OBSERVATION

TD Economics

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INDEFINITE LEAVE OR REMAIN: THE UK'S REFERENDUM ON EU MEMBERSHIP AND ITS ECONOMIC IMPLICATIONS

Highlights

- The UK is scheduled to hold a referendum on June 23, 2016 to decide on whether to accept or reject a modified agreement with the European Union (EU), thus remaining in the trade bloc. In our March economic forecast we assumed that the UK would vote to remain, consistent with polls and betting odds at the time.
- A vote to remain would likely have few implications for the outlook beyond lifting uncertainty and reversing some of the recent weakness in the pound. A vote to leave, however, could have more macroeconomic and political implications for the UK and the EU depending on the nature and outcomes of the negotiations that follow.
- Overall, a vote to leave could act to permanently lower the growth outlook for the UK, unless negotiations find a way to offset the reduced population growth with increased investment or productivity gains elsewhere in the economy. A vote to leave could also spur further fragmentation of the EU.

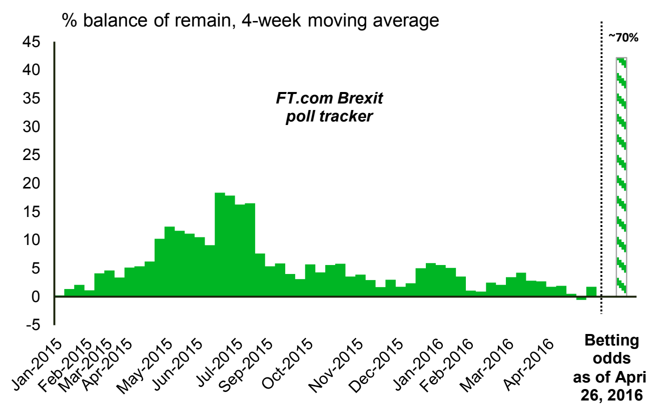
On June 23rd, the UK will vote on whether or not to remain in the European Union (EU). A vote for an economy the size of the UK's to exit the single market would be historically unprecedented. The long-run economic implications of such a vote are uncertain and highly contingent on a number of unknowns, including what trade deals the UK will end up reaching and when. Nonetheless, there is little doubt that in the near-term, an exit vote could have serious negative consequences for UK growth with spillovers into Europe and global financial markets.

Background on the referendum

This past February, the governing Conservative party made good on last year's campaign pledge to hold a referendum on whether to remain a member of the EU. All UK residents, including UK nationals living abroad but in good electoral standing, aged 18 years and older are entitled to vote. The referendum question will be "Should the United Kingdom remain a member of the European Union or leave the European Union?"

As in the lead-up to the Scottish referendum, recent polls are showing a close tie, while betting houses have set odds that voters will choose remain at more than two-thirds (Chart 1). It is worth noting that a vote to remain is not strictly business as usual. Prime Minister David Cameron negotiated a set of conditions that would take full effect immediately after a remain outcome (see **Box 1** for a summary of these measures). These measures are intended to help control costs for the UK government and appease some

CHART 1: POLLS AND BETTING ODDS SHOW PREFERENCE FOR REMAIN



Source: Financial Times Brexit poll tracker, PaddyPower.com, TD Economics.

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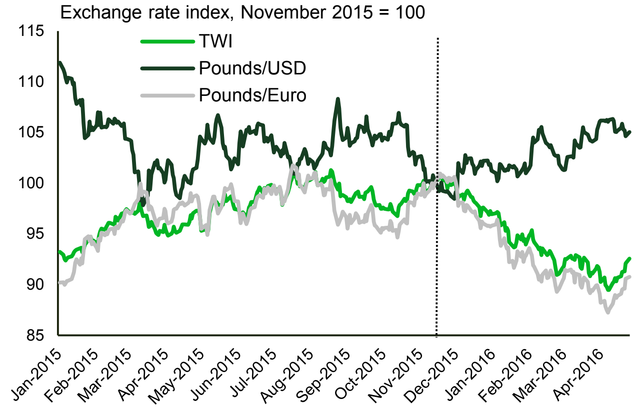
of the concerns of eurosceptics.

