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UK Economics | EU Referendum

Out into the Unknown

The UK looks like it has voted to leave the EU. We see protracted political and economic uncertainty, leading to a weaker GBP, pushing inflation up, and a hit to growth. In a referendum recession, we expect easier monetary and fiscal policy.

Key consequence - profound and protracted uncertainty: Although the final votes are still being counted, it looks increasingly clear that the UK has voted to leave. Following this vote, we expect a surge in political and economic uncertainty. Initially, we expect the focus to be on the political uncertainty, especially around whether Cameron continues as Prime Minister, and whether the Conservatives can maintain a working majority in parliament. Further down the line, we see a heightened risk of a second Scottish independence referendum. Economically, we see uncertainty regarding the UK's future trading relationship with the EU, its main trading partner, where we see a risk of a significant reduction in market access.

Economic impact - a hit to sterling and demand; a less open and more volatile economy: We think that the uncertainty after a vote to leave will have two immediate effects. First it will hit sterling, as uncertainty reduces non-residents' appetite for UK assets against the background of the UK's record current account deficit. Second, it will hit growth, as firms hold back on investment, and households increase precautionary savings. Longer term, we expect a less open and more volatile economy, with reduced inflows of capital and labour, and a lower rate of potential growth.

Policy response - an easing bias: We think that the MPC will have an easing bias, given the risk of lowflation from weak growth. We think it will be slow to act on rate cuts, but stands ready to intervene in case of disruptive market developments, especially in FX and gilts. In a 'civilised divorce' scenario, where the uncertainties are progressively reduced and the economy avoids recession, we see the MPC on hold. In an 'acrimonious divorce' scenario, where the uncertainties interact and amplify each other, we see the economy in a referendum recession by year-end. We expect this to trigger a cut in rates to 10bp, another £50 billion tranche of QE, and easier fiscal policy, including the possibility of a radical helicopter money experiment.

What to watch for today: i) Senior Conservative rhetoric – collaboration or brewing leadership challenge; ii) Hints at Cabinet reshuffle; iii) Central bank statements and actions.

Wider European and global impacts: Our European team sees a significant hit to eurozone growth and heightened European political risks (see [What Brexit Would Mean for Europe \(07 Mar 2016\)](#)). Our global team sees negative spillovers, particularly from further USD strength, which could put the global economy into the recession danger zone (see [What Would Brexit Mean for the Global Economy? \(20 Jun 2016\)](#)).

MORGAN STANLEY & CO. INTERNATIONAL PLC

Jacob Nell

ECONOMIST

Jacob.Nell@morganstanley.com

+44 20 7425-8724

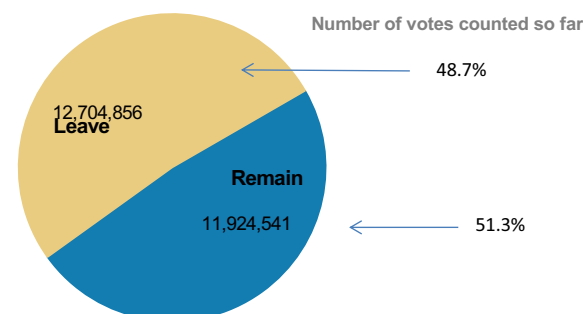
Melanie Baker, CFA

ECONOMIST

Melanie.Baker@morganstanley.com

+44 20 7425-8607

Exhibit 1: A vote to leave, based on 301 out of 382 areas declared



Source: BBC

Exhibit 2: Leave scenarios - key parameters

Scenario	Civilised Divorce		Acrimonious Divorce	
	50%		50%	
Probability	2016	2017	2016	2017
Growth	1.2	1.3	0.8	0.5
Inflation	0.8	2.1	1.1	2.2
Policy rates (eop)	0.5	0.5	0.1	0.1

Source: Morgan Stanley Research estimates

For our cross-asset strategy view, see [Cross-Asset Strategy: What Leave Means](#), June 24, 2016.

For important disclosures, refer to the Disclosures Section, located at the end of this report.

