Knowing me, knowing EU: an update on Brexit

In this update, LGIM European Economist Hetal Mehta assesses the outlook for the UK and how the Brexit negotiations are shaping up so far.

A weak pound and rising inflation, set against a tight labour market and loose credit conditions, should keep the UK out of recession and only result in a modest slowing of UK consumer spending. But challenging negotiations with the European Union (EU) are still ahead.

Nearly nine months on from the EU referendum in June last year, and it feels like a lot has happened. There is a new Prime Minister and a revamped set of senior cabinet ministers. The Bank of England (BoE) has shifted from pre-referendum talk about the next move in monetary policy being a tightening to significantly easing policy last August. Meanwhile, the new Chancellor of the Exchequer, Philip Hammond, announced a fiscal stimulus package that amounts to around 0.5% of GDP spread out over three years.

And yet, the UK economy seems to have barely noticed the result of the referendum, pumping along at a decent clip of over 2% annualised in the second half of 2016. Can this continue?

THE NAME OF THE GAME

Theresa May told the country that `Brexit means Brexit' and has now announced that Article 50 will be triggered on 29 March. That will kick off the formal process of leaving the EU and the negotiations around this.

While the economy has shown resilience beyond what was expected by most forecasters (including us), huge uncertainty looms over the horizon: what will the UK's relationship with the rest of the EU look like?

I HAVE A DREAM

The Prime Minister's 17 January speech outlined the future relationship with the EU. Key elements included the UK leaving the single market so that it can control

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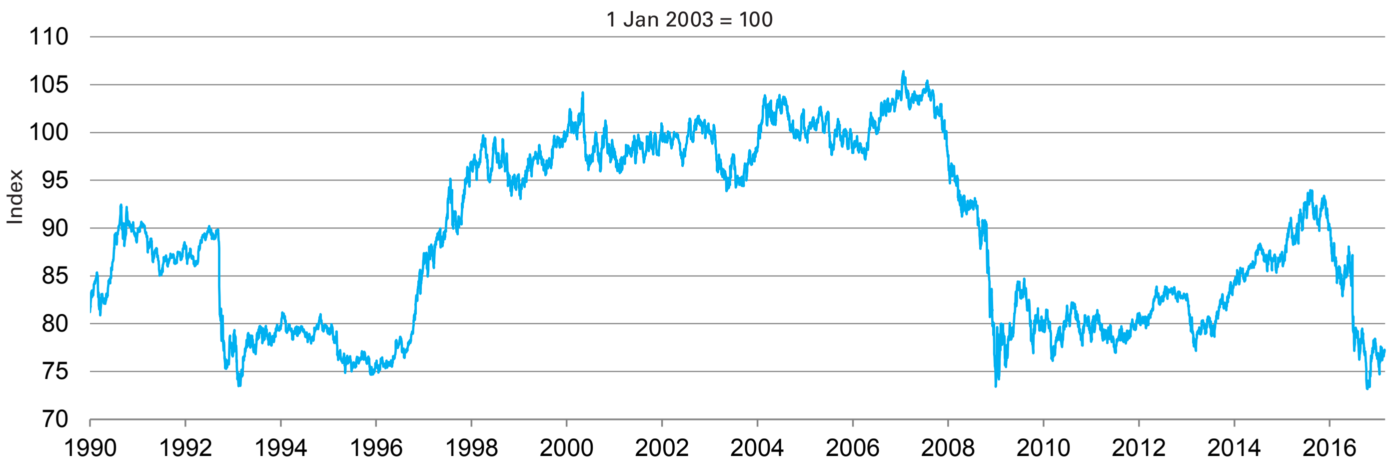
Figure 1. UK effective exchange rate (BoE)



Source: Macrobond, BoE

migration. The main objective will be to negotiate an ambitious free-trade agreement with the greatest possible access to goods and services markets. The UK hopes to be free to strike trade deals with non-EU countries (which is why it would need to leave the customs union) but will seek a 'customs agreement' with the EU; what this would look like is unclear.

Furthermore, the UK government will seek to stop contributing "huge sums" to the EU budget. There will be no unlimited transitional agreement. Instead, Theresa May wants to reach an agreement within two years, followed by a phased period of implementation to give businesses time to plan and prepare.

