July/August 2016

Global Economy Watch

What does Brexit mean for London, the UK and Europe?

Dear readers,

The UK's vote to leave the EU shocked currency and stock markets, and has led to an environment of economic and political uncertainty. Against this backdrop, we have revised our main scenario projections for UK real GDP growth to 1.6% and 0.6% in 2016 and 2017 respectively, down from 1.9% and 2.3%. This revised estimate assumes that the Bank of England embark on some monetary loosening due to the expected reduction in aggregate demand, and in an attempt to stabilise financial markets. We're also assuming that fiscal policy is supportive of growth.

But Brexit will be on the minds of policymakers outside the UK, and indeed the EU, as well. The Swiss central bank has already intervened in the foreign exchange markets and the US dollar appreciated slightly following the referendum – though it hasn't reached the levels it was at earlier this year. Therefore, we are still expecting the Fed to raise interest rates, although probably not until December or later.

For now, the question on many people's lips is what will the UK's future relationship with Europe look like. The main exit options discussed are membership of the European Economic Area (EEA); some form of bilateral free trade agreement with the EU; or trading under World Trade Organization (WTO) terms. The implications for the UK and EU economies will largely depend on which, if indeed any, of these scenarios comes to fruition.

From a trade perspective, EEA membership would see the UK retain full access to the Single Market. A free trade agreement could involve more limited access to the Single Market, but would at least reduce many trading barriers such as tariffs on goods. A WTO-type scenario would see trade barriers imposed, which would impact the UK and, in particular, economies that do a lot of trade with the UK such as Ireland.

Does the leave vote mean London's position as a leading international financial centre will weaken? If the UK loses Single Market access, UK firms and EU firms won't be able to passport financial services businesses, products and services in and out of London, which is likely to have a significant impact. Based on current expectations, only EEA membership would see this access maintained. Our financial services attractiveness indicator (see Figure 1) shows that London is currently Europe's leading financial centre, but the loss of passporting could call this into question over the longer-term.

Kind regards

Richard Boxshall
PwC | Senior Economist

Fig 1: London is currently the most attractive of the major European financial centres – but can it retain this position after Brexit?

	Connectivity	Law	Business environment	People	Critical mass	Financial market infrastructure	
Financial Services Attractiveness Indicator	Market access (1 for passporting, 1 for reserve currency)	Strength of legal rights (0 = weak, 12 = strong)	Ease of doing business ranking	Employment (15-64) with tertiary education (%)	Domestic credit to private sector (% of GDP)	Activities auxiliary to FS as a % of total GVA	Index score (0-100)
Weighting	*30%*	*14%*	*14%*	*14%*	*14%*	*14%*	
London	2	🟢	🟢	🟢	🟢	🔴	**68.8**
Dublin	2	🟢	🟢	🟢	🔴	🔴	**61.4**
Luxembourg	2	🔴	🔴	🟢	🔴	🟢	**52.1**
Paris	2	🔴	🔴	🟢	🔴	🔴	**49.4**
Vienna	2	🔴	🟢	🔴	🔴	🔴	**48.0**
Amsterdam	2	🔴	🔴	🔴	🟢	🔴	**47.8**
Frankfurt	2	🟢	🟢	🔴	🔴	🔴	**47.6**
Stockholm	1	🟢	🟢	🟢	🟢	🔴	**45.1**
Warsaw	1	🟢	🔴	🔴	🔴	🔴	**29.7**

🟢 Above average of the 9 financial centres 🔴 Below average of the 9 financial centres

Note: Strong legal rights mean that parts of the legal system facilitate a high degree of access to credit

Sources: PwC analysis, World Bank, Eurostat

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Economic update: Brexit vote weighing heavy on central bankers' minds in the UK and the US

UK policymakers are getting ready to act…

Following the vote to leave the EU, the UK economy is expected to face challenges in the short term, with high levels of uncertainty leading to a slowdown in business investment and lower GDP growth. In light of this, we have revised down our main scenario real GDP growth projection for the UK to 1.6% and 0.6% in 2016 and 2017 respectively, down from 1.9% and 2.3%.[1]

