ISSN: 1791-35 35

Eurobank Research
www.eurobank.gr/research
research@eurobank.gr

GLOBAL ECONOMIC & MARKET OUTLOOK
June 22, 2016
Eurobank
FOCUS NOTES

Counting down to the June 23rd EU referendum

Paraskevi Petropoulou
Economic Analyst
ppetropoulou@eurobank.gr

Olga Kosma
Economic Analyst
okosma@eurobank.gr

Contents

The road to the June 23rd EU referendum

In a speech in January 2013, UK PM and leader of the Conservative Party David Cameron outlined the key principles for the UK's EU membership; economic governance, competitiveness, sovereignty and immigration. He vowed to renegotiate a "better deal" for the UK's EU membership and put the result to an 'In/Out' referendum on the UK's EU membership if his party was reelected at the May 7th, 2015 general election. That promise figured prominently in David Cameron' s 2014-2015 election campaign at a time he was under intense pressure from euro sceptics within his own party, and when his party appeared to be losing votes to the eurosceptic right-wing UK Independence Party (UKIP). At the February 18-19 EU Summit, the UK PM secured an agreement that granted the United Kingdom a "*special status*" in the European Union, paving the way for the June 23rd referendum. The concessions the UK Prime Minister secured and were the basis of his campaign in favor of the UK remaining in the EU envision, inter alia: (i) *sovereignty:* the UK will not be obliged to commit to "ever closer" political integration into the European Union, which will subsequently be incorporated into an EU treaty change ; (ii) *economic governance:* introduction of specific safeguards for the UK's financial services industry to prevent EU regulations from being imposed upon the City of London; *(ii) competitiveness:* the EU committed to increase efforts towards enhancing competiveness (iv) *immigration:* application of an emergency brake with respect to in-work benefits for a period of up to four years from the commencement of employment.

What is the referendum question?

The EU referendum question is: *"Should the United Kingdom remain a member of the European Union or leave the European Union?"*

Economic arguments of the *Remain* campaign

– *Heightened uncertainty over future trade arrangements.* The greatest uncertainty associated with leaving the EU is that no country has ever done it before, so no one can predict how the post-Brexit era will look like. The cost of such long lasting uncertainty is difficult to gauge, but has the potential to be quite disruptive. The process of leaving, as set out in Article 50 of the Lisbon Treaty, will be protracted and could potentially take more than 2 years, [1] unless the UK opts for an arrangement with an existing template such as European Economic Area (EEA) membership (the Norway case). Recent trade agreements the EU has sealed with several countries including, inter alia, Switzerland and Canada took more than two years.

[1] Under Article 50 of the EU Treaty, a Member State which decides to withdraw shall notify the European Council (i.e., Heads of State and Government) of its intention. The Union shall negotiate and conclude an agreement with the Sate setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union. It shall be concluded on behalf of the Union by the Council, acting by a qualified majority, after obtaining the consent of the European Parliament. The Treaties shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the notification referred previously (i.e., notification of withdrawal) unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period.

– *Likely imposition of trade tariffs.* Trade tariffs could be reintroduced between the UK and EU, at least in some sectors, if the UK does not join the EEA and cannot negotiate a comprehensive free trade agreement. Note that the EU accounts for about 45% of total UK exports, far outweighing exports to the US (18%) and China (3.5%), the world's two largest economies. The UK's trade deficit with the EU is entirely comprised by goods as the country runs a service surplus (c. 1% of GDP). Therefore, while the EU could have an incentive to allow the UK unfettered access to the EU goods markets, the same may not be the case for services.

– *London's dominant role as a European financial hub likely to come at risk.* Many financial firms, whose European headquarters are in London, have already indicated that they would relocate sections of their business to Frankfurt, Luxembourg or Dublin if the UK were to vote in favor of leaving the EU. Indeed, the main reason for London's dominant role as a European financial hub is the ability of firms to "passport" services across the EU after an office is set up in the UK and obtains FCA approval. As a share of GDP, the UK financial and insurance services have comfortably the highest share of GDP, at 7.2%, c. 3-4 pp more than in Germany, France and Spain, reflecting the country's specialization in that area, in part due to its position as Europe's main financial centre. The UK also employs proportionately more people in financial services than other large EU countries.

