EY ITEM Club Autumn Forecast

Headwinds build, but ‘stagflation’ should be averted

November 2021

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Foreword

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The recovery hits some inflationary headwinds …

The headline from the autumn forecast is that the EY ITEM Club's expectations for GDP growth have been downgraded. The forecast is now for the UK economy to grow by 6.9% in 2021 and 5.6% in 2022, down from the 7.6% and 6.5% forecast back in the summer. Although a substantial reduction, it would still represent two of the best years for growth that the UK economy has experienced since the Second World War.

This revision reflects the fact that the economy, having staged an impressive recovery in the earlier part of the year as COVID-19 restrictions were removed, is now facing a set of headwinds. These include widespread supply-chain shortages, tight labour markets and rising energy prices. As a consequence, growth in Q3 was slower than expected, and this slower rate of growth is likely to continue as we head into the turn of the year.

… and interest rates are likely to rise sooner rather than later

Higher inflation has, in turn, raised expectations that the Bank of England will move soon on interest rates. The Monetary Policy Committee (MPC) held back from raising the Bank Rate in November, but the first rise – probably from 0.1% to 0.25% – is likely to come soon. The EY ITEM Club's view is that the Bank will wait until February – but perhaps an earlier move should not be ruled out just yet.

However, it is still worth reflecting the fact that, despite the downgrade to the forecast, the economy is in far better shape that we would have hoped for 12 months ago, and the recovery has been faster and more complete than most commentators and economic forecasters had predicted. The UK economy is expected to get back to its pre-pandemic size by Q1 2022, in line with our European neighbours.

The labour market remains robust which should support consumer spending

While concerns have rightly been raised about the consequence of higher prices – particularly energy prices – on living costs, there are continued causes for optimism for the recovery.

A very buoyant labour market means that, despite the end of furlough, unemployment is unlikely to rise significantly, with the EY ITEM Club expecting it to peak at just 4.6%, well below the expectations of 10%+ anticipated at the start of the pandemic. The strong labour market is feeding into higher wages, which should support consumer spending in the face of any squeeze on living standards caused by higher prices. As the EY ITEM Club has previously commented, households have also been able to save throughout the pandemic, amassing approximately £180bn of 'excess' savings. This means households' financial positions are far stronger than in an equivalent recovery phase of a normal business cycle, and this again should support consumption through the course of next year.

Business investment should (hopefully) follow

Business investment is also expected to bounce back strongly into 2022, making the recovery more broad-based than currently. The Chancellor's 'super-deduction' tax incentive acting as a one of the policy drivers.

On balance, there are still grounds for optimism as we enter into the more difficult phase of the recovery, with most of the easy growth from reopening already having been achieved. Businesses, as ever, will look to protect their position, but should also think about where they should invest to take advantage of the opportunities provided by a reopened economy.

A message from Hywel

Finally, I am delighted to formally announce Peter Arnold's appointment as EY's new UK Chief Economist. Peter has been with EY for 16 years and leads EY's Economic Advisory policy team. He has over 20 years' experience as a business economist, working with public and private sector clients in the UK and in over 30 countries internationally.

Highlights

- A combination of higher and more sustained inflation, recent surges in energy prices and intensifying supply-chain disruption mean the recovery has entered a much tougher phase. The EY ITEM Club now expects GDP to grow 6.9% this year and 5.6% in 2022, down from our summer forecast of 7.6% and 6.5%. But what would still be historically strong rates of growth indicate that the recovery is far from running out of steam. Households' balance sheets are the healthiest on record and firms are sitting on large cash piles. Fiscal policy will not be quite as much of a drag as previously expected, and the labour market has rebounded strongly.

- Since our last forecast in July, the economy has made further headway in retrieving COVID-19-related losses. As of September, GDP was only 0.6% shy of its pre-pandemic level in February 2020, aided by the removal of most remaining coronavirus restrictions over the summer. But momentum in the expansion has slowed, as scope for catch-up growth has declined and bottlenecks and shortages have prevented supply from keeping pace with the recovery in demand.

- The recovery in output has made its presence felt in the labour market. The official unemployment rate has fallen to within half a percentage point of its pre-COVID-19 position and job vacancies and hiring have recently run at record highs. That said, employment is still down on where it stood in early 2020. And it is still too soon to fully assess the impact of the furlough scheme's closure in September. But early indications suggest the scheme ended with more of a whimper than a bang.

- A jobs market emerging from the crisis remarkably little damaged will help support what has been strong momentum in consumer spending. But obstacles to growth in the dominant part of the economy are building. Rising fuel and energy prices mean we think CPI inflation will now peak at almost 5% early next year and remain above 3% until the second half of 2022. This will compound the drag on consumers' spending power from recent cuts in benefits and next April's hike in personal taxes.

- The financial strength of households, overall, could go some way to offsetting these headwinds. Households have continued to accumulate excess savings in recent months. Combined with a rapid rise in house prices, households' net wealth, as a share of income, has reached the highest on record. But holdings of savings and assets are skewed towards the better-off. So lower-income households are still likely to be compelled to cut spending on discretionary items to meet the rising cost of essentials.

- Business investment has been slower to recover than consumer spending. However, surveys have reported more robust investment intentions in recent months. And the healthy financial position of firms, in aggregate, should support spending on fixed assets. Many large companies have paid down bank debt during the pandemic, and the corporate sector has accumulated large cash holdings relative to pre-pandemic trends. As of late summer, these were equivalent to almost £110b, around 5% of GDP, or half a year's worth of business investment.

- The recovery has, so far, been aided by very stimulative fiscal and monetary policy settings. Much of the COVID-19-related support from fiscal policy has now ended, but extra public spending announced in October's Budget will relax the extent to which fiscal policy is tightened over the next few years. Meanwhile, the Monetary Policy Committee (MPC) chose not to raise interest rates in November, despite sounding increasingly hawkish. A rise in Bank Rate in December's meeting is a live possibility. But with the MPC wanting to assess the impact of the end of the furlough scheme before contemplating any change in policy, we think the committee will probably wait until next February before triggering rate 'lift-off'.

- The threat posed by rising inflation explains the MPC's change of tone. Inflation is set to be higher for longer than we thought a few months ago, driven mainly by surging energy and fuel prices. The CPI measure is forecast to rise to the highest in a decade. But structural factors and the likelihood that supply problems will eventually be resolved mean we still sit in the 'transitory inflation' camp.

- With 15 years having passed since the UK last faced a sustained rise in interest rates, how the economy responds to higher borrowing costs is subject to some uncertainty. But several developments since the financial crisis, including a fall in the share of households with a mortgage and growth in the popularity of fixed-rate home loans, mean rising interest rates should have a more muted effect on activity than would have been the case previously.

1. Introduction

Since the EY ITEM Club's last forecast was released in July, the economy has advanced further along the path to pre-COVID-19 normality. [1] As of September, GDP was only 0.6% below its level in February 2020, just before the pandemic struck. In comparison, the shortfall was over 8% at the start of 2021 and a massive 25% in April 2020 during the first lockdown. Job creation has been strong as employers have responded to the reopening of previously shuttered activities, and pent-up demand has lifted consumer spending. In addition, surveys suggest firms' appetite to invest is gaining pace.

But with the boost from reopening the economy having now largely passed, the UK was always due to enter a tougher phase of the recovery. Headwinds are also growing: policy support has diminished, with the Job Retention Scheme and most other government support measures phased out over the autumn. The Bank of England (BoE) intends to complete its current programme of asset purchases by the end of the year and has given increasingly strong hints that interest rates will soon rise. The UK central bank's change of tone has been triggered by the inflationary consequences of surging energy and fuel costs, as well as supply-side bottlenecks and shortages. Elevated inflation is likely to persist until well into 2022 and combine with tax rises and benefit cuts to squeeze households' spending power. And while the Government's 'learn to live with' approach to COVID-19 suggests a high bar to reintroducing restrictions, the future path of the virus and the public health response remains uncertain.

However, amid what often seems a media cacophony of bad news, including predictions of a 'winter of discontent', some proportion is necessary. While the recovery is looking more fragile, it is far from running out of steam. Households and firms have continued to accumulate 'excess' savings, leaving balance sheets in an unprecedently healthy position. Credit conditions remain loose and the strength of the jobs market coming out of the crisis has continued to surprise. Joblessness has fallen close to pre-pandemic levels, and job vacancies and hiring are at record highs. The speed at which labour market concerns have shifted from worrying about high unemployment to worrying about a shortage of workers is startling.

Overall, the new EY ITEM Club Autumn Forecast predicts a recovery less heated than we expected in July. Although the economy did better in the first half of 2021 than anticipated, GDP growth this year is downgraded to 6.9% from 7.6% previously. And forecast growth in 2022 is lowered from 6.5% to 5.6%. As imbalances between demand and supply narrow and COVID-19-related shifts in spending patterns unwind, supply-side problems and inflationary pressure should ease. But in the near term, those headwinds are looking more persistent and the outlook for household income growth weaker.

One thing the EY ITEM Club does not anticipate is 'stagflation' – a 1970s-style period of sluggish growth and high inflation. Inflation certainly looks like peaking higher, at nearly 5%, and staying higher for longer, than we previously expected. This will probably contribute to real household incomes falling around the turn of the year, stymieing the strong recovery seen earlier in 2021. But elevated price pressures still look like being a time-limited problem, and the ingredients for continued economic growth have far from disappeared.

