

Brexit: The Short and the Long of It

Avery Shenfeld and Andrew Grantham

Financial markets are starting to take it seriously, and with good reason. Polls show a tightening race ahead of the referendum on June 23rd (Chart 1, left), while internet searches for “Brexit” are running slightly higher than the peak seen for “Grexit”, when Greece’s status was in jeopardy (Chart 1, right).

A British exit from the EU would stir up new uncertainties, both for the UK and the Eurozone, that a decision to remain would avoid. So we can understand why sterling has headed weaker this year. However, we would be buyers of sterling and other affected assets just ahead of the vote. Should the “remain” side win, sterling would likely see a quick rebound, just as it did after the Scottish independence referendum, or when a general election seen as a close call returned the certainty of a Tory majority (Chart 2). Although there hasn’t been any obvious underperformance so far in UK equities versus others in Europe, that could still develop, and would be reversed on a “stay” vote.

True, a vote for “leave” would initially be a further negative for sterling, as investors worry about risks to British trade, or even London’s status as a European financial centre. But second thoughts on its long term implications could reverse that damage, since a “Brexit” need not be the slamming of economic doors to Europe

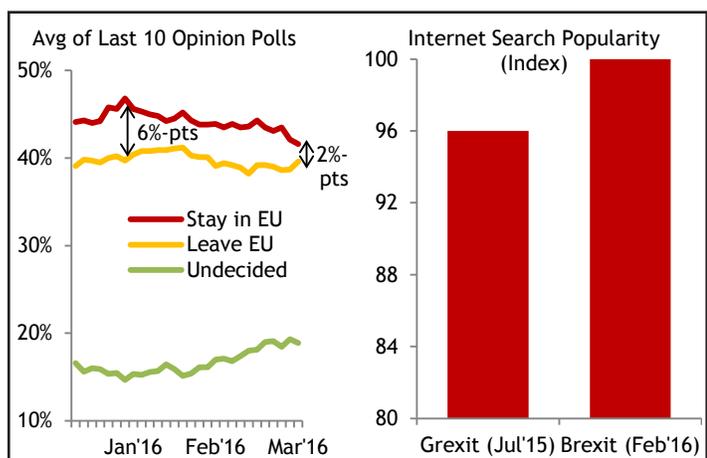
that many assume. History, trade patterns and other factors suggest that the most likely medium-term outcome of a “leave” victory would be fairly minimal in terms of actual disruptions to trade, markets or capital flows.

A Gentle Divorce

On trade, membership in the EU gives the UK tariff-free access to the continent’s largest markets, and opens British markets to goods and services from across the channel. Up until the past few years, UK trade appeared to be benefitting from EU membership. In the 18 years after the Maastricht treaty was signed (1992-2010), total export volumes rose by an average of 4.5% annually — almost the same pace seen by the Eurozone. However, since then, both the state of British industry and the sluggish pace to EU growth has eaten into UK performance. And Switzerland (not an EU member) is now outperforming the UK on the trade front (Chart 3).

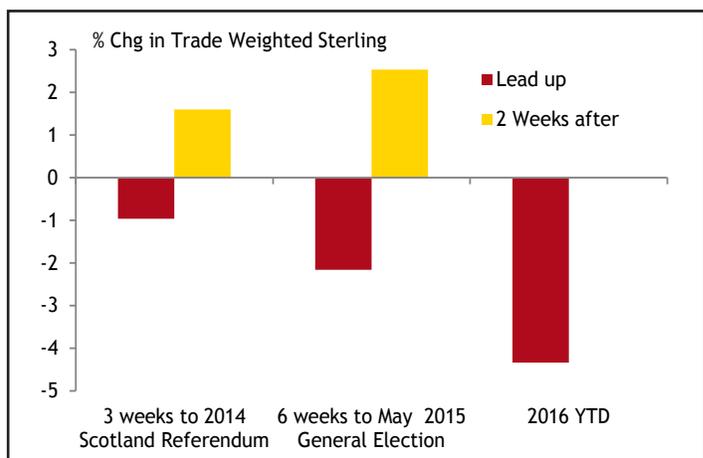
Still, trade matters, and building tariff and non-tariff walls between the UK and Europe would be a negative for British growth. But that’s not the likely outcome. Should the UK exit the EU, there would be huge incentives, ample precedent, and a structure in which to negotiate a side deal on free trade.

