Bank of Ireland

Economic Research Unit

UK Outlook

February 2017

Softer Growth in Store

2017

GDP	EMPLOYMENT	UNEMPLOYMENT RATE	INFLATION RATE
↑1.6%	↑0.5%	5.2%	2.8%

Consumer spending to slow

Unemployment back above 5%

Inflation to rise further

BOE to stay on hold

> **"The positive momentum in the economy going into 2017 will give way to slower growth in the period ahead as Brexit effects come to the fore"**
>
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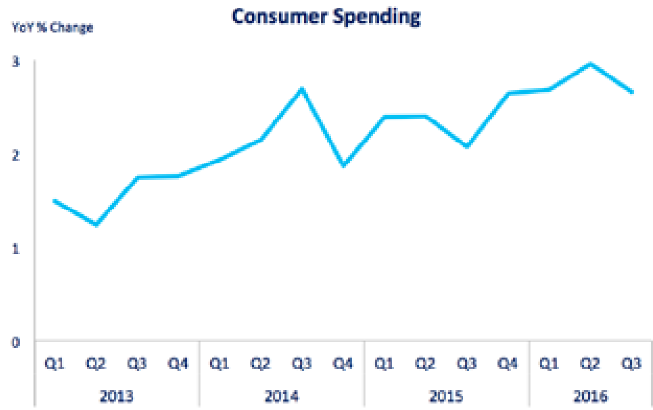
> Group Chief Economist

Overview The UK economy has proved more resilient than expected following the Brexit vote in June 2016. Annual GDP growth picked up over the second half of last year, to 2.2% from 1.9% in the first half, implying a greater degree of momentum going into 2017. Reflecting this, we have revised up our forecast for GDP growth this year to 1.6% (from 0.7% previously) and expect the economy to expand by 1.5% in 2018. Our updated forecast still implies a notable deceleration in the pace of activity during the course of this year. One clear consequence of the Brexit vote has been a sharp decline in sterling, which though regaining some ground recently has fallen by 19% from its peak in 2015. This will increasingly feed through to inflation, which is already picking up following a turnaround in oil prices, and so exert a significant squeeze on real incomes and dampen consumer spending. Uncertainty surrounding Brexit is also expected to weigh on business investment, which looks to have posted its first full-year decline in seven years in 2016. Slower economic growth will be accompanied by some softening of the labour market, with the unemployment rate projected to move back above 5%. In an environment of rising inflation but slowing growth, the Bank of England is likely to keep interest rates on hold. With Prime Minister May laying out her 'Plan for Britain' post exit from the EU, and the way being paved for the triggering of Article 50, we are entering the next phase and sterling is likely to remain volatile in line with the ebb and flow of the withdrawal negotiations.

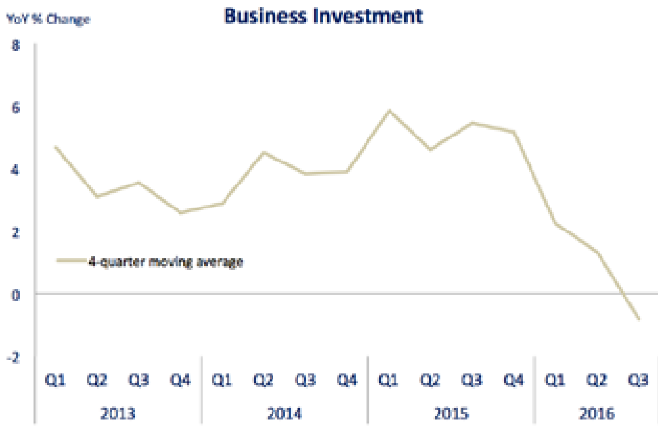
Outlook	2016 (e)	2017 (f)	2018 (f)
Personal Consumption	2.8%	1.7%	1.4%
Government Consumption	1.0%	0.9%	0.9%
Investment	0.5%	-0.5%	0.5%
Exports	2.4%	3.2%	2.9%
Imports	2.6%	1.8%	1.8%
GDP	2.0%	1.6%	1.5%
Employment	1.4%	0.5%	0.4%
Unemployment Rate (Average)	4.9%	5.2%	5.5%
CPI	0.7%	2.8%	2.5%
£/€ (Average)	1.22	1.12	1.14
£/$ (Average)	1.35	1.16	1.19

Consumer spending to slow

Consumer spending has held up well in the wake of the vote to leave the EU, with the volume of retail sales, for example, rising by almost 6.0% year-on-year over the second half of 2016. Confidence fell sharply immediately following the decision but has recovered some ground since. Spending has been supported by continuing gains in real incomes, and by robust growth in (non-mortgage) borrowing which has helped push the savings ratio down to a near-record low. Some of the current supports are beginning to wane however. Inflation is picking up and is set to rise quite sharply, while employment growth has started to moderate. This will dampen real income growth, leading to a slowdown in the pace of consumer spending. We expect the latter to increase by 1.7% this year and by 1.4% in 2018.



