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Westpac Institutional Bank

Breaking up is hard to do: The aftermath of the Brexit vote

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Following the Brexit vote, we take a look at some of the key questions regarding the UK's economic outlook, and how New Zealand might be affected.

- It will take around two years for the UK to negotiate the terms of its exit from the EU. Negotiating new trade agreements both with the EU and other economies could take substantially longer.
- The decision to exit the EU will result in weaker GDP growth in the UK in the near-term in large part due to the increase in uncertainty. The longer-term impacts on economic activity in the UK are more uncertain.
- The exit vote has resulted in significant volatility in financial markets, and has seen expectations for official interest rates scaled back in the UK and US.
- The Brexit vote will result in significant adjustments in the UK's political landscape. It also raises the risk that Scotland will seek independence from Britain.
- It will be a considerable amount of time before we know what the exit decision means for New Zealand's trading relationship with the UK, as well as its implications for global growth and export demand more generally. In the immediate aftermath of the vote, nervousness in financial markets has resulted in downward pressure on the NZD/USD, higher bank funding costs, and has seen increased expectations of an OCR cut from the RBNZ. The vote also adds to the downside risks for New Zealand's exports (especially tourism) in the short run.

On Thursday 23 June the UK voted to leave the EU. This was an unprecedented event. Consequently, there is a very high degree of uncertainty around how conditions in the global economy and financial markets will evolve over the coming weeks and months. In this report, we take a look at some of the key questions around the outlook for the UK, and what this may mean for New Zealand.

1. What happens following the vote?

The result of the referendum does not automatically trigger the UK's departure from the EU. The UK will now need to give formal notification to the European Parliament of its intention to exit the EU. This then triggers Article 50 of the Lisbon Treaty, which defines the process for exiting the union. It's not certain when the UK will give this notification, as outgoing Prime Minister Cameron is expected to leave this for his successor, who will not be appointed for some time yet.

Once notification is given, the UK will need to negotiate the terms of its exit. This includes clarifying the status of the roughly 1.2 million UK citizens living in the other 27 EU countries, and the roughly 3 million people from other EU countries living in the UK under existing arrangements. Other matters that would need to be determined include cross-border security agreements, regulatory responsibilities, and access to energy, maritime and aviation markets.

Over time the UK will also need to establish new trade agreements with the EU and other economies where trade is currently governed by existing EU agreements. In addition,

there will need to be adjustments to the UK's legislative framework to address areas currently covered by EU laws.

The process of exiting the EU is expected to take around two years (a time limit imposed by the Lisbon Treaty). It will likely take the UK much longer to negotiate new trade agreements with both the EU and other regions.

Until the terms of the UK's exit are agreed upon, the UK is still bound by existing and new EU legislation, but it lacks the ability to influence policy.

2. What form could the UK's new trade relationships take?

Over the coming years, the UK will need to negotiate new trade agreements with the EU. Analysis from HM Treasury indicates that new agreements are unlikely to be as favourable as the existing ones, and will likely result in increased costs for many exporters.[1] Furthermore, negotiating access to the EU single market may require the UK to agree to EU regulations related to migration and financial contributions – terms which they have just voted against. On top of this, the UK will no longer have the ability to influence such regulations.

There are some precedents for countries that trade closely with the EU but which are not in the union.

First, are *bilateral trade agreements* (similar to arrangements made by Switzerland and Canada). Such agreements allow access to the single market for some goods. But less restrictive agreements would likely require the UK to agree to regulations related to migration and financial contributions. It is also notable that in the case of Switzerland, access for service exports to the single market is restricted, which would be a significant concern for the UK given the importance of the financial sector to its economy.

Alternatively, the UK could join the *European Economic Area* (similar to Norway's arrangements). This would provide for unrestricted access for industrial goods and services. But again, this would likely require the UK to agree to many EU regulations, including unrestricted movement of labour and making financial contributions. In addition, existing European Economic Area agreements would require the reintroduction of tariffs on agricultural and fishery exports, as well as increased transaction costs such as customs checks.

In the absence of new agreements, the UK's trade will be governed by World Trade Organisation rules. This would provide the UK with regulatory flexibility, including the ability to set its own level of import tariffs with the EU and control of migration policies. However, this is not a panacea. In the absence of a preferential agreement, the EU imposes an extra tariff on imports from outside the union. And if the UK sets tariffs on EU imports at low levels to encourage trade with the EU, it would be required to extend a similar arrangement to other WTO members, diluting its bargaining position. On top of this, UK exporters would become subject to tariffs in many other markets and may also face other forms of trade barriers. Service exports are also likely to be restricted in this scenario.

On top of this, the UK will need to negotiate new trade relationships with a number of other countries and regions outside of the EU, including the US and New Zealand. Questions surround how favourable such agreements will be relative to current arrangements and how quickly they will be put in place given the UK's reduced bargaining clout relative to the single market bloc.

3. How will exit affect economic activity in the UK?

The EU is the UK's largest trading partner taking around 44% of its exports and accounting for around 48% of FDI. The decision to exit signals a weaker outlook for GDP growth in the UK. However, it is not clear just how pronounced or enduring this weakness will be. We'll be reviewing our forecasts for UK GDP growth over the next few weeks as the dust settles.

