Monthly Economic Review

February 2017

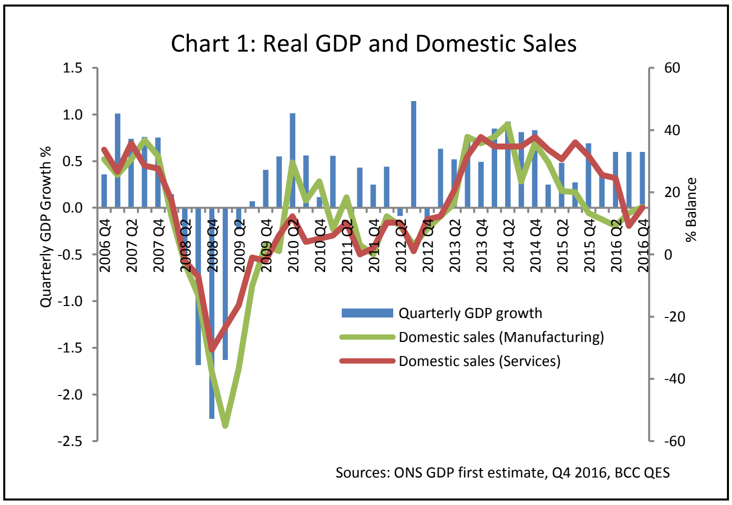
(Based on January 2017 data releases)

Monthly headlines:

- UK economy grew by 0.6% in Q4 2016 with services dominating GDP growth
- Falling value of sterling feeding through into higher inflation and squeezing real earnings
- GDP growth in the world's two largest economies – USA and China – slowed in 2016

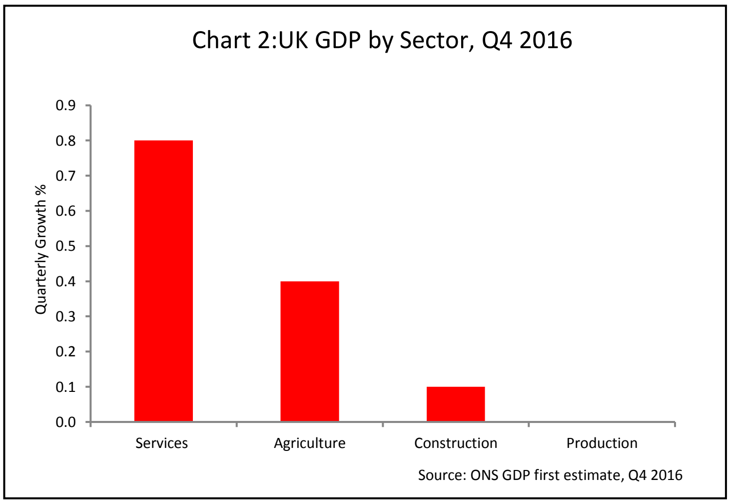
UK economy enjoys strong end to 2016...

The first official estimate of economic growth (GDP) revealed that the UK economy grew by 0.6% in Q4 2016, unchanged from the previous two quarters. This mirrored the latest BCC Quarterly Economic Survey (QES) which revealed that output from both the manufacturing and services sectors expanded in Q4 **(see chart 1)**. The UK economy grew by 2.0% in 2016 as a whole, slightly slower than the 2.2% recorded in 2015, but still broadly in line with historic trends. **Overall, the latest GDP data confirms that the UK economy enjoyed a strong end to 2016.**



