EY ITEM Club
Spring Forecast

Sluggish but stable

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EY
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Contents

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Foreword

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UK economy: a cloudy outlook

The calm after the storm ...

Despite a harsh winter, the economic outlook for the UK economy remains stable according to the EY ITEM Club spring forecast. EY ITEM Club expects the UK economy to expand by 1.6% in 2018 and 1.7% in 2019, little change from the projections in its previous forecast. While stability is welcome, especially in the uncertain world we find ourselves in, it is nevertheless the case that the projected level of UK growth is low relative to both the UK's historic performance and the rates of growth being achieved by the country's international peers. The reality is that the UK's economic performance is likely to be stable but sluggish, businesses cannot rely on the macroeconomy to drive growth.

... but not for everyone ...

But this overall picture of stability masks significant differences in performance across the UK economy. As the media has reported, the retail and consumer-facing sectors have found the going very difficult in recent months. Although retailers often blame the weather when their performance dips, this is not a short-term weather-related issue. EY ITEM Club highlighted the challenges facing these sectors in its recent Special report on consumer spending and EY's latest Analysis of profit warnings report confirms how severe the situation has become. While the overall number of UK profit warnings in the first quarter of 2018 was in line with historic norms, the number from the FTSE consumer services sectors reached a seven-year high, with general retailers and restaurants and bars the sub-sectors most affected.

The sector variations highlight the impact that differences in the strength of the UK domestic economy and the global economy have on businesses. FTSE SmallCap companies recorded their highest number of profit warnings since the financial crisis, a clear result of a challenging domestic economy. By contrast, capital investment by manufacturers, boosted by strong global demand and the post-referendum devaluation of sterling, grew by 6.7% on an annualised basis in the fourth quarter of 2017.

... with a changeable outlook ...

While the EY ITEM Club forecasts have not changed significantly quarter-on-quarter, there is a significant amount of uncertainty regarding the future development of the economy, and this means that the scope for outturns to vary from forecast is substantial. The outlook is very changeable.

The Brexit negotiations are the most obvious source of uncertainty for the UK economy and developments are likely to have a significant impact on business investment. Capital spend by corporates has been volatile for some time in the UK, falling after the financial crisis and then bouncing back before slowing again more recently. The UK's investment performance in 2017 was stronger than the initial data suggested but while the growth of 2.4% was a significant improvement on

2016's decline of 0.5%, it was below the 4.9% annual increase between 2010 and 2015.

The differences in sentiment between manufacturers and service companies are also impacting investment. Manufacturing investment grew significantly faster in 2017, and EY's recent survey of foreign investors found that manufacturers were more willing than service companies to wait and see how the Brexit negotiations progressed before adjusting their UK investment plans. By contrast, financial and business service companies have already paused UK investment and are three to four times more likely to move assets out of the UK in the next three years compared to manufacturers.

The progress of the Brexit negotiations could clearly lead to significant changes in investment activity over the coming year. However, Brexit is not the only source of uncertainty that businesses have to deal with.

As EY ITEM Club identifies, the global economy has been a source of support for the UK economy over the last year. The EY ITEM Club forecast incorporates a slowing contribution from trade moving forward, as the boost from sterling's devaluation fades. However, there is a risk that potentially adverse developments in trade policies and geopolitics could hit trade flows, so reducing growth beyond the levels currently envisaged.

The squeeze on consumer spending has already impacted businesses, and challenges remain. EY ITEM Club expects that the pressure on consumers will ease slightly as inflation slows and wage rises tick up as labour market conditions tighten. However, the changes to welfare benefits and the expected increase in interest rates will limit the upside. The net effect is a forecast for gradual improvement in consumer spending growth from 1.2% in 2018 to 1.6% in 2018 and 1.9% in 2020. However, this forecast is based upon a number of moving parts and it is possible that outturns could be different and potentially worse than forecast.

… so be prepared.

Stable does not mean certain or static. There are significant shifts taking place both within and between sectors and there is a large amount of uncertainty around the outlook for the UK economy. Conditions could change very quickly as a result of circumstances that businesses have no ability to control.

I have previously warned that UK businesses risk missing out on global growth and also risk failing to position for the future in the UK if they continue to wait for the clouds surrounding the economic outlook to clear. Technology, shifts in consumer behaviours, and demographics are all reshaping the economic landscape, and Brexit is another uncertainty. Failing to invest now risks making the future even more challenging.

Businesses should not take the stable, if sluggish, base case forecast as an excuse to sit and wait. It is important to test short-term resilience and mitigate potential risks while thinking hard about the future. The short-term outlook is cloudy, but this should not stop the pursuit of sunnier days.

Highlights

- Developments in our latest economic forecast are modest, reflecting an economy that has displayed a degree of stability in recent quarters, but also a lack of momentum in both absolute and relative terms. We expect GDP to expand by 1.6% (revised down slightly from 1.7% in our Winter forecast) this year and 1.7% next, little different from 2017's 1.8% pace. This would be sub-par growth by the standards of both history and the UK's international peers.

- Last year, consumer spending faced a significant headwind from elevated inflation. Growth in the dominant element of GDP slowed from an 11-year high of 3.1% in 2016 to a six-year low of 1.7%, with spending power squeezed by a combination of soft pay growth and accelerating price rises off the back of the weak pound and a revival in oil and commodity prices.

- However, that inflation obstacle is now in retreat. And we expect a tight jobs market to deliver some uptick in pay growth. However, what one hand giveth the other taketh away. The extent to which growth in household spending outpaced income gains over the last two years and the consequent plunge in the saving ratio in 2017 to the lowest level on record (5.1%), suggests that, at the very least, consumers may refrain from further dissaving. The strength of the jobs market reduces scope for further employment gains and a new headwind is set to build if, as we expect, the Monetary Policy Committee (MPC) gradually increases interest rates.

- Indeed, recent developments within the MPC, with two members voting for an immediate rise in Bank Rate in March and the minutes of that month's meeting reaffirming a hawkish tone, leave us more confident in predicting that Bank Rate will increase from 0.50% to 0.75% in May and from 0.75% to 1.0% in November. And we now expect two further increases in 2019. With inflation heading down and the Bank's view of the supply-side of the economy arguably too pessimistic, the expected degree of monetary tightening risks dragging on activity unnecessarily, even more so given that fiscal austerity, while watered down by the Chancellor in recent fiscal events, has not gone away.

- However, the hit to growth from higher interest rates should be limited by the fact that the proportion of households with a mortgage lies at a record low and that there has been a shift from floating-rate to fixed-rate mortgages in recent years. And with the burden of interest payments to the average household ending 2017 at a record low, consumers are in a relatively healthy position to cope with dearer money.

- Business investment has long been identified as being particularly vulnerable to Brexit. And the evidence suggests that uncertainty stemming from June 2016's vote has weakened firms' appetite to spend. That said, a 2.4% rise in this element of GDP in 2017 was an improvement on the previous year's 0.5% drop. And headline growth has been dragged down by a collapse in investment in the North Sea sector. Looking forward, the fact that a transitional arrangement between the UK and the EU following 'Brexit Day' next March is looking ever more likely should reduce uncertainty facing firms trading with the EU market. And the sizeable drag from the extraction sector may ease. But uncertainty around the ultimate UK–EU relationship will persist, as will structural factors which have acted to depress capital spending.

- Meanwhile, a buoyant world economy acted to bolster the UK economy last year in the face of domestic difficulties. Indeed, the contribution made by net trade to GDP growth was among the strongest over the last 25 years. On the face of it, 2018 should deliver more of the same. Global growth is expected to pick up further, with the UK's major export markets in Europe and the US forecast to expand at a decent pace. But a recovery in sterling, particularly against the US dollar, means that the 'sweet spot' enjoyed by UK exporters is set to sour somewhat. And the recent increase in protectionist rhetoric, originating in the US, poses some downside risk to the outlook for global growth.

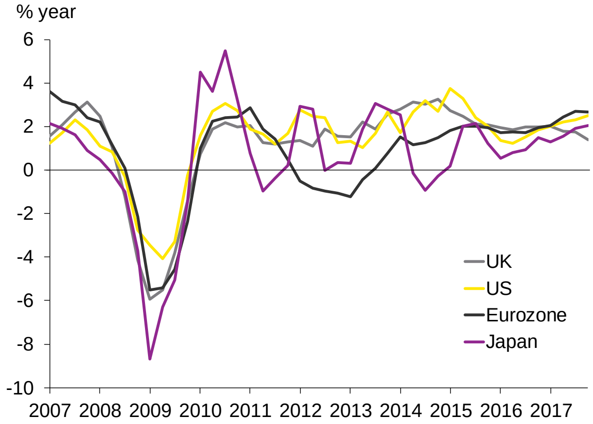
Introduction

Since our last economic forecast was published in February 2018, the economy has shown little sign of breaking out of the pattern of so-so growth seen in the second half of 2017.[1] Admittedly, the particularly severe weather seen at the end of February and first half of March appears to have weighed down significantly on economic activity (the Purchasing Managers' surveys showed a clear hit to services and construction activity in March while the CBI Distributive Trades Survey showed markedly weakened retail sales), but much of this forgone activity should subsequently be made up rather than permanently lost.

