Beyond Brexit: Outlook and Risks for the U.K Economy

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The path of UK economic output in 2020 mirrored that of the Eurozone. In the first half of the year, a deep contraction preceded a sizeable rebound in the third quarter as virus restrictions were partially eased. In the summer, the government's "Eat Out to Help Out" initiative to support the hospitality industry, paired with VAT cuts for the most disadvantaged industries, provided additional support. However, as countries introduced tighter restrictions to combat the spread of the COVID 19 pandemic, the UK's economy contracted again in the fourth quarter. The most significant difference between the Eurozone and the UK is that the UK experienced a more pronounced recession in 2020. This is mainly due to the fact that sectors most focused on social activities such as leisure, hospitality and tourism account for a greater share of the economy than in most other European countries. Longer lockdown periods during the spring and tighter than-average restrictions in the winter are also contributing factors. Overall, the UK economy is estimated to have fallen by 10 percent to 12 percent in 2020, compared to 2019 levels. Moving forward, the UK economy is expected to steadily recover in 2021 as restrictions are eased and life returns to normalcy. Vanguard projects UK growth of 7% to 9%, which slightly exceeds euro area growth. This can be explained by output starting from a lower base and expectations of GDP reaching its pre-pandemic level by the first quarter of 2022. As a result of continuing vaccine development breakthroughs, risks are once again skewed to the upside.

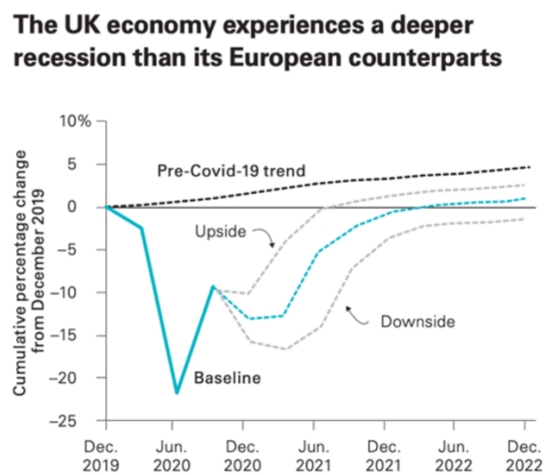

Figure 1: Source: Vanguard

The European trade deal signed with the European Union in late December has made Britain a more investable option than what it had been since the 2016 referendum. Market moves support the view. Exchange traded funds tracking the FTSE 250, a proxy for the domestic economy, experienced a record month for inflows in December while options market bets on sterling turned from negative to positive in 2021. According to Barclays, outflows during bearish years have made UK equities "particularly cheap in a world of liquidity-inflated asset prices". Additionally, based on 2021 earnings forecasts, the MSCI's UK index is the cheapest it's been since 1999, relative to the Eurozone index. One point that is essential to consider is that through commodity producers and financials, the UK has been a prime beneficiary of the reflation trade, the world's default strategy when the end of a recession is in sight. Chasing leverage into an earnings recovery is advantageous for so-called value sectors such as banking, energy and materials, which represent about 40 per cent of the FTSE 100 by market capitalization. One can therefore argue that the index's recent underperformance has more to do with a lack of growth stocks than with Brexit: the technology sector accounts for more than a quarter of the MSCI World index's weight but just 1% of the FTSE 100. This lack of highly valued tech companies also means that the UK may not be as cheap by earnings metrics as it looks. Indeed, the capital injection from Brexit-fearing investors can consolidate the reflation trade. Some would say that the FTSE's defensive balance is a hindrance as investors get limited upside exposure to growth stocks, but offers protection against a potential stalled recovery. The rate of consumer price inflation slowed significantly throughout 2020, due to lower energy prices, a VAT cut and weakening demand relative to supply. As with the euro area, aggregate prices are expected to gradually rise as these factors unwind in 2021. Both survey- and market-based measures of inflation expectations continue to remain well-anchored in the UK. As a result, inflation is projected to approach the Bank of England's target of 2% over the next year. On the policy front, the Bank of England eased monetary conditions considerably in the past year. The official Bank Rate was cut from 0.75% to 0.10% and the target stock of bond purchases was increased from 445 billion pounds to 895 billion pounds. The BoE purchased over 50 percent of the government-issued new debt between March and September as part of the extension of this quantitative easing program, which helped keep borrowing costs low for the UK government. The UK's primary deficit is set to exceed 10% of GDP in 2021 amid an expansionary fiscal stance, and, as with the euro area, the government's many support packages have helped to limit the increase in unemployment so far.The BoE's policy stance is likely to continue to remain accommodative and its QE program is expected to last until at least mid-2021. Although the Monetary Policy Committee has discussed the idea of implementing a negative interest-rate policy, such measures are very unlikely unless economic conditions substantially deteriorate. Another swing factor to take into consideration is fiscal policy. Up until today, fiscal policy has played the role of an automatic stabilizer during the pandemic and has been backstopped by monetary support from the Bank of England. Upside potential for fiscal policy will keep stimulating the U.K. economy in coming years, maybe more so than in the rest of Europe but less so than in the U.S, as the government turns to large-scale green infrastructure investments. Although there are signs of fiscal fatigue as a consequence of the high fiscal costs of emergency pandemic-related support measures, economists believe that the United Kingdom is unlikely to return to the austerity measures imposed after the financial crisis of 2008–2009 as these measures could decrease GDP growth, increase unemployment, and ultimately lead to a worsening of the budget deficit. Key risks to the UK economic outlook remain after the Brexit deal. Departing the EU has caused significant disruption as many UK firms have had to adapt their way of doing business. Brexit has arguably restricted the free movement of people and therefore the growth of labor supply and these aspects could, in turn, hamper productivity growth through less foreign direct investment and reduced innovation. However, Brexit supporters would advocate that, in addition to the U.K. being in a position where it can now control its own border, it is far from clear whether Brexit will lower net migration. Net inward migration has been largely unchanged since the referendum. Lower EU migration has been counterbalanced by higher non-EU migration, and there is no reason to expect this to change in the future. Another key risk factor is productivity. The new trading relationship could reduce productivity growth, with further trade barriers diluting the advantages of specializing in areas of comparable advantage. Although this has been a global phenomenon, the slowdown in Britain since the financial crisis of 2008-2009 has been especially pronounced. There are reasons to believe productivity will pick up in coming years as new technology enhances efficiency. However, other considerations, such as COVID-19's possible scarring impact, may further reduce efficiency. Thus, in contrast to these larger problems, the effect of Brexit on efficiency is likely to be small. This is part of the reason why the UK economy is expected to return to its pre-pandemic level of output slightly later than the rest of the euro area.