Business challenges and access to finance after the BREXIT vote

Costas Milas

Professor of Finance

University of Liverpool

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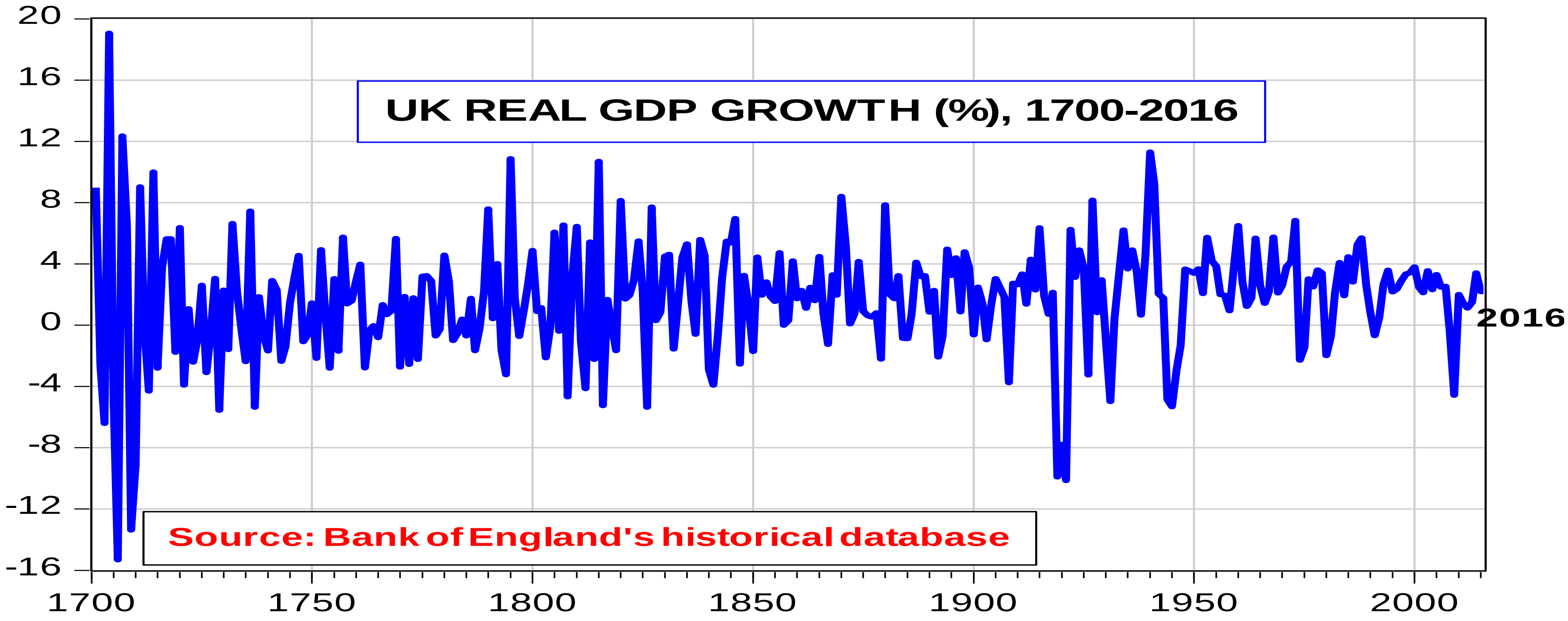
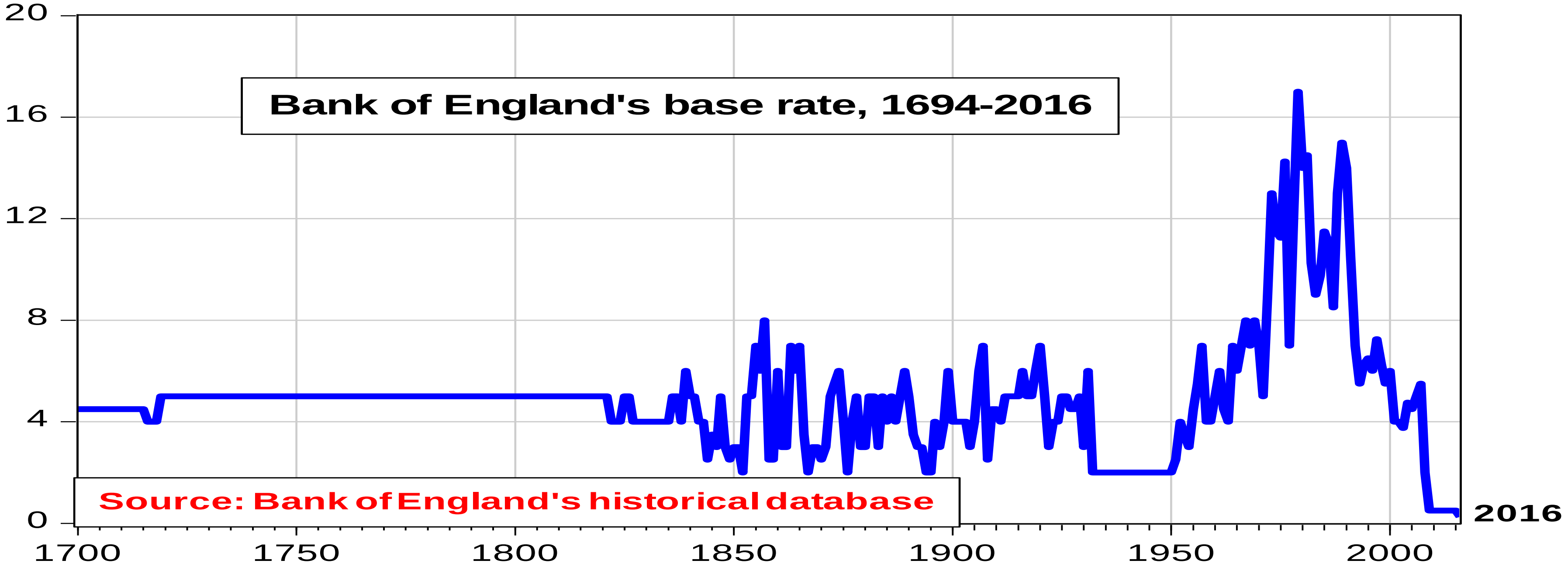
Hello BREXIT from a 'reasonably' strong position

