Economic update
First quarter 2021

This report has been prepared from information available as at 10 February 2021.
Further information from: Mark Berrisford-Smith, Head of Economics, Commercial Banking, HSBC UK.
Tel 020 7991 8565 ; Email mark.berrisford-smith@hsbc.com

Key points

- The race to vaccinate the world's vulnerable populations against Covid-19 is now off and running. The speed with which vaccines can be rolled out, and whether new variants of the disease circumvent them, will be the key determinants of the timing and strength of economic recoveries. At present, the political imperative in advanced economies is to immunize as many people as quickly as possible, which means that a concerted effort to provide vaccines to poorer countries won't get underway until later this year.

- The global economic revival is just about intact, although the second wave of the pandemic means that many economies, notably in Europe, are again in lockdown. But the restrictions are not as severe as those that were imposed last spring, while many businesses have adapted their offerings to the new environment. The surge in demand for manufactured goods, which helped to fuel strong growth in China in the autumn, is now waning as western consumers contemplate the re-opening of close-contact services in the spring.

- Financial markets continue to rally in anticipation of a vaccine-fuelled recovery. Commodity prices are now above where they were when the pandemic struck, and bond yields have edged up as investors anticipate higher inflation rates in the near term. Yet the roll-out of vaccines may not be as straightforward or as quick as markets expect, which could set the stage for further bouts of volatility.

- The UK has made a good start in rolling out vaccinations, and it is likely that some restrictions will be eased in March. With GDP expected to expand by around 4.5% both this year and next, the economy is projected to regain its pre-Covid level of output at the end of next year. A key driver of the recovery will be the £140 billion or so of additional bank deposits that have been built up by households during the pandemic.

- But before the revival gets underway, GDP is set to contract by nearly 3% in the first quarter, with matters made worse by the disruption encountered by businesses as they adjust to the new trading relationship with the EU, and with the operation of the Northern Ireland protocol.

- Rishi Sunak is due to present his second Budget on 3 March. He will be keen to signal how and when Covid support measures will be wound down, and how money might be raised to help pay for them. Nonetheless, the budget deficit is still likely to top £200 billion in the 2021/22 fiscal year.

- Negative interest rates in the UK are off the table for now, although a final dose of quantitative easing is expected, probably in May. Sterling has enjoyed a modest rally in recent weeks, most likely in response to the UK's relatively fast vaccine roll-out. But in the medium term, it will continue to be pressured by the abundance of quantitative easing, compared to other major economies, and by the UK's weak fiscal position.

HSBC UK

Economic update: 1st quarter 2021

The global economy: vaccine hope

The global economic recovery remains just about intact. The pace of the recovery, which started in May of last year, has slowed markedly as new waves of Covid infections have necessitated a raft of new restrictions: for many people and businesses, the opening months of 2021 are proving to be tough, with many countries in the northern hemisphere back in lockdowns similar to those imposed last March.

So, while the economic data from the closing months of last year were often better than had been anticipated (and show that many businesses have found ways of adjusting to life in a pandemic), activity in many countries will decline in the first quarter of this year, before a vaccine-fuelled recovery gets underway. Even in China, which enjoyed a stellar revival during the closing months of last year, business surveys suggest that the recovery lost steam at the start of the year as a result of restrictions being put in place to stem the spread of new infections around the New Year holiday. The jobs data from the United States were also weak in January, with the pick-up in employment levels offsetting less than a quarter of the drop seen in December. In Europe, the number of Covid cases is now on a declining trajectory, but lockdowns remain widespread and severe, and will be lifted only slowly.

The good news is that several vaccines have now been licensed for use in major economies, and programmes to vaccinate elderly and vulnerable groups are gathering momentum. Vaccine production will ramp up considerably in coming months, and new formulations are also likely to become available. At present, however, the political imperatives facing governments in advanced economies means that vaccinating the most susceptible groups in their populations will take priority over making them available to poorer countries. It's therefore likely that the bulk of populations in the world's more affluent economies will have been vaccinated by the end of this year, which should allow life to return to something approaching normality. Indeed, with people forced to save during the pandemic, consumer demand should enjoy a strong rebound, especially for the close-contact services that people have had to do without for the past year. But, even with a good measure of international co-operation and with richer countries footing much of the bill, vaccinating susceptible groups in low-income countries could well take two to three years. Ultimately, the pandemic crisis will not be over until most of the world's population are protected from the virus. It's also only at that point that international travel and tourism will be able to return to its pre-pandemic normal.

Some bright spots have already emerged

There are of course still risks that new variants of the virus may, for a time, be able to circumvent the available vaccines, and also that the uptake of vaccinations may not be high enough in some countries. It's also inevitable that there will be economic "scarring", in the form of businesses that have closed and jobs that have been lost, which means that economic activity won't bounce back to pre-Covid levels immediately after all restrictions are lifted. But 2021 should nonetheless bring the start of a sustained revival, with HSBC forecasting global GDP growth of 4.6% this year, followed by 3.5% growth in 2022. In China, where both the initial Covid crisis and the subsequent recovery were a few months ahead of other major economies, GDP has already climbed back above its pre-pandemic level. And in other countries where the decline in output during 2020 was relatively modest, such as the USA, it's possible that by the end of this year the level of GDP will be at or close to its pre-pandemic level. India is another country that could be on track for a strong rebound in GDP this year, with Covid cases having fallen sharply and January's business surveys pointing to an accelerating recovery.

But that's by no means the case everywhere: in other countries– including the UK – the recovery looks set to be a slower affair, with GDP not getting back to pre-Covid levels until the end of 2022. That's also the case for parts of the Eurozone, where matters have not been helped by the early difficulties encountered in the roll-out of vaccination programmes. Not for the first time, Germany's economy is holding up relatively well and, of the region's 'big four' economies, it's the only one where output could be almost back pre-Covid levels by the end of this year.

