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UK Economic Forecast

The Q2 2018 ICAEW Economic Forecast, is based on the views of those running UK plc: ICAEW Chartered Accountants working in businesses of all types, across every economic sector and in all regions of the UK, surveyed through the quarterly ICAEW Business Confidence Monitor (BCM).

Q2 Key findings:

UK economy set for weakest growth performance since 2009

Business investment remains on hold

Wages may need to rise faster than expected

Input price inflation continues to outstrip selling prices

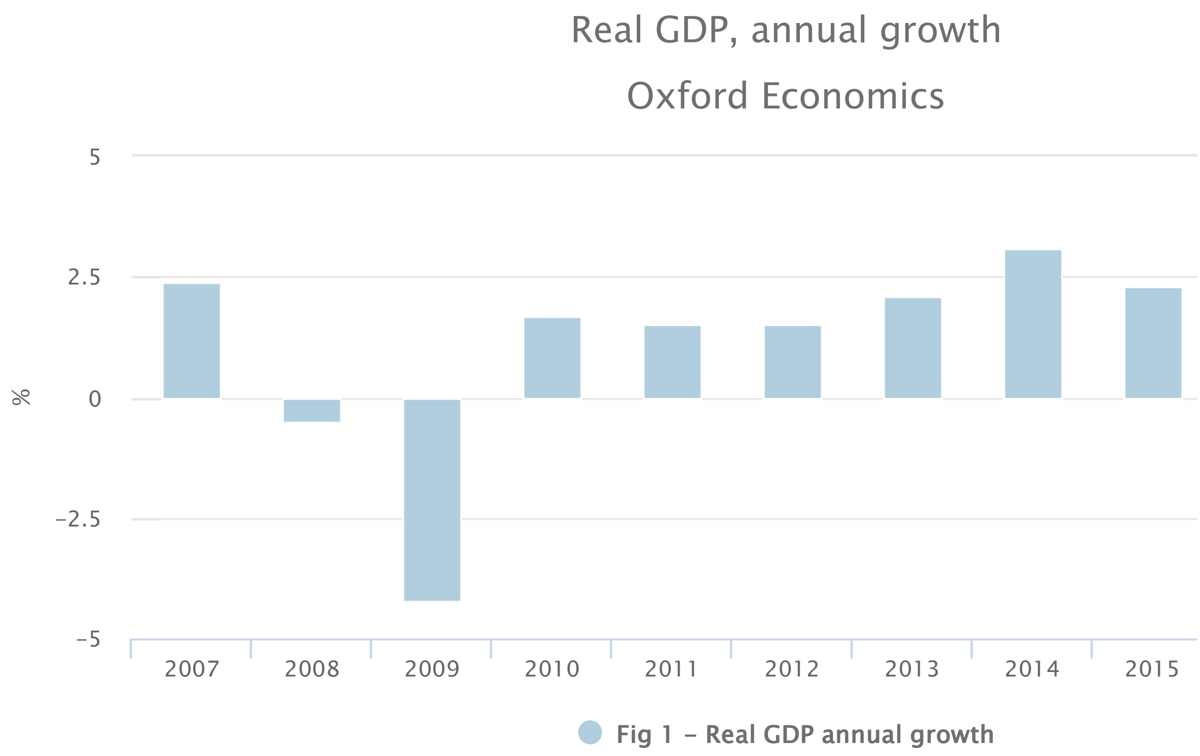
Economic outlook

UK economy set for weakest growth performance since 2009

Q1 2018 brought disappointing economic data, with UK GDP up 0.1% on the quarter, the weakest since Consumer spending grew at its slowest rate since 2014, and growth in exports was offset by growth in im But it's also important to note several unusual drags on activity in Q1 2018, including heavy snow in Febr March disrupting construction in particular.

Recent data has been more positive, with retail sales in April much better than in Q1, and broader service sector output also improving. Our forecast, derived from our **UK Business Confidence Monitor™ (BCM)** (/en/technical/economy/business-confidence-monitor/latest-business-confidence-monitor) data indicates a 0.4% expansion in GDP in Q2. But the pickup in oil prices will put pressure on both households and businesses (see Focus section), while the lack of progress on Brexit will continue to inhibit business investment (see next section). Both factors will weigh on growth through the rest of 2018.

Evidence from **BCM** (/en/technical/economy/business-confidence-monitor/latest-business-confidence-monitor) indicates an increasing divergence in confidence among exporting and domestic-facing businesses, with confidence among exporters rising more rapidly than non-exporters. Recent events in the global economy ie, trade and political tensions between the US and other countries, and political uncertainty in Italy, could pose a risk to this positive outlook though. Assuming no escalation in these risks, we forecast quarterly GDP growth to remain around 0.4% through the rest of 2018. The weakness of the first quarter will mean a disappointing outturn for 2018 overall, though, with forecast growth of 1.3% in our forecast, 0.4pp weaker than previously predicted.

