

UK Outlook

July 2017

Softer growth materialising

2017

GDP

↑ 1.6%

EMPLOYMENT

↑ 1.0%

UNEMPLOYMENT
RATE

4.6%

INFLATION
RATE

2.8%

Consumer under pressure

Employment gains to moderate

Inflation up sharply

Risk of interest rate hike

“The economy is evolving as expected, with higher inflation and uncertainty combining to dampen growth”

Loretta O'Sullivan
Group Chief Economist

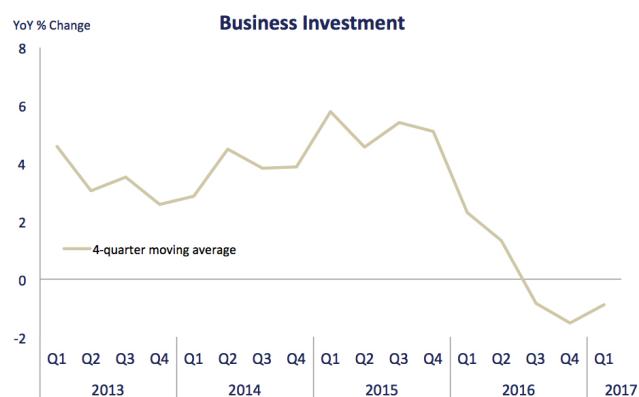
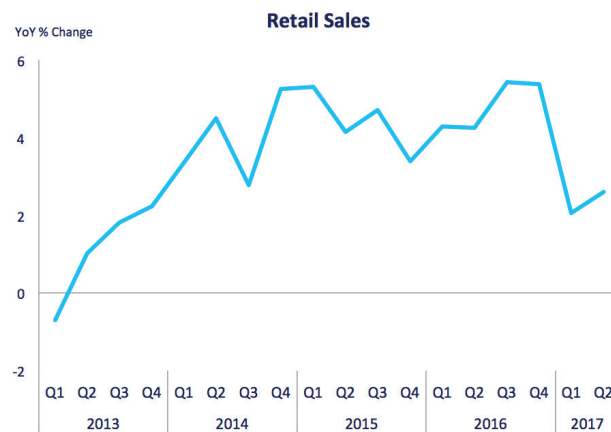
Overview A year on from the Brexit vote in late June 2016 and formal negotiations on the UK's withdrawal from the EU are underway. They commenced shortly after the recent general election, the outcome of which has added to uncertainty. The economy is evolving broadly as we expected, with the pace of activity easing in the opening months of this year. Given this, our forecasts for GDP growth in 2017 and 2018 – respectively 1.6% and 1.4% – are largely unchanged from our February outlook. Higher inflation resulting from sterling's fall, alongside subdued wage growth, will continue to squeeze households' income and dampen consumer spending over the forecast horizon. Other recent supports to spending, including strong credit growth and a falling saving ratio (to a record low), are likely to wane, with a softer housing market also weighing. Heightened uncertainty suggests business investment will remain relatively weak, though the pound's depreciation should support exports. Employment growth is expected to ease as the economy slows, with the unemployment rate ticking up in the coming years. On the policy front, the changed domestic political environment means the forthcoming budget is likely to result in some fiscal easing and we think the slowing economy will keep the Bank of England on hold. However, the risk of an interest rate hike has risen given less tolerance for above target inflation. Sterling has weakened against the euro since the election and is set to remain volatile as the Brexit negotiations continue.

