Economic Viewpoint

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Brexit: The economic, political and financial fallout

One more uncertainty in an already shaky global situation

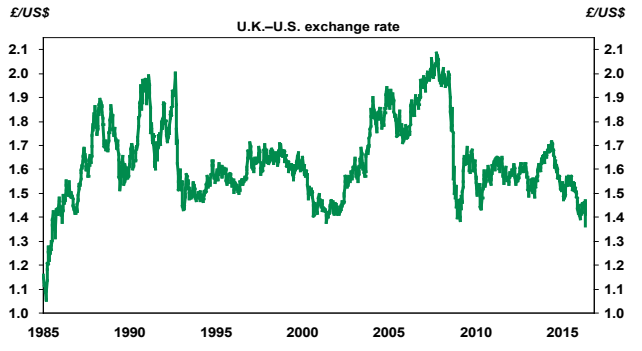
The Brits' June 23 vote to take the United Kingdom out of the European Union (EU) came as a surprise. Brexit (for "Britain-exit") dealt a hard blow to the financial markets, which were not prepared for this eventuality. This *Economic Viewpoint* takes a look at the potential repercussions of the decision that British voters made. The most plausible hypothesis is that the United Kingdom and the EU will, in the end, manage to negotiate an accord that will limit the impact on the economy. In the near term, the financial shock should be temporary, but it will still have longer-range economic and political effects, which will require some adjustments to our recently released economic and financial forecasts. We can expect more modest global real GDP growth in the next few years. The real consequences for Canada and Quebec will be relatively slight and will primarily depend on the uncertain future of the free trade agreement between Canada and the EU.

THE REFERENDUM'S IMMEDIATE CONSEQUENCES AND EFFECTS

Financial markets

Essentially unprepared due to the surveys that were giving the Bremain (Britain remain) option a slight majority in the days preceding the vote, the British public's decision took the financial markets by surprise. In just a few minutes, once the results started to show a Brexit majority, the British pound depreciated nearly 12%, hitting a 30-year low (graph 1). After Friday and the weekend, on Monday morning, the pound was down 12.3% from last Thursday's high. The London Stock Exchange is now down by 5.2% from where it closed Thursday. At one point on Friday, the loss stood at 8.7%. Nearly all of the world's stock markets took a hit. At the end of trading on Friday, the contractions were even bigger in Paris (-8.0%), Frankfurt (-6.8%), Tokyo (-7.9%) than they were in London (-3.2%). In North America, the S&P 500 fell 3.6% on Friday, while the S&P/TSX dropped 1.7%.

Graph 1 – The pound falls to its lowest point in more than 30 years



Sources: Datastream and Desjardins, Economic Studies

These movements reflect the anxiety generated by the Brits' decision. The uncertainty over the outcome is also showing in the enthusiasm for safe-haven securities. The U.S. dollar (DXY index) has gone up 3.8% since Thursday night. In contrast, the euro fell 3.9% against the greenback, while the Canadian dollar depreciated 2.3%. However, the Japanese yen rose 5.1% against the greenback, temporarily hitting ¥100/US$.

The U.S. bond market once again played its safe-haven role. Ten-year bond yields have shed 25 basis points since Thursday. The drop was less drastic in Canada (-16 basis points going to 1.12% on Monday morning).

The world's major central banks tried to calm matters; each central bank released a statement on Friday morning to confirm they were keeping a very close eye on the situation and were prepared to support the markets in the event of a liquidity shortage.

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The markets could remain unstable, especially in Britain. Elsewhere, too, as Brexit could affect upcoming key rate movements in the United Kingdom, as well as key rate decisions made by the European Central Bank (ECB) and the Federal Reserve (Fed). The financial markets will have to adjust to the new environment.

We can also expect credit conditions to tighten in the United Kingdom. Some international rating agencies have already indicated that they intend to downgrade the British government's credit rating outlook. The CDS indexes, which provide an indication of the possibility of a country's default, also went up substantially after the referendum.

