EU referendum
Initial response

Politics and policy

The government faces the historic task of engineering the UK's withdrawal from the EU. In doing so there is no template or model; no major nation has left the EU.

The immediate focus is on the prime minister's position, the composition of the cabinet and the role of Leave campaigners in planning the UK's exit from the EU. New machinery to carry forward the process of leaving the EU will be needed and could include a cabinet committee, an all-party parliamentary group, a cross-departmental task force and a negotiating team. Leave campaigners have suggested this machinery should also include businesspeople, lawyers and members of civil society.

The planning and negotiations that follow will tax the capacity and absorb the energies of a civil service that is smaller than at any time in the past 75 years. Other big initiatives, especially those likely to consume significant political capital, money and time, such as devolution, academies, major infrastructure projects and Trident, may lose momentum.

The UK's aims in its EU negotiations will reflect a set of fine judgements: on what can realistically be agreed with the EU, is acceptable to UK voters and commands support among MPs. Under Vote Leave's plans legislation would be passed under the current parliament to remove the UK from the jurisdiction of the European Court of Justice, placing controls on EU migration and repealing the European Communities Act 1972, which gives primacy to EU law in the UK. However, this proposal could be thwarted by the large pro-EU parliamentary majority. Just ahead of the referendum the BBC estimated that about 71% of MPs favoured Remain, 23% favoured Leave and 6% were undecided or undeclared.

Free movement of people within the EU is opposed by many Leave campaigners. If, as seems likely, the UK seeks to end free movement of EU nationals into the UK, it is likely to lose access to the Single Market. Some have made the case for the UK exiting the Single Market completely – with Michael Gove suggesting it would be possible to be "outside the Single Market but have access to it". A group of pro-Brexit economists have agreed on a trade model that involves Britain completely avoiding "tortuous trade talks" with the EU, and instead opting to export to all nations under World Trade Organisation (WTO) rules, while at the same time not imposing any trade tariffs on imports from any country.

Prime Minister Cameron has said he would invoke Article 50 of the Lisbon Treaty, which starts the two-year negotiating period with the EU on the terms of Brexit, immediately after a vote to leave the EU. However, the government could choose to delay the process, either to gauge parliamentary opinion with a debate and a vote or to open informal negotiations with EU leaders – to agree on the broad principles of a deal before invoking Article 50. Vote Leave has stated that it would seek to engage in "extensive preliminary discussions" with the EU before triggering Article 50. It believes a deal can be achieved in time for the next UK General Election, in May 2020. During the negotiations all existing EU regulations remain in place and the UK has no vote on EU matters. The two-year negotiating period can be extended by unanimous agreement.

Much will hinge on the nature of the UK/EU negotiations. Some EU states may resist a quick or relatively advantageous deal for the UK on the grounds that it would embolden secessionist and Eurosceptic movements elsewhere in the EU. However, a fractious and prolonged period of negotiations could be damaging to the EU – disrupting EU exports and fuelling uncertainty about the future of the EU itself.

Over the coming days and weeks the UK authorities are likely to try to provide reassurance and bolster sentiment. Measures which could be employed include a strong statement of the government's commitment to pro-business, open-market policies, tax cuts for business and consumers, and a temporary suspension of the government's fiscal rules. The Bank of England has made it clear it is ready to provide liquidity to the banking system. The Bank could also seek to boost growth by undertaking further rounds of Quantitative Easing, possibly by purchasing a wider, and riskier, range of assets.

The referendum vote raises two particular domestic political challenges. The Scottish National Party has repeatedly warned that if Scotland votes to Remain it may seek a second independence referendum. The referendum vote also creates uncertainty about the future of Northern Ireland's 309-mile open land border with the Republic of Ireland.

