



Moderate,
occasionally rough.
Visibility poor

UK Economic Outlook

Special focus

Housing market Autumn Budget

September 2018

kpmg.com/uk/economicoutlook



Chief Economist's introduction



With less than a year to go before Brexit, the UK is on the verge of suffering an unprecedented peacetime shock to its business environment. The type of arrangements agreed with the EU will have a lasting effect and touch many aspects of the UK, not just the economy.

Yet with so little clarity on what Brexit will look like in both the short and long term, and with so many aspects of our lives potentially affected, it is almost an impossible task to forecast what will ultimately happen to the UK economy.

Our advice to clients remains to do their homework thoroughly, so they understand their exposure from top to bottom and prepare for a range of possible Brexit scenarios.

Change is in the air more broadly than Brexit. Improvements in technology are bringing new opportunities and challenges to business. It is likely that the UK will undergo a major transformation in the next decade.

In the short term, a number of things play in the UK's favour. The economy remains solid, with low interest rates and inflation gradually returning to target, while wages are recovering modestly, giving more money for households to spend.

Growth will be slower than what we have been used to in normal times, but that is not for lack of demand but because UK productive capacity will have reached its limit.

And here is where some of the main challenges for the UK economy lie. If UK productivity performance could pick up to where it used to be, that will increase the economy's capacity and raise the UK's growth potential.

Making the most of what the UK has doesn't stop there, the disparity between North and South highlights the huge untapped potential outside the South East. And making the most of new technology to share future growth dividends more widely among the UK population will help create a more inclusive society.

There is so much to go for, let's hope the UK takes the best path.

Yael Selfin,
Chief Economist, KPMG in the UK

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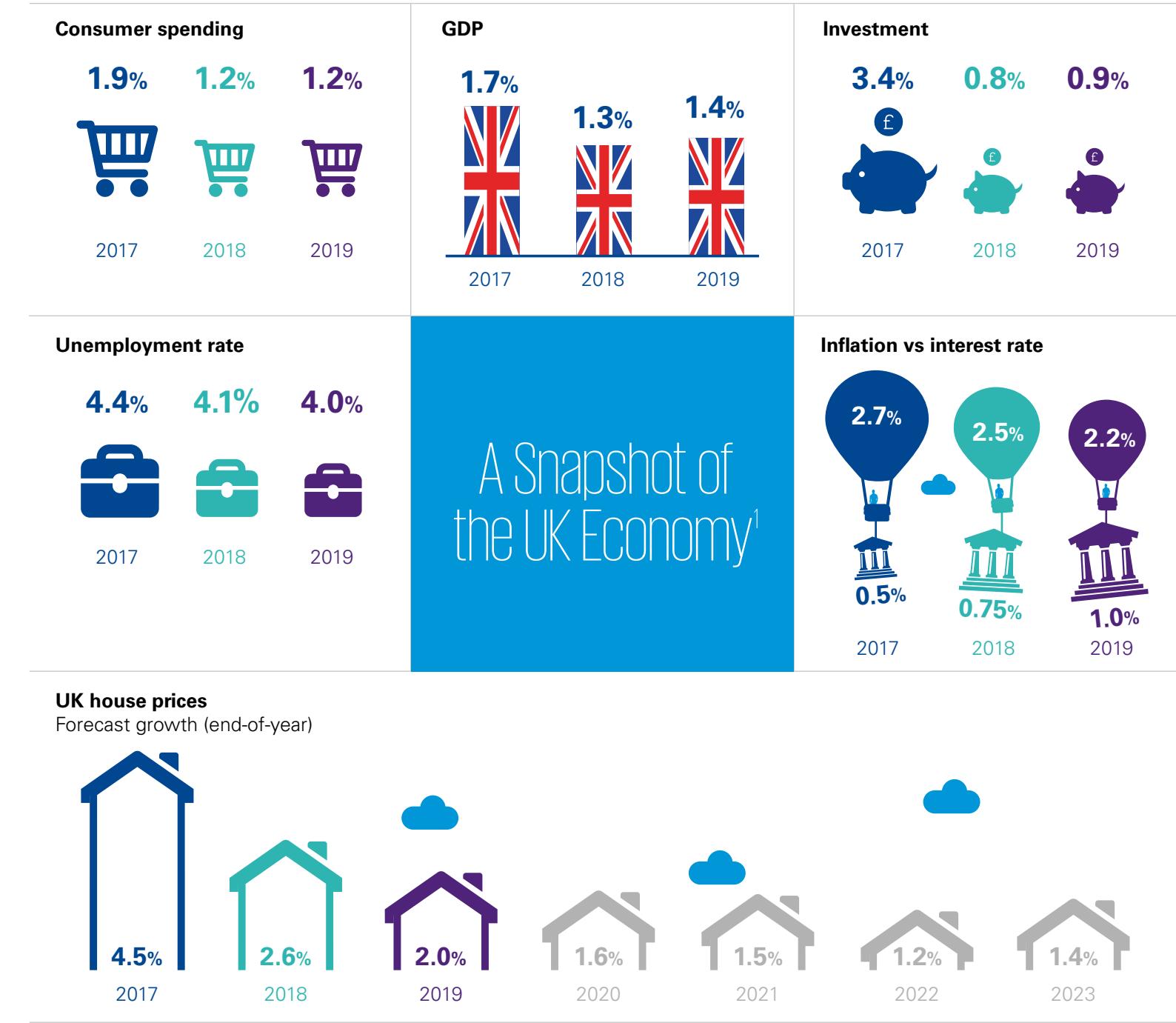


Current Outlook

Executive summary

- As **Brexit** approaches, the UK economy is entering a period of **unprecedented uncertainty**. With prospects of a swift deal becoming ever more elusive, the probability of considerable short-to-medium term disruption is rising.
- In the event that reason prevails, and the UK secures a Brexit transition period and a relatively friction-free trade deal, we see the **economy growing by around 1.4% over the medium term**. At the moment, this remains our main scenario, but risks are skewed considerably to the downside.
- If UK **productivity** turns a corner, growth could top 2%. By contrast, a disorderly **Brexit** would likely cause a sharp deceleration in growth.
- We see UK **house prices** entering a new phase of more **moderate growth, with some rebalancing between the regions**. The price of homes in Scotland will rise among the fastest, while London, the South East and East of England will experience slower growth.
- The chancellor will have limited flexibility in his **Autumn Budget** if he wants to keep to his target and not rock the boat on tax reform at least until Brexit terms are clearer. However, he may be tempted to look at **taxes on the online sector** and may wish to increase tax relief for innovation and R&D in support of the government's **Industrial Strategy**. The challenges ahead call for a focus on improving the UK's long term productivity and inclusiveness, while helping shield the economy in the short term from Brexit related disruption.
- Despite the lukewarm performance of the UK economy, the right **staff are harder to find**. With unemployment expected to stay at historically low levels, and with fewer EU workers expected to stay after Brexit, employers will have to place **more emphasis on retention and recruitment**.

