KPMG 150 years supporting the UK

A snapshot of the outlook for the UK economy

Updated: 29 April 2020

kpmg.com/uk/en/macroeconomics

Summary

— UK economy is expected to **contract by 7.8%** in 2020, recovering in 2021 with GDP growth reaching 8.4%.

— Our analysis assumes an initial **10-week lockdown** starting at the end of March, followed by two further four-week lockdowns in August and November 2020.

— Despite an unprecedented level of support on offer for workers, the rate of **unemployment** is expected to reach 8.8% this year, before gradually falling as the economy recovers after the end of the pandemic.

— **Monetary policy** is almost certain to remain supportive for at least until the end of 2021, with the headline policy rate unchanged at 0.1%.

— Despite this, **inflation** should stay below the Bank of England's target level, averaging 0.7% in 2020 and 1.3% in 2021.

— The **hospitality** industry could see a loss of nearly a third of output in 2020, bearing the brunt of the economic damage caused by the pandemic.

— Meanwhile, **consumers** focussing on essentials will see a modest increase in food and drink purchases and a severe drop in demand for durable goods categories. For some sectors, demand could remain weak throughout the year as the threat of reinfection keeps shoppers and restaurant goers at home.

— The cost of battling the pandemic will be reflected in a sharp increase in **government borrowing**, with debt set to rise to nearly 95% of GDP according to the OBR, for the first time since 1962.

Our forecasts for the UK economy

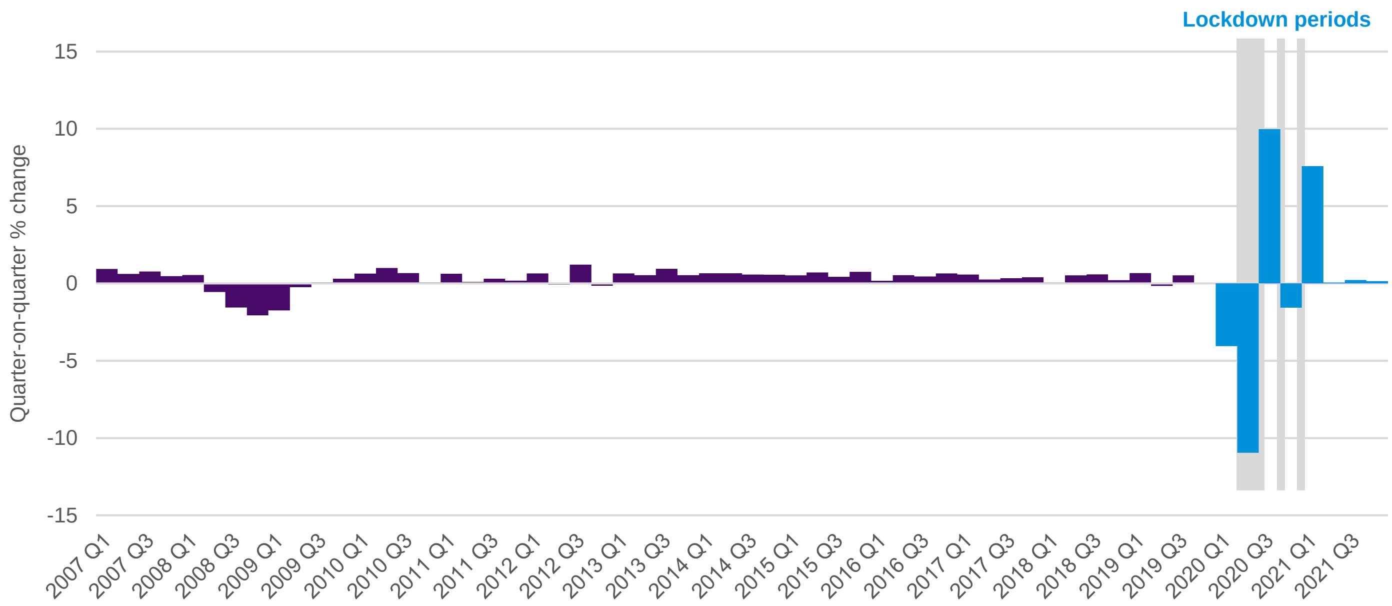
	2019	2020	2021
GDP	1.4	-7.8	8.4
Consumer spending	1.4	-13.5	14.8
Investment	0.4	-16	17.1
Unemployment rate	3.8	7.6	6.3
Inflation	1.8	0.7	1.3
Base interest rate	0.75	0.1	0.1

Source: ONS, KPMG forecasts. Average % change on previous calendar year except for unemployment rate, which is average annual rate. Investment represents Gross Fixed Capital Formation, inflation measure used is the CPI and unemployment measure is LFS. Interest rate represents level at the end of calendar year.

