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## What will be the impact of Brexit on the European Union?

**There has been a significant amount of press coverage around the impact on the United Kingdom of exiting the EU But what about the effects on the remaining members of the European Union?**

There is no doubting that impact of Brexit on the European Union (EU) will result in significant social and economic changes to the union, but also longer term political and institutional shifts as well. The extent of these are yet to be determined, and will be subject to some speculation until the precise terms of the United Kingdom's post-Brexit relationship with the EU becomes clear. With the EU's policies on freedom of movement and the economic benefits and drawbacks which the UK and the EU provide each other with, there will be a clear impact with consequences for both.

In terms of the impact on the EU Budget, at the time of the referendum in 2016, the United Kingdom's contribution to the EU budget after accounting for its rebate, was 19.4 billion Euros.



After removing about 7 billion Euros that the UK receives in EU subsidies, the loss to the EU budget comes to about 5% of the total. This will leave the remaining members of the EU to determine whether to reduce their expenditure budget, or to ask Germany as the largest net contributor to provide more cash, with its share of the shortfall estimated to be over 2.4 billion Euros.

In order to meet the shortfall, the European Commission has looked at reductions in

regional spending of up to 30%, which is of great concern for some of the poorer member states which rely heavily on the regional funds. However, the EU has been under-spending on regional funds to the extent that 7.7 billion of unpaid funds was paid back to member states in 2017 (in addition to several billion more that came in due to cartel and anti-trust fines). The result may be that most of the savings in the EU budget could be located in regional funds which are being under-spent regardless.

## Ideological shifts

As the EU's third most populous state, with over 12% of the Union's population, the UK is an influential member of the European Parliament and the Council of the European Union. Its absence will impact the ideological balance within the EU institutions.

In the Council, during the UK's membership there have been two blocs, each capable of forming a blocking minority against the other; the protectionist bloc of mainly southern states and the liberalist bloc of mainly northern states. As a member of the liberalist bloc, the UK's departure would weaken the bloc as the UK has been a sizeable and enthusiastic proponent of an economically liberal Europe, larger trade deals with non-EU countries and of further EU enlargement. While weakening the liberal bloc, it would also strengthen Germany's individual position in the Council through the loss of a key counterweight. However, this may put Germany in a difficult position as other member states who are uneasy about this situation may be tempted to ally against it.

Similarly, a majority of the UK's representatives sit with right-leaning groups, namely the European Conservatives and Reformists and the Europe of Freedom and Direct Democracy, both of which are built around, and led by members of the British Conservative Party and UKIP. The Progressive Alliance of Socialists and Democrats would also lose its members from the UK's Labour Party, but on the whole would be left strengthened by the greater loss to the right, and therefore able to form majorities without seeking support from the (conservative) European People's Party. This may lead to a Parliament which may:

- be more willing to pass extra regulations;
- have less support for strong copyright protection;
- pass a smaller budget, but with increased member-state contributions;
- support tax harmonisation and a financial transaction tax (taxation is out with current treaties);
- give less support to nuclear energy and shale gas in favour of renewable energy sources.

## Defence and foreign affairs

The UK has been a key asset for the EU in the fields of foreign affairs and defence given that the UK along with France, is one of the EU's major military powers. It has significant intelligence capabilities, and a far-reaching diplomatic network. Without the UK, EU foreign policy could be less influential. The US saw the UK as a bridge between the US and Europe, and the UK helped align the EU positions to the US and provide tougher responses to Russia. However, Brexit also produced new opportunities for the European defence cooperation, as the UK has consistently

vetoed moves in this direction, arguing it would undermine NATO. It attempted to do so again, even after its withdrawal referendum, in relation to the establishment of a military HQ. With the UK's withdrawal and a feeling that the Trump administration in the USA may not honour NATO commitments, the European Council has put defence cooperation as a major project in its post-Brexit vote Bratislava and Rome declarations, and moved forward with setting up a European Defence Fund and activating Permanent Structured Cooperation (a defence clause in the Lisbon Treaty).

## Freedom of movement

Freedom of Movement is an integral part of EU policy and is a core principle of European Union ideals. Created in an attempt to abolish borders between participating countries in Europe, the Schengen Area removes the necessity for passports and visas by allowing the free movement of people for a variety of reasons. This concept is designed to benefit the various member states' economy and society by allowing for business to thrive in Europe and for the EU to be more culturally interconnected.

However, free movement within the European Union is also one of the main contributing factors that was a cause of Britain's withdrawal from the EU as well as the increase in popularity of right-wing parties across Europe.

## Trade with UK

While the trade impact of Brexit on the UK is likely to be significantly negative, its impact on the EU is also expected to be negative, but small. The UK and the EU would become each other's biggest trading partner but some member states, notably Belgium, Cyprus, Ireland, Germany and the Netherlands, are more exposed to a Brexit-induced economic shock. The economy of the Republic of Ireland is particularly sensitive due to its common land border with the UK and its close agribusiness integration with Northern Ireland. The reintroduction of a customs border would be economically and politically damaging to both sides, particularly because of the risk to the Northern Ireland peace process that a physical border represents. In spite of expressions of good will on both sides, at this stage it is not obvious how border controls can be avoided unless the UK has a Customs Union with the EU. Arising from the agreements made at the Phase 1 negotiations (after the Northern Irish Democratic Unionist Party intervention), any arrangements to be made to facilitate cross-border trade in Ireland will apply equally to cross-Channel trade, but the details are unclear at this stage. The sectors across the EU that would be most hit by the UK's withdrawal are motor vehicles and parts (the UK is a large manufacturer and depends on an EU chain of supply for parts), electronics equipment and processed foods. Export of raw materials from the Ruhr Valley would also be impacted.

