

Brexit: Why the 23rd June Referendum is just the beginning

Mushtaq Khan, June 14, 2016

Introduction

For outside observers who are unfamiliar with Britain's relationship with the EU, there is some confusion about 2 specific issues: (1) why any country would want to leave the largest and most integrated common market in the world; and (2) why the *Remain* lead has narrowed so much (and even perhaps reversed) despite the clear urging by global leaders and major institutions (e.g. the IMF, World Bank, the OECD; etc.) that Britain should remain within the EU.

Trade blocks are increasingly important in global commerce; EU membership is sought after (e.g. Turkey); Britain maintains a seat at the EU Council; and it has become *the* global financial center partially because of its EU membership, and yet it seeks to leave despite being allowed to retain its own currency and monetary policy. It almost appears regressive to want to leave the EU.

Britain's on-off relationship with Europe

The issue of whether to stay within or leave the European Economic Community (EEC); the European Community (EC); or the more recent iteration – the European Union (EU), has been divisive since the late 1950s. Some observers claim that unlike the US or the other powerhouses in mainland Europe, British politics does not operate along a leftwing-rightwing political dimension, but in a stay-leave conundrum that changes with time.

This awkward relationship with Europe can be traced to Britain's history with mainland Europe in the 20th century, and its media that reminds the Europeans of this past. It could also be driven by Britain's colonial past, where it was more comfortable giving orders than following them; or the fact that it was not one of the 6 founding members of the Treaty of Rome in 1957; or the fact that when Britain did decide to join the EEC in the early 1960s, it was twice vetoed by France.

It is interesting to note that even the dominant Labor and Conservative parties are split on the EU issue. Since the ruling Conservative party is divided on Brexit (Cameron is for *Remain*, but Boris Johnson is championing to *Leave*), it has decided to remain neutral as a party. Although Labor's leadership is largely in favor of *Remain*, prominent Labor MPs disagree as grass-root support is shifting to *Leave*. The UK Independent Party (UKIP) is strongly for *Leave*, but the Scottish National Party (SNP) is equally strong in favor of *Remain*. In our view, this referendum will be decided by the people, without much influence by politicians.¹ Some would argue that Brexit is really about retaining a level of "Britishness" in British society.

Despite this confusion, some broad generalizations can be made. Big businesses in Britain are largely in favor of staying in the EU, while small-and-medium size enterprises (SMEs) find the regulatory structure too rigid for their smooth operation. People who are more affluent tend to support remaining in the EU (especially property owners), while the middle class are perhaps threatened by the open immigration policy for EU countries (especially the Turkey issue).

¹One could argue that as global leaders and institutions have entered into the debate (more later), the British public is getting increasingly suspicious about this interference, which may be pushing them to lean towards *Leave*. This does seem to prove that the global status quo (which supports the British status quo) is trying hard to influence the Referendum.

Issues

For the most part, British media attention on Brexit has focused on economic issues like: (1) the cost of EU membership (what the UK gives Brussels, and what it gets back); (2) energy and environment (EU climate standards are tougher, but retail energy costs are lower with membership); (3) agri & fishing (membership allows for subsidies to UK farmers, but hurts fishing activities); (4) immigration (blue-collar EU workers displace British workers and allegedly overstretch the welfare system; *Remain* advocates claim that immigrants pay more in taxes than they receive); (5) security (both sides claim this as a strength); (6) existing trade agreements (EU supporters paint a dire picture for British trade flows and resulting unemployment if the UK decides to *Leave*); (7) pay & work conditions (both sides claim this as a strength); (8) global clout (both sides claim this as a strength); and (9) the manner in which Brussels complicates decision-making, which means Britain's economic policies cannot quickly respond to the country's needs.

What is not discussed as openly, are issues like the anxiety created by fresh immigrants entering Britain; how EU-membership may have created a divide between *haves* and *have-nots*; how the EU is perhaps undermining British SMEs; and how EU integration has arguably skewed the UK economy to favor global banks, high-end retail outlets and services, and the property market in London (see **Table 1**). A glaring omission in the public debate, is whether the EU model *as it stands*, is sustainable. The fiscal austerity imposed on Greece to resolve its debt overhang; Iceland's banking crisis in late 2008; and the over-investment in real estate in Portugal and Spain, highlight how the lack of fiscal coordination (amongst EU members) undermines the sustainability of EU's single currency model.