Short term

The near-term GDP outlook for the UK is now weaker and there is even a possibility of recession through late 2016/ early 2017. Underlying this weaker short-term outlook is an environment of heightened uncertainty that will impact confidence and spending decisions. Tighter financial conditions will also weigh on economic activity.

Uncertainty ahead of the vote had already been weighing on investment spending and foreign investment. It's likely that this will become even more pronounced in the coming weeks. Furthermore, this nervousness in the business sector will also weigh on hiring decisions, with some increase in the unemployment rate likely over the coming months.

Household spending and housing market conditions are also likely to be dampened by the decision to exit. In the near term, there will be a drag from increased uncertainty and tighter financial conditions. In addition, the drop in the pound will push the price of many imported items higher. We are also likely to see some impact from a softer labour market.

Heightened uncertainty is likely to mean that financial conditions, including access to credit and trade finance, will be tougher at least for the next few months. This could amplify any downturn in activity. Furthermore, it's important to remember that real economy and financial conditions can interact and reinforce each other. The duration of tightness in financial markets will be a key determinant of how severe the near-term weakening in activity will be.

Providing some offset to the above factors is the decline in the pound which will help to support the export sector.

The exit decision and the likely weakening in GDP growth will challenge the UK Government's aim of improving its fiscal

[1] HM Treasury, "The long-term economic impact of EU membership and the alternatives" (2016).

position, which has already come under pressure in recent months. Estimates from HM Treasury indicate the loss in tax revenue could outweigh the reduced financial contribution to the EU. In addition, as discussed below, rating agencies are already signalling a weaker outlook for the UK's sovereign credit outlook.

Longer term

Longer term, it's much harder to say what the impact of the exit decision will be. The UK will gain the ability to structure laws, regulations, and economic policies that better focus on its own conditions. Over an extended period, this could assist with improving the economy's productivity.

However, this will need to be balanced against the likelihood of a less favourable environment for international trade, and the risk that changes in trade agreements make the UK less attractive for foreign investment.

In addition, over time changes to migration policy may contribute to slower growth in the economy's demand base and supply potential. Net migration rose to 330,000 in 2015 (equivalent to around 0.5% of the UK's population) including around 184,000 people from the EU.

An area of particular concern is the UK's financial sector, which accounts for around 7% of GDP. Currently, many providers of financial services based in the UK are able to operate across the EU (sometimes referred to as "passporting"). However, depending on the nature of the post-Brexit arrangements negotiated, this ability could be restricted. Providers of financial services may be required to establish subsidiaries in the EU, risking the eventual loss of jobs and earnings from the UK across the channel.

4. What does this mean for financial conditions and monetary policy?

The immediate impact of the exit vote has been a bout of risk aversion in financial markets. Brexit was not considered the most likely outcome by financial markets, and the resulting "risk off" reaction saw the pound fall 10% against the USD, taking it to its lowest level since 1985. The pound also fell against the Euro, while the NZD/GBP rose by 7%. Equity markets globally also dropped sharply following the vote, although some of this was later reversed.

Global interest rate markets have reacted by pushing credit spreads wider, while expectations of interest rate hikes from the US Federal Reserve have been pegged back. In New Zealand, pricing has moved more in favour of an OCR cut in August, which seems a reasonable reaction at this stage. Markets have also moved to price in some chance of the OCR falling below 2%.

Heightened concern around the UK's economic outlook saw Bank of England (BOE) Governor Carney moving swiftly to reassure markets soon after the referendum results were announced. In his statement, he noted that the BOE will not hesitate to take additional measures as required to support the economy, and pledged an additional £250 billion of liquidity to support lending. He also stressed the resilience of the UK's financial system.

The Governor did not mention the likelihood of rate reductions in his post referendum comments, but market pricing is consistent with a cut by the end of the year. Any decision on whether to cut rates would need to balance the risk of slower near-term growth and lower economic confidence against the boost to inflation from the lower GBP. However, we're conscious that the pick-up in inflation will be from relatively modest levels. In addition, the boost to prices from a lower pound will be temporary, while softer economic conditions could be more enduring.

If the BOE does decide that rate cuts are appropriate, they don't have a lot of ammo left. The BOE has held the Bank Rate at a record low of 0.5% since 2009. Any monetary easing beyond that would need to be in the form of unconventional measures, as the ECB has done.

The Brexit decision has cast doubt on the UK's position as a safe haven for foreign capital flows. Moody's has downgraded the UK's sovereign rating outlook from stable to negative on the back of concerns about the strength of economic growth, the Government's fiscal position, and the ability of the Government to pass policy. Similarly, S&P have downgraded the UK's sovereign credit rating two notches to AA and given it a negative outlook. S&P cited concerns about the effectiveness of the UK's policy environment and *"risks of a marked deterioration of external financing conditions"*. Fitch has also noted that the 'Leave' result is *"credit negative for most sectors in the UK."*

5. How does the decision to exit affect the UK's political landscape?

The decision to exit the EU will have significant impacts on the UK's internal political landscape. Immediately after the vote, David Cameron announced that he will be stepping down as Prime Minister in October. We won't know who's stepping into the role for some time, but former Mayor of London and face of the 'Leave' campaign, Boris Johnson, is a front-runner.

