MACROECONOMIC ANALYSIS

The slight post-Brexit recession will encourage more accommodative policies

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The easing of financial stresses following the Brexit vote is positive, but the high degree of uncertainty about the exit process and the sharp decline in confidence will probably cause a slight recession in the second half of the year, which will lead the BoE to ease its monetary policy in August and the Treasury to postpone the balancing of the public accounts. We are therefore revising our GDP growth forecast downwards by -0.3 pp for 2016 and -1.5 pp in 2017, to 1.5% and 0.4% respectively, mainly in view of a foreseeable fall in investment and a substantial moderation in private consumption, which the positive effect of the sterling's depreciation on net exports and the gradual adjustment of the current account deficit will not be enough to offset.

Robust growth in 1H16, somewhat better than expected before B*rexit…*

The **preliminary GDP estimate** showed a **0.6% QoQ growth in 2Q16**, 0.1 pp more than expected, and 0.2 pp more than in the previous quarter, **underpinned by the strength of the service sector, but above all by the rebound in the industrial sector**, which may have been partly thanks to the improvement in global demand and a much weaker pound (approximately 10% lower in effective terms in the first half-year). Although detailed results on the demand side are not yet available, **so far data on activity point to growth having once again been sustained mainly by private consumption, but also by investment**, while net exports may have ceased to be a drag on quarterly GDP growth. **Nonetheless, monthly activity data also paint a less rosy picture than that suggested by the quarterly figures**, since the improvement was seen mainly in April, whereas **they deteriorated in May** (industrial production) **and June** (retail sales).

…which has collapsed confidence in July and points to a slight recession as early as 3Q16

Following the surprise referendum result, **the sharp increase in financial stresses has moderated** (with stock exchange indices returning to their pre-referendum levels and the pound's depreciation being contained at 9% against the dollar), partly thanks to the emergency measures taken by the Bank of England (BoE) and other central banks, **and it does not seem likely to turn into a disruptive event in the short term. However, uncertainty about the management of the exit process remains high, and we can expect a bumpy road in the next few quarters, which will weigh on economic growth in both the short term** (delaying consumption, investment and hiring decisions) **and the long term**[1].

Although post-referendum data are very limited, **initial indicators** such as **July's sharp fall in confidence** to its lowest point in three years, **already point to a significant impact in the short term. The composite PMI fell by nearly five points to 47.7 moving into economic contraction territory**, dragged down above all by the service sector, while the fall in the manufacturing sector was somewhat more moderate, probably supported by the pound's sharp depreciation. In any case, it is still too soon to draw clear conclusions about the extent of the referendum's impact. It does seem to be much less than that of the 2008-2009 crisis, but may turn out to be rather more intense and persistent than that of late 2012, which registered some quarters with negative growth of about -0.1% QoQ.

Following David Cameron' resignation, Theresa May's election as prime minister was quick, partly in reaction to the rapidly deteriorating political climate. She has promised to implement the result of the

1: See document and presentation on "The economic consequences of Brexit"

referendum, and has reached an agreement with other European leaders to delay the formal request to leave the EU (by invoking Article 50) until year-end at the earliest.

The main debate now centres on whether the UK will seek a “soft” exit from the EU (so as to retain access to the single market and “passporting” for UK financial services), or on the contrary, a more radical one, which several members of the new government seem to be pushing for, so as to be able to negotiate trade agreements freely and reclaim sovereignty, mainly as regards immigration. Meanwhile, the EU is holding firm to the position that access to the single market must go hand in hand with the other pillars of the union, including the free movement of persons, while at the same time applying pressure for the process not to be drawn out beyond the beginning of next year. **It now seems most likely** therefore **that the negotiation process will start at the beginning of 2017 and that Brexit could take place in the first half of 2019 if an agreement is reached quickly.** One possibility often mentioned in the debate is that of opting for a provisional exit into a European Economic Area (very close to the EU), allowing more time to go on to negotiate a more independent option (bilateral agreement or customs union).

