Economic Perspectives

No quick fix for the UK economic predicament

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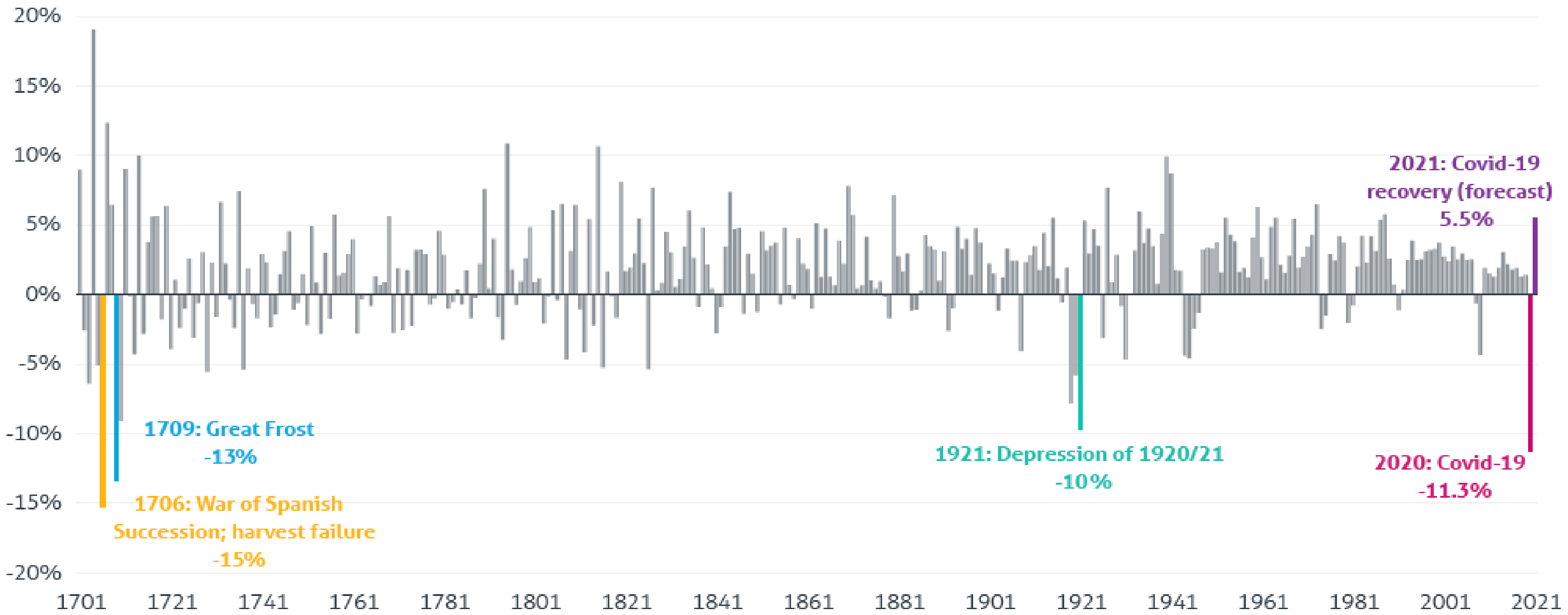
UK economy: multiple lockdowns = multiple uncertainties

- UK has been thrust into structural dislocation – output volatility likely to persist

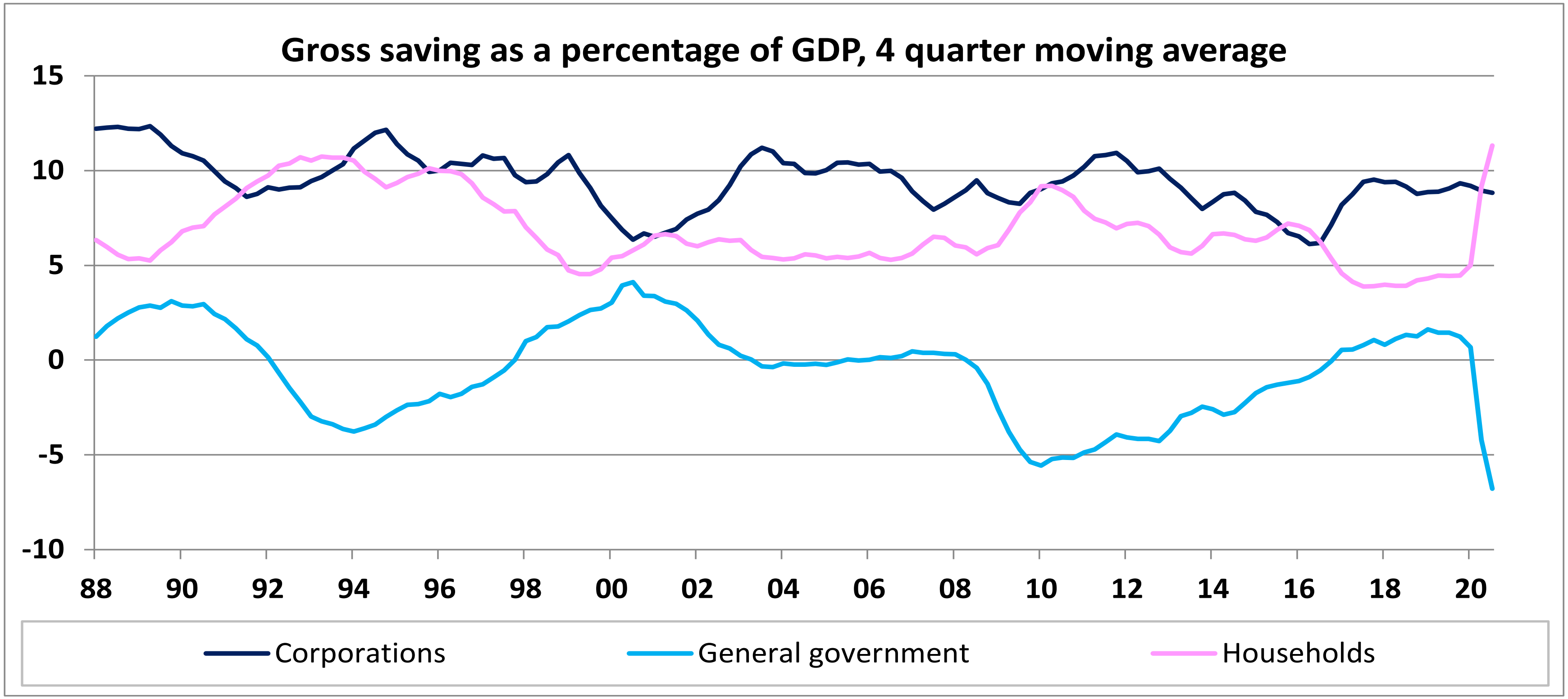
Figure 6.2 **Year-on-year changes in UK GDP, 1701–2021**



Source: Institute for Government analysis of Bank of England, 'A millennium of macroeconomic data', and OBR, *Economic and fiscal outlook*, November 2020.

UK gross national saving has fallen by 3pp of GDP in 2020

- There is no excess of global saving – and clearly no excess of UK saving either: public sector dissaving dominates household sector saving



Source: Office for National Statistics

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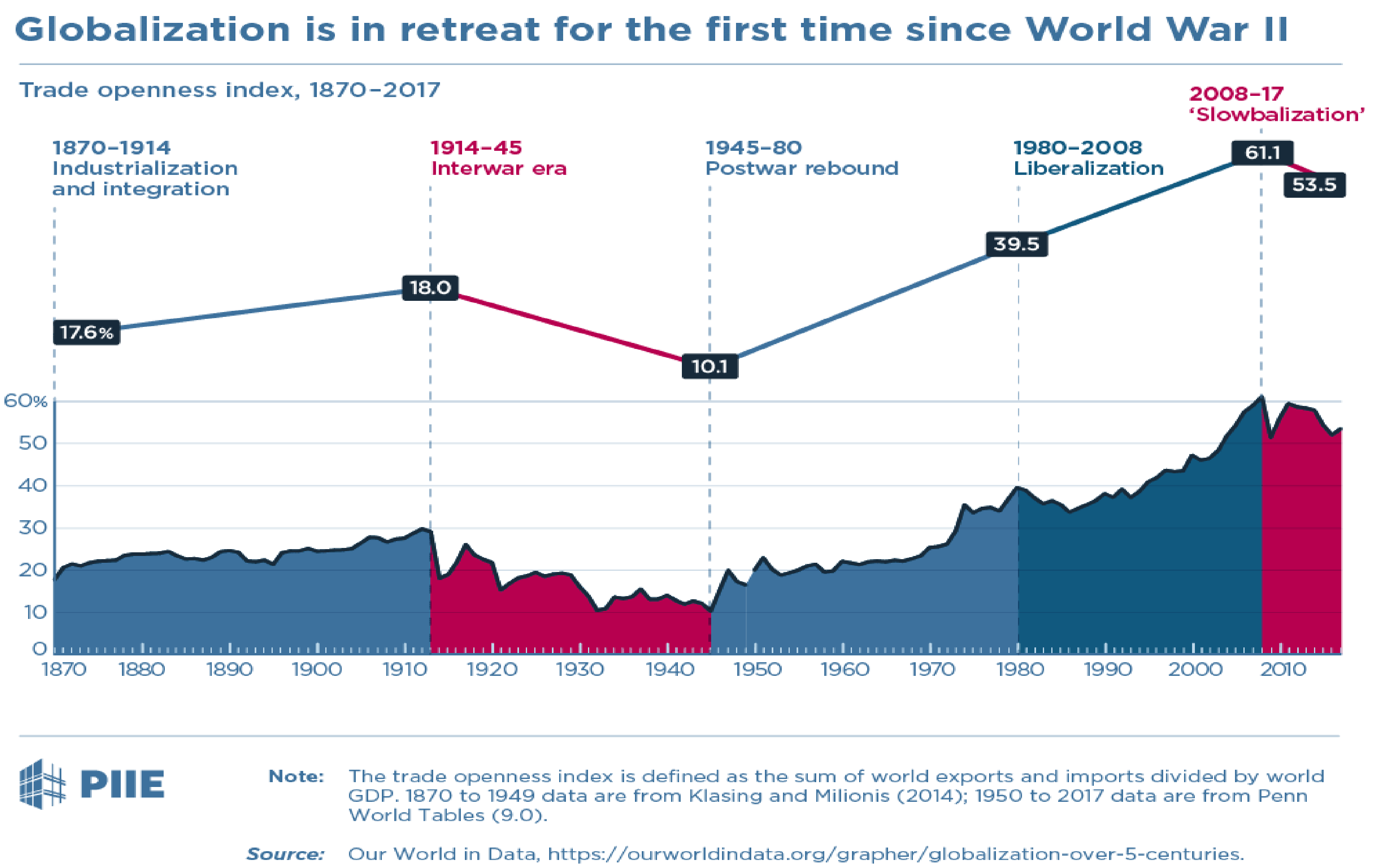
No quick fix for the UK economy (1)