Outlook	2016	2017 (f)	2018 (f)
Personal Consumption	2.8%	1.7%	1.0%
Government Consumption	0.8%	0.9%	1.1%
Investment	0.5%	0.5%	1.0%
Exports	1.8%	3.2%	2.9%
Imports	2.8%	1.9%	1.7%
GDP	1.8%	1.6%	1.4%
Employment	1.4%	1.0%	0.5%
Unemployment Rate (Average)	4.9%	4.6%	4.8%
CPI	0.7%	2.8%	2.5%
£/€ (Average)	1.22	1.14	1.12
£/\$ (Average)	1.35	1.26	1.26

Consumer under pressure

Having held up well in the wake of the Brexit vote, consumer spending slowed in the first quarter of 2017 and high frequency data suggest it remained relatively weak in the second quarter. Consumer confidence has also fallen in recent months amid increased economic and political uncertainty. Higher inflation resulting from sterling's depreciation, alongside subdued wage growth, is squeezing households' income and dampening spending. Other recent supports, including strong credit growth and a falling saving ratio, may prove unsustainable. A softer housing market will also weigh on spending, though the forthcoming budget may see some relaxation in austerity. But with the pace of job gains forecast to moderate as well, we expect consumer spending growth to slow to 1.7% this year (from close to 3% in 2016) and to 1.0% in 2018.

Investment grew by just 0.5% last year after increasing by almost 3.5% in 2015. Business investment was particularly weak, posting its first outright decline since 2009. The Bank of England reports some modest improvement in firms' investment intentions in recent months (albeit from weak levels), but uncertainty related to Brexit will continue to weigh on spending and has been exacerbated by the outcome of the general election. Sterling's fall has raised the cost of imported capital goods, which is another headwind to business investment. The latter could also be affected by firms deciding to relocate capital in advance of changes in the UK's trading relationship with the EU. Meanwhile, investment in dwellings slowed last year and given the indicators pointing to softening housing demand looks set to moderate further. Overall, total investment is forecast to remain quite subdued, increasing by just 0.75% a year on average in 2017-2018.



Weaker pound to support exports

Exports rose by less than 2% in 2016, though this followed a particularly strong increase in 2015. This year has started on a stronger footing however, with the annual rate of growth accelerating to almost 3% in the first quarter. The weaker pound – it has fallen by 13% on a trade-weighted basis since the Brexit vote – and stronger momentum in the Euro area economy should provide support and exports are forecast to increase by around

3% this year and next. Import growth slowed last year and is projected to slow further given weakening domestic demand, which means net exports will contribute positively to GDP. Further out, the nature of the UK's new trading relationship with the EU will have an important bearing on how export and import patterns evolve.

Employment gains to moderate

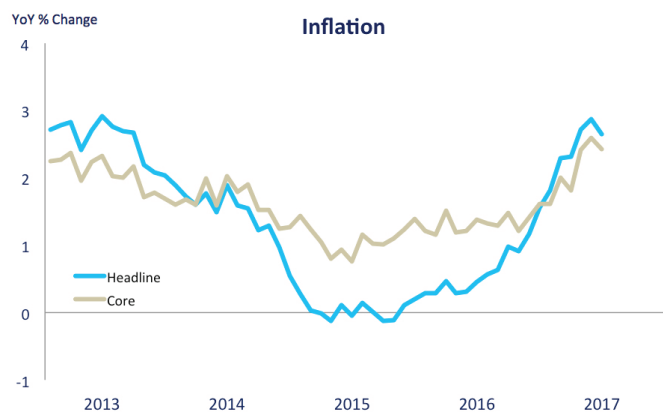
Job gains slowed over the second half of 2016, perhaps related to the Brexit vote, but picked up again in the opening months of this year. The underlying pace of employment growth is moderating though as the economy approaches 'full-employment', with the unemployment rate now at a multi-decade low of 4.5%. It is likely to moderate further as the economy slows – jobs growth of 1.0% is forecast for this year and 0.5% for next year – and will be accompanied by an uptick in the unemployment rate, which we expect to average 4.6% and 4.8% in 2017 and 2018 respectively. Given this, wage growth is likely to remain subdued.

Softening housing demand

A number of indicators point to softening activity in the housing market. Mortgage approvals for house purchase have edged down in 2017 to date and are running below year-earlier levels. The Royal Institute of Chartered Surveyors (RICS) surveys report lacklustre market conditions, with a fall in new buyer enquiries recently and sales expected to be flat over the coming months. House price inflation has also slowed, though it remains in positive low single-digit territory amid ongoing supply constraints. All told, it seems the pressure on incomes, as well as increased uncertainty, is impacting on demand.

