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MACROCOSM

Brexit: Opening Pandora's Brox

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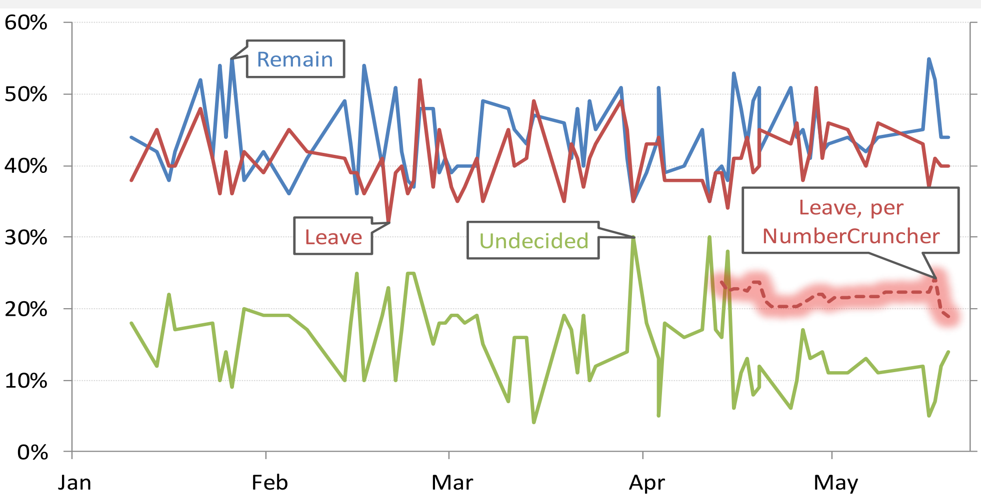
Here's a riddle. What do you call the European Union without the UK? Germany.

From the polls, it's not at all clear whether the United Kingdom will vote to "leave" or "remain" in the European Union at the June 23 "Brexit" referendum. But betting markets and quantitative analysis are indicating that "remain" has it in the bag (please see the chart below). For what it's worth, our British contacts generally say just the opposite – they expect a last-minute swing to "leave."

- There's been a great deal of alarmism about the consequences for the UK if it opts to "leave" – emanating from establishment sources ranging from the Bank of England ("sterling's exchange rate would fall further, perhaps sharply") to the President of the United States ("the UK is going to be in the back of the queue").
- This morning Her Majesty's Treasury published a new report on Brexit, warning on its website in blaring letters that "UK economy would fall into **RECESSION** if Britain leaves the EU" [emphasis in original].
- *We don't agree, and if a "leave" vote – which would be something of a surprise at this point – weakens sterling or other British markets, we'd see it as a buying opportunity. If anything, "leave" would be worse for Europe than the for UK, but not an immediate crisis.*

Brexit opinion polling and analytic forecasting



Source: Wikipedia, Number Cruncher, TrendMacro calculations

Update to strategic view

EUROPE MACRO, FX, EUROPE STOCKS, EUROPE BONDS: Elite forecasts call for Britain to "remain" in the European Union at the June 23 "Brexit" referendum, but polls remain virtually tied with a large undecided component. If "leave" wins, there is no global systemic risk, as the UK doesn't use the euro. We see no threat to the UK's currency, markets, banks or trade, and a "leave" panic would be a buying opportunity. The UK is a large net importer, and thus a highly desirable trading partner for whom any necessary accommodations will be rapidly made. The risk is to Europe. Without the counterbalance of the UK, Germany lacks the moral authority to drive integration and reform. And with the financial crisis passed, reform is at risk. And now, "leave" or "remain," with the UK having won substantial concessions from the EU, other large nations will demand the same special treatment. European integration will become a messy sequence of brinksmanship negotiations. Pandora's Box is wide open.

[Strategy dashboard]

- But "leave" or "remain," the fact that the Brexit decision is even being examined both reveals and aggravates deep structural strains in Europe, and will have lasting consequences for the "European project" for good and for ill.

Let's dispose of one issue at the very outset. "Brexit" rhymes with "Grexit," but the immediate stakes are quite different. <u>While the Greek economy is smaller than that of Boston, and the UK's is the fifth largest in the world, the past episodes of potential "Grexit" were more systemically risky than potential Brexit is today.</u>

- *It's simple. "Grexit" was about Greece leaving the euro currency. Even under the best of circumstances it is difficult to unwind a currency union. The repeated fiscal and banking crises that formed the background for "Grexit" were surely the worst of circumstances, in which "Grexit" would have likely led to a highly disorderly break-up of the euro.*
- *<u>So "Grexit" could have set off global systemic shocks potentially more severe than the those following the failure of Lehman and AIG. The UK does not use the euro, so that risk is simply not on the table.</u>*

What about potential shocks from Brexit for the UK itself if "leave" carries the day?

