UK Economic Forecast

Q4 2014

Introduction

Welcome to the tenth edition of the ICAEW Economic Forecast, based on the views of the people running UK plc; ICAEW Chartered Accountants working in businesses of all types, across every economic sector and across all regions of the UK, surveyed through the quarterly *ICAEW/Grant Thornton UK Business Confidence Monitor* (BCM).

In this latest edition, we have slightly revised down our 2015 economic growth forecast from 2.6% to 2.5%, as the global economic environment remains challenging. Our 2014 growth forecast has also been revised down marginally from 3.2% to 3.1%.

The eurozone continues to flounder, with significant weakness in the large economies of Germany, France and Italy. There are also signs that, outside of Europe, growth in other major economies is slowing. In particular, China appears to be losing steam while Japan has slipped into recession. The outlook in the Middle East remains highly uncertain amid geopolitical risks.

The global economic backdrop is expected to lead to a weak short-term outlook for UK exports, as well as a slight decline in business investment growth next year. BCM shows that businesses remain cautious in their capital spending plans for the next 12 months, reflecting, at least in part, global economic fragility. Further, uncertainty over the outcome of the next general election and the UK's future membership of the EU may also be hampering investment, as are concerns over the direction of tax and business policy after next May.

On the upside, inflation is likely to remain low in the UK next year, curbing cost pressures for businesses and helping support living standards for households. In its November Inflation Report the Bank of England noted that it expects consumer price inflation to dip below 1% over the next six months. This will support consumer spending and help ensure that the UK economy continues to grow at a robust pace next year. Such a benign outlook for price growth should also leave interest rates lower for longer. What looked like a Bank of England rate rise early next year now looks like a rise in mid-to-late 2015.

The deficit remains a major issue that will dominate both the political debate in the run up to the 2015 election and the next parliament. Restoring the public finances to good order will require restraint in government spending as well as rising revenues for the Exchequer. Worryingly, there are concerns in both of these areas. Spending has remained stubbornly high in the current parliament and cuts will be needed in the next one – something which will require considerable political willpower. The economic recovery has also been relatively 'taxless', in part due to the weakness of earnings growth which has suppressed income tax receipts. Even if earnings start to rise more rapidly next year, as ICAEW forecasts suggest, a cooling housing market and the recent reforms could lead to lower stamp duty revenues while global economic fragility is likely to impact corporation tax receipts. Hitting the government's public borrowing targets is going to be a struggle.

Economic outlook

FIG. 1 REAL GDP – ANNUAL GROWTH

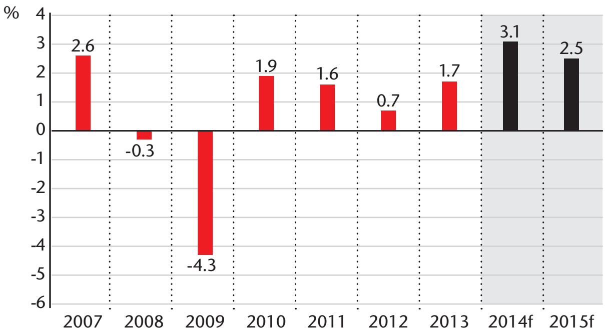
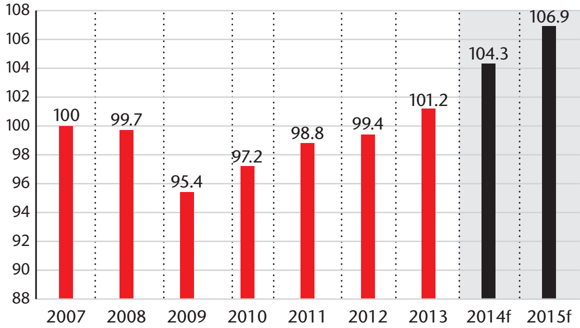


FIG. 2 REAL GDP – INDEX (2007 = 100)



Source: ONS, ICAEW forecasts

The UK economy is expected to grow by 2.5% in 2015, down from ICAEW's previous forecast of 2.6%. Global economic weakness poses a risk to exports and business investment.

