Macro focus

Can Brexit be this year's black swan?

- Economy and politics are both in play
- Damages could be limited by new forms of cooperation
- Expect rising risk premiums and increased market volatility

Summary
The UK is set to hold a referendum on EU membership by the end of 2017. The exact date has not yet been announced, but will almost certainly be this year. Ahead of the referendum, Prime Minister David Cameron is trying to renegotiate four areas, of which curbing benefits for EU workers is the most controversial. The immigration issue will probably be the most critical to the end result, especially now when the refugee inflow in Europe is a burning issue.

At this point we estimate the probability that the UK will stay in the EU at 75%. A complete exit, i.e., that isn't followed by a new form of agreement, would have broad economic consequences for the British labor market, foreign trade and not least London's status as a financial center. The Bank of England is expected to delay its first rate hike until after the referendum, but will keep a close eye on the pound. At the monetary policy meeting in January, members of the central bank noted that that the pound had depreciated in anticipation of the upcoming referendum. Equity, foreign exchange and fixed income markets will certainly be paying close attention to public opinion, especially when a date for the referendum is announced. But one thing is certain: *2016 is likely to be a bumpy year for the British financial markets, which could spread abroad.*

Brits likely to stay in some form of EU cooperation
The refugee crisis that escalated in Europe last autumn has made it both easier and more difficult for Cameron to win approval for his reform agenda. While there may be some understanding by the EU of the changes he wants on immigrant benefits, the negotiations could be complicated by the fact that certain countries are being forced to accept more refugees. The refugee crisis, like the recent terror attacks, has on the margin increased the likelihood that the British people will vote to exit the EU. Therefore the negotiations on the immigration issue are likely to be critical, and alternative solutions that slow labor force migration to the UK can't be ruled out.

At the same time one shouldn't underestimate the EU's, especially Germany's, desire to keep the UK in the union. Chancellor Angela Merkel has suggested that the proposed reforms could be agreed to now but implemented at a later date. Germany has also signaled that it would consider supporting a one-year ban excluding EU citizens from British social benefits. Other sources indicate that Germany is willing to reevaluate who is entitled to benefits, to tighten requirements, and to accept that those who earn the least wouldn't necessarily be entitled to benefits.

Today the UK is the third largest contributor to the EU budget, providing an estimated 13% in 2015 (£8 473 million) after taking into account the country's discount. Besides the budgetary effects, there is a political desire to keep England in the union. In the wake of the refugee crisis and growing EU

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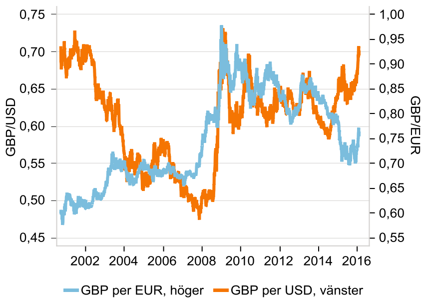
skepticism about the union, a Brexit is one of the last things that Brussels (and especially Berlin) wants.

At the time of writing we consider the probability that the UK will stay in the EU to be high (75%).

Financial markets hold their breath for a bumpy 2016

The British referendum is associated with extreme complexity. It is surrounded by great uncertainty and entails great risks for the financial markets. The GBP has already weakened since the referendum became news. When a date is announced and/or opinion polls start getting released, we can expect the markets to be on notice. If polls just before the vote indicate that the two sides are close, the market's risk aversion is likely to skyrocket. In addition to rising risk premiums in the equity and fixed income markets, we can safely assume that the GBP will weaken further as the referendum draws near and if public opinion is equally divided. Depending on the outcome, these effects could be temporary or, in the event of an exit, more long lasting.

Pound vs. euro and dollar



Source: Macrobond

The Bank of England has previously taken the EU's economic and regulatory development into consideration in its monetary decisions and favored financial stability. This is likely to remain the case going forward, regardless of whether or not the UK leaves the union. We expect an initial rate hike of 0.75% in the first quarter of 2017, i.e., after the referendum has been held. After that rates should rise steadily. An especially close eye will be kept on exchange rates, since a depreciating GBP could drive imported inflation.

Date not announced but September seems likely

Negotiations are underway between the UK and the EU's politicians. The referendum on EU membership is planned by the end of 2017, but will probably be held this year. Attention has turned to the first quarter's scheduled EU summits in February and March. Around 16 weeks have to pass between the end of the negotiations and the date of the referendum. Since the parties are still far apart, all indications are that it will be held in September. But a special EU summit in February could lead to an agreement that month, which means that the referendum could be held as early as June (the 23rd has been mentioned).

