2 – UK economic prospects

Key points

- UK economic growth remained relatively strong at around 2% in the year to Q4 2016, with no immediate deceleration after the 'Brexit' vote.

- In our main scenario, we now project UK growth to slow from 1.8% in 2016 to around 1.6% 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 surrounding the Brexit negotiation process. Businesses need to make contingency plans for alternative outcomes to this process.

- Consumer spending growth is projected to slow from previous strong rates, dropping from 3% in 2016 to only around 2% in 2017 and 1.7% in 2018 in our main scenario. This reflects a squeeze on household spending power from higher inflation as well as slower jobs growth.

- We also expect business investment growth to remain relatively subdued in 2017-18 due to uncertainty about the UK's future trading relationships with the EU and other geopolitical uncertainties.

- The weaker pound should boost net exports, however, together with the gradual strengthening of the world economy we have seen over the past year.

- We expect growth in the services sector to slow but remain positive in 2016-17. The construction sector will suffer the most from lower investment levels, but some manufacturing exporters will benefit from the weaker pound.

- We project that London will remain the fastest growing region, but its pace of expansion could slow from around 2.5% in 2015 to an average of just under 2% in 2017-18. Other regions are projected to see average growth in 2017-18 of around 1-1.5%, and we do not predict negative growth in any region in either 2017 or 2018 in our main scenario.

- The Bank of England is likely to keep monetary policy on hold in the short term, but rate rises could come back on to the agenda next year in our main scenario.

- The Budget saw small net giveaways in 2017/18, but the overall stance of fiscal policy will continue to tighten gradually over the following years based on previously announced tax and spending plans.

Introduction

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

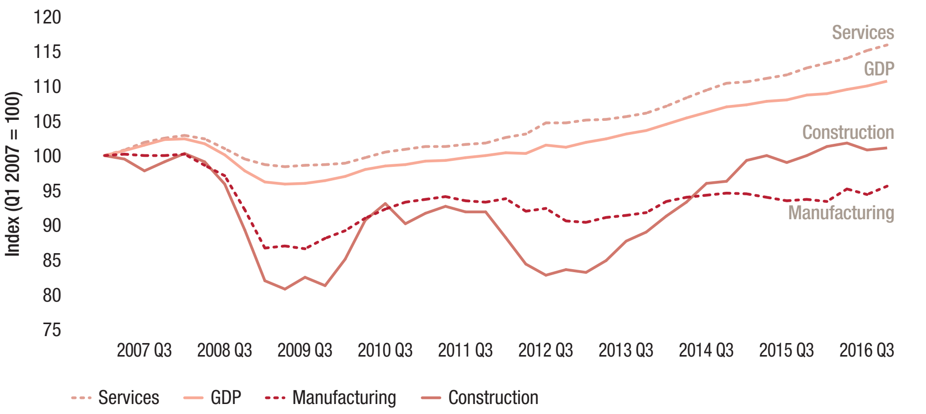
Section 2.1	Recent developments and the initial impact of Brexit
Section 2.2	Economic growth prospects after Brexit: national, sectoral and regional
Section 2.3	Outlook for inflation and real earnings growth
Section 2.4	Monetary and fiscal policy options
Section 2.5	Summary and conclusions.

2.1 – Recent developments and the immediate impact of Brexit

UK economic growth slowed from around 3% in 2014 to an estimated 1.8% in 2016. However, growth held up well in the second half of 2016, despite the vote for the UK to leave the EU ('Brexit') in June 2016. This was due in particular to the resilience of consumer spending in 2016, although there have been some tentative signs of this softening in early 2017.

