The Macroeconomic Policy Outlook

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This edition of the Macro Policy Outlook looks ahead to prospects for 2021. The early months of next year will pick up where 2020 left off, being much weaker than expected only a few weeks ago. Tight social-distancing restrictions to slow the spread of the new variant of coronavirus could mean the economy being 6 per cent smaller by Easter than forecast by the OBR just last month, reducing growth for 2021 as a whole from 5.5 to 4.3 per cent. Policy makers should target support on firms and households affected, particularly in the hospitality and leisure sectors, to bridge the gap to the vaccine induced return to normality.

More positively, our judgement is that the vaccine rollout should lead to a rapid recovery in hospitality consumption and employment once restrictions are lifted, financed by savings built up by higher-income households. While undoubtedly positive, it is important that policy makers do not mistake this for underlying economic strength. Unemployment looks set to rise sharply, and likely lead family incomes to fall in 2021 even as GDP rises. In response, policy makers need to refocus on the duration, not just the size, of fiscal stimulus which should remain in place until a recovery is secured.

2020 has turned out to be the year that nobody expected. Despite this warning against crystal-ball gazing, we look ahead to what 2021 might bring – not least because policy makers do not have the luxury of waiting to see what the year ahead holds before making policy decisions. We focus on the pandemic and its aftermath given that the last minute arrival of a Brexit deal has significantly reduced the uncertainty around (but not the economic impact of) this huge change to the UK's economic environment

EARLY 2021 LOOKS A LOT WEAKER THAN EXPECTED EVEN FEW WEEKS AGO

The New Year looks set to have a distinct 2020 feel to it. With a new variant of coronavirus raising the infection rate markedly, restrictions will need to be tighter and longer lasting than expected even a few weeks ago. New Tier 4 restrictions are likely to become even more widespread and remain in place for at least several months given that November's England-wide lockdown (with similar restrictions) was only sufficient to flatten the case load in areas affected by the new variant.

The duration of those restrictions will determine their economic impact. The Prime Minister has said he believes more normal times can begin from Easter. Whether or not that is the case depends on the pace of vaccinations, which in turn will largely be constrained by the supply of vaccines rather than by the delivery mechanisms. But, subject to significant uncertainty about further virus mutations, it provides a plausible basis for considering the economic impact, with the 15 weeks between now and Easter meaning that all of those aged 65 plus might have been vaccinated by that point if we are running at an average of just under 1 million vaccinations a week.[1] Were that to happen the death rate would be reduced by between 80 and 90 per cent (the latter is based on the age distribution of

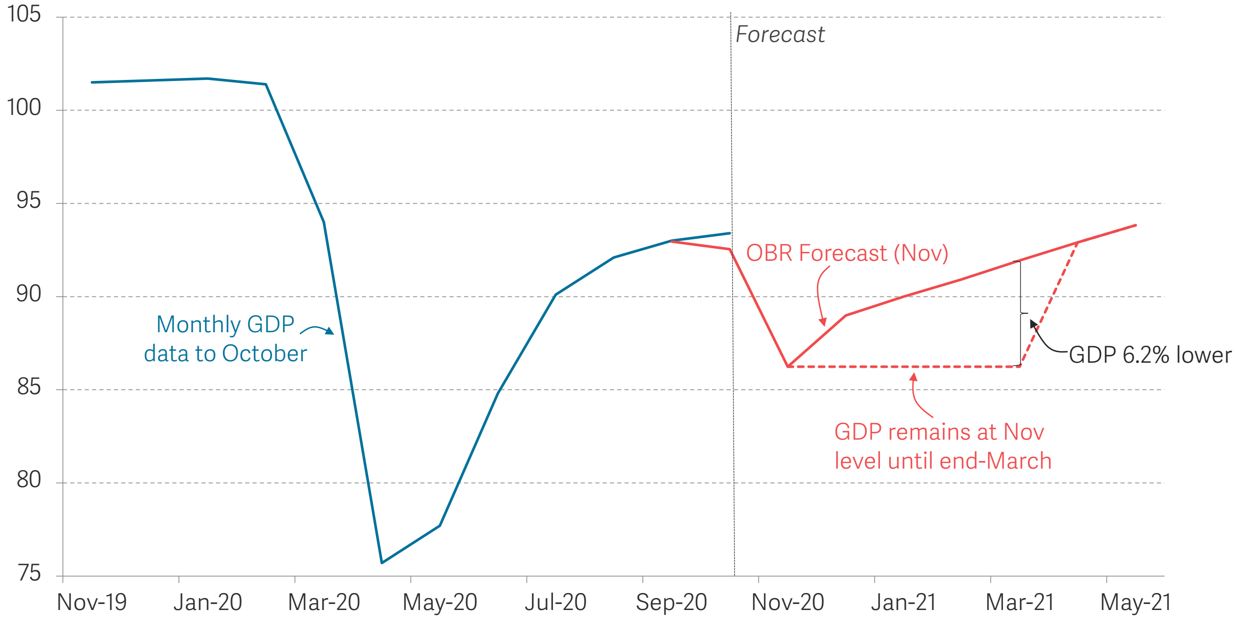
1 This would require vaccinating a little over 14 million people once we account for health workers and care home residents. This is challenging but plausible assuming that the Oxford vaccine is approved before the end of the year as planned.

