UK Economic Forecast

The Q1 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).

Q1 Key findings:

- **GDP growth to remain below 2% in 2018.**
  The UK economy remains constrained by the combination of faster-than-usual inflation, and continued uncertainty over the future. The Bank of England has become increasingly hawkish over inflation prospects, meaning a faster pace of monetary tightening is likely. Our forecast is for the UK economy to expand 1.7% in 2018. This is modestly faster than in our Q4 2017 forecast, but nevertheless would mark the third consecutive year of growth below 2%.
- **Slow growth in investment – at least for now.**
  The rate of business investment growth (on a year earlier) has been broadly stable around 2% since the EU referendum, and we forecast 1.8% growth in 2018. There seems little evidence to expect a step change until we see greater clarity on the UK's post-Brexit relationship with the EU. But UK plc remains in good financial shape, and business investment could rebound more forcefully if business felt more optimistic about future trade and investment flows.
- **Gradual pickup in wages, as companies compete for workers.**
  Recent data shows that little spare capacity remains in the labour market. Combined with a slower rate of inward migration, this means the pace of employment growth will slow to just 0.7% in 2018, half the pace of 2016. Meanwhile, we forecast wages to rise 2.7% in 2018, 0.5pp faster than companies' own expectations.
- **Movement at last on trade?**
  Though the government has finally revealed its vision of the future trading relationship with the EU, the EU is unlikely to accept its proposed approach. The EU is likely to push for the UK to choose between either a Canada-style free-trade agreement or EEA membership, like Norway, with the former a more likely option..

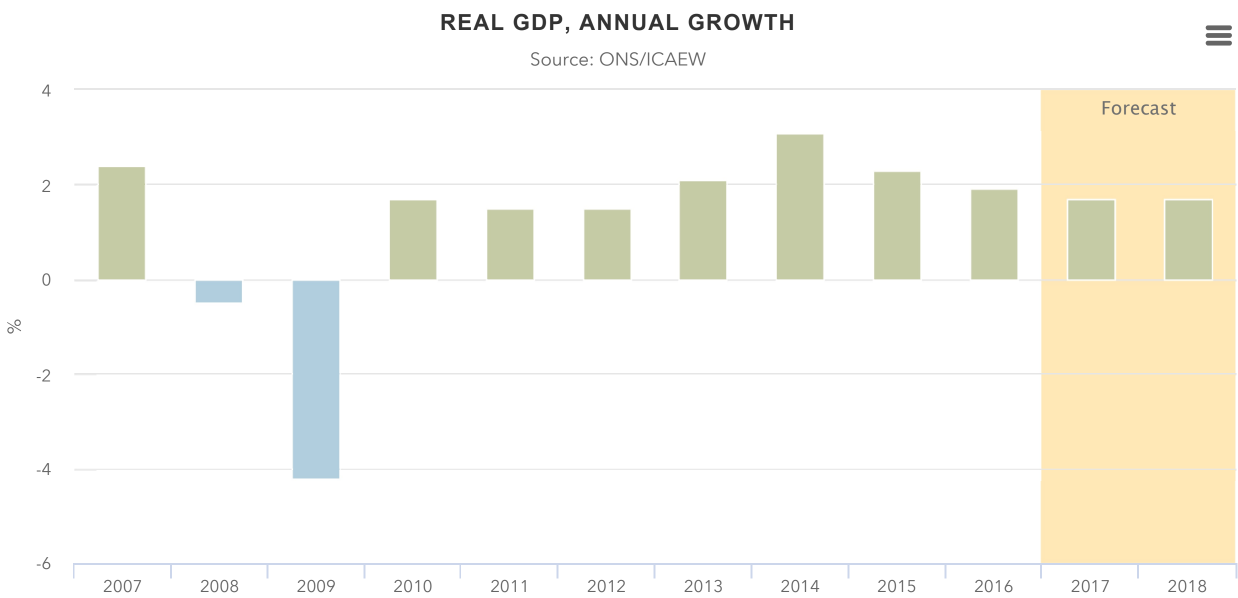
Economic outlook

Economy forecast to grow 1.7% in 2018 – third consecutive year at below 2%.

The UK economy grew 0.4% in Q4 2017, 0.1pp slower than Q3, but broadly in line with the average seen over 2016-2017. Within this, government spending made the largest contribution to growth, with business investment flat, the trade deficit widening, and another weak increase in household spending.

