# EY ITEM Club Spring Forecast

UK economy headed for record contraction as coronavirus has heavy near-term impact

April 2020

Building a better working world

# Contents

EY is the sole sponsor of the ITEM Club, which is the only non-governmental economic forecasting group to use the HM Treasury model of the UK economy. Its forecasts are independent of any political, economic or business bias.

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# Foreword

## Be careful what you wish for

Into the unknown …

One of the challenges in commenting on the UK economy over the last few years has been finding something new to say as Brexit dominated the agenda, and the underlying performance of the economy changed relatively little. Suddenly, the levels of uncertainty we had been complaining about look attractive compared to the situation we find ourselves in – we are struggling to look days ahead never mind develop sensible forecasts for any extended period.

… with unprecedented levels of change …

It is no surprise given the shock that the economy has received that the EY ITEM Club projects a record downgrading of our near-term outlook for the UK economy in its Spring Forecast 2020. This reflects the substantial hit to activity from coronavirus (COVID-19), with the Government imposing a lockdown on 23 March. UK GDP is now forecast by EY ITEM Club to contract by 6.8% in 2020 compared to the growth of 1.2% that they had projected in their Winter Forecast 2020 which was released at the end of January. Hard to imagine now, but in late January, coronavirus was not even mentioned as a factor seriously threatening the global economy, and it was not included in the list of downside risks to the UK economy.

Even more striking is the forecast reduction of 13% in GDP in the second quarter. EY ITEM Club is at the lower end of estimates, with the Office for Budget Responsibility (OBR) having outlined a scenario that suggests a 35% reduction in the quarter might be possible. The range of forecasts demonstrates exactly how uncertain the immediate outlook is as we are still assembling data to allow us to assess the scale of the shock to the economy.

… and no defined path forward …

Not only is the current state of the economy difficult to discern but the path forward is even harder to forecast. As the EY ITEM Club identifies, 44% of consumer spending – the major engine of UK growth over the last couple of decades – is at risk of either being delayed or lost completely. Until we have clarity on the pace and level of the removal of the lockdown restrictions, forecasting the scale of the shock and the pace of recovery will remain very difficult.

The discussion around the future path of the economy has centred around defining scenarios with V, U and L the most common stylised versions, describing different lengths of slowdown and alternative paces of recovery. The initial consensus was that a V-shaped recovery was most likely but without either a vaccine or any definitive view on the possibility of using drugs developed for other purposes to mitigate symptoms, a rapid recovery looks increasingly unlikely and a U-shaped, slower recovery with possible shifts back into lockdown is now the scenario I am seeing used most widely.

… mean new thinking is required, now …

In this highly uncertain environment, businesses need to think differently about how they plan. Scenario analysis is the best technique to allow companies to test the resilience of their operations and finances against a range of plausible shocks. This analysis should be designed to reflect the scale of each shock, with the reboot reflecting the approach taken to the relaxation of the lockdown, and the likely future state and how close to historic trend growth the economy recovers to, and in what time frame.

The UK government has responded to the crisis at scale providing support for business, employees, the self-employed and charities in a series of initiatives designed to protect the economy and preserve capability for the upturn. Rightly, constraints that have been imposed on public spending and borrowing have been relaxed. However, this may only be the start. The longer and deeper the hit to the economy is, the greater the role the Government will need to play in future. In my view, it is inevitable that the economic support measures will need to be expanded beyond the initial few months currently proposed and that this will have to be followed by stimulus programmes to restore economic growth to pre-crisis levels. We will have to get used to higher levels of public spending and debt for a sustained period.

... and into the future

I appreciate how difficult it is to look beyond the immediate challenges, but it seems very likely to me that coronavirus will amplify the megatrends we have already seen emerging in recent times. The moves towards deglobalisation, more rapid introduction of technology and the need to address the challenges of ageing populations are likely to become more significant issues for business and governments alike. Perhaps the most significant developments may be in policies to address the climate emergency. On one hand, the fall in oil prices and the challenging economic circumstances could combine to slow momentum towards reshaping the economy to protect the climate. On the other hand, the experience of home working and reduced travelling and the clear impact it has had on the environment might accelerate moves to decarbonise the economy, especially if governments perceive that policy could be used to provide stimulus to activity.

These are unprecedented times. Businesses need to prepare themselves to manage across multiple scenarios and for continuing change for several years into the future. And there is still the small matter of adjusting to life after Brexit.

# Highlights

- The EY ITEM Club Spring Forecast 2020 sees a record downgrading of our near-term outlook for the UK economy. This is a consequence of the substantial hit to activity coming from coronavirus, with the Government imposing a lockdown on 23 March following increasing restrictions on people's movements and businesses (especially in the services sector) prior to this. The lockdown was initially for three weeks but has been extended to 7 May when the situation will again be reviewed.
- UK GDP is now forecast to contract 6.8% in 2020 compared to growth of 1.2% that we had projected in our Winter Forecast 2020 which was released at the end of January. Hard to imagine now, but in late January, coronavirus was not even mentioned as a factor seriously threatening the global economy, and it was not included in the downward risks to the UK economy.
- The economy clearly took a major turn for the worse in March and it undoubtedly suffered substantial contraction over the month. In fact, the economy had been disappointingly lacklustre over the first two months of 2020 even before coronavirus started to become a factor, as a marked pick-up in consumer and business confidence resulting from reduced uncertainties following December's general election and the UK leaving the European Union (EU) with a deal on 31 January failed to translate into clearly improved activity.
- Given the economy's sharp downturn in March, we suspect GDP contracted by around 1.3% in Q1 2020. We expect the economy to suffer record contraction of around 13% quarter-on-quarter (q/q) in Q2 as the lockdown imposed by the Government in late March remains in place for most, if not all, of the quarter. To put this into perspective, the largest q/q contraction suffered during the 2008/9 financial crisis was 2.1% in Q4 2008.
- Consumer spending will obviously take a huge hit in Q2 2020 reflecting the major restrictions on people's movements, the fact that all non-essential shops are shut, and that the consumer services sector has essentially been closed down with restaurants, pubs, gyms, clubs, salons, etc. banned by the Government from opening. Business investment will undoubtedly suffer markedly in Q2 and beyond as it is pressurised by several factors. Meanwhile, UK exports will be hit by sharply contracting overseas markets, notably including the key markets of the EU and the US.
- We expect the economy to start to recover in Q3 2020 on the assumption that coronavirus peaks during the second quarter and the Government starts to relax some of the restrictions on people's movements and on business activity late on in the second quarter and then loosens them further in Q3. However, the Government indicated in mid-April that the country will have to get used to a new 'normal' for months to come as it gradually edges out of the coronavirus crisis. There is concern that its efforts will be wasted if social distancing measures are ended too early.
- The substantial fiscal and monetary stimulus that has been enacted by HM Treasury and the Bank of England should provide serious support to activity once the coronavirus impact starts to wane, while consumer purchasing power should benefit from very low inflation (we believe consumer price inflation could fall as low as 0.5% over the summer). There should also be a fair degree of pent-up demand following a collapse in consumer spending in Q2 due to the lockdown. Global economic activity should also be markedly stronger from the latter months of 2020 onwards as other economies recover from their coronavirus-related challenges.
- Despite the economy's expected return to growth in Q3 and then further improvement in Q4, it is still seen as contracting by 6.8% over 2020. We assume that the Government's measures aimed at mitigating the aftermath of coronavirus by supporting businesses and saving jobs have a significant positive impact, which is absolutely crucial to limiting the potential longer-term damage to the economy. Nevertheless, unemployment is expected to have risen markedly and many incomes will have taken a hit, and this will have some limiting impact on the recovery.
- With attention currently focused on the coronavirus impact on the economy, it should not be forgotten that there is the very significant matter of the UK's transition period for leaving the EU (which preserved the status quo) coming to an end on 31 December 2020. On the assumption that the UK and EU avoid a 'no-deal' outcome at the end of 2020, we expect the economy to grow 4.5% in 2021. Even so, the economy is not expected to return to its Q4 2019 size until 2023.
- A downside risk to the outlook is obviously coronavirus affecting the economy for longer than expected. This includes the possibility of a significant new coronavirus wave returning after restrictions have been eased. A more fundamental and particularly worrying downside risk is that the economy suffers severe near-term damage in terms of companies going under and jobs being lost, despite the Government's supportive measures, and that this holds back the subsequent recovery.

# Introduction

Our Spring Forecast 2020 sees a substantial downgrading of the UK economic outlook for 2020 with a deep, albeit short, recession expected as coronavirus takes a major toll on activity. Specifically, we now see UK GDP contracting 6.8% in 2020 compared to growth of 1.2% that we had projected in our Winter Forecast 2020[1] which was released at the end of January. This includes an anticipated 13% q/q drop in GDP in Q2 2020 after likely contraction of around 1.3% q/q in Q1.