Despite this omission, public sentiments regarding Brexit have focused on the growing perception that EU membership is really about the difference between those who are affluent, and those who are not. The preference of affluent foreigners to purchase property in London, is perhaps influencing the debate, as EU membership allows these foreigners to reside in Britain, after they have effectively bought residency rights in less vibrant EU countries. Unfortunately, the focus on immigration that is being used to push towards *Leave*, does not give due credit to the role of multiculturalism in the British experience, which has set a global example for inclusivity.

Changes in the UK economy:

As shown in **Table 1**, the UK economy has shifted heavily towards services, with a specific focus on banking, professional services and real estate activities.² Since the sub-prime crisis in 2008, the value addition by banks has been overshadowed by real estate, which is not directly related to the health of the British economy. It is a stylized fact that affluent foreigners from Russia, China, the Sub-Continent, Africa and the GCC, have specifically invested in residential and commercial properties in London, driving up prices. This has impacted the traditional flavor of British entrepreneurship, as businesses (shops and services) adapt to the new reality, especially

Table 1: UK GDP (% of total)	1990	2014
Agriculture, Forestry & Fishing	1.48	0.69
Industry, incl. Energy	24.02	14.75
Construction	7.53	6.19
Distributive Trade, Repairs, Transport, Accommodation & Food Services	19.51	18.24
Information & Communication	5.11	6.18
Financial & Insurance Activities	5.95	7.93
Real Estate Activities	6.37	11.24
Prof, Scientific, Technical, Admin & Support Service	8.65	12.21
Public Admin, Social Security, Education & Health	18.45	18.21
Other Service Activities	2.95	4.36

² Look at Finance, Insurance, Real Estate; professional/technical services; and Other Services.

in London. In gauging the Brexit vote, one cannot ignore how this potentially impacts those Britons who have been marginalized in this rarefied world.

The public reaction to multiculturalism does not get much media coverage, as it is an awkward issue. Perhaps this silence implies that media discussions on Brexit effectively miss the point- namely, the role of foreigners in driving the British economy. Although Britain has fared better than other European economies since 2008, as shown in **Table 1**, this growth has not been broad-based. The shift to the right in European politics could influence how British voters are likely to approach the Brexit vote. Hence, despite growing pressure from external players to Remain, the popular vote is moving increasingly towards Leave.

Bad timing

British skepticism towards Europe has gained traction in recent times. This can be traced to Britain's more optimistic economic outlook compared to the EU; its ability to better manage immigrant populations compared to mainland Europe; the fact that the burden created by Syrian (and other) refugees is creating fissures in the EU's political unity; and the fact that ISIS is using Iraq and Syria, to specifically target Western European countries during this period of political intolerance.

In effect, the timing for tapping British sentiments about their European identity could hardly be worse. Given its decisive role during WW2, many native Britons view their role in saving Europe from fascism, with a great deal of national pride. In some ways, the arguments aired in the British media are too broad (e.g. Britain's role in the global order; whether Britain is too open; or whether Westminster has the final say in how Britain evolves), and need to be narrowly focused by the simple question: should Britain lock-in its future with the EU's uncertain outlook?

Foreigners weigh in

It is the potential spillover from Brexit that US and European leaders are so concerned about.³ This extends to global institutions that should remain apolitical, but have decided to weigh in to influence a political decision the citizens of Britain alone should be making.⁴ Even as the model for neutrality and market etiquette, the Bank of England's Governor recently stated: "A vote to leave the EU could have material economic effects – on the exchange rate, on demand and on the economy's supply potential – that could affect the appropriate setting of monetary policy." (The Guardian, 12 May 2016). He went on to warn that Brexit would trigger a recession in Britain.

In our view, it is the manner in which these leaders and institutions have spoken out, that suggests there is more riding on this issue than just the preference of British citizens. If the Brexit vote is viewed as a shift away from multiculturalism, it could be construed as reflecting the growing xenophobia in mainland Europe. In some ways, Britain is unique in the global order: the British Empire did more than any other

³ The statements made are revealing:

David Cameron: "On 23rd June, nothing less than the future of our country is at stake. A vote to leave is the gamble of the century. And it would be our children's futures on the table if we were to roll the dice." (27 February 2016, The Telegraph);

Barack Obama: "[If it opts to leave] The UK is going to be in the back of the queue." (22 April 2016, The Guardian);

Angela Merkel: "I've said repeatedly before that I personally would hope and wish for the UK to stay part and parcel of the EU." (2 June 2016, The Independent).

