27 June 2016

Brexit: implications for the UK; Europe; and the global economy

- **Last Thursday, the UK voted in favour of exiting the European Union.**
- **52% of the population voted in favour of the decision, on a turnout of around 72%.**
- **The decision was against market expectations, bringing about a savage market response.**
- **Subsequent to the result being announced, Prime Minister David Cameron resigned, effective by October. The opposition is also in disarray, with ten or so members of the shadow cabinet having quit or been fired.**
- **Until a new Prime Minister takes office, the next step in the Brexit process seemingly will not take place.**
- **That next step is most likely to be Article 50 of the Lisbon Treaty being invoked, ushering in a two-year consultative period between the UK and European Union.**
- **Note the UK will also have to enter into separate negotiations with a further 60 non-EU nations, whose trade terms are dictated by European Union agreements.**
- **Of particular concern for markets is the potential for the 'Brexit' decision to trigger similar reviews of EU membership across other member countries and the unity of the UK itself, with Scotland and Northern Ireland voting in favour of the UK remaining in the EU.**
- **The above highlights that we are at the beginning of a long process full of uncertainty and tension.**
- **With the end-point of this process unknown, we are unable to estimate the full impact of Thursday's decision. IMF estimates however highlight it will be substantial: a shock to the level of GDP of between 1.4ppts and 5.6ppts by 2019. Note, UK growth to March 2016 was 2.1%yr.**
- **Of course, all of this is not happening in a vacuum. The implications for the rest of the world have, and will continue to be, significant.**
- **Market pricing for the FOMC has reversed, with a near 20% probability of a cut now priced in by November. A rate hike is not fully priced in until June 2018.**
- **Policy intervention by the Bank of Japan also seems likely, with USD/JPY nearing the ¥100 mark.**
- **Elsewhere in emerging Asia, policy makers will be paying close attention, not only for potential implications for their real economies, but also in case funding dislocations become apparent. Europe has long been a key provider of direct and portfolio funding for the region.**
- **For Australia, the RBA stands ready to act to provide liquidity (if needed), while the Australia dollar has fallen with the shift in risk sentiment.**
- **As such, while these events make Westpac expect a rate cut in August with near certainty, we don't believe they will spook the Bank into an 'emergency' cut in July. We instead believe the RBA will keep their powder dry as events unfold and be guided by the Q2 CPI print due to be released on July 27th.**

The decision and the market response

After months of discussions; debate; and uncertainty, Thursday evening in London the polls closed and counting began. With almost all market participants and commentators anticipating the UK would vote to remain in the European Union (EU), what came next sent shockwaves through markets.

Instead of a slim win to the remain camp, the UK voted 52/48 in favour of leaving the EU. As the regional polling results were reported, markets responded quickly and savagely.

Having started Asian trading at 1.50, GPB/USD fell by around 12% to below 1.35, a level not seen since 1985. Other currencies were also (unsurprisingly) heavily impacted: USD/JPY breached the ¥100 threshold before stabilising slightly above the mark at ¥102; while the AUD fell from an overnight high of USD0.76 to USD0.73.

Equity markets across the Asian region all moved sharply lower: the ASX200 fell close to 3.5%; although that was nothing compared to the Nikkei 225 in Japan, which closed down 7.9%.

Having opened over 8.7% lower, the UK's FTSE100 closed down 3.2%, leaving the index up circa 2.0% for the week. However, European and US markets could not follow suit, the Eurostoxx 50 and S&P500 ending the day at their lows, respectively -8.6% and -3.6%.

Currency markets regained some composure in European/US trading on Friday night, GBP/USD stabilising circa 1.37; USD/JPY above 102; and the AUD near 0.75. However, as we have opened for the week, all have moved lower again, notably GBP/USD is again back below 1.35 and AUD sub USD0.75.

It seems highly improbable that these abrupt market moves will be the last caused by this vote. Simply, the vote held last Thursday is the beginning of a process, not the end. The timing and specifics of any conclusion are highly uncertain.

