The road to Brexit: picking up the pace

Economic commentary

17 January 2019

In the space of a momentous 24 hours, the Government suffered a crushing defeat on its Brexit withdrawal agreement, but then successfully saw off a vote of confidence put forward by the Labour opposition. With the so-called "meaningful vote" now behind us, the Brexit saga could now move on more quickly. But there is still no certainty for businesses and individuals about when and how the UK will leave the EU. All that can be said after the dramas of recent days is that the probability of an orderly exit on 29th March has been reduced.

The next moves

The Prime Minister will bring new proposals before the House of Commons on 21st January, following cross-party consultations. It is at this point that MPs are expected to table a range of amendments, from which it might become possible to glean the mood of the Commons. It's clear that among MPs there is a large majority against a "no deal" exit on 29th March, but there is no clarity at this stage about which options might command the support of the House.

The scale of the Government's defeat on 15th January suggests that Mrs May's withdrawal deal with the EU, which was concluded in November, is a dead letter. Had the margin of defeat been under three figures it might have been possible to offer enough reassurances, insert a few tweaks, and twist enough arms to get it over the line. But having lost by 230 votes – the biggest defeat in modern political history – and with 118 Conservative MPs having failed to support the Government, it now appears that nothing short of a major rethink will suffice. Given that there is only a little over two months until the UK is scheduled to leave the EU, the scale of the defeat has made it more likely that the Government will be forced to seek an extension to the Article 50 process.

For those businesses which have been making plans to mitigate the impact of a "no deal" exit on 29th March, nothing that has happened in recent days offers them any comfort. A "no deal" exit remains the default position because that's how the EU's Article 50 process is set up and because the date of exit has been written into UK law in the European Union (Withdrawal) Act which Parliament passed last year. The EU can grant an extension if all 27 remaining members agree, but this is not something that can be taken for granted. The indications coming out of Brussels are that a delay would be agreed to if the UK Government wanted to hold a general election or a second referendum, but otherwise only an extension of a few months would be forthcoming.

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Some options for discussion

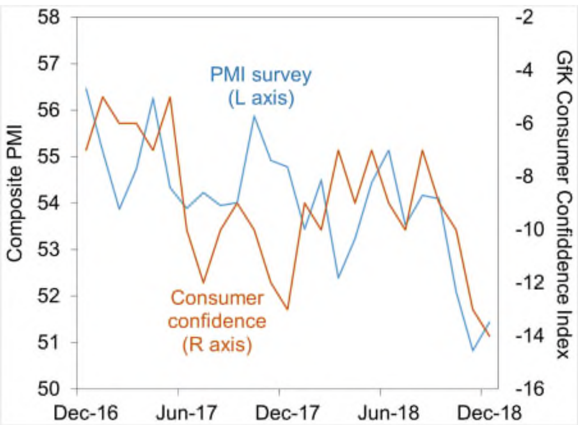
The options that will be considered by Parliament in the days and weeks ahead will include: holding a second referendum; a Norway-style relationship with the EU, either on a temporary basis ("Norway for now") or on a permanent basis ("Norway forever"); and some form of Customs Union with the EU. Although the House of Commons is logjammed over what to do, things will probably need to get a lot worse before another referendum becomes a realistic option. Quite apart from anything else, it's unlikely that MPs could agree on the choices that should be put before the voters. Of the other options (and MPs may well concoct entirely new ones) the most likely to get close to achieving majority support is a customs union. This is already Labour Party policy, and with the party suffering just three defections in the "meaningful vote", it would need the support of only around 70 MPs from other parties. In June last year, an amendment to the Trade Bill which sought to keep the UK in some sort of customs union with the EU was defeated by just six votes.

But this will not be the Government's preferred approach. While a customs union would remove the need for many of the provisions contained in the controversial Northern Ireland 'backstop', there would still be a requirement for arrangements to facilitate north/south relationships on the island of Ireland in areas not related to the movement of goods. It would also greatly limit the scope for the UK to conduct an independent trade policy, an ambition which is much cherished by many Conservative MPs. Indeed, Mrs May reiterated, after losing Tuesday's vote, that an "independent trade policy" remains a key objective for the Government.

Currency markets: looking at a blend of outcomes

The reaction in financial markets to the Government's thumping defeat in the "meaningful vote" was muted, albeit mildly positive. The pound had been rallying gently on the foreign exchanges in the days before the vote, in the expectation that a defeat for the government would pave the way for Parliament to take greater control of the process and rule out a "no deal" exit. Sterling rose a little further after the vote, and is now back close to $1.30 and €1.13. Although currency rates could well remain choppy in response to the political news flow, the pound is unlikely to break out of its recent narrow range until there is clear progress. A "no deal" would likely precipitate a sharp fall to around $1.10, while progress towards an orderly Brexit would likely trigger a rally to over $1.40. The pound's present level reflects a blend of the possible outcomes, with the currency rising and falling as the odds shift between a "no deal" exit, an orderly departure, or no Brexit at all.