Our new forecast report begins by examining how the economy has fared in the four months since the EY ITEM Club's Summer Forecast was published. Section 3 discusses our latest economic projections and Section 4 considers the stagflation question and the outlook for inflation. Section 5 examines what higher interest rates might mean for the economy, and Section 6 concludes the report.

2. The recovery has continued, if along a rockier path

GDP is almost back to pre-COVID-19 levels

The relaxation of COVID-19 restrictions over the summer contributed to GDP steadily narrowing the shortfall with its pre-pandemic level. But that the most important stages of the economy's reopening had already occurred meant inevitably less scope for 'catch-up' growth. As a result, the pace of expansion has slowed. And disruption from the virus and supply-side frictions has meant that the path back to normality has not been a completely smooth one.

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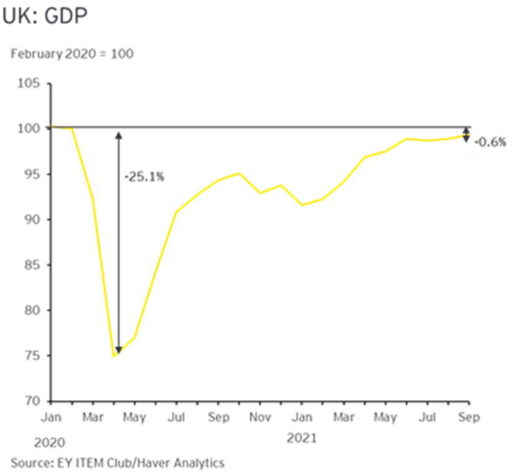
[1] EY ITEM Club Summer Forecast, July 2021. assets.ey.com/content/dam/ey-sites/ey-com/en_uk/topics/growth/ey-item-club/ey-item-club-summer-forecast-july-2021.pdf

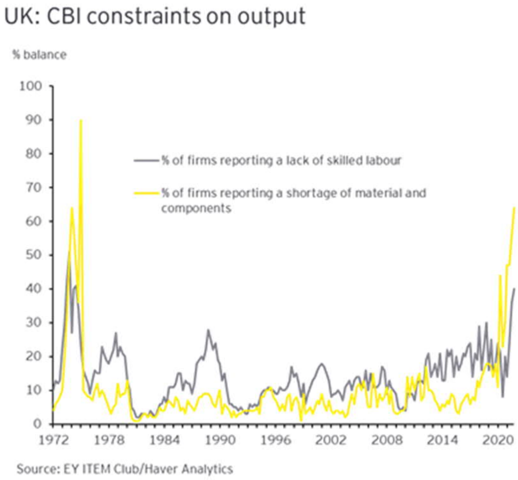
Activity got off to a good start in the summer, with GDP rising 1.4% month-on-month (m/m) in June. The increase was aided by a recovery in health sector output, as more people visited GPs, and a boost to the hospitality sector from the first full month of indoor dining since that activity resumed on 17 May. June's performance left GDP growth in Q2 at 5.5% quarter-on-quarter (q/q), a marked improvement on the lockdown-induced contraction of -1.4% q/q in the first three months of 2021.

However, the expansion stumbled in July, when GDP fell 0.2% m/m. That almost all remaining domestic COVID-19 restrictions ended on 19 July should have provided a fillip to output. But activity confronted two challenges that month – a rapid rise in COVID-19 infections and a surge in the number of people 'pinged' by the NHS Test and Trace app who were instructed to self-isolate after encountering an infected person. Daily infections reached a peak of almost 50,000 in mid-July, up more than 15-fold from 3,000 at the start of June. This probably weighed on consumer sentiment and discouraged some 'social consumption', such as eating out. And at the height of what was termed the 'pingdemic', also in mid-July, 1.7m people were isolating.

A fall in infections and a relaxation in the guidance around self-isolation helped GDP growth recover in August, the first full month after the removal of remaining legal limits on social contact, albeit to a modest 0.2% m/m. The pace of expansion then accelerated to 0.6% m/m in September. This left the economy 0.6% short of its pre-COVID-19 size, the smallest gap since the pandemic began, although quarterly growth in Q3 of 1.3% was well down on the previous quarter's pace. September's data showed output in the accommodation and food services sector, which had been hardest hit by lockdowns, rising above pre-crisis levels. The retail, utilities and scientific and technical sectors also exceeded their pre-pandemic size.

However, administrative and support services and what the Office for National Statistics (ONS) terms 'other services' were the laggards, with output 9% and 18% below that in February 2020 respectively. Manufacturing and construction also fell short. Manufacturers have been affected by the global shortage of some inputs, such as semiconductors. And a decline in construction output over the summer appears to have been exacerbated by a shortage of materials and staff. Evidence from the monthly Purchasing Managers Index (PMI) and Confederation of British Industries (CBI) surveys suggests that activity across different sectors during the autumn continued to be held back by supply constraints, with firms citing shortages of staff, raw materials and transport. October's CBI industrial survey showed concerns about supply shortages escalating to levels not seen since the 1970s.





That said, a rise in October's services and manufacturing PMIs offered some reassurance that momentum in activity held up that month. And evidence from the retail sector suggested that cost of living pressures were not imposing too much of a drag, yet. Retail sales volumes rose 0.8% m/m in October, the first increase in six months. And some high-frequency indicators have also been promising. For example, CHAPS data showed spending on credit and debit cards in the week to 4 November rising to 105% of its February 2020 average, the highest ratio since the spring.[2]

[2] Office for National Statistics, 'Economic activity and social change in the UK, real-time indicators', 11 November 2021. https://www.ons.gov.uk/economy/economicoutputandproductivity/output/bulletins/economicactivityandsocialchangeintheukrealtimeindicators/11november2021

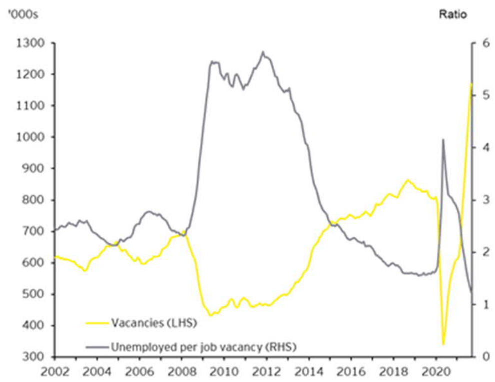
The job furlough scheme ended with probably more of a whimper than a bang

A recovery in GDP has been accompanied by a rapidly healing jobs market. During the pandemic, the Labour Force Survey (LFS) jobless rate peaked at 5.2% in late 2020, up from 4% at the start of last year. But the rate had fallen to 4.3% in the three months to September 2021, the lowest in 14 months, and only 0.3 percentage points (ppts) above the pre-COVID-19 position. An employment rate of 75.4% in Q3 compared with a pandemic-low of 74.7%. And timelier PAYE data from HMRC showed the number of paid employees growing 160,000 in October, leaving the total 230,000 above the level in February 2020. This compared with a peak shortfall of almost 1m in November 2020.

Granted, the LFS measure of employment was still 500,000 below its pre-COVID-19 level in Q3, with the deficit accounted for by a lower number of self-employed. But the fact that the main labour market measures moved favourably, despite almost 1m workers coming off the Coronavirus Job Retention Scheme (CJRS) over the summer, implies strong demand for workers. Moreover, job vacancies reaching a new record high of 1.2m in the three months to October, while the redundancy rate was back down to pre-COVID-19 levels, offered further signs that that any jobs shakeout following the end of the furlough scheme on 30 September should have proved modest. Section 3 explores this issue further.

The coexistence of still-depressed employment with plentiful vacancies offers some evidence of mismatches in the labour market, contributing to a shortage of workers in some sectors. Indeed, record vacancies and falling joblessness combined to produce a ratio of 1.4 vacancies per unemployed person in August, the lowest on record. And the media has not been short of anecdotal evidence of a lack of workers in industries such as transport and hospitality. However, not all the evidence is consistent with a dearth of workers. New hires in October reached a record high of 811,000, almost a quarter above the 2018–19 average. Firms taking on so many new employees is hard to square with employers, overall, struggling to find staff.

UK: Vacancies and unemployment/vacancy ratio



Source: EY ITEM Club/Haver Analytics

Firms that are having trouble recruiting could see the pool of available workers expand now that the furlough scheme has closed. According to the latest data from HMRC, September ended with 1.1m jobs still furloughed, around 4.5% of private sector jobs. This number included more than 150,000 jobs furloughed in both the distribution and accommodation and food sectors, with two other sectors reporting more than 100,000 furloughed jobs.[3] So the end of the CJRS may have gone some way to relieving any sectoral imbalances between the demand for, and supply of, workers.

Gauging the effect of strong labour demand on wages has been clouded by comparisons with weak pay growth in 2020. Average regular pay rose 4.9% y/y in the three months to September, well in excess of pre-pandemic rates of 2.5%-3%. But the fact that several million more workers were furloughed a year earlier (many of whom were on 80% of normal salaries) boosted the y/y comparison. The ONS estimated that underlying pay growth (excluding base effects) picked up to between 3.4% and 4.9% in August. So wages appear to be growing quite strongly, if not at the heated pace suggested by the headline numbers.