The current state and near-term outlook for the UK economy have changed dramatically since our Winter Forecast 2020. In fact, although hard to believe looking back at that forecast, coronavirus was not even mentioned as a factor seriously threatening the global economy, and it was not included in the downward risks to the UK economy. While coronavirus cases had been reported in Wuhan, China in late December, at the time of completing the Winter Forecast 2020, there was little – or no – inkling of just what a problem it would become and what a substantial toll it would take on global economic activity. And looking back at other projections for the UK economy released around that time, we can find no references at all to coronavirus as a potential threat.

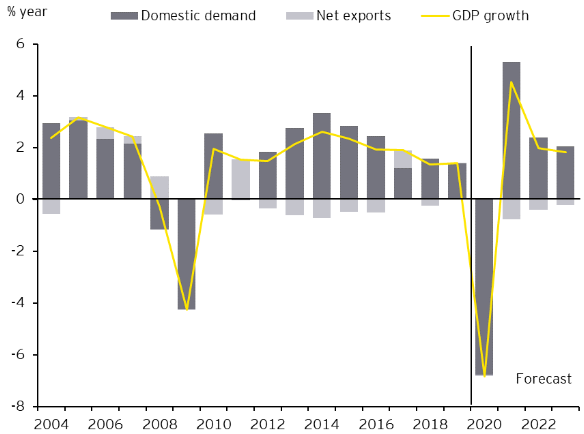
Since late January, coronavirus has rapidly come to the forefront to increasingly dominate the global and UK economic environment and (at least) near-term outlook. This culminated in the UK government imposing a lockdown on activity on 23 March; this was initially for three weeks but it has since been extended to 7 May, when the situation will be reviewed. In fact, it is currently essentially impossible to come up with a forecast for the UK economy with any confidence as is evident by the huge range of projections that are currently being published. There is no knowing just how long coronavirus will affect the UK economy, and a lot will also depend on how effective, ultimately, the substantial fiscal and monetary stimulus that has been enacted is in saving jobs and preventing companies from going under.

However, while it is all doom and gloom at the moment and there is no denying that there are substantial downside risks, we believe the economy can start to recover in the third quarter and then see decent activity late on in 2020 and during 2021. This is based on the assumption that coronavirus peaks during Q2 2020 and the Government starts to relax some of the restrictions on people's movements and on business activity late on in the quarter and then further loosens them during Q3. However, the Government indicated in mid-April that the country will have to get used to a new 'normal' for months to come as it gradually edges out of the coronavirus crisis. There is concern that its efforts will be wasted if social distancing measures are ended too early.

The substantial fiscal and monetary stimulus that has been enacted should provide serious support to activity once the coronavirus impact starts to wane, while consumer purchasing power should benefit from very low inflation. There should also be a fair degree of pent-up demand following a collapse in consumer spending in Q2 2020 due to the lockdown. We assume that the Government's measures aimed at mitigating the coronavirus hit by supporting businesses and saving jobs will have a significant positive impact. This is absolutely crucial to limiting the potential longer-term damage to the economy and enabling decent recovery to get underway in the latter months of 2020. Nevertheless, unemployment is expected to have risen markedly and many incomes will have taken a hit, and this will have some limiting impact on the recovery. Global economic activity should also be markedly stronger later in 2020 and during 2021 as other economies recover from their coronavirus-related woes.

Consequently, we believe the UK could grow by 4.5% in 2021 after expected contraction of 6.8% in 2020.

UK: Contributions to GDP growth




Source: EY ITEM Club

A downside risk to the outlook is obviously coronavirus affecting the economy for longer than expected. This includes the possibility of a significant new coronavirus wave returning after restrictions have been eased.

[1] EY ITEM Club Winter Forecast 2020: Economy set to benefit from reduced near-term uncertainties but UK–EU issues remain a threat. January 2020. See ey.com/en_uk/growth/ey-item-club/ey-item-club-winter-forecast-2020

Another downside risk to the growth outlook is that even after the Government relaxes the restrictions on activity, people may be cautious in their behaviour for an extended period.

A more fundamental and particularly worrying downside risk is that the economy suffers severe near-term damage in terms of companies going under and jobs being lost, despite the Government's measures aimed at helping businesses to keep going and to retain workers, and that this holds back the subsequent recovery.

With all attention currently focused on the impact of coronavirus on the economy, it should not be forgotten that there is the very significant matter of the UK's transition period for leaving the EU (which preserved the status quo) coming to an end on 31 December 2020. If the UK and EU have not reached agreement on their long-term relationship by the end of this year and the transition arrangement is not extended, trade between the UK and the EU will take place under World Trade Organization (WTO) rules – just as it would have done if the UK had left the EU without a deal on 31 January. There was already considerable uncertainty as to whether the UK and EU could come to an agreement over their long-term relationship by the end of 2020, even before the negotiations were hampered by coronavirus. Pressure for extending the transition period to allow for the coronavirus impact on negotiations (and also to gauge the impact on the UK economy) is mounting – but for now, at least, the UK government continues to insist that there will be no extension of the transition period.

There is therefore a very real possibility that the latter months of 2020 could see another Brexit cliff edge developing – with the risk of the UK ending the status quo with no deal. This mounting uncertainty will likely weigh on business behaviour in particular. It could well have some dampening impact on the expected rebound in economic activity later on in 2020 once the coronavirus impact is hopefully waning.

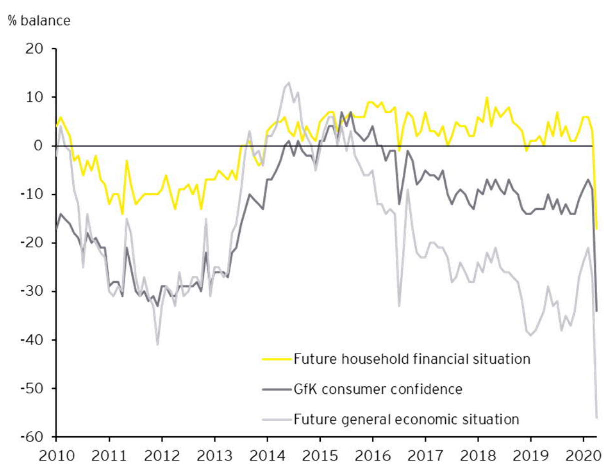
Our assumption is that the UK and the EU will avoid a 'no-deal' outcome at the end of 2020. We think it is most likely that the UK and EU will come to a bare-bones free trade agreement by the end of the year and then look to augment this with sector-related deals thereafter. We would also not rule out an extension to the transition arrangement, given the hampering of negotiations by coronavirus – particularly if the UK and EU appear to be close to coming to agreement on their longer-term relationship.

# Channels of impact for coronavirus on UK economy

Coronavirus is a significant supply shock, a demand shock and a financial shock to the UK economy. Obviously, the ultimate impact will depend on just how long the virus lasts, how many people are affected and how long restrictions in activity have to be in place. The hope is that while there will undoubtedly be a substantial shock to the economy, it will be restricted in terms of time and there will be limited longer-term repercussions. A danger is that the deeper and longer the coronavirus impact is on the economy, the greater the possibility that there will be significant after-effects once the virus has run its course. Much will clearly depend on how effective HM Treasury's and the Bank of England's measures are in preventing businesses from going under and in saving jobs. On the supply side, the hit to the UK initially came from Chinese economic activity plunging as coronavirus took hold early on in 2020 with the manufacturing sector suffering in particular. This increasingly affected global supply chains in the manufacturing sector with the UK starting to be affected in February (according to the purchasing managers' surveys). As coronavirus spread, it intensified the impact on supply chains.

The supply side of the UK economy is currently being significantly affected by people not being able to work due to restrictions on their movements, having coronavirus, being in isolation, or having to be at home to look after their children because schools have closed. While it is possible for many people to work effectively at home these days due to the internet, obviously in some sectors it cannot make up for being in the workplace e.g., in manufacturing, retailing etc. Additionally, the Government has shut down certain sectors of the economy, notably including bars, restaurants, hotels, theatres, cinemas, gyms, clubs etc. Non-essential retailers have also been closed. Construction activity is also being affected by some shutdowns. On the demand side, there is the hit to consumer and business confidence coming from coronavirus, which is clearly leading to a substantially more cautious approach in behaviour. In the case of consumers, this is most notably weighing down on their willingness to spend, particularly on

UK: GfK consumer confidence survey




Source: EY ITEM Club/Haver Analytics

discretionary items. Additionally, demand will be hit by people not physically able to go out due to being affected by the virus or being restricted in their movements due to government advice and dictates.

Of course, the more people that lose their jobs or have their incomes substantially reduced (including the self-employed) as a result of coronavirus, the greater the hit to demand. While this is being partly offset by the various supportive government measures that have been enacted to save jobs, support incomes and to increase benefits, these will not fully compensate.