- So far, staff scarcity has not led to excessive pay rises. Employers' uncertainties about Brexit and weaker workers productivity performance are likely to be some of the major forces behind that. We expect relatively modest average **pay growth of around 3%**.
- The rise in other business costs should become more modest. A slightly moderating global economy should put commodity prices in check, and the earlier rise in import prices as a result of the fall in the pound should now be mostly behind us. **Inflation** should therefore very gradually fall **to its 2% target by the end of 2019**.
- Uncertainties and risks around Brexit are likely to make the Bank of England (BoE) particularly cautious during the critical months ahead. We expected **a pause before interest rates are raised by 0.25% in November 2019 to 1%**. If Brexit negotiations fail, we expect rates to be cut to at least 0.25%, along with additional measures to ease any significant pressure on the banking sector.
- The steady pace in our main forecast masks some significant vulnerabilities. Results from our recent BRC-KPMG survey show **retailers continue to face a challenging environment**, with strong demand in only a handful of categories. Greater online competition will further scar the high-street while the industry adjusts.
- At the same time the **manufacturing sector cannot find its mojo**, with exports disappointingly weak despite the low pound. The prospects of Brexit disrupting supply chains and hurting exports to the EU market are not a good omen.
- Bridging the UK's **North-South divide** should be a priority but also an opportunity given that businesses in the South of England have to chase scarcer, more expensive workers. The North's full potential remains untapped but critical issues such as infrastructure links and skills shortages must be addressed before real progress can be made.



¹These figures represent our central scenario under which the UK secures a transition agreement after Brexit and a relatively friction-free trade deal after that. Figures for GDP, consumer spending, investment and inflation represent % change on previous year. Figures for house prices are house price changes over the course of the year and interest rates are quoted at the end of year.



Forecast for the UK Economy

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Outlook in our central scenario

The short to medium term outlook for the UK economy is clouded by major uncertainties around the form of UK's exit from the EU, which is by far the most significant event in the economic and business calendar for some decades. It will impact the economy and business environment on multiple levels. With so little agreed so far, and so much at stake, businesses would be wise to plan well ahead for a range of potential outcomes.

At the moment our **central scenario** assumes that exit negotiations evolve relatively favourably, with an orderly exit via an agreed transition period followed by a permanent agreement which amicably resolves the major possible frictions.

Table 1: Our main scenario for the UK economy sees the UK reaching its current full capacity

KPMG economic forecasts	2017	2018	2019
GDP	1.7	1.3	1.4
Consumer spending	1.9	1.2	1.2
Investment	3.4	0.8	0.9
Inflation	2.7	2.5	2.2
Unemployment rate	4.4	4.1	4.0
Base interest rates (end-of-period)	0.50	0.75	1.00

Source: KPMG Macroeconomics. Figures for GDP, consumer spending, investment and inflation represent % change on previous year. Investment measures Total Fixed Capital Formation, Inflation denotes Consumer Price Index, and Unemployment rate uses the LFS measure. These forecasts are based on the latest economic data. As with all forecasts, the final outcome is highly uncertain and will be determined by future events. These forecasts represent our best judgement on the path of the economy in the circumstances that now appear most likely.

A transition period with the EU allows trade relations with the EU-27 countries to remain unchanged, although in practice exports are expected to be weaker than historically, as companies anticipate the more difficult EU trading relationship and adjust their efforts accordingly ahead of the exit.

Despite the continued uncertainty and the squeeze on real incomes endured by households since the 2016 referendum, we expect consumers to remain relatively resilient, with spending growth continuing to surpass the growth in earnings at the expense of savings. Further rises in consumer borrowing would make some households particularly vulnerable to a sudden shift in the economic outlook, which has a greater probability today given the high level of uncertainty around Brexit outcomes.

Investment on the other hand is expected to be more affected by Brexit uncertainties, in particular in the shorter term while so much is still undecided. Though investment is then expected to resume in earnest at least temporarily in order to build the required new trading infrastructure once that's made known.

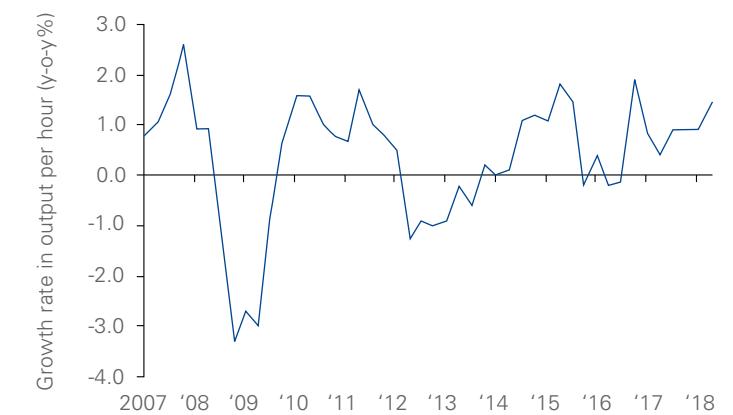
The overall economic environment may feel weak compared to the UK's historical performance, but it will be in line with the economy's average productivity growth since the Great Recession² of around 1% (Chart 1), which reduces UK potential economic growth to similar levels in our current forecast and sees the UK reach full capacity shortly.

Businesses will need to pay special attention to retention and recruitment policies with the labour market operating at near full capacity. The unemployment rate is expected to remain around 4% in the short term and could move even lower, unless there is a further slowdown in growth. Complications around the future rights and status of EU nationals in the UK will only exacerbate the problem. Figures up to June show an 86,000 year-on-year fall in the number of EU nationals working in the UK (to 2.28 million) – the largest annual decline since comparable records began in 1997³.

Despite growing difficulties finding staff, we don't foresee employers accelerating salary increases, with pressure on margins and Brexit uncertainties dictating caution. If productivity growth remains at around 1% then, as a basic rule of thumb, we would expect wages to rise by around 3% on average, accounting for an inflation rate of 2% in line with the Bank of England target.

With oil prices moderating and the impact from a weaker pound abating, inflation is expected to gradually move down to its 2% target by the end of next year. An absence of any significant inflationary pressures in the short term should see the Bank of England keep interest rates on hold before another 0.25 percentage point rise next autumn.

Chart 1: Poor productivity growth will limit UK future growth



Source: ONS

What should you plan for?

Now more than ever would be good to have a Plan B, and using two alternative scenarios could be a good starting point.

1. Disorderly Brexit

One of the largest risks to the short term outlook is a potential disorderly exit from the EU as a result of a breakdown in UK-EU negotiations. The outcome in this case would be extremely unpredictable, but our scenario and indicative path of GDP growth outlines some important features.

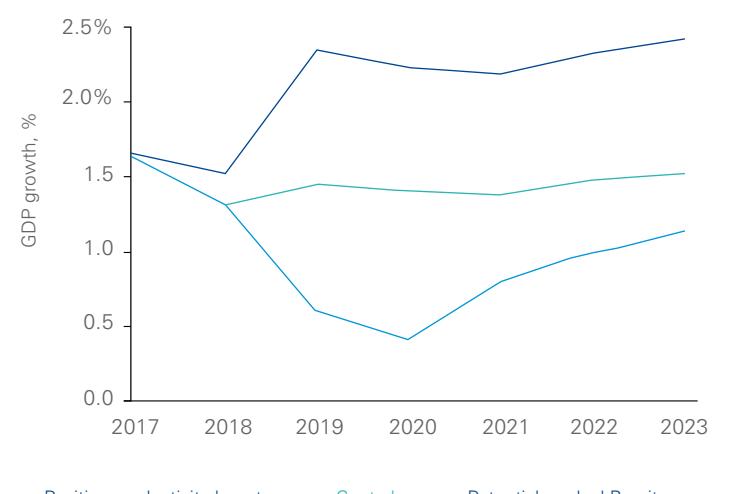
Any unprepared exit from the EU will create significant short-term disruption. For example, delays at ports or a breakdown in supply chains leading to production stoppages are likely.

With no other framework, trading relations will fall back to WTO rules. This in itself is a huge source of uncertainty as well as the potential for contractual disputes.

The pound would depreciate, in the range of 5-10% in our scenario. As in the aftermath of the referendum, this will lead to higher inflation, although the Bank of England is expected to ignore such a temporary spike and will most likely lower interest rates to 0.25% if not further.

