KPMG

UK Economic Outlook

June 2021

As restrictions are lifted and consumers flock back, we are expecting a robust recovery ahead. Some sectors, such as manufacturing and construction, have already recovered most of the ground lost last year, while for sectors such as hospitality and personal services, the big times are now.

There will be some permanent shifts in the way we work and consume goods and services. We expect business travel to remain supressed even after the pandemic clears internationally, and online retail and communications to hold on to part of the gains made.

The recovery is also likely to be uneven across the UK, with strongest growth expected in the West Midlands, London, and the East of England. It could provide an opportunity for the government to address its levelling up agenda by targeting investment to improve the long-term prospects of poorer regions, focusing on the new needs of local people and the range of areas that require support, from education and skills to technology infrastructure, housing, and social amenities.

— **The short-term outlook for the economy is favourable**. The vaccination programme is well underway and further easing of social distancing restrictions are expected later this month. A combination of excess savings, pent-up demand and a range of government incentives should see for a hot summer in the UK. We expect the economy to grow by 6.6% this year and by 5.4% in 2022, with a potential deceleration in growth thereafter. This will allow the economy to reach its pre-COVID level by the first quarter of next year.

— The possible emergence of new variants of the virus that are less responsive to the current vaccines is still a **downside risk**, albeit less severe than previously, as the economy has adapted to operating under social distancing restrictions. An expected rise in the level of insolvencies, as government support programmes are withdrawn could also impact recovery.

— The furlough scheme continues to support the labour market, keeping **unemployment relatively low**, while a fall in the participation rate also means that the labour market may be less tight at present. We expect unemployment to peak at 5.7% by the end of the year, as the furlough scheme ends and the majority of workers are reabsorbed by the labour market.

— Rising cost pressures and the reversal of temporary tax cuts will cause **inflation to rise this year**, but spare capacity in the economy should see inflation moderating next year without the need for the Bank of England to raise interest rates before 2023.

— While **public sector finances** are set to improve relatively quickly, they have become more vulnerable to a rise in interest rates.

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Table 1: KPMG forecasts

	2020	2021	2022
GDP	-9.8	6.6	5.4
Consumer spending	-10.6	5.7	8.6
Investment	-8.8	8.0	6.6
Unemployment rate	4.5	5.1	5.3
Inflation	0.9	1.7	2.1
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. Investment represents Gross Fixed Capital Formation, inflation measure used is the CPI and the unemployment measure is LFS. Interest rate represents level at the end of calendar year.

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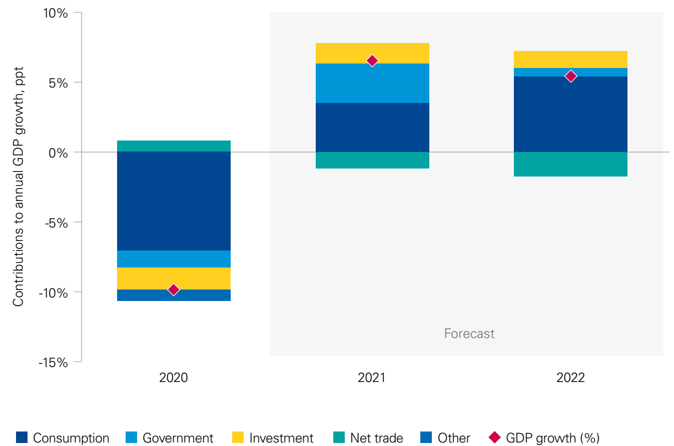
Outlook for the economy

With the worst part of the crisis now likely behind us, and with the vaccination programme well underway, we expect a rapid acceleration in growth this summer. Following a contraction of nearly 10% last year, we see annual GDP growth at 6.6% in 2021 and 5.4% in 2022 (chart 1). This will push the level of GDP back above its pre-COVID level in 2022Q1. We expect the recovery to be driven by a bounce-back in consumption, as the economy reopens and households catch up on some of their postponed spending. Government consumption also grows strongly this year, with health and education activities returning to more normal levels.

Our forecasts rest on the assumption that government restrictions are lifted as previously announced. Positive developments on the vaccine front, coupled with increasing herd immunity, support this assumption (chart 2). This implies the economy embarking on a 'new normal' operating model from the end of June. Consistent with that, business and consumer confidence have been recovering sharply (chart 3).

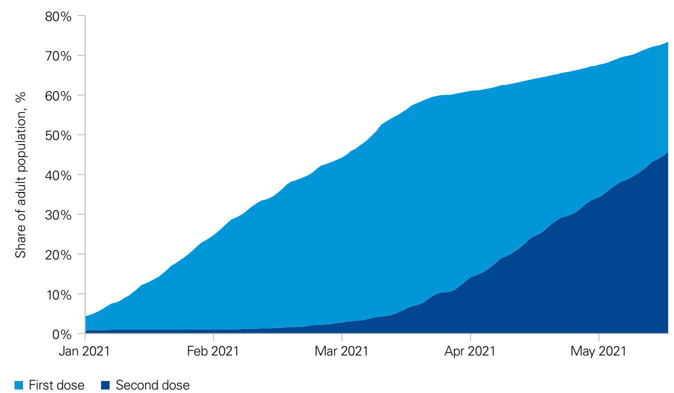
Social distancing measures introduced last year have constrained household consumption, in particular for services with a high share of social interaction. That has prompted a shift in consumption away from services and towards goods, for example switching from restaurant visits to home cooked meals, and from pubs to convenience stores. ONS data suggest that around 8% of the £120bn fall in services consumption in 2020 has been reflected in higher spending on non-durable goods. Some of the increased demand for goods has been satisfied by increased purchases online. The share of online retail sales jumped to 36.2% in February 2021, with the share of clothing & footwear sales made online nearly tripling over the year to 60%. We expect some of that trend to reverse as non-essential shops reopen and indeed initial figures post-lockdown point to a strong return to the high street for some categories.

Chart 1: Outlook for the UK economy



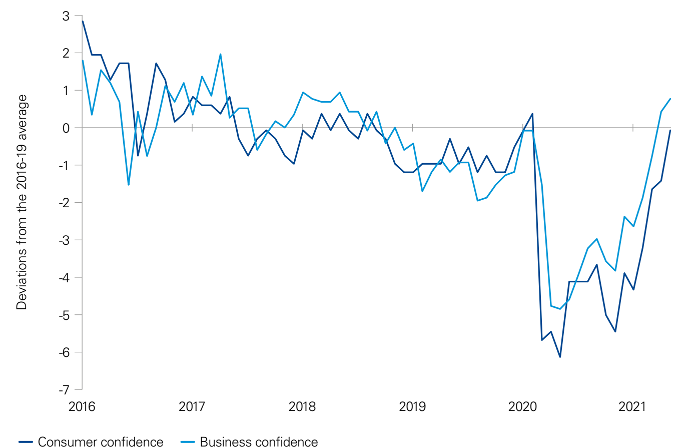
Source: ONS, KPMG analysis.

Chart 2: UK vaccination uptake is high



Source: Gov.uk, KPMG analysis.

Chart 3: Business and consumer confidence are recovering sharply



Source: GfK, Lloyds Business Barometer, KPMG analysis.

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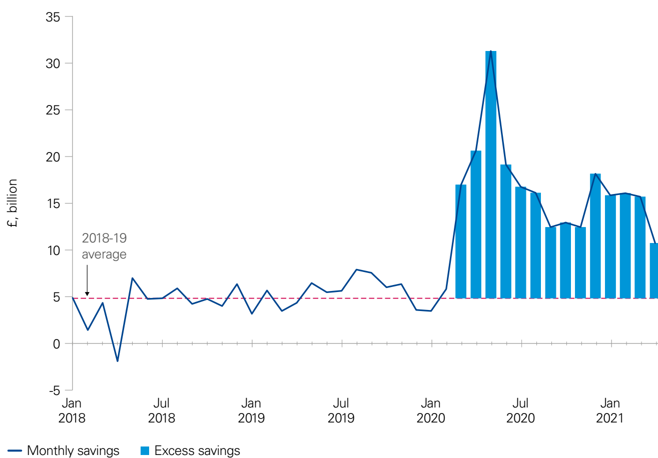
Household savings increased dramatically. Since not all foregone consumption of services has been redirected towards substitutes, that has led households to accumulate savings in excess of £168bn (chart 4). Although some households saw their incomes fall over the past year, whole-economy disposable income stayed broadly flat in 2020, in part cushioned by the government's income support schemes. As a result, the household saving ratio ended 2020 at 16% of disposable income, having peaked at 26% in 2020Q2.