Economic update: 1st quarter 2021

As the global economy recovers in 2021, making sure that the recovery is more evenly spread will be a key challenge in making the recovery more sustainable. In many countries, job losses during the pandemic have been disproportionately heavy among those on the lowest incomes and with the lowest savings levels; and at a global level, if vaccine rollouts are slower in the poorest countries, those countries could experience a delayed recovery.

HSBC global growth forecast

% change in GDP, vs previous year

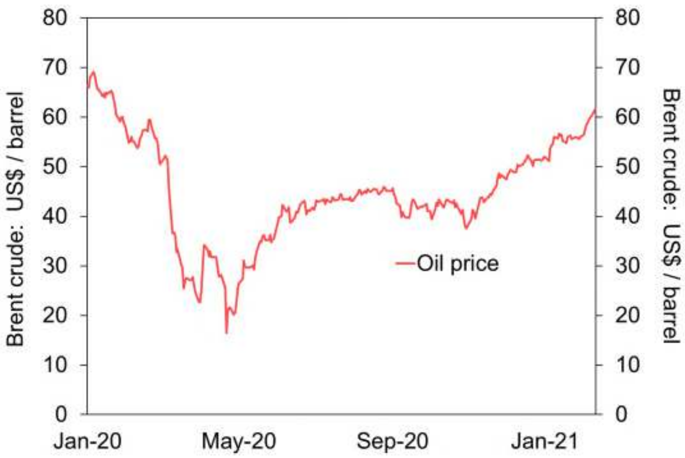
	2020	2021	2022
World	-3.6	4.6	3.5
USA	-3.5	3.5	2.5
China	2.3	8.5	5.6
Japan	-5.3	3.2	1.0
India	-8.0	8.3	4.4
Eurozone	-6.8	3.6	3.5
UK	-10.0	4.3	4.5
Russia	-3.9	2.3	1.3
Brazil	-4.2	3.2	2.3

Source: HSBC Global research

Inflation set to rise … but central banks are still in wait-and-see mode

As economic recovery gets underway, 2021 will also bring an uptick in global inflation rates, with business surveys already reporting that firms are facing sharp rises in their input costs. Several factors are at play, starting with rises in commodity prices: food prices have soared in the past few months, with the UN's FAO Food Price Index hitting a three-year high, driven by a combination of bad harvests and strong demand (particularly from China). In many emerging economies, where food represents a relatively high proportion of spending, this can quickly feed through to higher inflation rates. For the advanced economies, the recent rise in oil prices will be a bigger factor driving up inflation in the coming months. A significant milestone was reached in early February, when the price of Brent crude rose back to roughly pre-Covid levels, climbing above $60 a barrel for the first time since January 2020.

Oil prices have recovered: inflation in the pipeline for advanced economies



Source: Thomson Datastream

Upward cost pressures aren't just coming from commodities and raw materials. Shipping costs have soared over the past couple of months – particularly out of mainland China. This reflects strong global demand for goods produced in Asia, and a shortage of containers, particularly for European shipments, as many have been diverted towards North American shipping routes. It's thought that this surge in shipping costs will be temporary, but meanwhile the supply shortages could well mean lower inventories and therefore price rises during 2021.

As these price pressures feed through the inflation pipeline, it's likely that headline inflation rates in the USA, the Eurozone and in most G10 economies will be getting close to inflation targets or even rising above them during 2021. The question then arises, whether the inflation rates reached around mid-year will be the peak, or the beginning of a sustained trend of higher inflation? We expect the rise in inflation to be temporary, one key factor being the elevated level of unemployment, a legacy of the Covid disruption, meaning that upward pressure on wages is likely to remain muted. Of course, there are risks in the other direction. As and when Covid-related restrictions are lifted, a surge of pent-up consumer demand could put upward pressure on prices.

For the moment though, and given all the uncertainties that still surround the Covid outlook and how the major economies will emerge from their lockdowns, this is still an environment for loose monetary policy in the coming year. There are, therefore, no changes to HSBC's forecasts for US or Eurozone interest rates, with the benchmark rates in both cases expected to remain at their current levels (a range of between 0 and 0.25% in the USA, and a negative deposit rate of -0.50% in the Eurozone) until at least the end of 2022. In the UK likewise, we expect the Bank of England to make no change to interest rates during this period. The only significant change to our interest rate forecast is for New Zealand where, after an upside surprise on inflation adding to the 'V' shaped bounceback in GDP, we no longer expect rates to be cut into negative territory: rather boringly, we now expect the Reserve Bank of New Zealand to likewise keep rates on hold, at 0.25%, out to at least the end of 2022.

USA: a disappointing start to 2021

The first substantive data release for 2021, containing the official employment figures for January, was distinctly disappointing, and suggests that the Covid crisis is still hampering economic recovery in the USA. While there were some areas of jobs growth – the official statistics highlighted professional and business services among these – they were offset by losses in the sectors exposed to Covid restrictions, including leisure & hospitality, retail, transport & warehousing. The upshot is that the number of jobs ('Nonfarm payrolls') rose by just 49K in January, reversing less than a quarter of the 227K jobs that were lost in December.

On a more positive note however, the GDP figures suggest that the US economy was still enjoying positive growth at the end of 2020. The preliminary estimate of fourth-quarter GDP reported an 'annualized' growth rate of 4.0% for the three months to December, equivalent to a quarterly increase of 1.0%. With the full-year data now available, the figure for the calendar year 2020 shows an annual decline of 3.5%, which compares reasonably well with the performance of other major developed economies during 2020: the UK for instance, is likely to report an annual fall of around 10%, while Canada, Japan and Germany have all seen declines of over 5%. That said, the 1.0% growth in the USA during the final quarter of 2020 was a little weaker than expected, and is a marked slowing from the quarterly growth of 7.5% in the previous quarter.

