IFS Green Budget 2020
Citi Contribution

12/13 October 2020

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Agenda

1. Global economic outlook and topics
2. UK economic outlook: Substantial challenges ahead
3. Brexit: Costs to come
4. Monetary-Fiscal Coordination: Where’s the limit?
Ready or not? A ranking

Healthcare resources, policy stringency, pandemic outcome and government satisfaction ratings are connected.

<table>
<thead>
<tr>
<th>Country</th>
<th>COVID-19 outcome</th>
<th>Healthcare resources</th>
<th>Policy</th>
<th>Government record</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Confirmed cases per million</td>
<td>COVID-19 deaths per million</td>
<td>Rk.</td>
<td>Healthcare spending (% of GDP)</td>
</tr>
<tr>
<td>Germany</td>
<td>2,864</td>
<td>114</td>
<td>2</td>
<td>11.7%</td>
</tr>
<tr>
<td>Canada</td>
<td>3,403</td>
<td>252</td>
<td>3</td>
<td>10.8%</td>
</tr>
<tr>
<td>Japan</td>
<td>511</td>
<td>12</td>
<td>1</td>
<td>11.1%</td>
</tr>
<tr>
<td>Italy</td>
<td>4,327</td>
<td>593</td>
<td>5</td>
<td>8.7%</td>
</tr>
<tr>
<td>France</td>
<td>4,268</td>
<td>474</td>
<td>4</td>
<td>11.2%</td>
</tr>
<tr>
<td>UK</td>
<td>4,949</td>
<td>633</td>
<td>6</td>
<td>10.3%</td>
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<tr>
<td>US</td>
<td>17,609</td>
<td>627</td>
<td>8</td>
<td>17.0%</td>
</tr>
<tr>
<td>Spain</td>
<td>8,789</td>
<td>672</td>
<td>7</td>
<td>9.0%</td>
</tr>
</tbody>
</table>

Source: Johns Hopkins University (JHU), WHO, OECD, Statista, Oxford University, YouGov and Citi Research.

Note: Confirmed COVID-19 cases (as of 29 September 2020) and number of deaths from COVID-19 (as of 21 September 2020) are measured per million population. ICU beds per hundred thousand are based on the latest-available WHO data, in 2009 for the US, 2012 for the European countries and 2017 for Japan. The Oxford University lockdown stringency index tracks the daily level of typical measures such as school and shop closures, stay-at-home orders, restrictions on public gatherings or closures of public transport. YouGov data on confidence in not catching the virus and trust in government handling are based on the latest data available, from late August to early September. Healthcare spending as per OECD data. Testing as per Statista data. Countries are ordered based on their average rank across the four domains in the table (COVID-19 outcomes, healthcare resources, policy and government record).
The optimal policy response

Three “waves”: Fiscal absorption, stimulus and adjustment support, with help from the central bank

Share of net earnings replaced by furlough payments and standard unemployment benefits 2019–20

Combined fiscal responses to the COVID-19 pandemic (total size of policies announced as a share of 2020 GDP)

Note: Unemployment benefits for six months for average-wage worker excluding housing benefits. For the US, we present replacement rates for the ‘furlough scheme’ inclusive of the $600 per week federal top-up to unemployment benefits, which acts as a de facto furlough scheme.

Note: ‘First wave’ only includes actual spending / tax cuts (and excludes the guarantees, loans and equity measures shown in Figure 1.1). ‘Third wave’ currently largely includes the EU’s recovery fund. The figure represents total packages announced by August 2020 as a share of 2020 GDP, not annual numbers.
Political consequences of the virus

The pandemic is as much a political as it is an economic shock. Those presiding over its management may not reap the rewards.

- The return of big government
- The positive side of the bank–state nexus
- Rethinking of monetary financing

Approval ratings of selected world leaders

Source: YouGov (Donald Trump, Boris Johnson), Infratest Dimap (Angela Merkel) and Ifop (Emmanuel Macron).
Forecasts

Following historically large declines in GDP in 2Q, advanced economies will enjoy a big rebound over the summer. But lingering effects and more infection waves mean GDP will take between a year and three to return pre-crisis levels and will mostly stay below pre-crisis trends virtually everywhere.

**Figure 1.14. Year-on-year % growth in GDP, actual and Citi forecasts**

Note: 2019 actuals, Citi forecasts from 2020.

**Figure 1.4. Debt as a share of national income in selected developed economies**

Note: Debt-to-GDP ratios from 2020 onwards are based on Citi forecasts.
1. Global economic outlook and topics

2. UK economic outlook: Substantial challenges ahead

3. Brexit: Costs to come

4. Monetary-Fiscal Coordination: Where’s the limit?
Don’t conflate rebound and recovery

Following a record 19.8% quarter-on-quarter (QQ) fall in the Q2 2020, we expect output to rebound by 17.5% QQ in Q3. The sharp recovery has been driven by consumption. We think this is unlikely to last.

Cumulative changes in output (% change since February 2020)

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Discretionary fiscal stimulus implemented so far since March 2020, spending by month (£ billion)

- Public spending
- Wage and income support
- Business support
- Total

Note: Figures based on OBR monthly spending profile, alongside some Citi estimates. Public spending refers to additional departmental expenditure approved in response to Coronavirus. Wage and income support includes the Coronavirus Job Retention Scheme, the Job Support Scheme, the Kickstart Scheme, the Self-Employment Income Support Scheme, additional benefit support and self-assessed income tax deferrals. Business support includes the reduction in business rates and associated grant schemes, as well as the Eat Out to Help Out scheme and VAT deferrals.

