Brexit

A Retail Industry Perspective

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Overview

For the majority of businesses in Britain, the possibility that the UK might leave the European Union (EU) is a major source of concern. It is argued that both the break with the EU, and the uncertainty associated with it, would be damaging for businesses and could undermine the UK's economic recovery.

In reality, should Britain leave the EU, the severity of the impact would depend on the new relationship that emerges between the UK and the EU after a vote to leave. Put simply, no member state has ever left the EU so there is no precedent set for guidance. If the UK votes to leave the EU it is also unknown what arrangements will be agreed to replace the EU membership, however, there are likely scenarios which may develop.

The UK's current membership of the Single Market means that UK retailers can import and export goods "tariff free" within the EU or with little or no customs procedures and restrictions. So when it comes to Brexit, what are retailers themselves saying? A letter signed by almost 200 business leaders in late February – including the bosses of Asda, M&S, Dixons Carphone and Kingfisher – warned that leaving the EU would "deter investment" and "threaten jobs". Meanwhile three of Britain's biggest supermarkets - Tesco, Sainsbury's and Morrisons, refused to sign the letter. "The referendum on EU membership is a decision for the people of Britain," said Tesco in a statement, with similar sentiment echoed by Sainsbury's and Morrisons.

In the event of a vote to leave the EU, this paper examines the possible arrangements that may be negotiated and the possible macroeconomic effects and implications this could have for the retail industry.

Timeline

Referendum Bill Passed	Negotiations Conclude/ EU Summit Deal	Referendum Preparations	Election Day	EU Referendum
December 2015	February 2016	March/April 2016	5 May 2016	23 June 2016

What will happen in the event of a “leave” vote?

In the event of a “leave” vote, a country can withdraw from the EU two years after notifying the European Council of its intention to leave. However, leaving would still involve “complex and probably lengthy negotiations”, a Parliamentary briefing paper concluded. Talks would be held on the future of the UK’s relationship with the EU, including whether it could still have access to the Single Market. Resolving this is likely to take some time.

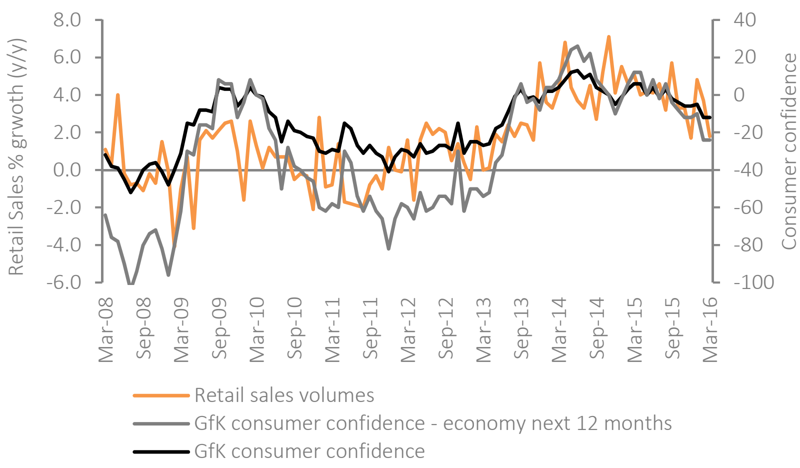
Scenarios – Trade Agreements in the Event of a Leave Vote

