United Kingdom

Brexit headwinds, global tailwinds

By: Ian Stewart

The Brexit effect

The United Kingdom's growth has weakened since the EU referendum—the economy grew 1.9 percent in 2016, the year of the referendum, and 1.8 percent in 2017, down from 2.3 percent in 2015. In the first quarter of 2018, activity nearly ground to a halt, with GDP expanding by just 0.1 percent, the slowest rate in more than five years.[1] Two years on from the referendum, there continues to be much dispute about the precise scale of its effect on the UK economy. While the slowdown has been milder than many forecasts prior to the referendum predicted, it has also dampened activity at a time of accelerating global activity. Some argue that the full effects of Brexit will not be felt until the United Kingdom exits the European Union, probably in March 2019.

Brexit has had two negative effects—higher inflation because of a weaker sterling, which is squeezing consumer spending power, and uncertainty, which is weighing on business sentiment. Weaker consumer spending power, especially, has been the

swing factor behind slower growth. This has only been partially offset by an acceleration in growth in manufacturing output, investment, and exports.

On average, economists see UK GDP growth slowing to the 1.5 percent in 2018 with Brexit remaining a significant drag on activity. Most forecasters see risks to confidence and investment from the Brexit process, with consumers continuing to be constrained by weak wage growth. And while levels of consumer debt to GDP are well below pre-crisis levels, they have been rising, buoyed by double-digit growth in unsecured lending. With banks pulling back from unsecured lending, the Bank of England worries this could weaken the resilience of the banking sector.

What looks increasingly like an entrenched productivity problem is another downside risk to UK growth. In the last six years, productivity growth has run at less than one-third the level seen in the decade before the financial crisis.[2] The persistence of low productivity has convinced the United Kingdom's official forecaster, the Office for Budget Responsibility (OBR), that it is here to stay. The OBR has almost halved its estimate for long-term productivity growth, to 1.2 percent. This, in turn, has reduced the OBR's forecast trend for GDP growth by a quarter.[3]

The UK political scene has also become more unpredictable. Since the government lost its Parliamentary majority last June, the Labour Party has been neck and neck with the Conservatives in the opinion polls—a significant change from April last year when the Conservatives' lead over Labour averaged 19 percentage points. Jeremy Corbyn is now the favourite to succeed Theresa May as the next prime minister, with betting markets assigning an 18 percent probability to the event.[4]

Brexit-related headwinds have, however, been partially offset by the strength of the global recovery. Stronger global growth and a weaker euro/sterling exchange rate have already bolstered UK exports. Small- and medium-sized manufacturers are more optimistic about export prospects today than at any time since survey data began in 1988.[5]

So far, wage pressures have defied economic theory, proving surprisingly weak in the face of declining unemployment. This seems to be changing. The unemployment rate stands at a 42-year low and the number of employed people has reached a record high.[6] Growth in self-employment, which is often seen as a sign of increasing spare capacity in the labour market, has softened. Job changing, another indicator of a tight labour market, has risen and many employers are reporting skills shortages. Meanwhile, a weaker pound and Brexit-related uncertainties have dimmed the appeal of the United Kingdom to EU workers who have accounted for around half of the job growth in the last 10 years. Rising wage pressures, coupled with falling inflation, should mean that 2018 is a marginally better year for consumers than 2017.

The accumulation of consumer debt is a potential risk for the United Kingdom, but one that is unlikely to crystallize this year. Most unsecured debt is held by households with above-average incomes, and half by households with enough assets to clear their liabilities. While the Bank of England has begun the process of raising rates from their historic lows, monetary policy is likely to remain accommodative for a long time to come. Financial markets are pricing in a rise in UK rates from 0.5 percent in April to roughly 1.5 percent by the end of 2020.

The United Kingdom vs. the EU

It is easier to think of things that will go wrong with Brexit, than right. The UK government says it wants to leave the EU's Single Market and Customs Union, but wants to maintain a close and special trading relationship with the EU. The EU says that the United Kingdom cannot enjoy the benefits and market access that come with membership outside the EU. There is a clear risk of a breakdown in talks between the United Kingdom and the EU, and a "no deal" outcome in the coming months, or the rejection of a deal by Britain's parliament this autumn. At the time of writing, in mid-May, the EU had re-

jected the UK proposals on one of the most difficult issues—the maintenance of an open border between the United Kingdom and Northern Ireland after the United Kingdom's exit from the EU.

But in our view, the most likely outcome is that by October, the United Kingdom and the EU will agree upon a deal to largely maintain the status quo during an extended period of negotiations beyond the United Kingdom's planned exit from the EU in March 2019. This would be consistent with the UK government's desire to avoid two major sets of change for business, one next March, and one with the implementation of the final settlement, from late 2020. Such an outcome would mean a "standstill" on many practical aspects of the United Kingdom's membership of the EU between March 29, 2019, and the scheduled end of negotiations in December 2020. The problem is that it would leave open the precise nature of the United Kingdom's future relationship with the EU, which would be the subject of continued negotiations through 2019 and 2020, thus extending the period of uncertainty for businesses.

If the Brexit negotiations were to fail, or a deal were to be blocked by Parliament, downside risks to growth would mount materially. Our hunch is that the United Kingdom will probably dodge that bullet this year and that growth is most likely to continue around a lacklustre 1.5 percent mark through 2018 and 2019.

ENDNOTES

1. Office of National Statistics.
2. Ibid.
3. Office for Budget Responsibility.
4. Based on data from UK betting markets.
5. Confederation of British Industry, "SME Trends Survey."
6. Office of National Statistics.

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