Economics

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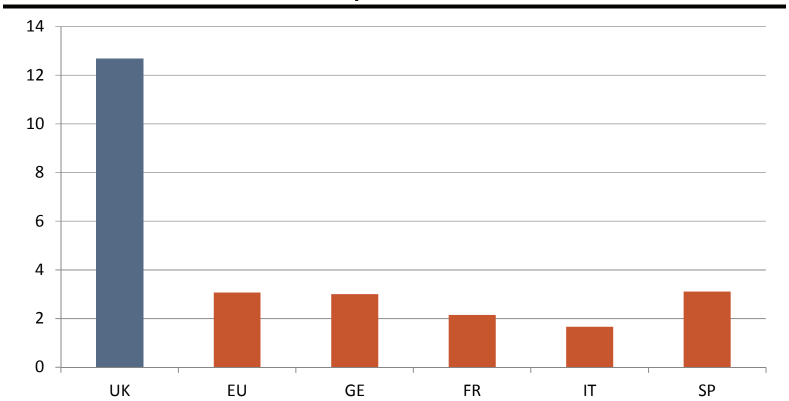
The Brexit Brief: our guide to the "what if"?

- **A serious shock.** If UK voters decide on 23 June to leave the European Union, the UK and, to a lesser extent, Europe as a whole could plunge into a significant crisis. Markets would price in the risks, possibly overdoing it in a first knee-jerk reaction.
- **The UK would end up poorer,** more isolated and somewhat at the mercy of a big neighbour over whose affairs it would have forsaken all influence. The **EU** would face a serious identity crisis with some risk of potentially losing a few further members later on.
- **But a Brexit would not be a black swan.** Markets have discussed the threat for the last six months; we identified it as the key risk to our modestly positive outlook for European economies long ago. The world as we know it would not end with a Brexit. It would just be a more risky place for a while.
- **Serious short-term and long-term economic damage for the UK:** The uncertainty caused by the UK filing for divorce from its major trading partner could lead to a modest UK recession with a plunge in business investment. This short-term demand shock would be followed by a permanent decline in trend growth as Brexit hurts the UK's supply potential.
- **Modest shock but no long-term damage to the EU economy.** The EU would likely suffer a significant short-term dent to growth. But as long as the EU does not fracture much further, a Brexit would not hurt trend growth. Modest losses from less trade with a less dynamic UK would be offset by the relocation of some jobs from the UK into the EU.
- **Opening a Pandora's box of political risks:** In the UK, Conservative EU sceptics would likely topple Prime Minister Cameron and Chancellor Osborne immediately or within a few months. Scotland may hold a second independence referendum later on, the future of Northern Ireland would become more uncertain as Ireland may again be separated by a visible border. In the UK as a whole, the political situation may become unstable if the UK falls into the recession that the victorious Brexiteers had promised would never happen.
- **Fodder for the right:** Across the EU, a UK vote for Brexit could embolden anti-EU populists in the mould of America's Donald Trump and Britain's Boris Johnson. Doubts about the future cohesion of the Eurozone could potentially trigger a small new euro crisis. However, we would expect the EU-27 and the Eurozone to remain largely intact after some modest political initiatives to strengthen the cohesion of these two clubs of European nation states. ECB bond purchases mitigate the risks.
- **Market impact:** A Brexit would likely trigger a rush to safe-haven assets. Sterling could fall by up to 10% against the US dollar over time; the euro may decline slightly. European equity markets may drop by 5-10% whereas yield spreads would widen with 10-year yields for gilts and bunds plunging to record lows while yields for Italy and Spain would rise. Some of that may happen before the vote already.
- **What if?** We see a 40% risk of a Brexit. We still expect that, for the majority of British people, common sense and status quo bias will prevail. But the Brexit risk is very real. In this note, we summarise our best guesses about the potential impact.

Who needs whom? Mutual trade exposure of UK and EU 27 to each other



UK data shows exports of goods and services to EU 27 as % UK GDP. All other country data shows exports to UK as a % of GDP. Source: ONS, Bank of England, Eurostat, Berenberg.

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23 June 2016: referendum logistics

UK Voters are asked a simple question: Should the United Kingdom remain a member of the European Union or leave the European Union?

