Bank of Ireland

Economic Research Unit

UK Outlook

July 2016

Weaker Economy Ahead

2016

GDP	EMPLOYMENT	UNEMPLOYMENT RATE	INFLATION
↑1.5%	↑0.9%	5.3%	↑1.0%

Uncertainty weighs on confidence

Softer labour market expected

Sterling's fall to support exports

BoE to cut interest rates

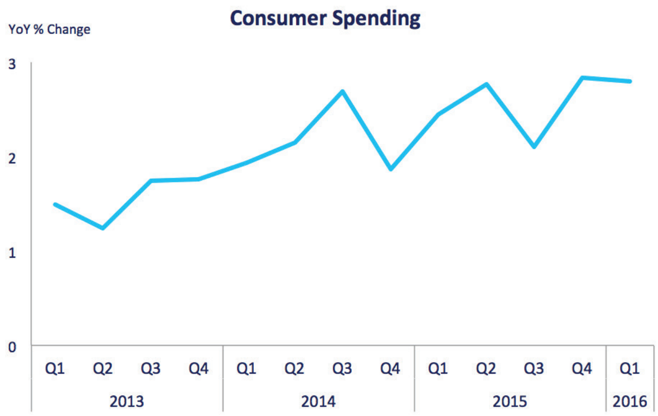
> **"The vote to exit the EU has led to an increase in uncertainty, which is impacting financial markets and will weigh on economic activity"**
>
> Loretta O'Sullivan
> Group Chief Economist

Overview The vote to exit the European Union in the referendum on June 23 marked the beginning of what is likely to be a protracted period of uncertainty in the UK. Once Article 50 of the EU Treaty is invoked by the Prime Minister, a two-year period (and potentially longer) of negotiations on withdrawal will commence. Increased uncertainty has already led to a fall in business and consumer confidence and is set to weigh on economic activity. Reflecting this, we have lowered our forecasts for growth in 2016 and 2017 and now expect GDP to increase by 1.5% and 0.7% respectively (compared to 2.3% in both years in our February Outlook). These new projections are consistent with the economy flirting with recession later this year and early next. Business investment had fallen in advance of the referendum and is forecast to decline further as expansion plans are delayed or cancelled. While consumer spending has been resilient to date, it is expected to soften as the labour market weakens. In addition, higher inflation resulting from the fall in sterling will dampen households' purchasing power, though the weaker pound should support exports. Policy action is also expected to cushion the impact on the economy, as the Bank of England looks set to cut interest rates and the government may well slow the pace of, or reverse, planned fiscal consolidation in the period ahead.

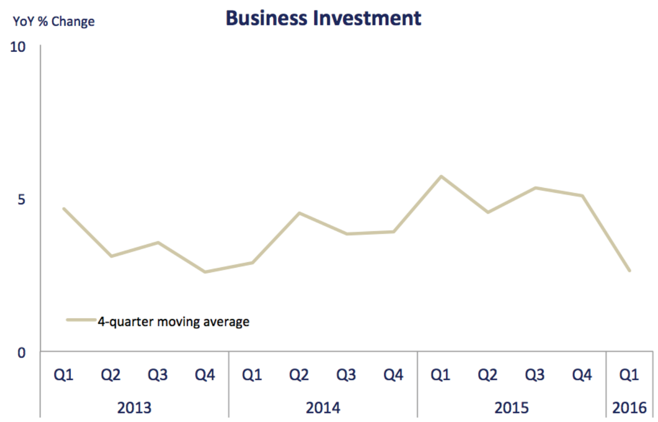
Outlook	2015	2016 (f)	2017 (f)
Personal Consumption	2.5%	2.0%	0.9%
Government Consumption	1.4%	1.0%	1.5%
Investment	3.3%	-0.4%	-3.8%
Exports	4.8%	3.4%	3.4%
Imports	5.8%	2.7%	1.9%
GDP	2.2%	1.5%	0.7%
Employment	1.8%	0.9%	0.1%
Unemployment Rate (Average)	5.4%	5.3%	5.7%
CPI	0.0%	1.0%	2.5%
£/€ (Average)	1.38	1.22	1.18
£/$ (Average)	1.53	1.34	1.26

Uncertainty weighs on confidence

Consumer spending rose by 0.7% q-o-q in Q1 2016, in line with its average quarterly growth rate in 2015, and retail sales data for April-June point to a further increase in the second quarter. Consumer confidence had eased a little ahead of the June referendum, while a snap GfK survey post the result showed a more pronounced fall. Increased uncertainty and a likely slowdown in the labour market is expected to weigh on confidence and spending, while higher inflation resulting from sterling's fall will also dampen households' purchasing power. Hence we expect the growth in consumer spending to slow to 2% for this year as a whole (from 2.5% in 2015), easing to 0.9% in 2017.



