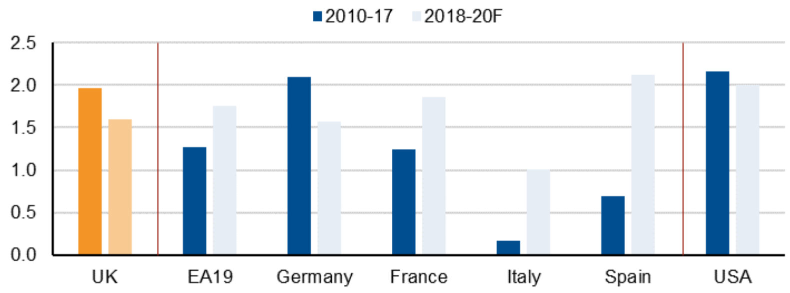
Brexit presents unique challenges to the UK's economic outlook and debt sustainability

Brexit continues to challenge the UK's economic and fiscal outlook, as uncertainty may loom well past the current March 2019 exit date. This may support a further modest slowdown in 2018. Scope notes in a positive light progress made this week on an implementation period, but adds that it does not resolve economic uncertainty – and may even extend it.

Uncertainty around the conclusion of Brexit will continue to weigh on the UK economy. Scope has noted that the effects are more complex and gradual than supposed by many before. Compared with forecasts for a sharp correction in the economy, the UK economy has instead to date exhibited some resilience.

However, in Scope's view, a gradual continued slowdown in the UK (AA/Negative) is expected. Some factors supporting UK growth against a more rapid slowdown may not be sustainable for an extended period: constraints are increasing for consumers, for example, and the export sector impetus to the economy may ease. In 2017, the UK grew 1.7%, the slowest rate since 2012. Scope foresees a further modest easing from 2017's 1.7% annual rate of growth in 2018.

Figure 1: UK growth and IMF 2018-20 projections, compared with peers



Source: Haver Analytics, IMFWEO, Scope Ratings GmbH

In part, this will be due to banking sector migration and softness in investments, with clarity still lacking around the future relationship with Europe. The deal on the implementation period, to be discussed at this week's European Council meetings, lacks safeguards until a final agreement is completed, and may instead extend uncertainty. As the transition is now to be instituted to finish trade talks, many businesses are already asking for a second transition, after the terms of the new relationship become clear.

Over the medium term, Scope assumes a baseline potential growth estimate of 1.5% to 2.0%. This marks a modest slowdown from 2.0% average growth rates from 2010-2017 post-crisis. However, we acknowledge significant uncertainty around this medium-run growth estimate owing to the inherent dependence on the end-outcome of Brexit, what trade agreement the UK reaches with the European Union (EU) and other trading partners, and the nation's overall policy framework. Owing to the significant demands of Brexit, Scope has highlighted the potential adverse impact of the exit process on the quality of economic policymaking vis-à-vis other significant policy areas, including long-run growth and fiscal discipline.

Analysts

Dennis Shen
+49 69 6677389-68
d.shen@scoperatings.com

Dr Giacomo Barisone
+49 69 6677389-22
g.barisone@scoperatings.com

Investor Outreach

Martin Kretschmer
+49 696677389-86
m.kretschmer@scoperatings.com

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Scope Ratings GmbH

Neue Mainzer Straße 66-68
60311 Frankfurt am Main

Phone + 49 69 6677389 0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

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In a 2016 analysis before the referendum, the UK Treasury emphasised the long-run adverse impact of Brexit – both in a soft exit and considerably more significantly in a hard Brexit. Scope's view on a *gradual slowdown* assumes our structural view that a soft Brexit (Scope's baseline) or a no Brexit scenario are the two most probable end-states. Obviously, a hard Brexit would entail significant downside to Scope's medium-run growth expectation range. This economic uncertainty and asymmetric risk underscores Scope's Negative Outlook on the UK's AA sovereign rating.

