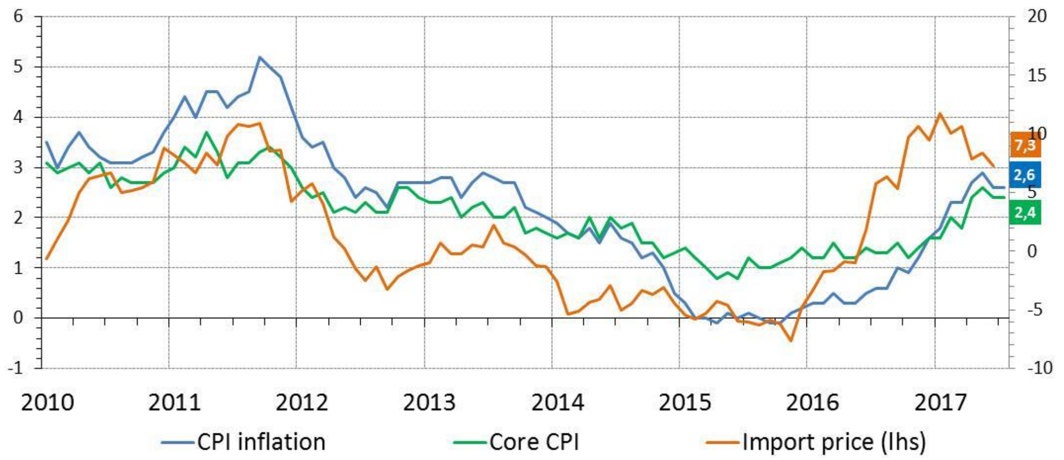
One year after Brexit: where is the UK economy heading?

by [Marie-Elisabeth de la Serve] and [Laurent Ferrara]

Since the vote on Brexit, the UK economy has shown resilience. However, due to the historically low level of savings rates, investment uncertainty and inflationary risk, we can ask ourselves whether the current growth model of the UK economy is sustainable over the short term.

Chart 1: Resurgence in inflation partly due to a rise in import prices
%, year-on-year change



Source : Office for National Statistics
Inflation: CPI; underlying CPI; Import prices (right-hand scale)

The macroeconomic adjustment that followed the shock triggered by the referendum first took place via the exchange rate: the sterling depreciated in real terms by 15% between May 2015 (the date of the Conservatives' victory in the general elections, whose programme included the holding of the referendum) and July 2017.

The impact of the depreciation of sterling on prices and exports

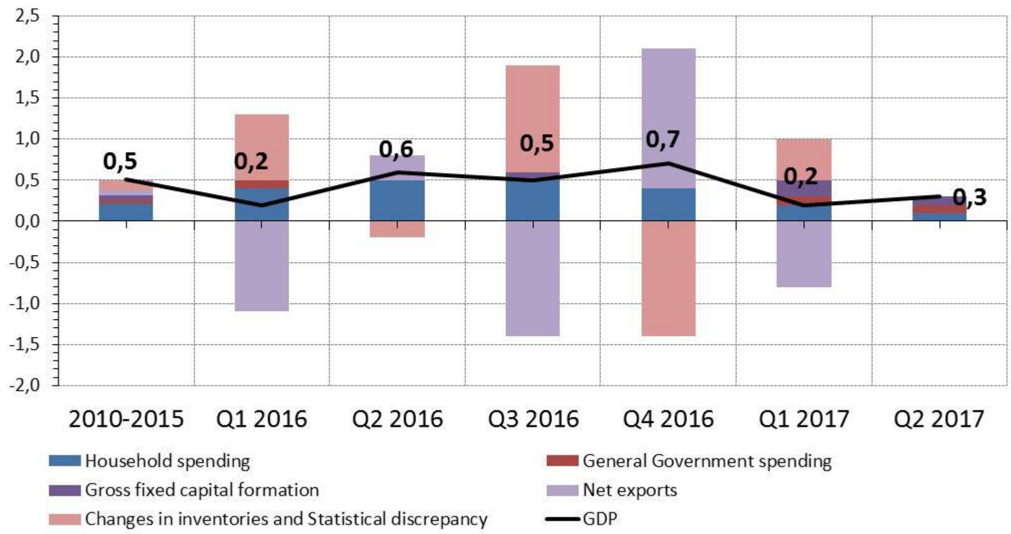
Sterling's depreciation has not yet fully fed through to consumer prices. The estimated total effect of an exchange rate depreciation on consumer prices is relatively high in the United Kingdom, of the order of 20% to 30% over 2 years. The mechanism at work is the following: depreciation increases the price of imports (elasticity of between 0.6 and 0.9), this effect takes place within a year maximum. This increase then has a knock-on effect (elasticity of 0.3) on consumer prices (especially via producer prices) about 1 year later (see Forbes, 2015).

Thus, according to these estimates, a 15% depreciation would lead to an increase in the level of the consumer price index between 2.5% to 4.0% after 2 years, all other things being equal. However, foreign firms exporting to the United Kingdom may have been initially tempted to limit price increases in sterling due to the uncertainty over UK demand. They may also have waited to see whether the depreciation of the pound was transitory or long-lasting. However, in view of the persistence of the phenomenon and the relative dynamism of domestic demand in recent quarters, import prices should continue to rise in the coming months, maintaining upward pressure on inflation (see Chart 1).

