EY ITEM Club Autumn Forecast

Is the economy taking Brexit in its stride?

October 2016

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Foreword

Mark Gregory

EY Chief Economist UKI
@MarkGregoryEY

Brexit: no need to worry?

A difficult forecasting environment…

We all know that economic forecasting is difficult at the best of times but the UK's path to leaving the European Union (EU) makes predictions even harder than usual. As the latest EY ITEM Club forecast makes clear, the outlook is complex and cannot be simply characterised as a typical economic slowdown: the consequences of Brexit could potentially impact sectors and segments of the UK economy in very different ways.

…which increases the risk of complacency…

The economy has not fallen off a cliff since the vote on June 23rd and commentators have been suggesting that this shows that fears about the UK leaving the EU were over-stated. The reality is that it is too early to celebrate the success of Brexit. Our sense from discussions with the corporate sector is that businesses are waiting for both data that has been collected post-referendum and for the details of future policy that the Autumn Statement is expected to provide. There have been no major moves as yet, the mood has been one of wait and see.

However, employment growth is slowing, wages are not rising as fast as EY ITEM Club previously expected and factory gate inflation is increasing and this will hit consumer prices next year. All of this points to a slowdown in consumer spending in 2017. The EY ITEM Club is forecasting consumer spending growth of 0.5% in 2017, a major change from the growth of 2.5% achieved in 2015. While the EY ITEM Club has been advising of a gradual slowdown in consumer spending for some time, the move towards Brexit has accelerated the expected rate of that slowdown.

At the same time, policy uncertainty has risen to record levels and this is feeding through into lower levels of business confidence which EY ITEM Club expects to translate into lower investment in 2017. This is also consistent with what we are hearing. Policy uncertainty together with a squeeze on margins from input cost inflation and a tightening labour market in some areas is leading to investment projects that are seen as marginal either being cancelled or delayed, with some of this capital being diverted to other geographies.

…but the signs are that there will be a slowdown in 2017 and a slow recovery afterwards…

The slowdown in consumer spending and investment will, EY ITEM Club expects, be compensated for to some extent by higher exports and some degree of stimulus from Government spending but GDP growth in 2017 will be low at around 0.8%. There will be some recovery afterwards but the headwinds on consumers and the reluctance to invest by businesses means that growth will not reach 2% annually by the end of the decade. It seems that the UK is facing a period of relatively low growth by historic standards.

Foreword

...characterised by uncertainty and variability

Beyond 2017, the outlook will be influenced significantly by the evolution of the UK's negotiations with the EU on exit and future trading arrangements, assuming the latter are part of the exit process. Details are sparse at this stage but the emphasis that the Government placed on control, especially over the movement of labour, during the Conservative party Conference suggests that the UK will be seeking to negotiate a bespoke deal unlike any other existing EU trade agreement. It may well be that this may be difficult to achieve and the UK and EU move towards trade on terms more akin to those available under the rules of the World Trade Organisation (WTO).

Certainly the new UK administration appears structured and willing to consider a deal along WTO lines. As the EY ITEM Club analysis shows, sectors such as financial and business services look vulnerable in this scenario as do certain goods sectors, such as aviation. The UK would need to develop a policy on agricultural subsidies and an industrial strategy to mitigate the shift to the new trading model. What is clear is that the impact will vary by sector and the specific impact will be difficult to estimate.

Time to start preparing

I have been an advocate of "wait and see" as far as corporate responses to Brexit are concerned, as there has been little post-referendum data or policy guidance on which to base decisions. While there is still a great deal of uncertainty, it does seem possible based on recent developments, both in the UK and in the policy statements of European politicians, that a "Hard" Brexit, by which I mean based around WTO rules, could happen and is currently probably the most likely case. It may well be that over time, further negotiations improve the situation.

Now is the time for businesses to update their strategies and associated business plans to reflect the slowing macro-environment and emerging policy outlook. Slowing growth and rising inflation together with a depreciating currency could potentially be an unhealthy cocktail. "Hard" Brexit is a downside on the current position but should now be the base case for future decision-making.

The key steps are:

- Start with looking again at potential vulnerabilities in the current plan given recent developments and identify any short-term moves required to mitigate these.

- Review capital allocation and consider investment decisions in the light of the future outlook. It now makes sense to consider investing more in export capacity given the low pound and push for new trade partners, while investing to substitute increasingly high cost imports may start to become more economically advantageous.

- Business structure is another potential area of change. Is there an option to change the business to place some parts in the future EU and others outside? This might also highlight possible M&A requirements either buying or selling of assets.

- Robust analysis of the preceding two areas could provide the UK Government with guidance on the exit negotiations or future trade priorities.

Highlights

- It may look like the economy is taking the referendum in its stride, but we think that impression is deceptive. Sterling's shaky performance so far this month provides a timely reminder that troubles lie ahead.

- At the moment, growth in the economy is being driven entirely by the consumer, supported by rising employment and real wages, as well as ultra-low interest rates. However, sterling's devaluation will push inflation up to 2.6% temporarily next year. With average earnings still surprisingly subdued, this will slow the consumer. In the meantime, many firms have put investment and recruitment on hold while they assess the likely impact of the Article 50 negotiations on their business and consider their long-term options.

- We see GDP growing by 1.9% this year, in line with our July forecast, but that is likely to be the best performance for some time. The forecast sees investment falling back by nearly 2% next year and with consumption slowing down, this leaves domestic demand flat. GDP growth will be driven by net exports, helped by the lower pound, at least while we retain access to the single market. GDP growth slows to 0.8% in 2017 before creeping back up to 1.4% in 2018, 1.6% in 2019 and 1.8% in 2020.

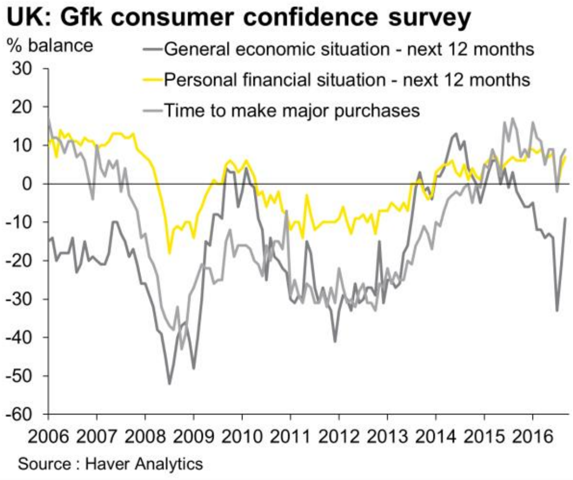
- It is increasingly clear that we are heading for a hard Brexit, and that our former European partners are determined to play hard ball. It is now consensus that, as we said in July, we will no longer have unfettered access to the European single market. In that case, it is vital that we get unfettered access to cheap world markets in food and manufactures when we finally leave the EU in the spring of 2019. That will mean trading under WTO rules initially, while we try to negotiate free trade agreements with the EU and others as best we can over the longer term.

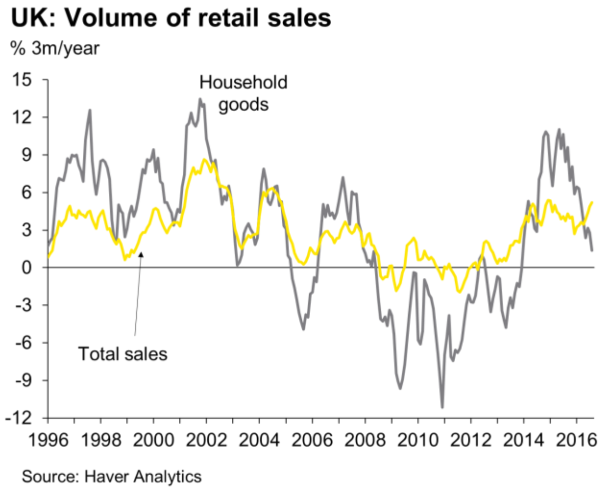
- This scenario would benefit UK consumers but would hurt farmers and manufacturers. They would need to be supported by subsidies and more imaginative procurement and industrial policies. Financial services are also vulnerable under this scenario, and would surely consider transferring some of their activities to EU subsidiaries. Manufacturers are a lot less footloose, but the worry is that post Brexit, their new models and investment projects will go to the EU rather than the UK. In the meantime of course, uncertainty is damaging to business spending.

