



The impact of Brexit: Asian edition

March 2016

For the majority of businesses in Britain the possibility the UK might leave the European Union - Brexit - is a major concern. The break with the EU and the uncertainty associated with it would be bad for business and damaging to the UK economy.

Much has been written on the economic consequences for the UK. Very little has been written on the consequences for the rest of the EU. Even less has been written about the issues that businesses outside of Europe - but with European interests - should be considering.

This report seeks to address this gap by systematically assessing the impact of Brexit on both the UK and the rest of Europe. It also identifies some of the issues that matter most for Asian firms that trade and invest in Europe.

At the heart of this analysis are seven channels of impact. For each we consider the impact on the UK and on the rest of the EU. We also assess the specific ways in which different EU member states are exposed through these channels.

We conclude that while the biggest impact of Brexit would be on the UK, there can be little doubt there would also be a significant wider impact. Businesses in Asia that trade and invest in Europe should consider now the potential impact on them.

Gregor Irwin
Chief Economist, Global Counsel

About Global Counsel

Global Counsel helps businesses across a wide range of sectors anticipate the ways in which politics, regulation and public policymaking create both risk and opportunity. Our senior team are former public policymakers who have worked at the highest level in the British government and European Union institutions. They draw on decades of experience and are backed by a global network.

With headquarters in London and a new office in Singapore we work with Asian businesses on securing their international interests, in Europe and beyond, tackling issues including market strategies, managing political or regulatory change, and corporate reputation building. Our work is backed up by high quality analytical content and collateral that is politically and economically informed and which builds quickly into executable strategy.

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Executive summary

For the first time in a generation there is a serious prospect of a member state leaving the European Union. On 23 June the UK will hold a referendum on whether it should leave or remain in the EU. The opinion polls suggest the outcome is uncertain. A vote to remain in the EU is far from assured.

If the UK leaves the EU the impact would depend on the future relationship between the UK and the EU. A lack of clarity over what would replace EU membership is just one reason why the path to Brexit - and beyond - would be long and uncertain, taking ten years or more.

The impact of Brexit through the trade and investment channels would be most severe in the UK. Regulatory divergence would increase over time, affecting trade volumes and reducing the attractiveness of the UK for investment. This would impact on European and international businesses invested or trading in the UK and supply chains involving UK firms, but the extent of the impact would depend on the UK's future relationship with the EU.

The rest of the EU would also feel the impact through other channels. The EU would lose an influential, liberalising member, shifting the balance of power in European policymaking. It would become harder to block illiberal economic initiatives. Moreover, there could likely be a new regulatory dynamic with the UK outside the EU, as the UK may seek to undercut the EU on standards impacting on the business environment.

There is little prospect of London being dislodged as Europe's leading international financial centre. This is sustained by

inherent advantages and a large network of financial and professional services that are hard to replicate. However, existing EU regulations would make it harder for London to serve European markets, particularly (but not only) for retail banking and euro-denominated trading. Some business would be likely to move to euro area financial centres or be lost to Europe.

Brexit would impact on the position of both the UK and the EU in the world. In economic terms this would be most evident in trade policy. While the UK would likely be free to strike new trade deals it would have less leverage. The EU would likewise be a less attractive partner at a time when it is only second priority for the US, Japan and many other Asian countries. The EU may, however, be able to take a tougher stance in negotiations without the UK and make more active use of trade defence instruments, impacting on some Asian interests.

The overall macroeconomic impact of Brexit is hard to quantify. This is because there are several unknowns and macro models do not capture many channels through which Brexit would impact on the economy. Most published studies find the impact on the UK would be negative and significant. The impact on the rest of the EU and further afield would be smaller.

There are three broader ways the UK and the rest of the EU would be affected by Brexit, which are not captured by macro models. The first is uncertainty. Surveys find many UK firms are already worried about the impact of referendum uncertainty. Yet the process beyond a referendum - if the UK votes to leave - to the point of exit and then establishing a new relationship with the EU would be prolonged and highly uncertain.

The second way is through the political dynamic between large states in an EU without the UK. Brexit could change the relationship between France and Germany. It could bind them together; it could cement France's position behind Germany in terms of influence; or it could push them apart, with the UK no longer providing political cover to mask their differences.

The third way is through political contagion. Some of the tensions in the UK regarding the EU also exist in other states, even if they manifest themselves differently. The 'proof of concept' of leaving the EU could mean that support for this grows in other countries.

We conclude that the European countries most exposed to Brexit are the Netherlands, Ireland and Cyprus. Each has strong trade, investment and financial links with the UK and in the cases of the Netherlands and Ireland are closely aligned in policy terms. Among the larger member states Germany would be most affected by the loss of the UK as a counterweight to France in policy debates. France may welcome the absence of the UK in policy debates, but like Spain has substantial direct investments in the UK.

For Asian businesses that trade and invest in Europe Brexit would not mean business as usual. It could potentially change the economic rationale for locating operations in particular European countries. It would likely impact on asset valuations, particularly in dollar terms. And it would certainly impact on the both politics and the regulatory dynamic in Europe in ways that will impact on all firms doing business in Europe.

Issues for Asian firms that trade and invest in Europe

- Financial services is among the sectors most exposed to Brexit, although cross-border retail services will be affected more than wholesale services. Strategic investors should consider their exposure under different scenarios.
 - FMCG companies in particular may need to adjust to treat the UK as a standalone market for the first time. This depends on the scenario for Brexit and the UK's future relationship with the EU.
 - Investors with large property exposures in the UK should assess the impact on the commercial sector if demand for corporate headquarters falls and the high-end residential sector if immigration controls are tightened.
 - A potential relaxation of UK state aid rules under some scenarios could create new opportunities for investors in sectors of the UK economy that are important from a UK economic, infrastructure or energy policy perspective.
 - The change in the balance of power in Brussels on regulatory debates could be material in sectors such as financial services, tax policy and the digital single market. Investors should review their exposure in these sectors in particular.
 - A vote for Brexit would mean a new and prolonged phase of political uncertainty and risk across European states. Asian firms and investors should review their capacity to monitor and mitigate these risks according to their exposure.
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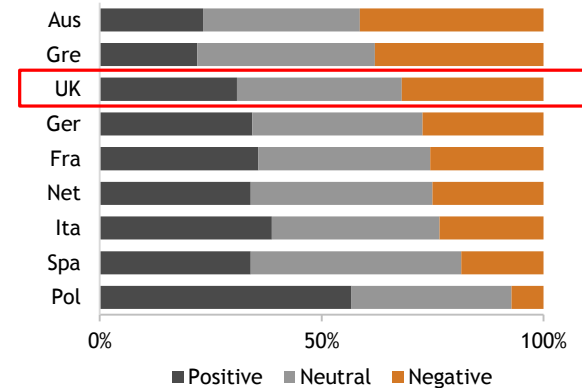
The day after a vote for Brexit

If the UK votes to leave the EU the decision would be binding, with no realistic prospect of a second referendum. It would be a major political shock that would create political instability in the UK and political uncertainty elsewhere in Europe. While there would be no immediate legal impact, the prospect of significant economic disruption and uncertainty would be reflected in financial markets.

- If the UK votes to leave the EU David Cameron would be called on to resign and find this hard to resist as he will have lost the confidence of his party and as the person who must negotiate a new relationship with the EU. It would take two-to-five months for the Conservative Party to choose a new leader who would become the next prime minister. The key issue in that contest would be the UK's future relationship with the EU. There might also be an early general election if the new prime minister judges this would benefit him or her. The most likely candidates are George Osborne, Boris Johnson, Theresa May, and Michael Gove.
- If the UK votes to leave the EU, but Scotland votes to remain, this is likely to lead to a second Scottish referendum on independence. The outcome would be uncertain, but there is a good chance Brexit could lead to the break up of the UK.
- Brexit would create considerable political uncertainty elsewhere in Europe. It would embolden Eurosceptic parties in other member states just as Europe is already struggling to respond to a migration crisis that is threatening incumbent governments at the ballot box. The EU's response to Brexit would be an issue in national elections in Germany and France in 2017.
- It is possible that the EU could be strengthened with the departure of a sometimes awkward member if the shock forces closer integration of the right sort to address the structural problems in the euro area. But European leaders would be greatly concerned about the potential for political contagion - Brexit could liberate centrifugal forces in the EU, particularly if the UK is seen to leave on favourable terms. This is arguably the biggest risk from Brexit to the rest of the EU.

A wider perception problem?

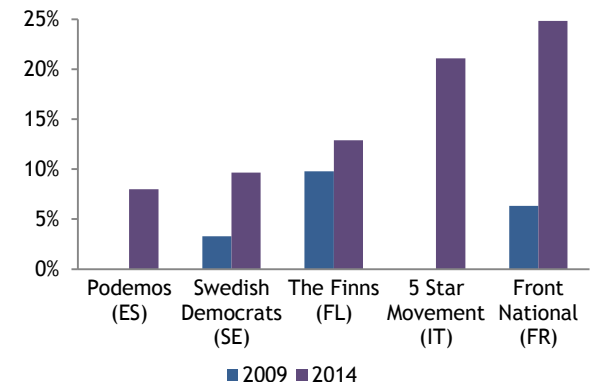
Does the EU conjure up a positive or negative image?



