

BREXIT: And Then There Were 27

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Referendum on the United Kingdom's membership of the European Union	
Vote only once by putting a cross <input checked="" type="checkbox"/> in the box next to your choice	
Should the United Kingdom remain a member of the European Union or leave the European Union?	
Remain a member of the European Union	<input type="checkbox"/>
Leave the European Union	<input checked="" type="checkbox"/>

With 100% of the votes counted, 51.9% of registered Britons voted for the U.K. to leave the European Union, while 48.1% voted to remain a member (*Chart 1*). (Turnout: 72%.) It looks like the polls over the past couple of weeks weren't far off after all, much to the surprise of financial markets.

Market reaction: Global financial markets sold off sharply early Friday morning following the historic victory for the “Leave” camp, with a massive flight to quality. The **British pound**, which had traded confidently higher yesterday (over \$1.50), plunged a record 10% as the outcome of the referendum became clear. The currency touched a three-decade low of \$1.3229, and is currently around \$1.37. Recall that the BoE warned last week that the currency would likely fall, “*perhaps sharply*”, in the event of a vote to leave. Indeed it has, especially after markets had leaned so heavily to the ‘Remain’ side in recent days. Other European currencies are also trading lower amid the heightened uncertainty, while the **greenback** and **Japanese yen** are surging. The **BoJ** will likely be prompted to intervene (if they haven't already) as the yen briefly broke below ¥100 before bouncing back, while the **Swiss National Bank** stepped in to “*stabilize*” the **Swiss franc** after the currency rallied against the euro. Meanwhile, the **Canadian dollar** is weaker at \$1.3025 (or 76.8 cents US). **Gold** is up \$60 to \$1,317. Ten-year **Bunds** yields touched record lows, down 18 bps to -0.08% while 10-year **Treasury yields** are 25 bps lower to 1.50% (the all-time low is 1.39% reached in 2012). Prospects for already-sluggish global growth to slow further are pushing most commodity prices lower.

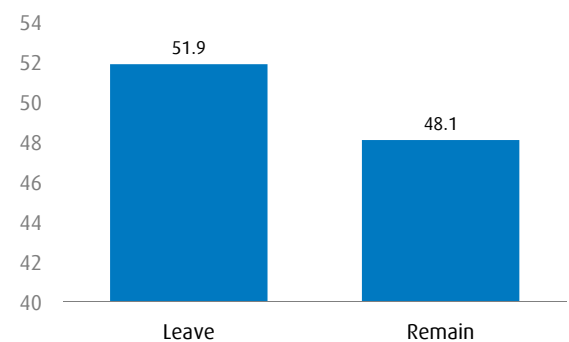
What happens next?

Politics: Parliament still has the final vote on leaving the EU but it could be political suicide if MPs voted against their constituents' will. There are also plans for a meeting on Saturday in Germany of the six founding members of the EU as a show of unity. Meantime,

Chart 1
Brexit by a Slim Majority

United Kingdom (% of votes : as of 5:00 am EDT, June 24, 2016)

Referendum Outcome



Source: BMO Economics, Financial Times

PM David Cameron announced he will step down from his post by October, leaving it to his successor to plot the course out of the EU. The immediate issue is finding a replacement.

Monetary Policy: The **Bank of England's** contingency plan now kicks in. Clearly, there will be no rate hikes for the foreseeable future; in fact, rate cuts are now a distinct possibility in the U.K. In a statement issued this morning, the Bank reassured that it “*will not hesitate to take additional measures as required as those markets adjust and the U.K. economy moves forward*” but signalled that they will wait and see how events play out. “*In the coming weeks, the Bank will assess economic conditions and will consider any additional policy responses.*” The **ECB** also spoke up, saying it is ready to provide liquidity if needed.

Fiscal Policy: The Chancellor of the Exchequer, **George Osborne** (who may also be on his way out), warned ahead of the vote that he would introduce an emergency £30 bln budget (~1½% of GDP) if the U.K. leaves, which would involve income tax hikes and spending cuts on services such as health care, education and defence. Note that with a new prime minister will likely come new priorities, and easing the potential negative impact of exiting the EU through looser fiscal policy is a possibility. The country's AAA rating is also at risk—**S&P** warned about this in May, and followed it up today with the comment that the rating is “*untenable under the circumstances*”.

Tick tock, tick tock: Once Article 50—formally informing Brussels of the intention to leave—is triggered, the U.K. will have two years to negotiate a deal with the EU. When the process will begin is not known, although a two-day EU Summit that starts on June 28th is one opportunity. According to European Commission President Juncker, Britain will have to negotiate withdrawal terms first, before talking about how the new relationship will work. In other words, there will be a deep dive into what other options or alternatives are available to the U.K. Anti-EU parties in other countries will be watching closely, as an amicable split may fuel further efforts to exit the EU. There is a web of issues around **regulations** and **trade**.

