BREXIT
A massive trade-off between politics and economics?

March 2016

BREXIT referendum June 23rd

Coming hot on the heels of a volatile start to the year, the BREXIT referendum on June 23rd, is another potential headache for investors. Our house view is that the ‘remain’ side will triumph in the June vote although current poll readings show ‘remain’ and ‘leave’ sides neck and neck with a large percentage of undecided voters.

In our view the vote represents a direct trade-off between politics and economics insofar as BREXIT offers a number of potential positives politically (chiefly around regulation, immigration and the costs of EU membership) but at the expense of massive uncertainty around trade and investment in the UK and likely lower long term economic growth rates. Therefore in our opinion the costs around BREXIT outweigh the benefits for the UK.

In this note we tackle the following questions:

• What does the path to BREXIT look like?
• Should the UK vote to leave the EU, how could the EU-UK relationship look going forward?
• What long term impact could BREXIT have on the UK?
• How could BREXIT affect the European economy and markets in 2016-17?
• How would BREXIT affect Ireland?
• What do current BREXIT opinion polls look like?

What does the path to BREXIT look like?

If the UK were to vote to leave the EU then the government would have two years to negotiate a withdrawal agreement under article 50 of the EU Treaty. Following this two year period the UK would have formally exited the Union but this would not be the end of the process. Further negotiations with the EU would be required to define the relationship between the two blocs. The UK would also have to replace treaties that no longer apply post BREXIT.
Potential models for the EU-UK relationship should BREXIT happen

Table 1 below highlights the possible models for the EU-UK relationship in the event of a ‘leave’ result. As we mentioned above, in many ways the models represent a direct trade-off between politics and economics insofar as what would be most beneficial from a political perspective (Independent approach to regulation, no contribution to the EU budget, freedom over immigration controls) could also be the most damaging economically from a trade and investment perspective. Of the models highlighted below the Norwegian style European Economic Agreement model represents the closest fit to the status quo assuming the UK votes to leave the EU. As we can see from the table, this relationship would retain similar trade and investment features of EU membership. At the other end of the extreme, the ‘Most Favoured Trade Nation’ approach probably represents the furthest departure from the status quo in a BREXIT scenario. This approach offers the UK plenty of flexibility in regulation, immigration while also eliminating the UK’s requirement to pay into the EU Budget. However this comes at the cost of introducing significant uncertainty in how the UK would trade with the EU, something which would likely adversely affect growth over the medium and long term.

Table 1: UK relationship with the EU post ‘Exit’ Vote

<table>
<thead>
<tr>
<th>Model</th>
<th>Norwegian Style European Economic Area (EEA) Agreement</th>
<th>Turkish Style Customs Union</th>
<th>Free Trade Agreement Based Approach</th>
<th>Swiss style Bilateral Accord</th>
<th>Most Favoured Trade Nation Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nearly no tariff barriers on trade in goods</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td>√</td>
<td>X</td>
</tr>
<tr>
<td>Dynamic Agreement</td>
<td>√</td>
<td>√</td>
<td>X</td>
<td>√</td>
<td>X</td>
</tr>
<tr>
<td>Rules of origin requirements avoided</td>
<td>√</td>
<td>√</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Single set of regulations for exporting firms</td>
<td>√</td>
<td>X</td>
<td>X</td>
<td>√</td>
<td>X</td>
</tr>
<tr>
<td>Full single market access retained</td>
<td>√</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Passporting of UK banks possible</td>
<td>√</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Influence over EU regulations retained</td>
<td>?</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Able to adopt own approach to regulation</td>
<td>X</td>
<td>?</td>
<td>?</td>
<td>?</td>
<td>√</td>
</tr>
<tr>
<td>Freedom to pursue trade deals independently</td>
<td>X</td>
<td>X</td>
<td>√</td>
<td>√</td>
<td>√</td>
</tr>
<tr>
<td>No contribution to EU budget</td>
<td>X</td>
<td>√</td>
<td>√</td>
<td>X</td>
<td>√</td>
</tr>
<tr>
<td>Freedom to impose immigration controls</td>
<td>X</td>
<td>√</td>
<td>√</td>
<td>?</td>
<td>√</td>
</tr>
</tbody>
</table>

Source: Global Counsel, June 2015
Long term BREXIT impacts on the UK economy

There are a number of channels through which the UK would be affected by BREXIT. Below we have highlighted some of the more significant ones:

**Trade within Europe**
It’s worth pointing out that from an external trade (exports and imports) and an investment perspective the EU is far more important to the UK than the UK is to the EU. The Bank of England Governor Mark Carney recently highlighted this in testimony to the Treasury Select Committee in the UK when he stated:

“The rest of the EU is more important to UK trade and investment than the converse. For example, UK exports to the EU represent 13% of UK GDP, whereas exports from the rest of the EU to the UK represent only 3% of rest-of-EU GDP.”

Essentially, the divergence in regulation for both blocs post BREXIT would likely increase the cost of trade, hurting trade volumes with the EU. Given Ireland’s close trading relationship with the UK, Ireland would also clearly be most at risk from the UK exiting the EU. For example, in its paper on the topic last year the Economic and Social Research Institute highlighted that bilateral trade flows between the UK and Ireland could be reduced by 20% or more as a result of BREXIT.

