ECONOMIC VIEWPOINT

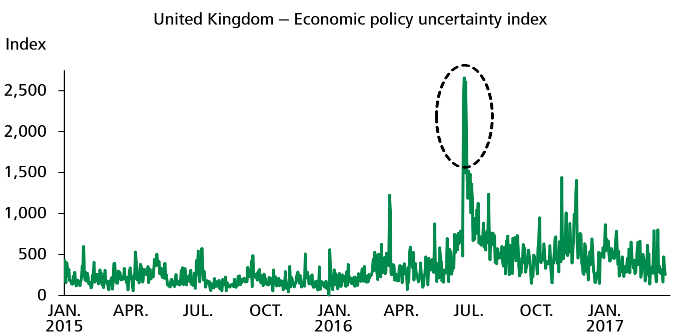
Will the British Economy's Stunning Resilience Last?

The Start Signal for Brexit Negotiations Is Given

Immediately after the referendum on June 23, 2016, there was substantial fear that Britain's economy would slump. However, the economy has done much better than expected, helped by the pound's depreciation, among other factors. Expectations increased, but we still expect the uncertainty surrounding Brexit to affect the United Kingdom, sooner or later. The impact of price increases on households' real spending is already one sign of the coming weakness. The scope of the fallout from the Brits' decision will be clearer once we know what happens with the negotiations now getting underway between London and the other European capitals.

On June 23, 2016, the Brits generated a major shock. The majority vote in favour of taking the United Kingdom out of the European Union (EU) flew in the face of most of the polls and many experts' opinions. It came as a complete surprise and the markets reacted accordingly. Stock prices plunged, not just in London, but in the world's other major stock markets as well. The pound quickly fell. U.K. bond yields also declined, to reflect the lower growth outlook and price in more accommodative monetary policy. The volatility indexes climbed, as risk and uncertainty made it back into the financial and economic headlines (graph 1).

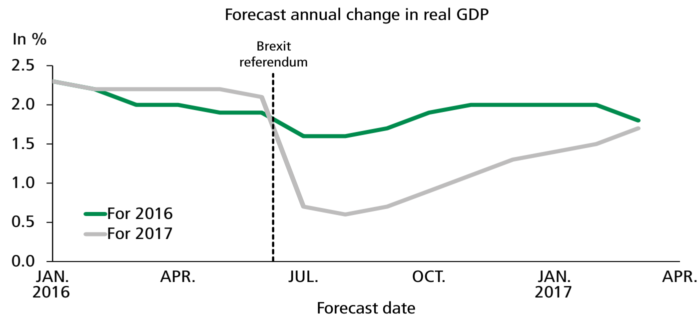
GRAPH 1
The referendum outcome pushed anxiety up



Sources: policyuncertainty.com and Desjardins, Economic Studies

The economic outlooks were also downgraded. The results of the consensus surveys released over the summer put the growth forecasts for British real GDP in 2016 and 2017 lower than they had been previously (graph 2). The main international organizations also adjusted their outlooks. In April, the International Monetary Fund (IMF) had been predicting 1.9% growth for the U.K.'s economy in 2016, and 2.2% in 2017. These forecasts changed to 1.7% and 1.3% in July.

GRAPH 2
The forecasts were promptly lowered after the referendum, but then later raised



Sources: Consensus Forecast and Desjardins, Economic Studies

As of July, a few economic indicators started to paint a bleak picture of the situation. Consumer confidence indexes deteriorated substantially. The PMI indexes lost points, dropping below 50, the cut-off point between economic growth and contraction. The outlook also worsened for the real estate market.

Better Growth Than Anticipated

Despite its difficulties, Britain's economy did not slump and the indicators quickly recovered as of the end of the summer. The solid real GDP growth posted by the United Kingdom in the

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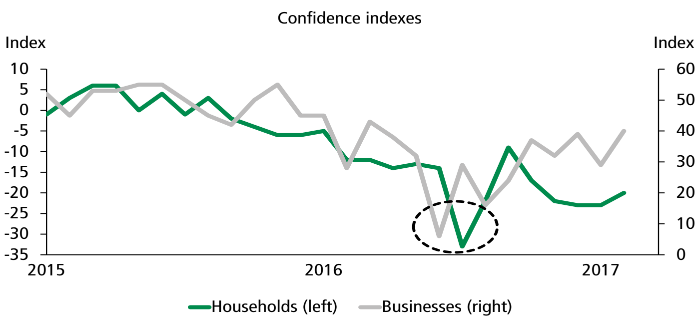
second quarter (before the referendum, but published in July) showed that the economy already had good momentum. The business and consumer confidence indexes quickly bounced back (graph 3). The stock market got back to its pre-referendum level.

