Brexit: What does it mean for Europe?

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Executive summary

- In a *soft leave* scenario, UK real GDP growth could be cut by -2.8pp between 2017 and 2019 and 1,500 additional bankruptcies are expected. In a *hard leave* scenario, the cumulated impact would be -4.3pp of real GDP growth and 1,700 insolvencies. The peak is expected in 2019. Brexit fears are nonetheless already affecting the UK: -GBP34bn in portfolio outflows.
- For the eurozone, real GDP growth could fall by -0.4pp by 2019 in a *soft leave* scenario, where a Free Trade Agreement is in place. Cumulated export losses would be EUR17.5bn for goods and services, EUR18.2bn for Foreign Direct Investments (FDIs) i.e. 1.9% of total and +1.0pp in business insolvencies growth. In a *hard leave* scenario, the impact will be higher: -0.6pp of real GDP growth, EUR23.6bn for exports (i.e. 0.5% of total), EUR29.7bn for FDIs (i.e. 3.1% of total) and +1.5pp in business insolvencies growth.
- The Netherlands, Ireland, and Belgium would be the most affected through their exports and cross-investment positions. Germany, France, and the United States would also see a significant impact. Biggest losses will be concentrated in sectors such as financial services, automotive, machinery and equipment, chemicals and agri-food.

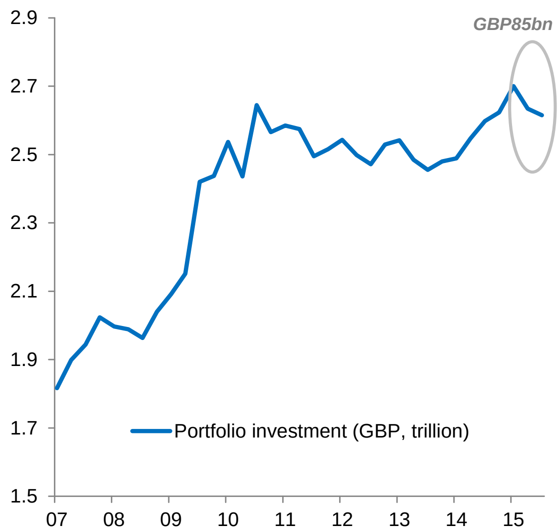
Fears of Brexit already affected the attractiveness of the UK

The last six months have confirmed that the risk of Brexit is already affecting the economy.

In the UK, portfolio investments from abroad suffered from the economic slowdown, the increasingly dovish stance of the Bank of England, and the fears of Brexit. We estimate that the latter accounts for 40% of the fall, i.e. -GBP34bn out of the total -GBP85bn (see Figure 1).

Rising uncertainty around the June 23 referendum will peak in Q2. Overall, 2016 growth could decelerate to +1.9% (from +2.3% in 2015). Also, note that the Bank of England will keep interest rates on hold until the end of the year given the subdued inflation – and what a Brexit would mean in terms of monetary policy stance (exchange rate effects and financial stress).

Figure 1 – Stock of portfolio investments, GBP trillion



Sources: ONS, Euler Hermes

Brexit: A scorecard for the impact on the UK

Last November, we published a first estimate of the cost of a Brexit for the UK (Brexit me if you can: Companies to suffer the most). Additional transmission channels are presented in Figure 2.

In our *soft leave* scenario, an exit with a Free Trade Agreement (FTA) with the EU post 2019, we estimate a -2pp cumulative impact on nominal GDP growth (-2.8pp in real terms) between 2017 and 2019. In 2019, the peak year, real GDP would stagnate, the GBP depreciate by 10%, firms' turnover growth slow down to +1.2% and margins should lose 1pp. Overall for 2017-2019, as much as 1,500 additional bankruptcies could be attributed to Brexit (out of ~20,000 in 2016).

In the *hard leave* scenario, no FTA with the EU (and subsequently with the 50 non-EU markets currently under FTAs), the impact would be much stronger: UK export losses could reach GBP30bn in 2019 (i.e. 8% of total UK exports). The overall impact on nominal GDP growth is estimated at -4pp over 2017-19 (-4.3pp in real terms) and 1,700 bankruptcies. The UK is expected in recession in 2019 (-1.3%), the GBP could depreciate by 20%, firms' turnover would be down -1% and margins will decrease by -2pp. In this scenario, the risk of capital flight and resulting financial stress is deemed very severe as the UK is running a large current account deficit (-7% of GDP vs. -2% of GDP on average since 1984).

For the eurozone the impact of Brexit should remain moderate

For the Eurozone as a whole, we forecast a moderate impact of -0.4pp for real GDP growth in 2019 in a *soft leave* scenario. On the contrary, in a *hard leave* scenario, the impact could climb to -0.6pp (see Figure 3).

