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UK: The Brexit-pandemic supply crunch

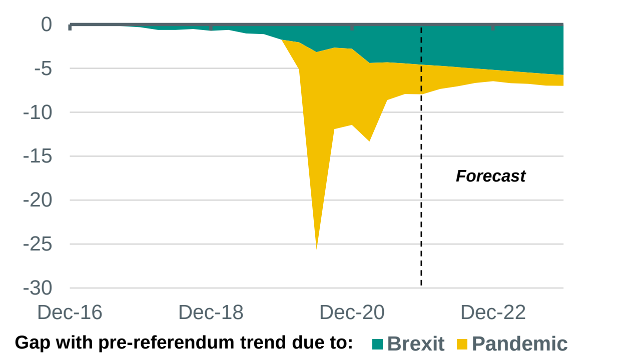
Bill Diviney – Senior Economist | bill.diviney@nl.abnamro.com

- **The economy is weaker than it appears, despite the sharp rebound in GDP this year and next**
- **Pandemic supply-side disturbances are conspiring with unique Brexit-related hits to the economy's productive capacity. This is limiting growth, and pushing inflation higher**
- **The mix of a shortfall in demand but an even bigger shortfall in supply poses a unique challenge for the Bank of England, which is likely to begin raising rates as soon as this month**

The UK economy was one of the hardest hit by the pandemic in 2020, with a peak to trough fall in GDP of 22% (compared with 15% in the eurozone, and 10% in the US). It is therefore no surprise that the rebound in 2021 has been among the strongest: we expect full year growth of 6.8%, compared with 5.1% in the eurozone, and 5.6% in the US. The strength of the rebound overstates the strength of the economy, however; GDP has just about recovered its pre-pandemic peak, but the economy is still expected to be 3.5pp smaller at the end of this year than it would have been absent the pandemic – and this is before we even talk about Brexit. Indeed, the effects of the pandemic are difficult to fully disentangle from Brexit given the timing of the UK's departure from the Single Market, a little under a year ago. The impact of new border checks and immigration restrictions has been significant, however, and aside from reducing the potential output of the UK economy, the reduced supply side capacity of the economy is also one of the main reasons the Bank of England will likely have to tighten monetary policy sooner than other major central banks. This earlier tightening of policy ought to bring inflation back to target, but it will also inevitably weigh on demand in the medium term.

Pandemic effect fading, but Brexit impact is increasing

GDP gap with pre-referendum (2016) trend, percentage points



Source: Refinitiv, OBR, ABN AMRO Group Economics

Inflation would stay above target without rate hikes

CPI, % y/y; Forecast = BoE estimate under different policy rate scenarios

Source: Bank of England, ABN AMRO Group Economics

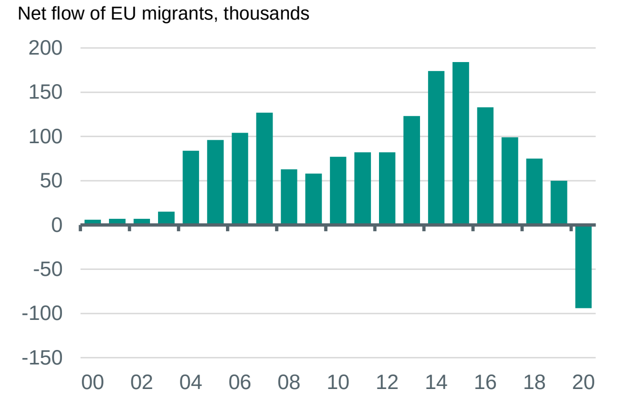
As with the eurozone and the US, inflation has picked up significantly in recent months, rising to a 10 year high of 4.2% y/y in October, and is expected to peak near 5% in the spring, when Ofgem (the national energy sector regulator) raises the household energy price cap to reflect the recent jump in wholesale gas prices. Indeed, although household energy bills already rose significantly in October, this incorporated only part of the rise in wholesale prices, with the result that some 28 energy suppliers have gone bankrupt this year so far, covering 5.8m households. However, energy is not the only driver of inflationary pressure in the UK. Core CPI inflation also rose to a 10 year high of 3.4% y/y in October. The UK has not experienced the same excess goods consumption that we have seen in the US – retail sales are broadly in line with the pre-pandemic trend. However, the UK is also facing some idiosyncratic supply-side bottlenecks via Brexit that are pushing up inflation, in addition to those faced by economies globally in recent months (such as shipping tariff rises and semiconductor shortages).

