Despite strong GDP data, it is difficult to ascertain what effect Brexit will really have on the economy

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Four months on from the referendum, it is still hard to establish how much it has affected the economy and what will happen next. ***Iain Begg*** *analyses the surprisingly strong GDP data published by the ONS on 27 October and asks whether the overall UK economy is as resilient as it seems.*

The more extreme projections of a slide into recession have, so far, proved to be unfounded and critics of 'project fear' will be gratified to see the flash estimates from the Office for National Statistics (ONS) for third quarter GDP which show that the British economy grew at an annual rate of 0.5%.

The detailed data from the 27th of October reveal that the service sector – accounting for nearly 80% of the economy – has been the engine of growth, whereas manufacturing and construction contracted. The ONS highlights retail services, accommodation and restaurants as consumer-orientated sectors growing especially rapidly. Financial and business services grew at the same rate as GDP, while government services managed only 0.3% growth.

Do these new figures debunk the projections released by the Treasury as recently as one month before the referendum? These suggested the short term effects of Brexit, even in their least adverse scenario:

> *would cause an immediate and profound economic shock creating instability and uncertainty which would be compounded by the complex and interdependent negotiations that would follow. The central conclusion of the analysis is that the effect of this profound shock would be to push the UK into recession and lead to a sharp rise in unemployment.*

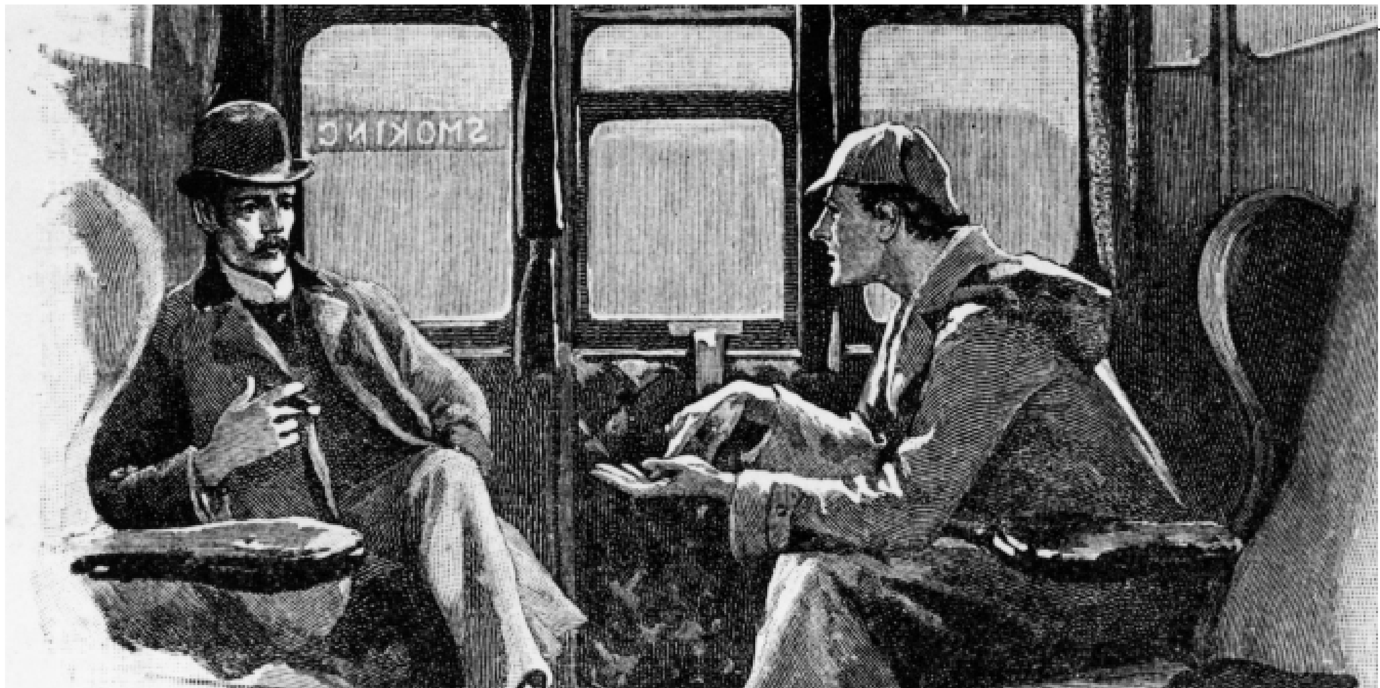
The Treasury analysis is peppered with the adjectives 'immediate' and 'profound', suggesting that the negative effects of Brexit should already be visible, although it was predicated on a rapid triggering of Article 50 and focused on the two-year period during which the UK's exit from the EU would take place: this meant from the third quarter of 2016 to the middle of 2018. The three factors expected by the Treasury to lead to adverse economic outcomes were: a transition effect stemming from the UK becoming less open to foreign trade and investment; uncertainty arising from not knowing how the negotiations would unfold, affecting key economic decisions, notably investment; and financial instability.

