COFACE BRIEF

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UK: What's next after the vote?

GDP growth forecast: 1.2 % in 2016, 1.1% in 2017
Coface country risk assessment: A2

What

On Thursday 23rd of June, **the UK voted to leave the European Union**. 52% voted to leave and 48% to remain. In this context, **Prime Minister David Cameron announced he will step down**. Shockwaves have spread across financial markets on June 24, **as both short-term and long-term uncertainties are high**. The GBP plunged to its lowest since 1985. Global equity markets have fallen too (Japan, Germany and France down by 7-8%), even more than the Footsie (-4.5%), as some stocks could not be traded when the market opened in London. Oil (-5%), gold (+5%) and the euro (-3% vs USD) also reflect this surge in volatility and global risk aversion.

Why

In 2013, Prime Minister David Cameron decided to hold a referendum if he won the 2015 general election, to respond to discontent from his own Conservative MPs and the UK Independence Party (UKIP), who argued that Britain has not had a say since 1975 when it voted to stay in the EU.

Risks

In the short-term, uncertainty and volatility is likely to prevail on financial markets. Its impact on business and consumer confidence in both the UK and in the rest of the world will depend on the magnitude of the correction on financial markets and on political developments in the coming weeks.

In the UK, if business and consumer confidence is affected by financial market volatility and political uncertainties, private consumption related sectors will be affected by the increased household precautionary savings and higher inflation (on the back of the lower GBP level that has hit a 31-year low versus the USD). Business investment will take a hit as well. And the construction sector could be impacted by higher prices of imported inputs. Hence, the paradox is exporting sectors are not the most at risk ones in the short-term, as they could benefit from the lower level of the GBP. All in all, this could push the **BoE to cut rates** by the end of the year. **And this leads us to revise down our GDP growth forecast** (to 1.2% this year instead of 1.8%, and 1.1% next year).

Domestic political uncertainties add to this risk, as **a conservative leadership election could take several months,** Boris Johnson and Michael Gove, the two leaders of the 'Leave' camp in the Conservative party, being the frontrunners. **The UK's vote to leave may lead to calls for another Scottish referendum, as Scotland voted to remain in the EU**. Northern Ireland's case could be an issue too, all the more since the region has borders with an EU country, the Republic of Ireland.

In the rest of the world and more specifically in the EU, the magnitude of spill-over effects in the short-term will mostly depend on coming political developments and central bank actions. The Bank of England (BoE), the US Fed, the ECB and the Bank of Japan are likely to announce common messages and action before financial markets reopen on Monday (for example by providing banks with ample liquidity to avoid stress on interbank rates).

As a reminder, **the widely expected general election in Spain is scheduled on Sunday and could bring further uncertainty on to the future of the European project**. Later this year, a referendum in Italy on the constitution reform is expected and the resignation of PM Renzi is at play. Then elections are scheduled in the Netherlands, in France and in Germany in Q1, Q2 and Q3 2017 respectively.

Higher volatility and uncertainty in the short-term will be driven by long-term challenges and unknowns resulting from the outcome of the referendum. In this regard, the key issue is of course the negotiation of a trade agreement between the UK and the EU. The trickiest point is the **access to the single market that ensures free movements of goods, services, capital and people (and makes it possible for firms in the financial sector based in the UK to operate easily in the whole EU** without having to comply with local regulations). According to Article 50 of the Treaty on the EU, the UK has to formally announce its intention to leave the EU during the European Council (the next one is on the 28th of June). The UK will then have **two years to negotiate a new agreement with the EU, which seems nonetheless unlikely due to the very long period usually required to negotiate trade agreements**: it took seven years for Canada and the EU to settle one (and it is still not ratified). **The two-year countdown could therefore be prolonged**. Three types of agreements are conceivable: (i) EEA membership, like Norway, which implies full access to the single market but loosing voting rights on regulatory framework and EU decisions; (ii) a "customised" bilateral agreement, like Switzerland, which establishes access to the single market for specific sectors and (iii) WTO rules, with existing custom tariffs and no access to the single market.

The agreement will largely depend on the political choices of the future PM, as there is a trade-off to be done between economic benefits resulting from access to the single market and political/regulatory constraints. As one of the leaders of the 'Leave' camp is very likely to be the next PM, a Norway-style agreement is less likely and the negotiation process with the EU will be tricky. And defaulting to WTO rules means higher custom tariffs and no access to the single market. In this worst case scenario, the long-term economic cost of Brexit would be higher:

1) In the UK, usual competitive exporting sectors being linked to the EU through supply chains (**pharmaceutical** and **automotive** are notable examples) will suffer from higher custom tariffs on their exports to the EU in the long-term. But on the other hand, the government could also decide to impose higher import tariffs, especially to help sectors currently suffering from foreign competition (e.g. the **metal** industry). The long-term effect on the **financial sector** (8% of GDP, i.e. twice as high as the OECD average) is an unknown at this stage (see above).
2) In the EU, countries having the strongest links (in terms of trade and investment) with the UK and comparatively small domestic markets are most exposed: **Ireland is by far the most at risk** in this regard, followed by **the Netherlands, Belgium, Denmark** and **Sweden,** where the impact will be smaller.

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