Economy

We must remember that, for now, nothing fundamental has changed for either the United Kingdom or Europe. The referendum's outcome is not equivalent to an immediate Brexit. No tariff barriers have been put up, both capital and people continue to move, and Great Britain is still a full EU member. A legal process exists to govern an EU member's exit, but nothing has started yet.

Accordingly, beyond the real impacts of potential trade and financial constraints, in the near future, it is the uncertainty that could affect the economic situation. It has been clear since the start of the year that, in the United Kingdom, economic agents were becoming nervous. The U.K.'s real GDP growth was 2.3% in 2015; in the first quarter of 2016, the annualized gain stood at just 1.4%, its lowest point since the end of 2012. A similar performance is forecast for the second quarter now ending.

We can, however, expect **the outlook for the U.K.'s economy to worsen in the very short term**, as uncertainty should take a bigger bite out of investment. Businesses don't know where the negotiations between the United Kingdom and the EU will lead or, in turn, the eventual scope of their market. A number of indicators are already pointing to some difficulties in the construction market, a situation that will naturally not get any help from the referendum's outcome. Another fear: London's role as Europe's leading financial centre and a major draw for international capital is going to change. Some international financial institutions have shown that they plan to cut back on their operations in the City. British financial businesses were among the hardest hit in last Friday's stock market shakeout.

All of this will affect confidence and, in the coming weeks, it will be important to keep a close watch on consumer and business confidence indexes. Such indicators will provide an idea of the immediate impact on the real economy (in the United Kingdom and elsewhere). For example, major declines that are not immediately followed by substantial rebounds could be a sign of a difficult second half of 2016 and a tough 2017.

As for British consumers, voting estimates per age bracket are revealing. Younger voters (who consume more and generate a greater proportion of housing investment) will no doubt not be happy with the referendum's outcome (graph 2). This could affect confidence, consumption and the housing market in the United Kingdom.

Graph 2 – Estimated referendum vote by age

Age bracket	Remain	Leave
18 to 24 years old	75%	25%
25 to 49 years old	56%	44%
50 to 64 years old	44%	56%
65 and older	39%	61%

Sources: YouGov and Desjardins, Economic Studies

Political environment

The outcome of the referendum has already claimed its first political victim in the United Kingdom: Conservative Prime Minister David Cameron announced his resignation, effective this fall. He stated that the start of the Brexit process would be initiated, not by his government, but by his successor's. On one hand, this has the advantage of calming the situation and postponing certain negative consequences. On the other, with no clear successor waiting in the wings aside from Boris Johnson, London's former mayor, political uncertainty could intensify financial market anxiety. George Osborne, Chancellor of the Exchequer (Britain's equivalent to the Minister of Finance), had previously been seen as a potential David Cameron successor, but he was one of the fiercest Brexit opponents during the referendum campaign. Moreover, an internal division seems to be developing within the Labour Party, the main opposition party.

Regional voting results are also a source of discord that could be very important for the United Kingdom's future. Brexit got a clear majority in England, with a slimmer majority in Wales; Bremain, however, won in Scotland

and Northern Ireland. The results will fan the demands of Scottish separatists and the Republicans in Northern Ireland.

MEDIUM-RANGE REPERCUSSIONS

Over a longer horizon, Brexit's impacts on the British, European and global economies will depend on the outcome of the upcoming negotiations between the United Kingdom and the EU. Under Article 50 of the Lisbon Treaty, which deals with the eventuality of a voluntary withdrawal by an EU member, the effective date for the country's exit is fairly flexible. The article calls for a maximum of two years to exit after formal notification is received, but that deadline can be extended under an agreement negotiated between the parties. Negotiations can also be extended (pursuant to a unanimous decision by the remaining EU members). A 2-year horizon seems the most likely, and a request made by the British government in the fall of 2016 means that Brexit would be effective at the end of 2018. However, the other zone members, and the European Commission in Brussels, could pressure for a quick resolution in order to minimize the uncertainty.

