III Standing Committee on Foreign and
European Community Affairs and XIV Standing
Committee on EU Policies

Brexit: the possible economic and financial effects

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Chamber of Deputies

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Mr Chairman, Honourable Members of Parliament,

I would like to thank the Committees for inviting the Bank of Italy to comment on the United Kingdom's exit from the European Union. I will begin with a brief description of some well-known institutional aspects and then make some comments on the possible economic (for the United Kingdom, Europe and Italy) and financial repercussions. At this point in time, my observations can only be preliminary ones.

Institutional aspects: negotiations, exit and future relationships

Following the agreements reached in Lisbon in 2007, an article was added to the Treaty on the European Union – the constitutional basis of the EU – which explicitly provides for the possibility that a member state might wish to withdraw, and regulates the relative procedure. This is Article 50, now well-known after being invoked for the first time by the UK on 29 March in Prime Minister May's letter to the President of the European Council.

Article 50 envisages four phases. The first one, already completed, requires the outgoing member state to notify the European Council of its intention to withdraw from the European Union. The other steps are as follows: the Commission is given a mandate to negotiate the withdrawal agreement according to the guidelines unanimously established by the Council; the Commission conducts the negotiations on the withdrawal agreement; and both parties approve the agreement. The United Kingdom will not participate in the Council's decisions; aside from that, it will retain meanwhile all the rights and obligations arising from its EU membership.

Given the geographical proximity, the long, shared history and the deep-seated economic integration of the UK with the rest of Europe, there is a great deal of discussion on both sides as to how the withdrawal will take place and what relations will be established afterwards, with comparisons made between hard and soft Brexits, concepts that have yet to be clearly defined.

In principle there are two separate but related negotiations. One concerns the exit agreement as such, to which the procedure of Article 50 refers. It should cover issues such as the position of people and firms that live and work in the EU, thanks to the current freedom of movement, but will find themselves on the other side of what will again become an international border in all respects in 2019: this applies to British citizens in Europe and to European ones in the UK. This agreement might establish transitional rules and temporary or permanent, conditional or

unconditional, recognition of status, on people's right to stay where they are and continue with their current activities. Another important issue, which will presumably be covered by the withdrawal agreement, is the UK's financial obligations towards the EU as a member state.

The other negotiation concerns relations between the two parties after the withdrawal, including any trade agreements. Although the two negotiations are linked conceptually and certainly politically, they could in theory have different outcomes. For example, an agreement may be reached on the exit but not on subsequent relationships; in any case, the agreement on the new relationships will only be formally stipulated at a later date.

It is also not inconceivable that the negotiations are a complete failure, which would lead to the hardest of hard Brexits (except in the case of an extension of the two-year deadline, which the Treaty allows if decided unanimously). Both sides have indicated their wish to avoid a traumatic conclusion and to reach an agreement, as called for in a recent speech by Barnier, the European Commission's chief negotiator; it is to be hoped that they hold to this intention so as not to cause serious and avoidable personal and economic problems.

As far as post-Brexit trade relations between the UK and the EU are concerned, in theory there are four possibilities.

1. Accession to the European Economic Area (EEA) to which Iceland, Liechtenstein and Norway belong, as well as EU member states. Membership of the EEA ensures full participation in the European Single Market for non-EU states and entails accepting the 'four freedoms' (the free movement of people, goods, services and capital), with the same rights and obligations as EU member states, including a financial contribution. However, though non-EU states must apply the rules for participating in the single market, they do not decide them within EU institutions, such as the Commission, the Parliament and the Council.[1]
2. Participation in a customs union with the European Union, as in the case of Turkey. This union provides for the free movement of goods, the obligation to implement the relevant European regulations and a waiver on deciding own customs duties and on the possibility of reaching independent trade agreements.
3. A free trade agreement.[2]

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[1] Switzerland, which is a member state of the European Free Trade Association (EFTA), as are Iceland, Liechtenstein and Norway, is not a member of the EEA, but over time it has stipulated over one hundred bilateral agreements with the European Union (including the free movement of goods and people, but not of services and capital) and is required to implement the relative European regulations.

[2] Depending on the scope of the agreement, ratification by all EU member states could be required.