We now know that the starting-gun for Article 50 will be fired no later than the end of March 2017, nine months later than previously assumed, hence the Treasury analysis could be deemed to be in abeyance rather than wrong. However, that interpretation would be disingenuous. There has already been financial instability and, according to the new ONS analysis, the pound is now some 14.4% lower than a year ago on a trade-weighted basis. The delay in triggering Article 50 and the impression of disarray in government on the negotiating stance have, if anything, added to the uncertainty. The 'transition' effect may not yet have started, but it would be hard to argue that the other two have not. In the Treasury projections, the economy was expected to have a slight downturn of -0.1% of GDP in the 3rd and 4th quarters of 2016 and again in the first two quarters of 2017, before returning to anaemic growth. Ironically, the new estimate of 0.5% growth is exactly in line with what the Office for Budget Responsibility forecast for Q3 2016 issued at the time of the budget in March.

Does this imply that the Brexit decision has had no economic impact and the Treasury, simply, was wrong in its conclusions about the immediate impact, casting doubt also on what it said about the longer term? Again, the conclusion would be disingenuous.

Brexit proper has yet to begin

Brexit proper has, in practice, yet to start and it is important to recall why it was projected, prior to the referendum, to have adverse effects on the economy. These were expected to stem from the combination of new trade barriers inhibiting UK exports and a falling-off of investment from abroad in the UK economy. In any profound recasting of the trade, investment or regulatory regime, there will be winners and losers. For example, companies competing with EU exporters will gain from the imposition of tariffs against the EU, if that is the outcome of the negotiations, whereas UK exporters will lose ground if they are subject to tit-for-tat tariffs or (as could become the case for the City of London), have to surmount new regulatory barriers.



In the approach economists take to appraising trade regimes, the shift in demand patterns is usually regarded as positive if it means consumers are able to purchase from a lower cost provider (conventionally called trade creation), but negative if it means a higher cost one (trade diversion). Overall, if trade creation exceeds trade diversion, the change is good for the country, but the catch is often that certain groups will be winners or loser from these shifts, whatever the aggregate outcome. Some of this is now happening, but it is early days.

The substantial fall in the value of the pound, as with any currency realignment, has to be analysed with subtlety and should not be thought of as purely a verdict on Brexit itself. In particular, the UK's large deficit on the current account of the balance of payments is a source of vulnerability. The devaluation has had, and will continue to have, diverse effects on the economy, distributive as well as macroeconomic. Nevertheless, the devaluation of the pound is one of three plausible explanations for the resilience shown by the economy. By making the UK relatively cheaper than foreign destinations, it reinforced UK tourism demand over the summer months and there may well have been an additional boost from those who opted for "staycations" because of concerns about possible antagonism to Brits in other EU countries. Data on hotel nights suggest that occupancy rates in England were marginally higher in July and August than in the corresponding months in the two previous years, and there was a record high in the number of foreign tourists coming to the UK in July and August, up 2% from the previous year. They also increased spending even faster with a jump of 4% over 2015.

By contrast, there has been only a very limited effect of the lower pound so far on real incomes as a result of import price inflation, although the recent story about Unilever's ill-fated attempt to blame a rise in the price of Marmite on the fall in the pound is a harbinger of more to come. It will not be long before imported inflation starts to feed through into consumer prices and if wages do not keep pace, consumer demand may suffer. That will dent optimism about the economy.

The second factor is that the speed of change of government greatly reduced the political uncertainty which might have accompanied a protracted and acrimonious contest on replacing David Cameron as Prime Minister. As a result, business and consumer confidence appears not to have been hit and there are few signs yet that investment decisions have been affected. However, if the government continues to procrastinate about revealing what sort of future it wants in Europe, it risks deterring investment decisions.

Third, the policy responses from the Bank of England and (more at the level of signalling, thus far, with no explicit tax or expenditure changes yet) the Treasury will also have had some impact, mainly again on consumer confidence. The small cut in interest rates in August and the complementary measures are unlikely, on their own, to have induced higher consumer spending, but by demonstrating a willingness to act, they help to forestall concerns.

Sherlock Holmes remarked on the curious incident of the dog that did not bark in the night. Plainly the economy has not suffered anything like the shock that was foreseen from Brexit, but it has relied mainly on buoyant consumer spending which may be hard to sustain if real incomes and debt levels exert a squeeze, or if the balance of payments does not improve. Even the great detective would need many more clues than we have so far to ascertain what effect Brexit will really have on the economy.

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***Iain Begg** is a Professorial Research Fellow at the European Institute, London School of Economics and Political Science, and Senior Fellow on the UK Economic and Social Research Council's initiative on The UK in a Changing Europe.*

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