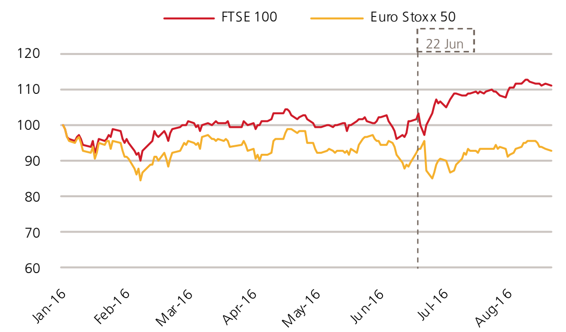
Withdrawal of The United Kingdom from the European Union

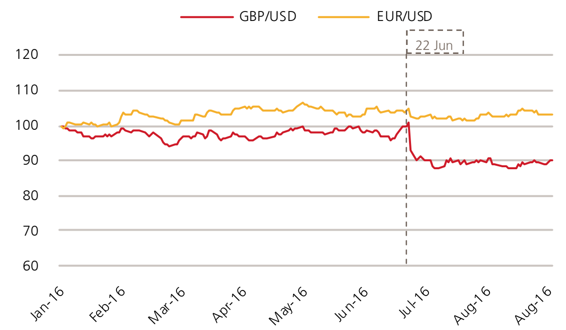
5 September 2016

In this report, we elaborate the reasons for the Brexit, the leaving mechanism and the ramifications.

FTSE 100 Index and EURO STOXX 50 Index Movement



GBP/USD and EUR/USD Spot Exchange Rate Movement



Sources: European Union, House of Commons of UK, HM Treasury, Eurostat, Bloomberg

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- On 23 June 2016, the United Kingdom voted on a reformed membership in the European Union. The referendum resulted in an overall vote to leave the EU by 51.9% on a national turnout of 72%.
- The EU treaty allows any EU member to withdraw from the union according to the procedures set forth in Article 50 of the Treaty of Lisbon. The leaving procedures commence once the member notifies the EU of its intention to withdraw from the union. The UK is not forecasted to notify the EU before the end of 2016. The Article 50, issued in 2009, has never been triggered before, so there is high uncertainty regarding how it will be applied. In accordance with Article 50, the UK has a two-year period to finalize a leaving agreement. If no agreement is concluded within two years, that state's membership ends automatically, unless the European Council and the Member State concerned decide jointly to extend this period. In the case of the refusal of any member state to expand the period or the expiry of the period without reaching an agreement, the leaving state will not be longer capable of benefiting from the rights stipulated in the EU treaties such as freedom of movement, investment and European market.
- The future agreement between the UK and the EU may necessitate the ratification of 29 legislative councils representing the 28 member states plus the European Parliament. In the case of the continuation of the British membership in the European Economic Area (EEA), the arrangement may be also approved by the Norwegian parliament as Norway is only a member in the EEA.
- The complex relationship between the Union and the UK may require more than two years to finalize a long-term agreement between the two sides. The British Chancellor of the Exchequer David Hammond has not ruled out that the negotiations might take six years.
- The impact heavily depends on the nature of the agreement that will be reached with the European Union. The British Treasury set three basic scenarios for the future of the relationship between the Kingdom and the European Union; (i) continued membership in the European Economic Area (EEA) such as Norway which is not a member of the EU, (ii) negotiating a bilateral trade agreement, such as the existing agreements between the EU and Switzerland or Turkey or Canada, and (iii) not signing special agreements and resorting to the rules of the World Trade Organization.
- It is difficult to predict the ramifications of Brexit on the EU as they rely on the date of the actual exit and future arrangements between the EU and Britain, however the implications on Britain are expected to be more significant.
- According to figures from the European statistics body Eurostat, the United Kingdom was the second largest GDP in the European Union in 2015 contributing 17.6% of the nominal EU GDP coming second after Germany which held 20.72%. France was third seizing 14.9% of the EU's nominal GDP.
- There are different estimates for the amount of the Saudi investments in London. According to Saudi Minister of Trade and Investment Majid bin Abdullah, the Saudi investments in June 2016 hit £60 billion varying among executive, tourism and real estate sectors at the private level. On the other side, the mayor of the financial district in London was quoted by Saudi newspapers in February 2015 as saying that Saudi foreign investments in stocks, bonds and real estate were in the amount of £120 billion, which is equivalent to SAR 684 billion.