With the disruptions to supply chains expected to take some time to be resolved and businesses adjusting to new trading relationships, the full impact on the economy may only be felt by 2020 before the economy begins to gradually recover (Chart 2).

Chart 2: Productivity and Brexit outcome crucial to UK Future



Source: KPMG Macroeconomics

2. Positive productivity boost

Another, more positive possibility is for an upside surprise to the rate of UK's productivity growth. Since the crisis, this measure has tended to disappoint – however as new technologies start making a meaningful contribution to businesses, there is cause for optimism.

For example, the rate of productivity growth could rise due to the adoption of new digital technologies, such as machine learning and automation. The wealth of innovations we see in the tech sector does not tally with

the persistently poor productivity data. The answer could lie in long implementation lags; as after new technologies are developed it takes time for them to be applied in the real economy. As these technologies begin to diffuse to firms and workers, we could see a global surge in the rate of productivity growth.

If these factors lift productivity growth by an additional percentage point per year, we could see the growth rate of the UK economy return to levels close to those in the era before the Great Recession.



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A shaky start before sunnier times

Economy unusually influenced by the weather in the first two quarters

The quintessentially British obsession with weather has managed to permeate economic data this year. A slow start to 2018 was blamed on unseasonably cold weather, which hit the construction industry particularly hard, and saw UK GDP growth slow to only 0.2% in the first quarter. Then, record-sunny weather, aided by a royal wedding, and World Cup football success, saw UK GDP catch up with the Eurozone in the growth league and rise by 0.4% in Q2 (see Chart 3 below). However, the good fortunes may not last, with a combination of uncertainties around Brexit and poor productivity likely to hold UK performance back over the coming year.

Chart 3: UK economy gained some ground in Q2

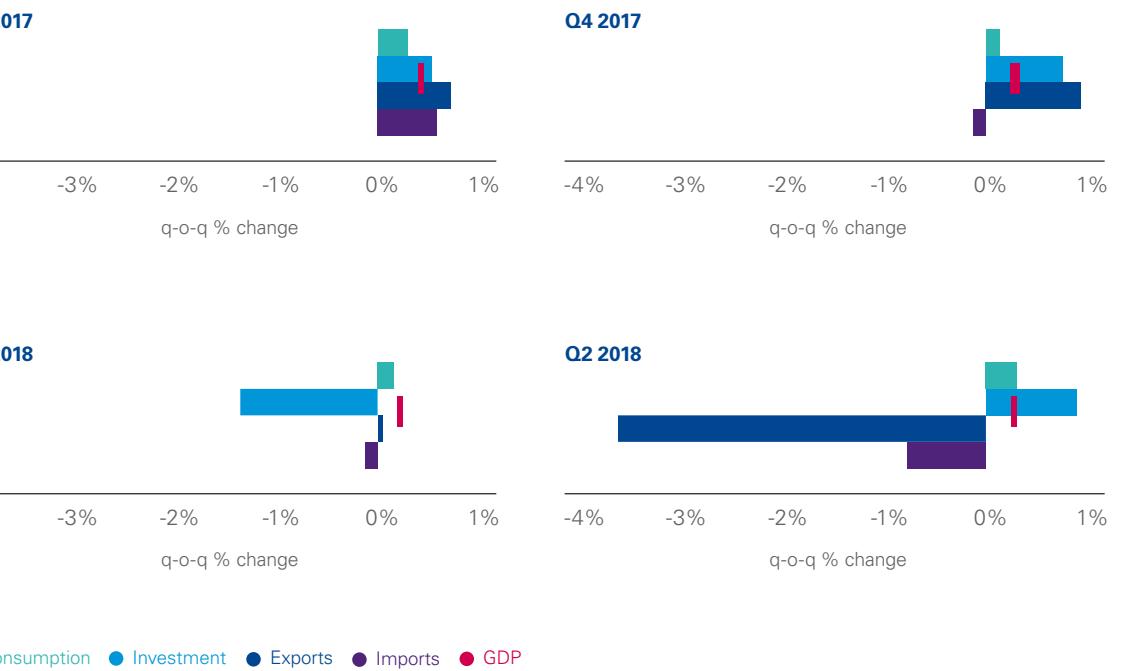


Source: ONS, BEA, Eurostat

Beware consumers' dwindling appetite

Faced by a squeeze on real income and Brexit uncertainties, households' spending resolve has dwindled over the past year. Low unemployment, steady house prices in most regions, and a buoyant stock market, are likely to be transmitting good vibes, despite a modest tightening in consumer credit conditions in recent months. However, there is a risk that any significant reversal in asset prices could make households feel exposed and likely to retrench more aggressively than the mild deceleration in consumer spending growth to 0.2% in Q1 and 0.3% in Q2 2018 (Chart 4). Despite relatively strong retail sales data for July, weak consumer confidence point at an unpromising start to Q3⁴.

Chart 4: Where did exports go?



Source: ONS

Brexit uncertainty upsetting investment plans

After contracting in Q1, overall investment recovered in Q2 (Chart 4), thanks to a potentially short-lived recovery in business investment. Faced with increasing Brexit and trade war worries, businesses remain reluctant to invest, with business investment particularly weak over the past two years.

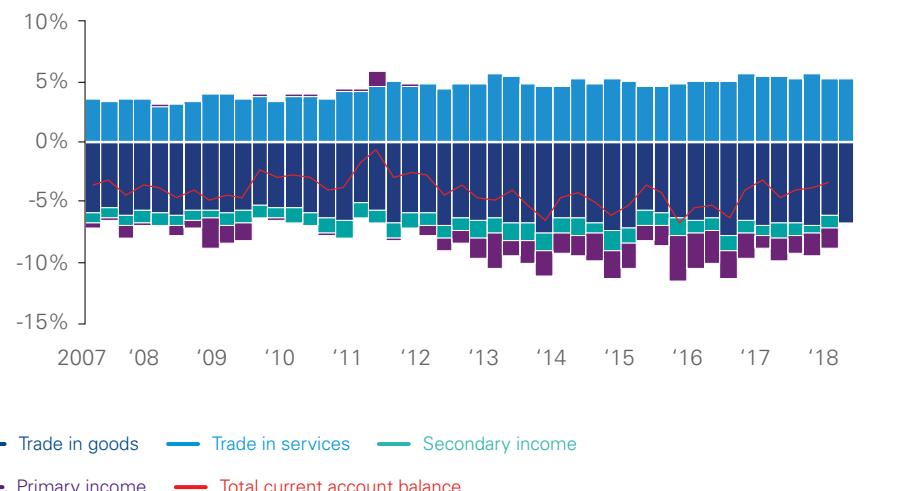
The cost of finance has been rising gently over the past year, with corporate bond spreads and bank borrowing rates on the up, raising the threshold of investments' viability, although some companies saw their equity prices pick up thanks to the weaker pound exchange rate.

Weaker pound not pulling its weight

A weaker economic environment among UK's main export markets was partially behind the poor export performance in the first half of the year (Chart 4). However, a sharp fall in Q2 (driven by a 12.5% decline in the value of car exports) signals more fundamental weaknesses.

The unremarkable performance of exports since the EU referendum – despite an 18% fall in the pound on a trade-weighted basis since its late 2015 peak – could be partially the result of companies anticipating the more difficult trading relationship with the EU and scaling back their export plans⁵. UK current account deficit (covering total trade flows and other payments to the rest of the world) fell to 3.4% in Q1 (Chart 5⁶), thanks to improvements in primary income and net trade, however net trade deteriorated again in Q2 putting pressure on the pound.

Chart 5: Vulnerability of UK goods exports could put pressure on pound



Source: ONS

⁵ See a new study by M Crowley, O Exton, L Han Renegotiation of trade agreements and firm decisions: evidence from the impact of Brexit on UK exports, which highlights how exporters have stopped establishing new EU trading relationships and started quitting existing ones ahead of Brexit.

