KPMG

UK Economic Outlook

January 2021

- We revised our short-term outlook for the economy downwards as infection and hospitalisation numbers climbed and the country entered into its third lockdown during the first quarter of 2021. We expect that the contraction in Q1 this year will be significantly milder than at the start of the pandemic.
- The prospect of vaccines reaching all vulnerable groups by April could herald a gradual easing of social restrictions with a return to normal by the autumn in our main scenario. This could see GDP grow by 4.2% in 2021. While the UK managed to secure a deal with the EU, avoiding significant disruptions to trade, the realities of the new trading relationship will dampen economic growth for a while.
- Uncertainty about progress in combating the pandemic could see growth oscillate between 5.6% in our upside scenario and 2.2% in our downside scenario in 2021.
- Government intervention, and in particular its Job Retention Scheme, should help keep unemployment relatively low considering the size of the negative shock experienced by the economy. Unemployment could peak at 6.3% this summer and average 6% this year.
- The expiry of the VAT cut to hospitality businesses should see inflation rise in April, although we expect the headline inflation rate will remain below the Bank of England's 2% target over the next two years.
- A lack of significant inflationary pressures will provide room for monetary policy to support the economic recovery through further quantitative easing while base interest rate is expected to remain unchanged.
- The deficit for the current fiscal year, which ends in March 2021, could reach nearly £380bn. While it should fall in fiscal year 2021-22, next year's expected figure of £188bn remains substantial.

Table 1: KPMG forecasts – main scenario

	2020	2021	2022
GDP	-9.7	4.2	5.5
Consumer spending	-12.1	3.8	8.9
Investment	-11.3	2.6	5.2
Unemployment rate	4.5	6	5.9
Inflation	0.9	1.5	1.7
Base interest rate	0.1	0.1	0.1

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

Authors

Yael Selfin
Chief Economist, KPMG in the UK
T +44 (0)7766 362 369
E yael.selfin@kpmg.co.uk

Dennis Tatarkov
Senior Economist, KPMG in the UK
T +44 (0)20 7311 2210
E dennis.tatarkov@kpmg.co.uk

Professor Hilary Thomas
Chief Medical Adviser, KPMG in the UK
T +44 (0)20 7311 4154
E hilary.thomas@kpmg.co.uk

© 2021 KPMG LLP, a UK limited liability partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

Pandemic scenarios this year

Having hoped that by September 2020 we would have passed the worst point of the pandemic, the reality is very different. The good news about vaccine development and deployment has been offset by the emergence of a new, more transmissible, strain of the virus. This has led to higher numbers of cases, a huge burden to the UK's NHS and ultimately, more deaths.

Looking at 2021, there is a plethora of unknowns, including wild cards in the form of the South African and Brazilian variants. We are using three potential scenarios in our analysis, set out in table 2.

Table 2: Assumptions underpinning our three scenarios

	Main	Upside	Downside
	Gradual easing of restrictions and falling infections. Current vaccines remain effective	Rapid easing of restrictions by April, once vulnerable groups are vaccinated	South African or other variants resistant to current vaccines trigger six-month development process for new vaccine
Lockdowns	Nationwide lockdown from Jan until Apr 2021	Nationwide lockdown from Jan until Apr 2021	Initial nationwide lockdown from Jan until Apr 2021, further lockdowns in Jul for one month and Oct-Nov 2021 lasting two months
Schools	Phased opening from end of Feb 2021	Open from end of Feb 2021	Open from end of Feb 2021. Closures in Oct and Nov 2021
Eat-in-restaurants	Re-opening from May 2021, continuing social distancing requirements until Sep 2021	Open from Apr 2021 with continuing social distancing requirements until May 2021	Closed until Aug and in Oct and Nov 2021, social distancing continues until Mar 2022
Non-essential retail	Open from Apr 2021	Open from Apr 2021	Open in Apr then closed again in Jul and in Oct and Nov 2021, social distancing continues until Mar 2022
Vaccination rate	All vulnerable groups vaccinated by Apr 2021	All vulnerable groups vaccinated by Apr 2021	New vaccine available by Dec 2021, roll-out in winter 2022
Travel restrictions/ people encouraged to go back to work	In place until Sep 2021	Lifted from May 2021	In place until Mar 2022

Source: KPMG.

