EY ITEM Club Spring Forecast

UK economy looks well placed for robust recovery to develop after resilient Q1 performance

April 2021

Building a better working world

Contents

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Foreword

What a difference a year makes

It's safe to glance backwards …

For the first time in what seems like forever, we can look back to 2020 and feel better. A year ago, we were in the dark about the future direction of the economy: forecasts were being downgraded on a daily basis; our understanding of coronavirus was nascent; and lockdown stretched ahead of us.

Fast forward and the vaccination programme continues at pace, lockdown restrictions are easing, and the economy has proven to be more resilient than we ever expected. Add in the additional support announced in the Budget, and the outlook is much better than we could ever have imagined 12 months ago.

… but even better to look ahead …

Without in any way wishing to play down the awful impact of the pandemic on individuals and society overall, the EY ITEM Club *Spring Forecast 2021* strongly suggests that at the level of the overall economy, we will emerge with much less damage than we expected. EY ITEM Club expects the UK economy to grow by 6.8% in 2020, a significant upgrade from its forecast of 5% expansion in its January forecast. Expected first quarter performance of a 1% fall in output rather than the 3% to 4% previously anticipated illustrates just how innovative and flexible UK businesses and consumers have been in adjusting to restrictions on activity.

It does appear that our economy will be less 'scarred' than some of the more pessimistic scenarios outlined. Most obviously, in the labour market. EY ITEM Club expects unemployment to peak at 5.8% in 2021 much better than the 8 to 9% estimates that formed the consensus 12 months ago. This is hugely important, as it suggests we will not have lost skills and capability in significant numbers and should have more scope to bounce back quickly.

A fall in business investment was a significant factor in the economic shock in 2020. With the Chancellor announcing enhanced capital allowances alongside increased public investment, EY ITEM Club expects 10% growth in fixed investment in both 2020 and 2021. Alongside the innovative solutions we have seen in health, logistics, pharma and technology, there is the potential for a strong corporate recovery. Reflecting these positive developments, EY ITEM Club now expects the UK economy to return to its pre-2020 levels in the second quarter of 2022, six months earlier than previously forecast.

… and plan for recovery and beyond

We are not out of the woods, but with EY ITEM Club forecasting further growth of 5% in UK GDP in 2022, businesses can start to plan for the possibility of two years of strong economic performance, with a very favourable tax regime to support capital investment. Once the return to more normal operations is achieved in the coming months, it will be important to take the time to understand how the new landscape is settling to shape longer-term strategies.

A staged approach makes sense as risks remain, both related to the pandemic through future outbreaks, and in areas that have been of concern for some time, including the impact of Brexit and increased geopolitical tensions. Although EY ITEM Club believes the recovery can be accommodated without any inflationary spike, there is more discussion of the risk of rising prices than for some time, and it would be wise to keep a close eye on input prices.

As we have noted before, we will remain in a policy-driven economy for some time with ‘levelling up’, the move to net zero and the drive to build Global Britain as the priorities. Understanding how these initiatives might impact the economy and what the opportunities arising could be will remain important for the foreseeable future.

PS And it’s goodbye from him. A message from Mark

Finally, I am hanging up my pen or whatever economists do, so this is the last EY ITEM Club forecast I will oversee. From the Global Financial Crisis, through the Eurozone Crisis, Brexit and finally the COVID-19 pandemic, it has been a fascinating if bumpy journey. Thanks for all your interest and support. I hope we have been of some use in shining a light on what, at times, was a very foggy world.

I look forward to watching how things evolve from the sidelines.

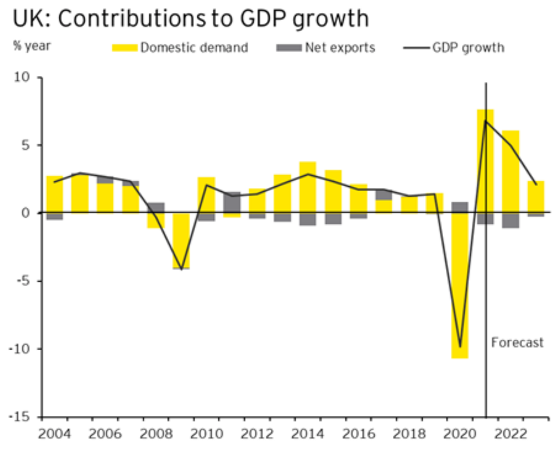
Highlights

- The EY ITEM Club *Spring Forecast 2021* sees a marked upward lift to our growth projection for 2021 to 6.8% from the 5.0% rate anticipated in our *Winter Forecast*, released in late January. This is the consequence of several factors. The economy held up better than had been expected in Q4 2020, and it also looks likely that GDP contraction in Q1 2021 was markedly less than had seemed probable, despite lockdown largely being in place through the quarter. Additionally, the Chancellor provided substantial further near-term fiscal support for the economy in March's Budget. Meanwhile, the Government has been able to set out a road map for the easing of restrictions in four steps due to end in late June, supported by the rapid rolling out of COVID-19 vaccinations.
- GDP grew 1.3% quarter-on-quarter (q/q) in Q4 2020 despite the economy facing major restrictions, including lockdown in November. This was better than the flat performance estimated in our *Winter Forecast* and meant the economy started 2021 on a firmer footing than anticipated. Furthermore, the economy seemingly showed greater resilience than had looked likely in Q1 2021, with GDP probably contracting by just over 1% q/q rather than by 3%–4% q/q as we had projected in January. Lessons have clearly been learned and experience gained in keeping activity going during lockdowns.
- A further positive for growth prospects is that the labour market has proved to be pretty resilient, supported by repeated extensions of the jobs furlough scheme. Indeed, the unemployment rate unexpectedly edged back to 5.0% in the three months to January, having trended up only gradually to 5.1% in the three months to December from 4.0% early on in 2020. With the furlough scheme now extended until the end of September and decent recovery expected to develop from Q2 2021 as restrictions are eased, we have reduced our expected peak in the unemployment rate to 5.8% from 7.0% previously. Furthermore, this relatively modest further rise in the unemployment rate will partly reflect currently inactive people returning to the workforce.
- Following an estimated contraction of just over 1% q/q in Q1 2021, we expect decent recovery to develop from Q2 as restrictions on activity are progressively eased in line with the Government's road map, supported by the ongoing roll-out of COVID-19 vaccines. Consumers are expected to play a leading role in the recovery as their purchasing power is buoyed by recent very high household saving ratios. After an extended period of weakness, business investment is expected to gain momentum over the course of the year as companies grow more confident in the economy. Business investment in both 2021 and 2022 should be supported by the tax incentive to invest.
- The recovery is seen continuing in 2022, although the GDP growth projection has been cut to 5.0% from the 6.5% rate that we anticipated in our *Winter Forecast*. This is primarily due to more growth being pulled forward into 2021 than we had previously expected. The economy is now seen returning to its Q4 2019 level in Q2 2022, six months earlier than we had previously expected.
- Consumer price inflation (0.7% in March) is expected to move markedly higher in the near term, primarily due to unfavourable base effects relating to the sharp fall in oil prices in the early months of 2020 and increased energy prices from April. A firming of the recovery will also likely have some upward impact on inflation as will the dilution, and then ending, of the temporary VAT cut for the hospitality and tourism sectors. However, inflation is not seen as becoming a major problem. Specifically, we expect consumer price inflation to approach 2% during Q2 2021 and to rise just above 2% during the second half of the year. However, the EY ITEM Club does not expect inflation to rise much above 2% as there will still be excess capacity in the economy and in the labour markets.
- Fiscal policy remains orientated in the near term to supporting the economy, with the Chancellor announcing a fiscal loosening of £65b over the next two fiscal years in March's Budget. This included extending the job furlough scheme to the end of September and a tax incentive scheme for companies investing in 2021/22 and 2022/23. The Chancellor also announced initial steps to be enacted further out to improve the public finances over the medium term. These steps notably included raising the corporation tax rate from 19% to 25% in 2023 and the freezing of income tax thresholds (after the April 2021 increase) until 2026. The massive cost of the Chancellor's supportive measures for the economy together with the major GDP contraction means that the budget deficit likely came in around £340b (16.2% of GDP) in 2020/21. It is seen as still being as high as £215b (9.2% of GDP) in 2021/22.
- The Bank of England has not made any further adjustments to monetary policy since enacting an additional £150b of asset purchases last November, which took the targeted total up to £895b. Interest rates remain at a record low of 0.10%. With decent recovery expected to get underway from Q2 2021 and inflation poised to pick up, we suspect that the Bank of England's ultimate next move will be to tighten monetary policy, initially through edging interest rates up. We believe the Bank is most likely to hold off from acting throughout 2021 but there is clearly a growing possibility that it could tighten monetary policy in 2022 — although at the moment, early 2023 seems more probable.