The BoE is inclined towards adopting more easing measures, and the Treasury will delay balancing the public accounts

Until now the BoE’s measures have focused on maintaining financial stability and ensuring the liquidity of the economy (by providing liquidity and cutting capital requirements) to reduce the probability of Brexit’s turning into a disruptive event. In July it kept its monetary policy unchanged pending initial post-referendum data and a clearer assessment of the economic impact, although the minutes of the meeting suggest that most members of the Monetary Policy Committee are inclined to adopt measures as early as August. **Given the sharp decline in confidence and a possible fall in GDP in this quarter, the BoE could cut the Bank Rate, probably by 25 bps to 0.25%**. Moreover, based on the discussions in the last meeting we cannot rule out the announcement of a package of measures that might include **some kind of Targeted Funding-for-Lending scheme or an increase of between £100 and £150 billion in the stock of purchased assets** (from the current £375 billion). However, **given that financial stresses seem to be contained, the BoE might act more gradually**, monitoring the functioning of the markets and economic performance so as to implement measures that ensure the operation of transmission channels for its policies. In other words, it might leave QE expansion for later, or look at alternative measures such as relaxing macroprudential requirements, targeted financing for other economic agents (such as certain households) or providing more liquidity beyond September and in the longer term. Our scenario envisages an interest rate of 0.25% at the forecast horizon and the extension of QE throughout the rest of the year if the recession intensifies.

As for fiscal policy, the new Chancellor of the Exchequer (head of the Treasury) has already indicated that the target of a balanced budget by fiscal year 2019/20 will not be met and that in any case the adjustment will be slower than previously envisaged (at around 1% of GDP per year). Although the budget and the possible measures to be taken will not be discussed until October or November, what seems certain is that **no additional measures will be taken to offset the cyclical deterioration in the budget, the automatic stabilisers being left to temper the decline in activity**. As a result, the deficit this year and next could be around 0.3 pp and 1 pp respectively above the official figures in March (2.9% and 1.9% of GDP respectively).

Forecasts for 2016-17: sharp fall in investment, and moderation in private consumption, which will not be offset by the increased contribution from net exports

The Brexit process will have a significant negative impact on economic activity at the forecast horizon, especially as a result of the high level of uncertainty associated with the exit process and the reduced confidence of both domestic and foreign economic agents, and despite the UK will remain a member of the EU for at least another two years. In this way, the relatively stable and robust recovery we were predicting three months ago (slightly below 2% for this year and next, having lost some of its steam as a result of the gradual withdrawal of stimulus measures, both fiscal and monetary) now turns into a slight recession in the second half of the year and feeble growth over the course of next year, which **results in a downward revision of our GDP growth forecast by around -0.3 pp to 1.5% for 2016 and of -1.5 pp to 0.4% for 2017**.

The high degree of uncertainty about the exit process and the expectations of a greatly reduced growth will act as powerful brakes on investment in the next few quarters, and we now expect investment to contract by **-0.5% over the whole of 2016**, after having grown by about 4% a year on average since the end of the 2008-09 crisis, **and to fall sharply by -2.5% in 2017**. The lower level of investment will be reflected in a **deterioration in the labour market, such that we now see the pace of job creation this year** being practically halved **to 0.9% from 1.8% in 2015, and halted in 2017**, which will also lead to an **increase in the unemployment rate to 5.6%** next year.

The deterioration in the labour market, **together with the higher increase in inflation** now expected for 2017 (by +0.6 pp to 2.2% as a result of higher import costs due to the pound's depreciation), **will affect households' disposable income**, while greater uncertainty could lead to an increase in the household savings ratio from its current very low level of 5.9%. For these reasons, following the strong growth of **private consumption** in the first half of the year, we now see it **slowing considerably from this quarter to post increases of 2.3% for 2016 as a whole and 0.5% in 2017**.

As for public consumption, we continue to expect growth of 1.1% this year and 0.4% in 2017, since in principle, unless there is a much deeper recession in the second half of this year, we do not expect major fiscal stimulus measures to be announced beyond not sterilising the operation of the automatic stabilisers. The result of all this is that **the contribution of domestic demand will fall to 1.5 pp in 2016 and to zero in 2017**.

Only the sharp depreciation of the pound (approximately 13% against the dollar forecast for 2016 and another 3% in 2017) **will help mitigate part of these effects**, although this will also be limited by the context of moderate global growth. In any case, we estimate that exports will increase by 3.4% this year and accelerate to 4.3% in 2017, while the rate of increase in imports will slow from 3.3% in 2016 to 2.5% next year. As a result, **the negative contribution of net exports will reduce to -0.1 pp** (compared with around -0.6 pp a year on average since 2012) **and will contribute around 0.5 pp to GDP growth in 2017**. **This improvement** in the balance of trade **should help to start reducing the large current account deficit this year** by around 0.3 pp of GDP **to 5.1%, and to 4.3% of GDP in 2017**. Nonetheless, the high degree of uncertainty surrounding Brexit makes it very difficult to predict movements of capital, so in any case the economy's large financing needs continue to pose a clear risk in the medium term.