IMF Chief Economist: "A Brexit could do severe regional and global damage by disrupting established trading relationships." (12 April 2016, The Guardian);

World Bank President: "There's no question that for us, the threat of Brexit is one of the biggest risks we face." (23 May 2016);

Secretary General, OECD: "The UK is much stronger as a part of Europe, and Europe is much stronger with the UK as a driving force... There is no upside for the UK in Brexit." (27 April 2016, The Guardian).

in influencing the evolution of the non-Anglo-Saxon world.⁵ In effect, if Britain is perceived as turning its back on multiculturalism, this could create a domino effect towards introversion, which could be viewed as a shift in global power away from the West. More specifically, Brexit could validate isolationist views in Europe and the US, which will unsettle the global status quo.

The US is especially concerned, as it views the EU as an economic/political block that helps it influence global affairs. Most armed interventions by the US since WW2, have been carried out in coalition with Europe to lend credibility to the undertaking. With the rise of China, and Russia reverting to its Cold War tactics, the US is clearly concerned that an introverted and disunited EU, could weaken US hegemony at precisely the time when it is being challenged by both Russia and China.⁶ At the risk of making too strong a point, if the British decide to leave the EU and other members of the EU start looking inward, this could challenge European/Anglo-Saxon domination of the world. With China's *One Belt One Road* foreign policy taking hold, this view cannot be dismissed outright.

It doesn't end on June 23rd

Whichever way the Brexit decision goes, negotiations will follow. This means the Brexit issue will not be decided by June 23rd. Whether the British decide to *Remain* or *Leave*, the real economic impact on Britain and Europe will largely be felt after the negotiations with Brussels (even with Leave, the terms of disengagement will only come into effect after negotiations). Cameron has publically stated that the UK should remain in the EU, but has vowed to negotiate a better deal for his country. This indicates that Conservatives still have concerns about the current arrangement with the EU.

In some ways, Cameron is saddled with more than he bargained for. As a Conservative, his party has often questioned economic integration with Europe, which explains why he promised a public referendum if he were re-elected in 2015. Little did he realize then, that subsequent global developments could shift British sentiments so sharply against the EU. If Britain votes to Leave, two things are likely to happen: (1) a political demand for another Scottish referendum to decide whether Scotland wants to become independent of the UK; and (2) Prime Minister Cameron may have to resign, leaving Boris Johnson as the likely replacement.

Global markets wake up

As of this past week, when polls showed that the Leave camp actually has a lead over Remain, the market has finally realized that Brexit is a distinct possibility. The potential spillovers on EU and the larger global economy have created a sense of panic pretty late in the game – the operative word being late. The market does not know what to react to, and is questioning what exactly will happen after June 23rd (this uncertainty is flushed out in more detail in the next section).

Given the viewpoint of global institutions and banks, markets associate a Leave vote with a weaker British economy, which explains the depreciation of the Sterling, and bearish sentiments in the UK stock market. There is also likely to be a sympathetic impact on the Euro, but it is not likely to be as severe. Global currency markets show a very strong Yen, and gaining strength of the Dollar: this is not surprising as Brexit is directly impacting two of the world's four hard currencies. In our view, global bond and stock markets may not adjust as much as in the UK, as market players do not know what to adjust to. Not

⁵ While the UK is a global player in world affairs, with significant economic and political clout (and an independent hard currency), unlike Germany, France and Italy, it is more than just European – it is considered the most mature and influential pillar of Western culture. That English is the global language of trade and diplomacy, says a great deal.

⁶ Domestically, the issues being debated in the US (courtesy of Donald Trump), could push the US to choose an isolationist path that has always had traditional support within the country.