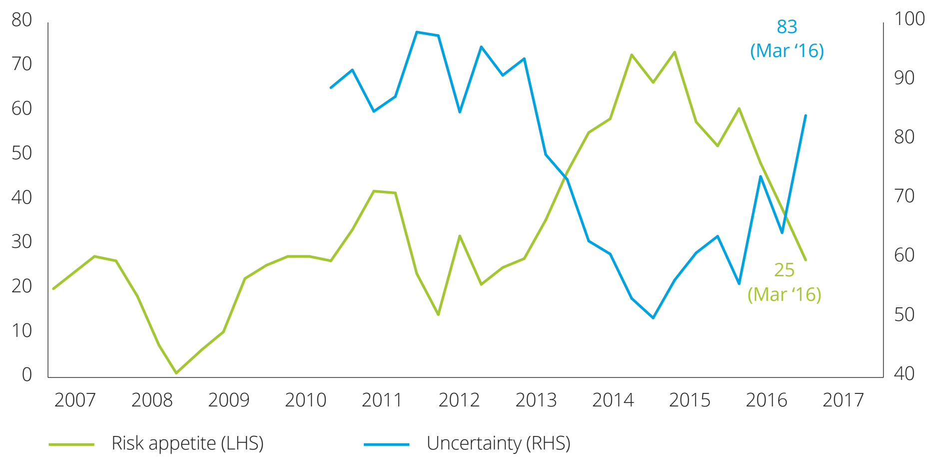
Financial and economic impact

Typically, sharp rises in economic uncertainty express themselves initially and most forcefully through liquid financial assets, driving down the value of currencies and equities.

In the UK corporate sector the vote to leave the EU is likely to fuel perceptions of uncertainty and depress risk appetite. This would be consistent with the findings of our first quarter survey of Chief Financial Officers in which large-cap CFOs rated Brexit as the greatest risk facing their business (Chart 1 illustrates how such concerns have already affected corporate sentiment). Lower risk appetite is likely, in turn, to lead to a squeeze in business investment and hiring, and a renewed focus on cash and cost control among corporates. Elevated uncertainty is likely to weigh on M&A, IPO activity and inward investment.

Chart 1. Deloitte CFO Survey: Risk appetite and uncertainty

% of CFOs who think this is a good time to take greater risk onto their companies' balance sheets and total % of CFOs rating the level of uncertainty facing their businesses as above normal, high or very high



Source: Thomson Reuters Datastream

Most economists predict that Brexit is likely to lead to a marked deceleration in growth in the short to medium term. The consensus or average forecast of economists is for UK growth to slow to 1.4% in 2016 and 0.7% in 2017, compared to a forecast growth of around 2.0% in each year with the UK in the EU. HM Treasury's central view is more pessimistic and forecasts no growth in the next two years. Significant and sustained weakness in sterling would drive inflation higher, with negative effects on consumer incomes and activity. A weaker pound could, however, deliver significant benefits for exporters.

In the medium term much will depend on the pace and success of the government's negotiations with the EU. Here the UK is likely to face a trade off between retaining current access to the Single Market and ending free movement of people. With greater clarity over time on the UK's new relationship with the EU and the world the dampening effects on growth are likely to diminish.

In the longer term, economic activity will be determined by a combination of the nature of the UK's post-exit trade relationship with the EU and its ability to exploit its newfound freedom to forge individual trade deals with emerging markets outside the EU. The long-term average or consensus forecast for UK GDP growth for the period 2018-2026 is 2.1% both in a Remain and a Leave scenario (Chart 2). A number of forecasting bodies have said in recent months that the UK would be unlikely to be able to make up for growth lost during the early years of secession.

The most pessimistic forecaster is the Centre for Economic Performance at the London School of Economics (LSE), which sees the UK economy being 6.3% to 9.5% smaller in 2030 with the UK outside the EU. However, given the frequency of large errors in short-term economic forecasts such very long-term forecasts are probably best viewed as speculative estimates.

Exiting the EU entails a period of uncertainty and great change. But this will not be the sole or, indeed, the most significant influence on the UK's economic performance, particularly in the longer term. The usual factors of financial conditions, interest rates and global growth will continue to play a considerable role. UK fundamentals remain favourable – strong institutions and an economy that is resilient and highly ranked in international league tables of competitiveness. These factors put the UK in a good position to navigate the changes and uncertainties that lie ahead.