Meanwhile, many businesses facing reduced or even ceased activity as well as major uncertainties, will undoubtedly cut back on their investment and delay committing to any new projects. Significantly, the Bank of England's regional agents reported in their Q1 2020 survey of business conditions that "at the start of the year, investment intentions had improved slightly, as companies reported that uncertainty had declined somewhat following the general election. But, over the past few weeks, coronavirus developments have led to the outlook becoming highly uncertain. This has resulted in some companies halting investment plans and retaining cash buffers, in particular in retail, leisure, travel and hospitality. However, some contacts in other sectors have said they plan to proceed with investment in expansion, product development and automation to reduce staffing costs and improve efficiency." [2]

A further demand-side shock to the UK economy will likely come from reduced tourism. As far back as February, the purchasing managers reported that services sector activity was starting to be affected by reduced travel and tourism-related bookings, especially from Asia. This could be partly offset by more staycations in the UK.

Financial conditions have also tightened because of coronavirus, and this will obviously have some negative impact on the UK economy. The FTSE 100 closed 2019 at 7,542 while the FTSE All-Share closed at 4,196. On 23 March, the FTSE 100 closed at an eight-and-a-half year low of 4,994 (down 33.8% from the end-of-2019 level), while the FTSE All-Share was trading at 2,728 (down 35.0%). Equity markets have since recovered some of their losses but still remain well down on their end-of-2019 levels with the FTSE 100 closing at 5,641 on 21 April and the FTSE All-Share closing at 3,201. Additionally, gilt yields rose sharply, although they fell back significantly after the Bank of England announced £200b of new asset purchases on 19 March as part of an emergency stimulus package.

Finally, coronavirus has already taken a major toll on global economic activity and there is clearly a lot more pain to come. There had been signs in late 2019 and the start of 2020 that the global economic situation was stabilising after largely deteriorating through 2019, when the manufacturing sector in particular suffered. However, starting with a very substantial downward impact on the Chinese economy in the first quarter, coronavirus has spread to take a major toll on all major economies – including the US, the eurozone and Japan. There will clearly be a global recession in 2020, with economic performance set to be one of the weakest for the past 50 years.

Additionally, the WTO forecast in early April that global trade in goods could contract anywhere between 13% and 32% in 2020 given the ongoing major uncertainty over the impact of coronavirus. This obviously has negative implications for UK exports. The WTO forecast that global goods trade could bounce back by 21%–24% in 2021 with the outcome depending on the duration of the coronavirus outbreak and the effectiveness of policy responses.

# Economy had subdued start to 2020 even before coronavirus started to impact

It already seems ancient history given the dominant impact of coronavirus, but the hope had been that the UK economy would see a decent start to 2020 as reduced uncertainties following December's decisive general election – reinforced by near-term clarity on Brexit with the UK leaving the EU with a deal on 31 January – would lead to businesses and consumers stepping up their activity. There was certainly a marked pick-up in both business and consumer confidence in late December and the start of 2020. Furthermore, survey evidence from the purchasing managers indicated that both services and manufacturing output expanded at their fastest rate for 16 months in January and stayed close to that level in February.

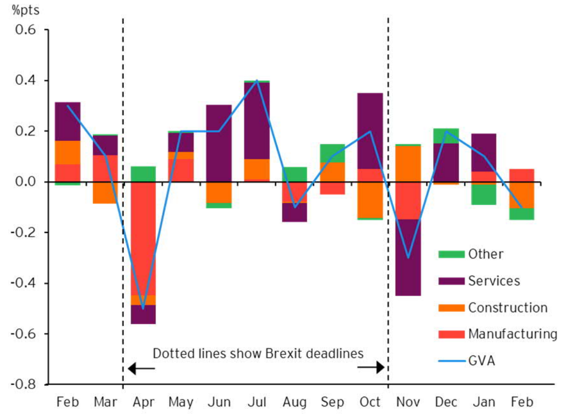
However, data from the Office for National Statistics (ONS) shows that GDP only edged up 0.1% month-on-month (m/m) in January and then dipped 0.1% m/m in February. Consequently, year-on-year (y/y) GDP

[2] Agents summary of business conditions – 2020 Q1. Bank of England Regional Agents. 26 March 2020. See bankofengland.co.uk/agents-summary/2020/2020-q1

growth slowed to just 0.3% in February from 0.7% in January and 1.1% in December. Furthermore, GDP was only up 0.1% on a three-month/three-month basis in February.

Even allowing for construction activity (and retail sales) taking a hit from very wet weather in February, the economy's performance over the first two months of 2020 was very disappointing. Construction output contracted 1.7% m/m in February after a drop of 0.2% m/m in January. Meanwhile, output in the dominant services sector was only flat m/m in February after edging up 0.1% m/m in January. Industrial production was the only sector to see growth in February as it rose 0.1% m/m with manufacturing output up 0.5% m/m. Industrial production had previously risen 0.2% m/m in January when manufacturing output increased 0.4% m/m. Data on the expenditure side of the economy shows that retail sales volumes rose 0.9% m/m in January but they then dipped 0.3% m/m in February when they were only flat y/y (which was the weakest annual performance since March 2013).

UK: Contributions to monthly Gross Value Added (GVA) growth



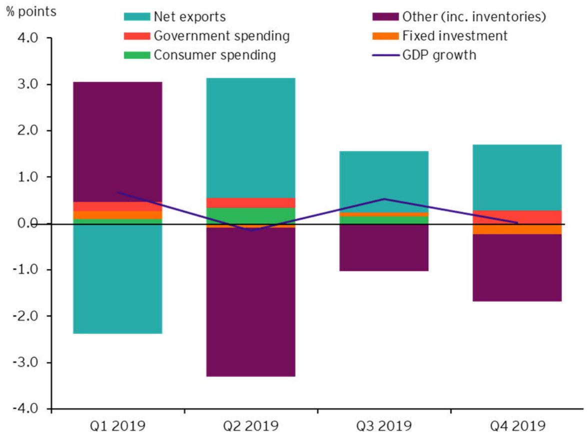

Source: EY ITEM Club calculations using data from Haver Analytics

There were signs that the coronavirus outbreak was beginning to impact on the economy in February, with the purchasing managers reporting supply chain disruptions affecting the manufacturing sector and export orders also being affected, especially tourism-related bookings from Asia. Furthermore, while the ONS indicated that coronavirus had not had a significant impact on February retail sales, it nevertheless observed that some retailers indicated that online orders shipped from China had been reduced.

The economy had earlier grown 1.4% in 2019, which was slightly up from a six-year low of 1.3% in 2018. The economy stagnated in Q4 2019 as it struggled in the face of particularly heightened domestic political and Brexit uncertainties – with the general election occurring on 12 December and the UK's exit from the EU being delayed for a second time. Indeed, 2019 was a real yo-yo year for the UK economy with its performance being particularly distorted by the two scheduled Brexit deadlines (28 March and 31 October). GDP grew 0.7% q/q in Q1, contracted 0.2% in Q2 (the first q/q decline since Q4 2012) and grew 0.5% q/q in Q3 before being flat in Q4.

On the expenditure side, the economy was hampered in Q4 2019 by more cautious consumers and a renewed drop in business investment as companies were clearly in 'wait and see' mood ahead of the general election and Brexit uncertainties. Consumer spending was only flat q/q – the weakest performance for four years. This was despite consumers seemingly benefitting in Q4 from reasonable fundamentals as the ONS reported that compensation of employees rose 0.6% q/q and 3.6% y/y. Increased consumer caution was evident in the household saving ratio rising to 6.2% in Q4 2019 from 5.0% in Q3. Meanwhile, business investment contracted 0.5% q/q in Q4 after rising over the previous three quarters. Even so, business investment was up 1.8% y/y in the fourth quarter.

GDP growth contributions in Q1- Q4 2019




Source: EY ITEM Club

Overall investment fell 1.2% q/q in Q4 and was down 0.3% y/y. In addition to the 0.5% q/q drop in business investment, there was a decline of 1.2% q/q in government investment. There was also contraction of 3.3% q/q in private dwellings investment. Government spending jumped 1.5% q/q and was up 3.6% y/y. Net trade made a substantial positive contribution to Q4 growth as exports surged 5.0% q/q while imports edged up 0.4% q/q. However, this was distorted by large movements in trade in non-monetary gold, which in turn weighed down on gross fixed capital formation which was sharply negative.

