ICAEW

UK Economic Forecast

Q1 2017

BUSINESS WITH CONFIDENCE

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Introduction

The UK economy moves into its post-Brexit era with a good degree of economic momentum, and with some signs that growth is becoming a little more balanced across sectors. But uncertainty over the eventual settlement with the EU seems likely to restrain investment in 2017, which may affect the pace of growth longer term. Policymakers will continue to focus on getting the best Brexit deal for Britain – and if they succeed, investment and growth could rebound more strongly than current forecasts suggest.

Welcome to the Q1 2017 *ICAEW Economic Forecast*, based on the views of the people running UK plc; ICAEW Chartered Accountants working in businesses of all types, across every economic sector and in all regions of the UK, surveyed through the quarterly *ICAEW Business Confidence Monitor* (BCM).

Key findings this quarter

- **Slower though still respectable, and possibly more balanced, growth in 2017**. The pace of economic growth in the UK looks set to have slowed in the first quarter of 2017, as rising inflation puts a dampener on the rate of consumer spending growth. But tentative signs of a better balance between manufacturing and service sector growth are welcome – though to be regarded for now with a degree of caution. We forecast GDP growth of 1.6% in 2017, modestly slower than the past few years, but close to the average from 2010–2013.

- **Business investment on hold in 2017**. The 1% quarter-on-quarter fall in Q4 2016 looks like the start of a period of restraint on the part of firms. We expect business investment to contract by 1.9% in 2017, but better-than-expected progress in Brexit negotiations could enable firms to start investing again more swiftly.

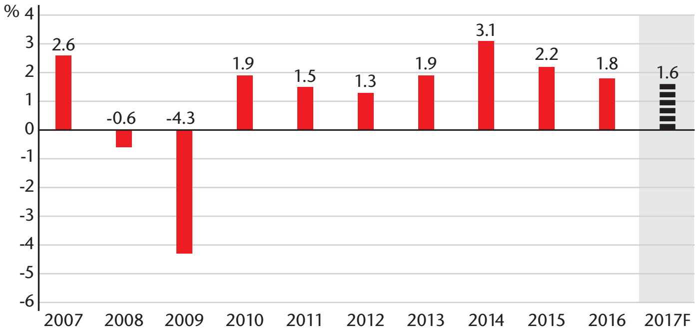
- **Easing, but still relatively robust, labour market**. The UK labour market remains historically strong, with the employment rate reaching a record high in Q4 2016, and unemployment remaining below 5%. We envisage a slowdown in job creation in 2017, with private sector employment rising by just 0.6% (versus 1.4% in 2016). But this will be enough to ensure the labour market remains relatively tight by the standards of recent years in 2017.

- **Falling real wages for the first time since 2013**. Inflation reached 1.8% in the year to January 2017, and the peak in price growth is not likely to be reached until the final months of this year. Businesses' expectations are for wage growth to slow modestly – in line with a weaker outlook for job creation. Together, these two developments mean wages will fall in real terms for the first time since 2013.

- **Policymakers likely to focus on managing a smooth Brexit**. The Monetary Policy Committee seems content to look through what is likely to be a temporary period of higher inflation. But while fiscal policy's squeeze on the economy has eased a little since last summer, it still remains on course to drag on activity over the next few years.

Economic outlook

Fig. 1 Real GDP – annual growth



Source: ONS, ICAEW forecasts

The economy's period of surprising post-Brexit resilience may be waning as we enter 2017. Household spending growth will slow as a result of faster inflation. Though exporters will see a boost to competitiveness from a weaker pound, for those relying on imported inputs these gains will be partly offset by the rising cost of production. Barring further policy support, we expect GDP growth to ease from 1.8% in 2016 to 1.6% in 2017.

The economy surpassed expectations in Q4 2016, posting quarterly GDP growth of 0.7%. This took growth for 2016 to 1.8% – close to the post-2010 average. But growth has become increasingly dependent on consumer demand in the past year. Retail sales grew 6.2% in the year to Q4 – the fastest since 2002. Consumption grew 0.7% on the quarter, contributing 0.4 percentage points (pp) of the total GDP growth seen in Q4. Given the pressures on household budgets (see focus section) this will be difficult to sustain, and latest data suggests a consumer slowdown has begun.

