UK Regional Economic Outlook

January 2022

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Outlook for the UK economy

As more information emerges about the Omicron variant, the latest expectations are that the surge in COVID infections will subside relatively quickly, ensuring that no further restrictions are imposed to contain the pandemic at this stage. That could see the current guidance to work from home where possible relaxed in the coming weeks, with global restrictions on international travel possibly lifted from the second quarter of this year.

The less severe burden of the Omicron variant and its implications for the economic outlook broadly coincide with our upside scenario that was published in our December report. With the UK economy now on the cusp of pre-COVID levels, growth momentum will no longer be able to simply rely on the rebound effect to propel it. We expect economic growth to gradually slow as a result of pressures on both demand and supply. Rising taxes and borrowing costs, as well as elevated inflation, will squeeze households' purchasing power. At the same time, the lingering effects of supply chain bottlenecks together with a persistent shortage of labour could constrain production this year. Nonetheless, after a relatively weak start to 2022 brought about by Omicron, growth should pick up from March, with overall GDP growth in 2022 reaching around half the rate of last year (see Table 1 below with a summary of our latest forecasts for the UK economy).

Inflation is expected to remain elevated this year, and to peak at around 6.5% in April as the new regulated price cap on households' gas prices takes effect. However, as energy prices gradually stabilise and supply chains recover, we expect inflation to moderate significantly by the end of this year and to approach the Bank of England's 2% target by the start of Q2 next year. Nevertheless, the current elevated level of inflation could see the Bank of England act relatively swiftly this year in an attempt to stem any permanent rise in inflation expectations. We currently pencil in three possible interest rate rises in 2022; in February, August, and November. This would represent a shift towards a significantly tighter monetary policy stance when considering the implications these rises will also have for the divestment of assets accumulated under the QE programme in line with the MPC's latest guidance. The Bank of England may therefore have room to hold off further tightening next year, with only one additional rate rise in November, taking Bank Rate to 1.25% by the end of 2023 (see Table 1 below).

As the UK economy leaves the worst effects of the pandemic behind, prospects for the UK nations and regions vary depending on their exposure to some of the headwinds and growth opportunities we expect over the next two years.

Table 1: KPMG forecasts

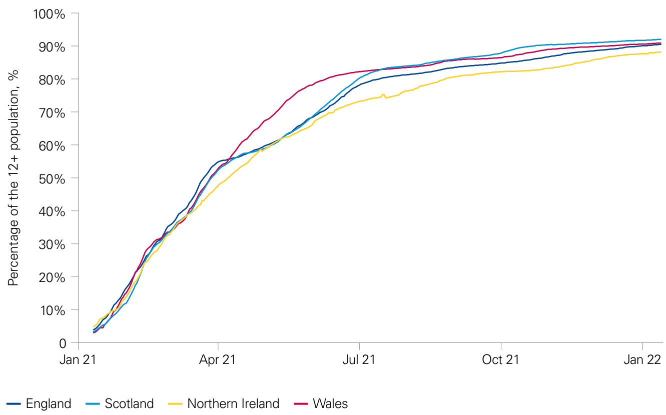
	2020	2021	2022	2023
GDP	-9.4	7.3	3.8	1.8
Consumer spending	-10.5	5.5	6.0	2.5
Investment	-9.4	5.2	3.5	2.0
Unemployment rate	4.5	4.6	4.4	4.3
Inflation	0.9	2.6	5.2	2.4
Base interest rate	0.1	0.25	1.0	1.25

