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Consequences of Brexit: short, medium and long term impacts

UK polling companies use samples of very poor quality. This was once again confirmed with the huge upset in the result of the EU referendum: 51.9% Leave to 48.1% Remain, where the market, bookmakers and pollsters were almost entirely betting on Remain. The geography and demography of the vote was largely as expected – London, university towns, Scotland and Northern Ireland voted Remain, the East of England, former Labour strongholds in the Northern England and South Wales voted Leave – with some unexpected Leave regions contributing to the final global balance (Birmingham, Southampton, Swansea, Canterbury and Watford).

We discuss below the short term, medium term and long term impacts.

Short term impacts

The first and immediate impact of the vote is found in UK politics. Mr. Cameron has already resigned and the Conservative party, with a strong majority in Commons, will choose a new prime minister.

There are three key issues there:

- The timing of Article 50 activation[1] - Mr. Cameron announced that this would be decided by the next PM, probably in October, and we expect no sooner activation, despite pressure from the rest of the EU to accelerate the timing.

[1] *Article 50 is the article of the EU Treaty allowing a country to exit the EU. It was recently introduced (Lisbon Treaty) and remains unchartered territory. The only precedent exit (Greenland) happened outside the scope of Article 50.*

- The name of the next PM – we believe there are two scenarios, either a Pro Leave campaigner (Johnson or Gove) or a person perceived to be more likely to achieve unity within a torn-up Conservative Party (Theresa May perhaps).

- Above all, the main focus of the market should be on the policy choices of the different candidates regarding the EU/UK negotiations. We discuss these below but we would stress that the Leave campaign was a mixture of very different parties (Labour, Tories, UKIP, etc.) and none of the statements made during the campaign will be binding for the Conservative candidates.

Medium term impacts

We believe the medium term impacts can be split into four different categories.

UK cohesion

This is perhaps the most significant challenge for the UK, far beyond any short term economic trouble. Two of the UK's four constituent nations – Scotland (62%) and Northern Ireland (55.7%) –voted strongly to Remain. Gibraltar voted 95% Remain.

- Scotland's First Minister has already called for another independence referendum within the next three years. There are substantial constitutional and legal difficulties, obviously (including the fact that the Scottish Parliament would have to repeal the 1972 European Communities Act as it was included into the Scottish devolution settlement.) The Catalan regional government is following the situation closely and this could sharply hinder any EU adhesion prospects of Scotland or Northern Ireland, as the required unanimity decision to accept new members is likely to be blocked by Spain.

- In Northern Ireland, there was a strong split between unionist and nationalist voters. Many scenarios can be imagined, from an independent Northern Ireland in the EU to a full reunification of the country – something Deputy First Minister Martin McGuinness of Sinn Fein has already called for.

- In a rather stunning statement, the Spanish Foreign Affairs Minister said that "*the Spanish flag on the Rock of Gibraltar is much closer than before*" (BBC).

We believe the development around the United Kingdom's unity will be a significant market driver over the next couple of years and strongly limit the negotiation leeway of the future UK government.

UK EU relationship

Article 50 provides for an exit agreement[2] to be signed for the exit to actually take place, within a 2-year deadline, that can be unanimously extended. In practice, this agreement is likely to define the main terms of the future relationship between the EU and the UK – or what's left of it! The main items covered by this agreement should be (i) trade, (ii) immigration and (iii) regulation

[2] *Technically there should be two agreements, as the German version of Article 50 clarifies.*

