MONTHLY ECONOMIC BRIEF

DECEMBER 2018

Economic Summary

- **The CBI's latest UK economic forecast expects growth to remain subdued through 2020, assuming the EU Withdrawal Agreement is ratified by parliament.**
- **The CBI's latest growth indicator points to slightly weaker growth in Q4 following a stronger Q3, which was supported by the warm weather and world cup.**
- **Evidence of stockpiling by companies as a form of contingency planning for Brexit remains limited.**
- **The latest Financial Stability Report concluded that UK banks are resilient to a sharp recession in the UK and global economy, more severe than the global financial crisis.**
- **Several major papers analysing certain Brexit scenarios were released at the end of November ahead of Parliament's vote on the EU Withdrawal Agreement bill.**

CBI Economic Narrative

- Underlying growth has largely evolved as we had expected during 2018, at a slow and underwhelming pace (averaging 0.4% per quarter since the EU referendum). We expect similar growth to persist ahead, with **the economy expected to grow by 1.3% in 2018 and 1.4% in 2019 – broadly unchanged from our previous forecast** (1.4% and 1.3% respectively). **We expect growth to pick up a little further in 2020 (to 1.6%)**, but to remain below pre-crisis norms (GDP growth averaged 2.9% between 1997-2007).
- Key assumptions in our forecast include:
  - Household spending remains subdued, with real incomes growth staying weak. Consumer spending growth picks up somewhat over 2020 as real earnings recover, though both remain below their pre-crisis averages.
  - Brexit uncertainty – including uncertainty around the full end-state of the UK's relationship with the EU – continues to weigh on business investment. We expect some firming in growth towards the end of our forecast period, as uncertainty lifts and the impact of greater automation spending kicks in.
  - Support to growth from net trade peters out over our forecast. While solid global growth continues to support exports, this is largely matched by a mild pick-up in imports growth, supported by a firming in domestic demand.
  - We also now expect a little more support from government spending, following announcements around increased spending on the NHS.
- **Our forecast is conditioned on the Withdrawal Agreement being ratified – particularly the implementation of a transition period until at least the end of 2020** – thus ensuring a smooth transition to a new relationship with the EU.
- **The prospect of a "no deal" remains the most immediate risk to the UK economy**, and would likely lead to both greater financial market volatility and significantly weaker economic growth than in our baseline forecast. GDP growth would likely be more volatile in the near-term too, particularly if firms turn to stockpiling in the event of a no deal.
- The global economy continues to expand at a decent pace, although the pace of expansion has slowed since the start of 2018. This reflects a combination of factors, such as the maturing of the economic cycle in key markets (such as China), higher oil prices, tighter global financial conditions, and the impact of rising trade tensions on business confidence. Nevertheless, the slowdown in global growth is expected to be gradual and the global economy is still expected to expand at a relatively healthy 3.7% in 2018, 3.4% in 2019 and 3.5% in 2020.

Latest CBI forecast expects subdued UK economic momentum through 2020

There has been some volatility in economic growth over 2018 so far, largely driven by the weather: the "Beast from the East" caused the economy to near-flatline in Q1, while the warmer-than-usual summer provided a bigger lift to activity in Q3. But looking through this volatility, underlying growth has largely evolved as we had expected, at a slow and underwhelming pace (averaging 0.4% per quarter since the EU referendum).

The latest CBI economic forecast (released 6 December) expects the UK economy to grow by 1.3% in 2018 and 1.4% in 2019, broadly unchanged from the June 2018 forecast (of 1.4% and 1.3%, respectively). The forecast sees growth picking up a little further in 2020 (to 1.6%), while remaining well below pre-crisis norms (GDP growth averaged 2.9% between 1997 and 2007).

The forecast is conditioned on the successful ratification of the EU Withdrawal Agreement, including a transition period until at least the end of 2020, with the UK than moving towards a relatively close relationship with the EU. Under this scenario (see below for discussion of recent Brexit impact studies), domestic demand is set to remain subdued – although it picks up slightly as the squeeze on household earnings eases and government spending increases – and business investment is expected to improve as Brexit uncertainty fades. Meanwhile, net trade is expected to support the economy to a lesser extent, due to the boost from the low pound having peaked and firmer domestic demand pushing imports growth higher.