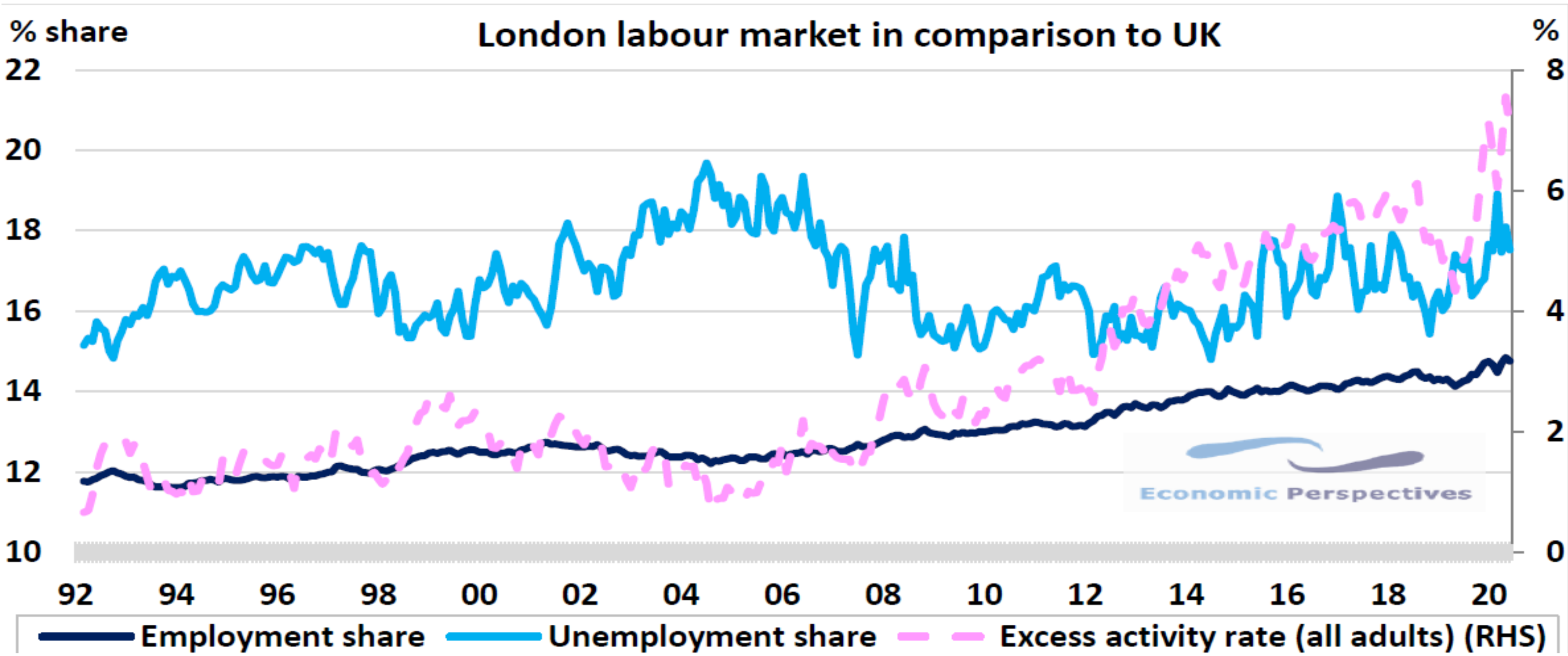
- Pandemic has supercharged de-globalisation and protectionism, to the disadvantage of the UK
- Brexit has overlaid a regional supply crisis on a global crisis
- Covid-19 has exposed the fragility of the UK's social contract and it will be impossible to return to anything approaching the *status quo ante*
- Major public health crisis is looming in the wake of the prioritisation of Covid patients
- Public finances are in disarray and heavily dependent on overt monetary finance

UK has been a major beneficiary of economic openness



London had become more important to UK economy …

- … attracting foreign labour, talent and capital
- But migrant departures in 2020 may be 1.3m, of which 670,000 were from London (ESCoE)



Source: Office for National Statistics

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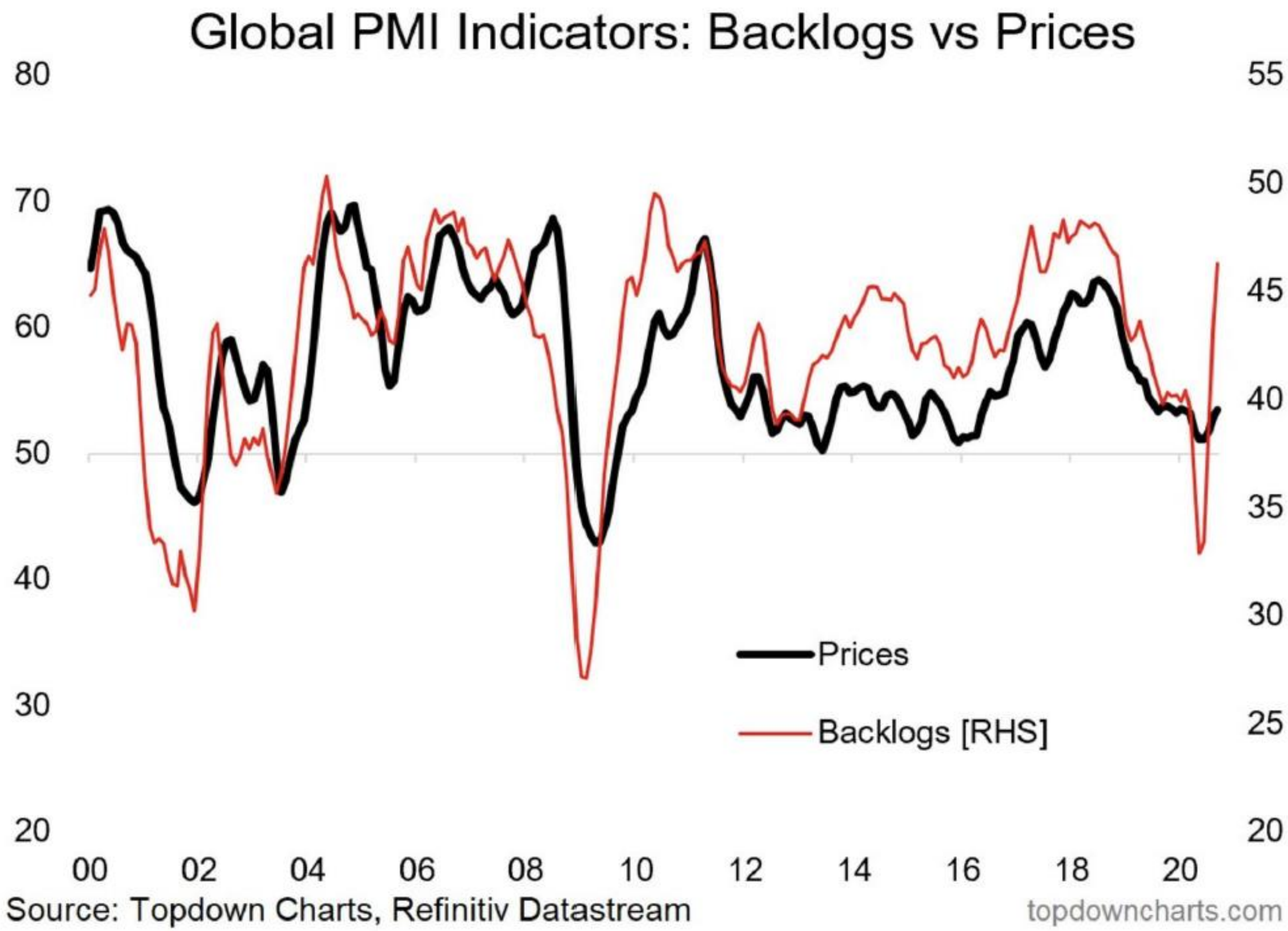
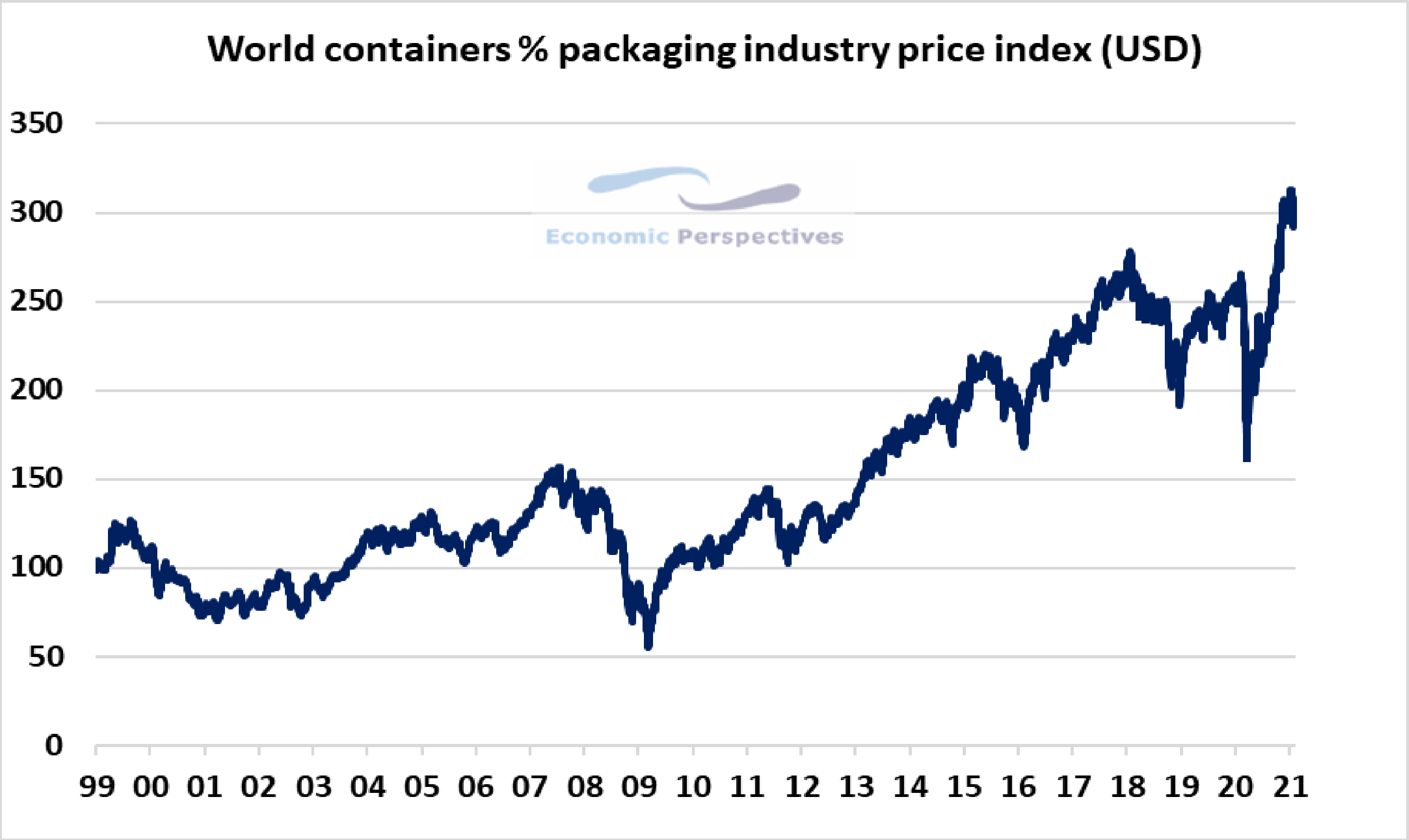
Global goods supply chains are creaking

