UK Monitor

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A full recovery remains a remote prospect

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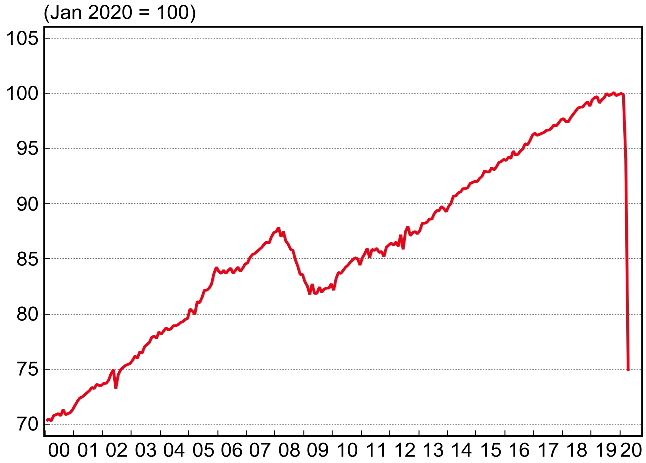
Activity will rebound as the lockdown is eased, but there are challenges ahead-

The coronavirus shock reduced the level of UK GDP by a quarter at the peak of the lockdown in April. With the economy shuttered and the public told to stay at home the magnitude of the economic downturn was not a surprise, but its duration is much harder to predict. To our minds, it is likely to be a long slog back to 'normal' levels of activity, even in the absence of a second wave of the virus.

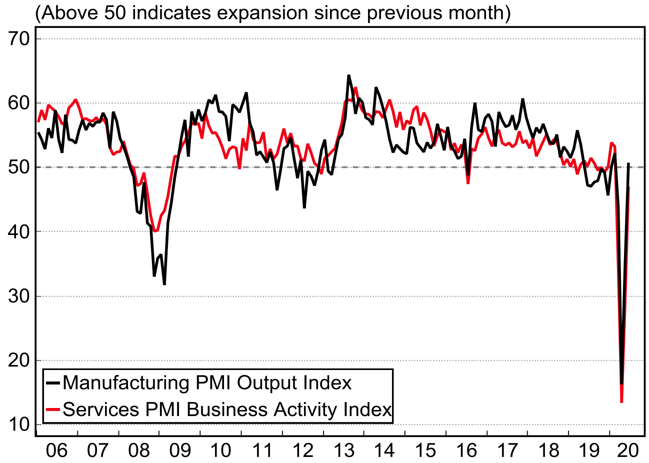
Initially, the steep fall in activity will naturally be followed by a something of a rebound as lockdown measures are eased. There are already some signs of this: retail sales increased by 12% MoM in May as some shops to reopen were allowed to reopen. There will be plenty of other data releases showing a similar pattern over the coming months. However, while high growth rates may generate headlines, it is the *level* of activity that matters: sales in May still remained 13% below the February figure.

UK Monthly GDP Estimate



Source: ONS, MUFG Bank Economic Research Office

UK PMIs



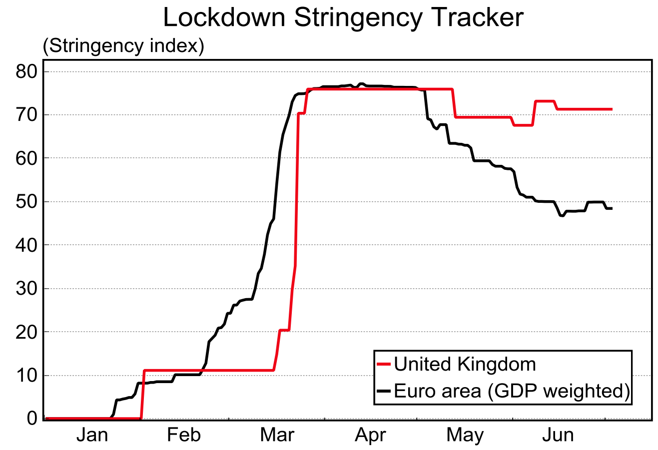
Source: IHS Markit, MUFG Bank Economic Research Office

The PMIs also rose sharply in June, to around 50 (the breakeven mark). But growth from a low base does not indicate a recovery. In fact, the PMIs should be much higher when considering the actual survey question asked (how output has changed compared to the previous month) given the easing of restrictions. It seems that many respondents actually consider a 'normal' level of activity as a baseline.

