UK Economic Outlook

December 2021

— The emergence of a more contagious Omicron variant brings new uncertainties to the fight against the COVID-19 pandemic. While growth momentum is expected to decelerate until a booster is rolled out to halt the rise in cases, the full impact will depend on the rise in the number of acute COVID-19 cases and any social distancing restrictions that are introduced.

— We expect GDP to grow between 1.8 - 4.2% in 2022, depending on the extent social distancing restrictions are introduced in the first half of the year (Table 1). Current government efforts to control the pandemic with minimal restrictions could see a relatively small impact on economic growth, as depicted in our Upside scenario.

— Labour shortages have become a significant impediment to growth and pay pressures more pronounced. The labour market appears to have weathered the end of the furlough scheme with the unemployment rate expected to peak at 4.5% in our Upside scenario, while new restrictions to combat the Omicron variant could see unemployment peak at 5 - 5.7% in 2022.

— A deteriorating pandemic outlook could once again increase the demand for goods and put more pressure on supply chains in the short-term. At the same time, cooling demand for energy and some services could ease inflationary pressures. Inflation could average between 4.3 - 4.8% in 2022 and 2.3 - 2.5% in 2023 depending on the evolution of the Omicron variant.

— High level of uncertainty about the Omicron variant is expected to see the Bank of England hold off raising interest rates in December 2021. However, rates are expected to rise to 1-1.25% by the end of 2023 in order to prevent a ratcheting up of wage growth as the recovery gathers renewed momentum.

— Rapid house prices growth seen during the past year is expected to moderate due to the rising cost of mortgages and the end of the temporary cut to stamp duty. Some locations may continue to benefit from buyers who can take advantage of a reduced need for commuting to move away from traditional market hotspots in favour of more affordable alternatives further afield.

— While the Autumn Budget provided a modest fiscal loosening, overall fiscal policy is set to become a headwind to growth in 2022.

Table 1: KPMG UK GDP growth forecasts

	2020	2021	2022	2023
Scenarios				
Upside	-9.7	6.7	4.2	2.2
Middle	-9.7	6.7	2.6	3.5
Downside	-9.7	6.7	1.8	4.3

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

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Growth outlook marred by Omicron

The emergence of a new COVID-19 strain throws a spanner in the economic recovery. The Omicron variant has elevated the level of uncertainty about the recovery path from the pandemic. While the impact is not expected to be as severe as at the start of the pandemic, or even the beginning of this year, increased uncertainty and the potential reintroduction of social distancing measures could see output fall this month and during the first quarter of 2022. Since a number of important factors about the new strain of the virus are still unknown, we created three alternative scenarios to capture some of the possible outcomes. An important question is how severe an illness Omicron can cause compared to earlier strains of the virus and how likely people who are infected would need hospitalisation as part of their treatment. That is likely to determine the extent of social distancing restrictions to reduce the spread of the virus. Our three scenarios range from no formal introduction of social distancing restrictions to a two-month lockdown at the start of next year (see Table 2 for a more detailed description of each scenario).

Table 2: Alternative Omicron scenarios

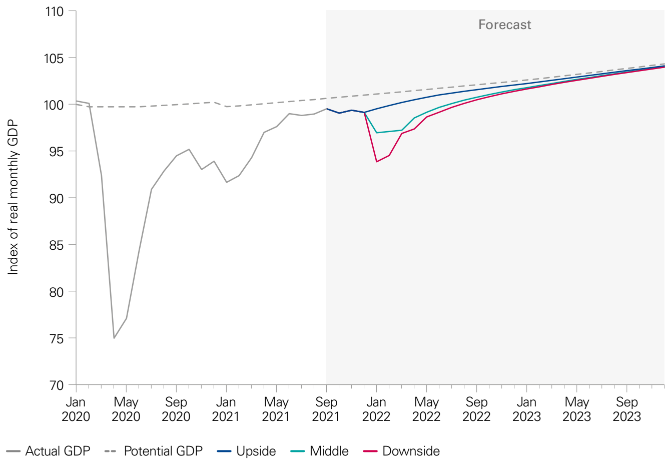
	Upside **False alarm** A combination of an accelerated booster programme, increased access to effective treatments and a milder form of illness which does not cause a large rise in hospitalisations.	**Middle** **Successful shield** New strain causes a severe form of illness in parts of the population but current vaccines are effective in moderating some of the symptoms.	**Downside** **Pandemic setback** New strain causes a severe form of illness and current vaccines prove ineffective. A new booster is developed within three months and rolled out by end of June 2022.
Lockdowns	No lockdown	No lockdown	Lockdown during January and February 2022
Schools	Open throughout	Open throughout	Open throughout
High street retail	No restrictions but reduced footfall in December 2021 due to cautious consumers	Social distancing restrictions reintroduced from January until end of March 2022	Non-essential retail closed in January 2022, social distancing restrictions until end of March 2022
Dine-in restaurants	No restrictions but reduced footfall in December 2021 due to cautious consumers	Social distancing restrictions reintroduced from January until end of March 2022	Closed January and February 2022, followed by social distancing restrictions until end of April 2022
Travel restrictions	International travel restrictions lifted in January 2022	People encouraged to work from home if they can in January and February 2022, international travel restrictions until end of April 2022	People encouraged to work from home if they can in January and February 2022, international travel restrictions until end of June 2022

Small disruption to the recovery if Omicron causes a relatively mild form of illness. In our **Upside scenario**, if no new restrictions are introduced and the increased measures for international travel are removed by January 2022, the economy may experience a small drop in output in December 2021 before recovering ground at the start of 2022. Increased precautions, with people more worried about catching the new strain of the virus, could see a fall in consumers' appetite for hospitality and travel in December. However, spending patterns could be restored if the milder nature of the virus is confirmed by the end of the year, with consumer spending rising by 7.1% in 2022 after 3.7% growth in 2021, followed by a potential 3.4% rise in 2023. The government's super-deduction scheme, which provides a 130% corporate tax deduction on investments in plant and machinery, is expected to see some investments brought forward into 2022 and early 2023. So far, only 1.1% of manufacturing businesses have reported that they have been able to benefit from the scheme, but falling levels of uncertainty related to COVID-19, as well as a significant, although broadly stable, level of uncertainty due to Brexit could lead to a pick-up in overall investment, which could expand by 5.5% in 2022 before moderating again to 1% growth in 2023. The short disruption to growth could see the UK economy reaching pre-COVID-19 levels by the third quarter of 2022, compared to the second quarter in our earlier forecast, with GDP up by 4.2% in 2022 and 2.2% in 2023 after growing by an estimated 6.7% in 2021 (see Chart 1).

Consumer confidence has taken a knock even before the new COVID-19 strain has been discovered. Recent readings of consumer confidence were below the average level for 2004-19, despite a rise in November (see Chart 2). Confidence ebbed due to the rise in COVID-19 cases since July, and recent developments are likely to exacerbate things, at least in the short-term. Consumers continue to accumulate savings, with a total of 'excess savings' now estimated at around £186bn since the start of the pandemic. However, households are facing higher taxes as well as higher inflation and interest rates. The risk is that they may seek to pull back spending if they are worried about their finances, and with consumer spending representing a major driver of the UK economy, even relatively small adjustments could be acutely felt.