- Longer term, the dynamic effects will tend to reduce cost to the UK of Brexit. Our membership of the EU has artificially boosted the EU share of UK imports and exports and this boost will now fade, providing we can access cheaper world markets and conduct trade deals with other countries. Despite this artificial boost, the slowdown in EU growth has reduced the EU share of UK exports from 60% in the late 1990s to around 45% currently. Non-EU markets will continue to outpace the EU, further lowering the EU share of UK imports and exports. Nevertheless, a WTO-based Brexit is still likely to take about 4% off UK GDP by 2030.

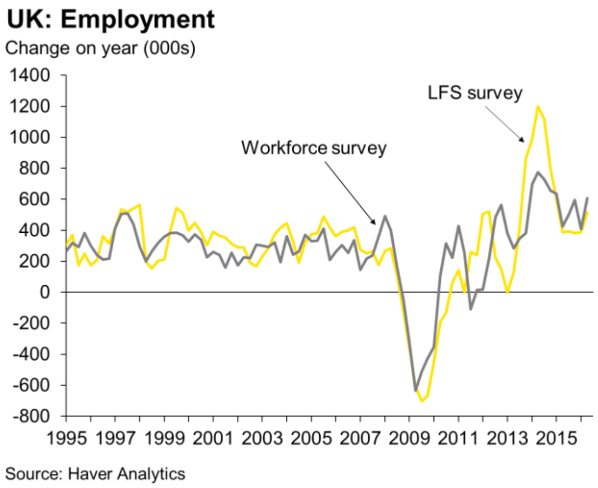
Introduction

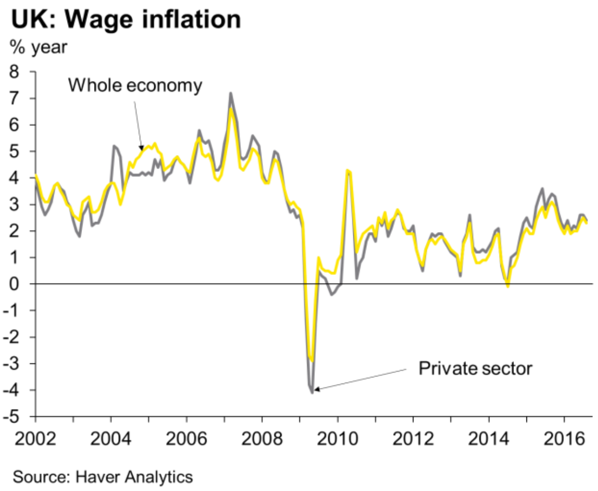
Now that the initial shock is over, it looks like the economy is taking Brexit in its stride. The pound has fallen against other currencies, but the stock market has recovered nicely from its initial wobble. The MPC has taken decisive action to support the economy and it looks like the new chancellor will follow suit in the Autumn Statement on 23 November. It's early days yet but it looks like business as usual, with consumer confidence and spending strong, unemployment stable and CPI inflation rising only slowly.





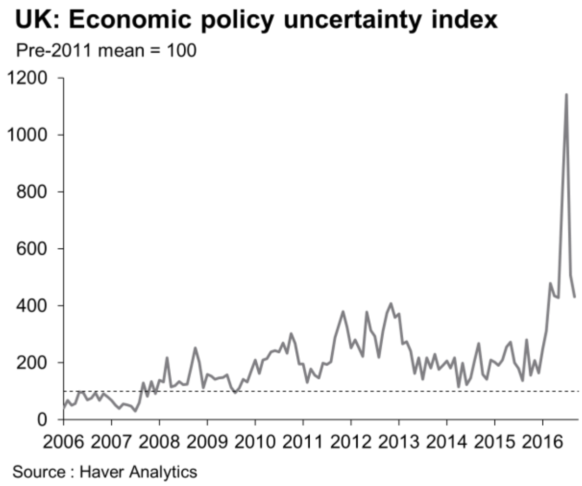
However that impression could be misleading. This growth is entirely driven by the consumer, supported by rising real wages and ultra-low interest rates. Wages have been very subdued, despite the introduction of the national living wage. Although CPI inflation remains well below target, industrial and import costs are rising strongly and inflation is likely to move above the 2% mark by the spring, squeezing household incomes and spending.

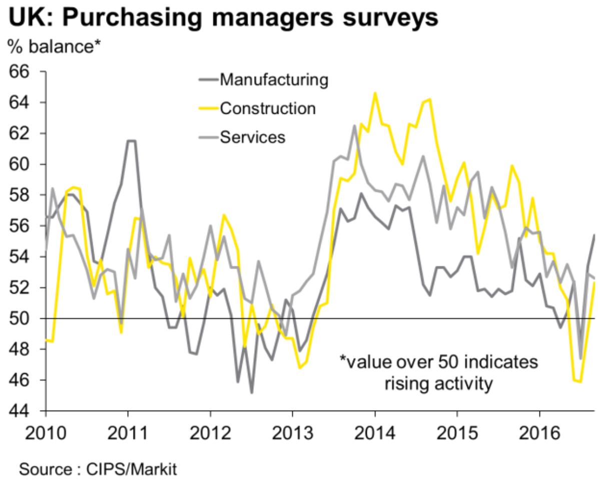




More worrying, business confidence has not recovered fully from the shock of the referendum. Though Theresa May has promised to trigger Article 50 before March 2017, the Prime Minister is holding her other cards close to her chest and there remains a high degree of uncertainty around the outcome of the exit negotiations with our former European partners. We will have to wait until 25 November when we see the first breakdown of spending in the third quarter, before we get any feel for the effect this is having on investment.

The basic problem here is that the government needs to come to a view about what is feasible and what would be best for Britain, which will not be easy given the conflicting interests at stake. It needs to recruit large teams of trade negotiators, which will also be difficult. And even if Article 50 is triggered by the end of March, as has been promised, with elections coming up in May in France and in October in Germany it may be a year or more before the serious negotiations begin.

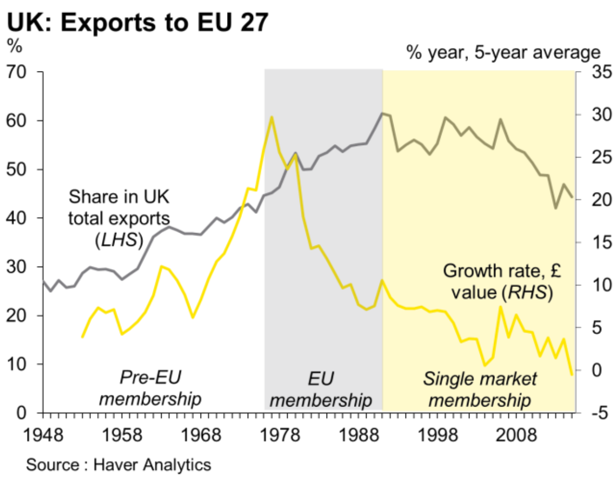


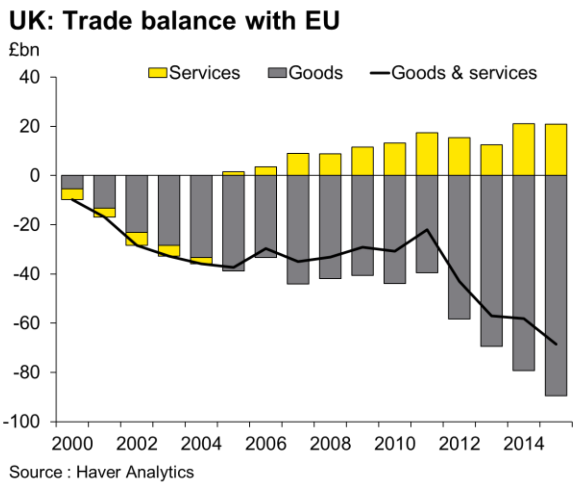


The basic question is: do we want to get this negotiation right or do we want to get it over with? The answer is not obvious. It's a vital decision, but unfortunately, the longer this takes, the longer the period of uncertainty and the bigger the hit on investment and employment in the meantime. This section of the report sets out our views on the constraints, the options and the most likely outcome.

