# 2 – UK economic prospects

## Key points

- The UK economy grew by 2% in the year to Q1 2017, but the quarterly rate fell to 0.2%, primarily as a result of a softening in consumer expenditure and the services sector.
- In our main scenario, we forecast UK growth to slow to 1.5% in 2017 and 1.4% in 2018. The UK would avoid recession in this scenario, although risks to growth are still weighted somewhat to the downside given the uncertainties associated with Brexit.
- A key factor behind the overall slowdown is a moderation in consumer spending growth to around 2% in 2017 and 1.5% in 2018. This reflects a squeeze on household spending power from higher inflation and sluggish wage growth.
- Wage growth continues to be low despite the lowest unemployment rate since 1975. This suggests that the traditionally negative relationship between these two variables, as described in the Phillips Curve, may have broken down – a view supported by our analysis in this report.
- Investment held up relatively well in the first quarter, but uncertainty surrounding Brexit may weigh on this going forward.
- We project that London could remain the fastest growing UK region in 2017-18, but its pace of expansion is expected to slow significantly from earlier rapid rates. Other regions are projected to see average real growth in 2017-18 of around 1-1.5%, but we do not predict negative growth in any region in our main scenario.
- Consumer price inflation is likely to rise above 3% later this year. This continues to be driven by the exchange rate depreciation since the Brexit vote, although this effect could start to fade later in 2018 if wage growth remains subdued.
- The Bank of England voted to hold interest rates at 0.25% in June, but three MPC members voted for an increase and we do expect a very gradual increase in rates to begin sometime over the next year unless there is a sharp deceleration of growth over this period.

## Introduction

In this section of the report we describe recent developments in the UK economy and review future prospects. The discussion covers:

| | |
|---|---|
| Section 2.1 | Recent developments and the initial impact of Brexit |
| Section 2.2 | Economic growth prospects after Brexit: national, sectoral and regional |
| Section 2.3 | Outlook for inflation and real earnings growth |
| Section 2.4 | Monetary and fiscal policy options |
| Section 2.5 | Summary and conclusions. |

## *2.1 – Recent developments and the initial impact of Brexit*

The UK economy has now grown for 17 consecutive quarters and remained resilient in the second half of 2016 despite headwinds from the vote for the UK to leave the European Union ('Brexit'). However, the first quarter of 2017 has seen a softening of growth as higher inflation squeezed consumers.

During the last decade, as shown in Figure 2.1, growth in the manufacturing sector has been relatively weak, with output remaining below pre-financial crisis levels. Growth in the construction sector has been volatile, but with a generally improving outlook since the beginning of 2013.

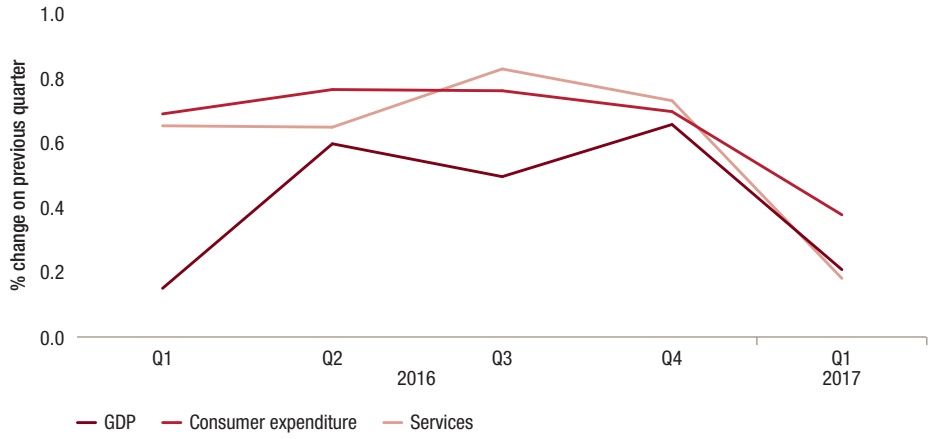
In contrast, the services sector has grown consistently and relatively strongly since the financial crisis. However, as shown in Figure 2.2, the rate of growth in the sector slowed sharply in the first quarter of 2017, pulling down overall GDP growth (in which services has a near 80% weight).

