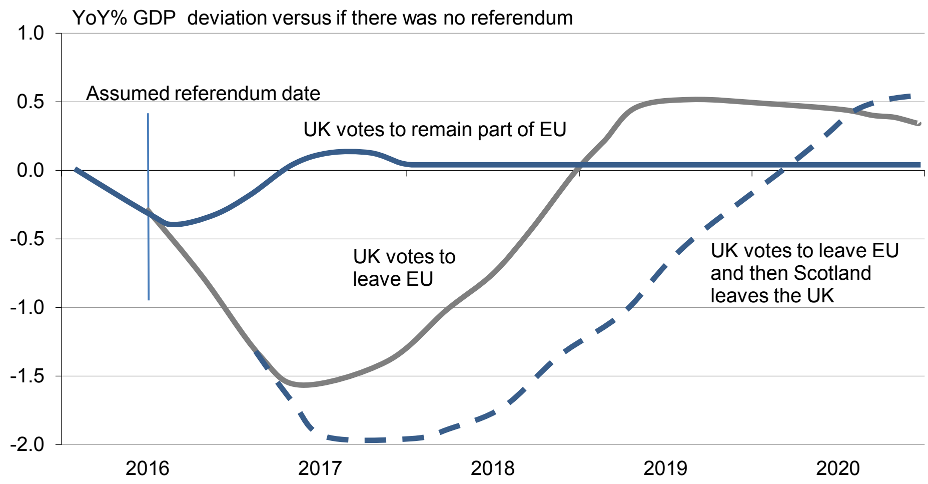
Economics
27 January 2016

The shock from Brexit

A sharp but short blow from a UK EU exit

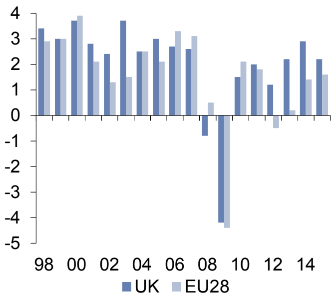
- UK Prime Minister David Cameron has a knack for winning the votes that matter. However, his luck may run out with the upcoming referendum on EU membership.
- The initial suggestion was that the referendum would be held by the end of 2017, but it could come as soon as this summer if a deal is agreed on at the European Council meeting on 18 and 19 February. The assumption is that Mr Cameron can then tell the electorate that he has won a "better deal for Britain" that will convince a majority of Britons to vote in favour of keeping the UK in the EU at a June referendum.
- Irrespective of the outcome, the uncertainty that the vote will generate is likely to see a loss of momentum in the UK economy – possibly knocking around a quarter of a percent off 2016 growth. Both UK and foreign businesses are likely to take a "wait and see" approach to hiring and investment, while consumer spending and confidence could weaken modestly. The Bank of England will sit on its hands and sterling is likely to continue softening in the build-up to the vote – touching 1.32 versus the USD.
- Should the UK vote to leave, Brexit raises clear risks for trade and investment and, by implication, growth and jobs. 2017 GDP growth could slow to 1.5%, some 1.2% below what it might have been, EUR/GBP would likely move towards the 0.90 mark and the Bank of England might loosen monetary policy. This outcome could also fuel the campaign for Scottish independence, which would compound the effects.
- The damage might prove short-lived. A trade deal would need to be agreed within two years and bilateral deals agreed with non-EU countries. Once the situation stabilises, growth prospects should improve – helped by a weaker currency and low interest rates, but the BoE may be forced to subsequently tighten policy aggressively to combat inflation risks. The UK's prospects would then be driven by what the post-Brexit Conservative government tried to do with its new found "freedoms".
- The loss of the UK would negatively impact the EU's own economy and runs the risk of boosting the campaigns of anti-establishment parties elsewhere. This suggests that the process of deeper European economic and political integration could reverse.

How the referendum could hit UK growth – stylised path



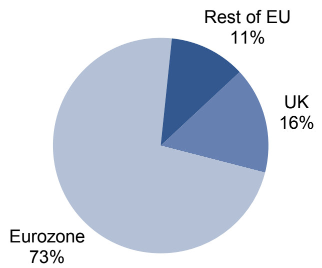
Source: ING

UK versus EU GDP (YoY%)



Source: ING

EU28 GDP (2014) = €13.9trn



Source: Eurostat

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Summary

We first published a report on the UK holding a referendum on EU membership together with the potential economic and political implications in January 2013 (*Heading for Brexit?, Referendum raises prospect of EU exit*, 23 January 2013). In this new and expanded follow-up, we provide a more detailed assessment of the political backdrop given the strong likelihood that the vote will be held this year. However, those readers that have been following the story more keenly may choose to skip to page 7, where we look at the relative pros and cons of ongoing UK membership of the EU.

We then go on to look at the potential direct economic and financial market effects from the referendum in both the build-up to the vote and what may happen afterwards, whether the decision is to remain or leave. If it is to leave, this could have huge implications for the EU more broadly. We will be looking at these in more detail in an upcoming report, but provide some initial thoughts on page 17.

Brexit time?

Background to the referendum

Offering the UK electorate a vote on EU membership was seen as a vote winner for PM Cameron

Fearing a significant loss of support to the anti-EU UK Independence Party at last May's General Election, Prime Minister David Cameron offered a vote on the UK's ongoing membership, hoping that this would sway wavering voters to back him. The alternative, he suggested, was supporting UKIP, hurting the Conservative vote, thereby allowing the Labour Party to form a left-wing coalition with the Scottish Nationalists that would keep the UK's relationship with the EU unchanged.

It worked, with the Conservatives gaining a parliamentary majority

This strategy appears to have contributed to the Conservatives' surprise election victory, which confounded every single opinion poll suggesting some form of coalition was inevitable. Consequently, a referendum is now scheduled to happen before the end of 2017 but looks likely to be held this summer.

The UK government is seeking a "better deal" from the EU

The campaign promise was that the UK government would look to negotiate more favourable arrangements for Britain's continuing membership of the EU, which would then be put to the British people for their approval. If they didn't like what was negotiated, the UK would then leave.

Last November, UK Prime Minister David Cameron sent a six-page letter to EU President Donald Tusk spelling out his key aims in the negotiations. These were listed as:

1) Economic Governance: Protecting the UK's access to the Single Market as a non-euro member;
2) Competitiveness: Easing the burden of regulation and cutting red tape in an effort to boost competitiveness, improve productivity and create jobs;
3) Sovereignty: Exempting Britain from "ever-closer union" whilst bolstering national parliaments;
4) Immigration: Ending EU migrants' ability to "abuse" freedom of movement with a proposal that insists people live and work in the UK for four years before qualifying for in-work benefits or social housing, while also ending the practice of sending child benefit payments overseas.

Migration is the main source of unhappiness with the EU amongst the UK's population

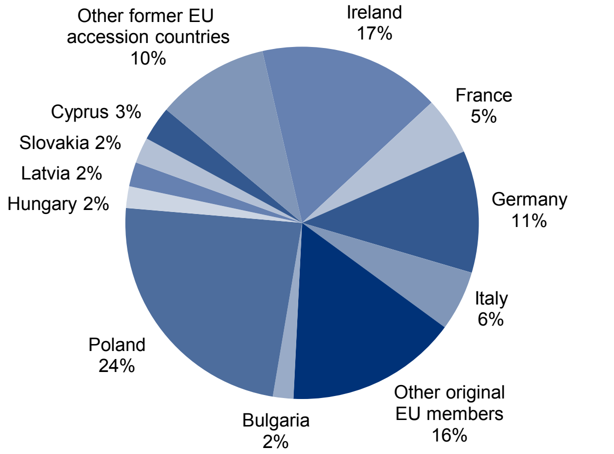
It is the last point that is the most important (at least politically) from the British perspective in negotiations with the EU. A widely-held view is that cheap EU workers have depressed the pay of low-skilled Britons, are claiming benefits they haven't contributed to, and are putting a strain on public services, which is leading to a lower standard of living. In response to the monthly Economist/Ipsos MORI poll[1] "What do you see as important issues facing Britain today?", 49% of the population, unprompted, cite immigrants or immigration. The state of the National Health Service (34%) and the economy (27%) lag well behind.