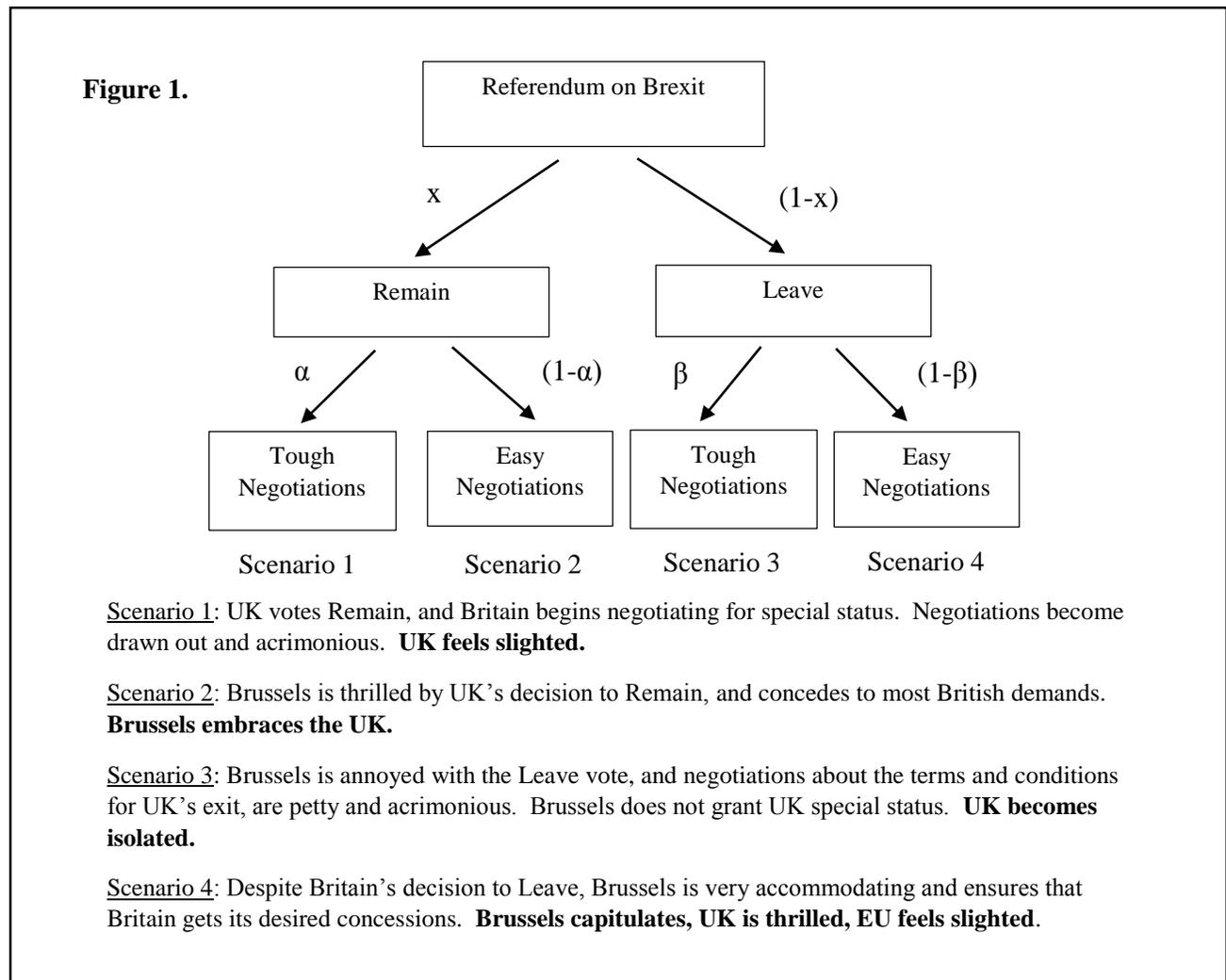
surprisingly, the Fed and Bank of Japan have stated that they will wait and see before deciding how to move forward.

Since the Leave and Remain campaigns will continue aggressively till the day of the vote, the week preceding the vote will see even more market volatility. However, one must realize that more information will only be available once the negotiations start, and the viewpoint of stakeholders and the media are made public. Hence, it is premature to take a view about what is likely to happen. However, one point can be categorically made: irrespective of the Brexit outcome, OECD governments will work closely together to minimize market volatility in global stocks, bonds, and currencies.

Regarding the impact of Brexit on Pakistan's trade flows into the EU or Britain, it is similarly too early to say anything.

The model

In terms of the end result of Brexit, we would propose the following model:



- x is the probability that British voters decide to Remain in the EU;

- If Britain votes Remain, α is the likelihood that the negotiations with Brussels are difficult (from the British perspective) as it seeks *special status* within the EU⁷;
- β is the likelihood that negotiations are difficult (again from a British perspective) after the UK votes to Leave; and
- α and β should be seen as the final assessment by the British after the negotiations are over.