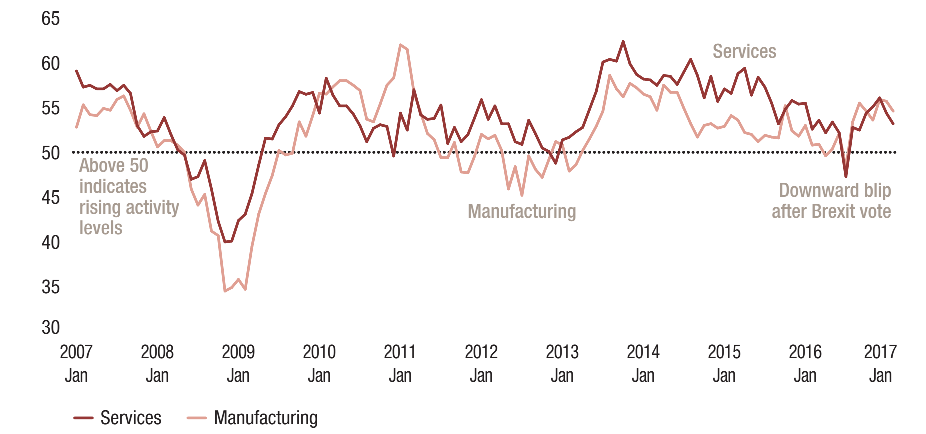
The general pattern, as shown in Figure 2.1, has been for services sector growth to remain relatively strong and steady, while growth in manufacturing and construction has been both weaker on average and more volatile. The purchasing managers' indices (PMIs) for services and manufacturing both saw impressive recoveries from the immediate post-referendum shock seen in July, but have dropped back somewhat in early 2017, particularly for services (see Figure 2.2). The construction PMI also bounced back in the autumn but has weakened somewhat in recent months.

Figure 2.1 – Sectoral output and GDP trends



Source: ONS

Figure 2.2 – Purchasing Managers' Indices of business activity

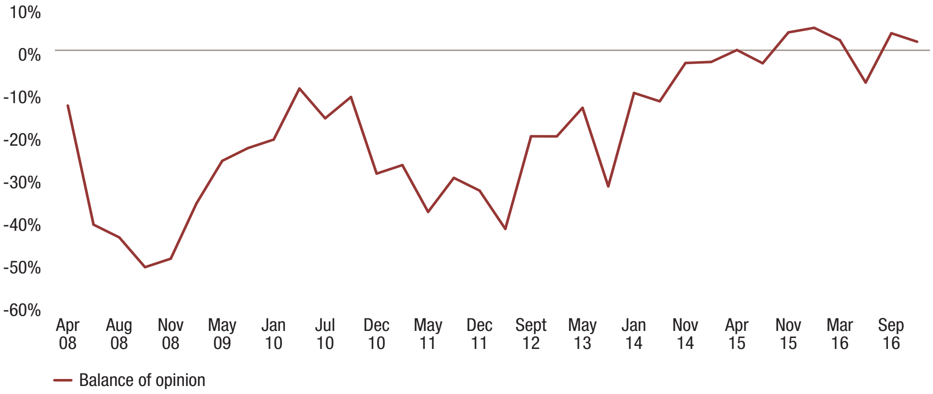


Sources: Markit/CIPS

Consumer confidence also suffered a dip immediately after the referendum, with the net balance according to PwC's regular survey (see Figure 2.3) falling to -8% in July, the first negative reading for almost a year. However, consumer confidence then bounced back strongly in September as the immediate shock of the Brexit vote faded, although it did fall back a little in December. A similar pattern has been seen in retail sales data, which was relatively strong between July and November, but weakened somewhat in December and January as inflation rose.

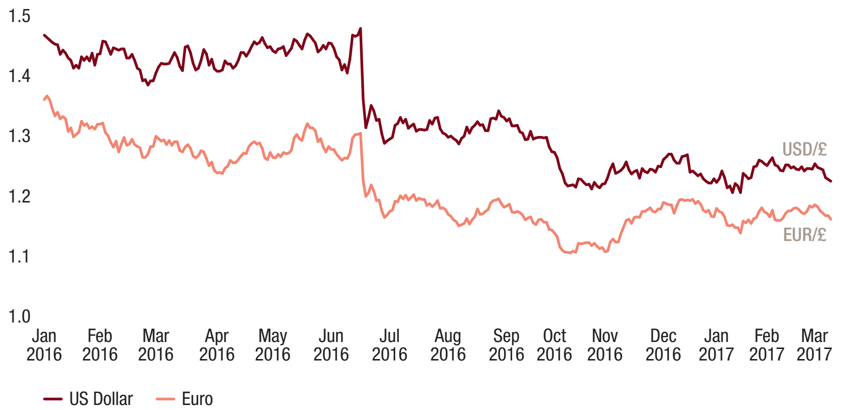
Following the vote to leave the EU, the pound fell sharply in value against both the dollar and the euro and has generally remained weak ever since despite short-term volatility (see Figure 2.4). The weaker pound will help UK exporters (including tourist flows into the UK), but will tend to push up import prices, which will ultimately feed through into a squeeze on consumers, alongside other factors such as the rise in global commodity prices from their lows in early 2016. The rise in headline consumer price inflation to 2.3% in February 2017 shows how inflationary pressures have already fed through to consumers and this is likely to continue through at least the next year, as we discuss further in Section 2.3 below.