With the outcome of the referendum far from certain, it is worth examining the benefits and costs of each outcome. Our analysis below breaks down the implications; namely financial markets reaction and macroeconomic impacts, the response of monetary and fiscal policy, political fallout, as well as the impacts outside of the UK.

Implications of a remain vote

- Financial market impact: As of this week, the British pound has depreciated about 8% since its peak last November against the euro and in trade-weighted terms (Chart 2). This likely reflects increased uncertainty driven by the upcoming referendum. The Bank of England (BoE) noted in its April monetary policy statement that surveys are beginning to show signs that businesses are delaying investment and hiring until after the June 23rd referendum. Given the financial market turmoil so far this year, it's difficult to assess how much of the uncertainty has been weighing on UK and EU asset prices, and/or driving flight-to-safety flows into U.S. government bonds. Ultimately, in the case of a remain vote, we anticipate that much of the weakness in the pound will unwind fairly quickly, pushing up the pound/euro exchange rate back near its level from last November.

CHART 2: BRITISH POUND HAS DEPRECIATED AGAINST MAIN TRADE PARTNERS (EU)



Source: Haver Analytics, TD Economics. TWI refers to the broad trade weighted effective nominal index.

- Macroeconomic impact: Our March forecast assumes growth averages about 2.2% over the next two years in the UK. A remain vote implies a lifting of the economic uncertainty that has started to cloud the outlook for not only the UK but also the EU. Economic uncertainty can act as a drag on domestic demand, as households forgo purchases and firms delay investment. Heading into the referendum date at the end of the second quarter, we anticipate consumer and business confidence indicators in the UK and EU will likely continue to weaken, with

Box 1: Highlights of the remain deal with the EU

Prime Minister David Cameron has negotiated a list of changes to the UK's membership pact with the EU that would immediately go into effect in the case of a remain vote. These include:

A recalculation of child benefit payments to migrant workers with children living overseas to reflect the cost of living in their home countries.

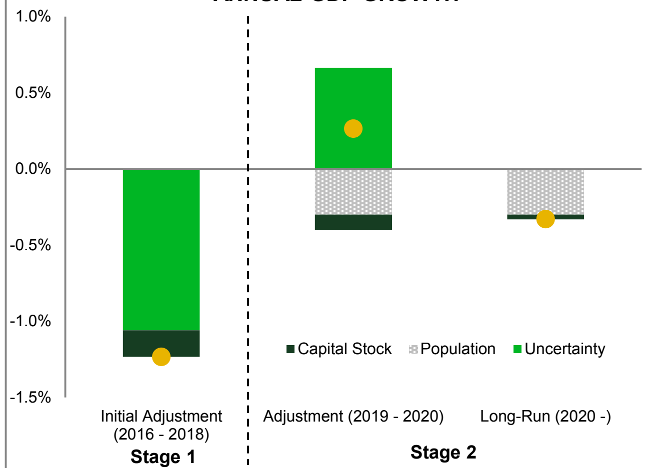
- The UK will be free to limit in-work benefits for EU migrants during their first four years in the UK, on condition that this restriction lasts no longer than seven years.
- The UK can continue to utilize the pound as its currency of trade with the EU without any discrimination, and any UK funds utilized to help bailout Eurozone member nations will be reimbursed (non-retroactive).
- Safeguards for Britain's financial services industry that will limit the ability for Eurozone regulations to be imposed upon it.
- Changes to the EU treaty to ensure language reflects the guarantee that the UK will not be part of the "ever closer union" clause that other EU members have committed to.
- An increased ability for national parliaments to join together and block unwanted legislation. Furthermore, a commitment to reduce red tape in order to improve competitiveness and strengthen the internal market.
- Limits on the free movement of non-EU nationals within the UK, including new powers to deny entry to those deemed a security risk.