There are three main transmission channels for Brexit to the rest of the world: (i) trade in goods; (ii) trade in services; and (iii) divestment costs from the UK by European companies and from British companies operating in Europe (including dividends repatriated):

(i) Trade in goods: The GBP depreciation and lower GDP growth would trigger a fall in UK imports. We estimate that in the case of a *soft leave*, the combined effect of a slowdown and GBP depreciation (at least 10%) would cause UK imports' growth to slow down. In 2019 the peak year, imports will increase by +0.5% instead of +3% (baseline). In a *hard leave* scenario, additional tariffs could even cause a contraction -1% of UK imports in 2019.

As a result, cumulated 2017-19 export losses for the eurozone could reach EUR15.3bn (i.e. 0.5% of total eurozone exports of goods) in a *soft leave* scenario and EUR20bn in a *hard leave* scenario (i.e. 0.6% of total eurozone exports of goods).

(ii) Trade in services: Changes in regulation and additional administrative costs could imply lower activity for European companies operating in the UK. The local market would shrink, notably for financial services, and foreign businesses would be looking for new markets. Finally, a Brexit would mean a jeopardized business model for the City of London. Access to the London Marketplace would be more complicated, namely due to higher cost of passporting rights. Also, UK-based subsidiaries in the financial sector will no longer access euro financing through the ECB as they do today.

As a result, export losses for the eurozone could reach EUR2.2bn (i.e. 0.2% of total eurozone exports of services) in a *soft leave* scenario and EUR3.6bn (i.e. 0.3% of total eurozone exports of services) in a *hard leave* scenario.

Figure 2 – Impact of a Brexit on the United Kingdom (2017-2019)

	2017		2018		2019		
	Stay	*Leave*	*Stay*	*Leave*	*Stay*	*Soft Leave* - exit with a FTA	*Hard Leave* - exit w.o. a FTA
Real GDP growth	1.8%	**1.0%**	1.7%	**1.2%**	1.7%	**0.2%**	**-1.3%**
Nominal GDP growth	3.3%	**2.7%**	3.3%	**3.0%**	3.2%	**2.5%**	**1.2%**
Goods export gains (GBPbn)	35	**30**	25	**20**	20	**-9**	**-30**
Services export gains (GBPbn)	10	**6**	12	**4**	14	**-5**	**-11**
GBP trend	< 5% depreciation	**> 5% depreciation**	> 5% appreciation	**> 5% depreciation**	> 5% appreciation	**> 10% depreciation**	**> 20% depreciation**
Net investment from abroad (GBPbn)	> 50	**< 10**	> 50	**< 10**	> 50	**-60**	**-210**
Firms' turnover (annual growth)	3.5%	**2.0%**	4.0%	**1.5%**	4.0%	**1.2%**	**-1.0%**
Firms' margins (pp)	0.5	**-0.5**	1.0	**-0.8**	1.0	**-1.0**	**-2.0**
Business insolvencies	3.0%	**3.3%**	1.0%	**2.5%**	0.0%	**3.3%**	**4.4%**

Sources: ONS, Eurostat, Euler Hermes

iii) Investment: The UK is very dependent on inward investments, but it is also an important investor abroad. EU countries would be inclined to invest less in the UK post EU-exit and conversely.

Britain has a positive net investment position vis-a-vis countries such as France, Italy, and the Netherlands. Yet its balance is significantly negative with the US. Most British investment in the EU ends up in financial services, and the chemicals, retail, and ITC sectors. An estimate of the investment losses in case of a Brexit (see Figure 3) finds that the United States (-EUR13.5bn for a *soft leave*), the Netherlands (-EUR8.2bn), France (-EUR3.2bn), Germany (-EUR2.1bn), Greater China (-EUR1.9bn), Spain (-EUR1.8bn) and Ireland (-EUR1.2bn) would be the main losers.

In the medium-term however, there could be increasing opportunities for EU countries to attract lost UK investments – as well as new inflows. Possible winners: the pharmaceutical, electronics and financial sector in Ireland; the automotive sector in Spain, Slovakia and Poland; machinery and equipment in Germany, Italy and Czech Republic; financial services, high tech and transportation sector in the Netherlands; aeronautics in France.

The Netherlands, Ireland and Belgium to be the most impacted by a Brexit, followed by Germany, France and the United States

The Netherlands, Ireland, and Belgium will be the most impacted under both scenarios (*soft* and *hard leave*). Biggest losses will be concentrated in sectors such as automotive, machinery and equipment, chemicals and agri-food.

Belgium and the **Netherlands** are major European trade hubs and have a high exposure to the UK market. For the Netherlands in particular, the overall impact of Brexit will be high: -1.5pp of GDP growth in a *soft leave* scenario and +2pp for business insolvencies growth. Most of the impact would come from important financial linkages (holding structures) but also from lower exports of chemicals, agri-food and electronics.