Chart 2. Effect of Brexit on UK and euro area GDP growth

Implied growth profile from economists' consensus forecasts for UK GDP growth in the event of a Remain or a Leave vote

UK GDP growth (% YoY)

UK votes to **Remain**			
2015	**2016**	**2017**	**2018-26 avg.**
2.3	*1.9*	*2.1*	*2.1*
UK votes to **Leave**			
2015	**2016**	**2017**	**2018-26 avg.**
2.3	*1.4*	*0.7*	*2.1*

Euro GDP growth (% YoY)

UK votes to **Remain**			
2015	**2016**	**2017**	**2018-26 avg.**
1.6	*1.6*	*1.7*	*1.4*
UK votes to **Leave**			
2015	**2016**	**2017**	**2018-26 avg.**
1.6	*1.6*	*1.4*	*1.4*

Source: Consensus Economics

The mechanics of exit

In the absence of additional parliamentary legislation, a public vote to leave the EU has weight in law once the government invokes Article 50 and initiates the two-year negotiations to agree the terms of our withdrawal. The final agreement with the UK must be ratified by a qualified majority (20/27) of remaining EU states, representing 65% of the population. The European Parliament would also need to approve the deal and this would require a simple majority of its 751 MEPs. During the two-year period, all existing EU legislation remains in place, although the UK has no vote on any EU policy matters.

The two-year deadline under Article 50, which could be extended by unanimous agreement, does not apply to trade negotiations, and the UK could conceivably continue in negotiations on a comprehensive UK/EU trade agreement for many years after Brexit.

However, if no agreement on trade is reached within the time taken to agree the terms of Brexit, the UK would begin to trade with the EU as a non-member most likely under the rules of the World Trade Organisation, while continuing trade negotiations. That would imply incurring tariffs on a number of goods, with analysis by the LSE suggesting tariffs on UK exports to the EU-27 of about 3.2% on a trade-weighted basis.

Although recent EU trade deals have taken between four and nine years to conclude, Vote Leave has argued that a UK/EU deal could be completed before May 2020. Its belief is that negotiations would be easier because there is already tariff-free trade between the UK and the EU, and regulations in the UK and the EU are already equivalent.

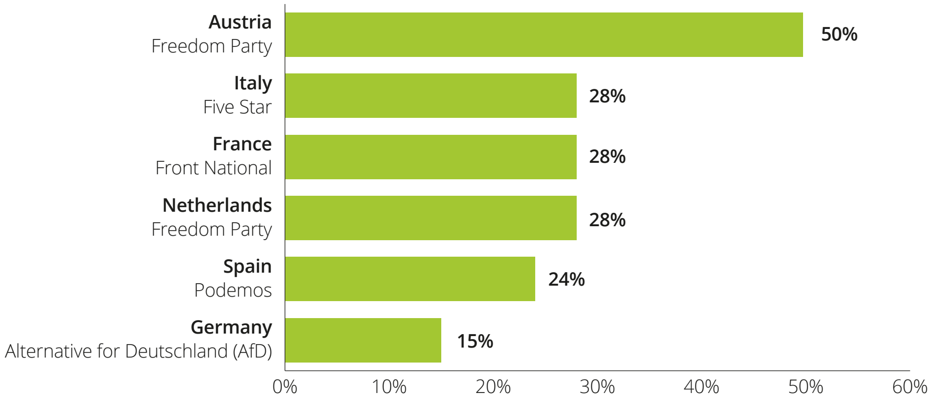
To minimise shock and to create additional stability, the UK and the EU may seek to arrange an extended transitional period beyond two years, as a kind of inverse of what countries joining the EU do. A transitional phase would give more time to introduce and ratify the necessary legislation.

It is also worth noting that the EU has sometimes interpreted its own rules flexibly. Some countries joined the euro despite not meeting all the formal criteria and recent euro area bailouts were contrary to EU treaties. Such decisions require political will. Achieving extra flexibility during the UK's negotiations with the EU would, similarly, require the support of other governments.