Q4 starts off on a more subdued pace…

The November CBI Growth Indicator showed that private sector activity was steady in the three months to November, its weakest pace since March 2016. The slowdown was driven by a weaker performance in services and slower growth in distribution – retailers saw sales volumes fall in the three months to November. Meanwhile, manufacturing growth picked up slightly, but remained below the stronger readings seen earlier this year.

The weaker growth momentum in the Growth Indicator chimes with the decline in the November IHS Markit/CIPS UK composite PMI, which fell to 50.7 in November from 52.1 in October, indicating barely any growth on the month. The drop in the composite PMI was driven by a larger-than-expected drop in the services PMI – which hit its lowest level since the EU referendum – that offset a rise in the manufacturing PMI. According to Markit, the composite PMIs in October and November would be consistent with quarterly GDP growth of around 0.1% in Q4 2018, a sharp slowdown from 0.6% growth in Q3.

…. as underlying conditions remain gloomy

The CBI's latest quarterly surveys on the services and retail sectors suggested that business conditions in the UK are noticeably lacklustre. The services sector saw profitability fall, while business sentiment deteriorated at its fastest pace since November 2016. Meanwhile, the retail sector recorded poor business sentiment, flat investment intentions, and declining headcounts. The November Services PMI chimed with this gloomy outlook. Markit mentioned that Brexit uncertainty was the main factor behind the fall in the services PMI, citing businesses and customers cancelling/postponing spending and investment decisions amidst the political turmoil.

Labour market remains tight, as pay growth improves

The UK labour market remained extremely tight in the three months to September, with the unemployment rate (4.1%) around its lowest since the mid-1970s (albeit edging higher on recent months). Encouragingly, pay growth continues to show signs of life, with average regular weekly earnings growth (excluding bonuses) picking up in the three months to September (3.2%). However, once inflation is taken into account, real pay growth remains modest and below pre-crisis norms.

Evidence of contingency stockpiling remains limited

There have been several high-profile reports in the media about businesses stockpiling, as part of Brexit contingency planning – particularly in preparation for supply chain disruption in the event of a "no deal". Generally, some CBI members do talk about stockpiling as part of their Brexit preparations – particularly in food & drink manufacturing, chemicals and pharmaceuticals. Some of these sectors are stockpiling (at least in part) as a response to guidance in the government's technical notes.

Overall, though, evidence of stockpiling remains limited. The CBI's business survey data on stock adequacy in the retail and manufacturing sectors remain around or below their long-run averages. Many CBI members explicitly talk about not building up stocks because of the practical difficulties in doing so (for example, in the case of perishable food). Of those businesses that reported that they are stockpiling, a number of them are only stockpiling enough for a short period (e.g. a few weeks).

Inventories are a direct component of GDP, so stockpiling would, in theory, boost growth over the near-term; however, one would expect stockpiling to drag on growth into the medium term as companies subsequently ran down stocks. The CBI forecast does not assume any further near-term boost to GDP from stockpiling due to limited supportive evidence from CBI members and the CBI's business surveys. One should note, though, the degree of support to near-term growth from stockpiling is very difficult to gauge, as that it is typically a very volatile driver of growth. Therefore, it remains an upside risk to our near-term growth forecasts.

FPC judges that UK banks are prepared to withstand a severe, global recession

In the Bank of England's latest Financial Stability Report, the Financial Policy Committee (FPC) judged that the UK banking system could withstand a deep, simultaneous recession in the UK and global economy that is more severe than the global financial crisis. Despite the dramatic, worst-case scenario tested in the Bank of England's annual stress test, UK banks would be able to maintain a capital ratio (following the scenario) twice as large as before the financial crisis.