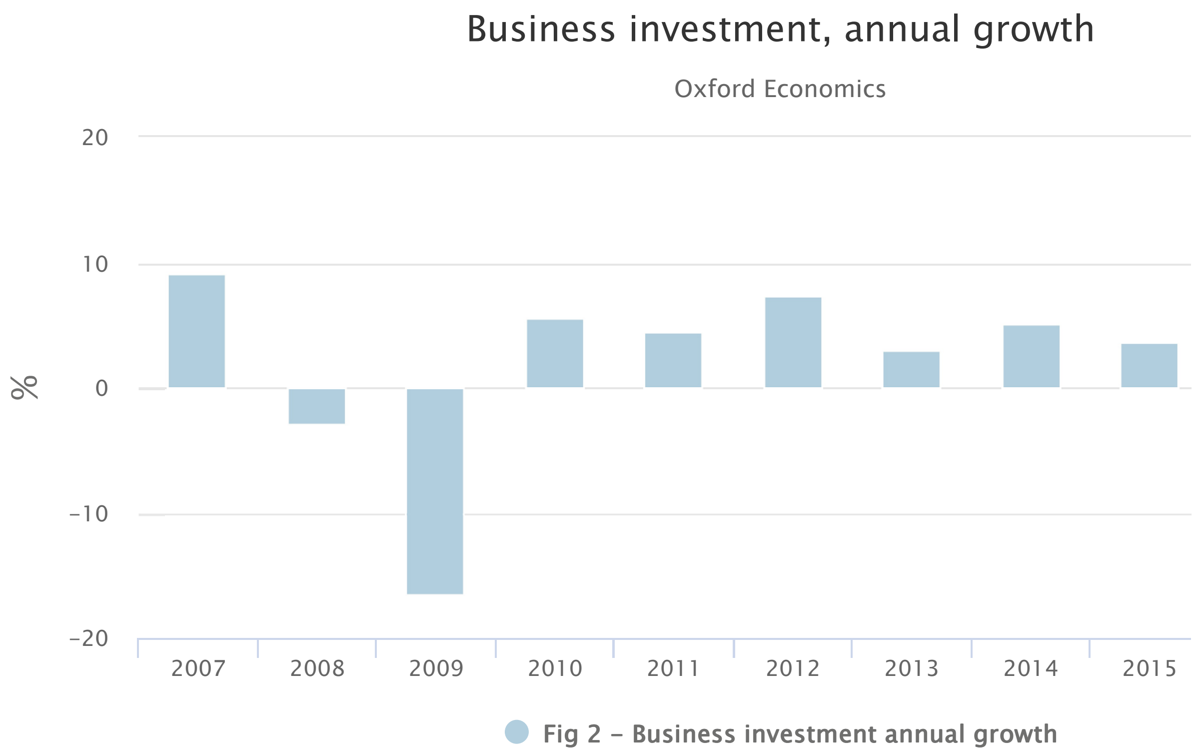


Business investment

Business investment remains on hold

Weaker business investment was one of the drivers of a disappointing Q1 2018 for the UK economy, but this series is notoriously volatile. Taking the data at face value, some of the weakness in investment is partly attributable to the temporary blows to construction output, (see previous section) with a sharp drop in North Sea investment also playing a role. Little has changed in terms of the fundamental question UK plc is facing – namely the future of the UK's trade and investment relationship with Europe. The 0.2% quarter-on-quarter contraction in capital spending in Q1 2018 therefore seems slightly out of kilter with modest growth seen in the four previous quarters, and some rebound in the coming quarters is likely.

Evidence from **BCM** (/en/technical/economy/business-confidence-monitor/latest-business-confidence-monitor) suggests business remains cautious. At 1.3% for 2018, our forecast is for minimal increase in capital investment, although companies are more upbeat about budgets for Research and Development. However, as we note in our Focus section, there are increasing concerns about the degree of spare capacity in the labour market. Businesses may need to decide between bidding up wages, or increasing capital spending a little faster than anticipated to achieve their growth plans. Moreover, with interest rates set to start rising again, business may want to take the opportunity to raise finance and invest now, ahead of higher borrowing costs later.



