professional economists did not see the economy returning to its pre-pandemic size until Q3 2022. We were even gloomier at that time, pencilling in a date of 2023 before GDP got back to its late 2019 level.[8]

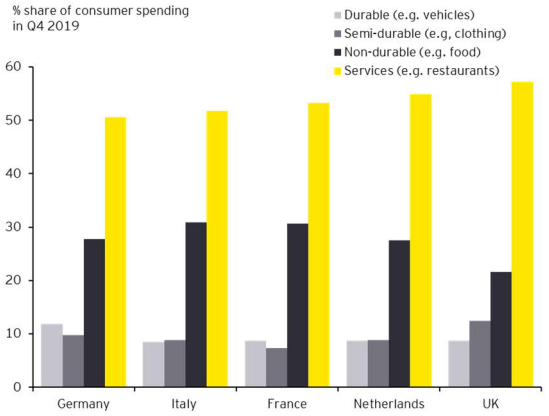
The resilience of the economy during the recent lockdown in Q1 goes a small way to explaining our upgraded forecast. A more modest drop in GDP than anticipated mechanically improves the growth outlook. But of much more importance is the speed of vaccinations and the leeway this has given to reopening previously shuttered parts of the services sector. As of mid-July, 46m people, or 88% of the adult population, had received one dose of a COVID-19 vaccine and 36m (68%) had received two doses.[9]

The UK economy should gain more than most from the removal of COVID-19 restrictions

Now that people are returning to working, shopping and socialising, the UK is relatively well-placed to reap a strong rebound in growth. In one sense, this represents previous negatives turning into positives, not least that the UK economy did so poorly during the pandemic in comparison with most of its peers. UK GDP in Q1 2021 was 7.8% below the level in Q4 2019. Among the 37 member states of the OECD, only Spain and Portugal saw larger contractions. The fact that the UK economy shrank so much, relatively speaking, means there is more lost ground to make up.

Two influences which compounded the UK's inferior performance during the pandemic should now reverse course. One is that UK consumers spend relatively more on consumer services – such as recreation and leisure, which were particularly vulnerable to lockdowns – than consumers in other European countries. But they spend relatively less on non-durables (food, energy and fuel), subsectors where spending was little impeded by COVID-19 restrictions. According to Eurostat data, in Q4 2019, 57.2% of UK consumer spending was devoted to services. The share of services in German consumption was only 50.6%, while the equivalent proportion in France was 53.3%. This difference left the UK more exposed to social distancing restrictions during 2020 and early 2021. But with barriers to spending removed, it now represents an upside for growth.

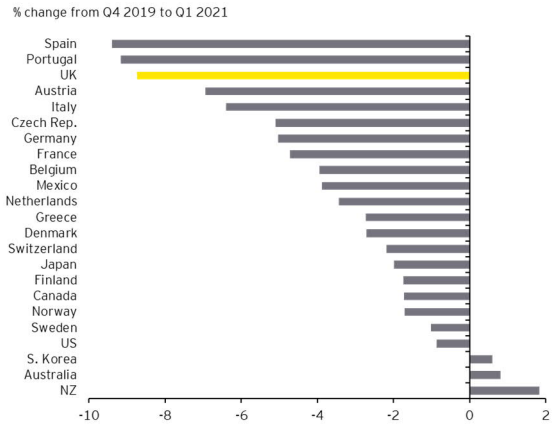
Consumer spending



Source : EY ITEM Club/Eurostat

A second factor concerns the way in which public sector output is measured. The UK takes a more sophisticated approach to measurement than some other countries by estimating how much activity takes place in sectors such as public health and education, rather than simply basing output on how much money is spent.[10] The pandemic caused more spending on health care. But it also meant school closures and a reduction in NHS elective and outpatient activity. The effect was a big divergence between cash and real measures of government output. A similarly large gap was not so apparent in other major economies. With schools now reopened, and the health service catching up with the backlog of non-COVID-19 work which arose during the pandemic, real government output should receive a comparatively bigger boost than elsewhere.

GDP in selected economies



Source: EY ITEM Club/Haver Analytics

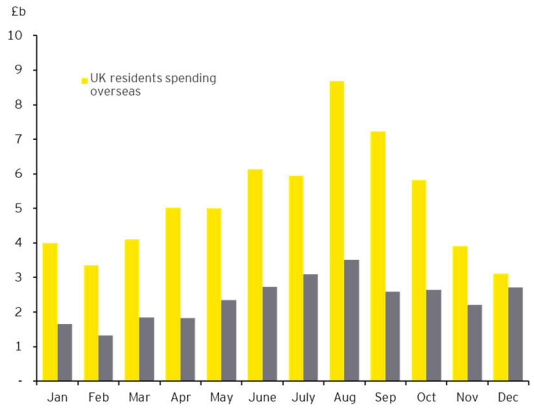
[8] Valentina Romei and Delphine Strauss. *UK economists' survey: recovery will be slower than in peer countries*. Financial Times. 3 January 2021. ft.com/content/21abdaf0-b3b6-4cf9-93f2-007fc1b1b1c8

[9] UK Government. *Vaccinations in the United Kingdom*. coronavirus.data.gov.uk/details/vaccinations

[10] Office for National Statistics. *International comparisons of GDP during the coronavirus (COVID-19) pandemic*. 22 February 2021. ons.gov.uk/economy/grossdomesticproductgdp/articles/internationalcomparisonsofgdpduringthecoronaviruscovid19pandemic/2021-02-01

The completion of the final stage of the 'road map' on 19 July meant the end of almost all remaining domestic legal restrictions on social activity. But impediments to international travel, ranging from the need for multiple COVID-19 tests to full-blown quarantining for those travelling to the UK from certain countries remain, for the time being. While a source of frustration for those longing for a holiday abroad, the net economic effect of obstacles to international travel should be positive. The UK runs a sizeable trade deficit in tourism with the rest of the world. In 2019, UK tourists spent almost £31b abroad between April and August, exceeding spending by foreign tourists in the UK in the same period by £17b. That gap corresponded to almost 1% of annual GDP. So 'staycations', or UK households diverting holiday budgets to alternative goods or services, could provide a meaningful lift to the economy.

Travel and tourism spending in 2019



Source: EY ITEM Club/ONS

However, the boost from these factors will not be uniformly strong across all sectors. Lockdowns resulted in a large degree of expenditure switching, as consumers diverted spending from shut down sectors, notably hospitality and leisure, towards less affected areas, such as home improvements. But with the economy now largely reopened, spending patterns should return to normal. This will boost demand in some sectors. But spending in areas which benefitted from social distancing restrictions is likely to fall back.

