Summary Report – November 2017

UK Economic Outlook

Special features on:

- How might lower EU migration affect the UK economy after Brexit?
- The twin puzzles – disappointing UK trade and productivity performance

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Key projections

	2017	2018
Real GDP growth	1.5%	1.4%
Consumer spending growth	1.6%	1.1%
Inflation (CPI)	2.7%	2.7%

Source: PwC main scenario projections

Recent UK developments and prospects

- UK economic growth held up better than expected in the six months following the Brexit vote, particularly as regards consumer spending. But growth has slowed in 2017 as inflation has risen sharply, squeezing household spending power.

- In our main scenario, we project UK growth to slow from 1.8% in 2016 to around 1.5% in 2017 and 1.4% in 2018. This is due to slower consumer spending growth and the drag on business investment from ongoing political and economic uncertainty relating to the outcome of the Brexit negotiations.

- The weaker pound could also boost net exports, however, which should offer some support for overall GDP growth and reduce the current account deficit relative to 2016. The pick-up in the Eurozone economy over the past year should also help here.

- Service sector growth will slow down but remain positive in 2017-18. Some manufacturing exporters will benefit from the weaker pound, but businesses serving domestic consumers are likely to see some slowdown in growth and commercial construction has been relatively weak recently.

- The Bank of England raised interest rates by 0.25% in November, but future rate rises are likely to be very modest and gradual.

- The government is under considerable political pressure to ease austerity, but a potential medium-term public borrowing overshoot means that the Chancellor may need to offset most of any giveaways (e.g. on health and housing) with takebacks in other areas.

How might lower EU migration affect the UK economy after Brexit?

- EU migrants have played an increasingly important role in the UK economy since 2004, with particularly large impacts on London and certain sectors such as food manufacturing, hotels and restaurants, warehousing and construction.

- As an illustration we have modelled the effect of an ONS population scenario involving a 50% reduction in future EU migration. We estimate that this could reduce the level of UK GDP in 2030 by around 1.1%, or around £22 billion at 2017 GDP values.

- However, a better measure might be the impact on average GDP per capita in 2030, which we estimate to be reduced by around 0.2%, or around £60 per person at 2017 GDP values, in this scenario.

- In the long run, efforts could be made to fill skill gaps arising from lower EU migration through enhanced training of UK nationals and automation. But, realistically, such alternatives are unlikely to make up for any large reduction in EU migrant workers over the next 5-10 years.

The twin puzzles – disappointing UK productivity growth and trade performance

- Two of the major puzzles about UK economic performance since the financial crisis relate to comparatively weak growth in both productivity and exports.

- New analysis in this report shows that weak UK productivity growth has been focused in particular sectors – notably financial services and property-related activities. Manufacturing and other private sector services have generally seen more reasonable productivity growth of around 2%, similar to pre-crisis norms.

- Relatively weak UK export volume growth since the crisis also seems to be focused on financial services and some other service sectors, rather than goods exports which have grown at close to pre-crisis rates since 2010.

- There is no quick fix for these issues, but rather requires a long-term strategy focused on improving access to skills, developing better transport networks, providing stronger incentives to invest and innovate, and creating the conditions for more balanced regional growth.

1 – Summary

Recent developments

The UK economy held up well in the six months after the EU referendum, particularly as regards consumer spending. But growth has slowed markedly during 2017 as both consumer spending and services growth have moderated, while construction output has fallen in the past two quarters.

A key factor behind this recent moderation has been an increase in the rate of consumer price inflation (CPI) from around zero on average in 2015 to 3% in the year to September 2017, as global commodity prices have picked up from lows in early 2016, and the effects of the weak pound after the Brexit vote have fed through supply chains. Higher inflation has squeezed real household incomes and this has taken the edge off consumer-led growth.

On the more positive side, UK exports should be boosted by the upturn in global growth over the past year, notably in the Eurozone. The weaker pound, although bad for UK consumers, has been helpful to exporters and inbound tourism.