Chart 4: Households accumulated £168bn of excess savings



Source: Bank of England, KPMG analysis.

We expect households to run down excess savings in a gradual manner, which adds extra impetus to consumption in the near term. Specifically, we assume that around 8% of the extra stock of savings is spent each year as households make up for the foregone spending on durable goods last year. We forecast consumption to grow by 5.7% in 2021 and 8.6% in 2022.

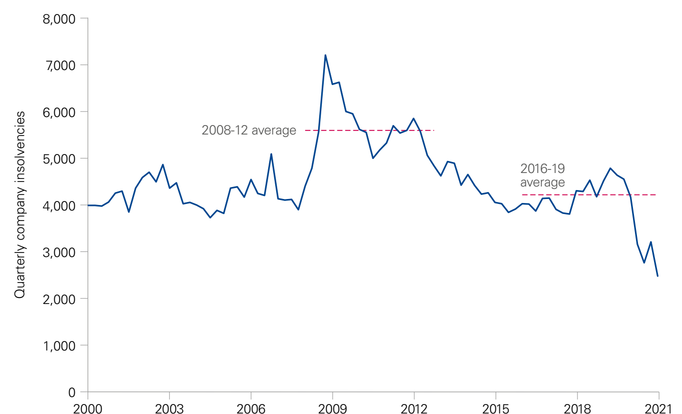
Business investment will be lifted in the near term by the generous capital allowance super deduction on plant and machinery. We estimate that this will boost investment by 1.1% in 2021 and 3.7% in 2022, as companies bring forward investment plans from future years. However, as a temporary incentive, we don't expect it to lift the level of investment permanently once the effects of the policy fade. Therefore, investment will likely be weaker than it would otherwise have been from 2023 onwards.

Net trade is set to drag on growth this year and next. Although we expect an increase in imports this year, in line with stronger domestic demand, exports are expected to remain weak, reflecting businesses adjusting to new trading requirements with the EU.

Potential new variants of the virus, if more resistant to the vaccine, could materially slow the economic recovery. The emergence of new variants of the virus – including the Indian variant – could see infections starting to rise again, prompting further government restrictions. A combination of a renewed period of lockdowns and rising uncertainty would pose a downside risk to our GDP forecast. However, the experience of the past months has shown that businesses have become much more adept to new operating models based on online interactions and homeworking, making the economy more resilient to social distancing measures.

There is also a significant likelihood that the end of the pandemic will be associated with a wave of company insolvencies. Since the onset of the pandemic, businesses have been partially shielded from insolvency both by the direct financial support on offer as well as by temporary measures suspending and relaxing insolvency procedures. Since the start of 2020, the number of insolvencies has been more than 25% below the average pre-pandemic levels, suggesting that these measures have suppressed some of the usual business churn and firm turnover on top of mitigating pandemic related pressures (chart 5). Once the temporary regime is over and businesses are forced to confront a new normal, we expect a significant uptick in the number of company insolvencies, potentially exceeding the highs seen in 2008-12.

Chart 5: Lifting of COVID-19 support could trigger a wave of insolvencies



Source: The Insolvency Service, KPMG analysis.
Note: Data for Northern Ireland start in 2009Q4.

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Uneven recovery across sectors

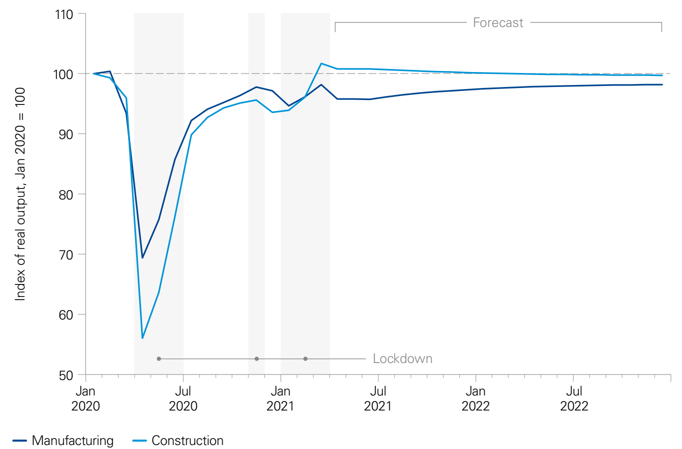
A robust recovery of the economy as a whole masks varied performance across sectors. This reflects the government's social distancing restrictions and lockdowns. As these are gradually lifted, the outlook will also depend on voluntary social distancing and the pace and degree to which people return to their pre-COVID lifestyle habits. The recovery is therefore unlikely to be equally shared across sectors and businesses.

Sectors like **manufacturing** and **construction** saw output fall sharply during the first lockdown, but they recovered most of it by the end of the year thanks to being exempt from subsequent lockdowns (chart 6). In March 2021 only 10% of jobs in these two sectors were on furlough, well below the national average of 18%. We forecast manufacturing output to grow by 6.7% and 3.7% in 2021 and 2022, respectively, and construction to grow by 16.2% and 5.4%.

The **retail** sector has had a volatile year (chart 7). Lockdown measures meant that non-essential retail had to stay closed for many months, while essential shops such as supermarkets remained open. But retailers have grown increasingly more adaptable to new operating models based on online shopping, with internet sales now accounting for more than a third of all purchases. As a result, the slump in retail sales has been much more shallow than in the rest of the economy, and the volume of sales is now above its pre-pandemic level. We expect retail output to grow by 5.4% in 2021 and 0.6% in 2022.

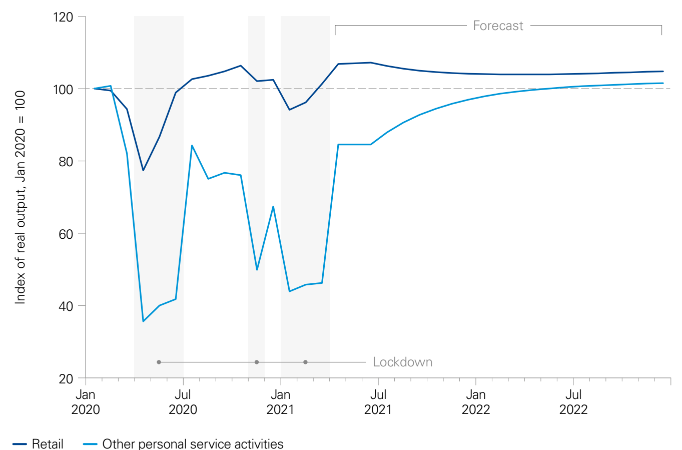
With many services unavailable, households have substituted certain activities with purchases of goods, for example enjoying home-cooked meals and more grooming products. This served to boost retail trade. Social distancing restrictions, lockdowns and people's fear of catching the virus saw a significant fall in the output of **other personal service activities** – which include hairdressers and beauty treatments. While dry cleaning, which is also included in this category, suffered from the shift to working from home and a more informal dress code. Overall, these activities were still at about half the level they were operating at prior to the pandemic by the end of March (chart 7). With the economy now reopening, we expect a sharp rebound across many of the businesses included in this category, although demand will likely take time to reach its pre-COVID strength while social distancing measures are in place, and as some consumers would have changed their spending habits. We forecast other personal activities to grow by 14.5% overall this year and by 27% in 2022.

Chart 6: Outlook for manufacturing and construction



Source: ONS, KPMG analysis.

Chart 7: Outlook for retail & other personal service activities



Source: ONS, KPMG analysis.

