



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 Germany 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 rise 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.

William De Vijlder

william.devijlder@bnpparibas.com



Group Economic Research

■ **William DE VIJDER** +33.(0)1 55 77 47 31 william.devijlder@bnpparibas.com
Chief Economist

ADVANCED ECONOMIES AND STATISTICS

■ **Jean-Luc PROUTAT** +33.(0)1.58.16.73.32 jean-luc.proutat@bnpparibas.com
Head

■ **Alexandra ESTIOT** +33.(0)1.58.16.81.69 alexandra.estiot@bnpparibas.com
Works coordination - United States - United Kingdom - Globalisation

■ **Hélène BAUDCHON** +33.(0)1.58.16.03.63 helene.baudchon@bnpparibas.com
France (short-term outlook and forecasts) - Labour markets

■ **Frédérique CERISIER** +33.(0)1.43.16.95.52 frederique.cerisier@bnpparibas.com
Euro Area - European Institutions and governance - Public finances

■ **Thibault MERCIER** +33.(0)1.57.43.02.91 thibault.mercier@bnpparibas.com
France (structural reforms) - European central bank

■ **Manuel NUNEZ** +33.(0)1.42.98.27.62 manuel.a.nunez@bnpparibas.com
Japan, Ireland - Projects

■ **Catherine STEPHAN** +33.(0)1.55.77.71.89 catherine.stephan@bnpparibas.com
Spain, Portugal - World trade - Education, health, social conditions

■ **Raymond VAN DER PUTTEN** +33.(0)1.42.98.53.99 raymond.vanderputten@bnpparibas.com
Germany, Netherlands, Austria, Switzerland - Energy, climate - Long-term projections

■ **Tarik RHARRAB** +33.(0)1.43.16.95.56 tarik.rharrab@bnpparibas.com
Statistics and Modelling

BANKING ECONOMICS

■ **Laurent QUIGNON** +33.(0)1.42.98.56.54 laurent.quignon@bnpparibas.com
Head

■ **Céline CHOLET** +33.(0)1.43.16.95.54 celine.choulet@bnpparibas.com

■ **Laurent NAHMIA** +33.(0)1.42.98.44.24 laurent.nahmias@bnpparibas.com

EMERGING ECONOMIES AND COUNTRY RISK

■ **François FAURE** +33.(0)1 42 98 79 82 francois.faure@bnpparibas.com
Head

■ **Christine PELTIER** +33.(0)1.42.98.56.27 christine.peltier@bnpparibas.com
Deputy Head - Greater China, Vietnam - Methodology

■ **Stéphane ALBY** +33.(0)1.42.98.02.04 stephane.alby@bnpparibas.com
Africa (French-speaking countries)

■ **Sylvain BELLEFONTAINE** +33.(0)1.42.98.26.77 sylvain.bellefontaine@bnpparibas.com
Turkey, Brazil, Mexico, Central America - Methodology

■ **Sara CONFALONIERI** +33.(0)1.42.98.74.26 sara.confalonieri@bnpparibas.com
Africa (English and Portuguese speaking countries)

■ **Pascal DEVAUX** +33.(0)1.43.16.95.51 pascal.devaux@bnpparibas.com
Middle East, Balkan countries - Scoring

■ **Anna DORBEC** +33.(0)1.42.98.48.45 anna.dorbec@bnpparibas.com
CIS, Central European countries

■ **Hélène DROUOT** +33.(0)1.42.98.33.00 helene.drouot@bnpparibas.com
Asia

■ **Johanna MELKA** +33.(0)1.58.16.05.84 johanna.melka@bnpparibas.com
Asia, Russia

■ **Alexandra WENTZINGER** +33.(0)1.42.98.74.26 alexandra.wentzinger@bnpparibas.com
South America, Caribbean countries

■ **Michel BERNARDINI** +33.(0)1.42.98.05.71 michel.bernardini@bnpparibas.com
Public Relation Officer



OUR PUBLICATIONS



CONJONCTURE

Structural or in the news flow, two issues analysed in depth



EMERGING

Analyses and forecasts for a selection of emerging economies



PERSPECTIVES

Analyses and forecasts for the main countries, emerging or developed



ECOFASH

Data releases, major economic events. Our detailed views...



ECOWEEK

Weekly economic news and much more...