Impact on the EU

The impact of the UK's withdrawal will not be limited to the UK. Economists forecast a spillover economic impact for the rest of Europe, especially via reduced inward investment and trade slowing the nascent EU recovery. Consensus forecasts suggest 1.5% growth in the euro area in 2016 and 1.4% in 2017, in the event of a UK decision to leave the EU. These compare with forecasts of 1.7% in each year under a Remain scenario. The softening in growth is far less pronounced than that forecast for the UK, but the risk of collateral damage to the EU gives European countries a possible incentive to ensure a speedy separation.

Chart 3. Share of vote in latest opinion polls for anti-establishment parties in Europe

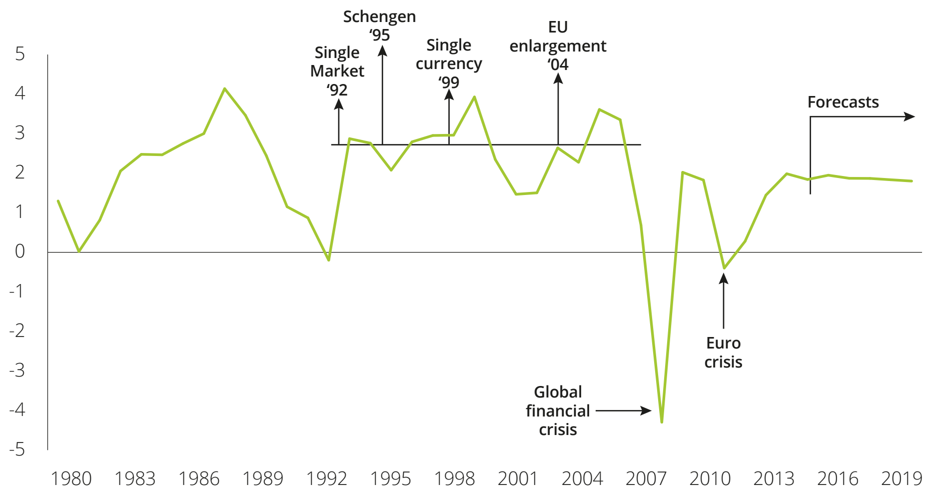


Some countries with closer UK ties are particularly exposed to Brexit. Analysis by the OECD suggests that the countries most affected will be Ireland, the Netherlands, Norway and Switzerland. Eastern and peripheral European economies have the least exposure to the UK.

But a far greater concern for European leaders will be the political impact of the UK's decision. A British exit from the EU represents the greatest political setback to the EU in its 65-year history. This comes at a time when the EU is already coping with a migration crisis and is trying to strengthen the euro area against future shocks. After a period of rapid economic and political integration in the '90s and '00s, European nations are experiencing a post-crisis rise in economic and political divergence accompanied by slower growth (Chart 4).

Chart 4. EU integration concentrated between '92 and '04

EU GDP growth (% YoY): Actual and forecast and timeline of major integration initiatives



Donald Tusk, President of the European Council, gave voice to the fears of Europe's leaders when he said the UK's departure could be the "beginning of the destruction of not only the EU but also Western political civilisation in its entirety". The immediate concern is the risk of a domino effect as Eurosceptic parties elsewhere in the EU demand their own referenda. Recent research conducted by Deloitte and the German employers organisation BDI found that 66% of German businesses believe a British exit would lead to further such votes in the EU.

