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Brexit: a preliminary assessment of the implications for the UK, the EU and Greece

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In the UK referendum of June 23rd the British people voted in favor of leaving the European Union by 51.9% (17.41mn voters). Turnout was 72.2%, the highest in a UK nationwide vote since 1992. England and Wales voted in favor of *exit* with 53.4% and 52,6% respectively, while Northern Ireland and Scotland voted in favor of *remain* with 55.8% and 62.0% respectively. Brexit is expected to have a profound and, to a large extent, unpredictable impact on the UK and the EU both on an economic and a political level. This report presents our preliminary assessment of the macroeconomic and market implications of the UK referendum's outcome on the UK, the EU and Greece. A more detailed analysis of the potential ramifications of Brexit for the Greek economy and the outlook of the current stabilization programme will be published early next week.

Brexit: potential implications for the UK economy

Trade relations with the EU. Brexit carries considerable uncertainty for both the EU and the UK, as there is no such precedent in the union's history. The process of a member state exiting the EU as set out in Article 50 of the Lisbon Treaty can potentially be protracted and last more than 2 years, [1] unless the exiting country opts for an arrangement similar to those already in place such as the European Economic Area (EEA) membership (the Norway case). Trade agreements the EU has sealed with individual countries, including Switzerland and Canada, took more than two years.

UK growth outlook. One of the key priorities for the UK government will now be to negotiate a new trade relationship with the EU, a procedure that could take longer than the 2 year period envisaged in the EU Treaty. This is because, during negotiations, the EU will need to strike a balance between preserving trade links with the UK and, at the same time, discouraging other EU member states from following suit. Increased political and economic uncertainty may primarily weigh on consumer and business confidence, eventually hampering household spending and investment activity. Labor supply may fall and sectors with a large proportion of non-British EU employees could be hard-hit, if existing immigrants were to return home or restrictions on inflows were to be imposed. According to a recent HM Treasury analysis on the potential long-term implications of Brexit, UK GDP could be between 3.8% and 7.8% lower in 15 years vs. the *remain* scenario, depending on the outcome of EU withdrawal negotiations.[2] Separately, in a report published earlier this month, the IMF explores the potential impact of uncertainty on UK growth during the post-Brexit transition under two illustrative scenarios, referred to as the limited scenario and the adverse scenario.[3] Under the first scenario, in which uncertainty is relatively moderate and the UK negotiates a status similar to that between Norway and the EU, cumulative GDP losses would amount to

[1] Under Article 50 of the EU Treaty, a Member State which decides to withdraw shall notify the European Council (i.e., Heads of State and Government) of its intention. The Union shall negotiate and conclude an agreement with the Sate setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union. It shall be concluded on behalf of the Union by the Council, acting by a qualified majority, after obtaining the consent of the European Parliament. The Treaties shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the notification referred previously (i.e., notification of withdrawal) unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period.

[2] "*HM Treasury analysis: the long-term economic impact of EU membership and the alternatives*", April 1916, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/517415/treasury_analysis_economic_impact_of_eu_membership_web.pdf

[3] IMF, Economic Health Check- Uncertainty Clouds the United Kingdom's Economic Prospects", June 17, 2016 IMFhttps://www.imf.org/external/pubs/ft/survey/so/2016/car061716a.htm

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1.4ppts by 2019, relative to the assumed *remain* scenario. Under the adverse scenario, which assumes protracted negotiations and a default to the trade rules of the World Trade Organization, cumulative GDP losses are projected at 5.6ppts by 2019. Overall, the long-term implications of Brexit for the UK economy are difficult to assess, as they will depend on future trade relationships between the EU and the UK.

