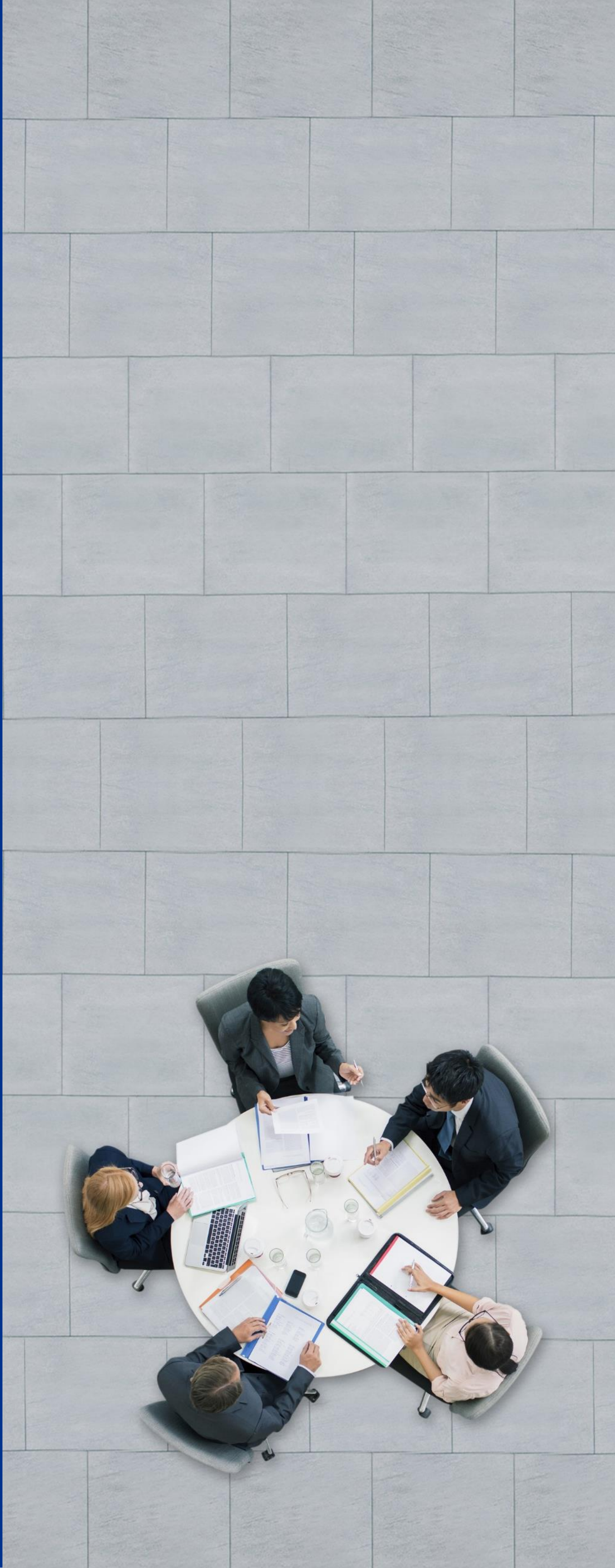
A new Brexit dawn for the UK economy

Short term scenarios to consider for planning ahead

31 August 2016



Planning for a Brexit future

As businesses and households recover from the initial shock of the UK's vote to leave the European Union, their focus is turning to the implications it will have on the UK economy and on their future. As people return from summer holidays, it seems like a good time for businesses to re-examine their strategies in light of the new realities.

We know little at present about the longer-term outlook. The extent to which the UK's economy is impacted will depend on the extent to which the UK can negotiate favorable trade deals with EU and non-EU countries. That will remain unknown for some time. However, the short-term climate has also shifted dramatically so businesses should evaluate immediate plans across-the-board.