— Our base case forecasts for 2020 sees GDP contracting by nearly 8% in 2020, before recovering in 2021. This reflects a sharp setback in household consumption and in overall investment that is only partially offset by a significant increase in government spending.

— We looked at the different goods and services consumed by households, categorising them by their exposure to the lockdown and to any additional measures imposed once it is removed. We estimated that in total, the consumption of goods will fall by 30% at the peak of the crisis and the consumption of services will fall by 40%, making consumer spending fall by 13.5% in 2020 as a whole, before recovering by nearly 15% in the following year.

Our base case assumptions



Source: ONS, KPMG analysis

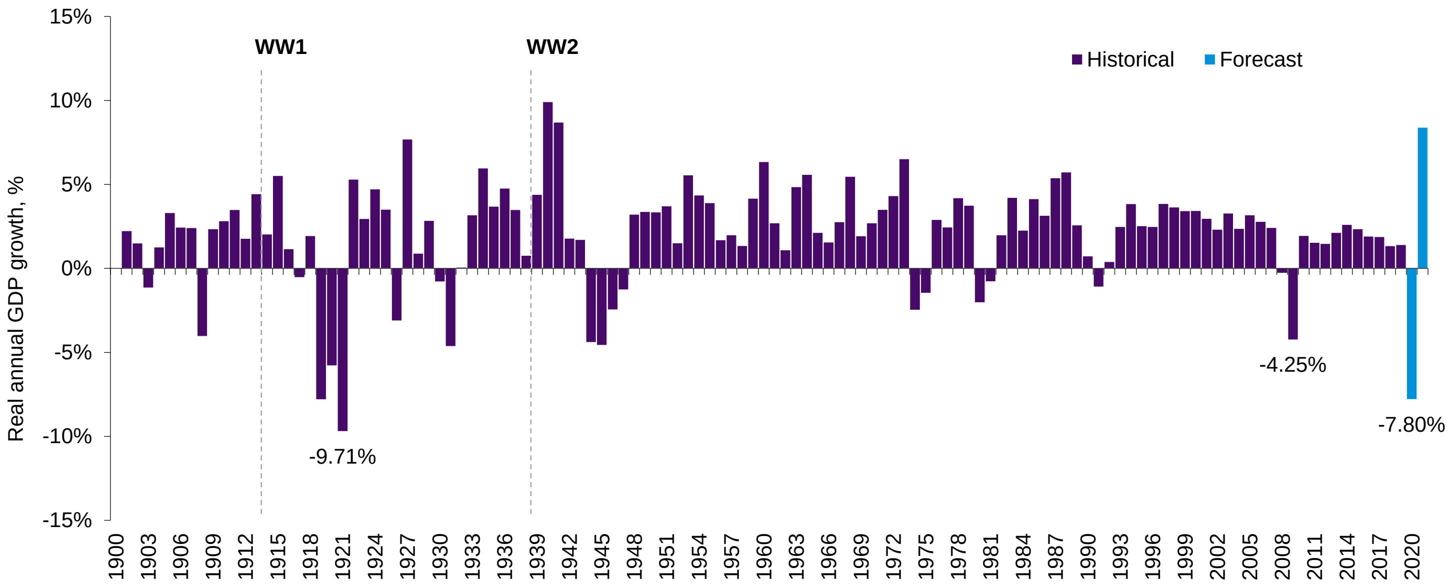
— Our base scenario currently assumes that the lockdown remains in place until the end of May but some measures, such as restrictions on social gatherings and travel, remain in place until 2021.

— We also assume additional secondary lockdowns, lasting around four weeks each, are imposed in the third and fourth quarters of 2020.

— We then assume that a vaccine becomes available in January 2021, allowing the removal of all restrictions shortly afterwards.

— GDP forecasts for 2020 reflect this pattern of stop-start economic activity, with the lockdown and continued social distancing measures anticipated until a vaccine is found. This means fluctuations in output will be sharper than in previous recessions.

