

## Flash Note

# Euro area: economy & politics

### There's life in Europe after Brexit – an early reassessment

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Focusing on direct trade and financial linkages, our in-house model points to a net drag on euro area GDP of around 0.50% over the next three years as a result of the Brexit vote, similar to the ECB forecast.

Downside risks are likely to dominate, including political contagion from Brexit. However, we believe that the risk of a referendum on EU membership in another country remains low for this year and next. In most countries, an outright parliamentary majority would be required for a referendum initiative to be launched. If anything, we suspect that the UK experience, leaving the political landscape in complete disarray, has reduced the political appetite for referendums elsewhere.

Eventually, Brexit could be positive for EU cohesion: the more painful the experience for the UK, the higher the chances that we see stronger commitment to Europe in other countries. After a period of instability, there is a chance that eurosceptic sentiment will decline rather than increase following the Brexit vote.

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Early estimates of the implications of Brexit for the euro area are coming in, and we suspect that the forecasting adjustment process is just starting. ECB President Mario Draghi reportedly said that Brexit could cut GDP by “as much as 0.5% for the next three years”. Focusing on the direct impact through trade and financial linkages, [our in-house model](#) points to a net drag on activity similar to that mentioned by the ECB. **We have lowered our euro area GDP forecast to 1.5% in 2016 (from 1.8%) and 1.3% in 2017 (from 1.7%).**

#### BREXIT: CHANGES IN OUR BASELINE SCENARIO

REAL GDP	UK		EURO AREA	
	Pre-ref.	Post-ref.	Pre-ref.	Post-ref.
2016	1.8%	1.3%	1.8%	1.5%
2017	2.2%	0.9%	1.7%	1.3%
INFLATION	Pre-ref.	Post-ref.	Pre-ref.	Post-ref.
2016	0.7%	0.9%	0.3%	0.1%
2017	1.7%	1.9%	1.3%	1.1%

Source: Pictet WM – AA&MR

The truth is that no one knows how long and how painful the political, economic and financial adjustments to Brexit will be. Downside risks are likely to dominate until we get a better idea of the post-Brexit framework, including in terms of possible political contagion to other EU states. Although the transmission channels are complex and our forecasts are fraught with huge uncertainty, we want to stress a few of our central convictions:

- **The formal exit process will be long and difficult.** Negotiations are likely to drag on until after the French and German elections in 2017 (see full timeline of European risk events in the appendix).
- Central banks remain on high alert, but the ECB is in no rush to act, barring severe financial stress. **Italy is the weakest link** given the relatively high political, economic and financial risks it is facing.
- **Brexit is not a systemic risk for the EU or the euro area.** We expect neither disintegration nor an “ever closer union” at this stage.
- Eventually, **Brexit could be positive for EU cohesion**; the more painful the experience for the UK, the higher the chances that we see stronger commitment to European integration in other countries. After a period of instability, there is a chance that eurosceptic sentiment will decline rather than increase following the Brexit vote.

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## European policymakers – Damage control

While European policymakers want to control the potential damage from the Brexit fallout, the ECB in particular seems in [no rush to ease](#). However, the central bank is naturally monitoring macroeconomic and financial developments closely. A downgrade to the outlook for price stability will likely force some policy adjustments by September, in our view, including a 6-month QE extension and some targeted [changes in QE parameters](#).

The first business confidence indicators that will fully cover the post-Brexit period will be published later this month, starting with the German ZEW (19 July), the euro area July PMIs (22 July) and the IFO index (25 July). The first hard data will come only later (in September) while the Q2 GDP reports (29 July) will hardly capture any of the Brexit impact on euro area activity. Ultimately, **the biggest risk to a sustained euro area recovery is a setback in investment**, in our view, which we will track closely over time.

In the meantime, stabilisation in economic and financial conditions will hinge on the so-called 'ECB put', i.e. the expectation that the ECB will intervene strongly to prevent any signs of prolonged market turbulence. With a strong focus on the monetary transmission channels, **the ECB is likely to respond to any renewed pressure on the banking sector** in general, and on peripheral banks in particular. The upcoming Bank Lending Survey to be published on 19 July is likely to provide only limited information on European banks' appetite to expand their balance sheets (with the notable exception of the ECB's first TLTRO-II operation, which banks are likely to comment on). The first bank credit-flow data to cover the post-Brexit period will be released on 26 August. Meanwhile, recent developments could prove to be highly significant for the Italian banking sector. Nothing has been confirmed in terms of potential liquidity support or capital injections, but **the Italian government is said to be pushing for flexibility on the EU side – far from guaranteed, yet a potential game-changer for the whole region if concessions are made eventually**.

## Political contagion – low risk of another referendum on EU membership

Political risks represent both the biggest threat to our forecasts and the most difficult to quantify because of the large number of (known and unknown) variables. Future developments need to be monitored both at a national and EU level, especially the shape of any future deal between the UK and the EU, and whether it comes with or without freedom of movement and single market access, something we might not know for more than a year.

**The transmission channels of political risk are varied, and so are the idiosyncratic risks** from one country to another. In the most vulnerable countries, the threat of populist pressures is likely to translate into weaker business confidence, posing further risks to the outlook for investment and employment. Meanwhile, higher risk aversion in financial markets means tighter monetary conditions for the private sector, although the deterioration has remained fairly contained so far and one offsetting factor has been the decline in sovereign borrowing costs. Fiscal policy could provide another buffer; in some cases, political tensions within ruling governments could force concessions that translate into a more accommodative budget policy.

