ECONOMICS
UK
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Britain backs Brexit

Turbulent times ahead

The UK has voted to leave the EU by a margin of 52-48%. Financial markets have reacted very negatively with sterling collapsing and risk assets plunging globally. The economic and political implications are likely to be even greater for the UK and Europe with years of uncertainty ahead. The key question is whether the divorce will be amicable or become acrimonious while the prospect of a renewed Scottish independence push only adds to threats policy makers have to deal with. Europe will never be the same again…

Financial markets have swung violently through the night with sterling initially rallying on announcements from some polling agencies suggesting a narrow IN outcome soon after voting closed at 10pm. However, as the regional results came in it became increasingly clear that they got it wrong and risk assets and sterling have consequently collapsed.

David Cameron will be stepping down as Prime Minister with the aim of a new Conservative leader (and PM) being in place by the Conservative Party Conference in October. It will then be up to the new Prime Minister to decide when to trigger Article 50 of the Lisbon Treaty in order to start the negotiation process for departing from the EU. The key question will be whether the UK can achieve an amicable divorce from the EU, which will limit the economic pain, or whether it will break down in acrimony.

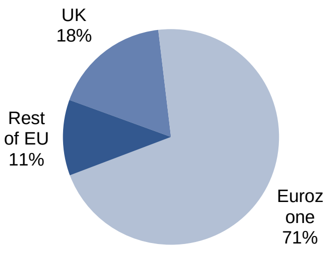
If it is the latter, a toxic political environment could lead to protracted negotiations, resulting in significant economic distress for the UK and Europe more broadly. We think UK growth in 2017 will be 1-1.5 percentage points lower in 2017 than would have been the case had the UK stayed in the EU. We will also have to wait and see if the Scottish nationalist movement launches a renewed push for independence.

This huge degree of political uncertainty is going to be massively disruptive for the economy. Trade gets the headlines, but nothing will change on this for two years and in actual fact the plunge in sterling could be beneficial in the near term. We are more worried about the hit to business sentiment given surveys suggested 75% of UK firms wanted the UK to stay in the EU. This suggests weaker investment spending and slower hiring, which ironically is likely to dampen migrant inflows. Foreign investors are also likely to take a dim view of putting money to work in the UK given the uncertainty over its future relationship with the EU.

The Bank of England will now have to decide whether it needs to step in and support the economy in some way. While the plunge in the currency is certainly a loosening of financial conditions, the Bank may be worried about domestic activity. We acknowledge that inflation will be pushed higher by sterling's collapse, but we think the BoE will look through this, as they did in 2011 and focus on the growth risks, which will dampen inflation pressures in the medium term. As such, we see a strong probability of an interest cut in the near future.

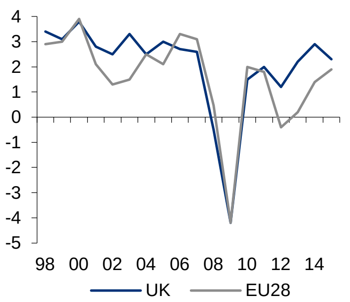
The EU leadership will be in crisis. Sentiment and currency effects could knock 0.6% off GDP by 2017. Political contagion might even be bigger. With the emergence of anti-EU parties, the EU is facing an existential crisis. Mainstream parties will struggle to resist pressures to step back from further integration and the risk of further electoral rebellions is high.

Respective contribution to EU GDP (2015=€14.6trn)



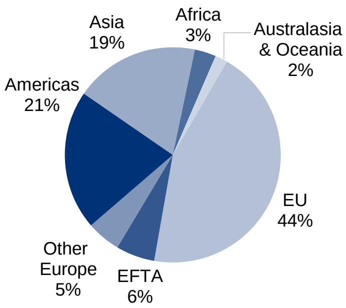
Source: Macrobond

UK vs EU GDP growth (YoY%)



Source: Bloomberg

Destination of UK exports



Source: Macrobond, ING

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Britain backs Brexit

How the country voted

The UK has voted to leave the EU by a 52-48% margin

Opinion polls released immediately after voting ended at 10pm had suggested that the UK would narrowly vote to remain a member of the European Union, but as the results came in it became increasingly clear that they had got it wrong. While London, Scotland and Northern Ireland posted strong pro-EU results, this enthusiasm for Europe was not replicated in Wales and the English regions. The results show 17.4 million votes for leave and 16.1 million votes for remain – a 51.9-48.1% victory.

Turnout was high, but not as high as predicted by the Electoral Commission

Turnout was high at 72.2% when compared with the 66.4% turnout for the 2015 General Election and the 35.6% turnout at the 2014 European Parliamentary elections. However, it was not quite as good as the Scottish Independence vote where 84.6% of eligible voters cast their ballot and is lower than the 80% turnout the Electoral Commission had been preparing for. Moreover, the turnout in pro-remain areas was disappointing with both Scotland and London seeing a turnout of less than 70%, the latter possibly reflecting bad weather yesterday.

Implication for currencies

Sterling has borne the brunt of the negative market reaction

FX markets have already suffered severe adjustments in response to the Leave vote. GBP has collapsed as markets re-assess UK growth prospects and question how much GBP assets need to cheapen to attract funding for the UK's 5% of GDP current account deficit.

We continue to look for EURGBP to head above 0.90 and GBPUSD to head towards 1.20

Before the vote, we had felt that EUR/GBP could move to extreme over-valuation in the 0.90/95 area. EUR/GBP looks well on its way to such a target and the speed of its attainment is probably a function of the UK political back-drop, where a policy vacuum would add to the already enormous policy uncertainty. Inevitably the dollar is gaining from safe haven flows and we see potential for GBP/USD to trade as low as 1.20 – levels last seen during the Volcker-inspired dollar surge in the mid-1980s.

EURUSD will be dragged lower

In this environment we see EUR/USD being dragged down to the 1.07/08 area. However, it remains relatively under-valued and losses may prove relatively limited.