Table 1.1: Summary of UK economic growth and inflation prospects

Indicator (% change on previous year)	OBR forecasts (March 2017)		Independent forecasts (October 2017)		PwC Main scenario (November 2017)	
	2017	2018	2017	2018	2017	2018
GDP	2.0	1.6	1.6	1.5	1.5	1.4
Consumer spending	1.8	0.9	1.6	1.1	1.6	1.1
Inflation (CPI)	2.4	2.3	2.7	2.7	2.7	2.7

Source: Office for Budget Responsibility (March 2017), HM Treasury survey of independent forecasters (average value of new forecasts made in October 2017 survey) and latest PwC main scenario.

Future prospects

As shown in Table 1.1, our main scenario is for UK GDP growth to slow from 1.8% in 2016 to around 1.5% in 2017 and 1.4% in 2018. Our views on growth are similar to the latest consensus forecasts but somewhat lower than the last OBR forecasts in the March 2017 Budget (see Table 1.1). However, the broad pattern of gradually slowing growth in 2017-18 is common to most forecasts at present. Our views on inflation are also similar to the consensus forecast, but higher than the OBR since we can take account of more recent data. We expect the OBR to revise their projections more into line with the consensus view at the time of the November Budget.

Consumer spending growth is expected to moderate in 2017-18 as inflation bites into real spending power. So far, consumers have offset this in part through higher borrowing, but there are limits to how much further this can go, particularly now interest rates have started to edge up.

On the other hand, the weak pound should also have some offsetting benefits for net exports as will a somewhat stronger global economy. Brexit-related uncertainty may hold back business investment, but this should be partly offset by planned rises in public investment (which could be added to in the Budget in areas like social housing).

There are always uncertainties surrounding our growth projections and these are particularly marked following the vote to leave the EU, as illustrated by the alternative scenarios in Figure 1.1. There are still considerable downside risks relating to international geopolitical risks and the fallout from Brexit, but there are also upside possibilities if these problems can be contained. In our main scenario, we expect the UK to suffer a moderate slowdown not a recession, but businesses need to monitor and make contingency plans for potential downside risks.

Inflation could rise further to just over 3% over the next few months, although it should then fall back gradually over the course of 2018 assuming no major shifts in exchange rates or global commodity prices. Given continued uncertainties around Brexit, we expect the MPC to be cautious about the pace of any further interest rate rises.

The Chancellor faces some tough choices in the Budget

Since the election in June, the Chancellor has come under significant political pressure to further ease austerity, over and above what he announced in his 2016 Autumn Statement (which was primarily focused on higher infrastructure spending). Public borrowing does look set to come in lower than expected this year, perhaps by as much as £10 billion. However, much of this is due to a temporary spending undershoot and, in future years, slower productivity growth may lead to lower tax revenues than the OBR forecast in March.

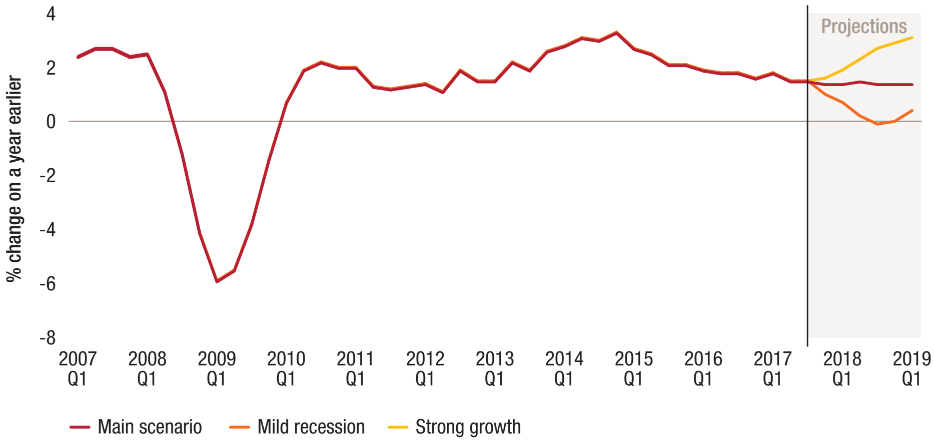
Our main scenario projection is therefore for a somewhat higher budget deficit of around £24 billion in 2021/22, assuming no new fiscal policy changes, as compared to the OBR's March 2017 forecast of a £17 billion deficit in 2021/22 (see Figure 1.2).

