MONTHLY ECONOMIC INSIGHT

October 2021

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This month's Economic Review looks at how the economy and public finances are shaping up ahead of the government's Budget and Spending Review announcement later in the month. We'll review the commitments already made and some of the trade-offs the Chancellor will face as he considers tax and spend priorities for the rest of this parliament.

FORECAST UPGRADES ON THE CARDS....SORT OF

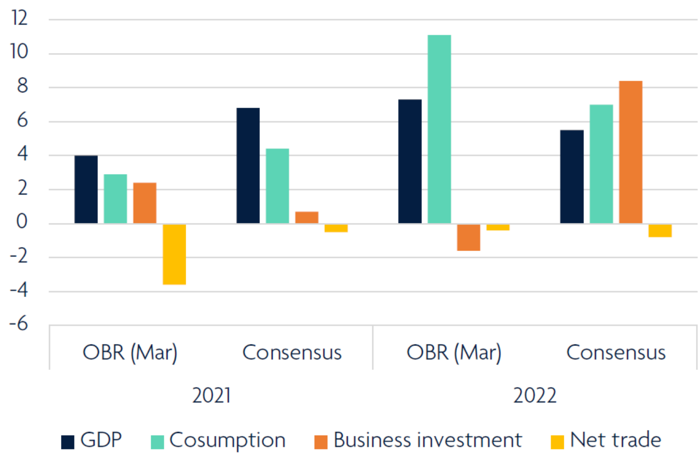
The backdrop to this month's Budget statement from the Chancellor has improved materially compared with the situation in March. The successful vaccine rollout has now reached the vast majority of the adult population, allowing the economy to almost fully reopen across the UK. GDP growth rebounded in the second quarter to an upwardly revised 5.5 per cent, driven in large part by the lifting of restrictions supporting a strong return to growth across service sectors and buoyant consumer spending.

As noted in previous **Economic Insights**, economic forecasters have been pushing up their GDP projections for 2021 and the Office for Budget Responsibility (OBR) is set to do likewise when it publishes its updated economic and fiscal outlook alongside the Budget.

Chart 1 shows where the OBR's growth expectations stood back in March, compared with the latest consensus view of independent forecasters published in September. Across most components of GDP, growth is expected to come in stronger than that forecast by the OBR earlier in the year. GDP is predicted to expand by nearly seven per cent this year, boosted by a 4.4 per cent increase in private consumption.

However, any forecast upgrades will likely reflect the timing of the recovery. Stronger growth this year should lead to a modest downward revision to the 2022 growth outlook as the pace of recovery normalises next year.

Chart 1: Percentage annual change



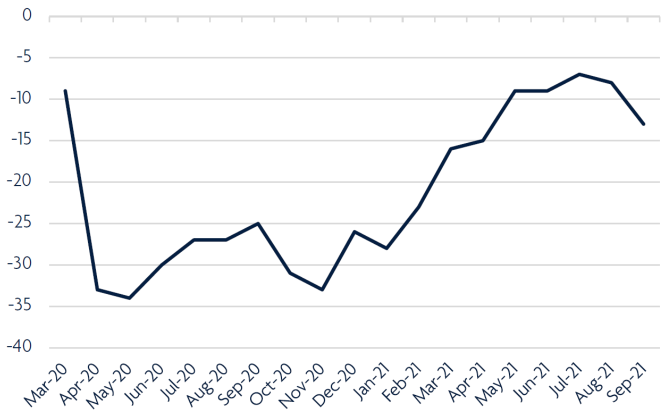
Source: HM Treasury

LIGHTS FLICKERING ON THE RECOVERY?

However, we may have seen the last of the forecast upgrades for now as the UK and global economy has hit some headwinds. The reopening of economies in many parts of the world has run into challenges on the supply side. Widely reported supply chain bottlenecks, skills shortages and a lack of transit capacity are constraining production – as seen in the UK manufacturing PMI hitting a seven-month low in September – and rising commodity and consumer prices. The UK is feeling some of these challenges more acutely as it manages its post-Brexit transition.

