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2021

ECONOMIC UPDATE – 2022 AND BEYOND

WEBINAR AND GROUP DISCUSSION

WEDNESDAY 17 NOVEMBER, ONLINE

ECONOMIC UPDATE – 2022 AND BEYOND

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As the Covid-related restrictions ease in most of the advanced economies, there is the sense of a gradual return to normal. Our economic update this year therefore turned to the question or what kind of economic recovery we might expect.

To guide us through a complex mix of economic data, we were joined by David Smith of *The Sunday Times*. He posed four initial questions:

1. Can the strong recovery continue, or is it already showing signs of petering out?
2. How worried should we still be about Covid, not just in the UK but internationally?
3. How much will the cost of borrowing go up?
4. Has Rishi Sunak done with tax hikes, or could there be more?

In addition, he answered some questions from the audience on related topics.

Here is a summary of David's presentation and the subsequent discussion.

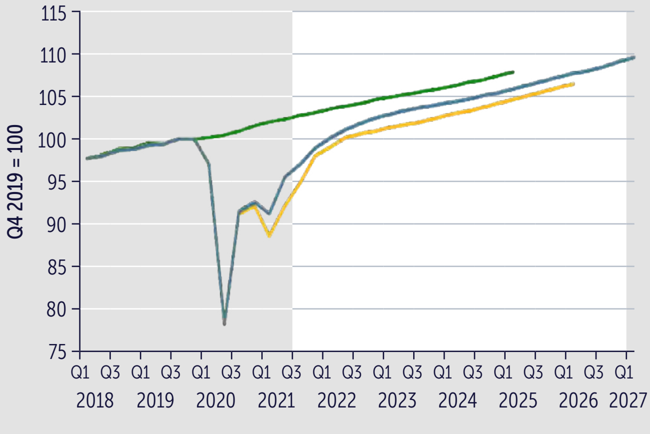
WATCH DAVID'S PRESENTATION HERE:

1 Can the strong recovery continue, or is it already showing signs of petering out?

The world economy is recovering well. There has been a strong bounce-back from what was the deepest recession since the Second World War. The global economy has shown stronger growth than any time in the previous decade. Unusually, GDP is growing more quickly in the advanced economies, while growth in the emerging economies has been slower. This is largely due to the availability of vaccines. Countries with a greater proportion of the population vaccinated have been able to remove Covid restrictions more quickly, enabling their economies to open up.

The UK recovery is almost complete. Forecasts suggest that the country will get back to its pre-pandemic GDP around end Q1 2022, around two years after the first lockdown. The UK's fall in GDP was unprecedented but so is the speed of its recovery. The UK has never experienced a lockdown before. Essentially, switching the economy off and then switching it back on again produced a rapid fall but also a rapid rise in GDP.

OBR's UK GDP Forecasts



Source: Office for Budget Responsibility

Retail sales have lost momentum. The shift to online shopping seems to have lasted. After rising earlier this year, **consumer confidence has fallen sharply.** Some of this is due to continuing Covid fears and worries about the end of the furlough scheme but the weakness of retail sales is also due to a shift to other spending. However, many households built up significant 'involuntary savings' during the lockdown. There is potentially £150 billion waiting to be released.

Business confidence has also lost momentum following a rise earlier this year. Supply shortages and rising labour costs are causing problems for many firms and it is not clear how long this will continue. **Business investment has yet to show any recovery.** It is still 12% below pre-Covid levels.

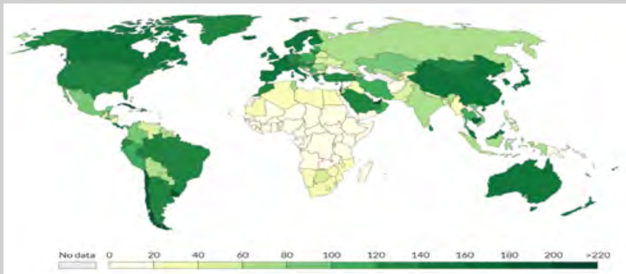
2 How worried should we still be about Covid, not just in the UK but internationally?

The UK still has a high number of Covid infections but fewer are needing treatment in hospitals so the impact on the NHS is not as serious as in 2020. It is likely that the UK will be able to avoid any more major lockdowns.

In much of the world, vaccination rates are still low. High rates of vaccination tend to be a feature of the richer economies. Until high rates of vaccination are universal it is likely that international travel will continue to be restricted.