Policy support from the Government and the Bank of England will bolster growth

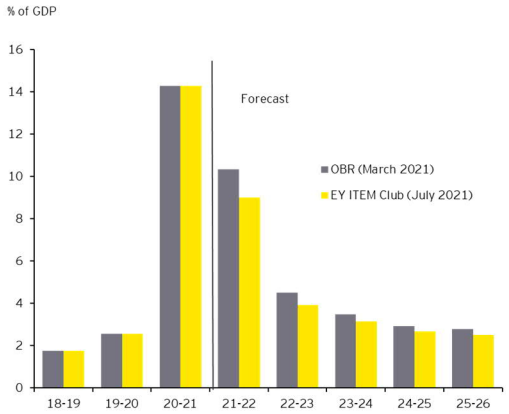
Beyond the mechanical boost provided by the economy's exit from partial hibernation, a boost enhanced by some idiosyncratic factors specific to the UK, support from macroeconomic policy also fuels our expectation of strong growth this year and next.

The Budget in March 2021 saw the Chancellor, Rishi Sunak, extend virus-related rescue support to households, businesses and public services by a further £44.3b, taking the total cost of COVID-19 measures to £344b. He also announced a temporary tax break (the 'super-deduction') costing more than £12b a year, to encourage businesses to bring forward investment spending from the future into 2021–22 and 2022–23.

Extra public spending will contribute directly to GDP growth, while the super-deduction, combined with greater clarity over the implications of Brexit, growing confidence about the medium-term outlook and the £100bn or so of excess savings accumulated by firms during lockdowns, should prompt a strong rebound in business investment.[11] Moreover, confirmation from the Chancellor that support measures, including the furlough scheme, would remain in place until September has provided clarity and stability to households and firms in planning for the future. This contrasts with the last-minute decision to extend the CJRS in October 2020, which may have contributed to the rise in unemployment late last year.

March's Budget did factor in some medium-term fiscal tightening which will drag on growth later in the forecast period. Most significantly, from April 2023, the corporation tax rate will increase to 25% from the current 19%, raising around £17b per year. Income tax thresholds were frozen in cash terms for four years from April 2021. And thresholds for inheritance tax, pensions allowances, and VAT registration were also frozen, while some small cuts to departmental spending were pencilled in from 2022–23 onwards. However, the Government's plans were based on a fiscal forecast from the OBR which is now looking increasingly pessimistic. In March, the OBR saw net borrowing running at 10.8% of GDP in 2021–22, before declining year-by-year to 2.8% of GDP in 2025–26. We think the deficit this year will be lower, at 9% of GDP, and fall to

UK: Public sector net borrowing



Source : EY ITEM Club/OBR

[11] See EY ITEM Club. *Special Report on Business investment*. 28 June 2021. info.ey.com/UKI-UK-ALL-ED-2021-06-23-EY-Item-Club-Special-Report-Launch.html

2.5% of GDP by 2025–26. So the Chancellor may find he can rein back on some planned tax rises and spending cuts while still keeping borrowing at what he considers to be a "prudent" level.

Monetary policy has stood still since November 2020, when the Monetary Policy Committee (MPC) announced a further £150b of asset purchases. This additional quantitative easing was, as of late July, still in play, so policy currently remains in loosening mode. And borrowers continue to benefit from Bank Rate still sitting at the record low of 0.1% announced in March 2020.

We think monetary policy will remain on hold until late 2022, with Bank Rate rising to 0.25% in November next year. Although inflation is likely to pick up sharply over the next six months or so to well above the BoE's 2% target, forces pushing up prices are likely to prove transitory, meeting the MPC's expectation (see Section 5).[12] Meanwhile, strong growth in GDP should not trigger any premature desire to tighten. Even if the economy returns to its pre-COVID-19 size by the end of the year, as we (and the MPC) predict, that still equates to two years of lost growth. And it will take some time beyond the end of this year for the level of GDP to regain its pre-virus trajectory.

What's more, the MPC has given itself plenty of leeway to keep policy loose. According to the wording used in each MPC policy statement since August 2020, "the Committee does not intend to tighten monetary policy at least until there is clear evidence that significant progress is being made in eliminating spare capacity and achieving the 2% inflation target sustainably."[13] So a return to the economy operating at full capacity and inflation consistently at 2% would be necessary, but not sufficient, to tighten policy. And the inclusion of "sustainably" suggests the MPC will not be swayed by temporary factors, such as supply bottlenecks, which may temporarily push up inflation and depress the economy's productive potential.

That said, the EY ITEM Club is more hawkish than most forecasters in expecting a rise in interest rates as 'soon' as late 2022. This is partly a function of our above-consensus forecast for GDP growth and below-consensus prediction for unemployment (see below). But it's also consistent with some of the mood music emanating recently from the MPC. Gertjan Vlieghe is an external MPC member who has been more explicit than most in setting out where he thinks Bank Rate is headed. Vlieghe argued in May that if the economy evolves in line with the MPC's latest projection (which has growth this year and next slightly less heated than our forecast), a rise in interest rates would likely become necessary in the second half of next year.[14] And more recently, both Michael Saunders, another external member, and Sir Dave Ramsden, one of the BoE's Deputy Governors, have hinted that they favour paring back the BoE's asset purchase programme soon.[15]

Consumer spending will gain from a return to more 'normal' savings behaviour and low unemployment

One of the most striking economic developments during the pandemic has been the extent to which households, faced with restrictions on their freedom to spend, but with incomes supported by Government aid, amassed involuntary savings. During the recent lockdown in early 2021, consumers responded to restrictions by moving an increasing share of spending online. But that was not enough to prevent consumption dropping 3.2% q/q in cash terms in Q1.

However, thanks to Government support and a private sector better adapted to lockdowns, household incomes saw a small gain. The net result was a rise in the household saving ratio to 19.9% in Q1, the second highest since records began in 1963 and surpassed only by a ratio of 25.9% during the first lockdown in Q2 2020. In cash terms, 'excess' savings from Q2 2020 to Q1 2021 (defined as the difference between total saving and what savings would have been if average levels in 2018–19 had continued) amounted to just over £190b. Higher savings, along with rising house prices, a rise in the value of defined benefit pension schemes

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[12] The MPC's case for higher inflation being transitory is set out in *It's a recovery, but not as we know it*, a speech by Andrew Bailey, Governor of the Bank of England, 1 July 2021. bankofengland.co.uk/speech/2021/july/andrew-bailey-speech-at-the-mansion-house-financial-professional-services-event

[13] The implications of this guidance are discussed in *Supply and demand during and after the pandemic*, a speech by Michael Saunders, external member of the Monetary Policy Committee, 26 March 2001. bankofengland.co.uk/speech/2021/march/michael-saunders-bank-hosted-speech-supply-and-demand-during-and-after-the-pandemic