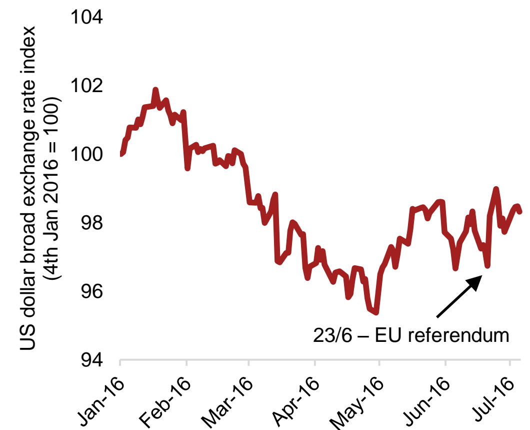
These numbers assume that the Bank of England will loosen monetary policy. It is likely that the interest rate will be cut further, but given it is already close to zero, this could also be accompanied by an extension of the quantitative easing programme involving purchases of government and corporate bonds. There could also be credit easing measures such as extending the Bank of England's Funding for Lending Scheme in addition to the already announced cuts in countercyclical capital buffers for UK banks. We also expect public borrowing to be allowed to rise in response to lower economic growth.

…while the Fed will hold off rate hikes for the moment

In the US, the dollar appreciated slightly following the Brexit vote as capital flowed to the safe haven of US assets. But despite recent market movements, the dollar is still weaker than it was at the start of 2016 (see Figure 2). Therefore, we still expect the Federal Reserve to raise rates within the next 12 months, but probably not until after the presidential election and the global economy has had some time to adjust to the UK's historic decision.

[1] We will discuss these revisions in more detail in our next UK Economic Outlook which is scheduled for release on 19th July 2016.

Fig 2: The US dollar appreciated slightly in trade-weighted terms following the referendum



Sources: PwC analysis, Federal Reserve

Focus on: Trade in Europe – which EU countries could be most affected by the UK's vote to leave?

Trade tops the list for uncertainty

The UK's future trading relationship with the EU is the biggest source of uncertainty following the referendum. The main reason for this uncertainty is the lack of precedent. For example, it is unclear whether the UK will be able to continue to access to the Single Market as it currently does now, or have to negotiate a free trade agreement, or even have to trade with EU member states under WTO terms.

Until this becomes clear, policymakers, businesses and even households across the EU should consider the different scenarios and, if possible, put contingency plans in place.

How could trade effects take hold?

There are two main channels which could impact trade between the UK and the EU. First, the market access arrangements, which could make it more difficult to trade. Second, the price effects that could result either because of exchange rate volatility or the erection of tariff and non-tariff barriers.

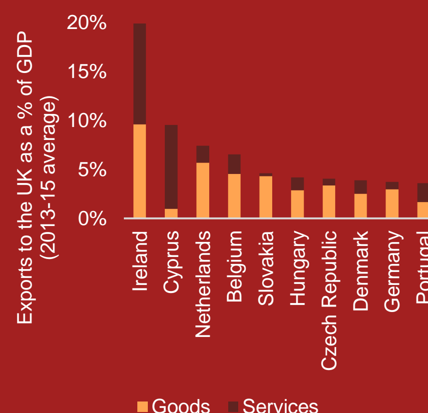
So, which economies are most at risk from disruption in current trading arrangements between the UK and the EU?

Ireland and Cyprus most exposed…

Figure 3 shows the ten EU countries that export the most to the UK, relative to the size of their economies. Ireland (19.9%) and Cyprus (9.5%) sit at the top of this list.[2]

In Ireland there is a fairly even breakdown between goods and services, but this high number should be set in the context of Ireland's economy, which has a particularly

Fig 3: Ireland is the most exposed EU country to Brexit from a trade perspective



Note: Spain, Luxembourg, Malta and Finland are excluded from our analysis due to data limitations
Sources: PwC analysis, Eurostat

strong orientation to exports. For Cyprus, the majority of its exports to the UK are services. Around half of this is accounted for by travel and tourism. This would be more affected by exchange rate volatility (for example, the pound depreciated by around 7% against the euro in the week following the referendum), rather than market access constraints such as passporting for financial services.

…but the larger economies are relatively less vulnerable

Of the larger European economies, Germany exports the most to the UK relative to the size of its economy (3.7%). France (2.5%) and Italy (1.7%) don't rank within the top ten.

These numbers are relatively modest at the macroeconomic level but could be more material for some industry sectors, so affected businesses in these economies do need to be prepared for different trade arrangements in the future.

Businesses need to start thinking about possible demand impacts

Businesses know what the standard WTO tariff rates are that could be applied to future UK sales if it cannot do a free trade deal with the EU. They can also take into account recent falls in the value of the pound against the euro and the dollar. This information is important for businesses to calibrate future cost projections, and to assess future competitiveness in the global market. However, they would need to consider what impacts potential non-tariff barriers could have on their operations as well.