⁶ Primary income consists of labour and investment income flows between residents and non-residents. Secondary income comprises of transfer payments between residents of different countries, such as foreign aid by government organisations and migrant workers sending payments to their home countries.

Services remain strong, but manufacturing disappoints

Cold snap hurts builders, helps utilities

The **construction** industry was among the most affected by the unusual weather, with output rebounding since May. Recent weakness in the construction of new private housing contrasts with a period of strong growth in 2017 and may be linked to uncertainties over future house prices. The weaker performance of the sector this year contrasts with its relatively strong recovery since 2013 (Chart 6).

Output of **utilities** saw a reversed trend, with the unseasonably cold weather earlier this year helping boost demand for gas and electricity, while energy demand fell in Q2 thanks to higher than average temperatures. **Mining and quarrying** picked up in Q1 and remained solid on average subsequently, despite some interruption in production due to unplanned maintenance.

Weather increased output volatility of some services

While UK **services** were overall hit least hard from the Great Recession⁷, and have been driving UK economic growth since (Chart 6), latest surveys such as the Purchasing Managers Index (PMI) point at a slower pace of growth in the second half of the year (Chart 8).

Within services, the growth in professional, scientific & administrative support services moderated in Q2 (Chart 5), largely due to a fall in **architectural** and **engineering** activities after a strong Q1.

Wholesale & retail trade were partially influenced by the weather, however, the strong rebound in Q2 sales masks significant weakness within the sector. The latest BRC-KPMG Monitor points to increased demand for only a handful of items linked with the warmer weather, while more substantial household items remaining harder to sell.

Chart 6: Sectors show mixed recovery since recession

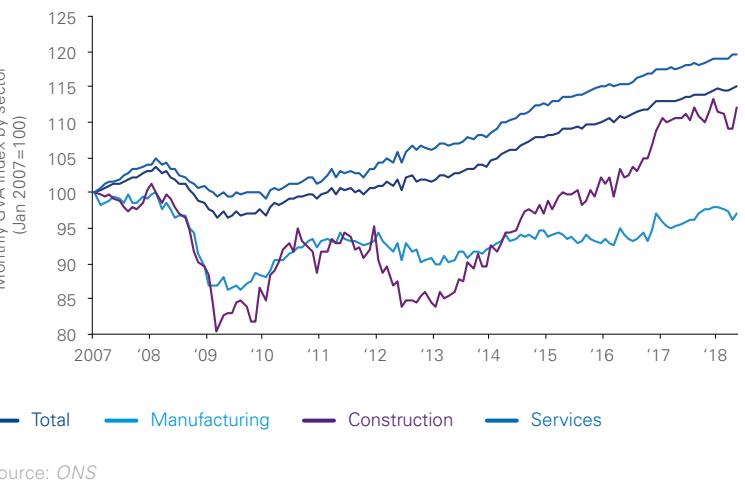
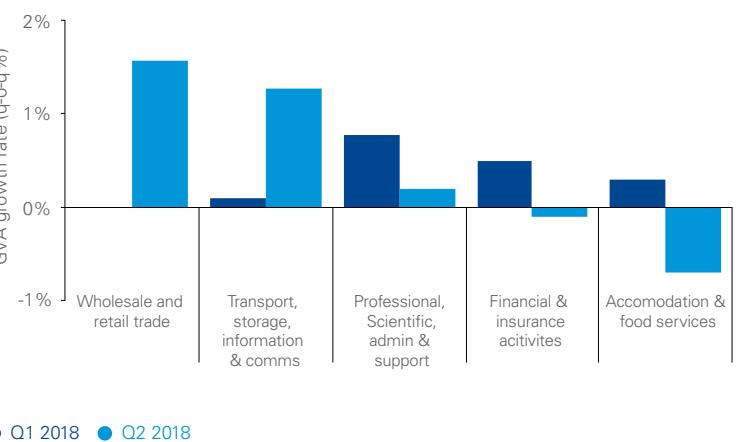


Chart 7: More volatile output in first half of the year



Transport, storage & communication

services saw a strong rebound in Q2. That appears to have been less weather-related and more due to stronger output in computer programming and motion pictures. The pick-up for warehousing and support activities for transportation points to businesses stepping up their preparations for Brexit.

Weak pound failed to lift manufacturing

Manufacturing output fell for most of the first half of the year, with export performance particularly disappointing given the weakness of the pound. Indeed, weak manufacturing exports drove a contraction in overall manufacturing output in Q2. Output of motor vehicles and trailers fell by 3.9%, which coincided with a 12.5% fall in the value of car exports that quarter.

Electrical equipment and metal products experienced the sharpest decline among manufacturers in Q2, while pharmaceutical products and computer, electronic and optical manufacturing experienced the strongest output rise in the sector.

After recovering somewhat last year, setbacks this year have pushed manufacturing output further away from its level prior to the Great Recession (Chart 6). While latest surveys point at an expansion in manufacturing output in the second half of the year pointing at a 'weak' short-term outlook, a slower pace of new orders was recorded pointing at a mixed short-term outlook (Chart 8).

Chart 8: PMI indices point to declining short-term prospects for manufacturing, construction and services



Recruitment gets trickier, but wages remain in check

The labour market continues to defy weaker economic growth, with the unemployment rate falling to 4.0% in the second quarter, down from 4.2% in the previous quarter, although the latest fall was mostly driven by an increase in the number of people dropping out of the labour force rather than any major rise in employment. Nevertheless, the current rate of unemployment is further below the equilibrium level of 4.25% that the Bank of England consider sustainable, indicating the tightness of the labour market (Chart 9).

Survey evidence from the BoE and the British Chamber of Commerce indicate businesses are having as much, or more, difficulty recruiting staff than they did before the Great Recession⁸. Other data shows that the proportion of unfilled vacancies rose in eight out of twelve sectors in the three months from May to July compared to the same period last year (Chart 10).

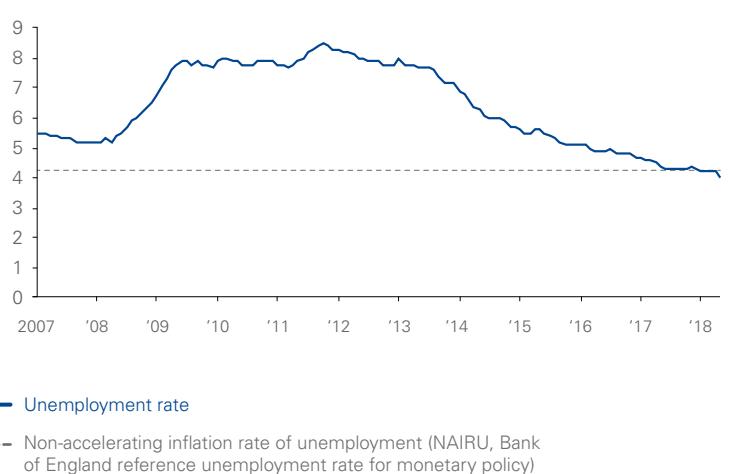
Earnings growth still moderate

Earnings, excluding the effect of bonuses grew by 2.8% in June (in nominal terms) compared to a year ago (Chart 11). This rate is towards the high end of 1-3% growth seen post-crisis, reflecting the effect of labour market tightness. However, it is well below the 3-6% range workers enjoyed in the run up to the Great Recession in 2008.

Given that the unemployment rate is at its lowest level since the 1970s and vacancies are becoming increasingly difficult to fill, you would expect wages to be bid up faster than at any time since the crisis.