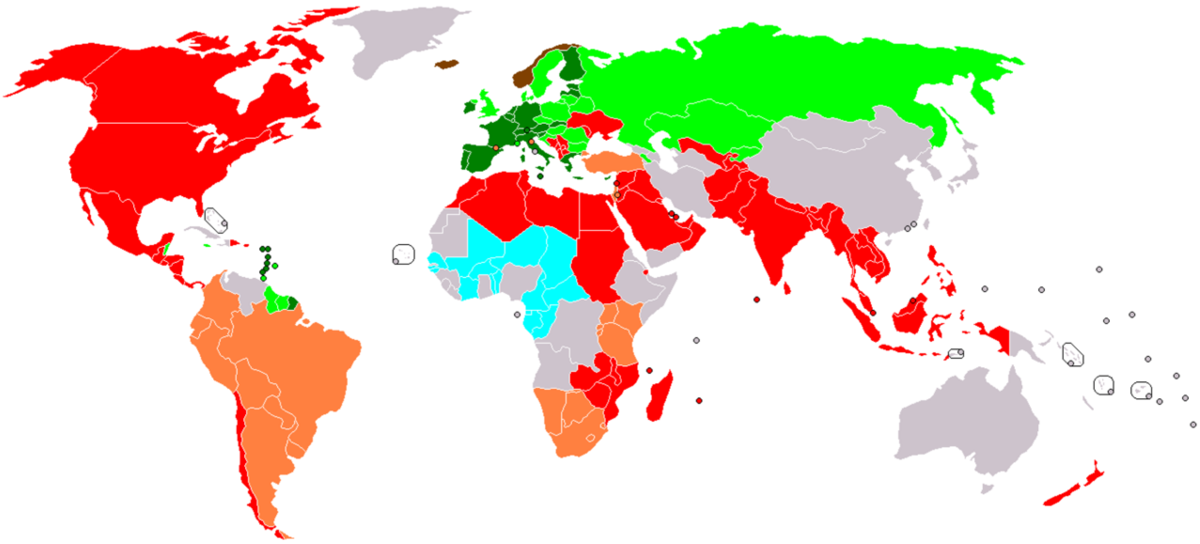
Trade

On trade, there are four likely scenarios.

Scenario	Precedent	Main terms	Rationale
EEA	Norway	Very close to a full-fledged EU membership but *à la carte* participation in various EU programs and no voting rights. UK contribution would be similar to the current one.	Keep access to the single market, likely to require substantial freedom of movement / trade.
Bi-lateral agreement	Switzerland	Not a full access to the single market, but most of it. UK contribution could be 50% lower (Switzerland pays 40% of the UK's contribution per capita).	More flexibility, probably less requirements on immigration and would probably be closer to the "spirit" of the Leave vote.
Free Trade area	CIS	A FTA is an agreement to reduce trade barriers (quotas and tariffs), sometimes including free movement of people.	This option allows for a lot of flexibility but is probably the most complicated one to negotiate and unlikely to achieve unanimity with all EU members.
Most Favoured Nation	WTO members	This is "minimal" agreement, where tariffs have to be set at the level of "most favored nations", but not zero.	This provides a full UK "sovereignty" but obviously at the expense of trade.

These different options are being used worldwide as shown on the following map.

Map of existing trade agreements



Economic and Monetary Union (CSME/EC$, EU/€,Switzerland–Liechtenstein/CHF),
Economic union (CSME, EU, EAEU),
Customs and Monetary Union (CEMAC/XAF,UEMOA/XOF),
Common market (EEA–Switzerland),
Customs union (CAN, EAC, EUCU, MERCOSUR,SACU),
Multilateral Free Trade Area (AFTA, CEFTA, CISFTA,COMESA, EFTA, GAFTA, GCC, NAFTA, SAFTA, SICA)
Source: Wikipedia

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We think the most likely scenario for UK is the EEA scenario as it offers many substantial benefits:

- It is the least disruptive for trade;
- It allows for a more flexible approach to the immigration issue which is widely quoted as being the major driver of the Leave vote;
- It is consistent with the Conservative Party's general economic policy;
- It would probably be supported by Labour in Parliament;
- It would be easy for the Conservative Leave campaign to show that they have obeyed the democratic vote without changing much to the current situation;
- It could be enough to ease independence concerns in Scotland and Northern Ireland.

In a nutshell, the EEA option is the "*Much ado about nothing*" option that would meet the targets of the most prominent Leave Conservative leaders, namely coming to power. This option would probably be opposed by UKIP and some dissident Conservative and Labour MP.

The minimal option that we believe the UK should and would pursue is the FTA option, first with other EU countries, then with countries which have a FTA agreement with the EU and finally with other countries. The UK currently has FTAs with 63% of its trade partners (in volume terms), possibly going to 81% if a deal with the US is finally signed. Reaching a similar number outside the EU would probably take a considerable amount of time. FTAs have generally taken between 4 to 10 years to negotiate, with the quick agreements usually addressing a much smaller scope (goods only). This is obviously one of the main drawbacks of this approach. Quick agreements could be stroked with countries where the trade is mostly in goods, e.g. China, India and Brazil. It should however be stressed that such agreements typically sharply reduce the capacity of the government to subsidize the relevant sectors (e.g. agriculture, steel) and this could eventually defeat the very reason why some voters chose to exit the EU. Services agreements would be much longer to negotiate but currently this only concerns 11 of the 33 EU FTAs.