The die has been cast

Prime Minister Cameron has sent a letter to European Council President Donald Tusk setting out four areas where he is seeking reforms. If the original proposals are approved, the EU's constitution would probably have to be amended. Otherwise there is a risk that actions could eventually be brought before the EU Court of Justice.

The letter sets out the following areas:

1) Economic Governance
2) Competitiveness
3) Sovereignty
4) Immigration

The aim of reform area (1) is to respect the legitimate interests of non-euro members and ensure that there are legal safeguards to protect businesses in all EU countries, i.e., that businesses operating in countries with a currency other than the euro are not discriminated against or at a disadvantage due to their currency. In addition, any changes such as a banking union must be voluntary for non-EMU members. Lastly, reform area (1) states that taxpayers in non-EMU countries should never be financially liable for the euro's survival. Reform area (2) concerns the legal requirements faced by businesses and cutting the total burden on them. The EU should also do more to achieve a free flow of capital, goods and services, the UK believes. More power should be returned to national parliaments and it shouldn't be obligatory to work towards an ever closer union, according to reform (3).

The last and perhaps most controversial reform area (4) deals with immigration. The UK wants a fairer system that reduces today's high level of migration from other EU countries. When new countries are admitted to the EU, free movement should not apply until their economies have converged more closely with existing members. Moreover, the UK wants to make it harder for those who abuse the system to return to the UK and easier to deport criminals. Last but not least, the UK wants to limit in-work benefits. To be entitled to work-related benefits or government housing assistance, people must live in the country and contribute to society for four years. Sending child benefits overseas shouldn't be allowed either.

What are the polls saying?

Opinion surveys have slowly started trickling in, but are likely to increase in number when the date of the referendum is announced and grows nearer. According to *The Washington Post*, history suggests that opinion polls tend to underestimate rather than overestimate support for staying in the EU. At the same time these surveys have to be taken with a grain of salt, since uncertainty and volatility can be higher than in party preference polls, which also give a snapshot. This was the case, for example, with last year's polls leading up Sweden's parliamentary election due to a non-representative sample and to some extent to the questions asked. Polls ahead of Scotland's independence referendum also saw a large degree of variation.

The latest published polls from Survation (January 16) and YouGov (January 12) show a majority on the exit side, uncertain voters included, while ICM's latest poll (January 27) shows that it's neck and neck, uncertain voters excluded. The negotiations with the EU are crucial, and a survey by YouGov (December 10) shows voter support swinging depending on the outcome of those negotiations.

It will probably be the Prime Minister himself who determines whether or not the negotiations with the EU are a success. It's unlikely all four reform areas will have positive outcomes. Some will probably be to his liking, but not all.

Though the proposal of a four-year rule for European workers to qualify for in-work benefits is still on the table, the UK has said it is open to alternative proposals with a similar purpose. Ahead of the next EU summit, representatives are working on a counterproposal that could include an "emergency brake" if a member country accepts so many immigrants that its public sector runs into trouble. Such a counterproposal might be attractive in theory, but in practice there are no guarantees that it would have the desired effect. The British are unlikely to accept such a counterproposal, so other alternatives will probably have to be put forth and discussed instead. For example, there could be a period (other than four years) when an immigrant is denied benefits or that benefits are curbed for both British and other European citizens until they have contributed to society for a while. Another alternative would be to redefine the group of workers who are entitled to social benefits.

Focus on EU negotiations but how important are they?

Several surveys last year show that the reform areas vary in importance to the British and that immigration was the top-of-mind issue. This is confirmed by the growing support for a Brexit since last summer, which coincides with the escalating refugee crisis.

The question is whether a compromise with the EU will be enough for British voters. Several commentators believe it would be enough to convince Cameron to campaign for the UK staying in the EU. It's also important to remember that it's probably in the Prime Minister's own best interest to reach a successful outcome, since it would be hard for him to stay in power if the exit side wins. He denies this himself, however.

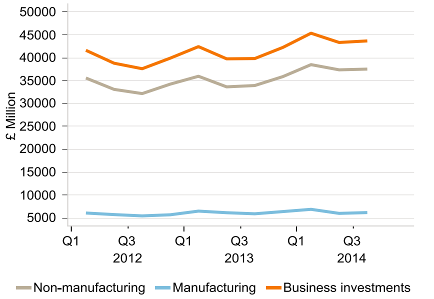
A simple question with many answers

In 1975 the UK held a referendum on membership in the EEC (the forerunner to the EU). In the end, 67% of the population voted to stay in European club after Prime Minister Harold Wilson (Labour) got a number of cosmetic changes accepted. Later Margaret Thatcher (Tories) pushed through a number of major budget improvements. These negotiations, where EEC governments had to accept concessions, are not unique. The EU has had to compromise on later occasions as well. One example is Denmark, which forced through three exemptions (really four, but the fourth is now governed by the Treaty of Amsterdam) from the Maastricht Treaty. Ireland has also received exemptions from the EU's treaty (Treaty of Lisbon).