deaths over the pandemic as a whole while the former reflects that during the second wave). Social distancing restrictions might then be eased, but far from removed given that if anything the caseload may rise even as the death rate falls. Hospital capacity will still remain a significant constraint even for a government prepared to tolerate significant numbers of deaths of those in their 50s.

To illustrate a plausible path for the economy, Figure 1 takes the OBR's November forecast and assumes that monthly output remains at its November level (reflecting the fact that Tier 4 is the equivalent of repeating the second lockdown) until Easter before returning to its forecast path (which included the impact of some ongoing restrictions). This would see the economy being 6 per cent smaller by Easter than forecast by the OBR just last month and reduce growth for 2021 as a whole from 5.5 to 4.3 per cent. Note this assumes a Brexit deal is done. Clearly even maintaining the levels of output seen in November would be unlikely amidst the widespread disruption and higher unemployment of a no deal Brexit. Note this OBR forecast was based on a Brexit deal being done so is the right baseline for this thought experiment.

FIGURE 1: **The near-term outlook for the economy is much weaker than expected even a few weeks ago**

Monthly index of Gross Value Added, chained volume measure (January 2020 = 100): UK



NOTES: The OBR forecast was made prior to the release of monthly GDP data for October; OBR monthly profiles beyond March 2021 are consistent with quarterly GDP growth.

SOURCE: RF analysis of ONS; OBR.

Through this extended period of harder lockdown the job of government remains to protect the incomes of workers and firms significantly affected by them. Sectors reliant on social consumption, specifically hospitality, leisure and non-essential retail, will remain hardest hit and support (which has been badly targeted in several areas) should be focused on them. More honesty that restrictions for these sectors will last should be accompanied by grants focused on them, rather than paid to all business rate payers. The extension of the furlough scheme until April means that while unemployment will continue to rise it will not shoot up. However, the Government should urgently allow firms to place workers on furlough where they are required to self-isolate. This is crucial to effectively controlling the now more virulent virus given the total inadequacy of our sick pay regime.

THE VACCINE ROLLOUT MEANS SOCIAL CONSUMPTION WILL BOUNCE BACK...

The start of 2021 will be very tough, but fortunately it is not 2020. Hugely positive news about the likely delivery of vaccines has materially reduced uncertainty about the medium term outlook, subject to those vaccines remaining effective against new strains of the virus.

A key judgement for laater in 2021 is how quickly social spending will bounce back once a semblance of normality returns. Our answer is: very quickly indeed. As was the case with America's roaring twenties following the Great Influenza pandemic people are desperate to get back to some social contact. Some will (at least temporarily) actually want to spend more time in restaurants and bars than they did pre-crisis: there's a lot of lost ground to make up.