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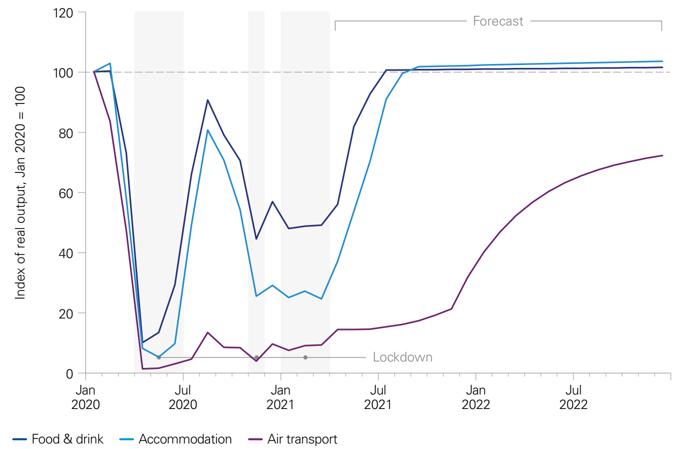
The sectors spared least from the impact of COVID-19 have been those unable to operate under social distancing rules, or those that rely on international travel. **Food and drink activities**, **hotels**, and **air travel** came to a virtual standstill last year, and took another hit during the latest lockdown earlier this year (chart 8). With the successful rollout of the vaccine and further easing of restrictions, we see hospitality businesses returning to their pre-pandemic levels by August, making for a busy summer in the hotel and restaurant industries. This is consistent with the latest high-frequency data for restaurant bookings (chart 9). Increased domestic activity should be boosted by reduced levels of foreign travel, with more people spending this summer holiday in the UK. Reduced business travel as well as the prevalence of 'staycation' holidays this year will see air transport activity stay at subdued levels, with the uneven progress on vaccinations outside the UK, and the longer term shift in business travel habits casting a shadow on the eventual recovery of the industry. We forecast food and drink activities to reach pre-pandemic levels in July, while hotels are expected to recover a bit more slowly and reach pre-COVID level by September. Air transport is set for a further fall of 32% this year, followed by strong growth in 2022, with output expected to reach 72% of pre-COVID level by the end of next year.

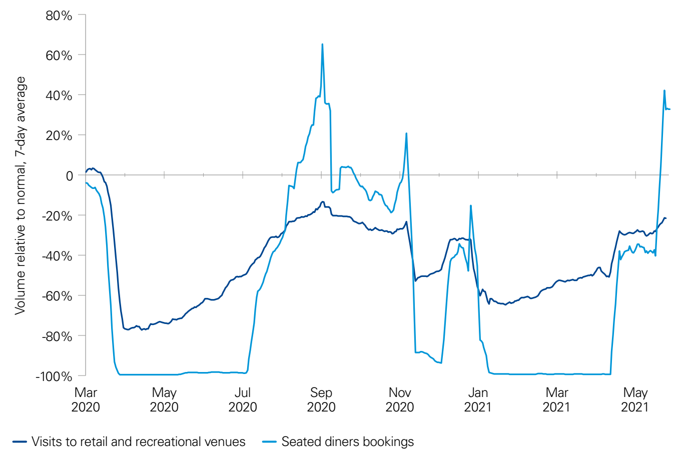
A full set of forecasts by individual sectors can be found in the Appendix.

Chart 8: Outlook for hospitality and air transport



Source: ONS, KPMG analysis.

Chart 9: High-frequency data for retail and restaurants activity returning to normal



Source: Google Mobility Reports, OpenTable, KPMG analysis.

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UK regions: widespread recovery

The outlook for all regions and nations of the UK is one of a recovery in both 2021 and 2022, although at varying speed. This reflects the uneven impact of the pandemic across sectors and regions, with a relatively quick bounce-back in manufacturing leading much of the early gains in output. However, as the economy emerges from the restrictions imposed to contain the virus, the shift towards a services-based economy will resume across most of the UK.

The recovery could provide the government with the opportunity to address its levelling up agenda by channelling a bigger share of investment towards struggling regions. The establishment of eight freeports announced in the March Budget could become a key first step in rebalancing the UK economy. However, freeport clusters will take time to develop on their own and are unlikely to be successful in shifting the prospects of whole regions without a consistent program of long-term investment across the region, with targeted investment in a range of areas including education, skills, housing and social amenities as well as transport links.

So far, the recovery is proceeding at pace. Data on online vacancies from job search engine Adzuna shows a rapid pick-up in hiring after the slump caused by the pandemic (chart 10). As of mid-May 2021, only London has yet to exceed pre-COVID levels of online vacancies.

Looking ahead, we see strongest growth this year in the West Midlands and London with the strongest growth enjoyed by East of England and West Midlands next year (table 2).

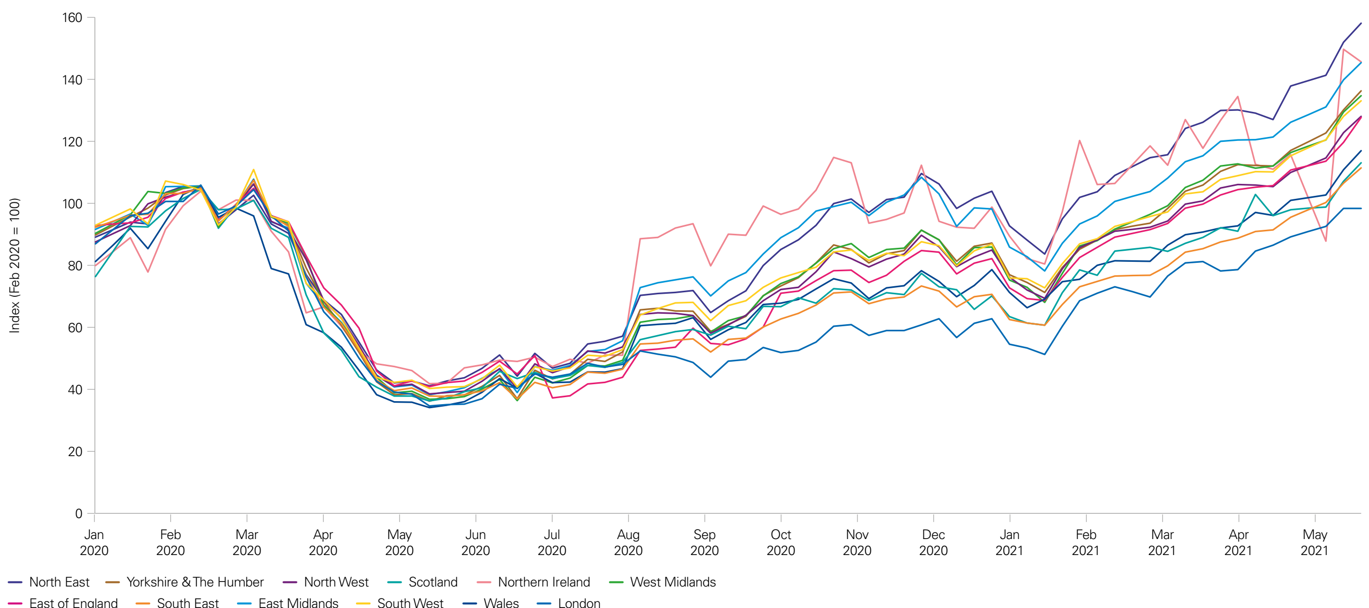
Table 2: All regions to see a recovery in output in 2021 and 2022

	2020	2021	2022
North East	-9.9%	5.3%	3.9%
North West	-7.9%	5.5%	5.7%
Yorkshire & The Humber	-8.7%	5.8%	5.2%
West Midlands	-11.8%	9.5%	6.4%
East Midlands	-9.9%	6.3%	4.8%
East of England	-9.2%	8.0%	6.8%
South East	-10.4%	7.1%	5.7%
South West	-8.0%	5.6%	5.6%
London	-7.2%	8.8%	5.8%
Wales	-8.2%	3.9%	4.2%
Scotland	-9.6%	6.4%	5.2%
Northern Ireland	-6.2%	0.7%	2.6%
UK	**-9.8%**	**6.6%**	**5.4%**

Source: ONS, Scottish Government, NISRA, KPMG analysis.