In the first, main, scenario we anticipate the gradual easing of restrictions and falling infection rates. Barring any resistant new variant, we could see a return to a 'new normal' by the autumn. That said, experience to date shows that the trajectory is not linear. At the present time hospital capacity, particularly in critical care, is the rate-limiting factor. Clearly the situation is evolving rapidly. Any successes of an efficient vaccine roll-out may be undermined by the risks from increased transmissibility of new variants.

Our downside scenario is that new variants are ultimately less responsive, or even resistant, to the current vaccines. If that is the case, it will trigger the need for the development of a new vaccine. Despite the significant agility of pharmaceutical companies in 2020, any new vaccine is still likely to take at least four months to develop. In addition, manufacturing at scale hard on the heels of the first vaccine would be challenging. Before the government lifts all restrictions, it will need to be confident it can manage transmission rates, hospital admissions and critical care demand. This will require 70-80% of the vulnerable population to have immunity, ideally through vaccination. That could take time if we see widespread vaccine resistant mutations arising in 2021, pushing a full relaxation to 2022.

If the vaccine roll-out is as good as hoped at lowering the number of patients needing critical care, our upside scenario is feasible. This means the government will be able to lift restrictions more rapidly. However, we don't yet know how effective the vaccine will be in older people, as relatively few were tested in the trials. Another question remains around the impact of a longer gap between doses. This may be more significant than anticipated, especially if a more resistant variant becomes widespread.

The return of children to school has been shown to cause a rise in the R rate but, given the vaccine roll-out, the impact on the NHS may be mitigated. It is likely the government will find a balance between the health implications of letting children mingle at school and the negative impact on their education of staying at home. No doubt modelling will inform whether this can be across the board or staggered.

Whatever happens, we are quite likely to be living with restrictions and social distancing for some time.

© 2021 KPMG LLP, a UK limited liability partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

Outlook for the economy hinges on a successful vaccination programme

The new year saw a setback in the fight against the COVID-19 pandemic, with a third nationwide lockdown likely to see the economy contract slightly in the first quarter of this year. While the UK managed to secure a deal with the EU, avoiding significant disruptions to trade, the realities of the new trading relationship will also dampen economic growth for a while.

The outlook for this year largely depends on progress in combating the pandemic, with the length and severity of social distancing restrictions key to the growth outlook. Given the level of uncertainty as to the evolution of the pandemic this year, we developed three scenarios with KPMG's Chief Medical Advisor, to help clients with their planning.

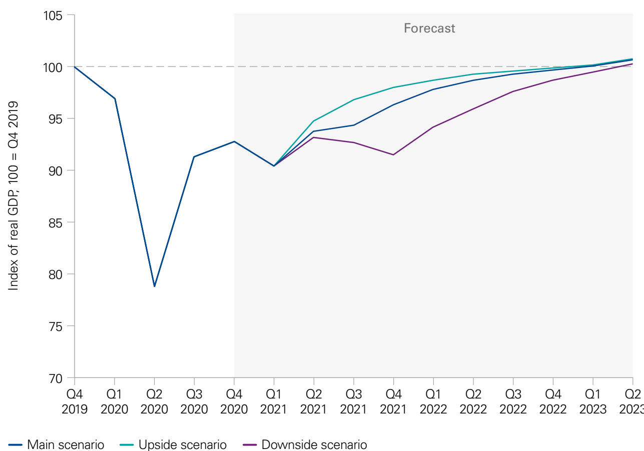
Our three scenarios see output contracting in the first quarter of 2021 by far less than the first lockdown last year (chart 1). Even though we expect the lockdown in the first quarter of 2021 to last until the end of March, more businesses are expected to be operating this time and many have adapted successfully to remote working by now and are managing to grow their output despite the restrictions. The contraction in Q1 this year is therefore expected to be much milder than the contraction at the start of the pandemic last year, with output potentially falling by 2.6% after an estimated 1.5% growth in the fourth quarter of 2020.

Our **main scenario** sees a recovery in the second quarter of 2021, with consumer spending particularly robust as households draw on savings made during the lockdown to pursue some of the activities they were unable to do. Growth picks up again in the autumn once people are encouraged to go back to normal and any remaining restrictions are lifted. The continued recovery sees the economy return to pre-COVID level by the first quarter of 2023, although investment is hampered by Brexit disruptions and remaining pandemic-related uncertainties, returning to pre-COVID level only by the fourth quarter of that year.

