ARBUTHNOT BANKING GROUP PLC

PERSPECTIVES

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GDP falls nearly 10% in 2020 but, after first quarter weakness, should recover well in 2021

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Introduction: GDP grows 1% in 2020Q4…

Even though GDP rose by a greater-than expected 1.0% (QOQ) in 2020Q4 (chart 1a), after 16.1% growth 2020Q3 (revised up), it was still 7.8% below its 2019Q4 (pre-pandemic) level.[1] Lockdown measures were tightened during the quarter, with the second lockdown being imposed in November, albeit this was relaxed in December. December's GDP, therefore, managed to increase, albeit by only 1.2% (MOM), after the 2.3% (MOM, revised) fall in November (chart 1b). The services sector was the main contributor to growth in December, increasing by 1.7% (MOM) as a number of consuming facing industries reopened following the easing of restrictions in the month, as well as strong growth in health (with the strongest contributions coming from the coronavirus testing and tracing schemes).[2-5]

In the quarter 2020Q4, there were increases in all three major sectors, though they all remained below 2019Q4 level. Services increased by 0.6% in 2020Q4 (to be down 7.3% YOY), with growth mainly driven by increases in the health and education industries. Health experienced an increase of 12.4%, mainly because of the coronavirus testing and tracing schemes, whilst education increased by 5.6%, reflecting higher levels of school attendance. Production output rose 1.8% (QOQ), largely driven by a 3.3% increase in manufacturing, but was still down 4.2% (YOY). The construction sector increased 4.6% (QOQ) to be just 2.8% below its 2019Q4 level.

Turning to the expenditure components, household consumption actually decreased by 0.2% (QOQ) in 2020Q4, following a bounce back of 19.3% in 2020Q3 (which had reflected a significant easing of public health restrictions). In particular, there was lower spending in restaurants and hotels, which fell by over 20% because of the reintroduction of restrictions. But Government consumption increased by 6.4% (QOQ) and gross fixed capital formation (GFCF) rose by 2.1% (QOQ), driven by a large increase in transport equipment. Stock-building was positive (possibly in preparation for the end of the UK's transition period with the EU) after significant de-stocking in 2020Q3. The trade deficit widened, however, as imports jumped 8.9% whilst exports were barely higher (0.1%), acting as a drag on GDP.