Table 1

UK: macroeconomic forecasts
(Annual rate of change in % unless otherwise indicated)

Rate (YoY)	2011	2012	2013	2014	2015	2016	2017
GDP	**1,5**	**1,3**	**1.9**	**3.1**	**2.2**	**1.5**	**0.4**
Private consumption	-0.5	1.7	1.6	2.2	2.5	2.3	0.5
Public consumption	0.2	1.7	0.3	2.3	1.4	1.1	0.4
Gross fixed capital formation	1.9	2.3	3.2	6.7	3.3	-0.5	-2.5
Inventories[1]	-0.6	0.4	0.6	0.5	0.2	0.0	-0.1
Domestic Demand[1]	**0.1**	**2.0**	**2.7**	**3.4**	**2.7**	**1.6**	**0.0**
Exports	5.8	0.6	1.1	1.5	4.8	3.4	4.3
Imports	0.8	2.9	3.4	2.5	5.8	3.3	2.5
Net exports[1]	**1.4**	**-0.7**	**-0.8**	**-0.4**	**-0.5**	**-0.1**	**0.4**
Inflation	**4.5**	**2.8**	**2.6**	**1.5**	**0.1**	**0.7**	**2.2**
Employment	0.5	1.1	1.2	2.4	1.8	0.9	0.0
Unemployment rate (% Active Population)	8.1	8.0	7.6	6.2	5.4	5.1	5.6
Government Balance (% of GDP)	-7.7	-8.3	-5.6	-5.6	-4.4	-3.7	-3.4
Public Debt (% of GDP)	81.8	85.3	86.2	88.2	89.2	88.8	89.9
Current account balance (% GDP)	-1.8	-3.7	-4.4	-4.7	-5.4	-5.1	-4.3

1 Contributions to growth.
Forecast closing date: 25 July 2016
Source: European Commission and BBVA Research

United Kingdom

National accounts: somewhat higher than expected growth in 2Q16 (0.6% QoQ), slight recession as early as 3Q16

According to provisional data, the acceleration in growth is due to the rebound in industry (2.1% QoQ; 1Q16: -0.2% QoQ) which contributed 0.3 pp to economic growth (1Q16: -0.03 pp) and the growth in services (0.5% QoQ; 1Q16: 0.6% QoQ) which contributed 0.4 pp (1Q16: 0.55 pp), partly offset by a further fall in construction (-0.4% QoQ 1Q16: -0.3% QoQ), which shaved 0.03 pp off growth. For 3Q16, we envisage that GDP could contract by around -0.1% QoQ.

Figure 1
GDP (% QoQ) and output by component (pp)*

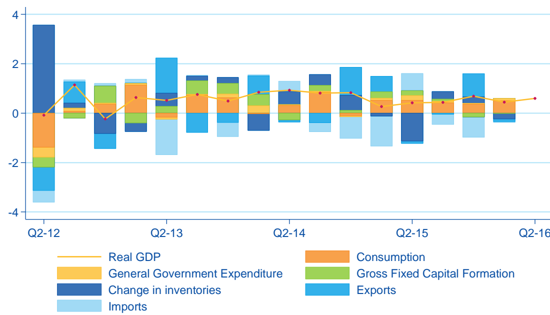
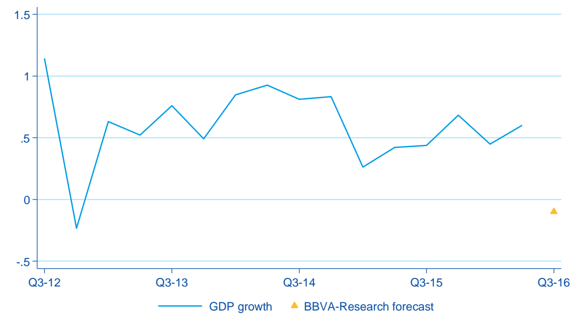


Figure 2
GDP growth (% QoQ) and BBVA forecast*



Confidence: sharp fall in confidence in July

The composite PMI entered contraction territory in July (47.7, from 53.4 in June), posting the biggest fall in the PMI since 2009, due to reduction in both services (47.4, from 52.3 in June) and manufacturing (49.1, from 52.1 in June). Both production and new orders were down in both sectors, although the external orders increased on the back of the plummeting pound.

