ARBUTHNOT BANKING GROUP PLC

PERSPECTIVES

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GDP rose 4.8% in 2021Q2, as lockdown restrictions were eased

16th August 2021

Introduction: GDP rose strongly in 2021Q2…

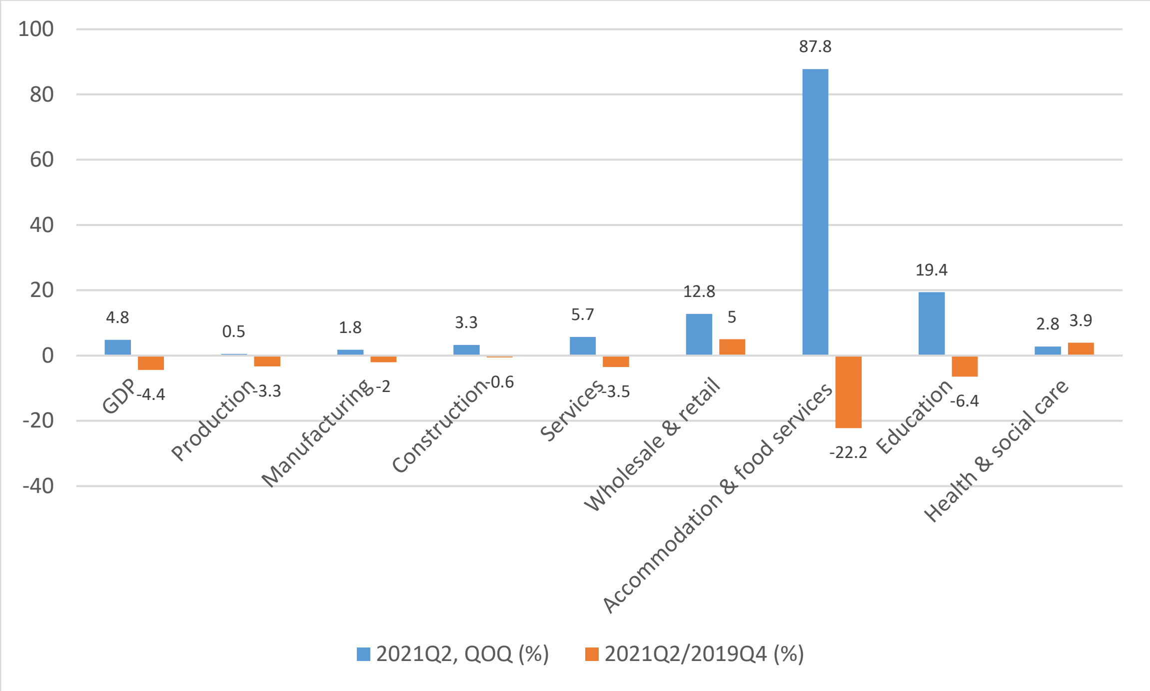
GDP rose by 4.8% (QOQ) in 2021Q2, after slipping 1.6% in 2021Q1, as lockdown restrictions were eased on 12 April and 17 May (see annex table 1 for England).[1] It was, however, still 4.4% below pre-pandemic 2019Q4 (chart 1), though the pre-pandemic level should be reached by 2021Q4, if not modestly surpassed. The ONS pointed out that the UK's quarterly increase was greater than for the US, Germany and France and Spain. But US GDP has now recovered to above pre-pandemic levels (0.8% higher), though it has been the only major economy to have done so, whilst the French economy was 3.3% lower than pre-pandemic levels, Germany's was 3.6% lower, Italy's was 3.8% lower and Spain's was 6.8% lower.[2-3]

Within GDP by far the biggest driver of the quarterly increase was the services sector, where output rebounded by 5.7% (QOQ) in 2021Q2, having contracted by 2.1% in 2021Q1, but it was still 3.5% below 2019Q4 levels. The largest contributors to the quarterly increase were from wholesale and retail trade, accommodation and food service activities, and education. Accommodation and food service activities increased by 87.8% (QOQ), while wholesale and retail trade increased by 12.8%, in response to the re-opening of indoor hospitality, Euro 2020 and the reopening of non-essential retail. Combined, these consumer-facing services increased by 16.7% (QOQ). There was also a 19.4% increase in education output, reflecting the re-opening of schools over the period as in-school attendance rates increased.