Introduction

The EY ITEM Club *Spring Forecast 2021* sees a significant upgrading of the outlook for the UK economy in 2021 compared to our *Winter Forecast*[1] released at the end of January. This is offset by expansion in 2022 being seen as less buoyant than previously anticipated, essentially due to some growth being pulled forward. Specifically, the GDP growth forecast for 2021 has been raised to 6.8% from 5.0%, while the 2022 projection has been cut to 5.0% from 6.5%.

The substantial raising of the 2021 GDP growth projection primarily reflects the economy holding up better than expected in Q4 2020, with it then likely contracting substantially less than had originally been feared in Q1 2021. Additionally, appreciable extra fiscal stimulus for 2021/22 was provided by the Chancellor in the March Budget. Meanwhile, further support for the economy is coming from the rapid roll-out of COVID-19 vaccines.



Source: EY ITEM Club

The economy held up even better than we had anticipated in Q4 2020 when it expanded 1.3% q/q despite the November lockdown and other very tight restrictions on economic activity. In our *Winter Forecast*, we had anticipated that the economy had been essentially flat over Q4 2020. Along with some modest revisions to the economy's performance over Q1–Q3 2020 made by the Office for National Statistics (ONS), this meant that UK GDP contracted 9.8% in 2020 (the largest decline for over 300 years) rather than by the 10.1% drop we had estimated.

So the economy entered 2021 from a stronger (or less weak) base than had looked likely at the time we produced our *Winter Forecast*. Furthermore, while the economy took more of a hit from the third lockdown (that essentially lasted fully through Q1 2021, aside from the opening up of schools on 8 March) than had been the case from the second lockdown in November, it looks highly probable that GDP contracted markedly less in Q1 than had been feared. It is evident that lessons have been learned and experience gained in keeping activity going during lockdowns. People have got used to working at home and companies to operating with them doing so. Significantly, many workplaces/offices/manufacturing plants/construction sites have been adapted to meet the COVID-19 social distancing requirements so that employees can still work there.

GDP contracted 2.2% month-on-month (m/m) in January compared to the consensus expectation of a drop of around 5% m/m. The economy then came modestly off its January low in February as GDP grew 0.4% m/m. In addition, activity looks to have taken significant steps forward during March as increasingly confident businesses prepared for the partial opening up of the economy on 12 April, and consumers looked to start releasing pent-up demand. Consequently, we now estimate that GDP contracted by just over 1% q/q in Q1 2021. This is markedly less than the contraction of around 3%–4% q/q in Q1 2021 GDP that we had anticipated in our *Winter Forecast*.

The Government has released a road map for the progressive easing of restrictions on UK economic activity. This will occur in four steps – with a minimum of five weeks between each step – which started on 8 March with the reopening of schools. There was also an easing of stay-at-home orders on 29 March. The second step, which occurred on 12 April, included the opening of non-essential retailers and the opening of hospitality venues for outdoor purposes only. Step 3 (to occur no earlier than 17 May) includes pubs and restaurants being able to open indoor facilities, while indoor entertainment venues and indoor leisure facilities can also reopen. Each step will see an easing of social contact restrictions, with those restrictions totally eliminated in Step 4, which is due to occur no earlier than 21 June.

This road map is expected to be supported and facilitated by the ongoing successful rolling out of the various COVID-19 vaccines. Substantial progress on this front has been made so far in 2021, and this is expected to largely continue – despite a possible near-term slowdown – with positive implications for business and

[1] *EY ITEM Club Winter Forecast: UK economy seen improving after difficult start to year*. EY. January 2021. See info.ey.com/UKI-UK-ALL-ED-2021-01-08-EY-ITEM-Club-Winter-Forecast_data-capture-form.html

consumer confidence.

Meanwhile, fiscal policy remains orientated to growth in the near term with the Budget on 3 March providing several further measures to support businesses and jobs in the near term. This notably included extending the jobs furlough scheme from the end of April to the end of September. Another significant move was the introduction of a temporary 'super deduction' tax break for companies under which firms can offset 130% of investment spending on eligible plant and machinery against profits in 2021/22 and 2022/23. The loosening implied by these and other additional supportive fiscal measures amounts to £65b over the next two fiscal years. However, Chancellor Sunak also announced initial steps to be enacted further out to improve the public finances over the medium term. These steps notably included raising the corporation tax rate from 19% to 25% in 2023 and the freezing of income tax thresholds (after the April 2021 increase) until 2026.

Monetary policy also currently remains strongly orientated to supporting growth. I Interest rates have remained at a record low of 0.10% (where they have been since March 2020), and the Bank of England is planning to continue undertaking asset purchases until the end of this year, bringing the planned total up to £495b. The Bank last enacted stimulative measures in November 2020 and we suspect that the case for further supportive action will wane from Q2 2021 onwards as recovery takes hold. Consequently, we believe that the Bank's eventual next move will be to tighten policy, initially through edging interest rates up from the current level of 0.10%. We expect the Bank to remain on the sidelines through 2021, and while there is a growing possibility that the Monetary Policy Committee (MPC) could decide to start tightening policy in 2022, we believe early 2023 is currently a more likely time for an initial move.

Consequently, the prospects look largely healthy for a decent recovery developing from Q2 2021 as restrictions on activity are progressively eased. Consumers look well placed to play a key role in the recovery given the recent high saving ratio, especially as it now looks likely that unemployment will rise much less than had been feared, helped by the extension of the furlough scheme. Additionally, after an extended period of weakness, business investment is expected to gain momentum over the course of the year as companies grow more confident in the economy. This should be supported by the tax incentive to invest which was unveiled in the Budget.

Assuming GDP growth of 6.8% in 2021 and 5.0% in 2022, the economy is seen as finally regaining its pre-COVID-19 level of Q4 2019 in Q2 2022.

Consumer price inflation (just 0.4% in February) is expected to move markedly higher in the near term, but it is not seen as becoming a major problem despite the recent heightened concerns evident in financial markets. Unfavourable base effects resulting from the fall in oil prices in the early months of 2020 will have a significant near-term upward effect on inflation. This will be magnified by oil prices trading at their highest level for 13 months in early March. In addition, energy prices will rise for many consumers from April following Ofgem's decision to raise the cap on the most widely used tariffs by 9.2%. An expected progressive firming of the recovery from Q2 2021 will also likely have some upward impact on inflation. Additionally, there will be some upward impact on inflation in October after the temporary VAT cut for the hospitality and leisure sectors is diluted to 12.5% from 5% at the end of September. There will be a further upward impact on inflation in April 2022 when the VAT rate rises back up to the full rate of 20% at the end of next March. Consequently, we expect consumer price inflation to approach 2% during Q2 2021 and to rise just above 2% during the second half of the year. However, the EY ITEM Club does not expect inflation to rise much above 2% as there will still be excess capacity in the economy and in labour markets.

Chancellor provided further near-term support to economy in March Budget

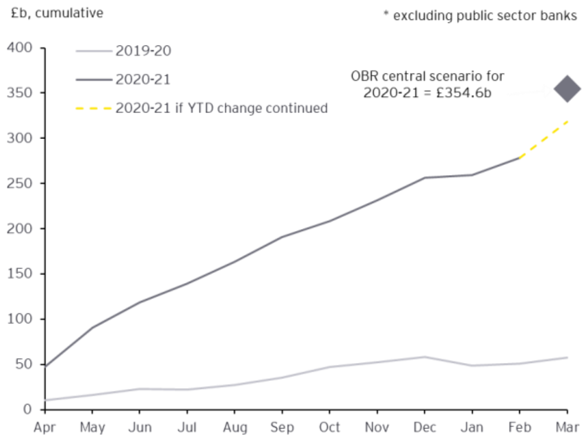
Fiscal policy currently continues to be very much orientated to supporting the economy in the near term, with Chancellor Sunak delivering a series of measures aimed at supporting businesses and jobs in his Budget on 3 March. While hopes are high that an ongoing rapid rolling out of the COVID-19 vaccinations will facilitate the Government achieving its road map of easing restrictions on the economy over the coming weeks and months, thereby fuelling economic recovery, there are currently still appreciable downside risks to the outlook. Significantly though, the Chancellor also announced some initial steps aimed at reining in the public finances over the longer term.