Option 4 is the option that would be applicable should the EU and the UK fail to reach an agreement.

Immigration

No one can deny that immigration was the number one driver for the Leave vote. Consequently, this will have to be one of the main items on the agenda of the future PM in his negotiations with the EU.

Despite the public perception on this matter, the economic truth is that the UK needs immigration to meets its demand for labor, with a record high employment rate, ageing demographics and globalization. Moreover, Commonwealth immigration will not be impacted by the Leave vote and the UK is far from having extraordinary migration trends (over the 2000 - 2015 period, migration was just above average and below Canada, Australia, Norway or Switzerland, but these countries have lower population density).

Hence, we think it is not very likely that immigration dynamics will shift dramatically. Without EU rules, the UK will probably increase the selectivity of its immigration policy, rather than adjusting the *quantum*.

The outcome will probably be driven by the extent to which the UK will have to accept EU free movement to achieve EEA membership or a FTA. The case of Switzerland and Norway shows that for stronger trade agreements, the EU is effectively requesting a "copy and paste" of EU migration rules (which, contrary to public opinion, are certainly not "absolute freedom" and allow for selectivity based on wealth, revenues and employment).

Regulation and competitiveness

We think regulation is the "forgotten debate". However, the weight of the financial sector in UK's GDP and the considerable legal issues linked with the EU passporting system, mean that the way regulation is handled could have a very significant impact on long term GDP. The UK will be probably willing to make the required concessions (effectively apply most financial directives) to keep its financial industry rather than to fight on subjects such as bonus caps.

Other important "regulatory sectors" include social employment law and renewable energies.

The EU's view and the negotiation process

The situation is very different from the EU's point of view. The final agreement with the UK will have to be approved by the Council, the European Parliament and possibly all Member States – unless there is no agreement, in which case EU Treaties would simply cease to be binding for the UK and bilateral agreements could be signed[3]. Each country will probably have a different agenda, also depending on their current electoral calendar (France and Germany being likely to adopt a harsh approach - at least until the end of 2017).

The mechanics of these talks probably mean that the EU will have the upper hand: the voting rules applicable to the Council (qualified majority with European Parliament approval or possibly unanimity[4]) and the final deadline (two years) under Article 50 will allow for a very strong negotiating position. The UK will probably try to hold informal talks with the EU before triggering article 50, but the impact and efficiency of such talks remains to be proved.

On top of that, failing to achieve an agreement within the deadline would be a legal and economic nightmare for the UK. As explained in the House of Lord's Committee on the European Union's report: "*the UK [would] be forced to withdraw unilaterally in this way, it would have no option but to fall back on the trading terms derived from its membership of the World Trade Organization (WTO). […] the following consequences would be likely to ensue: "We would impose tariffs on goods almost certainly at the same level as the common external tariff. That is the tariff we impose to the outside world currently. We leave the EU; we impose those tariffs on goods coming to us. The EU would be a third country; the EU would be imposing those tariffs on us. […] There would be tariffs between the UK and the EU, many of them not very high but some of them—as the Government pointed out—**would be 10% on cars and 35% on dairy products***." And "*A divorced couple live in the UK and another member state with special arrangements for access to children, and particularly cross-border payment of family maintenance. What happens to that? There are cross-border investments and tax treatment of capital and revenue. There are agricultural support payments and*

[3] *There is considerable legal debate around the question of the application of EU Treaties after their expiration, in particular with regard to "acquired rights", such as the residency rights of EU nationals currently living in the UK. This is because the Treaty of Vienna on treaties protects such rights after the expiration of a treaty but many scholars consider that EU Treaties are creating a sui generis legal order to which international law – and the Treaty of Vienna – does not apply.*

[4] *This is another legal grey area: the agreement could also be considered an Article 4 "mixed agreement", meaning that unanimity would be required. This is the opinion of the Committee on European Union from the UK House of Lords.*

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fishing quotas. Those are just examples. […] ***The long-term ghastliness of the legal complications is almost unimaginable.***" This further weakens the UK's negotiating position.

All in all, it is likely that the UK will be presented with a take it or leave it proposition and will have no choice but to accept it.

