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A snapshot of the outlook for the UK economy

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Summary

- **UK economy** is expected to contract by 7.2% in 2020, recovering in 2021 with GDP growth reaching 6.1%.
- Our analysis assumes an initial **10-week lockdown** starting at the end of March, followed by a period of continued social distancing restrictions until a vaccine is found at the start of 2021, with a resumption of normal activities shortly afterwards.
- Despite an unprecedented level of support on offer for workers, the rate of **unemployment** is expected to reach 11% this year, before gradually falling as the economy recovers after the end of the pandemic.
- Monetary policy is expected to remain supportive, with the headline policy **interest rate** unchanged at 0.1% at least until the end of 2021.
- The weak economic environment should see **inflation** stay below the Bank of England's target level, averaging 0.7% in 2020 and 0.9% in 2021.
- The **hospitality** industry could see a loss of 40% of output in 2020. Demand could remain weak throughout the year as the threat of reinfection keeps customers at bay.
- The cost of supporting the economy during the pandemic will be reflected in a sharp increase in **government borrowing**, with debt set to rise to nearly 96% of GDP according to the OBR.

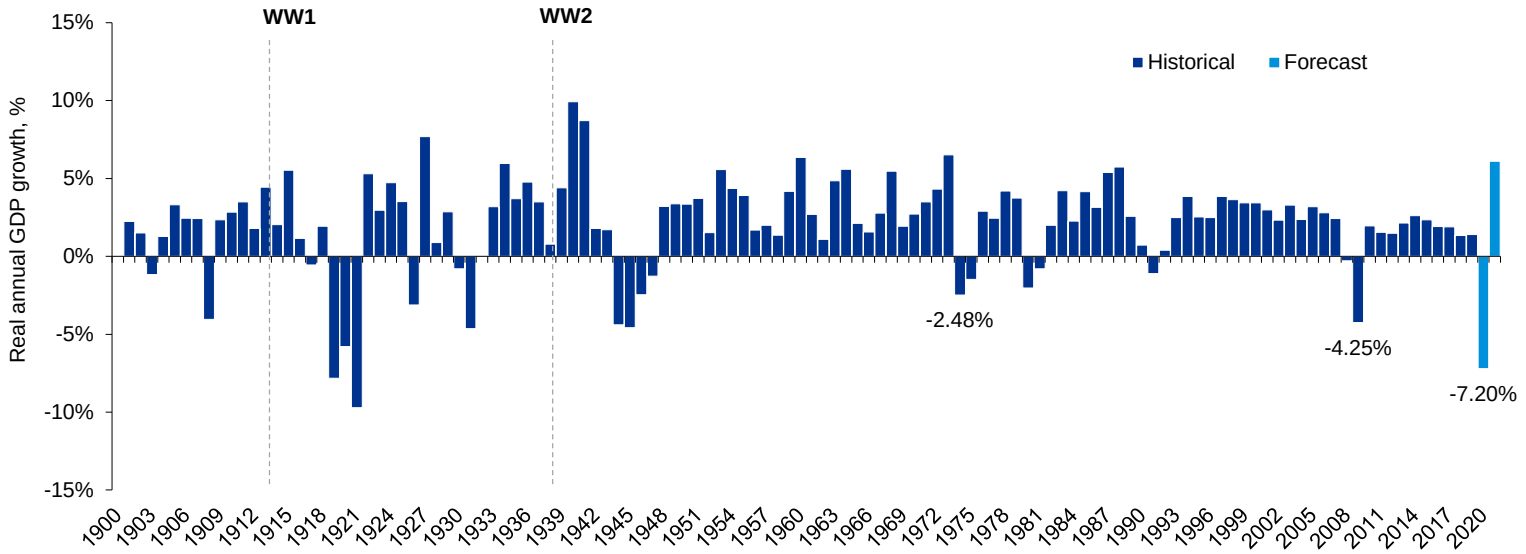
Our forecasts for the UK economy

	2019	2020	2021
GDP	1.4	-7.2	6.1
Consumer spending	1.4	-9.5	8.2
Investment	0.4	-12.6	6.8
Unemployment rate	3.8	11.0	9.4
Inflation	1.8	0.7	0.9
Base interest rate	0.75	0.1	0.1

Source: ONS, KPMG forecasts. Average % change on previous calendar year except for unemployment rate, which is average annual rate. Investment represents Gross Fixed Capital Formation, inflation measure used is the CPI and unemployment measure is LFS. Interest rate represents level at the end of calendar year.

