UK Economics | EU Referendum

An Ever Closer Call

We expect:

Outcome: A close referendum on June 23, and we currently assign a 60% probability for Remain and a 40% probability for Leave.

Impact:

(a) Before the vote: Referendum uncertainty to contribute to a mid-year slowdown, impacting investment and risk assets in particular, with the impact increasing with the perceived probability of a vote to Leave.

(b) After the vote: With a vote to Remain, we would expect a rebound in investment and growth, reflations and a start to rate normalisation. With a vote to Leave, we would expect an increase in political and economic uncertainty. We would expect this to hit investment hard, and push the economy close to recession, but the downside to be cushioned by easier policy. Risky assets, including sterling and equities, would be most impacted, in our view.

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1. Renegotiation and the road to the referendum slides 3-8
We got a UK deal with the rest of the EU on revised terms of membership on February 19 2016, including an opt-out from ever-closer union, safeguards for Euro Outs, and greater controls on immigration, including restrictions on migrant benefits.

2. Probability of Remain and Leave slides 9-14
The referendum will be held on June 23 2016. With Boris Johnson joining the Leave campaign, and evenly divided opinion, we see a close outcome as likely, and assign a 60% probability for Remain, 40% probability for Leave.

3. Vote to Remain: Political and economic impact slide 15
After a vote to Remain, we see some risk of continuing division in the Conservative party. In terms of the economy, we would expect a rebound in investment and growth, continued reflation and a start in 1Q-17 to rate normalisation.

4. Vote to Leave: Political impact slides 16-18
In the aftermath of a vote to Leave, the political situation would likely move faster than the economic relationship with the EU. There would be risks of an accelerated change in Prime Minister and another Scottish independence referendum.

5. Vote to Leave: Economic impact slides 19-28
We see a significant economic cost from a vote to Leave. Near term, we think the uncertainty would hit growth, reducing UK growth by ~1.5pp and eurozone growth by 0.8pp over 2016-17. Actual exit, probably 2019, would likely lead to reduced access to EU markets, reduced inflows of capital and labour, and lower trend growth. The only concrete economic benefit we can see is a fiscal saving of ~0.3% of GDP pa.

6. Overview: UK and Europe slide 29-30

Asset implications
For more detail on asset implications, see our cross-asset report on Brexit, and our report on What Brexit would mean for Europe (March 7, 2016)
1. The Road to the Referendum

A. UK and Europe - Partly in and partly out

UK stands aside in the 1950s, as European integration started. UK joins in 1973, confirmed in the 1975 referendum. UK promotes single market and enlargement, argues over CAP and budget, stands aside from euro and Schengen.

B. The strength of UK Euroscepticism

Conservative party divided on Europe, UKIP a significant electoral challenge – eg gained largest share of vote in the 2014 European Parliament election.

“…democratic consent for the EU in Britain is now wafer thin… That is why I am in favour of a referendum…. It is time to settle this European question in British politics.”

PM Cameron, Bloomberg speech, January 2013
1. Timeline

Steps on the Road to the Referendum

UK tables reform proposals  
Referendum bill passes  
Negotiations concluded  
Government calls referendum  
Electoral Commission designates lead campaign groups  
Referendum

Nov-15  Dec-15  19-Feb-16  23-Feb-16  13 April-16  23-June-16

Some key EU milestones around the UK referendum......

<table>
<thead>
<tr>
<th>Event</th>
<th>Dates</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK general election</td>
<td>7 May 2015, Conservatives formed a majority government</td>
</tr>
<tr>
<td>European Council</td>
<td>25-26 June 2015; Cameron outlined UK proposals</td>
</tr>
<tr>
<td>European Council</td>
<td>14-15 October 2015; UK committed to write with proposals</td>
</tr>
<tr>
<td>European Council</td>
<td>17-18 December 2015; 4 hour discussion of UK proposals</td>
</tr>
<tr>
<td>European Council</td>
<td>18-19 February 2016; deal reached on evening of 19th</td>
</tr>
<tr>
<td>European Council</td>
<td>7 March meeting with Turkish PM on migration</td>
</tr>
<tr>
<td>European Council</td>
<td>17-18 March 2016</td>
</tr>
<tr>
<td>UK local/regional elections</td>
<td>5 May 2016</td>
</tr>
<tr>
<td>EU referendum</td>
<td>23 June 2016</td>
</tr>
<tr>
<td>European Council</td>
<td>23-24 June 2016</td>
</tr>
<tr>
<td>European Council</td>
<td>20-21 October 2016</td>
</tr>
<tr>
<td>European Council</td>
<td>15-16 December 2016</td>
</tr>
<tr>
<td>French presidential elections</td>
<td>April-May 2017</td>
</tr>
<tr>
<td>UK Presidency</td>
<td>2H 2017</td>
</tr>
<tr>
<td>German elections</td>
<td>August-October 2017</td>
</tr>
</tbody>
</table>

