June 2016

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Saudi Economic Review

NCB Monthly Views on Saudi Economic and Financial Developments

Contents

Executive Summary

- Crude oil markets weathered the volatility, recovering from the lows reached immediately following the outcome of the UK referendum. However, the expected weakening of global economic outlook due to the Brexit poses downside risks to global oil demand, and is likely to weigh on oil prices.

- Despite the relative strength which may have been induced by Brexit, the Fed's policy normalization process unevenly tips the scale in favor of the dollar, especially with a more fragile economic recovery in the EU versus the US.

- By the end of June, prices of agricultural commodities surged 10.7% YTD according to the S&P/Goldman Sachs Agricultural Index highlighting mounting supply concerns

- The contrasting movement in these deposit accounts indicate a rising propensity to save for businesses and individuals under the currently dismal economic prospects.

- As for the primary market, the third Initial Public Offering (IPO) for 2016 concluded with the usual strong appetite. Lazurde Company for Jewelry offered 30% of its SAR430 million capital for the public, totaling 12.9 million shares at a premium price of SAR37.

- By the end of April, total bank credit extended to public and private sector enterprises amounted to SAR1.417 trillion which is up 10.0% from a year ago.

- The government's new efficiency measures coupled with the broad-based dollar strength have contributed to keeping imports muted. The balance of trade gap shrank 32% compared to the same period last year.

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View of the Month

Early forecasts predict a 2%-3% contraction in UK's GDP, a rate cut by the Bank of England, quantitative easing measures, and possible sovereign rating downgrades. Additionally, Scotland's Nicola Sturgeon said preparation for a second Scottish independence vote are "highly likely". The aftermath of the referendum remains a much debated discussion, however, the reaction of financial markets reveal the level of risk pertaining to the uncertain survival of European Union as well as the United Kingdom.

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Macroeconomic Indicators

	2011	2012	2013	2014P	2015F	2016F
Real Sector						
Average KSA Crude Spot Price, Arab Light, USD/BBL	108.1	110.2	106.4	97.2	50.2	45.0
Average Daily Crude Oil Production, MMBD	9.3	9.8	9.6	9.7	10.2	10.2
GDP at Current Market Prices, SAR billion	2,510.7	2,752.3	2,791.3	2,826.9	2,449.6	2,322.3
GDP at Current Market Prices, USD billion	670.4	734.9	745.3	754.8	654.1	620.1
Real GDP Growth Rate*	10.0%	5.4%	2.7%	3.6%	3.4%	1.7%
CPI Inflation, Y/Y % Change, Average	3.7%	2.9%	3.5%	2.7%	2.2%	4.5%
External Sector						
Current Account Balance, USD billion	158.5	164.8	135.4	73.8	-53.5	-63.7
Current Account Balance/GDP	23.6%	22.4%	18.2%	9.8%	-8.2%	-10.3%
Net Foreign Assets with SAMA, USD billion	535.9	648.5	717.7	725.2	609.7	539.0
Fiscal Sector (Central Government)						
Actual Revenues, SAR billion	1,117.8	1,247.4	1,156.4	1044.4	608.0	586.3
Actual Expenditure, SAR billion	826.7	873.3	976.0	1140.0	975.0	897.0
Expenditure Overrun, %	42.5%	26.6%	19.0%	33.3%	13.4%	6.8%
Overall Budget Balance, SAR billion	291.1	374.1	180.3	-95.6	-367.0	-310.7
Budget Balance/GDP	11.6%	13.6%	6.5%	-3.4%	-15.0%	-13.4%
Break-Even Oil Price	75.3	73.9	82.6	103.6	79.2	69.2
Financial Sector						
USD/SAR Exchange Rate	3.75	3.75	3.75	3.75	3.75	3.75
Growth in Broad Money (M3)	13.3%	13.9%	10.9%	11.9%	2.6%	2.5%
Growth in Credit to the Private Sector	11.0%	16.4%	12.1%	11.9%	9.8%	5.3%
Average 3M SAR Deposit Rate	0.7%	0.9%	1.0%	0.9%	0.9%	2.5%
Average 3M USD Deposit Rate	0.3%	0.4%	0.3%	0.2%	0.3%	0.9%
Spread, in Basis Points, SAIBOR-LIBOR	40.9	55.2	68.7	70.4	56.4	160.0