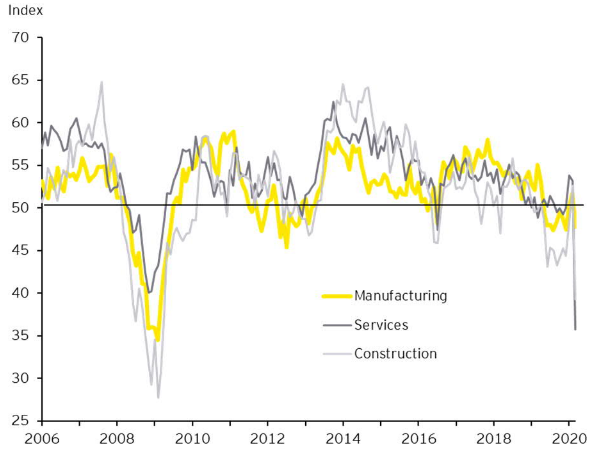
On the output side of the economy, GDP in Q4 2019 was held back by manufacturing contraction of 1.1% q/q as the sector extended its largely difficult performance over the year. Overall industrial production contracted 0.7% q/q. Meanwhile, construction output contracted 0.1% q/q. Output in the dominant services sector rose a modest 0.2% q/q in Q4. Output in the distribution, hotels and catering sector was particularly weak, contracting 0.2% q/q. Output in the business, services and finance sector rose 0.2% q/q.

## Coronavirus now hitting economy hard

The UK economy clearly took a major turn for the worse in March as coronavirus became a massively increasing problem as the month progressed. This led to the Government imposing restrictions on sectors of the economy and people's movements, culminating in a lockdown on 23 March. This was initially for three weeks but has been extended to 7 May when the situation will again be reviewed.

There is little hard data available so far to gauge just how much the economy deteriorated in March. Survey evidence from the purchasing managers points to a very sharp falling off in activity, although it needs to be borne in mind that the purchasing managers' surveys can tend to overstate developments at times of markedly changing economic, political and other developments. Specifically, the composite output index for manufacturing and services plunged to 36.0 in March; this was the lowest level in the survey's 22-year history. The previous low was 38.1 in November 2008. March's reading was down from 53.0 in February and 53.3 in January (which had been the highest level since September 2016). Furthermore, March's drop of 17.0 points was by far the largest single monthly decline on record.

UK: IHS Markit/CIPS surveys




Source: EY ITEM Club/IHS Markit/CIPS

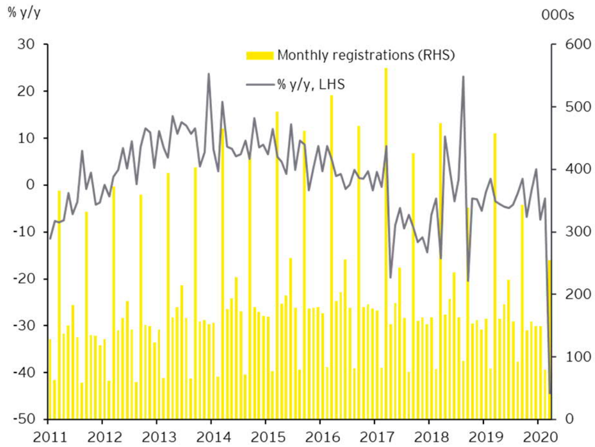
Services activity suffered a particularly sharp collapse in activity in March, with the services Purchasing Managers' Index (PMI) plunging to a record low of 34.5 (series started in July 1996). This was down from 53.2 in February and a 16-month high of 53.9 in January. IHS Markit reported "With measures to halt the spread of the coronavirus causing footfall to slump, by far the steepest downturns in activity were signalled by hotels and restaurants and other leisure activities such as sports centres, gyms and hair salons. The initial impact of emergency public health measures was also reflected in record downturns in activity across transport and travel and the vast business-to-business services category."

Meanwhile, the manufacturing PMI pointed to activity contracting anew in March after growing for the first time in 10 months in February. Specifically, the manufacturing PMI fell back to 47.8 in March after rising to 51.7 in February from 50.0 in January and a four-month low of 47.5 in December. Furthermore, the headline manufacturing PMI understated the sector's weakness as a marked positive contribution came from a sharp lengthening of supplier delivery times. This is normally seen as a positive, reflecting strong demand – but in this instance it was due to disturbance in supply chains stemming from the disruption to manufacturing inputs because of factory shutdowns around the world and shipping delays due to coronavirus.

A third survey from the purchasing managers relating to the construction sector showed a sharp falling back in activity in March as many sites were closed. Indeed, the construction PMI plunged to 39.3 in March (from a 16-month high of 52.6 in February) taking it to the lowest level since April 2009. All construction sectors saw contraction in March – indeed commercial and civil engineering activity both contracted by the largest level for 11 years, while house building also declined.

On the consumer front, retail sales volumes contracted 1.6% q/q in the first quarter. This was primarily the consequence of a record decline of 5.1% month-on-month (m/m) and 5.8% y/y in March. A record increase of 10.1% m/m in food sales was substantially outweighed by large falls in non-food sales (including clothing and textile sales plunging by

UK: New car registrations




Source: EY ITEM Club/Haver Analytics

34.8% m/m) as non-essential retailers were shut as part of the Government lockdown on 23 March. Additionally, fuel sales fell 18.9% m/m in March as private transport journeys were severely curtailed by the restrictions on people's movements. An interesting, if unsurprising, development saw online sales as a share of total retail sales reach a record 22.3% in March as people switched to online shopping from physically visiting shops. The British Retail Consortium (BRC) has reported that shopper footfall has fallen by 83% since the Government closed non-essential retail outlets in March.

Meanwhile, Barclaycard reported that consumer spending fell 6.0% y/y in March, the steepest fall since the series started five years ago. Travel expenditure was down 40.5% y/y while spending in restaurants fell by 35% y/y and in bars by 22% y/y (these were obviously closed in the latter part of the period).

Additionally, new car sales fell 44.4% y/y in the key month of March (when number plates changed) with private sales declining 40.4% y/y and fleet sales down 47.4% y/y. This was the weakest March performance for new car sales since biannual number plates were introduced in 1999.

This tied in with GfK reporting that consumer confidence saw substantial deterioration over the second half of March. Specifically, the index slumped by 25 points to -34 from -9 with sharp deterioration in consumers' expectations for the economy and for their personal finances. This took consumer confidence down to the lowest level since February 2009. There was an astonishing 50 points drop in the sub-index relating to the consumer willingness to make a major purchase index.

Meanwhile, 25% of companies responding to an ONS coronavirus impact survey[3] reported that they had temporarily closed or paused trading for the period 23 March to 5 April 2020, while 75% were continuing trading. For the 75% of companies still trading, 37.5% reported that their turnover was "substantially lower than normal" while 16.6% reported it slightly lower than normal.

We suspect that the sharp deterioration of the economy in March will have been sufficient to have caused GDP to have contracted by around 1.3% q/q in Q1 2020.

The Bank of England's Decision Makers' Panel for March reported that 71% of contacts expected coronavirus to have a negative impact on their business over the next year. 39% expected there to be a large negative impact (a hit of 10% or more), while 32% saw a less than 10% impact. 22% of contacts said that they expected there to be no impact while 7% anticipated a positive impact. "These sales impacts should be temporary." The impact of coronavirus on business was expected to be material across all sectors. Businesses in accommodation and food, leisure and transport services were expected to be the most severely impacted, followed by businesses in transport and storage. The Bank of England notably observed that responses became "significantly" more pessimistic during the 6–20 March survey period. Specifically, the average probability attached to a large negative impact on business rose from 25% at the start of the survey window to almost 60% at the end. Furthermore, the survey was completed before the Government imposed the lockdown on 23 March. [4]

## Massive fiscal action enacted to battle coronavirus; looser fiscal policy to help economy thereafter

The Chancellor has announced unprecedented, massive fiscal measures aimed at helping businesses and individuals impacted by coronavirus, as well as upping resources for the NHS.

The 11 March Budget for 2020/21 contained a £12b package to tackle coronavirus (£5b extra for the NHS, £7b support for businesses). Less than a week later, on 17 March, with it already becoming clear that the likely hit to the economy from coronavirus was going to be substantially deeper than expected when the Budget was being prepared, Chancellor Sunak announced a further £20b of supportive measures and announced that the Government would guarantee £330b (equivalent to 15% of GDP) of bank lending to businesses (the Coronavirus Business Interruption Loan Scheme). The combined £32b of direct fiscal support pledged by the Chancellor at this point was around 1.5% of GDP.

[3] Coronavirus, the UK economy and society, faster indicators: 16 April 2020, Office for National Statistics. 16 April 2020. See ons.gov.uk/peoplepopulationandcommunity/healthandsocialcare/conditionsanddiseases/bulletins/coronavirustheukeconomyandsocietyfasterindicators/16april2020

[4] Latest Results from the Decision Maker Panel survey – 2020 Q1. Bank of England Regional Agents. 2 April 2020. See bankofengland.co.uk/agents-summary/2020/2020-q1/latest-results-from-the-decision-maker-panel-survey-2020-q1

This was followed on 20 March by the strongest measures of all when the Chancellor announced the Coronavirus Job Retention Scheme under which the Government aimed to avert massive redundancies in the private sector by making pay grants to companies which would cover 80% of the salary of retained workers up to a total of £2,500 a month for three months, backdated to 1 March. Chancellor Sunak indicated that the scheme would be extended if necessary (it was duly extended for a month in mid-April).