## Migration

The UK's ultimate objective is to have as much access to the EU market without accepting free movement of people. The impact of this would be felt most on eastern European member states who have approximately 1.2 million workers in the UK by the end of 2015; the largest groups represented by Poland (853,000), Romania (175,000) and Lithuania (155,000). A year after the Brexit vote, net annual immigration to the UK fell by 106,000 with most attributed to EU citizens leaving for other states, with the biggest drop among those from the western European states.

In eastern Europe, the Polish government is already encouraging its young emigrant workforce to return to Poland, but due to regulatory or political reasons many would elect to either stay in the UK or move to other western cities such as Amsterdam or Berlin. Other western European member states may see much of the flow coming from eastern states in future. The influx of workers from the east would be economically beneficial to countries such as Germany, but may turn out to be as politically problematic for them as it has been for the UK.

## Agencies located in the UK

In 2017, the UK was currently hosting the European Medicines Agency and the European Banking Authority. As an EU agency cannot be located outside the Union, the Council began a process to identify new host cities for these agencies. Hosting an agency is seen as a valuable prize for a city, so the process was keenly contested by nearly two dozen EU centres. By November 2017 it was agreed that they would relocate to Amsterdam and Paris respectively.

The backup data centre for the security behind the Galileo satellite navigation system was also relocated from the UK to Spain due to the Brexit vote.

## What happens to the UK's European Parliament seats?

The UK is allocated 73 seats in the 751 seat European Parliament, which are likely to become vacant just before the 2019 elections. Under normal procedures, these seats would be re-distributed between the remaining members according to the standard formula, but there have been a number of alternative proposals. The Parliament has proposed that 22 seats would be redistributed and the remaining 50 would be reserved either for new members, or an additional trans-national list of MEPs which would be elected across the Union in an effort to deepen a direct democratic link. This has been a long-standing proposal, notably supported by the European Green Party and French President Emmanuel Macron. However, due to the legal uncertainty around Brexit, any bold moves are opposed by constitutional affairs committee chair Danuta Hübner.

## Public opinion following the Brexit referendum.

Following the UK's vote to withdraw, opinion polls showed that support for the EU surged across Europe. Surveying shows that the EU has the highest support in 35 years. Recently, the UK has also seen a resurgence of EU based support with polls showing that in September 2018 more UK residents thought Brexit would be wrong, in direct contrast to the original August 2016 polling data that showed more support for Brexit rather than remaining.

However, Euroscepticism across Europe has also increased heralded by a 'wave of populism' notably during the campaign of Marine Le Pen in the French presidential election in 2017. In the Italian general election in 2018, the populist Five Star Movement and the right wing Lega Nord, both Eurosceptic, received 32% and 17% respectively.

In Summary, while much of the commentary in the global news media have focussed on the Brexit implications for the UK, there remains significant unresolved issues within the EU as well.

Whatever the outcome of Brexit, there is no doubting that the future shape and dynamic of the EU will change forever, and Britain's fortunes will be very much dependant on her ability to establish new trade relations with countries outside the EU when and if Brexit becomes a reality.

## Where to now for interest rates in the United States?

2018 was a year where the United States Federal reserve was actively raising interest rates in line with policy expectations conveyed to financial markets. The year finished with four rises in borrowing costs, despite rising political pressure from the Trump administration to hold interest rates at lower levels.

Interest rate rises are however, forecast to be fewer in 2019 and policymakers have indicated that they may pause the monetary tightening process with only a possible two rises rather than three as projected.

Looking further on to 2020, only one rise is projected at this stage.

These announcements generated a significant Share market sell off, with a fall in US Treasury bond yields. In addressing a press conference after the release of the latest Federal Reserve decision, Fed Chairman Jerome Powell emphasised the point that this policy outlook was not on a pre-determined course.

He mentioned that there remains a significant level of uncertainty surrounding both the path and ultimate destination of any projected rate increases.

He noted that at this stage, inflation remains just below 2%, and that this gives the Fed committee some leeway to be patient in moving forward.

In addition, Jerome Powell and his committee colleagues mentioned that US economic activity has been rising at a strong rate. Risks to their outlook are however "roughly balanced", as they also flagged increasing threats from a softening global economy.

In this context, he mentioned that the Federal Open Market Committee will "continue to monitor global economic and financial developments and assess their implications for the economic outlook".

At this stage, the current fed funds rate is 2.5%, up from 2.25%. (In comparison, the Official Cash Rate in New Zealand is 1.75%. This is a very unusual situation where interest rates in the US are significantly higher.)

