BERENBERG
PARTNERSHIP SINCE 1590

MACRO NEWS 12/10/16

Kallum Pickering, Senior UK Economist | Kallum.pickering@berenberg.com | +44 20 3465 2627

# IMPLICATIONS OF THE WEAKER STERLING FOR THE UK ECONOMY

## Berenberg Macro Flash

*Sterling has depreciated by 21% on a trade-weighted basis since it peaked last November - it is down almost 16% since the Brexit vote. To put it into perspective, trade-weighted sterling declined by almost 30% in 2007/08 during the global financial crisis, and by almost 20% in 1992 when the UK exited the Exchange Rate Mechanism. Trade-weighted sterling is currently 15% below its 10 year average.*

The latest leg down for sterling reflects the shift in market expectations towards a hard Brexit following recent comments from Prime Minister May and her cabinet. Has sterling found a bottom? That depends on how Brexit negotiations play out. If the UK and EU clash noisily in the forthcoming negotiations or if the UK goes for a 'hard Brexit', a risk we cannot rule out, sterling is likely to continue to sink further. If the UK and the EU agree to part ways in an amicable manner, and if the UK secures good terms for post-Brexit trade, sterling is likely to rebound along with the UK economic outlook. While the nature and causes of the sterling depreciation has received much attention in markets, we too discussed this last week, less attention has been given to the near-term economic consequences for the UK.

**Impact on consumption - negative**
The weaker sterling will raise import prices. This will show up in higher inflation. Rising inflation is rarely good news for consumers. But in a world of sluggish nominal wage growth and low rates of return on savings, it is especially bad. While prices for imported goods such as fuel and food will be affected the most, households are unlikely to cut back on their consumption as these are essential goods. Instead, the rise in costs for these goods will eat away at the remaining income that would normally finance discretionary purchases such as leisure, retail, hotels and the like. Spending on non-essentials and luxury goods is therefore likely to be negatively affected the most.

The goods news is that the situation of the average UK households has improved in recent years. Employment has risen to a record high, credit is cheap and easily available, and household finances have strengthened since the financial-crisis. While we expect consumption growth to slow in the coming years, household fundamentals remain sufficiently strong to withstand a period of temporarily higher inflation.

**Investment outlook – negative with some potential bright spots**
For domestic investors, it is the cause of the drop in sterling that matters, not the drop itself. In times of uncertainty, the option value of delaying major investments and spending rises. The lack of clarity from the UK government on what Brexit will really mean for the business world is rather concerning. For markets and investors Brexit looks like a big black box. For UK firms that mostly export to non-EU markets and thus do not worry as much about the outcome for Brexit, the weaker sterling is positive net-net, it may encourage investment. But overall, this is not a healthy environment for firms to invest. Sterling has become the measure of this uncertainty.

At full employment and with domestic and foreign demand continuing to expand, firms will need to continue to invest to maintain existing capital stocks and to increase production, or else risk losing market share. Nevertheless, we expect major investments in long-lived assets to be put on hold until the sky clears.

The impact on foreign investment is likely to be negative, on balance, with some potential bright spots. Because of Brexit, firms looking to enter the EU market, or expand their existing presence, will be less in-

clined than before to head to the UK. The heightened risk of a hard Brexit furthers strengthens the case to look elsewhere in Europe. For other investments such as some equities and possibly some real estate markets, the weaker sterling – despite the hard Brexit risk – may raise demand for these assets. Many major UK based firms generate revenues abroad - for them the weaker sterling is plus. And for UK real estate, mainly prime commercial and residential in major cities, the weaker sterling offers a significant discount for investors with a long investment horizon.

**Impact on the current account - positive**
In 2015 the UK had the largest current account deficit in the G7 at 5.4% of nominal GDP. This compares to just 1.8% in 2011. The deterioration in the UK's balance of payments in recent years has been due to two factors: (1) EU demand for UK goods has declined since 2011 while UK demand for EU goods has risen. This caused the UK goods deficit with the EU to widen sharply. And (2), UK earnings on foreign assets abroad have fallen relative to foreigners earnings on their UK assets.

The weaker sterling should have some positive effects on the UK balance of payments and help reverse some of the negative trends that have emerged since 2011. We expect the current account deficit to fall to 3.5% of GDP by late 2018. The trade balance should begin to improve over the coming quarters as higher import costs weaken demand for foreign products while the cheaper exchange rate should lure more tourists into the UK and enhance the competitiveness of UK goods and services. The economic expansions in the UK's key trading partners, the US and EU, to which two-thirds of all UK exports go, have continued at a satisfactory pace since the Brexit vote. External demand should therefore respond positively to the more competitively priced UK goods and services.

The negative impact on imports is likely to be larger than the positive impact on exports due to the difference in the composition of UK imports and exports. Except for tourism, demand for services is less responsive to price changes than demand for goods. Services make up around 45% of all UK exports whereas they make up around 25% of UK imports. The weaker sterling should also lead to an improvement in the income balance. With a weaker sterling, earnings from UK resident's foreign assets will appreciate.

**The key message is that, overall, any positives that come from the weaker sterling are outweighed by the long-term risks underpinning its depreciation. Brexit risks will dominate the outlook for sterling for at least two years – or until the UK finally exits the EU. Any rebound in sterling should be viewed positively as it would probably indicate a better expected outcome for Brexit.**