Source: EU Barometer, autumn 2015

Growing support for disintegrative forces

Share of vote in EP elections



The path to Brexit

Brexit would be a protracted process lasting around ten years. The endpoint for the UK-EU relationship would be subject to a negotiation. Business would face high levels of uncertainty during this process, impacting on investment decisions. It could also have significant macroeconomic consequences.

- The UK government would have two years to negotiate a withdrawal treaty with the EU once it has formally notified its intention to leave. There is a legal process for exiting the EU (set out in Article 50 of the EU Treaty) but this is ambiguous and has never been tested. The UK would have a weak bargaining position partly because of politics and the need for other EU states to make Brexit costly, but also because the process gives all members states and the European Parliament a say in the deal. Establishing a new relationship would inevitably take more than the two years allowed, creating transitional risks. A messy transition would be damaging for business.
- One of the main criticisms of the Leave campaign is that they are unable to say what a vote for Brexit means in practice. This is because Leave supporters are divided on the relationship Britain should have with the EU on the outside.

Possible models for the UK-EU relationship after Brexit

Norwegian 	Swiss 	Canadian 
Based on membership of the European Economic Area. Full access to single market but no say in regulation. Bound by free movement of labour. Large budget contribution.	Based on bilateral accords. Access to single market in some sectors only. No say in regulation in those sectors. Still bound by free movement.	Based on an FTA. Non-tariff barriers and regulatory divergence likely. Major implications for access to single market for sectors like financial services.
<i>Government by fax from Brussels which politically hard to swallow in the UK</i>	<i>A difficult negotiation over sectors, oversight and enforcement</i>	<i>Highly disruptive, but would allow the UK more policy independence</i>

The full process could take ten years

Brexit timeline

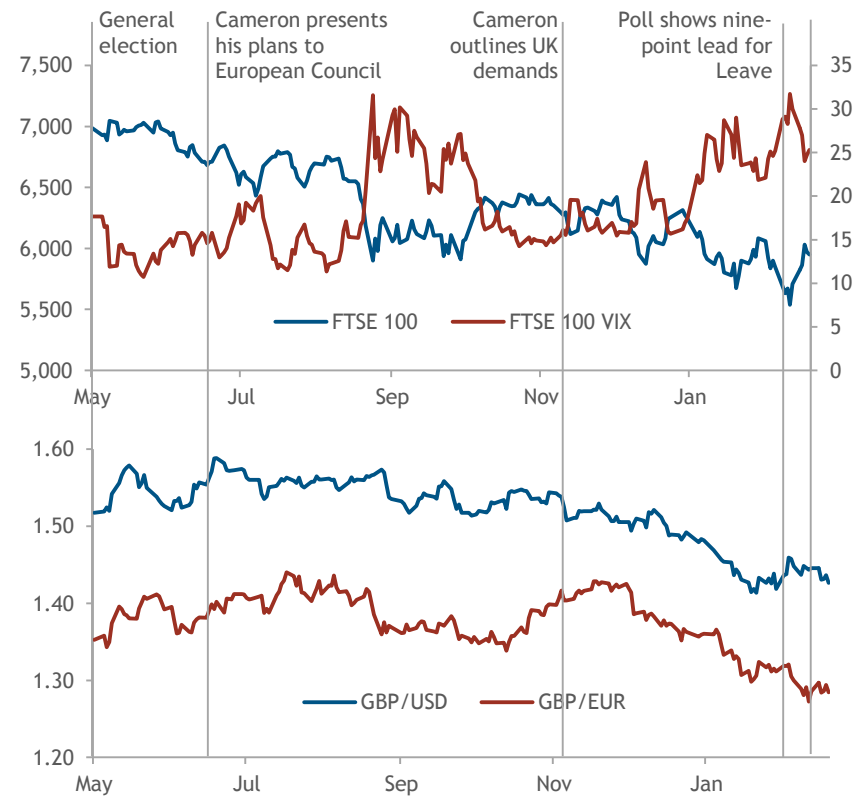


Market volatility

Brexit risk is already partly priced into financial markets, which have already seen sterling under pressure since the start of the year. The uncertainty about the referendum outcome means markets will again be impacted once the result is known. If the UK votes for Brexit it would also trigger a protracted period of market uncertainty.

- The run-up to the referendum is likely to be marked by further volatility for sterling, UK bond markets and UK equities with a high exposure to the domestic and European economies. Individual polls and events have the potential to move markets materially. The result itself, a prime ministerial resignation, the triggering of the Article 50 process and the outcome of an Exit Treaty negotiation are all likely to be among events impacting on market sentiment.
- Sterling could be expected to fall in most cases. It will fall more against the dollar and other currencies than it will against the euro, which will also be weighed down. This same events and market sentiment would be negative for UK gilts, particularly if the UK sovereign rating was downgraded. Risk premia are likely to rise, increasing financing costs, particularly at the short end of the yield curve.
- There could be longer-term impacts on property valuations, particularly if the UK financial services sector is damaged or there are significant new restrictions on migration from the EU.
- A likely Scottish decision to hold a second independence referendum would create additional market uncertainty about the future structure and prospects for the UK.

Sterling down, market uncertainty up
Financial market indicators and political milestones



EXIT



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AT ALL TIMES
POUR VOTRE SÉCURITÉ
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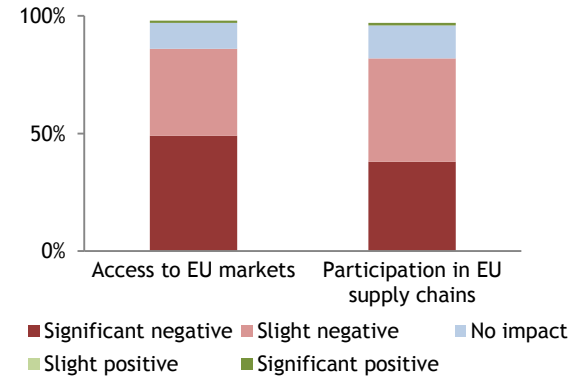
The channels of exposure

Channel one: trade within Europe

The impact on UK trade with Europe depend on the relationship between the UK and the EU after Brexit. In the most likely scenarios regulatory divergence that adds to the cost of trade is likely to increase over time, damaging bilateral trade volumes and the UK's position in European supply chains. The costs will be borne by consumers as well as businesses.

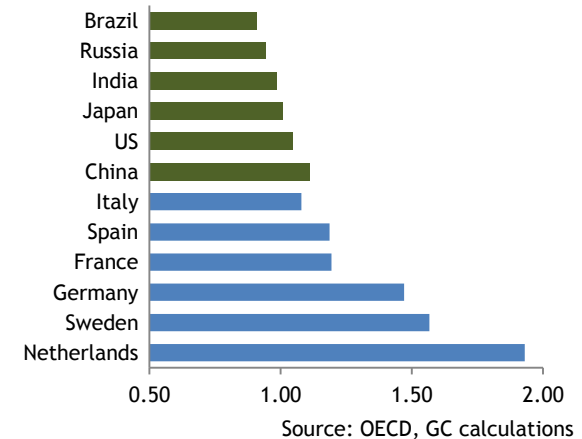
- EU membership is estimated to have boosted British goods trade with other member states by 55%, equal to £130bn in 2013.⁽¹⁾ Overall, the evidence does not suggest this has been at the expense of trade with non-EU states, but this may be a factor in individual protected sectors, such as agriculture, footwear and clothing. Costs for consumers might fall in these sectors, but rise overall.
- Under a Swiss or a Canadian-style relationship the UK would negotiate the terms of access for specific sectors, including the standards and regulations that apply in those sectors. The EU tradition of harmonization rather than mutual recognition means the choice for the UK is likely to be either to adopt EU standards or for firms to bear the cost of meeting two sets of standards. The UK would be less able to influence the future development of the single market, particularly in services where regulatory barriers remain significant and where full liberalisation could add 7% to UK GDP.⁽²⁾
- The single market provides opportunities for economies of scale, competition and innovation, which enhance productivity and which would be hard to replicate fully through trade outside Europe. There is a strong relationship between exporting and productivity: between 1996 and 2004 the productivity growth for UK exporters was 1.3%, compared to 0.8% for non-exporters.⁽³⁾
- Supply chains are becoming more important for competitiveness, but tend to be geographically concentrated. About half of EU imports to the UK are intermediates.⁽⁴⁾ The high ratio of trade in gross relative to value-added terms suggests that much UK trade with Europe is connected to supply chains.