- Delivery times are lengthening, prices rising



Spiralling container rates

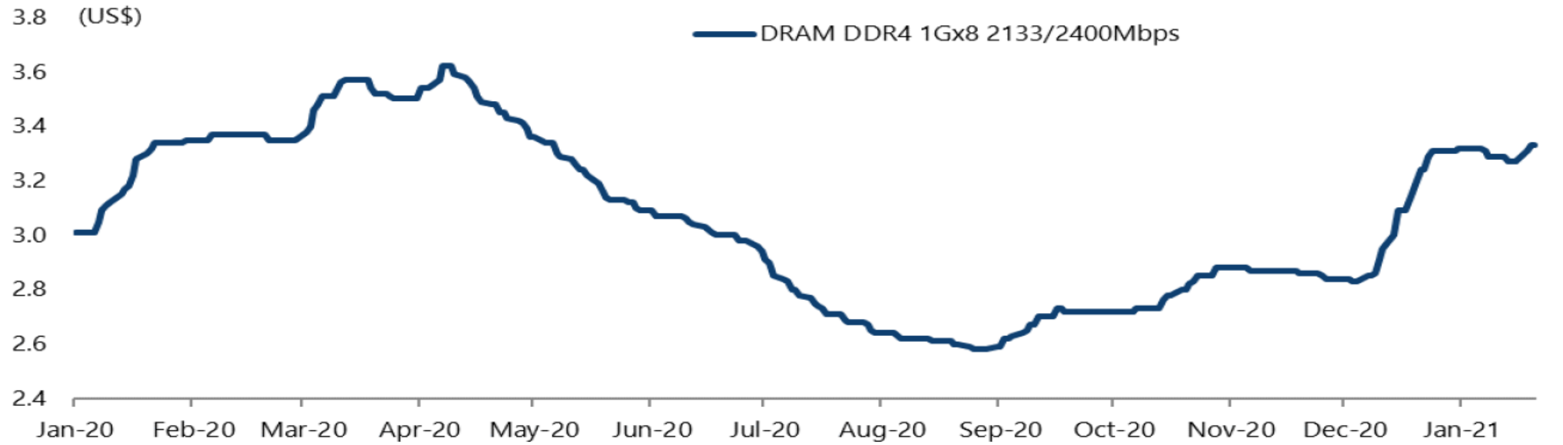
- Strong demand, ships in the wrong place!