Inflation and monetary policy response. Depreciation pressures of the GBP will likely push UK inflation significantly higher, with current deflation concerns being replaced by stagflation worries. Against this backdrop, the BoE will likely face a dilemma to either proceed with tighter monetary policy in order to address rising inflation risks and contain currency depreciation pressures, or retain a wait-and-see stance and even cut policy interest rates to support domestic economic activity. Yet, the BoE's initial aim would be to minimize the cost of any disruption to UK financial markets ensuring adequate liquidity provision mainly via the activation of its Contingent Term Repo Facility and the opening of swap lines with other major central banks. BoE Governor Mark Carney announced earlier today that the central bank is ready to provide £250bn of additional funds to support financial markets. He added that the BoE would consider whether to take additional policy responses in the coming weeks. Another issue for the BoE would be whether to intervene in FX markets unilaterally or as part of a coordinated intervention to support the GBP which fell sharply across the board.

Current account financing. Brexit could challenge UK's attractiveness as an investment destination, depriving the country of sizeable capital inflows that currently help to finance a wide current account deficit. The UK runs one of the largest current account deficits in the advanced world at 5.2%-of-GDP in 2015. Furthermore, it is the largest recipient of FDI in the EU, receiving c. 20% of all inward FDI.

London's dominant role as a European financial hub. Many financial firms, whose European headquarters are in London, have indicated that they would relocate sections of their business to Frankfurt, Luxembourg or Dublin if the UK were to vote in favor of leaving the EU. One of main reasons for London's dominant role as a European financial hub is considered to be the ability of firms to "passport" services across the EU after an office is set up in the UK and obtain Financial Conduct Authority (FCA) approval.

Potential sovereign credit rating downgrade. S&P has already warned for a 2 notches sovereign credit downgrade from AAA currently, in case the UK would vote to leave the EU. On its part, Fitch affirmed recently the UK's AA+ sovereign credit rating and warned that a Brexit would be moderately credit negative. Separately, Moody's has cautioned that a Brexit would risk UK's AA1 sovereign credit rating as it would consider assigning a "negative outlook" to that rating, compared with a "stable" outlook currently.

Domestic politics. David Cameron, who campaigned in favor of the UK remaining in the EU, announced his decision to resign from his post as Prime Minister and Leader of the Conservative and Unionist Party. Pro-EU Chancellor George Osborne may also resign and be replaced by an Euro sceptic political figure within the Conservative Party.

UK citizens' free access to live and work in the EU may come to risk. Whether or not this will be the case, it will depend on the deal the UK will strike with the EU after exit. Should the UK government opt to impose work permit restrictions to EU immigrant, as the Eurosceptic right-wing UK Independence Party (UKIP) has proposed, then EU countries may follow suit, suggesting that UK citizens may have to apply for visas to work.

Separatist tensions. Nicola Sturgeon, Scottish first minister has expressed her desire to hold another Scottish independence referendum, saying recently that a vote in favor of Brexit would result in an "overwhelming demand" in Scotland for a second independence referendum (c. 62% of the Scots voted in favor of *remain*). Meanwhile, the head of Northern Ireland's largest nationalist party Sinn Fein was quoted as saying that the referendum outcome intensified the case for a vote on whether Irish would quit the UK.

Potential implications for the EU

Macroeconomic impact

- Negative impact on GDP growth through direct trade *e.g.* reduced trade flows and/or increased cost of trade between the UK and the EU.
- Among the EU countries most vulnerable to Brexit are Ireland, the Netherlands and Cyprus which all have strong trade, investment and financial ties with the UK. With respect to Greece, the greater negative impact would potentially be through goods exports and tourism. In 2015, the UK ranked the 7th biggest trade partner of Greece, importing c. 4.2% (or €1bn) of total Greek merchandise

goods exports. According to BoG data, travel receipts from UK visitors to Greece accounted for 14.3% of total tourism receipts, the second largest share after Germany (15.9%). In the same year, tourist arrivals from the UK accounted for 9.2% of total inbound travelers, second after Germany (10.8%).

— Brexit would undermine business and consumer confidence in the EU, weighing on consumer spending and delaying a much needed recovery of investment activity. On the other hand, a weaker euro would likely provide support to EU exports.

Politics

— Brexit may lead to increased uncertainty about the process of EU integration and the future euro area project. Eurosceptic parties may become more vocal using the UK exit as an electoral argument for the 2017 elections in Germany and France. That is, especially if the UK economy proves more resilient to Brexit than currently feared.