Total investment fell in Q1 (by 0.1% q-o-q) and the annual rate of growth slowed further (to just 0.7%). Business investment - the largest component - fell for a second consecutive quarter. Part of this weakness is sector specific (i.e. reduced investment in the oil and gas sector in response to lower oil prices) but, more generally, firms may have curtailed their spending plans ahead of the referendum. Given the increase in uncertainty post the vote, business investment is likely to contract further. Investment in dwellings rose by around 4% in 2015, with a similar rate of growth recorded in the opening quarter of this year. Housing demand is likely to be quite sensitive to increased uncertainty and so we expect this component of investment to soften also. Overall, total investment is projected to fall by 0.4% this year and by 3.8% next.



Sterling's fall to support exports

The annual growth in export volumes (goods and services) picked up in 2015, to almost 5% from around 1% in 2014. However, the pace of increase moderated over the final months of the year, and slowed again (to around 2%) in the opening months of 2016, reflecting weaker global activity, including a deceleration in US growth, and also perhaps the impact of sterling's past appreciation.

Looking ahead, a modest pick-up in global growth, helped by a reacceleration in activity in the US, together with the fall in sterling, should provide support to exports, which we expect to increase by 3.4% in both 2016 and 2017. The growth in imports is projected to slow in line with weaker domestic demand, and net exports are expected to contribute positively to GDP this year and next.

Softer labour market expected

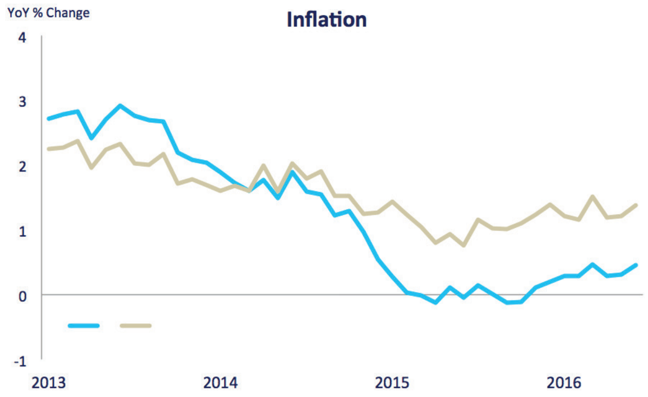
Employment growth, albeit remaining healthy, moderated in 2015 to 1.8% from 2.4% in 2014, and dipped a little further over the first 5 months of 2016. Job gains have continued to outstrip growth in the labour force, and the unemployment rate has fallen to 4.9%, its lowest level since October 2005. Notwithstanding the fall in unemployment, wage gains have been relatively subdued, though they have picked up somewhat since late last year. Early evidence following the Brexit vote points to firms postponing recruitment decisions, as noted by the Bank of England following its meeting in July. We expect the labour market to soften as economic activity weakens, with employment growth slowing and the unemployment rate moving up. The latter is forecast to average 5.3% for 2016 as a whole, increasing to 5.7% in 2017. In this environment, wage growth is likely to remain modest.

Housing activity may slow

The pattern of activity in the housing market in 2016 has been impacted by the increase in stamp duty on Buy to Let (BTL) transactions that came into effect at the beginning of April. A strong increase in activity in the first quarter gave way to some payback in April-May, with the number of housing transactions and mortgage drawdowns well down on Q1 levels. Annual house price inflation remained steady over the first half of the year however, at around 5% in both Q1 and Q2 according to the Nationwide Index. The Royal Institute of Chartered Surveyors (RICS) surveys (of estate agents) had reported a fall in new buyer enquiries in the run up to the Brexit vote, and weaker consumer confidence and slower employment growth may dampen housing demand. The Bank of England is likely to cut interest rates, though, which will provide support.