Barrier-free trade would be beneficial for all parties

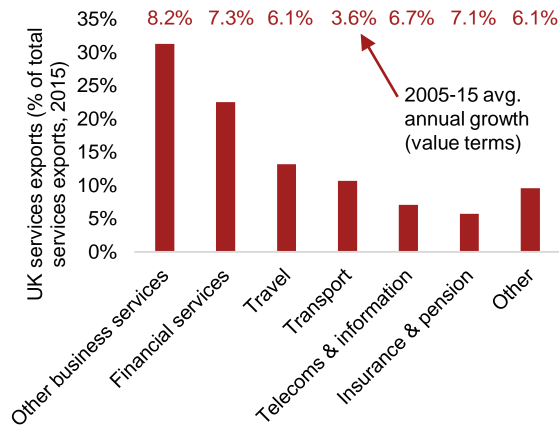
Trade agreements are complex and generally take many years to negotiate, but given the high level of integration that has been built up between UK and EU markets, it is unlikely that that would be allowed to fall away completely.

Businesses need to put the case to governments to make early progress in putting such trade deals in place in a way that is mutually beneficial to businesses in both the UK and other EU countries. But, in the interim, they need to make contingency plans for a range of different outcomes.

[2] This analysis was completed before Irish real GDP growth in 2015 was revised upwards to 26.3%.

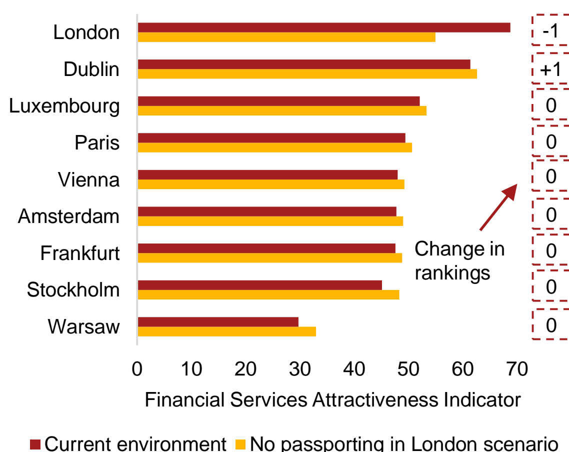
What does an EU exit mean for London's role as an international financial centre?

Fig 4: Financial services make up over a fifth of the UK's total services exports



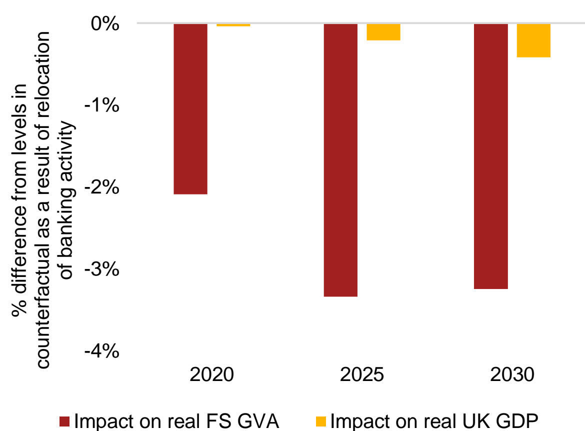
Sources: PwC analysis, ONS

Fig 5: The loss of EU market access could see London lose its place as the top European financial centre



Sources: PwC analysis, World Bank, Eurostat

Fig 6: Non-EU banks relocating could reduce UK GDP by around 0.4% in 2030 relative to the counterfactual



Source: PwC analysis

Brexit vote puts London under the spotlight

The UK's vote to leave the EU has put London's position as a leading international financial centre under the spotlight.

To assess the potential impact that Brexit could have on London as a financial hub, we developed a financial services attractiveness indicator. The indicator is constructed using six features associated with financial hubs.[3] Figure 1 shows that, using this approach, London currently ranks top of the European list, considerably ahead of Dublin and Luxembourg in 2nd and 3rd place. There are, however, some things that are not picked up in our indicator, such as the appeal of different cities and regions as a place to live, which can also contribute to the attractiveness of a financial centre.

Single Market access one of London's big drawing points

One important factor that contributes to London's success as an international financial centre is its access to the Single Market via passporting for financial services. This applies across the EU, Norway, Iceland and Liechtenstein, and gives UK-based financial institutions unfettered access to the rest of the Single Market.