Specifically, in the Budget, the Chancellor announced measures totalling £65b over the next two fiscal years to support businesses and growth; this brought the total cost of the COVID-19 support measures to £407b.

Among the major measures announced in the Budget was the extension of the jobs furlough scheme from the end of April to the end of September. There was also an extension of help for the self-employed. Other measures included the extension of the VAT cut from 20% to 5% for the hospitality and leisure sector from the end of March to the end of September, and then to 12.5% until March 2022; the extension of the increased stamp duty threshold from £125,000 to £500,000 from the end of March to the end of June and then to £250,000 until the end of September; and a mortgage guarantee scheme for buyers with low deposits. The business rates freeze is extended until June and then rates will be cut by two-thirds for the rest of the year. The £20 weekly increase in Universal Credit is extended for six months.

A highly significant move was the introduction of a large temporary increase in capital allowances in 2021/22 and 2022/23 under which companies will be able to offset 130% of investment spending on eligible plant and machinery against profits. This was termed a 'super deduction' tax break for companies and should provide a very strong incentive to bring investment forward.

UK: Public sector net borrowing*



Source: EY ITEM Club/Haver Analytics/OBR

The major move announced in the Budget by the Chancellor aimed at improving the public finances over the medium term is raising the corporation tax rate from 19% to 25% in 2023. Another notable move is the freezing of income tax thresholds (after the April 2021 increase) until 2026. Thresholds for inheritance tax, pensions allowances, and VAT registration will also be frozen. The Office for Budget responsibility (OBR) predicts that the tax rises announced in this Budget will increase the tax burden from 34.0% in 2020-21 to 35.0% of GDP in 2025–26. Mr Sunak also took around £4b a year off annual departmental spending plans from 2023/24.

In its forecasts for the Budget, the OBR cut its estimate of public sector net borrowing in 2020/21 to £354.6b (16.9% of GDP) from the £393.5b (19.0% of GDP) shortfall that it had expected back in November when it presented projections alongside the Spending Review. However, the OBR raised its forecast for public borrowing in 2021/22 markedly to £233.9b (10.3% of GDP) from £164.2b (7.4% of GDP) primarily due to the additional supportive measures for the economy and jobs. Borrowing is then seen falling to £106.9 b (4.5% of GDP) in 2022/23. This is little changed from the November expectation of £104.6b (4.4% of GDP). Thereafter, reflecting the corrective measures announced by the Chancellor, public borrowing is seen falling more than previously expected to £85.3b (3.5% of GDP) in 2023/24, £74.4b (2.9% of GDP) in 2024/25 and £73.7b (2.8% of GDP) in 2025/26. In November, PSNB ex (public sector net borrowing excluding public sector banks) had been seen stabilising around £100b (3.9% of GDP) in 2024/25 and 2025/26.

The Chancellor chose to make no changes in the March 2021 Budget to the current fiscal rules that were adopted in the March 2020 Budget. These were designed to give the Government scope to take advantage of current very low interest rates and to borrow to invest, particularly in infrastructure. This is seen as having a key role to play in the Conservative Party's pledge to 'level up' the economic performance of the least prosperous UK regions. Specifically, the fiscal rule was that the Government will only borrow to invest, and this will be capped at 3% of GDP.

Bank of England unlikely to enact more stimulus

The Bank of England has responded to the coronavirus threat to the UK economy by enacting several stimulative measures, starting on 11 March 2020, with the latest move coming on 5 November. The Bank subsequently left monetary policy unchanged after the last MPC meeting on 16 December.

Since first acting on 11 March 2020 — the same day as the 2020/21 Budget, highlighting that the central bank and the Treasury were taking coordinated action to support the economy — the Bank of England has taken interest rates down from 0.75% to a record low of 0.10% and announced a total of £450b in asset purchases. This included the announcement of a £200b tranche of asset purchases in March 2020, which was by far the largest single amount of asset purchases that the Bank had ever made (the previous highest was £75b).

Additionally, the Bank has announced measures aimed at supporting bank lending, especially to small businesses (the Term Funding Scheme with additional incentives for Small and Medium-sized Enterprises —

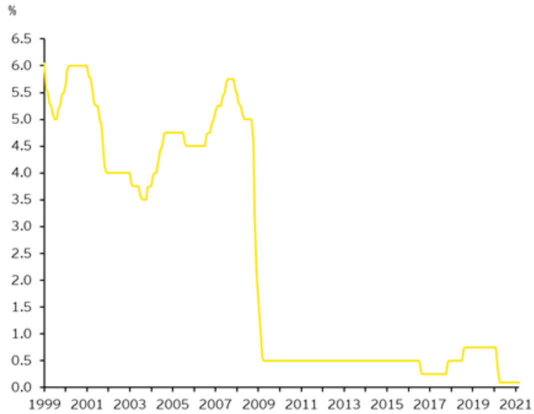
TFSME). The Bank also announced in March 2020 that a joint Treasury and Bank of England Covid Corporate Financing Facility (CCFF) would provide funding to businesses by purchasing commercial paper of up to one-year maturity, issued by firms making a material contribution to the UK economy. This type of short-term debt issued by companies needs to be of investment grade, meaning it must have a high credit rating.

At the November MPC meeting, the Bank of England announced an additional £150b of asset purchases, which took the targeted total up to £895b. The Bank also opted to keep interest rates at 0.10%. Both policy decisions were the result of unanimous 9–0 votes within the MPC. The MPC had made it very clear at their September meeting that they were willing to provide more stimulus if necessary, and they were prompted into stronger-than-expected action as some of the downside risks facing the UK economy that had concerned them had materialised. This most notably included renewed restrictions on activity due to a sharply increased number of COVID-19 cases, with a national lockdown in England being imposed from 5 November to 2 December. Furthermore, there were clear signs that the economy had lost appreciable momentum in October when some restrictions on activity had been imposed. Indeed, the minutes of the November MPC meeting noted there were signs that consumer spending had softened while investment intentions remained weak. With COVID-19-related restrictions expected to weigh on activity, the Bank of England saw GDP contracting in Q4 2020.

Since November, the Bank of England has not made any further adjustments to monetary policy. The MPC sat tight at their December, February and March meetings, and our suspicion is that they will continue to hold off from adjusting monetary policy for some time to come.

The odds always strongly favoured the MPC sitting tight at their latest meeting in mid-March, and this was reflected in unanimous 9–0 votes within the Committee both for keeping interest rates unchanged at 0.10% and for maintaining the targeted stock of asset purchases at £895b. The Bank of England stated that it plans to keep the pace of its purchases of gilts steady at around £4.4b per week.

UK: Bank Rate



Source: EY ITEM Club/Haver Analytics

In the minutes of their March meeting, the MPC come across as being more upbeat on the UK economy. The minutes concluded "the news on near-term economic activity had been positive, although the extent to which that news changed the medium-term outlook was less clear".[2] The MPC noted that GDP growth of 1.0% q/q (since revised up to 1.3% q/q) in Q4 2020 had been a little stronger than they had expected at their previous meeting in February. Furthermore, GDP contraction of 2.9% m/m in January was less than had been expected, largely due to developments in public sector output (specifically health output).

The MPC also considered that restrictions on UK economic activity will likely be lifted more rapidly than they envisaged in February as the vaccines are rolled out rapidly. This could lead to stronger consumption growth than had been expected in the second quarter, although the MPC was cautious about the longer-term implications. Meanwhile, the Budget held early in March was seen as providing more near-term support to the economy, including the extension of the job furlough scheme.

While the MPC considered that the latest unemployment rate (then 5.1% in the three months to December) likely underplayed the amount of slack in the labour market, they considered that the extension of the furlough scheme in the Budget meant that the near-term rise in the unemployment rate would be less than they had expected in February. In addition, as the furlough scheme is now due to last until September, by when the UK recovery is expected to be robust, the MPC considers there is a reduced risk that furloughed workers will not be reintegrated into the workforce.

The MPC also considered that developments in global growth had been a little stronger than they had expected in February, while the major US fiscal stimulus package should provide significant extra support.

