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Britain and Brexit: Clear-cut decision; uncertain consequences

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The unexpected outcome of the referendum on June 23 moved the United Kingdom into uncharted waters and will have profound constitutional, political and economic consequences for the country, the EU and the wider world. For up to the next two years, London and Brussels will be in formal negotiations over the United Kingdom's terms of withdrawal and informal discussions on a separate trade agreement for once its EU membership ceases. This will entail hard bargaining over the trade-off between the United Kingdom's desire to secure access to the single market, particularly for financial and professional services, and the fundamental EU right of the free movement of labour.

At the same time, both UK mainstream political parties face leadership battles and questions over the continued unity of the United Kingdom, while the politicians of continental Europe have to face questions about the future direction of the European project, rising Euroscepticism, and the repudiation of the political elite by their electorates.

Meanwhile, in capitals around the world, leaders are likely recalibrating the diplomatic and security standing in the world of London and Brussels, and the opportunities or risks that will result.

Brexit negotiations and beyond

While some have questioned whether the United Kingdom will actually leave the EU following the referendum, it will most likely do so. The two main UK political parties have indicated that Brexit will go ahead. It would be politically difficult for them to ignore the popular vote. The process of negotiating the terms of withdrawal will likely begin in September once Article 50 is triggered by a new UK prime minister and last up to two years. During this period of negotiations, the terms of the United Kingdom's membership of the EU will continue to apply.

Negotiations are expected to be difficult, starting with a dispute between EU leaders and the UK government over when Article 50 should be invoked, with EU leaders and the European Parliament pushing to start the process as soon as possible. Scotland's position in the negotiations will be critical. Governments of EU member states may adopt a punitive approach during the negotiations in order to deter others from seeking to leave the EU, demonstrating a rift between the governments and electorates in these countries. The United Kingdom's objective during the negotiations will likely be to gain access to the single market without accepting free movement of labour, though there will be obstacles to achieving this.

Following Brexit, the United Kingdom will likely be seen as having a diminished role in the world. However, membership of institutions and groups such as the G7, NATO and the UN Security Council will not be affected. Outside of the EU, the United Kingdom will be seen as a less important trade partner to countries such as the United States and China. The Russian government is likely to see Brexit as a positive development due to the United Kingdom's tough position on sanctions against Russia compared to other EU member states.

The United Kingdom may also see a general election after the new leader of the Conservative Party takes office as prime minister. The weakness of the opposition Labour Party may incentivise them to call an election. An election campaign would be unlikely to put forward a concrete plan for the United Kingdom's negotiations with the EU.

The future of the UK-EU relationship

While Brexit represents a significant crisis for the EU, the United Kingdom is likely to be more negatively affected. Its political system is currently under greater threat of disintegration than that of the EU.

In the short term, the EU summit held on June 28 and 29 is likely to generate statements by EU member states reaffirming their commitment to the EU. The tenor of negotiations going forward is likely to be affected by the choice of the new leader of the Conservative Party. An immediate threat by Scotland or Northern Ireland to leave the United Kingdom could potentially prevent Brexit, though this is unlikely. The reactions of the financial markets is another factor to watch in the short term.

In the medium term, the argument that other EU member states will now seek their referendums on EU membership appears to be overstated, as calls for referendums in continental Europe have only come from far-right parties that have long been anti-EU. The most likely countries to vote to leave would be Sweden and Denmark, for whom an exit would be less costly as they, unlike France, are not members of the euro area and do not rely on EU funds.

The question of which model of engagement with the EU the United Kingdom will choose is also important in the medium term. Of the several being proposed, each raises problems. The EU will also have to strike a balance in negotiations between the need to deter others from seeking to leave and the desire to avoid recession in the United Kingdom and economic fallout in Europe. Scotland's reaction to the negotiations will also be key.

Long-term questions relate to the extent of the impact on the UK and EU economies and the future of EU integration. With regard to the latter, there may be a push for further integration around the core euro area countries, whose commitment to the EU is strongest. By contrast, efforts to enlarge the EU are likely to be suspended for some time, partly in response to reactions to migrants from lower-income member states.

The economic outlook

The economic implications of Brexit depend greatly on the political trajectory of the negotiations. The choice of the next leader of the Conservative Party will help determine the course of the negotiations. Boris Johnson, before becoming the Conservative Party's lead campaigner for Brexit, made several statements suggesting a compromise agreement with the EU, while other potential Conservative leadership candidates have put forward different views.

As a result of tensions within the Labour Party as well as the fact that many Labour Party supporters in the north of England voted to leave the EU, there is no strong alternative emerging from the main opposition party either. While there has been discussion of Wales leaving the United Kingdom, a majority of Welsh voters supported Brexit despite receiving high levels of EU funding.

Markets reacted quickly to the vote, as expected. The rapid fall in the value of the pound raises questions of how quickly it will stabilise. The pound is likely to become even cheaper in the near future, offering opportunities for new inbound investors.

Actions by the Bank of England and other central banks will be important throughout the coming months. There appears to be a clear intention to avoid the worst of the ramifications with regard to currency volatility and the risk of liquidity shortages in the financial system. Support mechanisms for the interbank system will play an important role in this. However, support mechanisms cannot last indefinitely and other economic effects may subsequently appear.

Consumer price reports for August and September are likely to show price increases, which may well continue into the autumn as it will take time for the weaker pound to take effect. There are concerns that inflation may encourage rising pay demands during the winter, which could affect the public mood. More serious effects with regard to GDP and unemployment will take time to emerge.

However, there may be signs of trade stalling in some areas and declining investment in the economy by the end of 2016, continuing into 2017. Anecdotal information on firms' decisions to stay in the United Kingdom or relocate suggests a strong trend towards lower levels of investment.