Note: Forecasts for Northern Ireland are based on Northern Ireland Composite Economic Index (NICEI).

Chart 10: Online vacancies show accelerated hiring particularly in the North East



Source: Adzuna.

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Scotland growth shifting towards service sectors. Scotland's significant manufacturing sector is poised to benefit from increased investment demand during the initial stage of the recovery from the pandemic, while the oil and gas sector should see a boost from the rebound in global demand and the rise in oil prices. After regaining the pre-pandemic level of output by Q1 of 2022, financial and business services are expected to be the main contributor to GDP growth. A lesser relative impact of Brexit on the local financial service sector compared to London should help support growth over the longer-term.

Wales economy resilient during pandemic year. The Welsh economy saw a relatively mild impact at the outset of the pandemic, with the second smallest output fall of anywhere in the UK by the second quarter of 2020 (chart 11) and a full-year GDP fall estimated at 8.2%. This was driven by the resilience of the large manufacturing sector as well as relatively smaller falls in public sector output compared to other parts of the UK. In the short-term, Wales is set to be amongst the regions to benefit most from a potential boom in summer staycations, as holidaymakers choose to remain in the UK during this summer, while longer term growth is expected to be driven by public sector as well as professional and IT services.

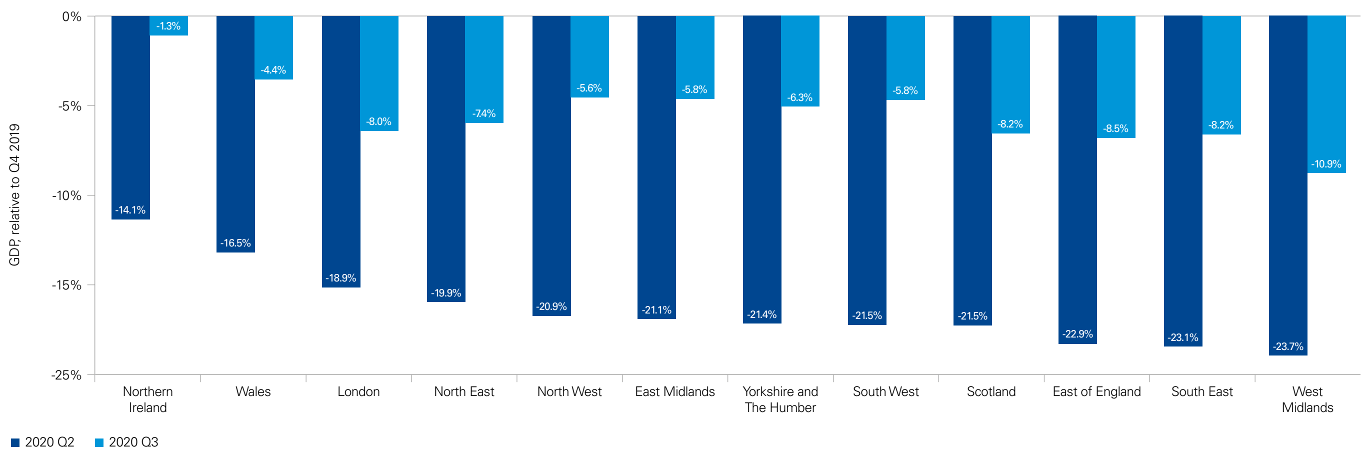
Northern Ireland's outlook complicated by Brexit. Northern Ireland's strong performance last year may reflect discrepancies in measuring public sector output rather than a divergence in fortunes. While looking ahead, the outlook for Northern Ireland is adversely affected by the impact of Brexit, although economic growth is likely to be sustained by the contribution of the life sciences, food manufacturing and public sectors.

North West sees a long term pivot to a service-based economy after recovery. The North West economy saw a sharp contraction in the first half of 2020, with GDP down by almost 21% by the second quarter of the year, driven by large falls in the manufacturing and health sectors. A strong bounce-back in the second half of 2020 could lead to a relatively shallower recovery in the short term, with the local economy reaching pre-COVID levels by the first quarter of 2022, in line with the UK average. Longer term, professional and business services are expected to be among the key sectors driving growth in the region.

North East could benefit from stronger public sector investment. Increased demand for investment goods and growing scale of public sector investment in the region could help bring about more rapid growth following the recovery from the pandemic. The expansion in the manufacturing sector could benefit from the establishment of the UK's largest freeport in Teesside. The Budget also saw the announcement of a new Treasury campus in Darlington, which may herald a wider expansion in professional and public services in the region.

Yorkshire and The Humber to see service-based growth. The region should benefit from strong investment growth this year owing to a sizeable industrial sector. While tourism in Yorkshire could see a boost from the increase in staycation holidays this summer, the post-pandemic economy is expected to be more reliant on the growing financial, professional and business services in the region.

Chart 11: Regional output compared to pre-COVID levels



Source: ONS, Scottish Government, NISRA, KPMG analysis. Note: Impact for Northern Ireland based on Northern Ireland Composite Economic Index (NICEI).

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West Midlands sees brighter outlook after a severe recession. The West Midlands economy is estimated to have suffered the sharpest contraction anywhere in the UK last year, which was mainly caused by falls in wholesale and retail trade as well as manufacturing output. As manufacturing operations were not restricted after the initial lockdown, output began to recover already last year, while the super-deduction allowance on plant and machinery investment introduced in the 2021 Budget should help accelerate manufacturing output over the next two years. However, the longer-term outlook for the local manufacturing industry remains uncertain, particularly owing to the ongoing impact of Brexit on the automotive manufacturing sector and the expected longer-term fall in business travel impacting other related industries. Future growth is expected to be supported by the IT and financial services sectors, especially after the well-publicised moves by a number of companies to open an office presence in Birmingham.

East Midlands could benefit from broad-based recovery. In the East Midlands, as in the West, the initial impact of the pandemic was driven by falls in manufacturing as well as in wholesale and retail trades. A large manufacturing presence is likely to benefit from the increased demand for investment, accelerated by the introduction of the super deduction allowance on plant and machinery. Following a recovery from the pandemic, the region should see growth spread across a diverge range of sectors. The establishment of a freeport around East Midlands airport could provide an opportunity to generate stronger growth in the medium to long term.

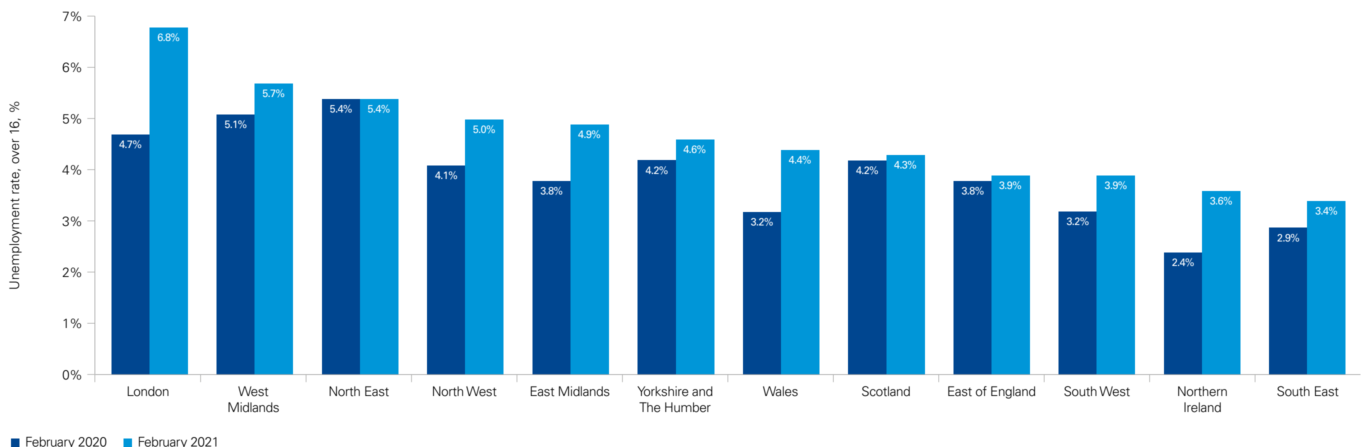
East of England well-placed for recovery. A rapid recovery in the East of England could see the region reach pre-pandemic levels of activity by the end of this year, ahead of the UK average. Proximity to London should mean the region could receive a boost as remote workers seek to relocate further from their usual place of work. The region could also see significant growth in the life sciences, IT, professional and business services sectors, particularly around the Cambridge-Milton Keynes corridor.