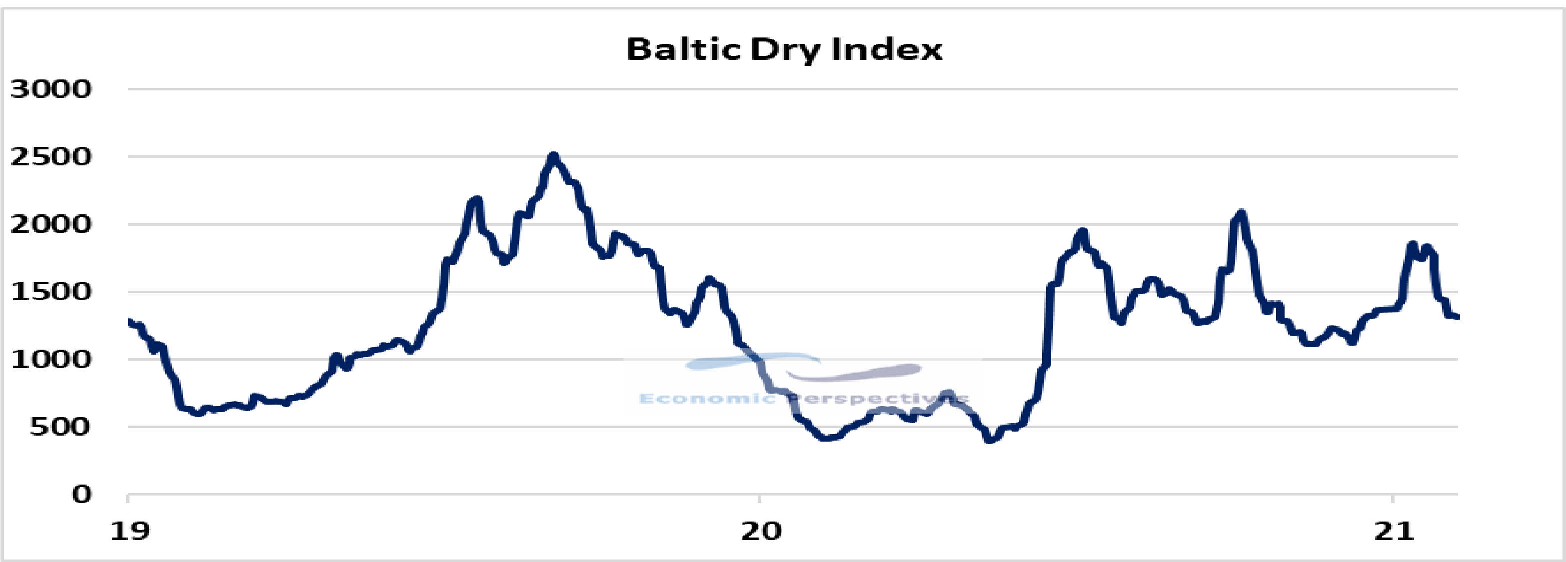
Data source: Eikon Reuters

Signs of supply bottlenecks in DRAM and shipping rates

Exhibit 1: DRAM price

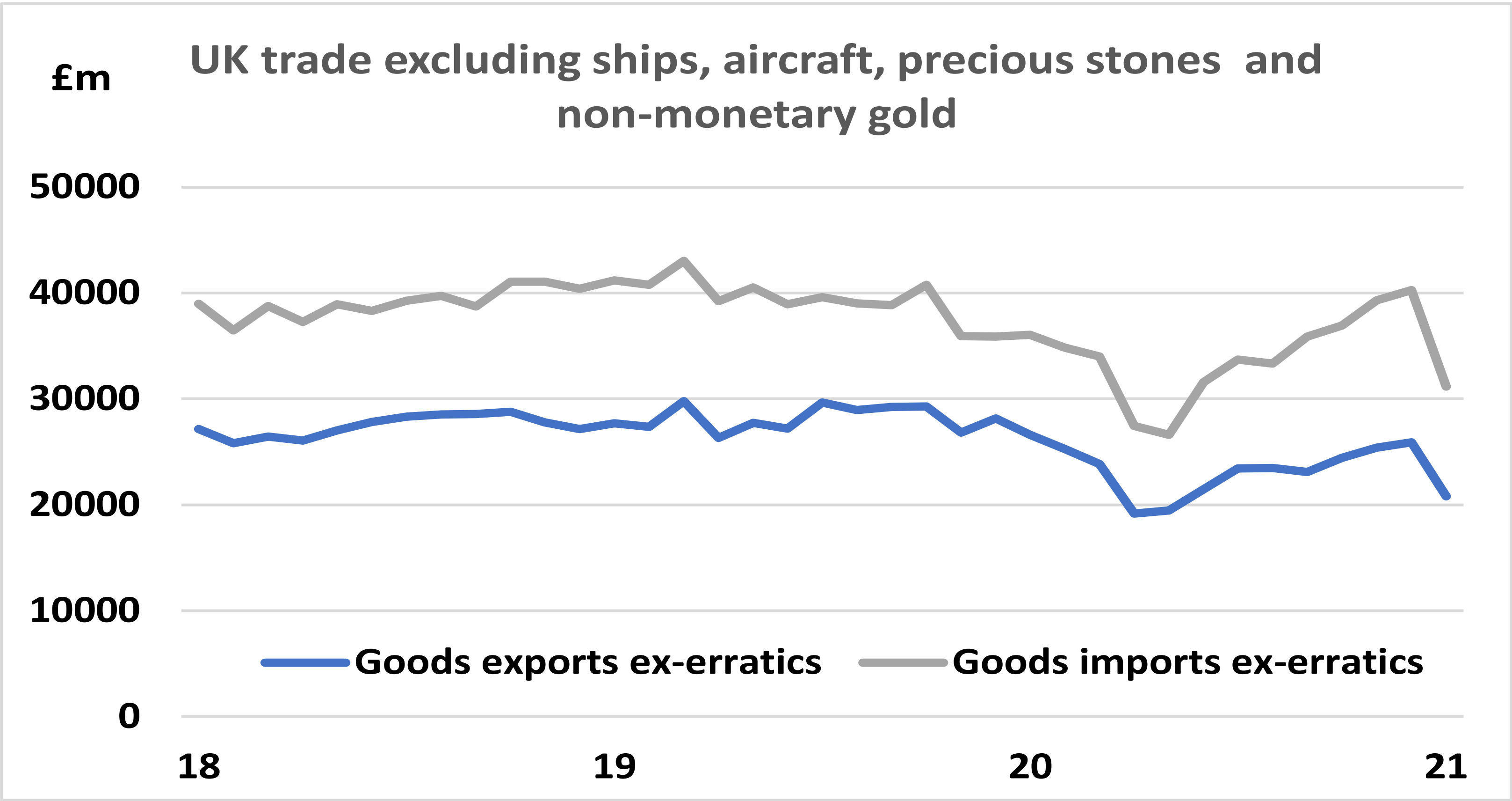


Source: Bloomberg



UK imports have rallied more impressively than exports

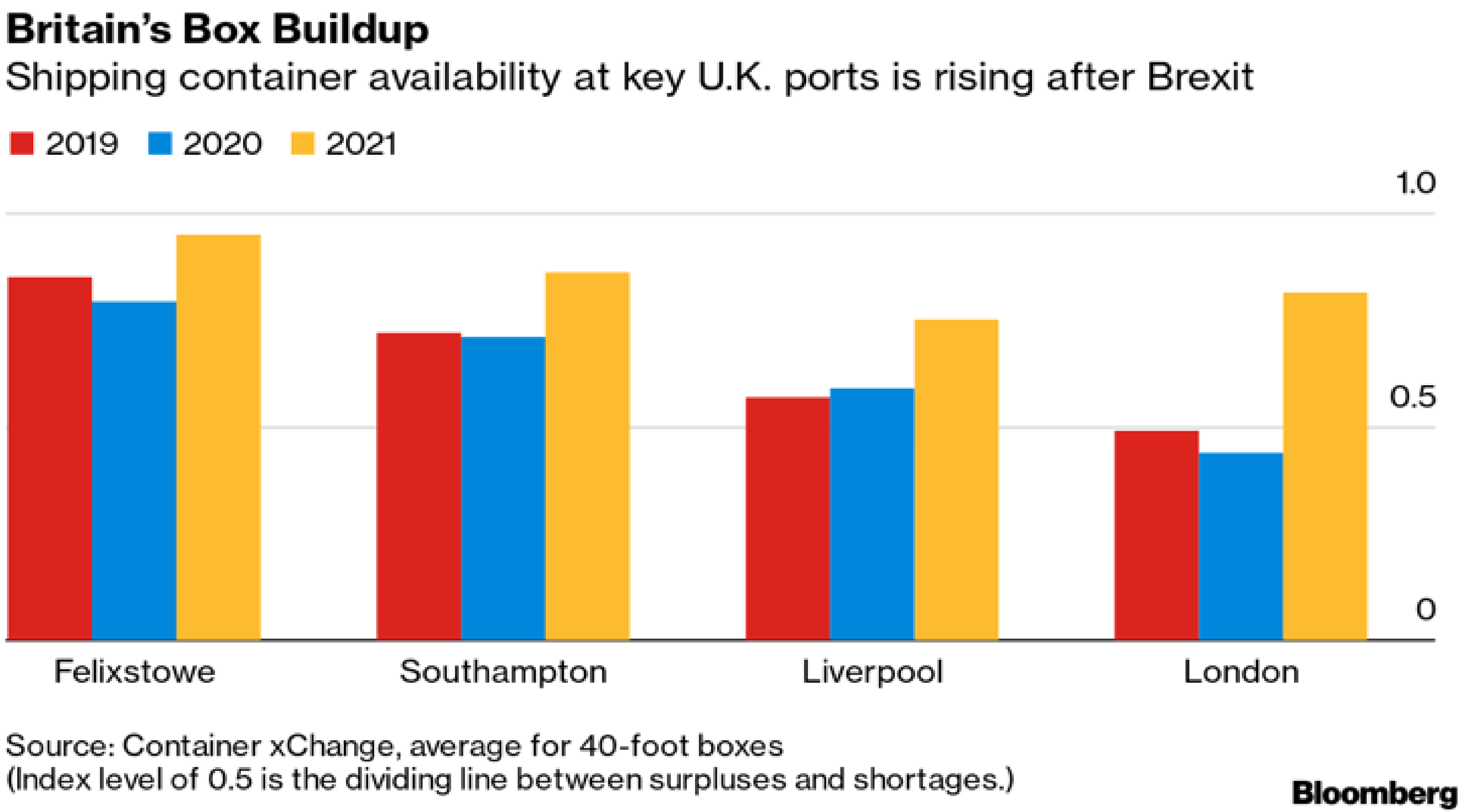
- Easier to substitute non-EU for EU imports



Source: Office for National Statistics

Containers are arriving full …

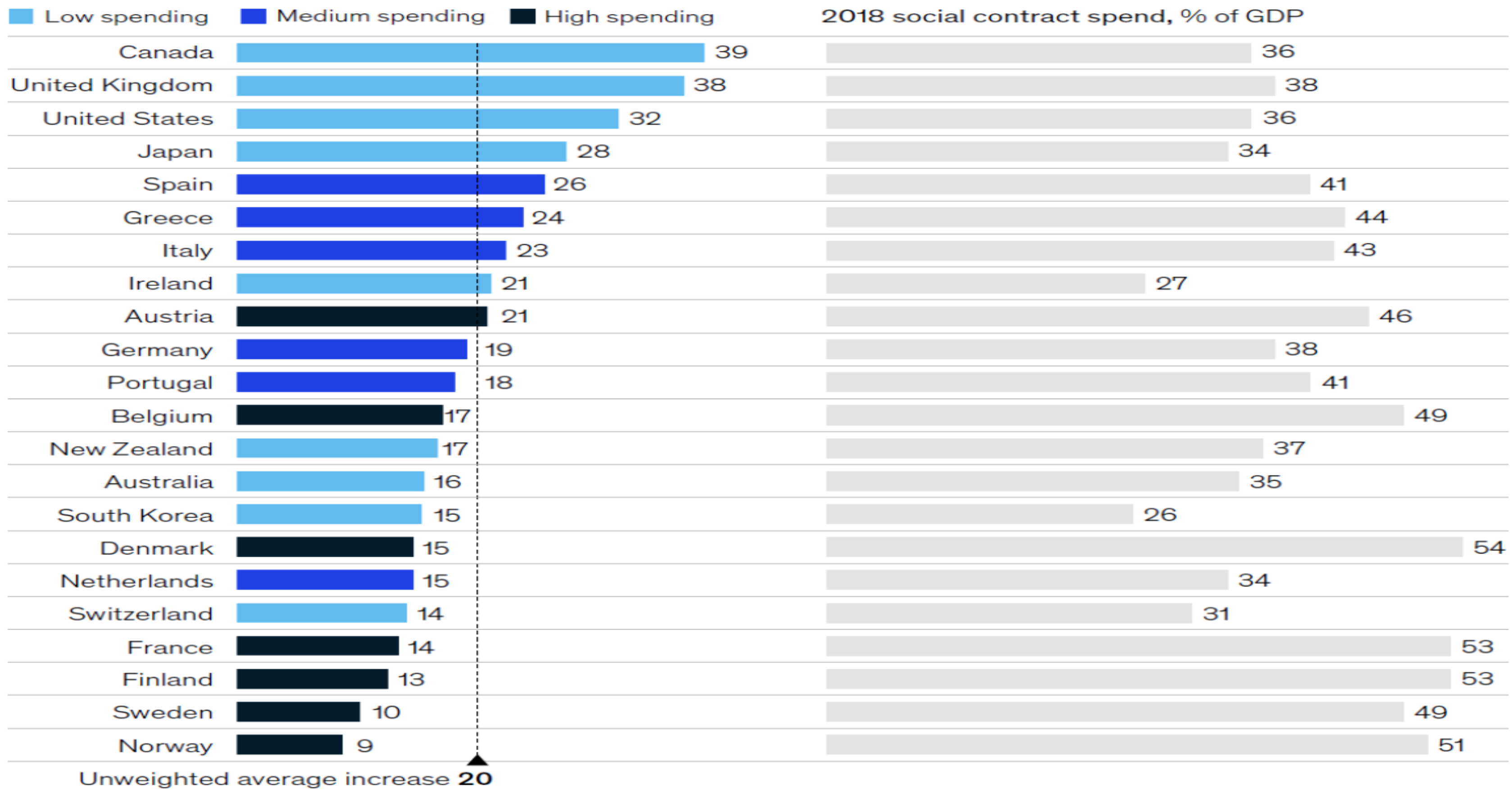
- … but many are returning empty



Covid-19 has rewritten the UK's social contract

As government expenditure rose, countries that usually spend less on the social contract have outspent higher-spending ones.

Increase in government expenditure in 2020 by archetype,[1]
% increase in 2020 vs 2019 as percentage of GDP



[1] Archetypes determined based on 2018 spending on the social contract including public-sector wages, total social spending (directed at individuals and households), for unemployment, active labor-market programs, family and other social policies, healthcare, housing, pensions, public spending on education, and government gross fixed-capital formation.
Source: IMF Fiscal Monitor; McKinsey Global Institute analysis

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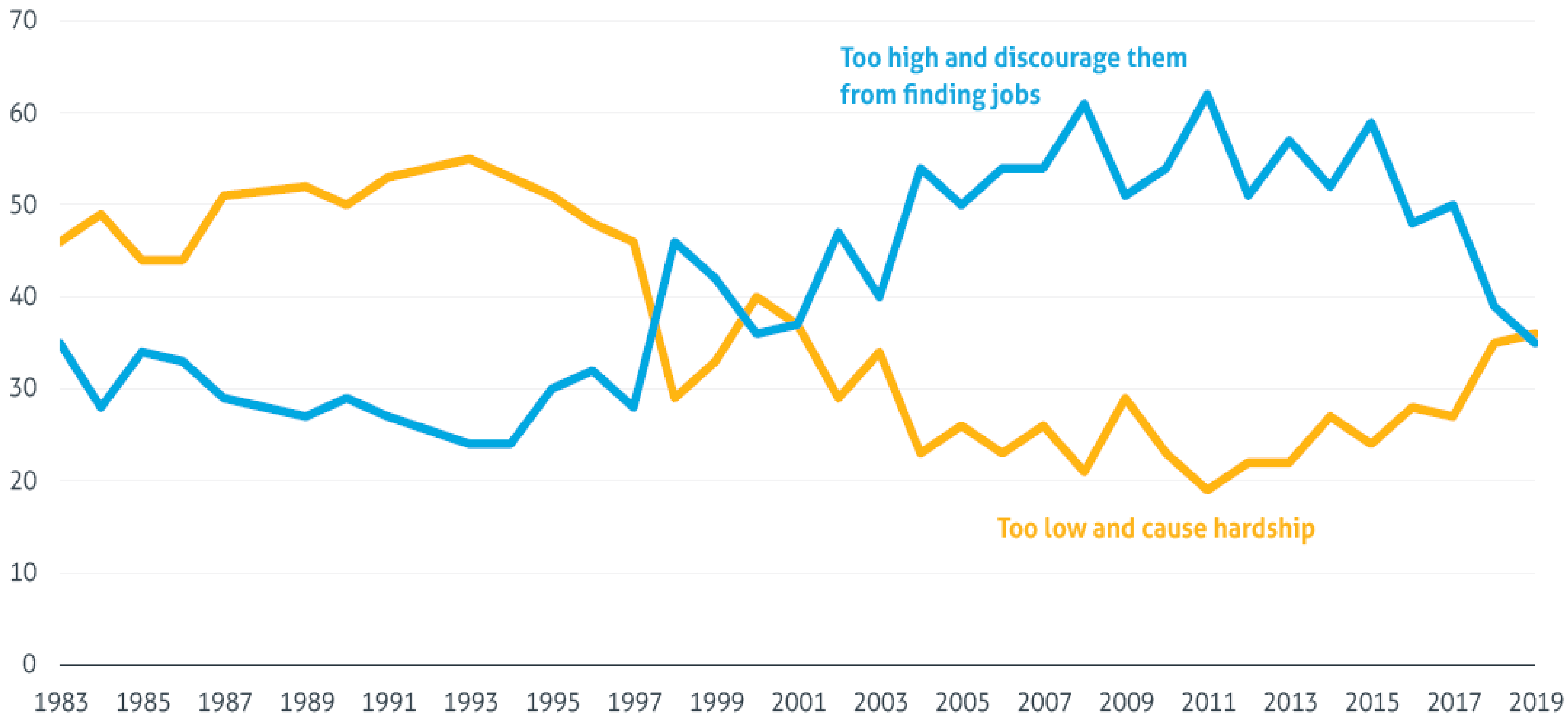
Dramatic shift in social attitudes post-GFC