Deepest recession since WW1

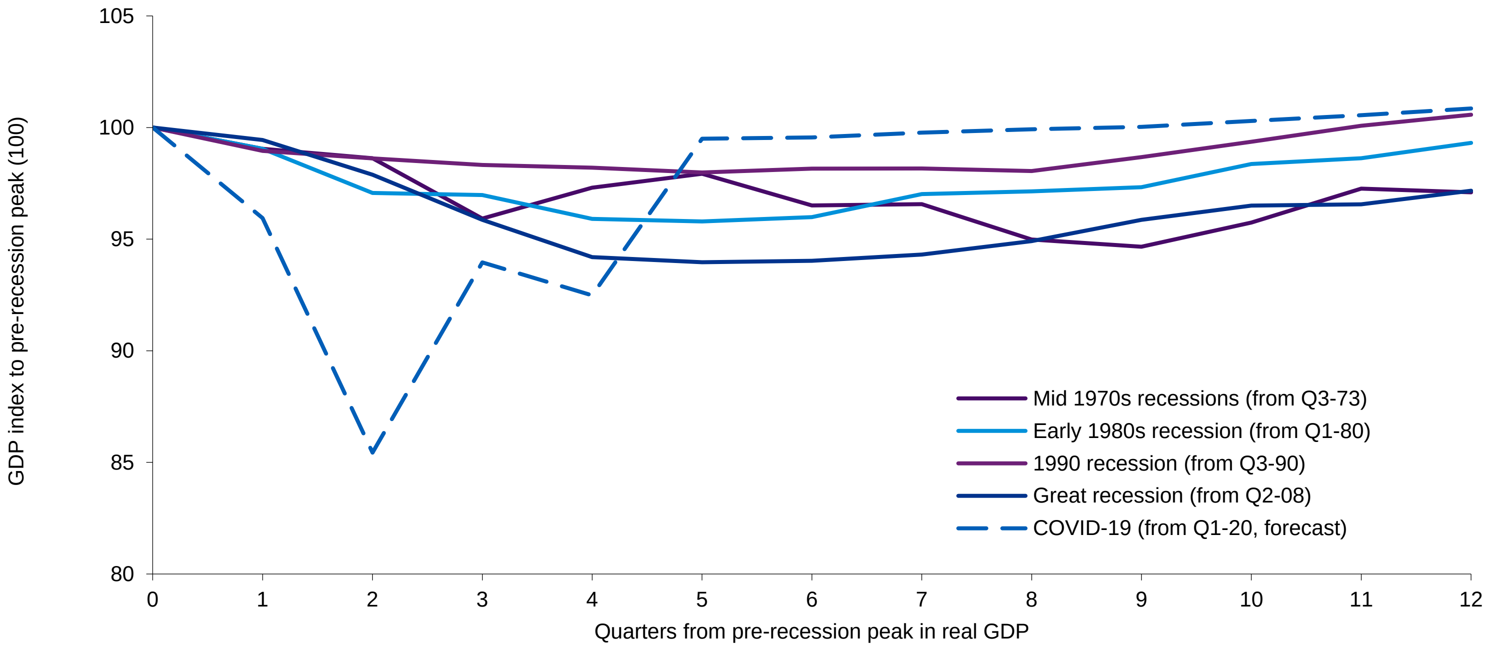


Source: ONS, KPMG analysis

- The current slowdown is unprecedented on a number of levels. One of them is the scale of contraction in output that is expected, due to the lockdown and continued social distancing measures that we anticipate will stay in place until a vaccine is found.
- The size of contraction of the UK economy this year is expected to be larger than in any period since the aftermath of the First World War.

W-shaped recession with a relatively quick recovery

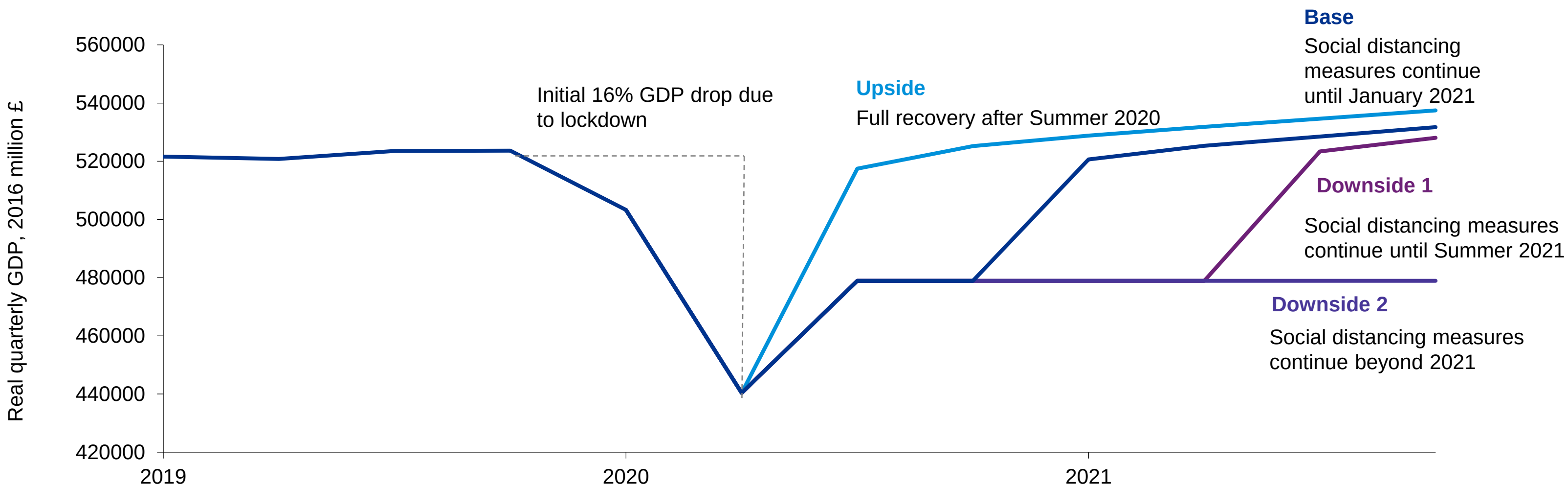
COVID-19 economic recovery compared to past recessions