...And some key UK dates

<table>
<thead>
<tr>
<th>Some milestones</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Designation of lead campaigns</td>
<td>13 April 2016</td>
</tr>
<tr>
<td>Referendum period starts</td>
<td>15 April 2016</td>
</tr>
<tr>
<td>Obama visit</td>
<td>ca. April 22-25</td>
</tr>
<tr>
<td>TSC hearing on Treasury analysis of Brexit</td>
<td>28 April 2016</td>
</tr>
<tr>
<td>UK local elections, regional elections (including to the Scottish parliament) and London mayoral elections</td>
<td>05 May 2016</td>
</tr>
<tr>
<td>Inflation Report</td>
<td>12 May 2016</td>
</tr>
<tr>
<td>TV debate (BBC, Glasgow)</td>
<td>19 May 2016</td>
</tr>
<tr>
<td>Purdah starts</td>
<td>26 May 2016</td>
</tr>
<tr>
<td>TV debate (BBC)</td>
<td>15 June 2016</td>
</tr>
<tr>
<td>TV debate (BBC, Wembley)</td>
<td>21 June 2016</td>
</tr>
<tr>
<td>Referendum</td>
<td>23 June 2016</td>
</tr>
</tbody>
</table>

Source: Morgan Stanley Research
1. Renegotiation – The February Deal

UK areas of negotiation, set out in a November 10 letter from David Cameron, UK Prime Minister, to Donald Tusk, President of the European Council. Tusk responded in a December 7 letter, indicating that only migration looked a major negotiating challenge. On February 2, Tusk set out draft proposals for the February Council, which Cameron responded to in a February 2 speech and a February 3 statement to the House. The diplomacy and negotiations culminated in a February 19 deal at the European Council.

Dossier 1: Competitiveness

**UK Demands:** The UK welcomes the focus on a single digital market and a Capital Markets Union and the new trade strategy including trade deals with America (TTIP), China, Japan and ASEAN. The UK would like to see a target to cut the regulatory burden on business. The EU should also do more to fulfil its commitment to the free flow of capital, goods and services.

**Deal:** "the relevant EU institutions and the Member States will make all efforts to strengthen the internal market...will take concrete steps towards better regulation, ... lowering administrative burdens and compliance costs on economic operators, especially SMEs, and repealing unnecessary legislation... And the EU will pursue an active and ambitious policy of trade."

Cameron assessment: Good progress - a declaration about completing single markets and setting targets to cut red tape

Dossier 2 - Sovereignty

**UK Demands:** A formal, legally binding and irreversible UK opt-out from the commitment to "ever closer union". Enhance the role of national parliaments, by proposing a new arrangement where groups of national parliaments, acting together, can stop unwanted legislative proposals. The precise threshold of national parliaments required will be a matter for the negotiation. EU's commitments to subsidiarity fully implemented.

**Deal:** "The Treaties allow an evolution towards a deeper degree of integration among the Member States that share such a vision...without this applying to other Member States...It is recognized that the UK...is not committed to further political integration into the EU...[This will be incorporated into the Treaties at the time of their next revision]... Where reasoned opinions...represent more than 55 % of the votes allocated to the national Parliaments...the representatives of the Member States...will discontinue the consideration of the draft legislative act in question..."

Cameron assessment: Good measures - a specific carve-out from "ever-closer union", power for national parliaments to block measures, an annual discussion on sending powers back to states

Dossier 3 - Economic Governance (MS gloss: Protection for Euro-Outs)

**UK Demands:** The UK seeks legally binding principles that safeguard the operation of the EU for all 28 Member States and a safeguard mechanism to ensure these principles are respected and enforced. These principles include: i) The EU has more than one currency; ii) There should be no discrimination and no disadvantage for any business on the basis of the currency of their country; iii) Integrity of Single Market must be protected; iv) Any changes the Eurozone decides to make, such as the creation of a banking union, must be voluntary for non-Euro countries; v) Taxpayers in non-Euro countries not financially liable for operations to support the Eurozone as a currency; vi) Financial stability and supervision remain a competence for national institutions for non-Euro members; vii) Issues that affect all Member States must be decided by all Member States.

