Brexit one year after

From doom to cautious confidence, expressed in economic performance and election outcomes

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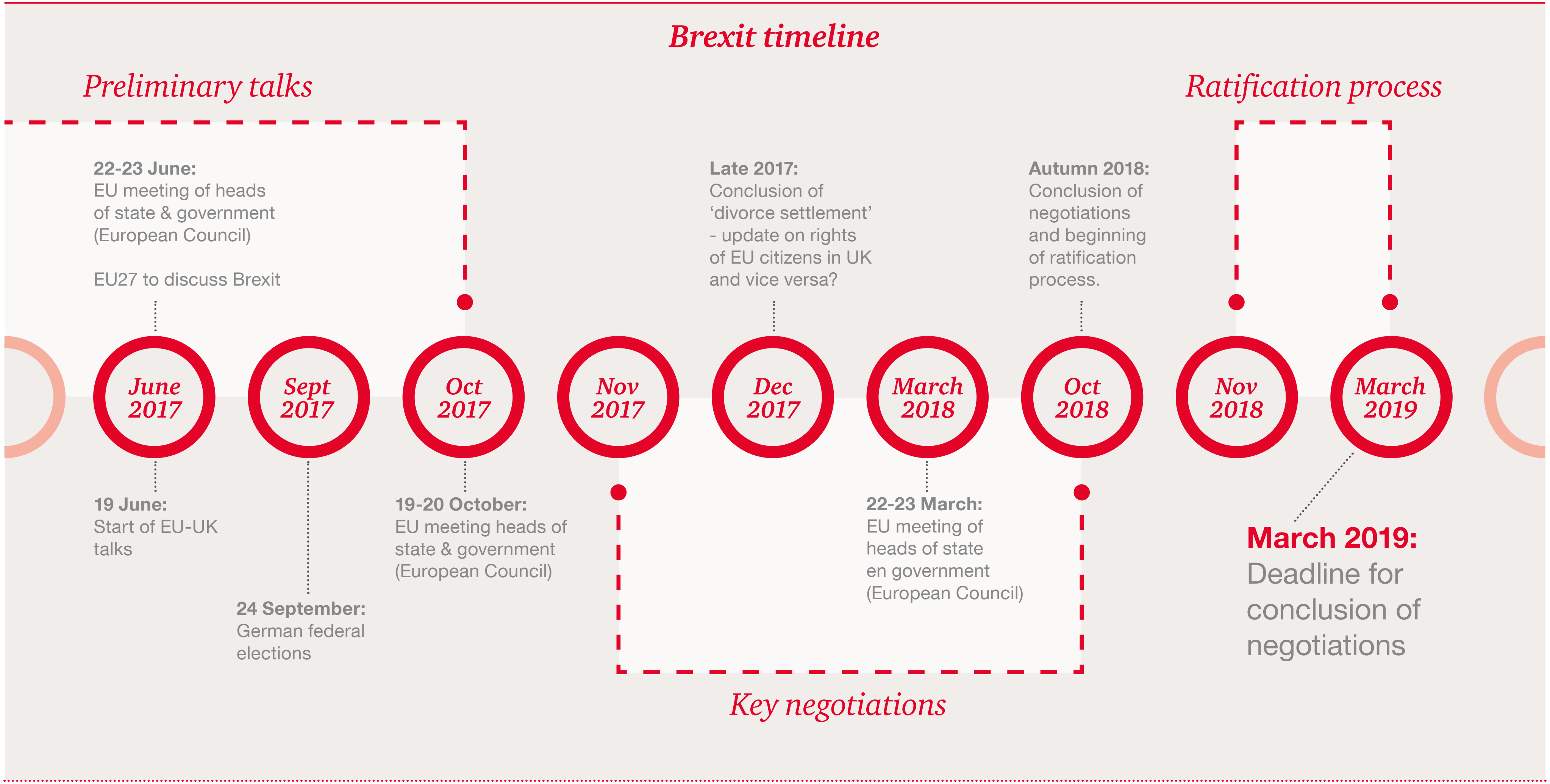
One year ago the UK voted to leave the European Union. In the year that followed events have continued to surprise: from economic shocks that didn't materialise to political messages that shocked. Downside risks have slimmed but remain present.



