LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

KEY TAKEAWAYS

Following its vote to the leave, the U.K. will need to enter negotiations with the EU regarding the terms of the exit.

The terms regarding movement of people across borders and the trade relationship will be the focus of the negotiations.

In addition to political uncertainty in the U.K., there are several other political events across Europe in 2016–2017 that we'll be watching.

July 5 2016

WHAT'S AHEAD FOR THE U.K. & EUROPE?

John J. Canally, Jr., CFA *Chief Economic Strategist, LPL Financial*

Following the United Kingdom's (U.K.) decision to leave the European Union (EU) in a referendum held on June 23, 2016, there are still many questions regarding the future of the U.K.'s relationship with the EU and other impacts throughout Europe. The ruling Conservative Party of the U.K will begin to formally elect a new leader early this week (July 4–8, 2016) to replace outgoing Prime Minister David Cameron. Cameron announced his intention to resign as Prime Minister on June 24, 2016, a day after the U.K. voted to leave the EU. The fallout from the vote will have many implications for the U.K.'s place in Europe and Europe itself as the politics of "Brexit" reverberate around the continent. Cameron was the leader of the "remain" camp in the U.K., and has said that the next Prime Minister should be the one to negotiate the terms of the U.K.'s separation from the EU after 40 years of membership. Nearly two weeks after the vote, the U.K. government has not yet officially notified the EU (by triggering Article 50 of the Treaty of Lisbon) that it intends to leave.

It's also possible that the U.K. may not end up leaving the EU at all. After all, the June 23 vote was a referendum that took place outside of the constitutional process in the U.K. and is not binding on the government. The market may be anticipating some sort of face-saving deal between the parties, where U.K. politicians can be seen as following the will of the people (mainly, restricting the flow of immigrants in the U.K., but also restoring some of the sovereignty the U.K. has lost in the past 40 years), while still allowing trade between the parties on essentially the same terms as it is conducted currently. Though possible, such a relationship will be difficult to achieve.

One sticking point may be movement of people across borders. The EU is founded on the "four freedoms":

- Free movement of goods
- Free movement of services
- Free movement of persons (and citizenship), including free movement of workers
- Free movement of capital

At the meeting of European leaders that ended last Wednesday, June 29, a number of elected officials, including German Prime Minister Angela Merkel, reiterated the importance of all four freedoms, or pillars, of the EU. Given that immigration was one of the major issues in the Brexit referendum campaign, this makes it hard to find an acceptable compromise. However, given the importance of the trading relationship between the parties, there is great economic incentive to find some way out of this position.

