QNB Economics
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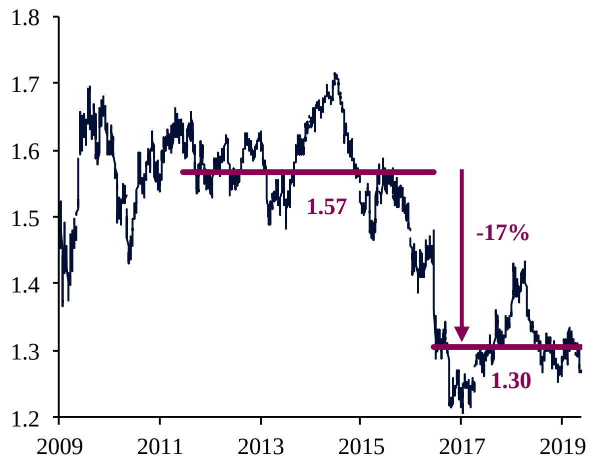
Economic Commentary

Brexit uncertainty a persistent drag on the UK economy

Uncertainty around Brexit has been a persistent drag on the UK economy ever since June 2016 referendum when the UK narrowly voted to "Leave" the EU rather than "Remain" in the EU. The British currency (GBP) fell sharply after the referendum and remains 17% below the average of the previous 5 years (see Chart 1).

Chart 1: UK foreign exchange rate
(USD per GBP)



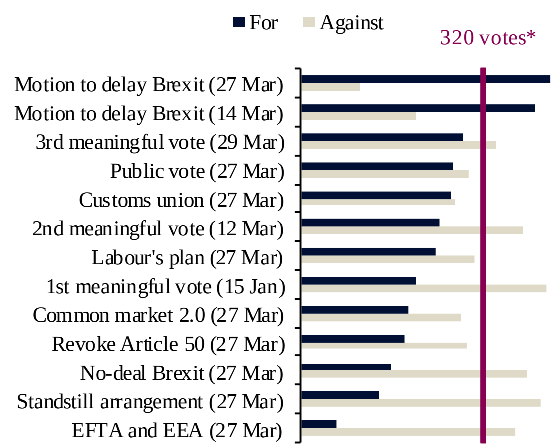
Sources: Bank of England, Haver, QNB analysis

Unfortunately, the uncertainty around Brexit has already impacted the UK economy. Indeed, Goldman Sachs estimates a 2.5% hit to the level of GDP. The main impact is via weaker confidence, causing consumers to spend less and businesses to invest less than they would have without Brexit risk.

The British Prime Minister (PM) Theresa May has negotiated a deal with the EU, but it is universally unpopular and has been repeatedly rejected in three "meaningful votes" by the British Parliament (see Chart 2). Instead, Brexit has been delayed multiple times and is now pencilled in for 31 October.

Parliament tried and failed to break the impasse with a series of "indicative votes" on 27 March (see Chart 2). In addition, PM May has announced that she will step down as Conservative Party leader on 7 June. The process to elect a new leader (who will also become PM) could last until September. However, whoever wins the race to become PM will face the same set of four difficult choices.

Chart 2: British Parliament Brexit votes
(number of votes)



* While the Commons has 650 MPs, 11 do not take part in voting – the Speaker, his three deputies; and seven Sinn Féin MPs. So a vote needs support of 320 MPs to be guaranteed a win, but can win with less if some MPs abstain or choose not to vote.

Sources: BBC, QNB analysis

First, a new PM could try and push through something similar to PM May's deal. However, that seems unlikely as it is so clearly unacceptable to a majority members of parliament (MPs). The so-called "Irish backstop" is unacceptable to Eurosceptics whereas the majority of MPs are pushing for either a softer Brexit or to "Remain".

Second, a new PM could appease Eurosceptics by proposing a harder Brexit or try to threaten a "no-deal". Under no-deal, the UK would immediately leave the EU, which would likely be disorderly. Mark Carney the Bank of England (BoE) has said in an interview with Sky News that "no deal would happen by accident, it would happen suddenly, there would be no transition - it is an accidental disorderly Brexit." Carney also points out that "Parliament is against no deal, the government, … , is against no deal, the European Union is against no deal, and yet it is a possibility, it is the default option". The BoE's modelling of no-deal scenarios suggest the level of UK GDP would be 2.75% to 4.25% lower after three years relative to its base case, which assumes a deal.

Third, a new PM could appeal to Europhiles and propose a softer Brexit. However, delivering a softer Brexit is difficult because it is opposed by both MPs who support a harder Brexit and those who support "Remain". Indeed, many proposals for softer forms of Brexit have already been made and all failed to achieve a parliamentary majority (see Chart 2). The softest form of Brexit is of course no Brexit at all, but that would require "Remain" to clearly win popular support via either a general election or a second referendum.

Fourth, is a further delay to Brexit beyond 31 October. We consider this to be the most likely path because of the challenges blocking all other options. A delay would allow time for a general election or second referendum, which is probably necessary to break the current impasse. We expect the EU to agree to an extension under these circumstances, because the UK can unilaterally revoke article 50 and then re-invoke it delaying Brexit by 2 years.

Fractures into "Leave" and "Remain" camps run through both main parties, making future voting patterns less predictable than ever.

One indicator is the results of the European Parliament election last week. Both the Conservative and Labour parties were decimated. The strong showing by Nigel Farage's Brexit party will inject new life into the "Leave" camp's calls for Brexit at any cost. Whereas, parties that support "Remain" actually won more UK votes and seats than the the Brexit party.

On the other hand, the latest opinion polls suggest that a general election would lead to a hung parliament with Labour as the largest party. Also, the majority of Labour MPs (198 out of 245) backed a second referendum in the indicative votes.

So despite fatigue on all sides it is likely that the Brexit, and the associated uncertainty, drags on into 2020, thus maintaining a substantial headwind for European economic growth.

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