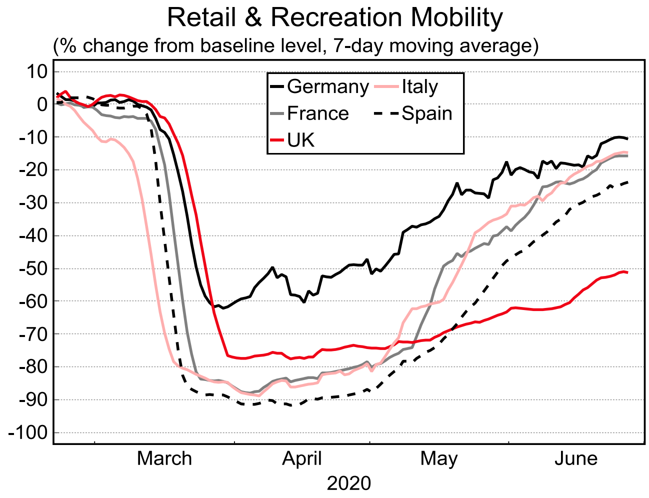
So, while some indicators suggest a quick rebound as the economy is unlocked, these should be interpreted with caution. Some of the least affected sectors are already returning to normal fairly quickly, but it is unlikely to be so straightforward for areas such as travel and hospitality. Beyond the initial bounce from reopening, a lot will hinge on how the labour market adapts to the new post-Covid normal and the effectiveness of policymakers' stimulus measures.

The UK has suffered more than most other countries

The UK government was slower to implement virus containment measures than other European countries and it has since proved harder to control the spread of the disease and unlock the economy. The Oxford University lockdown stringency tracker shows that, while euro area governments are now steadily withdrawing containment measures, the UK index actually moved in the opposite direction (travel quarantine measures were belatedly imposed on 8 June). Some European countries reopened bars and restaurants in May yet pubs in England remain closed until 4 July.



Source: Oxford COVID-19 Government Response Tracker, Blavatnik School of Government, MUFG Bank Economic Research Office



Source: Google, MUFG Bank Economic Research Office

While it can be argued that the UK government was slow in implementing lockdown measures, the immediate *economic* policy response to the crisis is harder to criticise. The focus for policymakers was to minimise the long-term damage to the economy by preventing bankruptcies and job destruction. To that end, around a quarter of the UK's workforce have had wages paid by the government under its furlough scheme, with millions of grants also given to self-employed workers. The Treasury and the Bank of England were quick to provide liquidity support to firms.

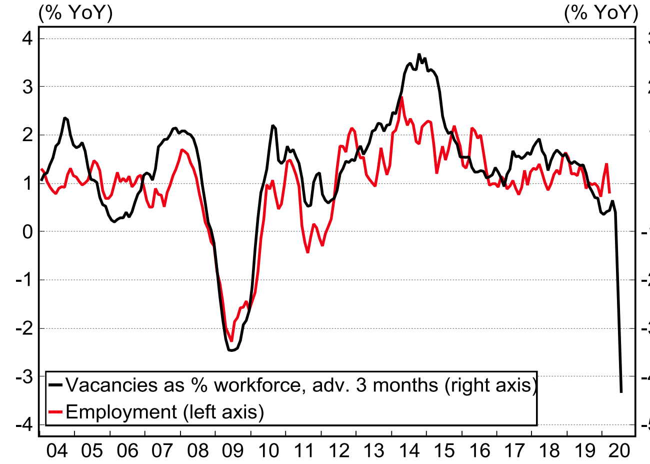
These initial measures have proven to be effective. The ILO unemployment rate remained unchanged at 3.9% in the three months to April, close to historical lows, as furloughed workers were not actively seeking other jobs. The unemployment rate will get worse; timelier claimant count data shows an increase of 1.3 million since March (but it should be noted that the government has widened the eligibility benefits which will have contributed to some of this increase). Meanwhile, the ONS has reported that "the number of company insolvencies remained low in May", although this may be partly due to the reduced court and tribunal service