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

The pandemic's regional map driven by different government policies

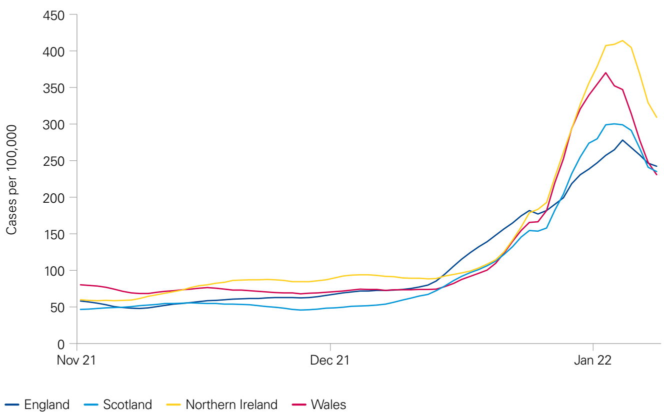
Over the past year, UK nations and regions have come a long way in their vaccination efforts against COVID-19. In Wales, a successful vaccination campaign in the middle of 2021 meant that it was the first UK nation to vaccinate 80% of its population with both the first and second dose (Chart 1). In the latter part of 2021, the government met its target to offer a booster to everyone eligible before the New Year, which meant that nearly two-thirds of the population have now had three doses of the vaccine.

Chart 1: Vaccination uptake, first dose



Source: Gov.uk, KPMG analysis.

Chart 2: Daily COVID-19 cases per 100,000

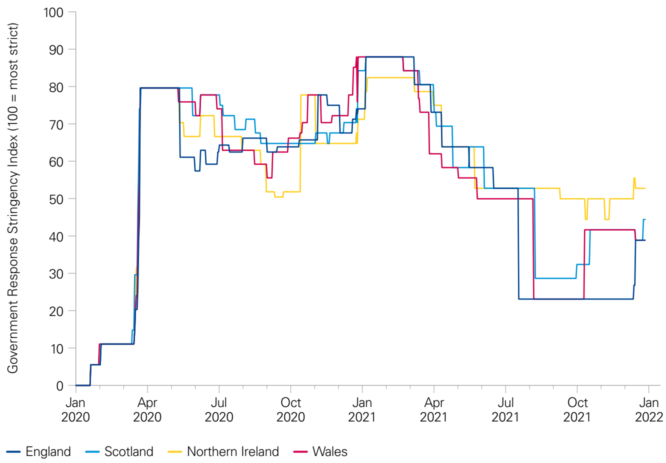


Source: Our World in Data, KPMG analysis.

Nonetheless, since the emergence of the more transmissible Omicron variant the number of cases has spiralled over the Christmas period and into 2022. Northern Ireland has generally been lagging the rest of the UK in terms of COVID-19 vaccinations (particularly for the booster dose), and infections are now at their highest level of any nation (Chart 2). This is despite the new rules which prevent indoor standing events and enforce a closure of nightclubs.

Indeed, Northern Ireland currently has the most stringent government policy (Chart 3). England has tended to have lighter rules compared to other nations in recent months, although the move to Plan B in early December brought it back into line with Scotland and Wales. The COVID-19 rules for Scotland introduced after Christmas imposed table service only for the hospitality venues, while in Wales they included the closure of nightclubs, although people could still attend certain events with an NHS Pass. While greater uncertainty around the relative evolution of local rules could weigh on business confidence, the overall sensitivity of the economy to government restrictions is now much weaker than at the start of the pandemic.