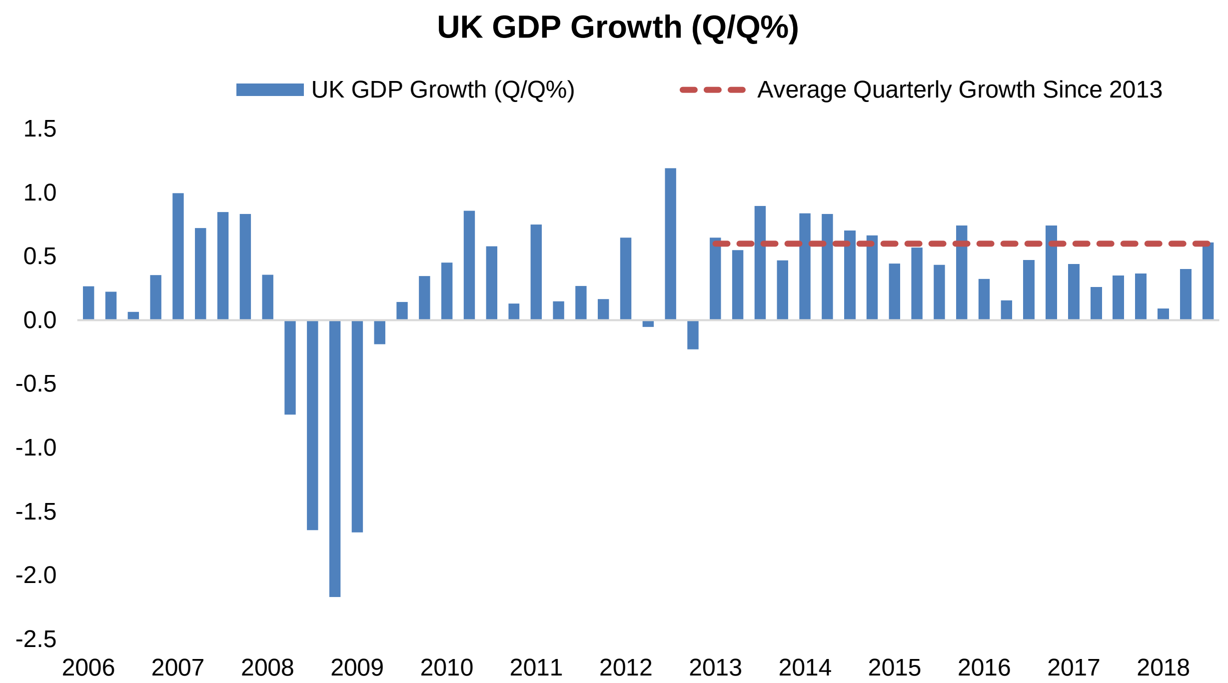
Additionally, the FPC judged that the negative impact of a disorderly Brexit on UK banks' capital would likely be "limited". This is partly due to the geographic diversification of major UK banks, with only around half of their exposure being to the UK. This means that UK banks would be able to balance losses incurred in the UK through their considerable exposure to foreign markets. The FPC noted a risk in the form of a sharp rise in corporate non-bank finance globally, particularly in the form of leveraged loans. Additionally, the FPC noted that current global debt vulnerabilities – specifically stemming from emerging markets, China, and Italy – pose a considerable risk to the UK banking system.