Below we assess the political and economic way forward, giving account of the key factors to consider in both the short and long-term for the UK and Europe. Also, as evinced by global markets on Friday, none of this is happening in a vacuum. The effects for the rest of the world will be material and long lasting.

Political shambles

Immediately after the formal announcement of the referendum's result, Prime Minister David Cameron tendered his resignation, effective by October. While Boris Johnson is favoured to take over from Cameron in coming months, with a majority of conservatives having supported the 'remain' position, it is not clear how long it will take to form a new leadership team to commence negotiations.

For UK labour, there are also major concerns. There have been calls for Jeremy Corbyn to resign as opposition leader; and around 10 members of his shadow cabinet have now reportedly quit (or, in one instance, been fired).

Both sides of Parliament are seemingly currently unable to move ahead with interim discussions on how and when the UK should begin negotiations to leave the UK. Further, it is not at all clear how the Brexit camp within Parliament envisages the UK's post-EU future, nor how to get there.

Against this seeming inability to act in the months to come is a call from Germany, France and European authorities (the Presidents of the European Council, Commission and Parliament) for Article 50 of the Lisbon Treaty (the most likely mechanism for the UK's exit) to be invoked 'without delay'.

Even if a new leadership team is organised and the formal request to leave the EU made, the UK would still have at least two years to come to terms with the Continent (more on this below).

(Note, the exact legal process by which the UK unwinds its involvement with the EU is unclear. At some stage, the 1972 European Communities Act needs to be repealed in the UK. But this is more likely to follow Article 50 being invoked and consequent discussions occurring. Herein we assume that the path forward is commenced via Article 50.)

The UK and Europe, near-term consequences

For both the UK and the EU, the immediate consequences of Thursday's vote are a material shock to confidence (for consumers; businesses; and banks) and a potential rise in the cost of funds and availability of funding for UK and European banks.

Ahead of the vote, the Bank of England took every opportunity to warn the population of the potential negative consequences for growth. In both the May and June policy meeting statements, the Bank of England emphasised that the decision was already impacting demand and went on to note the material and wide-ranging potential consequences of a vote to exit:

"A vote to leave the EU could materially alter the outlook for output and inflation, and therefore the appropriate setting of monetary policy. Households could defer consumption and firms delay investment, lowering labour demand and causing unemployment to rise. Through financial market and confidence channels, there are also risks of adverse spill-overs to the global economy."

On policy specifically, they went on to note that:

"In such circumstances, the MPC would face a trade-off between stabilising inflation on the one hand and output and employment on the other. The implications for the direction of monetary policy will depend on the relative magnitudes of the demand, supply and exchange rate effects."

Now with headline inflation currently around 0.3%yr, it seems unlikely that the inflation impact would put at risk the Bank of England's 2.0%yr inflation target. If, in time, activity warrants easier policy, inflation should allow action. But, being only 50bps from the lower bound, and given the lack of success of negative rates on the Continent, even if they did decide it was appropriate to ease policy, their ability to do so is very limited. The one benefit for the UK economy is that the sharp depreciation in the pound aids their competitiveness versus Europe (obviously sans the implementation of tariffs or other trade barriers).

For the Euro Area, confidence in their financial system and the general outlook for the economy is more crucial than it has ever been. While negative interest rates are seemingly having next-to-no positive impact on the economy (or indeed bank profitability), their asset purchase program has brought results.

European banks are increasingly becoming willing to lend to consumers and to businesses, the former on more agreeable terms than the latter. For this to continue, consumers, businesses and banks all need to have confidence. The Brexit result, combined with similar anti-EU murmurs in a number of other countries across the Union and (more worryingly) the Euro Area (i.e the monetary union) mean this fragile belief in the outlook for the region is at material risk.