Our **upside scenario**, which assumes all restrictions are lifted in the second quarter of this year, sees a stronger rebound in in the second and third quarters of 2021. In this scenario, we forecast the economy will grow by 5.6% in 2021.

Some of the risks around the deployment and efficacy of current vaccines are captured by our **downside scenario**. This envisages further milder contractions in Q3 and Q4 this year as a result of the additional lockdowns. In this scenario, growth is projected to pick up more strongly only next year, with output reaching pre-COVID levels in Q2 2023. Under this scenario the economy would grow by 2.2% in 2021 and by 5.1% in 2022 as all social distancing restrictions are finally lifted from the second quarter (table 3).

Chart 1: UK economy could return to pre-COVID size in the first half of 2023



Source: ONS, KPMG forecasts.

Table 3: KPMG GDP forecasts under alternative scenarios

	2020	2021	2022
Main scenario	-9.7	4.2	5.5
Upside scenario	-9.7	5.6	4.6
Downside scenario	-9.7	2.2	5.1

Source: ONS, KPMG forecasts. Average % change on previous calendar year.

© 2021 KPMG LLP, a UK limited liability partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

Higher unemployment on the horizon

Unemployment is set to continue to rise across all three scenarios as the ongoing lockdown will have a destructive effect on the labour market.

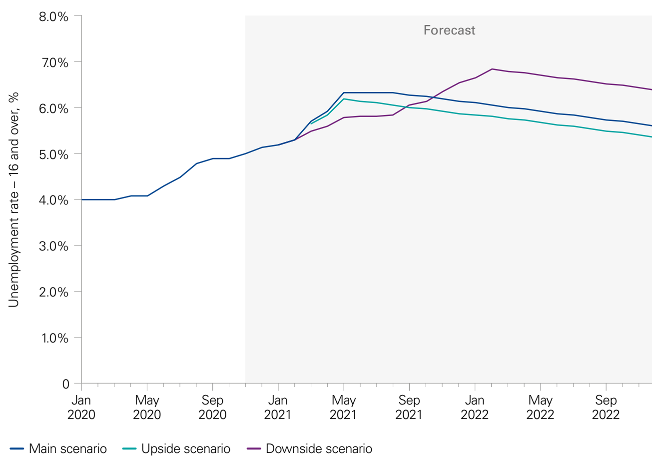
We assume that the government's job support schemes will remain in place until the end of April in our main and upside scenarios and in both cases, we forecast a peak in the unemployment rate in May 2021. After reaching 6.3% in our main scenario that month, we expect the unemployment rate to gradually decline as restrictions are lifted. Recovery then starts to pick up from September 2021 onwards as the last social distancing restrictions are finally lifted.

The absence of any restrictions from May onwards allows for a more rapid recovery in the upside scenario and a lower path for the unemployment rate, reaching 5.4% by the end of 2022 (chart 2).