At this stage, sterling's depreciation has not led to a systematically positive contribution of exports net of imports to growth (see Chart 2). This may partly be due to the fact that UK exporters can take advantage of the depreciation to raise their prices in pounds (only slightly adjusting prices denominated in foreign currency), thereby improving their margins. This seems to be the case insofar as, since the end of 2015, export prices expressed in pounds have increased by 14%; this phenomenon had already been observed during sterling's depreciation in 2007.

Chart 2: GDP growth supported by private consumption

Real GDP growth (in %) and contribution of the principal components (in % points)



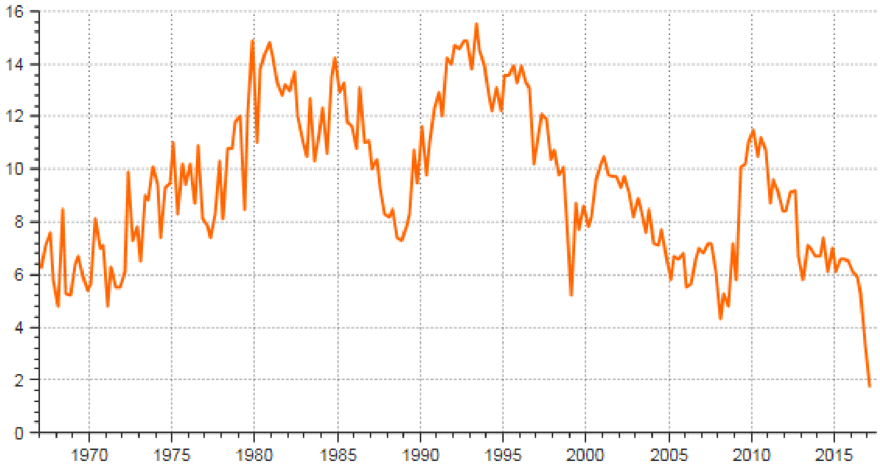
Source: Office for National Statistics

Support from private consumption via a very low savings rate

In recent years, despite moderate growth in average wages, the almost continuous rise in employment has led to an increase in household income and consumption, even though the creation of many part-time jobs has introduced some uncertainty about income prospects for the individuals concerned. Households were also able to benefit from purchasing power gains as a result of the marked slowdown in inflation in 2014 and 2015. However, a trend reversal has occurred since 2016, where wage income growth has been modest even though we have seen a rise in inflation. There has actually been a decline in real wages in recent months.

In addition, household consumption depends on the trade-off between consumer spending and savings (or credit). And yet, the ratio of the savings rate to income reached its lowest historical level at 1.7% in Q1 2017 (see Chart 3), while household debt is gradually converging towards its pre-crisis level.
The decline in real wages and the low savings rate would suggest that the current rate of consumption could become difficult to sustain in the near future.

Chart 3: A historically low household savings rate (in %)



Source: Office for National Statistics

Business investment already affected by uncertainty?

Business investment, another component of demand, has declined in recent quarters. The peak level of the investment cycle was reached in Q3 2015, at the same time as the uncertainty surrounding the outcome of the referendum has grown strongly.

Despite a recent rebound, the Bank of England's quarterly survey indicates that companies remain cautious about their investment decisions, in particular those exposed to household demand or trade with the European Union. This wait-and-see behaviour regarding investment decisions is particularly visible for the most irreversible type of investment (for example in infrastructure); by comparison, intangible investment has been less affected, which is characteristic of an uncertainty shock (see the blog Econbrowser). This decrease directly affects the stock of available capital and could have a significant impact on the country's growth potential over the next few years.

In conclusion, the effects of Brexit on the UK economy have for the moment been limited. This is probably partly due to a number of factors, such as the decline in sterling or a more buoyant international environment. The policy of the Bank of England, which decided in August 2016 to launch a vast programme of monetary easing (by lowering the key rate to its lowest historical level – i.e. 0.25%, by expanding its bond purchase programme and, among other things, by launching a new corporate bond purchase programme, in a context of fiscal austerity) has also played a role.

As regards short-term growth, it could remain buoyant provided that there is a switch in the growth engines (i.e. net exports taking over from a household consumption which is running out of steam). However, this new situation has no precedent, which generates considerable uncertainty about what lies ahead. While the negative macroeconomic effects of an uncertainty shock, in particular on business investment, are well-known (see, for example, Ferrara and Guérin, 2016), the uncertainty shock associated with Brexit is different from a standard shock insofar as we know that the duration of the shock itself can be extended. Indeed, the Treaties provide for two-year negotiations from the triggering of Article 50, signed on 29 March 2017, but the possibility of a transition period is being widely discussed. Finally, the recent literature shows that an uncertainty shock has strong negative effects when it is associated with a financial shock. Monitoring the developments of financial tensions in the United Kingdom in the coming months will therefore be crucial.