PANTHEON MACROECONOMICS

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THE **UNITED KINGDOM** IN H2 2016

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Post-Brexit Slump Will Be Met by Meagre Policy Response

* **The U.K.'s Brexit vote looks set to push the economy into recession as businesses retrench and households endure a renewed real income squeeze.** The support from reduced fiscal tightening and net trade won't bear fruit until the second half of next year, and it will be modest when it arrives. Meanwhile, shocks to potential supply and inflation mean that the MPC will not rush headlong into easing. We expect the Committee to cut Bank Rate to 0.25% from 0.50% in August, but to hold back from unconventional stimulus.

* The U.K.'s economic recovery would be losing momentum even if the referendum had led to a Remain vote. **The economy enjoyed one-off boosts to growth in 2014 and 2015 from lower commodity prices, household saving and mortgage rates, which have now run out of steam.** Labour shortages also were beginning to bite. But the Brexit vote has delivered a powerful shock to the income prospects for households and firms, and it has set in motion a long period of uncertainty.

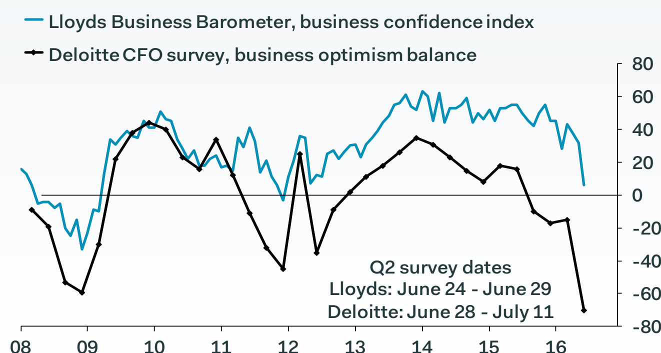
* In the end, we think a "hard Brexit" will be avoided. **Losing unfettered access to the single market simply will be too costly for Britain.** This will require the Government to soften its stance on free movement of labour, but with the struggling economy likely to replace immigration as voters' top concern, this will be politically feasible. Even a "soft Brexit" might not happen if the E.U. itself reforms or if an exit package is put to a second referendum.

* **The situation, however, will remain highly uncertain for a long time.** The Government has said it will not trigger Article 50, which starts the clock on formal negotiations that likely will last the maximum two years, this year. The risk of a less business-friendly deal will compel firms to shelve discretionary expenditure and run down inventories. Business confidence already has slumped to 2008 crisis levels.

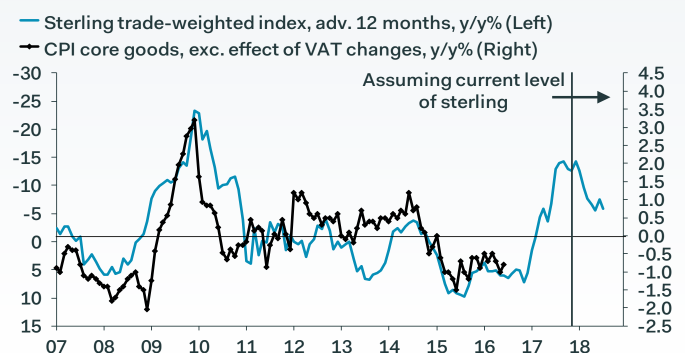
* Households' real incomes probably will stagnate in 2017, as firms reduce headcounts and retailers pass on higher import prices to consumers. **Indeed, sterling's depreciation has set up CPI inflation to soar to 3% in little more than a year, from just 0.5% in June.** A weakening labour market will prevent nominal wage growth from fully responding to higher inflation.

* Consumers will respond to the deterioration in the outlook for their incomes by increasing saving and foregoing big-ticket purchases immediately. Falling house prices will sap consumer confidence too; we expect house prices to fall by 3% from current levels over the next twelve months. **New buyer enquiries already have plunged and banks soon will become more reluctant to lend.**

BUSINESS CONFIDENCE HAS COLLAPSED SINCE THE REFERENDUM



STERLING'S DEPRECIATION WILL BOOST INFLATION NEXT YEAR



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* **We hold out little hope for a meaningful boost to GDP growth from net trade.** Past experience suggests that sterling's 15% drop will increase net trade by between 1% and 1.5% of GDP after four years. But most of this boost will come in the third and fourth years following sterling's depreciation. And with the extent to which the U.K. will preserve its free trade arrangements with EU and non-EU countries highly uncertain, firms won't invest in the capacity required to export more.

* The new Chancellor is not shackled by his predecessor's rules, but fiscal policy likely won't actively *support* the economy. We expect Mr. Hammond to scrap the fiscal consolidation—0.8% of GDP—planned for 2017 in the Autumn Statement, and allow the automatic stabilisers to do their work as the economy struggles. These decisions alone likely will push borrowing up to about £90B in 2017/18, from £75B in 2016/17. **Accordingly, the Chancellor will not offer extra stimulus and we expect the fiscal squeeze to resume in 2018/19.**

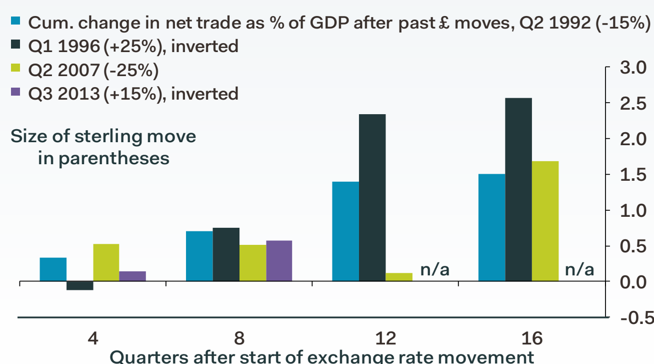
* **The MPC likely will cut Bank Rate to 0.25% at its August meeting, but we think hopes of additional stimulus will be dashed.** Alongside cutting rates to or below zero, the MPC has many policy levers it *could* pull, including restarting its government bond buying programme, purchasing private-sector assets, or enhancing the ongoing Funding for Lending Scheme, either by broadening its scope to include household lending or by improving the terms of liquidity provision. Note that the Committee "discussed various easing options and combinations" at its July meeting.