Covid -19 vaccine doses administered per 100 people, 4 November 2021

All doses including boosters are counted individually. As the same person may receive more than one dose, the number of doses per 100 people can be higher than 100.



Source: Our World in Data

3 How much will the cost of borrowing go up, given the pressure from rising costs and wages?

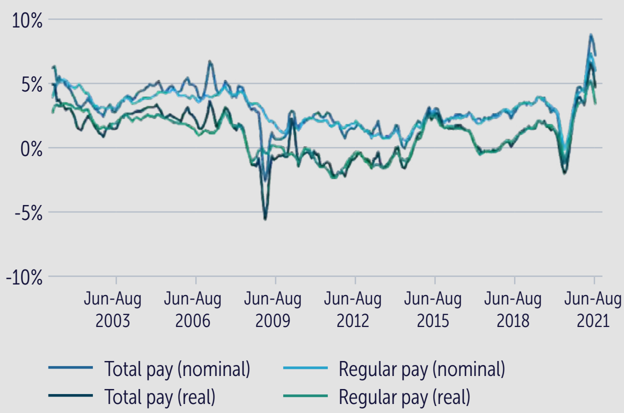
The Bank of England expects inflation to peak at 5% early in 2022. It is high by recent standards but the Bank expects it to have returned to somewhere near its target rate of 2% by early 2024. The Bank believes that much of the inflationary pressure is due to the mismatch of supply and demand caused by the sudden and simultaneous stopping and restarting of economies around the world.

Usually, after a recession, there is a surplus of supply, especially of labour. That hasn't happened this time because of government support schemes. Consequently, supply and labour costs have risen for businesses.

Likewise, the predicted house price crash didn't happen. Instead, house prices rose as many people reassessed their housing needs in the light of new homeworking arrangements.

Wages have risen faster over the last year than at any time in the previous thirty years. There is some distortion in the figures due to the end of the furlough scheme. If people move from their 80% pay on furlough back to their full-time rates it is bound to lead to an overall increase in average pay. Even so, this is the first significant increase in wages we have seen for over a decade.

Great Britain, average weekly earnings annual growth rates, seasonally adjusted, January to March 2001 – June to August 2021



Source: ONS

Despite these inflationary pressures, the expected UK rise in interest rates on 4 November didn't happen. The Bank of England has left them at an all-time low. When interest rates fell to 3.5% in the early 2000s it was the lowest it had been since the mid-1950s. Nowadays we would regard 3.5% as a profound shock, such has the landscape changed.

The Bank will come under pressure to raise rates but it is likely to be cautious for the following reasons:

- The belief that most of the increase in inflation coming through is temporary or 'transitory';
- Ongoing concern about the vulnerability of the recovery. – It will take a "softly-softly" approach to raising rates and reversing quantitative easing (QE).
- It does not want to convey panic to the markets, which could result in a sharp rise in bond yields.

It is likely that there will be a gradual return to 0.75%, the rate before the pandemic, or possibly 1%.

4 Has Rishi Sunak done with tax hikes, or could there be more?

By recent standards, this has been an exceptional year for tax hikes. The freezing of tax thresholds and the increase in Corporation Tax and National Insurance will add up to a £40 billion increase by 2023/24.

Government debt has increased by 20% points of GDP during the pandemic. The tax increases should keep the debt-to-GDP ratio from increasing.

The chancellor has said that he wants to cut taxes but he is likely to face difficulties in doing so. There will be upward pressure on public spending from an ageing population with increased social care needs and from the public investment needed to move to Carbon Net Zero. It is also likely that significant tax reform will be needed in a number of areas:

- Green taxes, and taxes to replace those lost from the shift to net-zero;
- Equalising the tax treatment of capital gains and income;
- Bringing the tax treatment of the employed and self-employed into line.

Forecasts suggest a return to low levels of economic growth in 2024, once the post-Covid bounce has worked through. The 1-1.4% per capita GDP growth forecast by the OBR from 2024 does not bode well for achieving a reduction in the UK's debt-to-GDP ratio alongside significant tax cuts.

5 How important is the level of public sector net debt?

Public debt is now close to 100% of GDP, if that held by the Bank of England is included. This is high by recent historical standards but some major economies, such as Japan and Italy, have coped with higher debt-to-GDP ratios for some time.

In recent years, low interest rates, low inflation and high demand for government bonds have brought government borrowing costs down to historically low levels.