The immediate shock

The outcome of the UK's EU referendum last year took much of the world by surprise. A series of events followed in the immediate aftermath of the vote, and both the UK and the EU politics quickly realigned to face a new set of circumstances.

In the UK a new Prime Minister and government were quickly put in place to take the country through the 'Brexit' process. The remaining EU 27 member states started to hold their first gatherings without the UK, and aligning their positions on the UK's future departure from the EU. The first months following the vote felt for many like a period of great upheaval.

Yet, taking stock one year later, the fear of immediate negative consequences may now seem largely overstated. While the vote had an immediate effect on the exchange rate of the pound sterling and there was heightened market uncertainty, neither the EU, nor the UK were hit by apocalyptic economic shocks. In terms of politics, Brexit has not, to date, triggered a wave of major victories for populists in European elections.

Figure 1 Exchange rate of the pound sterling vs the Euro

Source: Thomson Reuters

On the contrary, European populists seem to have lost traction in Dutch and French elections, and increasingly likely, in future German elections as well.

The doomsday scenario that didn't happen

A year ago, many well-reputed economic forecasters painted a bleak picture for the UK economy, as well as for the EU.

Increased uncertainty in the wake of the vote was expected to result in a deterioration of GDP growth in the UK, and in the rest of the EU starting in 2016 and 2017. In July 2016, the European Commission revised down their growth forecasts for the Eurozone and predicted a GDP loss of 0.25-0.5% by 2017, and of 1-2.75% in the UK, as a direct result of the vote.[1]

With 2016 behind us, preliminary GDP figures from Eurostat suggest that growth in the Eurozone has been unaffected by the UK vote to leave the European Union. GDP growth in the Eurozone came in at 1.7%, which was the level that was forecasted before the referendum. Overall the performance of the UK economy surpassed expectations in 2016, and the Eurozone's steady economic recovery, which began in 2016, was largely unaffected.

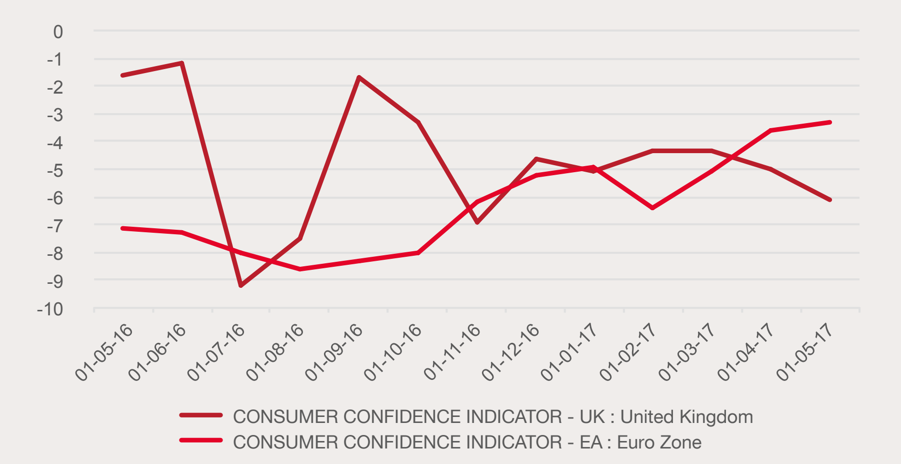
Nonetheless, one direct effect of the UK's Brexit vote has been the impact on the exchange rate of the pound sterling (*figure 1*). Since the beginning of 2016, the pound has fallen by more than 16% against the Euro, and by 14% against the US dollar. After a slight recovery in late 2016/early 2017, the pound again seems to be the first victim of heightened market uncertainty in the wake of the UK's general elections.

1 In its Economic Outlook after the UK Referendum: First Assessment July 2016 the European Commission predicted growth in the euro area to moderate to 1.5%-1.6% in 2016 and to 1.3%-1.5% in 2017, down from the previous 1.7% forecast for both those years.

Moving into 2017, some Brexit related effects are starting to be felt in the UK. Inflation has crept up to 2.7% – the highest price level increase in four years – and has resulted in a decline in the purchasing power of UK consumers. Higher inflation is largely due to imported goods being more expensive as a result of a weaker sterling. Consequently, many consumers may be forced to trim their expenses and will continue to place emphasis on essential spending over non-essentials in the remainder of 2017.