Several Brexit scenario papers have been published

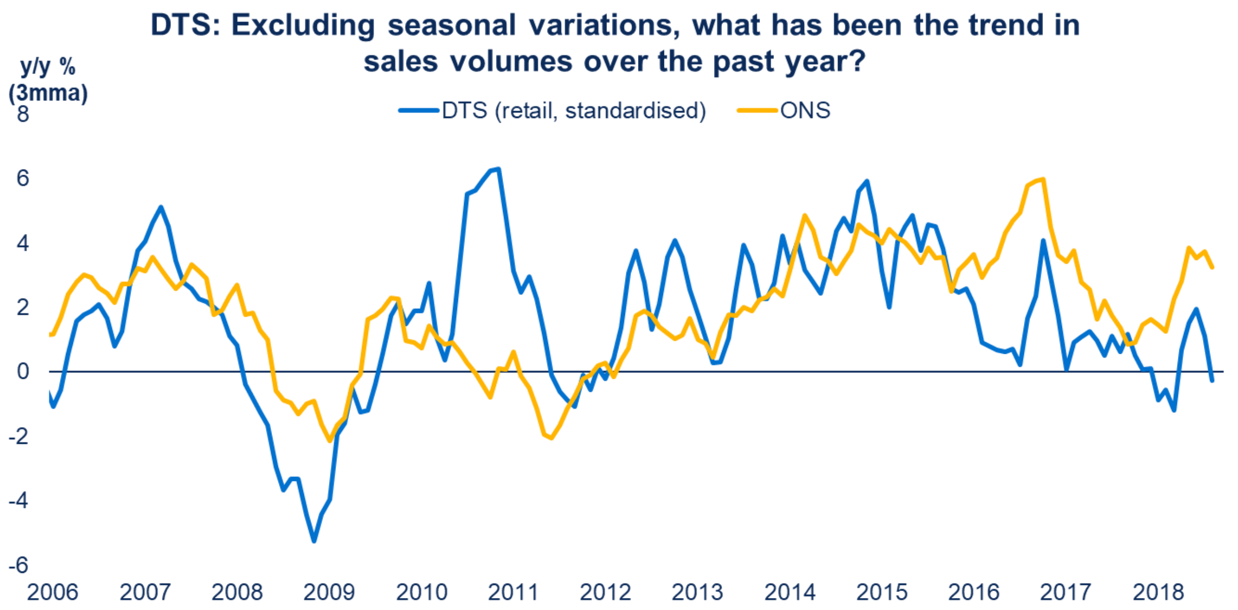
Four significant pieces of analysis on the impact of Brexit were released on the week of 26 November (in chronological order of release):

- NIESR: *The economic effects of the government's proposed Brexit deal*
- Centre for Economic Performance (CEP) and UK in a Changing Europe: *The economic consequences of the Brexit deal*
- HMG: *EU Exit: Long-term economic analysis*
- Bank of England: *EU withdrawal scenarios and monetary and financial stability: A response to the House of Commons Treasury Committee*

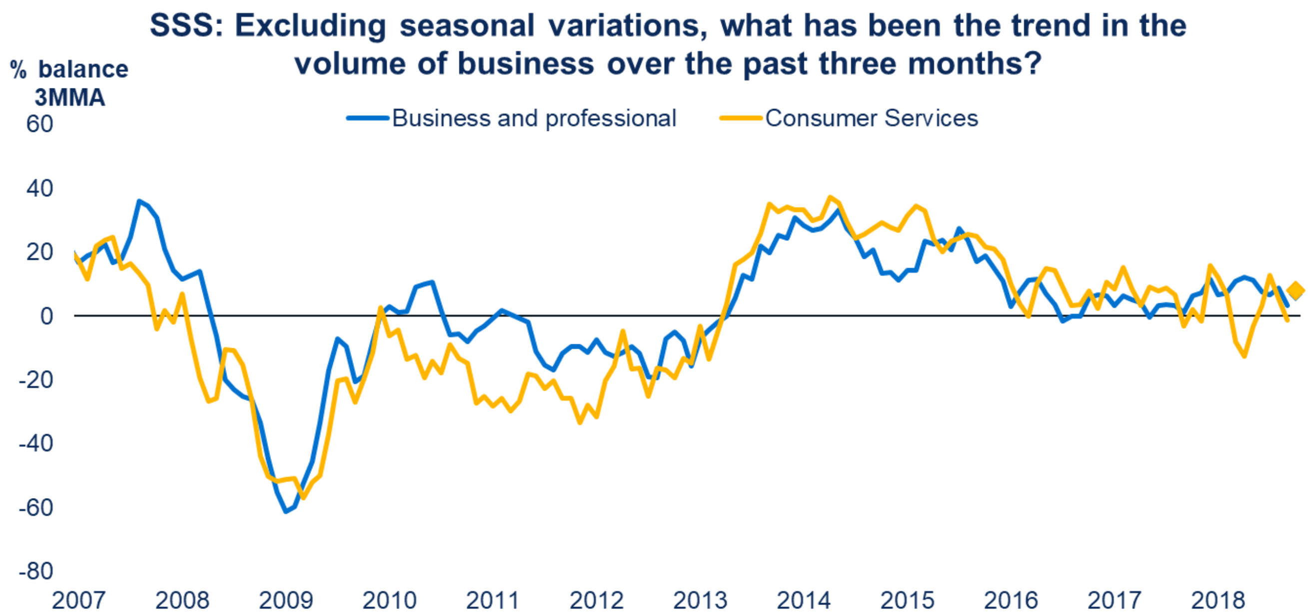
The first three pieces of analysis looked at the long-term economic impacts of Brexit (i.e. the impact in 2030 or beyond) under various assumptions about the form that Brexit might take. The government paper was the most detailed of these three, including analyses of sectoral and regional impacts. Meanwhile, the Bank of England's paper looked at the economic impact of different Brexit scenarios in the short-term (through to 2023). The results of the different papers can be found in the chart below.