Polling booths close at 22:00h BST. There will be no official exit polls. Whereas some private companies have reportedly commissioned their own exit polls, no finding or result of such polls can be announced before the official voting ends at 22:00h BST, to avoid affecting the outcome. In the age of social media, it seems quite likely that results of – or rumours about - such unofficial exit polls could spread from 22:00h onwards.

First official results for some of the 382 counting areas will likely be published shortly after midnight. Even if the result is close, we should have a clear idea of the likely outcome by 04:00h BST. The overall result will be announced at some time during the morning of 24 June at Manchester Town Hall by a chief counting officer.

Asian markets will be open during the counting, with the Tokyo exchange opening at 01.00h BST and Hong Kong and Shanghai opening at 02.30h BST.

The referendum is non-binding. The ultimate decision to file for divorce from the European Union rests with the UK parliament. However, Conservative leaders have made it clear that they want to honour the result of the referendum.

Brexit impact on the UK

Economic damage

Immediate demand shock

In the short term, a vote to leave the EU would likely cause a demand side shock. Heightened uncertainty would damage confidence, causing business investment to contract and household spending growth to slow. We have seen a foretaste of this in the weaker UK economic data so far this year. Tighter credit conditions would exacerbate the fall in domestic demand. A vote to leave the EU would likely mean a brief a recession in the second half of 2016. The concurrent fall in the sterling exchange rate would need at least six to nine months to mitigate the short-term damage.

Slower trend growth

In the long term, a Brexit would mainly impact the supply-side of the economy. The immediate recession would be followed by permanently lower trend growth, perhaps slowing to 1.8% annually from 2.1%. How badly Britain's long-term growth prospects would be impaired would depend on the degree of market access which the EU would grant Britain after Brexit. This is highly uncertain. Our best guess is that the UK would retain most of its access to the Common Market for goods but would face significant restrictions on the politically sensitive services market. Less access to its largest export market would restrain Britain's growth machine. Slower population growth and weaker investment could exacerbate the long-term supply-side damage.

Tail risk: sterling crisis

Brexit uncertainty has already caused a 10% plunge in the trade-weighted sterling exchange rate since last November. A Brexit could trigger a sharp drop in market confidence. The UK's current account deficit reached a record 7% of GDP in late 2015. This makes the UK vulnerable to an investor panic and a run on sterling. However, a full-blown sterling crisis remains a low probability tail risk. Serious political uncertainty in the UK after a Brexit could raise the risk.

Bank of England reaction

A Brexit could cause a major headache for the Bank of England. Instead of possibly starting to raise rates gradually in late 2016 in response to an ongoing economic recovery if Britain votes to stay in the EU, a post-Brexit recession could force the BoE to ease policy in the second half of 2016 to support domestic demand through a lower rates and possibly through renewed asset purchases (quantitative easing, QE).

In the event of a severe sterling crisis, however, the BoE might have to raise rates to defend the currency and contain capital flight. But rate hikes may do little to stem capital outflows, as the experience of 1992 demonstrated. As a result, the BoE may possibly just stand by without a significant reaction even if major capital outflows caused a disruptive drop in the sterling exchange rate and an additional decline in UK living standards through higher prices for imports.

Beyond the near term, the longer-term outlook for BoE rates would be shaped by the impaired outlook for growth after a Brexit. If the damage to supply exceeds the damage to aggregate demand in the long-run, inflation risks would rise. This would ultimately cause higher rates which, in turn, may contribute to a setback for the UK housing market. But as it is difficult to predict whether the fall in supply would exceed the fall in demand, the long-term consequences of a Brexit for UK monetary policy are difficult to predict.

Precise impact highly uncertain

Economics is not a precise science; it deals with the behaviour of a vast multitude of people who often influence each other in not fully foreseeable ways. Depending on how policy makers, investors, households and companies react to a Brexit, the economic impact could be worse or less bad than described above.

Political consequences in the UK

Cameron and Osborne to lose office soon?

A vote for Brexit could open a political can of worms in the UK. It would probably topple Prime Minister (PM) David Cameron and Chancellor George Osborne and exacerbate the tensions within the ruling Conservative Party. More importantly, the United Kingdom may even fracture a few years later as a result if Scotland reacts with a second independence referendum at a time chosen by the Scottish Nationalists. Even Northern Ireland may eventually rethink its position within the UK if the border between Northern Ireland and the Republic of Ireland turns into an EU external border. For the UK as a whole, heightened political tensions could worsen the post-vote economic damage described above.

PM Cameron could lose his job in various ways.