In the rest of Europe confidence initially slipped during the summer, but recovered quickly in the following months. The index published by the European Commission dropped from -7.1 to -8.6 during the three months after the referendum, but has recovered ever since and climbed to -3.3 in May 2017. As the timeline for the UK exit from the EU became increasingly clear, business managers realised that Brexit is a process which will last years – it is a marathon rather than a sprint. As a result, in the autumn of 2016, Europe reported the highest level of optimism among consumers and businesses since the onset of the financial crisis in 2008.

Figure 2: Consumer confidence in the EU and in the UK

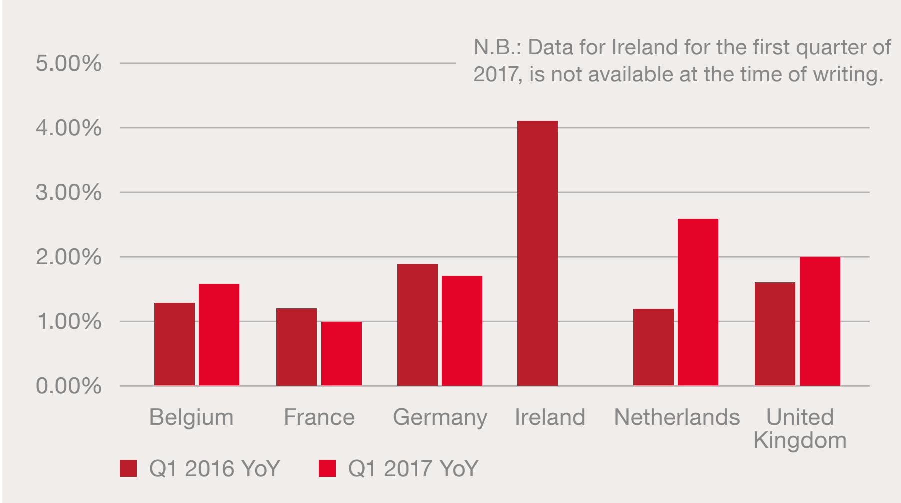


Source: Thomson Reuters Datastream/ Fathom Consulting

Yet, the clearest manifestation of the absence of Brexit shockwaves were the favourable hard economic data[2] for the last two quarters. Consumer spending has continued to serve as the main driver of the recent recovery, and investment and export levels have picked up, as well. Encouragingly, the economic progress has been broadly based among most sectors, boosting confidence that the current upswing is robust.

Both Europe and the UK seem to have weathered the uncertainty shocks that characterised the second half of 2016. The UK's main EU trade partners recorded robust GDP growth figures. Moreover, there was no major withdrawal of capital from the area's most affected countries, as some had anticipated. In the first quarter of 2017, UK capital investments increased by 1.2%, whereas in Europe it rose by 1.3%.

Figure 3: Year-on-year GDP growth of selected countries



Source: Thomson Reuters Eikon

2 Hard data refers to actual developments in the economy, such as a company hiring more workers or an increase in government spending events versus sentiment, while soft data refers to sentiment indicators.

A view to the future

It is worth emphasising that, as for now, the relationship between the UK and the EU has not fundamentally changed. The UK remains a full member of the European Union until the day it formally leaves.[3] Longer term economic consequences hinge on the future relationship between the EU and the UK. Any minor adverse effects at the macro level, before this date, would largely be due to the heightened level of uncertainty in the economy. For now, this uncertainty persists, pending more clarity on the outcome of the EU-UK negotiations.

Figure 4 Brexit scenarios

EEA member (Norwegian option)	Bilateral agreement *(Swiss model)*	Free trade Agreement *(Canada model)*	No access agreement *(WTO terms)*
~~Low degree of disruption to UK-EU economic relations~~	~~Medium degree of disruption to UK-EU economic relations~~	Low degree of disruption to UK-EU economic relations	Significant disruption to UK-EU economic relations
~~- Application of four freedoms~~ ~~- Application of EU Regulations and directions~~ ~~- Access to single market for FS via passporting~~ ~~- Contribution to EU budget~~	~~- Access to some areas of the Single Market, at the cost of adopting the relevant EU regulation~~ ~~- No application of four freedoms~~ ~~- No innuence over EU Regulations or Directives~~ ~~- Not part of the EU Customs Union and no access to intra-EU trade systems~~	- No application of four freedoms - No influence over EU Regulations or Directives - Market access depending on the shape of the FTA deal struck	- Only WTO terms applied - No application of four freedoms - Independent migration policy - No access to the EU single market - No UK contribution to EU budget - The UK not part of the EU Customs Union and no access to intra-EU trade system