– *Financing of the UK's current account deficit may be jeopardized.* In case of Brexit, the UK may no longer be seen as an attractive place to invest having the potential to deter capital inflows. The UK runs one of the largest current account deficits in the advanced world at 4.7%-of-GDP in 2015. Note that the UK is the largest recipient of FDI in the EU, receiving 20% of all inward FDI. In particular, the UK is the host of choice for US outward FDI, with the UK accounting for 13.4% of the US outward FDI stock compared to just 2.7% for Germany.

– *UK citizens' free access to live and work in the EU may come to an end.* Whether or not this will be the case, it will depend on the deal the UK will make with the EU after exit. Should the UK government opt to impose work permit restrictions to EU immigrants post-Brexit, as UKIP has proposed, then EU countries may reciprocate, suggesting that UK citizens may have to apply for visas to work. According to UN data, over 1.3mn UK citizens live in the EU, 309k of which in Spain, 255k in Ireland and 185k in France.

– *Brexit likely to lead to another Scottish referendum*. A number of polls have shown that the majority of Scottish people are in favor of the UK remaining in the EU. Nicola Sturgeon, Scottish first minister has expressed her desire to hold another Scottish independence referendum, saying recently that a vote in favor of Brexit would result in an "overwhelming demand" in Scotland for a second independence referendum.

– *Potential sovereign credit rating downgrade.* S&P has warned over a 2 notches downgrade from AAA currently, in case the UK votes to leave the EU. On its part, Fitch affirmed earlier this month the UK's AA+ sovereign credit rating and warned that an exit would be moderately credit negative. Along the same line, Moody's has warned that Brexit would risk UK's AA1 sovereign credit rating in the future, as it would consider assigning a "negative outlook" to that rating compared with a "stable" outlook currently.

– *Domestic political stability.* In the event that the United Kingdom votes to leave the EU, PM Cameron is highly likely to step down and Chancellor George Osborne would presumably have to resign as well and be replaced by euro sceptic political figures within the Conservative party.

– *Security:* EU membership makes Britain safer.

Economic arguments of the *Leave camp*aign

– *The UK's financial contribution to the EU budget will come to an end or at least will be significantly reduced should the UK end up as an EEA member*. The UK was the 8th largest net contributor to the EU budget in 2014, largely because it has a relatively small farming sector compared to other EU members; Netherlands contributed the most followed by Germany, Sweden, Finland, Austria, Denmark and France. The annual average EU contribution of the UK between 2010-2014 stood at £6.4bn or c. 0.3%-of-GDP. Post-Brexit, if the UK does not choose EEA membership or does not negotiate a Swiss-like deal (both of which require some financial contribution to the EU), the relevant cost might fall significantly.

– *The UK could reserve access to the single market even after leaving the EU.* The EU's trade and current account surplus with the UK could give the EU the incentive to offer the UK a good deal on free trade. The EU could even have an interest in keeping the UK in the single market, taking into account that the UK is the second largest trading partner of the EU after the US. In the period 2008-2015, an annual average 49.3% of UK total exports went to EU countries, while UK imports from EU countries amounted at an average c. 50% per year of UK total imports over the relevant period.

– *The UK would be free to seal bilateral trade deals with non-EU economies* (this is currently done by the EU on behalf of the UK). The UK, the world's 5^{th} largest economy, could negotiate more advantageous trade deals. The UK may gain by leaving the single market as, among others, the EU sets tariffs on imports from outside the block and the imposition of certain regulations makes trade with non-European countries more difficult.

