Alternative forecasting scenario for the United Kingdomin the event of a no-deal Brexit

The forecast for British growth presented in this Conjoncture in France report is based on a specific scenario regarding the outcome of negotiations between the United Kingdom and the European Union (EU) over the terms of Brexit post-29th March 2019. In the primary scenario, the two sides succeed in ratifying a deal in time and embark upon a transition period which will last until the end of 2020. This would enable the United Kingdom to continue to trade internationally in conditions similar to those in place at present, while working to negotiate new trade agreements with partners. Nevertheless, if this primary scenario does not come to pass, various options remain on the table as this Conjoncture report goes to press. The aim here is to assess the potential consequences for the British economy of a "no-deal» Brexit, as an alternative to the main forecast presented in the United Kingdom sheet. These alternative estimates nevertheless remain shrouded in a high level of uncertainty.

The situation post-29th March 2019 remains uncertain

In the principal forecasting scenario used in this Conjoncture in France, the United Kingdom and the EU would reach an agreement which would be approved by both the European Parliament and the British Parliament before 29th March 2019. This agreement would allow for a period of transition from 30th March 2019 to 31st December 2020, during which time the United Kingdom would continue to benefit from free trade arrangements with the EU, while also continuing to contribute to the European budget.

If an agreement were not to be reached by the end of March 2019, a second option would be to delay the exit date, providing that the British government should request such an extension from the EU and the other member states should agree to grant it. A third possibility is that Brexit could simply be cancelled: the Court of Justice of the European Union (CJEU) ruled on 10th December that it would be possible for an EU member state having commenced the process of exiting the EU to unilaterally reverse that decision and instead remain in the union.

These three options are compatible with the central scenario used when compiling this issue of Conjoncture in France: that the United Kingdom will not leave without a deal on 29th March 2019, i.e. that there will be a transition period, an extension of negotiations, or else the United Kingdom will stay in the EU.

There is one other possible scenario: that the negotiations should fail and no deal should be reached. In this case the United Kingdom would leave the EU on 29th March 2019 without any certainty regarding the nature of their future political and economic relations. In trade terms, the United Kingdom would thus become a non-EU nation: trade between all EU members and the United Kingdom would automatically be governed by the terms of the WTO's "most favoured nation» (MFN) clause, leading to a sharp increase in customs duties and non-tariff barriers of both exports and imports (see Special Analysis report), which would be felt immediately in Q2 2019. To cover this eventuality, an alternative Brexit scenario is presented here, albeit beset by all the uncertainty which naturally applies to such speculative exercises.

A no-deal Brexit could cause British GDP to shrink by 1.0% in Q2 2019

A number of institutes have attempted to predict the effects on GDP growth of a no-deal Brexit occurring on 29th March 2019. According to the National Institute Economic Review published in November 2018 by the National Institute of Economic and Social Research (NIESR), a no-deal Brexit would cost the UK 5.3% of GDP between now and 2030 compared with the soft Brexit scenario (a very moderate increase in customs barriers). In 2019, the loss of GDP would be around 1.5%. A working document published by the Bank of England, in response to a request from the House of Commons Treasury Committee for analysis of how Brexit would affect monetary and financial stability, suggests that leaving the EU without a deal or transition period would cause GDP to fall by between 4.8% and 7.8% between now and 2023, compared to a managed Brexit scenario with an agreement and transition period. This negative effect would be concentrated in the year 2019. Finally, according to the figures published by the British government in November 2018, the impact of a no-deal Brexit would be equivalent to losing between 8.0% and 10.7% of GDP in the long term.

The Brexit scenario envisaged in this Focus takes these factors into consideration, but is nonetheless limited to the forecasting horizon of this issue of Conjoncture in France, i.e. mid-2019. Since the Brexit deadline date is 29th March 2019, the scenario would remain unchanged for Q1 from the primary forecast for the United Kingdom. However, activity in Q2 would suffer considerably if the UK were to leave the EU without a deal: GDP would drop by 1.0% (after +0.1% in the preceding quarter).