Scope notes that economic uncertainties feed, moreover, into vulnerabilities of the UK's fiscal position. In the near term, the debate may remain around the Brexit Bill, in which a net payment of GBP 37.1bn is estimated by the Office for Budget Responsibility (OBR) – the UK's fiscal watchdog. But, more consequentially, the main risk to the UK's debt sustainability ties to an economic shock. In a July 2017 review, the OBR showed that a stress case akin in severity to the financial crisis raises public sector net debt significantly to 114% of GDP by 2021-22, compared with 80% by 2021-22 in a baseline.

Some resilience in recent growth figures

The UK economy has shown, to date, some resilience

Uncertainty around the conclusion of Brexit has and will continue to weigh on the UK economy. Scope has previously noted[1] that the effects are more complex and gradual than supposed. Compared with forecasts for a sharp correction in growth around the referendum (the Bank of England and professional economists[2] warned of an impending recession, for example), the UK economy has to date shown some resilience. In July 2016, the IMF cut the UK's 2017 growth projection to 1.3% from 2.2% (2017 growth turned out around 1.7%).

Strong export performance has helped explain the resilience of the UK economy since the 2016 Brexit vote. Factory production has seen a record run. This has been helped by external conditions with broad-based expansion in the European and global economies, alongside gains in UK manufacturing competitiveness after earlier sterling depreciation. While higher net exports have boosted growth, the drop in the rate of growth in investment and household consumption cannot be ignored, and continues to weigh on the economic outlook.

But factors boosting UK growth may not be sustainable

However, Scope does not consider some factors supporting UK growth to be sustainable for an extended period. Household consumption growth, despite decelerating, has been supported against a deeper slowdown by growth in unsecured borrowing and a near record low household savings rate. But, these *supports* have now started to unwind: the savings rate has risen slightly back to 5.5% in Q3 2017, from a trough of 4.0% in Q1 2017. And, consumer credit growth has eased to (an albeit still elevated) 9.3% YoY as of January 2018, from peaks of 10.9% YoY in November 2016 – following regulatory scrutiny.

At the same time, constraints are gathering for consumers. The housing market remains soft. Meanwhile, the unemployment rate unexpectedly rose to 4.4% in the three months to December 2017, the first MoM increase since the referendum. Consumer confidence remains near a trough, while inflation remains elevated (at 2.7% YoY in February 2018, with core inflation at 2.4% YoY in the same month), driving negative growth in real earnings (though some inflationary effects from earlier pound depreciation are fading). With high inflation, rate increases are expected, gradually removing some monetary accommodation.

[1] United Kingdom Rating Report, 18 August 2017
[2] https://www.bloomberg.com/news/articles/2016-07-21/brexit-to-halt-u-k-s-growth-streak-with-mild-recession-forecast

The export sector impetus should fade

The export sector impetus to the economy may ease in the future as the pound has recovered to about 1.4 against the dollar – amid rate-hike expectations and signs of resilience in the economy, from about 1.2 in early 2017. The weakness in the dollar against sterling is partly to blame, though the UK's nominal effective (trade-weighted) exchange rate has similarly risen 7% from an August 2017 low. A stronger pound reverses some gains in export competitiveness at the same time that global trading conditions have become more fraught after escalation of trade disputes between the United States and Europe.

Scope anticipates a further easing in growth

While Scope has maintained the view that the UK slowdown may prove *gradual and complex*, we consider a further modest easing from the 1.7% annual rate seen in 2017 to be on the cards in 2018, factoring in increasing constraints and a reduction in supporting factors. Increasing Brexit uncertainty as we approach the 29 March 2019 exit date will affect investment decisions, and fiscal support may be just a partial offset, with additional supportive measures delayed until the Autumn Budget.

