Brexit

Planning for all eventualities

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If you knew the UK would vote OUT, what would you do today?

It is the issue no business can avoid. For months, supporters and opponents of EU membership have bombarded us with the economic and political arguments for and against a Brexit. Their positions are well rehearsed and I am not going repeat them here. I sense what businesses actually want is a roadmap – a practical plan – in the event that the UK votes 'Out' on June 23. KPMG have produced this paper – and our Brexit website – with that in mind.

Some might question whether a practical plan is even possible given the different paths negotiations could take in the next two years. Companies might question investing in an entire plan based on shaky assumptions. By the same token, it would seem there is a need to do something given the very real possibility – based on current polling – that the UK does leave the EU.

Fortunately, there is a middle path company boards can take – a compromise between 'waiting to see' and 'full planning mode'.

First, they can get on the front foot by assessing where they are vulnerable and where they also see opportunities. That risk-reward equation will look different for each and every business in the UK. In the immediate term, that means assessing things like hedging strategies, but it also means companies should start planning to plan.

For instance, what would you do on that Friday morning after an Out vote? Do you know which parts of your organisation would be impacted from a legal or regulatory standpoint most immediately? Do you know how each should respond? Or in what order? What would that first boardroom agenda look like on 24 June?

Brexit is a once-in-a-generation question, yet in another sense, it is merely the latest in a line of issues – from disruptive technologies to the power of the connected consumer – to which businesses must respond at lightning pace. Companies that have an effective contingency plan and an agile response, to Brexit or any of these issues, are companies that have the best chance of mitigating risk and seizing opportunities.

Beyond these operational questions, business needs to address a broader issue of the voice it wants to project after a Brexit vote.

In such an uncertain and fluid situation – one in which the Government would be stretched to the limit – it is their interest to influence and inform the debate. If we want the UK to have a trade policy or regulatory environment in which companies can flourish, businesses need to start thinking, today, about what they would want government should focus on in those vital first months.

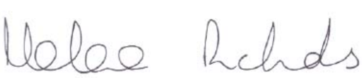
I've detected real momentum in the way clients have engaged with the issue over the past month or so. But while some industries appear to have given the implications a lot of thought, many across a range of sectors are only now starting to consider what a Brexit would mean for them. I hope this paper is a useful aid to businesses at both ends of that spectrum.

Over the following pages, our economics team sets out an overview of its work over the last couple of months, modelling the short and longer-term impact of a Brexit.

Giles Williams, who leads our Financial Services Regulatory Centre of Excellence, then offers his take on how businesses can use those forecasts to model the impact of a Brexit, and start 'planning to plan'.

We believe KPMG can best serve its clients by remaining neutral on Brexit. Our aim is to help you adapt and thrive in any situation that might emerge this summer.

In that spirit, I encourage you to imagine what *you* could do today, if you knew the UK was leaving the European Union in a few weeks' time. I look forward to hearing your thoughts.



Melanie Richards
Vice Chair, KPMG in the UK

The economic implications of a Brexit

UK Macroeconomics Team
Yael Selfin, Dan Aylward and Dennis Tatarkov

The outcome of the referendum on June 23 on whether to leave the EU has the potential to alter the UK economy at a cost. The long-term effects of an exit will depend on the relationships the UK forges with the remaining EU countries, and those further afield.

The uncertainty around the result of the vote is already inflicting damage on the UK economy, as businesses postpone some of their investment decisions. A fall of 2% in business investment in the fourth quarter of 2015 and a marked downturn in investment intentions captured by business surveys attest to that.

This briefing sets out some of the potential ways in which an Out vote could affect the UK economy, and provides a range of assumptions that businesses planning for the event of an Out vote may consider.

If the UK votes to leave the EU, uncertainty about the future shape of trading relationships will dominate in the short term while negotiations with the EU about exit are ongoing. Those could last up to two years and possibly longer. Both foreign and domestic business **investment** are expected to be impacted as a result.

