Market Update March 2016

AIB Treasury Economic Research Unit

BREXIT UPDATE:

The Event Risk for UK & Ireland in 2016

The Key Points

- The UK Government has set **June 23rd as the date for its 'In-Out' referendum vote** on Britain's continued membership of the EU. Opinion polls are pointing to a very close vote. The issue has now moved centre stage in the UK. We view Brexit as the **main event risk for the UK and Ireland in 2016** as a vote to leave would have profound economic and political consequences for both countries.

- **Most studies show that leaving the EU would have a negative impact on the UK economy.** It could take up to a decade for the full economic impact to be felt in terms of FDI, trade flows, migration etc. There would obviously be negative knock-on effects for Ireland given its close ties with the UK.

- **It is very difficult to quantify the full macro-economic effects of a Brexit on the UK and Irish economies.** We don't know what the post-Brexit trade arrangements would be between the UK and EU. Brexit would also be a prolonged and complicated process, creating much uncertainty that would impact on economic activity. FDI into the UK would be negatively impacted, especially if there is uncertainty over free trade with the EU. Some 45% of UK exports go to the EU, so it is a vital market. On the other hand, the UK takes just 10% of EU exports. Thus, the UK is not as vital to the EU as the EU is to the UK.

- The critical question centres around trade and what type of arrangements would be put in place between the UK and EU post a Brexit. **The more the UK seeks to regain control over policy and regulations, the more difficult it will be for it to negotiate a worthwhile trade deal with the EU.** In order to secure a preferential trade deal, the UK is likely to have to adhere to EU rules and regulations. It would be a major drawback for the UK if it had to fall back on WTO rules, as the EU imposes common external tariffs on non-EU countries that don't have preferential trade deals with it. The UK would also lose its preferential access to the 53 countries which have trade deals with the EU.

- **Ireland has very close trade and economic links with the UK and so would be greatly impacted by Brexit.** The UK is a very important market for Irish indigenous exporting firms. Those trading with the UK, at a minimum, would face increased administrative and regulatory costs following a Brexit. A recent ESRI report suggests that there could also be a significant decline in bilateral trade. Sectors such as agriculture, retailing, energy and financial services are likely to be most impacted by Brexit.

- The border with **Northern Ireland would become an external EU land border** post Brexit. This could give rise to all sorts of issues in terms of customs posts, passport controls etc, depending on the extent to which Brexit impacted the movement of goods, services and people between the UK and EU.

- EU law provides for **a two year period for discussions on arrangements for exiting the EU after a country decides that it wants to leave.** This period may be extended. Thus, the earliest the UK would leave the EU is likely to be mid-2018. However, the effects would be felt well before then, as a vote to leave the EU would create great uncertainty, impacting economic activity and financial markets.

- **We are already seeing an impact, with sterling losing considerable ground** against the euro since the start of December on growing concerns about a possible Brexit, as opinion polls point to a close result. A vote in favour of Brexit is likely to see sterling fall even more sharply.

Oliver Mangan
Chief Economist
oliver.n.mangan@aib.ie

John Fahey
Senior Economist
john.j.fahey@aib.ie

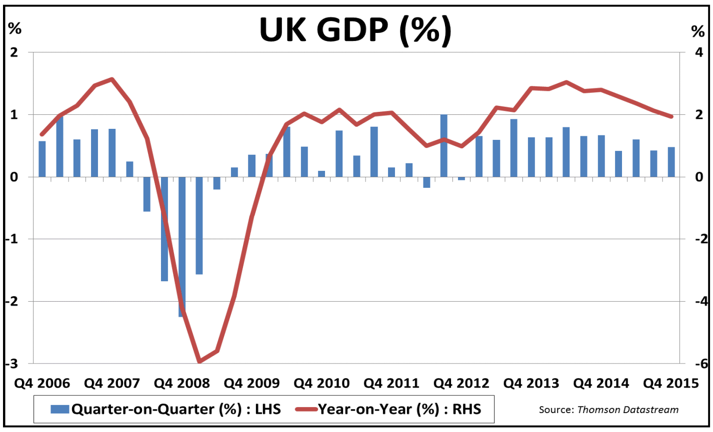
Dara Turnbull
Economist
dara.c.turnbull@aib.ie

Trade the key Economic Consideration in Brexit Vote

- **The British Government is holding a referendum on June 23rd of this year to decide whether or not the UK should remain a member of the EU.** Opinion polls over the past year had generally shown a majority in favour of remaining within the EU. However, the lead has narrowed in recent months and the polls are now pointing to a very close vote. Referenda are unpredictable and sentiment can change quickly, especially given the current controversy in the EU over migration policy. Brexit has divided the British Government and split the Conservative Party down the middle. Brexit is now a real possibility for the UK and an issue that is being taken very seriously by all.