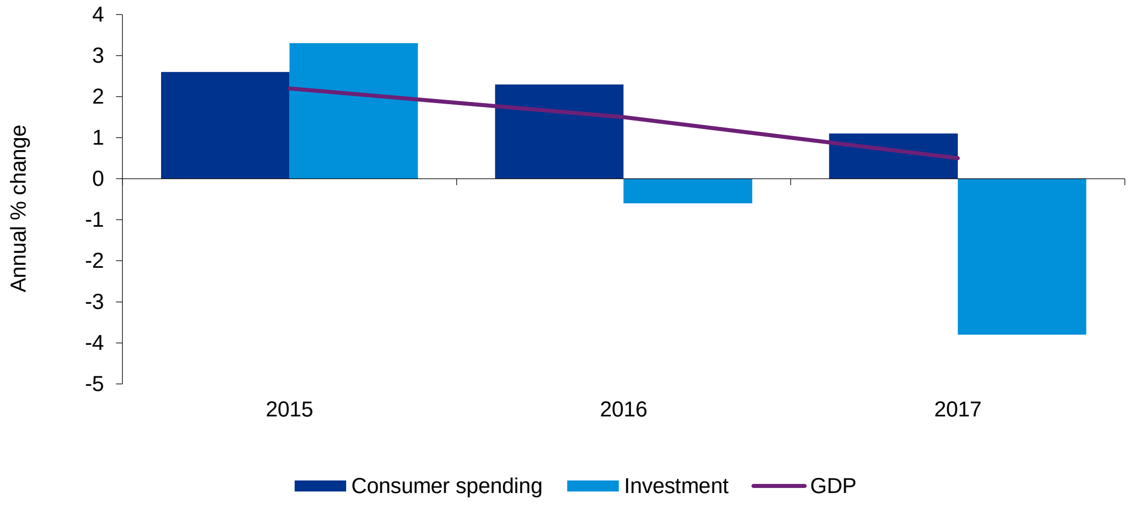
Our main scenario

While the UK economy performed well in the second quarter of 2016, and July retail sales were buoyant, these may not be a bellwether for future economic conditions. There are signs that businesses are treading water while they wait and see what deal is struck between the EU and the UK. The timing of when the UK government decides to trigger Article 50 will affect the uncertainty, with greater negative impacts the more messy and hostile the negotiations.

The new prime minister has already announced that, faced with the new challenges ahead, previous fiscal targets will be abandoned. This should see stronger government spending in coming years, though concrete plans may not materialise until late in the year, with spending proposals beginning to take effect in 2017.

The uncertainty around the shape of Britain's exit, and the prospects of a smaller internal market for those companies based in the UK are likely to hit investment hardest in our main scenario (see chart 1 below). Foreign direct investment that relies on Britain's EU links will potentially be the most vulnerable, but other businesses are likely to adopt a wait-and-see attitude until things get clearer.

Chart 1: Short term slowdown under our main scenario



Source: ONS, KPMG.

Consumer spending may also falter (see chart 1 above) as meagre pay rises and higher inflation erode households' purchasing power, and a fragile housing market and vulnerable pension pots put pressure on their wealth.

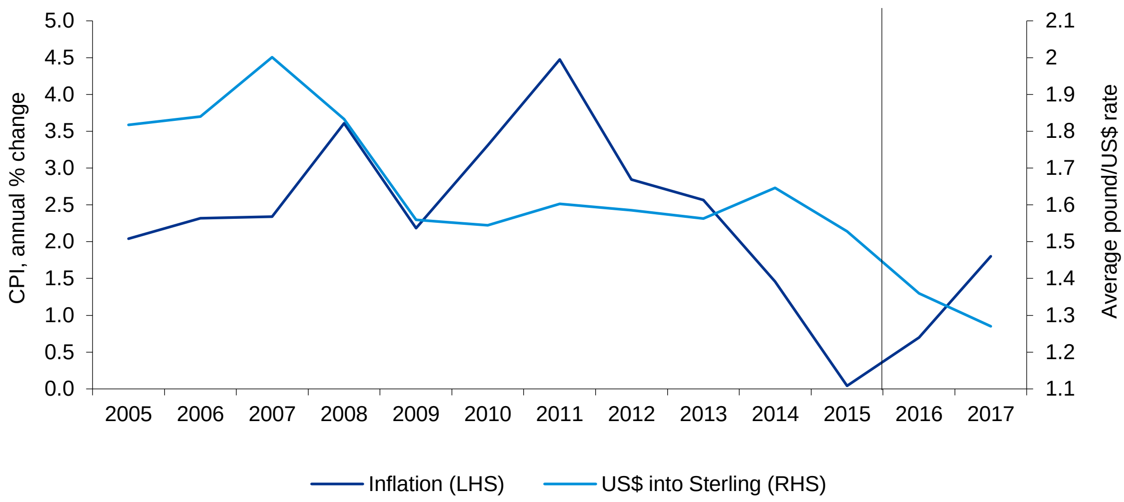
Exports should benefit from the lower pound and add some momentum to growth, whereas imports should also moderate. Overall, this could see UK GDP growth easing to 1.5% in 2016 (from 2.2% last year), before a further decline to 0.5% in 2017.

The pound is expected to remain low and volatile in the short term, perhaps falling even further than the sharp decline we've already seen since the referendum results (see chart 2 below) due to the twists and turns of trade negotiations and by the emergence of new economic and business data.

A low pound will cause a significant rise in inflation in coming months. How far inflation rise will depend in great part on the extent to which companies pass on the increased cost of imports to their customers.

We are likely to see a fine balance between a squeeze on profit margins – as companies look to absorb some of the costs – and higher prices of finished goods and services. The weaker the economy and the more flexible demand, the more companies will be cautious in passing on costs. Hence the picture will vary from industry to industry.

Chart 2: Inflation and exchange rate outlook



Source: Haver, KPMG.