GRAPH 3
Consumer and business confidence rose



Sources: GfK, Lloyds and Desjardins, Economic Studies

A number of factors lessened the negative effects that were feared. Firstly, it quickly became clear that the Bank of England would try to help the U.K.'s economy cushion the shock. Secondly, while several financial indicators bounced back, the pound remained low (graph 4). This helped exporters regain confidence despite the risks associated with a potential divorce from the rest of Europe (graph 5). The pound's depreciation also seems to have boosted tourism, especially toward year's end (graph 6). Purchases made by travellers jumped after the referendum.

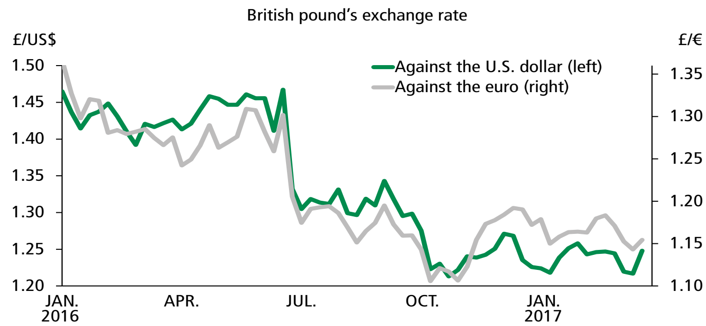
Political Breather

The political situation was also less complicated than expected. Given the results of the June 23 vote, Prime Minister David Cameron was clearly going to lose his job. A fight to the death for the job of leader of the Conservative Party was expected to start, and last several months. However, a few days later, Theresa May was named party leader and Prime Minister. One source of uncertainty was gone. Secondly, the new Conservative government formed by Theresa May quickly signalled it would take its time before officially triggering Article 50 of the Treaty on EU, the article that triggers a country's exit process. This respite allowed economic agents to breathe and better assess the outlook. The fears over Brexit thus shifted from a very short-term factor to a medium-range factor, given that it is expected to take two years from the time formal negotiations begin to achieve the exit.

In the End, 2016 Was Fairly Good

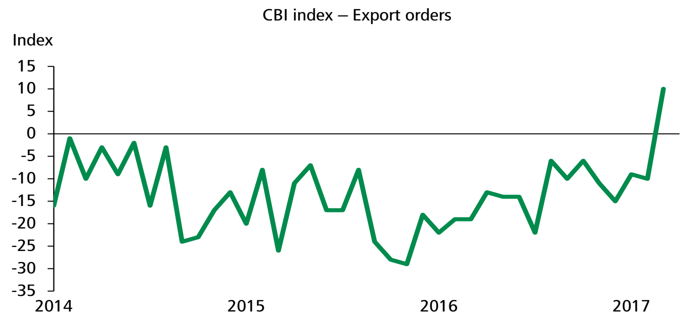
While, at its worst, the consensus forecast was calling for U.K. GDP growth of 1.6%, and the IMF and Organisation for Economic Co-operation and Development (OECD) had lowered

GRAPH 4
The pound remained weak after the initial shock



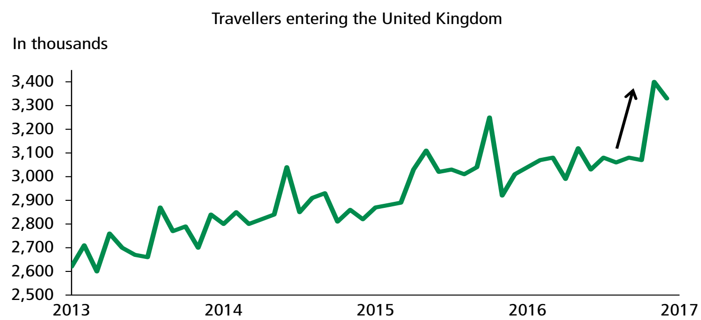
Sources: Datastream and Desjardins, Economic Studies