ECOTV

In this monthly webTV, our economists make sense of economic news



ECOTV WEEK

What is the main event this week? The answer is in your two minutes of economy

The information and opinions contained in this report have been obtained from, or are based on, public sources believed to be reliable, but no representation or warranty, express or implied, is made that such information is accurate, complete or up to date and it should not be relied upon as such. This report does not constitute an offer or solicitation to buy or sell any securities or other investment. It does not constitute investment advice, nor financial research or analysis. Information and opinions contained in the report are not to be relied upon as authoritative or taken in substitution for the exercise of judgement by any recipient; they are subject to change without notice and not intended to provide the sole basis of any evaluation of the instruments discussed herein. Any reference to past performance should not be taken as an indication of future performance. To the fullest extent permitted by law, no BNP Paribas group company accepts any liability whatsoever (including in negligence) for any direct or consequential loss arising from any use of or reliance on material contained in this report. All estimates and opinions included in this report are made as of the date of this report. Unless otherwise indicated in this report there is no intention to update this report. BNP Paribas SA and its affiliates (collectively "BNP Paribas") may make a market in, or may, as principal or agent, buy or sell securities of any issuer or person mentioned in this report or derivatives thereon. BNP Paribas may have a financial interest in any issuer or person mentioned in this report, including a long or short position in their securities and/or options, futures or other derivative instruments based thereon. Prices, yields and other similar information included in this report are included for information purposes. Numerous factors will affect market pricing and there is no certainty that transactions could be executed at these prices. BNP Paribas, including its officers and employees may serve or have served as an officer, director or in an advisory capacity for any person mentioned in this report. BNP Paribas may, from time to time, solicit, perform or have performed investment banking, underwriting or other services (including acting as adviser, manager, underwriter or lender) within the last 12 months for any person referred to in this report. BNP Paribas may be a party to an agreement with any person relating to the production of this report. BNP Paribas, may, to the extent permitted by law, have acted upon or used the information contained herein, or the research or analysis on which it was based, before its publication. BNP Paribas may receive or intend to seek compensation for investment banking services in the next three months from or in relation to any person mentioned in this report. Any person mentioned in this report may have been provided with sections of this report prior to its publication in order to verify its factual accuracy.

BNP Paribas is incorporated in France with limited liability. Registered Office 16 Boulevard des Italiens, 75009 Paris. This report was produced by a BNP Paribas group company. This report is for the use of intended recipients and may not be reproduced (in whole or in part) or delivered or transmitted to any other person without the prior written consent of BNP Paribas. By accepting this document you agree to be bound by the foregoing limitations.

Certain countries within the European Economic Area: This report has been approved for publication in the United Kingdom by BNP Paribas London Branch. BNP Paribas London Branch is authorised and supervised by the Autorité de Contrôle Prudentiel and authorised and subject to limited regulation by the Financial Services Authority. Details of the extent of our authorisation and regulation by the Financial Services Authority are available from us on request.

This report has been approved for publication in France by BNP Paribas SA. BNP Paribas SA is incorporated in France with Limited Liability and is authorised by the Autorité de Contrôle Prudentiel (ACP) and regulated by the Autorité des Marchés Financiers (AMF). Its head office is 16, boulevard des Italiens 75009 Paris, France.

This report is being distributed in Germany either by BNP Paribas London Branch or by BNP Paribas Niederlassung Frankfurt am Main, a branch of BNP Paribas S.A. whose head office is in Paris, France. BNP Paribas S.A. - Niederlassung Frankfurt am Main, Europa Allee 12, 60327 Frankfurt is authorised and supervised by the Autorité de Contrôle Prudentiel and it is authorised and subject to limited regulation by the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin).

United States: This report is being distributed to US persons by BNP Paribas Securities Corp., or by a subsidiary or affiliate of BNP Paribas that is not registered as a US broker-dealer. BNP Paribas Securities Corp., a subsidiary of BNP Paribas, is a broker-dealer registered with the U.S. Securities and Exchange Commission and a member of the Financial Industry Regulatory Authority and other principal exchanges. BNP Paribas Securities Corp. accepts responsibility for the content of a report prepared by another non-U.S. affiliate only when distributed to U.S. persons by BNP Paribas Securities Corp.

Japan: This report is being distributed in Japan by BNP Paribas Securities (Japan) Limited or by a subsidiary or affiliate of BNP Paribas not registered as a financial instruments firm in Japan, to certain financial institutions defined by article 17-3, item 1 of the Financial Instruments and Exchange Law Enforcement Order. BNP Paribas Securities (Japan) Limited is a financial instruments firm registered according to the Financial Instruments and Exchange Law of Japan and a member of the Japan Securities Dealers Association and the Financial Futures Association of Japan. BNP Paribas Securities (Japan) Limited accepts responsibility for the content of a report prepared by another non-Japan affiliate only when distributed to Japanese based firms by BNP Paribas Securities (Japan) Limited. Some of the foreign securities stated on this report are not disclosed according to the Financial Instruments and Exchange Law of Japan.

Hong Kong: This report is being distributed in Hong Kong by BNP Paribas Hong Kong Branch, a branch of BNP Paribas whose head office is in Paris, France. BNP Paribas Hong Kong Branch is registered as a Licensed Bank under the Banking Ordinance and regulated by the Hong Kong Monetary Authority. BNP Paribas Hong Kong Branch is also a Registered Institution regulated by the Securities and Futures Commission for the conduct of Regulated Activity Types 1, 4 and 6 under the Securities and Futures Ordinance.

Some or all the information reported in this document may already have been published on <https://globalmarkets.bnpparibas.com>

© BNP Paribas (2015). All rights reserved.

You can read and watch our analyses on Eco news, our iPad and Android application



<http://economic-research.bnpparibas.com>

© BNP Paribas (2015). All rights reserved.

Prepared by Economic Research – BNP PARIBAS
Registered Office: 16 boulevard des Italiens – 75009 PARIS
Tél : +33 (0) 1.42.98.12.34
Internet : www.bnpparibas.com - www.economic-research.bnpparibas.com

Publisher: Jean Lemierre
Editor: William De Vijlder