Global Letter Brexit two months on

- *Uncertainty over access to the single market stands to be a principal driver of investment*

There being no applicable precedent for what the UK has elected to do by voting to leave the EU – whatever that ultimately proves to mean – there is little alternative but to resort to conjecture.

The situation is more complex than most (including we ourselves) fully understand: and that makes for uncertainty about the near-term evolution of the so-called business cycle. It may also, more fundamentally, affect the UK's prospects over the long term: but that is another issue.

A priori reasoning for 2017

In our judgement the story almost certainly starts with the uncertainty over future access to the Single Market, and the consequences for investment.

- **Business investment**. The rational action for any firm thinking of investing to produce exports to the EU is to wait for the issue of access to clarify. Every business person to whom we have spoken takes that view. (Indeed, some domestic projects are being put on hold too.) But clarification on access to the Single Market will be slow in coming – many months at least.

  To calibrate possible consequences, suppose that half of such investment were to be postponed for a year. That would directly reduce aggregate demand by ¾ to 1 percent.[1]

  Alternatively, translating the observed post-Brexit increase in uncertainty into the consequences for investment suggests, on the basis of past relationships, a reduction in investment of the order of 8-10 percent, thereby yielding a similar figure of a ¾ to 1% reduction in GDP for 2017.

Three other developments are likely to follow:

- **Household saving ratio.** Weaker sterling and resulting higher import prices can be expected to reduce consumption – which is around 65% of GDP – by perhaps ¼ to ½ of a percentage point. Furthermore, past negative shocks have seen the household saving ratio rise by between 1 and 4 percentage points (the latter following the 2008 crisis).[2] These and related influences taken together may reduce aggregate demand directly by between 1% and 2½%

On the positive side, weaker sterling can be expected to lead to stronger net exports.

- **Exports.** The 10%-odd effective depreciation to date would, on the basis of historical relationships, but taking account of the current weakness of world trade, add between ½ and 1½ percentage points to GDP growth in 2017.

Net result. Assessment of the potential effects of such shocks, positive and negative, requires that due account be taken of tax, savings, and import leakages, together with other, smaller, influences.

Such a calculation, performed on the basis of assumptions along the lines above using the NIESR macroeconomic model NIGEM,[3] suggests a post-Brexit reduction, relative to what would have happened otherwise, of 1 to 2 percentage points in UK 2017 GDP.

Pre-Brexit, the consensus forecast was around 2%. Post-Brexit the OECD and the consensus forecast have come down by around ½ a percentage point, and the IMF by almost a full point. Both estimates seem to us to be somewhat on the conservative side.

Whatever the correct figure, however, the implication is that UK GDP will grow little, if at all, in 2017.

Potential impact beyond 2017

Uncertainty over access to the Single Market will remain for many months, and quite conceivably much longer than that.

Such uncertainty is more fundamental than the more common, inherently cyclical, kind, and may hit investment, and thereby aggregate demand, more severely and for longer than has yet been appreciated.■

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[1] Exports account for about 30% of GDP, and currently about half of these (i.e. 15% of GDP) go to the EU. Business investment represents between 10% and perhaps 15% of UK GDP, depending upon the extent to which intangible investment is included. Hence, as a possible order of magnitude, perhaps 30% of investment is undertaken to produce exports, and in turn half of this investment relates to exporting to the EU. Were this to halve, the direct effect on GDP would be of the order of (15%*[10% to 15%] *0.5 = ¾ to 1 percent of GDP.

[2] The UK household saving rate increased by 1.1 percentage points in 1963; 2.4 points in 1972; 1.8 points in both 1979 and 1980; 1.4 points in 1989; 2.3 points in both 1990 and 1991 and a further 1.5 points in 1992; by 1.1 points in 1995; by 1.4 points in 1999 and a further 1.8 points the year after that, 2000, and a further 1 point in 2001; and by a massive 4 percentage points following the 2008 great financial crisis. The mean of these figure is 1.8 percentage points.

[3] Thanks are due to Simon Kirby and Jack Meaning of the National Institute for Economic and Social Research (NIESR) for two most helpful discussions about simulations undertaken using the Institute's NIGEM model.