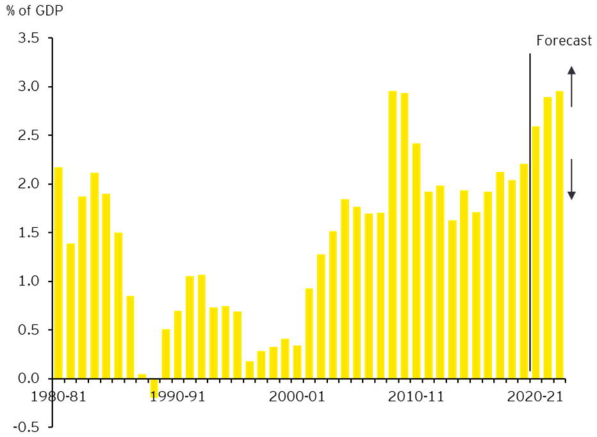
The Chancellor also announced additional measures including increasing the Universal Credit standard allowance for the next 12 months by £1,000 a year, with the working tax credit basic element also rising by the same amount. He also deferred the next quarter of companies' VAT payments until June. The self-employed would be able to defer the regular payment of income tax due in July 2020 to January 2021. Another initiative was that the Coronavirus Business Interruption Loan Scheme would be interest-free for 12 months, rather than the six months announced initially.

An additional major step by the Chancellor was taken on 26 March, this time aimed at providing support to the self-employed affected by loss of work and income due to the coronavirus outbreak. Specifically, self-employed workers will be able to apply for a grant worth 80% of their average monthly profits over the last three years, up to £2,500 a month for three months, backdated to 1 March. Chancellor Rishi Sunak again indicated that the scheme would be extended if necessary. The scheme will be open to those with trading profits of up to £50,000, with HM Treasury estimating that up to 3.8 million workers will be covered.

The cost of supporting the self-employed has been estimated at around £10b, taking the total bill for government interventions to support businesses and individuals to around £60b (2.6% of GDP). This cost will rise further now that the support to incomes has been extended for another month.

The Budget had contained sustained fiscal loosening over the five-year period 2020/21 to 2024/25. Indeed, the Office for Budget Responsibility (OBR) observed that "the Government has proposed the largest sustained fiscal loosening since the pre-election Budget of March 1992. Relative to our pre-measures baseline forecast, the Government's policy decisions increase the budget deficit by 0.9 per cent of GDP on average over the next five years and add £125 billion (4.6 per cent of GDP) to public sector net debt by 2024–25".[5]

UK: Public sector net investment




Source: OBR

In particular, the Budget contained an additional £18b of fiscal stimulus for fiscal year 2020/21 rising to some £42b for 2023/24 (accounted for entirely by extra spending). This was essentially split evenly between extra current spending and extra capital spending.

The new fiscal rules that were contained in the Conservative manifesto and adopted in the Budget (although the Chancellor indicated they would be reviewed) were designed to give the Government scope to take advantage of current very low interest rates and borrow to invest, particularly in infrastructure. This is seen as having a key role to play in the Conservative party's pledge to 'level up' the economic performance of the least prosperous UK regions. Specifically, the fiscal rule was that the Government will only borrow to invest, and this will be capped at 3% of GDP. Consequently, the Budget sees government investment spending averaging 2.9% of GDP over the five years 2020/21 to 2024/25. This would be up from an average of 2.0% of GDP over the past 10 years, including 2.0% of GDP in 2018/19.

## Bank of England has slashed interest rates to record low and reactivated quantitative easing

The coordinated response by HM Treasury and the Bank of England to the coronavirus threat to the UK economy was evident in the central bank delivering a package of measures on the morning of 11 March – immediately before the Budget took place. This followed the holding of a special Monetary Policy Committee

[5] Overview of the March 2020 Economic and Fiscal Outlook. Office for Budget Responsibility. 11 March 2020. See obr.uk/overview-of-the-march-2020-economic-and-fiscal-outlook/

(MPC) meeting on 10 March – ahead of the next scheduled meeting on 25 March. This incidentally was Mark Carney's last act as Governor, as he was replaced by Andrew Bailey on 16 March.

The Bank of England slashed interest rates by 50 basis points to 0.25% from 0.75% on 11 March, following a unanimous 9–0 vote by the MPC. This took interest rates back down to the record low that the Bank of England had last enacted in August 2016 in the aftermath of the UK voting to leave the EU (they had subsequently been raised to 0.50% in November 2017 and to 0.75% in August 2018). Additionally, the Bank of England announced measures aimed at supporting bank lending, especially to small businesses (the Term Funding Scheme with additional incentives for Small and Medium-sized Enterprises – TFSME).

Furthermore, the Bank of England announced on 18 March that a joint Treasury and Bank of England Covid Corporate Financing Facility (CCFF) will provide funding to businesses by purchasing commercial paper of up to one-year maturity, issued by firms making a material contribution to the UK economy. The short-term debt issued by companies needs to be of investment grade, meaning it must have a high credit rating. The scheme will operate for at least 12 months and will be open to firms that can demonstrate they were in sound financial health prior to the shock. The Bank of England observed that it will help businesses across a range of sectors to pay wages and suppliers, even while experiencing severe disruption to cash flows. The Bank of England will create new money to pay the for the scheme, similar to its previous purchases of government and longer-term corporate bonds.

When announcing its interest rate reduction and other measures on 11 March, the Bank of England had made it clear that it was prepared to take further action if the threat to the UK economy from coronavirus deepened. Specifically, the minutes of the emergency MPC meeting on 10 March concluded that "Should the MPC need to provide further monetary stimulus, there were a number of options at its disposal, including cutting Bank Rate further, enlarging the TFSME, and expanding asset purchases."

It did not take long for the Bank of England to deliver on this promise. Indeed, it did not even wait for the scheduled MPC meeting on 25 March as it held another special meeting on 19 March and took further action. Specifically, the Bank of England took interest rates down by a further 15 basis points to an all-time low of 0.10%.

Additionally, the Bank of England revived quantitative easing (QE) by announcing it will buy a further £200b of government and corporate bonds, taking the total up to £645b (the current mix is £435b gilts; £10b corporate bonds). The majority of this will be through the purchase of gilts. The Bank of England announced on 2 April that it intends to make at least £10b purchases of corporate bonds and at a significantly faster pace than it purchased corporate bonds in 2016. This is by far the largest single announcement of asset purchases that the Bank of England has ever made (the previous highest was £75b). The Bank of England also stated its intention to front-load these purchases, as much as was operationally possible, as this was seen as increasing the effectiveness of the policy in counteracting an unwarranted tightening of monetary and financial conditions. The Bank of England had last undertaken quantitative easing in August 2016 in the aftermath of the UK voting to leave the EU.

The third strand of the Bank of England's latest measures saw it announce that it will enlarge the TFSME. These moves were all taken with unanimous 9–0 votes within the MPC.

The Bank of England's statement accompanying its 19 March moves observed that the spread of coronavirus and the measures being taken to contain it will result in an economic shock that could be sharp and large but should be temporary. The role of the Bank of England is to help to meet the needs of UK businesses and households in dealing with the associated economic disruption. The statement went on to comment that the MPC judged that a further package of measures was warranted to meet its statutory objectives. The statement noted that "Over recent days, and in common with a number of other advanced economy bond markets, conditions in the UK gilt market have deteriorated as investors have sought shorter-dated instruments that are closer substitutes for highly liquid central bank reserves. As a consequence, UK and global financial conditions have tightened." [6]

The Bank of England subsequently made no further changes to monetary policy at the regular MPC meeting held on 25 March. The minutes observed that given the major recent steps taken by the Bank of England, there was "not a strong case for further policy changes at this meeting". It noted that gilt yields had fallen

[6] Monetary Policy Summary for the special Monetary Policy Committee meeting on 19 March 2020. Bank of England. 19 March 2020. See [bankofengland.co.uk/monetary-policy-summary-and-minutes/2020/monetary-policy-summary-for-the-special-monetary-policy-committee-meeting-on-19-march-2020](bankofengland.co.uk/monetary-policy-summary-and-minutes/2020/monetary-policy-summary-for-the-special-monetary-policy-committee-meeting-on-19-march-2020)

significantly following the previous week's special MPC meeting and the commencement of additional gilt purchase operations from 20 March. It notably commented that "If needed, the MPC could expand asset purchases further". The minutes concluded that the MPC would continue to monitor the situation closely and, consistent with its remit, stood ready to respond further as necessary to guard against an unwarranted tightening in financial conditions and to support the economy. [7]

Further Bank of England action to support the economy remains very much on the cards. This could very possibly occur at its May MPC meeting if the economy is struggling as much as we suspect it will be. This is most likely to be in the form of more asset purchases.

