United Kingdom

PLUS ÇA CHANGE…

- **Although the December general election delivered a decisive parliamentary majority for the Johnson Government, Brexit-related uncertainty is likely to remain elevated and a significant drag on growth over our forecast horizon to end-2021.**
- **We continue to expect the Bank of England to keep its benchmark Bank Rate on hold through end-2021 unless the Johnson Government makes good on its threat to crash out of the post-Brexit transition period without an agreement in place to ensure continued free trade with the European Union.**

WE'LL ALWAYS HAVE BREXIT

The United Kingdom (UK) and Northern Ireland's December 12 general election gave the ruling Conservative Party a clear mandate to "get Brexit done", but the UK's future economic relationship with the European Union is likely to remain under development for years to come. There is now little doubt that the UK will leave the EU on January 31, 2020: the Johnson Government's EU *Withdrawal Agreement Bill* (*WAB*) is expected to be passed into law before end-January, pushed through by the Conservatives' strong parliamentary majority.

Brexit will take the UK into a transition period during which the UK and EU will maintain their current mutual rules while they negotiate their future economic relationship. Prime Minister Johnson has vowed to conclude the transition by end-2020 and the *WAB* current prohibits any extension beyond this point. During the transition, the UK remains in the EU customs union and continues to pay into the EU budget, but loses membership in EU institutions and ceases to have Euro MPs in Brussels. A substantial portion of the Conservative caucus would threaten revolt at a longer spell of taxation without representation.

Since it is entirely unrealistic to expect a comprehensive UK-EU post-Brexit agreement to be hammered out by end-2020, the Johnson Government will either move to amend the *WAB* in the autumn of 2020 to permit an extension of the transition period for multi-year negotiations—or it will settle for a modest deal that substantially increases frictions in UK-EU commerce, likely reintroduces some tariffs, and is an ongoing dampener on UK growth. The remaining 27 EU member states and European Parliament aren't likely to agree on a common negotiating position until March. A high-level UK-EU meeting is subsequently planned for June to check on progress.

Boris Johnson's pledge to push for a "super Canada-plus" deal—an enhanced facsimile of the Comprehensive Economic and Trade Agreement (CETA)—by end-2020 isn't credible. CETA, which came into effect in 2017, took seven years to negotiate and has so far been ratified by only half of the 28 EU member states, and will only be fully implemented seven years from its

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United Kingdom	2018	2019e	2020f	2021f
Real GDP (annual % change)	1.3	1.1	1.2	1.6
CPI (y/y %, eop)	2.1	1.8	2.0	2.1
Central bank policy rate (%, eop)	0.75	0.75	0.75	0.75
UK pound (GBPUSD, eop)	1.28	1.33	1.36	1.42

Source: Scotiabank Economics.

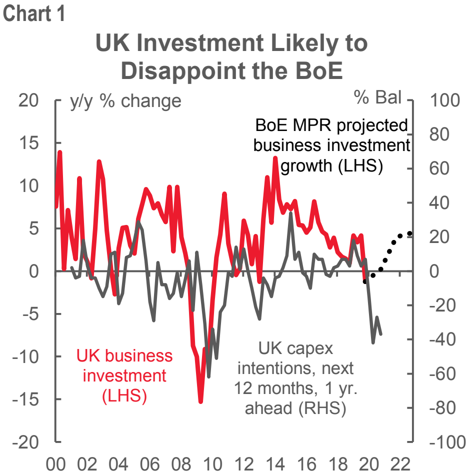
Table 1

BoE November MPR Forecasts

	2019	2020	2021	2022
Real GDP (% y/y)	1.3	1.3	1.8	2.0
CPI Inflation (% y/y)	1.5	1.5	2.0	2.3
LFS unemployment rate (%, eop)	4.0	4.0	3.8	3.5
Output gap (% potential GDP)*	-0.25	-0.25	0.50	1.00
Bank Rate (%, eop)**	0.70	0.50	0.50	0.50

Sources: Scotiabank Economics, BoE Monetary Policy Report.
* +'ve = excess demand, -'ve = excess supply.
** The path for Bank Rate implied by forward market interest rates. The curves are based on overnight index swap rates.

Chart 1



Sources: Scotiabank Economics, ONS, BoE Monetary Policy Report, CBI.

