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UK ELECTION

Five issues that need watching for Brexit risk

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The outcome of the general election means that the UK should have a reasonably stable government for the next five years. Two issues, however, will increase uncertainty for businesses and investors in coming years: the strong performance of Scottish nationalists and David Cameron's promise of a referendum on Britain's EU membership. Although recent opinion polls indicate that most Britons prefer to stay in the EU, it is too early to make meaningful forecasts about the referendum result.

David Cameron's Conservative party has confounded pollsters by winning an absolute majority in the House of Commons in the general election on May 7th. The other election winner was the Scottish National Party (SNP) that can now claim 56 of the 59 seats that Scotland has in the Westminster parliament. Labour, the main opposition party, is in disarray after its disappointing result, as are the Liberal Democrats, Mr Cameron's erstwhile coalition partner.

Mr Cameron's victory removes uncertainties that Labour's strong showing in the opinion polls had raised over post-election economic management and business regulation. Mr Cameron has a clear mandate to continue his pro-business and fiscally conservative policies. His party has pledged to close the budget deficit by 2018-19 – although other election pledges, such as ruling out increases in key taxes, could reduce the government's fiscal room for maneuver.

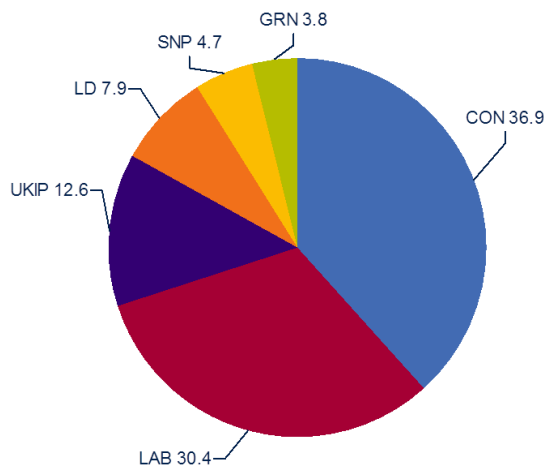
Nevertheless, business leaders and investors in Britain will face considerable uncertainty over the next couple of years. The big questions going forward concern the cohesion of the United Kingdom and the UK's future inside the EU.

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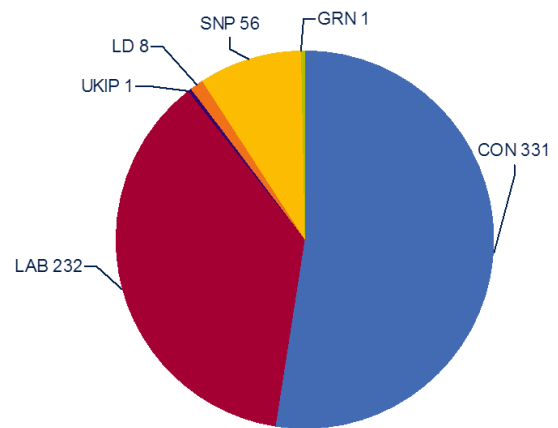
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In 2013, Mr Cameron promised to use a renewed mandate after the election to push for a reform and recalibration of powers in the EU, followed by a referendum on British EU membership by the end of 2017.

UK vote share in %



Number of seats in parliament



Source: BBC.

Most observers consider the risk of the UK leaving the EU tangible but low. British voters seem a lot less interested in the “European question” than they were a couple of years ago. In the election campaign, the EU was hardly mentioned – despite the vocal campaign and strong result (in terms of votes, not seats) of the anti-EU UK Independence Party (UKIP). When asked how they would vote in a referendum, significantly more people now say they would opt for staying in the EU (45%) than leaving it (36%).

It would be wrong, however, to dismiss the specter of Brexit already. Domestic uncertainties, in combination with European developments, render any forecast at this point highly speculative. The following five issues can help us assess the risk of Brexit going forward.

1. **Current opinion polls do not say much about the future.** Two years ago, over 50% of Britons wanted to leave the EU, compared with a quarter who wanted to stay. Only since the beginning of last year did the polls show a shift in favor of staying in the EU.