While the March minutes did not come across as significantly more concerned about inflation, there was acknowledgement that "there was a range of views across MPC members on the degree of spare capacity in the economy currently, whether demand would outstrip supply during the recovery from the pandemic, and

[2] *Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 17 March 2021*. Bank of England. 18 March 2021. See bankofengland.co.uk/-/media/boe/files/monetary-policy-summary-and-minutes/2021/march-2021.pdf

how the assessment of supply should take into account the unique nature of the economic shock from the pandemic". The minutes recorded that the MPC considered that consumer price inflation (0.7% in January) would rise to around its 2% target level in the spring, lifted primarily by unfavourable oil base effects and increasing energy prices. Inflation was projected to be close to 2% over the medium term.

The MPC noted the recent rapid rise in advanced country bond yields to levels similar to those that had been seen shortly before the pandemic. The MPC considered this development to be in line with the rapid roll-out of COVID-19 vaccines and the boost to global growth from the US fiscal package and concluded that the rise in bond yields for the most part had reflected higher real yields.

Concluding, the MPC indicated that they are still prepared to take further stimulative action to support the economy should it fail to pick up as anticipated or downside risks intensify. Specifically, the March minutes commented: "The MPC will continue to monitor the situation closely. If the outlook for inflation weakens, the Committee stands ready to take whatever additional action is necessary to achieve its remit."

On the inflation front, the MPC indicated that they are not minded to tighten monetary policy any time soon. The March minutes recorded "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."

Up until very recently, the focus has been very much on whether the Bank of England would provide more stimulus for the UK economy, and if so, when? Now, instead, there is a growing focus on when the Bank could start tightening monetary policy.

The EY ITEM Club suspects that the case for further Bank of England support for the economy will wane from Q2 2021 onwards as recovery takes hold. Consequently, we believe that the Bank's eventual next move will be to tighten policy, initially through edging interest rates up from the current level of 0.10%.

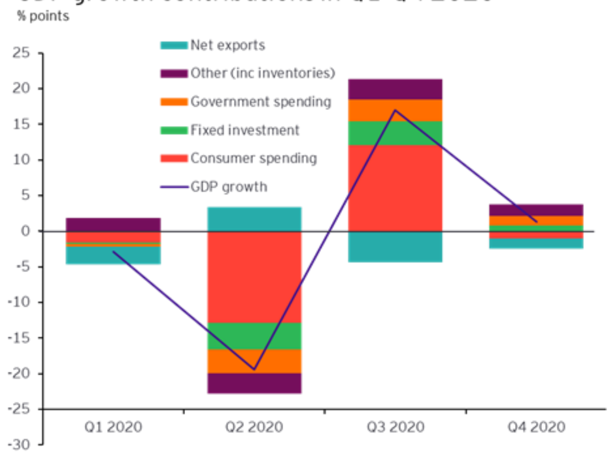
We believe the Bank is most likely to hold off from acting throughout 2021 but there is clearly a growing possibility that it could tighten monetary policy in 2022 — although at the moment, early 2023 seems a more likely prospect.

Economy contracted 9.8% in 2020 but grew in Q4 despite restrictions

The economy contracted 9.8% over 2020, the largest fall for over 300 years, as the COVID-19 lockdowns and restrictions imposed on the economy at various times starting from March took a major toll on activity.

On the output side of the economy, output in the dominant services sector contracted 9.0% over 2020 with the largest drop occurring in the distribution, hotels and restaurants sector (14.9%). Within this there was a massive 44.0% decline in the output of the accommodation and food services subsector, reflecting the major restrictions on activity and closures that were imposed over the course of the year. There were also sizeable declines in the output of transport, storage and communication (9.2%), and government and other services (11.0%). Output of business services and finances contracted 5.3%. Meanwhile, industrial production contracted 8.0% over 2020 with a 9.5% drop in manufacturing output. Construction output declined 14.0% over 2020.

GDP growth contributions in Q1-Q4 2020



Source: EY ITEM Club

On the expenditure side of the economy, domestic demand contracted 10.5% over 2020, with a record decline in consumer spending (10.6%) as well as substantial drops in total investment (8.8%), business investment (10.2%) and government spending (6.5%). Net trade made a positive contribution of 0.7 percentage points as a 15.8% drop in exports of goods and services was outstripped by a 17.8% fall in imports.

The economy grew 1.3% q/q in Q4 2020 when it showed considerable resilience in the face of the November lockdown and tight restrictions during much of the rest of the quarter. This followed growth of 16.9% q/q in Q3 2020 when the economy had bounced back from its record contraction in Q2 2020, supported by the progressive easing of restrictions on activity starting in mid-May and occurring through to July. There had earlier been GDP contraction of 2.8% q/q in Q1 2020 and 19.5% q/q in Q2 when the economy was particularly affected by the introduction of the first lockdown on 23 March 2020. GDP in Q4 2020 was down 7.3% year-on-year (y/y); this was down from the peak y/y decline of 21.4% in Q2 2020.

The economy's Q4 2020 performance was much stronger than had been originally anticipated. It had earlier seemed probable that the economy would see a renewed contraction in the fourth quarter, but it is evident that lessons have been learned in keeping activity going amid lockdowns and other tight restrictions.

The economy managed growth of 1.0% (m/m) in December after a limited contraction of 2.3% m/m during a lockdown-affected November. It had earlier grown 0.9% m/m in October. Still-tight restrictions on activity in December, following the ending of the November lockdown, limited the scope for a strong rebound. December saw services output partially rebound 1.4% m/m after a drop of 3.0% in November as there was some reopening of consumer-facing services, and the health sector saw robust growth. Manufacturing output was flat m/m while construction output fell 2.2% m/m.

Fourth quarter growth on the output side of the economy was led by decent performances in the manufacturing and construction sectors which saw respective q/q expansions of 3.3% and 2.7%. Both sectors benefitted from adjustments being made to many factories and sites to make them consistent with social distancing requirements. There was also a clear boost to manufacturing activity in the fourth quarter from stockpiling and increased demand from the EU ahead of the ending of the UK–EU transition arrangement on 31 December. In the meantime, construction activity was lifted by robust housebuilding, supported by a buoyant housing market.

The services sector was affected in Q4 2020 by restrictions but still achieved output growth of 1.0% q/q. Large parts of the hospitality and leisure sectors were closed for much of the quarter while non-essential retailers also saw extensive closures. However, services output was lifted by the health sector growing 11.8% q/q, mainly because of the coronavirus testing and tracing schemes across the UK. Meanwhile, education output grew 9.2% q/q, reflecting higher levels of school attendance.

On the expenditure side of the economy, growth in Q4 2020 was largely due to increased investment, government spending and a building up of inventories. However, consumer spending fell markedly while the contribution of net trade to GDP was negative as imports rose much more than exports.

Consumer spending contracted 1.7% q/q as the ability to spend was limited by the closure of hospitality, leisure and non-essential retail businesses during much of the quarter. This meant that the household saving ratio rose to an elevated level of 16.1% in Q4 2020, up from 14.3% in Q3. The household saving ratio amounted to 16.3% over 2020 (up substantially from 6.8% in 2019 and an average of 7.2% over 2015–19), which has increased consumers' future purchasing power.

Overall investment rose 4.4% q/q in the fourth quarter. Business investment recovered further after sharp contraction over the first half of the year as it rose 5.9% q/q, but it was still 7.4% below its level in the same period in 2019. The ONS notably reported that "investment tended to be limited to essential equipment or maintenance, rather than discretionary or strategic projects, because of concerns about the strength of the recovery, uncertainty about the outlook, and cash positions". [3] Meanwhile, government investment rose 4.5% q/q in Q4.

Government spending rose 6.7% q/q, led by increases in expenditure on health, including on testing and tracing.

There was a positive impact from the inventories component of the economy in the fourth quarter. The ONS reported "the revised unaligned inventories data now show an increase of £1.5b in stocks being held by UK companies in Q4 2020, mainly finished manufacturing goods." This appears to have been lifted by stockpiling ahead of the ending of the UK–EU transition arrangement on 31 December.

Net trade made a significant negative contribution to fourth quarter GDP as exports of goods and services rose 6.1% q/q while imports grew 11.0% q/q. Imports were lifted by some stockpiling behaviour ahead of the

[3] *GDP quarterly national accounts, UK: October to December 2020.* Office for National Statistics. 31 March 2021. See ons.gov.uk/economy/grossdomesticproductgdp/bulletins/quarterlynationalaccounts/octobertodecember2020

ending of the UK–EU transition arrangement.

