ECONOMIC VIEWPOINT

Brexit Is Coming… but the Uncertainty Will Continue

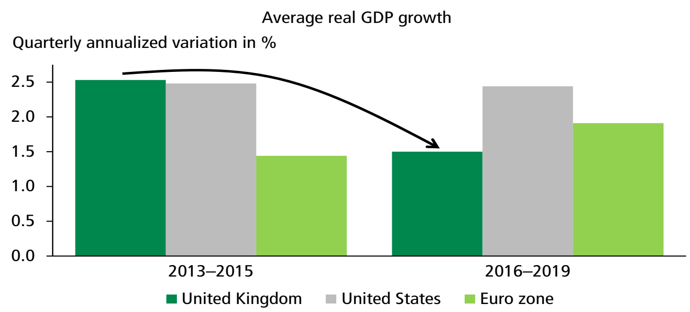
The United Kingdom will officially leave the European Union (EU) on Friday, January 31, at 11 p.m. London time. This saga, which began with the June 23, 2016 referendum, will not end then, however. The divorce will become official, but from an economic standpoint, little will have really changed on February 1, given that the transition period is expected to last until the end of 2020. This transition period will be used to negotiate the future economic ties between the EU and the United Kingdom, among other things. The effects of Brexit on the economy therefore depend on these negotiations. In the short term, the as-yet-unknown conclusion of these negotiations may fuel uncertainty. In the medium term, the closer the relationship between the two economies remains, the more moderate the negative effects of Brexit will be.

The British Economy since 2016

The start of the 2016 referendum campaign immediately increased economic uncertainty in the United Kingdom (graph 1) and that uncertainty then spread to the British economy. Before the referendum, Britain's economy was one of the strongest among the leading advanced nations. But from 2016, the U.K.'s real GDP underperformed those in the euro zone or the United States (graph 2).

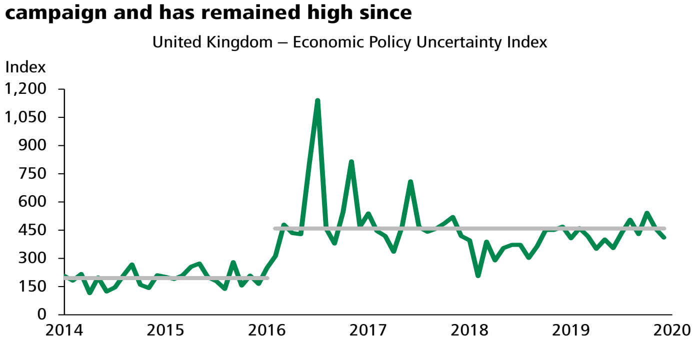
It also bears noting that the likelihood of recessions as perceived by Bloomberg consensus forecasters increased and has remained relatively high (graph 3). It took the outbreak of a trade war for the probability of a recession in the euro zone or the United States to reach comparable levels to those of the United Kingdom.

GRAPH 2
Growth has slowed markedly since 2016 in the United Kingdom



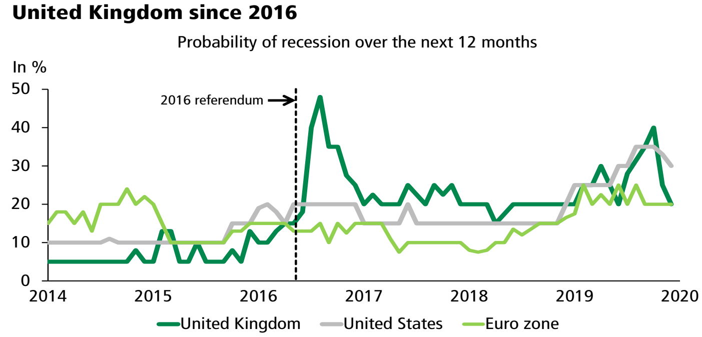
Sources: Office for National Statistics, Bureau of Economic Analysis, Eurostat and Desjardins, Economic Studies

GRAPH 1
Uncertainty increased at the start of the 2016 referendum campaign and has remained high since



Sources: policyuncertainty.com, Datastream and Desjardins, Economic Studies

GRAPH 3
The probability of a recession has been higher in the United Kingdom since 2016



Sources: Bloomberg and Desjardins, Economic Studies

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It appears to be mainly business investment that has slowed in recent years (graph 4). The contrast is also striking when comparing the evolution of British investment with that of other countries (graph 5).

