# Contents

## Summary 4

### 1. UK economic prospects 5

- 1.1 Recent developments in the UK economy 5
- 1.2 The outlook for the UK economy 7
- 1.3 Outlook for inflation 11
- 1.4 The impact of COVID-19 on public policy 12
Summary

1. The UK was officially in a recession following two consecutive quarters of negative growth in 2020 Q1 and Q2. As global coronavirus (COVID-19) cases rose, social distancing measures were imposed in the UK, forcing the closure of shops and businesses from the end of March until the beginning of July. The overall effect of the virus on the UK economy was to erase around a quarter of GDP in 2020 Q2.

2. Early signs in Q3 pointed to a recovery, which accelerated in June, buoyed by the release in business and economic activity, partly supported by pent-up consumer demand and growing confidence from the drop-off in COVID-19 cases. This, combined with the additional economic policies announced in July (e.g. Eat Out to Help Out, the temporary cut in VAT for the hospitality and leisure sector), helped boost spending.

3. There is still significant uncertainty over the pace and path of the recovery, especially in light of the growing number of cases which have led to another round of limited national restrictions, as well as the behaviour of the virus in the winter, degree of economic scarring and the outcome of the UK-EU trade negotiations.

4. Under our ‘contained spread’ and ‘further outbreak’ scenarios, the expected contraction in GDP ranges from around -11% to -12% in 2020 before returning to growth of around 10% and 4% in 2021. Our expectation is that the UK economy would recover to the pre-lockdown levels by the end of 2021 under the ‘contained spread’ scenario, and in the middle of 2023 under the ‘further outbreak’ scenario.

5. We anticipate that most sectors will return to growth in 2021, including hard-hit sectors such as retail and hospitality as they recover from a low base in 2020. There is some variation in the impact of the crisis across regions, with the impact on 2020 output to be relatively less disruptive in London. Regions in the north, which have seen targeted lockdown measures are more likely to experience bigger economic impacts.

6. However, risks are clearly weighted to the downside in relation to both the length and depth of the COVID-19 impact and the possibility of no UK-EU FTA deal by the end of 2020, as well as wider global economic risks.

7. We expect inflation to remain somewhat below target for the rest of 2020 in our main scenario, mainly due to the continued impact of energy prices, the temporary reduction in VAT as well as subdued wage growth. Inflation is then expected to pick up again in 2021 as these effects unwind. The reversal in spare capacity, and the rise in consumer demand as economic activity recovers and wage growth picks up again will feed through an increase in domestic price pressures.

8. Our public finance projections suggest a sharp increase in the 2020/21 budget deficit to about £380bn to £430bn, or around 19% to 22% of GDP. Into 2021/22, we expect much of this rise to reverse, with a smaller deficit of around 6% to 12% of GDP. The extent to which it improves will depend on whether any further fiscal stimulus measures are introduced to provide a boost to the economy. Under both scenarios, the deficit would still be above the 3% of GDP ceiling implied by current fiscal rules. Therefore, we expect some longer-term fiscal tightening may be needed after full recovery has been achieved.
1. UK economic prospects

1.1 Recent developments in the UK economy

UK economic growth in 2019 was largely shaped by the uncertainty surrounding the UK’s withdrawal from the EU. Strong GDP growth in the first and third quarters of the year coincided with increased stockpiling activity ahead of the March and then October Brexit dates. However, confidence waned due to uncertainty over Brexit, dampening consumer spending and business investment, particularly towards the end of the year.

Following a period of flat output in the fourth quarter of 2019, economic prospects showed signs of turning early in 2020, as Brexit-related and political uncertainty faded. The services and manufacturing purchasing managers’ index (PMI) both showed an upswing into positive sentiment territory in January, which was largely sustained through February. This period also marked the first time that the manufacturing PMI had indicated an expansion in activity since early 2019. Similarly, the services PMI pointed to a stronger recovery in business activity and employment in January.

