UNITED KINGDOM

Economic growth will continue to weaken in 2018 and 2019. Private consumption is projected to remain subdued as higher inflation, pushed up by the past depreciation of sterling, holds back household purchasing power. The unemployment rate is at a record low, but with slower growth this is unlikely to persist. Exchange rate depreciation should support exports, while import growth is projected to fall owing to weaker private consumption. An agreement about a transition period linked to the EU exit after March 2019 is assumed and should support growth in 2018 and in 2019, reducing the extent to which uncertainty weighs on domestic spending. Prospects of maintaining the closest possible economic relationship between the United Kingdom and the European Union would further support economic growth.

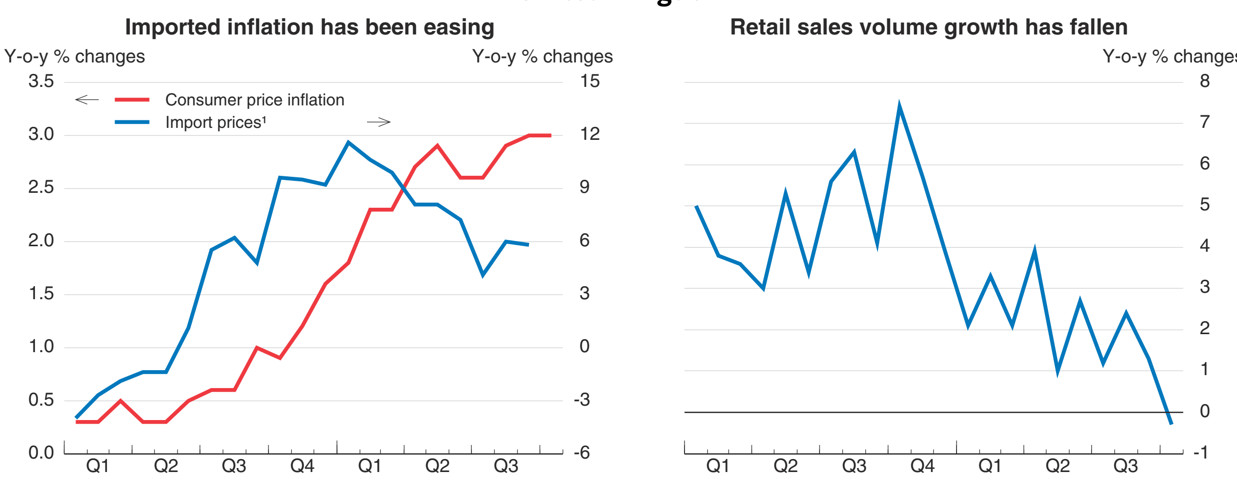
Monetary and fiscal policies need to remain accommodative. Inflation has risen to 3%, but in the absence of wage pressures the central bank should look through the temporary inflationary impact of currency depreciation. Fiscal consolidation of less than 1% of GDP is planned for 2018 and 2019, but the authorities should stand ready to further increase productivity-enhancing measures to support investment if growth weakens significantly ahead of Brexit.

High consumer debt growth, coupled with stagnant household incomes, is a major financial stability risk. Household debt has been rising gradually, reaching 140% of household disposable income. Banks' exposure to consumer loans is rising and write-off rates on such loans have been ten times higher than on mortgages over the past decade and defaults are much more sensitive to economic conditions. Introducing measures to ensure that household balance sheets remain sound, such as maximum debt-to-income ratios depending on borrowers' financial buffers, would bolster financial stability.

Economic growth has weakened

GDP growth has eased to 1.5% in 2017. Private consumption growth is held back by a pick-up in inflation and household confidence has been moderating towards its long-run

United Kingdom



1. Import prices of total trade in goods.

Source: Office for National Statistics.