Scope's view on a gradual slowdown assumes our structural view[3] that a soft Brexit (Scope's baseline) or a no Brexit scenario are the two most probable end-outcomes of current negotiations. Obviously, the implications on the economic environment in a non-baseline 'cliff-edge' exit scenario would be significantly more severe.

Banking sector departures from the UK to the EU-27

Economic slowdown to be exacerbated by banking exits

How significant an impact Brexit has on the UK banking sector is critical in assessing how leaving the European Union will affect the broader British economy. The deal on the implementation period, to be discussed at this week's European Council meetings, lacks safeguards until a final agreement is confirmed before March 2019 – reducing its supportive impact in ensuring a predictable investment environment.

The costs of heightened uncertainty on delayed or cancelled investment and movement of some existing operations out of the UK could exacerbate. In a 2017 report, Bruegel concluded that about 35% of London wholesale banking is related to EU27-based clients.[4] Extrapolating this, they estimated that EUR 1.8tn of banking assets (or 17% of the total) could be relocated to Europe in the scenario of no access to the single market, placing as many as 30,000 domestic jobs at risk. The Bank of England has estimated that up to *75,000* financial services jobs could be lost in a hard Brexit. Even if such scenarios are not fully realised, a Financial Times analysis (based on public statements and interviews of bank executives) points to about 4,600 jobs[5] that could be moved by April 2019.[6]

Scope considers estimates around the FT's to be more realistic in the short term under the scenario that hard Brexit is avoided – consistent with a modest negative growth impact due to contingency-related exits. However, given the likelihood that the Brexit end-state will *not* be decided by March 2019, a state of extended uncertainty may facilitate additional relocations after April 2019. More significant downside would clearly be seen should financial services' access to the single market (per 'passporting' rights) be more overtly suspended.

Declines in the financial sector are credit-negative

As finance and related professional services contributed GBP 192bn in 2017 (about 11% of the UK economy), the continued uncertainty affecting the sector dampens the UK's economic outlook, questions external sector vulnerabilities (given the importance of EU inflows to the UK's financial sector in the funding of the UK's current account deficit), and

[3] See Scope Ratings, 'Uncertainties around Brexit challenge UK credit outlook', 24 August 2017
[4] Sapir, André, Dirk Schoenmaker and Nicolas Véron. (2017) 'Making the best of Brexit for the EU27 financial system'. Bruegel Policy Brief, Issue 1, February 2017.
[5] https://www.ft.com/content/931b1b1a-df49-11e7-a8a4-0a1e63a52f9c
[6] https://www.bloomberg.com/graphics/2017-brexit-bankers/

weakens the City of London as one of the world's preeminent financial hubs, a pillar moreover in the pound sterling's status as a leading global reserve currency.

Medium-term implications of Brexit are critical to outlook

Scope assumes a moderate medium-term growth expectation of 1.5%-2.0%

In the medium term, Scope assumes a baseline UK growth potential of 1.5% to 2.0%. This marks a modest slowdown from 2.0% average growth rates from 2010-2017 post-crisis, and compares with a medium-term growth forecast from the IMF of 1.7%[7] (revised down from 1.9% in October 2017). Scope's medium-term growth baseline assumes labour productivity growth of around 0.5%-1.0% (compared with 0.8% over 2010-17).

At the same time, we acknowledge significant uncertainty around this medium-run growth estimate due to the inherent dependence on the end-outcome of Brexit, what trade agreement the UK reaches with the EU and other trading partners, and the nation's overall policy framework. Owing to the heavy demands of Brexit on the government's policy focus, Scope has highlighted the potential adverse impact of the exit process vis-à-vis other significant policy areas, including long-run growth and the consolidation of public finances. The strength of the Labour Party and party leader Jeremy Corbyn's anti-market policy prescriptions add to economic uncertainty in the medium term.