1) He may simply resign shortly after losing the Brexit vote. This is fairly likely. Although he has said publicly that he would remain PM, it would be difficult for him to rule the country effectively for long after a majority of voters have rebuked him on this key issue. As one variant, Cameron may announce that he will still see the UK through the first few months of post-referendum uncertainty but leave office before the negotiations with Brussels about a post-Brexit deal between the UK and the EU-27 start in earnest. That would give the Conservatives time to sort out the succession.

2) Conservative members of parliament (MPs) could try to oust Cameron with an internal vote of no confidence. Under Conservative Party rules, just 15% of the party's 330 MPs are needed to call such a vote among Tory members of parliament. With the Conservative Party almost split down the middle on EU membership, getting the required 50 signatures ought to be fairly easy. If Cameron lost this vote, he would have to resign, triggering a leadership race within the Conservative Party. If Cameron won the vote, he could remain leader and prime minister. No further such vote could be called for 12 months. However, even if he wins the vote among his party's MPs, who tend to be less EU-sceptic than the Conservative rank and file, the pressure from within his party may still force him to resign shortly afterwards. Cameron has already suggested that he wants to leave office before the end of the parliamentary term in May 2020 anyway. After losing the Brexit referendum, he would probably be seen as too lame a duck to continue for long.

3) The other parties in the Houses of Commons could overthrow the Conservative party through a no confidence motion in parliament. Such a vote to trigger a general election could be held if the ruling party were either defeated on a budgetary vote, or if the House of Commons, with the support of two-thirds of its total membership (including vacant seats) called for a general election. The last time a leader was ousted by a parliamentary vote of no confidence was in 1979 when Labour PM James Callaghan was defeated by opposition Conservative leader Margaret Thatcher. Serious infighting within a bitterly divided Conservative Party could possibly lead to early elections if some factions team up with the opposition parties for the purpose. But this

remains unlikely. Whatever their views on the EU and Cameron, Conservative MPs would have much to lose in early elections. In addition, it would not even be clear whether the Labour and Scottish Nationalist opposition would actually want to trigger an immediate election. Instead, they may favour to wait, letting the Tories confront the immediate post-vote economic and political fallout - and their own internal divisions – first in order to possibly weaken or split the Conservatives for good.

Boris Johnson to succeed Cameron?

In the scenario of Cameron stepping down or being ousted as prime minister, the de facto leader of the Brexit campaign, the popular ex-mayor of London, Boris Johnson, would likely win the leadership race within the Conservative Party. Whereas current Justice Secretary, Michael Gove, may also be a candidate for the top job, he would more likely end up with the second prize, replacing Osborne as chancellor. Conservative Party members and not just MPs would be eligible to vote in a leadership race to replace Cameron.

Cameron's successor could face a serious crisis of legitimacy soon

Would the political outlook with a leading Brexiteer such as Boris Johnson or Michael Gove at the helm be stable? Probably not. The new prime minister may enter office amid a post-Brexit economic shock. As Johnson and Gove had told British voters that a Brexit would be good for the UK economy, they could face a major public backlash if the economy tanks nonetheless. This could raise the likelihood of a no confidence vote in the House of Commons. At the least, it would significantly impair the Conservatives chances of securing a majority in the 2020 election.

In addition, a pro-Brexit prime minister would have to work with a parliament where roughly half of his own Conservative MPs and most of the opposition members do not share his views on Europe. Forging a position for divorce discussion with the EU and agreeing on the sequence of steps (when would the UK formally file for divorce) may not be easy.

What is the alternative to a Conservative government? In a post-Brexit general election the Conservatives may well lose their current slim majority of 330 out of 650 seats in parliament. The most likely result of a post-Brexit election would be a hung parliament made up of Conservative, Labour and SNP, or possibly Liberal Democrat MPs.

Disunited Kingdom: Scotland or Northern Ireland to leave the UK?

Much of Scotland and most Catholics in Northern Ireland are far more pro-EU than the English average. A UK vote for Brexit shaped by an English majority for leaving the UK while most Scots would have preferred to stay in would raise the risk that Scotland and possibly Northern Ireland may eventually leave the UK to stay in or return to the EU instead.