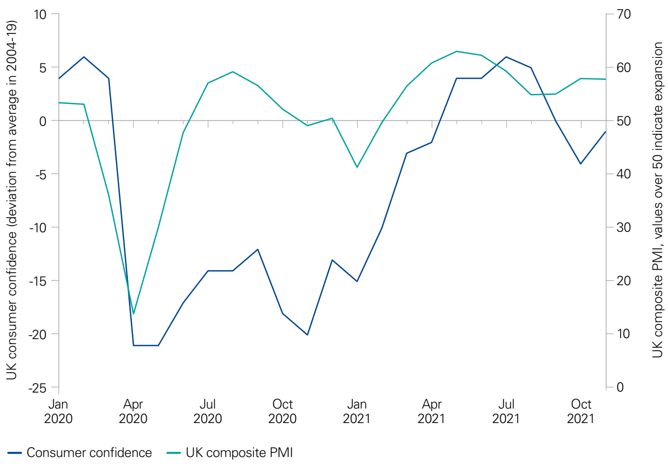
A reintroduction of social distancing restrictions could set the economic recovery back in 2022. In the event that Omicron is expected to see an increase in hospitalised cases, government may wish to act early in order to prevent the need to impose harsher measures, such as the closure of schools, later. In our **Middle scenario**, the reintroduction of social distancing restrictions in retail and hospitality venues could see the economy contract by around 2% in the first quarter of 2022 before growing by a similar rate in the second quarter once most restrictions are lifted. That could see overall growth for 2022 at 2.6%, followed by a 3.5% rise in GDP in 2023.

Chart 1: Level of UK GDP under three Omicron scenarios



Source: ONS, KPMG analysis.

Chart 2: Summer-autumn dip in consumer confidence



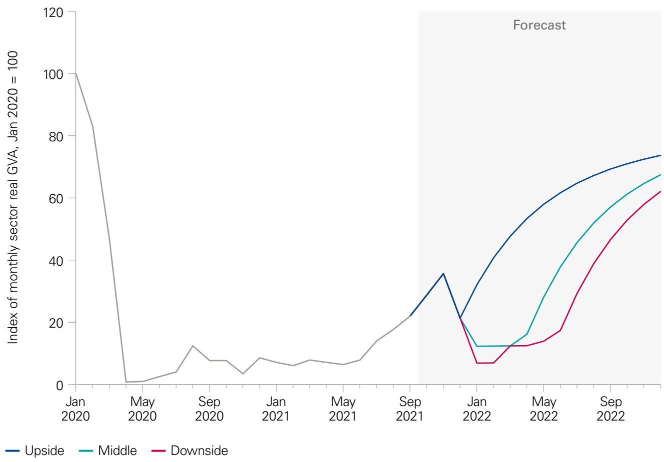
Source: GfK, IHS Markit, KPMG analysis.

Some sectors may remain significantly impacted by the pandemic compared with the overall economy. Air travel is expected to operate well below pre-pandemic levels through most of 2022 (see Chart 3). While earlier data saw the highest number of passengers since April 2020 pass through Heathrow Airport in October 2021, that was still less than half the activity level in October 2019. Additional travel restrictions and new pandemic hot spots are expected to see a slower and more protracted recovery in the sector. Rail travel will also be affected by a slower return of commuters to their workplaces. Commuter footfall was still down by 22% in late November[1] compared to pre-pandemic levels and is likely to fall as people are encouraged to work from home.

The threat of a significant rise in acute COVID-19 cases could trigger another lockdown in early 2022. While the UK economy is expected to fare better than in earlier lockdowns, with businesses and households well-versed and better equipped to work and shop from home, the short lockdown envisaged in our **Downside scenario** could still see GDP fall by 4.2% in the first quarter of 2022 (see Chart 1). That could take overall GDP growth down to only 1.8% in 2022 before the economy grows by 4.3% in 2023. Unlike international travel, bars and restaurants could see a relatively swift recovery even in our Downside scenario once restrictions are lifted (see Chart 4).

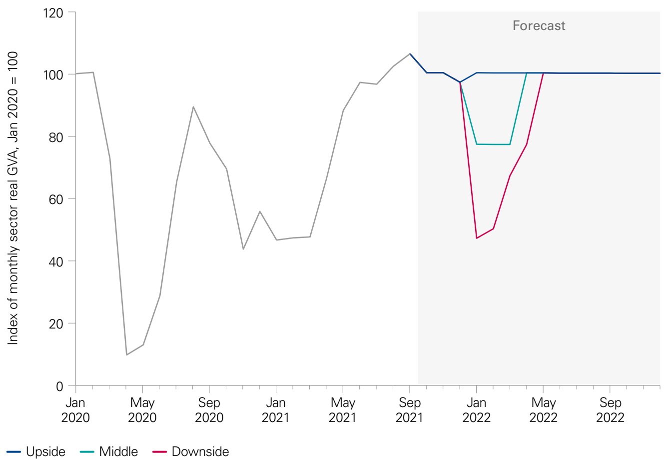
Longer-term outlook remains dependent on raising productivity and a fall in uncertainty. While businesses have had to deal with global supply chain problems for some months, with output of car and other transport equipment manufacturing down by 15% in October 2021 compared to a year ago, we expect supply chain disruptions to ease gradually as increased capacity comes on board. Nevertheless, growth momentum may stall as businesses find it harder to recruit more staff and a more sustained pick-up in UK GDP growth would require productivity to rise. There are some encouraging signs of businesses' intention to increase investment in technology, and a fall in uncertainty could accelerate that. Such developments could see an uplift in the UK's productivity and longer-term growth.

Chart 3: Air travel is expected to be particularly affected by the new virus strain



Source: ONS, KPMG analysis.

Chart 4: Bars and restaurants could recover relatively quickly in the event of a lockdown



Source: ONS, KPMG analysis.

1 Google mobility reports, United Kingdom, workplace mobility 7-day average to 27 November 2021.

The labour market: unscathed by the storm

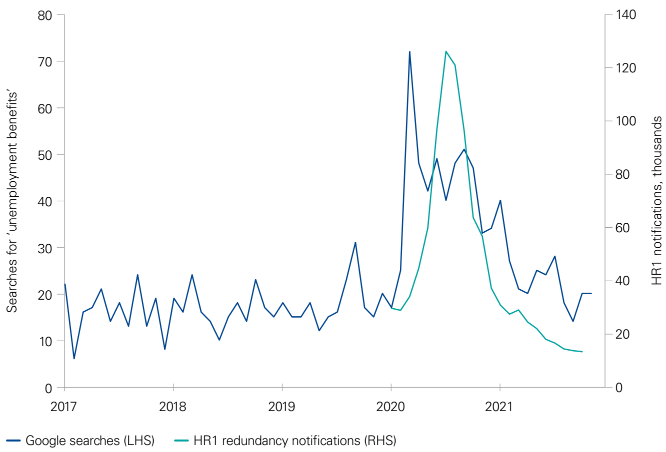
The labour market benefitted from the government's support schemes during the pandemic and from strong labour demand during the reopening phases. The timely PAYE data from HMRC showed that in the first month since the closure of the furlough scheme, the number of payrolled employees rose by 160,000 and reached 0.8% above its pre-pandemic peak. Leading indicators also painted a favourable picture of the job market. The redundancy rate remained below 4%, while HR1 redundancy notifications – where employers are required to notify at least 30 days before the first dismissal when 20 or more redundancies are proposed – were also very low. Meanwhile, the most up-to-date figures showing the number of Google searches related to unemployment benefits were back to the pre-pandemic levels (see Chart 5).