Economy likely saw modest contraction in Q1 2021

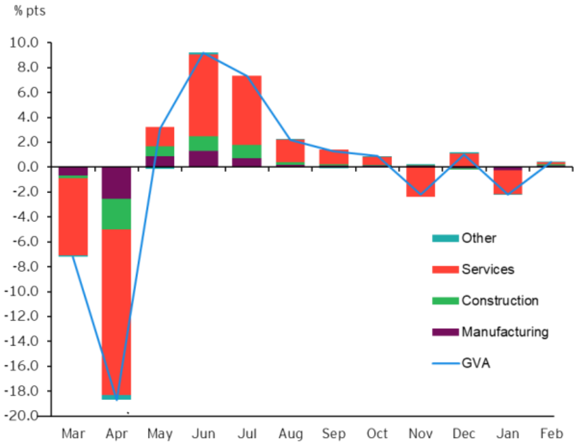
With the economy hampered by lockdown through Q1 2021, lightened only by the reopening of schools on 8 March, renewed contraction highly probably occurred. We expect GDP declined by just over 1% q/q.

The latest lockdown measures had a significant impact on the economy in January, with GDP contracting 2.2% m/m. This was similar to the 2.3% m/m fall in GDP that occurred in November when earlier lockdown measures were in place and was again substantially less than the negative impact of the lockdown measures introduced in March last year, reflecting the experience gained and measures taken in keeping activity going. GDP was down 8.5% y/y in January, compared to a decline of 6.3% y/y in December. With lockdown measures in place in two out of the three months, GDP was down 1.4% in the three months to January compared to the three months to October.

January's GDP fall was primarily due to activity in the services sector declining, but there was also a decline in manufacturing output.

Predictably, the services sector was the most affected by January's restrictions, with output contracting 2.5% m/m and 9.3% y/y. Non-essential retailers were closed, while restrictions limited activity for many consumer-facing businesses, particularly those in hospitality, leisure or travel. Significantly, there was a drop of 13.7% m/m in education services as schools were closed. On the positive side, health made a large contribution to growth in January 2021, mainly through coronavirus testing and tracing, and vaccine schemes.

UK: Contributions to monthly GVA growth



Source: EY ITEM Club calculations using data from Haver Analytics

Both the manufacturing and construction sectors have been helped by experiences and lessons being learned in keeping activity going in the first lockdown, as well as many manufacturing plants and construction sites being made compatible with social distancing requirements.

Nevertheless, manufacturing output fell in January, in contrast to November when it managed to keep growing. Specifically, manufacturing output dipped 2.3% m/m in January, with output falling in 9 out of 13 subsectors. The weakest performance occurred in the transport equipment sector. There are reports that manufacturing activity was affected in January by supply chain issues caused by transport delays – particularly at ports – following the end of the Brexit transition period, as well as COVID-19 restrictions. Additionally, there was some payback after manufacturing activity had been boosted in late 2020 by firms in the UK and EU stockpiling finished goods ahead of the ending of the Brexit transition arrangement. Overall, industrial production dipped 1.8% m/m in January.

Construction output was flat m/m in January.

On the expenditure side of the economy, it appears that consumers were markedly more cautious in January and that their spending contracted appreciably, given that retail sales volumes fell 8.2% m/m while the scope to spend on hospitality, leisure and consumer services was curtailed.

It is also notable that there was a sharp fall in both UK exports and imports in January. Specifically, total exports of goods and services fell 11.2% m/m while imports were down 13.1% m/m. This was primarily due to respective drops of 19.5% m/m and 17.3% m/m in traded goods. Within this, exports of traded goods to the EU slumped 42.0% m/m while imports declined 29.5%. While reduced demand in both the UK and EU due to renewed COVID-19-related restrictions on activity obviously contributed to these declines and the ONS also indicated that there were changes in the way the data is collected, it is evident that trade between the UK and EU was hit significantly by new border rules and restrictions following the ending of the transition arrangement.

Activity came modestly off its January lows in February as GDP expanded 0.4% q/q. The y/y decline in GDP moderated to 7.8% in February while GDP was down 1.6% in the three months to February compared to the three months to November.

All output sectors contributed to February's month-on-month increase in GDP. Services sector output rose a modest 0.2% m/m in February after a 2.5% decline in January, as it continued to be the sector most affected by restrictions. The ONS reported that that was a slight pick-up in retail and wholesale trade in February. Health output fell 2.7% m/m in February, after a sharp jump in January when it was lifted by coronavirus testing and tracing and vaccine schemes across the UK.

Manufacturing output rebounded 1.3% m/m in February after dipping 2.3% in January, with output rising in 7 out of 13 subsectors. The strongest performance occurred in the transport equipment sector (which grew by 5.4% m/m) and the manufacturing of computer, electronic and optical products (which grew by 9.0% m/m). Manufacturing supply chain issues seemingly eased to some degree in February, although they did not disappear. Overall, industrial production rose 1.0% m/m in February after falling 1.8% in January. February's 1.3% rise in manufacturing output was partly offset by mining and quarrying output falling 2.1% m/m.

Construction output grew 1.6% m/m in February after being flat in January. Both new and repair work expanded in February.

On the expenditure side of the economy, consumers appear to have been modestly more active in February despite non-essential retailers remaining closed, as did much of the hospitality and leisure sectors. Retail sales volumes rose 2.1% m/m in February. Additionally, GfK reported that there was a marked rise in consumer confidence in February.

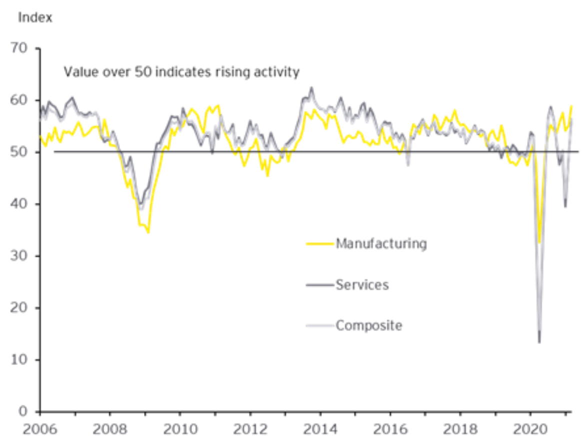
However, new car sales continued to suffer from closed showrooms, falling 35.5% y/y in February after a 39.5% y/y decline in January.

Significantly, UK trade came well off its January lows in February. Total exports of goods and services rose 5.4% m/m while imports were up 12.9% m/m. Trade with the EU partially recovered in February as the ONS reported the value of goods exports to the EU, excluding non-monetary gold and precious metals, rose 47% m/m in February, while goods imports excluding non-monetary gold were up 7% m/m.

Following the modest improvement in February, the economy seems to have taken significant steps forward during March as increasingly confident businesses prepared for the significant opening up of the economy on 12 April and consumers looked to start releasing pent-up demand.

Most notably, the purchasing managers reported that overall, manufacturing and services activity rose appreciably in March, having almost stabilised in February after contracting at the sharpest rate for eight months in January. The composite output index for manufacturing and services improved substantially to a six-month high of 56.4 in March from 49.6 in February and an eight-month low of 41.2 in January. This took the composite output index well above the 50.0 level that indicates flat activity. Joint new orders grew for the first time in six months and at the second fastest rate in four years, due to a marked pick-up in domestic demand. The pick-up in new orders was attributed to a "rebound in sales ahead of easing lockdown measures, alongside stronger consumer confidence and a surge in demand for residential property services." However, export orders fell for a third month running in March, although employment rose for the first time in 13 months. Another positive development saw confidence improve to the highest level since the series began in July 2012; this primarily reflected hopes that the rolling out of the COVID-19 vaccine would boost economic activity over the longer term. The services Purchasing Managers' Index (PMI) rose substantially to a seven-month high of 56.3 in March from 49.5 in February and an eight-month low of 39.5 in January. The manufacturing PMI improved to 58.9 in March (the highest level since February 2011) from 55.1 in February from a three-month low of 54.1 in January.

