28. THE UNITED KINGDOM

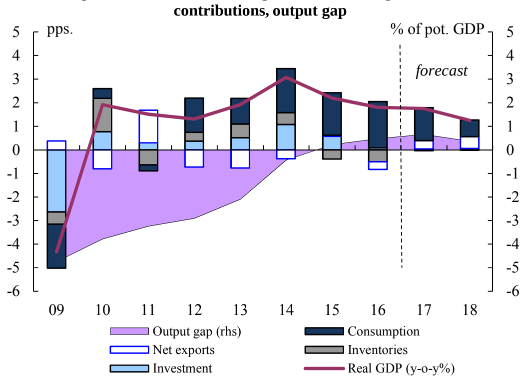
Growth to moderate and inflation set to continue to rise

Growth remained resilient in the second half of 2016 but is expected to soften throughout 2017 and 2018. Private consumption growth is projected to slacken as real household disposable income is squeezed due to prices rising faster than nominal wages. Business investment is forecast to stagnate as companies react to uncertainty. However, net exports are projected to support growth, reflecting the impact of the depreciation of sterling. The labour market is expected to remain resilient while inflation is forecast to rise further.

Domestic demand drove growth in 2016

After rising by 2.2% in 2015, GDP growth moderated to 1.8% in 2016, supported by strong growth in the second half of the year. A brisk rise of 2.8% in private consumption, the highest increase since 2007, was the main determinant of GDP growth, contributing 1.8 pps. to growth. By contrast, business investment rose only marginally while net exports detracted from growth by 0.3 pps.. Growth remained unbalanced across sectors in 2016; it was strongest in the services sector, which expanded by 2.9%, while industrial production grew by 1.2%.

Graph II.28.1: **The United Kingdom - Real GDP growth and contributions, output gap**



Growth set to ease in 2017 and 2018

Although annual growth is projected to remain unchanged in 2017, at 1.8%, the expected weakening in the quarterly rates of growth is more marked – from 0.7% in 2016-Q4 to 0.3% in most quarters of 2017. The waning profile of quarterly growth reflects fading household consumption growth and stagnant business investment.

Household consumption growth has outstripped that of GDP recently, buoyed by rising household disposable income, rapid growth in unsecured credit and a decline in the saving ratio. However, private consumption growth is forecast to fall below GDP growth in 2018. Given the high weight of household consumption in GDP, this slowdown is expected to have a strong influence on overall growth.

Growth in real household disposable income is forecast to fall in 2017 and 2018, with ongoing modest growth in nominal wages offset by higher inflation. Households are, nevertheless, expected to support consumption by further reducing savings. The saving rate, which is already low, is projected to decline further, from 5.2% in 2016 to 4.2% and 3.8% in 2017 and 2018 respectively. Households' lack of willingness, or ability, to continue to rundown savings to maintain consumption is a downside risk to the forecast.

Business investment is forecast to increase only slightly in 2017 and 2018. Measures of investment intentions from recent surveys are soft and businesses are expected to defer investments in the face of uncertainty relating to the negotiations regarding the UK's withdrawal from the EU. The response of businesses to the negotiations is difficult to predict and represents both an upside and downside risk to the forecast.

In contrast to the weakening of domestic demand, the contribution of net exports to GDP growth is expected to rise significantly, reaching 0.4 pps. in 2017 and 0.5 pps. in 2018. The sharp depreciation of sterling in 2016 should boost exports amid a strengthening growth outlook for the euro area and the US. The fall in sterling should dampen import growth and this effect is likely to be amplified by waning growth in domestic demand. The current account deficit is projected to decline from 4.4% of GDP in 2016 to 3.2% in 2018.

Resilience in the labour market but inflation continues to rise

Despite the expected slowing of real GDP growth, the labour market is expected to remain firm. At the same time, and despite historically low rates of unemployment and rising inflation, nominal increases in compensation of employees are forecast to remain modest at somewhat above 2% in 2017 and 2018, less than in 2016. Although employment growth is projected to weaken, the unemployment rate is projected to rise only modestly – from 4.8% in 2016 to 5.0% and 5.4% in 2017 and 2018 respectively. Real unit labour costs are projected to fall in 2017 and 2018.

Inflation is projected to continue to rise, reaching 2.6% in both 2017 and 2018 – above the Bank of England's target of 2%. The upward momentum in inflation is driven by a sharp rise in import prices reflecting the recent depreciation of sterling.

General government deficit falls below 3%

The general government deficit is expected to have fallen to 2.7% of GDP in the 2016-17 fiscal year, compared to 4.0% in 2015-16. This significant improvement is partly due to a temporary boost to revenues arising from a number of factors, including higher-than-expected dividend taxation receipts ahead of a dividend tax rise in April 2017. The improvement also reflects ongoing moderation in expenditure growth, with the public sector wage bill and social spending both having grown below the rate of nominal GDP growth. In contrast, there was a substantial rise in interest payments, reflecting higher interest payments on inflation-linked bonds and an increase in bond yields. The structural deficit is expected to have fallen to 3.0% of GDP in 2016-17, from 4.1% in 2015-16.