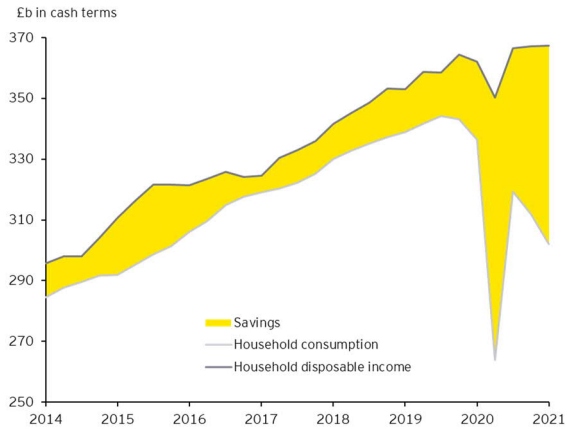
[14] *What are government bond yields telling us about the economic outlook?*, a speech by Gertjan Vlieghe, external member of the Monetary Policy Committee, 27 May 2021. bankofengland.co.uk/-/media/boe/files/speech/2021/may/what-are-government-bond-yields-telling-us-about-the-economic-outlook-speech-by-gertjan-vlieghe.pdf

[15] See 'The inflation outlook'. Speech by Michael Saunders, external member of the Monetary Policy Committee, 15 July 2021. https://www.bankofengland.co.uk/speech/2021/july/michael-saunders-speech-the-inflation-outlook and 'Navigating the economy through the Covid crisis'. Speech by Dave Ramsden, Deputy Governor of the Bank of England, 14 July 2021. https://www.bankofengland.co.uk/speech/2021/july/dave-ramsden-speech-at-the-strand-group

(reflecting last year's fall in gilt yields), and a reduction in debt, resulted in households seeing their net worth increase by almost £950b, or 9.4%, in 2020, the latter a six-year high.[16]

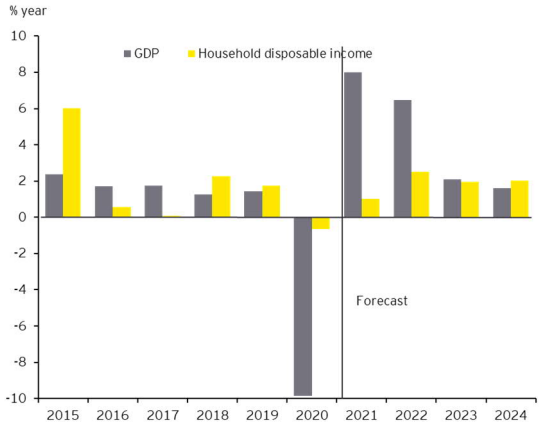
Section 4 examines the forces which will influence how much of these savings households might spend. The boost to sentiment from rising wealth should encourage spending. And a return to more 'normal' savings behaviour should be encouraged by lower-than-expected unemployment. Admittedly, the winding down of the furlough scheme may result in some job losses. The taxpayer's contribution to furloughed staff's wages was scaled back from 80% to 70% from 1 July and will be cut further to 60% from the beginning of August. But we think related job losses should be small. The scheme is not due to close completely until the end of September, more than two months after almost all domestic restrictions have been lifted. Moreover, the changes in the terms of the CJRS were announced at the beginning of March 2021. If there was going to be a wave of job losses, this should already have been evident in the statutory notices that warn of large-scale redundancies. In fact, redundancy figures for June suggested employers were planning the lowest number of job cuts for over six years.[17] So while the LFS unemployment rate may creep up in the second half of 2021 (also reflecting some people moving from inactivity to searching for work), it is forecast to end this year only a little above 5%, before declining during 2022 and closing next year at 4.6%.

UK: Income, consumption and savings



Source : EY ITEM Club/Haver Analytics

UK: GDP and household income



Source: EY ITEM Club

Overall, we forecast consumer spending to rise 4.8% this year and 7.4% in 2022. The latter would be the strongest calendar year performance since 1945. But it would be remiss to say that all is rosy for the financial position of households. Household incomes are forecast to rise 1% in real terms this year, well short of growth in GDP. The fact that incomes suffered a comparatively modest 0.6% fall in real terms in 2020 goes some way to explaining this. But higher unemployment and inflation will drag on real income growth this year. And the end of the temporary uplift to Universal Credit (UC) from October will cut the incomes of 6m households by £1,000 per year, just as an inflation spike is pushing up the cost of living.

[16] Office for National Statistics. *The national balance sheet and capital stocks, preliminary estimates, UK: 2021*. 29 April 2021. ons.gov.uk/economy/nationalaccounts/uksectoraccounts/bulletins/thenationalbalancesheetandcapitalstockspreliminaryestimateuk/2021

[17] Ben King. 'Covid: Planned redundancies at lowest level since 2015'. BBC News, 14 July 2021. https://www.bbc.co.uk/news/business-57826625

The EY ITEM Club forecast for the UK economy, summer 2021

% 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	0.5	1.4	0.4	3.0	2.7
2019	1.4	1.6	1.1	1.5	2.7	2.7
2020	-9.8	-10.5	-10.9	-8.8	-15.8	-17.8
2021	7.6	7.8	4.8	9.5	3.6	4.1
2022	6.5	7.2	7.4	10.4	9.0	11.4
2023	2.1	2.3	2.2	3.4	3.2	3.8
2024	1.6	1.7	1.9	1.3	3.4	3.7

	Net Govt borrowing(*)	Current account (% of GDP)	Average earnings	CPI	Bank rate	Effective exchange rate
2018	1.8	-3.7	3.2	2.5	0.6	78.5
2019	2.6	-3.1	3.5	1.8	0.8	78.2
2020	14.2	-3.5	1.8	0.9	0.2	78.1
2021	9.0	-2.9	4.3	1.8	0.1	81.9
2022	3.9	-2.6	1.2	2.0	0.1	82.0
2023	3.1	-2.7	3.0	2.0	0.4	81.5
2024	2.7	-2.8	3.2	2.0	0.8	81.6

*Fiscal years, as % of GDP

Source: EY ITEM Club

Risks to the forecast are partly epidemiological, partly economic

The unique circumstances the economy finds itself in mean that modesty on the part of forecasters is more needed than ever, as is an awareness of upside and downside risks. In terms of upsides, 'Freedom Day' on 19 July could fuel an unexpectedly strong surge in sentiment, to the benefit of consumer spending. A similar outcome could materialise if the recent jump in COVID-19 infections were to burn out quickly in the face of an increasingly vaccinated population. Euphoria following confirmation that the pandemic is finally past could make the increasingly clichéd talk of a 'roaring twenties' more of a reality.

