EY ITEM Club Summer Forecast

The world post-Brexit

July 2016

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Can Brexit be the catalyst for UK economic reform?

An uncertain outlook….

The EY ITEM Club Summer forecast sets out how challenging and uncertain the economic outlook is with a significant downgrade in expected GDP growth compared to April's forecast. Given the likely shock to the economy from the decision by the people of the UK to leave the European Union, this change in outlook is unsurprising.

However, all the current forecasts are highly uncertain - we arguably know no more, and possibly less, than we did before the referendum. The result is clear but the UK political landscape is being rebuilt after an earthquake and discussions with the other members of the European Union have not yet started.

…unlikely to change soon…

Businesses should organise their planning and analysis in this uncertain environment around 3 time periods:

- The short-term, probably until after the Autumn Statement, when we will have more clarity on UK Government policy and sufficient post-referendum economic and corporate data to enable us to develop a clearer view on the likely future path of the economy;
- The negotiation period: two years seems a sensible working assumption for the process. The hope is that the options will be narrowed down as time progresses and hence uncertainty will be reduced; and
- The longer-term: post exit when the UK will be pursuing its individual economic course. It is of course possible that a new trade deal may take longer than 2 years but the longer-term should nevertheless be significantly clearer in 2 years than it is today.

…so take the time to prepare.

In the short-term, businesses should avoid knee-jerk reactions. Absent good data, decisions made in this period are as likely to be good as they are bad. The focus should be on shoring up the business and initiating

Foreword

the research and analysis to enable strategic and operational decisions as we learn more.

There are obvious challenges moving forward: the EY ITEM Club expects both business investment and consumer spending to slow for the rest of 2016 and companies will need to adjust to this. However, there will also be opportunities, especially for exporters, as the pound is likely to remain low for some time. Moreover, as the UK develops its new trade strategy, new markets may open up and existing markets could become more attractive under improved trading arrangements.

Monitoring developments will be critical...

The move from the current arrangements to the long-term post-EU position will be driven by four factors:

- Agreement on arrangements for post-Brexit, UK-EU and UK-rest of the world trade which will impact both exports and imports, the latter critical for many supply chains;
- Approach to movement of labour between UK and EU and UK and the rest of the world with clear implications for the recruitment and retention of skilled and unskilled workers and also potentially for investment in labour saving technology
- UK regulation in areas where EU rules no longer apply, offering the scope to "free up" British businesses; and
- UK Government policy across a range of areas, using the potential freedom from EU "State Aid" rules to forge a new role for the public sector in UK economic activity.

Each of these four areas has clear implications for business but their impacts could vary significantly depending on negotiations. Some effects are likely to be felt sooner than others. Beyond the exchange rate effect already mentioned, shifts in trade are likely to take some time to become clear. But just the potential for changes in the current arrangements for the free movement of labour might start to impact current workforces and upcoming recruitment activity very quickly.

Close attention to the developments in each of these areas in the UK's exit negotiations will be critical in shaping strategy over the next two years and for the longer-term. Signs of clarity are emerging, the new prime Minister has made clear the approach to the free movement of labour needs to change, and more details in other areas will hopefully emerge in the not too distant future.

...and especially not ignoring opportunity.

Some of the likely opportunities arising from the UK leaving the EU are relatively easy to identify: a reduced regulatory burden and greater trade freedom most obviously. But there are others.

With the likely slowdown in both consumer spending and business investment identified by the EY ITEM Club, the public sector may need to take up some of the slack. The referendum campaign identified concerns over immigration, inequality and geographic differences in economic opportunity amongst others, policy is also likely to evolve to address these concerns.

I expect that there will be a greater focus on infrastructure, education and skills going forward and that this will create business opportunities. It also seems likely that these initiatives will have to be delivered locally meaning an acceleration of the devolution of powers and responsibility to bodies such as the Northern Powerhouse and Midlands Engine.

The outlook is challenging and things may well be rocky in the short-term but the die has been cast and now is the time to begin to shape the future.

Highlights

- The post-referendum economy will follow a very different path from the one we envisaged in April, which assumed a vote to remain in the EU. Short-term, although the fundamentals will not change, there are likely to be severe confidence effects on spending, only partially cushioned by a fall in the pound. We see GDP growth of 1.9% this year, followed by just 0.4% next year and 1.4% in 2018.

- The financial markets have stabilized following the initial shock, but we expect the downward pressure on the exchange rate to persist, leaving the sterling exchange rate index in the last quarter of this year down 15% on a year earlier. Judging by the experience of the ERM exit in 1992, the weakness of the economy should keep inflation under control and we expect MPC to have cut base rates from 0.5% to zero by the end of the year, with an average CPI inflation rate of 2.5% next year.

- We have already had a couple of worrying business polls from the IOD and Lloyds Bank, as well as a special consumer confidence survey from GfK which reported the sharpest drop in 21 years. Such surveys will offer an important guide to the course of the economy over the next few months. In the meantime, there seems little doubt that the jitters seen in the run up to the referendum held back business, housing and other transactions and that these transactions will now be further delayed or perhaps abandoned given the heightened level of economic uncertainty.

- The path that the economy follows in 2019 and subsequent years will depend upon the outcome of the negotiations with the rest of the EU. However, it seems very likely that Theresa May's new government will make control of immigration its top priority, at the expense of access to the single market. We are assuming that the UK is able to negotiate a free trade agreement with the EU, similar to the recent EU-Canada deal. But that could prove to be optimistic.

- The single market has been vital for industries like aerospace and automotive, which need a large home market to bring down unit costs and ensure success in the world market. This could now be forfeited. However, going forward, these considerations should be less important for growth in the new 'weightless economy'. The UK is relatively well placed in services and the digital market place. It also enjoys a reputation for high value added pharmaceuticals, designer-label and branded consumer products and has a lot of experience in marketing these overseas. This reorientation should be helped by a switch in the balance of demand in emerging markets away from investment towards consumer goods.

- The vote to leave the EU came as a nasty shock to the government, business leaders and investors and it is vital that they respond positively to the challenges and opportunities that lie ahead. Short-term, while we still have full access to the single market, the fall in the exchange rate will provide an excellent opportunity for exporters, while the increase in inflation and unemployment will help to rebalance the economy away from consumption.

- As we have consistently argued, infrastructure and housing investment should play a much bigger role in government spending plans when long term financing is so cheap. If we do lose access to the single market, much will depend upon the way the new government uses the freedoms it gains in return.

Introduction

The world post-Brexit

The post-referendum economy will follow a very different path from the one we envisaged in April, which had assumed a vote to remain in the EU. Short-term, although the fundamentals will not change, there are likely to be severe confidence effects on spending, only partially cushioned by a fall in the pound. We see GDP growth of 1.9% this year, followed by just 0.4% next year and 1.4% in 2018.