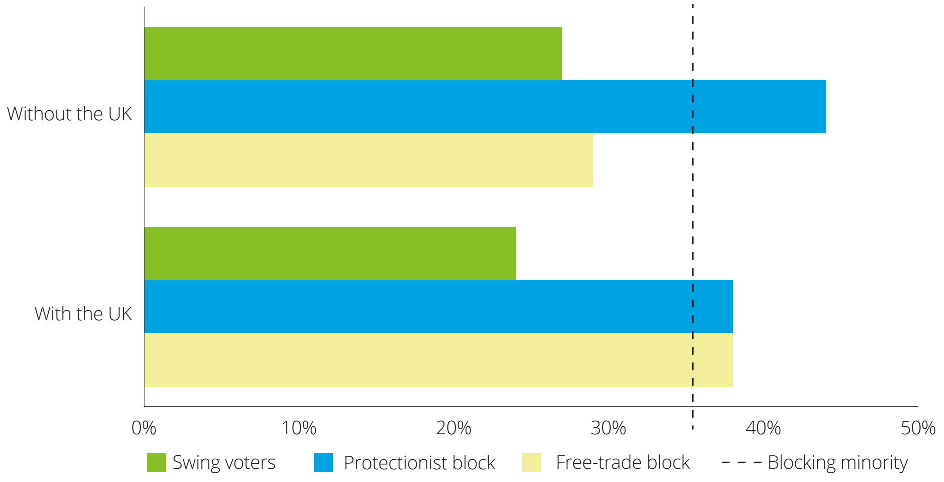
The UK's departure from the EU also raises significant questions about the future direction of the trade bloc. Without the UK, the EU loses a significant supporter of free trade and free-market policies. Analysis by the Open Europe think tank suggests that the UK's exit from the EU will tilt the balance of power in the EU under Qualified Majority Voting significantly towards a more protectionist, less free-market, approach (Chart 5).

Europe's politicians face a more nationalistic, more Eurosceptic mood. This is reflected in the rise of more extreme, anti-establishment political parties such as the Freedom Party in Austria, with 50% of the vote in the latest polls, the Five Star Movement in Italy, the Front National in France and Freedom Party in the Netherlands each with 28% of the vote in the latest polls (Chart 3). This is likely to be a significant factor in next year's general elections in Germany (August to October 2017), France (April to May 2017) and the Netherlands (March 2017), and also in the latest Spanish elections on 27th June 2016.

The Pew Research Center's latest polls (conducted in early June) show that, across ten major member nations, support for the EU has been falling and just 47% of respondents now have a favourable view of the EU. 70% said they would view a British exit from the EU as a "bad thing" for the future of the EU (Chart 6).

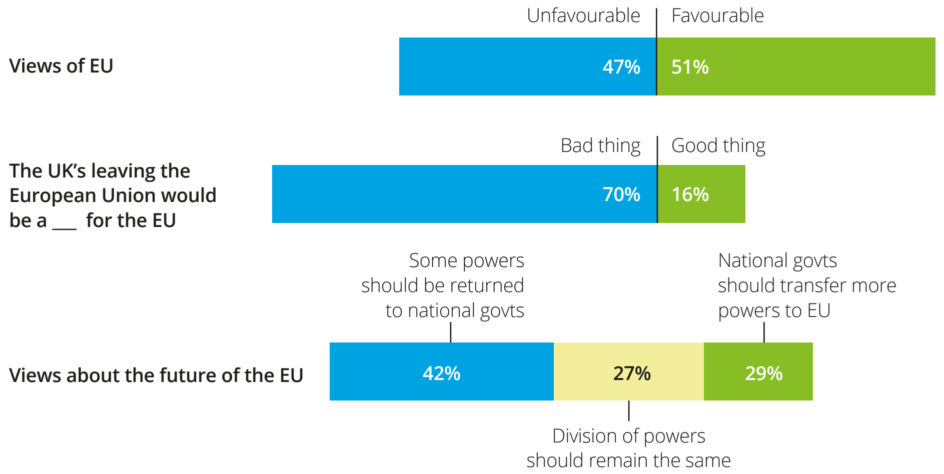
Faced with the risk of further secessions across Europe, and seeking to avoid political drift, EU leaders may seek to 'double-down' on ever closer union. Reports have suggested that European leaders have already been drawing up plans for a future union without the UK, developing a so-called "Plan B" focused on closer security and defence cooperation.

Chart 5. Qualified Majority Voting in the EU: Blocking minorities with and without the UK (%)



Source: Open Europe

Chart 6. European views of the EU and potential Brexit



Source: Pew Research Center poll of ten major EU nations

Deloitte contacts

If you would like to discuss risk assessment and mitigation strategies for your firm in light of the Brexit vote, contact Rick Cudworth, our Resilience & Crisis Management Leader, whose team could help you plan a response. On economics, contact our Chief Economist, Ian Stewart.

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