UK Watch

Group Economics
Financial Markets Research

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The macro impact of Brexit scenarios

Bill Diviney
Senior Economist
Tel: +31 20 343 5612
bill.diviney@nl.abnamro.com

Nick Kounis
Head Financial Markets Research
Tel: +31 20 343 5616
nick.kounis@nl.abnamro.com

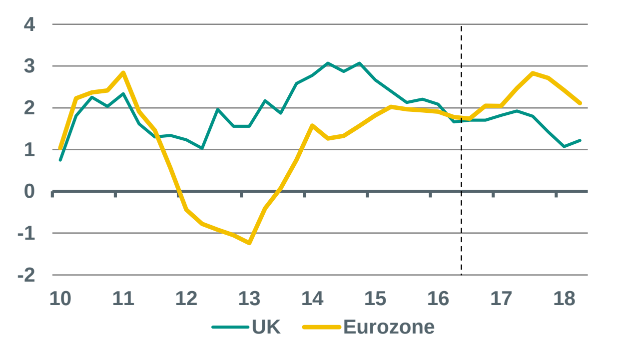
- **Brexit negotiations are now in the final stretch, but there remains considerable uncertainty over whether a deal will be struck…**
- **…and if it is, whether it would get through Parliament**
- **We present three scenarios, with the macro and policy implications**
- **Our base case continues to be an orderly Brexit, but our conviction level on this is low**
- **A disorderly Brexit is the next most likely outcome, and would lead to stagflation in the UK economy**
- **A second EU referendum and subsequent Remain vote cannot be ruled out, and would drive a sharp rebound in pent-up investment**

Introduction

Brexit negotiations between the UK and the EU are reaching an inflection point, but the likelihood of a deal continues to ebb and flow almost with each meeting between UK-EU negotiators. Even if an agreement is reached over the coming weeks, there is a significant risk that it will not gain sufficient support in parliament. Opposition parties look set to vote against the plan, with the Labour Party being particularly vocal on this point, while pro-Brexit Conservative MPs may also vote against the plan. From here, events can take any number of directions, both in terms of the negotiations but also the domestic political environment in the UK. As such, we lay out three main scenarios that focus on the likely *outcomes*, rather than the processes that lead to those outcomes.

UK significantly underperforming since referendum

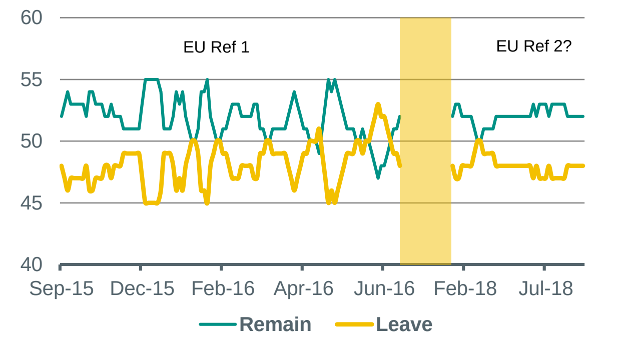
GDP growth, % yoy



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

EU polling less volatile, but remains tight

% voting intention in a referendum on EU membership



Source: What UK Thinks: EU, ABN AMRO Group Economics

Negotiations remain fraught

Initially, the goal was to have an agreement on an orderly EU exit and an outline of the future relationship by October, but this has now slipped to December. The key sticking point remains the backstop plan to avoid a hard border in Northern Ireland. This is not the default long-term arrangement, but rather the alternative if a better solution that accommodates both UK and EU red lines cannot be found during the transition period. The EU first proposed that this backstop should involve only Northern Ireland remaining part of the customs union and the Single Market. It appears now that the EU will accept the UK's proposal of the *entire UK* remaining in the customs union as a backstop, but with Northern Ireland also remaining in the Single Market, and that this cannot be time-limited (as it would then not meet the definition of a 'backstop').

While the situation remains fluid, it looks like the UK will have to accept – perhaps with some creative political fudging – that the backstop is open-ended rather than strictly time-limited, with some limited regulatory checks between the UK mainland and Northern Ireland to enable it to remain in the Single Market. The Prime Minister is now suggesting a possible extension to the transition period, in order to reduce the likelihood that such a backstop is activated – though it is unclear whether this would assuage the concerns of Brexit-supporting MPs in her party.

The longer term question of what kind of trade deal the UK and the EU strike remains up in the air, and it looks likely that any agreement on this will be vague and non-committal, with details to be hammered out during the transition period. So far, the UK's stated goal is to have a free trade agreement on goods – with a 'common rulebook' governing this – but not in services. The EU has pushed back against this, viewing it as cherry-picking. It is likely however that any near-term agreement on this matter will be vague enough that it avoids forcing clear decisions to be made at this stage.

