The British economy: from Brexit to trade wars

Economic commentary

22 May 2019

Key points

- The UK economy has made a surprisingly strong start to 2019, thanks mostly to robust spending by households.
- With Brexit uncertainties set to persist, many firms now face a tricky choice about whether to run down their inventories back towards normal levels.
- Prospects are also being clouded by the revival of trade tensions between the USA and China, which threatens to slow the pace of economic growth in the world's two largest economies.
- Growth in the UK during 2019 will come in at a similar rate to last year – provided that a "no deal" Brexit is avoided.
- With inflation well-contained, the Bank of England is not expected to hike Bank Rate any time soon, despite Mark Carney's rhetoric to the contrary.

Amid the uncertainties that afflicted both households and businesses in the run-up to the Brexit-day that never was, the British economy turned in a resilient performance in the first quarter. But the pace of growth is unlikely to be sustained in coming months. Not only do many businesses face tricky decisions about how to plan for the UK's delayed departure from the EU, but the recent resurgence of trade tensions between the USA and China is darkening the global economic sky.

On 10th May the office for National Statistics (ONS) released all the output and trade data for the month of March and for the first quarter of the year. The figures for individual months should be given a wide berth, notwithstanding that these often generate a lot of media headlines. Much economic and financial data is subject to natural monthly variations – what might loosely be called "white noise" – so that taking three months' figures together is generally the best way of getting a feel for what's actually going on.

continued overleaf …

HSBC UK

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A remarkably robust first quarter …

On the surface, the UK economy turned in a remarkably robust performance in the first quarter. GDP expanded by a solid 0.5% compared with the final three months of last year, and was up by a respectable 1.8% from the first quarter of 2018. By comparison, the US expanded by 0.8% (still enjoying the stimulatory effects of President Trump's tax cuts), while the Euro Area managed 0.4%, and Japan 0.5%.

Given that the opening months of this year have been dominated by the political wrangling over Brexit, with the House of Commons doing a passable imitation of some ghastly TV soap opera, it's somewhat surprising that the pace of economic growth actually accelerated. For all the talk about the build-up of inventories by businesses in advance of Brexit, in the end the biggest contributor to the economy's acceleration was the renewed appetite of households to spend. In real terms, their expenditure increased by a solid 0.7%, the strongest quarterly growth rate in two years.

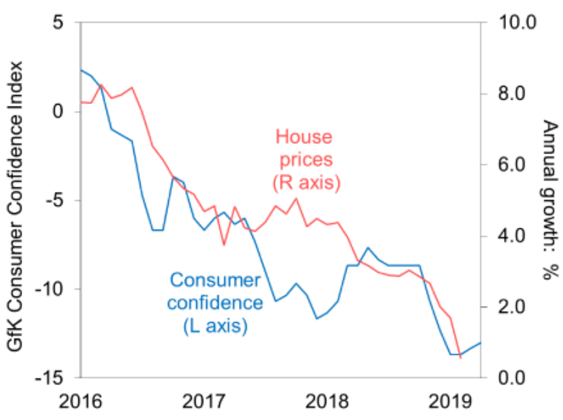
…despite some headwinds in the consumer sector

At first glance, this looks somewhat perplexing. Consumer sentiment, as tracked by the long-running monthly GfK survey, is languishing at a level that's a little below the long run average, with respondents citing concerns about Brexit and the political situation as dampening influences.

There is, moreover, still a good deal of reticence about "big ticket" purchases. The housing market remains becalmed, with price growth in the year to February coming in at just 0.6%, which is the weakest reading since 2012. It's also clear that prices are now falling in both London and the wider South-East, with annual declines of 3.8% and 1.8% respectively. Meanwhile, the number of new car registrations by private buyers continues to fall, with the total for the first four months of this year being 2.5% down on the same months of 2018.

But the appetite for spending on less-expensive goods and services has clearly returned, as reflected in a brisk increase of 1.6% in the volume of retail sales during the first quarter. With earnings growth now outstripping the rate of inflation, and by some margin, people are feeling better off; they're just not ready in the current uncertain climate to splash out on expensive goodies.

Confidence and house prices stuck in the doldrums



Source: GfK / ONS

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Evidence of pre-Brexit stockpiling