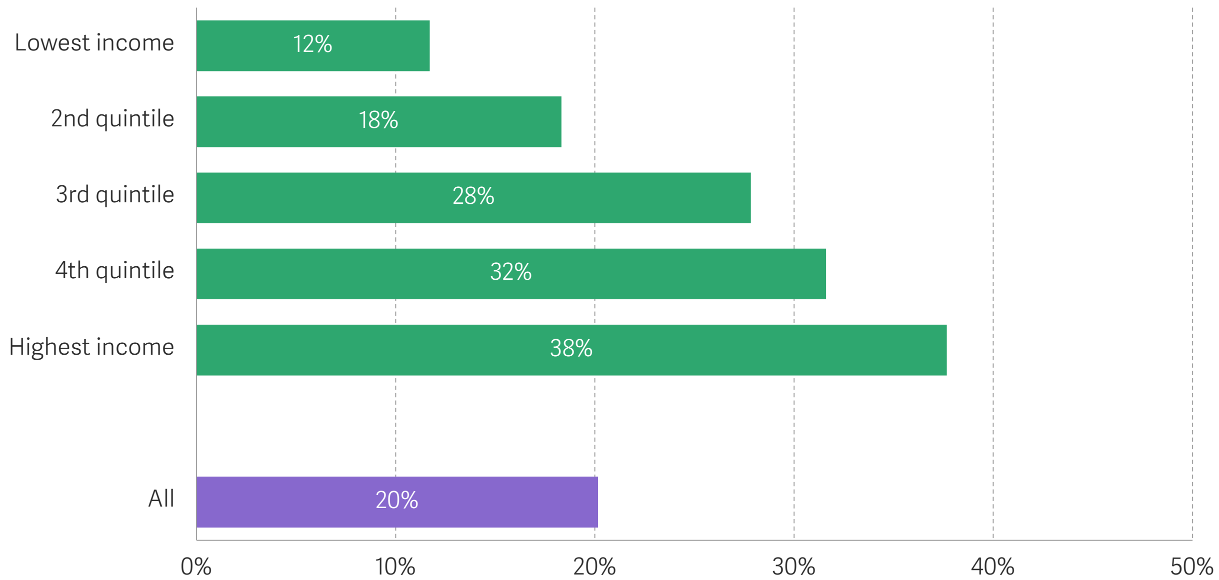
More recent history also reinforces this history lesson. Over recent decades as incomes have grown Brits have chosen to spend a greater share on social consumption. There's a reason that a full 18% of the 2010s employment increase came from hotels and restaurants.

...AND (SOME) WILL HAVE THE MEANS TO DO SO

The nature, and very uneven impact, of this pandemic also explains why many will have the means to drive a swift hospitality recovery later in 2021. This crisis has seen high income households stop spending on services, with lower earners providing those services losing their jobs.

FIGURE 2: **Those on higher incomes have seen their finances improve**

Proportion of adults who increased their rate of saving from February to September 2020, by household income quintile in February 2020: UK



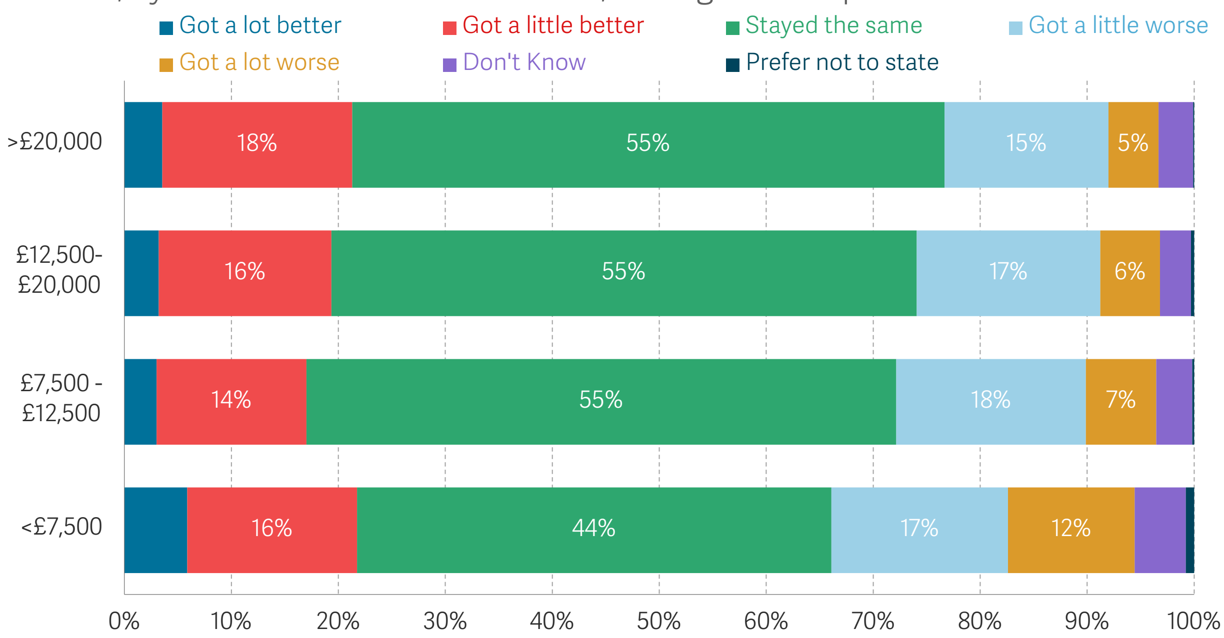
NOTES: Base = all adults aged 18-65 with valid income data (n=3,128), apart from the 'all' category where the base is all UK adults aged 18-65 (n=6,061). Family income distribution based on equivalised, disposable benefit unit incomes among 18-65-year-old adults, excluding families containing retired adults or nonworking adult students (for more details see: K Handscomb & L Judge, Caught in a Covid Trap, Resolution Foundation, November 2020). These figures have been analysed independently by the Resolution Foundation.
SOURCE: RF analysis of YouGov, UK Adults Age 18 to 65 and The Coronavirus (Covid-19) – September wave.