These developments are making their presence felt in business and consumer confidence surveys. September's index from GfK (*Chart 2*) saw consumer confidence take a backward step with all components of the index recording falls. Rising prices, particularly energy, signs that the recovery slowed over the summer and potential concerns about labour market developments following the end of furlough (more on that in a moment) are weighing on sentiment – and this was even before the country started panic buying petrol.

Chart 2: Consumer confidence index



Source: GfK consumer confidence in

And a recent survey from the Institute of Directors reported a drop in business confidence to levels not seen since February, primarily in response to rising costs.

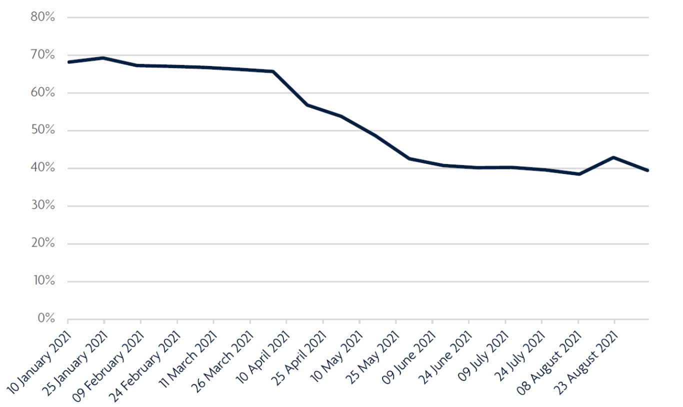
The question is how persistent these supply chain disruptions will prove to be. If they linger into next year it could mean that inflationary pressures prove not to be as transitory as many economists believed a few months back. It could also sap businesses' appetite to invest and consumers' ability to spend, leaving the recovery somewhat more fragile in the coming quarters.

THE END OF FURLOUGH

The largest element of support by government through the pandemic was through the Coronavirus Job Retention Scheme (CJRS). As of August, the cost of the scheme had run to nearly £70 billion. It is judged as being successful in maintaining links between employers and employees as businesses have been closed or operating under restrictions, while also offering some protection for household incomes. Labour market statistics bear this out with a much lower rise in overall unemployment through the pandemic than had initially been predicted.

With the economy largely reopen, the CJRS formally closed at the end of September. However, through the summer, as restrictions were lifted, numbers still furloughed had not dropped as quickly as some had anticipated – a point noted by the MPC in the minutes of its September meeting. "The number of full and part-time furloughed jobs has continued to decline, but, on the basis of the most recent reported number of 1.7 million in July, to a materially lesser degree than estimated in the August Report."

Chart 3: Proportion of furloughed employees on 'full furlough'



Source: ONS BICS

With the furlough scheme offering employers flexibility, a majority of those receiving furlough support are now working some hours, but the proportion of people fully furloughed has flatlined since May, according to the ONS BICS survey (*Chart 3*).

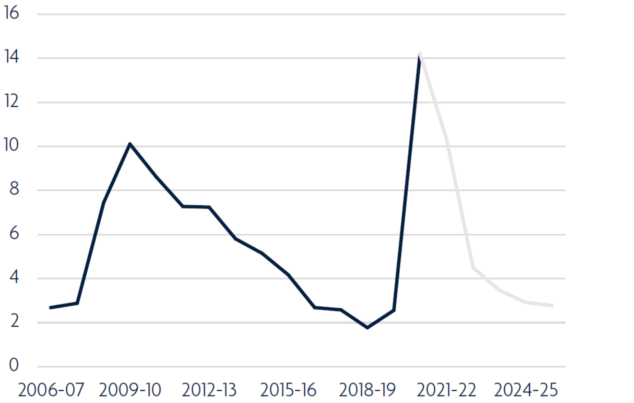
What will happen now is a key source of uncertainty for policy makers. While vacancies are running at record levels, there is a mismatch between industries where furlough was still in play in September and those seeing strong vacancy growth in recent months. In addition, the current uncertainties facing businesses may also lead some to delay recruitment activity. The extent to which those that have now left furlough will return to their employers or be absorbed into the labour market will be seen in the unemployment and inactivity indicators in the coming months.

