Summary Report - November 2015

UK Economic Outlook

Will consumer spending growth continue to fuel the UK recovery?

The future shape of UK exports

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Highlights and key messages for business and public policy

- The UK economy has slowed a little in 2015 but domestic demand growth remains relatively strong, helped by lower oil prices. The global outlook remains mixed with a gradual pick-up during the year in the US and the Eurozone, but a slowdown in China, recessions in Russia and Brazil, and increased volatility in emerging markets more generally.

- In our main scenario we expect UK GDP growth to average around 2.4% in both 2015 and 2016. Consumer spending and business investment will be the main drivers of UK growth in these years.

- Risks to growth are weighted somewhat to the downside in the short term due to international risks, particularly in relation to emerging markets. But there are also upside possibilities if the global environment improves and productivity growth rates accelerate in the UK.

- London and the South East continue to lead the recovery, with average growth of around 3% in 2015-15, but all other UK regions should also register positive real growth of around 1.6-2.4% per annum over this period.

- Inflation has been close to zero this year but seems likely to rise back towards its 2% target by the end of 2016, so the MPC may start to raise interest rates gradually during the first half of next year. Businesses and households should still plan for rates to be back to around 3-3.5% by 2020.

- The Autumn Statement is likely to confirm plans for further fiscal tightening to eliminate the budget deficit before the end of this decade (although there seems likely to be some softening of planned tax credit cuts). This will impose some drag on the UK economy, but the private sector should be strong enough to offset this in terms of GDP growth. However, unprotected Whitehall government departments and local authorities in England could face cumulative real budget cuts of around 25% over the next four years.

Key projections

	2015	2016
Real GDP growth	2.4%	2.4%
Inflation (CPI)	0.1%	1.5%

Source: PwC main scenario projections

Consumer spending growth may moderate in medium term

- UK consumer spending has grown by around 2.5% per annum in real terms over the past three years. This has been driven by rapid jobs growth and a falling household savings rate, which in turn has been supported by rising house prices and increased consumer confidence and borrowing.

- We expect this positive momentum to be maintained in the short term, helped by near zero inflation rates that are boosting real income growth and continued historically low mortgage rates.

- In the medium term, however, we expect real consumer growth to moderate to just over 2% per annum in 2017-20 due to slower employment growth and a gradual rise in inflation and interest rates towards more normal levels.

- Housing and utilities is projected to be the fastest growing category of consumer spending over the next five years, accounting for over a quarter of total UK household spending by 2020.

- The share of household spending on leisure-related activities should also rise over time, but we project that the share spent on food and clothing will fall, in part due to continued intense price competition from online and high street discounters.

UK exports turning gradually from Europe to Asia

- In 1999, the EU accounted for 54% of total UK exports, but this has declined gradually to around 44% now and we expect it to fall further to around 37% by 2030.

- By contrast we expect the share of UK exports going to China, India and the next five largest emerging markets (which we collectively call the 'E7') to continue to rise gradually from around 9% now to 13% in 2030.

- Services have also become increasingly important for UK trade. Indeed we expect the total value of UK services exports to exceed that of manufactured goods exports by 2020. This will help to keep the share of UK exports going to the US, which is by far our largest trading partner for services, broadly stable at around 17-18% over the period to 2030.

1 – Summary

Recent developments

The UK economy grew by just under 3% in 2014, which was the fastest rate seen since 2006 and the strongest growth rate in the G7.

However, UK growth has slowed somewhat during the first three quarters of 2015, which appears to reflect the drag in that period from sluggish growth in the Eurozone and uncertainties related to problems in Greece earlier in the year and risks associated with China and some other emerging markets more recently.

In contrast, UK domestic demand growth has remained relatively strong so far this year, driven by rising employment, the recent pick-up in earnings growth and the benefits of lower global oil prices for UK consumers (and many businesses).

UK growth continues to be driven primarily by services, with manufacturing growth having slowed since last year and construction trends being erratic. Business investment has shown signs of a stronger recovery in the latest official data, although this has not yet translated into consistently stronger productivity growth.