South West set for repeat of summer staycation bonanza. In the summer of 2020 the South West economy expanded by 20% on the previous quarter, making it the fastest growing region in the UK at that time. This summer is shaping as another strong season for the region's hospitality industry, with the South West expected to see a repeat of the staycation boom of last year.

South East to benefit from remote working shift. The ongoing and protracted slump in international travel caused by the pandemic could hinder the recovery in the South East, particularly affecting the Crawley area, which hosts Gatwick airport. In the medium to long term, the close proximity to London should make the region one of the main beneficiaries of the shift to more remote working, while the IT services sector is expected to make a key contribution to growth in the region as a whole. However, alongside London, the South East could see the largest fallout from the impact of Brexit, particularly due to the effect of border frictions on the configuration of supply chains between UK and the EU.

London set for rapid growth despite ongoing Brexit impact. London's unemployment rate reached 6.8% in the three months to March 2021, the highest level anywhere in the UK (chart 12), highlighting the impact of the pandemic on London's workforce. While the relatively modest 7.2% contraction that London experienced in 2020 was partly caused by a widespread shift to remote working – this also caused a deeper fall in the number of visitors and commuters in the capital, accentuating the slump in consumer services. With an almost complete absence of any manufacturing activity, the fall in GDP was instead driven by falls in hospitality, construction and other services. These sectors appear to have adapted to lockdown restrictions during the course of the past year and may have helped London become the only region to avoid a contraction during the lockdown in the first quarter of this year. Looking ahead, the impact of Brexit is likely to weigh on growth in London's important and outward-facing financial services sector over the medium-term.

Chart 12: London saw the sharpest rise in unemployment during the pandemic



Source: ONS.

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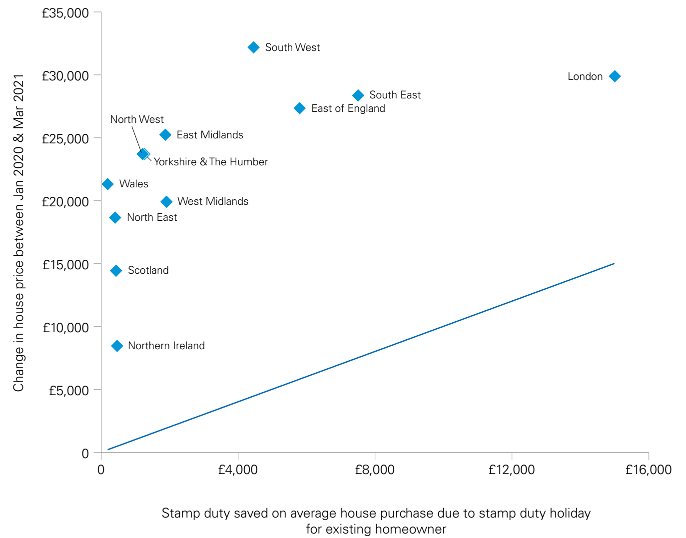
All regions saw strong increases in house prices despite the severe economic shock of the pandemic. House prices across the UK rose by 6% to 15% between January 2020 and March this year according to data from the Land Registry (chart 13). The strongest rises took place after the introduction of the 'stamp duty holiday' in the 2020 Summer Statement. Latest data shows that by March 2021 the overall increase in house prices has exceeded the level of duty that would normally be due on the average house price in each region leaving little benefit for new buyers (chart 14).

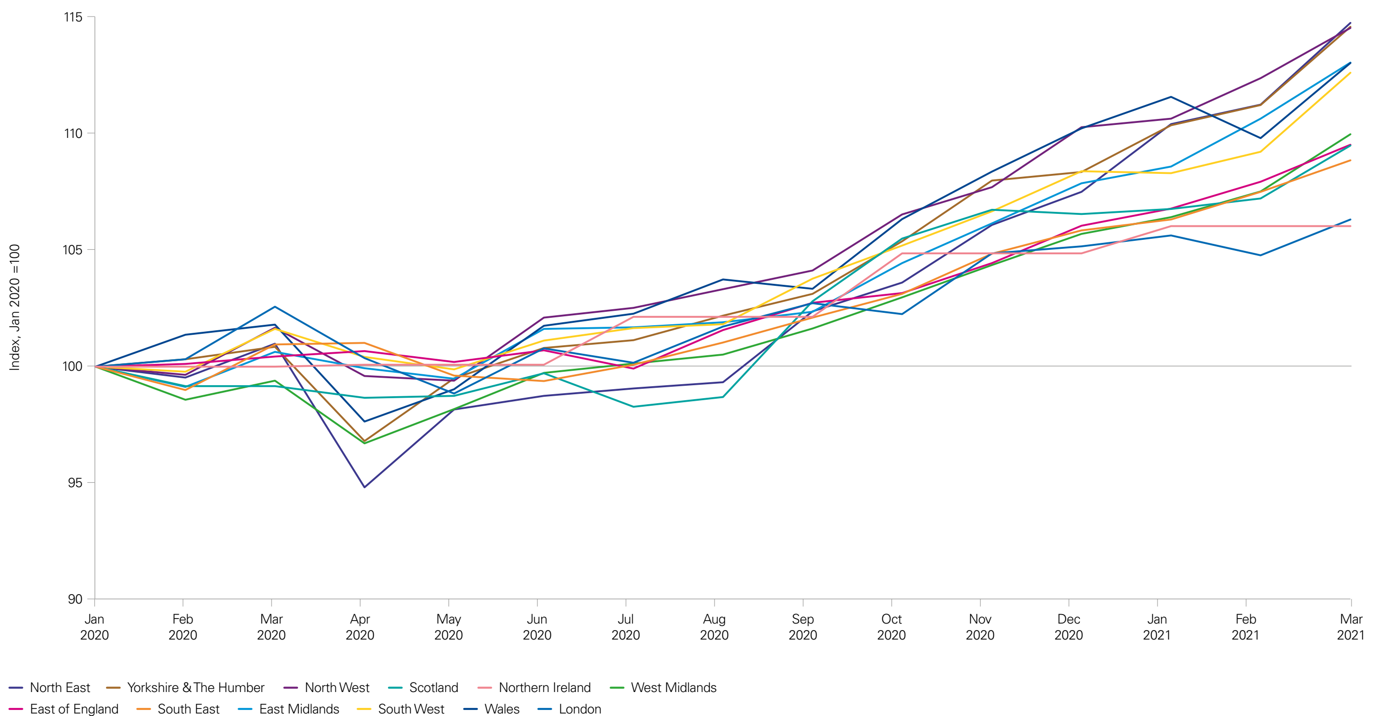
The pace of house price rises is unlikely to be sustained in the medium term. The next six months will see the reversal of the cut to stamp duty, which could trigger a deceleration in demand. Changes in lifestyle preferences, with people working remotely more from now, may have also already manifested themselves in market movements over the past year, although we could see an additional transformation of the list of the most sought-after residential areas in the country.

Chart 14: The reduction to stamp duty has been more than absorbed by the increase in average prices



Source: Land Registry, Gov.org, Revenue Scotland, Welsh Revenue Authority, KPMG analysis.

Chart 13: All regions saw rapid house price increases since the start of 2020



Source: Land Registry, KPMG analysis.