Chart 1a GDP growth (QOQ, %), OBR forecast, ONS outturns, Bank forecast

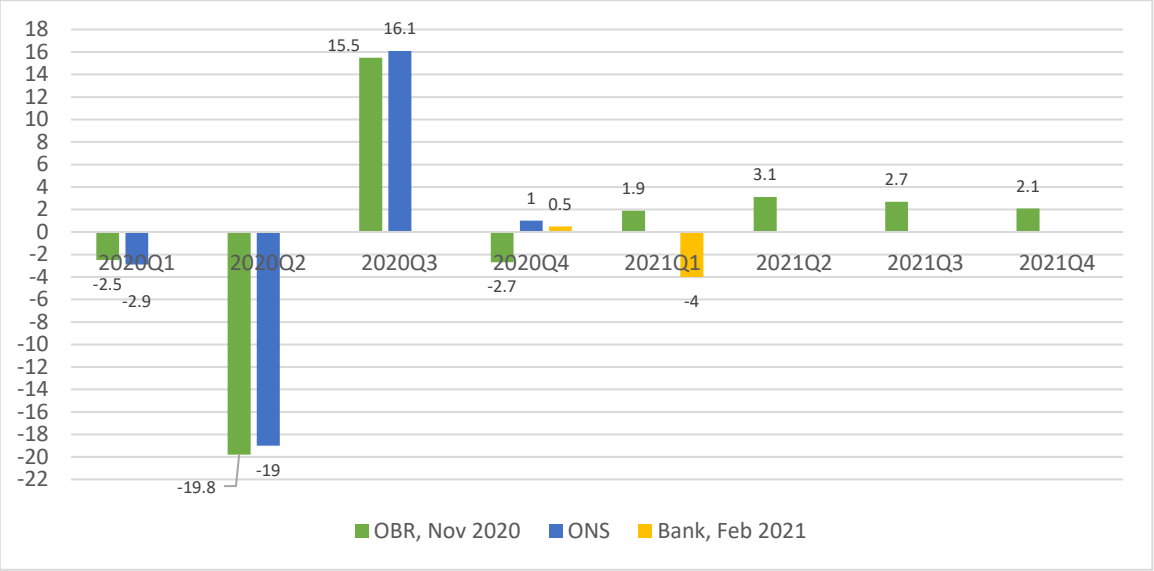
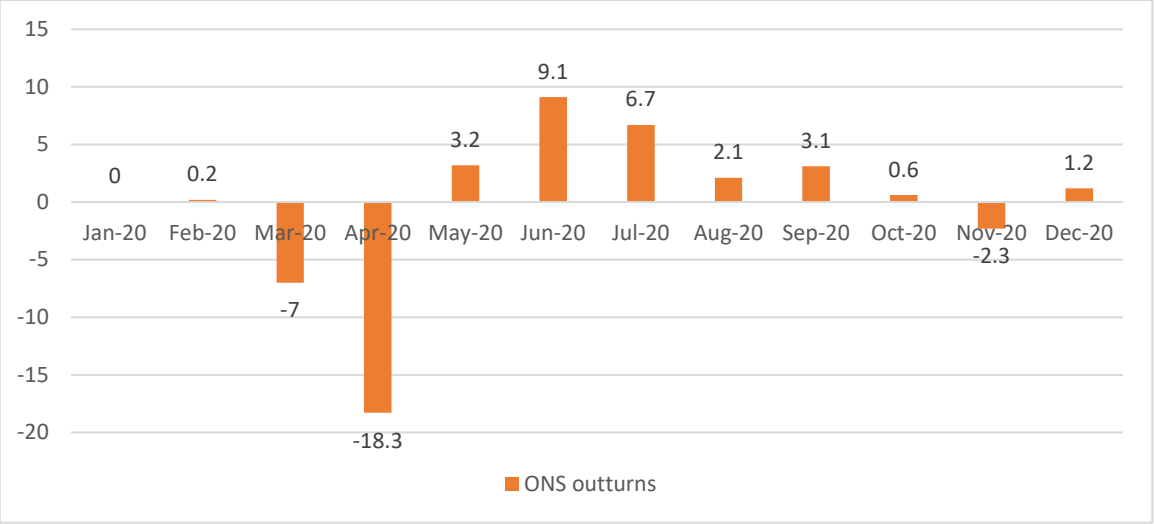


Chart 1b GDP growth (MOM, %), ONS outturns



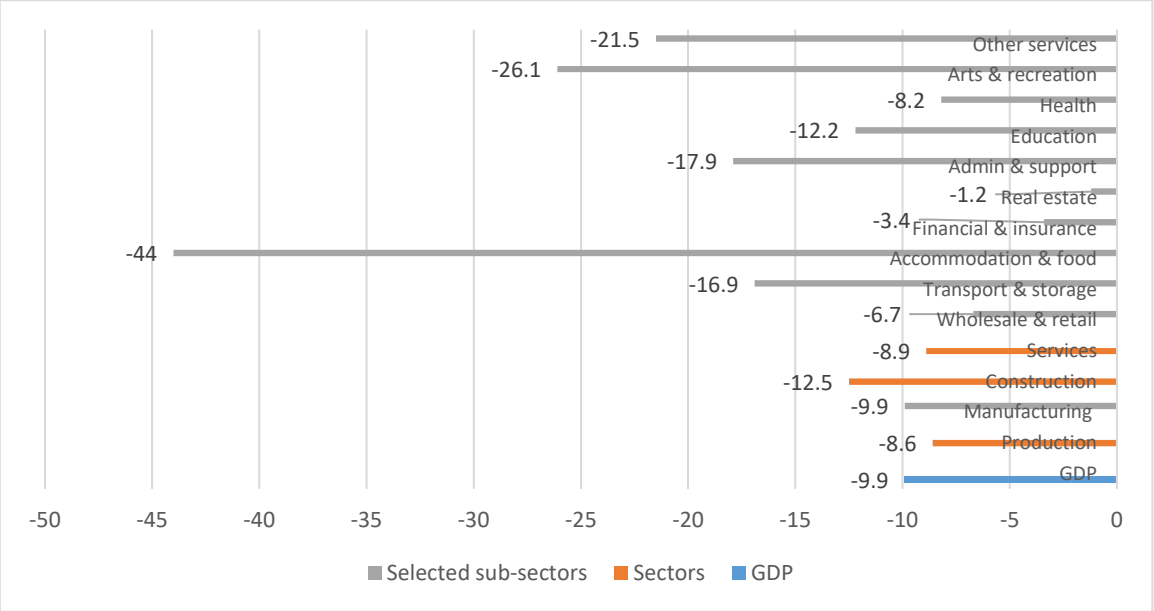
Sources: (i) *OBR*, "Economic and fiscal outlook", CP318, November 2020, table 2.3; (ii) *ONS*, "GDP first quarterly estimate, UK, 2020Q4", 12 February 2021; (iii) *Bank of England*, "Monetary Policy Report, February 2021", 4 February 2021; (iv) *ONS*, "GDP monthly estimate: December 2020", 12 February 2021.

