2 – UK Economic prospects after Brexit

Key points

- UK economic growth had slowed somewhat to around 2% before the EU Referendum, but the vote to leave the EU could lead to a significant further slowdown.

- In our main scenario, we now project UK growth to slow to around 1.6% in 2016 and 0.6% in 2017 due to the increased political and economic uncertainty following the 'Brexit' vote. The UK would narrowly avoid recession in this scenario, although risks are weighted to the downside. Businesses need to make contingency plans for these alternative outcomes.

- The main reason for the slowdown is an expected decline in business investment, particularly from overseas in areas like commercial property, due to uncertainty about the UK's future trading relationships with the EU and other key trading partners.

- Consumer spending growth is projected to hold up better, but will still slow from previous strong rates, dropping to around 1.3% in 2017 in our main scenario. This reflects the impact of a weaker pound in pushing up import prices and squeezing the real spending power of households, as well as slower jobs growth.

- The weaker pound should also boost net exports, however, which should move from being a negative drag on growth in 2015 to a positive contributor in 2017. This should also see the UK current account deficit begin to shrink from recent high levels.

- Service sector growth will slow but should remain positive in 2016-17, but construction will suffer from lower investment levels. Capital goods manufacturers will suffer for the same reason, but some manufacturing exporters will benefit from the weaker pound.

- We project that London will remain the fastest growing region but its pace of expansion could slow from around 3% in 2015 to just over 1% in 2017. Other regions will see even more modest growth in 2017, though we do not predict negative growth in any region in 2017 in our main scenario.

- The UK recovery is also exposed to global risks related to possible problems in China and some other large emerging economies leading to further volatility and weakness in international financial markets. However, there are also upsides associated with the gradual recovery we have seen in the Eurozone economy, which we expect to be only slightly dampened by Brexit.

- The Bank of England seems likely to relax monetary policy in the short term through a mixture of lower interest rates, asset purchases and credit easing, which should help to support growth.

- We would also expect fiscal policy to be reasonably supportive, with public borrowing allowed to rise to take the strain of slower growth and possible cuts in corporation tax rates to support business investment.

Introduction

In this section of the report we describe recent developments in the UK economy and review future prospects. The discussion covers:

Section 2.1	Recent developments and the immediate impact of Brexit
Section 2.2	Economic growth prospects after Brexit: national, sectoral and regional
Section 2.3	Outlook for inflation and real earnings growth
Section 2.4	Monetary and fiscal policy options
Section 2.5	Summary and conclusions

2.1 Recent developments and the immediate impact of Brexit

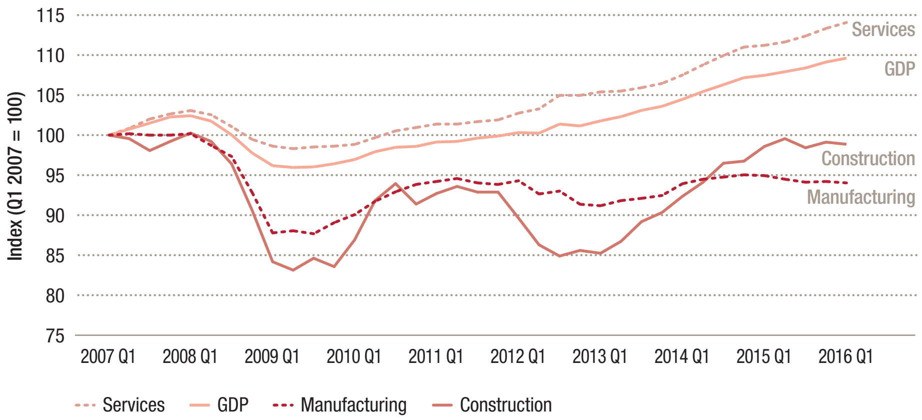
UK economic growth slowed from around 3% in 2014 to around 2% in the year to Q1 2016. This slowdown reflects sluggish global growth as well as, more recently, uncertainty related to the outcome of the EU Referendum.

The general pattern, as shown in Figure 2.1, was for services sector growth to remain relatively strong, while the recoveries in manufacturing and construction have stalled recently. This pattern has also been seen in the generally stronger trends in purchasing managers' indices (PMIs) for services and manufacturing, although the latter did see a pick-up in June ahead of the referendum while the services PMI fell back somewhat (see Figure 2.2).

