MONTHLY ECONOMIC INSIGHT

January 2022

We kick off the year with a look at how 2021 finished up ... more of a whimper than a bang, and what forecasters are expecting for the UK and wider global economy in 2022.

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A NOT-SO-HAPPY NEW YEAR

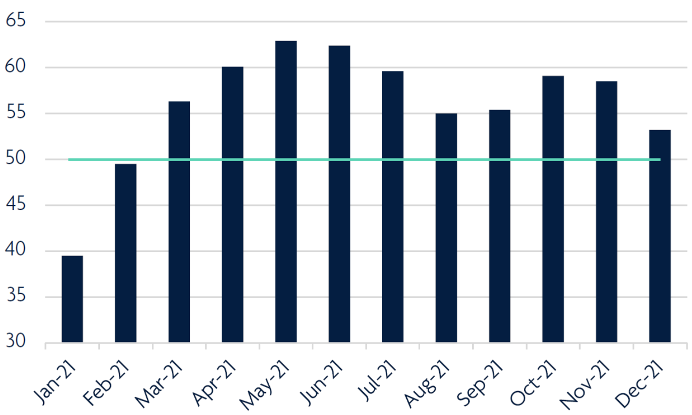
Economic reviews have been tracking the recovery of the UK economy following the lifting of public health restrictions over the past few quarters. With activity restarting from last spring, the economy had posted two solid quarters of growth and GDP was closing in on pre-pandemic levels, with that gap predicted to be eliminated at the start of this year.

So far so good, and the first couple of months of the final quarter of 2021 suggested that trajectory remained on track, with solid gains in private sector activity and some strength in consumer spending as seen in the ONS retail sales data and UK Finance's card expenditure statistics. However, the acceleration in inflation, and energy costs in particular, exerted some pressure on household budgets leading to a wobble in consumer confidence in relation to the outlook for household finances.

However, Covid-19 has proven to be unpredictable over the past two years and the emergence of the new Omicron variant at the end of last year brought renewed concerns about the path of the pandemic. The very rapid spread of the new Covid-19 variant saw the reintroduction of some limited public health measures but stopped well short of the restrictions on activity seen earlier in the year. Nevertheless, individuals appeared to take a more cautious approach to their activity in the run up to Christmas, either as a voluntary measure or due to the need for self-isolation.

While it will be a few months before the full impact of the new variant and households' responses to it become clear in the data, there are some indications that Omicron appears to have applied the brake to activity at the end of last year. Footfall on the high street was down in the run up to Christmas and consumer confidence continued to be more subdued compared with that seen earlier in the summer.

Chart 1: Services PMI, 50 = no change



Source: IHS Markit

As a result, **Chart 1** shows, activity in the service sector dropped back in December with the services PMI recording a ten-month low, with respondents reporting a negative impact on consumer demand from new Covid-19 measures, some travel restrictions and an increase in business uncertainty. This trend was not confined to the UK, with a similar fall in service sector activity seen across major European economies in December.

While this further disruption to activity will be unwelcome for consumer-facing businesses, the overall impact on the economy is not expected to be as severe as that seen earlier in the year. Not least because businesses and individuals have adjusted to the virus and various public health measures. That said, the UK economy goes into 2022 with somewhat less momentum than hoped for.

WHAT'S IN STORE IN 2022?

While the recent Covid-19 developments will likely delay the UK economy's return to pre-pandemic levels, so far at least, it does not look like it will put growth into reverse.

The average independent forecast for UK GDP growth in 2022, as reported by HM Treasury, was 4.7 per cent in December, with household consumption continuing to be the main driving force this year. It is important to note that this recovery is likely to be uneven across both industry sectors and regions. Factored into those forecasts will be the recovery challenges which emerged last year and are expected to persist into 2022 – namely inflationary pressures and supply chain constraints.

