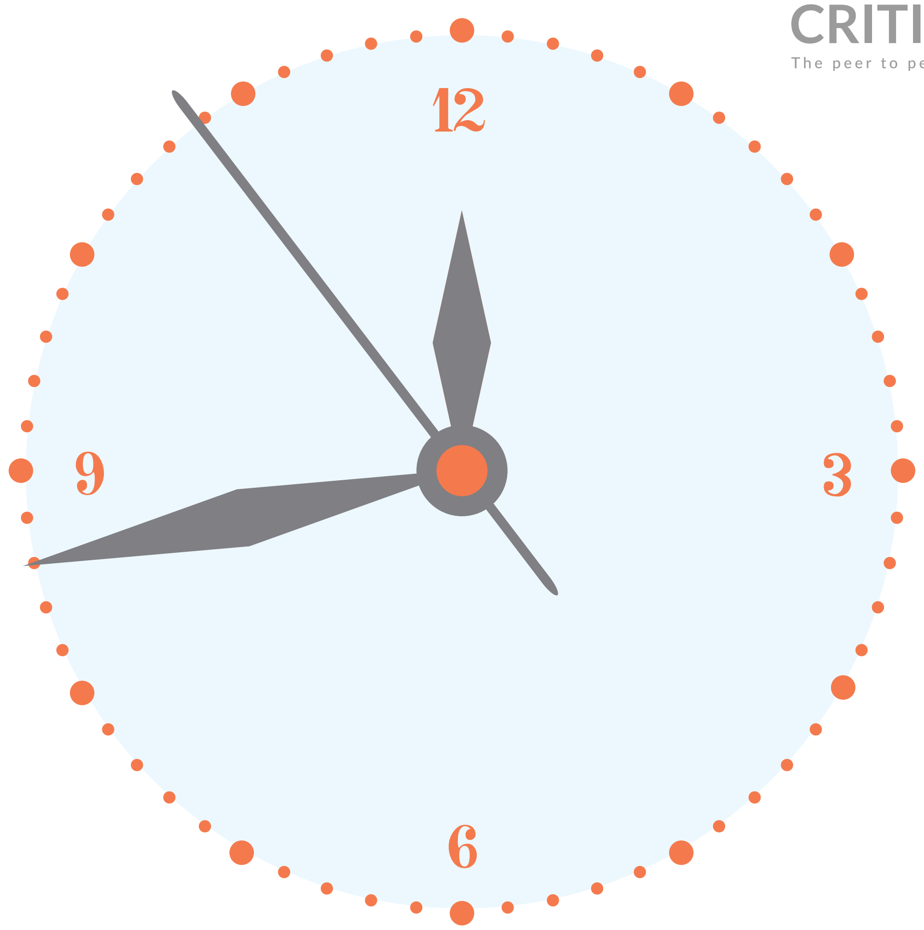

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Brexit – The Clock is Ticking

How will the UK economy respond to Brexit negotiations? **Tim Drayson**, Head of Economics at Legal & General Investment Management (LGIM), shares his views with **Dawn Murden** and tries to cut through some of the uncertainty

Article 50 has been triggered and the clock is ticking. The UK has two years to strike a deal with the European Union on the terms of its departure, during which time there will be complex negotiations on trade agreements and labour mobility.

We spoke to **Tim Drayson**, Head of Economics at Legal & General Investment Management (LGIM), to get his view on what business leaders can expect as the UK embarks on its long goodbye from the EU.

What impact might a snap general election have on Brexit?

The surprise decision to hold a general election on 8 June has no direct impact on the Government's timetable or objectives in the negotiations with the EU on the terms of withdrawal, assuming it wins.

However, it may have two important indirect impacts that reduce the likelihood of a hard rupture with the EU. Firstly, a larger Conservative majority would reduce the influence of those MPs prepared to tolerate an acrimonious departure from an ideological perspective.

Secondly, it removes the political imperative to have a clean break with the EU in place by 2020 – the >

previously scheduled election date. A lengthy transition and implementation phase after the eventual agreement is arguably now more likely.

What are some of the UK's key points for negotiation with the EU?

Immigration and trade are the two crucial areas.

We need to be careful that Brexit doesn't cut the flow of skilled labour coming to the UK. Talent shortages are already emerging in many areas, such as in IT, engineering, construction, agriculture and hospitality. Business leaders want reassurance that they are able to hire the best talent available from the global labour pool.

We also don't want to stop workers coming here because it helps drive economic growth. We have a large amount of debt and we need to generate tax revenues.

On trade, minimising barriers is the most desirable outcome. It's likely the EU will want to strike a deal in goods, as they run a large trade surplus with the UK. On balance, it's likely the UK is going to end up with more restrictions to trade, especially in services, once it leaves the Single Market.

Why will services encounter more restrictions?

Services are more problematic because the UK has the advantage. For instance in financial services (FS), which is a big export for the UK, there will be non-tariff barriers. This means there will be more checks on services covering whether they conform to the same regulations imposed by the EU.

> *“If negotiations quickly create a plan for free trade, sterling could appreciate”*

Initially, the UK will have the same regulations and hopefully a deal will be struck to allow the UK to demonstrate equivalence. However, as the UK begins to make changes to regulations, onerous checks to ensure compliance will be required, which could be disruptive to trade flows.

If this is the case, it could restrict the ability for FS to sell into the EU from the UK. Certain services could be manufactured in London, but companies may need to set up distribution centres within Europe.

Even though trade is set to become more difficult, I'd be surprised if there wasn't agreement because it would damage the EU and the UK if we fail to find a compromise.

