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How Did We Get Here and Where Are We Going? A Brexit Update.

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How did we get here?

What happened with the Withdrawal Agreement in the past few months?

What are the economic consequences of Brexit when it happens?

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The victory of the "Leave" advocates in the June 2016 referendum on the United Kingdom's (UK) participation in the European Union (EU) initiated the complicated process of disentangling the UK from the EU. After activating Article 50 of the Lisbon Treaty on March 29, 2017, the UK had two years to negotiate the terms of the exit deal with the EU. The official exit, commonly referred to as "Brexit," was scheduled to occur on March 29, 2019. However, a very divided British parliament repeatedly rejected the exit deal negotiated by Prime Minister Theresa May, leading to a postponement of Brexit to mid-April and then most recently to the end of October 2019.

Foreign exchange and stock markets showed a muted response to the latest delay, indicating that it was largely expected. Broadly, the seven-month delay means that uncertainty will continue in the months ahead, likely costing the UK more jobs and investments, as a "no-deal Brexit" scenario, in which the UK leaves the EU without any form of negotiated trade and investment relations, remains on the table. Against this background, our newsletter provides an overview of Brexit, possible scenarios going forward, as well as their implications for the UK, the EU, and financial markets.

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The negotiation process: how did we get here?

In the run up to the 2015 Parliamentary elections in the UK, then Prime Minister David Cameron agreed to a referendum asking the British people if they wanted to stay in the EU if his Conservative party, also known as the Tories, won. At the time, his main goal was to gather support from the Euro-sceptic Tories in the elections, which would then enable the UK to pressure the EU and negotiate better terms for the UK's membership (see our note from December 2016). The UK held the Brexit referendum in June 2016. In a surprise result, the "Remain" ticket, supported by PM Cameron, lost by a narrow margin, with England and Wales voting in favor to leave, and Scotland and Northern Ireland voting to remain. The vote launched the UK into the complicated process of leaving the EU after over four decades of membership. Prime Minister May, the successor to Prime Minister Cameron, activated Article 50 of the Lisbon Treaty (which provides for member withdrawal from the EU) in late March of 2017. This marked the beginning of the "Brexit negotiations" between the UK and the EU. Initially, if the UK and EU could not negotiate an agreement within two years, the UK was supposed to immediately leave the EU and all existing agreements with EU countries would cease to apply to the UK.

The focus of the negotiations between the UK and the EU has been to avoid major financial, economic, and legal disruptions that could result from the UK leaving the EU. The UK government and the EU completed a "Withdrawal Agreement" in the fall of 2018, subject to approval by Parliament.

The Withdrawal Agreement

Unsurprisingly, disentangling over four decades of economic integration and common policies between the UK and continental Europe has been a difficult task. The Withdrawal Agreement is a framework that defines the conditions of this process. This 599-page document focuses on four main areas: money (the division of assets and liabilities, as well as settlement of outstanding debts), citizens' rights, border arrangements and customs (particularly the border between the UK and Northern Ireland), and law (the mechanisms for resolving disputes which is currently vested with the European Court of Justice). The Withdrawal Agreement also establishes a two-year transition period after the UK leaves the EU that gives time for administrations, businesses, and citizens to adapt to Brexit, and allows the UK and the EU to decide on their future relationship. Negotiations on the future relations will commence once the UK has left the EU and will address the long-term relationship between the UK and the EU, in which they will formalize matters such as trade, defense, security, and other issues.

During the transition period of the Withdrawal Agreement, EU law will continue to apply to the UK as if it were a Member State: the UK will remain in the EU

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Customs Union and the Single Market (with free movements of goods, services, capital and people) and all EU policies and international agreements continue to apply. However, the UK will no longer have representation in EU institutions, agencies, and bodies. The Withdrawal Agreement also defines arrangements applicable at the end of the transition period such as the rights of the over three-million EU citizens living in the UK and over one million UK citizens living in EU countries.

Importantly, the deal includes a protocol on the relations between Ireland and Northern Ireland.[1] The Withdrawal Agreement seeks to avoid a hard border (i.e., one with customs and passport checks) between Ireland and Northern Ireland and to uphold the 1998 Good Friday Agreement that concluded the peace process in Ireland. This protocol has proven to be the most contentious part of the deal and led to the current deadlock situation.

[1] It also includes protocols on Gibraltar and the UK military base in Cyprus.

The Irish border headache in a nutshell

Northern Ireland is part of the UK, while the Republic of Ireland (comprising the southern majority of the island) is an independent country, as well as a member of the EU. The UK split from the EU means that products and people would no longer freely circulate between Northern Ireland and Ireland, whereas currently both enjoy freedom of movement. Furthermore, Brexit would require a proper border crossing the island, which would conflict with the Good Friday Agreement. How to deal with this issue continues to be the main source of tensions. No party in Parliament controls a majority position and several smaller parties, including one in coalition with the Conservative party, strongly oppose any solution.