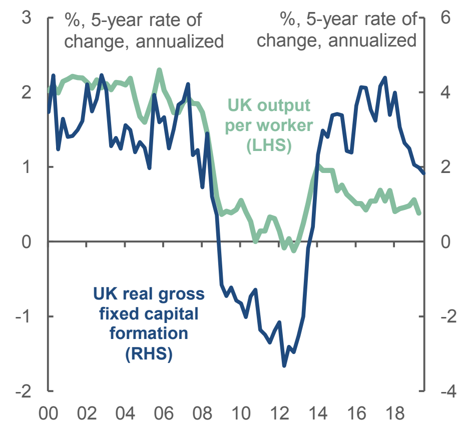
inception, i.e., 2024. CETA eliminates tariffs on 98% of goods traded between Canada and the EU, but maintains a range of regulatory barriers and doesn't provide full access for Canadian financial and other services to the European market.

PM Johnson has argued that a wide-ranging UK-EU deal will be easier to agree than CETA was because standards are currently aligned between the UK and the European common market—but this contradicts the core of the Brexit project. Regaining regulatory sovereignty has always been a major priority for Brexiteers and a divergence in standards from the EU will be nearly unavoidable as the UK pursues free-trade agreements with other countries.

As a result, the UK's Brexit *Sturm und Drang* is set to go on for years, with ongoing uncertainty curbing business activity, consumer confidence, and growth. Any UK attempt to simultaneously open free-trade talks with the US will just delay further an eventual UK-EU arrangement.

Chart 2

UK Faces Long-Term Brexit Costs



Sources: Scotiabank Economics, ONS.

THE POST-ELECTION REBOUND WILL—STILL—HAVE TO WAIT

With Brexit-related uncertainty set to remain elevated and the possibility of new EU-UK trade frictions, consumers and businesses are going to remain tentative through 2021. Growth in 2019 appears to have fallen to its lowest rate outside of a recession since WWII and isn't showing incipient signs of a post-election bounce. Labour markets appear to have come off their mid-2019 boil. As a result, consumer confidence has dropped, retail activity has stagnated, and savings behaviour has turned precautionary. Our pre-election macroeconomic forecasts (table) remain largely unchanged and less optimistic than the Bank of England's (BoE) outlook (table 1).

Major surveys imply that a rebound doesn't lie just over the horizon. December's composite purchasing managers' index (PMI) fell into contractionary territory at 49.3, with manufacturing down markedly at 45.6 and services at 50. The British Chamber of Commerce's (BCC) fourth-quarter survey of 6,500 firms saw a clear downturn in the service sector, while factories' export and domestic orders were negative for two consecutive quarters for the first time in a decade; similarly, manufacturers' investment intentions fell to an eight-year low and capex growth looks set to significantly undershoot the Bank of England's forecast (chart 1). In the context of a decade of poor productivity gains (chart 2), weak investment growth implies that the costs of the UK's Brexit saga will stretch well into the coming decade and be compounded by an ageing population.

CONSERVATIVES WILL SPEND, SPEND, SPEND AND THE BoE WILL REMAIN ON HOLD

The Conservative Party's election platform promised extra fiscal stimulus of 0.2% of GDP by end-2022. Moreover, the Johnson Government has also indicated that it will loosen existing fiscal rules to allow nearly 1% of GDP in additional investment spending in its first post-EU budget due on March 11. Fiscal policy could be even more stimulative and would be focused in five areas: (i) at least GBP 20 bn of additional capital spending; (ii) a change in investment decision rules to de-emphasize gross value added and consider expected improvements in well-being and reductions in regional disparities in an effort to direct more spending to the North and Midlands; (iii) improved public services through additional funding for new hospitals, schools, and vocational training; training additional police officers; and better social care; (iv) meeting the government's 2050 net-zero carbon emissions commitment, including through support for more efficient homes and public buildings, carbon capture, emissions reduction, and alternative energy; and (v) individual and business tax cuts. Together, this would take public spending from 39.3% of GDP in FY2019 to more than 42% by FY2023.

In its first post-election rate-setting decision on December 19, the BoE's Monetary Policy Committee (MPC) confirmed that economic developments remained consistent with its November MPR forecasts and that it didn't see pressures ahead to move rates in either direction. Both the BoE and we expect headline inflation to get back to 2% only at end-2020. Even if 2020 comes in weaker than forecast, the MPC would keep its powder dry for the divergent possibilities of a larger-than-expected fiscal stimulus and/or a hard Brexit at year-end. If the economy over-performs, the MPC would likely be inclined to let it run a bit hot to ensure the rebound is locked in after all of the disruptions of the last three years of Brexit. The change in Governor at mid-March should have little bearing on this outlook.

