Challenges ahead

Looking for growth

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Trevor Williams considers the state of the economy in 2017 before turning his attention to what next year may hold in store

Much of the government's attention this year has been delivering on the UK's exit from the EU – too much some would say. While much of UK discourse has been on the politics surrounding Brexit, the big economic news in 2017 is the sharp slowdown in growth. From an annual rate of growth of 2% in 2016, the Office for Budget Responsibility (OBR) estimates that it was 1.5% in 2017.

No longer can the UK boast of being the fastest growing of the Group of Seven's (G7) advanced industrialised countries – that accolade belongs to the U.S. But neither is the UK growing faster than the Eurozone economies.

After a few years of outperforming other economies; however, perhaps the UK was due a period of slower growth, and it may return to a faster pace in 2018 and beyond. Will this ever happen and what do the forecasts for 2018 look like? The answer is: pretty much the same pace of growth as last year looking at the estimates for the OBR.

Projections taken from the OBR's economic forecasts in the November Budget show a distinctly pessimistic bent, with growth slowing to 1.3% next year and remaining close to that in 2019 as well. Moreover, after falling behind the growth rate of the EU economies as a group in 2017, the UK is expected to underperform for at least the next two years. (**See chart A**).

It is worth bearing in mind that forecasts should not be mistaken for outcomes. The one-year ahead standard error on OBR GDP forecasts is around 1% historically. In other words, the economy could expand 1% more than they forecast or 1% less. That may seem a considerable error band, but recall that the overall UK economy generates a value add of around £2 trillion a year, so a 1% margin of error in an economy that size equates to £20 billion. Thought of in that way, a 1% difference in the level of GDP is eminently possible in an economy that size, with so many dimensions to the eventual outcome over a whole year.

What factors could boost the economy or weaken it over the year ahead?

The OBR has identified the biggest challenge facing the UK as weak productivity. Leaving the EU will impact the UK's economic performance for good or ill, but whether in or out of the EU, its institutions and markets the UK faces a significant challenge in improving its rate of productivity growth. **Chart B** illustrates that UK productivity has grown by just 0.2% between 2008 and 2016; a sharp slowing on the ten-year average before the crisis.

While the G7 and the Organisation for Economic Cooperation and Development (OECD) countries have also experienced a sharp slowdown in productivity since the financial crisis (something common is going on), the UK stands out for its unusually poor performance.

An obvious question, of course, is: if the UK productivity performance has been so poor, how has it managed to grow faster than the EU and G7 economic for some of the years since 2008? The answer is that the UK economy has been increasing employment more quickly than many of these other economies. Over the period since the financial crisis, the UK has indeed been able to overcome its relative poor productivity gains by expanding employment. A lack of that outperformance over the next years is one reason for the OBR's expectation of a weaker economic outturn.

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The argument is based on the fact that with the UK at or around full employment – the employment rate peaked at 75.3% a few months ago, and has since fallen back to 75.1% in the last quarter – there is little scope for further gains. Unless, therefore, productivity picks up sharply in the next few years, the best the economy can achieve is a pace of growth of a little over 1% a year. Even this scenario assumes that there will be a rise in productivity growth towards 1% a year on from 2018.

Looking ahead to 2018

What will happen to price inflation, the exchange rate and interest rates given the UK's slowing pace of economic expansion?

The answer seems clear on price inflation: barring another sharp fall in the exchange rate in 2018, the UK's inflation rate will fall towards 2% from the 3.1% reached in November 2017. This may not be entirely enough to prevent another hike in official policy rates in 2018, but it makes it unlikely that there will be more than the two quarter moves the MPC signalled at its December 2017 meeting.

An unchanged bank rate in 2018 seems to be a real possibility if the economy slows more than the OBR forecasts and if inflation falls more sharply. Bias in the risk profile for the economy over the next two years is to the downside: i.e. it is more likely that the UK economy will expand more slowly than the OBR projects, instead of growing rapidly.

In the absence of a currency fall, wage inflation holds the key to consumer price inflation. If wage inflation takes off, price inflation is likely to not fall as much or even accelerate. In such a scenario, the Bank of England would act more aggressively in raising policy rates – but how likely is that?

Employment seems to have peaked and wage inflation at rougly 2.25% a year is hardly inflationary. Moreover, the experience of the last 10 years suggests that wage inflation is flexible to the downside but not the upside. Arguably, this implies a continued loose monetary policy stance from the Bank of England and underpinned financial markets, with high equity valuations and equally high-priced bonds.

Can Brexit change this economic profile? It will undoubtedly have an impact. But we do not know what that will be, so let us focus on what little we do know. ■

Chart A: GDP growth

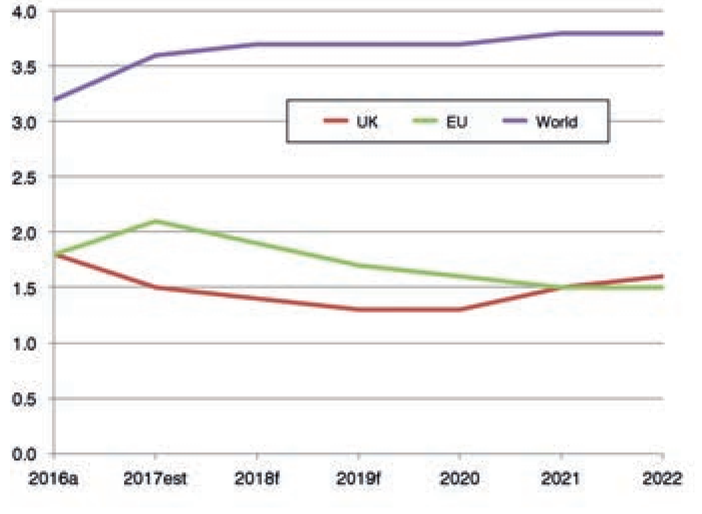

Chart B: UK productivity