For **Scotland**, we would expect the Scottish Nationalists (SNP), who hold the majority of seats in the Scottish parliament, to call a new independence referendum only if they are fairly certain that the outcome would be in their favour. At current oil prices, that looks dubious. However, the SNP would likely argue that Brexit changes materially the basis on which 55% of Scots voted to stay in the UK in 2014, claiming that this would give SNP the right to call a new referendum at a time of its choosing (for instance when Brexit terms become clear, as cover for waiting with a second referendum). The Damocles sword of a new Scottish referendum would hang over the UK. Also, the worse the political infighting in England gets or the more the UK suffers a post-Brexit recession, the stronger could be the Scottish urge to leave.

In **Northern Ireland**, a Brexit would raise the prospect of an EU external border separating it from EU member Ireland. The nature of the border dividing the emerald isle would depend principally on whether the CTA (common travel area) between the UK and Ireland can survive the Brexit vote. Nationalists and republicans might argue that re-imposing the border would threaten the very basis of the Good Friday Agreement of 1998 that largely ended the sectarian violence in Northern Ireland. While the demographics favour Catholics, the leading party in the Northern Ireland Assembly is the Democratic Unionist Party which supports Brexit. The proportion of Catholics in the Northern Irish population has risen from below 30% in 1971 to 41% in 2011. In 2011, Protestants and other non-Catholic Christians made up 42% of the population. Based on these trends, the mostly pro-

Irish Catholics should become the major religious group in the next few years, further raising the prospect of a Northern Irish referendum to leave the UK and possibly rejoin the EU as an independent country or part of the Republic of Ireland some time in the future.

Will the referendum settle the issue for good?

Probably for a while. But we cannot be sure. If the result is very close or if the winning side loses legitimacy shortly afterwards because its main arguments turn out to have been wrong, the referendum may not be the end of the story. As in the case of Scotland's 2014 independence referendum, the "leave" campaign may just wait for a second chance if it narrowly loses the EU referendum on 23 June 2016. EU-sceptic Tories could still try to install an EU-sceptic successor to Cameron once the prime minister leaves office, perhaps in 2018. The successor could then promise a new referendum. More importantly, if the "leave" side wins the referendum on 23 June 2016 and the UK falls into a recession which the Brexiteers had promised would never happen, the issue whether Britain may want to rescind its application for divorce could be an issue in the next general election campaign in the UK.

The mechanics of leaving the EU

The UK referendum is non-binding. The formal process to leave the EU would begin with an Act of Parliament to repeal the 1972 European Communities Act. Once the UK has officially notified the EU that it wants to leave, the UK and the EU would have up to two years to negotiate the withdrawal according to Article 50 the European treaties. During this negotiation phase the UK would still be a member of the EU and hence of the Common Market for goods and services, capital and labour. But the UK would forfeit its right to vote on EU legislation.

Extending the two-year negotiating period or agreeing on an earlier or later exit from the EU would require unanimous agreement between the UK and all members of the remaining EU-27. If the exit negotiations conclude in less than two years and both the UK and EU agree, the UK could formally withdraw from the EU earlier. Given the complex nature of the issues, we consider this unlikely. After the two-year period, the UK could withdraw from the EU even if it has not agreed on the terms of divorce with the EU.

The negotiations between the UK and the EU-27 would cover two intertwined but somewhat different issues: the terms of divorce and the future relations between the UK and the EU-27 after the divorce. Settling the technical questions of divorce may be much easier than negotiating future market access and ratifying such a deal. Judging by the experience with other significant international trade deals, agreeing on future market access may take much longer than two years. For example; the EU and Canada started to discuss a free trade deal in 2009. Seven years later, it has not been ratified yet.

Post-Brexit: an unfavourable deal for the UK

Careful what you wish for: in is in, out is out

As German finance minister Wolfgang Schäuble has already suggested, "in is in, out is out". The UK could not pick and choose, keeping the benefits of the Common Market while revoking its obligations to its European neighbours. For five separate reasons, the EU-27 would have a much stronger hand than the UK in negotiations about post-Brexit relations across the English Channel.

1) Size: the UK needs trade with the EU much more than vice versa. Whereas the UK earns 13% of its GDP through exports to the EU, the EU-27 earns 3% of its GDP through its exports to the UK. And the EU-27 economy is over four times larger than the UK.

