Brexit

Economic and Financial Implications of the British Referendum Results: Initial Evaluation

The Finance Division > Economics Department

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Expected developments in the short-term:

- The referendum concluded with a thin majority of 52% in favor of Britain exiting the European Union (EU).
- The uncertainty that is expected to prevail in the near-term poses a number of central questions: if and when Article 50 of the Treaty of Lisbon[1] will be invoked; and if indeed the article is activated, what trade agreement will be signed between Britain and the EU countries.
- Following the publication of the referendum results, David Cameron announced his resignation from the position of prime minister, and declared that the next prime minister will decide on the timing of the activation of Article 50, this in contradiction to his declaration prior to the referendum.
- Cameron is expected to leave his position in October. There is a reasonable possibility that Cameron's replacement will announce general elections in order to strengthen the mandate granted to lead Britain in managing negotiations with the EU. This move will cause the activation of Article 50 to be delayed until after the elections.
- The possibility that Article 50 will not be invoked at all and that Britain will remain within the EU despite it all, should not be ruled out. Since the referendum was decided by a thin majority (a majority of less than two percent) a situation may be created in which the balance of powers between the two camps (leave versus remain) may change, and that actually a candidate that supports remaining in the EU will receive most of the support from the citizens of Britain. It is important to note, on this regard, that the referendum does not represent any legal obligation on the part of government to act on the results.
- The EU is expected to pressure Cameron to invoke Article 50 immediately, in order to reduce the duration and the degree of uncertainty; however, it is not reasonable that Cameron will indeed submit to these pressures.

What new trade agreement can be expected?

- The extent of the impact of Brexit will be dependent to a large degree on the new trade agreement that will be created between Britain and the EU, and also the

[1] The Treaty of Lisbon, signed in 2007, serves as the constitutional basis for the EU. Article 50 permits exiting countries to reach an agreement with the EU within two years. After two years Britain's membership will expire, unless all 27 of the other countries in the EU will agree to extend Britain's membership.

period of time that will pass until such an agreement is finalized. The EU leaders will need to decide whether or not to "punish" Britain for its decision to exit the EU, or to take a more conciliatory approach, and to try to maintain as much as possible the trade relations that currently exist. The first approach will likely weigh on the economies of both Europe and Britain, while the second approach will likely encourage other countries to consider exiting the EU. Britain will also need to decide if it prefers more free trade or more sovereignty. As the time period extends until an agreement is finalized, the uncertainty will rise and with it the economic damage.

There are three main models that can serve as a basis for a new trade agreement between Britain and the EU, and they are:

<u>The "Norwegian" model</u> – membership within the European Economic Area (EEA). This is the closest model to membership in the EU, which includes access to the common European market (the single market). Within this arrangement, Britain will not be obligated to pay customs within the framework of trade with EU countries, and in exchange for this benefit Britain will continue to transfer "membership fees" in the same amount that Britain transfers today and will continue to be obligated to fulfill the laws of the EU, this without the ability to vote or to issue a veto within the EU institutions.

<u>The "Swiss" model</u> – this agreement permits only partial access to the single market. According to this model, Britain will need to sign onto additional trade agreements with the EU in order to ease access to specific sectors. However, Britain will not be obligated to fulfill all the laws of the EU. In addition, it should be noted that an agreement of this sort requires the agreement of all the other 27 EU member countries, as well as the countries that are members of the EEA. This process is likely to lengthen the period of time until a final agreement can be signed.

<u>Agreement via the WTO</u> – this is the minimalist approach between the two sides, and within this framework Britain will not benefit from any preferred status in trade conditions vis-à-vis the EU. An agreement of this sort is expected to create the most substantial economic shock. Reverting to the WTO conditions represents the default case in the event the sides will not succeed to reach a mutual agreement in the required two year period according to the Lisbon Treaty.

- It should be noted that a completely new agreement could possibly be created that will not rely on any of the models mentioned above.