But this reprieve was short-lived. As global COVID-19 cases rose, social distancing measures began to be imposed in various countries – as early as January in China, followed by parts of Europe from February. The implementation of restrictions in the UK forced the closure of non-essential retailers, required people to work from home whenever possible and to avoid social places.

Despite the lockdown being in place for only eight days in March, the impact of social distancing measures on the economy was significant. The services sector experienced the largest decline in output across all sectors in March, largely driven by the halving of output in travel, tourism and accommodation, while footfall at retail venues fell in March by 45% year-on-year.¹

April was the first full month spent under lockdown, and the month when the economy bore the brunt of the contraction in output. The worst affected sectors were either activities that required physical interaction, could not be carried out remotely or had their supply chains disrupted.

Stay at home restrictions caused activity in the hospitality and accommodation sectors almost entirely to stop, while construction and manufacturing output fell markedly.

There was a limited reopening of the economy in May that accelerated in June. Growth was strongest in manufacturing and construction where workers were able to return to factories and building sites. Economic activity remained weakest in the non-essential retail sector where restrictions prevented up to a fifth of usual household spending.

The overall effect of the virus on the UK economy was to erase around a quarter (25.6%) of GDP in 2020 Q2.

¹ ONS, Index of Services, March 2020 – link
² ONS, More than one-fifth of usual household spending has been largely prevented during lockdown – link
Household consumption fell by 23% in Q2 (see Figure 1.2). The reduction in consumer demand caused businesses to focus on securing their cash flows, aided by government support schemes. The heightened uncertainty and reduced consumer demand meant that businesses also postponed or cancelled non-essential investment. But this may have been offset somewhat by increasing investment in other areas, such as in digital technology. The lack of construction activity also constrained the accumulation of capital during this period. Overall, business investment fell by nearly a third in Q2, the largest quarterly fall on record.³ Unsurprisingly, the greatest impact on investment was in consumer-facing services, consistent with these sectors experiencing the largest fall in sales.

Overall government consumption fell in real terms in the first half of 2020. The decline in government consumption reflects the overall reduction in education, driven largely by school closures ahead of the summer holidays. While some areas of healthcare spend rose, e.g. ramping up health system capacity in response to the anticipated rise in COVID-19 cases, the net impact on healthcare spend was negative due to the cancellation of elective hospital procedures in April and May.

On external trade, the UK’s exposure to the economic slowdown in other countries reduced both exports and imports in the first half of the year. Tourism (both inbound and outbound) was severely impacted due to border closures in the UK and abroad. The greatest fall in goods trade was in manufactures and fuel, reflecting the sharp fall in global demand for oil as industrial activity fell. The overall impact on net trade was positive, such that the UK recorded a trade surplus of £8.6bn for the three months to June.⁵

COVID-19 has also had a significant impact on the UK labour market. Public support measures prevented a record fall in Q2 output translating into a corresponding fall in unemployment. However, the scale of workers being placed on furlough (which included 9.6 million workers at its height, or one-third of employees), corresponded to an 18% decline in the number of hours worked between Q1 and Q2.⁶ There was considerable variation in the share of workers furloughed by sector, with nearly eight in nine workers furloughed in the accommodation and food services sector, while take-up in other sectors such as business services were much lower.⁷

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³ GDP first quarterly estimate, UK: April to June 2020 – link
⁴ ONS, GDP expenditure components – link
⁵ ONS, UK trade: June 2020 – link
⁶ ONS, Total actual weekly hours worked – link
⁷ Gov.uk – Coronavirus job retention scheme statistics, July 2020 – link
1.2 The outlook for the UK economy

Early signs in Q3 pointed to a recovery following the damaging impacts of the coronavirus crisis.

There was a mild recovery across sectors in May which accelerated in June (8.7% growth on a monthly basis) as more businesses and non-essential retailers were allowed to reopen and as restrictions eased, culminating in the reopening of restaurants, pubs and bars in July.