As to the future of the commercial, financial and political relationships between the United Kingdom and the EU, there are numerous possibilities. Most analysts agree that the negotiations will be arduous. Brexit constitutes new territory, as, so far, no country has asked to leave the union. Moreover, European negotiators will not want to make the negotiations a positive example that would motivate Eurosceptic forces in member nations. Note, however, that the United Kingdom has always been unique within the EU. It has never been part of the euro zone (common currency) or Schengen area (shared borders). Since the United Kingdom has often had more political leeway within the European group, this should streamline its departure from the EU. A different member with more common ties (euro and Schengen) would no doubt face even more constraints.

The negotiations over an agreement on exiting the EU will not necessarily be the same as negotiations to achieve a new economic partnership. The two sets of negotiations could happen simultaneously, but there is no legal requirement there. It would, of course, be best for the situation in Europe and Britain to know what will happen quite soon. Table 1 (compiled by the Organisation for Economic Co-operation and Development [OECD]) summarizes the various potential avenues.

The level of ties maintained by the United Kingdom and the EU will determine much of Brexit's medium-range economic fallout. As the scope of the tariff and financial barriers raised increases, and the more the movement of goods, services, capital and people is constrained, the negative impacts on growth and on the economic potential of the EU and the United Kingdom will intensify. This would also affect the global economy.

Table 1
Possible post-Brexit arrangements with the European Union (EU)

Arrangements	Examples	Characteristics
European Economic Area	Iceland, Norway, Liechtenstein	⇒ Contribution to the EU budget. ⇒ Free movement of goods, services, capital and people. ⇒ Very limited influence on EU regulations.
European Free Trade Association	Switzerland	⇒ Contribution to the EU budget. ⇒ Requires trade agreements with individual EU countries. ⇒ No passporting rights for banks. ⇒ Very limited influence on EU regulations.
Customs union	Turkey	⇒ Tariff-free access to the Single Market, except for financial services. ⇒ Adoption of EU external tariffs for non-EU trade. ⇒ Very limited influence on EU regulations.
Free Trade Agreement	Canada (not in force)	⇒ Mostly tariff-free Single Market access. ⇒ Required compliance with European regulations. ⇒ No full access to the Single Market for services and no automatic passporting rights for banks.
World Trade Organization (Most Favoured Nation)		⇒ Trade subject to the EU's external tariffs.

Sources: Organisation for Economic Co-operation and Development and Desjardins, Economic Studies

According to the OECD, Brexit's negative impacts will be relatively substantial; all of the hypotheses expect trade between the EU and the United Kingdom to decline. In a study completed in April[1], the OECD anticipates a 3.3% decline by Britain's real GDP compared to what it would have been without a Brexit. Between now and 2030, the OECD scenario calls for the U.K.'s real GDP to be 5.1% lower. The most optimistic scenario calls for a shortfall of 2.7%; the most pessimistic one puts that shortfall at 7.7%. The negative factors that Brexit introduces for the economy include:

- Higher risk premiums;
- Erosion of confidence;
- Contraction of trade;
- Drop in direct international investment;
- Lower contribution to growth from immigration.

Reuters created the following compilation of the various forecasts for Brexit's impact on the economy (graph 3). Most of the analyses paint a rather negative picture.

Graph 3 – Different forecasts for Brexit's impact on the U.K.'s economy

	Short- and medium-term impact	Long-term impact
British Treasury	from -3.6% to -6.0% in 2 years	from -3.4% to -9.5% in 15 years
Bank of England	Slowdown and possibility of a technical recession; higher inflation	
Organisation for Economic Co-operation and Development (OECD)	-3.3% by 2020	from -2.7% to -7.7% by 2030
International Monetary Fund	from -1.5% to -5.5% by 2019	
Economist for *Brexit*	+1.4% by 2020	
NIESR	approximately -2.3% by 2018	from -1.8% to -7.8% by 2030