- ‘Austerity’ is not an option post-Covid-19

Figure 2 **‘Benefits for unemployed people are too high/low’**

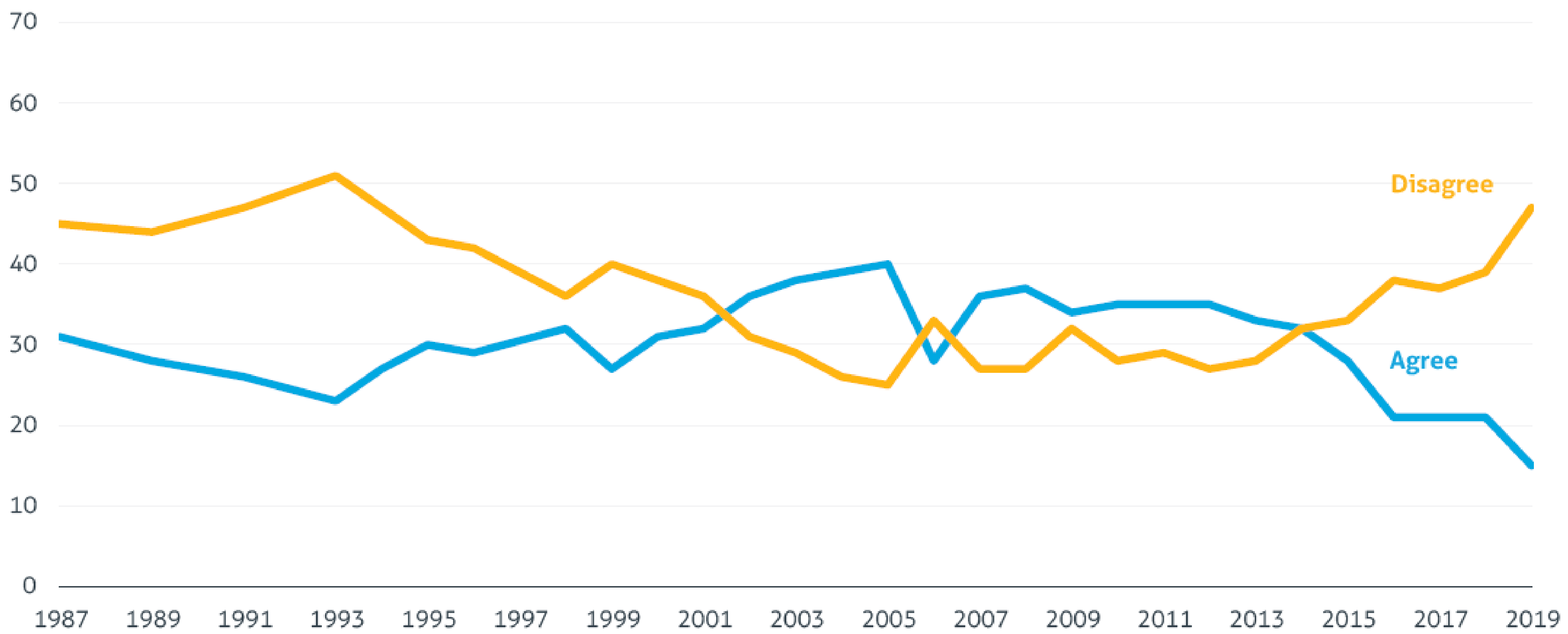


Source: British Social Attitudes Survey.

Majority support enhancement of the social contract

- No way back to pre-Covid public spending levels

Figure 3 **'Many people who receive social security don't really deserve help'**



Source: British Social Attitudes Survey. 'Agree' shows the percentage of respondents who either agreed or strongly agreed with the statement. 'Disagree' shows the percentage of respondents who either disagreed or strongly disagreed with the statement.

Pandemic has highlighted the UK's skimpy safety net

Table 1 **Replacement rates for different family types for workers on average earnings, 2018**

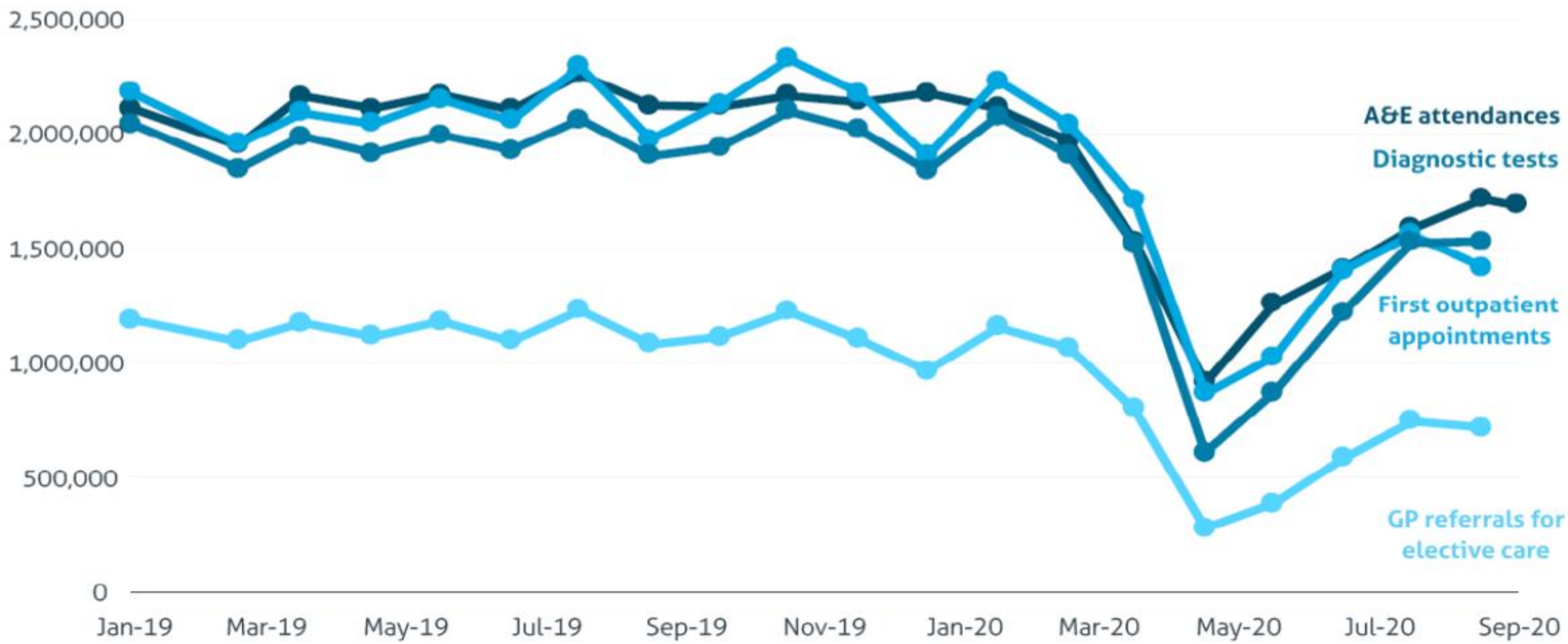
	UK	OECD average	
		Without contributory benefits	**With contributory benefits**
Single, no children	0.13	0.20	0.55
Single, two children	0.35	0.40	0.66
Couple, no children	0.20	0.31	0.57
Couple, two children	0.41	0.47	0.66

Source: Bourquin P and Waters T, 'The temporary benefit increases beyond 2020–21', Chapter 8 of C. Emmerson, C. Farquharson and P. Johnson (eds) IFS Green Budget: October 2020, Institute for Fiscal Studies (www.ifs.org.uk/publications/15074). Based on a family with one worker paid average earnings. 'With contributory benefits' shows what replacement rates would be for a worker receiving unemployment benefit who is aged 40 and has worked uninterrupted since age 19. All figures relate to the second month of unemployment. Ignores housing benefits. Children are 4 and 6 years old. The OECD average is measured across 36 OECD countries (Turkey is excluded because of lack of data availability). The replacement rate measures out-of-work income as a share of in-work income.

Covid-19 intensity has had massive side effects

- Huge increase in undetected illnesses

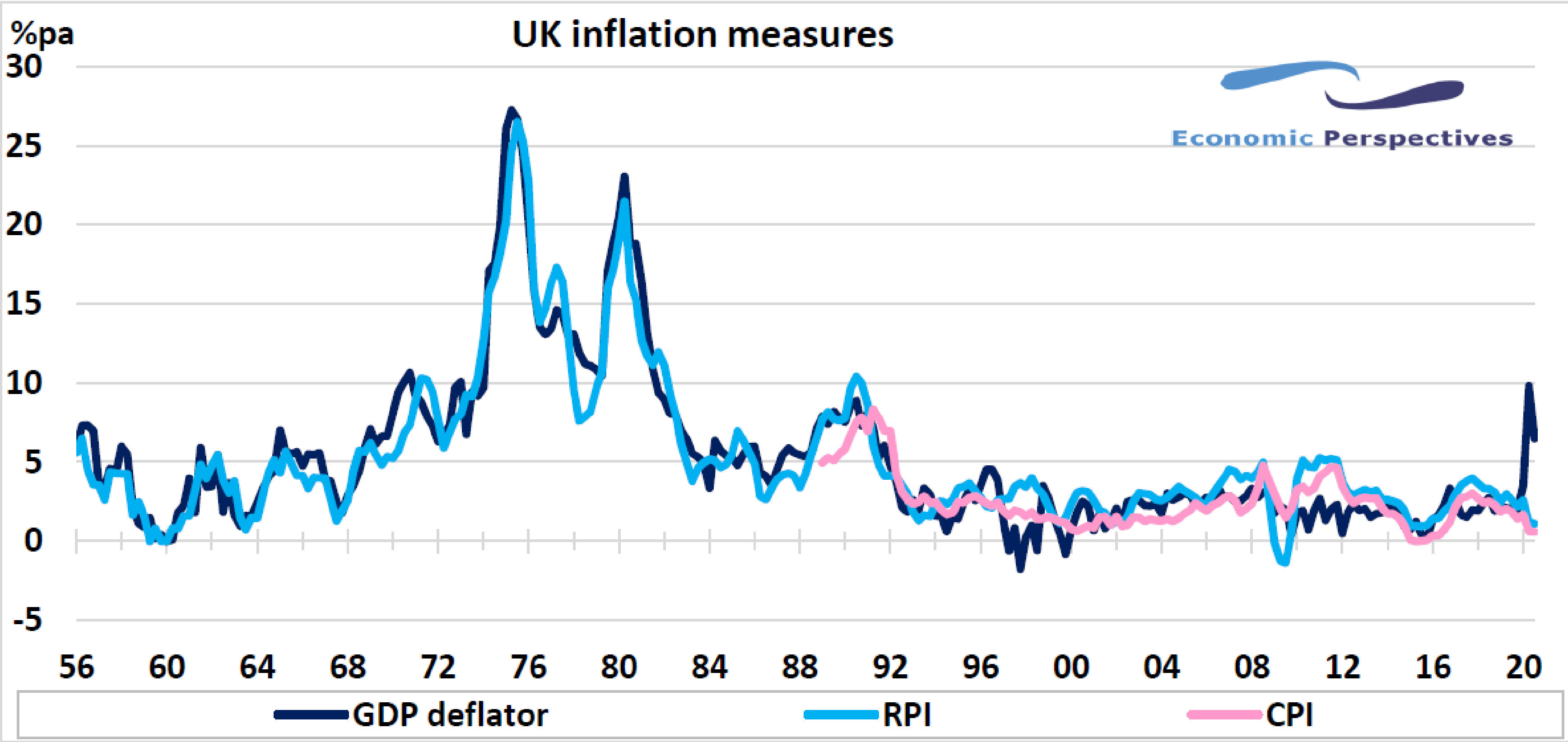
Figure 9 **Volume of hospital activity**



Source: Institute for Government analysis of NHS England and NHS Improvement, A&E Attendances and Emergency Admissions, Monthly Outpatient Referrals Data, & Monthly Diagnostics Data; NHS Digital, Provisional Monthly Hospital Episode Statistics.