...and falls nearly 10% in the year 2020…

GDP was estimated to have contracted by 9.9% (YOY) in 2020, marking the largest annual fall in UK GDP on official record and, apparently, the biggest annual collapse since the Great Frost of 1709.[6-7] On the output measure (chart 2, annex table 1), services output fell by 8.9% (YOY), within which accommodation and food services slumped by 44.0%, arts and recreation by 26.1% and "other services" (including personal services) by 21.5%. In contrast, the decrease in financial and insurance output was a modest 3.4%. The production and construction sectors fell by 8.6% and 12.5% respectively.

Turning to the expenditure components, all components were strongly negative, except the trade balance. Household consumption contracted by 10.7% (YOY), Government consumption fell by 5.7% (YOY), and gross fixed capital formation (GFCF) fell by 8.7% (YOY), whilst there was major destocking. The trade deficit narrowed, as exports (volume terms) fell by 16.7% whilst imports fell by 18.1%.

Chart 2 GDP, main sectors, selected sub-sectors, 2020 (YOY change, %)



Source: *ONS*, "GDP monthly estimate: December 2020", 12 February 2021. See annex table 1 for data.

Suffice to say, the 9.9% fall in UK volume in 2020 is, at first glance, one of the worst of the major developed economies bar Spain where GDP fell by 11.0% in the year. In comparison, the latest data suggest falls of 5.0% for Germany, 8.3% for France, 8.8% for Italy and 3.5% for the US.[8-9] But, as we discussed in last week's Perspective, the ONS has warned that the international GDP differences "…might also reflect differences in how non-market output is measured in different countries, specifically the extent to which volume indicators are in place and how these have been affected by the pandemic. Consistent with international guidance, the ONS [mainly] uses direct measures of the volume of activity to estimate the volume of non-market output such as health and education [whilst, by implication, other countries do not tend to use these direct measures]. International comparisons should be made with care if the estimates being compared are based on different approaches to measuring the volume of non-market output".[10-11]

The outputs of education (weight 5.7%) and health (weight 7.5%) fell by 12.2% and 8.2% respectively (see annex table 1 for the weights), which together accounted for around 1½% of the fall in GDP in 2020. (The volume fall in health output is all the more significant given the large increase in spending in current prices.) Allowing for this decline, would put the overall fall in UK GDP much in line with France.

The ONS has also pointed to another feature relating to the UK's different methodology for calculating volumes. They pointed out that the UK's relative shortfall in GDP over 2020 was much more marked for volume estimates than in current prices. This would suggest that there have been large movements in the "price" for UK GDP during the time of the coronavirus pandemic, which do not appear to have been experienced elsewhere in the G7 so far. In a recent paper they calculated the changes in GDP between 2019Q4 and 2020Q3 in both current prices and in volume terms (chart 3). In volume terms the UK would appear to be quite the worst performer, but the current price shortfall in GDP for the UK is 3.4%, less than that of Canada, Italy and Germany.[12]

Chart 3 GDP change (%) between 2019Q4 and 2020Q3, G7 countries, current prices, volume estimates

Source: *ONS*, "International comparisons of GDP during the coronavirus (COVID-19) pandemic", 1 February 2021.

