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Economic Research:

Brexit's Impact, Part 2: Recession Averted, Slow Growth Ahead

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Table Of Contents

U.K. Growth Depends On The Performance Of Monetary Policy, The Housing Market, And Exports

The Eurozone Looks For A Second Wind

The Brexit Pain Will Last Several Years

Economic Research:

Brexit's Impact, Part 2: Recession Averted, Slow Growth Ahead

Three months after the U.K.'s historic vote to leave the EU, we're beginning to see hard evidence about Brexit's immediate impact on growth in Britain and the European Monetary Union. In short, the sky hasn't fallen on either side of the Channel, contrary to concerns that the U.K. would soon fall into recession, precipitating a marked slowdown in the European Monetary Union. Our own initial assessment, which we published in early July, forecast a relatively benign hit to U.K. growth in the short-term--that appears to be playing out. However, we revised our growth projections for 2017 and 2018 sharply downward. Here, while we haven't made any major revisions to our July forecast, we now more clearly see the factors that are likely to influence the longer-term outlook either up or down, both in the U.K. and in the eurozone.

Overview

- We continue to believe the Brexit decision will have negative effects on U.K. economic growth spread over several years, reducing GDP growth by 2.1 points between now and end-2018.
- The depreciation of the pound will positively impact U.K. exports, but will be a drag on purchasing power and consumption.
- The impact on the eurozone economy will be milder, reducing GDP growth by 0.7 point over 2017-2018, though in a context of already sluggish growth.

U.K. Growth Depends On The Performance Of Monetary Policy, The Housing Market, And Exports

U.K. economic activity in the first two months after the Brexit referendum has been stronger than some had feared. Indeed, confidence indicators as well as hard data have been quite resilient. Retail sales declined marginally in August after a very strong July, and are up 6.2% year on year on the back of stable employment and a low unemployment rate of 4.9%. Wages were up 2.3% year on year in July, and with inflation still at 0.6%, real income growth is supporting consumption. British households continue to spend--and so do foreign visitors--taking advantage of the weaker pound exchange rate. Business confidence has also rebounded, with the PMI manufacturing index surging to 53.3 from 48.3, services to 52.9 from 47.4, and even construction from 49.2 from 45.9.

This rebound in consumer and business sentiment is a sigh of relief that can be attributed to three important factors:

- First, contrary to what could be feared, the ruling conservative party was able to quickly appoint a new prime minister, Mrs. Theresa May, and a new cabinet, thus avoiding a protracted leadership crisis.
- What's more, one of Mrs. May's first statements was to suggest that Brexit negotiations with the EU were not going to start soon at all, possibly not before the second half of next year, once key elections in France, The Netherlands, and Germany are passed. Second, the new cabinet made it clear that with Brexit possibly hampering economic

growth in the coming two years, the next Autumn Statement on Nov. 23 will see the previous chancellor's commitment to achieve a budget surplus by 2019-2020 abandoned. Looser fiscal policies in the short term have now become a distinct possibility.

- The third factor relates to the Bank of England's immediate and vigorous response to post-Brexit uncertainties. The BoE's monetary policy committee (MPC) implemented a four-pronged stimulus package consisting of a cut in the bank rate to 0.25% from 0.5%, the introduction of a term funding scheme to reinforce the pass-through of the cut in the bank rate, purchase of £10 billion of U.K. corporate bonds over 18 months, and purchase of £60 billion of U.K. government bonds over six months.