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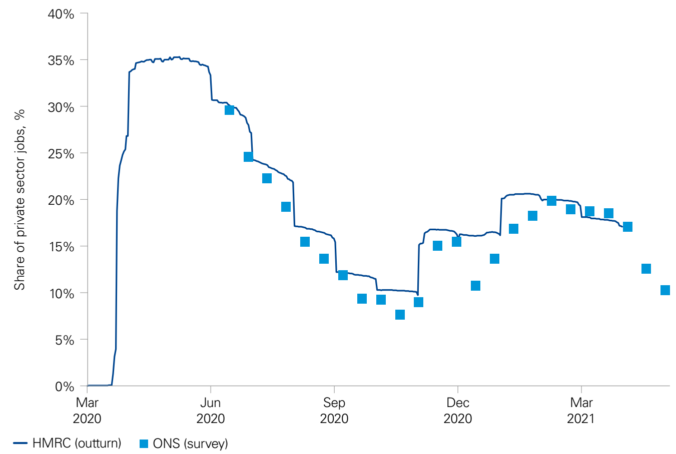
The labour market: damage control

Despite the tumultuous year for the economy, the UK labour market has so far been relatively resilient. At its peak, the Coronavirus Job Retention Scheme has supported around a third of private sector employees, by temporarily placing them on furlough during times of weak demand. An average of 4.4 million, representing 18% of private sector jobs, were furloughed in March, with hospitality and distribution sectors accounting for nearly a half of the support received. The latest official data show that furlough has probably peaked in January this year, with more timely survey data pointing to a further decline through April (chart 15).

Participation rate – the share of population either employed or looking for a job – has declined over the past year. People may have been less likely to actively look for work with a large part of the economy shut down and school closures during the lockdown period. A rising share of students has also contributed to the inactivity figures. This has mechanically pushed down the reported unemployment rate by around 2 percentage points. But with broadly stable rates of unemployment and participation since the start of the year, this suggests that people exiting furlough have thus far been successfully reabsorbed by the labour market.

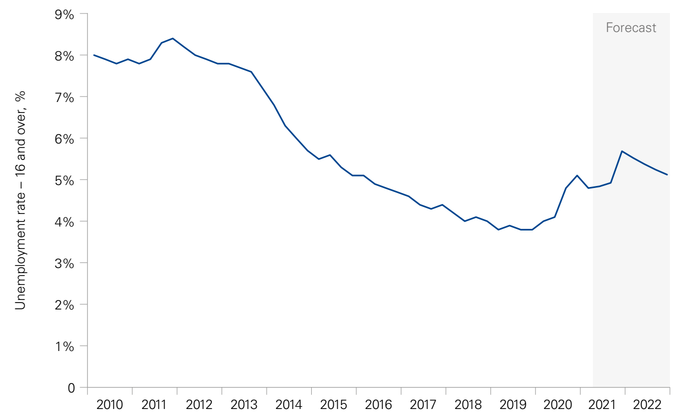
As we approach the end of furlough scheme in September, this creates tangible risks for unemployment. To put it into context, in an extreme scenario where all those on furlough at the end of March were to be reclassified as unemployed, that would increase the unemployment rate to a staggering 17%. But our forecast is consistent with 9 out of 10 workers currently on furlough remaining in employment after September. We forecast the unemployment rate to average 5.1% in 2021, with a peak of 5.7% in the three months to December, and 5.3% in 2022, as the labour market normalises (chart 16).

Chart 15: The share of furloughed jobs is set to fall



Source: HMRC, ONS, KPMG analysis.

Chart 16: Outlook for unemployment



Source: ONS, KPMG analysis.

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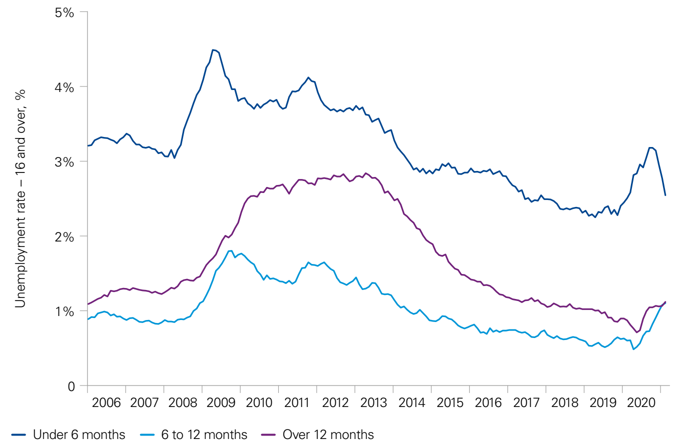
Nonetheless, the rise in unemployment may prove to be more contained than we currently forecast. The rate of redundancies has fallen for four months in a row, suggesting that firms paused making cutbacks around the turn of year. Short-term unemployment, which captures those without work for under six months, has peaked at the end of 2020 and declined since (chart 17). The decline in short-term unemployment coincided with a pickup in the 6-12 months unemployment rate, reflecting the newly unemployed cohort moving up to longer durations. In normal times, short-term unemployment is a good leading indicator of the overall jobless rate and leads it by around five months. At face value, that would suggest that unemployment could already be close to its peak. But the incentives from the furlough scheme make this relationship much more complicated, as employers may choose to hold onto their staff for as long as the support is in place.

The labour market remains relatively loose, although furlough could have masked employees taking on jobs elsewhere. Hiring intentions have picked up, with the latest KPMG-REC survey showing that overall vacancies rose in April at the quickest rate for 23 years. But because vacancies are still almost 20% down relative to early 2020, the ratio of vacancies to unemployment is well below its pre-COVID peak. This would generally suggest little hiring difficulties going forward, consistent with the Bank of England's Agents' survey. However, anecdotal evidence from some sectors such as hospitality suggests that some employers have been unable to bring back all their staff as the venues reopened, because they found another job or had other commitments whilst on furlough. Although that phenomenon – if confirmed at a wider scale – would limit the rise in unemployment relative to our forecast, it could also mean that the labour market is tighter than the official statistics suggest.

Chart 17: Short-term unemployment peaked in 2020



Source: ONS, KPMG analysis.

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UK inflation: returning to normal

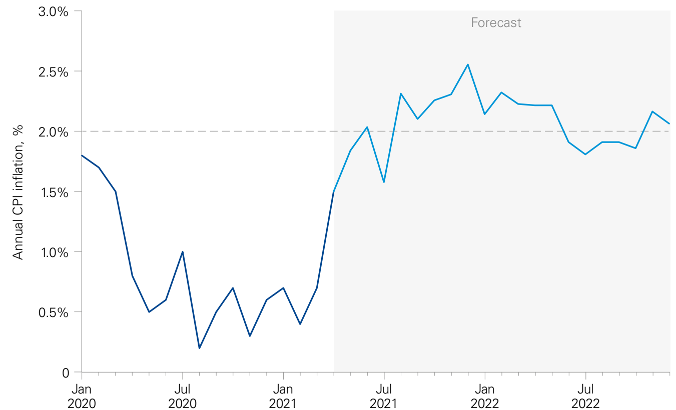
Inflation is set to be higher and more volatile in the medium term. Rising cost pressures from raw materials and energy prices, as well as the increased costs of importing from the EU, together with the withdrawal of temporary VAT provisions all point to a period of higher inflation. While inflation is expected to exceed the Bank of England's 2% target in the short term, the overshoot is likely to be temporary, and inflation is expected to return to target by the middle of next year, averaging 1.7% in 2021 and 2.1% in 2022 (chart 18).

A recovery in oil prices will continue to boost inflation over the summer. Crude oil prices have recovered from last year's slump and have remained in the range between 60-70 US$ per barrel since February this year. Road fuel prices and energy costs, which are sensitive to oil prices, have followed a similar path, recovering after having fallen early in 2020. As the annual comparison of these components takes into account the lower prices seen last year, energy costs will make a bigger contribution to overall inflation rates this year.

Global supply chain shortages and higher commodity prices have led to rising cost pressures. Global demand has outstripped supply for a whole range of goods: from microchips to basic metals (chart 19). For UK businesses also impacted by Brexit, input costs have risen by over 10% in April 2021 compared to a year ago. So far, the impact on consumer prices has been limited, but as the UK economy re-opens fully over the course of the summer, these pressures could manifest themselves more fully later this year.