Eurozone

SETTLING IN

- **The Eurozone economy appears to have stabilized, with reduced trade tensions and export demand from China likely to provide an ongoing floor under European growth. A further pick-up in activity will need to be led by increased credit demand and business investment.**
- **The ECB is expected to maintain its recent package of exceptional monetary measures over the entire forecast horizon. It's not clear that further monetary easing is politically feasible or would be effective.**

GROWTH HAS BOTTOMED, BUT NOT CLEAR IT WILL PICK UP

Eurozone growth continues to underperform, dampened by the gradual slowdown in China, the ongoing Brexit saga, White House protectionism, and the threat of more tariffs to come. Nevertheless, the worst appears to be passing and the currency-area's economy appears to be stabilizing, but with a still-weak hand-off into 2020 owing to drags from inventory drawdowns and trade. We forecast annual real GDP growth to pick up only slightly over the next two years and remain just north of 1%—below potential and too slow to bring unemployment down further and return inflation to the ECB's target by end-2021. Our forecasts are changed only marginally from a quarter ago, and remain consistent with the ECB's own projections (table 1).

Manufacturing has been particularly hard hit by decelerating growth in China and the trade wars (chart 1), but we believe that it has found its bottom and will not slide further and pull down services with it. European exports, particularly from Germany, tend broadly to track a range of major Chinese aggregate demand components, such as public spending (chart 2). With the centenary of the Chinese Communist Party coming in 2021, we expect efforts to sustain Chinese demand will put a floor under their imports of European manufactured goods.

On the domestic front, greater private-sector credit demand will be critical to driving a virtuous circle in which exceptional monetary stimulus leads to increased lending and investment, jobs growth, higher incomes, greater demand for goods and services, and an acceleration in inflation that would permit the ECB to move out of negative-rate territory. A reduction in uncertainty, fiscal stimulus, and foreign demand will be needed to translate banks' survey expectations of stronger business-loan demand into a meaningful pick-up in credit extension and investment. Exceptionally accommodative monetary policy has so far been necessary, but not sufficient, to stimulate borrowing (chart 3).

Europe's consumers could also help lead the recovery in Europe. Retail spending growth remains remarkably resilient across the Eurozone's four largest economies, with sustained gains over the last few months. December's Eurozone consumer confidence readings provide some measure of hope for continued retail strength, with intentions to make major purchases at a one-year high, while savings expectations have come down to a one-year low. It will, however, take several months of similar readings for business to commit to more investment.

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Eurozone	2018	2019e	2020f	2021f
Real GDP (annual % change)	1.9	1.0	1.1	1.3
CPI (y/y %, eop)	1.5	1.2	1.3	1.5
Central bank MRO rate (%, eop)	0.00	0.00	0.00	0.00
Central bank deposit rate (%, eop)	-0.40	-0.50	-0.50	-0.50
Euro (EURUSD, eop)	1.15	1.12	1.16	1.20

Source: Scotiabank Economics.

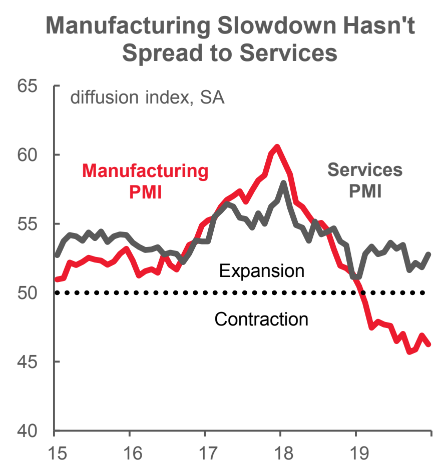
Table 1

ECB December 2019 Macro Projections

	2019	2020	2021	2022
Real GDP, % y/y	1.2	1.1	1.4	1.4
HICP Inflation, % y/y	1.2	1.1	1.4	1.6
Unemployment rate, %, eop	7.6	7.4	7.2	7.1

Sources: Scotiabank Economics, ECB.

Chart 1



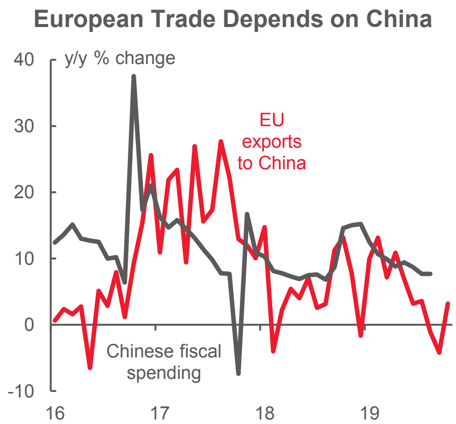
Sources: Scotiabank Economics, IHS Markit.

