MARCH 14, 2016

HOORAY 好盈

Economic Report

Brexit

Economic Research

British Trade and Pound Sterling Will Be As Great As Great Britain

Uncertainty of Brexit Adversely Affected the Pound Sterling Recently

The recent announcement of Britain's EU membership referendum, together with the disagreement of the Conservative Party on staying in the EU or not, have caused the significant depreciation of the pound sterling in the FX market.

Background of the EU

The EU is an economic and political partnership currently comprises of 28 member states located in Europe. It suggests "four freedoms" – namely free movement of goods, capital, services, and people – between the member states.

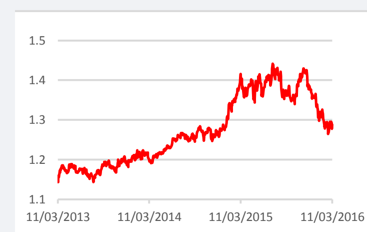
Possible Alternatives after Membership Withdrawal

If Britain leaves the EU, there are five options that the UK can trade with the EU: membership of the EEA; membership of customs union; membership of the EFTA which involves a bunch of bilateral agreements; a normal FTA; and trade under WTO rules.

What Would Happen to the UK in the Case of Brexit

Trades between the UK and the EU are so important for both sides, it is highly likely that the UK will be given special access to the EU markets, and trading under WTO rules with common external tariff is unlikely. If Brexit does not crash the UK economy, the pound sterling will remain stable, and the recent depreciation will reverse when the uncertainties, including trade arrangement in goods and services in the case of Brexit, are wiped away.

3-Year GBP/EUR Exchange Rate



Source: Bloomberg

Scott Tsoi
(852) 2159 – 4505
scott.tsoi@hooraysec.com.hk

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Britain joined the European Economic Community (EEC) – which was renamed the European Union (EU) in 1993 – in 1973. The recent announcement of Britain's EU membership referendum, together with the disagreement of the Conservative Party on staying in the EU or not, have caused the significant depreciation of the pound sterling in the FX market.

Background of the EU

The EU is an economic and political partnership currently comprises of 28 member states located in Europe. It suggests "four freedoms" – namely free movement of goods, capital, services, and people – between the member states.

The EU was founded by 6 countries (Belgium, France, Italy, Luxembourg, Netherlands and West Germany) in 1957 after signing the Treaty of Rome, which created the EEC – the foundation of EU – and established a customs union. It was set up with the aim of ending the frequent wars between neighbors. The idea was that economic cooperation and interdependence will avoid conflict.

According to Article 13 of the Treaty of Lisbon – the treaty that amended the former EU treaties – there are 7 institutions in this supranational organization – including the European Parliament, the European Council, the Council (of the EU), the European Commission, the Court of Justice of the EU, the European Central Bank and the Court of Auditors – to promote its values, advance its objectives, serve its interests, the citizens' interests and the member states' interests, and ensure the consistency, effectiveness and continuity of its policies and actions.

Britain's Historical Relationship with the EU

The UK was invited to participate in the EU's predecessors – the Coal and Steel Community – in 1950, but it did not show interest after considering the relationship with the Commonwealth. In 1957, the UK refused to join the EEC since it was in favor of free trade only, but the customs union as the common external tariff arose from the trades between Britain and the Commonwealth would be considerable.

Britain founded European Free Trade Association (EFTA) with 6 countries – Austria, Denmark, Norway, Portugal, Sweden and Switzerland – in 1960. Like the EEC, the EFTA promoted free trade between members. But unlike the EEC, the EFTA did not have uniform external tariffs and had no supranational institutions.

The UK applied to join the EEC in 1961 due to the unfavorable economic situation, including the Commonwealth states seeking to deal with the new bloc, and the booming economies in France and Germany. Britain finally

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joined the EEC in 1973 with Denmark and Ireland after vetoed by the French President – Charles de Gaulle – twice in 1963 and 1967 partly due to the UK's close relationship with the US. Mr. de Gaulle was hostile to the US and conceived of the EEC in part as an opponent force to the US. Consequently, Britain and Denmark left the EFTA, and free trade agreements were signed in 1972 and 1973 between the EEC and ETFA nations.

Margaret Thatcher – the former British Prime Minister – and the Conservative Party had supported Britain joining the EEC in the 1975 national referendum when she was still the Leader of the Opposition, but she believed that the role of the EEC should be limited to ensuring free trade and effective competition, and feared that the EEC's approach was inconsistent with her views on smaller government and deregulation. To the Conservative Party, in Mrs. Thatcher's legacy, the European political integration was taking sovereignty and national identity away from British.