There has been a broadly similar trend in consumer expenditure, with a marked decline in growth to around 0.4% in the first quarter of 2017, after holding up well throughout 2016. This reflects the rise in inflation, due in large part to the weak pound since the Brexit vote, which has squeezed real incomes.

**Figure 2.1 – Sectoral output and GDP trends**


Source: ONS

**Figure 2.2 – Trends in GDP, consumer spending and the services sector**



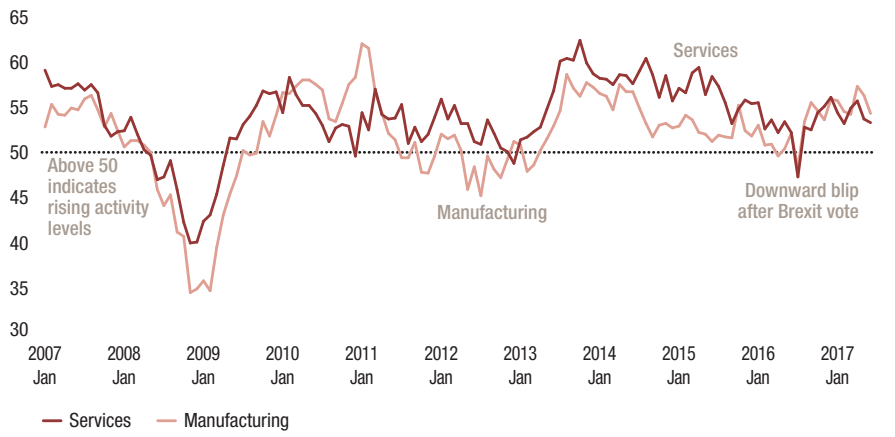

Source: ONS

There was a further hit to disposable incomes from relatively high tax payments in Q1 2017, though consumers seem to have smoothed this out through higher borrowing rather than reducing their spending more markedly in that quarter. But household savings rates were at the lowest for over 50 years in Q1 2017 as a result, which does not look sustainable in the longer term. The Bank of England has also warned recently that consumer credit growth has become uncomfortably high and suggested that some banks may need to tighten up lending standards in this area.

Even as official GDP growth has slowed, the Markit/CIPS purchasing managers' indices (PMIs) for services and manufacturing have remained relatively strong, as shown in Figure 2.3. However, both signalled a slowdown in growth in May and June. The construction PMI saw a strong rebound in business activity during May, but some slowdown in June.

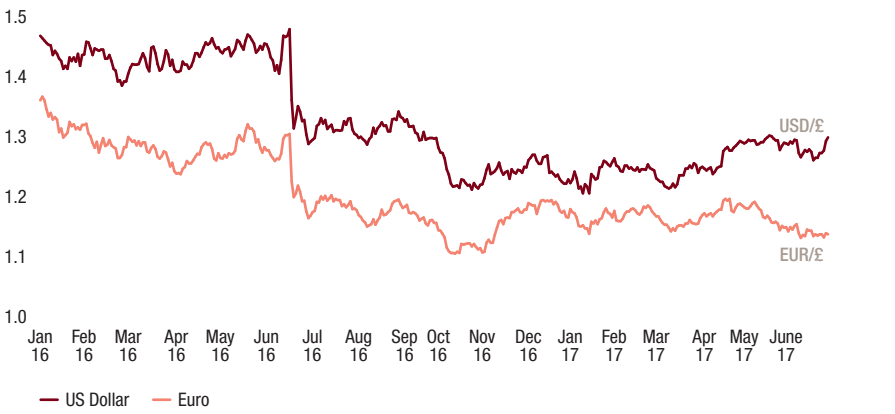
As noted above, a key factor underpinning recent trends has been the sustained weakness of the pound since the Brexit vote, as shown in Figure 2.4. A weak currency makes exports relatively cheaper to overseas customers, promoting the sale of British goods and services while also improving tourist inflows. But the depreciation has also raised the prices of imports, which has pushed up inflation to nearly 3% in the year to May and this could rise further later this year, as we discuss in Section 2.3 below.