Chart 3: UK nations have diverged in stringency of pandemic response

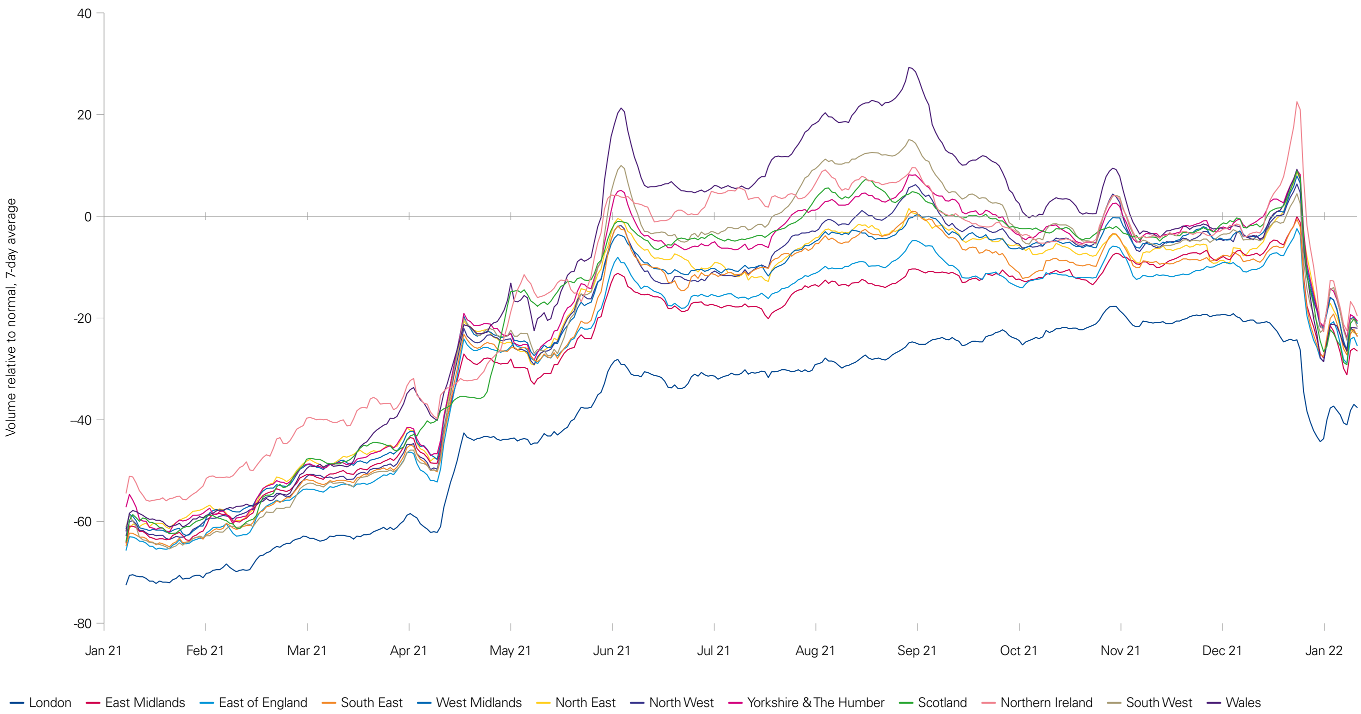


Source: University of Oxford, Haver.

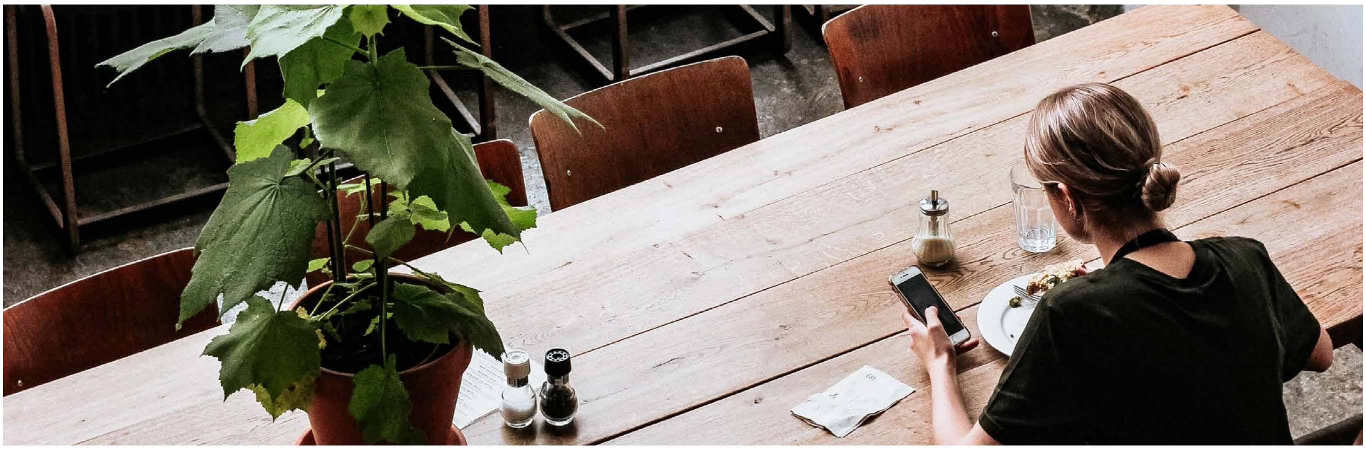
Mixed impact of COVID-19 on regional consumption patterns