Consequently, the broad contours of the latest forecast are little changed from earlier this year, with GDP expected to grow by 1.6% in 2018 (down 0.1% from February's prediction), compared to 1.8% last year. The composition of growth is also seen as progressing along a similar course, with consumer spending and investment expanding at a soft rate, albeit with declining inflation and the increased likelihood of a Brexit transition deal offering the promise of a stronger performance next year. However, as one set of headwinds fades, another – a limited but steady increase in interest rates – is looking more likely to make its presence felt.

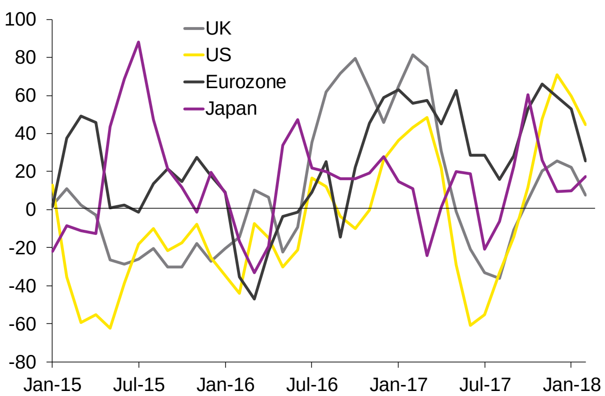
Meanwhile, thanks to a buoyant world economy that, across many regions, has continued to surprise on the upside, net trade should repeat the positive contribution to growth seen last year. Although the eurozone economy has recently shown signs of cooling from 2017's relatively heated pace of growth, it is still on course for another good year. And US demand looks robust, underpinned by high levels of consumer and business confidence and the Trump administration's fiscal stimulus plans.

World: GDP growth



Source : EY ITEM Club/Haver Analytics

Citigroup Economic Surprise Index



Source : EY ITEM Club/Haver Analytics

That said, the UK's ability to exploit a healthy global backdrop will be dampened by the recovery in sterling, at least against the US dollar. As of mid-April, the pound was trading around $1.42, only marginally below the rate averaged in the run-up to the EU referendum, albeit still substantially down against the euro compared to mid-2016. But one of the drivers of sterling's revival – the increased likelihood of a smoother Brexit following the UK and EU agreeing the outlines of a 'status quo' transition to follow the UK's formal departure from the EU next March – should be an unambiguous positive for activity, giving firms more time to adjust to a post-EU future. But with the transitional deal subject to a wider withdrawal agreement and some issues, particularly the status of the border between Northern Ireland and the Republic of Ireland, not yet resolved, avoiding a 'cliff-edge' Brexit in March 2019 is not a done deal.

[1] *EY ITEM Club Winter Forecast: Will the UK economy hold up as Brexit nears?* February 2018. See ey.com/Publication/vwLUAssets/ey-item-club-winter-forecast-2018/$File/ey-item-club-winter-forecast-2018.pdf

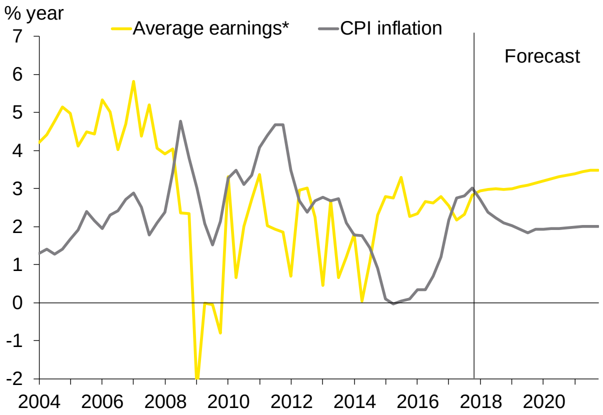
Consumers should face a more benign environment, in some respects ...

On the consumer front, elevated inflation represented the chief headwind to growth in 2017. With the cost of imports pushed up by 2016's fall in sterling, and oil and commodity prices reversing previous weakness, annual inflation on the CPI measure averaged 2.7% in 2017, up from 0.6% the previous year and only 0.1% in 2015. With average weekly earnings rising 2.3%, slightly down on 2016's 2.4%, the result was a squeeze on households' spending power. Real pay fell 0.4% last year, bringing an end to two years of decent rises in 2015 and 2016.

Unsurprisingly, the consumer sector suffered. Real consumption growth dropped to 1.7% in 2017 from 2.9% in 2016, while the slowdown in the retail sector was more marked, with growth in sales volumes slowing to 1.9% compared to a rise of 4.7% the previous year. And private new car registrations dropped 6.8%, the biggest fall since 2011.

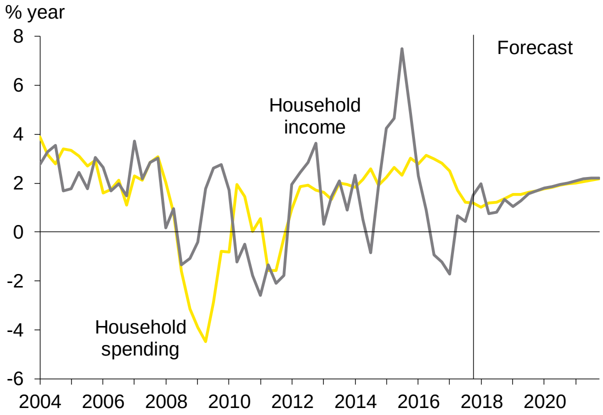
But the headwind from inflation is starting to fade. March 2018 delivered a 2.5% rise in the annual CPI measure, the lowest in a year and down from a recent peak of 3.1% in November last year. With powerful base effects at work, aided by a recovery in the pound's value, we think inflation will drop back to 2.0% in December 2018, before averaging 1.9% in 2019.

UK: Average earnings & inflation



Source: EY ITEM Club *National Accounts measure

UK: Real household income and spending



Source: EY ITEM Club

Happily, lower inflation is forecast to combine with stronger pay growth to deliver a double-positive for real incomes. Granted, falling unemployment (the Labour Force Survey (LFS) jobless rate fell back to a 42-year low of 4.2% in the three months to February 2018), has delivered surprisingly little impetus to pay growth since the number out of work began falling consistently in 2010. But times may be changing. A 2.8% annual rise in average earnings in the three months to February was the strongest since September 2015, while regular pay growth in the same period touched a 30-month high of 2.8%. Given that developments in pay tend to respond to changes in the jobless rate with a lag, we expect the decline in unemployment in 2017 to deliver a better pay outcome for workers this year, with average earnings rising 3% (on a National Accounts basis), followed by 3.1% in 2019.

But confronting these positives is the likelihood that, following two years when spending growth substantially outstripped rises in incomes, consumers will choose to rein back. Over 2016 and 2017, real consumption increased 4.9%, but real household disposable incomes saw a rise of only 0.5%, resulting in the biggest gap between the two measures since the late 1980s. Consequently, the household saving ratio dropped to 5.3% in the last quarter of 2017 (and had been as low as 3.9% in the first quarter) compared to an average of 8.6% since 2010 and 9.5% since 1963, when Office for National Statistics (ONS) data begins. The overall saving ratio average of 5.1% in 2017 was a record low.

To the extent that households choose not to continue dissaving, an element of the putative boost to spending from a better real income outlook will be lost. Moreover, the very success of the UK jobs market, with employment and unemployment rates beginning 2018 at a record high and a multi-decade low respectively, inevitably limits the scope for further gains. Indeed, after increasing 1.4% in 2016 and 1% in 2017, we see employment rising by 0.8% this year and 0.4% in 2019.

Putting these forces together, along with other factors including the continued cash freeze on working-age benefits, household disposable incomes are forecast to grow 1.2% in 2018 and 1.4% in 2019.[2] While this is a marked improvement on 2017's negligible 0.2% rise, our predictions still mean a soft performance by historical standards (real income growth has averaged 2.7% a year since the mid-1950s).

But with the saving ratio expected to stabilise, following the record low of 5.1% recorded in 2017, stronger income growth is not expected to pass through to an improvement on 2017's 1.7% rise in consumer spending. In fact, the forecast sees consumer spending growth weaken to 1.2% this year. Spending growth then sees a gradual revival, reaching 1.6% and 1.9% in 2019 and 2020 respectively, as inflation stabilises at a modest rate, the freeze on working-age benefits ends and household balance sheets strengthen.

… but an emerging interest rate headwind is set to build.