4. If no agreement were reached, trade relations would be governed by World Trade Organization regulations. In this case, the Most Favoured Nation (MFN) clause would apply, which prohibits any form of discrimination: each state undertakes to extend to every other state the same treatment granted to all countries with which there are no specific bilateral trade agreements.

In practice, however, neither membership of the EEA nor of a customs union seem realistic options. The former would impose the free movement of people and the obligation to implement the 'acquis communautaire', both of which the UK wants to abolish; the latter, as well as laying down certain regulatory restrictions, would greatly curb the UK's freedom to decide independently on its trade relations with other countries. The UK government's notification of withdrawal makes a general reference to a 'deep and special partnership' with the EU, but effectively appears to exclude staying in the single market.

The most likely scenario – if there is no change of heart – is that the UK will become a real 'third country' for the EU. Under this hypothesis, the question is whether it is possible to reach at least a free trade agreement, which would benefit the common interest; the notification letter expresses a desire for it to be 'bold and ambitious'. At this stage, the nature, timeframe and contents of any future agreement cannot be predicted. Negotiations are yet to begin; the UK government's stance will also depend on the outcome of the recently announced general election. We may imagine that the main topics of negotiation will be the trade of goods and, above all, financial services.

There are free trade agreements with nearly one hundred advanced and emerging countries, including Switzerland, Canada and South Korea. The agreement recently concluded with Canada is particularly interesting since, as well as eliminating customs duties, it makes access to public tenders and investments easier and facilitates trade in services.

If, or for as long as, there is no agreement, the trade relations between the EU and the UK will be governed by WTO regulations, unless there are specific transitional agreements, and the MFN clause will be applied.

The economic impact

United Kingdom – In the short term, the negative effects on the UK's economy that many expected immediately after the referendum failed to materialize. GDP growth actually increased in the second half of 2016, rising from 1.6 to 2.4 per cent on an annual basis, and employment continued to rise. Much depended on the strongly expansionary measures introduced by the Bank of England in August and on a more accommodative fiscal policy stance.

On 3 August 2016 the Bank of England cut its Bank Rate by 25 basis points; resumed the purchase of UK government bonds; and launched new schemes for corporate bond purchase and for extending loans to commercial banks. The HM Treasury put a brake on the fiscal consolidation process.

Analysts have progressively revised growth forecasts upwards for 2017, but continue to expect a slowdown over the year. According to the most recent consensus estimates, growth in the UK's GDP is expected to average 1.7 per cent over the year, slightly below that of 2016.

The most significant effects of the referendum have been on the sterling exchange rate, which has depreciated by about 10 per cent since 23 June, both against the euro and in nominal effective terms (that is, against all the other main currencies, weighted according to their trade with the UK); inflation rose by nearly 2 percentage points, to 2.3 per cent in March. The severe tensions besetting international financial markets around the time of the referendum dissipated quickly (Table 1). The economic policy uncertainty index rose in late June and early July, but then returned to pre-referendum levels (Figure 1).

It cannot be ruled out that any tensions arising from negotiations with the EU may trigger new bouts of financial volatility over the next few years, especially if they coincide with renewed concerns on the markets as to the cohesion of the Union.

What may happen in the long term remains uncertain. Openness to trade, immigration, and foreign investment generally promote growth, while a decrease in these factors, especially if it occurs in a climate of increasing protectionism at global level, could create significant costs for the UK economy in terms of innovative capacity, competitiveness, and productivity growth. This would also occur in the EU market, though on a more limited scale and would vary from country to country, depending on their links with the UK. The UK market is quite a small one for the EU, accounting for 7.1 per cent of total exports; in contrast, the EU is the destination for 44 per cent of UK goods.

According to our studies, if the UK and the EU imposed reciprocal trade tariffs, the long-term economic cost to the British economy would be significant, particularly if productivity growth diminished at the same time; the repercussions for the euro area would instead be small.

Brexit is expected to have an impact on the EU's budget, to which the UK makes a positive contribution. From 2010 to 2015, even taking into account the rebate negotiated by Margaret Thatcher in 1984 and the rebate received by the UK for its partial participation in justice and home affairs policies, the country contributed over €13 billion a year on average while receiving less than €7 billion. Moreover, the EU will no longer receive the customs duty collected in the UK; instead it will collect the duty levied on British exports to the EU. The overall effect is still difficult to assess.