Exactly because less has been spent in 2020, we've been saving like never before. Indeed, the OBR expect the household savings ratio in 2020 will be 19.9 per cent, compared to 6.5 per cent in 2019, suggesting saving has been three times its usual rate. This has been concentrated among those on higher incomes: households in the top fifth of the population are three times more likely to have increased their saving than those in the bottom fifth, as Figure 2 shows. In contrast, poorer households are more likely to have borrowed to cover day-to-day expenses during this crisis.

In general the propensity of higher incomes households to spend their wealth tends to be low. But there are three reasons for thinking these savings will facilitate 2021's hospitality bounce back. First, this isn't just any old wealth – the £186 billion increase in cash savings amounts to a large increase in the most liquid subset of household wealth (accounting for just 5.6 per cent of the total pre-crisis). Cash in the bank is much easier to turn into consumption than housing or pension wealth. Second, even if these savings aren't spent they mean those on higher incomes have boosted their financial buffers giving them the confidence to at least go back to their pre-crisis spending habits. This will reduce the usual post-recession increase in precautionary savings. And, as Figure 3 shows, higher income families are much less likely to feel the need to engage in such precautionary behaviour anyway given their relative optimism about their prospects. The lowest income households are 50% more likely to think their situation will deteriorate next year than the highest income ones.

FIGURE 3: **Lower income households are most worried about their finances deteriorating**

Proportion of households expecting these changes in their financial position over the next 12 months, by annual household income: UK, 25 August-15 September 2020: UK