The constraints...

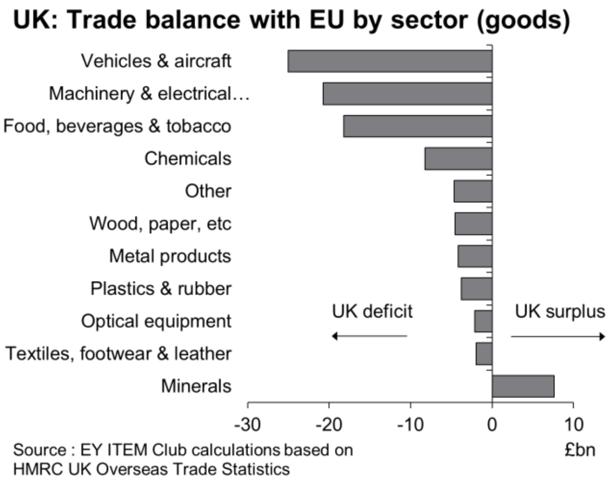
Although the government has not given anything away on their game plan, it is possible to piece together a likely scenario given the political and economic constraints involved. First, as we argued in July in the immediate aftermath of the referendum, it is unlikely that there will be a Norwegian or a Swiss solution that retains full access to the single market. That is simply because free movement of labour is both an integral part of this market and unacceptable to British voters.

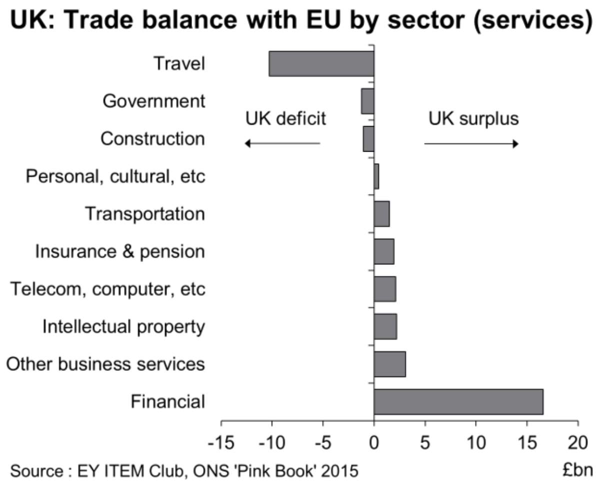




The communique issued by the EU27 after their immediate post-referendum summit made it clear that we will have to accept free movement if we want full access. EU politicians and officials have so far stuck rigidly to this line and are likely to continue to stick to it. They were forced to suspend the free movement of capital to keep Greece in the European Monetary Union, but they have no reason to relax the free movement of people to keep the UK in the European single market. Quite the opposite. That would encourage others to demand similar treatment and with nationalism on the rise, this could even trigger the exit of other countries.

Moreover, the EU has little to lose and could potentially gain if the UK is excluded from the single market. The UK has a huge deficit in goods with the EU, reflecting the general weakness of UK manufacturing. It is heavily in deficit with the EU in automotive and aerospace; electrical and mechanical machinery, as well as food products. The Brexiteers argue that this puts the UK in a strong negotiating position, since we could threaten to impose duties on these imports. However, in our view it is a weakness, since it is unrealistic to suppose that UK manufacturers and farmers could replace these imports effectively or that UK consumers would want to switch their spending to other products. The only card the UK holds here is that it could potentially buy these products more cheaply in world markets. It is important that we play this card to best advantage





The UK does of course have a surplus with the EU in services. This reflects London's natural advantages in terms of location, law and language as well as the skills and other strengths that have built up over the years. However, these advantages are not overwhelming and in fact are also to be found to some degree in Dublin and other EU financial centres. These competitors would dearly love to restrict UK access to EU financial markets and are already attempting to lure business away from London. And even if we did manage to negotiate access to the market in services, we would almost certainly need to sign up to financial regulations that were made in Brussels rather than in London.

…narrow the options…

Clearly, this is not a particularly strong hand. But how is it best played? We basically need to choose between a customs union similar to the 1995 EU-Turkey Ankara agreement; a free trade agreement (FTA), similar to the 2014 EU-Canada Comprehensive Economic and Trade Agreement; or a reversion to World Trade Organization (WTO) rules. Arranging the various pieces of the jigsaw, it seems to us that the latter is the least bad outcome and thus the most likely, at least initially. Nevertheless, we think this is a second best solution, which will take around 4% off GDP by 2030 compared to membership of the single market.

A customs union would certainly not suit the UK given its industrial and trade structure. Although it would not restrict the movement of goods, it would not give unrestricted access to the EU market in services. Moreover, like Turkey, we would then have to accept the common external tariff and would only be able to negotiate any trade treaties with non-EU countries with the agreement of the EU.

That would be doubly problematic because the common external tariff would prevent us from tapping into world food markets, which are still much cheaper than under the Common Agricultural Policy.

Similarly, in the case of capital goods and consumer durables like cars, we would not be able to access cheaper substitutes from Japan, Korea and other countries. Aerospace is perhaps less problematic given the strength of UK producers and the importance of government cooperation and support for this industry. But it remains a concern given the heavy dependence on joint European projects. The EU would doubtless be happy to enter into a quick deal with the UK based on a customs union since it would suit its manufacturing and service industries very well. But by the same token, it would not suit the UK.

An FTA would be less problematic for the UK than a customs union. It would not restrict imports from world goods markets. But it would imply complicated rules of origin procedures to stop these being re-exported to the EU, as well as tiresome border controls. An FTA would also leave UK exports and in particular financial services prone to non-tariff barriers. Moreover, a comprehensive agreement along the likes of the Canadian one would have to be agreed unanimously by all 27 countries. Even if agreement were obtained, this would almost certainly take a lot longer than the two year period allowed for by Article 50 of the Lisbon treaty: the Canadian agreement has still to be ratified by all EU members.

…leaving the WTO as the default

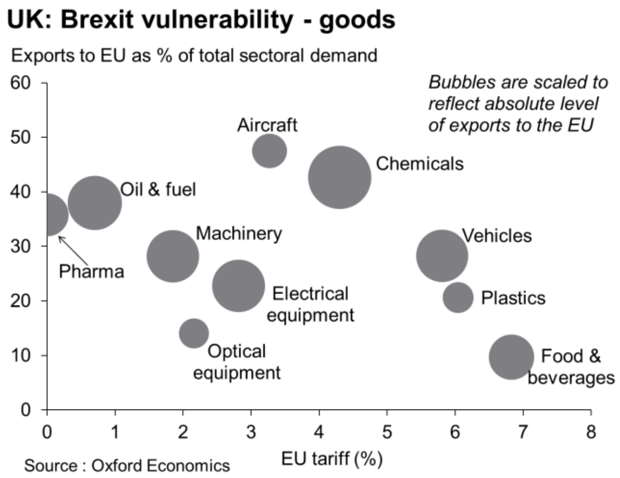
This leaves the default option, which is to fall back on WTO rules. Its Most Favoured Nation (MFN) provisions mean that we would access the market on the same terms as other non-EU countries (except those that have negotiated FTA and other agreements which are exempt). Short-term, this is better than anything that the EU would be likely to offer, and thus seems the most likely choice. It would come into play two years after Article 50 was triggered, irrespective of the any European elections or other political developments. It would give the UK unfettered access to world markets, with the freedom to negotiate third-party trade deals and tailor procurement and industrial policies to domestic needs.

