CURRENT ANALYSIS
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Will Brexit send waves across the Atlantic?

Looking at the impact on Canada's economy of the UK's vote to "leave"

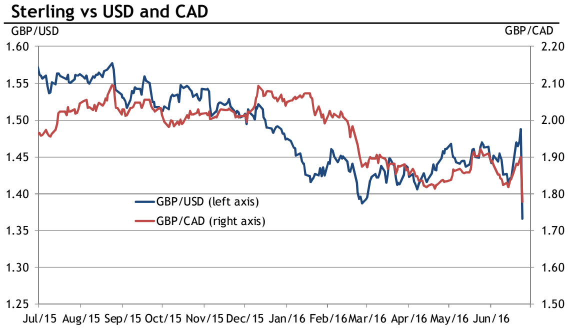
Highlights

- The UK voted for "Brexit" and will likely begin official negotiations to leave the European Union in October.
- Uncertainty about Single Market access is expected to result in a slowdown in the UK economy, sterling depreciation, and monetary policy stimulus from the Bank of England.
- The UK is one of Canada's top trading and investment partners, however the small relative size of these relationships points to a muted direct effect on Canada's economy. Knock on effects could weaken the euro area and remaining EU economies with which Canada also has important trade and investment relationships.
- A return to risk aversion in financial markets is expected to put downward pressure on oil prices, government bond yields, and the Canadian dollar (relative to USD). In a more severe reaction, upward pressure on peripheral spreads in the euro area risks replaying the volatility seen during the European debt crisis.
- Financial market effects have the potential to exacerbate regional divergences within Canada's economy. A pickup in uncertainty about the global economy also presents a downside risk to the outlook for the Canadian economy.
- Ratification of CETA, Canada's free trade agreement with the EU, will likely be delayed amid Brexit negotiations.

The UK votes to leave the EU. Yesterday, 23 June 2016, voters in the UK were asked in a referendum: "Should the United Kingdom remain a member of the European Union or leave the European Union?" Preliminary results indicate the UK electorate voted to "leave" by a margin of 52% to 48%. Importantly, the "leave" vote will not immediately result in the UK exiting the European Union (so called "Brexit"), as the UK has up to two years—or even longer under unanimous agreement—to negotiate a withdrawal agreement during which EU rules will continue to apply. Although the formal Article 50 withdrawal process is not expected to begin until October, it is possible that the cabinet will agree on some informal negotiations being entered into with the EU before that time.

Uncertainty will have a sizeable impact on the UK economy. During the negotiation period there will be considerable uncertainty as to what form the UK-EU relationship will take. The most significant item will be whether the UK will continue to have full access to the EU's Single Market that allows UK businesses to benefit from the free movement of goods, services, persons and capital throughout the EU. It is likely that uncertainty regarding future access to the Single Market will result in a cyclical downturn in the UK economy. The likely channel would be through postponed investment decisions amid this uncertainty, with knock-on consequences for employment and confidence. That scenario assumes that markets, at least temporarily, discount a scenario in which the UK is a long way from full Single Market access. In the case that the main details of a new framework for UK-EU relations are fleshed out fairly quickly, or if it appears the UK will retain significant access to the Single

Sterling vs USD and CAD



Source: Bloomberg, RBC Economics Research

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Market, the impact of uncertainty will be more limited.

Knock on effects could be significant for the euro area. The UK is the euro area's largest export market, accounting for 15% of goods exports that amount to roughly 3% of aggregate euro area GDP. During withdrawal negotiations, while the UK remains an EU member, spillover through the trade channel should be limited to any moderation in demand due to the UK's economic slowdown. Brexit could have a more disruptive effect on trade flows in the longer run, although the extent of that impact will ultimately depend on the UK's relationship with the Single Market. More immediately, financial markets could be the most significant source of Brexit spillover. Safe haven flows within Europe are expected to put downward pressure on German government bond yields, but spreads in riskier peripheral economies are likely to widen in a risk off move. A significant tightening in financial conditions in these economies could jeopardize the euro area's fragile economic recovery. In a more extreme case, if Brexit stokes existential fears about the future of the EU or Eurozone currency union, a replay of the more intense periods of volatility seen during the European debt crisis would be a concern.

Sterling depreciation and lower yields are likely in the near term. A broad 10-15% decline in sterling is anticipated over a period of weeks amid expectations for lower growth and easier monetary policy. This currency depreciation is expected to result in a temporary spike higher in inflation as import prices rise. However, over the medium term, inflation is more likely to undershoot the Bank of England's target as the weak economic performance results in an increase in spare capacity. With monetary policy focusing on the medium term, the BoE is expected to lower the Bank Rate (currently 0.50%) and a new round of quantitative easing under the Asset Purchase Programme (current holdings amount to £375 billion) is possible. These policies are expected to keep downward pressure on government bond yields. Expectations of lower medium term inflation are likely to more than offset upward pressure on yields due to rising risk premia associated with cyclically deteriorating public finances.

Market volatility is likely to spill over into Canada. We expect the Brexit vote will have significant financial market effects in the near term, in addition to sterling depreciation and lower UK rates. The stock market declines that occurred during the week of 13 June, when the "leave" vote began to surge in the polls and bookmakers' Brexit odds rose, prefaced the flight from risky assets that is likely to occur following the UK's vote to "leave". Safe haven flows are likely to put downward pressure on US Treasury yields and upward pressure on the US dollar. Given the Fed's sensitivity to global economic and financial market developments, rate hikes could be further delayed, putting additional downward pressure on Treasury yields. A risk off move in financial markets and expectations of reduced demand for commodities (with the UK economy weakening and greater uncertainty about global growth) will likely weigh on commodity prices. Commodities traded in US dollars (for example, WTI crude oil) will also be under downward pressure from USD appreciation. For Canada itself, demand for less risky assets is likely to push Canadian government bond yields lower. While CAD is likely to appreciate against GBP, safe haven flows and lower commodity prices will likely result in the Canadian dollar depreciating relative to the US dollar.