The UK has seen significant inward flows from Eastern Europe

EU expansion, combined with the EU policy of free movement of people, has resulted in significant numbers of Eastern Europeans moving to the UK in recent years. Official data shows that there are 1.1 million former EU accession state nationals living in the UK, of which Poles make up just over half, with another 1.3 million nationals of countries that were members of the EU before 2001.

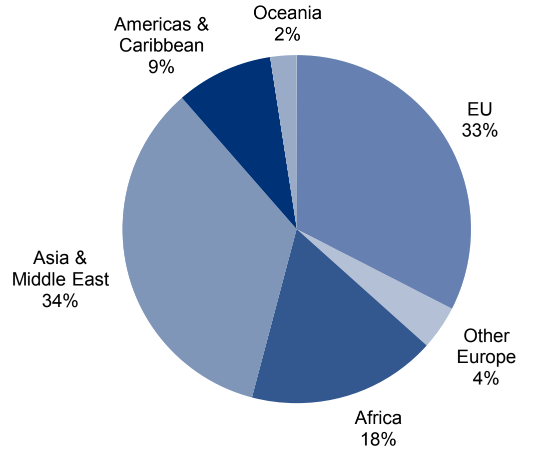
[1] https://www.ipsos-mori.com/researchpublications/researcharchive/3656/EconomistIpsos-MORI-November-2015-Issues-Index.aspx

Fig 1 Origin of the 2.4 million EU migrants to the UK



Source: Office for National Statistics

Fig 2 Origin of all 7.5 million immigrants to the UK



Source: Office for National Statistics

The UK's demands were not well received initially…

… but there are signs that a deal can be agreed

Initially, the EU's response was not encouraging with respect to Cameron's list. Tusk stated on 7 December that there is "presently no consensus" on the UK's demands, adding that we "have to overcome the substantial political differences that we still have on the issue of social benefits and free movement". The mood did improve following the December 16-17 Brussels summit, with Tusk stating that he was "much more optimistic than before our meeting" after Cameron apparently backed down on his plans to restrict benefits for migrants to four years. There have also been words of encouragement from Poland (the source of many of the recent migrants to the UK), suggesting that it would be amenable to helping Cameron in return for support for Polish defence initiatives.

The February EU leaders' summit will be key to determining if Cameron can call the referendum

This means that the focus is now on the February 18-19 EU leaders' summit in Brussels, about which David Cameron has said he is "hopeful" of reaching a deal. After all, no European government has ever publicly announced that it would favour a Brexit scenario. Therefore, the Summit, from the EU's perspective, will be another attempt to accommodate David Cameron's demands and ideas.

The migrant influx may make it easier for David Cameron to reach some kind of compromise deal

On the "hot" topic of immigration, the negotiations with the UK might be a welcome occasion for many European governments, including Germany's, to tackle increasing populism in their own countries. Indeed, the migrant influx may make it easier for David Cameron to reach some kind of compromise. The Financial Times[2] signalled a willingness from the Danish, Dutch, Austrian, French and German governments to back a stricter stance on immigration. While the EU, in our view, will never agree to change the principle of free labour movement in the EU, stricter rules for immigration from non-EU countries and stricter rules for access to social benefits for EU-citizens could pave the way for a compromise. A more exclusive and harmonised approach to EU citizens moving from one EU country to another without having a job is also possible.

Cameron is getting the backing of several EU politicians

In this regard, it is worth noting that several politicians have recently made statements backing, to some extent, the British view. Deputy German Finance Minister Jens Spahn said on Bloomberg TV that Mr Cameron had raised some relevant questions, especially when it comes to immigration and social welfare systems. While he had some reservations on the specifics of the British proposals, he sees a readiness to "find a common solution on this because we don't want social welfare migration within the European Union — that's a common point."

European Commission President Jean-Claude Junker is also looking at alternative measures to curb excessive migration, including deploying an "emergency brake"

[2] http://www.ft.com/cms/s/0/801e6408-bcf6-11e5-9fdb-87b8d15baec2.html#axzz3xmZD2kNO

As the European recovery gains traction, migration flows should moderate in the longer term

mechanism if public services are at risk of being overwhelmed[3]. This means that there is the potential for a stop-gap deal that would slow the migrant flow. After all, it is important to remember that a key reason for EU migrants coming to the UK is the relatively strong economy. As Europe's economy continues to recover these migration flows from the EU might reverse – former UK Prime Minister Sir John Major suggested it might be a "shortish-term problem".

British euro-scepticism is going to be tough to overcome

Despite the fact that a compromise is feasible, it is very hard to tell where the negotiations are at. As these negotiations are highly technical, it is hard to see how any result – even if presented as a victory for David Cameron – would be so compelling to the British people that they would lose their EU-scepticism. The latest Eurobarometer[4] public opinion survey shows just 30% of Britons have a "generally positive" view of the EU.

June would be the most likely option

When asked about whether a referendum could be held this summer, Mr Cameron replied, "that is what I would like to see, a deal in February, then a referendum that would follow".[5] The general assumption is that there will be a minimum 16-week gap between the announcement of the poll date and the date of the referendum[6]. There will be at least ten weeks of campaigning and then 28 days before the vote there is a purdah period, during which the government cannot use public resources to publish information that could sway the vote. Assuming that David Cameron does get a deal at the February EU leaders' summit, this suggests that June is the earliest feasible date for the referendum.

Proposed referendum question:
Should the United Kingdom remain a member of the European Union or leave the European Union?
- *Remain a member of the European Union*
- *Leave the European Union*

Opinion polls suggest it will be a close vote

At present, opinion polls suggest the vote is looking incredibly close. In most polls, those wanting to stay in are narrowly in front of those wanting to leave, but it is important to point out there are a large proportion of the population that is undecided, typically around 20% of the electorate. Consequently, the "deal" that David Cameron achieves, how it is explained, and possibly most significantly, how the press portrays it, will be critical to determining whether the UK stays in the EU.

How the media interpret the "deal" will be crucial

The problem for Cameron is that the bulk of the UK popular press is fairly hostile to the EU. This is very different to 1975 when the last EU referendum was held. Communist newspaper *The Morning Star* was the only national newspaper to campaign against ongoing membership. This time round, we could see several of the major dailies favouring exit.

Pro- and anti-EU campaigners will also have to make their economic cases

In an environment where UK households have little time for the European Union, Mr Cameron is therefore going to have to make the economic case for remaining in the EU. UK businesses and trades unions are broadly in favour of remaining and Cameron is going to need these groups to become more vocal too.

[3] http://www.ft.com/cms/s/0/8724e406-a591-11e5-97e1-a754d5d9538c.html#axzz3x8hswksg
4 http://ec.europa.eu/COMMFrontOffice/PublicOpinion/#p=1&instruments=STANDARD
[5] http://www.bbc.com/news/uk-politics-eu-referendum-35275297
[6] http://commonslibraryblog.com/2015/10/21/a-brief-guide-to-the-period-before-the-eu-referendum/

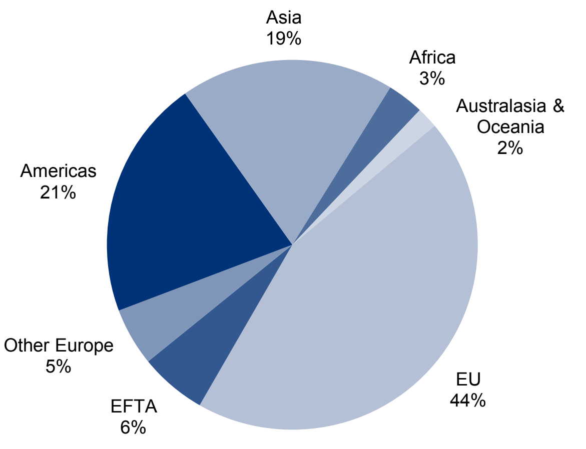
The economic costs and benefits of EU membership