There seems little immediate reason to expect an acceleration in any sector of the economy in 2018. After one of the worst Christmases in 20 years, retail sales improved modestly in January, but may be further hampered by recent bad weather. Meanwhile a range of business surveys have also weakened modestly in the early months of 2018. Our own forecast, driven by evidence from the **ICAEW Business Confidence Monitor (BCM)™** (https://www.icaew.com/en/technical/economy/business-confidence-monitor/latest-business-confidence-monitor), is for GDP growth of 0.3% in Q1 2018.

Drags on growth are likely to persist through 2018. With inflation cooling only gradually, consumers will remain squeezed. Meanwhile a stronger pound may mean the best competitive conditions for exporters are behind us. This is increasingly pertinent given the MPC now seems to be planning two rate hikes in 2018 rather than one. Finally, a rebound in investment seems unlikely without further detail on post-Brexit trading arrangements (see next section). Our forecast is therefore for GDP growth of 1.7% in 2018. This is modestly higher than our last forecast, but largely reflecting upward revisions to GDP growth in Q3 2017 – these give an arithmetic boost to the level of GDP in 2018 versus 2017. Nevertheless, this would mark the third year of growth below 2%, following an average rate of 2.5% per annum in 2014-2015.



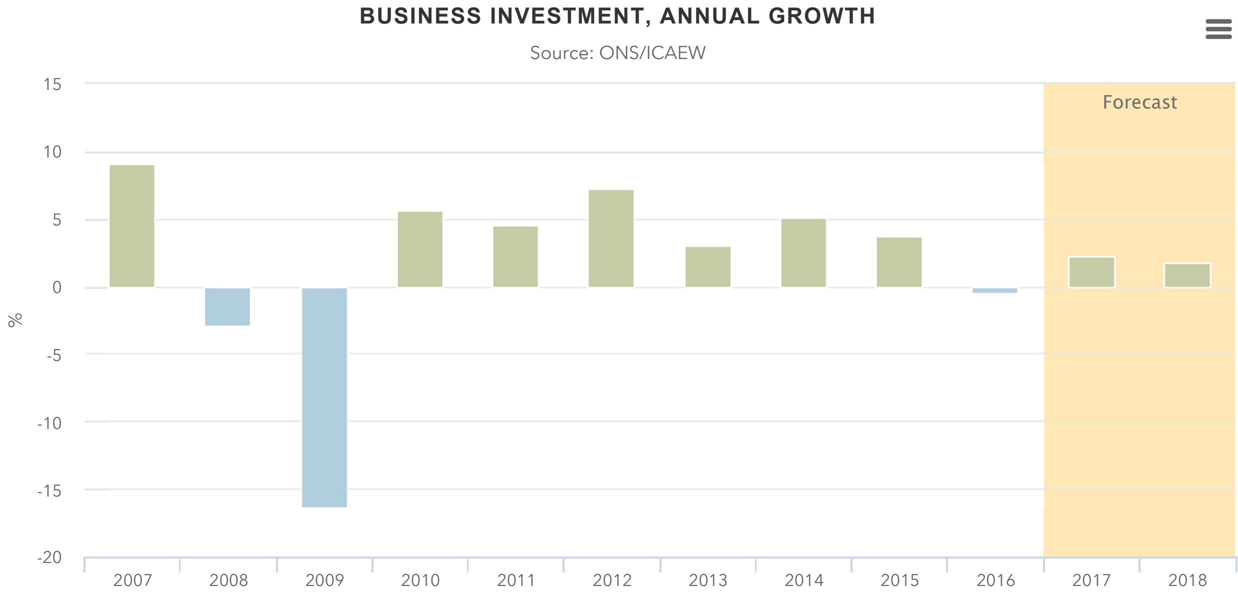
Business investment

"New normal" business investment growth will persist until post-Brexit landscape becomes clearer

Business investment data is notoriously volatile and prone to revision. But the pattern of the past couple of years points towards capital spending being in something of a holding pattern, pending greater clarity over the UK's post-Brexit trade and investment relationship. Business investment was flat on the quarter in Q4 2017, albeit 2% higher compared to a year before. This is broadly in line with the average year-on-year rate of growth since the EU referendum.

As we have noted for some time, the fundamental conditions for business investment remain very supportive. Total corporate profits rose broadly in line with GDP in 2017, while non-financial companies' wealth relative to GDP remained close to an all-time high. Moreover, even after potentially two rate rises in 2018, interest rates will remain very low by historical standards. As such, business faces few financial constraints to faster capital spending.

Our forecast, informed by data from BCM, is for business investment to grow 1.8% in 2018. This will be partly driven by companies needing to expand capacity to raise output during a period of scarcer labour (see next section). More positively, recent weeks have seen both the government and opposition set out more clearly competing visions of the UK's trade relationship with the EU (see Focus section). If this leads to greater clarity in actual negotiations with EU partners, this could help resolve one of the key uncertainties preventing a faster pickup in investment spending this year.