…but should recover well in 2021

As we discussed in last week's Perspective, the Bank's latest forecasts suggested that GDP could fall by around 4% (QOQ) in 2021Q1 (and see chart 1a, above).[13-15] GDP was then "…projected to recover rapidly towards pre-Covid levels over 2021, as the vaccination programme is assumed to lead to an easing of Covid-related restrictions. Projected activity is also supported by the substantial fiscal and monetary policy actions already announced. Further out, the pace of GDP growth is expected to slow as the boost from these factors fades". However, they also noted that "the outlook for the economy remains unusually uncertain. It depends on the evolution of the pandemic, measures taken to protect public health, and how households, businesses and financial markets respond to these developments." The Bank's assessment seems eminently reasonable and, assuming lockdown restrictions are eased significantly, the economy should recover well in 2021.

The Bank's Chief Economist, Andy Haldane, emphasised the positive narrative in a recent article, writing "…the rapid rollout of the vaccination programme across the UK means a decisive corner has been turned in the battle against Covid. A decisive corner is about to be turned for the economy too, with enormous amounts of pent-up financial energy waiting to be released, like a coiled spring".[16-17] In particular, he pointed to the significant increase in household savings during the pandemic (which could rise to over £250bn by end-June 2021), much of which was likely to be spent, boosting household consumption. Companies were also expected to increase their spending and this, coupled with Government support, would lift the economy. He concluded that "…so come the Spring, we can expect the UK economy to be firing on all three cylinders – households, companies and government".

The trade data continued to deteriorate in 2020Q4

The trade balance (goods and services) continued to deteriorate in 2020Q4.[18] The ONS's trade data are complicated by the distorting effects of swings in trade of precious metals (including non-monetary gold (NMG)) and they publish two sets of data: a total series (including precious metals) and a preferred "underlying" series (excluding precious metals).

Firstly, the total trade (goods and services) deficit widened to £17.5bn in 2020Q4, compared with £3.9bn in 2020Q3 (table 1). Within the total:

- The visible (goods) deficit widened to £42.4bn (from £31.4bn), as exports rose by 7.6% whilst imports rose by 15.7% (QOQ). Within the goods total, the deficit with the EU widened to £25.7bn (from £21.4bn), whilst the deficit with non-EU countries widened to £16.8bn (from £10.0bn). Increasing goods imports were driven by machinery and transport equipment, chemicals and miscellaneous manufactures in 2020Q4. The ONS added that medicinal and pharmaceutical products and car parts were (probably) stockpiled in preparation for the end of the transition period (31 December 2020).
- The services surplus fell to £24.9bn (from £27.5bn). Exports slipped by 7.9%, whilst imports slipped by 6.7% (QOQ).

Table 1 also includes the "underlying" series, which shows that the overall deterioration was, in part, due to an adverse movement in precious metals, where a deficit of £3.2bn was recorded for 2020Q4, compared with a deficit of £0.5bn in 2020Q3, a fairly significant swing. In volume terms, the "underlying" total trade deficit widened by £10.9bn to a £15.6bn in 2020Q4, as imports increased by £10.9bn and exports decreased by £0.1bn. This would act as a drag on GDP, as noted above under GDP.

Table 1 also includes the data for the year 2020, which shows the total trade (goods and services) deficit narrowed to £9.6bn in 2020, compared with £27.5bn in 2019. Within the total, the visible deficit narrowed to £116.0bn in 2020 (£130.8bn in 2019), as exports decreased by 16.5% whilst imports decreased by 15.1%. The deficit with EU countries narrowed to £81.1bn (£97.5bn in 2019), but the deficit with non-EU countries marginally widened to £34.9bn (£33.3bn in 2019). The services surplus increased to £106.4bn in 2020 (from £103.3bn in 2019), as exports fell by 17.7%, whilst imports fell by 27.8%. The improvement in the goods (visible) balance was, therefore, reinforced by a small improvement in the services balance.

Finally, table 1 includes the annual data for the "underlying series", which shows that a good part of the improvement in 2020 reflected a significant turnaround in the balance on precious metals (of £6.6bn). In volume terms, the "underlying" total trade deficit narrowed by £6.5bn to £19.4bn in 2020. This would support GDP, as also noted above under GDP.

