Press release

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Euler Hermes: Brexit's economic impact on UK and European economies

- Despite the uncertainty regarding Brexit, the UK economy proved resilient in 2016, registering growth of 1.8% (2015: +2.2%)
- The EU-UK negotiation period (2017-2019) should trigger a slowdown in the UK economy, to 1.4% in 2017 and to 1% in 2018
- A "divorce" without a signed 2019 agreement is possible but unlikely (20% probability)
- The two-year timeframe is insufficient to agree both an exit and a free trade agreement. A transition deal (80% probability) permitting limited duty free sectors would bridge the gap, with a final agreement in 2021 after the 2020 UK general election.
- Annual UK GDP growth should slow to +0.3% in 2021
- Trading partners most affected by Brexit 2017-2021: the Netherlands, Ireland, Belgium, Germany, France and Spain, in order of impact.

PARIS –3 APRIL 2017 – In its latest Brexit study, Euler Hermes, the global leader in credit insurance reviews the potential scenarios and economic consequences.

The UK economy steered a steady course through the storm (2016)

Despite the British population's 2016 June decision to leave the European Union, the UK economy managed to maintain strong momentum, growing at 1.8% in 2016 vs 2.2% in 2015. The resilience is essentially due to the containment of political uncertainty through a range of proactive measures. A new government was formed quickly and was able to reassure investors that it sought an orderly exit. A supportive fiscal policy targeted infrastructure spending and both consumer and corporate tax relief: these should support nominal average annual GDP growth by +0.5 pp for the next four years. The Bank of England's swift relaxation of its monetary policy helped avoid tighter financial conditions.

Economic fundamentals also explain the UK's resilience. The UK economy returned to its pre-crisis level in 2014 and before Brexit GDP was 8% above its 2008 peak. Consumers played a key role – confidence remained strong and unemployment declined further. In addition, the services sector remained the main contributor to GDP growth (+2.3pp in 2016). Foreign investors continued to find the UK attractive, and like domestic companies, understood that major changes would require an extended process.

The EU-UK negotiations may cause a stir, but overall resilience will continue (2017-mid-2019)

Euler Hermes believes that from 2017 to 2019, the UK and the EU will have to negotiate not just the EU exit but also a bilateral trade agreement. This double negotiation suggests a continuation in the growth deceleration that began in 2016.

"In the second half of 2017, UK growth should experience a distinct slowdown," said Ana Boata, economist for Europe at Euler Hermes. "Consumer spending for the year will grow by only 1.9% (2016: +3%), impacted by a rise in inflation (+2.5% vs +0.7% in 2016) linked to the depreciation of sterling and the moderate wage increase (+1.6% vs +2.4% in 2016). In terms of investment, a wait-and-see mood will continue: companies will not take significant decisions before knowing more about the shape of the UK's exit agreement. UK GDP growth should also slow, to 1.4% in 2017 (2016: +1.8%)."

In 2018, inflation will approach 3%, triggering a slowdown in consumer spending (+1.4%). Investment should contract further as the 2019 deadline approaches (-2.3%). Given the high ratio of imported intermediary goods, UK exports will no longer benefit from sterling's depreciation; export growth will decline to 1.7% in 2018 (2017: +2.4%).

Without or without an agreement: what kind of exit for the UK? (2019-2021)

The double negotiation process remains to be clarified: will the UK and the EU be able to reach agreement on both Brexit and a Free Trade Agreement (FTA)? The 2017-2019 period should be sufficient to negotiate the UK exit. However, more time will be needed to reach a free trade agreement, potentially involving a 2019-2021 transition period for further negotiations. In this period, the UK would remain subject to EU rules and retain common market access.

The 3 possible Brexit scenarios are:

(i) the UK and the EU agree to extend negotiations and reach a **Limited Free Trade Agreement** in 2021;

(ii) the UK and the EU decide to extend negotiations and reach an **Extensive Free Trade Agreement** in 2021;

(iii) the UK and the EU cease negotiations in 2019 and **no free trade agreement** is signed.