- To be sure, there would be a period of uncertainty, and that tends to depress economic activity and asset values. But we're not at all convinced that the UK wouldn't be better off, on net, once everything settles out. Almost by definition, an optimistic consensus would underlie a "leave" vote in the first place. So while uncertainty adds a risk-penalty to the economic calculus, that optimistic consensus skews for the better the distribution of expected outcomes to which any uncertainty applies.

What is the bear case? What possibilities skew the distribution for the worse?

- *<u>Scale is not really an issue.</u>* Again, the UK is the fifth largest economy in the world. And its "soft power" in the global marketplace of ideas is of the first rank. It's not, say, Portugal, that has to stay safely attached to some mother-ship in order to make its way in a globalized world.
- *<u>A key issue is trade.</u>* Today the UK's trade with other EU members is mediated by EU rules, and its trade with other nations piggybacks on EU agreements. All that would have to be renegotiated if the UK left the EU. Again, President Obama warned that the US is already busy with a lot of trade deals now, and "the UK is going to be in the back of the queue."
- *<u>We don't think the UK will have any trouble at all getting trade deals quickly and on favorable terms. The UK is a large net importer. Of the UK's top 25 trading relationships (ranked by total trade), it is a</u>*

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[About us]

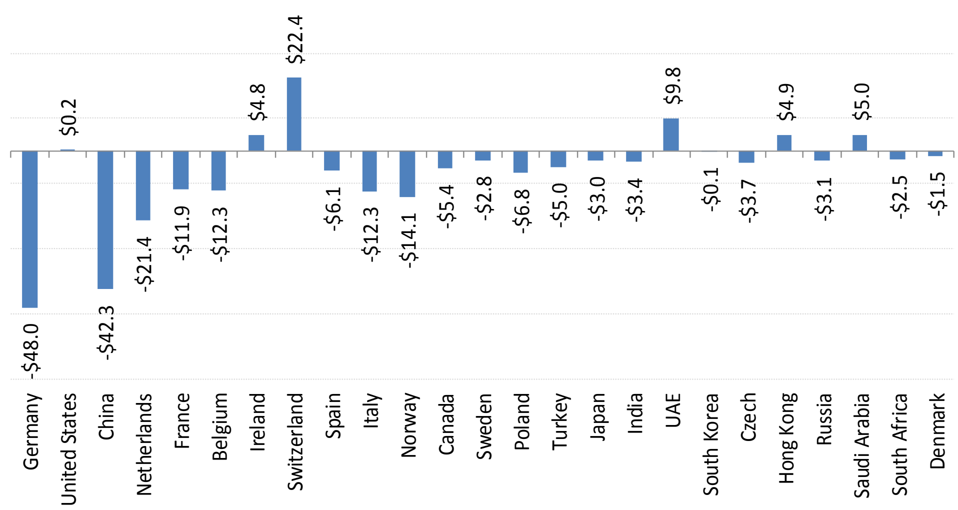
Recommended Reading

Only About One-Quarter of Corporate Stock is owned by Taxable Shareholders
Steven M. Rosenthal
TaxVox
May 16, 2016

How the West (and the Rest) Got Rich
Deirdre N. McCloskey
Wall Street Journal
May 20, 2016

[Reading home]

UK 2015 trade balance, ranked by total trade volume USD billions



Source: Bloomberg, TrendMacro calculations

net exporter to only six (please see the chart above). *That makes it a rare and valuable trade counterparty.*