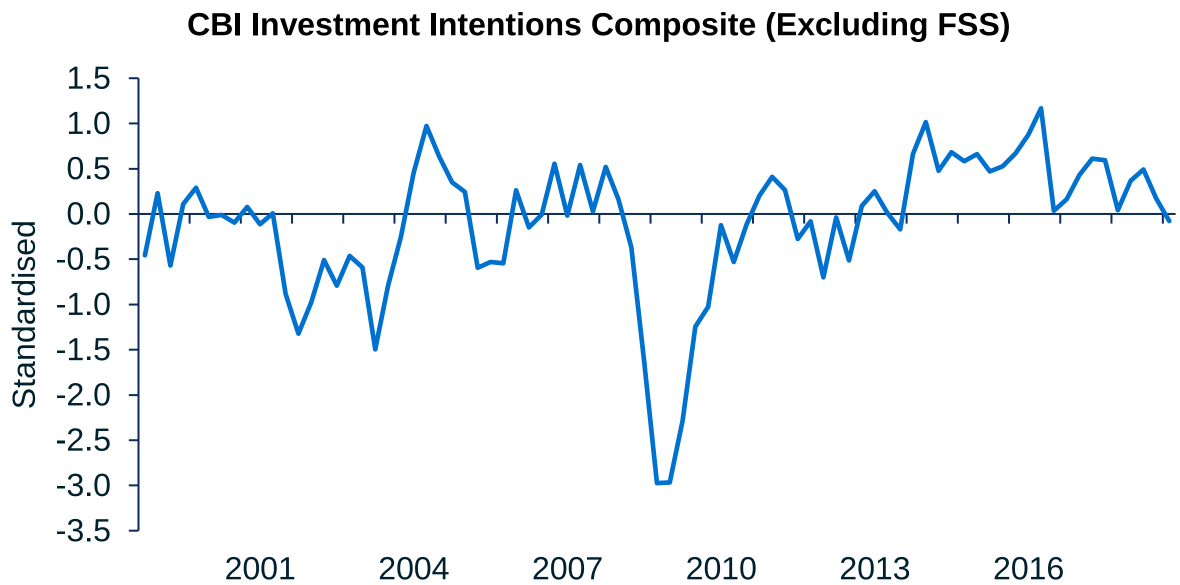
Source: ONS/Macrobond



Source: ONS, CBI

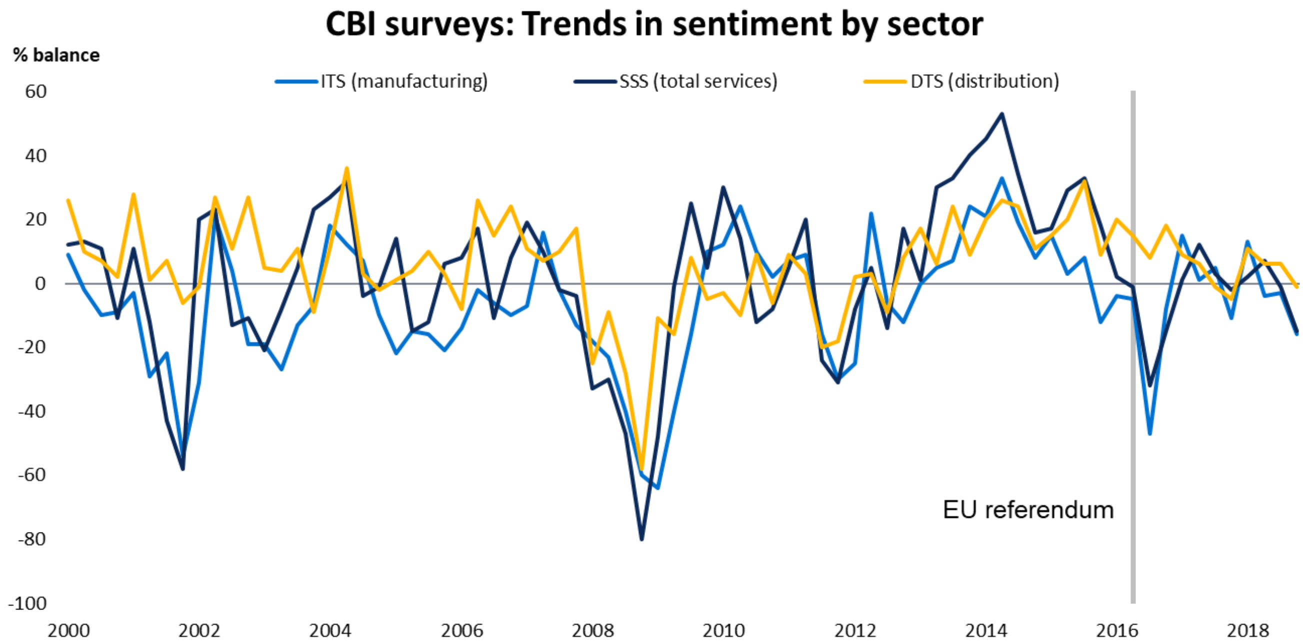


Source: CBI

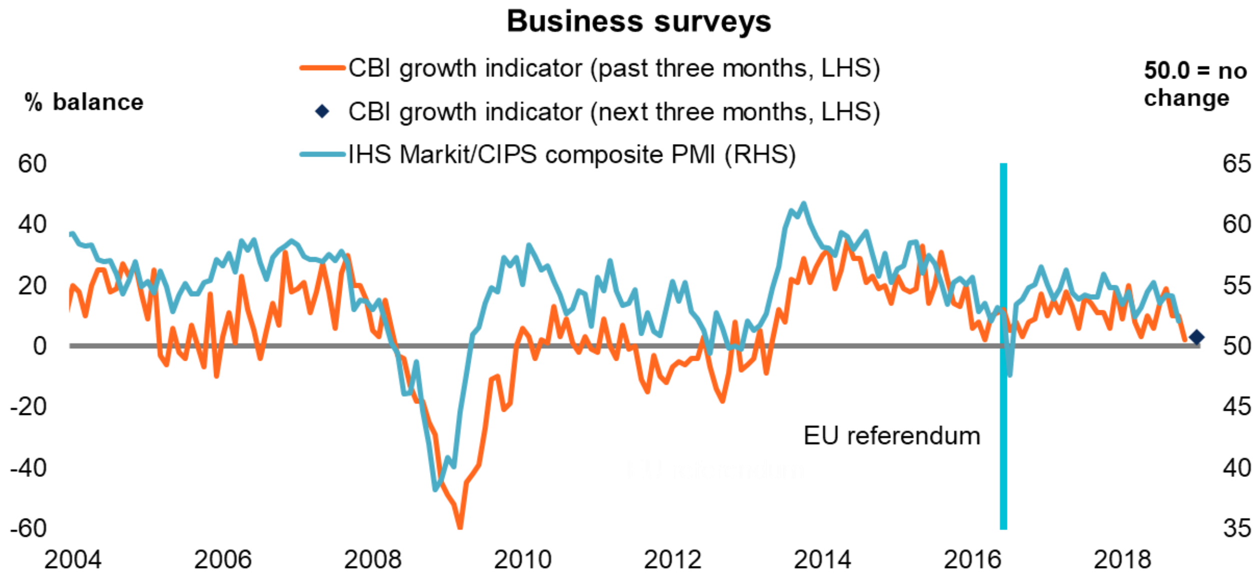


**Includes CBI survey data for manufacturing; distribution; consumer services; professional & business services; financial services, weighted by share in real business investment.*