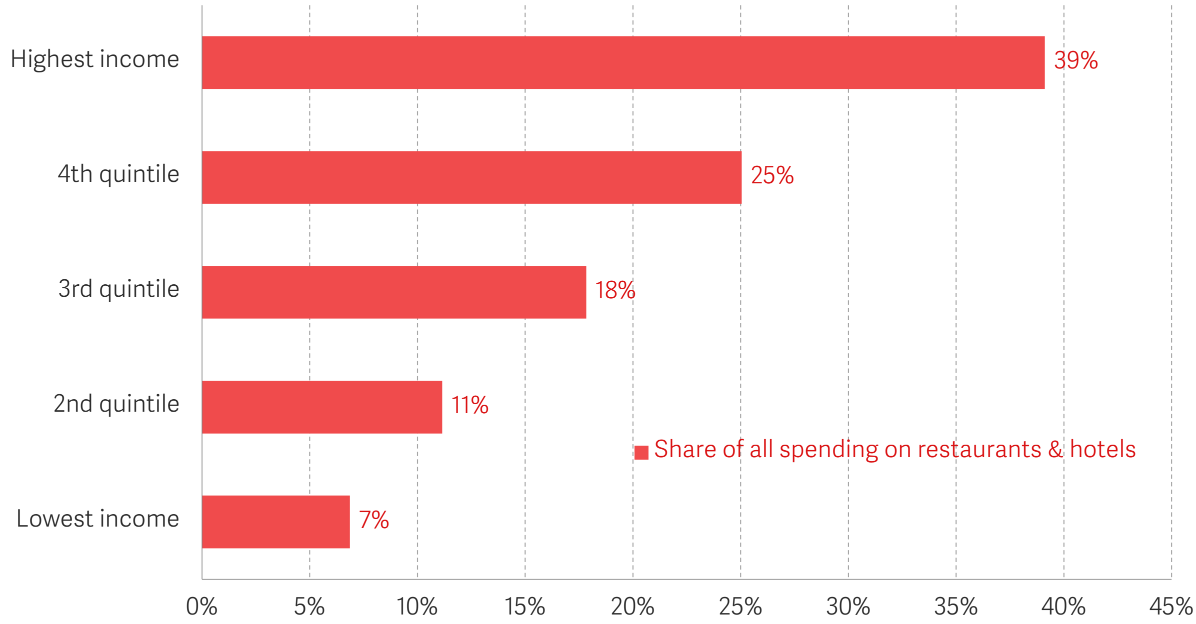


NOTES: Households without income data have been excluded from the sample.

SOURCE: RF analysis of Bank of England, NMG.

FIGURE 4: **Those on higher incomes spend much more on social consumption**

Household expenditure on restaurants and hotels by disposable income decile group



SOURCE: RF analysis of ONS, Family Spending.

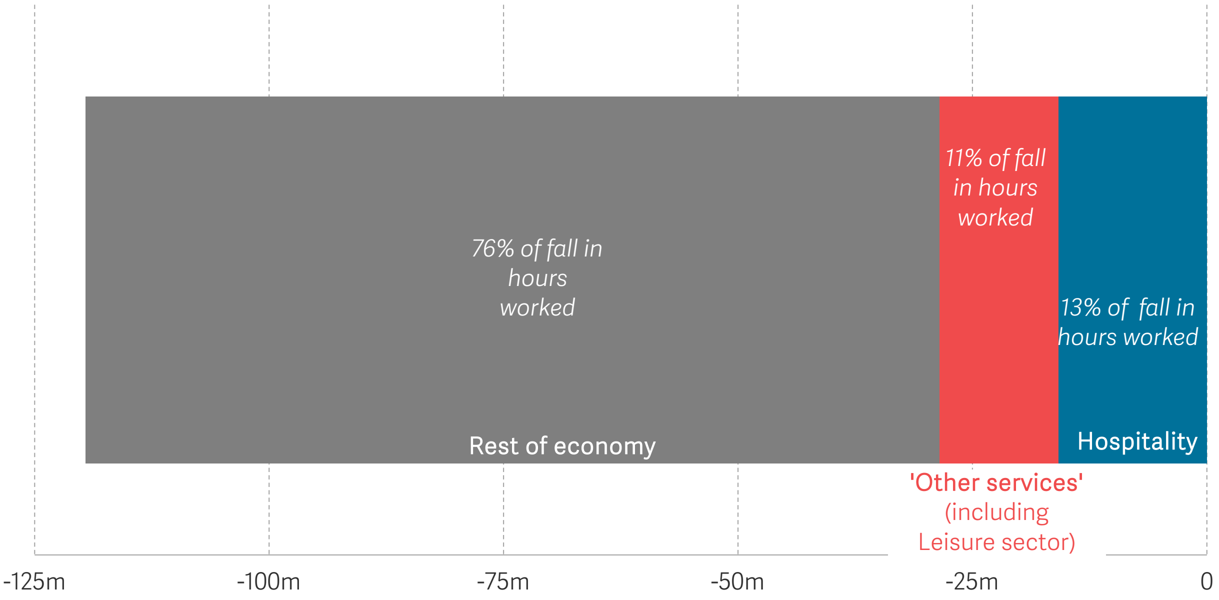
Third, the extra cash is being held by the very same people that drive hospitality spending. Not only do the top devote a greater share of their consumption to non-essentials like hotels and restaurants, they do more consuming full stop (due to having more income). Pre-crisis the top 40 per cent of households undertook nearly two-thirds (64 per cent) of hotel and restaurant spending (Figure 4).

IF HOSPITALITY RECOVERS QUICKLY THAT SHOULD BOOST EMPLOYMENT...

So the conditions for a rapid improvement in social consumption appear to be in place and the good news is that should lead to a big labour market boost. This is true in hours terms where, despite only accounting for 1 in 10 hours worked in the economy pre-crisis, hospitality and leisure account for a full 1 in 4 of the huge reduction in hours worked during this crisis. And it is also true in heads terms: of the 819,000 reduction in payrolled employment since February, 297,000 and 89,000 came from hospitality and leisure respectively.

