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ECONOMICS: EUROPEAN PERSPECTIVES

BREXIT VOTE RAISES ECONOMIC AND POLITICAL STAKES FOR EU

+ Darren Williams, Senior European Economist—Global Economic Research, darren.williams@abglobal.com

If the UK votes to leave the EU on June 23, investors will scramble to figure out what it really means. The near-term impact on the British economy is likely to be negative—although the magnitude is uncertain—and Brexit would surely come as a massive shock to global financial markets. Beyond that, though, it may be in the European political arena that the impact is most lasting and damaging.

As campaigning heats up for Britain's referendum on membership of the European Union (EU) on June 23, there's still no clear message from opinion polls. There has recently been a slight swing towards those in favor of remaining in the EU, but it would be premature to assume that this represents a sustained shift in public opinion. Our view is unchanged: the most likely outcome on June 23 is a vote to remain in the EU. However, the closeness of the opinion polls means we still cannot dismiss the risk of Brexit—Britain deciding to leave.

Economic Impact

There is little doubt that Brexit would have a negative impact on the British economy, at least in the near term. But how significant might this be?

Initially, we thought Brexit was likely to have only mildly negative near-term repercussions. But we're now more concerned that it could push the economy into outright recession.

There are three main reasons:

First, it has become increasingly apparent that Brexit concerns have already started to weigh on the economy.

Second, the doom and gloom scenarios being painted by the British government, the Bank of England and International Monetary Fund (among others) could turn into a self-fulfilling prophecy should the UK actually vote to leave the EU.

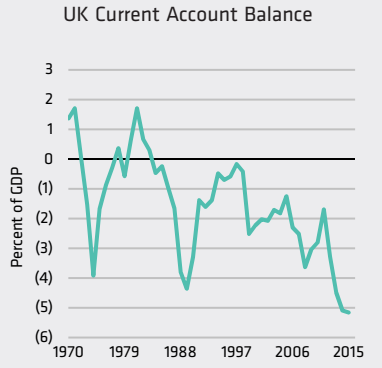
Third, the UK's reliance on foreign investors to finance its twin government and household-sector deficits make it vulnerable to any shock, like Brexit, which might cut off the flow of foreign capital (*Display 1*).

In spite of this, we're skeptical about the certainty with which many forecasters—including the British government—predict an economic meltdown should the country vote to leave the EU. Put simply, there's no obvious parallel upon which to base a Brexit simulation. So while the direction of travel following a vote to leave the EU might seem clear, the magnitude is not.

Broader Consequences

While the domestic debate has, not surprisingly, been dominated by the potential impact on the British economy, Brexit would also have broader consequences. Indeed, many observers—now including the G7 group of leading developed economies—claim it would pose a major threat to the global economic outlook.

Display 1
External Vulnerability



As of December 31, 2015
Source: Haver Analytics

On the surface, it's hard to understand why. The UK accounts for just 2% of world output and it's not obvious to us why a decision to alter its trading relationship with the EU and eschew political integration with the rest of Europe should have a large and sustained impact on the global economy. All the more so as Brexit would involve a transitional period lasting two years, and perhaps longer.

Even so, financial markets would respond adversely to the shock of a Brexit vote and a period of considerable turbulence would

probably follow—with the pound likely to be the biggest casualty. However, this is a "known unknown," for which central banks have had some time to prepare, making a systemic or lasting crisis unlikely. Eventually, markets would turn their attention back to other concerns: i.e., China, commodity prices and the magnitude and timing of Federal Reserve (Fed) tightening.

Where Brexit could create lasting shockwaves is in terms of its political impact—both within Europe and perhaps further afield. Over the years, the UK has been an uncomfortable bedfellow for its European partners. But a decision to quit the EU would still be the biggest setback the European "project" had ever faced.

It would probably embolden radical and separatist parties that have already gained considerable ground elsewhere in Europe. And it might encourage investors to question the irrevocable nature of the single currency, at a time when the European Central Bank is facing stiff criticism in Germany. The result could be another wave of the sovereign-debt crisis.

In the past, EU leaders have tended to respond to major setbacks by pushing ahead with deeper integration. A similar response is possible if the UK votes to leave the EU. But we would question whether or not there's any appetite for this at present—particularly given the leadership void and lack of strong government now clearly evident outside Germany.

Europe has faced many challenges in recent years; a Brexit vote could create fresh difficulties as its leaders attempt to hold the euro area together. ■