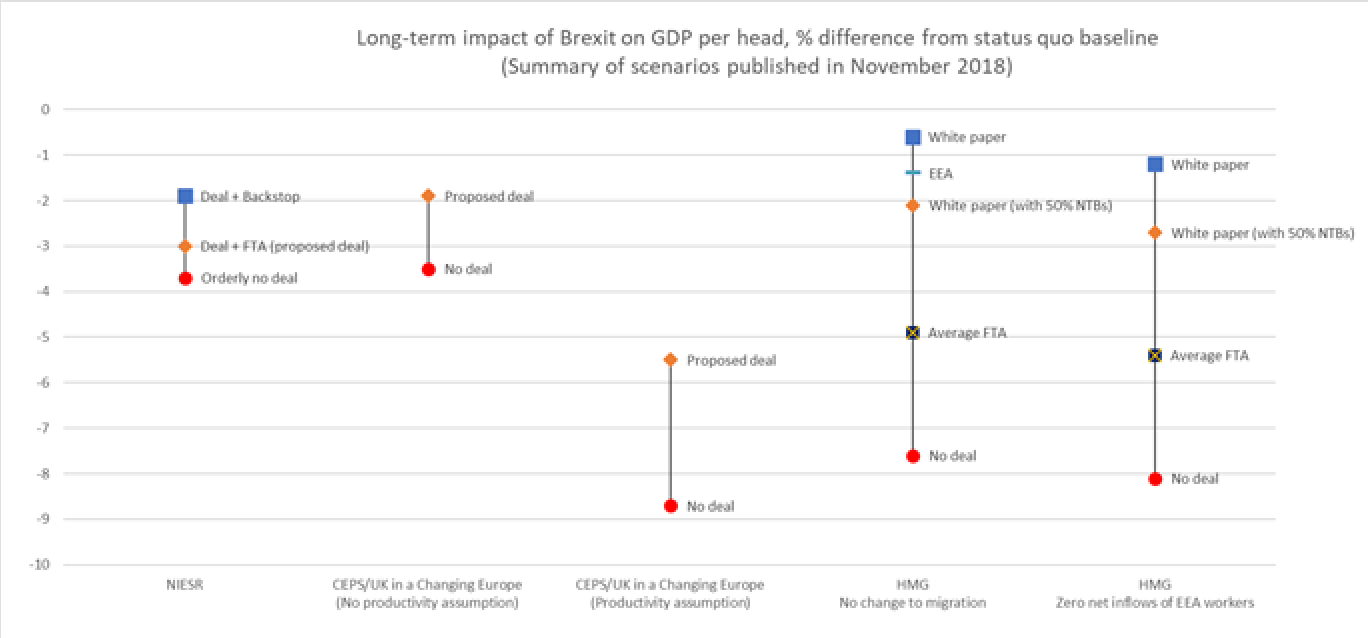
Source: CBI



Source: CBI



Source: IHS Markit & CBI.



Source: NIESR, CEP/UK in a Changing Europe, HMG

Results of November CBI Surveys[1]