The recovery was buoyed by the release in business and economic activity, partly supported by pent-up consumer demand and growing confidence from the drop-off in COVID-19 cases. This, combined with the additional economic policies announced in July (e.g. Eat Out to Help Out, the temporary cut in VAT for the hospitality and leisure sector), helped boost consumer confidence. Car registrations rose by 11.3% in July and property transactions jumped by 125% in September compared to the same period last year, partly boosted by the temporary reduction in stamp duty.

However, there is still significant uncertainty over the pace and path of the recovery. While the initial lockdown had effectively reduced the number of cases over the summer, the lifting of lockdown restrictions has led to a gradual rise in the number of new daily cases. This has necessitated the re-imposition of lockdowns at the local level, notably in Birmingham, Manchester and Leicester, as well as a re-introduction of the advice to workers to work from home where possible and the introduction of a 10pm closure time for hospitality venues.

Figure 1.4: Projections of the UK economic growth by scenario

The gradual winding down of the Coronavirus Job Retention Scheme (CJRS) has coincided with a gradual increase in both workers returning from furlough – the share of furloughed workers has fallen from a peak of nearly 30% in May to 11% in the second half of August. Redundancies have risen a bit, but companies are also waiting to see how demand recovers later this year before making workforce decisions.

The nature and duration of further measures to stem new infections will influence the economy’s trajectory. Whilst the Government is aiming to avoid a national-level lockdown, the reopening of schools and universities, especially heading into the winter months, may contribute to a rise in the effective reproduction rate (or ‘R’).

To capture the range of likely outcomes following the lifting of lockdown restrictions, we design two illustrative COVID-19 scenarios that capture the extent to which the outbreak is controlled and managed.

Under the ‘contained spread’ scenario – we anticipate that R stays slightly above one in the autumn, resulting in a gradual but marked rise in the number of new reported cases as winter approaches. This sees the continuation of limited restrictions at the national level (as was announced late September) or the reimposition of lockdowns at the local level, but this is largely sufficient to prevent worse outbreaks of the virus. The successful implementation of non-pharmaceutical interventions – including testing, contact tracing, quarantine and physical distancing – would prevent the number of new cases growing exponentially. Warmer weather in the spring would see R falling below one, resulting in the decline in cases over next year.

Under the ‘further outbreak’ scenario – we expect to see a more significant rise in infections leading to a number of simultaneous outbreaks in various parts of the country, possibly at levels close to the May peak, which precipitates the return of a national-level lockdown. Both scenarios assume that a vaccine becomes available in the middle of 2021.

\[ Link to ONS Insights of the Business Impact of Coronavirus (COVID-19) Survey: 23 March to 5 April (Wave 2) to 1 to 14 June (Wave 7) 2020 \]

\[ Link to ONS, Coronavirus and the economic impacts on the UK: 10 September 2020 \]
As can be seen from Figure 1.4, under the ‘contained spread’ and ‘further outbreak’ scenarios, the expected contraction in GDP ranges from around -11% and -12% in 2020 before returning to growth of around 10% and 4% in 2021. We expect output in Q3 to be markedly improved than in Q2, perhaps closing half of the gap between Q2 output and pre-COVID levels. However, performance starts to diverge in Q4 between the two scenarios; the economy continues to recover (albeit at a slower pace) under the ‘contained spread’ scenario, whereas output remains flat under the ‘further outbreak’ scenario until the end of the year. There is a pick-up in both scenarios in Q3 and Q4 2021 following the availability of a vaccine. Our expectation is that the UK economy would recover to around pre-lockdown levels by the end of 2021 under the ‘contained spread’ scenario, and in the middle of 2023 under the ‘further outbreak’ scenario. These projections are broadly in line with other external projections (see Figure 1.5).