JPY is likely to be a big winner

The preferred safe haven, however, remains the JPY. Asia's much smaller trade and financial linkages keep the region's currencies relatively insulated from the chaos in the UK. And the JPY time-and-again proves the outperformer, backed by one of the largest Net Foreign Assets positions in the world. From a policy perspective, we also feel that Japanese authorities remain constrained with respect to FX intervention. Today's events warn of USD/JPY extending decisively through 100 and we would not expect intervention until the 90/95 area. If there is any intervention, it seems it will more be via liquidity-adding use of bilateral swap lines, particularly USD swap lines with the Fed, rather than outright FX intervention per se.

European FX markets are also at risk of contagion

Outside of the typical safe havens of CHF and CZK, European FX should remain pressured. The extent of the sell-off, particularly in PLN, HUF and RON will also be a function of how quickly fears spread regarding the Eurozone's future. See Brexit:Collateral Damage for a full analysis of how we expect Brexit to impact global FX markets.

Implications for bond markets

A curve steepening will likely be followed by a back end rally

An initial steepening of the Gilt 2/10yr curve led by the front end will likely quickly be followed by a back end rally to result in a net parallel shift lower in the sterling curves by the same magnitude of the front end move. In subsequent weeks, the Gilt curve and

GBP IRS curve also sees a material follow-through back end move lower in yields as rate hikes are priced out of the forward space.

German bund yields are moving further into negative territory

The 10yr Bund yield likely tests structurally below zero, to head to the -20bp area, a level that is currently occupied by the Japanese 10yr yield. Eurozone rates could go lower for longer with the German curve structurally negative. The 30yr yield is likely to see one of the biggest cumulative moves. It had climbed back towards 70bp in past days, but is now liable to slowly rally in the direction of (but not get to) zero. The logic for the latter centres on likely build of a wider break-up risk across the EU project and within the Eurozone one. As fissures emerge the logic of having an extreme exposure to the core becomes more secure.

The ECB could step in with additional stimulus

While the ECB would be more likely to extend QE, Bund ASW spreads are bound to widen structurally supported also by the distortive effects of PSPP purchases. The impact on peripheral spreads will be in the direction of widening. Weaker growth for longer is poor for debt dynamics and for re-inflation ambitions. The E-names in the SSA space will likely come under pressure. The EIB due to a likelihood that a high rated issuer (UK) would step out, and the likes of the EU, ESM and EFSF due to association with a wider implosion of EU/EUR sentiment. The fair value BTP spread to Bund in the 10yr will likely extend into the 150bp to 200bp range against levels of around 130bp yesterday.

US Treasuries are receiving a safe haven bid

A feedback loop to the US centres on an interlink through both financial markets and macro circumstances. A relative premium attached to USD favours Treasuries as a safety play, and USD-denominated products generally. Given the higher volatility of USD product versus EUR product generally, we also expect to see a convergence of USD versus EUR product, starting with a tightening in the Treasury/Bund spread to below 150bp.

Fed rate hikes are looking less likely

With a Fed hike less likely the US Treasury curve is shifting lower as an impact effect (2yr yield to target 50bp, coming from above 70bp), but also a slow burner subsequent flatter curve should evolve. The upward sloping USD yield curve contains not just a term premium, but also an expectation for rate hikes. To the extent that rate hikes are pulled out, the forwards should be tamed and the cash curve flatter.

This should be supportive for emerging markets

With a more benign Fed outlook in play, there is a ray of comfort for rates product in emerging markets. However, that would be offset by increased systemic pressures which would add to the overall perception of risk.

Central bank action likely

The BoE may feel the need to shore-up confidence with a rate cut

Bank of England Governor Mark Carney has sought to re-assure the public today that the BoE stands ready to support the economy through both stimulus and liquidity measures if required. While the plunge in sterling would normally be considered a big stimulus (while generating future inflation), it also creates a sense of panic and the Bank of England may consider cutting interest rates by 25bp in an effort to shore-up confidence. The economy has already lost some momentum and as BoE Governor Mark Carney has already stated, Brexit poses “the biggest domestic risk to financial stability”.

The consensus amongst economists is that more stimulus is likely

A rate cut at some point was also the view of 17 out of 28 economists surveyed by Bloomberg ahead of the result while 85% of economists suggested that the economy will need further BoE support in the event of Brexit. Credit easing policies are highly probable with the central bank already injecting liquidity while there is a good chance of an expansion of quantitative easing, which may provide some support for asset prices.

What happens next?

Having failed to convince the nation of the virtues of staying in Europe, David Cameron has taken the decision to stand down with the aim of having a new Conservative Party

David Cameron will step down and Boris Johnson is in pole position to take over in October

leader being in place for the October Party Conference. This person would then take over as Prime Minister. Boris Johnson would be a natural choice for many given he has been one of the leading campaigners for Brexit. However, his style of campaigning has not been universally appreciated in the party. This may mean that Theresa May is a strong possibility (George Osborne's political career, given his ties to David Cameron and the Remain campaign, is likely to be over). May has been far more cautious in her support for the Remain campaign and may be seen as an option that would have a better chance of uniting the party. In terms of this leadership election, Conservative MPs would settle on two candidates that are put forward to the full party membership to vote on.

We await the triggering of Article 50…

which will start two years of formal exit negotiations

Under Article 50 of the Lisbon Treaty, the UK formally has two years to negotiate the terms of its exit before all EU treaties cease to apply (it could be extended if all EU countries agree, but this is not our central view). However, it is important to remember that this referendum is not binding and the decision still has to be formally ratified by the UK parliament, after any legal challenges have been made. Moreover, much will depend on how the rest of the EU reacts, with some politicians having advocated that a hard-line should be taken against the UK. Thus, both the timing and the character of the actual negotiation process is not yet clear.

Last ditch efforts to keep the UK in the EU?

MPs are unlikely to oppose Brexit

Article 50 may not be triggered until late 2016

Seeing as there is likely to be a majority in the House of Commons who wanted the UK to stay in the EU there is the risk that MPs don't back Brexit given the vote was very close. This is not our central case – opposing the will of the people is not going to help you get elected next time, particularly if you are in a marginal constituency. The implication of all of this is that formal negotiations on the UK's withdrawal might not be able to start until 4Q16.