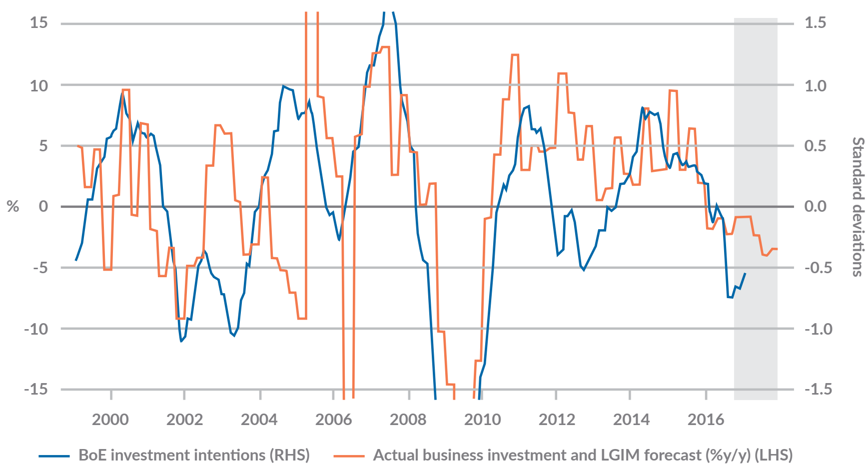
How do you expect sterling to fare?

After the initial sharp depreciation, sterling has remained relatively stable, despite the uncertainty. If negotiations break down that could be a catalyst for another fall in sterling, but this would actually make UK business more competitive.

The UK runs a trade deficit on goods and if this narrows it will add to GDP growth. We'll see money coming back into the UK because of those taking advantage of the cheap pound. This would be good for the UK manufacturing sector, which is one of the biggest sectors for exports.

On the other hand, if negotiations quickly create a plan for free trade, sterling could appreciate sharply – but I think that's unlikely. >

Graph 1: UK Business Investment



Source: Legal & General Investment Management

The next couple of years could see some volatility as negotiations unfold, but assuming there is a congenial agreement, sterling should rise back towards fair value.

What about inflation, do you see it rising?

Over the next 12 months, I don't see it going much beyond 3 per cent, but this does hinge on oil prices. If it spikes, that could push up inflation.

We're not seeing much service sector inflation. While the labour market in the UK is tight, Brexit uncertainty is giving employers an excuse to keep a lid on pay.

However, this does present a risk because if the economy fares better than anticipated and unemployment falls further, we may see more wage pressure.

In that case, if you get service inflation alongside higher import costs you're in danger of a more persistent overshoot of the inflation target. The Bank of England can tolerate a year or so at 3 per cent, but if this becomes embedded in expectations we may see interest rate increases. It would be real shock if it happened this year.

Businesses should not expect interest rates to remain low indefinitely – don't take on too much debt just because it's easy to pay back at the moment.

Overall, how optimistic are you about the UK economy over the next 12 months?

We are seeing a squeeze on incomes from high inflation but consumer spending has been remarkably strong after the Referendum. While that does appear to be slowing, consumer confidence is still elevated.

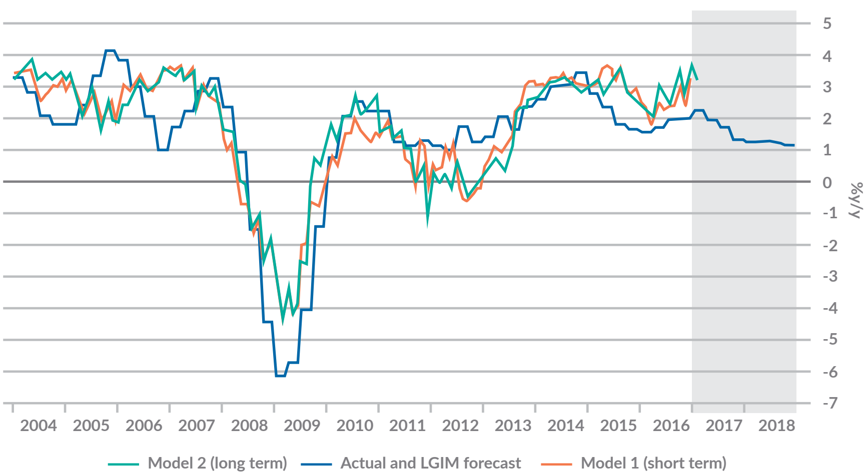
Business investment is probably the main area of concern, because we can see a delaying of projects. The Bank of England's investment intentions has been declining since Brexit and actual overall UK business investment has also started to fall.

Our forecast shows a modest reduction in business investment over the next couple of years **(See Graph 1)**. If anything, the policymakers have been complaining that companies are being too cautious and sitting on cash piles.

In conclusion, we expect continued economic growth. Our forecast for GDP growth is around 2 per cent, which will eventually lower to 1 per cent **(See Graph 2)**.

A slowdown is expected, though not a recession. ■

Graph 2: UK GDP Forecast



Source: Legal & General Investment Management / Macrobond

Tim Drayson spoke at Criticaleye's fourth [Human Resources Director Retreat 2017](), held in association with LGIM.

Tim Drayson
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Tim is Head of LGIM's Economics team. He joined LGIM in 2008, after four years at ABN AMRO as a Global Economist.

Previously, he was an Economic Adviser for five years at HM Treasury.

Tim graduated from the University of Nottingham in 1999 with an MSc in Economics.

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