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INSIGHT

VIEWPOINT

Brexit: An Examination of the Consequences of the UK's Euro Decision

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As the political status quo is challenged globally, intergovernmental partnerships that have existed in harmony for decades are under examination by nations who believe these agreements are no longer mutually beneficial. In the past few years, we have seen Scotland put their United Kingdom membership to a vote, Catalonia push for independence from Spain, and Greece threaten to leave the European Union (EU). In a similar vein, British Prime Minister Cameron has fulfilled his election promise of a full referendum on European Union membership to be held on June 23rd. Central to the Stay or Leave argument are the trading relationship between Britain and the EU, British contribution to the EU budget, regulation, immigration and influence within the EU. In an attempt to quell these concerns, UK Prime Minister Cameron secured a deal with the EU in October which gives Britain special status within the EU. Inherent to this special status is a clear directive from the EU that Britain will not be part of a move towards a closer union with other EU member states, a key goal of the currency bloc. This deal will take effect immediately if the UK votes to remain in the European Union, but, it appears that the concessions the EU promised Britain were insufficient to pacify members of the Leave campaign. If Britain does indeed exit the Eurozone it will be the first instance of a developed market country leaving the safety of their trade union to set out independently to forge their own trading accords.

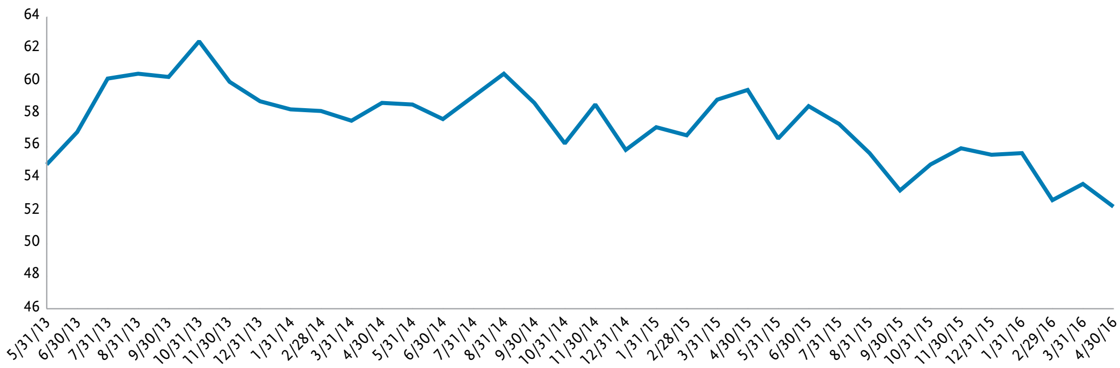
On June 23rd, British citizens will enter polling booths to answer the question "Should the UK remain a member of the EU or leave the EU?" At the core of this question is another question. Are the benefits of trade agreements within the EU and increased leeway to manage immigration policies worth the £20bln pound a year EU membership fee and compliance with EU mandated regulations? The Britain Strong in Europe campaign, spearheaded by Prime Minister Cameron, believes the case to stay in the EU is compelling. By keeping ties to the common currency union, the UK would continue to enjoy favorable terms of trade with fellow EU members as well as recently negotiated special member status. As an EU member, the UK avoids exporter tariffs on goods sent to other EU countries, which comprises nearly 45% of total British exports. Conversely, the Vote Leave campaign, led by London Mayor Boris Johnson and Tory Cabinet Minister Michael Gove, sees the Eurozone as something of a free rider, leeching profitability of British business. Supporters of the Leave campaign argue that while the EU is indeed a large importer of British goods, they are an even larger exporter to Britain. In fact, the UK imports 54% of its total goods from the EU versus exporting nearly 50% of total goods to the EU. This combination suggests that trade dependence is nearly equal and could impact both sides if Britain does decide to go through with a Leave vote. However, a Leave vote does not necessarily preclude the UK from tariff free trade with the EU. Instead, the two parties could potentially enter into a similar trade agreement that is currently in place with non EU members Norway, Iceland, and Liechtenstein. In this scenario, the UK would join the European Economic Area and no longer be subject to EU agricultural and fishing policies while still enjoying free movement of goods, persons, services and capital recognized by both the EU and European Economic Area. Alternatively, if the UK agreed to simply enter into a Free Trade agreement with the EU they would be subject to tariffs but at a lower rate than prescribed by the World Trade Organization. While paying tariffs may not be ideal for the UK, this scenario would return a significant amount of policy power to the UK government as they would no longer be subject to EU regulation. It is difficult to assign probabilities to each of these outcomes though, as there is no precedent for a Eurozone exit despite a few close calls with other EU members in the past.