Indeed, our predicted (by the Bank of England) annual growth of 2.2% for 2016 is higher than our historical average (**since 1700**) of 1.7% p.a. Notice also that growth has become less volatile after World War II.



Not so fast! What is the obvious worry?

We expect to achieve 2.2% growth in 2016 despite historically low interest rates. In fact, our annual growth will be the same as in 2015 but down from 3.1% in 2014. The Bank expects GDP growth to slow further down to 1.4% in 2017.



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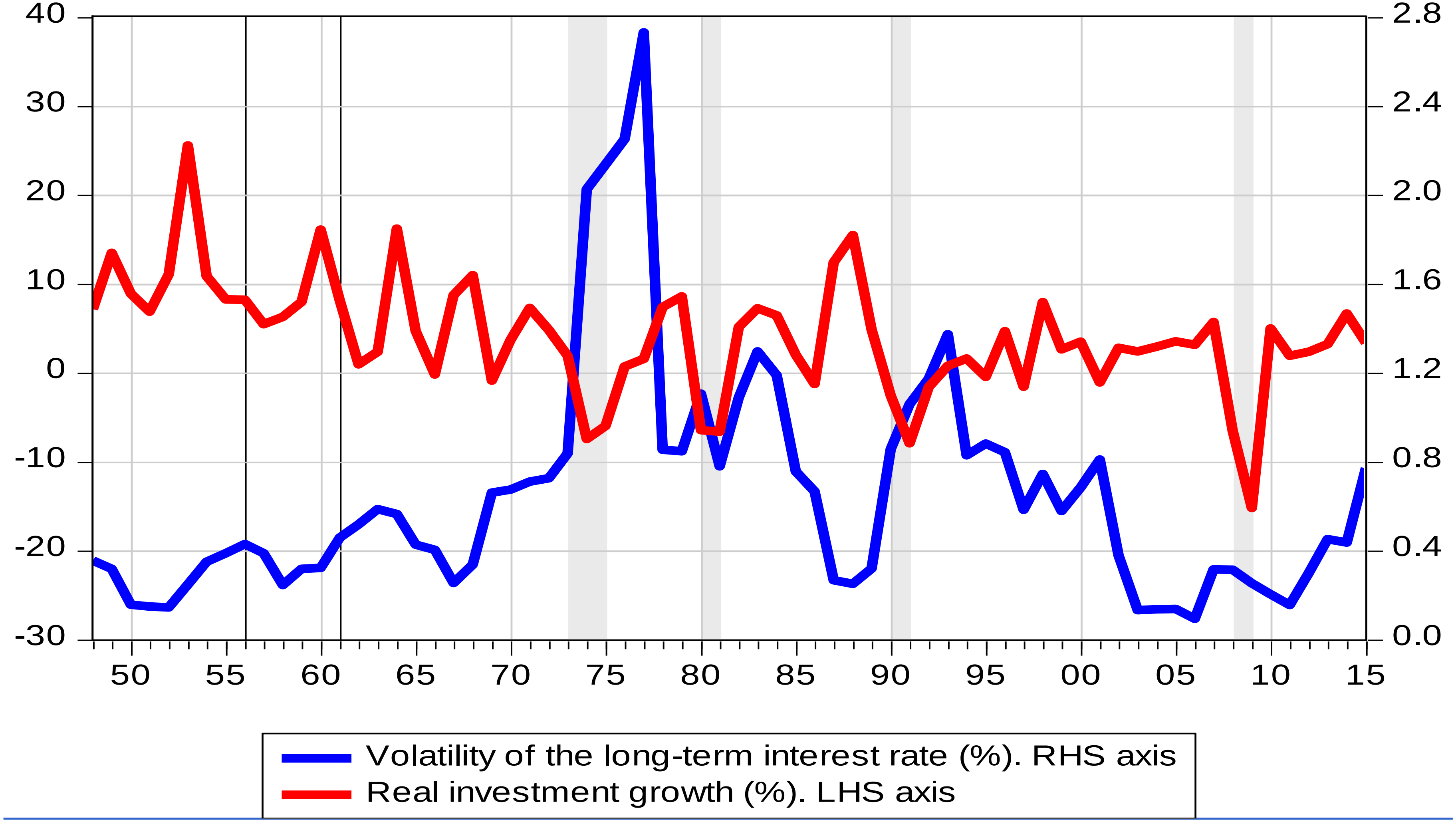
More data trends

Historically, real investment growth in the UK has been **negatively** correlated with economic uncertainty/volatility (proxied by the 4-year rolling standard deviation of changes in the UK long-term interest rate).

[Dr Michael Ellington and I have a research project on this very issue]

More data trends [Data source: Bank of England's website]



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More uncertainty to come…

- Expect more economic uncertainty until 'notorious' "Article 50" is triggered by March 2017. There will also be more uncertainty during the following two years of "hard" negotiations with Europe.
- In fact, the latest Bank of England Inflation Report predicts business investment growth (which increased by an average of 2.5% p.a. over 1998-2007) to drop by 2% in 2016 and drop by 1.75% in 2017. It will return to a 2% positive growth only in 2018.

UK effective exchange rate, 1990-2016

The pound's average value (daily data), on a trade-weighted basis, dropped to its lowest in October 2016.

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The impact of the exchange rate

- Daily growth of the £ effective exchange rate has witnessed a surge in volatility since the Referendum. In fact, the volatility of the daily growth in the exchange rate has more than **doubled** from 0.42% pre-Referendum to almost 1% afterwards!

- A challenge for exporters because it creates uncertainty for their earnings and future investments even if firms manage to partly hedge against exchange rate volatility.

The impact of the exchange rate

- The £ effective exchange rate has lost 14% of its value since the Referendum which should offer exporters a boost.

- However, Bank of England warns that (exporting) companies will not invest until they know the country's future terms of trade following the Brexit vote.

The impact of the exchange rate

- Bank of England (BoE) predicts that CPI inflation, boosted by the weak exchange rate, will shoot up from its current level of 0.9% to 2.8% in 2017.

- This will squeeze real incomes. Businesses need to factor in the drop in household expenditure which grew by an average of 3.5% p.a. over the 1998-2007 period. The Bank of England expects this to slow down to 2.75% in 2016 and even further to 0.75% in 2018.