In the case of **Ireland**, the UK is the second biggest market for exporters, with a high concentration on oil and higher value added products (electronics, chemicals, machinery and equipment). The impact is estimated at -0.9pp for GDP growth and will trigger an additional increase in business insolvencies by +1.5pp in the *soft leave* scenario. In the *hard leave* scenario, the fall in GDP growth will be bigger (-1.4pp) and will be a higher drag on business insolvencies (+2.0pp).

The UK imports mostly intermediate goods from **Germany**, notably vehicle components and machinery. In a *hard leave* scenario, we expect a loss of –EUR2.0bn for German automotive exporters and of –EUR1.0bn for machinery exporters (see Figure 4). The German chemical sector is also relatively exposed to the UK and we expect a loss of -EUR1.1bn by 2019 in a *hard leave* scenario. Overall, the impact on real GDP growth by 2019 is expected to range between -0.3pp and -0.4pp; the impact on business insolvencies growth could be as much as +1.2pp additional turbulence.

France will be impacted in a similar way as Germany, although to a lesser extent. The sectors that are likely to suffer the most are machinery, agri-food and chemicals that are expected to lose -EUR0.5bn each by 2019 in a *hard leave* scenario.

Figure 3 – Impact of a Brexit outside the United Kingdom (2017-2019, cumulative)

		Exports of goods (EURbn)	Exports of services (EURbn)	FDI (EURbn)	Earnings (EURbn)	GDP growth (pp)	Business insolvencies growth (pp)	Exports of goods (EURbn)	Exports of services (EURbn)	FDI (EURbn)	Earnings (EURbn)	GDP growth (pp)	Business insolvencies growth (pp)
High impact	Netherlands	-2.5	-0.2	-8.2	-0.1	-1.5	2.0	-3.2	-0.4	-13.4	-0.2	-2.4	2.5
	Ireland	-0.8	-0.2	-1.2	0.0	-0.9	1.5	-1.0	-0.3	-2.0	0.0	-1.4	2.0
	Belgium	-2.0	-0.1	-1.0	0.0	-0.7	1.0	-2.6	-0.2	-1.7	0.0	-1.0	1.5
Significant impact	Germany	-5.2	-0.4	-2.1	0.0	-0.2	< 1	-6.8	-0.6	-3.4	0.0	-0.4	1.2
	France	-1.9	-0.5	-3.2	0.0	-0.2	< 1	-2.4	-0.8	-5.2	0.0	-0.4	1.1
	United States	-2.2	-0.9	-13.5	-0.4	-0.1	< 1	-2.9	-1.4	-22.0	-0.6	-0.2	1.1
	Spain	-1.0	-0.4	-1.8	0.0	-0.2	< 1	-1.3	-0.6	-2.9	0.0	-0.3	1.0
	Portugal	-0.2	-0.1	-0.1	0.0	-0.2	< 1	-0.2	-0.1	-0.1	0.0	-0.3	1.0
Moderate impact	Italy	-1.2	-0.2	-0.4	0.0	-0.1	< 1	-1.6	-0.3	-0.6	0.0	-0.2	< 1
	Slovakia	-0.1	0.0	0.0	0.0	-0.2	< 1	-0.2	0.0	0.0	0.0	-0.2	< 1
	Finland	-0.2	0.0	-0.1	0.0	-0.1	< 1	-0.2	0.0	-0.1	0.0	-0.2	< 1
	Romania	-0.1	0.0	0.0	0.0	-0.1	< 1	-0.1	0.0	0.0	0.0	-0.1	< 1
	Greece	-0.1	-0.1	0.0	0.0	-0.1	< 1	-0.1	-0.1	-0.1	0.0	-0.1	< 1
	Austria	-0.2	0.0	-0.1	0.0	-0.1	< 1	-0.3	-0.1	-0.2	0.0	-0.2	< 1
Low impact	China Region	-2.5	-0.1	-1.9	-0.1	0.0	< 1	-3.2	-0.2	-3.1	-0.2	0.0	< 1
	Poland	-0.5	-0.1	-0.1	0.0	0.0	< 1	-0.7	-0.1	-0.2	0.0	-0.1	< 1
	Denmark	-0.4	0.0	-0.4	0.0	0.0	< 1	-0.5	-0.1	-0.6	0.0	-0.1	< 1
	Sweden	-0.5	-0.1	-0.7	0.0	0.0	< 1	-0.7	-0.1	-1.2	-0.1	0.0	< 1
	Czech Republic	-0.3	0.0	0.0	0.0	0.0	< 1	-0.4	0.0	-0.1	0.0	0.0	< 1
For information	***Eurozone***	***-15.2***	***-2.2***	***-18.2***	***-0.2***	***-0.4***	***1.0***	***-19.9***	***-3.6***	***-29.7***	***-0.4***	***-0.6***	***1.5***
	% of total	***0.5%***	***0.2%***	***1.9%***	***1.4%***			***0.6%***	***0.3%***	***3.1%***	***2.4%***		