Figure 2.3 – Consumer confidence: net balance expecting rising household disposable income over next 12 months



Sources: PwC Consumer Survey

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



Source: Bank of England

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

We have continued to revise our growth projections for the UK based on the economic data that have been released since the vote to leave the European Union. Since the last UK Economic Outlook report in November, we have revised estimated growth in 2016 up from 1.2% to 1.6%. This reflects the relatively encouraging economic news that has emerged since mid-2016, but we still expect some drag on growth this year from rising consumer prices and an uncertain environment for business investment while the Brexit negotiations proceed. This means that below trend growth is also expected to persist into 2018, when our main scenario is for GDP growth of 1.4% as shown in Table 2.1. Our projections are similar to the latest consensus of independent forecasters, although slightly less optimistic than the OBR forecasts in the Budget. But the broad profile of gradually slowing growth over the next few years due to Brexit-related effects is common across most forecasters at present.

Overall, we expect growth to slow in 2017-18 but not to fall into recession, with the economy starting a gradual recovery later in 2018 on the assumption of no major adverse global shocks. We also assume here that Brexit negotiations proceed reasonably smoothly, leading to the expectation 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.

Table 2.1: PwC main scenario for UK growth and inflation

% real annual growth unless otherwise stated	2016	2017	2018
GDP	1.8%	1.6%	1.4%
Consumer spending	3.1%	2.0%	1.7%
Government consumption	0.8%	0.6%	0.7%
Fixed investment	0.5%	0.0%	0.7%
Domestic demand	1.6%	1.1%	1.3%
Net exports (% of GDP)	-0.4%	0.4%	0.0%
CPI inflation (%: annual average)	0.7%	2.3%	2.8%

Sources: ONS estimates for 2016, PwC main scenario projections for 2017-18. Note that domestic demand growth and the contribution from net exports does not sum to overall GDP growth in 2016 due to additional statistical adjustments by the ONS. In 2017 and 2018 any difference is much smaller and due largely to rounding.

We assume here that monetary policy remains supportive (as discussed further in Section 2.4 below) and that tax and spending plans are as set out in the Budget.

Consumer spending growth remained strong at around 3% in 2016, but we expect this to slow to around 2% in 2017 and 1.7% in 2018. As discussed in detail in Section 3 below, this primarily reflects higher inflation squeezing real spending power, as well as softening jobs growth.

The other main drag on GDP growth will come from continued subdued business investment, giving ongoing uncertainties about the exact outcome of the Brexit negotiations, even if we assume here that worst case 'WTO scenarios' are avoided. While we assume some kind of free trade agreement will eventually be reached with the EU, this will take time and (given the need to increase control over immigration) will involve some reduction in access to the EU single market relative to the current position. Even if tariffs on goods are largely avoided, non-tariff barriers are likely to increase for both goods and services.

Government consumption growth will be less affected than business investment, but is likely to remain moderate in line with Budget plans. Public sector investment is planned to be stronger, however, which should partly offset the expected weakness in private investment in 2017-18.

UK net exports should move in a more favourable direction this year as import demand weakens and the fall in the pound helps exports and import substitutes to become more competitive. We therefore expect a positive contribution from net exports to GDP in 2017, but this may become more neutral again in 2018.

Overall, our growth projections are broadly similar to the latest average of independent forecasters, but slightly more cautious than those of the Bank of England and the OBR. But all economic projections are subject to particularly large uncertainties at present after the shock of the Brexit vote.

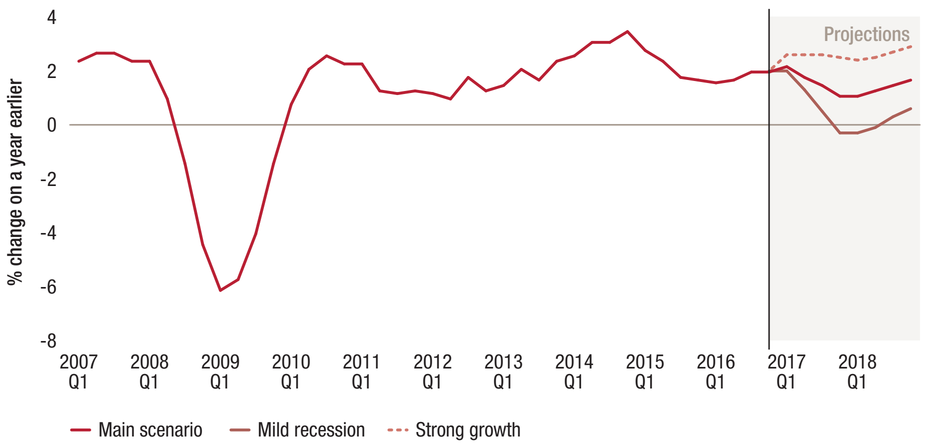
Alternative growth scenarios – businesses need to make contingency plans