The impact of the exchange rate

- As noted earlier on, businesses should **benefit** from the lower exchange rate and perhaps further access to non EU markets. But then again, EU remains a large trading partner of ours. 44% of our exports of goods and services go to the EU and 53% of our imports come from the EU. "Only" 16% of EU exports come here.
- So we cannot *really* play hardball…

- That said, BREXITERS might be tempted to do just that after Trump's victory.

Exchange rate and queueing ‘issues’

- Referring to President Obama’s claim that Britain would be “at the back of the queue” for a trade deal, Mr Trump said: “I’m not going to say front of the queue but it wouldn’t make any difference to me whether they were in the EU or not. You would certainly not be back of the queue, that I can tell you.”

- **In any case, it is easier said than done** that we will benefit from the impact of the exchange rate given its volatility and the difficult times ahead in terms of negotiations especially if tariffs are imposed, which, of course will add further to inflation!

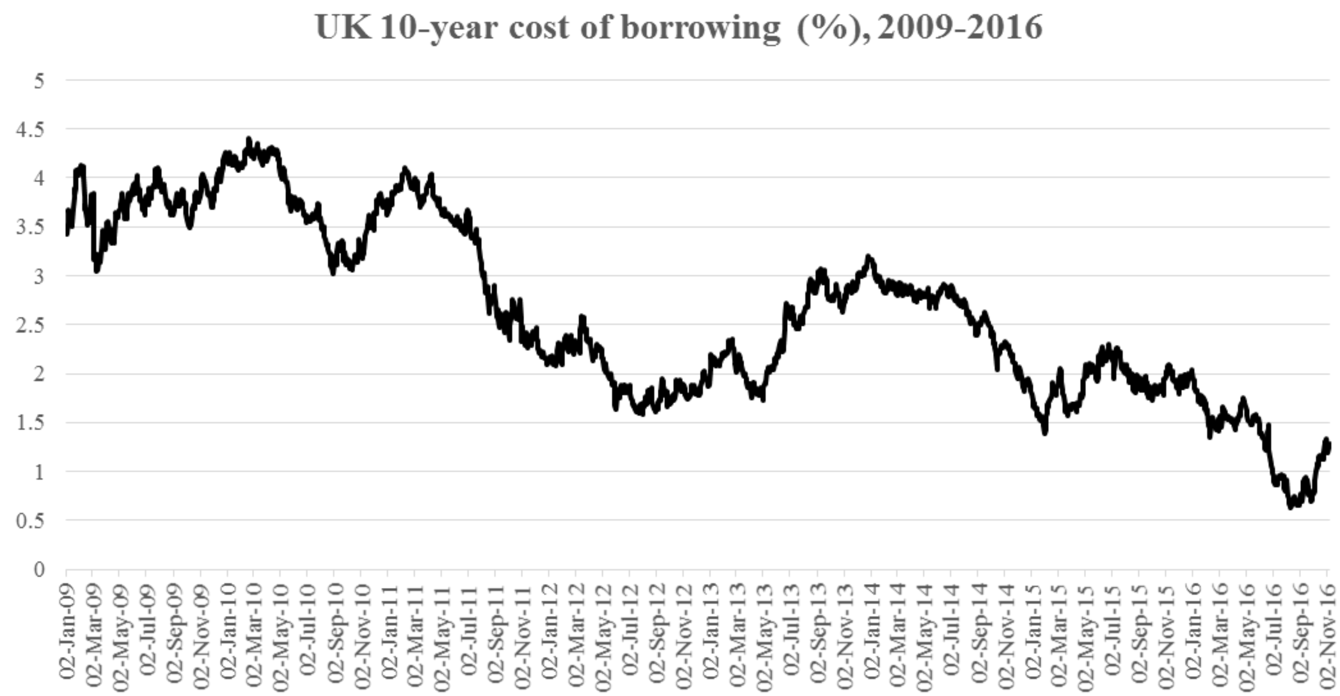
Cost of borrowing set to rise

- BoE Governor Mark Carney has said in October that the BoE is willing to tolerate a bit of an inflation overshoot (above the 2% target) to avoid unnecessary unemployment. This means that the BoE policy rate will not rise soon.