We anticipate that with the resumption of the retail and hospitality sector, household spending is likely to support the recovery in both scenarios, boosted by stimulus measures aimed at consumers (such as the temporary VAT reduction and the Eat Out to Help Out scheme). This is likely to continue for the rest of 2020 and into 2021 but at a slightly slower pace.

Business investment will pick up a bit in the ‘contained spread’ scenarios but is likely to remain subdued overall given the degree of uncertainty in the outlook. However, investment is likely to take a further hit in the ‘further outbreak’ scenario as companies seek to shore up their capital positions.

Both of our scenarios assume an orderly transition from the end of the Brexit transition period to new trading arrangements between the UK and the EU. There could be continued volatility in stockbuilding in Q4 2020 due to the end of the Brexit transition period, although this would then be followed by destocking in early 2021.

However, there is still some uncertainty over the shape of new trading arrangements, with risks weighted to the downside. Defaulting to WTO trading arrangements would result in an increase in trade costs due to higher tariff and non-tariff barriers, putting further downward pressure on the recovery.
In terms of our sectoral projections, we anticipate that most sectors will return to growth in 2021, including hard-hit sectors such as retail and hospitality as they recover from a low base in 2020. The lifting of travel restrictions next year would boost the sector, but this is nevertheless subject to considerable uncertainty – the continuation of travel restrictions and lockdown measures would constrain growth, as assumed under our ‘further outbreak’ scenario.

We expect the construction sector to grow in 2021, partly driven by fiscal measures to boost infrastructure investment. Similarly, adaptations made by manufacturing businesses should enable businesses to continue operating to support the recovery. Unlike the rest of the transport and storage sector, the logistics sector is likely to recover more strongly, driven by the acceleration of e-commerce.

The economic impact is more significant under the ‘further outbreak’ scenario. However, the impact of the lockdown is likely to be less disruptive to the economy than the earlier lockdown in April, for the following reasons:

- A national-level lockdown is likely to be of shorter duration and less severe, affecting fewer sectors of the economy. For example, hotels, restaurants and pubs may face additional restrictions (including restrictions on travel, self-isolating on arrival, 10pm closing time and table services), but non-essential shops and businesses may be allowed to continue operating, on the basis of the new precautions and adaptations made to improve customer and employee safety.

- Workers have been encouraged to work from home, but business investment in adaptations, such as technology to support remote working or automating/digitising processes will help minimise disruptions to business activity.

- More generally, there has been an increase in people’s awareness and change in behaviours to prevent the spread of the virus, such as mask wearing and practising social distancing.

- We also assume that under the ‘further outbreak’ scenario, there will be a proportionate fiscal policy response to support businesses and workers, which could see the redeployment of measures seen during the summer.

![Figure 1.7: Projected GVA growth rate by industry sector, % annual change in 2020 and 2021](source: PwC analysis)
However, a more important consideration is the degree of economic 'scarring' effects, which will influence the recovery trajectory of the economy. For workers and households, the impact of the virus on employment and earnings are likely to have permanent effects. Uncertainty over the economic outlook and job security, the desire for more precautionary savings, mean that the reopening of economies will not result in a rapid return to normality.

For businesses, uncertainty over the outlook, potential overcapacity, especially in structurally challenged sectors such as air travel and tourism, as well as higher debt levels as a result of necessary crisis survival measures, could constrain business investment and innovation, with implications for future productivity growth. Businesses that have failed will take time to re-form. Similarly workers that have lost their jobs will need to find new ones or retrain. It will take time for firm-worker links to be re-established post-crisis.

There are also early signs that the recovery appears to be losing a bit of momentum after the initial sharp recovery in June and July. For example, car sales briefly rebounded to pre-COVID-19 levels in June and July before halving in August. The number of employees on the payroll is still around 895,000 below March 2020 levels, and while hours worked rose by around 30% in the three months to August, it is still around 17% lower than pre-crisis levels. There is also a significant unknown on the behaviour of the virus come winter when the crisis is likely to coincide with a rise in flu cases. While the new restrictions outlined by the Prime Minister affect fewer sectors of the economy than in March and are therefore less disruptive, prolonged uncertainty could dampen business and consumer confidence and constrain the recovery.

