CUSTOMER TREASURY SERVICES
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Brexit Breezes Cool UK Economy

The vote for Brexit in the June 2016 referendum has led to a marked slowdown in the UK economy in the first half of 2017. GDP rose by 0.2% in the first quarter and 0.3% in the second quarter, well down from the growth rates of 0.5% and 0.7% recorded in the final two quarters of last year.

What's more, the growth rate in the UK has slipped well below that of the US and the Eurozone, which grew at double the rate of the UK in the first half of this year. The performance of the UK is all the more disappointing given the sharp fall of sterling over the course of last year, which should have provided a fillip to external trade, while the economy should have also benefited from the further loosening of monetary policy a year ago.

The external environment has also turned more favourable, with a strengthening of the global economy this year, most noticeably the UK's main export market, the Eurozone. However, these positive factors have been overwhelmed by the negative consequences that have flowed from the vote for Brexit.

The resulting sharp fall in sterling has led to a big rise in import prices and thus a marked acceleration in retail price inflation. Meantime, wage growth has slowed and real incomes are now falling as prices are rising faster than earnings. Employment growth has also slowed. As a result, there has been a slowdown in consumer spending, which has been the cornerstone of growth in the UK in recent years.

Meanwhile, the Bank of England Governor observed last week that businesses have invested much less aggressively than usual since the referendum. The uncertainty around Brexit is weighing on investment activity, while there has also been a slowdown in the UK property market. Consumer confidence has also fallen appreciably in recent months.

Nonetheless, survey data suggest that the UK should see moderate growth over the second half of the year. The Bank of England also looks for the UK economy to grow at a moderate pace, with a weak sterling and stronger external demand expected to have a positive impact on trade.

The Bank is forecasting that the UK economy will grow by 1.6% next year and 1.8% in 2019. However, it is important to note that the Bank's macro forecasts are based on the assumption that households and businesses continue to act on the expectation of a "smooth" Brexit that does not cause a material disruption to the UK economy and its trade with the EU.

As expected, last week's meeting of the Bank of England's Monetary Policy Committee concluded with no changes to interest rate policy. The decision to leave rates unchanged, though, was once again not unanimous. Two of the eight MPC members wanted to hike the Bank Rate from 0.25% to 0.5%.

Sterling weakened after the meeting, falling by around 1% on the exchanges. This was reflected in EUR/GBP rising above 90p and GBP/USD moving down near $1.31. The reaction was somewhat surprising given that the Bank stated that rates may need to rise by a "somewhat greater extent" in the next couple of years than markets are expecting.

The extent of any UK rate hikes is likely be very much dependent on how the negotiations with the EU on Brexit evolve, as this will impact economic activity. A 'soft' Brexit could see rates rise by more than the 50bps currently priced in by markets over the next three years. On the other hand, rate increases would seem unlikely if a 'hard' Brexit unfolds, given all the risks this would pose for the economy.

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