It's not clear whether other officials who had backed the 'Remain' campaign will also stand down. Around three quarters of MPs were in favour of remaining in the EU, including the Chancellor of the Exchequer, George Osborne, and most cabinet ministers. The opposition Labour party is also facing a number of disruptions.

More significant than the future of individual political figures, however, is the fate of the actual countries that form the UK. While those in England voted to leave (53.2% to 46.8%), those in Scotland and Northern Ireland voted to stay, and by larger majorities (62% in Scotland and 55.7% in Northern Ireland).[2] This schism in preferences regarding EU membership means that there is a risk that the UK fractures.

2 Wales voted to leave with the votes split 51.7% to 48.3%.

Scotland's First Minister, Nicola Sturgeon, has already indicated that a second vote on Scottish independence is *"highly likely"* within the two-year time frame in which the UK will negotiate its exit. During the 2014 referendum on Scottish independence, membership in the EU was a key consideration and the incumbent Scottish government wishes to maintain access to the single market. However, this could be protracted process, involving not only a vote on Scottish independence, but also the negotiation of the terms for Scotland's entry into the EU.

In Northern Ireland, the exit vote has unsurprisingly stoked concerns about the potential downside for growth and employment. Furthermore, the implications of the referendum for border control and migration are a major concern for Northern Ireland, as it has the UK's only land border with the EU.

Brexit also raises concerns about the broader EU political landscape. The UK vote may bolster euro-sceptic sentiment in other countries.

6. What about New Zealand?

Nervousness in the global environment may see the New Zealand dollar fall further against the US dollar in the weeks ahead. In time, the uncertainty will also result in higher bank funding costs for New Zealand. This means that although NZ two-year swap rates have fallen, mortgage rates and business lending rates are unlikely to fall as far (or may not fall at all).

Financial market nervousness is also likely to affect New Zealand business confidence in the near future, although whether that actually translates to hiring and investment decisions remains to be seen.

The Reserve Bank is likely to factor all of this into its thinking on the OCR, and an August OCR reduction now seems more likely than it did before the Brexit referendum.

What Brexit will mean for New Zealand exporters is very difficult to say. In the near term, uncertainty is likely to weigh heavily on prospects for the UK economy, potentially dampening New Zealand's exports. The higher NZD/GBP also signals a softer outlook for New Zealand's exports.

Beyond this, the nature of New Zealand's trade with the UK and EU will depend on what sort of trade deals we negotiate. It will be a considerable amount of time before we know what form these relationships will take, or what the implications of the exit decision are for global growth and export demand more generally. However, it's hard to envision much upside for New Zealand exports to the UK. Suggestions that the UK will now trade more freely with New Zealand seem overconfident and premature to us. Existing trade agreements would remain in place for some time while the UK and EU negotiate the exact nature of exit arrangements. So at least in the immediate aftermath of the vote, NZ's trading relationships with the UK and the EU will be unaffected. While New Zealand would have the opportunity to negotiate new goods trade agreements with the UK and EU, with a swing toward protectionism in recent times, it's difficult to see New Zealand being afforded more favourable trade conditions in either jurisdiction. So we will withhold judgement on what this means for New Zealand's merchandise exports.

What we do know is that the UK accounts for a much larger share of New Zealand's tourism sector than it does merchandise exports. The large drop in the pound versus the New Zealand dollar, combined with the likelihood of a weaker UK economy, will impact UK tourist arrivals into New Zealand. So for the short-run at least, we regard Brexit as a negative for New Zealand's external sector.

It's also not clear what this will mean for New Zealanders wishing to move to the UK. The UK may look to change its policies related to migration with countries other than the EU. In addition, if economic conditions in the UK look less attractive, this may see some New Zealanders cancelling travel plans or looking to travel elsewhere.

By the numbers

Exports

- The UK takes around 3% of New Zealand's merchandise exports (around $1.7bn). Key exports include sheep meat, wine and produce.
- The UK accounts for around 9% of New Zealand's service exports (around $1.5bn). This mainly relates to tourism, with around 210,000 visitors from the UK last year.

Imports

- New Zealand purchased around $1.3bn of goods (around 3% of merchandise imports) and $0.9bn of services from the UK last year (around 5% of total services imports). New Zealand's imports from the UK mainly relate to vehicles and machinery, as well as tourism.

New Zealand trade statistics

		Total		Goods		Services	
		Exports	Imports	Exports	Imports	Exports	Imports
NZ $m	EU	8,728	11,914	5,328	8,773	3,400	3,141
	Eurozone	4,640	8,154	3,061	6,610	1,579	1,543
	UK	3,181	2,177	1,647	1,308	1,533	869
Share of NZ trade (%)	EU	13%	18%	11%	18%	20%	19%
	Eurozone	7%	12%	6%	13%	9%	9%
	UK	5%	3%	3%	3%	9%	5%

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