UK: IHS Markit/CIPS surveys



Source: Oxford Economics/IHS Markit/CIPS

Further very encouraging news from the purchasing managers saw the construction PMI jump to 61.7 in March, which was the highest reading since September 2014 and up from 53.3 in February and an eight-month low of 49.2 in January. Housebuilding was the strongest growing sector in March, with activity picking-up to the highest level since July 2020, while commercial activity and civil engineering both expanded at the fastest rate since the second half of 2014. All elements of the construction survey were improved in March with most hitting long-term highs. New business growth was the strongest since September 2014, while employment saw the largest rise for over two years. Confidence in future output was the highest since June 2015.

Consumers seem to have been more willing to spend in March despite the ongoing closure of non-essential retailers. The British Retail Consortium reported retail sales rose 13.9% y/y. There was a sharp further rise in consumer confidence in March reported by GfK, with its measure rising by seven points to its highest level for 12 months. This particularly reflected increased optimism over the economic outlook for the next 12 months, while there were also appreciable rises both in perceptions of personal finances over the past 12 months and expectations of how they would develop over the coming year. This was reflected in an eight-point jump in the index relating to willingness to make major purchases.

New car sales achieved their first annual growth in March since last August as they grew 11.5% y/y. However, this was from a low base as new car sales had fallen 44.4% y/y in March 2020 when car showrooms were first closed. Significantly, new car sales this March were 36.9% below their monthly average during 2010–19.

Labour market outlook has improved markedly

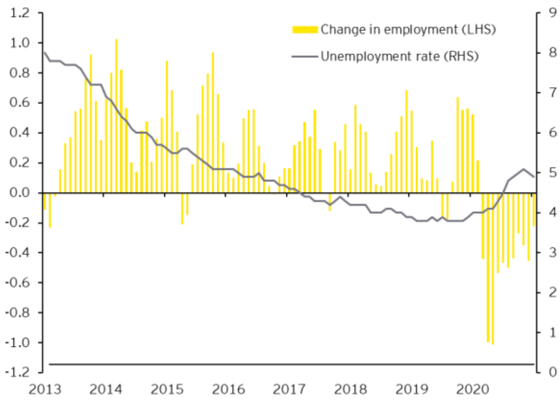
The performance of the labour market is vital to the economy's prospects over both the short term and further out, and this has been reflected by the Chancellor repeatedly extending the furlough scheme, which was originally due to conclude at the end of October 2020. The latest extension from the end of April to the end of September was announced in the March 2021 Budget. The Chancellor also included measures aimed at supporting the creation of jobs in the Spending Review held on 25 November.

The latest labour market data shows considerable resilience overall indicating that the Chancellor's repeated extension of the furlough scheme is having a significant impact in limiting job losses. The labour market would likely have come under appreciable pressure in Q4 2020 and the start of 2021 from increased restrictions on activity, notably lockdowns. The ONS reported that the number of workers on full or partial furlough stood at 17% during 22 March–4 April.

The Labour Force Survey (LFS) data shows that the number of people in employment fell 73,000 in the three months to February to 32.430 million. This was essentially half the drop of 147,000 in the three months to January. Employment had been at a record high of 33.073 million in the three months to February 2020. The employment rate edged up to 75.1% in the three months to February 2021, having dipped to 75.0% in the three months to both January and December from 75.2% in the three months to November and 76.6% in the three months to February 2020.

HMRC and ONS Pay as You Earn Real Time Information data indicates that the number of paid employees in March was down 56,000 from February after rising over the previous three months and was down 813,000 since March 2020.

UK: Employment and unemployment



Source: EY ITEM Club/Haver Analytics

The number of job vacancies continued to trend up from a record low in the three months to June 2020: it stood at 607,000 in the three months to March compared to 599,000 in the three months to February and 597,000 in the three months to January. It had dipped as low as 341,000 in the three months to June (which had been the lowest level since the series began in 2001) from 818,000 in the three months to February 2020. The number of unemployed people fell 50,000 in the three months to February to 1.675 million; this followed an increase of just 11,000 in the three months to January. There had previously been substantially larger increases of 121,000 in the three months to December, 202,000 in the three months to November, 241,000 in the three months to October and 243,000 in the three months to September. This caused the unemployment rate to dip to 4.9% in the three months to February. It had previously edged back to 5.0% in the three months to January after rising to 5.1% in the three months to

December (the highest since March 2016) from 4.1% in the three months to June. The unemployment rate stood at 4.0% in the three months to February 2020.

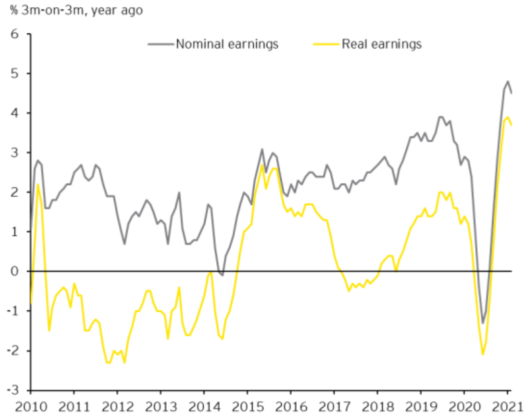
The inactivity rate rose to 20.9% in the three months to February, which was up 0.2 percentage points on the quarter and 0.7 percentage points on the year. This was largely made up of students and people who had given up looking for work who do not count as unemployed.

Claimant count unemployment rose 10,100 in March to 2.6730 million, after a rise of 67,200 in February. Claimant count unemployment had previously risen to a peak of 2.6870 million in August from 1.2472 million in March 2020.

In the meantime, redundancies slowed sharply to 204,000 in the three months to February from 308,000 in the three months to January, 343,000 in the three months to December and a record high of 395,000 in the three months to November.

The ONS also reported that total actual weekly hours worked in the UK was 959.9 million hours in December 2020 to February 2021. This was a decrease of 20.1 million, or 2.1%, from the previous quarter, coinciding with the introduction of further COVID-19 lockdown measures, which stalled the recent recovery in total hours.

UK: Average weekly earnings



Source: EY ITEM Club/Haver Analytics

The resilience of the labour market to date, the Chancellor's extension of the furlough scheme to September and expected decent recovery developing from Q2 2021 means that the rise in unemployment now looks likely to be considerably less than was feared at the start of the downturn and even only a few months ago. Indeed, we have reduced our expected peak in the unemployment rate to 5.8% in Q4 2021. There will probably be some upward impact on unemployment from people looking for work again, thus returning to the workforce. In our W*inter Forecast* in January, we had expected the unemployment rate to peak around 7% in Q3 2021. The labour market is expected to improve during 2022 as recovery continues, bringing the unemployment rate down to 4.5% by the end of the year.

Meanwhile, annual earnings growth was mixed in February itself and was still at a relatively elevated level. Specifically, annual average earnings growth dipped to 3.9% in February itself from 4.3% in January and 5.4% in December. In contrast, there had been annual falls in earnings growth between April–July 2020. Earnings were up 4.5% in the three months to February. Annual regular earnings growth (which strips out bonus payments, which can be erratic and distort the overall figures) rose 4.5% in February itself, up slightly from 4.3% in January and 4.4% in December. There had earlier been marginal annual declines during April–June 2020. Consequently, annual regular earnings growth was up 4.4% in the three months to February.

Significantly, the ONS has reported that current average pay growth rates are being impacted upwards by a fall in the number and proportion of lower-paid jobs compared with before the coronavirus pandemic. It is estimated that underlying wage growth – if the effect of this change in profile of jobs is removed – is likely to be around 2.5% for total pay and 2.5% for regular pay.

Looking ahead, we suspect that earnings will be limited over the coming months by many companies looking to freeze pay or hold down pay increases to limit their costs following their very challenging past year.

Economy expected to progressively improve after modest Q1 2021 contraction

GDP growth is forecast at 6.8% in 2021. Following estimated contraction of just over 1% q/q in Q1 2021, the economy is expected to see marked improvement from Q2 as restrictions on activity are eased in line with the Government's road map, while the ongoing rapid roll-out of the various COVID-19 vaccines further supports consumer and business confidence.

Following the first step of the Government's road map for the removal of restrictions, which saw the opening of schools on 8 March, the second step occurred on 12 April and included the opening of non-essential retailers as well as the opening of hospitality venues for outdoor purposes only. Step 3 (to occur no earlier than 17 May) includes pubs and restaurants being able to open indoor facilities while indoor entertainment venues and indoor leisure facilities can also reopen. Each step will see an easing of social contact restrictions and these will be totally eliminated in Step 4, which is due to occur no earlier than 21 June.

