IHS MARKIT COUNTRY RISK

# Brexit – The Public Makes a Decision

4 November 2016

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## Implications

**On 23 June, the United Kingdom voted to leave the European Union by 52% to 48% on a 72% turnout, the highest for a national poll since the early 1990s. With no precedent for such a move, exact Brexit timelines and details regarding future UK-EU relations remain widely unclear. However, UK Prime Minister Theresa May intends to trigger Article 50 of the EU's Lisbon Treaty by March 2017 to begin formal negotiations on new trade relations as well as political and security collaboration after Brexit. This timeline is likely to be delayed following a High Court ruling in November saying that the UK government needs parliamentary approval for launching formal Brexit proceedings. In case the Supreme Court confirms the High Court's verdict in December, it is likely that parliament will have a much greater role in Brexit negotiations than previously envisaged by the government.**


## Summary:

- **The economy is currently proving pretty resilient following June's Brexit vote, which necessitates raising IHS Markit's GDP growth projections in our October forecast to 2.0% (from 1.9%) for 2016 and to 1.0% (from 0.7%) for 2017.**

- **More Bank of England stimulus now looks unlikely due to heightened inflation risks resulting from sterling's sharp fall. The Monetary Policy Committee moved from an easing to a neutral stance at their November meeting.**

- **The nature of upcoming negotiations depends on UK domestic politics, the country's administrative preparedness and external factors, such as pressure from the EU level and general elections in key EU member states (e.g. France and Germany) in 2017.**

- **In case the UK Supreme Court confirms the recent High Court ruling in December, parliament will have to approve Article 50 procedures. This could delay the government's timetable and Theresa May will likely have to disclose at least some parts of her Brexit strategy.**

- **The High Court ruling has also increased the likelihood of an early general election being called in 2017 in order to resolve potential parliamentary deadlock over Brexit from low to moderate.**

- **The UK government's disunity on what Brexit should look like and uncertainty around timings complicate risk-mitigation planning for both domestic and international businesses.**

- **The centre-left Labour Party faces a protracted internal crisis during which it will be difficult to challenge the Conservatives in parliamentary opposition.**

- **Brexit increases the risk of a new referendum on independence in Scotland, where 62% of the electorate voted to remain in the EU.**

**Indicators we are watching**

- Sterling's sharp fall in mid-October to a record low on its trade-weighted index, a 31-year low against the US dollar and a five-year low, complicates matters for the Bank of England. Indeed, the Bank of England has moved to a neutral policy stance, indicating that its next move in interest rates could be in either direction. IHS Markit believes that the Bank of England would likely only respond to sterling weakness by raising interest rates if the drop became rapid and disorderly.
- The ability of Theresa May to consolidate power within the Conservative Party, while the Labour Party is trying to resolve their intra-party challenges.
- Clear and comprehensive proposals for future UK-EU relations from the UK government ahead of formal Brexit negotiations planned to start around April 2017.
- Involvement of the UK parliament in forming the government's Brexit strategy.
- Although extremely unlikely, an officially recognised meeting between Nicola Sturgeon and a representative of an EU member state indicating that EU states are ready to seriously investigate legal options for Scotland to stay in the EU, while also remaining in the UK (the Council presidency has already stated that Scotland's status is an internal matter for the UK).

## Detailed Analysis

- **The economy is currently proving pretty resilient following June's Brexit vote, which necessitates raising IHS Markit's GDP growth projections to 2.0% (from 1.9%) for 2016 and to 1.0% (from 0.7%) for 2017.** The economy has been helped significantly by consumers' willingness to keep on spending amid still decent fundamentals, and the weakened pound lifting foreign orders for UK goods and services. A "flash" estimate indicates that the economy grew 0.5% q/q in the third quarter, which was only modestly down from 0.7% q/q expansion in the second quarter. We expect expansion of 0.3-0.4% q/q in the fourth quarter.

- **2017 is seen particularly difficult, although the economy will likely dodge recession.** The fundamentals for consumers will likely increasingly weaken as their purchasing power is diluted by rising inflation (up to a 22-month high of 1.0% in September from 0.6% in August), muted earnings growth and a softening labour market. Businesses will likely be very cautious over investment and employment, and their uncertainty is seen heightened when the government triggers Article 50 of the Lisbon Treaty and negotiations begin over the UK's future relationship with the EU, particularly trade and access to the Single Market. Additionally, a weakened pound is set to elevate companies' costs by lifting prices for imported oil, commodities and components. Companies will probably clamp down on pay increases as they seek to contain costs, which will add to the squeeze on consumer purchasing power that is expected to be exerted from a markedly weaker pound pushing up inflation. Likely limited housing-market activity and softer prices could also dampen consumer spending and as well as weighing down on residential construction. On the positive side, a markedly weaker pound should support UK exports, although we suspect lacklustre growth in the Eurozone will be a handicap. On the policy front, help to UK growth is coming from the Bank of England cutting interest rates to 0.25%, alongside reviving quantitative easing and other measures to loosen credit conditions. However, further Bank of England stimulus looks increasingly unlikely due to increased inflation risks. On the fiscal front, some stimulus measures will likely be announced in the Autumn Statement on 23 November now that the government has dropped its plans for a fiscal surplus by fiscal year 2019/20. This could include increased infrastructure spending. However, the weakness of the public finances effectively precludes major fiscal stimulus.