- Our base case forecasts for 2020 see GDP contracting by just over 7% in 2020, before recovering in 2021. This reflects a sharp setback in investment and consumer spending, as well as exports, that is only partially offset by a significant increase in government spending.
- Our base case scenario assumes an initial 10-week lockdown starting at the end of March, followed by a period of continued social distancing restrictions until a vaccine is found at the start of next year, with a resumption of normal activities shortly afterwards.

Deepest recession since WW1

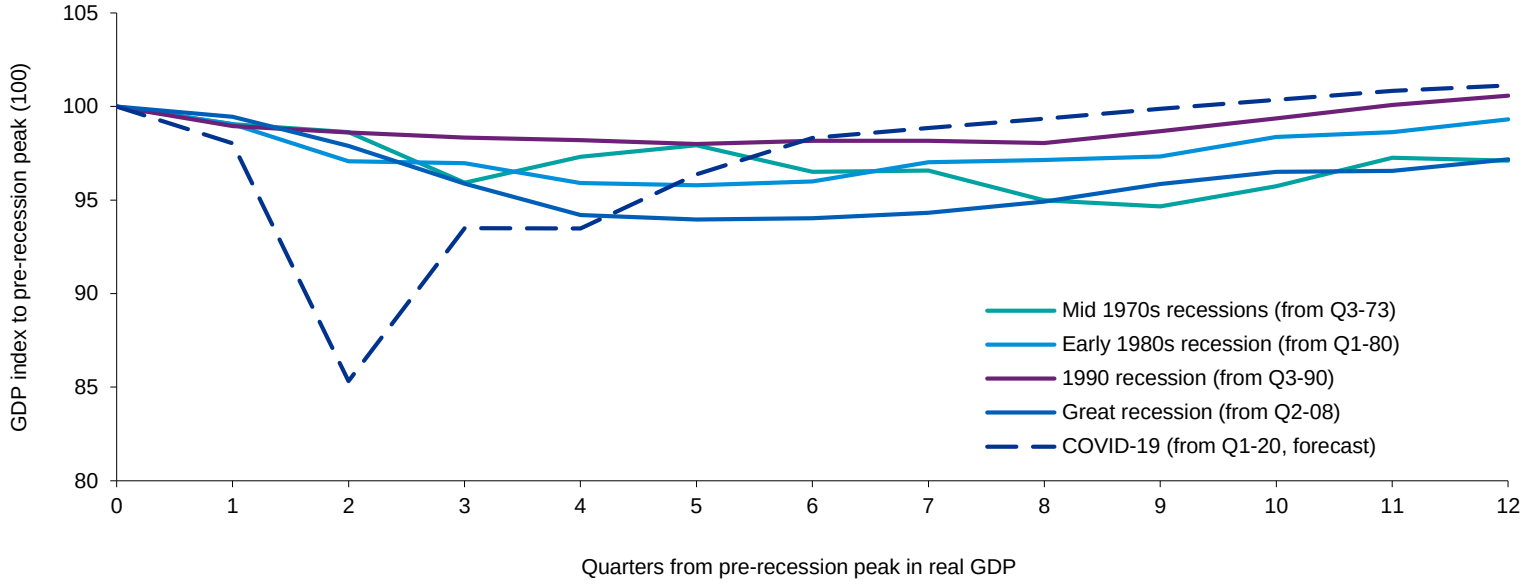


Source: ONS, KPMG analysis

- The current slowdown is unprecedented on a number of levels. One of them is the scale of contraction in output that is expected, due to the lockdown and continued social distancing measures that we anticipate will stay in place until a vaccine is found.
- The size of contraction of the UK economy this year is expected to be larger than in any period since the aftermath of the First World War.