- **There is no doubt that Brexit would pose serious risks and challenges for the UK economy.** Virtually all aspects of UK external trade and much of economic activity are currently conducted under EU rules and policies. EU States are part of a customs union, with no tariffs or customs on goods moving within the EU. A common tariff is applied to imports from outside the EU. The EU is also a Single Market, based on the principle of the freedom of movement of goods, services, capital and labour between all member states. Thus, leaving the EU would be a radical change for the UK.

- **The main impact of Brexit would be on external trade, investment and the labour market.** However, it is unclear what type of trade arrangements would be put in place between the UK and EU in a Brexit scenario. This will have a major bearing on the economic impact of Brexit. Leaving the EU would also be a prolonged and complicated process, with a lot of uncertainty, which would be damaging for economic growth, especially investment. Other effects need to be taken into consideration as well, including restrictions on migration, impact of productivity, reduced competition and increased business costs. Overall, **it is very difficult, if not impossible, to quantify the full macro-economic effects and costs of Brexit, but they are likely to be quite negative for the economy.**



- **It is unclear what the new trade arrangements would be, or indeed, what the EU would agree to, in the event of Brexit.** Continued membership of the EEA (European Economic Area) would allow the UK to maintain full access to the single market. However, non-EU EEA member countries such as Norway, must accept and adopt virtually all EU rules and regulations and also make a contribution to the EU budget. There would seem little point in the UK leaving the EU while remaining in the EEA. The UK could also seek to get Swiss-style bilateral accords for specific sectors or a Turkish type of customs union, but these are quite limited forms of trade deals. **Thus, a major dilemma that Brexit would pose for the UK, is that the more it seeks to regain control over policy and regulations, the more difficult it will be to negotiate a worthwhile Free Trade Agreement that negates many of the downside effects of leaving the EU.**

- The UK could also try to negotiate its own Free Trade Agreement with the EU, as many in favour of Brexit have argued. However, again, the UK is likely that to have to adopt nearly all EU regulations and make a contribution to the EU budget, in order to gain access to EU markets. It should be clearly understood that **the EU is not just a free trade area. It is a Single Market** with its own rules and regulations. Countries that get preferential access to it must abide by these rules. It would make no sense for the EU to give the UK special access to the Single Market and not require it to adhere to the rules of the market as it would greatly disadvantage EU countries in competition with the UK.

- ON Brexit, **the UK would lose its preferential access to 53 markets outside the EU with which the EU has Free Trade Agreements.** These would take years to renegotiate with no guarantee the UK would secure terms as good as the EU. The UK would not be included in any new EU trade deals either.

Many Risks for UK Economy from Brexit

- External trade is very important to the UK economy. Exports account for some 30% of GDP. Key export sectors include financial services, chemicals and food/drink. **The EU takes nearly half of the UK's exports.** Meanwhile, over 50% of UK imports come from the EU, with about half of these classed as intermediates which are used as inputs in the production of other goods and services, and so are of vital importance to the UK. About 10% of EU exports go to the UK, so quite obviously, EU trade matters more to the UK than UK trade does to the EU. Nonetheless, the UK is still one of the major European economies.

- **The UK is the biggest recipient of FDI in the EU,** with around half of this coming from other EU member states and 30% from the US. The UK is the main centre of the financial services industry in the EU. In another important European link, there is a **large inflow of migrants into the UK from other EU countries.** This helps address skills shortages in the UK, boosts productivity and also increases competition in its labour market. It is also very positive in terms of addressing the problem of the ageing UK population, as migrant workers tend to be young, improving the dependency ratio.