The combination of government restrictions and voluntary social distancing paints a mixed picture for consumption across UK nations and regions. Mobility data show that visits to retail and recreation venues returned close to their pre-pandemic levels as the economies reopened in mid-2021 (Chart 4). In addition, a greater prevalence of staycation holidays resulted in particularly strong activity in Wales and the South West over the summer months as many holidaymakers chose to stay in the UK. We expect this seasonal pattern of summer destinations to continue in the medium term, given the uncertainty related to local COVID-19 outbreaks and rules in other tourist hotspots globally.

Chart 4: Visits to retail and recreation venues were stronger in Wales and the South West during the summer



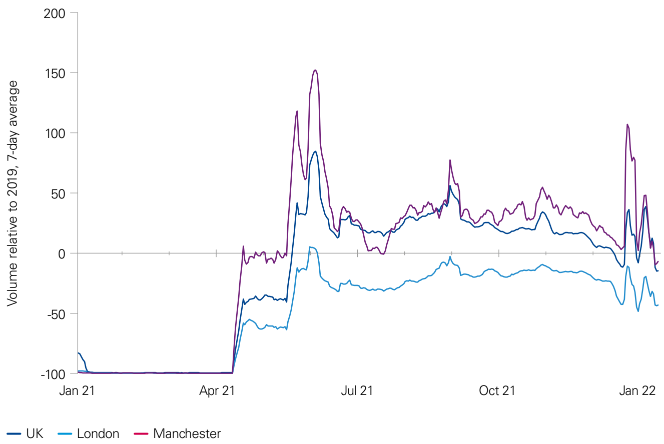
Source: Google Mobility Reports, KPMG analysis.



London has been a clear outlier in terms of retail and recreation visits, which are still some 40% below pre-pandemic levels. This could be down to a number of factors. The fall in international travel has restricted the demand from tourism and business travel. In addition, the shift to homeworking has meant a loss of commuter workflow in parts of the city that rely heavily on spontaneous or work-related demand for consumer services. This is corroborated by data on restaurant bookings, which have also underperformed the rest of the UK in London (Chart 5). This hasn't just been a big city story, as similar data for Manchester have generally followed the UK pattern. Instead, it could point to greater vulnerabilities in the capital, which may take longer to overcome.

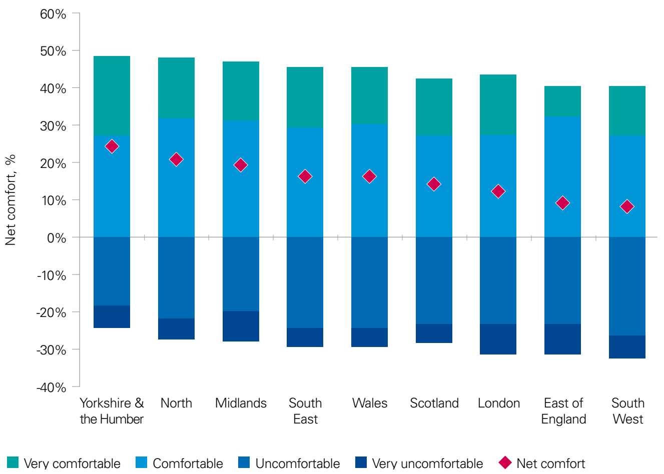
Another reason behind London's relative underperformance may be due to increased caution to go out in the South. The latest ONS survey found that households remain wary about being out and about due to COVID-19, particularly in regions such as London, the East of England, and the South West (Chart 6). That is in contrast with regions in the north of England, where households reported being more comfortable leaving home in the second half of December. This could be because Omicron cases were higher in London initially, but now that cases have risen in other parts of the UK attitudes may have changed.

Chart 5: Seated diners bookings underperformed in London



Source: OpenTable, KPMG analysis.

Chart 6: Attitudes towards leaving home



Source: ONS, KPMG analysis. Survey conducted 15 Dec - 3 Jan.