W-shaped recession with a relatively fast recovery

COVID-19 economic recovery compared to past recessions

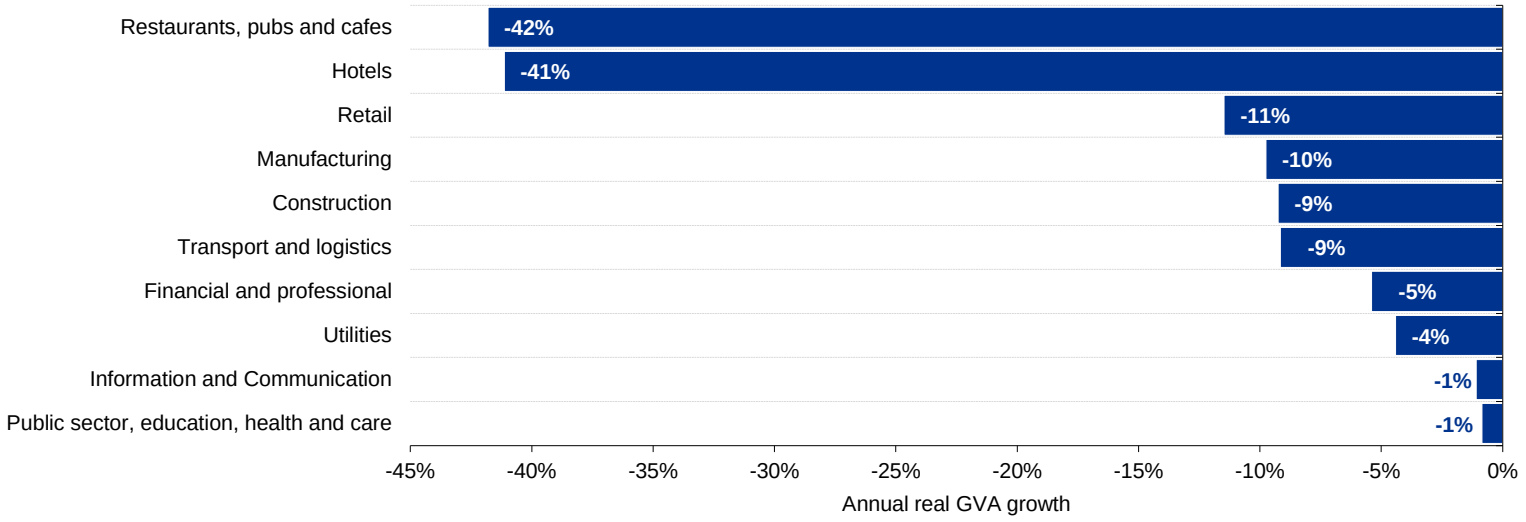


Source: ONS, KPMG analysis

— Despite the severe shock to the economy, output is expected to return to pre-crisis levels sooner than in previous recessions.