In 1987, the EEC passed the Single European Act, which strengthened EEC's ability to regulate the economic, social, and foreign policies of its members. The Maastricht Treaty signed on 1992 created the EU and led to the creation of the euro. The UK and Denmark are the only two member states that are not legally bound to adopt the euro when certain criteria are met. They were given the right to join the euro if they wish to. The former British Prime Minister – John Major – negotiated an opt-out from the euro as he believed that a unified monetary policy without a unified fiscal policy would be difficult.

UK's EU Membership Referendum

David Cameron – the current British Prime Minster – had promised a referendum vote on Britain's EU membership if his party won the general election in 2015.

The referendum will take place in the UK on 23rd June 2016. Mr. Cameron has renegotiated the terms of Britain's membership of the EU and secured a deal which will come into effect if the UK stays in the EU. The terms include recalculation of child benefit to migrants, restriction on new migrants' welfare payments, reimbursement of money spent on bailing out Eurozone nations, prevention of Eurozone regulations being imposed on British financial services industry, etc.

The Eurosceptics argue that the EU has been extending its control, charging massive amount of membership fees for a little benefit, and migrates are attracted from the Eastern Europe and are eligible to receive social insurance and work in the UK. They believe a withdrawal allows the UK to regain control over immigration policies and legislation, and also free the country from an economic burden, given the recent migration crisis and the fact that the UK is one of the ten member states that are making net contribution into the EU

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budget. Britain's net contribution to the EU budget for 2014/15 was £8.8 billion, nearly double what it was in 2009/10, and accounting for around 0.5% of GDP in 2015. In addition, compared to the EU's enormous size, it is believed that other countries are more willing to establish free trade agreement (FTA) with a country like the UK after considering the possible impact on the domestic industries.

The Europhiles believe that leaving the EU will result in loss of trades due to common external tariffs imposed by the EU and also a significant decrease in foreign direct investment in the UK, leading to unemployment as a result. Even if joining the European Economic Area (EEA) and the EFTA at the same time like Norway, Britain will have no voting right and influence in the EU but still obligated to make contribution to the EU budget and comply with EU regulations in order to export goods and services to the single market. Also, it may be difficult to negotiate FTAs with other countries if the UK is outside the EU, given the apparently smaller population and therefore weaker bargaining power.

Leaders of other countries have been giving pressure to the UK. For example, French President warned that there will be consequences if Britain leaves the EU.

Eligibility of Withdrawal from the EU

Under the first 2 paragraphs of Article 50 of the Treaty of Lisbon:

"1. Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements.

2. A Member State which decides to withdraw shall notify the European Council of its intention. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union. That agreement shall be negotiated in accordance with Article 218(3) of the Treaty on the Functioning of the European Union. It shall be concluded on behalf of the Union by the Council, acting by a qualified majority, after obtaining the consent of the European Parliament."

Any member state, including the UK, is entitled to withdraw from the EU.

Britain's Trades with the EU and the Rest of World

Britain is a key exporter of financial and professional services and high-end manufactured goods, such as the aerospace and defense sectors. According to CIA World Factbook, the high-valued commodities that the UK exports include manufactured goods, fuels, chemicals, food, beverages and tobacco.

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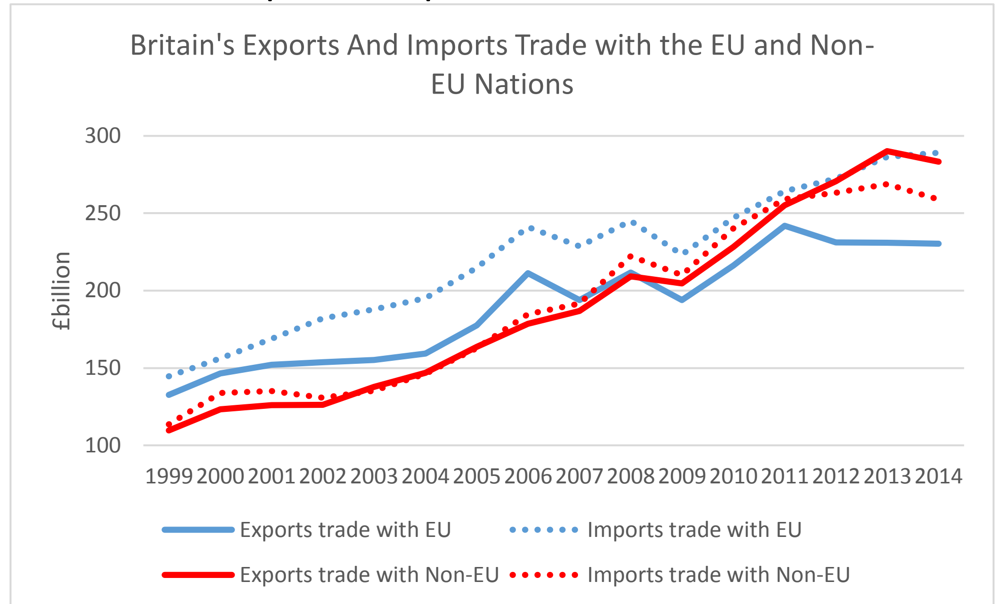
And the high-valued imported commodities include manufactured goods, machinery, fuels and foodstuffs.