Another possibility, which has been raised by experts such as the Jacques Delors Institute, is that the EU will propose very harsh terms to the UK but will continuously extend the deadlines for these terms – until the UK finally accepts them or decides to withdraw its exit.

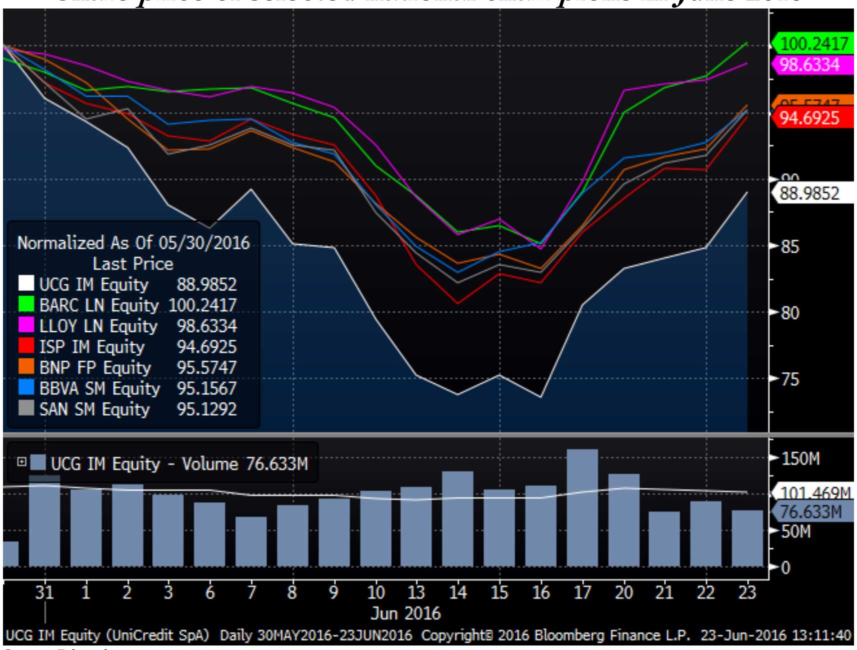
Market impact of the various options

In terms of the final agreement, we think the market would rank the different choices in the following order, from the best to the worst: EEA, Bi-lateral agreement, Free Trade area, Most Favored Nation (i.e. no agreement). Internal Conservative Party politics will probably be the main driver of the UK's final choice in that respect – to the extent that they have any choice.

EU contagion

We believe one the main risks attached to Brexit is political risk in the rest of the EU. The market became obsessed with Brexit in June, when the odds of Leave began to increase. Over that period, the two UK banks most exposed, we believe, to Brexit risk (Barclays & Lloyds) behaved as expected. But what is striking is that they were actually reacting less negatively to Brexit risk than Italian, Spanish or French banks, as shown below (comparison of the share price of each country's national champions).

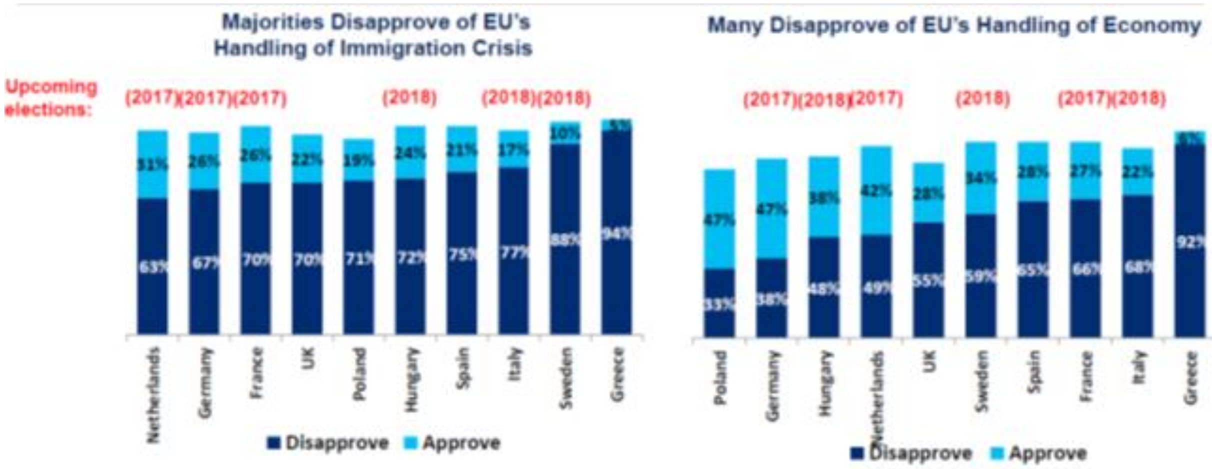
Share price of selected national champions in June 2016



Source: Bloomberg

We believe there is clear explanation for this: the UK is probably the country which is the best equipped to leave the EU: it is not in the Eurozone, not in the Schengen, it has a strong economy, etc. Other countries would not fare that well.