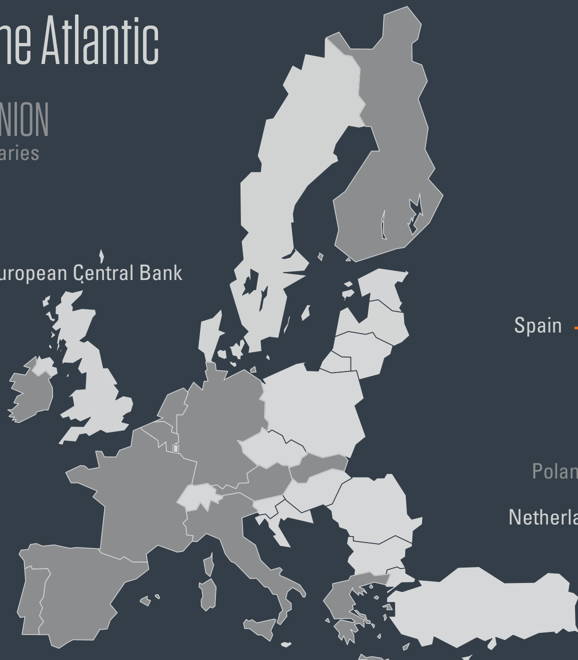
Across the Atlantic

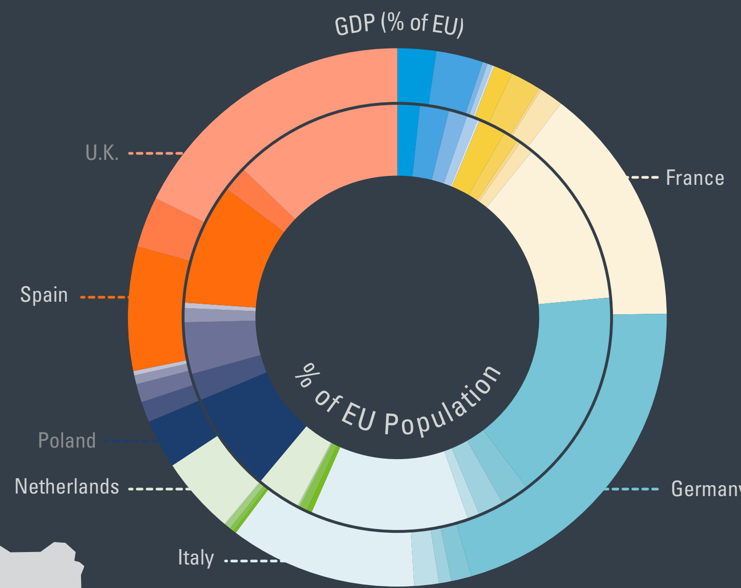
EUROPEAN UNION

Central Bank: Varies
Curency: Varies

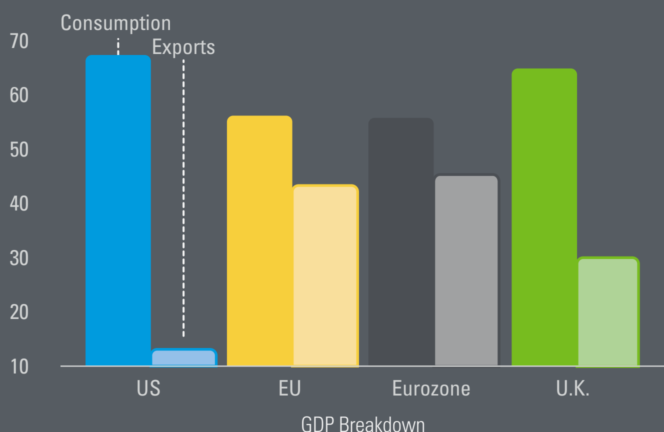
EUROZONE

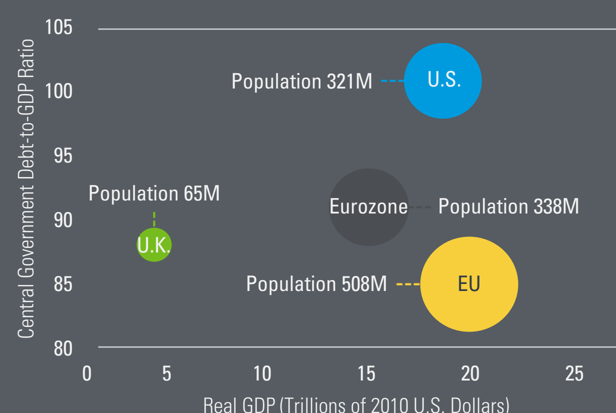
Central Bank: European Central Bank
Curency: Euro





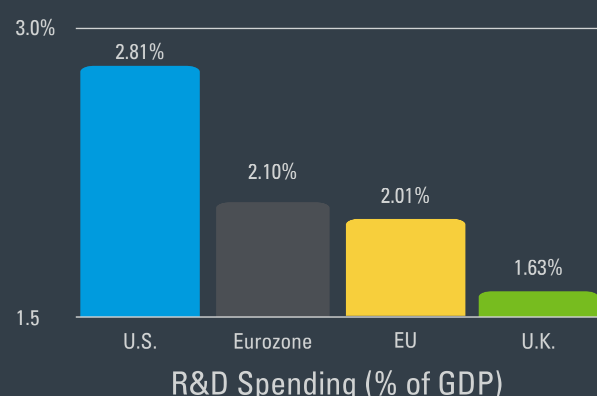
How Does It Compare with the U.S.?





Good Old American Know-How

	EU	Eurozone
U.S. Goods Deficit −	-$157 B	-$134 B
U.S. Services Surplus +	$54 B	$35 B



Source: LPL Financial Research, IMF, Haver, Bloomberg 07/05/16

POLITICAL CHAOS IN THE U.K.

As we and many other observers expected, the U.K.'s vote to leave the EU has caused nothing less than political chaos in the U.K. The current Prime Minister, David Cameron, announced his resignation the day after the referendum. The leader of the largest opposition party in Parliament (Jeremy Corbyn, leader of the Labour Party) held and lost a no confidence vote by the members of his own party in the week after the referendum. As of Tuesday, July 5, 2016, his status as Labour leader is tenuous, at best. Over the weekend of July 2–4, 2016, Nigel Farage, leader of the far right U.K. Independence Party (UKIP), who strongly advocated for "leave," also resigned, adding to the chaos.

If and when the U.K. government triggers Article 50, it would begin the process of negotiating the U.K.'s exit from the EU. Markets are realizing that trade between the U.K. and the EU is not going to cease as a result of this vote. What will be negotiated is not whether there will be trade, but on what terms this trade will take place. Some have referred to the concept of a "Brexit Lite," whereby the U.K. would be able to gain access to European markets, but without having to accept the regulatory system that many in the U.K. believe is too restrictive, a message that was clearly sent by the leave voters on June 23.