- In the Not So Great Expansion following the Great Recession, demand is scarce – so every nation welcomes any chance to preserve and increase its exports. And inflation isn't an issue – quite the contrary – so there's no particular rush to get cheap imports. That makes the UK the most beautiful girl at the global trade prom.
- The UK's largest trade relationship – and its largest trade deficit – is with Germany. The UK's only notable trade surplus within the EU is with Ireland. So when it's decision-time in Brussels on a trade a trade agreement with a UK that has left the EU, let's not waste a lot of time wondering how it's going to turn out. *If anything, the UK could come away with a better deal that it has now.*
- Pretty much the same for the US, the UK's second-largest trade relationship. Trade between the UK and the US is almost perfectly balanced, so to be sure the UK doesn't have quite the same bargaining leverage that it enjoys over the EU. That said, the UK is one of the world's very few large economies with which the US is not running a significant trade deficit. So from the US perspective, the trade relationship with the UK is not something to be trifled with, Obama's trash-talk notwithstanding.
- *How about financial services, a sector so critical to the UK's total output?* We give a little more credence – but not much – to the chance that the London banking industry might lose some of its pre-eminence in the European financial system. We see no case for why, as some hysterical voices have warned, it should become systemically unstable.
- To be sure, even ensconced within the EU, London has already seen its role diminish, one small step at a time, as the Franco-German axis that controls the European Central Bank has put its thumb on the scales in favor of the Continent. For instance

Euroclear, by any reasonable estimation, should have been located in London, but it ended up in Brussels. So to the extent that this risk is real, it is at least not new.

- But the core reality is that, all along, London's pre-eminence has not been because of a cozy relationship with the Continent, but rather despite a distant one (again, the UK doesn't not use the euro currency). Instead, leadership has come as the result of London's concentration of highly skilled people and deeply trusted financial and legal institutions. None of that would change after "leave."
- And if the negotiating gets difficult in keeping London's banks and brokers plugged in to the EU, the matter of those net imports can always be discreetly mentioned…

What's the bull case? Why should the UK want to "leave"?

- <u>*The UK is not alone in wanting, nor wrong to want, a reappraisal of the costs and benefits of globalization.*</u>
- Such considerations have animated the rise of Donald Trump as a US presidential candidate. Indeed Trump himself has <u>come out in favor</u> of "leave." But that might have been motivated by having been called a <u>"wazzock"</u> in <u>debate in the House of Commons</u>.
- As in the US, there is a sense in the UK of sapped economic vitality and a sense that a flood of immigrants has eroded the national character – there's that net importer thing again, in two different dimensions.
- All the worse in the UK, because both matters can be blamed on EU membership. The UK economy would likely be stronger, all else equal, without overweening regulations emanating from Brussels. And as an EU member, the UK has essentially given up control over immigration policy, at least with respect to immigrants from other EU member nations, entirely to Brussels.
- We don't pretend to know what optimal immigration policy for the UK ought to be. But we do think that, generally, less regulation of the economy is better. But no matter how you come down on those issues, we have a strong conviction that economic dynamism is enhanced when the workers, entrepreneurs and investors who make it happen have a sense of pride and self-determination. It goes to the enabling of the <u>"animal spirits"</u> that British economist John Maynard Keynes so correctly emphasized as necessary for growth.
- <u>*So "leave" contains some strong objective benefits (less regulation) and some dubious ones (less immigration). But it also contains a strong subjective benefit (animal spirits).*</u>

<u>*Evidence of the strength of these objective and subjective cases for "leave" is that, to a significant degree, both of them had already been agreed through negotiation before the referendum was even put on the calendar.*</u>

- Indeed, British Prime Minister David Cameron was only willing to put Brexit to a vote because, on February 19, he was able to return from Brussels having won a package of <u>concessions he demanded</u>

for the UK – which he could claim were so favorable that, because of them, "remain" should surely carry the day.

- According to Cameron, the package gets the UK "Out of the open borders. Out of the bailouts. Out of the euro. And out of all those schemes in which Britain wants no part."
- Brussels' portrayal of the so-called "new settlement," as you'd expect, minimizes Cameron's victory. The truth is in-between, and won't really be known for years, as many of the negotiated points are subject to future implementation of ambiguous commitments.
- But there can be no doubt that Cameron brought back a valuable trophy.
    - Perhaps symbolically, but nevertheless world-historically, the EU agrees that "It is recognised that the United Kingdom, in the light of the specific situation it has under the treaties, is not committed to further political integration into the European Union." It promises to incorporate this in the EU treaties next time they are opened, and include language stating that the words "ever closer union" specifically "do not apply to the United Kingdom."
    - The EU commits to a "red card" system in which European nations can band together to veto unwanted legislation passed by the European Parliament.
    - The UK gets a "benefits brake" lengthening the period over which employers can wait to give full benefits to immigrant workers.
    - The UK gets an explicit waiver on membership in the euro currency union, and assurances that its financial sector won't be discriminated against.
    - The UK is exempted from participating in bail-outs of nations that use the euro.
    - The UK gets a commitment – vague, unfortunately – to an easing of regulatory burdens.
- *With these trophies, much of the benefit of "leave" can actually be obtained by "remain" – without the risks of "leave." So if UK voters are thinking about optimality, a "remain" vote probably makes the most sense.*
- *But we don't see all that much risk from "leave." So from an investment standpoint, we see the Brexit referendum as a winner for the UK economy no matter how it turns out.*

We think the effect of Brexit on Europe overall, though, are not so unambiguously positive. And that caution, too, is deserved whether "leave" or "remain" wins the referendum.

