ING

Ready for Brexit? (updated)

Conservative win means EU referendum on its way

- David Cameron's Conservative Party has confounded pre-election polls and won a majority in the House of Commons. Having promised a referendum on the UK's ongoing membership of the European Union by the end of 2017 we will have to prepare for up to two years of significant uncertainty ahead of the vote.
- The clear risk is that this could unsettle businesses and households. As we saw with last year's Scottish Independence vote, foreign investors may take fright with UK asset prices and sterling likely to come under downward pressure. The economy may well lose some momentum and the BoE may raise interest rates more cautiously.
- UK GDP growth in 2017 could be half a point lower than we had been predicting, irrespective of the outcome of the vote. Should the UK negotiate a stronger deal with the EU and vote to stay, there could be a substantial bounce back in growth (3.5%+ in 2018) as delayed investment projects are finally implemented and confidence returns. UK asset prices will rebound.
- Should the UK vote to leave, Brexit raises clear risks for trade and investment and, by implication, growth and jobs. 2018 GDP growth could be 1.6%, EUR/GBP would likely move towards the 0.85 mark and the Bank of England may loosen monetary policy. This outcome could also fuel the campaign for Scottish Independence.
- A trade deal would need to be agreed very quickly and bilateral deals agreed with non-EU countries. This should be relatively straightforward, but foreign investors will remain nervous. As the situation stabilises in 2018, growth prospects should improve, helped by weaker currency and low interest rates. The UK's longer term prospects will be driven by what it can do with its new found "freedoms".
- The loss of the UK – a relatively fast growing economy that is on course to be larger than Germany in the next 20-30 years – would negatively impact the EU's own economic outlook and global influence. The loss of the UK's more laissez faire influence could also upset the political balance within Europe.
- Given the Conservative's mandate there is the potential for the vote to come sooner than 2017, depending on how discussions with the EU go. This would be less economically damaging for the UK, but with the EU focusing on Greece right now EU officials may be less keen to sit down to immediate negotiations.

Fig 1. Forecasts under different referendum scenarios

	2016F	2017F	2018F	2019F
GDP (%YoY) – no referendum	2.7	2.8	2.6	2.4
GDP – UK remains in EU	2.4	2.3	3.2	3.0
GDP – UK leaves EU	2.4	2.1	1.6	2.7
CPI (%YoY) – no referendum	2.0	2.0	2.0	2.0
CPI – UK remains in EU	2.2	2.4	2.5	2.2
CPI – UK leaves EU	2.2	2.4	2.9	2.5
BoE policy rate (%, year end) – no referendum	1.75	2.50	2.75	3.25
BoE policy rate – UK remains in EU	1.50	2.00	2.75	3.25
BoE policy rate – UK leaves EU	1.50	1.00	1.50	2.25
EUR/GBP (year end) – no referendum	0.63	0.70	0.78	0.80
EUR/GBP – UK remains in EU	0.68	0.70	0.75	0.78
EUR/GBP – UK leaves EU	0.68	0.85	0.83	0.83

Source: ING estimates

The emergence of the UK Independence Party in UK politics, whose main policy aim is for the UK to leave the European Union, has shaken up British politics. A major consequence was Prime Minister David Cameron promising to hold a referendum on the UK's membership of the European Union (EU) should he win the General Election. Now that he has done so we have to prepare for a referendum on the UK's ongoing membership of the EU by the end of 2017.

Part A of this report looks at the political debate regarding the UK's relationship with the EU and examines some of the key benefits and costs of EU membership. In part B (page 10 onwards) we analyse the potential economic and financial market impact of the UK leaving the EU (Brexit) on both the UK and also the EU.

Part A: The economics behind the rhetoric

The political backdrop - Conservatives pressured by UKIP

The global financial crisis, recession, austerity programmes and rising unemployment has seen hostility to the European Union rise right across the continent. The UK has been no exception. In fact the latest Eurobarometer[1] public opinion survey shows just 23% of Britons have a "generally positive" view of the EU. Only Greece has a lower rating (22%).

Concern about migration is also an issue across Europe, but one that is particularly felt in the UK. The monthly Econo-

[1] http://ec.europa.eu/public_opinion/archives/eb/eb81/eb81_anx_en.pdf

mist/Ipsos MORI poll[2] response to the question "What do you see as the most important issue facing Britain today?" has immigration/immigrants as the top answer at 37% with the economy on 33%.

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. The perception among many of the UK's population is that these extra workers have depressed pay and potentially led to higher unemployment among the local population. Another often quoted concern is that a large number of migrants are "benefit tourists" receiving welfare payments that are higher than they get back home.

These beliefs have been a key factor in the rise of support for the UK Independence Party (UKIP), which advocates an immediate withdrawal of the European Union (colloquially known as Brexit). UKIP won the most votes in the May 2014 European Elections and received around 13% of the votes at the May 7 General Election despite winning only one seat at Westminster.