The seeming paradox of a predicted better performance from real wages this year but the absence of a revival in consumer spending can also be reconciled with reference to the outlook for borrowing costs. The recent mood music from the Bank of England's MPC, with two members voting for a hike in Bank Rate in March and the minutes of that month's Committee meeting maintaining a hawkish tone, fuelled our belief that interest rates will rise by 25 basis points (bps) in both May and November's meetings, taking Bank Rate to 1% by the end of the year. While a sharper-than-expected dip in consumer price inflation to 2.5% in March and some recent disappointing UK economic data, have led to a scaling back of market expectations of further interest rate hikes after May, we suspect that the Bank of England will remain keen to gradually normalize monetary policy. Indeed, we now forecast two further 25bps hikes in 2019, up from the one rise we expected in our last forecast.

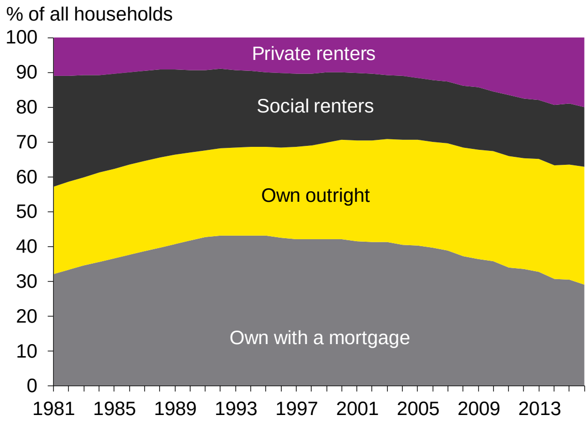
Higher interest rates should be good news for hard-pressed savers' incomes. But we expect dearer money to be a net drag on household incomes and, therefore, consumer spending and activity more generally. Last November's 25bps increase in Bank Rate was almost entirely passed onto borrowers on variable rate deals, with the average interest rate on floating-rate loans rising by 22bps between October and December 2017. Full pass-through of the 100bps of tightening in 2018 and 2019 assumed in our forecast would imply that the average interest rate on a variable loan would rise from 2.78% to 3.78%. The average (mean) outstanding mortgage balance is a little over £120,000, so such an increase would imply a rise in monthly mortgage interest payments of £103, to £390.

The good news (relatively speaking) is that the economy is probably less sensitive to higher interest rates than in the past. This reflects two factors. The first is changes in household tenure. The proportion of UK households with a mortgage dropped to a post-1981 low of 29% in 2016, down from a peak of 43% in 1995. Second, UK mortgages have seen a shift from floating rates to fixed rates in recent years, with the latter's share of the total mortgage stock rising to 61% in Q4 2017, up from 40% in 2007.

So, many households will not need to deal with the impact of higher interest rates for some time to come. Bank of England calculations, based on the results of the NMG Consulting Survey, suggest that, with respect to last November's hike in rates, 38% of mortgages will see no change in mortgage interest rate until at least 2019, with 18% seeing no change until 2020 or beyond.[3] Therefore, the increase in the average mortgage rate faced by households over the next two years will be somewhat smaller than the anticipated rise in Bank Rate.

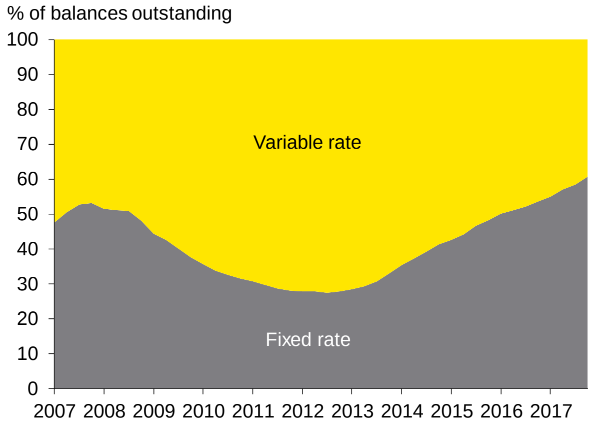
[2] These factors were explored in detail in EY's recent *Special Report on Consumer Spending*. March 2018. See ey.com/uk/en/issues/business-environment/financial-markets-and-economy/ey-item-club-special-report-on-consumer-spending
[3] "The financial position of British households: evidence from the 2017 NMG Consulting survey", *Quarterly Bulletin, 2017 Q4*, Bank of England. See bankofengland.co.uk/-/media/boe/files/quarterly-bulletin/2017/the-financial-position-of-british-households-2017-nmg-consulting-survey.pdf

UK: Households by tenure



Source : English Housing Survey

UK: Stock of mortgages by type of deal



Source : Bank of England MLAR Statistics

Moreover, households are starting from a relatively good position as far as the burden of interest payments is concerned. Debt servicing costs absorbed 4.1% of the average household's disposable income in the last quarter of 2017, the joint lowest ratio since records began in 1987.[4] This compared with a ratio of 9.6% in 2007, immediately before the financial crisis, and an average of 7.1% from 1987 to 2017. However, the uneven distribution of debt means that lower-income households are more vulnerable than data on averages might suggest.

Business investment has been held back by a collapse in extraction …

Turning to the investment outlook, on the face of it, business's willingness to spend on things like transport equipment, machinery and intellectual property mimicked the soft performance of consumer spending in 2017. While growth in business investment of 2.4% was a marked improvement on 2016's 0.5% decline, it compared poorly with an average rise of 4.9% from 2010 to 2015. The Brexit vote making its mark? Not entirely. Investment data in recent years has been distorted by a collapse in capital spending in the extraction sector (largely North Sea oil and gas output). Past low oil prices and the cost and difficulty of exploiting oil and gas reserves in the North Sea contributed to extraction investment in 2017 being a huge 49% down on the level in 2015. Despite this sub-sector accounting for around only 3%–4% of business investment, the decline was sufficient to knock nearly 1.5 percentage points off average total investment growth in 2016 and 2017 (2.4% a year excluding extraction versus a 1% headline rise).

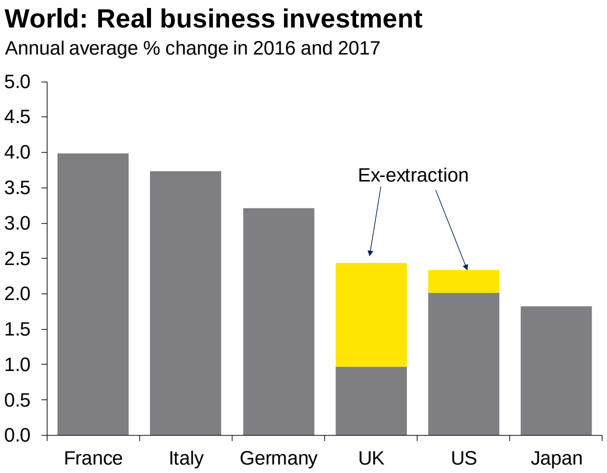
Hence, while on a headline basis, the UK was firmly bottom of the G7 pack in terms of business investment growth in 2016 and 2017, on an excluding-extraction basis, it was ahead of the US and Japan and closer to the norm among major European economies.

Signs that the North Sea may be on the cusp of an investment revival suggests that the drag from this sub-sector could ease over the next few years.[5] What is more, developments in the labour market may also encourage a more capital-intensive focus among firms. The current low unemployment rate (which we expect to broadly persist over the forecast period) and falling net migration from abroad (down to 244,000 in the year to September 2017 from the record high of 336,000 in June 2016), will constrain the ability of firms to expand via growing their workforces and so may encourage investment in reorganisation and labour-saving technology.

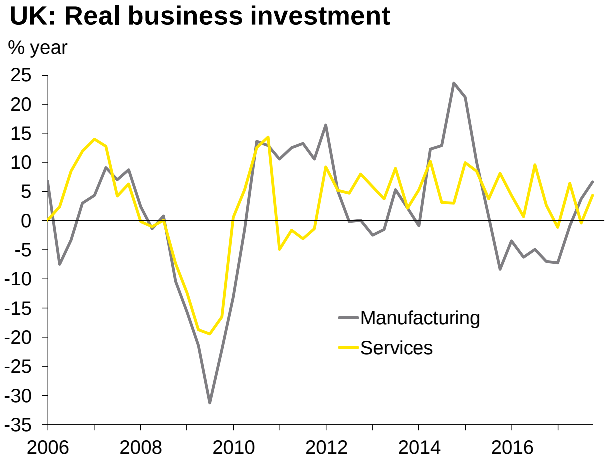
[4] This calculation is made using debt interest payments prior to the Financial Intermediation Services Indirectly Measured (FISIM) adjustment.
[5] "New investment drives revival of North Sea oil and gas", *Financial Times*, 20 March 2018. See ft.com/content/39ee4fa0-2b64-11e8-a34a-7e7563b0b0f4

However, a divergence in the appetite to invest in manufacturing and services firms is likely to feature in the near term, continuing the pattern evident at the end of 2017. With 'the makers' benefitting from strong export growth and a boost to profitability provided by the pound's weakness, Q4 2017 saw manufacturing investment rise 6.7% year-on-year (y/y), a two-and-half-year high, while survey evidence from the Bank of England's Regional Agents in February 2018 showed investment intentions among manufacturers at the strongest since the summer of 2014.

