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UK UPDATE: ECONOMIC OUTLOOK, SUPREME COURT HEARING AND INFRASTRUCTURE SPENDING

Berenberg Macro Flash

Beware opening Pandora's box

Since the UK voted to leave the EU five months ago, the economy has held up much better than expected, probably owing to the healthy household fundamentals heading into the vote. As we have argued before, it is the long-run risks that need to be watched closely. Through less trade, investment and migration with its biggest market, the EU, Brexit represents a long-term supply-side shock for the UK. On the political side, the apparent lack of progress on a Brexit strategy and the unforeseen hurdles before triggering Article 50 are concerning. They reflect a complacency and lack of planning by the government before the referendum and do not bode well heading into the Brexit-negotiations with an increasingly frustrated EU-27. The stark difference between how the currency market has reacted compared to UK households reflects this economic and political divergence since the vote – see Chart 1.

In this update, we cover the three key themes for the coming months: (1) the economic outlook, (2) the Supreme Court hearing on Article 50, and (3) what to expect in terms of infrastructure spending at the 23 November Autumn Statement.

Macro: Keeping up appearances

Despite the Brexit-related uncertainties, the economic performance since the Brexit vote has been remarkably resilient. After a very strong second quarter (0.7% qoq), according to the first estimate, the economy expanded at its trend rate – 0.5% qoq – in the third quarter. The first estimate of GDP gives a limited picture of the underlying economy - covering GDP only on an industry basis.

The second estimate - published 25 November - will provide a detailed breakdown of consumption, government spending, investment and trade for the quarter. It is likely to show that consumption continued to expand at a healthy pace while business investment growth stalled amid the heightened uncertainty. We will pay close attention to the frequently revised and often volatile trade-balance for a signal that the large sterling depreciation over the course of 2016 has started to yield some positive effects.

Heading into the fourth quarter, the UK economy continues to expand at around trend. In addition to soft data on housing and confidence, the purchasing managers' indices have recovered from their Q3 dip. We forecast growth of 0.4% qoq in Q4 with a little upside risk according to the mostly positive survey data for October. This suits our above-consensus calls for the medium-term. While resilient, the growth rate will slow as Brexit uncertainty will weigh on growth prospects, driven by nervous businesses pausing investments and a slowdown in consumption growth as higher inflation erodes real income gains. The weaker sterling may have a modest offsetting effect through the trade balance.

We forecast below trend growth of 1.5% in 2017 and 2018 with risks tilted to the downside if the heightened risk of a hard Brexit begins to weigh on confidence and investment. According to Bloomberg, the consensus for GDP growth is 0.9% for 2017 and 1.5% in 2018. Notably, the Bank of England recently upgraded their outlook for 2017 to 1.4% in the November Inflation Report from 0.8% in the August Inflation Report.

The resilient post-referendum performance does not, however, say anything about the UK's ability to perform outside of the EU. After all, Brexit hasn't happened yet. The current resilience does not alter our long-term view that the Brexit supply-side shock will lower UK trend growth, to around 1.8% from 2.2% per year. Ultimately, the size of the shock will depend on the final terms for trade, migration and investment between the UK and the EU.

Article 50: Major unforeseen hurdles

The government has appealed the High Court ruling that it needs parliamentary approval to begin the UK's exit from the EU – to trigger Article 50. The Supreme Court will hear the case from 5 December onwards and is expected to rule in January. In the run up to the referendum, and until the High Court ruling, the government had assumed that the prime minister had the authority to trigger Article 50 under the executive's "royal" prerogative.

Let us be clear about the implications of the High Court decision, should it be backed up by the Supreme Court: contrary to the immediate harsh knee-jerk reaction by some UK media that the High Court had attempted to block Brexit, or something to that effect, Brexit will still happen. The likelihood of parliament going against the result of the referendum is very slim indeed. The initial challenge against the prime minister's ability to use royal prerogative extends the same democratic principles that underlie the argument that government should follow through on the result of an advisory referendum. On a more general point, that the government had overlooked such a critical detail as who was responsible for triggering Article 50 is both remarkable and troubling.

As economists, we cannot offer any insight on the likely outcome of a court ruling. But we do expect the final decision to be respected. That a further appeal could imply that the case would be taken to the European Court of Justice (ECJ) is somewhat ironic, amusing and probably irrelevant. The issue will be resolved using the UK's domestic institutions. Jokes aside, the data do not show any major trend in how the Supreme Court rules after a High Court decision has been appealed. Bloomberg reports that of the 92 appeals heard by the Supreme Court in the 12 months from April 1, 2015; 31 were dismissed, 34 were successful and 2 were referred to the ECJ. We presume the remaining cases were settled in some other way or are still underway.

