Economic Background

The UK GDP annual growth rates in each calendar year 2013 – 2016 of 1.9%, 3.1%, 2.2% and 1.8%, have all been the top rate, or near top rate, of any of the G7 countries in every year. It is particularly notable that the UK performance was repeated in 2016, a year in which the Bank of England had forecast in August 2016 that growth would be near to zero in the second half of the year due to the economic shock it expected from the result of the Brexit referendum in June. However, it has had to change its mind and in its February and May 2017 Inflation Reports, the Bank upgraded its forecasts for growth (May Report - 2017 1.9%, 2018 and 2019 1.9%). However over these years, it also expects inflation to accelerate towards nearly 3% as increases in costs as a result of the fall in the value of sterling since the referendum, gradually feeds through into the economy, though it should fall back to 2.2% in 2019. Provided those cost pressures do not feed through into significantly higher domestically generated inflation within the UK, the MPC is expected to 'look though' this one off blip upwards in inflation. Wage inflation, which is a key driver of domestically generated price pressures, is currently subdued. There is, though, a potential risk that the MPC might muster a majority to reverse the emergency 0.25% rate cut before embarking on a progressive trend of increases in Bank Rate at a later time.

GDP growth in the US has been highly volatile in 2016 but overall mediocre, at an average of 1.6% for the year. Quarter 1 in 2017 has also been mediocre at 1.4% but current indications are that growth could rebound strongly in quarter 2. The disappointment so far has been the lack of decisive action from President Trump to make progress with his promised fiscal stimulus package. The Fed has, therefore, started on the upswing in rates now that the economy is at or around "full employment" and inflationary pressures have been building to exceed its 2% target. It has, therefore, raised rates four times, with the last three following quickly on one another in December 2016 and March and June 2017. One or two more increases are expected in 2017 and possibly four in 2018.

Growth in the EU improved in 2016, to 1.7%, after the ECB cut rates into negative territory and embarked on massive quantitative easing during the year. The ECB is now forecasting growth of 1.9% in 2017, 1.8% in 2018 and 1.7% in 2019. It has committed to continuing major monthly quantitative easing purchases of debt instruments, though in April 2017 it reduced the rate from €80bn per month to €60bn, to continue until the end of 2017, in order to stimulate growth and to get inflation up to its 2% target.

There are major concerns about various stresses within the EU; these could even have the potential to call into question the EU project. The Dutch and French elections passed off without creating any waves for the EU but we still have a national election in Germany on 22 October; this is not currently expected to cause any significant change. What could be more problematic is the general election in Austria on 15 October where a major front runner is the Freedom Party which is strongly anti-immigration and anti EU. There is also a risk of a snap general election in Italy before the final end possible date of 20 May 2018. A continuing major stress point is dealing with the unsustainable level of national debt in Greece in the face of implacable opposition from Germany to any further bail out. High levels of unemployment in some EU countries and the free movement of people within the EU, together with the EU's fraught relationship with Turkey in controlling such people movements, are also major stress issues. On top of which the EU also now has to deal with Brexit negotiations with the UK.

China is expected to continue with reasonably strong growth, (by Chinese standards), of 6.5% in 2017. However, medium term risks are increasing. Japan has only achieved 1% growth in 2016 and is struggling to get inflation to move from around 0%, despite massive fiscal stimulus and monetary policy action by the Bank of Japan.

Detailed economic commentary on developments during quarter ended 30 June 2017

This section has been provided by **Capital Economics** and therefore includes their views and opinions of future trends and events.

- During the quarter ended 30 June 2017:

- The economy showed signs of re-accelerating;
- There was an intensifying squeeze on households' real earnings;
- The MPC took a more hawkish turn, with 3 members voting to raise interest rates;
- A snap General Election delivered a hung Parliament;
- Face-to-face negotiations with the EU began.

- After sluggish growth of 0.2% in Q1, the early indications are that the economy has re-gained some momentum in Q2. Indeed, the quarterly average of the Markit/CIPS all-sector PMI points to GDP growth of about 0.5% or so. Admittedly, the PMI pointed to a similar rate of growth in Q1, which didn't materialise. However, this is partly because the service sector PMI excludes the retail sector, which performed poorly in Q1 – sales volumes fell by a quarterly 1.6%. On the basis of the survey data and hard evidence released so far, retail sales look to have rebounded by over 1% in Q2.

- There is some concern, however, about the sustainability of consumer spending. After all, Q1's National Accounts showed that the 0.4% quarterly rise in spending was entirely funded through households reducing the proportion of their income that they save to just 1.7%, the lowest level since comparable records began. What's more, unsecured consumer borrowing has been rising at an annual rate of over 10%, prompting the Bank of England's Financial Policy Committee to bring forward its stress tests of UK banks' consumer loan books to July. It also increased the counter cyclical capital buffer that banks are required to hold from 0% to 0.5% and intends to increase that further to 1.0% in November. This will have little immediate impact on overall lending as most banks already hold capital in excess of the overall minimum required. However, the FPC also signalled that it is likely to take targeted action specifically on falling consumer credit quality at its next meeting in September after it has the results of its stress tests.