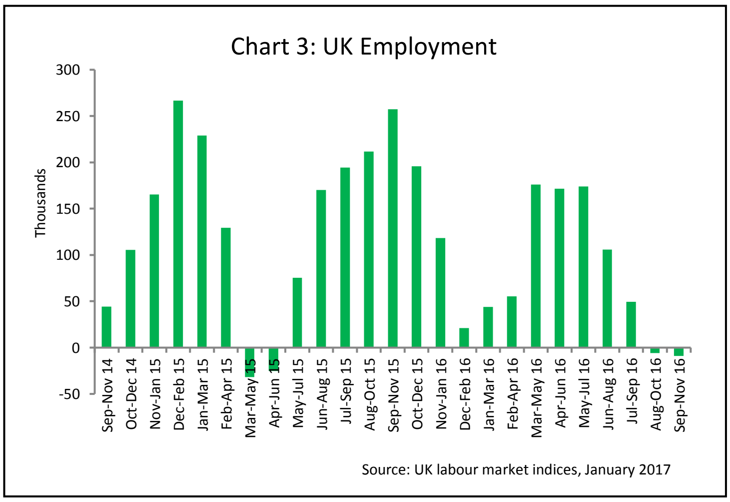
...driven by the services sector...

Output rose in three of the four main industrial groupings. Service sector output grew by 0.8% in Q4 **(see Chart 2)** and accounted for almost all of the growth recorded in the quarter. While overall industrial production was flat in the quarter, manufacturing output rose by 0.7%. Construction sector output increase by 0.1% and agricultural production rose by 0.4% in Q4. **Taken together the Q4 GDP data confirms remains that the UK growth remains unbalanced with an over reliance on services and consumer spending to drive growth.**



...but while unemployment is still falling...

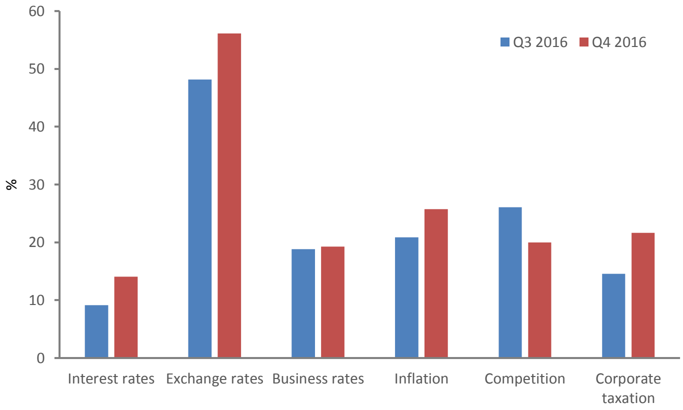
In the three months to November 2016, the number of people who are unemployed dropped by 52,000, compared with the previous three-month period. In contrast, the number of people in employment declined by 9,000 over the same period, the second successive quarterly fall **(see Chart 3)**. However, UK employment remains close to record levels. While labour market conditions could soften over the next year as economic growth slows**, the high degree of flexibility in the jobs market will help limit the extent of any increase in unemployment.**



…sterling weakens further…

On a trade-weighted basis (weighted average of currencies as measured by trade flows) the value of sterling rose by 0.5% in January, but is 12% lower than its pre-EU referendum level. The latest BCC QES revealed that firms are increasingly reporting the exchange rate as a concern to their business. 56% of manufacturers felt that the exchange rate was more of a concern to their business, up from 48% in Q3 **(see Chart 4)**. In the service sector, 31% of businesses reported that the exchange rate was a concern. **While a weak pound can make UK exports more price competitive, it can also raise the cost of imports.**

Chart 4: % of manufacturers reporting the following factors as a concern to their business

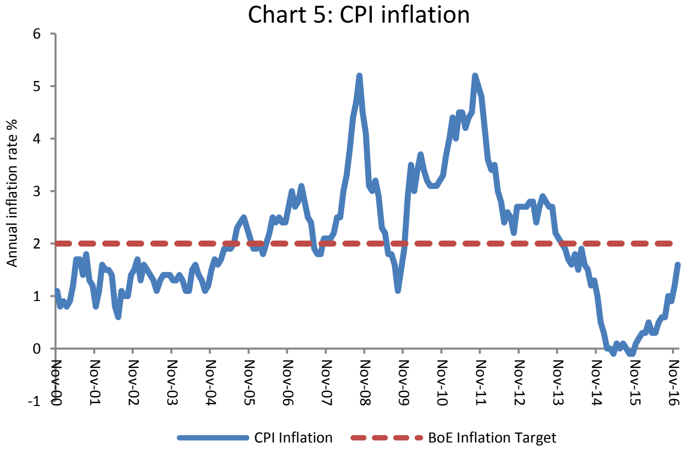


Source: BCC QES, Q4 2016

...pushing up inflation...