But with consumer-facing services firms buffeted by the reluctance of households to spend more, services investment growth ran at a more modest 4% y/y at the end of 2017. And investment intentions in the sector have shown little sign of breaking out of a long-running subdued trend.



Source : EY ITEM Club/Haver Analytics



Source : EY ITEM Club/Haver Analytics

… but should be supported by more Brexit clarity.

Meanwhile the cloud of uncertainty presented by the Brexit vote and the drag this has exerted on investment should hopefully diminish as the economy moves through 2018 and into 2019. Survey evidence gathered by the Bank of England suggests that the UK's forthcoming departure from the EU has weighed significantly on recent investment growth. Based on the responses given by firms surveyed, nominal business investment was estimated by the Bank to have been around 3%–4% lower over the year to the first half of 2017 than would have been the case if the UK had remained in the EU. [6] Given the rise in the cost of imported capital goods resulting from sterling's 2016 depreciation, the effect on real investment was, in the Bank's view, likely to have been larger. Moreover, EY's latest *UK Attractiveness Survey* found some evidence of a slowdown in inbound foreign direct investment (FDI) flows. That said, only a minority (21%) of firms surveyed had changed their investment plans since the referendum. And of those firms, the proportion increasing investment (7%) was greater than those which had reduced theirs (6%).[7]

In terms of potentially recouping some of the investment forgone since the summer of 2016, the conditional agreement reached by the UK and the EU in March 2018 offers cause for hope.[8] It provides for a 'status quo' transition period following the UK's formal departure from the EU next March, which will effectively extend participation in the single market and customs union until 31 December 2020 and so give businesses trading with EU counterparties a longer period of certainty.

[6] Box 3, page 17, of the Bank of England's quarterly *Inflation Report*, February 2018. See bankofengland.co.uk/-/media/boe/files/inflation-report/2018/february/inflation-report-february-2018.pdf
[7] *EY's UK Attractiveness Survey: Inward investment after Brexit*, March 2018. See eydigital.cld.bz/UKAS-Brexit-report
[8] "Draft Agreement on the withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community", 19 March 2018. See www.gov.uk/government/uploads/system/uploads/attachment_data/file/691366/20180319_DRAFT_WITHDRAWAL_AGREEMENT.pdf

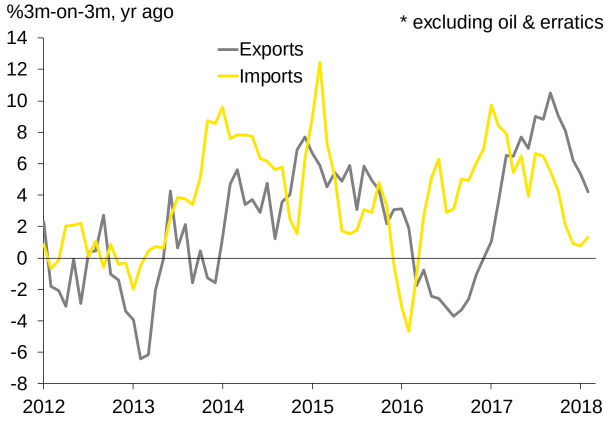
That said, the transition arrangement is conditional on the UK and EU reaching a complete withdrawal agreement, including the thorny issue of avoiding a 'hard' border on the island of Ireland. And even in the event of such an agreement being reached, businesses will still have to confront the challenge of potential new trade barriers at the end of 2020. Hence, while uncertainty from Brexit should gradually clear to the benefit of investment, some firms will still have cause to stay their hand when it comes to spending on capital equipment, vehicles and other fixed assets. Overall, with a weak end to 2017 providing a poor launch pad for growth this year, we expect business investment to expand 1.7% in 2018, with a pickup to 2.7% in 2019.

A buoyant global economy will continue to provide ballast to the UK …

With exports making up around 30% of UK GDP, overseas developments are an important driver of the UK economy's performance. In the context of recent domestic weakness, the synchronised strength of the global economy, magnified by sterling's competitive value, helped to support GDP growth last year. Indeed, the ONS's latest judgement is that net trade boosted annual growth by 0.6 percentage points (ppts) in 2017 compared with a 0.8ppts drag in the previous year. Only twice since 1995 has net trade offered such strong support to GDP growth.

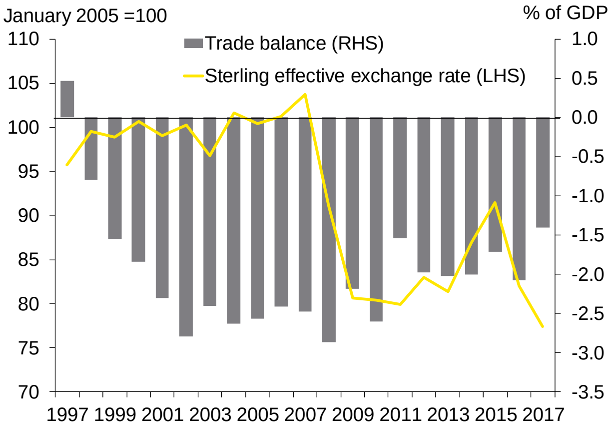
Interpreting the UK trade data has continued to be complicated by the effect of inflows and outflows of non-monetary gold and other erratic items, reflecting in part London's position in accounting for most of the global trade in the yellow metal. But stripping out these influences paints a picture of an export sector in good health, helping to drive a revival in export-orientated manufacturing. The manufacturing sector expanded 2.5% in 2017, almost three times 2016's 0.9% increase. However, manufacturing's modest weight in the economy (around 10% of GDP) limited the boost to overall output growth.

UK: Goods export & import volumes*



Source : EY ITEM Club/Haver Analytics

UK: Sterling and trade balance



Source : EY ITEM Club/Haver Analytics

Meanwhile, although goods export volumes excluding oil and volatile components like gold dropped 0.6% in Q4 2017, the full year delivered a 7.5% rise, the strongest since 2011 and a marked turnaround from 2016's 1.9% decline. Similarly, while the UK's traditional trade deficit in goods and services widened in Q4 of last year, a deficit of £28.6bn in 2017 was substantially down on 2016's £40.7bn. Moreover, at 1.4% of GDP, 2017 delivered one of the smallest gaps between exports and imports relative to output since records began in 1997.

In theory, 2018 should offer up more of the same. The International Monetary Fund (IMF) expects global GDP growth to accelerate to 3.9% both this year and in 2019, up from 2017's 3.7% and 3.2% in 2016, with expansion unusually broad-based. 2017 saw around 120 economies, accounting for three-quarters of world GDP, enjoy a pickup in growth in year-on-year terms, the broadest synchronised global growth upsurge since 2010. [9]

Although the revival in the eurozone economy (which accounted for 43% of UK goods exports in Q4 2017) showed some signs of easing back in the early part of 2018, growth is expected to run at a relatively healthy 2.2% in the year. And activity in the US should benefit as the impact of the Trump administration's tax reforms, including a cut in the corporate tax rate from 35% to 21%, kicks in. The IMF predicts US GDP growth will accelerate to 2.7% this year from 2.3% in 2016, before moderating to 2.5% in 2019. Overall, we expect world trade (weighted by UK export shares) to grow by 5.3% in 2018, up from 5.0% in 2017, before steadily cooling in later years.

… but the revival in sterling means exporters' 'sweet spot' will sour.

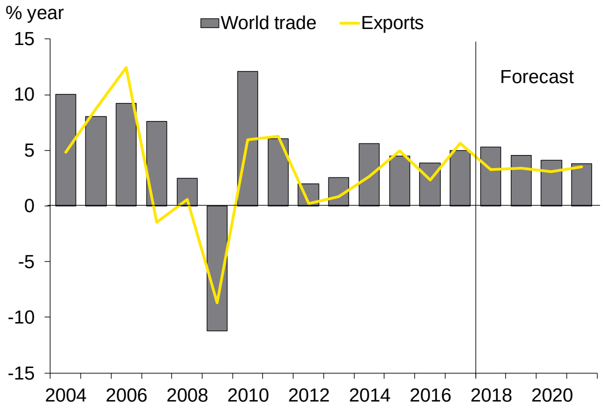
However, for the UK, the recovery in sterling may take some of the edge off what a promising global outlook should continue to deliver to exporters. Having dropped to a post-EU referendum low of $1.20 in January 2017, the pound's dollar value has steadily recovered since, trading around $1.42 as of mid-April, not far off the $1.44 averaged in the three months to referendum day on 23 June 2016. However, the resurgence against the euro has been more modest, with a mid-April value of €1.15, up on last August's low of €1.08, but still a long way from the €1.27 averaged in the run-up to the Brexit vote.

Given the relative importance of the eurozone as a market for UK exports (and as a source of income from UK overseas investments), sterling's recent revival will represent less of a headwind to the tradable sector than a more broad-based recovery in the currency would imply. And the fact that the pound's (relative) strengthening has been against the US dollar offers some good news in terms of stemming rises in the price of oil and other commodities, which are typically priced in greenbacks.