Table 1 Trade (goods and services), balances (£bn)

	Quarterly data			Annual data		
	2020Q3	2020Q4	Change	2019	2020	Change
Total balances:						
Goods (total)	-31.4	-42.4	-11.0	-130.8	-116.0	+14.8
Services	27.5	24.9	-2.6	103.3	106.4	+3.1
Goods and services	-3.9	-17.5	-13.6	-27.5	-9.6	+17.9
"Underlying" balances:						
Goods (excluding precious metals)	-30.9	-39.2	-8.3	-129.6	-121.4	+8.2
Services	27.5	24.9	-2.6	103.3	106.4	+3.1
Goods and services	-3.4	-14.3	-10.9	-26.3	-15.0	+11.3
Goods and services, volume terms	[-4.7]	-15.6	-10.9	[-25.9]	-19.4	+6.5
Memo item:						
Precious metals	-0.5	-3.2	-2.7	-1.2	+5.4	+6.6

Source: *ONS*, "UK trade: December 2020", 12 February 2021 (table 2 of the press release provides the volume data).

The European Commission's latest forecast

The European Commission's Winter (February) forecast (an interim forecast) was guardedly optimistic.[19-20] As they explained:

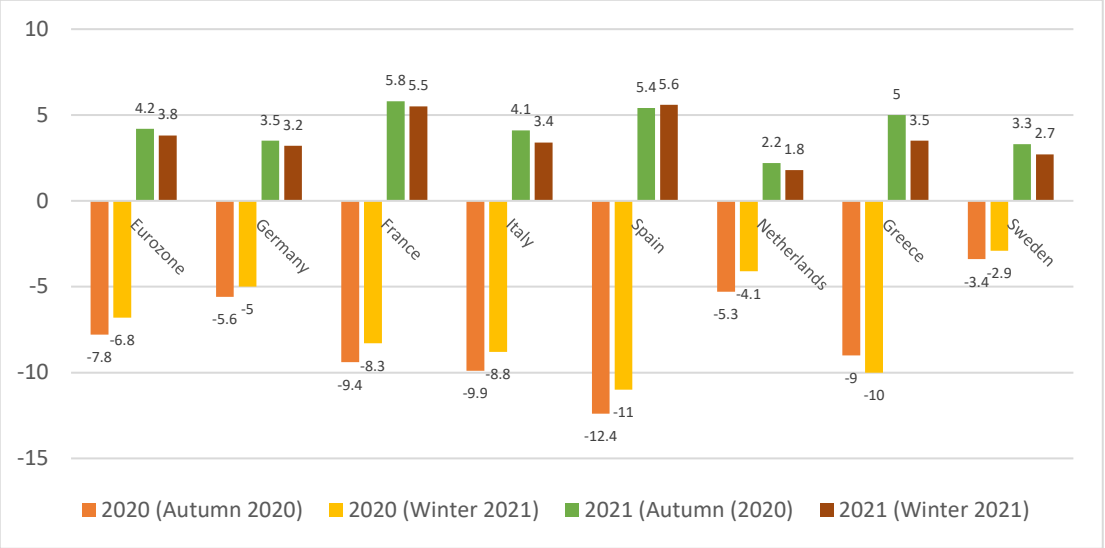
- "…the near-term outlook for the European economy looks weaker than expected last autumn, as the pandemic has tightened its grip on the continent. …the European economy is thus expected to have ended 2020 and started the new year on a weak footing. However, light has now appeared at the end of the tunnel that the European economy entered almost exactly one year ago. As vaccination campaigns gain momentum and the pressure on health systems to subside, containment measures are set to relax gradually. Activity is thus forecast to pick-up, still moderately in 2021Q2, but more vigorously in 2021Q3, led by private consumption with additional support from global trade".

Chart 4 (and annex table 2) shows the latest Commission forecasts, which they emphasised were "subject to significant uncertainty and elevated risks". Eurozone GDP is now expected to fall by 6.8% in 2020 (7.8% in November), as the "…European economy showed considerable resilience in 2020H2, rebounding vigorously in 2020Q3". Most EU countries have now released their first estimates for GDP for the year. Partly reflecting the better-than-expected outturns for 2020 and the weak start to 2021, growth in 2021 is now projected to be 3.8% for the Eurozone (4.2% in November), making up much of the ground lost in 2020. Outside the Eurozone, it is notable that the Commission expects Sweden's GDP to fallen by only 2.9% in 2020 (3.4% in November).

