2 – UK Economic prospects after Brexit

Key points

• UK economic growth held steady at just over 2% in the year to Q3 2016, with no immediate marked deceleration after the ‘Brexit’ vote.

• In our main scenario, we now project UK growth to slow from around 2% in 2016 to around 1.2% in 2017 due to the increased political and economic uncertainty following the Brexit vote. The UK would avoid recession in this scenario, although risks to growth are still weighted somewhat to the downside. Businesses need to make contingency plans for these alternative outcomes.

• The main reason for the projected slowdown is an expected decline in business investment, particularly from overseas in areas like commercial property, due to uncertainty about the UK’s future trading relationships with the EU and other key trading partners.

• Consumer spending growth is projected to hold up better, but will still slow from previous strong rates, dropping to just over 2% in 2017 in our main scenario. However, we do not expect as great a drop as initially feared immediately after the referendum.

• The pound has fallen to historic lows on a trade-weighted basis, which will push up import prices and squeeze the real spending power of households.

• The weaker pound should also boost net exports, however, and help to reduce the UK current account deficit gradually from recent high levels.

• We expect growth in the service sector to slow but remain positive in 2016-17. The construction sector will suffer the most from lower investment levels and capital goods manufacturers will also be hit, but some manufacturing exporters should benefit from the weaker pound.

• We project that London will remain the fastest growing region but its pace of expansion could slow significantly from around 3% in 2015 to around 1.7% in 2017. Other regions will see more modest growth in 2017, closer to 1%, but we do not predict negative growth in any region in 2017 in our main scenario.

• The Bank of England has already loosened monetary policy and we would also expect fiscal policy to be reasonably supportive, with public borrowing allowed to rise to take the strain of slower growth and increased public investment on housing and transport.

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 just over 2% in the year to Q3 2016. This slowdown reflects sluggish global growth as well as, more recently, uncertainty following the vote for the UK to exit the European Union (‘Brexit’).

The general pattern, as shown in Figure 2.1, was for services sector growth to remain relatively strong, while growth in manufacturing has stalled and growth in construction has been volatile in 2015 and 2016 so far. However, the purchasing managers’ indices (PMIs) for services and manufacturing have both seen impressive recoveries from the immediate post-referendum shock seen in July (see Figure 2.2). The construction PMI also strengthened in September and October after dropping back sharply in July and August.

Consumer confidence also suffered a dip immediately after the referendum in July, with the net balance according to PwC’s regular survey (see Figure 2.3) falling to -8%, 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. This has also been reflected in relatively strong retail sales figures between July and September, with the third quarter as a whole seeing sales volume growth of 1.8% compared to the second quarter.
Following the vote to leave the EU, the pound has continued to fall in value against both the dollar and the euro (see Figure 2.4). The announcement by the Prime Minister in early October that she intended to trigger Article 50 by March 20171 and concerns about a possible ‘hard Brexit’ prompted a further fall in the value of the pound to its lowest level against the dollar for 31 years and near record lows against the euro. In trade-weighted terms, the Bank of England estimated that sterling had fallen by late October to its lowest ever level, based on data going back to the mid-19th Century.

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 together with other factors such as the rise in global commodity prices from their lows in early 2016. The rise in headline consumer price inflation to 1% in September was an early harbinger of these likely future trends, as we discuss further in Section 2.3 below.

The FTSE 100 reached record highs in early October before falling back towards the end of the month (Figure 2.5). The upward movement in the FTSE 100 since the referendum has been heavily influenced by the sharp decline in the value of the pound since many of the companies making up the index make their profits abroad.

Likewise the FTSE 250 also reached a record high during October before falling back later in the month. This was underscored by the fact the top six biggest risers on the FTSE 250 in the year to October were overseas-based commodities companies, which have benefitted greatly from the fall in the pound. Both of these indices, however, would be down on pre-referendum levels if measured in US dollar terms, which emphasises that this is more of an exchange rate effect than a sign of stronger underlying corporate earnings growth potential.