The BreX-Factor: UK is running up against capacity constraints sooner than elsewhere

First off are the permanent, albeit one-off cost-push pressures related to the UK's exit from the EU's customs union at the end of 2020, which has increased the bureaucratic burden on importers and exporters. While full checks have yet to start on UK imports from the EU – checks on UK exports on the EU side began from day one – businesses have already faced higher costs from the need to prepare for the start of checks (this has been repeatedly delayed, with checks now due to start in phases from next January to July). Time and money spent on bureaucracy is time and money that cannot not spent on raising the economy's productive capacity. While we had expected an immediate impact from increased border frictions on the goods sector, however, a more surprising effect of Brexit has been a worker shortage, following the end of free movement of people linked to the UK's Single Market exit. While the movement of migrant workers has been hampered globally by the pandemic, in the US for instance, migrant worker levels have more or less normalised. The UK saw a net outflow of EU citizens for 2020 as a whole – the first such outflow in three decades – following many years of net inflows from the continent. Although we only have estimates for 2021, the latest data to June suggests that outflow has continued. This pairs well with data suggesting a very tight labour market, despite the continued shortfall in aggregate demand vs pre-pandemic trend, as well as the many anecdotal reports of difficulty finding staff for vacancies often filled by EU workers. The most visible of these shortages – and one that has had a near-systemic impact – has been that of lorry drivers, which has led at various stages to fuel shortages and supermarket shelves being empty of certain goods. As well as having a restraining impact on consumption, this has also put upward pressure on inflation.

The net effect of all of this is that the economy is running up against capacity constraints much sooner than we are seeing in other advanced economies, with potential output perhaps even lower than the pessimistic assumptions we laid out in last year's UK Outlook publication. While we expect the economy to continue its strong recovery from the pandemic in 2022, with growth of 4.9% expected, the level of output is likely to significantly lag what would have been possible absent both the pandemic and Brexit, with a net shortfall in GDP of around 6.5pp at end-2022 on our estimates. In 2023 – once the bulk of the pandemic recovery is behind us – Brexit will continue to limit growth in the supply side of the economy, with the drag on output therefore increasing modestly (see chart on previous page).

First net outflow of EU migrants in three decades…



Source: Refinitiv, ONS, ABN AMRO Group Economics

…likely a key driver of the tight labour market

Source: Refinitiv, ABN AMRO Group Economics

Rate hikes look increasingly necessary to bring demand back into balance with weaker supply

This mix of a continued shortfall in demand but an even bigger shortfall in supply poses a unique challenge for the Bank of England, which has until now aimed to support demand, but is now having to be mindful of the inflationary consequences of the supply shortfall. This is particularly pertinent given that inflation has been historically higher in the UK compared with the US and especially the eurozone, with a bigger corresponding risk of a de-anchoring of inflation expectations. With inflation already far above the central bank's 2% target, and little sign of an increase in labour supply either from a loosening in the government's strict new immigration regime, or from the end of the pandemic wage subsidy scheme in October (which initially looked like it would generate some rise in unemployment), governor Andrew Bailey and a number of MPC members began signalling imminent rate rises over the coming months. Our base case is that, following an initial 15bp rate hike in December – which will take Bank Rate to 0.25% from the current 0.10% – we expect another two 25bp hikes next year (in February and August), followed by two 25bp hikes in 2023 (also February and August). This takes Bank Rate to 0.75% in 2022, and 1.25% in 2023. This is slightly less tightening than what we have pencilled in for the Fed, as the UK has less of an excess demand issue than we are seeing in the US. Rather, the case for tightening in the UK rests more on a) the unique supply-side constraints from Brexit, as well as b) historically higher inflation expectations.

Key forecasts for the UK

	2020	2021e	2022e	2023e
Economic outlook (% yoy)				
GDP	-9.7	6.8	4.9	2.3
- Private consumption	-10.8	4.0	6.9	2.7
- Government consumption	-6.3	15.8	5.1	1.3
- Fixed Investment	-9.1	4.4	5.1	2.8
- Net exports (pp contribution)	-5.7	0.9	0.1	0.1
Inflation	0.9	2.5	3.8	1.9
- Core inflation	1.4	2.3	3.6	2.4
Unemployment rate	4.5	4.6	3.9	3.8
Interest and exchange rates (eop)				
Bank of England Bank Rate	0.10	0.25	0.75	1.25
GBP/USD	1.37	1.36	1.33	1.30
EUR/GBP	0.89	0.81	0.79	0.77