Rothschild Perspectives: Brexit Q&A with Marc-Antoine Collard

Based in Paris, Marc-Antoine Collard serves as Chief Economist for Rothschild. Below is a brief Q&A with Marc-Antoine in the aftermath of the referendum for the United Kingdom to leave the European Union.

Q. On June 23rd, the British electorate voted for the United Kingdom to exit the European Union (EU). Will this change be immediate? If not, what are the next steps?

A. The only change expected in the next 90 days is that the Prime Minister, David Cameron, will resign, and the Conservative Party will elect his successor in October.

Britain's exit will trigger Article 50 under the Lisbon Treaty. Under the treaty, a country has to renegotiate its trade agreements, and has two years to do so. This timeframe can be extended, but only if there is unanimous consent among all EU members. But completing renegotiations in two years' time will be highly unlikely.

Q. Why do you say that?

A. The so-called Euro-skeptics—Germany, France, and Italy—will take a hard stance with the U.K.. They will not want to make it easy on the British, but will want to make them "pay the price" for exiting, so as to discourage other members from doing the same. Similar sentiments have appeared in the Five-Star and Podemos parties in Italy and Spain, respectively, while others in France and Germany have expressed separatist views.

At the same time, the EU doesn't want to "kill the patient," so to speak. The U.K. will likely enter a recession in the next 18 months. If the EU is too hard on the U.K., it's likely to depress exports from the EU, and the pain will be self-inflicted.

Q. You mentioned other "leave" campaigns in Europe. Are we witnessing the end of the EU?

A. We certainly can't rule that out, but it's not the most likely scenario. From now on, everyone will be well aware of the need for flexibility and unanimity among EU members. But it has become a real political situation.

For instance, the next vote on the horizon is the Italian referendum on the potential new constitution. If Italian Premier Matteo Renzi loses, he says he will resign. The leftist 5-Star Party has gained power in Rome and Turin.

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So it's possible that the EU could break up, but not the most likely scenario, as heads of government will put every effort into making this work. I don't think the EU will break apart solely based on Brexit.

Q. What is the potential impact of Brexit on London as a financial center?

A. We may see a shift to Paris or Frankfurt. Indeed, the European Central Bank (ECB) itself will need to relocate its London operations. London will lose its current position as a leading financial center, which may help not only Paris or Frankfurt, but New York or Hong Kong as well.

Q. How will the U.S. economy be affected by Brexit?

A. We estimate that Brexit may cost 1.5% GDP growth in the U.K. and 0.50% in Europe. Twenty years ago, the effect on the U.S. would have been marginal, but today, the world is more interconnected. Financial conditions will tighten overall. The dollar has already risen, and the Bank of Japan, Bank of England, and the ECB will have more work to do. Even prior to the referendum, I thought that the ECB was not done easing.

In the U.S., the effects will not be felt through trade, but through financial linkages. A higher dollar could lead to a retrenchment on the order of 0.50% in GDP growth. In the context of a strong economy, that would be no big deal, but given a forecast of 1.50% GDP growth, a 50 basis points decrease is a big deal.

Previously, I thought that the Fed might manage one rate hike before year-end, but I'm not sure anymore. Chairwoman Yellen cited the world economy in her comments this week.

Q. Were the referendum results reflective of higher turnout amongst pensioners?

A. It wasn't as simple as young people not going out to vote; voter turnout was actually high. The results really represent the majority of those in the U.K. not wanting to pay for the EU budget anymore, and questioning the freedom of movement across borders—both of which are prerequisites for EU membership.

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Q. What is the mood like in Europe now, and how does it compare with the early days of the financial crisis?

A. The first word that comes to mind is "surprise." I had thought the vote would be close, but 52% to 48% is more significant than say 50.5% to 49.5%. People are very surprised and very disappointed, and there's the feeling that now this is in the hands of the politicians. This will take months and years to sort out. This uncertainty is leading world markets lower.

We don't know who will succeed Cameron—possibly former London Mayor Boris Johnson. And will Scotland or Northern Ireland hold a referendum on leaving the U.K.? I wouldn't say there's panic, just uncertainty.

Q. Let's end with the immediate market reaction. If this was a U.K. decision, why was the FTSE 100 down just over 3% on the first day of trading following the decision, while German and French markets saw declines of 7% to 8%?

A. Much of that is explained by the composition of the index. The FTSE 100 has a very high weighting in the defensive sectors, and in sectors not linked specifically to the U.K. economy, such as energy. The value of British Petroleum's stock is determined more by the price of oil than Brexit.

Conversely, the DAX (Germany's major index) is approximately 25% comprised of auto stocks, and banking stocks make up a large portion of the CAC 40 (the Paris-based exchange). In fact, U.K. exporters could actually be helped by the weaker pound.