**Deal:** Discrimination between euro ins and outs is prohibited. Any difference of treatment must be based on "objective reasons". Legal acts directly linked to the functioning of the euro area are to respect the internal market, not discriminate in trade between member states and respect the "competences, rights and obligations" of euro outs. Euro outs promise not to impede legal acts relating to the functioning of the euro area. Euro area emergency financial stability measures won't be paid for by euro outs. Financial stability measures (including macro pru) are a matter for euro-outs own authorities - subject to respecting the common rulebook on the single market in financial services.

Cameron assessment: Proper recognition that you can have more than one currency in the European Union, a set of principles to implement this - no disadvantage no discrimination, no eurozone costs for non-eurozone members - and a safeguard mechanism - elevation to heads of state.

Dossier 4 - Immigration

**UK Demands:** Restricting access to welfare and services for EU migrants - for instance requiring a minimum four year period of residence before EU migrants can claim entitlement to certain benefits- in the hope that this may reduce the inflow. When new countries are admitted to the EU, free movement will not apply until their economies have converged with existing member states.

**Deal:** Child benefit indexed to the standard of living where the child resides for new migrants from deal coming into force and for existing migrants from 2020; 2) A 7 year "emergency brake" which restricts migrant access to benefits for 4 years, and will be enacted from the deal coming into force. Also restrictions on sham marriages and suspected terrorists.

Cameron assessment: A very big change, a strong and powerful package - an emergency brake allowing the UK not to pay in-work benefits in full for four years, as well as paying child benefit at local rates, plus measures to crack down on immigration through sham marriages

Source: Prime Minister’s Office, European Council, Morgan Stanley Research. Colour indicates an MS “traffic light” assessment of the relative difficulty of achieving UK negotiating objectives, ranging from green (easy) to yellow (more difficult) to red (most difficult).
1. Key issue: Migration

UK is middle of the pack – and similar to France and Germany – in stock of both EU and non-EU migrants

EU net migration still lower than non-EU migration, but rising

Immigration seen as a top 3 "issue of concern" to the country


Source: ONS, Morgan Stanley Research

Source: Yougov
1. Key issue: Migration

Since the May 04 enlargement, EU migration has accounted for half of the UK’s additional 3 mn jobs.

EU migrants, particularly from Eastern Europe, have high employment rates.

Restrictions on migrants may prove key to the Brexit debate, based on poll done pre-deal.

Source: ONS, Morgan Stanley Research
1. Assessment of Deal - “Thin Gruel” vs “Best of Both Worlds”

**MS Assessment** – A strengthening of the UK’s special status, with competitiveness and sovereignty changes largely presentational, and economic governance and immigration changes more substantive

<table>
<thead>
<tr>
<th>The Dossiers</th>
<th>Importance for referendum</th>
<th>Easy to Negotiate?</th>
<th>Material Change?</th>
<th>Impact on vote for &quot;Remain&quot;</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Competitiveness</td>
<td>Low</td>
<td>Yes</td>
<td>No</td>
<td>Mild positive</td>
</tr>
<tr>
<td>2. Sovereignty</td>
<td>Medium</td>
<td>No</td>
<td>No</td>
<td>Mild positive</td>
</tr>
<tr>
<td>3. Economic Governance</td>
<td>Medium</td>
<td>In some respects</td>
<td>Yes</td>
<td>Positive</td>
</tr>
<tr>
<td>4. Immigration</td>
<td>High</td>
<td>No</td>
<td>Yes</td>
<td>Unclear</td>
</tr>
</tbody>
</table>

Source: Morgan Stanley Research. Colour indicates an MS “traffic light” assessment, ranging from green (easy/positive) to yellow (mixed) to red (difficult/negative).

**Leave campaigners:** argue that the deal is “thin gruel” with no meaningful reform or repatriation of powers to the UK

The 'Best of Both Worlds' argument will be deployed in the Remain campaign

**Source:** PM’s statement after European Council meeting, 19 February, No. 10 Downing Street

“...I believe it is enough for me to recommend that the United Kingdom remain in the European Union... Our plan for Europe gives us the best of both worlds. It underlines our special status through which we will be in the parts of Europe that work for us, ... but we will be out of the parts of Europe that don’t work for us. ...I believe we are stronger, safer and better off inside this reformed European Union. And that is why I will be campaigning with all my heart and soul to persuade the British people to remain in the… European Union.”