Voting intentions in the run-up to the referendum could swing back towards “no” under any number of scenarios. If the eurozone crisis flared

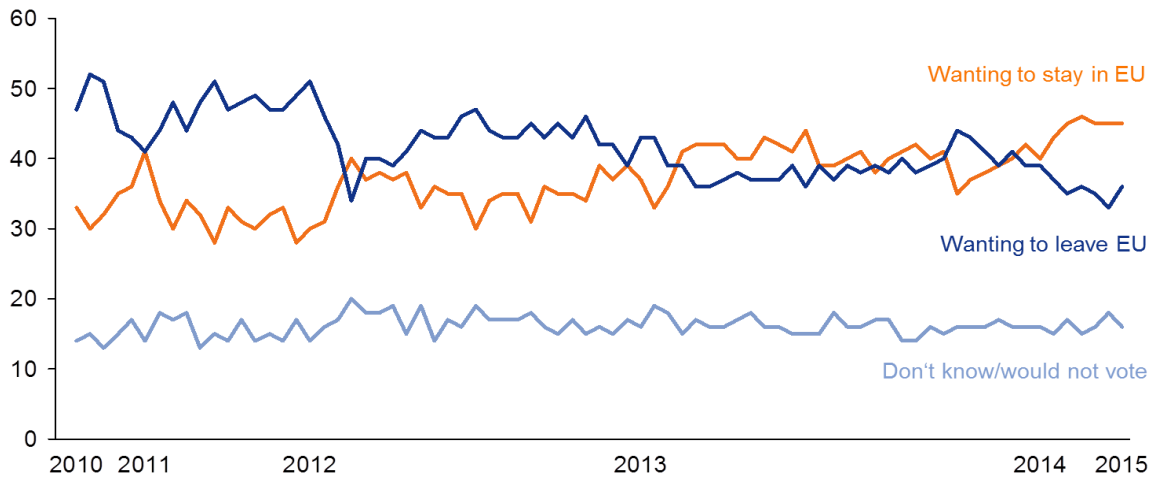
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up again, for example, Britons would once again perceive the EU as a zone of economic instability and slow growth that is not worth belonging to.

If there was a referendum on Britain's membership of the European Union, how would you vote?

2010-2015 in %



Source: YouGov.

- The timing of the referendum will be important.** For domestic political reasons, Mr Cameron might want to call the referendum sooner rather than later, perhaps as early as mid-2016. Eurosceptics would prefer an early decision, as would business, to forestall the risk of prolonged uncertainty and a government distracted by EU negotiations.

During an early referendum campaign, Mr Cameron might still benefit from post-election political momentum, especially since most of the opposition parties look set to be weak and leaderless for a while. In 2017, by contrast, voters might be tempted to use the EU referendum to register their disapproval with Mr Cameron's leadership. Support for governments tends to dip around mid-term, and this risk is pronounced for the new Conservative government, which has promised further swingeing cuts to welfare budgets and public services that may well be more painful than those implemented during the previous term.

However, the tighter the schedule, the less likely it is that the British government can achieve meaningful compromises with other EU leaders who will resent being hurried along by Mr Cameron's political timetable. Mr Cameron must also take into account the upcoming elections in France (spring 2017) and Germany (fall 2017), during which national leaders in

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the respective countries will be less inclined to make big concessions. Finally, the negotiations should ideally be concluded before the UK takes over the EU's rotating presidency in July 2017, since presiding countries are expected to act as independent arbiters.

Mr Cameron's strategy for the plebiscite will become clearer once he introduces the required "referendum bill" in parliament, which could well be one of the first acts of the new government.

3. **Britain's new deal with the EU will be limited.** In more nuanced opinion polls, a large majority of Britons say they would vote for staying in the EU if Mr Cameron managed to negotiate a "better deal" for his country's membership. Mr Cameron has so far said very little on what he thinks such a deal should look like.

Most likely, Britain will demand a mixture of safeguards and subsidiarity rights (the right to restrict benefit payments to EU migrants, a stronger say for national parliaments in EU lawmaking), policy initiatives (deepening the single markets, free trade agreements) and general principles (the right to opt out of future integration, deleting any reference to "ever closer union" in the EU treaties).

On issues such as subsidiarity and further market opening, Mr Cameron can expect sufficient support from Germany and other member states. They would not, however, back the right of the UK to opt out of significant areas of EU law and policy. Poland, the Czech Republic and other Central and East European countries have traditionally been allies of the UK in EU negotiations. They have, however, been antagonized by the Conservative party's anti-immigration rhetoric of recent years. Unlike in the past, Mr Cameron and his cabinet will have to devote significant time to building coalitions in Europe, to ensure that the negotiated deal is accepted by the other 27 member states.