FIGURE 5: **Hospitality, Leisure, and Retail/wholesale account for a significant proportion of the total reduction in hours worked across the economy**

Change in the number of hours worked compared to February, and contribution to total reduction in hours worked: UK



NOTES: Total hours worked at sector level have been calculated by multiplying employment by average hours worked.

SOURCE: RF analysis of ONS, Labour Force Survey.

...BUT A BOUNCE BACK IN HOSPITALITY WON'T SOLVE OUR ECONOMIC CHALLENGES

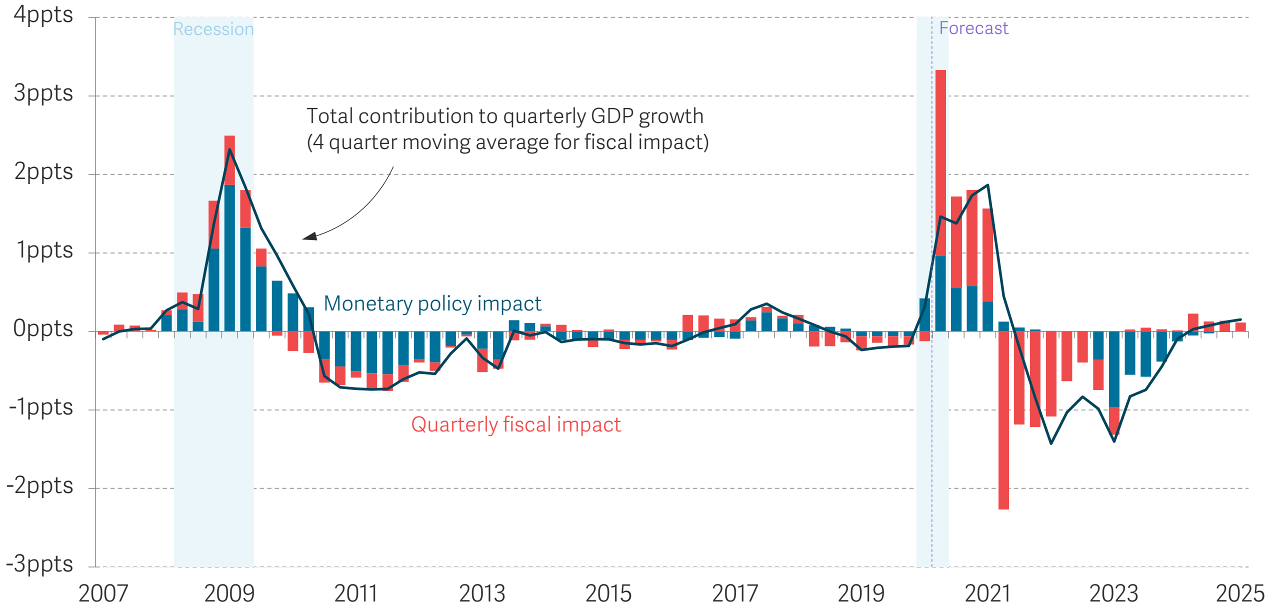
Even if there is a strong bounce back in social consumption in the second half of 2021, this does not mean all will be plain sailing. By October, the economy was 7.9 per cent smaller than it was in February, and a hospitality bounce back alone will make relatively little difference to GDP. This employment heavy but output light sector contributed less than a seventh of the GDP shortfall.

A robust recovery will therefore need to be much broader based. This speaks to how the recovery phase in the back half of 2021 will differ from the experience of 2020. As the economy reopens with vaccine rollout and the labour market unfreezes itself as the Job Retention Scheme (JRS) is phased out, the crisis will become a much more typical downturn: across a broad range of sectors unemployment will rise and incomes will fall. Policy therefore needs to adjust – in particular, fiscal policy will need to transition from targeting support at closed sectors to more broad-based support for that recovery.

Crucially that support will need to last well into the second half of next year. Figure 6 shows the scale of the challenge here. It presents our estimate for the impact of monetary and fiscal policy on quarterly GDP growth based on current fiscal plans. The unprecedented support for the economy is currently set to be withdrawn from the second quarter of 2021, so without substantial additional fiscal stimulus in 2021 macroeconomic policy risks becoming a headwind for the recovery.