Timeline of European Union history

The European Union passed through several historical stages and critical stations which played important roles in the formation of this union. The most prominent of these stages are highlighted below:

1951: The European Coal and Steel Community created by six countries: Belgium, France, Italy, Luxembourg, the Netherlands and west Germany.

1957: The creation of the European Economic Community, in accordance with the Treaty of Rome.

1968: The commencement of the Customs Union.

1979: The first election of the European Parliament took place through direct elections.

1985: Removing the borders between European countries, according to the Schengen Treaty.

1986: The Single European Act was adopted, setting out a timetable for the completion of the Common Market by 1993.

1992: Changing the name of the bloc to the European Union (EU), according to the Maastricht Treaty, in addition to setting new ambitious goals: monetary union, European citizenship, new common policies – including a Common Foreign and Security Policy (CFSP) – and cooperation in matters of internal security.

1997: Reshaping the CFSP as well as employment and social protection policies, in accordance with the Treaty of Amsterdam.

2002: The use of a common European currency (the euro).

2009: The Lisbon Treaty came into force.

European Monetary Union (EMU):

The transition to EMU occurred in 1998 for countries that met the requirements through three stages Union:

The first phase (May 1998 - January 1999): During this stage, the Member States that would adopt the euro were identified based on the terms of accession, a unified European banking system was created, legislative changes by the parliaments of the member states were ratified. The arrangements for the issue of the common currency were also agreed.

The second phase (January 1999 - January 2002): At the beginning of this stage, the euro was issued as well as its exchange rates with other currencies were determined. During this phase, the euro was only an accounting unit for the settlement of transactions among banks in the stock market. Furthermore, government bonds issued during this period were in euros, and in particular that maturing after January 2002. This stage also coincided with the partial and optional shift to the euro , permitting the use of the use of the euro or the national currency, without any discrimination.

The third phase (January 2002 - June 2002): the euro is considered the official currency of the Member States of the European monetary union coupled with the withdrawal of national currencies.

Beginning in 2004, the EU stretched towards Eastern Europe adding ten new countries namely Estonia, Poland and the Czech Republic, Slovakia, Slovenia, Latvia, Latvia and Hungary, Cyprus and Malta. In 2007, Romania, Bulgaria and Croatia also joined bringing the number of members to 28 countries. It is worth mentioning that the general secretariat of the EU and European Commission are headquartered in the Belgian capital, Brussels. The premises of the parliaments are located in the French city of Strasbourg.

EU Structure

The European Union works through five main bodies:

European Parliament: members are directly elected by the voters of the Member States and has a legislative role.

European Commission: the executive arm of the Union and is considered the most important organ.

Council of the European Union: the legislative branch of the union and comprises ministers from the Member States.

Court of Justice: the judiciary oversees the respect for legislation and laws of the Union.

The Court of Auditors: a watchdog auditing the EU budget.

The EU also created several other institutions such as the European Council which consists of the Heads of State and Governments of Member States, the Economic and Social Committee, the European Central Bank and the European Investment Bank.

The Motives of Brexit

Several factors ignited the British desire to withdraw from the EU such as:

- The pursuit of broader political independence and sovereignty, especially as EU decisions are dominated by Germany and France.
- Reduction of immigration and social benefits granted to immigrants which largely come from Eastern Europe. There is a fear that the expansion of the EU will contribute to the worsening of the problem, leading to deterioration in the quality of public services provided to citizens in the United Kingdom and imposing an additional burden on the UK .
- Failure of the European Union to tackle the ongoing economic crises.
- The staggering UK contribution to the EU budget which netted £8.5 billion in 2015 edging up from £4.3 billion in 2009. The net contribution has been forecasted to oscillate between £7.3 billion and £11.2 billion per year during the period from 2016 to 2020. The contribution amount is determined based on GDP, value-added taxes, customs and tax on sugar production.
- Bureaucratic problems stemming from the concentration of decision-making and legislation in Brussels. According to a study for Open Europe, that the cost of the 100 most burdensome EU regulations was £33.3 billion a year. The Treasury Committee has pointed out that this is an estimate of the cost to firms of compliance with the 100 most burdensome EU regulations. It is not the net economic cost of regulation or the savings to business arising from Brexit.