Trade – options for change

The EU is the UK's most important trade partner

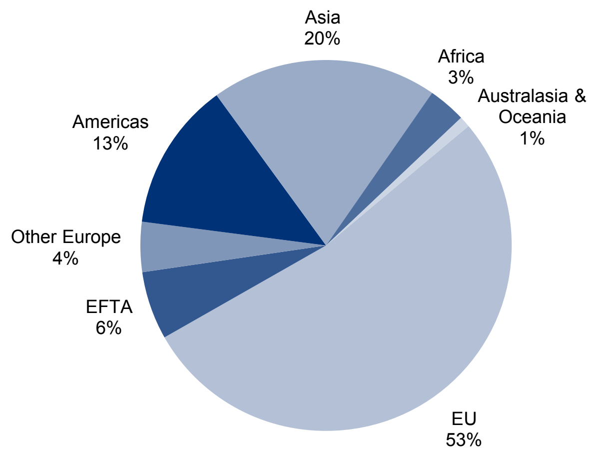
The EU is the UK's largest trade partner by far, accounting for just under half of all exports, and is the origin of more than half of all the UK's imports. While the EU share of UK trade is shrinking, due to weak growth in Europe and the growing importance of developing economies, it will continue to be the UK's biggest trade partner for many years to come. UK exports to the EU account for 9% of British GDP – responsible for 2.3 million jobs. Consequently, if the UK were to leave the EU then it will need to negotiate a new trade agreement to prevent tariffs and other non-tariff trade barriers that would harm growth. There are three options open to the UK.

Fig 3 UK exports of goods & services (2014) – £515bn



Source: ONS

Fig 4 UK imports of goods & services (2014) – £550bn



Source: ONS

The UK could operate under WTO rules

First, if the UK wants to avoid participating in trade agreements that involve significant net EU financial contributions, it could choose to operate under World Trade Organisation (WTO) rules. In this option, the UK would face so-called "Most Favoured Nation" import tariffs when exporting to the EU, just like the US. Similarly, the EU would have to pay these tariffs when exporting to the UK.

But there would be tariffs that could harm trade

These tariffs would harm trade. The negative welfare effect of this for the UK adds up to 0.14% of GDP each year, according to a study from the London School of Economics (LSE) by Sampson, Ottaviano and Pessoa (Figure 5). In our view, the costs of tariffs make it unlikely that the UK would choose this option since it removes the advantages of free trade with the EU.

The UK could join the EEA, leaving it a member of the single market, but without any say in how it is run

A second option is to join the European Free Trade Association (EFTA) along with Norway, Switzerland, Iceland and Liechtenstein, and sign up for the European Economic Area (EEA), which would allow the UK to participate in the single market with zero tariffs. At the same time, it would free itself from obligations related to the Common Agriculture Policy and the Common Fisheries Policy.

It would also have to make financial contributions and would not be able to prevent EU migration

However, the UK would still have to make a financial contribution to the EU and adopt all EU legislation relating to the single market without having a say on these laws. Being a member of the EEA would also mean that workers from other EU member states would continue to be able to live and work in the UK. Consequently, we doubt that the UK would sign up to the EEA either.

It could alternatively just agree a separate trade deal with the EU

A third option would be to follow Switzerland's lead. It is an EFTA member, but did not sign up to the EEA. This way the UK does not have to adhere to EEA rules and can therefore try to negotiate its own immigration rules with other EU countries. However, the UK would still need to pay some contributions to the EU budget if it wants to enter into bilateral agreements with the EU on trade.

There are also non-tariff barriers to overcome

Non-tariff barriers

Besides tariffs, the UK would have to deal with non-tariff barriers if it leaves the EU. Examples include product standards, anti-dumping legislation and labelling standards. Many studies show that this issue is a bigger trade obstacle than tariffs, which have been reduced steeply over recent decades. Following the LSE study, we distinguish between pessimistic and optimistic scenarios in terms of the outcome of the negotiations (Figure 5). The impact over the next ten years could be between 0.4% and 0.9% of GDP.

The UK would lose out on a deepening of the single market

Moreover, by leaving the EU, the UK will miss out on the advantage that non-trade barriers tend to decline much faster between EU countries than between other OECD countries. According to a study from Méjan and Shwellnus, non-tariff barriers have been declining 40% faster. Leaving the EU could lower UK GDP by between 1.2% and 2.6% over a 10-year period.

The UK could be up to 3% of GDP worse off over the next decade

Taking these factors together and accounting for the fiscal benefit of no longer contributing to the EU budget, the London School of Economics paper estimates that the net costs to the UK of leaving the EU will be somewhere between 1% of GDP (optimistic scenario) and 3% of GDP (pessimistic scenario) over the next ten years.

Fig 5 10-year GDP level impact of UK leaving EU versus remaining in EU

	GDP impact (%)	
	(Optimistic scenario)*	(Pessimistic scenario)**
Increase in tariffs for trade with EU	0.0	-0.1
Increase in non-tariff trade barriers with EU***	-0.4	-0.9
Missing out on future decline non-tariff barriers	-1.2	-2.6
Fiscal benefit	+0.5	+0.5
Total welfare effect	**-1.1**	**-3.1**

*In the positive scenario, tariffs on goods remain at zero. Non-tariff barriers are equal to 1/4 of the non-fixed barriers faced by US exporters to the EU. A slowdown of the observed relatively rapid reduction in intra-EU non-tariff barriers takes place (20% extra fall within the EU instead of 40%).

** In the negative scenario, tariffs on goods are the MFN tariffs imposed by the EU, such as those faced by the US. The non-tariff barriers are equal to 2/3 of the no-fixed barriers faced by US exporters to the EU and it is assumed that in the next ten years the intra-EU non-tariff barriers will fall 40% faster.

*** For an explanation on the method used to quantify the costs of non-tariff barriers, see Berden, K., J. Francois, S. Tamminen, M. Thelle, and P. Wymenga (2009): "Non-Tariff Measures in EU-US Trade and Investment: An Economic Analysis," report, Ecorys.

Source: The Costs and Benefits of leaving the EU, London School of Economics/ Centre of Economic Policy research, May 2014

The UK would likely follow the Swiss lead, which would allow trade to continue and give the UK control over EU migration

What to do?

It is unclear as to what the UK would choose in the event of Brexit. We suspect that if the UK were to leave the EU, then the most likely option would be to sign a specific EU Free Trade Agreement and then agree as quickly as possible on bilateral deals with non-EU trade partners, as the UK would no longer come under the EU or EEA banner. This would prevent sizeable tariffs and would allow control over the number of EU migrants moving to the UK.

Thankfully, under Article 50[7] of the Lisbon Treaty, the UK has two years to agree to an exit deal before all treaties it has signed with the EU cease to apply. Consequently, the UK will continue to benefit from free trade until then.

Non-EU countries may not place as much importance on getting a quick deal though

We assume that the UK would be able to sign a deal with the EU within that two-year window, but it could take longer with non-EU countries. US Trade Representative Michael Froman has stated that the US is "not particularly in the market" for a free-trade deal with Britain on its own, adding that "we have no Free Trade Agreement with the UK so they would be subject to the same tariffs and other trade measures as China, Brazil or India." This is not good news, given the US is a hugely important trade partner, sucking in £37bn in UK goods exports and £51bn of UK services. Consequently, there will potentially be

[7]http://www.lisbon-treaty.org/wcm/the-lisbon-treaty/treaty-on-European-union-and-comments/title-6-final-provisions/137-article-50.html

significant disruption that will hurt trade if other countries do not feel the same urgency that the UK does in getting a deal.

That said, we suspect that the US would agree to a trade deal quickly – their current public position is likely an attempt to sway the debate in favour of the UK staying in the EU; post exit the rhetoric would likely change. However, other countries could be slower and/or try to negotiate a deal that is more in their favour, at the expense of the UK. Indeed, the UK is going to be in a weaker position to set the terms of any deal relative to having been a member of the EU. For example, Chinese trade with the whole EU dwarfs that of Chinese trade with just the UK.