Consumer spending remained relatively robust in the run-up to the referendum, but business investment growth turned negative in late 2015 and early 2016. Commercial property transactions and financial market deals both fell back significantly as investors waited for the EU referendum result.

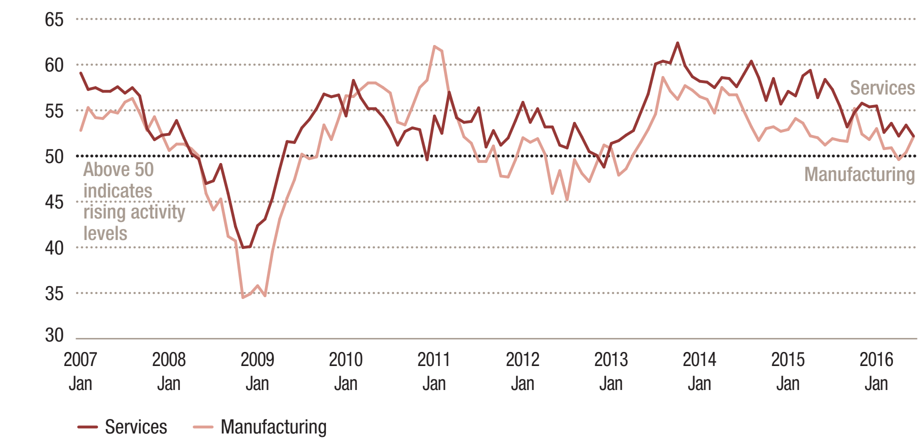
Following the vote to leave the EU on 23rd June, the most immediate effects were seen in financial markets. Most obviously there was a sharp fall in sterling (see Figure 2.3), particularly against the dollar where it fell to its lowest levels since the mid-1980s. The fall against the euro was less marked, remaining within the normal trading zone of recent years (although lower than it had been previously during 2016 as the chart shows).

Figure 2.1 – Sectoral output and GDP trends



Source: ONS

Figure 2.2 – Purchasing Managers' Indices of business activity



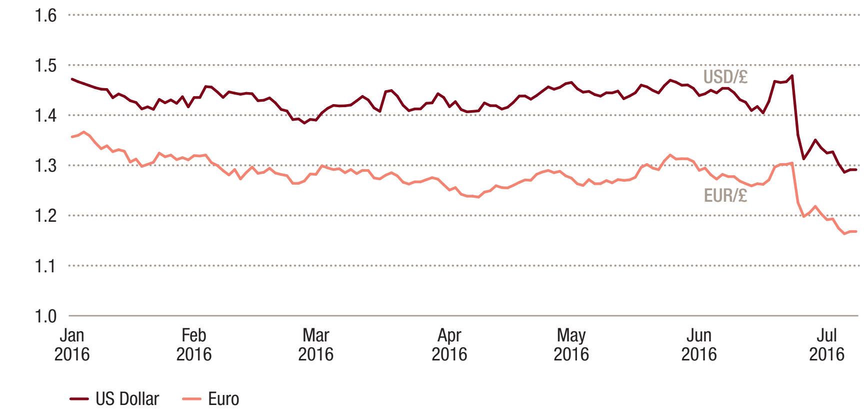
Source: Markit/CIPS

Stock markets have also been very volatile, with the FTSE 100 first falling and then rising in the week after the referendum. The rapid recovery seems to reflect a number of factors, including:

- The FTSE 100 having a heavy weight of global multinationals influenced by wider international trends not just what is happening in the UK. The more domestically-focused FTSE 250 saw a larger fall though it has also recovered to a more modest degree from the initial shock (see Figure 2.4).
- The weak pound raised the value of overseas earnings in sterling, which again particularly supported the FTSE 100 where these overseas earnings are more important than for the FTSE 2050.
- Gilt yields fell sharply and remain very low, in part due to a flight to safety and in part due to lower expected official interest rates in the UK following Brexit. This implied a rise in the price of bonds, which made equities look cheaper by comparison and so supported their rebound from initial post-Brexit lows.
- There has been particular weakness in commercial property funds, leading some of them to suspend investor withdrawals in early July to prevent forced sales of illiquid assets. The Bank of England is monitoring this situation carefully for any signs of further contagion.