Moreover, approval for EU's policies are at dangerously low levels in almost every single country in the EU, especially when it comes to the immigration crisis, as shown below.



Source: Citi Research

The combination of (i) reduced perceived democratic legitimacy in the EU, (ii) opinion backlash and (iii) rise of populist parties could significantly increase political risk in the EU. The two main risks are Spain and Italy, with upcoming elections or referendum.

In terms of portfolio strategy, the main consequence is that we favor banks from countries that have a strong coalition history (Germany, Nordics) or an electoral law that is a very effective shield against populist governments (France). Riskier countries are countries in the periphery where the financial crisis led to a sharp rise in populist parties and where strong coalitions are hard to achieve (Italy or Spain) or electoral laws provide substantial first party premiums (Greece), and countries that allow for referendum being called easily (Netherlands).

Economics

We are not at all comfortable with making a prediction on the GDP impact of the Brexit – especially with such uncertainties regarding the withdrawal agreement – and estimates we have seen from economists cover a very wide range. Presumably, GDP will slow down due to the uncertainty, possible investment and consumer spending freeze, etc. The interaction with the politics will be extremely interesting to watch: the longer the UK government waits to trigger Article 50, the harsher the contraction is likely to be, but the stronger UK's negotiating power could be. It is also likely that the rest of the EU will face lower GDP growth, to a lesser extent than the UK.

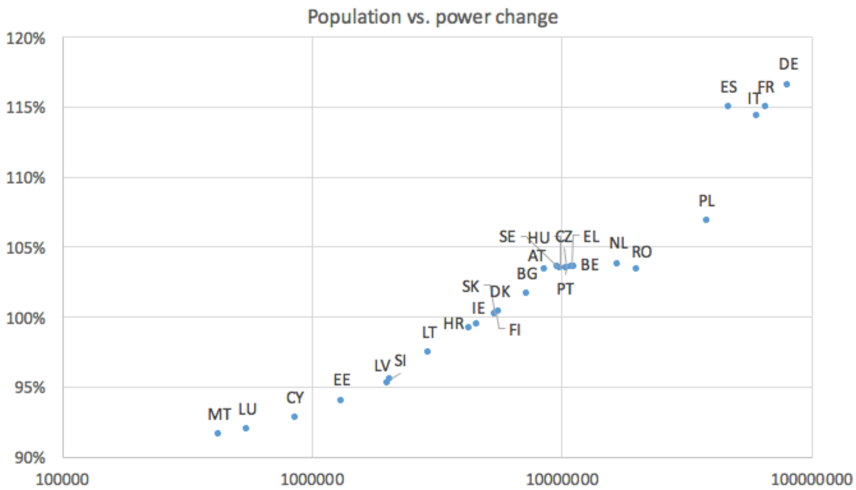
As a reaction to that, one can expect central banks to act further. On the FX side, we believe the BoE lack the firepower required to make significant interventions, but coordinated approaches should not be totally excluded. Standard (lower rates) and non-conventional (asset purchases) monetary policy is likely to be eased even further, both by the BoE and the ECB – even if the latter is probably closer to its limits.

Long term impacts

There is one long term impact of the Brexit that we would like to stress: it will significantly increase the political power of large EU countries, strengthening the cohesion of the "Core Member States", Germany, France, Spain and Italy, thus reversing part of the dilution of power that happened through the enlargement process.

Voting mechanisms within the EU are complicated (Commission, Council and Parliament all have different voting rules and all play a role in the final decision process) but academics have used the so-called Banzhaf index and Shapley-Shubik index – concepts that originated in game theory – to show what the shift in political power would be post-Brexit, as shown below.

Adjusted share after Brexit as a percentage of the current share



Source : László Kóczy 20 June 2016