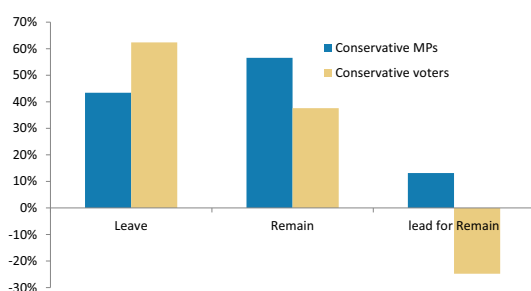
A period of uncertainty

The uncertainties of Leave: We see heightened political and economic uncertainty on a vote to leave (see [UK Economics & Strategy | EU Referendum: Insight: A Close Call \(13 Nov 2015\)](#)). In the immediate aftermath, David Cameron, who has campaigned for Remain, will likely see his credibility suffer, and could face a leadership challenge. More generally, it may be a challenge to reunify the Conservative party, which is deeply divided on EU membership. This could lead to a period of weak government, and increased risk of early elections. We also see a significant risk of a second independence referendum for Scotland. Second, there will be protracted uncertainty over the trading relationship with the EU, which is the UK's main trading partner. We expect that this would, in the end, lead to a considerably more restricted trading relationship with the EU.

The magnitude of these uncertainties and how they would play out is unclear. We think it will depend on three issues, which we list in the order in which they would likely come into the spotlight:

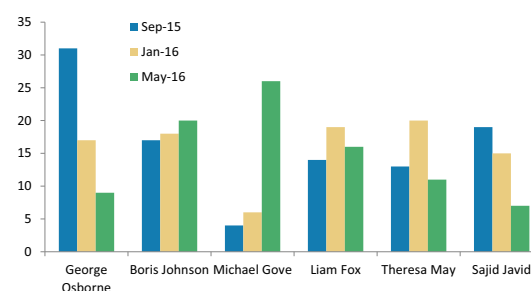
1) **Government:** In the immediate aftermath of this vote, we think that there is a heightened risk of an accelerated succession to Cameron. His credibility has presumably been damaged after campaigning for Remain and he may face a leadership challenge. If he does face a leadership challenge, the composition and policies of the government will remain uncertain for the duration of any Conservative leadership election. In 2005, the leadership election, which involves a postal ballot of all members, took two months. In the UK, a change in ruling party leader or Prime Minister does not necessarily imply a general election - both Thatcher and Blair, for instance, were replaced without a general election. However, the government's majority is only 16 and the Conservative party is divided on Europe. Until a new leader is in place and is able to command the confidence of the Commons, some market participants would likely worry about the risk of an early general election.

Exhibit 3: Political risk - divided Conservative MPs and divided Conservative voters



Source: BBC for MPs, Yougov between June 10-17 for Conservative voters

Exhibit 4: Conservative preferences for the next leader are not yet clear

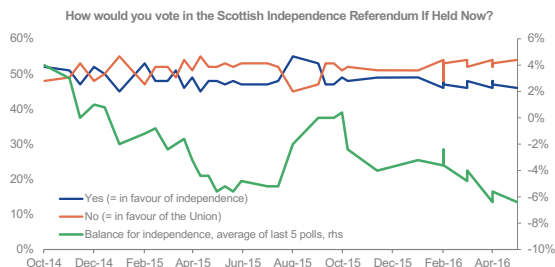


Source: ConservativeHome, monthly poll asking the question "Who should be the next Conservative leader?"

2) **Scotland:** We see Scottish independence as a potential further source of political uncertainty. The SNP leadership has suggested that a second independence referendum in Scotland would be "highly likely" if the UK votes to leave and Scotland votes to remain. That particular vote split seems to have materialised. We see a second independence referendum as a possibility. Certainly, the SNP's 54 MPs give it considerable leverage to extract the commitment to a second referendum from a government led by a divided Conservative party with a narrow majority. Moreover, we see a second referendum as being potentially attractive to the SNP, since the prospects of winning a vote for independence might be higher if the choice could be presented as a choice between two change options - leaving the EU or leaving the UK - rather than a choice between the status quo and a change option. However, the pathway to a second independence referendum is long and tortuous, and involves complex negotiations with both the UK government on a second referendum and the EU on Scotland's relationship with the EU. Moreover, it comes against the challenging fiscal backdrop caused by a low oil price, with the 2014-15 Scottish fiscal deficit at 10% of GDP. To become a live possibility, there would need to be a strong move in Scottish public opinion - which has been trending in a more Unionist direction recently - in