The EU as a whole is Britain's major trading partner. According to ONS, the EU accounted for 45% of UK exports, and 50% of imports, of goods and services in 2014. The UK has always been running trade deficits with the EU since 1999 and trade surplus with the rest of the world since 2012 (Exhibit 1). As the trade deficit with the EU outpaced the trade surplus with the rest of the world, Britain had a trade deficit in general in 2014.

Exhibit 1: Britain's Exports And Imports Trade with EU and Non-EU Nations



Source: ONS

As a customs union, EU member states must adopt a common external tariff on imports from other countries that have not signed FTAs with the EU. Member states do not have the right to implement custom policy unilaterally. Instead, any changes in such policy must be decided by the European Council and negotiated by the European Commission, and all member states will implement the new common external tariff (if any). As a result, signing an agreement will be a time-consuming process and may not be the interest of member states with high proportion trades with non-EU nations, such as the UK, Malta and Greece (Exhibit 2).

Britain will be better off if FTAs are signed with other trading partners. According to World's Top Exports, the US, the UAE, Hong Kong, Saudi Arabia, Singapore, Australia and Azerbaijan were the 7 of the top 10 economies that the UK had trade surplus with (in goods) in 2015 but have not yet had FTAs with the EU. Only Switzerland, Ireland and Macedonia were within the EU or had a FTA with the EU. On the other hand, 8 of the top 10 economies that the UK had trade deficit in goods with in 2015 were the EU member states.

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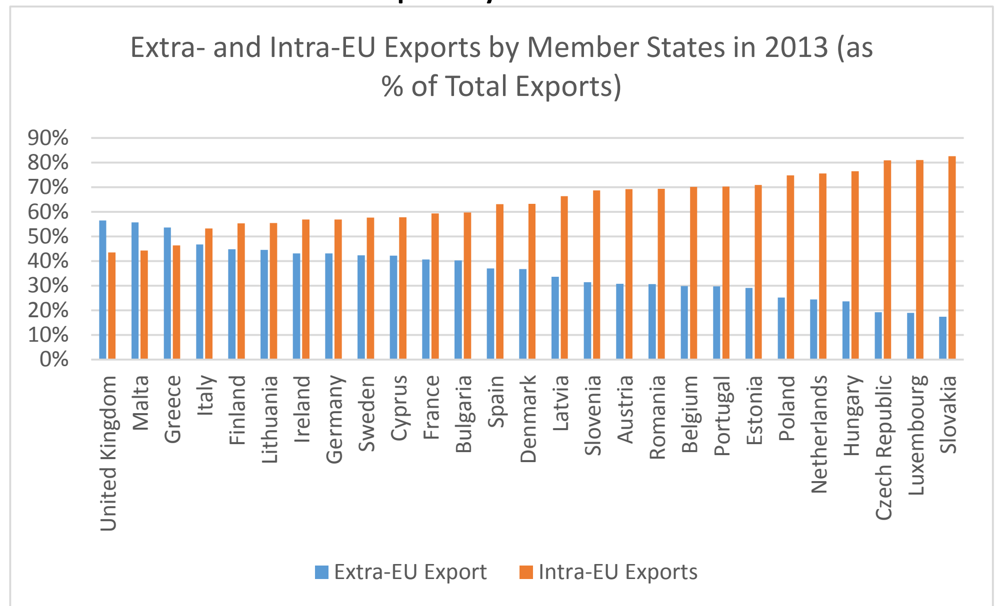
Exhibit 2: Extra- and Intra-EU Exports by Member States in 2013



Source: Eurostat

The EU has FTAs with some non-EU countries (Exhibit 3). In addition to preferential tariff treatment, these agreements also often include clauses on trade facilitation and rule-making in areas such as investment, intellectual property, government procurement, technical standards and sanitary and phytosanitary issues.