However, we very much doubt that the Bank of England will take interest rates any lower than 0.10%. The Bank of England has regularly indicated that it sees the lower boundary for interest rates as close to, but just above zero. In particular, the Bank of England is concerned about the potential impact of negative interest rates on the profitability of the UK banking sector. Indeed, after cutting interest rates to 0.10% on 19 March, the new Governor, Andrew Bailey, stated that negative UK interest rates are not compatible with attempts to boost the capacity of banks to lend.

## UK economy still facing significant Brexit uncertainties despite UK exit from EU on 31 January

The current dominating effect of coronavirus on the economy and the near-term outlook has diverted attention away from the fact that there are major uncertainties over what will happen on the UK–EU relationship front over the coming months and that this could well affect the economy.

The UK's exit from the EU with a deal on 31 January reduced immediate uncertainties over Brexit – but it far from ended them and they look highly likely to build up again as 2020 progresses.

The transition agreement between the UK and the EU that came into effect after 31 January preserves the status quo but is only scheduled to last until 31 December 2020. If the UK and EU have not reached agreement on their long-term relationship by 31 December 2020 and the transition arrangement is not extended, trade between the UK and the EU will take place under WTO rules – just as it would have done if the UK had left the EU without a deal on 31 January.

There is considerable uncertainty as to whether the UK and EU can come to an agreement over their long-term relationship by the end of 2020. The history of trade agreements between countries and groups of countries suggests that it takes several years to reach a successful conclusion. Furthermore, the massive task of UK and EU policymakers in trying to deal with the impact of coronavirus on their economies and populations, as well as the need for social distancing, has made Brexit negotiations more difficult to conduct.

The arrangement allows for the transition period to be extended from the end of 2020 up until December 2022 if both sides agree. However, any extension request must be agreed by 1 July 2020. The Government has repeatedly stressed that it will not seek an extension to the transition arrangement and it even enshrined this into law. While there is mounting concern that UK–EU negotiations will be seriously hampered by the coronavirus outbreak, Prime Minister Johnson currently shows no signs of relenting with regard to extending the transition period.

Boris Johnson has regularly argued that the UK and the EU can negotiate a free trade agreement that will be ready to come into effect on 1 January 2021. Of course, one major difference between the UK and the EU's negotiations and the usual negotiations between countries is that the UK and EU are looking to come to an agreement on a trade relationship that is less close than it was before Brexit.

Consequently, there is a very real possibility that the latter months of 2020 could see another Brexit cliff edge developing – with the risk of the UK ending the status quo with no deal.

Our assumption is that the UK and the EU will avoid a 'no-deal' outcome at the end of 2020. We think it is most likely that the UK and EU will come to a bare-bones free trade agreement by the end of the year and then look to augment this with sector-related deals thereafter. We also would not rule out an extension to the

[7] Minutes of the special Monetary Policy Committee meeting on 19 March 2020 and the Monetary Policy Committee Meeting ending on 25 March 2020. Bank of England. 26 March 2020. See bankofengland.co.uk/-/media/boe/files/monetary-policy-summary-and-minutes/2020/march-2020.pdf?la=en&hash=F79A300BF2CE1E918CD5D873364D9985B45B9C50

transition arrangement given the hampering of negotiations by coronavirus – particularly if the UK and EU appear to be close to coming to agreement on their longer-term relationship.

However, neither of these alternatives can be taken for granted and there may well be tortuous twists and turns before then, as occurred with the UK actually leaving the EU on 31 January.

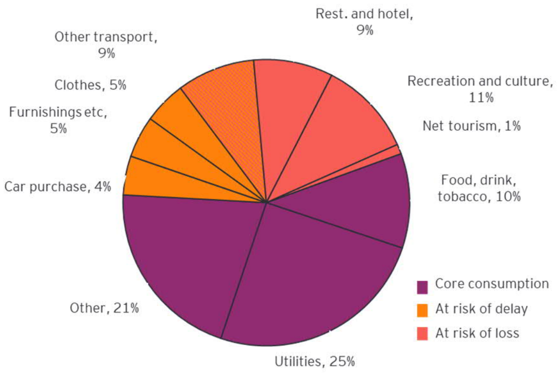
Furthermore, a concern for many businesses regarding the long-term UK–EU relationship is that the Johnson government is aiming for a free trade agreement with the EU with less regulatory alignment. This is seen as making a frictionless border between the UK and the EU less achievable. Indeed, in setting out its negotiating position ahead of talks with the EU, the Government stressed that it wants full economic and political independence and that self-determination must trump economic concerns.

## Economy set to see record contraction in Q2; could see decent recovery if coronavirus fall-out can be contained

We expect the economy to suffer record contraction of around 13% q/q in Q2 2020 – after an estimated GDP drop of 1.3% q/q in Q1– as the lockdown imposed by the Government in late March remains in place for most of the quarter. To put this into perspective, the largest q/q contraction suffered during the 2008/9 financial crisis was 2.1% in Q4 2008 (although this was preceded by a drop of 1.6% q/q in Q3 2008 and followed by a drop of 1.7% q/q in Q1 2009).

The first information on the economy in April was dire, coming from the “flash” purchasing managers survey. This showed the composite output index for manufacturing and services plunging by a record 23.1 points to just 12.9 in April from the previous all-time low of 36.0 in March. A reading of 50.0 indicates unchanged activity. Forward-looking elements of the survey were very worrying for near-term activity at least. Combined new business and backlogs of work for the two sectors fell at record rates, while prices charged were cut at a record pace as manufacturing and services companies tried to get business by discounting. Employment also fell at a record pace. The services PMI plummeted to an all-time low (by far) of 12.3 from 357 in March. Meanwhile, the manufacturing PMI fell back to a record low of 32.9 in April from 47.8 in March with the output index down to 16.6 from 4.9.

UK: Structure of consumer spending




Source: EY ITEM Club/Haver Analytics

Consumer spending will obviously take a huge hit in Q2 2020 reflecting the major restrictions on people’s movements, the fact that all non-essential shops are shut, and that the consumer services sector has essentially been closed down with restaurants, pubs, gyms, clubs, salons, etc. banned from opening by the Government. Food sales are likely to remain strong through Q2 while online sales can be expected to see some pick-up to make up for some purchases that would otherwise have been made in the shops that are closed.

Consumer spending is also likely to take a strong hit in Q2 from a sharp rise in unemployment and a substantial number of people taking a hit to their income. While the Government’s measures will hopefully be successful in saving many jobs, there will be substantial losses and many people will suffer reduced earnings. (The Government will cover 80% of the salary of retained workers to a total of £2,500 a month and also 80% of the average monthly earnings of most self-employed.) We suspect that the unemployment rate could rise as high as 6.7% in Q3 2020 from 3.9% in the three months to February. Along with substantially lower consumer confidence, this is likely to weigh heavily on discretionary spending. Consequently, we suspect that consumer spending could contract by around 12% q/q in Q2.

Business investment will undoubtedly suffer markedly in Q2 and likely beyond as it is pressurised by several factors. With many companies facing sharply reduced or even non-existent near-term business, and with cash flows suffering, they are currently focused on getting through the near-term crisis rather than planning for a future that they may not have – particularly as they cannot be sure of how long coronavirus will be impacting on the economy.

Meanwhile, UK exports will be hit by sharply contracting key overseas markets, notably including the EU and the US. Furthermore, some exports could be affected by production problems in the UK resulting from coronavirus affecting workforces.

We expect the economy to start to recover in Q3 2020 on the assumption that coronavirus peaks during the second quarter and the Government starts to relax some of the restrictions on people's movements and on business activity towards the end of Q2, and then loosens them further during Q3. However, the Government warned at the end of March that normal life in the UK may not return for up to six months as its efforts may be wasted if social distancing measures are ended too early.

The substantial fiscal and monetary stimulus that has been enacted should provide serious support to activity once the coronavirus impact starts to wane, while consumer purchasing power should benefit from very low inflation (we believe consumer price inflation could fall as low as 0.5% over the summer). There should also be a fair degree of pent-up demand following a collapse in consumer spending in Q2 due to the lockdown. Global economic activity should also be markedly stronger in the latter months of 2020 and during 2021 as other economies recover from their 2020 coronavirus-related woes. The WTO forecast that global goods trade could bounce back by 21%–24% in 2021 after contraction of anywhere between 13% and 32% in 2020 (the wide range for 2020 reflects the WTO's major uncertainty over the duration of the coronavirus outbreak).