At least partially in response to the rise of UKIP, David Cameron, leader of the Conservatives, promised a direct "In or Out" referendum in the first half of the new Parliament (2015-17) if he remained Prime Minister (note Labour and the Liberal Democrats are opposed to the referendum). While keen to see the UK remain part of the EU, it is Cameron's belief that there needs to be fundamental change in how the EU operates, based on seven key points[3]:

1. Power must flow back to member states, not just away from them
2. National parliaments able to work together to block unwanted EU legislation
3. Free movement to take up work, not benefits
4. Ongoing EU enlargement, but with mechanisms to prevent vast migrations
5. Business liberated from red tape
6. Security forces to protect British Citizens unencumbered by unnecessary EU interference
7. Ensuring Britain is no longer subject to the concept of "ever closer union".

The obvious risk is that the EU refuses to acquiesce, with German Chancellor Angela Merkel suggesting that she does not want to see changes to the "fundamental" rules of the free movement of workers. Der Spiegel newspaper quoted sources within the German Chancellor's office saying "Should Cameron persist, Chancellor Angela Merkel would abandon her efforts to keep Britain in the EU. With that a point of no return would be reached".

Other countries are also opposed to changing the principles, leading Mr Cameron to suggest that he is prepared to lead the UK out of the EU – "if our concerns fall on deaf ears and we cannot put our relationship with the EU on a better footing, then of course I rule nothing out". That all said, it is important to remember that much of the aggressive rhetoric from both sides is political posturing ahead of any negotiations.

Opinion polls show that those in favour and those opposed to ongoing EU membership are close in number. Nonetheless, there is a large proportion of people that don't know how they would vote – around 20%. As we saw with the Scottish independence referendum, there is a tendency for the majority of this group to end up voting for the status quo, with fear of the unknown a powerful disincentive for change. On the other hand, we have to remember that the bulk of the UK popular press is fairly hostile to the EU – back in 1975 when the last EU referendum was held, Communist news-paper the Morning Star, was the only national newspaper to campaign against ongoing membership. This time round, we could see some of the major dailies favouring exit.

The UK's debate becoming less one-sided

Those opposed to the UK's ongoing membership of the EU say that it is too powerful, it has too much influence over what goes on in the UK and is undemocratic and unaccountable. They cite a number of key reasons for withdrawal that include: Cost – the UK is a net contributor to the EU's budget, to the tune of 0.5% of GDP each year. The bulk of this money goes towards subsidising farmers in "old Europe" and supporting growth in former Accession states in Eastern Europe. Keeping this money in the UK would improve the government's finances and support domestic activity.

Red tape – EU rules are a burden for business while the free trade agreements on services, where the UK excels, have stalled. Growth could therefore be stronger if the UK merely signs free-trade deals with the EU and agrees new bilateral deals with other countries.

Immigration – Cheap EU workers have depressed the pay of low-skilled Britons, they are claiming benefits that they haven't contributed to and are putting a strain on public services, such as education and health, leading to a lower standard of living for everyone.

Up until recently, there have been very few people making the case for the EU. Nick Clegg, the former Deputy Prime Minister, has been the most vocal, arguing that the "costs" of EU membership are overplayed and that membership gives the UK

[2] https://www.ipsos-mori.com/researchpublications/researcharchive/3484/Economist-Ipsos-MORI-Issues-Index-November-2014.aspx

3 http://www.telegraph.co.uk/news/newstopics/eureferendum/10700644/David-Cameron-the-EU-is-not-working-and-we-will-change-it.html

more influence on the international stage, it promotes trade and creates jobs. Business groups and trades unions, both in general very pro-EU, are starting to come into the debate a little more, but even so, are treading carefully given public antipathy. Now that we have the election result and the reality of an EU referendum the debate will start to open up. It also means the potential for Brexit will become a very important issue for financial markets.

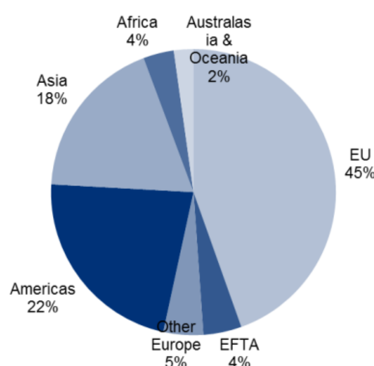
The costs and benefits of EU membership

The following section contains a brief look at the frequently cited costs and benefits of EU membership for the UK.

Trade – options for change

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, which is 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 non-tariff trade barriers that would harm growth. There are three options open to the UK.

Fig 2. UK 2013 exports, goods & services: £511bn

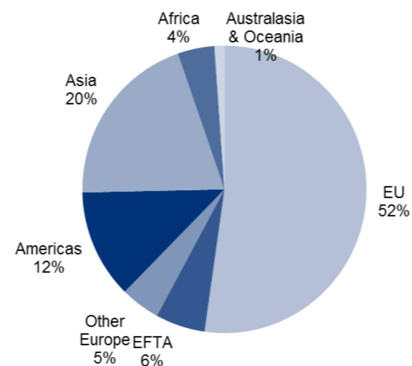


Source: ONS

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, that is espoused by UKIP, the UK would face the so called "Most Favoured Nation" import tariffs when exporting to the EU, just like the US. Vice versa, the EU would have to pay these tariffs for exporting to the UK.