PUBLIC FINANCES IN THE SPOTLIGHT

Turning to the upcoming Budget and Spending Review – rarely stress-free events for Chancellors, but this one has the potential to be a particularly tricky balancing act – sustaining the recovery, managing the public finances and funding longer-term government policy priorities are likely to be on the agenda.

Chart 4 shows the OBR's forecasts for public sector net borrowing (PSNB) at the time of the last Budget in March. The deficit ballooned in FY 2020-21 as government (national and devolved) funded some 50 schemes to support businesses and individuals through the pandemic, and tax receipts fell sharply. The latest ONS estimates put borrowing in the year at over £325 billion or 15.5 per cent of GDP.

Chart 4: Public sector net borrowing as a percentage of GDP



Source: : Office for Budget Responsibility

As already noted, one of the largest elements of this additional spend (CJRS) has come to an end, in addition the stamp duty holiday concluded at the same time and the universal credit uplift will also shortly finish. This will see public spending fall in the second half of this financial year. The OBR had expected borrowing to fall to around ten per cent of GDP in 2021-22, but the latest public finance statistics and forecasts suggest a somewhat better outturn. Borrowing to August was around a quarter lower than the OBR's March predictions; a bit of good news for the Chancellor ahead of the Budget and Spending Review. Nevertheless, HM Treasury is unlikely to see this as a license to spend given that borrowing numbers, while better, are still massive and it's likely any wiggle room would be short-lived.

In terms of addressing the public finances, we know a bit about this already. The March budget announced a number of future tax increases, such as rises in corporation tax and the freezing of personal tax allowances. And, since then, we have had statements on funding health and social care through a 1.25 percentage point increase in NICs and a temporary suspension of the triple lock on state pensions. In addition, the Chancellor may also bring forward (another) new set of fiscal rules; a commitment not to borrow for day-to-day spending was referenced in the spring budget.

On the spending side, again large commitments to capital investment in the rest of this parliament were made back in March, but there is likely to be something of a bunfight on how the departmental spending pie is cut, with departments such as health, education and work and pension no doubt making the case for a bigger slice to aid with post-Covid-19 recovery.

There are some known unknowns – the Chancellor, facing pressure from the opposition and some in his own party to respond to the pressure facing households this winter from rising prices and fuel costs, may use some of the limited room for manoeuvre to provide greater temporary and targeted support. Then there's the 'levelling-up' plan, it's got a new Secretary of State and detail is expected later in the year, but presumably this will also have a price tag, with a potential down payment made in the Spending Review.

ROUND UP

After what feels like the longest 18 months, the UK is closing in on pre-pandemic levels of output as the economy has reopened. A lot of things could have been done differently – that's not for this briefing – and a lot has gone right. The number of business failures has thus far been minimised (the rapid deployment of government-backed loans through the finance sector deserves a mention here) and furlough support has proved its worth by limiting job losses through the crisis. Fears that the pandemic would lead to significant long-term scarring in the economy have eased.

As discussed, new pressures have surfaced. The rise in demand following the end of restrictions in many parts of the world have not been met with an accompanying expansion of supply, generating supply chain disruptions and inflationary pressures. The impact of these pressures will continue to be uneven across households. The persistence of them will determine the evolution of the recovery into 2022 and any shift in policy from, for example, the Bank of England.

Indicator	Period	Value	Change	2021 Forecast*
GDP	Q2 2021	5.5%	↑	6.8%
CPIH inflation	Aug 2021	3.0%	↑	3.4%
Unemployment rate	Jul 2021	4.6%	↓	5.2%
Average earnings	Jul 2021	8.3%	↓	4.7%
Brent crude	Aug 2021	$70.61	↑	-
$ Exchange rate	Sept 2021	$1.37	↓	-
PSNB	Jul 2021	£10.4 bn	↑	£203.5 bn

Source: ONS, HM Treasury, Bank of England,