- **Brexit would threaten all of these close links between the UK and the rest of the EU.** External trade at best would be faced with higher costs from increased regulation and controls. At worst, **exports to EU markets could be restricted or face customs barriers or tariffs. Brexit would be a big threat to FDI as the UK would no longer be a gateway with uninhibited access to EU markets.** This could do major damage to the UK economy. Meanwhile, skills shortages might become an issue for the economy in the event of restrictions on inward migration. Lower FDI and skills shortages would also be a negative for the UK in terms of its impact on productivity growth and innovation.

- Furthermore, important sectors of the UK economy, notably financial services, could find themselves facing regulatory changes which would put them at a disadvantage vis-à-vis EU countries. While it is hard to see the City of London losing its status as the premier financial centre in Europe, Brexit could make it more difficult to service EU markets from the UK, especially if the EU is not satisfied with the UK regulatory regime or the UK's compliance with EU rules and regulations. There would also be a risk that some of the trading activities currently done in euros in the UK could shift to Eurozone countries.

- Not surprisingly then, **most studies and economic models show that Brexit would have a significant negative impact on the UK economy, lowering the level of GDP.** Virtually all models agree it could take up to a decade for the full impact to materialise. **A number of studies have estimated that there could be a loss of 2-3% in GDP**. However, these studies tend to take quite a restricted view of the impact of Brexit and, in our view, the fall in GDP could well be much greater.

- Most studies assume that the UK will be able to negotiate some type of free trade deal with the EU that would nullify most of the negative effects of Brexit on external trade and FDI. However, this may prove difficult to achieve for a number of reasons, some of them political. Meanwhile, most models and studies make no allowance for the impact on the economy of a prolonged period of uncertainty that would surround a Brexit. This would hit investment in particular. One also needs to allow for the impact of lower migration, less competition and the hit to productivity from Brexit. **More dynamic models that try and capture these effects, while also assuming a severe impact on trade and FDI, suggest that UK GDP could fall by 10% or more.**

- **Another issue to consider is whether Brexit could be a catalyst for a break-up of the UK.** There could well be another referendum on Scottish independence, this time with a key issue being Scotland wishing to be part of the EU. Brexit would also have major ramifications for Northern Ireland and would likely mean a loosening of ties with the Republic, as well as between the Republic and the UK. Indeed, **the border between Northern Ireland and the Republic would become an external EU land border.** This could give rise to all sorts of issues in terms of customs posts, passport controls etc, which most likely would have major political ramifications.

Serious Implications for Ireland

- **Ireland has long and well established political, trading and economic links with the UK**. Although EU membership and FDI have lessened Ireland's dependence on the UK, it remains a key economic partner. Some 17% of Irish exports go to the UK. This may seem relatively small, but Ireland has a very large and well diversified export base. Exports are bigger than GDP. Thus, exports to the UK actually account for 18.5% of Irish GDP. Indeed, when one includes imports, **total external trade with the UK equates to 35% of Irish GDP. Thus, the UK economy is vitally important for Ireland.** Ireland enjoys an overall trade surplus of around €2.5 billion with the UK, thanks to a large surplus on services as the goods balance is in deficit.

- The main Irish exports to the UK are food, pharma, ICT and a broad range of services, while on the import side, energy, manufactured goods and services are all important. **Ireland is the UK's fifth largest export market.** Some 33% of Ireland's imported goods come from the UK. It is worth noting that **more goods are imported into Ireland from the UK than the rest of the EU combined.**

- It is not just trade links that are important between Ireland and the UK. **There is also substantial cross-country investment between the two countries.** UK companies have a big presence in Ireland in particular, most notably in retailing and financial services. The two countries also effectively share a common labour market, with continuing significant emigration from Ireland to the UK. As the ESRI noted recently, a UK exit from the EU opens up the possibility of restrictions on the free movement of people between Ireland and the UK for the purposes of work. Indeed, passport controls could have to be imposed following a Brexit, including at the border with Northern Ireland, which would become the only external land border between the UK and EU.

- **Britain is Ireland's most important market for tourism,** while the UK is the most visited destination for Irish people travelling abroad. Ireland is the only EU country to share a common land border with the UK and there have been much closer ties between the Republic and Northern Ireland in the past two decades. Thus, the **economic links between Ireland and the UK run very deep and are well established.**

- **Hence, Brexit would have major implications for Ireland at many levels.** The negative impact of Brexit on the UK economy would have knock-on effects in Ireland given it is a key export market. It would certainly impact trade between the two countries, even with a trade deal. Any customs clearance requirements would increases trade costs. Small firms that trade with the UK could be badly impacted by this in particular.

