Euler Hermes Economic Research

Economic Insight

Brexit me if you can: Companies to suffer the most

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Executive summary

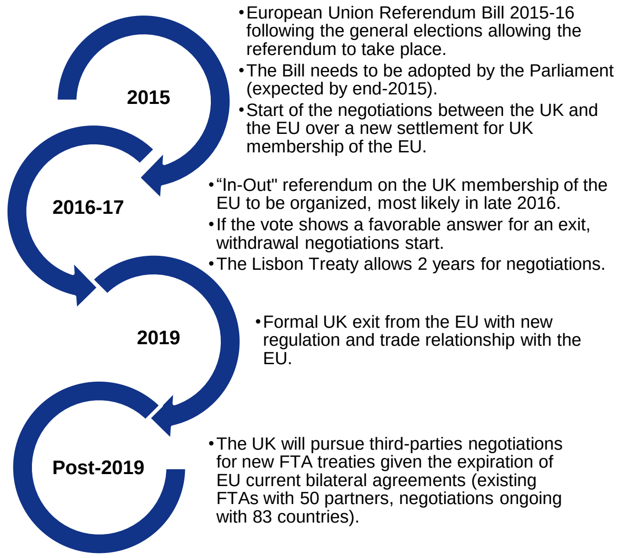
- Increasing uncertainty around Brexit will affect sentiment and might delay investment decisions. We expect GDP to grow by +2.1% in 2016 and +1.9% in 2017, 0.1pp below our previous forecasts due to uncertainty.
- In case of a Brexit, companies' turnover growth could be halved, if an FTA with the EU is signed, and contract without one. Three transmission channels explain this doom and gloom scenario for companies: direct export losses, falling margins (due to higher input and financing costs) and divestment.
- Export losses could reach GBP30bn in the worst case scenario: it would take 10 years for the UK to fill the gap. Margins could fall by up to 2 points on the back of higher input costs and tighter financing conditions. Last, up to GBP210bn of foreign investment could be lost in the next 4 years following the referendum, with the financial sector being hit the most.
- The financial, automotive, machinery and equipment, chemicals, agrifood, textile and energy sectors would be affected the most.

What does Brexit mean?

One of the core 2015 election pledges by the Conservative party was to hold a referendum on the UK's European Union (EU) membership by the end of 2017. This referendum on a so-called *Brexit* (Britain's exit) also is an opportunity to discuss: (i) reducing the involvement of and improving economic governance for non-eurozone countries (e.g. no contribution to euro-bailouts and the banking union); (ii) improving competitiveness (in particular reducing current regulatory burden); (iii) increasing national sovereignty (instead of further European integration); and (iv) allowing more national control on the immigration policy.

An effective exit from the UK will be far from brief: the Lisbon Treaty, which the UK is a signatory of, allows exit negotiations to last for a full two years. During this period, the UK would continue to function as if it still was an EU member (see Figure 1). Euler Hermes' core scenario (and baseline) is *No Brexit*.

Figure 1 - The timeline for a Brexit referendum



Sources: Euler Hermes

However, pre-vote uncertainty will be high, impacting sentiment and delaying investment decisions. According to our forecasts, GDP growth in the UK should slow down to +2.1% in 2016 and +1.9% in 2017, with a loss equal to 0.1pp per year due to investors' risk aversion.

For the sake of this note, we built three scenarios to assess the impacts of a Brexit on British companies. Indeed, being part of the EU gives UK businesses access to a 500-million-strong customer base as well as capital and skills. Our first scenario or baseline scenario (highest likelihood): no Brexit. Our second scenario is a Brexit followed by the conclusion of a Free Trade Agreement (FTA) between the UK and the EU that allows the UK to sign also extra-bilateral agreements with third parties. Our third one is a Brexit without any advantageous FTA.

All in all, without Brexit, companies' turnovers are expected to grow by +4% on average after 2017. In case of a Brexit with FTA, they would grow only +2% i.e. half as fast, and without an FTA, they would contract (-1% per year on average; see Figure 2).