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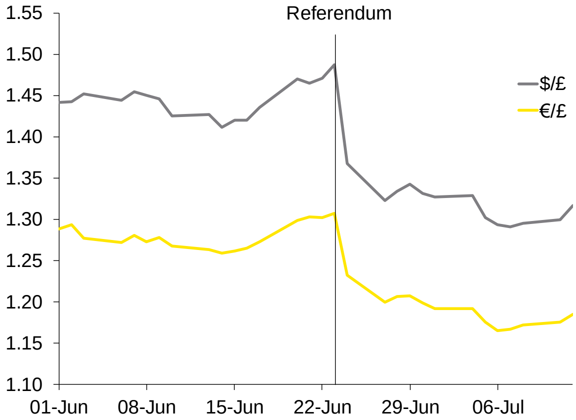
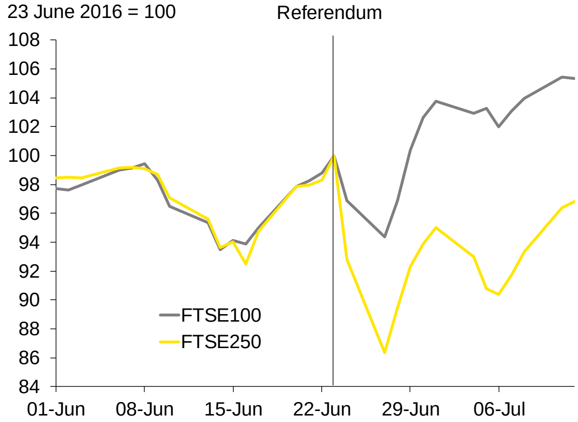
UK: Sterling



Source : Bloomberg

UK: Equity markets



Source : Bloomberg

The path that the economy follows in 2019 and subsequent years will depend upon the way that the political situation resolves itself and the outcome of the negotiations with the rest of the EU, both of which are difficult to gauge at the moment. However, it seems very unlikely that there will be a Norway/Swiss solution that retains full access to the single market given that free movement of labour is both an integral part of this and unacceptable to voters. We are assuming that the UK is able to negotiate a free trade agreement with the EU, similar to the recent EU-Canada deal. But that could prove to be optimistic.

This section of the report considers what will this could mean for the economy in the short and medium term and then summarises the forecast.

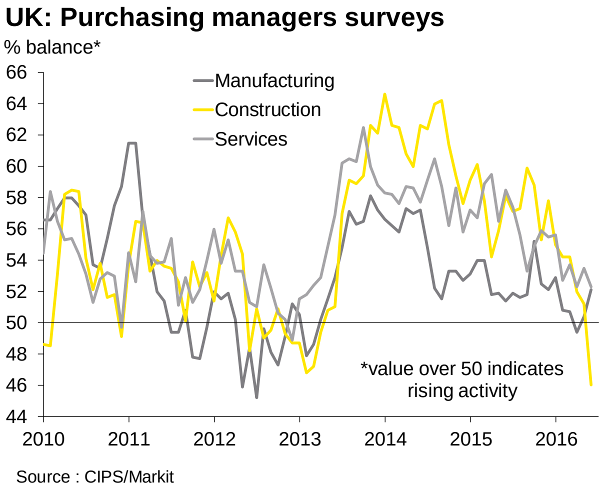
Article 50 will trigger the starting gun…

Nothing will change in terms of the free movement of goods, services, capital and people between the UK and the remaining EU27 for two years after the starting gun of Article 50 of the Lisbon Treaty is triggered. But then, if, as seems inevitable, we decide to leave the single market, the new Government will be free to rewrite the regulatory rule-book and try to control immigration. We are assuming that the UK will eventually be able to negotiate a free trade agreement along the lines that Canada did, which keeps UK-EU27 trade free of tariffs, but leaves UK exports and in particular financial services prone to non-tariff barriers. Financial services would be a worry even if we could keep the reciprocal passport arrangement, since the UK (and its erstwhile Commissioner Lord Hill) will no longer have any influence over financial regulation.

...but the markets and the economy will not wait for that

Although our relationship with the EU27 will not materially change for at least two years after Article 50 is triggered, the vote will clearly impact confidence and expectations in the meantime. The financial markets must also anticipate any adverse effects on the balance of payments and growth that are likely once the UK finally leaves the EU.

We have already seen some worrying business polls and a special consumer confidence survey from GfK which reported the sharpest drop in 21 years. Such surveys will offer an important guide to the course of the economy over the next few months. In the meantime, there seems little doubt that the uncertainty seen in the run up to the referendum held back business, housing and other transactions and that many of these never materialize. We took the view in the April forecast that if we remained in the EU, these delayed investment projects would come through, adding 1.2% to GDP next year and pushing the growth rate up to 2.6%. Banks, already very cautious, are likely to cut back on UK lending until they get more clarity on the situation.



Some major banks have already said that they are moving their Euro trading units to Dublin, Frankfurt or Paris and firms like EasyJet[1] in other sectors where an EU domicile is important for business may also choose to move activity out of the UK. The associated flows of inward direct investment and other capital inflows from abroad will almost certainly fall, triggering a potentially painful adjustment in the UK's current account position. Other capital inflows from abroad may also slow.

The warnings of economists and the major economic institutions were dismissed by the Brexiteers during the referendum campaign on the grounds that they and their models failed to predict the financial crisis. However, we are not as reliant upon models as much as metaphor and precedent. What guidance do these offer us now? Like doctors, we can warn of the consequences of reckless behaviour, without being able to say exactly when these will be seen. But we do know what to do when this happens, as Ben Bernanke fortunately did in 2007. And if someone is determined to shoot themselves in the foot, we can warn of the likely consequences...

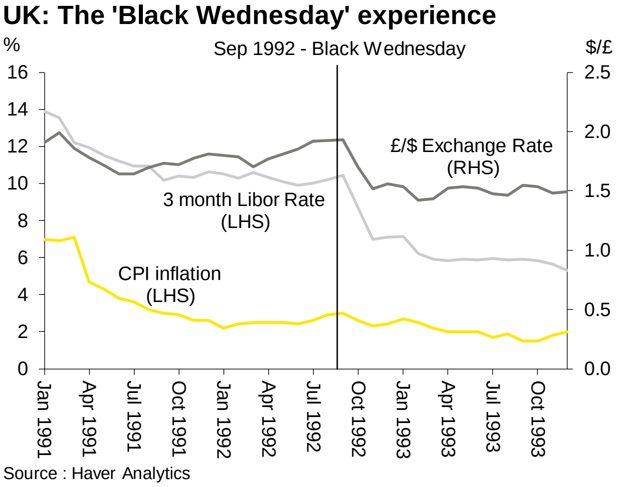
Is this a rerun of 1956...

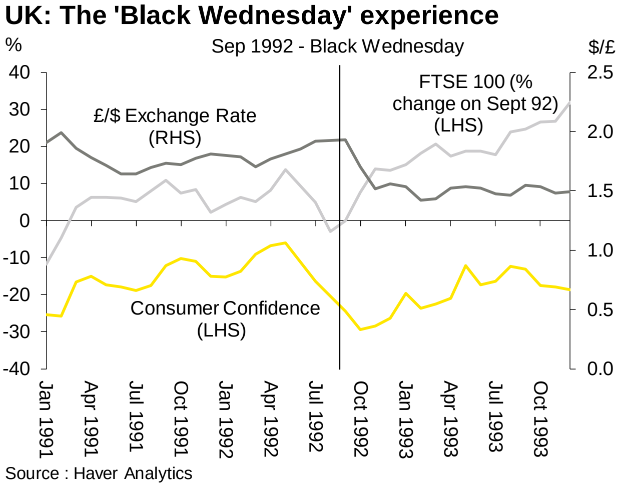
We are entering unchartered territory as there is no precedent for a member state leaving the EU. However, the political fallout has been compared to the aftermath of the Suez crisis of 1956. This forced Britain to find a new identity, ultimately in Europe. But it precipitated a change of leadership that kept the Conservatives in power until 1964.

[1] *'EasyJet Opens Talks Over Post-Brexit HQ Move'*, Sky News, 7th July 2016: http://news.sky.com/story/easyjet-opens-talks-over-post-brexit-hq-move-10330339

...or 1992...

Britain's exit from the ERM on Black Wednesday on 16th September 1992 offers the Conservatives a less encouraging political precedent. The reaction to the Brexit vote in the financial markets has been uncannily close. The pound fell back by from 2.787 Deutschemark ($1.994) the previous Wednesday to 2.565 DM ($1.708) a week later on 23rd. Then as now, the depreciation against the dollar was greater than that against the DM. The FTSE index ended up on the week and then pushed higher, just as it has this time. The economy recovered nicely too, but the government lost its reputation for economic competence and went on to lose the election by a landslide in 1997.