The simple question that the British will be asked – "Do you think that the United Kingdom should remain a member of the European Union?" – doesn't have a clear answer. For one thing, it's still up in the air which reforms Cameron will get accepted. And secondly, an exit from the EU doesn't have to mean that the UK would totally break off from the EU.

Norway, for example, is a member of the European Economic Area (EEA), and as such has committed to adopt the inner market's four freedoms and "flanking policies." Another possible solution is illustrated by Switzerland, which is a member of neither the EU nor the EEA, but is a member of the European Free Trade Association (EFTA). To strengthen ties to the EU, Switzerland has signed more than 120 bilateral agreements covering, among other things, free trade, increased economic cooperation, a broader collaboration on asylum issues and free movement within the Schengen area. Turkey's cooperation with the EU demonstrates another possible outcome, where Turkey and the EU are linked by a customs union. The cooperation between the UK and the EU could also be governed through the WTO.

Investments in Scotland, real (CVM)

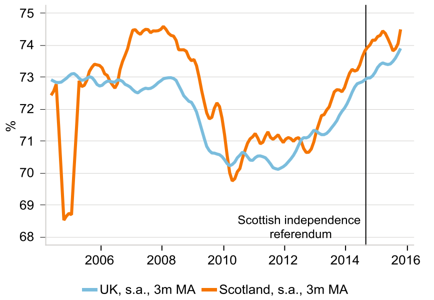


Sources: ONS, Swedbank and Macrobond

Economic effects

For the UK, the Scottish referendum on independence in 2014 is the most recent event that is comparable with the EU referendum. Leading up to the referendum there was a lot of talk about the economic effects of an independent Scotland. One of the fears was that increased uncertainty was going to hurt investment decisions. Data shows, however, that actual investment in Scotland did not fall in the quarters preceding the referendum. Nor did the referendum have much effect on Scottish house prices or employment, which continued to rise.

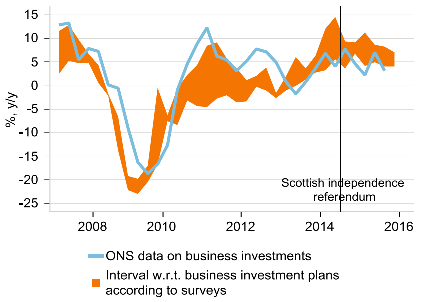
Employment among those ages 16-64 years



Sources: Swedbank and Macrobond

Estimating the economic effects of a British exit from the EU involves a number of uncertainties. For (local) businesses, future *investment decisions* could be affected by increased uncertainty ahead of the referendum. Thus far the number of companies that have delayed investments is still small, but if uncertainty grows their confidence will wane. The Bank of England's inflation report in November predicted robust investment growth in the near term. This was mentioned by Governor Mark Carney in his speech on January 19. Since the second half of 2015 investment plans have cooled somewhat, according to weighted surveys, though this can certainly be attributed to external factors such lower oil prices and slower growth in emerging economies.

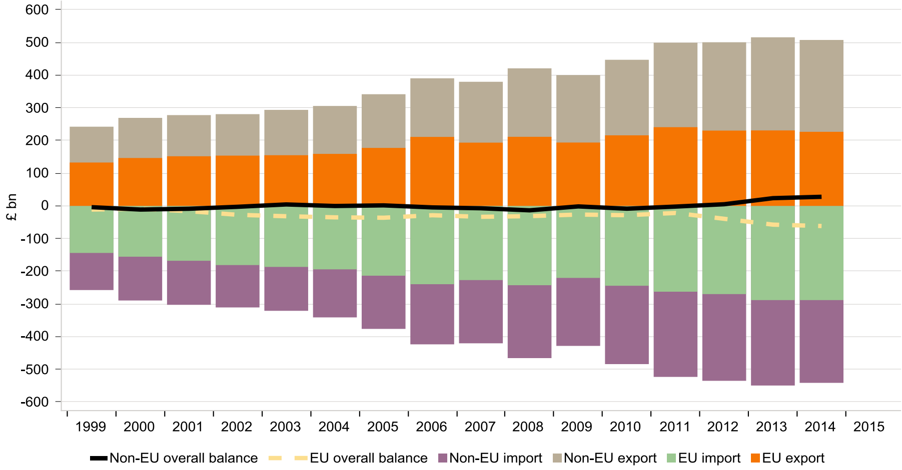
Business investment and plans in the UK



Sources: Swedbank, Bank of England and Macrobond

Foreign trade accounts for a significant share of the UK's GDP. If it completely cuts ties with the EU, trade could slow significantly or become more expensive. In 2014, 44.6% of UK service and goods exports were to the EU, while 53.2% of imports were from the EU. If the UK instead chooses a third way like Norway or Switzerland, the effect on foreign trade will probably be limited.