Overall, the plan scored some points with markets and European politicians. It's important to remember, however, that this is still a wish list and Europe has so far largely kept its cards close to its chest. The transition agreement is helpful as it makes a harmful cliff-edge exit less likely, albeit not impossible, as May rather strikingly insisted that "no deal would be better than a bad deal". The risk of negotiations becoming bitter and acrimonious is there.

WATERLOO

While some in Brussels might wish to "punish" the UK for Brexit to deter others from leaving, it is the heads of state who ultimately make the decision. They will be lobbied by domestic industries set to lose out from trade barriers with the UK. Europe's trade surplus in goods with the UK is a strong incentive for Europe to do a deal. However, the UK is unlikely to sign up to free trade in goods without a reasonable arrangement on services (where the UK has a surplus).

Financial services will be a key battleground: London is still likely to be Europe's dominant financial centre, but it is possible that there are some job losses in the distribution of products sold to Europe and less inward foreign direct investment while negotiations are taking place.

In a thinly-veiled threat, May also suggested the UK could slash taxes to attract companies and investors if the UK fails to agree a positive deal with EU. We do not find this very credible for two reasons: the negotiating position of the UK remains relatively weak and corporation tax in the UK is already relatively low.

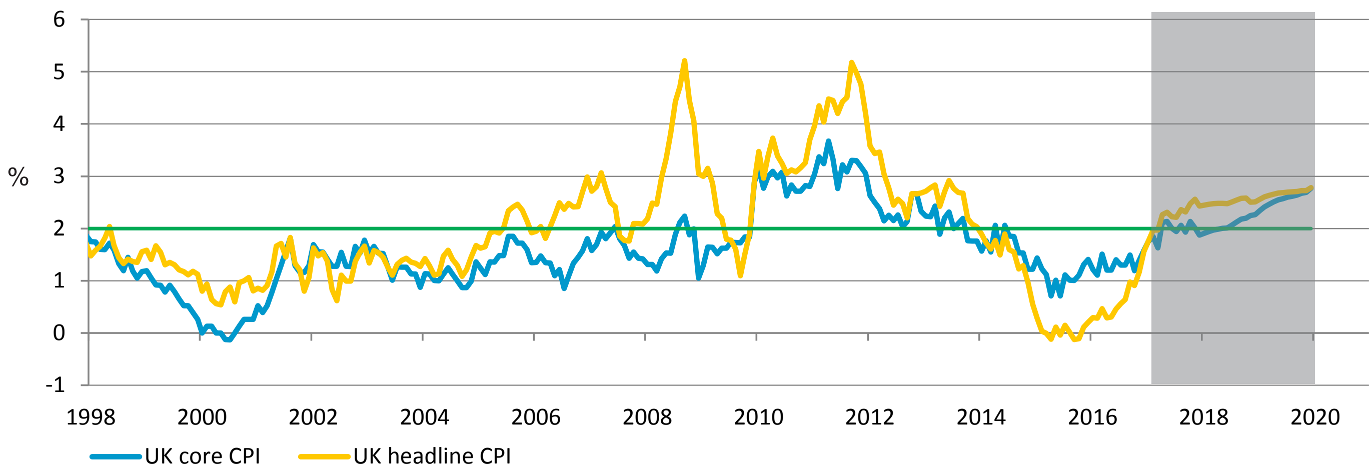
(NOT) SO LONG

The timeframe for getting a deal agreed in two years is limited. Any deal has to be approved by all 27 remaining members of the EU – a process that could take several months and eat into the time for finalising the deal itself.

Furthermore, the political calendar in Europe is tightly packed this year, with Dutch, French and German elections. With ongoing issues with the Greek bailout also bubbling away under the surface, there are plenty of things to keep our European neighbours occupied.

Even if it is in nobody's interest, the risk is that there is simply not enough time to prevent the UK from being

Figure 2. UK consumer price inflation



Source: Macrobond, LGIM estimates

thrust onto a World Trade Organisation (WTO) schedule with tariffs and customs checks on goods arriving into the UK.

YOU OWE ME ONE

Another point of contention is likely to be the 'Brexit bill' – the costs the UK could incur to leave the EU such as existing commitments to pensions for EU officials, bailout programmes, structural funds and outstanding project commitments. These are estimated to be in the order of £60bn (or 3% of nominal GDP). Spread out over a number of years this would not be too costly for the UK's public finances but could provoke Brexit campaigners.