**Figure 2.3 – Purchasing Managers' Indices of business activity**




Source: Markit/CIPS

**Figure 2.4 – US dollar and euro exchange rates against the pound**




Source: Bank of England

**Figure 2.5 – UK Phillips Curve shifts and flattens over time**


Source: ONS

## Has the Phillips Curve gone flat?

Higher inflation will lead to a real squeeze on consumers so long as wage growth remains subdued by historical standards. Traditional theory would suggest that low wage inflation will correlate with high unemployment (and vice versa), as described in the 'Phillips Curve' (named after the economist who first identified this relationship in the 1960s). However, the unemployment rate in the UK now stands at its lowest level since 1975, and wage growth is comparable to that seen at the time of the recent unemployment peak in 2011, suggesting that this relationship may have broken down.

To explore this further, we have modelled the relationship between wage growth and unemployment using annual data available from 1971. The UK economy during this period can be characterised by three distinct periods:

- **1971-1992:** a period when the UK government struggled to control inflation while unemployment was relatively high and volatile due to three major recessions;
- **1993-2007:** a period of relative economic stability in which the UK government switched to inflation targeting from 1993 onwards; and
- **2008-2016:** the global financial crisis and its aftermath.

As can be seen from Figure 2.5, the relationship between unemployment and wage growth has become much flatter in the 1993-2007 and 2008-2016 periods than in the 1971-1992 period when a downward-sloping Phillips Curve did seem to be in operation, albeit with considerable variation around the 'best fit' line shown in Figure 2.5. As well as flattening, we have also seen the Phillips Curve shift downwards over time as 'normal' levels of nominal wage growth have declined[1].

A number of factors are likely to be at play in these Phillips Curve shifts, but one key factor is the reduction in the bargaining power of workers. Unionisation of the workforce has fallen from 38% in 1990 to 23% in the middle of 2016 (and lower than this in the private sector), while self-employment and part-time and temporary working has increased. These changes reduce wage bargaining power as firms are able to negotiate with individuals rather than groups, while the increased flexibility of modern work may induce people back into the workforce, restricting upward pressure on wages.

The globalisation of organisations and continuing digitalisation is also a likely contributor to this flattening, as a broader range of work can be completed anywhere in the world, thus lifting the constraints of labour supply in any one country. Increased migration to the UK from other EU countries since 2004 may also have played some role here in dampening wage growth in response to increased labour demand as it has made labour supply more elastic. Depending on how UK migration policy evolves, this factor may become somewhat less important after Brexit. This could potentially worsen skills shortages in the UK, but might also offer some support for wage growth at the lower end of the labour market (in addition to the effect of planned future increases in the national minimum wage). Over the next couple of years, however, wage growth seems likely to remain relatively subdued.

1 Similar shifts in the Phillips Curve were found in a recent analysis by Andrew Haldane, chief economist at the Bank of England: http://www.bankofengland.co.uk/publications/Pages/speeches/2017/984.aspx

## 2.2 – Economic growth prospects after Brexit: national, sectoral and regional

Since the last UK Economic Outlook report in March, we have revised estimated real GDP growth in 2017 down marginally from 1.6% to 1.5%. This primarily reflects softening economic indicators, particularly consumer spending and services output in early 2017 as described above. Below trend growth is expected to persist into 2018, when our main scenario is for GDP growth of around 1.4%, as shown in Table 2.1.

**Table 2.1 - Main scenario projections for UK growth and inflation**

| % real annual growth unless otherwise stated | 2016 | 2017 | 2018 |
|---|---|---|---|
| GDP | 1.8 | 1.5 | 1.4 |
| Consumer spending | 2.8 | 1.9 | 1.5 |
| Government consumption | 0.8 | 1.0 | 0.7 |
| Fixed investment | 0.5 | 1.6 | 1.6 |
| Domestic demand | 1.5 | 1.5 | 1.4 |
| Net exports (% of GDP) | -0.4 | -0.2 | -0.1 |
| CPI inflation (%: annual average) | 0.7 | 2.8 | 2.9 |

Sources: ONS for 2016, PwC main scenario for 2017-18

As in our March report, we expect UK growth to slow in 2017-18 but we do not expect the economy to fall into recession. We assume here that the Brexit negotiations will proceed reasonably smoothly, and therefore that the UK will avoid an extreme 'hard Brexit' where it falls out of the EU in 2019 without any trade deal or transitional arrangement, so reverting to WTO rules.