The Mechanism of Withdrawal from the EU

- The EU treaty allows any EU member to leave according to the procedures set forth in Article 50 of the Treaty of Lisbon. The leave procedures commence once the exiting member notifies the EU of its intention to withdraw from the union. The UK is not expected to notify the EU before the end of 2016.
- Article 50 does not establish any substantive conditions for a Member State to be able to exercise its right to withdrawal, but only procedural requirements. The Article 50 has never been triggered before, so there is high uncertainty regarding how it will be applied.
- In accordance with Article 50, the UK has a two-year period in which to trigger Article 50 and formally begin the process of leaving. If no agreement is concluded within two years, that the membership ends automatically, unless the European Council and the Member States decide jointly to extend this period. In the case of the refusal of any member state to expand the period or the expiry of the period without an agreement, the leaving state will not be capable of benefiting from the rights stipulated in the EU treaties such as freedom of movement, investment and European market.
- The leaving process is difficult and complicated, negotiations are underway on the exit formula. Signing trade agreements with the European Union may take a long time and may require to the ratification of the legislative councils of the member states, which may create a state of uncertainty up to a decade, according to the British government .
- Factoring in the staggering size of the UK economy, a period of two years may not be sufficient for the withdrawal; thus this provides opportunities for other members in the EU to obtain concessions from the United Kingdom.
- The UK may find it difficult to reach trade agreements with other countries outside the EU until reaching a settlement regarding the future relationship between the United Kingdom and the union.

The UK Status in the EU

- According to figures from the European statistics body Eurostat, the United Kingdom was the second largest GDP in the European Union in 2015 contributing 17.6% of the nominal GDP of the European Union coming second after Germany which held 20.72%. France was third seizing 14.9% of the EU's nominal GDP.
- In 2014, direct investment from EU countries accounted for 48% of the stock of foreign direct investments in Britain amounting to £496 billion. Over the past decade, the ratio ranged between 47% and 53%. On the other side, the UK accounted for 40% of the total direct investment in other EU countries in 2014, according to the UK Ministry of Commerce. In the period (2005-2014), the European Union captured 44% of the total direct investment flows in the Kingdom.
- In 2015, the UK exported goods and services to other EU countries in the amount of £223 billion, or about 43.7% of the total UK exports. The amount of imports of goods and services totaled £291 billion, or about 53.1% of total imports, thus generating a trade deficit with of £68 billion with other EU countries. The United Kingdom achieved a trade surplus of £31 billion with the rest of the world.
- The European Union is the largest trading partner of the United Kingdom followed by the United States and China's with £95.1 billion and £15.9 billion, respectively.
- In 2002, exports to the rest of the EU countries seized 55% of the total exports, but fell to 44% last year. Similarly, the proportion of imports from the EU dwindled from 58% in 2002 to 53% in 2015.

UK trade with EU and non-EU countries 2015 - Goods and Services

	Exports		Imports		Balance
	£ billion	%	£ billion	%	£ billion
EU	223	44%	291	53%	-68
Non-EU	288	56%	257	47%	31
Total	**512**	**100%**	**548**	**100%**	**-37**

Shares of UK trade with EU (%) - Goods and services

- There are opinions that the trade figures with other EU countries are distorted and exaggerated, factoring in the staggering amount of trade between the UK and the Netherlands. The Netherlands is an intermediate station for trading with the UK, and thus any imports from the Netherlands are considered imports from an EU member even if the source of those imports is a non-EU country. Likewise, exports of the Netherlands are deemed exports to an EU country even if the goods will be re-exported to other countries. This is widely known as Rotterdam effect. Even with excluding all the trading amount with the Netherlands, given the speculation on the real amount of final exports, the EU will remain the primary trade partner of the Kingdom representing 41% of exports and 46.7% of imports.

UK Trade with EU Member States - Goods and Services

Top 5 exporters - £ billion		Top 5 importers - £ billion	
Germany	44.9	Germany	69.8
Netherlands	36	Netherland	37.7
France	30.9	France	36.8
Ireland	26.9	Spain	24
Italy	16.4	Belgium	23.1

UK contribution to the EU budget (2009 - 2020)

