A Robust Recovery Will Be Underway by Mid-2021 as Pandemic Recedes; Businesses Are Adjusting to Post-Brexit Trade Rules

The winter lockdown and Brexit transition caused a double-dip recession at the turn of the year

A rapid recovery is beginning in the second quarter of 2021

A double-dip recession interrupted the UK’s recovery in late 2020 and early 2021. Economic activity plummeted by one-quarter between January and April 2020, recovered four-fifths of that downturn through October, and then a second recession began in November (See Chart 1). The UK’s monthly GDP index fell 3% from October 2020, its recovery-to-date high, through February 2021, and real GDP in February 2021 was still 8% below the 2019 pre-crisis peak.

Two new shocks interrupted the UK’s recovery and started the double dip in late 2020. The first was a second lockdown imposed in November as the pandemic worsened, and maintained through the spring. Like the first lockdown, it caused a sharp contraction of service sector activity, concentrated in high-contact industries like hospitality. The second shock was Brexit. UK-EU trade plummeted at the turn of the year as post-Brexit trading rules came into force. This is partly because businesses built up inventories ahead of the rule change to hedge against supply chain disruptions, and partly because Brexit will permanently reduce UK-EU trade. Goods exports plunged 13% in January and February from the fourth quarter on a 26% collapse of exports to the EU, and goods imports fell 7% with imports from the EU down 23%. Services exports were down 21% from their October 2019 peak in January and February 2021.

The second downturn will give way to a robust recovery by mid-2021. Classrooms reopened in March, and restrictions on nonessential businesses began to ease in April. Service sector activity will recover rapidly from the second quarter of the year as the UK’s vaccination drive—one-half of all adults had received at least a first dose by mid-March—allows the government to lift remaining containment measures. The service sector accounts for four-fifths of the economy, so its reopening will propel a rapid recovery in real GDP in the second and third quarters of 2021; output will return to the pre-crisis level before year-end. Exports will lag the recovery due to Brexit’s higher trade barriers and the slow recovery of international travel.

The highly expansionary fiscal and monetary policies that are supporting the UK’s economy in 2021 will start to normalize in 2022. The UK government’s 2021-22 budget anticipates a fiscal deficit of 11% of GDP, down from 17% last year but still much more expansionary than the fiscal deficits of 2% to 3% run between 2017

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**CHART 1: DOUBLE-DIP RECESSION IN EARLY 2021 WILL GIVE WAY TO A RAPID RECOVERY BY MID-YEAR**

![Chart showing monthly real GDP index from 2002 to 2021](chart2.png)

Chart source: UK Office for National Statistics
The Bank of England will likely slow asset purchases in late 2021 and raise the policy rate in 2023

Slower potential economic growth post-Brexit will keep British interest rates low in coming years

Brexit will change the structure of the UK’s labor market and complicate the Bank of England’s withdrawal of stimulus. Between the end of the 2008-09 recession and the 2016 Brexit referendum, EU nationals accounted for 40% of British employment growth despite comprising 5% of all workers. Immigration from the EU slowed between the referendum and the UK’s official exit from the EU in early 2020. Then after the pandemic struck, the UK saw an historic exodus of EU workers and outmigration of EU nationals back to the continent (See Chart 2). It is impossible to know what share of these workers will return to the UK workforce in the recovery, but it will not be all of them—the pandemic and Brexit have permanently reduced the UK’s potential labor force, and new immigration restrictions will slow its growth in coming years. This means the output gap will be smaller during the recovery than it otherwise would be, but also that trend growth will slow substantially after the economy returns to full employment. Slower-growing economies tend to have lower inflation and real interest rates, so interest rates will likely be lower in the UK in coming years than they were pre-Brexit. The Bank of England will likely make a 15 basis point hike in the Bank Rate to 0.25% in early 2023, but this might actually end the BoE’s rate hiking cycle—the Bank Rate averaged just 0.50% between 2010 and 2020.

After averaging $1.29 per pound sterling between the Brexit referendum and the end of 2020, pound sterling strengthened and averaged $1.38 in the first quarter of 2021 as political uncertainty lifted and the vaccination drive boosted economic recovery prospects. PNC’s forecast is for the pound sterling to weaken through year-end 2021, and average $1.34 in 2022 as financial markets price in the UK’s diminished growth potential. Political tensions from the Scottish independence movement and Irish nationalist movement are risks to monitor in 2021 and 2022; 10% of the UK’s population lives in Scotland and Northern Ireland.

**Chart 2: Historic Drop in EU Nationals Working in the UK Previews Slower Labor Force and GDP Growth**

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