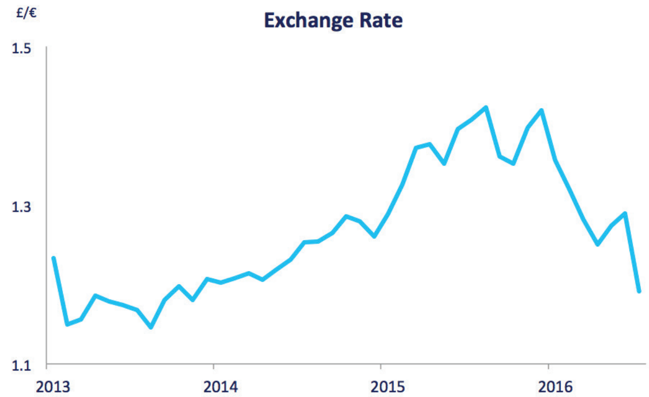
Inflation set to accelerate

Annual inflation has remained subdued in 2016, though at 0.4% for the first six months of the year it is running ahead of the outturn for 2015 as a whole (0%). The core rate has also picked up a little this year, to 1.3% in January-June from 1.1% last year. The slide in oil prices towards the end of 2015 and the start of this year has held down headline inflation, but this effect is now starting to unwind as oil prices have rebounded strongly in recent months. The fall in sterling, which accelerated following the Brexit vote, will also exert upward pressure on inflation via higher import prices. While weaker demand and a softer labour market will serve to dampen price pressures, we expect inflation to pick up quite notably over the second half of this year and through 2017. Our forecasts see the annual rate averaging 1.0% this year, rising to 2.5% in 2017.



BoE to cut interest rates

The Bank of England's MPC kept interest rates unchanged at 0.5% at its July meeting, but said there was the 'prospect of a material slowing of the economy' following the vote to exit the EU, noting too that the referendum result has 'affected sentiment among households and companies'. In light of this, 'most members' of the MPC expected 'monetary policy to be loosened in August', with the 'extent of…stimulus measures' to be based on the Committee's updated forecasts in its August Inflation Report. We expect the MPC to cut interest rates by 25bps in August and by a further quarter-point (to 0%) before year-end, while it may also reactivate its QE programme. Having remained in a range of 70-74p against the euro for much of 2015, sterling weakened in the months leading up to the referendum, trading between 76p-81p. It has fallen since late June, weighed down by the prospect of monetary policy easing, and our expectation is that sterling will establish a new trading range centred on 85p in the period ahead.



Fiscal policy may be eased

The budget deficit (i.e. net public sector borrowing) fell to around 4% of GDP for the financial year ending March 2016 (from 5% in the financial year 2014/15), slightly larger than expected at the time of this year's spring Budget. The latter envisaged a further steady decline in the deficit over the coming years with a small surplus expected in 2019. However, the new Chancellor of the Exchequer has said he will take into account the Brexit vote and its implications for the economy in his first pre-Budget statement in the autumn. This may well see the announcement of measures to slow the pace of, or reverse, the previously planned fiscal consolidation. Meanwhile, the net public debt ratio declined further in the last financial year to stand at just under 84% of GDP.

Northern Ireland

The Composite Economic Index of activity in Northern Ireland increased by 0.4% quarter-on-quarter in Q1 2016 and by 0.7% on an annual basis (following full-year growth of 1.6% in 2015). The private sector expanded again in the first quarter, but the public sector contracted as the numbers employed in this sector continued to fall. The latest Purchasing Managers' data suggest the economy grew again in Q2 but the pace of increase may have slowed, with the composite PMI index averaging 52.7 after 55.5 in Q1. Similar to the UK as a whole, increased uncertainty following the Brexit vote is likely to weigh on confidence and thereby dampen spending in the economy, though export-oriented businesses should benefit from the weaker pound.

Risks to the outlook

While increased uncertainty post the Brexit vote is set to weigh on economic activity, attempting to quantify the degree and impact is difficult and so an outcome better or worse than we are projecting is possible. More general risks to the outlook also remain, including those relating to on-going geopolitical tensions and global economic prospects.

THE UK ECONOMY

Bank of Ireland

Brexit

The UK voted to leave the European Union on 23rd June 2016

Leaving Mechanism

Negotiated withdrawal under Article 50 of the EU Treaty

• Two year timeframe

Post exit arrangements including the nature of the trade agreement with the EU to be determined

Possible Options

European Economic Area | Bilateral Swiss Type Arrangement | Customs Union | Free Trade Agreement | WTO

A New Relationship?

Short Term Outlook

Uncertainty

Impacting financial markets

To weigh on business and consumer confidence

	GDP	Consumer Spending	Investment	Exports	Employment	Unemployment Rate
2015	2.2%	2.5%	3.3%	4.8%	1.8%	5.4%
2016f	1.5%	2.0%	-0.4%	3.4%	0.9%	5.3%
2017f	0.7%	0.9%	-3.8%	3.4%	0.1%	5.7%

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