However, other things are likely to be at play, among them workers' relatively weak productivity growth since the Great Recession, which acts as a ceiling on what employers can pay without reducing margins. Real earnings growth, accounting for inflation, returned to positive levels this year, giving households a little bit more room to spend or ease their borrowing. As inflation continues to moderate towards its 2% target, real earnings growth will catch up more closely with nominal rises, alleviating some of the pressure on households.

Chart 9: Unemployment is below the Bank of England's equilibrium rate



Source: ONS, Bank of England

Moderate wage growth across most of the UK

The North-South divide is ever present in labour market statistics. Regions in the South of England continue to report higher average weekly earnings than those in the North, while unemployment rates in the South tend to be lower than the national average.

However, at present the moderate positive growth in earnings seems to extend across most regions. **Northern Ireland** has outperformed with six consecutive quarters of significant growth since the start of 2017. Likewise, the **East Midlands** (having suffered from falls in earnings over the past two years) saw some signs of a pick-up in Q2.

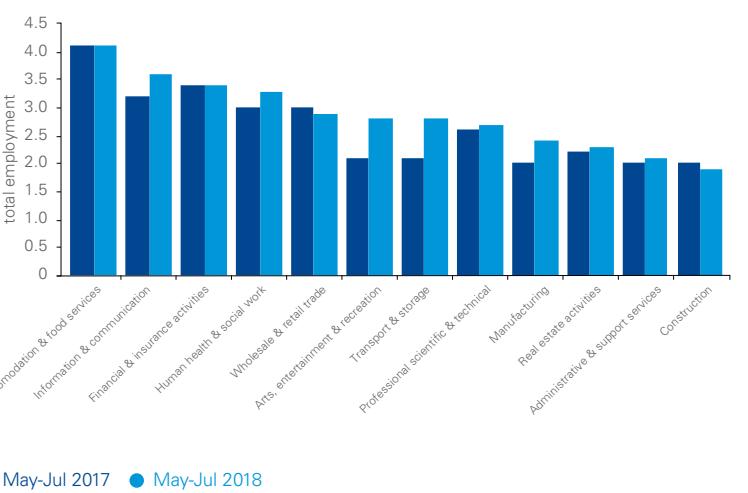
The overall trend of falling unemployment is also shared by most regions, with the only recent exceptions being **Northern Ireland** and the **South East** (although both regions' unemployment rate remains below the national average).

Chart 11: Earnings are gradually on the up



Source: ONS

Chart 10: Vacancies increased across most sectors



● May-Jul 2017 ● May-Jul 2018

Source: ONS

Inflation falling towards target while rates on the up

Inflation – as good as it gets

The latest rate of CPI inflation of 2.5% may still be above the Bank of England's 2% target but, in historical terms, the 0.5 point difference is already closer to the Bank's target than the rate has been for 60% of the time since 2007 (Chart 12).

When CPI inflation hit 2.5% just after March 2017, it had overshot the target rate without skipping a beat due to higher prices from imported inflation, as a result of the sharp fall in the pound following the EU referendum results. The impact of that earlier fall on inflation is now largely passed through.

As global oil prices have risen over the past 12 months in particular, the costs of liquid fuel and motor fuel continue to stand out as the biggest single driver of higher inflation over the past year, increasing by 35.9% and 12.4% yoy respectively.

However, as the price of Brent Crude fell back to below 75 US\$/bbl in July/August – any further impact is likely to be modest and fleeting, with the prices of liquid fuel falling back between June and July by 2.5%.

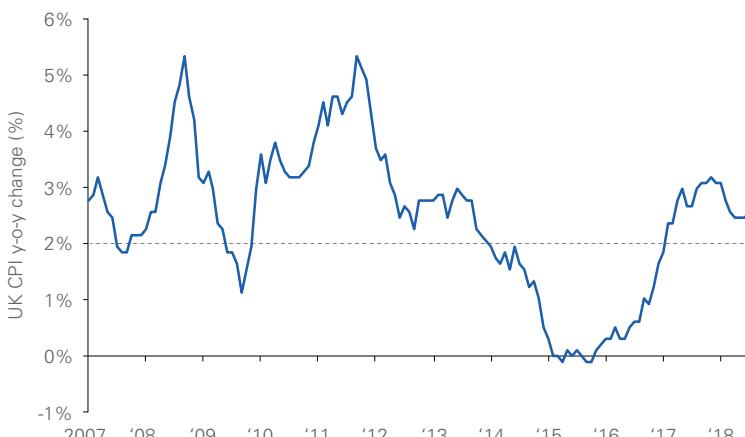
Sterling troubles

Sterling has lost around 10% of its value against the US dollar from its peak of 1.43 in April 2018, returning to levels last seen in May 2017 (Chart 13). In contrast, over the same period, the fall against the euro was much more limited, at only 4%. Taken together, this meant that the trade-weighted exchange rate index (using ERI measure) fell by 5%.

The big swings against the US dollar may be pointing more to the volatility in the US economy, which is engaged in a tug of war between expansionary fiscal policy and contractionary monetary policy. Mixed signals on trade policy, exemplified by an intermittent "trade war" are only adding to the volatility.

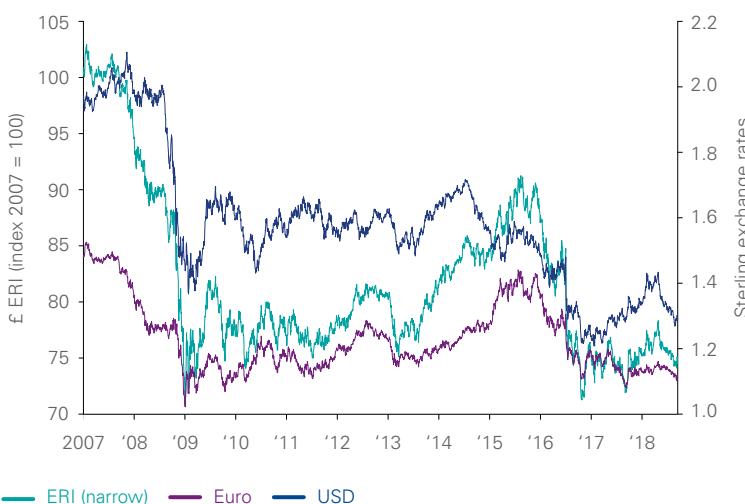
The fact that the pound fell against many currencies is a reflection of the performance of the UK economy and worries about the progress (or lack thereof) in Brexit negotiations.

Chart 12: Inflation moving back to target



Source: ONS

Chart 13: Sterling has lost ground gained against US\$



Source: Bank of England. ERI is the narrow measure of the Exchange Rate Index, which is a trade-weighted average of bilateral exchange rates

Low rates leave little room for manoeuvre

The Bank of England raised interest rates for only a second time in August 2018, in the midst of the slowest tightening cycle in recent history (Chart 14). And it now appears likely that almost a year on from the first rate rise there will be no further increases for at least a year. The gradual nature of interest rate changes will help households and businesses prepare for a new environment as the UK leaves the EU.

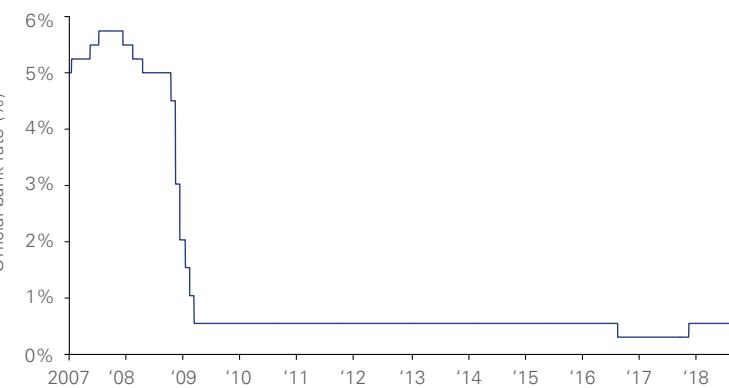
The MPC may yet rue the missed opportunities to create some policy space by raising interest rates further ahead of the Brexit deadline in March 2019. Higher levels of the policy rate can provide more ammunition with which to respond to economic shocks. Unlike other potential economic shocks, which are unpredictable and irregular – Brexit has a clear due date and the MPC may wish to get more prepared.