Exhibit 3: Countries that the EU has Free Trade Agreements With

Europe	Mediterranean	Other countries	Customs Unions
Albania	Algeria	Cameroon	Andorra
Bosnia and Herzegovina	Egypt	CARIFORUM States	San Marino
Faroe Islands	Israel	Central America	Turkey
Iceland	Jordan	Chile	
Macedonia (FYROM)	Lebanon	Ivory Coast	
Montenegro	Morocco	Korea	
Norway	Palestinian Authority	Mexico	
Serbia	Syria	Peru - Colombia	
Switzerland	Tunisia	South Africa	

Source: European Commission

Possible Alternatives after Membership Withdrawal

If Britain leaves the EU, there are five options that the UK can trade with the EU: membership of the EEA; membership of customs union; membership of

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the EFTA which involves a bunch of bilateral agreements; a normal FTA; and trade under WTO rules.

1. EEA

British firms could do business as before the Brexit if Britain remains in the EEA. The country can enjoy the EU's trade agreements with other countries, while it still has to follow the EU regulations with no representation in the EU institutions and has little influence over the legislative process. The non-EU members of the EEA (Iceland, Liechtenstein and Norway) have agreed to enforce regulations passed in the EU in the areas of social policy, consumer protection, environment, company law and statistics.

2. Customs Union

As a member of the customs union, like Turkey, the country must follow the EU's preferential agreements with non-EU countries, while enjoying tariff-free EU trade in goods. However, it does not include trade in services.

3. EFTA

By joining the EFTA – whose member states include Iceland, Liechtenstein, Norway and Switzerland today – the UK may have to sign over one hundred bilateral trade agreements. For Switzerland, there are around 129 agreements at the moment. This option allows Britain to arrange FTAs with other countries, while the country is not bound by FTAs between the EU and third countries. Products will have to comply with EU standards. Britain will have little influence over EU regulations and have to pay for the access to the EU market. However, Switzerland contributes to the EU budget with an amount less than Norway. Switzerland is required to comply with EU regulations only in the area that it has access to the EU market.

4. Normal FTA

A normal FTA will allow the UK to trade goods with the EU as usual. In addition, no contribution to EU budget is allowed under this option. A representative of this model is South Korea.

5. Trade under WTO rules

Trading under the WTO is the worst case, in which Britain would not need to abide by EU regulations, but it would face the common external tariff and some non-tariff barriers.

What Would Happen to the UK in the Case of Brexit

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Trades between the UK and the EU are so important for both sides, it is highly likely that the UK will be given special access to the EU markets, and trading under WTO rules with common external tariff is unlikely. As the EU had net exports both in goods and in general to the UK in 2014 (Exhibit 4), it is reasonable to expect that the single market will remain the current trading terms after Brexit in order to preserve the competitiveness of its goods. In this circumstance, the UK can improve its trade position with the rest of the world by establishing bilateral trade agreements with the trading partners that have not yet signed FTAs with the EU, such as China, Indian, Japan, Australia and Singapore. As a result, the concern about the employment of Britain's export industry is unnecessary for the goods trading section.

Exhibit 4: UK Trade in Goods with EU and Non-EU Nations in 2014

Source: ONS

Even if the UK did not sign any FTA with the 27 EU member states, with a net import, leaving the EU and levying tariff may reduce value of trades and trade deficit with the union. Households may switch to domestic products from EU products, GDP will improve as net exports rise. Together with the freedom to sign FTAs with other countries, which effectively reduces trading costs, there will be a positive effect on the trade surplus.

However, exiting from the EU is more uncertain for trade in services, especially for the renowned financial services, which is heavily regulated. The UK had trade surplus with both the EU and the rest of world in services in 2014 (Exhibit 5). The trade surplus in services with the EU in 2014 accounts for around 1% of the GDP. If FTAs are signed only for goods, Britain's overall trade deficit would be deteriorated. The EU regulations on financial industry may impede financial institutions located in the UK to operate as smoothly as before the Brexit in implementing cross-border transactions. As a result, some financial institutions, such as HSBC and JP Morgan, claimed that they