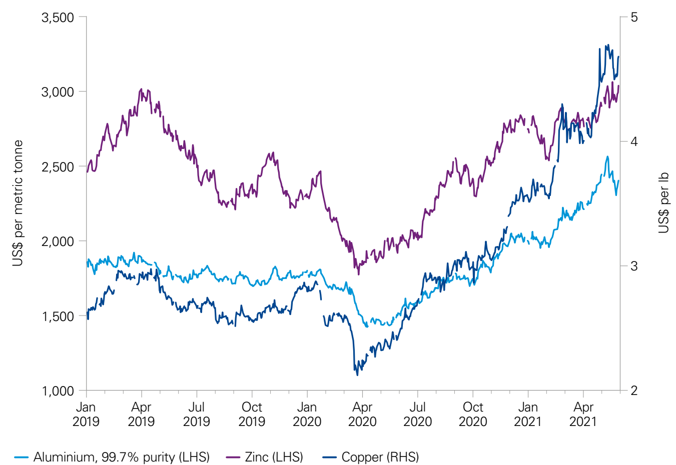
The withdrawal of the VAT cut for hospitality businesses will temporarily lift inflation. This reverses the change made last year, which was partly responsible for lower inflation at the time. In a similar way the impact of the Eat Out to Help Out (EOTHO) Scheme will briefly raise the rate of inflation in August, when the cost of eating out will be compared to the discounted values last year. These changes have little to say about the underlying price pressures in the economy, although their impact on the headline inflation numbers will be significant this year.

Chart 18: Inflation set to rise this year as the economy reopens



Source: ONS, KPMG analysis.

Chart 19: Global commodity prices have risen steadily



Source: Financial Times, Wall Street Journal via Haver.

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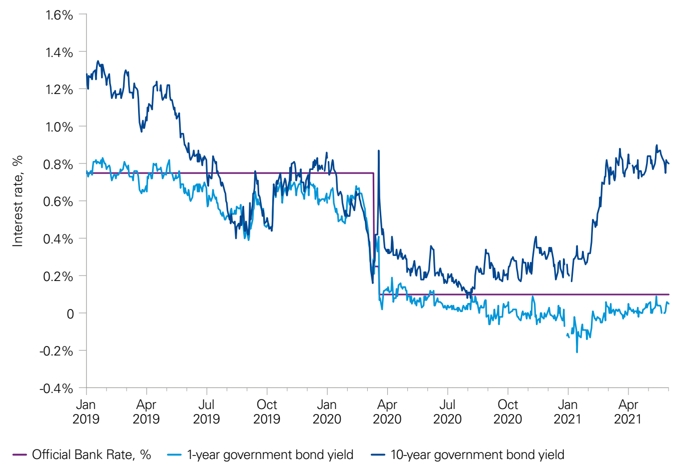
The Bank of England is unlikely to raise interest rates due to the higher inflation, as its target overshoot is likely to be temporary. While a re-opened economy could see rapid economic growth over the next two years, there is still a significant level of slack which would prevent higher inflation from taking hold. We anticipate that the Bank of England will see through the temporary rise in inflation above its target and keep interest rates at current levels for approximately two years, in order to allow the economy to fully recover, and mitigate the downside risks to the outlook.

Yields on longer duration government debt have remained steady with 10-year yields close to 0.8% after a sharp increase in February this year (chart 20). The increase reflected an anticipation of higher real interest rates and inflation in the future and brought yields back to pre-pandemic levels. Mortgage interest rates also rose in the second half of 2020 but have since eased slightly. The rise was caused by a combination of high demand for mortgages from an accelerating housing market and the anticipation of higher credit risk for borrowers during the pandemic. Current mortgage rates remain relatively elevated, especially for higher loan-to-value mortgages.

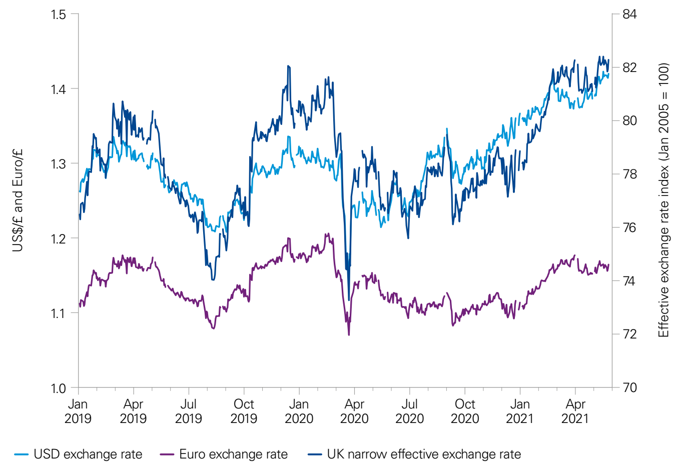
Exchange rates have remained relatively stable. The value of Sterling's trade-weighted exchange rate rose by around 5% between the start of the year and March but has since remained relatively stable (chart 21).

Chart 20: Short-term interest rates remain low, while yields on longer maturity government debt recovered early this year



Source: Bank of England, Refinitiv.

Chart 21: Sterling exchange rates close to levels reached in March



Source: Bank of England.

Note: UK narrow effective exchange rate index is the value of Sterling against a basket of foreign currencies, weighted by the share in UK trade, composed of economies with more than 1 percentage point share of imports or exports over the last three years.

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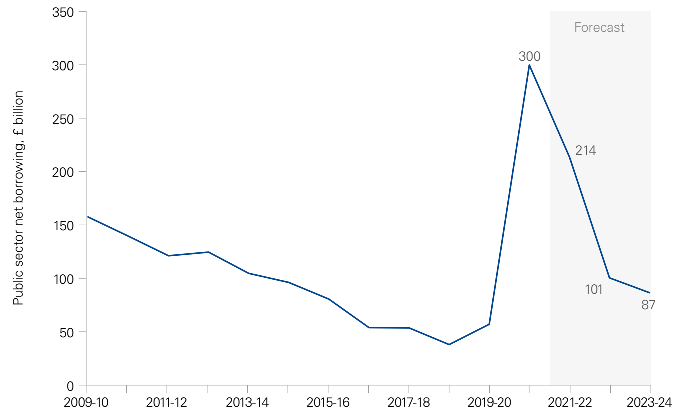
Public sector finances: from rescue to recovery

Public sector net borrowing rose in 2020-21 to 14.3% of GDP, the highest proportion of GDP since 1945-46. At £300bn, that was also the highest amount on record, and around double the level it reached at its peak following the Great Recession (chart 22). The rise in borrowing has so far been a spending story, with higher expenditure accounting for 85% of the increase in the deficit in 2020-21. The total cost of past and planned COVID-related government interventions now amounts to nearly £350bn. Receipts were relatively resilient thanks largely to the Coronavirus Job Retention Scheme (CJRS), which served to protect the income of affected workers. We expect this to reverse this fiscal year, with the fall in spending being the driving force in the reduction in government borrowing.

Improvement in the state of public finances could be swifter this time. It took five years following the last recession to halve the deficit from its peak. In this crisis we may already see that happen next year, once the support schemes come to an end, although a full return to pre-COVID state of finances could take longer. Thanks to an improved outlook for growth we see the deficit falling to £214bn this fiscal year, £101bn in 2022-23, and £87bn in 2023-24, with cumulative borrowing potentially undershooting the OBR's latest forecast by around £24bn.