We could see a last ditch effort to keep the UK in the EU

This time period could conceivably see a last ditch effort to keep the UK in the EU with many politicians and central banks wary that Brexit runs the risk of severe financial market volatility and economic contagion that is likely to weigh on global growth. The EU offered major concessions after Danish voters initially rejected the Maastricht Treaty and Irish voters opposed both the Nice and Lisbon Treaties. It is therefore possible that some members want to keep the EU together at all costs and are prepared to offer the UK more on migration.

But this is unlikely to succeed

However, other EU members are going to be opposed to what they see as a watering down of the European project (especially with free movement of people being one of the EU's central tenets). They may therefore feel that the departure of the UK is a price worth paying. Consequently, getting an agreement to give the UK more power to control EU migration whilst staying in the EU does not appear to be a probable outcome.

An Amicable or an Acrimonious Divorce?

How the negotiations go will determine the level of economic pain

The key question now will be whether the UK's divorce with the EU can be a friendly one, which will limit the economic pain, or whether it will break down in acrimony. If it is the latter a toxic political environment could lead to protracted negotiations, resulting in significant economic distress for the UK and Europe more broadly. The resulting financial market volatility coupled with economic contagion could have global ramifications.

EU and UK officials said lots of things ahead of the referendum, but positions may well change now it is happening

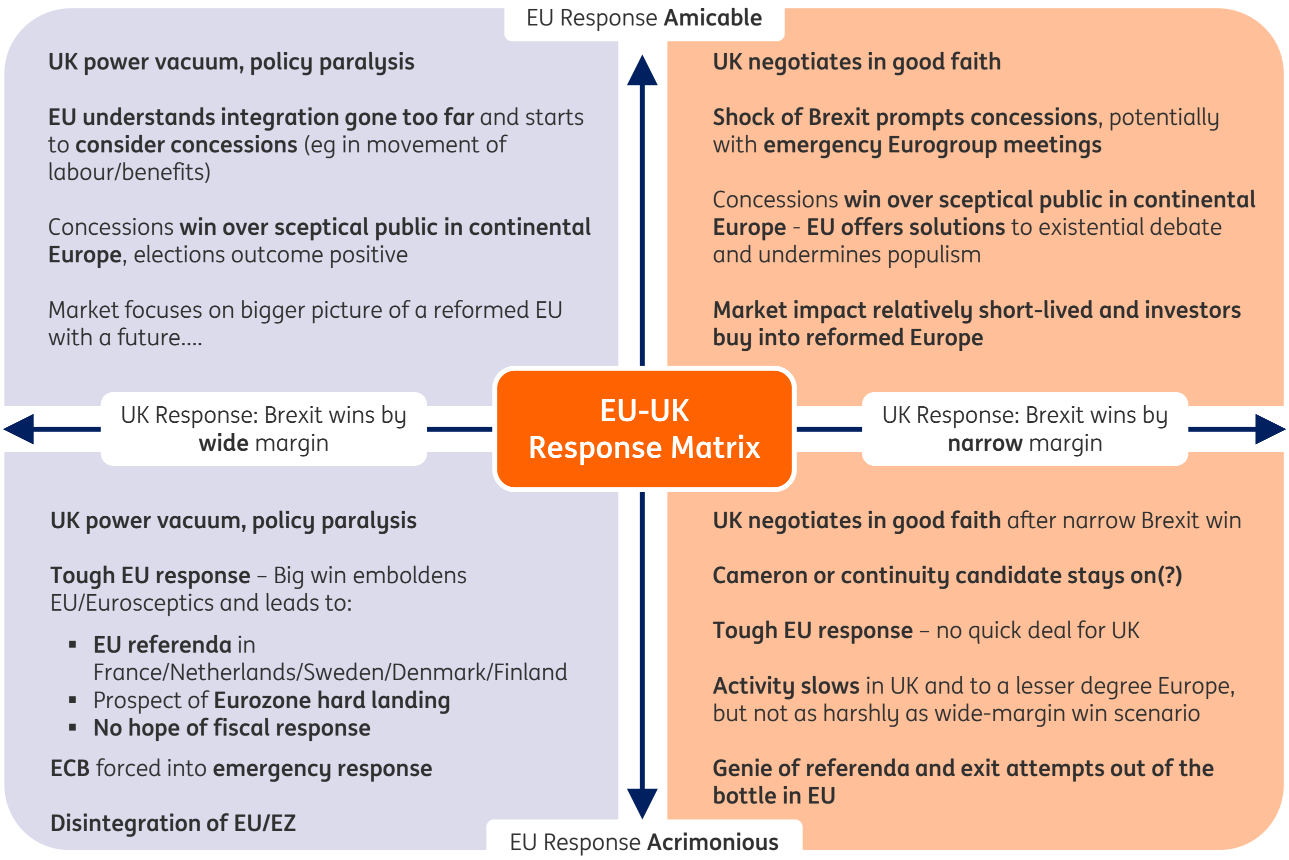
Comments made ahead of the referendum from British and non-UK politicians (on both side of the campaign) have to be interpreted cautiously. We have to consider that the respective narratives were at least partly designed to convince British voters to either vote in favour of staying in the EU or leaving. For example, things may not be as black and white as comments from German Finance Minister Wolfgang Schauble that "If the majority in Britain opts for Brexit, that would be a decision against the single market. In is in. Out is out." Nor too from the US Trade Representative Martin Froman that he is "not particularly in the market for free trade agreements" with the UK. The economic realities of the situation may mean people are more pragmatic now that they have to deal with Brexit.

The initial steps

Britain will have to decide which laws it wants to keep

The first step will be to decide which EU laws the British government wants to keep and which to discard. How long this would take is unclear, particularly given the small government majority (in what will be a deeply divided Conservative party) and the need to get all of these changes approved through parliament. Legal experts also suggest that this is going to be far trickier and will take longer to achieve that many in the Brexit camp had claimed

Fig 1 Potential EU-UK responses in alternative scenarios



Source: ING

This could take years to agree and then there are plenty of other issues to grapple with

However, things will soon get much tougher as we get preliminary discussions on the rights of British citizens living and working in Europe and the reciprocal rights of EU citizens living and working in the UK. They then become even more challenging when we move onto the topic of trade. We think it is helpful to look at how the situation may develop using the table below.