Style	Agreement	Verdict	Full Access to Single Market	Nearly no EU tariff barriers on trade in goods	No Contribution to EU budget
Norwegian style EEA agreement	The UK joins the European Economic Area and maintains full access to the Single Market, but must adopt EU standards and regulations with little influence over these. The UK still makes a substantial contribution to the EU budget and is unable to impose immigration restrictions.	**UNLIKELY** - After voting to leave the EU, partially on sovereignty grounds, the UK is unlikely to agree to apply EU law without a say in drafting it	✓	✓	✗
Turkish style customs union	Internal tariff barriers are avoided with the UK adopting many EU product market regulations. The UK is required to implement EU external tariffs, without influence or guaranteed access to third markets.	**POSSIBLE** - It would all depend on the deals reached	✗	✓	✓
Free Trade Agreement (FTA) based approach	The UK is free to agree FTAs independently and the UK’s relationship with the EU is itself governed by a FTA. Tariff barriers are unlikely but, as with all FTAs, the UK will need to trade off depth – which means agreeing common standards and regulation – with independence.	**POSSIBLE** - It would all depend on the deals reached	✗	✓	✓
Swiss style bilateral agreement	The UK and the EU agree a set of bespoke bilateral agreements in return for extensive market access and accept some obligations to EU regulation and pay some contribution to EU programmes.	**UNLIKELY BUT DESIRABLE** - It is unclear if the EU would agree and it could be a lengthy process. It took Switzerland considerable time to negotiate the deal after rejection from EEA	✗	✓	✗
Most Favoured Nation (MFN) based approach	No need to agree common standards and regulation, but at the expense of facing the EU’s common external tariff, which damages UK trade with the EU in goods as well as services. Non-tariff barriers may emerge over time to damage trade in services in particular.	**POSSIBLE** - Could be risky and costly. If a complex trade agreement cannot be reached in two years, then a hard exit is likely to cause a sudden reversion to the WTO relationship with EU	✗	✗	✓

Consumer Spending

The UK retail sector is not exposed to the same degree of capital flow or major regulatory issues as other sections of the economy. Therefore, the likely impact of Brexit, and the lead-up to the EU referendum, is a higher degree of uncertainty and the damage this is likely to cause to consumer confidence. If consumer confidence was to deteriorate sharply, it is likely that households will cut back on spending which will lead to a fall in retail sales. It is also highly likely that a "leave" vote will be followed by a sharp fall in sterling which would increase import prices, pushing up inflation and therefore squeeze real household incomes and depressing consumer spending.

Figure 1 - Consumer confidence and retail sales show strong relationship



Source: ONS, GfK

Given that consumer spending accounts for two thirds of total economic output, the outlook for households is vital to the health of the overall economy. The most recent data from the ONS showed that consumer spending remained robust in the first quarter of 2016 and has continued to be the driving force in the recovery. However, the EU Referendum was only announced on 20 February and so confidence is likely to have taken a knock since the announcement.

More recent data from Barclaycard, which processes nearly half of all credit and debit card transactions in the UK, shows growth in consumer spending slowed down for the second consecutive month in February, as UK shoppers started to show signs of more cautious behaviour in response to an uncertain economic outlook. Consumer spending grew by 3.3 per cent in February, the second consecutive monthly slowdown since year-on-year growth reached a peak of 4.0 per cent in December 2015.

However, GfK's consumer confidence measure has been more telling. The latest data has shown a sharp decline in perceptions on the future strength of the UK's economy. GfK commented in their March release "Are we seeing Brexit jitters at work now" as the overall measure has been on general decline over the last six months. Expectations for the General Economic Situation over the next 12 months have decreased seven points to -12; this is 15 points lower than this time last year.

Investment

The UK is the largest recipient of Foreign Direct Investment (FDI) in the EU. Brexit could reduce the attractiveness of the UK as a doorway to Europe. It may become harder to attract corporate HQs. The EU was the source of 59% of the stock of FDI in the UK in 2014[1]. This dependence has fallen on the previous year, with the EU share down from 61% in 2013.

Half of all European headquarters of non-EU firms are in the UK, with the UK hosting more HQs than Germany, France, Switzerland and the Netherlands combined. This could become harder following Brexit given the favourable tax treatment available to member states through the Parent-Subsidiary Directive.

Many large European corporates are heavily invested in the UK and the commercial logic for this investment could be affected by Brexit. For investment in retail, it could mean that some investors will put off or shrink their UK operations, particularly if the EU is a key market for their business.

The EU share of FDI is much higher in the energy, retail and wholesale trade, transportation and manufacturing sectors than it is in financial and professional services. Retail and Wholesale trades EU share of FDI in 2014 was 67% amounting to £90bn, surpassed only by the financial sector.