Firms worry Brexit would damage trade
Business opinion of the impact of Brexit on EU trade



Source: CBI/YouGov (June-July 2013)

EU supply chains are important to the UK
Gross exports divided by value-added exports by destination

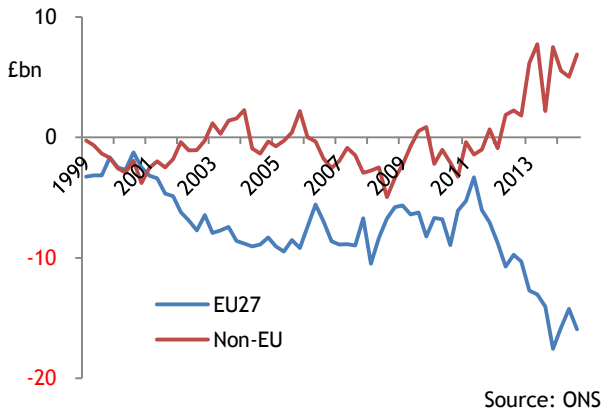


Source: OECD, GC calculations

Channel one: trade within Europe

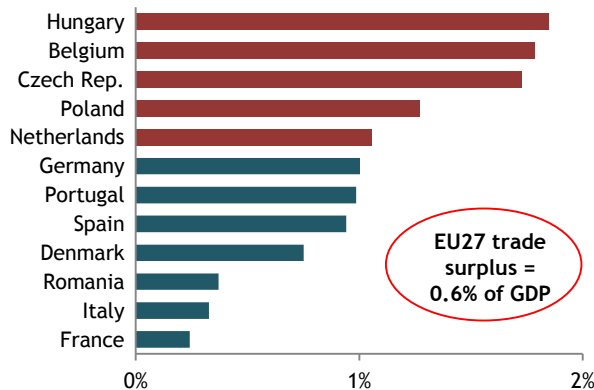
The UK's deficit with Europe is growing

Trade balance in goods and services (quarterly, SA)



The UK is a major source of demand

Trades surplus with the UK (% of GDP, 2013)



Source: ONS, Eurostat, GC calculations

Post-Brexit outcomes which reduce trade or increase the cost of trade between the UK and the rest of Europe would be damaging for both sides. The EU is a more important trade partner for the UK than the UK is for the EU. But UK demand is very important in macro terms for many EU countries. The UK runs large bilateral deficits against several member states.

- The UK accounts for just one sixth of the EU economy.⁽⁵⁾ One-tenth of EU exports are to the UK, whereas almost half of UK exports are to the EU. However, the imbalance in the trade relationship is such that the UK is an important source of demand for the rest of the EU. The UK's trade deficit with the rest of the EU has grown substantially in recent years and was €66bn in 2013, the equivalent of 0.6% of the GDP of the EU27 countries.⁽⁶⁾
- In value terms the trade surpluses with the UK are concentrated in a small number of countries, notably Germany, which exported €78bn to the UK in 2013 and imported €50bn.⁽⁷⁾ However, as a percent of GDP the trade surplus with the UK is important for many countries. It exceeds 1% of GDP in the Netherlands, Poland, Czech Republic, Belgium, Hungary, Latvia, Lithuania and Slovakia.⁽⁸⁾
- Only a few EU countries run a trade deficit with the UK, notably Ireland at 6.2% of GDP in 2013.⁽⁹⁾ But the UK is an extremely important bilateral trading partner with many Irish firms exporting into UK supply chains.
- UK companies are relatively upstream in global supply chains, compared to companies in other European countries. The importance of the UK in international supply chains is particularly concentrated in a small number of sectors. In 2009 the UK exported almost \$54bn of business and financial services into the supply chains of other countries, with companies in other EU countries accounting for a large proportion. In the same year the UK exported over \$30bn of mining and chemical products and over \$20bn in the transport, telecom, and wholesale and retail sectors into international supply chains.⁽¹⁰⁾

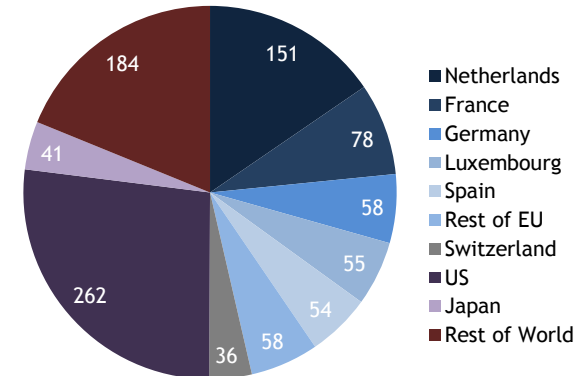
Channel two: foreign direct investment

The UK is the largest recipient of FDI in the EU. Brexit could reduce the attractiveness of the UK as a gateway to Europe, including for Asian firms. It could lead to a reduction in investment from the rest of the EU, which is the biggest source of UK FDI. It may become harder to attract corporate HQs.

- The EU was the source of 46% of the stock of FDI in the UK in 2013. This dependence has fallen somewhat in recent years, with the EU share down from 53% in 2009.⁽¹⁾
- The UK has many advantages that would be unaffected by Brexit such as language, light regulation and deep capital markets. Even so, the UK may struggle to attract as much new investment following Brexit. Other locations inside the EU are likely to be more attractive for marginal investment decisions by Asian and other investors.
- A poll of British firms suggests the impact of Brexit would be damaging not only to FDI, but also to the investment intentions of UK firms, with 29% more saying it would have a negative than a positive impact.⁽²⁾ However, the EU features low down the list of important factors according to a separate poll, with fewer than 1% of firms saying the UK needs to focus on access to the European market to remain a major global destination for investment.⁽³⁾ Opinions are likely to vary across sectors. Investment in vehicle production, for example, appears particularly dependent on the single market, both for sales and due to long European supply chains.
- Half of all European headquarters of non-EU firms are in the UK, with the UK hosting more HQs than Germany, France, Switzerland and the Netherlands put together.⁽⁴⁾ This could become harder following Brexit given the favourable tax treatment available to member states through the Parent-Subsidiary Directive. The UK would either need to negotiate third-country treatment under the directive or a series of new double taxation agreements with member states. That would take a considerable amount of time.

EU states are the biggest source of UK FDI

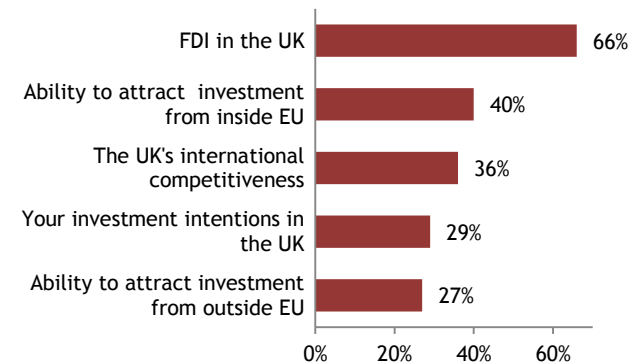
Inward stock of FDI in the UK (£bn, 2013)



Source: ONS

Brexit would damage investment prospects

Balance of CBI members who say the impact is negative



Source: CBI/YouGov (June-July 2013)

Channel two: foreign direct investment

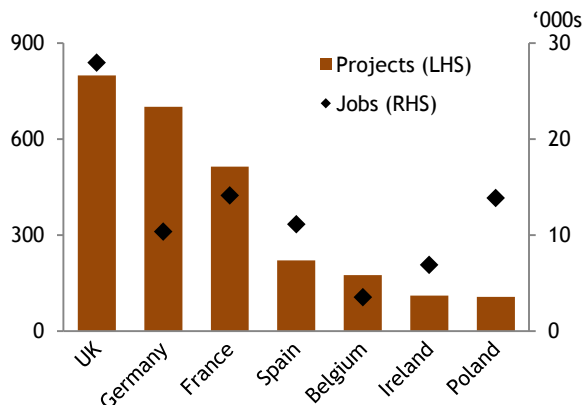
EU firms are invested across sectors in the UK 2013 data

Sector	EU FDI \$m	EU share	Biggest EU investors
Retail, wholesale	66,443	62%	NE, DE, FR
Mining, quarrying	61,708	73%	n/a
Financial services	55,850	24%	NE, DE
ICT	39,190	34%	FR, DE, LU
Utilities	34,989	90%	n/a
Transportation	31,125	75%	DE, NE, ES
Food, beverages	23,555	41%	NE, FR, LU
Total	452,525	46%	NE, FR, DE

Source: ONS, GC calculations

The UK is currently very competitive

FDI projects and jobs secured in 2013



Source: EY

Many large European corporates are heavily invested in the UK and the commercial logic for this investment could be affected by Brexit. The cost of adjustment for European corporates could be considerable. The UK may seek to compete more aggressively for investment by undercutting the EU on taxation and the business environment.