Source: The UK's EU referendum: All you need to know, BBC News, April 11, 2016. http://www.bbc.com/news/ uk-politics-32810887 consumption and investment subsequently slowing enough to pull annualized quarterly growth below 2.0%. A vote to remain will result in a bounce in consumption and investment in the UK in the second half of this year, helping boost second half GDP growth close to 2.5%.

- Monetary policy reaction: At its first meeting after the referendum vote (July 14), the BoE will likely reinforce the view that continuous improvement in the UK economy will eventually result in inflationary pressures, with the next move for interest rates likely being up. Our baseline forecast assumes that the BoE begins raising rates at the end of this year, with the potential for an additional 50 basis points next year, but the timing will depend on the degree to which the economic data are affected by the EU referendum.
- Fiscal policy reaction: A remain result is not expected to have material implications on government expenditures, although some aspects of the deal negotiated by Prime Minister David Cameron could ultimately reduce the size of the annual transfers from the UK to the EU.
- Political repercussions: Given that he played a lead role not only by sticking to his re-election pledge of holding the referendum on EU membership, but also serving as the lead advocate of the remain campaign, David Cameron would remain leader of the Conservative party and the Prime Minister of the UK. Furthermore, a vote for remain should at least temporarily silence those advocating for another Scottish referendum.
- External impacts: We do not expect any material impacts on Canada or the U.S. from a vote to remain. Looking abroad, there probably will not be a noticeable impact on currencies other than the pound from the return of capital flows into the UK economy. However, the special agreement reached between the UK and the EU will likely remain a thorny issue for some time. It's very well possible that other EU member states will threaten to hold referendums on EU membership in order to force a renegotiation of unfavourable treaty clauses, which could lead to future bouts of volatility.

While a remain vote has few implications for our outlook, a vote to leave could necessitate some dramatic changes. We see the adjustment period proceeding primarily in two stages. The first stage encompasses the post-referendum period and lasts roughly two years. During this stage, the UK government is likely to feverishly negotiate new deals with its former EU partners, while also working to reassure foreign businesses that they will be able to maintain UK operations without interruption. In the second stage of adjustment, the supply side impacts of weaker investment and potentially slower migration would start to materialize.

CHART 3: IMPACT OF LEAVE ON AVERAGE ANNUAL GDP GROWTH



Source: TD Securities

Implications of leave: Stage 1 (2016 to 2018)

- Financial market impact: We anticipate that financial markets would react quickly, with the pound falling up to 10% initially against the euro, possibly depreciating further (up to an additional 10% more) in ensuing months. The depreciation against the U.S. dollar could be less pronounced. This would likely be reflected through a temporary spike in the risk premiums for gilts, and a decline in share prices for UK firms – particularly for those firms reliant on unfettered access to EU markets for sales or as a source of inputs. Markets would likely increase the odds of monetary policy easing in the near-term.
- What would likely follow the initial knee-jerk reaction would depend on the actions of policy makers and negotiators. This includes critically the perception surrounding negotiations on trade between the UK and EU. But another area of concern would be the prospect of further fragmentation within the EU, since calls for other referendums to secede from the EU – and possibly the euro – would likely grow louder. To the extent that EU leaders succeed in calming these fears, market conditions should improve. Regardless, within the UK, a weakened growth profile would likely lead to further –

albeit more modest – depreciation in the pound through the 2016-2018 negotiation period. By 2018, the pound could be as much as 20% below current levels relative to the U.S. dollar.