Production output increased by 0.5% (QOQ), after a fall of 0.5% in 2021Q1, remaining 3.3% below 2019Q4. The increase in production output was driven mainly by a 1.8% rise in manufacturing, in particular that of food products, beverages and tobacco, and machinery and equipment. But there was a fall (overall) in the output of the manufacture of transport equipment, which was particularly impacted by microchips shortages. Mining and quarrying output was down 16.6% (QOQ) reflecting the planned temporary closures for maintenance of oil field production sites throughout the quarter.

Finally, the construction sector increased 3.3% (QOQ) in 2021Q2, reflecting a rise in new work (3.7%), particularly infrastructure, and repair and maintenance (with growth of 1.7%). Construction has nearly recovered to pre-pandemic levels, with output in 2021Q2 at just 0.6% below 2019Q4 levels.

Chart 1 GDP, main output components, selected industries (%): 2020Q2 (QOQ) & change over 2019Q4



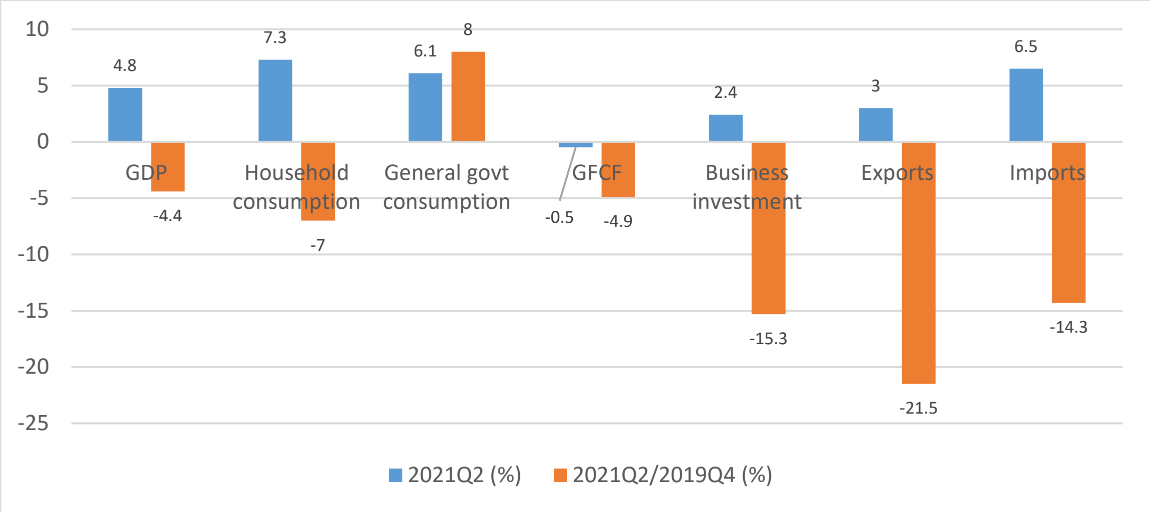
Source: *ONS*, "GDP first quarterly estimate, UK, 2021Q2", 12 August 2021.

Turning to the expenditure components in 2021Q2, there were notable increases in household consumption and government consumption, but GFCF slipped back and the trade balance deteriorated. The largest positive contribution was from household consumption.

Household consumption rebounded by 7.3% (QOQ) in 2021Q1, following a 4.6% contraction in the previous quarter. In comparison with pre-pandemic levels, however, household consumption is still 7.0% lower than in 2019Q4. The largest contributions in 2021Q2 were from spending on restaurants and hotels, and transport, which all performed strongly with the reopening of the economy. This was partly offset by a fall in food and drink consumption expenditure, which may be because of the strong rise in spending on restaurants and hotels. Government consumption rose by 6.1% driven by increases in education (schools reopened) and health (GP appointments increased and output was boosted by test and trace services and the vaccination programme).