Looking beyond a potentially economically damaging Brexit, the long period of low interest

rates has fostered a long list of potentially adverse side-effects for the UK economy. From "zombie" firms to inflated asset prices and rising consumer debt, economic vulnerabilities are slowly on the rise due to the low price of borrowing. Returning interest rates to more "normal" levels may help restore order.

In terms of inflationary pressures, on the other hand, the Phillips curve – representing the positive theoretical link between inflation and economic activity – may be more elusive than the MPC believe. Many factors about this relationship are uncertain. We do not yet know if spare capacity in the economy is used up. And even if it has, we do not know the strength of that relationship. Estimates suggest that the link has weakened since the Great Recession⁹ so the trade-off between output and inflation is now much more favourable. If fighting the threat of runaway wage inflation ends up tilting at the windmills, growth in the real economy will unnecessarily suffer.

Chart 14: Official bank rate rose by 25bps in a second rate rise in August



Source: Bank of England



Outlook for UK house prices

The regional picture

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The regional picture

The UK housing market may be entering a new normal of moderate price growth, as we expect to see an average growth rate of house prices of just 1.8% over the next five years. This means the recent trend towards slower growth will continue, as average annual growth of house prices in the UK fell to 3% for the year leading up to June 2018 compared to 8.2% just 2 years ago in June 2016.

The regional picture

We expect house price growth to be slower in almost every region over the next five years than in 2017. Only Scotland, where increasing investment and relatively modest valuations have helped support price increases, will grow faster this year than last. The most subdued picture for price growth will be in the relatively more affluent regions of London, South East and parts of the East of England, where valuations are already stretched.

We also expect differences in house price growth across the regions to flatten out over the next five years. From a span of just over 5 percentage points between the slowest and fastest growing regions in 2018, by 2023 the difference could narrow to under 1 percentage point.

Table 2: KPMG regional house price forecasts¹⁰

	2017	2018	2019	2020	2021	2022	2023
London	1.6%	-0.3%	-0.7%	-0.2%	0.4%	0.7%	1.3%
North East	2.6%	1.1%	3.2%	3.3%	3.0%	2.2%	2.0%
South East	4.3%	1.8%	0.6%	0.5%	0.7%	0.7%	1.3%
East of England	5.2%	2.1%	0.4%	0.1%	0.4%	0.5%	1.1%
South West	5.8%	2.2%	1.9%	1.6%	1.4%	1.1%	1.4%
North West	5.8%	2.3%	2.6%	2.3%	2.0%	1.5%	1.6%
Wales	5.1%	2.8%	2.8%	2.5%	2.1%	1.5%	1.6%
Yorkshire and The Humber	4.2%	3.2%	2.7%	2.3%	2.1%	1.5%	1.6%
Northern Ireland	3.6%	3.6%	2.3%	1.9%	1.8%	1.3%	1.5%
East Midlands	6.3%	3.8%	2.2%	1.4%	1.2%	0.9%	1.3%
West Midlands	6.0%	4.2%	2.1%	1.2%	0.9%	0.7%	1.1%
Scotland	4.5%	4.9%	3.6%	2.7%	2.2%	1.4%	1.5%
UK average	4.5%	2.6%	2.0%	1.6%	1.5%	1.2%	1.4%

Source: ONS/Land Registry historical data, KPMG Macroeconomics forecasts.

The relative speeds of house price growth will help a little in rebalancing prices nationally. However, the disparities will remain stark. After rising by 7.5% a year between 2011 and 2018, the average house in London costs £476,752, while in the North East of England the average price increase has been just 1% over the same period and a similar property costs, on average, £127,271. By the end of 2023, a house in London will still be £484,206 compared to £145,285 in the North East.

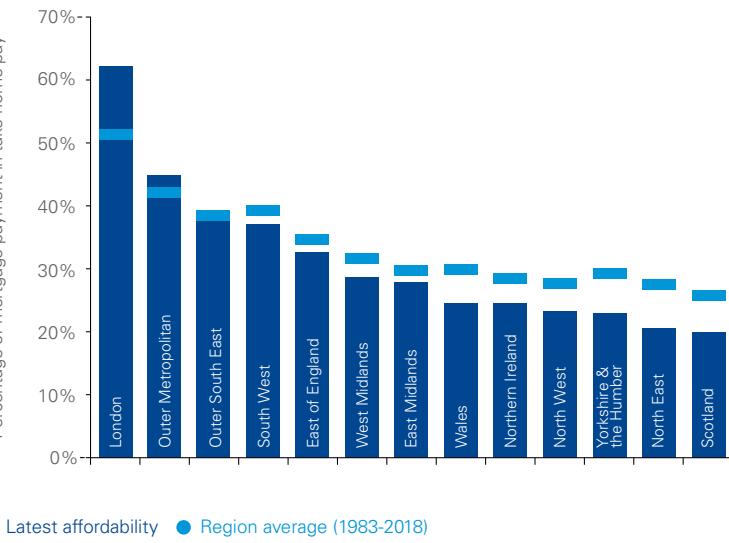
After such a sharp and sustained run, affordability remains a huge issue in areas such as the South East and particularly London, although lower interest rates have kept monthly repayments manageable. Chart 15 shows the ratio of average mortgage payment / take-home pay for first-time buyers. In London, this ratio reached 62%, compared to a national average of 33%.

Comparing the latest data to historical averages in each region shows that only London and the Outer Metropolitan areas are less affordable than historical averages.

Rapid price rises in some regions have meant that younger first time buyers are finding it increasingly difficult to take the first step onto the housing ladder. The Resolution Foundation have called this phenomenon "Generation Rent" and report that 40% of millennials were still living in rented accommodation at 30¹¹.

Our forecasts suggest that the next few years should provide a little relief as the growth rate of house prices in the areas with the lowest affordability will be slower, thus giving incomes a chance to catch up.