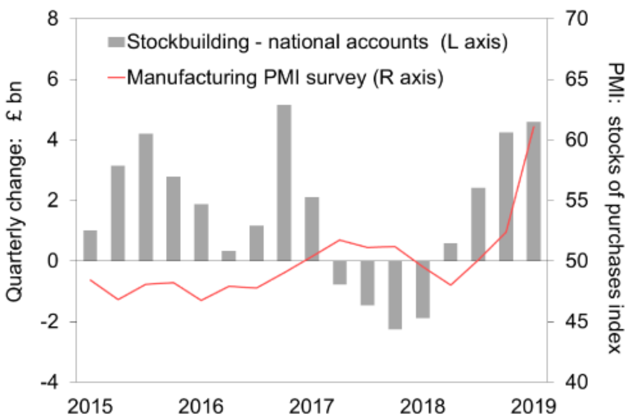
In the business sector meanwhile, firms who export or import, or who are involved in cross-border supply chains, have been engaged in planning to mitigate the risk of disruption in the event of a 'no-deal' Brexit. In many cases, the notion of operating a lean supply chain has gone out of the window as stocks of raw materials and finished goods have been accumulated, and as distribution networks have been revamped to reduce cross-border movements. The result is that warehouses the length and breadth of the land were crammed to the rafters in the run-up to what was supposed to be Brexit Day (29^{th} March). In the official economic statistics, this process has resulted in 'stockbuilding' (the technical term for inventory accumulation) of £8 billion in the six months to March. This is above the usual level, though it isn't off the scale: during 2014, for instance, firms added some £12 billion to inventories.

It was also notable that business investment spending showed signs of recovery at the start of this year. Firms had reduced their capital outlays for four consecutive quarters, with the Bank of England reckoning that the level of spending is now about a fifth down on where it would have been had the EU referendum produced a different outcome. Quite why firms decided to increase spending on the brink of Brexit is unclear, and the statisticians admit that the numbers may be a little flakey, owing to the adoption by many businesses of the IFRS16 accounting standard, which requires operating leases to be brought on to balance sheets. This may have affected the way in which figures were reported to the ONS.

Erratic movements in UK trade flows

With some businesses stocking up ahead of Brexit, or rushing to ship orders to overseas customers, the trade figures have behaved erratically. The effect has been to cause the UK's habitual deficit to widen dramatically, with the shortfall on trade in goods and services ballooning to £18.3 billion in the first quarter, compared with just £9.4 billion in the final three months of last year. But much of this widening related to a surge in imports of non-monetary gold. With London still a major centre for trade in precious metals, inflows and outflows can often send the trade statistics a bit haywire, but not usually to the extent seen in the past few months. During the first quarter of 2019, imports of so-called "unspecified goods", of which non-monetary gold is by far the largest part, were £6 billion higher than in the preceding three months. Stripping out trade in non-monetary gold and other "erratics", such as precious stones, ships, and aircraft, the deficit widened by just £3.1 billion to £14.5 billion.

A stockbuilding boost to activity



Source: ONS, IHS Markit

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A manufacturing rebound

On the output side of the GDP coin, the most striking aspect of the first-quarter figures was the strength of the manufacturing sector. At a time when manufacturing activity has been dampened in many countries in response to the global economic slowdown and renewed trade tensions between the USA and China, UK manufacturing output expanded by an unusually brisk 2.2%. This took output back to where it had been in the first quarter of 2008, at the brink of the deep recession triggered by the global financial crisis. It's likely that Brexit preparations played a part here, with the output of the pharmaceuticals sector surging by 9.8%, for instance.

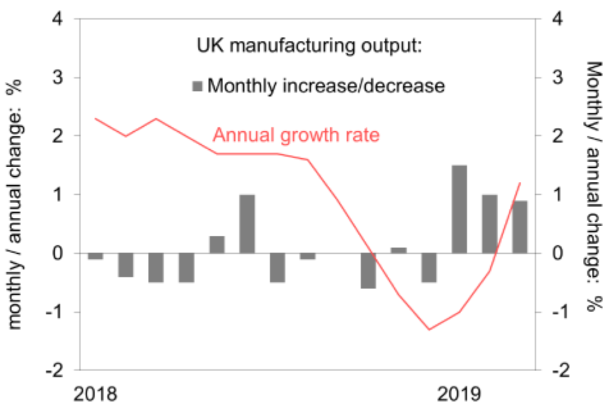
Meanwhile, the retail revival boosted output of the distributive trades by 1.2%, while activity in the construction industry expanded by 1.0%.   Less positively, an unusual feature of the first quarter was the first decline in nearly seven years in the professional and business services sector. This has been a powerhouse of the UK economy in the years since the financial crisis, with activity now over three-fifths bigger than in the trough of the last recession. It's also worth noting that finance and insurance continues to have a rough time, with output declining in seven of the last eight quarters. For this sector, there has been no recovery since the crisis.

Brexit: tricky choices for UK businesses

So what of the future? It seems unlikely that the present Brexit purgatory will end before October, and further extensions after that cannot be ruled out. The difficult issue facing all those businesses who have put contingency measures in place and built up inventories, is to what extent they should now run down their stock levels back towards normal levels. On the one hand, carrying extra stock represents a straight hit to cash flow, which finance directors will now be keen to unwind if at all possible. On the other hand, the threat of a "no deal" exit could be back on the table after the summer holidays, in which case the process of building inventories would have to be undertaken all over again.

Some unwinding of inventories is inevitable in the coming months, which will act as a minor and temporary drag on economic growth. Having undertaken stockbuilding of around £4 billion in the first quarter, if inventory levels were to be cut by £1 billion in the second quarter, then this would subtract 0.1 percentage points from growth. But there is no reason to anticipate any renewed belt-tightening on the part of consumers in the coming months, which should continue to provide the basis for further economic growth at a modest pace.