The **cost of capital** is likely to rise as short-term uncertainty and increasing concerns about the UK's future economic performance lead to both higher risk premia for corporate debt and equity and higher government bond yields, although some of the risk of Brexit may have already been priced in.

Summary of potential Brexit impacts on the UK economy

Short to medium term impact	
Exchange rate	10% to 25% depreciation in value of the pound
Inflation	0.5% to 1.5% higher CPI inflation rate
BoE interest rates	Up to 1% higher policy rate in the medium term
GDP	0.5% to 1.5% on average lower GDP growth in the first years
Longer-term impact	
Trade	5% to 10% fall after UK exits the EU
Tariffs	Up to 4.4% average tariff rate after UK exits the EU
Labour force	1% to 2.5% smaller workforce by 2021
Wages	0.2% to 0.6% higher wages for low skill jobs in some industries
Public finances	1% to 2% of GDP increase in government deficit per year
Regulations	Lower costs of regulations representing up to 0.7% of GDP
GDP	Between 4% to 6% lower GDP level by 2031

*This table summaries some of the **potential impacts**, which are further explained in this paper. These are meant as indicative values and are based on the existing available evidence, but should not be seen as firm predictions about the impact of a Brexit.*

Source: KPMG analysis

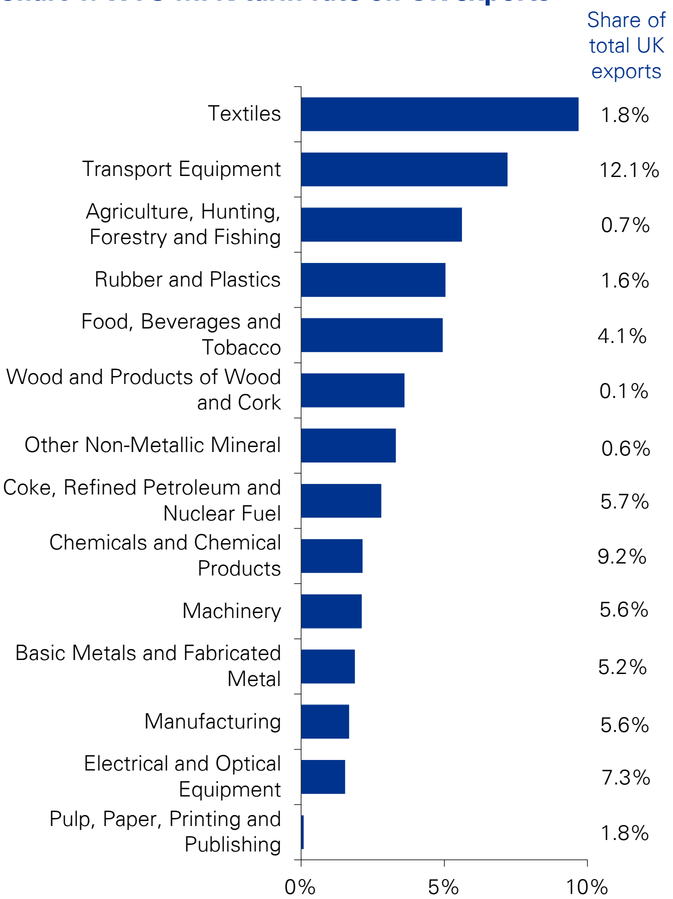
Concerns over Brexit have also already contributed to the slide in the **exchange rate** since late 2015. Market analysts expect further falls in the immediate aftermath of an Out vote in the referendum- perhaps by up to 25%. Uncertainty on the status of the UK-EU relations could continue to weigh on the exchange rate in the medium term in the event of a Brexit. In the longer term, the losses in the value of sterling could be partially reversed once uncertainty is resolved through negotiations.

An In vote may see the exchange rate recover more quickly, although expectations for an interest rate hike have also been pushed back, suggesting the pound is unlikely to regain all of its recent losses.

