The Impact of a Brexit from the EU

Abdur Chowdhury, Ph.D. Chief Economist
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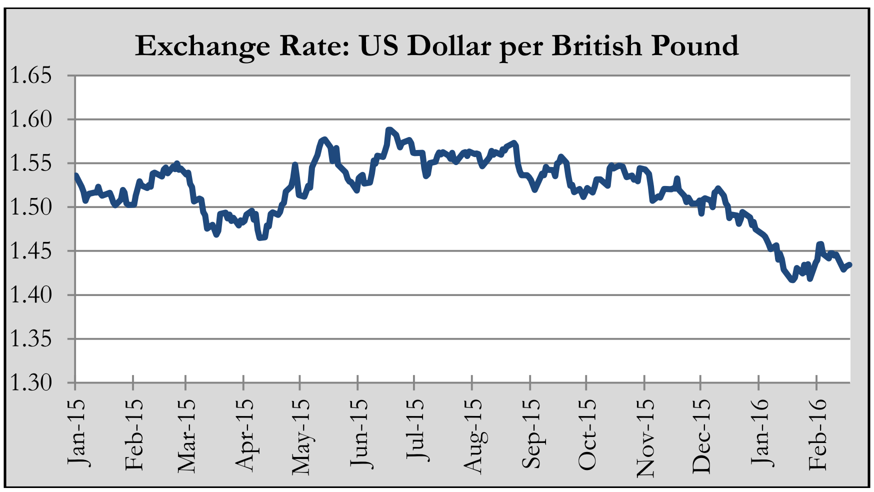
Volatility has jumped across currency markets this year because of wider concerns about China, European banks, negative interest rates and volatile markets. The last thing investors need is more economic uncertainty with the breakup of the world's biggest free-trade area. With United Kingdom's (U.K.) referendum on whether to leave the European Union (EU) set for June 23rd, investors are beginning to worry that it could be another major concern for them with unknown outcomes.

The long-run impact of a vote to leave is impossible to assess. Major unknowns after an exit include market access to the EU for the City of London, the potential for stand-alone trade deals, and the danger that Scotland would once again insist on another independence vote.

In the short run, the investors and traders are, however, focused on a sharply weaker pound. The British pound fell to a seven-year low against the dollar after the announcement of the referendum. Investors are using options to hedge against a fall by the pound.



Source: Board of Governors of the Federal Reserve System

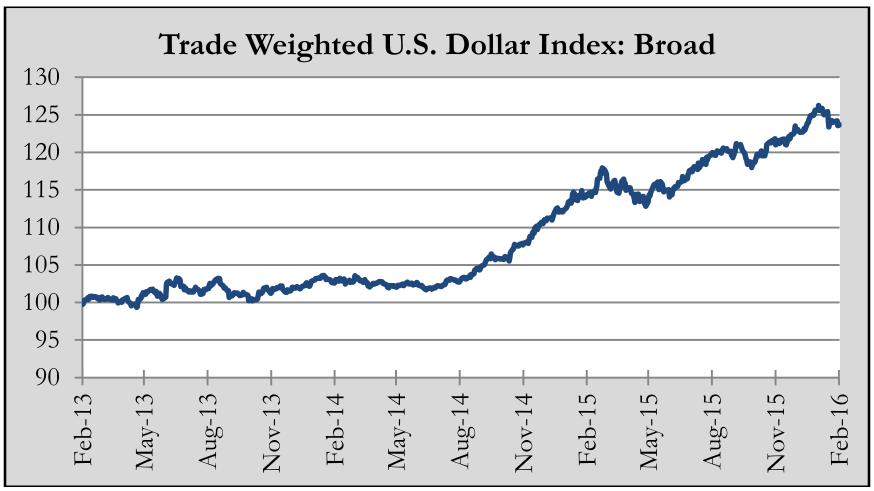
Leaving the EU would likely hit pound on several fronts. Impacts would likely include significantly lower economic growth for the U.K., capital flight, reduced direct investment in the U.K. and the Bank of England would likely need to keep its easy-money policies in place for longer.

There are other asset classes that could be affected following a referendum. Topping the list would be London's property market. London's housing prices have been among the most expensive in the world, in part due to overseas demand and immigration, and so will be susceptible to price drops if the U.K. leaves the EU. Gold may also benefit as the potential for a U.K. exit adds to political and monetary risks that can push investor money into gold. In equity markets, U.K. companies with significant European exposure could be hit if access to Britain's biggest trading partner is affected.

The impact wouldn't just effect the U.K. A vote to leave could be catastrophic for confidence in an already fragile Europe. The pound might suffer the most, but the euro would also come under pressure against other major currencies. Even worse for the common currency, the European Central Bank would surely become even more dovish if faced with two years of uncertainty while U.K's exit details were negotiated.

So what could this mean for the U.S. economy?

One immediate effect would likely be a strengthening of the U.S. dollar. The dollar has already strengthened nearly 25 percent in the past eighteen months as investors began to anticipate the prospects of higher U.S. interest rates. The high exchange rate has already been blamed for crimping exports and putting deflationary pressure on the U.S., and could be a new key source of risk for the economy in 2016.



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An even stronger dollar would also tend to keep downward pressure on commodity prices. This of course would continue to benefit consumers and businesses that are helped by lower import prices. But it would continue the woes of America's oil production industry, including its hiring and capital expenditures.

Frankly, the UK has very little to gain by quitting the EU and much to lose. Opinion polls indicate the British population is divided over EU membership with the chance of a British exit currently as high as 40%. Irrespective of the twists and turns of the 'Brexit' debate, the uncertainty over the vote could continue to weigh on both the U.S. and global financial markets in the coming months.

Dr. Abdur Chowdhury is a Professor of Economics at Marquette University, the Chief Economist at Capital Market Consultants, Inc. (CMC) and a member of the Federal Reserve Board of Chicago's Academic Advisory Council. CMC provides capital market, investment manager and economic research to financial professionals (for more information about Capital Market Consultants, Inc. see our website at (www.cmarkc.com).