The fact that the UK avoided an immediate crisis does not tell us much about the future

blogs.lse.ac.uk/brexit/2016/09/12/the-fact-that-the-uk-avoided-an-immediate-crisis-does-not-tell-us-much-about-the-future/

12/09/2016

*More than ten weeks ago now, the UK voted to leave the European Union. **Holger Schmieding** explains why the initial shock has subsided fast. First, instead of taking charge, the leading Brexiteers lost the ensuing power struggle within the Conservative party as the mildly pro-EU Theresa May prevailed within just three weeks. Second, May's calm and slow approach to Brexit issues has fostered the impression that she will seek realistic co-operation rather than ideological confrontation with the EU27.*

While nothing has been settled and the uncertainty about the UK's future access to its major market seems to be weighing on investment and parts of the real estate market in the UK, the country did not fall into an escalating economic and political crisis. Financial markets re-priced UK assets in an orderly fashion through the exchange rate. Although a weaker Sterling does little to ease concerns about the future of Greater London as the services centre for Europe, it helped to lure more tourists to the UK. For the EU27, the repercussions of the Brexit vote have been rather mild.

Immediate Brexit impact: the calm after the shock

UK economy: On the morning after the Brexit vote, we reduced our economic forecasts for the UK significantly, projecting an immediate hit to demand that would bring the economy from trend growth of 0.5-0.6% QoQ to virtual stagnation with just 0.1% QoQ gains in GDP for Q3 and Q4, followed by a return to trend growth. Evidence over the last two months suggests that the short-term damage to demand will be even less pronounced than that. Strong retail sales in July, partly fuelled by tourist spending, and a major rebound in August in most sentiment indices after a plunge in July point to the ongoing growth of at least 0.2% QoQ, and possibly more than that.

EU economy: While exports to the EU27 account for 12% of UK GDP, the much bigger EU27 earns just 4% of its GDP through exports to the UK, making the region much less vulnerable to potential Brexit risks than the UK. Right after the Brexit vote, we shaved our calls for Eurozone growth modestly from 0.4% to 0.2% QoQ for Q3 and Q4, followed by a return to a trend rate of 0.4% QoQ for early 2017. The fact that the UK avoided an escalating crisis has also mitigated the downside risk for its major trading partners on the continent. Surveys such as the purchasing managers' indices show only a modest reaction to Brexit.

UK politics: For now, prime minister May has steadied the ship. Despite some grumblings, Scotland has not taken any decisive step towards a new independence referendum. Although Scotland voted overwhelmingly to stay in the EU, opinion polls do not show a clear and lasting shift in favour of independence that could encourage the Scottish regional government to go for a new referendum fast. A YouGov poll from 28 July even put the opponents of independence ahead again with 53% to 47%. With the UK Labour party mired in its own internal conflicts, PM May enjoys strong public support. Recent opinion polls in the UK put her Conservatives at 40% after 35% right after the Brexit vote.

EU politics: In a similar vein, the Brexit vote has triggered no political contagion elsewhere in Europe. Instead, support for staying in the EU rose in a number of EU countries after the Brexit vote. So far, opinion polls on the continent show that the UK Brexit referendum is seen more as a problem that voters elsewhere would like to avoid rather than an example that they would like to follow.

Long-term impact: less trend growth in the UK, little contagion in the EU27

That the UK avoided an immediate crisis does not tell us much about the future, though. The UK is nowhere close to taking any of the hard decisions of market access versus immigration control. We continue to project trend growth in the UK to slow from 2.1% to a rate of 1.8% as a result of Brexit because businesses will use the UK less as a springboard into the biggest common market in the world, the EU, than before. Being less attractive for investment, the UK will likely attract fewer qualified immigrants as well. Over time, that would contribute to the slowdown in trend growth. For our estimate of trend growth, we assume that the UK will maintain virtually full access to the common market for goods and will face only modest restrictions on access to the EU market for services. If the UK were to take a hard line on EU immigration, the deal the EU will eventually strike with the UK on market access could be worse, potentially reducing UK trend growth by more than we project.

1.8% trend growth for the UK would still be above the 1.6% rate of the Eurozone that is held back by the lack of a serious labour market reform in France. Of course, the Brexit vote will still be costly for the UK. As a result of some immediate dent to demand, slower trend growth and the likely fiscal stimulus to be unveiled this autumn, the UK's debt-to-GDP ratio will probably be 8 percentage points higher in 2020 than it would have been otherwise (98% instead of 90%, well above the likely 86% for the Eurozone).

For the Eurozone, the somewhat reduced dynamism of its major external trading partner after the US will not make a huge difference for trend growth. The marginal decline in the trend of export growth to the UK will likely be offset by the shift of some jobs from London to the continent.

Theresa May may still trigger the formal two-year divorce proceedings early next year by invoking Article 50 of the EU treaty. However, we note the discussions within her government whether this should be delayed even further. Some of the reasons quoted for such a delay, namely to wait for the result of the French and German elections in April and September 2017, respectively, make little sense. The real decisions will be taken at the end rather than the beginning of the formal negotiations anyway, that is long after the French and German votes.

A longer wait would prolong the uncertainty about future UK access to the EU market. It may nonetheless suit both sides in the end. If the UK needs more time to prepare for the hard choices it will have to make, fine. And the longer the UK hesitates before it actually starts to follow-up on the referendum result, the easier it will be for pro-EU policy makers on the continent to deflate the wilder claims of their own anti-EU firebrands of paradise outside the EU.

Could Brexit still be avoided?

Right after the vote, this was the question Bloomberg was asked most by UK and US clients. Our answer remains the same: probably not. First, the EU27 will not make a "better" offer to the UK to keep it in the EU. Instead, the EU27 has accepted the result rather calmly. The EU27 will focus on reforming itself slightly (a bit less bureaucracy, a more flexible interpretation of existing rules, more co-operation in sub-groups rather than more integration for all 27 ex-UK members). Second, any Conservative prime minister in the UK has no realistic choice but to implement the referendum result and go for Brexit. The mostly anti-EU Conservative rank-and-file would accept nothing else. Reversing course on Brexit could tear the party apart.

Of course, one hypothetical way to still avoid Brexit may exist. For the UK, it would take a new popular mandate to stay in the EU. If the terms of Brexit, that is the result of the eventual negotiations between the EU27 and the UK, have not been ratified by the UK before the next UK election in May 2020, a new UK parliament led for instance by a new Labour leader could still reject the terms. Instead, it could ask the EU to stay on the terms that David Cameron had once negotiated. It would take some Brussels ingenuity to negate the divorce process that will have started once the UK triggers Article 50. But Brussels is not bad at such ingenuity. In theory, delaying the actual Brexit until after May 2020 so that a new UK government could potentially still keep the UK in the EU may be possible. The longer the UK now waits before it starts the negotiations, the closer the final talks will get to the next UK vote. Also, if Brussels really wanted, it could probably find a way to extend the difficult two-year negotiation period so that the deal could be struck, ratified, rejected or put to a new referendum by a new UK parliament. "Stopping the clock" is not unheard of in Brussels.

Still, this is a rather far-fetched and unlikely scenario. Prime Minister May will probably try to wrap up the Brexit issue before the next UK election to keep the issue out of that campaign. More importantly, the trouble within the Labour party, where left-winger Jeremy Corbyn will probably win the current leadership challenge, makes it unlikely that Labour – or any other – will seriously challenge the UK Conservatives at the next parliamentary election. Most likely, the Brexit vote will lead to Brexit.

This article represents the views of the author and not those of the Brexit blog, nor the LSE. Image credit.

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