CPI inflation likely would rise to a peak of about 4.0% in early 2020 in the event of a no-deal Brexit.

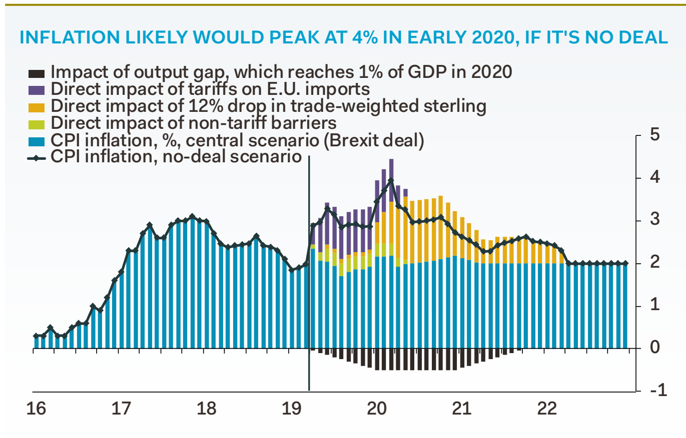
The total CPI boost would amount to about 2.5%, with 1.0% coming from tariffs on E.U. imports...

...and lower sterling providing a further 2.0% uplift; a renewed output gap won't dampen inflation much.

How High Would Inflation Get After A No-deal Brexit?

With a no-deal Brexit still a potential outcome and just over five weeks to go until the U.K. is scheduled to leave, it's about time we put some numbers on how high inflation could get in this worst-case scenario. We estimate that the level of the CPI will be about 2.5% higher by the end of 2021 than if a Brexit deal is signed off by the end of March, as we currently expect. ***CPI inflation probably would peak in the first quarter of 2020, at around 4%.*** For simplicity, our estimates assume that no-deal is a permanent state of affairs and no other trading relationship emerges between the U.K. and E.U. in the subsequent months.

CPI inflation will come under upward pressure via four main channels. First, the U.K. government likely will levy tariffs on E.U. imports. In order to abide by the Most Favoured Nation rules of the World Trade Organisation, the government must apply tariffs on imports even handedly, regardless of their source. In order to preserve some leverage in future trade negotiations and to protect domestic firms from a flood of cheap imports, the Government likely will choose to impose tariffs on E.U. imports, rather than remove tariffs on imports from non E.U. countries. In a speech to the National Farmers Union earlier this week, Michael Gove indicated that the government would publish tariff levels over the coming days.



The trade-weighted MFN tariff levied by the E.U. on non-E.U. imports was 3.2% in 2016. Food and cars, however, account for a relatively high proportion of the goods that the U.K. imports from the E.U.; both these items carry higher tariffs. The Bank of England estimates that food and non-alcoholic beverage imports from the E.U. would incur a 5% tariff, while cars would carry a 4% tariff. *The long-run impact on the CPI from these tariffs would be about 1.0%.* Mirroring the experience of the 2010 and 2011 increases in VAT and duty changes in recent years, pass-through likely would be rapid; we expect the boost to have fed through fully within 12 months.

Second, compliance costs for importers would rise in the event of a no-deal Brexit, as goods would have to undergo customs checks. The Bank estimates that such non-tariff barriers would boost the level of the CPI by a further 0.3%.

Third, the depreciation of sterling following a no-deal Brexit would boost the price of imports, regardless of whether they came from the E.U. or not. We judge that sterling would fall to $1.15 against the dollar, in the event of no-deal in March. Assuming that sterling dropped by 12% against all other currencies too, the scales on our second chart, based on past experience, suggest that import prices would rise by about 7%. Exporters to the U.K. likely would absorb around 40% of the decline in the exchange rate.

