Rabobank

United Kingdom: Brexit hangover

Economic Update
Alexandra Dumitru and Stefan Koopman

- **With Boris Johnson as Prime Minister, Brexit is likely to get messier in the coming months.**
- **Namely, his intention to take the UK out of the EU on 31 October, no matter what is likely to lead to a major conflict with the British Parliament, and push UK politics into uncharted territory.**
- **This increases the odds of a hard Brexit on 31 October, though we see a further delay of Brexit as the most likely outcome.**
- **Brexit uncertainty is taking its toll on the British economy.**
- **Economic activity in 19Q1 was boosted by stockpiling ahead of an eventual hard Brexit on 29 March, but this frontloading of expenditure is expected to dent economic performance in the rest of the year.**
- **This impact is already visible in 19Q2 when the economy shrank.**
- **The labor market is still historically tight, though Brexit is likely to have a lagged effect on it in the longer term.**
- **The prospect of a hard Brexit is casting a shadow on the UK economic outlook, as this outcome would push the UK into a long and deep recession.**

Brexit expectations: bracing for impact

The replacement of Theresa May with Boris Johnson as Prime Minister (PM) of the UK has affected Brexit for the worse as the UK is heading for a turbulent period in its politics. The new PM wants to renegotiate the deal with the EU. But, as expected, the negotiations with the block have reached a stalemate after the PM demanded that the EU remove the Irish backstop from the Withdrawal Agreement. The EU had stated repeatedly that the Withdrawal Agreement is not up for re-negotiation.

Against this backdrop the PM is likely to opt for a no-deal Brexit on 31 October and this would put him at war with Parliament, which strongly opposes a no-deal Brexit. The parliamentary arithmetic looks bad for Johnson: he has a thin majority of one seat and a number of Tory MPs are considering supporting a confidence motion against the cabinet in order to prevent a no-deal Brexit. The Tory MPs that actively oppose a no-deal Brexit have already flexed their muscles and adopted legislation that will make it harder for PM Johnson to prorogue Parliament in October. Further interventions to impose an extension of Article 50 and/or trigger snap elections are expected. There is speculation that this could happen as soon as early September when Parliament returns from recess. Both the executive and the legislative are exploring legislation vacuums to place the opponent on the offside. British politics is heading for unchartered territory and that increases the odds of a hard Brexit on 31 October. Nevertheless, we see a third extension of Article 50 as the most likely outcome in October. An early election is part of this scenario, which adds to the uncertainty surrounding the

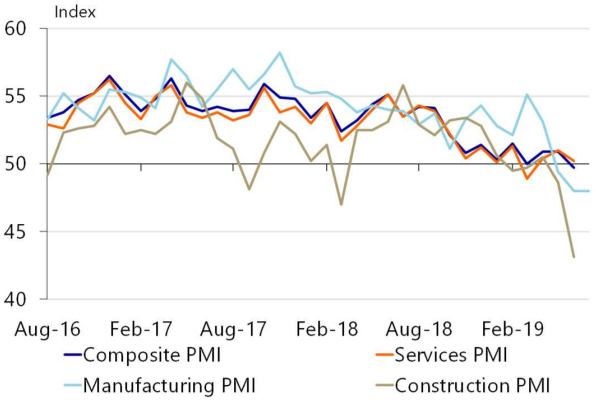
eventual outcome. That said, we continue to regard an orderly Brexit as slightly more likely than a hard Brexit or a Bremain.

Conjuncture: the Brexit shadow

All of this means that the already elevated level of uncertainty will probably rise further in coming months, leaving its mark on economic activity. The economic impact appeared to be positive in the first quarter of 2019, when growth was buoyed by hoarding behavior ahead of the 29 March deadline. Growth surprised on the upside, accelerating to 0.5% from 0.2% q-o-q in the previous quarter. Companies and households prepared for a possible hard Brexit on March 29 by bringing forward their purchases, which was reflected in soaring imports and inventories. Even private investment growth turned positive, following four consecutive quarters of contraction, as companies frontloaded replacement investment in anticipation of a possible no-deal exit.