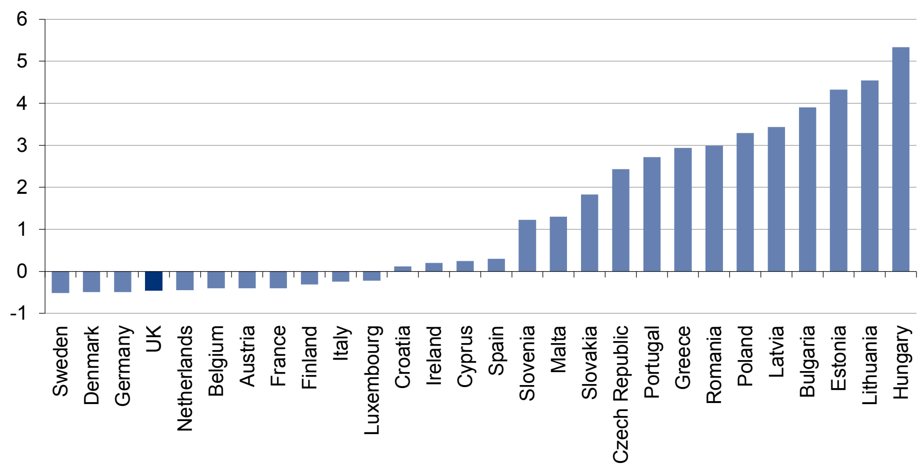
The counterpoint is that China is only negotiating with one country – the UK – rather than 28 EU countries together, so any agreements would be much simpler to broker. Moreover, the Chinese-EU trade agreement already in place could be used as a template for the UK that could be built upon to develop an even better deal. We doubt that most countries would want to damage trade relations with the UK, largely because most countries actually run a trade surplus with the UK.

EU cost – savings would be minimal

The UK is a big net contributor to the EU, but the overall cost is small as a proportion of the economy

The UK is a net EU contributor, having paid around £8.5bn in 2014, although contributions are set to rise to just above 0.5% of GDP in coming years. It is a substantial amount of money, but should be compared with other government expenditure – the UK spends more than 12 times as much on pensions, for example. If the UK were to leave the EU, the money saved would do little to narrow the budget deficit, which is set to come in at around £75bn this financial year and is tiny relative to a national debt that currently stands at £1.6 trillion.

Fig 6 Net receipts from EU (% of GDP)



Source: Eurostat

Investment – a real threat

The UK is a major recipient of FDI

The UK has been a key recipient of both portfolio and Foreign Direct Investment (FDI) over the past few decades, receiving more FDI than any other EU country[8], while the stock of inward FDI is second only to the US. There is clear concern that should the UK leave the EU then this situation could change, which would be bad news for growth and jobs. Note that United Nations data shows 21% of all investment spending in the UK over the past 20 years has come from FDI.

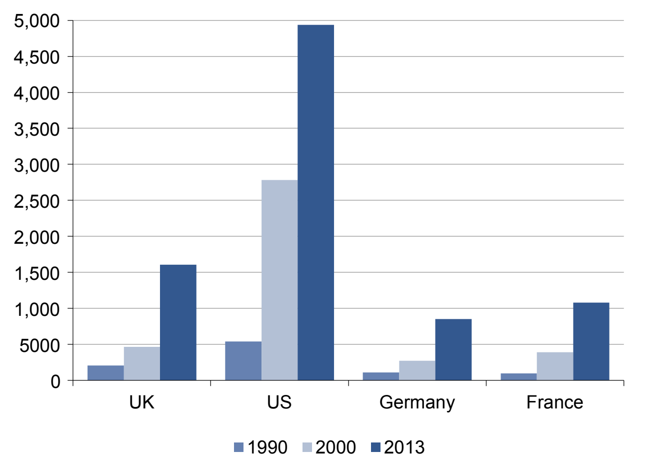
FDI will be at risk due to the uncertainty a referendum brings

There are a number of factors that determine whether a foreign company wants to invest in the UK. These include the regulatory and tax environment, the quality and cost of

[8] http://unctad.org/en/PublicationsLibrary/wir2014_en.pdf

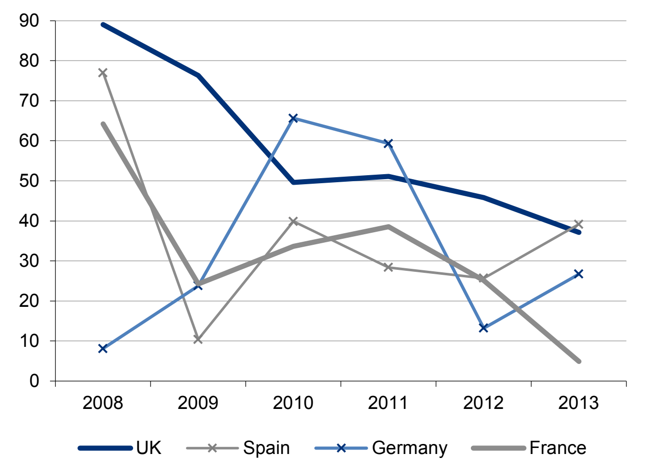
workers, a competitive exchange rate and the strength of the economy. However, the decision will also be based on whether there is good access to key markets. Therefore, even if the UK manages to negotiate a favourable trade deal with the EU, the uncertainty that a referendum generates and the time taken to agree on a deal will likely make foreign investors cautious.

Fig 7 FDI inward stock (US$bn)



Source: United Nations Conference on Trade and Development

Fig 8 Annual inward FDI flows (US$bn)



Source: United Nations Conference on Trade and Development

Non-EU companies are particularly nervous

FDI from EU countries is obviously at risk, but non-EU FDI will potentially be impacted too. If, as a foreign (non-EU) company, your main objective is to sell into the EU market, then it would probably make more sense to place your factory or plant in a country that is actually a member of that economic zone and not one that is potentially subject to tariffs or some form of restrictions. Interestingly, Toyota has said[9] that it will continue to make cars at its plant near Derby in the East Midlands of England and plans to be there in 2090, 100 years after starting production, even if the UK votes to leave the EU. However, it is important to remember that Toyota's European headquarters are in Brussels, not the UK, and so future heavy investment in the UK may be brought into question. Many other Japanese companies have their European headquarters in the UK and take a very different view[10].

The stock of FDI is perhaps less vulnerable, but it does pose risks for jobs and growth

The stock of FDI is less likely to be impacted in the near term, as it would be very expensive to shut down a factory and build a new one in an EU country. However, there may be a diminished prospect of that factory receiving ongoing investment. Furthermore, if a global economic downturn were to hit, it would run the risk of being relatively high on the list of plants to shut down. This emphasises why the UK government will be keen to get a deal done in the two-year window that keeps the UK's trade relationship with the EU at the current level.

UK companies are largely pro-EU and may be tempted to invest overseas

It is also possible that some UK companies may contemplate investing overseas rather than in the UK, fearing that they may be at a disadvantage if they do not have an EU base. Note that a British Chambers of Commerce Survey of 4,387 UK companies showed 60% of respondents saying they thought an EU exit would harm their business, with just 18% in favour of an entire withdrawal from the EU.

Both equity and property markets could become vulnerable in this environment, given the international nature of these markets. If foreign buyers become more cautious on the outlook for the UK, domestically focused companies could see share prices come under pressure, while higher-end London properties might experience price falls.