UK CPI inflation stood at 1.6% in December 2016, the highest rate since July 2014 and up from the 1.2% rise in November. The main contributors to the increase in the rate were rises in air fares and the price of food. UK CPI inflation has increased markedly over the past year, from just 0.2% in December 2015 **(see Chart 5)**. Significantly with factory gate prices rising by 2.7% in annual terms in December 2016, the sixth successive period of annual growth, further price rises are likely. Overall, **we expect inflation to surpass the Bank of England's 2% target in the coming months**, reaching around 2.5% by the end of the year.

Chart 5: CPI inflation

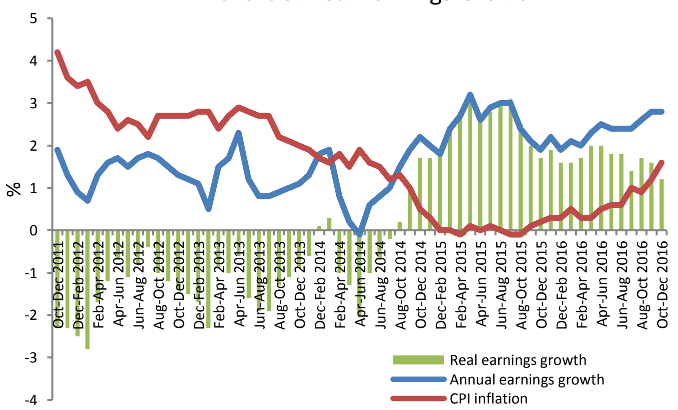


Source: ONS Consumer Price Inflation, December 2016

…and could squeeze real earnings...

In the three months to November 2016, annual earnings growth, including bonuses, rose by 0.2 percentage points to 2.8%. With consumer price inflation currently at 1.6%, pay growth outstripped inflation for the 27th successive month. However, rising inflation has meant that the gap between wage and price growth has narrowed to 1.2 percentage points, from a peak of 3.1 percentage points in Q3 2015 **(see Chart 6)**. If this continues as we expect, **real earnings could be squeezed, stifling consumer spending which is a key driver of UK economic growth.**

Chart 6: Real Earnings Growth

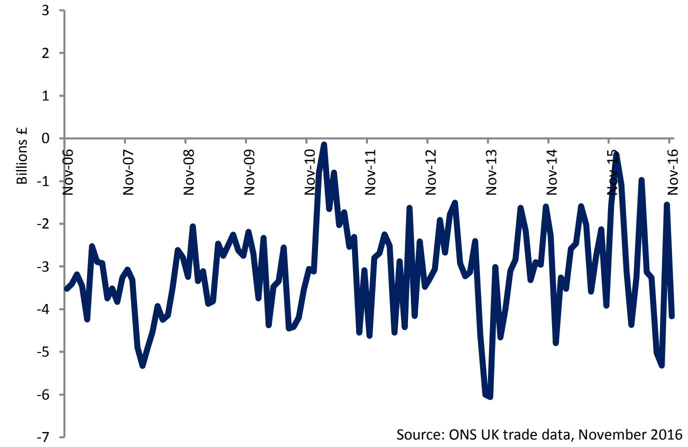


Source: ONS UK labour market indices, January 2017

...as UK's trade position deteriorates...