The emergence of the 'Delta' variant presents probably the biggest downside risk. Experience suggests that rising case numbers can damage consumer confidence and discourage social consumption. In addition, the Government might feel it necessary to reimpose some restrictions, and this cannot be ruled out. But the extent to which this would affect economic activity is very uncertain and the Government would likely try 'softer' forms of intervention, such as mandating mask wearing, before closing sectors again.

Another threat to growth relates to psychological scarring stemming from the crisis. Academic research on the drivers of consumption has found that individuals' spending and saving behaviour over their lifetimes is disproportionately shaped by developments in their formative years. For example, 2019 analysis from the US, using consumer and investor surveys, found that those who experienced the global financial crisis in 2008 as young adults spend significantly less, controlling for the usual determinants of consumption even when their future incomes showed no correlation with the economic shock experienced.[18] Other US research, focusing on individuals who lived through the Great Depression of the 1930s, found a higher lifetime level of risk aversion among 'depression babies' compared to other age cohorts.[19] After COVID-19 delivered the second major economic shock in little over a decade, a heightened perception of severe economic downturns could make households more prudent.

A further downside risk is inflation. As set out in Section 5, we think higher inflation will be transitory. But even a temporary period of high inflation could permeate expectations among the public, triggering a hawkish shift from the MPC and causing financial conditions to tighten.

[18] Ulrike Malmendier and Leslie Sheng Shen. *Scarred Consumption*. International Finance Discussion Papers 1259. October 2019. https://doi.org/10.17016/IFDP.2019.1259

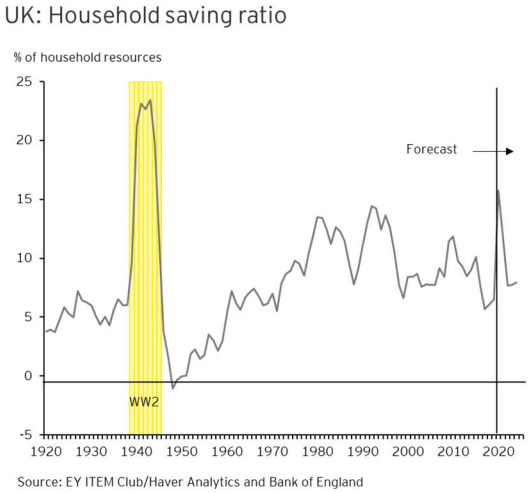
[19] Ulrike Malmendier and Stefan Nagel. *Depression Babies: Do Macroeconomic Experiences Affect Risk-Taking?* The Quarterly Journal of Economics, Volume 126, Issue 1, February 2011, Pages 373–416. econ.yale.edu/~shiller/behmacro/2007-11/malmendier.pdf

Finally, there's uncertainty around labour supply. The suspension of the International Passenger Survey in March 2020 has made gauging the impact of the pandemic on the UK's population difficult. Research published by the Economic Statistics Centre of Excellence (ESCoE) in January using Labour Force Survey data argued that the UK population could have fallen by 1.35m from Q3 2019 to Q3 2020.[20] But the ONS has regularly pushed back against the ESCoE's verdict and released a preliminary study estimating that the UK's population in fact grew by 316,000 (0.5%) in the year to June 2020, with net inward migration running at 282,000.[21] Just how many people have left the UK, and how many will return, will bear on the capacity of the economy to grow without running into inflationary bottlenecks.

4. Household "saving lake" offers a major backstop to demand

Section 3 touched on what Andrew Haldane, who left his role as Chief Economist at the BoE in June, described as the "saving lake" built up by households during the pandemic.[22] With savings influenced, in part, by psychological factors, the big unknown is the extent to which households will hold onto to these savings, or spend them. A smaller, or bigger, appetite to save would bear on the strength of the economic recovery.

Several factors should prompt lower saving …



The saving ratio should fall back rapidly now the economy is reopening, and this is supported by parallels with the last time the UK population experienced 'forced' saving. During the Second World War savings soared as incomes rose and consumption was subject to rationing. After the war, the end of rationing released a wave of pent-up spending. Post-COVID-19, four factors could support a repeat of this cycle:

- The first is the liquid nature of much of the extra saving. Between March 2020 and May 2021, households' holdings of cash and bank deposits rose by almost £130b more than a continuation of the average monthly accumulation during 2018 and 2019 would have implied. This was equivalent to around 8.5% of annual household income. Cash and bank deposits are the most liquid part of household wealth and easier to turn into consumption than, say, savings put into property or pensions.

- Second, higher household saving has probably, in large part, been involuntary, as opportunities for normal day-to-day spending were curtailed by measures to contain the virus. In that sense, much of the extra saving corresponds to a windfall gain – money that people would not have had if life had carried on as normal. Research on windfalls has found a high propensity to spend such gains, a consequence of their unanticipated nature.[23]

- Third, the saving ratio historically has tended to rise in the immediate aftermath of recessions, probably reflecting caution triggered by downturns. But the extent to which households have already bolstered their balance sheets during the COVID-19 crisis should reduce the odds of history repeating itself.

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[20] Michael O'Connor and Jonathan Portes. *Estimating the UK population during the pandemic*. Economic Statistics Centre of Excellence. 14 January 2021. escoe.ac.uk/estimating-the-uk-population-during-the-pandemic/

[21] Office for National Statistics. *Early indicators of UK population size and age structure: 2020*. 16 April 2021. ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationestimates/articles/earlyindicatorsofukpopulationsizeandagestructure2020/2021-04-16

[22] *Thirty years of hurt, never stopped me dreaming*, a speech by Andrew Haldane, Chief Economist of the Bank of England, 30 June 2021. bankofengland.co.uk/speech/2021/june/andy-haldane-speech-at-the-institute-for-government-on-the-changes-in-monetary-policy

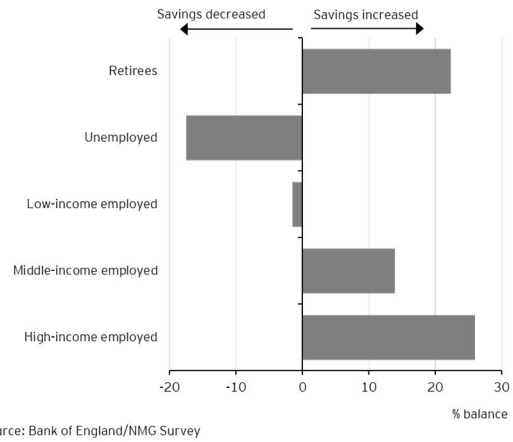
[23] Hal R. Arkes et al. *The Psychology of Windfall Gains*. Organizational Behaviour and Human Decision Processes, Vol. 59, pages 331-347, September 1994. deepblue.lib.umich.edu/bitstream/handle/2027.42/31364/0000276.pdf?sequence=1&isAllowed=y

- The fourth factor relates to who has been doing the extra saving. Survey evidence from the BoE and NMG Group found that it is mostly households in the upper half of the income distribution that have experienced marked increases in savings during the pandemic. Lower-income households, particularly those with children, have been compelled by the economic crisis to spend more and save less.[24] And it's these higher-income households who are relatively most optimistic about their financial prospects. Last autumn, the BoE/NMG survey suggested that lowest-income households were 50% more likely to think their situation would deteriorate over the following 12 months than higher-income ones.