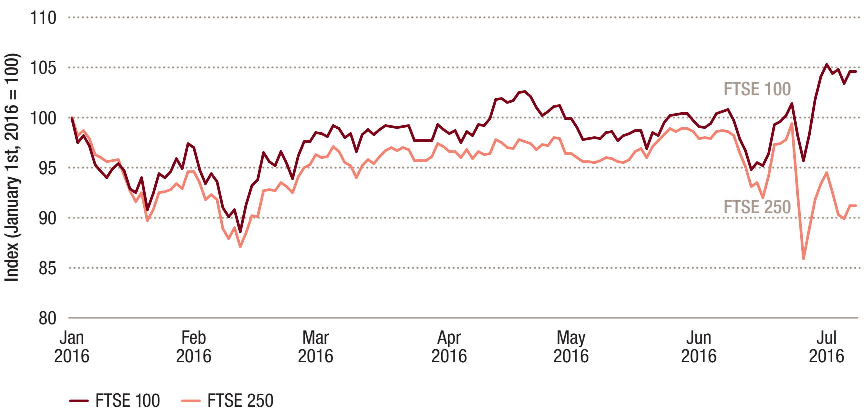
It would be wrong to draw overly strong conclusions from these early market gyrations, and we would expect continued financial volatility going forward. But some of these movements – a weak pound and lower interest rates – seem likely to be lasting effects of Brexit and are factored into our view of future UK economic prospects. Trends in equity markets are much less clear at this early stage.

Figure 2.3 – US dollar and euro exchange rates against the pound



Sources: Thomson Reuters Datastream

Figure 2.4 – UK equity market indices



Source: Thomson Reuters Datastream

2.2 Economic growth prospects after Brexit: national, sectoral and regional

Prior to the Brexit vote, we were expecting UK growth to dip to 1.9% in 2016 before recovering to 2.3% in 2017. Following the EU referendum result, we have revised down our growth projections significantly for the second half of 2016 and 2017, with the level of GDP being around 2.5% lower by the end of 2017 than in our previous main scenario, which was conditioned on the UK voting to remain in the EU. This produces the average annual growth rates shown in Table 2.1[1].

Overall, we still expect growth to remain positive on average in 2017, with the economy narrowly avoiding recession and starting to recover later next year as negotiations with the EU proceed. We assume here that monetary policy is supportive (as discussed further in Section 2.4 below), public borrowing is allowed to rise in the short term to absorb some of the impact of slower growth, and that some progress is made during 2017 on negotiating a free trade deal with the EU, even though all the details of this are unlikely to be agreed until later.

Consumer spending growth remained strong in the first half of 2016, but we expect a moderation in this later in 2016 and into 2017, so that annual growth falls to around 1.3% next year. This reflects a squeeze on real earnings growth from a stronger pound raising import prices, as well as weaker employment and, as discussed in detail in Section 3 below, slower house price growth.

Table 2.1 - PwC main scenario for UK growth and inflation

% real annual growth unless stated otherwise	2015	2016p	2017p
GDP	2.2%	1.6%	0.6%
Consumer spending	2.6%	2.5%	1.3%
Government consumption	1.4%	1.4%	0.8%
Fixed investment	3.3%	-1.4%	-4.6%
Domestic demand	2.5%	1.4%	0.3%
Net exports (% of GDP)	-0.5%	-0.2%	0.3%
CPI inflation (%: annual average)	0.0%	0.7%	1.8%

Source: ONS for 2015, PwC main scenario projections for 2016-17

The main drag on growth will come from business investment, which had already weakened before the referendum and is likely to be particularly hard hit by the vote to leave the EU. This will be particularly true of foreign investment in commercial property and in sectors aimed at accessing the EU single market. While we assume some kind of free trade agreement is eventually reached with the EU, this will take time and (given the need to increase control over immigration) will almost certainly involve some reduction in access to the EU single market relative to the current position. Even if tariffs on goods are largely avoided, non-tariff barriers are likely to increase.

Government consumption growth will be less affected, but is likely to remain moderate in line with previously announced plans (although these could be revised in November's Autumn Statement).

UK net exports may move in a more favourable direction, making a positive contribution to GDP growth in 2017 as import demand weakens and the fall in the pound helps exports and import substitutes to become more competitive. This should also help to moderate the large current account deficit, which helps to explain the weakness of sterling.