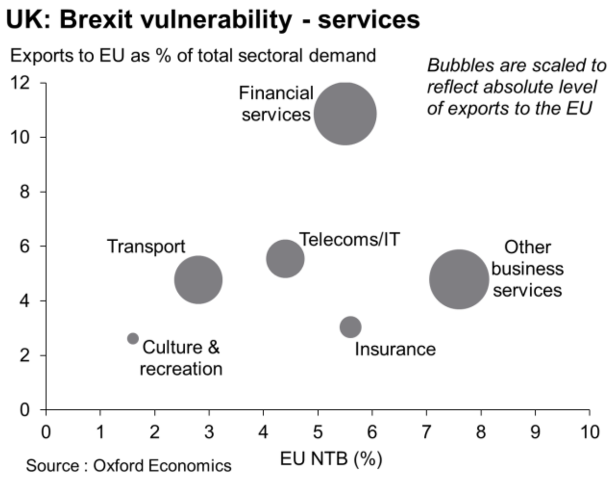
To sum up: if we cannot get unfettered access to the European single market, it is vital that we get unfettered access to cheap world markets in food and manufactures. This would benefit UK consumers but, absent supportive subsidy and industrial policies, this would hit farmers and manufacturers hard. Longer term, it would release labour and other resources to allow the economy to gradually rebalance towards exports, particularly branded consumer goods and financial services exports to EMs, helped by a lower exchange rate and favourable long run growth trends. That's basically the Economists for Brexit argument for a clean break with Brussels. However, we would see it as a stop-gap while product specific FTAs were concluded with the EU and other countries. But how would the WTO option play out for different sectors?

WTO rules OK?

Recent research by Oxford Economics[1] argues that the vulnerability of UK goods sectors depends upon the EU's MFN tariff and the share of exports to the EU as a share of total demand. In this respect, aerospace and automotive and food again stand out, together with chemicals. However, we would again argue that this would not be too serious a problem given access to cheaper substitutes in world markets. Moreover, the low EU tariffs on imports of industrial machinery means that they are in any case less vulnerable than the trade imbalances suggest.

[1] '*Brexportgeddon?*', UK Research Briefing, Oxford Economics, 23rd March 2016, http://www.oxfordeconomics.com/my-oxford/publications/329799





However, the main problem with the WTO option is that it would leave UK exports to the EU hostage of non-tariff barriers (NTBs), which, with non-agricultural tariffs now reduced to small proportions by successive GATT and WTO trade rounds, are now the main obstacle to international trade. For example, these would impose administrative costs on UK-EU goods trade associated with border controls and complex rules of origin documentation. Although UK exporters are currently compliant with EU regulations (and in many cases have flexible manufacturing facilities that cater for different market standards), this could be a problem in future. Research based on US-EU NTBs suggest that these could be equivalent to tariffs of the order of 10% in vulnerable industries like chemical, aerospace and automotive.

NTBs are particularly relevant to services. While some industries like tourism and maritime transport are not affected, others like aviation, business and financial services are vulnerable. Where these services are provided by a UK head office under UK supervision, these would need to be transferred to EU subsidiaries and subject to EU supervision. Moreover, US, Swiss and other firms using UK subsidiaries to service the EU market would surely decide to move.

As in the case of goods exporters, the vulnerability of service industries also depends upon the share of their total output sold into the EU. Services are much less export-oriented than goods, meaning that this is generally low. However, EU exports account for over 10% of total demand for financial services, making this sector potentially vulnerable.

To the extent that any industries do decide to shift activity out of the UK, this will have the effect of reducing the associated inward direct investment flows. These are a major factor in the international transfer of knowledge and best practice, helping to drive UK exports and productivity. However, these inflows are a mixed blessing because they have the side effect of pushing up the value of sterling and reducing exports from other industries.

For example, many well-known Japanese firms operate in the UK. In total, they employed 140,000 people and had a turnover of £72 billion (of which £14.5 billion was value added) in the UK last year. This was supported by new inward direct investment of £2.2 billion. Many of these firms are here to support their UK client base, but the larger ones are here to access the EU market. Their response to Brexit will depend upon the outlook for the Article 50 negotiations and how flexible their business models are.

The Japanese Foreign Ministry has warned[2] that some financial institutions may have to apply for corporate status in the EU if they lose the 'single passport'. On the other hand Japanese manufacturers are unlikely to be able to move in a hurry. The worry here, is what will happen to new models and investment projects post Brexit. In the meantime, uncertainty can be damaging to business spending.

[2] *'Japan's message to the United Kingdom and the European Union'*, Japanese Foreign Ministry, September 2016, http://www.mofa.go.jp/files/000185466.pdf

The forecast shows the economy losing momentum…

Recent data have continued the run of decent consumer-led growth. The National Accounts now show an increase in GDP of 0.7% in the second quarter, with household consumption up 0.9%. Business investment increased by 1.0%, but this followed several quarters of falling investment, leaving it down 0.8% on the year. Exports fell back by 1.0% while imports increased by 1.3%.

The EY ITEM Club forecast for the UK Economy, Autumn 2016
% changes on previous year except borrowing, current account and interest & exchange rates

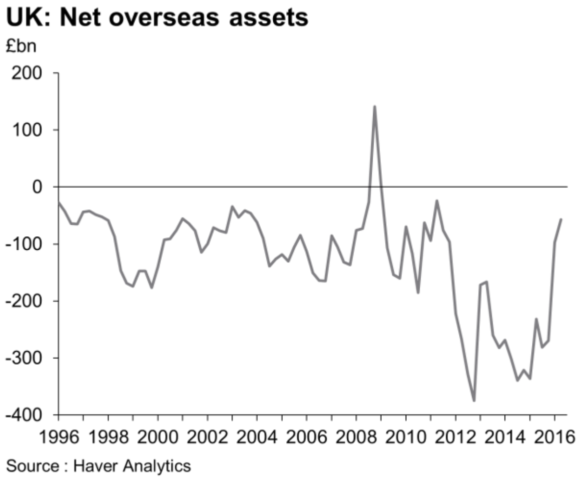
	GDP	Domestic Demand	Consumer spending	Fixed investment	Exports	Imports
2014	3.1	3.4	2.2	6.7	1.5	2.5
2015	2.2	2.5	2.5	3.4	4.5	5.4
2016	1.9	1.5	2.5	0.1	2.3	2.1
2017	0.8	0.1	0.5	-1.8	4.5	1.8
2018	1.4	0.9	0.9	1.1	5.6	4.0
2019	1.6	1.3	1.2	2.8	4.3	3.4
2020	1.8	1.5	1.3	3.3	3.9	3.0
	Net Govt Borrowing(*)	**Current account (% of GDP)**	**Average earnings**	**CPI**	**Bank Rate**	**Effective exchange rate**
2014	4.9	-4.7	1.4	1.5	0.5	87.0
2015	4.2	-5.4	2.5	0.0	0.5	91.4
2016	3.2	-5.6	2.6	0.8	0.4	81.1
2017	2.9	-4.1	2.9	2.6	0.0	71.9
2018	2.2	-3.9	3.0	1.8	0.0	70.9
2019	1.5	-4.2	3.0	1.7	0.2	69.5
2020	1.7	-4.0	3.0	2.0	0.8	68.5

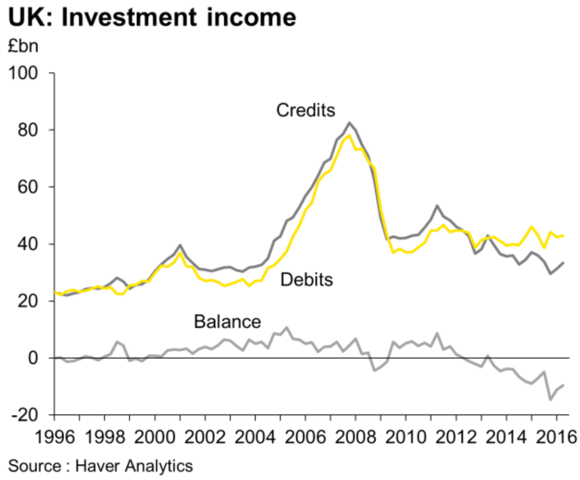
(*) Fiscal years, as % of GDP

Source: EY ITEM Club

Retail sales have moved into the third quarter with a confident pace, and this strength has been reflected in the service sector. Output of services increased by 0.4% in July, putting us on track to see GDP growth in the region of 0.2-0.3% in Q3. With September's GfK consumer confidence barometer reporting a second successive improvement in sentiment, wiping out all of the post-referendum losses, the economy looks to be in much better shape than many had feared it would be as we move towards the end of the year. The latest data supports our July forecast that the economy will grow by 1.9% this year.

The MPC's August forecast assumed GDP growth of around 0.1% in both Q3 and Q4 and these strong-looking data could persuade the committee to delay the cut in the base rate that we expected in November. They may also want to see the shape of the Chancellor's Autumn Statement on 23 November. Yet we still expect base rate to end the year at zero.