Government departmental spending cuts have slowed down somewhat over the past couple of years, but the Budget indicated that real reductions will continue for the next four years. The Budget also announced net tax rises building up to around £7 billion by 2020 and welfare cuts that will hit some lower earners quite severely, albeit with a partial offset from the more generous National Living Wage in some cases. We would expect the broad thrust of these policies to be confirmed in the Autumn Statement, although there now seems likely to be some softening of the tax credit cuts (either by scaling these down and/or by introducing some form of transitional relief).

Table 1.1: Summary of UK economic prospects

Indicator (% change on previous year)	OBR forecasts (July 2015)		Independent forecasts (October 2015)		PwC Main scenario (November 2015)	
	2015	2016	2015	2016	2015	2016
GDP	2.4	2.3	2.5	2.4	2.4	2.4
Consumer spending	3.0	2.5	3.0	2.5	2.9	2.7

Source: Office for Budget Responsibility (July 2015), HM Treasury survey of independent forecasts (average values in October 2015 survey) and latest PwC main scenario.

The rate of consumer price inflation (CPI) has remained around zero in recent months as commodity prices have generally remained weak, partly due to relatively subdued global demand growth. The latter has also been a factor in causing both the US Federal Reserve and the Bank of England to hold off from interest rate rises in recent months.

Future prospects

Consumer spending growth is projected to be slightly stronger than GDP growth in 2015-16, with a boost from lower oil prices and increased real earnings growth, but it may slow later as discussed further below.

We expect continued relatively strong business investment growth in 2015 and 2016, but at a somewhat slower rate than in 2014. Business confidence could be affected by increased international risks relating to China and other emerging markets, as well as continuing uncertainties relating to Greece, conflicts in the Middle East and the planned referendum on UK membership of the EU (although there is little hard evidence of this having had a large effect so far). But the domestic outlook still seems reasonably favourable for UK business investment, helped by the further corporation tax rate cut announced in the Budget in July.

As always there are many uncertainties surrounding our growth projections, as illustrated by the alternative scenarios in Figure 1.1. There are still considerable downside risks relating to international developments, but there are also upside possibilities if these problems can be contained and a virtuous circle of rising confidence and spending can be established as in past economic recoveries.

Inflation will remain very low this year, but could rebound to close to its 2% target by the end of 2016 assuming there is no repeat of past falls in global energy and food prices. There could be upside risks to this inflation outlook in the longer term if domestic wages continue to recover without a corresponding rise in productivity.

We do not expect any immediate rise in official UK interest rates, but a gradual upward trend seems likely from the first half of 2016 onwards. In the long term, we would expect official rates to rise very gradually to more normal levels of around 3-3.5% by 2020.

Higher interest rates will help savers and reduce pension fund deficits, but borrowers (including businesses and the government) might gain from locking in funding now for long term investments such as infrastructure and housing. Households need to bear in mind likely future interest rate rises in any decisions on mortgages or other longer term loans.

Can the UK consumer continue to drive the recovery?

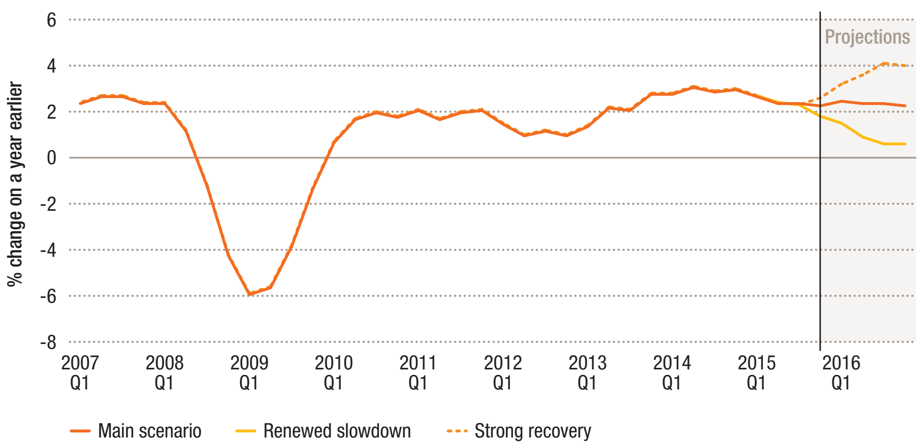
As discussed in detail in Section 3 of this report, consumer spending has grown relatively strongly over the past three years due to strong employment growth, low mortgage interest rates and higher personal income tax allowances. All of these have boosted household disposable incomes, although real cuts in non-pension benefits have partly offset these factors. In addition, increased confidence and borrowing since mid-2012 have been reflected in a declining savings ratio, giving a significant additional boost to real consumer spending growth (2.5% per annum in the three years to Q2 2015) over and above real disposable income growth (0.8% per annum over the same period).