The option favored by the UK was the creation of a free trade area between the EU and the UK. This approach means that the UK participates in the EU single market for goods only. However, the EU considers the four freedoms of movements (people, goods, services, and capital) as indivisible. While both sides are exploring non-physical border options via the development of new technologies, the Withdrawal Agreement includes a "backstop solution" for Ireland in case the issue remains unsolved by January 2021. Under this backstop solution, the EU's Customs Code, as well as most of the regulations that enable the single market, will continue to apply in Northern Ireland, and a customs agreement between the EU and the rest of the UK would apply until a new agreement can be found.

What happened with the Withdrawal Agreement in the past few months?

In January 2019, the UK Parliament rejected the Irish backstop proposal and as a result the whole Withdrawal Agreement. It mandated the UK government renegotiate the backstop, but the EU refused to reopen the discussion.

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In March, the UK government failed twice to get sufficient votes on the Withdrawal Agreement. These votes clearly exposed major divisions among UK Members of Parliament. Lines were drawn between those in favor of leaving the EU without a deal (referred to as a "hard Brexit"), those who want to leave with a deal (referred to as a "soft Brexit"), and those who do not want to leave at all. In April 2019, after the EU agreed to a two-week extension, the UK requested a further extension of Article 50 to avoid the dramatic consequences of a hard/no deal Brexit. The EU approved this additional request and a new deadline is set for the end of October 2019. The EU (especially France, which refused a longer extension advocated by other EU members) argues that there should be no further extensions as they are worried that the UK could block the functioning of the EU from inside if allowed to stay too long. In addition to dampening the economic impact of Brexit, some speculate that the EU has an equally important secondary agenda; specifically, to negotiate terms in such a manner as to discourage other EU members from contemplating a split from the union.

October 31 is the new March 29, at least for now

Four options remain on the table with no clear frontrunner:

- Soft Brexit: the current Withdrawal Agreement or a re-negotiated similar deal is considered a "soft" Brexit deal, and if the UK Parliament (which previously rejected the current version three times) approves it before October 31, it would commence the transition period.
- Hard/no deal Brexit: the UK cannot approve the Withdrawal Agreement by October 31, 2019.
- No Exit: The UK cancels Brexit any time between now and October 31.
- Another Extension: In addition to these outcomes, there is also the possibility that as they approach another cliff-edge, the UK and the EU will negotiate another extension to the Article 50 period.

The economic consequences of Brexit so far

The UK's economic growth has already slowed considerably since the 2016 referendum, as reflected in the low business investment and GDP data. (Figure 1) shows that while the UK was growing much faster than the rest of the EU prior to mid-2016, it has weakened since. Additionally, after a period of wait-and-see, business investment slowed down sharply in 2018 (Figure 2). Estimates suggest that the UK's GDP is already 2 to 3 percent lower than where it would have been if no Brexit vote had occurred. The new delay means more months of uncertainty and most likely slower growth.

The impact of Brexit can be felt across the economy and perhaps most notably in the construction sector, which has started to contract due to delayed investment. Additionally, there is evidence that the non-British labor force has

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started to leave the UK (e.g., in the medical sector where 10% of the workforce comes from other EU countries). Businesses are also relocating or planning to do so. For example, Sony and Panasonic have already moved their headquarters to continental Europe, and several Japanese automakers are shutting down plants. More broadly, according to the Institute of Directors survey, because of Brexit one-third of British companies plan to move at least part of their business abroad or are actively considering it. The EY Financial Services Brexit Tracker[2] found that 23 financial companies have announced a transfer of assets (worth a total of £1 trillion) to other EU countries while 75% of the large banks have announced relocations of operations and/or staff. Moreover, Breinlich et al. (2019)[3] estimate that between June 2016 and early 2018 the number of new investments made by UK firms in EU 27 countries increased by 12% (mostly in the financial sector), while new investments in the UK from the EU 27 declined by 11%.

[2] The EY Financial Services Brexit tracker monitors the public statements made by 222 of the largest financial services firms with significant operations in the UK across universal banks, investment banks, brokerages, wealth and asset managers, retail banks, private equity firms, insurers and insurance brokers, and FinTechs. It focuses on issues across sub-sectors relating to staffing, domicile, financial impact, policy asks, product changes, remuneration and opportunities.

[3] See "Voting with their money: Brexit and outward investment by UK firms", Holger Breinlich, Elsa Leromain, Dennis Novy, Thomas Sampson, February 12, 2019, Voxeu.org.