Although the end result of June 23rd will influence the values of α and $\beta \in (0, 1)$, it is also the public's assessment of the ongoing negotiations that will determine these parameters. Balanced negotiations imply that both parameters are 0.5, and easier negotiations are if α and β are less than 0.5 (that is, less than 50%).

There are 4 possible scenarios described in **Figure 1**. We start with the assumption that Brussels would prefer to see a Remain vote as it fortifies the EU. Intuitively, Scenario 1 and 4 are low probability outcomes, as they show either Brussels being tough when it gets a positive result, or being easy when it gets a negative result. More simply, these outcomes are *unstable*.

If the UK feels slighted as negotiations get bogged down (Scenario 1), it is not unreasonable to assume that public pressure within the UK could push for another more decisive referendum to effectively leave the EU. On the flipside, if the UK opts to leave, but Brussels is very accommodating and agrees to most British demands, this will almost certainly create a public backlash in mainland Europe, which could incentivize some EU members to seek a similar referendum to secure better terms for their citizens. This is quite likely in countries that are already flirting with rightwing political parties, which have xenophobic views on fresh immigrants, as well as the burden of existing immigrants.

Ignoring the stability of the four scenarios, Scenarios 2 and 4 would be preferred from the perspective of the global status quo (i.e. UK stays within the EU on its terms, or it leaves the EU on comfortable terms that keep the British government close to Europe and the US). However, as stated earlier, the Brexit referendum is about more than how the British will vote; it is also about how this decision will impact other countries in the EU.

Table 2: Probability Distribution				
Event 1: Brussels is Very Biased				
$\alpha=0.2, \beta=0.95$	x=45%	x=49%	x=51%	x=55%
Scenario 1	9.00	9.80	10.20	11.00
Scenario 2	36.00	39.20	40.80	44.00
Scenario 3	52.25	48.45	46.55	42.75
Scenario 4	2.75	2.55	2.45	2.25
Event 2: Brussels is Biased				
$\alpha=0.3, \beta=0.85$	x=45%	x=49%	x=51%	x=55%
Scenario 1	13.50	14.70	15.30	16.50
Scenario 2	31.50	34.30	35.70	38.50
Scenario 3	46.75	43.35	41.65	38.25
Scenario 4	8.25	7.65	7.35	6.75
Event 3: Brussels is Somewhat Biased				
$\alpha=0.4, \beta=0.75$	x=45%	x=49%	x=51%	x=55%
Scenario 1	18.00	19.60	20.40	22.00
Scenario 2	27.00	29.40	30.60	33.00
Scenario 3	41.25	38.25	36.75	33.75
Scenario 4	13.75	12.75	12.25	11.25
Event 4: Brussels is Totally Unbiased				
$\alpha=0.5, \beta=0.5$	x=45%	x=49%	x=51%	x=55%
Scenario 1	22.50	24.50	25.50	27.50
Scenario 2	22.50	24.50	25.50	27.50
Scenario 3	27.50	25.50	24.50	22.50
Scenario 4	27.50	25.50	24.50	22.50
Event 5: Brussels is Bureaucratic and Very Biased				
$\alpha=0.65, \beta=0.95$	x=45%	x=49%	x=51%	x=55%
Scenario 1	29.25	31.85	33.15	35.75
Scenario 2	15.75	17.15	17.85	19.25
Scenario 3	52.25	48.45	46.55	42.75
Scenario 4	2.75	2.55	2.45	2.25

⁷ In some ways, Britain already has a privileged position within the EU. Seeking more concessions could be construed as "First Amongst Equals", which could annoy founding members of the EU. The point to be made, is that post-Referendum negotiations will not be easy.

To get this model to give more concrete results, we assume Brussels will approach the negotiations with a prior bias depending on how the Brexit decision plays out. More simply, negotiations are likely to be easier (friendlier) if the UK decides to *Remain*, and more drawn out if British decide to *Leave*. Hence, we have chosen a probability distribution that reflect this possibility. For example, we assume the referendum is close (say *Leave* is between 45 to 55% of votes, and vice versa); negotiations are *not* tough if UK votes *Remain* (α is 20 to 40% tough); but very tough if they decide to *Leave* (β is 75 to 95% tough). This gives rise to the results shown in **Table 2**.