The projected slowdown in growth is driven in large part by slower consumer spending growth due to the squeeze on real household incomes from higher inflation. Employment growth could also slow from recent high levels as the economy as a whole slows. So far consumers have increased borrowing to keep spending growth going, but the household savings ratio fell to a record low in the first quarter of 2017 so there are limits to how much further this can go.

Investment growth is expected to continue but only at a moderate rate of around 1.6% in both 2017 and 2018. While public investment and housing investment has held up relatively well recently, business investment growth is likely to be dampened by uncertainty over the outcome of the Brexit negotiations.

Net exports as a percentage of GDP were negative in 2016 and this is expected to continue in 2017-18 but with a declining negative contribution over time. This reflects a boost to exports from the competitive value of sterling and the recovery in growth in the Eurozone in particular. The current account deficit has fallen back as a share of GDP in the past two quarters and this declining trend in the deficit looks set to continue (although we would still expect considerable volatility from quarter to quarter in these figures, in line with what we have seen in the past).

Overall, our growth projections are broadly similar to the latest average of independent forecasters, but somewhat more cautious than those of the Bank of England and the OBR for both 2017 and 2018. Almost all forecasters are, however, projecting some moderation of UK growth over this period.

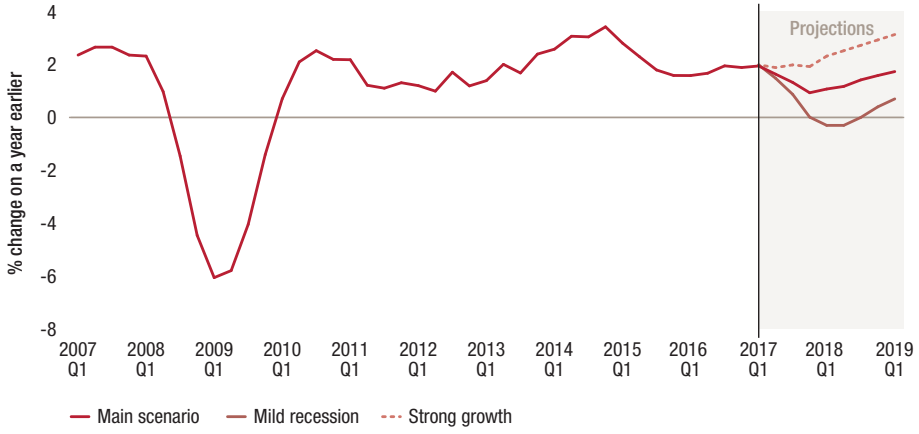
## Alternative growth scenarios – businesses need to make contingency plans

To reflect the uncertainties associated with any such projections, particularly in light of Brexit, we have also considered two alternative UK growth scenarios, as shown in Figure 2.6.

- Our **'strong growth'** scenario projects that the economy will expand by 1.9% this year and 2.6% in 2018. This is a relatively optimistic scenario which assumes that good early progress is made in UK-EU negotiations and that there are strong favourable trends in US and Eurozone growth in 2017-18.

- Our **'mild recession scenario'** sees UK GDP growth become negative in the first half of 2018 as the global outlook worsens and there is little progress in early negotiations with the EU, suggesting that the UK may have to fall back on WTO rules with consequent imposition of tariffs on trade with the EU. This would deepen and prolong the period of uncertainty around the outcome of Brexit, reducing investment, jobs and growth. Even in this downside case, however, we are only projecting a mild technical recession, with negative growth lasting the first two quarters of 2018, as opposed to the deep downturn seen after the global financial crisis, when UK GDP fell by around 6% from peak to trough.