Within gross capital formation, gross fixed capital formation (GFCF) fell by 0.5% (QOQ), as government investment fell by 9.7%. Within GFCF, business investment rose by 2.4% in the quarter but was still 15.3% below the pre-pandemic levels. Inventories rose modestly 2021Q2, after destocking in 2021Q1. Finally, the trade balance slipped into deficit, having been in balance in 2021Q1 (constant prices), as exports roses just 3.0% (QOQ), whilst imports increased by 6.5%. The trade data are discussed in more detail below (in current prices).

Chart 2 GDP, main expenditure components (%): 2020Q2 (QOQ) & change over 2019Q4



Source: *ONS*, "GDP first quarterly estimate, UK, 2021Q2", 12 August 2021.

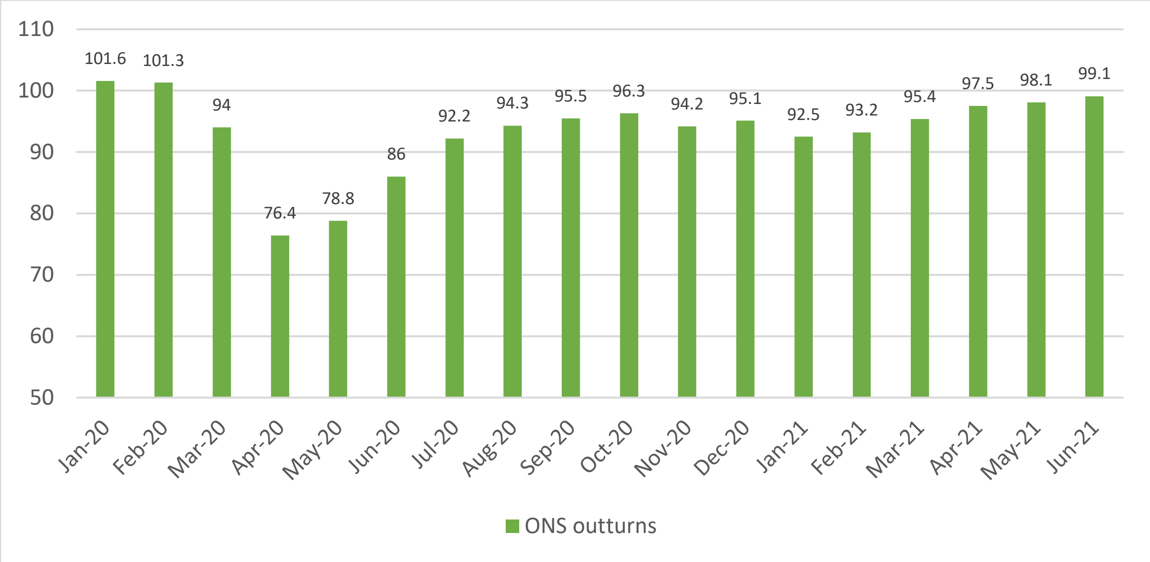
…whilst growth continued in June

GDP increased by 1.0% (MOM) in June, the fifth consecutive month of growth, as government restrictions affecting economic activity continued to ease (chart 2).[4] However, May's growth was revised down to 0.6% (MOM), from 0.8% and June's GDP was still 2.2% below pre-pandemic February 2020. Concerning the industrial breakdown, services rose but production and construction contracted.[5-7]

The service sector recovered by a further 1.5% (MOM) in June but was still 2.1% below pre-pandemic February 2020. Health activities contributed the most to services growth as visits to GPs increased in June 2021, while hospitality benefitted from its first full month of indoor dining since coronavirus restrictions were eased on 17 May (see annex table 1). The food and beverage services activities were again the main contributor to the growth in consumer-facing services, growing by 10.1% (MOM) in June 2021.

Output in the production sector fell by 0.7% (MOM) and it was 3.2% below February 2020. Within mining and quarrying, planned temporary closures for maintenance of oil field production sites hit output in June and output from the extraction of crude petroleum and natural gas was at its lowest monthly level since records began in 1997. Manufacturing rose a very modest 0.2% (MOM), even though production in 8 out of the 13 manufacturing sub-sectors increased in June. According to the ONS the manufacture of transport equipment showed some growth following a weak May 2021 when microchip shortages notably disrupted car production. But the manufacture of basic pharmaceutical products and pharmaceutical preparations, a volatile sector, fell back. Construction output contracted for a third consecutive month, following exceptionally strong growth in February and March 2021, with output down by 1.3% (MOM), but it was just 0.3% below its pre-pandemic level (February 2020).