- **Activity may slowly improve during 2018, but growth will likely be limited for an extended period.** This assumes that uncertainty is sustained by the UK government only slowly making progress in its negotiations with the EU. Meanwhile, there is likely to be periodic political instability and uncertainty within the UK, particularly if major, aggressive disagreements break out in the government between policymakers facing a “hard” Brexit and those favouring a “soft” one. Over the long term, how the United Kingdom fares outside the European Union depends on many factors. This notably includes the extent of the trade agreements that are reached not only with the EU but also with other regions/countries; how much the UK is affected by non-trade barriers when exporting to the EU; the amount of deregulation that is undertaken in the UK; what immigration policy is followed, how the City of London’s role as a dominant financial centre is impacted; and how foreign direct investment into the UK is affected. It could take 5-10 years for all of these matters to be sorted. In the meantime, there is a very real risk that Scotland at least could leave the United Kingdom. This would substantially aggravate political and economic instability.

- **The nature of upcoming negotiations depends on UK domestic politics, the country’s administrative preparedness, and external factors such as pressure from the EU level, and general elections in key EU member states (e.g. France and Germany) in 2017.** The EU is very unlikely to grant the UK fully-fledged access to the Single Market while it restricts EU migration, as this is clearly incompatible with the EU’s “four freedoms” – the guarantee for free movement of goods, capital, services and people within the bloc’s internal market. While neither the UK nor the EU have indicated what their exact strategy for Brexit talks will be, this predicament to trade freely and without non-tariff barriers is likely to feature prominently at the core of negotiations.

- **A recent High Court judgment increases the likelihood that pro-EU legislators in both chambers of parliament will play a significant role in shaping the nature and timeline of Brexit talks.** In the event that the Supreme Court adopts the same position as the High Court, the UK government will likely have to provide greater clarity on exactly what the UK will aim for in Brexit negotiations to secure parliament’s support for triggering Article 50. MPs opposed to a 'hard Brexit', where the UK subordinates access to the EU’s Single Market to full control of migration, will likely put hurdles in the government’s way if it does not soften its initial Brexit strategy and definition of future UK-EU relations. If May and her cabinet refuse to do so, Article 50 is unlikely to be triggered in accordance with the government’s current timetable for exiting the EU.

- **The High Court ruling has also increased the likelihood of an early general election being called in 2017 from low to moderate in order to resolve potential parliamentary deadlock over Brexit.** In addition, a leadership challenge to May has become more feasible as she will come under attack from hard Brexiteers in her own Conservative Party if she gives in to legal and parliamentary pressure leading to a change in strategy. Although May has repeatedly stated that she does not wish to call an election, it would be tempting for the Conservatives to try to benefit from the current intra-party turmoil of Labour. The Fixed-term Parliaments Act 2011 makes the dissolution of parliament possible only with two-thirds backing (433 votes) for an early election by the 650-member House of Commons or in the event of a no-confidence vote in the government and if an alternative administration is not confirmed by the Commons within 14 days.

- **Notwithstanding the upcoming Supreme Court ruling on whether the government has the power to unilaterally trigger Article 50, the envisaged timeline to finalise Brexit talks by 2019 remains unlikely to be realistic and business as well as investor uncertainty will prevail for several years to come.** May said she would set before parliament a “Great Repeal Bill” to overturn the European Community Act 1972, which would end the supremacy of EU law. This would not come into force until the UK ceases to be an EU member state though. In addition, IHS Markit currently does not anticipate major legal changes in the initial years following Brexit as the government indicated that it does not intend to overturn en bloc EU laws that have been harmonised with UK legislation over the last four decades. This is likely to mitigate parliamentary opposition to the passage of the bill.

- **The UK government’s disunity on how Brexit should look complicates risk-mitigation planning for both domestic and international businesses.** May’s efforts to reconsolidate her divided party in the run-up to negotiations with the EU are an essential first step to present a clear and effective plan for future trade relations, as well as political and security collaboration with the bloc. While regulatory and legal uncertainty remains high for both domestic and international businesses operating in the UK, the apparent lack of administrative preparedness, and of a common government view on the most-favoured final agreement with the EU, is likely to further limit companies in timely adjusting their mitigation plans for Brexit. This would likely to become even more complex in case the Supreme Court allows for a vote in parliament to approve the launch of Brexit talks. Sectors with high exposure to foreign workers, such as the financial and insurance industries, construction, agriculture, hospitality and research and development, will be particularly affected by the government’s plans to end the free movement of workers from the EU.

- **The centre-left Labour Party faces a protracted internal crisis during which it will be difficult to challenge the Conservatives in parliamentary opposition.** Significant differences between the pro-business and pro-EU "New Labour" faction and the socialist and pro-union wing of the party have become more pronounced under its current leader Jeremy Corbyn. In this context, many prominent members of the Labour Party are highly critical of Corbyn's views on foreign and defence policy, the EU, NATO and the UK's nuclear programme, as well as his calls for the nationalisation of the railways and energy companies. Labour's internal divisions have increased the risk of causing a split of the party into a left-wing faction supporting Corbyn and a more centrist political entity. This risk is particularly high in the context of envisaged electoral district boundary changes, aimed to reduce the total number of MPs from 650 to 600, due to take effect at the 2020 election.

- **Brexit increases the risk of a new referendum on independence in Scotland, where 62% of the electorate voted to remain in the EU.** It is highly unlikely that the EU would officially support continued Scottish membership of the EU if it is not an independent country, given strong opposition to separatism from member states such as France and Spain. In addition, a new legally binding referendum on Scottish independence could only happen if agreed by the UK and Scottish governments, unlikely amid the current uncertainty. IHS Markit’s current view is that the Scottish executive will probably seek to use the threat of a further non-binding referendum in Scotland (similar to that held in Catalonia in 2014) to extract some concessions from the UK government. Most likely, they will seek inclusion in the Brexit negotiating team, and expanded tax-raising powers. The majority of voters in Northern Ireland also voted to remain in the EU, and Sinn Féin has called for a referendum on a united Ireland. That is equally unlikely to take place during the current parliament, and is highly unlikely even after 2020.