	Orderly Brexit (45%)	Disorderly Brexit (35%)	Remain in EU (20%)
Scenario	**Variation on Chequers plan (relatively frictionless trade)**	**WTO rules (no transition period, customs controls)**	**Second referendum leading to Remain, or EEA/CU membership**
Macro view	Growth and inflation to remain subdued, as the introduction of new – though modest – trade barriers hinders investment.	Stagflation. Investment would fall, trade heavily disrupted (both imports and exports), and inflation would rise on a weaker sterling.	Investment would rebound strongly, although this will be mostly felt in 2020. Inflation stable as stronger demand offset by stronger sterling.
Growth and inflation (2019)	GDP: 1.7%, CPI: 1.9%	GDP: 0.1%, CPI: 2.6%	GDP: 1.9%, CPI: 1.9%
Growth and inflation (2020)	GDP: 1.9%, CPI: 1.8%	GDP: 1.2%, CPI: 2.2%	GDP: 2.5%, CPI: 2.0%
BoE	One rate hike in 2019 and 2020	Policy likely on hold, but depends on supply-demand mix (see text)	Two rate hikes in 2019 and 2020
Markets (end-2019)	Gilts: 1.8%, GBP/USD: 1.42	Gilts: 1.0%, GBP/USD: 1.24	Gilts: 2.3%, GBP/USD: 1.50

Source: ABN AMRO Group Economics

Recent macro developments

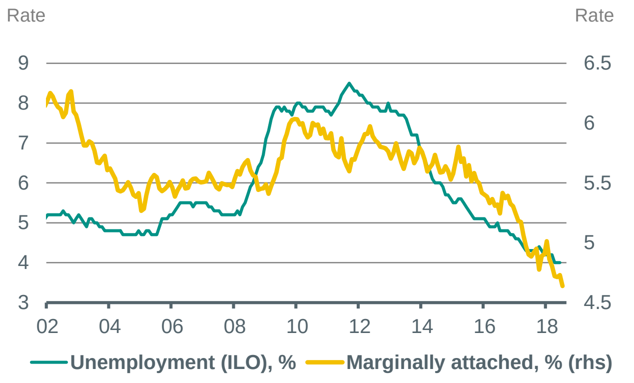
While avoiding the dire predictions of recession in the post-referendum period, the UK economy has significantly underperformed over the past year. This underperformance has been driven chiefly by private consumption, which has weakened partly due to the squeeze on real earnings (driven by the fall in sterling), but also investment, which is likely being dampened by uncertainty over the outlook. On the positive side, net exports did very well in 2017, adding 0.6pp to GDP growth, but even this bright spot of the economy is now exerting a drag, *subtracting* 0.6pp from growth so far this year (as of Q2). In the meantime, the unemployment rate has continued to fall, and the firming in domestically generated inflationary pressure has led the Bank of England to raise Bank Rate by a cumulative 50bp over the past year.

Orderly Brexit (45% probability)

Our base case – with a low conviction level – is that the UK will leave the EU in an orderly manner. An orderly Brexit scenario would require some form of agreement which maintains significant and relatively frictionless trade in goods, while services trade would become more restricted. There would be a transition period lasting 21 months during which existing arrangements remain. The UK would remain in or reach new agreements on, for instance, aviation and financial derivatives trading.

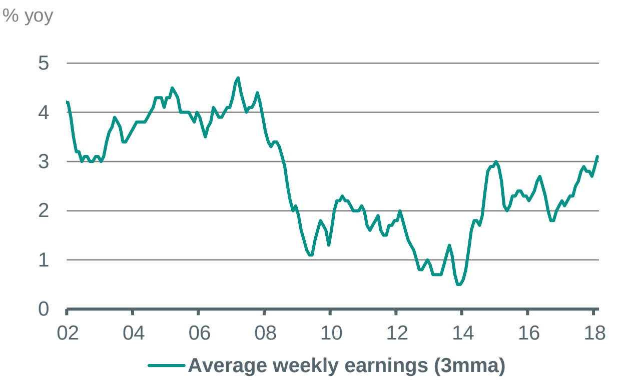
In this scenario, growth would likely continue roughly on the path that it has been on since the referendum, with some pickup in investment back to more normal levels, but still weighed by the introduction of new – even if limited – trade barriers. For instance, even in this relatively benign scenario, the loss of passporting is likely to weigh on growth in financial and other export-oriented services over the coming years, as multinationals move certain functions to EU jurisdictions. Against this backdrop, core inflation would be broadly stable, as modestly stronger demand is partly mitigated by a further recovery in sterling and the (very) gradual tightening of monetary policy by the Bank of England.