There are two other points to note. Firstly, the Commission discussed the UK/EU agreement reached on the terms of their future cooperation, which "…reduced the cost of the UK's departure from the Single Market and Customs Union". They calculated that Brexit on free trade agreement (FTA) terms would generate an output loss of around ½% of GDP for the EU on average by the end of 2022, and some 2¼% for the UK. Compared with the "WTO assumption" that was modelled in the Autumn forecast, the EU-UK FTA reduced the negative impact for the EU on average by about 1/3 and for the UK by about 1/4. Whereas the FTA had set tariffs and quotas on goods at zero, the Commission assessed that there was still a significant increase in non-tariff barriers (NTBs) for both goods and services. Moreover, they assessed that Member States with a higher share of goods trade with the UK benefited relatively speaking more from the FTA than those with a higher share of trade in services. The Commission concluded that whilst "…the FTA improves the situation as compared to an outcome with no trade agreement between the EU and the UK, it cannot come close to matching the benefits of the trading relations provided by EU membership."

Secondly, the Commission believed that an ambitious and swift implementation of the Next Generation EU (NGEU) Covid-recovery package (including its Recovery and Resilience Facility) should provide a strong boost to the EU economy, supporting Member States on their way to "a sustainable recovery". The European Council brokered agreement on 21 July 2020 for both the Budget for 2021-27 and the €750bn NGEU programme (comprising €390bn of grants and €360bn of low-interest loans).[21-22]

Chart 4 Commission forecasts, GDP, Autumn 2020, Winter 2021, selected countries, 2020 and 2021



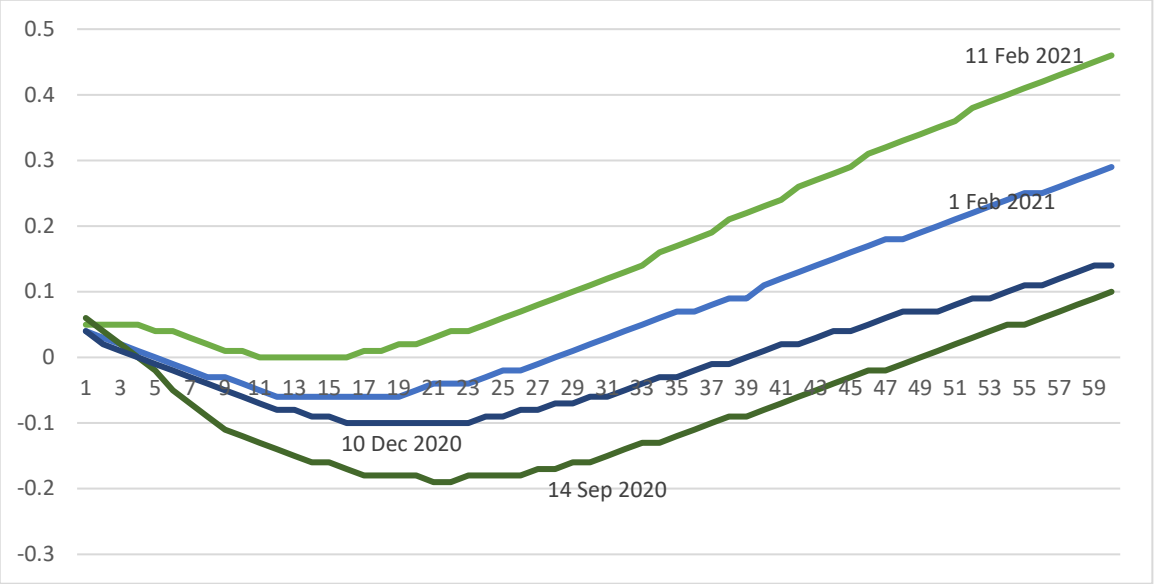
Source: *European Commission*, "A challenging winter, but light at the end of the tunnel: Winter Economic Forecast (interim)", 11 February 2021. See also annex table 2.