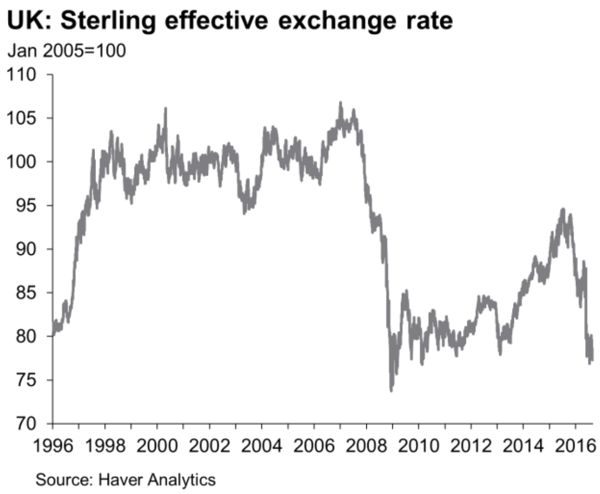


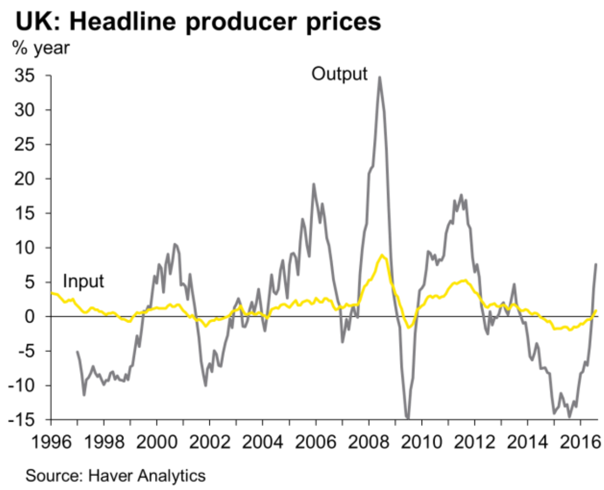


Although the referendum result came too late to influence output and expenditure in the second quarter, the effect of the associated depreciation of sterling can be seen in the balance of payments statistics. Sterling fell by 6% between the end of 2015 and Q1 2016 and by another 5% during the second quarter. This has had the effect of boosting the sterling value of overseas assets (which are largely denominated in foreign currency) relative to liabilities (which are, apart from bank deposits, largely denominated in sterling). The UK's net external liabilities were reduced from £270 billion at the end of 2015 to £57 billion by the end of Q2. This currency translation effect is already reflected in a modest improvement in the UK's net overseas earnings, and should lead to a further improvement in the second half of the year.

...as inflation bears down on the consumer...

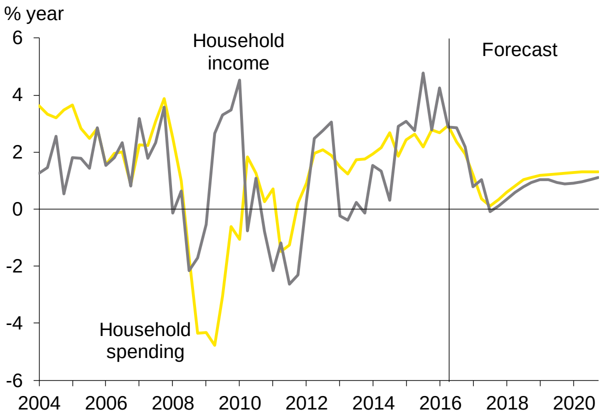
The outlook for consumption depends, as ever, on the outlook for the labour market. Recent data suggest that employment continues to grow, albeit at a much slower pace than seen in the previous two years. The surprise is that with the National Living Wage coming into play in April, pushing up the lower end of the pay scale, earnings inflation has also fallen back. We have lowered our assumption about earnings growth to reflect this. With CPI inflation now picking up on the back of sterling's devaluation, the outlook for real take home pay is deteriorating. Industrial input prices, which had pushed producer price inflation well into negative territory, are now back-tracking sharply, pulling it back up.





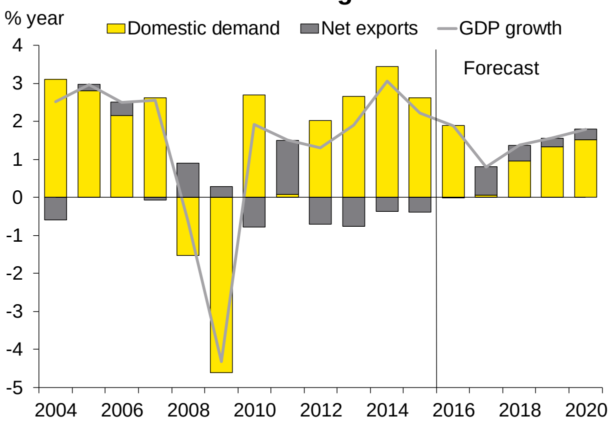
The worry remains that as it becomes clear that the UK will leave the single market as well as the EU, uncertainty over the new trading arrangements will arrest the growth of employment. After increasing by 2.4% in 2014, 1.8% last year and 1.4% this year, we see total employment increasing by just 0.2% in 2017, falling by 0.2% in 2018 and then remaining flat in 2019. The growth in subsequent years is very subdued by recent standards. To set against this, a move by the new government to reduce the influx of migrant workers once we leave the EU will tend to reduce the growth in labour supply and mitigate the consequences for unemployment and wages. Nevertheless, the forecast sees ILO unemployment rising from 4.9% currently to 6.7% by the end of 2019, while the claimant count rises from 2.2% to 3.4%. The risk is that these figures, depressing though they are, could prove to be optimistic.

UK: Real household income and spending



Source : EY ITEM Club

UK: Contributions to GDP growth



Source : EY ITEM Club

This risk will surely bear down on consumer confidence and spending given the importance of job security. With real earnings much less supportive than over the last two years, household real disposable income and consumption grows by just 0.5% in 2017. The growth in real incomes remains subdued over the rest of the forecast period and households reduce their savings to keep consumption growing.

…and companies worry about the new trading environment…

Business and housing investment are especially vulnerable to this heightened mood of uncertainty. It is very unlikely that the more competitive position of sterling and the likely relaxation of fiscal policy will provide enough support to prevent business investment falling over the next eighteen months. The forecast sees business investment falling by 1.5% this year and by another 2.3% in 2017.

We see little to support the housing market in this situation. The forecast sees house prices falling for the first time since 2011, down 0.2% next year. The weakness of real incomes and house prices will be reflected in housing investment, as well as spending on big-ticket items such as appliances and of course motor vehicles. The forecast sees housing investment growing by 2.9% this year after 3.7% in 2015, but then falling by 1.7% in 2017.

…leaving the balance of payments the one bright spot on the horizon

The balance of payments outlook has brightened considerably since sterling's devaluation. The deficit narrows from £107 billion this year to £82 billion in 2017, reflecting the fall in sterling and the weakness of domestic demand. Exports increase by 4.5%, well ahead of import growth of 1.8%. Net exports add 0.8% to GDP next year, accounting for almost all of the expected growth. Import growth accelerates as the economy begins to get back on its feet in 2018, and the current deficit moves back up briefly to £89 billion in 2019, before subsiding further over the remaining years of the forecast. Trade performance in 2020 and beyond will depend critically upon the terms that can be agreed with the EU27 and other countries.

As noted, the currency translation effect is already apparent in a modest improvement in the UK's net overseas earnings, and should lead to a further improvement in the second half of the year. The forecast sees the balance on primary investment income improving from a hefty deficit of £35.7 billion last year to a more manageable one of £16.5 billion by 2018. Assuming that we no longer contribute to the EU budget after 2019, the balance of payments will also be helped by an improvement in the balance of international transfers.