The bad exit scenario

Negotiations are going to be very difficult

Obviously an amicable solution would be the most beneficial economically and UK government officials will likely try to achieve this. However, one political miss-step could quickly lead to a rapid deterioration in relations that would be very difficult to rescue.

Disagreements could soon intensify, making an acrimonious divorce look very likely

One initial issue is how the British trigger Article 50 and formally seek to start negotiations on Brexit. Firstly, we don't know who is going to lead the negotiations and the commentary we have been hearing from senior Brexiteers hasn't always been consistent. For example, some in the Brexit campo say that Article 50 should be triggered immediately. However, Chris Grayling, Leader of the House of Commons and a key

Brexit campaigner, said he wants Britain to ask Brussels for a more informal divorce process. He believes Article 50 may not need to be triggered quickly and has suggested that it could be end 2019 before the UK exits the EU. This is at odds with the 2 year timetable suggested under the Lisbon treaty.

Brexiters are already proposing early changes that flout current EU law

More controversially, Grayling also suggested that the UK could limit the role of EU judges, while also restricting free movement of people before the UK leaves, stating that "we should start delivering change at the earliest opportunity… to prevent a massive influx of people". While again we have to interpret these pre-referendum vote comments cautiously given the "spin" surrounding them, they will only infuriate EU officials.

The political backdrop in Europe is likely to make agreeing a deal even more difficult.

This is especially significant given the political backdrop in Continental Europe. There are Spanish, Dutch, French, German and Italian elections in the next eighteen months, and the rise of anti-EU sentiment has been felt here too. Marine le Pen's National Front is leading opinion polls in France – she wants to be known as "Madam Frexit if the European Union doesn't give us back our monetary, legislative, territorial and budget sovereignty". In the Netherlands it is Geert Wilders' Freedom Party that is leading and he backed Britain leaving, saying that he wanted the Netherland to become more like Switzerland, "in the heart of Europe, but not in the European Union". As for Italy, Beppe Grillo of the Five Star Movement has backed the idea of a referendum on EU membership, saying "either this Europe changes, or Italy must once again become Italy".

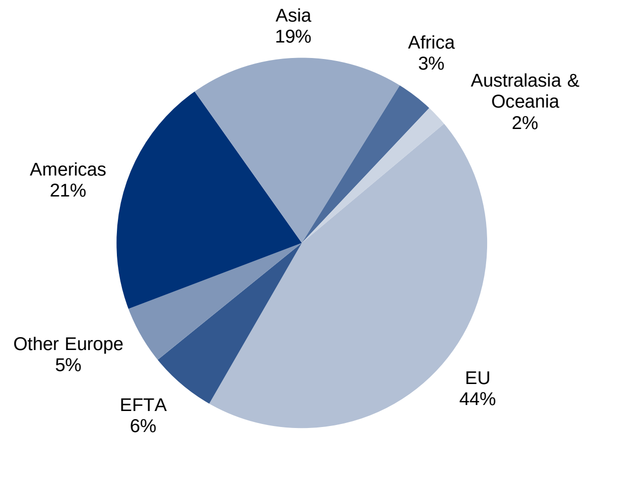
Support for the EU in Europe is weakening too

A recent study by Pew Research Center showed that currently only a median of 51% across ten EU countries have a favourable view of the European Union. Support for transferring more national powers to the European level is much smaller, ranging from 6% in the UK to 34% in France. This unease with Europe is likely to gain more momentum after the British leave-vote. Therefore there is the clear risk that EU leaders to head into "self-preservation" mode with some governments feeling that they can't make leaving the EU look an easy or "cost free" option.

Politicians on both sides will be fighting for their own futures as well as their nations

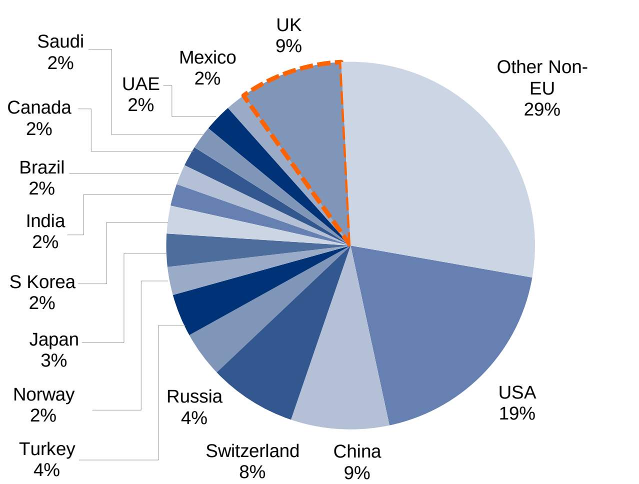
As a result, negotiations could start in an environment of high tensions. This could be fuelled if EU countries take a tit-for-tat response to UK citizens in their countries should the UK government choose to disregard the EU rules over the free-movement of people. One conceivable policy stance in such an environment could be for the Spanish and French governments to threaten to ban UK retirees from reciprocal arrangements on healthcare. In a worst case scenario the EU could enact Article 7 of the EU Treaty that is used to deal with law breaches by EU members and would suspend the UK's rights within the single market.

Fig 2 Destination of UK exports



Source: Macrobond

Fig 3 Destination of extra EU (ex UK) exports



Source: Macrobond

Trade agreements will be the huge challenge

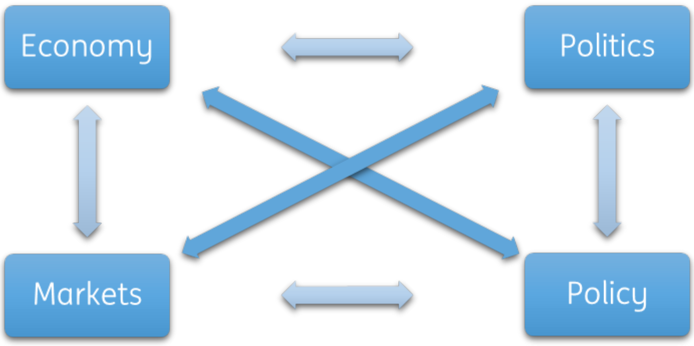
In any case, trade negotiations are clearly going to be difficult. This is despite the claims of Brexiters that it is in the EU's economic interest to give the UK a quick deal on the basis that the UK runs a substantial trade deficit with the EU so it isn't in their interest to harm trade relations. It can be looked at in another way whereby 50% of the UK's exports go to the EU while less than 10% of the EU's exports go to the UK. This suggests that the balance of power in negotiations favours the EU – the UK would be damaged far more if no deal was agreed.