Sources: Thompson Reuters, SAMA, and NCB

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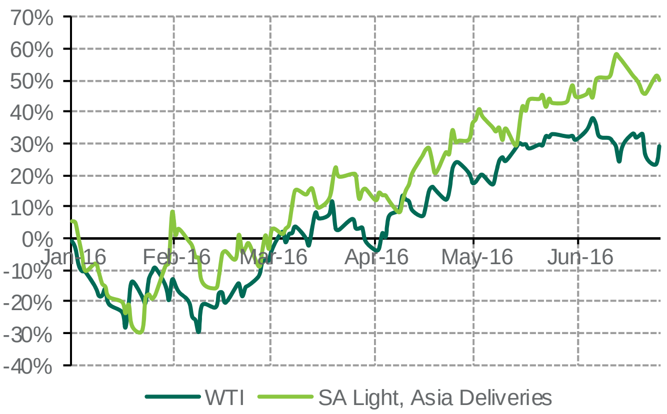
Oil Market
Crude Shook off Brexit

West Texas Intermediate (WTI) crude traded above USD50.0 a barrel recently as US oil industry data showed a decline in crude stockpiles. While stockpiles in US have declined for five straight weeks, fostering a price rally to about USD50.0 a barrel, the drop is expected at this time of year as America's peak driving season kicks off. WTI futures have gained more than 80% since dropping to a 12-year low in February. Brent crude oil prices fell from a peak of USD51.50 a barrel to a trough of USD47.50 a barrel, as the UK referendum results trickled through early on June 24th and illiquid conditions prevailed, only to revert during trading hours. Crude oil markets weathered the volatility, recovering from the lows reached immediately following the outcome of the UK referendum. However, the expected weakening of global economic outlook due to the Brexit poses downside risks to global oil demand, and is likely to weigh on oil prices. In addition to weaker global growth, the likelihood of a stronger US Dollar following the UK's vote would also put downward pressure on the prices of oil in the medium term. In the meantime, the core fundamentals of oil demand and supply remain unchanged by Brexit, but prices will not regain USD50 a barrel in the short-term, attributed to higher risk aversion. The forward curve may weaken, but only temporarily.

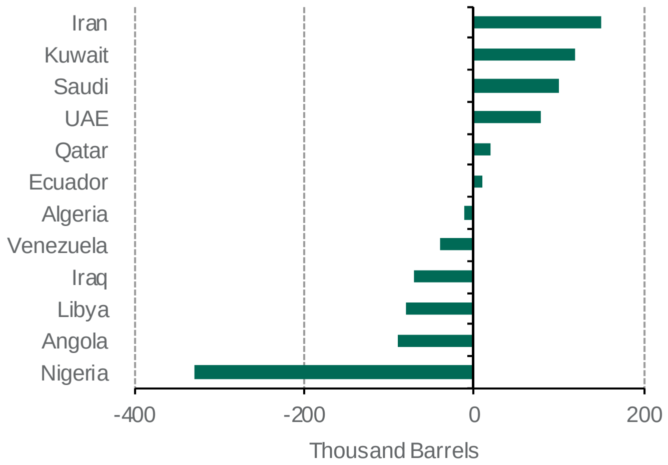
Chart 1: Oil Price Developments, YTD



Source: Thomson Reuters

On the supply side, outages in OPEC and Non-OPEC countries cut global oil supply by nearly 0.8mb/d in May. OPEC crude production dropped by 0.11mb/d, as oil losses in Nigeria due to sabotage of oil installations were more than offset higher production in the Middle East. In Iran, output is expected to have made an increase of 0.7mb/d this year. Non-OPEC supply growth is expected to return in 2017, but at a modest 0.2mb/d, after falling by 0.9mb/d in 2016. It is expected that average annual US production would decline by 0.66mb/d in 2016 and by 0.42mb/d in 2017 at the current level of rig count. The IEA projects shale oil production will decline a further 0.19mb/d next year, after a forecast drop of 0.5mb/d this year. While Saudi Arabia and the IEA share a more optimistic view that global oil supply is now back in balance with demand, the US crude inventories suggest that the call might be premature. The US inventories typically decline through summer to the end of August, so it will take further stock reductions after that point to ascertain that oil surplus has actually disappeared. The global oil glut will probably persist until next summer as markets would take time to absorb excess crude in storage.