Source: PM’s statement after European Council meeting, 19 February, No. 10 Downing Street
2. Referendum: State of Public Opinion

Internet polls roughly 50-50

Source: whatukthinks.org, Morgan Stanley Research, internet polls only

YouGov tracker – a recent shift to remain

Poll Results: % Voting Intentions


Telephone polls have shown a solid lead for remain – but narrowing sharply

Source: whatukthinks.org, Morgan Stanley Research, telephone polls only

Predictive markets little changed – ca. 1/3 risk of Leave

Source: Betfair
2. Referendum: Why Remain is our base case

Our simple referendum tracker

- Telephone Polls
- Internet Polls
- Predictive Markets
- Combined Score, % risk of Leave, rhs

Source: whatukexpectseu.org, Befair, Morgan Stanley Research. As explained inside, we translate the probability of a vote to Leave into a 10 point scale (on the left hand side) for the monthly average score obtained under each predictive technique, and then aggregate across the three high frequency predictive techniques to generate an approximate probability of a vote to Leave (on the right hand side).

“Gold standard” face-to-face polls supported remain

- Do you think that Britain should continue to be a member of the EU or should it withdraw? (BSA2015)
- If there was a referendum on Britain’s membership of the EU, how would you vote? Leave or Stay (BES2015)

6pp+ hidden bias to status quo?


Cameron seemed important to people in deciding how to vote

Source: Ipsos Mori (fieldwork 13-16th February), Morgan Stanley Research. In answer to question: Who will be important to you in deciding how to vote in the referendum on EU membership. Respondents were asked to chose from a list of names.
2. Referendum: Why Leave is not just a tail risk

An unenthusiastic attitude towards the EU compared to peers

Source: In answer to the question "In general, does the EU conjure up for you a very positive, fairly positive, neutral, fairly negative or very negative image?", with the net balance defined as the total positive (= fairly and very positive) minus the total negative (= fairly or very negative). We have not included Luxembourg. Eurobarometer Spring 2015, Morgan Stanley Research

A Eurosceptic trend in UK public opinion over time

Source: British Social Attitudes, Morgan Stanley Research

The British are the least likely to identify as partly European of all the EU nationalities

Source: Eurobarometer, Morgan Stanley Research

Leave has a heavy lead on key issue of concern

Source: ORB, averaged scores from March and April polls. Choices in response to a list of 8 options describing how the respondent intends to use their vote in the referendum
2. Referendum: Potential Pathways to Leave

Pathway 1 – low turnout, and high turnout among Outs

- Positive attitude to the EU
- Turnout in 2015 general election

Remain lead disappears among those certain to vote

Pathway 2 – attitude to Europe had been “soft”; referendum vote may therefore be driven by events

15 referenda have gone against the ‘European’ choice

<table>
<thead>
<tr>
<th>Country</th>
<th>Year</th>
<th>% against</th>
<th>Impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Norway</td>
<td>1972</td>
<td>53.5</td>
<td>Rejected joining the EEC</td>
</tr>
<tr>
<td>Greenland</td>
<td>1981</td>
<td>53.0</td>
<td>Voted to leave the EEC</td>
</tr>
<tr>
<td>Denmark</td>
<td>1992</td>
<td>50.7</td>
<td>Rejected the Treaty of Maastricht, before approving it with opt-outs.</td>
</tr>
<tr>
<td>Switzerland</td>
<td>1992</td>
<td>50.3</td>
<td>Rejected EEA agreement with the EU</td>
</tr>
<tr>
<td>Norway</td>
<td>1994</td>
<td>52.2</td>
<td>Rejected joining the EEC a second time</td>
</tr>
<tr>
<td>Ireland</td>
<td>2001</td>
<td>53.9</td>
<td>Rejected Treaty of Nice</td>
</tr>
<tr>
<td>Switzerland</td>
<td>2001</td>
<td>76.9</td>
<td>Against applying for EU membership</td>
</tr>
<tr>
<td>Denmark</td>
<td>2000</td>
<td>53.2</td>
<td>Rejected joining the euro</td>
</tr>
<tr>
<td>Sweden</td>
<td>2003</td>
<td>56.1</td>
<td>Rejected joining the euro</td>
</tr>
<tr>
<td>France</td>
<td>2005</td>
<td>54.9</td>
<td>Rejected the Treaty establishing a Constitution for Europe</td>
</tr>
<tr>
<td>Netherlands</td>
<td>2005</td>
<td>61.5</td>
<td>Rejected the Treaty establishing a Constitution for Europe</td>
</tr>
<tr>
<td>Ireland</td>
<td>2008</td>
<td>53.2</td>
<td>Rejected the Treaty of Lisbon, before approving it in 2009</td>
</tr>
<tr>
<td>Switzerland</td>
<td>2014</td>
<td>50.3</td>
<td>Rejected free movement of labour</td>
</tr>
<tr>
<td>Denmark</td>
<td>2015</td>
<td>53.1</td>
<td>Rejected lifting Danish opt-out in justice areas</td>
</tr>
<tr>
<td>Netherlands</td>
<td>2016</td>
<td>61.1</td>
<td>Rejected the Ukraine-EU Association Agreement</td>
</tr>
</tbody>
</table>