- If negotiations become tougher (both α and β increase), this raises the probability of an isolated UK.
- If we assume Brussels takes an extreme stance on its negotiations (i.e. **Event 1 & 2**), then the probability of Scenario 2 & 3 is the highest. This is interesting, as Scenario 2 is the first-best from a global status quo perspective (UK remains and negotiations are easy), but also the worst option (UK leaves and negotiations are very tough – Scenario 3).
- If Brussels is more balanced in its negotiations (**Event 3**), the probability of Scenarios 2 and 3 are lower than the above cases (see **Table 2**). The flipside of this, is that the combined probability of Scenario 1 and 4 will increase, which, as we have discussed earlier, are unstable equilibria that could eventually move to Scenario 3 (UK feels slighted and moves towards isolation), or where EU members become frustrated and undertake their own referendums.
- If Brussels is assumed to be inherently bureaucratic, and despite EU instructions to go easy on a Remain vote, it cannot help but annoy the British negotiators (say Brussels penalizes the Leave vote – 95% tough, but is not that easy with Remain – 65% tough, i.e. **Event 5**), then the probability distribution on a close vote to Remain or Leave, is *almost* the same. This means that irrespective of how the UK votes, as long as the margin of difference is very small, the most likely outcome is that the UK moves towards isolation from the EU. Equally disturbing, the probability of a *stable* Remain vote is just higher than 17%.
- From the parameters we have listed, the highest probability of a stable Remain vote is only 44%, and this follows a strong Remain vote (55% vote to remain), and Brussels is the most biased in its negotiations (**Event 1**). By the same token, the lowest probability of a stable Remain vote is less than 16% (**Event 5**).
- If Brussels is totally unbiased in its negotiations (**Event 4**), anything is possible in terms of the probability distribution over the four scenarios – this is irrespective of how the British actually vote.⁸

Conclusion

The primary insight from this assessment, is the Brexit story does not end with the vote itself. Furthermore, the end-game of this decision will not just be shaped by policymakers or the bureaucrats in Brussels. In our view, the following issues are creating a combustible mix in social and mainstream media: (1) the global dynamics created by ISIS; (2) the disunity within the EU following the influx of Syrian refugees (and those fleeing North Africa); (3) the issue of Turkey's inclusion into the EU; (4) the uncertain economic outlook for the EU region; and (5) the growing popularity of rightwing political parties in mainland Europe. These issues are perhaps gaining more traction with the British voter, compared to more analytical economic arguments that had dominated before.⁹

The results of our simplified analysis are equally disturbing. Assuming a path-dependent decision-making process, the British may have the first say in what is likely to happen in Europe, but it will

⁸ Mathematically, this game has only 2 outcomes, and the likelihood of either scenario (leave or stay) is directly reflected by how the referendum goes. As Brussels is unbiased, the possible scenarios are stable.

⁹ In our view, the issue of Turkey's inclusion into the EU and Cameron's pointed attack on Boris Johnson's ambitions to become PM, will further shift the arguments towards a more subjective or emotional debate.

certainly not be the final say. The range of possible outcomes, show that a stable Remain vote is unlikely to be realized. From the model, the most likely outcome is the UK becoming increasingly isolated from the rest of Europe. This may not suit the global status quo, but the combination of socio-political developments in Europe and the Middle East, may prevent a preferred outcome.

In the final analysis, the first step will be taken by the British, to reflect their views about the trajectory of Britain. The growing divide between the *haves* and the *have-nots* should not be ignored, especially by those *haves* who are confident a stable *Remain* vote is in the bag. As much of the Western world is becoming gradually introverted, so are the British. The decision to Leave the EU may not be a vote against multiculturalism, but it could be a vote against the changes in the British economy that increase volatility (and vulnerability), after years of globalization. In our view, Britain's economy has become somewhat lop-sided in favor of the financial sector and high-end services, which cater to rich foreigners (who anecdotally appear to own most of Central London). The resulting change in the cultural landscape in Britain (especially in London) has surely dislocated and alienated many Britons. Perhaps Brexit resonates with these people. Distancing Britain from the EU could be the first step in being more assertive about the changes they seek.

Data Source: UK Office for National Statistics