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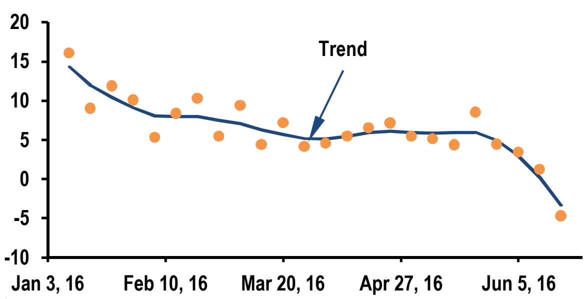
Economic Research Note

The implications of Brexit

- **Polls make the referendum result too close to call**
- **Brexit would see a big shift in UK politics and BoE rate cuts before exit negotiations begin**
- **Euro area growth likely to be hit by less than half a point—we do not anticipate referenda elsewhere**
- **Denmark, Sweden, and Switzerland will respond to unwanted FX strength**

Opinion polls ahead of next week's referendum have made a powerful move toward Brexit (Figure 1). Our attempt to clean up the polls for methodological issues suggests a lead for leave in the 3%-5%-pt range at the time of writing. Prior referenda suggest that a swing toward the status quo is often seen, both in polling over the final two weeks of the campaign and in comparing the result with final projections from the polls. In the Scottish independence referendum, for example, polls made a small move back toward remain ahead of the vote, and the eventual 10%-pt win for remain compared to an average projection of a 5%-pt win from the eve-of-vote polls. This time around, however, the swing toward leave appears to have accelerated as we moved into the period when we would expect status quo bias to show. Moreover the dispersion in polling results and controversy over methods suggests the margin of error around any estimate derived from the polls is high. In our view, it is now unlikely that the polls will offer clear guidance on the outturn of the referendum before the vote takes place. Hence here we update and summarize views on the economic, political, and policy implications of Brexit for both the UK and the rest of Europe, should it occur.

Figure 1: Weekly lead of remain over leave
%-pts, dots represent weekly averages of "cleaned up" lead



Source: Various polling organizations, J.P. Morgan

UK: Prepare for a bumpy ride

Process and politics: The referendum is consultative and does not legally compel politicians to take any particular course of action. The day after a leave vote, the UK's legal relationship with the EU would remain largely unchanged. But the political environment would change enormously. Our best guess is that David Cameron would resign as rime minister within hours of the result being known. While he might attempt to remain in office until the Conservative party conference in October, his authority during this period will have been eroded. Boris Johnson is likely to take over as PM subject to the vagaries of the Conservative leadership election process (see below). A snap general election is possible, but in our view, unlikely.

Under Conservative party rules for election of the party leader, MPs reduce the field of candidates to two through successive rounds of voting, with the candidate with least votes eliminated in each round. The election between the last two candidates is via a postal ballot of Conservative party members. If only one candidate stands unopposed, that candidate becomes PM. If Boris Johnson is the only MP to stand, the process could be completed within a matter of days. If other individuals choose to stand, however, the process will be more drawn out (in 2005, for example, it took two months).

Vote Leave has argued that a formal "article 50" request to leave the EU should not be made in the immediate aftermath of the vote, and informal negotiations about how the process will evolve should take place first. The organization has also argued that the UK will not accept free movement of labor as part of the subsequent arrangements and should exit the single market. This position may not bind a future UK prime minister. But it suggests that the UK will take an assertive stance in negotiations toward an exit at the early stage. Although new negotiations on terms of EU membership and a further referendum are possible, we see them as very unlikely.

Growth: Uncertainty around the UK's future trading regime is likely to depress firms' employment and investment decisions, and to limit household spending. Although sterling is likely to fall in value, recent experience has not shown UK corporates to be well positioned to take advantage of currency weakness by increasing their investment and building market share. In the meantime, import price increases would likely be passed through to households, compressing real income growth. It is tough to calibrate the net impact on growth, and some portion of those effects may already have been at play in the data. Our base case is that GDP growth would slow by close to 1% in sequential terms, pushing it below 1% in the near term. We would expect some of that effect on the growth rate to dissipate as it becomes clear that the terms of EU exit will take a period of years to negotiate (Table 1).

