Economic Update October 2017

The pace of change in the political scene within the EU is making forecasting difficult. It would be tempting to extrapolate from the past, but it would be a mistake. The political ground is shifting everywhere. In Europe, proportional representation voting systems produce parliaments which represent the will of the people (unlike the UK). Coalitions are usually required to approve decisions.

Advocates for proportional representation - and I am one - argue that an election is a census of opinion as to how the country should be governed, and only if a Government reflects the full range of opinions within a country can its decisions be regarded as legitimate. The UK plurality system (first past the post) often produces unrepresentative, minority governments. In the UK, from 1970-2000, the two major parties governed the country with little more than 40 percent of the votes.

In the June 2017 UK election, the result was as follows:

Conservatives	*42.3% of the popular vote:*	*316 seats*
Labour	*40.0%*	*262*
Libdem	*7.4%*	*12*
SNP	*3.0%*	*35*
DUP	*0.9%*	*10*

Since 1999, voters in Britain have elected MEPs under a proportional representation system. In the last elections, in 2009, all MEPs in the European Parliament were elected under some form of proportional representation. In fact, contrary to popular belief, the EU structure is more democratic and transparent than Westminster.

A year ago, commentators were suggesting that there would be significant re-alignment in EU members states' elections. There have been changes but these are relatively small and the surge in economic growth has probably reduced the pressure for change. However the rise of the extreme right in Germany, the AfD, with 12.5% of the vote and 94 seats in the Bundestag is significant. It means that Merkel will not be able to accept Macron's vision of a more federal Europe. Macron wants a large Eurozone budget, a euro finance minister, a European monetary fund, and a common bank deposit insurance scheme. The changing politics in Italy, France, Germany and the Netherlands suggest that the EU will be required to tighten controls significantly on external and internal immigration.

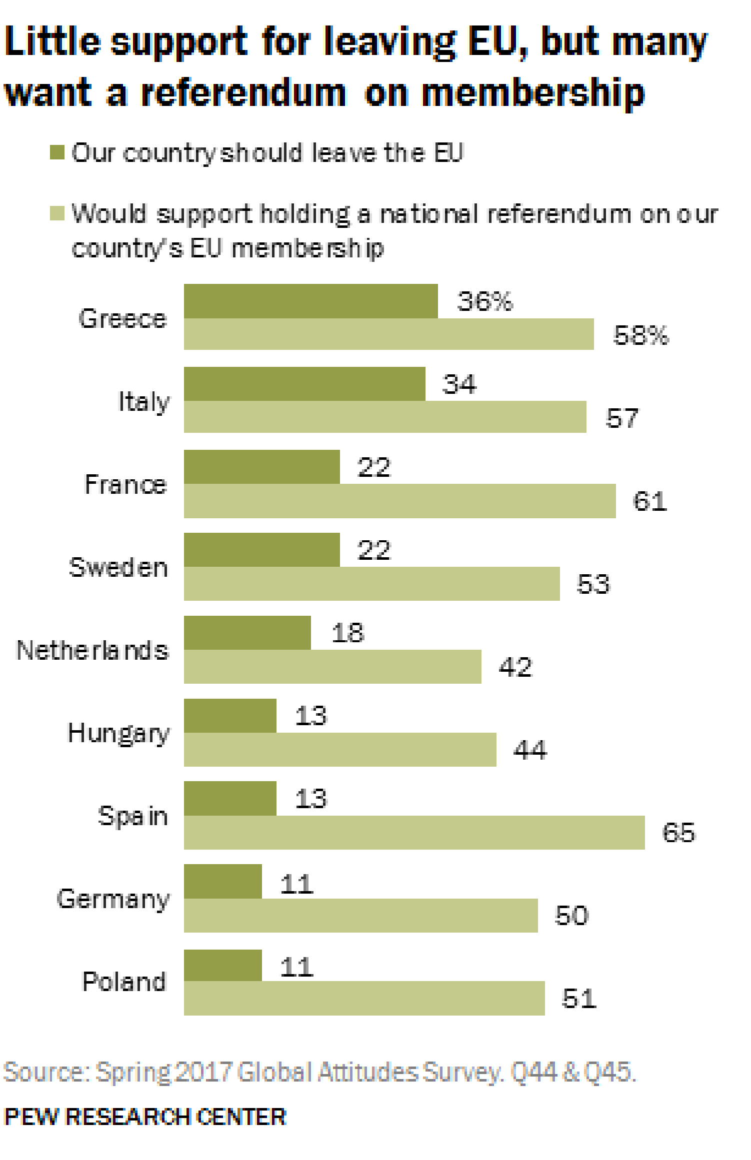
Michel Barnier, the EU's negotiator, has been consistently clear that there is a trade-off between sovereignty and access that Britain must confront. The more unfettered access Britain wants after it leaves, the more it must be a rule-taker; the more control it wants over its own borders, the greater an economic hit it must take. This may be modified as time goes on.