A surge in unemployment has been prevented – for now

Despite the initial policy success, an increase in the unemployment rate is inevitable. It will be some time before we have a clear picture of how many jobs have been permanently lost as a result of the Covid-19 crisis. The furlough scheme has been effective, covering around nine million workers, but it will not last forever. It is expensive (the OBR estimates that the scheme will cost £60 billion, 2.7% of 2019 GDP, in total) and there may be hysteresis effects if workers lose skills after not working for months.

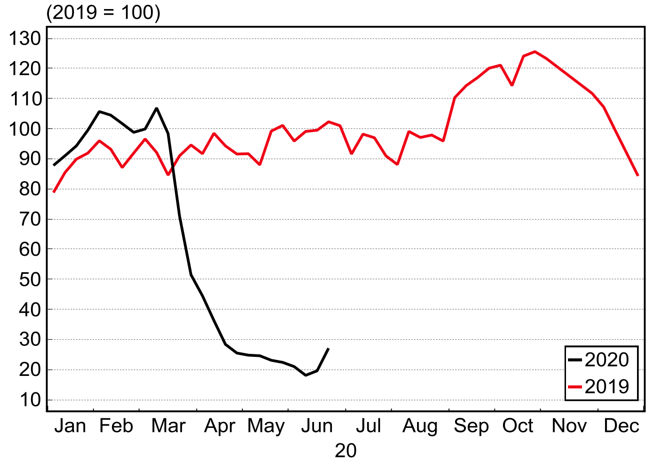
However, unwinding the scheme will be a delicate task. It is a narrow path between increasing the number of permanent job losses and providing unnecessary state support. The government has begun to cautiously withdraw its support. Workers who have not previously been furloughed are now ineligible for the scheme, and employers can now bring staff back to work part-time. From August, the government will reduce its contributions. This could be the trigger for firms to decide not to retain workers, even if the state continues to pay the bulk of their salary. The initial signs from business surveys and vacancy data are not encouraging, especially if the most affected sectors. We expect the unemployment rate will increase to around 9% by the end of the year. This would be bad news for the UK's consumer-driven economy.

