UK FINANCE

MONTHLY ECONOMIC INSIGHT

July 2021

Written by:

Lee Hopley
Director,
Economic Insight and Research

Charles Cornes
Intern,
Data and Research

This month's economic bulletin has a business focus, reviewing the latest indicators on business confidence, trade performance and the outlook for investment – all of which will be important in driving the UK's recovery from the Covid-19 pandemic.

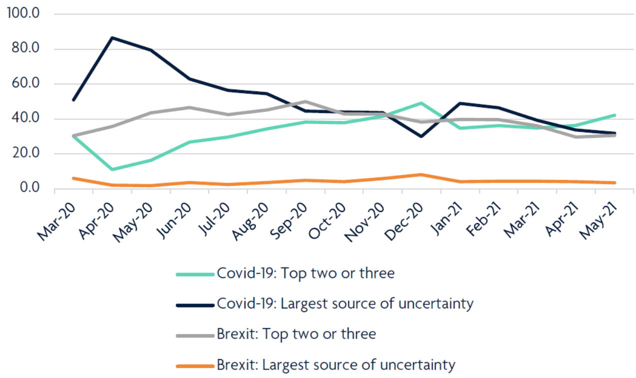
BUSINESS UNCERTAINTY WANING .. SLOWLY

A range of business surveys point to a recovery in confidence as the vaccine roll out continues apace and government restrictions are lifted. Recent PMI readings also point to activity rebounding across manufacturing and services and we expect to see this reflected in upcoming GDP figures, with recovery gaining momentum in the second quarter of 2021.

That said, uncertainty about the Covid-19 crisis and the impact of Brexit still lingers. The Decision maker panel survey (**Chart 1**) shows that while Covid-19 as a primary source of uncertainty has generally reduced across businesses since the start of the year, it remains one of the top two or three sources of uncertainty for many. The path of the virus has proved unpredictable, with new variants and potential concerns about it re-emerging over the winter months. The final step to unlocking the economy will provide a further boost to confidence, but the response of consumers, vaccine roll out in the rest of the world and management of costs deferred through the crisis are all likely to remain on the minds of businesses.

Brexit uncertainty has been largely unchanged throughout the pandemic apart from a temporary increase ahead of the end of the transition period at the end of last year. While the confidence-sapping effects of the UK's exit from the EU have diminished, for around a third of firms managing the new trading arrangements Brexit is still a top three source of uncertainty.

Chart 1: Brexit and Covid-19 as a source of uncertainty



Source: Decision maker panel

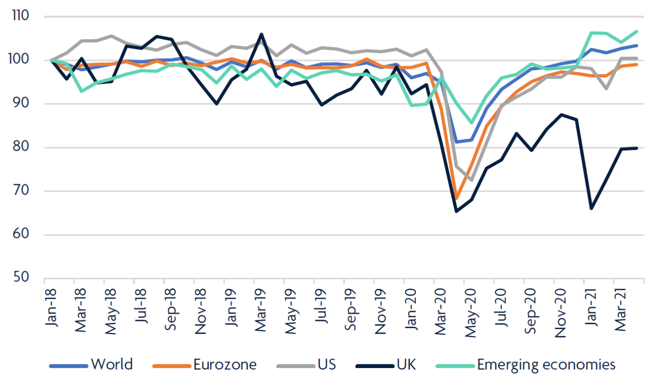
RECENT TRENDS IN EXPORTS

The jury is still out on the long-term impact of Brexit on the UK's trade performance, but the early signs are not encouraging. Trade flows globally were significantly disrupted through the Covid-19 crisis as businesses around the world faced restrictions on activity and adjusted to changes in consumer demand.

The hit to global exports was short-lived (**Chart 2**), with trade flows recovering after the initial shock at the beginning of last year – led by emerging market exporters. And the index of world exports has now surpassed pre-pandemic levels.