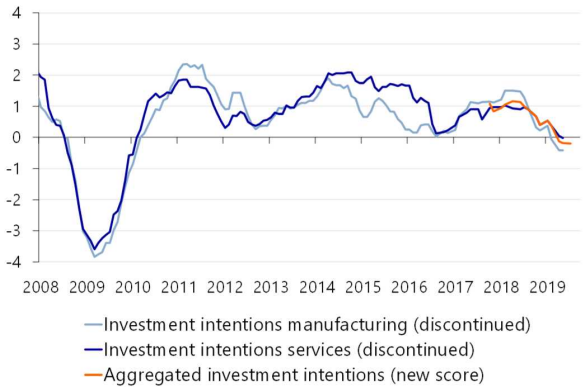
High frequency data have been gloomy recently. The composite output PMI dipped into negative territory in June, before recovering to a meagre 50.7 in July, as the indices for manufacturing and construction reached new lows (Figure 1). Other survey data show that investment intentions have also turned negative in recent months, for the first time since the Great Financial Crisis (Figure 2). The slowdown in investment is unlikely to be reversed anytime soon.

Figure 1: PMI Indices break historic records



Source: Macrobond, IHS Markit

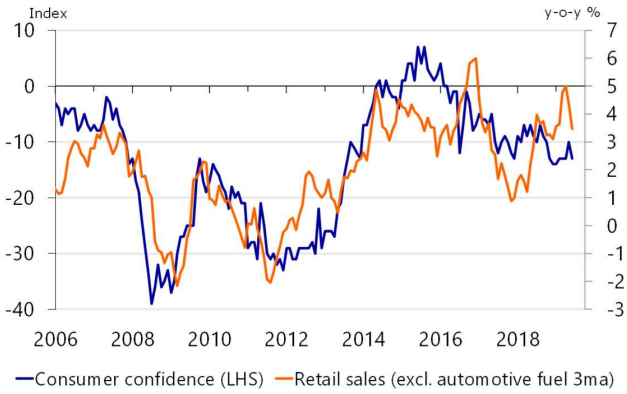
Figure 2: Investment outlook looks grim



Source: Macrobond, BoE

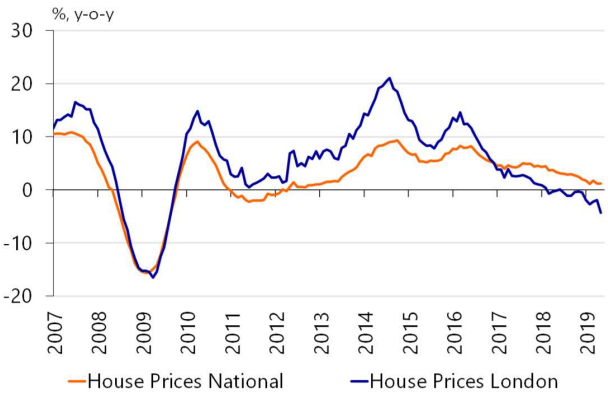
Consumption has been fairly resistant to Brexit as it has found support in a historically tight labor market (see below). In 19Q1 it was further boosted by hoarding behavior. But Brexit has been weighing on sentiment (Figure 3) and higher frequency data such as retail sales was pointing towards a dent in consumption in 19Q2.

Figure 3: Brexit is also weighing on consumption



Source: Macrobond, ONS

Figure 4: Housing market slowing down

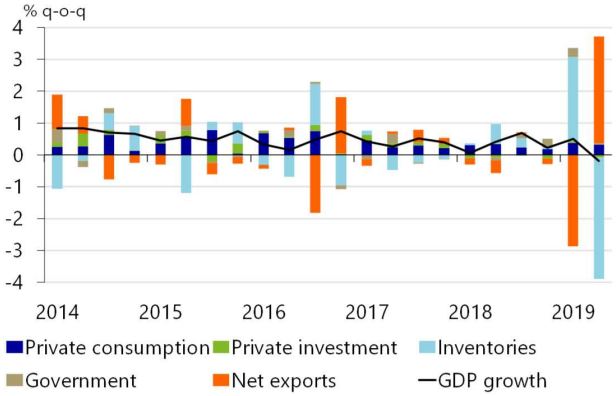


Source: Macrobond, UK Land Registry

A persistent slowdown on the housing market could also hurt consumption in the medium term. Tax and regulatory changes intended to reduce speculation have pushed the housing market toward a softer patch in the past three years and Brexit uncertainty is adding to the mix. That is particularly the case in London, where house prices fell by 4.4% y-o-y in May – the sharpest yearly contraction since 2009 (Figure 4).