The UK could trade under World Trade Organisation Rules…

… but this would cause tariffs

In such a caustic environment, trade negotiations are likely to be long and tough and will almost certainly exceed the 2 year window that the UK can continue to operate in with free trade. Consequently UK-EU trade may have to operate under the World Trade Organisation rules for a time, leading to the introduction of some tariffs. This could become something of a barrier to trade although the actual economic cost is not particularly clear. Another consequence of this drawn out situation is that it will show to disaffected continental European voters that leaving the EU is not a panacea (note that opinion polls across Europe show rising demands for new deals and referendums along the UK lines) and may weaken support for anti-establishment political parties.

Fig 4 Systemic Interaction: politics, economics, policy and markets



Source: ING

All sides will lose and we could see heightened tensions within the EU

The economic cost will be high for both Europe and the UK and could be even worse if at the upcoming European elections the financial market turmoil and deteriorating growth backdrop results in a victory for anti-EU politicians. Such a scenario could see another referendum on EU membership being called that could lead to fears of a domino effect of EU breakup and Eurozone break-up. At the very least, we may see incumbent politicians adopt some of the more populist parties policies, leading to heightened tensions within the EU. Such an environment would lead to the EU's "ever closer union" mandate switching towards "ever looser union".

Political uncertainty will add to the economic risks

If negotiations go really badly for the UK we could see political defections and bi-election losses for the Conservatives that could lead to domestic gridlock in the House of Commons. In this environment we could see MPs falling on their swords and voting for a new election in an effort to kick-start discussions under new leadership. This would add to the political uncertainty and intensify the risks for growth

The good exit scenario

There are possibilities that don't lead to such a negative outcome

Given that the vote to leave was a narrow one, there is clearly the possibility that the UK negotiates in good faith and doesn't seek to flout EU law before concluding formal negotiations. In turn, European politicians take the view that it is better not to penalise a key ally and trade partner meaning an amicable deal can be agreed that minimises the economic costs.

Certainly, Europe's worst nightmares have come true. Last night's Brexit-vote has finally buried the idea of an ever closer union, in which all European countries strive for more

It may kick-start a new enthusiasm for changes in the way the EU operates

integration. Obviously, this process had already been battered by several events over recent years but the Brexit-vote is now convincing evidence that continuing with "business as usual" is not sustainable. The risk of political contagion is high – potentially as bad as a gradual and lingering disintegration of the European Union and the Eurozone. The British leave-vote has already led to copy cats in other countries, as illustrated by recent comments by Marine Le Pen and Dutch support for the British leave-camp. The rest of Europe could therefore see the British vote as a chance to start a real and detailed discussion on the future of Europe and the Eurozone.

This would weaken the anti-EU parties that have been gaining momentum

In an amicable scenario we could see the EU take on board some of the criticisms it faces, helping to nullify to some extent the rhetoric of the anti-establishment/anti-EU parties that have been on the rise across the continent. Indeed, earlier this month the president of the European Council, Donald Tusk suggested that the EU should abandon its "utopian dreams" of ever closer integration and focus on practical measures such as reinforcing borders and a banking union. He went on to say that "obsessed with the idea of instant and total integration, we failed to notice that ordinary people, the citizens of Europe, do not share our Euro-enthusiasm."

This would be a more encouraging environment for the economy

If the EU does indeed take on board some of the criticisms and act we could see a sceptical public gradually being won over, leading to mainstream parties holding onto power. Such an environment could see significant positives as businesses and markets focus on the bigger picture of an environment more conducive to reforms prompting growth and employment.

Scope for a change of heart?

Could the UK and Europe have a change of heart if discussion reach gridlock?

Another (admittedly low probability at this stage) possibility is that after 18 months of negotiations there is no sign of a deal being agreed. It may be possible that the EU offers Britain more concessions in return for staying in the EU or alternatively, the British take the view that actually it may be better off staying in Europe after all. This could lead a relatively pro-EU British parliament approving a second referendum that could see the UK stay.

The outlook for negotiations is unclear with plenty of scope for disappointment

Given the fast moving environment in the wake of the Brexit vote it is very difficult to determine what is the most likely path for UK-EU relations at this stage. Discussion could quickly veer from the positive to the negative and back again. What we do know is that the longer it takes to decide the outcome the greater the political and economic costs for both the UK and the EU.

UK Political implications

The Conservative Party will have been deeply wounded by this referendum

While Brexit is going to have immediate political repercussions for the Conservative party and the country as a whole with a new Prime Minister, it may trigger a broader realignment of British politics, particularly on the centre-right and right. It may prove to be difficult to re-unite the Conservative Party around a Brexit strategy after a very divisive campaign. It is not inconceivable that the pro-EU and economic liberal part of the Conservative Party peel-off while some UKIP members join an avowedly Eurosceptic Conservative government (although UKIP only has one MP).

UKIP could wither now that its reason for existence has gone

In fact, it brings into question the future of the UK Independence Party, led by Nigel Farage. They won 12.7% of the vote at the 2015 General Election and if the party withers now that their reason for existence has disappeared, both Labour and Conservatives could benefit. However, Nigel Farage has suggested that UKIP will continue to have a job, stating that "we'll need a strong UKIP to make sure the Government do not break faith with the British people and keeps its promises". This may be the case in the near term, but the next election isn't until 2020, by which time the UK will have left the EU and what would be the point of a vote for UKIP?.

The labour Party is also deeply split

There are also possible implications for the Labour Party – the UK's main opposition Party. The right wing of it is likely to be deeply unhappy that its leader, Jeremy Corbyn, was rather lacklustre in his efforts to avert Brexit. This could run the risk of a leadership challenge. However, given the populist disaffection with austerity and migration, uniting the Labour Party around Blairite pro-European social democracy would not be easy either.