£ billion	Gross Contribution	Rebate	Total Contribution	Public sector receipts	Net contribution
2009 (outturn)	14.1	-5.4	**8.7**	-4.4	**4.3**
2010 (outturn)	15.2	-3.0	**12.2**	-4.8	**7.4**
2011 (outturn)	15.4	-3.1	**12.2**	-4.1	**8.1**
2012 (outturn)	15.7	-3.1	**12.6**	-4.2	**8.5**
2013 (outturn)	18.1	-3.7	**14.5**	-4.0	**10.5**
2014 (outturn)	18.8	-4.4	**14.4**	-4.6	**9.8**
2015 (estimated)	17.8	-4.9	**12.9**	-4.4	**8.5**
2016 (forecast)	20.5	-4.8	**15.7**	-4.5	**11.2**
2017 (forecast)	18.0	-6.1	**11.9**	-4.6	**7.3**
2018 (forecast)	18.6	-4.4	**14.1**	-4.8	**9.4**
2019 (forecast)	19.8	-4.7	**15.0**	-5.2	**9.8**
2020 (forecast)	20.3	-5.1	**15.2**	-5.4	**9.8**

Repercussions of Brexit on the UK Economy

The impact heavily depends on the nature of the future arrangements with the European Union. The British Treasury set three basic scenarios for the future of this relationship:

- Continued membership in the European Economic Area (EEA) such as Norway which is not a member of the EU.
- Negotiating a bilateral trade agreement, such as the existing agreements between the EU and Switzerland or Turkey or Canada.
- Not signing special agreements and relying on the rules of the World Trade Organization.

In all the three scenarios, it is certain that the openness of the British economy and the interdependence with the European economies will be adversely affected, as well as investment and trade flows, compared with the current situation. Nevertheless, the membership in the economic zone will bring the least possible losses, while the cost of exit will be exacerbated under the third scenario.

According to the British Treasury, the Brexit losses for GDP per household after 15 years under the three scenarios will be as follows:

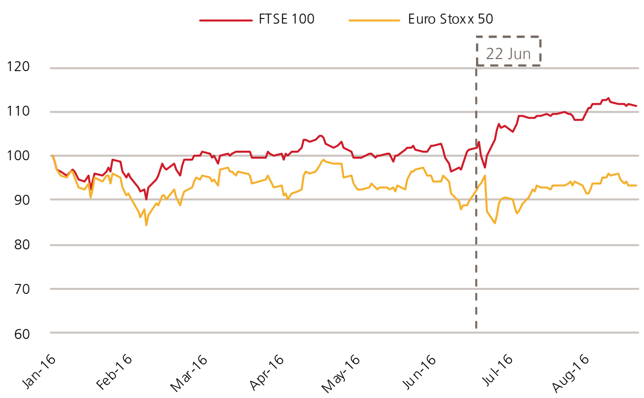
- First scenario: £2600 in the case of continued membership in the European Economic Area
- Second scenario: £4,300 for a bilateral trade agreement.
- Third scenario: £5,200 for adherence to the rules of the World Trade Organization.

The following table shows some estimates for the impacts of Brexit on the UK economy until 2030:

Organization	Scenario	Estimate (%GDP)	Range	Impacts modeled
CEP (2016)	Dynamic EEA/FTA	-7.9	-6.3 to –9.5	Budget, trade, productivity
	Static EEA	-1.3	N/A	Trade only
	Static WTO	-2.6	N/A	Trade only
HM Treasury	EEA	-3.8	-3.4 to –4.3	Budget, trade, FDI, productivity
	FTA	-6.2	-4.6 to –7.8	
	WTO	-7.5	-5.4 to –9.5	
OECD	WTO/FTA	-5.1	-2.7 to –7.7	Budget, trade, FDI, productivity, migration, regulation
NIESR	EEA	-1.8	-1.5 to –2.1	Budget, trade, FDI
	FTA	-2.1	-1.9 to –2.3	
	WTO	-3.2	-2.7 to –3.7	
	WTO+	-7.8	N/A	
PWC/CBI	FTA	-1.2	N/A	Budget, trade, FDI, regulation
	WTO	-3.5		
Oxford Economics	FTA	-2.0	-0.1 to –3.9	Budget, trade, FDI, migration, regulation
Open Europe	FTA[a]	-0.8 to +0.6	-2.2 to 1.6	Budget, trade, migration, regulation
Economists for Brexit	WTO	+4.0	N/A	Budget, trade

- The slump in GDP will cut tax revenue more than the saving from the contribution to the EU budget, thus a rise in government borrowing and debt services which may require raising taxes or curbing public spending.
- Negative impacts on the political integration of the UK especially from the pro-Europe Northern Ireland and Scotland.
- Almost 3.3 million jobs in Britain are related to the exports to the EU. Not all these jobs will be affected as the trade with Europe will continue, however the shape of the future relationship with the EU will determine the magnitude of the impact.
- Restrictions on movement and labor movement raises the cost for companies located in the United Kingdom especially London which is one of the main financial centers in the world. According to the Organization for Economic Cooperation and Development, a study found that immigrants are a strong addition to the British economy and estimated the study their financial addition to the economy of the United Kingdom by more than 34% than what they obtain.
- In the financial services sector, the Brexit may push some companies to relocate their headquarters to other financial centers in Europe.
- The United Kingdom must pursue competitive and tax policies maintain the large investment inflows.
- The uncertainty will weigh on stock prices and lead to a 20%-30% depreciation in the exchange rate of the pound compared to the pre-referendum level.