Investment eased back in 2016. Business investment in particular was weak - it looks to have recorded its first full-year decline since 2009 - and the indications are that it will remain so, despite favourable financing conditions. The weaker pound is adding to the cost of importing capital goods, while Brexit uncertainty is weighing on firms' investment intentions (the Bank of England reports that many businesses are choosing to hold more cash rather than increase spending). Business investment could also be affected by firms deciding to relocate capital in advance of changes in the UK's trading relationship with the EU. Meanwhile, investment in new private dwellings - the other major component - is on track to post another increase in 2016, though growth was again moderate. Housing demand is likely to remain relatively subdued, dampening investment. Overall, total investment in the economy is forecast to decline by 0.5% this year and to increase only marginally (by 0.5%) in 2018.



Weaker pound to support exports

The growth in exports slowed last year following a strong performance in 2015. The improvement in competitiveness resulting from sterling's fall provided support, but the impact was diluted by the sluggish global economy (including the US over the first half of the year in particular). A pick up in global growth, led by reaccelerating activity in the US, together with on-going competitiveness gains should underpin exports, which are expected to increase by 3.2% this year and by 2.9% in 2018. In line with weaker domestic demand, import growth is forecast to slow, which means that net exports will make a positive contribution to GDP. Further out, the nature of the UK's new trading relationship with the EU will have an important bearing on how export and import patterns evolve.

Unemployment back above 5%

Employment has risen strongly in recent years and the unemployment rate stood at an 11-year low of 4.8% in the three months to November 2016. The pace of job gains has moderated lately, which is not too surprising given that the economy has been moving closer to full employment. Looking ahead, some surveys (e.g. from the Bank of England) point to subdued hiring intentions reflecting uncertainty about future demand prospects. With general economic activity softening, we expect employment growth to slow over the forecast horizon. In line with this, the unemployment rate is projected to increase to an average of 5.2% and 5.5% in 2017 and 2018 respectively. Earnings growth ticked up in the latter part of 2016, but with the jobs market easing is expected to remain moderate.

Housing activity to remain moderate

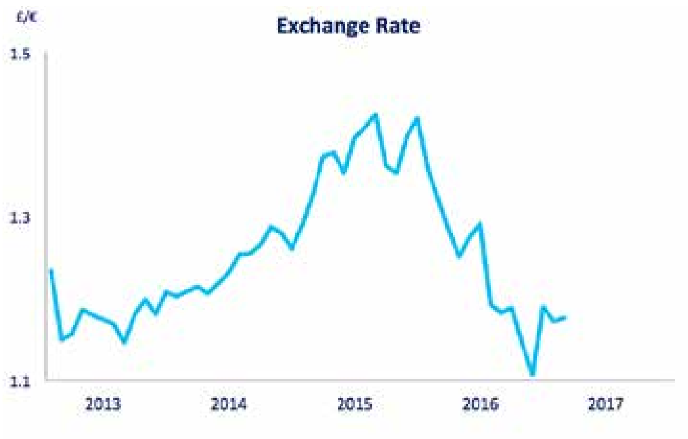
Activity in the housing market strengthened in the first quarter of 2016 ahead of the stamp duty increase on Buy to Let (BTL) purchases in April, but fell back in quarter two. It remained subdued following the Brexit vote, before picking up a little during the final quarter. New buyer enquiries increased according to the Royal Institute of Chartered Surveyors (RICS) surveys, as did transactions and mortgage approvals albeit both were still down on their late 2015 levels. House prices are rising at a solid enough pace, with the Nationwide index showing an annual increase of 4.3% in January 2017. Over the forecast horizon, uncertainty, along with weaker employment and real income growth, is likely to dampen demand, though low borrowing costs will provide some support.

Inflation to rise further

The annual rate of inflation has picked up notably of late. It stood at 1.6% in December 2016, up from 0.5% in June. Energy costs continued to fall on an annual basis through the middle of last year, thus pushing down on inflation, but are now increasing in line with the rebound in oil prices. This is likely to remain a source of upward pressure on inflation for some time, with the weaker pound also playing a key role. While slowing demand and a weakening of the labour market may dampen domestically-generated price pressures, inflation is expected to accelerate to 2.8% in 2017 and to average 2.5% in 2018. Higher inflation in turn will act as a significant drag on real income growth over the forecast period.