However, the scale and the pace of reopening has also revealed some frictions in the labour market. There has been ample demand for staff, with the vacancy rate reaching 3.9% in the three months to October, its highest level since records began. The latest KPMG/REC Report on Jobs suggested continued rise in recruitment activity. Set against that, lower availability of non-UK staff, as well as potentially greater skills mismatch, have meant that vacancies have been more difficult to fill. Box A provides more detail on the causes and consequences of recent labour shortages.

The ending of the furlough scheme may have limited impact on unemployment. At the end of September, there were still 1.14 million people on furlough, representing 3.4% of the economically active population. The scale of the jobs support had previously led us to conclude that unemployment may rise once the furlough scheme ends. However, recent survey evidence suggests that the majority of employees may have been successfully reabsorbed by the job market. As Chart 6 shows, only around 3% of those on furlough were made permanently redundant following the end of the scheme, with an equivalent share leaving their job voluntarily. Together, these translate into 63,000 workers, or 0.2% of the workforce.

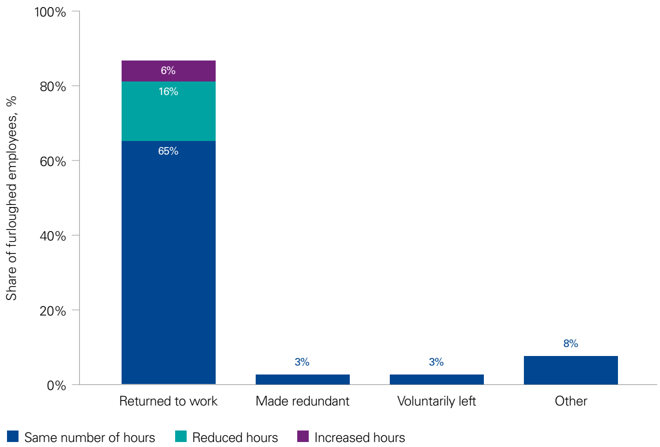
Assuming that no government restrictions are introduced to tackle the spread of the Omicron variant, unemployment might rise only gently before falling. Our Upside scenario is consistent with unemployment peaking at just 4.5% (see Chart 7). That would leave the unemployment rate not far from the levels immediately prior to the pandemic. However, the short-term outlook for the labour market will be sensitive to virus-related developments, and the government's response to it. Even if the economy avoids another national lockdown, social distancing measures for some retail and hospitality venues could result in significantly weaker demand over 2022 Q1, with unemployment potentially peaking around 5% at the start of 2022. While a reimposition of stricter lockdown measures (such as the closure of indoor hospitality and non-essential retail), which unlike previous lockdowns may not be accompanied by job support measures in the form of furlough, could lead to a sharper rise in unemployment in 2022. In that scenario, unemployment could rise to 5.7% in 2022 Q1, exceeding its pandemic peak of 5.2% at the end of 2020.

Chart 5: Unemployment leading indicators back to pre-pandemic levels



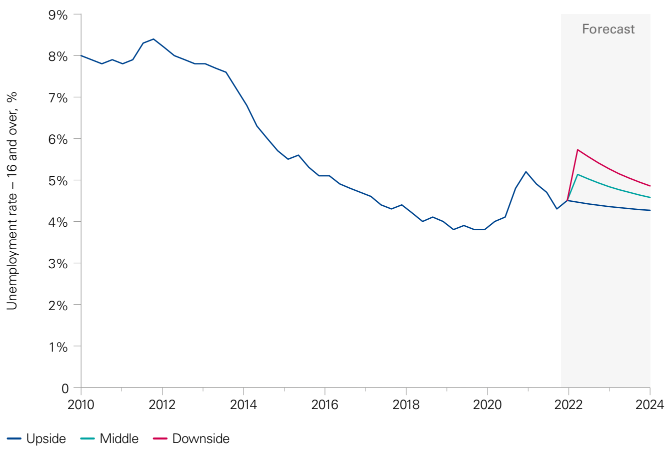
Source: Google Trends, The Insolvency Service, KPMG analysis.

Chart 6: Job status of furloughed employees, October 2021



Source: ONS.

Chart 7: Outlook for unemployment



Source: ONS, KPMG analysis.

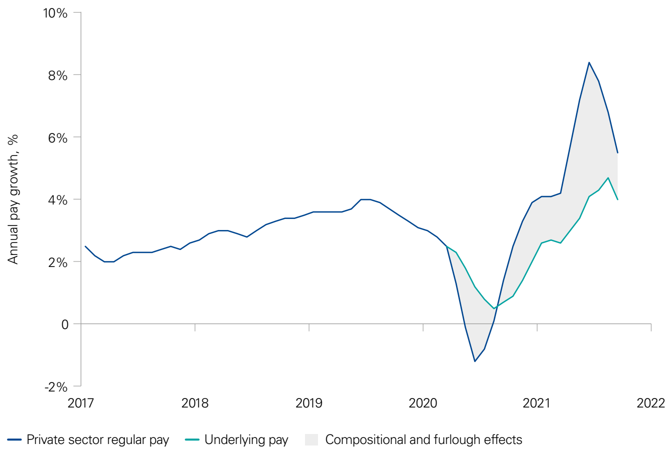
Further out, we see unemployment gradually converging to its 'natural' rate, which is the level we would expect it to settle at once the impact of shocks has dissipated. We can't be certain what rate of unemployment that is, but we can observe the factors which influence it in the long-run. On the one hand, greater educational attainment, which would be expected given more people taking up studies over the past year, would tend to push down the unemployment rate. On the other hand, if a greater mismatch between jobs and workers were to persist, that would drive it up (see Chart A2). Our current estimates suggest that the unemployment rate could settle at slightly above 4%.

Pay growth has picked up in recent months. Excluding the impact of bonuses, annual private sector pay growth peaked at 8.4% in 2021 Q2, before easing to 5.5% in 2021 Q3 (see Chart 8). There are a number of factors at play which can explain such strong growth in 2021. For example, the re-opening of the economy, coupled with strong demand for labour, has pushed up wages across the board. However, the 'underlying' pay growth has been weaker than the headline suggests. That's because workers who lost their job during the pandemic were more likely to be at the lower end of the pay spectrum, which meant that average pay per worker has been lifted up. On the other hand, many workers were on furlough and saw their pay reduced relative to normal levels. This depressed wages in 2020 but has been pushing up wage growth in 2021 as workers were exiting the furlough scheme and returning to work. Taken together, the underlying pay growth in the private sector could be closer to 4% (see Chart 8).