Source: ONS, KPMG analysis

- The good news is that, despite the severe shock to the economy, output is expected to return to pre-crisis level sooner than in previous recessions.
- The recession could adopt a W shape as a result of the secondary lockdown measures later this year.

A longer pandemic will cause greater damage to business



Source: ONS, KPMG analysis

— While there is more information available on how to detect and treat the virus, there's still no clarity over when we'll reach crucial milestones (like a viable vaccine). We have developed four simple scenarios to help planning for the next two years:

	Upside	Base	Downside 1	Downside 2
Current lockdown ends	End of may 2020	End of May 2020	End of May 2020	End of May 2020
Secondary lockdowns		Aug and Nov 2020	Aug and Nov 2020 and Feb and May 2021	Aug and Nov 2020 and Feb and May 2021
Pandemic contained	Sep 2020	Jan 2021	July 2021	

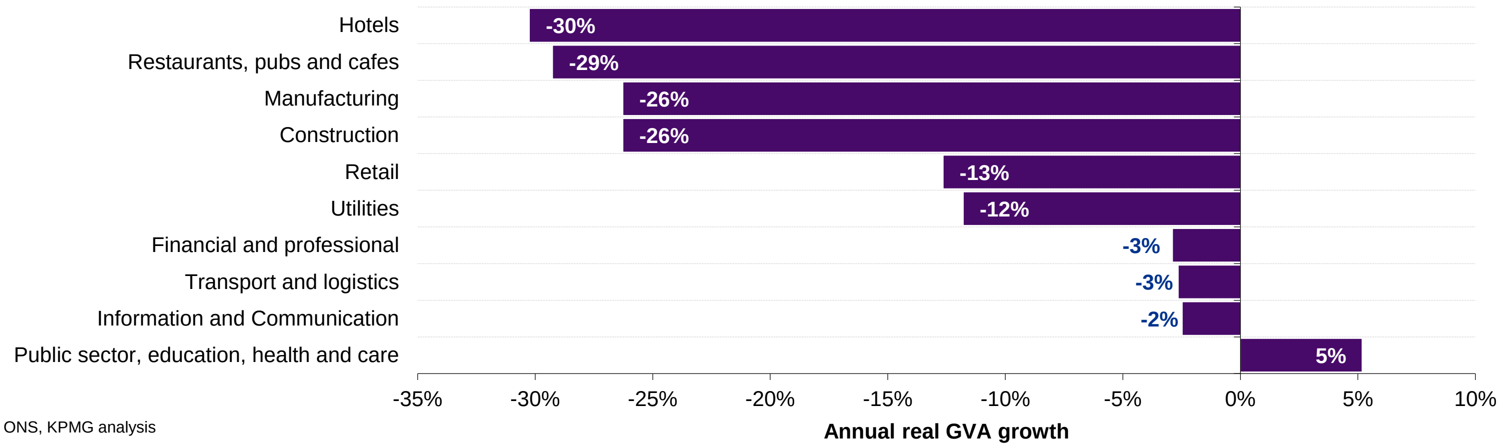
Source: KPMG

— Current medical evidence points at the upside scenario as the least probable, while our base scenario and downside 1 scenario most probable, and the downside 2 scenario a bit more probable than the upside.

— The four scenarios assume that government support, in the form of grants and loans, preserves as many businesses as possible. That means their output can return to pre-crisis levels quickly once the pandemic is eradicated in the UK (see chart). As the pandemic lingers, more permanent damage to business is likely and risks to the outlook are heavily weighted to the downside.