Our fiscal projections suggest a cyclically adjusted budget deficit of just over 1% of GDP in 2020/21, which would still be below the Chancellor's medium term target of getting the structural deficit below 2% of GDP in that year.

This would leave the Chancellor some scope for selective easing of austerity in his Budget, but he is likely to want to retain most of this 'wiggle room' for future years given the uncertainties around how the Brexit process will play out and what its economic impact will be.

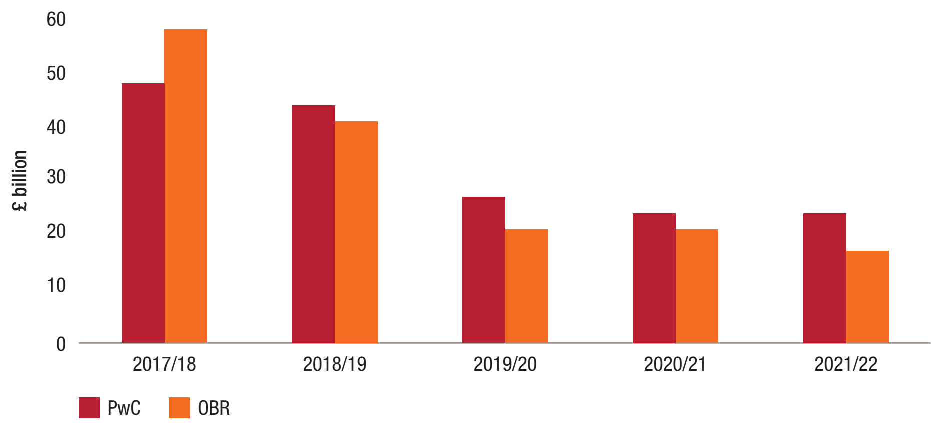
Nonetheless, we would still expect the Chancellor to find some room for additional spending on priorities like housing, health and social care, and some selective further relaxation of public sector pay caps. Any such giveaways are, however, likely to be largely offset by 'takebacks' through net tax rises (e.g. further anti-avoidance measures) or spending cuts in lower priority areas.

Figure 1.1 – Alternative UK GDP growth scenarios



Sources: ONS, PwC scenarios

Figure 1.2 – PwC and OBR public borrowing projections



Sources: OBR (March 2017), PwC main scenario assuming no fiscal policy changes

How might lower EU migration affect the UK economy after Brexit?

Our detailed analysis in Section 3 of this report shows that EU migrants have played an increasingly important role in the UK economy since 2004, with particularly large impacts on London and certain sectors such as food manufacturing, hotels and restaurants, warehousing and construction (see Figure 1.3)