Hospitality to be the worst affected by the crisis

Forecast GVA growth in 2020 for selected sectors

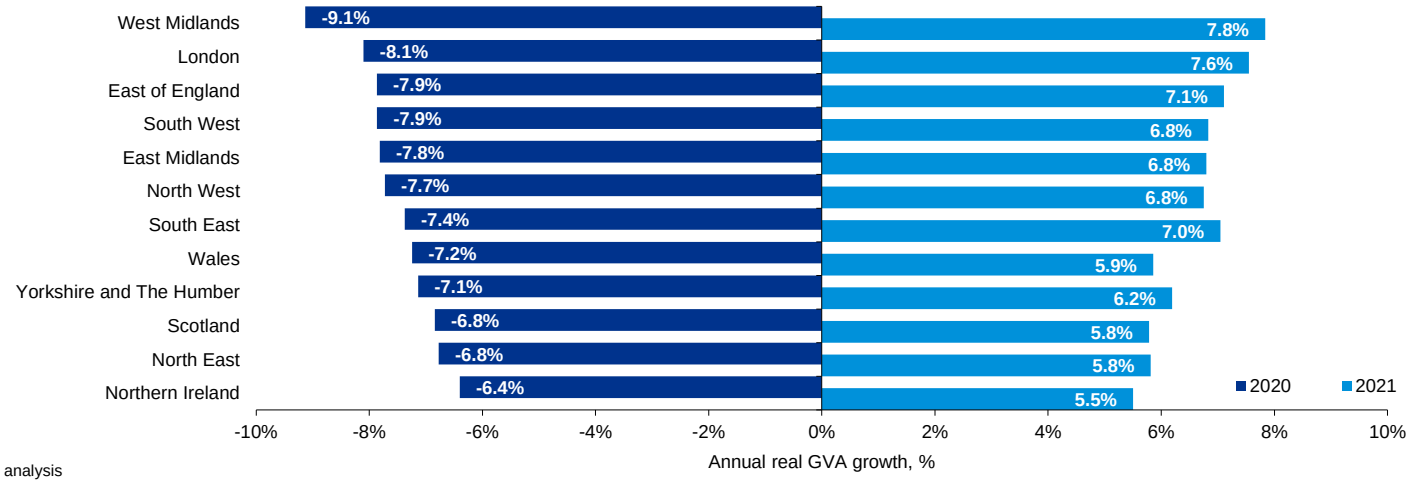


Source: ONS, KPMG analysis

- Curbs on social gatherings could see over 40% of output in **hotels** and **restaurants** lost this year. The hospitality industry will also find it harder to recover lost output next year, as cancelled travel plans and restaurant bookings will mostly be gone for good. By contrast, **manufacturing** and **construction** should see a stronger rebound this year and benefit more from back orders that can be filled once the lockdown is over.
- **Financial** and **professional services** could see more muted reductions in output, with the majority of staff working from home and focusing on servicing clients' more immediate needs.
- A surge in demand for home deliveries contrasts with the fall in travel this year, with the **transport and logistics** sector potentially contracting by 9% overall in 2020. Similarly, the sharp rise in online communications and virtual meetings will provide support for the **information and communication** services sector in the face of an overall fall in economic activity.