Chart 15: Mortgage payment as percentage of take home pay



Source: Nationwide Building Society

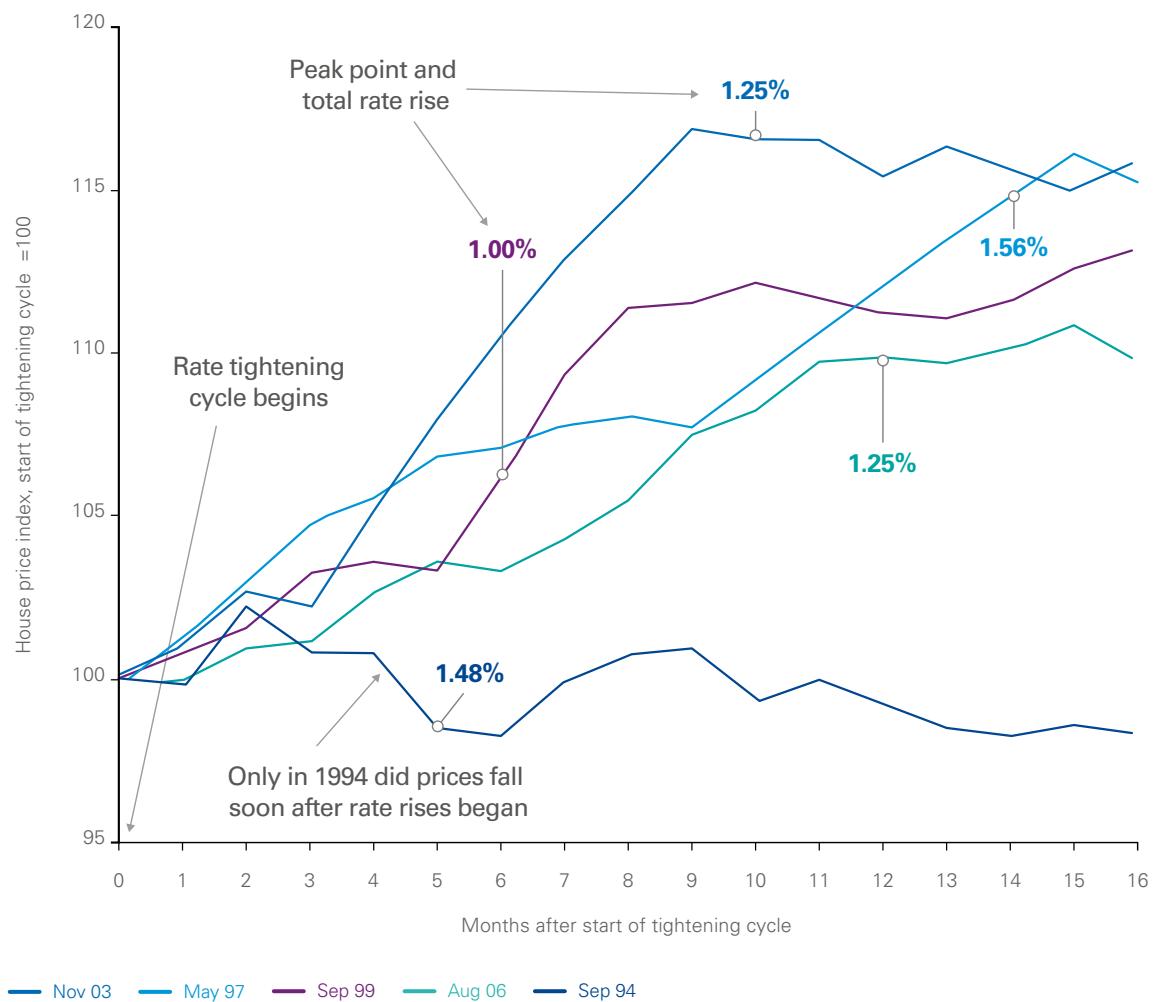
Will interest rates matter?

As the Bank of England embarks on a course of tighter monetary policy, what might be the likely effect on house prices?

The long period of low interest rates, intended to stimulate the economic recovery, have played their role in making mortgage payments affordable and provided an uplift to house prices across the whole of the UK, with house prices resuming their upwards trajectory in most regions soon after the Great Recession¹².

To see what impact higher policy rates might have this time around, we have looked at five previous cycles, stretching back to 1991, in which the Bank of England has embarked on a period of policy tightening. Chart 16 shows the path of house prices during the 16 months following the start of each cycle. The labels show the peak of that interest rates raising cycle while the lines show the path of house price growth.

Chart 16: House price responses in previous tightening cycles



Source: Bank of England, Nationwide Building Society

¹² The Great Recession refers to the economic downturn experienced during the late 2000s.



The data shows that in only one of these tightening cycles, the one starting in September 1994, falling house prices coincided with a tighter policy. On that occasion, prices fell by 1% in 12 months, while interest rates were increased by 1.48% within 5 months.

In all other cases, house prices continued to increase by an average of 13% in the first year of the tightening cycle, despite similar rate rises of between 1.00% and 1.56%. This includes the period from August 2006 until August 2007, when the policy rate was increased by 1.25 percent – potentially in response to an overheating housing market in some regions, which was followed by the Great Recession.

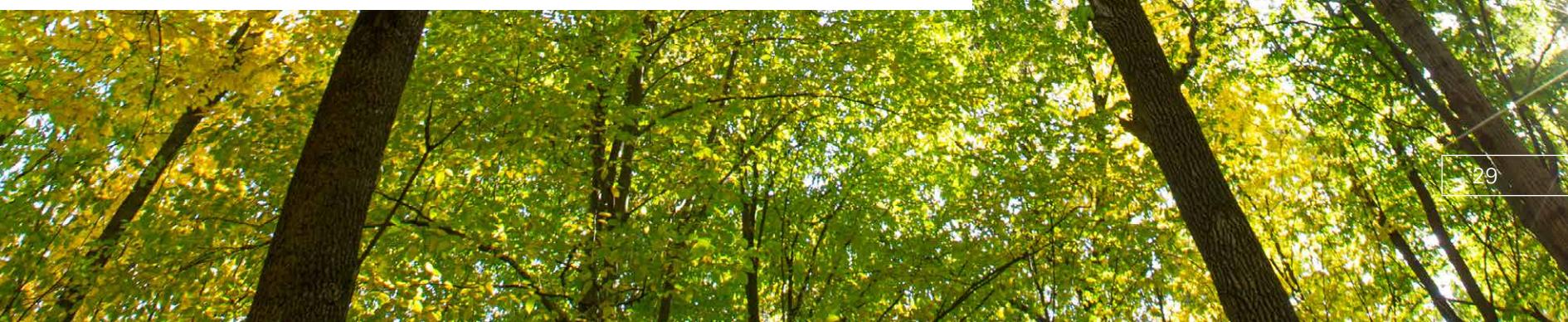
This may seem obvious, but is a point worth emphasising: there are many other factors in play that affect housing prices beyond interest rates. Valuations, growth in the wider economy and supply of available housing are all crucial determinants. Regional issues, as our own modelling demonstrates, are

enormously important. Lastly, none of the episodes we listed have been as severe as the hikes witnessed in the 1980s – but then neither is the current one expected to be.

In each of the five previous episodes outlined above, rates rose rapidly, and the whole cycle was completed within the space of 15 months.

This time around, the Bank of England have insisted that things will be gradual and limited in scope, illustrated by the fact that a year since the tightening cycle began in November 2017, we have only seen one other increase – bringing the total rise to 0.5%.

For this reason, interest rates are likely to play only a supporting role in terms of what moves the housing market and are currently more relevant to regions where prices are already high. Far more important is likely to be income growth, valuations and external influences such as Brexit, which can have a major bearing on the direction of the UK economy.





A look ahead to the Autumn Budget

Public finances will require extra funding

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Public finances will require extra funding

The fiscal position of the UK Government has continued to improve, with the deficit falling to 2% of GDP in the latest 2017-18 fiscal year. This has led to a fall in the ratio of gross debt to GDP for the same period to 85.8% (Chart 17). There are no immediate targets to be met in the coming Autumn Budget, however in the longer term, the chancellor has set a goal to bring the structural deficit to below 2% in 2020-21.

While it may be too early to speculate on the public sector net borrowing outturn this fiscal year, we know that for the fiscal year ending in March 2018 net borrowing was £5.8 billion lower than had been anticipated, potentially giving the chancellor a small extra pot to spend. He will have to balance many competing demands for extra spending across many departments.