**Figure 2.6 – Alternative UK GDP growth scenarios**




Sources: ONS, PwC scenarios

We do not believe that either of these two alternative scenarios is the most likely outcome, but they are certainly possible. At present, risks to growth still appear to be weighted somewhat to the downside given the political and economic uncertainties related to Brexit. Businesses would therefore be well advised to make appropriate contingency plans for such less favourable outcomes, but without losing sight of the more positive possibilities for the UK economy should these downside risks not materialise.

More generally, companies should be making detailed contingency plans for the immediate impact of Brexit[2] on all aspects of their businesses, covering the kind of questions listed in Table 2.2.

**Table 2.2: Key issues and questions for businesses preparing for Brexit**

| Issues | Implications | Questions |
|---|---|---|
| Trade | The EU is the UK's largest export partner, accounting for around 44% of total UK exports – leaving the EU is likely to make trade with EU more difficult. | • How much do you rely on EU countries for revenue growth?<br>• Have you reviewed your supply chain to identify the potential impact of tariffs and additional customs procedures on your procurement?<br>• Have you identified which third party contracts would require a renegotiation in the event of a Brexit? |
| Tax Contributions | The UK would gain more control over VAT and some other taxes. Brexit could also open the door to new tax initiatives within the EU that the UK might currently have sought to block. | • Have you thought about the impact of potential changes to the UK and EU tax regimes after Brexit?<br>• Have you upgraded your systems to deal with a significant volume of tax changes? |
| Regulation | The UK is subject to EU regulation. Brexit may mean less red tape. It could also mean that UK businesses need to adapt to a different set of regulations, which could be costly. | • Have you quantified the potential regulatory impact of Brexit to keep your stakeholders up-to-date?<br>• How flexible is your IT infrastructure to deal with potential changes to Data Protection laws?<br>• How ready is your compliance function to deal with potential new reporting requirements arising from Brexit? |
| Sectoral effects | The UK is the leading European financial services hub, which is a sector that could be significantly affected by Brexit. Other sectors which rely on the EU single market could also feel a strong impact. | • Have you briefed potential investors on the impact of Brexit for your sector and organisation?<br>• How up-to-date are your contingency plans in place to deal with Brexit?<br>• Are you aware of the impact of potential volatility in financial markets on your capital raising plans? |
| Foreign direct investment (FDI) | FDI from the EU makes up around 45% of the total stock of FDI in the UK. Brexit could put this inbound investment at risk. | • How much do your rely on FDI for growth?<br>• How does Brexit affect your location decisions?<br>• How are your competitors responding to the risk of Brexit? |
| Labour market | The UK may change its migration policies. Currently EU citizens can live and work in the UK without restrictions. Businesses will need to adjust to any change in this regime. | • How reliant is your value chain on EU labour?<br>• Have you communicated with your UK-based employees who are nationals of other EU countries? What advice should you give them on registering for UK residency?<br>• Has your compliance function considered the additional cost of hiring EU labour after Brexit?<br>• Could changes in access to EU labour increase the case for automation? |
| Uncertainty | Uncertainty has increased since the referendum and this seems likely to continue through the Brexit negotiation period. | • How well prepared are you to manage future volatility in the Sterling exchange rate as Brexit negotiations proceed?<br>• Have you communicated your approach to Brexit to your key stakeholders, customers and suppliers?<br>• Is your organisation ready for a worst-case scenario where there is a prolonged period of uncertainty and/or a 'hard Brexit'? |

2 For more material on the potential impact of Brexit on your business, please see our EU Referendum hub here: http://www.pwc.co.uk/the-eu-referendum.html

## Growth is expected to slow in most sectors, but manufacturing exports could be stronger in 2017

The sector dashboard in Table 2.3 shows latest ONS estimates of growth rates for 2016 along with our projected growth rates for 2017 and 2018 for five of the largest sectors within the UK economy. The table also includes a summary of the key trends and issues affecting each sector.

Manufacturing is the only major sector expected to experience higher growth in 2017 than 2016, as exporters gain from the weaker pound and stronger global growth.

All other sectors are predicted to experience lower growth in 2017-2018 as they are impacted, to some degree, by leaving the EU.