2) EU inertia: a post-Brexit deal with UK would be a new and substantial deal for the EU. It would have to be approved by all 27 other members. That has become rather difficult anyway. The lowest common denominator for the 27 EU countries would hardly be to offer a good deal to a UK that has filed for divorce against the wishes of its 27 EU partners. While Brussels has a reputation for forging compromises, would Germany really lean hard on, say, Poland, to give Britain a good deal? Probably not. Without a deal on future access, the UK could fall into a near-void. After Brexit, mutual

exchanges with its biggest market would then be governed only by WTO rules rather than a preferential deal with the EU. The UK would have to fear that shock much more than the EU.

3) Political incentives: The political priority for the EU27 would not be to agree a deal that is reasonable for the UK. Instead, the EU's objective would be to contain the political fallout. The EU is a package deal. Members take most of the bits whether they like individual parts of it or not. Making it cheap and easy for the UK to pick and choose, that is to leave the EU and maintain full market access nonetheless, would set a precedent which the EU would not want. Conversely, the Brexiteers in the UK who have promised that post-Brexit disruptions would be minimal would be under intense pressure to forge a good deal fast. That would weaken their bargaining position versus the EU-27.

4) Goods versus services: The UK has a comparative advantage in services, where it runs a surplus of around 1% of its GDP with the EU. In trade in goods, the UK's position is weak with a deficit of 5% of its GDP with the EU. Unfortunately for the UK, services are politically much more sensitive than goods. Just think of financial regulations. If the City of London turns from an onshore to an offshore centre for services, the EU would find it politically very easy to argue that future UK access to the EU market needs to be regulated strictly.

5) Free movement of labour: To maintain domestic support and not be exposed as having misled the public, the anti-immigrant Brexiteers would have to impose significant restrictions on EU immigration into the UK. In response, other EU countries (think Poland) would want to impose counter-restrictions on the UK in areas where it hurts the UK without damaging the EU-27 very much. Services would be the natural political target for that.

Future market access

These considerations inform our best guess as to the substance of a possible future deal on mutual market access between the UK and the EU-27 for the four basic freedoms in the Common Market:

Goods: no major change. The EU would likely agree to keep the UK in the common market if the UK offers some concessions such as paying into the EU budget.

Services: the UK would face significant restrictions to market access. In financial and many other tradable services, the EU would likely not grant a post-Brexit UK the automatic access rights ("passporting") which UK-based companies now enjoy across the whole EU.

Labour: some restrictions. The EU27 would retaliate against any UK breach of free movement, probably by imposing restrictions on services. UK citizens residing in the EU may also face restrictions similar to those which the UK may impose on EU-27 citizens in the UK.

Capital: no major change. We expect no capital controls or the like. Of course, the flow of capital would be affected by restrictions to market access for financial services.

Brexit impact on the EU

Economic impact

Short-term dent to Eurozone growth

In the EU, the uncertainty about future relations with the UK and the future of the EU itself that would be caused by a UK vote to leave the EU would weigh modestly on investment and growth later this year. It would probably halve the Eurozone's growth rate from 0.4% qoq to 0.2% qoq for a couple of quarters. Of course, escalating financial or political turbulences could exacerbate this effect.

No direct impact on trend growth

Beyond the short-term dent to confidence, investment and aggregate demand, a Brexit need not have any significant economic impact on the continent. As long as the EU does not fracture further or escalating concerns that the EU may eventually fracture reach fever pitch, trend growth would likely remain around 1.6% annually. The small losses from less trade with a less dynamic UK would be offset by some gains in jobs as some UK providers of financial and other services would relocate some jobs into the EU to maintain full market access.

Political consequences in EU: a domino effect?

If the UK votes to leave the EU, businesses and financial markets will be caught out as having underestimated the Brexit risk for a long time. As a result, markets would probably pay much more attention to those populists across Europe who also rail against the EU or the euro. This could potentially trigger potentially a modest echo of the euro crisis and some widening of risks spreads even when the initial knee-jerk reaction has faded.

Fortunately, the UK is a somewhat special case. It has always been the most detached EU member, harbouring serious doubts about integration fuelled by an often viciously anti-EU press. In the process, the UK secured a panoply of opt-outs. Outside Scandinavia and possibly the Netherlands, few people would likely see the island kingdom UK as a potential role model for how to structure relations with their European neighbours.

Fodder for the right

A UK vote to leave the EU would encourage right-wing populists across Europe who also protest vehemently against immigration. It may also embolden those libertarians who perceive the EU as a socialist conspiracy against unfettered capitalism or, in a milder version, view the common rules that underpin the common market as unacceptably burdensome.