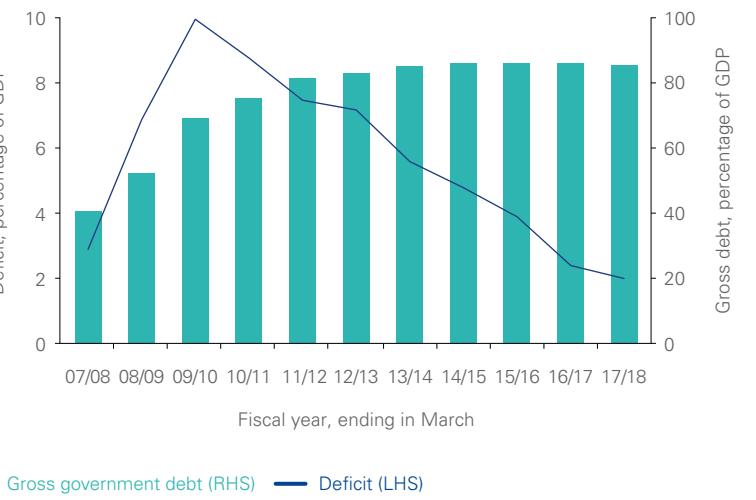
The largest line items in the government's budget are welfare spending and health at £268 billion and £146 billion respectively in 2017-18 (Chart 18). If new measures in these areas are to make any dent on the overall quality of services, the commitments required may be substantial.

The government has already made a promise to increase spending on the NHS by 3.4% per year for the next five years – an additional £16 billion in real terms, according to the IFS¹³. Strong data on public finances for the first third of this fiscal year, together with last year's surplus, may be enough to cover that, but any further largesse will require higher taxes or cuts in spending elsewhere.

Melissa Geiger, Head of International Tax at KPMG

believes that one option is to row back on existing tax cut pledges on the basis that people will not miss what they never had. The most likely targets in that scenario would be the planned increases in the personal income tax allowance to £12,500 and the increase in the higher rate threshold to £50,000.

Chart 17: Government deficit and debt as a percentage of GDP, fiscal years



Source: ONS

Another option according to her is to look at raising corporation tax to help fund additional spending, which could be done by abandoning the planned reductions in the headline corporation tax rate to 17%. This would generate short term gains but may have longer term negative impacts on growth and investment. The government has made much of its goal to have the lowest corporation tax rate in the G7 and the chancellor would be loath to abandon the pledge, especially as pressure on the UK's competitiveness builds from both Brexit and the recent reduction in the US tax rate to 21%.

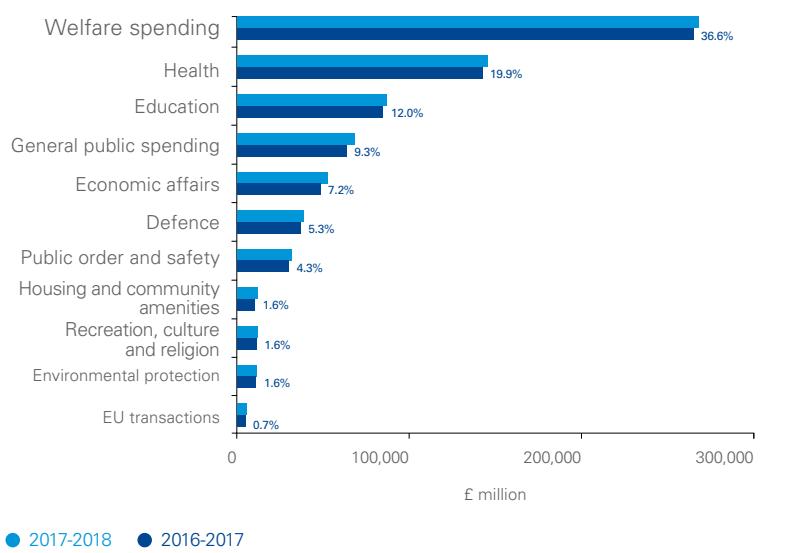
A budget focus on the future

Given his limited room in the Autumn Budget, any additional spend which is not already committed will have to be far reaching. Three areas of focus come to mind, where it would be good to see investment increased and additional measures introduced to help:

- Boost productivity to improve long-term growth
- Create a more inclusive society, with a larger proportion of people in the UK benefiting from the country's success
- Shield the UK economy from potential short term Brexit-related disruption

Spending on certain items would help hit several of these objectives. For example, in 2017-18, spending on transport reached £31 billion, making up 60% of the total spending on economic affairs (a figure that is on par with the entire budget for police, fire, prison services and law courts – see "Public order and safety" in Chart 18). Judging from the chaos experienced by commuters in the North of England following the timetable changes earlier this year, and continued commuter misery in the South East, more funding on fixing critical transport links is needed urgently.

Chart 18: Spending by government function, 2017-18 fiscal year



Source: ONS

According to Melissa, it is unlikely that the chancellor will wish to inflict significant tax changes on the economy as the uncertainty of Brexit looms. He may well choose to keep his powder dry until the terms under which we leave the EU are clearer. Any deal that is ultimately struck is likely to involve close adherence to the EU's rule book, limiting Hammond's flexibility on tax.

A 'no-deal' scenario would give him the freedom to pursue a more independent agenda which could provide an antidote to the disruption many expect a no-deal to produce. The business community dislikes disruption and craves certainty and stability. The Chancellor may choose to adopt a 'wait and see' approach until it is clear which way he needs to jump. This will be what business hopes for.

Notes

The digital dilemma

Yet, even in such uncertain times, there are signs that the Chancellor feels change is justified and can be weathered in some areas. He has said he is considering some form of tax on online sales with the intention of levelling the playing field between traditional High Street retailers who pay much higher business rates than their online competitors.

Were some kind of online tax be levied, calls to use the revenues raised to reduce business rates may well be resisted if the Chancellor views this as tying his hands too much. But in any case, this issue is much more complex and far-reaching than a business rates conundrum. Those welcoming the introduction of an online tax in anticipation of it attaching primarily to large US tech businesses may be in for an unpleasant surprise. For the issue of how to tax online sales is interlinked with the more fundamental question of how to tax an increasingly digital economy.

Increasingly digitalised business models mean that value can be created in locations where a business has little physical presence. Currently no mechanism exists to tax that value. This frustrates governments who naturally want to make sure they get a decent slice of tax from the profit cake.

This problem is not UK-specific and there is widespread acknowledgement that governments need to work out how to tax new business operating models as the world moves towards a digital future. Work has been going on internationally to seek a solution both at the OECD and the EU, but progress is not as quick as some would like and this has led many jurisdictions to consider unilateral action. The UK is one such country. The government acknowledges that the optimum solution for taxing the digital economy lies in international consensus. Yet, as pressure mounts in the public domain on this issue a unilateral tax on online sales is beginning to look more likely.

Encouraging innovation and productivity

Tax policy, especially in areas as fundamental as taxing digitalised businesses, is inextricably linked to issues of international competitiveness. Forbes recently published lists of the World's 25 largest technology companies for 2017. Of the total, fourteen were US based (including 8 of the top 10), three were from South Korea and a number were based in China. There were no UK technology businesses in the top 25.

So the more pressing question for government may be: 'how can the UK create an environment that fosters this innovation so that it is home to the next generation of tech companies?' With concern mounting that inward investment is stalling, at least temporarily in the run-up to Brexit, the business community will be looking for signs that the UK is open for business.

One such sign could be an increase in tax relief for innovation and R&D. An important pillar of the Government's industrial strategy is to build an economy of science and research, of ideas and innovation. The UK has a phenomenal skills base backed by strong academic institutions. Building a knowledge economy on these foundations is widely viewed as key to unlocking the UK's potential. In addition, as concerns grow around importing and exporting of goods post-Brexit, the market for knowledge remains relatively frictionless at the border.

As we approach the Autumn Budget we can expect to see demands for such positive measures to increase. Not only would it signal an economy that recognises its power and is moving forward, but it would also give a pre-Brexit shot in the arm to productivity.

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