[9] http://www.ft.com/cms/s/0/1afaf414-b81f-11e5-b151-8e15c9a029fb.html#axzz3x8hswksg

[10] http://www.ft.com/intl/cms/s/0/fdced228-b92e-11e5-bf7e-8a339b6f2164.html#axzz3wyQvd3Wp

Regulation and financial services – still have to play by the rules

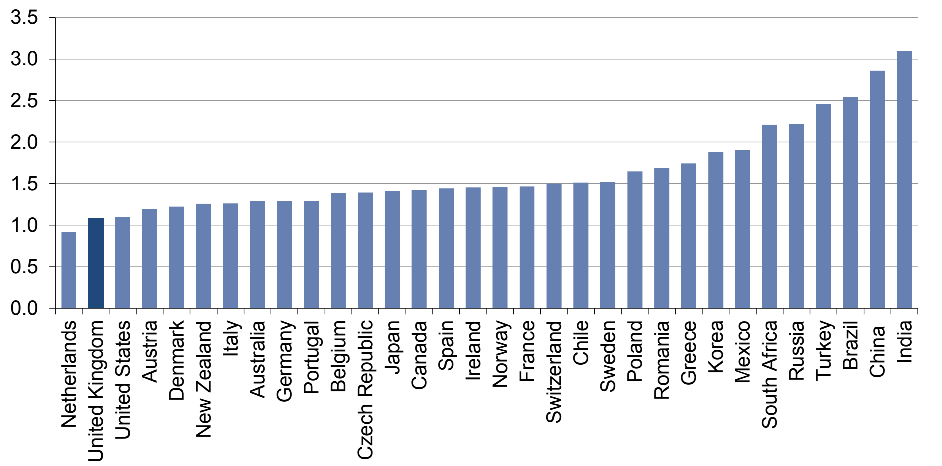
Regulation is always a gripe when discussing the EU

Those opposed to ongoing EU membership often cite burdensome regulation as something that holds back British business. Examples often include the working-time directive, which theoretically caps the working week at 48 hours, along with the EU's agency worker directive, which gives temporary staff the same rights as regular employees.

But the UK is one of the most competitive economies in the world

It is debatable as to how much the UK is impacted. For example, UK workers can opt out of the 48-hour working week. Moreover, the UK is widely regarded as having one of the most flexible labour markets in the world. The OECD's product market regulation index suggests that the UK is already one of the countries least burdened by regulation in the world – even less so than the US and Canada.

Fig 9 OECD product market regulation index



Source: OECD

The UK would still have to meet EU standards and regulations when exporting there

In any case, if the UK does leave the EU, it will still be subject to product regulations for exports to the EU. We also have to consider the fact that many of the European regulations are intended to bring benefits in terms of quality of products and services. There is also the point that the EU passes regulations in order to try and harmonise minimum standards, which should help the single market function.

London's role as the world's leading financial centre could come under threat

There is also the impact on the City of London to consider. Would it be able to hold onto its position as the world's leading financial centre if the UK is perceived as becoming increasingly isolated? This is all very uncertain, with several EU countries keen to take advantage. While London might not be hugely impacted, given that financial sector regulation is increasingly monitored internationally due to the global nature of financial markets, it might potentially hurt employment in the financial services sector. This sector employs around 700,000 people in London and 2.1 million nationwide (source: CityUK).

Free movement of labour

The UK has experienced large EU migration flows over the past decade

One of the key tenets of the single market is the free movement of labour. However, since the EU's expansion eastwards in 2004, migration has become a growing political issue, with large numbers of foreign workers entering the UK in a short period of time.

Migration may have limited wage rises, but it also boosts the size of the UK economy

Logic dictates that a greater supply of labour, in large part caused by immigration, has helped keep a lid on wage growth. It is also probable that immigration has meant that unemployment among British workers is higher than it would otherwise have been. However, increased immigration also boosts the size of the economy, as there are more people within it. It doesn't seem plausible that every immigrant has displaced a British worker, given what has happened to the UK's unemployment rate in recent years. EU membership will also have boosted capital inflows and therefore raised the production potential of the UK.

Immigration is a broader social issue

That said, it seems fair to say that the pace of immigration is putting an immense burden on housing and infrastructure with, for example, school class sizes rising. Consequently, the standard of living is seen as being under threat and it could be argued that this is forcing a type of fiscal easing through necessitating extra government spending.

What happens to the nearly 2 million Britons living in the EU?

On the other side of the equation, there are 1.8 million Britons living elsewhere in the EU[11] – around half of whom live in Spain. This highlights the fact that the free movement of people means the UK is experiencing two-way flows and not purely immigration. Furthermore, if the UK were to leave the EU, would these Britons then have to obtain dual citizenship in order to stay living and working in the EU, or would some of them have to return to the UK? Given that a substantial number are retired, this could significantly increase the demands on the UK's National Health Service, thereby increasing government expenditure.

The impact of Brexit

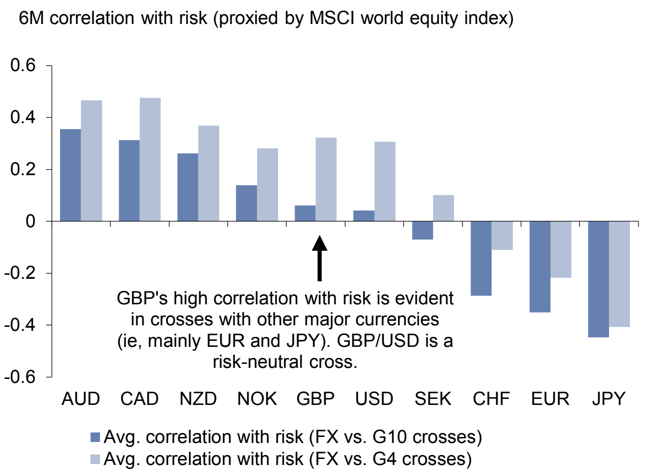
Negative for growth, asset prices and sterling

Generating a single figure on the GDP implication is impossible

We suggest the risks to growth are front-end loaded

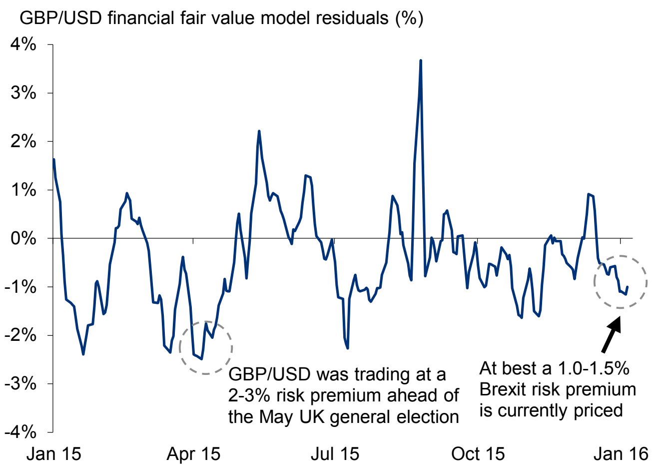
Coming up with a single number for the impact on GDP of the UK leaving the EU is almost impossible. Gauging the effects on business and consumer confidence and how this translates into spending within the economy is difficult at the best of times. Incorporating potentially big swings in asset prices and sterling and also the uncertainty over how foreign investors and businesses will behave, it becomes even more challenging. That said, political and economic uncertainty is an unambiguous negative that we feel will be damaging to the UK growth story, particularly in the lead up to the referendum and the period just after the vote, irrespective of the outcome.

Fig 10 Major GBP crosses vulnerable to risk sentiment



Source: ING, Bloomberg

Fig 11 GBP sell-off not extreme by historical standards



Source: ING estimates, Bloomberg

GBP looks particularly vulnerable, given what happened ahead of the Scottish independence vote

The risks associated with a Brexit will principally be reflected in GBP markets ahead of the referendum. While GBP has endured a woeful start to 2016, caution is required in overestimating the impact of Brexit-specific risks on recent price action. With the dovish BoE re-pricing story only partly liable, we note that a sharp risk-off market – characterised by falling oil prices and a sell-off in global equities – has played a heightened role in the latest bout of GBP weakness. Indeed, the UK's large current account deficit places the GBP amongst those most vulnerable to any deterioration in risk sentiment (Figure 10).