- FDI in the UK from the EU comes disproportionately from a small number of countries, including France, Germany, Spain and Ireland, although the picture is distorted by FDI routed through third countries, such as the Netherlands and Luxembourg. The EU share of FDI is much higher in the energy, retail and wholesale trade, transportation and manufacturing sectors than it is in financial and professional services.⁽⁵⁾
- The success of the UK in attracting FDI projects and jobs creates opportunities and risks for other EU countries if the UK leaves the EU. Whether they can seize the opportunity depends on how they respond to the loss of UK competitiveness that Brexit would likely represent. One particular challenge would be to attract European headquarters for multinationals away from the UK, but this will depend as much on the business environment in individual European countries.
- The UK would almost certainly seek ways to restore the competitiveness of the FDI offer. The UK might attempt to 'undercut' the EU further on social regulation and taxation, but probably not on environmental legislation. The risk to the EU is of the UK acting 'like Ireland' but over ten times bigger and largely liberated by the constraints and obligations of EU membership.
- This could impact in one of two ways in the rest of the EU. It could distort location choices and draw investment away from the rest of Europe over time. Or it could benefit firms elsewhere in the EU to the extent that it puts pressure on their governments to be more liberal and to take steps to improve the environment for investment.

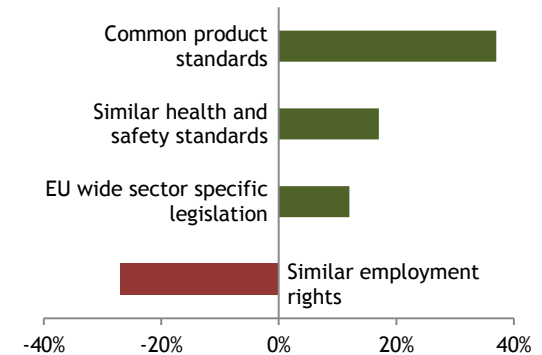
Channel three: liberalisation and regulation

The UK has championed the single market, but outside the EU would no longer be an effective advocate of further liberalisation. UK critics often complain about EU regulatory excesses, but many regulations are intended to create the level playing field the single market requires. A paradox of UK euroscepticism is that following Brexit the UK would lose influence over EU regulation without gaining much freedom to regulate independently.

- One estimate suggests national regulation is 2.5 times more cost effective than EU regulation.⁽¹⁾ EU processes are criticised for being opaque and hard to influence, particularly for SMEs.⁽²⁾ However, under most Brexit scenarios the UK must choose between adopting EU rules or being excluded from the single market, either in its entirety or in specific sectors.
- The public debate in the UK often fails to recognise the benefits from EU regulation. The 100 most expensive regulations cost the UK economy £27.4bn each year, whereas the benefits total £57.1bn, according to UK government impact assessments. Some individual regulations appear particularly costly, such as the Agency Workers Directive, which has a net cost of over £500m each year.⁽³⁾ The figures are contestable as the benefits are hard to estimate and some of the costs are due to gold-plating of standards by the UK.⁽⁴⁾
- The OECD regards the UK as the second least regulated product market after the Netherlands. Labour market regulation is comparable with the US, Canada and Australia and is much lower than other EU countries.⁽⁵⁾ This suggests there is no conflict between EU regulations and a highly-liberal market economy. Moreover, the OECD observes that one of the most heavily regulated areas in the UK - and one of the most damaging for productivity - is the system for obtaining planning permission, which has nothing to do with the EU.

Business views on EU regulation are mixed

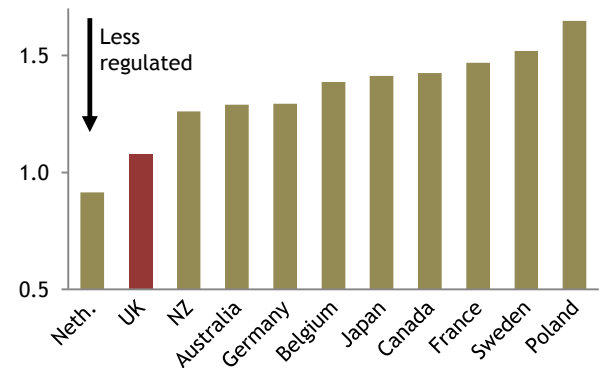
Balance of CBI members who say the impact is positive



Source: CBI/YouGov (June-July 2013)

UK product market are less regulated

Economy wide indicator of product market regulation

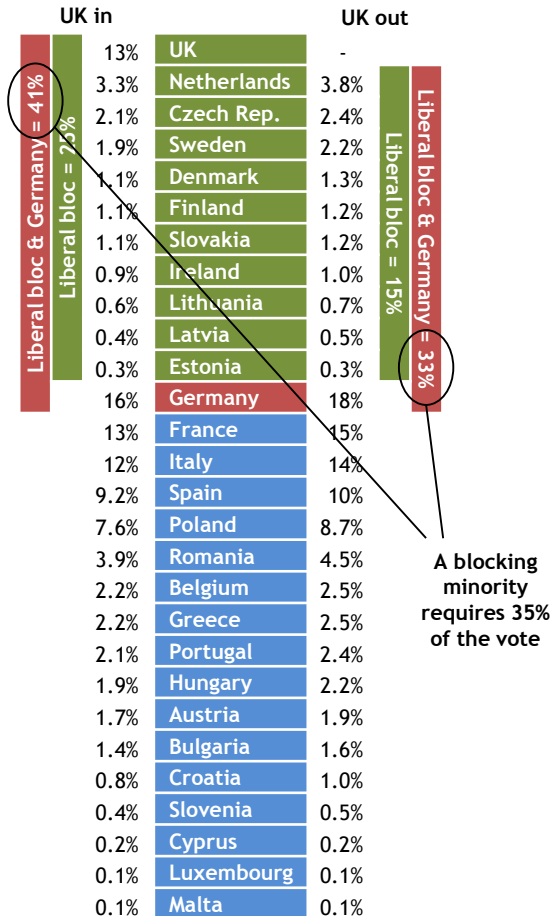


Source: OECD

Channel three: liberalisation and regulation

The challenge of forming a blocking minority

Vote shares by member states, with the UK in or out



Source: Eurostat, GC calculations

After Brexit the balance in the European Council on economic policy debates would shift, with the loss of a large member state supporting liberalisation. Germany, in particular, would find it harder to assemble a blocking minority or to act as the swing state in regulatory debates. Germany would become more exposed politically, by having to lead opposition to illiberal measures.

- The UK is one of the most economically liberal states and along with the Nordics, the Netherlands, and Ireland can be relied upon to oppose illiberal proposals in Brussels. Under the voting rules introduced in 2014 the liberal states can typically secure about 25% of the votes. If Germany votes with the liberal states this provides enough votes to achieve a 35% blocking minority. This puts Germany in a powerful position as a swing voter.
- If the UK leaves the EU this will shift the balance of power in Brussels away from the liberalisers, who will find it harder to assemble a blocking minority, even with German support. The combined votes of Germany plus the ten most liberal states would by itself be insufficient to achieve the necessary 35% of votes. More generally, Germany would no longer be able to use the UK to counterbalance France in regulatory policy debates.
- The UK has also played a significant role of shaping policy debates in the EU in ways that matter irrespective of the UK's voting weight. The UK has on several occasions used its clout to frame a policy debate in liberalising terms. This has been evident in major, set-piece liberalising initiatives, such as the services directive.
- The impact of the change in the balance of power in Brussels will vary from sector to sector, but might be greatest in financial services (where the UK has strong interests and expertise), taxation (where the UK has dug in to protect sovereignty) and the digital single market (where the UK has put its weight behind liberalisation).

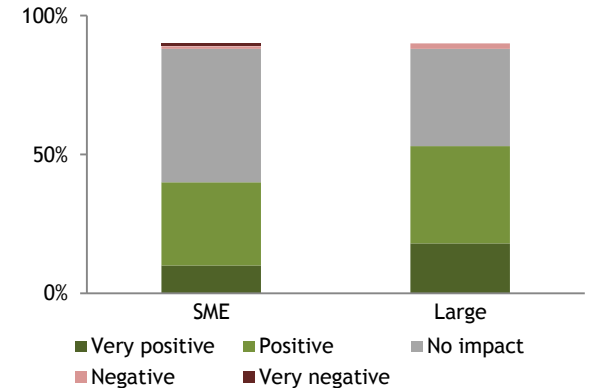
Channel four: competition and industrial policy

UK industry benefits from research collaboration in Europe and researchers have done well in EU competitions. While the UK would gain flexibility over industrial policy outside the EU it would lose the benefits from scale and influence over policy in areas such as energy.

- The UK receives more funding from the European Research Council than any other country and 50% more than Germany, allowing UK universities to fund more than 10% of project-based research from EU contributions.⁽¹⁾ Ten of the top twenty universities in the EU funding programme are in the UK, including the top three.⁽²⁾ UK researchers benefit from the pan-European collaboration encouraged by programmes like Horizon 2020. 49% of CBI members say access to EU research funding helps their business.⁽³⁾ The automotive, aerospace, pharmaceuticals, and chemicals sectors are among the beneficiaries.
- In early 2014 restrictions were placed on Swiss researchers accessing European Research Council grants following a dispute with the EU over free movement of workers. While the UK would most likely access science funding outside the EU, the Swiss experience shows this cannot be taken for granted. The UK would also be likely to have less influence over research priorities.
- The UK may be able to gain leeway to run a more active industrial policy unconstrained by EU state aid rules depending on the relationship with the EU. This might include reinstating a public interest test for takeovers, or introducing more comprehensive R&D tax credits. State aid rules have constrained UK policy in several areas including investment in Hinckley Point, renewables support schemes and the British Business Bank. The UK would, however, still be bound by WTO rules and even an FTA-based approach would impose disciplines in this area.
- The UK would also remain subject to the Third Energy Package if British firms continue to trade energy into the EU. The UK would lose influence over this policy area, including the development of any fourth package in future.