This means that after a swift bounceback, the economy will take time to recover fully to pre-crisis levels. As a result, sustaining the pace of recovery we have seen for the remainder of 2020 and 2021 will become more challenging, more so under the 'further outbreak' scenario. This also explains why our scenarios assume a 'kinked-V' or 'swoosh-shaped' recovery. Clearly there is still significant uncertainty over the degree of scarring. This will depend on:

- Business survival and the pace of business reopening – at the moment the rate of insolvencies that have occurred are lower compared to 2019, but this could be masked by the scale of public support keeping business afloat. There is a risk that insolvencies could increase as public support measures are withdrawn or if the economic situation deteriorates.
- Whether furloughed workers will have jobs to return to – our analysis showed that in the absence of intervention, around 17% of furloughed workers may not have jobs to return to by the end of the year.
- The impact of the crisis on firm balance sheets – business indebtedness has increased. This could constrain balance sheets and firms' ability to grow and innovate – this could constrain future productivity growth.
- The scale of public support measures. There is some variation in the impact of the crisis across regions, largely due to the sectoral mix across regions. Regions that are relatively more reliant on services-based sectors requiring physical interaction such as tourism and hospitality, are likely to experience lower growth. There are also more likely to be disproportionately affected by local lockdowns, which will likely focus on the retail and hospitality sectors.

Overall, the general economic environment remains uncertain given that the full impacts of the COVID-19 crisis are yet to play out, and as such there are particularly large uncertainties around economic projections at present. There are also other risks on the horizon: both scenarios assume an orderly transition to a free trade agreement between the UK and the EU. However, a disruptive shift towards a WTO-style trade agreement could constrain the UK's recovery, particularly through trade. Trade and geopolitical tensions between the US and China are also showing signs of flaring up again. Organisations should therefore stress test their business and investment plans against alternative economic and political scenarios and review their implications for all aspects of their operations.

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10 See for example, Clarke, S., Growing Pains, Resolution Foundation, May 2019.
11 Our July analysis suggests that 17% of furloughed workers may not have jobs to return to by the end of 2020 – link
1.3 Outlook for inflation

Over the long-term, UK consumer price inflation has been on a steady downward trajectory since mid-2017, falling from an average of around 2.7% in 2017 to 1.0% on average for the first eight months of 2020\(^{12}\). The decline was partly due to the effect of a weaker pound on import prices, as well as due to the fall in global oil and gas prices, which feeds through into lower input costs, as well as fuel and transport costs.

Since then, inflation has fallen below target, and apart from a small pick up in January 2020, has continued on a downward trend, exacerbated by COVID-19. The combination of weak demand as well as excess capacity and suppressed wage growth, contributed to downward price pressure. While excess capacity eased over the following months, weak demand continued to exert a strong downward pull. Inflation began to pick up as shops reopened in July, but quickly reversed in August, mainly due to the discounts on offer from the Eat Out to Help Out scheme in August and the VAT cut in the restaurants and hotels sector.

We expect inflation to remain somewhat below target for the rest of 2020 in our main scenario, mainly due to the continued impact of energy prices, the temporary reduction in VAT until January 2021 for the hospitality and leisure sector, as well as subdued wage growth.

Inflation is then expected to pick up again in 2021 as these effects unwind. The reversal in spare capacity, and the rise in consumer demand as economic activity recovers and wage growth picks up again will feed through an increase in domestic price pressures.

\(^{12}\) ONS, Consumer price inflation, UK: August 2020 – link
However, as set out in Section 1.2, there is still considerable uncertainty on the path to recovery. Consumer confidence is to some extent dependent on their perception of health risks, which will influence the level of household spending. A significant rise in cases could make consumers less willing to spend or hold more precautionary savings. The uncertainty surrounding job security, subsequent waves of the virus, and the end of the UK’s withdrawal period are all factors that risk keeping demand restrained into the first half of 2021, which will put downward pressure on domestic prices.