Employment and Vacancies



Source: ONS, MUFG Bank Economic Research Office

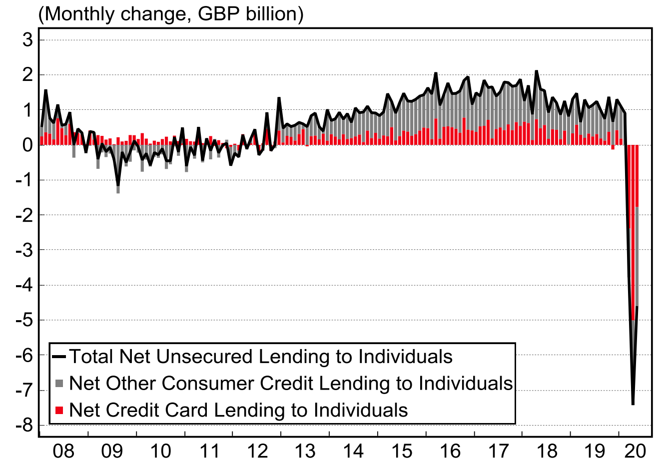
Catering and Hospitality Job Adverts



Source: ONS, Adzuna, MUFG Bank Economic Research Office

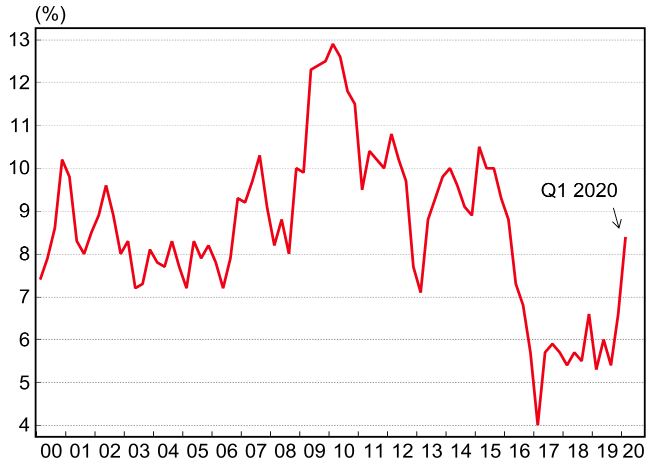
The UK does have a flexible labour market and jobs could be re-added quickly later on if social distancing measures are reversed and consumer behaviour returns to normal. However, the nature of this crisis might hamper any recovery in employment. After the GFC, employment in accommodation and food services grew rapidly while employment in the total private sector continued to fall. Any persistent drag on the hospitality sector, which has absorbed job losses from other sectors in the past, would not be helpful. Employment in the retail sector may also be affected if the shift to internet shopping (33% of sales in May, up from 19% in February) endures.

Net consumer credit



Source: Bank of England, MUFG Bank Economic Research Office

Household Saving Ratio



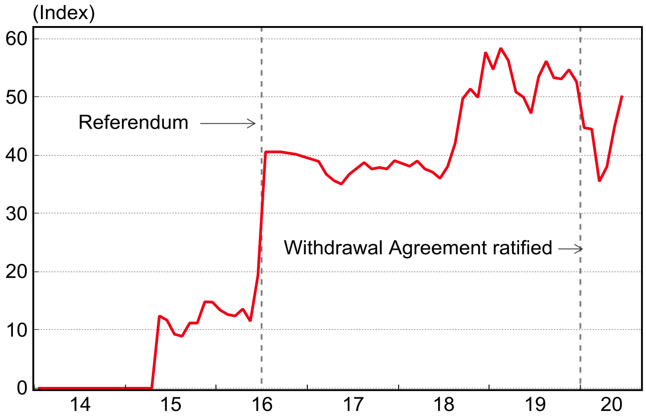
Source: ONS, MUFG Bank Economic Research Office

For now, households' finances are in reasonable shape. With government support, the majority of salaries are still being paid. At the same time, many individuals would have spent less on entertainment, holidays and commuting during the lockdown. Almost £16 billion of consumer credit has been repaid since March, mostly driven by lower borrowing. A shift towards stronger household balance sheets may be good news on an individual basis. However, an increase in precautionary saving driven by concerns about the labour market outlook could reduce the chances of a full spending recovery for the economy as a whole. The saving rate was already close to historical lows and we had expected it to rise over coming years, but the Covid crisis has caused a sharp increase in Q1. Consumer surveys suggest that this trend will continue, which could weigh on spending.

Brexit is an additional source of uncertainty

In most 'normal' or cyclical downturns, it is usually business investment or trade that contracts most sharply. This economic crisis has been led by a slump in consumer spending, meaning that the length of the resulting recession is likely to hinge on how quickly households return towards normal spending patterns. However, all parts of the economy have been affected, including gross fixed capital formation which fell by 1.1% in Q1. The ONS reports that there "is evidence that the lower level of sales and higher levels of uncertainty has led to the cancellation and postponement of investment projects".

Brexit Uncertainty Index



Note: Index tracks the percentage of businesses reporting that Brexit is one of the top three sources of uncertainty.
Source: Bank of England, MUFG Bank Economic Research Office

Key dates

29 June	Restricted round of negotiations begin
1 July	Germany assumes rotating presidency of EU Council
30 September	The UK government has suggested the end of September as a deadline for a deal
15-16 October	EU Summit
26 November	Deadline for any deal to be presented to the European Parliament for ratification
10-11 December	EU Summit
31 December	End of the transition period

Source : UK Government, EU Commission, Reuters, MUFG Bank Economic Research Office