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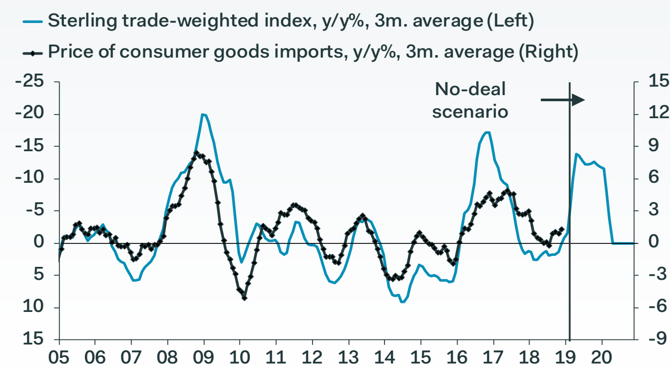
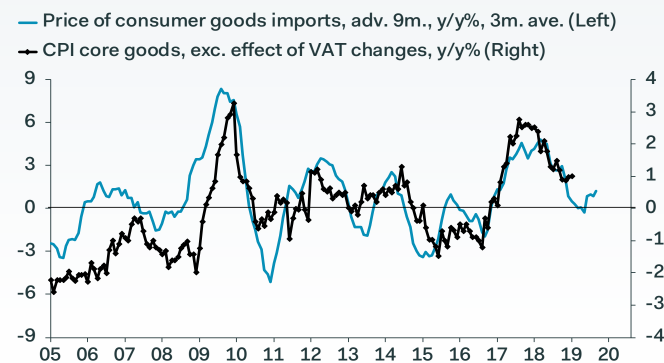


A 7% rise in import prices eventually would lift the level of the CPI by 2%, as imported goods have a 30% weight. Consumers wouldn't feel any impact immediately, however, because retailers carry stocks and hedge short-term FX risk. Besides an immediate uplift to petrol prices, the import price boost wouldn't start to feed through to the CPI until early 2020.

That said, the Bank repeatedly has been caught out by how concentrated the burst of CPI inflation has been after an initial period of stasis. It assumes that the process of pass-through from import prices to consumer prices, beyond the first nine months after the depreciation, occurs gradually over three years. But as our final chart shows, it was caught out by how quickly inflation rose in 2017. Based on the experience of the last depreciation, we assume 70% of the jump in import prices feeds through to consumer prices in the nine-to-21 months after the depreciation, and the other 30% over the following 12 months.

The final main influence on CPI inflation will be the resulting imbalance between supply and demand



following a no-deal Brexit. It is widely accepted that the output gap is about zero at present. The economy's supply potential clearly would be inhibited by disruption to supply chains and labour shortages in some sectors that are particularly dependent on migrant labour. But at the same time, people likely would be prepared to work longer hours, in order to offset the impact of the rise in inflation on their standard of living. In addition, demand likely will fall sharply, as precautionary saving rises and firms shed staff. As a result, we judge that supply would hold up a bit better than demand, thereby dampening inflation. We expect a small output gap to emerge, equalling 1.0% of GDP in 2020 and shrinking thereafter in response to looser monetary policy.

Nonetheless, the downward impact of spare capacity on inflation will be fairly small. The Bank's model implies that a 1% deviation of GDP from its potential reduces CPI inflation by 0.5pp. The surge in CPI inflation above 5% in 2011, despite an 8% unemployment rate and an output gap equal to about 1.5% of GDP, demonstrates that slack doesn't have much impact on the price level.

Given the unprecedented nature of a no-deal Brexit, our estimates are merely illustrative. We suspect that the political pressure to resolve the chaos after no-deal would compel the government to seek a deal with the E.U. before the end of 2020, easing the inflation pressure. And as things stand, we see only a 15% chance of a no-deal Brexit.

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THIS WEEK IN BRIEF

Note: "**D**" prefix denotes Datanotes for these releases.

Monday, February 18

- **No significant data released.**

Tuesday, February 19

- **D: Labour market data (12)/09:30 GMT**

Employment rose by **167K**, or 0.4%, quarter-on-quarter in Q4. This drove down the unemployment rate to just **4.0%**—the joint-lowest rate since 1975—from 4.1% in Q3. Admittedly, self-employment made up nearly half of the rise in overall employment and now accounts for 15% of the total. But employee numbers rose by a brisk 80K, or 0.3%. In addition, full-time work accounted for two-thirds of the increase in total employment. And while surveys of employment intentions deteriorated at the start of this year, they still suggest that job gains will match the rate of growth in the workforce. Meanwhile, both the headline rates of year-over-year growth in average weekly wages, including and excluding bonuses, held steady at **3.4%** in December. While job-to-job moves may slow in response to the recent decline in consumers' confidence, recent evidence on pay settlements has been encouraging.