On a trade-weighted basis, we expect sterling's value to broadly stabilise at its current rate over this year and next, with continued, albeit diminishing, uncertainty stemming from Brexit, the likely end of the European Central Bank's quantitative easing programme later this year and further monetary tightening by the US Federal Reserve putting a lid on the pound's value.

However, if as we expect, the Bank of England goes ahead with two hikes in Bank Rate this year, a tighter monetary policy will provide some offsetting support to the currency. With the tradable sector forgoing the currency-related boost seen in 2017, we expect the contribution to GDP growth from net trade to fade this year to around 0.1ppts.

UK: Exports & world trade



Source : EY ITEM Club

A 'so-so' performance is set to persist

Recent months have seen shifts and developments in the balance of pressures, both positive and negative, affecting the economy. And it is possible that we will see a bumpy quarterly profile to GDP growth in the first half of this year, as the disruption caused by the late-February/early-March snow weighs on Q1 before the lost activity is largely recouped in the second quarter. But in our view, the bigger picture is little changed compared with our February forecast. GDP growth is expected to run at 1.6% in 2018 and 1.7% in 2019, implying a quarterly pace of around 0.4%, before picking up slightly as we move into the early years of the next decade.

[9] "World Economic Outlook Update", International Monetary Fund, January 2018. See http://www.imf.org/en/Publications/WEO/Issues/2018/01/11/world-economic-outlook-update-january-2018

The dominant consumer sector will face swings and roundabouts. Pressure from inflation should ease and earnings growth see some revival. But countering these developments, interest rates are set to rise, households may potentially seek to bring spending and income growth closer into line and the very strength of the jobs market means that the scope for further increases in employment and reductions in unemployment are inevitably more limited.

There also seems little reason to expect a dramatic change in the outlook for investment. The fact that a transitional arrangement between the UK and the EU following 'Brexit Day' next March is looking ever more likely should reduce the weight of uncertainty facing firms trading with the EU market. And the sizeable drag from the extraction sector may ease. But it is noticeable that even in those major economies where business investment is currently rising fastest, growth is still a long way from the double-digit rates seen in the investment boom of the 1990s. Hence, beyond Brexit, structural factors, such as the long-running shift from relatively capital-intensive industry towards less capital-intensive services, are likely to cap firms' willingness to spend.

The EY ITEM Club forecast for the UK economy, spring 2018
% changes on previous year except borrowing, current account, and interest and exchange rates

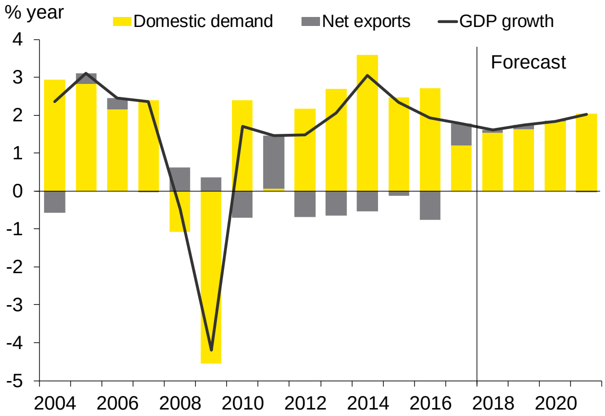
	GDP	Domestic demand	Consumer spending	Fixed investment	Exports	Imports
2015	2.3	2.3	2.6	2.8	5.0	5.1
2016	1.9	2.2	2.9	1.8	2.3	4.8
2017	1.8	1.4	1.7	4.0	5.7	3.2
2018	1.6	1.6	1.2	2.4	3.3	2.9
2019	1.7	1.6	1.6	2.0	3.4	2.8
2020	1.8	1.8	1.9	2.5	3.1	2.9
2021	2.0	2.0	2.1	2.6	3.5	3.4
	Net Government borrowing(*)	**Current account (% of GDP)**	**Average earnings**	**CPI**	**Bank Rate**	**Effective exchange rate**
2015	4.2	-5.2	2.8	0.0	0.5	91.5
2016	2.8	-5.8	2.6	0.6	0.4	82.0
2017	2.1	-4.1	2.5	2.7	0.3	77.4
2018	1.8	-3.9	3.0	2.4	0.7	78.8
2019	1.6	-2.9	3.1	1.9	1.2	79.6
2020	1.3	-2.5	3.3	1.9	1.7	81.2
2021	1.1	-2.6	3.4	2.0	2.0	81.9

(*) Fiscal years, as % of GDP

Source: EY ITEM Club

However, net trade will provide a much smaller boost to the economy this year. On the plus side, the upswing in the global economy shows little sign of running out of steam, notwithstanding recent protectionist tremors, with the broad-based nature of global expansion particularly beneficial to the UK as it seeks to pursue a post-Brexit ‘Global Britain’ strategy, and offset the risk of a spike in business uncertainty when formal departure from the EU takes place in less than a year’s time. But the boost from strong UK export markets will be largely offset by the impact of a stronger pound, meaning that net trade offers only modest support to growth.

UK: Contributions to GDP growth



Source: EY ITEM Club

Risks and uncertainties

The UK and EU conditionally agreed earlier this year that a transitional period will follow the UK’s formal departure from the EU, something which we assume in our baseline forecast. But this has not eliminated the possibility of a ‘cliff-edge’ Brexit next March, and the trade barriers, both tariff and non-tariff, which would immediately follow. A transition phase is still dependent on a satisfactory withdrawal agreement being reached, including provisions on the future status of Northern Ireland, an issue on which the two sides currently have very different views. The consequences of failure mean that a compromise is the most likely outcome, but this will require one, or both sides to make substantial concessions, so the possibility of a breakdown in talks cannot be ruled out.

Meanwhile, the relative openness of the UK economy leaves it vulnerable to the risk of a snowballing of recent protectionist moves by the US. While the higher tariffs and other measures and countermeasures announced to date by the US, China and EU are likely to have only a small near-term impact on the global economy, the seeds of a more serious conflict are there.

Domestically, there was a strong pickup in output per hour in the second half of last year, although it appeared to have been driven by an erratic drop in hours worked. Though we do not expect the H2 2017 strength to persist (and there may well have been a relapse in Q1 2018 as hours worked were up 0.4% in the three months to February), our forecast does assume somewhat stronger growth in productivity than we have seen since the global financial crisis, as low unemployment and falling migration compel a shift away from labour-intensive activity.

Our forecast is also more upbeat than those of the Office for Budget Responsibility (OBR) and the Bank of England, suggesting that, if it is realised, both monetary and fiscal policy could justify looser settings. But equally, if H2 2017 does prove to be a flash in the pan and productivity growth regresses to its post-financial crisis average, our baseline forecast may prove to be too optimistic.

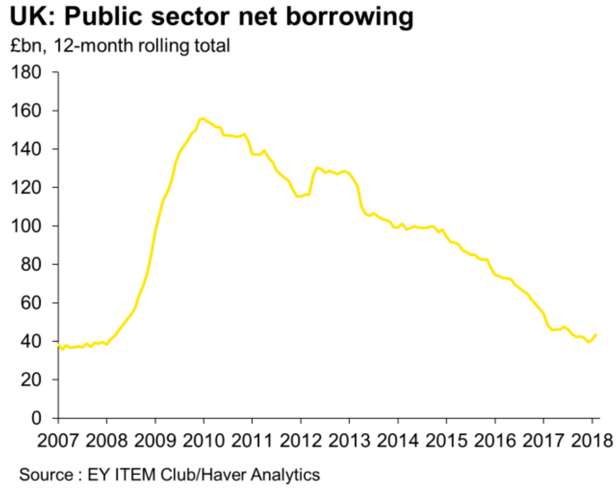
Forecast in detail

1. Fiscal policy

The fact that net public sector borrowing for 2017–18 was revised down in March 2018’s Spring Statement offered the Chancellor some cause for cheer. But the OBR’s relative pessimism around the economy’s productive potential meant that there was little move in the margin against the Government’s fiscal rule. And the longer-term ambition of a balanced budget continues to look very challenging.

The OBR's forecast for 2018's inaugural Spring Statement predicted a budget deficit of £45.8bn in 2017–18, some £4bn less than expected last November and £13bn smaller than the deficit predicted in the March 2017 Budget.

This improvement was largely a consequence of stronger-than-expected tax receipts. In particular, the loss of self-assessment revenues arising from forestalling ahead of a rise in dividend taxation in 2016 appears to have been more modest than anticipated. Corporation tax (CT) receipts were another source of unexpected buoyancy, with financial sector companies, important payers of CT, reporting rapid profit growth in 2017.



However, lower than expected borrowing in 2017–18 and in subsequent years of the OBR's forecast did not, in the official forecaster's view, translate into a smaller structural deficit, the metric used for judging the Government's fiscal mandate (which compels the Government to achieve a cyclically adjusted deficit of less than 2% of GDP in 2020–21).