While a high vacancy rate is a sign that available labour is scarce, a large volume of job switches may provide a further boost to pay. The rate of job-to-job moves rose in 2021 Q3 to its highest level on record (Chart 9). This is likely to put further upward pressure on pay growth, as job switchers tend to experience higher rates of pay growth than stayers. In addition, the tight labour market will require employers to make greater efforts to retain staff, upping wages as one of the options and adding to the wage momentum.

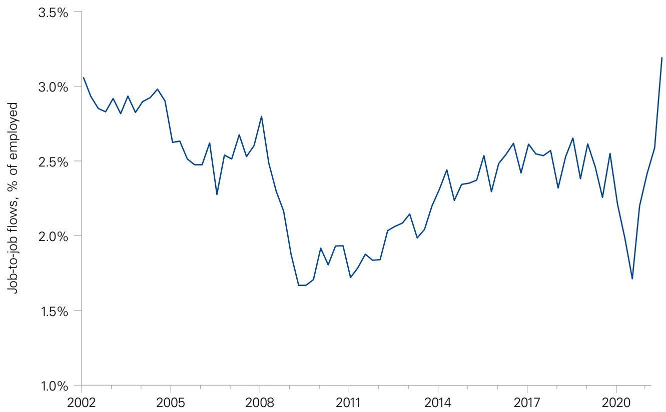
Nonetheless, the broadly positive outlook for pay and unemployment will be partly offset by rising inflation. The government has announced an increase of 6.6% in the National Living Wage from April 2022, in line with the recommendations from the Low Pay Commission. Coupled with rising pay at higher wage brackets and low unemployment, this would at face value suggest a positive outlook for household finances. However, rising inflation could cast a shadow on that outlook. Indeed, the 'misery index', which adds together the rates of unemployment and inflation, is set to rise sharply in 2022 in our Upside scenario (see Chart 10). Higher consumer prices will also drag on real pay growth. Combined with the estimates described above, inflation reaching 4.2% in the year to October was consistent with no real growth in underlying pay over the past year.

Chart 8: Underlying pay growth has been weaker than the headline suggests



Source: ONS, Bank of England, KPMG analysis.

Chart 9: Workers have been more confident to switch jobs



Source: ONS.

Chart 10: The misery index is set to rise despite low unemployment

Source: ONS, KPMG analysis.

Box A: Labour shortages, pay and productivity

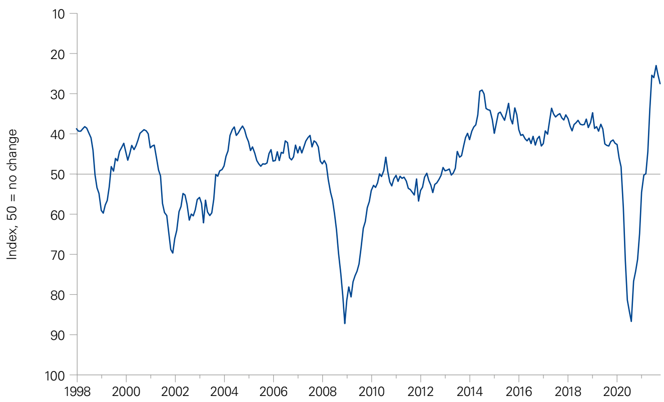
As the economy reopened over the summer, many businesses have been reporting severe staff shortages. The KPMG/REC survey shows that staff availability is around record lows, and much lower than in the period following the Great Recession (Chart A1). At a sectoral level, the ONS BICS survey suggests that staff shortages are most commonly reported in hospitality (38%) and health (26%). And with some regions reopening at a faster pace than others, this could explain why sectors which report the highest vacancy rates (e.g. hospitality) still had many workers on furlough in 2021 Q3.

This phenomenon is not unique to the UK, but Brexit may have exacerbated the problem. In the Eurozone, a net balance of around a quarter of companies list labour as a factor limiting production. But while the Eurozone can rely on the flexibility of its single market, it is less clear how many EU nationals who left the UK because of COVID-19 will eventually return once the pandemic is over. The ONS data suggest that employment by EU nationals fell by around 200,000 since 2019 Q4. Of those, around 15,000 were HGV drivers.

The UK vacancy rate also looks unusually high compared to the current unemployment rate. The relationship between the two variables fluctuates up and down during a normal economic cycle (Chart A2). But since the start of 2021, it has departed far from its pre-pandemic norms. That suggests that the efficiency with which workers and jobs are matched has deteriorated. It may also suggest that there is a skills mismatch, where it takes more time for workers to pick up new skills as they move to different industries.

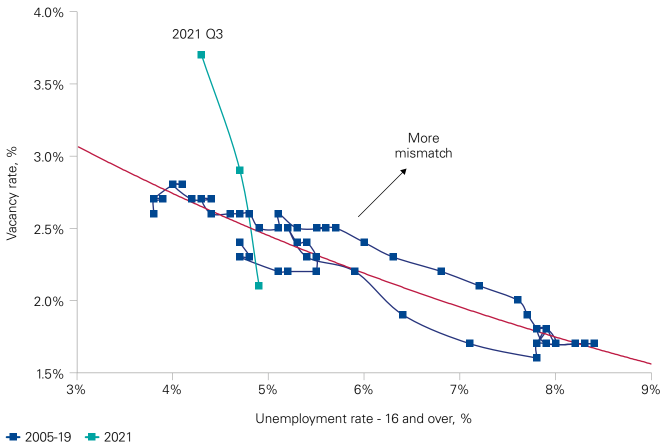
The skills mismatch also seems evident in the employment data. This is particularly pronounced across occupations with lower socio-economic status, as higher managerial & professional roles were less affected by the COVID-19 restrictions. Since 2019 Q4, employment has fallen by most in the lower supervisory & technical (-26%) and semi-routine (-22%) occupations. This was in contrast to routine occupations, which grew by 19% as those require limited employee discretion and are less influenced by the level of skills. It is therefore possible that some workers migrated from jobs requiring some skills to those based on routine tasks.

Chart A1: Hiring difficulties are much higher than during the previous recovery



Source: REC, KPMG analysis.

Chart A2: The vacancy rate is well above the level implied by unemployment

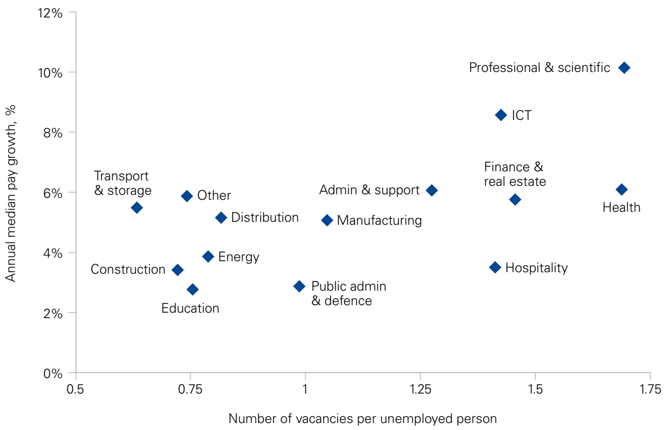


Source: ONS, KPMG analysis.

