Economic Update: UK

The ICAEW Economic Update: UK, 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).

Q4 2019 Key findings:

Brexit distortions fade, but underlying weakness in GDP growth persists

Business investment remains down in the dumps

Cracks emerge in the jobs market

Austerity comes to an end

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Economic outlook

Brexit distortions fade, but underlying weakness in GDP growth persists

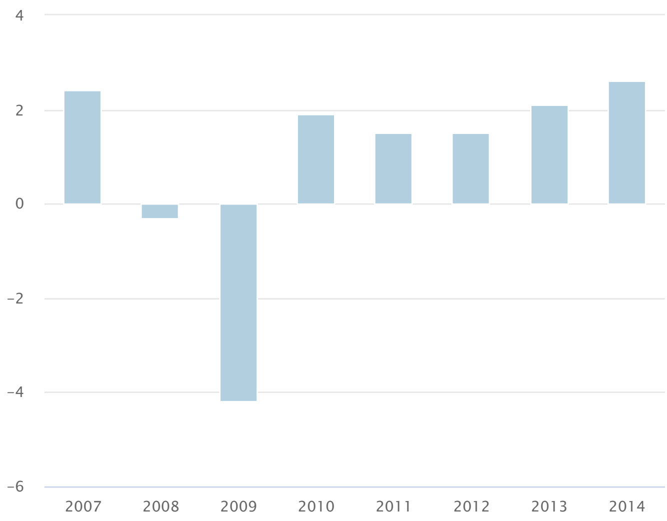
Interpreting the performance of the economy in the first half of this year was complicated by activity being successively boosted, then hindered, by companies stockpiling and then destocking because of Brexit-related contingency plans. Those distortions were less evident in Q3, but a soft underlying pace of expansion continued. GDP rose 0.3% on the quarter, below expectations, leaving the year-on-year rise at 1%, the weakest since Q1 2010.

Among the components of GDP, consumer spending expanded 0.4%, with the services sector growing by the same amount. And there was a sizeable positive contribution from net trade. But despite the imminence of another Brexit deadline at the end of October, the level of inventories dragged on output, while the manufacturing sector stagnated.

The outlook for growth in Q4 is poor. Declines in output in August and September offer a poor launchpad for the final quarter of the year. And retail sales fell by 0.1% in October, the third successive month in which sales have either been flat or have fallen. These developments are consistent with the message of the ICAEW Business Confidence Monitor™ (BCM) that the economy will flatline in the final three months of the year.

Stagnation in Q4 would cap GDP growth in 2019 at 1.2%, resulting in an underwhelming starting point for growth next year. So even with positives from greater political certainty stemming from December's general election outcome and the high likelihood that the UK will now leave the EU in an orderly fashion in January, we expect growth next year of only 1%, which would be the slowest since 2009.

Real GDP, annual growth



Business investment

Business investment remains down in the dumps

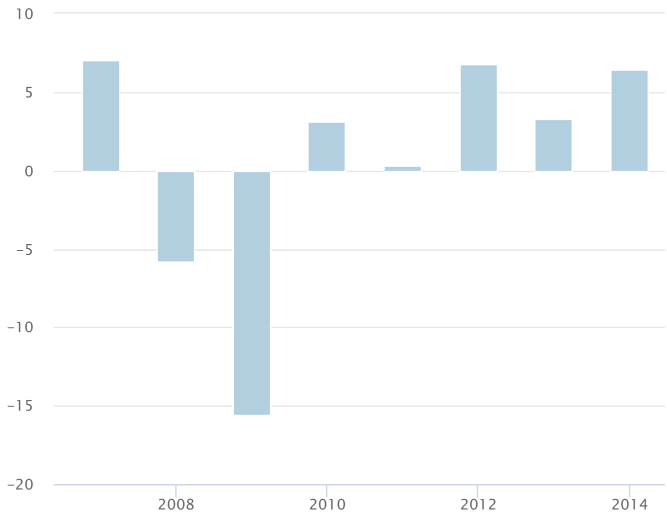
Although flat business investment in Q3 was a relative improvement on the second quarter's 0.4% drop, it still left this element of GDP as a key weak spot of the economy. In fact, with six of the last seven quarters delivering either contraction or stagnation in business investment, the level of spending by firms in Q3 on fixed assets like machinery and buildings was 1.2% lower than at the time of the EU referendum in 2016.