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1 Subject to any delays due to the potential need for a vote by Parliament before the triggering of Article 50, following the High Court judgement on 3rd November (subject to appeal at the time of writing) that this would be required.
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 has been released since the vote to leave the European Union. They remain some way below our pre-referendum view for 2017, but have moved up since our last UK Economic Outlook report in July from 0.6% to 1.2%. This reflects the relatively encouraging economic news that has emerged over the summer and early autumn such as strong retail sales, house price and employment figures and a solid 0.5% rise in GDP in Q3 2016. Counter to this is the dramatic fall in the pound and an increase to inflation that could slow domestic demand next year. Taking all of these factors into account produces the average annual growth rates shown in Table 2.1 for our main scenario.

Overall, we expect growth to remain positive on average in 2017, with the economy avoiding recession and starting to recover later in 2017.

We assume here that monetary policy remains on current supportive settings (as discussed further in Section 2.4 below) and that public borrowing is allowed to rise in the short term to absorb some of the impact of slower growth (as discussed in detail in Section 3 of this report). We also assume that some progress is made during 2017 on negotiations with the EU that mitigate fears of a ‘hard Brexit’ where the UK has to revert to WTO rules after leaving the EU in early 2019.

Consumer spending growth remained strong in the first nine months of 2016, and we expect the average growth rate for the year to be around 2.9%. For 2017, however, we expect consumer spending to feel the effects of a weaker pound, higher import prices and weaker jobs growth, so that annual real spending growth will moderate to around 2.2% next year.

The main drag on GDP growth will come from business investment, however, which seems likely to remain fragile as negotiations as to the exact nature of the UK’s exit continue during 2017-18. This will be particularly true of foreign investment in commercial property and in sectors aimed at accessing the EU single market including manufacturing exports (e.g. automotive) and financial services. 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 almost certainly 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 previously announced plans. Public sector investment could be boosted over the next few years, however, as discussed in more detail in Section 3, which would provide some support to GDP growth in 2017 and partly offset the expected weakness in private investment.

UK net exports may move in a more favourable direction, making a less negative contribution to GDP growth in 2017 as import demand weakens and the fall in the pound helps exports and import substitutes to become more competitive. This should also help to moderate the large current account deficit, which helps to explain the recent weakness of sterling.

Overall, our growth projections are broadly similar to the latest average of independent forecasters, which see UK growth falling to around 1% in 2017. But all economic projections are subject to particularly large uncertainties at present after the shock of the Brexit vote.

Table 2.1 - PwC main scenario for UK growth and inflation

<table>
<thead>
<tr>
<th>% real annual growth unless stated otherwise</th>
<th>2015</th>
<th>2016p</th>
<th>2017p</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>2.2%</td>
<td>2.0%</td>
<td>1.2%</td>
</tr>
<tr>
<td>Consumer spending</td>
<td>2.6%</td>
<td>2.9%</td>
<td>2.2%</td>
</tr>
<tr>
<td>Government consumption</td>
<td>1.5%</td>
<td>1.2%</td>
<td>0.7%</td>
</tr>
<tr>
<td>Fixed investment</td>
<td>3.4%</td>
<td>1.1%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Domestic demand</td>
<td>2.5%</td>
<td>2.1%</td>
<td>1.4%</td>
</tr>
<tr>
<td>Net exports (% of GDP)</td>
<td>-0.4%</td>
<td>-0.4%</td>
<td>-0.3%</td>
</tr>
<tr>
<td>CPI inflation (%: annual average)</td>
<td>0.0%</td>
<td>0.6%</td>
<td>2.3%</td>
</tr>
</tbody>
</table>

Source: ONS for 2015, PwC main scenario projections for 2016-17
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 2.6.

- Our ‘early recovery’ scenario projects growth to dip in the next few quarters before picking up again to around 2% on average in 2017. This is a relatively optimistic scenario which assumes that good early progress is made in UK-EU negotiations towards retaining tariff-free access to the EU single market and that there are relatively favourable trends in US and euro area growth over the next year.

- 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.

We do not believe that these two alternative scenarios are 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 posed by the EU referendum result. Uncertainty about the economic and trade policies of the incoming US President could also be a source of volatility over the coming months.

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 further in Section 4 of this report.