Northern Ireland's economy is least affected in the UK

Forecast of regional GVA growth in 2020 and 2021

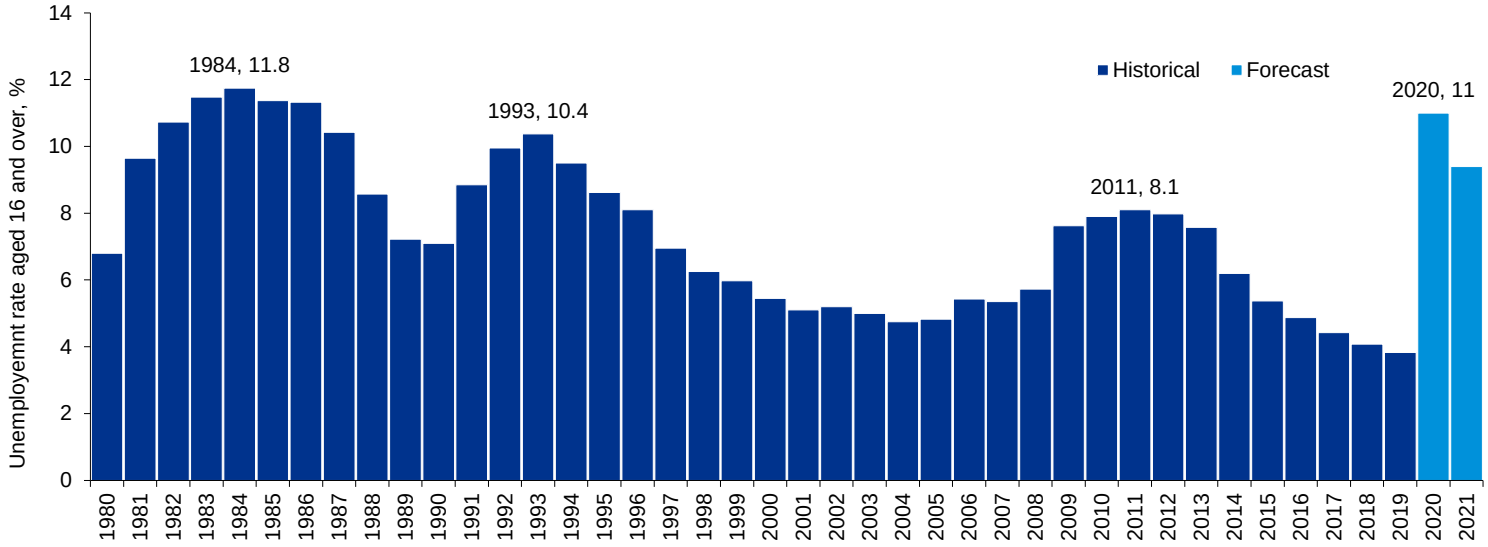


Source: ONS, KPMG analysis

- The region that will feel the biggest impact of the pandemic in 2020 could be the **West Midlands**; we forecast its economy will contract by just over 9%. This is because it is home to many automotive manufacturers; they make up 5% of the local economy. This sector faces a severe downturn as a result of supply-chain factors interrupting production and falling demand as consumers cut back spending.
- In **London**, we expect a decline of about 8% due to the high contribution of publishing, media production and advertising industries to the capital's economy. Together, these account for more than 7% of total output. This partially negates the stability provided by financial services, one of the least affected sectors.
- At the other end, we expect **Northern Ireland** to be the least affected region. We forecast the economy will contract by around 6.4% in 2020. The region hosts a large share of food manufacturing businesses, which continue to operate throughout the period of lockdown. It also has a strong presence of life science businesses and government employment, which leads to a lower overall impact on the Northern Irish economy.

Unemployment rate set to rise

Unemployment rate

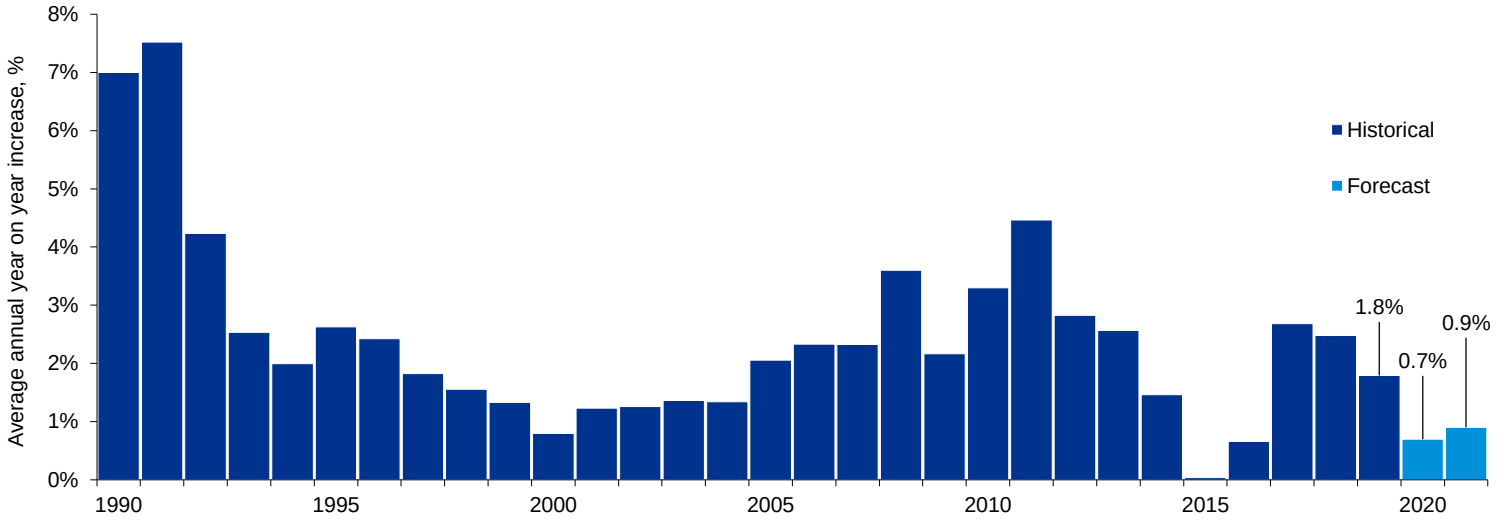


Source: ONS, KPMG analysis

- Despite the government's Job Retention Scheme, and the record low unemployment prior to the crisis, the unemployment rate could reach similar levels to earlier recessions, owing to the severity of the downturn.
- Latest data shows that 7.5 million people have been placed on furlough by their employers. We assumed that many furloughed workers will resume active employment very rapidly when that becomes possible, but as many as a million furloughed workers could face unemployment instead. Weaker demand and continued uncertainty will make companies reluctant to bring back employment to pre-lockdown levels.