Chart 2 GDP (2018=100), ONS outturns, since January 2020



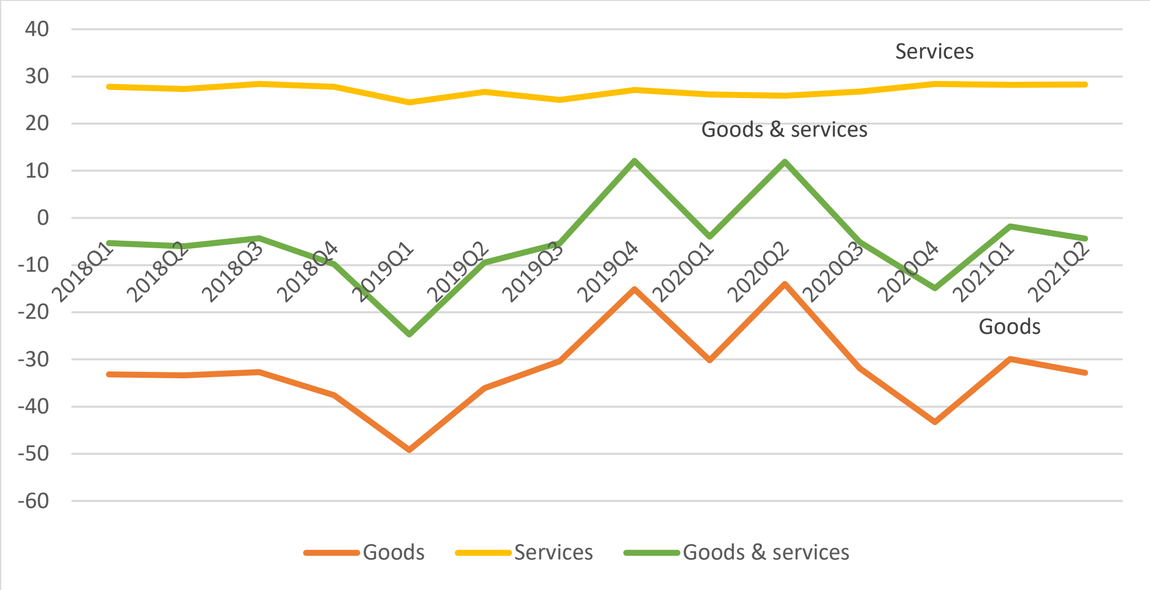
Source: *ONS*, "GDP monthly estimate: June 2021", 12 August 2021.

The trade balance deteriorated modestly in 2021Q2…

The change in the goods and services deficit between 2021Q1 (£1.8bn) and 2021Q2 (£4.4bn) was relatively modest, mainly reflecting a deterioration in the goods deficit.[8] However, the EU deficit improved in 2021Q2 (as exports rose 27.1% (QOQ) and imports rose 12.3%, showing a considerable recovery in trade after the dip after the end of the transition period), but the non-EU deficit worsened (as exports rose by 3.0% (QOQ) whilst imports increased by 12.8%). The services surplus was little changed. The ONS commented "…some of the increase in trade flows in the second quarter is likely to reflect the recovery following the effects of EU exit and the coronavirus pandemic earlier in the year".

The trade figures over the past couple of years have been extraordinarily volatile, reflecting political developments. Chart 3 shows that the goods and services deficit widened significantly in 2020Q4, ahead of the end of the Brexit transition period, before "improving" in 2021Q1. Chart 3 also shows the deficit increased sharply in 2019Q1 (ahead of the original "Brexit Day", 31 March 2019) only to ease in 2019Q2. There was also a notable improvement in the trade deficit in 2019Q4, as the deferred Brexit Day (31 October 2019) was deferred again (to 31 January 2020). The waxing and waning of coronavirus restrictions have added to the volatility.