Survey evidence suggests that uncertainty stemming from that vote has weighed heavily on businesses' willingness to invest. Indeed, the BCM's latest Confidence Index showed sentiment at a 10-year low. So the Conservative Party's victory in December's general election and the route this creates towards ratification of the UK-EU withdrawal agreement by the current 31 January 2020 deadline offers some upside for the performance of business investment in 2020.

But ratification of that deal would still leave the UK's future trading relationship with the EU to be negotiated. And whether those negotiations can arrive at a trade deal by the end of the transition period in December 2020 is a moot point. So while political uncertainty may well reduce, it will far from disappear. Moreover, a sluggish growth outlook, both at home and abroad, will constrain the incentive to invest.

These factors reinforce our expectation that, following a predicted drop of 1% this year, 2020 will see business investment remain in contractionary territory, falling 0.5%.

Business investment, annual growth



Labour market

Cracks emerge in the jobs market

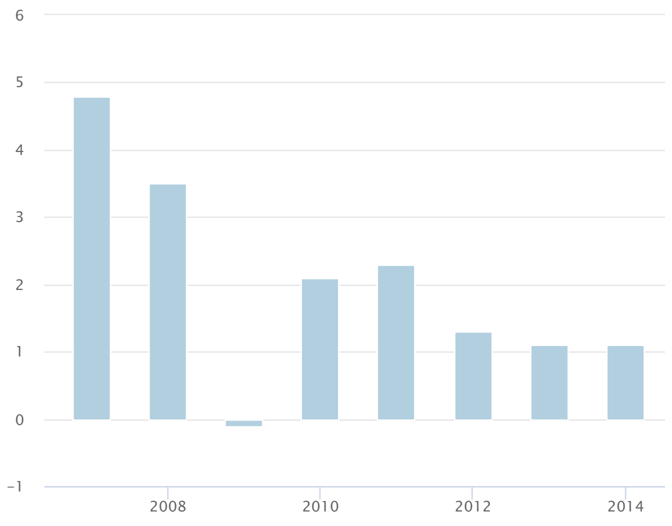
Against the backdrop of a sluggish economy, the UK jobs market had displayed a degree of immunity. But that immunity now appears to be fading. Q3 saw the first quarterly drop in employment in two years. Moreover, job vacancies continued to decline, falling to the lowest level in two years. And while the Labour Force Survey (LFS) unemployment rate ticked down to 3.8% in Q3 from 3.9% three months earlier, this reflected a drop in the size of the labour force, not more people in work.

There have also been signs of weakening on the pay front. Annual growth in regular pay slipped from 4% in Q2 to 3.7% in Q3. That said, this was still the second fastest rise since 2008. And more timely evidence from pay settlement surveys suggests that the pay growth may have bounced back towards the end of 2019.

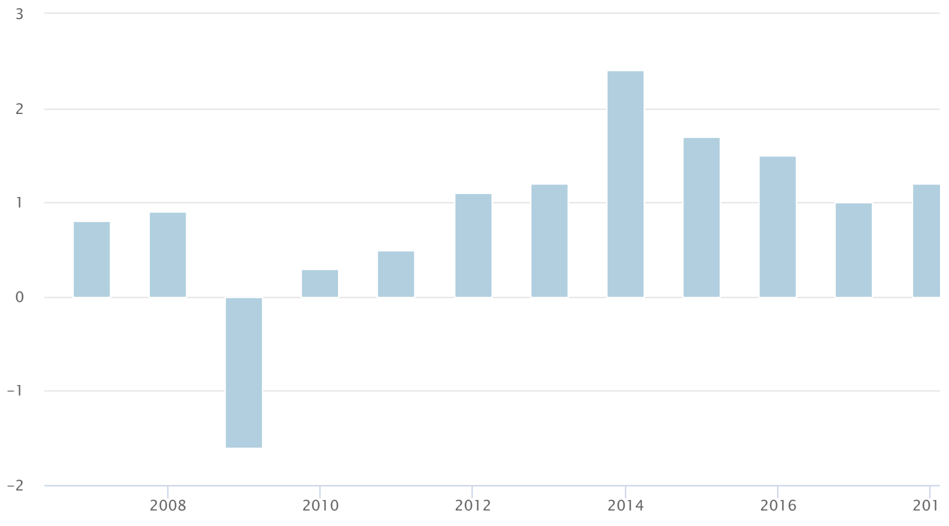
Looking forward, the continued drop in job vacancies suggests the labour market is likely to continue cooling, at least on the quantities side. So while the number in work is forecast to rise by a robust 1% this year, growth is expected to slow to 0.5% in 2020, a pace which would be the softest since 2010.