The labour market has not been too affected by this uncertainty. The unemployment rate has fallen significantly in recent years, from 5.2% at the end of 2015 to 3.9% in the fall of 2019. That said, there has been a slowdown in job growth since 2016 (graph 6). One of the reasons for this divergence may be the slow growth of the labour force. Like other advanced countries, the United Kingdom is experiencing an aging population, but the movement may have been exacerbated by a slowdown in net migration since the referendum (graph 7).

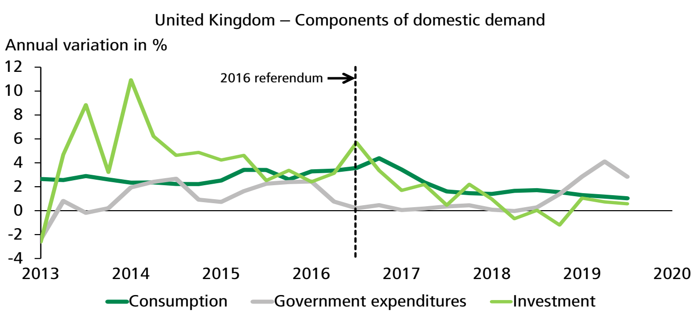
2019: The Year of Deferrals

After a lull in 2018, uncertainty increased over the course of 2019. Throughout the entire year, much of the attention was focused on Brexit. Initially, the official date for leaving the EU was to be March 29, 2019, two years after the British government invoked Article 50 of the Treaty on European Union.

As the British parliament was not able to pass the agreement negotiated between Theresa May's government and the EU, the risk of a no-deal Brexit had increased significantly by the end of winter 2019. To avoid this possibility, an initial postponement of the Brexit deadline took place, pushing the date to April 12. Still in a parliamentary deadlock, a second postponement was requested by the British to push the date to June 30, but instead the EU granted a deadline of October 31. The continuing impasse led to a further extension to January 31, 2020, and to a general election held on December 12.

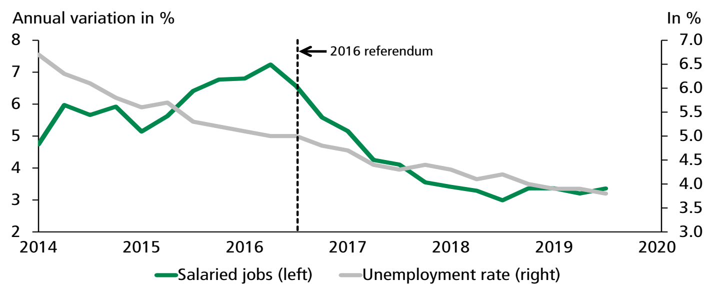
The arrival of the first Brexit deadline caused significant fluctuations in the economy. Businesses made preparations to leave the EU, primarily by stockpiling inventory to avoid post-Brexit complications. This additional demand temporarily supported supplier production and real GDP, which grew at an annualized rate of 2.5% in the first quarter of 2019—its best growth since fall 2016. However, a pullback quickly emerged, with real GDP falling by 0.7% in the second quarter, the first negative result since the end of 2012 (post-Olympic decline). The

GRAPH 4
Consumption has proven to be more stable than investment



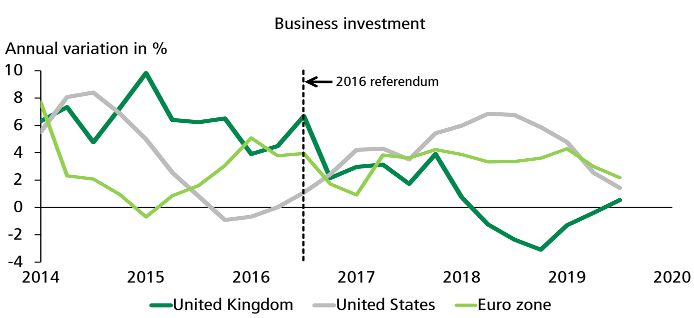
Sources: Office for National Statistics and Desjardins, Economic Studies

