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**Article**

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# Brexit decision puts strain on German economy

By Ferdinand Fichtner, Christoph Große Steffen, Michael Hachula, Simon Junker, Simon Kirby, Claus Michelsen, Malte Rieth, Thore Schlaak and James Warren

As a result of Britain's decision to leave the EU, global economic output is likely to grow at a somewhat slower pace than anticipated. The decision will have consequences for the UK and for the euro area in particular; this is also confirmed by simulations produced by the National Institute Global Econometric Model (NiGEM). An expected deterioration of economic relations—especially between the UK and the EU—and the associated increase in uncertainty have led to greater investment restraint. This has been accompanied by a devaluation of the British pound. Both will inhibit the development of the German economy with its strong focus on foreign trade. It will also dampen domestic investment and result in a lower level of consumption due to slightly weaker real wage growth. All in all, the German economy is likely to grow at a slower rate than previously predicted due to the Brexit decision. Growth is forecasted to be 0.1 percentage points lower in 2016 and 0.3 percentage points lower in 2017.

Since the Brexit referendum on June 23, 2016, the UK's economic outlook has become decidedly gloomy. Given the significance of the British economy for global production, this is likely to have a negative impact on many other countries: although the UK accounts for only two-and-a-half percent of global production, it is still a key trading partner for many euro area countries and for Germany in particular. The share of exports of goods to the UK, both for Germany and the euro area as a whole, amounts to nearly eight percent of total goods exports.

The Brexit decision has led to an increase in uncertainty, which has already put a strain on the UK's short-term economic development.<sup>1</sup> The effects are likely to persist in the short term, since negotiations on withdrawal from the European Union are likely to take several years. Consequently, lower investment growth and weaker employment development are to be expected. Only limited economic data from the period after the Brexit referendum are available to date. These indicate that an economic slowdown is underway. Consumer confidence in the UK has deteriorated sharply and the Purchasing Manager Index (PMI) surveys have weakened substantially (see Figure 1).

Growth in the euro area is also likely to be weaker than previously anticipated. Trade effects should play a major role here: weaker British demand dampens exports from the euro area. The devaluation of the British pound will probably reinforce this decline, as it results in an increase of import prices denominated in British pounds. Increased uncertainty in the euro area is expected to raise financing costs and also affect investment activities. Euro-sceptic voices in other member countries of the EU are also likely to become louder.

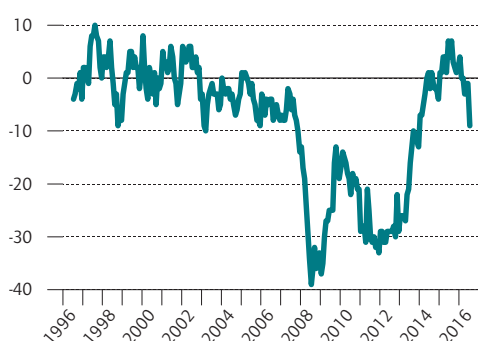
However, the PMI for the euro area – and especially the PMIs for Germany and France, respectively – has so far shown no sign of a decline in response to the referendum decision. Yet the previously observed increase

<sup>1</sup> Ferdinand Fichtner et al., "Brexit decision is likely to reduce growth in the short term," *DIW Economic Bulletin*, no. 26/27 (2016): 301–307.

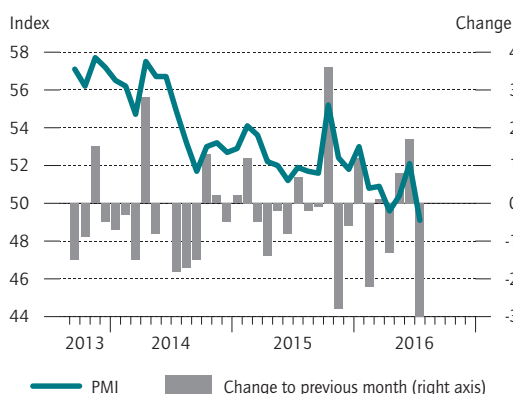
Figure 1

### Leading indicators for the United Kingdom

#### GfK Consumer Confidence Index



#### Purchasing Manager Index, Manufacturing



Sources: Datastream, Eikon.

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Consumer confidence and purchasing manager index in the UK dropped after the Brexit decision.

in consumer confidence has not continued, and existing problems such as difficulties in the Italian banking sector have intensified.