For European and UK banks, it is also important to recognise that their ability to lend (and the price at which they can do so) is dependent on their funding and capital situation. Having experienced a circa 20% drop in their share prices on Friday (Lloyds –21%; Barclay's and RBS –18%; and EuroStoxx 50 banks –19%) and given that the Bank of England has already noted the potential ill-effect of an exit on wholesale funding costs, it is clear that Thursday's vote and discussions around whether any other countries will follow suit will increase their cost of funds and could potentially hinder their funding activities.

Weaker investment; employment; and consumption across both the UK and Europe are therefore likely to ensue, with a clear risk of recession.

Discretionary spending and purchases which result in a long payback period (such as housing and durable goods purchases) are the most likely to be affected. On the latter issue, we note that UK housing is not only under threat from weaker domestic confidence and tighter credit conditions, but also perhaps a reduced flow of foreign demand from Europe and beyond.

The flow-on financial market impacts of these developments would also be significant. We note that UK homebuilders Barratt Developments and Persimmon (reportedly the largest UK developers by sales and market capitalisation respectively) fell 24% and 28% on Friday. And in Europe, car makers declined 8.5% (EuroStoxx 50 automotive index).

The UK and Europe, the medium and long term

Whereas the immediate consequences are clear in form albeit not scale, the longer-term implications of Thursday's vote are the real point of concern.

The first major issue is the scale and length of time required to formally complete an exit. Under Article 50 of the Lisbon Treaty, a nation wishing to exit the EU has a two-year window to negotiate the terms of exit from the date Article 50 is formally invoked.

At that juncture, negotiations between the UK and EU would begin. Any draft deal would have to be approved by the European Council and receive agreement by at least 20 of the

27 EU nations who make up at least 65% of the region's total population. Negotiations could be extended beyond two years, if all 27 members agree.

Should there be no agreement, then after two years EU treaties would cease to apply to the UK; but equally the UK would have no special relationship with the members of the EU – presumably this would necessitate individual agreements being reached with all parties, with obvious further delays.

It bears remembering that many of the UK's trade relations outside the EU are also currently governed by EU agreements. Consequently, as recently highlighted by the IMF, an exit from Europe also requires negotiation of new agreements with a further "60 non-EU economies", which certainly could take more than two years.

Until the necessary agreements are reached, rumours of potential tariffs and other trade barriers would continue to give UK and indeed European firms good reason to rethink potential investment and hiring.

Added to this lingering general angst over the outlook for the UK is news that Scotland will look to arrange another referendum over its part in the UK, with their population and politicians clearly favouring membership in the European Union over the UK. Ireland re-unification has also been raised as a potential issue going forward. This is obviously a topic that carries much historic animosity and fear. For Ireland, while the UK was part of the EU, there could be a relatively free flow of people and goods, despite alternative currencies. But this is unlikely to be the case following an exit. In Scotland's case, should they go ahead as planned, then Scotland and England would need to be divided (physically and financially) from England.

Of course, for the European Union, the reason why swift action is desired is because the longer that this process rolls on, the more likely that interest in secession across the Continent will grow. Already calls for a referendum on their part in the EU have been heard from National Front in France as well as the Northern League and 5-star party in Italy. Meanwhile, Scandinavian countries have also voiced their displeasure with the Continent's authorities.

For now, whether these votes would have any chance of success is beside the point. Just the existence of this tension across a number of nations means that the confidence impact on investment and consumption is set to persist for a long period. The UK is not the only party in these discussions that is at risk of a material downturn in economic activity, or potentially a recession.

Eventually, once agreements are made, it is inevitable that the UK will face new trade barriers to the European Union as well as reduced financial access. Given the importance of the financial system to the UK and particularly to London, this is a shock that will not be easy to digest.

Arguably it seems logical to suggest that the UK would also have to introduce some barriers to trade from the EU in 'retaliation' to barriers imposed against its exports.