Key

Positive
Neutral
Negative

	Optimism	Orders	Output/Volumes[2]	Prices and costs	Employment	Investment
CBI Industrial Trends Survey (monthly[3]/quarterly) *Covers* *Manufacturing sector* *Conducted* *Quarterly: 26 Sept – 12 October* *Monthly: 25 Oct – 13 Nov*	Both overall (-16%) and export sentiment (-15%) deteriorated at a faster pace in the three months to October. The latter was the weakest balance since October 2012.	In the quarter to November, the level of total order books (+10%) and export order books (0%) improved, after weakening in October. Both remained far above their negative long-run averages.	Output growth accelerated in the three months to October (+18% from +13%) and remained above average. However, output is expected to grow at a slower pace next quarter (+8%).	In October, cost growth slowed a touch (+30% from +36%) and is set to ease slightly further (+26%). Export prices were relatively flat (+3% from +12%) but are set to inch up slightly (+5%). Domestic price growth eased (+6% from +20%) but is set to pick up a little next quarter (+10%).	Employment growth slowed in the three months to October (+7% from +17%), the weakest expansion since April 2017, but still above the long run average (-11%). Over the next quarter, headcount is expected to fall (-6%).	Capital expenditure on buildings (-30%) and plant & machinery (-19%) is set to be cut back over the next 12m at a faster pace than average. Investment in training & re-training (-10%) and innovation (-6%) is set to be reduced, but at a slower pace than July.
CBI Distributive Trades Survey (quarterly) *Covers* *Retail* *Conducted* *Quarterly: 29 Oct – 14 Nov* *Monthly: 27 Sept - 15 October*	Sentiment about the business situation declined in November (-9%), having fallen in all but one quarter in the previous two years.	Orders placed on suppliers rose in the year to November (+15% from -10%). Orders are set to grow at a steady pace in the year to December (+15%).	In the year to November, retail sales growth accelerated (+19% from +5%, av: +10%). Sales growth is set to grow at a similar pace in the year to December (+22%).	Selling price inflation eased in the year to November, but remained historically high (+58% from +70%; av +27%). Prices are expected to increase at a steady pace in the year to December (+58%).	Employment continued to fall in the year to November (-15% from -29%), the eighth quarter running. Headcount is set to be reduced in the year to December, but at a slower pace (-11%).	In November, investment spending was expected to remain broadly unchanged over the year ahead (-3% from -10%).
CBI Service Sector Survey (1) (monthly/quarterly) *Covers* *Consumer services* *Conducted* *Quarterly: 26 Oct – 14 Nov* *Monthly: 28 Sept - 15 October*	Sentiment deteriorated in consumer services in the quarter to November (-7% from +7%).		Volumes continued to fall in the quarter to November (-13% from -4% in October), with a further fall expected next quarter (-7%).	Cost growth eased to around the LR average in November (+40% from +51%, av: +37%) but is set to accelerate next quarter (+59%). Selling price inflation slowed (+6% from +20%) but is set to pick up (+16%).	Employment growth remained steady in the quarter to November (+21% from +20%). Employment growth is set to accelerate next quarter (+33%).	In November, firms expect to spend more on IT (+27%), reduce spending for land & buildings (-10%) and reduce spending on vehicles, plant & machinery (-20%).
CBI Service Sector Survey (2) (monthly/quarterly) *Covers* *Business & Professional* *Conducted* *Quarterly: 26 Oct – 14 Nov* *Monthly: 28 Sept – 15 October*	Sentiment declined sharply in the quarter to November (-18% from -4%).		Volumes were flat in the three months to November (-2% from +10% in October). Next quarter, volumes are expected to fall slightly (-5%).	Cost growth eased in November (+32% from +45%) with similar growth expected (+29%). Selling price inflation remained steady (+7% from +9%) but is set to pick up a little (+13%).	Employment growth remained steady in the quarter to November (+12% from +11%) with a slight pick up expected over the following quarter (+17%).	In November, firms expected to reduce spending on vehicles, plant & machinery (-4%), keep it steady on land & buildings (+1%) and raise investment in IT (+20%).
CBI Financial Sector Survey (quarterly) *Covers* *Financial sector* *Conducted* *14 November – 3 December*	Optimism deteriorated sharply in three months to September (-30% from -4%), having failed to register any material improvement for three years.		Business volumes grew broadly in line with average in the quarter to September (+12% from -4%, av: +14%) but were expected to be unchanged in the quarter to Dec (+1%).	In Sept, spreads grew slightly (+4% from -12%) but were expected to remain stable (+1%). Fees/ commissions were flat (-1%). Costs rose (+17% from +4%, av: +8%) and steady growth was expected (+16%).	Numbers employed were unchanged in Sept (+3% from +24%). Employment was expected to remain flat in the three months to December (0%).	In Sept, firms expected to raise investment in IT (+49%) at a robust pace. Firms expected to cut back on spending on vehicles, plant & machinery (-15%) and land & buildings (-18%).

[1] CBI survey results are reported as a 'balance' statistic – calculated as the difference between the percentage of respondents replying 'up' minus the percentage replying 'down'.
[2] The Industrial Trends Survey queries respondents on output, whereas the remaining surveys ask about volumes.
[3] Monthly ITS data covers orders and output, otherwise data is quarterly Monthly SSS data is unpublished, but is used to compile the monthly growth indicator. We do not include the monthly growth indicator in the scorecard as it is a composite of the CBI's survey data shown above.