FIGURE 6: **Fiscal policy is on track to become a drag on growth in 2021**

Estimated impact of macroeconomic policies on quarterly GDP growth, history and forecast: UK



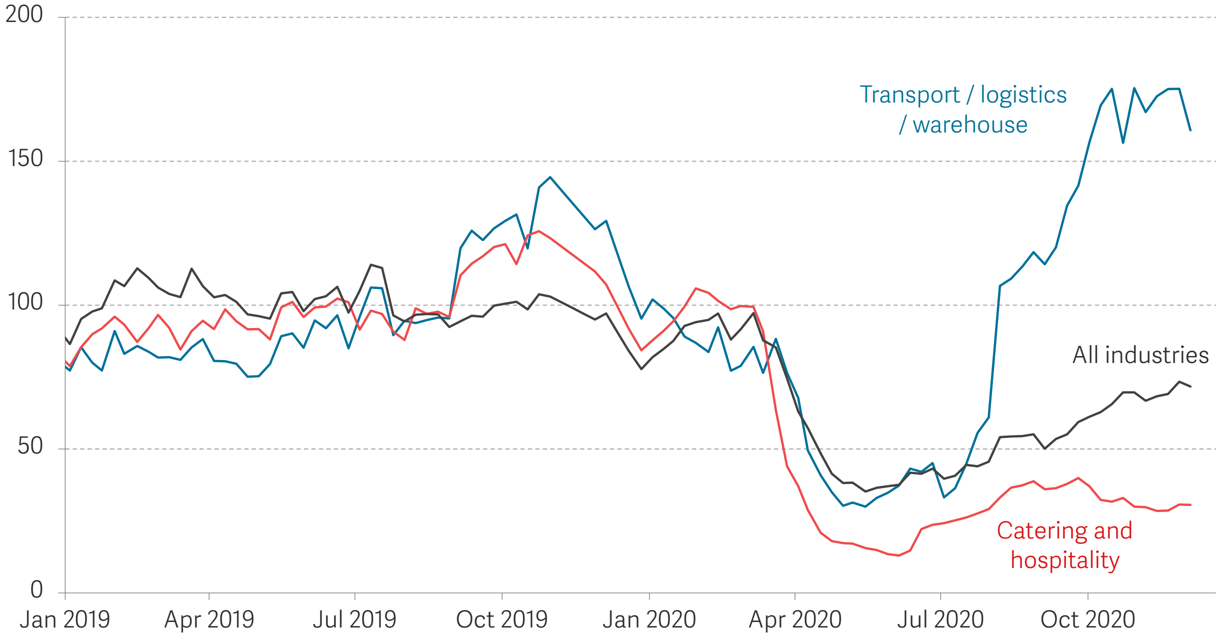
NOTES: Monetary policy impact is calculated using estimates from P Bunn, A Pugh & C Yeates, 'The distributional impact of monetary policy easing in the UK between 2008 and 2014', Bank of England Working Papers no.720, Bank of England, March 2018. This covers the Bank of England stimulus during the financial crisis. Subsequent changes in Bank rate and quantitative easing purchases are incorporated using equivalent scaling factors between policy changes and GDP. The fiscal policy impact is calculated based on a UK version of the Hutchins Center Fiscal Impact Measure, adjusted for the OBR's estimate of fiscal multipliers. The values for 2020 and 2021 are based on assuming Bank rate is held at 0.1 per cent and the OBR's central scenario from the November Economic and Fiscal Outlook.
SOURCE: RF analysis of OBR, various; ONS; Bank of England.

Putting that right with longer lasting fiscal support is essential to securing a broader labour market recovery. While 2021 will see hospitality hiring again, a lot of labour market churn will be taking place elsewhere. The Job Retention Scheme has suppressed some of the normal, non-Covid-related job losses which will materialise next year. Despite being set for an annual fall in GDP of more than twice that seen during the depths of the financial crisis, fewer employees flowed off payrolls in 2020 than in 2019.

Moving back towards a measure of normality will in of itself also lead to job churn. Some spending seen in the exceptional pandemic circumstances will unwind, at least partially. Demand for delivery drivers and other roles related to online shopping surged in 2020 (as Figure 7 shows) as hospitality posts cratered. The former will now reduce as the latter recovers. Record demand for bikes, and perhaps even puppies, will unwind. Brexit will add further to this labour market churn as firms adjust to the new world they find themselves in.