Continued strength in the labour market…



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

…is supporting firmer wage growth



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

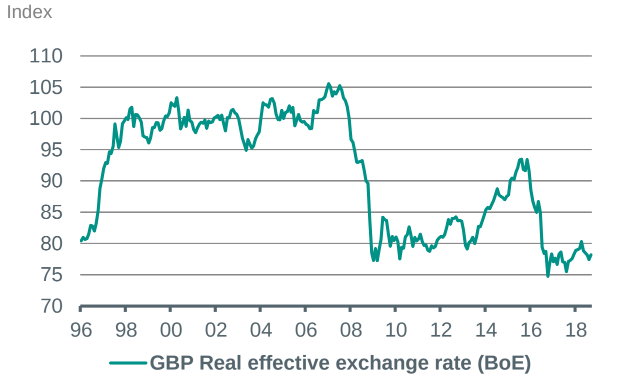
Why do we see this as – marginally – the most likely scenario? Despite the difficulties in the negotiations, the UK and EU could find a renewed imperative to reach a compromise as the prospect of a No-deal Brexit – and all that would entail (see below) – looms. For the same reason, parliament may pass the deal to avoid a No-deal scenario. Finally, if the government collapses, a new government could be returned with a stronger mandate to push through an agreement, whether Conservative or Labour.

Disorderly Brexit (35% probability)

A disorderly Brexit is one where no agreement is reached. This would have a number of consequences. First, there would be no transition period and the new relationship would then begin as of April next year. The UK's trading relationship with the EU would be defined by WTO rules. This would mean tariffs on goods trade, and customs checks at the border. The UK could fall out of other arrangements, such as on aviation.

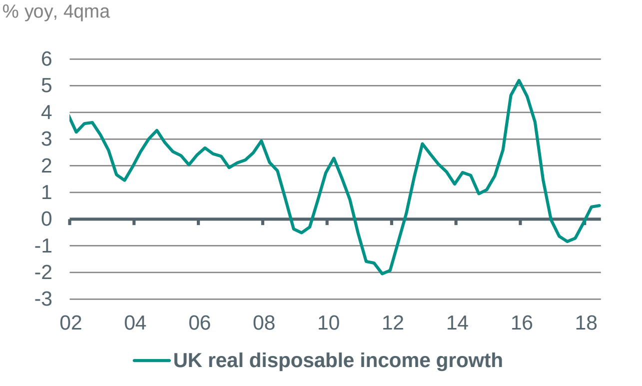
The economic impact of a disorderly Brexit is inherently uncertain, dependent on the degree of disruption to trade, the impact on business and consumer confidence, and on foreign direct investment. We believe the biggest impact on growth is likely to come via investment, which has already been depressed since the referendum, and is likely to contract as the prospect of a No-deal nears. In this scenario, we would expect the fall in investment to start in Q1, as it becomes clear that the UK is leaving without a deal and corporate contingency plans are activated. Consumption would also be dampened as consumers begin to fear the economic fall-out of No-deal, and a fall in sterling leads to higher inflation and another squeeze on real earnings. Net exports could remain stable, as both exports and imports fall, although trade disruption will surely impact other parts of the economy. All told, the UK could experience a technical recession in the first half of 2019, with only a shallow recovery thereafter as uncertainty continues to weigh on the outlook.

A renewed fall in sterling…



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

…could drive another real earnings squeeze



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

As BoE Governor Mark Carney has apparently indicated at a Cabinet meeting, the central bank's response to a No-deal scenario is likely not as clear-cut as it was in the aftermath of the referendum. This is because the UK economy has now absorbed much spare capacity, and because a No-deal Brexit would represent a real supply shock to the economy (as opposed to only the *potential* for a supply shock, as in the post-referendum period), as well as hitting demand. The BoE's policy would therefore depend on to what degree demand contracts vis-à-vis supply. On balance, we think policy would probably stay on hold, with the bias for further easing rather than a tightening of policy. The exception would be if inflation expectations become unanchored.

A No-deal scenario could occur because of a lack of flexibility on either side, or simply because it may not be possible to find an agreement that both respects the 'spirit of the referendum decision' as the government sees it, solves the Irish border issue and secures some of the economic benefits of trade. Even if the government falls following a no deal outcome to negotiations, it could still be re-elected however on a manifesto of leaving with no deal.

UK remains in the EU (20% probability)

This scenario is one where the UK either remains in the EU, or the EEA, as the economic implications are similar. Should the UK government fail to reach a deal, or reaches a deal but is unable to get it through parliament, a second referendum could be a way to break the impasse. The opposition Labour Party has become more open to the possibility of a second referendum, but it still seems to prefer to trigger new elections and then subsequently resume negotiations with the EU. The current Conservative-led government has ruled out another referendum. Recent polling suggests Remain could have a better chance in a new referendum, but the outcome would likely still be very close – and far from certain.

In a scenario where a second referendum takes place, with Remain winning, we would see pent-up investment demand driving an acceleration in GDP growth, with the biggest impact likely to be felt in 2020. Consumption would also see a lift, as consumer confidence recovers and the tight labour market encourages greater bargaining for higher wages. A rebound in sterling would dampen the inflationary impact initially, but we would expect the Bank of England to modestly increase its pace of tightening – with an additional rate hike in 2019 alongside our base case of just one hike, and two further rate hikes in 2020. The BoE will probably wait for growth momentum to show a meaningful acceleration before increasing the pace of rate hikes.

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