Vaccination programmes boost oil prices and sterling

In a recent Perspective we discussed the recovery in oil prices, specifically after Saudi Arabia had unilaterally agreed in January to cut production in February and March which, along with the rest of the OPEC+ coalition's agreement to keep overall production almost flat for these months, would help suppress supply in the face of the then renewed concerns over the Covid-19 pandemic.[23] By way of an update, prices have firmed further so far in February, on expectations that vaccination programmes will stem the Covid-19 pandemic and, hence, boost demand. Brent Crude was over $62pb on 12 February, the highest since January 2020.[24]

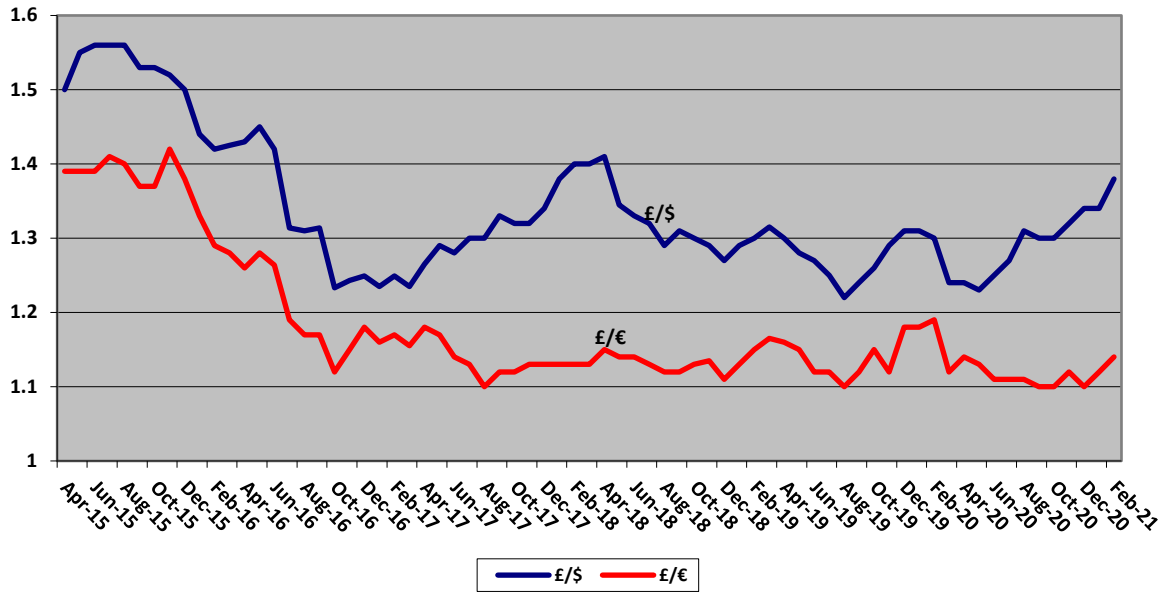
The UK financial markets have also taken the view that mass vaccination should underpin economic recovery and significantly reduce the probability of negative rates (see chart 5a for the yield curve data). Moreover, rates expectations firmed after the February MPC meeting, the minutes of which said that the fact they had authorised the PRA to ensure PRA-regulated firms were ready to implement negative interest rates after six months should not be seen as a signal that negative rates were "imminent or, indeed, in prospect at any time."[25] Sterling has also benefited from the rapid vaccine rollout, as well as the falling expectations of negative interest rates and the UK/EU Trade and Cooperation Agreement (TCA) (chart 5b).[26] The possibility of a "no deal" end to the transition period had weighed on the currency towards the end of 2020.

Chart 5a UK instantaneous OIS forward curve (%), months out to 60 months (5 years), at selected dates



Source: Bank of England, yield curve data, archive and latest. Overnight index swap (OIS) rate (latest data, 11/2/21).

Chart 5b £/$, £/€: January 2015-January 2021, 11 February 2021



Source: Bank of England database for currencies (spot rates): monthly averages. Daily rate for 11 February 2021.