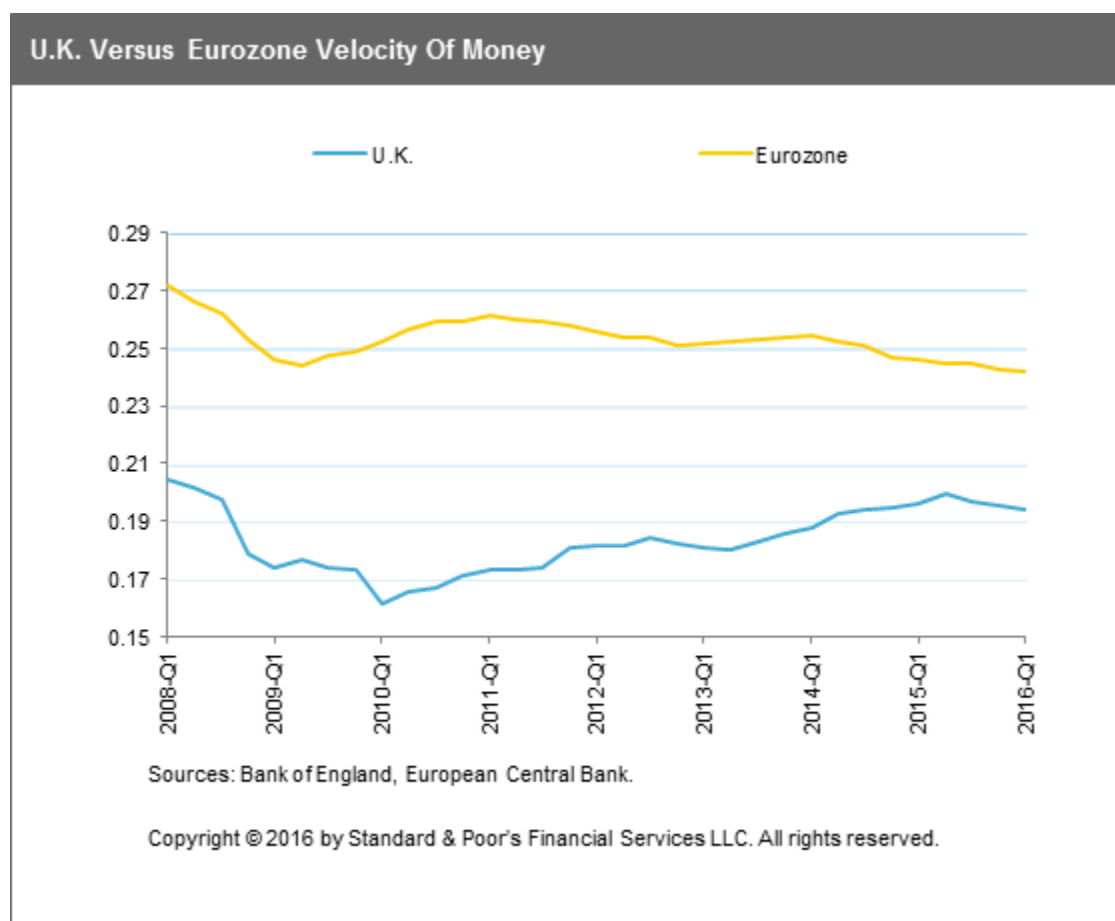
More surprising than the rate cut was the return so soon to sovereign quantitative easing (QE), intended to demonstrate the BoE's determination to support the domestic economy amid heightened uncertainties. One of the MPC's fundamental concerns, we believe, is financing the current account deficit. The U.K. current account deficit reached a record 6.9% of GDP in the first quarter. The current account deficit results from deficits or surpluses run in the public, corporate, and household sectors. In past years, the budget deficit has steadily declined to 4.4% of GDP in 2015 from 9.6% in 2010. Meanwhile however, the deficit of the household and corporate sectors--the difference between their total savings and their investment--has increased. The net balancing item is the rest of the world surplus, as measured by the current account deficit, which is financing by foreign investors of the domestic deficits in the economy. To put it in another way, a country that runs a large current account deficit is a country that relies on the rest of the world to finance a large part of its domestic investment. Such financing wasn't an issue in the past for the U.K., but could become more problematic as uncertainties increase about its new relationship with the EU's single market. To summarize the new challenge ahead, BoE Governor Mark Carney said the U.K. should not be "relying on the kindness of strangers," echoing the last line of a famous book.

The Bank of England's readiness to act as a buyer of last resort for now succeeded in appeasing gilt markets and in preventing a steepening in the yield curve. But two other factors will influence the real economy's longer-term response to Brexit: the housing market and exports.

The residential real estate market is poised for a soft landing

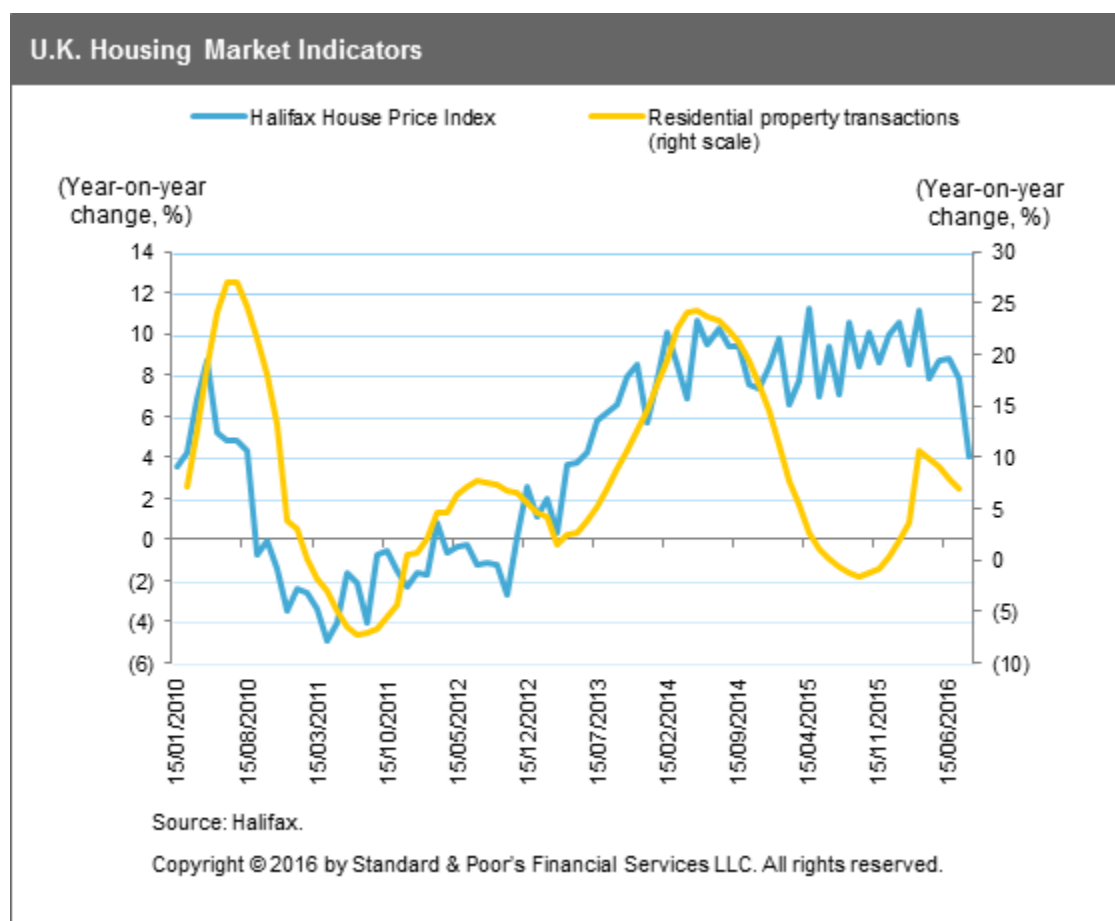
The U.K. housing market plays an important role in the transmission of monetary policy to the real economy, via consumer demand. Unlike on the Continent, household consumption reacts more visibly to the wealth effect induced by higher asset prices, homes in particular, as a result of an increase in monetary policy stimulus. For instance, look at the velocity of money in the U.K. compared with in the eurozone. According to the relationship established by economist Irving Fisher, the impact of a monetary stimulus on nominal output partly depends on the velocity of money, illustrated by the relationship: $MV=PT$, where M is the total quantity of money, V the velocity of circulation of money, P the price level, and T the total amount of goods and services exchanged for money. Amid today's very low interest rates, where consumers are wary of unemployment and deflation, the typical response of GDP to money supply growth has been less than the typical 1-1 relationship. Velocity has proven to be key in the transmission, or lack therefore, of monetary impulse. While the velocity of money has been trending downward in the EU, it's risen in the U.K. since 2010 (see chart 1). In our view, this increase is related to the broad recovery in U.K. asset prices, especially housing, creating a wealth effect that has stimulated consumer spending.