- **Brexit could pose major problems for large retailers** and other companies that treat Ireland and the UK as one market for goods distribution, sales, accounts and business administration. Brexit would have **serious implications for the Irish agri sector** in particular, as the UK takes around 35% of Ireland's food exports. The likely weakening of sterling as a result of Brexit would also negatively impact our competitiveness vis-à-vis the UK. It would also hit sectors like tourism and possibly see increased cross-border shopping.

- **Ireland is a big importer of energy from the UK, especially natural gas.** It would be more costly if this had to be imported from mainland Europe in the future, should Ireland seek to diversity its supply base post Brexit to reduce its dependence on a non-EU country. Such a move would require a large capital investment in new infrastructure. Meantime, **an all-island electricity market** has been in operation in Ireland since 2007, which has introduced a very high degree of interdependence between the Republic and Northern Ireland. This has led to efficiencies and greater security of supply, but an all-island market might be more difficult to sustain in the event of an energy crisis if the UK is not in the EU.

- **One area in which Ireland could benefit from Brexit is foreign direct investment,** as it would be the only English speaking country left in the EU that could act as a gateway to the Single European Market. The UK would become much less attractive to foreign direct investment that required access to EU markets. It certainly could be a decisive factor in the decision of whether to locate in the UK or Ireland, especially in sectors where Ireland already has a strong presence, such as ICT, pharma and financial services. Ireland could also attract some firms, most notably in the financial services sector, that are located in the UK but need to maintain a presence in the EU or access to EU markets. However, this is a double-edged sword as some Irish firms could be tempted to relocate part of their operations to the UK, if it is their main market.

- The Irish **financial services sector, in particular, looks well positioned to benefit from a Brexit.** Ireland already has a well established financial services industry. It is an English speaking country with a similar legal system to the UK. This makes it an obvious destination to consider for firms in the UK financial services sector that wish to keep part of their business operations within the EU in the event of Brexit.

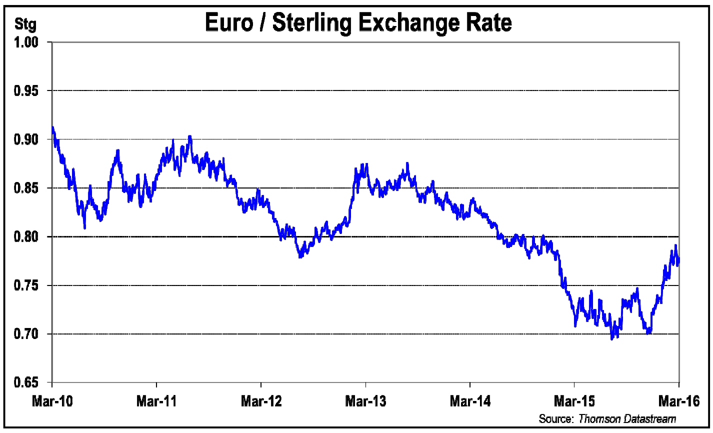
- Meanwhile, **at a European level, Brexit would see Ireland lose a very close and natural ally within the EU.** The UK and Ireland are two of the most economically liberal members of the EU, whose interests are generally closely aligned in areas such as taxation, trade, competition, banking and finance. As a very small member state, Ireland would need to build new alliances with other EU member states, possibly moving closer to Germany and some Scandinavian countries, in the event of Brexit.

Risk of Brexit Already Putting Pressure on Sterling

- **Brexit would clearly impact UK financial markets.** UK stocks could be expected to take a major hit on a Brexit vote, because of the risk to future earnings, especially for those companies exporting to the EU. Meantime, **the BoE could be expected to keep rates on hold for an even longer period of time, or even loosen policy further,** because of the negative impact on the economy of a vote for Brexit. The impact on gilt yields is less clear: higher inflation on sterling weakness, a likely rise in the budget deficit and increased uncertainty would argue for higher yields but a weaker economy and more accommodative monetary policy would point to lower yields. Overall then, we could see a steeper yield curve.