The margin against that mandate was forecast to be £15bn, virtually unchanged from the previous November's expectation. This reflected the official forecaster's judgement that the economy was operating slightly above full capacity in 2017, with a positive output gap forecast to persist this year and next.

Despite that view, the OBR's projections for GDP growth remained very subdued, with GDP growth not expected to be above 1.5% in any of the five years from 2018. This would be the first five-year period since the late 1940s not to see that growth threshold exceeded.

In part reflecting a weak growth outlook, the Government's objective of achieving an overall balanced budget by the mid-2020s looks, on the OBR's reckoning, very challenging. The OBR expects the public finances to still be in deficit to the tune of £21bn or 0.9% of GDP in 2022–23. Further deficit reduction will be threatened by growing age-related spending, particularly on health and pensions.

In practice, we think that the OBR is taking an overly pessimistic view of the economy's prospects. However, despite our stronger growth forecast and more optimism about 'slack' in the economy, the forecast deficit is broadly in line with that expected by the OBR. Net borrowing is predicted to run at £37bn in 2018–19, dropping to £22bn by 2022–23, reflecting our view that GDP growth may be less revenue-rich than the OBR expects and that there may be some overshooting in Government spending. But the latter would relax the drag on the economy from fiscal policy, which, on current plans, is forecast to knock 0.2 to 0.4 percentage points off GDP in each of the four years from 2018/19 onwards.

2. Monetary policy

The direction of monetary policy has taken a hawkish turn in recent months. Although the case for higher interest rates looks far from watertight, the Bank's pessimism around the economy's supply-side and the speed at which inflation will drop back to the 2% target, point to two 25bps hikes in interest rates this year, taking Bank Rate to 1% by the end of 2018.

The MPC's decision last November to raise Bank Rate from 0.25% to 0.5% reversed the 'emergency' cut in rates following the EU referendum and appears to have been absorbed by the economy with little difficulty. This, along with a revised view of the economy's demand- and supply-sides, may have bolstered the Committee in adopting a more hawkish tone in February's meeting when the Bank of England also released its latest quarterly *Inflation Report*.

Last November, financial markets anticipated one rate hike towards the end of this year, followed by one each in 2018 and 2019. But the minutes of February's meeting saw the MPC indicate, albeit with not complete clarity, that rates would have to rise earlier and faster than the markets believed. In the words of the Committee, "*Were the economy to evolve broadly in line with the February* Inflation Report *projections, monetary policy would need to be tightened somewhat earlier and by a somewhat greater degree over the forecast period than anticipated at the time of the November* Report".[10]

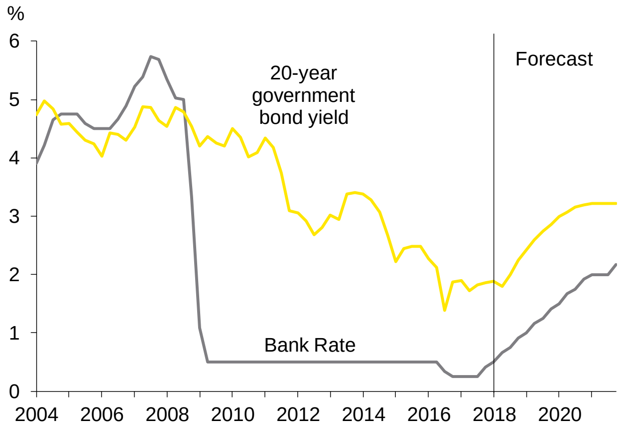
This view reflected, in part, an upgraded forecast for economic growth from the Bank. GDP was forecast to rise by 1.8% this year and in both 2019 and 2020, albeit a still modest rate by historical standards.

But more important was a reaffirmation by the Committee of its pessimistic assessment of the economy's supply-side, judging that there was virtually no spare capacity remaining and that the economy's potential, non-inflationary, rate of growth was only 1.5% per annum. Consequently, with GDP expanding more quickly than the Bank's view of potential over the next few years, inflation was predicted to remain above the 2% target all the way through to the end of 2020.

Although the first quarter of 2018 saw CPI inflation come in below the Bank's expectation (2.7% versus 2.9% with March's reading at a 12-month low of 2.5%), and recent economic data has been far from stellar, it looks like the MPC remains on course to announce a 25bps rise in Bank Rate in May, when the next *Inflation Report* forecast is published. March's MPC meeting saw two of the nine members vote for an immediate hike, and the tone of recent speeches by MPC members has been consistent with traditionally more dovish members preparing the ground for higher rates. Our forecast for another hike in November is more tentative, particularly if, as we expect, inflation drops back more quickly than the Bank forecasts.

A steeper path for Bank Rate will feed through to the level of long-term interest rates, which we expect also to be pushed up as the current unusually large margin between UK and US bond yields narrows. We expect the 20-year gilt yield to rise to 2.3% by the end of this year and end 2019 at 2.9%.

UK: Bank Rate and 20-year bond yield



Source: EY ITEM Club

In recent months, sterling has moved closer to regaining its pre-referendum rate against the US dollar, trading around $1.42 in mid-April compared to an average of $1.44 in the three months to 23 June 2016, and the early-2017 low of around $1.20. However, the fact that the pound has made relatively little headway against the euro (trading at around €1.15 in mid-April 2018 against a pre-referendum three-month average of €1.28), suggests that the movement against the greenback has been more a story of dollar weakness than pound strength.

The pound is expected to hold on to its revived rate against the dollar, helped by increased clarity over the Brexit endgame and a tightening in UK monetary policy. However, a continued outperformance from the eurozone economy, and the likelihood that the European Central Bank will bring an end to its programme of quantitative easing, is set to hold back gains against the euro. Consequently, we see sterling largely trading in a $1.40–$1.43 and €1.10–€1.12 range over the course of this year.

[10] "Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 7 February 2018", Bank of England. See https://www.bankofengland.co.uk/-/media/boe/files/monetary-policy-summary-and-minutes/2018/february-2018.pdf

3. Prices

Inflationary pressures intensified through 2017, with the CPI measure peaking at 3.1% in November, its highest rate since April 2012. But it has since dropped back, coming in at a 12-month low of 2.5% in March 2018 and, after a brief hiatus, we expect to see a steady cooling of inflationary pressures as the impact of the 2016 sterling depreciation fades.

The pickup in inflation in 2017 was due largely to three factors. First, the post-referendum plunge in the value of the pound, which steadily passed along the supply chain into consumer prices. Second, a steep rise in petrol prices resulting from a sharp increase in the oil price. And third, an 11.5% increase in domestic electricity bills. However, it now appears that these factors are weakening or, in some cases, set to change direction.

There is already evidence that the sterling impact is fading. Core inflation has slowed, as have both producer input cost and output price inflation, with the latter at a 16-month low in March. This picture is consistent with the literature, which suggests that it usually takes around a year to see the maximum impact of a depreciation on consumer prices. And, given that we expect sterling to continue to be modestly firmer overall through the coming year, these exchange rate effects should soon begin to put downward pressure on inflation.

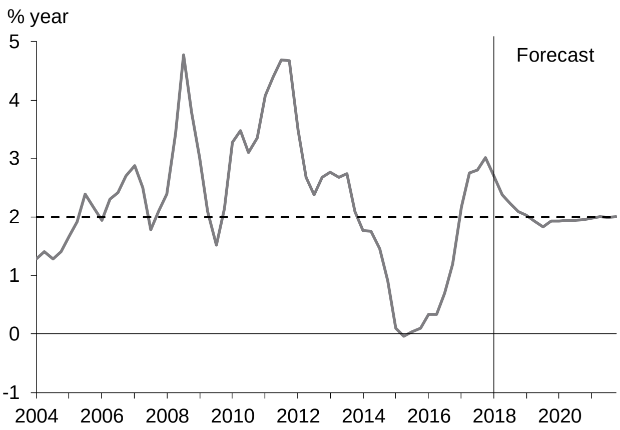
There is scant evidence that the weaker pressures from sterling will be offset by an escalation of domestic cost pressures. Services inflation is largely driven by domestic costs, but this has stabilised of late, standing at 2.5% in March. And we expect the tighter labour market to result in only a modest uptick in pay growth. As a result, core inflation is likely to be lower this year than in 2017.

The upward pressure on inflation from rising oil prices steadily faded through last year and looks set to remain muted throughout 2018. We expect Brent Crude to remain in the mid-$60 per barrel range which, combined with a firmer pound against the dollar, will see the sterling oil price fall.

Furthermore, other global commodity prices have also been more stable of late, suggesting that last year's sharp rise in domestic energy bills is unlikely to be repeated, nor is there likely to be a renewed pickup in food prices. So, with the contribution from the food, energy and petrol categories easing significantly and core pressures cooling, we expect the CPI measure to slow from 2.7% in 2017 to 2.4% this year and 1.9% in 2019.