Overall, our growth projections are broadly similar to the latest average of independent forecasters, which see UK growth falling to around 0.4% in 2017. But all economic projections are subject to particularly large uncertainties at present after the shock of the Brexit vote.

1 These projections are calibrated to be broadly consistent with the 'Free Trade Agreement' (FTA) scenario in our March 2016 report for the CBI on the economic implications of leaving the EU, which is available here: http://www.pwc.co.uk/services/economics-policy/insights/implications-of-an-eu-exit-for-the-uk-economy.html

Alternative growth scenarios – businesses need to make contingency plans

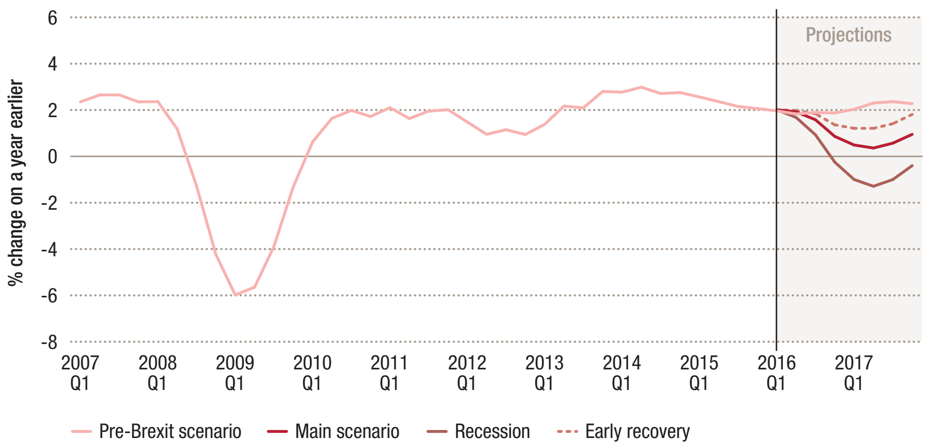
To reflect these uncertainties, we have also considered two alternative UK growth scenarios, as shown in Figure 2.5.

- Our '**early recovery**' **scenario** projects growth to dip in the next few quarters before picking up again to around 1.5% on average in 2017. This is a relatively optimistic scenario which assumes that good early progress is made on retaining access to the EU single market and that there are favourable trends in US and euro area growth.

- On the other hand, our '**recession scenario**' sees UK GDP growth fall to around -1% in 2017 as the global outlook worsens and there is little progress in early negotiations with the EU, suggesting that the UK may have to fall back on WTO rules with consequent imposition of tariffs on trade with the EU. This would deepen and prolong the period of uncertainty around the outcome of Brexit, reducing investment, jobs and growth.

We do not believe that these two alternative scenarios are the most likely outcome, but they are certainly possible and, at present, risks do appear to be weighted to the downside given the political and economic uncertainties posed by the EU referendum result. Businesses would therefore be well advised to make appropriate contingency plans for such less favourable outcomes, but without losing sight of the more positive possibilities for the UK economy should these downside risks not materialise.

Figure 2.5 – Alternative UK GDP growth scenarios



Source: ONS, PwC scenarios

More generally, companies should be making detailed contingency plans for the immediate impact of Brexit[2] on all aspects of their businesses, covering the kind of questions listed in Table 2.2.