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However, Spain and Portugal are unlikely to benefit much from looser fiscal policy, given their ongoing dispute with the European Commission about their budget plans. Still, there is no mechanical relationship between stronger eurosceptic forces and economic performance.

**Importantly, we consider the risk of another referendum on EU membership as relatively low**, at least for the next couple of years. For a start, the legal hurdles look high. Although a referendum can often be initiated by a public initiative, in most cases eurosceptic parties would need to win an outright parliamentary majority to make it happen. In those countries where the political risks are perceived to be the highest, including Italy or France, eurosceptic parties are unlikely to reach such an absolute majority, in our view. Moreover, in many cases, referendums on the EU treaties are either constitutionally impossible (as per Article 75 of the Italian constitution, for example), or are non-binding on such matters without new legislation or a vote in parliament (as in France, the Netherlands, Austria and Finland). In the Netherlands, the rejection by referendum of the EU deal with Ukraine earlier this year drew some attention, but the experience is unlikely to be repeated unless countries' change their constitutional rules.

**Italy is once again a case in point.** PM Renzi has threatened to step down should his constitutional reforms be rejected by voters in October. The political risk premium should remain high going into the referendum and a 'no' vote would likely trigger a broader crisis. The latest polls point to a very tight outcome. Still, we rule out a referendum on EU/euro membership in Italy, if only because, as we have pointed out, the legal rules would need to be bypassed. The eurosceptic Five Star Movement might not benefit from Brexit. And, even if it has called for a referendum on Europe, the Movement wants it to be non-binding.

More fundamentally, **we suspect that the UK experience, leaving the political landscape in complete disarray, has reduced the political appetite for referendums elsewhere.**

### **Neither disintegration, nor “ever closer union” (for now)**

Our working assumption is that we will see neither a disintegration of the European Union nor an “ever closer union” in the foreseeable future. The most favourable scenario for European financial markets would consist of a new push towards new integration initiatives and, possibly, some targeted fiscal measures. Progress needs to be made in several other areas, including the Banking Union, the Capital Market Union, or the fiscal framework. But we suspect there will not be much political appetite for any grand initiative ahead of the general elections in France, Germany and the Netherlands next year. This may only change in a situation of severe financial stress, which is not our baseline.

**Table 1: European political deadlines and risk events**

	Date	Country	Event	Importance †
<b>June</b>	02	EA	ECB meeting	**
	23	UK	<b>EU referendum</b>	***
	26	Spain	<b>New general elections</b>	***
	28-29	EU	EU Council meeting	***
<b>July</b>	During month	EA	EBA bank stress tests	**
	During month	EU	EC verdict on budget plans (Spain, Portugal facing sanction)	**
	11	EA	Eurogroup meeting	*
	14	UK	<b>BoE meeting</b>	***
	19	Spain	Parliament reconvenes	*
	21	EA	<b>ECB meeting</b>	***
<b>August</b>	04	UK	<b>BoE meeting and Inflation report</b>	***
<b>September</b>	01	World	G20 meeting (finance ministers and CBs)	*
	04	Germany	State election (Mecklenburg-Vorpommern)	*
	04-05	World	G20 leaders summit	**
	08	EA	<b>ECB meeting</b>	***
	09	UK	<b>New Conservative leader and PM to be named</b>	***
	10	EU	EcoFin (meeting of EU finance ministers)	**
	15	UK	BoE meeting	***
	16	EU	<b>Informal EU summit in Bratislava</b>	***
	16	World	G20 summit in Hangzhou	**
	18	Germany	State election (Berlin)	*
	25-28	UK	Labour party conference	*
<b>October</b>	During month	EU	EC final approval of national budget plans	**
	During month	Greece	2nd review of the bailout programme	**
	02	Hungary	Referendum on EU migration quotas	**
	02-05	UK	<b>Conservative party conference</b>	***
	06	World	G20 meeting (finance ministers and CBs)	*
	07	Czech Rep.	Elections (Senate & regions)	*
	07-09	World	IMF & World Bank annual meeting	*
	02 or 09	Italy	<b>Referendum on Senate reform</b>	***
	09-14	Lithuania	Parliamentary elections	*
	13-15	UK	Scottish National Party conference	*
	20	EA	ECB meeting	***
	20-21	EU	EU Council meeting	***
	21	Portugal	DBRS rating review	**
<b>November</b>	During month	France	Conservative primaries for 2017 Presidential elections	**
	03	UK	BoE meeting and Inflation report	**
	08	US	<b>Presidential elections</b>	***
	20	Spain	Basque regional elections	*
<b>December</b>	08	EA	ECB meeting	**
	15	UK	BoE meeting	**
	15-16	EU	EU Council meeting	**
<b>By year-end</b>		UK	<b>Art.50 triggered (could be delayed into 2017)</b>	***
<b>2017</b>				
	22-29 January	France	Socialist party primaries for 2017 Presidential elections	**
<b>March</b>		Netherlands	<b>General elections</b>	***
<b>23 Apr. - 07 May</b>		France	<b>Presidential elections</b>	***
June		France	General elections	**
<b>October</b>		Germany	<b>General elections</b>	***

Source: Pictet WM – AA&MR, Bloomberg

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