This sharp fall would come as a result of several factors. Firstly, the pound would depreciate by at least as much as it did following the referendum in June 2016. Prices of imported goods would increase, stimulating inflationary pressures, particularly in the energy and food sectors. Without an agreement covering the situation of European Union nationals residing in the United Kingdom, and with some businesses relocating their activities, the number of people in employment would fall more rapidly than the labour force, causing unemployment to rise. Faced with an increase in imported costs, businesses would not raise wages by any more than the compulsory 4.9%

increase in the National Living Wage (NLW) scheduled to take effect on 1st April 2019: overall, purchasing power would fall by 0.8% in Q2 2019.

This decline in purchasing power, combined with the crisis of confidence engendered by a no-deal Brexit, would lead to a reduction in household spending: consumption would fall by 0.4% and investment by 0.5%. The savings ratio would also decline slightly (3.8% after 4.2%), since the decline in consumption would be less substantial than the decrease in purchasing power.

Faced with such uncertainty, corporate investment would decrease for a sixth consecutive quarter (–3.0% after –0.5% in Q1), representing a total loss of –6.0% over the course of the year. There are multiple factors combining to stifle corporate investment. On the one hand, faced with this unprecedented situation, many firms are delaying investment decisions. On the other hand, the planned relocation of some companies should reduce total investment by the amount that these companies would have invested if they had stayed on British soil.

Finally, a no-deal Brexit would see customs barriers immediately jump to WTO MFN levels as of 30th March 2019 (see *Special Analysis report*), unless the British government decided to delay the increase in customs duties applied to imports from the EU and temporarily reduce a proportion of the dutie applied to imports from the rest of the world. Faced with this sharp increase in prices, British exports would fall steeply while imports would fall by even more. The latter would be adversely affected by both prices and the decrease in domestic demand, while also being hampered by bottlenecks caused by new border checks. Moreover, after sharp inventory increases in several quarters of 2018, storage capacities are already reduced. As a result, the contribution of international trade to GDP growth would remain positive (+0.4 points, *Graph*), but businesses would reduce their inventories substantially in Q2: changes in inventories would thus knock 1.0 point off quarterly growth.

This forecast is beset by various uncertainties

This forecasting scenario remains subject to considerable uncertainty: on the one hand, it is based on ex-ante estimates of the potential effects of a no-deal Brexit, which are relatively fragile and dependent on numerous hypotheses. On the other hand, it is based on forecasting tools which use past relationships between macroeconomic variables to predict their future behaviour. But the nature of these relationships is likely to change in the event of a no-deal Brexit: for example, the decline in purchasing power could lead to a greater-than-expected decrease in household consumption, with households adopting an attitude of caution and prioritising their savings. Or, on the contrary, they might decide to maintain the same level of consumption, leading to a sharp fall in the savings ratio. This attempt at numerical analysis is therefore simply an illustration of the possible consequences of the UK leaving the EU without a deal in place. ■

Bibliography

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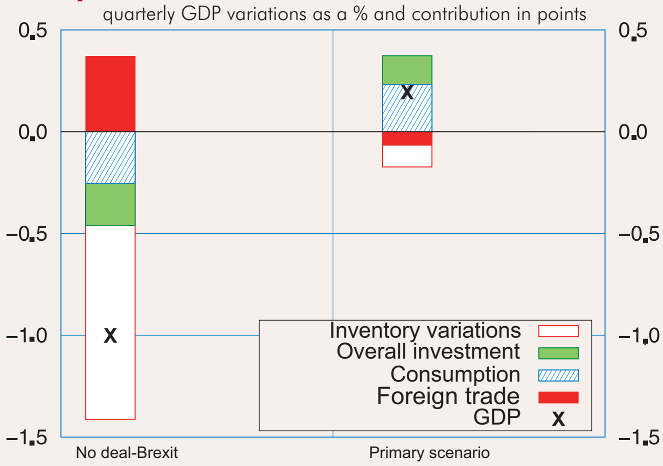
If a deal is not reached by 29th March, domestic demand would slow down British GDP growth

quarterly GDP variations as a % and contribution in points



How to read it: a no-deal Brexit would lead to a 1.0% decline in GDP in Q2 2019, of which 0.4 points would come from the decrease in domestic demand excluding inventory.

Source: ONS, Calculs INSEE