Under the Federal Reserve's 'main-case' growth forecast (issued in December), the level of GDP should recover to pre-Covid levels during the second half of this year – perhaps in the third quarter. Our own forecast for GDP growth is somewhat more cautious but is still consistent with this being achieved by the end of 2021. The support package of $1.9 trillion proposed by President Joe Biden should help to sustain growth through 2021, and while this has contributed to pushing up inflation expectations, the US Federal Reserve is expected to leave interest rates unchanged through 2021 and 2022.

Economic update: 1st quarter 2021

Eurozone: recovery delayed by slow vaccine roll-out

As Europe's second (and then third) wave of Covid infections gathered pace through last autumn, economic activity at the end of last year was curbed by another round of restrictions. Yet Eurostat's preliminary estimate of fourth quarter GDP shows a relatively modest decline of just -0.7% during the final three months, an outcome that was a lot better than many had expected. In its December staff forecast for example, the ECB had pencilled in a contraction of -2.2%. The resilience of activity at the end of the year means that over the year as a whole, the Eurozone economy shrank by 'only' 6.8% (rather than the 7.2% that we had expected. And with households across the Eurozone having saved around €470 billion more in 2020 than they did in 2019 (equivalent to almost 4% of GDP), there could be a sizable boost to consumer spending as restrictions are lifted during 2021. But, with the relatively slow vaccine roll-out across the EU meaning that many restrictions remain in place at the start of the year, it now seems that the consumption bounce-back is likely to be delayed. This in turn has prompted a downward revision of our Eurozone growth forecast for 2021 to 3.6% (from our previous forecast of 4.3%), though offsetting this our 2022 forecast has been nudged up from 3.1% to 3.5%.

As is often the case, there are marked variations at national level, where our forecasts still imply an uneven recovery. Germany's economy in particular has been relatively resilient, and GDP could be almost back to pre-pandemic levels of output by the end of this year. By contrast, Spain's recovery is slower, because of its dependence on the service sector and tourism, and will take much longer to return to 2019 levels of activity.

China: an uneven recovery

By the end of 2020, China had staged an impressive economic recovery from the Covid-induced slump in activity at the start of last year. While GDP fell by nearly 10% during the first quarter of 2020, activity rebounded strongly and relatively quickly, such that the loss in output was made good in the following quarter. And with two quarterly increases of around 3% during the second half of 2020, China was unique among the world's major economies in achieving positive growth over the calendar year as a whole (albeit that the 2020 growth rate of 2.3% was a marked slowdown compared to previous years). By the final quarter of 2020, GDP was up by 6.5% compared to the final quarter of 2019, an annual growth rate higher than China's pre-pandemic growth rates.

Yet the picture is not quite as straightforward as these headline figures suggest. For one thing, the recovery has been uneven across different parts of China's economy, with activity in the consumer sector lagging behind a more robust recovery in industrial production and, in particular, exports. A contributory factor here has been the strength of global demand for pandemic-related products, such as protective clothing and equipment, so that by the end of 2020 export growth was running at an annual rate of nearly 20%. By contrast, consumer spending has been slower to recover, with retail sales at the end of 2020 showing a more moderate annual growth rate of below 5%.

Meanwhile business surveys have hinted at a slight loss of momentum at the start of this year. China, like other countries, has recently seen another uptick in Covid cases, prompting renewed restrictions in some regions. This has contributed to a softening in business sentiment, across both manufacturing and services, the latter seeing a fall of over four points in the Caixin services PMI in January. The more subdued mood may persist through February as, although we do not expect to see a full national lockdown, most local governments have put in stricter travelling and gathering restrictions, dampening consumer activity over the New Year holiday.

Looking forward, the data over the coming months are liable to volatile: many of the key statistics are presented as a percentage change compared to the corresponding period of the previous year, and such comparison will of course be heavily skewed by last year's exceptional circumstances. For the calendar year as a whole, HSBC expects China's GDP to expand by 8.5% this year, with annual growth settling back down to 5.6% in 2022.

Economic update: 1st quarter 2021

The UK economy – set for a summer surge

With Covid-19 running rampant and Brexit uncertainties unresolved until the last moment, the opening months of 2021 were always going to be tough. The New Year has ushered in a third national lockdown, as well as a new trading relationship with the EU under the Trade and Co-operation Agreement (TCA) that was finally concluded on Christmas Eve.

The survey of community Covid infection, published by the Office for National Statistics (ONS), reported that in the week to 9 January over 1.1 million people in England were infected. This is a random sample of the 'community population' (it excludes hospitals, prisons, and other institutional settings) and is the most reliable guide to the progress of the pandemic as it tests people irrespective of whether they have any symptoms. By the middle of the month, the number of people receiving hospital treatment for Covid had topped 37,000 and the daily death count was averaging 1,100, meaning that the second wave of the pandemic has turned out to be even more virulent than the first one back in March and April of last year. Meanwhile, the other main focus of media coverage were the reports of businesses struggling to cope with the new trade barriers with the EU: stories included 30 tonnes of meat rotting in Rotterdam, 71 pages of documentation accompanying one lorry of fish, and individuals being hit with large surcharges by courier companies to cover the cost of customs processing and paying import VAT.

By the start of February, there were clear signs that the pandemic was starting to abate, albeit not as quickly as it did last spring. The daily case numbers for the whole of the UK, which peaked at over 60,000 in early January, were running at closer to 20,000, with a daily decline averaging around 3%. Although these figures only track the status of those people who have taken a test after displaying symptoms, they suggest that, at the very least, fewer people are falling ill. Meanwhile, the programme of mass vaccination has ramped up to the point where around three million doses are being dispensed each week, with the UK well ahead of other large economies, notably those in the EU. The Government will therefore hit its target to inoculate the top four groups on the priority list, set out by the Joint Committee on Vaccinations and Immunization (JCVI), which includes all those aged 70 and above, by the middle of February.

