HENRY COOK
Europe Economist

Economic Research Office

T: +44 (0)20 7577 1591
E: henry.cook@uk.mufg.jp

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The recovery is set to lose some steam as consumers remain cautious

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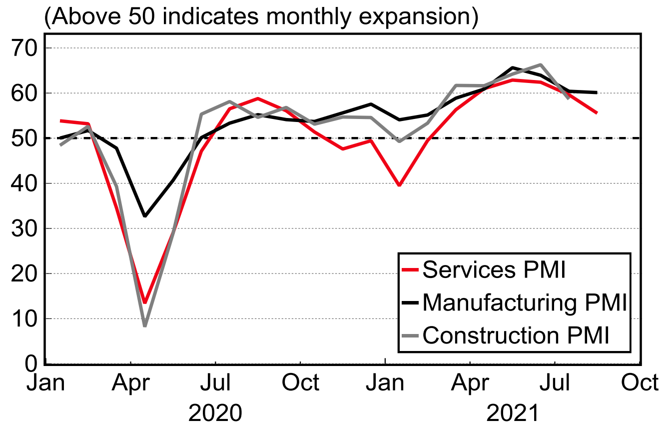
After rapid growth in Q2 the recovery is set to slow through the second half of the year. Recent data on consumer spending have been underwhelming. The spread of the Delta variant seems unlikely to prompt a return to significant lockdown measures – the UK government has shown that it can tolerate a high daily caseload – but individual caution will probably delay a complete return to 'normality'. Meanwhile, headline vacancy figures are encouraging, but we expect that the labour market will look increasingly fragmented over coming months. While Brexit is likely to exacerbate worker shortages in many individual sectors there's likely to be an increase in overall headline unemployment once furlough support ends in September.

Slowing momentum as households keep their powder dry

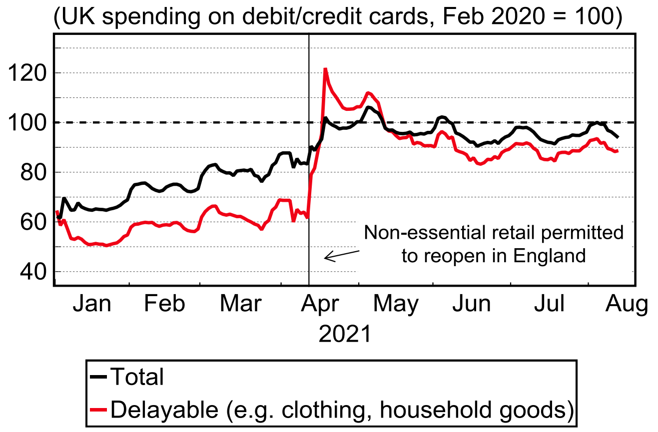
The UK economy grew by 4.8% Q/Q last quarter. This is a high figure by historical standards but an entirely expected rebound after COVID-19 restrictions on retail businesses were lifted in April and all legal limits on social contact removed by 19 July. Growth will inevitably now slow as the reopening effect fades, but we suspect that the extent of the loss of momentum might still take some by surprise. Our current 2021 GDP forecast is below-consensus at 6.7% Y/Y.

BUSINESS SURVEYS ARE LOSING STEAM



Source: IHS Markit, MUFG Bank Economic Research Office

NO PICK-UP IN MOMENTUM IN RECENT SPENDING DATA



Note: data are not seasonally-adjusted. Source: ONS, MUFG Bank Economic Research Office

Business surveys are showing signs of cooling recently. While still firmly in 'expansion' territory, the PMIs slipped back again in August on the back of staff and supply shortages. Ongoing improvement in consumer confidence – now back to its February 2020 level – is more encouraging. Indeed, the most bullish outlooks for the

UK economy hinge on the assumption that UK households will draw down savings accumulated during lockdown when there were fewer spending opportunities.

