UK Referendum

The economic consequences of Brexit

BBVA Research

- **There was a strong risk-off market reaction to the unexpected Brexit referendum result.**
- **The negotiating process is full of uncertainties. It will start in October at the earliest and take at least two years.**
- **The long-term economic impact on the UK will be negative and dependent on the model of agreement it negotiates with the EU.**
- **The impact on Europe will be mainly political, with a difficult voting calendar ahead. EU leaders will have to define their negotiating strategy with the UK and decide whether or how they reinforce the integration process towards a two-speed Europe.**

The UK has decided to **exit the European Union in a referendum with a 52%-48% margin**, and a participation rate of 72%. Prime Minister (PM) **Cameron has resigned and will remain in charge until October**, when the Conservative Party will choose its next leader. According to Mr. Cameron, the new PM will have to invoke article 50 of the Lisbon Treaty to trigger the exit negotiations. After that, a two-year period is open to negotiate with the EU the terms of separation, and especially the new agreements that will rule the relationship between the UK and the EU. This period can only be extended by unanimity within the EU.

The unexpected outcome of the referendum, together with political and economic uncertainties, are **leading markets to a very strong risk-off mood**, looking to safe assets as US treasuries and German bund (with falls in yields of more than 20 bps), strong currencies (yen, CHF and USD) and gold. Risk assets have experienced large losses (European stock markets around -10%) and risk premia in the periphery countries widened (see table below).

Central banks are ready to act in order to limit these short-term movements. The first contingency measure would be liquidity provision. **The Bank of England has announced a very large line of additional liquidity available** (250 billion GBP, or around 12% of GDP). The ECB has also confirmed that is ready to provide additional liquidity, if needed. Other central banks seem to have intervened in the FX market.

The **long-term economic impact of an exit for the UK is clearly negative but its magnitude is very uncertain as it depends on the trade agreements** that the UK will have to negotiate with the EU and with a large number of third countries (now covered by EU trade agreements). Those models of relationship with the EU that allow a direct access to the EU single market and are less damaging economically (such as the "Norway model") do not meet the Brexiteers' demands of no contributions to the EU budget or an independent immigration policy. There are **also doubts about a diminished role of the City** as a financial center, given that outside the EU the UK would lose its passport to freely provide financial services in Europe, unless an alternative agreement is reached.

The result of the referendum will also generate **uncertainty on the political front**, at least until the new PM is chosen and defines its negotiation strategy, but also because the referendum campaign has divided both major parties and the result will spook Scottish demands for independence. General elections in the coming quarters cannot be discarded.

The **economic impact on the eurozone is estimated to be significantly lower** than for the UK. Still, market volatility and the impact on confidence have the potential to affect the pace of the recovery. And in a relatively low-growth environment, this drag will introduce and unwelcome uncertainty, especially in a context where political can take place in some countries in Europe. Anti-European movements that have grown following the economic -and refugee- crises may feel reinforced. This is why **the response of EU leaders (who will meet in a summit on 26-27 June) will be important to renew confidence in the European process**. The short-term reaction should be focused in limiting the economic damage of the referendum result and to prepare the negotiations with the new UK government.

It is this vital that the EU generates confidence in the **European project, which needs to be shaped as a two-speed Europe** (the eurozone and the EU). In the medium to long term, probably after key elections in the Netherlands, France and Germany, there should be initiatives towards reinforcing the euro area on the basis of the Five Presidents report. In the meantime, there is large margin to improve EU policies and coordination in areas where it would be easier to reach consensus, such as domestic security, external border controls and immigration policy.

Next steps to watch include:

- The **reaction of EU authorities next week** (meeting of A. Merkel with F. Hollande and M. Renzi on Monday 27 and EU Council summit on 28-29). The EU will have to define a negotiating strategy which involves a **balancing act between reducing economic impacts and limiting political contagion** to other countries.
- **Political developments in the UK** (nomination of new PM in October, division within parties on the strategy to follow, eventual new elections, Scottish demands to decide whether to stay in the EU –with which currency?-).
- **Whether article 50 will be invoked in the Fall leading to a rapid negotiation, or will be (or try to be) delayed** to bring some time.
- **Political contagion and a difficult voting calendar**: Spanish elections this weekend, Italian referendum on constitutional reform in October, US presidential elections in November and general elections in the Netherlands, France and Germany next year.

Table 1

Today markets react to shock Brexit vote: depreciation of the British Pound, flight to safety (lower bond yields) and correction of risky assets (equity)

Bonds	Level %	Change bps	Equity	Level points	Change %	Fx	Level	Change* %	Others	Level USD	Change %
UK	1.11	-26	FTSE 100	6,181	-2%	GPBUSD	1.37	-7.9%	Gold	1327	6%
GER	-0.06	-16	Eurostoxx	2,807	-8%	EURUSD	1.11	-2.9%	Oil	48.55	-5%
US	1.57	-17	S&P	2,057	-3%	USDJPY	102.2	3.7%	Copper	211.40	-3%
JPN	-0.17	-3	Nikkei	14,952	-8%						
SPA	1.61	14	IBEX	7,895	-11%						
ITA	1.55	15	DAX	9,607	-6%						

*Negative: USD appreciation
Source: BBVA Research

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