A road map out of lockdown

A 'road map' of how the present lockdown in England will be lifted is to be announced on 22 February. It's likely that a return to face-to-face teaching at schools and universities will be at the top of the list, with 'non-essential' retailers allowed to re-open next, although possibly not before Easter. As regards the hospitality sector, scientific advice is leaning towards keeping outlets shut until at least May or June. Over 90% of people who have become seriously ill from Covid have been aged over 50. The Government may therefore judge that re-opening hospitality venues will not be safe until this portion of the population, numbering some 25 million, have received at least one dose of vaccine. Assuming that this can be done by early May, and allowing a couple of weeks for the jabs to become effective, this would suggest the end of May or early June as the most likely dates for re-opening pubs, restaurants, and holiday and leisure venues.

The roll-out of vaccinations to older age groups has prompted a renewed interest in booking holidays. But, with the Government and its scientific advisers becoming increasingly concerned about the spread of new variants that might circumvent the present vaccines, especially the South Africa variant, travel restrictions are now tighter than at any time during the pandemic. If the vaccine roll-out continues as planned, a good measure of re-opening will be possible by the summer, but it remains doubtful whether people will be able to take their holidays abroad, and what proof of vaccination or test results will be needed. The same applies to the ability of people from overseas to come to the UK, whether for holidays or to work. Matters aren't helped by the fact that, as yet, there is no international consensus as to how to handle travel and tourism.

Economic update: 1st quarter 2021

Learning to live with Covid

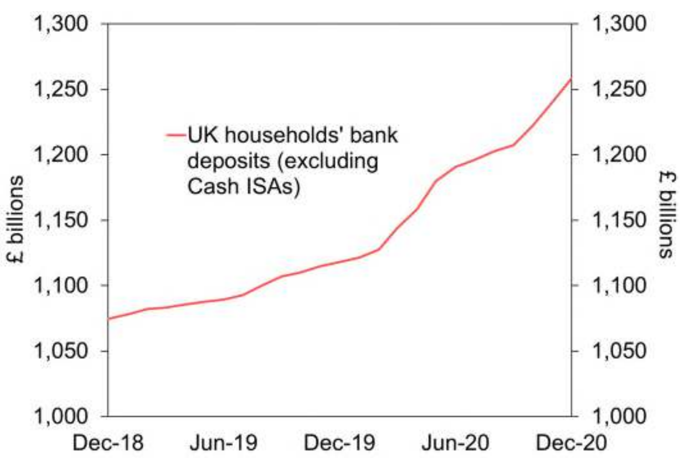
In the meantime, the only consolations are that the third English lockdown isn't as severe as the first lockdown of last spring, as is obvious from road traffic levels. The biggest difference is that manufacturing and construction sites are still functioning fairly normally. And even in the sectors more directly affected by lockdown, many firms have adapted and found new ways to serve their customers – albeit often at below-normal levels. Meanwhile the various government support schemes remain in place, with the Jobs Retention Scheme (furlough) extended until the end of April. As a result, the negative impact on economic activity won't be anything like as severe as that which occurred in the second quarter of last year.

During the short England-wide lockdown in November, the UK's GDP fell by just 2.7%, with construction output slightly higher than it had been last February, and manufacturing production only marginally lower. It now looks as if the UK will narrowly avoid a 'double-dip recession', with output in the fourth quarter expected to be marginally higher than in the preceding three months. This is despite the curtailed re-opening in December, which saw many shops and restaurants closed again by Christmas. GDP in the fourth quarter is expected to have expanded by just 0.2%, meaning that for 2020 as a whole it would be 10% lower than in 2019. By way of comparison, the economy contracted by 4% in 2009. Which seemed pretty grim at the time, perhaps because it wasn't mitigated by the extensive government support schemes that have been put in place this time round.

Forced to save

Consumer confidence, as measured by the monthly GfK/NOP poll, has remained at depressed levels, falling from -24 in December to -26 in January. But, as has been evident throughout the pandemic, these findings say more about peoples' fear of catching Covid than about their ability to spend money. Retail sales have held up remarkably well, buoyed by the switch from 'leisure spending' (for example restaurant visits) in favour of goods, such as bicycles, barbecues, firepits, kitchen gadgets, consumer electronics, and exercise bikes. This shift, which has been evident across many advanced economies, has contributed to the global shortage of shipping containers and, together with Brexit and imports of PPE, explains the congestion at ports. In both November and December, the volume of retail sales, excluding automotive fuel, was 6.5% higher than in the same months of 2019, while non-store retailing (mostly sales by online specialists) were around 40% higher. That said, overall spending by households remains well down from pre-pandemic levels. Even during the third quarter of last year, when pubs, restaurants, gyms, and holiday venues were open, spending was still a tenth lower than in 2019.

The build-up of household savings



Source: Bank of England

Economic update: 1st quarter 2021

With households' incomes being sustained by the government's furlough scheme, by several rounds of payouts to the self-employed, and by increased Universal Credit payouts, there has been no appreciable economy-wide loss of spending power. Indeed, aggregate wages and salaries received in the first nine months of last year were still 1.3% higher than they had been the year before. So, as the lockdowns continue, people are effectively being forced to save. The savings rate (that portion of income that isn't spent) reached a record 30.7% on a cash basis in the second quarter of last year, before falling back to 17.8% in the third quarter, which is probably where it will remain until life returns to something like normal.

This enforced saving means that households have continued to build up bank deposits, most of which will be spent at some point in the next few years, even if it takes some while before long-haul holidays are back on the agenda. In the ten months to the end of December, households added £139 billion to their stock of bank deposits (excluding funds held in cash ISAs). The pace of accumulation has not been quite as frenetic in recent months, as businesses have found more innovative ways to continue to serve (or tempt) their customers. Nonetheless, the amount added between the end of September and the end of December was still £57 billion.