However, being the provocateur in this situation, the UK is likely to be the net loser vis a vis trade and financial market access. Presumably, UK authorities would aim to receive the same access as Norway and Iceland (an ability to opt-in to the European Fair Trade Agreement; pass-porting rights for financial service firms into the EU; but an ability to opt-out of a wide range of EU laws), but nothing is guaranteed.

Of course, any quarter given to the UK by the European Union in negotiations weakens their authorities' position when dealing with other parties within the system that may seek to exit in the future. Consequently, EU leaders have a vested interest in making an example of the UK. An aside, as noted above, the UK's access to other non-EU markets (where EU agreements are currently in place) could also be impaired. Again it would be in the EU's interest to make an example of the UK when managing third-party trade relations to give others considering an exit further pause for thought.

At this point in time, the timeline over which all of this will take place is unknown. Hence, the scale of the economic impact is also, in effect, unforeseeable. For now we will use forecasts from the IMF as a guide. From their recent Article 4 consultation:

"The IMF explored the potential impact of uncertainty on U.K. growth during the post-Brexit transition in two illustrative scenarios, referred to as the limited scenario and the adverse scenario.

"In the limited scenario in which uncertainty is relatively moderate and the U.K. is assumed to negotiate a status similar to what exists between Norway and the EU, output falls by 1.4 percent by 2019 (compared to the baseline case in which the U.K. remains in the EU). In the adverse scenario of long negotiations and a default to the trade rules of the World Trade Organization, GDP plunges by 5.6 percent by 2019 (again compared to the baseline case in which the U.K. remains in the EU), the study found."

As a means of comparison, UK growth over the past year stands at 2.1%yr. Both scenarios above would therefore have a substantial impact on the level of activity and ongoing momentum.

The global context

Weaker growth in the UK and Euro Area is a negative not only for the region, but also the global economy. This comes at a particularly inopportune time, when emerging market growth is weak (at best) and considerable uncertainty lay ahead. Europe is not only a source of demand for the raw materials and manufactured goods of emerging markets, but has also been a prime source of foreign direct and portfolio funds for emerging markets. Weaker confidence will hinder Europe's willingness to lend indefinitely and trade financing may also be affected, depending on whether a shock to market liquidity occurs.

All of the above will take time to play out and be assessed. But in the meantime, it is clear that the greatest impact on the rest of the world of last Thursday's vote will be on monetary policy in the US; Japan; and, potentially, Australia.

Apparent in the June FOMC meeting press conference was a clear assertion from Chair Yellen that the then-upcoming UK vote had contributed to their decision to remain on hold. Coupled with the recent weak employment outcomes and headline inflation well below target, the surprise Brexit decision will arguably give them cause to remain on hold in July and potentially much longer.

Until we see the next few payroll reports and the implications of the vote play out, we will hold onto our expectation of a hike in September; but, as evinced by current market pricing (a near-20% chance of a cut by the November meeting), the risks to that view are firmly to the downside. Indeed, if we consider longer-term market expectations, it is clear that not only is the September decision at risk, but the FOMC may remain on the sidelines well into 2017. A rate hike in the US is now not priced in until June 2018.

For Japan, there have already been rumours of intervention to stop or slow the yen's appreciation. For Japanese authorities, nearing the ¥100 threshold amid weak global growth and persistent domestic weakness will be a major concern.

We already believed the Bank of Japan to be on the threshold of taking further action. The events in Europe justify the scale of any action being increased materially – across asset purchases and the deposit rate; however, we must caveat this by saying that the Bank of Japan has a long track record of taking a reactive approach to policy. Where they have typically been more forward in acting is on the currency; a further appreciation of the yen in coming days is therefore likely to elicit intervention.