- A clever client of ours poses this riddle. *What do you call the European Union without the UK? Germany.*
- Nothing wrong with Germany. It's one of the world's most dynamic developed economies. But as the leading economic and political force behind the "European project," Germany is more effective with the UK as a counterbalance to provide the separation of

powers that gives the drive to greater integration deeper moral authority.

- It's not just that the UK is the EU's second-largest economy. It's the UK's historic role as a check on German hegemony that gives the EU the moral authority to proceed with integration. With the UK out of the EU mix, will the many small states of Europe trust France to counterbalance Germany? How'd that work for you last time?
- To be sure, the "European project" was first visualized in 1946 by Winston Churchill, who called for a "United States of Europe," for which the "first step…must be a partnership between France and Germany."
- But Churchill had said sixteen years earlier, while supporting French Prime Minister Aristide Briand's plan for the creation of a European federal union, that the UK has "our own dream and our own task. We are with Europe, but not of it." And in the 1946 speech, he was clear that "We British have our own Commonwealth of Nations."
- This British stance toward Europe is now to be enshrined in treaty, assuring that the goal of "ever closer union" for Europe does not apply to the UK.
- Fine from Britain's perspective, but as Europe has struggled with banking and debt crises over the last six years, salvation has always come from "ever closer union." Stronger European nations have intervened to bail out and underwrite the weaker ones, provided the weaker ones would adopt Germany-like reforms in labor and product markets (see "Europe's Supply-Side Revolution" February 17, 2012).
- Now the crises have passed, precisely because of those interventions and those reforms. We believe those reforms have generally been very successful at stabilizing debt and banking markets, and reinvigorating growth – especially in Spain, where they have been most wholeheartedly applied. Over the past three years, real growth in Spain has set the pace for large developed economies, beating both Germany and the US.
- But without the threat of crisis, the reforms in Spain and elsewhere are under threat. In Spain, Prime Minister Mariano Rajoy, the reformer who in 2011 won the greatest landslide in the history of Spanish elections, couldn't form a government after last December's elections, and isn't set to do much better in new elections set for late June.
- At the same time, with Syrian and African refugees flooding Europe from the east and the south, populist/nativist movements are gaining traction in several nations – and not just the little ones, most recently Austria's near-miss presidential election over the weekend.
- *In this dangerous environment, it seems to us that Cameron – with his "new settlement" and his referendum – have opened a political Pandora's Box in Europe that will now be impossible to shut.*
- With Cameron having won so many concessions from Brussels under the Brexit threat, why now would Italian Prime Minister Mateo Renzi not demand his own "new settlement," under a threat of "Itexit"? There are hints already.

- Such demands usually involve some measure of brinksmanship. In the "Itexit" negotiations, we can imagine Renzi reminding Brussels that Italy is the fourth most indebted country in the world – and would make a real mess if it decided to stop using the euro currency.
- Germany is willing to stare down little Greece over such threats – but Italy, or Spain for that matter, will be much more difficult negotiating counterparties.
- *Now it could well be that the cause of the "United States of Europe" would be well served by an ever-changing network of "new settlements" that fine-tune each nation's special place in the federal matrix. But it won't be obtained without risk.*
- *And without the moral authority of an EU anchored by Germany and the UK, can it be obtained at all?*

Bottom line

Elite forecasts call for Britain to "remain" in the European Union at the June 23 "Brexit" referendum, but polls remain virtually tied with a large undecided component. If "leave" wins, there is no global systemic risk, as the UK doesn't use the euro. We see no threat to the UK's currency, markets, banks or trade, and a "leave" panic would be a buying opportunity. The UK is a large net importer, and thus a highly desirable trading partner for whom any necessary accommodations will be rapidly made. The risk is to Europe. Without the counterbalance of the UK, Germany lacks the moral authority to drive integration and reform. And with the financial crisis passed, reform is at risk. And now, "leave" or "remain," with the UK having won substantial concessions from the EU, other large nations will demand the same special treatment. European integration will become a messy sequence of brinksmanship negotiations. Pandora's Box is wide open.