Brexit uncertainty has weighed on consumer and business sentiment



Source: GfK, HIS Markit

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A headache for businesses

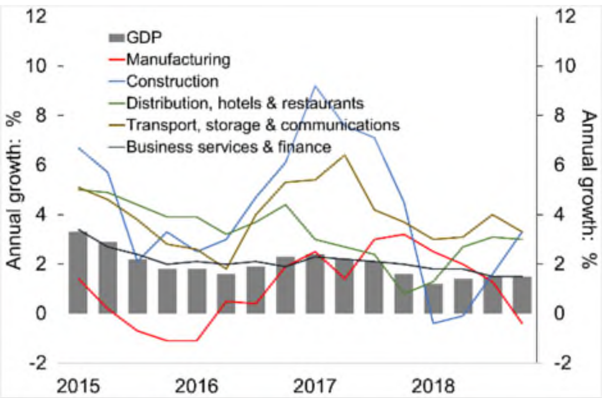
The protracted and messy evolution of the Brexit process has caused headaches for many businesses, especially those engaged in moving goods between the UK and EU countries. This has been reflected in the exasperated warnings from organisations representing the business community, such as the CBI and the British Chambers of Commerce. Some firms are building up inventories to mitigate the risk of disruption at ports, and anecdotal reports suggest that warehousing space is now in short supply, and has therefore become more expensive.

Despite these very real concerns, so far there is little evidence that the period of heightened uncertainty stretching back to mid-November has had a major impact on the UK economy. The monthly estimate of GDP growth for November, published by the Office for National Statistics (ONS) on 10th January, showed GDP expanding by 0.2%, suggesting an economy that was enjoying modest growth even as the Brexit denouement loomed. Since then, business surveys, especially the Purchasing Managers' Index (PMI) surveys, have reported further expansion, albeit still fairly sluggish, in December. Measures of consumer sentiment, such as the long-running GfK survey, point to a deterioration in confidence in recent months, with the headline measure having slipped below its long-run average. But the retail sales figures for November were strong, and the trading statements from major retailers tell a story of a Christmas period that was good for some – not so good for others, but in any case not an all-round disaster. It therefore seems quite likely that GDP growth for the fourth quarter will still come in at around 0.2%.

Weathering the storms

This is clearly nothing to shout about. But given the gnawing uncertainty that is pervading much of the business community, it wouldn't have come as a great surprise if things had turned out rather worse. The UK economy is not only weathering the Brexit uncertainties, but it's also proving to be relatively resilient in the face of a global economic slowdown. The ongoing trade tensions between the United States and China have caused a chilling of investor and business sentiment, reflected in falling equity prices and a pull-back in capital expenditure. This has hit most major economies, but especially the big economies in the Euro Area, and has manifested itself in falling manufacturing production. Indeed, the Eurozone's manufacturing sector has entered a 'technical' recession, having registered negative growth in the third and fourth quarters of 2018. This is also true at a national level for both Germany and France. The economy of the Euro Area expanded by just 0.2% in the third quarter, and the final three months may have been even worse. An outright recession is not on the cards, but growth is very sluggish, just as it is in the UK.

A spell of sluggish growth for the UK … but with some bright spots



Source: Office for National Statistics (ONS)

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A rough patch for Britain's manufacturing sector …

Britain's manufacturing sector has also been through a rough patch of late. After a spell of unusually brisk growth in 2017, the sector is once again contracting, with the motor industry under particular strain. In the automotive sector, JLR and Ford both announced substantial job losses in early January, while other car-makers have announced plans to halt production briefly in early April to counter the threat from a disruptive Brexit. But with manufacturing accounting for only 10% of the UK's economic output, there's plenty of scope for other sectors to sustain GDP growth. So although manufacturing output contracted by 0.8% during the three months to November, GDP still registered an increase over the previous quarter of 0.3%. In particular, there was solid growth in the construction industry, where buoyant housebuilding activity has combined with strong infrastructure spending.

If a way can be found through the Brexit morass, then the pace of growth could see a modest acceleration in 2019. Quite apart from the beneficial effect of removing 'Brexit uncertainty', one of the main causes of the recent spell of retrenchment by consumers has been removed, in that real earnings growth is once again positive: in December, the annual rate of inflation fell to just 2.1%, the lowest it's been for nearly two years, while annual growth of average earnings has risen to 3.3% (in the three months to October).

… but a more benign outlook for consumers

The more benign relationship between inflation and earnings should help to restore consumer confidence, if worries about Brexit are lifted, and meanwhile Philip Hammond's recent Budget has signalled a period of fiscal loosening by the government. In the event of an orderly Brexit, on or shortly after 29th March, HSBC therefore forecasts that the UK economy would expand by 1.6% this year, as against 1.3% in 2018. It's hardly setting the world alight, but in the aftermath of severe Brexit nervousness and against the backdrop of a global slowdown, it's an outcome that most people would settle for.

In the meantime, there is still much work to be done to set the UK on a course to an orderly exit from the EU, and no guarantee of success. But after the "meaningful vote" and the subsequent confidence motion, the way is now open for the process to gather momentum.

Mark Berrisford-Smith
Head of Economics, Commercial Banking
HSBC UK Bank plc

Issued by HSBC UK Bank plc
CMB Economics, 71 Queen Victoria Street, London EC4V 4AY