Economic implications of a hard Brexit are significant, but even soft Brexit presents challenges

Though the economic impact of a softer exit could be more tenable in the long run, the implications of a hard Brexit are severe. In 2016, the UK Treasury concluded that trading on WTO terms could reduce UK GDP by 5.4% to 9.5% after 15 years relative to a baseline of remaining in the EU.[8] At the same time, Treasury concluded that a Norwegian model in which the UK exits the EU but remains in the European Economic Area would nonetheless reduce GDP by 3.4% to 4.3% after 15 years relative to the baseline of remaining in the EU.

In addition, the economic risks from hard Brexit asymmetrically affect the United Kingdom. Oliver Wyman and Clifford Chance showed in a study[9] that the impact (calculated only on the direct costs from tariff and non-tariff barriers, indirect costs are not considered) of a 'no deal' exit would equate to about a 1.5pp reduction in annual gross value added, whereas the effect in this scenario would be *just* 0.4pp of gross value added for EU-27 firms.

The implications in a hard Brexit implies meaningful risk to Scope's medium-term growth expectations in an adverse scenario. Moreover, the economic hit even in a soft Brexit scenario underscores a weaker economic outlook. These risks are reflected in the Negative Outlook on the UK's AA rating.

Brexit risks to debt sustainability

A shock to long-run growth challenges UK debt sustainability

Scope notes that the UK's fiscal position is vulnerable to economic shocks of either domestic or external origin.

In a July 2017 report[10], the Office for Budget Responsibility noted that the *greatest risk* to the long-term fiscal outlook would stem from an economic shock, including impacts of Brexit on long-run growth. The report pointed out the weakened state of Britain's public-sector balance sheet, making the UK more susceptible than in 2007, before the global financial crisis. To illustrate this, the authors implemented a stress case akin in severity to the financial crisis: in the scenario, public sector net debt ended the forecast horizon

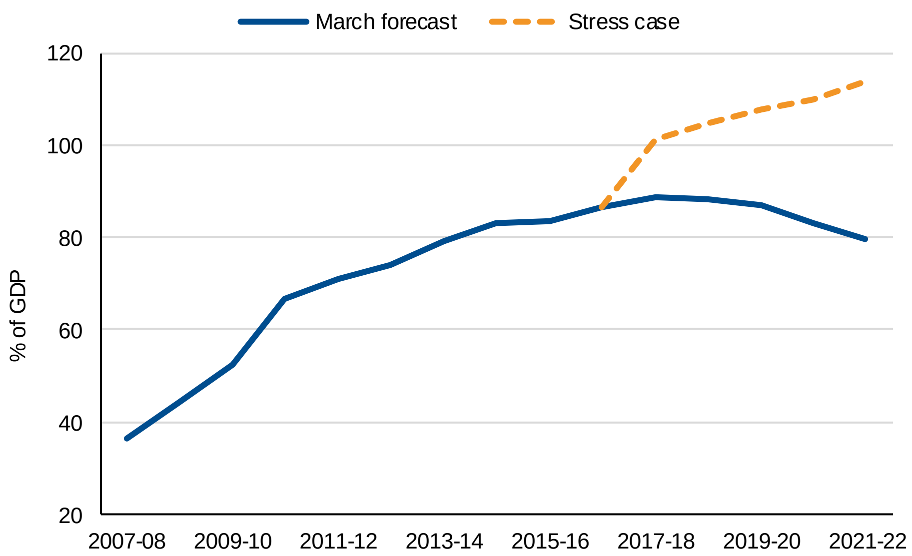
[7] IMF World Economic Outlook, October 2017, projection for UK growth in 2022
[8] HM Treasury. (2016) 'HM Treasury Analysis: the long-term economic impact of EU membership and the alternatives'. Cm 9250, April 2016.
[9] Oliver Wyman and Clifford Chance. (2018) "The "Red Tape" Cost of Brexit".
[10] Office for Budget Responsibility. (2017) 'Fiscal risks report'. Cm 9459, July 2017.