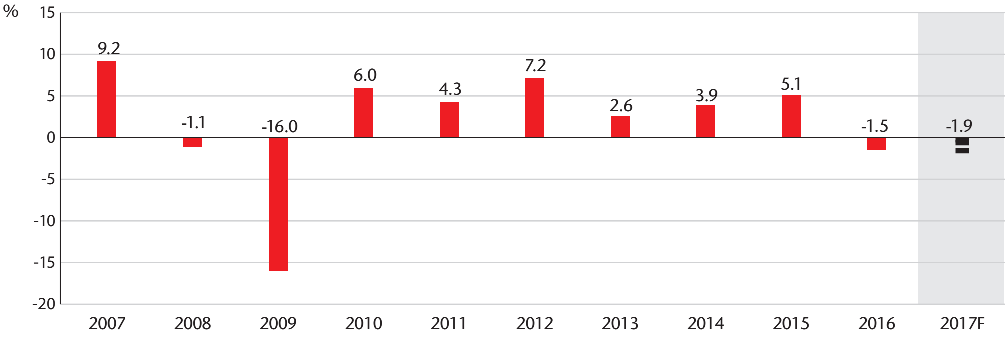
More positively, there is tentative evidence of a rebalancing. Manufacturing grew 1.2% in Q4, outperforming services. But it is too early to claim definitive proof of a rebalancing, given a 1% fall in business investment on the quarter, and the likelihood of falling capital spending in 2017 (see next section).

Looking into 2017, the weakness in business confidence points to modest GDP growth in Q1. Of course, growth has recently surprised to the upside but with household budgets under pressure we expect growth to ease. More positively, BCM implies the improvement in export volumes should continue – though the boost to competitiveness will be partly offset by rising input costs. Assuming the tentative rebalancing continues, we expect GDP growth of 1.6% in 2017.

We predict little movement on monetary or fiscal policy. The Bank of England has made it clear above-target inflation will be tolerated during a period of economic uncertainty. Meanwhile, the Chancellor remains committed to deficit reduction, and the recent Budget was fiscally neutral.

Business investment

Fig. 2 Real business investment – annual growth



Source: ONS, ICAEW forecasts

After holding up reasonably well in the immediate aftermath of the Brexit vote, business investment fell by 1% in Q4 2016, marking a decline of 1.5% for the year as a whole. Based on the latest BCM, we expect a contraction of about the same pace again in 2017. But when viewed over a longer-term period, including the financial crisis, this looks more like a pause in capital spending rather than a collapse. Firms remain in good shape to invest if political uncertainties are resolved in the months ahead.

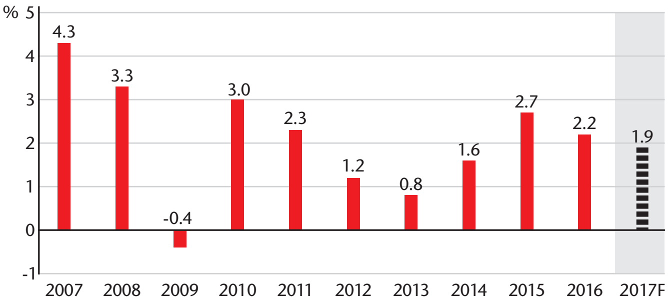
Business investment contracted in Q4 2016, falling by 1% on the quarter. The difficulty in classifying spending as investment or intermediate consumption means that the series is highly prone to revisions as time goes on. Nevertheless, it is hard to dispute that firms are now starting to take a more cautious approach to major investment decisions, as they wait for further clarity on the UK's new relationship with Europe and the wider world.

Looking forward, evidence from the BCM survey suggests a fall of 1.9% in business investment in 2017. This is a modestly smaller fall than in our previous forecast, but nevertheless still more significant than that seen during 2016 (when capital spending contracted by 1.5%). However, it is useful to view these figures in a longer-term context, and in particular with reference to the global financial crisis – when business investment declined by 16% during 2009. In this context, the impact of the referendum on business investment has to be viewed as a pause on spending, rather than a collapse.

As we have noted in previous editions, in many fundamental aspects firms remain in good financial shape for investment. Cash balances held by UK non-financial firms relative to GDP reached an all-time high of 32.5% in Q3 2016 (2pp higher than a year earlier). According to BCM, firms think they will maintain their profit margins in 2017, in spite of rising input costs. Finally, with the Bank of England likely to keep borrowing costs low, business will continue to enjoy very supportive credit conditions. As such, investment could surprise to the upside in 2017 and beyond, given more clarity on the UK's future relationship with Europe.