Discussions are still under way about the UK's financial obligations to the EU when it leaves (the Brexit bill). Calculating the amount is a complex and controversial matter. One question is how the UK's share of the EU total should be calculated (it amounts to about 15 per cent of gross national income but 12 per cent in terms of contribution to the budget after rebates) and what asset and liability items should be included. This will probably be one of the most delicate issues faced during the exit negotiations.

Italy – Unfavourable economic developments in the UK would in any case not have any major repercussions for Italy in the short term. The slowdown that the Bank of England has forecast for 2018-20 would have a negligible impact. Even if the UK experienced such a deep recession as to reduce imports by 10 per cent over a three-year period, we estimate that the effect on Italy's GDP would be at most 0.25 percentage points.[3] Italy's trade and financial ties with the UK are not as close as those of other major euro-area countries (Table 2).

In 2015 Italian exports to the UK amounted to 1.8 per cent of GDP, against 2.7 for France, 3.2 for Spain and 3.7 for Germany. Imports amounted to 1.1 per cent of GDP, again less than for the other countries. Italy mainly exports machinery and mechanical engineering products, agri-food products, transport equipment, clothing and footwear, and tourism services. The bilateral balance on goods is very positive for Italy, while the balance on services is generally even.

Italy's financial ties with the UK are not as close as those of the other main European countries, as regards both portfolio investment and direct investment.

In June 2016, Italian residents' portfolios included €60.8 billion worth of UK-issued securities (that is, 3.7 per cent of GDP, compared with France's 10.1 and Germany's 5.9). Italian investors have limited exposure to exchange rate risk between the euro and sterling, with securities denominated in sterling accounting for little more than 1.1 per cent of the total. At the end of 2015 Italian direct investment in the UK stood at 1.4 per cent of GDP, compared with significantly higher percentages for the other leading euro-area countries. UK investment in Italy amounted to 2.2 per cent of Italian GDP.

If negotiations for a free trade deal between the EU and the UK are unsuccessful, trade between the two will become subject to customs duties. To have an idea of the potential economic impact for both sides let us assume that the UK applies the current EU tariffs at least until it has put its own tariff system in place; in other words, the trade tariffs that the EU

[3] *Economic Bulletin* 3/2016.

currently applies outside the area will apply between the area and the UK. On this basis, and considering only the impact effect (i.e. excluding any reallocation of trade flows), customs duty on goods exported by the 27-member EU to the UK would total about €16 billion and the duty on British goods exported to the EU-27 over €6 billion. Customs duty would on average represent a higher proportion of the value of goods (5.2 per cent) for exports from the EU-27 to the UK than the other way round (3.9 per cent) because of the different sectoral composition.

In fact, tariffs differ considerably across goods categories. Close to one fifth of the value of EU-27 exports to the UK relates to motor vehicles, which carry very high duty.

Moreover, as the structure of exports differs across EU-27 member countries, the average incidence of the tariff applied to exports to the UK would also differ. In the case of Germany, the tariff would be similar to the EU-27 average; for France and Italy it would be slightly less; Ireland, Spain and Poland would be faced with average duties in excess of 6 per cent.

If the existing European tariffs were applied to Italy's exports to the UK, in the case of machinery and mechanical engineering products, a sector that accounts for 20 per cent of Italian exports to the UK, the effect would be small (about 2 per cent of the value). The difference would be greater in the case of agri-food products (almost 10 per cent), clothing and footwear (8.2 per cent), and above all motor vehicles, even though the sector accounts for a much smaller share of exports to the UK (12 per cent) than in other countries (Germany 33 per cent, Spain 32 and Belgium 26).

Even with a free trade agreement, the UK would have to pay the administrative costs associated with the 'rules of origin', i.e. certification that goods being exported to the EU-27 (and many of the inputs needed to manufacture them) do not come from countries subject to EU customs duty. Differences in regulations and other non-tariff measures could further increase the cost of trade.

Financial regulation, banks and market infrastructure

Financial regulation – One of the biggest unknowns of Brexit is what shape future financial relations will take, starting with the regulatory aspect.

As an EU member state, the UK is part of the single market in financial services in which the single passport applies. Thus, a bank authorized in one member state can operate in any other member state (by establishing branches or through the free provision of services) under a system of notification and without the need for authorization. Prudential controls are conducted by the authorities of the home member state; the host state is responsible for anti-money-laundering and consumer protection.

