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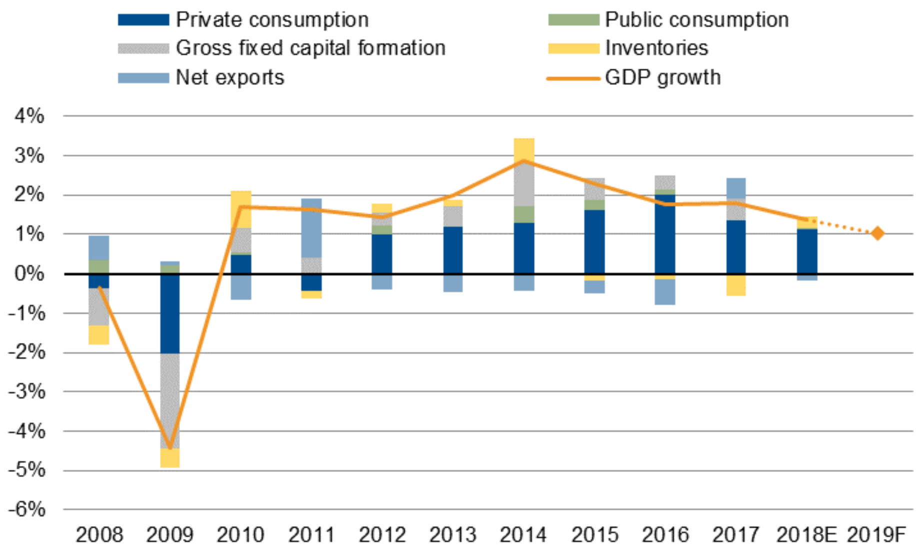
Brexit-hit investment, weak exports and consumer spending show growing impact on UK economy

Brexit uncertainty and a slowing global economy continue to weigh on Britain's growth, with any extension to UK-EU negotiations exacerbating the cumulative adverse impact on output, says Scope Ratings.

Scope identified in 2018 three factors contributing to a deeper slowdown in the economy of the UK (AA/Negative): i) declining investment related to the prolonged uncertainty over Brexit, notably visible in financial-services companies cancelling investment or shifting it abroad; ii) a weaker export sector against a backdrop of global trade disputes; and iii) less dynamic consumer spending.

Growth in the UK eased to 0.2% QoQ in Q4 2018. For the full year, growth declined to 1.4% in 2018, from 1.8% in 2017 and an average of 2.0% a year over 2010-17. Scope expects growth of just 1% in 2019.

Figure 1: UK growth by expenditure component, %YoY



Source: Office for National Statistics, Scope Ratings GmbH

"Prolonged economic uncertainty has had a gradual, but undeniable impact in setting back growth, even if the UK avoids in the end a no-deal Brexit as we expect it will," says Dennis Shen, analyst at Scope. "The cost of the divorce process would nonetheless continue to accumulate were negotiations extended past 29 March – via an Article 50 extension and/or even if the UK were to leave the EU in time with a deal but with uncertainty set to continue during the transition phase."

The UK Treasury published its assessment last November that a no-deal exit could entail an 8.0%-10.7% loss in GDP after 15 years considering the effect on trade, migration and regulation compared to today's arrangements inside the EU. Scope has estimated that the cost to the economy of Brexit, even were a no-deal outcome to be avoided in the end, is already higher than 1% of GDP since the June 2016 referendum even before the UK's scheduled EU departure. The costs of uncertainty, including the impact on the country's long-run growth potential, inform Scope's Negative Outlook on the UK's ratings.

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Under this existing economic backdrop, Scope reviews where the three previously outlined drags on growth stand:

1. **Shrinking investment:** Business investment growth was only -0.9% YoY in 2018, the weakest annual figure since 2009. The CBI's sentiment indicator was just off of post-referendum lows in January 2019. Industry is feeling the impact: Nissan and Honda made headline-grabbing announcements to curtail production plans in the UK. However, the financial sector is a core concern. About 5,000 financial-services jobs could be moved by March 2019, according to the Bank of England. Extended uncertainty may easily facilitate additional relocations after March given that the Brexit end-state will *not* be decided by next month. Some of this lost investment is permanent.

   Offsetting this to an extent, an increase in inventories contributed 0.3% to growth in 2018 – tied to contingency stockpiling. This temporary growth boost, however, will endure only while the immediacy of concerns surrounding a no-deal exit looms. Were concerns to be alleviated even temporarily via an agreement kicking the can down the road, the immediate unwind of elevated inventories would hit GDP growth.

   Meanwhile, significant net FDI inflows that averaged GBP 113bn a year between 2014-16 – more than covering the UK's current account deficit – have dried up. They amounted to just GBP 19.5bn over the seven quarters between Q1 2017 and Q3 2018, making the UK more dependent on portfolio and debt inflows.

2. **Less dynamic exports:** Strong export performance helped explain the resilience of the UK economy after the 2016 Brexit vote, as Britain escaped the technical recession feared by many forecasters. A post-referendum 15% depreciation in sterling in nominal effective terms helped. However, the slowdown in European and global growth since 2018 has spread to the UK export sector, exacerbating weakness in the domestic economy. Net exports cut 0.2pp from annual growth in 2018, compared with a contribution of 0.5pp in 2017. The effects of earlier sterling depreciation on manufacturing export growth are moreover fading.

3. **Tightening consumer constraints:** The jobless rate remained stable at around 4.0% in the three months to December 2018 and high wage growth of 3.4% YoY (December 2018) has outpaced inflation (of 1.8% in January 2019). However, household consumption growth eased modestly to 1.9% YoY in 2018 from 2.2% YoY in 2017 and 3.2% in 2016. Alarmingly, consumer confidence in January fell to its lowest level since 2013. Unsecured consumer lending – which has buoyed consumption – has eased under regulatory scrutiny, with loan extension up only 6.6% YoY in December. Brexit uncertainty has moreover contributed to a soft housing market – weakening the sense of wealth gains on the part of households.

"Economic weakness will endure in 2019 – probably including below-potential growth," says Shen. "At the same time, the UK maintains important credit strengths, which support the AA sovereign rating, among them sterling's status as a global reserve currency, a very long, 15-year average maturity of government debt and comparatively low annual gross government financing requirements, plus a modest fiscal deficit of just above 1% of GDP."

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