- Macroeconomic impact: Overall, we anticipate that these headwinds on annual UK growth would likely cut our baseline forecast for UK growth by more than half over the 2016-2018 period, and reflected in the following components:

  a) *Household consumption*: Increased fear of job losses will likely delay consumer expenditures for many UK households, with heightened uncertainty responsible for the majority of the initial drag on growth. If some UK firms make good on threats to relocate to EU member states, than job losses could be quite severe, further dampening expenditures.

  b) *Business investment*: Uncertainty about the future is always bad for business; therefore we anticipate a marked slowdown and even possible contraction in business investment, which could act to exacerbate any job losses. The net implications through the initial adjustment period into the second stage are a little more ambiguous, but the risks are tilted to the downside. After a vote to leave the EU, continental businesses will likely see it necessary to open UK locations, which could act to partially offset the reduction in business investment growth in both stages. In particular, while some financial intermediaries domiciled in the UK would be less impacted by EU regulations, other EU domiciled financial firms could choose to relocate to other financial centres such as Dublin or Frankfurt to ensure regulatory certainty. **Box 2** outlines the implications of a vote to leave on the UK financial services sector in more detail.

  c) *Net trade and the current account adjustment*: The rapid depreciation in the pound will help UK exporters, but this is not the primary channel that we would expect for an improvement in the UK current account deficit. We expect that imports will contract first, a result of the combination of the weaker pound and the corresponding slump in aggregate demand. Additionally, recent research from the BoE highlighted that a rebalancing in the UK current account was more likely to occur through increased redenomination of UK income received from the rest of the world rather than an improvement in the export of goods.[1] Nevertheless, the reversion to WTO rules immediately after a leave outcome would result in UK exporters losing favourable access to EU markets. This may cause EU and UK firms to reconsider their supply chains, particularly firms in the automotive, chemical, aerospace and food, beverages, and tobacco industries.

- Monetary policy reaction: As noted, immediately following a leave vote, the BoE will likely act to reassure markets that they will do whatever is necessary to ensure that the UK financial system will continue to function without disruption. Barring a major crisis of confidence, which we don't expect, the central bank may also decide to issue broad statements about monetary policy remaining extraordinarily accommodative through the initial transition period. At the August meeting, the BoE will likely decide to cut interest rates to help spur demand – the opposite of the hike anticipated in our baseline forecast. If aggregate demand were to slump excessively such that the output gap widened at a pace that risked the unanchoring of inflation expectations, the BoE would be expected to react by engaging in some quantitative easing. Although the estimated depreciation in the pound is substantial, the BoE will likely tolerate a weaker pound temporarily to facilitate the necessary adjustment of the UK economy to what is likely to be slower long-term growth. We could also see the euro depreciate relative to the U.S. dollar, potentially forcing the ECB to unleash further monetary stimulus before it has had a chance to gauge the impact of the easing measures announced this past March.

- Fiscal policy reaction: In terms of fiscal programs, it's very difficult to gauge what type of stimulus, if any, UK fiscal authorities will undertake to help offset some of the immediate downturn in domestic demand. If weak business investment and household consumption were to result in a prolonged slump in employment, it's likely that legislators will act to reinforce automatic fiscal stabilizers by extending unemployment benefits or shoring up welfare payments. Given the conservative political philosophy of the ruling party, it's also quite likely that there will be some form of tax reduction/export incentives for those industries most likely to help lead the economic recovery. Aside from these programs, the probability of a major stimulus program is low as it would only occur if the economic downturn was sufficiently severe. Having said that, we expect the UK government to experience a fall in revenue, necessitating more debt issuance that could result in the need for austerity measures once the economic transition away from the EU is well underway.

- On a somewhat perverse positive note, a leave vote is likely to temporarily increase public sector employment

Box 2: Impact of a vote to leave on the financial services sector

Among UK's key services sectors, the potential impact on financial services from a leave vote has garnered the most attention. The financial services industry contributes about 10% to UK annual GDP, and the UK receives about 49% of annual inflow of FDI through its financial services sector. Therefore a slowdown in the sector's growth or a halt in this FDI inflow could prove unfavourable to the UK's outlook for investment and the financial services industry. And, given the ease of mobility in this sector, there's an elevated risk that some UK domiciled firms would choose to relocate from the UK closer to their major markets. As such, in the event of a potential leave vote, the hit to exports and GDP could be substantial.