Chart 1



Today, the U.K. housing market is subject to conflicting influences: On one hand, the MPC's vigorous response should be stimulating demand for housing loans and underpinning transaction growth. But on the other hand, uncertainties about growth prospects and the future relationship with the EU throw doubts over the market's ability to keep growing. The behavior of foreign buyers is particularly hard to predict: They may take advantage of the weaker pound and buy into the housing market, or conversely they may shy away because of fears about the future prospects of the City of London. This comes at a time when the housing market has already been slowing (see chart 2). The rate of increase in prices has been on a downward trend since the beginning of the year. Home sales numbers are harder to interpret as they've been distorted in recent months by the introduction in April of higher stamp duty tax rates for buy-to-let and second-home purchases, but in July mortgage approvals fell to their lowest level since January 2015. At this point, we expect the housing market to experience a soft landing in the coming 12 months, thanks to still very favorable financing conditions. A steeper fall would undoubtedly be associated with a sharper contraction in consumer demand and residential investment.

Chart 2



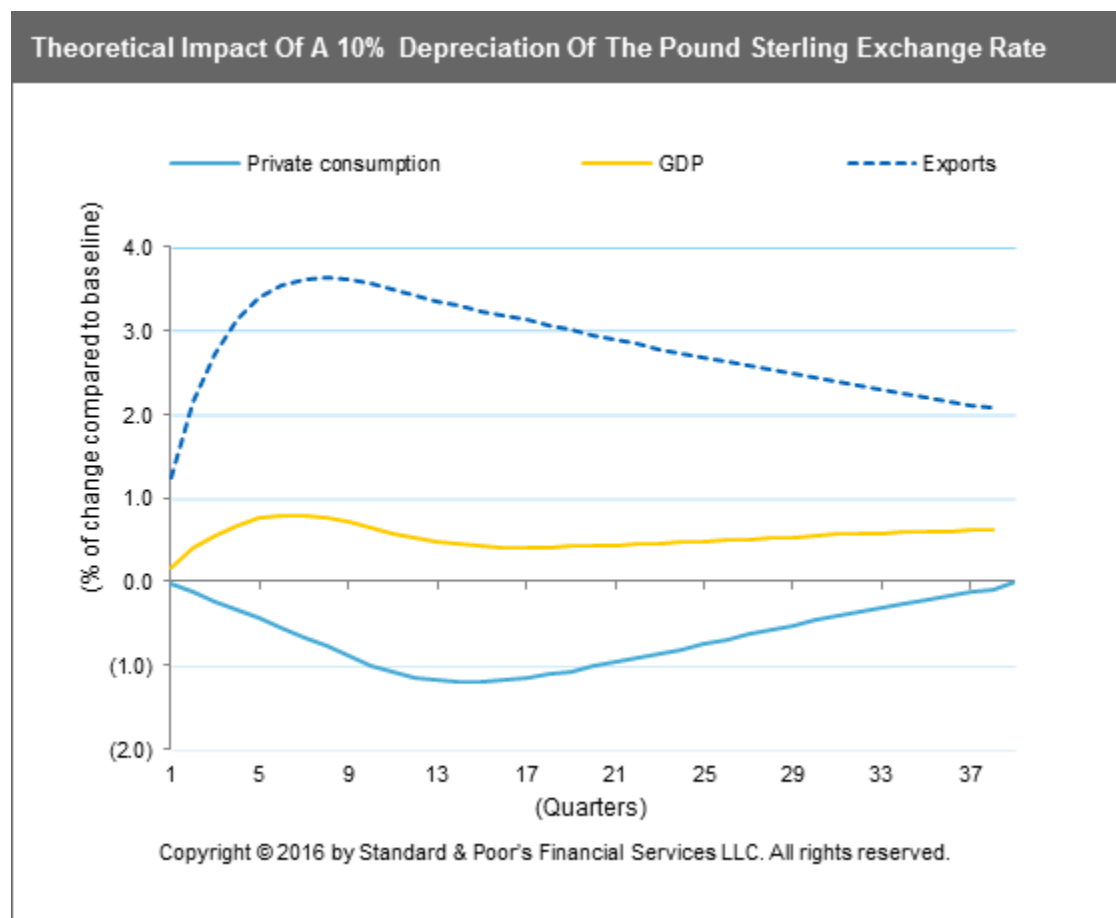
The pound's depreciation should boost exports, translating in only limited lift for GDP