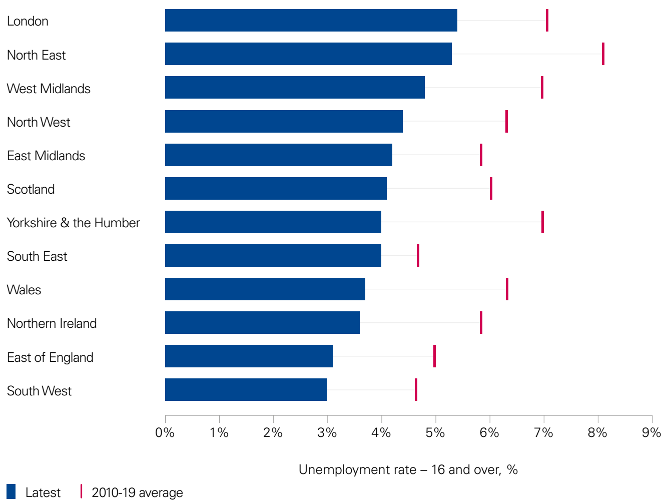
Regional labour market resilient but staff shortages to influence the outlook

For the large part of 2020 and 2021, the labour market was supported by the Coronavirus Job Retention Scheme which placed staff on furlough during times of weak demand. That has prevented a large spike in unemployment across all nations and regions (Chart 7), with the largest increases since the start of the pandemic (of around 1 percentage point) recorded in Northern Ireland, the South East, and London.

The sectoral composition of the labour market determined the use of the furlough scheme across the UK. A reliance on the hospitality sector, which was hit hard by the social distancing measures, meant that London had the largest share of staff on furlough of any region, and nearly 6% of total eligible workers were still on furlough when the scheme closed at the end of September 2021. Meanwhile, in the North East and the West Midlands the largest number of furloughed employees was in the manufacturing sector.

The regional outlook for 2022 will be influenced by the persistence of the current labour market shortages. A high number of vacancies at present points to a very tight market, where employees generally have a stronger bargaining power, including when making claims on pay and other non-financial benefits. Vacancies in the North East, for example, are currently around 30% above their 2019 average, according to Adzuna.

Chart 7: Unemployment rates have stayed low throughout the pandemic



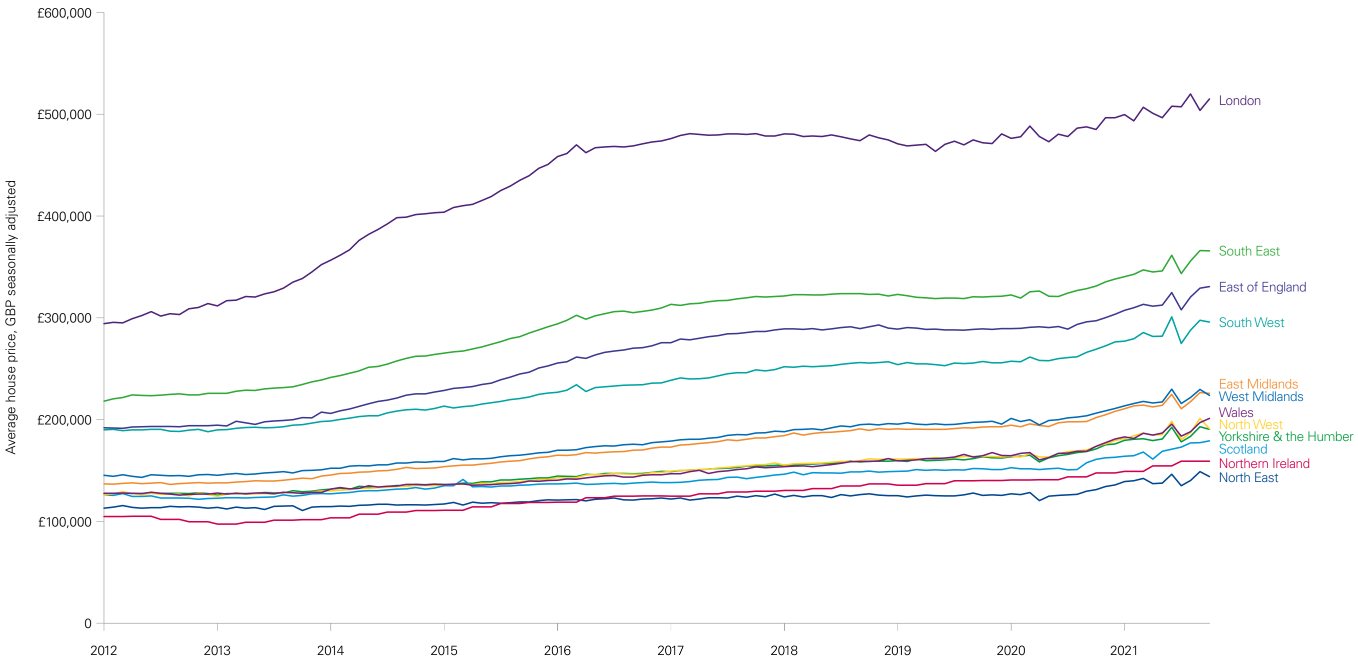
Source: ONS, KPMG analysis.