We are likely to see an extended period of political infighting and instability

The consequence of all of this is that we are likely to see an extended period of political infighting and instability, which would be bad news for confidence and growth. We could also see major shifts in policy. There are a number of competing tendencies of the Right: small-state free-marketeers, One-Nation social liberals, and English nationalists prepared to pay an economic price for tight migration control.

We may see a loosening of fiscal austerity

Eventually, we may see a compromise that waters down the current government's austerity strategy, partly to put more resources in to help cope with the migrant influx, and partly because of a neo-liberal bias to tax cutting. Pragmatists may also argue that fiscal rules should be loosened to support investment (whether public or private).

Scotland (& Northern Ireland?)

Scottish independence may now come back on the agenda

With Scotland having voted in favour of remaining in the EU and Scottish nationalists communicating a strong message that this highlights the need for independence (having been forced out of the EU by the English against their wishes) we are going to hear mounting calls for a second independence referendum, especially If opinion polls in Scotland show a strong swing towards independence. Polls are currently 44% pro-independence with around 48% wanting to stay in the UK with the rest undecided.

Despite the 2014 vote being described as a "once in a generation" event

The British government at Westminster may argue that it is not going to acquiesce given that the 2014 referendum was supposedly a "once in a generation" event and that the UK authorities will be focussed on resolving the "divorce" with the EU. Privately, the thought of negotiating two divorces at the same time (UK leaving the EU and Scotland leaving the UK) would be far too challenging and intensify the economic dislocation and damage to growth and jobs. The British government may say that people should wait to see what the deal with the EU is likely to be before pushing for Scottish independence.

Some Conservatives may be willing to listen though

That said, the Conservatives are divided (and might even split) while elements of UKIP may potentially defect to the Conservatives. Therefore there may be more willingness to bow to the democratic will of Scotland to stay in the EU, particularly as a Scottish departure from the UK would strengthen the Conservatives' hold on power in the rest of the UK. Moreover, in an environment of weak economic activity, popular discontent, north and south of the border, would mount.

The Northern Ireland vote for EU membership could have implications for the UK

The emergence of a strong Northern Ireland vote for 'Remain' could also awaken calls for some form of split with the UK given the relationship with the Republic of Ireland. Developments on this topic are certainly something to watch.

The economic impact on the UK

The UK has already been showing signs of slowing ahead of the vote

There had been evidence of a loss on economic momentum in the build-up to this referendum. Confidence indicators had softened, employment creation had slowed, housing activity had weakened (although this may also partially be due to tax changes) while business surveys suggested that investment plans had been scaled back due to the uncertainty being generated by the vote. We are concerned that this loss of momentum will only intensify due to the economic uncertainty the UK now faces.

Trade concerns are what most people have been focusing on

Trade always attracts the headlines when it comes to the economic impact from Brexit. Certainly any deal that is agreed will have implications for the economy, but we have to remember that for the next two years the UK remains a member of the single market and can trade freely within the EU – assuming the EU hasn't invoked Article 7. In actual fact, the UK's trade position could improve in the near-term due to the plunge in sterling, which will boost the UK's international competitiveness – it is around 9% lower than its November high.

We are more wary of the near-term hit to investment and jobs

Domestically, the near-term growth story is likely to be dominated by the impact on sentiment and the implications for spending and job creation. Given that the majority of businesses were in favour of staying in the EU (The Deloitte survey of UK Chief Financial officers showed 75% said it was in the UK's economic interest to stay in the EU with just 8% favouring Brexit), there is likely to be a very cautious reaction. Indeed, with stock market futures pointing to a sharp fall in share prices this morning after a 7% fall since April this air of uncertainty is likely to lead firms pulling back or even cancelling hiring and investment plans. A more gloomy prognosis for the economy and falling asset prices and a significant weakening of the currency (which will put up imported goods and services prices) is also likely to dampen consumer activity.

Foreign investors will react cautiously, but could pull back doing to uncertainty

The UK has been a key recipient of both portfolio and Foreign Direct Investment (FDI) over the past few decades, receiving more FDI than any other EU country while the stock of inward FDI is second only to the US. There is clear concern that now the UK is leaving EU then this situation could change, which would be bad news for growth and jobs. Note that United Nations data shows 21% of all investment spending in the UK over the past 20 years has come from FDI. Given the uncertainty over the UK's future relationship with the EU, immediate investment plans by foreign companies into the UK could be put on hold. Likewise, there will be knock on effects for investment by British firms as they consider whether they need to boost continental European operations at the expense of the UK.

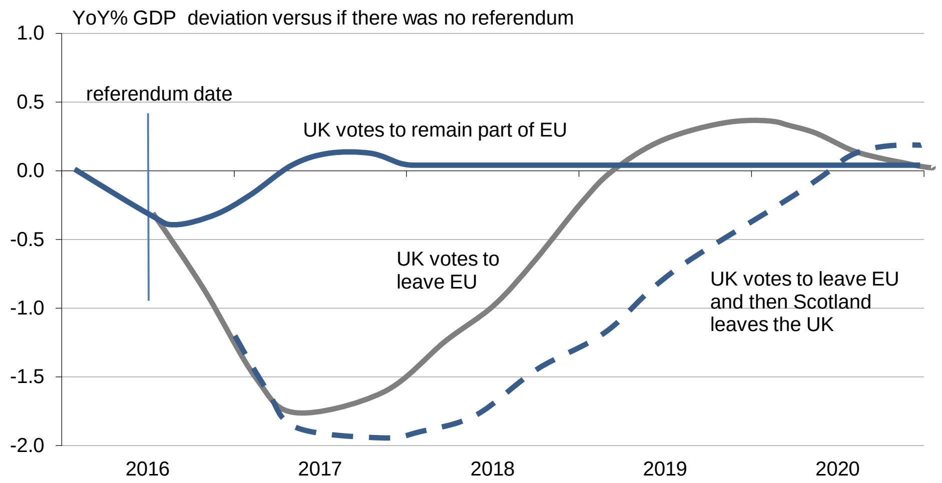
Brexit will be very bad news for the growth outlook

In our Brexit preview report published in January, we suggested that growth in 2017 could be around 1.2 percentage points lower if the UK left the EU relative to what would have been the case if there was no referendum. This is, of course, is speculative, but we see no reason as to why the short-term economic outlook should be improved by Brexit. However, should the negotiations prove to be acrimonious then we have to think that the downside risks for growth would be even greater.