Risks and uncertainties

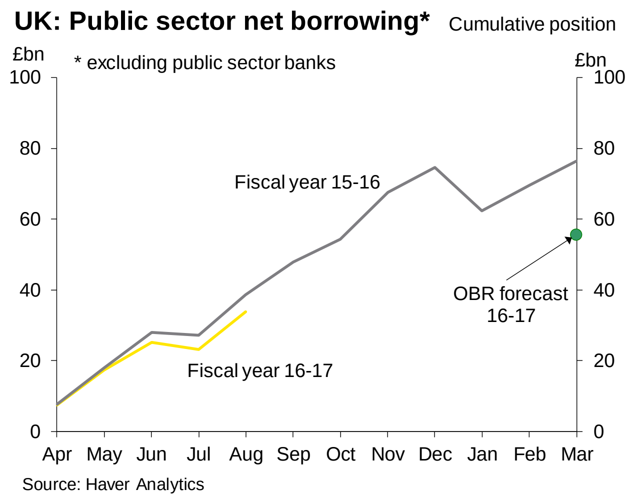
There are plenty of other things to worry about besides Brexit. The US election is now upon us, with many companies saying that is number one on their worry list. Oil inventories have cushioned the world from the effects of Middle East conflicts, but these are spilling over into immigration and political problems in continental Europe. These problems could seriously complicate the new government's foreign policy and make Britain's exit from the EU even more difficult.

Forecast in detail

1.Fiscal policy

The first four months of fiscal year 2016-17 have seen the government fall well behind schedule in terms of deficit reduction. And with the UK's vote to leave the EU leading the Chancellor to promise a "reset" of fiscal policy, we are effectively in a holding pattern until the Autumn Statement on 23 November.

The OBR's forecast in March's Budget predicted a £16.7bn (23%) reduction in public sector net borrowing over the course of 2016-17, from an expected deficit of £72.2bn in 2015-16 to £55.5bn. But the first four months of the current fiscal year have seen borrowing come in only 13% lower than the same period a year earlier. Moreover, the deficit in 2015-16 has been revised up to £76.5bn – more than £4bn higher than had been estimated at the time of the OBR's forecast – implying a weaker starting point for the current year.



However, the new Chancellor, Philip Hammond, has made it clear that he plans to drop the commitment to achieve a budget surplus by 2019-20 when he presents November's Autumn Statement. Mr Hammond has suggested that he would like to retain greater flexibility around fiscal policy, potentially moving away from the rigid fiscal rules adopted by several of his predecessors. However, he has stressed that lowering the budget deficit remains a key priority of the government.

Over the longer-term, this may mean that there is further austerity beyond that already planned, given that most economists agree that Brexit will result in a weaker medium-term outlook for the UK economy.

However, in the shorter-term, the Chancellor has hinted that there might be room for a temporary loosening of fiscal policy in order to provide some offset to the prospect of softer private sector activity. There are several reasons why a temporary increase in infrastructure investment is the most likely policy. Capital spending tends to have higher multiplier effects than current spending or tax cuts, meaning that it is likely to offer a larger boost to demand for a given fiscal outlay. It is also easier to ensure that a boost to capital spending is temporary, as the spending associated with a project ceases once it is completed. And when viewed on a national accounts basis, the level of government investment is much lower in the UK than in most other G7 countries.

With the government's National Infrastructure Pipeline containing almost £500bn worth of planned projects, there should be plenty of scope to accelerate existing projects and implement others which had previously been delayed by funding constraints. The government has also suggested that it will commit £3bn of funding to provide loans to stimulate housebuilding.

However, while we expect the Autumn Statement to deliver a modest loosening of fiscal policy, we do not expect the package to be a game changer and the Chancellor appears likely to restate his commitment to tighter policy further out.

2. Monetary policy

The MPC took decisive action to support the economy in the aftermath of the EU vote. But with activity proving more resilient than many, arguably including policy-makers, expected, there is more uncertainty over whether the economy will receive further monetary medicine.

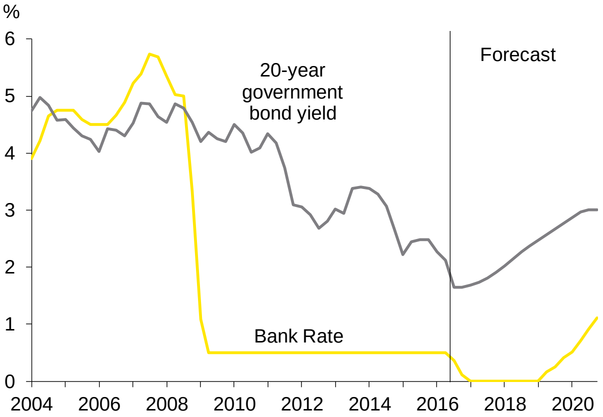
In light of what appeared to be a sizeable weakening in economic indicators following the EU referendum, the MPC announced a major and multi-pronged package of policy loosening in August. This included a cut in Bank Rate to 0.25%, a 'Term Funding Scheme' to ensure that the cut was passed on by commercial lenders and a new round of quantitative easing, involving purchases of £60bn of gilts and £10bn of corporate bonds. Moreover, forward guidance was also on display – a majority of MPC members said they would support cutting Bank Rate to just above zero by the end of the year if the MPC's assessment of the outlook at the time of the next Inflation Report in November was "*broadly consistent*" with that made in August.

While we still expect rates to go lower by the end of the year, a run of better-than-expected data means that the odds of a further rate cut are looking more touch and go. The Committee conceded in September that the data since August's meeting had "*been slightly to the upside*" relative to the August Inflation Report projections, prompting a rise in the Bank's projection of GDP growth in Q3 from 0.1% to 0.2-0.3%. If the Government were to announce a sizeable fiscal stimulus in November's Autumn Statement this would also provide cause for caution.

Gilt yields have plateaued at historic lows in the months since the EU vote, reflecting monetary loosening in the UK and global developments. We expect UK yields to remain low, with the 20-year yield ending 2016 at 1.7% and 2017 at 2.2%.

Sterling fell by around 11% in the immediate aftermath of the UK's vote to leave the EU and lurched down again in early October as it became clear to markets that the Government was likely to pursue one of the more extreme versions of Brexit. In light of the uncertainty surrounding the Brexit process, we expect sterling to slip further over the coming year.

UK: Bank Rate & 20-year bond yield



Source : EY ITEM Club

3. Prices and wages

Inflation has run at historically low rates in recent years, thanks to the continued influence of past falls in commodity prices, weak pay growth and past rises in sterling. But a reversal of the latter factor, in particular, presages a rise in price pressures.

Although annual CPI inflation of 0.6% in August was unchanged from the previous month, this represented a steady upward increase from the near-zero, or negative, rates seen in late-2015 and early-2016. With a rise in sterling oil prices accounting for much of this rise, core inflation has been more stable, running at 1.3% in August.

This upward drift in headline inflation now looks set to accelerate. Pressures are growing along the pricing pipeline, with industrial and import costs rising strongly on the back of the weakness in sterling and rising commodity prices. As of mid-October, the pound was down by 18% on a trade-weighted basis since the beginning of the year and by around 21% since the recent peak reached in August 2015.

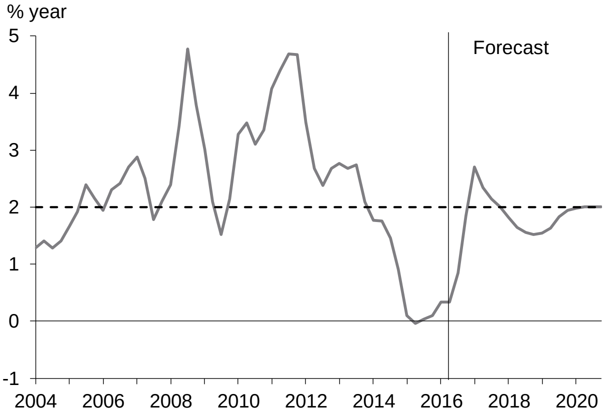
We think it is likely that the pound will drift a little lower through the forecast horizon. And the existing fall has already contributed to a steady rise in the sterling price of oil, up from less than £20 per barrel in January to around £37 in early October. Pump prices have followed suit, with the cost of a litre of unleaded petrol at an 18-month high in October and up almost 10% on the level six months earlier.

Though we expect the oil price to stabilise at current levels until well into next year, we are moving from a situation where petrol prices were exerting a drag of 0.4-0.5pp on CPI inflation at the end of 2015, to one where fuel costs add 0.5pp to inflation in early-2017.