Remote working is driving a housing market adjustment across all areas of the UK

The housing market continues in a state of flux as the demands for more space driven by the ability to work from home have led many to reassess their housing needs. For a more detailed analysis, see our December 2021 UK Economic Outlook,[1] but the main winners appear to have been areas further afield from city centres and coastal areas within reach of major employment centres. All regions have shown high levels of volatility driven by changes to stamp duty as the housing market has decoupled from the wider economy, seeing continued upwards price pressures even as economic performance faltered (Chart 8).

A tight labour market and savings accumulated during the pandemic could drive a similar pattern over the next two years, as buyers put a greater emphasis on space and living environment over the ease of commute.

Chart 8: House prices have been unusually volatile since the start of the pandemic



Source: HM Land Registry.

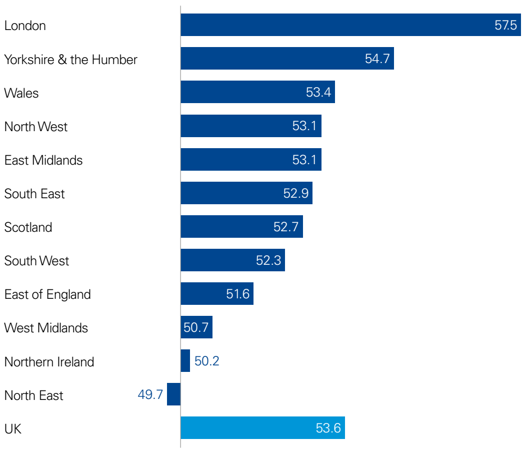
1 KPMG December Economic Outlook, 2021 https://home.kpmg/uk/en/home/insights/2018/09/uk-economic-outlook.html

Regional business activity relatively resilient

Growth in business activity was led by just a few regions in December, according to the Purchasing Managers Index (PMI) survey, with London well ahead of the rest of the UK. Although the North East appears to be the only UK region experiencing a contraction, with its PMI score falling below 50 (Chart 9). The data for last month is expected to be heavily skewed by the Omicron wave, and the fact that 11 regions and nations out of 12 show a continued expansion highlights the relative resilience of the UK economy to the latest pandemic-related disruptions.

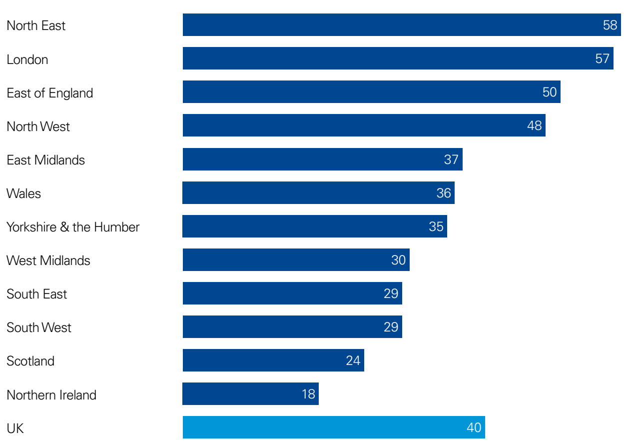
A separate survey of overall business confidence[2] is also relatively optimistic, with all regions and nations showing a positive balance of business confidence in December 2021 (Chart 10). This suggests that any setbacks caused by the emergence of the Omicron variant are expected to be temporary, with lost output made up relatively quickly later this year.