Gross Domestic Product (GDP) in the UK expanded at a quarter-on-quarter rate of 0.7% in Q3 2014, according to the Office for National Statistics (ONS) – down on the growth of 0.9% seen in Q2 2014. Compared with the same quarter a year ago, GDP is 3.0% higher.

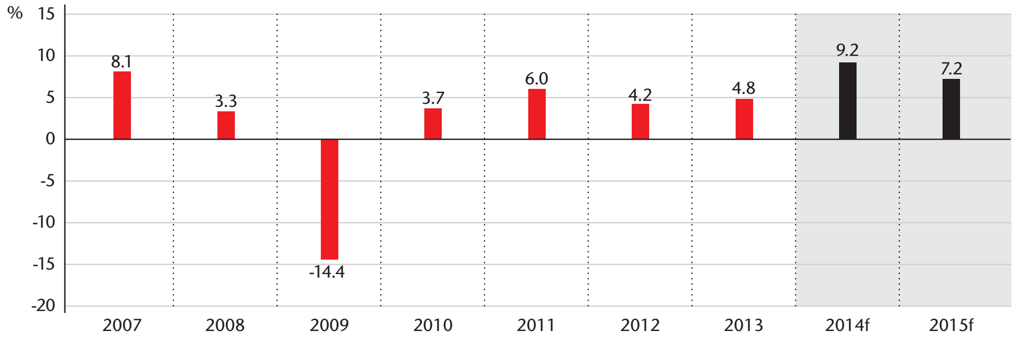
Overall, ICAEW expects the UK economy to have grown by 3.1% across 2014 as a whole, the strongest performance since the financial crisis. However, growth is expected to slow to 2.5% next year – marginally down from a previous forecast of 2.6%.

While still a respectable pace of expansion, we have made a downward revision to our forecast for 2015 to reflect the impact of global economic uncertainty on the UK's growth performance in the short term. The eurozone economy remains in the doldrums and, worryingly, a significant amount of weakness is being driven by the largest economies in the currency bloc – Germany, France and Italy. The economic malaise gripping the Continent is likely to have a significant impact on the UK's performance next year. As such, the prospect of an export-led recovery anytime soon remains slim.

On the upside, inflation is expected to stand at very low levels in 2015, driven by falling global commodity prices. This should support consumer spending, helping to offset weaknesses in other areas of the economy. While this is not the sort of sustainable, balanced growth that policymakers should be pursuing in the longer term, it may be what the UK needs to continue growing robustly next year.

Business investment

FIG. 3 REAL BUSINESS INVESTMENT – ANNUAL GROWTH



Source: ONS, ICAEW forecasts

Business investment is expected to slow next year as companies become slightly more cautious.

New ONS estimates show that business investment has grown much more rapidly in recent years than initially thought. The new estimates, which include R&D spending (unlike previous calculations), are more in line with what business surveys such as BCM have been suggesting.

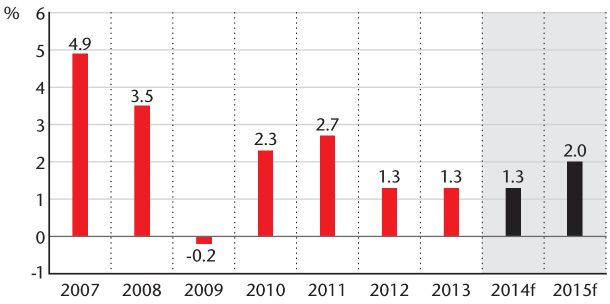
In light of the new and more encouraging data, ICAEW has revised up its forecast of real business investment growth in 2015 from 5.2% to 7.2%. However, ICAEW still expects investment to expand at a slower rate than in 2014.

The slowdown in investment growth next year partly reflects concerns about the underlying strength of the global economy. With question marks hanging over the outcome of next year's general election and the UK's future membership of the EU, a slightly more cautious stance among businesses is understandable. This uncertainty comes out in investment intentions, as the latest figures from BCM suggest that businesses expect capital spending growth to slow over the next 12 months, compared with the previous 12 months.