To reflect these uncertainties, we have also considered two alternative UK growth scenarios, as shown in Figure 2.5.

- Our 'strong growth' scenario projects that the economy will expand by over 2% this year and over 3% in 2018. This is a relatively optimistic scenario which assumes that good early progress is made in UK-EU negotiations and there are strong favourable trends in US and euro area growth in 2017-18.

- On the other hand, our 'mild recession scenario' sees UK GDP growth fall into negative territory later in 2017 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, not the deep downturn seen after the global financial crisis, when UK GDP fell by around 6% from peak to trough.

Figure 2.5 – 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 and, at present, risks to growth still appear to be weighted somewhat to the downside given the political and economic uncertainties related to Brexit (and, in the short term, also the French presidential elections, which are due to be completed in early May). 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. Looking further ahead, these also include the scope for longer term trade expansion with non-EU trading partners like China and India, as discussed in more detail in the November issue of this report.

More generally, companies should consider making detailed contingency plans for the potential impact of Brexit[1] on all aspects of their businesses, covering the kind of questions listed in Table 2.2.

1 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

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? • Have you reviewed your supply chain to identify the impact of tariffs on your procurement? • 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? • 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 could have to adapt to a different set of regulations, which could be costly.	• Have you quantified the regulatory impact of Brexit to keep your stakeholders up-to-date? • How flexible is your IT infrastructure to deal with potential changes to Data Protection laws? • 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? • How up-to-date are your contingency plans in place to deal with Brexit? • Are you aware of the impact of illiquidity and volatility in financial markets on your capital raising plans?
Foreign direct investment	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? • Have you considered alternative sources of funding aside from banks? • 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? • 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? • Has your compliance function considered the additional cost of hiring EU labour after Brexit? • Could changes in access to EU labour increase the case for automation?
Uncertainty	Uncertainty has increased since the referendum and this may continue through the Brexit negotiation period.	• How well prepared are you to manage future volatility in the Sterling exchange rate as Brexit negotiations proceed? • Have you communicated your approach to Brexit to your key stakeholders, customers and suppliers? • Is your organisation ready for a worst-case scenario where there is a prolonged period of uncertainty and/or a 'hard Brexit'?

Source: PwC assessment

Service sector growth has slowed, 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 issues affecting each sector.

The outlook is clearly stronger for private non-financial services than for other sectors, but all are likely to be negatively affected to some degree by leaving the EU. Construction may be hardest hit due to its reliance on large scale private sector investment projects that may be particularly prone to be delayed or even cancelled due to uncertainty following the vote to leave the EU, although public sector investment is being increased to partly offset this. Manufacturing exporters will gain from the weaker pound and stronger global growth, however, so this sector may show a modest revival this year.

Financial services companies could also be affected by any loss of access to EU markets, notably through the possible loss of 'passporting' rights for UK-based firms[2].

Table 2.3: UK sector dashboard

Sector and GVA share	Growth 2016	Growth 2017	Growth 2018	Key issues/trends
Manufacturing (10%)	0.7%	1.3%	1.0%	Manufacturing PMI reached its highest level for over two years in December, before falling back slightly in January and February Capital goods manufacturers vulnerable to a fall in investment after vote to leave EU But exporters should gain from weaker pound
Construction (6%)	1.5%	0.1%	0.9%	The construction sector saw negative growth in the third quarter but a small increase in the fourth quarter The latest PMI survey data suggested continued modest growth in early 2017, though housebuilding has slowed recently Increased public investment may partly offset weaker private construction activity due to Brexit-related uncertainty
Distribution, hotels & restaurants (14%)	5.0%	3.3%	1.7%	ONS figures show that retail sales were strong up to November but weakened in December and January A weaker pound will hit real spending by domestic consumers as import prices rise, but tourists to the UK will benefit from the weak pound and could spend more here as a result
Business services and finance (32%)	2.7%	1.6%	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. Some banks may be preparing to relocate some functions abroad due to Brexit, though we have not seen large moves yet For the moment, however, household borrowing remains relatively robust, supporting retail banks
Government and other services (23%)	1.6%	1.0%	0.8%	Philip Hammond announced some new infrastructure investments in November, but public services will continue to face real-term cuts for the next few years as confirmed in the Budget
Total GDP	**1.8%**	**1.6%**	**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%.