The economic implications of Brexit for Britain:

- A broad range of possibilities exist regarding the estimated damage to Britain's GDP, of up to 10%, which are expected to unfold over the course of time, although mostly in the short-term (the second half of 2016 through the end of 2017).
- The damage to economic activity will be felt through a number of channels: weak consumer and business confidence levels; a decline in investments; heightened perception of credit risks, against the backdrop of estimates for a reduction in Britain's credit rating; an increase in finance costs for companies; and more.
- These developments are expected to lead to a decline in private consumption, a decline in investments, an increase in the unemployment rate, and damage to export activity. It is possible there will be a delay in signing on new trade agreements in the short-term, which will lead to a decline in activity levels. The industrial sectors are expected to be hurt to a larger extent, but also the services sectors (primarily financial services) and real estate will experience a slowdown in activity.
- Shocks are expected in the exchange rate of the sterling, and in the event the deficit in the current account of the balance of payments will continue to increase, parallel to a reduction in the amount of net incoming direct investments into Britain, then the risk of a currency crisis will rise.
- Brexit is likely to lead to an increase in the government budget deficit in the short-term, due to the need to support economic activity. This development, together with an expected slowdown in growth, is expected to lead to an increase in the debt/GDP ratio, and to deterioration in Britain's fiscal profile.

The economic implications of Brexit on the EU:

- Brexit is expected to also affect the EU, primarily in the short-term (the second half of 2016 through the end of 2017), although to a lesser extent than the impact on Britain.
- The main implications involve: a decline in foreign trade activity, the possibility for a drop in foreign direct investment (FDI), an increase in immigration to the Euro Area countries (primarily the stronger countries), an increase in the payments to the EU, a delay in the implementation of various economic reforms, damage to the international standing of the EU, and an increase in political risks.
- In the longer-term, the main risk is the potential departure of other countries from the EU (and from other unions), and in the extreme case even the complete dissolution of the EU.
- The countries that are the most exposed to Brexit are: Ireland, Belgium, Holland, and Germany. This is because these countries have substantial trade relations with

Britain. Also Cyprus and Malta are subject to risk against the backdrop of their tight financial relations with Britain.

What are the sectors that are especially exposed to damage due to Brexit?

- Domestic sectors with a high degree of leverage will apparently be subject to higher risk in the event Britain exits from the EU. Furthermore, the impact of Brexit is likely to be seen also in weakness in activity in construction, retail trade, services, and the aviation sector. This, against the backdrop of, among other things, the expectations for depreciation, an increase in interest rates, and a certain decline in consumer and business confidence levels. In addition, it is expected that the risk premiums of the companies active in the above-mentioned sectors will climb, which is likely to make things more difficult for companies to finance their activities.
- The effects of Brexit on **the financial and banking sectors**, which account for a substantial portion of economic activity in Britain, are expected to be concentrated in the short-term, together with a risk to the status of London as a leading global financial center. This is due to the cancellation of agreements permitting British companies to act freely in Europe, which will lead to an increase in costs and a possible decline in the levels of activity and employment. Furthermore, it is possible that some of the activity of international financial institutions that are currently located in London will be moved to other financial centers, such as: Dublin, Paris, Frankfurt, and other locales.
- Brexit is expected to present a number of challenges to the **European pharmaceutical industry**, headed by: uncertainty regarding the status of the European regulatory authority in the area of pharmaceuticals, the EMA, which is located in London. Brexit is likely to lead to a decline in the financing of pharmaceutical research in Britain; a reduction in patients’ access to innovative pharmaceuticals; an increase in barriers to entry in the pharmaceutical market, primarily to international pharmaceuticals manufacturers; and to delays in granting pharmaceutical approvals. In addition, scientific research is also exposed to high risk since Britain receives the highest budget for scientific research in this area of activity, which is likely to change as a result of Brexit.
- Brexit is likely to especially impact **Britain’s automobile industry**, since the EU represents a very substantial trade partner for this sector, both in terms of import of input components and also in terms of exports.

Quantitative estimates on the effects of Brexit by the IMF and other financial organizations:

- The large differences between the possible types of agreements, and the period of time until a new trade agreement is finalized, account for the basis of the IMF's quantitative expectations, which include an adverse scenario[2] and a limited scenario[3]. These expectations were published on June 17, 2016 (a couple of days before the referendum). The possible scenarios are presented together with the basic scenario, in other words without Brexit.

  Below are the estimates of the IMF for the development of GDP growth in Britain (real rates of change):

	2016	2017	2018	2019	2020	2021
Basic scenario	1.9	2.2	2.2	2.1	2.1	2.1
Limited scenario	1.7	1.4	1.8	2.0	2.1	2.1
Adverse scenario	1.1	-0.8	0.6	1.7	2.6	2.9