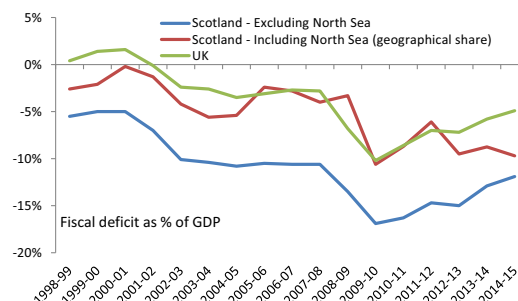
favour of independence. In any event, we suspect that negotiations over a possible second Scottish independence referendum would not start until the UK's political situation was more settled.

Exhibit 5: A modest trend to the union



Source: What Scotland Thinks

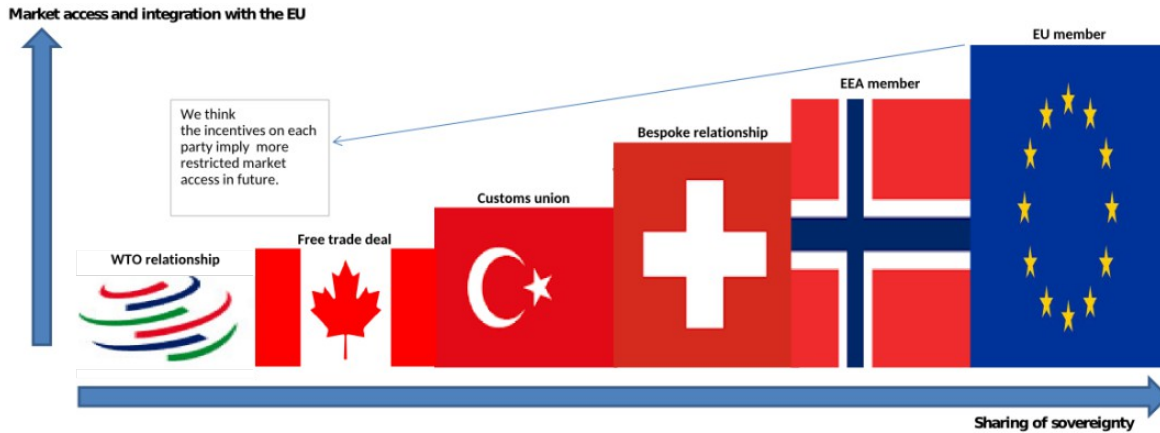
Exhibit 6: Low oil makes independence more challenging: Scotland's fiscal deficit, even with North Sea oil, is 10% of GDP



Source: GERS, Morgan Stanley Research

3) **Trade:** We think the vote to leave will result in the UK moving to a different trading relationship with the EU. This will be a long, uncertain process that will eventually result in worse access to the single market than the UK has at present, in our view:

- A slow, uncertain process:** This will not be a rapid process. In practice, we see a three-step process. First, the **UK government agrees a policy on exit**, which we think may take to the end of 2016, and triggers the Article 50 exit process by notifying the European Council of its intention to leave. Second, we expect **negotiation of the terms of exit** to take at least the two years allowed for in Article 50 (extendable only by unanimity among 28 member states). This points to the UK exiting from the EU no earlier than January 1, 2019, in our view. Even this timetable may be disrupted by the political calendar - for instance, it might not be until after the French and German elections in 2017 that the UK would be able to get down to negotiating some of the details. Third, **negotiations on future trading arrangements**, which may take considerably longer. These trade negotiations with the EU could run alongside the negotiations of the terms of exit or subsequent to it, but the UK government has warned that it could take "up to a decade" to complete negotiations with the EU and other major trading partners. Since the UK will continue to be a member of the EU until the exit, the existing trade arrangements should remain in force until exit. Beyond that, there is considerable uncertainty over the timetable and the extent of legal change.
- Less access to the single market:** In our view, the reassertion of national control over borders and laws, which the Leave side has been promising, will make it difficult for a eurosceptic UK to secure broad access to the single market. At least in the existing Swiss and Norwegian precedents, access to the single market has come with acceptance of free movement and EU regulations. We also think that negotiations will be complicated by the EU's desire to avoid a precedent which might increase the risk of further exits.