However, a lot of people will have lost their jobs despite the Government's supportive measures (we forecast the unemployment rate to spike to 6.7% over the next few months from 3.9% in the months to February), while a significant number of businesses will likely go under, and this will have some limiting impact on the economy's recovery. Obviously, the more successful that the Government's measures are in saving businesses and jobs, the better for the economy's recovery prospects. We expect the measures to have a fair degree of success in preventing an even worse jobs situation.

Despite the economy's expected return to growth in Q3 and then further improvement in Q4 with, hopefully, little lingering negative impact from coronavirus, GDP is still seen as contracting by 6.8% over 2020. Consumer spending is forecast to contract by 7.5% while total investment is seen plunging 9.7% with business investment declining 13.6%. Government investment is seen rising 5.8%, while public spending is projected to increase by 3.0%. Net trade is seen making a marginal negative contribution of 0.1 percentage points to GDP as exports of goods and services fall by 5.3% while imports decline by a lesser 4.9%.

## EY ITEM Club forecast for the UK economy, spring 2020

% changes on previous year except borrowing, current account, and interest and exchange rates

| | GDP | Domestic demand | Consumer spending | Fixed investment | Exports | Imports |
|---|---|---|---|---|---|---|
| 2018 | 1.3 | 1.3 | 1.6 | -0.2 | 1.2 | 2.0 |
| 2019 | 1.4 | 1.6 | 1.1 | 0.6 | 4.8 | 4.6 |
| 2020 | -6.8 | -6.7 | -7.5 | -9.7 | -5.3 | -4.9 |
| 2021 | 4.5 | 5.2 | 4.9 | 3.5 | 6.3 | 8.4 |
| 2022 | 2.0 | 2.4 | 1.6 | 6.0 | 5.4 | 6.3 |
| 2023 | 1.8 | 2.0 | 1.8 | 2.3 | 3.3 | 3.7 |
| 2024 | 1.6 | 1.8 | 1.7 | 2.2 | 3.4 | 3.7 |
| | **Net government borrowing*** | **Current account (% of GDP)** | **Average earnings** | **CPI** | **Bank rate** | **Effective exchange rate** |
| 2018 | 1.8 | -3.9 | 3.0 | 2.5 | 0.6 | 78.5 |
| 2019 | 2.1 | -3.8 | 3.5 | 1.8 | 0.8 | 78.2 |
| 2020 | 9.1 | -3.8 | 1.9 | 1.0 | 0.2 | 78.3 |
| 2021 | 5.1 | -4.3 | 2.7 | 1.7 | 0.2 | 80.3 |
| 2022 | 3.8 | -4.4 | 3.5 | 2.2 | 0.7 | 82.0 |
| 2023 | 3.1 | -4.5 | 3.5 | 2.0 | 1.2 | 82.1 |
| 2024 | 2.7 | -4.6 | 3.5 | 2.0 | 1.7 | 79.6 |

*Fiscal years, as % of GDP

Source: EY ITEM Club

On the assumption that the UK and EU avoid a 'no-deal' outcome at the end of 2020 when the transition arrangement ends, we expect the economy to grow 4.5% in 2021. Even so, the economy is not expected to return to its Q4 2019 size until Q1 2023.

After contracting 7.5% in 2020, consumer spending is expected to rebound 4.9% in 2021 as the labour market recovers from the sharp deterioration suffered in Q2 and Q3 2020. Low inflation for much of the year should also support consumer spending (although inflation is expected to trend up during the year). However, the labour market is not expected to recover all the job losses suffered in 2020 and that will have some limiting impact on consumer spending.

Government spending and investment should contribute significantly to growth in 2021. Indeed, government investment is seen increasing 11.8% in 2021 contributing to overall investment growth of 3.5%. Business investment is forecast to pick up modestly in 2021 as companies become more confident in the recovery. However, the upside for business investment is likely to be limited by the hit that many companies will take to their profitability in 2020. Consequently, business investment is seen as only rising 1.2% over 2021, although this masks a significant q/q pick-up as the year progresses.

Net trade is seen significantly negative in 2021 as exports (up 6.3%) are forecast to be outgrown by imports (up 8.4%).

# Risks and uncertainties to forecast

The risks to the forecast currently seem very much loaded to the downside. The most obvious downside risk is that coronavirus affects the economy for longer than expected. This includes the possibility of a significant new coronavirus wave returning after restrictions have been eased.

Another downside risk to the growth outlook is that even after the Government relaxes the restrictions on activity, people may be cautious in their behaviour for an extended period.

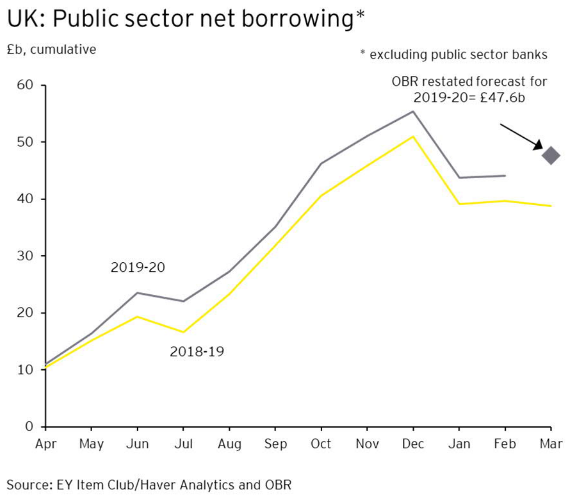
A more fundamental and particularly worrying downside risk is that the economy suffers severe near-term damage in terms of companies going under and jobs being lost, despite the Government's measures aimed at helping businesses to keep going and to retain workers, and that this holds back the subsequent recovery.

A very significant downside risk to the forecast stems from the very real possibility that the UK and the EU could fail to reach a free trade agreement by the end of 2020 and the transition arrangement is not extended, causing trade between the UK and the EU to take place under WTO rules – just as it would have done if the UK had left the EU without a deal on 31 January.

If this happens, we suspect growth in 2021 at least will take a major hit. Probable major uncertainty would negatively impact business sentiment and investment, and also affect consumers (albeit to a lesser extent). Trade would be substantially affected as non-tariff barriers kicked in. The impact of changes in tariffs is harder to judge as the Government has indicated in the past that, under a temporary scheme, 88% of imports by value would be eligible for zero-tariff access compared to 80% of imports which are currently tariff-free. Meanwhile, supply chains would be affected by any disruption at ports. While a likely sharp fall in sterling would help UK exporters, it would also raise import prices, pushing up businesses' costs and consumer price inflation, thereby hitting households' purchasing power. As well as limiting their investment, businesses would probably be more cautious on employment and pay, with negative repercussions for consumers. We expect policymakers would react by easing both fiscal and monetary policy.

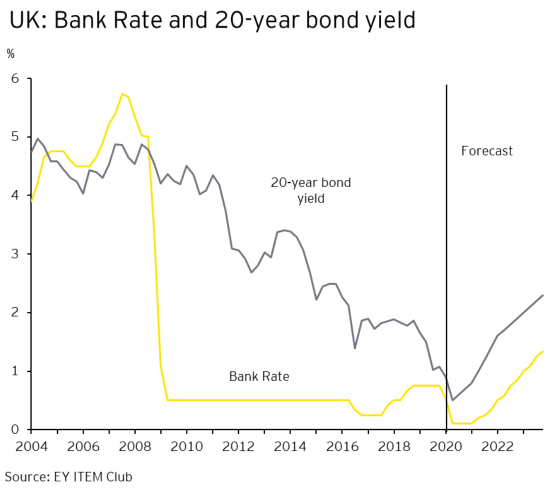
# Forecast in charts

## Fiscal policy



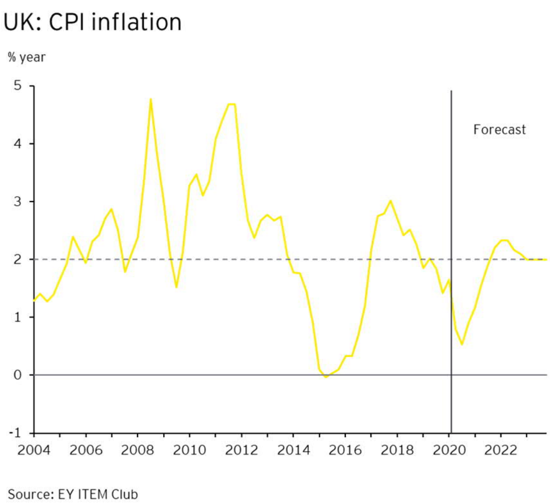

- Fiscal policy is playing a substantial role in aiming to limit the long-term damage to the economy from coronavirus.
- Cost of fiscal packages to support economy likely to see budget deficit (PSNBex) reach £190b (9.4% of GDP) in 2020/21.
- OBR observed of the March Budget for five-year period 2020/21 to 2024/25: “the Government has proposed the largest sustained fiscal loosening since the pre-election Budget of March 1992”.