NB: China Region includes China and Hong Kong

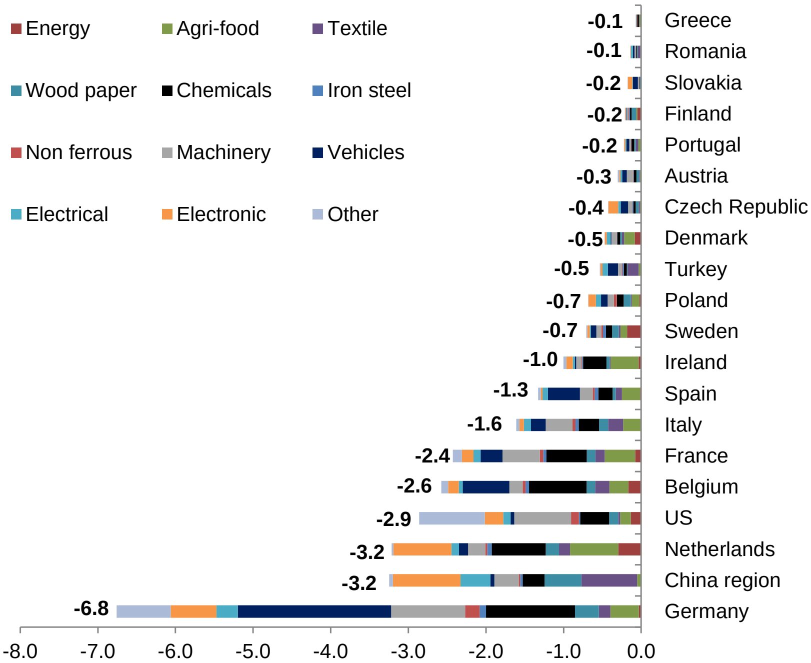
Sources: Chelem, ONS, Euler Hermes forecasts

Outside Europe, the **United States** appears to be one of the most impacted countries, notably given its investments in the UK as a gateway to Europe. The interconnection between the US and the UK markets for financial services is significant: 26% of total UK exports of financial services go to the US and 30% of total UK's imports come from the US in this sector. In total, we expect a loss of -EUR13.5bn of FDIs in the case of a *soft leave* scenario and up to -EUR22bn in a *hard leave* scenario.

The UK is the US's fifth trade partner for goods. We estimated cumulated losses by 2019 to reach –EUR2.2 in a *soft leave* scenario and –EUR2.9bn in a *hard leave* one. Biggest losses will come from machinery and equipment (-EUR0.7bn) and chemicals (-EUR0.4bn) – see Figure 4.

In total, -0.1pp of GDP growth should be lost in a *soft leave* scenario vs. -0.2pp in the *hard leave*.

Figure 4 – Export loss by country and by sector in a *hard leave* scenario, EURbn



Sources: Chelem, Euler Hermes

The hidden costs of a Europe *à la carte*

Uncertainty and legal cost

Legally, a Brexit would prove burdensome. Article 50 of the Lisbon Treaty only briefly outlines the procedure for exit negotiations. As details are yet to be defined, legal costs and more importantly uncertainty on its final status should not be underestimated.

The risk of a spillover to other EU countries

On the one hand, a Brexit could boost centrifugal forces and slow down the integration process. The transfer of competencies to Brussels, especially in the political and social fields, could come to a halt resulting in a so-called *Europe à la carte*. Scandinavian countries, Poland and Austria, have already advocated for less political integration. On the other hand, Brexit could also be an opportunity for Europe to opt for a one-speed model of integration including faster reforms towards federalism.

Productivity puzzle

The UK is the second biggest recipient of EU research funding. EUR8.8bn were granted between 2007 and 2013, with funds going to key projects such as the Joint European Torus in Durham, and nuclear research. What is more, UK universities coordinate one-third of the projects funded by the EU's 80 billion euro Horizon 2020 research program. If the UK were to leave the EU, economies of scale for R&D will be limited at a time when productivity is stagnating. Access to cutting-edge science, reduced scientific cooperation, and cross-border cooperation is a must and often a forgotten side benefits of trusted trade relationships.

Mobility

In 2015, around 1.2 million foreign workers were employed in the UK. Many of these are posted workers from Eastern Europe whose presence is permitted and regulated under an EU directive. If the UK were to exit, working visas and benefits would have to be redefined.

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