ECONOMIC RESEARCH

The NewsLine

February 22, 2016

} MACROECONOMICS | FINANCIAL MARKETS | ECONOMIC POLICY | SECTORS

Dr. Michael Heise
Phone +49.89.3800-16143
michael.heise@allianz.com

Katinka Barysch
Phone +49.89.3800-4997
katinka.barysch@allianz.com

Katharina Utermöhl
Phone: +49.69.24431-3790
katharina.utermoehl@allianz.com

Allianz SE
https://www.allianz.com/economic-research/en

Allianz Research

https://twitter.com/AllianzResearch

UK

And now for the referendum

At the EU summit last week, British Premier David Cameron reached an agreement with his EU peers on the renegotiated terms of Britain's EU membership. The deal paved the way for the promised in-out referendum, which will now take place on June 23.

Whether and how the outcome of the Brussels deal will influence the referendum is unclear. Eurosceptics, including in Mr Cameron's own party, decry the deal as inconsequential and insist that Britain is still better out than in. Mr Cameron, on the other hand, will argue that he has achieved all his key demands – limited though they were – which proves that the disadvantages of EU membership can be minimized, leaving Britain with mostly benefits.

Recent polls show those intending to vote for 'leave' neck and neck with those in favor of remaining. Almost half of the British people have not yet fully made up their mind, however. Since immigration is the top concern in Britain, a worsening of Europe's refugee crisis in spring or summer might sway many towards a 'leave' vote. Much will also depend on turnout: older voters, who are overwhelmingly eurosceptic, are much more likely to vote than younger, more europhile ones.

Most informed observers now put the risk of Brexit at 30-40 percent. Our base-case remains that Britons will – narrowly – vote to stay in the EU. Not because of convictions – most English have a negative view of the EU – but for fear of the unknown. Nevertheless, Brexit is more than a tail risk and it is worth thinking through the consequences.

Brexit: Short-term pain is certain….

In the run-up to the referendum, uncertainty is bound to rise further, particularly if the polls remain inconclusive. We expect higher financial market volatility and a slowdown in economic activity, as companies hold back on investment. If such delays

also affect FDI, this would put further pressure on Britain's current-account deficit, which already stands at close to 5 percent of GDP.

If Britons in June vote for leaving the EU, we would expect a market sell-off, since Brexit risk is unlikely to be fully priced in at the time of the decision. Heightened uncertainty will drive up risk premiums and borrowing costs for the public and private sector. The pound will depreciate markedly as capital flees the country, which, in turn, will push up import prices. The blow to private consumption and investment – domestic and foreign – could be strong enough to push the UK economy back into recession. The Bank of England then faces a conundrum. A tumbling currency and the associated inflationary pressure mandate higher rates. On the other hand, financial market turmoil and the economic blow of Brexit require looser for longer. We believe that the BoE will choose the latter.

While short-term pain after a referendum shock looks certain, the UK would then enter a period of extreme economic and political uncertainty as it sets about negotiating a new relationship with the EU. Under Article 50 of the EU Treaty, the UK would formally apply for withdrawal from the EU. It would then have two years to negotiate its new relationship before its EU membership lapses. These negotiations will be neither easy nor swift. The talks will oscillate between compromise and confrontation, with repeated bouts of drama and threats compounding uncertainties for businesses and investors.

On the one hand, the EU cannot allow London to 'cherry pick' EU benefits while discarding those obligations of membership it does not like. Such precedent would quickly be followed by other EU countries, with Poland perhaps demanding to be freed from EU climate policy, Ireland discarding EU social and tax clauses, and France opting out of the free trade of services. On the other hand, many European governments have a solid interest in keeping Britain close: first because they run trade surpluses with Britain (notably Germany and the Netherlands); and second because they will want the UK to remain a partner in policy areas ranging from climate protection to security.

Prolonged uncertainty during the renegotiations will severely dampen economic activity in Britain, with GDP growth 1-2 percentage points lower in the years following a 'leave' vote. Politics could aggravate the economic blow, if, for example, David Cameron resigns over his referendum defeat, ushering in a period of domestic political turmoil, or if a new Scottish referendum quickly leads to a dissolution of the UK.

…while long-term gain is highly questionable

Whereas few people doubt that a 'leave' vote would take a short-term toll on the UK economy, there are economists and business people who argue that in the long run, Britain's economy would gain from leaving the EU. Much, of course, will depend on the details of the new relationship between Britain and the EU. The key question will be access to the EU's EUR 11 trillion (excl. UK) single market. Roughly half of British goods exports currently go to other EU countries. Possibilities range from the UK remaining a full member of the single market to trading with the EU under the WTO rules.

If Britain wants to retain full access to the single market, it will have to accept three conditions: continued free movement of workers from the EU, acceptance of all single market regulations, and some payments into the EU budget. Since worries about migration are the main reason why many Britons want to leave the EU, and since many eurosceptics are particularly enraged about EU 'red tape' and its 'wasteful' budget, this outcome looks unlikely. A more likely outcome is a customized, and largely favorable, free-trade agreement under which the UK trades more restricted access to the single market for a greater degree of policymaking autonomy in other areas.

The dynamics of the single market

The EU single market, however, is not static. Currently, efforts are under way to create a digital single market, a capital markets union, an energy union and to deepen trade in services. A key question, therefore, would be how Britain complies with evolving single market legislation. The 'Norwegian model', under which Norway (and other EEA members) transpose all new single market rules quasi-automatically, will not be acceptable to the UK. The 'Swiss model' of laboriously negotiated sectoral agreements is no longer available (the EU is currently demanding that Switzerland itself changes the way it complies with EU rules).