The fall in sterling will lead to a temporary spurt in **inflation** through higher costs of imports, and this could extend into the medium term if tariffs and non-tariff barriers increase the costs of trade - lifting inflation perhaps 0.5% to 1.5% higher.

Whether the Bank of England's Monetary Policy Committee would move to counteract this by raising its **interest rate** is unclear. They have not reacted to temporary inflationary effects previously, but it would be expected to act if there were a perception that inflationary pressures had become embedded in the economy.

Chart 1: WTO MFN tariff rate on UK exports



Source: CEP, 2016.

In the short run, uncertainty, falling confidence and investment could reduce GDP growth on average by 0.5% to 1.5% per year

This could see interest rates up to 1% higher in the medium term, which should help steer inflation back to its 2% target in the long run.

Only once the dust has settled and the negotiations are over will we know the extent to which **trade** is likely to be impacted. There are many possible scenarios for the UK's future position, ranging from preserving its existing trade relationship with the EU, through to a failure to reach agreement and reversion to World Trade Organisation (WTO) Most-Favoured Nation tariffs, which average 4.4%.

Under WTO rules, the most significant impact on UK trade is likely to be felt through sectors such as transport equipment and food and beverages, where tariffs are above average and their share in total UK exports is also relatively large (see Chart 1 below).

Even under the most benign scenarios, non-tariff barriers may emerge, particularly on services where the Single Market is still under construction. This is an area of particular significance to the UK economy, yet outside the EU, the UK would have no influence over its shaping.

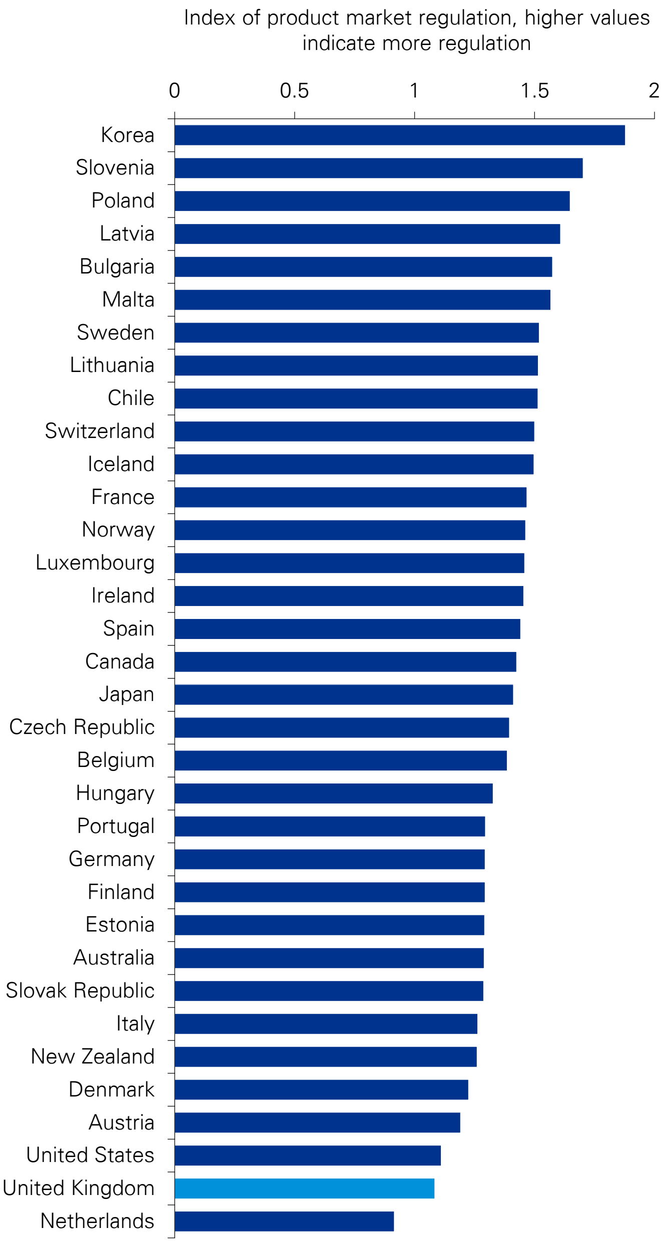
Half of UK trade is with the EU, but the other half may also be affected, depending upon whether existing trade agreements needed to be renegotiated and whether new ones could be negotiated outside the umbrella of the EU. Overall, the impact of a Brexit may therefore be a 5% to 10% fall in trade.