The UK is a major trading partner, but makes up a small share of Canada's exports. Outside of financial market developments, the effects of Brexit on Canada's economy will be felt through trade and investment channels. The United Kingdom is Canada's fourth largest trading partner in terms of bilateral trade, and third largest export market behind the US and China. However, a closer look reveals that a slowdown in the UK economy is unlikely to make significant waves for Canadian exporters. Canada exported over C$22 billion in goods and services to the UK in 2015, but that represents just 3.5% of total Canadian exports as the US remains by far Canada's most significant trading partner. A slowdown in the UK economy would be expected to result in reduced UK demand for Canada's exports, which will be further exacerbated by higher prices for Canadian goods and services in the UK as the Canadian dollar appreciates relative to sterling. While this impact is likely to be felt by Canadian businesses with close ties to the UK market, the overall macroeconomic effect is likely to be negligible given the relatively small share of Canadian exports destined for the UK market.

Ontario and Newfoundland & Labrador have the greatest relative trade exposure to the UK. Both provinces sent more than 5% of their total goods exports to the UK in 2015. In the case of Newfoundland & Labrador, crude oil and iron ore made up ¾ of UK exports. While lower prices for these commodities will likely hurt the province's terms of trade, export volumes should be less significantly impacted. Even if slower growth in the UK economy reduces demand for those goods, other export markets should be readily available for such globally traded commodities. Trade is even more highly concentrated in the case of Ontario, with gold making up ¾ of exports to the UK. In fact, that relationship accounted for over half of all Canadian goods exports to the UK in 2015. It is likely that the majority of Canada's C$9.4 billion in gold sent to the UK last year was related to the London Bullion Market, a significant global market for over-the-counter trading in precious metals. These exports are less likely to reflect macroeconomic conditions in the UK itself and a flight to safety that boosts demand and prices for gold could have a positive impact on gold exports. In that case, the apparent trading relationship between the UK and Ontario (and even the UK and Canada) likely overstates the potential impact of weaker UK demand. For other provinces, exports to the UK account for roughly 2% or less of total goods exports.

Investment in the UK is small on a relative basis. The UK is the second-most significant destination for foreign direct investment (FDI) by Canadian businesses and investors, although the US continues to receive by far the greatest share of Canada's outward FDI. As of 2015, Canadian FDI in the UK amounted to C$93 billion, which makes up a non-trivial 9% of total Canadian FDI abroad. The UK is also second only to the US as a destination for portfolio investment by Canadians. The C$103 billion in portfolio investment in the UK (as of 2014, of which C$77 billion is in equity and investment fund shares while C$26 billion is in debt securities) represents 7.5% of total portfolio investment abroad. However, that amounts to less than 1% of total Canadian financial asset holdings, domestic and abroad, of debt and equities. While both FDI and portfolio investment levels are non-trivial at close to $100 billion each, that amounts to just 0.5% of national balance sheet assets.

Lower oil prices and weaker CAD represent more of the same. Falling oil prices and Canadian dollar depreciation would represent a re-emergence of trends seen during the recent oil price shock, which has had a significant impact on Canada's economy over the last two years. Lower investment spending and layoffs in the oil and gas sector, and the second-round effects of those cuts, have resulted in deteriorating economic and labour market conditions in energy-producing provinces. Meanwhile, the accompanying Canadian dollar depreciation (also driven in part by easier monetary policy) provided some offset by boosting the competitiveness of Canada's non-energy exports to the benefit of provinces like Ontario and British Columbia. At the margin, Brexit-related declines in oil prices and the Canadian dollar could further exacerbate this regional divergence, negatively impacting energy-producing provinces but potentially having a net positive effect on non-energy provinces and sectors—as long as US demand holds up. However, we expect the magnitude of these price adjustments will be much less significant than during the recent oil price shock, and may not be enough to fully reverse the recent rally in oil prices and CAD.

Brexit-related uncertainty could weigh on Canada's economy more broadly. Non-energy business investment has been disappointingly weak amid concerns about domestic and global economic conditions. A slowdown in the UK economy and potential spillover to EU economies will generate renewed uncertainty about the global outlook and could further discourage investment at a time when there are finally indications that non-energy exporters are gearing up to spend. It is unlikely that second round effects on employment and confidence will result in the type of cyclical downturn expected in the UK; however, to the extent that Brexit uncertainty further complicates the already "uneven" rotation in Canada's economy, the Bank of Canada is likely to keep monetary policy accommodative and maintain a cautious tone in communications. Just as the Fed may be expected to proceed even more gradually in raising interest rates, there is a risk that the Bank of Canada holds the overnight rate steady for longer than previously assumed.

Brexit throws CETA ratification into question. Legal review of the Comprehensive Economic and Trade Agreement (CETA) between Canada and the European Union has been completed and the ratification process is ready to begin. The UK has been a champion of CETA, so the country's exit from the EU removes an important supporter of the agreement at this crucial juncture. Furthermore, it is possible that remaining EU countries will seek changes to some of some of the terms of the agreement that the UK argued for during negotiations—reopening the agreement and returning to the negotiating table would result in significant delays to implementation. The ratification process is also likely to be delayed with EU lawmakers now focusing on Brexit negotiations and putting CETA on the backburner. Overall, Brexit represents a blow to the federal government's hopes that CETA will come into force in 2017, and creates uncertainty as to whether the agreement will ever be implemented as it currently stands.

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