Source: Eurobarometer Spring 2015, House of Commons Library, Aliyah Dar, Elections: Turnout, July 2013, BBC

Source: Ipsos Mori. Average number identifying as an issue of concern Jan-Oct 2015
2. Referendum: Sources of Uncertainty

Turnout

<table>
<thead>
<tr>
<th>Event</th>
<th>Turnout, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>General election, 2001</td>
<td>60</td>
</tr>
<tr>
<td>General election, 2005</td>
<td>70</td>
</tr>
<tr>
<td>General election, 2010</td>
<td>80</td>
</tr>
<tr>
<td>General election, 2010</td>
<td>80</td>
</tr>
<tr>
<td>General election, 2010</td>
<td>80</td>
</tr>
<tr>
<td>General election, 1997</td>
<td>70</td>
</tr>
<tr>
<td>General election, 1997</td>
<td>70</td>
</tr>
<tr>
<td>General election, 1997</td>
<td>70</td>
</tr>
<tr>
<td>General election, 1983</td>
<td>70</td>
</tr>
<tr>
<td>General election, 1979</td>
<td>70</td>
</tr>
<tr>
<td>EEC referendum, 1975</td>
<td>50</td>
</tr>
</tbody>
</table>

Source: House of Commons, BBC

Number of undecideds is greater than in general elections. Higher if no ‘squeeze question’ asked

Source: Ipsos Mori, Morgan Stanley Research

Is the status quo bias reliable?

Support for Union in Scottish independence referendum
Support for Remain in EU referendum

Has Cameron’s credibility been impaired?

Cameron - net approval

2. Referendum: Who is In and Who is Out

Print media have a Eurosceptical readership

Source: Yougov, Audit Bureau of Circulation (January 2015). Morgan Stanley Research

Northern Ireland and Scotland are clearly pro-EU, elsewhere quite close

Source: Source: Yougov/Times (January 2016), except RTE/BBC N Ireland for Northern Ireland (October 2015)

Government, and many organisations starting to express a view

- Government in favour of Remain
- CBI, TheCityUK are in favour of Remain. BCC are neutral.
- 35 FTSE-100 chief executives signed a letter in support of Remain.
- Some business leaders are in favour of Leave.

Sharp Remain/Leave divisions by age, party and class

Source: Morgan Stanley Research. Graph shows average of four Yougov polls held between February 29 and March 4, following a change in methodology. Number shows net balance of opinion for Remain, excluding don’t knows.
3. Vote to Remain: Political and Economic Impact

Conservative divisions over Europe could prove difficult to heal

Limited Slack Left in Labour Market

Pay growth likely to rise, if growth recovers

Inflation Heading Back above Target – Triggering a First Hike in Feb-17, we think
4. Vote to Leave: Political Impact

The political situation is already somewhat fragile, in our view, since the incumbent government has a narrow majority, voter support appears more volatile, and policy divergence is higher.

In the immediate aftermath of a vote to Leave, the political situation is likely to move faster than the economic relationship with the EU.

There would be risks of:

1) an accelerated change in Prime Minister. This could delay or complicate exit negotiations, especially if the incoming government is more euro-sceptic.

2) another Scottish independence referendum.

Fragmented politics: challenger parties doubled their vote share to 25% in 2015

Background fragility: a slim parliamentary majority

By-elections could erode the Conservatives’ majority of 12 by the end of the Parliament

Source: www.politicsresourcess.net, BBC, Morgan Stanley Research

Source: The Guardian, Morgan Stanley Research

Source: Houses of Parliament
4. Vote to Leave: Political Risk (1) – Divided Government, Accelerated Succession

**Conservatives are split over Europe**

Source: Average of five recent internet polls after the referendum date announced (ICM, 29th February and 6th March, Yougov, 1st, 2nd, 3rd March), whatukthinks.org, Conservative MPs from BBC, Morgan Stanley Research