GRAPH 6
The unemployment rate fell despite slower job creation



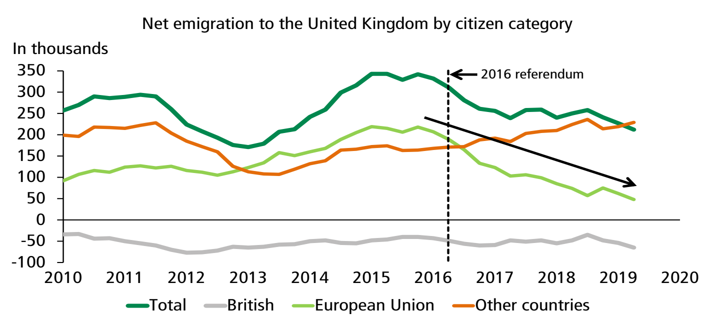
Sources: Office for National Statistics and Desjardins, Economic Studies

GRAPH 5
Uncertainty has hurt U.K. business investment



Sources: Office for National Statistics, Bureau of Economic Analysis, Eurostat and Desjardins, Economic Studies

GRAPH 7
Emigration from the European Union has fallen significantly



Sources: Office for National Statistics and Desjardins, Economic Studies first three quarters of 2019 showed large variations in inventories and net exports (graph 8).

At the time of writing, fourth-quarter growth was not yet known. However, monthly October and November data for most indicators, including monthly GDP, point to a small variation and possibly a negative result (graph 9).

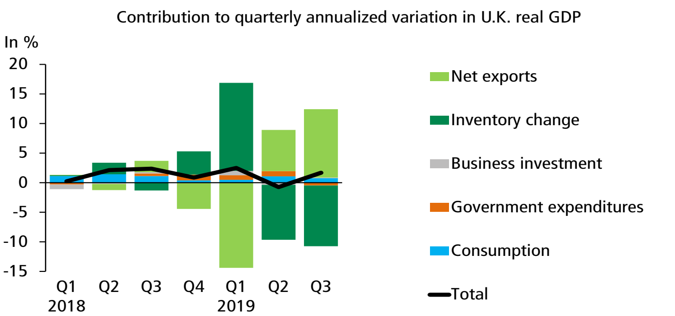
Household and business confidence was relatively low for most of the year. The PMI indexes have also fallen below 50 (graph 10). It's not abnormal that the manufacturing index has fallen, given that most economies experienced a decline due to the rise in trade tensions. However, the United Kingdom is characterized by more problems for its services sector (graph 11).

The Positive Effects of Having Avoiding the Worst

As can be seen in recent developments in the PMI indexes, certain indicators have improved lately. These gains are most evident in the industrial and CFO confidence indexes (graph 12).

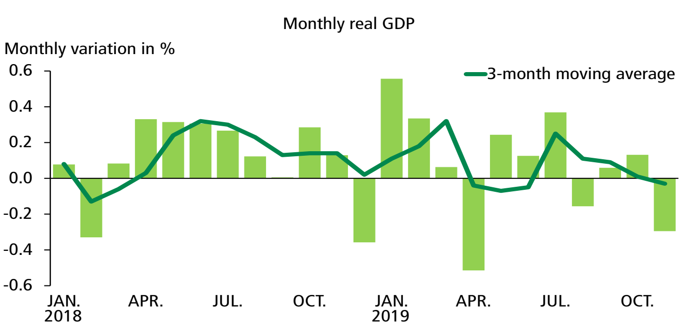
Where does this nascent improvement come from? The source is likely the election result on December 12 that saw Boris Johnson's Conservative win a strong parliamentary majority. It provides clarity with the government's firm resolve to go ahead with Brexit, without parliamentary hindrance. The adoption of the Brexit Act has allowed a no-deal Brexit by January 31 to be set aside, thus avoiding a worst-case scenario for the British economy. Boris Johnson's victory over Labour candidate

GRAPH 8
Brexit preparations have led to big movements in inventories and net exports



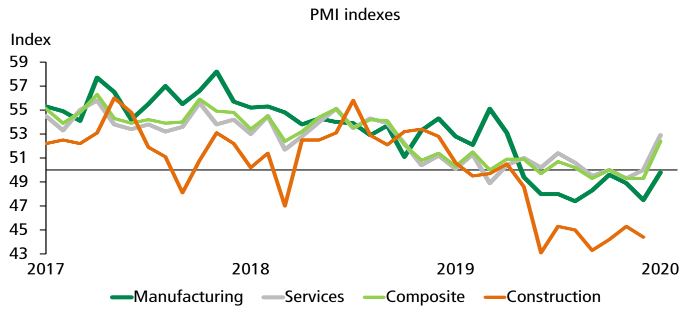
Sources: Office for National Statistics and Desjardins, Economic Studies