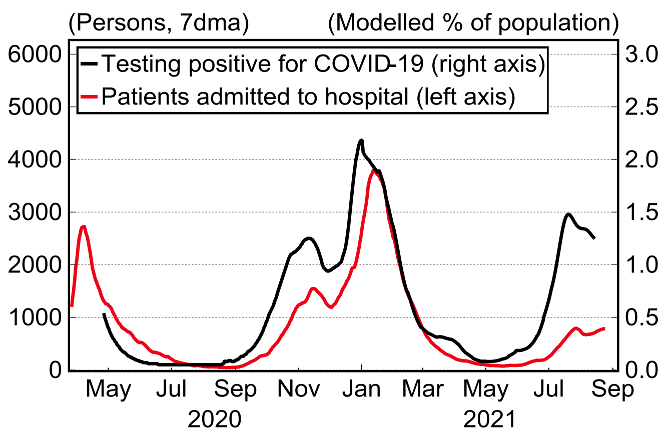
Households certainly have ammunition – currency and deposit holdings are around 10% above their pre-pandemic trend. Given that, we think that consumer spending will inevitably be a growth driver, at least to the extent that household consumption growth slightly exceeds headline GDP growth. But savings are likely to provide more of a steady trickle of support over several years rather than cause a sudden rush of activity. We expect many households will be happy to maintain stronger balance sheets, both as a post-pandemic precaution but also because savings had previously been looking thin. Before COVID we had speculated that a drag on consumption from higher saving rates seemed inevitable after a period of lower saving (the saving ratio was 6% from 2017 to 2019, after an average of 9% from 2000 to 2016).

So far there is certainly little sign of a savings-driven surge in spending. Retail sales slumped by 2.5% M/M in July. Data from Springboard suggests that overall retail footfall was at 82% of the level seen in the equivalent week in 2019 at the start of August as consumers are remaining cautious. Some of this can be attributed to a pivot in spending back towards services as hospitality venues reopened. However, high frequency CHAPS data on household credit/debit card spending, which includes bars and restaurants, have remained muted this month.

No more lockdowns but COVID likely to continue to drag on economic activity

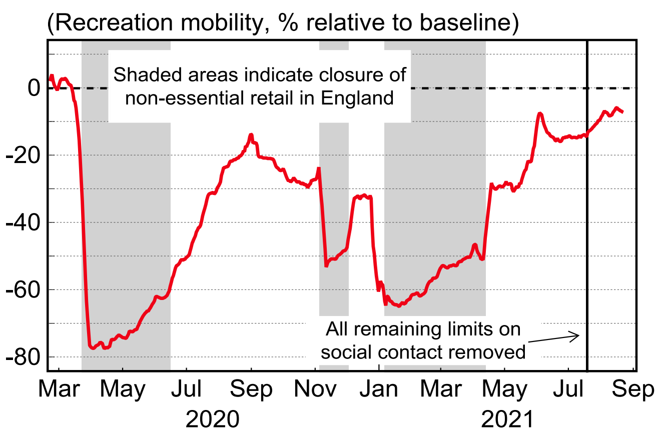
Spending hesitancy may be largely due to the COVID situation. The UK's caseload surged in July as all remaining restrictions were removed and the Delta variant became dominant. The number of new discovered cases began to fall by the end of the month but has now started to edge higher again, towards 40,000 cases a day.

HIGH PREVALENCE OF COVID IN THE ABSENCE OF RESTRICTIONS



Source: ONS, PHE, MUFG Bank Economic Research Office

MOBILITY INDICATORS REMAIN BELOW THE PRE-PANDEMIC BASELINE



Source: Google, MUFG Bank Economic Research Office

While the link between cases and COVID-related hospitalisations and deaths is much weaker now that around 80% of adults are fully vaccinated, the prevalence of the virus probably still discourages people from certain activities. The ONS COVID-19 Opinions and Lifestyle survey reported that the proportion of people either 'uncomfortable' or 'very uncomfortable' about leaving their home has ranged from 24% to 17% since non-essential retail was permitted to reopen in April. The latest figure is 21% – if a fifth of people are uneasy about leaving the house then that is certainly significant when it comes to economic activity.

It might take some time for many people to regain confidence to lead a 'normal' lifestyle. The UK government has made it clear that it can tolerate high infection rates now that vaccinations have greatly reduced hospitalisations. There was little suggestion that restrictions might be re-imposed when daily cases hit 50,000 a day in July, despite being close to the January peak which triggered weeks of lockdown. In the absence of any meaningful restrictions, the R number is estimated to be between 1.0 and 1.2. This suggests that the UK is currently below, but close to, the immunity threshold, so cases may continue to edge up from current range.