Chart 3 Trade balance (£bn), goods, services, goods & services: 2018Q1-2021Q2



Source: *ONS*, "UK trade: June 2021", 12 August 2021.

…and the trade balance also deteriorated in June

There was also a worsening in June's total trade balance (a deficit of £2.5bn), after May's improvement (a deficit of £0.2bn) (see annex table 2).[9] The services surplus edged up to £9.5bn from £9.4bn in the month, though the ONS commented that, on the whole, services trade (exports and imports) remains subdued compared with pre-pandemic times.

Concerning June's goods trade (including precious metals, see charts 4a-4c):

- The visible (goods) deficit widened to £12.0bn (from £9.6bn in May), as exports slipped (MOM) whilst imports rose. Both the EU and the non-EU (especially) balances worsened.
- The deficit with the EU widened marginally to £4.9bn (from £4.4bn in May). Exports were flat, whilst imports rose by 2.8% (reflecting higher car imports). But, as chart 4b shows, exports in June retained their levels seen in early 2020 and in December 2020, having dipped significantly in January 2021. Indeed, they were a little higher. The ONS noted that the EU trade data in the early months of 2021 probably reflected the hangover from stockpiling ahead of the end of the EU transition period and disruption after the end of the transition period, as well as the impact of the pandemic including reduced demand and global supply issues.
- The deficit with non-EU countries widened to £7.1bn (from £5.2bn in May). Exports fell 7.2% (MOM, mainly because of falls in medicinal and pharmaceutical products and cars), whilst imports rose by 4.3% (reflecting higher imports of mechanical machinery).

Chart 4a Trade in goods, exports, imports, balance: total EU & non-EU (£bn), Jan 2020-June 2021