Scottish independence would compound the problems

It would likely be even worse if Scotland was to push for independence. Going through one divorce (with the EU) is painful enough, but two (with Scotland as well) would have huge economic, political and social ramifications that will only intensify any negative confidence and growth implications of Brexit, while also prolonging the economic pain.

Fig 5 Potential deviation from trend growth of Brexit



Source: ING

We think the bank of England will try and support the economy with stimulus, rather than focus on temporary currency induced inflation

Given the lack of inflationary pressures in the global economy, the Bank of England will have plenty of room to leave monetary policy ultra-accommodative and they may well decide to loosen policy if activity does deteriorate as we expect – hence our call that such a move could happen today. Indeed, the BoE admitted last year that 0.5% is no longer viewed as the "effective lower bound" for Bank Rate due to the improved health of the UK's financial system and the fact that negative interest rates are in operation in many parts of Europe. We doubt that Bank Rate would turn negative, but a level of 0 or 0.25% seems probable for end 2016. We may also see some credit easing policies coming though should the Bank of England become increasingly concerned about the possibility of a lending slowdown as banks become more cautious on providing credit.

We don't think they will raise interest rates

Some analysts argue that the Bank of England may go the other way and raise rates to help support sterling and prevent the plunging currency pushing up import prices and CPI. There is a strong probability that inflation will rise sharply as a result of currency weakness, but we think that the BoE will look through this, as they did in 2011, and focus on the growth risks, which would dampen domestic inflation pressures over the medium term.

Some businesses may look to change suppliers in advance of a trade deal

While we suggested that trade is not our biggest concern in the near term, there is the risk that some European businesses start to look elsewhere for suppliers (rather than UK businesses) on the basis of securing long term trade partnerships that avoid tariffs in a post Brexit world. However, (depending on the rhetoric) we assume that most organisations will expect the UK to get some form of trade deal eventually and therefore the impact on UK activity from early switching is likely to be small.

The medium term

A weak currency and lower interest rates should help offset some of the negatives

After a period of economic upheaval, growth prospects should be boosted by a weaker currency and low interest rates. There would be more positives if a trade deal with the EU can be agreed quickly (amicable divorce). As we outlined earlier the political calendar in Europe may make this difficult, but should Europe in aggregate take a pragmatic view then it cannot be ruled out. On balance we still think that it takes longer than the 2-year window to agree a trade deal.

But there will be abrriers to trade

If the UK ended up having to trade with the EU under World Trade Organisation (WTO) rules the UK would face the so called "Most Favoured Nation" import tariffs when exporting to the EU, just like the US. Vice versa, the EU would have to pay these tariffs for exporting to the UK. Besides tariffs, the UK would have to deal with non-tariff barriers if it leaves the EU. Examples include product standards, anti-dumping legislation and labelling standards. Many studies show that this issue is a bigger trade obstacle than tariffs, which have been reduced steeply over recent decades.

Some form of bi-lateral deals seem likely, but the city of London is facing a tough environment

In terms of any eventual deal, the most likely option would be to sign a specific EU Free Trade Agreement and then agree as quickly as possible bi-lateral deals with non-EU trade partners as the UK would no longer come under the EU or EEA banner. This would prevent sizeable tariffs and would allow control over the number of EU migrants moving to the UK. However, there could be damage to the City of London's status as a leading financial status if the UK cannot negotiate "passporting" to allow firms to operate as they currently do, risking the loss of business to Dublin, Paris and Frankfurt. It would also see jobs transferred abroad, which would lead to lower UK tax revenues as well

Trade with non-EU countries could face extreme difficulties

We also have concern that the UK may struggle to agree trade deals with non-EU countries on terms that match what it currently has as an EU country. Consequently there may be broader trade disruption if other countries do not feel the same urgency that the UK does in getting a deal. That said, the EU trade agreements already in place could be used as a template for the UK. We doubt that most countries would want to damage trade relations with the UK largely because most countries actually run a trade surplus with the UK.

Foreign investment will continue to weaken

Another key headwind will be investment. There are a number of factors that determine whether a foreign company wants to put money to work in the UK. They include the regulatory and tax environment, the quality and cost of workers, a competitive exchange rate and the strength of the economy. However, the decision will also be based on whether there is good access to key markets. Therefore, even if the UK manages to negotiate a favourable trade deal with the EU, the uncertainty during the negotiation process and the time taken to agree a deal will likely make foreign investors cautious.

The UK will no longer be viewed as favourably as a base for European operations

FDI from EU countries is obviously at risk, but so too is non-EU FDI. If, as a foreign (non-EU) company, your main objective is to sell into the EU market then it would probably make more sense to place your factory or plant in a country that is actually a member of that economic zone and not one that is potentially subject to tariffs or some form of restrictions.

Current investment projects may not be renewed

The stock of FDI is less likely to be impacted in the near-term as it would be very expensive to shut down a factory and build a new one in an EU country. However, there may be a diminished prospect of that factory receiving ongoing investment. Furthermore, if a global economic downturn was to hit, the UK plant would run the risk of being relatively high up on the list of plants to shut. This emphasises why the UK government will be keen to get a deal done as quickly as possible that keeps the UK's trade relationship with the EU at the current level.

UK companies may also start to move investments abroad

It is also possible that some UK companies contemplate investing overseas rather than in the UK, fearing that they be at a disadvantage if they do not have an EU base. Note that a British Chambers of Commerce Survey of 4,387 UK companies showed 60% of respondents saying they thought an EU exit would harm their business with just 18% in favour of an entire withdrawal from the EU. This would depress domestic investment.