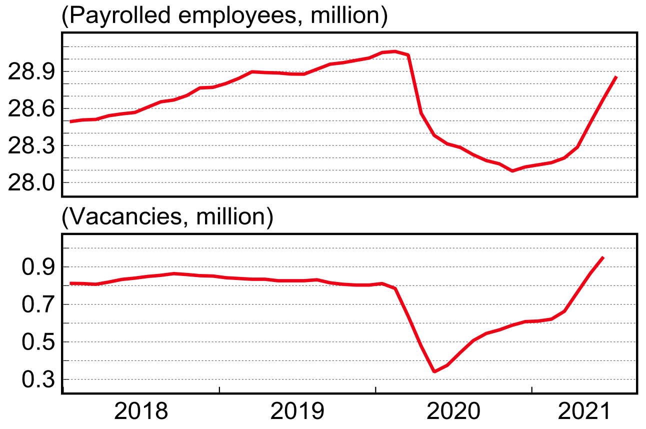
However, the caseload could increase fairly quickly from this relatively high starting point if conditions change. The immunity threshold is likely to rise in the autumn as schools reopen after the holidays, working in offices becomes more common and people spend more time indoors generally as summer ends. At the same time, the risk of waning immunity from vaccinations may move into focus. If the government does introduce a programme of 'booster shots', as seems likely, there is a risk that demand might be considerably lower than it was for the initial doses.

So we expect that the prevalence of COVID will remain very relevant to the outlook through the rest of the year. A significant proportion of the population will remain uneasy about returning to 'normal' activities, certainly through the rest of the year, even if there are very few restrictions to doing so. The direct costs to the economy from high infection rates are also relevant – around 3% of adults reported having to self-isolate in mid-August.

Good news for labour market

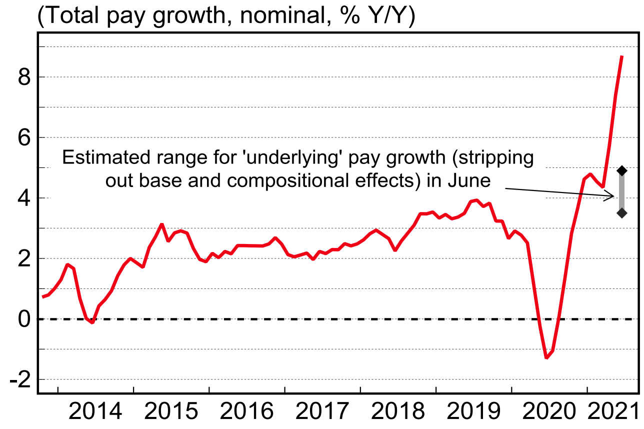
The UK labour market is providing some better news. The latest jobs report showed that headline unemployment rate fell by 0.2pp to 4.7% in Q2. There was a striking increase in nominal pay growth to 8.8% (nominal, including bonuses). This is inflated by pandemic-related distortions such as base effects (there were low or negative growth rates in April to June 2020) and compositional effects (there was a smaller proportion of lower paid jobs during the pandemic). But 'underlying' nominal pay growth is probably somewhere between 3.5 and 5.0% Y/Y, which is comfortably above the pre-pandemic average. The number of payrolled employees increased by 180,000 in July and is now just 200,000 below the February 2020 figure.

EMPLOYMENT AND HIRING ACTIVITY POINT TO AN INCREASING HEALTHY LABOUR MARKET



Source: ONS, MUFG Bank Economic Research Office

HIGHER WAGE GROWTH MAY REFLECT LABOUR SHORTAGES IN SOME SECTORS



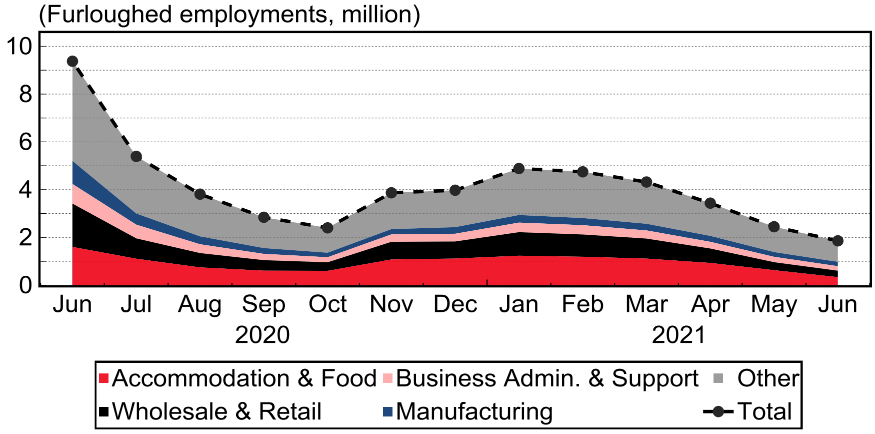
Source: ONS, MUFG Bank Economic Research Office