While the future of the trade relationships between the UK and EU is a source of consternation for both sides, there are a plethora of other issues separating the Stay and Leave campaigns. Supporters of the Stay campaign point to the £24bln average yearly investment from Europe as a significant positive of the relationship. Furthermore, the Confederation of British Industry found that the totality of the economic partnership with the EU is worth nearly £3,000 per year to each British household, a non-trivial windfall considering subpar British wage growth seen post 2008. Those who side with the Leave campaign argue those inflows are dwarfed by the £250 million pounds that is paid weekly to the EU. Leavers argue that this £250 million weekly payment, which amounts to almost half of the entire UK education budget over the course of the year, is better spent elsewhere especially given the UK has to submit to EU employment, health and safety law as well. They also fear that by remaining in the EU, London a global financial center; will become marginalized as EU leadership retains some control over financial regulation. Also implicit in the Leave campaign is a sense of nationalism and security. Leavers argue that British social welfare and safety are best provided by the British government, who will put the needs of British citizens first. While it is true that the British government doesn't have to factor in the needs and safety of any constituency aside from its own, voters will have to decide if the marginal benefit of additional social and physical security is greater than the marginal cost of an EU departure.

Though the outcome of the June 23rd vote will certainly have an impact on the UK economy, the uncertainty around the outcome may be negatively impacting the economy already. For the month of March, the UK Purchasing Managers Index fell to its lowest reading since February 2013, retail sales printed a horrific -0.7% and YoY GDP showed a mere 2.1% growth rate. Similarly, construction output, manufacturing production, and industrial production all entered contractionary territory for the month of April, painting a remarkably negative picture of UK business conditions. The slowing of these economic measures suggests that economic investment and confidence has dried up ahead of the referendum and might even have a lingering negative impact even in the case of a vote to stay. According to Markit financial information company, clients cited the upcoming referendum as a reason to delay new business contracts indicating that British business interests view a Leave vote as a real risk. That is not to say that the recent decline in UK data is strictly a function of referendum uncertainty, however, as UK Q4 2015 real GDP also clocked in at a meager 2.1%. If this economic slowdown is part of a slowing global macro picture and not referendum specific, Brexit uncertainty will merely provide additional tinder to what could already be a slowdown or contraction in economic activity.

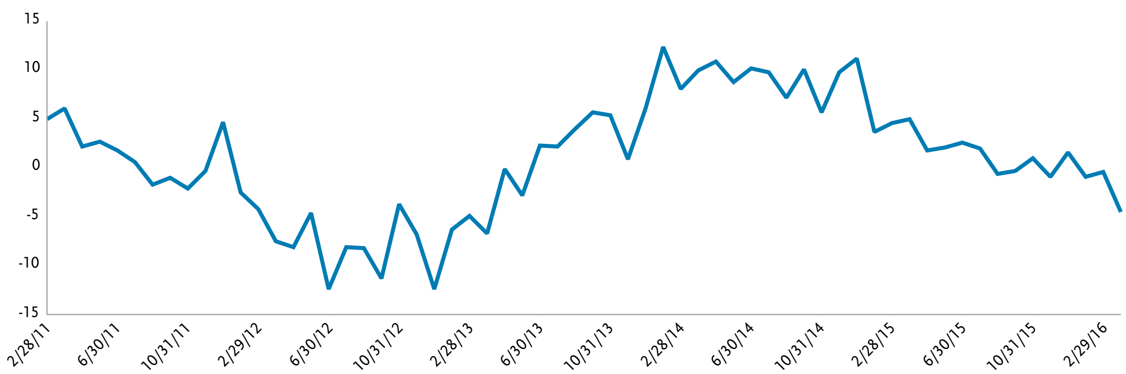
Almost a month before the vote, polls are showing the Stay vote starting to pull away from the Leave vote as the uncertainty of the impact of a Leave vote drives voters back to the status quo. To that end, the most recent poll from the London Telegraph shows Stay leading Leave 55% to 42% as the immediacy of economic consequences prove to be a stronger impetus to voters than nationalistic concerns. Interestingly, Betfair a British odds maker, currently has the odds of a Leave vote passing at around 15% which draws a stark comparison to the near 42% tally in recent polls. This disparity may be a result of low volumes at the bookmaker however, and not be fully representative of public opinion. Regardless of outcome, Britain is undergoing a fascinating socioeconomic experiment in finding the clearing price of a nation's sovereignty while the rest of the globe watches, hoping for minimal disruption in their own market as a result.