Looking ahead, our analysis suggests that real income growth will pick up further in 2015-16, but may then moderate as jobs growth slows and further real benefit cuts take effect. With limited scope for further reductions in household savings ratios from already low levels, this is likely to cause either a moderation in consumer spending growth in the medium term, or a potentially unsustainable build-up in household debt.

More specifically, we project in our main scenario that real household spending will grow by around 2.9% in 2015 and 2.7% in 2016, but this could then slow down to an average of around 2.3% per annum in the 2017-2020 period (see Table 1.2).

There are considerable uncertainties around this, however, with alternative scenarios suggesting a plausible range for medium term real consumer spending growth of around 1.5-3% per annum.

Figure 1.1 – Alternative UK GDP growth scenarios



Source: PwC based on latest ONS data

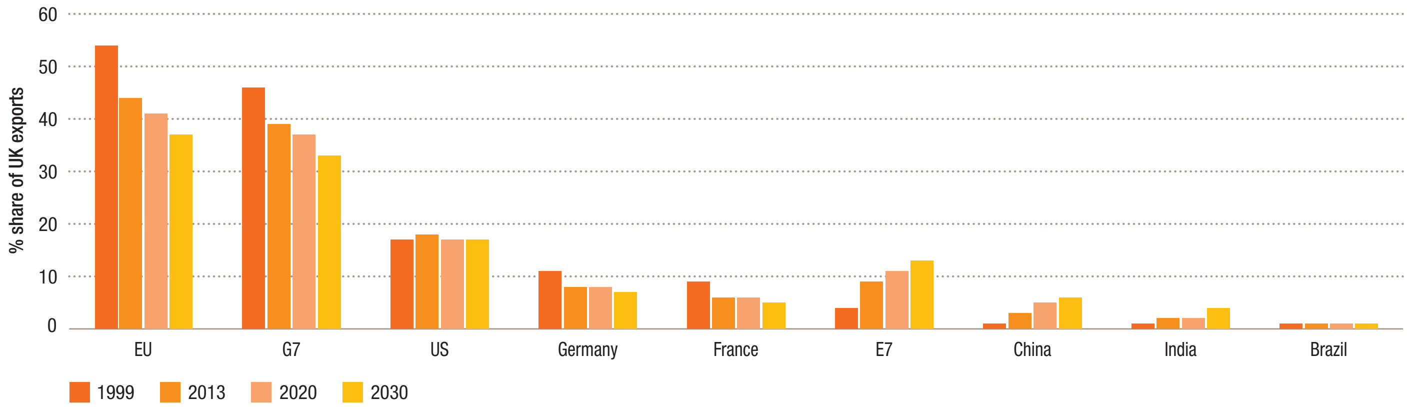
Table 1.2: Main scenario projections of real consumer spending growth

% per annum	2015	2016	2017-20
Real household disposable income	3.5%	2.3%	1.8%
Adjusted savings ratio	-0.7%	-1.1%	-2.5%
Real household expenditure	2.9%	2.7%	2.3%

Source:PwC analysis taking account of actual ONS data for the first half of 2015

We also project that, by 2020, household will have to allocate more than 25% of their budget to spending on household and utilities. This is the fastest growing category, reflecting factors such as upward pressure on real rent levels from continued housing shortages. We also expect the share of total spending in leisure-related areas such as recreation, culture, hotels and restaurants will also increase assuming the economic recovery continues up to 2020.
By contrast, the share of spending on categories such as food and clothing are projected to decline as online and high street discounters play an increasing role in these retail sectors.