Lower government borrowing, but higher spending and taxes are on the way

The public finances have also enjoyed the fruits of the economic recovery. Public sector net borrowing in the first seven months of the current fiscal year (2021–22) came in at £127.3b, down from £230.7b in April–October 2020. Granted, the rate of improvement seen so far this year is unlikely to persist. Government debt interest costs have recently gone up sharply, reflecting higher yields on both conventional gilts (as expectations of a rate hike by the BoE have grown) and index-linked debt, as inflation has picked-up. That said, the October forecast from the Office for Budget Responsibility (OBR), published alongside the Budget on

[3] HMRC, Coronavirus (COVID-19) statistics, 4 November 2021. gov.uk/government/statistics/coronavirus-job-retention-scheme-statistics-4-november-2021

27 October, cut predictions for government borrowing in 2021–22 to £183b (7.9% of GDP) from £233.9b (10.3% of GDP) expected in March. And the forecast deficit in 2022–23 was reduced to £83b from £106.9b.[4]

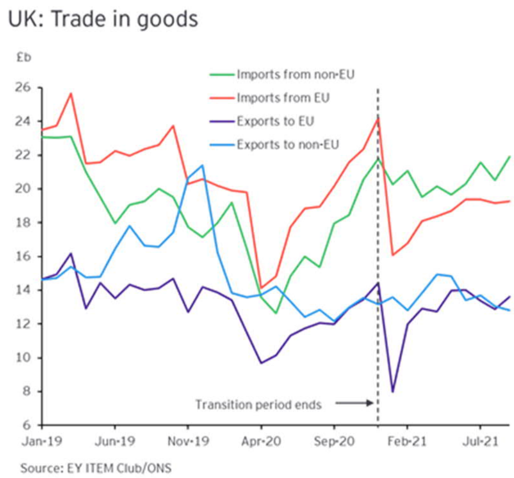
Although October's Budget relaxed the degree to which fiscal policy will be tightened over the next few years, it was relatively light on big policy shifts.[5] This was unsurprising, following some major fiscal developments over the autumn. One was the end of most government support schemes introduced during the pandemic, notably the CJRS which closed on 30 September. As of September, government support to households and businesses since March 2020 was estimated to have cost £370b, equivalent to 16% of 2019 GDP.[6]

September also saw the Government announce extra money for health and social care, funded by a rise in National Insurance Contributions (NICs) and dividend taxation.[7] A 'Health and Social Care Levy' will take effect in April 2022, adding 1.25% to the rate of both employee and employer NICs, with the levy also applying to the earnings of workers over the state pension age (which were previously exempt from NICs). The rate of tax on dividends will also increase by 1.25%. In total, the tax rises set out in September will yield around £14b per year from 2022–23.

The package of health and social care spending and tax rises was accompanied by the suspension of the average earnings component of the pensions 'triple-lock' for one year (2022–23). Since the triple-lock was introduced in 2010, the state pension has increased each year by the higher of growth in average earnings, CPI inflation or 2.5%. Excluding the average earnings component avoided what would have been an 8% rise in pensions next April based on a highly distorted measure of average earnings, as pay growth was exaggerated by workers returning from furlough and job losses during the pandemic being concentrated in low-paid roles. The state pension will now rise by an inflation-linked 3.1%, saving the Exchequer around £6b annually.

UK–EU trade has seen some post-Brexit recovery, but peculiarities in the data remain

After trade between the UK and EU initially plunged following the end of the Brexit transition period on 1 January 2021, flows of goods saw some recovery, a trend which broadly continued over the summer. But a surprising, and, so far, not easy to explain divergence between export and import performance has persisted. As of the three months to September, UK goods exports to the EU were almost 4% above the (pre-Brexit) level in the second half of 2020. Non-EU exports were 2.6% higher. But goods imports from the EU were 9.1% lower, a sharp contrast with a 14% rise in imports from countries outside the EU.



Some of the divergence could reflect measurement issues. Prior to Brexit, some imports from non-EU countries may have been shipped to the UK via EU ports and so have been recorded as EU imports – the so-called 'Rotterdam effect'.[8] Brexit may have seen some of those imports come directly to the UK. UK demand switching to domestic suppliers ('import substitution') or non-EU sources may have also played a role. As might supply-chain disruption – vehicle production has been hard hit by a shortage of semiconductors, and around 80% of UK vehicle imports come from the EU.

That goods imports from the EU will soon face new border frictions could prompt the divergence between export and import performance to widen. The Government announced in September that full customs declarations and controls will be introduced, as previously planned, on 1 January 2022. But some new requirements have been delayed again. Paperwork and checks for EU farm products that were due to be

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[4] Office for Budget Responsibility, Economic and Fiscal Outlook, 27 October 2021. obr.uk/download/economic-and-fiscal-outlook-october-2021/

[5] HM Treasury, Autumn Budget and Spending Review 2021: A stronger economy for the British people, 27 October 2021. assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1029973/Budget_AB2021_Print.pdf

[6] National Audit Office, COVID-19 cost tracker, September 2021. nao.org.uk/covid-19/cost-tracker/

[7] HM Government, Build back better. Our plan for health and social care, September 2021. assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1015736/Build_Back_Better-_Our_Plan_for_Health_and_Social_Care.pdf

[8] Giordano Mion and Ana Rincon Anzar, Economic Statistics Centre of Excellence, The 'Rotterdam-Antwerp Effect' in the Context of UK Trade Statistics. escoe.ac.uk/projects/the-rotterdam-antwerp-effect-in-the-context-of-uk-trade-statistics/

imposed from October will not be introduced until next year. And certification and physical checks on food and animal goods designed to protect against diseases, pests and contaminants – due to be introduced on 1 January – will not now come in until July 2022.[9] These delays will give firms more time to prepare, hopefully reducing the cost of new checks.

3. The forecast sees a less heated rebound in GDP

Having taken a much more optimistic view of growth this year and next in July's EY ITEM Club forecast report, we have reined some of that optimism back in in our latest projections. We now expect the economy to grow 6.9% this year, down from the 7.6% expected in July. Activity proved more buoyant in the first half of 2021 than even our relatively bullish summer forecast anticipated. But Q3 went the other way, proving unexpectedly sluggish. And the adverse consequences of a faster-than-expected rise in inflation and more widespread supply bottlenecks will increasingly bear on growth as this year comes to an end.

The odds of the economy performing softly around the turn of this year and early next will drag on calendar-year growth in 2022. We have downgraded our 2022 growth forecast to 5.6% from 6.5% previously. We now expect the economy to match its pre-pandemic size during Q1 2022, a quarter later than in our summer forecast. But this would still be well ahead of predictions at the start of this year. And forecast growth over 2021 and 2022, if achieved, would be the fastest over any two-year period since the Second World War. As the economy approaches its pre-COVID-19 trajectory, growth slows to 2.3% in 2023 and settles at around 1.8% in 2024 and 2025. This is more bullish than some other forecasters, reflecting our view that economic scarring from the pandemic should be minimal and that policymakers going forward will be more concerned about growth and running a high-pressure economy compared to the 2010s, when fiscal austerity and supply-side pessimism were dominant.

Consumer spending faces a battle between cost-of-living pressures and strong household balance sheets

In July, we were particularly upbeat on prospects for consumer spending. Beyond the mechanical boost provided by the reopening of previously shuttered parts of the services sector, that view reflected two factors. One was resilient household incomes, helped in part by a jobs market coming out of the crisis remarkably little damaged. The second was the scope for households to draw on substantial 'excess' savings accumulated during lockdowns. Consumption did see a healthy 7.2% q/q rise in Q2 as COVID-19 restrictions were relaxed. And high-frequency measures, such as spending on credit and debit cards, pointed to a further improvement over the summer.

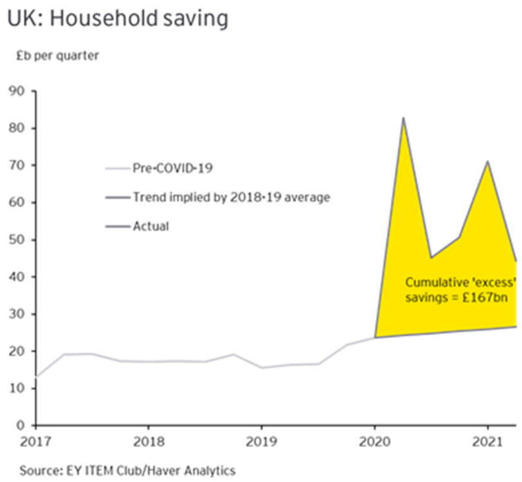
However, the outturn for Q3 was a softer than expected 2% q/q increase. And growth is likely to slow further. Inflation is set to be higher for longer than we thought (an issue explored in more detail in Section 4), largely because of more expensive energy and fuel. This means prospects for real household income growth have dimmed. We now expect CPI inflation to peak at a decade-high of almost 5% early next year, a percentage point and a half above our July forecast, and remain above 3% until the second half of 2022. That inflationary pressures are concentrated in the price of essentials will likely exacerbate the drag on consumption. UK households spend an average of around £2.8b per month on electricity, gas and other fuels, and a similar amount on petrol (using 2019 data). Total retail spending, excluding fuel, is roughly £33b per month. So all else being equal, every 5% rise in energy and fuel costs could depress other retail spending by around 1%, by forcing people to divert spending from other goods and services.