The nature of the UK's future relationship with the EU is another source of uncertainty. The UK left the EU on 31 January this year but has so far been shielded from almost all the consequences of this by the standstill transition period. The UK government chose not to extend this transition period, which ends on 31 December this year, and has now missed the legal deadline to do so. This leaves precious little time to avoid a 'no trade deal' Brexit. There has been limited progress since negotiations on the future trading relationship began on 2 March this year and 'no trade deal' is certainly a risk. While history has shown that looming deadlines do tend to sharpen minds, the UK government may be working under the assumption that a 'no trade deal' Brexit would now be less damaging politically as the economic consequences would be hard to disentangle from the coronavirus shock. However, the disruption will be much harder to justify if the labour market is already severely damaged by the Covid crisis. We expect that pressure on the government to reach an agreement which limits further economic disruption will increase as the unemployment rate picks up in the autumn. Our base case is still that a limited trade deal will be reached in the autumn.

Initially, at least, a limited deal may not actually differ that much to a 'no deal' situation in terms of market access in that plenty of trade friction will be introduced either way. But the direction of travel will matter. Some type of deal would likely pave the wave for further agreements down the line and, while there will not be a formal extension to the transition period, elements of the deal could be gradually implemented over time. On the other hand, 'no deal' would likely mean acrimony and a breakdown of trust between the two sides.

This uncertainty is not helpful for UK firms. Brexit contingency planning will understandably have fallen down the list of priorities since the start of the pandemic (the UK's first confirmed case of Covid-19 was actually on 31 January – the day it left the EU). The trade policies that will apply from 2021 are yet to be determined, but we know that customs declarations will be required to move goods in and out of the EU. The paperwork burden for importing and exporting firms will increase but the last-minute negotiations will leave little time to prepare for specific legislation.

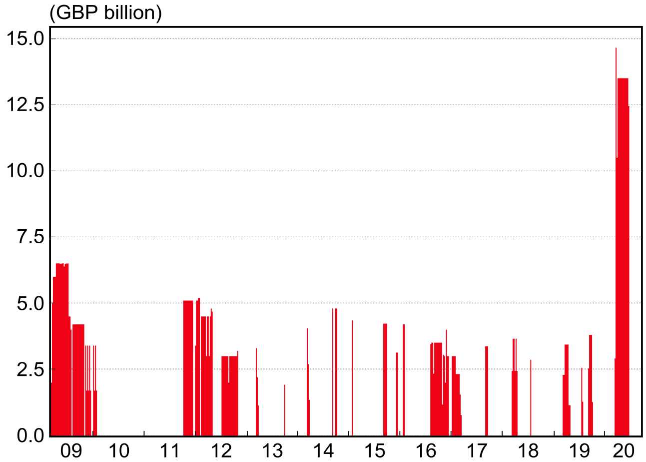
The pandemic also means that any precautionary stockpiles that were built up ahead of the previous Brexit deadlines are now likely to have been depleted. The ONS has reported "a substantial decrease in stocks being held by UK companies in Quarter 1 2020, led by a fall in the level of stocks held within the wholesale and retail trades".

Europe is no longer the epicentre of Covid-19, but the virus shows no sign of disappearing as the number of confirmed cases jumps in the US and emerging economies. With regional flare-ups seemingly set to continue (at least until a vaccine can be developed) there is likely to be an ongoing drag on global trade. This will make it harder for firms to replenish stockpiles before the transition period end. More broadly, the introduction of significant trade friction between the UK and its largest trading partner could be especially damaging during a global slowdown. The risk of weak external demand is another reason to fret about the UK economic outlook over the medium term.