With Brexit the single passport will be withdrawn. British banks will be treated like third-country banks: they will need to obtain a licence in all the member states where they wish to operate and will become subject to supervision by their host country.

UK-based banks and economic policymakers and financial regulators view the possibility of losing the single passport with trepidation, fearing that the City will lose part of its role as a financial centre for Europe and the world. At present, many non-EU banks (especially American and Asian ones) have their European legal and operational headquarters in the City, thus gaining access to the European financial market as well as to plentiful professional expertise and specialist services.

When it leaves the EU the UK's supervisory framework will, by definition, be 'equivalent' because – partly in consideration of the commitments set out in Prime Minister May's letter of notification – European regulations will initially be incorporated en bloc in the UK's internal regulations. Any changes made subsequently will have to be examined to ensure that equivalence is maintained.

Supervisory 'equivalence', as defined in the EU's financial legislation, gives some benefits to third countries. Most of these are exemptions from specific requirements, but in the case of investment services (MIFID/MIFIR2) and alternative investment funds (AIFMD) the legislation effectively gives equivalent third-country financial intermediaries a single passport of sorts in all EU member states, though only with respect to their professional clientele. Ensuring that domestic financial legislation stays aligned with that of Europe would make it easier for UK banks to set up a presence in countries, like Italy, that only grant authorization after verifying the standard of home country supervision.

Under a proposal of the European Commission included in the Review of the Capital Requirements Directive and Regulation, in the future, third-country banks that are of systemic importance in the area would have to set up an intermediate parent undertaking (IPU) in Europe. The IPU and its subsidiaries in the EU would be subject to consolidated supervision and crisis management under European rules. Hence, the major UK banking groups – many of which are spin-offs of international groups – would presumably be required to set up an IPU.

The UK will certainly try to reach agreements with the EU-27 that allow it to keep some of the benefits that London banks enjoy in terms of access to the European market. It is impossible to predict what these agreements will be or how they will affect London's competitive advantage.

Brexit also means that the European Banking Authority (EBA) headquartered in London will have to find a new home.

The decision, which will be taken in the coming months, is connected to an on-going debate on possible changes to the architecture of European system of financial supervision. The Commission has launched a public consultation prior to introducing new legislation. The present model is a sectoral one: the EBA is responsible for the banking sector, the EIOPA (headquartered in Frankfurt) for the insurance and pension fund industry, and the ESMA (based in Paris) for securities and markets. One of the options considered (with some variations) would reduce the number of authorities to two: one for banks and insurance and the other for markets and securities.

The debate is further complicated by the fact that the competencies transferred to the European level differ across sectors and activities (for example, more competencies are transferred for regulation than for supervision, except in the case of the banking industry where the application of the Single Supervisory Mechanism to the euro area alone has created a further difficulty).

Banks – As far as Italy's banking system is concerned, the importance of UK-based banks is limited. The 16 banks with branches in Italy account for 0.6 per cent of lending to customers. The majority of them (11 of the 16) belong to third-country groups that have established their European headquarters in London. They only have a significant role in some specific segments (advisory on extraordinary financing and placements, syndicated loans, and guarantees) relating to large corporations. Some international banks may move part of their activities from London to another European country, via either new or existing subsidiaries. The effect on Italian banking will probably be minimal.

Moreover, there are about 80 UK banks operating in Italy without a branch, through the free provision of services. They could continue to do so, failing any specific agreements, only if they set up a subsidiary in an EU member state. The scope of their activity in Italy is also limited.

There are very few Italian banks in the UK. The leading Italian banking groups jointly have six branches in London, mainly involved in trading and investment banking; they use the City to access the international wholesale funding market, though on a smaller scale than before the financial crisis. If they decided to move the management of these activities after Brexit, the cost is unlikely to be very high.

The Italian banks have limited exposure to UK residents: at the end of 2016 it was just under €34 billion (1.3 per cent of the Italian banking system's total exposure), three quarters of which consisting of loans to other banks and financial corporations.