**Foreign Direct Investment**
If the UK were to decide to leave the EU then clearly the UK would be less attractive as a gateway location into Europe for foreign direct investment. As a single bloc the EU is the largest economy in the world with GDP of over €14Tn and a population of over 500 million. The UN estimates that the UK’s current stock of inward foreign direct investment stands at a whopping $1.7Tn, over 50% of UK GDP. Much of this is in the financial sector given the importance of the city of London as a financial hub. Overall, the EU accounted for approximately 46% of UK foreign direct investment in 2013 (source: Office for National Statistics).

Furthermore the EU and the US are currently negotiating a Transatlantic Trade and Investment Partnership (TTIP) which could further open up the US market to EU firms over the next few years. A study from the Centre of Economic Policy Research in the UK in 2013 estimated that the implementation of the TTIP could increase UK GDP by 0.14%-0.35% annually over a ten year period. Therefore the UK could stand to lose significantly in investment terms should it vote to leave the EU.
The UK government could look to mitigate BREXIT’s impact on foreign direct investment by cutting its corporation tax rate. But it remains to be seen how much scope it would have to do so considering its current budget deficit (estimated at 4.4%) and considering the government wishes to ring-fence certain sectors (health, defence) from spending cuts over the next few years.

**EU Budget**
The UK could gain financially but this depends on the model assumed for the EU-UK relationship going forward. At present the UK’s net contribution to the EU Budget amounts to only around 0.4% of GDP. Under certain models of the EU-UK relationship, the UK would still have to make contributions to the EU budget (see table 1) and so would gain little or nothing financially from a vote to leave the EU.

**Regulation/Policy Influence**
The UK would lose influence over EU regulation meaning that in trade terms it would likely still have to comply with EU regulations but without the power or influence to shape them.

**Overall Long Term Impact on the UK economy**
The overall impact of BREXIT on the UK economy is incalculable and really depends on the model for the EU-UK relationship going forward. However a number of recent papers on the topic have attempted to calculate the impact on the economy. The general conclusion of these is that GDP would be lower by 0.5%-3% compared to its level if the UK were to remain in the EU.
How could BREXIT affect the European economy and markets in 2016-17?

**UK Economy**

Over the 2016-17 period both Goldman Sachs and Morgan Stanley have estimated that a vote to exit the EU could hit UK GDP growth to the tune of around 1% in a medium stress scenario (at present economists are expecting UK growth of 2.2% for 2016). In a highly stressed scenario (similar to the Global Financial Crisis) a UK recession could not be ruled out. In the medium stress scenario it is possible sterling could fall in value by 5-10% (in time this would help the economy) and that the Bank of England would cut UK interest rates to counteract the short term negatives for the economy.

BREXIT would be a very protracted process, lasting years. Consequently a vote to leave and its consequences is likely to impact on investment decisions in the UK for some time, particularly since a vote to leave would by no means end this uncertainty given the need for further negotiations. A vote to leave would probably have political ramifications for the UK government (this could hamper the UK’s subsequent negotiations with the EU) and could also trigger more independence referenda similar to the Scottish vote in 2014.

**Euro Area Economy**

A vote to leave would also likely have a negative impact on Euro area growth in the 2016-17 period. For example, Morgan Stanley estimates it could reduce growth by around 0.8% in a medium stress scenario (the current consensus growth forecast for the Euro area in 2016 sits at 1.6%).

**Markets**

In light of the potential growth shock in Europe as a result of a UK vote to leave, European equity markets would likely struggle short term. It's anyone’s guess how much both markets (UK and Euro zone) could sell off in the event of BREXIT but a fall of 10% around the date of the result wouldn’t seem inconceivable. Safe havens like government bonds would also probably find short term favour with investors in the event of a vote to exit. From a property perspective the uncertainty around BREXIT could cause UK occupier take-up to weaken ahead of the vote (this was noticeable outside London in the run-up to the Scottish referendum in 2014). Should the UK vote to leave the EU it is possible yields would widen a little with perhaps a negative impact also being felt in the London market given its high concentration of financial sector occupiers.
BREXIT Impacts on Ireland

Given Ireland’s strong economic links with the UK clearly Ireland’s economy would be hit by a UK vote to leave. Again, it’s almost impossible to quantify the short term impact given we don’t know the post BREXIT form of the EU-UK relationship. However Open Europe (a UK think tank) has estimated that in a worst case scenario Ireland’s economy could be around 3% smaller in GDP terms by 2030 as a result of Brexit. Even in a best case scenario Ireland’s economy would be around 1% smaller in its view. In its 2015 report the ESRI also cited reports showing that Irish per capita GDP could be lower by 0.8%-2.7% by 2030 if BREXIT were to happen. As well as the negative impact on trade volumes, the ESRI also highlighted that BREXIT could adversely affect the Irish economy from an energy perspective (given the interconnection of the UK and Irish electricity markets) and also from a migration (flow of workers between the respective labour markets) perspective.

Current indicators of the vote

At present opinion polls on the EU referendum are extremely close with the latest poll of polls showing the ‘remain’ side marginally ahead with 51% of the vote (once undecided voters are excluded). Other indicators though have the ‘remain’ side more comfortably ahead. For example, the BREXIT barometer published by Open Europe has the ‘remain’ side at 81% although it should be borne in mind that this is not based on an opinion poll.
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