Brexit: the economic consequences

Some of the economic and political issues on the horizon

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As governments, businesses and households scramble to respond to the unexpected decision by the UK to leave the EU, what are the immediate political consequences and economic implications that they should be expecting?

What we can expect in the UK over the short term

A key player in this first act to watch out for is the UK consumer - the spending power of the UK consumer is going to be squeezed. The combination of the large degree of uncertainty, pressure on earnings, a weaker pound and higher inflation biting into purchasing power, and potential falls in house prices could all combine resulting in a freeze in spending. Given that consumer spending represents about 60% of the economy, its direction over the coming months will be crucial to determine the path of the overall economy.

Another important component will be investment performance. Following Q2, when anecdotal evidence pointed at many businesses having put on hold investment and hiring decisions until the referendum result, things are now expected to be put on ice for longer, while companies reassess priorities and plan for the many implications an exit would mean for them.

On a positive note, a weaker sterling should boost exports and restrain imports, providing support for UK GDP growth in the coming months. We have therefore revised our forecasts for UK GDP to 1.5% in 2016 and 0.5% in 2017, down from the 2% projection prior to the referendum results.

The sectors which seem to have taken the initial hit are travel, banking, insurance, and real estate. In the immediate, public spending is less clear. We expect Whitehall to be focused on the impact of Brexit so it is inevitable that the pace of decision-making will slow and so it is probably safe to conclude that public spending will be affected. Major decisions that are needed on long term infrastructure programmes and major contracts could also be delayed, putting further pressure on investment and growth.

It will be October (at the latest) before the UK has a new government. A Day 1 action for a new Prime Minister will be to work out their non-Brexit priorities and how to deliver the Conservative manifesto on which they were elected in a much more politically and economically constrained environment. So the earliest fiscal moment in the calendar will likely be the Autumn Statement, in autumn this year. No significant changes to fiscal policy, including public spending commitments and tax policy, will be announced before then.

The Bank of England should provide more clarity on the direction of monetary policy and interest rates before then. Any surge in inflation, as a result of the slump in exchange rate, may be short-lived in a weak domestic economic environment.

The Bank of England may largely ignore such a temporary blip and focus instead on the fundamental need to support the economy. We could, therefore, see further loosening of monetary policy in the form of rate cuts and a new programme of quantitative easing if it proved necessary to ensure market liquidity. Over the medium term, the more fragile state of the economy could see rates starting to rise later and more slowly, with yields perhaps 0.25 – 0.5 percentage points lower.

The prevailing view at the moment seems to be that companies that are more exposed to the UK are to be hit more harshly than those which are internationally diversified, but that could prove deceptive.

Meanwhile, over on the Continent

The implications of the UK vote are already starting to be felt across Europe and beyond, so our larger clients are looking to understand the implications beyond Britain. And fearful of a prolonged period of political and economic uncertainty, European leaders are eager for the UK to make a swift start on its exit arrangements by triggering Article 50 as soon as possible. The current government favours starting informal talks with the bloc, but European leaders have ruled out that option, saying "no notification, no negotiation".

So the two main questions circling around Europe are what position European governments will take in future trade negotiations with the UK, and whether UK exit will trigger further instability on the Continent.

General elections are taking place around spring and autumn next year in the Netherlands, France and Germany. This is significant because the results of these elections in the big European project countries will inevitably influence the position that their new or returning governments will take towards the UK and its exit negotiation. The UK referendum result could potentially have a contagion effect in Amsterdam, Paris and Berlin, something that has been the source of much speculation in Brussels and in the respective capitals. But the results of the Spanish elections this past Sunday showed a shift back towards the establishment rather than the other way round.

There was never any doubt that the shocks emanating from the UK referendum would touch the Eurozone economy. But the impact so far looks less dramatic than in the UK and we now expect GDP growth to fall to about 1.5% in 2016 and a bit lower in 2017, compared with earlier expectations of a slight improvement on 2015 with 1.7% GDP growth over the next two years.

Implications of UK exit will go further than the European Economic Area, however. US dollar strengthening is doing the job for the Fed in terms of tightening monetary conditions, and the Fed is likely to proceed with more caution when looking at raising interest rates, given market turmoil. President Obama has already started to use soothing tones. The flight of capital to perceived safe havens is also pushing up the yen and complicating policy there to revive the Japanese economy, while those countries whose currencies are linked to the US dollar, like China, are also impacted. The uncertainty and flight to safety will put pressure on other emerging markets too, with a stronger US dollar and capital outflows further destabilising their economies.

These are early days, and we will release further analysis to support our clients over the coming weeks. The full picture is unlikely to become clear for some time. With every twist and turn, brace yourself for further volatility.

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