A mini-boom in the housing market

Some of this money has already found a use, with the Chancellor's temporary removal of Stamp Duty Land Tax helping to spur a mini-boom in the housing market. By the end of 2020, activity in the market was at its briskest since the halcyon days before the financial crisis, with monthly loan approvals for mortgages (excluding re-mortgaging) running at more than 90,000. Having successfully taken the heat out of the market since 2016's tax changes, annual price growth was running at around 7.5% by the end of last year, which may ring alarm bells at the Treasury, as the Government doesn't want to see potential first-time buyers being priced out.

Of course, some of the savings that have accumulated during the pandemic will be kept back as "rainy day" funds, to get through spells of unemployment or under-employment. The official labour market statistics are still showing an unemployment rate that is creeping up only very slowly, standing at 5.0% in the three months to November. This represents an increase of more than one percentage point from the pre-pandemic level, but is nonetheless still low by historic standards. It's worth mentioning though that there are concerns that the official unemployment measures, which are published by the ONS and derived from the Labour Market Survey, may have gone a bit awry as the statisticians work out how to go about their work in a pandemic.

An exodus of labour?

This was highlighted by a research note published in January by the Economics and Statistics Centre of Excellence (ESCOE). The note casts doubt on the way in which the Labour Force Survey is being used to measure the number of people who are out of work, and also suggests that the official unemployment rate is low because of an exodus of foreign nationals, which has reduced the size of the workforce. ESCOE believes that some 1.3 million people have left the UK since March of last year, with some 700,000 quitting London alone. It wouldn't be the first time that statisticians have missed large migrant flows, and if ESCOE is correct then it will be interesting to see whether these people will want to return to the UK once all this is over, or whether they've left for good, with implications in the medium term for the supply of labour, especially in the hospitality and accommodation sectors.

The narrower measure of job losses, based on the number of people registered on PAYE, has now reached 828,000 (as at December). But that month actually saw an increase of 52,000 in PAYE employment, halting the Downward trend of previous months. Although further jobs were lost from the distributive trades, and from food service and accommodation businesses, this was more than offset by increases in administration and support services, and in the public sector.

Economic update: 1st quarter 2021

The impact of the furlough scheme

Meanwhile, the number of people on furlough has held at a much lower level during recent lockdowns (compared to the numbers who were furloughed last spring during the first lockdown). Last spring, the number of employments furloughed peaked at 8.9 million at the start of May, and had fallen to 2.4 million by the end of October, when the scheme was originally slated to end. During November's lockdown it peaked at just 4.1 million, but then fell back only slightly to 3.8 million during December's abortive re-opening. By the end of 2020, HMRC reported that 36% of employers were availing themselves of the scheme to furlough 13% of their jobs.

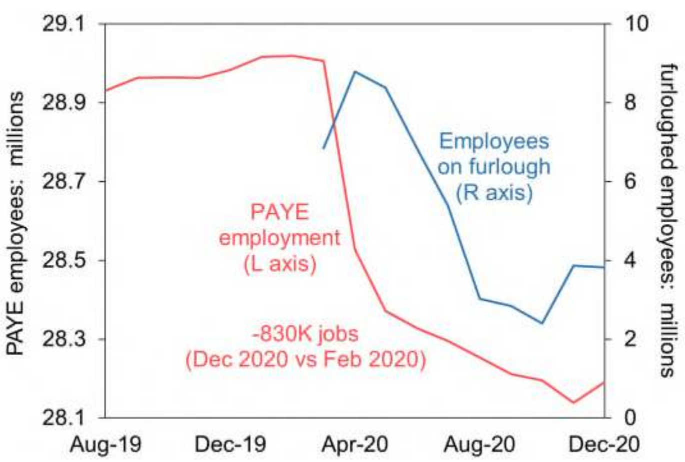
The decision to extend the Jobs Retention Scheme (JRS) initially to March, and then to April, has clearly taken a lot of immediate pressure off employers. Yet it's still likely that the spring and summer of this year will bring a new wave of lay-offs as businesses adjust to the "new normal" without furloughs. The official unemployment rate is expected to top out at 6.7% in the third quarter, although it shouldn't come as a surprise if methodological and measurement changes mean that it is eventually reported as being somewhat higher.

Persuading firms not to get stuck in the retrenchment rut

For businesses, the pandemic continues to serve up a wide variety of outcomes, with some long-established high-street retailers going to the wall, while firms in some other sectors are reporting stellar expansion. Across the economy as a whole, the profits of private sector businesses shrank by around 5% between the first nine months of 2019 and 2020, a slightly smaller decline than in 2009 after the financial crisis. With firms deferring tax payments, reducing dividend payouts and slashing capital expenditure, their net lending position (similar to the cashflow before financing for an individual business) swung from a modest deficit of £10 billion last year to a surplus of nearly £14 billion during the first three quarters of 2020.

This is a perfectly normal response on the part of businesses during tough times, as they seek to look after their balance sheets. During and after the financial crisis, firms collectively racked up surpluses on their net lending positions of £115 billion, and didn't return to being borrowers until 2013. The hope this time around is that the combination of the government support measures, including the various loan schemes, together with a strong revival of demand from the second quarter of this year, will ensure that the nation's businesses don't spend five years in retrenchment mode, and that they return to being net borrowers before too long.

830K jobs lost … and about 4 million on furlough



Source: ONS, HMRC

Economic update: 1st quarter 2021

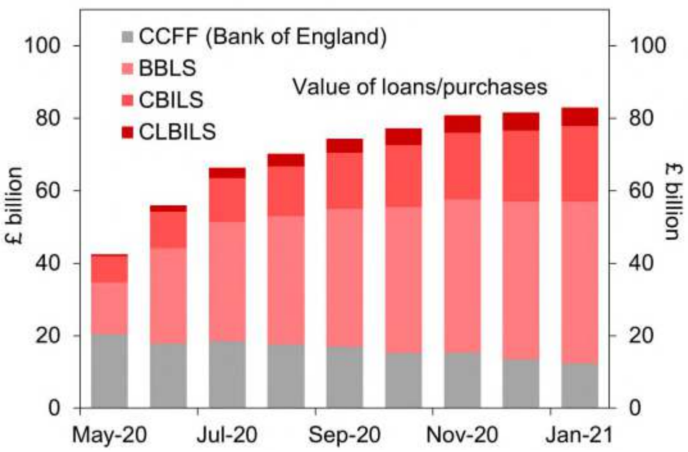
Businesses, especially smaller firms, are still availing themselves of government-backed loans, after the three schemes backed by HM Treasury were extended until the end of March. By late January, £70.7 billion of facilities had been granted: £44.7 billion of BBLS, £20.8 billion of CBILS, and £5.1 billion of CLBILS, with the Bank of England's commercial paper scheme providing an additional £12.1 billion of funding to investment grade corporates.

