The credibility of the European federalisation project was hit by the near-meltdown of the euro and the Greek bailout. If the UK votes for a Brexit, what does that mean for its financial future?

Money & Markets

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REFERENDUM

BREXIT VOTE COULD THROW A SPANNER IN THE EU WORKS

BRITAIN WILL HAVE a referendum in June on staying in or leaving the European Union. The EU has long been a political project to unify the three power blocs of Europe, loosely defined over the ages as Anglo-France, France and the Holy Roman Empire. Attempts to rebuild the Western Roman Empire have fuelled a thousand years of horrific conflict. A United States of Europe is seen as a way to end the underlying cause of perpetual war.

While the economic efficiencies of a single currency, the removal of borders, a tariff-free trading block and the standardisation of infrastructure is put forward as an imperative to federate, the purpose of the EU is to create a union to end hostilities between European states, especially France and Germany.

The creation of an integrated Europe was conceived as a gradual absorption of sovereign countries into a US-style federal state, and its first stage was a simple unification of European steel-making interests. This primary platform for industrial cooperation has been enthusiastically morphed into a European sovereignty-sapping overlord, a top layer of governance to weld the EU into the biggest homogenised economic bloc on earth.

Most Europeans love the 'common market', as it was once branded, but the waning economic performance of the EU, which has still to recover from the US-created financial markets credit crisis of 2007-2008, is stressing the new governmental structure to the point that outlying provinces are starting to revolt.

The underlying European economic structure taxes away all private-sector GDP for government spending. That fiscal status quo makes private-sector growth extremely difficult. State stability comes from employment, but without a private sector that can create and keep a surplus it is hard for commerce and new employment to grow. Only austere Germany seem to have the key to growing its economy, with its 'Mittelstand' engineering heartland pumping out sophisticated engineering products that help drive global manufacturing.

The European Central Bank keeps the bloc afloat through financial engineering while making it clear that tweaking the money supply is only a temporary fix and that the EU must restructure. But there is little economic restructuring going on, so the EU is permanently mired in high unemployment, large budget deficits and political paralysis.

Britons, particularly British Tories, find this economic status frightening; they see Europe as broken politically, fiscally and economically.

The key benefit of EU membership is a classic engineering one: standards. The EU is the governmental equivalent of ISO. Whereas the International Organization for Standardization was set up by the UN in 1947 to govern standards for 'nuts and bolts' in 164 nations around the world, the EU was set up in 1948 to standardise the 'nuts and bolts' of government across [now] 28 nations around Europe. The purpose is the same, to make life easier and more productive.

This homogenisation hasn't gone smoothly. The agent of strain has been money. The euro, planned as the common currency of the largest trading bloc, turned into a straitjacket of interest rates and money supply. The southern states, lashed to a hyper-efficient Germany, took the easy way out; rather than striving to become engineering powerhouses like the north, they took advantage of cheap northern liquidity and went on an economic bender.

The European Central Bank, based in Frankfurt, 'keeps the bloc afloat through financial engineering'

IMAGE SOURCE

The resultant euro crisis saw Portugal, Ireland, Italy, Greece and Spain (collectively known as the PIIGS) brought to account and forced to writhe in economic agony. The historical tactic of reneging on debts through printing cash and inflating couldn't work under the carefully controlled EU euro regime. The PIIGS countries were forced to be 'German' about their economic remedies.

This market comeuppance gave notice to many UK eurosceptics that EU federation was a one-way process with no way back. To these people, it is now or never to avoid absorption.

For all the emotion, an 'in' vote is 2/1 on favourite as I write and the 'leave' vote is the 2/1 against outsider. The gambling markets are pretty good at calling the outcome at an early stage. This will relieve the elites of both Europe and the UK, but the prospect of a major reversal of the European dream will still create an atmosphere of panic.

A 'Brexit' leave outcome could happen. This is a world where Scotland almost voted to leave the UK, a Tory government got re-elected with a majority, considered impossible until a few hours before the result, and a game-show host may be only one election away from the US presidency.

While the ISO-like purpose of Europe is meant to bring the stability and efficiency of a standardised political and economic regime, an improbable outcome like a Brexit can threaten the whole system.

Brexit would be a classic 'black swan' – the freak event that brings disaster. The EU is about peace and efficiency, so while the UK might gain autonomy, it would lose the benefits of scale brought by being in Europe.

What would a 'leave' vote mean? Europe would have to react in a draconian way. To laugh off the UK's rejection of Europe while leaving its privileges little changed would embolden other economically stressed countries to consider moving in the same direction. The UK would have to be locked into an economic pillory for years. Outside the low-friction tariff-free trading zone of the EU, the UK would lose a lot of trade. Costs would rise because sales to Europe would be hit by tariffs and red tape.

The dislocation of leaving would be expensive. A cold economic wind would blow for years. But expulsion into isolation would not be destiny for the UK, and independence could suit it well. Black swans and random walks drive markets; few outcomes are not chaotic.

Without the EU, the UK would gain the benefits and drawbacks of more volatility and variance, and risk expressed by volatility equals reward. Markets are driven by fear and greed and the