Limited FTA (55% probability)

A limited trade agreement signed in 2021 is Euler Hermes' central scenario. Goods traded would be subject to a weighted average tariff of 2-3%[1]. Additional costs on services of 10% are expected. Sterling could depreciate between 5-7%, resulting in higher import costs and reduced profitability for British companies. This fragility would increase corporate insolvencies to 5% in 2017, 6% in 2018 and 9% in 2019. The UK economy should, however, show resilience and not fall into recession.

"Such an agreement would be followed by two years of limited deceleration in 2019 and 2020, and UK GDP growth would reach a low of +0.3% in 2021," said Ana Boata. "This deterioration would stem principally from a sharp drop in investment (-4%) and exports (-2.5%), due to changes in trade relations between the UK and the EU. In total, we estimate export losses of £12 billion for goods (2% of the total) and £14 billion for services in 2021. At that time, despite the loss of access to the European common market, the UK would remain attractive and retain a significant amount of existing foreign investment, due to its favourable business climate, strong rule of law and a signed agreement with the EU."

Extensive FTA (25% probability)

In this scenario, most of the main production sectors would be exempt from tax (less than 1% on goods)[2], particularly the strategic sectors of the UK economy: agri-food, automotive, chemicals and pharmaceuticals. Total export losses would be softer: £5 billion for goods and £4 billion for services. Sterling would appreciate 5 - 7% against the euro triggering a moderation in inflation (+2.3%). Consumer spending growth would therefore stabilize (+1.0%), while GDP growth would decelerate only slightly (to 0.7%) in 2021.

No transition agreement, no FTA (20% probability)

Even if this scenario is in no one's interest, the UK and the EU may decide to go their separate ways from 2019 without signing an FTA. Trade relations between the two parties would become complicated, with severe economic consequences for the UK due to disrupted trade flows.

"Without a bilateral free trade agreement, the UK would have to trade with the EU under the World Trade Organization's (WTO) 'most-favoured nation' status. British goods would be subject to the full European common external tariffs, customs controls and very restrictive non-tariff barriers – creating supply chain chaos. Exports losses on UK goods would reach £30 billion. Services would have not special access to the EU market; financial services would lose passporting rights – equivalent to 20-30% in additional cost, or a loss of £36 billion in UK services exports. In this strained context, sterling would depreciate 20% against the euro in 2019. Foreign direct investment could fall, and, given the economic outlook, investment could decline by 8%. Inflation would accelerate significantly (2019:

[1] Calculated according to the standards currently in force between the EU and Mexico & EU and Norway

[2] Calculated according to the standards between the EU and Switzerland and EU and Canada

+3.5%), directly and negatively impacting consumer spending (-1%). A UK recession would take hold from 2019, with GDP declining by 1.2%," explained Ana Boata.

Key trade partner impact: the Netherlands, Ireland and Belgium at the forefront

In the most likely scenario of a limited FTA, three countries will be the most affected by export losses to the UK, reduced investment, overall GDP and business insolvencies: the Netherlands, Ireland and Belgium. Germany, France and Spain would be more moderately impacted. Overall, between 2017-2021, the eurozone could lose €24.6 billion in goods exports, and €5.5 billion in services exports.

In the WTO scenario, sterling would depreciate by -20% and the UK would implement tariffs on its imports from the EU (on average 3% if it UK adopts existing EU standards at the WTO). Major negative impacts on total exports would be felt in Germany (~€8 billion), the Netherlands (~€4 billion) and France (~€3 billion). The greatest investment losses would be felt in the US (€25 billion), the Netherlands (€15 billion) and France (€6 billion).

Media contacts:

Publicis Consultants
Romain Sulpice +33 (0)1 44 82 46 21
romain.sulpice@mslfrance.com