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INTERNATIONAL ECONOMIC REPORT

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AS EXPECTED, UK BEGINS EXIT FROM THE EU; LONG-TERM ECONOMIC IMPACT UNCERTAIN, BUT MORE LIKELY NEGATIVE THAN POSITIVE

SUMMARY

- The UK formally launched negotiations to leave the EU a.k.a. "Brexit" March 29. The British government telegraphed its intentions clearly prior to the event, so financial markets had little immediate reaction.
- Brexit's economic impact will be felt only gradually, since the negotiations will take two years or longer.
- Brexit could ultimately reduce British exports, especially of services, and cause job losses in related industries, and may increase the possibility that Scotland demands independence and breaks up the UK.
- Brexit should have limited impact on the US economic outlook or US monetary policy. US exports to the UK are only 5 percent of total US exports, and less than 1 percent of US GDP.
- PNC Economics forecasts for the pound to depreciate to $1.20 in the second half of 2017 and in 2018.

The UK formally began its withdrawal from the EU ("Brexit") March 29 when its permanent representative to the EU, Sir Tim Barrow, delivered a letter to the EU President from British Prime Minister triggering Article 50 of the Treaty of the European Union, which governs how states leave the EU. Triggering Article 50 launches a negotiation between the UK and EU about their political and economic relations after the UK leaves the union. The UK will continue to be an EU member during these negotiations, and EU laws will continue to apply until the Brexit negotiation ends, most likely in March 2019, although the Treaty of the EU gives the UK and EU an option to extend negotiations by mutual agreement. Financial markets have been preparing for the trigger of Article 50 since the UK's Brexit referendum last June 23, in which a narrow 52 percent majority favored leaving. The pound exchange rate on March 29 was $1.24 dollars per pound sterling, little changed on the day or the week, but down precipitously from $1.47 the day before the referendum in June 2016 (See chart on second page).

The UK's withdrawal from the EU has profound implications for the British economy, since nearly half of British exports are sold to EU end markets. In a speech to Parliament March 29, Prime Minister Theresa May said the British government would propose "a bold and ambitious free trade agreement between the United Kingdom and European Union … of greater scope and ambition than any such agreement before it so that it covers sectors crucial to our linked economies such as financial services and network industries." British businesses currently can export services to other EU states on a level playing field with domestic businesses by using the "passporting rights" granted through the UK's participation in the EU common market. The UK aspires to a trade deal preserving as much access as possible to EU end markets for its businesses, but the obstacles are large: The EU does not grant passporting rights to any country which is not a member of its common market. The UK's service exports to other EU states account for 5 percent of the UK's GDP, so a loss of the right to export a significant share of these exports could weaken British growth. The UK may also lose business and jobs from global companies whose EU operations are located in the UK, and that might now move some operations to other EU states. Similarly, EU states could lose some degree of market access for exports to the UK, but they have less at stake in the Brexit negotiations: Other EU's states exports to the UK are more weighted toward goods and less services than the UK's, and World Trade

Organization rules will ensure a fairly free trade in goods for the EU and UK regardless of the outcome of their negotiations.

