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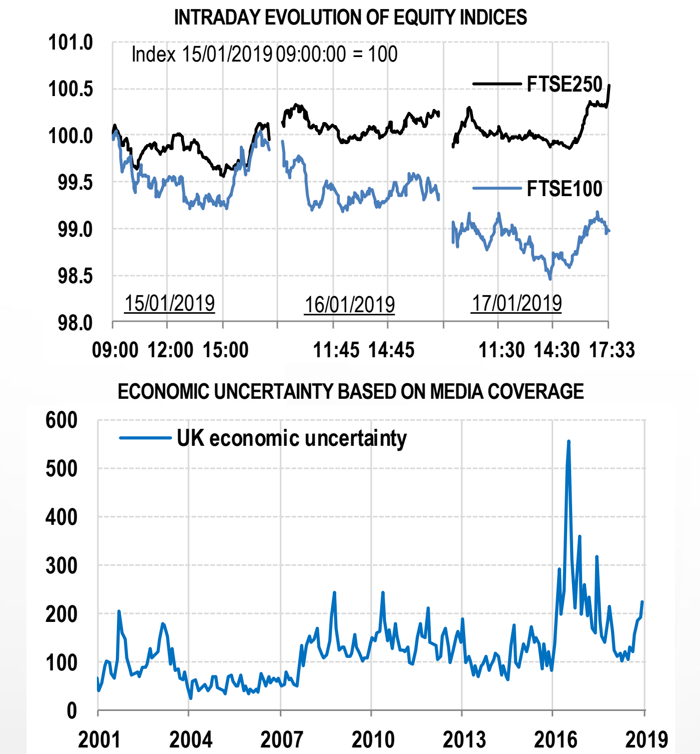
United Kingdom: Brexit, the cost of uncertainty

■ Market reaction suggests that the parliamentary vote, with a wide majority, against the Brexit deal which had been negotiated with Europe, has reduced the likelihood of a no-deal Brexit ■ Whether this feeling of relief lasts will depend on how the discussions on possible outcomes evolve ■ The economic headwind which comes with this prolonged uncertainty, for the UK but also for the companies in the EU which trade with the UK, will not go away soon

Judging by the equity market reaction the day after the debate in parliament on Brexit, during which prime minister Theresa May suffered a historically large defeat, it seems investors are of the view that the likelihood of ending up where one does not want to be, that is a no-deal hard (i.e. without a transition period) Brexit, has receded. This reading is based on the underperformance of the more internationally oriented FTSE100 versus the more domestically focused FTSE250 index. It suggests that markets are a bit less concerned about the hit to the economy in case of a no-deal departure from the EU. The Bank of England has estimated that the negative impact of a hard Brexit on the level of real GDP in 2023 could range between 4.75% and 7.75%. These estimates are surrounded by uncertainty but it seems safe to assume that the impact would be considerable. It would also be front-loaded: confidence would drop in view of the jump in uncertainty of how business would cope with the disruption in supply chains, household purchasing power would suffer from the increase in inflation due to the introduction of import tariffs and the weakening of sterling.

A no-deal Brexit can be considered as a tail risk and market reaction suggests that tail risk fears have abated. Whether this is more than just temporary relief will depend on how the discussions in the UK and between the UK and the EU evolve. The huge majority against the deal which had been negotiated implies that profound changes are needed to get parliamentary support keeping in mind that the European partners need to agree as well. At the risk of oversimplifying, it's like trying to square a circle: taking enough distance from the EU so as to be able to negotiate its own trade agreements whilst avoiding a hard border between Ireland and Northern Ireland. Given the challenge, delaying the Brexit date of 29 March seems quite likely now. Giving the negotiators more time provides hope that the tail risk can be avoided but it does imply that the economic headwind which comes with this prolonged uncertainty, for the UK but also for the companies in the EU which trade with the UK, will not go away soon. The observation that, all in all, the UK economy has held up well since the referendum should not make us forget that uncertainty since then did imply an opportunity cost and will continue to do so.

BREXIT: POLICY UNCERTAINTY AND MARKET REACTION



Source: Bloomberg, www.policyuncertainty.com, BNP Paribas

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