Table 2.2: Key issues and questions for businesses preparing for Brexit

Issues	Implications	Questions
Trade	The EU is the UK's largest export partner, accounting for around 45% of total UK exports – leaving the EU is likely to make trade with EU more difficult.	• How much do you rely on European countries for revenue growth? • Have you reviewed your supply chain to identify the impact of tariffs on your procurement? • Have you identified which third party contracts would require a renegotiation in the event of a Brexit?
Tax Contributions	The UK would no longer be required to make a financial contribution to the EU and would gain more control over VAT and some other taxes.	• Have you thought about the impact of potential changes to the EU tax framework? • Have you upgraded your systems to deal with a significant volume of tax changes?
Regulation	The UK is subject to EU regulation. Brexit may mean less red tape. It could also mean that UK businesses could have to adapt to a different set of regulations, which could be costly.	• Have you quantified the regulatory impact of Brexit to keep your stakeholders up-to-date? • How flexible is your IT infrastructure to deal with potential changes to Data Protection laws? • How ready is your compliance function to deal with potentially new reporting requirements arising from Brexit?
Sectoral effects	The UK is the leading European financial services hub, which is a sector that could be significantly affected by Brexit. Other sectors which rely on the EU single market will also feel a strong impact.	• Have you briefed potential investors on the impact of Brexit for your sector and organisation? • How up-to-date are your contingency plans in place to deal with Brexit? • Are you aware of the impact of illiquidity and volatility in financial markets on your capital raising plans?
Foreign direct investment	FDI from the EU made up around 46% of the total stock of FDI in the UK in 2013. Brexit could put this inbound investment at risk.	• How much do your rely on FDI for growth? • Have you considered alternative sources of funding aside from banks? • How are your competitors responding to the risk of Brexit? • Have you informed your investors on your plans for a post-Brexit UK?
Labour market	The UK may change its migration policies. Currently EU citizens can live and work in the UK without restrictions. Business will need adjust to any change in this regime.	• How reliant is your value chain on EU labour? • Have you communicated with your UK employees from elsewhere in the EU? • Have your compliance function considered the additional cost of hiring foreign labour?
Uncertainty	Uncertainty has increased since the referendum and may continue into the negotiation period.	• Can you manage volatility in the Sterling exchange rate? • Have you communicated your stance on Brexit to your key stakeholders, customers and suppliers? • Is your organisation ready for a worst-case scenario where there is a prolonged period of uncertainty?

2 For more material on the potential impact of Brexit on your business, please see our EU Referendum hub here: http://www.pwc.co.uk/the-eu-referendum.html

Construction hardest hit, but all sectors likely to slow due to Brexit

The sector dashboard in Table 2.3 shows the actual growth rates for 2015 along with our projected growth rates for 2016 and 2017 for five of the largest sectors within the UK economy. The table also includes a summary of the key issues affecting each sector.

The outlook is clearly stronger for private non-financial services than other sectors, but all are likely to be negatively affected by leaving the EU.

Construction may be hardest hit due to its reliance on large scale capital investment projects that may be particularly prone to be delayed or even cancelled due to uncertainty following the vote to leave the EU. Commercial property is also being hit hard, particularly in London. Manufacturers of capital goods may also be hard hit for the same reasons, although some exporters will gain from the weaker pound.

Financial services companies could also be affected by any loss of access to EU markets, notably through the possible loss of 'passporting' rights for UK-based firms[3].

Table 2.3: UK sector dashboard

	Growth			
Sector and GVA share	**2015**	**2016**	**2017**	**Key issues/trends**
Manufacturing (10%)	-0.1%	-0.7%	-1.0%	Manufacturing PMI rose in June, but activity trends generally weak over past year Capital goods manufacturers vulnerable to fall in investment after vote to leave EU But exporters should gain from weaker pound, limiting the fall in total output
Construction (6%)	4.2%	-0.7%	-2.0%	The construction sector fell back in the second half of 2015 and early 2016, with the June PMI the weakest in seven years Our projections reflect the high vulnerability of construction projects to delay or cancellation after Brexit vote
Distribution, hotels & restaurants (14%)	4.6%	3.8%	1.2%	ONS figures show that retail sales volume growth was healthy up to May, but consumer confidence and spending may be hit by vote to leave Prices continue to fall on the high street and online due to fierce competition Slower real earnings growth and possible job cuts could hit retail, hotels and restaurant spending after vote to leave EU
Business services and finance (32%)	2.9%	2.1%	1.1%	Business services and finance sector saw some slowdown in early 2016 and could be vulnerable to shift of some financial services out of London/ UK due to Brexit Financial sector also faces regulatory challenges but business services have been stronger and should recover after Brexit
Government and other services (23%)	0.3%	1.4%	1.2%	Civil service and local authority spending is expected to be cut back in real terms over the next few years, but growth should remain positive for the NHS and schools Tax and spending plans to be reviewed in Autumn Statement
Total GDP	**2.2%**	**1.6%**	**0.6%**	

Sources: ONS for 2015, PwC for 2016 and 2017 main scenario projections and key issues.
These are five of the largest sectors but they do not cover the whole economy - their GVA shares only sum to around 85% rather than 100%.