Market infrastructure – Since 2007 Borsa Italiana Group has been controlled by London Stock Exchange Group (LSEG), which owns two important financial market management

companies (MTS and EuroTLX), the Italian central counterparty (Cassa di Compensazione e Garanzia) and the central securities depository (Monte Titoli). In March of this year the interbank deposit market management company (e-MID) also came under the control of an English group.

LSEG and Deutsche Börse had already planned a merger in 2016. The European Commission, however, recently announced that it had blocked the plan, which in its opinion would have created a virtual monopoly of the clearing market for fixed-income instruments: in fact the new group would have included the four central counterparties with the largest volume of business in this segment. Competition in clearing for equity derivatives would also have been significantly reduced.

Even if they are controlled by a foreign entity, the trading and post-trading management companies remain fully responsible for all operating processes. They are supervised at the domestic level by the Bank of Italy and Consob. Indeed, unlike banks, markets and market infrastructure are supervised at the solo level, rather than on a consolidated basis.

Controlling shareholders can be located outside the EU provided they meet the requirements of integrity and capital adequacy.

When the UK leaves the EU, the Bank of Italy and Consob will need to have closer contacts with controlling shareholders. When some of the cooperation mechanisms envisaged by European legislation are no longer in place, the Italian authorities will have to step up their efforts in the sphere of cross-border supervisory cooperation, as well as increase their bilateral cooperation with the UK supervisory authorities.

At European level, Brexit raises a matter of some importance regarding the supervision of central counterparties, since euro-denominated financial instruments, especially derivatives, are mostly cleared by UK-based entities.[4] We will need to make sure that supervision of UK central counterparties does not fall below the level set by European regulations for the main stability profiles: prudential supervision, currency of cleared contracts, and market control.

ESMA proposed a review of EMIR to strengthen the process of recognizing the third-country CCPs and provide forms of direct supervision by the European authorities. In the weeks to come, the Commission will publish its proposed review of EMIR; the prospect of the UK's exit requires this aspect to be carefully considered as well.

* * *

Prime Minister May's letter triggered for the first time the process by which a Member State can leave the Union. Difficult negotiations will now begin, although they will not be lengthy since the Treaty imposes strict time limits, given the technical complexity and political sensitivity of many of the issues. Both sides will require foresight and good will.

[4] For example, in the case of interest rate swaps, 50 per cent of global trades and 90 per cent of standardized swaps (i.e. which have to be cleared through a central counterparty) are cleared by the London-based LCH Group Ltd. and a very large share is denominated in euros.

To the surprise of many analysts, there were no immediate adverse effects of the UK's decision to exit on confidence, investment or the economic outlook. There was a significant but orderly devaluation of sterling.

There is no reason to expect any serious direct and immediate repercussions on the Italian economy and banking system.

Nevertheless, we cannot rule out the possibility that difficult negotiations, especially if they interact with the increasing global and European political and institutional uncertainty, could at a certain point trigger further market turbulence. It is unlikely that Italy would be immune. For us, the only way to prepare is to reinforce internal stability, to deal with any fragilities perceived by the markets, and to pursue the path of reform.

What will happen in the long run is as yet difficult to foresee. History teaches us that international openness is, at the end of the day, a powerful driver of economic growth. An economist may find it hard to believe that a country's prosperity can be furthered by creating barriers to the free movement of goods, capital and people. Naturally, a great deal will depend on future trade and financial agreements and on global developments. In any case, this is more of a risk for the United Kingdom than for the rest of Europe or the world.

Allow me to close by saying that, personally, I will miss my British colleagues in the European institutions that I participate in: not only because of their skill and level of preparation, which have always been admirable, but I will also miss their pragmatism, dislike of red tape and openness to the market, which has generally characterized their approach. I can only hope that 40 years of working together has allowed us all to learn from each other's best qualities.