The general government deficit is forecast to rise slightly in 2017-18, mainly due to the fading of temporary boosts to revenue growth in 2016-17. The deficit is then expected to resume a declining trend in 2018-19, driven by ongoing expenditure-focused fiscal consolidation. This will be partly offset, however, by additional expenditure on social care, as announced in the recent budget. The structural deficit is expected to reach 3.1% of GDP in 2017-18 and 2.2% of GDP in 2018-19. Risks to these projections are to the upside, with possible higher-than-expected inflation pushing up interest payments and current expenditure. The government debt ratio is projected to fall to 86.1% of GDP in 2018-19, after peaking at 88.0% in 2016-17.

Table II.28.1:
General government projections on a financial-year basis

ESA10	Actual		Forecast		
	2014-15	2015-16	2016-17	2017-18	2018-19
General government balance~	-5.1	-4.0	**-2.7**	**-2.8**	**-2.0**
Structural budget balance	-4.8	-4.1	**-3.0**	**-3.1**	**-2.2**
General government gross debt	87.2	87.6	**88.0**	**87.1**	**86.1**

~APF transfers included

Table II.28.2:
Main features of country forecast - UNITED KINGDOM

		2015			Annual percentage change					
	bn GBP	Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP		1872.7	100.0	2.0	1.9	3.1	2.2	**1.8**	**1.8**	**1.3**
Private Consumption		1214.7	64.9	2.4	1.6	2.2	2.4	**2.8**	**1.8**	**0.9**
Public Consumption		362.8	19.4	2.3	0.3	2.3	1.3	**0.8**	**1.2**	**0.7**
Gross fixed capital formation		317.1	16.9	1.1	3.2	6.7	3.4	**0.5**	**0.2**	**0.3**
of which: equipment		74.9	4.0	0.7	2.5	6.8	4.7	**1.7**	**-0.8**	**0.3**
Exports (goods and services)		517.4	27.6	3.6	1.1	1.5	6.1	**1.8**	**3.4**	**3.0**
Imports (goods and services)		547.2	29.2	4.3	3.4	2.5	5.5	**2.8**	**2.0**	**1.2**
GNI (GDP deflator)		1847.0	98.6	2.0	1.4	2.3	2.1	**2.0**	**2.5**	**1.7**
Contribution to GDP growth:		Domestic demand		2.2	1.6	2.9	2.4	**2.1**	**1.4**	**0.8**
		Inventories		0.0	0.6	0.5	-0.4	**-0.5**	**0.0**	**0.0**
		Net exports		-0.2	-0.8	-0.4	0.0	**-0.3**	**0.4**	**0.5**
Employment				0.8	1.2	2.4	1.8	**1.4**	**0.6**	**0.4**
Unemployment rate (a)				6.0	7.6	6.1	5.3	**4.8**	**5.0**	**5.4**
Compensation of employees / head				4.0	2.1	0.7	1.1	**2.8**	**2.4**	**2.4**
Unit labour costs whole economy				2.8	1.4	0.0	0.7	**2.4**	**1.2**	**1.5**
Real unit labour cost				0.7	-0.5	-1.6	0.1	**0.7**	**-0.4**	**-0.3**
Saving rate of households (b)				8.4	6.7	6.8	6.5	**5.2**	**4.2**	**3.8**
GDP deflator				2.0	1.9	1.6	0.6	**1.7**	**1.6**	**1.9**
Harmonised index of consumer prices				2.1	2.6	1.5	0.0	**0.7**	**2.6**	**2.6**
Terms of trade goods				0.0	1.4	-0.4	-1.5	**2.3**	**-1.9**	**-0.8**
Trade balance (goods) (c)				-4.6	-6.9	-6.7	-6.4	**-6.9**	**-7.4**	**-7.3**
Current-account balance (c)				-2.1	-4.4	-4.7	-4.3	**-4.4**	**-3.9**	**-3.2**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-2.1	-4.4	-4.7	-4.3	**-4.5**	**-3.9**	**-3.2**
General government balance (c)				-3.6	-5.6	-5.7	-4.3	**-3.0**	**-3.0**	**-2.3**
Cyclically-adjusted budget balance (d)				-3.4	-4.3	-5.4	-4.5	**-3.2**	**-3.4**	**-2.6**
Structural budget balance (d)				-	-4.4	-5.3	-4.5	**-3.2**	**-3.4**	**-2.6**
General government gross debt (c)				49.2	86.2	88.1	89.0	**89.3**	**88.6**	**87.9**

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.