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UK UPDATE: POLITICS, BREXIT, MACRO

Berenberg Macro Flash

BACK TO BREXIT AS PARLIAMENT STARTS UP AFTER THE SUMMER RECESS

Winter is coming: Even as Big Ben goes quiet for a period as the Palace of Westminster undergoes repair, the noise from UK politics is likely to go up again as MPs return to parliament on 5 September following the summer recess. Before parliament closed for summer, there was a clear divide across the Conservative leadership between the Remainers and Brexiteers about the type of Brexit the UK should aim to negotiate with the EU. There has been some consensus building on the key issues over the summer break. Beginning last week, the UK government started – and will continue - to release a series of white papers setting out its solutions to, among other things; the checking of goods at the UK-EU border, a potential customs union replacement, creating a frictionless border between Northern Ireland and the Republic of Ireland, and settling consumer and trade disputes. While some of the UK's positions are somewhat vague, they signal a reconciliation within the key factions of government on its key aims, namely, the need for a transitional period – probably three years – and the desire for a close trading relationship within the EU after Brexit. This is a positive step – it signals the UK government's desire to avoid a hard Brexit.

But there remains a glaring omission - the UK's future policy on EU migration. The EU27's priority is to safeguard the political cohesion of the group of 27. Preserving preferential access to the UK market plays no major role in EU27 discussions about Brexit. The more the UK restricts free movement of labour after Brexit, the more the EU27 will restrict the UK's access to the Single Market. The UK might not like this, but this is how trade deals work – the bigger partner typically sets the terms. No doubt the UK will find a similarly uncompromising stance when it gets around to negotiating trade with the US and China. The more the UK insists on violating a fundamental principles of the EU, namely the free movement of labour, the less preferential the market access granted by the EU27 will be. This holds especially for the Single Market for financial services, where it is politically easy to hide outright protectionism behind arguments about a need to regulate all such services sold to EU27 citizens according to standards fully controlled by the EU27. Until the UK sets out its policy on migration, none of its white papers offer anything tangible.

In a way, Brexit seems to be working its "magic" already. In 2016, net migration from the EU into the UK fell for the first time in seven years (Chart 1). Is this a one-off or the start of a trend? Although we cannot be sure yet, it could well be the latter. The relative improvement in the economies of continental Europe, the weaker GBP and the UK's less-welcoming stance on migration since the Brexit vote, probably make the UK a lot less attractive than before, to put it mildly. How will migration into Britain change after Brexit? Nobody really knows just yet. If recent trends in EU net-migration continue, within a year, the headline EU number will be easily into the 'tens of thousands' prime minister Theresa May promised to British voters for total net-migration. In such an outcome, the UK government would find it easy to divert the Brexit debate from its current destructive focus on EU migration onto what really counts – a trade deal with the UK's major partner, the EU27.

Let's not forget about Brexit. In a way, discussing future trade and migration rules is putting the cart before the horses. As UK Brexit minister David Davis UK has already agreed to the EU's ordering for negotiations – Brexit first – the EU is unlikely to address any of the UK's proposal for future relations until the formula for the Brexit bill, the rights of EU citizens and a solution to the Irish border question have been dealt with.

Expect little progress at the third round of Brexit negotiations next week as the UK's Davis tries to push ahead with trade talks before the EU is satisfied with the progress on Brexit. Pro-EU factions of the UK government would prefer to concede to the EU's divorce demands in order to swiftly move onto trade talks. But the hard-line Eurosceptics – who do not see major costs from Brexit – prefer to play hard ball with the EU. In time, and probably after some more confusion and infighting within government, the UK will agree to the EU's terms of divorce before the end of the year. This can allow the UK and the EU to work toward a transitional arrangement in 2018 that would come into force when Brexit actually happens in March 2019. We expect this agreement to retain preferential trade in most goods and some services. Over time, this arrangement will probably solidify into the final terms for post-Brexit trade between the UK and the EU. In this, our base case, Brexit could reduce trend growth to 1.8% from the pre-Brexit rate of 2.2%. In the case of a hard Brexit (30% chance), trend growth could fall to 1.5%.

NOISY COMMENTARY DISTRACTS FROM RESILIENT ECONOMY

The economy is resilient and Britain is gradually taking steps to avoid a hard Brexit. That would make a boring headline, wouldn't it? But underneath the noise, that is the current bottom line. The often strongly worded articles and analysis about the current state of the UK economy can reflect the sentiment of the author toward Brexit as much as the reality of the facts. While we – along with the consensus - have warned about the long-term negative consequences of Brexit on UK supply growth, we remain confident that the UK can continue to grow at an acceptable pace over the medium term. The underlying fundamentals and latest data flow point to continued real GDP growth a little under the UK's post-Brexit trend rate of around 0.45% qoq (0.55% qoq pre-Brexit vote). As long as the UK avoids crashing out of the EU in March 2019 without a replacement EU trade deal or period of transition the most likely outlook remains that the UK gradually shifts towards its new long-term growth path without a major disruption to real GDP growth over the medium-term.

Real consumption continues to expand even as higher import prices temporarily squeeze real wages. Households can temporarily afford to borrow a little more and save a little less until real wage growth returns next year – see 'UK households still coping well with higher inflation'. The impact of higher inflation on households is mainly showing up in lower confidence rather than spending. As we have argued before, the markets' worries about the impact on consumers from rising inflation are exaggerated and distract from the real threat coming from the housing market – see 'UK housing – the risk to watch'. Business are cautious amid Brexit uncertainty but nevertheless continue to increase investment and hiring at a modest pace. And after a disappointing start to the year, soft data suggest exports and industrial production will add to growth in H2. Altogether, this makes for a somewhat boring outlook – the UK is missing out on the upswing elsewhere, growth would be around 2.5% this year without Brexit, but the downside risks to growth are no higher than usual. The initial downside risks to demand after the Brexit vote have not manifested in a major way. As Chart 2 shows, economic uncertainty is at its lowest rate in two years – almost a year before the June 2016 EU referendum.

In our base case, we look for real GDP growth of 1.7% in 2017, 1.6% in 2018, and 1.7% in 2019 – broadly in line with the BoE and a little above the market consensus (2017 = 1.5%, 2018 = 1.3%, 2009 = 1.6% (Bloomberg consensus 22 August)). As we wrote here, 'Is the market misreading the BoE?' – on the back of continued economic expansion, a first hike in November of 25bps remains our base case.

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