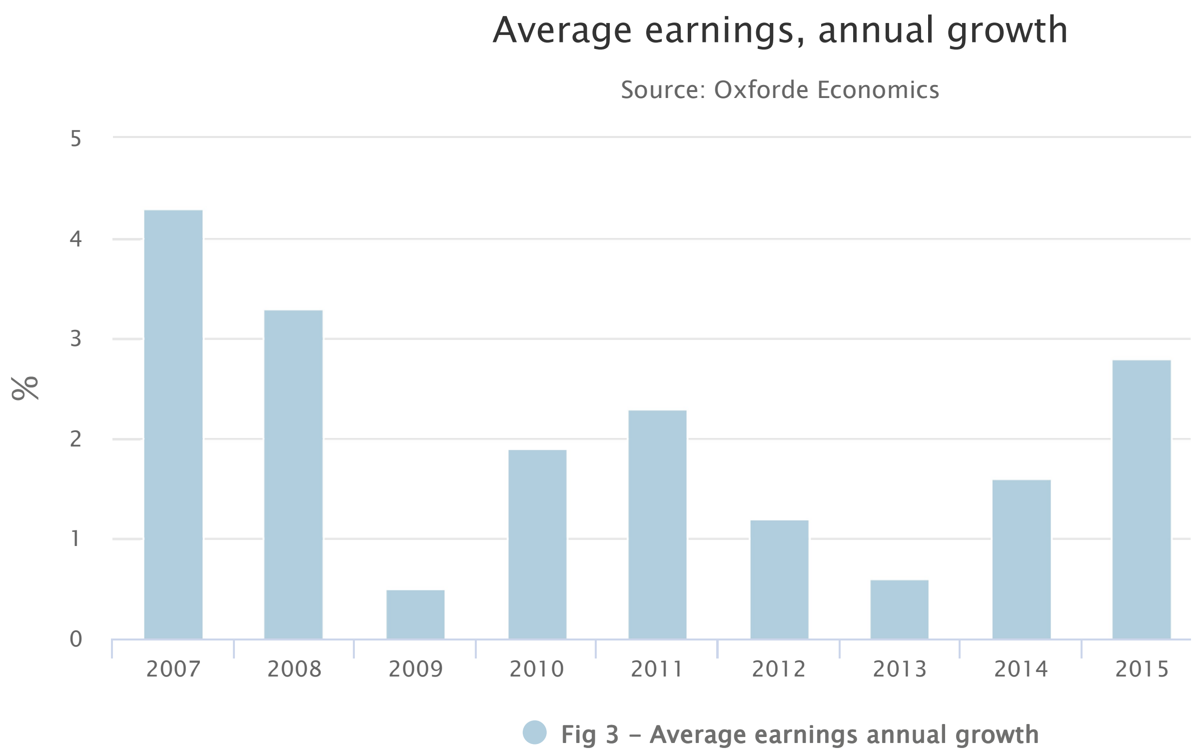
Labour market

Wages may need to rise faster than expected

The UK labour market had an impressive start to 2018 – employment rose by 197,000 during Q1 2018, the biggest increase since late 2015, when the economy was growing at a relatively firm 2% annual rate. Moreover, the proportion of working-age people in employment ticked up to an all-time high of 75.6%, while the unemployment rate remained at its 43-year low of 4.2%.

But despite the apparently buoyant demand for labour, the picture on wages was more mixed. Average weekly earnings (AWE) excluding bonuses have picked up, with March recording growth at 2.9% on a year ago, a 29-month high. But on an AWE including bonuses basis (which perhaps offers an additional insight into business profitability and optimism), wage growth eased back to a three-month low of 2.6%.

Our forecast suggests the rate of job creation will cool through 2018. At 0.9%, our forecast for growth in total employment in 2018 is 0.1pp lower than in 2017, and 0.5pp lower than in 2016. This would stabilise the unemployment rate around current readings but, given the weakness of GDP growth, this suggests another poor year for productivity growth. Our forecast for growth in AWE including bonuses is 2.5% for 2018 overall, up 0.1pp from 2017. But with the number of spare workers much-diminished, businesses may need to raise pay faster than expected if they face difficulties recruiting or retaining the staff they need.


Average earnings, annual growth
Source: Oxforde Economics
5
4
3
2
1
0
%
2007
2008
2009
2010
2011
2012
2013
2014
2015
Fig 3 - Average earnings annual growth