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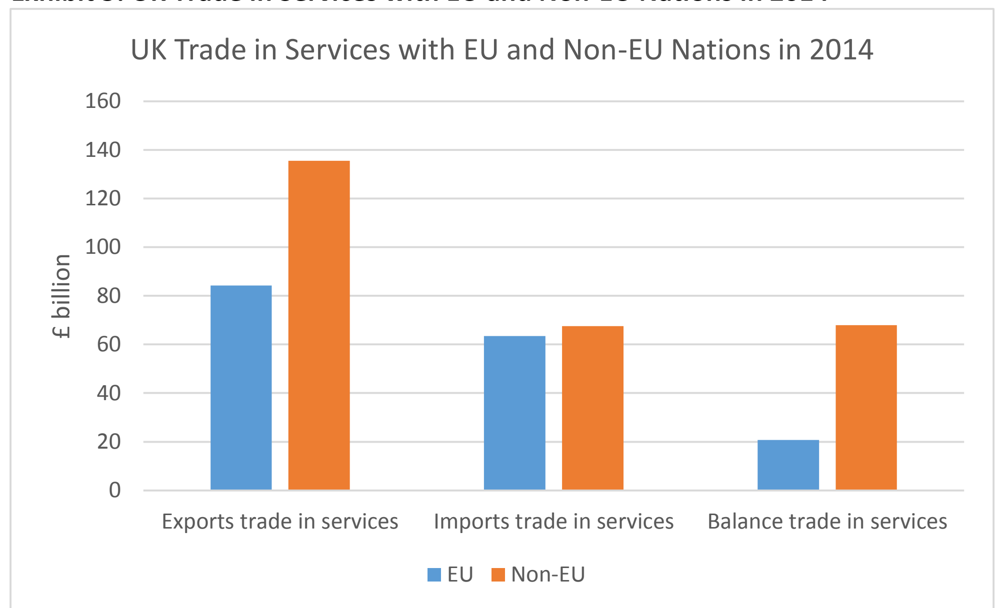
may relocate some businesses to Luxembourg in order to stay away from the possible risks of Brexit.

Iain Mansfield, the winner of the IEA Brexit Prize and the Director of Trade and Investment at the UK's embassy in the Philippines, mentioned in his winning entry, "financial services are a particularly critical sector: from 2019 onwards, providers outside the EEA will only be able to offer a more limited range of services, unless they establish a subsidiary within the EEA. The UK should therefore seek to negotiate an exit agreement that will allow this access to be preserved, potentially accepting a certain degree of regulatory cooperation as the price for access". Joining the EEA will mean the EU's policies to the Britain's financial services will be intact.

Exhibit 5: UK Trade in Services with EU and Non-EU Nations in 2014



Source: ONS

The UK currently has a surplus in financial, insurance and pension services of £18.5 billion. To have a greater trade surplus and to penalize the UK for withdrawing the EU membership in order to deter other nations from leaving, the EU may refuse to issues MiFID – a "financial passport" required to sell or advise on investment in funds within the EU – to the UK. Nonetheless, the rest of the 27 member states may not have incentive to exit from the EU, especially those relying on financial aids and subsidies from the union and those without independent currency. With a long history and infrastructure as a major financial center, the position of London cannot be easily replaced.

Once remained in the MiFID regulatory framework after Brexit, the British financial institutions can do business as usual when following EU rules although the country will have no participation in the legislative process.

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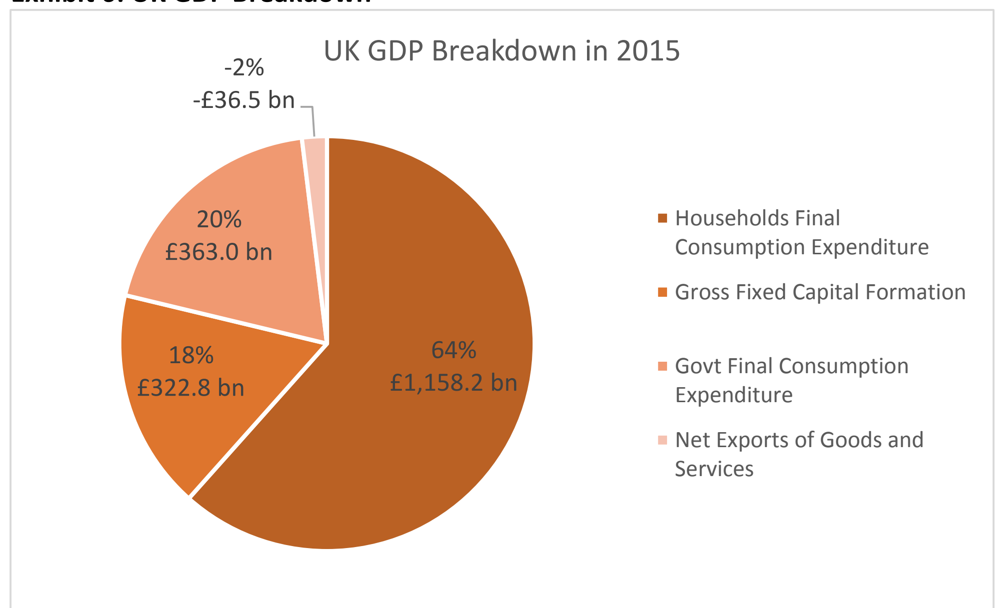
The thinktank Open Europe noted that an exit might boost UK GDP by 1.6% in 2030 if the UK enter into trade agreements with the EU and the rest of the world, while deregulating in the domestic market. But failing to strike a deal with the EU may result in 2.2% fall in GDP in 2030.

