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Research Briefing | Global

Brexit – very unlikely to be a ‘Lehman’s moment’

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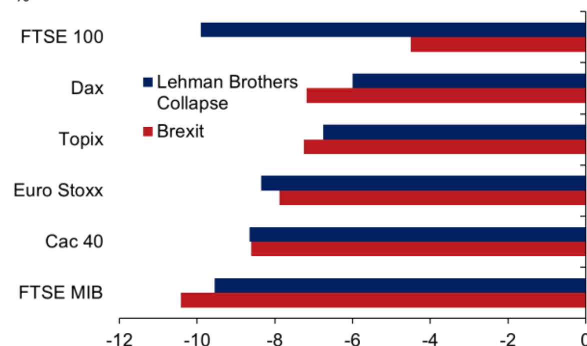
- **The surprise vote in the UK to quit the EU has seen sharp falls in world financial markets. These reactions are out of line with any likely impact on the UK economy from the vote; markets are instead pricing in a high risk of a broader financial crisis engulfing the rest of the EU. This risk looks exaggerated to us.**
- Today’s sharp drops in global stock markets and periphery bonds are hard to square with the likely long-term impact on the UK – at worst a few percent of GDP in the long run in an economy that is only 3.5% of world output. Initial market reactions were of similar magnitude to the immediate aftermath of the Lehman Brothers failure in 2008.
- It appears markets are pricing in a moderate risk that the UK vote is a systemic event that leads to a political chain reaction in the rest of the EU that collapses the single currency area and/or leads to debt restructuring in the Eurozone ‘peripherals’ – a re-run of the 2011-12 crisis.
- The possibility of such a chain reaction has probably gained credence in recent weeks with polls suggesting discontent with the EU in countries such as the Netherlands and Italy. In Italy, as well as a large debt stock there is also the issue of high bad debts at banks as a systemic risk factor.
- We think these market concerns are overdone. We do not see a high chance of a systemic crisis in the EU involving other countries exiting the EU quickly or a sovereign debt restructuring – especially as the ECB has the capacity to step in to prevent a runaway rise in peripheral bond spreads, as it did in 2012. We also think the EU could take steps to avoid break-up spreading including by concessions to member states on the migration issue.

Big market sell-offs followed the Brexit vote

Global: Stock markets Brexit vs Lehman Collapse



Source : Oxford Economics/Bloomberg
Note: for Lehmans we calculate peak to trough dates based on daily data from 14th-16th September 2008. The Brexit data are from 23rd June to 12.50pm UK time, 24th June

Brexit saw sharp stock falls, not just in the UK but also Asia and the Eurozone – reminiscent of the falls seen around the collapse of Lehman Brothers in 2008

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UK Brexit vote sparks big market sell-off…

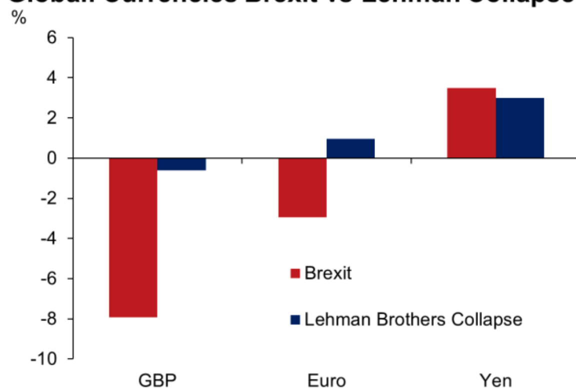
The surprise UK vote for Brexit caught markets on the hop. Predictably, sterling and UK shares were down sharply, but the effect was broader – Eurozone shares were down some 8% this morning and Japanese stocks fell a similar amount overnight.

In part, this must reflect a 'shock' effect, as markets had priced in a 'Remain' result yesterday. But there is more to it than that – the latest price action is a continuation of the big swings we saw in the weeks leading up to the UK vote.

We noted earlier this week that these swings seemed hard to square with any likely impact on the UK economy from Brexit, and we continue to think this. The UK accounts for only 3.5% of world output, and studies (including our own) looking at the economic impact of Brexit in the UK are mostly arguing about a few percent plus or minus on GDP in the long term.

Chart 1

Violent currency moves after Brexit were greater than at the time of the Lehman Brothers failure



The sharpness of market moves has gone beyond shares. Sterling sank almost 12% within five hours to a low of 1.32/$ before recovering somewhat. Eurozone 'peripheral' bond yields were also badly affected, with Greek government bonds due in 2019 seeing yields spike 400 basis points at the open, while Italian 10-year yields initially rose 30 basis points.