Only the public health sector will avoid a decline

Forecast GVA growth in 2020 for selected sectors

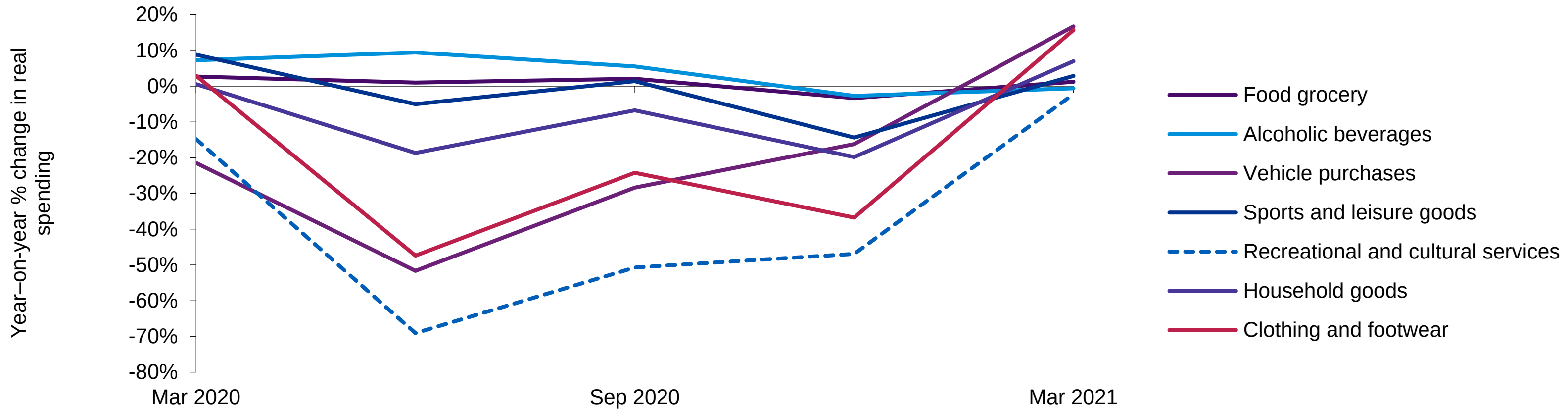


Source: ONS, KPMG analysis

- Curbs on social gatherings, including after the lockdown is lifted, could see a third of output in **hotels and restaurants** lost this year. The hospitality industry will also find it harder to recover lost output next year as cancelled travel plans and restaurant bookings will mostly be gone for good. By contrast, manufacturing and construction should see a stronger rebound this year thanks to back orders that can be filled once the lockdown is over, even if the initial fall in output during the lockdown will also be considerable.
- The drop in **manufacturing** production, and to some extent the temporary closure of many workplaces, will reduce the amount of energy required and lower utilities' output this year. **Financial and professional services** could see more muted reductions in output, although the type of services offered and the way they are delivered will change, with the majority of staff working from home and focusing on servicing clients' more immediate needs.
- A surge in demand for home deliveries could offset some of the fall in travel this year, providing support for the **transport and logistics** sector. Similarly, the sharp rise in online communications and virtual meetings will provide support for the information and communication services in the face of an overall fall in economic activity.
- Unsurprisingly, given the nature of this crisis, the main rise in output will be concentrated in **public health** services. We have also factored in a small increase in public administration's output as it draws in more help to address the immediate challenges.

Consumers focus on the essentials

Consumer spending on selected categories in 2020



Source: ONS, KPMG analysis

— Our forecasts for consumer spending reflect the increased focus on essentials, as the lockdown restricts consumers' opportunities to spend, and lower earnings coupled with changing preferences take their effect. Purchases of food and alcoholic beverages show mild increases owing to the closures of pubs and restaurants, with the latter relying on home delivery to retain some business during lockdown.

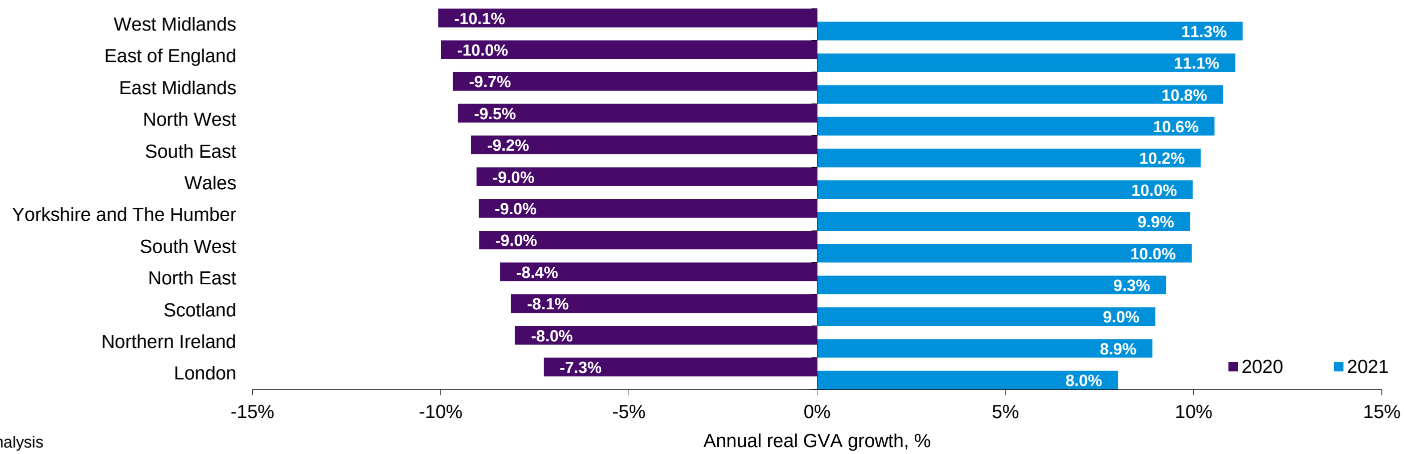
— The impact of the lockdown also shows up in the sharp fall in demand for recreational and cultural services, which are limited to what can be supplied online. For many of these businesses, we expect the recovery to be more gradual than the recovery of the overall economy, as the threat of reinfection may keep people away beyond the lockdown period until a vaccine becomes available.

