Euro Outlook – Long Term

More countries may follow Brexit

The loss of one of the EU's biggest members would cause a deep damage to it. BREXIT had nothing to do with economic logic, it happened due to nationalistic and xenophobic sentiments fuelled by populist media and the likes of Marine Le Pen and Donald Trump. Now there is a grave risk that Brexit could fuel Euroscepticism and nationalistic sentiment across the region and spark other members to question their membership in the union. It is not just an economic loss for EU and UK but is a defeat for the liberal order that has underpinned the West's prosperity.

- **Deterioration in EU growth**
- **Volatile Currencies**
- **BREXIT contagion**
- **Existence of EU in question**

Immediate Implications: Brexit negotiations are set to dominate the political dialogue in the Eurozone in the coming months and even years. According to European Union regulations, once formal notice from a member country has been given, a two-year period is set for negotiating an exit—with a possibility for extension. Given the complexity of negotiations, discussions are likely to drag out and when the United Kingdom will actually give formal notice remains unknown.

Regarding economic implications, in the short term, the Eurozone economy will likely face heightened volatility in financial markets and lower confidence levels. The former could impact monetary policy and investment in the bloc will most likely take a hit as a result of the latter. The impact of financial market vibrations could be particularly pronounced for the periphery nations such as Italy and Spain. However, strong domestic fundamentals, which have supported the Eurozone's recovery so far—regional GDP expanded by a one-year high of 0.6% quarter-on-quarter in Q1—should buttress growth in the near term as uncertainty over the terms of Brexit lingers.

In the longer term, the impact of Brexit is less clear and dependent upon how negotiations between the two concerned parties evolve. The UK is the Eurozone's second-largest trading partner and barriers to trade on top of a projected slowdown in UK growth will likely hurt the region. More ambiguous will be the possible changes to foreign direct investment patterns, migration and fiscal transfers within the bloc. On top of this, there is a risk that Brexit could fuel Euroscepticism and nationalistic sentiment across the region and spark other members to question their membership in the union.

Outlook for EU economy

Expectations for European companies' earnings this year are 3.5 percent below pre-Brexit forecasts, according to Thomson Reuters data, putting annual profits on course for their fourth decline in five years. A leading U.S. bank says for sectors most affected by a slowdown in UK investment spending, earnings estimates could realistically fall by 10-20 percent.

The International Monetary Fund on Friday cut its euro zone growth outlook for the next two years over uncertainties sparked by Britain's vote to leave the European Union, and warned that the conditions could worsen if confusion continues to reign in financial markets.

In its annual policy review of the 19-country bloc, the IMF said a further global growth slowdown could derail the euro area's domestic demand-led recovery, and further Brexit spillovers, the refugee surge, increased security concerns and banking weakness all could take their toll on growth.

IMF European Department Deputy Director Mahmood Pradhan said that if the separation negotiations drag out between the EU and the UK, euro area growth would slow further.

He added that we are assuming a relatively swift negotiation of a deal that would preserve full tariff-free access to the European Union common market for Britain. Even this "best-case" scenario will cause a slowdown in investment and weigh on consumer and market confidence.

The IMF has not fully calculated the drag on growth that would result from a full arm's-length relationship that would revert Britain's EU status to basic World Trade Organization tariff and access rules. That would be a "significant change" for Britain, which sends some 40 percent of its exports to the EU. If Britain went to the WTO option, just getting there would take a very long time — and that itself will be very damaging.

In its report, the IMF said medium-term prospects for the euro zone are "mediocre", constrained by crisis legacy problems from high unemployment, elevated public and private debt and deep-rooted structural weakness.

Weaker Britain implies weaker EU

Britain’s economy is one of the largest in Europe, where it is a reliable consumer in an otherwise high-saving continent. Any negative development on trade with Britain will deteriorate EU’s economy. European growth is already fragile and any further blow is particularly unwelcome now.

The Bank of England said “We are well prepared for this.” It may cut its main interest rate from its present level, of 0.5%. It may restart its quantitative-easing programme. A recession in Britain nevertheless seems likely. Corporate investment will be hurt by uncertainty about future access to the single market.

EU will also be hurt by a cut in consumer spending in Britain. As the bleak consequences for the economy become clearer, spending on big-ticket items is likely to slump. The collapsing pound will push inflation up, crimping real incomes. Employment and wage growth will fall. And a recession in Britain which is a big economy of Europe will have a significant impact on Europe’s economy. As a rule of thumb, whatever the reduction in Britain’s GDP growth, Europe’s economy will suffer a drop of about half as much.

Structural Weaknesses in EU

Britain’s absence in EU will create big imbalances. The EU will lose one of its strongest liberal voices on trade, competition and the single market; a proposed trade and investment deal with the United States may be one casualty of Brexit. And although Britain’s departure removes a brake on European defence co-operation, it also leaves France as the only EU member with any military clout.

The world now also faces a grave long-term risk. If Britain, long a champion of free trade, can vote to revoke a regional trade deal, how much faith can businesses worldwide put in other international economic agreements? Nationalist, populist and protectionist forces in other countries will be greatly encouraged by Brexit. The WTO recently gave warning that protectionist trade measures in the G20 are multiplying at their fastest rate since 2008. More countries may now curb migration of workers, which will be costly for businesses.

How soon Britain can negotiate with the EU and on what terms, will be crucial for both. But in any scenario, one thing looks certain that the world trend is now going to be that of rising protectionism, populist policies, declining liberalism, and continuing currency wars.

Impact on Euro Currency

Euro is expected to face heightened volatility and may see bouts of sharp swings in either direction. Best strategy would be to hedge for medium to short term.