Confusion on the left

A Brexit would be seen across Europe as a victory for the likes of Nigel Farage and ex-London mayor, Boris Johnson. This would question the world view of some left-wing populists who perceive the EU as a capitalist conspiracy against the oppressed workers of Europe, or so they claim. A Brexit would make it more difficult for the ultra-left to portray the EU as an instrument of “Anglo-Saxon capitalism”. That may slightly mitigate the potential boost to right-wing anti-EU populism.

Most Euro crisis countries look safe

We see little risk that a Brexit would seriously change the political discourse in Greece, Portugal or Spain, where austerity has fuelled some left-wing backlash against the EU. With the exception of Greece, austerity is over in these countries. In addition, the UK is rarely seen as a relevant example to follow in these countries.

French follies? Probably not

Jointly with Germany, France is the indispensable anchor of European integration. In France, the ultra-right Front National threatens to pull the country out of the euro after a referendum; the small centre-right DLF is also somewhat euro-sceptic. Parts of the radical left want the ECB to fund socialist policies without wanting to leave the euro. However, polls suggest that the pro-euro centre-right Republicans will win the 2017 elections. Support for the Front National seems to be capped at around 30%. In addition, French reactions to a Brexit could be mixed. While it may embolden the Front National somewhat, it could also strengthen hopes of many French that, without the UK, they may be able to shape the EU a bit more to their liking.

Italy is the country to watch

Italy matters because of its size (the fourth-largest in the EU) and its debt (133% of GDP). Since the demise of Silvio Berlusconi, Italy lacks a strong centre-right that could take over from Matteo Renzi’s centre-left. Renzi’s government could be at risk if he loses the referendum on constitutional reform this October. This is unlikely but not impossible. Of the five Italian opinion polls since mid-May, three projected a “yes” and two a “no” for Renzi’s October referendum. Renzi has stated that he would step down if he loses. His government would very likely try to soldier on without him. But in the absence of a new charismatic leader, the risk that the government may disintegrate well before the end of the parliamentary term in May 2018 would be real. If so, parties with more than 50% support in current opinion polls may campaign in hypothetical early elections with a promise to hold a referendum on euro membership. That could rattle markets. Fortunately, Renzi remains in the pole position. That Italy could be governed by an anti-euro coalition still looks unlikely.

What about Scandinavia?

Within the EU, a Brexit could resonate most in Scandinavia, especially in Denmark and, to a lesser extent, also in Sweden. Like the UK, both countries are EU members outside the euro. In the wake of the migrant crisis, anti-immigrant sentiment has risen in both countries. They could thus be fertile ground for a populist campaign to leave the EU. But both countries are also tied even more closely economically to core Europe than the UK. Calling a referendum would be comparatively easy in Denmark. That risk would need to be watched. But because of Denmark's small size, a hypothetical Dexit – Danish exit from the EU – would likely not be a major shock to the EU. More to the point, we consider a Dexit rather unlikely albeit not fully impossible.

EU responses to Brexit

With the rising risk of Brexit, EU leaders have started to discuss a potential response. On the day after a UK vote to leave the EU, senior EU leaders would likely come up with carefully choreographed statements emphasising that they are well prepared to deal with any issue that may arise, that no other country will leave the EU and that the EU will try to be as close a friend to the UK as possible even after Brexit. EU-27 leaders would likely use the regular EU summit on 28-29 June to present a somewhat coordinated response, possibly meeting on the even of that summit without the UK already for that purpose.

More cooperation on less controversial issues

On substance, EU-27 leaders would face a quandary. On the one hand, the natural impulse in a crisis is to stick together more closely. To dispel doubts about the future cohesion of the EU and the Eurozone, a clear signal that they would work to strengthen the EU and the Eurozone could help to quell market concerns. On the other hand, responding to a British vote against integration with more integration would be politically difficult. It may even invite a negative response from significant parts of the population in many EU member states. Recent statements by various EU leaders have highlighted the potential conflict.

As a result, we would expect EU-27 leaders to quell talk about domino effects amid doubts about the political cohesion of the EU and the Eurozone by some modest political initiative to strengthen co-operation on comparatively uncontroversial issues. The focus could be some German-French led political initiative on security issues (anti-terror co-operation, more joint military brigades). In the age of serious terrorist threats, such co-operation could be a comparatively easy sell.

