The Telegraph

S&P scoffs at 'Armageddon' warnings for Britain

S&P thinks sterling devaluation will prove shock absorber as in 1992, dismissing disaster scenarios as unlikely

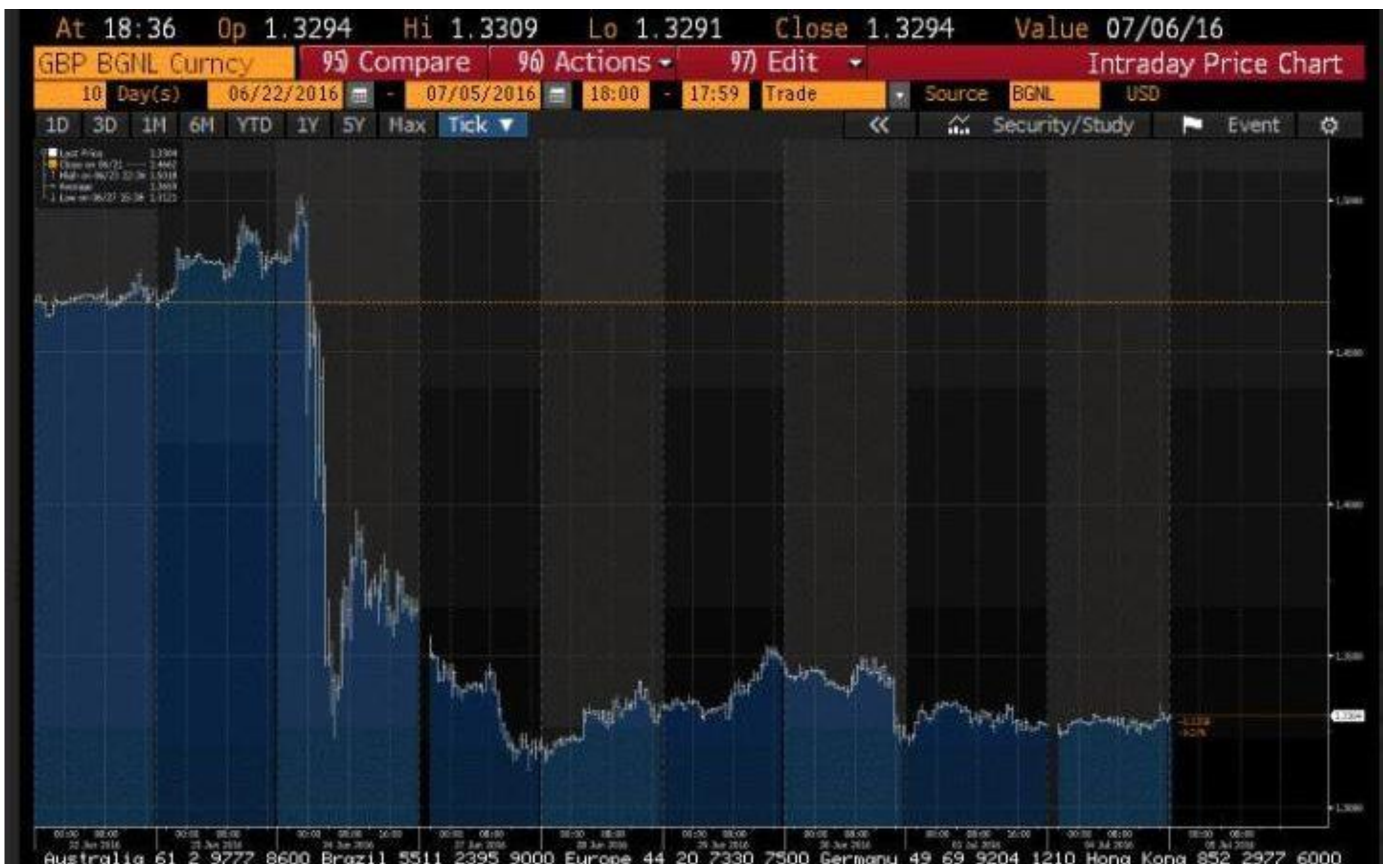
- Ambrose Evans-Pritchard

4 JULY 2016 • 6:47PM

Britain will scrape by without a full-blown recession over the next two years as a weaker pound cushions the Brexit shock and panic subsides, Standard & Poor's has predicted.