Impact #1: Direct losses for exporters

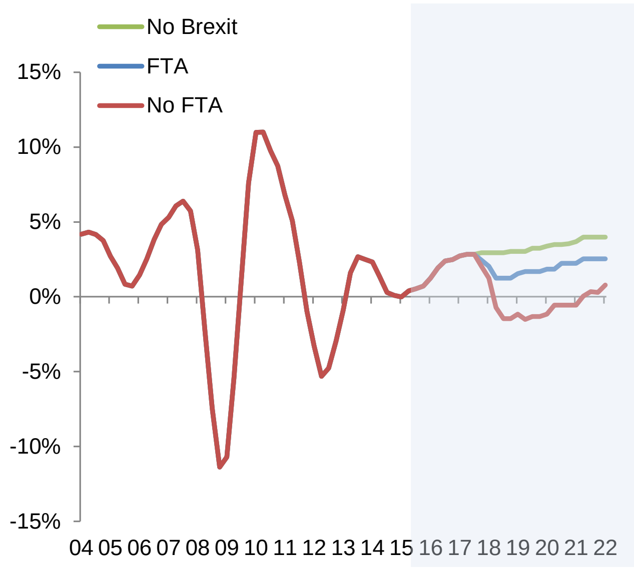
Without a Brexit, the estimated additional nominal goods export growth would be +2% on average per year, i.e. a gain of GBP26bn by 2019. A Brexit with FTA would result in a sizeable impact: the total export loss with the EU could reach close to GBP9bn, or 3% of UK total goods exports.

In the case of a Brexit without FTA, losses could reach up to GDP30bn or 8% of UK total goods exports. It means that it would take at least 10 years to fill up this export gap, even if trade with Commonwealth countries did offset some of it. Under this worst-case scenario, the trade balance deficit, already at record high level, would widen by GBP35bn within 12 months after the formalization of the UK exit from the EU (-30% deterioration, see Figure 3).

UK's SMEs export roughly 37% of total exports, far less than other European countries like Italy and Netherlands where 50% of total exports come from small and medium-sized firms; moreover, the UK is the 8th European economy if we rank countries by their exports. These two characteristics combined together show the high growth and export potential of UK's small businesses (see Figure 4) and make of the Single Market the biggest advantage of being a member of the EU.

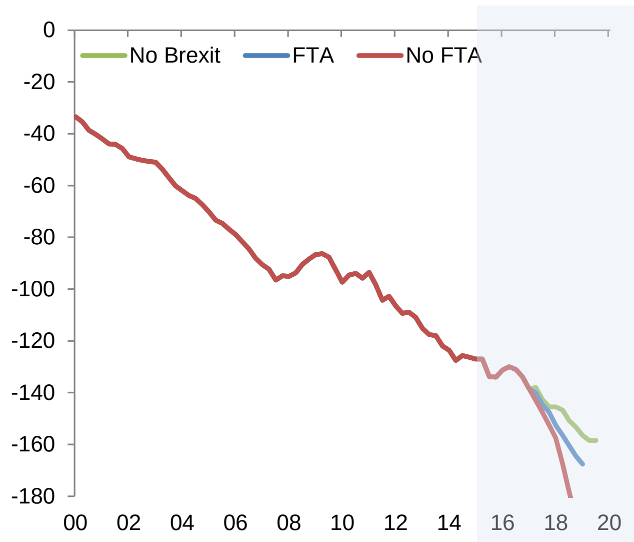
When itemizing export losses by country and by industry, 60% of the UK loss in goods' exports would come from four main markets: Germany, the Netherlands, France and Ireland (see Figure 5).

Figure 2 – Firms' turnovers, 4Q/4Q



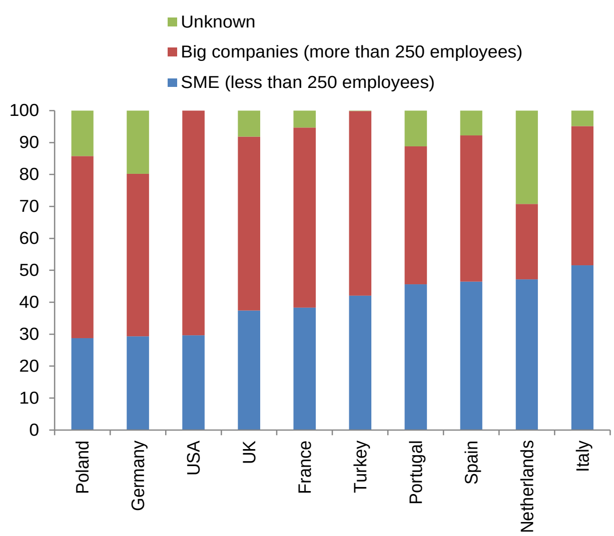
Sources: Eurostat, Euler Hermes forecasts

Figure 3 – Goods' trade balance, GBPbn



Sources: ONS, Euler Hermes forecasts

Figure 4 – UK total exports by size of company (% of total exports)



Sources: OECD, Euler Hermes

Moreover, companies focusing in sectors where the dependency on the European market is significant, such as Chemicals, Machinery-equipment, Automotive, Textile, Energy and Agri-food will feel the pinch most (see Figure 6).