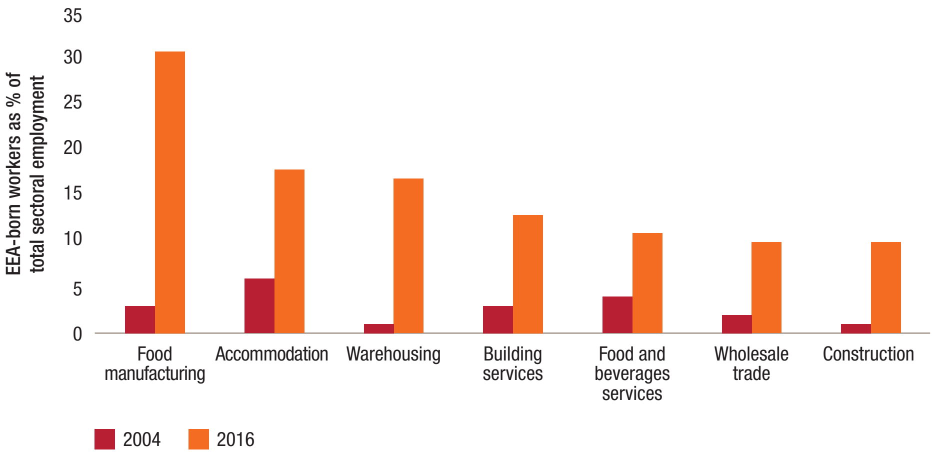
High-skilled EU migrants also play a key role in sectors like finance, business services, technology, healthcare, academia and the arts.

As an illustration we have modelled the economic impact of a recent ONS population scenario involving a 50% reduction in future EU migration. We estimate that this could reduce the level of UK GDP in 2030 by just over 1%, or around £22 billion at 2017 GDP values.

However, a better measure might be the impact on average GDP per capita in 2030, which we estimate to be reduced by around 0.2% in this scenario, or around £60 per person at 2017 GDP values, in this scenario.

Any such model estimates have their limitations, and the net impacts on GDP per capita are relatively small compared to the many other uncertainties about average UK income levels in 2030. Indeed, based on earlier analysis[1], the potential negative trade implications of a 'no deal' scenario where the UK had to fall back on WTO rules would be worse than any negative impacts from migration changes.

Figure 1.3 – UK industry sectors with highest reliance on EEA-born workers



Source: ONS Labour Force Surveys

Nonetheless, our analysis makes clear that unduly restricting future migration from the EU could have disproportionate effects on some industry sectors and regions, notably London. In the long run, efforts could be made to fill skill gaps through enhanced training of UK nationals, and automation might also be a solution in certain sectors if we look 10-20 years ahead. But, realistically, such alternatives are unlikely to make up for any large reduction in EU migrant workers over the next 5-10 years. Government policy decisions on the post-Brexit EU migration regime need to take full account of these considerations.

1 PwC (2016), 'Leaving the EU: Implications for the UK economy': https://www.pwc co.uk/services/economics-policy/insights/implications-of-an-eu-exit-for-the-uk-economy.html

The Twin Puzzles – disappointing UK trade and productivity performance

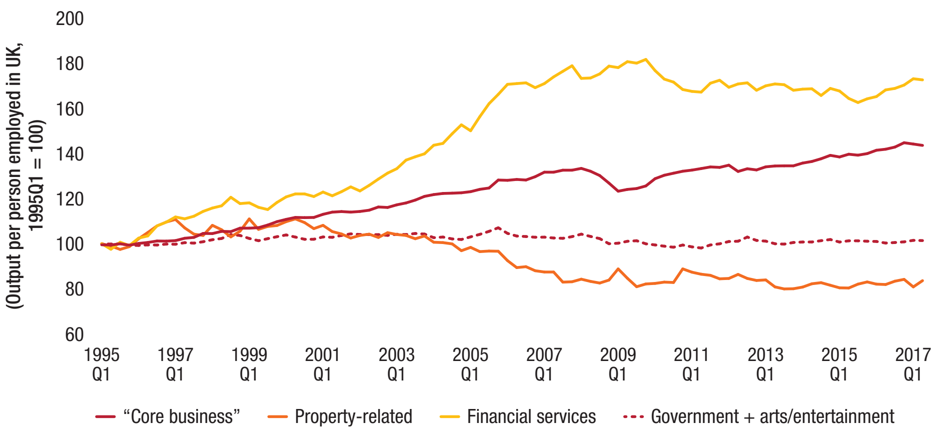
As discussed in detail in Section 4 of this report, the UK has been one of the better performers in terms of economic growth since the Global Financial Crisis relative to the other G7 economies, with GDP increasing on average by close to 2% a year, a creditable record in the post-crisis "new normal" economic climate. But export and productivity performance has been less impressive – at or close to the bottom of the G7 league table.