Public sector productivity paradox

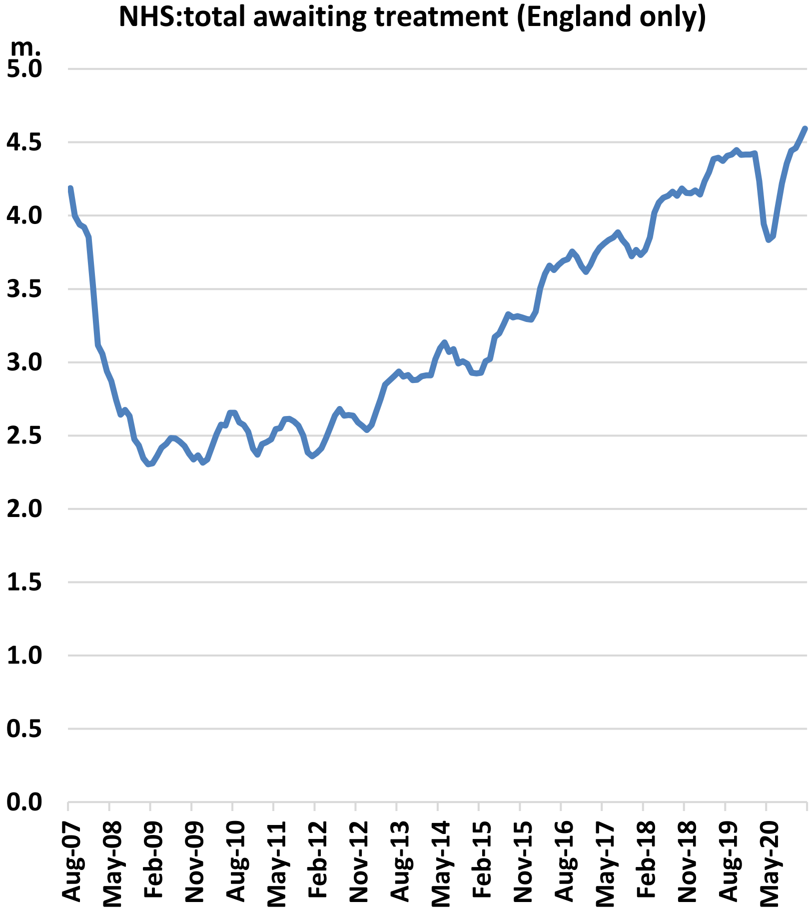
- An overstretched NHS, but fewer patients seen
- GDP deflator rose by 6.1% in year to 2020 Q4



Data source: Thomson Reuters Datastream

How will the NHS ever catch up?

- Informal estimates rise to 6m awaiting treatment



Source: NHS England

- At the end of January 2021, 66.2% of patients waiting to start treatment (incomplete pathways) were waiting up to 18 weeks, thus not meeting the 92% standard.

- The number of RTT patients waiting to start treatment at the end of January 2021 was 4.59 million patients. Of those, 304,044 patients were waiting more than 52 weeks.

- For patients waiting to start treatment at the end of January 2021, the median waiting time was 12.1 weeks. The 92nd percentile waiting time was 50.1 weeks.

Government has turned a fire hose on the problems …

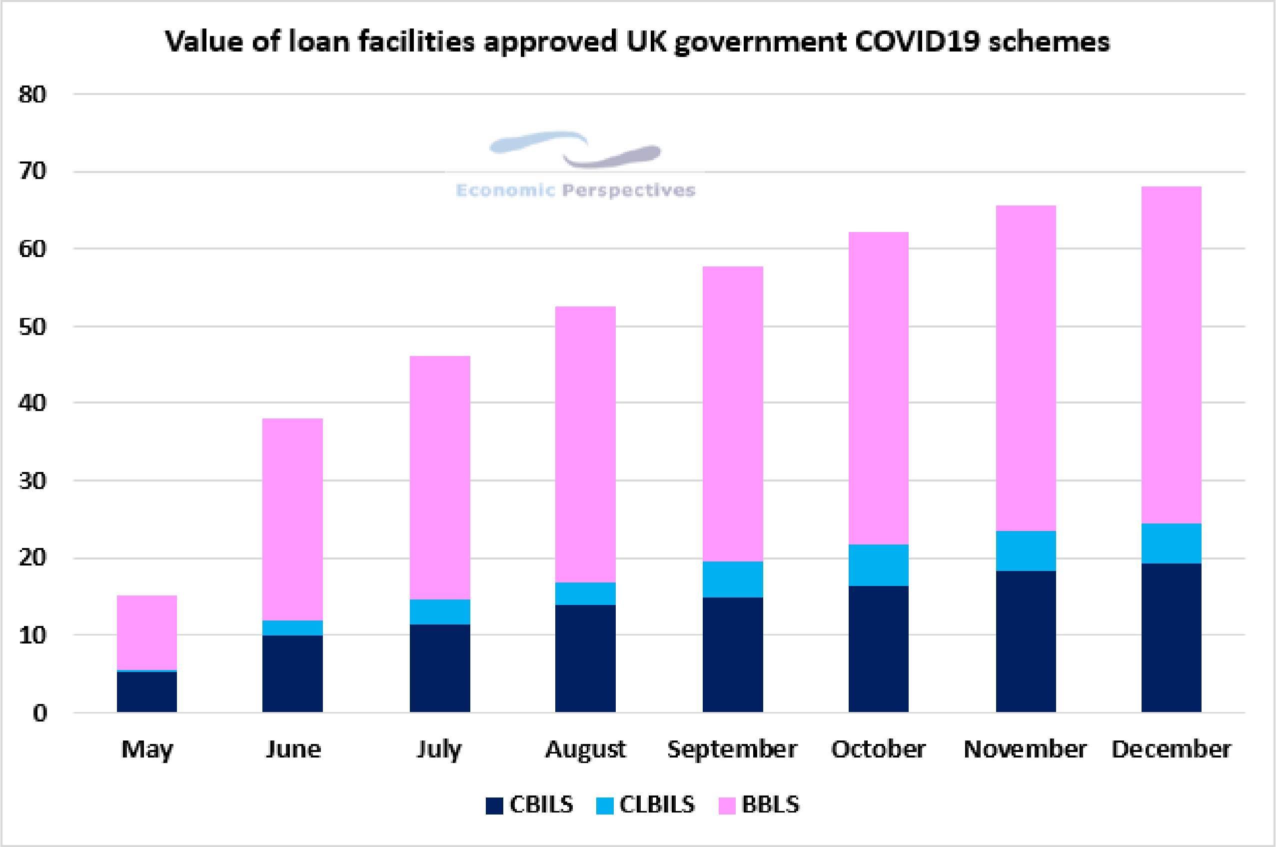
- … at enormous fiscal expense

Figure 1.5 **Coronavirus-related policy measures in 2020/21, £bn**

Source: Institute for Government analysis of Office for Budget Responsibility, 'Economic and fiscal outlook', November 2020. CJRS = Coronavirus Job Retention Scheme. SEISS = Self-Employment Income Support Scheme.

UK business lending supports are poorly screened

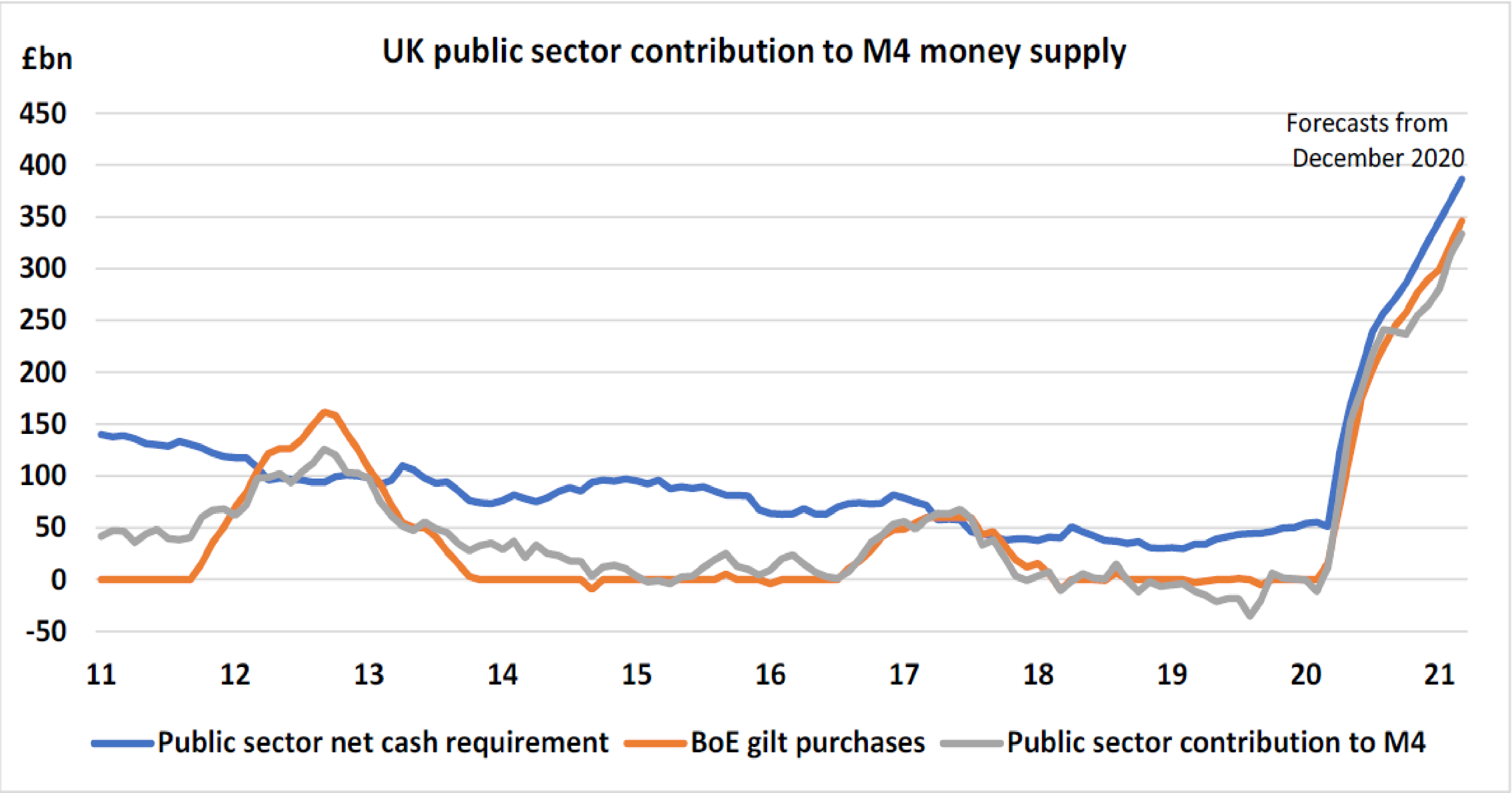
- Presumption that much will be lost
- CBILS and BBLS for UK SMEs, CLBILS for large businesses



Data source: https://www.gov.uk/government/collections/hm-treasury-coronavirus-covid-19-business-loan-scheme-statistics