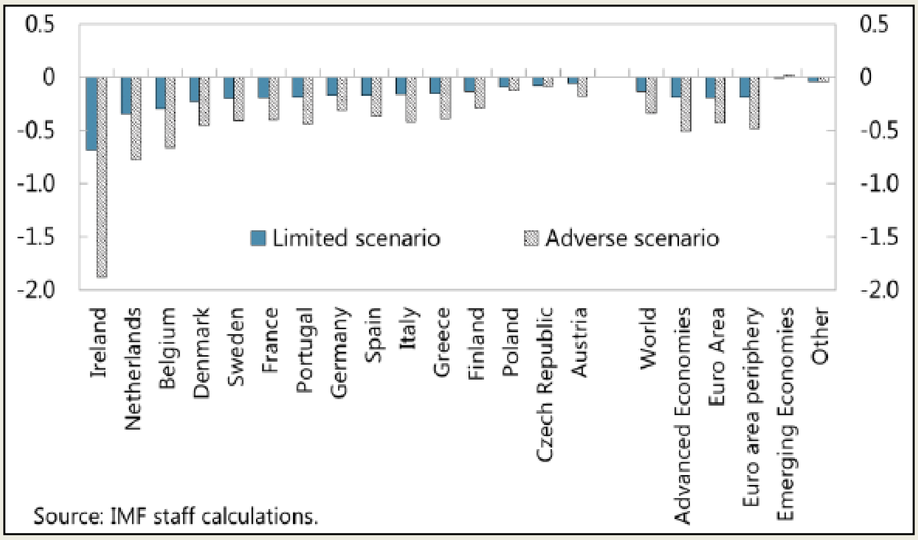
  It should be noted that most financial institutions estimate that Brexit will lead in the short-term (primarily in 2017) to a slowdown in economic activity compared to the basic scenario. However, there is broad diversity in the quantitative estimates regarding the strength of the impact of Brexit on the British economy, some of which indicate a recession. Below is a table showing the estimates of a few select financial institutions (real GDP growth, in percentage):

	UK		Euro Area	
	2016	2017	2016	2017
Barclays	1.1	-0.4	1.4	0.4
EIU	1.5	-1.0	1.6	1.3
Capital economics	1.5	1.5	1.2	

- According to the estimates of the IMF, the countries that will be hurt the most by Brexit include: Ireland, Holland, and Belgium. These countries have tight commercial and financial relations with Britain. Below is a diagram that summarizes the estimates of the IMF regarding the effects of Brexit countries other than Britain, with an emphasis on European countries, in the limited scenario and

[2] This scenario assumes the formation of a new trade agreement between the UK and the EU based on the terms and conditions of the WTO, following drawn out negotiations, accompanied by a strong degree of uncertainty.
[3] This scenario assumes the formation of an EEA type agreement, achieved within a relatively short period of time.

the adverse scenario (a decline in GDP compared to the basic scenario, in percentage):



The effects of Brexit on the Israeli economy:

- Brexit is expected to affect the Israeli economy primarily through heightened uncertainty in the financial markets, a strengthening shekel vis-à-vis the sterling and the currency basket, and a possible decline in foreign trade with Britain. These developments support a moderate cut in our growth forecast of Israel; a revised forecast will be published at a later date.

- Among the EU countries, Britain represents the main export destination for Israeli goods, and the second most important export destination following the US. Israeli exports to Britain amounted to US$3.6bn in 2015, accounting for 8% of total goods exports from Israel. At the same time, services exports to Britain equaled US$0.8bn. Israeli exports to Britain are expected to be hurt both from the possibility of a decline in demand from Britain, against the backdrop of heightened uncertainty there, and also from an increase in the price of Israeli exports due to the weakness in the sterling vis-à-vis the shekel. Israeli exports to Europe (with an emphasis on the euro area) are also expected to be hurt for similar reasons.

- Israeli exports to Britain are concentrated primarily in the chemicals and pharmaceuticals sectors, but also in the rubber and plastics, as well as the machinery and electronic equipment sectors. In 2015 Israeli exports of chemicals and pharmaceuticals to Britain amounted to US$2.7bn, accounting for 20% of total chemicals and pharmaceuticals exports from Israel. Therefore, the main impact is expected to be concentrated in these sectors, as it is possible there will be an inclination to shorten trade agreements (exports and imports) in light of the high degree of uncertainty.

We note that the export activity in each of these sectors relies for the most part on one dominant company – Teva Pharmaceuticals and Israel Chemicals Limited (ICL). There is a very substantial level of risk for each of these companies for deterioration in activity (however, each company is international, with activity in other markets).