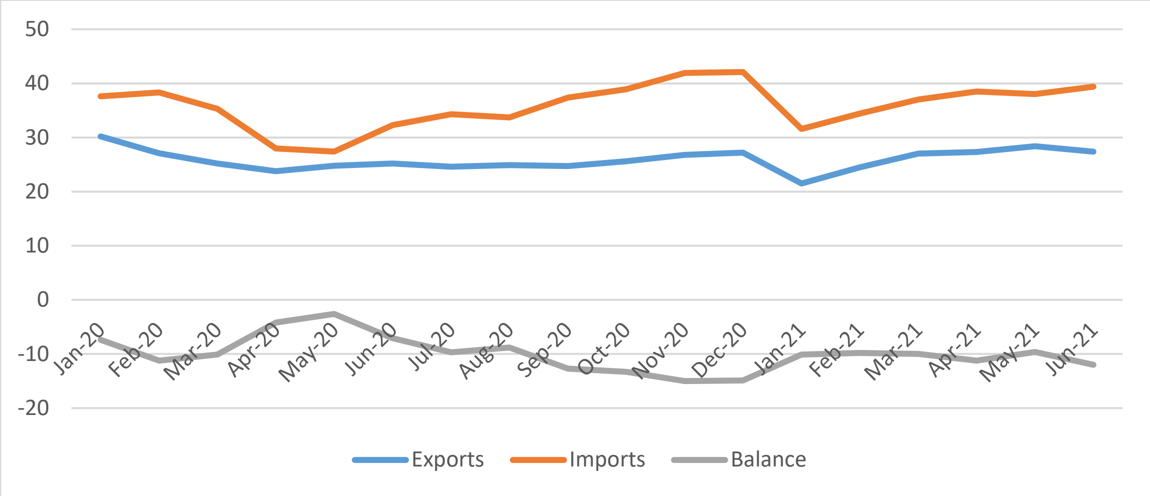


Chart 4b Trade in goods, exports, imports, balance: EU (£bn), Jan 2020-June 2021

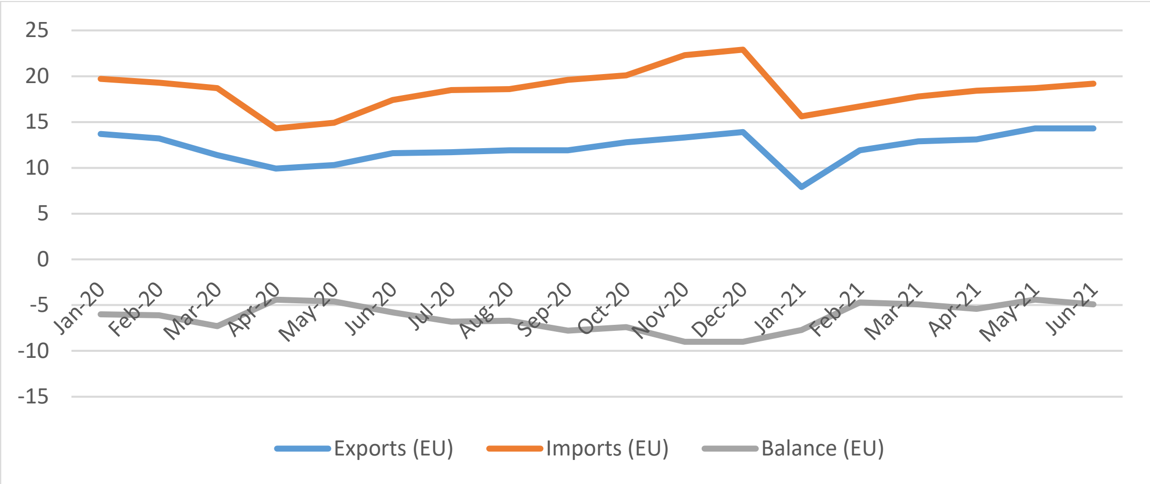
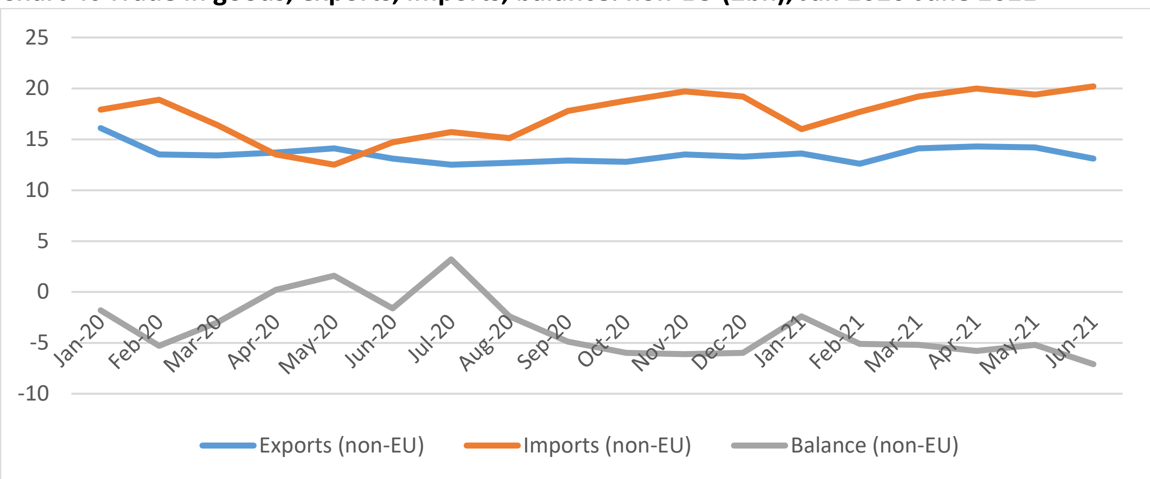


Chart 4c Trade in goods, exports, imports, balance: non-EU (£bn), Jan 2020-June 2021



Source: *ONS*, "UK trade: June 2021", 12 August 2021, tables 1 and 2. Revisions taken from January 2021 (from January 2020 for non-EU).

The ONS points out another complicating factor relating to the trade data in that they are potentially distorted by swings in trade of precious metals (including non-monetary gold (NMG)). They, therefore, publish two sets of data: a total series (including precious metals, see above) and their preferred "underlying" series (excluding precious metals). The distorting effects were not, however, especially large between May and June. The "underlying" data (excluding precious metals) showed a deterioration in the goods and services trade deficit to £2.1bn in June (compared with May's deficit of £0.6bn), see annex table 2. There was also a deterioration in the balance on precious metals to a deficit of £0.4bn in June (a £0.2bn surplus in May). The distorting effects on trade caused by precious metals mainly, but not entirely, relate to non-EU trade, rather than to EU trade.