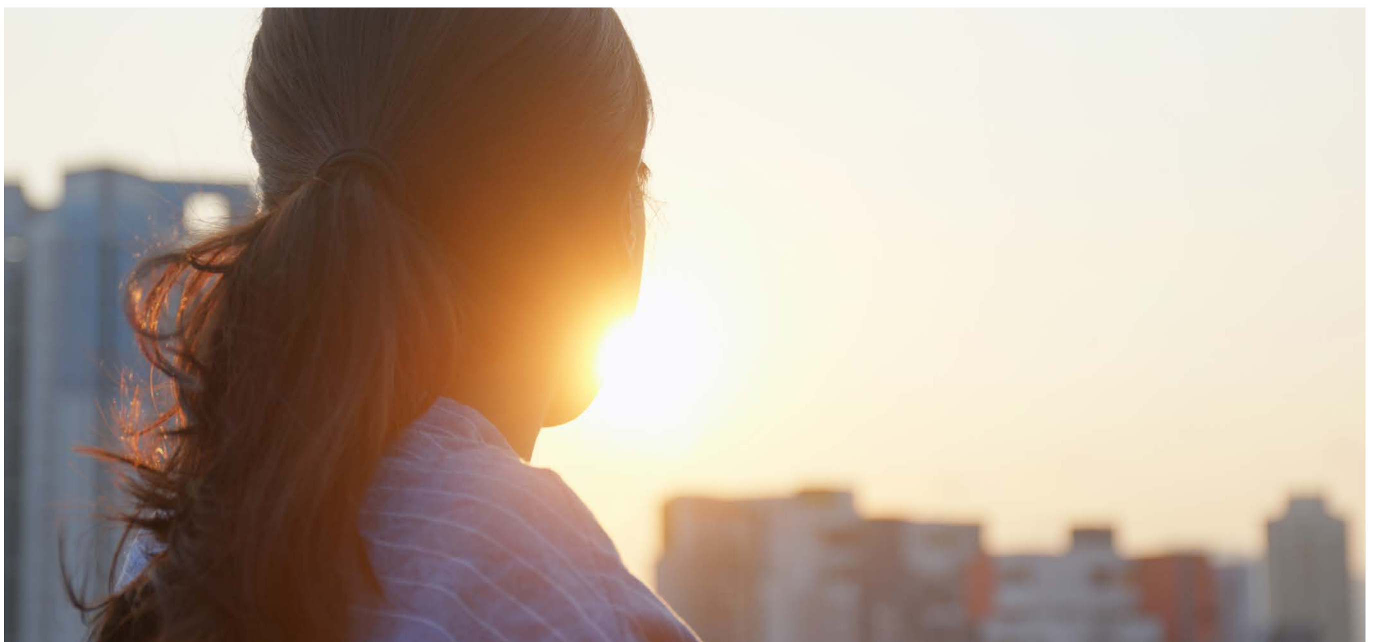
Our downside scenario sees a continuation of severe restrictions through the summer and autumn of 2021 alongside two additional lockdowns in July and October/November. This scenario avoids the cliff-edge of ending the furlough scheme in May; the severe and deteriorating pandemic conditions would make the extension of the furlough scheme inevitable. However, despite the extension of the job support schemes, these are unlikely to completely prevent job losses throughout the year. In this scenario, we forecast that the unemployment rate will continue to rise, peaking at 6.9% in February 2022.

In the event that job support schemes are not extended past April this year, the downside scenario could see the unemployment rate reaching 9% by the time of a final lockdown in November 2021.

Chart 2: Outlook for unemployment



Source: ONS, KPMG forecasts.



© 2021 KPMG LLP, a UK limited liability partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

Inflation and interest rates: mostly below target

Inflation is set to remain low throughout 2021 as the economy gradually recovers to a new normal. The headline rate of inflation is expected to stay below the Bank of England's 2% target in all but the most optimistic scenario we consider, while a supportive stance of monetary policy will see a prolonged period of low interest rates.

We assume that the expiry of the VAT cut to hospitality businesses goes ahead as planned. This would help boost the headline rate of inflation in April 2021 for all three scenarios, lifting the headline inflation rate for the rest of the year.

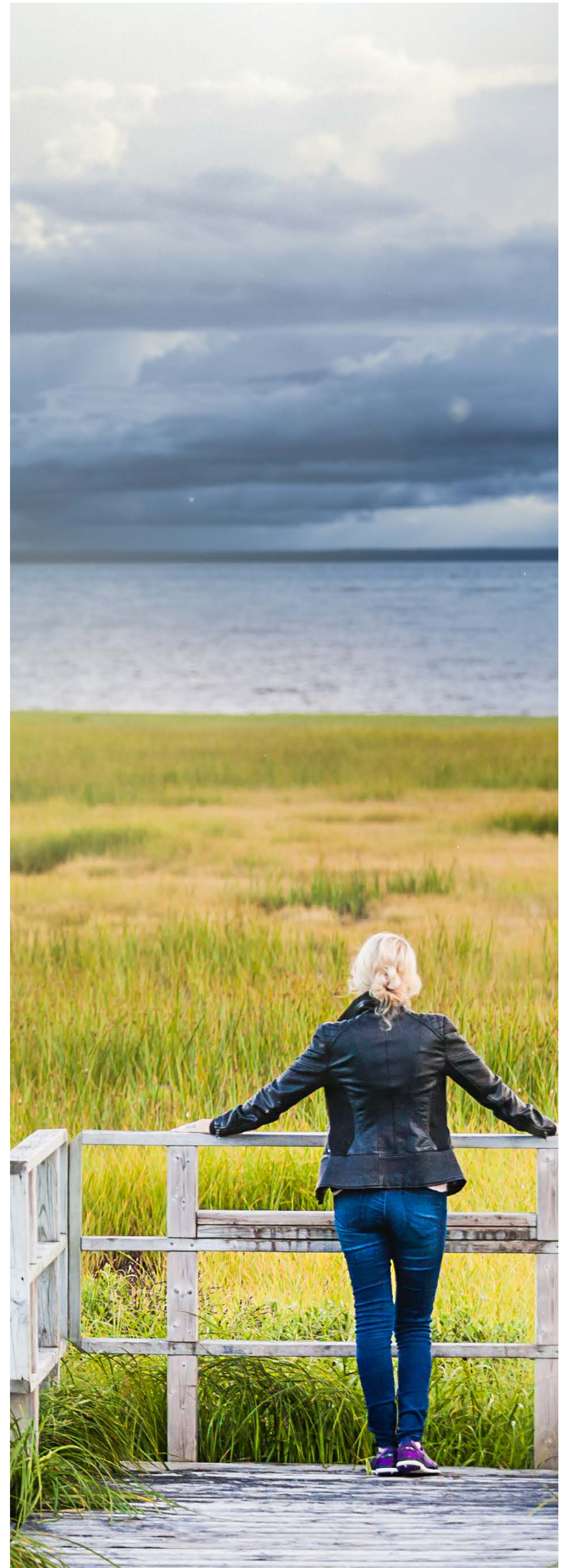
In the main scenario, the gradual lifting of restrictions over the summer will mean that inflation remains around 1.7% from the middle of this year and into 2022.