According to a study published by Open Europe this past March, the financial services sector would be vulnerable initially to a temporary decline in inward foreign direct investment (FDI).[†] The export of financial services and insurance to the EU is a significant export market for the UK. Financial services are estimated to employ up to 3.6% of the UK's labour force, and about 41% of financial services exports goes to the EU. Similarly, about 18% of the export of insurance and pension services from the UK is to the EU – a relatively smaller share when compared with financial services and is therefore less exposed to Europe. Due to this high degree of exposure of these sectors to the EU, a vote to leave could result in substantial initial disruption in these services exports. Unlike the goods sector which could face 4% tariffs in the case of a leave vote, there would be no increase in tariffs for the financial services sector but there remains a possibility that UK financial firms could lose cross-border access to the EU, requiring them to establish more costly subsidiaries on the continent.

Ultimately, these negative immediate impacts could be mitigated by successful negotiations in the ensuing months, but that would likely be a highly politicized process. Maintaining uninterrupted access in the initial period after an exit by the UK will depend upon the UK regulation of its financial services sector being deemed "equivalent" by the EU. Even if negotiations were to proceed at a fairly rapid pace, any agreement would likely see the UK face strict conditions which could act to limit access to the EU market. Only European Economic Area membership, such as that agreed to with Switzerland, Norway and Iceland, guarantees unfettered access to most EU goods markets with no guarantee of continued access to financial services, but this would entail the UK having to comply with EU regulations without any input into the regulatory framework. This last point is important, since the UK would no longer have a voice concerning any new or existing EU regulations despite its current 36% share of Europe's wholesale finance markets.

Advocates of a leave argue that the net benefits to financial services from the UK exiting the EU could outweigh the negatives. The strengths of the UK that motivated the growth in the sector in the first place – namely the legal system, English language, and global exposure – should continue to work in favour of many firms maintaining a presence in the UK. Moreover, there are a couple of benefits to the financial sector from a vote to leave. One such benefit is the removal from the reach of EU regulators which is often perceived as too focused on the resilience of the Eurozone at the expense of the financial industry. In that case, the financial sector could be better off with tailored regulations to ensure the global competitiveness of the sector. The other benefit is that removal of the UK financial services sector from EU oversight could make it easier for the UK to negotiate trade agreements for financial services with other globally important financial hubs located in the U.S. and Asia.

[†] Source: The impact of Brexit on the UK's key export sectors, Open Europe, March 2016. http://openeurope.org.uk/intelligence/britain-and-the-eu/securing-free-trade-eu-brexit-likely-goods-sectors-far-harder-services/

as more civil servants would be needed to aid the negotiations between the UK and its trade partners.

- Political repercussions: A vote to leave would be a victory for those members of the ruling Conservative party heading the leave campaign. As a result, it's very likely that David Cameron would step down as leader of the Conservative party, resulting in a leadership convention sometime before the end of the year. Furthermore, it's likely that voices calling for EU referendums in other member nations will grow louder, risking further fragmentation of the Eurozone, although any prolonged increase in financial market volatility could dampen calls for secession.
- External Impacts: Financial market volatility would likely act to put upward pressure on the U.S. dollar and other safe-haven currencies in the immediate aftermath of the referendum as money flows out from UK, and, to a lesser extent, Eurozone assets. This will likely spark a bid for bonds, notably for U.S. government Treasuries. Given how important external developments have been to the Federal Reserve's decision, we deem it likely the Fed waits until uncertainty diminishes after the June 23rd referendum before raising rates. On a related note, a stronger U.S. dollar would imply a weaker Canadian dollar, all else equal, which could help support Canada's non-energy exports.

- Given the relatively small size of the UK economy a slowdown in UK growth is unlikely to materially affect our outlook for global growth. However, in the case of a vote to leave, the uncertainty around the future of the Eurozone as well as potential spillovers to other economies through financial and confidence channels could shave at least 0.1 percentage points off our annual global growth forecasts through 2018 (our baseline global growth forecast is 3.1% for 2016 and 3.4% for 2017).