The most likely outcome will be a general obligation to follow single market rules that is riddled with safeguards and caveats, so as to preserve British sovereignty, at least on paper. For business, such a mechanism would create continued uncertainty, over both the legal environment in the UK and the ease of market access to the EU. Over time, growing regulatory divergence will raise the costs of trade and reduce the UK's attractiveness for foreign as well as domestic investment.

One sector that faces particular uncertainty is the financial sector, which contributes 8 percent to the British economy. Since the UK runs a trade surplus in financial services with the rest of the EU (of roughly EUR 100 billion), other EU governments

might have limited incentives to compromise. In the short to medium-term, regulatory and tax advantages as well as the benefits of an established cluster will keep banks and fund managers moored in London. However, EU countries are unlikely to accept that a less tightly regulated financial center across the Channel has unencumbered access to their markets. Barriers to access will increase over time and new EU rules might explicitly require more eurozone-related business to come onshore.

Not only in the City, but for the UK economy more generally, the gains from deregulation that many eurosceptics are hoping will prove illusory. The British economy is not overregulated to start with: OECD measurements of labor and goods market regulation reveal that the UK is as lightly regulated as the US and Australia, and much less than the EU average. Moreover the idea that once outside the EU, the UK would simply scrap health and safety regulations, food standards and the like is not plausible. First those British businesses that want to export to the continent would still have to comply with EU rules. Second, there is no majority among the British people for a drastic lowering of environmental, product and labor standards.

And the rest of Europe?

Britain is the second largest economy in the EU. If it leaves, the size of the EU economy will shrink by 1/6. Although the main impact of Brexit will be felt in the UK, the rest of the EU will also be negatively affected. The countries that will suffer most are those with strong financial, trade and investment ties to the UK, most notably Ireland, the Netherlands and Germany.

Exporters to the UK will suffer as the pound plummets and the Brexit shock generally reduces demand for imports. There will also be disruptions in supply chains, particularly in the automotive sector. With financial markets in turmoil, and the economic outlook getting bleaker, the ECB might delay the exit from ultra-loose monetary policy.

The impact on the rest of the EU would not be all bad. Some EU countries would benefit from a diversion of FDI and skilled labor away from Britain. Individual professions, in particular in services, might gain a temporary advantage if British competitors lose access to their home markets.

The politics would be worse

On the whole, the economic impact of Brexit is likely to be manageable for the EU. The political fallout would be more dangerous. Brexit would further damage the EU's international standing, already weakened after the euro and refugee crises. Lengthy

and antagonistic Brexit negotiations would sap the EU's political energy – at a time when political leaders need all their political capital to deal with the refugee crisis, stand up to an assertive Russia and fix the remaining flaws of the euro.

Brexit would also upset the EU's internal balance of power. While many Britons bemoan that their lives are 'dictated' by Brussels, the truth is that Britain has been the main driving force behind the single market, the inventor of the EU's security and defense policy, one of the main proponents of eastward enlargement and a co-creator of EU climate change targets. If the UK leaves, the EU policymaking machinery will lose one of its most liberal, outward-looking and strategically thinking members. This would leave Germany and the Nordics to fight a rearguard battle against more statist and protectionist Mediterranean member states.

Some commentators argue that without the reluctant Brits, EU integration could move forward more swiftly. More likely, however, is that Brexit would reinforce centrifugal forces in the EU: eurosceptic parties in other EU countries would gain momentum while calls for in-out referendums and special deals would be heard in countries ranging from the Czech Republic to the Netherlands.

These assessments are, as always, subject to the disclaimer provided below.

ABOUT ALLIANZ

Together with its customers and sales partners, Allianz is one of the strongest financial communities. About 85 million private and corporate customers insured by Allianz rely on its knowledge, global reach, capital strength and solidity to help them make the most of financial opportunities and to avoid and safeguard themselves against risks. In 2014, around 147,000 employees in over 70 countries achieved total revenues of 122.3 billion euros and an operating profit of 10.4 billion euros. Benefits for our customers reached 104.6 billion euros.
This business success with insurance, asset management and assistance services is based increasingly on customer demand for crisis-proof financial solutions for an aging society and the challenges of climate change. Transparency and integrity are key components of sustainable corporate governance at Allianz SE.

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

The statements contained herein may include prospects, statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such forward-looking statements.
Such deviations may arise due to, without limitation, (i) changes of the general economic conditions and competitive situation, particularly in the Allianz Group's core business and core markets, (ii) performance of financial markets (particularly market volatility, liquidity and credit events), (iii) frequency and severity of insured loss events, including from natural catastrophes, and the development of loss expenses, (iv) mortality and morbidity levels and trends, (v) persistency levels, (vi) particularly in the banking business, the extent of credit defaults, (vii) interest rate levels, (viii) currency exchange rates including the euro/US-dollar exchange rate, (ix) changes in laws and regulations, including tax regulations, (x) the impact of acquisitions, including related integration issues, and reorganization measures, and (xi) general competitive factors, in each case on a local, regional, national and/or global basis. Many of these factors may be more likely to occur, or more pronounced, as a result of terrorist activities and their consequences.

NO DUTY TO UPDATE

The company assumes no obligation to update any information or forward-looking statement contained herein, save for any information required to be disclosed by law.