One of the Brexiters' key arguments was that a weaker pound exchange rate would benefit exports and hence overall economic growth. History is more complex. Sterling's most recent depreciation, in late 2008 when the pound lost 16% against the dollar in six months and 28% against the euro, did not point to a large trade boost. At that time, consumer spending was dampened by the subsequent increase in import prices. That episode could arguably be seen as a special case, as world trade collapsed over the same period. However, we have many other episodes of sterling depreciation from which to draw conclusions. Since 1975, the pound experienced eight major bouts of decline. On average those episodes lasted six months, with the pound losing 13.8% against the dollar and 18% against the euro. The pound's biggest drop against the greenback was in 1981 and again in 1982 (19% each time).

In an econometric analysis, we found that a 10% depreciation in sterling's exchange rate against the U.S. dollar would boost real exports of goods (excluding fuel exports) 2.5% to 3% over the following 18 months. More broadly, a 10% depreciation in the real effective exchange rate produces a 4% boost to real exports of goods. This is not insignificant at all. Over the past 12 months to the end of August, the pound's real effective rate lost 17%. All things being equal, this should boost real exports by about 7% by the beginning of 2018. Let's not forget that by then U.K. exporters should still have full access to the European single market as the Brexit negotiations will most likely not be over. However, the net effect on real GDP growth will be more limited. For one thing, exports of goods represent only 15%

of the U.K.'s real GDP. That ratio for Spain would be 21.6%, and for France 22.3%. Plus, the weaker pound reduces consumption via higher inflation. Chart 3 illustrates this trade-off, assuming a 10% depreciation of the pound against the euro.

Chart 3



In the present situation, we estimate that sterling's depreciation in the past year will boost real exports of goods by about 7%, but real GDP by only about 1.2% by the middle of 2018. As a result, we forecast GDP growth will be 1.8% in 2016, 1.0% in 2017 and 1.1% in 2018. For comparison purposes, the projections we did before the referendum, assuming no Brexit (and consequently an appreciation of the pound in the second half of the year) had GDP at 1.9%, 2.1%, and 2.0% respectively, which suggests an overall negative impact of Brexit on GDP growth of about 2.1 points in two and a half years.

The Eurozone Looks For A Second Wind

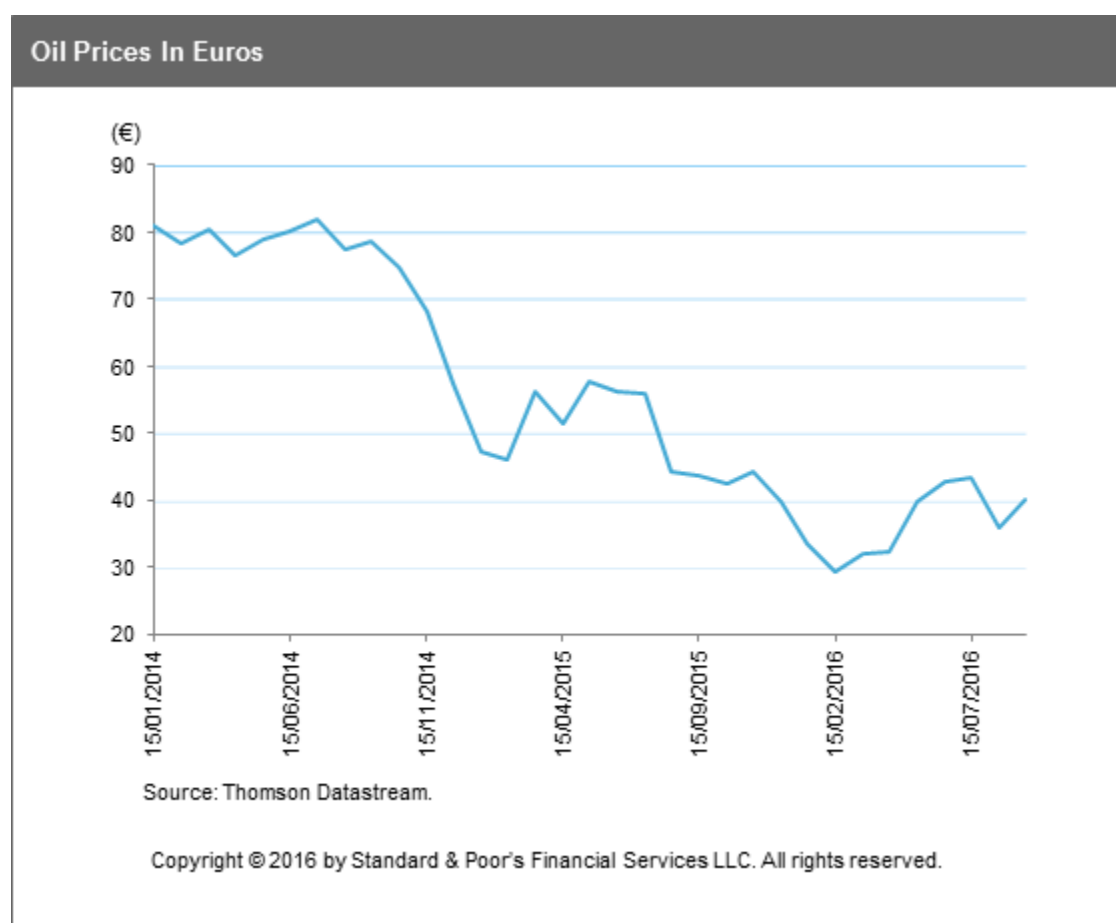
The purchasing managers indices and the European Commission economic sentiment survey revealed some weakness in the eurozone in August, but still pointed to a muted response so far to the Brexit surprise. To date, the survey data still aren't pointing to a marked slowdown in growth. But Brexit occurred when the eurozone was struggling to find a