GRAPH 5
The pound's drop helps exporters



Sources: Confederation of British Industry and Desjardins, Economic Studies

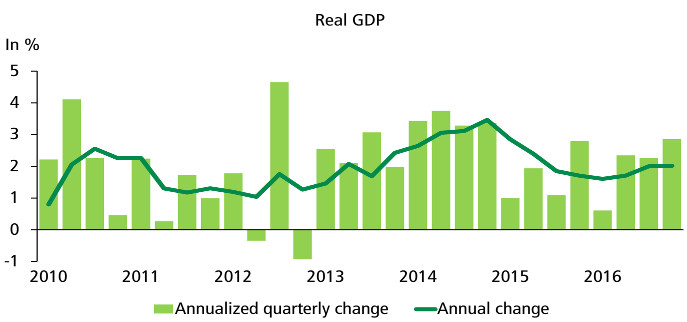
GRAPH 6
The pound's depreciation also helped tourism



Sources: Office for National Statistics and Desjardins, Economic Studies

their projections to 1.7%, for 2016 as a whole, growth was 1.8%. This is better than expected, but also below 2015's 2.2% and 2014's 3.1%. Note that average real GDP growth was stronger in the second half of the year than the first, mainly due

GRAPH 7
The U.K.'s economy is resilient

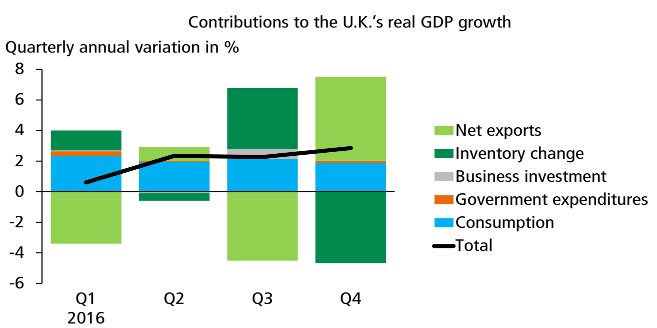


Sources: Office for National Statistics and Desjardins, Economic Studies

to the fourth quarter's strong annualized quarterly 2.9%, the most growth since the fall of 2014 (graph 7).

Throughout the year, real GDP growth primarily came from the solid contribution by consumer spending (graph 8). The annual change in households' real expenditures was 3.0% in 2016, the biggest increase since 2004. In the year's final quarter, net exports also gave growth substantial support, backed by the pound's depreciation (and a surge in tourism) and a general increase in global trade at the end of last year. Note, however,

GRAPH 8
Consumption was the main factor supporting real GDP growth in 2016



Sources: Office for National Statistics and Desjardins, Economic Studies

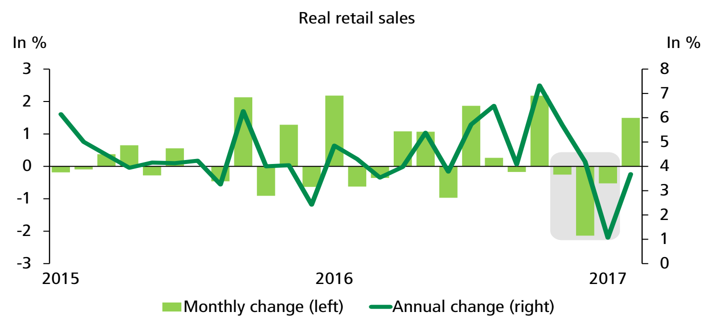
that business investment weakened in 2016 from 2015, going from a strong 6.1% increase to just 1.4%.

The good year-end and the British economy's previous resilience prompted an increase to the forecasts for this year. For 2017, the consensus is now calling for real GDP growth of 1.7% in the United Kingdom compared with the forecast of just 0.6% made last summer.

Signs of Weakness

Although the British economy is showing resilience, it is not completely impervious. We've already seen somewhat anaemic investment. The risk of a steeper slowdown now involves the health of consumption, which is already showing signs of weakness. Consumer confidence already seems to have lost momentum since the post-referendum rebound. In the last few months, growth by real retail sales has slowed sharply, recording three consecutive monthly declines from November to January (graph 9). It rebounded in February, but the trend remains

GRAPH 9
Retail sales declined at the turn of the year

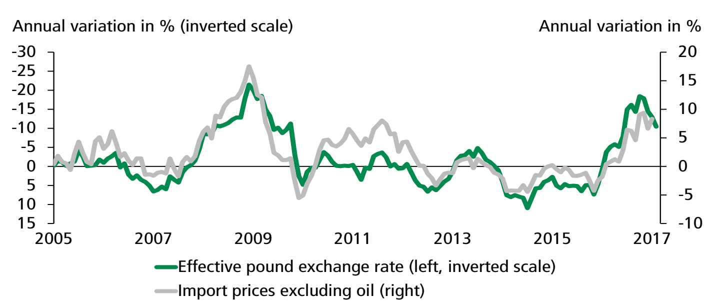


Sources: Office for National Statistics and Desjardins, Economic Studies

worrisome and, after two months, the carryover for the first quarter is -4.2%.