Overall, the tone of the Federal Reserve is one of managing a careful balance. The Fed still has a positive view on the United States economy, however it is reluctant to convey a policy outlook that may appear too bullish, especially as there are some vulnerabilities for the US around the spectre of the ongoing trade dispute with China, and other economic pressures emerging from Europe, and the possibility of the UK failing to agree on terms for exiting the EU.





## Residential property investment. Is it falling out of favour?

For many years, New Zealanders have favoured investing in residential property. However, there is growing evidence that purchasing a residential property to rent is simply not as attractive as in the past for a variety of reasons.

Auckland property prices are flat, after experiencing strong growth for over 10 years. Real estate agencies in the region are finding that there are now many more houses being passed in at auction, a reversal of the trend a couple of years ago. In November last year, the ASB Bank noted in an economic report that New Zealand residential property prices movements tend to broadly track those in Australia, with Sydney in particular, giving a stronger lead on the probable outcome for Auckland prices than Melbourne.

In addition, a combination of reserve bank lending restrictions, persistently low rental yields, along with the reports from Australia of significant price drops in key cities, have contributed to the perception that the potential returns from rental property is not going to be as attractive going forward from here for some time.

Lending some weight to this scenario, is a combination of proposed tax changes that will further impact on residential landlords. These changes include an extension of the bright line test relating to any capital gains on sale within 5 years, and the removal of the ability to use revenue losses on rental property to offset tax payable on other earnings (known as negative gearing).

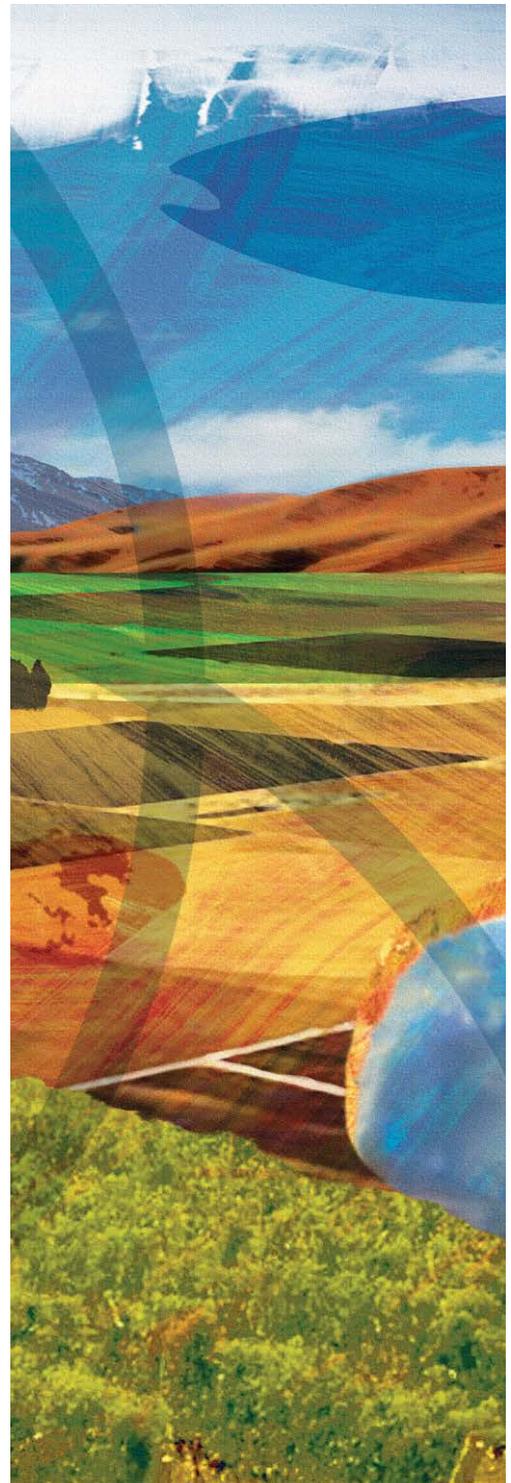
Rental yields in Auckland are rarely above 5% gross, and routinely below 4% according to [interest.co.nz](http://interest.co.nz). This makes the removal of negative gearing provisions even less attractive.

Landlords are also facing additional costs to ensure that their properties meet current insulation and heating regulations.

Changes to the Residential Tenancies Act will also substantially change the landlord/tenant relationship. They include:

1. Ending no-cause tenancy terminations, while at the same time ensuring that landlords can still evict bad tenants.
2. An increase in the notice period that must be provided to tenants to terminate a tenancy from 42 to 90 days.
3. A limit on rental increases to one per annum.

There are also several other proposed changes to the act which will have a significant impact on the residential rental sector in New Zealand. While many landlords may not be viewing the changes favourably, this sector is however an important provider of accommodation across New Zealand and will remain so for many years to come.



  
**accordia**

[www.accordia.co.nz](http://www.accordia.co.nz)

Freephone  
Email

**0800 444 999**  
[service@accordia.co.nz](mailto:service@accordia.co.nz)

Auckland  
Hamilton  
Christchurch

Level 17, 55 Shortland Street  
22 Westminster Place  
4B, 303 Blenheim Road