UK Votes to Leave

Leaving Europe, what could it mean?

In a historic vote which has ended months of speculation, the UK electorate has voted to leave the European Union (EU). While the speculation may have ended, the uncertainty has not. What will an exit from the EU mean, not just for the UK, but for Europe and beyond?

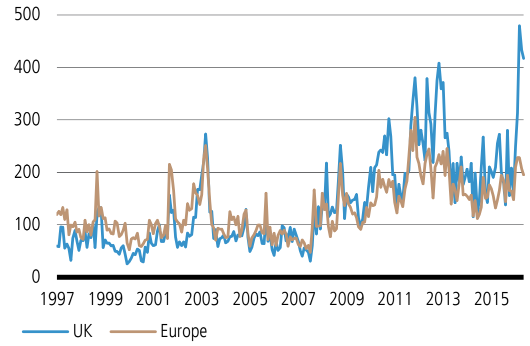
Too soon
Clearly it is far too early to give any definitive answers. Although the short-term response will likely be intense, the longer term implications and the reality of the 'Leave' vote will take years to play out. For the moment the UK remains in the EU, and the process of leaving could take two years or more. Together with domestic political disruption, this will lead to a prolonged period of uncertainty.

A vote to leave – the economic implications

The economic implications of the vote to exit are almost uniformly negative. The near-term impacts will be dominated by uncertainty, lack of confidence, movements in the exchange rate and asset price fluctuations. The longer-term impacts will be dominated by trade, the financial sector, demographics and productivity.

Near-term
Rising uncertainty is bad for business investment. Firms do not like to commit to significant expenditure when there is substantial uncertainty about the business environment and hence about the likely payoffs. Individually this makes sense, but when all businesses do it, there is a multiplier effect. Business investment had already started to fall in advance of the referendum, but the uncertainty is compounded following the UK's decision to leave the EU because it could take years to know where the economy is going. Hence the effect on investment looks set to worsen.

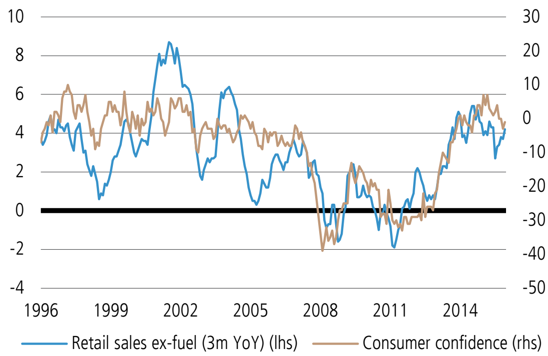
Policy uncertainty indices for the UK and Europe
News-based policy uncertainty indices for the UK and Europe



Source: www.policyuncertainty.com

Uncertainty also discourages firms from hiring, and a worsening labour market is likely to hit consumer confidence. This could lead to a reversal of the recent unusual strength in consumption.

Consumer confidence has been supporting retail sales
Retails sales volume growth and consumer confidence

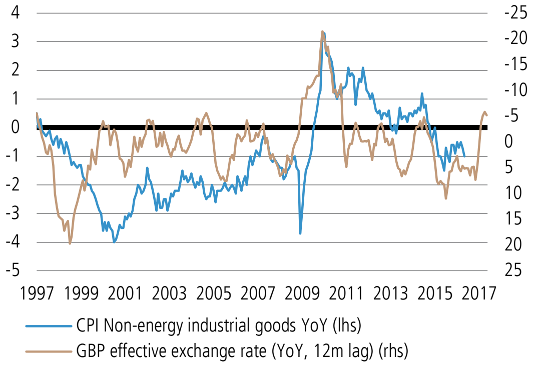


Source: ONS, GfK

In terms of currency, a very sharp adjustment in the exchange rate of sterling vs. major currencies such as the US dollarand euro looks likely. This would have a significant impact on inflation because the UK imports a significant amount of goods from overseas, which will consequently be more expensive. Research by the Bank of England (BoE) suggests that a 10% drop in sterling pushes up inflation by up to 1.5% cumulatively over the next two years . This is a one-off effect however, and will likely fade after that time as the currency stabilises. Hence it is arguable that the BoE can ignore that inflationary impulse.

A weaker currency leads to higher inflation (with a lag)

Inflation in non-energy industrial goods and Bank of England trade-weighted effective exchange rate index for GBP



Source: ONS, Bank of England

On the more positive side, a drop in the exchange rate acts as a buffer for the economy. Cheaper sterling makes UK exports more competitive and imports more expensive. All else being equal this should help to correct the UK's trade deficit.