The UK is the second world exporter of services (GBP207.2bn in 2014). Almost one-fourth comes from financial services. Accounting for 80% of total UK output, services have contributed to the strong economic recovery since 2013 and remain major growth drivers, partly offsetting the slowdown of the manufacturing and construction sectors. In case of a Brexit without FTA, services would be impacted by: (i) the drop in activity (transportation sector, IT services e.g.); (ii) the reduction in foreign direct investments (FDIs), especially regarding financial services; (iii) fewer tourists from the EU; and (iv) the additional reporting to a Foreign Regulatory Authority instead of the national one.

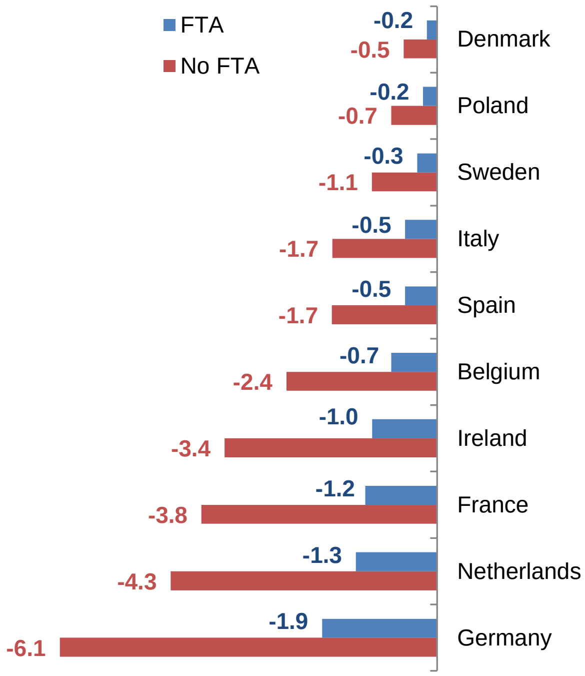
Impact #2: Higher import bills and financing costs

The UK is a net importer of most types of merchandise, with 55% of imports coming from the EU. In case of Brexit without FTA, import prices could increase through: (i) the depreciation of the pound; and (ii) the introduction of new import tariffs from the EU or by the UK (to increase local production and accelerate the reindustrialization process).

Looking at import tariffs that the EU already applies to the rest of the world, following the Most Favored Nation (MFN) rule and extrapolating these to the UK situation, most affected sectors would be Clothing, Chemicals, Automotive and Agri-food, with the highest imposed tariffs on Beverages (32%). On top of tariffs, non-tariff barriers could be put in place such as introducing new products standards (packaging, labelling and sanitary requirements e.g.). If we look at the UK's (final) demand of goods by sector (see Figure 7), more than 50% of the value added in Agri-food, Machinery and Equipment and Automotive sectors comes from the EU. The first supplier of intermediate goods in the three abovementioned sectors is Germany. In case of a Brexit, British production structure will also have to adjust. The British automotive sector (third market in Europe) is a good example: (i) the supply chain is entirely dependent on Germany, France, Spain and Italy; and (ii) foreign car makers would not be incentivized to manufacture in the UK without Europe's demand. Flexible labor market and supportive taxation will not avoid relocation to Slovakia, Spain, France or even Turkey.

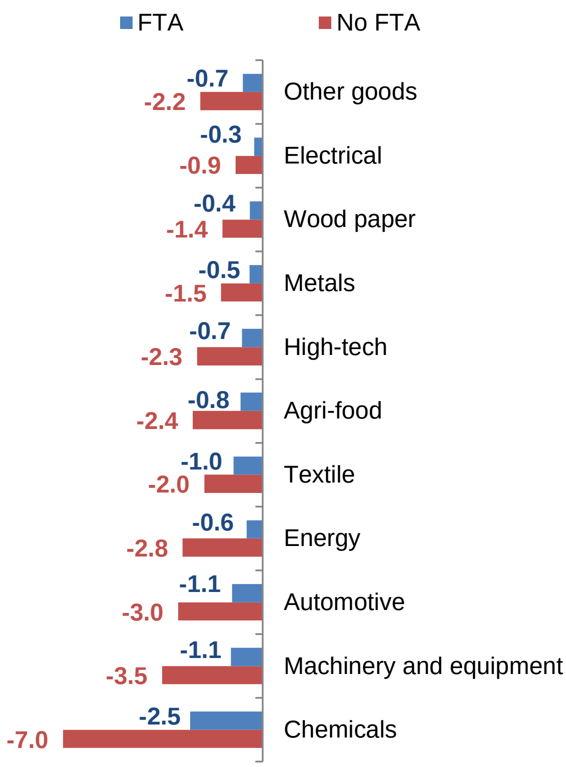
In addition, financing costs will increase: (i) UK-based banks would lose their ability to secure cheap EUR financing from the ECB; and (ii) the Bank of England's will increase interest rates to fight GBP depreciation (in the short-term). Currently, rates on loans to SMEs stand at around 3% (1 year) and 5% (5 years).