RPI inflation will be higher than the CPI measure over the forecast period. This is largely due to the so-called 'formula effect' (i.e. the different methods of aggregation between the RPI and CPI measures that place an upward bias on RPI) and the impact of a steady increase in interest rates on mortgage interest payments.

UK: CPI inflation



Source: EY ITEM Club

4. Activity

Since our last forecast, the economy has shown few signs of breaking out of the pattern of 'so-so' growth seen in the second half of 2017. The National Accounts for Q4 2017 reported quarterly GDP growth of 0.4%, unrevised from the ONS's second estimate. However, there was clearly a hit to economic activity from the severe weather seen in March, with surveys for the month pointing to construction, services activity and retail sales all being adversely affected. Weakened industrial production and construction output data for February also suggest that bad weather at the end of that month may have hampered economic activity. Consequently, our forecast assumes that GDP growth dipped to 0.3% q/q in Q1 2018, and it is very possible that it could have been as low as 0.2% q/q. We expect this lost activity to be largely recouped in Q2, when we see GDP growth improving to 0.5% q/q.

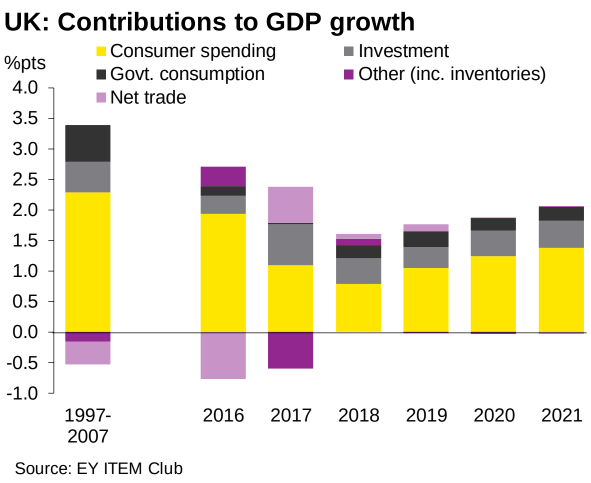
Growth of 0.4% in Q4 meant that the economy expanded by 1.8% over 2017 as a whole, down from 1.9% in 2016, but a slight upward revision from the ONS's previous judgement that GDP rose 1.7%. This left the UK ahead of only Japan and Italy in terms of rates of expansion among G7 economies in 2017 and it was the only one of the Group of Seven to see growth slow year-on-year. Indeed, it was the slowest pace of UK GDP growth since 2012. The relatively poor performance was largely a function of a sharp slowdown in consumer spending, as high inflation squeezed spending power.

The economy looks unlikely to break out of this lacklustre pace as we move through 2018. Although inflation has begun to fall, the boost to household spending power will be mitigated by rising interest rates and softer employment growth. And with the household saving ratio falling to a record post-1963 low in 2017, it seems likely that households will want to stabilise their balance sheets. As such, we expect consumer spending growth to slow from 1.7% last year to 1.2% this year, before recovering to 1.6% in 2019.

Although corporate profitability remains firm, business surveys suggest that investment intentions remain soft. And while the likelihood of a UK–EU transitional deal has improved following March's UK–EU agreement, Brexit-related uncertainty is likely to continue weighing on firms' appetite to invest.

The combination of a weaker pound and a synchronised pickup in the world economy strengthened export demand and resulted in net trade lifting GDP growth by 0.6ppts in 2017. But with sterling recovering most of its post-EU referendum loss against the dollar, so eroding some of the recent gains in competitiveness, we expect that stimulus to fall to 0.1ppts in both 2018 and 2019.

Overall, we expect little move in growth this year and next compared to 2016, with GDP rising 1.7% in both 2018 and 2019. Growth is then expected to accelerate modestly in subsequent years, as the drag on the economy from fiscal policy eases and clarity over the ultimate relationship between the UK and EU emerges.



5. Consumer demand

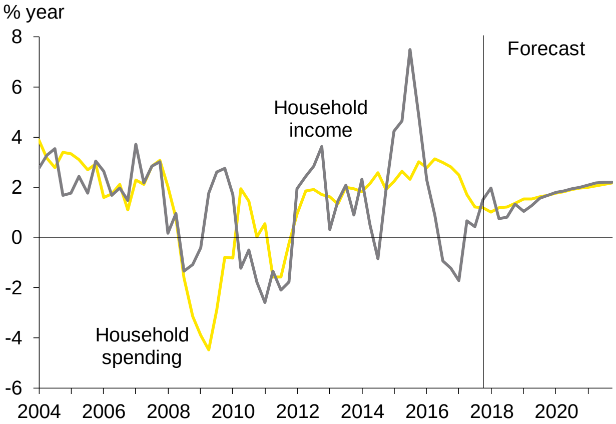
Consumer spending growth slowed from an 11-year high of 3.1% in 2016 to a six-year low of 1.7% last year and 2018 looks set to be another challenging year for households.

The cause of the slowdown in consumer spending growth was a severe squeeze on household spending power. Real incomes grew by just 0.2% in both 2016 and 2017. Consumers, therefore, were only able to finance continued growth in spending though dissaving, with the household saving ratio falling from 9.2% in 2015 to just 5.1% in 2017 — this was the lowest calendar-year average since records began in 1963.

Looking ahead, we are optimistic that inflation peaked last November and will slow markedly as we move through 2018. However, the boost to spending power from this source will be mitigated by weaker employment growth, the likelihood that nominal wage growth will firm only gradually and remain relatively sluggish, and the ongoing freeze on most working-age benefits. As a result, we expect the recovery in real household income growth to be gradual in nature, with rises of 1.2% this year and 1.4% in 2019.

In such a climate of relatively gradual real income growth, the economy will be reliant on households continuing to save less if consumer spending growth is to run at a reasonable rate by past standards. That the strength of households' balance sheets is close to record highs, with net financial wealth representing around three-and-a-half times the average household's income, offers some hope in this respect.

UK: Real household income and spending



Source: EY ITEM Club

But in spite of this balance sheet strength, there are signs that consumers' appetite to borrow is starting to wane. Strong growth in unsecured lending had been a key factor in allowing consumers to lean against the real income squeeze, but this has slowed overall during the past six months. And this is not just a reflection of consumers becoming warier about making major purchases — lenders have also started to rein in credit availability. This year will also see the minimum employee contributions for pensions auto-enrolment increase from 1% to 3%, which should also encourage higher saving.

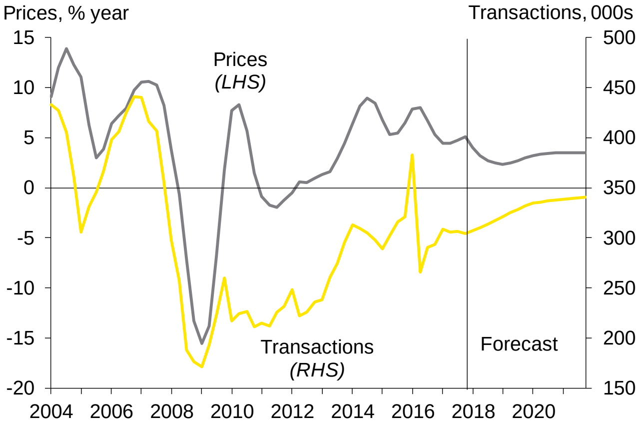
Therefore, with households unlikely to further reduce the saving ratio to compensate for subdued growth in real incomes, consumer spending growth is forecast to slow to 1.2% this year, with a pickup to 1.6% in 2019.

6. Housing market

The housing market appears to have become stuck in a rut of relatively low levels of activity and subdued price growth. And this is likely to persist, with soft household income growth and the recent rise in interest rates continuing to weigh on the market. Furthermore, house prices are currently significantly above long-term averages with respect to incomes.

Bank of England data showed mortgage approvals for house purchases running in a relatively narrow range of 64,000–69,000 a month through 2017, while transactions were similarly stable at a little over 100,000 a month. However, the period since last November's rise in interest rates has delivered a couple of softer readings for mortgage approvals. December and January typically see very low levels of approvals, around 30% lower than a typical month, so readings at that time of the year must be interpreted with care, given the small sample and large degree of seasonal adjustment. But given that we have also seen the Royal Institution of Chartered Surveyors (RICS) survey report a slump in new buyer enquiries, it does appear that the start of the rate-hiking cycle has had some dampening effects on demand.

UK: House prices & transactions



Source: EY ITEM Club

On the whole, the recent data continues to show price growth slowing, with Nationwide and Halifax both reporting annual price growth of around 2.5% in the three months to March. However, the ONS/Land Registry measure has been a notable outlier, reporting much stronger price growth of 4.4% over the year to February (a 7-month low), and well ahead of the increase in nominal household incomes.

With the fundamentals for house buyers likely to remain weak, we expect prices and activity to remain subdued over the next two years. The squeeze on real incomes will ease only gradually, while the support from strong employment growth will ebb. And a steady increase in interest rates is likely to reinforce buyer caution.