Low levels of inflation as the economy recovers

Consumer Price Inflation

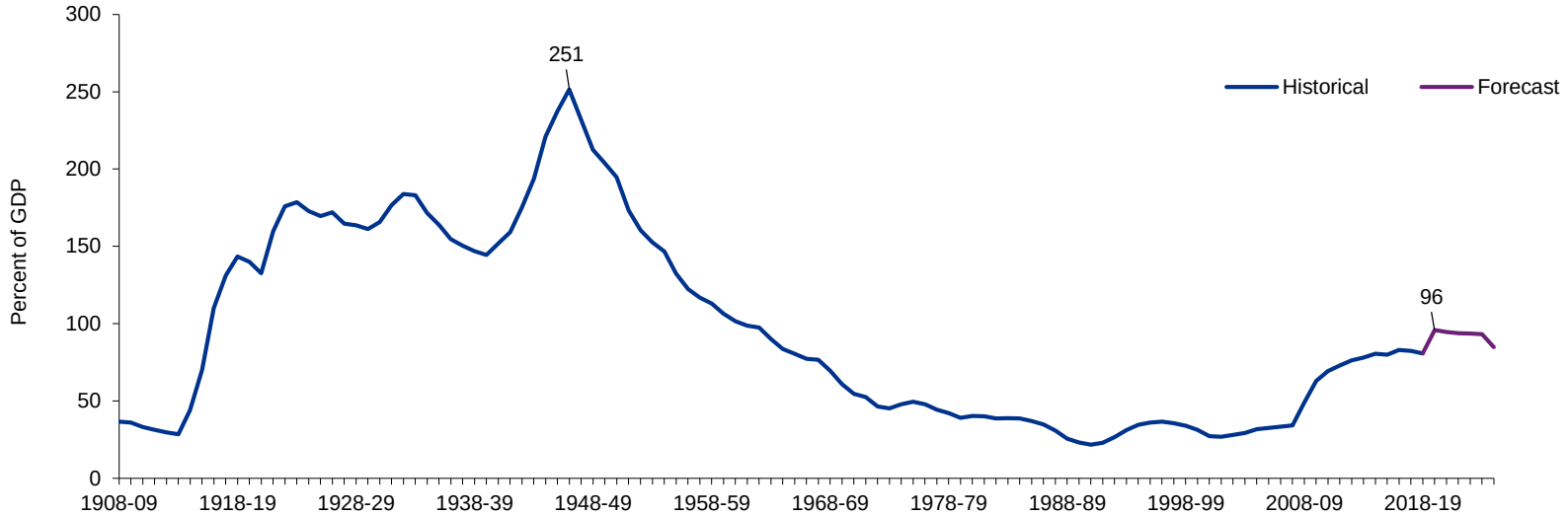


Source: ONS, KPMG analysis

- Despite the weaker pound and cuts in output production, inflation is expected to remain low this year and next, at less than half the Bank of England's 2% target on average. While the pandemic represents a shock to both the demand and supply capacity of the economy, in practice it is the shock to demand that is expected to dominate.
- Outside of a few select goods categories, we should see weaker price pressures throughout the next two years, with inflationary pressures remaining low while the job market slowly recovers.
- Consistent with moderate inflationary pressures and the need to support economic growth, the Bank of England's policy interest rate is expected to stay at 10 basis points throughout the next two years.