ECB: WAITING FOR A MIRACLE AT HOME AND FROM ABROAD

Following the package of exceptional monetary policy easing agreed in September during Mario Draghi's second last meeting as ECB President, the Eurozone continues to have the lowest real policy rates of any major economy (chart 4). Inflation remains well shy of the ECB's just-below 2% target and is not projected—by us, by consensus, or by markets—to get back to the target during our forecast period (chart 5); as a result, we expect the ECB to remain on hold at least through end-2021 as it's not clear a push for further easing is possible. A move by Pres. Lagarde to lower rates again would exacerbate the already stark divisions between the Governing Council's hawks and doves and impose greater costs on the European banking system, without a firm expectation that it would translate into higher credit growth.

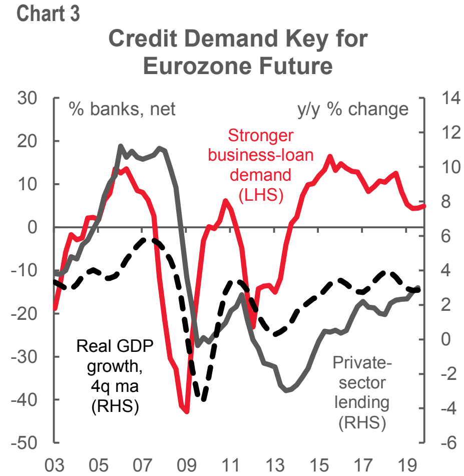
Instead, we expect the ECB to focus on amplifying Pres. Lagarde's calls for Eurozone members with unused fiscal space to put it to work to stimulate growth. Yet, even if this lobbying is met with extra spending, it will not be enough to have a meaningful impact on Eurozone activity. Under European and national fiscal rules, governments don't have sufficient remaining room to provide meaningful stimulus. The ECB Governing Council will have to hope that a combination of ex-Pres. Draghi's last shot of "whatever it takes, for as long as it takes", combined with easing by nearly all of the world's major central banks, whatever fiscal stimulus it can cajole member states into deploying, and a mild reduction in global trade uncertainty will, together, provide European business with the conditions it needs to borrow and invest at greater scale. With all of these contingencies, we expect the ECB's restarted, open-ended programme of quantitative easing to extend beyond end-2021.

Chart 2



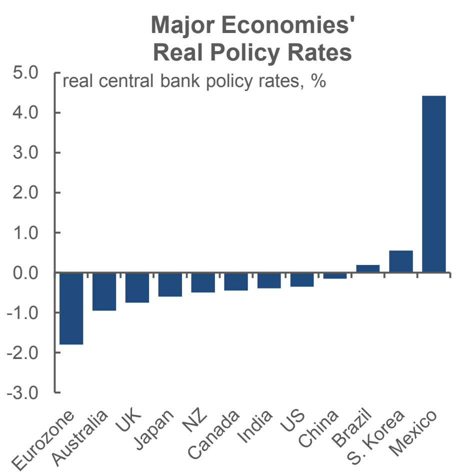
Sources: Scotiabank Economics, Bloomberg, Statistical Office of the European Communities

Chart 3



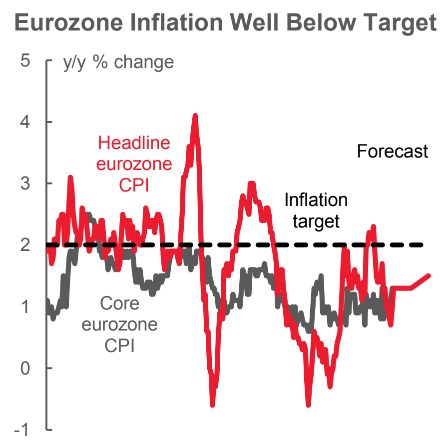
Sources: Scotiabank Economics, ECB, Bloomberg.

Chart 4



Sources: Scotiabank Economics, Bloomberg.

Chart 5



Sources: Scotiabank Economics, Bloomberg.

The ECB's coming strategic review will also dominate headlines over the course of 2020, but we expect few meaningful changes to result from it beyond a possible move away from characterizing the inflation target as sitting just below 2% and toward full institutionalisation of symmetry in the objective—a move that ex-Pres. Draghi left only partially complete.

ZOMBIE BREXIT REPLACES HARD BREXIT THREAT

As we explain in the United Kingdom section of this report, we do not foresee a substantial reduction in Brexit-related uncertainty over the next two years. It is incredible to believe PM Johnson's claims that a comprehensive free-trade deal can be negotiated by end-2020. This could imply that London and Brussels will agree on only a minimalist deal to meet the deadline—a deal that would insert substantial trade frictions across the English Channel. Instead, we expect the Johnson Government's self-imposed end-2020 deadline to be extended, with UK-EU trade negotiations continuing for years to come.