FIGURE 7: **Most sectors have posted significantly fewer job adverts during the crisis, but averts for jobs in transport, logistics and storage have risen sharply**

Number of online job adverts, indexed to 2019 average: UK



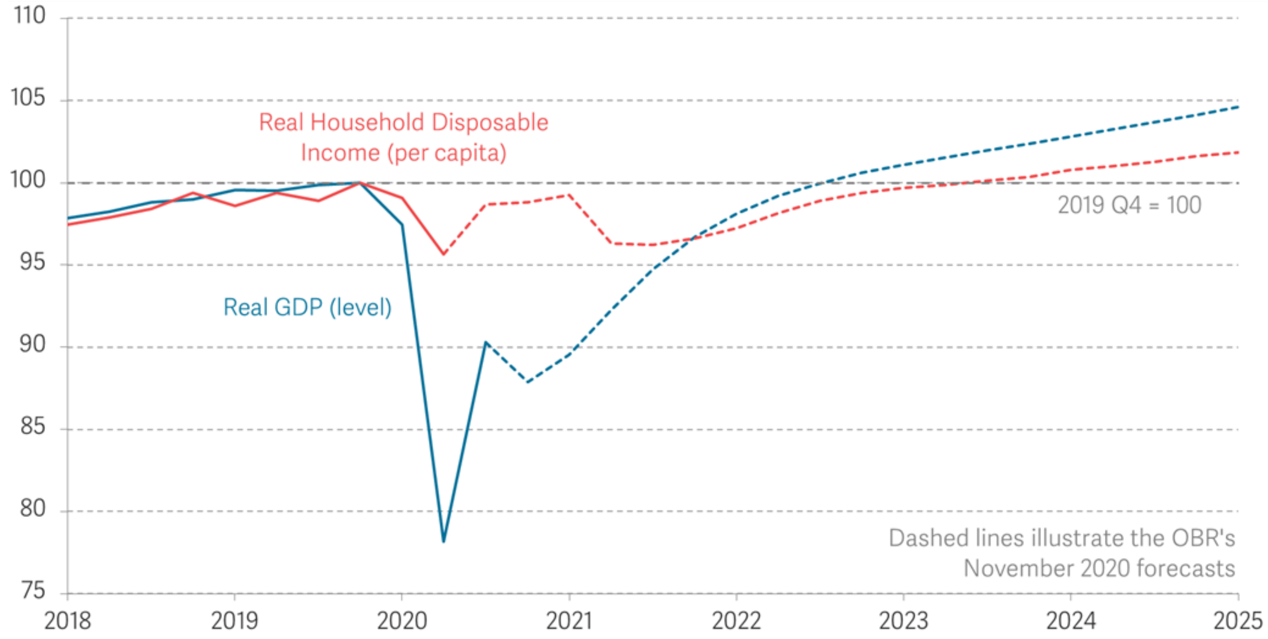
NOTES: Job adverts are indexed to 2019 average.

SOURCE: Adzuna, via ONS.

Higher unemployment will hit household incomes. With household living standards protected from the drops in GDP in 2020 by the unprecedented policy response, 2021 may actually be the low point for family finances during this crisis with incomes falling next year even as GDP grows. Figure 8 illustrates this with the OBR's forecast for household incomes showing a fall of £210 in 2021 compared to 2020 (taking the average across each year). This should provide yet another reminder of why it makes no sense for the government to go ahead with plans to reduce benefits by £20 a week for 6 million households in April.

FIGURE 8: **Household incomes may fall, even as GDP recovers, in 2021**

Outturn and OBR November forecast of the level of real GDP and Real Household Disposable Income per capita, index: 2019 Q4 = 100



SOURCE: RF analysis of OBR, Economic and Fiscal Outlook

BETTER TIMES SHOULD BE AHEAD OF US, BUT THE ROAD IS A BUMPY ONE

Better times are ahead of us, thanks to vaccines and the human wish to put this pandemic behind us and get spending again. Some of the conditions are there for that human wish to turn into economic reality, not least huge savings built up by better off households. But 2021 is going to be a rough ride. The early months of the year will try the patience of a nation fatigued by the trauma that was 2020. And with unemployment rising and incomes possibly falling in 2021, it certainly won't be roaring for everyone. The difficult task facing policy makers will not end with the vaccine roll-out, not least in securing the recovery. And while everyone rightly wants to get back to normal, no-one should think we came through this crisis only to see the better off eating out while poorer families struggle with higher debts.

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We do this by undertaking research and analysis to understand the challenges facing people on a low to middle income, developing practical and effective policy proposals; and engaging with policy makers and stakeholders to influence decision-making and bring about change.

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