The gloomy picture was confirmed by the 9 August quarterly GDP release for 19Q2 (Figure 5). GDP contracted by 0.2% in this period, as companies ran down inventories and imports contracted even harder than exports as a result. The contraction was fairly broad-based and as expected the slump in investments continued. The only exception was consumption which has so far been fairly resilient to the Brexit uncertainties.

Figure 5: The British economy has a Brexit hangover



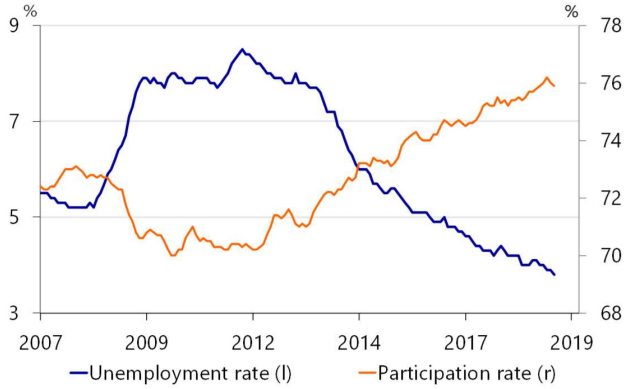
Source: Macrobond, ONS

As Brexit is only going to get messier in coming months and a hard Brexit casts its shadow on this outlook, we do not see economic activity becoming brisker moving forward, though there might be a slight pick-up due to base effects. All in all, we might see a small downwards revision of our 2019 projection that the economy grows by 1.4% y-o-y with the next quarterly. For 2020 we see the economy growing around 1% y-o-y. This baseline forecast is based on our house view that Brexit will be delayed in October 2019, that a transition period will commence in the second quarter of 2020 and that the EU and the UK will reach a comprehensive Free Trade Agreement (FTA) that includes a Customs Union that will be implemented as of January 2023.The risks to this forecast are tilted to the downside, mainly due to a looming hard Brexit and further escalation of the trade tensions between China and the US.

Labor market: still holding strong

The labor market has been the silver lining of the British economy in the past year. As we explained in a previous study, the tightness of the labor market is caused by both the UK economy being at the top of the economic cycle and a number of one-off factors. Lingering Brexit uncertainty is one of those factors, as companies prefer to meet growing demand by hiring more workers, rather than by investing in hardware and facing the risk of large sunk costs if a hard Brexit does indeed materialize. Both the participation rate and the unemployment rate have broken records in recent months. In the three months to May the participation rate was 76% and the unemployment rate was 3.8%. Other trends also point towards a tight labor market, such as the falling share of part-time employment in total employment and the decline in zero hours contracts. This has kept real wage growth in positive territory in 2019. However, the lackluster economic outlook is likely to feed into the labor market eventually.

Figure 6: Tighter labor market



Source: Macrobond

Monetary policy: the Bank of England is stuck

After raising its key interest rate twice in the past two years to 0.75% as of now, the Bank of England is essentially stuck due to the lingering Brexit uncertainties. Its forward guidance of a gradual rise in short-term interest rates is therefore coming under increased pressure. This is primarily due to the progressively binary future path of the UK economy. While sending a tough message with regards to a no-deal Brexit now looks to be government policy, the Bank of England has maintained the official view that the government is ultimately looking for a deal. This, in turn, implies an increasingly divergent outlook from the Bank of England on the one hand and the market–which has to put a price on the risk of a no-deal–on the other.

While we stick to our forecast of no changes in the policy rate in 2019 and 2020 (on the premise that the UK will leave the European Union with a deal in place) the risk of a series of cuts toward record lows following a no-deal Brexit is clearly on the rise. It seems increasingly likely that the Bank of England will prefer to stimulate activity rather than to fight rising inflation. The changing external environment, with slowing global growth, also adds to the argument in favor of easier monetary policy.