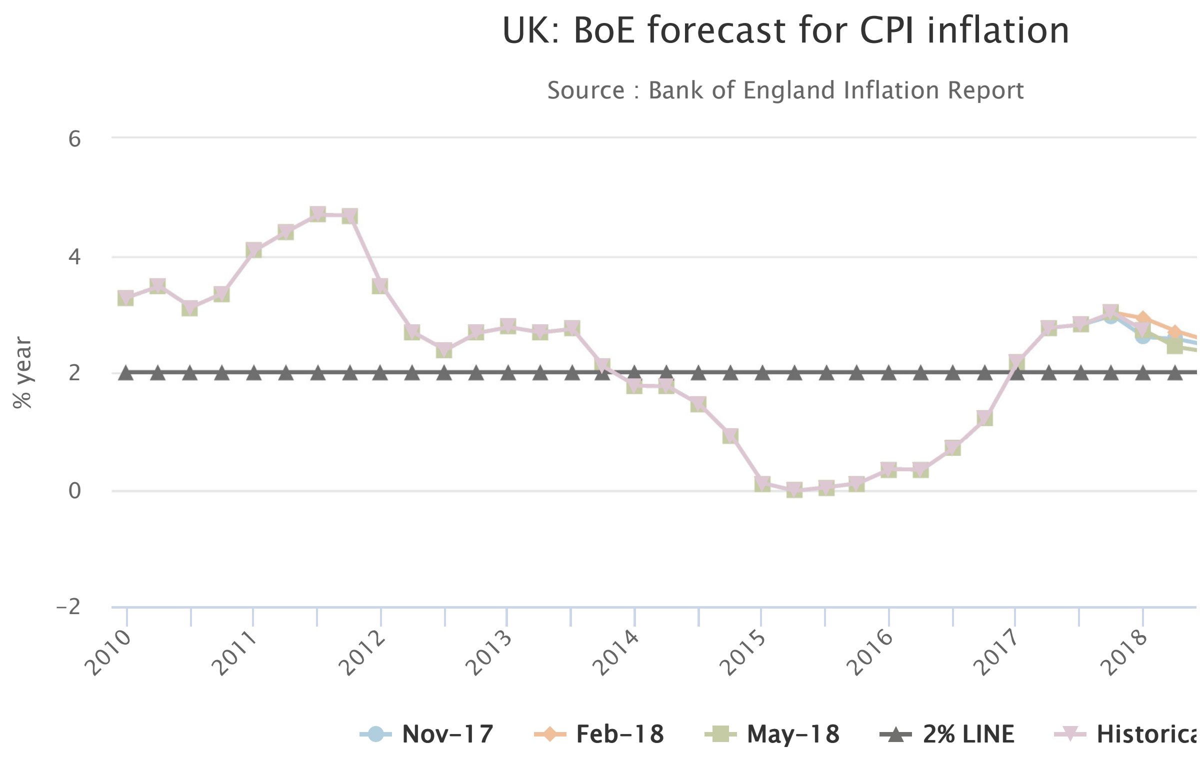
Focus: Input price inflation continues to outstrip selling prices

Moving into H2 2018, the financial environment for businesses looks set to become gradually more favourable, with slowing (but still-elevated) input cost inflation alongside relatively stable selling price growth. If this pattern continues, businesses could see profitability improve through 2018-2019. But the possibility of businesses needing to increase wages higher than anticipated (see the labour market section), and the likelihood of higher borrowing costs could both limit the improvement in the bottom line.

From an input cost perspective, businesses are starting to see the impact of the post-referendum depreciation of sterling fade – the Bank of England's May 2018 Inflation Report noted this was happening a little faster than expected. But recent financial and commodity market developments are less favourable. The pound has fallen 6% versus the dollar since mid-April, augmenting the rise in oil prices from around $60 per barrel in February to just above $76 at the time of writing. This will particularly affect intensive users of transport services and energy. Overall, although latest evidence from **BCM** (/en/technical/economy/business-confidence-monitor/latest-business-confidence-monitor) shows expectations for input costs starting to ease, input cost inflation is expected to remain well above the average of recent years into mid-2019.

On the other side of the ledger, although expectations for selling price growth (according to **BCM** (/en/technical/economy/business-confidence-monitor/latest-business-confidence-monitor)) are in line with the long-run average, the gap between selling price growth and input price growth is expected to remain wider than the historical norm well into 2019. To protect margins, businesses are controlling labour costs. Our forecast is for wages to grow at a relatively steady 2.5% in 2018 but with increasing concern about staff turnover, companies may struggle to contain the rate of expected wage growth.

These are issues the MPC is closely focused on ahead of its meeting on 21 June. The decision not to raise rates in May was regarded as a U-turn given earlier signals hinting at a rate increase. But with an ever-diminishing degree of spare labour it seems likely the committee will tighten policy, perhaps in August. This could raise businesses debt-servicing costs, squeezing profitability. But the pace of tightening is predicted to be very modest – the May Inflation Report suggests that market expectations for just three rate hikes between now and 2021 will be enough to achieve the Bank's 2% inflation target.



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

Useful links

- **Economic Insight: Middle East** (/en/technical/economy/economic-insight/economic-insight-middle-east)
- **Economic Insight: South East Asia** (/en/technical/economy/economic-insight/economic-insight-south-east-asia)
- **Economic Insight: Africa** (/en/technical/economy/economic-insight/economic-insight-africa)
- **Economic Insight: Greater China** (/en/technical/economy/economic-insight/economic-insight-greater-china/archive/2018-q1)
- **Business Confidence Monitor** (/en/technical/economy/business-confidence-monitor)

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