	EU £m	World Total £m	EU Share of Total FDI
Retail/Wholesale	90,783	135,966	67%
Primary Industry	71,946	100,735	71%
Financial Industry	103,815	279,872	37%
ICT	54,543	86,139	63%
Utilities	46,584	50,134	93%
Transport	31,703	41,216	77%
Food/Beverage	29,058	68,127	43%
Other	180,304	272,146	66%
Total	608,736	1,034,335	59%

Source: ONS/ Retail Economics Analysis

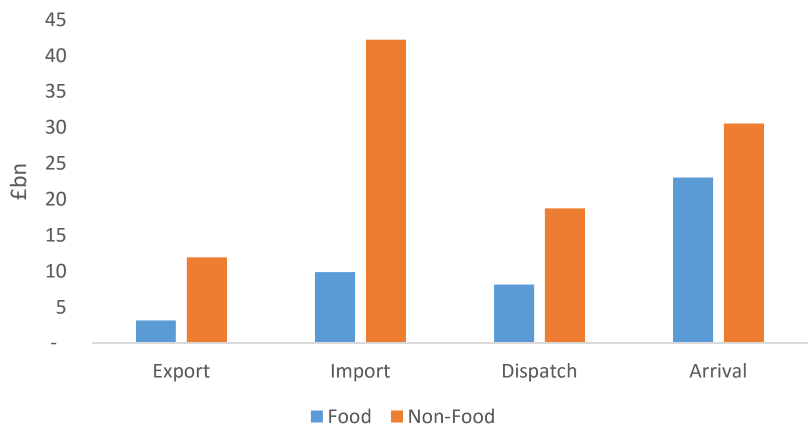
However, the Single Market is not the only reason for investing in the UK. In the World Bank's "Doing Business" survey (which assesses countries according to the ease of doing business in them), Britain ranks highly in areas such as attaining credit, dealing with construction permits and protecting minority investors. Also, the UK benefits from good transport connections, a welcoming political environment, a strong rule of law and the English language.

1 FDI data ONS

Trade

When it comes to the retail industry, the effects of Brexit on trade will have the most significant effect. When the UK joined the European Economic Community in 1973, just over 30% of UK exports went to the EU. By 2014, 44% of UK exports went to EU countries. For retail this is even higher, with 64% of exports dispatched to the EU.

Figure 2 – Retail Trade



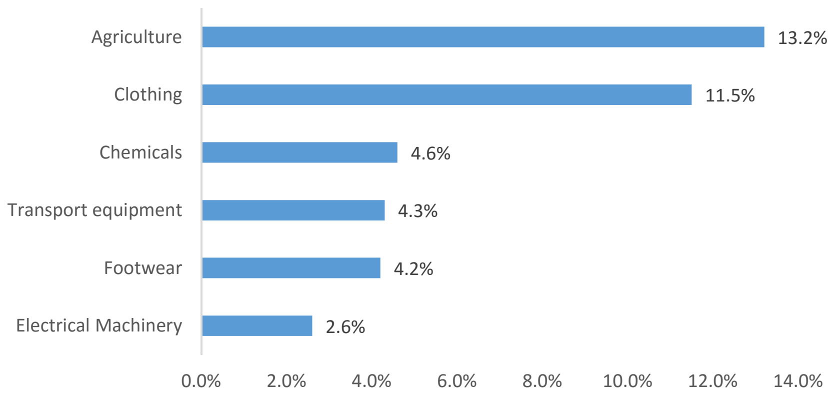
Source: UKTradeInfo/ Retail Economics Analysis

The effects on trade are dependent on the trade agreement that would be reached (see trade scenarios table). If the UK were able to negotiate a Swiss style agreement, then free trade with EU states would still be possible, although the EU would still require funding and the free movement of labour would remain in place. This is unlikely, therefore, but if tariffs and quotas did remain broadly consistent with current levels then prices in the UK are unlikely to be impacted.