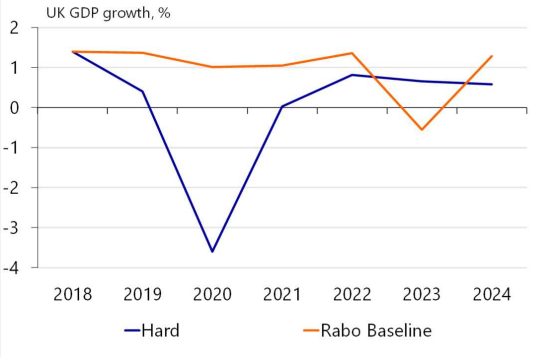
Box 1: A hard Brexit looming over October

The election of Boris Johnson as PM and his intention to take the UK out of the EU "no ifs or buts" has brought the possibility of a hard Brexit on 31 October back into play. This casts a shadow on the economic outlook of the UK.

A hard Brexit will push the UK out of the EU Internal Market and the EU Customs Union. International trade between the UK and all of its trading partners would fall back on WTO rules, unless new FTAs are put into place (or rolled over from existing EU FTA's). This will have direct consequences for trade, foreign direct investment and immigration, but also an indirect impact on, for example, productivity. In 2017 we explained the channels through which the Brexit would feed into the UK economy and also assessed the indirect impact by using an endogenous UK productivity model to estimate the consequences for productivity. However, both the international economic environment and the expectations around the Brexit outcomes have changed. Therefore we recently revised our calculations for a hard Brexit.

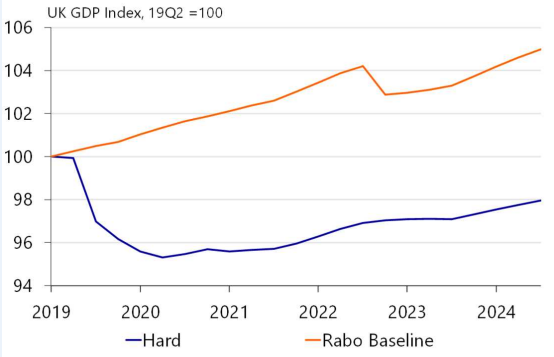
We assess that a hard Brexit on 31 October would push the UK economy into a deep recession that spreads over two years. Compared with our current baseline forecast as described above, the recession would reduce GDP growth by 1ppt to 0.4% in 2019 (or lower if revised downwards) and by 4.6ppt to -3.6% in 2020. We note that the economy will also contract under our baseline in 2023, by 0.6%, but this is a light and short contraction. Moreover, while in a hard Brexit scenario GDP growth would gradually recover after 2020, it would lag behind the baseline levels. By the end of 2024 the size of the economy would be almost 7% lower in a hard Brexit scenario than under the baseline.

Figure b1: Brexit pushes the British economy into recession



Source: NiGEM, Rabobank

Figure b2: GDP is persistently lower in a hard Brexit than under an FTA+CU



Source: NiGEM, Rabobank

The economic contraction in 2020 under a hard Brexit would be broad-based, though investments would be particularly hard hit. It would also wreak havoc on sterling, which we see moving towards parity for EUR/GBP, a depreciation of approx. 9% when compared to the current exchange rate. As the price of imported goods would rise, a hard Brexit would be highly inflationary. In fact, inflation may even reach 5%. While the Bank of England has previously signaled that it may raise interest rates to bring inflation back to its 2% target, the current macro- economic environment is not conducive to this. The impact on the labor market would be lagged and unemployment would increase towards 5% in 2021, but this impact would also be short-lived given the flexibility of the UK labor market.

The hard Brexit impact we estimate is similar to the damage caused by the Great Financial Crisis, though somewhat lower. Our estimates are also in the range estimated by the Bank of England in 2018. The BoE has two hard Brexit scenarios, the difference being major disruptions in the immediate Brexit aftermath. Our results are in between those two scenarios in terms of effects on GDP and unemployment, while our estimate of the impact on inflation is more moderate than in both BoE scenarios.

Author(s)

Alexandra Dumitru

RaboResearch Netherlands, Economics and Sustainability

raboresearch@rabobank.nl

Stefan Koopman

RaboResearch Global Economics & Markets

Stefan.Koopman@rabobank.com