Potential response to a new euro crisis

As our base case, we do not expect a UK vote for Brexit to spark a serious euro crisis. In the absence of a dramatic spike in tensions, EU-27 or EU leaders would not want to deepen integration on controversial issues after a UK vote for Brexit. However, if concerns about domino effects were to cause a major crisis, a more forceful if controversial political response could become necessary and likely. At a political and fiscal level, such a potential response to a hypothetical crisis could involve faster progress towards joint deposit insurance in the Eurozone. In case of extreme tensions, it may even include some element of common financing with a "Eurobond light" for certain extraordinary government expenditures for all eurozone members signing up to enhanced fiscal rules. But again, this is not our central case.

ECB response

The central bank's options to respond to a Brexit would be fairly limited. The strong German resistance to the ECB's existing aggressive ECB stance adds an additional layer of difficulty, as may the verdict of the German Constitutional Court on German participation in a potential OMT programme on 21 June 2016. In any case, the ECB's current bond purchase programme of €80 billion per month and the generous four-year liquidity injections starting right at the time of the Brexit referendum would offer significant support for markets, banks and the overall Eurozone economy anyway. The very fact that these initiatives are already quite aggressive would make it difficult for the ECB to come up with more. As our base case, we expect the ECB to inject liquidity where needed and to state clearly that the bank is ready to act against any undue tensions that could impede the transmission of its monetary policy to the Eurozone economy. In case of a serious crisis, the ECB could and would act further.

Potential market impact

Recent days and months have given us a foretaste of the potential market reaction to a Brexit that has not been fully priced in. Since November 2015, Brexit risk has been a major driver of sterling, which has lost 10% of its value in trade-weighted terms. Bond and equity markets have also been affected by some capital flows out of risk into supposedly safer assets.

If the UK votes for Brexit, we would expect roughly the following market reactions within a month. Of course, depending on the newsflow about how the fallout from a Brexit vote would be managed politically, the reactions could be more or less pronounced.

Currencies

Recent evidence suggests that a 5ppt increase in the bookmakers' implied Brexit risk tends to lead to a fall in **sterling** versus the **US dollar** by 1% week-on-week. Based on this very limited evidence, an increase in the risk by 60ppt from a 40% risk now to a 100% certainty on 24 June would translate into a 12% drop in cable. Concerns about the future of the EU and the Eurozone could also weigh on the **euro**. But this effect would likely be limited to no more than 3% against the US dollar. Even at the height of the euro crisis, the euro exchange rate remained comparatively stable. After all, some market participants may believe that the hypothetical successor of the current euro could be a stable core European currency.

The **Swiss franc** and the **Danish krona** would also receive some safe-haven inflows, probably forcing their central banks to intervene against a rise in their exchange rates.

Bond markets: safe haven flows

Uncertainty, recession risks and talk about potential BoE easing in response to such recession risks could cause a drop in 10-year yields for **gilts** by, say, 30bp. **German bund yields** may fall by 20bp, pushing them deeply into negative territory. Conversely, Italian and Spanish 10-year bond yields could rise by some 40bp in response to perceived additional risks within the Eurozone.

Bonds from **Switzerland**, **Denmark**, **Sweden** and **US Treasuries** and some other countries seen as comparatively safe would also get an extra bid after a pro-Brexit vote.

Equities

Equity markets would be hit by a likely spike in risk aversion, with cyclically sensitive sectors and financials possibly reacting more than other sectors. Drops in UK markets and European markets by up to 10% in local currency terms look quite possible.

For equity markets, however, the sell-off as measured in local currency could be tempered somewhat by a likely fall in exchange rates. Exchange-rate sensitive sectors may thus fare best – or least badly – after a pro-Brexit vote.

An accident foretold?

Of course, a major part of the potential market reactions described above could happen before 23 June if polls continue to show a rising Brexit risk. Being forewarned about an accident can mitigate the overall impact. The fact that markets have already moved in the last ten days could also contain the short-term market impact.

If the UK votes to leave the EU, perceptions of risk in Europe could change. Markets may react more to, say, any restrictions which Germany's constitutional court may place on Bundesbank participation in the ECB's OMT "do all it takes" programme in its upcoming verdict on 21 June or to an inconclusive result of the Spanish repeat election on 26 June.

What if the UK stays in?

If the UK votes to stay in the EU, which is not the major focus of this "what if" note, we would expect a sigh of relief with about one-third of the market impact outlined above, just with reverse signs.

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