* But the case for easing in August will be undermined by the inflation outlook; the Bank's new forecasts likely will show inflation comfortably above its target throughout 2017 and 2018. Inflation has spent two-thirds of the last decade above the 2% target, so substantial easing would cast doubt on the strength of the MPC's commitment to its target. **Just as concerns that near-zero inflation would persist held back the MPC from following the Fed last year, worries about lasting excess inflation will keep the MPC inactive.**

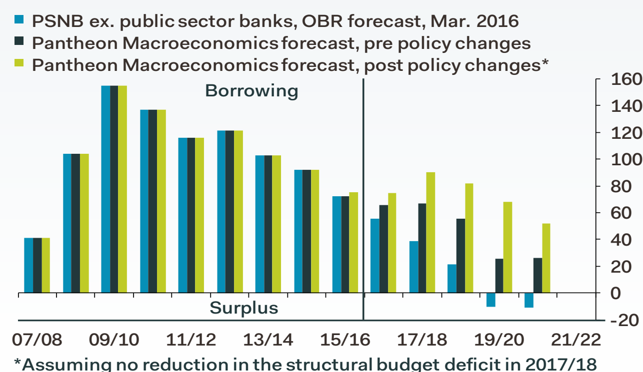
* In addition, the MPC is sensitive to the damage that even lower bond yields will inflict on banks' profitability and firms' pension fund deficits. Brexit also is just as much a shock to potential supply—both employment and investment—as it is to demand. MPC members may question the wisdom of more stimulus if it simply brings forward future demand. The Bank also has acted on other fronts already, by ensuring banks have ample liquidity and by reducing capital requirements. Accordingly, we think the MPC will adopt a 'wait and see' approach. **If more QE is unveiled, we expect only a three-month programme, not an open-ended one.**

* Sterling could fall further in the near-term as foreign capital inflows turn to outflows, but the combination of a "soft Brexit" and a meagre policy response eventually will help sterling recover some lost ground. We expect sterling to rise to around €1.32 by the end of 2016. The pound's rally against the dollar probably will be more modest, with sterling reaching $1.38 at the end of 2016, because the greenback should receive support from earlier Fed rate hikes than the market current expects. **Meanwhile, we think that 10-year gilt yields will spring back to about 1.40% in December, from 0.90% currently, as the MPC's timidity surprises the market.**

PAST STERLING FALLS HAVE TAKEN A WHILE TO BOOST GROWTH



AUSTERITY WILL PAUSE, BUT FISCAL POLICY WON'T BOOST GROWTH



*Assuming no reduction in the structural budget deficit in 2017/18

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Economic Activity (year-over-year, %)	2014	2015	2016	2017	2018
Household spending	4.8	3.3	2.5	1.0	1.2
Fixed investment	7.4	4.5	-4.0	-3.0	2.0
Government spending	2.7	1.6	1.3	0.8	0.8
Inventories, cont. to GDP growth	0.4	-0.4	-0.6	-0.2	0.0
Domestic demand	5.0	2.9	0.8	0.2	1.2
Exports	2.4	5.9	2.3	3.0	3.5
Imports	3.1	6.5	1.2	1.7	2.5
GDP	4.8	2.8	1.4	0.5	1.5
Labour Market, Costs and Prices (year-over-year, %, unless stated)					
Output per worker	0.4	0.8	0.3	0.5	1.0
Employment	2.4	1.8	1.2	0.0	0.6
Unemployment rate (%)	6.2	5.4	5.1	5.7	5.7
Average weekly wages	1.2	2.4	2.6	2.8	3.0
Unit wage costs	0.5	1.7	2.3	2.3	2.0
CPI	1.5	0.0	0.6	2.6	2.4
Core CPI	1.6	1.1	1.2	2.7	2.5
RPI	2.4	1.0	1.4	3.2	3.5
House prices, Nationwide measure (end year)	7.2	4.4	-1.0	3.0	5.0
Other					
Current account, % GDP	-5.3	-5.2	-5.0	-3.0	-2.5
Budget deficit, £B, FY	91.9	75.0	75.0	90.0	82.0
Budget deficit, % GDP, FY	5.0	4.0	3.9	4.5	4.0
Bank Rate, December	0.50	0.50	0.25	0.25	0.75
Asset Purchase Facility, £B, December	375	375	375	375	375
10-year gilt yields, Q4 average	1.76	1.96	1.40	2.20	3.00
30-year gilt yields, Q4 average	2.51	2.67	2.30	3.00	3.30
$ per £, Q4 average	1.56	1.47	1.38	1.40	1.40
€ per £, Q4 average	1.29	1.36	1.32	1.35	1.35
FTSE 100	6566	6242	6200	6500	7000

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