[11] http://www.ft.com/intl/cms/s/0/5cd640f6-9025-11e3-a776-00144feab7de.html#axzz3OJu3CbYW

Brexit risks are emerging in the FX market

Talk of a summer Brexit referendum has produced some early warning signs that the drivers for GBP price action are changing. These include: (a) a drop-off in correlation with rate spreads; (b) limited FX reaction to positive UK data; and (c) a steady build-up of short GBP speculative positions. Figure 12 shows a comparison with the Scottish referendum and the 2015 UK general election. One unusual aspect of the current situation is the early inception of these signals; in the two prior occasions, the market focus had only materially shifted towards the looming event risk one or two months ahead of the key date.

Fig 12 Early-warning indicators for rising GBP political risk premium

	Scottish referendum (Sep 2014)		UK General Election (May 2015)		EU in-out referendum (tba)	
	Inception	Change	Inception	Change	Inception	Change [1]
Drop-off in correlation with rate differentials [2]	Aug-14	-0.28	Mar-15	-0.45	Dec-15	-0.19
Limited reaction to positive UK data	Aug-14	-	Apr-15	-	Jan-16	-
Increase in short GBP contracts [3]	Aug-14	+15k	May-15	+9k	Dec-15	+19k
Risk premium derived from GBP FFV model [4] (%)	Sep-14	2.0-3.0	Apr-15	2.0-3.0	Dec-15	1.0-1.5

Notes: 1) Latest change in indicator as of 11 Jan 2015; 2) Defined as the peak-to-trough change in correlation preceding event risk; 3) Data from CFTC weekly Commitments of Traders report; 4) Average risk premium based on GBP/USD and EUR/GBP ING financial fair value (FFV) models.
Source: Bloomberg, CFTC, ING

Not fully reflected in the risk premium

Given the uncertainties surrounding: (a) the actual timing of the vote and (b) the precise terms of the EU reform deal, it is likely that any evolving Brexit risk premium has yet to be fully embedded into markets. Our short-term financial models show that a 1-1.5% risk premium is currently priced into GBP/USD – approximately half of the risk premium observed ahead of the Scottish referendum.

We see further GBP downside risk

We see scope for further GBP downside over coming months as markets take more account of the true economic costs of a Brexit. In risk-premium terms, this could be worth more than 3.0% and, with the broader risk-off environment also likely to persist in 1H16, we think GBP/USD could fall to the low 1.30s in the run-up to the referendum.

Sterling and UK asset prices are likely to weaken early on

With the UK's status as a relative safe haven being brought into question, the UK stock market could underperform its peers in the build-up to the vote as political and economic uncertainty weighs on sentiment. As the vote approaches, market volatility is likely to be at its maximum, with asset prices and the currency reacting to poll readings being published daily.

While corporates become more cautious

Meanwhile, both UK and foreign corporates will likely become more cautious, leading to a slowdown in investment spending and labour hiring as they wait to see what the outcome is. Given the lack of inflationary pressures and the uncertainty that the referendum will generate, the Bank of England will be keen to leave monetary policy unchanged with, if anything, a bias to ease, given the current negative global backdrop and absence of inflation.

The UK stays…

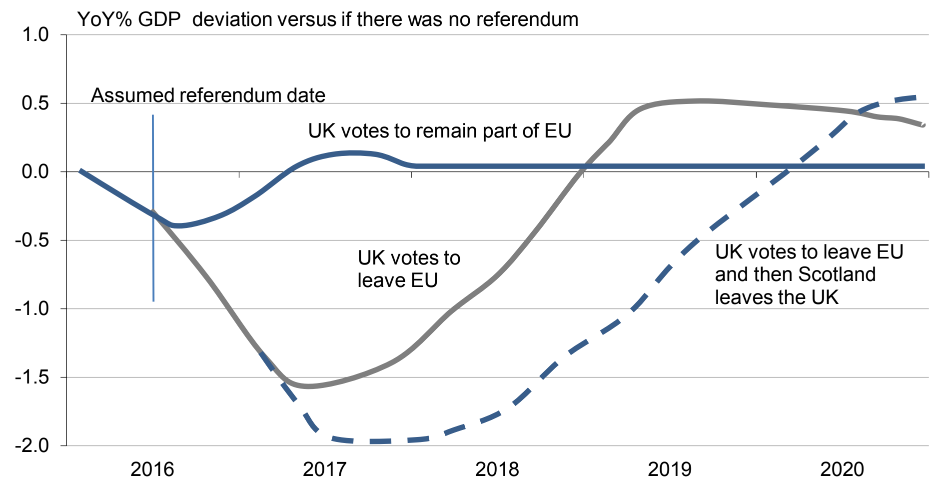
If the UK votes to remain in the EU, this should lead to a bounce in asset prices and GBP

If the UK votes to remain part of the EU, there is likely to be a bounce in UK asset prices, although we doubt that this will immediately make up for the losses seen prior to the referendum. After all, there is likely to be a hit to economic momentum from the uncertainty that the referendum generated.

Investment is also likely to recover as firms have greater clarity on the economic environment

Such an outcome would suggest that the EU has made concessions and therefore the UK-EU relationship is on a new, sounder footing that should boost confidence in prospects for trade and investment. Furthermore, companies that delayed investment and/or hiring in the lead up to the referendum might now have the confidence to go and spend. This suggests to us that 2017 GDP growth should be stronger than in 2016. We would then expect growth to fluctuate around long-term trends.

Fig 13 How the referendum could hit UK growth – stylised path



Source: ING

Inflation could climb, requiring relatively swift BoE policy action

This positive "pent up" growth story, coupled with a tight labour market and lagged effects of a weak sterling exchange rate, means there is the potential for inflation to rise swiftly in 2017 (remember sterling has fallen 7% already since November). Consequently, the Bank of England could end up tightening monetary policy more quickly through 2017/18 than financial markets are currently anticipating. Nonetheless, given our view on euro undervaluation, EUR/GBP is likely to continue grinding higher.

Fig 14 Forecast profiles under different referendum scenarios

	2016F	2017F	2018F	2019F
GDP YoY% - UK remains in EU	**2.4**	**2.7**	**2.6**	**2.4**
GDP - UK leaves EU	1.9	1.5	1.9	2.8
CPI YoY% – UK remains in EU	**1.4**	**3.0**	**2.8**	**2.4**
CPI – UK leaves EU	1.4	3.2	3.2	2.7
BoE policy rate (year-end) – UK remains in EU	**0.75**	**1.75**	**2.50**	**3.00**
BoE policy rate (year-end) – UK leaves EU	0.25	0.50	1.25	2.25
EUR/GBP (year-end) **– UK remains in EU**	**0.76**	**0.80**	**0.81**	**0.82**
EUR/GBP (year-end) – UK leaves EU	0.90	0.85	0.85	0.85

Source: ING estimates

Brexit risks may not be completely over though

One concern though is that, as with the Scottish referendum, there will be lingering uncertainty that another Brexit referendum could be called if the UK doesn't like what is agreed at any upcoming treaty negotiations.

The UK leaves…

The reverse will happen if it votes to leave – uncertainty over what it means being the key issue

If the UK votes to leave the EU such a move will plunge UK-EU relations into unknown territory, and will clearly be negative for the GBP and other UK asset prices. Business sentiment would be hit, with surveys suggesting that the corporate sector is largely supportive of EU membership. Firms that had delayed investment and hiring plans could even abandon them.

If the UK votes to leave we may see plunging UK asset prices, with business confidence weakening too

While a deal on zero-trade tariffs might be agreed on relatively swiftly with the EU, this cannot be taken for granted. Furthermore, the UK will potentially lose out on a deepening of the single market, which would reduce non-tariff barriers. The process might take longer with non-EU countries, with numerous bilateral deals having to be negotiated. Here too, we suspect that similar terms can eventually be agreed, but there is likely to be some trade disruption. Nonetheless, given the UK will have up to two years before formally leaving the EU, the immediate impact on trade may not be too serious.

