International developments

Brexit: Late momentum with "Leave", politics crucial after the vote

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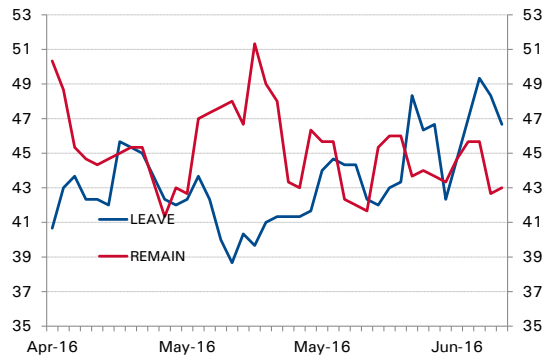
Highlights

- **The Brexit vote is upon us on 23 June. The outcome is doubly uncertain: as to the vote results, but also as to what follows the results, especially if the UK votes to leave the EU.**
- **A Brexit vote will influence sentiment and markets, in the UK and the EU, and by extension the world economy. The obvious is pressure on UK asset prices for a time, including the currency, and some of that has already occurred.**
- **Either way, what follows 23 June may not be as dire as some expect. In the case of exit, the UK will have two years or more to redefine its relationship with the EU, long enough for the cooler heads to prevail.**
- **Nevertheless, it (exit) does have an outside chance for significant and lasting disruption, with timing and magnitude unknown, should things political gather a momentum of their own. Recent polls show momentum favoring the "Leave" camp.**

Chart: Recent Brexit polls

(%, moving average)



Source: Financial Times and various polling agencies.

Background

The United Kingdom's (UK) referendum on its membership in the European Union (EU), commonly referred to as Brexit, is scheduled to take place on 23 June 2016. Prime Minister David Cameron promised to hold the referendum if he won the 2015 general election, in response to growing calls from within his own party arguing that the EU is gaining excessive control over Britons' daily lives.

According to various polls, those in favor of an exit, the "Leave" camp, have been gaining ground in recent weeks, closing in on the "Remain" camp. Yet, most research houses believe the chances of a Brexit are currently between 30%-40%.

The consequences of a British vote to leave the EU would depend critically on the nature of the UK's post-vote relationships, in particular with the rest of the EU. The outcome of the referendum and/or the shape that the exit could take will have implications for the UK, the EU, and the global economy.

The Brexit referendum

The 23 June referendum will ask one question: "Should the UK remain a member of the EU or leave the EU?" While a "Yes" vote would keep the UK in the EU, it will give Britain a "special" status that is the result of a deal already negotiated with EU leaders. The deal terms should help sort out some of the issues Britons say they do not like about the EU, such as high levels of immigration. A "No" vote will trigger a two-year window, to re-negotiate the relationship between the UK and EU post-Brexit.

Possible outcomes of a "Leave" vote

At one end of the spectrum, the UK could follow the Norwegian model, which would allow it broad access to EU markets through the single market system, including retaining the financial services passport. Members of the single market are exempt from trade tariffs and enjoy free movement of goods, capital, services and people. The "financial services passport" allows financial service providers established in one member state to provide services in another without additional licensing or red tape. However, in order for the UK to benefit from the single market, it will be required to implement EU rules and regulations without having any direct input into shaping them. It will also be required to contribute to the budgets of EU regulatory institutions.

At the other end of the spectrum, the UK could enjoy no special relationship with EU countries. Failure to negotiate a more favorable deal at the end of the 2-year window would mean that the UK's trade with EU countries would be governed by World Trade Organization (WTO) agreements; this would entail losing the current favorable access the UK has to the European single market and the EU customs union.

In between, there are intermediate types of arrangements. Economically and financially, given the size of the UK, both sides have a tremendous incentive to come up with new mutually beneficial arrangements with minimum disruption from the status quo. Politically, however, the EU has an incentive to make things extremely hard and unpleasant in order to discourage other potential "leavers", especially given the rise of many separatist and Eurosceptic movements across Europe today. Indeed, several leaders in EU countries have indicated that they are not inclined to give the UK access to the European single market in the event the UK votes to leave.