Of these, the distribution, hotels and restaurants sector will face the largest decline of any sector in growth between 2016 and 2017 as consumer spending growth slows, but should still outperform most other sectors this year and next.

Business services and finance growth will remain relatively strong and will face a smaller decline in growth between 2017 and 2018 than other sectors.

However, financial services companies could be particularly affected by any loss of access to EU markets, notably through the possible loss of 'passporting' rights for UK-based firms[3], which introduces additional uncertainty and may impact performance in the medium term. Construction growth is expected to remain relatively strong in 2017 after a good performance in the first quarter of the year, but could slow in 2018. This reflects the impact of Brexit-related uncertainty on business investment growth, offset by a planned increase in public sector investment.

**Table 2.3: UK sector dashboard**

| | Growth | | | |
|---|---|---|---|---|
| **Sector and GVA share** | **2016** | **2017** | **2018** | **Key issues/trends** |
| Manufacturing (10%) | 0.7% | 1.4% | 1.0% | Manufacturing PMI has remained resilient despite Brexit, and peaked at a three-year high in April, before falling slightly in May and June<br>Exporters should gain from a weaker pound, limiting the fall in total output during Brexit negotiations |
| Construction (6%) | 2.4% | 2.3% | 1.2% | Construction PMI rebounded strongly in May, but lost some momentum in June<br>The construction sector saw relatively strong growth in the first quarter of 2017, but is expected to weaken during the remainder of 2018<br>The government has extended the UK Guarantees scheme to construction to stimulate private infrastructure investment |
| Distribution, hotels & restaurants (14%) | 5.1% | 2.2% | 1.6% | A weaker pound may drive tourism, both from overseas and domestically, leading to increased expenditure in the hospitality sector<br>ONS figures show the retail sector experienced its lowest annual growth rate in May since April 2013, constrained by higher inflation from a weakened pound |
| Business services and finance (31%) | 2.4% | 1.8% | 1.7% | The financial sector remains particularly concerned about the possible implications of Brexit, especially if a "hard Brexit" occurs with the loss of EU passporting rights<br>Some banks are preparing to relocate some functions and thousands of staff overseas, though we have not seen large moves yet<br>The Bank of England has increased the counter-cyclical capital buffer to constrain consumer debt levels, which may impact lending by retail banks |
| Government and other services (23%) | 1.5% | 1.3% | 1.2% | Public services may continue to face real-term cuts for the next few years as confirmed in the Budget<br>Since the general election, the government has recommitted to its target of balancing the budget |
| **Total GDP** | **1.8%** | **1.5%** | **1.4%** | |

Sources: ONS for 2016 estimates, PwC for 2017 and 2018 main scenario projections and key issues.
These are five of the largest sectors but they do not cover the whole economy - their GVA shares only sum to around 85% rather than 100%

3 The potential impact of Brexit on financial services was considered in detail in our April 2016 report for TheCityUK, which can be accessed here: http://www.pwc.co.uk/industries/financial-services/insights/leaving-the-EU-implications-for-the-UK-financial-services-sector.html

**Figure 2.7 – PwC main scenario for output growth by region in 2017 and 2018**


Source: PwC analysis

### Regional prospects: all parts of the UK likely to see some moderation in growth in 2017-18, but none should fall into recession

London is expected to continue to lead the regional growth rankings in 2017, expanding by around 1.8% as shown in Figure 2.7, although this is down from around 2.4% in 2016. Most other regions are projected to expand at a rate at or below the UK average of 1.5% in 2017, while Northern Ireland is predicted to lag behind somewhat with growth of around 1%.

Growth is expected to decelerate slightly further in most regions during 2018, as the UK continues to feel the effects of Brexit-related uncertainty. But we do not project negative growth in any region in our main scenario.

It is important to note that regional output data are published on a much less timely basis than national data. As a result, the margins of error around these regional output projections are even larger than for the national growth projections, so they can only be taken as illustrative of broad directional trends.

## *2.3 – Outlook for inflation and real earnings growth*

Consumer price inflation (CPI[4]) rose to 2.9% in May 2017, up from 2.7% in April and significantly above the 2016 average rate of 0.7%. The large fall in the value of the pound since the Brexit vote has put upward pressure on prices as did earlier rises in global commodity prices (although these have been reversed in part in recent months, particularly for oil).