A further factor that may act as a drag on capital spending is the measure announced in the Autumn Statement that banks will now only be able to offset 50% of their brought forward losses against taxes on profits. This change to regulation may make the UK and London look less attractive to investors, coming on the back of London's recent demotion to second place on Long Finances' Global Financial Centres Index, and could weigh on growth.

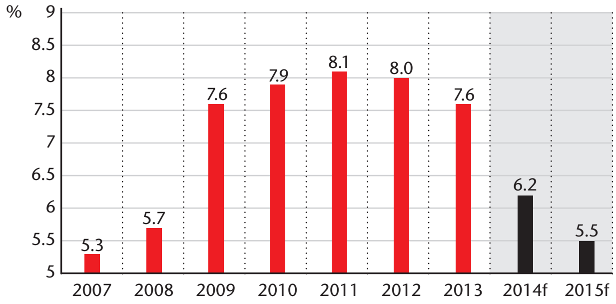
Labour market

FIG. 4 AVERAGE EARNINGS – ANNUAL GROWTH



Source: ONS, ICAEW forecasts

FIG. 5 UNEMPLOYMENT RATE, %



Source: ONS, ICAEW forecasts

Unemployment continues to fall but earnings growth remains subdued.

In the three months to September 2014, the unemployment rate stood at 6.0%. This was down from 6.3% in the three months to June and 7.6% in the same period a year earlier. The last time the unemployment rate was lower was in 2008. ICAEW expects the unemployment rate to have averaged 6.2% over 2014, with a decline to 5.5% expected in 2015.

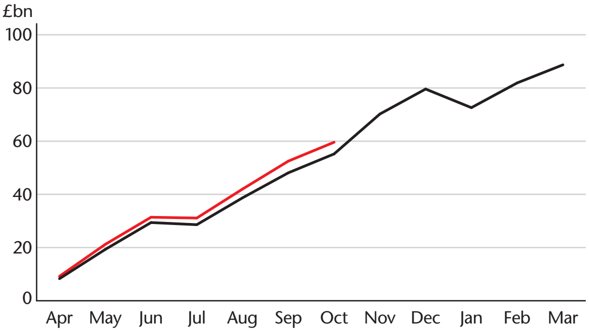
One measure announced in 2014’s Autumn Statement that may help to further support labour market statistics is the removal of employer’s national insurance contributions for apprentices aged under 25. This could make a significant reduction to employment costs, given that businesses pay on average up to £400 a year on this jobs tax for apprentices.

However, despite falls in the headline rate of joblessness, average wage growth remains very subdued. Although ICAEW expects average earnings growth to pick up from 1.3% this year to 2.0% in 2015, this is still low by pre-financial crisis standards of over 4%.

The weakness of wage growth in recent years is likely to reflect a number of factors. First, unemployment didn’t rise as much as thought during the downturn, as companies held on to staff to avoid rehiring costs. This staff retention was partially funded through pay restraint. Secondly, the UK is currently going through a period of little productivity growth. In the economic downturn, high-productivity, high-pay jobs in sectors such as financial services disappeared. Many of the jobs created since then have been lower productivity, pushing down average earnings.

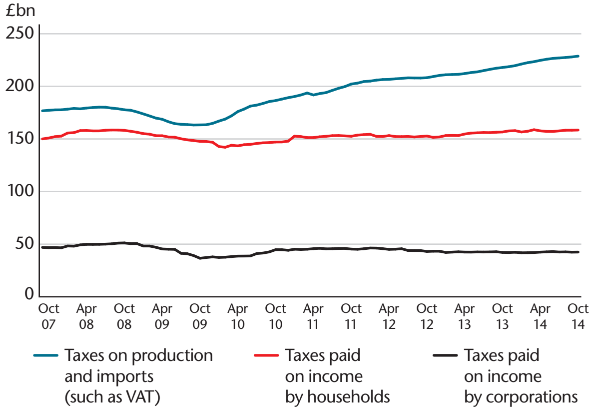
Focus on: the deficit

FIG. 6 PUBLIC SECTOR NET BORROWING, £BN, FISCAL YEAR TO DATE



Source: ONS

FIG. 7 TAX RECEIPTS BY SOURCE, £BN, ROLLING 12-MONTH TOTAL



The deficit is not going away anytime soon. Government spending cuts will be required in the next parliament, and raising the necessary tax revenue is going to be a challenge.

