ECONOMIC RESEARCH

The NewsLine

October 27, 2016

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UNITED KINGDOM

Post-Brexit vote economic honeymoon will soon come to an end

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The UK economy slowed down in the third quarter of 2016, but the GDP reading – the first official indicator of how the economy as a whole has fared following the Brexit-vote – contained little of the doom and gloom that many had expected following Britain's decision to exit the EU. Looking ahead, however, economic clouds are already gathering on the horizon: for 2017 we expect GDP growth to more than halve. In the long run Brexit does not have to be a disaster for the UK economy, but we expect the exit from the EU to cause significant economic damage during the transition phase.

The flash estimate for Q3 GDP growth in the UK confirms the economy's relative resilience in the aftermath of the Brexit vote. In the three months to September GDP growth slowed to 0.5% q/q – exceeding consensus expectations – down from a buoyant 0.7% q/q in the previous quarter. The service sector provided the only positive contribution to growth (+0.6 percentage points).

No breakdown of components is available yet, but higher frequency data suggests that private consumption was the main engine of growth in the third quarter. The referendum result in favour of an EU exit has not yet negatively impacted spending plans. To the contrary, expected price increases given the sharp depreciation of the pound likely caused households to pull forward spending decisions instead. Meanwhile investment probably stagnated during the third quarter with surveys suggesting that UK firms are sitting on their

investment plans in light of elevated uncertainty about the future EU-UK ties and resulting implications for the business environment. A sharp drop in investment meanwhile is unlikely for now with domestic demand still going strong. In fact UK confidence surveys for the manufacturing and the services sector returned to pre-referendum levels in Q3 while capacity utilization rates in industry rose. Exports meanwhile probably enjoyed a boost thanks to the sharp sterling depreciation allowing for a small positive growth contribution from net exports.

Despite the relatively strong Q3 performance of the UK economy, we expect the current post-referendum economic honeymoon to come to an end soon. The sharp drop in the pound sterling against the euro has already started to push up import prices. This will fuel inflation in the UK with consumer prices rising 2.5% in 2017 after 0.8% this year reducing household purchasing power. Moreover increasing insights into Prime Minister May's thinking on what Brexit really means – most likely an exit from the Single Market if the British government's rhetoric is taken at face value - should lead to a significant downward correction in investment (-1.6%) and hiring plans in 2017. Exports should benefit from the weak currency – even if only temporarily given the dependency of UK manufacturers on imports – but this boost will prove far too weak to offset the expected drop in domestic demand. We forecast economic growth in the UK to more than halve in 2017 to 0.7% - the worst growth performance since 2009 - following a strong reading of 1.9% this year.

The UK's long-term growth prospects will depend on the outcome of the negotiations with the EU, an immensely complex process, which will take years to complete. A comprehensive free trade agreement between the EU and the UK, with considerable sectoral add-ons – in particular for services – is still the most likely scenario for us. But the agreement will fall well short of the degree of integration that has been achieved within the European Single Market. Key pillars of Britain's economic success – such as the financial services industry – could lose some of their importance going forward. Other industries that require large markets for scale-up and access to international talent could also come under pressure. If the UK economy wants to thrive post-Brexit, it will have to reinvent itself. With the right vision and policy mix, Brexit does not have to be an economic disaster in the long run but in the medium term significant economic costs are inevitable.

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