... but there are also forces working against a splurge of accumulated cash

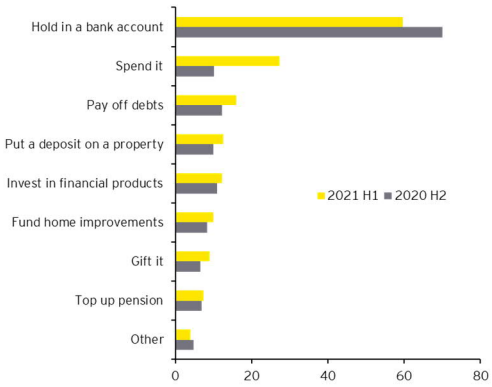
But the concentration of savings among the better-off is also one reason to temper expectations of a savings-fuelled spending splurge. Higher-income households have a lower propensity to spend than lower-income households and may be more content to hoard their savings. The latest BoE/NMG survey, conducted in March, found that 27% of respondents planned to spend additional savings built up during the pandemic. Although this was up from 10% six months earlier, retaining savings in bank accounts was still the most popular option, cited by 60% of survey respondents. And of the 27% who intend to spend some of their savings, only 13% plan to spend more than half of them.[25]

UK: Change in savings by type of household



Source: Bank of England/NMG Survey

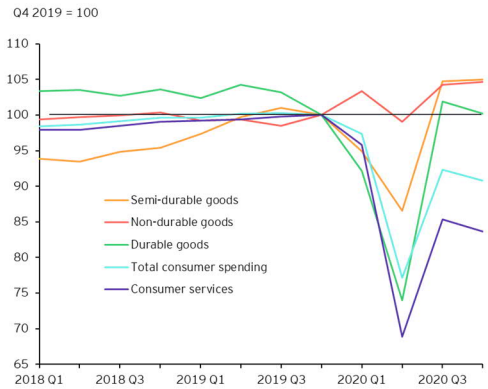
UK: Households' plans for pandemic savings



Source: Bank of England/NMG survey

It's also worth bearing in mind that consumption was far from entirely repressed by COVID-19 restrictions. Overall consumer spending fell heavily during lockdowns, but this was almost entirely accounted for by consumer services, such as restaurant meals and cultural activities. In Q1 2021, spending in the consumer services category was 21.8% lower in real terms than in Q4 2019. But spending on durable goods suffered a more modest 6.7% drop. Spending on semi-durables (e.g. clothing and games, toys and hobbies) was unchanged and spending on non-durables (food, drink and energy) was 3.4% higher.

UK: Consumer spending by category



Source: EY ITEM Club/Haver Analytics and ONS

Undoubtedly, post-lockdown, people may draw on savings to satisfy pent-up demand for some services, such as eating out and travel. But there are limits on how many extra restaurant meals and holidays people will be able to enjoy. And individuals will not be getting multiple haircuts or beautician appointments to make up for the ones they did not get during lockdown. So the

[24] Mike Brewer and Ruth Patrick. *Pandemic Pressures: Why families on a low income are spending more during Covid-19*. Resolution Foundation, January 2021. resolutionfoundation.org/app/uploads/2021/01/Pandemic-pressures.pdf

[25] Alice Crundwell, Marco Garofalo and Charlie Nourse. *How have households' spending expectations changed since last year?* Bank Overground blog, Bank of England, 11 June 2021. bankofengland.co.uk/bank-overground/2021/how-have-households-spending-expectations-changed-since-last-year

type of consumption disrupted during lockdowns implies that consumers may not draw on savings heavily to return to 'normal' spending habits.

These competing forces make it very tricky to arrive at an estimate of how much excess savings will be spent. But note that a return to merely more 'normal' savings behaviour would be enough to propel a very powerful rebound in consumer spending. Our forecast sees the saving ratio falling from 15.8% in 2020 to 12.5% this year and 8.2% in 2022, before settling around that level. This would be a little above the pre-pandemic, 2000–19, average of 7.9%, reflecting an assumption of more caution among consumers following two 'once in a lifetime' economic shocks in the space of 12 years. But the absence of major dissaving (i.e. the saving ratio temporarily dropping well below the long-run average) is still consistent with a rapid revival in consumer spending.

5. Inflation is heading higher, but this should prove temporary

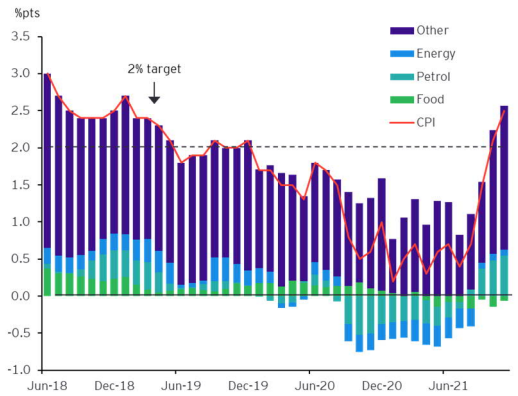
Among the economic challenges and problems confronting the UK, it's been a long time since high inflation figured in the list. True, there have been several occasions in the last decade when the CPI measure of inflation has broken well above the BoE's 2% target. Notably, inflation exceeded 5% in late 2011 and breached 3% in the second half of 2017. But such elevated levels were short-lived and generally a consequence of a weaker pound, higher oil prices and/or hikes in VAT, not any fundamental mismatch between supply and demand.

Recently, inflation fears have started to stir, promoted by a pick-up in price pressures and concerns about the consequences of the pandemic for supply chains, consumption patterns and labour markets. In the words of probably the most prominent among today's inflation hawks, Andrew Haldane, the UK faces "the most dangerous moment for monetary policy since inflation-targeting was first introduced into the UK in 1992".[26]

We think CPI inflation will hit 3.5% this year …

Certainly, inflation has recently been on the rise. CPI inflation was 2.5% in June, up from 2.1% a month earlier and just 0.3% last November. This was the highest rate since August 2018. Further up the supply chain, producer input inflation was only slightly down on May's 10-year high. These developments have mainly reflected the recovery in oil and commodity prices since the early stages of the pandemic (the price of a barrel of Brent Crude in mid-July was around $70, up from less than $20 in April 2020), and higher household energy bills, boosted by Ofgem raising the price cap on energy bills by 9% from April.