The UK's export performance has seen a comparatively bumpier ride over the past year – recovering from the Covid-19 shock more gradually than advanced economy counterparts and recording significant volatility at the turn of the year, as a consequence of stockpiling, subsequent adjustments to new trading rules as well as Covid-19 transit restrictions. However, we have seen some notable differences by commodity export in 2021 Q1. Widely reported concerns from the food and agricultural sector about export challenges are reflected in ONS data, with large quarter-on-quarter contractions in exports of food, beverages as well as chemicals to EU customers. It may take some time yet to ascertain whether businesses adapt and/or find alternative markets.

Chart 2: Index of merchandise exports, Jan 2018 = 100



Source: CPB World Trade Monitor

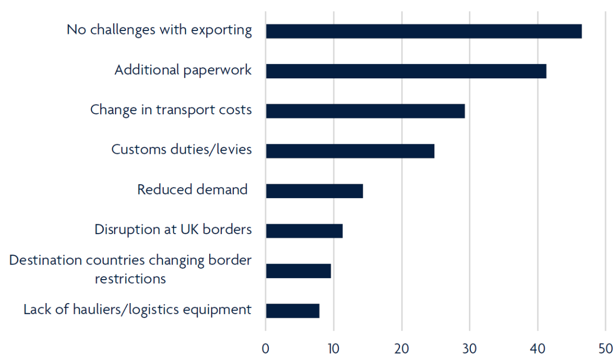
TRADE CHALLENGES PERSIST

The last wave of the ONS BICS survey suggests there are a number of export challenges that exporters will have to adapt to (**Chart 3**). The survey reports the response of businesses that have been active exporters in the past 12 months.

Just over half of respondents reported some challenges with exporting in the previous fortnight – a proportion that has been largely unchanged since the start of the year and varies little by business size. The most cited problem was additional paperwork required. This appears to be a particular issue for manufacturers (72 per cent noted this as a challenge) and wholesale and retail (58 per cent). Transportation costs and new custom duties and levies are also hindering exporters.

As for the cause of these disruptions, over half (53 per cent) attribute the problems to the end of the Brexit transition period and over one third point to a combination of Covid-19 and Brexit as the root of the challenges faced.

Chart 3: Export challenges experienced in the past two weeks, percentage of exporters



Source: ONS BICS

A LOT OF INVESTMENT GROUND TO BE MADE UP

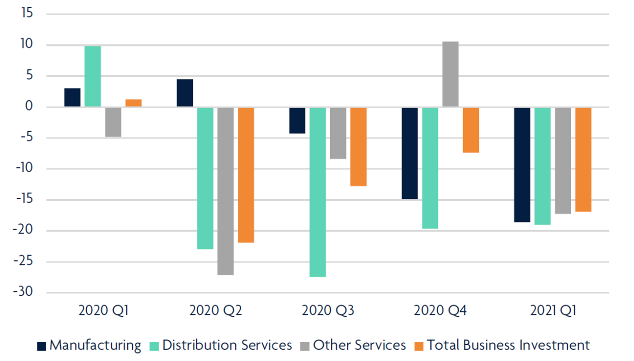
Elevated uncertainty, muted demand and pressure on cash have taken their toll on business investment over the past year. There was an immediate pull back on investment at the onset of the Covid-19 crisis, across all sectors (except manufacturing in 2020 Q2) and in every quarter since restrictions were introduced investment was lower than the same period a year ago (**Chart 4**). The pace of contraction across the whole economy eased at the end of last year, driven by other services – likely reflecting some necessary investment in systems and equipment to support new business models during the pandemic.

There was a further fall in investment in the first quarter of 2021, with an estimated decrease of 11 per cent. Manufacturing saw a particularly significant decline in business investment, with a decrease of 24 per cent from Q4 2020.

Investment recoveries tend to lag behind an upturn in output and sales. However, the Bank of England's Agents report provides some optimism about investment prospects. Investment intentions have been on the increase since April, though this is likely conditional on a recovery in demand and revenues. The super-deduction for investment announced in the March Budget also offers an incentive for businesses to accelerate investment plans. Technology advancements, such as digitisation, are also likely to drive investment. To that end, while business investment was a drag on overall GDP growth in the first quarter of this year, NIESR forecasts business investment to expand by nearly seven per cent this year and next.