On the basis that this road map continues to be followed, we believe the economy will see marked, progressive improvement developing from Q2 2021, when GDP growth could very well be in the region of 4%–5% q/q. Supportive Government fiscal policy and ongoing very accommodative monetary policy will further help recovery develop.

UK: Household saving ratio

Source: EY ITEM Club/Haver Analytics

As restrictions on retailing, consumer services, hospitality and leisure are progressively reduced, and social distancing rules are relaxed, consumers do look well placed overall to increase their spending appreciably, although much will obviously depend on just how much unemployment rises over the coming months. Recently, an extremely high household saving ratio (still up at 16.1% in Q4 2020 after jumping to a record 25.9% in Q2 2020) has boosted consumers' ability to spend. Meanwhile, with the labour market proving resilient overall so far and the furlough scheme extended until September, it now looks likely that the rise in unemployment will be markedly less than had originally been feared and even less than had looked probable at the time of our *Winter Forecast*. Indeed, we have reduced the expected peak in the unemployment rate (5.1% in the three months to December 2020) to 5.8% from the 7% level that we anticipated three months ago.

Admittedly, many companies will undoubtedly look to limit pay growth in 2021 following their challenging past year and generally weakened positions. Also, inflation is expected to trend up appreciably from Q2 2021 although it is not expected to rise to punitive levels. On balance, we expect consumer spending to expand 4.4% in 2021 after contracting by 10.9% in 2020.

Government spending and investment will contribute significantly to growth in 2021, as fiscal policy is expansive with the Chancellor's near-term priority being to provide further support to jobs and businesses. In addition, monetary policy is forecast to remain highly accommodative, although further stimulus from the Bank of England looks unlikely.

The EY ITEM Club forecast for the UK economy, Spring 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	6.8	7.6	4.4	10.3	4.9	7.6
2022	5.0	6.0	5.7	10.0	8.0	11.3
2023	2.1	2.3	2.2	3.7	3.2	3.8
2024	1.7	1.8	1.9	2.0	3.4	3.7
	Net govt borrowing*	**Current account (% of GDP)**	**Average earnings**	**CPI**	**Bank Rate**	**Effective exchange rate**
2018	2.1	-3.7	3.2	2.5	0.6	78.5
2019	2.9	-3.1	3.4	1.8	0.8	78.2
2020	16.2	-3.5	1.8	0.9	0.2	78.1
2021	9.2	-3.5	4.0	1.5	0.1	81.9
2022	4.8	-3.5	3.2	2.2	0.1	83.0
2023	3.7	-3.6	3.5	2.0	0.3	81.5
2024	3.2	-3.7	3.5	2.0	0.8	79.7

* Fiscal years, as % of GDP
Source: EY ITEM Club

Public spending is forecast to rise 9.9% in 2021, while government investment is seen up 14.9%, contributing to fixed investment growth of 10.3%.

Following a contraction of 10.2% in 2020 and prolonged weakness, business investment is forecast to rise 7.1% over 2021 as companies become increasingly more confident in the recovery supported by the rolling out of COVID-19 vaccinations. There may also be an increasing need for many companies to invest to replace/upgrade plant and processes that have become increasingly dated due to the lack of investment in recent years. Furthermore, the introduction of a large temporary increase in capital allowances provides a very strong incentive for companies to lift investment or at least bring it forward. In 2021/22 and 2022/23, companies will be able to offset 130% of investment spending on eligible plant and machinery against profits. Hopes that this will have a significant upward impact on investment were supported by a Make UK survey released in early April which found that almost a quarter of manufacturing companies planned to increase investment as a direct response to the policy, while more than a quarter plan to bring forward their investment plans.[4]

Nevertheless, the upside for business investment will probably be limited by the hit many companies will have taken to their profitability in 2020. Productive business investment may also continue to be limited by the amount of resources that companies have had to devote to making their facilities compatible with social distancing guidelines.

Net trade is seen as significantly negative in 2021 as exports (up 4.9%) are forecast to be markedly outgrown by imports (up 7.6%). The overall export and import growth rates for 2021 are limited by expected marked falls in Q1, which are largely the consequence of a sharp reduction in trade between the UK and EU reflecting the impact of new rules and restrictions following the ending of the transition arrangement. Despite the UK and EU reaching a free trade agreement that avoided the damaging imposition of tariffs on goods trade between the two, UK trade will be substantially affected by the fact that the UK has now left the EU's Single Market and Customs Union. This has resulted in increased non-trade factors in the form of customs bureaucracy and some regulatory barriers. While much of the dampening impact that occurred at the start of 2021 will likely prove to be temporary, there will undoubtedly be some lasting impact. On the positive side, improved global trade in 2021 compared to 2020 should support both UK imports and exports while faster global growth should boost exports just as stronger UK domestic demand will lift imports.

The economy is expected to build on its recovery in 2022 with GDP growing 5.0%. This means the economy is expected to regain its Q4 2019 level in Q2 2022. While still decent, the expected q/q growth pattern for 2022 is not as marked as it is for Q2–Q4 2021.

Monetary policy is expected to remain accommodative in 2022 with the Bank sitting tight. Fiscal policy will also be accommodative, although less so than in 2021. Government investment is likely to remain robust.

Consumer spending is forecast to expand 5.7% in 2022 as it benefits from falling unemployment and increased earnings growth. Inflation is expected to be higher overall in 2022 (averaging 2.2%) but households are still expected to benefit from decent growth of 3.5% in real household disposable income. Additionally, many consumers will continue to benefit from relatively healthy balance sheets following the sharply improved saving ratios of 2020.

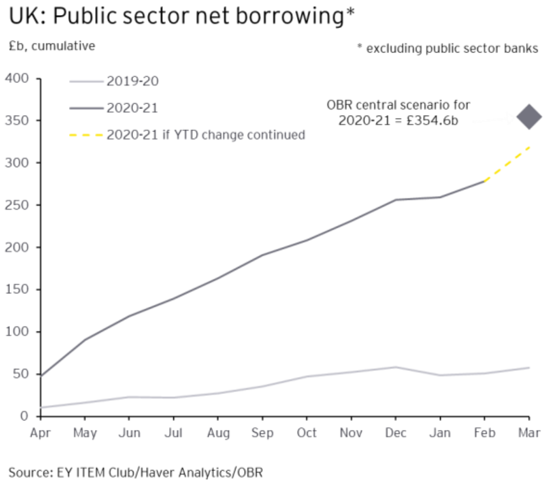
Business investment is expected to see further decent growth in 2022 as confidence benefits from a firmer and more settled business environment. Business investment should also continue to be lifted by companies looking to take advantage of the ongoing large temporary increase in capital allowances in 2022/23. However, it should be noted that this measure is likely to primarily bring forward business investment to 2021 and 2022 rather than increase it overall, especially as a large jump in the corporation tax rate from 19% to 25% is planned for 2023. Specifically, business investment is projected to expand 10.5% in 2022 as overall fixed investment increases 10.0%.

However, growth in government spending is forecast to slow markedly to 1.7% in 2022, as supportive measures for the economy come to an end while government investment growth is seen moderating to 7.7%. Net trade is expected to be markedly negative in 2022 as exports of goods and services rise 8.0% and imports expand 11.3%.

[4] 'Sunak's tax break plan pushes UK manufacturers to invest, survey shows.' Reuters. 6 April 2021. See reuters.com/article/uk-britain-investment/sunaks-tax-break-plan-pushes-uk-manufacturers-to-invest-survey-shows-idUSKBN2BS24R