With CPIH inflation rising sharply to 4.6 per cent in November last year and predicted to accelerate further through spring of this year, there will be a real squeeze on household incomes this year. While there will be a boost to the national minimum wage in April, private sector pay settlements are expected to fall behind price increases. In addition, many individuals will also see higher National Insurance contributions from April, and the increased employer contribution may be another factor holding down pay rises. However, the upside for the consumer outlook is the relatively positive prospects for the labour market. Fears that the end of furlough would prompt a wave of job losses do not show signs of materialising.

The second major challenge built into this year's forecast is persistent supply chain bottlenecks, which contributed to some of the slowdown in growth during the autumn. The reopening of economies around the world brought a rebound in demand that supply failed to match, together with shortages of shipping containers and port congestion. This has led to shortages in materials from electronic components to PVC (used in vinyl records). We've seen the impact in the survey data – including extended lead times, reduced orders and rising prices. Economists expect these challenges to unwind, but not swiftly. New production capacity will take time to come on stream and Covid-19 related restrictions will see some persistence of supply tightness. A recent CIPS survey of its supply chain managers confirms that business expect likewise, with more than seven in ten UK managers expecting supply chain disruptions to last for six months or more.

The next step in the UK's Brexit journey could also add to these frictions. From the beginning of this year EU imports will face increased administration and checks that had previously been delayed. Depending on the preparedness of border controls and businesses, this may well further add to supply-side issues as exporters and importers navigate the new paperwork.

FASTEST GROWING ECONOMY IN THE G7?

The shape of the recovery in other developed economies looks much like the forecast for the UK (**Chart 2**). The OECD expects global growth to ease from 5.6 per cent in 2021 to 4.5 per cent this year as the post-pandemic bounce fades in developed economies and support from monetary and fiscal stimuli is tapered. Employment rates are also expected to return to pre-pandemic levels by the end of 2022.

OECD forecasts also note that supply chain bottlenecks, labour shortages and rising prices, prevalent in the UK, are also contributing to a loss in growth momentum across all developed economies going into 2022. While inflationary pressures globally are expected to ease, upside risks remain. The Bank of England has already responded by raising Bank Rate in December and the US Federal Reserve and European Central Bank are tapering asset purchases. In the US, the Fed policy rate is also expected to be gradually increased through this year.

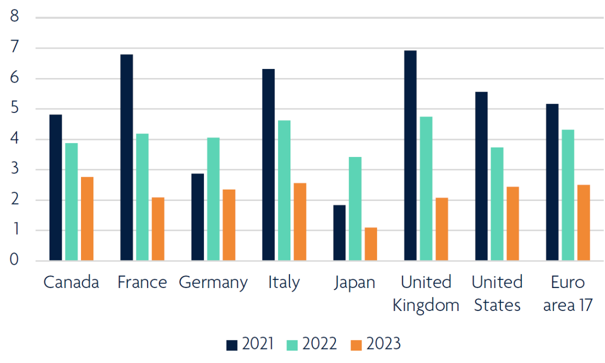
While the unprecedented level of support that governments' have provided throughout the pandemic has put pressure on public finances, the recovery job is not yet done. As we have seen with the Omicron variant, governments, including in the UK, will need to re-orient spending towards rebuilding resilience in healthcare, education and retraining, in addition to commitments made on infrastructure and the move to net zero.

Additional actions will also be required on ensuring that the high vaccination rates seen in developed economies can be replicated in lower income economies to minimise risks of new variants and to avoid exacerbating global growth imbalances.

Aside from economic risks and challenges in the year ahead, politics will continue to the 'interesting' US midterms, and the French presidential elections later this year.

