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## Inflation at 3.5% and a two-year recession: the impact of no deal

*We hear a great deal about the risks of a no-deal Brexit, but what would the economic effect really be? **Ana Boata (Euler Hermes)** and **Michael Heise (Allianz)** look at the economic hit the UK has already suffered as a result of Brexit and forecast the likely effect of a disorderly departure in March, as well as the impact on EU exports to the UK.*

Over the past two years, Brexit-related uncertainty has had a strong impact on the United Kingdom's economy. In our analysis, the high level of uncertainty has shaved growth by about -0.3% of growth per year via a multitude of channels to the real economy.

Firstly, the dampening effects of Brexit uncertainty have come from a lower (and highly volatile) valuation of sterling, which has diminished households' real purchasing power and company margins through higher import prices. In order to compensate for the loss of purchasing power, UK households have reduced their average savings rate to a record low of 4.2% of gross disposable income in Q3 2018. This has more than halved since the referendum. Furthermore, non-financial corporates' margins in the third quarter of 2018 reached their lowest level since early 2014.

Second, investment will remain weak as long as significant uncertainty persists. In Q4 2018, business investment is likely to have contracted for the fourth consecutive quarter. This would be the first time such prolonged contraction since 2009.

Third, the labour market should remain tight as net migration flows from the EU remain negative and push wages higher (+3.3% year on year in Q4).

Fourth, real estate prices are adjusting downwards contributing to negative wealth effects and deteriorating consumer confidence. Consumer confidence has returned to the low levels seen in the aftermath of the Brexit referendum. The construction sector has been impacted by accelerating business insolvencies (+15% in 2018, second highest increase after accommodation and food services).

Fifth, contingency stockpiling by companies has intensified since Q3 2018 and will pose downside risks in 2019 given the weakness of domestic demand. In some sectors, such as agri-food companies have planned four to seven months of stocks.

Sixth, UK attractiveness as an investment location has deteriorated, notably for foreign investors. Total M&A deals fell by 60% to £42.4bn on average since 2016. Several EU companies seem to be switching from a British supplier to an EU supplier which feeds into higher insolvencies in the UK market: +9% in 2019 after +10% in 2018. In addition, insolvencies of companies with a turnover of above 50m euros have risen in Q4. In total, 19 cases in 2018 against 15 in 2017.

Seventh, worsening business and consumer confidence coupled with higher risk aversion have triggered tighter loan availability by banks. The prevailing uncertainty could push the Bank of England to delay its rate hike expected in Q2 (+0.25 base points to 1%).

Given the economic effects that the Brexit uncertainty has already had, a disorderly Brexit seems a big risk for the economy. Fortunately, the risk of a disorderly Brexit on March 29 could be reduced with an

extension of Article 50 until July or December. With more time for logistical preparation the disruption of supply chains and financial business could be reduced. But if a disorderly Brexit does happen, it would have grave consequences. In our view, it would push the GBP/EUR exchange rate below parity rather quickly and thus increase the inflation rate to 3.5%.

As a consequence, purchasing power would decline and consumer spending and imports would contract. Overall, the economy would enter into something like a two-year recession. For the UK's trading partners, goods exports to the UK could go down by £30bn in a year. Top EU losers on goods exports include Germany (~EUR8bn in the first year following the EU exit), the Netherlands (~EUR4bn), France (~EUR3bn) and Belgium (~EUR3bn). If we add to this the expected losses in investment, the negative impact on GDP growth would be above -1% for Belgium and Ireland and above -2% for the Netherlands for a time span of two years.

Should a "hard Brexit" come later, the impact would be lower as it would be possible to better prepare the introduction of WTO tariffs (5% on average) and to mitigate negative effects through uncertainty. Looking at existing WTO tariffs that the EU has in place with countries with which there is no Free Trade Agreement in place, export losses from the tariff introduction would be highest for the automotive sector, followed by chemicals and agri-food products. Overall, they would be half of what we would see in a "disorderly Brexit" – i.e. for Germany, we would expect them at EUR3.5bn.

But what should be noted is that even before Brexit happens, trade and investment connections between the UK and the EU have started to adjust. Real imports in the UK have presumably grown by less than 1% in 2018, which is the lowest rate of growth since 2011. This translated into lower outlets of Western European companies into the UK. We estimate that the eurozone as a whole missed around EUR60bn of potential outlets into the UK market since the Brexit vote.

Overall trade exposure of European countries to the UK has been reduced since 2015. The UK used to be the third biggest export market for Germany. Due to the slowdown of economic activity, it has dropped to the fourth rank. Exports in EUR terms fell by almost -6% in 2016-17 cumulated (or EUR5bn in value terms).

For the long term development of the UK economy and its trading partners, the success of the negotiations on a Free Trade Agreement is absolutely essential. From a normative point of view, it should involve a free and open border on the Irish island, zero tariffs on goods trade between the UK and the EU, as well as "passporting rights" for the UK's financial sector. As the UK's political ambition is to exit the customs union and to negotiate Free Trade Agreements with non-EU countries on its own, an economically viable and beneficial solution that takes account of the above seems to be a Norway-type of agreement.

However, given that political opposition to such an agreement seems strong in the UK, the negotiations over the future trade agreement will prove no less difficult than the negotiations on the exit deal. Therefore, we expect an extension of the transition period beyond 2021.

Brexit will continue to generate uncertainty about the prospects for trade and investment and will therefore continue to keep UK growth below potential. Assuming a moderate growth of the world economy, we expect the UK to reach around 1.5% over the transition period – half the 2000-07 average, for example.

*This post represents the views of the authors and not those of the Brexit blog, nor the LSE. It is based on Heise, M. & Boata, A. Int Econ Econ Policy (2019): Economic costs of Brexit.*

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