P.S: Some new research from the Enterprise Research Centre[1] on business support and productivity though the pandemic indicates that firms in receipt of support through CBILS and BBLS government-backed loans were more likely to plan investments than those receiving no government support.

Chart 4: UK Business Investment by industry, % change from the previous year's quarter



Source: ONS

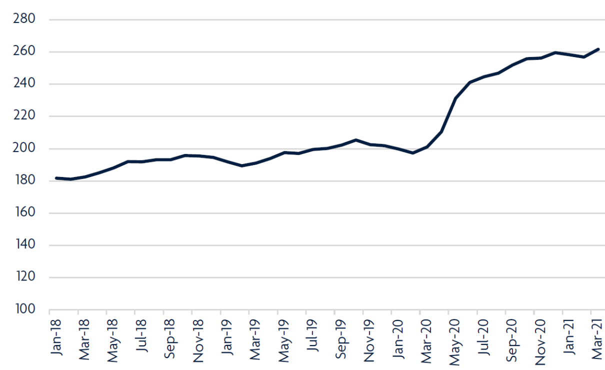
CASH DEPOSITS COULD SUPPORT INVESTMENT PLANS

Another factor which may support investment this year is the level of cash deposits currently held by SMEs. Our Business Finance Review[2] has been tracking the rise in SME deposits since the start of the pandemic.

Quarter-on-quarter increases were particularly robust in the second and third quarters of 2020, as businesses accessed government-supported loans but had yet to fully deploy them. Following the surge in SME deposits in the middle of last year, growth has continued, albeit at a more subdued pace (**Chart 5**).

Our data again aligns with trends reported in the SME Finance Monitor, which reported that SMEs held the equivalent of 34 per cent of turnover in credit balances - the highest seen to date in the survey in 2021 Q1. While businesses will face cashflow pressures restarting activity and many will see deferred rent and tax payments come due, as well as repayments on government-backed loans come due, the availability of cash deposits could also underpin an upturn in investment.

Chart 5: SME deposits



Source: UK Finance

[1] ERC (2021) Covid-19, business support and SME productivity in the UK https://www.enterpriseresearch.ac.uk/wp-content/uploads/2021/06/ERC-ResPap94-COVID-19-business-support-and-SME-productivity-JibrilRoperHart.pdf
[2] Business Finance review https://www.ukfinance.org.uk/data-and-research/data/business-finance/business-finance-review

ROUND UP

The latest GDP data for 2021 Q1 confirmed that the UK economy contracted by 1.6 per cent. Unsurprisingly given restrictions on businesses and individuals remained in place, household spending, services and investment were the main drags on growth.

With activity reopening the initial signs of recovery are encouraging. The PMI surveys have rebounded, businesses are hiring again and confidence about future output has returned. The latest ONS BICS survey continues to see a growing share of businesses trading and a declining proportion reporting that turnover is below normal. The proportion of employees on full or partial furlough also continues to drift down. With the government signalling that the final stage of unlocking will take place later this month, official data on growth should continue to strengthen in the coming quarters.

There are still some risks to this outlook. In the short term, government support for furlough and business rates holidays is tapering off, which could lead to transitional challenges for some businesses. And, as we have noted in this briefing, the contribution of net trade to future growth will require exporters to continue to work to overcome some of the current challenges with the transition to the new trading arrangements with the EU.

While near-term prospects for investment look reasonably positive, pre-pandemic levels of investment were widely seen as sub-optimal. Sustaining improved productivity and harnessing new technologies will require a step change in investment levels, for which businesses will need both cash and confidence.

Indicator	Period	Value	Change	2021 Forecast*
GDP	Q1 2021	-1.6%	↓	6.8%
CPIH inflation	May 2021	2.1%	↑	2.4%
Unemployment rate	Apr 2021	4.7%	↓	5.7%
Average earnings	Apr 2021	5.6%	↑	3.9%
Brent crude	Jun 2021	$69.73	↑	-
$ Exchange rate	Jun 2021	$1.40	↓	-
PSNB	May 2021	£24.3 bn	↓	£217.1 bn

Source: ONS, HM Treasury, Bank of England,