— Spain's incumbent Prime Minister Mariano Rajoy and leader of the People's Party (PP) may benefit from Brexit in the upcoming Spanish general election (June 26th) on the basis that this development may mobilize some right-wing voters in favor of the "safe choice". The PP election campaign has been built around economic stability, a message that has become particularly appealing in the context of the post-referendum market turmoil. In addition, the uncertainty generated by Brexit is likely to put pressure on Spanish political leaders to form a new government swiftly and avoid a repeated election. In Italy, where a referendum on the recently approved constitutional changes is expected to take place in October 2016, Brexit is anticipated to reinforce the internal cohesion of the coalition supporting Prime Minister Matteo Renzi against anti-EU political parties (i.e., Five Stars Movement, the Northern League).

— Brexit will alter the balance of power on economic policy debates in the EU Council with the loss of a large member state which, in principle, supports less market regulation and liberalization.

EU Budget

— Other EU members would have to fill in at least part of the shortfall from the lack of UK contributions to the EU budget. The UK was the 8th largest *net* contributor to the EU budget in 2014, largely because it has a relatively small farming sector compared to other EU members. Netherlands contributed the most followed by Germany, Sweden, Finland, Austria, Denmark and France. The annual average EU contribution of the UK between 2010 and 2014 stood at £6.4bn or c. 0.3% of its GDP.

Inward FDI

– Some inward FDI would be diverted to other EU countries if the UK loses access to the EU single market. Note that the UK is the largest recipient of FDI in the EU, receiving 20% of all inward FDI. In particular, the UK is the host of choice for US outward FDI, with the UK accounting for 13.4% of the US outward FDI stock compared to just 2.7% for Germany.

Migration

— Negative impact on worker inflows from Eastern European countries, especially Poland, Romania and Lithuania. Workers from these countries in the UK in late 2015 amounted to c. 1.2million. By contrast, Western European countries could experience higher inflows of Eastern European immigrants, a development that could prove economically beneficial but politically challenging.

EU integration

— Longer-term, the implications of Brexit on the EU integration process will largely depend on whether the EU political leadership will manage to effectively address Euroscepticism's concerns, accelerate investment and jobs creation and eventually move towards greater fiscal and political unification.

Impact on Greece

In this section we discuss briefly the potential impact of Brexit on bilateral trade flows between Greece and the UK as well as on Greek tourism. A more detailed analysis of the potential ramifications of Brexit for the Greek economy and the outlook of the current stabilization programme will be published early next week.

- The UK economy absorbed 4.2% of total Greek exports of goods in 2015. This amounts to c. €1.06bn or 0.6% of Greek GDP. During the same year, the UK had the 7th highest share in total Greek exports. Italy was in the 1st place (11.3%) followed by Germany (7.2%), Turkey (6.7%), Cyprus (5.6%), Bulgaria (5.0%) and the United States (4.9%). Furthermore, the products with the highest share in total Greek exports to UK were: pharmaceutical products (14.3%), electrical, electronic equipment (10.8%), mineral fuels, oils, distillation products, etc., (8.3%), vegetable, fruit, nut, etc. food preparations (8.2%), dairy products, eggs, honey, edible animal product nes (7.9%), edible fruit, nuts, peel of citrus fruit, melons (5.7%).
- The aforementioned figures suggest that a decline of Greek goods exports to the UK by, say, 5 ppts would have a direct impact of 0.03 percentage points on annual Greek GDP growth. However, given that EU-28 absorbed c. 53% of total Greek merchandise exports or 7.68% of GDP in 2015, a possible overall reduction in EU-28 trade activity (triggered by the "Brexit") could have a higher negative impact on Greek GDP growth. This is especially as Greece is more vulnerable to trade shocks than before the beginning of the crisis due to the increase in its trade openness. On the other hand, a further significant depreciation of the trade-weighted EUR due to protracted uncertainty in the euro-area following the UK referendum could provide some offset.
- With respect to Greek tourism a negative impact may not be ruled out as the UK is among Greece's most significant markets. More specifically, according to BoG data, in 2015 UK ranked second in terms of both its share in travel receipts (14.3% of total tourism receipts) and tourist arrivals (9.2% of total tourist arrivals), very close to Germany, Greece's leading tourist market, with shares of 15.9% and 10.8% respectively. In the short-term, tourism from the UK may not be significantly affected as a large part of tourist reservations have already been materialized. In the medium term, however, a weak sterling relative to the euro may decrease UK inbound tourism. This effect may, nevertheless be offset by increased flows from third countries due to a potential euro devaluation.