"We're not in the Armageddon camp," said Jean-Michel Six, the rating agency's chief economist for Europe.

"Devaluation acts a shock absorber. It stimulates exports and makes the London Stock Exchange more attractive to foreign investors," he said.



How sterling has fallen against the dollar since the referendum

The UK economy should muddle through with growth of 1.5pc this year, 0.9pc in 2017, and 1pc in 2018, shielded from the storm by fiscal largesse and monetary stimulus a l'outrance.

The benign outcome assumes that the Bank of England will cut interest rates to zero and relaunch quantitative easing, buying £100bn of bonds in each of the next two years.

It also assumes that Britain joins the European Economic Area – the "Norway model" – or a close equivalent that safeguards full access to the single market and preserves the City's passporting rights for financial services.

"If that does not happen, it could be extremely negative," said Mr Six. A hostile EU divorce could push the housing market into a downward spiral as an exodus of migrants compounds the damage from an economic slump.

The agency warned that devaluation has its drawbacks but the net effect in these specific circumstances is positive. "Down the road, by the end of the year or early next year, the inflation effect will hit real incomes and weigh on consumption," it said.

Bank of England Governor Mark Carney has promised stimulus measures to help the economy get through the shock of Brexit CREDIT: MATT DUNHAM

Sterling has fallen 12pc in trade-weighted terms since January. Standard & Poor's said the adjustment is largely behind us and expects the pound to rise slightly to €1.23 against the euro by 2017. It cannot fall far against the euro because the European Central Bank will take active steps to prevent this happening in order to head off deflation.

There is a raging debate among economists over whether a weaker pound will do much to restore the UK economy to equilibrium or to narrow the current account deficit, stuck at record levels of near 7pc of GDP.

Part of the deficit is caused by a collapse in investment earnings from overseas, a symptom of low global returns and the commodity bust. But what is disturbing is that the trade deficit for goods and services failed to improve much when sterling plunged by 20pc during the Lehman crisis, suggesting that there may be deeper structural malaise in the British economy.

Mr Six said the post-Lehman picture was distorted by the collapse of world trade, and later by the double-dip recession in the eurozone. "It is not a good precedent. We think this is more like 1992 when Britain left the Exchange Rate Mechanism," he said.

Britain's economy should largely brush off the impact of Brexit, according to S&P

The eurozone should brush off the Brexit drama with lost growth of 0.8pc of GDP spread over two years, though Ireland, Belgium and Netherlands are all heavily exposed to the UK export market.

S&P said the eurozone recovery is now in full swing as fiscal austerity eases and QE gains traction, all helped by cheap oil. The growth of consumer credit has jumped from zero to 5.4pc over the last year, and car sales are up 18.4pc.

Pessimists counter that the collapse in European bank shares is an early warning sign of trouble ahead. The Euro Stoxx bank index has fallen by half over the past year, with Deutsche Bank plumbing historic depths almost daily.

The epicentre of financial stress is in the Italian banking system. Non-performing loans - equal to 18pc of balance sheets - have long been a ticking time-bomb. They have now combined with new EU "bail-in" rules that expose creditors to sweeping haircuts.

Most of the banks are shut out of the capital markets and cannot raise fresh money to meet tough banking regulations. Monte dei Paschi di Siena crashed by 14pc on Monday after it was ordered to slash its bad loan book of €46.9bn by a third over the next three years, a near impossible task.

Italian bank Monte dei Paschi di Sienahas been ordered to slash its bad loans CREDIT:BLOOMBERG

Premier Matteo Renzi has been unable to take radical action to shore up the financial system and inject capital directly into the banks because of EU state aid rules, yet the eurozone itself has not plugged the gap with a genuine banking union. The EU has authorised a €150bn liquidity line but that does not solve the underlying capital crisis.

Faced with a festering crisis that is turning more dangerous by the day, Mr Renzi is preparing to take matters into his own hands and defy the EU authorities. This would be a dramatic escalation, risking a head-on collision with Brussels, Frankfurt and, above all, Berlin.

Sources say he is mulling a rescue under Article 107 of the Lisbon Treaty to inject capital, if necessary up to a limit of €40bn raised through sovereign bonds or guarantees. While the action would almost certainly be illegal, it would take years for the European Court to rule on the case.

“No prime minister can let his banking system collapse just for the sake of enforcing the EU’s crazy rules,” said one official. “This cannot go on.”