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Table 1: GDP forecasts and UK referendum outturns
%ch over prior period, annualized

	UK		Euro area	
	Remain	Leave	Remain	Leave
1Q16	1.6	1.6	2.2	2.2
2Q16	1.0	1.0	1.5	1.5
3Q16	2.5	0.5	2.0	1.6
4Q16	2.5	0.5	2.0	1.6
2016	1.9	1.5	1.8	1.7
1Q17	2.0	1.0	1.8	1.6
2Q17	2.0	1.5	1.8	1.6
2017	2.1	1.1	1.8	1.6

Source: J.P. Morgan

Policy: If the result is a vote to leave we would anticipate a 25bp cut in the Bank rate at the July meeting, followed by a further 25bp move alongside the August inflation report. The speed and magnitude of the response will be sensitive to moves in financial markets; the MPC likely would interpret a weaker currency as reflecting weaker growth expectations provided it is accompanied by weakness in other UK asset markets. The Bank of England has already planned emergency liquidity auctions and will stand ready to provide more if needed.

Euro area: A meaningful but manageable shock

Growth: The impact on growth would come from the direct spillovers from the uncertainty effect in the UK, a hit to Euro area confidence and financial markets, and currency appreciation. In our view, Euro area growth would be around 0.4%-pt lower than it otherwise would have been over the coming year, which would put average GDP gains at around 1.5% ar compared to the current 1.9% projection based on the assumption that the UK remains in the EU. Unemployment would still likely decline, although at a much reduced pace. Inflation would likely be slightly lower, perhaps by around 0.1%-pt.

Policy: The ECB's response to this shock would depend on the extent of the impact on growth and inflation, and on the extent to which financial market stress looked likely to weigh further on spending and increase sovereign and bank funding costs. We expect the ECB would quickly express its commitment to ensure price stability in the region, which would necessitate a commitment to the integrity of the region.

In the first instance, we would expect more easing on rates and the balance sheet. Our forecast already anticipates further easing in September, in the form of an extension of the current asset purchase program through end-2017 (an increase in asset purchases worth €720bn). If UK left the EU, we would expect additional easing involving a 10bp cut in the deposit rate (to -50bp) and a further extension of asset purchases into 2018. We would not expect these additional moves to come quickly, unless financial markets put the central bank under a lot of pressure. If peripheral financial market pressure were intense enough to threaten the integrity of the region, the ECB could introduce a new instrument to limit contagion. This could involve country-specific bond market intervention (like the OMT) but without conditionality. In our view, the ECB would rather introduce a new instrument to limit peripheral stress than divert purchases from the existing asset purchase program. Regarding potential bank funding pressure, banks already have access to unlimited liquidity in the weekly and three-monthly operations. If needed, the ECB could adjust the timing of these operations.

Politics: The rest of the EU is torn between fear and fantasy: Fear that a UK exit will lead the region to unravel, and a fantasy that without the UK the Euro area can take a leap forward in terms of integration. Neither of these extremes seems very likely. Non-mainstream political parties that are hostile to the EU would be energized by a UK vote to leave, but no other country in the EU looks likely to call a referendum on membership. And, in our view, it is not the UK that has held back the Euro area from further integration: it is domestic politics in the member states. In the event, we would expect EU politicians to express strong commitments to the integrity of the EU, but we would not expect any concrete action to integrate further. Such steps likely would need to wait at least until after the German and French elections next year.

In terms of the negotiations around UK exit, the rest of the EU is unlikely to agree to a significantly preferential trading arrangement. Given the reluctance of the UK Leave camp to provide contributions to the EU budget or to accept free movement of labor, the UK's new trade relationship with the EU would likely be more restrictive than Norway's or Switzerland's. If the UK were to take unilateral action that was perceived as unfriendly, negotiations could get very difficult, and in the extreme the UK could end up trading with the EU under WTO rules.

Spillovers elsewhere

A UK decision to exit the EU would also be a meaningful shock to the rest of Western Europe—Sweden, Switzerland, and Denmark. These countries are very sensitive to upward pressure on their currencies, and they would respond either to sustain the current peg in Denmark or to limit appreciation in Sweden and Switzerland. Depending on the extent of the pressure, these countries would likely see some combination of rate cuts, asset purchases, and FX intervention. Limits on rate cuts or asset purchases due to concern about pressure on bank profitability or market liquidity are not as relevant as elsewhere.

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