Given that the risks to inflation are weighted to the downside, it is likely that monetary policy will remain accommodative in the near-to medium-term, and the Bank of England faces little pressure to raise rates at the moment. This was more recently confirmed by the Bank of England’s decision in September to maintain the Bank Rate at 0.1%, and maintain its existing bond purchasing programme.

1.4 The impact of COVID-19 on public policy

Besides increasing spending on healthcare supplies and equipment, the focus of the government’s direct fiscal support package over the summer has been to preserve jobs and keep businesses solvent. Of the £159bn (5.6% of GDP) so far spent on direct support measures, £69bn has been spent on the CJRS.13 More recent measures announced include direct support to the rail sector (£3.5bn), cultural sector (£1.3bn) and VAT cuts across the hospitality and leisure sectors (£2bn).14

The total cost of the government’s fiscal support has so far reached £280bn (10% of GDP).15 By comparison, the total stimulus package in response to the 2008-09 financial crisis amounted to 2.1% of GDP, or £42bn.16 The size of the fiscal response means that debt as a percentage of GDP rose to just above 100% of GDP, its highest level since March 1961.

The focus of fiscal policy at this stage is to support the recovery, as the risk of further restrictions impacts businesses and economic performance. For example, the Job Retention Bonus allows businesses to claim a wage subsidy for each furloughed worker that remains continuously employed until the end of January 2021.17

The latest measures announced by the Chancellor in the Winter Economic Plan are much more targeted than the ‘rescue’ package announced earlier in the year. It aims to address specific issues around securing the return of workers and alleviating pressures on working capital. For example, the Treasury’s new job support scheme targeted at SMEs allows greater flexibility around bringing back part-time workers. Other working capital measures include the extension of the Coronavirus Business Interruption Loan (CBILS) the ‘pay as you grow’ scheme that will allow loan repayments to be extended from six to 10 years, as well as the spreading out of payments of deferred VAT over FY21/22.

The nature and scale of further fiscal measures will depend on the path of the recovery. Figure 1.11 below shows our latest projections of the UK annual budget deficit to the end of fiscal year 2021/22. Our projections for both scenarios indicate a sharp increase in the 2020/21 budget deficit to about £380bn to £430bn, or around 19% to 22% of GDP, compared to just 10% in 2009/10 after the financial crisis.

As the economy starts to recover, we expect much of this rise to reverse in 2021/22, with a smaller deficit of around 6% to 12% of GDP. The extent to which it improves will depend on whether any further fiscal stimulus measures are introduced to provide a boost to the economy. Under both scenarios, the deficit would still be above the 3% of GDP ceiling implied by current fiscal rules. Therefore, we expect some longer-term fiscal tightening may be needed after full recovery has been achieved.

13 HM Treasury, Plan for Jobs, July 2020 – link
14 Bruegel, The fiscal response to the economic fallout from the coronavirus – link
15 HM Treasury, Plan for Jobs, July 2020 – link
16 IFS, How should fiscal policy respond to the coronavirus (COVID-19)? – link
17 HM Treasury, Plan for Jobs, July 2020 – link
Our projections of public debt suggest that this could stabilise at around 90% in 2021/22 under the ‘contained spread’ scenario, which should present no major threat to longer-term fiscal sustainability. But the debt profile appears less sustainable in a ‘further outbreak’ scenario as that may be associated with a larger permanent loss in GDP, and hence, tax revenues. Although there is currently little appetite to cut back on spending in the near-term, there will be increasing pressure for government to raise taxes to fund the recovery. We anticipate that in the long-term there may be a need for future tax rises as well as renewed spending restraint, but only once we have passed the crisis. Until then, low interest rates and the raft of liquidity measures made available by the Bank of England mean that the cost of government borrowing remains low.