At September's party conferences, the main parties in the UK highlighted how they would aim to bring down the fiscal deficit in the next parliament. With the annual deficit still standing close to £100bn, current levels of spending are not sustainable. Austerity will be the order of the day after 2015 and policymakers will need to make some difficult decision if the target of eliminating the deficit by 2018/19 is to be met.

Part of the reason the deficit remains so huge is that government spending is stubbornly high. The next parliament will require cuts in spending to get the public finances into good order.

Spending is only part of the problem. Another issue in recent years has been the relatively 'taxless' nature of the economic recovery – something the Office for Budget Responsibility (OBR) noted in its October Forecast Evaluation Report. The increase in VAT to 20% in 2011 has pushed revenues from this source of taxation to new highs. But other sources of revenue, such as income and corporation tax, have failed to grow. In part this reflects the fact that the current government has implemented tax cuts (such as increases in tax-free personal allowances and reductions in corporation tax). However, with income tax it also reflects the fact that wage growth in the economy has been extremely weak.

The tax side of the deficit is likely to remain an issue in 2015, even if rising earnings growth translates into higher income tax receipts. A cooling of the housing market next year, something which seems increasingly likely, looks set to curb stamp duty revenues, which will be exacerbated by the recent reforms to the tax. Further, corporation tax receipts could be impacted by global economic fragility.

Back in 2010, the OBR forecast that the deficit would largely be eliminated by the end of the current parliament. Their most recent forecast from the 2014 Autumn Statement suggests that the government will start to run a surplus by 2018/19. However, this forecast is based on a pick-up in wage growth that may still prove elusive and as such, taking further measures to tackle the deficit will be an unwelcome legacy for whoever is Chancellor after the next election. He or she will have to use all the levers available to them, including the prospect of further cuts to public spending alongside potential tax hikes.

Forecasting methodology

Headline economic forecasts

	2007	2008	2009	2010	2011	2012	2013	2014f	2015f
Real GDP – annual growth	+2.6%	-0.3%	-4.3%	+1.9%	+1.6%	+0.7%	+1.7%	+3.1%	+2.5%
Real business investment – annual growth	+8.1%	+3.3%	-14.4%	+3.7%	+6.0%	+4.2%	+4.8%	+9.2%	+7.2%

Labour market forecasts

	2007	2008	2009	2010	2011	2012	2013	2014f	2015f
Earnings (total pay) – annual growth	+4.9%	+3.5%	-0.2%	+2.3%	+2.7%	+1.3%	+1.3%	+1.3%	+2.0%
Employment – annual growth	+0.8%	+0.9%	-1.6%	+0.2%	+0.5%	+1.1%	+1.2%	+2.3%	+1.3%
Unemployment rate	+5.3%	+5.7%	+7.6%	+7.9%	+8.1%	+8.0%	+7.6%	+6.2%	+5.5%

ICAEW's forecasts for economic growth, business investment and the outlook for the labour market are based on the correlation between *ICAEW/Grant Thornton Business Confidence Monitor (BCM)* indicators and official economic data. BCM contains data – from a survey of 1,000 UK businesses – on business confidence, financial performance, challenges and expectations. BCM indicators provide a useful and unique steer on future developments in the UK economy.

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ICAEW
Chartered Accountants' Hall Moorgate Place London EC2R 6EA UK

T +44 (0)20 7920 8705
E economicforecast@icaew.com
icaew.com/ukeconomicforecast

linkedin.com – find ICAEW
twitter.com/icaew
facebook.com/icaew