Brexit: Treaties, Tensions, and a Referendum

By Jim McCaughan, Chief Executive Officer, Principal Global Investors

Highlights:

- On 23 June, Britain will hold a vote to either continue on as a member of the European Union (EU), or break those economic and political ties and exit the EU.
- The Treaty of Paris, the Treaty of Rome, and the The Maastricht Treaty of 1992 provide important historical information to help understand the current situation.
- Held together by the euro, the Eurozone countries have been gradually moving towards fiscal integration and integrated regulation and support of financial activities, but resistance has arisen in most participating countries.
- A decision by Britain to remain in the EU would remove a lot of risk and uncertainty. The impacts of a Britain exit from the EU are much harder to predict.
- The risk of Britain's exit from the EU is of global significance, and not just a local difficulty confined to Europe.

The Right Honourable Clement Attlee was a modest, unassuming man whose appointment as British Prime Minister after World War II was a surprise, even to himself. As leader of the Labour Party, Attlee was objective and rational, if somewhat uncharismatic. He was also potentially one of the first voices in a chorus that has led Britain to the verge of a referendum vote to leave the European Union.

On 23 June, Britain will hold a vote to either continue on as a member of the European Union, or break those economic and political ties in favor of something else. The roots of the European Union and of Britain's tepid relationship with a united Europe go back to the years following World War II, and to understand the current situation and its impact on markets, it is important to understand the history that it is built on.

The EU and a history of three treaties

In the years just after the Second World War, the nations of Belgium, France, West Germany, Italy, the Netherlands, and Luxembourg established the European Coal and Steel Community (ECSC) by the Treaty of Paris in an effort to strengthen ties between these nations and prevent future warfare on the Continent. The Treaty, signed in 1951, created a supranational entity and a common market for steel and coal among member nations.

Britain, under Winston Churchill, had been very much on the path towards a united Europe, with the Prime Minister actually uttering the words "the United States of Europe" on several occasions. That changed under the post-War Labour government of Prime Minister Attlee. By the time the Treaty of Paris had established the ECSC, Attlee had nationalized Britain's coal and steel industries and wasn't keen to cede control to a supranational body. In eschewing the ECSC, the United Kingdom began formalizing its arms-length relationship with Europe.

In fact, Attlee's feelings on the Common Market were best encapsulated years later in his last public speech, "The Common Market, the so-called Common Market of six nations, know them very well. Very recently, this country spent a great deal of blood and treasure rescuing four of them from the other two."

A Timeline of Eurozone Treaties and Britain's Participation

Understanding the roots of the European Union and of Britain's relationship with a united Europe provide context to the current situation and its impact on markets.

1951

The Treaty of Paris established the European Coal and Steel Community (ECSC), which created a supranational entity and a common market for steel and coal among member nations. Britain was not a member.

1957

The Treaty of Rome established the European Economic Community (EEC), which was the direct precursor to the modern European Union. Being a free-trade area was the intent of the EEC. Britain joined the EEC in 1973, 16 years after it was established.

1985

The Schengen Agreement was established to allow travel between participating countries without immigration or customs controls. Britain opted out because of security concerns.

1986

The Single European Act (SEA) revised the Treaty of Rome and was particularly aimed at free movement of goods, people, services, and capital.

1992

The Maastricht Treaty of 1992 ratified all of these moves, and also set out the plan for EEC members to create a single currency. Britain negotiated an opt-out from the common currency, driven by the perception that a currency union would be unstable in the absence of an accompanying fiscal union. The group's name was changed from the "European Economic Community" to the "European Union" (EU).

In 1957, the Treaty of Rome established the European Economic Community (EEC), the direct precursor to the modern European Union. Comprising the same six countries that had established the ECSC, the European Economic Community, as the name suggests, was clearly intent on being a free-trade area. As with the ECSC, the secondary aim was to bring the countries of Europe politically closer, to prevent recurrence of the wars that had devastated Europe and much of the world in the first half of the Twentieth Century.

It took 16 years, but Britain eventually joined the EEC. And in 1973, along with Denmark and Ireland, Britain signed up to a free-trade area. Though, in Britain's case, there was not a consensus for closer political union with the other member countries.

The benefits of the EEC were initially disappointing to many, so the Treaty of Rome was revised with the Single European Act (SEA) in 1986. The SEA was particularly aimed at free movement of goods, people, services, and capital. In other words, the SEA was meant to give more momentum to the free-trade area. The SEA also provided for changes to simplify decision making, and this allowed proponents to make moves pursuing "ever closer union." This latter idea was never well supported in Britain and some other Northern European countries. Even now, the moves to a banking union, even more than a decade after the establishment of Europe's single currency, are still faltering.

At the same time, five out of the then ten members of the EEC entered into the Schengen Agreement of 1985, allowing travel between the countries without immigration or customs controls. Led by Britain, the five countries that opted out of the Agreement did so because of security concerns.

The Maastricht Treaty of 1992 ratified all of these moves, and also set out the plan for EEC members to create a single currency, the euro, which started in 1999. Britain, this time joined by Denmark, negotiated an opt-out from the common currency. This opt-out was mainly driven by the clear perception that a currency union would be unstable in the absence of an accompanying fiscal union. In recognition of the broader alliance involved, the group's name was changed from the "European Economic Community" to the "European Union" (EU) after the Maastricht Treaty. There was a further expansion of membership to Eastern Europe in 2004 and 2007, and the EU now has 28 member states and a population of over 500 million.