But the financing needs and experience of large and small companies are very different.   Many larger companies, after initially drawing heavily on existing unused facilities and revolving credits, have also looked to other sources of funding, including the bond and equity markets. By the end of 2020, they owed UK banks £283.4 billion, the same as at the end of February, just before the pandemic struck. This suggests that having taken out loans under the CBILS and CLBILS schemes, after the shock of last spring's cliff-edge decline in economic activity they have been able to repay pre-existing borrowings.

By contrast, SMEs (defined as businesses with a turnover of under £25 million on their main bank account) increased their bank borrowings over the same period from £155.5 billion to £204.4 billion. The issue of how best to manage this increased burden of debt taken on by SMEs is just one of the many tricky conundrums that the Government will need to find answers to in the months ahead. On 5 February, the Chancellor, Rishi Sunak, announced that SMEs who have taken out Bounce Back Loans will be able to extend the repayment periods and to take holidays from repaying the interest and the capital.

It's perhaps no surprise that the process of "creative destruction" has accelerated among businesses during the pandemic. Both the numbers of business births and deaths have increased sharply, and well in excess of rates that have been typical in recent years. The processes of "birth" and "death" when applied to businesses means that they leave or join the government's Inter-Departmental Business Register (IDBR). In the fourth quarter of 2020, the number of births was 24% higher than a year earlier, while deaths were up by 37%. With 'deaths' often taking several months to register, this increase is a reflection of businesses being closed throughout the period of the pandemic. But, with the number of insolvencies remaining at low levels, most closure decisions have been voluntary; and some may still be a reaction to the impending changes in the IR35 regime for contractors, which is due to take effect in April, having been delayed for a year.   The increase in business 'births' is most likely a reflection of people seeking to take advantage of new opportunities presented by the pandemic, such as in online retailing, or people who have lost their jobs opting to start their own businesses.

Covid lending schemes: an £80 billion bridge over the abyss



Source: Bank of England

Economic update: 1st quarter 2021

A summer revival, rather than spring

The conditions are starting to fall into place for a strong revival of activity in the UK later this year – provided that the vaccines are successfully rolled out, and that new virus variants don't emerge to circumvent them. As a result of the second and third national lockdowns in England, the economy's performance in the first few months of 2021 will be worse than was expected at the time of our previous *Update*. But this shortfall is expected to be made good fairly quickly, and with the help of some modest upward revisions to last year's data, the economy is now expected to regain its pre-Covid level of GDP in the closing months of 2022, a few months earlier than previously forecast. Bearing in mind that there are still many uncertainties, annual GDP growth is forecast to come in at 4.3% this year and 4.5% next year, before slowing to a more muted, and more typical, pace in 2023.

The big question for this year is about the precise timing of the revival. But that can't be known until the Government announces firm plans for lifting restrictions, with one crucial issue being the date from which people are allowed (or encouraged) to return to offices. While non-essential shops, pubs and restaurants, and holiday and leisure venues may well be allowed to open up during the second quarter, it could be the third quarter before the nation's city centres return to life. Much will also depend on how people respond to the lifting of restrictions: looking back at last summer's re-openings, for all the media coverage of night-time revelry in city centres, the data on footfall showed a more general caution about returning to pubs, restaurants, and shopping malls.

Looking further ahead, the trajectory of the economy will depend on whether restrictions can be lifted altogether, or whether some restrictions are retained during the winter of 2021/22. It will also depend on how much economic 'scarring' has been caused, despite the extensive government support and bank loans – in other words, how much productive capacity will be lost as businesses either close for good or downsize their operations, and how long will it take for other firms to make good those losses. For individuals, the 'capacity' of the economy translates into employment prospects, and the time that it will take to replace jobs that are lost as a result of the pandemic. Having peaked this year, the unemployment rate is expected to fall back only slowly, averaging 6.1% during 2022.

The forecasts also take account of the negative impact on growth during the early months of this year arising from the new trading arrangements between the UK and the EU. The UK-EU Trade and Co-operation Agreement (TCA) preserves tariff-free trade in goods, but with the proviso that local content requirements need to be demonstrated. The added cost and complexity of moving goods across the border, which have been widely reported in the media, may eventually force many businesses to reconfigure their supply chains, though it's possible that behind the scenes the technocrats will find ways to make the processes easier.

With import and export volumes likely to be materially lower in the first few months of the year, the volume of exports during 2021 as a whole is expected to be 1.3% lower than in 2020, while imports are forecast to revive by just 4.4%. In the case of exports it's the new barriers in getting shipments to the EU that will inhibit the revival; for imports, it's the ongoing restrictions on Britons taking foreign holidays and business trips that will act as a constraint. In both cases, the volume of trade is still likely to be well down from 2019's level.

The inevitable re-jigging of supply chains will take place over the next 12-18 months. In that process, it's likely that some UK firms will get cut out of predominantly EU supply chains, and vice versa. Some British businesses will only be able to continue to serve their customers in the EU by moving parts of their operations to an EU country. Given the relative size of the markets, it's likely that the UK will be a modest net loser from this process. Looking further out, the UK's economic growth rate is likely to be a little slower than would have been the case had it not left the EU's Single Market. This is on account of the economy being less open than it was before, with barriers to the movement of goods, services, and people from the EU. Signing new trade agreements will help, but is unlikely to be enough.