In response to the labour shortages, employers may be left with no choice but to raise pay to attract workers to their sectors. We can already see evidence of pay pressures being more pronounced in those sectors which are particularly tight (i.e. have more vacancies per unemployed people) (Chart A3). Pay pressures have been particularly acute in sectors where strong demand may prove long lasting due to changing consumer preferences, such as the ICT sector, which has experienced growing demand for digital products and services. Other sectors like hospitality, where the rise in demand was linked primarily to the surge in activity as pandemic-related restrictions were lifted, have not raised pay to the degree implied by recent labour tightness. That may change over the next year if employers continue to encounter difficulties in filling vacancies, with pay growth accelerating closer to 6%. The opposite may happen in professional & scientific services, which have seen unusually strong pay growth recently that could moderate closer to 7%, although we see upside risks to pay growth given the recent rise in inflation.

While higher pay doesn't automatically translate into higher productivity, COVID-related efficiency savings could boost labour productivity by around 1%, mitigating some of the impact of higher pay. Thanks to more widespread homeworking, businesses should benefit from the cost savings associated with more efficient use of office space. We expect a boost to labour productivity of around 0.5% from agglomeration effects, as firms outside of central business areas are able to relocate there and make use of the vacant space.[2] In addition, the cost savings from a reduced use of office space may be re-directed away from buildings and towards more productive capital. Recent survey evidence suggests that firms expect to use those savings on extra spending on software & IT and personnel training (Chart A4). The Bank of England estimates that this shift could boost productivity by a further 0.5% to 0.7%.

Chart A3: Sectors with more tightness saw greater wage pressure in 2021 Q3



Source: ONS, KPMG analysis.
Note: Pay growth is based on PAYE RTI data.

Chart A4: Firms plan to spend office-related cost savings on productive capital

Source: Decision Maker Panel.

2 For more detail, see KPMG (2021), New working patterns and the transformation of the UK business landscape

Inflation and interest rates: on the rise

Inflation worries are back at the forefront of economic concerns, as the threat of even higher inflation weighs on the economic outlook. UK inflation accelerated to 4.2% in the 12 months to October, with more increases on the horizon. This is now more than double the Bank of England's target of 2% and marks the fastest pace of consumer price increases for almost a decade. Some of this increase in inflation reflects the impact of lower prices during 2020 and the mechanical impact of the reversal of temporary VAT cuts, the first part of which took place in October. But this is only part of the story, with price pressures taking hold as the global economy began to recover from the pandemic. The emergence of the Omicron variant could lower some of the inflationary pressures as demand cools, while exacerbating the strain on some supply chains in the short-term.

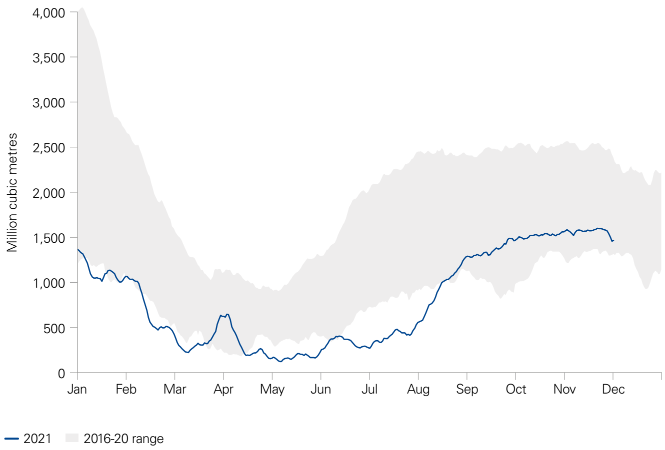
The almost synchronised surge in activity around the world in 2021 strained supply chains, causing goods shortages and production delays in the UK and elsewhere. Among the many pinch points, the costs of shipping rose dramatically, and microchip shortages have limited production, including of new cars. Delays in new car deliveries then led to a surge in the prices of more readily available second-hand cars, which climbed by 27.4% between April and October 2021. Highlighting the pressure supply chains are under, the pace of annual inflation for goods reached 4.9% in October, up from -0.5% back in February 2021 (see Chart 11). With the fear of COVID-19 increasing, people are likely to substitute some spending on services with spending on goods, while a turn to the worse in COVID-19 cases could see more disruption to ports and logistics in the short-term, putting upward pressure on goods prices. Further bottlenecks appear inevitable, until supply chains can finally be put right in the second half of 2022 and early 2023.

A range of factors, in additional to stronger global demand, saw a sharp rise in the price of oil and gas in 2021. The UK experienced very low levels of gas stock earlier in 2021, although the situation improved slightly in late autumn (see Chart 12). Minimal gas storage facilities since the North Sea storage facility was shut in 2017 makes the UK particularly vulnerable to short-term price fluctuations. Despite the fall in oil prices as Omicron came to light, higher gas prices continue to feed into inflation, with a new cap set to take effect from 1 April 2022. Tracking the increase in wholesale gas prices between cap announcements from early August 2021 to February 2022 and allowing for changes in line with market forecasts could add another 0.6 percentage points to the rate of inflation in April 2022 (see Chart 13). However, the recent fall in global oil prices associated with the emergence of the Omicron variant should help bring fuel prices down from recent highs, translating into lower pump prices over the next three months.

Chart 11: Strong demand for goods is straining global supply chains and fuelling higher inflation for goods

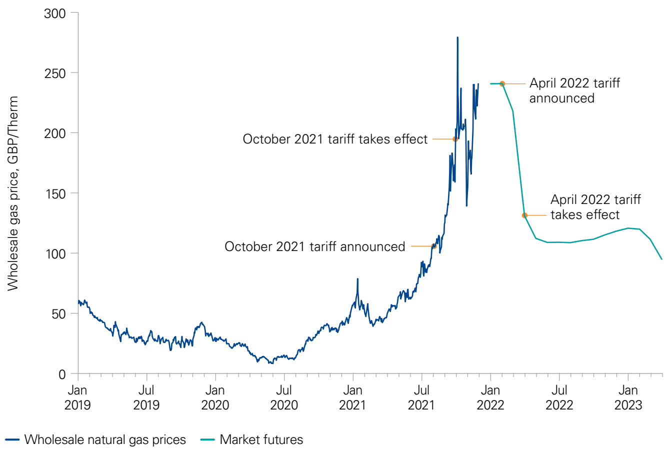
Source: ONS, KPMG analysis.

Chart 12: UK stock level of gas remains relatively low



Source: National Grid's Storage Data via Refinitiv Eikon, KPMG analysis.