BoE policy easing would also be likely

Given the lack of inflationary pressures in the global economy, the Bank of England will have plenty of room to leave monetary policy ultra-accommodative and may well decide to loosen policy further if activity does deteriorate as we expect. Indeed, the BoE admitted last year that 0.5% is no longer viewed as the “effective lower bound” for the Bank Rate, due to the improved health of the UK’s financial system and the fact that negative interest rates are in operation in many parts of Europe. BoE Chief Economist, Andrew Haldane, even raised the possibility of negative UK interest rates[12]. We doubt that the Bank Rate would turn negative, but a level of 0 or 0.25% seems probable for end-2016.

In the event of a Brexit, the implications for GBP are likely to operate via three channels: (i) the uncertainty channel; (ii) the monetary channel; and (ii) the fundamental channel.

Uncertainty over the negotiation process will weigh on sterling

While GBP markets are likely to inherently discount the likelihood of a Brexit in the build-up to the referendum, we think that an **uncertainty premium** will persist – and most likely increase – should the UK vote to leave the EU. In addition to concerns over how UK-EU trade relations will evolve, Scotland’s case for independence is also likely to gain traction, making the uncertainty factor unambiguously negative for GBP.

Looser monetary policy will also depress sterling

Easier **monetary conditions** in the UK relative to its major trading partners will add downward pressure on GBP. BoE policy expectations are likely to be neutral ahead of the referendum and a Brexit should see a dovish re-pricing at the short-end of the curve. Recent risk-off episodes have highlighted GBP’s vulnerability to hot money outflows.

Questions might also be raised about the size of the UK’s current account

From an economic perspective, the UK’s net foreign asset position will come under scrutiny and a Brexit is likely to weigh on GBP’s medium-term **fundamental value**. Any immediate trade and investment impact might prove to be small. Direct investment tends to be sticky and we suspect that any exodus of capital from the UK might not materialise until after the post-Brexit corporate environment has become clearer. The Conservative government would likely be in disarray, with the Prime Minister probably standing down (see next section), but they would presumably try to create a more pro-business economic environment at the following Budget announcement.

EURGBP could spike to 0.90 before settling closer to 0.85, with Scottish independence uncertainty depressing the currency

Taking these channels together, we suspect the first two will dominate in the near-term and heightened speculative pressure could see EUR/GBP spike to 0.90 by end-2016. However, as uncertainty begins to diminish, we think the overshoot in EUR/GBP would partially correct and see 0.85 as the medium-term equilibrium level in a Brexit scenario. Indeed, concerns about another Scottish independence vote resulting from Brexit (see next section) will keep sterling relatively weak in the medium term.

As the dust settles, UK economic activity will be driven by what it can achieve with its new found “freedoms”

The situation will likely settle in 2017, helped by loose monetary policy and a very competitive exchange rate in an environment of improving external demand. Thereafter, the UK’s prospects will be driven by what it can do with its new found “freedoms”. One potential course of action could be sweeping tax changes designed to encourage investment and job creation in the UK. These could well offset the negative impacts highlighted in the LSE study regarding the drag on UK trade from leaving the EU. Consequently, growth could actually turn out to be stronger in 2018-20 than the hypothetical forecast of no referendum, but this is far from certain, and also depends on the implementation of bilateral trade deals with non-EU economies. If it is, then the collapse in sterling is likely to create inflation and prompt BoE rate hikes.

There are many other uncertain outcomes to consider

There are other uncertainties, such as what will happen to the nearly 2 million Britons living and working in the EU? Will people either have to leave and possibly sell property that they own in Europe or take second citizenship? Will European citizens in the UK have to do the same? Will work permits have to be introduced and will there be longer queues at passport control? These are all issues that could harm growth.

[12] http://www.bankofengland.co.uk/publications/Documents/speeches/2015/speech840.pdf

The political fallout of Brexit

PM David Cameron would face calls to step down

David Cameron has suggested that he would remain Prime Minister should the UK vote to leave, but the hit to his credibility might make his position untenable and he would likely face pressure to stand aside. The Conservatives would maintain their majority in the House of Commons, but it would require the party to elect a new leader, who would also become prime minister. The contest to take over would likely be between the Chancellor, George Osborne, outgoing London Mayor, Boris Johnson, and Home Secretary, Theresa May. Note that Conservative MPs hold a preliminary ballot, leaving two candidates that are then put to the full party membership for election.

UKIP would presumably cease to be a relevant political party…

… meaning 15% of the electorate's votes are up for grabs

At the same time, the future of the UK Independence Party would be brought into question, given that its aim of pulling the UK out of the EU would have been achieved. The general perception is that the majority of its support is right of centre in their beliefs, but UKIP has also made inroads into the Labour (left of centre) heartlands in recent years. Nonetheless, with UKIP's 15% of the vote up for grabs, the Conservatives may be looking to elect a leader than can try and bring the majority of the UKIP support over to their party. This could partially explain why Boris Johnson is being rather vague in his position on EU membership.

With Labour also likely to be split by Brexit, a more right-wing Conservative government could emerge

Like the Conservatives, the main UK opposition party, Labour, may find itself divided by the Brexit vote given the differing views on their front bench. Therefore, they may find it difficult to capitalise on any Conservative weakness, making it likely that we will see a more right-wing Conservative government in charge until 2020. This could see more emphasis on austerity and pro-business policies.

Scottish nationalists will also be pushing hard for a new independence vote

We have to consider the possibility of a renewed push for Scottish Independence. The Scottish parliament has elections on 5 May and opinion polls suggest that the Scottish Nationalist Party will take the majority of seats, after winning 56 out of the 59 Scottish seats available in last May's General Election. This is a remarkable turnaround after their defeat in 2014's Independence referendum, which was labelled a "once in a generation vote". However, SNP leader (and First minister of Scotland) Nicola Sturgeon suggested that another independence referendum could be called if something "material changed".

A majority in Scotland are in favour of EU membership

SNP officials have suggested that should a majority of voters in Scotland vote to remain in the EU (Scotland in general appears more pro-EU than England), but the UK in total votes to leave, this would be a "material change" and that they would push ahead with another independence referendum.

If the UK leaves the EU and Scotland withdraws from the UK it could be very turbulent times for the economy

Opinion polls now suggest that if there was another Scottish independence vote held, it would be much closer than the 55-45 outcome in September 2014. We suggest that if the oil price hadn't collapsed, raising fiscal viability concerns regarding an independent Scotland, then we could be seeing a majority in favour of splitting up the UK. Therefore, if Brexit occurs and oil prices move higher over the next twelve months, there could be calls for another independence referendum in 2017. This would add to the economic malaise and could see sterling and UK assets come under even further pressure, intensifying the short-term downside risks for UK growth (see Figure 13). However, since Scottish independence would likely reinforce the Conservative Party's dominance in Westminster, markets might welcome the prospect of a more stable producer-business policy climate.

What does it mean for the EU?

Just as trying to predict the impact on the UK, trying to quantify the potential impact of Brexit on the rest of Europe is immensely difficult. We will provide a detailed examination of the implications for broader Europe in an upcoming report, but below we list and provide a brief summary of our thoughts on some key issues:

1) **The end of the EU?** The political implications could be greater than the perceived economic threat from Brexit. Rather than the loss of a “difficult” reluctant member being the catalyst for closer European integration, the UK’s exit could potentially lead to thoughts of a broader fragmentation of the EU. With anti-establishment parties gaining increased traction ahead of upcoming European elections due to the weak recovery and worries over migration, the sight of the UK acquiring complete control over its own borders along with economic and domestic policy could give the broader anti-EU movement more momentum. At the very least, pressure from nationalist parties could deter mainstream parties from moving on with deeper integration and instead campaign for more devolvement of powers to member states. Additionally, if Scottish independence also comes about, then separatist movements such as in Catalonia, could gain confidence and support.

2) **EU balance of power.** Even if the UK’s departure doesn’t lead to catastrophe, it could still upset the political balance. Without the UK and its advocacy of free trade, the influence of more interventionist European countries, led by France, would become greater. It could also impact the EU-US negotiations on the Transatlantic Trade and Investment Partnership. The pro-TTIP group would lose a major supporter if the UK left, with a recent Eurobarometer survey showing 62% of Britons in favour, compared to an EU average of 53%.