The worry, then as now, was that the fall in sterling would cause a rebound in inflation and prevent interest rates from falling back to the level needed to support the economy at a time of confusion and chaos. However, to the surprise of many economists, inflation continued to fall. Interest rates fell back sharply, allowing the stock market and the economy to recover. Indeed, the exit from the ERM marked the beginning of the NICE decade of Non-inflationary Constant Expansion, which continued uninterrupted until the financial crisis in 2008.

This near-precedent holds out the hope that Brexit could be less dangerous than feared. But unfortunately, the parallel with the ERM debacle is misleading. That exit led to a massive expansion in monetary policy, which the Bank of England simply does not have the leeway to repeat this time.

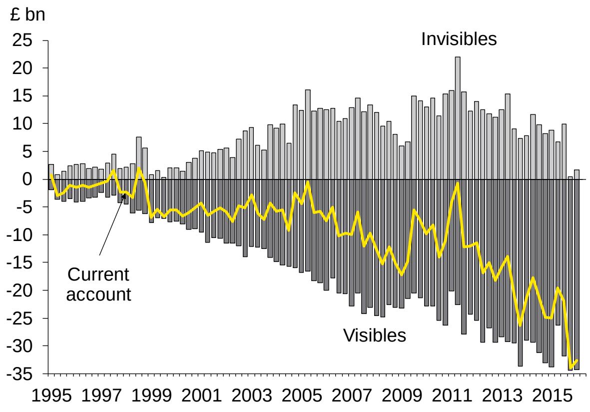
Moreover, the ERM exit led to a shift in the policy target from the exchange rate to inflation, and ultimately to Bank of England independence in 1997. This effectively locked in low inflation and further reduced interest rates, particularly at the long end of the gilt market. These institutions, together with the OBR, are vital to preserving stability in the present situation. But the risk is that populist political pressures and the clamour for parliamentary sovereignty could now undermine their independence. The Governor of the Bank of England has been roundly criticised by Brexiteers both during and since the referendum and seems particularly vulnerable in this situation.

...or is this a rerun of 2007-08?

The ERM debacle is misleading in other respects. The problem then was that UK interest rates were far too high, with the floor set by high German interest rates post-reunification. Monetary policy was simply too tight and the economy recovered once this was relaxed. The current account was close to balance. This time, the pound is overvalued, pushed up by capital inflows seeking a safe haven. We face a major adjustment in the exchange rate and the terms of trade.

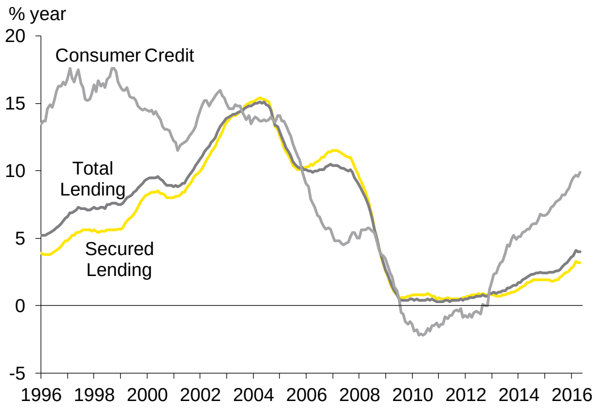
The devaluation of sterling following the onset of the financial crisis in August 2007 is very revealing in this respect. The pound was trading at €1.49 in late July 2007, pushed up by capital inflows helping to finance mortgage and other bank lending. It started to fall once these markets froze, reversing this inflow. It had depreciated to around €1.23 a year later and fell to its historic low of €1.025 in late December 2008.

UK: Current account



Source: Haver Analytics

UK: Lending to individuals



Source: Haver Analytics

The current account did improve as the recession hit imports in 2009, but once the recovery started in 2011, the deficit bounced back towards the level seen before. Last year's deficit of 5.4% of GDP was double the 2.5% seen before the crisis in 2006 and 2007, although the pound did admittedly recover to €1.20 by the end of 2013 and to around €1.40 last year. The weakness of the response of trade volumes has raised serious questions about the hollowing out of UK capacity in manufacturing and other key export sectors, which have yet to be resolved. Moreover, much of the capacity that remains is in place to supply our continental markets, which are now at risk.

The longer term outlook depends upon securing a free trade deal with Europe…

Once the period of transition is over, much will depend on the deal negotiated with the EU27 and the way in which the new UK government choses to use any freedom of manoeuvre on trade, regulation and immigration. Given that free movement is integral to the single market but unacceptable to English voters, it seems highly unlikely that we will see a Norwegian, Swiss or other solution that retains preferential access to the single European market. But how important is access to tariff-free trade with Europe? This played a vital role in the UK's economic renaissance since the 1970s, but is it still important in present circumstances?

As we learned in the 1950s and 1960s when we were trying to compete with giant US producers in areas like aerospace, a large home market is essential in securing the production runs and economies of scale that bring down unit costs and hence success in the world market. We joined what was then the European Economic Community (EEC) in 1973 to secure this advantage and expose UK manufactures to competition. Until then, the UK and European markets had been characterised by largely segmented national markets dominated by one or two local producers like British Leyland that enjoyed quasi-monopoly positions but lacked the scale to keep costs down. This limited consumer choice and put up prices. It also depressed profitability and hampered exports.

…since the large continental market is vital to success in other markets

Much of UK manufacturing went to the wall after we joined the EEC, handicapped by the high exchange rate precipitated by North Sea oil. However, those in high value added areas like finance, aerospace and pharmaceuticals were able to compete effectively, helped by the Big Bang, labour market and other reforms of the Thatcher administration. Then, after the single European market was instituted in 1992, we saw a shift to an integrated continental market resembling that of the US, where consumers are served by a wide range of quality- and price-competitive producers that enjoy large production runs and economies of scale.

The proximity and diversity of the European market was certainly a boon when the growth in international trade was focused on capital goods, cars and consumer durables. However, the growth in these mass markets has slowed, while the growth in services has accelerated. Nevertheless, UK manufactures will suffer if they forfeit the economies of specialization and scale they enjoy in the European market, making it more difficult to compete in other export markets. Moreover, unlike the 1960s when their European competitors were also miniscule domestic producers, they would have to compete with mega-European as well as giant US producers.

To compensate for the more difficult trading conditions now likely in European market, UK exporters will really need to focus their energies on the hard-to-access but high-growth Emerging Markets. Pro-Brexit economists have argued that this move would be facilitated by striking trade deals with the rest of the world. However, the EU has trade agreements in place with over 50 countries (with a trans-Atlantic agreement in the offing). These will have to be re-negotiated from a weak position since the UK market is only an eighth of the size of the EU. These deals are typically a long time in the making, and the UK's skill in this sort of trade negotiation, like so many skills, has been lost over the last 43 years of EU membership.

Having said that, these considerations largely relate to large high-volume industries like automotive and aerospace and, going forward, should be less important for growth in the new 'weightless economy'. The UK is relatively well placed in services and the digital market place. It also enjoys a reputation for high value added pharmaceuticals, designer-label and branded consumer products and has a lot of experience in marketing these overseas. This reorientation should be helped by a switch in the balance of demand in emerging markets away from investment towards consumer goods.

As noted, we are assuming *faute de mieux* that we get a free trade deal from end-2018. On that view, we would hope to retain some of the advantages of the European market. Exports of goods would be likely to weaken, but would be cushioned by a lower exchange rate. The associated inward direct investment is also likely to fall, especially while we lack clarity on how the UK's exit from the EU will affect its trading arrangements. We may see an improvement in the international transfers balance if we no longer contribute to the EU budget. But on the other hand, exports of business and financial services, which are prone to non-tariff barriers, are likely to be hit hard.