Wednesday, February 20

- **D: CBI Industrial Trends Survey (2)/11:00 GMT**

The total orders balance rose to **+6** in February, from -1 in January. It points to year-over-year growth in manufacturing output of 3%, but it tends to be too slow to register downturns after a prolonged period of growth.

Thursday, February 21

- **D: Public Finances (1)/09:30 GMT**

We expect a surplus on the PSNB ex. borrowing measure of **£11.5B** in January, better than last year's £9.3B. Past movements in the RPI suggest accrued interest payments will be about £0.7B lower than in January 2018. In addition, nearly all self-assessment and capital gains tax receipts are collected in January. Both will refer to income and capital gains generated in the 2017/18 fiscal year, when asset prices picked up. **Consensus: £10.0B**.

- **D: MPC member Haldane speech published/12:00 GMT**

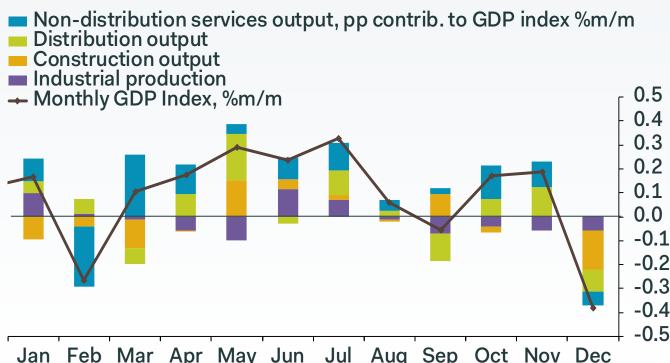
A transcript of a speech on innovation delivered on November 22 will be published. We expect no news on the outlook for monetary policy.

Friday, February 22

- **D: CBI Distributive Trades Survey (2)/11:00 GMT**

We expect the reported sales balance to rise to about **+10** in February—close to last year's average level—from zero in January. Although Brexit uncertainty has hit consumers' confidence, improving growth in real incomes should keep retail sales on an upward trend. **Consensus: +5**.

CHART OF THE WEEK: DECEMBER GDP DIP DRIVEN BY NOISY SECTORS



PANTHEON'S FINANCIAL FORECASTS

	End-month:					
	4pm Wed.	Mar	Jun	Sep	Dec	Dec 20
Bank Rate	0.75	0.75	0.75	1.00	1.00	1.50
3m Libor	0.87	0.90	1.00	1.10	1.20	1.70
12m Libor	1.13	1.20	1.30	1.40	1.60	2.00
2-year Gilt	0.74	0.90	1.20	1.40	1.60	2.00
10-year Gilt	1.16	1.40	1.60	1.80	2.00	2.40
30-year Gilt	1.69	1.80	2.00	2.20	2.30	2.50
FTSE 100	7182	7000	7200	7400	7600	8000
USD/GBP	1.30	1.35	1.36	1.38	1.40	1.40
EUR/GBP	1.15	1.23	1.24	1.25	1.27	1.27
Sterling TWI	77.2	83.7	84.3	85.6	86.8	86.8

PANTHEON'S ECONOMIC FORECASTS

	Period average:						
	Q1 19	Q2 19	Q3 19	Q4 19	2018	2019	2020
GDP, q/q%	0.2	0.4	0.5	0.6	-	-	-
GDP, y/y%	1.5	1.4	1.3	1.8	1.4	1.5	2.0
Employment, y/y%	0.8	0.9	1.0	0.9	1.1	0.9	0.9
Unemp. rate, %	4.1	4.0	4.0	4.0	4.1	4.0	3.8
Wkly earnings, y/y%	3.4	3.2	2.9	2.6	2.9	3.0	3.2
CPI, y/y%	1.9	2.2	1.8	1.9	2.5	1.9	2.1
RPI, y/y%	2.7	3.0	2.7	2.7	3.4	2.8	3.1
PSNB FY, £B	-	-	-	-	27	32	38
Cur. acc't., % GDP	-4.5	-4.6	-4.8	-4.9	-4.1	-4.7	-5.0
House prices, y/y%	1.9	1.7	1.3	1.2	3.3	1.5	2.5

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