Sources: Reuters and Desjardins, Economic Studies

Potential positive effects

Although the risks and negative impacts clearly win out, we must not overlook the promises of those who supported the Brexit camp during the referendum period. Here are the key ones:

- It will be easier for Britain's economy to liberalize trade with non-EU countries.
- The United Kingdom's economy will be less weighed down by the bureaucratic and regulatory burden imposed by the EU. Deregulation will support investment.
- The United Kingdom will be able to do more to select its immigrants and attract more skilled workers.
- The United Kingdom will save on its contributions to the EU budget and reinvest those sums in its economy or social services.

It would be astounding if these positives managed to offset the much more obvious factors that should negatively impact the United Kingdom's economic growth.

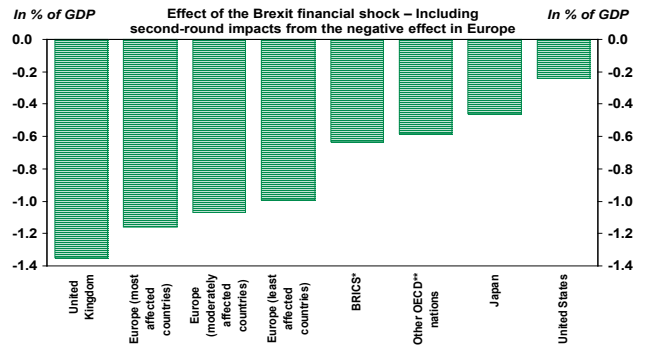
CONSEQUENCES FOR THE GLOBAL ECONOMY

According to the data compiled using purchasing power parity, Britain has the world's tenth largest economy. Within Europe, it is outranked by Germany and France. Using the U.S. dollar as the basis for comparison, the United Kingdom moves up to fifth place. It is a large economy with very close trade and financial ties with the world's other major economies. Marked deterioration in Britain's economy would necessarily mean downgrading the growth outlook for global real GDP.

The rest of Europe will, of course, take the brunt of the Brits' astounding decision. The OECD maintains that the EU's GDP will see a 1% shortfall in its real GDP by 2020.

Factoring in only the impact of the financial shock, in its latest forecasting document, the OECD estimated the scope of the impact on various parts of the world. Some European nations would of course be more affected than others (graph 4), particularly Ireland, the only country that shares a land border with the United Kingdom. According to the OECD, the Netherlands, Switzerland and Norway would also be particularly affected. France and Germany are in

Graph 4 – The financial shock triggered by the Brits' decision could have real repercussions



* Brazil, Russia, India, Indonesia, China and South Africa; ** Organisation for Economic Co-operation and Development.
Sources: Organisation for Economic Co-operation and Development and Desjardins, Economic Studies

[1] Rafal Kierzenkowski *et al.*, "The Economic Consequences of Brexit: A Taxing Decision," *OECD Economic Policy Paper*, Organisation of Economic Co-operation and Development, No. 16, April 2016, www.oecd-ilibrary.org/docserver/download/5jm0lsvdkf6k.pdf?expires=1467025273&id=id&accname=guest&checksum=4106B595F62FCC6B0D9DBF96779788BF.

the "moderate" category. The impact on the United States is relatively moderate, at just above -0.2%. The major emerging economies and other OECD members would be more affected than the United States, although clearly much less so than the European economies.

Just as some see positive effects from Brexit, it is also possible to find factors that would help the situation in Europe. It would be a response aimed at taming the criticism from Eurosceptics in other member nations.

- Greater convergence among countries that use the euro (fewer compromises with the United Kingdom).
- An incentive to improve structures, particularly democratic and bureaucratic structures, to fine-tune the functioning of common institutions (European Commission, Parliament, ECB, etc.).