2 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 2.6 – 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 due to Brexit, but none should fall into recession in 2017 or 2018

London is expected to continue to lead the regional growth rankings in 2017, expanding by around 2% as shown in Figure 2.6, although this is down from around 3% in 2015. Most other regions are expected to expand at rates closer to the UK average of around 1.5%, but Northern Ireland is expected to lag behind somewhat with growth of around 1.2%.

Growth is expected to decelerate a little further in all regions in 2018 as the UK continues to feel the effects of Brexit-related uncertainty. We do not, however, project negative growth in any region in our main scenario. Growth in London might fall to around 1.8% in 2018, while Northern Ireland may again lag behind the rest of the UK with growth of just under 1%.

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[3]) picked up from 0.6% in August to 2.3% in the year to February 2017. Higher import prices are beginning to feed through to consumers because of the significant and persistent fall in sterling since the Brexit vote on 23 June. In addition to this, an increase in oil prices since their low point in early 2016 will push up costs for energy and transport, helping push inflation higher (though oil prices remain a long way below mid-2014 peaks).

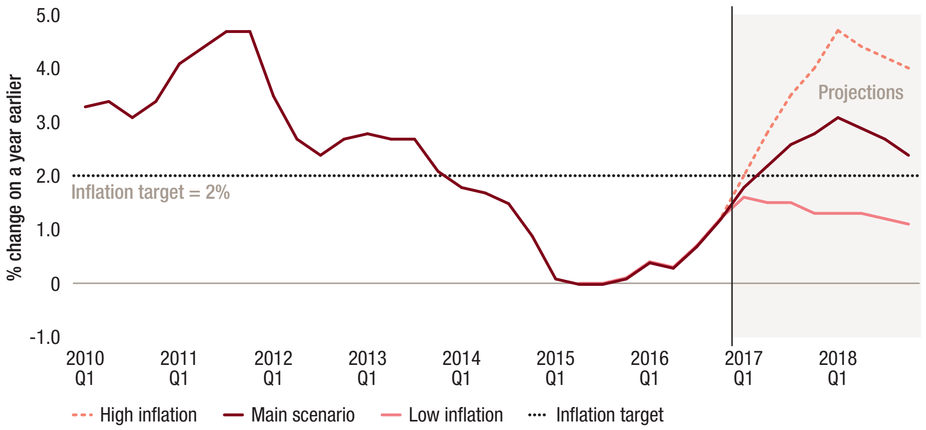
Over the course of 2017 we therefore expect CPI inflation to rise well above the Bank of England's 2% target rate, perhaps peaking at around 3% in early 2018 in our main scenario (see Figure 2.7) before easing back to around 2.5% by the end of next year as the effects of earlier import price rises fall out of the 12-month inflation calculation. Annual average rates of inflation in our main scenario would be around 2.3% this year and around 2.8% next year, but this disguises significant movements within these years.

Alternative inflation scenarios

In our main scenario we are projecting an average consumer price inflation rate of 0.6% in 2016 and 2.3% in 2017, which we have revised up since our last UK Economic Outlook report in the face of the recent weakness of the pound. By the fourth quarter of 2017, inflation could average around 2.7%, well above the Bank of England's 2% target rate (see Figure 2.7).