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

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

<table>
<thead>
<tr>
<th>Issues</th>
<th>Implications</th>
<th>Questions</th>
</tr>
</thead>
</table>
| Trade                         | The EU is the UK’s largest export partner, accounting for around 45% of total UK exports – leaving the EU is likely to make trade with EU more difficult. | • How much do you rely on European 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 no longer be required to make a financial contribution to the EU and would gain more control over VAT and some other taxes. | • Have you thought about the impact of potential changes to the EU tax framework?  
                             |                                               | • 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 potentially 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 will 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 made up around 46% of the total stock of FDI in the UK in 2013. Brexit could put this inbound investment at risk. | • How much do you 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?  
                             |                                               | • Have you informed your investors on your plans for a post-Brexit UK? |
| 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 employees from elsewhere in the EU?  
                             |                                               | • Has your compliance function considered the additional cost of hiring EU labour? |
| Uncertainty                   | Uncertainty has increased since the referendum and may continue into the negotiation period. | • Can you manage volatility in the Sterling exchange rate?  
                             |                                               | • Have you communicated your stance on 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? |
Construction hardest hit, but all sectors likely to slow due to Brexit

The sector dashboard in Table 2.3 shows the actual growth rates for 2015 along with our projected growth rates for 2016 and 2017 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 other sectors, but all are likely to be negatively affected by leaving the EU.

Construction may be hardest hit due to its reliance on large scale capital investment projects that may be particularly prone to be delayed or even cancelled due to uncertainty following the vote to leave the EU. Commercial property is also being hit hard, particularly in London. Manufacturers of capital goods may also be hard hit for the same reasons, although some exporters will gain from the weaker pound. 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.

### Table 2.3: UK sector dashboard

<table>
<thead>
<tr>
<th>Sector and GVA share</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>Key issues/trends</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing (10%)</td>
<td>0%</td>
<td>0.2%</td>
<td>-0.4%</td>
<td>Manufacturing PMI reached its highest level for over two years in September, before falling back slightly in October. Capital goods manufacturers vulnerable to a fall in investment after vote to leave EU. But exporters should gain from weaker pound, limiting the fall in total output.</td>
</tr>
<tr>
<td>Construction (6%)</td>
<td>4.9%</td>
<td>-0.1%</td>
<td>-2.2%</td>
<td>The construction sector saw negative growth in the third quarter according to official data, but the October PMI survey was somewhat stronger after falling sharply in July and August following the referendum. Our projections reflect the high vulnerability of construction projects to delay or cancellation after the Brexit vote.</td>
</tr>
<tr>
<td>Distribution, hotels &amp; restaurants (14%)</td>
<td>4.6%</td>
<td>4.8%</td>
<td>2.3%</td>
<td>ONS figures show that there was no change in retail sales volume between August and September though there was growth of 4.1% compared to September 2015. A weaker pound could 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.</td>
</tr>
<tr>
<td>Business services and finance (32%)</td>
<td>2.6%</td>
<td>2.4%</td>
<td>1.6%</td>
<td>The financial sector remains particularly concerned about the possible implications of Brexit, especially if a “hard Brexit” occurs with the loss of passporting rights. Some banks may be preparing to relocate some functions abroad as early as 2017 according to the British Bankers’ Association, although it remains to be seen how large any such moves will be.</td>
</tr>
<tr>
<td>Government and other services (23%)</td>
<td>0.5%</td>
<td>1.6%</td>
<td>0.8%</td>
<td>The new Chancellor has abandoned George Osborne’s commitment to balance the budget by 2020 and announced some new infrastructure investments, but public services are likely to continue to face real-term cuts for the next few years.</td>
</tr>
<tr>
<td>Total GDP</td>
<td>2.2%</td>
<td>2.0%</td>
<td>1.2%</td>
<td></td>
</tr>
</tbody>
</table>

Sources: ONS for 2015, PwC for 2016 and 2017 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%. 

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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](http://www.pwc.co.uk/industries/financial-services/insights/leaving-the-EU-implications-for-the-UK-financial-services-sector.html)
Regional prospects: all parts of the UK likely to see slower growth due to Brexit, but none should fall into recession in 2017

London is expected to continue to lead the regional growth rankings in 2016, expanding by around 2.6% as shown in Figure 2.7. Most other regions are expected to expand at rates closer to the UK average of around 2%, but Northern Ireland is expected to lag behind somewhat with growth of around 1.4%.

