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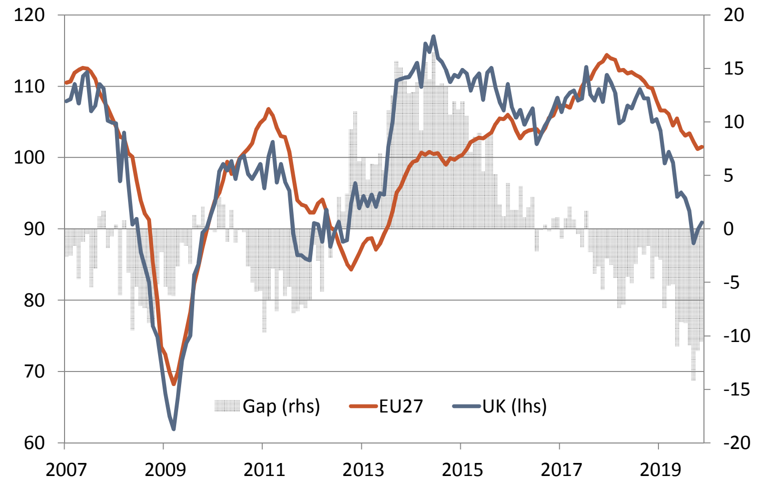
6 December 2019

UK election: a chance to stop the rot

European Commission economic sentiment indices (100 = long-term average)



Monthly data. Source: European Commission

- **Falling behind:** The Brexit vote in June 2016 turned the UK from one of the EU's economic leaders into one of its laggards. As our chart shows, the UK outperformed the EU27 from 2012 until the Brexit vote. Then, after tracking the European average in H2 2016 and H1 2017, the slide in UK sentiment gathered momentum. While global factors such as trade wars and the China slowdown have dampened sentiment across Europe since 2018, domestic political risks have pushed UK sentiment even further below the already falling European average (see chart).
- **The damage so far:** The contrast between the UK and EU in GDP terms is stark. From Q1 2010 to Q2 2016, UK real GDP growth averaged 2.0% yoy versus 1.2% for the EU27. UK growth has eased to 1.6% since the referendum. After UK growth barely exceeded 2.0% during the 2017 global boom, it slowed to just 1.0% yoy in Q3 2019. EU27 growth has averaged 2.2% since Q3 2016. After peaking at 3.1% in Q3 2017, it dropped to 1.5% in Q3 2019.
- **Long-run costs:** All else being equal, erecting barriers to trade, investment and migration with its biggest market – the EU – will reduce the rate at which the UK can sustainably grow in the long run. Inside the EU, the UK had a potential growth rate of c2.1% yoy. Outside the EU, we estimate that this rate will fall to c1.7%. Of course, a lot depends on the outcome of upcoming UK-EU negotiations on future trade, any non-EU trade deals the UK strikes and UK domestic economic policy choices. The range around this estimate could be as wide as 1.5-1.9%.
- **Heading for a medium-term pick-up:** On 12 December, UK voters will head to the booths for the third time since 2015. Prime Minister Boris Johnson and the Conservative Party remain well ahead, according to opinion polls. They look set to win a majority of seats in the House of Commons. Unlike in 2017, which ended in a hung parliament, Labour does not seem likely to close the gap with the Conservatives. If Johnson wins, expect medium-term UK economic growth to far exceed the European average for around 18 months.
- **Key drivers:** We see three reasons why a Conservative majority would be positive for the medium-term UK economic outlook: i) it would put the UK on the path to an orderly Brexit on 31 January 2020; ii) with a majority of seats, the Conservatives would be likely to back a large fiscal stimulus in spring 2020; and iii) it would do away with the risk that Labour leader Jeremy Corbyn could ever become prime minister and damage the UK with far-left economic policies. On this basis, we look for real GDP growth to accelerate from 1.3% in 2019 to 1.8% in 2020 and 2.1% in 2021.
- **Watch the risks:** There are two main threats to our positive call on the UK. First, a further escalation of US-China tensions would deepen the ongoing downturn in global trade and production, which would eventually spread into domestic-oriented consumption and services across the Western world. Second, in the event that the Conservatives do not win a majority, continued political uncertainty as the two major parties scramble for a coalition partner or else face repeat elections could further damage confidence and keep growth at its current subdued annualised pace of under 1%.

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