Exhibit 7: We think the balance of risks points to significantly reduced market access

Source: Morgan Stanley Research

Civilised versus acrimonious divorce: We see two broad scenarios now:

- A civilised divorce:** In this scenario, the sources of uncertainty over the government and the relationship with the EU are progressively resolved, capping the negative hit to demand and keeping the economy out of a recession. For instance, Cameron or an alternative unifying figure emerges as Conservative party leader and agrees a low-key and constructive approach to negotiations with the EU, paving the way for a constructive deal, e.g., the EU maintaining tariff-free access to the UK for manufactured goods and the UK retaining the financial services passport, with the UK continuing to accept some free movement of workers - e.g., if you have a confirmed job offer - and making some financial contribution to convergence in Eastern Europe.
- An acrimonious divorce:** In this scenario, the sources of uncertainty interact with, and amplify, each other. For instance, a eurosceptic wins control of the Conservative party on a platform of negotiating hard with the EU, triggering political stand-off and a hardening of opinions on each side, and increasing the risk of a second Scottish independence referendum. In this case, we would expect a deeper impact on demand, pushing the economy into a referendum recession, and triggering a substantial policy response.

Which way will it go? Before hearing from politicians in the UK and Europe after the referendum, we see the two scenarios as equally likely. Developments in the coming days will likely determine whether the Conservative party can unite. The next few days may also offer clues as to whether the UK and EU can find a constructive approach to negotiating their future relationship. However, we fear the risks are tilted towards an acrimonious divorce, since the incentives on the parties - for a eurosceptic UK to deliver on control over borders and laws, and for the EU to avoid a precedent which raises the risk of fragmentation - suggest the risks are weighted towards an uncooperative negotiation.

Today and in the coming days we will be watching for:

- Whether **language** used by senior Conservative politicians on opposite sides of the debate, towards each other, is conciliatory or combative;
- Whether **Cameron reshuffles his Cabinet**, including whether he offers leading Leave supporters promotions or positions in his Cabinet, or seeks to demote or sack any leading Leave supporters;
- Whether **Cameron seeks to regain the policy initiative**, taking on some of the concerns underlying the Leave campaign, e.g., with measures to restrict immigration further and focusing on issues that unite the party (such as Trident renewal, which divides the opposition).
- Any press reports on whether a Conservative party **leadership challenge** is brewing.

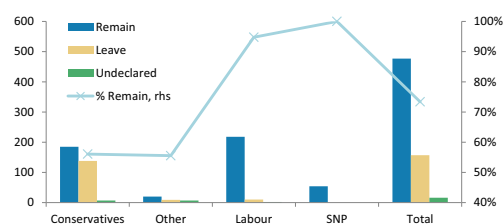
- Any suggestion that the result may face a **judicial review**.
- Leave campaigners talking about the **possibility of another referendum** in the future.
- The statements of other European leaders, particularly at the **European Council next week**.
- **Statements and actions by central bankers:** Elga Bartsch and Chetan Ahya, our global economists, think that in the immediate aftermath of a vote to leave key global central banks will make statements that they stand ready to support markets by providing liquidity and by reopening existing FX swap lines. Such statements could well be coordinated across the G7. Central banks with active QE programmes could make operational adjustments to their asset purchase programmes, if needed. Beyond these emergency measures, however, they do not expect changes in the monetary policy stance in the immediate aftermath of a vote to leave.

Does Leave really mean Leave?

On balance we think so, although we do see a political pathway to reversing the result.