second wind, now that the boost from very oil prices on spending power is vanishing, while investment remains hesitant and the effects of monetary policy are taking time to materialize.

Consumers are looking for help, again

As far as consumption goes, hourly labor cost growth fell to 1% in the second quarter from 1.6% in the first quarter, the slowest pace since 2014. This slowdown was due primarily to the weak wages and salaries component, which rose just 0.9%, the lowest in six years. The nonwage cost component growth rate, meanwhile, remained relatively stable, falling to 1.4% in the second quarter from 1.7% in the first quarter. Looking at the national breakdown, the surprising slowdown in German wage growth was the key reason behind the sluggish figure for the eurozone overall. In eurozone's largest economy, wages grew by 1.1% in the second quarter, down sharply from 2.7% in the first quarter. The slowdown comes at a time when inflation is likely to pick up somewhat as energy base effects dissipate. This is an important change for consumers: the counter oil shock that boosted purchasing power in the past two years is all but over. This is not to say that we expect oil prices to spike in the near term. But prices seem to have found a bottom, and in euro-denominated terms they have actually been rising since the beginning of the year, marking the end of the "energy dividend" (see chart 4).

Chart 4



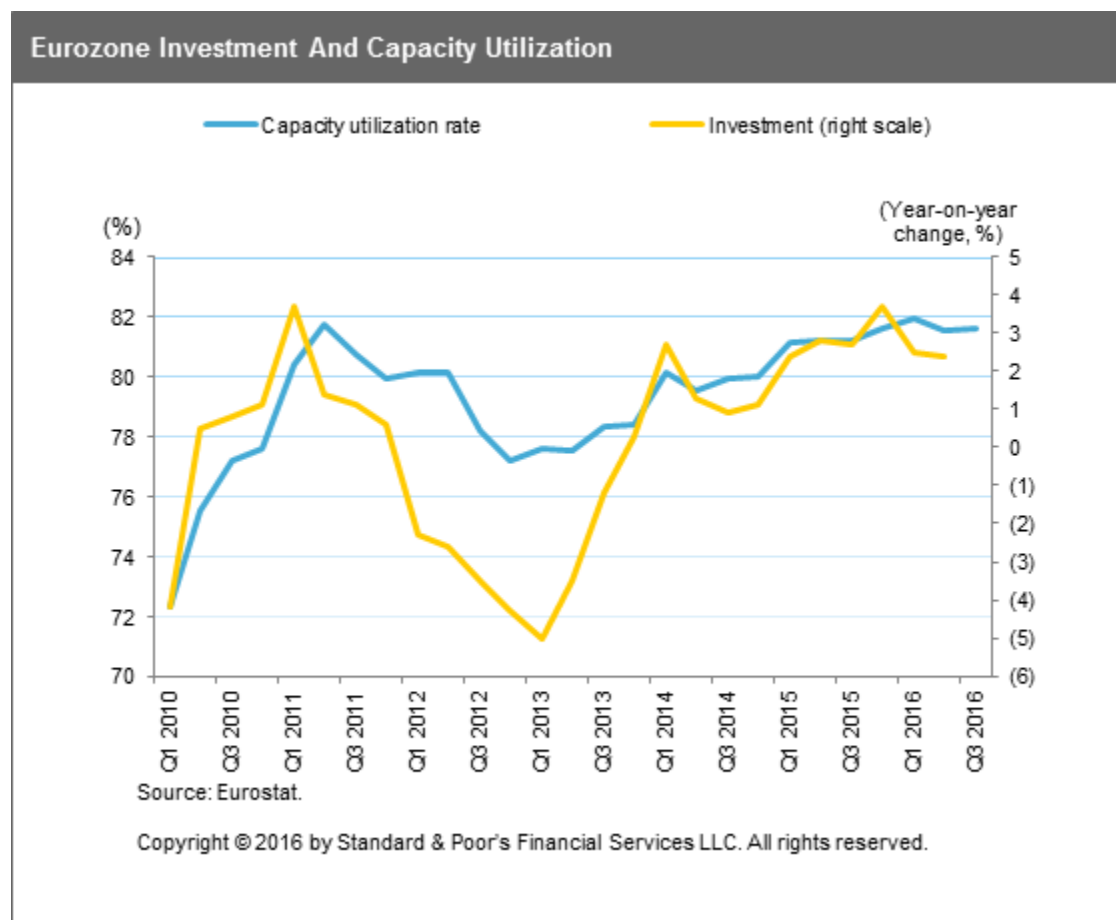
For sure, not all is negative on the consumer front. Labor markets continue to improve in many countries such as

Spain and even France. The coming election schedule leads us to expect mild fiscal easing in most countries, which should underpin purchasing power growth. But overall, our new forecast has growth in consumer demand slowing in the eurozone to 1.3% in 2017 and 2018, from 1.6% this year.