**Widespread Euroscepticism among Tory MPs**

<table>
<thead>
<tr>
<th>Stance</th>
<th>Cabinet</th>
<th>Frontbench</th>
<th>Backbench</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firmly In</td>
<td>0</td>
<td>6</td>
<td>8</td>
</tr>
<tr>
<td>In leaning</td>
<td>4</td>
<td>16</td>
<td>24</td>
</tr>
<tr>
<td>Swing voter</td>
<td>12</td>
<td>46</td>
<td>145</td>
</tr>
<tr>
<td>Out leaning</td>
<td>5</td>
<td>2</td>
<td>40</td>
</tr>
<tr>
<td>Firmly Out</td>
<td>0</td>
<td>0</td>
<td>22</td>
</tr>
<tr>
<td>Total</td>
<td>21</td>
<td>70</td>
<td>239</td>
</tr>
</tbody>
</table>

33 MPs were founding members or officials of Conservatives for Britain; 37 Tory MPs rebelled over the purdah rules on the EU referendum bill; 6 Ministers attending Cabinet (20%) and ~140 MPs (40%) are for Leave.

Source: Open Europe October 2 2015, ConservativesforBritain.org, Morgan Stanley Research

**Boris goes for Out**

“There is only one way to get the change we need, and that is to vote to go, because all EU history shows that they only really listen to a population when it says No. The fundamental problem remains: that they have an ideal that we do not share. They want to create a truly federal union, *e pluribus unum*, when most British people do not.

It is time to seek a new relationship, in which we manage to extricate ourselves from most of the supranational elements. We will hear a lot in the coming weeks about the risks of this option; the risk to the economy, the risk to the City of London, and so on; and though those risks cannot be entirely dismissed, I think they are likely to be exaggerated.”…

“This is a once-in-a-lifetime chance to vote for real change in Britain’s relations with Europe. This is the only opportunity we will ever have to show that we care about self-rule. A vote to Remain will be taken in Brussels as a green light for more federalism, and for the erosion of democracy.”

Source: Johnson, *Daily Telegraph*, 21 February 2016, Morgan Stanley Research
4. Vote to Leave: Political Risk (2) – Scottish independence

**SNP continues to dominate Scottish politics**

Scotland’s First Minister (and SNP leader) Sturgeon has laid down a marker

“If you try to take Scotland out of the EU against our democratic wishes, you will be breaching the terms of last year’s vote...In those circumstances, you may well find that the demand for a second independence referendum is unstoppable.”

Nicola Sturgeon, SNP Conference, 15 October 2015

**Scotland appears materially more pro-European than England**

Scottish public opinion remains finely balanced between supporters of the Union and supporters of independence

Source: University of Edinburgh, Morgan Stanley Research

Source: Yougov, Morgan Stanley Research

Source: What Scotland Thinks, Morgan Stanley Research. Note: *Don't knows removed **In months where a number of polls occurred, we have attempted to equally space out the polls for presentational purposes

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**How would you vote in the Scottish Independence Referendum If Held Now? **

- Yes (= in favour of independence)
- No

Source: Yougov, October 13 2015

Source: Yougov, February 4 2016
5. Vote to Leave: Economic Impact – Opinion Divided?

- Near-term impact would be lower investment (and consumption) given a protracted period of uncertainty as exit negotiations could take years.
- Economic sources of uncertainty include the wide range of economist estimates about the impact, and uncertainty about the eventual trading relationship with the EU. To some extent, different economic estimates can be boiled down to: Does the UK turn inward or outward?
- The costs of exit look more concrete and near term to us than the potential benefits.

Mix of economic views on the impact

Different economists focus on different impacts

<table>
<thead>
<tr>
<th>Some Costs of EU Exit</th>
<th>Some Benefits of EU Exit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Exit shock</td>
<td>A. Greater stability</td>
</tr>
<tr>
<td>2. Protracted exit uncertainty</td>
<td>B. Greater policy sovereignty</td>
</tr>
<tr>
<td>3. Reduced market access</td>
<td>C. Reduced Trade diversion</td>
</tr>
<tr>
<td>4. Lower investment inflows</td>
<td>D. Fiscal saving</td>
</tr>
<tr>
<td>5. Lower labour inflows</td>
<td>E. Lower food prices</td>
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<tr>
<td>6. Financial sector shrinkage</td>
<td>F. Reduced redtape</td>
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Source: Morgan Stanley Research. For full notes relating to this chart, see ‘A Close Call’, November 2015
5. Vote to Leave: Economic Impact: The UK’s Most Important Trading Relationship