A background of tension

In the intervening years, tension has grown between two factions within the EU. On the one side, there are those seeking ever-closer union. Led from Brussels, the de facto capital of the EU, this faction is supported most strongly by France and Italy. On the other hand, led by Britain, there are those primarily seeking a free-trade area. This tension has been a serious fault line in the European debate for years.

Consensus would suggest that the single market has been a big success, but that the euro and Schengen (shorthand for the free movement of people) have been at various times much more problematic. In reaction to these problems, both sides look at the same evidence and reach drastically different conclusions. The integrationists throughout Europe have pushed for ever closer union as the remedy. Skeptics have basically said "I told you so," and portrayed integration as the problem, not the solution.

The formation of the EU and the euro helped bring about the belief that interest rates across the region would converge to the low levels of German debt. This misperception ultimately brought about the European sovereign debt crisis. It was furthered by regulations that allowed banks to hold no reserves against that sovereign debt. So, European banks gorged on all the higher-yielding debt of southern countries with little regard to the country's particular long-term repayment ability.

Held together by their common currency, the Eurozone countries have been gradually moving towards fiscal integration and integrated regulation and support of financial activities. That said, there has been resistance even in France and Germany. Right-wing populist parties in those countries have been calling for their governments to exit this process, fearing subsidies through fiscal transfers to Southern Europe.

Brexit and Scottish Independence

An interesting parallel to Brexit referendum is the Scottish independence referendum of 2014. Pollsters pointed to a finely balanced result right up to the day of the vote, but in the end the result went decisively against independence. The polls in the Brexit referendum may be unreliable and votes in the end may be cast for the prevention of a lot of uncertainty, but Scottish opinion has been very clearly in favor of EU membership. A Brexit vote would likely be followed by vociferous demands for another independence referendum. It is far from clear, however, that an independent Scotland would get decent terms to re-enter the EU. Countries such as Spain and Belgium, with their own secessionist movements might be opposed, and a newly admitted Scotland might have to switch to using the euro.

While Schengen freed up labor to move about Europe, seeking out opportunities, it did not address the language and culture differences between countries. These have often been too great to allow the kind of easy movement of workers, as is the case in the United States, where a worker could move easily from Mississippi to North Dakota to follow the oil boom. Further tension has arisen over the immigration crisis of the last year. Initially, any refugees or immigrants entering Europe, mainly through Greece, were allowed to travel on without restraint to any Schengen country. Since then, many borders in the Schengen area have seen renewed border controls, a set-back for those who seek further European integration.

At writing, details are emerging of the despicable terrorist attacks in Belgium. While our focus is on the human toll of such a tragedy, it will inevitably push critics of Schengen across Europe to use this incident as a means to question the safety and legitimacy of open borders.

The referendum and its impacts

So the British are not alone in having misgivings about many of the integration efforts of the EU, but they will be the first to bring this skepticism to a head at the

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referendum on 23 June. Meant to answer the question, should Britain leave the European Union, this referendum was promised by Prime Minister David Cameron in an effort to quiet the "Euroskeptics" in his own Conservative Party. He appears to have expected to win the referendum easily, but the outcome is now looking quite finely balanced.

"Brexit," a portmanteau of "Britain" and "exit," is generally favored by those who have not benefitted from free trade and globalization. There is also a strong, mostly English, nationalistic patriotism held against the EU. More education and frequent travel elsewhere in Europe are among the features of those who want to stay in the EU. Given the divisions among different politicians, the eventual outcome is hard to predict, and right now the referendum's result looks like a 50/50 call.

A decision to remain in the EU would remove a lot of risk and uncertainty, and would be positive for British and Eurozone economies and markets. The impacts of a Brexit are much harder to predict. Since Britain neither in the currency union nor part of Schengen, these aspects of integration would not be an issue.

The problems would all depend on what gets negotiated as terms of exit, in particular as regards access to the single European market. The more optimistic proponents of Brexit claim that Britain could negotiate very free access, similar to that granted to Norway and Switzerland. These two countries are not EU members, but for most purposes are part of the single market. That optimism, though, ignores the fact that these are two small economies that do not offer much competition to some key European industries.

Attitudes towards a Britain that had just rejected EU membership may be more hostile in reality. In fact, the German finance minister, Wolfgang Schäuble, argued recently that Britain would effectively be shut out of the single market. In a recent interview with the BBC, Schäuble said, "We would have years of the most difficult negotiations, which would be difficult for the EU as well. For years, we would have such insecurity that would be a poison to the economy of the UK, European continent, and global economy as well." Therefore, it seems dangerous to assume that Britain would automatically be granted favors in these post-Brexit negotiations.

So what happens if access to the single market is restricted? The EU is by far the dominant trading partner of the UK; there could be tariffs on some exports from Britain. In addition, inconsistent standards on products from autos to pharmaceuticals could restrict trade. In recent years, London has become the clear leader among European financial centers. According to some analysts, changed regulations and restrictions around the euro could lead to loss of up to 20% of jobs in financial services in London.

Estimates suggest Britain could lose 2% to 5% of GDP in the year or two after a Brexit vote. This would likely also cause recession in the Eurozone. The knock-on effect on trade would be enough for a visible impact on global growth, particularly if aligned with political moves against trade, especially in the United States.

So the risk of Brexit is a risk of global significance, and not just a local difficulty confined to Europe. In particular, the likely economic damage would be a negative factor for equities on a Brexit, and central bank support for both the euro and the British pound would keep rates at or near zero.

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