## Monetary policy




- Bank of England set to keep interest rates at record low of 0.10% until well into 2021.
- We do not expect Bank of England to take interest rates any lower as bank is concerned about impact of negative interest rates on bank lending.
- If there is any further Bank of England stimulus, most likely to be in the form of more asset purchases, particularly gilts.

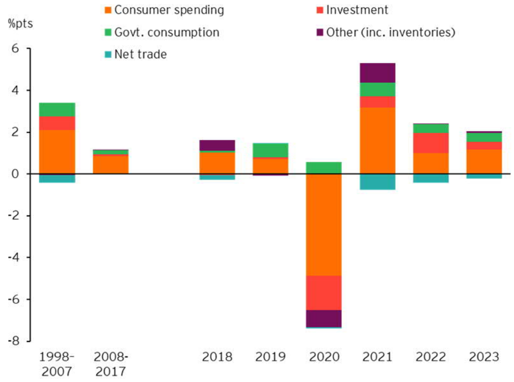
## Prices




- Consumer price index is seen falling back markedly from 1.5% in March over the coming months, which will provide much-needed help for consumers.
- Recent slump in oil prices and very weak economic activity could well see inflation fall as low as 0.5% over the summer despite the weakness of sterling.
- Inflation is expected to start edging up in latter months of 2020 and then heading towards 2% in 2021. Seen as averaging 1.7% in 2021 after 1.0% in 2020.

## Activity

UK: Contributions to GDP growth

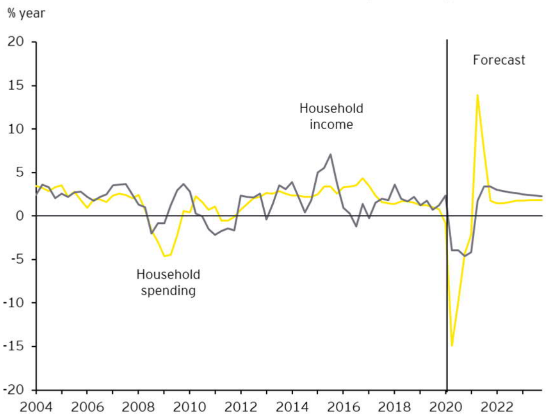



Source: EY ITEM Club

- GDP seen contracting 6.8% in 2020 as coronavirus takes a major toll on activity, particularly in Q2 when the economy is seen contracting around 13%. This follows expected 1.2% q/q contraction in Q1.
- Recovery seen getting underway in Q3 assuming coronavirus peaks during Q2 and the Government starts to relax some of the restrictions on people's movements and on business activity.
- GDP growth seen at 4.5% in 2021 but will not return to Q4 2019 size until Q4 2022.

## Consumer demand

UK: Real household income and spending

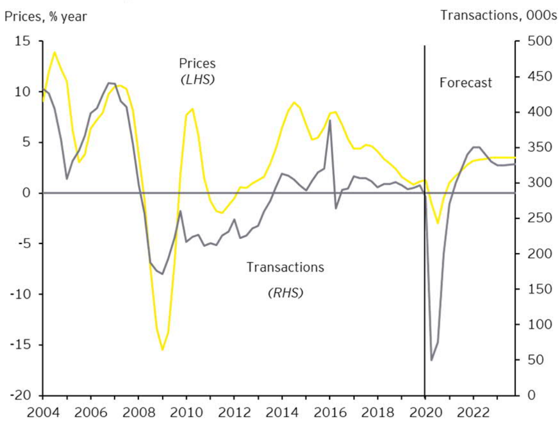



Source: EY ITEM Club

- Consumer spending will take a major hit from the lockdown as well as from sharply reduced confidence as people worry about their personal finances and jobs.
- Consumer spending seen contracting 7.5% over 2020 despite some pick-up anticipated in second half of the year.
- Consumer spending seen growing 4.9% in 2021, making up for a lot of the drop in 2020. However, likely to be some limiting impact from labour market not fully recovering from 2020 hit.

## Housing market

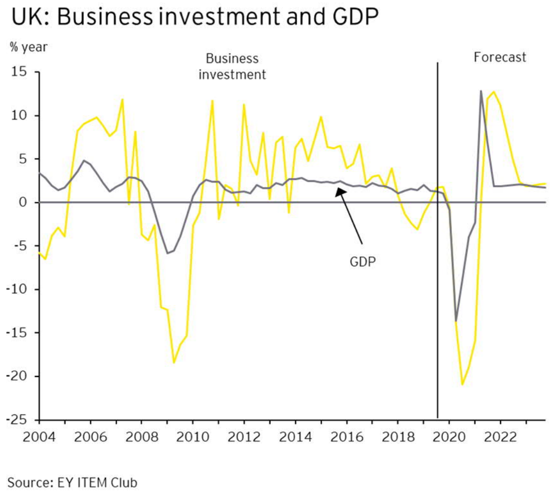
UK: House prices and transactions




Source: EY ITEM Club

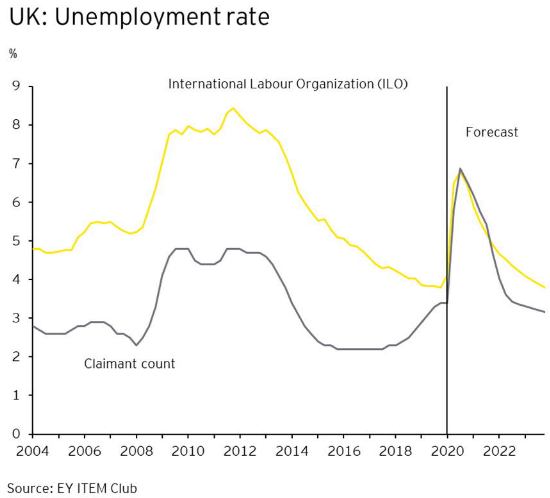
- Housing market made strong start to 2020 as was boosted by uncertainties and increased confidence after election.
- Housing market has been brought to a standstill by coronavirus impact. Likely to put downward pressure on prices.
- Once restrictions start to be lifted on people's movements, housing market activity should progressively pick up. Even so, the housing market looks unlikely to return to the levels seen at the start of 2020 for some time.

## Company sector



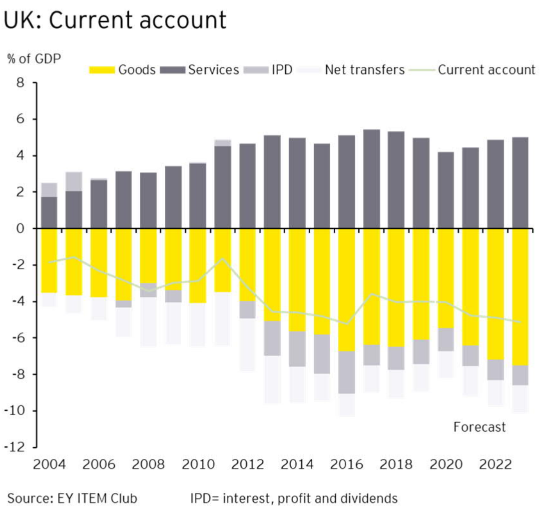

- Having been limited over past couple of years, it was hoped that business investment would receive a lift from reduced uncertainties after December general election and the UK leaving the EU with a deal on 31 January.
- However, impact of coronavirus on economy and businesses likely to weigh heavily on business investment in near term at least. The same applies to uncertainties over UK–EU relationship.
- Business investment seen down 13.6%.

## Labour market and wages




- The labour market is taking a substantial hit from the sharp weakening of economic activity and several businesses going under due to coronavirus, despite the Government's supportive measures.
- We suspect that the unemployment rate could rise as high as 6.8% in Q3 2020 from 4.0% in the three months to February.
- Earnings growth will also take a marked hit from the weakened jobs market. However, the labour market and earnings should see some recovery in 2021.

## Trade and the balance of payments




- Net trade essentially in balance in 2019 as exports rose by real 4.8% and imports up 4.6% but trade performance distorted by movements in non-monetary gold.
- Current account deficit little changed over 2019 compared to 2018. Q4 2019 saw the smallest deficit (£5.6b) since Q2 2011, due to a rare trade surplus reflecting major exports of non-monetary gold.
- Net trade expected to make slight negative contribution to GDP growth in 2020 and a larger one in 2021.

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EY ITEM Club is the only non-governmental economic forecasting group to use the HM Treasury's model of the UK economy. ITEM stands for Independent Treasury Economic Model. HM Treasury uses the UK Treasury model for its UK policy analysis and Industry Act forecasts for the Budget. EY ITEM Club's use of the model enables it to explore the implications and unpublished assumptions behind Government forecasts and policy measures.

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