- On the other hand, Israeli exports to the "dollar bloc" countries, including the US and some countries in Asia that trade in dollars, is likely to expand against the backdrop of a possible depreciation in the shekel vis-à-vis the dollar in light of the dollar's expected strengthening vis-à-vis the sterling and the euro.
- An increase in the amount of imports from Britain and the euro area is expected, in light of the strengthening of the shekel vis-à-vis the sterling and the euro. This will involve primarily the import of electronic goods and electronics, automobiles, commodities, and more.
- Furthermore, Britain represents a source for the inflow of foreign direct investment (FDI), which amounted to US$2.6bn in 2014. It should be noted that US$1bn of this amount was invested in the diamond processing sector, and this accounts for all the investment in Israel in this realm. The remaining balance of investment is concentrated in the following sectors: scientific research and development, insurance companies, information services and communications, and electronics. We note that a decline in investments is likely in these sectors.
- Brexit is expected to lead to a delay in the process of raising interest rates in Britain, and to leaving monetary policy in Britain and in Europe expansionary for a longer period of time than previously expected. This development is likely to lead to an additional delay to any interest rate hike in Israel.
- A change is likely in the legal status of Israeli companies that have commercial activity in Britain, as well as Israeli citizens who work in Britain.

The effects of Brexit on the financial markets

Main points:

- Due to the results of the referendum in Britain, with the people choosing to exit the EU, there is a high degree of uncertainty regarding both the short-term, against the backdrop of the possible political changes in Britain (the resignation of the prime minister, elections in October, etc.) and the implications of the exit of Britain from the EU, and also regarding the medium- and long-terms, against the backdrop of concerns regarding additional changes in the structure of the EU. Due to the high degree of uncertainty, we expect the financial markets will be characterized by high volatility at least in the immediate- and the short-terms.

- In geographical terms, the trend involving the flight to safety is likely to also support a shift of funds away from markets that are exposed to the consequences of Brexit and/or emerging markets (which are considered risky). These funds will be diverted to relatively financially strong and developed markets, and that are less exposed to the consequences of Brexit.
- Due to the results of the referendum, expected interest rate curves fell broadly in the main economies of the world because of estimates that additional monetary expansion is likely in the short-term, and because the interest rate paths in countries in which interest rate hikes were previously expected, such as the US and some emerging markets, will moderate and rates hikes will be postponed for a later period. Looking forward, we expect further expansionary monetary actions in the euro bloc, Britain, Japan, and in some of the other major economies of the world.
- The decline in interest rate expectations around the world and the flight to safety were seen in the yield curves of government bonds, primarily in countries that are not affected to a substantial degree by the exit of Britain from the EU and considered as investment “safe havens”, including the US and Japan.
- Also the government bonds of European countries that are considered immune from a financial standpoint to Brexit, such as Germany, were characterized by declining yields. In contrast, countries that are supposed to “suffer” from a rise in economic and/or political risks were characterized by a rise in yields in government bond markets.
- As expected, a sharp depreciation occurred in the sterling vis-à-vis the currency basket. The multi-years high deficit in the current account, together with expectations for a decline in foreign investments, is likely to cause a continued depreciation in the currency.
- In contrast, countries currently considered to be investment “safe havens” saw their currencies appreciate, expressed primarily in the dollar, yen and Swiss franc. The appreciation in these countries is likely to negatively affect any economic recovery in these countries, and to cause changes in monetary policy in the short-term (as mentioned, with a delay in interest rate hikes in the US, and possibly additional monetary expansion in Japan).
- The yield differentials between government and corporate bonds, particularly those with low credit ratings, are likely to widen. Corporate bonds that are exposed to risks, such as changes in trade conditions and regulations, are likely to be characterized by a rise in yields and wider margins.

Government Bonds Market:

The results of the referendum in Britain were strongly reflected in the financial markets. One of the main reactions was a deviation of capital towards both assets considered currently to be relatively “safe”, and also towards assets that will be affected by the expected changes in monetary policy in certain economies.

For example, the government bonds in the leading economies that are considered safe, including the US, Germany, and Japan, were characterized by a decline in yields-to-maturity in reaction to the referendum results. Also in Britain there was a substantial decline in yields in the government bond market against the backdrop of estimates that there will likely be an expansion in current monetary policy, apparently through additional quantitative easing; however, the possibility of an interest rate cut cannot be ruled out.

It should be noted that the Bank of England is likely to find itself in a trap in the near term. On one hand, the British economy is expected to continue to slow in the second half of the year, and maybe even fall to a technical recession, which would justify monetary expansion. However on the other hand, the sharp depreciation that occurred in the currency recently (see details below) is likely to cause a rise in inflation and in inflation expectations, which is likely to limit the central bank’s room to maneuver and to prevent it from cutting the interest rate. However, against the backdrop of the very low inflation environment today, it appears that the balance could tilt towards the direction of monetary expansion.