MONEY, MONEY, MONEY

Turning back to the near term, one thing that is notable and seemingly stuck at a much weaker level than before the referendum is the UK's exchange rate. On a trade-weighted basis, sterling is still some 18% below the recent peak of mid-2015 and 7% below the pre-referendum level **(Figure 1)**. And this is where the impact is likely to be felt soon.

The weaker pound is already starting to feed through into import prices, and will continue to do so for many months. As businesses gradually pass this on to consumers, we are seeing headline consumer price inflation in the UK pick up. Indeed, it has already risen (although this is also partly thanks to energy prices) and is set to rise further still, overshooting the BoE's 2% target for quite some time **(Figure 2)**. Unless wage growth can keep pace with the rise in inflation, this will hurt consumers' purchasing power and cause the economy to slow.

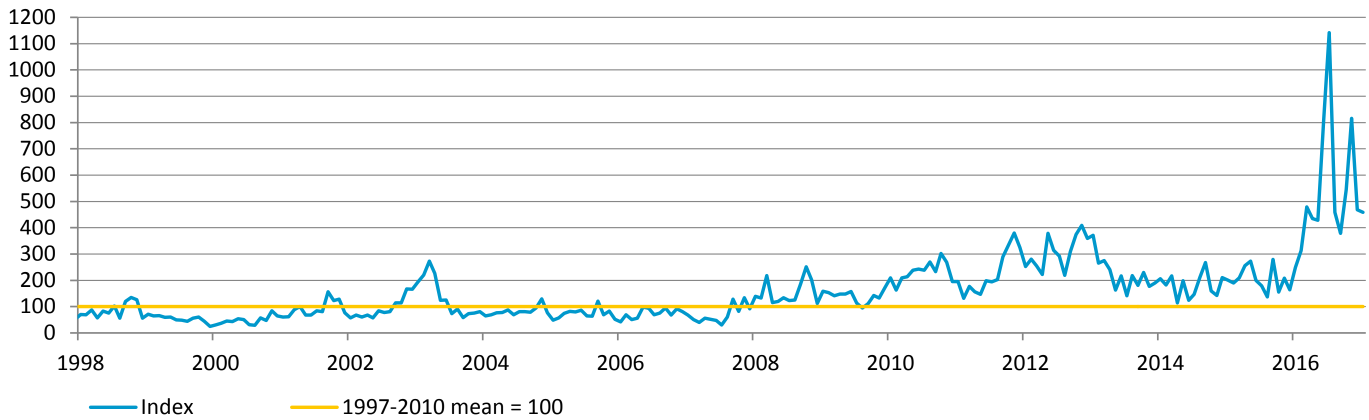
On the other hand, the weaker pound should boost UK export competitiveness; for instance, tourism numbers are up, which is helping services exports. Manufacturing exports rely on imported components, meanwhile, so the benefits here may be more muted.

Another potential impact of the weaker currency could be on immigration flows – a weaker sterling makes the UK less attractive. We expect slower inflows in the future (partly because of the increased uncertainty), which could keep unemployment down and potentially put upward pressure on wage growth.

How will the Bank of England react? So far we have seen the monetary policy committee (MPC) remain cautious. The inflation overshoot will be uncomfortable for the BoE but the key is the labour market. If the UK continues to create jobs, and the economy holds up well, we expect the BoE's tolerance for higher inflation to fade. Indeed, a number of MPC members are already signalling that monetary policy is currently too loose.

Yet uncertainty is big factor currently staying the BoE's hand. As **Figure 3** shows, policy uncertainty in the UK (as measured by news articles references to indicative wording) remains high. Periods of high uncertainty usually correspond to low business investment, an area of concern for the BoE.

Figure 3. UK policy uncertainty index



Source: Macrobond, Economic Policy Uncertainty, News Based Index

WHEN ALL IS SAID AND DONE

So far, Brexit has not been so bad for the UK economy. The formal process is yet to commence, but is it likely to cause a material economic downturn? Given that people have accepted the result, and that the media has flagged this, we would not expect a change in momentum caused by the start of the formal process in itself.

The main danger is around the nature of the negotiations, and the shifting risks around the UK. However, if the discussions are well-mannered and make good progress, the risks should diminish and we believe that the BoE could turn markedly hawkish as a result.

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