UK: Contributions to CPI inflation



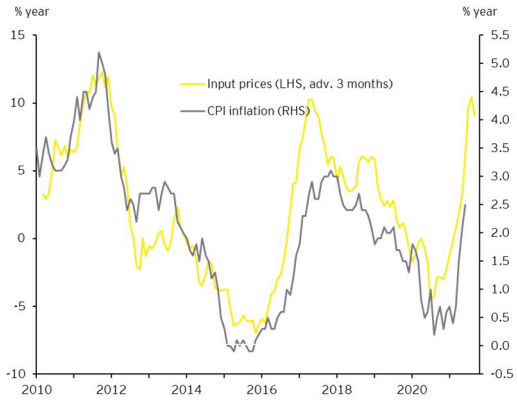
Source: EY ITEM Club/Haver Analytics

The path for inflation over the rest of this year is likely to continue being a rising, if volatile, one. Comparisons with weak activity and prices in 2020 mean base effects will continue to push up year-on-year inflation measures. Services inflation temporarily spiked in July 2020, as parts of the service sector reopened, which should press down on inflation this July. But the Eat Out to Help Out scheme lowered inflation in August 2020, which will boost inflation this coming August. Another inflationary impulse will come from the temporary 5% VAT rate for tourism and hospitality rising to 12.5% at the end of September and returning to the original 20% in March 2022. Shortages and supply chain disruption and bottlenecks caused by imbalances in the recovery of supply and demand, as the latter recovers more rapidly than the former, presents an additional source of inflation. And a switch from demand for goods towards services as restrictions are removed could lift the prices of the latter (indeed, hairdressing and personal grooming inflation reached an annual rate of 8% in May, a 29-year high).

[26] Andrew Haldane. *The beast of inflation is stalking the land again*. New Statesman. 9 June 2021. newstatesman.com/2021/06/dangerous-moment

Bringing these influences together, we expect CPI inflation to reach around 3.5% by the end of this year, before slowing over the course of 2022. Uncertainty over quite how significant, and long-lasting, supply-chain pressures will be means that the risks around our forecast probably err towards inflation ending up higher than lower. The historical association between surging manufacturers' input costs and CPI inflation points in this direction, albeit with signs of the former moderating in the latest, June, data. Input costs have spiked recently, and while pressure from this source should dissipate as supply-chain bottlenecks are resolved, that may not happen particularly quickly.[27]

UK: CPI inflation and manufacturers input prices

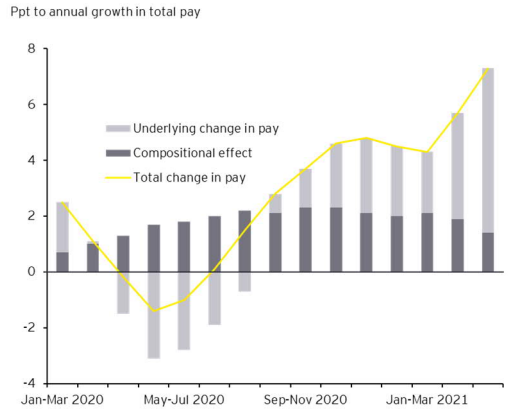


Source: EY ITEM Club/Haver Analytics

Another upside risk is consumers spending a larger than expected proportion of lockdown savings. Stronger demand running up against tight supply would imply rising prices. And while surging growth in the money supply over the last year, fuelled by BoE asset purchases, was offset by slowing money velocity as household spending was curtailed, the freedom and resources to spend more now could spark a return to the old maxim of too much money chasing too few goods. Although again, this will be a time-limited issue. At some point, households will have worked their way through excess savings and spending will once again be constrained by incomes.

One potentially inflationary development we are less concerned about is apparently rocketing pay growth. Average private sector pay in the three months to May was 7.3% higher than a year earlier, the biggest increase since the series began in 2001. However, headline earnings growth has been artificially boosted by two effects. One is compositional. Lower-paid and part-time employees were more likely to lose their jobs during the pandemic, reducing the weight of these jobs in the average pay calculation. The second reflects comparisons with a weak 2020. Workers returning to work from furlough (and so moving from 80% to 100% of their usual salaries) have flattered headline earnings growth. If job creation as the recovery proceeds proves to be skewed towards lower-paid roles – a likely development if recent trends in online job postings are anything to go by – average wage growth will be depressed. This will reverse to some degree the compositional effects seen to date.

UK: Compositional effects on pay



Source : EY ITEM Club/ONS

… but not all forces influencing inflation will push it higher

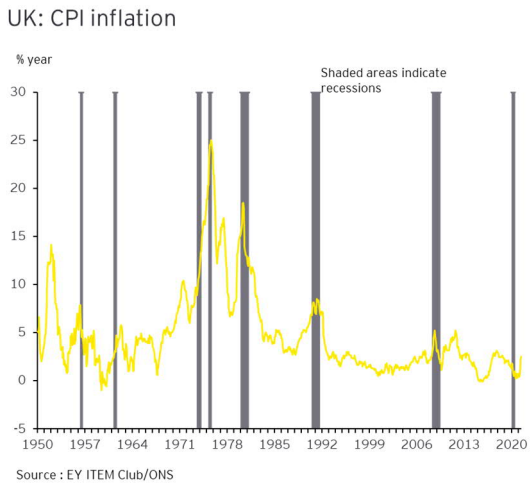
There are other forces which should also hold back the prospective jump in inflation. One is the disinflationary effect of sterling's recent strength. On a monthly average basis, the pound's trade-weighted value in mid-July was almost 7% higher than the COVID-19-related low of March 2020. This will hold down import prices, and based on BoE rules of thumb, should, all things being equal, lower the level of consumer prices by 1.5%–2%.[28] Moreover, the resilience of the labour market suggests that the economy's supply capacity may come out of the crisis with far less permanent damage than many feared. This should reduce the extent to which stronger demand runs into longer-term supply constraints.

And there are more fundamental factors working against sustained high inflation. One is just how insensitive UK inflation has been to ups and downs in the economy since the early 1990s. For example, in the 2008–09

[27] Theo Leggett. *Disruption to shipping could delay Christmas orders*. BBC News. 13 June 2021. bbc.co.uk/news/business-57446437

[28] See page 6 of *Much ado about something important: How do exchange rate movements affect inflation?*, a speech by Kristin Forbes, external member of the Monetary Policy Committee, 11 September 2015. bankofengland.co.uk/-/media/boe/files/speech/2015/much-ado-about-something-important-how-do-exchange-rate-movements-affect-inflation.pdf

recession, the core CPI measure (excluding the volatile food and fuel components) dropped to a low of 1.0%. But this was close to rates in the early 2000s and the mid-2010s, periods of solid economic growth. Moreover, inflation stayed low through the 1990s, 2000s and 2010s despite the unemployment rate ranging from a peak of 10% to a trough of less than 4%.