### Simulations with NiGEM

The global macroeconomic model NiGEM was used to assess the quantitative effects of the Brexit referendum on the European economy.<sup>2</sup> In this model, a range of shocks were introduced that lead to poorer financing conditions for companies and households in the UK and the euro area. Furthermore, shocks to the relative risk premia on exchange rates and business investment via uncertainty were added to the simulation. These shocks were calibrated to match the observed developments in financial markets.

<sup>2</sup> See National Institute Economic Review No 237 August 2016 (NIESR).

Table 1

### Change in real gross domestic product

Percentage points compared to summer 2016 forecast

	2016	2017
Euro area	-0.1	-0.3
without Germany	-0.1	-0.4
France	-0.1	-0.3
Spain	-0.1	-0.5
Italy	0	-0.5
Netherlands	-0.1	-0.3
United Kingdom	-0.3	-1.2
World	0	-0.2

Sources: National statistical offices; DIW forecast update 2016.

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Global production will develop weaker than expected.

Compared to a “remain counterfactual,” British GDP growth is expected to be 0.3 percentage points lower in 2016 and 1.2 percentage points lower in 2017 (see Table 1). Growth rates in the euro area are predicted to be 0.1 percentage points lower in 2016 and 0.3 percentage points lower in 2017. In the euro area, countries such as Ireland and the Netherlands should be particularly affected, since they have large trade links with the UK.<sup>3</sup> Countries such as Italy and Spain are likely to suffer from weaker economic development due to the strong reaction of the financial markets in these countries following the referendum decision.

As a result of lower growth in the UK and the euro area, the global economy will experience slightly lower growth than recently forecast. In particular, the higher level of political and economic uncertainty plays a role in increasing the volatility of financial markets, which deteriorates financing conditions for both public and private borrowers in developing economies. International investors are more likely to turn to safer assets in the US or Japan. Global investment activity is also likely to slow somewhat. All in all, this will most probably be reflected in the 2017 GDP growth rate, which is expected to be 0.2 percentage points lower than previously forecast.

### German economy will also suffer from Brexit

Due to its strong export orientation and its focus on capital goods, the German economy is doubly affected.

<sup>3</sup> An overview of trade relations between the individual euro area countries can be found, for example, in Ferdinand Fichtner et al., “Brexit decision is likely to reduce growth in the short term,” DIW Economic Bulletin, no. 26/27 (2016): 301–307.

Table 2

### Effects of the Brexit vote on the German economy

Change in annual growth rates (unless indicated otherwise)

	real		nominal	
	2016	2017	2016	2017
Gross domestic product	-0.1	-0.3	-0.1	-0.4
Consumption	0.0	-0.1	0.0	-0.2
Investment	-0.1	-0.3	-0.1	-0.2
Exports	-0.3	-1.2	-0.3	-1.2
Imports	-0.2	-0.9	-0.2	-0.9
Net exports <sup>1</sup>	0.0	-0.2	-1.2	-8.8
Hourly wages			0.0	-0.2
Gross wages and salaries			0.0	-0.3
Domestic employment <sup>2</sup>			-3	-20

<sup>1</sup> Real: change in growth contribution; nominal: change in billion euros.

<sup>2</sup> In 1.000 persons.

Source: Calculations by DIW Berlin.

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Brexit vote dampens German economy.

Consequently, less growth is expected for employment figures and household incomes, which restricts consumption somewhat. Economic output will therefore temporarily exhibit a lower increase than previously forecast, until production has adjusted to the lower demand (see Table 2).

Conversely, some of the capital removed from the UK should flow into Germany and improve its already favorable financing conditions. This will probably boost investment in real estate, which is already in demand, and also depress yields on German government bonds, which are considered to be a safe haven.

Real GDP is expected to grow by 0.1 percentage points less in 2016 and by 0.3 percentage points less in 2017 as a result of the Brexit decision.