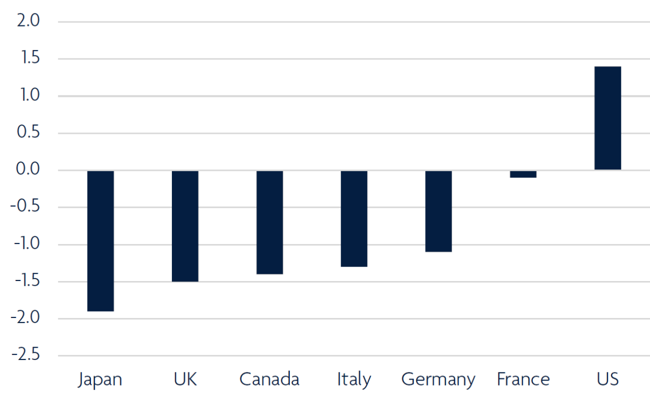
Note: While ***Chart 2*** *does point to a more rapid expansion in UK GDP than other G7 economies this year, that's not quite the full picture. The UK economy is largely facing the same growing pains as other developed economies as the world recovers from the pandemic and as* ***chart 3*** *illustrates, as of 2021 Q3, the UK was far from leading the pack on closing in on pre-pandemic levels of output.*

Chart 2: Annual percentage change in GDP



Source: OECD

Chart 3: Percentage change in GDP 2021 Q3 compared with pre-Covid-19 (2019 Q4)



Source: ONS

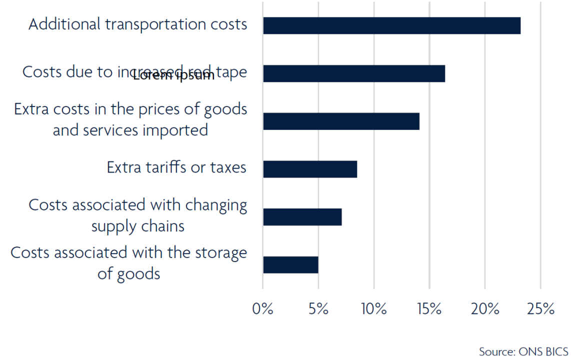
A WORD ON BREXIT...

The UK enters 2022 with a new phase of Brexit customs rules and regulations. There has been a phased introduction of new trading arrangements since the UK formally left the EU in January 2020. Following the end of the transition period, businesses were required to adjust to some significant changes to trading activity during 2021, including new import/export declarations, the introduction of tariffs on goods not originating in the UK or EU and new administrative procedures to move goods between Great Britain and Northern Ireland.

For many businesses, as reported by the ONS BICS (**Chart 4**), this has not been a hassle-free adjustment.

The latest survey wave suggests that around a third of the businesses (with over nine employees) can point to additional costs incurred as a result of the end of the transition period, with additional transport costs and red tape most commonly cited.

Chart 4: Percentage of businesses reporting extra costs due to the end of the EU transition period



Over the course of this year other changes at the GB-EU will be phased in, including full customs controls at the border and new rules for agricultural products. As for consumers, mobile roaming charges will return, and a new visa waiver fee will apply to UK travellers. The extent to which business can either accommodate the administration procedures or adjust supply chains will have a bearing on the persistence of supply chain frictions and the contribution of net trade to growth this year.

ROUND UP

It's not quite been the start to 2022 that we wanted, but neither are we far off track, even with the new Omicron variant. Nevertheless, the UK and global economy continue to face a range of risks and challenges to growth in the year ahead.

On the upside, high vaccination rates and the responsiveness of businesses and consumers to the uncertainty of the past two years does offer some greater resilience going into year three of the pandemic than was the case a year ago. The central forecast is that output recovery will chug along this year and labour market prospects look better now than at any point during the pandemic.

In addition to these broad developments, the team at UK Finance will also be keeping track of other finance-related indicators over the course of this year. These will include how consumer payment behaviour will continue to evolve with the use of online purchasing, contactless payments and mobile banking. On the business side, we'll be monitoring developments across both business lending and progress on repayments of government-backed loans. Readers can keep up to date with these in our **quarterly Finance Reviews**.

Indicator	Period	Value	Change	2022 Forecast*
GDP	Q3 2021	1.3%	↓	4.7%
CPIH inflation	Nov 2021	4.6%	↑	3.1%
Unemployment rate	Oct 2021	4.2%	↓	4.3%
Average earnings	Oct 2021	4.9%	↓	4.0%
Brent crude	Dec 2021	$77.78	↓	-
$ Exchange rate	Dec 2021	$1.33	↓	-
PSNB	Nov 2021	£17.4 bn	↑	£100.6 bn