Ultimately, the exchange rate must fall to restore equilibrium to the balance of payments in the face of such adverse changes. Unfortunately, the scope for import substitution and higher exports is very limited, especially in the short term when a depreciation can actually worsen the current account by pushing up import costs up before volumes have time to react. This is a particular worry given the large deficit and high level of existing overseas investments in the UK, presumably made on the assumption of continued EU membership and political stability. The pound basically has to fall (or interest rates to increase) until overseas investors are prepared to hold on to these investments and indeed to continue adding to them unless and until the current deficit turns to surplus.

The size of the necessary adjustment in the exchange rate and the terms of trade will depend upon the impact on the balance of payments and the various price and income elasticities. Unfortunately, as we have argued in the context of sterling's devaluation of 2007-8, there is little reason to be optimistic about this adjustment. Indeed, there has been very little increase in capacity in key export sectors like manufacturing despite the lower exchange rate seen since then. Moreover, uncertainty over trading arrangements and the difficulties of obtaining bank finance will make it difficult to increase this capacity in the near-term.

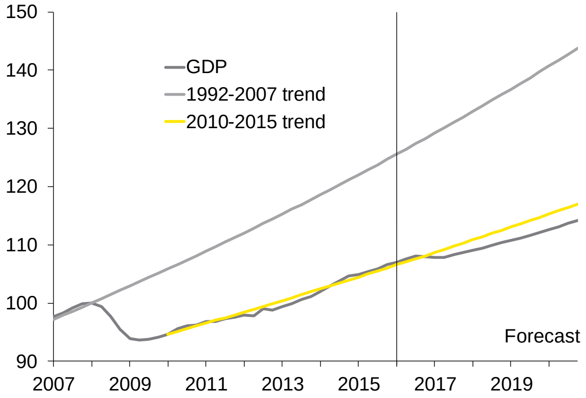
A Nike Swoosh or L-shaped recovery?

The last recession saw a permanent reduction in the level of UK GDP relative to the trend established over the period 1992-2007. In contrast, Boris Johnson and other Brexiteers have argued that although there could now be a loss of momentum in the short run, this will be reversed, resulting in a pattern resembling the Nike Swoosh. However, given the likely short run fall in investment; the disruption of trade & supply chains and other adjustment costs, we would expect a permanent reduction in the level of

UK output and productivity compared to the trend-line that seemed plausible at the time of our April forecast.

UK: GDP vs recent trends

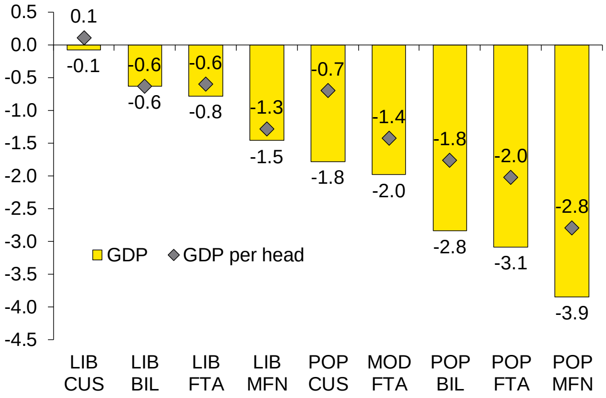
Q1 2008 = 100



Source : EY ITEM Club

UK: Impact of Brexit in 2030

% difference from base



Source : Oxford Economics

Key to scenarios covered in Brexit chart

Policy direction:	Trade agreement:
LIB - liberal	CUS - customs union
MOD - moderate	BIL - bilateral accords
POP - populist	FTA - free trade agreement
	MFN - most favoured nation

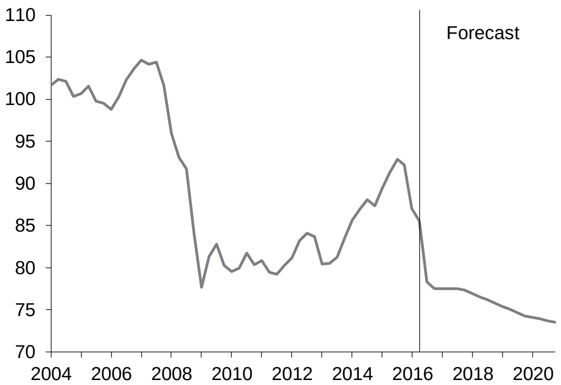
Having said that, the loss of output in the long run is, on any scenario, likely to be much less than that caused by the financial crisis. Moreover, the trade and regulatory levers that EU membership restricted, will be available if we do indeed quit the single market. The longer term economic effects will ultimately depend upon the skill with which those levers are used. But with the complexion of the next government unknown, it is hard to say whether to expect a neo-liberal or populist response.

The forecast sees the UK economy...

The post-referendum economy will follow a very different path from the one we envisaged in April. Short-term, although the fundamentals will not change, there are likely to be severe confidence effects on spending, only partially cushioned by a fall in the pound. The financial markets have stabilized following the initial shock and the pound has recovered some of its losses, but we expect the downward pressure to be resumed, leaving the sterling index in the last quarter of this year down 15% on a year earlier. Judging by the experience of the ERM exit, the weakness of the economy should keep inflation under control.

UK: Sterling effective exchange rate

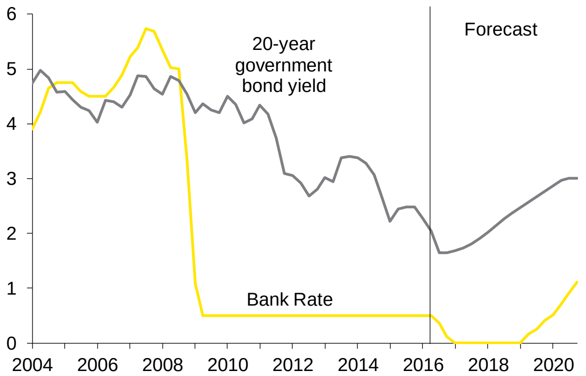
Jan 2005 = 100



Source : EY ITEM Club

UK: Bank Rate & 20-year bond yield

%



Source : EY ITEM Club

The Bank of England still has some scope to cut interest rates and we expect base rates to be cut back to zero by the end of the year. The MPC is also likely to revive its programme of QE debt purchases to help mop up the increase in government debt and cope with the weakness of the economy.

...losing momentum...

The economy went into the referendum buoyed up by a strong service sector, supported by strong household disposable income and spending. Service sector output grew by 2.5% in the year to the first quarter, while consumption increased by 2.8%. The monthly indicators suggest this strong momentum was maintained into the second quarter.

In contrast, the investment picture remains bleak, with business investment estimated to have fallen in both of the past two quarters, leaving it down 0.8% on the year. Given the heightened uncertainty in the lead up to the referendum, Q2 is likely to have seen a third successive decline and we expect this downturn to deepen post-referendum.

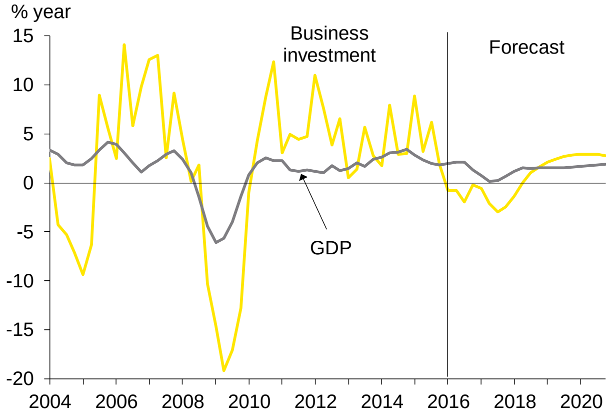
The deficit on the current account of the balance of payments narrowed only marginally from its record level of 7.2% of GDP in the final quarter of 2015 to 6.9% in the first quarter of this year. However, we expect the current account deficit to narrow significantly over the next eighteen months given the sizeable depreciation of the pound and the subdued demand for imports.