– G*reater control over regulation that could raise productivity and supply-side potential.* EU rules and directives create unnecessary burden and costs for businesses and thereby reduce productivity. Note that the UK has either opposed or abstained on 12.3% of EU legislation, the highest among all EU nations. Undoubtedly, the UK's ability to set its own regulations will eventually depend on whether it will become an EEA member or opt for an alternative model that might secure more regulatory autonomy.

– *Brexit will allow the UK to control borders and immigrants flow*. EU's open borders mean that the UK can't protect itself at a time when the EU is on the brink of an immigration crisis. In the year to June 2015, UK net immigration amounted to 336k (of which 180k came from the EU), up from 240κ in 2005 and 100k which is the "silent" annual maximum threshold for the UK government.

– *Positive impact on the UK welfare system.* In-work benefits for the low paid EU immigrants are considered as more generous compared to those in the majority of EU countries, especially for families with children.

Who are entitled to vote?

Individuals over the age of 18 who are entitled to vote are:

- ✓ British citizens over 18 who are residents in the UK
- ✓ Irish citizens over 18 who are residents in the UK
- ✓ Maltese citizens over 18 who are residents in the UK
- ✓ Cypriot citizens over 18 who are residents in the UK
- ✓ Commonwealth citizens over 18 who are residents in the UK
- ✓ Commonwealth citizens over 18 who are residents in Gibraltar (unlike in a general UK election)
- ✓ UK nationals living abroad for less than 15 years

	The UK remains in the EU	The UK leaves the EU
FX	The removal of uncertainty is expected to trigger a **relief GBP rally** expecially vis-a-vis the **JPY** and the **CHF.** Potential GBP gains against the **EUR** likely to be less pronounced than against the **USD** as the EUR/USD is seen moving higher amid less political risks within the EU. With the EU referendum out of the way, on a medium-term basis, the UK economy's vulnerabilities are expected to take center stage pushing the **GBP** lower against the **EUR** to levels above 0.8000 in a 3-6 month horizon.	The **GBP is expected to move lower across the board** amid heightened uncertainty over the UK's growth prospects, higher political risk premium, increased concerns about the UK's current account deficit as well as the prospect of the BoE adopting a more dovish stance. **GBP** weakness likely to be most pronoucned vs. the **USD** while the **GBP/CHF** may experience high volatility in view of the SNB's determination to counter any surge in an already "overvalued" local currency . In more detail, the size of the GBP's expected depreciation will depend to a certain degree on the UK authorities's policy response to Brexit (e.g., lower BoE interest rates). Potential **JPY** gains vs. the **GBP** likely to prove relatively contained on the back of lingering expectations for further BoJ policy stimulus ahead. Amid concerns about potential repercussions for the future of the EU, the **EUR** is likely to weaken against the **USD** but any losses expected to prove limited and not long lasting. The **EUR** is anticipated to outperfrom the **GBP** supported by the euro area's current account surplus.
Sovereign bond rates	**Major sovereign bond rates** are expected to move modestly higher on the back of reduced uncertainty while the BoE is likely to adopt a more hawkish tone in the coming months	**UK sovereign bond rates** are expected to outperfrom all other asset classes favored by their safe-haven status. **Long-dated** UK rates likely to outperform triggering a 2/10-yr yield bull flattening; UK GDP growth is expected to slow down while a long period is needed until the post-exit terms between UK and EU are striken. With respect **to core EU countries**, long-end rates are expected to fall more than short-end as the latter are anticpated to remain well supported by the ECB's ongoing QE. **EMU sovereign debt spreads** to widen sharply; Spain likely to undeperform expecially if the June 26th general election fails to yield a conclusive outcome. **US Treasuries** likely to prove the star performers favored by EU political risks.
Equity markets	Firmer **major equity markets** as Brexit risk premium is removed from the markets	Major equity markets expected to weaken with **FTSE 100** and **European bourses** likely to underperform

Possible implications of Brexit on the UK: A vote to "Leave" the EU is expected to exert profound implications on the future of the UK.