This market access is an important factor driving London's strength in this area, which is reflected in the fact that financial services make up over a fifth of UK services exports, equivalent to around 3% of UK GDP (see Figure 4).

Potential loss of passporting a challenge for London

It seems, at present, that the only way for London to continue to benefit from passporting would be for the UK to join the EEA when it leaves the EU. But given this scenario would probably mean free movement of labour continuing to apply, the UK making a contribution to the EU budget and EU-wide regulations still having to be applied in the UK, this could be a difficult outcome to achieve politically. So, what would losing (some) access to the Single Market mean for London?

In a survey of senior financial and professional services representatives, 49% of respondents identified access to EU customers as a significant benefit to their business, while 44% noted the importance of straightforward cross-border trade within the EU.[4] Both of these factors are related to connectivity and passporting, so we have given this a larger weight in our indicator.

Our analysis shows that, everything else remaining equal, the loss of passporting could see London lose its place as the EU's strongest financial centre as it would fall into 2nd place in our league table behind Dublin. Its gap with Luxembourg, Paris and other EU cities could also narrow significantly (see Figure 5). Though factors such as a change in government policy, the extent of spare capacity which could support an inflow of FS activity or the presence of bodies like the European Securities and Markets Authority (ESMA) in Paris or the European Central Bank (ECB) in Frankfurt, could also see one of the other financial centres we have identified emerge as a new star performer.

How could FS businesses respond to the loss of passporting?

FS businesses are already starting to evaluate scenarios, particularly the impact of losing passporting rights. Firms doing business across multiple EU countries would need to establish or expand their presence in one EU country and passport to other EU countries from there. That may involve applying for or varying regulatory licenses, which can take many months. MiFID II is a classic example – in the WTO scenario, UK firms could face a licensing gap of 6 months or more.

Because they cannot afford a licensing gap, they may be able to wait to see if politicians can preserve passporting rights and/or agree transition arrangements.

But if UK-based FS businesses were eventually to lose their market access via passporting, they could move some operations to the EU. In our previous analysis, commissioned by TheCityUK, we showed that a partial and gradual withdrawal of non-EU banks from the UK could reduce UK FS gross value added by around 3.3%, and UK GDP by around 0.4% in 2030, relative to the counterfactual where the UK remained a member of the EU with passporting staying in place (see Figure 6).

Other policies and regulations could also lead UK businesses to move to other EU financial centres. For example, if the ECB implemented its proposed plans to require clearing for euro-denominated transactions to be based in the Eurozone, then UK businesses would have to move too.

Terms of exit package will be critical

London's position as an international financial centre is not by any means purely dependent on EU passporting. Other factors such as access to skills and a strong and stable legal system should see it remain as a leading global financial hub in the years ahead. But the potential loss of EU market access poses a challenge for many FS businesses. Business leaders based in London should focus their efforts on lobbying UK Government and EU politicians to retain as much EU access as possible, including retaining EU passporting rights.

[3] See, for example, "From local to global: Building a modern financial centre", City of London, 2013
[4] "Single Market Membership Survey", Ipsos MORI / TheCityUK, 2013