These tariffs would harm trade. The negative welfare effect of this for the UK sums up to 0.14% of GDP each year, according to a study from the London School of Economics (LSE) by Sampson, Ottaviano and Pessoa (see Figure 4). In our view, the costs of tariffs make it unlikely that the UK would choose this option since it would remove the advantages of free trade with the EU.

Fig 3. UK 2013 imports, goods & services: £543bn



Source: ONS

A second option is joining the European Free Trade Association (EFTA) along with Norway, Switzerland, Iceland and Liechtenstein, and sign up to 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.

However, the UK would still have to make a financial contribution to the EU and adopt 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.

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 EU budget if it wants to enter into bilateral agreements with the EU on trade.

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 non tariff barriers are a bigger trade obstacle than tariffs, which have been reduced steeply over recent decades. Following the LSE study we distinguish in figure 6 between a pessimistic and optimistic scenario on the outcome of the ne-

gotiations with the EU. The impact on GDP over the next ten years could be between 0.4% and 0.9% of GDP.

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 a study from Méjan and Shwellnus, non-tariff barriers have been declining 40% faster. This could lower GDP by between 1.2 and 2.6% over the 10 year period versus the UK staying in the EU (see fig. 4).

Total costs of trade barriers of Brexit

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 of leaving the EU will be somewhere between 1% of GDP (optimistic scenario) and 3% of GDP (pessimistic scenario) over the next ten years.

This may underestimate the impact since the UK would have to negotiate trade deals with all of its other trade partners around the world as it would no longer come under the EU or EEA banner. It may not be able to negotiate as good a deal as it gets at present with these trade partners given, for example, China's trade with the whole EU dwarfs that of China's trade with just the UK. This means that the UK would be in a weaker position to set terms for the deal.

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 template already in place could be applied to the UK. We doubt that most countries would want to damage trade relations with the UK because most countries actually run a trade surplus with the UK. Still, it will take time to agree deals and this poses risk for UK exporters during that period so any hit to trade from an EU exit is likely to be predominantly felt in the first year of EU exit.

Fig 4. Ten year GDP level impact of Brexit vs no Brexit

Causes	GDP Impact (positive scenario)*	GDP Impact (negative 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 optimistic scenario	-1.1%	-3.1%

* In the positive scenario tariffs on goods remain zero. Non-tariff barriers are equal to 1/4 of the non-fixed barriers faced by USA 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 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.

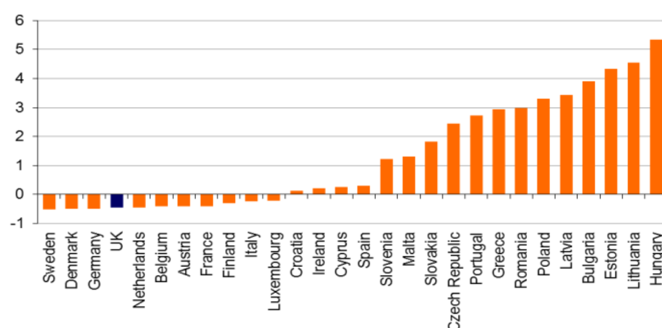
Source: The costs and Benefits of leaving the EU, London School of Economics/ Centre of Economic Policy research, May 2014

Summing up, we suspect that if the UK was 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 bilateral deals with non-EU trade partners. This would prevent sizeable tariffs and would allow control over the number of EU migrants moving to the UK.

EU cost; savings would be minimal

The UK is the fourth-largest net EU contributor, having paid just over €8bn in 2013 (equivalent to £7bn). The 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 12 times as much on pensions, for example. If the UK were to leave the EU, the money saved would do little to pay down a national debt that currently stands at £1.583 trillion.

Fig 5. Net receipts from EU (% of GDP)*



Source: Eurostat

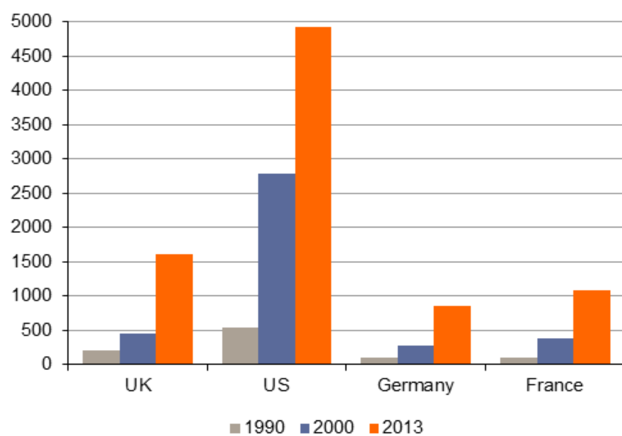
Investment – a real threat

The UK has been a key recipient of Foreign Direct Investment (FDI) over the past few decades, receiving more than any other EU country[4] while the stock of inward FDI is second only to the