Manufacturing starts 2019 on a stronger footing



Source: ONS

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More sand in the wheels: global 'trade wars'

Although many UK businesses will bemoan the continuation of the Brexit purgatory, a possibly bigger fly in the ointment is the renewal of trade hostilities between the United States and China. Having supposedly been close to a deal just a few weeks ago, the mood has soured dramatically. On 10th May the USA implemented an increase in import tariffs on some $200 billion of Chinese exports from 10% to 25%. Unsurprisingly, China has announced retaliatory measures, in the form of higher tariffs on some $60 billion of American exports from 1st June. On top of this, the USA has threatened to levy tariffs of up to 25% on the remaining $300 billion or so of imports from China, with a public hearing scheduled on 17th June, and action possible from as early as 1st July.

Even with the truce that was called at the end of November, the tensions of the past year or so have already had an impact on the flow of trade between the world's two biggest economies. In the first quarter of this year, the value of America's exports to China was down by 18.8% compared with the same months of 2018, while the flow of imports fell by 13.9%. Looking more specifically at the goods covered by the tariffs, it seems that after an initial surge, imports have fallen by around a third in the past year as American importers have found alternative suppliers.

From China's perspective, the raising of tariffs to 25% on $200 billion of its exports to the US is reckoned to slow the annual growth rate by between 0.3 and 0.5 percentage points after a year. This suggests that annual GDP growth could be running at around 6.0% by the middle of next year, after coming in at 6.4% in the first quarter of this year. Were the United States to impose tariffs of 25% on the remainder of China's exports, as has been threatened, then the impact rises to a hit of more than one percentage point. Under this scenario, and without any mitigating policy measures China's growth rate would slow to closer to 5%.

For America's economy, the higher tariffs on Chinese imports represent a supply shock as the prices for these goods increase. Simple arithmetic shows that raising import duties on $200 billion of imports increases costs by $30 billion, which must either be absorbed in the supply chain or passed on to consumers: media reports already suggest marked increases in the price of washing machines, for instance. Further tariffs of 25% on the remaining $300 billion or so of imports from China which are currently still tariff-free would impose an additional cost of $75 billion. In practice, the effects are rather less than these crude calculations suggest, thanks to supply switching as noted above. Nonetheless, the USA's annual growth rate is already reckoned to have been trimmed by 0.1 to 0.2 percentage points as a result of the various tariff hikes imposed so far. The increase in the tariff rate to 25% on $200 billion of Chinese imports is expected to shave a further 0.1 percentage point off annual GDP growth, while levying a tariff of 25% on the remainder of imports from China would take off another 0.2 percentage points.

'Trade wars' start to bite

Source: US Census Bureau

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It's always possible that the latest measures will turn out to be part of President Trump's 'art of the deal' and that all will be settled with smiles and handshakes when he meets President Xi at the G20 summit in Osaka on 28-29 June. But failing that, the present cyclical slowdown in the global economy will only get worse, with the prospect of more bouts of volatility and risk aversion in financial markets. Yet even if this dispute is resolved, long-term damage has been done to the global economy. Multinational companies will now be thinking twice before they set up supply chains that span the globe. Once sand has got into the wheels of global trade, it will take some shifting.

The Bank of England: the boy who cried 'wolf' ?

In view of these global economic uncertainties, HSBC is sticking to its forecast for GDP growth of just 1.2% in the UK during 2019. Admittedly, with such a strong start to the year there is a chance that this forecast will turn out to be too pessimistic. By way of example, if the three remaining quarters of this year each see GDP increases of 0.2%, then the full-year growth rate would come in at 1.4%, the same as last year. The *caveat* here, as ever, is the assumption that the UK avoids a "no deal" Brexit, although it's worth noting that a "cliff edge" departure at the end of October would make little difference to this year's overall growth rate.

A continuation of stronger-than-expected growth readouts would inevitably re-ignite chatter about interest rate rises, especially if some form of Brexit deal can be achieved. Indeed, Mark Carney tried to steer the financial markets towards anticipating some action in his remarks delivered at the Bank of England's *Inflation Report* press conference on 2nd May. At present, the markets are expecting barely one hike in the next three years. But Mr Carney's assertion that they are underpricing the prospect of rate hikes fell on deaf ears. He's made Similar statements before, but the Monetary Policy Committee has rarely followed through with any action.

With inflationary pressures looking to be well contained, and with most other major central banks having turned their backs on any further monetary tightening (that's if they even got started), HSBC continues to expect that the Bank of England will also keep sitting on its hands. But their inaction will, nonetheless, require some kind of explanation. The assessment in the latest *Inflation Report* is that the economy has just about used up all its capacity, and that by the end of the forecast period in 2022, demand will be outstripping supply by around 1.5%. In the past, that situation would have certainly triggered an acceleration of inflation. The MPC will therefore need to explain why 'this time is different', or admit that it has only the haziest notion of the economy's supply capacity.

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