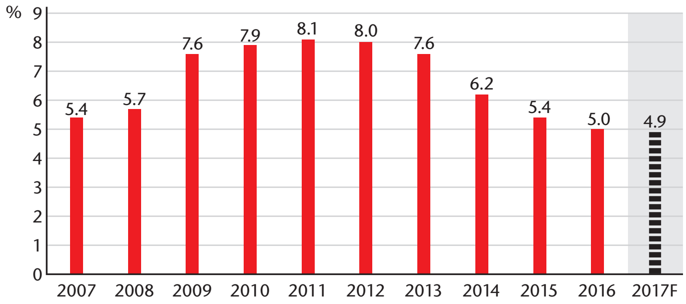
Labour market

Fig. 3 Average earnings – annual growth



Source: ONS, ICAEW forecasts

Fig. 4 Unemployment rate



Source: ONS, ICAEW forecasts

Labour market data has matched the surprisingly firm performance of the wider economy in the months since Brexit. But evidence points towards tougher conditions for households in 2017, with employment growth slowing sharply, and wage rises (which have already started to slow in nominal terms) failing to keep pace with inflation.

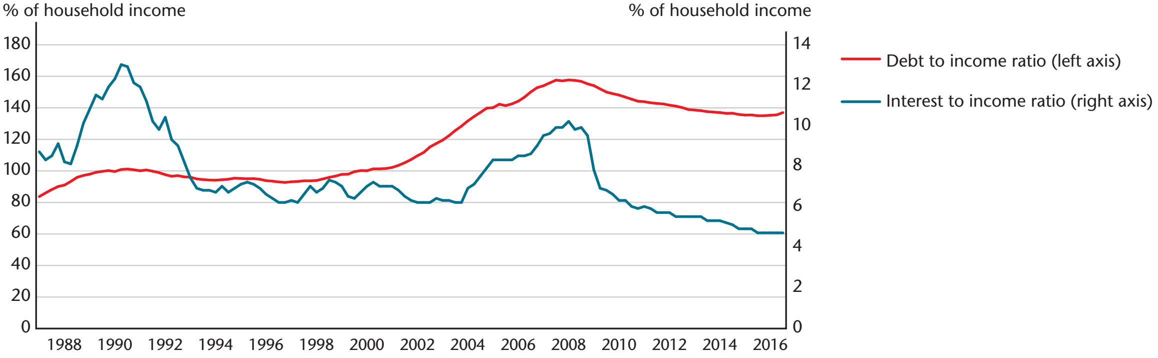
The labour market has remained fairly resilient over the past few months, in spite of the business uncertainty caused by the vote to leave the EU last June. Labour market data for Q4 2016 shows that the employment rate ticked up to a new all-time high of 74.6%, while more recent statistics pertaining to January 2017 revealed the International Labour Market Organisation measure of UK unemployment fell to its lowest rate since 1995, at 4.7%.

BCM shows the rate of job creation is set to slow markedly in 2017. We expect total private sector employment to grow by just 0.6% in 2017, less than half the average pace achieved in 2015 and 2016. In turn, this means the improvement seen in the unemployment rate through recent years will stall, with an average unemployment rate for the year of 5.0%. But viewed in the context that unemployment averaged 7.6% in 2013, 6.2% in 2014, and 5.4% in 2015, the UK labour market remains in relatively good shape.

However, recent data on average earnings has been rather less encouraging. Even as inflation started to pick up through the second half of 2016, nominal wage growth slowed. Wage growth on a year ago slipped from 2.8% in the three months to November to 2.6% in the three months to December, and further to 2.2% in the three months to January. Evidence from BCM suggests that wage growth is set to slow still further. Our forecast is for growth of 1.9% in 2017 – firms have kept their expectations for wage growth in the coming twelve months stable around this rate for the past few quarters. This is likely to result in real wages falling for the first year since 2013.

Focus – Slower consumer spending in 2017, but no debt crisis

Fig. 5 UK household debt and interest ratios



Source: Oxford Economics

Consumer spending has been the mainstay of growth in recent years, but as we move through 2017 several drivers of this spending power will turn less favourable. The legacy of the Brexit vote is part of this story, but other factors in the world economy would in any case have weakened UK household spending power. More positively, in spite of the rate of credit growth in recent years (and the debt burden of lower-income households in particular), household finances remain in good shape, and a debt crisis seems highly unlikely.