Where are we now?

The PM has at last recognised that the UK cannot demand an agreement which is inconsistent with the clearly defined values and principles of the EU. It will not be possible for the UK to have its cake and eat it. For the EU member states, leave means leave. The UK position is currently that we reject a Norwegian relationship; we reject a Swiss relationship. We want a unique tailored deal as yet unspecified on the grounds that it would reduce are bargaining position. I suspect that is because the cabinet cannot agree on the priorities.

The PM was explicit that Britain will seek a continuation of the status quo during a transition period: Britain will remain a member of the single market and customs union and it will continue to be subject to freedom of movement of people and to fall within the jurisdiction of the European Court of Justice. It will continue as before.

She refrained from explicitly saying that no deal would be better than a bad deal, dropped the incendiary suggestion that Britain might use security co-operation as a bargaining chip in the negotiations and gave reassurances that Britain would not be looking to undercut the EU by going for a Singapore-style deregulatory model.



It is becoming clear that the cabinet is shifting its stance towards a version of a softer Brexit. But recognising that there will be an election a year after the end of the transition period, the future of the Tory party depends on a deal which will be supported by more than 40% of the electorate. And the deal has to dampen the support for Corbyn; otherwise the Tories are likely to lose in 2022.

Implications?

Since the speech, sterling has risen to \$1.35 and €1.14 . In my view, this is because the Bank of England can now raise base to 0.5% in October, as the possible cliff edge has been pushed forwards to 2021. I repeat my May 2017 forecast assuming the EU accept the transition period I think it credible. The key is my assumption that average earnings will rise at rates above inflation in 2019 and 2020 because of severe labour shortages as skilled EU workers decide to return home to booming local economies.

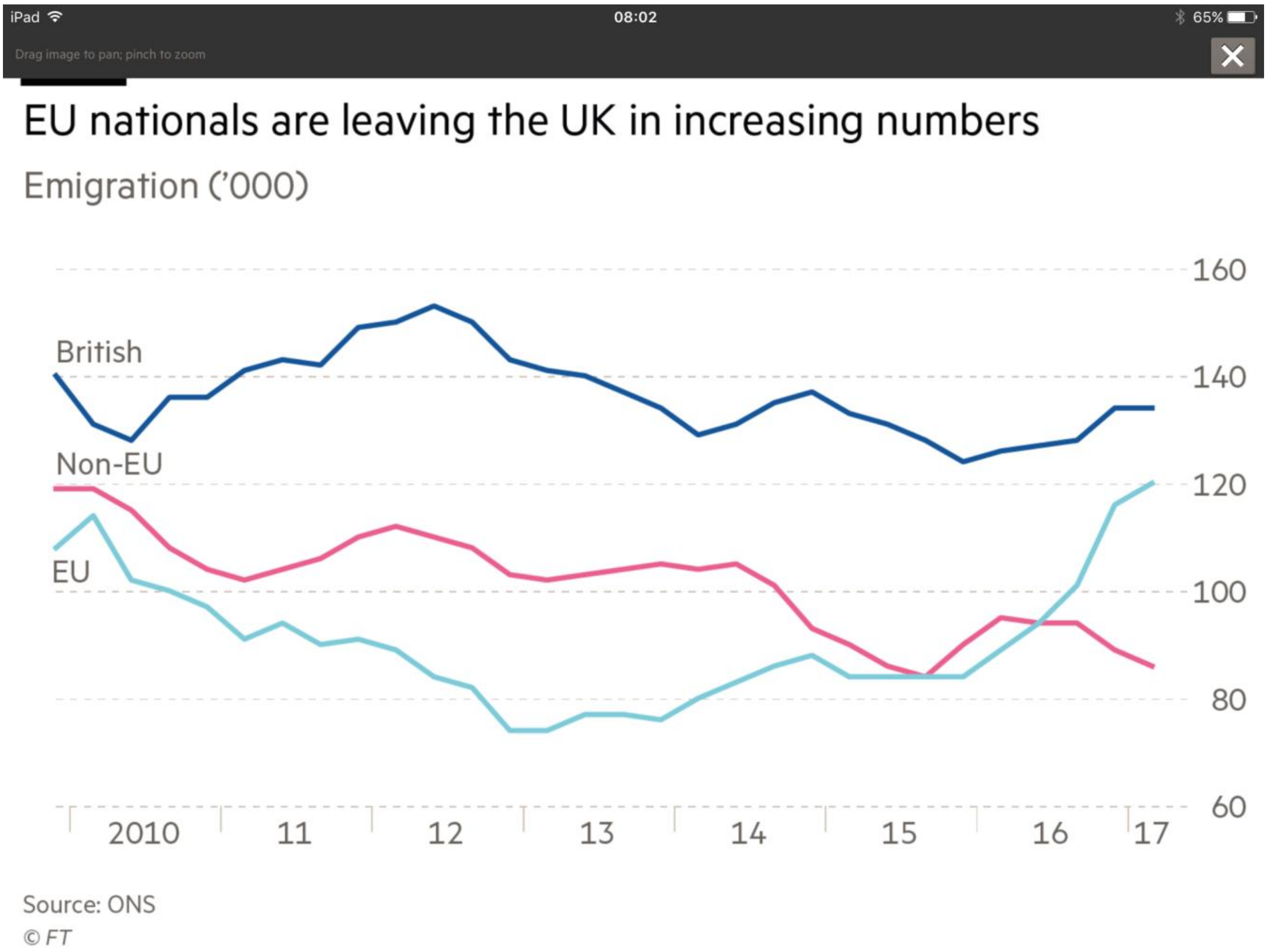
Averages of 27 other forecasters' central projections May 2017