Growth is expected to decelerate in all regions in 2017 as the UK begins to feel the effects of the vote to leave the EU. We do not however project negative growth in any region in our main scenario. Growth in London might fall to around 1.7% in 2017, while once more Northern Ireland will lag behind the rest of the UK at around 0.6%.
In terms of employment growth, we also expect London to lead the way in 2016 with growth of 2.1% closely followed by Yorkshire and Humberside with 2% growth. In 2017, we expect a broadly similar story. Scotland could lag behind here, with negative jobs growth in 2016-17. This reflects the fact that, although the unemployment rate in Scotland is falling, the number of “economically inactive” people is rising, particularly for women. This is in contrast to the rest of the UK, where the number of people active in the labour force is rising. However, we do expect some ‘reversion to the mean’ for Scottish employment growth in 2017, even though it remains slower than elsewhere in the UK (see Figure 2.8).

It is important to note that regional output data are published on a much less timely basis than national data, while regional employment data are more timely but sometimes based on surveys with relatively small sample sizes. As a result, the margins of error around these regional output and employment 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) picked up from 0.6% in August to 1% in the year to September. Higher import prices are beginning to feed through to consumers because of the fall in sterling since June as a result of the vote to leave the EU. This rise could be seen to be just the tip of an inflationary iceberg coming the UK’s way. Since late September, sterling has fallen further against the euro and dollar and this will continue to push up inflation in the months ahead. Further 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 above the Bank of England’s 2% target rate. This will squeeze real household spending power and add to the slowdown in the economy in 2017.
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 2.9).

There is considerable uncertainty over how far and fast inflation will rise, however, and we therefore also present two alternative scenarios for UK inflation in Figure 2.9:

- In our ‘high inflation’ scenario we project inflation to rise to around 4% by the end of 2017 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 Eurozone economies weaken by more than expected in our main scenario in the aftermath of Brexit, while global commodity prices also fall back next year. In this case, UK inflation could remain at only around 1% on average in 2017.

As with our GDP growth scenarios, these two alternative variants are not 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 around 2%, which remains weak by historical standards.

We had been assuming a gradual pick-up in earnings growth in 2016-17, but this is now much 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 after Brexit. Balancing these two effects, our preliminary projection is that earnings growth remains fairly flat in 2016-17 at just over 2% in cash terms, with real earnings growth declining slightly in 2016 and falling back to around zero in 2017.

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 asset purchase (QE) scheme by £60bn for UK government bonds and up to £10bn for high quality corporate bonds. Monetary policy has remained on hold since then.

The impact of the cut in interest rates may be limited with savings rates already near-zero and borrowing costs for business and homeowners already very low by historical standards. Furthermore, monetary policy may not be the most appropriate tool to address the uncertainty created by the Brexit referendum result. There are some circumstances when a central bank can do little to offset the shock to the economy and the resulting uncertainty, and that may be the case now.

As discussed further in Section 3, we therefore expect the focus to switch to fiscal policy to support growth over the next few years, in particular through increased public investment in housing and transport infrastructure. But the continuing high budget deficit does put some limits on how far the Chancellor can go on this in the Autumn Statement.

2.5 - Summary and conclusions

UK economic growth remained relatively strong in the second quarter of 2016, increasing by 0.7%, before moderating to a still solid 0.5% in the third quarter. There has certainly been no immediate collapse in the UK economy following the Brexit vote. However, we do expect this to lead to a more significant slowdown in the UK economy in 2017 as negotiations with the EU get underway.

In our main scenario, we therefore project UK growth to fall from around 2% in 2016 to around 1.2% in 2017, although this would be a slowdown rather than a recession. This takes into account the Bank of England’s monetary loosening announced in August and also some expected boost to public investment in the Autumn Statement. It also assumes no major new adverse shocks to the global or EU economies.

The main reason for this significant slowdown in UK growth is projected to be a downturn in business investment driven by the uncertainty surrounding the negotiations to leave the EU and to what extent the UK will retain access to the EU Single Market. This will particularly hit the construction, commercial property and capital goods sectors, and potentially also parts of financial services.

Consumer spending growth is also projected to slow to around 2% in 2017 from just under 3% in 2016, reflecting slower real average earnings growth (partly due to higher import prices and a consequent rise in headline consumer price inflation to well above its 2% target by the end of 2017) and an expected deceleration in UK jobs growth from the rapid pace of recent years. But somewhat stronger net exports, helped by the weaker pound, should dampen the scale of the fall in overall GDP growth next 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 their operations.
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