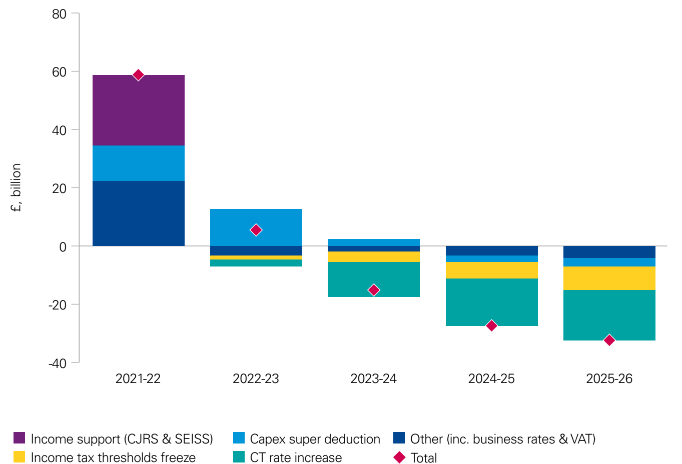
The Chancellor extended COVID-related measures at his March Budget and announced additional temporary giveaways. Rescue measures in the form of the CJRS extension and two further grants under the Self-Employment Income Support Scheme (SEISS) add £24bn to borrowing in 2021-22, on top of the £80bn already spent last year (chart 23). Business support measures (including extensions to business rates holiday and the VAT cut for hospitality and accommodation) amount to a further £16bn this fiscal year. The large giveaway to support the "recovery phase" is the 130% capital allowance super deduction on plant and machinery, estimated to cost an average of £12.5bn this year and next. Overall, we estimate the measures announced in the Budget will boost the level of GDP by 0.7% at its peak impact in 2022-23, before dragging on growth in later years.

Chart 22: The outlook for government borrowing



Source: ONS, KPMG analysis.

Chart 23: The impact of Budget 2021 on borrowing



Source: OBR, KPMG analysis.

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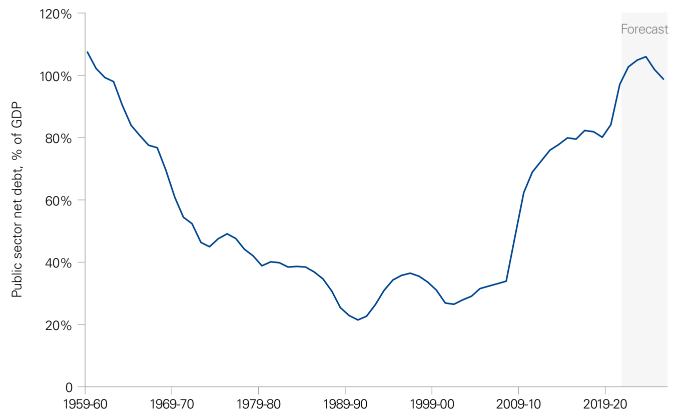
Higher taxes are on the horizon. From 2023-24 onwards, the public finances enter a repair phase, with fiscal consolidation measures largely accounted for by a higher main rate of corporation tax (rising from 19% to 25%) and income tax thresholds freeze. Fiscal tightening reaches £32bn by 2025-26.

Public sector net debt is set to rise to above 100% of GDP. The large fiscal loosening has had ramifications for public debt, which we forecast to peak at 106% of GDP, and amount to £2.7tn, in 2023-24, its highest level since 1959-60 (chart 24). We then see debt starting to decline as fiscal consolidation kicks in. The government has benefitted from low borrowing costs, with interest spending falling to a record low of 2.2% of total revenues, despite the rise in borrowing (chart 25). The latest quantitative easing (QE) measures will have effectively reduced the servicing cost of public sector debt by around £9bn.

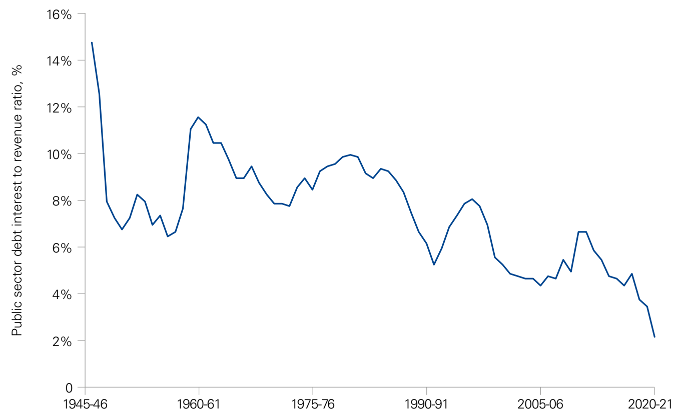
Public finances are now more vulnerable to a rise in interest rates. Over the past year, the government's demand for cash to meet its COVID-related spending needs has coincided with the Bank of England's policies to meet its 2% inflation target, which included QE. Once fully completed, the bonds purchased under QE will account for around a third of total government debt. But because QE finances gilt purchases with newly created reserves that pay an overnight rate of interest of 0.1% – rather than the market rate which is generally higher – this has reduced the effective maturity of government debt. A shorter maturity means that government finances are more exposed to a sudden rise in short-term interest rates. The OBR estimates that a 1% rise in short rates relative to baseline could increase debt interest spending by £12bn.

Chart 24: The outlook for government debt



Source: ONS, OBR, KPMG analysis.

Chart 25: The government has benefitted from low debt servicing costs



Source: ONS.

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Appendix: GVA forecasts by individual sectors

	2020	2021	2022
Agriculture	-9.3%	-1.5%	7.7%
Mining & quarrying	-7.6%	-5.1%	0.0%
Food manufacturing	-5.1%	1.5%	4.5%
Textiles	-11%	5.8%	-7.6%
Wood and paper	-10%	7.2%	-0.2%
Coke, refined petroleum	-19%	0.8%	14%
Chemicals	3.4%	1.1%	-8.8%
Pharmaceuticals	14%	-4.7%	-4.2%
Rubber and plastic	-8.1%	7.8%	-0.9%
Basic metals	-10%	5.9%	2.5%
Electronics	-9.6%	7.5%	6.9%
Electrical equipment	-9.5%	2.2%	0.6%
Machinery	-20%	18%	3.5%
Transport manufacturing	-24%	14%	17%
Other manufacturing	-9.7%	7.6%	2.7%
Energy utilities	-4.0%	3.4%	1.1%
Water utilities	-1.3%	3.8%	1.0%
Construction	-14%	16%	5.4%
Vehicle sales & servicing	-20%	16%	13%
Wholesale	-6.4%	4.2%	3.5%
Retail	-2.2%	5.4%	0.6%
Rail transport	-62%	1.6%	79%
Land transport	-13%	7.3%	6.1%
Water transport	-25%	-5.6%	19%
Air transport	-77%	-32%	290%
Warehousing & logistics	-4.8%	6.8%	4.5%
Postal services	7.0%	4.6%	-6.0%
Hotels	-51%	41%	48%
Bars & restaurants	-39%	34%	24%
Publishing	-12%	3.7%	0.3%
Media production	-17%	18%	7.2%
Broadcasting	-4.6%	5.1%	4.8%

	2020	2021	2022
Telecoms	-0.9%	0.8%	11%
IT communication	-3.6%	5.6%	9.0%
Banking	-5.9%	-1.5%	-3.3%
Insurance	-1.0%	-3.1%	-5.2%
Auxiliary to finance	-1.4%	0.4%	-5.2%
Real estate	-1.2%	1.6%	3.6%
Legal & accounting	-3.3%	11%	1.6%
Management consulting & head offices	-10%	4.4%	13%
Architectural & engineering	-4.6%	5.8%	3.4%
Scientific R&D	12%	6.1%	3.7%
Advertising & market research	-12%	9.9%	5.3%
Other professional services	-16%	3.9%	11%
Veterinary	-3.6%	6.2%	7.1%
Leasing, excluding property	-12%	7.9%	11%
Employment services	-15%	11%	12%
Travel agency	-73%	9.0%	150%
Security & investigation	-5.4%	6.9%	2.0%
Buildings & landscape services	-10%	3.1%	11%
Office administration & business support	-7.6%	7.5%	6.7%
Public administration	2.1%	0.5%	-0.9%
Education	-16%	14%	7.1%
Health	-11%	18%	4.8%
Residential care & social work	-1.9%	2.1%	2.7%
Arts & entertainment	-45%	40%	33%
Libraries, museums & other cultural	-31%	22%	22%
Gambling & betting	-5.9%	6.7%	1.3%
Sports & recreation	-32%	23%	21%
Membership organisations	-12%	4.0%	11%
Household repairs	-3.9%	4.7%	2.6%
Other personal services	-32%	15%	27%
Households as employers of domestic personnel	-26%	21%	18%

Source: ONS, KPMG analysis.

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