GRAPH 9
U.K. monthly GDP has been particularly weak in recent months



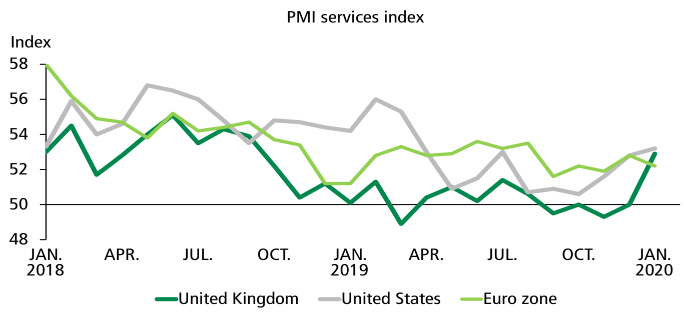
Sources: Office for National Statistics and Desjardins, Economic Studies

GRAPH 10
U.K. PMI indexes have all fallen below 50 in 2019



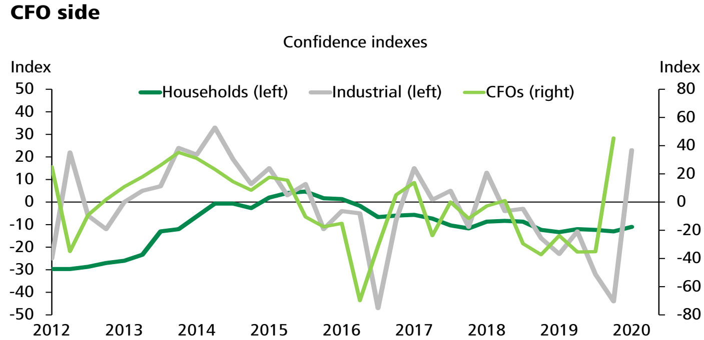
Sources: IHS/Markit, Datastream and Desjardins, Economic Studies

GRAPH 11
Unlike the United States and the euro zone, the United Kingdom has seen its services PMI contract



Sources: IHS/Markit, Datastream and Desjardins, Economic Studies

GRAPH 12
Confidence indexes are starting to improve, particularly on the CFO side



Sources: GfK Group, Confederation of British Industry, Deloitte and Desjardins, Economic Studies

Jeremy Corbin was also viewed favourably, as the latter's rather left-wing agenda worried businesses and investors.

Make Way for the Transition Period

The agreement negotiated between Theresa May's government and the EU (and partly renegotiated by Boris Johnson's administration) provides for a transition period that will take place as soon as Brexit begins and is expected to last until December 31, 2020. This period means that on the economic side, there will be no real change on the morning of February 1; the United Kingdom will continue to be part of the common market and no tariff or non-tariff barriers or customs will arise overnight. British companies will continue to have full access to the European market and vice versa and they will also have to continue to apply EU regulations and law.

However, on the political side, the changes will be more important, as the United Kingdom will stop participating in European institutions. There will be no more British members in the European Parliament, neither in the European Council (meeting of heads of government), nor in the European Commission and its committees. Yet decisions from these institutions will continue to apply in the United Kingdom during the transition period.

The Return of Negotiations... and Uncertainty?

The main raison d'être of the transition period is to be able to negotiate the future ties between the EU and the United Kingdom. The scope of the possible ties is rather broad, but some options are already being ruled out by the Johnson government. For example, according to Chancellor of the Exchequer (Finance Minister) Sajid Javid: "There will not be alignment, we will not be a ruletaker, we will not be in the single market and we will not be in the customs union." The United Kingdom is therefore ruling out the ties that would bring the least trade friction and which would probably be the easiest to negotiate.

The British government and the EU must therefore negotiate, adopt and implement a new trade agreement in 11 months. This is already a major challenge, because there are no European examples of major trade treaties that have been negotiated in such a tight time frame. One possible reference for post-Brexit ties, the Comprehensive Economic and Trade Agreement (CETA) between Canada and the EU, took more than five years to negotiate. Moreover, there is not really an example of a trade agreement that seeks to reduce rather than increase the ties between two regions.