The *Index of Services* data completed a series of very strong set of sectoral output figures for April, providing a strong launch-pad for GDP growth in the second quarter, which is currently on course to be in the region of 0.5-0.6%. However, last week's Brexit vote is likely to cause growth to slow significantly in the second half of this year. Although we are expecting that a new Prime Minister will be in place by October, opening the negotiation with the EU27, the high level of uncertainty continues well into next year.

...and skirting recession next year

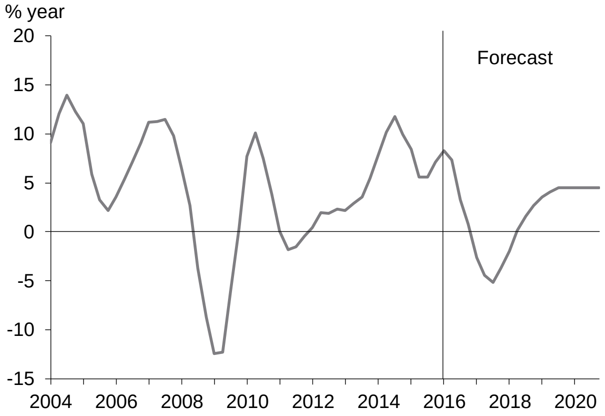
Business and housing investment are especially vulnerable to this heightened mood of uncertainty. As we have argued, it is clear that many transactions were held back in the run up to the referendum, and the risk is that they will never materialize. It is very unlikely that the more competitive position of sterling and the likely cut in interest rates will provide enough support to prevent business investment falling over the next eighteen months. The new forecast sees business investment falling by 0.9% this year and by 2.0% in 2017.

UK: Business investment & GDP



Source : EY ITEM Club

UK: House prices



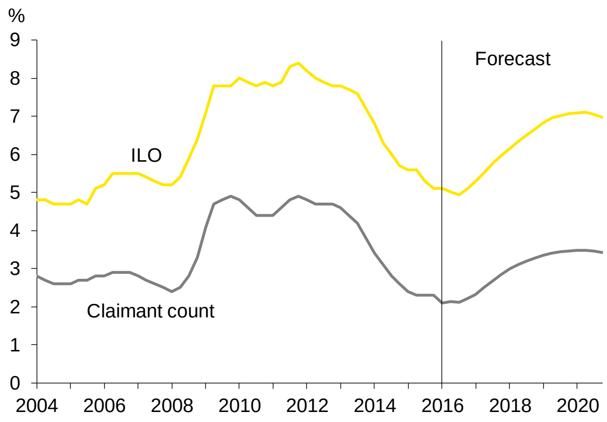
Source : EY ITEM Club

Although there have been reports of bargain hunting by overseas investors on the back of the lower pound, we see nothing to support the housing market in this situation. Once the consequences become clear, consumer confidence is likely to suffer, despite the fact that 17 million consumers voted for Brexit. The forecast sees house prices falling for the first time since 2011, down 4.0% next year. The weakness of house prices and confidence 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 2.8% this year after 3.7% in 2015, but then falling by 3.3% in 2017.

The outlook for consumption depends, as ever, on the outlook for the labour market. Recent business polls are also very worrying in this respect, suggesting that the hiatus on investment now extends to recruitment. The uncertainty over the new trading arrangements with Europe and the future path of the economy will surely arrest the strong growth of employment seen in recent years. After increasing by 2.4% in 2014, 1.8% last year and 1.0% this year, we see total employment falling by 0.2% in 2017 and 0.3% in 2018. The growth in subsequent years is very subdued by recent standards.

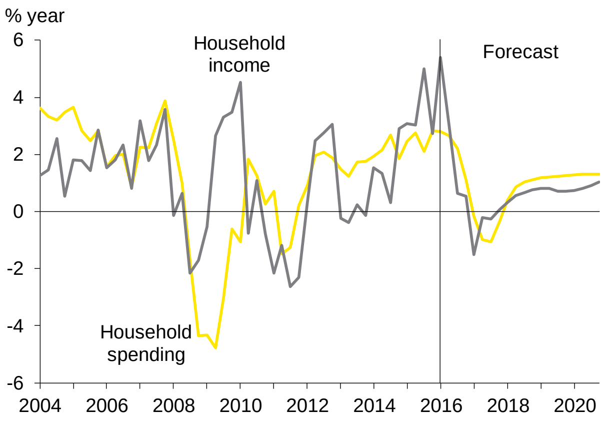
To set against this, a move by the new government to reduce the influx of migrant workers once we leave the EU would tend to reduce the labour supply and mitigate the consequences for unemployment and wages. Nevertheless, the forecast sees ILO unemployment rising from 5.0% currently to 7.1% by the end of 2019, while the claimant count rises from 2.1% to 3.5%. The risk is that these figures, depressing though they are, could prove to be optimistic.

UK: Unemployment



Source : EY ITEM Club

UK: Real household income and spending



Source : EY ITEM Club

This risk will surely weight down on consumer confidence and spending given the importance of job security. However, wage growth will be supported by the National Living Wage, and we see average earnings growing by 3.4% over the forecast period, staying ahead of price inflation. Nevertheless, with employment and working hours falling back, household real disposable income falls by 0.5% in 2017. The forecast sees consumer spending increasing by 2.2% this year but then falling by 0.6% in 2017, followed by subdued growth over the rest of the forecast period.

...with exports the only bright spot on the horizon

We see a marked improvement in the current account of the balance of payments, the one bright bit of the forecast. The deficit narrows from £106 billion this year to £58 billion in 2017, reflecting the fall in sterling and the weakness of domestic demand. Exports increase by 3.4% while imports fall back by 0.3%. Net exports add 1.1% to GDP next year. Import growth resumes as the economy begins to get back on its feet in 2018, and the current account deficit moves back up briefly to £65 billion, before subsiding further over the remaining years of the forecast. Assuming that we no longer contribute to the EU budget, the balance of payments will be helped by an improvement in the balance of international transfers.

The EY ITEM Club forecast for the UK Economy, Summer 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	3.3	4.8	5.8
2016	1.9	1.3	2.2	0.0	3.2	2.2
2017	0.4	-0.7	-0.6	-2.1	3.4	-0.3
2018	1.4	0.9	0.9	0.5	4.4	2.6
2019	1.6	1.2	1.2	2.3	4.2	3.1
2020	1.8	1.6	1.3	3.7	3.9	3.2
	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	3.7	-5.4	2.6	0.0	0.5	91.4
2016	3.5	-5.6	2.6	1.5	0.4	82.1
2017	3.1	-2.9	3.4	2.5	0.0	77.5
2018	2.5	-3.2	3.4	1.6	0.0	76.4
2019	1.6	-3.4	3.4	1.7	0.2	74.8
2020	2.0	-3.3	3.4	2.0	0.8	73.8

(*) Fiscal years, as % of GDP

Source: EY ITEM Club

Fortunately the banking system is in better shape than it was in 2007-08. But the public finances are in a worse state, despite the efforts of George Osborne to repair the damage inflicted by the crisis. His plan for a fiscal surplus is now in tatters. We assume that the automatic stabilizers will be allowed to operate, reducing tax revenues and pushing up welfare spending. We assume that the plans for discretionary spending will remain unchanged, but it is possible that the next administration will take the opportunity offered by zero interest rates to expand infrastructure investment. Who can say as this stage? Either way, it seems that the fall in government borrowing is likely to be reversed, pushing the debt to GDP ratio up to even higher levels. This will add to the intergenerational divide revealed by the referendum vote. The older generation is expecting young workers to pick up the bill for Brexit and fund their triple-locked pensions and bus passes. It remains to be seen whether this expectation can be met.