Meanwhile, stretched affordability in many areas leads us to expect to see transactions remain low and price growth moderate further. Our forecast shows price growth slowing from an average 4.7% in 2017 to 3.1% this year (on the ONS/Land Registry measure) and 2.6% in 2019. A severe correction in house prices looks unlikely given the low level of unemployment and the likelihood that interest rates will increase only gradually. Additionally, a shortage of properties on the market is expected to continue to limit the downside for house prices; the latest RICS survey showed new instructions to sell fell again in March, resulting in 26 successive months without a positive reading. Consequently, average stock levels on estate agents' books in February fell to a new record low for the survey, and they remained very close to this low in March.

7. Company sector

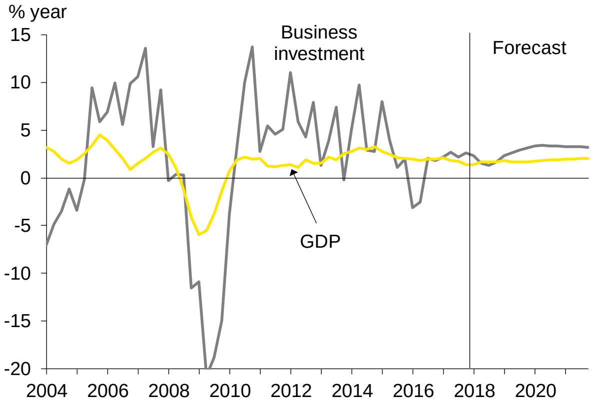
On a headline basis, business investment put in a relatively soft performance in 2017, albeit improving on the previous year's decline. Granted, a collapse in investment in the extraction sector dragged significantly. But with Brexit uncertainty hanging over the economy, firms' underlying appetite to invest is likely to remain subdued.

Q4 2017's National Accounts showed a 0.3% rise in business investment in the quarter, leaving calendar-year growth at 2.4%. While it was an improvement on 2016's 0.5% fall, 2017's gain remained well below the 4.9% annual increase averaged from 2010 to 2015.

But sectoral developments, specifically a collapse in investment in the North Sea sector, dragged the headline number down. On an excluding-extraction basis, business investment rose 3.8% in 2017, closer to the 2010–15 average rise of 4.7%.

That said, even on this narrower basis, UK investment growth fell behind that seen in the major European economies. And there is good reason to believe that a UK-specific factor — Brexit — has weakened firms' appetite to spend. Analysis by the Bank of England suggests that nominal investment was around 3%–4% lower over the year to the first half of 2017 than would have been the case if the UK had voted to remain in the EU.

UK: Business investment & GDP



Source: EY ITEM Club

The fact that the UK and EU conditionally agreed in March to a 21-month transition period (lasting through to 31 December 2020) to smooth the UK's departure from the EU, should reduce the weight of Brexit uncertainty on near-term investment projects. And cheap credit, elevated profitability and strong global demand represent other investment-positive factors, particularly for manufacturing.

Indeed, the Bank of England's latest Regional Agents survey showed investment intentions among manufacturers at the strongest since the summer of 2014. But the appetite to invest in the much more important services sector remained subdued. And structural factors, such as the long-running shift from relatively capital-intensive industry towards less capital-intensive services, are likely to cap firms' willingness to spend.

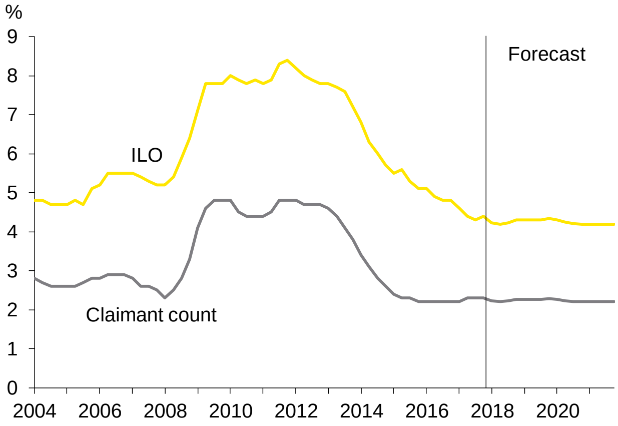
Overall, with a weak end to 2017 providing a poor launch pad for growth this year, we expect business investment to expand 1.7% in 2018, with a pickup to 2.7% in 2019, aided by our expectation that the UK–EU transitional arrangement will be confirmed and implemented.

8. Labour market and wages

A relatively soft economic performance has not stopped the jobs market putting in a very robust performance, with the employment and unemployment rates beginning 2018 at a record high and four-decade low respectively. But the strength of the present position inevitably limits scope for further gains. However, the tightness of the labour market augurs well for better news on pay growth.

The labour market data for the three months to February 2018 showed a 55,000 rise in employment to a record high of 32.262m. This lifted the employment rate to an all-time high of 75.4%. Joblessness fell by 16,000 over the same period, meaning that the Labour Force Survey (LFS) unemployment rate nudged down to 4.2%, the joint lowest since April 1975.

UK: Unemployment rate



Source: EY ITEM Club

The current elevated employment rate inevitably reduces room for further improvement. Moreover, the participation rate is also close to a record high. And growth in the foreign-born workforce (which accounted for the bulk of UK workforce growth in recent years) has slowed sharply. Consequently, after increasing 1.4% in 2016 and 1% in 2017, we see employment growth cooling to 0.8% this year and 0.4% in 2019. But the jobless rate is expected to broadly stabilise around the current level.

Tightness in the jobs market may be translating into stronger pay pressures. A 2.8% annual rise in average earnings in the three months to February was the joint strongest since September 2015, while regular pay growth in the same period touched a 30-month high of 2.8%.

Given that developments in pay tend to respond to changes in the jobless rate with a lag, we expect the decline in unemployment in 2017 to deliver further improvements this year. Increases in the National Living and Minimum Wages will also help those at the lower end of the pay scale.

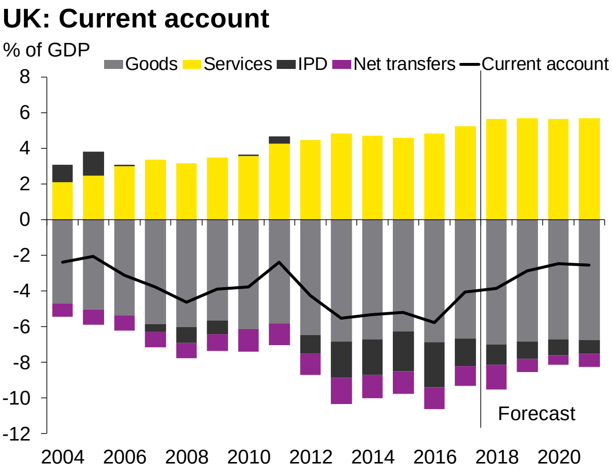
However, the fact that employers face rising costs — from pensions auto-enrolment (contribution rates will rise from 1% to 2% in April this year and then to 3% in April 2019) and the recently introduced Apprenticeship Levy — will constrain their ability to pay more. Overall, average earnings are forecast to rise 3% (on a National Accounts basis) in 2018, followed by 3.1% in 2019.

9. Trade and the balance of payments

The trade data has continued to be heavily distorted by erratic factors, most notably movements in non-monetary gold. But the underlying picture suggests that the weak pound and a more buoyant global economy have boosted exports — goods export volumes excluding oil were up 6.1% in 2017, the best performance for six years. At the same time, import growth has slowed, meaning that net trade boosted GDP growth by 0.6ppts in 2017.

Business survey data suggests that while export orders continue to grow at rates well above historical norms, there has been some loss of momentum over recent months. And we expect this trend to continue, with global growth gradually cooling and sterling holding on to its recent revival, thus reversing some of the gains in competitiveness accrued over the past couple of years. Therefore, the contribution of net trade to GDP growth is forecast to drop to just 0.1ppts in both 2018 and 2019.

The weakness of sterling also played a role in narrowing the UK's current account deficit over the past year, moving from an average shortfall of 5.8% of GDP in 2016 to 4.1% in 2017. We expect the general trend over the next few years to be one of improvement, partly through the improved trade performance and partly because the stronger relative performance of the UK's key trading partners will boost the UK's net investment income from abroad. Our forecast shows the current account deficit narrowing from 3.9% of GDP this year to 2.9% in 2019 and 2.5% by the end of the decade.



Source: EY ITEM Club IPD= interest, profit and dividends

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EY ITEM Club is the only non-governmental economic forecasting group to use the HM Treasury's model of the UK economy. ITEM stands for Independent Treasury Economic Model. HM Treasury uses the UK Treasury model for its UK policy analysis and Industry Act forecasts for the Budget. EY ITEM Club's use of the model enables it to explore the implications and unpublished assumptions behind Government forecasts and policy measures.

Uniquely, EY ITEM Club can test whether Government claims are consistent and can assess which forecasts are credible and which are not. Its forecasts are independent of any political, economic or business bias.