(2021-22) at 114% of GDP (**Figure 2**)[11], compared with 80% by 2021-22 in a baseline scenario.

While the scenario of a sudden economic shock of the scale in OBR's stress case (involving two years of a deep economic recession) does not represent a Scope baseline, it does speak to the scale of risks should long-run growth meet material tribulations.

In addition, Scope monitors the reversal in earlier counter-cyclical fiscal consolidation reforms in favour of fiscal expansion (with the UK still growing near its potential rate). In Scope's view, some budgetary proposals will have positive impacts on long-run economic growth. Nonetheless, they highlight moreover the government's need to sustain public support for tough Brexit negotiations and the probability that a prolonged phase of uncertainty may pose meaningful risks to the medium-term fiscal trajectory, due to both the adverse economic impact and the effects of accommodating policy on fiscal performance.

Figure 2: Net public debt, OBR baseline versus stress case



Source: Office for Budget Responsibility

Gradualised fiscal adjustment

To support the economy during Brexit negotiations, the overall budgetary adjustment has been gradualised. There have been some improvements in short-term budgetary projections (OBR now estimates 2017-18 net borrowing at 2.2% of GDP (compared with 2.4% in November 2017 estimates), before 1.8% in 2018-19 and 1.6% in 2019-20)[12], but at the same time, medium-run budgetary forecasts (from 2019-20 onwards) are now weaker than earlier envisaged, owing partly to new fiscal spending.

[11] OBR's stress case involves a shock to the tune of the global financial crisis, in which there's a sharp slowdown in global growth, the UK falls into two years of deep economic recession, there's a sharp rise in unemployment, a sudden increase in the return investors demand for holding UK assets (and fall in the pound), a fall in house prices, stock markets and commercial property prices, and inflation increases forcing an increase in the Bank Rate.

[12] Improved projections for the budgets for 2017-18 and 2018-19 largely owe to better-than-anticipated receipts and lower spending, alongside some accounting/classification changes, with the impact of policy changes adding to the deficit. OBR has said there has been no improvement in the underlying fiscal position.

In the 2017 November Budget, the government took action to support housebuilding, prepare for exiting the EU (by setting aside an additional GBP 3bn between 2018 and 2020), expand the National Productivity Investment Fund, invest in the NHS, and boost the National Living Wage, actions seen adding GBP 6.0bn to the national deficit in 2018-19, GBP 9.9bn in 2019-20 before GBP 3.3bn in 2020-21. In the Spring Budget, Chancellor of the Exchequer Philip Hammond mentioned extra public spending could arrive in this year's Autumn Budget, appropriating GBP 15bn of fiscal space out of current overachievement in the structural deficit target[13].

While fiscal loosening has been targeted to support long-run productivity growth, address societal bottlenecks and prepare at the margins for Brexit contingencies, the piecemeal process of easing in the fiscal stance highlights the consequences and demands of the Brexit process, weakening the fiscal trajectory (already confronting the costs of an ageing population) as a result and combined with the gradual economic slowdown and more severe consequences in a hard Brexit scenario, challenging the economic outlook. Owing to limited fiscal space, the lack of a shorter-term strategy to neutralise the longer terms consequences of Brexit represents a concurrent dilemma.

[13] The UK is presently projected by OBR to meet its 2% structural deficit target in 2018-19, two years ahead of schedule. In addition, net debt is forecasted to peak at 85.6% of GDP in 2017-18 (to peak well ahead of a previous target of a falling net debt ratio by 2020-21), and fall in every year thereafter to 77.9% of GDP by 2022-23.

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389-0

Paris
33 rue La Fayette
F-75009 Paris

Phone +33 1 82885557

London
Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

Madrid
Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan
Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo
Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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Scope Ratings GmbH, Lennéstrasse 5, 10785 Berlin, District Court for Berlin (Charlottenburg) HRB 192993 B, Managing Director(s): Dr. Stefan Bund, Torsten Hinrichs.