Strikingly, the scale of these market moves is comparable to those seen around the time of the Lehman Brothers collapse in September 2008. Indeed, the currency moves have been more marked. The big losses in bank shares are also reminiscent of that incident.

…with markets pricing the risk of a political chain reaction and financial instability across Europe

There are some important differences though: in particular, in 2008 the collapse in risk appetite around the Lehman Brothers failure saw government bond yields contract in most advanced economies. This time around, there has been a bifurcation – core bond markets like the US, Germany and the UK have seen yields drop but yields have risen in the Eurozone periphery.

How can we interpret this pattern? It appears that markets are placing considerable weight on the possibility that Brexit is a moment of systemic importance in financial markets. But the nature of the systemic risk is different to 2008. Markets seem to be concerned that the UK vote will trigger some kind of political chain reaction in the rest of

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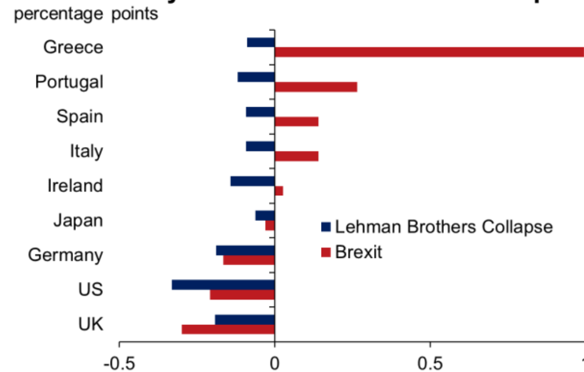
the EU that leads to very serious financial instability: either a collapse of the single currency area, a restructuring of 'peripheral' Eurozone countries' debt, or both.

Chart 3



Brexit has seen a bifurcation in bond markets – yield compression in the core markets, higher yields in the Eurozone periphery

Market moves would need real risk of collapse of single currency or debt restructuring in Eurozone to be justified...

These are the kinds of things that would need to be on the cards to justify such extreme market moves: it was fears about such outcomes that generated the Eurozone financial crisis of 2011-12.

This scenario has probably gained some credence in recent weeks with opinion polls suggesting that public discontent with the EU extends beyond the UK and to countries such as France, the Netherlands and even Italy:

- Polls in France have suggested 53% of the voters want a referendum on EU membership
- In the Netherlands, far-right leader Geert Wilders has already called for a referendum following the UK vote and, again, recent polls suggest both considerable public appetite for such a vote and a potentially high vote for exit in the case such a vote occurred
- In Italy, there is also evidence of increased anti-EU sentiment with recent election successes by the Five Star movement
- In Spain, polls put the anti-establishment coalition Podemos in second place ahead of this Sunday's legislative elections

The Eurozone 'peripheral' debt market (Italy, Spain, Portugal and Greece) is large, with 3 trillion euros of debt outstanding. A default on a significant part of this debt therefore could saddle investors with considerable losses. A 20% writedown would imply losses of €600bn, which compares to investor losses of around US$4 trillion in the global financial crisis (GFC). In Italy, there is also the thorny question of the large volume of bad debts at Italian banks, estimated at 18% of loans or €360 billion.

But while it is possible to sketch out a scenario in the EU that might justify large market moves like those seen last night and today, how likely is such a scenario?

We do not think the risk is very high. A lot would have to go badly wrong at once and there are several points at which crisis risks can be reduced before it becomes irreversibly systemic.

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…but the risk of such developments is small, in our view – markets are overreacting

First, the probability of knock-on referendums leading to other EU members exiting is relatively small in our view; apart from anything else, the EU countries will be very keen to avoid this even if it means granting member states significant concessions on issues such as migration/free movement to head off populist sentiment.

Second, even if further referendums go ahead, a leave vote is much less likely than in the UK. As Greece has shown, the belief in a European vision remains very strong in the periphery, and can outweigh even very strong resentment of austerity.

Third, policymakers have further scope to alleviate financial stress. The ECB showed in 2012 that it is willing to step in to buy up sufficient volumes of sovereign debt to head off an upward spiral in yields: Draghi's 'whatever it takes' formula worked in 2012 and there is no reason why it should not work now. There is also scope for fiscal solutions including increased debt mutualisation and the state purchase of bad debt from Italian banks, if necessary. These may have a cost in terms of long-term growth in the rest of the EU but it is not going to be a very large one.

So overall, we see the immediate market moves in response to Brexit as an overreaction. The UK vote is not a 'Lehman's moment'. It would make sense, nevertheless, for Eurozone policymakers in particular to quickly reassure markets about their readiness and capacity to prevent any re-run of the 2011-12 scenario.

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