Meanwhile, following a forecast rise of 3.3% in 2019 (which would be an 11-year high), growth in average weekly earnings is expected to slow to 2.9% next year as sluggish growth in economic activity and no sign of productivity growth reviving take their toll.

Average earnings, annual growth



Employment growth on year ago



Focus – Fiscal austerity comes to an end

One reason behind the UK economy's historically weak expansion since the last recession in 2008-09 has been the drag from fiscal austerity. Government borrowing reached a peak of almost 10% of GDP in 2009-10. But, aided by public spending restraint and tax rises, the deficit dropped to 1.9% of GDP in 2018-19. In real terms spending per person, overall government expenditure has fallen by around 5% since 2010. Meanwhile, the taxes as a share of GDP have increased from the equivalent of 36.4% of GDP in 2009-10 to 38% of GDP in 2018-19.

But fiscal austerity now looks to have ended. Although the scale of general election spending commitments made by the Conservative Party were dwarfed by those of Labour, the new Tory government is still set to preside over an increase in public spending as a share of the economy. Just before the election, Chancellor Sajid Javid had announced a 4.1% real terms rise in day-to-day spending by government departments for 2020-21, the biggest for 15 years. On top of this, the Conservative manifesto pledged further rises in spending on the NHS and other areas. The new government will also introduce a rule permitting spending of up to 3% of GDP on public sector investment (the current level is around 2.3% of GDP). Compared to current plans, this would allow an additional £20bn of infrastructure spending per year. Overall, the drop in public spending as a share of GDP seen since 2009 will see a partial reverse over the next few years, while borrowing is set to grow.

So having acted as a drag on economic growth, fiscal policy should support momentum in the economy. But the extent of that support is debatable. One determinant is the degree of spare capacity in the economy and the extent to which extra government borrowing creates new activity or diverts activity from the private sector. Low unemployment suggests that spare capacity is limited, but, conversely, low inflation points to the economy having more room to grow in a sustainable manner.

A second factor is how the Bank of England reacts. If the Bank judges that looser fiscal policy will cause the economy to overheat and inflation to rise, it will respond by raising rates more rapidly than otherwise, with tighter monetary policy offsetting the boost to growth from looser fiscal policy. On that issue, Mark Carney will be replaced as governor of the Bank of England in January 2020 — how optimistic, or pessimistic, that individual is towards the economy's potential, could be key.

UK: Total public expenditure

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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) (https://www.icaew.com/technical/economy/economic-insight)** 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.

Webinars

- **Q4 2018: Budget Brexit and Business Confidence** (https://event.on24.com/wcc/r/1888390/D86278595CE9914A59C58CAEFF999A8B)
- **Q3 2018: Autumn Economic Weather Forecast** (https://event.on24.com/eventRegistration/EventLobbyServlet?target=reg20.jsp&referrer=&eventid=1831111&sessionid=1&key=82A8CE60B8AD30D7058FF46AAEED264C&regTag=&sourcepage=register)
- **Q2 2018: End of term Economic Report Card: The outlook gets cloudier** (https://event.on24.com/wcc/r/1773897/BD4616D80B96EDD9B6B960D42D071956)
- **Q1 2018: Is a rise in interest of interest to businesses?** (https://event.on24.com/wcc/r/1632842/F125066CD0B5B2CBA183B12F435CC9DD)
- **Q4 2017: Autumn Budget 2017: What does the future hold for the UK Economy?** (https://event.on24.com/wcc/r/1522744/20FE07D86A58756BAFF1A4D67583FBEC)

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