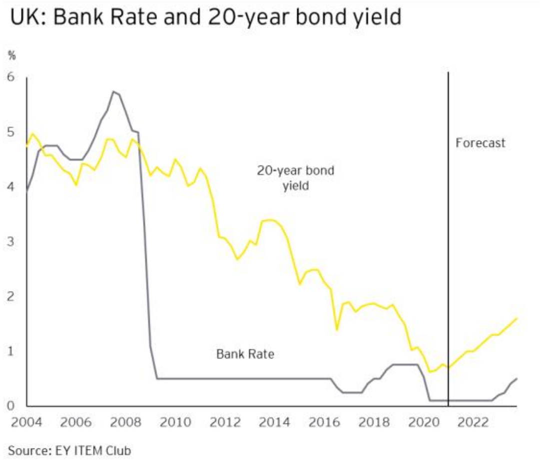
Forecast in charts

Fiscal policy



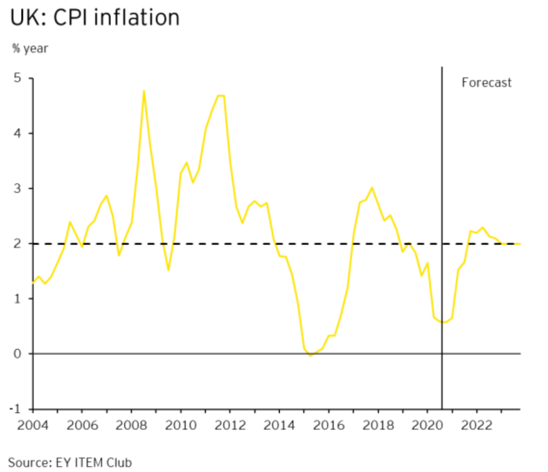
- Fiscal policy remains orientated in the near term to supporting the economy, with the Chancellor announcing measures amounting to £65b over the next two years in the 3 March 2021 Budget.
- Cost of fiscal packages to support the economy likely saw the budget deficit (PSNB ex) reach £340b (16.2% of GDP) in 2020/21. It is expected to still be as high as £215b (9.2% of GDP) in 2021/22.
- Chancellor Sunak has set out initial measures aimed at reining in the public finances over the longer term. This includes raising the corporation tax rate from 2023 and freezing income tax thresholds.

Monetary policy



- Having provided substantial monetary policy stimulus between March and November 2020, the Bank of England has since remained on the sidelines, keeping interest rates at 0.10% and targeted asset purchases at £495b.
- With the economy likely to see recovery increasingly developing from Q2 2021, we believe the Bank of England is done on providing stimulus for the economy.
- While inflationary concerns have increased, we doubt the Bank of England will start tightening monetary policy before late 2022, and more likely early 2023.

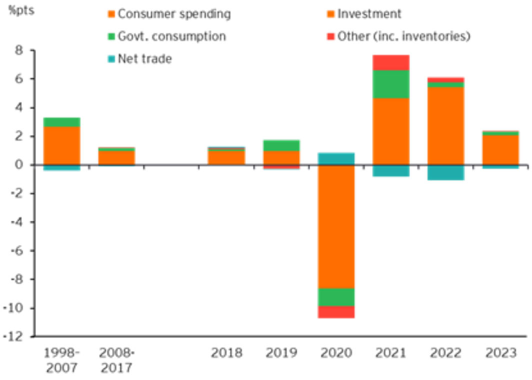
Prices



- Annual consumer price inflation was limited to 0.4% in February, not far above the August 2020 low of 0.2% (the lowest rate since January 2016).
- Inflation is seen moving towards its 2% target level during Q2 2020 due to unfavourable base effects resulting from the sharp fall in oil prices in early 2020. There will also be a rise in energy prices in April.
- Inflation is seen as rising just above 2% during the second half of 2021 but should be limited by excess capacity in the economy and labour markets. Seen averaging 1.5% over 2021 and 2.2% over 2022.

Activity

UK: Contributions to GDP growth



Source: EY ITEM Club

- GDP estimated to have contracted just over 1% q/q in Q1 2021 as the economy showed resilience amid the lockdown which essentially existed throughout the quarter.
- The economy is seen as developing decent recovery from Q2 2021 as restrictions are progressively eased through to mid-year, supported by ongoing rapid roll-out of COVID-19 vaccines. Consumers seen playing a leading role while business investment should increasingly kick in.
- GDP growth is forecast at 6.8% in 2021 and 5.0% in 2022. The economy will return to Q4 2019 size in Q2 2022.

Consumer demand

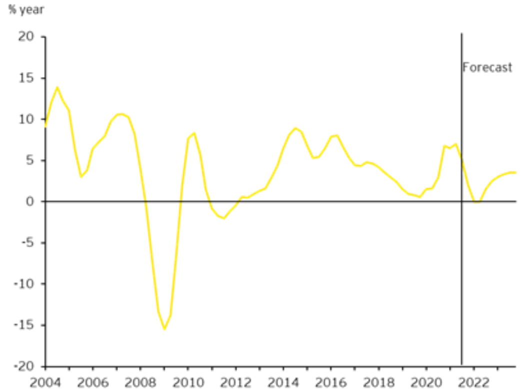
UK: Real household income and spending

Source: EY ITEM Club

- Consumer spending likely contracted for second successive quarter in Q1 2021 as limited by the lockdown, with non-essential retailers closed and with restrictions on many consumer services.
- Consumers look well placed to play a key role in the recovery from Q2 2021 as restrictions are eased, given recent very high household saving ratios. Lower than previously feared rise in unemployment will help matters, while there is probably some pent-up demand.
- Consumer spending seen up 4.4% in 2021 and 5.7% in 2022.

Housing market

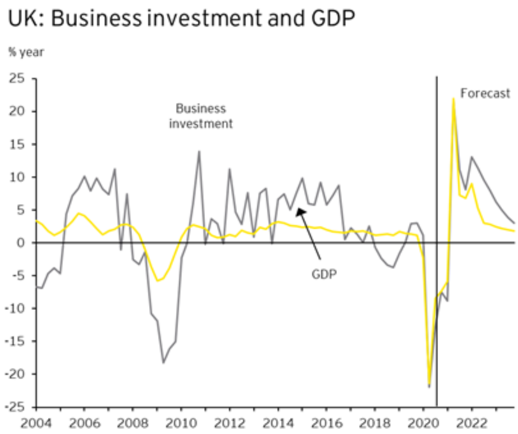
UK: House prices



Source: EY ITEM Club

- Housing market showed some signs of coming off the boil in early 2021 after the strong second half of 2020, supported by the release of pent-up activity, a temporary raising of the stamp duty threshold and lockdown leading to people re-evaluating their housing desires and needs.
- Housing market strength will likely get near-term support from helpful measures in the March Budget.
- Prices seen flat y/y by early 2022 with some quarters of decline as market pressured by higher unemployment, waning pent-up demand and weakened affordability.

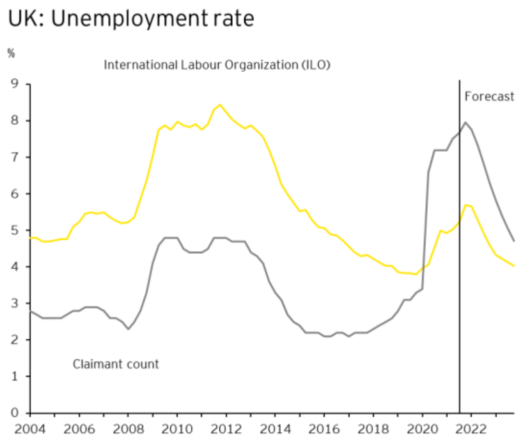
Company sector



Source: EY ITEM Club

- Impact of COVID-19 on the economy and businesses has weighed heavily on investment. Business investment rose 5.9% q/q in Q4 2020 but was still down 7.4% y/y and declined 10.2% over 2020.
- Business investment was likely soft in Q1 2021 but should improve progressively from Q2 after extended weakness as business confidence is supported by a firming recovery. Tax break should lift investment in 2021 and 2022 but may be significantly bringing it forward.
- Business investment seen rising 7.1% in 2021 and 10.5% in 2022.

Labour market and wages



Source: EY ITEM Club

- Labour market has proved resilient overall with the unemployment rate edging back to 4.9% in the three months to February after rising to 5.1% in the three months to December from 3.9% at start of 2020.
- Resilience of labour market, extension of jobs furlough scheme to end of September and expected recovery developing from Q2 2021 seen as limiting peak in unemployment rate to 5.8% in Q4 2021.
- Earnings growth has been lifted by changes in composition of labour force during pandemic. Companies are likely to look to limit pay increases for some time.

Trade and the balance of payments

Source: EY ITEM Club

- Net trade made a positive contribution to GDP in 2020 as real imports fell 17.8% while exports fell a lesser 15.8%. There was clearly a sharp fall in both exports and imports in Q1 2021, with these limited by reduced domestic and foreign demand amid COVID-19 restrictions, as well as by increased regulations on UK–EU trade.
- Current account deficit amounted to £73.9b (3.5% of GDP) in 2020, little changed from £68.6b (3.1% of GDP) in 2020. Trade deficit was slightly reduced.
- Current account seen essentially little changed at £80.2b (3.5% of GDP) in 2021 and £85.4 (3.5% of GDP) in 2022.

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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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