The law is clear and the constitution is permissive. Legally, under the Referendum Act, the result is determined by whichever gets more votes, Remain or Leave. So, the Referendum Act is clear about who is the winner and the margin of victory makes no difference. Constitutionally, the UK parliament is sovereign, so the outcome of the referendum is technically advisory, which implies that it would be constitutionally possible for parliament to ignore or frustrate a vote to leave. However, it is also a convention in the UK that a manifesto commitment is binding on a government and shall be respected by parliament, and the Conservative manifesto for the 2015 election contained the commitment “to hold an In/Out referendum on UK membership of the EU and honour the result”. So, in practice, our judgement is that the current parliament would not be able to frustrate implementation of the vote.

Exhibit 8: 56% of Conservative MPs and 73% of all MPs are in favour of Remain



Source: BBC

However, the politics will likely be bumpy. In particular, over 70% of MPs support Remain, and there would have to be some parliamentary scrutiny of the exit negotiations and approval of some legislation. However, we think there is no requirement for parliamentary approval of the notification to the EU of the UK's intention to leave, which is the step that triggers the exit negotiations. Furthermore, in the event of a vote to leave, we see a high risk that Cameron would be replaced by a more eurosceptic PM. In that case, the government would have the mandate to leave, a leader who *wanted* to leave, and ample time for that leader to decide when to initiate the two-year Article 50 exit negotiation,

and to complete the exit negotiations, before the next election in 2020.

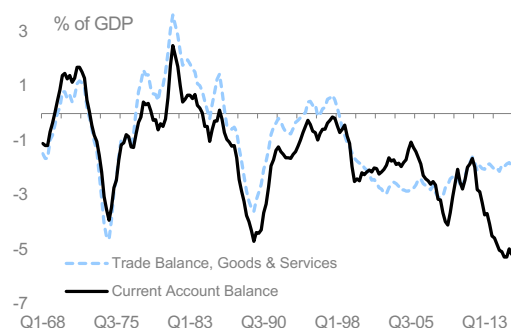
We do see a political route to reversing the decision – a new parliament with a majority for a pro-Remain party which is either elected on a reversal platform or subsequently holds and wins a new referendum on reversing the decision. But this is quite an ask: First, the reversal of the decision probably has to be done before the UK actually exits, since at that point the UK may lose its special status (its opt-outs from the euro and Schengen and the rebate), which would significantly reduce the attractiveness of EU membership. This, in turn, would require early dissolution of parliament. That would require some Conservative MPs to vote against the government, given that the condition for early dissolution is: a) A two-thirds majority of MPs voting in favour of a new election, or b) That the government loses a vote of confidence (and that another government cannot be formed within two weeks). Second, there is a risk that if the EU and UK get into an acrimonious divorce, then UK political sentiment will harden behind Leave.

The economic impacts of Leave

The impacts of Leave: We see three main impacts from the UK's decision to leave the EU, as set out in more detail in [UK Economics & Strategy | EU Referendum: After the Vote \(05 May 2016\)](#). First, we expect a significant effect on asset markets, including GBP (see [Cross-Asset Strategy: What Leave Means](#), June 24, 2016). Second, we expect increased uncertainty regarding the economic outlook to have a significant impact on demand, especially investment. Third, longer term, we expect reduced potential growth, since we expect that this vote to leave the EU will lead to: 1) Greater immigration control, reducing inflows of labour; 2) Reduced access to the single market, leading to less trade; and 3) A lower capital stock and less ongoing investment than would have been the case with a Remain outcome.

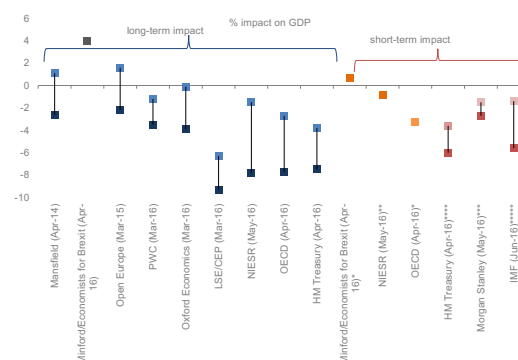
Weaker GBP: Our currency strategists see at least two reasons for expecting a weaker GBP over the referendum period, given a vote to leave. First, the challenge of financing a record current account deficit. The UK had a record annual current account deficit in 2015 at 5.2% of GDP and a record quarterly current account deficit in 4Q15 at 7% of GDP. It currently has the widest current account deficit of any major economy. This creates a potential vulnerability to sudden changes in sentiment towards the UK, since the UK depends on the willingness of foreigners to buy UK assets in order to finance the deficit, and we expect this willingness to be reduced by uncertainties after a vote to leave. Second, the prospect of weaker fundamentals. A vote to leave would, in our view, imply a transitional cost, with the referendum shock hitting demand in the short run. It would also imply a less open economy, attracting reduced inflows of capital and labour and reducing potential growth in the long run. If market participants share this assessment, then a sharp fall in sterling and domestic UK equities would be a natural reaction to such a decline in the UK's growth prospects.