In addition, government bonds of countries considered as less safe in the eyes of investors around the world and as likely to be hurt in economic terms or to suffer from political uncertainty caused by of the results of the British referendum, were characterized by a rise in bond yields. Increases in yields-to-maturity were seen in the bond markets of Italy, Spain, Portugal, Ireland, and others.

Looking forward, we estimate that the uncertainty regarding the implications of the referendum on the global economy, and on Europe in particular, will influence risk aversion in the financial markets. The uncertainty regarding the implications of the exit of Britain from the EU and the assumption that there will be slowdown in the short-term in Britain and in the EU, caused a decline in interest rate expectations, and it is possible that the central banks may also implement monetary expansion in the short term. Consequently, the potential for an increase in yields in the short-term, in the government bonds of the economies considered to be safe, is limited, and we don't rule out that in the short-term the yields will continue to decline, from their current low levels, in certain markets. On the other hand, after the degree of certainty regarding the economic environment will rise, the yields-to-maturity are likely to “correct” upwards and to be influenced in the short and medium-term by expectations regarding the interest rate path and from other fundamental factors, including the fiscal risks.

Regarding Israel, we estimate that in the event there will be a delay in hikes in the US interest rate, in parallel to monetary expansion in certain primary economies around the world, then it is possible a hike in the Israeli interest rate will be postponed to a certain degree. The government bond market reacted to the results of the referendum with a positive trend and a decline in yields-to-maturity. In our opinion, in the short-term the government bonds of Israel will be affected by the trend in comparable bonds in the developed markets, particularly in the US and in the euro area.

Foreign Exchange Market:

The reactions in the foreign exchange market to Brexit were as expected. The dollar, Swiss franc, and yen, which are considered as "safe havens" at times of economic uncertainty, were characterized by appreciation vis-à-vis many currencies, and primarily against the euro and the sterling.

The British sterling fell sharply against most currencies around the world. A look at the sterling-euro duo shows, as expected, depreciation of the sterling by more than 8% vis-à-vis the euro (as of 28.06.2016). It should be noted that the Israeli shekel strengthened vis-à-vis the sterling by a sharp rate of more than 10%, and by a more moderate rate of 1.3% vis-à-vis the euro. In contrast to the trends vis-à-vis the sterling and the euro, the dollar (+1.8%) and the yen (+4.6%) reacted with substantial appreciations vis-à-vis the shekel, similar to the trend around the world, this due to the trend involving a flight to safety. In the immediate term it is likely that the flight to safety trend will continue and will support the stronger global currencies, such as the dollar and the yen. Strengthening of these currencies is likely to cause a delay in any interest rate hike in the US, and expansion of monetary policy by the central bank of Japan.

Looking forward, in light of the economic uncertainty in Britain and the expectations for monetary expansion, the sterling is likely to continue to weaken. It is notable that the deficit in Britain's current account is at a peak level and that investments by foreigners are likely to decline in the foreseeable future in light of the economic uncertainty. These factors are likely to weigh even more so on the currency; therefore, a continued trend of depreciation in the sterling cannot be ruled out, at least in the short-term. The uncertainty surrounding the political risks in Europe due to the exit of Britain from the EU and against the backdrop of the elections scheduled in the EU in the short-term, will also apparently limit the potential for appreciation of the euro in the foreseeable future.

Commodities:

The prices of most commodities fell in reaction to the results of the referendum, both due to the expectations for a slowdown in demand among some economies around the world, and also due to the strengthening of the dollar around the world.

Looking forward, if indeed there will be a slowdown in demand around the world (in Britain a slowdown is expected in economic activity or recession in 2016 – 2017, and a moderating effect is expected on Europe and on the main exporters of Britain) and the dollar continues to strengthen, then a moderating impact is expected on commodities prices (all else equal). This development is of course likely to have a moderating effect on the inflation environment around the world, and consequently on the interest rate environment.

Corporate Bonds Market:

We estimate that in light of the rise in uncertainty and an increase in the degree of risk aversion, it is likely that the credit spread (yield differentials between government and corporate bonds) will rise to some degree. In light of the trend of the flight to safety, we estimate that the widening of the credit spreads will be much greater among bonds with lower credit ratings. In addition, we estimate that sectors that are exposed to substantial changes in the trade laws and in regulations are likely to suffer from greater volatility and possibly also from increases in yields-to-maturity in the short-term.

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