— While output of recreational and cultural services is likely to take a big hit, it is partially offset initially by strong demand for sports and leisure goods that can be used at home. Demand for household goods that improve home stay also remain relatively resilient.

— Clothing and footwear purchasing could see a significant drop, as working from home during the warmer months will eliminate the need to update one's summer wardrobe, while a large proportion of car purchases could be postponed until next year.

London's services-based economy is the least affected

Forecast of regional GVA growth in 2020 and 2021

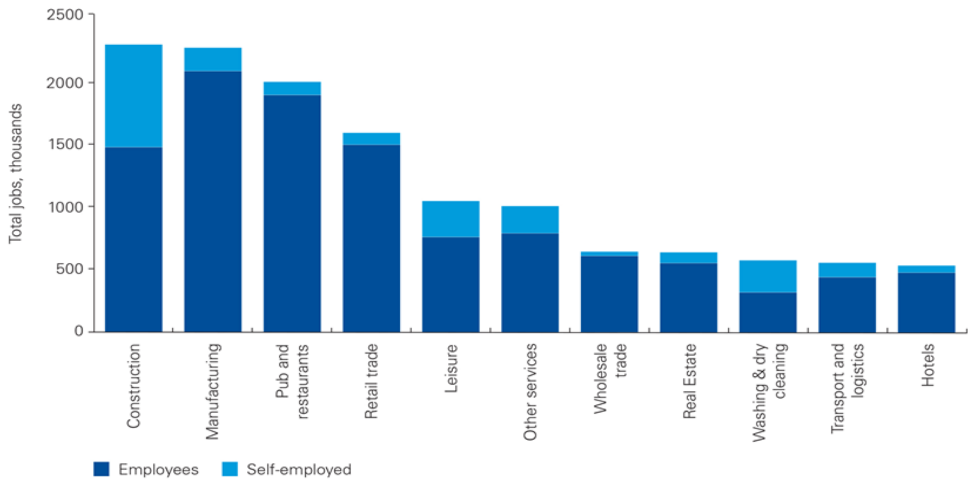


Source: ONS, KPMG analysis

- The region that will feel the biggest impact of the pandemic in 2020 could be the **West Midlands**; we forecast its economy will contract by just over 10%. This is because it is home to many automotive manufacturers; they make up nearly 6% of the local economy. This sector faces a severe downturn as a result of supply-chain factors interrupting production and falling demand as consumers cut back spending.
- In the **East of England**, the relatively high share of construction sector activity means the region is expected to undergo a 10% fall in GDP this year. Current social distancing restrictions have put a halt on the majority of this sector's activities.
- At the other end, we expect **London** will be the least affected region. We forecast the economy will contract by just over 7% in 2020. A relatively higher share of services that are less impacted by Covid-19, like financial and professional services, mean the capital's economy is more resilient to the restrictions imposed by the lockdown. An ONS survey conducted last year showed that more than 34% of London workers had worked from home at least once, compared to 27% for the UK as a whole.
- **Northern Ireland** follows close behind London; we expect it will shrink by 8% in 2020. The region hosts a large share of food manufacturing businesses, which continue to operate throughout the period of lockdown. It also has a strong presence of life science businesses and government employment, which leads to a lower overall impact on the Northern Irish economy.