Exhibit 9: Uncertainty creates a challenge in financing the record current account deficit



Source: ONS

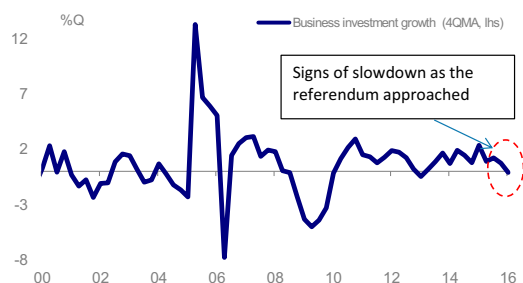
Exhibit 10: The prospect of weaker fundamentals could impact valuations of UK assets



Source: Treasury Select Committee

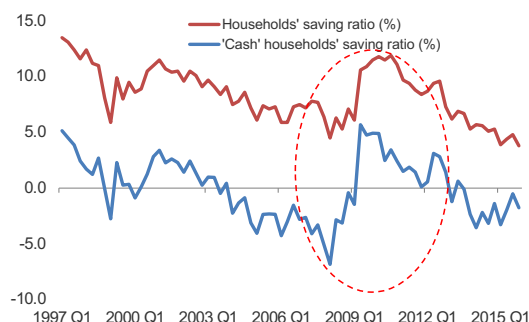
A hit to demand: We saw some impact from referendum-related uncertainty in the run-up to the referendum, particularly in the impact on the capital markets, the slowdown in business investment and the slowdown in employment growth. However, we note that evidence of the soft patch has not been uniform: Retail sales have held up well, and some aspects of the economy - manufacturing output, trade - might have benefited from the weaker GBP already. Now that the UK has voted to leave the EU, we expect a more significant negative impact, with firms deferring investment, and consumers increasing precautionary savings.

Exhibit 11: Investment particularly vulnerable to uncertainty



Source: ONS, Morgan Stanley

Exhibit 12: Precautionary savings - household savings jumped 5pp in 2009

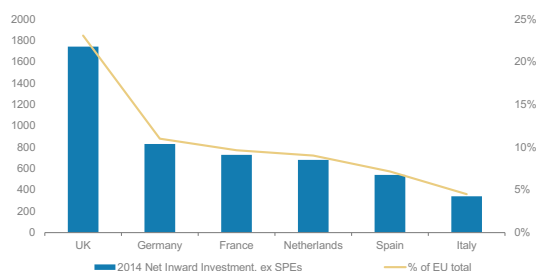


Source: ONS, Morgan Stanley Research

Lower potential growth: We think that a vote to leave is likely to lead to a less open UK, which will attract reduced inflows of capital and labour, and have a lower potential growth rate. In the case of labour, we think that a vote to leave will lead to increased immigration control and reduced inflows. This will likely have a material impact on the labour market, given that non-UK workers have accounted for over 80% of the net increase in the workforce since 2004. In the case of capital, we think that the vote to leave is likely to lead to the UK leaving the single market, and that the UK's success in attracting such a high proportion of FDI flows into the EU is built on the combination of the UK's competitive advantages (legal and political stability, a competitive business environment) *and* access to the EU's 500 million strong market. Without access to the larger market on as good terms, we would expect a portion of that FDI to follow the larger market and go elsewhere in the EU.