More fiscal support will be needed

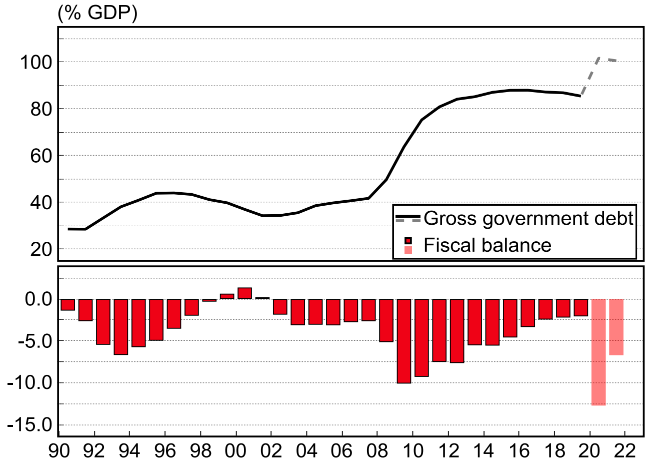
Policymakers are now shifting their focus from immediate emergency support to a growth-friendly mix to help the economic recovery. PM Johnson has announced a £5bn infrastructure spending plan this week. At just 0.2% of GDP this was underwhelming (it pales in comparison with the stimulus programme unveiled by Angela Merkel at the start of the month of around 4% of German GDP) and is more less just an acceleration of existing pledges from the 2019 election manifesto rather than new initiatives. Infrastructure spending over the next few years will provide little immediate solace for the beleaguered hospitality sector.

BoE Weekly Gilt Purchases



Source: Bank of England, MUFG Bank Economic Research Office

Debt and Deficit (with IMF projections)



Source: IMF, MUFG Bank Economic Research Office

Hopefully more fiscal measures are in the pipeline. We will have to wait for a statement from the Chancellor next week to see if the UK will copy any elements of the German approach, perhaps by implementing VAT cuts which could help coax consumers into spending again. If some retailers opt not to pass the cut on to customers in order to increase their margins this could also help to reduce permanent job losses as the furlough scheme is wound down. Another option to ease the burden on employers would be to reduce their national insurance contributions or business rates (perhaps in most-affected sectors only).

On the monetary policy side, the Bank of England expanded its QE programme by an additional £100bn. The aim is for this to be completed "around the turn of the year" which implies a notably slower pace of purchases. However, the door is probably open to further measures if required. The meeting statement noted the risk of "higher and more persistent unemployment".

Given recent comments from policymakers we cannot rule out the introduction of negative rates. However, the evidence from elsewhere suggests that the benefits might be limited, and there was no mention of a move into negative territory in the minutes of the June meeting. With rates already at an all-time low of 10bp we suspect that that any additional support, if required, would probably come in the form of another expansion to QE.

Outlook – an initial bounce, but a full recovery may take years

The UK economy faces a long grind ahead to recover from one of the sharpest falls in activity ever recorded. At least initially, economic data releases are likely to suggest the start of a 'V-shaped' recovery as certain sectors respond quickly to the end of lockdown conditions. However, many businesses in areas such as travel, hospitality and retail are likely to find it much tougher to fully recover. It will be some time before the extent of the drag becomes clear as emergency government policies will disguise any changes in the underlying health of the labour market. Job losses are unfortunately inevitable as state support is withdrawn later on – but the unemployment rate could easily soar much higher if policymakers misstep. This would risk 'second round' effects which are not directly related to the pandemic and could lead to a prolonged economic downturn.

After suffering a much wider and more persistent spread of Covid-19 than other European countries, the UK faces extra risks now that it has left the EU. With an abrupt end to the Brexit transition period on the horizon, there is another source of uncertainty for firms which have will have focused almost exclusively on the pandemic in the first half of the year. Negotiations between the UK and EU now look set to go to the wire again in the autumn which would limit the time firms have to prepare for the new relationship. Our base case is that a limited trade deal will be reached between the two sides, but the reality is that trade friction will significantly increase whether a deal can be reached or not. A drag from net exports is a clear risk factor for any medium-term outlook.

Against that background, economic policy support will be especially important – we expect more fiscal measures and perhaps monetary stimulus too over the coming months. Nonetheless it is still likely to be a tough road back for the economy. After falling by 8% across 2020 as a whole, we expect a limited bounce back of 6.5% in 2021. While this growth rate would be unprecedented in recent decades, it would leave the overall *level* of GDP well below that of Q4 2019. Even in the absence of a second wave of the virus, we currently estimate that it will be some years before we see a full recovery to pre-Covid levels of activity.

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