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1. *ONS*, "GDP first quarterly estimate, UK, 2020Q4", 12 February 2021.
2. *ONS*, "GDP monthly estimate: December 2020", 12 February 2021.
3. *ONS*, "Index of Production, UK: December 2020", 12 February 2021.
4. *ONS*, "Index of Services, UK: December 2020", 12 February 2021.
5. *ONS*, "Construction output in GB: December 2020", 12 February 2021.
6. *ONS*, "GDP first quarterly estimate, UK, 2020Q4", 12 February 2021.
7. *Daily Telegraph*, "Economy suffers its worst slump for 300 years", 13 February 2021.
8. *European Commission*, "A challenging winter, but light at the end of the tunnel: Winter Economic Forecast (interim)", 11 February 2021 for EU data (and see annex table 2).
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13. *Bank of England*, "Monetary Policy Report, February 2021", 4 February 2021.
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16. Andy Haldane, "Britain to fire on all cylinders after year to forget", *Daily Mail*, 12 February 2021.
17. *BBC*, "UK economy poised like a coiled spring, says Bank economist", 12 February 2021.
18. *ONS*, "UK trade: December 2020", 12 February 2021. The ONS identifies erratic commodities ("erratics"), such as aircraft, ships and precious metals (including non-monetary gold (NMG)).
19. *European Commission*, "A challenging winter, but light at the end of the tunnel: Winter Economic Forecast (interim)", 11 February 2021.
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24. *BBC*, "Oil prices climb back to pre-pandemic levels", 8 February 2021.
25. *Bank of England*, "Monetary policy summary and minutes of the MPC meeting ending 3 February 2021", 4 February 2021.
26. *Daily Telegraph,* "Sterling work: headwinds subside to help pound's belated recovery", 12 February 2021.

Annex

Table 1 Standard Industrial Classification (SIC).

Sections (divisions)	Weights per 1000, 2020	2020 (YOY, % change)
GDP	1000	-9.9%
A Agriculture, forestry & fisheries (1-3)	6.4	-9.4%
PRODUCTION (B-E):	138.7	-8.6%
B Mining & quarrying (5-9)	11.2	-9.5%
C Manufacturing (10-33)	100.6	-9.9%
D Electricity, gas, steam & air conditioning supply (35)	14.2	-4.5%
E Water supply, sewerage, waste management et al (36-39)	12.7	-1.7%
F Construction (41-43)	64.4	-12.5%
SERVICES (G-U):	790.4	-8.9%
G Wholesale & retail trade, repair of motor vehicles et al (45-47)	104.5	-6.7%
H Transportation & storage (49-53)	40.4	-16.9%
I Accommodation & food services activities (55-56)	29.4	-44.0%
J Information & communication (58-63)	65.7	-7.8%
K Financial & insurance activities (64-66)	67.7	-3.4%
L Real estate activities (68), including imputed rent	135.0	-1.2%
M Professional, scientific & technical activities (69-75)	76.9	-5.2%
N Administrative & support service activities (77-82), including travel & tour operators, employment activities	52.7	-17.9%
O Public administration & defence (84)	49.1	+2.1%
P Education (85)	56.8	-12.2%
Q Human health & social work (86-88)	75.3	-8.2%
R Arts, entertainment & recreation (90-93)	16.1	-26.1%
S Other services (94-96), including personal services (hairdressers et al)	17.8	-21.5%
T Activities of households as employers (97-98)	…	…
U Extraterritorial organisations & bodies (99), does not contribute to GDP	…	…

Sources: (i) *ONS*, "UK SIC 2007" (A-U are sections; 1-99 are divisions); (ii) *ONS*, "GDP output approach – low-level aggregates", 22 December 2020; (iii) *ONS*, "GDP monthly estimate: December 2020", 12 February 2021.

Table 2 Commission forecasts, February 2021, GDP, comparison with November 2020, selected countries

	GDP growth (%), February 2021			GDP growth (%), November 2020		
	2020	2021	2022	2020	2021	2022
Eurozone (EU19):	-6.8	3.8	3.8	-7.8	4.2	3.0
Germany	-5.0	3.2	3.1	-5.6	3.5	2.6
France	-8.3	5.5	4.4	-9.4	5.8	3.1

Italy	-8.8	3.4	3.5	-9.9	4.1	2.8
Spain	-11.0	5.6	5.3	-9.4	5.8	3.1
Netherlands	-4.1	1.8	3.0	-5.3	2.2	1.9
Greece	-10.0	3.5	5.0	-9.0	5.0	3.5
Non-EU19:						
Poland	-2.8	3.1	5.1	-3.6	3.3	3.5
Sweden	-2.9	2.7	4.0	-3.4	3.3	2.4
EU27	-6.3	3.7	3.9	-7.4	4.1	3.0

Source: *European Commission*, "A challenging winter, but light at the end of the tunnel: Winter Economic Forecast (interim)", 11 February 2021.