Chart 13: Higher wholesale gas prices could significantly raise home energy tariffs in April 2022



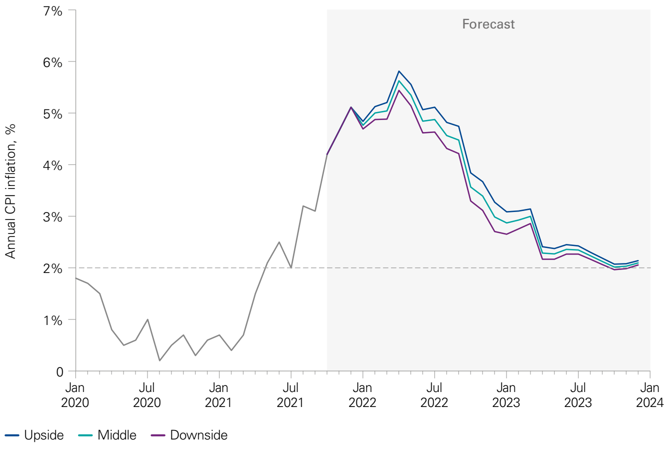
Source: Eikon Refinitiv, KPMG analysis.

Looking ahead to 2022, the path of inflation will depend in part on the potential economic fallout of the Omicron variant. Our Upside scenario, which avoids the need for any additional restrictions over the winter, could see inflation reach 5.8% in April 2022 before declining towards the Bank of England's 2% target. On the other hand, any combination of curbs on social gatherings would see a sharp drop in the demand for services and a weaker pace of services inflation, especially if the restrictions are reinforced by more cautious behaviour by consumers. Weaker energy prices, together with an expected easing of supply chain bottlenecks, will help to bring down inflation to around 3% by the end of 2022 in all three scenarios (see Chart 14). A tighter monetary policy is also expected to play its part in containing some of the domestically generated inflationary pressures.

Risks posed by the Omicron variant to see the Bank of England adopt a more cautious approach. With uncertainty around the potential impact of the new Omicron variant still high, the first increase in interest rates is now not expected before February 2022, and could be delayed to May, or even August 2022 if the arrival of the Omicron variant causes significant restrictions to be reintroduced. This first base rate hike would mark an official exit from the period of low interest rates associated with the pandemic and the beginning of a tightening cycle. If the initial rate rises go smoothly, gradual increases are likely to continue, potentially taking rates to 1.25% by the end of 2023 in our Upside scenario (see Chart 15).

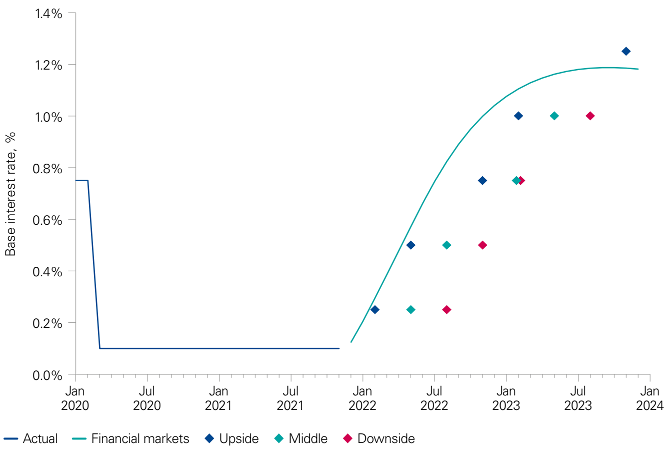
We expect the current spell of higher inflation to prove transitory, reflecting the disruption caused by the pandemic on the global economy. Once the pandemic is behind us, longer-term drivers of inflation and interest rates are likely to take hold and see a lower inflation environment reassert itself. That is likely to be accompanied by relatively low interest rates, which may peak at around 3%, as opposed to the higher rates seen prior to the Great Recession of 2008-09.

Chart 14: Headline inflation expected to moderate after April 2022



Source: ONS, KPMG analysis.

Chart 15: UK base interest rates are set to increase over the next two years



Source: Bank of England, KPMG analysis.
Note: Financial markets curve represents the forward OIS curve as of 29 November.

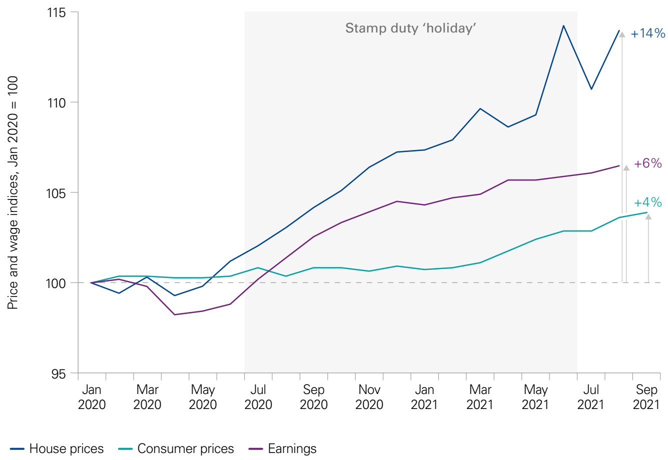
Box B: Outlook for house prices: market losing steam with a few hotspots

UK's housing market proved COVID resilient, with transactions recovering strongly after the initial shock. Despite the economic shock caused by the COVID-19 pandemic, UK house prices increased by around 14% since March 2020 (see Chart B1), faster than earnings and general consumer prices, with the price of housing rising both in nominal and real terms and as a proportion of incomes. Following an almost complete shut-down of the market during the initial lockdown, market activity gradually resumed since May 2020, with the introduction of a temporary cut to stamp duty from the middle of 2020 adding a further boost, and causing a rush to complete transactions ahead of the expiry of the tax cut in mid-2021. The resulting boost to demand may have seen the tax savings absorbed in higher prices.

House prices are expected to continue to rise in the medium term, although at a slower pace than recently. Stronger pay growth, and a relatively tight labour market, should help ease the pressures on affordability and help prevent a correction in house prices as interest rates rise. However, higher mortgage interest rates, reversing the downward trend over the past decade (see Chart B2), will add to households' declining purchasing power as a result of rising taxes and inflation.

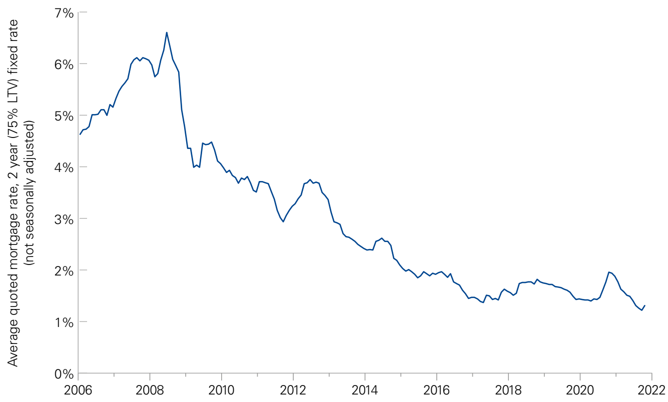
Against a backdrop of weakening overall growth, the outlook for local areas is increasingly driven by changing preferences and regional market performance. This has increased the attractiveness of more affordable locations, which saw a surge in demand and pushed prices higher. We expect this trend to continue into 2022, as the market adjusts to changes in working patterns, with some buyers taking advantage of fewer commuting trips. There are signs that more buyers are looking for homes in areas that offer more space and access to a green environment, driving stronger house price growth in these areas.

Chart B1: House prices are up by more than incomes and inflation



Source: Land Registry, ONS, KPMG analysis.