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

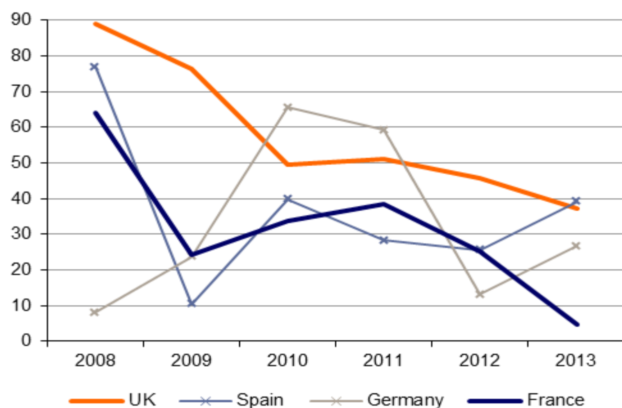
US. There is clear concern that should the UK leave the EU then this situation could change, which would be bad news for growth and jobs. Note that United Nations data shows 21% of all investment spending in the UK over the past 20 years has come from FDI.

Fig 6. FDI inward stock ($bn)



Source: United Nations Conference on Trade and Development

Fig 7. Annual inward FDI flows ($bn)



Source: United Nations Conference on Trade and Development

There are a number of factors that determine whether a foreign company wants to invest in the UK. They include the regulatory and tax environment, the quality and cost of 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 a deal will likely make foreign investors cautious.
FDI from EU countries is obviously at risk, but also non-EU FDI will potentially be impacted. 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. Japanese car manufacturers, that have big plants in Sunderland and Derby, have been particularly vocal about this since car imports into the EU have a 10% tariff placed on them and car parts have a 5% tariff.

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 was to hit, it would run the risk of being relatively high up on the list of plants to shut. This emphasises why the UK government will be keen to get a deal very quickly that keeps the UK's trade relationship with the EU at the current level.

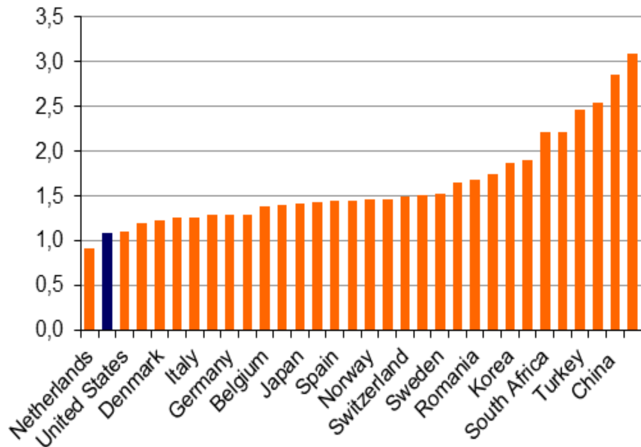
It is also possible that some UK companies contemplate investing overseas rather than in the UK, fearing that they be at a disadvantage if they do not have an EU base. Note that a British Chambers of Commerce Survey of 4,387 UK companies showed 60% of respondents saying they thought an EU exit would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

There are also risks in terms of portfolio investments. Several world leaders, including US President Obama and the Japanese, Irish and Australian governments have made it clear that they would prefer the UK to remain part of the EU. Consequently, there is the potential for a UK exit from the EU to be viewed negatively globally, which could impact sentiment regarding the UK and see an outflow of portfolio flows. This would be negative for sterling and asset prices.

Regulation – still have to play by the rules

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, that gives temporary staff the same rights as regular employees.
However, 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. In addition, the OECD's product market regulation index suggests that the UK is already one of the least regulatory burdened countries – even less than the US and Canada – not just the EU.

Fig 8. OECD Product Market Regulation Index



Source: OECD

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.

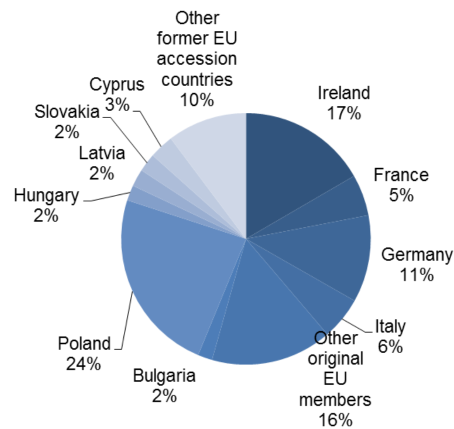
Migration – the crux of the problem

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. Official data shows that there are nearly 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.

A key concern among the electorate is that not all migrants find work and those that do are often in low paid jobs and therefore qualify for "in work" benefits, such as child tax credit. Consequently, David Cameron is now seeking amendments designed to reduce the UK's attractiveness for low skilled migrants on low wages relative to staying in their own countries or moving to other EU countries. The Prime Minister, in a speech in November, stated that these proposals are an "absolute requirement in the renegotiation" with the EU, adding that "freedom of movement has never been an unqualified right, and we now need to allow it to operate on a more sustainable basis in the light of the experience of recent years".