A fragile recovery in investment

The investment recovery was visible in the first quarter (2.9% year on year), led by investment in equipment. However, the second quarter was disappointing, as capital spending stalled after two quarters of robust growth. The renewed softness could be attributed to stabilization in the capacity utilization rate (see chart 5).

Chart 5



On the other hand, there is no doubt that the eurozone corporate sector is operating under more favorable financial conditions. The gross savings ratio (profits net of taxes and debt servicing costs as a % of value added) has sharply recovered and now stands at record highs. Low wage growth and ultralow interest rates are boosting corporate earnings. In addition, investment is no longer simply concentrated in machinery and equipment. A broader recovery in construction investment is now occurring, boosting activity and employment as well. Overall, what remains uncertain is how the balance will play out between better financing conditions and political uncertainties, such as the fallout from Brexit, and the coming elections in many countries.

ECB policies are taking time to materialize into economic gains

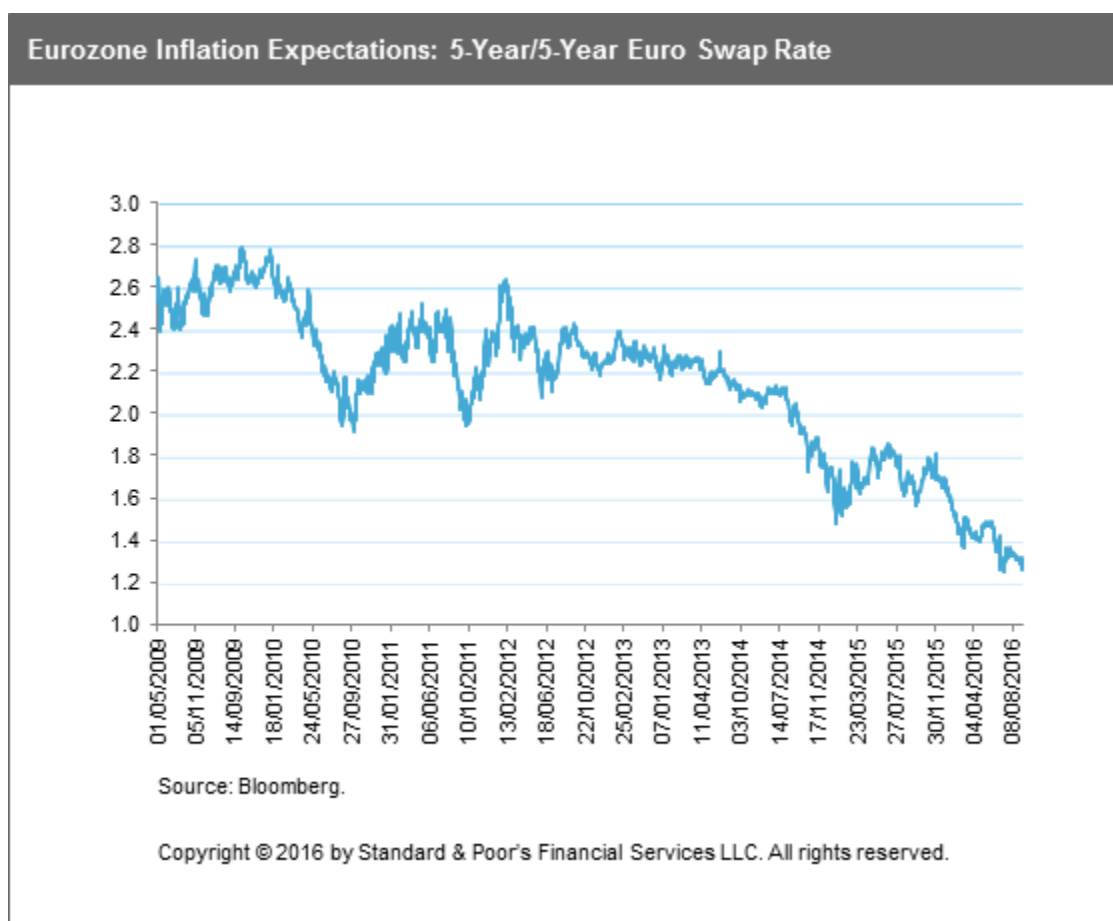
Another question mark about the eurozone recovery is uncertainty around the effects of the European Central Bank's monetary policy. Over the past year and a half since it kicked off its quantitative easing (QE) program, the bank has purchased €1 trillion of assets. By the time the program reaches its first review date in March 2017, the bank will have acquired €1.6 trillion of assets, the equivalent of 12% of eurozone GDP. At present, the ECB holds about 14% of all eurozone sovereign debt. By comparison, the U.S. Federal Reserve holds about 18.3% of U.S. sovereign debt. The ECB holding varies by member state, at 24% of German debt, but only 8.5% of Italy's, and 13% of French debt.