Debt will rise as the government increases spending

Historical ratio of UK government debt to GDP

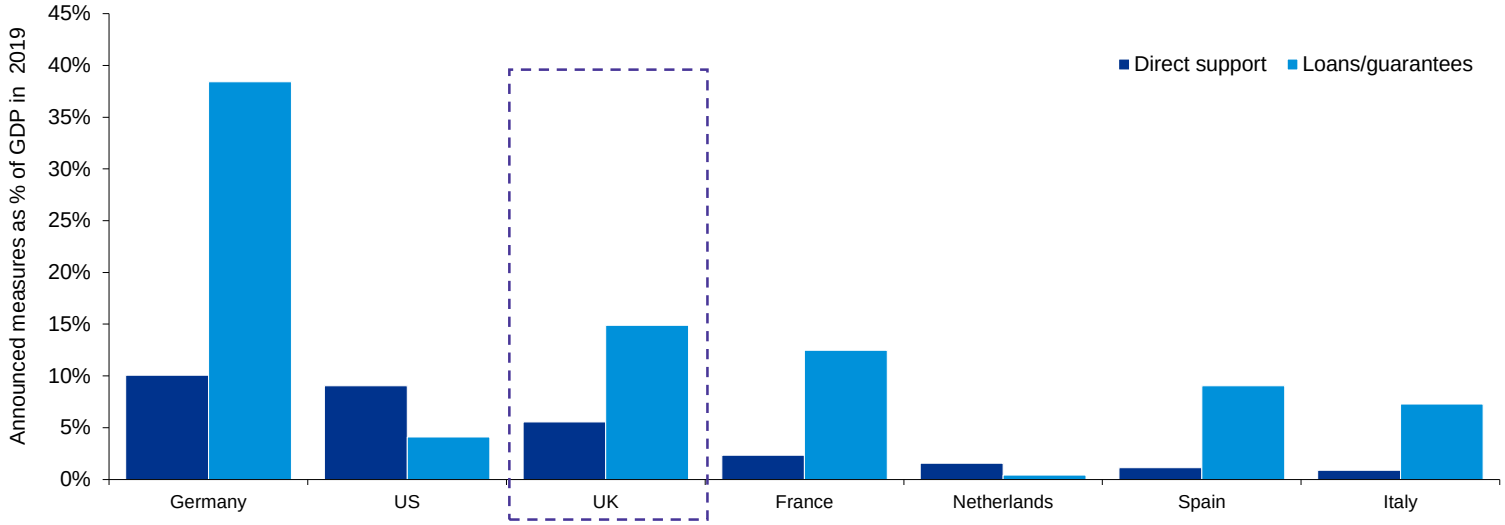


Source: ONS, Bank of England and OBR

- Estimates published by the OBR show that government debt could rise to 96% of GDP this year. This combines an £118bn increase in government net spending, a £17bn hit to revenues from additional measures to reduce and delay the burden of taxes, and a slowing economy as well as a lower level of GDP, which pushes the ratio to its highest level since the 1962-63 fiscal year. This could be an underestimate as the OBR's calculations do not cover the cost of loan guarantees for businesses for example.
- These figures indicate that the rising cost of government schemes to help Britain through the COVID recession will result in a budget deficit of nearly 15 percent of GDP in the current financial year. The OBR expects the government to borrow £298.4bn in 2020-21, up from £55bn at the time of chancellor Rishi Sunak's budget on March 11.
- However, a longer term perspective shows that the UK government's level of debt was far higher for most of the first half of the 20th century, when it rose as a result of two world wars. At its peak UK debt reached a record 251% of GDP in the aftermath of the Second World War.

Government policies around the world

Total direct support and loans/guarantees as a share of annual GDP



Source: Bruegel, OBR, Haver, KPMG analysis

- The UK is not alone in offering a substantial package of fiscal measures to support the economy during the period of lockdown. With large chunks of business activity suspended, governments have committed to providing unprecedented support to companies and households caught up in short-term financial stress, while central banks have delivered a range of liquidity measures at a large scale.
- Germany leads with almost 7% of GDP worth of direct stimulus from the central government, with additional initiatives by local governments not included in this figure. European countries have tended to favour larger guarantee pledges for business loans over direct commitments, although direct spending pledges can be still substantial.

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