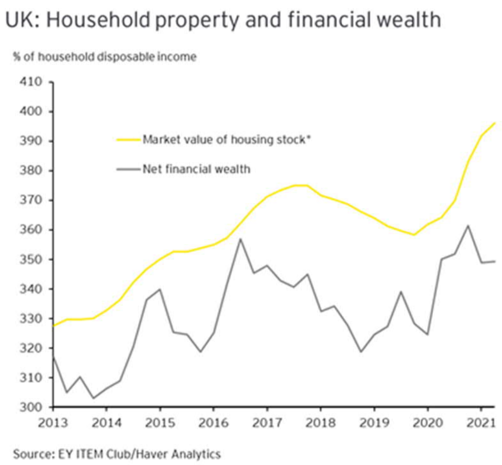
And inflation is not the only force weighing on spending power. The temporary £20 per week increase in Universal Credit (UC) introduced in March 2020, ended last October. On average, the 4.4m affected households have lost over 5% of disposable (after housing costs) income. For 1m households (almost one-in-four of those affected) losses are over 10% of income.[10] While the Chancellor's decision in October's Budget to reduce the rate at which UC is tapered will go some way to offsetting the hit to incomes, an estimated 73% (or 3.6m) of families on UC will still be worse off than they would have been absent the Budget changes but if the £20-per-week uplift had been retained.[11] Moreover, April 2022 will see the introduction of the Health and Social Care Levy. Those earning above the minimum income threshold for NICs will pay an additional 1.5% of

[9] HM Government, Government sets out pragmatic new timetable for introducing border controls, 14 September 2021. gov.uk/government/news/government-sets-out-pragmatic-new-timetable-for-introducing-border-controls
[10] See Torsten Bell, Adam Corlett and Daniel Tomlinson, Resolution Foundation, To govern is to choose: The choices facing the Chancellor this autumn, September 2021. resolutionfoundation.org/app/uploads/2021/09/To-govern-is-to-choose.pdf
[11] Mike Brewer, Karl Handscomb and Lalitha Try, Resolution Foundation, Taper cut: Analysis of the Autumn Budget changes to Universal Credit, November 2021. resolutionfoundation.org/app/uploads/2021/11/Taper-cut.pdf

their salary in tax, a loss of £6b across all workers. And if evidence from other countries on the effect of payroll tax hikes is anything to go by, employers may end up passing on the cost of the 1.5% rise in employer NICs to their staff via lower wages.[12]

In theory, households drawing on savings could insulate consumption from pressures on incomes. The household saving ratio fell from 18.4% in Q1 2021 to 11.7% in Q2, implying some return to more 'normal' savings behaviour over the spring and summer. But this left the ratio still high by historical standards. In cash terms, 'excess' household savings (i.e., the level of household savings relative to what a continuation of the pre-COVID-19 trend would imply) were around £170b in Q2, equivalent to almost 11% of annual household incomes and 10% of spending. And timelier data on cash held by households in bank deposits suggests excess savings grew over the summer and early autumn. Higher savings, along with rapid rises in house prices, have contributed to a surge in household wealth. Household net wealth (housing and financial assets minus liabilities) reached an estimated £11.4t in Q2 2021, up from £10.2t in Q1 2020. This was equivalent to almost 750% of household income, a record high, and a supportive prop for consumer spending.





However, the bulk of extra savings, as well as financial and other assets, are held by higher-income households.[13] But it is households at the lower end of the income scale who are most exposed to rising prices for energy and other essentials. In 2020, food, electricity and gas accounted for 22% of average weekly spending by households in the bottom fifth of all earners. The share for households in the top fifth of the income distribution was 10 percentage points lower. So plentiful savings and higher wealth levels will help protect some households from the pernicious effect of higher inflation. But the distribution of savings and wealth mean consumer spending will not escape unscathed. Lower-income households may be compelled to cut spending on discretionary items to meet the rising cost of energy and other essentials.

Amid a less supportive environment for consumption, one saving grace should be the labour market. The strength of demand for workers indicated by record vacancy numbers and falling redundancies leaves us confident that the end of the furlough scheme caused only a modest rise in unemployment. This confidence has been strengthened by survey evidence from the ONS, whose findings suggest that, as of late October, 87% of furloughed employees had returned to work. Only 3% had been made permanently redundant, while 3% had voluntarily left their role and 8%

[12] Jonathan Deslauriers, Benoit Dostie, Robert Gagné and Jonathan Paré, IZA Institute of Labor Economics Discussion Paper Series, Estimating the Impacts of Payroll Taxes:
Evidence from Canadian Employee-Employee Tax Data, June 2018. ftp.iza.org/dp11598.pdf
[13] See Jack Leslie and Krishan Shah, Resolution Foundation, (Wealth) gap year: The impact of the coronavirus crisis on UK household wealth, July 2021. resolutionfoundation.org/app/uploads/2021/07/Wealth-gap-year.pdf

were classed as 'other'.[14] What appears to be a very muted effect from furlough's end leads us to forecast the LFS unemployment rate rising only modestly to 4.6% early next year, before starting to fall from Q2 2022 onwards.
Strong demand for workers should keep pay growth running at just above pre-COVID-19 rates over the next year or two. The fact that the National Living Wage will rise 6.6% next April will boost the incomes of those at the lower end of the pay scale. But notwithstanding a decent job and pay outlook, the net effect of the various influences on incomes points to household disposable incomes seeing an outright fall around the turn of 2021 and 2022. As inflation falls back, real income growth should return. Consumer spending is forecast to grow 3.9% this year, followed by a 6.8% rise in 2022.

Business investment has been slow to recover, but ingredients for a revival still look favourable

Business investment has been slower to recover than consumer spending. Following a 9.3% q/q drop in Q1, spending by firms on fixed assets such as machinery, buildings and intellectual property saw a revival in the second and third quarters. But growth of 4.5% q/q and 0.4% q/q respectively left the level of investment in Q3 still almost 12% below that in Q4 2019.

However, business surveys have reported more robust investment intentions in recent months as firms have responded to strengthening demand. For example, the BoE's regional agents reported over the summer that the balance of firms intending to increase investment was at the highest on record. The strong financial position of firms, in aggregate, should support a further pick-up in investment. Many large companies have paid down bank debt during the pandemic, and the corporate sector has accumulated large 'excess' cash holdings. Outlays on wages, dividends and investment fell during the pandemic while revenues were shielded by government aid, including the Job Retention Scheme.

As a result, corporate profitability was remarkably unscathed by the crisis. For non-financial companies, profits over the period Q2 2020 to Q2 2021 were 1% higher than during the five quarters to Q1 2020. The net result was that non-financial companies' holdings of bank deposits rose £130b between March 2020 and August 2021. This was almost £110b (around 5% of GDP, or half a year's worth of business investment) higher than if the average monthly increase during 2018 and 2019 had continued.

The two-year 'super-deduction' tax incentive, which took effect in April, should encourage firms to make use of this cash and bring forward capital spending. That said, this faces off against the longer-term disincentive posed by a rise in the corporation tax (CT) rate from the current 19% to 25% from April 2023. This will be the first increase in the main rate of CT since 1973 and takes the UK from having the joint fourth-lowest corporate tax rate among OECD economies at present to being in the upper half of the international league table, absent any changes to other countries' rates.

But overall, we think the elements are still in place for a strong rebound in investment. The weakness of investment so far this year points to fall of just over 1% in 2021. But growth is forecast to surge to almost 14% in 2022. That said, after years of weak GDP gains, Brexit and two 'once in a lifetime' economic shocks in little more than a decade, sustaining rapid investment growth in the longer term could be harder.

Fiscal and monetary policy will not be as supportive going forward

The recovery has, so far, been aided by exceptionally stimulative fiscal and monetary policy settings. But much of the discretionary support to households and businesses from fiscal policy has now gone, as COVID-19 support schemes were phased out over the autumn. The BoE will end the current programme of asset purchases, which began in November 2020, at the end of this year. And the MPC looks like it will raise interest rates sooner rather than later. However, we think the recovery is sufficiently well entrenched that it can withstand the withdrawal of policy support.

On the fiscal side, help is not over quite yet. Extra public spending and other measures outlined in the Budget in October will relax the degree to which fiscal policy is tightened over the next few years, by 0.8% of GDP in 2022–23 and 0.7% of GDP in 2023–24, declining to 0.2% of GDP in 2026–27. Applying the OBR's estimated fiscal multipliers, the economic effect of the Budget announcements should be to raise the level of GDP by a peak of around 0.4ppts in 2022–23 compared to previous fiscal plans.[15]

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[14] Office for National Statistics, Business insights and impact on the UK economy, 4 November 2021. ons.gov.uk/businessindustryandtrade/business/businessservices/bulletins/businessinsightsandimpactontheukeconomy/4november2021

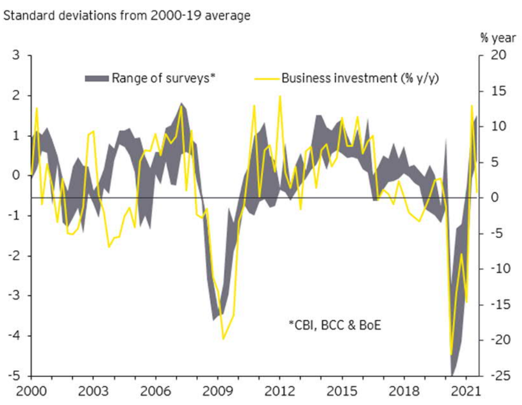
[15] Office for Budget Responsibility, Fiscal Multipliers, August 2017. obr.uk/box/fiscal-multipliers/

As we have noted, next April's Health and Social Care Levy could drag on consumer spending. However, since the money raised by the levy will be spent on public services, the net effect could be a small boost to GDP. At 0.3, the estimated multiplier effect of a rise in NICs on GDP is half that of higher government spending (reflecting the assumption that households and firms will partly pay higher tax bills by saving less, rather than the tax hike translating one-for-one into lower consumption or investment).[16] So the £12b or so of NICs-funded higher public spending from next year should also add around 0.2ppts to GDP.