There has been a general slowdown in productivity growth across the major industrialised economies since the crisis. This reflects some combination of long-term structural factors, the unintended consequences of policies designed to cushion the impact of the financial crisis (including monetary policy), and a lack of investment of various forms.

In the case of the UK, however, the lacklustre performance of the financial sector and property-related activities has also exerted a further drag on productivity growth (see Figure 1.4). The impact of this drag on performance relative to the period before the financial crisis is reinforced by the fact that the same sectors provided a boost to productivity growth as the world economy expanded and trade opportunities increased in the 1990s and the first half of the 2000s.

Disappointing UK export performance can also be attributed to a similar pattern in key services industries, including financial services. Services exports boosted UK trade performance before the financial crisis, but have been relatively lacklustre since.

Figure 1.4 – Divergent UK productivity trends



Source: PwC calculations based on ONS data for output per job

There is no easy quick fix to address these issues, and a devalued exchange rate has not yet given a significant boost to either trade performance or productivity. A modern industrial strategy which seeks to improve the conditions in which all businesses operate in the UK is likely to prove a more successful approach, but it needs to be pursued as a long-term strategy that will yield long-term dividends. This should be focussed on improving access to skills, developing better transport networks, providing stronger incentives to invest and innovate, and creating the conditions for more balanced regional growth.

Appendix A
Outlook for the global economy

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

World economic growth strengthened through 2016 and this is expected to continue, increasing the global weighted average real growth rate to 3.1% in 2017 and 3% in 2018 (using GDP at market exchange rates as weights). This growth is expected to be driven by the large emerging economies with continued strong growth of around 7-7.5% in India and around 6.5-7% in China projected for 2017 and 2018. The outlook for emerging markets has also brightened as a result of somewhat improved economic conditions in Russia and Brazil, which are now moving gradually out of recession.

There has been a clear upswing in Eurozone economic activity this year, increasing projected growth to over 2% this year. Relative to the rest of the G7, reasonably strong growth is projected for the US economy in 2017-18 as fiscal stimulus strengthens an already recovering economy. But this could be offset by gradual rises in US interest rates to keep inflation under control.

These projections are updated monthly in our Global Economy Watch publication, which can be found at www.pwc.com/gew

Table A.1: Global economic growth and inflation prospects

	Share of world GDP	Real GDP growth (%)		Inflation (%)	
	2016 at MERs	2017	2018	2017	2018
US	24.7%	2.2	2.2	2.2	2.1
China	14.9%	6.8	6.4	1.8	2.2
Japan	6.6%	1.4	0.8	0.5	0.7
UK	3.5%	1.5	1.4	2.7	2.7
France	3.3%	1.7	1.7	1.0	1.0
Germany	4.6%	2.1	1.9	1.8	1.7
Greece	0.3%	1.6	2.0	1.1	1.2
Ireland	0.4%	4.4	3.4	0.3	0.9
Italy	2.5%	1.5	1.2	1.3	1.2
Netherlands	1.0%	3.2	2.3	1.4	1.5
Portugal	0.3%	2.8	2.0	1.5	1.5
Spain	1.6%	3.2	2.5	1.8	1.2
Poland	0.6%	3.6	3.3	1.8	2.0
Russia	1.7%	1.6	1.6	4.2	4.0
Turkey	1.1%	4.1	3.2	10.0	8.1
Australia	1.7%	2.3	2.8	1.9	2.3
India	3.0%	6.9	7.4	3.6	4.8
Indonesia	1.2%	5.1	5.3	4.0	4.0
South Korea	1.9%	3.0	2.7	2.1	2.0
Argentina	0.7%	2.6	2.9	25.0	n/a
Brazil	2.4%	0.6	1.7	3.6	4.1
Canada	2.0%	2.4	1.9	1.9	1.8
Mexico	1.4%	2.0	1.8	5.9	3.5
South Africa	0.4%	0.9	1.2	5.8	5.5
Nigeria	0.5%	0.7	1.8	15.0	14.1
Saudi Arabia	0.8%	-0.1	2.0	0.0	4.8
World (PPP)		3.6	3.6	2.8	2.8
World (Market Exchange Rates)	100%	3.1	3.0	2.5	2.3
G7	47.1%	2.0	1.8	1.8	1.8
Eurozone	13.9%	2.2	1.9	1.4	1.4