Drawing back to Australia to conclude. The immediate trade impact on Australia is likely to be modest. Australian exports to the UK were valued at $8.5bn in 2014/15, accounting for 2.7% of Australia's total exports of goods and services. And Australian exports to the European Union were $22bn in 2014/15, 7% of Australia's total exports of goods and services. By category, services are more likely to feel the impact of recent developments. Holiday travel, at $1.9bn, is a key export to the UK; overseas travel will now be materially more expensive for the British following the collapse in the pound. Further, almost half of Australia's exports to the EU are services. Of service exports, half are accounted for by the combined value of holiday travel, at $3.9bn, and professional, technical and other business services, at $1.3bn.

For the resource sector, where goes the global economy, so too do commodity prices and the Australian dollar. For now, with the focus mostly on the UK, we have seen something of a modest correction in commodity markets. This is spread between a solid rally in gold (+8%) and weakness in crude oil (–5%) and base metals (copper lost 2%). Australia's main bulk exports have seen a smaller reaction, with spot iron ore prices down 2.5% since the results came in.

While the broader risks to the commodity markets may not manifest in the short-run, the UK's decision could have a deep and meaningful impact, particularly if business sentiment in Europe is impacted. Business confidence in China has a closer relationship with business confidence in Europe than in the US or Japan, and this shift would disturb commodity prices, particularly for iron ore and coal. While this is clearly a risk it is, at least for now, not our core expectation.

So the critical issue at this point is just how far the AUD falls relative to commodity prices. In the GFC, the fall in the AUD significantly overshot the fall in commodity prices. This was an important buffer that helped the Australian economy navigate a path through the uncertainty the GFC. Post the referendum results being know on Friday, the AUD fell 3 cents or 4% against the USD.

From the events leading up to, and post, the GFC we know the RBA stands ready to provide liquidity for the Australia banking system should it be needed. And RBA representatives have even said so on recent occasions. For now the Australia dollar is doing the work for the RBA in easing financial conditions and thus should be supportive of business confidence, in particular export and/or import-competing industries.

The fall in the AUD, which would deepen further should uncertainty and volatility increase over the next few weeks, should give the RBA time to assess the situation and prevent them from having to provide an 'emergency' rate cut in July.

Westpac's previously anticipated a cut in August, following the Q2 CPI; this now seems a near certainty if global developments play out as we expect. But following that, given the now much greater degree of global uncertainty, we would expect the RBA to provide a notional easing bias from that point on to assure markets; households; and businesses that all is being done to help smooth troubled waters.

Conclusion

The implications of last Thursday's UK referendum will be significant in scale and breadth and long lasting. In the short to medium-term, the confidence impact on consumption and investment will be key. A further downside shock could also come from higher funding costs for European and UK banks and/or reduced access to funding.

As the months roll on, we will get a more concrete understanding of the timeline to the UK's exit and the terms on which it will take place. We remind readers again that it could be around 2 years before a final deal is reached. And it could be longer still until all affected agreements between the UK and non-EU trading partners are formally agreed.

Should other nations also look to exit the European Union (or in Scotland and Northern Ireland's case the UK) then this tension could linger longer still.

Monetary policy makers in the UK and Europe are likely to hold fire on easing policy in the short-term, save for providing market liquidity as necessary. With a limited capacity to act, and with confidence at risk, there is a real need for caution and calm.

From a geopolitical perspective, the Brexit decision will make the UK a smaller player on the global stage, with its sway in Europe reduced. This has implications not only for the UK itself, but also the ruling powers on the Continent and the US.

For US monetary policy, the UK's decision to exit puts their tightening cycle at real risk. Not only is there a threat that the September decision will be delayed, but if global growth slows and the USD strengthens, the FOMC may need to remain on hold well into 2017 or beyond.

In the Asian region, Japan is likely to ease policy in coming months to alleviate some of the building pressure on the yen. And for the RBA, reduced global growth; risks to our national income and confidence; and weak inflation globally all give cause to act on their easing bias come August.

A final caveat: the way forward for the UK; European Union; and the global economy is fraught with risk and uncertainty. Only time will tell the inevitable scale of the impact on the global economy.

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