Chart 9: December PMI Business Activity Index shows London ahead of the rest of the UK



Note: A reading above 50 indicates an overall increase compared to the previous month.
Source: NatWest, IHS Markit.

Chart 10: Business confidence has remained robust, despite the onset of the Omicron wave



Source: Lloyds Bank Business Barometer, BVA BDRC.

2 Lloyds Business Barometer, December 2021
https://www.lloydsbankinggroup.com/assets/pdfs/media/press-releases/2021-press-releases/lloyds-bank/2021.12.21-december-business-barometer.pdf

Outlook for UK regions

With the Omicron variant posing a milder setback than earlier strains, we expect all regions and nations to reach their pre-COVID levels of output in line with the UK as a whole. Local economies have therefore largely exhausted the boost to growth momentum from the recovery, with growth expected to moderate and settle at more typical levels in 2023.

As global supply chains gradually return to normal, those regions that were particularly held back by supply shortages, such as the West Midlands and the North East, could see a boost to their economies. While in Scotland, Wales and Northern Ireland, the easing of pressures on supply chains is expected to follow the easing of pandemic restrictions, which have up till now been more stringent than in England.

The UK's exit from the European Union continues to negatively impact UK growth in our forecast. This is particularly important for London due to the impact on its financial services sector, which is set to experience significant headwinds over the coming decade. There is also still significant uncertainty in Northern Ireland which is likely to impact the outlook for business investment in the region.

A strong performance of the IT and Telecoms sectors could support relatively robust growth in the West Midlands and the South East, as well as help lift London's performance, thanks to tech hubs in London, the South East and Birmingham.

In the West Midlands, 2022 could see a boost from the Commonwealth Games, particularly to the hospitality sector.

Table 2. Outlook for GDP growth in UK's nations and regions

	2020	2021	2022	2023
North East	-10.3%	6.3%	4.5%	1.5%
North West	-7.9%	6.7%	3.3%	1.5%
West Midlands	-13.0%	6.5%	7.8%	1.9%
East Midlands	-10.0%	6.4%	4.3%	1.6%
East of England	-9.6%	8.5%	3.1%	2.0%
Yorkshire and the Humber	-9.3%	7.3%	3.6%	1.4%
South East	-10.4%	7.4%	5.2%	2.3%
South West	-8.7%	8.1%	3.0%	1.5%
London	-7.1%	7.9%	2.6%	1.9%
Wales	-8.0%	5.0%	2.3%	1.1%
Scotland	-9.7%	6.4%	4.8%	2.0%
Northern Ireland	-6.3%	6.4%	2.1%	1.0%
UK	**-9.4%**	**7.3%**	**3.8%**	**1.8%**