Chart 1
Polls Narrowing Again (L),
“Brexit” Fears Eclipsing “Grexit” (R)



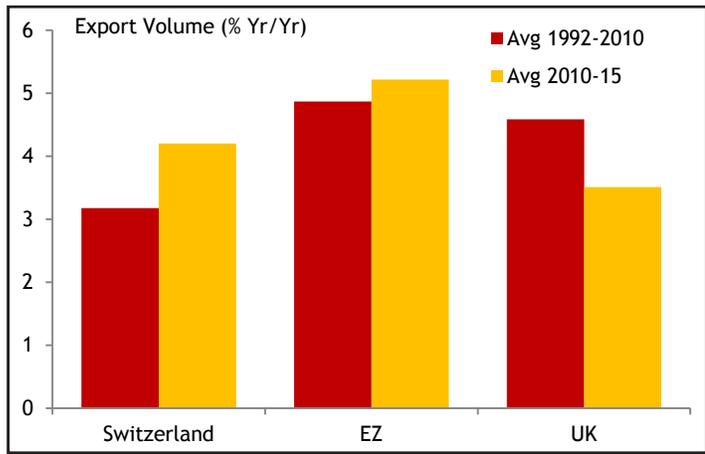
Source: Haver Analytics, StatCan, CIBC

Chart 2
Sterling Would Rebound if Status Quo Retained



Source: StatCan, CIBC

Chart 3
UK Exports Have Slowed to Lag Others in Europe



Source: IMF, CIBC

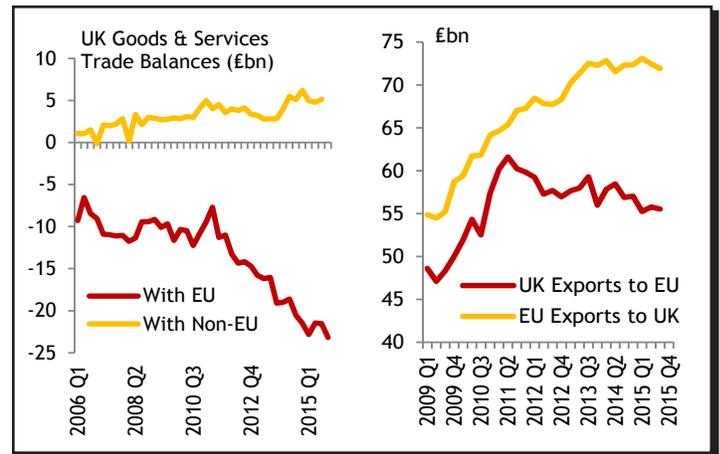
Article 50 of the Lisbon Treaty states that “the Union shall negotiate and conclude an agreement” with a country opting to exit, one that will take into account “the framework for its future relationship with the Union.” Surely, given the stakes involved for both parties, such a framework could include a deal to maintain the free movement of goods and services across the channel. Indeed, the rest of the EU would have more to lose if trade with the UK were disrupted, given the existing trade balance and recent export trends (Chart 4).

True, some of the precedents would include the ones set by other European non-members that have signed on to most of the EU’s rules and regulations, including the liberalized movements of people. That would be a stumbling block for London, given that the politics of Brexit involves the desire for border controls. But the Swiss voted in favour of a “stop mass immigration” initiative in 2014 that has its government seeking an agreement to replace its former deal with the EU with one that would allow quantitative restrictions on immigration. The refugee crisis is pressing some EU governments to set up their own border controls.

For the UK, however, there’s also the matter of trade with non-EU members, since British access to those markets comes under bilateral EU deals with those other nations. The UK is rare among EU members in having a minority of its exports destined for markets inside the bloc (Chart 5).

A Brexit would initially leave the UK outside the rubric of the EU’s trade deals with those third countries. But that’s similar to the status of Switzerland. And its much

Chart 4
UK Trade Deficit With EU Widens Sharply (L), EU Have More To Lose in Terms of Exports (R)

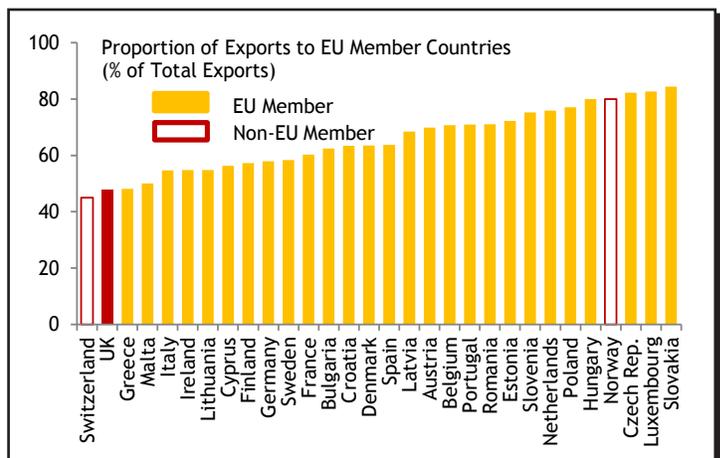


Source: ONS, CIBC

smaller position as a trading nation hasn’t prevented it from signing 31 trade deals with other countries, precisely matching the total number of deals reached by the EU. For the UK to replicate that feat would be a multi-year project, but that might not be much longer than the lead time for concluding arrangements for exiting the EU.

Bank of England Governor Mark Carney also raised the risk that Brexit could see major global financial institutions relocate their European headquarters from London to the continent. A survey by property consultants Healey & Baker found that nearly half of all senior executives in Europe believe Frankfurt could supersede London as Europe’s financial capital.