EU important for UK exporters

UK Exports Breakdown (2014), % of Total

Source: ONS, Morgan Stanley Research

Share of UK exports going to EU has declined over time, but remains large

Source: ONS, Morgan Stanley Research

Europe – the largest destination for outbound FDI

UK Direct Investment Assets by region, %

Source: ONS, Morgan Stanley Research

Europe – the largest origin of inward FDI

UK Direct Investment Liabilities by region, %

Source: ONS, Morgan Stanley Research
5. Vote to Leave: Economic Impact: “A Leap in the Dark?”, aka post-Brexit trading relationship with the EU

**Sovereignty for market access**: We see a complex tradeoff after a vote to Leave between the economics (which would tend to favour minimal change to current trading arrangements and maintain market access), and the politics (which is likely to be concerned with protecting UK sovereignty and reducing migration, even at the cost of market access, on the UK side, and, from the EU side, with avoiding a deal that might encourage others to follow the UK precedent. Financial stability/regulation concerns will likely also be important in EU decision on granting access for UK financial services firms. On balance we think the post-Brexit trading relationship with the EU is likely to be less favourable.

Source: Morgan Stanley Research
5. Vote to Leave: Economic Impact: Will the Surplus Persuade the EU to be ‘Reasonable’?

**EU has a £104bn current account surplus (1.0% of EU GDP) with the UK**

Breakdown of UK’s current account balance with the EU, GBP mlns

But the deficit is concentrated with core EU…

... And many have limited trade exposure to the UK

Source: ONS, Morgan Stanley Research. 2014 Pink Book data, in £ bn

Source: ONS, Morgan Stanley Research

Source: IMF, Morgan Stanley
5. Vote to Leave: Economic Impact: Exit process - uncertainties

Article 50, Lisbon Treaty – the exit process

"A Member State which decides to withdraw shall notify the European Council of its intention. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union. … It shall be concluded on behalf of the Union by the Council, acting by a qualified majority, after obtaining the consent of the European Parliament.

The Treaties shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the notification referred to in paragraph 2, unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period.

…the member of the European Council or of the Council representing the withdrawing Member State shall not participate in the discussions of the European Council or Council or in decisions concerning it.”

Key uncertainties

For UK side:
1. When to notify the European Council and start the 2-year negotiation period
2. How rapidly to complete the negotiations

For EU side:
1. To what extent to cooperate (minimising disruption) or not (to reduce “unravelling” risk of Brexit being a precedent)
2. Whether to extend the negotiation period after 2 years

82% of UK exports could face increased barriers

- UK exports to EU
- UK exports covered by existing EU external trade agreements
- UK exports which would be covered EU external trade agreements in process
- UK exports not covered by current or prospective EU trade agreements

82% of UK exports could face increased barriers

Source: Morgan Stanley Research

Duration of major EU negotiations has tended to grow

5. Vote to Leave: Economic Impact: Negotiating Advantage with the EU?

WTO tariffs cap downside on goods exports

Source: WTO, Tariff Profiles 2014, Morgan Stanley Research. Most Favoured Nation (MFN) status is the trading relationship that applies to all WTO members when trading with another WTO member, and who have not agreed with each other another and more advantageous trade agreement, such as a customs union or free trade agreement.

Services a growing proportion of UK exports

Source: ONS

UK specialised in services

Source: OECD

Finance: The UK’s large financial and business services sector might be at risk

Source: Eurostat, Morgan Stanley Research. For business services we have used ‘Professional, Scientific & Technical Activities’
5. Vote to Leave: Economic Impact: Longer Term, Reduced Inflows of Capital and Labour

Investment: UK the FDI leader in the EU

- Source: OECD

Migration: We would assume lower labour inflows

- Source: ONS

Investment: But only recently became the top FDI hub

- Source: OECD

Migration: Migrants averaged 15% of employees, ranging from 11-22% in 2011 census

- Source: ONS, 2011 Census.
5. Vote to Leave: Economic Impact: Some Benefits of Exit

UK net contribution to EU has averaged 0.3% of GDP since the UK joined the EU in 1973

But UK may still pay contributions if it exits the EU. Estimated UK, Swiss and Norwegian net contributions to the EU, % of GDP

Lower food prices – but CAP reform has materially reduced the EU food price “gap” to market prices


Source: Estimated by Morgan Stanley research based on data provided by Norwegian mission to the EU, by the Swiss paper Tagesanzeiger HMT, EU, Morgan Stanley Research.