UK GDP growth: The priority for the UK government would be to negotiate the type of a new trade relationship with the EU, a procedure that could potentially take longer than the 2 years envisaged in the EU Treaty. That is probably because, during negotiations, the EU would likely try to strike a balance between preserving links with the UK and discouraging other EU member states from following the UK. Increased political and economic uncertainty would primarily weigh on spending and investment decisions, as well as consumer confidence eventually slowing household spending. Labor supply would likely reduce sharply and sectors with a large proportion of non-British EU employees would likely be hard hit. The above are expected to result in a marked slowdown in UK domestic economic activity. A relevant OECD study suggested that, under a central scenario, UK GDP would be 5% lower by 2030 compared with where it would be with continued EU membership which equates to £3200 per household per year (today's prices). As per the same study, under an adverse scenario UK real GDP would be 7.5% lower by 2030, which is equivalent to a cost per household of £5000 per year (today's prices). Along similar lines, the HM Treasury's analysis of the long-term economic impact of Brexit, UK GDP would be between 3.8% and 7.5% lower in 15 years, depending on the outcome of the EU withdrawal negotiations. Separately, in a report released just a week ahead of the EU referendum, the IMF estimated that even under the most favorable scenario — in which the UK retains access to the EU single market and both business and household uncertainty dissipate quickly — GDP will be 1.4% lower by 2021, compared with where it would be under continued EU membership. Under the IMF's adverse scenario that envisions that the UK adopts World Trade Organization rules after failing to reach an agreement with the EU that secures access to the single market, GDP would be 4.5% lower by 2021.

The long-term implications of a Brexit for the UK are difficult to assess, as they will be highly related to the type of trade relationship the UK will seal with the EU; the economic implications of a "soft exit" where the UK retains some kind of access to the single market would be very different to a "hard exit" where the UK withdraws fully.

Inflation: The expected depreciation of the GBP will push inflation sharply higher with current deflation concerns being replaced by stagflation worries.

BoE policy: The BoE will likely face a dilemma: either to proceed with tighter monetary policy to address soaring inflation and lure foreign capital inflows or to retain a wait-and-see stance and even cut interest rates to support domestic economic activity. Yet, the BoE's initial aim would be to minimize the cost of any disruption to UK financial markets ensuring adequate liquidity provision mainly via the activation of its Contingent Term Repo Facility or/and Fed swap lines. Another issue for the BoE would be whether to intervene in FX markets unilaterally or as part of a coordinated intervention to support the GPB.

Possible implications of Brexit on the EU

Economics

- Negative impact on GDP growth through direct trade (via reduced trade or increased cost of trade between the UK and the rest of Europe).
- The EU would lose one of its most dynamic economies. Among the EU countries most vulnerable to a Brexit are Ireland, the Netherlands and Cyprus which all have strong trade, investment and financial ties with the UK. With respect to Greece, the greater negative impact would be potentially through goods exports and tourism. In 2014, the UK ranked the 6th biggest import partner for Greece importing almost c. 1bn of commodities. According to the BoG, arrivals from the UK increased by 14.7%YoY in 2015, while receipts from British visitors rose by 30.1%YoY which was second only to tourists from the US. Receipts from UK travelers accounted for 14.3% of total, the second largest share after Germany (15.9%) and 9.2% of total inbound travels, second after Germany (10.8%). According to the IMF, under the adverse scenario, Brexit could shave c. 0.5% of Greek GPD.
- Brexit would undermine business confidence hindering business investment, while uncertainty would hurt consumer confidence and ultimately private consumption.
- Euro area exports likely to be supported by a weaker EUR.

Politics

— Possible contagion effects on euro area countries pointing to increased uncertainty about the future of Europe; Eurosceptic parties likely to become more vocal using the UK exit as an electoral argument for the 2017 elections in Germany and France; risk of a domino effect.
— The exit of the UK from the EU could alter the balance of power on economic policy debates in the EU Council with the loss of a large member state supporting liberalization.

Budget

— Other EU members would have to fill in at least part of the shortfall from the lack of UK contributions to the EU budget.