Chart 5
UK Already Exports Comparatively Small Proportion to EU



Source: IMF, CIBC

But that survey was conducted in 1998, and the perceived threat to London was the decision to retain the pound and eschew membership in the euro. Those fears proved unfounded as, last we looked, the City was still doing just fine as a locus for banks serving Europe. Indeed, the financial services sector has actually grown to account for 8% of UK GDP, up from just over 6% in 1998.

Admittedly, relative to euro adoption, an exit from the EU raises greater issues, including those relating to regulatory regime differences. But there are many advantages that London has over its competitors, including the use of English. To the extent that the UK would have to allow flexibility in terms of granting work visas for transfers from home offices, it would be free to do so.

Short-Term Pain for Longer Term Gain?

The UK could therefore address some of the downsides from an exit, although some may take time. But are there any material benefits that would accrue after a “leave” result? The most obvious is the elimination of the payments to Brussels. The other would be the ability to tailor various EU regulations to match UK needs, although it’s difficult to quantify such benefits.

None of this is to say that leaving the EU would have no short-term economic costs. Even just the dose of additional uncertainty for investors could matter. That goes beyond financial market jitters to real capital flows, as the EU is the source of some 500 bn pounds of direct investment in the British economy (Chart 6). Doubts

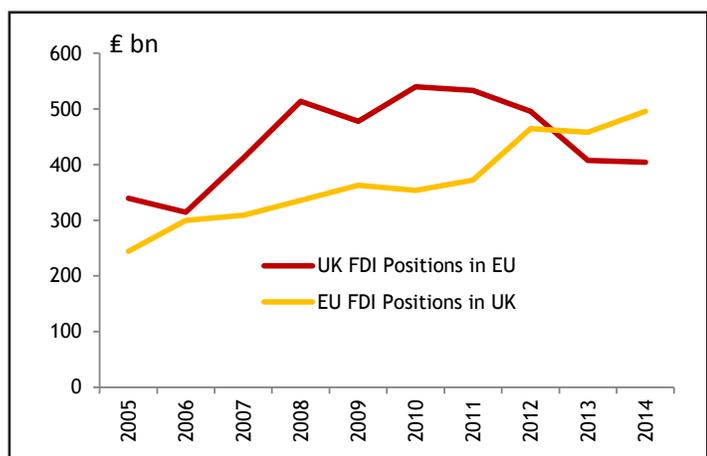
about the post-Brexit environment could slow or reverse inflows while negotiations drag on for months or even years.

Still, the final tally is not a black and white issue. A comprehensive study by Open Europe found that an exit without a replacement trade pact would trim UK GDP by 2% by 2030. But more likely outcomes involving replacement trade deals with the EU and/or other partners would leave the UK economy little affected by an exit, or even a small net winner under the best case scenario (Chart 7).

We have doubts about the precision of such estimates, but their order of magnitude suggests that Brexit isn’t a make or break issue for the UK. Should such views sink into market discussions, the selling of sterling or other UK assets before and after a Brexit vote might be reversed long before any negotiations take place.

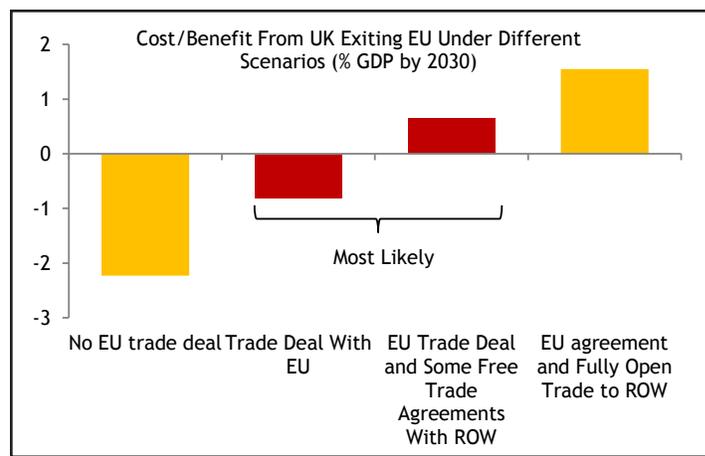
Brexit fears will remain a source of financial market volatility right up until the June referendum. As with the recent Scotland vote, the polls heading into the referendum are close. But as in that case, they likely overstate the probability of a “leave” result. A vote to stay in the EU would obviously lift the uncertainty surrounding sterling and other assets, and likely be a good buying opportunity. But outside of the likely negative response initially, even a vote to leave could present buying opportunities, with the economic fallout for the UK unlikely to be as bad as many fear.

Chart 6
EU Investment Positions in UK Have Overtaken the UK’s in EU



Source: ONS, CIBC

Chart 7
“Brexit” Unlikely to be a Big GDP Impact in the Long Term



Source: ONS, CIBC