The impact of a Brexit on the size of the **labour force** is the second big economic question mark in the longer term. Inward migration has been a significant contributor to UK economic growth for much of the past decade. If, post Brexit, the Government achieved its target of bringing net inward migration down below 100,000, UK population could be up to 1.3% lower by 2021. Migrants have higher labour market participation than the wider population, meaning that the labour market could contract by up to 2.5% by 2021. That would push up **wage** costs for low skill jobs in some industries.

UK residents born outside the UK tend to have higher levels of education, on average, than those born in the UK so **productivity** could also be dented, although the impact from a less open economy, due to lower levels of trade and Foreign Direct Investment is expected to exert a bigger weight on productivity performance, as they would lead to fewer opportunities for companies in the UK to catch up on latest technology and best new working practices.

Falls in investment, and increased cost of capital and uncertainty could reduce demand for commercial **property**, making leases more affordable, especially if some businesses choose to relocate to the Continent. A weaker economy, higher interest rates, and a smaller flow of net migration may also bring house prices down. London would likely see the greatest effect since foreign nationals account for a significant share of house sales in some areas.

Chart 2: Product market regulation



Source: OECD

A Brexit could harm **public finances**. As the economy cooled as a result of the UK's departure, we estimate UK government revenue could deteriorate by 1.5% to 2.25%. The UK would make up some of that fall by retrieving its net contribution to the EU budget, which amounted to about 0.5% of GDP last year. However, factoring in other payments the EU made to UK non-governmental bodies – payments the government may need to pick up - the net savings may amount to only 0.25% of GDP.

It is also worth noting that both Norway and Switzerland contribute to the EU budget while not part of the EU, so the savings are not certain.

The scope for changes to **regulations** will depend on UK trading agreements with the EU and the need to comply with the rules of the European Single Market. Open Europe estimated the UK could save up to £12.8 billion from revoking specific labour and product market regulations – equivalent to around 0.7% of GDP. It is worth noting, however, that an OECD study ranked the UK second best in terms of product market regulations, behind the Netherlands – a fellow EU member, so whilst there is some scope for improvement, the causal chain in terms of a Brexit is unclear (see Chart 2 above).

In the short run – uncertainty, falling investment and possible knocks to consumer confidence and spending could reduce **GDP** growth on average by 0.5% to 1.5% per year. Once new trade relations are established, the UK economy is expected to recover some ground, but Brexit could still leave a mark with a long term impact on GDP. Some 15 years after a Brexit occurs GDP could be between 4% and 6% lower than had the UK stayed in.

The numbers above should be treated as indicative estimates only. The uncertainties involved point at potential risks weighted towards the downside. However, other scenarios such as a lower reduction in labour supply or a more resilient economy could see the impact of a Brexit on the UK economy reduced. Businesses may therefore wish to incorporate broader ranges when planning for the possible economic effects.

Note that KPMG aims to provide unbiased, non-political information on the EU referendum. KPMG is not a registered campaigner in relation to the referendum and we do not express a view or a preference either for or against leaving the EU.

Have you performed a Brexit stress test yet?