That said, government borrowing is set to decline dramatically over the next few years from its pandemic-related peak in 2020–21. Some of this fall reflects a discretionary tightening in fiscal policy, following measures announced in the March 2021 Budget. Income tax thresholds will be frozen in cash terms for four years from 2022–23 onwards and April 2023 will see that substantial hike in the CT rate. However, the bulk of the decline reflects the Government no longer needing to act as 'spender of last resort', now that private sector activity is on the path back to its pre-pandemic trajectory.

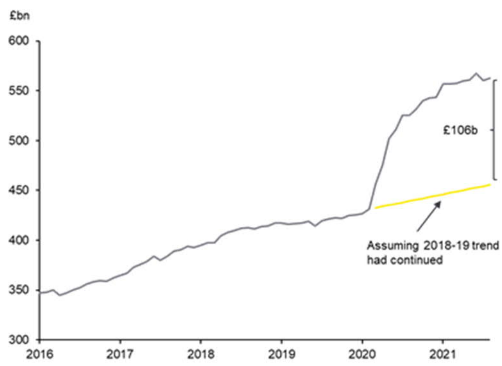
Turning to monetary policy, the autumn saw market pricing becoming increasingly aggressive towards the short-term path of UK interest rates. Following some hawkish comments from BoE Governor Andrew Bailey, as of late October, markets were pricing in not only a rate hike at the subsequent meeting in November, but also an expectation that Bank Rate would reach 1% before the end of 2022. The fact that the MPC chose not to raise rates in November saw investors' expectations of where borrowing costs were heading slip back.

UK: Business investment



Source: EY ITEM Club/Haver Analytics

UK: Non-financial corporate deposits



Source: EY ITEM Club/Haver Analytics

Given the hawkish rhetoric we have heard from the Governor and some others on the MPC, and the tone of November's policy statement, a rise in Bank Rate in December's meeting from the current 0.1% is a live possibility.

But we think the committee will want to wait a bit longer. In the minutes of September's MPC meeting, most members said they wanted to assess the impact of the end of the furlough scheme before contemplating any change in policy.[17] However, the data to make a full assessment will not be available until early next year. And given that rising inflation is being driven largely by factors beyond the control of monetary policy, we think the MPC will judge the risk of continuing a wait-and-see policy to be acceptable.
As a result, we think the committee will pause until next February before raising Bank Rate to 0.25%. February will see the BoE's next set of forecasts published and it will hopefully be clear by then that the jobs market has not been badly damaged by the end of furlough. If next February does see rate 'lift-off', there is a good chance the MPC will hike again in August 2022, leaving Bank Rate at 0.5% by the end of 2022. But this would still leave the official interest rate below the level in early 2020, immediately before COVID-19 struck.

[16] Ibid.

[17] Bank of England, Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 22 September 2021, 23 September 2021. bankofengland.co.uk/-/media/boe/files/monetary-policy-summary-and-minutes/2021/september-2021.pdf

COVID-19, savings behaviour, supply-chain problems and inflation all present risks to the outlook

The combination of the more transmissible Delta variant and the removal of almost all social distancing restrictions has meant COVID-19 infections have remained high in recent months. But the UK's rapid vaccination programme appears to have curbed the rise in hospitalisations compared with previous waves. Cases could increase further over the winter as the weather cools and there is greater indoor mixing. This could damage consumer confidence and discourage social consumption. And the reimposition of some restrictions 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 shuttering sectors again.

Another risk concerns the savings built up by households. The fact that savings have continued to grow by more than normal in recent months, despite the lifting of COVID-19 restrictions, could foreshadow a persistently more cautious attitude on the part of consumers and a less-strong rebound in consumer spending than we anticipate. Conversely, if the UK moves through the winter and into next year with the public health impact of COVID-19 under control and new virus restrictions avoided, consumer spirits could be boosted, yielding a stronger recovery in consumption.

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

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

	GDP	Domestic demand	Consumer spending	Fixed investment	Exports	Imports
2019	1.7	1.6	1.3	0.5	3.4	2.9
2020	-9.7	-10.1	-10.8	-8.3	-14.7	-16.8
2021	6.9	8.1	3.9	6.3	-2.3	1.5
2022	5.6	5.1	6.8	6.0	10.1	9.4
2023	2.3	2.2	2.3	3.1	4.0	3.7
2024	1.8	1.9	2.0	1.3	2.2	2.4
2025	1.8	1.9	1.8	2.5	2.0	2.2
	Net Govt Borrowing (*)	Current account (% of GDP)	Average earnings	CPI	Bank Rate	Effective exchange rate
2019	2.5	-2.7	3.4	1.8	0.8	78.2
2020	14.9	-2.6	1.8	0.9	0.2	78.1
2021	7.8	-2.3	5.2	2.5	0.1	81.6
2022	3.3	-1.9	2.7	3.6	0.3	82.4
2023	2.3	-1.8	2.9	1.7	0.7	82.2
2024	1.7	-1.8	3.0	2.0	1.0	81.8
2025	1.7	-1.8	3.0	2.0	1.3	81.4

* Fiscal years, as % of GDP

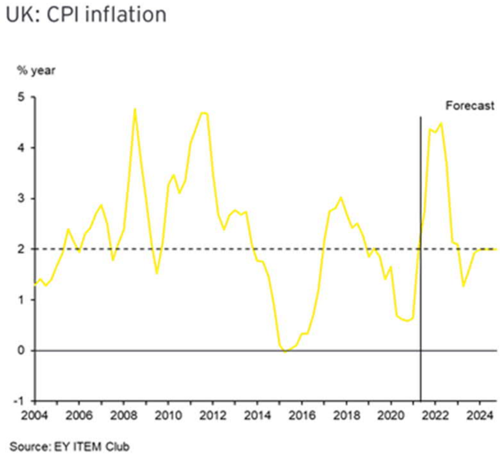
Source: EY ITEM Club

Supply-chain bottlenecks might also constrain activity more than we anticipate. Although domestic labour shortages should have been eased by the end of the furlough scheme, some sector-specific issues, such as a lack of HGV drivers, will take longer to resolve. Similarly, component shortages in the manufacturing sector could last well into next year, and their impact on the supply chain could be larger than expected. At worst, supply-chain problems could cascade, via a combination of companies over-ordering components, a lack of warehouse space, containers being withdrawn from circulation for storage and overworked employees in the distribution sector demanding big pay rises or quitting.

Finally, there is the issue which has increasingly occupied the attention of economists and the commentariat – inflation. Consumer prices could rise faster than we expect, off the back of commodity prices picking-up further, inflation expectations among the public breaking upwards and labour shortages promoting an acceleration in pay growth. In this world, consumers would struggle more to maintain real incomes in the face of higher prices, and domestic demand would be hit. And asset prices would suffer as markets anticipated a more aggressive tightening of monetary policy.

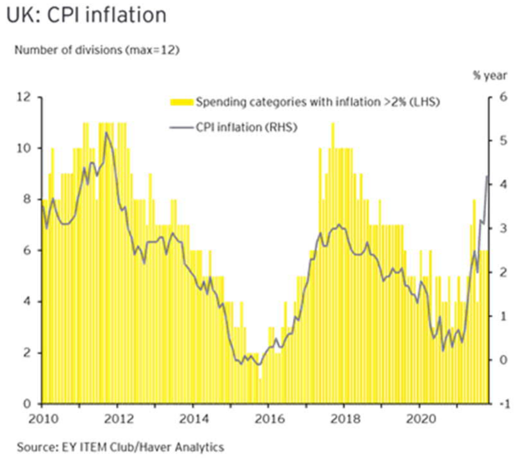
4. Inflation set to be higher for longer, but ‘stagflation’ fears are overdone

Section 3 outlined some of the factors behind our new forecast. GDP growth this year and next is predicted to be less strong than previously hoped, but still rapid by historical standards. The strength of household balance sheets, alongside low unemployment, should maintain a degree of momentum in consumer spending, even in a world of squeezed household incomes. A decent outlook for consumption, combined with tax incentives, should provide strong foundations for growth in business investment. And the extra public spending announced in October’s Budget means fiscal policy will not be as much of a drag as previously thought. So we are not aligned with at least the ‘stagnation’ element of ‘stagflation’ concerns.



But while a rapid slowdown in GDP growth is unlikely, the outlook for inflation has deteriorated. CPI inflation jumped to 3.2% in August from 2% in July, the biggest monthly rise since records began in 1989. Inflation was running at only 0.7% at the start of this year. Growth in consumer prices slipped back to 3.1% in September, but then rose to 4.2% in October, a near-ten-year high. We expect CPI inflation to peak at nearly 5% in early 2022 and remain above 3% until the second half of next year.

