Brexit: One Year Later

One year ago, on June 23, 2016, the majority (small at 51.9%) of the British opted, through a referendum, for the United Kingdom to leave the European Union (EU). This decision sent a shock wave through several financial markets. The situation generally calmed over the following weeks and, contrary to some scenarios established immediately after the referendum, neither the British economy nor the euro zone economy collapsed during 2016.

However, this decision by the British left some very clear marks. First, the political situation has changed significantly in the United Kingdom. Then Prime Minister, David Cameron, was replaced by Theresa May, who, after the recent election on June 8, found herself with a fragile minority government, as the Labour opposition strengthened. Second, in terms of the markets, the British pound remained generally fairly low after the dive triggered by the decision of the referendum. Compared with June 23, 2016, it has depreciated 14.5% against the U.S. dollar, and 13.0% against the euro.

From an economic perspective, the resilience of the British economic condition throughout 2016 is worth noting. Boosted by favourable monetary conditions, including the depreciating currency and monetary policy softening by the Bank of England (BoE), growth continued at a good pace. Much better than feared the day after the referendum. Another positive factor is that it quickly became clear that there wouldn’t be an immediate break, and that the process leading to Brexit would be long.

However, this resilience is now faltering. After average growth of 2.4% from spring to fall 2016, British real GDP only increased 0.7% (annualized) in the first quarter of 2017. Estimates for the second quarter do not suggest a recovery either. We also note that incomes are stagnating while inflation, bloated by the depreciation of the pound, greatly accelerated. Total inflation was 2.9% in May, by far the strongest among the G7. We have also observed some weakness in retail sales.

IMPLICATIONS

Clearly, what happens next essentially depends on negotiations with the EU on the terms of Brexit. These talks began on June 19, and we already sense a somewhat weakened position for the British negotiators; a direct consequence of Theresa May’s losing electoral gamble. They wanted to negotiate the exit from the EU and a future free trade agreement at the same time. It has now been decided that, before addressing the question of trade, there should be significant advancements on three points, namely 1) the status of European citizens in the United Kingdom and of British citizens in the EU; 2) the exit fee that could rise up to €100B (C$148.6B); 3) the terms of the United Kingdom’s exit. At the same time, the political fragility of the British government means that a Hard Brexit without a trade agreement is less probable.

Lastly, it is now fairly clear that the British economy has been weakened by last year’s decision. In this context, the BoE is confronted with a dilemma where inflation is well above the comfort zone of the central bank’s leaders, and at the same time, the economy is slowing and uncertainties abound. As BoE Governor Mark Carney recently reminded, “the timing is not right for an interest rate rise,” despite opposing voices even from within the institution he heads.

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