18 July 2017

Research UK

Negative real wage growth has slowed GDP growth

- **While the UK was remarkably resilient to Brexit uncertainties in H2 16, the economy has begun to slow, as negative real wage growth has hit consumption.**
- **We expect GDP to grow around 0.3% q/q per quarter throughout the forecast horizon. As growth is below trend, we still think it is likely that the unemployment rate will increase slightly.**
- **Inflation has risen significantly due to the weaker GBP and is expected to remain high in the years to come.**
- **We expect the Bank of England to remain on hold despite higher inflation due to growth concerns and high political uncertainty.**

Slower growth

Against expectations, the UK economy was remarkably resilient to Brexit uncertainties in H2 16, as GDP growth was stronger than in H1 16. There were several reasons for this. In our view, the instant easing of monetary policy from the Bank of England (BoE), the clarification of the political situation with the 'crowning' of Theresa May as new Prime Minister and the postponement of triggering Article 50 explained why confidence among consumers and businesses was restored quickly, after most economic indicators fell sharply in July. Also the strong acceleration of economic growth in the rest of the world was positive for the UK.

Unfortunately, we are seeing the first signs that the economy is slowing, in line with what we projected in our latest forecast update, as Q1 GDP growth was just 0.2% q/q (the weakest among the EU member states) and indicators suggest growth was not much higher in Q2. In comparison, GDP grew by 0.6% q/q on average in H2 16. The main reason is that private consumption has slowed, as the weaker GBP corresponds to a de facto wage cut: The weaker GBP has pushed up import prices and thus consumer prices (higher inflation) eroding consumers' purchasing power. The combination of still weak nominal wage growth and higher inflation means real wage growth has turned negative for the first time since 2014. We do not expect business investments to compensate for slower private consumption growth, as we believe firms will be more reluctant to invest due to Brexit uncertainties, so we think GDP growth will slow from 1.8% last year to 1.6% this year and 1.2% next year. Some have argued that growth may be spurred by the GBP depreciation through more exports but this has not been the case so far, as UK export companies are relying on imported inputs to production and input prices have surged.

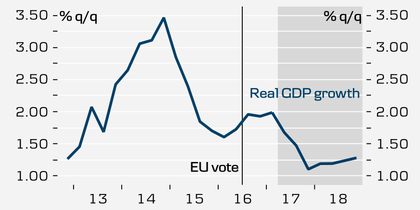
Still, we stress that uncertainty surrounding our forecast is higher than usual due to the forthcoming negotiations, as Brexit is uncharted territory.

UK forecasts

	Calendar year average 2016	2017	2018
GDP % y/y	1.8	1.6	1.2
Private consumption (% y/y)	2.8	1.9	1.2
Government consumption (% y/y)	0.8	0.8	0.4
Fixed investments (% y/y)	0.5	1.9	1.2
Net exports (contribution, pp)	-0.4	-0.1	0.2
Unemployment rate (%)	4.9	4.5	4.7
CPI (% y/y)	0.7	2.5	2.6
Core CPI (% y/y)	1.3	2.4	2.7
Current account (% of GDP)	-5.0	-4.9	-3.3
BoE Bank Rate (%) (end of period)	0.25	0.25	0.25

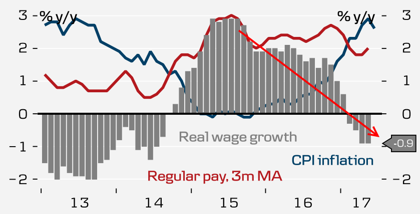
Source: Office for National Statistics, EU commission, Danske Bank

UK growth is slowing



Source: Office for National Statistics, Danske Bank

Real wage growth has turned negative



Source: Office for National Statistics, Danske Bank

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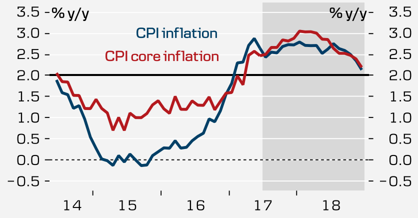
Inflation

Both headline and core CPI inflation have risen significantly this year due to a combination of higher import prices and commodity prices. We expect inflation to remain high in coming years, as it takes some time for currency changes to feed fully into consumer prices. The reason we do not expect CPI inflation to move much higher now is a combination of missing wage growth and stabilising commodity prices. We think the underlying inflation pressure, as measured by wage growth, will stay muted, as we see limited room for significantly higher wage growth when GDP growth is slowing and the unemployment rate may stop falling.

CPI inflation to remain high in coming years



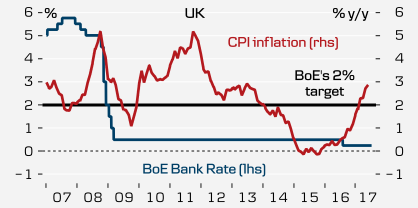
Source: Office for National Statistics, Danske Bank

Bank of England has become more hawkish

UK gilt yields moved significantly higher, as more BoE members have turned more hawkish. UK 2yr gilt yields rose from 0.10% and peaked around 0.35% but have fallen back to around 0.25% due to weaker economic data. The reason the BoE has become more hawkish is the combination of higher inflation and lower unemployment rates than it projected back in May. That said, our base case is still that the BoE will stay on hold, as we think the BoE is too optimistic on both GDP growth and wage growth. The market has priced in a rate hike in November by approximately 50%.

The BoE has already tightened in other ways. The countercyclical capital buffer has been raised from 0.0% to 0.5% and is expected to be raised further to 1.0% in November. Also, we think it is likely that at the August meeting the BoE will announce that the Term Funding Scheme (TFS) will end by February 2018.

The BoE has become more hawkish, as CPI inflation has moved higher than expected



Source: UK GOV, Office for National Statistics, Danske Bank

Brexit negotiations and political uncertainty

As we are now over the UK general election, the Brexit negotiations have finally begun, despite the weak minority government. Despite some speculations that PM Theresa May would soften her Brexit stance given the election result, it does not seem to be the case, at least not as the starting point for the negotiations. PM May still wants to end the jurisdiction of the EU court, leave the single market in order to curb EU immigration, leave the customs union in order to strike free trade deals with countries outside the EU and stop paying as much to the EU budget. That said, PM Theresa May's position has clearly weakened after the surprisingly bad result for the Conservative Party, and the government is already being challenged by both remainers and Brexiters. Although UK politics is unpredictable at the moment, we maintain our base case that we expect the UK and EU to agree on a transitional phase, as it is unlikely that a full deal can be reached before the end of March 2019, when the UK formally exits the UK. We expect the final deal to look like the EU-Canada CETA deal, which reduces/removes trade barriers for goods but is weak on services.

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None.

Date of first publication

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