Britain stumbles, Europe takes off

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The course of the UK-EU negotiations in 2017 will have come as no surprise to long-time observers of this fractious relationship. Brinkmanship and late-night deals have long been part and parcel of UK-EU relations, and December's frantic meetings were no exception. But while the European Council's decision that sufficient progress has been made for the talks to move on to discussing the UK's future relationship with the EU is positive, 2018 looks set to disappoint those looking for clarity.

The European Council's endorsement paves the way for talks on transition and trade to start in earnest in 2018, though probably not until at least March. But this does not mean that the phase one topics – agreeing the post-Brexit rights of EU and UK citizens, protecting the Northern Ireland peace process, and paying the UK's so-called "divorce bill" – are done and dusted. No sooner had the UK-EU deal been announced in the small hours of 8 December than British officials set about clarifying it, with Secretary of State for Exiting the EU David Davis suggesting that it was a "statement of intent" rather than a binding agreement. Moreover, the deliberately vague phrasing with respect to future arrangements for Northern Ireland reflects the complexity of negotiating a post-Brexit agreement that satisfies the competing requirements of all stakeholders, in particular relating to border issues.

Internal and external obstacles will continue to complicate negotiations in the UK in 2018. Fundamental splits in the governing Conservative Party over the shape of the eventual deal will persist, undermining the government's negotiating stance and fostering continuing uncertainty for businesses. Prime Minister Theresa May's success in coming up with a turn of phrase acceptable to all parties in December provided a much-needed but short-lived fillip to her leadership. Barely a week later her government experienced its first defeat in the House of Commons (lower house), when MPs – including rebels from her own party – voted in support of an amendment to the EU Withdrawal Bill that ensures parliament will have the right to vote on the final Brexit deal.

With the festive goodwill towards May already waning, internal party divisions will become increasingly apparent as substantive Brexit negotiations get under way. While these will weaken her government's negotiating position, the Conservatives are unlikely to risk triggering a leadership challenge or early elections in the coming year, because of the lack of a credible alternative candidate and a resurgent Labour Party. The sense of government fragility will nevertheless continue to cast a shadow over the negotiations throughout 2018, ensuring that May's 2017 election campaign pledge of "strong and stable" leadership is remembered only as an example of political irony.

It is imperative that the UK agrees a transitional deal to buy some time to negotiate a free trade agreement, which is likely to take several years. Such a transition would inevitably prove contentious within the Conservative Party, given that in this period the UK will continue to make contributions to the EU budget, but will lose its voting rights. However, such a step is essential given the dire consequences for trade of the UK crashing out with "no deal". Oxford Economics estimates this would subtract around one percentage point a year from

UK GDP growth in 2019 and 2020 relative to our forecast baseline, leaving the UK economy 2% smaller by the end of 2020 than would otherwise have been expected. Still, it is by no means certain that a transition will be agreed. Some UK-based businesses with exposure to the EU have started to plan accordingly. Those that have not, need to, at the very least by assessing the impact on their operations of a no deal scenario and by developing shadow supply chains, or even carefully considering relocation options.

Mixed outlook for UK economy

How is this political uncertainty likely to weigh on the economy? The story of the UK economy in 2017 has been decidedly mixed. Output has continued to expand, but at a soft pace, even by the sub-par standards of the post-financial crisis period. The forces driving that performance suggest that 2018 is unlikely to see much change. Consumer price inflation arising from sterling's sharp fall in 2016 should ease, but will remain elevated by the standards of recent years. Pay growth seems unresponsive to low unemployment. Government efforts to cut welfare spending, combined with pressure on consumers' spending power, will persist, dragging on the most important driver of economic activity.

On a positive note, the flip side of the weaker pound – a competitive boost to exporters – and a buoyant global economy should result in net trade making a positive contribution to GDP growth. The appetite of businesses to invest will be supported by strong profitability in overseas markets (aided by the pound's weakness) and cheap financing. Brexit uncertainty will continue to weigh on sentiment, but if, as we expect, negotiations between the UK and the EU proceed – albeit with difficulty – towards a post-March 2019 transition arrangement, companies may release some previously held-back capital spending as next year progresses. Overall, economic growth is forecast to run at around 1.5% in 2018, compared with an annual average of 2% since the current economic expansion began in 2010.

Prospects healthier elsewhere in Europe

While the political risk outlook for the UK in 2018 is not promising, prospects elsewhere in Europe in the year before Brexit are generally more benign than they have been for some years. This is not to downplay the significance of events in Spain. Here, the crisis over Catalonia will create headaches for politicians and businesses alike, but we expect the repercussions to remain largely confined to the domestic arena. Political contagion elsewhere will be limited, as will any wider economic impacts.

Businesses in Europe can look forward to more positive developments. Remarkably, given concerns about the impact of artificial intelligence and globalisation, Europe is enjoying something of an industrial revival and is proving to be a veritable engine of job creation. With Germany's Chancellor Angela Merkel likely to remain in office – assuming a successful outcome to the drawn-out coalition negotiations she is leading following the September 2017 elections – and French President Emmanuel Macron beginning to march slowly forward with his reform agenda, in 2018 businesses can expect a stronger Franco-German relationship. Coupled with the region's improving economic prospects, this pairing will foster a more favourable investment and operating climate than has been the case for some time.

Regardless of the composition of the government that emerges in Germany, the next coalition – like its predecessors – will remain broadly pro-business. Meanwhile, strengthened by a combination of his election mandate and the victory of his party in parliamentary polls, Macron will begin to push through long-overdue reforms aimed at introducing greater flexibility into the labour market. Pension and tax reforms are next on his agenda. While he will face considerable resistance from domestic constituencies, Macron has a window of opportunity in 2018 to make progress in these areas, and will seize it.

These more favourable political developments will be accompanied by a more positive economic story across the continent. Traditionally, Europe has spent much of the last decade consigned to the economic doldrums, constrained by slow growth and crushingly high unemployment. In part, this represented the hangover from the financial crisis, which required Europe to undertake a series of structural reforms, fiscal consolidations and banking sector recapitalisations. These efforts now appear to be bearing fruit, with growth in 2018 forecast to come in at 2%, building on 2017's 2.3% – the fastest and most sustained period of expansion for ten years. Even more remarkably, much of the engine for this upswing in activity comes from what can only be called a resurgence in Europe's industrial activity. Industrial confidence indicators are at record highs, while order books are full to bursting.

Rising employment – more than 2.5m jobs were created in the 12 months to November 2017 – is supporting rapid growth in consumer incomes. In turn, this will continue to support a healthy pace of consumer spending growth. With European businesses generally in a solid financial position, the combination of dynamic demand growth and easy financing conditions sets the stage for the recovery to mature into a phase where expansion will also be supported by stronger investment growth. This suggests that Europe may be at the start of long period of sustained expansion. A number of acute political risks may exist across Europe, but it is far from obvious that any have the potential to derail what is otherwise a very positive economic picture.

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