The UK's trade deficit was £4.2 billion in November 2016 **(see Chart 7)**, a widening of £2.6 billion from October 2016. While exports increased by £0.7 billion, this was more than offset by a £3.3 billion rise in imports, the highest on record. Imports of machinery and transport equipment, which rose by £1.4 billion, were the largest contributors to the increase in imports. **There remains little evidence that the fall in the value of the pound is boosting the UK's net trade position**. As a consequence, rebalancing the UK economy remains a major challenge.

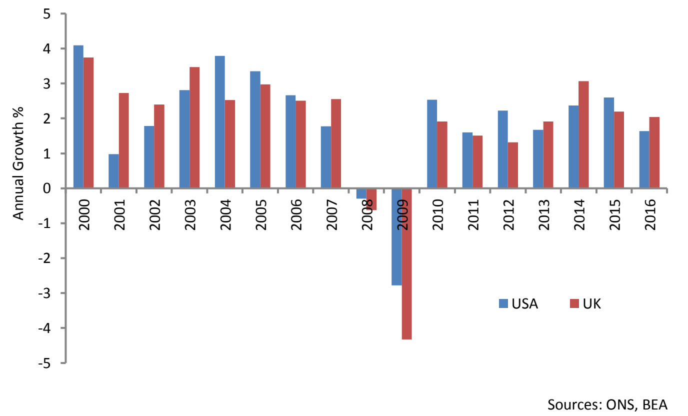
Chart 7: UK's Net Trade Position



…US growth slows sharply...

The US economy, the world's biggest, grew at an annualised rate of 1.9% in Q4 2016, a marked slowdown from the 3.5% growth recorded in the previous quarter. Consumer spending was the main driver of growth rising by 2.5%. Business and residential investment also contribute to growth in Q4. In contrast, **exports were a drag on GDP growth** having dropped by 4.3% in Q4. The US economy grew by 1.6% in 2016 as a whole, the slowest growth rate since 2011. US growth was also lower than the outturn for the UK, the first time since 2014 **(see Chart 8)**

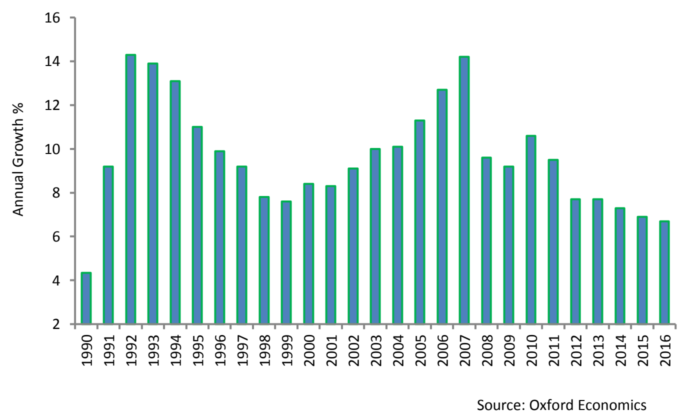
Chart 8: UK vs US GDP



…and Chinese GDP growth weakens.

China's economy, the world's second-largest, grew by 6.7% in 2016. While this was the lowest rate of growth since 1990 **(see Chart 9)**, it was in line with Beijing's growth target of between 6.5% and 7%. Growth was boosted by strong consumer spending and fiscal stimulus measures. There remain concerns that Chinese GDP growth could be weaker that its official data is showing. China's economy also remains overly reliant on debt-fuelled investment to drive growth. The size of its economy means that a **slowdown in China is a major risk to the outlook for the global economy.**

Chart 9: China Real GDP Growth



Bottom line: *Although the UK economy enjoyed a strong end to 2016, higher inflation and uncertainty over the impact of Brexit are likely to mean that conditions will become more challenging in the coming months. It is vital the upcoming Spring Budget is used to tackle the escalating burden of upfront business costs.*