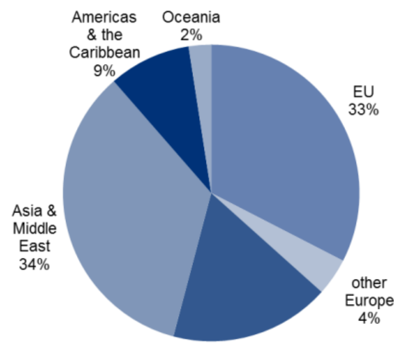
Furthermore, the UK is a very densely populated country and is even more so in England where there are 413 people per square kilometre (only Malta is more densely populated in the EU). The scale of immigration is putting an immense burden on housing and infrastructure with pupil class sizes rising and hospitals struggling. Consequently, the standard of living is seen as being under threat.

Fig 9. Origin of 2.4 million EU migrants in UK



Source: Office for National Statistics

Fig 10.: Origin of all 7.5 million immigrants in UK



Source: Office for National Statistics

However, it is important to remember that a key reason for migrants coming to the UK is the relatively strong economy. It is likely that the flow of migrants has been accelerated by the poor economic performance of much of Europe. As Europe recovers we may see these migration flows from the EU reverse. Indeed former UK Prime Minister, Sir John Major, suggested it may be a "shortish-term problem". Consequently, the UK may not need to agree sweeping changes to the free movement of labour directive, just a short-term fix to limit immigration flows until the European economy is stronger.

As for wages, it might seem logical to argue 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 the decrease of UK's unemployment rate in recent years.

We also have to look at this from the other side of the equation. There are 1.8 million Britons living elsewhere in the EU[5] – 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 a substantial number are retired, this could significantly increase the demands on the UK's National Health Service, thereby increasing government expenditure.

Part B: The impact of Brexit

Negative for growth, asset prices and sterling

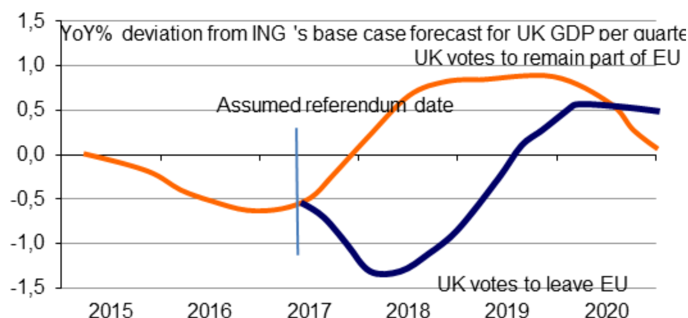
Coming up with a single number for the impact on GDP of the UK leaving the EU is almost impossible. Gauging the effects on business and consumer confidence and how this translates into spending within the economy is difficult at the best of times. When you have potentially big swings in asset prices and sterling on top of this and add in the uncertainty over how foreign investors and businesses will behave and 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. Consequently, what we have done in Figure 11 is set out the timing and approximate scale of risks as we see it to a "base" case forecast for GDP – one in which there isn't a referendum.

The country will have to prepare for an EU-exit vote in a little over two years' time and, as was the case with the Scottish independence referendum last year, it is likely to be close. This means that financial markets are going to be faced with a very long window of uncertainty over the implications for the economy and jobs. The clear fear is that this will hurt direct and portfolio investment flows even if a deal can eventually be agreed with the EU that leaves the trading relationship largely unchanged.

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

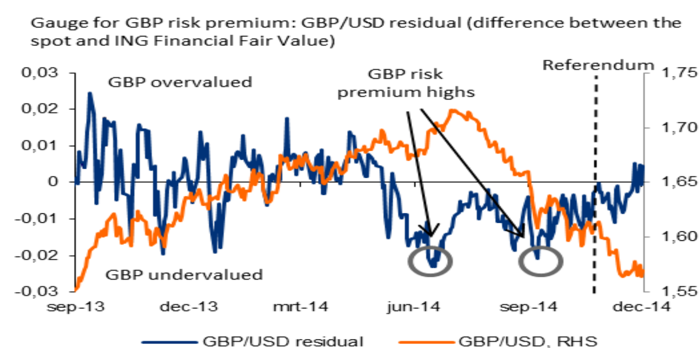
Fig 11. How referendum could hit UK growth – stylised path



Source: ING

The past might be a good guide for the future in gauging the scale of the GBP risk premium. For GBP/USD, for example, such a risk premium was present in the cross prior to the Scottish referendum (Figure 12). Risk premium (measured as the residual between the "justified" GBP/USD fair value and the spot rate) started to be built into GBP/USD some three-to-four months prior to the referendum date. Interestingly, the risk premium was highest months (rather than days) before the referendum (at c.2%) but declined somewhat closer to the date, although did not disappear.

Fig 12. Risk premium in GBP prior to Scottish vote



Source: ING

As the same chart shows, GBP/USD declined materially in the months and weeks prior to the referendum. Indeed, over this time period concerns about the potential negative implications of the "Yes" vote spread into other asset classes, including UK rates and UK equities, making the decline in GBP partly justified by these explanatory variables (this meant that the actual residual between spot and fair value narrowed modestly). In other words, what started as a risk premium reflected only in FX markets (ie, in GBP) then spread elsewhere. As we attempt to quantify GBP-specific risk to what would normally be our base-case forecast, we believe there could well be more than a

2% risk premium built into GBP crosses. After all, Brexit is likely to be viewed even more significantly by global financial markets than Scottish independence.