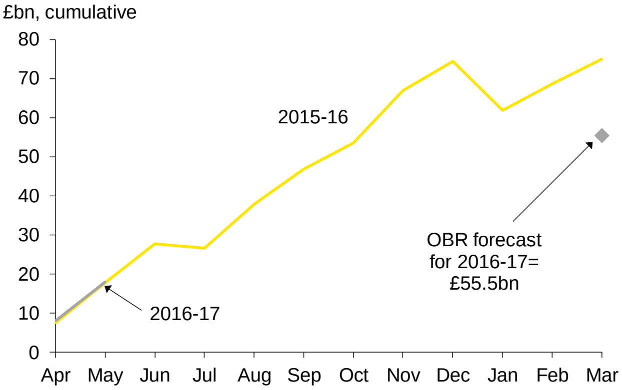
Forecast in detail

1. Fiscal policy

Recent months have seen the Government's endeavours at cutting public sector borrowing stall. The UK's vote to leave the EU will now throw previous fiscal plans up in the air via both a likely slowdown in the economy and the possibility of a discretionary fiscal loosening. But the latter could prove a silver lining for the economy.

The OBR's forecast in March's Budget predicted a £19.5bn 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 two months of the current fiscal year saw borrowing come in £0.2bn higher than the same period a year earlier. Moreover, the deficit in 2015-16 was revised up to £74.9bn, implying a weaker starting point for the current year.

UK: Public sector net borrowing excluding public sector banks



Source : Haver Analytics, OBR

Granted, two months of data is too little to draw meaningful conclusions over the likely path of the deficit over the year as a whole. And the likelihood that GDP growth picked up in Q2 on the first quarter's 0.4% pace should deliver gains to the public finances in the near-term.

But the UK's vote on 23 June to leave the EU is set to have major repercussions for Government borrowing over the next few years. Notably, the prospect of a Brexit-inspired slowdown in the economy is forecast to push up the deficit relative to previous expectations and curtail the chances of achieving a budget surplus by the end of the decade, as required by the fiscal mandate.

Indeed, we now expect 2019-20 (the year in which the mandate was supposed to be achieved) to see borrowing of 1.7% of GDP, compared to the OBR's March forecast of a surplus of 0.5% of GDP. So it is no surprise that the Chancellor has already abandoned that target.

That said, the nature of the weakening in growth should cushion the fiscal position to a degree. Part of the softer economic outlook forecast reflects businesses delaying investment. But this will translate into less use of capital allowances, representing a fiscal saving.

Moreover, a rise in inflation off the back of a weaker pound should boost nominal GDP and the nominal tax base. That said higher inflation will also carry fiscal costs by increasing the rate at which the state pension and tax thresholds are uprated and the inflation uplift on index-linked gilts.

Most importantly, a flight to safety among investors and the prospect of the Bank of England loosening monetary policy has seen a plunge in the cost of borrowing faced by the Government. For example, as of early July, 10-year yields were below 1%, the lowest since records began.

A weaker economy is not the only way in which Brexit will affect the fiscal position. Ultra-low borrowing costs and limited room for the Bank to cut rates strengthens the argument for an active loosening of fiscal policy to support the economy. With spare capacity likely to widen, a fiscal stimulus could produce a relatively high 'multiplier' effect on GDP.

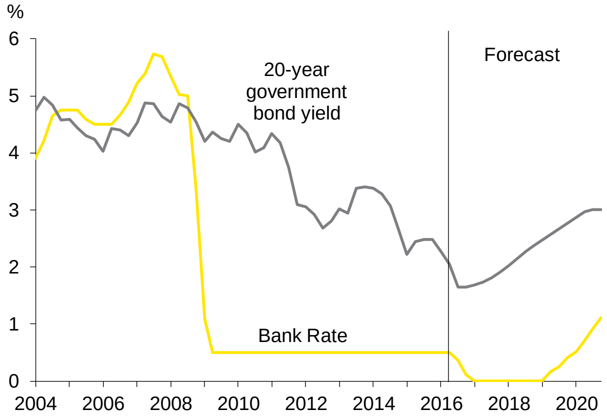
2. Monetary policy

Prior to the EU referendum the MPC was in a holding pattern, with the future path of policy critically dependent upon the result of the vote. The Committee's communications was careful to avoid pre-committing to a path for interest rates in the event of a vote to leave the EU, but the minutes of the May and June meetings asserted that Brexit "*could lead to a materially lower path for growth and a notably higher path for inflation than in the central projections set out in the May Inflation Report*."

A week after the referendum result was announced, Mark Carney gave a speech outlining the issues that the economy faced, in particular the challenges caused by uncertainty, and how the Bank might react. Though not wishing to pre-judge the views of other members of the MPC, Mr Carney said that he felt that "*some monetary policy easing will likely be required over the summer*." In our view, this is likely to manifest itself in Bank Rate being cut to zero by the end of the year.

Given that Mr Carney has previously questioned the efficacy of negative interest rates, more QE is the most likely option should the slowdown deepen and warrant further monetary easing.

UK: Bank Rate & 20-year bond yield



Source : EY ITEM Club

Gilt yields dropped sharply after the referendum in anticipation of the MPC cutting Bank Rate. Though two of the major credit rating agencies have downgraded the UK and government borrowing is likely to be higher, we expect UK yields to remain low with the 20-year yield ending 2016 at 1.7% and 2017 at 1.9%.

At one point on 24 June sterling was down 15% against the dollar compared with its level of the previous night. The situation has stabilised to some extent since then, but sterling ended Q2 down 7% on its end-Q1 level against the dollar and 4% lower against the euro. We expect sterling to slip further during Q3 given the degree of uncertainty surrounding the outlook, ending 2016 at $1.30.

3. Prices and wages

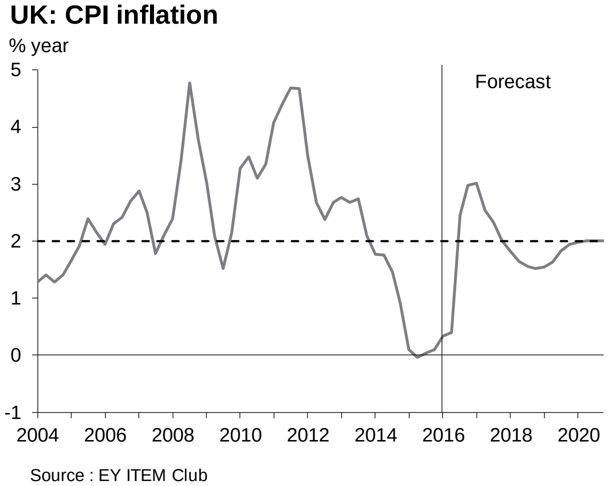
With the exception of March's Easter-distorted reading, CPI inflation has come in at 0.3% in each month of 2016 to date, barely higher than the rate seen throughout 2015. Furthermore, there was little sign of any pickup in core inflationary pressures over the early part of the year, with the modest acceleration on 2015's pace being largely due to base effects, as the impact of the sharp falls in food and petrol prices in late-2014 and early-2015 dropped out of the year-on-year calculation. However, we are now likely to see inflation start to accelerate for a number of reasons.

The oil price has risen sharply over the past few months, from below $30 per barrel for much of January to just under $50 at the beginning of July. This is feeding through to prices at the pump, with weekly data from the Department of Energy & Climate Change (DECC) suggesting that the price of a litre of unleaded petrol has risen by 10% since the start of February, while diesel prices have increased by nearly 12%. 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.

The pressures from higher oil prices will be compounded by the influence of a weaker pound. The depreciation of the pound since the referendum has added to the downward trend which had already been in train since mid-2014. By the end of 2016 we expect the pound to have fallen by more than 20% against the dollar compared with its mid-2014 level. This will increasingly feed through into higher import prices.

The recent producer prices data provide some evidence that these pressures are already having some effect. Both input costs and output prices have rose in each of the four months to May and we would expect these pressures to intensify in H2 2016 and to start to feed along the supply chain into consumer prices.