Business values access to EU funding streams

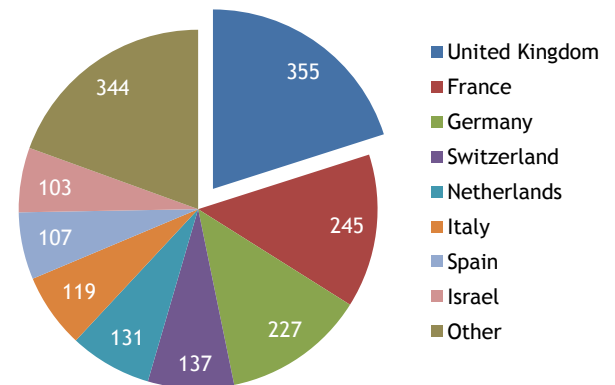
Impact of sector-specific aid, EIB funds, research support



Source: CBI/YouGov (June-July 2013)

UK-based researchers have done well

ERC grants by host country, 2007 to 2010

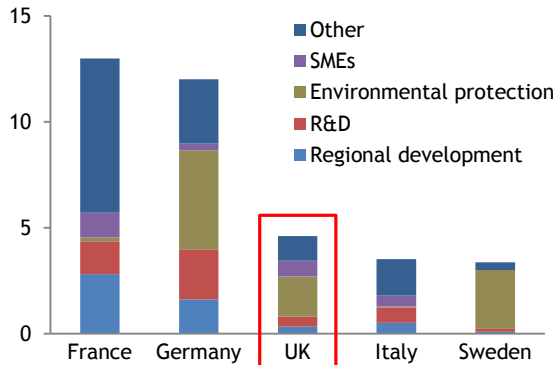


Source: European Commission

Channel four: competition and industrial policy

The UK is relatively restrained on state aid

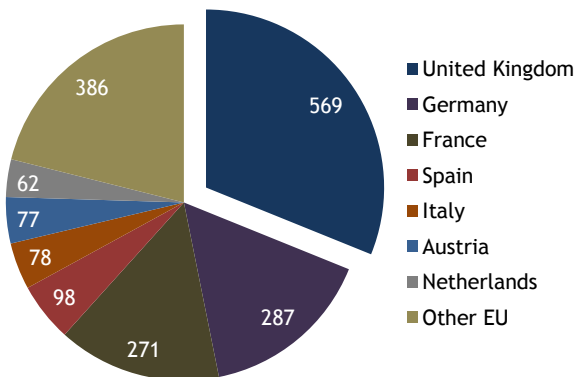
Non-crisis state aid in 2013 (€bn)



Source: Eurostat

The UK is a draw for foreign students

International student populations in 2012 (thousands)



Source: Eurostat

The impact on industrial policy in the EU depends on the Brexit model, but we may see a weakening of competition policy, looser collaboration in education and research, and fewer EU students in the UK. The UK government may intervene more in high-profile and politically sensitive procurements.

- Business would need to bear the cost of mergers being separately reviewed by the UK and EU authorities.⁽⁴⁾ The application of EU competition policy may change with the UK no longer playing an influential role in the European Competition Network. While the UK has advocated the principle of undistorted competition within the EU, the UK may seek to exploit its freedom from the constraints of state aid policy under some Brexit models.
- The UK may adopt a different approach to procurement following Brexit with government discretion being used more freely, particularly when under political pressure. The potential is evident from the controversy surrounding the Thameslink competition between Bombardier and Siemens.
- The UK was an important influence on the 2030 targets for emissions reduction, calling for tighter targets, while successfully fighting off calls for additional binding targets for renewables and energy efficiency. This would have added to the cost to business of meeting the emissions targets.
- UK influence over the culture and style of regulation in key sectors, including the utilities, would be likely to diminish following Brexit. UK bodies such as Ofcom, Ofgem, Ofwat and the Intellectual Property Office have provided a model for similar bodies in several EU states.
- Science collaboration could suffer following Brexit, with friction between the EU and the European Space Agency potentially complicating projects like Galileo.

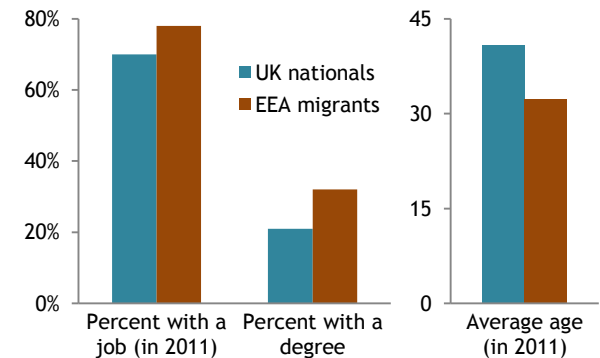
Channel five: immigration

Immigration is a fraught political issue in the UK both because the costs and benefits are not distributed evenly and as perceptions have become disconnected with reality, partly due to hostile media coverage. The scope to tighten immigration depends on the Brexit model. This risks damaging competitiveness, particularly of London, and being economically costly.

- Immigration helps address skills shortages and the consequences of an aging population. Free movement of EU workers allows UK firms access to specialist skill that are increasingly important to high-value added industries. 63% of CBI members say free movement has benefitted their business.⁽¹⁾ It is estimated that 1.5m new jobs will be created in higher-skilled jobs by 2022. Few new lower-skilled jobs will be created, but there will be a high demand for labour to replace retirees in these areas.⁽²⁾
- According to the OECD migrants are more likely to be net contributors to public finances if they are younger, in work and skilled. The evidence suggests that on average EU migrants make a net contribution to public finances and the OBR estimates the net contribution will be large in future.⁽³⁾ However, central European migrants will increasingly have families and put pressure on education spending. They also exacerbate the shortage of affordable housing. On average migrants have contributed 34% more in fiscal terms to the UK than they have taken out, or £22.1bn in total in 2011 terms.⁽⁴⁾
- If the UK adopts the Norwegian or Swiss models it would still need to sign up to the free movement of labour. Under the Canadian model the government could choose to align EU immigration with the non-EU points system. Tier 1 (highly skilled, entrepreneurs) and Tier 2 (skilled, graduate) immigration quotas would need to be raised significantly if the flow of immigration in these categories was not to be seriously disrupted.⁽⁵⁾
- It is possible that restrictions on non-EU states, including in Asia, could be relaxed, but this is likely to be marginal.

Immigrants are young, educated and employed

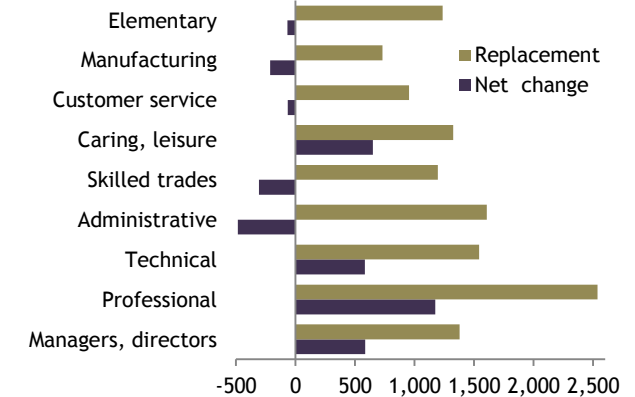
Profile of EEA immigrants to the UK



Source: Dustmann and Frattini (2013)