As Figure 12 shows, the existence of risk premium is reflected in our new EUR/GBP 2016 forecast (which takes into account the spectre of the EU referendum), showing EUR/GBP at 0.68 compared to 0.63 previously. Note that this new revised 2016 forecast does not only reflect the EU-exit related risk premium, but also a less hawkish profile for the BoE rate path (the latter being a function of the likely tighter fiscal policy under the Conservative government as well as a some negative effects of the EU referendum associated uncertainty on sentiment and investment). However, under the scenario of the UK remaining in the EU, EUR/GBP shows a return to its previous "base case" path and our forecast for the cross in 2017 remains unchanged at 0.70 (as depicted in Fig 12).

With the UK's status as a relative safe haven likely being brought into question, the UK stock market should begin underperforming as political and economic uncertainty weighs on sentiment. Meanwhile, both UK and foreign corporates become more cautious, leading to a slowdown in investment spending and labour hiring – note that the UK stands out as a country in which Foreign Direct Investment is responsible for a large proportion of total investment (21% for the UK versus a developed market average of 9%) .

As we move through into 2016 the weaker currency relative to baseline is likely to have provided a boost to international competitiveness, supporting net exports. However, it also pushes up import prices with consumer price inflation responding soon after – the Bank of England will presumably "look through" this and not respond with tighter monetary policy given worries for economic activity. With the economy and jobs market not looking as robust as under the base case then it is likely that we will be seeing a less positive real income story. Consequently, consumer spending will be softer. Taking this altogether, we suspect GDP growth in 2016/17 could be 0.25-0.75% lower than if there was no referendum.

Assuming the opinion polls remain close as we head into 2017, market volatility is likely to be at its maximum with asset prices and the currency reacting to the now daily poll readings that are being published.

A Yes vote

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 it will immediately make up for the losses seen prior to the referendum. After all, there is going to be a hit to economic momentum from the uncertainty that the referendum generated.

Such an outcome would suggest that the EU has made concessions with regards to the UK and therefore the UK-EU relationship is now on a new, sounder, footing that should boost confidence in the prospects for trade and investment. Furthermore, companies that delayed investment and/or hiring in the lead up to the referendum may now have the confidence to go and spend. This suggests to us that 2018 GDP growth could be substantially stronger – perhaps a full percentage point stronger – than we have as a "base" forecast. We would then expect growth to converge on our "base" case. This should be a very positive environment for sterling and UK asset prices in general.

Fig 13. Forecast under different referendum scenarios

	2016F	2017F	2018F	2019F
GDP (%YoY) – no referendum	2.7	2.8	2.6	2.4
GDP – UK remains in EU	2.4	2.3	3.2	3.0
GDP – UK leaves EU	2.4	2.1	1.6	2.7
CPI (%YoY) – no referendum	2.0	2.0	2.0	2.0
CPI – UK remains in EU	2.2	2.4	2.5	2.2
CPI – UK leaves EU	2.2	2.4	2.9	2.5
BoE policy rate (%, year end) – no referendum	1.75	2.50	2.75	3.25
BoE policy rate – UK remains in EU	1.50	2.00	2.75	3.25
BoE policy rate – UK leaves EU	1.50	1.00	1.50	2.25
EUR/GBP (year end) – no referendum	0.63	0.70	0.78	0.80
EUR/GBP – UK remains in EU	0.68	0.70	0.75	0.78
EUR/GBP – UK leaves EU	0.68	0.85	0.83	0.83

Source: ING estimates

A No vote

If the UK votes to leave the EU, this will undoubtedly be bad news for GBP and other UK asset prices given it will plunge UK-EU relations into unknown territory. Business sentiment would be hit given that surveys suggest the corporate sector is largely supportive of EU membership, and could cause firms that had delayed investment and hiring plans to potentially abandon them.

While a deal on zero trade tariffs could likely be agreed quickly with the EU, the UK will potentially lose out on a deepening of the single market, when they reduce non-tariff barriers. It may take a little longer with non-EU countries with numerous bilateral tariff deals having to be agreed. Here too, we suspect that similar terms can eventually be agreed, but there is likely to be some near-term trade disruption.

The Bank of England is likely to err on the side of caution and leave monetary policy relatively loose, prompting further falls in sterling. We suspect the Bank of England rate may be around

100-150bp lower than would otherwise be the case so we could see the policy rate at 1.0% in mid-2017 versus 2.5% if there was no referendum.

Furthermore, while sterling's Brexit risk premium would disappear (as Brexit would turn into certainty and its impact on the UK economy and local assets would be priced into GBP), we would expect new additional risk premium to (re)emerge – the renewed Scottish independence risk. This is because Brexit may reignite calls for Scottish independence given that the population, and political parties in Scotland, are much more pro-European than the English.

Such an outcome would likely compound the problems for the UK economy and further diminish its attractiveness in the eyes of international investors. In such an environment we could see EUR/GBP spike to 0.90 as the UK economy slowed sharply and doubts emerged about the price at which the UK could fund its external deficits.