Source: ONS and Citi Research.

Note: Each sector weighted by GVA share.

Source: ONS, OBR, Saunders (2020) and Citi Research.
A lingering virus effect

The economic impacts of the virus extend well beyond lockdown. Output fell before restrictions were implemented, and we expect weak demand will persist until an effective health treatment is available.

- The **risk posed to human health by the virus** is likely to persist to Q2-21.
- The **affects preferences** – some sectors are highly exposed, some much less.
- **Precautionary effects** are likely to drive saving up.
- As the shock is temporary, **reconfiguration is likely to only be partial**, also pushing saving up.

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Source: Barclays and Citi Research.
Households leading, firms following

Despite substantial support, corporate balance sheets have deteriorated. Alongside substantial uncertainty and weak demand, we think this implies subdued investment. We think firms will instead focus on preserving cash.

Cash reserves and share of UK firms making a loss, August 2020

COVID-related changes in business investment intentions

Note: Answer to the question ‘relative to what would have otherwise happened, what is your best estimate for the impact of the spread of COVID-19 on the capital expenditure of your business in [various quarters]?’.

The challenge facing the UK labour market

The labour market has been well protected so far, but this is now likely to change. The key challenge is Covid hits labour intensive sectors hardest, just at the point when we will depend on households to drive the recovery.

Output per worker and average drop in sectoral value added in 2020 Q2

Cumulative media-reported redundancies (thousands) during the Great Financial Crisis (2008–10) and Coronavirus Crisis (2020)

Note: Size of the bubble reflects the number employed in a sector before the outbreak.

Source: ONS and Citi Research

Note: Only includes announcements reported in national media outlets.

Source: Guardian redundancy tracker, personeltoday.com, various national media outlets and Citi Research.
Covid risks and scenarios from here

With case numbers increasing once again, a second set of more sweeping lockdown measures cannot be ruled out. These would weigh sharply. An ‘upside’ scenario of a quick return to ‘economic normality’ seems unlikely.

- **Baseline** – we assume lingering virus concerns to dissipate gradually in 2021. Output recovers gradually thereafter.

- **Pessimistic scenario** - More widespread/severe restrictions would weigh sharply. 25-35% of the UK is covered by Q2 type restrictions over the winter months.

- **Optimistic Scenario** – stronger consumption and a more resilient labour market reinforce one another. While possible, this seems unlikely.

Scenarios for real UK GDP

Note: GDP figures are based on chained value methodology. Forecasts/scenarios shown in dashed lines.

Source: ONS, IFS and Citi Research.
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Brexit: The costs lie ahead

Sectors both positively and negatively exposed to the impact of Brexit have grown more quickly in recent years. Substantial adjustment still likely lies ahead. We think this may now prove more front loaded.

- Deal or no deal? – Our forecasts are conditioned on the agreement of a thin deal.

- Adjustment to come – Weak Sterling since 2016 has provided an incentive to keep activity in the UK, economic cost has yet to come

- Weaker investment – firms may react more suddenly to an increase in costs

- Several factors increase the risk of more front loaded adjustment:
  - Low government preparation
  - Lower firm resilience

- We expect Brexit to weigh on output by 2.1% in 2021.

Note: Tradable and non-tradable sectors derived using ONS supply and use tables across two-digit SIC industrial classifications. The total imports plus exports are divided by the sector’s GVA to obtain a traded share for each sector for 2015. A 10% threshold is then used to delineate between tradable and non-tradable sectors (Betts and Kehoe, 2006; Broadbent et al., 2019).

Source: ONS and Citi Research.
The future isn’t what it used to be

Both Brexit and Covid constitute huge structural shocks to the UK economy. The economy that emerges from both crises will look very different to that in Q4-2019. This implies a slower recovery to a weaker level of output.

- Capital write-offs – Both Brexit and Covid are likely to result in some firm and sector specific capital being written off.
- Protracted adjustment – re-allocating workers and capital across sectors takes time. This could compound the degree of economic ‘scarring’.
- Lower immigration poses risks to potential growth in the longer-term.
- Productivity a key challenge – Weak in recent years, and Covid and Brexit are likely to weaken it still.

UK real quarterly GDP in various policy scenarios (2016 prices)

Note: GDP is calculated as a chained value measure. The OBR-EFO reference scenario is derived from tables 2.3 and 2.7 from the March 2020 Economic and Fiscal Outlook.

Source: ONS, OBR and Citi Research.
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Monetary fiscal coordination, what are the limits?

In the near-term, monetary and fiscal support are likely to remain closely aligned. However in the medium and longer-term there are substantial risks. Increases in rates would pose substantial challenges from here.

- Fiscal policy taking the lead – in response to the Covid crisis, fiscal policy has carried most of the burden.
- Monetary policy has been required to be supportive, protecting low funding costs for the economy as a whole.
- In the medium term, an upward shift in inflation expectations could force the Bank to withdraw support sooner.
- In the longer-term, the UK’s external account is also a notable vulnerability. This could make it difficult for monetary policy to provide support in a future crisis.
- Low rates, for many years, will be essential for the recovery

Cumulative changes in the UK Bank Rate and public sector net borrowing over the last three recessions

Source: Bank of England, ONS and Citi Research.
### Appendix A-1

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