A note on average maturity of debt

The July data for the public sector borrowing requirement (PSNB) will be released this week (on 20 August) and they are expected to continue showing moderation in borrowing on a year-on-year comparison. Significantly, however, June's data were characterised by a jump in interest payments. Interest payments on central government debt were £8.7bn in June 2021, the highest monthly payment on record (records began in April 1997). Specifically, the interest relating to the £470.7bn index-linked gilts in circulation (redemption value) increased sharply in June 2021 compared with June 2020, mainly as a result of the large increase in the RPI between March and April 2021 "…impacting on the uplift of the three-month lagged index-linked gilts".[10-11] Suffice to say, debt interest payments are very sensitive to the movements in the Retail Prices Index (RPI) to which index-linked gilts are pegged.

The increase in debt interest payments serve as a salutary reminder that they are also very sensitive to changes in interest rates, as the OBR pointed out in the *Economic and fiscal outlook*, accompanying the March 2021 Budget.[12]

The OBR explained that the average maturity of the net debt of the public sector as a whole (including the Bank of England) had shortened considerably since the global financial crisis, reflecting the large-scale gilt purchases by the Bank, via its Asset Purchase Facility (APF), as part of its quantitative easing (QE) operations. The gilt purchases have been financed through the creation of extra central bank reserves. The OBR estimated that 32% of the public sector's gross debt (£875bn out of £2.7trn) would be in the form of central bank reserves (issued to finance gilt purchases) by the end of FY2021. As these reserves currently paid an interest rate of 0.1% (whereas the gilts they have in effect refinanced paid an average interest rate of 2.1%) the net interest saving for the public sector as a whole was estimated at £17.8bn in FY2021. However, because the gilts purchased by the Bank had an average maturity of 13 years, whereas the liabilities issued to finance them carry an overnight rate of interest, this net saving came at the price of a significant reduction in the average maturity of the net debt of the public sector as a whole. This had significantly increased the sensitivity of debt interest spending to changes in short-term interest rates.

The OBR estimated that the mean maturity of the government's total gilt liabilities (including those held in the APF) was over 15 years at end-2020, very long by international standards. However, the impact of QE had been to reduce the <u>effective</u> mean maturity of the gilt stock to 11 years by end-2020. And, by the end of the current gilt purchase programme in FY2021-22, the OBR estimated that it will have fallen to around 10 years.

But this was not all, the OBR judged that the median maturity was probably a more useful summary statistic than the mean when assessing medium-term fiscal risks. Moreover, the median maturity is considerably lower than the mean - 11 years versus 15 years when ignoring the impact of APF, but a more dramatic shortening to 4 years rather than 11 years when the effects of the APF were factored in. And this median maturity would continue to decline over 2021 as the Bank continued to buy gilts. In addition, the other main sources of government financing (Treasury bills and NS&I savings products) were either variable rate or short-dated, which further increased interest rate sensitivity relative to that implied by gilt liabilities alone. The OBR estimated that when these liabilities were included the median maturity was reduced to less than one year by March 2022.

The OBR calculated the potential fiscal impact of an increase in interest rates to illustrate the greater interest rate sensitivity arising from the reduced effective mean/median maturity. If short- and long-term interest rates were both 1 percentage point higher than the rates used in their central forecast (in March 2021) debt interest payments would be increased by £20.8bn in FY2025.