Source: OECD Agricultural Support Data. Consumer Support Estimate is an estimate of the transfer to farmers (producers) from consumers. Morgan Stanley Research.
5. Vote to Leave: Economic Impact: Limited Scope for Gains from Deregulation

Relative UK performance has improved since the 1973 accession

Average GDP growth, %

Source: Statistisches Bundesamt, INSEE, ONS, Datastream, Haver Analytics, Morgan Stanley Research

Moving up the ease of doing business rankings

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Source: World Bank, Ease of Doing Business

UK has “some of the most flexible labour markets in the G7” according to Governor Carney

Low levels of product market regulation

Protection of permanent workers against individual and collective dismissals

Source: OECD Employment Protection Legislation

Low levels of product market regulation*

Source: OECD (2013), Product Market Regulation Database
5. Vote to Leave: Cumulative Economic Impact

- **Initial Negotiations**
  - Modest impact, mainly though a drag on investment
  - UK economy continues to do well

- **Campaign Volatility**
  - Referendum approaches, outcome unclear:
    - Broad impact on asset prices, confidence & investment
    - Volatility rises with risk of an 'Out' vote

- **Referendum shock**
  - The day after a vote to exit:
    - Profound uncertainty & market sell-off
    - Hit to confidence & investment
    - Official reaction, including halting rate rises

- **Protracted Uncertainty**
  - After actual exit:
    - Political & economic uncertainty lasting several years
    - Initially, monetary policy likely to stay on hold and fiscal policy to ease

- **New Equilibrium: Slower - but More Stable?**
  - Reduced inflows of labour and capital slow growth
  - Reduced exposure to external factors
  - But lower labour supply may mean faster rate hikes

Source: Morgan Stanley Research
6. Overview: UK Scenarios

Base, ‘medium stress’ and ‘high stress’ scenarios

- In our **base case** (60% probability), there is a close contest – leading to substantial uncertainty, a growth slowdown and higher financial market volatility – but ultimately a vote to remain, triggering a relief rally and subsequent growth pick-up:
  - **GDP growth**: 1.7% (2016); 2.3% (2017)
  - **Inflation**: 0.7% (2016); 1.7% (2017)
  - **Monetary policy**: 0.5% (end-2016); 1.00 (end-2017)

- In our **Leave base case**, the UK votes to Leave the EU, there is a further reaction in markets and uncertainty is higher. Resilience of domestic demand just keeps the UK out of recession:
  - **GDP**: Cumulative hit of 1.5pp spread over 2016 and 2017 (compared to a no referendum scenario)
  - **Inflation**: Pushed above target by a weaker GBP
  - **Monetary policy**: On hold over our forecast horizon, but with a higher risk of easing.

- In our **Leave bear case**, the effects of a vote to Leave are compounded by worse feedback effects in the rest of Europe and an additional shock to financial conditions:
  - **GDP**: Cumulative hit to GDP over our forecast horizon of a bit more than 2.5pp.

Our assumption is that, at least for a while, potential growth in the UK would move closer to 1.5% a year from a little above 2% currently:

- **Trade**: We expect that after Brexit, the UK would have a significantly worse level of access to EU markets.
- **Investment**: Weaker investment would have a lingering effect on the capital stock and could damage productivity growth.
- **Migration**: We assume a vote to Leave would lead to a tightening of immigration controls.
### 6. Overview: Impact of Brexit on the rest of Europe

#### Sizeable Negative Effects in Brexit Scenarios

Impact of Brexit on GDP Growth Dev. from Base (pp)

![Graph showing impact of Brexit on GDP growth](image)

**Medium Stress Scenario**

- Eurozone: -1.2%
- CEE: -1.6%
- UK: -2.0%

**High Stress Scenario**

- Eurozone: -2.0%
- CEE: -2.5%
- UK: -3.0%

Source: Morgan Stanley Research estimates

#### EU Exit Risk Monitor

Our European economics team think that the likelihood of any other country exiting the EU following Brexit is very unlikely, but the market may see contagion risk

<table>
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<th>Country</th>
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<th>Gov’t Debt Held by Non-Residents</th>
<th>Trading with Non-EU Countries</th>
<th>Net Payments to Other EU Countries</th>
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Source: European Commission Eurobarometer 84, Autumn 2015, QD2.1 (Not Feeling an EU Citizen); Eurostat, HM Treasury and Danmarks Nationalbank (Government Debt Held by Non-Residents); Eurostat (Trading with Non-EU Countries); European Commission (Net Payments to Other Countries); Morgan Stanley Research (Eurosceptic parties)
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