If the UK were to make a total break from the EU and use the WTO default, Most Favourable Nation (MFN) based approach, then imports from the EU would also be subject to MFN tariffs.

The scale of the increase in prices would vary from product to product but it could be up to 11.5% for clothing as certain non-food products have high tariffs. However, it is likely to be even higher for food products. Whether these costs will be passed on to consumers remains to be seen. Imports from outside the EU would be largely unaffected. The real opportunities would come from the UK's ability to source food products, particularly, from outside the EU, and take advantage of not having to comply with EU regulation – for example, the possibility of sourcing more cost-effective Genetically Modified foods from the US.

Figure 3 - Average MFN tariff duties by the EU by tariff line



Source: WTO

From an exports point of view, the worst case scenario would be that the EU imposes MFN tariffs on UK exports. This could have a significant effect on retail as e-commerce sales could be subject to custom controls which would increase delivery times and costs. MetaPack, who work with around 200 UK retailers, suggest that c.20% of online orders in the UK are sent overseas. It would also mean that UK retailers supplying goods to the EU would be subject to the full range of duties applied by the EU. The same would apply to business-to-business transactions. Also, this would mean non-participation in future steps the EU takes towards deeper integration and the reduction of non-tariff barriers.

The charts below show UK dispatches to the EU for all categories of Food and Non-Food (except Furniture) goods outweighs that of exports to Non-EU countries.

Figure 4 - Total Food Exports

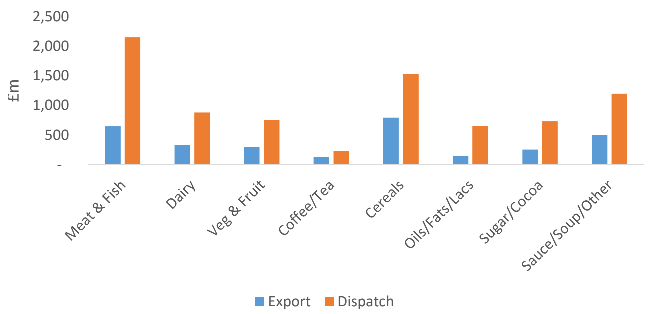


Figure 5 - Total Food Imports

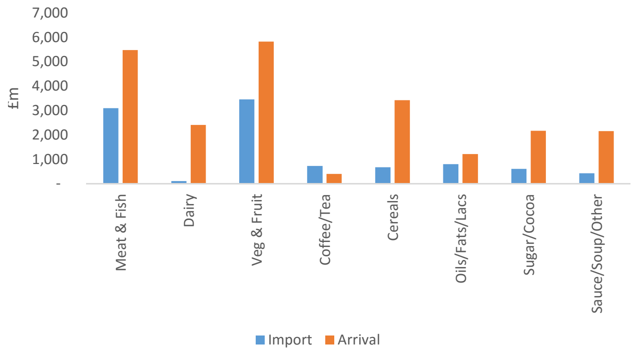


Figure 6 - Total Non-Food Exports

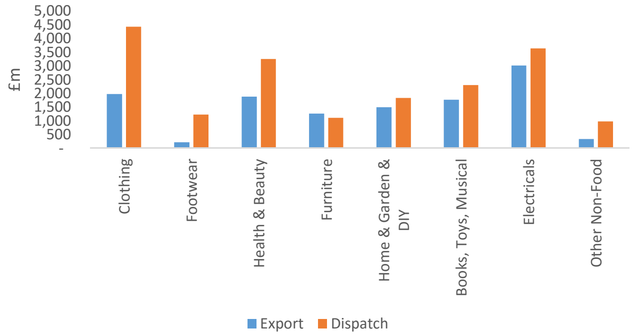
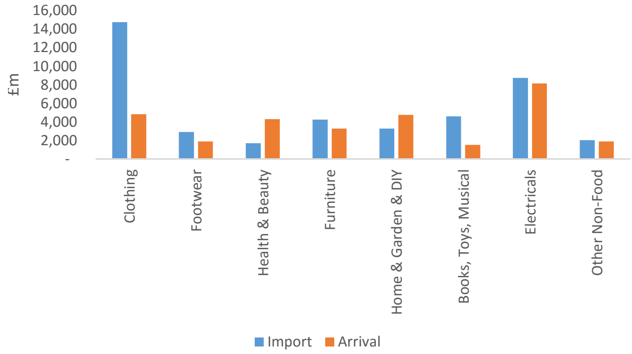