The situation will likely settle in 2018, helped by loose monetary policy and a very competitive exchange rate. Thereafter, the UK's prospects will be driven by what it can do with its new found "freedoms". The Conservative government would presumably try to create a more pro-business economic environment. One potential course of action could be sweeping tax changes designed to encourage investment and job creation in the UK. These may 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 base case, but this is far from certain.

The key point that we are making is that any economic pain from the referendum, irrespective of the outcome, is likely to be biased towards the next couple of years. Economic and political uncertainty will hurt sentiment with consumer and business spending suffering as a result. This is likely to be more damaging for growth than direct trade implications from the UK leaving the EU, which we believe are manageable.

Scotland and the UK

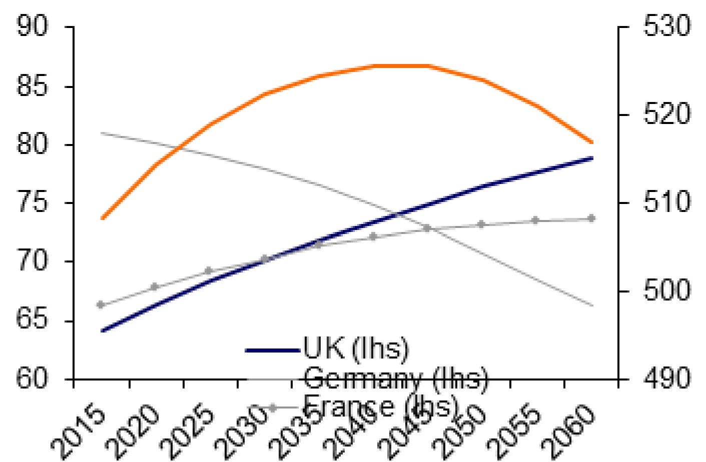
One of the stunning results from the General Election was the surge in support for the Scottish Nationalist Party. They have taken 56 out of the 59 seats available in Scotland, which is a remarkable turnaround after their defeat in last September's Independence referendum. That was described as a "once in a generation vote", but given they have taken over half of all the votes in Scotland, SNP leader Nicola Sturgeon suggested that another independence referendum could be called if something "material changed". SNP members have suggested that should a majority of voters in Scotland vote to remain in the EU, but that the UK in total votes to leave, this would be a "material change" and that they would push ahead with another referendum.

What does it mean for the EU?

Several European nations may take the view that the UK leaving the EU is for the best since it can allow Europe to press on with greater integration without having to continually make amendments to appease the British. On the other hand, several EU countries are of the view that it is better to keep the UK in the EU. Italian Prime Minister, Matteo Renzi has stated that the UK leaving the EU could be "a disaster for Europe obviously, I believe also for the UK" adding that "we need a UK able to invest in a different idea of Europe".

Brexit would negatively impact the EU's own economic outlook. The UK is the second biggest economy within the EU with a share of 15% in total EU GDP. The British population is expected to grow, unlike the German one. And because there is no reason why the productivity growth of British workers would structurally lag that of German workers, the UK economy is forecasted to be larger than Germany over the next twenty to thirty years.

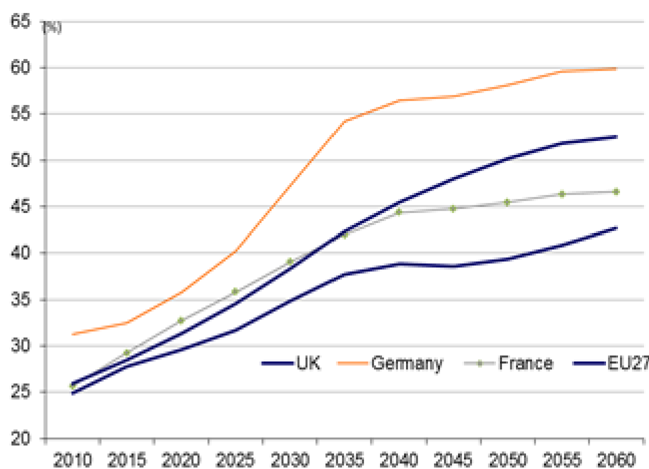
Fig 15. EU population projections (millions)



Secondly, the UK's market-based economic policy matches quite well with the approach of EU countries such as Germany, the Netherlands and Ireland. A UK departure could therefore upset the political balance within the EU in a way that some EU- countries may feel is detrimental to them. It would also set a precedent that could potentially lead to fears over the break-up of the EU given the low public support for the institutions of the EU in many member states. If Brexit increases the chances of Scotland leaving the UK, it could also worry other countries with separatist movements, such as with Catalonia and Spain.

Thirdly, the UK is a very important trading partner for most EU-countries. The demand from the UK for products and services from other EU countries is responsible for €218 billon of production in EU countries (excluding the UK). This means that the UK makes up 11% of the income that the EU (excluding the UK) makes from exports to other countries. That is 1.6% of EU GDP. This makes the UK the third most important trading partner of the EU, after the US (17%) and China (12%). The demand from the UK for EU products and services has created 3 million jobs in the EU, 1.5% of total EU employment.
For some EU countries the contribution of the UK to GDP and employment is much higher than the EU average. For the Netherlands, exports to the UK contribute 3.7% to Dutch GDP and is responsible for more than 3% of total Dutch employment.