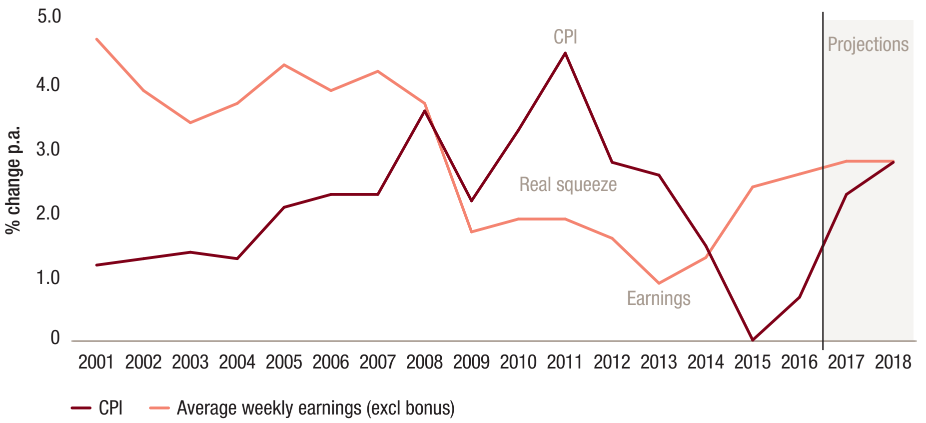
There is considerable uncertainty over how far and fast inflation will rise, however, and we therefore we also present two alternative scenarios for UK inflation in Figure 2.7:

Figure 2.7 – Alternative UK inflation (CPI) scenarios



Sources: ONS, PwC scenarios

Figure 2.8 – CPI inflation vs average earnings growth



Sources: ONS, PwC analysis

- In our **'high inflation' scenario** we project inflation to rise to over 4% in 2018 as a result of potential 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 remain below target.

3 The ONS is due to switch to CPIH as its main inflation indicator from 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 this edition of UK Economic Outlook, 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).

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 after Brexit and 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).

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.

There might be a gradual pick-up in earnings growth in 2017-18, but this is less clear after the vote to leave the EU. On the one hand, higher consumer price inflation due to the weaker pound could feed through into higher nominal earnings growth, but on the other hand this could be offset by weaker economic growth and so labour demand in 2017-18. Balancing these two effects, our preliminary projection is that earnings growth remains at moderate levels in 2017-18, with real earnings growth falling back to around zero in 2018, as shown in Figure 2.8. But there are considerable uncertainties around any such projections at present.

2.4 – Monetary and fiscal policy options

The Monetary Policy Committee (MPC) cut interest rates in August and announced an expansion of its quantitative easing (QE) asset purchase scheme, by £60bn for UK government bonds and up to £10bn for high quality corporate bonds.

Monetary policy has remained on hold since then and we would expect this to continue for at least the next few months as the MPC waits for more data on growth and inflation, as well as seeing how the Brexit negotiations develop. If the data evolve broadly in line with our main scenario, however, we might expect a very gradual rise in official interest rates to begin sometime in 2018.

The OBR revised down its 2016/17 public borrowing forecast significantly, but this was mostly due to one-off factors and shifts in the timing of revenues and spending that pushed some borrowing forward into 2017/18. The OBR's medium term view on both growth and borrowing was little changed from its last forecast in November. Accordingly, there was little change in the overall stance of fiscal policy, although the Chancellor did use some of the short-term borrowing undershoot to pay for an increase in social care and NHS spending to ease short term pressures in these areas.

Looking beyond the next two years, however, the Budget actually involved small net tax rises, but the macroeconomic impact of the changes will be minimal. Previous plans to cut current spending as a share of GDP were left broadly unchanged, with austerity set to continue well into the early 2020s, albeit proceeding at a markedly slower rate than planned by George Osborne in his 2015-16 Budgets.

2.5 – Summary and conclusions

UK economic growth remained relatively strong in the second half of 2016, increasing by around 2% in the year to the fourth quarter as consumer spending in particular remained resilient. But business investment was less strong last year (albeit volatile from quarter to quarter) and there have been some signs in early 2017 that higher inflation is starting to take its toll on retail sales growth. These less favourable trends seem likely to continue for the rest of 2017 and into 2018 assuming the outcome of the Brexit negotiations remains unclear and the pound continues to be relatively weak.

In our main scenario, we therefore project UK growth to slow gradually from around 1.8% in 2016 to around 1.6% in 2017 and 1.4% in 2018. This assumes no major new adverse shocks to the global or EU economies (e.g. from the French presidential election results in early May).

The main reason for this significant slowdown in UK growth is projected to be a downturn in business investment driven by continued uncertainty surrounding the negotiations to leave the EU, and a squeeze on real household spending power from rising inflation, which could reach around 3% by early 2018 in our main scenario, and a softening of jobs growth. But somewhat stronger net exports, helped by the weaker pound, should dampen the scale of the fall in overall GDP growth this year.

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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