Special EU membership terms agreed at the February EU Summit are now void

EU Council President Donald Tusk, ECB President Jean-Claude Juncker, EU Parliament President Martin Schulz and Mark Rutte, the Prime Minister of the Netherlands which currently holds the EU's Presidency, held an emergency meeting earlier today (Friday, June 24th). Addressing the press, they made clear that the special EU membership terms the UK government secured earlier this year are void and could not be renegotiated. The four EU officials collectively stressed that they "regret" but respect the outcome of the referendum urging the UK government to call Article 50 of the Lisbon Treaty speedily in order to avoid prolonging uncertainty.

How quickly a new EU-UK relationship agreement can be sealed

EU foreign ministers are reportedly scheduled to meet later in the day to prepare the ground for the June 28/29 European Council. In that meeting, the UK Premier will formally report the result of the referendum to his European counterparts and hold preliminary discussions on the procedure for the UK's exit, the first by an EU member state.

Triggering Article 50 will take some time. As suggested by PM David Cameron, the activation of the required procedure will occur once a new Prime Minister is in place, expected by early October when the Conservative Party conference is scheduled to take place. Meanwhile, international newswires suggested earlier today the possible establishment of a new "Ministry of Brexit" to coordinate and lead the UK's negotiations with the EU.

Once an agreement has been reached between the UK and the EU Commission on the future relationship arrangements (in line with Article 50), it has then to be approved by the EU Council (Heads of State & Government) by a qualified majority. According to Article 50, a qualified majority is defined as approval by at least 72% of member states comprising at least 65% of the EU population (without the withdrawing state). The new UK/EU agreement has also to be approved by the 751-seat European Parliament by a simple majority vote.

Initial market reaction to UK referendum

Major markets

Equities: Market volatility surged and equity market indices plunged on Friday on growing concerns over the potential macroeconomic, financial and political implications of a Brexit. In Asia, the MSCI's broadest index of Asia-Pacific shares outside Japan fell almost 5.0%, while the Japanese Nikkei 225 closed 7.9% down, recording its steepest daily slump since 2011. Elsewhere, the Euro Stoxx 600 index was losing ca. 7.5% in European trade at the time of writing, heading for the biggest losses since the global financial crisis in 2009.

Fixed Income: The Japanese 30y government bond yield dropped 7bp to a record low of 0.13% earlier on Friday on deteriorating risk sentiment, while the US 10y Treasury yield fell 34bp to a 4-year low of 1.40% in late Asian trade. In Europe, 10yr peripheral spreads widened with the 10yr German bund yield declining to a historical low of -0.17%. The 10yr Italian government bond yield rose to a 7-month high of 1.81%, resulting in an increase of Italian-German 10yr yield spread to a one-year high of ca. 160bp in European trade at the time of writing. Along the same lines, the 10yr Spanish and the Greek government bond yields rose to a 4-month high of 1.83% and a 3-month high of 10.37%, respectively, earlier on Friday, with the yield spreads vs the corresponding Bund surging to a 2-year high of ca. 170bp and a 2-month high of ca. 870bp, respectively.