A more rapid easing of restrictions, similar to our upside scenario, could see the rate of inflation rising to target by mid-2021 thanks to a faster recovery in economic activity. While renewed escalation of restrictions in 2020, in line with our downside scenario, could lead to downward pressure on prices and cause the headline inflation rate to dip to only 0.9% by July 2022, before returning to an upwards trajectory (chart 3).

Chart 3: The outlook for inflation under our three scenarios

Source: ONS, KPMG analysis.

A supportive monetary policy is likely to see base interest rate kept at current level with further quantitative easing (QE) announced later this year. We do not expect interest rates to begin normalising in any of the scenarios we consider before the end of 2022, while the downside scenario could see the policy interest rate cut to zero and further increases to the scale of the ongoing QE programme.



© 2021 KPMG LLP, a UK limited liability partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

Public sector finances: spend now, pay later

Stronger economic performance in the fourth quarter of 2020 could alleviate the pressure slightly on public finances, however the government's deficit could still reach nearly £380bn in the current fiscal year. While we expect the deficit to be lower in the coming fiscal year starting in April 2021, it is likely to remain substantial ranging from £170bn in our upside scenario to £288bn in our downside scenario. In the main scenario, the deficit would reach £188bn in fiscal year 2021-22.

Our £379bn estimate for borrowing this year is around £14bn below the Office of Budget Responsibility's forecast in November. While the deterioration in the pandemic and the ongoing lockdown in January would have increased government spending by around £24bn, growth in the fourth quarter was stronger than expected. This has helped offset some of that increased borrowing through higher revenues and lower welfare spending.

Chart 4: The outlook for government borrowing

Source: OBR, ONS, KPMG analysis.

Nevertheless, these projections imply a sharp increase in the UK government's debt: it is set to rise to £2.7tn by fiscal year 2023-24 in our main scenario and as much as £2.9tn in our downside scenario. The downside scenario represents a risk to public finances. An additional three months of lockdown, alongside severe restrictions until March next year, would probably entail further extensions of the job support schemes and new rounds of grants through the self-employed income support schemes. Together, these two schemes could end up costing the taxpayer over £180bn since the start of the pandemic in March 2020 in the downside scenario.

However, there is scope in the upside scenario to see a more rapid improvement in public finances: it could see a reduction in the deficit of over £18bn compared to our main scenario. An early relaxation of restrictions could open the way for a quicker return to normal in sectors such as hospitality. This could help to raise revenue, while simultaneously lowering the cash needed to fund support schemes. This means that, if the government were to spend more now to roll out the vaccine quicker, it could end up paying for itself. When we reach a crucial vaccination threshold, the government can ease restrictions and pave the way for this scenario.

© 2021 KPMG LLP, a UK limited liability partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

kpmg.com/uk/**economicoutlook**

© 2021 KPMG LLP, a UK limited liability partnership and a member firm of the KPMG global organisation of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organisation.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

CREATE | CRT133543 | January 2021