RMF view in red

	2018 Q2		2019 Q2		2020 Q2	
CPI inflation(b) yoy	2.8	3.2	2.4	3.0	2.2	3
GDP growth(c) yoy	1.3	1.7	1.7	1.9	1.9	2.1
LFS unemployment rate	5.1	4.8	5.3	4.8	5.3	4.8
Bank Rate (per cent)	0.4	0.5	0.5	1.25	0.9	1.5
Stock of purchased gilts (£ billions)(d)	438		439		439	
Stock of purchased corporate bonds (£ billions)(d)	10		11		11	
Sterling ERI (exchange rate index)	77.6	77	77.4	77.8	77.6	77
Growth in average earnings (basic plus overtime)	2.5		3.6		4.0	

RMF forecast assumes a transitionary deal which maintains access to the single market from early 2020 will be signposted mid 2018

RMF assumes number of EU workers will fall by 700,000 to 1.9 million increasing the pressure on wages


iPad
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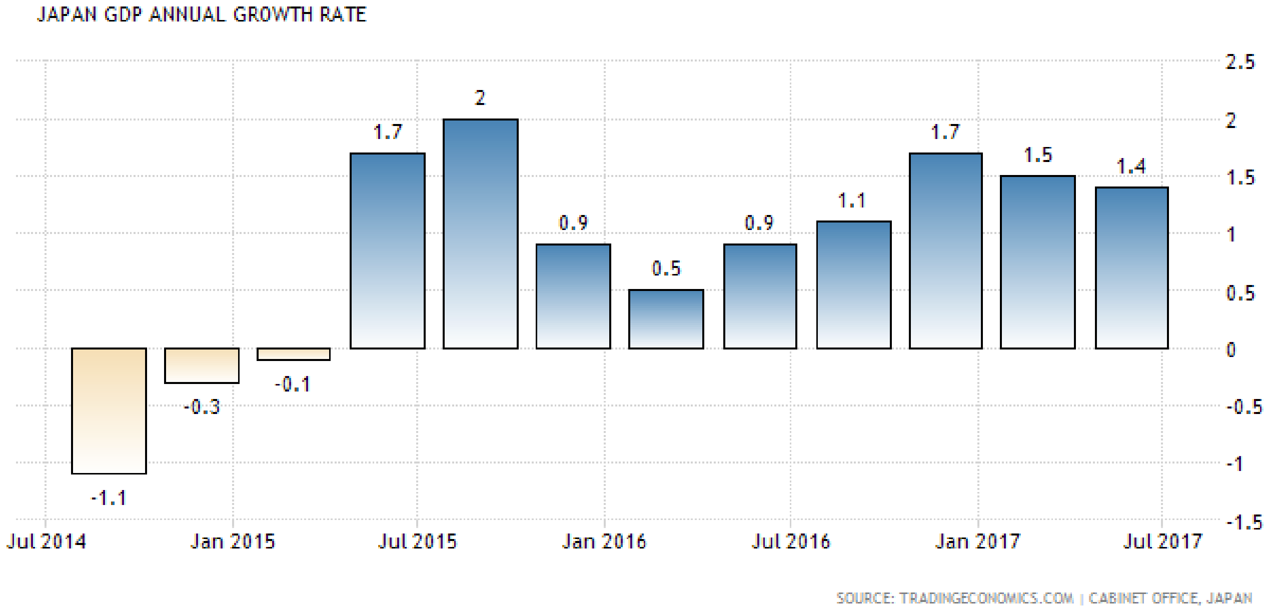
EU nationals are leaving the UK in increasing numbers
Emigration ('000)
British
Non-EU
EU
160
140
120
100
80
60
2010
11
12
13
14
15
16
17
Source: ONS
© FT