Economic update: 1st quarter 2021

The fiscal challenge

Rishi Sunak will present his second Budget on 3 March. Since his first Budget, delivered at the onset of the crisis last March, he has presented several statements to Parliament, which have contained more measures than would be found in a typical set-piece Budget. This time around, he must wrestle with the difficult choices about when, and how quickly, to withdraw the various support schemes that have been introduced in the past year, and whether he should start to take tangible measures to restore the government's battered finances through higher taxation. Recent months have seen a flurry of ideas floated in the newspapers, including reform of Capital Gains Tax, windfall profits levies, online sales taxes, and various schemes for taxing wealth.

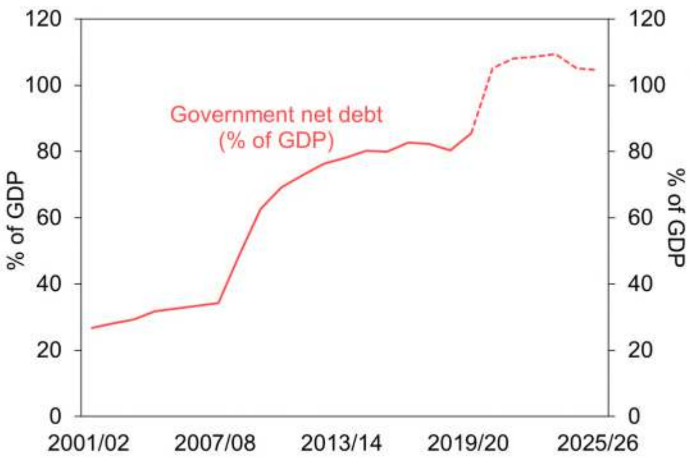
With the budget deficit on course to come in at around £365 billion the current 2020/21 fiscal year is a lost cause; but the Chancellor will be keen to make tangible progress during 2021/22 to get the public finances heading in the right direction. Nonetheless, with parts of the economy unlikely to re-open before the summer, and international travel likely to be disrupted for longer, there is no prospect of an abrupt withdrawal of support. In the light of that, the budget deficit is still likely to come in at over 11% of GDP in 2021/22, or in cash terms well over £220 billion.

Ongoing pressure for sterling

The pound has gained several cents on the euro in recent weeks, reaching €1.14 in early February. This could be partly in response to the agreement of trade deal with the EU, but probably is much more to do with the UK's relatively swift roll-out of Covid vaccines. Looking further ahead, sterling is expected to remain under pressure, on account of a weak fiscal position and the Bank of England's penchant for quantitative easing. Nearly every country in the world has thrown the proverbial kitchen sink at the Covid crisis, but few have spent as much as Britain, relative to the size of the economy. The public finances weren't in great shape before the crisis blew up, and the upshot will be a debt to GDP ratio that will top out at around 110%.

Meanwhile, the Monetary Policy Committee (MPC) remains committed to ensuring that monetary policy supports the coming recovery, and is expected to opt for another £100 billion of asset purchases, most likely at the policy meeting in May. This would take the total value of acquisitions since 2009 to £995 billion. In relation to the level of UK GDP, the Bank of England's expansion of its balance sheet has been more aggressive than other central banks, and is likely to add to the downward pressures on the pound. The recent revival of sterling is therefore not expected to endure, with the pound ending 2021 at €1.06 against the euro, and against the dollar at $1.30.

Borrowing during the Covid crisis has pushed debt above 100% of GDP



Source: ONS / Office for Budget Responsibility

Negative interest rates off the table, for now

As for interest rates, the Bank of England appears to have ruled out negative interest rates, at least for the time being. But, like almost all of its central bank counterparts, it will be in no hurry to start tightening policy. The MPC will certainly be inclined to "look through" any short-term uptick in the rate of inflation, and no move is expected before the end of 2022.

But looking to the medium term, the combination of loose monetary and fiscal policy stances could well finally bring inflation back to its 2% target, or even higher. The main measure of the UK's money supply, known as M4, is now expanding at an annual rate of around 14%, markedly faster than at any point in the aftermath of the financial crisis. With the pandemic having led to the destruction of some supply capacity, all this extra money will eventually be competing for scarce goods and services, at which point inflation will make a comeback.

Once that happens, the Bank of England will be justified in starting to get Bank Rate back to where it ought to be in normal economic and monetary conditions, that's to say around 2.5-3.0%. In the last economic cycle, the US Federal Reserve was, among the major developed economies, the only central bank that managed to get rates back to normal levels – and then only for a short period. It would be no bad thing if, this time around, the combination of monetary and fiscal stimulus paved the way for an eventual escape from 'Planet Zirp' (zero interest rate policy).

Mark Berrisford-Smith
Head of Economics, Commercial Banking, HSBC UK.