We expect CPI inflation to climb sharply, rising above the 2% target before the end of this year and averaging 2.5% in 2017, before slowing to 1.6% in 2018.



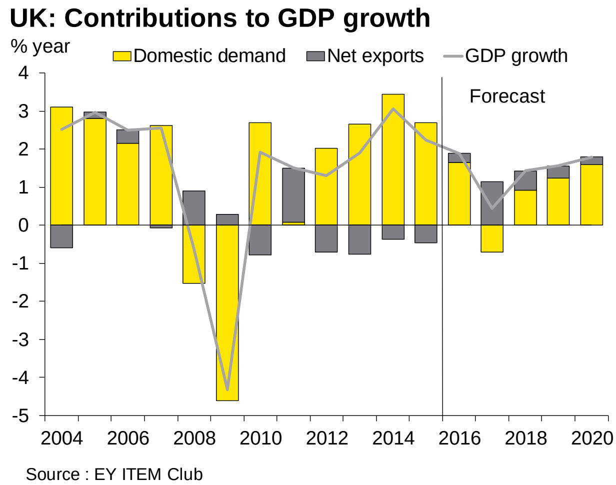
RPI inflation will be higher over the forecast period. This is largely due to the so-called 'formula effect' (i.e. the different methods of aggregation between the RPI and CPI measures which place an upward bias on RPI), though the wedge should widen further over the back end of the forecast horizon 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 ONS has carried out its annual re-write of economic history, but this year's Blue Book revisions were much milder than in recent years. The Q1 data has been unusually stable since April's preliminary estimate and the Quarterly National Accounts again saw quarterly growth unrevised at 0.4%. Digging beneath the surface yields a wearingly familiar story, with growth heavily reliant on the consumer on the expenditure side and on services for the output breakdown.

On a brighter note, the early data for Q2 have been much stronger than expected, with the monthly output data showing very strong growth in April across the production, construction and services sectors. As a result, we have revised up our expectations for Q2 GDP growth to 0.6%. But despite the upgrade to Q2, we have reduced our forecast for 2016 as a whole from 2.3% in April to just 1.9% now, with the second half of the year set to see a significant slowdown as the repercussions of the referendum result take effect.

Business investment had faltered prior to the referendum as uncertainty weighed on corporate confidence. The surprise decision to leave the EU is likely to amplify the degree of uncertainty, with some firms set to postpone capital spending plans at least until the UK's future trading relationship with the EU begins to become clearer.



The consumer outlook has also worsened. Weaker corporate confidence is also likely to weigh on hiring plans, causing unemployment to rise. Alongside this, the depreciation of the pound since the referendum has added to the downward trend which had already been in train since mid-2014. This will feed through into higher import prices and we expect it to push CPI inflation above 2% by the end of this year. 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.

We expect the UK to endure a short, shallow, recession at the turn of the year and have slashed our forecasts for GDP growth in 2017 and 2018 from 2.6% and 2.4% three months ago, to 0.4% and 1.4% now.

5. Consumer demand

Consumer spending has continued to be the mainstay of economic growth in recent quarters. While Brexit may deliver some silver linings for the consumer sector in the form of lower interest rates and a delay to fiscal austerity, heightened uncertainty, higher inflation and a weaker jobs market point to a gloomier overall outlook.

Quarterly GDP growth of 0.4% in Q1 2016 was almost entirely accounted for by the consumer, continuing a long-running trend where this component of expenditure has punched above its weight in driving the economy's expansion.

However, an environment of uncertainty post- June's EU referendum is unlikely to leave the consumer sector unscathed. Some shoppers may hold back on big ticket purchases, such as cars and housing-related spending, until there is more clarity over the UK's future relationship with the EU.

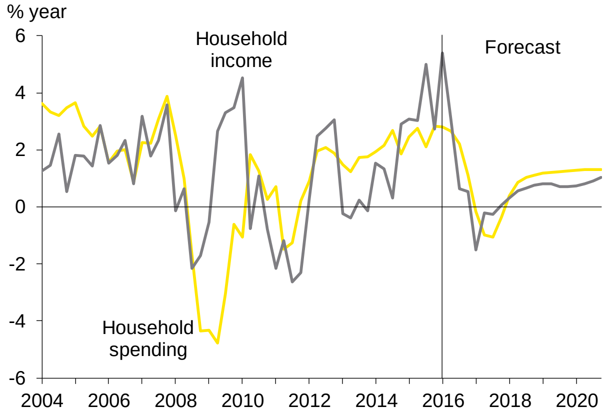
Meanwhile, a slowdown in hiring and our forecast of a rise in unemployment will hurt consumer confidence (which had already dipped in the run-up to the vote) and spending given the importance of job security. Moreover, higher inflation off the back of sterling's weakness will squeeze growth in real incomes. We expect real household disposable income fall by 0.5% in 2017.

That said, the fact that a majority of voters (who are also consumers) voted to leave the EU suggests that the hit to consumer confidence is likely to be smaller than in the event of a more conventional economic shock. Indeed, opinion polls in the run-up to the vote suggested that between two-thirds and three-quarters of people did not believe they would be worse off in the event of Brexit.

At the same time, we expect the Bank of England to provide some offset by cutting interest rates over the next few months. However, with Bank Rate already close to zero, the Bank has limited room for manoeuvre on this front. We would not rule out the possibility of a looser fiscal policy, including tax cuts, offering another potential fillip to the consumer sector.

However, the balance of these factors suggests that while consumer spending will grow by 2.2% this year, a 0.6% drop is likely in 2017. This would be the first annual fall since 2011. A subdued recovery is then expected from 2018 onwards.

UK: Real household income and spending



Source : EY ITEM Club

6. Housing market

Analysis of housing market trends in the first half of 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 has been a degree of forestalling; buyers rushed to complete their transactions before the increase came into effect, with a consequent drop off in activity since April.

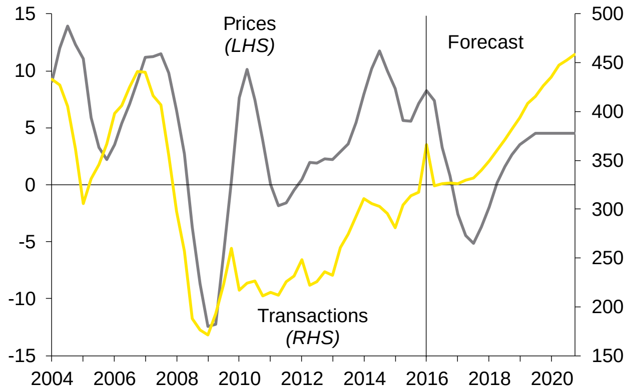
The recent house price data have generally pointed to a slowdown. The Nationwide and Halifax series are currently showing three-month-on-three-month price growth in the 0.4-0.7% range, which is well down on the pace seen at the start of the year, although the new ONS/Land Registry series continues to show growth in excess of 1% on this measure.

We had already been flagging the likelihood that demand-side factors would offer less support to activity and prices moving forwards, with both employment and household income growth set to slow. The repercussions of the vote for Brexit are likely to exacerbate these factors, with our latest forecasts showing employment falling over the next year and real income growth slowing sharply. However if, as we expect, the MPC responds by cutting Bank Rate, this should provide some offset and help to cushion demand.

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 believe that the housing market outlook has deteriorated relative to our April forecast, in line with weaker prospects for the labour market and household incomes. But while this means that prices are set to fall over the coming year, 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 4.8% in 2016, our forecast shows house prices falling by 4% next year and then recovering to rise by 0.6% in 2018.

UK: House prices & transactions



Source : EY ITEM Club

7. Company sector

Business investment has put in a disappointing performance in recent quarters, with uncertainty around the UK's future in the EU probably playing a role. With that uncertainty now crystallised, we expect business spending to continue to suffer. But the underlying fundamentals should stave off too much of a decline.