- Therefore, the typical monetary policy framework (that is, long-term cost of borrowing increases following a policy rate hike) will not be operating soon. Clearly, Quantitative Easing is also helping to keep our long-term borrowing costs low.

Cost of borrowing set to rise

- However, the rising economic uncertainty makes investors nervous. As they are less willing to hold UK debt, there is already pressure, from financial markets, on our cost of borrowing.



Cost of borrowing set to rise

- At the same time, Credit Rating Agencies (CRA's- Standard & Poor's, Moody's and Fitch) who assess our credit score, are keeping an eye on BREXIT developments. All three CRA's have already stripped the UK of its precious AAA rating – the highest possible.

- Their current credit score outlook for the UK is 'negative'. Whether or not we will suffer further downgrades, remains to be seen!

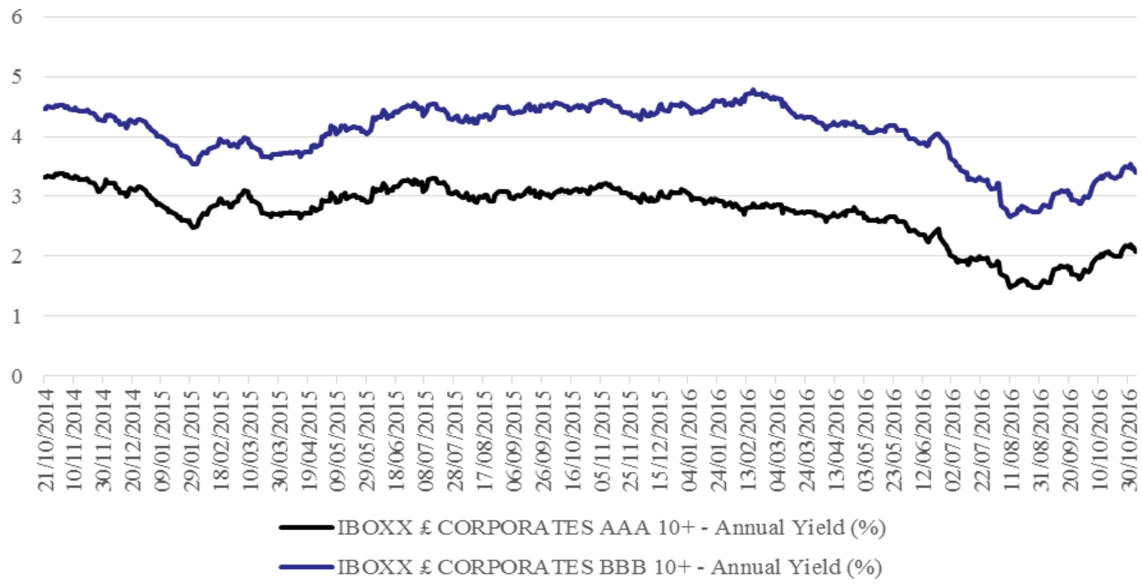
Cost of borrowing set to rise

- In any case, the cost of long-run borrowing for the government and businesses is set to rise further.This, combined with lengthy and cumbersome negotiations, will make the life of the business sector harder than before.

- How does the long-run (10-year) cost of borrowing for AAA firms (that is, UK firms with the highest possible credit rating) and BBB firms (that is, UK firms with much lower credit rating) look like?