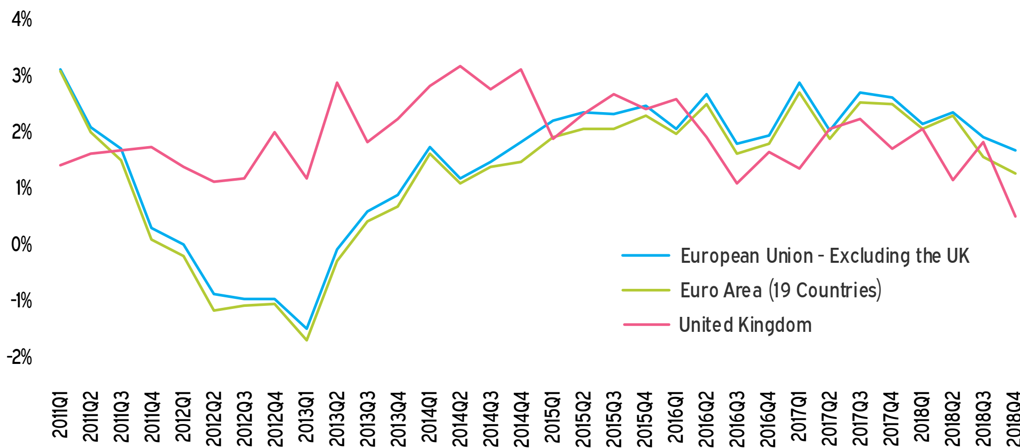

FIGURE 1

Economic Growth Has Slowed Since 2016

GDP Growth (Quarterly, Year on Year)

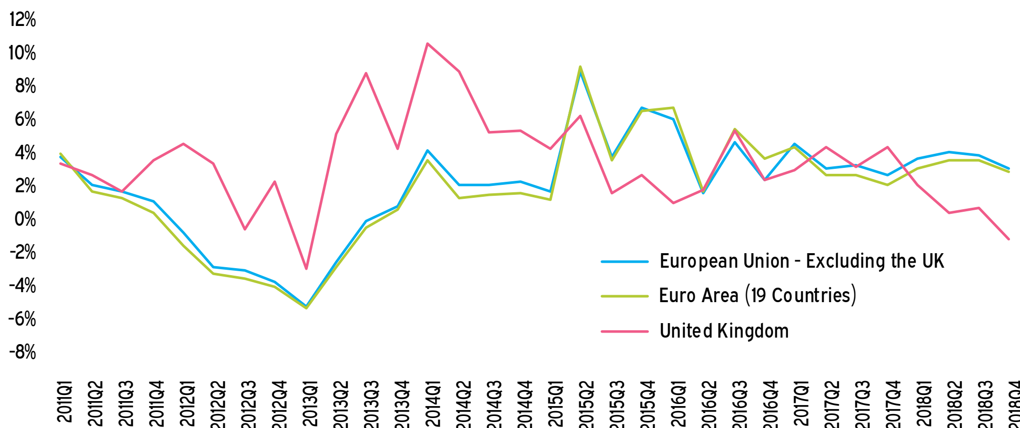

FIGURE 2

Sharp Slowdown of Business investments In 2018

Fixed Investment Growth (Quarterly, Year on Year)

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Relocations are likely to have a negative short-term impact on companies' business profits due to the costs associated with a move. However, they have weighed the risks of a no deal Brexit and many have decided that relocating makes long-term economic sense, since a hard Brexit could mean a temporary or even long-lasting loss of access to the EU market, both for UK firms and foreign firms that were using the UK as an entry point into the EU.

In a hard Brexit scenario, trade between the UK and the EU would require new inspection and regulatory systems that do not exist yet. In a worst-case scenario, it would result in massive trade disruptions with no trade or very low trade for some time.[4] Even if temporary solutions are found to avoid a worst-case scenario, major changes to long-established supply chains within the EU and the UK have to be expected.

[4] See "Untangling Brexit", Dennis Snower, Rolf Langhammer, January 7, 2019, Voxeu.org.

In the financial sector, the main risk of a hard Brexit is the end of "passporting," which would result in UK-based financial institutions losing their ability to sell products and services in the EU. They will instead need a license and regulatory approval or local affiliates to conduct business in the EU.

The economic consequences of Brexit when it happens

The International Monetary Fund has compiled a range of estimates on the impact of Brexit. A "WTO" scenario under which the UK loses preferential access to the EU and adopts World Trade Organization tariffs would result in a GDP 5 to 8 percent lower than in a no Brexit scenario. This estimate may be optimistic, as it does not take into account the initial disruptions. In a scenario where the UK and EU agree on a free trade pact, the cost is expected to be about half the cost of the WTO.[5]

[5] IMF staff calculations.

Even in a soft Brexit scenario where Parliament approves the current Withdrawal Agreement, the conditions for trade and financial activity after the transition period are not yet set. With about 20% of the total manufacturing inputs used by UK companies originating from the EU, any tariff resulting from Brexit would increase manufacturing costs and disrupt supply chains.