Source: PwC main scenario for 2017 and 2018; IMF for GDP shares in 2016 at market exchange rates (MERs).

Appendix B
UK economic trends: 1979 – 2016

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	4.2
1980	-2.0	0.1			16.6	0.5	3.9
1981	-0.8	0.3			13.9	1.5	3.0
1982	2.0	1.2			12.2	0.6	2.3
1983	4.2	4.4			10.1	0.2	3.0
1984	2.3	2.5			10.0	-0.5	3.3
1985	4.2	5.1			12.2	-0.3	2.5
1986	3.2	6.1			10.9	-1	2.0
1987	5.4	5.1			9.7	-1.6	1.3
1988	5.8	7.4			10.4	-3.5	-0.6
1989	2.6	3.9		5.2	13.9	-4.1	-0.6
1990	0.7	1.0		7.0	14.8	-3.1	0.6
1991	-1.1	-0.6		7.5	11.5	-1.3	2.6
1992	0.4	0.9		4.3	9.6	-1.5	5.6
1993	2.5	2.8		2.5	5.9	-1.3	6.7
1994	3.9	3.2		2.0	5.5	-0.5	5.8
1995	2.5	2.1		2.6	6.7	-0.7	4.6
1996	2.5	3.9		2.5	6.0	-0.6	3.3
1997	6.6	8.7		1.8	6.8	-0.1	1.9
1998	3.1	4.0	0.4	1.6	7.3	-0.7	0.2
1999	3.2	4.9	0.5	1.3	5.4	-2.6	-0.8
2000	3.7	4.8	2.3	0.8	6.1	-2.4	-1.5
2001	2.5	3.6	-1.5	1.2	5.0	-2.1	-0.2
2002	2.5	3.8	-2.2	1.3	4.0	-2.2	2.0
2003	3.3	3.6	-0.5	1.4	3.7	-1.9	3.4
2004	2.4	3.2	1.8	1.3	4.6	-2.4	3.3
2005	3.1	3.1	0.0	2.1	4.7	-2.1	3.2
2006	2.5	1.8	2.1	2.3	4.8	-3.1	2.8
2007	2.4	2.7	0.6	2.3	6.0	-3.8	2.6
2008	-0.5	-0.6	-2.8	3.6	5.5	-4.6	5.4
2009	-4.2	-3.3	-9.4	2.2	1.2	-3.9	10.1
2010	1.7	0.7	4.6	3.3	0.7	-3.8	9.1
2011	1.5	-1.0	2.2	4.5	0.9	-2.4	7.1
2012	1.5	1.8	-1.5	2.8	0.8	-4.2	7.6
2013	2.1	1.9	-1.0	2.6	0.5	-5.5	5.7
2014	3.1	2.2	2.9	1.5	0.5	-5.3	5.3
2015	2.3	2.7	0.0	0.0	0.6	-5.2	4.1
2016	1.8	2.9	0.9	0.7	0.5	-5.9	2.9
Average over economic cycles****							
1979 - 1989	2.8	3.7			12.2	-0.8	2.2
1989 - 2000	2.5	3.3		3.3	8.3	-1.6	2.4
2000 - 2014	1.8	1.9	-0.2	2.2	3.3	-3.3	4.4

* 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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