The ECB's accommodative policy comprises not only a large asset purchase program (€80 billion a month), but also a negative interest rate on banks' excess reserves (currently set at -0.4%). It also includes a series of four, targeted long-term refinancing operations (TLTRO II) extending from June 2016 to March 2017, with a maturity of four years. Banks are allowed to borrow an amount equivalent to up to 30% of their outstanding eligible loans as of Jan. 31, 2016, less any amount borrowed from the previous TLTRO (June 2014 to June 2016). Assuming fully repaid funds from the first TLTRO, eurozone banks can borrow up to €1.7 trillion under this new program (30% of the €5.7 trillion eligible loans amount). Allocations of available funds vary materially across Europe; Germany, France, Italy, and Spain have the largest shares, with €408 billion, €351 billion, €317 billion, and €208 billion, respectively. Borrowing conditions as part of the new TLTRO can be as low as the interest rate on the deposit facility (currently at -0.4%) if banks increase their loans more than 2.5% over two years, above what they currently hold on their books (an increase of 1.2% annually in 2016 and 2017).

The ECB's aggressive package has started to produce some results. Bank lending flows to the private sector have improved. Loans to households (adjusted for sales and securitization) rose 1.8% year on year in July, while credit to nonfinancial corporations was up 1.9%. These rates are undoubtedly still modest historically but, given the concerns about the impact of negative interest rates on banking system profitability, it remains encouraging that actual lending data and the ECB bank lending survey show continued improvement. Financial fragmentation within the monetary union has also decreased: Interest rates on new loans for small and midsize enterprises have narrowed considerably in Italy and Spain. Firms in those countries can now borrow at rates about 30 basis points (bps) higher than their German counterparts, compared with a gap of as high as 250 bps at the height of the sovereign crisis in 2012.

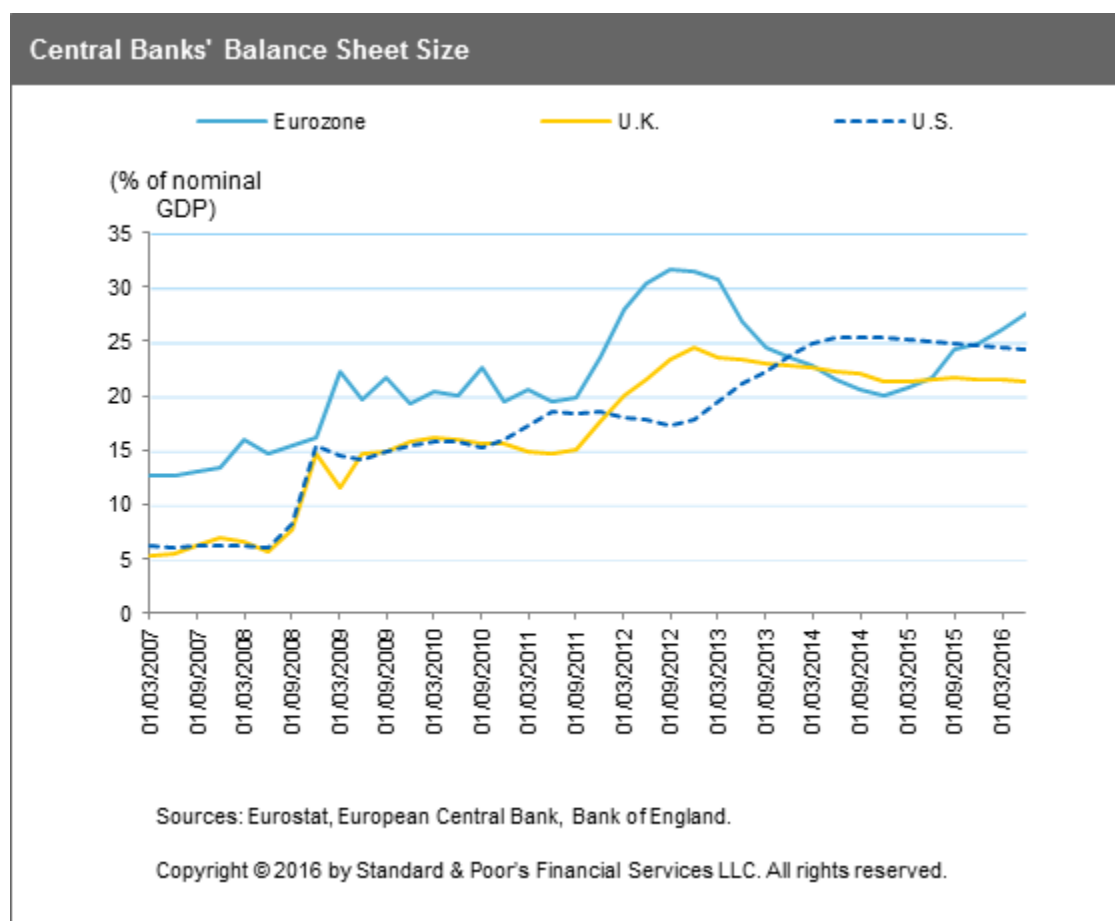
Taking a broader view, the ECB's strategic targets remain elusive. Inflation expectations have not improved meaningfully. In fact, after a short period of increase, on the back of a weaker euro exchange rate, expectations have diminished again since the beginning of this year.

Chart 6



The lack of movement in inflation expectations reflects the ECB's struggle to influence the euro exchange rate. The euro is up 4.3% from its January level against the U.S. dollar. As a result, markets expect the ECB to introduce additional measures before the end of the year. In our view, such expectations may be partly misplaced. First, it's important to remember that the new ECB package introduced between March 2014 (negative rates) and March 2015 (QE and TLTRO) follows an extended period when the bank's balance sheet actually shrank, a sign generally associated with tighter, not looser, monetary policies. This contraction occurred as banks were repaying the amounts borrowed during the first LTRO operations. This phenomenon stands in stark contrast with the results of monetary policy at other major central banks, and suggests that the ECB's new stance still needs time to produce effects.

