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EU and Brexit: the economic implications

- **We expect the UK's decision to leave the EU to shave about 0.5% off the eurozone's GDP in 2016−17 by fuelling uncertainty, hurting trade and tightening monetary and financial conditions.**
- **The ECB is likely to respond by providing additional liquidity and potentially front-loading asset purchases. A 10 bp cut in the repo rate is also possible. These measures are likely to come on top of the six-month extension of the asset-purchase programme that we still expect the ECB to announce in September.**
- **The long-term economic impact of 'Brexit' is unclear. It will depend on what form the new EU–UK relationship takes, including decisions on trade, regulation and competition. The UK's departure may temper its dominance of EU financial services, potentially to the advantage of other financial centres.**
- **The EU without the UK could see a shift towards less liberal policy and a decline in its international influence. But decision-making in the EU could also become more fluid.**
- **The key risk for the EU is that the UK's departure could have a contagion effect and that support for EU-sceptic or protest parties would increase. If so, the impact could be bigger in non-eurozone countries than in the euro area, which has successfully managed periods of market tension in the past.**
- **All eyes are now turned towards the European political leaders and how they will react. Reuters has reported over the weekend that the foreign ministers of France and Germany have already drafted a paper with proposals of a common European policy to address security, migration and strengthening convergence. The summit of Berlin between Angela Merkel, François Hollande, Matteo Renzi and Donald Tusk of Monday 27 June will be particularly important in providing a perspective on how the consequences and implications of the UK referendum will be addressed by the EU.**

Short-term negative effect

The UK's decision to leave the EU will affect the EU's short-term growth outlook via a direct impact on trade, heightened uncertainty and a tightening of monetary and financial conditions as a result of wider peripheral-eurozone spreads and a rise in corporate funding costs.

Leaving the EU will knock about 2% off UK GDP over the next 2-3 years, we estimate, with most of the impact being felt in 2017. With exports to the UK accounting for about 14% of the eurozone exports, the net trade effect should knock about 0.1% off the eurozone's GDP in 2016-17. Eurozone exports should be negatively impacted by the economic slowdown in the UK as a result of its decision to leave, the weakening of the GBP and the uncertainty over the future relationship between the UK and the EU. Among the four largest eurozone countries, Germany is the most exposed to the UK in terms of trade and Italy the least. Ireland has by far the greatest exposure: exports to the UK account for 17% of Irish GDP.

Domestic demand in the EU should be impacted by ongoing uncertainty about the implications of Brexit for the political debate in EU countries. This could cause a tightening of monetary conditions and in the eurozone, peripheral spreads could be wider for longer reflecting increased risk aversion of financial market investors. For this reason we expect our year-end target for Bunds yields of -20 bp to be reached earlier. Higher risk aversion could increase the funding costs for banks and non-financial corporations in the EU. Higher funding costs for banks could translate into tighter credit conditions.

The negative effect of market uncertainty and the tightening of monetary conditions on GDP is harder to pinpoint, but based on past stress events, we would estimate it at about 0.4% over two years. Eurozone GDP is, therefore, likely to be 0.5% lower than we had envisaged in our central 'pre-Brexit' scenario for 2016-17, with the bulk of the hit likely to come in 2017. We now expect growth of 1.4% (down from 1.5% previously) and 0.9% (down from 1.3%) in 2016 and 2017, respectively. Because of the uncertainty the risks are skewed to the downside.

Slower growth and heightened uncertainty are, in turn, likely to put renewed downward pressure on inflation. Core inflation is likely to breach spring 2015's record low of 0.6% y/y.

How will the ECB react?

In responding to the shock of the UK referendum result, the ECB has four possible lines of defence. The first is the provision of liquidity to counteract any possible liquidity squeeze. The second one concerns QE. Before Brexit we already expected an announcement in September of a six-month lengthening of the ECB's QE programme from March 2017 to September 2017. The UK's referendum result has strengthened the likelihood of such a move. The decision could come earlier than September and the extension could be longer than six months. Thirdly, the ECB could front-load some of the purchases, as it did last summer, through a temporary increase in the size of QE, which would be offset by a slower pace later in the programme. Finally, the ECB could cut the refi rate taking it into negative territory. A further cut in the deposit rate is unlikely.