Figure 5 - Expected losses in UK total exports by main EU market, GBPbn



Sources: ITC, WTO, Euler Hermes forecasts

Figure 6 - Total losses in UK total exports by sector, GBPbn



Sources: Chelem, WTO, Euler Hermes forecasts

The increase could be as much as 100bp in the case of a Brexit. As a result from higher input and financing costs, margins could fall by 1 point with an FTA to 35% of value added and by 2 points to 34% of value added, (2009 levels) without an FTA.

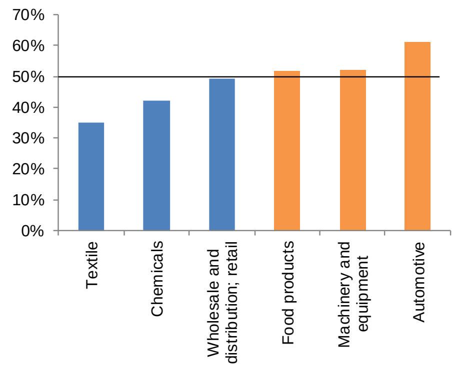
Impact #3: Divestment

In case of a Brexit, capital flight is expected. Foreign Direct Investment (FDI) inflows should be structurally lower as foreign companies will benefit less from relocating into or expanding in the UK without access to the Single Market. Domestic investment (16% of GDP on average over the past decade compared to 20% in the Eurozone) is not expected to compensate for the lost FDI. Overall, roughly GBP210bn of investment would be lost during the four years following the referendum (see Figure 8).

In 2013, the UK attracted a total amount of FDI inflows of GBP975bn, almost twice as much as in 2005. Out of this, 46% (GBP453bn) came from EU countries (~ 25% of the UK GDP). The Netherlands, France and Germany were the biggest contributors. The US was the largest single investor with GBP262bn (27% of total FDI), as the UK was a bridge into the Single Market. Sector-wise, inflows from the EU are concentrated in utilities, logistics, textile, chemicals, pharma, retail, and machinery and transport equipment.

Under our Brexit without FTA scenario, we expect the total stock of FDI from the EU to fall by 20% i.e. a loss of GBP90bn in the next 4 years following the referendum (2016-2020, see Figure 8). A decrease in investments coming from outside the EU (U.S., Asia) equal to GBP105bn is also likely. In addition under the worst-case scenario, investor's protection could also be at stake. As for flows, they could reduce as fast as GBP13bn per year. Roughly one fourth of the yearly lost investment would come from the EU; the most impacted sector would be the financial one. The City of London relies mostly on non-EU investment (notably from the US – 49%, and Asia – 5%). However, financial services out of London are mainly boosted by the common regulation between the UK and the EU. Around 40% of the City's trades take place with Single Market partners. Brexit would mean the City will stop being the financial hub for Europe as regulation will tighten and competing markets will develop.

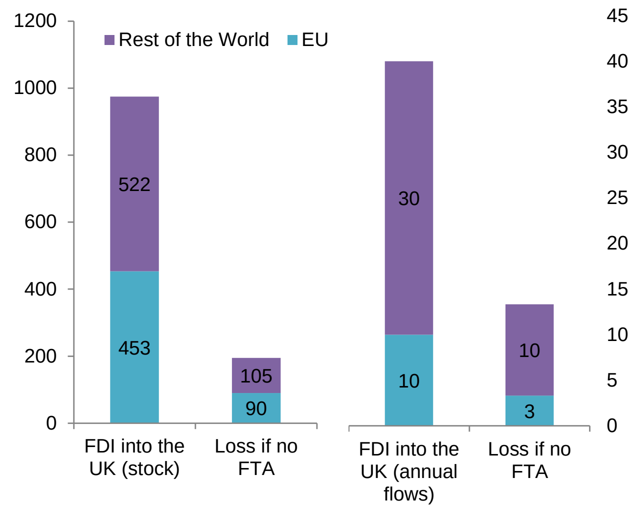
Figure 7 – Value added coming from the EU in final UK demand, % of total



Food products		Machinery and equipment		Automotive	
Germany	3.0%	Germany	10.9%	Germany	18.4%
Ireland	2.6%	Italy	5.0%	France	5.0%
Netherlands	1.7%	France	3.2%	Spain	4.4%
Italy	1.7%	Spain	1.8%	Italy	3.4%
Spain	1.6%			Poland	2.1%
				Belgium	1.6%

Sources: OECD, Euler Hermes

Figure 8 – Loss in FDI inflows (stock and flows) in the 4 years following the referendum (2016-2020), GBPbn



Sources: ONS, Euler Hermes forecasts

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