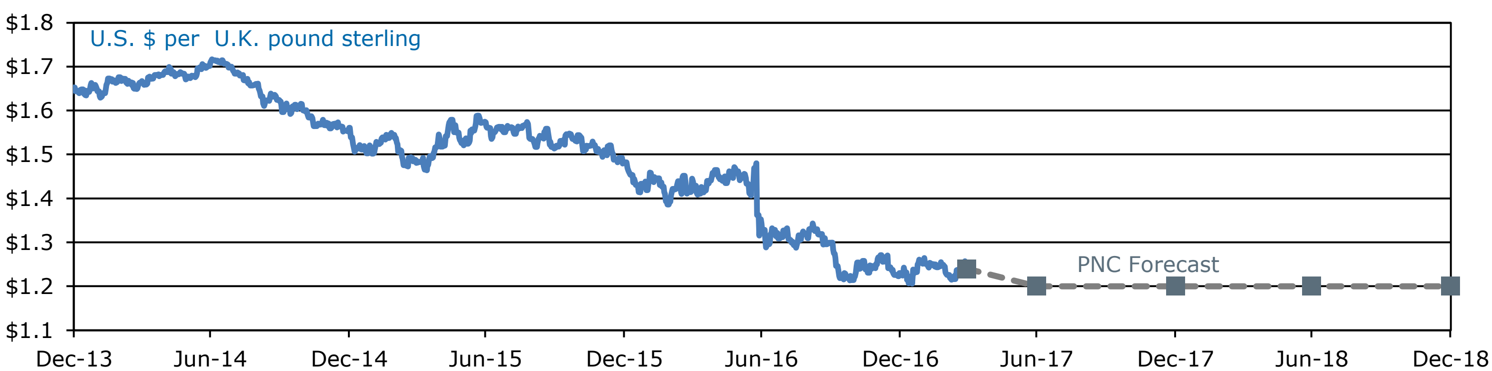
The other downside risk from Brexit is the possibility that it breaks up of the United Kingdom. The Scottish Parliament yesterday voted to hold a referendum on Scottish independence during the Brexit negotiations. A majority of Scottish voters supported remaining in the EU during the 2016 Brexit referendum, and losing the referendum bolsters pro-independence arguments that the UK's government in Westminster does not represent Scottish views. The Scots last held an independence referendum in September 2014, when a narrow majority favored remaining part of the UK. Brexit also creates problems for Northern Ireland, which shares the UK's only land border with an EU state. Northern Irish political parties who favor closer ties with the Republic of Ireland and the European Union gained 16 seats of the 90 total in the Northern Ireland Assembly's March 2 elections, with equal losses to the pro-Westminster, pro-Brexit parties.

Potential upside to the British economy from Brexit comes from the Conservative government's strategy to broker trade agreements with non-EU member states after Brexit, reviving the UK's historical identity as a "great trading nation"; to pass pro-growth deregulation of businesses; and to attract foreign investment by positioning the UK as Europe's "safe haven" from future EU financial or political turmoil. Realizing this upside will be extremely difficult. New trading agreements may face domestic political opposition if they threaten to open the British economy to cheaper foreign imports. Britain fondly remembers the prosperous trade of its imperial past in part because that trade was conducted with colonies, on a basis that favored home country trading parties and disadvantaged colonial ones – this was one of the causes of the Boston Tea Party and American Revolution. British business deregulation will be highly controversial if it threatens labor protections for British workers, and will be long delayed in any case: The UK has pledged to incorporate all EU law into British law as part of Brexit and cannot make changes until Brexit is done. Finally, the UK's attractiveness as a "safe haven" in Europe is compromised by the possibility that Scotland breaks away from the UK.

In short, while Brexit's economic implications may ultimately prove minimal, they seem more likely to be negative than positive. The UK has seen little economic drag from Brexit so far, since business managers seem to be waiting for clarity on how Brexit will affect them before changing staffing or moving operations to other EU states. But if Brexit ultimately reduces British exports or employment, the Bank of England is likely to delay interest rate hikes, restart quantitative easing, or even cut interest rates into negative territory. PNC Economics forecasts for the exchange rate to average $1.20 dollars per UK pound in the second half of 2017 and in 2018, weaker than late March's $1.24, reflecting a balance of risks that seems more negative than positive.

Brexit likely has limited implications for the US economic outlook and monetary policy. US exports of goods and services to the UK are about 5 percent of total US exports and about 0.7 percent of US GDP, so a British recession would have limited direct effects on US GDP or employment. US exports to other EU states are larger, 17 percent of total exports and 2 percent of US GDP, but Brexit poses less downside risk to those economies than it does to the UK.

CHART: POUND LITTLE CHANGED AFTER BRITISH GOVERNMENT TRIGGERS ARTICLE 50 MARCH 29, SINCE MARKETS ALREADY REACTED AFTER THE JUNE 2016 REFERENDUM



Sources: Bank of England, CEIC, The PNC Financial Services Group

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