Future job growth varies across skill segments

Job creation and replacement, 2012 to 2022

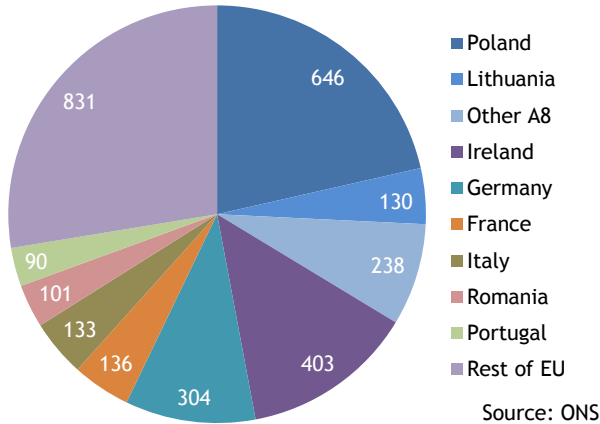


Source: UK Commission for Employment and Skills

Channel five: immigration

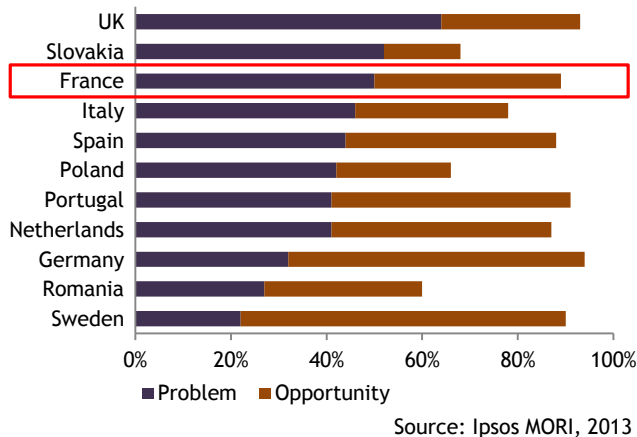
Poland is a major source of UK immigrants

EU immigrants to the UK by country of birth



Immigration concerns are high in other states

Attitudes on immigration as opportunity or problem



Businesses operating elsewhere in Europe can largely work around any restrictions on the free movement of labour imposed by the UK. However, changes to the labour supply and the flow of remittances will impact on some countries. Perhaps the biggest risk, but the hardest to predict, is of 'political contagion' elsewhere in Europe if the UK tightens border controls.

- The biggest costs from UK controls will be borne by EU firms invested in the UK as operations based outside the UK could likely substitute for UK labour. There is no limit to inter-company transfers under Tier 2 for salaries above £40k.⁽⁶⁾ This would reduce the negative impact on EU firms invested in the UK.
- There would be a significant effect on countries that are major sources of immigration to the UK, such as Poland. It would impact positively on skills and the supply of labour, but negatively on remittances. There could be an indirect impact on other countries, such as Germany, if UK immigration is 'deflected' there. The economic consequences will depend on the scale and composition, but are likely to be net positive if unevenly distributed.
- The biggest risk for the rest of the EU is that UK restrictions increase hostility towards immigration in other states, both because of deflected immigration and how UK policies impact on the policy debate elsewhere. Polling shows concerns are already high in several states.
- Immigration will be a factor in the French and German elections in 2017. However, there is one important difference between the UK and other member states. In the UK the contentious issue is intra-EU immigration, whereas elsewhere it is mostly extra-EU immigration and the cost of dealing with the refugee crisis that is impacting on much of continental Europe.

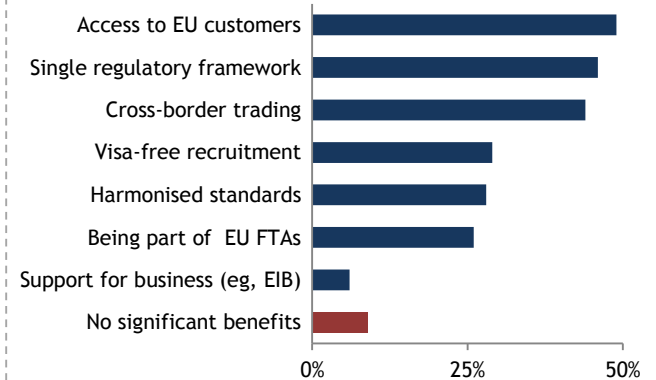
Channel six: financial services

Established advantages and agglomeration effects mean the UK has a strong competitive edge that would be hard to dislodge. However, existing EU regulations would make it harder for London to serve European markets, particularly for retail products and in euro trading. Business could move.

- Under the Swiss or Canadian models the UK must negotiate access to the EU markets in financial services. The EU only allows access to countries with equivalent regulations. The approach varies across directives. No access is allowed in some areas, such as UCITS (undertakings for collective investment in transferable securities). The logic is that retail consumers need additional protection. By contrast, the EU takes a flexible approach to wholesale banking, where equivalence is defined largely by reference to international standards. This matters for the UK given its dominance in wholesale banking. In many other directives the EU takes an intermediate approach. For example, the EU evaluates the equivalence of insurance regulation ‘line-by-line’ under Solvency II, although the impact is softened by transitional arrangements.
- The Swiss experience highlights the risks to the UK. They have equivalence under AIFMD, are being assessed under Solvency II and will try under MIFID. But they have failed under EMIR, ostensibly due to capital requirements, but with a suspicion that the real problem is Swiss immigration policy.
- The UK is the leader in euro-denominated wholesale banking, but Eurozone countries and institutions want this activity to move to the Eurozone and be overseen by the ECB. This would be much more likely following Brexit, as the UK would no longer be protected by single market rules.
- The UK might also suffer an opportunity cost from being absent from future liberalising initiatives such as Capital Markets Union, which could open up new markets in areas such as securitisation and covered bonds.

Financial sector firms value EU membership

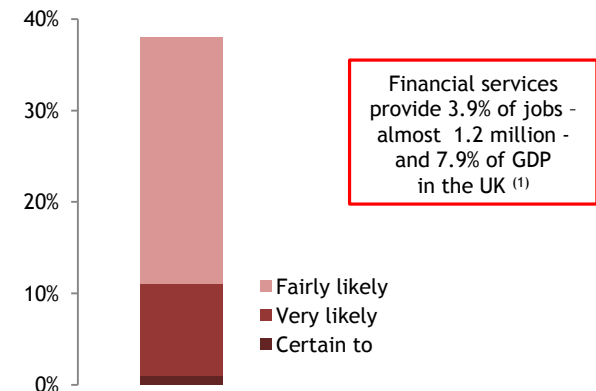
The benefits according to TheCityUK members



Source: Ipsos MORI (August-October 2013)

Jobs could move

Likelihood of relocating jobs if the UK leaves the single market



Source: Ipsos MORI (August-October 2013)

Channel six: financial services

The UK leads in most financial services

International market share by country

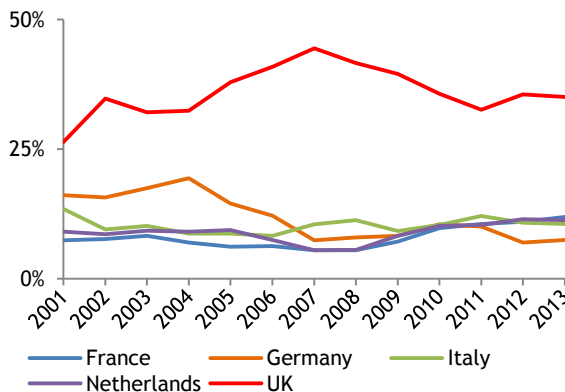
	UK	Fra	Ger
Cross-border bank lending	17%	9%	9%
Foreign exchange turnover	41%	3%	2%
Exchange-trade derivatives	7%	---	8%
Interest rate OTC derivatives	49%	7%	4%
Hedge funds assets	18%	1%	---
PE investment value	10%	5%	2%
Fund management	8%	3%	2%
Marine insurance	22%	4%	5%

Note: various time periods in 2012 and 2013

Source: TheCityUK

UK dominates wholesale financial services

Share of EU wholesale financial services GVA



Source: London Economics, Eurostat

Brexit may impact on the location, liquidity and cost of financial services in Europe if it undermines London's competitive position. This would be costly for businesses and households across Europe. Most large European banks have major operations in London which would be costly to relocate. Only a small number of financial centres elsewhere may benefit.

- The UK is highly integrated into the European financial system. Total UK claims on the EU15 alone are \$880bn with most of the credit to households and firms, but some also to governments and interbank lending. European bank exposure to the UK is even greater at \$1.7tn in total.⁽²⁾ It would be costly for European banks to relocate wholesale banking activity away from London.
- London is not just a European financial centre - it is an international centre with a dominant position in many product areas. However, London's international position could be damaged if large amounts of European business migrate following Brexit. There is a risk that some business, particularly more mobile activity such as derivatives, may leave Europe altogether.
- The most likely beneficiaries in the EU are Paris, Frankfurt, Amsterdam and Dublin. But they cannot replicate overnight the advantages of the London 'ecosystem' supporting financial services, including skilled staff, legal services and market infrastructure. Competition between them borne out of new barriers to trade with London would be disruptive and costly. Businesses in Europe would lose due to higher charges, poorer products and less liquidity. European corporates would, for example, find it more inconvenient and costly to raise capital in London, which currently provides a one-stop shop.
- Brexit would likely change the balance of financial regulatory debates in Europe. The UK now takes a more interventionist and risk-averse approach to regulation. Even so, the UK largely avoids politically-motivated interventions. Initiatives such as the Financial Transactions Tax and the cap on banker bonuses would have found an easier passage in an EU without the UK.