EU GDP ANNUAL GROWTH RATE
1.2
1.4
1.8
2
1.9
1.9
1.7
1.6
1.7
1.9
2
2.3
2.4
2.2
2
1.8
1.6
1.4
1.2
1
Jul 2014
Jan 2015
Jul 2015
Jan 2016
Jul 2016
Jan 2017
Jul 2017
SOURCE: TRADINGECONOMICS.COM | EUROSTAT


JAPAN GDP ANNUAL GROWTH RATE
-1.1
-0.3
-0.1
1.7
2
0.9
0.5
0.9
1.1
1.7
1.5
1.4
2.5
2
1.5
1
0.5
0
-0.5
-1
-1.5
Jul 2014
Jan 2015
Jul 2015
Jan 2016
Jul 2016
Jan 2017
Jul 2017
SOURCE: TRADINGECONOMICS.COM | CABINET OFFICE, JAPAN


US GDP GROWTH RATE
5.2
2
3.2
2.7
1.6
0.5
0.6
2.2
2.8
1.8
1.2
3
6
5
4
3
2
1
0
Jul 2014
Jan 2015
Jul 2015
Jan 2016
Jul 2016
Jan 2017
Jul 2017
SOURCE: TRADINGECONOMICS.COM | U.S. BUREAU OF ECONOMIC ANALYSIS

The BIG constraint which no-one is talking about.

Despite the lower pound and an expanding global system, the UK's trade performance is poor. Recent revisions to our balance of payments data show a worrying increase in our deficit with the rest of the World.