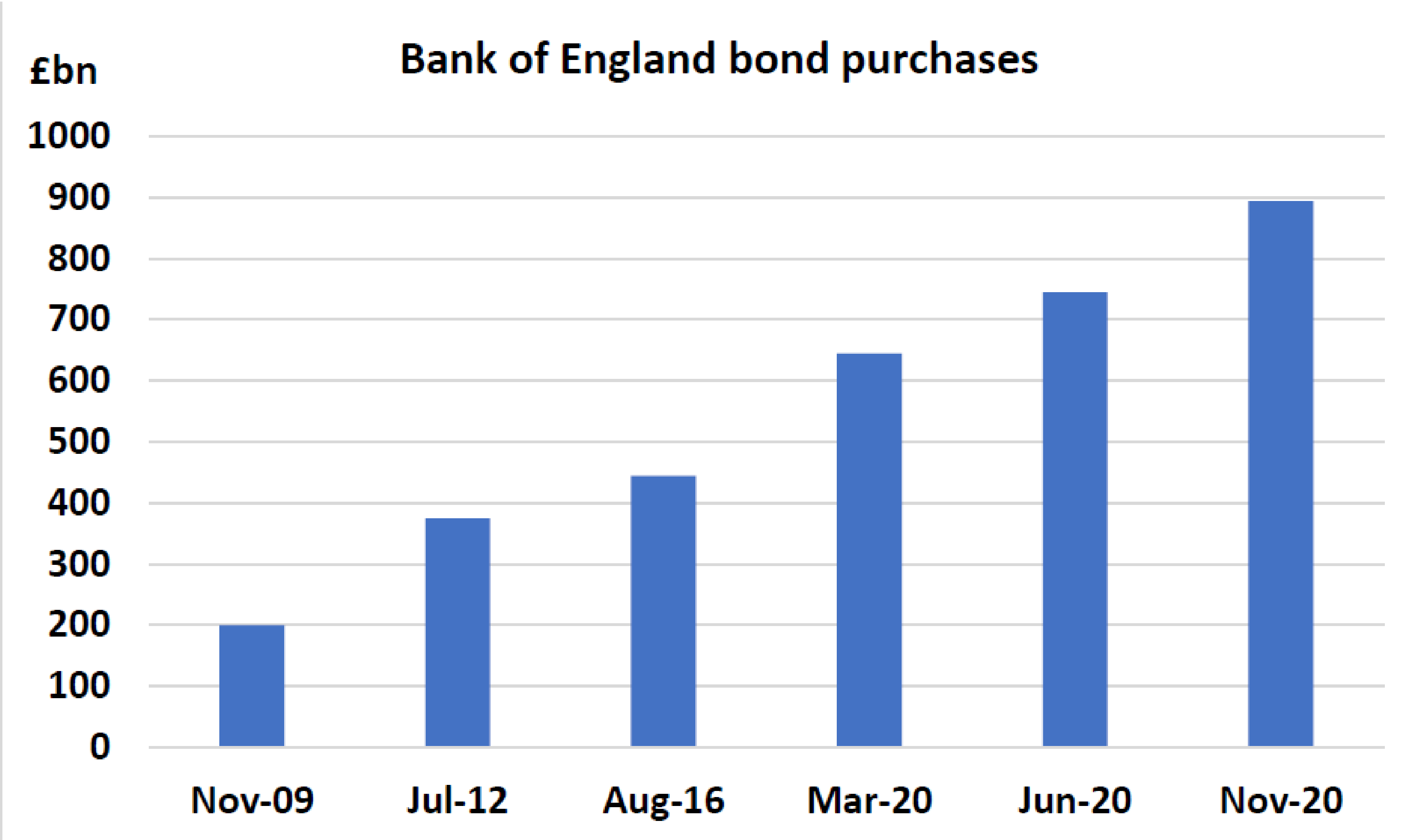
UK public sector monetary expansion on an epic scale

- Bang goes the funding rule



Source: Office for National Statistics and Bank of England

BoE's new QE strategy: go long, go large

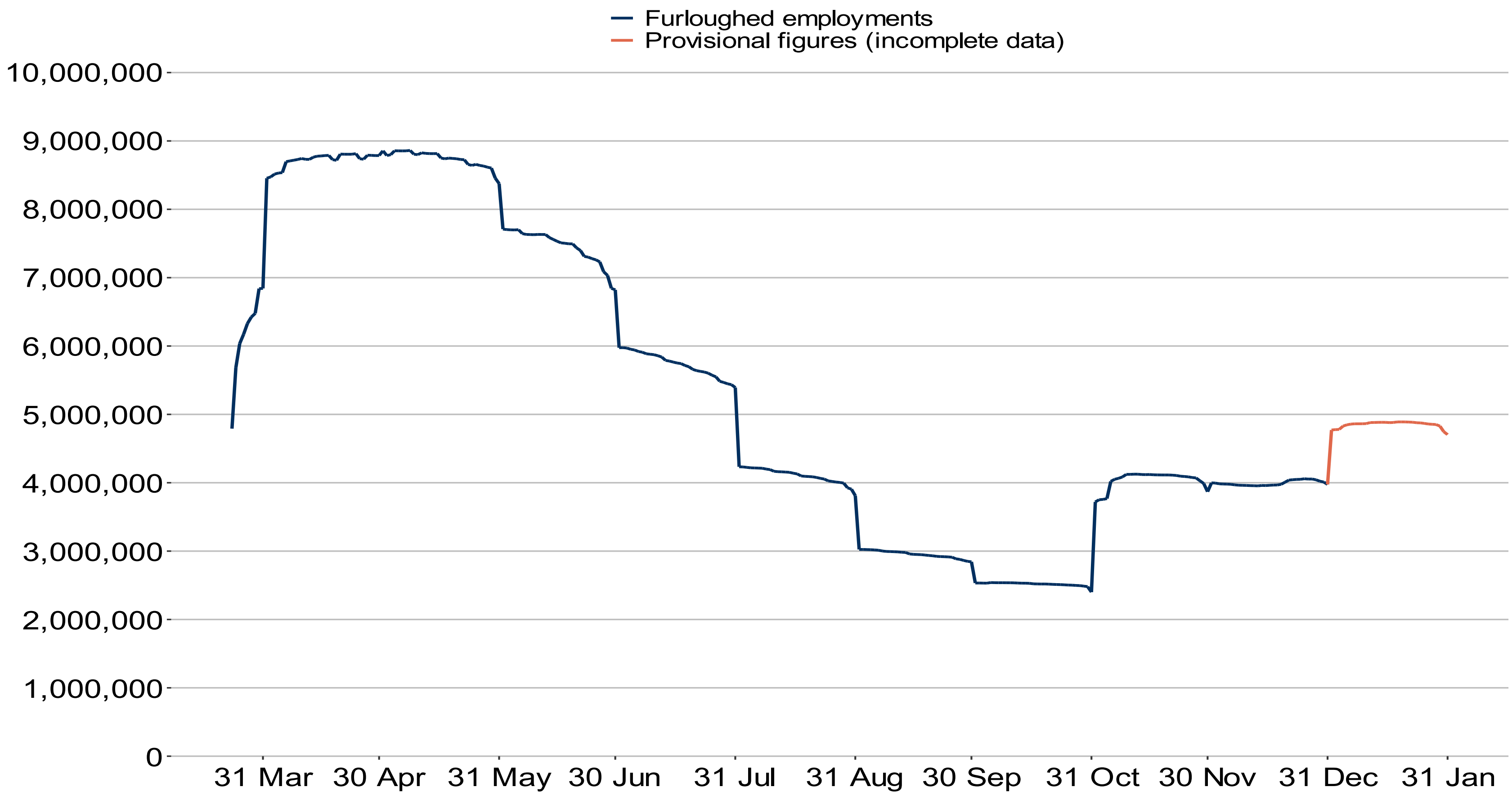


Source: Bank of England

No quick fix for the UK economy (2)

- Serious doubts over the Coronavirus Job Retention Scheme, which has cost £53.8bn (to mid-Feb)
- OBR reckons 1.3m will never return to their jobs, but there is a wide margin of error
- Self-employed and part-timers in sharp decline
- Unit labour costs have risen abruptly, adding to the job-shedding pressure
- UK sliding towards a stagflationary end-game after the sugar-high of reopening is past
- Gilts and Sterling in the firing line

Total employments furloughed during pandemic

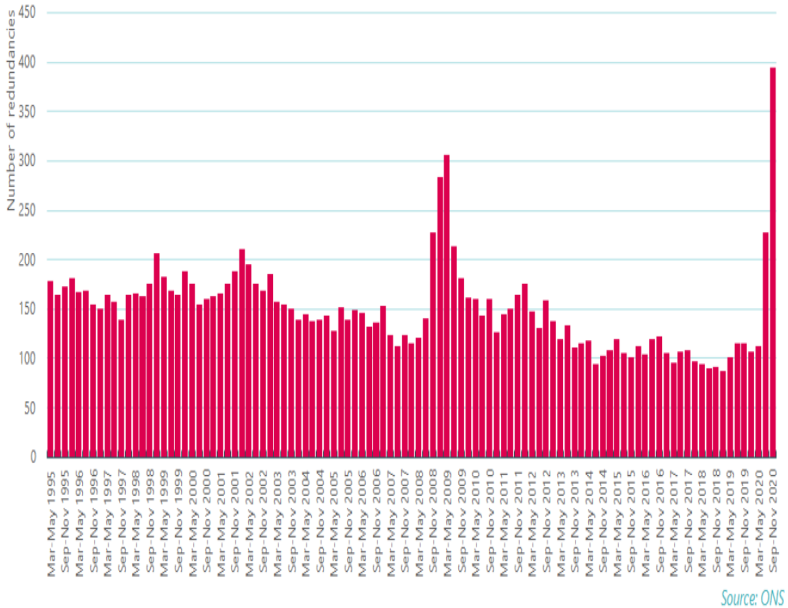


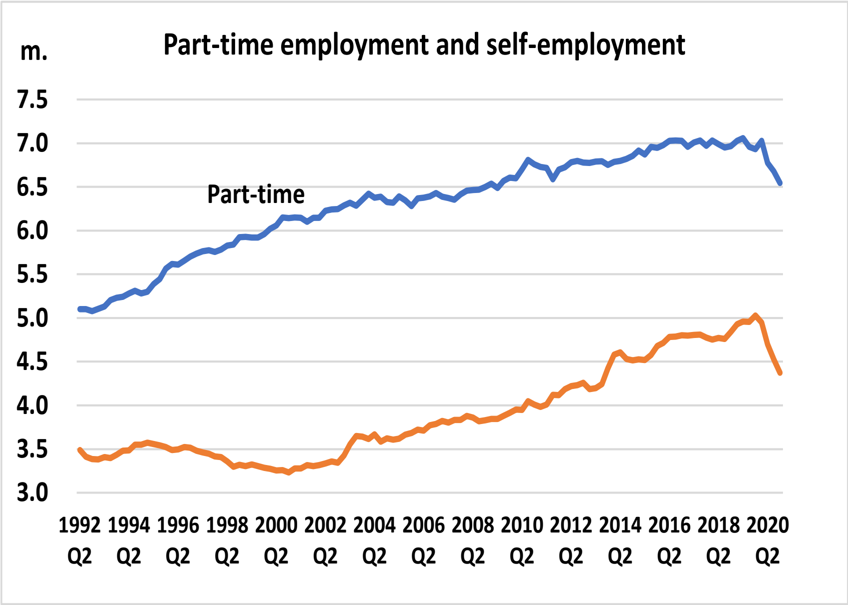
Source: Office for National Statistics

Plunge in part-time working and self-employment

- Insecure workers have suffered most

  - Self-employed numbers down by 13% since December 2019
  - Part-time employee numbers down 7% since February 2020
  - Redundancies jumped to nearly 400,000 in Sep-Nov 2020 quarter, up 243% on a year earlier

