TRUSTING IN THE SPIRIT OF CAPITALISM

Strategy and economics

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There is no doubt that the principal immediate consequence of the Brexit vote has been a further increase in uncertainty. There was some evidence that this was already rising and having a negative impact on investment decisions during the run up to the referendum, but in the ensuing period it will have intensified. Uncertainty will be damaging to economic activity, of that we can be certain. However, it is less certain how long this period will last and the extent of the damage that will be done. To date, the focus has been largely on a few supply-side surveys that appear to show a very sharp dip in activity in the immediate aftermath of the vote to leave the EU. Such results are as unsurprising as they are unreliable as a guide to even the shorter-term future of the economy. More to the point, the fortunes of the economy are not determined by supply, but by demand.

Gauging Brexit

Over the coming months, to help gauge the magnitude of the proximate Brexit impact on growth, it will be important to focus on indicators that provide a guide as to demand trends in the economy. The general view is that the impact could be substantial. However, forecasters tend to over-react when trying to analyse the impact of shocks, partly because the effects of the shock are often most evident in the financial markets and that disturbance then influences economic assessments.

One way of categorising the Brexit impact on the economy is to look through the components of aggregate demand (demand-based GDP) and then identify indicators that can help us interpret the wider trends.

Household consumption

The most obvious place to start is with household consumption which accounts for 62% of total GDP. In the immediate aftermath of the Brexit vote, there was a reported drop in consumer confidence. It was substantial but hardly surprising. More importantly, the early data that we have for spending by households shows little or no identifiable Brexit influence. John Lewis, for example, publishes its sales figures on a weekly basis with virtually no lag (we have just had data for the sales-week to 23rd July). These data reveal a little weather disruption in the latest week (negative for the department stores, positive for Waitrose), but no obvious Brexit effect. Analysis of alternative data sources for spending on dining and drinking out leads us to a similar conclusion: no Brexit impact. Of course, it is early days, and the summer months may not be the best benchmark of underlying or medium-term trends. But to the extent that we have real information relating to household spending, it is reassuring.

Capital formation and inventories

Areas that are likely to reveal more damage are fixed capital formation, or capital investment, and inventories. Together, these comprise around 20% of GDP. There was already evidence of weakness in capital spending prior to the referendum. Some of this was probably a reflection of the wider world problem of over-capacity in manufacturing, but it is undeniable that concerns over the longer-term implications of the UK leaving the EU are likely to damage both local and inwards investment for a period. The only contemporary evidence for the post-referendum period that we have comes from a few comments from companies and the PMI construction survey. The latter looked very weak in July, but probably overstates the true drop in activity. Looking further ahead, as companies plan for the challenge of being outside the single market, this could well prove a stimulus to domestic investment spending, although inwards investment may remain weaker for longer. With regard to inventories, these will be determined by broader demand trends in the economy – to date, there is no evidence companies are reducing stock levels (indeed, in the first quarter of the year, they rose sharply).

Government spending and trade

Government spending on goods and services accounts also for about 20% of GDP. There is no reason why this should be negatively impacted by the Brexit vote – and it is even possible that the restyled Conservative government will choose to ease spending constraints.

This leaves trade. There are inevitable concerns relating to the longer-term implications of the UK's possible loss of access to the single market. On this, I will simply make the observation that over the past fifteen years, the proportion of UK exports going into the EU has dropped from around 54% to 43%. However, what will be the shorter-term consequences of the referendum result? Clearly, there could be a negative reaction from potential buyers of UK products within the EU. This is plausible, but improbable. Similarly, I would not expect to see a significant impact on import volumes – unless demand weakens more generally. Looking a little further ahead, however, exporters and businesses competing with imports should begin to benefit from the improvement in competitiveness that has resulted from the fall in sterling. Initially, the trade deficit is likely to widen, reflecting the increased cost of imports. Later, with a lag of around a year, the deficit should begin to contract as the benefits of greater competitiveness come through. This, it may be noted, is exactly what happened after the UK's apparently devastating exit from the Exchange Rate Mechanism in 1992 – which happened to initiate the longest period of uninterrupted growth in the UK's post-war economic history.

Alternative indicators

Other indicators that will be important to watch relate mainly to the labour market, inflation and credit growth. A way in which concerns on the supply side of the economy could feed back into demand is through employment. At the moment, the labour market is very tight, with the unemployment rate the lowest since 2005. I doubt that there will be a significant change in employment levels in the near term, but a forewarning, were this to happen, it would come through vacancy levels. Currently, these are not far short of an all-time high – and much higher than prior to the recession. However, if they were to drop sharply, they could foreshadow a more general deterioration in labour market conditions, which could then undermine consumer sentiment and demand.

With regard to inflation, it is inevitable that the fall in sterling will have some upwards impact on the price level. Initially, this will show through in fuel prices and then on a more widespread basis. Higher inflation will tend to reduce households' real spending power; it could also provide a test in terms of monetary policy. With regard to the former, the impact is likely to be relatively modest (and may well be offset by a reduction in the savings ratio). While the impact on monetary policy is harder to judge, I suspect that, for better or worse, the Bank of England will prove remarkably inflation tolerant. Interestingly, it has already proven very tolerant in relation to recent rapid growth in consumer credit. Reduced growth seems probable in the very near term and could become another negative influence on household spending. To date, however, lenders have not suggested that initially lower credit demand in the post-referendum period has persisted.

While it is inevitable that the prospect of leaving the EU has led to some nervousness, the British Isles have not been towed 1,500 miles into the mid-Atlantic. The shock to the political system in the UK has been huge and will continue to reverberate. On the other hand, and surprisingly to some, the economy may prove resilient.

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