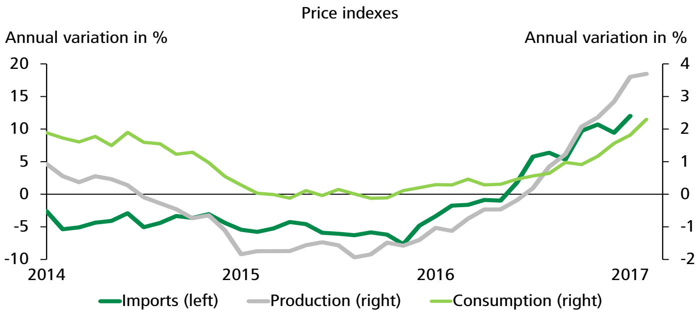
One reason for the weakness is the increasingly strong surge by prices in the United Kingdom. As in most of the advanced nations, in recent years, and into 2016, consumer prices had been on a downward slope and flirting with deflation. Oil prices certainly had some responsibility for the situation, which several central banks were concerned about. While prices have started to go up again in many places, the situation seems more pronounced in the United Kingdom. The new inflationary pressure is primarily feeding off the pound's depreciation, which is having a direct impact on prices for imported goods (graph 10). A similar situation arose during the Great Recession. In turn, the increase in import prices (year over year, they are up more than 10%) is starting to affect producer and consumer price indexes

GRAPH 10
The pound's decline pushed import prices up



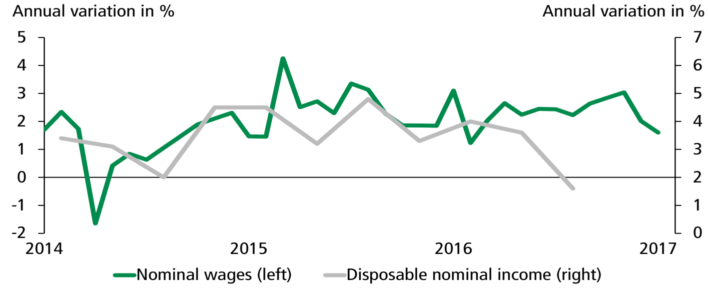
Sources: Bank of England, Office for National Statistics and Desjardins, Economic Studies

GRAPH 11
The rise in import prices is now affecting producer and consumer prices



Sources: Office for National Statistics and Desjardins, Economic Studies

GRAPH 12
Household income is not accelerating

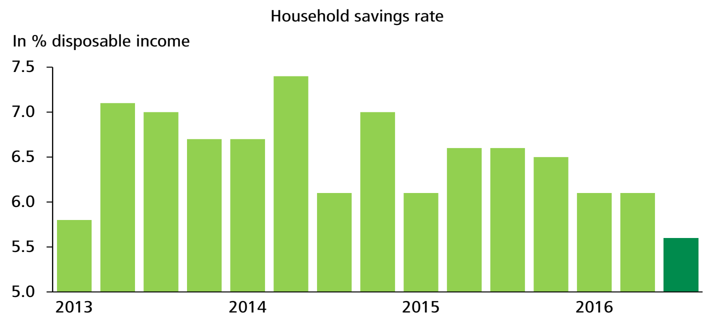


Sources: Office for National Statistics and Desjardins, Economic Studies

(graph 11). We are now seeing the strongest inflation in nearly four years.

However, the reflation is not really being echoed in household income. Although the British job market is doing well, wages have been fairly stable for some time (graph 12). Rising prices are therefore increasingly eating into consumers' disposable income. For a while, especially if consumers remain confident, they can deal with that by doing less saving. This is what has been happening in the United Kingdom recently (graph 13). The weakness on the savings side is also being reflected in stronger credit demand, and the pace of consumer lending growth is currently high in the United Kingdom, back to where it was in the early 2000s (graph 14).