Table 1

Effects of the Brexit referendum on the finanical markets
(*changes between 23 June 2016 and 12 April 2017*)

Market	Index	Change
Share prices	S&P 500 (USA)	11%
	Eurostoxx 600 (Europe)	10%
	DAX (Germany)	19%
	FTSE MIB (Italy)	11%
	FTSE 100 (UK)	16%
	Nikkei (Japan)	14%
	Hang Seng (Hong Kong)	17%
Bank share prices	S&P 500 Banks (USA)	31%
	Eurostoxx 600 Banks (Euro area)	15%
	GERMANY DS – Banks (Germany)	11%
	FTSE All-Share Italy Banks (Italy)	0%
	FTSE 350 Banks (UK)	22%
Exchange rates	EUR USD	-6%
	GBP EUR	-10%
	GBP USD	-16%
10-year yields	Germany	10 bp
	Italy	90 bp.
	UK	-32 bp
	USA	49 bp
Sovereign spreads	SPREAD ITA GER 10Y	80 bp.
Expected volatility	VIX	-1 pp
CDS prices	ITRAXX Europe	2 bp
	ITRAXX Senior Financial	-2 bp
Gold		1%
Oil	Brent	10%

Sources: Based on data from Thomson-Reuters Datastream and Bloomberg; bp: basis points; pp: percentage points

Table 2

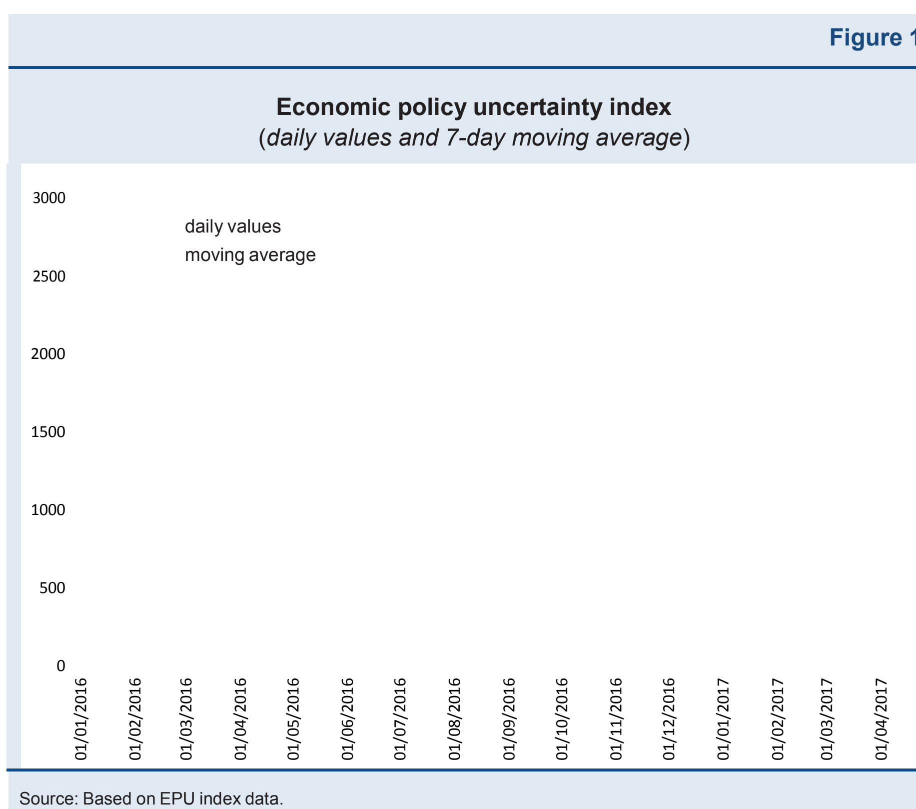
Economic and financial relations between the main EU countries and the United Kingdom
(*as a percentage of GDP*)

	Trade in 2015 (1)		Portfolio investment at end-H1 2016 (2)		Direct investment at end-2015 (3)	
	Exports	Imports	Assets	Liabilities	Assets	Liabilities
Italy	1.8	1.1	3.7	6.6	1.4	2.2
France	2.7	2.1	10.1	11.4	5.6	3.7
Germany	3.7	2.1	5.9	7.2	4.8	1.1
Spain	3.2	2.1	2.6	4.0	7.1	5.3

Sources: Based on data from Bank of Italy, Eurostat and the IMF (Coordinated Direct Investment Survey and Coordinated Portfolio Investment Survey). Notes: (1) Goods and services. – (2) End-of-period stocks; data based on statistics provided by the country holding the assets. – (3) End-of-period stocks; data based on the statistics provided by Italy and, for the other euro-area countries, by the United Kingdom.

Figure 1

Economic policy uncertainty index
(*daily values and 7-day moving average*)



Source: Based on EPU index data.

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