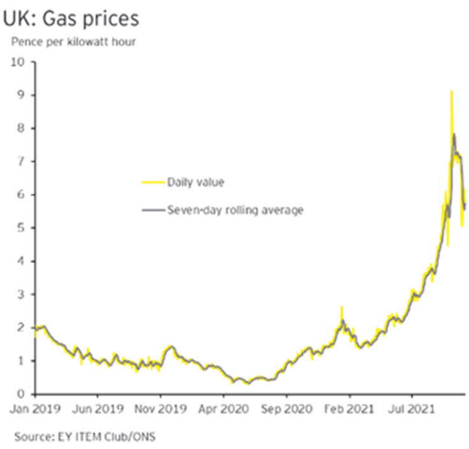
Forces driving inflation still appear to be short term



While inflation is set to be higher for longer, we still sit in the ‘transitory inflation’ camp. For one, most of the forces driving inflation up still appear to be temporary in nature. The record jump in the CPI measure in August was largely caused by base effects: the Eat Out to Help Out (EOHO) scheme lowered restaurant prices a year earlier, and August 2020 was the first full month of the temporary cut in VAT for hospitality. And price rises in the UK have remained relatively localised – we have not yet seen the rapid and sustained increase in the general price level which arguably defines high inflation. In August, September and October 2021, only half of the 12 official categories of household spending saw prices rise by more than 2%. This was no different to the average share over the previous decade.[18]

Also, rising inflation has remained more marked in goods than services. In October, goods price inflation was 4.9% – three times the 2010–19 average. But a 3.3% y/y rise in the price of services was only slightly above the 2010–19 average of 3%. Relative demand for goods and, consequently, goods price inflation, has been boosted by consumers’ inability or unwillingness to spend on services, particularly those involving face-to-face activities. And the production of goods has been particularly vulnerable to disruption from shortages of raw materials and components and transport bottlenecks. A good example is second-hand cars. A shortage of new vehicles, as manufacturers have struggled to get hold of semiconductors, has triggered strong growth in the demand for, and price of, used vehicles. In October, used car prices were up a huge 22.9% on a year earlier. This accounted for one-eighth of the rise in overall consumer price inflation that month, despite used vehicles having a weight of only 1.6% in the basket of goods and services used to measure inflation. Over time, as consumer spending patterns normalise, demand is likely to rotate from goods (putting downward pressure on goods prices) back to services, where inflation tends to be less responsive to demand pressures.

[18] These categories are grouped by national statistical agencies under the classification of individual consumption by purpose, or COICOP.



A key factor in inflation rising faster than we expected a few months ago has been energy. Petrol prices increased strongly over the summer, partly reflecting a higher oil price (which, as of mid-November, was running at $83 for a barrel of Brent Crude, a three-year high). But an unusually large gap between retail petrol prices and the sterling oil price has also played a role. The pre-tax pump price in October was about 9p per litre higher than that implied by the historical relationship with the price of crude – a hefty gap given that the pre-tax element of the price per litre was only 55p.

Meanwhile, demand and supply factors across Europe have propelled gas prices upwards. This contributed to the energy regulator Ofgem's energy price cap rising 12% on 1 October, a much larger increase than had looked likely earlier this year. Although electricity and gas bills have a weight of less than 3% in the CPI basket, October's increase in the cap added around 0.3ppts to the inflation rate. As industrial energy users might pass on these higher costs to customers, this could also boost inflation. And movements in wholesale gas point to another double-digit rise in bills when Ofgem next changes the price cap in April. But if energy prices do not continue to increase indefinitely, the influence of recent rises will start to drop out of the annual inflation comparison in the second half of 2022.

Supply problems are looking more persistent, but not permanent

Still, the threat of a rolling series of temporary inflation shocks stretching well into 2022 has increased. Though some of the global bottlenecks facing industry should soon start to ease, many sectors are likely to face disruption for much of next year. And should vaccine efficiency wane, and some parts of the world, particularly in south-east Asia, stick to 'zero COVID-19' policies, global supply disruption could be prolonged.

Some have argued that localised pressure on prices from supply problems will ultimately turn into generalised inflation. In June, Andrew Haldane, then BoE Chief Economist, claimed this to be one of the "laws of economic gravity".[19] But he did not expand on the mechanism behind this 'law' or provide evidence to support his claim. We think a countervailing force to Haldane's argument is the price mechanism. Localised price and wage rises and shortages should bring about more supply, at least in some areas. For example, recent evidence of big pay rises for HGV drivers should encourage some qualified drivers who had left the haulage industry for alternative jobs to return, as well as attracting new recruits. Cost pressures should also incentivise firms to boost efficiency, for example via automation and using existing staff more efficiently. Or rising prices might encourage customers to do the economising themselves. Granted, this process will take time, and average inflation will increase in the meantime. Also, the price mechanism may not be effective in dealing with some of the more high-profile supply problems in sectors like semiconductors and energy. Here, scope for economising is limited and supply could take time to react to price signals. But imbalances between demand and supply, at least in some sectors, should eventually be resolved by market forces.

Not all risks to inflation point upwards

Nevertheless, the fact that inflation could rise faster and peak higher than our new forecast cannot be ruled out. One risk is that firms could respond to the introduction of the Health and Social Care Levy next April by trying to pass some of the £6b cost on to customers via higher prices. There is also uncertainty over the extent to which higher VAT for the hospitality sector will be passed on to consumers (the rate was reduced to 5% in July 2020 as part of the Government's package of measures to help businesses, but rose back to 12.5% in October 2021 and will return to the original 20% next April).

But not all risks are to the upside. If the northern hemisphere can avoid an unusually long and cold winter, gas prices might fall back quickly.[20] Indeed, as of mid-November, gas prices had already dropped 30% on the peak seen in the middle of that month, although they were still 160% up compared to the start of 2021.

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[19] Thirty years of hurt, never stopped me dreaming – 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

[20] Mike Fulwood, Financial Times, Surging gas prices likely to reverse course, 1 October 2021. ft.com/content/f2ca6690-0390-4374-a9d5-29caf2d651dd

Meanwhile, the structural arguments against higher inflation becoming a persistent problem have not gone away. The last 30 years of historically low and stable inflation are now embedded in price and wage setting behaviour in a way that would probably take a major shock or institutional crisis to undo. Indeed, while the public's inflation expectations have recently picked-up, they are still below the post-2010 average.

The BoE's long-established inflation target has probably helped in keeping expectations in check. Since the Bank was made independent in 1997, in periods of rising inflation, inflation expectations have tended to rise by less. And the UK is taking its foot off the monetary policy accelerator. Unlike the US Fed and the ECB, the BoE has already tapered asset purchases and will end them by the turn of the year, and we think interest rates will begin to rise within a few months.

Still, the public appears to be increasingly noticing inflation, if Google searches are anything to go by. This could prove a bad omen. One of the triggers for rising inflation in the 1960s and 1970s was the fading of 'money illusion' – as inflation began to creep up, workers became more aware that growth in pay was being eroded by rising prices and sought to offset that with larger pay demands. But the mechanisms for workers to collectively make big pay demands today in response to inflation are weak. Only 20% of workers, mostly in the public sector, were members of a trade union in 2020, down from a peak of over 50% in the late 1970s.

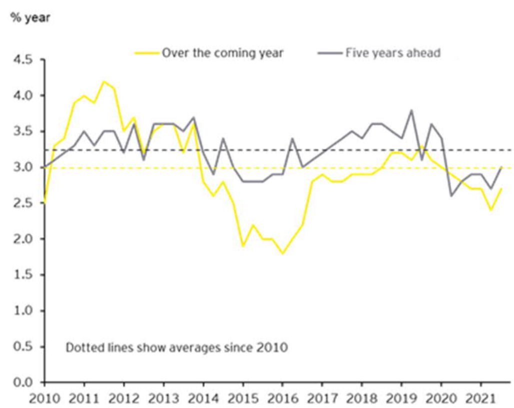
True, even if workers outside sectors experiencing labour shortages lack the power to demand higher wages, employers could respond to a rising cost of living by raising pay in order to discourage employees from quitting. Quit rates have picked-up sharply this year and, as of September, were above pre-pandemic levels. But the increase in resignations may be more to do with people re-evaluating career options – and being able to meet potential employers face-to-face since lockdowns ended – than cost of living concerns. But along with pay growth itself (when the data is free from COVID-19-distortions) and the standard surveys of inflation expectations, this is one measure to watch as a potential inflationary warning.

If wages do not keep pace with inflation, that is clearly bad news for households' spending power. But a consequent weakening in demand would then help in pulling inflation back down again. 'The solution to high prices is high prices' would be going too far, but this is another route by which the economy might adjust out of short-term inflationary difficulties.

5. Interest rates are heading up, but the economic impact should be smaller than in the past

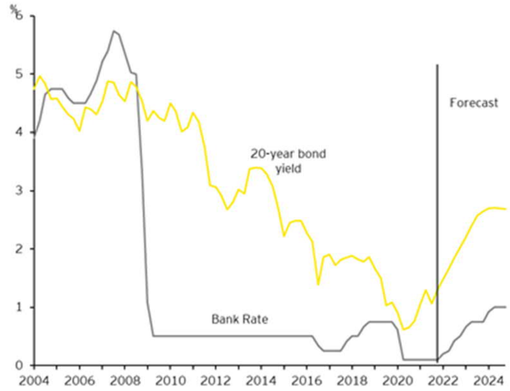
The MPC confounded market predictions by not raising interest rates in its November meeting. But higher borrowing costs do not look far away. With the economy set to be back to its pre-COVID-19 size around the turn of the year and unemployment hopefully little impacted by the end of the furlough scheme, the case for holding Bank Rate at the current 'emergency' level of 0.1% is weakening. And while the present bout of inflation should prove temporary, fears expressed by BoE Governor Andrew Bailey and other MPC members around higher inflation becoming embedded in price and wage setting behaviour, also offers a case for tightening monetary policy, if one which can be quibbled with.

UK: Inflation expectations among the public



Source: EY ITEM Club/Bank of England/Kantar

UK: Bank Rate and 20-year bond yield



Source: EY ITEM Club

We think the MPC will increase Bank Rate to 0.25% next February. Our forecast then sees a further 25 basis points (bps) rise to 0.5% in August next year, with a subsequent hike not occurring until early 2023. At that point, Bank Rate will be back to the level it was just before the COVID-19 crisis began.