Any fundamental redefinition of powers would require a change in the EU treaties. Almost no other EU government wants this at present. In any case, it would not be feasible within the timetable set by Britain – after all, the last EU treaty change took a decade to negotiate and ratify. The best Mr Cameron can hope for is a protocol that sets out issues to be addressed if and when the EU treaties are re-opened the next time.

Therefore, the results of the negotiations will most likely be a mixture of limited concessions and political pledges. Since some voters have incomplete knowledge of what EU membership actually entails, Mr Cameron might be able to sell even limited results as the promised "new settlement". For others, whose ultimate objective is to leave the EU, no result – however comprehensive – is likely to be satisfactory.

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4. **Party politics will be intractable.** Whatever the outcome of the negotiations, Mr Cameron will have to campaign for a yes vote in the referendum. His party, however, will not necessarily follow him.

The Conservative grassroots have long been more eurosceptic than the population at large. In a poll in early 2015, for example, 58% of Conservative party members said they wanted their country to leave the EU while 33% opted for staying. Several members of Mr Cameron's new cabinet are on the record as saying they would vote no in a referendum. Among the new Conservative members of parliament, one third are said to be in favor of leaving the EU. Mr Cameron's slim parliamentary majority of only 12 seats strengthens the position of these eurosceptic backbenchers, who will now be in a position to "blackmail" the government into concessions over Europe.

In the past, Mr Cameron's key decisions on Europe have often been driven by the desire to placate a restive party base – most notably the decision to take Conservative members of the European Parliament out of the mainstream center-right EPP grouping and the promise of an EU renegotiation and referendum.

Perhaps, Mr Cameron's successful re-election will leave him more resilient to eurosceptic demands within his own party. Much will also depend on the future of UKIP – the party that has risen so spectacularly on the back of growing anti-EU sentiment and helped to push Mr Cameron into promising an in-out referendum. With UKIP's popular leader, Nigel Farage, bouncing back quickly after his failure to win a parliamentary seat, UKIP's success could, as in the past, push the Conservative party to the right, in an attempt to retain more nationalist and anti-EU voters.

Mr Cameron will have to perform an almost impossible balancing act between striking a pragmatic deal with the other EU governments and placating the hardliners within his own party. A number of Conservative politicians will reject any EU deal that does not restore significant powers from Brussels to London. Since such a deal is not feasible, they will insist on the right to campaign against their own government. There is, therefore, a high risk that the party will split during a referendum campaign, which might also imply a lost parliamentary majority and an early election.

5. **Union questions will complicate the EU campaign.** Mr Cameron will be distracted not only by European issues but also by the pressing need to redefine the relationship between England and the other constituent parts of the United Kingdom, most notably Scotland. With the SNP, a party devoted to Scottish independence now fully dominates Scottish politics

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and has become the third biggest party in the House of Commons. SNP leader Nicola Sturgeon is not expected to call for another referendum on Scottish independence in the near future, instead concentrating on fighting for the devolution of powers from Westminster.

She will also demand that in the EU referendum each of the four constituents of the UK must individually consent to a decision to leave the EU. Scotland is traditionally more pro-European than England. If Scotland voted for staying in the EU while England opted for leaving, this would invariably trigger another referendum on Scottish independence. The impact on the future of the United Kingdom will thus be one issue that people will consider when they vote in the EU referendum.

All things considered, there are still good reasons to assume that the UK will stay in the EU for the foreseeable future. If the British economy continues its recovery – and the good performance in the labor markets starts translating into wage growth – most Britons will have few reasons to opt for a radical change in the upcoming EU referendum. Although some of Mr Cameron's EU-related decisions appeared to be less-than-fully thought through, the prime minister is an experienced political operator who should be able to navigate the turbulences ahead. The other EU countries are, on balance, willing to take a constructive attitude towards Britain's demands for EU reform – provided London does not ask for unreasonable opt-outs, for example from the free movement of labor.

On the other hand, the political landscape of the UK has been changing so rapidly in recent years that it is impossible to predict which constellation will prevail at the time of the EU referendum in 2016 or 2017. Brexit remains a tail-risk of low probability but with tremendous consequences for both Britain and the EU should it happen.

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