Giles Williams, Partner KPMG

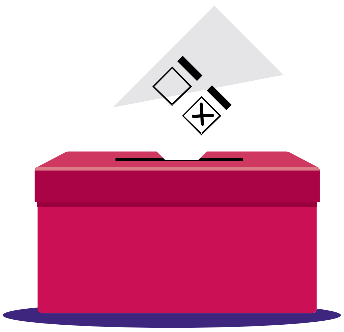
Like or loath the idea, all businesses need to take early steps to prepare for a Brexit. Yes – officially – nothing changes the morning after a Leave vote: the UK remains an EU member for a further two years, minimum. In reality, events could very quickly get away from those who are unprepared. But even with the referendum just around the corner, some scenario planning now can protect a business from fallout, as well as prime it for opportunities.

The immediate task is for businesses to perform a stress test against uncertainty and potential instability. Run the numbers. You may have a long-standing hedging strategy. But could it withstand a much greater level of volatility on FX, debt or equity markets as might be the case after the referendum? Do you have enough headroom to service debts if the cost of borrowing rises?

Prepare for shocks

The exchange rate is an obvious hotspot. Yael Selfin's economics team quote estimates of falls in the pound of up to 25%. Break down your supply chain and model what would that do to your costs – both dollar and euro denominated. It's not just going to French wheat or German tyres that become more expensive, it's the dollar price of oil, iron and aeroplanes too.

The flipside is a potential bonanza for exporters – if they have the aptitude to get after it. Look at how Germany has pursued the Chinese market during periods of relative euro weakness. To do that, business needs government support, but also bravery and commitment from the businesses themselves. Weak sterling is no substitute for executives travelling to these markets and selling. The challenge for British companies could be significantly complicated by uncertainty around tariff regimes and concerns over the course of the British economy.



With this in mind, it is doubly important to lay the groundwork now by building relationships, securing financing and again reviewing your hedging strategy. For example, you might be better off leaving yourself unhedged to gain exposure to a sliding pound.

Assess workforce exposure

Ask yourself what might happen to your workforce too. Labour issues might bubble up quicker than you think. The flow of workers from EU countries would inevitably slow in the months after the referendum. Some foreigners in the UK might start questioning their long-term future here.

With that in mind, how heavily do you and other companies in your sector rely on EU-born workers? Three-quarters of EU citizens working in the UK would not meet current visa requirements for non-EU overseas workers if Britain left the bloc, according to an Oxford University study for the Financial Times.

We don't know what restrictions the government might impose – if any – after an Out vote, but it is worth asking yourself the question: "is the pool of talent from which we recruit sufficiently diverse?

If our estimates are right, the whole workforce could contract by up to 2.5% within five years if the government successfully brought net migration down below 100,000. This now becomes not only a question of securing talent, but also one of costs and the risk that a shortfall of skilled workers could push up the wage bill.

You need to examine all these issues in the round – not isolation. For example, a hit to profitability from currency movements might affect your ability to service debt. Conversely, a number of banks relocating operations to the Continent after a Brexit might increase available office space and therefore cut your real estate bill.

Keep an eye on talks

Your second task is less urgent, just as important and even more difficult: to perform an operational audit against the (as-yet-unknown) outcome of negotiations between London and Brussels.

For exporters, the challenge is to model demand in a world where the UK might exist outside the Single Market. You might make high-margin products with a low price elasticity, in which case a 5% or 6% tariff might make little difference. On the other hand, you might not…

Which countries, outside the EU, do you export to? The British Government will need to establish trade relations with all of them. It remains a moot point whether the UK will have something in place by the time its two-year negotiation period expired.

Importers will also need to closely watch the domestic political scene to assess the risk of tariffs on inbound goods. The UK might seek to secure trade deals by taking the moral high ground, throwing open its doors to the world. Equally, it may play tough and ramp up tariffs as a bargaining chip, with the intention of lowering them later.

Like so much in the Brexit debate, there are no simple facts or certainties, however much we demand them. It is incumbent on Brexit supporters – as well as the Remain camp – to explain how different scenarios would play out and what our relationship with the EU would look like. Stay in or leave, shocks and surprises do not make for happier or healthier businesses.

Giles Williams leads KPMG's Financial Services Regulatory Centre of Excellence for Europe, Middle East and Africa

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