Relatively low and stable inflation has been a long-running fact of life for an increasingly large share of the population, and this means that shifting to a higher inflation world would not be easy. And institutional factors also work against that risk. The BoE has a clear and long-established inflation goal and an independent committee charged with meeting that objective. This is a far cry from the 1970s, when the objectives of monetary policy were confused, and the 1980s, which saw the aim of policy switch between controlling different measures of the money supply, before shifting to stabilising the exchange rate. At present, the MPC has made it clear that they will not rush the raising of interest rates. But unlike the US Fed, the UK central bank has not committed to deliberately allowing inflation to run above target. Stability in the BoE's mandate should mean less risk of a rise in the public's inflation expectations and the prospect of a temporary rise in inflation turning into something more persistent.

6. Conclusions

The extent of the economic slump in 2020 meant that a reopened UK economy was always on course to see rapid growth this year. But the recovery is shaping up to be stronger than almost anyone anticipated. Granted, the emphasis in the last line should probably be placed on "shaping up". With respect to COVID-19, the false dawn of a year ago – when just as the green shoots of higher confidence among businesses and consumers started to appear, a surge in new infections plunged the country back into lockdown – should caution hopes now.

Indeed, rapidly rising 'Delta' infections raise the risk of history repeating itself. But the big difference this time is, of course, vaccinations. And if, as the evidence currently suggests, vaccines are effective at greatly weakening the link between COVID-19 infections on the one hand and virus-related hospitalisations and deaths on the other, there will hopefully be no going back on the resumption of social freedoms.

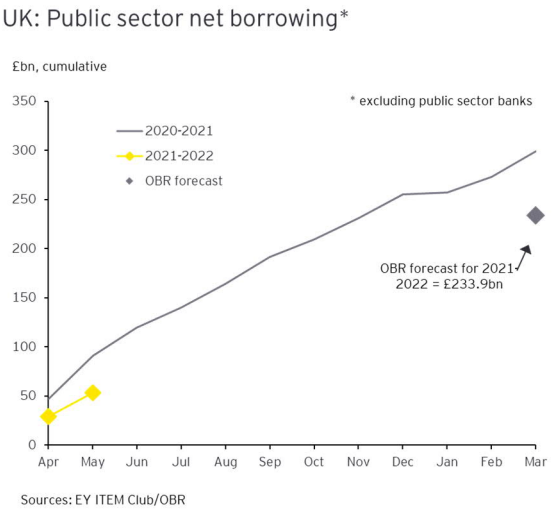
If so, the economy could find itself riding the wave of a virtuous circle of positive expectations among firms about future demand, increased job creation, and rising household incomes, confidence and spending, which, in turn, boosts firms' revenues and employment further – what the economist John Hicks back in the 1950s called a "super-multiplier".[29] And the fuel to sustain that virtuous circle is there, in the form of very strong household balance sheets and still very expansionary fiscal and monetary policies.

Whether the supply side of the economy can cope with what is likely to be a particularly pressured environment for demand is a question that only time will answer. There's certainly cause for optimism. Strong demand should bring forth new supply, as firms become more confident about investing in new capacity. The pandemic has revealed new ways of working and producing, potentially resulting in a more efficient use of capital and labour and higher productivity. Inflation will almost certainly increase over the next 12 months, potentially to a greater extent than we expect, but the rise will likely be driven by transitory pressures, rather than foreshadowing a return to the bad old days of the 1970s and 1980s. So policymakers (and economists) should avoid panicking prematurely and, as was arguably the case with austerity after the financial crisis, sacrificing economic growth on the altar of pessimism about the economy's potential.

[29] John Hicks (1950). *A Contribution to the Theory of the Trade Cycle*. Clarendon Press.

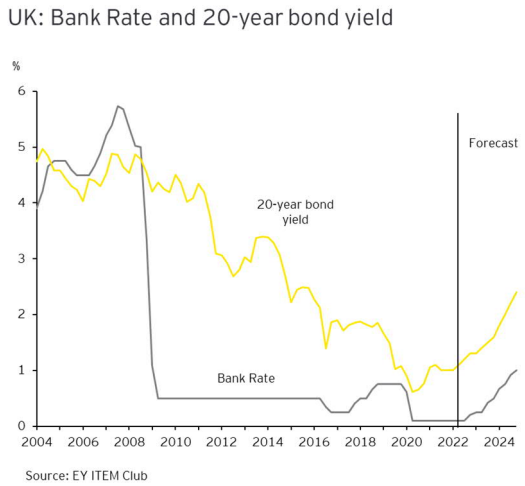
Forecast in charts

Fiscal policy



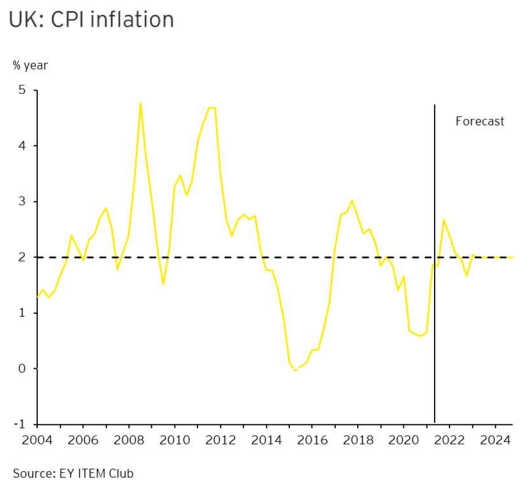
- March's Budget extended COVID-19 support schemes and announced more money for public services. This contributed to a fiscal loosening of almost £60b in 2021–22.
- The deficit in 2020–21 is now estimated to have been £299.2b, compared to the OBR's forecast of £356b in March. Borrowing in early 2021–22 has also undershot the OBR's forecast.
- The Chancellor has announced some medium-term measures to rein back the deficit, including a rise in the corporation tax rate.

Monetary policy



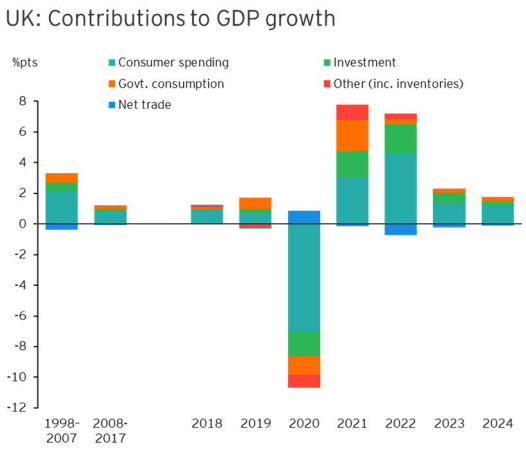
- The MPC has stood firm since last November, keeping Bank Rate at 0.1% and the target stock of asset purchases at £895b.
- The language used in recent MPC policy statements gives the committee plenty of leeway to keep policy loose, even as the economy recovers and inflation rises.
- The MPC's view that higher inflation will be transitory is one reason why we doubt that monetary policy will be tightened until late 2022.