3) **Trade.** Around 10% of EU exports go to the UK, with the majority of EU countries running trade surpluses with the UK. Even if a trade deal is agreed within the two-year window, our expectations of a sharply weaker EUR/GBP exchange rate in an environment of weaker UK demand means that exports to the UK are likely to suffer. Sterling devaluation also means UK exports to Europe become cheaper, potentially taking market share from intra-EU trade. Ireland, the Netherlands, Belgium and Germany have the greatest exposure to the UK, while diverging regulatory and product standards could exert a negative influence. The euro could come under pressure against other (non-sterling) major currencies, which might provide some support, while uncertainty means European stock markets could well weaken in the short-term.

4) **The EU budget.** The UK is a net financial contributor to the EU and so the loss of revenue means either lower spending on the poorer Eastern and Southern EU states or higher contributions from the likes of the Netherlands, Finland and Sweden. We estimate that Germany might need to pay an extra €2.5bn.

5) **Foreign direct investment**. European companies with FDI in the UK could take a loss on currency revaluations, while weaker EUR/GBP means profits from UK operations would be lower in euro terms. However, non-EU corporates may switch investment plans from the UK to EU member states

6) **Financial services**. The UK may find it increasingly difficult to be the centre of excellence for financial services to the rest of the EU, meaning increasing business for other European Financial centres, so boosting employment, incomes and taxation revenue.

7) **Free movement of workers**. If Brexit occurs, will the 2.4 million EU workers residing in the UK be forced to leave? Likewise, what will happen to the 2 million Britons living

and working in the EU? Will we see huge reverse migration flows? Brexit might provide political cover across the EU for more restrictive action in the wake of the current refugee crisis.

8) **International influence**. Although the EU would be smaller in size post-Brexit, it is unlikely that the EU would lose significant influence at institutions such as the IMF and the UN given that it is mostly represented by the individual member states. However, the loss of the UK from the EU umbrella could potentially hurt at the margin.

9) **Longer term.** European Union demographic projections show that the UK is the country with the fastest growing population, which is expected to be larger than both France and Germany in around 25 years. At the same time, the EU's population is projected to shrink. This suggests higher taxes will be required in the EU relative to the UK, to cover the costs (healthcare, pensions, etc) of an ageing population.

Conclusions

We think that a deal is achievable for Cameron to call a referendum in June

With most EU countries preferring to keep the UK as a member, we feel that there is scope for a deal to be done at the February EU leaders' summit. Migration is likely to be the main stumbling block, with the EU refusing to allow anything that would be seen to break the principle of free movement of people. However, there does seem to be growing momentum behind the idea of doing something to prevent "benefit tourism". Moreover, the migrant crisis in Continental Europe and the rise of populist parties there suggest something more substantial may be agreed. If a deal is done that Mr Cameron feels that he can sell to the electorate then he will campaign for the UK to remain in the EU.

Given widespread political and business support, we believe the UK would vote to remain in the EU…

… but financial markets will be nervous…

If the UK votes to stay then sentiment will rebound

Ahead of the vote, business might become more cautious on hiring and investment in the UK, resulting in slower growth while asset prices and sterling are likely to come under selling pressure, falling to the low 1.30s versus the USD. Mr Cameron's pro-EU campaign will have the support of the majority of business leaders, trade unions and other political parties (except UKIP and a substantial number of his own MPs), and we would expect the country to narrowly vote to remain within the EU. This should see sterling and UK asset prices recover, but they may not recover all of their declines immediately, given the likelihood of some loss of momentum in the economy caused by economic and political uncertainty. Nonetheless, the UK-EU relationship is likely to be stronger as a result of the new agreement and a pro-EU vote.

If the UK leaves then growth could slow markedly…

… with the BoE cutting rates and sterling hitting 0.90 versus EUR

However, if the UK were to vote in favour of leaving, it would have significant ramifications for both the UK and the EU. The uncertainty that this would generate would hurt confidence and likely lead to a retrenchment in activity. We see 2017 UK GDP growth coming in at around 1.5% YoY in such a scenario, versus 2.7% if the UK votes to stay. Sterling's plunge would push up medium-term inflation risks, but we suspect that the Bank of England would try to loosen monetary and financial conditions in this environment, with the Bank Rate being cut soon after the results are known. Sterling could therefore test its 2011 lows, with EUR/GBP possibly touching 0.90 later this year.

A trade deal would need to be agreed…

…presumably along Swiss lines

The UK and EU would then have to thrash out a separation deal. In terms of trade, we suspect that the most likely outcome would be for the UK to join EFTA, but not to sign up to EEA, just like Switzerland. This is simply because the big issue for the UK is the free movement of people and if it signs up to the EEA, it would still have to allow this. At the same time, this would mean that the UK would not have full access to the single market. Instead, it would have to quickly agree on a separate trade deal with the EU and then set up bilateral deals with other countries.

There are still risks to trade despite the two-year withdrawal window

UK-EU trade would not be immediately threatened given the two-year window for negotiating EU withdrawal under the Lisbon Treaty. However, the UK will continue to be subject to EU product regulations and may not benefit in the future from the EU removing more non-tariff barriers from the single market. Still, we have to remember that any emergence of trade barriers would also be costly to the EU, given the amount of trade done with the UK.

But non-EU countries may not have the same sense of urgency in agreeing UK trade deals

Even if the UK does manage to negotiate a trade deal with the EU within the two-year period, the desire or ability to agree on deals between non-EU countries and the UK may mean things take longer, which could damage trade. The UK will have less bargaining power on its own than it does as a member of the EU when it comes to negotiating trade deals. However, the assumption is that it could use current EU deals as a template and could probably agree on bilateral trade deals fairly quickly.

We have doubts that the UK would suddenly become more competitive outside of the EU

We doubt that Britain would become significantly more competitive on the international stage with the removal of "burdensome" EU regulations. The UK already has several opt-outs, and various international bodies suggest that the UK is already one of the most competitive economies in the world. Nonetheless, it could also be argued that an EU exit would give the UK greater flexibility to do even more.

UK growth, sterling and asset price risks skewed to the downside by risk of a renewed Scottish Independence campaign

Taking this all together, from an economic perspective we see little near-term upside from the UK leaving the EU. The UK would have more freedom to set its own policies, but there are risks to trade and also to investment and employment, while the UK may look like a less-attractive destination for foreign capital. Furthermore, the prospect of a renewed push for Scottish independence during a period of economic and political upheaval will intensify these major concerns for growth, sterling and UK asset prices.

In the longer term, a weaker currency, looser BoE policy and the use of "freedoms" may provide support…

Looking further ahead, the UK's greater control over its own policies and regulations and a shift towards a more pro-business approach might offset the perceived negatives of not being an actual EU member. Additionally, ultra-loose monetary policy, coupled with a very competitive exchange rate (after potentially falling by c.25% on a trade-weighted basis) should see economic activity rebound sharply from late 2018 onwards. However, inflation will be high and the Bank of England could follow up with fairly swift rate hikes.

…and the greater sense of British sovereignty may make the public feel that the economic risk is worth it

That said, it is important to remember that this isn't purely an economic debate. Opinion polls show that immigration is the key concern of voters in what is one of the world's most densely populated countries. Moreover, the sense of greater British sovereignty may make the population feel that it is worth the risk of some economic damage. However, if the European economy can continue strengthening and the UK underperforms, in an environment that is perhaps less conducive for UK exporters and investment, then these feelings could change. The EU may not welcome back the UK with open arms, even though it too could be hurt by the loss of such a major economy.

UK departure could lead to an "integration versus disintegration" debate on the EU.

The UK's departure could raise concerns that far from leading to more integration of EU member states, it could potentially be the catalyst for disintegration. The rise of anti-establishment parties across Europe could gain more momentum if the UK is seen as getting complete control over its own future, fuelling calls for greater devolvement of power to national parliaments. Scottish independence could also boost the campaigns for other separatist movements. As such, the process of deeper European political and economic integration could stall and potentially reverse.

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