- **Brexit is a major event risk for sterling**, especially in the aftermath of its near 20% appreciation on a trade-weighted basis between 2013 and 2015. The euro fell from close to 90p versus sterling in 2011 to 80p in 2014 and a 70-74p trading range for most of 2015.

- **Some of the gains made by sterling, though, have unwound over the past three months.** This is partly due to the fact that markets are starting to think about Brexit as something which is more than just a remote possibility. Opinion polls have tightened up and are now pointing to quite a close referendum result, forcing markets to pay more attention to the issue.



- **The euro has risen by more than 10% against sterling since the start of December,** climbing from 70p to 78p. Meanwhile, cable has fallen from a high of $1.59 last summer, to around $1.40 recently. **Cable is now getting close to its 2009 trough of $1.38.** This represents the lowest exchange rate for sterling against the dollar since 1985 and so should be a strong support level for the currency. Hence, we would expect sterling to find support near current levels ahead of the referendum vote, unless opinion polls start to clearly point in the direction of a vote in favour of Brexit.

- **A further sharp fall by sterling is likely to occur if the UK votes to the leave the EU.** The markets are likely to expect a messy exit from the EU, with a lot of difficulties in reaching some form of a trade deal. Markets also greatly dislike uncertainty and with no template to follow and a long exit process, a Brexit vote would almost certainly put further severe downward pressure on sterling.

Concluding Remarks

- **Brexit has come right to the fore this year with the UK Government setting June 23rd as the date for the referendum on the topic.** It is an issue that has clearly divided the country in many ways. Opinion polls had been pointing to a vote against Brexit but the polls in recent months have shown a marked narrowing of the gap and now suggest a very close result in the referendum.

- **Brexit would pose many risks for the UK**. There is no suitable, ready-made template for the UK to use as the basis for a trade deal, if it leaves the EU. Indeed, the UK is likely to have to continue to adhere to EU rules and regulations to maintain access to the EU Single Market. Otherwise, Brexit could lead to significant tariffs on UK imports and exports if the country has to fall back on WTO rules. FDI could also be greatly impacted, especially if there is uncertainty about future trade with the EU.

- **Most studies show that Brexit would have quite a negative impact on the UK economy. However, these are just estimates as it is impossible to quantify the full costs.** A change like this has not been attempted before by a major economy. There is a lot of uncertainty about what would follow Brexit in terms of the UK's future trading and economic relations with the EU. The uncertainty alone in the lead up to Brexit would be quite damaging to the UK economy.

- **Ireland has very close political, trade and economic links with the UK and so would be greatly impacted by Brexit.** The UK is a very important market for Irish indigenous exporting firms. Those trading with the UK, at a minimum, would face increased administrative and regulatory costs following a Brexit. **Tariffs would be a disaster.** Sectors such as the agri-food industry, energy, retailing and financial services would be most impacted by Brexit because of either their heavy dependence on UK markets or the close, cross-country business links between the two countries in these areas.

- **We are already beginning to see some effects of the Brexit referendum via its impact on sterling.** The UK currency has lost considerable ground recently, partly due to the fact that markets are starting to think about Brexit as something which is more than just a remote possibility. Opinion polls have tightened up and are now pointing to a close vote, forcing markets to pay more attention to the issue. This is putting downward pressure on sterling. The UK currency is likely to fall even more sharply should the country vote to leave the EU. Opinion polls will be closely watched by the markets in the coming months as they will impact on the UK currency.

- Not surprisingly, **the Irish authorities view the Brexit referendum as probably the biggest event risk facing Ireland this year.** They very much hope that the UK will vote to remain within the EU. If the UK was to leave the EU, it would force a major rethink by Ireland about its future relationships with both the EU and the UK. Indeed, Ireland could well become a bridge between the UK and the EU in the event of Brexit, given it is a close ally of the UK but is also a very committed member of the EU.

- Brexit has the capacity to throw up all sorts of issues in relation to Northern Ireland. Indeed, **the border between the Republic and Northern Ireland would become an external EU land border,** which could give rise to all sorts of issues in terms of customs posts, passport controls etc.

AIB Bankcentre, Ballsbridge, Dublin 4 Tel: 353-1-6600311 www.aibeconomicresearch.com