Figure 1.2 – Actual and projected UK export shares to key markets: 1999-2030



Source: ONS Pink Book 2014, PwC analysis

UK exports shift gradually from Europe towards emerging markets

Our detailed analysis in Section 4 shows that the EU will remain the most important destination for UK exports up to 2030, but we project that its share of the total will decline gradually from 54% in 1999 and 44% in 2013 to around 37% in 2030 (see Figure 1.2).

By contrast, the share of UK exports going to the US will remain more stable at around 17-18%. This partly reflects the importance of the US for UK services trade, which is the fastest growing part of our exports.

Although much discussion has centred on the importance of emerging markets as UK export markets, they are not yet that significant. We still export more to Ireland, for example, than to China and Hong Kong combined. In the future, we expect this to change, but it will be a slow process – even by 2030, the share of UK exports going to the largest seven emerging economies (the E7), led by the Asian giants of China and India, will still only be around 13%, up from 9% now. UK trade is rather like a supertanker – it cannot be turned around quickly.

It is also important to note that, as recent developments show, exports to emerging markets also tend to be more volatile and susceptible to external and domestic shocks. Therefore it is important that the UK also continues to focus on its established trading partners in the EU and the US.

For UK companies, the key message is that whilst there are great opportunities in rapidly expanding emerging markets in Asia and elsewhere, including Africa, businesses need to be well prepared to manage the risks associated with these markets.

Appendix A
Outlook for the global economy

Table A.1 presents our latest main scenario projections for a selection of economies across the world.

Growth in leading developed economies remains modest in 2015-16, with the US narrowly taking over from the UK as the fastest growing G7 economy. Overall Eurozone growth rate is picking up slowly led by Spain and Ireland rebounding from earlier crises, but remains modest in the big three economies of Germany, France and Italy.

Growth in emerging markets has lost some momentum with a slowdown in China and continuing recessions in Brazil and Russia, though the growth outlook appears brighter at present in India (which is a gainer from lower oil prices). In light of these uncertainties, global GDP projections remain moderate for 2015 at 3.2%, picking up slightly to 3.5% in 2016 (using PPP weights – rates are lower using MERs), though this is slightly lower than we previously projected.

Global inflation has fallen in 2015 as rates hover around zero for most of the G7. Inflation is expected to edge back up through 2016, however, as past commodity price decreases fall out of 12-month inflation rate calculations.

These projections (including those for the UK) are updated monthly in our Global Economy Watch publication, which can be found at www.pwc.com/gew.

Table A.1: Global economic prospects

	Share of world GDP	Real GDP growth (%)		Inflation (%)	
	2014 at MERs	2015p	2016p	2015p	2016p
US	22.5%	2.5	2.7	0.1	1.4
China	13.4%	6.9	6.5	1.7	1.8
Japan	6.0%	0.7	1.2	0.9	1.0
UK	3.8%	2.4	2.4	0.1	1.5
France	3.7%	1.1	1.3	0.2	1.1
Germany	5.0%	1.5	1.7	0.2	1.3
Greece	0.3%	-2.2	-1.4	-0.4	0.1
Ireland	0.3%	5.6	4.5	0.2	1.3
Italy	2.8%	0.7	1.2	0.1	0.9
Netherlands	1.1%	2.0	1.5	0.8	1.3
Portugal	0.3%	1.7	1.8	0.7	1.2
Spain	1.8%	3.1	2.6	-0.6	0.8
Poland	0.7%	3.7	3.4	-0.8	1.1
Russia	2.4%	-3.8	-0.5	15.6	8.9
Turkey	1.0%	2.7	3.0	7.9	7.0
Australia	1.9%	2.0	2.9	1.7	2.5
India	2.7%	7.3	7.9	-2.5	3.0
Indonesia	1.1%	4.0	4.1	6.8	5.6
South Korea	1.8%	2.8	3.3	0.9	1.9
Argentina	0.7%	2.1	1.7	20.0	25.0
Brazil	3.0%	-2.4	-0.5	8.5	6.5
Canada	2.3%	1.0	2.0	1.0	1.6
Mexico	1.7%	2.3	3.0	2.8	3.2
South Africa	0.5%	1.5	1.8	4.8	5.6
Nigeria	0.7%	3.5	4.5	9.3	9.5
Saudi Arabia	1.0%	2.8	2.3	2.1	2.5
World (PPP)		3.2	3.5		
World (Market Exchange Rates)	100%	2.7	3.0	1.7	2.4
Eurozone	17.4%	1.5	1.6	0.1	1.1

Source: PwC main scenario for 2015 and 2016; IMF for GDP shares in 2014 at market exchange rates (MERs).