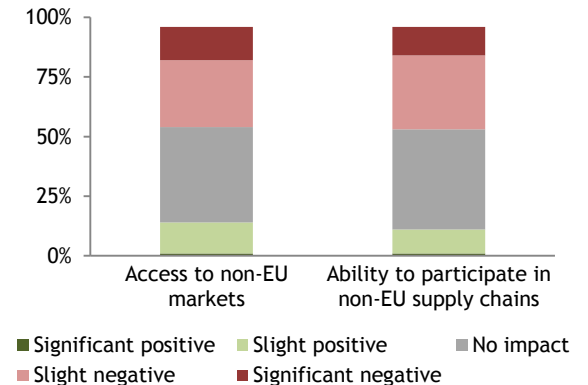
Channel seven: trade policy

The UK would be free to set its own trade policy priorities following Brexit, but these are unlikely to be much different from the EU's. The UK would have less leverage and be a lower priority trade partner than the EU for the major economies. The UK would lose the strength in numbers at the WTO when settling disputes with countries like China.

- The EU has considerable experience negotiating deep and comprehensive trade agreements. The EU is a signatory to over 30 bilateral and regional agreements with over 50 partners. The EU is currently negotiating trade deals with the US and Japan which would improve access to markets worth over \$20tn in total. The EU is negotiating an investment agreement with China.⁽¹⁾
- The UK would gain flexibility in negotiating trade deals and in particular be less encumbered by agricultural protectionism. However, economic size matters given trade negotiations are increasingly bilateral or regional, rather than multilateral. The UK gains leverage when addressing irritants or concluding FTAs through the EU. This is particularly important in services, where regulatory obstacles often need resolving to gain meaningful access to markets. Evidence from UK business suggests the UK benefits from the EU's negotiating weight when concluding bilateral deals on intellectual property.⁽²⁾
- If the focus ever shifts back to the WTO the UK will find it no longer has influence at the top table. Moreover, the UK may find itself more exposed when seeking to settle disputes at the WTO. While many cases are technical some can take on a political dimensions and provoke retaliation.
- The UK would likely have to renegotiate EU trade agreements as these would not automatically apply. This includes deals with Singapore and South Korea. This would require considerable diplomatic effort before the UK could turn to new deals.

Accessing markets will be harder after Brexit

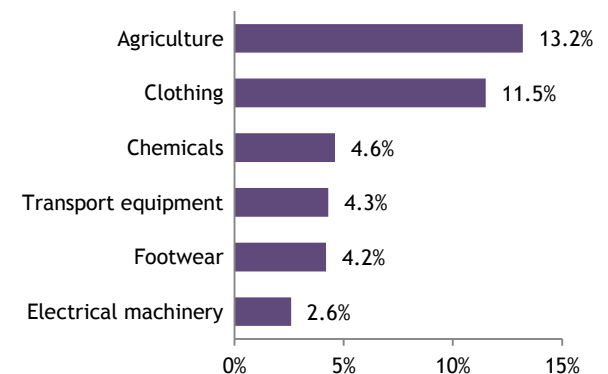
Business opinion on the impact of Brexit on market access



Source: CBI/YouGov (June-July 2013)

There is room to cut duties

Average MFN duties applied by the EU by tariff line

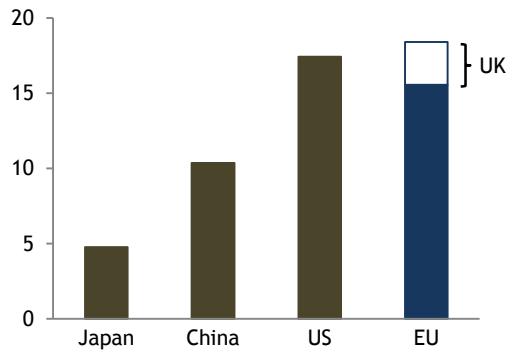


Source: WTO

Channel seven: trade policy

The EU would remain a large economic bloc

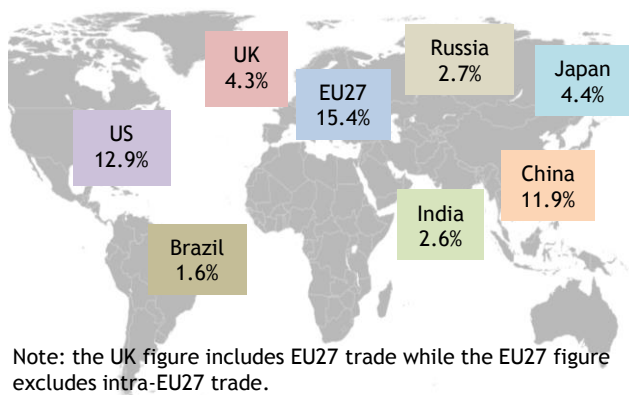
Nominal GDP in 2014, \$trillion



Source: IMF WEO

The EU would be a smaller trade bloc

Share of global trade by country/bloc, 2013



Note: the UK figure includes EU27 trade while the EU27 figure excludes intra-EU27 trade.

Source: World Bank, Eurostat, GC calculations

The EU has an open, liberalising approach to trade policy, in part due to UK influence. The UK, more than any other state, has put top-level political weight behind trade negotiations. The EU would be a less attractive partner for trade agreements if the UK was no longer part of the deal.

- The EU's top trade priorities are the Transatlantic Trade and Investment Partnership (TTIP) with the US and the Economic Partnership Agreement with Japan. But the EU is not the top trade priority for either the US or Japan, who are preoccupied with ratifying the Trans-Pacific Partnership (TPP).
- EU GDP would be around 15 percent lower without the UK.⁽³⁾ While the EU will remain an attractive trade partner, its appeal will be reduced. The external trade of the EU 27 would be about 15% of the global total compared to 4.3% for the UK.⁽⁴⁾
- The UK has championed a liberalising agenda for the EU. The UK was one of the strongest advocates for launching TTIP. The UK wants an investment agreement with China to lead to a full FTA negotiation and is a strong supporter of trade deals elsewhere in Asia. The UK was also the strongest supporter of the Doha round. Successive UK Prime Ministers have invested political capital in the completion of trade deals.
- The EU may turn out to be a tougher negotiating partner without the UK. This is arguably most true with China, where the UK has been criticized for rushing to launch negotiations, without obtaining prior commitments.
- The UK leaving the EU may shift the balance in favour of more active use of trade defence instruments. While some industries would welcome this and this as a legitimate means to counter unfair competition, it would also disadvantage consumers and firms that rely on imported intermediates and risks a protectionist response.

Brexit impact through seven channels

Impact scale ■ moderate ■ significant ■ severe

	Impact on the United Kingdom			Impact on the European Union
Trade within Europe	■ significant	Regulatory divergence grows over time increasing the cost of trade, impacting on volumes and the UK place in supply chains	EU trade matters more for the UK than UK trade for the EU, but some states with big bilateral surpluses feel a macro chill from Brexit	■ significant
Foreign direct investment	■ severe	The UK is less attractive as a gateway to Europe, as a base for corporate HQs and as a location for investment	Businesses find it costly to relocate investment from the UK and there is a risk the UK attempts to undercut the EU on standards to attract FDI	■ moderate
Liberalisation and regulation	■ severe	The UK loses influence over EU regulation without necessarily gaining much freedom to regulate independently	The balance in the European policymaking shifts away from liberalisation and it becomes harder to form a blocking minority against illiberal economic initiatives	■ severe
Competition and industrial policy	■ moderate	The UK gains flexibility over industrial policy and possibly also state aid, but loses the benefits from scale and influence in some areas	There could be a weakening of competition policy, looser collaboration in education and research and impacts on public procurement	■ moderate
Immigration	■ significant	Immigration is tightened, damaging competitiveness, particularly of London, but how much depends on the Brexit model	Some countries are affected by the impact on remittances or diverted migration, with the extent of political contagion a big unknown	■ moderate
Financial services	■ severe	The UK retains a strong competitive edge, but most likely loses business as it becomes harder to provide certain services to EU markets	One or two financial centres may benefit, but businesses and households suffer from the loss of liquidity and increased cost of financial services	■ severe
Trade policy	■ significant	The UK has less leverage, is a lower priority partner in trade negotiations and finds it harder to resolve trade disputes	The EU is a less attractive trade partner without the UK in the deal and loses a member state that puts its political weight behind negotiations	■ significant

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Who is most exposed?

Who is most exposed?

The impact of Brexit would vary depending on connectedness with the UK, alignment with UK policy objectives, or underlying vulnerability to shocks. Our ranking of EU country exposures to Brexit is based on an assessment of the potential importance of the different channels and how individual countries are exposed to each. We conclude that there is a wide variation in exposure, which is partly explain by geography.