Figure 3
PMIs and GDP growth (% QoQ) *

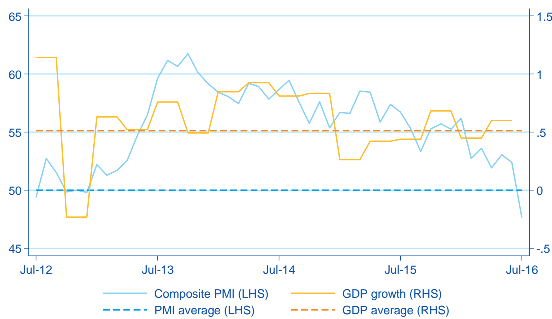
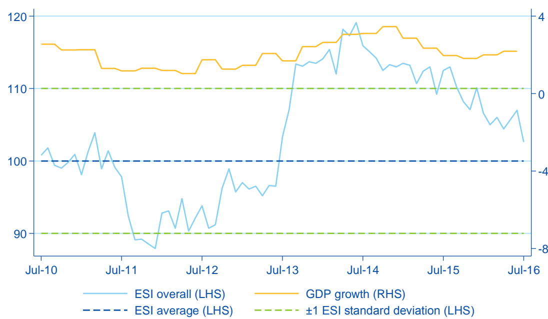


Figure 4
Confidence (ESI) and GDP growth (% YoY) **



Activity: industrial production fell in May and retail sales fell in June

In May, industrial production fell by 0.5% MoM, after the April rebound (2.1% MoM), leaving the first two months of the quarter 2.1% ahead of 1Q16 (-0.2% QoQ). Retail sales fell by -0.9% MoM in June (May: +0.9% MoM), putting the 2Q16 figure 1.7% above that of 1Q16 (1.2% QoQ).

Figure 5
Industrial production (% YoY) and manufacturing PMI*

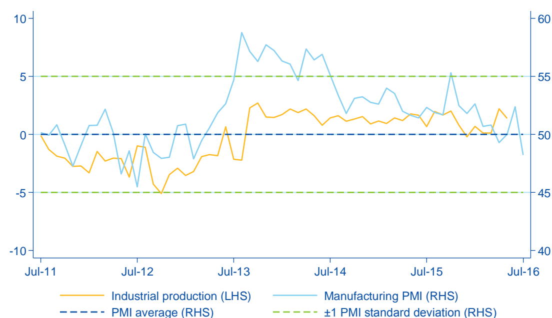
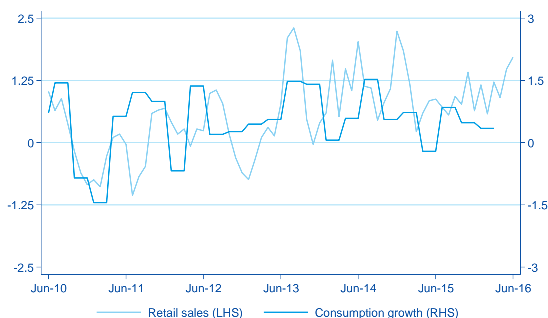


Figure 6
Retail (% 3m/3m) and consumption growth (% QoQ)*



*Sources: HAVER and BBVA Research

Foreign sector: Exports and imports both fell in May

Exports of goods and services fell by -4.4% MoM in May after the increases seen in previous months, but grew by around 3.4% relative to 1Q16 when they practically stagnated. Imports also declined in May (by -3.5% MoM), representing a fall of around 1% relative to the previous quarter. All the same, net exports may have ceased to contribute negatively to growth.