In response to expectations of a weaker economy, the Bank of England announced a package of measures on 4th August, including a cut to interest rates and further quantitative easing, designed to encourage lending by lowering borrowing costs. More measures could be announced later this year. However, the Bank has limited fire power to shelter the economy, with interest rates hovering just above the lower bound and low rates putting pressure on pensions, banks and insurers.

Stressing your plans

The uncertainties surrounding the current outlook are almost unprecedented. A lot will depend on the path the new government decides to take, as well as on the actions of businesses and households as more information emerges in regards to the exit arrangements.

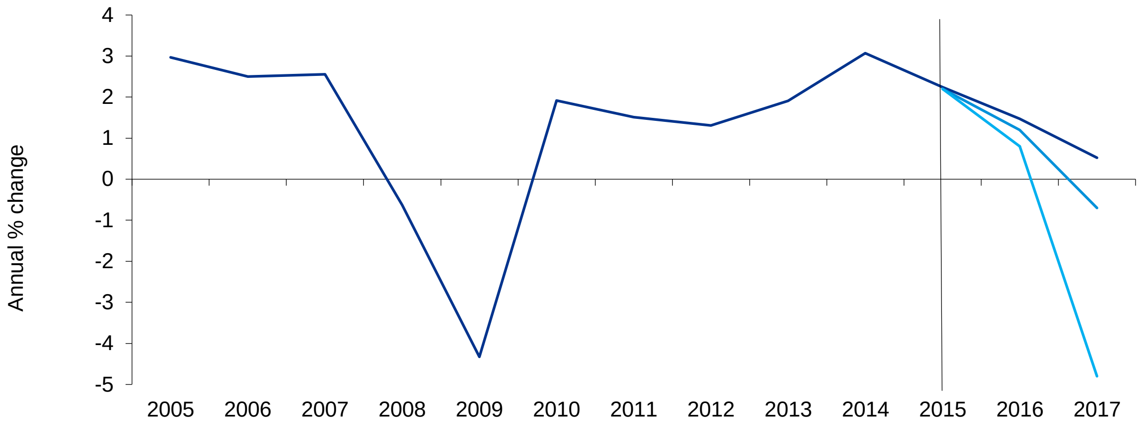
The Brexit vote has put increasing pressure on the UK government to address net migration and meet its 100,000 target. A fall in net migration will have a larger proportional impact on the labour force than on the overall population because migrants have higher labour market participation than the wider population. It is still unclear how far and how fast the government will move to address migration concerns expressed during the referendum. Our stress scenarios incorporate some of these possibilities, together with assumptions about further changes to the exchange rate and risk premium.

Our first stress scenario sees consumer spending fall and investment declining more sharply. Government spending picks up slightly and exports remain strong, but together they are not enough to offset the shortfall in demand, and the UK economy grows by 1.2% in 2016 before contracting by 0.7% in 2017. This stress scenario is somewhat akin to the performance of the UK economy in the early 1990s.

Our second stress scenario sees an even sharper contraction in investment and a more acute retrenchment by consumers. Export performance disappoints despite the weaker pound, although imports are also curtailed thanks to softer domestic demand. A significantly weaker economy puts further pressure on government revenue, leaving it with little room for additional spending to boost the economy. The worsening environment sees the economy grow by only 0.8% in 2016, before contracting by 4.8% in 2017.

This stress scenario represents a much more significant setback to the economy, with overall economic performance broadly akin to that experienced in the Great Recession of 2008-9 (see chart 3 below).

Chart 3: Alternative short term scenarios for UK GDP



Source: ONS, KPMG scenarios.

Opportunities ahead

It would be wrong to plan for the short term challenges without considering the opportunities ahead. The weaker pound is already proving a boon to UK tourism industry, benefiting a range of businesses from hotels and restaurants to retail. A weaker currency should help exporters expand and open new markets, and with imports more expensive, some UK companies will find it easier to compete in their home market.

Lower interest rates that will stay low for longer could prove a good opportunity to refinance and invest for the longer term, while higher inflation will see the real burden of debt reduced.

Beyond the new economic realities, the new government will have new priorities, which could offer opportunities across different industries. Some extra government spending could be forthcoming to support middle-sized cities as the government looks to narrow the income gap between UK regions – galvanising town centres, bolstering local trade, and boosting construction.

Other opportunities are also bound to emerge, and it is important that companies are prepared to grab them, by putting their finances in order and re-evaluating their strategies.

The numbers above should be treated as indicative estimates only. The uncertainties involved point at potential risks weighted towards the downside. However, other scenarios such as a lower reduction in labour supply or a more resilient economy could see the impact of a Brexit on the UK economy reduced. Businesses may therefore wish to incorporate a broader range of scenarios for planning, and regularly update the economic scenarios as new data become available.

Yael Selfin
Head of Macroeconomics
T +44 (0)20 7311 2074
E yael.selfin@kpmg.co.uk

www.kpmg.com/UK/economicoutlook