Chart 7



In addition, the ECB remains "Fed-driven" in the sense that its ability to influence its exchange rate, and hence the level of imported inflation, also depends on the timing of the Fed interest rates hikes. Delays, as has been the case through 2016, tend to weaken the U.S. currency.

What else could the ECB do? There's been speculation that it could use "helicopter money" in the form of targeted fiscal giveaways--like the U.S. tax rebate checks to consumers in 2001 and 2008. In our opinion, this is highly unlikely at this point for a number of reasons. The absence of an EMU-wide fiscal authority should preclude such measures. Such giveaways could also appear to be backhanded incentives for national governments to relax their fiscal stance further and postpone structural reforms, a temptation that's already quite tangible after the Brexit vote and ahead of key elections in Italy (a constitutional referendum) or France.

Instead, we believe the ECB's next move, in December, could consist of a further drop in its negative deposit rate, especially in the case of lack of Fed action and a further cut by the Bank of Japan. In a recent speech, ECB executive board member Peter Praet stressed once again that ECB rates could still go lower when he noted: "We expect our policy rates to remain at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases [in March 2017]" (speech at the Bank of New York Mellon 20th anniversary, in Brussels, on Sept. 15, 2016). The ECB is also likely to extend its QE program beyond March 2017, a move that's all but certain. Would it also

venture further into unconventional policy territories, by extending its QE program to exchange traded funds, thus indirectly purchasing equities like the Bank of Japan? Such a decision would certainly surprise the markets and raise eyebrows in many circles.

The Brexit Pain Will Last Several Years

Three months on, our latest forecast update reinforces our initial post-Brexit assessment that the U.K. decision to leave the EU (at some point) will hurt the U.K. economy, with an adverse impact spread over several years, knocking off about 2.1 points of GDP growth between now and the end of 2018--but without precipitating a full-fledged recession. The impact on the eurozone will be milder, taking off about 0.7 point of growth, but in a context of already sluggish growth in the single monetary union.

Table 1

Main European Economic Indicators September 2016									
Central forecast									
	Germany	France	Italy	Spain	Netherlands	Belgium	Eurozone	U.K.	Switzerland
Real GDP (% change)									
2014	1.6	0.7	-0.3	1.4	1.4	1.3	1.1	3.1	1.9
2015	1.5	1.2	0.6	3.2	2.0	1.4	1.9	2.2	0.9
2016(f)	1.8	1.3	0.9	3.2	1.7	1.5	1.6	1.8	1.0
2017(f)	1.5	1.2	0.8	2.3	1.5	1.3	1.4	1.0	1.5
2018(f)	1.4	1.4	0.9	2.0	1.2	1.2	1.4	1.1	1.5
CPI inflation (%)									
2014	0.8	0.6	0.2	-0.2	0.3	0.5	0.4	1.5	0.0
2015	0.1	0.1	0.1	-0.6	0.2	0.6	0.0	0.1	-1.1
2016(f)	0.4	0.2	0.0	-0.4	0.1	1.9	0.2	0.7	-0.4
2017(f)	1.6	1.2	1.1	1.4	1.0	1.8	1.3	2.0	0.4
2018(f)	1.7	1.3	1.3	1.5	1.3	1.5	1.5	1.9	0.8
Unemployment rate (%)									
2014	5.0	10.3	12.7	24.5	7.4	8.6	11.6	6.2	3.2
2015	4.6	10.4	11.9	22.1	6.9	8.5	10.9	5.4	3.3
2016(f)	4.2	10.0	11.5	19.9	6.2	8.3	10.1	5.0	3.7
2017(f)	4.2	9.6	11.1	17.8	5.8	8.0	9.5	5.5	3.9
2018(f)	4.4	9.4	10.9	16.3	5.5	7.8	9.2	6.3	4.0
10-year bond yield (yearly average)									
2014	1.2	1.7	2.9	2.7	1.5	1.7	2.0	2.6	0.7
2015	0.5	0.8	1.7	1.7	0.7	0.9	1.2	1.9	-0.1
2016(f)	0.1	0.4	1.4	1.4	0.3	0.7	0.8	1.1	-0.4
2017(f)	0.5	0.9	1.8	1.7	0.7	1.2	1.2	0.9	0.1
2018(f)	0.9	1.2	2.2	2.1	1.0	1.9	1.6	1.3	0.5

Table 1**Main European Economic Indicators September 2016 (cont.)**

Central banks policy rates (yearly average)					
	ECB	BOE	SNB		
2014	0.16	0.50	0.03		
2015	0.05	0.50	-0.75		
2016(f)	0.01	0.38	-0.75		
2017(f)	0.00	0.05	-0.75		
2018(f)	0.00	0.05	-0.75		
Exchange rates (yearly average)					
	USD/EUR	USD/GBP	EUR/GBP	CHF/USD	CHF/EUR
2014	1.33	1.65	1.24	0.91	1.21
2015	1.11	1.53	1.38	0.96	1.07
2016(f)	1.11	1.37	1.24	0.99	1.10
2017(f)	1.06	1.23	1.16	1.05	1.11
2018(f)	1.08	1.23	1.15	1.06	1.14

f--S&P Global Ratings forecast.

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