While a ruling against the prime minister at the Supreme Court would not prevent Brexit, it may affect the government's negotiation strategy and the final outcome for Brexit. There are more Remainers than Brexiteers in parliament. This could lead to some softening of the hard-Brexit stance the government has pursued since the Conservative Party conference in October. If the Supreme Court sides with the High Court, the Government's plan to trigger Article 50 by March 2017 may face serious delays unless government agreed to try to pursue a soft exit from they EU; one that maintained a high level of market access, which, presumably, involved few restrictions on EU migration. Parliament would only back a soft strategy fast. The pro-EU majority of MPs would likely drag their feet on any plan that resembled a hard-Brexit.

Infrastructure: Don't get your hopes up

The risks from temporarily higher government borrowing are exaggerated. High global demand for low risk-government debt, the government's ability to borrow mainly in its own currency, plus the large-scale purchases of government debt by the BoE suggest that long-term gilt yields would not rise significantly if the government temporarily increased borrowing. As the UK faces a looming supply-side shock from Brex-

it, we would argue that that the government should not shy away from critical infrastructure spending that yields a real positive return. However, despite some excitement in markets, we do not expect the new chancellor Philip Hammond to announce a major infrastructure boost on November 23 at the Autumn Statement.

While the level of government debt does not pose serious risks, the deficit is still high at around 4% of GDP and needs to be reduced in a sustainable way. That the UK has avoided a worse near-term fate after the vote seriously diminishes the rationale for a short-term fiscal stimulus. This has shifted the focus back onto the long-term fiscal challenge. Essentially, Chancellor Hammond's major problem is how to rebalance taxes and spending in light of the looming supply-side shock. If Brexit reduces trend growth by say 0.4 ppt per year, those few tenths of a percent with add up badly in fiscal terms.

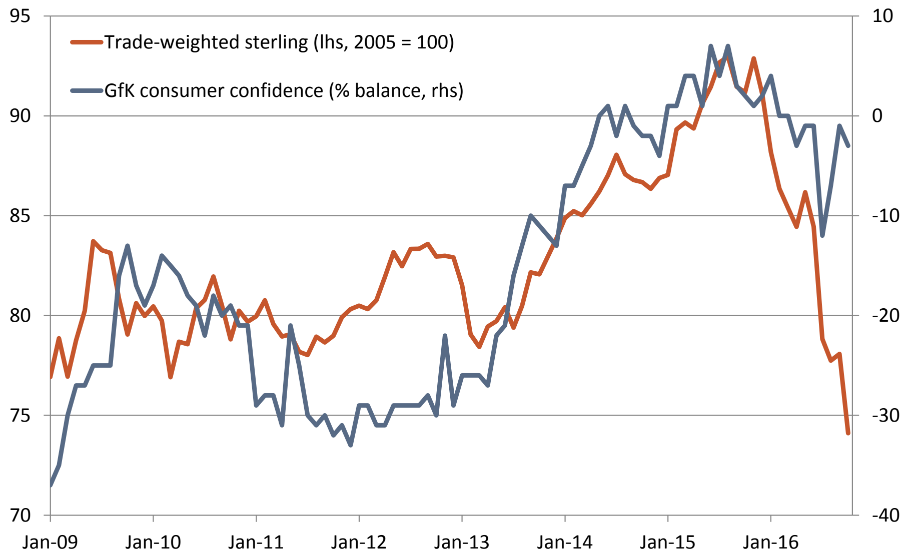
Hammond has already scrapped ex-chancellor Osborne's target of a balanced budget by 2019-20. To show he is credible, Hammond will need to include some targeted date for a balanced budget. With the economy at close to full employment, the current 4% fiscal deficit is mainly a structural issue. Our baseline case thus remains that the new chancellor will plan for an slower, but broadly similar, path of fiscal consolidation to his predecessor Osborne.

We therefore anticipate no more than a modest fiscal boost over the medium-term. Probably no more than 0.2ppt to GDP per year. The Government may shift some spending around under its current infrastructure plan called 'The National Infrastructure Delivery Plan 2016-21' which follows on from the 'National Infrastructure Plan' which was first rolled out in October 2010. As always with such schemes the numbers are quite vague. But the plan promises £100 billion of public capital investment to 2020-21 as part of a £483 billion private and public pipeline that extends beyond 2020-21.

In short, rather than detailing additional spending, this plan documents existing planned spending under one umbrella. Each year, the plan is revised and re-packaged to grab a few headlines. But it does not represent a major increase in infrastructure spending. If it did it would have a significant impact on GDP growth and long-term supply. Any major funding or project announcement linked to this plan my seem like a sizeable boost at first glance but may not actually represent a rise in spending.

Note: we will publish a more detailed Autumn Statement preview later this week.

Chart 1: Trade-weighted sterling versus consumer confidence



Monthly data. Source: Bank of England, GfK