An agreement will have to be worked out to determine the fate of Brits working elsewhere in Europe (introduce work permits?), and the fate of Europeans working in the U.K. New workers may need to apply for a special visa, which is an added barrier to a once free-flowing supply of labour. Existing workers may need more paperwork to justify their roles. New restrictions will have the effect ‘desired’ by Brexiteers: limiting the number of immigrants (and refugees) into the U.K. and giving the country greater control over its borders, particularly as there has been a record inflow recently. In fact, immigration was among the biggest factors driving the Brexit vote. But it also works against those Britons working elsewhere. In any event, the U.K. job market would likely suffer, particularly **financial services**, a sector which accounts for 8% of British GDP.

The **City of London's** future as a global financial centre is now in question, and a number of global banks could potentially relocate some of their operations out of the U.K. and into other EU financial centres in the years ahead. One of London's most attractive features (besides access to Europe's single market, use of the English language, flexible labour laws) is the EU ‘*passport*’, which allowed U.K.-regulated

banks based in London to open branches easily in other EU countries, and to sell services across the EU, all under one set of rules. Without these ‘*passports*’, U.K.-headquartered banks can still open branches, but they will be subject to more restrictions and more regulations.

On a broader note, the exit could cause the U.K. economy to meaningfully underperform, if not tip into **recession**. There’s a wide range of impact estimates. The **U.K. Treasury** calculates that GDP will be 3.6% lower in two years than had they remained in the EU, the **OECD** estimates a 3% loss by 2020, while the **IMF** warned of a 5.5% loss by 2019. **Foreign investment** may decline as access to other EU markets could become much more limited. But it will be a long stretch of uncertainty, which could make a meaningful dent in the U.K. economy and trade. British goods trade with the EU is significant, accounting for 45% of exports and over 50% of imports (*Chart 2*). And, the EU may not let go easily; they **could make this very painful** in order to discourage other countries from contemplating departure. (The issue of Scotland’s independence is also likely to again come to the fore, further weakening Britain’s position, especially since the Scots voted heavily in favour of staying in the EU.)

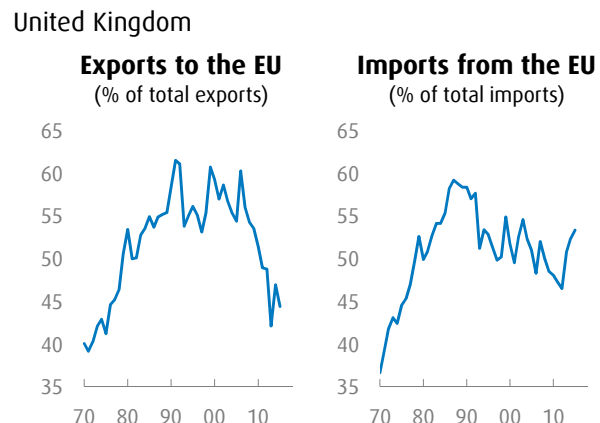
There have already been signs of delayed consumer and business spending, as well as hiring, in the months ahead of the vote but the weaker British pound could give exporters a needed boost.

Trade negotiations will begin. Remember President Obama’s warning that the U.K. would be “*at the back of the queue*”, and senior European lawmakers’ position that Britain would receive “*no special treatment*”. There are a number of trade possibilities that could arise.

The **U.K. could be like Norway** and join the **European Economic Area (EEA)**, which is the EU plus Norway, Iceland and Liechtenstein. That would give the U.K. full access to the EU single market but little say in regulations, and they would have to still contribute to the EU budget and allow free movement of labour (the latter two being non-starters for the ‘exit’ camp). An alternative could be something similar to the **Comprehensive Economic and Trade Agreement (CETA)** the EU has yet to ratify with Canada. The deal is one step removed from a full open market in many respects—though the financial sector would likely still come under pressure—and might be more than the EU is willing to give. Or, the **U.K. could pull out completely and trade under the WTO’s regulations**, but that means goodbye to both full and preferential access.