The costs to EU members are also expected to be substantial, given the impact on supply chains, especially German ones, but obviously the impact will be lower in a soft Brexit scenario. Compounding the impact is the potential that this event may occur at a time when growth has already slowed in the EU and financial risks are elevated across multiple EU member countries such as Italy and Greece.

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The direct trade impact on the United States (US) is likely to be moderate. Although the UK is the United States' fifth largest export market, it only comprises about 3.6% of total US exports. Brexit may even represent an opportunity going forward for US exporters, especially under a no deal scenario. However, as mentioned above, Brexit will negatively affect US companies using the UK as a gateway to free trade with the rest of the EU, at least in the short-term. Currency fluctuations may also affect trade between the US and the UK. For example, if the UK were to leave the EU with no trade deal the British pound sterling would likely drop in value relative to the US dollar and other major currencies. This depreciation could create additional inflationary pressures and weigh on import demand in the UK, impacting the US and others.

A stronger impact could come from the consequences of Brexit on financial markets. The reactions of currency and stock markets to the extension were limited as it was largely expected. The probability of a hard or soft Brexit both remain high while the cancelation of Brexit is less likely. Given the very different economic outcomes that would result from a hard or soft deal, the potential final market impact has the potential of being large. While the market has likely priced in a weighted average of expectations, in the case of a hard Brexit, substantial further repricing is likely with possible liquidity strains, which in turn could precipitate additional selling, trigger significant further asset price moves, and increase overall risks to financial stability.[6] To mitigate these risks, the UK and EU financial authorities have already put in place safety mechanisms, and the current extension will give them more time to strengthen these mitigation tools.

[6] IMF analysis of intraday liquidity conditions in the 10-year UK gilt market shows some jumps in volatility and liquidity strains around key Brexit events. IMF (2019) Global Financial Stability Report: Vulnerabilities in a Maturing Credit Cycle, April.

Conclusion

As of this writing, the UK and EU had successfully delayed the Brexit decision until October 31, 2019 without dire economic repercussions. However, cracks are starting to form in the British economy. We expect that business investment will keep slowing and the exodus of non-UK workers will continue, weighing on growth and keeping the pound weak in the near term. A weak pound will result in increased inflationary pressures and could weigh on demand for imports from both the US and elsewhere. Our baseline assumption has been that the UK government will eventually manage to secure parliamentary approval for a Withdrawal Agreement. However, the chance of a hard Brexit remains, which is not reassuring given the large potential negative implications. It is worth noting that during the votes on March 27, the motions posed and votes cast indicate that Parliament is strongly opposed to a no-deal Brexit and other forms of hard Brexit.

Political ramifications from the UK's historic decision to sever ties with the EU continue to unfold. After three years of repeatedly trying but being unable to

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negotiate a Withdrawal Agreement that the EU would accept and that could command the support of a majority of the UK Parliament, Prime Minister May capitulated on May 24, announcing that she would resign as leader of the Conservative Party effective June 7. Ms. May will remain as Prime Minister until the party chooses a new leader. At this time, the front-runner candidates to replace her are pro-Brexit, and it seems unlikely that any of them will be able to succeed where May failed given the current makeup of Parliament. However, a new general election or a second referendum could emerge between now and October 31, either of which could break the present deadlock. The UK electorate remains deeply divided, as shown by the results of the recent European Parliament elections, in which all EU members including the UK took part. The leading vote-getter in the UK was the unambiguously named Brexit party, but when taken together the parties that support Remain slightly outpolled those supporting Leave.

In terms of the actual total portfolio impact of the UK leaving the EU in a no-deal or hard Brexit scenario, we estimate it could be approximately a one-time loss of 0.5% to 0.6% of return, based on several assumptions.[7] Regardless, we do not recommend that investors sell their exposure to Developed ex. US assets as a tactic to avoid the potential loss even if the worst-case outcome were to occur. The expected impact for most US institutional investor portfolios is not large even in such a scenario, the proposed way to avoid it is drastic, and it is far from certain that the worst case will be realized, as all sides continue to have incentives to extend the deadline even further.

While this lengthy negotiation surely has many negative ramifications, there may be a silver lining in that Brexit has become a cautionary tale for other countries considering leaving the EU.

[7] Assumes 10% of assets in Developed ex. US equity of which the UK is about 15%, or 1.5% of total assets. The Economist recently forecast a ~20% decline in the pound if the UK leaves with no-deal, based upon FX fluctuations that have occurred as the chance of reaching agreement has seemed more or less likely. Thus, the immediate impact from just the currency move would be -0.3%. There is additional impact from disruption to the UK economy, and to a lesser extent from a decline in the euro and disruption to the EU economies (which are collectively about 1/3rd of Developed ex. US equity). Accounting for the economic impact, we arrive at -0.5% to -0.6%.

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