BANCA D'ITALIA
EUROSISTEMA

# Annual Report

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## THE ECONOMIC IMPLICATIONS OF BREXIT

On 29 March the UK government notified the European Council of its intention to withdraw from the EU.[1] This act formally initiated the Brexit process, which envisages three phases according to Article 50 of the Treaty on the European Union: the European Commission is given a mandate to negotiate the withdrawal agreement; the negotiations are conducted; and any agreement reached is ratified. The withdrawal must take account of future relationships with the EU, although they will be covered by a separate agreement (see the box 'The implications of the referendum for relations between the United Kingdom and the European Union', *Economic Bulletin*, 3, 2016).

In theory, there are four possibilities for future economic relations between the UK and the EU: (a) accession to the European Economic Area;[2] (b) participation in the EU customs union;[3] (c) a bilateral agreement; and (d) no agreement. In the last case, trade relations would be governed by World Trade Organization (WTO) rules, which envisage the application of bilateral tariffs based on the Most Favoured Nation clause (MFN).

The UK government's notification letter indicates its desire to maintain a special relationship with the EU by reaching a wide-ranging bilateral agreement on the trading of goods and services, but rules out participation in the European Economic Area or in the customs union. This only leaves the last two of the options described above.

On 29 April the European Council, following the UK's notification of withdrawal, adopted the guidelines forming the basis for the Commission's negotiation mandate: the negotiations should try to achieve an orderly exit from the EU and decide, among other things, on mutual guarantees to safeguard the rights of European and UK citizens affected by the withdrawal, and the settlement of all the UK's financial obligations deriving from its EU membership. Contrary to the UK's position, the European Council has indicated that it will only begin preliminary and preparatory negotiations for a trade agreement when it has established that there has been sufficient progress towards a satisfactory agreement on how to withdraw. The exit agreement will have to be approved by 29 March 2019 and the trade agreement may only be stipulated after that date.

The Brexit referendum outcome has not yet had the feared negative impact on economic activity in the UK, which actually accelerated over the second half of 2016. The economy has benefited from aggressively expansionary monetary policy

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1 The letter was signed under the European Union (Notification of Withdrawal) Act 2017 according to which the UK government, in compliance with the Supreme Court's ruling of 24 January, authorized the Prime Minister to notify the EU of its intention to withdraw.

2 The European Economic Area, which includes EU member states together with Liechtenstein, Norway and Iceland, extends the EU's single market and its four basic freedoms (free movement of goods, services, capital and people) to these three countries.

3 The customs union is a cornerstone of the EU and the single market: no customs duties are applied at internal EU borders, whereas a common customs tariff is applied to imports from outside the EU. Turkey, Andorra and San Marino are also in the EU customs union.

measures, a more accommodative fiscal policy, the improvement in the international economy and the marked depreciation of sterling. The risk of a crisis of confidence among households, firms and investors has not materialized. The depreciation in the exchange rate has also contributed to the increase in current and expected inflation: according to the Bank of England, consumer prices are expected to rise to 2.8 per cent in the fourth quarter of the current year.

The prospects for the negotiation and thus the medium-term consequences of Brexit remain subject to considerable uncertainty. Trade in goods and services between the UK and the EU could be affected by the resulting increase in tariffs, especially if no trade agreement is reached and tariffs based on the MFN clause are then adopted. The economic costs would be even greater for the UK were a lesser degree of trade integration to have repercussions on foreign direct investment, on productivity and on the vitality of the UK economy.[4]

The effects of Brexit on the euro area and the rest of the EU would be more limited and vary from country to country according to the extent of their trade and financial links with the UK (relatively limited for Italy; see the box 'Trade and financial relations between Italy and the United Kingdom', *Economic Bulletin*, 3, 2016). If, for example, the UK were to adopt an identical tariff system to that applied by the EU to third countries, given the sectoral composition of trade, UK exports would be subject to an average duty of 3.9 per cent. The corresponding figure for exports to the UK would be 5.3 per cent for Germany, slightly lower for France and Italy, and over 6 per cent for Ireland, Spain and Poland.[5]

The UK's withdrawal could have a major impact on the financial services sector,[6] which is especially important for the UK economy. In the absence of specific agreements, it will lead to revocation of the single passport, on the basis of which banks authorized to operate in one member state are automatically authorized throughout the EU. Many international banking groups currently operate in Europe through subsidiaries established in London. With the loss of the single passport, UK banks will have to obtain a licence in member states where they wish to operate and will become subject to supervision by the host authorities. Another important issue for London's financial centre is possible future pressure to move elsewhere the clearing of euro-denominated financial instruments, currently conducted for the most part (and especially in the case of over-the-counter derivatives) at central counterparties in the UK.

4 M. Pisani and F. Vergara Caffarelli, 'What will Brexit mean for the UK and euro area economies? A model-based assessment of trade regimes', Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

5 R. Cappariello, 'Brexit: estimating tariff costs for the EU countries in a new trade regime with the UK', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), forthcoming.

6 'Fact-finding enquiry on the future of the European project', testimony of L.F. Signorini, Deputy Governor of the Bank of Italy, Joint III and XIV Standing Committees, Chamber of Deputies, Rome, 26 April 2016.