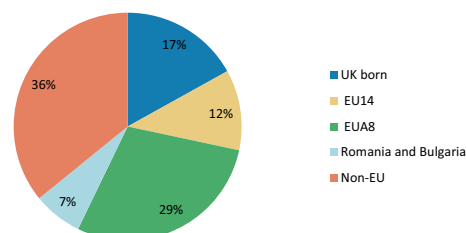
Increased volatility: Longer term, we expect a less open UK to be more volatile, with less supply being created to balance growth in demand. More specifically, with reduced immigration, we would expect more volatility in pay and employment, which would feed through into inflation. With increased volatility, we see a risk that rates might need to be higher to hit a given inflation target.

Exhibit 13: The UK's leading position in attracting FDI could be weakened once out of the single market



Source: OECD

Exhibit 14: Net increase in employment levels since enlargement in May 2004: Non-UK workers have been the main net marginal supplier of labour



Source: ONS

The policy response in Leave

An easing bias: The MPC's reaction at first sight looks unclear. It seems likely to face an apparent dilemma between tightening in response to inflation rising above target as a result of pass-through from a weaker GBP, and easing in response to rising unemployment and a widening output gap as a result of a shock to demand from higher levels of uncertainty.

Moreover, the MPC has stressed that it does not have an automatic policy response, and its reaction (direction as well as magnitude) will depend upon the relative strength of the impact on sterling, demand and supply.

Nonetheless, we think that the MPC will be relaxed about an inflation overshoot as a one-off effect from a move in the currency, partly since the current challenge is too little inflation, partly since it may see a lower level of sterling as justified by changed fundamentals, and partly since it will be confident in how to respond to an inflation overshoot, if there are clear signs of second-round effects. Consequently, we see a bias to easier policy after a vote to leave since growth running below potential implies downward medium-term pressure on inflation.

Liquidity provision and targeted actions, before rate changes: The MPC said it will "react cautiously" during this period, to avoid overreacting to a temporary effect. We think this sets a relatively high bar - evidence that any disruption was large and sustained, and hitting the broader economy - to rate actions, suggesting in particular emergency rate actions are unlikely, and meaning that we are expecting the policy reaction to come at the November rather than August Inflation Report meeting. We expect the BoE to focus initially on providing liquidity to markets, and then be ready to intervene in the event that market functioning deteriorates in any particular area. During the financial crisis in 2009, for example, the BoE used the Asset Purchase Facility to buy up to £2.4 billion of commercial paper (see [here](#) for more detail) at spreads below market rates but above those expected to prevail in normal conditions. This sets a precedent that we think could be used in other markets which experience distress.

Triggers for intervention in FX... For different reasons, we do not expect early intervention in the FX and gilt markets. On FX, we think that the authorities would see an initial fall in sterling as justified, and helpful in reducing the deficits on the trade and income accounts. However, if there was significant sterling volatility after a substantial initial fall, then we think the Bank of England, as agent of the government, would be prepared to intervene to stabilise GBP - and we note that it now has more firepower to do so, with increased reserves. The BoE also has access to swap lines with the Fed and ECB.

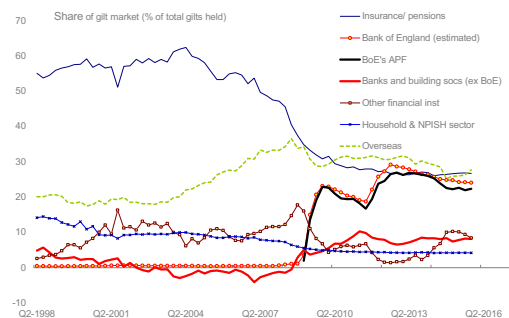
...and gilt markets: In the gilt market, our rates strategist expects a bid for gilts from sterling liability managers, and yields rallying 10-20bp, which suggests little reason for intervention. Some argue that gilt yields might start to rise strongly, for instance as a result of foreign holders of gilts selling UK gilts in response to higher UK risk premia, and this would create a reason for an MPC 'credibility hike' to support demand for gilts and prevent longer-term rates rising further. However, where the economy has had a negative shock and is in need of support, we think that the BoE would prefer to respond to a 'buyers' strike' by buying more gilts rather than raising rates. It may regard the impact of rate rises as uncertain, and with the potential for making things worse rather than better, given the risk that such policy action could be seen by the market as inconsistent with the ultimate recovery of the underlying economy and/or with the bank's inflation mandate.