Economic update: 1st quarter 2021

Forecasts

Global economic growth					
Annual % change in real GDP				(f) = forecast	
	2018	**2019**	**2020**	**2021**(f)	**2022**(f)
World (nominal GDP weights)	**3.3**	**2.6**	**-3.6**	**4.6**	**3.5**
Developed economies	2.3	1.6	-5.2	3.8	2.6
Emerging economies	4.8	4.0	-1.6	6.1	4.3
North America					
USA	3.0	2.2	-3.4	3.5	2.5
Canada	2.0	1.7	-5.6	3.5	2.6
Asia/Pacific					
China	6.7	6.1	2.3	8.5	5.6
Japan	0.6	0.3	-5.3	3.2	1.0
India	6.8	4.9	-8.0	8.3	4.4
Australia	2.8	1.9	-2.8	3.5	2.8
South Korea	2.9	2.0	-1.2	2.7	2.0
Indonesia	5.2	5.0	-2.1	4.9	5.4
Taiwan	2.8	3.0	2.5	3.5	2.7
Thailand	4.2	2.4	-6.1	3.6	3.9
Malaysia	4.8	4.3	-5.4	6.7	5.1
Singapore	3.4	0.7	-6.1	6.5	3.5
Hong Kong	2.8	-1.2	-6.2	4.4	2.9
Philippines	6.3	6.0	-9.7	6.5	6.5
New Zealand	3.2	2.3	-3.6	4.3	3.3
Eurozone	**1.9**	**1.3**	**-6.8**	**3.6**	**3.5**
Germany	1.3	0.6	-5.3	3.1	3.2
France	1.8	1.5	-8.3	4.6	3.5
Italy	0.8	0.3	-8.9	3.9	3.4
Spain	2.4	2.0	-11.0	5.0	5.2
Other Western Europe					
UK	1.3	1.4	-10.0	4.3	4.5
Switzerland	3.1	1.1	-3.4	2.4	1.9
Sweden	2.0	1.4	-3.5	2.9	2.9
Norway	2.5	2.4	-3.9	4.4	2.3
Eastern Europe, Middle East & Africa					
Poland	5.4	4.5	-3.4	3.3	4.4
Hungary	5.4	4.6	-5.7	3.5	4.1
Czech Republic	3.2	2.3	-6.1	3.2	4.1
Russia	2.3	1.3	-3.9	2.3	1.3
Turkey	3.0	0.9	1.0	2.1	3.6
Saudi Arabia	2.4	0.3	-4.2	3.6	3.5
South Africa	0.8	0.2	-7.0	3.5	1.7
Latin America					
Brazil	1.8	1.4	-4.2	3.2	2.3
Mexico	2.1	0.0	-9.0	3.0	2.0
Argentina	-2.6	-2.1	-11.0	4.0	2.7
Chile	4.0	0.9	-6.0	4.5	3.3

Source: HSBC Global Research

Economic update: 1st quarter 2021

Forecasts

Policy interest rates

Interest rate (%) at end-period	Dec 2020	Forecast June 2021	Dec 2021	June 2022	Dec 2022
North America					
USA*	0.25	0.25	0.25	0.25	0.25
Canada	0.25	0.25	0.25	0.25	0.25
Western Europe					
Euro Area (Refi rate)	0.00	0.00	0.00	0.00	0.00
Euro Area (deposit rate)	-0.50	-0.50	-0.50	-0.50	-0.50
UK	0.10	0.10	0.10	0.10	0.10
Norway	0.00	0.00	0.00	0.25	0.50
Sweden	0.00	0.00	0.00	0.00	0.00
Switzerland	-0.75	-0.75	-0.75	-0.75	-0.75
Emerging Europe					
Poland	0.10	0.10	0.50	0.50	0.50
Hungary	0.60	0.60	0.60	0.60	0.60
Czech Republic	0.25	0.25	0.50	0.75	1.25
Asia/Pacific					
Japan	-0.10	-0.10	-0.10	-0.10	-0.10
China	3.85	3.85	3.85	3.85	3.85
India	4.00	4.00	4.00	4.00	4.00
Australia	0.10	0.10	0.10	0.10	0.10
New Zealand	0.25	0.25	0.25	0.25	0.25

* Upper end of target range
Source: HSBC Global Research (*Global Policy Rates, 8 February 2021*)

Currency exchange rates

Exchange rate at end-period		2020 Q4	forecast 2021 Q1	Q2	Q3	Q4
Rates against £						
US dollar	USD/GBP	1.37	1.34	1.34	1.34	1.34
Euro	EUR/GBP	1.12	1.09	1.08	1.07	1.06
Japanese yen	JPY/GBP	141	139	138	137	137
Canadian dollar	CAD/GBP	1.74	1.69	1.66	1.65	1.63
Australian dollar	AUD/GBP	1.78	1.74	1.70	1.68	1.65
New Zealand dollar	NZD/GBP	1.90	1.86	1.84	1.81	1.79
Swedish krona	SEK/GBP	11.24	11.11	10.91	10.83	10.63
Norwegian kroner	NOK/GBP	11.72	11.33	11.13	10.94	10.63
Swiss Franc	CHF/GBP	1.21	1.19	1.19	1.19	1.19
Other rates						
US dollar / euro	USD/EUR	1.22	1.23	1.24	1.25	1.26
Chinese yuan / USD	CNY/USD	6.53	6.45	6.40	6.50	6.60

Source: HSBC Global Research (*Currency Outlook*, February 2021)

Economic update: 1st quarter 2021
Forecasts

UK economy

annual % change, adjusted for inflation (except where otherwise stated)

	2020	*forecast* 2021	2022
GDP	-10.0	4.3	4.5
Consumer spending	-12.5	5.9	5.3
Government spending	-7.8	8.2	3.9
Investment	-12.7	2.3	6.0
Stockbuilding (% of GDP)	0.4	0.5	0.7
Domestic demand	-11.0	6.1	5.1
Exports	-13.9	-1.3	7.8
Imports	-19.2	4.4	10.0
Manufacturing output	-9.8	7.6	3.2
Unemployment rate (%)	4.6	6.5	6.5
Average earnings	0.9	2.7	2.9
Inflation - CPI	0.8	1.4	1.9
Current account (US$ bn)	-54	-138	-148
Current account (% of GDP)	-2.1	-5.1	-5.2
Public sector net debt (% of GDP)	107	107	109
Public sector net borrowing (% of GDP)	18.2	11.3	6.3
Exchange rate[1] US$ / £	1.37	1.34	--
Exchange rate[1] € / £	1.12	1.06	--
UK Bank Rate[1] (%)	0.10	0.10	0.10

1. at end-period.

Forecast as at 10 February 2021; data and forecasts are subject to revision

Source: HSBC Global Research

Issued by HSBC UK

CMB Economics, HSBC UK, 71 Queen Victoria St, London EC4V 4AY