Consequences for the UK economy of Brexit

In the short term, post-referendum uncertainty would hit business confidence, investment and hiring, possibly tipping the UK into a recession in the second half of 2016, according to the Institute of International Finance (IIF). The Bank of England (BOE) has warned of a technical recession following a decision to leave the EU.

Slowdown in economic activity has already been recorded since the announcement of the referendum in February 2016. Britain's growth slowed to 0.4% in the first quarter of the year compared to 4Q15, while the PMIs (Purchasing Managers Index) have been trending lower in recent months.

The pound has been under pressure since the announcement of the referendum; it is now down 3.5% against the dollar ytd (down 6.5% versus the euro). In the event of a vote in favor of Brexit, we should expect further pressure on the pound and greater volatility.

The UK financial sector would be hit hard from a Brexit, particularly if the UK ended up losing the so-called "financial services passport". Currently, over 2,000 UK financial services firms use the "passport" to access EU markets directly. In addition, in the near term, a decision in favor of Brexit would put higher risk premiums on UK assets and the cost of funding for UK banks would be expected to rise, at least initially. The cost of dollar funding for UK banks has spiked up earlier this year, to its highest levels since 2013. Potential credit rating downgrades would also cause banks near-term pain.

In the long term, some argue that a post-Brexit British government will have a weaker negotiating position when negotiating trade deals with

countries and regional blocks than it currently enjoys, and that this would have a negative economic impact on the UK. Others contend that the UK might be better placed to settle more ambitious trade agreements with the wider world, which, if successful, would have positive implications on long-term growth.

Impact on the EU economy of Brexit

A Brexit is also expected to cause broader market volatility and could add further pressure on the euro. Turmoil for the UK financial sector could easily slow economic activity in the rest of the EU by a few percentage points of GDP; this could in turn put additional strains on already challenged EU financial systems. Weaker growth prospects would also hurt EU equities.

Britain is one of the EU's top trading partners; total EU exports to the UK accounted for about 3% of GDP on average between 2010 and 2014. The EU is also a net exporter (by far) to the UK. European growth might be negatively impacted if trade between UK and EU were to take a hit.

With nearly 80% of EU capital market activity and 75% of European hedge fund assets, the UK has the lion's share of EU asset management services. A possible loss of the financial passport for UK providers would open up new business opportunities for competing EU institutions.

The UK has been a leading voice in financial services regulation. Without the technical competence of the UK regulators, the quality of the EU regulations is likely to suffer.

Political implications of Brexit

Brexit could push the Scottish out of the UK. EU membership was one of the main reasons the Scottish referendum on independence from the UK failed in 2014. At the time, it was argued that independence from the UK would mean Scotland would also have to leave the EU. In an ironic turn of events, now if Britain left the EU, those in favor of Scottish independence and EU membership, would argue for the need to leave the UK in order to apply for EU membership.

A Brexit would also set a precedent for other Eurosceptic movements across Europe. No country has ever left the 28-member EU. Should the UK decide to leave, it would set a precedent others might follow. Nationalistic and Eurosceptic movements would be emboldened across Europe. The EU would want to signal to all other potential "leavers" that the costs are very high. Several EU countries are expected to see some political impact in the event of Brexit including France, Spain, and Italy. In the UK, the Prime Minister David Cameron is likely to be gone in case of Brexit; some even argue in case of a narrow "Remain" victory.

Impact of Brexit on the GCC

According to some analysts, a weakening of the British pound could make GCC investment in the UK look much more attractive. The UK will continue to be a popular investment destination for the GCC, but investors are likely to stay at bay for a time, while the dust settles.

Extracting itself from the EU, the UK would be able to negotiate a bilateral free trade agreement with the GCC, as opposed to the currently stalled EU-GCC agreement (negotiations started in 1988).

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