3 The potential impact on financial services was considered in detail in our April 2016 report for TheCityUK, which can be accessed here: http://www.pwc.co.uk/industries/financial-services/insights/leaving-the-EU-implications-for-the-UK-financial-services-sector.html

Figure 2.6 – PwC main scenario for output growth by region in 2016 and 2017

Source: PwC analysis

Regional prospects: all parts of the UK likely to see slower growth due to Brexit

London is expected to continue to lead the regional growth rankings in 2016, expanding by around 2.2% as shown in Figure 2.6. Most other regions are expected to expand at rates closer to the UK average of around 1.6%, but Northern Ireland is expected to lag behind somewhat with growth of around 1%.

More marked slowdowns are expected in all regions in 2017 as the effects of the vote to leave the EU come through, though we are not projecting negative growth in any region in our main scenario. Growth in London might fall to just over 1% in 2017, while it could be close to zero in Northern Ireland.

It is important to note that regional output data are published on a much less timely basis than national data. As a result, the margins of error around these regional projections are even larger than for the national growth projections and so they can only be taken as illustrative of broad directional trends.

There is also a strong case to look at a broader range of indicators of regional economic performance, as discussed further in Section 4 of this report. This focuses in particular on the relative performance and prospects of the Northern regions of England. The geographically divided nature of the EU vote arguably reinforces the case for further investment to promote growth in the Northern Powerhouse and other regions outside London. It could also raise further issues around devolution in Scotland and elsewhere.

2.3 Outlook for inflation and real earnings growth

Consumer price inflation (CPI) remained low at 0.3% in the year to May. The major cause of this persistently subdued inflation has been the low level of global prices for oil and other commodities, but unit labour cost growth also remained low despite the tightening of the labour market in recent years. Looking ahead, however, the 12 month inflation rate will tend to rise back to target as earlier commodity price declines fall out of the index and the effects on import prices of the recent fall in the pound feed through. But weaker demand due to the vote to leave the EU will offset this to some degree in 2017 and beyond.

Alternative inflation scenarios

In our main scenario we are projecting an average consumer price inflation rate of 0.7% in 2016, which we have revised up since our last Economic Outlook report in the face of the recent weakness of the pound and a modest recovery in oil prices since February. We project a gradual rise back to close to the 2% target rate by the end of 2017 (see Figure 2.7) as these commodity price effects are assumed to fall out of the 12 month inflation rate calculation and the effect of the recent fall in the pound comes through. But this is subject to particularly significant uncertainties at present due to the offsetting effects of the vote to leave on the pound and on aggregate demand.

To capture these we have also considered two alternative scenarios for UK inflation:

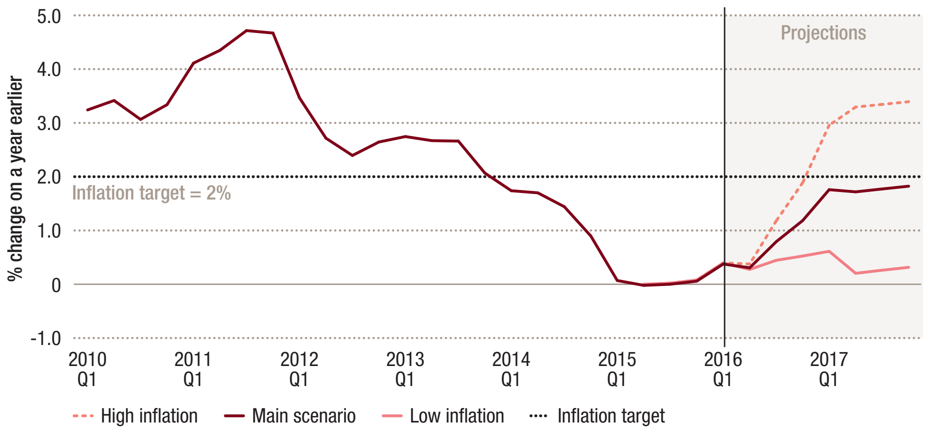
- In our '**high inflation**' **scenario** we project inflation to rise to over 3% in 2017 as a result of the weaker pound and a possible pick-up in global commodity prices if other economies grow more strongly.
- In our '**low inflation**' **scenario**, by contrast, the UK and Eurozone economies weaken by more in the aftermath of Brexit, as do global commodity prices. In this case UK inflation could remain close to zero.

As with our GDP growth scenarios, these two alternative variants are not as likely as our main scenario. But given recent volatility and uncertainty, businesses should plan for a broad range of outcomes after Brexit.

