BRACING FOR BREXIT

The Lisbon Treaty allows a member-state planning to leave the EU a two-year period from the invocation of Article 50 to negotiate a smooth exit from the rights and responsibilities flowing from its EU membership. Already six months have elapsed since Mrs May sent an Article 50 letter to Brussels setting the Brexit procedure in motion. Yet the form a Brexit agreement will take, or whether there will be an agreement at all, is no clearer than it appeared to be at the end of March. Indeed, in some respects it is less clear, following a UK general election which failed to provide Mrs May's Government with the negotiating mandate it had been seeking.

The representatives of industry and commerce, in Britain, on the Continent and, indeed, further afield have been demanding early clarification of the terms on which trade will be conducted between the UK and the EU after March 2019 – whether there will then be a 'cliff edge', with all existing treaty provisions lapsing, or whether there will be transitional arrangements that will give time to companies and their workforces to adapt to new conditions. Any hopes they harbour for early resolution of the uncertainty are likely to be disappointed, however. Even if the UK Government were to set forth in detailed terms the results it wants to achieve from its ongoing talks with the EU Commission, that would not bring the much-sought clarity. This is because it is highly unlikely the Commission would accede to everything the UK wanted. There are two parties in these talks. Further, since this is a negotiation, the UK Government would be tactically naïve if it stated early in the process precisely what it wanted to achieve.

This partly explains the crab-like progress of the UK-EU discussions so far. There is a further important point. The Commission has been entrusted by the Council of Ministers with conducting the negotiations on behalf of the EU. But in the end, it will be the Council, that is, national governments of the 27 remaining member-states, that will be required to seal any agreement. Even if the UK and Commission representatives were to reach an accord, there would be no guarantee of the shape of the final deal. That will be for the governments to decide. It might be thought that this is a technicality, that the governments will rubber-stamp whatever the Commission approves. The history of the Greek debt negotiations shows how mistaken such a view would be. In that instance, the Council of Ministers had no compunction in overturning assurances given by Commissioners, whenever national interests were seen to be at stake. Not only the UK Government but also the governments of the other EU member-states will need to establish firm views on their Brexit preferences before serious discussions can begin.

Of the EU member-states, Germany is one of the more influential in determining the Brexit outcome. Last weekend's federal election may help to clarify how firmly Germany will enforce the 'red lines' it has set in areas such as movement of labour. Most serious of all for German policymakers is likely to be the money question. Any money that the UK does not pay in future into the EU budget will have to be replaced by funds from other sources, and Germany stands to shoulder a significant part of the increased fiscal burden. In the end, settlement of the money question would probably unlock solutions to many of the other outstanding issues in dispute.

It is not in the nature of EU negotiations to reach agreement well ahead of deadline. Indeed, the authorities in Brussels have been known to 'stop the clocks' when a deadline has been reached without an agreement, in the hope of eventually reaching an accord. It would be truly remarkable, therefore, if there were a Brexit deal before the end of March 2019, for all the clamour for clarity from the commercial world.

Industrialists are not alone in regretting the lack of visibility as they look to the UK's future. Economic forecasters are also in a bind. They have no firm set of assumptions on which to base their projections for such variables as UK output, employment and inflation. Further, without guidance from forecasts, policymakers are at a loss to know how to evaluate alternative policies with regard to such macroeconomic instruments as interest rates and the fiscal balance. There is usually reckoned to be a lag between policy-action and its economic effects. In the case of interest rate changes, this lag is widely estimated to be two to three years. The impact of any measures the monetary and fiscal authorities take now may not be felt until well after March 2019, a time when the needs of the UK economy are currently anyone's guess. The Bank of England and the UK Treasury are flying blind.

It is, perhaps, easier to forecast the UK economy's likely course over the next eighteen months, before the notional cut-off date for the UK's EU membership, than to form a view on its prospects thereafter. Even a near-term projection, however, is not free of political risk. After all, it cannot be entirely excluded that the May Government will be displaced before March 2019. The most reasonable assumption, though, is that the UK economy for the next several quarters will be primarily responsive to the economic influences that forecasters are used to incorporating in their forecasting models.