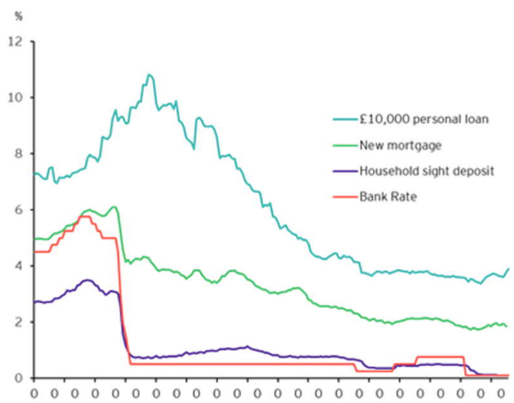
The fact that interest rates are likely to rise in a slow and gradual fashion should reduce any adverse impact on economic activity. As with other forecasters, such as the BoE, the model used by the EY ITEM Club includes an estimate, based on historical experience, of how the economy usually reacts to policy rate changes. The ITEM model suggests that every 25bps on Bank Rate cuts GDP by just under 0.2% and inflation by around 0.25% after two to three years. So our forecast for a 40bps rise in the Bank Rate by the end of 2022 has limited macroeconomic implications. In terms more relevant to the average mortgage holder, a 25bps rise in rates translates to approximately an extra £26 per month in mortgage payments on average for a tracker rate customer and £16 for the typical borrower on a standard variable rate. But higher mortgage payments will be starting from a very low base – interest payments on household debt absorbed 3.5% of the average household's income in Q3 2021, a record low (this ratio peaked at almost 13% in 1990).

But how the economy will respond to higher borrowing costs is more uncertain than it has been in the past. It is 15 years since the economy last faced a sustained rise in rates, in 2006 and 2007. But on balance, we think rising interest rates may have a more muted effect on activity than would have been the case previously.

One reason for this view is a considerable widening of the spread between the interest rate set by the BoE and market lending rates. Over 2006–07, the spread between Bank Rate and the average interest rate on a new mortgage averaged 29bps. Since the start of 2020, it has averaged 167bps. For a £10,000 personal loan, equivalent spreads were 230bps and 340bps. Certainly, interest rate margins in the mid-2000s were probably unsustainably tight, a symptom of the lax attitude among lenders that contributed to the financial crisis. But the fact that spreads today are much wider means that mortgage and personal lending rates may initially rise less in response to increases in Bank Rate than in the past.

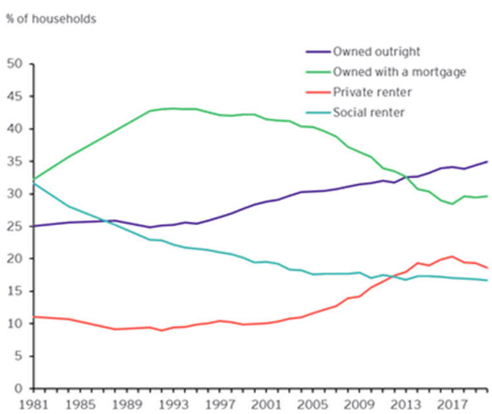
A second factor which should reduce the economy's sensitivity to interest rate changes is a fall in the number of households with a mortgage. In 2019–20, this group made up 29.7% of households in England, down from 38.9% in 2007. This was the lowest since at least 1981. This trend is likely to reduce the impact of a rise in interest rates, since movements in borrowing costs tend to have a bigger effect on spending among households with a mortgage than other groups. The move to fixed-rate mortgages over the last decade will also dampen the macroeconomic consequences of higher rates. The share of the mortgage stock with a fixed rate rose from 51% over 2007 and 2008 to almost 80% in Q2 2021.

UK: Interest rates



Source: EY ITEM Club/Haver Analytics

Housing tenure in England

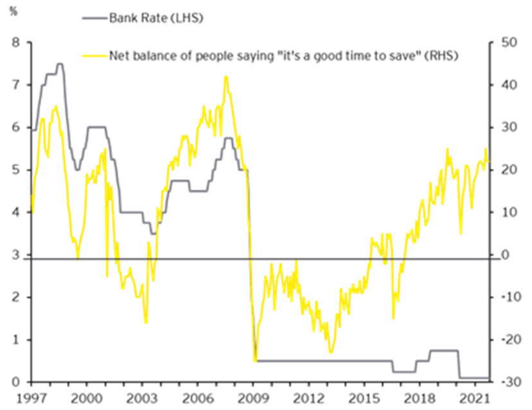


Source: EY ITEM Club/English Housing Survey

The combined impact of fewer households having a mortgage and those that do now largely holding fixed-rate debt is significant. 15 years ago, any rise in Bank Rate would have immediately impacted the finances of 20% of households. The proportion today is around 6%.

Psychology is a more uncertain factor. Given how much time has passed since interest rates rose on a sustained basis, how people might react to dearer money is harder to predict. Borrowers might overreact, interpreting even a small increase in Bank Rate as a sign that interest rates are headed back to levels considered normal before the financial crisis. Or some might see higher borrowing costs as a precursor to a sharp slowdown in the economy, resulting in a bigger than anticipated drop in spending. On that note, the recent rise in the GfK survey's balance of households that think it is a good time to save has not been significantly out of line with trends seen in past episodes where Bank Rate was heading up, or on course to do so. But this indicator is at the highest level since 2008, despite the policy rate being only 0.1%. The message is that the MPC should pursue a very gradualist approach to raising rates, which all the indications suggest it will do.

UK: Bank Rate and appetite to save



Source: EY ITEM Club/Haver Analytics

The focus of our discussion has so far been on the consumer side. Of course, businesses are also exposed to higher interest costs, if they hold bank debt. But as with households, companies are less vulnerable to rising rates than they were in the late 2000s. Corporate debt liabilities were equivalent to 75% of GDP in Q2 2021 (using 2019 GDP to avoid COVID-19-related distortions). But this was 20% of GDP lower than the peak reached in Q4 2008 and below the 2000-19 average of 81% of GDP.

Finally, there's the Government. There is a view that the debt interest payments on UK government debt are now much more sensitive to interest rates as a result of purchases of gilts by the BoE under its quantitative easing (QE) programme. The BoE pays commercial banks Bank Rate on the reserves it creates to finance gilt purchases. And it remits the interest it receives on the gilts it owns, net of payments to commercial banks, back to the Government. The OBR estimates that this will save the Government £17.8b in interest payments in 2021-22. [21] In the absence of QE, because of the long maturity of UK government debt, if the BoE raised short term interest rates this would have a very limited immediate impact on the cost of UK government debt. However, QE means that if the BoE continued to pay its policy rate on reserves, the cost to the public sector would rise much more quickly.

This argument is conditional on the BoE continuing to pay interest on reserves even as the policy rate rises. But it seems implausible that a situation would be tolerated where the BoE (via the UK taxpayer) was paying potentially billions of pounds of extra interest to commercial banks each year (the BoE will hold £875b of gilts by the end of 2021, so every 1% rise in Bank Rate would increase interest payments by the UK central bank by £8.8b). More likely is that the BoE would follow the example of the European Central Bank and Bank of Japan by paying interest on only a narrow part of commercial banks' reserves.[22] Or it could return to the pre-financial crisis situation, where interest was not paid on reserves at all.

[21] Office for Budget Responsibility, 'Debt maturity, quantitative easing and interest rate sensitivity'. 3 March 2021. https://obr.uk/box/debt-maturity-quantitative-easing-and-interest-rate-sensitivity/
[22] Karl Whelan, 'Are Central Banks Storing Up a Future Fiscal Problem?', 16 July 2021. https://karlwhelan.com/blog/?p=2087

6. Conclusions

The economy faces a tough winter. The chief threat to the outlook – higher inflation and the squeeze this will exert on spending power and consumer confidence – is intensifying. The prospect of another jump in energy bills next April, combined with the certainty of rises in personal tax, would make things even more uncomfortable. And elevated price pressures could inflict some indirect damage if the BoE is panicked into tightening monetary policy too soon and by too much.

In the near term, growth will be slower than we had hoped. But the emphasis is on slower, not coming to a halt. As supply-chain problems are ironed out by the operation of market forces and spending patterns rotate back to their pre-COVID-19 norm (more spending on 'fun' and less on 'stuff'), inflation, and the damage it inflicts on living standards, should ease. And growing economic headwinds will face off against several positives. Households' financial balance sheets are the strongest they have ever been and companies, overall, are sitting on large cash piles. The extra public spending outlined by the Chancellor in the Budget should offer some support to demand. And record job vacancies and hiring, and a strong upswing in firms' investment intentions, are not things one would expect to see in a recovery that was seriously faltering.

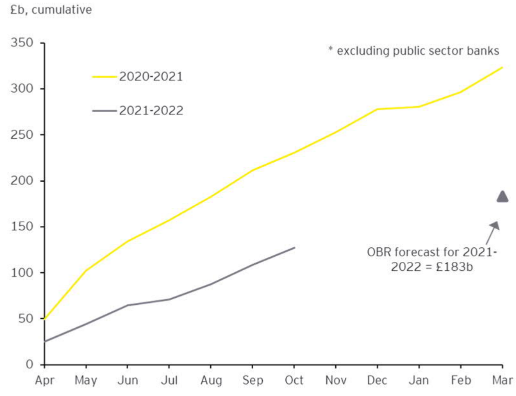
Economic commentators and forecasters underestimated the economy's resilience to lockdowns and the boost from reopening early this year. And there is a risk now that the positive factors which could support spending amid cost-of-living pressures, and the capacity of firms to adapt to supply-side frictions, are being underplayed.