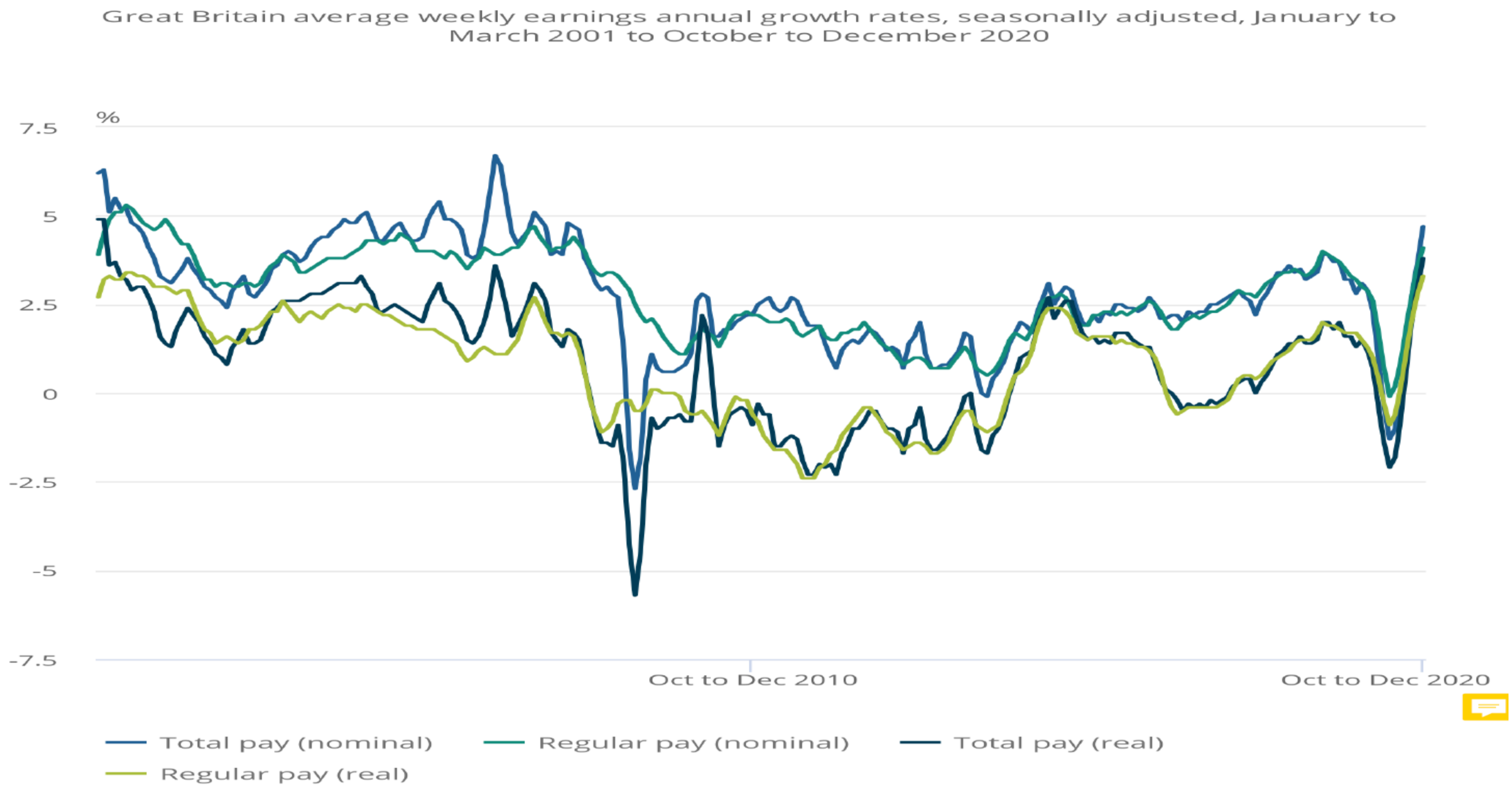




Source: Office for National Statistics

What to make of the dramatic recovery in average pay?

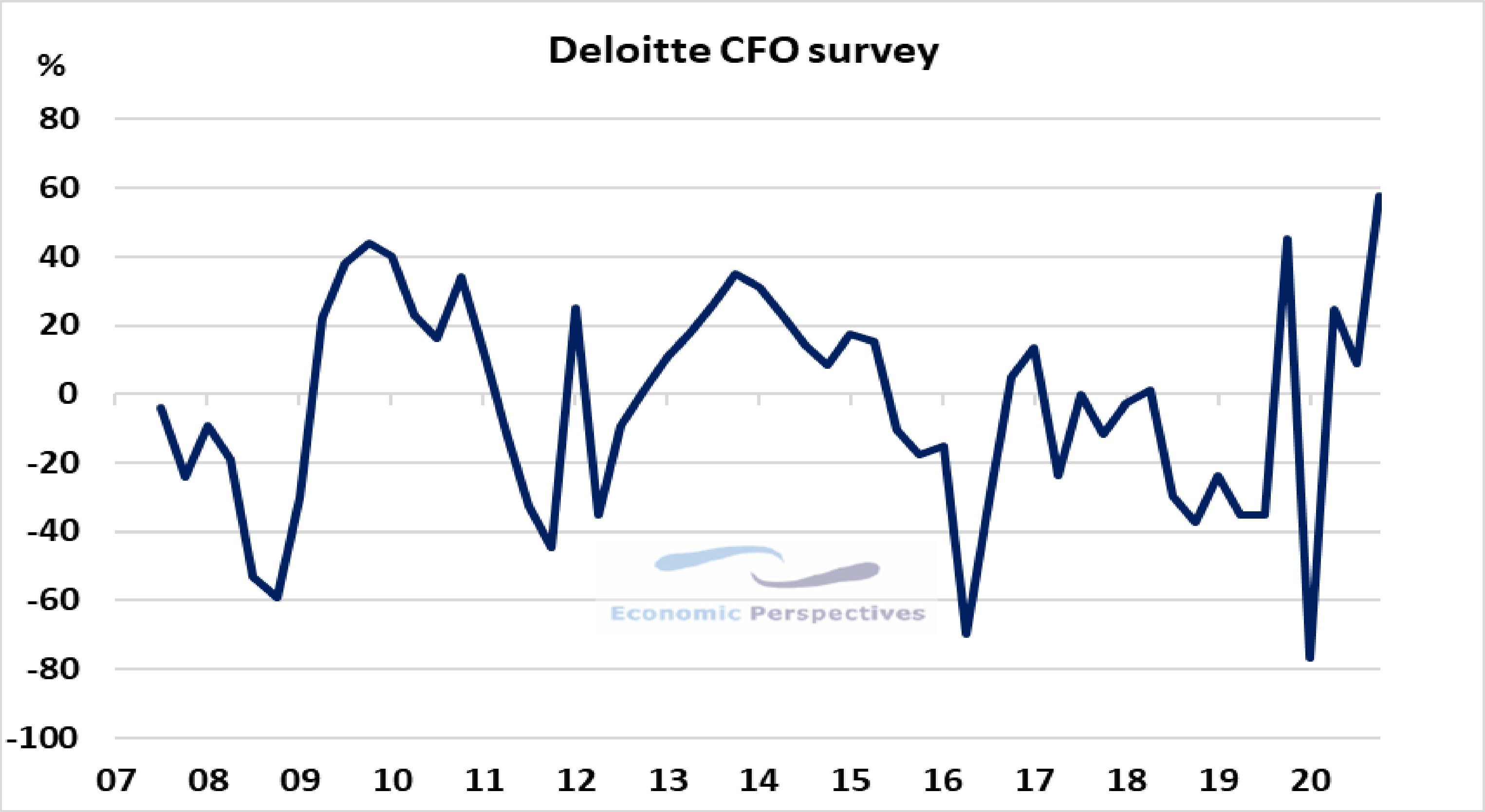
- What if the lower-paid workers don't return?



Source: Office for National Statistics – Monthly Wages and Salaries Survey

Large profitable businesses are cleaning up

- Incredible rebound in profitability according to business surveys…



Data source: Deloitte, Eikon Reuters

Inflation: the shifting landscape

- Many more commentators willing to contemplate future inflation
- Diehard Keynesians insist inflation is impossible because they assert a negative output gap
- Many more refuse to believe that rapid broad money supply growth will trigger a rise in inflation
- Most popular inflation narrative revolves around a melt-up scenario: explosive demand pressure overwhelms supply capabilities
- However, consensus sees inflation scarcely higher in 2022 than 2021, and not above target

Pricing in the coming inflation

- Market-implied inflation compensation, 5y ahead

US inflation expectations based on 5-year nominal less 5-year TIPS rate in %; German inflation expectations based on 5-year breakeven inflation rate in %; UK inflation expectations based on 5 year breakeven minus 0.8ppts (average RPI % yoy minus average CPI % yoy from 2010 onwards). Source: Federal Reserve Board, Deutsche Bundesbank, BoE, Berenberg.

Inflation: a richer narrative (1)

- Melt-up scenario is the credible inflationary trigger
- Public sector budget deficit reduction will squeeze the private market sector – lurch toward a command economy and smaller SME sector
- Public sector pricing of labour and materials is driving up the aggregate price level
- Impending market-led credit tightening will force a tidal wave of bankruptcy and closed businesses
- Semi-permanent contraction of supply will keep inflation strong even when the sugar-high is over

Inflation: a richer narrative (2)

- GDP inflation is faster than CPI inflation
- Home-working revolution will dominate the rise in unemployment as a driver of housing inflation
- FAO food price index at its highest since 2014. Covid-19 limited the planting of crops in 2020 and subsequent harvests; this is likely to recur
- Non-food commodity price increases are driving up construction and industrial costs. Natural resource ‘nationalism’ becoming more evident
- E&D expenditures have plummeted since 2014, meaning curtailment of new sources of supply

Inflation: a richer narrative (3)

- Disruption of the public's inflation expectations as frequently-purchased items have risen in price more obviously than the CPI
- Central banks have failed to explain the rationale for significant additions to QE, implying a loss of inflation-objective credibility
- QE has brought a massive acceleration in the growth of the broad money supply (M3/M4)
- Fears of a second 'taper tantrum'
- Yield curve control may be impractical in the context of large foreign ownership of bonds

Summary

- There is no quick fix for the UK predicament
- This is not a ‘Prometheus unbound’ moment!
- Very difficult for UK to emerge from lockdown without an inflationary resurgence
- Politically, there are long odds against public sector deficit reduction
- BoE is heavily compromised: unlikely to have the authority to respond to elevated inflation
- Huge investments in supply infrastructure needed
- 10Y gilt yields to 2%; Sterling to drop 10-15%

Economic Perspectives

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