Figure 7 - Total Non-Food Imports



Source: UK Trade Info/ Retail Economics analysis

On a more optimistic note, due to favourable trade conditions with the EU, the UK may have "overtraded" with slower growing EU economies at the detriment of trading with dynamic and fast growing emerging markets. With fewer benefits of trading within the EU, it could bring about faster export growth in the future and less reliance on slower growth of the EU market. However, EU membership does not create a barrier to trade for the UK and the rest of the world and so a lower proportion of trade with the Rest of the World may be the result of softer demand for UK goods.

Export – UK exports outside the EU

Dispatches – UK Exports within the EU

Imports – UK Imports from outside the EU

Arrivals – UK Imports from within the EU

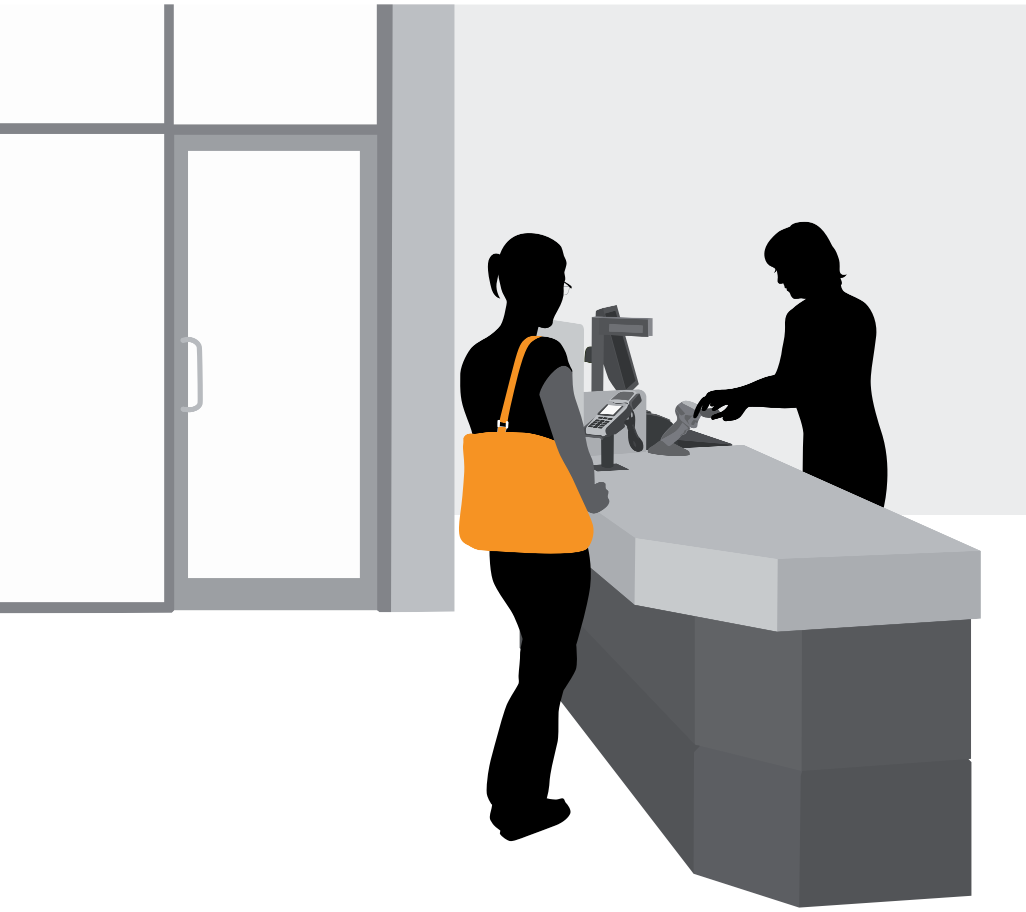
Prices

The main impact on prices in the event of Brexit would be through the depreciation of sterling and the impact this would have on the cost of imports. However, it is also likely that firms attempt to increase their margins in the face of uncertainty and so inflation is likely to ripple through the supply chain.