Chart B2: Mortgage interest rates have fallen over the past decade, but are now set to rise



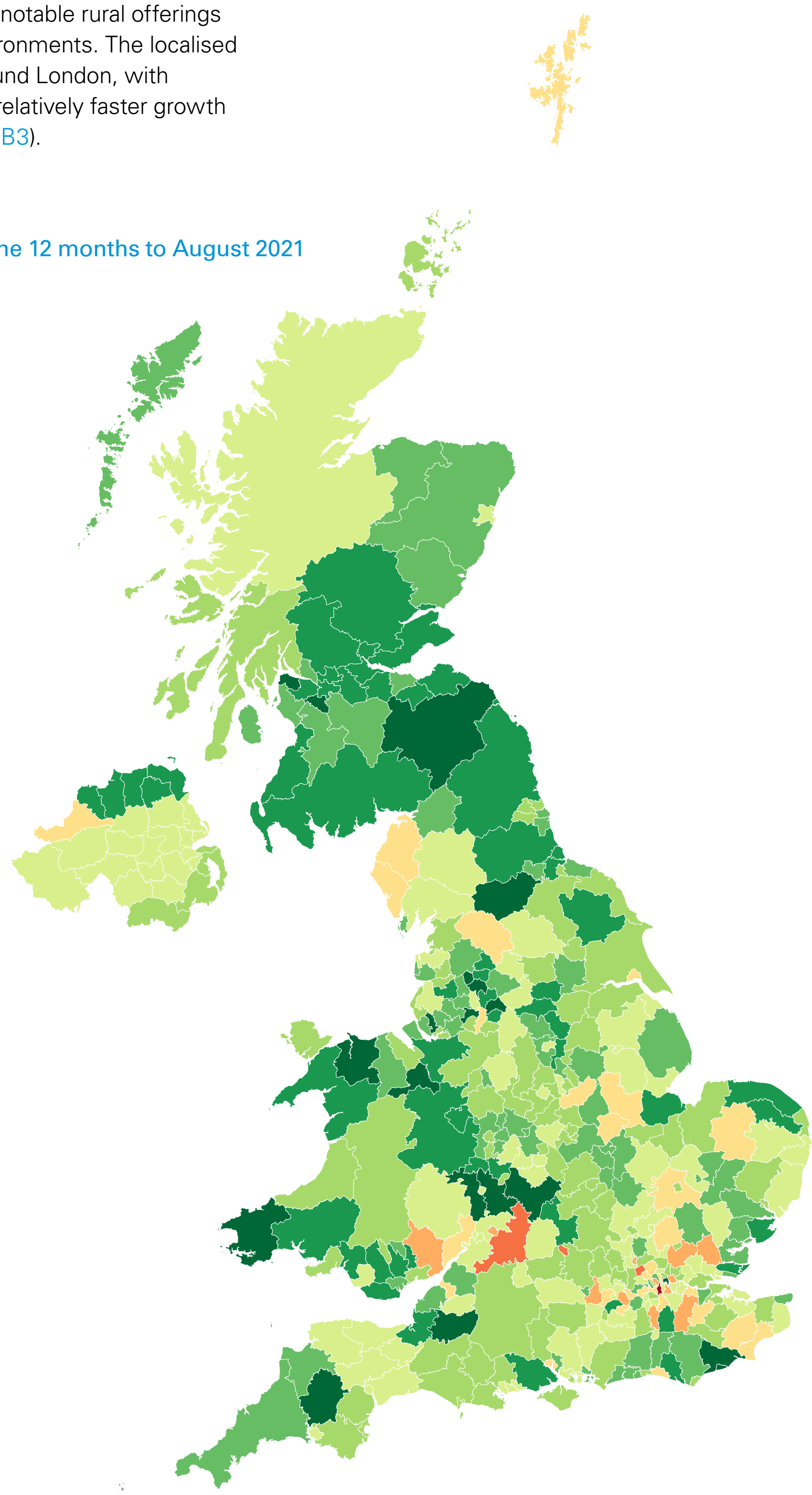
Source: Bank of England.

Coastal and rural areas have benefitted from strong demand over the past year. In particular, coastal areas such as Rochford and North Norfolk saw prices increase by around 17% in the year to August 2021 and may continue to experience strong growth next year. Similarly, Rother, Hastings and Lewes have topped growth in the South East, with house prices increasing by over 17%. Away from the coast, there was rapid growth in areas such as Rossendale in the North West (24.6%) and Richmondshire in Yorkshire (20.6%), while Pembrokeshire, Wrexham and Conwy saw the strongest price rises in Wales with prices up by more than 19% on a year ago. These locations benefit from notable rural offerings away from more congested urban environments. The localised rise appears particularly prominent around London, with surrounding areas having experienced relatively faster growth than areas closer to the city (see Chart B3).

For many years the UK housing market has been characterised by significant regional imbalances. House prices in London reached a level of almost 10 times the average income of first-time buyers compared to only 6 times nationally just before the pandemic started. While the structural changes unleashed by a shift to hybrid working will take time to become fully reflected in house prices, the net change is undoubtedly positive if it helps address these regional imbalances by shifting demand away from more congested areas.

Chart B3: UK house price growth in the 12 months to August 2021

Source: Land Registry, ONS, KPMG analysis.



Public sector finances: repairing the books

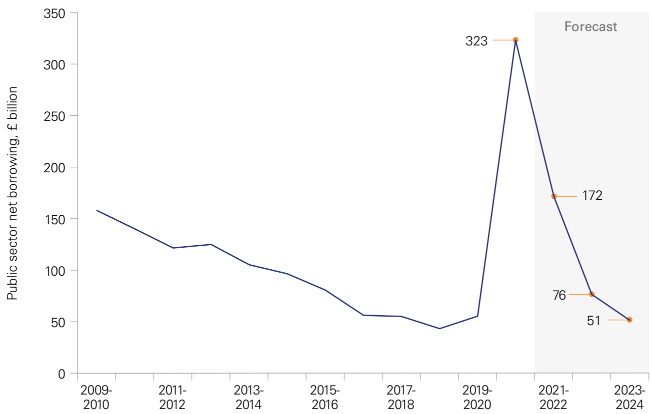
Public sector net borrowing has surprised to the downside this year. So far, borrowing is down by £103.4bn (45%) in 2020-21 on a year-to-date basis (April-October). This was driven by higher current receipts (£59.7bn), lower non-interest spending (£40.4bn), and lower net investment (£18.5bn). Set against that, interest spending increased by £14.8bn (63%) on a year-to-date basis. Borrowing is expected to fall further now that spending on furlough is over, and income tax receipts rise as the economy recovers. In the absence of new social distancing restrictions to tackle the spread of the Omicron variant, the deficit could reach around £170bn this fiscal year, before falling further in 2022-23 and 2023-24 (Chart 16).

Nonetheless, interest spending is set to be on the rise. The cost of debt servicing reached its highest monthly level since records began in both June and August 2021. This reflected an acceleration in RPI inflation, to which around a quarter of government debt is pegged in the form of index-linked gilts. Higher inflation also saw a reversal in the downward trend in debt interest to revenue ratio since 2012 (Chart 17). We project debt interest payments to total £62bn in 2021-22, up from £39bn in 2020-21, although spending could come in lower if the Omicron variant leads to lower inflation.