Less disruption → *More disruption*

Source: PwC analysis

A comprehensive trade deal between the EU and the UK would be the least disruptive to EU-UK trade but is unlikely to be agreed upon within the two year window of exit negotiations. A transition period would ease some of the immediate effects on the economy and give businesses time to adjust to the new circumstances.

In short, the 'no deal' scenario would be the most damaging to businesses active both in the EU and in the UK. Under the WTO's MFN tariff scheme[4], the UK and the EU would have to apply the same tariffs and customs regulations to its EU/ UK imports as they do to imports from other parts of the world with which there are no trade agreements. This would raise the transaction costs of trade substantially.

In this scenario, tariffs, quotas and non-tariff barriers may force EU exporters to increase their prices, which, depending on the price elasticity of demand of the UK consumers, may reduce their sales performance. At the same time, the WTO scheme would also increase the price of UK intermediate products, diminishing the profit margins of EU firms that use UK components in their final products.

Under a WTO scenario, the average tariff rate for EU countries could rise by up to 11%.[5] However, for specific products, such as tobacco and meat, the ad valorem tariff rate may get as high as 38% or 49%.

3 Estimated at the end of March 2019, following the end of the two year negotiation period.
4 Most Favoured Nation tariff scheme of the World Trade Organisation
5 The average tariff rate under the WTO scheme is determined by the structure of a country's export flows. For example, tariffs on agricultural goods are high, so if a country exports a relatively significant amount of agricultural goods to the UK, then the average tariff rate exposure for this country will be high.

Figure 5 UK and EU industries facing the highest tariffs in a WTO scenario (weighted %)

EU	Exporters of	Average Tariff	UK	Exporters of	Average Tariff
1.	Dairy Produce	39.9%	1.	Tobacco and manufactured tobacco substitutes	43.7%
2.	Tobacco and manufactured tobacco substitutes	39.5%	2.	Preparations of meat or fish	39.9%
3.	Meat	32.3%	3.	Dairy Produce	39.4%
4.	Preparations of meat or fish	31.8%	4.	Meat	37.8%
5.	Sugars and sugar confectionery	30.2%	5.	Sugars and sugar confectionery	31.6%
6.	Products of milling (e.g. Flour)	25.2%	6.	Products of milling (e.g. Flour)	25.5%
7.	Preparations of vegetables and other parts of plants	19.7%	7.	Cereals	23.9%
8.	Waste from food industries and animal fodder	18.4%	8.	Residues and waste from the food industries	22.8%
9.	Vegetables	15.1%	9.	Preparations of vegetables and other parts of plants	17.7%
10.	Animal or vegetable fats and oils	14.8%	10.	Preparations of cereals	12.7%

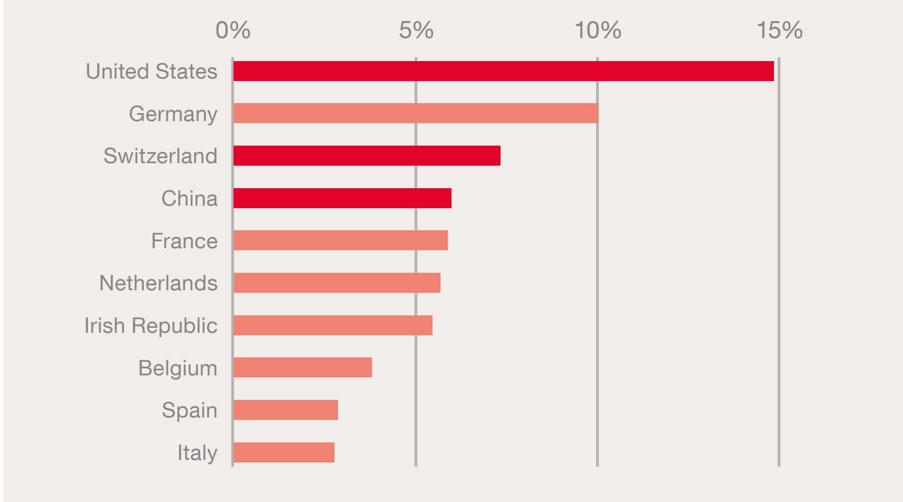
Source: Civitas (2016)

Finally, the departure of the UK from the customs union would also have far-reaching consequences for all multinationals in terms of the tax regime.