StatLink http://dx.doi.org/10.1787/888933632216

United Kingdom: **Demand and output**

	2014	2015	2016	2017	2018	2019
	Current prices GBP billion	Percentage changes, volume (2015 prices)				
GDP at market prices	1 837.1	2.3	1.8	1.5	1.2	1.1
Private consumption	1 200.5	2.6	2.8	1.7	1.2	0.8
Government consumption	359.0	0.6	1.1	0.6	0.9	0.8
Gross fixed capital formation	301.0	2.8	1.3	2.3	-0.6	-1.3
Final domestic demand	1 860.5	2.2	2.2	1.6	0.8	0.5
Stockbuilding[1]	13.4	0.2	-0.1	-0.6	0.1	0.0
Total domestic demand	1 873.9	2.5	2.1	1.0	1.0	0.5
Exports of goods and services	518.9	5.0	1.1	4.5	2.5	2.9
Imports of goods and services	555.8	5.1	4.3	2.9	1.4	0.8
Net exports[1]	- 36.8	-0.1	-0.9	0.4	0.3	0.6
Memorandum items						
GDP deflator	_	0.5	2.0	2.1	1.9	2.0
Harmonised index of consumer prices	_	0.1	0.6	2.7	2.6	2.2
Harmonised index of core inflation[2]	_	1.1	1.2	2.3	2.6	2.2
Unemployment rate (% of labour force)	_	5.4	4.9	4.4	4.4	4.6
Household saving ratio, gross (% of disposable income)	_	9.2	7.1	5.1	4.8	4.5
General government financial balance (% of GDP)	_	-4.3	-3.3	-2.3	-2.1	-1.9
General government gross debt (% of GDP)	_	111.7	121.9	121.0	120.3	119.5
General government debt, Maastricht definition (% of GDP)	_	88.2	88.3	86.8	87.2	87.3
Current account balance (% of GDP)	_	-5.2	-5.9	-4.7	-4.4	-3.5

1. Contributions to changes in real GDP, actual amount in the first column.
2. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933633128

average. Weaker aggregate demand and high uncertainty weigh on capital expenditure growth. The depreciation of sterling has increased input costs and led to pressures on corporate margins and private sector wages.

The trade deficit has been narrowing due to an increase in exports of goods. The current account deficit was around 4.5% of GDP in the second quarter, but it is expected to shrink as domestic demand weakens. As there were net outflows of both direct and portfolio investments, this deficit was financed by other capital flows. Equity divestment by foreign investors was significant, and the total net direct investment position fell by around 1% of GDP, reducing the net asset position to a low level.

Job creation is losing momentum and the unemployment rate has stabilised at 4.3%. The number of vacancies has remained high, but nominal wage growth has been steady at about 2%, consistent with subpar labour productivity growth. Self-employment has continued to rise to 15% of employment and its share could continue to expand. This form of work supports labour market flexibility, entrepreneurship and higher labour market participation of older workers. Its rising incidence could stem from a lower tax wedge relative to employees and exemption from the minimum wage, which continues to increase. The self-employed could contribute to the weakness of total earnings growth if they are less productive, have a lower bargaining power and are paid below the minimum wage. If it is involuntary, self-employment could reduce job quality.