Being a net importer, trading does not contribute to UK GDP, indeed, a negative 2%. The UK economy is substantially dependent on consumption, fixed capital formation and government expenditure (Exhibit 6). The small portion of UK economy that is already affected by trade deficit is not expected to seriously disrupt the economy under different circumstances discussed above, given that the EU budget that is saved can be injected into the economy through fiscal policy – increasing government expenditure or reducing taxes or both.

Exhibit 6: UK GDP Breakdown



Sources: Eurostat, Bloomberg

If Brexit does not crash the UK economy, the pound sterling will remain stable, and the recent depreciation will reverse when the uncertainties, including trade arrangement in goods and services in the case of Brexit, are wiped away.

Conclusion

Free trade makes every country better off in general due to comparative advantage. But the EU promotes free trade only within the customs union and to few economies that signed FTAs with the EU. It is protectionism to the rest of the world to some extent, unlike the EFTA that gives member states the freedom to negotiate bilateral FTAs with other economies and does not set unilateral common external tariff.

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It is possible that the UK can remain the terms in trades in goods and services after it leaves the EU, by joining the EEA. If so, there may have no serious impact on UK's economy, the primary drawback is instead the obligation to comply with the EU rules and the loss of influence over the EU legislation. On the other hand, the UK will have more freedom to establish FTAs with other trading partners that have not signed FTAs with the EU, although the US claimed that it is not keen on establishing a separate FTA with the UK if it leaves the EU. With a more and more expansionary monetary policy in the Eurozone which causes depreciation of the euro, it is foreseeable that the relatively more expensive British goods will deter the European consumers, vice versa, deteriorating the UK's trade deficit with the EU. FTAs with other countries are therefore important to British exports. By contributing less to the EU budget, the UK government is allowed to increase its budget to the domestic economy for a greater multiplier effect to boost private consumption and economic growth.

Even without the FTAs with the EU, net import is a burden of UK's GDP, and most of the trade surplus in services is from non-EU nations, the effect of the loss of trade surplus from the EU is expected to be small in general. The UK may impose more restrictions on the imports of EU services if the financial services are penalized by the EU, the decline in exports in services may offset the possible improvement in trade deficit in goods. The original budgets to the EU can then be used to aid the relevant industries that are adversely affected in order to keep employment stable.

As the UK economy does not rely on the EU budget and the likelihood of remaining the trading terms is high if the UK leaves the EU, together with the existence of an independent currency that is widely trusted internationally, the UK economy is not likely to suffer from a great shock in the case of Brexit.

With an expectation of a stable or even improved economic performance after Brexit or remaining in the EU with the renegotiated terms of Britain's membership of the EU, the Bank of England may raise interest rate after the Fed, and the stronger incentive to invest in the UK will result in an appreciation of the pound sterling. Countries that are likely to sign FTAs with the UK may also be better off with the stronger UK demand for imported goods and services resulting from its prosperity.

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Contact

H. C. Kwan – Head of Research	kwan.hc@hooraysec.com.hk	(852) 2159 – 4506
Scott Tsoi – Research Assistant	scott.tsoi@hooraysec.com.hk	(852) 2159 – 4505
Research Department	research@hooraysec.com.hk	(852) 2159 – 4500

Hooray Securities Limited
1/F
Guangdong Investment Tower
148 Connaught Road Central
Sheung Wan, Hong Kong

Main：	(852) 2159 – 4500
Customer Services：	(852) 2159 – 4515
Dealing Hotline：	(852) 2159 – 4511
Facsimile ：	(852) 2110 – 4044

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