FX Markets: The sterling fell sharply across the board, with the GBP/USD plunging to a 30-year low of 1.3229 earlier today, before recovering modestly to levels around 1.3721/22 at the time of writing after the BoE offered to provide more than 250bn GBP ($345 billion) to calm financial markets. Market anxiety over Brexit repercussions on the future of the euro area weighed on the EUR, with the EUR/USD falling to a three-month low of 1.0914 earlier on Friday before gaining some ground in European trade to hover around 1.1058/59. Safe-haven currencies like the CHF and the JPY were the main outperformers, with the EUR/CHF falling to an 11-month low of 1.0624 before increasing to levels around 1.0797/99 on SNB intervention to drive down the value of the CHF. Along the same lines, the EUR/JPY fell to as low as 109.57 for the first time since 2012, before recovering to levels of 112.85/86 at the time of writing on speculation that the Bank of Japan could also act to limit the JPY's upward momentum.

Commodities: The risk-off sentiment hitting global stocks was mirrored by strong demand for safe haven assets. Gold prices increased to a 2-year high of 1,358.54$/Oz intraday on Friday before losing some ground to ca. 1324$/Oz at the time of writing. On the flipside, WTI and Brent crude oil prices were losing roughly 5.0% in European trade to around 48$/barrel amid a global flight from risky assets.

Emerging Markets

EM assets fell sharply across the board earlier on Friday after Britain voted in favor of leaving the European Union in the June 23rd referendum. A drop in commodities exacerbated the downtrend. Although most opinion surveys conducted ahead of yesterday's plebiscite in the UK suggested that the outcome was too close to call, the latest polls indicated that the Remain camp was marginally ahead with a Leave outcome appearing not to have been adequately priced in by financial markets. CESEE assets bore the brunt of yesterday's Brexit vote as they are more closely (directly or indirectly) related to the EU, in terms of financial, economic and political linkages. Although trade ties between most countries in the CESEE region and the UK seem to be relatively limited, many economies have close links via remittances and in many, such as Hungary and Poland, growth is dependent on European Structural and Investment Funds which may be reduced as a result of lower contributions to the EU budget.

Equity markets: The MSCI Emerging Markets index fell by more than 3% in Asian trade on Friday compared to its level on Thursday's close. The main stock market index in the Czech Republic was amongst the worst performers in the CESEE region, with a 9.9% drop to a 7-year trough. In Poland, the blue-chip WIG20 index plummeted by more than 11% on the day to a 7-year low and the main WIG index fell 8.6% plunging to its lowest level since late January. Hungary's BUX and Turkey's BIST index shed 6.7% and 5.1%, respectively, easing to corresponding multi-month lows shortly after the announcement of the UK referendum outcome.

EM currencies: The Polish zloty eased to a 4 ½ year trough of 4.5385/€ in Asian trade before recovering some ground towards 4.4485 later in the session. Nevertheless, Poland's deputy finance minister noted on Friday that the weakening of the zloty was not a risk to the Polish economy adding that there is no reason for an intervention on the currency market. Elsewhere, the Hungarian forint declined to a 1 ½ year low of 321.84/€, though it bounced back towards 317.10 in European trade. The National Bank of Hungary said earlier in the session that it had all the necessary tools in order to continuously ensure financial stability. The Serbian dinar, which had already been under depreciation pressures over the last few sessions as a heavy EUR-denominated bond auctions calendar this and last week resulted in an increase in euro demand, lost further ground earlier today. The EUR/RSD rose to a new record high of 124.26 earlier on Friday, before pulling back towards 123.90 later on the day after the Central Bank intervened in the FX markets to halt the domestic currency's depreciation trend. The Romanian leu fell as far as a 5-month low of 4.5600/€ but made a significant recovery to stand modestly weaker on the day at 4.5250/€. Central Bank spokesman Dan Suciu highlighted that the Central Bank has all necessary tools, if needed, to deal with the Brexit vote.

Fixed income: A similar picture was evidenced in emerging sovereign debt markets in European trade on Friday, with Turkish paper leading the losses in the CESEE region. In more detail, the 2- and 10-year benchmark bond yield bounced by 11 and 25 basis points compared to the prior session's settlement to 8.94% and 9.50%, respectively. In view of the sharp increase in market volatility as a result of the UK referendum outcome, the Polish Ministry of Finance announced earlier today that it would cancel a switch auction scheduled for June 27. In the external debt markets, Emerging Market sovereign bond spreads over USTs on the EMBI Global index widened by 30bps.

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