Fig 16. EU forecasted population 65+ share



Source: Eurostat

Fourthly, Brexit would make the EU smaller and therefore less powerful in International economic affairs, for example when negotiating trade deals with the US or China.

Last but not least, Brexit would set a precedent that could lead to fears over the break-up of the EU given low public support for EU institutions in many member states. If Brexit increases the chances of Scotland leaving the UK, this could also worry other countries with separatist movements, such as with Catalonia and Spain.

Given that most EU countries have older populations than the UK, they will be paying relatively more in pension and healthcare costs. This is likely to imply higher taxes than will be the case in the UK. This could lead to weaker growth in the EU versus the UK. It could therefore be argued that in coming years it would be damaging for the EU, and look rather odd to other trading blocs, that the (future) largest European country isn't part of "Europe".

In terms of the free movement of workers, the prospects for migrants that are currently residing in the UK is uncertain if Brexit happens. Presumably a significant number will be allowed to remain in the UK through marrying Britons or having children in the UK or having lived for long enough in the UK to remain permanently through gaining British citizenship. However, a significant number may end up having to leave and move to another EU member state. This may, in some instances, most probably Poland, lead to a return of workers, which could increase labour supply. It may end up being a positive for growth in Poland and other former Accession countries if these workers have learned additional skills while working in the UK. If not, migration from the UK may also weigh on wages and potentially lead to higher unemployment in these countries.

Conclusions

Following the Conservative Party victory at the 2015 General Election we have to prepare for an EU referendum by the end of 2017. It is possible that the UK government seeks to go into negotiations with the EU earlier and push ahead with a vote in the next twelve to eighteen months. This would potentially help reduce the damage to the UK economy from political uncertainty. However, given the EU is focussed on Greece right now we suspect that they will be reluctant to do so. As such we suspect it will be held around the summer of 2017.

A major concern relates to investment, primarily because of the uncertainty a referendum will cause. Foreign investors may not be prepared to wait for clarity on the UK-EU situation with UK asset prices and sterling coming under pressure, as was the case in the run-up to the Scottish independence referendum. Then there is the debate over whether the referendum would make the UK a less attractive place to do business. Any slowdown in foreign direct investment would be a negative for economic growth and employment.

With many EU countries preferring to keep the UK as a member, we feel that there is scope for concessions to be won. Admittedly, some studies of the "balance of competencies" suggest that the balance of powers between the UK and the EU is broadly appropriate , but we are still await a formal government assessment. Moreover, 2017 sees elections in both France and Germany and the rise of populist parties there could make it more likely for incumbent European politicians to agree a deal to appease their own electorates ahead of this.

The migration flows that have caused so much EU hostility within the UK, are likely to have been accelerated by the poor economic situation in many parts of Europe. As this changes, migration flows should diminish, which suggests that perhaps only a temporary fix is required to help the UK. If a deal is done that the Prime Minister feels that he can sell to the electorate

then he will campaign for the UK to remain within the EU.

If the European economy is in better shape in a couple of years' time – growing strongly and sucking in more UK exports – then this too could increase support for ongoing EU membership. Cameron will also have the support of the majority of business leaders, trades unions and other political parties (except UKIP) and we would expect the country to vote to remain within the EU. This would see sterling and UK asset prices recover sharply, but they may not make all of their losses back immediately given the likelihood of some loss of momentum in the economy caused by economic and political uncertainty. Nonetheless, with the UK-EU relationship likely to be stronger as a result of the new agreement and a pro-EU vote, asset prices may perform better over the medium term.

However, if the UK were to vote in favour of leaving, it would have significant ramifications for both the UK and the EU. 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 a separate trade deal with the EU and then set up bilateral deals with other countries.

We doubt that Britain would suddenly become 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 EU exit would give the UK greater flexibility to do even more.

Brexit should not significantly impact trade tariffs with the EU in the longer term as we assume the UK will be granted similar terms to those it currently gets. However, the UK will 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. At the same time, any emergence of trade barriers would also be costly for the EU, given the amount of trade with the UK.

There are also issues regarding UK trade with non-EU countries. 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, it could use current EU deals as a template and likely agree bi-lateral trade deals fairly quickly.
The Bank of England would likely leave monetary policy looser than would otherwise be the case, which should be supportive for growth. The UK's greater control over its own policies and regulations and a shift towards a more pro-business approach may offset in the longer run the perceived negatives of not being an actual EU member in the minds of foreign investors.

All together, we see little economic upside for the UK from leaving the EU. The UK would have more freedom to set its own policies, but there are risks to trade and investment, particularly in the build up to the referendum and in the immediate aftermath. However, sterling is likely to weaken and the Bank of England would likely leave monetary policy looser than would otherwise be the case, which should be supportive for growth. The UK's greater control over its own policies and regulations and a shift towards a more pro-business approach may offset the perceived negatives of not being an actual EU member in the minds of foreign investors.

However, 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. The sense of greater British sovereignty may make the population feel that it is worth the risk of some economic damage. That said, if the European economy can finally exit its current malaise 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 in the long run by the loss of such a major economy.

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