BOE to stay on hold

The Bank of England's Monetary Policy Committee (MPC) has kept monetary policy unchanged since August 2016, when it cut interest rates (by 25bps to 0.25%) and reactivated quantitative easing following the Brexit vote. It has adopted a neutral stance on interest rates since, saying it could move them 'in either direction' in response 'to changes in the economic outlook as they unfold'. If the economy slows as we expect in 2017, the MPC is likely to 'look through' the rise in inflation and keep interest rates on hold. Sterling has regained some ground recently, having weakened sharply following the referendum. Prime Minister May has laid out her 'Plan for Britain' post exit from the EU, and the way is being paved for the triggering of Article 50. We expect sterling to remain volatile in line with the ebb and flow of the forthcoming withdrawal negotiations.



Slower pace of fiscal consolidation

The Government's pre-Brexit vote target of achieving a budget surplus by financial year 2020-21 will be missed by a considerable margin, according to the Office of Budget Responsibility's (OBR) latest forecast. This partly reflects weaker growth over the coming years, as well as a discretionary slowing in the pace of fiscal consolidation to cushion the impact of Brexit on the economy. The budget deficit (i.e. public sector net borrowing) is now projected to fall to 3.5% of GDP for the financial year ending March 2017 and to decline to 0.7% by 2021-2022, which equates to a cumulative upward revision of £100 billion to the deficit relative to earlier plans. The OBR expects the public debt to GDP ratio to rise to 90.2% in 2017-18, almost 10 percentage points higher than previously forecast, before declining to 81.6% in 2021-2022.

Northern Ireland

Economic activity in Northern Ireland immediately after the Brexit vote was not as resilient as in the wider UK economy. The Composite Economic Index fell by 0.9% q-o-q in the third quarter of 2016 (after increasing by an average of 0.8% q-o-q over the first two quarters of the year), driven by declines in both the public and private sectors. More positively, output in the private sector rebounded in the final quarter of the year judging by the Purchasing Managers' Business Activity Index. It rose to a two and a half year high of 58.7 in December, with sterling's weakness contributing to a considerable increase in new export orders. The unemployment rate is declining gradually and stood at 5.6% in September- November, down 0.3 percentage points on the same three months in 2015. Meanwhile, the devolved administration has collapsed with elections scheduled for March 2nd.

Risks to the outlook

Brexit-related uncertainty is set to remain an important feature of the economic landscape over the coming years and may impact growth to a greater or lesser extent than factored into our forecasts. More specifically, the combination of uncertainty and higher inflation could result in consumer spending slowing by more than projected, thus posing a downside risk to our forecasts, though spending might be more resilient than allowed for if households significantly run down savings. Another upside risk to growth in the UK relates to global economic activity, which could be firmer than expected due to the potential for a sizeable fiscal stimulus in the US.

Bank of Ireland

The UK Economy

"Positive momentum to date to give way to slower growth"

Recent Developments

- Activity resilient post **Brexit** vote
- GDP ↑ **2.2%** YoY H2 2016
- Unemployment rate at **11 year** low

Brexit

- **Article 50** to be triggered by end March 2017
- MPs give approval following Supreme Court ruling

Government's "Plan for Britain" post Brexit

- Build a "Global Britain"
- "Ambitious" UK-EU FTA
- FTAs with non-EU countries
- Control of immigration & laws

A bespoke Free Trade Agreement (FTA)

- Out of single market but "greatest possible access"
- A new customs agreement or retain elements of EU Customs Union

Maintain Common Travel Area between **UK** and **Ireland**

Outlook

- Higher inflation to ↓ households' spending power
- Uncertainty to impact business investment and financial markets

But weaker pound to support exports

	2016e	2017f	2018f
GDP	2.0%	1.6%	1.5%
Consumer Spending	2.8%	1.7%	1.4%
Investment	0.5%	-0.5%	0.5%
Exports	2.4%	3.2%	2.9%
Employment	1.4%	0.5%	0.4%
Unemployment Rate	4.9%	5.2%	5.5%
Inflation	0.7%	2.8%	2.5%

Prepared by: Bank of Ireland Economic Research Unit
Sources: Bank of Ireland, Office of National Statistics, Bloomberg, HM Government

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