Lockdown is taking its toll on the labour market

Total jobs affected by lockdown measures



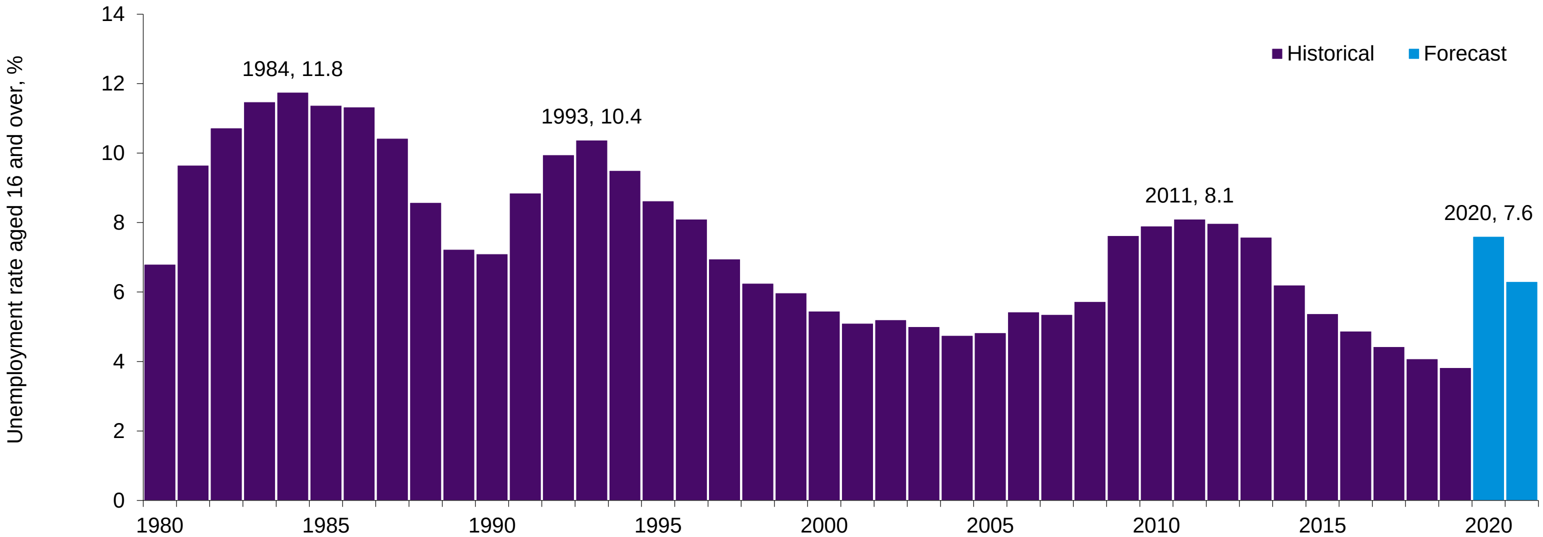
Source: ONS, KPMG analysis

— As many as 13 million jobs are in sectors highly affected by the lockdown, representing 36% of all jobs in the UK. Of these, nearly 2.2 million are self-employed and 10.6 million are employees.

— If we assume that three quarters of affected employees are placed in furlough during the lockdown and the rest are split 15% and 10% respectively between claiming unemployment and leaving the labour market, the unemployment rate could peak at 8.8% during the lockdown period.

Unemployment rate could stay below peaks seen in previous recessions

Unemployment rate

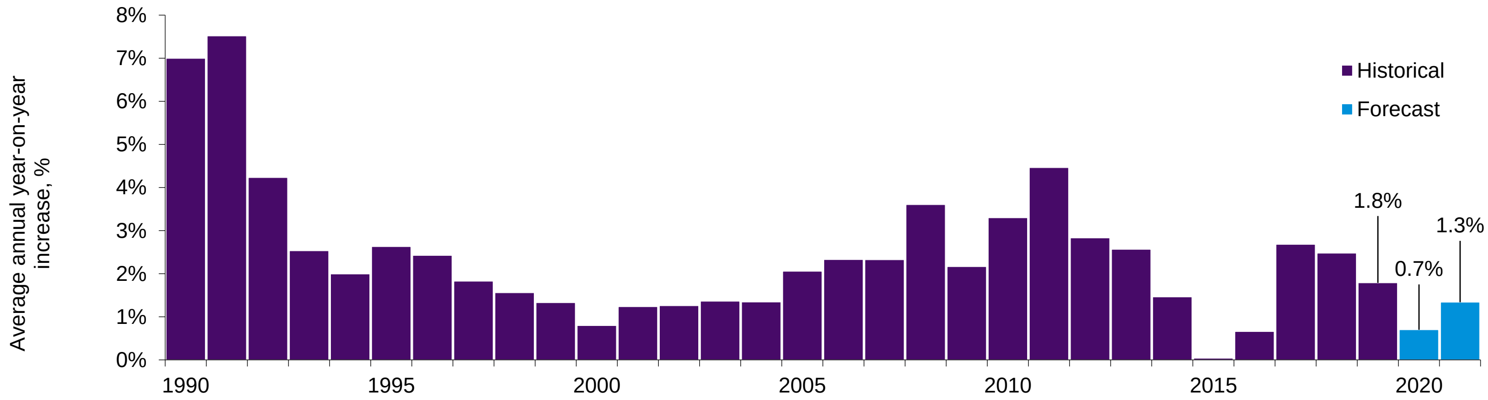


Source: ONS, KPMG analysis

- Thanks to the government's Job Retention Scheme, and to record low unemployment prior to the crisis, the unemployment rate could be lower than in previous recessions, despite the severity of the downturn.
- We assumed that furloughed workers will resume active employment very rapidly when that becomes possible. We also assumed that fear of renewed restrictions later in the year will make companies reluctant to bring back employment to pre-lockdown levels straight away, particularly while they face weaker and uncertain demand. This could see unemployment falling only gradually over the next two years.