Consumer spending has been an increasingly important part of UK economic growth over the past few years, with households contributing 1.7pp to GDP growth in 2016, up from 1.5pp in 2015 and 1.3pp the year before. Over this period, consumers have benefitted from a number of domestic and global economic factors that underpinned their spending power, including a robust jobs market, low interest rates, and falling oil prices. Lower oil prices provided a boost to household budgets by lowering fuel and energy bills, allowing travel firms to reduce fares, and via 'second round' effects, for example on the transport element of retailers' costs.

As we move through 2017 though, many of these factors have become less supportive of consumer spending, and in some cases are set to substantially undermine households' spending power. Most immediately, the post-referendum slump in the value of sterling raised the cost of overseas travel, and in the months that followed this gradually began to feed through into the cost of imported goods. Alongside this, global energy prices have started to recover, thanks to agreement on the part of many oil producing economies to cut output as well as increased global demand.

As a result, after a long period of stagnant prices, households are starting to see faster increases in the cost of living. Inflation on the CPI measure was close to zero in 2015, and just 0.6% for 2016 overall, but this masks a sharp upturn in the latter months of last year. Prices were up by 1.6% in the year to December, 1.9% by January 2017. The Bank of England's latest forecast is for prices to be rising by 2.7% by the end of this year – the fastest rate since 2012.

Focus – Slower consumer spending in 2017, but no debt crisis (continued)

At the same time, employers are bracing themselves for the possible impact to their access to the European market (or in the case of non-exporting firms, the wider effects on UK growth) by becoming more cautious on hiring. At the same time, evidence from BCM suggests firms will seek to offset the rising cost of imported inputs by squeezing wage growth. Consequently, households are likely to face shrinking spending power in real terms for the first year since 2011. As such, the contribution of consumer spending to overall GDP growth is likely to fall in the coming year.

On a more positive note though, in spite of recent concerns over the growth of consumer debt, household finances (in aggregate at least) remain strong by historical standards. The ratio of household debt to household income remains well short of the peak reached before the financial crisis. Meanwhile the burden of debt service has fallen to a record low thanks to low interest rates. So while households may feel a little more squeezed in 2017, neither the demand for or supply of credit is likely to see a sharp fall-off this year.

Forecasting methodology

Headline economic forecasts

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Real GDP – annual growth %	+2.6	-0.6	-4.3	+1.9	+1.5	+1.3	+1.9	+3.1	+2.2	+1.8	+1.6
Real business investment – annual growth %	+9.2	-1.1	-16.0	+6.0	+4.3	+7.2	+2.6	+3.9	+5.1	-1.5	-1.9

Labour market forecasts

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Earnings (total pay) – annual growth %	+4.3	+3.3	-0.4	+3.0	+2.3	+1.2	+0.8	+1.6	+2.7	+2.2	+1.9
Employment – annual growth %	+0.8	+0.9	-1.6	+0.2	+0.5	+1.1	+1.2	+2.5	+1.8	+1.4	+0.6
Unemployment rate %	+5.4	+5.7	+7.6	+7.9	+8.1	+8.0	+7.6	+6.2	+5.4	+5.0	+4.9

ICAEW's forecasts for economic growth, business investment and the outlook for the labour market are based on the correlation between *ICAEW Business Confidence Monitor* (BCM) indicators and official economic data. BCM contains data – from a survey of 1,000 UK businesses – on business confidence, financial performance, challenges and expectations for the year ahead. BCM indicators provide a useful and unique steer on future developments in the UK economy.

Oxford Economics is one of the world's foremost advisory firms, providing analysis on 200 countries, 100 industries and 3,000 cities. Their analytical tools provide an unparalleled ability to forecast economic trends and their economic, social and business impact. Headquartered in Oxford, England, with regional centres in London, New York, and Singapore and offices around the world, they employ one of the world's largest teams of macroeconomists and thought leadership specialists.

ICAEW is a world leading professional membership organisation that promotes, develops and supports over 147,000 chartered accountants worldwide. We provide qualifications and professional development, share our knowledge, insight and technical expertise, and protect the quality and integrity of the accountancy and finance profession.

As leaders in accountancy, finance and business our members have the knowledge, skills and commitment to maintain the highest professional standards and integrity. Together we contribute to the success of individuals, organisations, communities and economies around the world.

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GAA
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ICAEW
Chartered Accountants' Hall   Moorgate Place   London   EC2R 6EA   UK

T +44 (0)20 7920 8705
E economicforecast@icaew.com
icaew.com/ukeconomicforecast

linkedin.com – find ICAEW
twitter.com/icaew
facebook.com/icaew