The economic effects of a new leadership and road map for a new agreement are unlikely to be clear until early 2017, and will depend partly on the extent to which these veer towards protectionism or towards opening up the economy. Uncertainty about the long-term economic prospects for the United Kingdom remains. Serious long-term losses in investment and decreases in GDP of up to 10-15% compared to forecasts by 2020 cannot be ruled out. Brexit therefore poses a risk for the United Kingdom ending up with a stagnant economy like some euro area countries.

The economic implications of Brexit may also affect its political standing internationally, as lower GDP growth could shrink the UK economy relative to others.

Further topics from Q&A session

Implications for international security

In the short term, there are likely to be efforts on all sides to project unity at the upcoming NATO summit to send a signal to Russia and the wider world. However, in the longer term, the United Kingdom may become a less central strategic partner for the United States if Brexit goes ahead and Washington loses its Atlanticist partner in the EU. In this case, the United States would likely turn to Germany more on strategic issues.

While cooperation on intelligence is particularly close between the United States, Australia, Canada, New Zealand and the United Kingdom, and is likely to remain so, the United States also has relatively close connections with Germany in this area. In general, NATO allies are expected to continue to advocate working together on counter-terrorism and intelligence sharing, though there may be some disputes concerning data sharing.

With regard to the conflict in Ukraine, Brexit is likely to worry Kiev as it represents a weakening of the EU and potential strengthening of Russia. Once outside of the EU, the United Kingdom is expected to have little contact with Ukraine as the two parties have few common interests.

Brexit is unlikely to have a significant impact on the conflict in Syria, as the West's involvement there has been limited to begin with. With a political solution unlikely at this point, the military side of the conflict becomes more salient, in which Russia has taken the leading role.

Implications for the financial sector

If international support of the UK banking sector is not maintained, the City's ability to operate as it has done may be severely damaged. While some elements of the UK financial sector may move to Paris or Frankfurt, it is possible that these moves would have occurred without Brexit due to the high costs of operating in London.

The competition between the financial sectors in London and New York could also mean that business moves to New York if in the wake of Brexit the UK sector is no longer able to maintain its role in the intermediation of international cross-border financial flows. This issue is likely to be more important for London than the question of retaining the financial services' 'passport' system that allows UK firms to operate as branches across the EU and to be supervised EU-wide by London regulators.

Brexit could potentially put a hold on plans to merge the London and German stock exchanges if the political situation puts business at risk.

Implications for the unity of the UK

There is a tangible risk that Brexit will result in a backlash move towards independence from the United Kingdom on the part of Scotland and Northern Ireland. While Article 50 allows for a member state to decide to withdraw from the EU in accordance with its domestic constitutional requirements, the lack of a written constitution in the United Kingdom means that it is not clear what those requirements are.

This means that it is unclear whether the Scottish government could block Brexit on the basis of the Scotland Act of 1998. If the Scottish government attempts to do so and is overridden by Westminster, Scotland will likely seek independence from the United Kingdom.

A similar process could occur in Northern Ireland, where the question of the border with the Republic of Ireland and the applicability of the Good Friday Agreement are particularly salient. The Good Friday Agreement is deeply nested within the framework of EU law. A withdrawal from the EU could call the terms of the agreement into question.

In the longer term, demographic changes mean that the majority of the population in Northern Ireland could soon be Catholic. Based on this, any attempt by the United Kingdom to re-establish the border between Northern Ireland and the Republic of Ireland could well lead to re-unification instead.

Implications for immigration

Signs of growing xenophobia and racism in the United Kingdom emerged even before the results of the referendum were announced, with a significant part of the Leave Campaign's rhetoric, particularly by the UK Independence Party (UKIP), taking on these undertones.

UKIP is expected to benefit from recent developments and may gain voters, particularly from the Labour Party, in a future election. Far-right parties across Europe will likely be encouraged by Brexit to adopt even stronger rhetoric against immigration and refugees.

There has been a strong political reaction by mainstream political parties in the United Kingdom against these outbursts of xenophobia and racism, and it is hoped that they will prove a temporary phenomenon.

Even prior to the Syrian refugee crisis, migrants arriving in Italy caused resentment among the Italian population during a difficult economic period. By contrast, the unemployment rate in the United Kingdom is relatively low at 5%, making the backlash against immigration surprising.

Implications for investment into the UK

A possible further fall in the pound makes it unlikely that there will be a great rush in the short term to take advantage of UK assets that are now cheaper to foreign investors. However, once the currency stabilises and the terms of the United Kingdom's future relationship with the EU have been set, there may well be interest due to the lower value of the pound, notably favouring the property sector. In the short term, pressure on safe-haven assets like gold is likely to continue.

Implications for European politics

Brexit is unlikely to effect the forthcoming referendum on constitutional reform in Italy, but elections in Germany and France next year may well be influenced. In particular, Marine Le Pen, the leader of France's far-right National Front, may be encouraged in her campaign for the presidency, and may see strong support. German Chancellor Angela Merkel has been heavily criticised over her policy in the refugee crisis. Those who would challenge her for the leadership of the Christian Democratic Union may take into account the Brexit vote.

With regard to the EU itself, while the referendum has triggered much discussion about the need to reform the EU, member states have different views on which reforms are needed and whether to deepen or lessen integration. Fundamentally, member states want a functional EU, which may mean more integration is needed in some areas and less in others.

The refugee crisis and the euro-area crisis have both contributed to a perception of the EU as being inept. In this way, while new treaty negotiations over the structure of the EU are unlikely, there may well be more concerted efforts to better address specific issues and capacities.