Cost of borrowing for UK firms set to rise

- Cost of corporate borrowing on the rise since mid August 2016

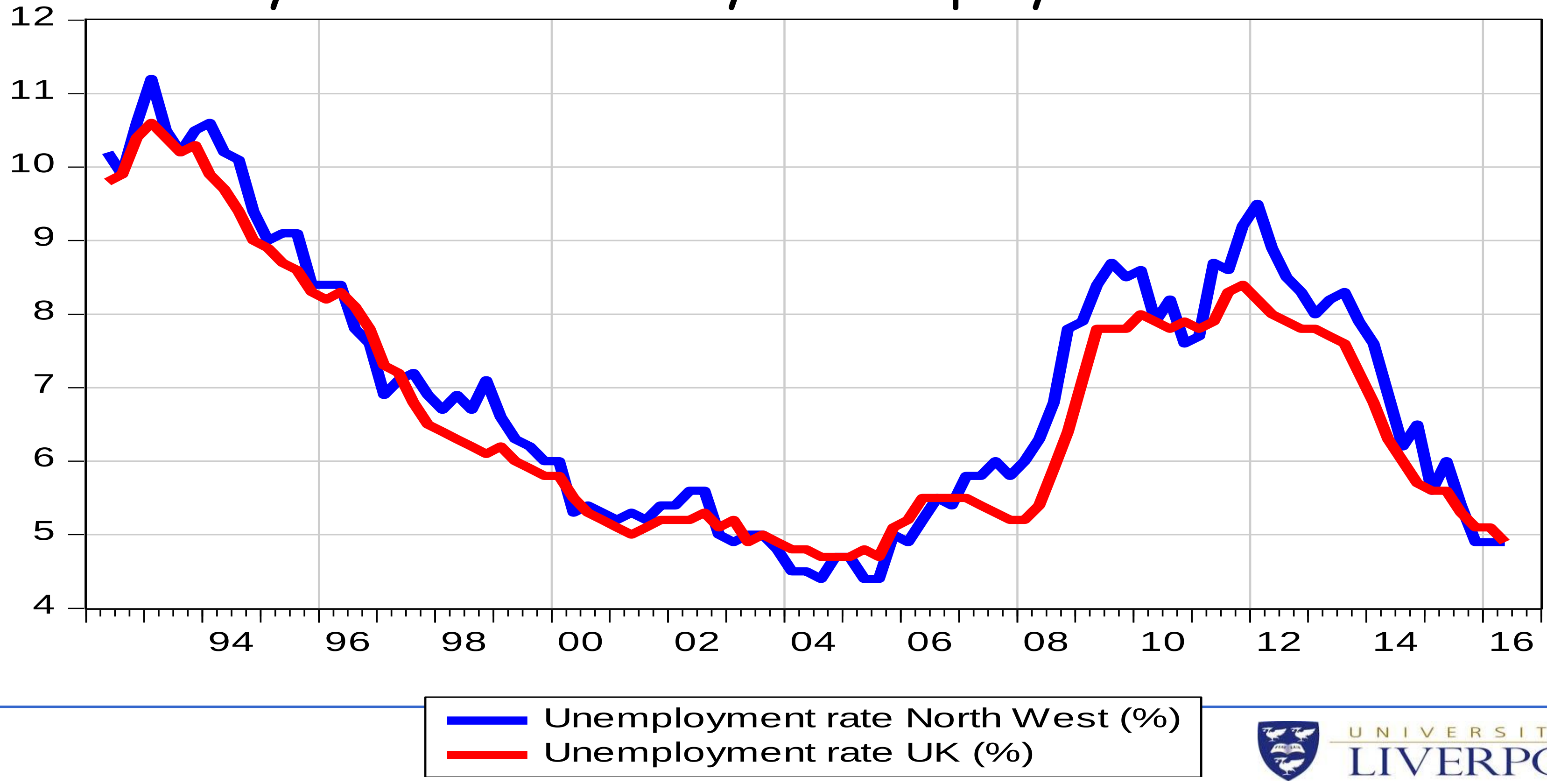


As cost of finance increases, further expansion of firms will slow down

- According to a House of Commons Business Statistics Briefing Paper (Number 06152, 7 December 2015), there were, in 2015, 532,000 enterprises in the North West (a healthy 5% increase since 2014 and notably **higher** than the 3% UK average).
- All of these were SME's (employing 0 to 249 employees). Further expansion might take a hit if access to finance is undermined through higher borrowing costs…

Cost of borrowing set to rise and unemployment to go up

Higher borrowing costs will delay investments and add pressure on the North West unemployment rate (currently at 5.1%) which, despite being more volatile, tracks reasonably well the country's unemployment rate.



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But there is some 'good' news

- The good news (of course) is that we won't have to replace Bank of England Governor Mark Carney before June 2019. As I wrote recently in a *London School of Economics* blog:

- Finding another 'suitable' candidate would have been a very tricky job.
- Think about it….Would another candidate be willing to risk their reputation on such a demanding job knowing, or at least suspecting, that their predecessor decided to step down partly because of rising tensions and/or interference by government officials?