The increased uncertainty and a drop in confidence will likely combine to hurt asset prices. For many households, the most important factor will be the likelihood of a negative impact on house prices, especially in London and the south-east. However, for those who would like to buy a new or larger home this is actually beneficial. Higher risk premiums could also affect other assets, which would mean lower prices for risky assets. That would reduce household wealth, having a further negative impact on expenditure.

The BoE will likely be faced with a situation where inflation pressures are rising but the economy is entering into recession. A cut in rates is less likely as a response, but a resumption of quantitative easing cannot be ruled out. A drop in the exchange rate would be viewed as a form of monetary easing, which would limit the need for an immediate policy reaction. There would be no attempt to 'defend' the currency. Further easing looks more likely in Q4 than Q3, unless there is a disruptive adjustment in financial markets.

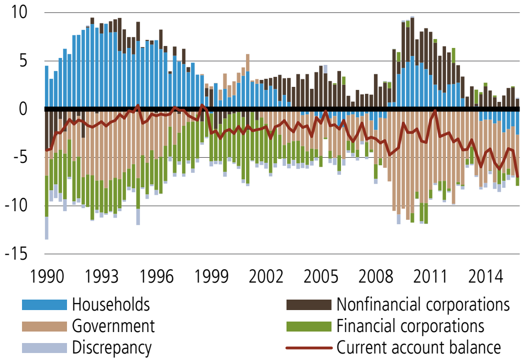
Long-term

The greatest long-term impact on the UK is likely to be through trade. Firstly, there is the adjustment process for the UK's trade deficit and secondly, there is the impact on productivity.

The UK runs a very large current account deficit, so the UK as a whole spends more than it earns. That means the UK must borrow from the rest of the world. The rest of the world will only lend to the UK if they have confidence in the economy and political situation. If that willingness drops, there are two ways to adjust. The most painful option is to change quantities: have a recession so that imports drop enough to bring the UK into balance (this is what happened in Spain following the financial crisis). The other option is to change prices: the exchange rate falls enough to make UK assets look relatively attractive. If the world becomes less willing to lend to the UK after its vote to leave the EU, the adjustment is likely to be a combination of the two: lower imports and a lower exchange rate. A drop in the world's willingness to lend to the UK, if any, will not be as painful as it would be for countries that do not have the opportunity of exchange rate adjustment.

Excess spending by government and households drives the current account deficit

Savings-investment gap by sector and current account (% GDP)



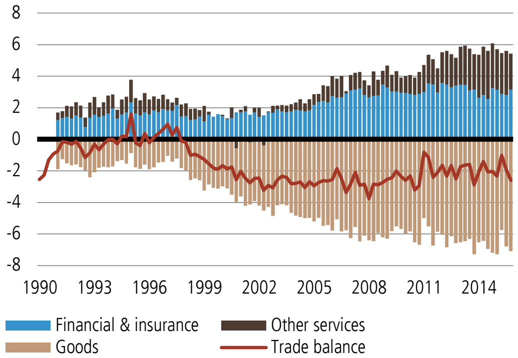
Source: ONS

Trade benefits grow through specialisation (comparative advantage) and competition pressures. Trade barriers and tariffs interfere with that, so the UK leaving the EU will likely be negative for growth. The UK has the opportunity to negotiate new trade deals, but we know these take an extremely long time, especially since a number of countries are already involved in large trade negotiations. Game theory, and experience, also tell us that smaller economies (as the UK will be) have much less bargaining power so benefit less from new trade deals.

The UK is a services exporter, and it is notoriously difficult to write trade deals that include free trade in services. The standards are too complex and there are many vested interests. The single market in services in the EU so far is much less developed than the single market in goods, but it is still more open than in other trading blocs. There will be a loss to the UK, but the loss of potential future benefits from staying in the EU and developing a more complete single market in services is also significant.