To believe that this situation will continue would be a fool's paradise. A 1% rise in inflation would add £20bn to the cost of servicing UK government debt. With such a high stock of debt, any upward pressure on bond yields would have a significant impact on public finances.

High public debt brings with it a fear of tax increases which discourages both spending and investment. With the tax-to-GDP ratio due to rise to its highest level since the 1950s, there is a danger that high debt levels may heighten this fear.

6 Do we really understand the implications of the shift to Carbon Net Zero and the level of adaptation required?

Every business is having to have some sort of green business strategy but a lot of it in the UK is very messy and un-co-ordinated.

For example, we have a very old and poorly insulated housing stock in the UK. This ought to be low-hanging fruit in the push to Carbon Net Zero. A co-ordinated programme would create employment while significantly reducing emissions – but we are not doing it.

We've had the grand words at COP26 but what we need now is practical implementation. The government seems to be less engaged with this.

7 Given that populations are ageing everywhere and countries will all want the same skills at the same time, how might businesses adapt to a long-term labour shortage?

The UK has shot itself in the foot with some of the labour shortages.

Brexit has happened so we can now have whatever immigration regime we want. The UK now has total control, over its immigration policy. It can issue as many visas as it likes. The Migration Advisory Committee recommended issuing more visas. The temporary visas for truck drivers that end on Christmas Eve were never going to attract large numbers of foreign drivers. But the government is still afraid of relaxing immigration rules.

We have had warnings about a shortage of drivers for years. It is an older workforce. Many older drivers have seen the pandemic as a watershed moment and they don't want to carry on even if companies like John Lewis are offering headline £50K.

To an extent, we were heading off some of the labour pressure of the ageing population by increasing the pension age and encouraging the over-65s to stay in the workforce. The pandemic has undone much of that. The proportion of people over 65 in the workforce has fallen significantly. Many older people have simply changed their minds about wanting to remain in employment.

We have had the wrong emphasis on skills. The UK does well in tertiary education, when compared to other countries but its record in developing intermediate skills is poor. Getting people to recognise the importance of these skills is difficult. We seem to have a reluctance to give them equal status.

8 How important are trade deals?

Most of the trade deals done since Brexit have simply rolled over the ones we already had through the EU. The new ones, such as New Zealand and Australia, have tended to give more advantage to the counterparty rather than the UK. The hoped-for US trade deal is less of a priority for Biden and probably won't happen for some time.

That said, we should not over-state the importance of trade deals. They are seen as symbolic by governments but they add very little to overall GDP. It is possible to trade without them provided the right legal recognition agreements are in place. The UK already sells a lot to the US, even without a formal trade deal.

9 Is GDP still a useful measure? Does it actually relate to the experience of businesses and people?

GDP is still the all-encompassing economic measure. It was developed as part of the wartime effort to understand the economy. It is probably true that it doesn't mean a lot to most businesses. Small GDP changes, while significant, are of little interest to most people. The difference between growth of 5% and 4.5% might not register with people but the difference between 5% and 1% will.

So far, nobody has come up with a better measure of what is happening in the UK or global economy. Other measures which look at the economy from different angels are always published alongside GDP but never instead of it. GDP takes us as close to understanding what is going on in the economy as any aggregate measure can.

Summary and Conclusions

David described his view as a mix of optimism and pessimism. It could perhaps be summarised as optimism about the economic recovery from the pandemic, combined with concern about some of the underlying problems in the economy, many of which were long-term features.

Forecasts suggest that the bounce-back will continue and that the inflation and supply problems will ease towards the end of next year. However, the economy then returns to low growth and the looming challenges of public debt, demographics, skills shortages and the shift to Carbon Net Zero (all of which we have known about for some time) – and they will continue to act as a brake on the economy. At the moment, the government appears to have no overall plan of how to deal with these questions.

SPEAKER

VIDEO SUMMARY

DAVID SMITH has been Economics Editor of *The Sunday Times* since 1989, where he writes a weekly column. He is also chief leader-writer, an assistant editor and policy adviser. Since 2016 he has also been writing a weekly column for *The Times*, where he worked from 1984 to 1989. The author of many books, including *The Rise and Fall of Monetarism*, he has won a number of awards, including Financial Journalist of the Year, Economics Commentator of the Year and Business Journalist of the Year. He is also a visiting Professor at both Cardiff and Nottingham Universities.

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Review and 2022 Programme Launch Keynote address and Member Dinner	2 December 18.30 – 22.00 LONDON

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