- That said, it could be argued that the drop in saving is an entirely rational response to what households perceive to be a temporary squeeze on their real incomes. Annual growth in the headline measure of average weekly earnings was just 2.1% in the three months to April, down from the 2.3% rate recorded in Q1 and below CPI inflation of 2.4% over the same period. Given that inflation picked up to 2.9% in May, the squeeze on real earnings is likely to have intensified since then.

- The weakness of wage growth still looks hard to square with the performance of the labour market. Employment growth has held up at an annual rate of 1.2% in April and the unemployment rate has continued to drift lower, reaching a new post-crisis low of 4.6%.

- Inflation has risen faster than expected. But this appears to be because the impact of the drop in the pound is feeding through faster than in previous depreciations, rather than by a larger amount. Note that price pressures at the beginning of the production pipeline are already beginning to fade. Producer input price inflation has fallen from a peak of almost 20% in January, to 11.6% in May. And output price inflation – which did not rise as far as its past relationship with input price inflation would have suggested anyway – has stood at 3.6% for three consecutive months now.

- Accordingly, inflation still looks set to peak before the end of this year, at around 3.2% in Q4. Given that it has accelerated more quickly than anticipated, it should fall back quicker as well. We think that inflation should be close to 2% by the end of 2018.

- Given the continued weakness in wage growth, and the fact that inflation's rise is set to be only temporary, it is perhaps surprising that the Monetary Policy Committee appeared to take a more hawkish stance in the second quarter.

- The Committee came its closest to voting for a rate hike since 2007 at its June meeting, with three out of eight members (Kristin Forbes, Michael Saunders and Ian McCafferty) voting to increase Bank Rate by 0.25%. There have been some indications that the rift between MPC members has grown since then, with Bank of England Chief Economist, Andy Haldane, also giving a relatively hawkish speech in which he indicated that he would probably vote to raise interest rates in the second half of 2017. This is particularly symbolic given that he is a Bank "insider" and has typically been quite dovish.

- However, Kristin Forbes term came to an end on 30th June – she will be replaced by Silvana Tenreyro at the next meeting in August. However, we do not know much about Ms Tenreyro's views on UK monetary policy. As a result, the next meeting could see a 5-3 split once again though a 4-4 split with Carney voting for a rise, would put him in the deciding vote hot seat, (until the MPC is restored to its full nine person membership by filling one vacancy).

- However, despite the media reporting that Carney had shifted his view to a more hawkish position between his two speeches in June, it is not at all clear that he is on the cusp of voting to raise interest rates. In particular, his list of specific conditions, including signs that wage growth is firming, and that business investment and net trade pick up the slack from slower consumer spending growth, may not be met.

- One possibility is that the MPC could vote to simply reverse the emergency cut in interest rates that took place following the EU referendum, but then leaves rates on hold for a while thereafter. This appears to be an argument that one or two MPC members are sympathetic to. That said, markets still expect rates to remain on hold until August 2018, around six months earlier than they thought at the end of Q1.

- Meanwhile, the public finances started the fiscal year on a fairly solid footing, with borrowing in April and May in line with last year's outturn. Note, however, that the Office for Budget Responsibility expects borrowing to rise this fiscal year as a whole by £7bn, as a number of temporary factors – including income shifting related to the rise in the dividend tax rate – unwind.

- What's more, borrowing could increase further if the Government is forced to ease back on austerity at the autumn Budget. The snap general election on June 8th saw the Conservatives fail to gain an overall majority, and instead the party has had to agree a confidence and supply agreement with the Northern Irish Democratic Unionist Party (DUP). The fact that votes on the Queen's Speech were passed without too much difficulty suggests this should be able to function for a while. But the fragile nature of the arrangement could see the Government soften its stance on Brexit and austerity, in order to ensure legislation is passed.

- Face-to-face negotiations with the EU started in June. The Government capitulated on day one to the EU's demand that the withdrawal and future arrangements occur in sequence, rather than in parallel. What's more, the Government appeared to concede some ground to the EU in its initial offer on citizens' rights, including allowing the exporting of EU citizens' child benefits. We have not learnt much in terms of what Brexit will ultimately look like from the initial exchanges, although it still looks likely that the UK will leave the single market and customs union.

- Finally, in financial markets, the FTSE 100 index and FTSE UK Local Index (which only includes firms that make 70% of their sales domestically) have fallen by 0.4% and 0.1% respectively. Most of this decline occurred in June, and probably reflects a combination of election uncertainty as well as the prospect of higher interest rates. Meanwhile, 10-year gilt yields rose by 12bp between end-Q1 and end-Q2. However, there was significant variation within the quarter, with yields falling to as low as 0.9%, before picking up following a more hawkish turn by the MPC.

About Capital Economics

Capital Economics is one of the leading independent economic research companies in the world. Its large team of more than 60 experienced economists provides award-winning macroeconomic, financial market and sectoral analysis, forecasts and consultancy, from offices in London, New York, Toronto, Sydney and Singapore.

Founded in 1999, it has gained an enviable reputation for original and insightful analysis, and has built up a diverse and distinguished client base. The majority are in the financial sector, including some of the world's largest investment banks and wealth managers, as well as smaller and more specialist firms. But it also have a growing number of corporate clients from a wide range of sectors and industries, and many relationships with governments and central banks, both in advanced and emerging economies.