Figure 7
Current account (% of GDP)

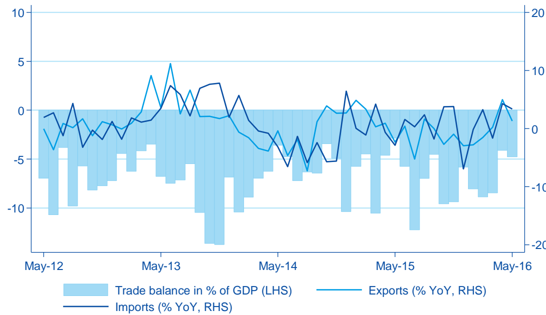
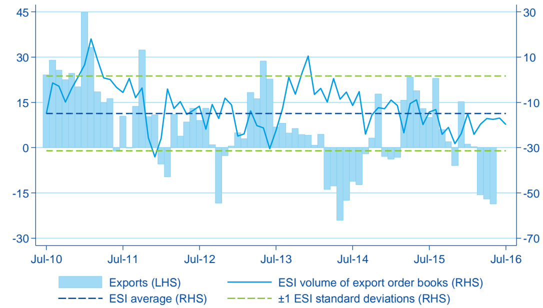


Figure 8
Exports goods (% YoY)



Labour market: unemployment rate fell to 4.9% in May

The number of persons unemployed (average of the past three months: March-May) fell by -0.1% relative to December-February, to 4.9%. Labour costs in the business sector moderated their pace of growth (1Q16: 1.5% YoY after 3.4% YoY).

Figure 9
Unemployment rate (%) and employment expectations*

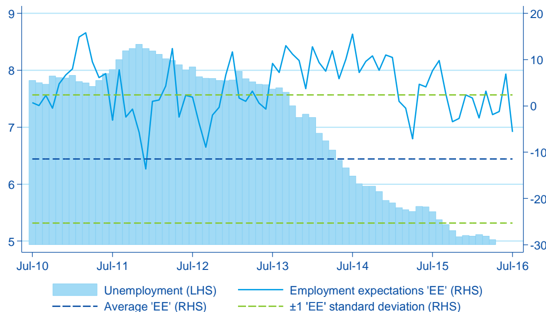
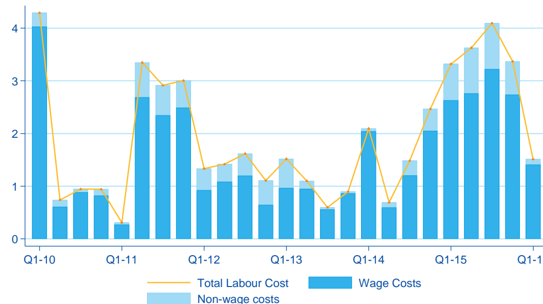


Figure 10
Labour costs in the business sector (% YoY)*



Prices: inflation rose in June to 0.5% YoY

Headline inflation for the year to June increased to 0.5%, driven by core inflation (1.4%). Price increases were mainly in services, particularly communications (3.6% YoY), recreation and culture (+0.9% YoY), education (4.8% YoY) and hotels and restaurants (2.4% MoM), partly offset by a negative contribution from prices of food (-3.0% YoY), clothing and footwear (-0.7% YoY) and transport (-0.2% YoY).

Figure 11
Headline and core inflation rates (% YoY)*

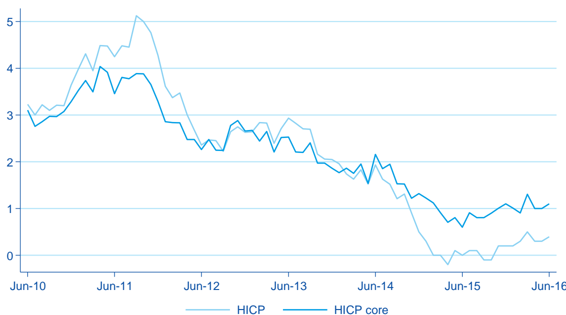
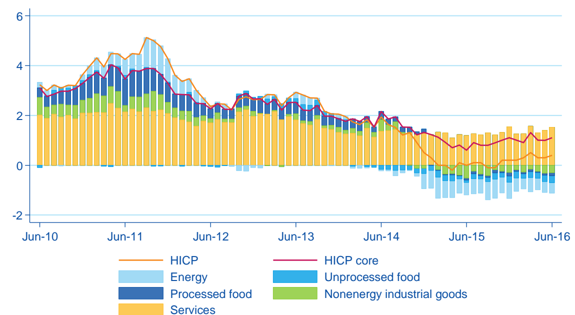


Figure 12
Inflation by components (contribution in %)*



* Sources: HAVER and BBVA Research

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