It is the extent of these future ties that will decide the short- and medium-term economic effects of Brexit on the British economy. The transition period and negotiations are therefore crucial. But, similar to what has been experienced in recent years, they could be difficult. It is therefore to be expected that uncertainty will rise as the news unfolds. Thus, the economic consequences that we have already seen between 2016 and 2019 will not be completely erased this year. Businesses do not yet know what awaits them in a year's time and it would be surprising to see them resume investing quickly and sustainably. A Hard Brexit, where few economic ties remain between the EU and the United Kingdom, remains entirely possible by the end of 2020—it all depends on the negotiations and what each side really wants.

What's at Stake in the Negotiations

There are major questions being asked about the negotiations that will take place this year... Will there be free trade or not? Only goods or also services? What will happen with the London-based financial sector? Will the United Kingdom comply with EU regulations to ensure access to the European market? Will the Northern Ireland issue be satisfactorily resolved? The automotive sector (particularly with environmental regulations and rules of origin), the fishing sector, and defence and security also appear to be areas where negotiations will be difficult.

Regulatory alignment is likely to be a major hurdle. On the one hand, the British want to ensure some regulatory freedom and the unwieldiness of European dictates has been a major argument in favour of Brexit. Some proponents of divorce dream that outside the European straitjacket, the United Kingdom will become "Singapore-on-the-Thames." For their part, EU negotiators already want to ensure that the British will work in a level playing field. They want to prevent the United Kingdom from taking advantage of deregulation or tax incentives that would benefit British companies at the expense of European competitors. It is the British government's desire to attach itself to European regulations, or not, that will determine whether the Europeans will want to make concessions about opening up their market. This is also true for the financial sector, as the acceptance of financial rules by the British would possibly ensure a place for London institutions in the provision of financial services in Europe.

Anticipated Effects of a New Agreement on the Economy

It has already been said that Brexit's true impact on the British economy will depend on what happens on January 1, 2021. Two scenarios can already be completely ruled out, a no-deal Brexit and a step backwards where Brexit would not take place. However, within these two extremes, there is a host of possibilities.

One of these, **a Hard Brexit, where there is no free trade** between the United Kingdom and the EU, is both plausible—at least temporarily—and very negative from an economic standpoint. This heavy assumption would not be very different from the no-deal avoided in 2019. Trade between the two countries would be under World Trade Organization (WTO) rules and would involve maximum friction (regulations, customs, tariffs and quotas). In November 2018, the British Treasury was anticipating that this scenario would slash 7.7% from the U.K. economy in the long term.

On the other hand, a scenario with the assumption of a **customs union** and the almost total acceptance of European regulations by the British would result in a shortfall of only 0.6% in the long run. However, this scenario is unlikely given the Johnson government's current desire to negotiate trade agreements with other countries.

Then there are intermediate scenarios, where the degree of **free trade** for goods is high, but there is some friction, particularly on the services side. The British often use the example of CETA. According to the Treasury, such an agreement would reduce the U.K. GDP by just under 5% in the long run. A study by the London School of Economics suggests that this free trade scenario would lower national per capita income by 2.5% to 6.0%. Of the 14 studies surveyed by the Institute for Government, all show a negative effect on GDP of a free trade agreement compared with the current situation, but this is also less serious than in a scenario where WTO rules prevail.

A Situation Far from Being Resolved, but Where Compromises Are Possible

The Brexit saga will not end at 11 p.m. on Friday, January 31, 2020. And we will not know for several months what Brexit will really be, that is, the real situation that will prevail at the end of the transition period. What is easy to assume is that these negotiations will be difficult and may lead to uncertainty for economic agents and volatility for financial markets. It took three and a half years to agree on the terms of the divorce. Will it be easier now? With any hope, yes, because it is not in anyone's interest to let the situation escalate for 11 months and thus harm the British and European economies. One possible compromise would be for negotiators to reach a partial agreement and extend negotiations on the more difficult issues beyond 2020.

That said, we can expect the lull to present uncertainties and that the rebound of certain indicators will be short-lived. As a result, the British economy is expected to grow slowly in 2020. An adjustment that would feel like a short recession in early 2021 cannot be ruled out if the transition period is not extended. In the meantime, however, the economy could be supported by further monetary easing by the Bank of England as well as a stimulative budget policy as Boris Johnson's Conservative government seems to want to adopt.

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