UK Services PMI Has Maintained Its Downward Trajectory



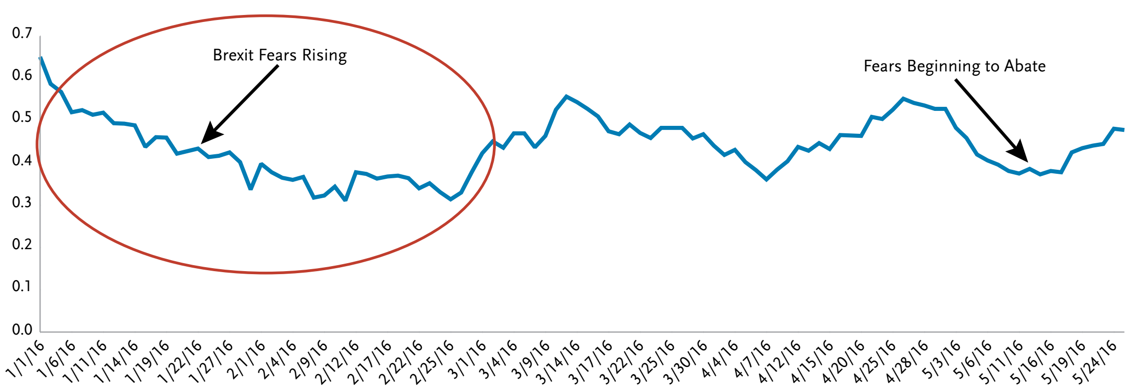
Source: Bloomberg

UK Construction Output YoY % In Contractionary Territory



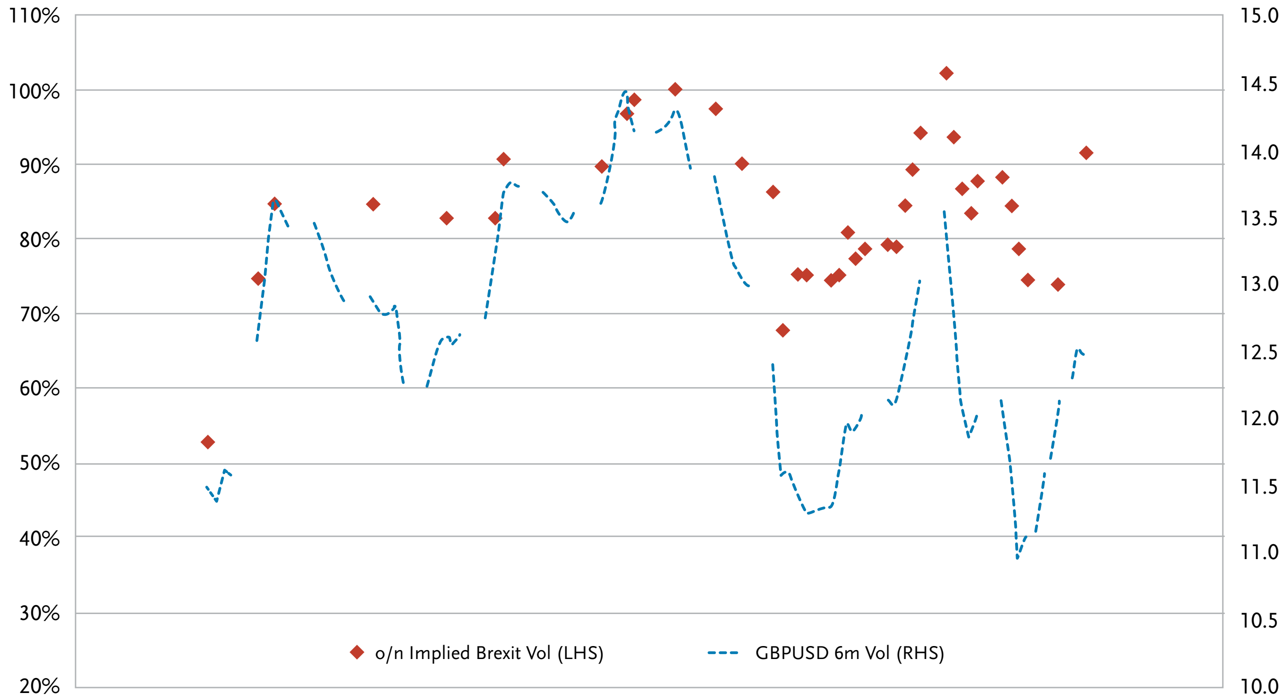
Source: Bloomberg

UK Government Debt Has Cheapened As Brexit Concerns Have Started to Subside



Source: Bloomberg

GBPUSD Volatility Has Fallen as Brexit Fears Abate



Source: Deutsche Bank

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