Inward FDI

— Some inward FDI would be diverted to other EU countries if the UK losses access to the EU single market.

Migration

— Negative impact on Eastern European countries (especially Poland, Romania and Lithuania) from which some 1.2mn workers were in the UK in late 2015.
— By contrast, western European countries could experience higher inflows of EU migrants, a development that could be economically beneficial but politically challenging.

ECB policy

— In an attempt to contain negative repercussions to the euro area, the EB would take action (i.e., expansion of the TLTRO II programme, Outright Monetary Transactions). A further cut to the deposit rate seems unlikely.

The long-term implications of Brexit on the EU will largely depend on whether such a development would encourage Europe to move towards greater integration or open a "Pandora's box" that could lead to the collapse of the European project.

Opinion polls: The EU referendum outcome remains too close to call

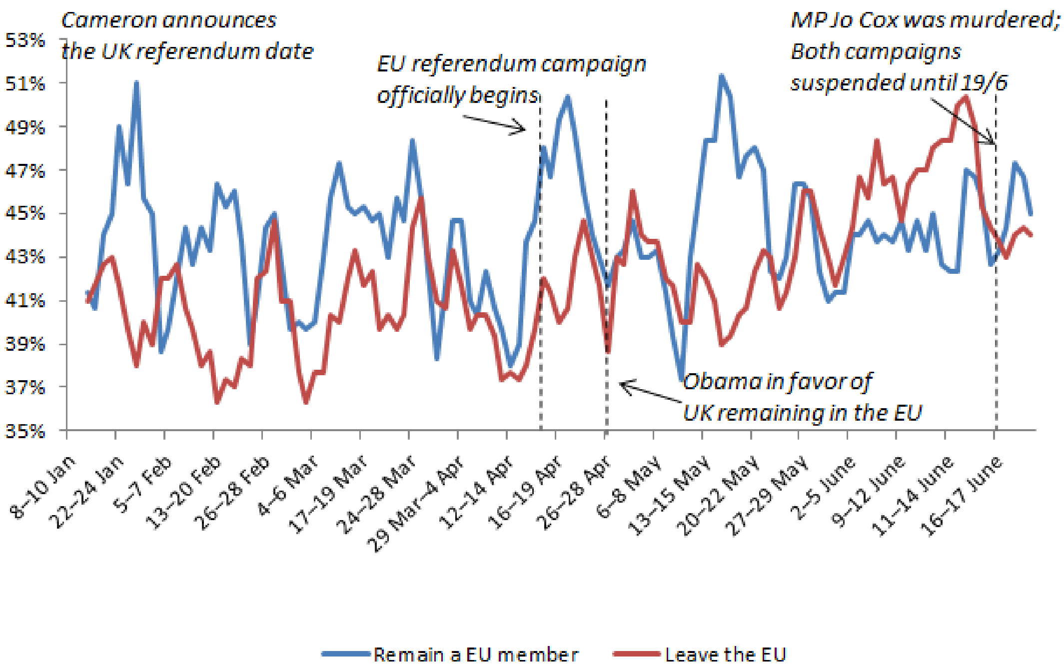
Since the official announcement on February 20th of the UK's referendum on whether the country will remain a member of the European Union (EU), uncertainty in global financial markets has surged. Opinion polls and betting markets have been the major source of information so as to estimate the implied probability of Brexit. With regards to the evolution of the opinion polls over the past month, it has been a rollercoaster ride for Leave/Remain polls with Remain in the lead into mid-May. According to the results of seven published opinion polls conducted between 11-15 May, the public support of the Remain camp averaged around 50% vs. 40% for the Leave camp. Momentum reversed in favor of the Leave camp that took a narrow lead in the period between mid-May to mid-June, when 27 published opinion polls averaged 46% vs. 44% for the Remain side (Figure 1). Sadly, the murder of the 41 year pro-EU British lawmaker Jo Cox on June 16th has again altered the balance at a crucial moment just a week ahead of the June 23 poll. Although polls now show the two sides neck-and-neck, the widespread assumption is that Cox's demise has dented pro-Brexit forces. In any case, opinion polls should be dealt with caution as they had been poor predictors of last year's UK general elections. Surveys suggest that c. 10% of the people are still undecided or do not intend to vote while, according to bookmakers, odds are roughly 72-28 for Remain.