Most encouraging of all were the signs of increased hiring activity. Total vacancies reached 950,000 in the three months to July, a record high. Higher frequency data on online adverts suggest that this momentum has continued into August. This is good news as the Coronavirus Job Retention Scheme will end in the autumn. The government has already tapered its support from 80% to 60% of an employee's wages and the scheme will come to an end entirely on 30 September.

Brexit increases the risk of fragmentation

However, the labour market is likely to look very fragmented over coming quarters, with a shortage of workers in some sectors but a rise in unemployment across the economy as a whole. To our minds, job losses still seem inevitable once the furlough scheme comes to an end – it's unclear what will change by September for jobs which are not currently viable without government support in the absence of any meaningful restrictions. There were still around 1.8m furloughed employments at the end of June. This includes around 180,000 furloughed jobs in manufacturing, a take-up rate of 8% in a sector which has not faced significant restrictions for some time now.

MANY FIRMS ARE STILL DRAWING ON FURLOUGH SUPPORT AS THE SCHEME NEARS ITS END



Source: HMRC, MUFG Bank Economic Research Office

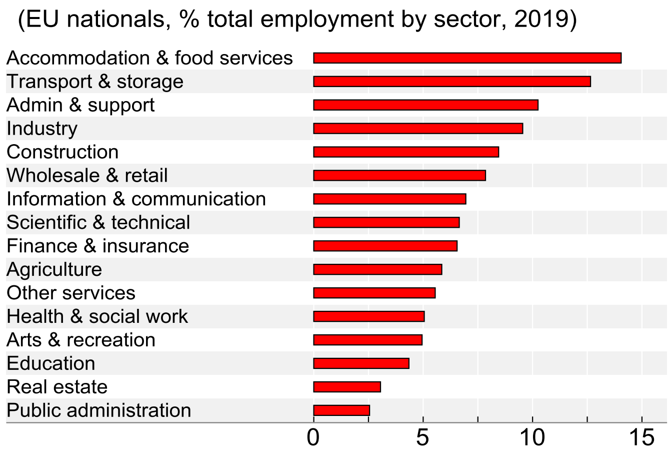
At the same time we also expect shortages of skilled labour in sectors which experience rapid post-lockdown growth. The pandemic may have brought into focus the importance of benefits and job security, deterring applicants to vacancies for traditionally casual work in industries such as tourism, hospitality and leisure.

Brexit, with the end of free movement for EU citizens, is very relevant here. The most immediate risk of disruption is in the haulage industry after an estimated 25,000 EU lorry drivers left the UK following the transition period and start of lockdown. This has contributed to a shortage of around 60,000 lorry drivers in the UK according to the Road Haulage Association. Recently there have been widespread reports of shortages in supermarkets and restaurants. Other industries are likely to be affected too. Around half of firms in the health and social work sector have reported to the ONS that the reduced availability of EU applicants is reducing their ability to hire. It's also probably not a coincidence that the sector with the highest proportion of unfilled vacancies in June – accommodation and food services – was also the sector with the highest proportion of EU workers to total employment in 2019 (17.9%).

History suggests that worker mobility between sectors can be hard to achieve. The labour market adjustment process – to both long-term post-pandemic shifts in the economy and to the reduced availability of EU workers – is likely to take time. We expect skills shortages and hiring difficulties to persist well into next year. Bottlenecks in the haulage industry may be particularly disruptive, but any difficulty in vacancy-worker matching points to productivity problems for the wider economy as well.