Projections: July/August 2016

	Share of 2015 world GDP		Real GDP growth				Inflation			
	PPP	MER	2015e	2016p	2017p	2018-2022p	2015e	2016p	2017p	2018-2022p
Global (Market Exchange Rates)		100%	2.8	2.6	2.8	3.0	1.7	2.1	2.6	2.7
Global (PPP rates)	100%		3.2	3.1	3.4	3.4				
G7	31.5%	46.6%	1.8	1.6	1.6	1.9	0.2	0.8	1.8	1.8
E7	36.1%	25.8%	4.7	4.6	5.2	5.0	0.4	1.5	3.3	3.3
United States	15.8%	24.5%	2.4	1.9	2.2	2.3	0.1	1.2	2.2	2.0
China	17.1%	15.0%	6.9	6.5	6.5	5.7	1.5	1.8	1.8	2.8
Japan	4.3%	5.6%	0.6	0.7	0.5	0.8	0.8	0.2	1.4	1.5
United Kingdom	2.4%	3.9%	2.2	1.6	0.6	2.1	0.0	0.7	1.8	2.0
Eurozone	11.9%	15.8%	1.6	1.6	1.5	1.5	0.0	0.2	1.3	1.4
France	2.3%	3.3%	1.2	1.4	1.5	1.6	0.1	0.3	1.2	1.2
Germany	3.4%	4.6%	1.4	1.6	1.4	1.4	0.1	0.3	1.5	1.7
Greece	0.3%	0.3%	-0.4	-1.4	0.3	1.5	-1.1	-0.3	0.5	1.3
Ireland	0.2%	0.3%	7.8	4.5	3.3	2.5	0.0	0.8	1.8	1.7
Italy	1.9%	2.5%	0.6	0.9	1.0	1.2	0.1	0.2	1.1	1.4
Netherlands	0.7%	1.0%	2.0	1.6	1.6	1.8	0.2	0.8	1.5	1.3
Portugal	0.3%	0.3%	1.5	1.3	1.3	1.2	0.5	0.7	0.9	1.5
Spain	1.4%	1.6%	3.2	2.6	2.3	2.0	-0.6	-0.4	1.3	1.2
Poland	0.9%	0.6%	3.6	3.5	3.4	3.5	-0.9	-0.3	1.0	2.4
Russia	3.3%	1.8%	-3.7	-1.7	1.0	1.5	15.5	7.3	6.8	4.0
Turkey	1.4%	1.0%	4.0	3.8	3.7	3.5	7.7	7.7	7.5	7.0
Australia	1.0%	1.7%	2.2	2.4	2.5	2.7	1.5	2.3	2.5	2.5
India	7.0%	2.9%	7.1	7.7	7.7	6.5	4.9	4.1	4.3	5.0
Indonesia	2.5%	1.2%	5.2	4.8	4.8	5.4	6.8	6.1	6.1	5.1
South Korea	1.6%	1.9%	2.6	2.7	2.7	3.2	0.7	1.1	1.7	3.3
Argentina	0.9%	0.8%	2.4	-0.8	2.1	2.5	17.0	25.0	25.0	20.0
Brazil	2.8%	2.4%	-3.8	-3.8	0.0	3.0	9.0	9.0	6.5	5.0
Canada	1.4%	2.1%	1.1	1.6	1.9	2.2	1.1	1.5	1.8	2.0
Mexico	2.0%	1.6%	2.5	2.3	2.7	3.3	2.7	2.9	3.1	3.0
South Africa	0.6%	0.4%	1.3	0.4	1.0	2.0	4.6	6.0	5.5	5.5
Nigeria	1.0%	0.7%	2.7	1.0	2.5	3.5	9.0	14.0	13.5	11.0
Saudi Arabia	1.5%	0.9%	3.5	1.3	1.5	2.5	2.2	3.9	3.2	2.5

Sources: *PwC analysis, National statistical authorities, Datastream and IMF. All inflation indicators relate to the Consumer Price Index (CPI). Argentina has declared a national statistical emergency, and as such, inflation data releases have been suspended. Therefore our inflation projections are based on the latest available data from 2015. Also note that the tables above form our main scenario projections and are therefore subject to considerable uncertainties. We recommend that our clients look at a range of alternative scenarios.*

Interest rate outlook of major economies

	Current rate (Last change)	Expectation	Next meeting
Federal Reserve	0.25-0.5% (December 2015)	Rate rise delayed until December 2016 or later	26-27 July
European Central Bank	0.0% (March 2016)	No rate rise for the foreseeable future	21 July
Bank of England	0.5% (March 2009)	Some monetary loosening likely in response to Brexit vote	4 August

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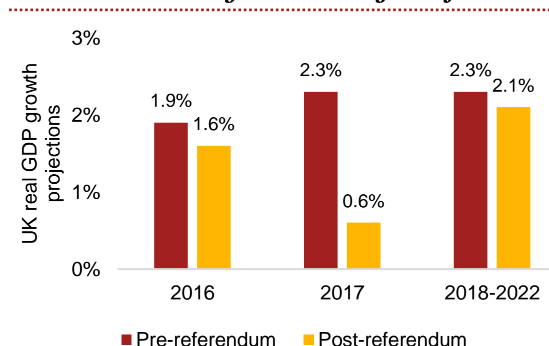
Chart of the month

Following the UK's vote to leave the EU, we have revised our main scenario projections for real GDP growth.

We are projecting that quarter-on-quarter growth could fall to around zero in the last quarter of this year and the first quarter of 2017, but we would narrowly avoid a recession. Growth would then gradually pick up later in 2017 and beyond.

Chart of the month: The largest impact of the Brexit vote on annual GDP growth is likely to be felt in 2017



Source: PwC main scenario projections

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