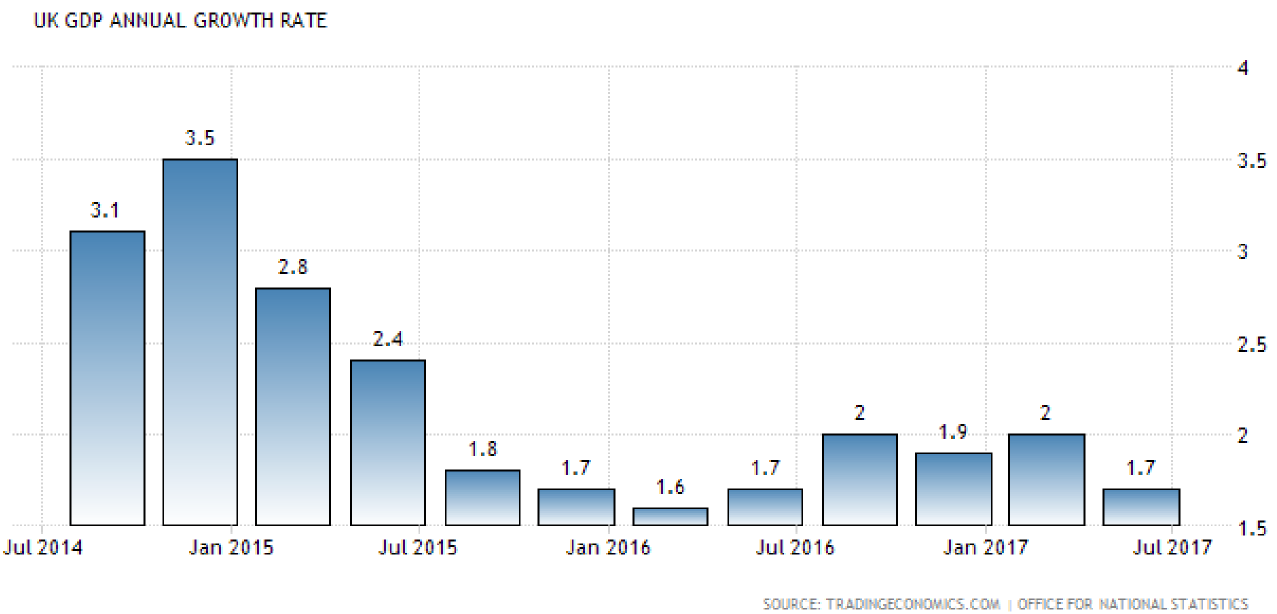


Figure 5: Total trade balance including and excluding erratics

I make no apology for emphasising what these graphs tell us. It is this: the UK needs to run a surplus of £100Bn a year on the capital account to finance our excess consumption. The sale of British businesses and real estate to foreigners is an important source of finance, but the long term investment inflow which comes from EU companies is crucial.

If we crash out of the EU, I predict a recession caused by the collapse of long term investment inflows. To pay our bills with the rest of the World, we would need interest rates to be the average for Western economies at the time.

Despite a devaluation and a rapidly growing global economy, our balance of trade is showing no improvement. There is no reason to believe it will improve after 2022. In fact Oxford Economics has suggested that if there was a hard Brexit, trade with the Commonwealth and the rest of the World would only replace 10% of the potential loss of trade with the EU.

If you look at the larger Commonwealth countries put together - including India, Pakistan, Australia, and Canada - the top 10 make up simply 8% of our exports compared with 44% for the European Union. And if you take all 52 or 54 Commonwealth countries, they make up just 9% of all our exports.

The outlook for the next two years

Assuming the EU agree to a two year transition period (they will; money talks!) then there is no reason for the UK economy to collapse. Growth will be lower due to falling real incomes, labour shortages, and the increase in interest rates which will begin in October or November - but we will still manage around 2%. The PM has, albeit belatedly, shown some British pragmatism and has at last indicated that we are serious about keeping good relations with the EU. The potential crunch point has been moved forwards to 2021.

The ONS have just revised their data on the savings rate. Previously it was just 3.2% for 2016 which suggested households were living hand to mouth. The revisions recognise that in recent years many small businesses have been using dividends in lieu of salary, in this way incomes were understated. One can assume when the data for 2016 is available the ratio will be around 7%. This is encouraging. It means that people do have a store of just-in-case money which can be drawn on if required to keep consumption going. Also there is much less likely to be an increase in precautionary savings if Government continues to show sense.

It is reasonable to assume that long term investment inflows will be maintained for the time being. If this is the case, and if interest rates rise, then sterling will recover against the basket of currencies.

It is possible now to imagine $1.40 and €1.20 over the next two years unless and until the divorce talks go wrong.

Some observations

Juncker is the President of the European Commission. Before becoming President in 2014, Juncker was Prime Minister of Luxembourg for 18 years. Luxembourg is the smallest country in the EU. With a population of 570,000 it is smaller than Glasgow. 85% of its GDP is derived from financial services attracted by light regulation and tax breaks.

He is the EU's Boris Johnson, prone to unsubstantiated outlandish remarks. The media have honed in on his personal view of how the EU should develop. It is not the view of the Commission or the member states. And Junckers will be gone in 18 months. So all the talk of every member in the Euro, a European Army, fiscal convergence, debt sharing, is as silly as Liam Fox suggesting the Commonwealth could replace the lost trade with the EU.

The Brexit issues for the UK are as follows.

1. the border with the EU in Northern Ireland (but read the section on NI)
2. the loss of skilled young EU workers
3. the possible loss of passporting rights for UK financial services
4. the divorce bill
5. the renegotiation or cut and paste of 750 international arrangements
6. the fact that Brexit will take up all of the horsepower of the civil service leaving other, possibly more important, issues on the back burner
7. the divisiveness in families and social groups who did not vote the same way
8. the rise of xenophobia
9. the collapse in the Government's capital investment budget
10. the wry smiles of our EU neighbours

In conclusion

- There was a step change with the speech in Florence: there is now a sense of leadership and some direction. Most importantly the UK has recognised that it is up to us to indicate possible paths, post-Brexit, and that it is not the fault of the other countries that the UK voted leave.

- A two year - possibly longer - transition period is essential which will reduce the economic risk substantially.

- The change in the political landscape particularly in Germany may help our cause, it is too early to say.

- Most importantly there will be no recession until at least 2022, and then only if we crash out.

- In my view things are looking up compared to three months ago!

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