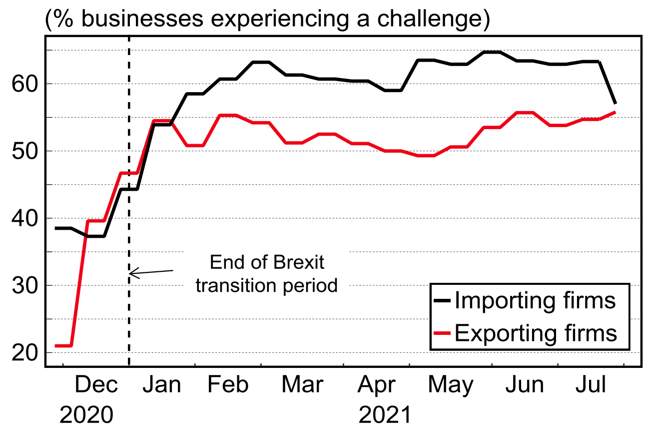
More broadly, we continue to expect that the effects of Brexit, which have been hard to disentangle from those of the pandemic, will become more apparent over coming quarters. There's nothing too alarming in headline trade figures as yet. But 30% of firms reported that they had either been unable to export or had exported less than normal in July. The main challenge cited, by over 40% of firms engaged in international trade, was 'additional paperwork' – less to do with lockdowns and more about the end of the UK leaving Europe's single market, we suspect. Our long-held view is that exactly this type of trade friction will result in a drag on UK potential growth over the medium to long term.

MANY SECTORS ARE VULNERABLE TO AN EU LABOUR SUPPLY SHOCK



Source: ONS, MUFG Bank Economic Research Office

BREXIT HAS INCREASED TRADE FRICTION



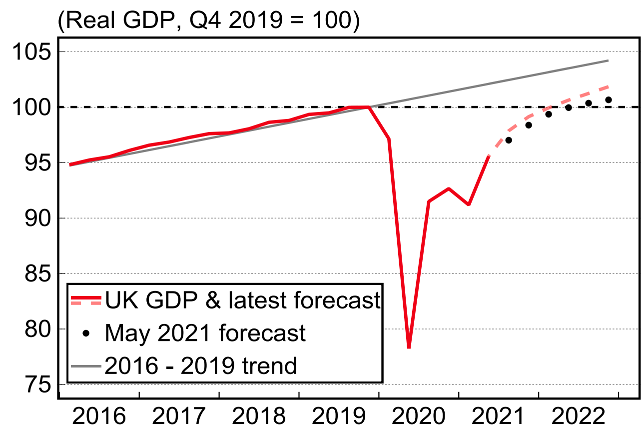
Source: ONS, MUFG Bank Economic Research Office

Outlook- UK growth has peaked

It would most likely take a very vaccine-resistant or significantly deadlier variant to push the UK back to a full lockdown. In the absence of these, the most likely scenario is an acceptance of COVID being endemic with the government attempting to manage it via public health measures and regular vaccination. With national lockdowns now (hopefully) a thing of the past, the economic recovery will continue through H2 and we expect UK GDP will return to its pre-pandemic level around the turn of the year. Indeed, we have raised our projections slightly from our previous forecast round in May despite the spread of the Delta variant. This reflects better-than-expected labour market data which has allayed some fears about the withdrawal of furlough support in September.

We now look for GDP growth of 6.7% Y/Y in 2021 and 5.2% Y/Y in 2022. These would be historically very high numbers with the UK economy still having a lot of ground to catch up after the steep decline in 2020 (monthly figures showed that output in June was still 2.5% below that of January 2020). Our UK forecast remains below consensus, however. Consumer spending may underwhelm over coming quarters, especially as the COVID caseload is likely to remain relatively high. We still expect some labour market scarring to become apparent once the furlough scheme ends in September. The likelihood of Brexit friction – on labour supply over the short-term and for trade more fundamentally – is also a factor. Overall, we expect that the pace of the recovery will steadily decrease over coming quarter, with GDP unlikely to converge back to its pre-pandemic trend during our forecast horizon.

UK QUARTERLY FORECAST



Source: ONS, MUFG Bank Economic Research Office

MUFG GDP FORECASTS - EUROPE

(Real GDP, % Y/Y)	2020	2021(F)	2022(F)
Euro area	-6.5	4.6	4.3
Germany	-4.8	3.4	4.5
France	-8.0	6.0	4.0
Italy	-8.9	5.6	4.2
UK	-9.8	6.7	5.2

Source: MUFG Bank Economic Research Office

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