### Noticeable slowdown in foreign trade

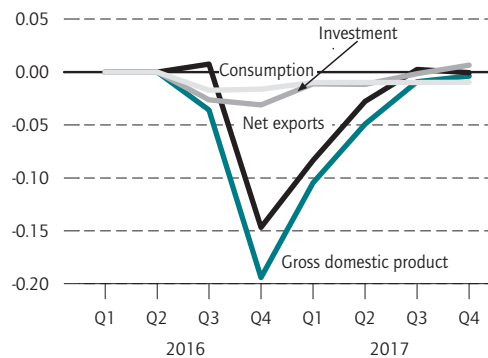
As a consequence of the Brexit referendum, demand for German exports will rise less than previously expected. In particular, exports of important capital goods are likely to be curbed. This effect will be most striking in the winter of 2016/17 (see Figure 2).<sup>4</sup> On average, German exports will grow by 0.3 percentage points less this year and by 1.2 percentage points less in the coming year. German imports are not expanding as strongly, partly

<sup>4</sup> The direct effect of the decline in exports will be to slow economic output by a good half a percentage point in the coming year; this forecast takes into account both declining exports to the UK and falling exports to other sales markets that have also seen a stronger decline in growth than previously expected. By contrast, foreign trade only fell by two-tenths of a percentage point because of a more limited increase in imports.

Figure 2

### Change in growth contributions due to Brexit vote

In percentage points



Source: Calculations by DIW Berlin.

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Brexit vote dampens contributions of demand components to GDP growth; for net exports, the negative effect is more pronounced.

due to the lower demand for intermediate goods in the export sector and partly due to weaker investment and consumer demand in Germany: the effect is 0.2 percentage points in 2016 and 0.9 percentage points in 2017. However, the growth effect of the decline in exports will be larger than the corresponding effect of imports, so the growth stimulus of foreign trade will be lower—even negative—in the winter months. The impact of Brexit will barely affect net trade at all this year, but next year should dampen the growth contribution of net trade by 0.2 percentage points relative to a counterfactual no-Brexit situation. German exporters are likely to counter falling demand in part by reducing prices; consequently, the terms of trade will increase at a more subdued rate.

### Uncertainty dampens corporate investment propensity

Corporate investment will be doubly affected by the Brexit referendum decision. First, export-oriented companies will adjust their capacities to the lower demand for exports. This will manifest itself in weaker investment growth, particularly since the production of export goods is largely capital-intensive. In addition, the Brexit referendum decision will probably increase the costs of bilateral trade and is therefore likely to curb trading volumes. Lower capacities appear to be sufficient to meet demand, especially in the long term.

However, the uncertainty will probably have a greater effect. The decision in favor of Brexit has led to considerable uncertainty about future trade relations. This will

also have a negative impact on corporate investment. This effect is likely to dampen equipment investment by 0.3 percentage points in the current year and by 0.9 percentage points in the coming year.<sup>5</sup>

Other investment is not likely to be considerably affected by the Brexit referendum decision. This refers largely to R&D spending, which contributes substantially to the international competitiveness of German companies. It is more probable that companies will continue developing products for new markets and improving processes.

The real estate industry is likely to benefit: residential, office, and retail properties will all become more attractive to investors such as internationally operating real estate funds, which will now be looking for alternatives to investment in the UK. Initially, this should be reflected primarily in rising real estate prices because the additional demand will probably affect competition for scarce building land in urban centers. Investors unfamiliar with the local area are not very likely to implement their own construction projects. It is therefore more probable that previously active investors will be crowded out rather than stimulating additional construction activity.

<sup>5</sup> See also Michelsen, C., Piffer, M., Rieth, M. (2016), DIW Economic Bulletin Nr. 32+33/2016, in preparation.

## Lower incomes curb consumption

The weaker development of foreign trade and investment also weakens household income from entrepreneurial activity and assets. In addition, companies are likely to revise their staffing plans downward, albeit only slightly, and depressed profits are likely to slow down wage increases somewhat. Consequently, private consumption will increase at a slower pace, even though lower inflation will counteract the lower income growth to some degree.

## Conclusion

The Brexit decision is likely to cause a locational disadvantage for the UK in particular, where investment is likely to fall appreciably. In addition, it can be expected that commercial relations with the rest of the world will deteriorate in the longer term and hamper global trade. Consequently, companies will adjust their capacities. The resulting uncertainty will also affect investment. The overall weaker development of trade and production will mostly place a strain on the UK's major trading partners; the relatively open German economy, which is also likely to be affected disproportionately from declining demand for capital goods due to its focus on this product group, will temporarily slow down as a result of the Brexit referendum decision, particularly in the winter of 2016/17.

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