In this regard, it will probably be right to continue to accord a relatively low weight to Brexit concerns. The major source of error in many economic forecasts for 2016 and 2017 was the assumption that, surely, as dramatic a development as the Brexit referendum result would have an effect on the UK comparable with that of the 2008-09 global financial crisis. This concern was misplaced. To be sure, those who are anxious to rescue the credibility of their forecasts point to the 2016-17 weakness in sterling as the most striking consequence of the Brexit vote. The slide in the pound boosted import costs and consumer price inflation and thereby squeezed the real spending power of households. This argument, however, overlooks the fact that sterling started to fall several months before the Brexit referendum was called. It also brushes aside the consideration that the steepest part of the fall in sterling came in August last year when the Bank of England, somewhat precipitately, cut Bank Rate from 0.50% to 0.25% and resumed its market purchases of bonds. While the Bank's action was its response to the Brexit vote, it might well have desisted from those measures, in which case sterling might very well have shown greater resilience.

It is worth noting that this month's rise in the pound, back to its pre-August 2016 level, came not in response to growing optimism regarding Brexit but rather to the Bank's indication that it might raise Bank Rate in the near term. This is persuasive evidence that the conditions under which the UK economy is operating are still heavily influenced by the usual policy considerations, and are not dominated by the Brexit news.

Household spending has softened this year, but, relative to actual outlays, consumer confidence is holding up fairly well. This strongly suggests that households are experiencing a squeeze on their incomes and may be feeling over-borrowed. The surprise is that wage growth remains subdued despite apparent tightness in the labour market. But the effective supply of labour may well be greater than UK data indicate in a market where labour is internationally mobile. If so, the prospect of falling immigration may lead to slightly stronger wage growth. In any case, a slight relaxation of the cap on public sector pay and a further increase in the 'living wage' next April should impart upward impetus to average earnings, if only minor. If this combines with a slight easing in consumer price pressures, there could be scope for a modest upturn in household spending in the year ahead.

It is, however, unlikely that consumption will resume its role as the powerful engine of growth in the UK economy. A strong housing market would probably be a needed for that to happen. Yet, secondary housing activity appears to have entered a period of consolidation after the increase in activity amidst rapid price rises over recent years. Government measures, relating to stamp duty on house purchases, have probably played no small part in cooling this market. By contrast, primary housing activity, that is, housebuilding, has been recording solid year-over-year gains. It is Government policy to sustain this trend, especially through the construction of 'affordable housing'. This is likely to be a significant factor helping to support capital spending.

The outlook for business investment is harder to judge. There has been no shortage of warnings from the CBI and from leading companies of cutbacks in investment as Brexit approaches but this sense of alarm is not borne out by the findings of business surveys. These show that companies' investment intentions are being well sustained. Probably, there will be a hiatus in the investment spending of those international businesses that have used the UK as a base for supplying the whole of Europe. But there will also be companies that have supplied the UK from elsewhere in the EU; they must now think whether they should establish operations in the UK from which to supply the world's sixth largest economy. For many businesses, whose sales are largely domestic, Brexit will be a minor concern. The chief factor determining their investment decisions will be the state of the home market for the goods and services they supply.

On a longer view, the Bank of England Governor, Mr Carney, has said that monetary policy cannot counter the potential effects of Brexit in reducing economic growth. This is evidently not what the Bank thought last August, so Mr Carney's statement may reflect a general shift in Bank thinking in favour of a somewhat tighter monetary stance. It would in any case be dangerous for the Bank to try to buck what appears to be an international trend towards higher interest rates that the US Federal Reserve initiated earlier this year.

While some parts of the UK economy might suffer under a more restraining monetary regime, others might benefit. Those who depend on interest from their savings, for example, might find themselves better off. The differential impact of tighter policy is likely to bring changes in the pattern of consumption, with downward pressure on debt=dependent sectors such as autos and housing-related goods and services and a boost to demand for those goods and services purchased by pensioners.

A tighter monetary stance in the UK and elsewhere might also test the resilience of capital markets. It is not clear to what extent rising capital values in bond and equity markets since the global financial crisis have depended on expansive monetary policies. Possibly, they have owed more to central banks' 'quantitative easing' than to ultra-low short-term interest rates, though it is unlikely that low rates have had no effect at all. Consequently, rising short rates may well be accompanied by weaker momentum in equity markets and rising bond yields.

Weaker equity prices would tend to reduce the valuation of pension funds' assets. But the negative impact of such a development on the balance between funds' assets and liabilities would probably be outweighed by a reduction in the present value of their future liabilities, consequent on a rise in the long-term interest rate used to discount those liabilities. Only if the terms of Brexit precipitate a sharp fall in equity prices, which seems unlikely in view of the wide international spread of interests of the companies which contribute the greatest weight to the UK market, would serious deficits persist in the funds' balance sheets.

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