Brexit Market Volatility? The Big Financial Blockbuster. Three Scenarios

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"Global financial markets are churning and growing more volatile in expectation of a possible 'Brexit'—a United Kingdom referendum to vote on leaving the European Union scheduled for June 23, 2016. Brexit has literally become the big financial blockbuster event of summer 2016! But it may very well prove a 'non-event'—even if the vote on the 23rd is to leave the European Union (EU).

Over recent weeks global financial markets and investors have become increasingly focused, even obsessed, with the outcome of the Brexit vote and its potential, but still largely unknown, effects on the global economy that continues to slow.

In anticipation of a possible exit vote, global stock markets have been growing more volatile, alternately collapsing and recovering. Government yields on bonds have been plummeting, driving deeper into negative rate territory. Currency exchange rates—the pound, the euro, the yen—have been fluctuating wildly. Professional and institutional investors have, for weeks now, been moving their money to the sidelines, awaiting the outcome. Meanwhile, central banks in Europe and Japan stand primed, ready to jump in with still more money injection in the hope of stabilizing what might prove to be a major upheaval in their financial markets—while the U.S. central bank, the Federal Reserve, at the same time has begun back-peddling on raising interest rates in the U.S..

Global financial speculators have reaped trillions of dollars in profits and capital gains since 2009. In the U.S. alone, more than US$5 trillion has been distributed to investors and wealthy households by corporations in the form of stock buybacks and dividend payouts. Add in the rest of the global economy, and markets for derivatives, foreign exchange, real estate speculation, and the like, and the total is easily more than US$15 trillion.

Trillions more remain tied up in financial assets as investors await the Brexit—prepared to quickly cash in the rest if there's a 'leave the EU' vote or to double down in financial speculation if the vote is to 'remain'. In the worse scenario, June 23 could augur in a worldwide major correction in financial asset prices, with dire consequences for a global economy already in retreat along a number of economic fronts.

But then again, maybe not. Maybe nothing happens. Because a Brexit vote on the 23rd is just the start of a process, not the final event.

The Potential Consequences of Brexit

Should a vote to leave on June 23rd occur, the worst case scenario is that the current volatility in stock, currency, and bond prices would shift to a general more rapid decline in all the above.

The British pound would drop precipitously, as would the Euro. Stock markets in the U.K. and Europe would likely experience a major selloff, and the contagion spreads to the United States, Japan and emerging markets. Negative rates on government bonds in Europe and Japan would fall further, and rates in the United States and U.K. would decline, approaching zero and eventually negative levels. To the extent that it is occurring, bank lending to businesses would thereafter tighten significantly and the collapse of financial assets would thereby transmit to the real economy, resulting in less real investment, production cutbacks, and eventually layoffs and wage decline.

With the global economy already slowing, with global trade volumes nearly flat, with productivity collapsing and prices trending toward deflation, with more than US$10 trillion non-performing loans to non-bank businesses, with global oil and commodity prices declining once again, it's almost certain the consequences would quickly translate into another recession in the U.K. and Europe, and in the United States no later than 2017. Current recessions in Japan and emerging markets would deepen, and China growth would slow even more rapidly than it has been.

Europe and Japan central banks would respond to this scenario with further massive money injections into their economies. Global currency wars would re-ignite. The United States would back off raising short term interest rates for the next two years, at minimum, as U.S. long term rates and the dollar rose. China would be hard pressed not to officially devalue its own currency in response—sending further shock waves throughout the global economy.

This most negative scenario would of course not occur should the U.K. vote to 'remain' in the EU. In such alternative best scenario case, the response would be a surge once again in stock prices and bond rates. Central banks would hold off for a time from even more desperate actions. And the global economy would continue its otherwise slower, progressive shift toward stagnation that has been occurring since 2014. Brexit provoked financial instability would not accelerate the process of global decline as in the worst case scenario.

But what of a third scenario? A Brexit vote occurs but there's no intensified financial instability and accelerated global economic decline?

Cameron's Faustian Bargain

A possible Brexit only exists today because U.K. prime minister, David Cameron, and his conservative party injected it as a political issue in the 2015 U.K. national elections. Cameron hoped to appeal to British voters in the parliamentary election held last May 2015 by offering, if he were elected, to hold a referendum vote—a simple 'yes' or 'no'—on whether Britain should remain in the EU.

Cameron struck what might be therefore called a 'Faustian' bargain with U.K. voters. In classic literature, Faust was a professor who made a deal with the devil for something he could not otherwise obtain himself without the devil's help. The devil gave him his wish, but demanded his soul in payment. Cameron believed he could turn the growing discontent into votes for himself in May 2015, and thereafter control the consequences of a referendum vote once elected. He got his election victory in 2015; the devil granted his wish. But he now faces the consequences; now he has to pay up. The devil on June 23rd may now demand

Cameron’s political soul.

After his election in May 2015, Cameron issued a set of impossible demands to the EU for keeping Britain in the union. They included a four year wait for immigrants already in the U.K. before becoming eligible for U.K. benefits, including healthcare, and even if they already were in the U.K. and had a U.K. job; limits on how many immigrants could come from eastern European countries and how fast they could enter Britain; a formal revision of the Free Trade treaty itself; the right of the British parliament to pass legislation that would veto EU provisions; plus other preferential trade treatment for British businesses at the expense of other EU businesses.

These proposals are non-starters. They would mean all the other 29 EU member countries would have to unanimously revise the Treaty, and thus cede to Britain various economic benefits. And there’s no way the 29 other EU states can or will ever agree to do so. All it takes is one eastern European state to veto such proposed EU treaty changes and Cameron’s proposals are DOA—dead on arrival.

Brexit Does Not Mean Leaving the EU

Should an exit vote occur on the 23rd the more likely scenario is that little will change in the short term. That is because a vote by the U.K. electorate does not mean an actual ‘exit’ follows. An exit requires a vote by the British parliament to leave. That would activate what is called Article 50 of the EU Treaty, the treaty’s hereto unused ‘exit’ clause.

It is highly unlikely the British parliament, with a Conservative party majority, would vote to exit as a follow up to the referendum. Conservative party members in parliament favoring Brexit at the moment most likely would be ‘convinced’ by party leaders to vote to remain. If they refused, it would likely mean a vote of no confidence and a fall of the Cameron government and that’s not likely to happen.

What is likely is Cameron and his government open negotiations with the EU and seek changes to create a preferential arrangement for Britain to remain in the EU similar to that provided to Norway at the present. Article 50 provides for a two year negotiation period and automatic renewal of EU membership thereafter. Notwithstanding EU leaders in France, Belgium, and Germany wanting to avoid negotiations dragging out that long, they have no way to avoid it.

In short, Cameron will try some way to negate the will of the U.K. voters should they choose to Brexit. The U.K. may vote to exit on the 23rd but Cameron, the ‘City of London’ bankers, the U.K.’s multinational corporations that profit from the U.K.’s 47 percent exports to the EU, and U.K. economic interests who have much to lose from an exit will maneuver to ignore the Brexit referendum should it occur. The Brexit vote will prove merely a tactic for U.K. elites to try to extract concessions from their EU capitalist competition.

Cameron may have struck a Faustian deal with the devil, but that doesn’t mean he ever intends to pay up.

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