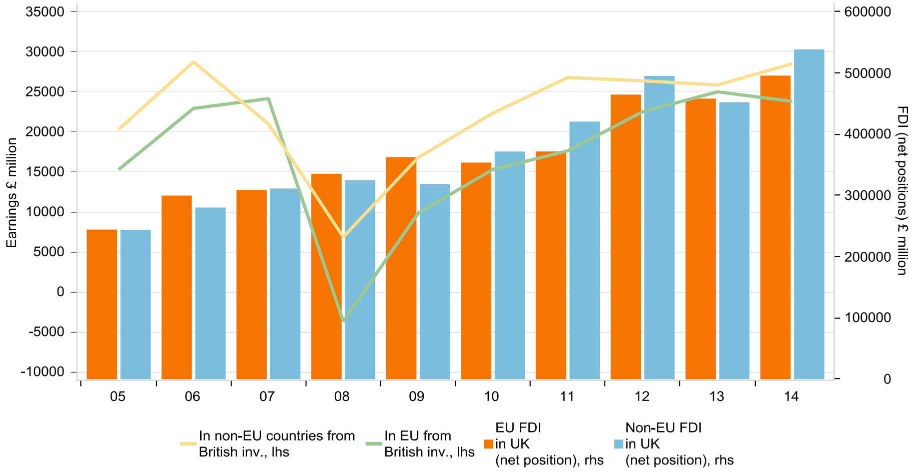
UK: Trade with the EU (goods and services)



Sources: Swedbank Research & Macrobond

Perhaps the biggest effects of a Brexit would instead be in other parts of the balance of payments. Between 2005-2014 foreign direct investment (FDI) between the UK and Europe was considerably higher than for other parts of the world. In the event of an exit from EU, there is a risk that the inflow from foreign investors would shrink and that foreign M&A activity in the UK would decline. All else being equal, this would eventually lead to a rising capital account deficit and have negative wealth effects through falling asset prices.

UK: FDI in UK and earnings



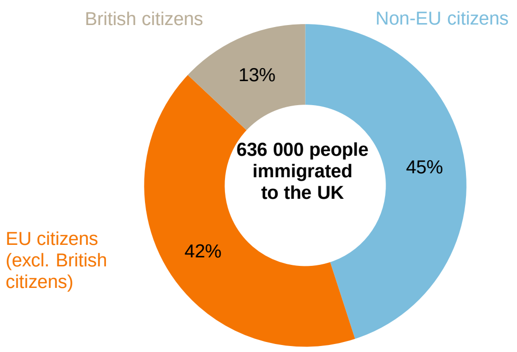
Sources: Swedbank Research & Macrobond

More specifically, there have been discussions whether banks would move some of their operations from London and the UK if the exit side wins. In the crisis plans they drew up earlier, where alternative cities such as Frankfurt, Paris and Dublin were evaluated, banks usually came to the conclusion that it wouldn't it be profitable. The incentive to move some business is probably greater for global banks than local ones. If the UK completely exits the EU, trading and risk management would probably be among the areas that go. There's always the possibility that financial trading with the EU could instead be done through a subsidiary within the EU or that the terms for access to the European market could be renegotiated. The UK would at the same time have less influence on European financial regulation. In spite of this, we expect London to maintain a relatively strong status in the short and medium term, though it could become frayed along the edges.

It's likely that a Brexit would also affect the *labor market*. During a one-year period (July 2014-June 2015) 636 000 people immigrated to the UK. Of them, 42% were from EU member nations who didn't have British citizenship, an increase from the previous year. Most came from Central and Eastern Europe (Bulgaria and Romania), the same region that is most critical of Cameron's fourth reform proposal on immigration.

Most of those who immigrate to the UK do so for work. Preliminary calculations from the International Passenger Survey (IPS) show that 162 000 EU citizens between July 2014 and June 2015 wanted to work in the UK, an increase from the previous year, though the results are not statistically significant. Other sources also indicate that labor immigration from other EU nations increased in the last year. If the UK completely exits the EU, we would expect it to be harder for immigrants to work there. The impact on the labor market from a EEA- or EFTA-like arrangement (think Norway or Switzerland) would be more limited, however.

Immigration to the UK July 14-June 15



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