Final result of the EU referendum to be known early morning of June 24th

Polling stations open at 7.00am local time and close at 10:00pm local time in the UK (BST) in 382 counting areas, including one for Northern Ireland and one for Gibraltar, varying in size from 1,700 to 700,000 eligible voters.

The first results are expected from 1:00am on Friday, June 24th while by 05:00am turnout announcements from nearly 80% counting-areas are likely to have been declared. The final nationwide result of the EU referendum will be announced in Manchester Town Hall by the Chief Counting Officer, Jenny Watson, between 7:00 am and 08:00 am local time.

Figure 1: Evolution of opinion polls regarding UK's referendum on June 23rd



Eurobank Economic Analysis and Financial Markets Research

Dr. Platon Monokroussos: *Group Chief Economist*
pmonokrousos@eurobank.gr, + 30 210 37 18 903

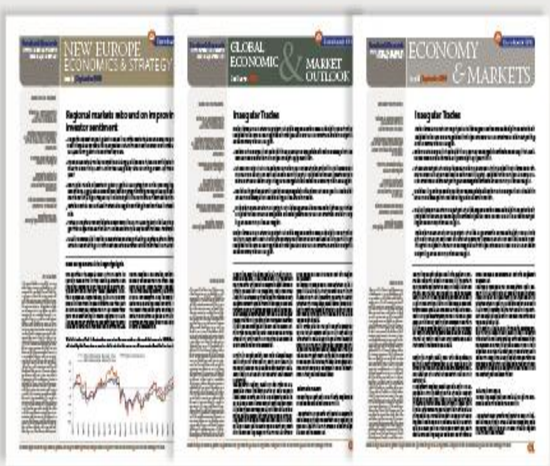
Dr. Tassos Anastasatos: Deputy Chief Economist
tanastasatos@eurobank.gr, + 30 210 33 71 178

Research Team

Anna Dimitriadou: *Economic Analyst*
andimitriadou@eurobank.gr, + 30 210 37 18 793
Ioannis Gkionis: *Research Economist*
igkionis@eurobank.gr + 30 210 33 71 225
Stylianos Gogos: *Economic Analyst*
sgogos@eurobank.gr + 30 210 33 71 226
Olga Kosma: *Research Economist*
okosma@eurobank.gr + 30 210 33 71 227
Arkadia Konstantopoulou: *Research Assistant*
arkonstantopoulou@eurobank.gr + 30 210 33 71 224
Paraskevi Petropoulou: *G10 Markets Analyst*
ppetropoulou@eurobank.gr, + 30 210 37 18 991
Galatia Phoka: *Research Economist*
gphoka@eurobank.gr, + 30 210 37 18 922
Theodoros Stamatiou: *Senior Economist*
tstamatiou@eurobank.gr, + 30 210 33 7 1 228

Eurobank Ergasias S.A, 8 Othonos Str, 105 57 Athens, tel: +30 210 33 37 000, fax: +30 210 33 37 190, email: EurobankGlobalMarketsResearch@eurobank.gr

Eurobank Economic Analysis and Financial Markets Research



More research editions available at http://www.eurobank.gr/research

- **Daily Overview of Global markets & the SEE Region:** Daily overview of key macro & market developments in Greece, regional economies & global markets
- **Greece Macro Monitor:** Periodic publication on the latest economic & market developments in Greece
- **Regional Economics & Market Strategy Monthly**: Monthly edition on economic & market developments in the region
- **Global Economy & Markets Monthly**: Monthly review of the international economy and financial markets

Subscribe electronically at http://www.eurobank.gr/research

Follow us on twitter: http://twitter.com/Eurobank