But some humility on our part (and that of all forecasters) is in order. Emerging from an unprecedented shutdown and temporary collapse in output, the economy is in a highly unusual situation with no obvious historical parallels. And with COVID-19 infections in the UK still running in the tens of thousands each day and many countries still subject to social distancing restrictions, we do not yet have clarity over what the post-pandemic 'normal' will look like. So our latest forecasts have a bigger health warning attached than would typically be the case. But barring a catastrophic mutation in the COVID-19 virus, we'd probably use Mark Twain's famous words to describe prospects for the economic recovery – "reports of my demise have been greatly exaggerated".

Forecast in charts

Fiscal policy

UK: Public sector net borrowing*

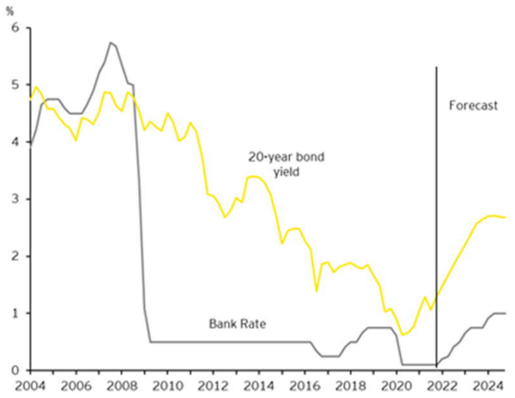


Sources: EY ITEM Club/OBR

- October’s Budget saw the OBR cut its forecasts for government borrowing. The Chancellor chose to use some of the ‘windfall’ to increase spending but banked much of the improvement.
- Borrowing in the first seven months of 2021–22 has come in well below levels for the same period last year. The OBR expects a full-fiscal year deficit of £183b or 7.9% of GDP.
- The Chancellor is likely to meet his new fiscal rules by a comfortable margin. This raises the prospect of pre-election tax cuts.

Monetary policy

UK: Bank Rate and 20-year bond yield

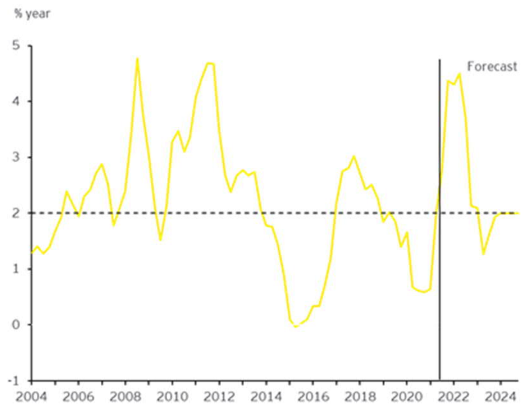


Source: EY ITEM Club

- The MPC confounded market expectations by not raising Bank Rate at its meeting in November.
- But language used in its policy statement implied that a rate hike is not far away. December is a possibility, but we think next February is marginally more likely.
- Waiting a few more months will allow the MPC to properly assess the impact of the furlough scheme’s closure. Thereafter, rates are forecast to rise at a modest pace.

Prices

UK: CPI inflation

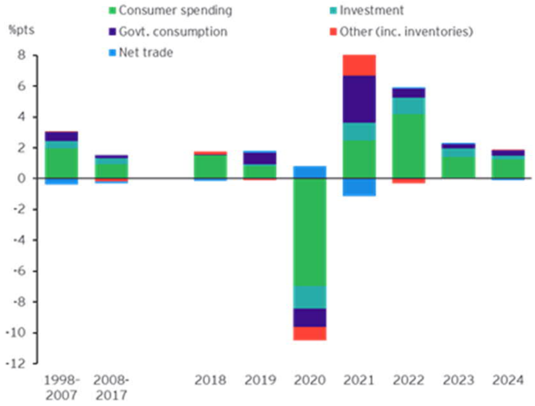


Source: EY ITEM Club

- Inflation jumped over the summer, reaching a nine-year high of 4.2% in October. Higher energy prices drove much of the increase.
- A likely jump in energy bills next April, alongside rising petrol prices and an increase in VAT for the hospitality sector, are set to push inflation up to nearly5% by early next year.
- But subject to energy prices not rising indefinitely and supply-side disruption easing, inflation should fall back over late 2022 and into 2023.

Activity

UK: Contributions to GDP growth



Source: EY ITEM Club

- While GDP performed better than expected in the first half of this year, several factors have combined to slow growth in H2 2021.
- The scope for catch-up growth has diminished, as output in different sectors has been held back by supply bottlenecks, and rising inflation will squeeze households' spending power.
- GDP growth is forecast at 6.9% in 2021 and 5.6% next year. The economy is expected to regain its pre-pandemic size during Q1 2022.

Consumer demand

UK: Real household income and spending

Source: EY ITEM Club

- The lifting of COVID-19 restrictions over the spring and summer triggered a strong rebound in consumer spending.
- Consumption growth slowed in Q3, reflecting disruption from higher numbers of COVID-19 infections and the 'pingdemic'. Momentum will now be tested by cost-of-living challenges presented by higher inflation and tax hikes.
- Consumer spending is forecast to increase by 3.9% this year and 6.8% in 2022.

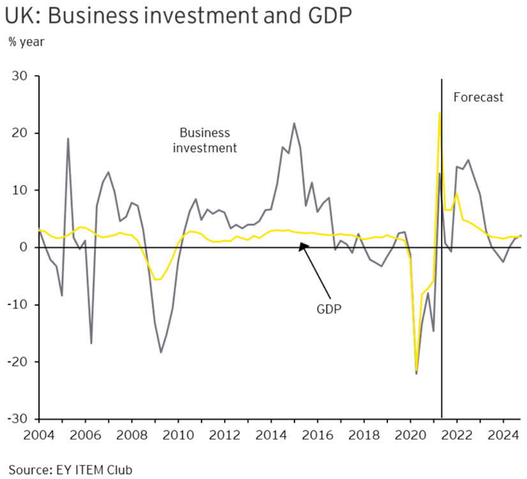
Housing market

UK: House prices

Source: EY ITEM Club

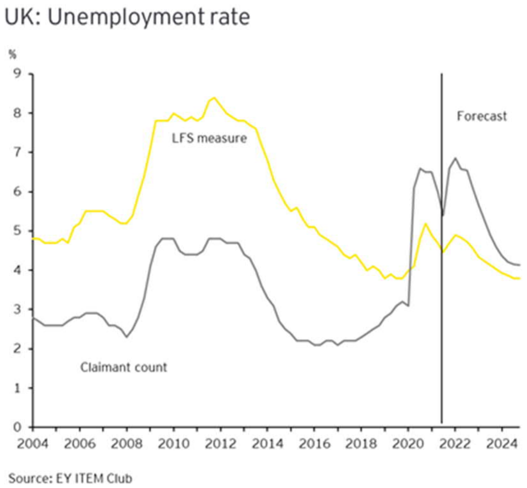
- The stamp duty holiday had a very distortionary impact on demand for houses, causing transactions to be brought forward and probably acting as a major factor behind the recent frothiness in house prices.
- Activity will probably be less heated in the near term. But other forces, including strong household balance sheets and demand for out-of-town properties, will support the market.
- Although we see house price growth decelerating over the next 12 months, we no longer expect an outright drop in values.

Company sector



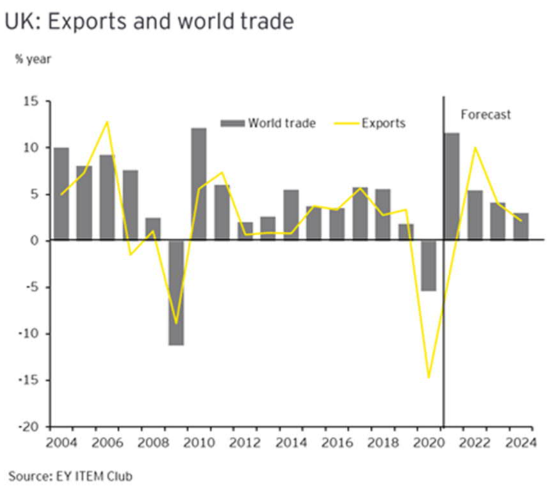
- ► The recovery in business investment has got off to a relatively sluggish start. Growth of 4.5% q/q in Q2 and 0.4% q/q in Q3 left investment still 12% below the pre-pandemic level in Q4 2019.
- ► A strong economic recovery, the incentive to invest offered by the 'super-deduction', and structural changes triggered by COVID-19 and Brexit, should see business investment rebound strongly.
- ► A weak start to 2021 holds back growth this year to a forecast 1%, accelerating to almost 14 in 2022.

Labour market and wages



- ► The official unemployment rate fell to 4.3% in Q3 2021. This was despite the number of furloughed employees falling by over 1m during the summer.
- ► The end of the furlough scheme may have triggered some job losses, but early evidence suggests the damage was small. The unemployment rate is forecast to peak at 4.6%.
- ► Earnings growth has been exaggerated by workers returning from furlough as well as changes in the composition of the workforce.

Trade and the balance of payments



- ► Net trade made a strongly negative contribution to GDP in Q3 2021.Exports fell 1.9% q/q but imports rose 2.5% q/q.
- ► This suggests that the current account deficit probably widened from 1.5% of GDP in Q2. We expect the deficit to average 2% of GDP in 2021.
- ► The current account is 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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