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Thoughts on the Imminent Brexit Referendum

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On June 23, the United Kingdom (U.K.) will hold a referendum on its continued membership in the European Union (EU). The vote will be the first regarding Britain's membership to the EU since 1975. Since the referendum is non-binding, it is unclear if and when the U.K. would exit the EU if the "leave" camp prevails. However, Article 50 of the Lisbon Treaty sets out that a member state has the right to withdraw from the union, and once it notifies the European Council of its intention, the state must negotiate and conclude an agreement setting out the arrangements for its withdrawal, while taking into account the framework for its future relationship with the union.
The potential outcome of the vote and the legal framework in which it takes place creates many uncertainties. Would the British government move immediately to invoke Article 50? Or would the government instead use the referendum result as a negotiating tool with the EU? If the "remain" side wins the referendum, will the decision put the uncertainty over the U.K.'s membership in the EU to rest? What if the vote is close? If Article 50 is invoked, how long would it take for the U.K. to negotiate an exit?

In very big picture terms, Britain's exit from the EU would be a move toward isolationism, a shift away from globalization, and a negative for regional trade and global growth. The U.K. appears to have the most to lose, at least in the short term, owing to the large scale of its exports flowing to Europe. Only a small fraction of Europe's exports flow into the U.K., which leaves the U.K. in a bad negotiating position in terms of any new relationship with the EU. Negotiation over the structure of a future framework to define their relationship would be very long and the end point is uncertain.

In the interim, it is likely that direct investment would flow out of the U.K., as businesses relocate to other EU members in order to retain access to this market. Presumably weakness in the pound sterling would act to bolster competitiveness of British exports and new markets could be discovered. But all this would take time and take place against a background of meager global growth.

The longer-term consequences could be very negative for Europe. A "Brexit" could trigger a wave of countries in the European Monetary Union to consider exiting as well. The breakaway of a member of the monetary union would effectively end the European unification project, call the foundation of the euro into doubt, and possibly trigger an investor revolt against peripheral European debt that could fall under the suspicion of leaving the union. It is probable that investors would move quickly to assess which countries might be part of any new currency blocs that could conceivably form in the aftermath of more defections.

Regardless of which side wins the June 23rd vote, the British people have voiced their dissatisfaction with Brussels's economic and immigration policies. The EU bureaucrats must heed warnings seriously; deep reforms are needed in order to maintain the long-term survival of the economic union. Ignoring member countries' grievances and complaints could eventually fracture this important economic and political union.

The overall economic consequence of a "Brexit" seems negative for global growth, arguably a positive for global fixed income, especially safe-haven bonds such as U.S. Treasurys, German Bunds and Japanese Government Bonds. However, implications for sovereign bond yields as well as foreign exchange rates would be extremely idiosyncratic in nature. In general, the "Brexit" is a risk-off event that could hurt risk assets including stocks, corporates, and emerging market assets. Nevertheless, it is also true that in the event of a "Brexit," central bank policy would have to stay ultra-easy for much longer than it would otherwise be.

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