Appendix B
UK economic trends: 1979 – 2014

Annual averages	GDP growth	Household expenditure growth	Manufacturing output growth*	Inflation (CPI**)	3 month interest rate (% annual average)	Current account balance (% of GDP)	PSNB*** (% of GDP)
1979	3.7	4.8			13.7	-0.6	4.5
1980	-2.2	0.1			16.6	0.6	4.1
1981	-0.8	0.3			13.9	1.7	3.3
1982	2.1	1.2			12.2	0.7	2.5
1983	4.2	4.4			10.1	0.3	3.3
1984	2.3	2.5			10.0	-0.5	3.6
1985	4.1	5.1			12.2	-0.2	2.8
1986	3.2	6.5			10.9	-1	2.2
1987	5.6	5.4			9.7	-1.6	1.4
1988	5.9	7.8			10.4	-3.8	-0.7
1989	2.5	3.9		5.2	13.9	-4.3	-0.7
1990	0.6	0.7		7.0	14.8	-3.3	0.7
1991	-1.3	-0.8		7.5	11.5	-1.4	2.8
1992	0.4	1.2		4.3	9.6	-1.6	6.0
1993	2.6	3.1		2.5	5.9	-1.4	7.2
1994	4.0	3.3		2.0	5.5	-0.5	6.2
1995	2.5	2.1		2.6	6.7	-0.7	5.0
1996	2.7	4.2		2.5	6.0	-0.6	3.6
1997	3.1	4.9		1.8	6.8	-0.2	1.8
1998	3.4	4.4	0.3	1.6	7.3	-0.4	-0.1
1999	3.1	5.0	0.6	1.3	5.4	-2.5	-1.2
2000	3.8	5.3	2.3	0.8	6.1	-2.2	-1.5
2001	2.8	3.7	-1.7	1.2	5.0	-2	-0.7
2002	2.5	4.1	-2.4	1.3	4.0	-2.1	1.8
2003	3.3	3.7	-0.6	1.4	3.7	-1.7	2.8
2004	2.5	3.5	1.7	1.3	4.6	-1.8	3.2
2005	3.0	3.1	0.0	2.1	4.7	-1.2	3.5
2006	2.7	2.0	2.1	2.3	4.8	-2.3	2.6
2007	2.6	3.1	0.7	2.3	6.0	-2.5	2.8
2008	-0.5	-0.7	-2.8	3.6	5.5	-3.6	4.9
2009	-4.2	-3.4	-9.4	2.2	1.2	-3	10.2
2010	1.5	0.0	4.5	3.3	0.7	-2.8	9.1
2011	2.0	-0.1	2.1	4.5	0.9	-1.7	7.1
2012	1.2	2.0	-1.4	2.8	0.8	-3.3	7.6
2013	2.2	1.9	-1.1	2.6	0.5	-4.5	5.8
2014	2.9	2.7	2.7	1.5	0.5	-5.1	5.4
Average over economic cycles****							
1979 - 1989	2.7	3.7			12.0	-0.4	2.7
1989 - 2000	2.3	3.0		3.5	8.5	-1.5	2.9
2000 - 2007	2.8	3.3	0.0	1.5	4.7	-1.9	1.7

* After the revisions to the national accounts data, pre-1998 data is not currently available ** Pre-1997 data estimated *** Public Sector Net Borrowing (calendar years excluding public sector banks)
**** Peak-to-peak for GDP relative to trend
Sources: ONS, Bank of England

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Economics and policy

Our macroeconomics team produce the UK Economic Outlook three times a year.

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