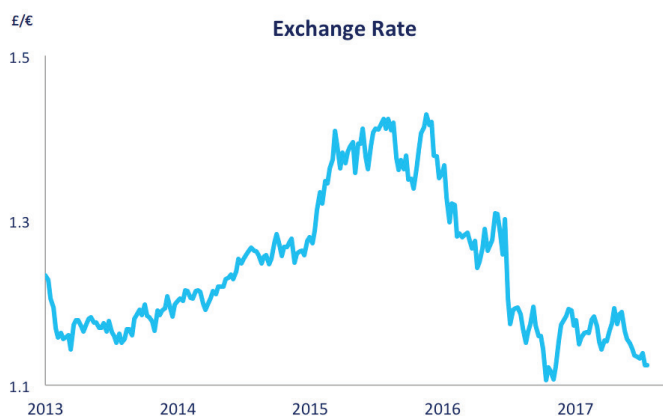
Inflation up sharply

The annual rate of inflation has picked up sharply and stood at 2.6% in June (compared to 0.5% a year ago). Part of this reflects rising energy costs, as oil prices have rebounded from last year's lows. However, inflation excluding energy costs has also increased, due to the impact of the fall in sterling. This has raised import prices, which in turn has fed through into higher consumer prices. Domestic inflation pressures, in contrast, remain subdued and are set to remain so given weak demand prospects. Hence, assuming no further lurch lower in sterling, inflation should begin to ease back again over the forecast period albeit still remain elevated. We expect it to average 2.8% this year and 2.5% in 2018.



Risk of interest rate hike

The Bank of England's Monetary Policy Committee (MPC) has kept policy on hold since cutting interest rates (and reactivating quantitative easing) in the immediate aftermath of the Brexit vote. However, the rise in inflation to well above its 2% target means an increase in interest rates is now on the agenda. Indeed, three MPC members voted for a 25bps hike at its June meeting. The majority, though, were prepared to 'wait and see' how the economy evolves, particularly as domestic price pressures remain weak. On balance, we expect the Committee to keep rates on hold as activity softens though clearly the risk of an increase has risen. Meanwhile, sterling has weakened since the general election, but remains off its lows of late last year. While the possibility of higher interest rates may cap the downside for sterling, it is set to remain volatile as the Brexit negotiations continue.



Fiscal easing likely

The Office for Budget Responsibility's (OBR) Economic and Fiscal Outlook published in March envisaged a decline in the budget deficit (i.e. public sector net borrowing) to 0.7% of GDP by 2021-2022, predicated on the previous government's plans for a further significant cut in real public services spending per person. However, the changed political landscape post the general election means some easing of fiscal policy is now likely, with the newly re-appointed Chancellor of the Exchequer noting that people are weary of austerity. While this would provide some support for the economy, the OBR has warned that it is not without risks for the public finances over the medium-term given the uncertainties posed by Brexit.

Northern Ireland

Northern Ireland's economy contracted immediately following the Brexit vote, with output falling by -0.9% q-o-q in Q3 2016 according to the Composite Economic Index, but recovered strongly in Q4 and rose further in the first quarter of 2017 (+0.3% q-o-q). Positive growth continued in the second quarter judging by the PMIs, which are in solid expansionary territory. Looking ahead, the weak pound will support exports, while the 'confidence and supply' arrangement between the DUP and the new minority Conservative government will potentially see a significant increase in public spending. Meanwhile, the labour market is improving with the unemployment rate at 5.3% in Q1 2017, down from 6.1% a year ago.

Risks to the outlook

As usual there are risks to the outlook. At this juncture, Brexit-related uncertainty is to the fore and could impact growth to a greater or lesser extent than captured in our forecasts. Consumer spending could also prove more or less resilient to the pressure on incomes than we expect, while exports might be stronger on foot of a better than projected global environment. An increase in interest rates would negatively impact growth though.



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