High exposure	Three countries stand out for having the highest exposure - the Netherlands, Ireland and Cyprus. Ireland is no surprise, given its proximity to the UK. The Netherlands and Cyprus, like Ireland, share very strong trade, investment and financial links with the UK. These countries also tend to be closely aligned with the UK in terms of regulatory and trade policy objectives.
Significant exposure	Several countries have a significant exposure including Germany, Belgium and Sweden. Germany is in the middle of the pack across most metrics, suggesting Berlin will not only be influential, but also a good gauge of the wider EU interest in preventing Brexit. Sweden is particularly vulnerable due to a close policy alignment with the UK, while Belgium has close trade links.
Niche exposure	France and Poland are among a group of countries that are more exposed to Brexit in specific areas. In the case of France mid-level trade, investment and financial linkages are balanced by often conflicting policy objectives with the UK. Poland is most exposed through migration and the EU budget.
Low exposure	Italy is among a small group of states in the south-east of the EU with little direct exposure to Brexit. This reflects their distance and different political cultures, which means there is less alignment of policy interests. Italy in particular may be indirectly affected by the impact of Brexit on political dynamics in the EU.

States ranked by exposure to Brexit

Score based on multiple metrics (see next page)

Rank	Country	Score
1	Netherlands	28
2	Ireland	25
3	Cyprus	23
4	Portugal	17
5=	Greece	16
5=	Malta	16
7	Sweden	16
8	Denmark	15
9	Czech Republic	14
10=	Belgium	13
10=	Latvia	13
10=	Lithuania	13
13	Germany	13
14	Luxembourg	12
15=	Slovakia	12
15=	Spain	12
17	Finland	11
18=	Estonia	9
18=	France	9
18=	Hungary	9
21	Poland	8
22	Bulgaria	7
23	Austria	7
24	Romania	5
25	Italy	5
26=	Croatia	4
26=	Slovenia	4

Exposure metrics

	Exports to the UK % of GDP, 2013	FDI stock in the UK % of GDP, 2013	Regulatory policy alignment subjective	Residents in the UK % popln, 2013	UK bank links ^(a) % of GDP, 2014	Trade liberalising alignment subjective	Net budget contribtn. % of GNI, 2013	Output gap % potential, 2015	EU perception % negative, 2014	Overall Score ^(b)
Austria	1.3%	0.8%	No	0.2%	6%	Swing	0.4%	-1.1%	36%	7
Belgium	6.8%	4.9%	No	0.1%	21%	Swing	0.4%	-1.2%	22%	13
Bulgaria	1.9%	0.0%	No	0.7%	8%	Swing	-3.9%		18%	7
Croatia	1.2%	0.0%	No		6%	Swing	-0.1%		19%	4
Cyprus	7.1%	23.0%	No	4.0%	77%	Swing	-0.2%	-2.8%	38%	23
Czech Rep.	3.9%	0.0%	Swing	0.4%	3%	Swing	-2.4%		22%	14
Denmark	3.2%	1.9%	Yes	0.4%	12%	Yes	0.5%	-1.2%	18%	15
Estonia	1.5%	0.0%	Swing		1%	Swing	-4.3%	-0.6%	7%	9
Finland	1.8%	0.8%	Swing		16%	Swing	0.3%	-3.2%	17%	11
France	2.0%	4.3%	No	0.2%	25%	No	0.4%	-2.8%	23%	9
Germany	2.8%	2.4%	Swing	0.2%	19%	Swing	0.5%	0.0%	20%	13
Greece	1.7%	0.3%	No	0.4%	24%	Swing	-2.9%	-6.7%	44%	16
Hungary	3.7%	0.4%	No	0.7%	4%	Swing	-5.3%	0.0%	18%	9
Ireland	11.8%	7.5%	Yes	7.1%	174%	Swing	-0.2%	-1.4%	16%	25
Italy	1.4%	0.6%	No	0.2%	10%	No	0.2%	-4.2%	28%	5
Latvia	3.6%	0.0%	Swing	4.4%	3%	Swing	-3.4%		11%	13
Lithuania	3.4%	0.0%	Swing	5.3%	1%	Swing	-4.5%		6%	13
Luxembourg	4.1%	142.1%	No		365%	Swing	0.2%	-0.1%	16%	12
Malta	7.8%	11.8%	No		67%	Swing	-1.3%	0.3%	8%	16
Netherlands	7.6%	27.6%	Yes	0.4%	63%	Yes	0.4%	-4.0%	26%	28
Poland	2.8%	0.1%	No	1.9%	4%	No	-3.3%		6%	8
Portugal	2.6%	0.3%	No	1.3%	21%	Swing	-2.7%	-3.1%	25%	17
Romania	1.5%	0.0%	No	0.6%	2%	No	-3.0%		9%	5
Slovakia	3.2%	0.0%	Swing	1.0%	2%	Swing	-1.8%	-1.7%	19%	12
Slovenia	1.2%	0.0%	No		2%	Swing	-1.2%	-0.9%	17%	4
Spain	2.5%	6.0%	No	0.2%	8%	Swing	-0.3%	-3.5%	21%	12
Sweden	2.5%	2.2%	Yes	0.4%	14%	Yes	0.5%	-0.5%	22%	16

^(a) This is the sum of UK bank liabilities and bank claims in the member state.

^(b) Each channel is given a weight of 1 (moderate), 2 (significant) or 3 (severe), according to the grade for each. The impact on competition and industrial policy is assumed uniform across states and excluded. Two additional channels for EU budget contribution (significant) and uncertainty (severe) are included. These weights are multiplied with scores from this table of 1 (medium), 2 (high) or zero for each channel. For uncertainty and average of the output gap and EU perception is used.

medium high n/a

Sources: ONS, Bank of England, IMF, European Commission, EU Barometer Survey, CEIC

Trade within Europe

⁽¹⁾ CER, The Economic Consequences of Leaving the EU, June 2014; ⁽²⁾ Aussilloux, Boumellassa, Emlinger and Fontagné, The Economic Consequences for the UK and the EU of Completing the Single Market, BIS Economics Paper, February 2011; ⁽³⁾ Harris and Li, Firm Level Empirical Study of the Contribution of Exporting to UK Productivity Growth, UKTI, 2007; ⁽⁴⁾ CBI, Our Global Future, November 2013 (using the World Input-Output Database); ⁽⁵⁾ IMF, WEO database; ⁽⁶⁾ GC calculations, data from ONS, The Pink Book, 2014; ⁽⁷⁾ ONS, The Pink Book, 2014; ⁽⁸⁾ GC calculations, data from ONS, The Pink Book, 2014; ⁽⁹⁾ GC calculations, data from ONS, The Pink Book, 2014; ⁽¹⁰⁾ OECD-WTO Trade in Value Added database

Foreign direct investment

⁽¹⁾ GC calculations, with data from ONS; ⁽²⁾ CBI/YouGov, June-July 2013; ⁽³⁾ EY's Attractiveness Survey, UK 2014; ⁽⁴⁾ HM Government, Review of the Balance of Competences between the UK and the EU: The Single Market, July 2013; ⁽⁵⁾ GC calculations, with data from ONS

Liberalisation and regulation

⁽¹⁾ Open Europe, Still out of Control? Measuring Eleven Years of EU Regulation, June 2010; ⁽²⁾ HM Government, Review of the Balance of Competences between the UK and the EU: Single Market - Free Movement of Goods, February 2014; ⁽³⁾ Open Europe, Briefing Note, October 2013; ⁽⁴⁾ CER, The Economic Consequences of Leaving the EU, June 2014; ⁽⁵⁾ OECD Indicators of Productivity and Long Term Growth

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⁽¹⁾ HM Government, Review of the Balance of Competences between the UK and the EU: Research and Development; ⁽²⁾ Sixth FP7 Monitoring Report, August 2013; ⁽³⁾ CBI/YouGov, June-July 2013; ⁽⁴⁾ Burnside, What Would a Brexit Mean for EU Competition Policy, CER, September 2013

Immigration

⁽¹⁾ CBI/YouGov, June-July 2013; ⁽²⁾ UK Commission for Employment and Skills, Labour market projections for the UK, February 2015; ⁽³⁾ OBR, Fiscal Sustainability Report, July 2013; ⁽⁴⁾ Dustmann and Frattini, The Fiscal Effects of Immigration to the UK', UCL Centre for Research and Analysis of Migration, November 2013; ⁽⁵⁾ CER, The Economic Consequences of Leaving the EU, June 2014; ⁽⁶⁾ CER, The Economic Consequences of Leaving the EU, June 2014

Financial services

⁽¹⁾ TheCityUK, Key Facts About EU Financial and Related Professional Services, April 2014; ⁽²⁾ Deutsche Bank Research, A Future in the EU?, EU Monitor, September 2014

Trade policy

⁽¹⁾ European Commission memo/13/1080, December 2013; ⁽²⁾ HM Government, Review of the Balance of Competences between the UK and the EU: Single Market - Free Movement of Goods, February 2014; ⁽³⁾ IMF WEO database; ⁽⁴⁾ GC calculations using World Bank data

Contact Global Counsel

The possibility of Brexit creates many risks and some opportunities. Global Counsel can help businesses in Asia understand what the issues identified in this report mean for them.

With headquarters in London and a new office in Singapore we work with Asian businesses on securing their international interests, in Europe and beyond, tackling issues including market strategies, managing political or regulatory change, and corporate reputation building. Our work is backed up by high quality analytical content and collateral that is politically and economically informed and which builds quickly into executable strategy.

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