Consumer price inflation exceeded earnings growth for six consecutive years following the onset of the 2008-9 recession, which was in marked contrast to pre-crisis norms. Positive real earnings growth resumed in 2015 and early 2016 as consumer price inflation fell to close to zero, but nominal earnings growth in cash terms was still only around 2%, which remains weak by historical standards.

We had been assuming a gradual pick-up in earnings growth in 2016-17, but this is now much less clear after the vote to leave the EU. On the one hand, somewhat higher consumer price inflation due to the weaker pound could feed through into higher nominal earnings growth, but on the other hand this could be offset by weaker economic growth and so labour demand after Brexit. Balancing these two effects, our preliminary projection is that earnings growth remains fairly flat in 2016-17 at just over 2% in cash terms, with real earnings growth declining slightly in 2016 and more markedly in 2017. But there are considerable uncertainties around any such projections at present.

Figure 2.7 – Alternative UK inflation (CPI) scenarios



Source: ONS, PwC scenarios

Figure 2.8 – CPI inflation vs average earnings growth

Source: ONS, PwC analysis

2.4 Monetary and fiscal policy options

Monetary policy expected to be loosened in short term

The Financial Policy Committee (FPC) has already taken early action by eliminating the 0.5% countercyclical capital buffer for UK banks. The FPC estimates that this could add up to £150 billion to bank lending capacity, although there is no guarantee that this will be used if the demand for loans is not there, or if banks remain understandably cautious about new lending following the Brexit vote.

The Monetary Policy Committee (MPC) is expected to loosen monetary policy over the summer, as has already been signalled by the Governor of the Bank of England. This could combine a number of measures including rate cuts, asset purchases and credit easing (e.g. through extension of the Funding for Lending Scheme).

We would not expect this action to offset all of the negative demand effects of the vote to leave the EU, but they should offer continued support to asset prices and could dampen the blow to business investment and economic growth to some degree.

Public borrowing higher as growth slows

The UK budget deficit stood at around £75 billion in 2015/16 and initial evidence is that it was falling only very slowly in early 2016/17 even before the EU referendum. After the vote to leave, it seems likely (as the Chancellor has recognised) that budget deficit projections will need to be revised up significantly in both the short term and the medium term. We would expect the fiscal automatic stabilisers[4] to be allowed to operate in full to dampen somewhat the potential negative impact on growth from the vote to leave the EU. The former Chancellor, George Osborne, also mentioned the possibility of further corporate tax cuts in the medium term, on top of existing plans to reduce the main rate to 17% by 2020, in order to incentivise inward investment in particular after Brexit. But it remains to be seen if the new government will pursue this proposal.

Specific fiscal policy measures and updated official public borrowing projections have been delayed until the Autumn Statement. We will update our own public borrowing projections ahead of this statement in the light of emerging evidence on the fiscal impact of the vote to leave the EU.

2.5 Summary and conclusions

UK economic growth slowed a little in 2015 and early 2016, but remained close to its long-term trend at around 2% per annum prior to the EU referendum. However, the vote to leave seems likely to lead to a significant slowdown in the UK economy.

In our main scenario, we project UK growth to fall to around 1.6% in 2016 and around 0.6% in 2017, narrowly avoiding recession. This assumes some monetary loosening to support growth and reasonable early progress over the next 12-18 months in negotiating a free trade deal with the EU. It also assumes no major new adverse shocks to the global or EU economies.

The main reason for this significant slowdown in UK growth is projected to be a downturn in business investment, which will particularly hit the construction, commercial property and capital goods sectors. Consumer spending growth is also projected to slow to just over 1% in 2017 from close to 3% recently, reflecting slower real income growth (partly due to higher import prices) and possible job losses. But stronger net exports, helped by the weaker pound, should dampen the scale of the fall in overall GDP growth.

There are considerable uncertainties around any such projections at present, with risks being weighted to the downside until the negotiating position with the EU becomes clearer. But there could also be longer term opportunities for UK businesses from trade with other parts of the world if they can ride out the short term economic storm. This will require companies to perform a stocktake of the possible impacts of Brexit across all areas of their operations in order to identify and respond to consequent risks and opportunities as early and effectively as possible.

4 This refers to the fact that, as economic growth slows and employment declines, so social security benefit and tax credits payments tend to rise automatically and average effective tax rates tend to fall.

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