In the longer term, new tariffs are also likely to add upward pressure on supply chains which will manifest in higher prices for consumers, especially in sectors where margins are typically lower, such as food.

In the case of an exit where the UK were unable to negotiate a trade agreement and was faced with the default WTO MFN tariffs, the cost of imports from the EU would rise significantly. For some products, it would be more cost effective to source from outside of the EU.

Already, imports of Non-Food products from Non-EU countries (see tables on previous page) exceeds imports from EU countries. Food arrivals from the EU are significantly higher than Non-EU imports but a UK exit from the EU would provide significant opportunities to source a greater selection of lower priced products from outside the EU. However, the UK would have to remove its barriers to trade and some of the regulation around health and safety to achieve this.



Labour Migration

EU migrants became a key source of labour supply after the UK labour market opened to Eastern Europeans with the 2004 enlargement. Brexit would end the free movement of labour from the EU into the UK. People would still come into the UK, but without free access and permanent residency rights. All migrants would need a valid visa/work permit to work in the UK or stay for long periods. This would make it harder for many retailers to recruit, in particular, entry level jobs in major cities, particularly those who depend on large numbers of Eastern European staff in, typically, lower skilled positions.

Higher wages will occur anyway as a result of the National Living Wage phased in by stages up to 2020. Higher wages and fewer workers should increase retail automation, enabling retailers to reduce their operating costs. In a recent report from the BRC, "Retail 2020, Fewer But Better Jobs", it is estimated that retail jobs in the UK will decrease by over 900,000 by 2025. The expected policy for migrant workers is likely to be based on a points system designed to encourage professional/educated persons or entrepreneurs to come here from other European countries, but also from India, China and further afield. This in turn would help retailers to recruit specialists in IT and logistics from all over the world, to compensate for the shortages of unskilled workers.

Conclusion

	Costs	Benefits
Consumer Spending	Uncertainty leading to falls in consumer confidence coupled with rising inflation due to weaker sterling and the increased price of imports. This would squeeze disposable income and might dampen consumer spending.	UK might have a more stable balanced economy. Less exposed to shocks in financial markets. Lower immigration and reduced housing demand, house price growth might moderate.
Investment	Prolonged uncertainty for business and investors, loss of confidence, a credit downgrade and a fall in investment. For investment in retail, it could mean that some investors will put off or shrink their UK operations particularly if the EU is a key market for their business.	Brexit and loss of access to the single market doesn't appear to have any real benefit to investment. Fiscal saving estimate, maybe?
Trade	Higher tariff barriers between the UK and the EU. Higher non-tariff barriers to trade (arising from different regulations, border controls, etc.) between the UK and the EU. Non-participation in future steps the EU takes towards deeper integration and the reduction of non-tariff barriers.	Take advantage of trade with fast growing more dynamic economies, source goods particularly food from cheaper countries. The UK would not to obliged to comply with the strict EU regulations around the sourcing of food.
Prices	Weaker sterling resulting in higher import price. Tariffs on imported goods from EU. Retailers may pass on these price increases to consumers.	Opportunities to source from cheaper countries. There may be over supply of particularly food products in the UK as exports face tariffs, bringing downward pressure on prices in the UK.
Labour Migration	Could face staffing/recruitment problems. Big retailers rely on EU migrant workers for their logistics, these employees work close to National Minimum Wage.	Higher wages and fewer workers should increase retail automation, enabling retailers to reduce their operating costs. Could result in the employment of more specialist retail employees.

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