These factors also meant that August saw the cost of fuel and materials paid by manufacturers rise by 7.6% on a year earlier, the fastest since December 2011. And factory gate prices rose by 0.8% in the same month, following July as only the second month to see an increase since the middle of 2014. We would expect these pressures to intensify in H2 2016 and to start to feed along the supply chain into consumer prices.

That said, not all forces working on inflation are pointing in the same direction. The UK will continue to be influenced by very low inflation in many of its trading partners. And the prospect of relatively weak growth means that the degree of spare capacity is likely to remain significant. Therefore, if anything, underlying inflationary pressures are likely to become even weaker than they have been over the past couple of years. But even though core pressures are set to remain weak, we expect CPI inflation to climb back above the 2% target early next year and to average 2.6% in 2017 before dropping to 1.8% in 2018.

UK: CPI inflation



Source : EY ITEM Club

RPI inflation will be higher over the forecast period. This is largely due to the so-called ‘formula effect’ (i.e. the different methods of aggregation between the RPI and CPI measures that place an upward bias on RPI), though the wedge should widen further over the back end of the forecast horizon due to our expectation that house prices will rise more quickly than general prices and that interest rates will eventually be increased.

4. Activity

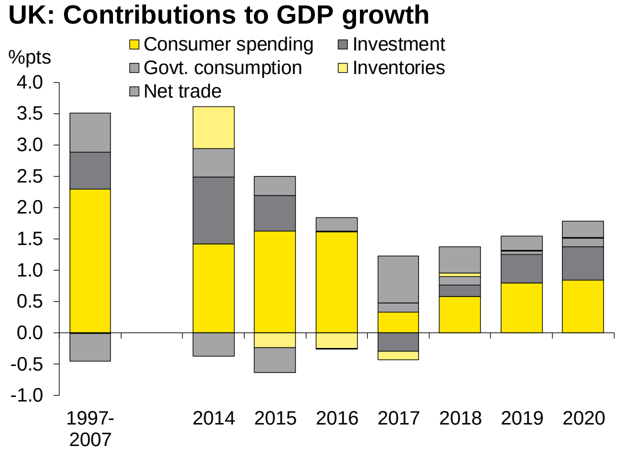
The Quarterly National Accounts contained a welcome surprise, with Q2 GDP growth revised up from 0.6% to 0.7%. However, the expenditure breakdown was wearingly familiar, with the consumer sector doing virtually all of the heavy lifting and net trade once again detracting from growth.

A run of very weak business survey data in the immediate aftermath of the EU referendum had raised fears that activity might contract in Q3. However, the surveys have since rebounded strongly, while the official data for services output and retail sales have remained robust. As a result, our short-term model, which uses business survey results to fill gaps in the official data, suggests that GDP is likely to have risen by around 0.3% in Q3.

But while the economy has shown greater resilience than many had anticipated since the referendum, we still expect to see much slower growth over the next couple of years than observed over the past two years. The slowdown is likely to be focused on two main areas.

First, the decision to leave the EU is likely to weigh on corporate confidence, with heightened uncertainty meaning that some firms postpone capital spending plans, at least until the UK’s future trading relationship with the EU begins to become

UK: Contributions to GDP growth



Source : EY ITEM Club

clearer.

Second, the consumer outlook is expected to worsen. Weaker corporate confidence is likely to weigh on hiring plans, causing unemployment to rise. Alongside this, the sharp depreciation of the pound since the referendum has added to the downward trend which had already been in place since mid-2014, and this is likely to push CPI inflation above 2% by early-2017. With household spending power also under pressure from the Government's welfare reforms, we expect consumer spending growth to slow sharply.

There will be some offset from a stronger net trade performance, as the boost to competitiveness supports export growth and some import substitution. But the net impact of Brexit on the growth outlook is likely to be negative. After GDP growth of 1.9% this year, we expect the UK economy to expand by just 0.8% in 2017, followed by a modest recovery to 1.4% in 2018.

5. Consumer demand

Consumers have demonstrated unexpected resilience in the period since the EU referendum. But with inflation set to pick-up off the back of the weaker pound and heightened uncertainty likely to cut back hiring, the environment for consumption is set to deteriorate.

A 0.9% rise in consumer spending in Q2 accounted for the bulk of the rise in GDP in that quarter, although output growth was not quite as dependent upon this component of spending as in the previous three months.

Evidence from the post-referendum period suggests that consumer spending has continued rising at a robust rate. Retail sales were up by over 6% year-on-year in July and August, while the slowdown in private vehicle purchases seen earlier in 2016 has levelled off. Meanwhile, although consumer confidence plunged in July, the subsequent two months saw the post-referendum drop made good.

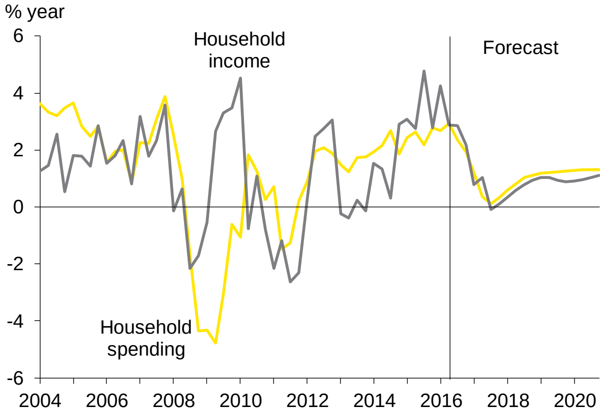
The Bank of England's decision in August to cut interest rates and engage in further monetary easing may have helped to bolster the consumer sector. And the possibility of tax cuts in November's Autumn Statement would provide another fillip.

However, these supports will have to battle a number of headwinds. With CPI inflation now picking up as a result of sterling's depreciation and likely to breach the MPC's 2% target early next year, the outlook for real pay is deteriorating.

Meanwhile, as the possibility grows that the UK will leave the European single market as well as the EU, uncertainty over the trading arrangements may arrest the growth of employment. A slowdown in hiring and a forecast rise in unemployment will knock back consumer confidence and spending given the importance of job security. With a gloomier outlook for pay growth and employment, we expect growth in real household disposable income to slow from 3.1% in 2016 to only 0.5% in 2017.

Overall, after rising by an expected 2.5% in 2016, consumer spending growth is then expected to slow significantly to 0.5% in 2017 and 0.9% the following year. Growth in real incomes is forecast to remain subdued over the rest of the forecast period, with households reducing their savings to keep consumption growing.

UK: Real household income and spending



Source : EY ITEM Club

6. Housing market

Analysis of housing market trends in H1 2016 has been complicated by the distortions caused by April's increase in stamp duty on buy-to-let properties and second homes. With the change announced well in advance, there was a degree of forestalling; buyers rushed to complete their transactions before the increase came into effect, leading to a drop off in activity from April.

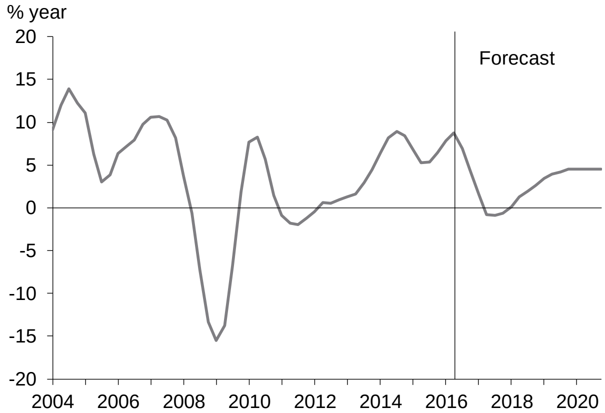
But there does appear to have been a slowdown in activity compared with 2015 – over the three months to August (by which time any distortions should have worked through), transactions averaged 97,000 per month, down from 104,000 in the same period of 2015. It is a similar story with prices, with annual price growth in the 5-6% range now, compared with the high single digits last year.

The RICS survey has reported a substantial slowdown in new buyer enquires, which as of August had fallen for five successive months, and we expect demand-side factors to offer less support to activity and prices moving forward. In particular, employment is expected to fall over the next year, while real income growth is set to slow sharply. However, there will be some offset from looser monetary policy, with the MPC having cut Bank Rate to 0.25% in August and indicated that it may cut again later this year.