By leaving the EU, the U.K. would lose its vote in the European Parliament, which makes the rules governing the "four freedoms" noted earlier. Currently, Norway, Iceland, Lichtenstein, and all 28 members of the EU (see the infographic) are members of the European Free Trade Association. All 31 countries have access to the single market of the EU, and are bound by the four freedoms. The freedom of movement of people is likely to be the major sticking point for the U.K. and the EU as they negotiate, using the other three freedoms (goods, services, and capital) as bargaining chips.

KEY POLITICAL EVENTS IN THE U.K. & EUROPE THROUGH 2017

The leadership vote for the head of the Conservative party that begins this week in the U.K. is likely only the beginning of a series of political events in the U.K. and across Europe that markets will be keeping close tabs on over the rest of this year and into 2017:

- **Another election in the U.K.** In essence, this will be to ratify the referendum results and may occur as soon as later this year, although one isn't required until 2020 (five years after the general election in 2015).
- **The political situation in Scotland.** The electorate voted by a wide margin to remain in the U.K. in the September 18, 2014 referendum; Scotland's political leadership wants to hold another referendum to leave the U.K. and rejoin the EU.
- **Referendum in Italy.** The Italian government will hold a referendum on constitutional reforms in Italy in October 2016. The results may lead to the resignation of the Italian government and further bolster anti-EU sentiment in that country.
- **Political uncertainty in Spain.** Spain's economy is the fourth largest in an EU without the U.K., and has held two elections in the past seven months (including one just three days after the referendum in the U.K.). Although centrist, pro-Europe parties picked up seats in the June election, the ruling center-right party did not win a majority in Spain's 350 seat parliament, leaving political uncertainty high.
- **Elections in Germany, France, and the Netherlands in 2017.** In an EU without the U.K., these countries rank first, second, and fifth, respectively, in the size of their economies. Each will hold a parliamentary election in 2017, and although Germany remains fully committed to the EU, there are sizable political entities in both France and the Netherlands that are generally opposed granting the EU more power at the expense of national governments. The rise of

these anti-EU political movements in recent years makes the EU's negotiation with the U.K. over its exit crucial; the EU leadership wants to make sure that the terms are onerous enough politically and economically to send a message to any of the remaining 27 nations who may be thinking about leaving the EU.

THE EUROPEAN LANDSCAPE

The EU is defined as the 28 nations within Europe that share a single market, but not a single currency, government, or central bank. The Eurozone is the collective name for the 19 of those nations that currently use the euro as their currency, and the European Central Bank (ECB) serves as the central bank for these countries. This group includes (in order of size of their respective economies):

- Germany, France, Italy, Spain, the Netherlands, Belgium, Austria, Greece, Finland, Portugal, Ireland, Slovakia, Luxembourg, Slovenia, Lithuania, Latvia, Estonia, Cyprus, and Malta.

The 9 nations that are members of the EU, but do not use the euro or the ECB (again, arranged by the size of their economies) are:

- The United Kingdom, Sweden, Poland, Denmark, the Czech Republic, Romania, Hungary, Bulgaria, and Croatia.

Although sharing some of the economic and trade linkages with the 19 nations that use the euro and the ECB, each of these 9 nations has its own currency and central bank.

To make matters even more confusing, Switzerland, Norway, Iceland, and tiny Lichtenstein are also European nations with sizable economies, but are not members of the Eurozone (19 nations) or the EU (28 nations) and also have their own currencies and central banks. These nations share many of the "four freedoms" of the EU, but don't have a say in the European Parliament to make any of the rules governing the movement of goods, services, capital, or people.

The nearby infographic puts the population, size, and indebtedness of the EU, Eurozone, U.K., and U.S. in perspective. It also shows that exports are a much bigger part of the economies of the Eurozone and EU than either the U.S. or U.K., which may help to influence the coming Brexit negotiations between the EU and the U.K. The U.S. runs an overall trade deficit with the EU and the Eurozone, but runs a large trade surplus on the service side, or what we like to call good old American know-how. We export far more financial, legal, education, and travel services to the EU than we import, and we send the EU far more intellectual property, entertainment, and TV broadcast rights than we import. Our large trade surplus on good old American know-how is likely to persist regardless of the outcome of Brexit, aided by the fact that the U.S. spends 40% more (as a share of GDP) on research and development than the EU, and nearly 75% more than the U.K. ■

RES 5551 0716 | Tracking #1-513210 (Exp. 07/17)