Overall, the most affected countries will be those with smaller, open economies. Although sudden disruptions will be relatively minor, in the long run higher trade cost may hamper economic growth (*figure 8*). The larger economies of Germany and France will likely be less affected, since their relative exposure to the UK is smaller and they are also better able to find new markets for their exports.

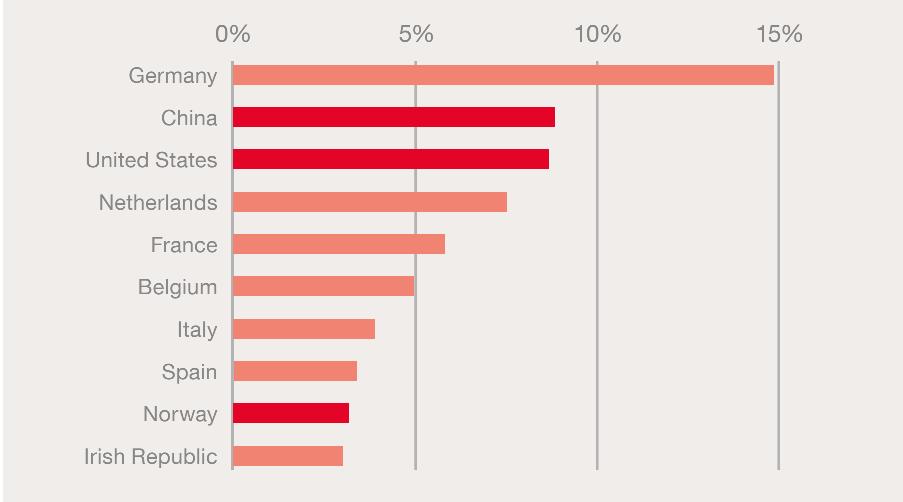
Overall, Ireland, the Netherlands and Belgium stand to lose the most from future trade barriers. These three countries sent 15.4%, 8.3% and 7.8% respectively of their total goods exports to the UK in the years 2011-2015.

Figure 6: Top 10 export destinations of the UK in 2015 (% of total export)



Source: Thomson Reuters Eikon

Figure 7: Top 10 import origins of the UK in 2015 (% of total import)



Source: Thomson Reuters Eikon

Figure 8: Relative importance of exports to the UK, estimated economic impact of WTO scheme and industries at risk

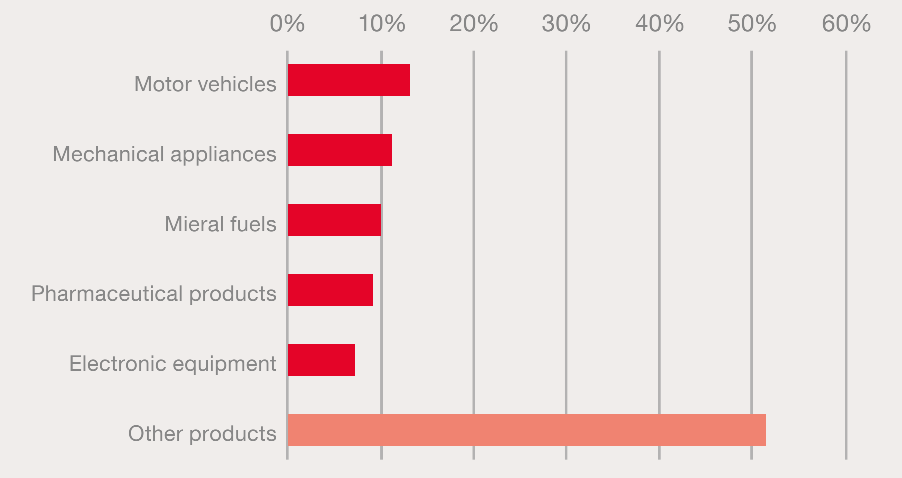
Country	% of total exports to the UK, 2011-2015 average[6]	Estimated impact overall economy by 2030	Most severely affected industries
Germany[7]	6.7%	-0.1-0.3%	- Automotive - Pharmaceuticals
Netherlands[8]	8.3%	-1.2%	- Chemicals - Plastics - Rubber - Electronics - Automotive components - Food processing
Ireland[9]	15.4%	-3.7%	- Agrifood - Food & beverages - Basic metal
Belgium	7.8%	-2.1%	- Vehicles - Pharmaceuticals - Plastics
France	6.9%	-0.6%	- Automotive[10] - Machinery - Aerospace - Chemicals - Pharmaceuticals - Agrifood
Denmark	7.9%	-0.8%	- Machinery - Food & beverages - Pharmaceuticals

