Analysis

What would Brexit mean for the financial markets?

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On 23 June 2016, the United Kingdom will hold a referendum on whether to remain in or leave the European Union. Opinion polls suggest the outcome of the vote is uncertain. Given that no country has yet left the EU, there are no experiences of the consequences of exit to draw on. The economic implications will largely depend on the arrangements for economic relations between the EU and the UK. However, the risk of the UK leaving the EU has already pushed down the exchange rate of the pound. The status of the City of London as an international financial centre would probably weaken, and some financial actors might relocate to the euro area.



A Member State may withdraw from the EU simply by notification. Unless otherwise agreed, the withdrawal will take effect two years from the notification.[1] There is no experience of the consequences of such withdrawal. When Greenland left the European Economic Community in 1985 and Algeria upon gaining independence in 1962, neither were actual Member States of the Community, and the EU in its present form did not exist at that time.

The UK does not rank among the most integrated EU Member States, which is likely to mitigate the impact of exit. The country does not participate in Schengen, the euro area or the TARGET2 payment system for central banks. In fact, the status of the UK upon leaving the EU is still unclear. If the country were to become a member of the European Economic Area (EEA) and EFTA, like Norway and Iceland, the effects could be limited. However, more substantial consequences would ensue if the EU and the UK were only to form a loose customs union. In the extreme case, EU-UK trade would be subject to the rules of the World Trade Organisation (WTO).

The Bank of England has estimated that leaving the EU would erode the UK's economic growth potential.[2] Both an analysis[3] by the HM Treasury and a report[4] commissioned by the Confederation of British Industries (CBI) find that leaving the EU would have strong adverse implications for the UK economy, even more so if the country were also to be outside the EEA.

If the key conclusions are correct, many UK bond issuers would probably be facing a downgrade.

The credit derivatives market has already incorporated the higher risk in UK government bonds in their price setting. A fall in bond prices would lower the capital adequacy of many banks both in and outside the UK, which could reduce credit supply. In addition, the creditworthiness of UK banks would be likely to suffer, and the UK's long-standing current account deficit would certainly not ease the situation.

Considering that expectations are reflected in foreign exchange rates, the exchange rates of the pound against other currencies could change substantially. On 17 March, the Monetary Policy Committee of the Bank of England assessed that the recent depreciation of the pound was partly related to the risks associated with the referendum, although no effects on asset prices or risk premia were discernible.

The City of London is one of the most important financial centres in the world. All banks authorised by an EU or other EEA Member State may establish a branch in London or anywhere else within the EEA on the basis of their domestic authorisation. Similarly, authorisation granted in one EEA Member State gives the bank the right to provide financial services to other EEA Member States on a cross-border basis without establishing a branch. Many US and Swiss banks have gained access to the EU market from London on the basis of a UK authorisation. This practice may end if the UK were also to stand outside the EEA. Financial actors based in London provide many important services, including central counterparty services,[5] for customers resident in other EU Member States.

A report[6] published by Deutsche Bank argues that it is not in the interests of the EU to negotiate a deal with the UK that would offer a Member State extensive benefits upon leaving, as this could encourage other countries to follow suit. For example, access to the Single Market for Financial Services could be denied upon exit. Many other EU Member States would be happy to welcome high-earning financial professionals into their country as taxpayers. For example, when interviewed for radio on 15 February, the Chairman of the Board at the bank HSBC, Douglas Flint hinted at the possibility of relocating around 1,000 jobs to the Paris-based subsidiary in the event of the UK leaving the EU.

Winding down operations in one location and starting up operations to replace them elsewhere would not be a simple exercise. In the process of transition, errors could be made that could cause interruptions to business and major losses not only for the relocating businesses but also for their customers and other stakeholders. Some turnover of staff would be likely to occur, which would increase these operational risks.

Brexit would require legislative reform in the UK, at EU level and in the remaining EU Member States. Many legal acts have been drafted under the assumption of UK membership. The

Directives include explicit references, for example to national derogations, while the assumption of UK membership may be more implicit in many national and EU regulations. The necessary legislative changes would consume resources needed for other supervisory and regulatory developments.[7]

Notes

1. Article 50 of the Treaty on European Union. ↑
2. EU Membership and the Bank of England (October 2015). ↑
3. HM Treasury analysis: The long-term economic impact of EU membership and its alternatives (April 2016). ↑
4. PricewaterhouseCoopers (March 2016) Leaving the EU, Implications for the UK Economy. ↑
5. For more details on central counterparty services, see the forthcoming article 'Central counterparties can both prevent and cause risk' by Kasperi Korpinen, www.bofbulletin.fi. ↑
6. Brexit update: the days ahead and what chances a good UK deal? (14 April 2016). ↑
7. Association for Financial Markets in Europe (2016): The UK Referendum – challenges for Europe's capital markets. p. 36–57. ↑

Keywords

Brexit, EU membership, referendum, United Kingdom