

UK outlook resilient: first rate hike in 2018

- **Firm growth outlook despite clear risks:** The UK economy has carried significant momentum into 2017. The second estimate of Q4 2016 GDP (to be published on 22 February) will likely show that growth accelerated to 0.7% qoq from 0.6% qoq in Q3. This is an upward revision for Q4 from the initial estimate of 0.6% qoq to a pace well above the trend rate of 0.5% qoq. Despite significant political and economic uncertainty linked to Brexit, real GDP growth looks set to remain resilient in 2017 and 2018 as domestic demand continues to expand at a robust rate and external demand increases amid the improving global backdrop. We change our key forecasts as follows.
 - **Real GDP growth:** We raise our calls for 2017 and 2018 from 1.8% and 1.6% to 2.0% and 1.7%, respectively. Our forecasts exceed Bloomberg consensus (16 February 2017) of 1.4% in 2017 and 1.3% in 2018.
 - **Unemployment:** We reduce our forecast from 5.0% to 4.8% for 2017 and from 5.2% to 4.9% for 2018.
 - **Bank of England (BoE) outlook:** Based on the GDP growth and labour market upgrades, we expect the BoE to hike the bank rate by 25bp in Q2 2018 to 0.5% from the current rate of 0.25%.
 - We see risks to the growth outlook as roughly balanced rather than tilted to the upside as before. See the table on the following page for our detailed forecasts.

Key reasons for our forecast revisions

- **GDP:** We expect real consumption growth to slow from an average rate of 2.6% yoy in 2015/16 to 2.0% in 2017/18, as higher inflation erodes real wage increases while job gains become more limited after the labour market has reached full employment. However, with a continued rise in consumer credit and a small decline in their savings rate, households will be mostly able to smooth spending growth despite a slower gain in real wages. Household consumption will probably remain the key driver of real GDP growth over the medium term. Meanwhile, UK exports will benefit from the global upswing in demand and the continued recovery in the UK's biggest external market, the EU. For many exporters, the weak sterling further supports the rise in demand.
- **Unemployment:** Driven by a stronger outlook for consumption, but a still relatively weak outlook for capital investment, demand for labour as a factor of production will likely remain high. We therefore do not expect a material change in the unemployment rate over the coming years, except for a small rise in 2018 as a rise in the minimum wage reduces demand for low-skilled workers at the margin. With little slack in the labour market and job vacancies currently at a near-record high, nominal wage growth could pick up over the next few years as firms offer higher wages in order to attract better-skilled workers, reinforcing our positive outlook for household demand.
- **Monetary policy:** We continue to expect the BoE to look through the transitory inflation pressure in 2017/18 that will mostly be driven by the rise in import prices from the sterling depreciation. Our upgrades to growth and employment point to a sustained rise in underlying inflation to which monetary policy ought to respond. After gradually rising over the course of 2017/18, core inflation will likely remain above the BoE's 2% target after the exchange rate effects have passed. That households are gearing up to support spending further strengthens the case for a higher bank rate, although amid Brexit uncertainty the BoE will likely wait for clear evidence of stronger nominal wage growth – probably to above 3% from the current rate of 2.6% – before the first rate hike. The rise in nominal wage growth will likely lag inflation (we expect yoy CPI to peak at 3% in Q3 2017). As our base case, we now look for a 25bp first rate hike in Q2 2018, with a 30% chance the BoE raises the bank rate earlier. So far, we had not expected a rate hike before 2019.

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UK economic forecasts

		2015	2016	2017	2018	1Q16	2Q16	3Q16	4Q16	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18
GDP	% y/y	2.2	2.1	2.0	1.7	1.8	2.0	2.2	2.2	2.4	2.1	1.9	1.7	1.7	1.7	1.7	1.7
	% q/q					0.3	0.6	0.6	0.7	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4
	%q/q ann.					1.4	2.6	2.3	2.7	1.8	1.5	1.7	1.7	1.8	1.6	1.6	1.6
Private Consumption	% y/y	2.4	2.8	2.1	1.9	2.7	3.0	2.7	2.9	2.6	2.3	2.0	1.7	1.7	1.8	2.0	2.2
	% q/q					0.8	0.8	0.7	0.7	0.5	0.4	0.4	0.4	0.5	0.5	0.6	0.6
	% y/y	1.3	0.9	1.1	1.2	1.8	0.7	0.2	0.9	0.7	1.1	1.4	1.2	1.2	1.2	1.2	1.2
Government Consumption	% q/q					0.5	-0.1	0.0	0.5	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
	% y/y	3.4	0.9	1.3	1.4	0.6	0.4	0.5	1.9	2.5	1.4	0.7	0.6	1.0	1.4	1.6	1.6
	% q/q					-0.5	1.1	0.9	0.5	0.0	0.0	0.2	0.4	0.4	0.4	0.4	0.4
Final Domestic Demand ¹	% y/y	2.3	2.1	1.8	1.7	2.2	2.1	1.8	2.4	2.2	1.9	1.7	1.4	1.5	1.6	1.8	1.9
	% q/q					0.5	0.6	0.6	0.6	0.4	0.3	0.3	0.4	0.4	0.4	0.5	0.5
	% y/y	0.0	-0.6	-0.3	0.0	0.3	0.0	-0.9	-1.8	-0.8	-1.0	0.3	0.3	0.2	0.1	-0.1	-0.2
Net Exports ¹	% q/q					-1.0	0.3	-1.2	0.1	0.1	0.1	0.1	0.0	0.0	0.0	-0.1	-0.1
	% y/y	-0.2	-0.4	-0.2	0.0	-0.7	-0.6	-0.2	-0.1	0.1	0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
	% q/q					-0.2	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Current Account Balance	GBP bn	-80.2	-93.8	-67.0	-58.9	-23.6	-22.1	-25.5	-22.6	-19.7	-16.9	-15.5	-15.0	-14.7	-14.6	-14.7	-14.9
	% of GDP	-4.3	-4.9	-3.3	-2.8	-4.9	-4.6	-5.3	-4.6	-3.9	-3.3	-3.1	-2.9	-2.8	-2.7	-2.8	-2.8
Industrial Production ²	% y/y	1.2	1.2	2.0	1.2	0.1	1.6	1.1	1.9	3.1	1.2	1.9	1.9	1.2	1.2	1.2	1.2
	% q/q					-0.2	2.1	-0.4	0.4	1.0	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Unemployment Rate ²	%	5.3	4.9	4.8	4.9	5.0	4.9	4.8	4.8	4.7	4.8	4.8	4.8	4.9	4.9	4.9	5.0
CPI ²	% y/y	0.1	0.6	2.7	2.6	0.3	0.3	0.7	1.2	2.2	2.8	3.0	2.9	2.8	2.7	2.5	2.4
General Govt. Balance ³	% of GDP	-4.4	-3.7	-3.2	-2.7												
General Govt Debt ³	% of GDP	89.2	91.1	90.2	89.2												
BoE Bank Rate ⁴		0.50	0.25	0.25	0.50	0.50	0.50	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.50	0.50

¹ Contribution to GDP growth ² Period averages ³ Maastricht basis ⁴ End period

Source: Berenberg

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