Public sector net debt to peak at a lower level than previously thought. The better outturn data on borrowing, as well as the tightening measures announced by the Chancellor, mean that debt could peak below 100% of GDP. We expect debt to reach around 97% of GDP in 2021-22 – equivalent to £2.4tn – its highest level since 1962-63 (Chart 18). We then see debt on a declining path as fiscal consolidation kicks in.

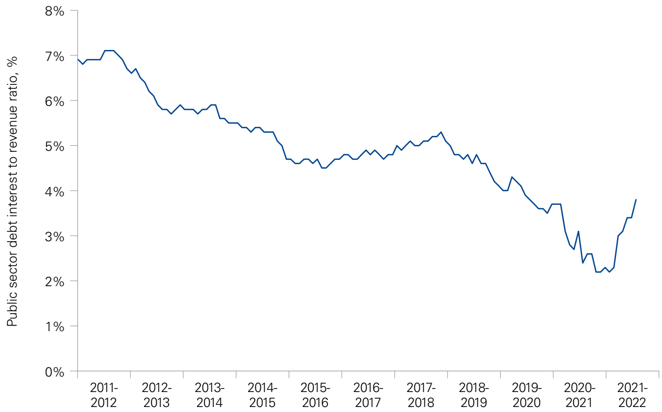
Similarly to other parts of our forecast, the outlook for public finances will depend on virus-related developments. On the spending side, we assume that the government would be reluctant to bring back the furlough scheme in any of the three scenarios, given the high vacancy rate at present and the renewed focus on balancing the books. However, an introduction of new social distancing measures would see weaker receipts in the form of income tax and VAT, among others. Relative to our Upside scenario, targeted social distancing measures or a nation-wide lockdown would each see borrowing around £10bn higher by 2022-23, with a less pronounced effect on the profile for debt. The possibility of new spending measures to support households, while not part of our assumptions, could nonetheless increase borrowing and debt.

Chart 16: The outlook for government borrowing



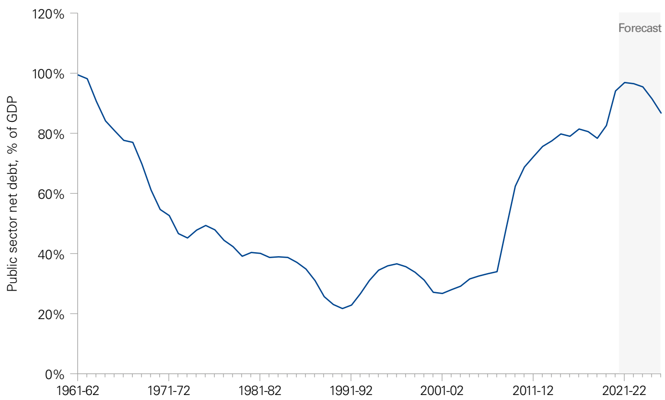
Source: ONS, KPMG analysis.

Chart 17: Debt servicing costs are up



Source: ONS.

Chart 18: The outlook for government debt



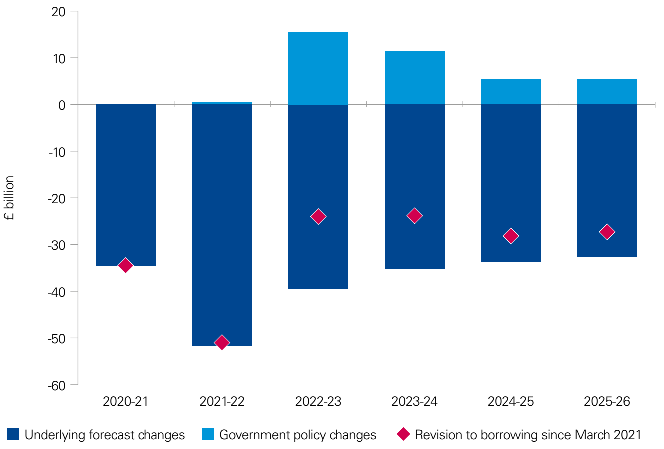
Source: ONS, OBR, KPMG analysis.

The Autumn Budget provided a modest fiscal loosening. The Chancellor announced a package of measures worth around £60bn over the forecast horizon. Using the standard fiscal multipliers, we estimate that these measures will boost the level of GDP by around 0.6% at their peak in 2023-24. There was a slew of spending announcements, as the Chancellor sought to avoid the impression of a return to austerity budgets of the past, with overall day-to-day spending set to rise by 3.3% per year in real terms. However, despite the extra fiscal headroom gained, thanks to an improved economic outlook since March, the Chancellor decided to spend only a modest part of the windfall (Chart 19). Compared with the March Budget, that could leave borrowing £26bn a year lower on average from 2022-23 onwards.

New fiscal rules announced at the Autumn Budget signal a return to fiscal prudence. Fiscal sustainability is underpinned by a new fiscal mandate, supplemented by three additional targets. The new mandate requires the 'underlying' debt (that is public debt excluding the Bank of England) to start falling as a share of GDP by the third year of the forecast horizon (currently 2024-25). Targeting of future fiscal aggregates on a rolling basis gives the Chancellor the flexibility to react to sudden developments and temporarily raise spending and deficits if required. In addition, there is a commitment to balance the current budget by that time. The focus on current budget balance means that the government can still borrow for investment purposes. However, two expenditure caps have also been introduced to limit public sector net investment (at 3% of GDP) and welfare spending.

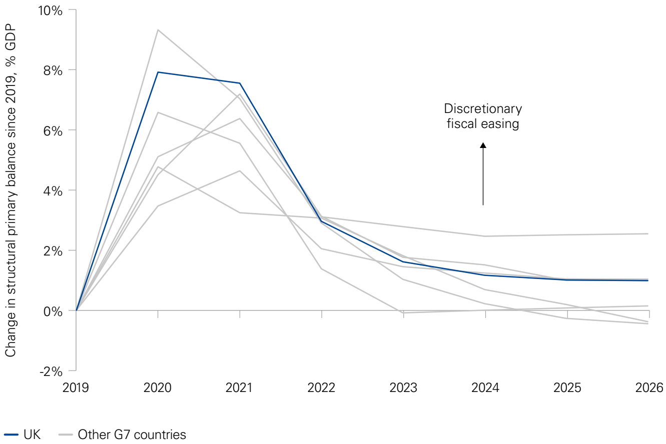
Fiscal policy is set to become a headwind to growth from next year. Notwithstanding the measures announced at the Autumn Budget, the total effect of past policies means that under current plans, fiscal support is set to unwind over the medium term. The fading fiscal impulse is not unique to the UK (Chart 20). However, the UK is set to have the sharpest reduction in relative public spending of any G7 country in 2022, as measured by the fall in the deficit.

Chart 19: The impact of Autumn Budget on borrowing



Source: OBR, KPMG analysis.

Chart 20: The deficit is set to fall most sharply in the UK in 2022



Source: IMF, KPMG analysis.

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