Shot in the Arm for UK Economy

The Covid-19 pandemic has had a particularly severe impact on the UK economy, with GDP contracting by 10% in 2020, despite a strong rebound in activity during the second half of the year. More recently, retail sales data for January were very weak, showing an 8.2% fall in the month, while PMI services data for the opening two months of the year have been downbeat. The data suggest that with the economy back in lockdown, UK GDP is set to contract again in the opening quarter of 2021.

However, it won't be anything on the scale of the fall in output seen during the first half of 2020. Indeed, on the back of the rapid roll out of vaccines in the UK, with almost 30% of the population receiving at least one shot, and Covid case numbers falling, the government has unveiled a plan to gradually reopen the economy in the coming months. The impressive vaccine roll out should lay the basis for a strong and sustained rebound in UK economic activity from the second quarter onwards.

Thus, despite a decline in first quarter GDP, growth forecasts are quite upbeat for the UK. The IMF is predicting GDP growth of 4.5% for this year and 5% in 2022. The Bank of England is even more bullish, projecting GDP growth of 5% and 7.25% in 2021 and 2022, respectively. This positive economic outlook forms the backdrop for Chancellor Sunak's Budget that is being presented tomorrow.

The deep recession has created an enormous hole in the UK public finances, with the budget deficit put at 18% of GDP in Fiscal Year 2020/21, far higher than elsewhere. Thus fiscal tightening will be required in the UK, but not just yet. The Chancellor is extending supports for the economy for a number of more months until it fully reopens. However, he could still signal in his budget that fiscal tightening can be expected from 2022 onwards when the economy has returned to a sounder footing. There is speculation he could announce tomorrow that the corporation tax rate will rise over the next few years.

Brighter economic prospects are reflected in markets no longer expecting additional UK monetary policy easing. Futures contracts have moved to price out further rate cuts – a move to negative UK rates had been expected by markets until very recently. Instead, markets are now beginning to contemplate when UK rates could start to rise. Futures contracts suggest that we may get a 15bps hike in the bank rate to 0.25% as soon as the third quarter of next year. Until recently, markets believed that UK rates would not rise to this level until 2025.

Sterling has been a major beneficiary of the improved UK economic outlook as a result of the rapid roll out of vaccines there. It has made significant gains in the opening two months of the year, rising from $1.35 to $1.40 against the dollar while the euro has dropped back from 90p to below 87p.

Brexit, though, could remain a lingering headwind for the currency. There are festering disputes with the EU, especially around financial services, while Brexit is also resulting in delays in supply chains and higher trade costs. Sterling still remains at relatively low levels. The negative effects of Brexit on trade and investment could limit the upside potential of the currency from the good news story around vaccines and the rebounding economy.

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