Exhibit 15: UK FX reserves substantially larger than in past, at over 5% of GDP



Source: BoE

Exhibit 16: Nearly 30% of gilt market held by overseas investors



Source: BoE, ONS

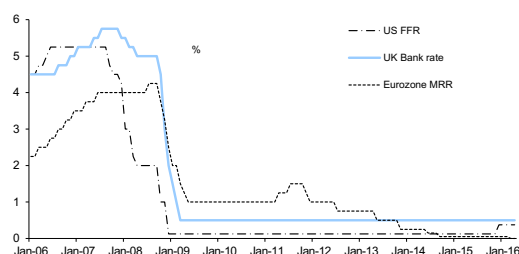
Civilised versus acrimonious divorce: In a 'civilised divorce' scenario, where the sources of uncertainty are progressively tackled and the UK stays out of recession, we would expect the MPC to stay on hold through 2017-18, as opposed to a scenario of gradual rate hikes in Remain. In an 'acrimonious divorce' scenario, where we see the different sources of uncertainty amplifying each other, pushing the economy into a recession, we would expect a major policy reaction, including:

- A cut in rates. The MPC sees rates as the marginal instrument of policy, now that UK bank capital has been built up, and building society exposure to tracker mortgages reduced. So, a standard 25bp cut is likely the first step, and we believe that the MPC could do more, and take rates down, e.g., 40bp, close to zero. But we think rates will stay positive, given BoE concerns that zero or negative rates may pose a risk to financial stability and have perverse impacts.

- Another tranche of QE. At this point, with interest rates constrained by the lower bound, we think the MPC would look to provide further easing through additional unconventional policy. The most likely option would be the tried and tested option of gilt purchases.

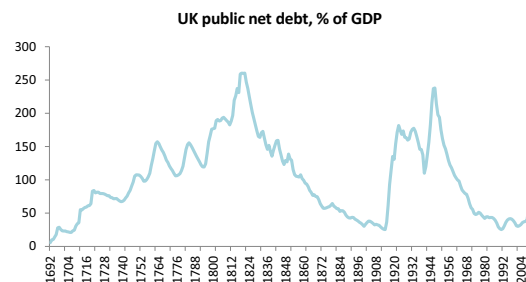
Easier fiscal policy: The UK government has maintained a tightening stance after the narrow Conservative victory at the May 2015 general election. But after a vote to leave we see several reasons why fiscal policy, which has already been significantly eased compared to the original pre-election plans, may be eased. First, monetary policy is running out of ammunition. Second, the government's fiscal mandate, which requires a surplus by 2019-20, is closely associated with George Osborne, and a future Chancellor may not feel so committed to the target. Moreover, the government's fiscal targets are suspended when the OBR judges that real GDP growth is less than 1%Y (or likely to be less than 1%Y). Third, we note that the Leave campaign has argued that there would not be a major shock from a vote to leave, which could create political pressure for easier fiscal policy if growth does slow significantly.

Exhibit 17: Global policy rates are on the floor - limited scope for easing



Source: ECB, Fed, BoE

Exhibit 18: UK public debt not high compared to history



Source: B.R. Mitchell, British Historical Statistics, OBR for recent data

Helicopter money in the UK? As argued in a recent note (see [UK Economics: Can Helicopter Money Really Fly? \(26 May 2016\)](#)), we see a possibility of a more radical fiscal and monetary policy option to help a UK economy suffering from a referendum recession. The objective would be to provide policy support through a targeted intervention with a high multiplier - use-it-or-lose-it consumption vouchers for the liquidity-constrained. We see this as a form of government money, which would ultimately be backed by long-term government debt held by the central bank. It would be cheap, since the interest and principal would be paid by the central bank back to the government, and it could be effective, if it drove additional consumption rather than savings. However, such radical policy experiments would open up risks and could impact the credibility of UK institutions and the demand for UK assets. In this situation, the BoE's scope for monetary policy action could become more constrained by the potential reaction of the FX and gilt markets.

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