As already noted, these estimates were made in March 2021. And it will be interesting to see if the OBR revises them significantly in the next Economic and Fiscal Outlook. The Chancellor of the Exchequer recently commissioned the OBR to prepare their next forecast for the economy and public finances for publication on Wednesday 27 October 2021.[13]

References

1. *ONS*, "GDP first quarterly estimate, UK, 2021Q2", 12 August 2021.
2. *Reuters,* "Fiscal stimulus, vaccinations lift US economy above pre-pandemic level", 29 July 2021.
3. *BBC, "*UK economy rebounds as Covid restrictions ease", 12 August 2021.
4. *ONS*, "GDP monthly estimate: June 2021", 12 August 2021.
5. *ONS*, "Index of Services, UK: June 2021", 12 August 2021.
6. *ONS*, "Index of Production, UK: June 2021", 12 August 2021.
7. *ONS*, "Construction output in GB: June 2021", 12 August 2021.
8. *ONS*, "UK trade: June 2021", 12 August 2021, including the quarterly data.
9. *ONS*, "UK trade: June 2021", 12 August 2021, including the quarterly data.
10. *ONS*, "Public sector finances: June 2021", 21 July 2021.
11. Ruth Lea, "Public sector borrowing: debt interest payments jump in June", *Arbuthnot Banking Group*, 25 July 2021, discussed the public finances.
12. *OBR*, "Economic and fiscal outlook", CP387, 3 March 2021, specifically the box titled "Debt maturity, quantitative easing and interest rate sensitivity".
13. *OBR*, "Economic and fiscal outlook date announced", 29 July 2021.

Annex

Table 1 Roadmap to easing lockdown (England)

	Dates	Developments
…	6 January	• Third lockdown begins.
Step 1	8 March	• Schools and colleges to reopen. "Stay at home" order remains in place.
…	29 March	• "Stay at home" order will end, but people urged to stay local. Outdoor sports facilities to reopen and formally organised sports can restart.
Step 2	12 April	• Non-essential retail, and personal care premises (such as hairdressers and nail salons, "close contact") can reopen. Hospitality venues (pubs and restaurants) can serve people but outdoors only. Self-contained accommodation can reopen (with restrictions). Indoor leisure facilities (such as gyms); zoos, theme parks, drive-in cinemas; public buildings (including libraries) can reopen (with restrictions).
Step 3	17 May	• Indoor hospitality (pubs and restaurants) can reopen (with restrictions); the rest of the accommodation sector (including hotels) can reopen. Remaining outdoor entertainment (such as outdoor theatres and cinemas) and indoor entertainment (such as museums, theatres and cinemas) can reopen. Some large events (including conferences, theatre and concert performances and spectator sports), subject to limits, can restart. Adult indoor sports/exercise groups can restart.
Step 4	19 July (originally "no earlier than 21 June")	• All legal limits on social contact to be removed. Reopen the remaining closed settings (including nightclubs) and restrictions on large events (including theatre performances) will be lifted. Working from home still encouraged, but under review.
…	16 August	• Requirement for people who are contacted by NHS Test and Trace to self-isolate will be relaxed on 16 August for people who are fully-vaccinated and for the under-18s.

Sources: *HM Government*, "Prime Minister sets out roadmap to cautiously ease lockdown restriction", press release, 22 February 2021 and updates.

Table 2 Trade (goods and services) in June, balances (£bn), exports and imports (% change)

	Monthly balances (£bn)			Exports and imports (June, MOM, %)	
	May 2021	June 2021	Change	Exports	Imports
Total balances:					
Goods (total): of which EU/non-EU:	-9.6	-12.0	-2.4	-3.6	3.6
• EU	-4.4	-4.9	-0.5	0	2.8
• Non-EU	-5.2	-7.1	-1.9	-7.2	4.3
Services	9.4	9.5	+0.1	1.3	2.0
Goods and services	-0.2	-2.5	-2.3	-1.5	3.2
"Underlying" balances:					

Goods (excluding precious metals): of which EU/non-EU:	-10.0	-11.6	-1.6	…	…
• EU	-4.5	-4.9	-0.4	…	…
• Non-EU	-5.5	-6.7	-1.2	…	…
Services	9.4	9.5	+0.1	…	…
Goods and services	-0.6	-2.1	-1.5	…	…
Precious metals: of which EU/non-EU:	0.4	-0.4	-0.8	…	…
• EU	0.2	0	-0.2	…	…
• Non-EU	0.2	-0.4	-0.6	…	…

Source: *ONS*, "UK trade: June 2021", 12 August 2021. There are rounding errors in the table.