Over the course of 2017 we expect CPI inflation to rise further, peaking at over 3% around the turn of this year in our main scenario (see Figure 2.8). We then expect the inflation rate to ease back to around 2.6% by the end of next year as the effects of import price rises due to the weaker pound are no longer included in the 12-month inflation calculation. Annual average rates of inflation in our main scenario would be around 2.8% this year and around 2.9% next year, but this disguises significant movements within these years.

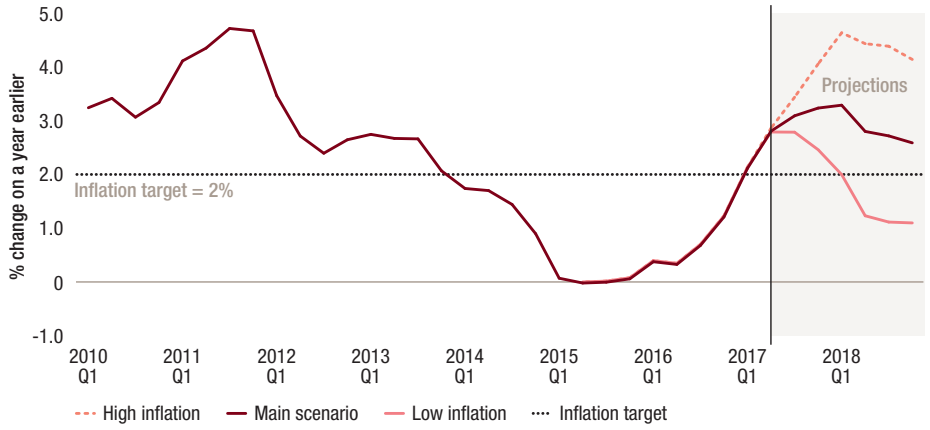
4 The ONS switched to CPIH as its main inflation indicator in March 2017, despite some continuing methodological concerns about the reliability of the way that CPIH captures owner occupied housing costs through estimates of equivalent market rents rather than actual outlays on mortgage payments. For the moment, we have stuck to CPI as our key inflation indicator, but we may consider switching to CPIH in future if this becomes more widely used. In the long run, however, we would not expect significant differences between average inflation on these two measures (based on long-term historical averages).

## Alternative inflation scenarios

There is considerable uncertainty over how far and fast inflation will rise and will depend on how Brexit negotiations proceed and the strength the global economy over the coming year. As such, we also present two alternative scenarios for UK inflation in Figure 2.8:

- In our 'high inflation' scenario we project inflation to rise to over 4% in 2018 as a result of further falls in the pound and a possible pick-up in global commodity prices if other economies grow more strongly and/or oil supply is constrained by producers.
- In our 'low inflation' scenario, by contrast, the UK and global economies weaken by more than expected in our main scenario in the aftermath of Brexit, while global commodity prices fall back sharply over the next year. In this case, UK inflation could fall back to below the Bank of England's 2% target in 2018.

**Figure 2.8 – Alternative UK inflation (CPI) scenarios**




Sources: ONS, PwC scenarios

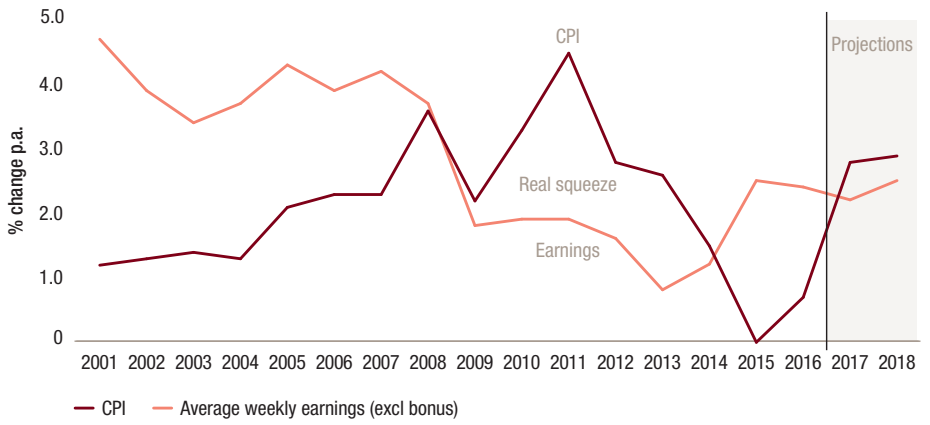
As with our GDP growth scenarios, neither of these two alternative variants is as likely as our main scenario. But given recent volatility and uncertainty, businesses should plan for a broad range of outcomes. Risks to UK inflation do seem to be weighted to the upside at present (in contrast to risks to real GDP growth, which we think are still weighted somewhat to the downside).

