UNITED KINGDOM

ANOTHER CONTRACTION IN Q4, BEFORE THE DEFINITIVE RECOVERY?

The record fall in UK GDP in the second quarter gave way to unprecedented growth in the third, and the news that an effective vaccine against Covid-19 will soon be widely available suggests that the economy could start its definitive recovery in 2021. However, the UK is not out of the woods yet. Given that a second national lockdown was introduced in England in November, there is little doubt that economic activity will drop again in the fourth quarter. Moreover, the strength of the recovery is, because of Brexit, more uncertain than elsewhere. This not only because of the UK's decision to leave the EU's single market and customs union, but also due to continued uncertainty over whether a free-trade agreement will be found.

According to the initial estimate from the Office for National Statistics (ONS), the UK's GDP bounced back in the third quarter, growing by 15.5%. This strong rebound, which followed a fall of 22% in the first half, was driven by the reopening of the economy after the first lockdown – bars and restaurants, for instance, had to wait until early July before reopening their doors.

THE ECONOMY HAS FALLEN A LONG WAY BEHIND

Despite this record growth in Q3, UK GDP was still nearly 10% lower than it was at the end of 2019. Although Spain is in a similar position, in the USA, France, Germany and Italy, GDP has recovered to "only" 5% below its level back then (see chart 2). One of the explanations for this gap is the significant collapse in household consumption. While it has fallen by around 2% in France and 3% in the USA, in the UK it is down more than 12% in real terms since the end of 2019. In its latest *Economic Outlook*, published in December, the OECD forecasts that the fall in private consumption will be twice as deep in the UK as it will be in France or the Euro Zone as a whole.

In addition, the recovery has shown signs of running out of steam since the end of the summer. Monthly figures from the ONS showed that GDP grew by only 1.1% in September. On top of this, a fresh drop in GDP looks highly likely in the final quarter of 2020. This is because the government responded to a deterioration in the health situation by introducing a national lockdown across England from 5 November to 2 December. After this ended, England returned to a tiered system of restrictions that is stricter than the one that was introduced in October. In the highest tier ("Very High"), household mixing is forbidden indoors and only allowed in outdoor public spaces for groups of six people maximum; in addition, bars, restaurants and hotels are not closed, except for sales by takeaway, click-and-collect, drive-through or delivery services.

That said, the adverse economic impact of this second lockdown will surely be less severe than the first. One reason is that it was shorter and less restrictive. Another is that the starting point for the economy was much lower than it was in the first quarter. As a result, BNP Paribas expects that GDP will fall by 'only' 3.7% in the final quarter.

In addition, fears of a sharp rise in unemployment at the end of the year have dissipated somewhat. Admittedly, those businesses forced to reduce, or indeed stop, their activity are certainly facing increased difficulties. However, the government has also chosen to reintroduce its Coronavirus Job Retention furlough scheme (CJRS) until March 2021. This programme has already proved its worth. Although the unemployment rate has increased since the beginning of the crisis, the rise has been limited to less than a percentage point. In October the unemployment rate was 4.8%. The CJRS had been due to end in October, to be replaced by a less generous scheme. This led the Office for Budget Responsibility (OBR) to predict a rise in the unemployment rate to over 10% by the end of the year. Since the announcement of the extension, the OBR has revised its forecasts, and now expects unemployment to peak at 7.5% in the second quarter of 2021.

GROWTH AND INFLATION (%)

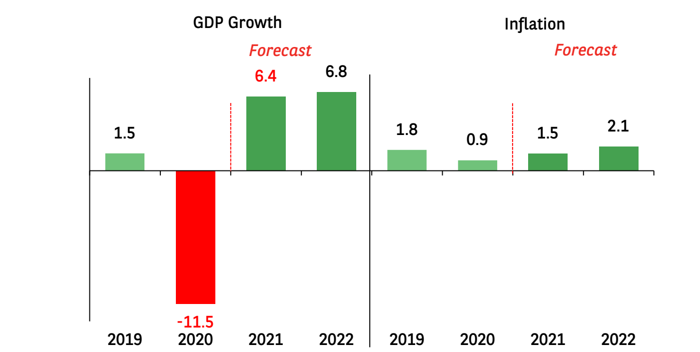

CHART 1 SOURCE: EUROPEAN COMMISSION, BNPPARIBAS

REAL GDP (Q4 2019 = 100)

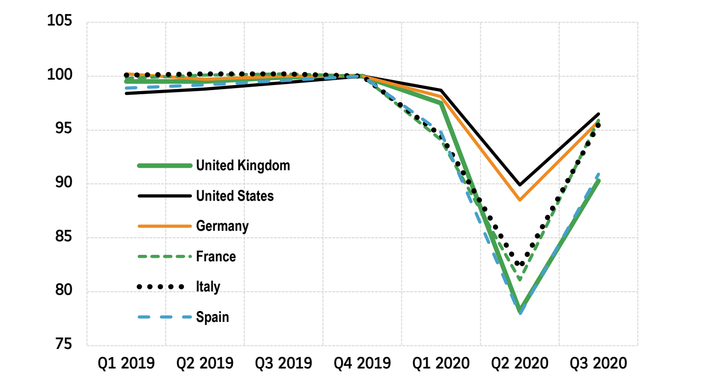

CHART 2 SOURCE: ONS, OECD

WHAT NEXT FOR MONETARY AND FISCAL POLICIES?

To face the health and economic crises in 2020, the British government will have spent more than GBP280 billion, and the OBR forecasts that the government deficit will hit 19% of GDP. In his latest Spending Review, the Chancellor of the Exchequer, Rishi Sunak, announced that GBP 55 billion would be made available to public services in 2021-22.

