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Dr. Michael Heise
Phone +49.89.3800-16143
michael.heise@allianz.com

Britain votes to leave: A leap in the dark

This is not a good day for Europe. Brexit is not an event, it is a process. The repercussions of yesterday's vote will be felt not only in the UK but across Europe for years to come. In the short run, we expect severe financial market turmoil, compounded by political instability in the UK. Heightened uncertainty will reduce UK GDP growth by 1-2 percentage points per year while London and Brussels seek to come to an agreement about a new bilateral relationship. Unilateral decisions by the UK, e.g. to restrict EU migration, would prompt retaliation and would make negotiations even more difficult. Beyond that, the economic impact of the decision to leave the EU will depend crucially on the details of this agreement. Assuming that Britain will not maintain full access to the single market and will have to conclude its own trade arrangements, we expect this impact to be negative, also over the longer term. For the rest of the EU the economic fallout from Brexit will be manageable over the medium term. It is the political implications that we worry more about. Brexit will not spell the end of EU integration but it will sap the EU's political energy for years to come.

Immediate impact: Financial and economic turmoil compounded by political uncertainty

Over coming weeks, heightened economic and political uncertainty will likely lead to recurring bouts of intense market turmoil. Since the economic impact of Brexit had not been priced in, financial markets are in for a marked sell-off. The pound will depreciate strongly as capital flees the country, which, in turn, will push up import prices. The blow to private consumption and investment – domestic and foreign – could be strong enough to push the UK economy back into recession. The Bank of England will face a conundrum. A tumbling currency and the associated inflationary pressure mandate higher rates to mitigate the risk of a currency crisis. On the other hand, financial market turmoil and the economic blow of Brexit require looser for longer. We believe that the BoE will choose the latter. The economic impact will be compounded by political uncertainty. Although David Cameron has said that he would stay on as prime minister even in case of a Leave vote, this seems highly unlikely. His political standing is closely wound up with the referendum outcome and he is not in a position to unite the Conservative party in which the Brexiters have prevailed. Even if he does not resign immediately, we expect him to set a date for an early hand-over of power, perhaps at the Conservative party conference in October. His most likely successor at this stage appears to be Boris Johnson, although another less divisive figure might yet emerge. Although a new law makes calling early elections constitutionally difficult, they cannot be ruled out.

The negotiations: The only certainty is more uncertainty

Brexit is not an event, it is a process – and an untested one at that. Dissolving 40 years of joint law making and trade policy will create massive uncertainties until agreement can be reached on new relationships with the EU as well as non-EU trading partners. The economic impact beyond the short term will depend crucially on the details of the new arrangement between the UK and the EU and how quickly a new deal can be struck. Unilateral decisions by the UK, e.g. to restrict EU migration, would prompt retaliation and would make negotiations even more difficult.

We expect the UK to invoke Article 50 of the Treaty of the European Union (December 2009) in due course, after which both sides have two years to conclude an exit arrangement. Most likely, Brussels and London will seek to negotiate the new arrangement for trade, investment and participation in EU policies at the same time, although this is not a legal requirement. A firm deadline for concluding this complex package will be needed to focus minds. Nevertheless, we share widespread doubts whether two years will be sufficient for anything but a broad outline of the new relationship. Simultaneously, Britain must replace 53 preferential trade agreements that the EU has concluded with third countries – a task complicated by the fact that Britain no longer has its own trade negotiators. Prolonged uncertainty in UK trade relations, particularly with the EU, will be poison for business and investor confidence.

Although both the UK and the EU have a strong interest in maintaining broadly stable and open economic relations, they have conflicting interests in the negotiations. The UK will want to maintain maximum access to the single market, including and especially for services, but without being obliged to admit workers from other EU countries or contribute to the EU budget, as is required of Switzerland and the members of the European Economic Area. The EU, however, cannot accept such a cherry-picking approach, lest it set a precedent for some other EU governments that would like to comply with certain parts of the EU acquis but not others.

If the Brexit deal is seen as overly advantageous to the UK, many EU leaders will fear the consequences for their domestic politics more than risks to EU cohesion. Although copy-cat referenda are not imminent in other EU countries, a too generous deal for Britain would play into the hands of populist parties who will seek to gain votes by promising “to give the people a voice on Europe”.

With such conflicting interests and domestic pressures, the Brexit negotiations will prove anything but swift and easy, which will periodically unsettle the markets, weigh on economic sentiment and reduce the UK’s attractiveness for foreign as well as domestic investment. We expect annual GDP growth to be 1-2 percentage points lower in the next couple of years.

Instability will rise further if, in the midst of these negotiations, Scotland holds another referendum on independence. Since most Scots voted for staying in the EU, many will now call for unshackling themselves from the United Kingdom in order to remain part of the European Union.

The long term: Economic dampener

Beyond the negotiation period, the economic impact of the Brexit vote will materially depend on the details of the new relationship. Given the constraints and conflicting interests under which both sides are negotiating, it is highly unlikely that it will be anywhere near as favorable to the UK as EU membership. Therefore, we expect the long-term economic consequences for the UK to be negative in terms of productivity and competitiveness and growth. It is hard to see what economic policy changes could take place within the UK that would compensate for a reduced access to the common market.

The impact on the EU

Although the main impact of Brexit will be felt in the UK, the rest of the EU will also be negatively affected by economic uncertainty and disrupted trade and investment flows. Exporters to the UK will suffer as the pound plummets and the Brexit shock generally reduces demand for imports. With financial markets in turmoil, and the economic outlook getting bleaker, the ECB is likely to delay the exit from ultra-loose monetary policy. Amid major turmoil on the financial markets and ongoing political uncertainty, the impact on GDP growth in Germany and the eurozone could add up to as much as 1 percentage point over the coming 2 -3 years.

On the whole, however, the economic impact of Brexit is likely to be manageable for the EU as a whole. The political fallout could prove to be more worrying. Warnings that Britain's vote to leave spells the end of the EU are overdone. Still Brexit serves as a wake-up call for the EU that the period of seamless integration is over and that much more attention needs to be paid to feelings of Euroscepticism and political discontent that are by no means confined to England.

Some observers have predicted that the remaining EU countries, or more likely the eurozone members, would now rush into new European integration initiatives, to demonstrate to their voters and the outside world that Brexit is not a mortal blow to the European project. With Italy heading into its constitutional referendum in the fall and elections due in Germany, France and the Netherlands next year, there is no chance of any big push towards political union or other ambitious projects. Even beyond 2017, there is probably little political appetite for far-reaching EU initiatives anywhere outside Brussels.

The UK has traditionally been one of the most liberal and outward-looking members of the EU. Many observers therefore fear that, without it, the EU might become more statist, protectionist and parochial. It is true that without the UK at the table, there will be less progress on services market liberalization and the EU would be even weaker as a foreign policy and security actor. But in many other areas of the single market and economic policies, the EU has been making progress towards openness in recent years even though the British voice has already been much diminished. Germany, the Nordic countries and the Netherlands will continue to push for a broadly liberal economic policy agenda, while a newly elected French president and Matteo Renzi (perhaps with a fresh mandate after early elections in 2017) might also become more conducive to reforms.

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