Sources: Eurostat, ifo Institute (Germany), Netherlands Bureau for Economic Policy Analysis (CPB), Barrett et al. (2015), Credit Agricole

PwC has highlighted several sectors which are considered to be at risk. Among these are the most intensively traded products between the UK and the EU: the automotive, mechanical appliances, pharmaceutical, electronic and plastic industries.

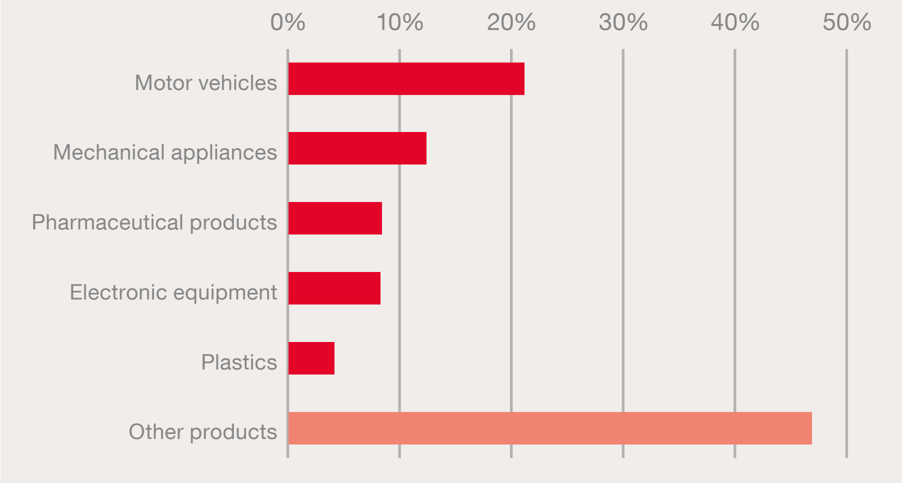
6 Eurostat
7 Ifo estimates
8 CPB estimates
9 Barret, Bergin, FitzGerald, Lambert, McCoy, Morgenroth, Siedschlag & Studnicka (2015), Scoping the Possible Economic Implications of Brexit on Ireland; Research paper ESRI (Economic & Social Research Institute)
10 Credit Agricole

Figure 9: Top 10 export destinations of the UK (% of total export, 2015)



Source: Thomson Reuters Eikon

Figure 10: Top 10 import origins of the UK (% of total import, 2015)



Source: Thomson Reuters Eikon

In response to the Brexit vote, key players in the financial industry have indicated that they may transfer staff to other major financial hubs within the EU, such as Frankfurt, Paris and Dublin. Some have already announced relocation decisions. If the financial services sector's ability to serve global clients from London becomes severely impeded post-Brexit, others may decide to follow suit.

As outlined in this briefing the past year's Brexit events have continued to surprise, both in terms of political messages that shocked, as well as the economic shocks that did not happen. In this context, downside risks have slimmed but remain present.

Hard rhetoric aside, however, a disorderly Brexit would not be in either the EU's or the UK's interest. Additionally, while both tariffs and non-tariff barriers will make EU-UK trade more complex, 44 years of EU membership and 25 years in the single market mean that the EU and the UK are more economically intertwined than ever before. For this reason Brexit may turn out to have less severe effects than many have feared, as old trade ties may still hold strong. Nonetheless, trade barriers will increase the cost of this trade. For companies active in the EU and in the UK, not preparing for Brexit is not an option.

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