## Real earnings squeeze to persist through 2017 and 2018

Consumer price inflation exceeded earnings growth for six consecutive years following the onset of the 2008-9 recession, which was in marked contrast to pre-crisis norms. Positive real earnings growth resumed in 2015 and 2016 as consumer price inflation fell to close to zero, but nominal earnings growth in cash terms was still only just over 2%, which remains weak by historical standards.

Inflation has since picked up and we expect this trend to continue in 2017-18 while growth in nominal earnings growth remains relatively subdued (see Figure 2.9). This implies persistent negative real earnings growth over the period, which in turn will have a negative impact on real consumer expenditure growth. But there are considerable uncertainties around any such projections at present, given the apparent structural shifts in the behaviour of wages in response to variations in unemployment illustrated by our Phillips Curve estimates in Figure 2.5 earlier in this section.

**Figure 2.9 – CPI inflation vs average earnings growth**




Sources: ONS, PwC analysis

## 2.4 – Monetary and fiscal policy options

The Monetary Policy Committee (MPC) voted at its meeting in June to maintain the monetary policy stance introduced last August after the Brexit result, holding interest rates at 0.25%. But three members voted to raise rates and subsequent speeches by MPC members point to an active debate on the MPC in coming meetings as to when it is appropriate to start to normalise policy as the US Fed has been doing for some time.

At present, we would expect the majority of the MPC to want to wait for longer to see how the Brexit negotiations go and how this affects UK growth. But with inflation set to rise above 3% later this year, the case for a rate rise has clearly become stronger and we are assuming a modest increase during the course of 2018 in our main scenario.

While monetary policy may gradually tighten over the next 18 months, the Chancellor has come under significant political pressure to further ease austerity. A range of areas including health and social care, schools, police, social housing and public pay have emerged as priorities for additional spending following the election result. But we would expect the Chancellor to defer major decisions on recalibrating tax and spending policy until his Autumn Budget, when he can look at these issues in the round with the benefit of an updated OBR economic and fiscal forecast.

## 2.5 – Summary and conclusions

The UK economy grew by 2% in the 12 months to the first quarter of 2017, but the quarterly rate slowed to 0.2%, weighed down by slowing consumer expenditure and a weaker services sector.

In our main scenario, we project UK growth to slow gradually from around from 1.8% in 2016 to around 1.5% in 2017 and 1.4% in 2018. The slowdown will be felt across most major industry sectors, although manufacturing exports may receive a short-term boost from the depreciation of the pound and stronger Eurozone growth. London will see growth slow, but could remain the fastest growing UK region as other areas of the country will also see some easing of growth in 2017-18 compared to recent years.

The slowdown in UK growth is projected to be primarily a result of a slowdown in consumer expenditure, with real spending power squeezed as consumer price inflation increases faster than earnings growth. This continued stagnant wage growth, combined with low unemployment, suggests a breakdown of the traditional negative relationship described by the Phillips Curve.

Business investment growth is also expected to remain relatively subdued in 2017-18, driven by continued uncertainty surrounding the negotiations to leave the EU, although this will be partly offset by stronger public investment.

There are considerable uncertainties around any such projections at present, however, so businesses should stress test their business and investment plans against alternative economic scenarios and also review the potential wider implications of Brexit for all aspects of their operations.

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