CONSEQUENCES FOR CANADA

Prior to the vote in Britain, on June 20, Bank of Canada Governor Stephen Poloz said that: "We will bring a completely new analysis to the table in July, so all these estimates are subject to change, based on these risks or new ones. Just by way of illustration, the outcome of the Brexit referendum next week poses new risks at the global level that could mean a shift in view."

Like the global economy, Brexit will have economic consequences for Canada's economy. Once again, however, the impact will be heavily dependent on what happens in the markets in the next few weeks and, of course, on the future relations between the EU and the United Kingdom. We could assume that the major factors to watch for Canada's economy will be:

- The level of uncertainty and erosion of financial conditions.
- A drop in commodity prices.
- An economic decline in the United Kingdom and Europe, and the effect of that on direct trade (the United Kingdom accounts for 3.5% of Canadian exports, with the rest of the EU representing 4.5%).
- The direct and indirect impacts on the U.S. economy.

It is especially difficult to pinpoint what will happen to the trade agreement between Canada and the EU. Some EU countries are already expressing doubts about the agreement, and the United Kingdom's support was essential. When Brexit happens, the Brits will probably want to negotiate a new accord with Canada, but that could take quite some time.

FINANCIAL SCENARIOS

The immediate financial shock and the many uncertainties generated by the Brexit vote of course mean the economic and financial scenarios have to be modified.

U.S. bond yields and, to a lesser extent, Canadian yields have come down a lot since the vote, and the safe-haven effect provided by the U.S. bond market should keep yields lower than anticipated.

Another safe haven, the U.S. dollar will consolidate its recent upswing and could even rise further, particularly if the situation between the Europeans and the Brits becomes heated.

Weaker global economic growth will generate lower demand for commodities, including oil, whose prices could decline. The strength of the dollar will add to the downward pressure.

Under these circumstances, and given the financial instability and risks to its own scenarios, the Fed could further postpone its next key rate increase into 2017. The extended status quo already anticipated for the Bank of Canada could be prolonged further, given the even more cautious U.S. monetary policy. Weak oil prices and a strong U.S. dollar could take the loonie down against the greenback and up against European currencies.

If early signs point to further erosion in the European economic outlook, the ECB could be tempted by additional monetary easing measures.

At the eye of the storm, the Bank of England would be torn between the risks of a major economic shock or even recession in the near future and the possibility of seeing inflation go up (as a result of the pound's depreciation and, eventually, the drop in trade). We can expect the downside risks to dominate, leading to easing measures.

The stock markets have already taken a big hit. They could remain volatile in response to new developments. The European and British markets should take a more lasting blow, to factor in more uncertain profit outlooks and weaker potential economic growth.

CONCLUSIONS AND LESSONS

The Brit's decision to leave the EU is dealing a blow to an already fragile international economic situation. The global economy has not managed to prove its resilience since the 2008–2009 recession; the string of shocks (European sovereign debt crisis, Greek crisis, political paralysis in the United States, collapse by oil prices, slowing Chinese economy, problems in emerging nations and global trade stagnation) have kept it from really accelerating. It is therefore not surprising that the financial markets have reacted so sharply to this new crisis. The upcoming movement in confidence indexes in the United Kingdom, Europe and elsewhere will tell us about the reach of the immediate impact. Over the longer term, the situation will be dependent upon how much British and European negotiators can agree on.

Another major consequence could be a destabilizing impact on European politics. Political parties in several EU nations will want to follow the path set by the United Kingdom. Voting intentions for Eurosceptic parties are particularly high (although not in the majority) in the Netherlands, France, Austria and Italy. Indeed, some commentators predict a possible EU disintegration.

We must also not overlook the wave of populism that is hitting the advanced nations. The fear of an economy that is (too) global and the temptations of isolationism seem to be the underlying trends. This means that the factors that allowed the Brexit camp to win (fears about immigration, middle-class frustration over a lack of economic power) may lead to political surprises in other countries. For example, Donald Trump in the United States or some radical parties in Europe could get elected. Underestimating the risks, the financial markets would be very unprepared for such outcomes.

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