Q1 2016 saw business investment drop by 0.6% q/q. This followed a 2.6% decline in the last quarter of 2015 and left the level of business investment back to where it sat at the end of 2014.

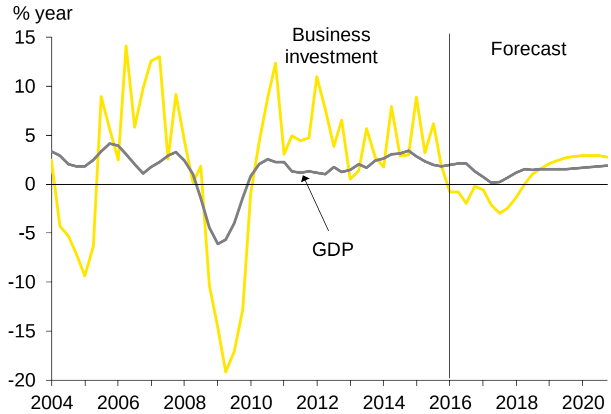
Some of this drop reflected a sharp fall in investment by North Sea firms. Investment in the extraction sector, which accounts for 7% of the total, was down almost 40% in the first quarter of 2016 compared to the level a year earlier.

But uncertainty in the run-up to June's referendum on EU membership may also have played a role. The Bank of England's Agents Survey showed a drop off in investment intentions in early May, although the CBI's Industrial Trends Survey struck a more optimistic tone.

Now that the UK has voted to leave the EU, a lack of clarity over the UK's future relationship with the bloc will intensify uncertainty. This is likely to have a particularly marked effect on business investment, given the often high cost involved in reversing investment decisions and hence the so-called 'option' value of waiting until uncertainty has been resolved.

That said, confidence-related effects aside, that many of the fundamental drivers of investment

UK: Business investment & GDP



Source : EY ITEM Club

remain strong means that any fall in investment should be more modest than in previous downturns. The likelihood of the Bank of England cutting interest rates will depress already very low borrowing costs faced by firms, while a weaker pound should boost capital investment by exporters to non-EU markets. Moreover, the possibility of a fiscal stimulus directed at infrastructure would encourage private sector capital spending.

Overall, having previously forecast business investment to rise by 3.2% and 7.8% in 2016 and 2017 respectively, we now expect declines of 0.9% this year and 2% in 2017, with growth returning in 2018 as uncertainty falls.

8. Labour market

In some respects, the jobs market has seen a near continuous improvement since the beginning of 2013 with the unemployment rate dropping back to the pre-financial crisis average. However, turbulence stemming from the UK's vote to leave the EU threatens to reverse some of that progress.

As of the three months to April, the LFS unemployment rate sat at 5%, the lowest in a decade and in line with the average recorded from 2003-07. What's more, employment was at a record high in terms of both numbers (31.6m) and rate (74.2%).

But recent months have seen employment growth slow and it now threatens to go into reverse as a result of uncertainty stemming from 'Brexit'. To the extent that this uncertainty causes firms' expansion plans to be placed on hold, hiring will suffer. Indeed, recent business polls have suggested that the weakness observed in investment plans has extended to recruitment.

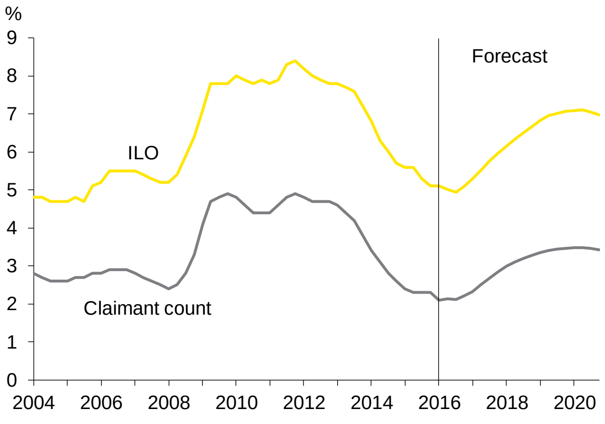
In light of this, we expect employment growth to slow from 1.8% in 2015 to 1% this year, before declining by 0.2% in 2017.

On the pay front, falling unemployment has failed to trigger the rise in earnings that a conventional view of the labour market would have suggested. In fact, 2% annual pay growth in the three months to April was well below the 2.8% recorded a year earlier.

April's introduction of the National Living Wage should spur some pickup. But this will have to combat the drag from rising unemployment. We expect the LFS rate to reach 7.1% by the end of 2019, holding back annual growth in average earnings to 3.4% in the same period, well below the pre-financial crisis norm.

On a brighter long-term note, any move by UK governments to reduce the influx of migrant workers once the UK leaves the EU would tend to reduce labour supply and mitigate adverse consequences for unemployment and earnings. Moreover, to the extent that restrictions on migration compelled firms to invest more in labour-saving technology and improving efficiency, productivity could be boosted, translating into higher wages.

UK: Unemployment



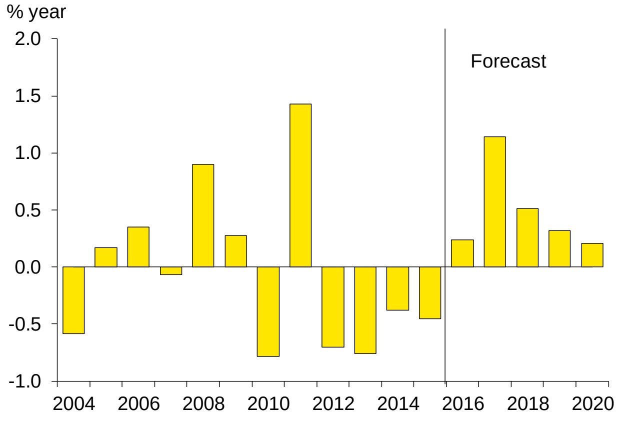
Source : EY ITEM Club

9. Trade and the Balance of Payments

Net trade has provided little support to the economy recently, with the first quarter of 2016 seeing this component knock 0.2 percentage points off GDP growth. This followed a positive contribution of 0.1ppts in the preceding three months. However, the volatility of the official trade data and its proneness to revisions means that recent outturns have to be taken with a pinch of salt.

Recent survey evidence has struck a relatively weak tone, reflecting the subdued performance of the global economy. However, if the decline in sterling triggered by the UK's vote to leave the EU were sustained (as of early July, it was at the lowest level against the dollar since the mid-1980s), then it should drive a robust rise in exports. We expect export growth to accelerate to 4% in 2017, compared to the 3.5% expected in 2016. With demand for imports held back by higher prices and weaker domestic demand, net trade is expected to add 1.1pp to GDP in 2017.

UK: Contribution of net exports to GDP growth



Source : EY ITEM Club

The current account deficit was a sizeable 6.9% of GDP in Q1 2016 only slightly down on the record 7.2% recorded in the last quarter of 2015. To the extent that uncertainty following the referendum leads to less capital flowing into the UK, this will automatically cut the deficit, facilitated by the export-boosting and import depressing effects of a weaker pound and subdued domestic demand and by gains to the sterling value of the UK's overseas earnings. We expect the current account deficit to fall from 5.6% of GDP this year to 2.9% of GDP in 2017, before edging up to 3.2% in 2018.

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About EY ITEM Club

EY ITEM Club is the only non-governmental economic forecasting group to use the HM Treasury's model of the UK economy. ITEM stands for Independent Treasury Economic Model. HM Treasury uses the UK Treasury model for its UK policy analysis and Industry Act forecasts for the Budget. ITEM's use of the model enables it to explore the implications and unpublished assumptions behind Government forecasts and policy measures.

Uniquely, ITEM can test whether Government claims are consistent and can assess which forecasts are credible and which are not. Its forecasts are independent of any political, economic or business bias.