Stage 2: Longer-run leave implications (2019 onward):

Post 2018, we anticipate that there will be success in re-establishing formal trade agreements between the UK and EU, but not to the current degree. With the resulting rebound in confidence, growth should record a solid uptick from the post-referendum weakness. Yet, we would not expect all the losses to be recouped (see Chart 3).

- Financial market impact: After much of the uncertainty around the referendum has faded, the actions of policymakers will have long stabilized markets. Inflows of capital will act to reverse some of the decline in the pound, reducing yields on gilts as well. Still, we would expect the longer-term equilibrium rate for both the pound and UK interest rates to be permanently lower than in the past, reflecting a reduced rate of underlying growth in the UK.
- Macroeconomic impact: Despite an eventual rebound in growth, there are still some lasting effects. Two key components of long-term growth will be negatively affected by a leave vote, ultimately resulting in the weakening of long-run, or potential, annual growth rate for UK output by about a third of a percentage point:

  i) *Less growth in labour supply*. Even with new trade agreements in place, the UK would likely enforce tighter migration and border controls than when they were a part of the EU, reducing population growth and therefore labour input growth. This would exert downward pressure on UK long-run growth.

  ii) *Weaker labour productivity*. Despite increased monetary policy accommodation, the rise in business uncertainty would likely reduce total capital investment in the UK over the next few years, with some lasting effects on longer-term growth.
- The longer-term economic implications for the Eurozone and global growth are less clear. Increased uncertainty in the Eurozone could put off investment and therefore delay the recovery, possibly necessitating further stimulus by policymakers. Furthermore, while a slower growing UK would have limited direct impact on trend global growth, there could be some unknown long-term trade, financial and confidence effects that may act to hold back the capacity of the world economy.
- Reaction of monetary and fiscal policy: Lower long-run growth in the UK implies a lower neutral interest rate, reducing long-term interest rates in the economy. Furthermore, there is little that monetary policy can do to offset structurally lower labour input and labour productivity. Fortunately, there is some scope for governments to utilize fiscal levers to incentivize greater UK labour force participation, and implement programs that encourage productivity enhancing research and development.
- Political and external repercussions: It's difficult to speculate on the long-run political fallout from leave. However, it's likely that another Scottish independence referendum would occur as the Scottish National Party has made it clear that they prefer to remain part of the EU. Looking abroad, we anticipate that a leave vote could result in further fragmentation in the EU, fomenting financial market volatility. A persistent increase in uncertainty may push risk spreads wider for some time, while acting to deter investment.

Bottom line

To conclude, heading into the referendum this June we anticipate an increase in volatility in UK and EU financial markets, which could delay a rate hike by the Fed. Following the June referendum, a vote for remain should see most of this uncertainty abate, leaving our outlook broadly unchanged. A leave result, on the other hand, would see both parties move quickly to put in place a remediation plan to temper market volatility. Potentially violent initial market reaction would eventually give way to stability once sober second thoughts to the political response take hold. However, a vote to leave could shave more than a full percentage point off our 2016-2018 outlook for UK annual GDP growth, with most likely meaningful long-term costs to the UK and the EU. The estimated long-term impact on UK GDP outlined here is broadly in line with estimates from the UK's Treasury that were released last week.[2]

Endnotes

[1] Speech by Kristin Forbes, Bank of England: "The UK Current account deficit, risky or risk-sharing?" Given at the Official Monetary and Financial Institutions Forum Roundtable, Vintner's Hall, London, March 21, 2016.
http://www.bankofengland.co.uk/publications/Pages/speeches/2016/890.aspx

[2] The report by the UK's HM Treasury outlined the long-term (15-year) impact on economic output from a vote to leave the EU. Our estimate of the long-term economic impact over a similar time horizon of a vote to leave the EU results in UK GDP falling about 5.5% below our baseline. This falls well within the -4.6% to -7.8% shock to the level of real GDP cited by the HM Treasury in their negotiated bilateral scenario.
Source: HM Government: "HM Treasury analysis: the long-term economic impact of EU membership and the alternatives". April 18, 2016.
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/517415/treasury_analysis_economic_impact_of_eu_membership_web.pdf

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