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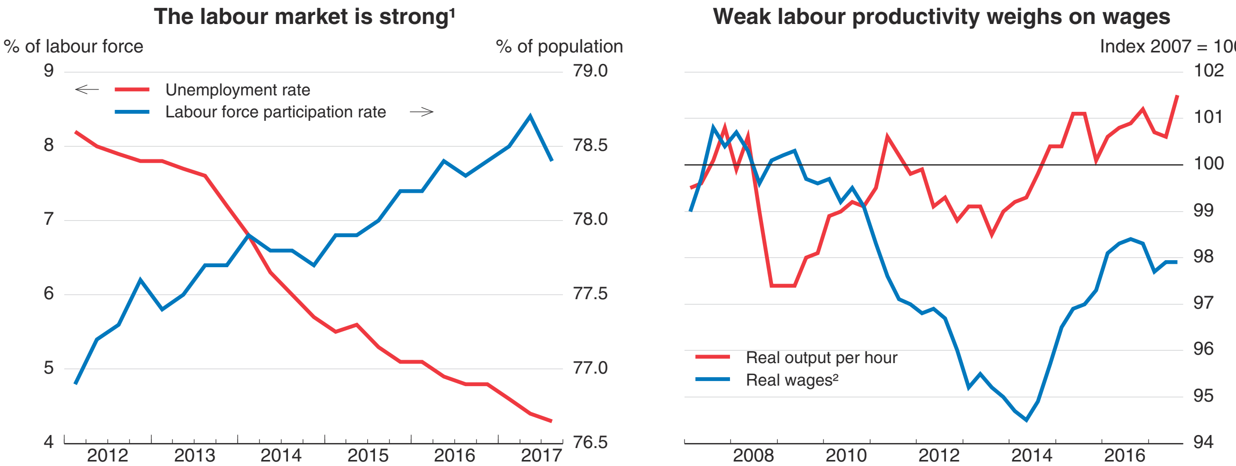

1. Data for the unemployment rate refer to the population aged 16 and over. Data for the labour force participation rate refer to the population aged between 16 and 64.
2. Real average weekly earnings excluding bonuses.

Source: Office for National Statistics.

StatLink http://dx.doi.org/10.1787/888933632235

The policy mix needs to remain supportive

The budget deficit has fallen to around 2.5% of GDP and further consolidation of less than 1% of GDP is planned over 2018 and 2019. The automatic stabilisers should continue to work fully and the authorities should continue to identify in advance productivity-enhancing fiscal initiatives on investment that could be implemented swiftly, such as spending on repair and maintenance or soft investment, should growth weaken significantly ahead of Brexit. If possible, spending financed from the National Productivity Investment Fund, which has recently been increased, could also be brought forward.

Large monetary stimulus has continued to support the economy but consumer price inflation has picked up to 3%, as sterling's depreciation has raised import prices. The Monetary Policy Committee increased the policy rate by 25 basis points to 0.5% in November 2017, judging that a further erosion of slack and a gradual rise in underlying inflationary pressure warranted some withdrawal of monetary stimulus. However, wage pressures are low and monetary policy should continue to be supportive amidst the ongoing slowdown in the economy induced by Brexit.

Household debt remains high and slightly over 40% of outstanding mortgage loans are at variable interest rates. Moreover, consumer lending growth has been vibrant and the Bank of England's Prudential Regulation Authority has recently found that some aspects of underwriting standards are weakening, notably with falling interest rates (including longer interest-free periods), lower average risk-weights and higher lending into high-risk segments. The policy response has been to bring forward stress tests to assess banks' exposure to consumer credit. Banks' capital buffers are planned by the regulator to be adjusted accordingly, so that each bank has sufficient loss-absorption capacity against consumer loan defaults. Adopting caps on debt-to-income ratios for all types of debt, with further affordability tests to assess household buffers to absorb shocks, would be welcome.

Growth is projected to stabilise at a low rate

Economic activity is set to grow at just above 1% in 2018-19, with the negative impact of uncertainty about the final outcome of Brexit negotiations being partly countered by an assumed agreement on a transition period after March 2019. However, this pace of growth will not be sufficient to prevent a moderate rise in the unemployment rate. Private consumption growth is projected to slow further, as higher inflation holds back real earnings, but households are expected to continue to smooth their consumption by reducing their saving ratio. Business investment is projected to contract amid longer-term uncertainty and reduced domestic demand growth, with exports projected to be the main engine of growth.

The major risk for the economy is the uncertainty surrounding the exit process from the European Union, which could hold back private spending more than projected. However, prospects of maintaining the closest possible economic relationship with the European Union would lead to stronger-than-expected economic growth. Inflationary pressures could be greater than projected if the supply side of the economy weakens more than the demand side, leading the Monetary Policy Committee to further raise interest rates at a gradual pace.