What's more, the impact of government support on public finances will be felt for years to come. The OBR estimates that the deficit will still be around GBP 100 billion, or 4% of GDP, by 2025-26. As far as growth is concerned, UK GDP is not expected to return to its end-2019 GDP level until the fourth quarter of 2022[1].

Faced with such a sharp deterioration of public finances, the government could respond rapidly. Indeed, there is a risk that it will react too quickly. While the IMF recently cautioned against tightening fiscal policy too quickly in the UK[2], the Chancellor has pledged to balance the books as soon as possible. In its central scenario, the OBR estimates that GBP 20-30 billion in spending cuts or tax rises would be required to *"balance revenues and day-to-day spending and stop debt from rising by the end of this Parliament"*. Any tightening could come as early as in the 2021 Budget, which is due to be presented in March 2021.

When it comes to monetary policy, the Bank of England has further relaxed its stance. Although it has left its policy rate at 0.10%, it has increased its asset purchasing programme by GBP 150 billion at the beginning of November. Overall, this means that its programme has more than doubled in size since the beginning of the crisis, to nearly GBP 900 billion, or some 40% of GDP.

BREXIT: SO FAR, SO GOOD

Meanwhile, the UK has concluded a free trade agreement with Canada, but negotiations with the EU drag on. According to European Commission President Ursula von der Leyen, the outline of a final agreement is in place for most areas, but three main points of disagreement remain.

The first concerns the two parties' commitment to respecting a "level playing field", which means a framework that aims to maintain open and fair competition in the long term. The second has put fisheries, a minor industry, at the centre of the discussions. The Europeans want to ensure substantial access to UK territorial waters for their fishermen, but the UK wants to regain full sovereignty over its waters. Lastly, the two sides are still arguing over the governance of the agreement, which is to say on its dispute resolution mechanism.

Whatever happens, the UK will leave the EU's single market and customs union at the end of 2020. The country is therefore heading towards a "hard Brexit", and numerous non-tariff barriers will hinder its exchanges with the EU from 1 January 2021[3]. In the case of goods, these may include additional procedures, notably to meet EU standards, and enhanced customs controls, resulting in additional costs and more border delays for UK exporters.

If no agreement is reached, these non-tariff barriers will come on top of tariffs imposed on goods traded between the two sides. The OBR estimates that a no-deal exit will trim two percentage points off UK growth in 2021. Given that the forecast recovery in 2021 in the scenario of a deal was, at 5.5%, already feeble in the light of the contraction in 2020, the rebound in a no-deal scenario would be very disappointing. This reduction in GDP growth would be due to border disruption, lower business investment, reduced productivity, increased structural unemployment, and other short-term effects on demand and supply, resulting in part from heightened uncertainty and tighter credit conditions (see chart 3). This would delay the point at which GDP regains its pre-virus level by almost a year (see chart 2 again).

DIFFERENCE IN REAL GDP BETWEEN NO-DEAL AND DEAL SCENARIOS (%-PT)

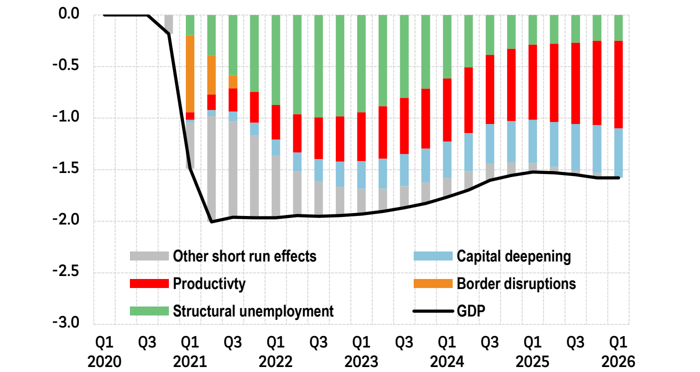

CHART 3 SOURCE: OBR

In the long term, the OBR estimates that the UK's GDP will be 4% lower than it would have been without Brexit, and that a no-deal exit would cost an additional two percentage points. Although failure to reach a free trade agreement with the EU would probably harm the UK economy, it is in fact the UK's exit from the single market that will have the biggest negative effect on growth.

With all that in mind, Brexit will surely have an impact on fiscal and monetary policy. On the fiscal side, if Brexit does have a negative effect on the economy – as predicted by the vast majority of studies on the topic – public finances will come under further pressure due to lower tax revenue and higher spending (unemployment benefits, etc.). Moreover, any benefits from stopping its contributions into the EU budget will be minor and will surely be offset over the next few years by the payment of the UK's past commitments – the so-called "Brexit Financial Settlement", which is estimated at more than GBP30 billion. Meanwhile, the UK might be tempted to deregulate its economy, but it is already one of the most lightly regulated and any relaxation would take the country further away from the EU, which would lead to more non-tariff barriers between the two parties.

As far as monetary policy is concerned, the Bank of England may find itself faced with, on the one hand, a weakened economy and, on the other hand, strong inflationary pressures – for example caused by a drop in the pound and the application of tariffs on UK imports. However, in such circumstances, the central bank would almost certainly opt for a loosening of its policy, as it did when confronted with the same dilemma after the 2016 referendum.

In summary, this saga which began more than four years ago will reach its final act before the end of this year. Although the effects of Brexit on the UK economy have so far been milder than many had feared, the real shock will not come until 1 January 2021, with the after-effects possibly to be felt for many years. What matters is not the fall, it is the landing.

Completed on 7 December 2020

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1 Economic and fiscal outlook, November 2020, OBR.
2 United Kingdom: Staff Concluding Statement of the 2020 Article IV Mission, IMF, 29 October 2020.
3 What will be the economic consequences of a hard Brexit?, BNP Paribas, 30 November 2020.