GRAPH 13
The savings rate is already dropping

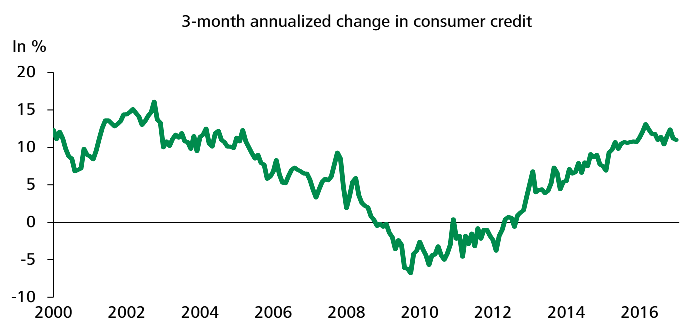


Sources: Office for National Statistics and Desjardins, Economic Studies

Threats of Relocation

We have already mentioned the weakness in business investment. However, the threat Brexit poses to the European operations of businesses located in the United Kingdom could be even more harmful. We do not know what the new trade agreement between the United Kingdom and the EU will be. The status of the European workers located in the United Kingdom is also making it difficult for businesses to manage their human resources. Business people may be patient and wait to learn more before making decisions about the scope of their British operations. However, others are already more worried. London's position as Europe's financial capital is in jeopardy and several major financial institutions have already announced that they may transfer some of their operations, in particular to Frankfurt, Germany or Dublin, Ireland. In manufacturing, auto industry businesses have also raised the possibility of moving operations to the continent.

GRAPH 14
Consumer credit has accelerated



Sources: Bank of England and Desjardins, Economic Studies

The Future Depends on the Negotiations

The British government's invocation of Article 50 of the Treaty on EU on March 29, 2017 is the official notice of the U.K.'s decision to leave the EU. This is the starting point for the negotiations, which should take about two years. It is the outcome of the negotiations that will give us an idea of Brexit's actual economic price tag. We can reasonably assume the negotiations will be arduous, even if the parties gather around the table in a spirit of good will. The EU has already mentioned financial claims: according to Jean-Claude Juncker, President of the European Commission, the "exit bill" for the United Kingdom will be at least €60B.

Negotiations between the EU and the United Kingdom are generally expected to unfold in two stages, and yield two separate agreements. The first will deal with the United Kingdom's withdrawal. Among other things, it should include the issue of financial claims, details on the end to Britain's participation in common institutions, and answers regarding the 3 million Europeans who have settled in the United Kingdom and 2.5 million Brits living in EU nations. The second agreement should focus specifically on the trade ties that will bind the two parties after the divorce. The extent of these ties is a critical factor in gauging Brexit's potential economic impacts. There is a very big difference between nearly total access to the European common market, a more limited free trade agreement, and limited access governed by World Trade Organization rules. Therefore, while uncertainty has waned substantially since the referendum decision, it could come back to haunt the markets and the economy if it becomes clear that the negotiations are failing and a "hard Brexit" becomes the core scenario.

The Scottish Question

Britain's government will also have to deal with the Scottish issue. In the June 23, 2016 referendum, a majority of Scots opted to keep the United Kingdom in the EU. Note that, in the September 2014 referendum on Scottish independence, one of the "stay in the United Kingdom" camp's main arguments was membership in the EU. The "no" vote was supposed to be final, but Brexit has changed the situation. Scottish nationalists, led by Prime Minister Nicola Sturgeon, are now demanding another referendum on Scotland's independence, to be held between fall 2018 and spring 2019.

Caution and Realism

The Brexit issue and its political, economic and financial impact is far from settled. The months that followed the June 2016 decision, however, showed that the short-term economic forecasts associated with this type of event are not guaranteed, and the equation contains many unknowns. At the same, the financial markets' rapid reactions do not perfectly reflect movement by the main financial variables in later weeks and months. We can see that the markets, the economy and the institutions are playing their buffer role relatively well. The pound's decline, fuelled by concerns and the prospect of lower interest rates, was one of the key factors that allowed the U.K.'s economic growth to hold up.

That being said, while the very short-term expectations proved to be too gloomy, the medium- and long-range expectations continue to point to potential difficulties. The risks have simply shifted in time. Dark clouds still loom over British growth and, at the start of the negotiation process, it is too early to see if they will dissipate.

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