Financial savings from Brexit may be overstated

The Brexit campaign has placed a strong emphasis on the amount of money the UK government contributes to the EU budget (just under £9bn per year in net contributions). The fact the UK is leaving will mean that this is no longer going to be happening, leading to savings for the taxpayer. However, the price of trade access to the single market might be some form of continued contributions. Moreover, given the hit to economic output we anticipate, tax revenues are likely to be lower than would have been the case if the UK had voted to stay in the EU. To put these "savings" in some context the government will still have a debt in excess of £1.6 trillion pounds.

The Longer term

UK's prospects will be driven by the "new found freedoms" it can obtain

In the longer term the UK's prospects will be driven by what the post-Brexit Conservative government tries to do with its new found "freedoms" out of the EU. One potential course of action could be sweeping tax changes designed to encourage investment and job creation in the UK – the scale of which will be dependent on who is actually in power. These may well offset the negative impacts highlighted in the LSE study regarding the longer term drags on UK trade from leaving the EU. It is also possible that there are other benefits such as lower house prices being a positive for society while less focus on financial services would help diversify the UK economy.

There may be issues about obtaining migrant labour…

… while we may see pensioners returning to the UK

There have been concerns that not having access to EU workers could lead to labour supply shortages in the future – recruitment company, Manpower, has been vocal on this issue. Brexit supporters argue that not being in the EU will allow immigration policy to be planned to better match the needs of the economy and that the UK can still accept EU workers, but on the UK's own terms. It is therefore difficult to make judgements on the likely long-term growth rate in the labour force. Nonetheless, if we do have the acrimonious divorce then we could see a significant number of pensioners having to return to the UK (if health benefits have not been reciprocated, for example). This would have implications for government policies and spending.

We doubt that any gains from Brexit will offset to earlier pain

In aggregate, thanks largely to the weaker sterling and low interest rate environment, growth could actually turn out to be temporarily stronger in 2019-20 than had the UK voted to stay in the EU, but this is far from certain and also depends on the implementation of bi-lateral trade deals with non-EU economies. However, we doubt very much that it will have made up for the economic losses through 2016-18. It is also impossible to say whether growth after 2020 will be any better out of the EU than it would have been within it.

What does it mean for the rest of the EU?

Europe's economy will also suffer from Brexit, largely from sentiment and FX moves

We have already suggested that in the short term the Brexit-vote will likely create a lose-lose situation for both the UK and the rest of the EU. Financial market turmoil, plunging sentiment indicators and new uncertainty are likely to dent consumer confidence, bringing the recent tender revival of consumer spending to an end, and are also likely to further undermine investment. However, as there will be no imminent substantial changes to trade agreements or investments, the economic impact for the rest of Europe will come from psychological factors, sentiment and the exchange rate.

EU leaders will be focused on keeping the European project alive

Much will depend on the reaction and rhetoric of European political leaders. Most likely, we expect European leaders to send out strong messages about their commitment to facilitate smooth negotiations with the UK but also about strong determination to keep the European spirit and project alive. Even though European leaders might be tempted to opt for an amicable divorce, in our view an acrimonious divorce is more likely. Indeed, there is the clear possibility that Brexit will swiftly spark anger and recriminations that will have severe implications for confidence and activity.

Growth will be around 0.3pp weaker in the Eurozone

In our base case scenario, we expect the Brexit decision to shave off 0.3 pp of Eurozone GDP growth over the next two years, with countries with important trade and investment ties with the UK (Ireland, Netherlands, Belgium) hit the most. In a more acrimonious divorce, uncertainty is likely to last much longer, reducing Eurozone growth in the period 2016-2017 by 0.6 pp. Note that these are the median estimates and that a worse outcome cannot be excluded.

ECB will have to stand ready to support the economy

In those circumstances there will be even more pressure on the ECB to calm markets and play an active role in stabilising the economy. The ECB is likely to set up swap lines with the Bank of England to provide for sufficient liquidity both in euro and sterling. Apart from that, we expect the ECB to stay in crisis mode with additional liquidity injections if need be but also a very flexible and tailor-made use of its QE purchases to tackle any widening of government yield spreads.

The emergence of anti-European and anti-immigration parties mean discussion of Europe's future are more pressing

Looking beyond the short-term turmoil and European emergency measures, the British leave-vote will bring new momentum to the EU's existential debate. With elections coming up as early as this weekend in Spain and then next year in the Netherlands, France and Germany, Europe has reached an important crossroads again. In the run-up to the British referendum, European leaders have refrained from a fundamental discussion on the future of and for Europe. Now, however, with the emergence of anti-European and anti-immigration parties, it will be hard to shy away from this discussion.

Other EU countries may want their own "deal"

In that regard a fast amicable solution with the UK after Brexit is unlikely to solve the existential problems, on the contrary. If the UK is able to get a quick deal this would also encourage other disgruntled member states to seek their own tailor-made arrangements, by threatening to leave. While this could push some European leaders to be tough in the negotiations with the UK, the likely more negative economic impact of this approach, is not going to improve the popularity of the European Union either.

Europe has many challenges heading its way

Even though we think that there could be long-run benefits, particularly for Eurozone core countries, from a Brexit, the British referendum in the short run will add to the already existing list of unsolved issues or issues that were pushed under the carpet in recent weeks, in order not to influence the referendum. Just think of the slowing reform efforts in all European countries, the fundamental discussion on the right direction for fiscal policies in the context of the Stability Pact, how to deal with Greek debt or the general failure to really kick-start the economic recovery.

It may also have to respond to shifts in UK policy

Adding to the complications will be how Europe deals with any significant change in UK government policy in response to its own challenges. A shift in the UK's economic strategy – say to competitive tax cutting or deregulation – may also add to the pressure for change, either to follow suit, or to retaliate with protectionism (including on financial services).

The risk of sneaking disintegration of the European Union and also the Eurozone is still there

The worst-case scenario for the rest of Europe after the British leave-vote would be to consider the British vote as a horrible one-off and return to business as usual. The risk of sneaking disintegration of the European Union and also the Eurozone is still there. This is all the more likely if the rest of Europe fails to see the British vote as a chance to start a real and detailed discussion on the future of Europe and the Eurozone. A discussion which goes far beyond the questions: 'in or out', 'more Europe or less Europe'.

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