Prices



- A comparison with depressed prices in 2020 and April's rise in Ofgem's energy price pushed annual CPI inflation up to 2.1% in May.
- Higher energy prices, recovering demand and supply-side bottlenecks are likely to keep inflation well above the BoE's 2% target this year.
- Counter-inflationary forces, including the stronger pound, and the transitory nature of price pressures point to inflation falling back during 2022.

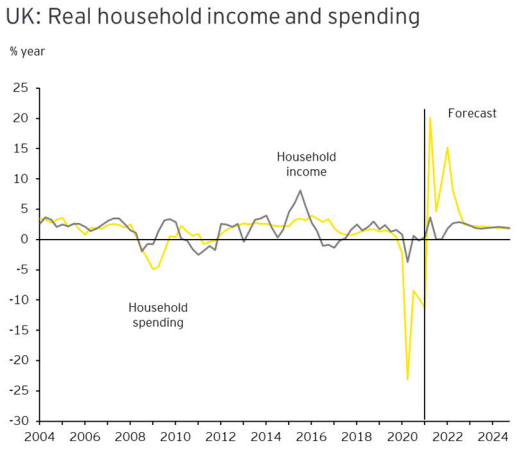
Activity



Source: EY ITEM Club

- GDP fell by an unexpectedly modest 1.6% in Q1. And the reopening of previously shuttered parts of the services sector over the spring has triggered a consumer-led recovery.
- Growth will be propelled this year and next by the mechanical boost from reopening, fiscal and monetary stimulus and households returning to more normal savings behaviour.
- GDP growth is forecast at 7.6% in 2021 and 6.5% in 2022. The economy is expected to return to its Q4 2019 size in Q4 2021.

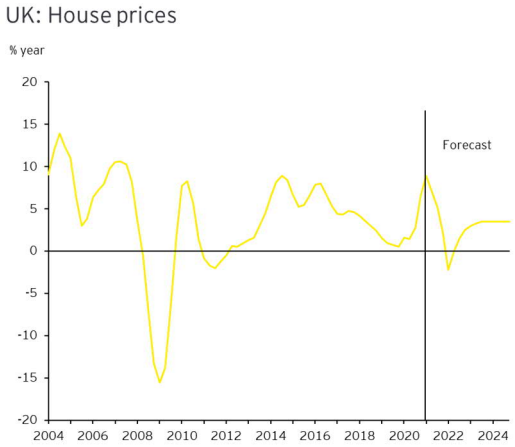
Consumer demand



Source: EY ITEM Club

- The reopening of non-essential retailers in April triggered a surge in retail spending. And the resumption of hospitality and entertainment over the spring and summer reinforced the consumer bounce-back.
- Households awash with savings and confidence boosted by the economy's reopening should fuel a sustained recovery. However, a switch from shopping to socialising means retail growth may cool.
- Consumer spending seen as rising 4.8% in 2021 and 7.4% in 2022.

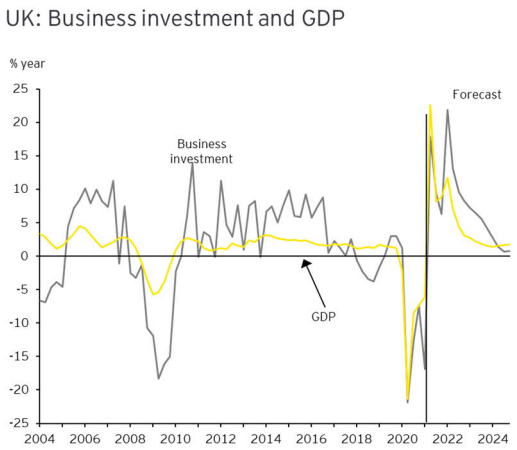
Housing market



Source: EY ITEM Club

- Demand for properties and house prices appear to have been boosted by buyers rushing to benefit from the stamp duty holiday before the concession was tapered on 30 June.
- Activity will probably be less heated in the second half of 2022, reflecting transactions brought forward by the tax holiday. But other forces, including strong household balance sheets and very low mortgage rates, will support the housing market.
- These factors suggest that any correction in house prices, once pandemic-related factors work their way through, is likely to be modest.

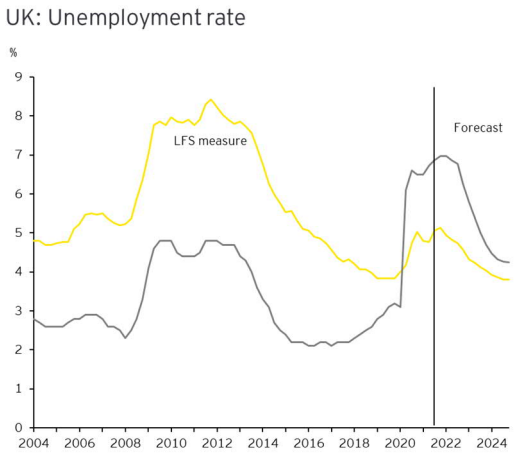
Company sector



Source: EY ITEM Club

- As the third lockdown bit, business investment fell 10.7% q/q in Q1, compounding 2020's 10.2% drop.
- A strong economic recovery, the incentive to invest offered by the Chancellor's 'super-deduction' and structural changes triggered by COVID-19 and Brexit should see business investment rebound strongly over the next few years.
- Business investment seen as rising 3% in 2021 and 12.9% in 2022.

Labour market and wages



Source: EY ITEM Club

- The official unemployment rate fell to 4.7% in February–April. The furlough scheme continued to insulate employees from the effect of COVID-19 restrictions.
- A strong revival in demand for workers is in play. The end of the furlough scheme may trigger some job losses. The unemployment rate is forecast to peak at 5.1%.
- Earnings growth has been exaggerated by workers returning from furlough and changes in the composition of the workforce.

Trade and the balance of payments

Source: EY ITEM Club

- Net trade made a strongly positive contribution to GDP in Q1 2021. The third lockdown curtailed imports, but exports held up better, despite new EU trade barriers on UK exports.
- The current account deficit narrowed to only 0.1% of GDP in Q1. The deficit is forecast to average just under 3% of GDP this year, as exports benefit from a revival in world trade, but imports are boosted by consumer and investment demand.
- Current account then seen as essentially little changed during the early 2020s.

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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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