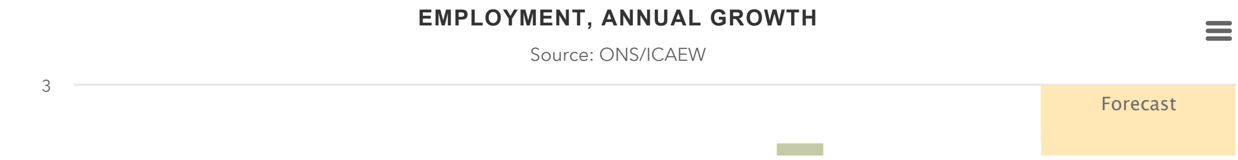
Labour market

Employers will need to increase wages to secure workers in 2018

Recent labour market data have been consistent with there being little spare capacity remaining in the UK labour market. Both employment (up 88,000) and unemployment (up 46,000) rose in the three months to December. The increase in both people in work and people seeking work was facilitated by an increase in the participation rate (the proportion of working-age people in or actively seeking work) – up from 78.4% in Q3 2017 to 78.7% in Q4 2017, the joint-highest on record.

The rate of job creation will slow in 2018 though. Recent migration data showed that although inward migration of EU citizens has remained reasonably stable over the past year, the outflow of EU citizens from the UK rose to the highest level since 2008. BCM also reports staff turnover is an increasing concern for business. The ONS' Vacancy Survey suggests that the number of unfilled jobs is at a record high. Our forecast is for private sector employment to grow by just 0.7% in 2018, 0.3pp weaker than last year and half the pace of 2016. This will leave the unemployment rate broadly stable at 4.4% in 2018.

In this context of decreased labour availability, it seems likely the pace of wage growth will need to pick up through 2018. Our forecast, based on evidence from BCM but estimated econometrically, is for average wage growth in 2018 at 2.7%. This is around half a percentage point faster than companies' own expectations, suggesting that UK businesses may find themselves having to increase wages more than they expect in the coming year.



Focus: The UK's trade framework, post-Brexit

The Prime Minister set out last week her proposals for trade with Europe post-Brexit. Under her proposals Britain would negotiate an agreement involving:

• Tariff-free trade

• A customs agreement, removing the need for customs at the border, but short of a customs union

• The UK remaining part of regulatory bodies in areas such as chemicals, medicines and aerospace

• "A comprehensive system of mutual recognition" for other sectors, with a new independent mechanism to help resolve disputes.

Overall, the UK is seeking maximum leeway to negotiate new trade deals, while minimising friction in UK-EU trade. But it is unlikely the EU will be prepared to negotiate such a deal. Indeed, the EU has already made clear a "pick and mix" approach is not possible, and that there are two models available; a free-trade agreement (FTA) like the EU has with Canada, or membership of the European Economic Area (EEA), like Norway.

The FTA would offer the UK maximum flexibility to agree new trade deals, but would add friction to UK-EU trade. The sectoral and regional impacts of an FTA would of course depend on the agreements reached. But FTAs typically offer little on services trade, so it is likely UK financial services firms would find it harder to export to the EU (with a particular impact on London). An FTA model would also necessitate customs and regulatory checks. This would complicate trade across the Irish border, where agricultural supply chains are particularly heavily-integrated between Northern Ireland and the Republic. As such, a FTA would require agreements on regulation and customs, covering either Northern Ireland or the whole of the UK.

Membership of the EEA would enable the UK to continue to enjoy access to both goods and services markets in the EU on the same terms as currently. But it would require the UK to abide by all four freedoms of movement (goods, services, capital and people). Since both main UK parties have pledged not to allow free movement of people, a Canada-style deal seems far likelier given the government's current approach. Oxford Economics estimates suggest that GDP will be 3% lower in 2030 under a FTA versus a "no Brexit" scenario.

However, a sizeable minority of Conservative MPs favour a "no deal" exit, moving straight to World Trade Organisation "Most Favoured Nation" (MFN) rules when the UK formally leaves in March 2019. Oxford Economics analysis suggests "no deal" would result in GDP being almost 4pp lower than in a "no Brexit" by the end of 2030.

Economic Forecast reports are produced with ICAEW's partner Oxford Economics, one of the world's foremost advisory firms. Their analytical tools provide unparalleled ability to forecast economic trends.

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.

Key resources

- **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)
- **Business Confidence Monitor** (/en/technical/economy/business-confidence-monitor)

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