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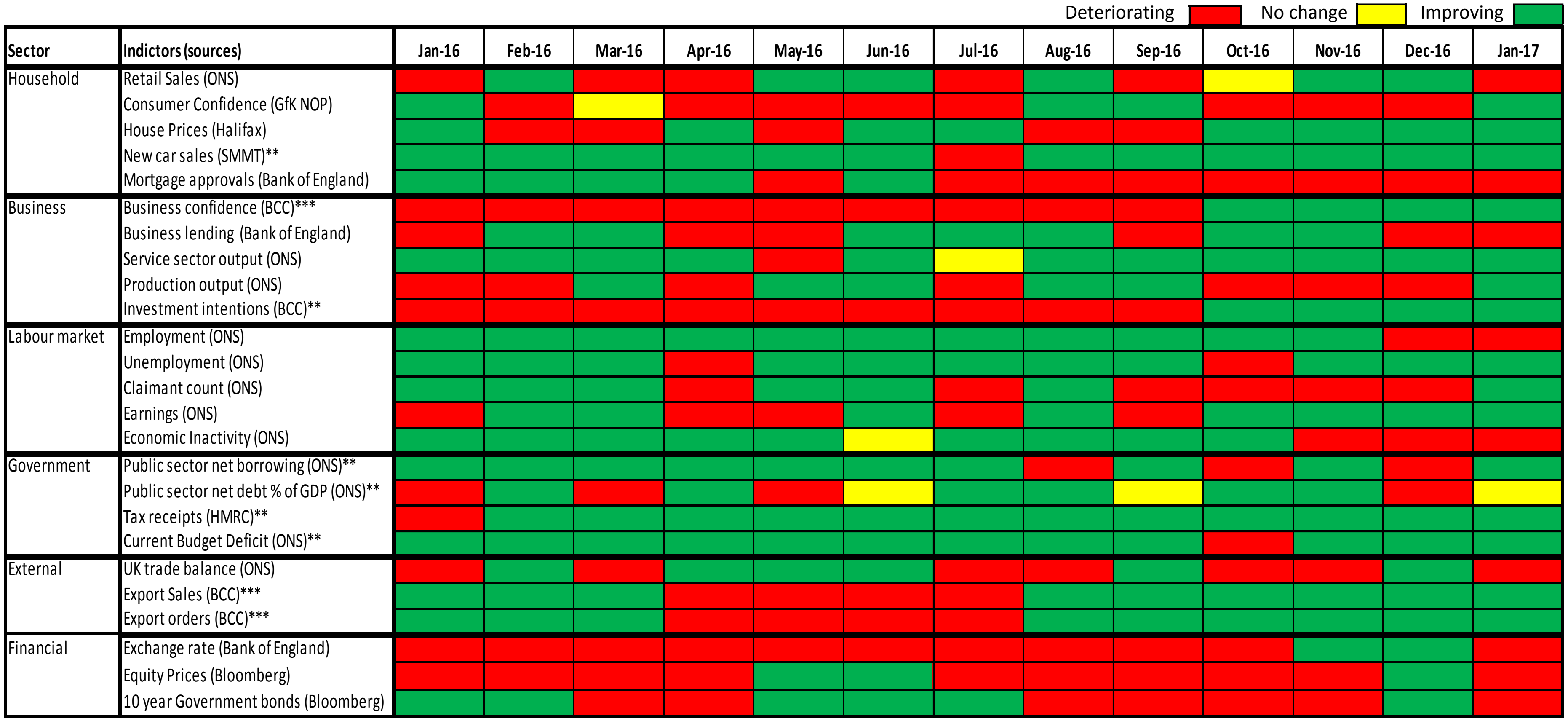
Economic summary chart



*Colours indicate an improvement or deterioration of each indicator and refer to monthly changes unless stated. For example, an improvement in employment refers to an increase, while an improvement in unemployment refers to a fall. Also a depreciation in the exchange rate refers to an improvement and an appreciation in the exchange rate refers to a deterioration. Dates refer to the release dates for each indicator. **Annual changes. ***Quarterly changes. ****Latest figures are estimates.