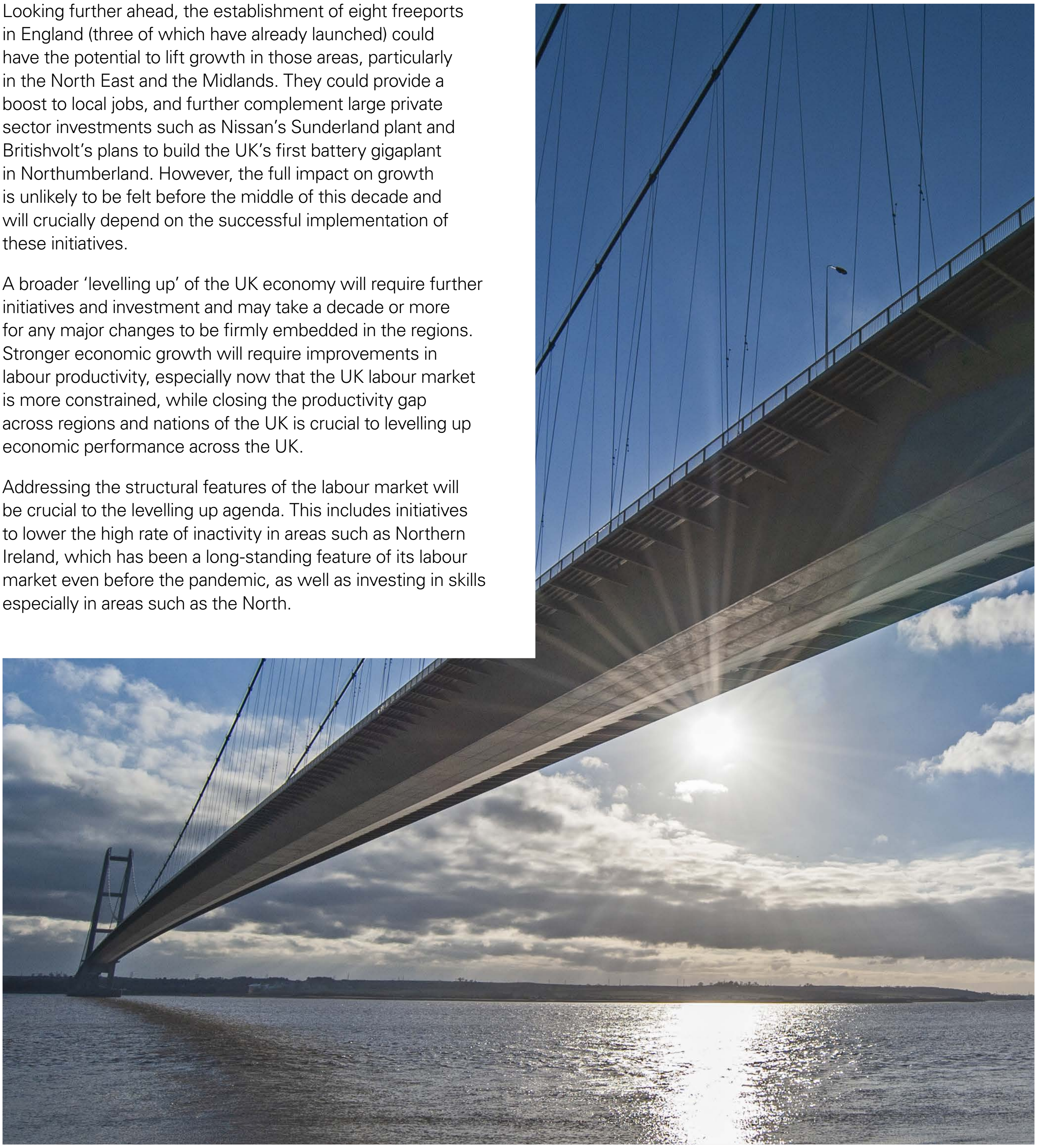
Source: ONS, Scottish Government, NISRA, KPMG analysis.

Achieving sustainable long-term growth

Looking further ahead, the establishment of eight freeports in England (three of which have already launched) could have the potential to lift growth in those areas, particularly in the North East and the Midlands. They could provide a boost to local jobs, and further complement large private sector investments such as Nissan's Sunderland plant and Britishvolt's plans to build the UK's first battery gigaplant in Northumberland. However, the full impact on growth is unlikely to be felt before the middle of this decade and will crucially depend on the successful implementation of these initiatives.

A broader 'levelling up' of the UK economy will require further initiatives and investment and may take a decade or more for any major changes to be firmly embedded in the regions. Stronger economic growth will require improvements in labour productivity, especially now that the UK labour market is more constrained, while closing the productivity gap across regions and nations of the UK is crucial to levelling up economic performance across the UK.

Addressing the structural features of the labour market will be crucial to the levelling up agenda. This includes initiatives to lower the high rate of inactivity in areas such as Northern Ireland, which has been a long-standing feature of its labour market even before the pandemic, as well as investing in skills especially in areas such as the North.



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