More ambiguous long-term economic effects

The long-term effects are less clear-cut. The UK is one of the largest recipients of foreign direct investment (FDI) in the EU. The UK is also by far the most popular location for large corporate European and global headquarters. 'Brexit' could call into question the UK's allure as a business destination over other EU states. The potential disruption and costs of relocation are likely to have a negative short-term impact on some EU companies, but the longer-term impact is unclear, as it will depend heavily on the regulatory environment. This point is particularly relevant for financial services where the UK is the undisputed EU leader. Other financial centres could now benefit.

Of particular importance will be the shape of the future UK-EU relationship and its potential impact on regulation and policy. If the UK's departure leads to greater integration of the remaining EU countries, accompanied by liberal policies, for example, this could benefit the EU economy, enabling it to attract foreign direct investment (FDI) and, potentially, some relocation of financial services from the UK. As the UK is one of the bloc's most non-interventionist economies, however, its withdrawal could leave the EU with a less liberal policy agenda, with negative repercussions for long-term growth.

Impact on EU fiscal transfers

The UK's net annual operating budget contribution (excluding its rebate and EU expenditure allocated to the UK) is about EUR 5 bn. This is set to change. If the UK joins the European Economic Area (EEA), for example, it will still have to pay a contribution to the EU, albeit a smaller one. This implies that the other net contributors to the bloc will have to shoulder a bigger burden, net receivers will see a drop in funding, and/or there will have to be less spending across the bloc, with a negative impact on the economy.

Impact on migrant flows

'Brexit' may have a significant effect on migration, reducing the overall number of people moving to work in the UK. In the short-to-medium term, the UK's exit is likely to reduce the remittances of EU migrants to their home countries. These are sizeable for some countries (Malta, Lithuania, Latvia) but more limited for others.

In the longer term, however, less migration to the UK could benefit the EU. EEA migrants to the UK tend to be relatively young and educated. Some of these migrants may opt for other non-EU destinations, but a slowdown or a reversal of migration to the UK would very likely increase the working-age population of the EU, with a positive, albeit limited, impact on trend growth.

Future political direction: a key factor

In terms of potential political implications of 'Brexit' for the EU, the first is a potential loss of international political weight. However, without the UK, we could see an increase in cohesion among the remaining EU member states, strengthening their combined international negotiating stance. Secondly, the EU's internal balance of power could shift. The UK is one of the union's most liberal countries and has often acted as a mediator in the Franco-German relationship. The UK's departure could bring about a shift in internal EU relations. It will be more difficult to pass legislation if France and German do not agree. In the event of a shift of the EU towards a less liberal agenda, it will be more difficult to block legislation (as a blocking minority without the UK will require a larger number of countries). This could actually mean that the decision process in the EU becomes smoother. The third is the risk of contagion effects. Surveys show that popular support for the EU has deteriorated in many countries and there has been a rise in support for EU-sceptic, protest parties. A nationalist push has also been evident in a number of EU countries, whereas Spain has seen a 'regionalist' push with Catalonia's quest for independence. All this gives rises to a feeling of political uncertainty. Against this backdrop, UK withdrawal from the EU could fuel anti-EU and/or nationalistic sentiment across the bloc. If so, the impact could be bigger in non-eurozone countries than in the euro area, which has successfully managed periods of market tension in the past.

The future political direction of the EU is a crucial element in assessing how the economy will fare. The UK's exit could fuel anti-establishment sentiment within the remaining member states. Because of lingering uncertainty, eurozone peripheral spreads could remain wider for longer, which would impact the growth outlook. With fiscal adjustment and reform still underway in many countries, questions about national relationships with the EU could come to dominate the public debate. However, the push towards more integration and better cooperation could be enlivened.

All eyes are now turned towards the European political leaders and how they will react. In their relationship with the UK, the EU countries face a difficult choice. On the one hand, they could minimise the economic cost of 'Brexit' by reaching a quick compromise with the UK and establishing a relationship with it outside the EU that would preserve most of the advantages of EU membership. On the other, such a deal would send a signal that tailored national deals were up for grabs and that leaving the EU was a viable option. Then there is the question of the vision of a post-Brexit EU. Reuters has reported over the weekend that the foreign ministers of France and Germany have already drafted a paper with proposals of a common European policy to address security, migration and strengthening convergence. The summit of Berlin between Angela Merkel, François Hollande, Matteo Renzi and Donald Tusk of Monday 27 June will be particularly important in providing a perspective on how the consequences and implications of the UK referendum will be addressed by the EU.

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