UK relies on services exports, especially financial

Trade balance by type (% GDP)



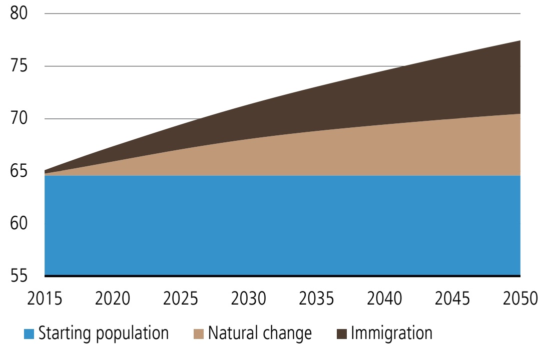
Source: ONS

A particularly important export service for the UK is financial services. Those financial services benefit from "passporting" into the EU, which allows exports of financial services. That freedom could come under threat. In addition, proposals to force all EUR transactions to be cleared in a Eurozone country could be resurrected – and if passed would make trading difficult for UK-based financial institutions. Larger firms who already have a presence in Europe would find it easier to adapt.

An exit from the EU means demographics are likely to become less favourable if the UK is successful in limiting immigration. Economic research suggests that immigration is a net benefit to the government in terms of tax versus spending, and also that lower immigration has a limited impact on wages. Lower immigration means lower population growth, which means a smaller labour force. While this is less important for GDP per capita, it is important for GDP overall. This is particularly important for public debt: a larger population allows the burden of the current stock of debt to be spread over more workers. Immigrants tend to be younger and hence act to counter the impacts of an ageing population.

Half of population growth projected from immigration

UK population projections (millions)



Source: ONS

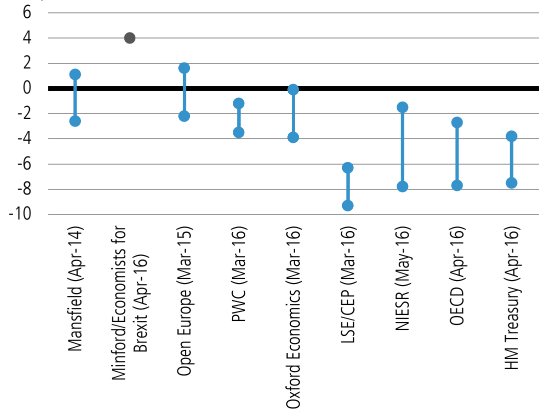
A combination of less comparative advantage, less competition through trade and lower immigration is likely to damage productivity growth, which is already weak in the UK. Ultimately, an economy becomes richer through a combination of more people and higher productivity. Lower productivity and slower population growth would ultimately slow growth – leading to lower asset returns.

Economists' estimates

Various estimates have been made on the likely consequences of an exit from the EU. Almost all estimates are for a substantial negative long-run effect. Our analysis shows that GDP is expected by most to be 2-8% lower in the long-run than it would be under the baseline of remaining in the EU. The exception is the estimate from those economists who have been in favour of Brexit: they see significant benefits. Some who argued for Brexit have suggested that the UK will be able to reduce its regulations and this will boost growth. However, the UK is already quite deregulated, and in practice, it would be politically difficult to reverse them (for example, employee rights, environmental standards, etc.).

Dominant expectation is negative impact from Brexit

Economists' estimates of long-run impact (% of baseline GDP)

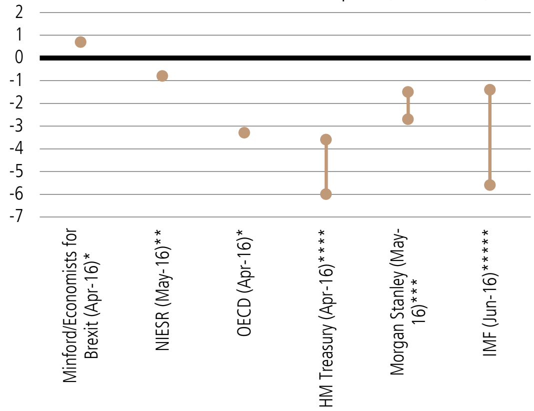


Source: HM Treasury, Morgan Stanley

Estimates of the near-term impact are also quite severe, with most predicting an outright recession within the next year or two.

Near-term impact is mostly expected to be more severe

Economists' estimates of near-term impact (% of GDP)



Source: HM Treasury, Morgan Stanley. Note: * 2020; ** 2017 only, *** By end 2017; ****After two years, *****By 2019.

Conclusion

The coming weeks will undoubtedly be characterised by ongoing volatility as the markets seek to absorb the longer-term ramifications of the UK's departure from the EU. Our teams will continue to monitor the situation closely and we will be providing further in depth commentary as both the domestic implications for the UK and the broader global ramifications become clearer.

In the meantime, please do not hesitate to contact your usual UBS representative for further information.