FTSE 100 Index and EURO STOXX 50 Index Movement



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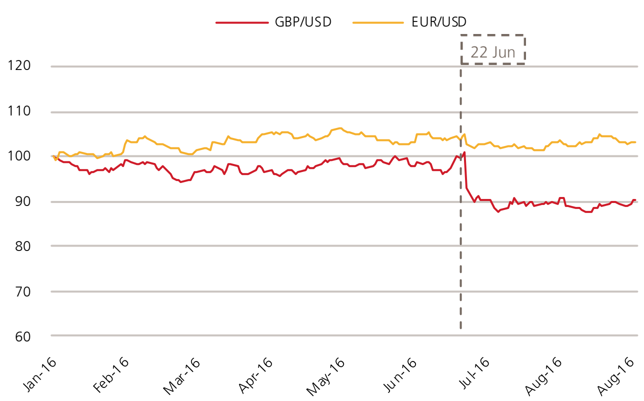

Brexit Repercussions on the European Union

It is difficult to predict the impacts of Brexit on the EU as the matter relies on the date of the actual exit and future arrangements between the European Union and Britain, however the anticipated implications on Britain are expected to be more significant, nevertheless there is a consensus on some issues including:

- The decline in the political and economic weight of the EU worldwide, and increasing the economic power of Germany and France in the decision-making process within the union.
- Strengthening the Eurosceptic movements within the member states.
- The Brexit will prompt more autonomy and privacy for the member states in some issues.
- The depreciation of euro and the increase in inflation which could bode well in the long term factoring in the ongoing recession in the EU.
- The nature of the future relationship with the EU may have a strong influence on the countries that have strong trade ties with Britain, especially the Netherlands and Ireland.
- The ultimate impact of Britain's exit will rely on the nature of the future relationship between the Union and Britain, especially in the trade in goods and services, and the movement of funds and citizens.
- The share of the countries outside the Eurozone in the EU's output will shrank from more than 30% to 15%.

The Economic Relationship Between Saudi Arabia and the European Union

- Saudi exports to the United Kingdom in 2015 totaled SAR 6.9 billion (USD 1.8 billion) compared to SAR 9.5 billion (USD 2.5 billion) in 2014, thus the UK was ranked 23 among the largest recipients of Saudi exports.
- Saudi imports from the United Kingdom rose from SAR 17.3 billion (USD 4.6 billion) in 2014 to SAR 18.8 billion (USD 5.0 billion) in 2015 and came in the tenth place in the largest countries exporting to Saudi Arabia arrangement.
- Saudi Arabia exports to the EU hit SAR 89 billion (USD 23.7 billion) in 2015 sliding 43% fueled by the sharp decline in the oil and petrochemical prices. The exports to the EU represented 11.7% of Saudi exports in 2015 compared to 12.2% in 2014.
- The volume of Saudi imports from the European Union hit SAR 168.5 billion (USD 44.9 billion) in 2015, down 1.7% from 2014, and represented 25.7% of total imports in 2015 compared to 26.3% in 2014.
- The Brexit may lead to further depreciation of euro and the pound sterling, which will bode well for exports of the EU and the UK as the exports of these countries will become less expensive, however the cost of imports will accelerate. The future relationship between the EU and UK will form the future pace of the euro and the pound; further depreciation may provide good opportunities in the future for investments in real estate at favorable asset prices and offloading assets before the final leaving date.
- The Saudi investments in London hit £60 billion varying among executive, tourism and real estate sectors at the private level, according to a statement by the Saudi Minister of Trade and Investment Majid bin Abdullah in June 2016. On the other side, the mayor of the financial district in London was quoted by Saudi newspaper in February 2015 as saying that Saudi foreign investments in stocks, bonds and real estate in the amount of £120 billion, which is equivalent to SAR 684 billion.

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