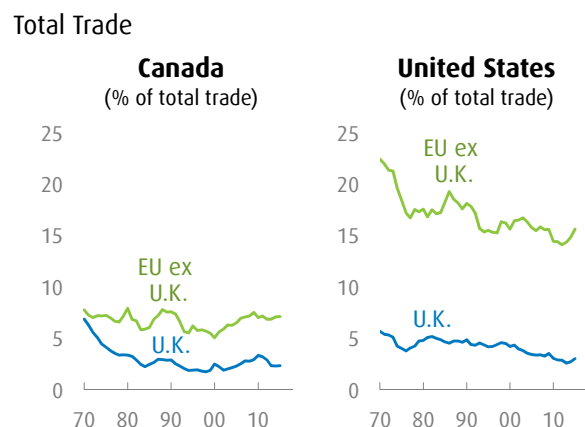
Impact on North America: The most immediate impact on the North American economy will come from the financial market volatility that we are seeing in the aftermath of the vote. The Federal Reserve has been hyper aware of global economic risks, and a Brexit qualifies, which rules out a July rate hike. A move by December remains a reasonable possibility, provided markets soon calm and the near-term

Chart 2
The EU is a Big Player in British Trade



Sources: BMO Economics, IMF, Haver Analytics

Chart 3
U.K. Trade Modest with Canada and the U.S.



Sources: BMO Economics, IMF, Haver Analytics

economic fallout is minimal, but that's still a long way off. Global economic growth remains lacklustre and more uncertainty around this decision won't help, with a Brexit magnifying the risks that already exist. With Fed rate hikes now delayed even further, we expect the **Bank of Canada** to remain on hold until at least 2017Q4. Accordingly, look for global bond markets to be well supported, with yields likely drifting even lower in the near term.

The direct economic consequences will be unclear for some time due to the two-year negotiation period. However, **the U.K. accounts for a modest 3% of total U.S. trade and an even lesser 2.5% of Canadian trade (Chart 3)**. Such small shares and the likely modest impact on total trade suggest the direct risk to the North American economy is minimal. Moreover, while the EU might drive a hard bargain to lessen the potential desire of others to leave, there's no reason for Canada or the U.S. to materially alter the current trade relationship on their own (despite what President Obama suggested). However, the EU could apply pressure to both countries to make things somewhat more difficult for the U.K. Canada's CETA deal with the EU may itself be at risk, given that the U.K. was its biggest supporter in the EU.

Impact on the currency: BMO European FX Strategist **Stephen Gallo** does not rule out a further decline in the British pound or the euro over the coming three to six months, particularly if negotiations with the EU proceed badly. But given the fact that the pound is already at generational lows, while the euro isn't even at this year's low, he believes there is more room for the euro to depreciate (*Chart 4*).

Who is next? There are already rumblings of EU membership referendums in other countries, with anti-EU parties taking advantage of yesterday's results. **Scottish** independence will be back on the table (Scots voted heavily in favour of Remain). **Italy** is another possibility, particularly given the outcome of their recent mayoral races. The rise of the anti-establishment Five-Star Movement gives the party an opportunity to contest elections in 2018. On a broader scale, the rise of populist, anti-EU parties in the rest of Europe is a risk, particularly with Spanish elections on June 26th, while France, Germany and the Netherlands go to the polls in 2017. Moreover, the Sunday's Spanish vote could be a key driver for markets next week, as another anti-EU vote would ramp up fears that the EU and, in turn, the euro could be unravelling.

The Bottom Line: A Brexit will be messy, and will act as a further dampener on North American growth. However, given the size of the U.K. economy (9th largest in the world, 2% of global GDP, see *Chart 5*) and its small share of trade with Canada and the U.S., the uncertainty and its impact on financial markets may be the biggest negative at the moment. Indeed, the broad declines in equities, commodities and bond yields globally point to further downside in near-term global growth prospects. Ultimately, though, Brexit is about a trade deal and political arrangements, and the biggest loser from Brexit will be the U.K. itself.

Chart 4
U.K. Pound... Pounded

(local currency / £ : as of June 24, 2016)

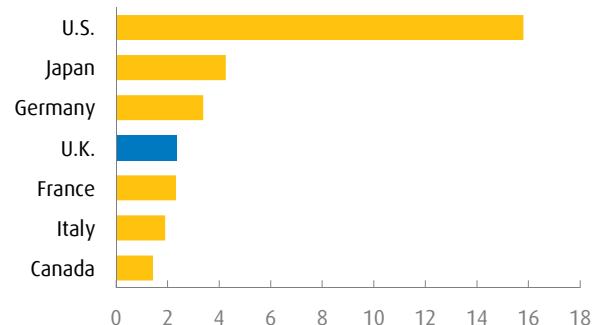


Sources: BMO Economics, Federal Reserve, Haver Analytics, Bloomberg

Chart 5
U.K. Middle of the G7 Pack

2015 (percent)

Share of Global Economy



Source: BMO Economics, IMF, Haver Analytics

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