A weaker inflation, but unremarkable for previous decade

Consumer Price Inflation

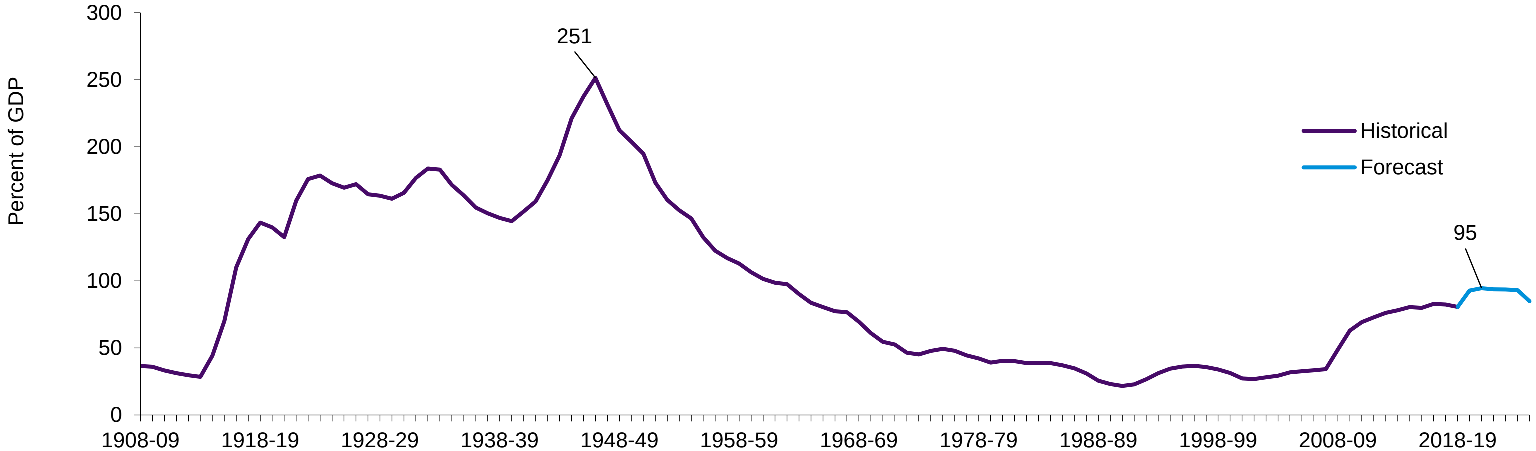


Source: ONS, KPMG analysis

- Despite the weaker pound and cuts in output production, inflation is expected to remain low this year and next, at half the Bank of England's 2% target on average. While the pandemic represents a shock to both the demand and supply capacity of the economy, in practice it is the shock to demand that is expected to dominate.
- Outside of a few select goods categories, we should see weaker price pressures throughout the next two years, with inflationary pressures remaining low while the job market slowly recovers.
- Consistent with moderate inflationary pressures and the need to support economic growth, the Bank of England's policy interest rate is expected to stay at 10 basis points throughout the next two years.

Debt will rise as the government increases spending

Historical ratio of UK government debt to GDP



Source: ONS, Bank of England and OBR

— Estimates published by the OBR show that government debt could rise to nearly 95% of GDP in the current fiscal year. This combines an £85bn increase in government spending, a £130bn hit to revenues from additional measures to reduce and delay the burden of taxes, and a slowing economy as well as a lower level of GDP, which pushes the ratio to its highest level since the 1962-63 fiscal year. This could be an underestimate as the OBR's calculations do not cover the cost of loan guarantees for businesses for example.

— However, a longer term perspective shows that the UK government's level of debt was far higher for most of the first half of the 20th century, when it rose as a result of two world wars. At its peak UK debt reached a record 251% of GDP in the aftermath of the Second World War.

Yael Selfin

Chief Economist
KPMG in the UK
Email: yael.selfin@kpmg.co.uk

Dennis Tatarkov

Senior Economist
KPMG in the UK
Email: dennis.tatarkov@kpmg.co.uk

You can access more of our research on the economic outlook here: **kpmg.com/uk/en/macroeconomics**