The likely Brexit impact on the prime central London investment market is also uncertain. On one hand, the heightened uncertainty surrounding the economic outlook may dampen confidence. But on the other, the sharp depreciation of the pound has made central London prices look much more attractive to foreign buyers.

On balance we expect to see housing market activity remaining relatively stable at close to current low levels, with price growth continuing to moderate in line with the weakening of the labour market and household income growth. However, with the softer economic outlook unlikely to trigger a material rise in forced sales and housing supply set to remain very tight, we see no reason why there should be a sharp correction in property values. After rising by 7% in 2016, our forecast shows house prices broadly flat next year, before they subsequently begin to rise from 2018.

UK: House prices



Source : EY ITEM Club

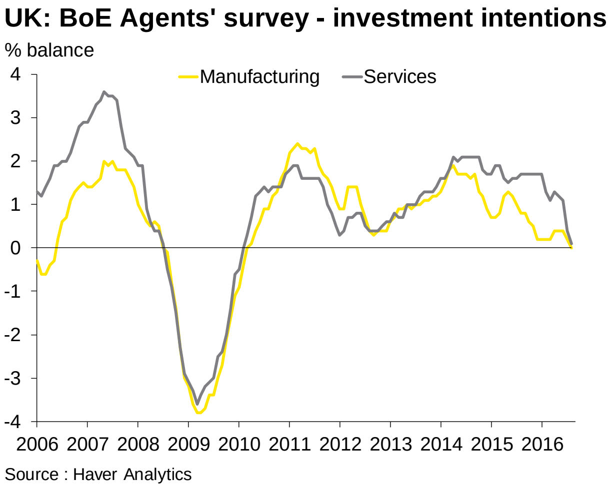
7. Company sector

Business investment remains more vulnerable to Brexit-related uncertainty than other components of GDP. Companies also face other headwinds, including record pension fund deficits. But we should remain a long way from the scale of decline in investment seen in the last recession.

Business investment rose by 1% in Q2, the first increase in three quarters, confounding expectations that uncertainty in the run-up to the EU referendum would curtail capital spending. That said, surveys of investment intentions, including by the Bank of England's Agents, have dropped in recent months.

In some respects, conditions remain supportive for further growth in investment. Action by the Bank of England has pushed down corporate borrowing spreads below their levels on 23 June and should aid a plentiful supply of credit. Competitiveness gains as a result of sterling's decline should boost the resources and incentives of firms in the tradable sector to invest. And if a fiscal stimulus directed at infrastructure materialises in November's Autumn Statement this should encourage private sector capital spending.

But against these positives, the still uncertain outcome of leaving the EU will caution firms that sell to the European bloc from taking decisions involving sunk costs and long-term pay-offs. A weaker pound will increase the cost of imported capital equipment. And to the extent that firms in general fear an economy-wide slowdown, a weaker appetite to invest may manifest itself in domestically-focused sectors too. What's more, pressure to reduce record pension deficits among UK corporates (which reached a record aggregate high of £459bn in August) also threatens to divert cash from spending on buildings, vehicles etc.



Overall, that investment unexpectedly grew in Q2 means that we have revised up prospects for this year. Business investment is forecast to decline by 1.5% compared to our previous expectation of a 2.4% drop. However, with heightened uncertainty likely to weight on business spending for some time, we expect a further fall of 2.3% in 2017, before the following year sees a modest rise. But the outlook remains a long way from the double-digit declines seen during the financial crisis.

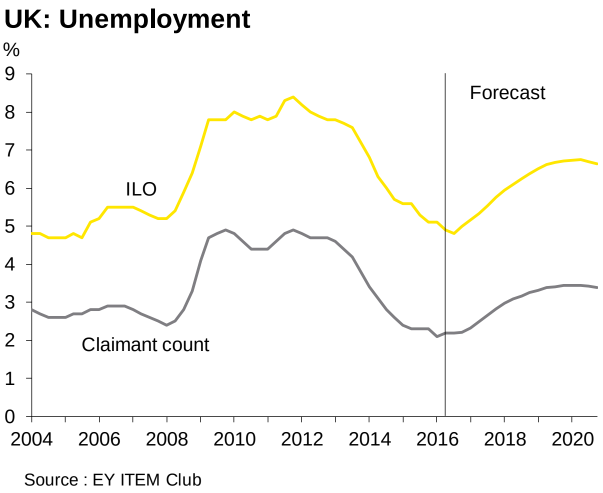
8. Labour market

Growth in employment has accelerated in recent months compared with that seen at the beginning of the year. However, a slowdown now seems likely – in the near-term reflecting the fact that spare capacity in the labour market has been increasingly absorbed and, longer-term, as heightened Brexit-related uncertainty reduces the demand for workers.

In the three months to July, employment was 1.8% up on a year earlier, a pick-up on growth of 1.3% seen at the beginning of the year. But a continued rise in the economically-active population meant that the LFS unemployment rate held steady at 4.9%, the joint lowest since October 2005.

Recent rises in the number of people in work have been disproportionately driven by a large increase in self-employment, with growth in the number of employees easing. This is not too surprising, given very rapid rises in employment in recent years and the degree to which slack in the jobs market is diminishing.

Our expectation is that uncertainty around the UK's exit from the EU will discourage hiring until the economy's longer-term prospects are clearer. We forecast employment to grow by just 0.2% in 2017, before falling by 0.2% in 2018 and then flat in 2019. Against this, likely action to reduce the influx of migrant workers once the UK exits the EU will depress growth in labour supply and mitigate the consequences for unemployment and wages post-Brexit.



The extent of the deterioration in job prospects will be influenced by the degree to which lower pay growth can absorb the consequences of a weaker economy. That earnings growth has remained very subdued in recent months, despite falling unemployment and April's introduction of the National Living Wage, offers some hope here. Average earnings rose by 2.3% in the three months to July, broadly unchanged from the rate seen since the beginning of the year.

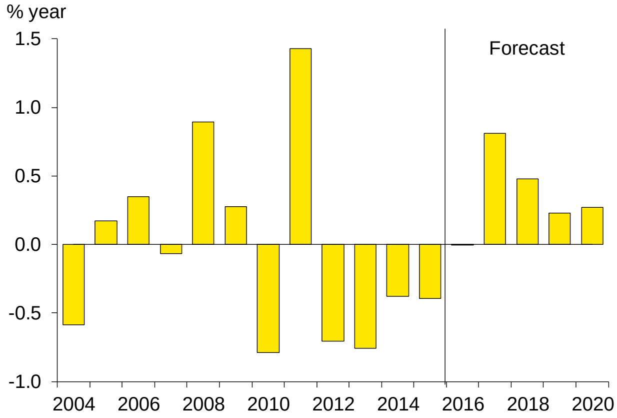
Earnings growth is forecast to remain below 3% over the next year. But this subdued rate will not be enough to prevent a rise in joblessness. We expect the LFS rate to reach almost 6% by the end of 2017, although there is considerable uncertainty over the precise extent of any deterioration.

9. Trade and the Balance of Payments

Net trade was again a drag on the economy in Q2 2016, knocking 0.8pp off GDP growth. But of late, the data has been exceptionally volatile and prone to revision, so the situation may not be quite as bad as first appears.

Indeed, recent survey evidence has struck a slightly more upbeat tone, suggesting that the sharp depreciation of the pound over the past 18 months is finally starting to boost export demand. In particular, September's CIPS manufacturing survey saw the strongest balance for export orders since January 2014. We expect this pattern to continue, with the weaker pound also driving a degree of import substitution, although the experience of 2008-09 leads us to take a relatively cautious view about the extent to which lower sterling can support activity. Our forecast shows exports rising by 4.5% in 2017 and 5.6% in 2018 which, alongside softer import growth, would mean that net trade adds 0.8pp and 0.5pp respectively to GDP growth in those years.

UK: Contribution of net exports to GDP growth



Source : EY ITEM Club

At 5.9% of GDP, the current account deficit remained very wide in Q2 2016. However, we expect the current account deficit to narrow through a combination of the export-boosting and import-cutting effects of a weaker pound, subdued domestic demand and by an improvement in the primary income balance as the weaker performance of the UK economy dents the returns of investments held by foreigners in the UK. We expect the current account deficit to narrow from 5.6% of GDP this year to 4.1% of GDP in 2017 and 3.9% in 2018.

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