Chart 2: OPEC's Monthly Oil Production Changes



Source: OPEC Survey

On the demand side, all else being equal, adjustment to weaker global growth due to the Brexit would reduce global oil demand growth in the 2nd half of 2016 and in 2017, as contagion effects were to spread. On the other hand, lower oil prices are likely to stimulate price elastic transport demand, offsetting part of the effects of weaker global economic growth. Moreover, global demand growth, driven by US, China, and India remains robust. Oil markets appear to be gradually recovering from excess supply after OPEC decided in 2014 to let its members produce without limits in a struggle to defend market share with higher-cost producers including US shale drillers. While Supply and demand for oil seems to be gradually moving toward re-balancing, the response of shale producers to rising prices will eventually determine how high crude prices can go. Shale producers in the US would only ramp up output if they have reasonable expectations that prices will not fall back to the level of USD30 a barrel.

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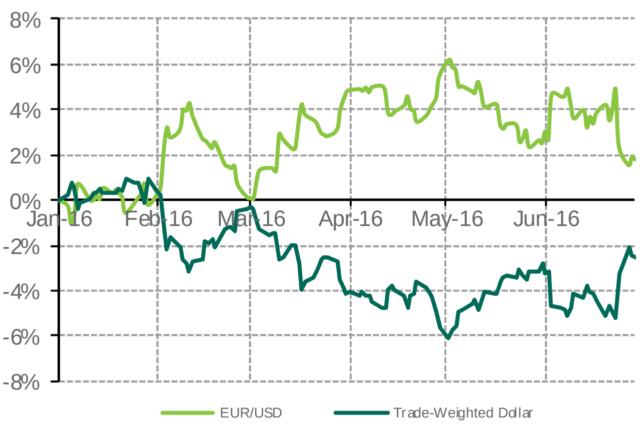
Foreign Exchange

USD Maintains Broad-based Appreciation

Renewed bouts of turbulence in financial markets ensued after mixed data influenced the EUR/USD pair. Subpar US job growth in May of just 38’000 new hirings has some market speculators betting that the Fed will lower its forward guidance after this important indicator marked a 6 year low. Meanwhile, the unemployment rate was also at a pre-crisis record low of 4.7% lending support to the second Fed rate hike rhetoric. The Fed has yet not ruled out the possibility of a second hike this year although the timing remains a matter under speculation. The likelihood of a June rate hike dissipated after the jobs report and Britain’s EU exit referendum results will likely dissipate any further hikes in 2016. Heightened uncertainty pushed benchmark treasury yields to record lows. By the end of June, yields on the 10-year Japanese government bonds hit a fresh all-time low of -22.1 bps owing to foreign investors plowing money in the Japanese government bond market at an increasing rate this year. The German bund was also sent to negative territory at -8.8 bps whereas US 10-year treasuries managed to stay above the 1.40 record low seen in July of 2012, standing at 1.47 by the end of June. The trade-weighted dollar regained some footing in May as the Fed hike is becoming increasingly likely. However, the US jobs report has put a lid on the greenback’s appreciation and extended the Fed’s monetary policy debate. By the end of June, the DXY index stood at 96 which is down by 2.6% YTD.

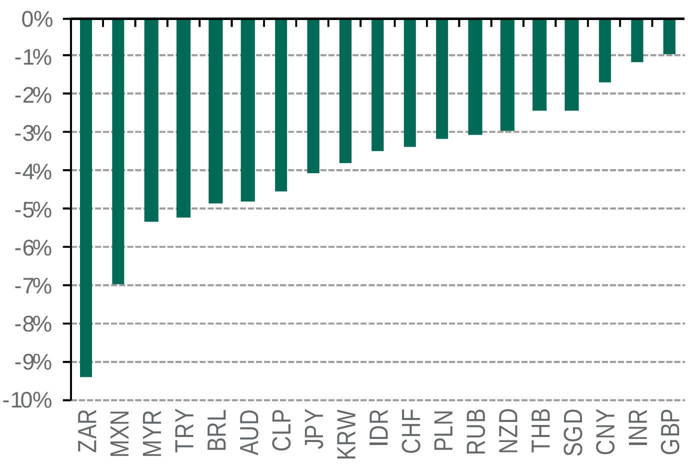
Chart 3: Trade-Weighted Dollar and the Euro



Source: Thomson Reuters

The European single currency is under pressure as investors gravitate towards the USD countered by an upside pressure from the Brexit referendum results. The 30-day volatility index (EVZ) recorded a YTD high in June, measuring 14.49, as speculation intensified. By the end of June, the euro stood at USD1.1 appreciating by 1.9% on a YTD basis. Despite the relative strength which may have been induced by Brexit, the Fed’s policy normalization process unevenly tips the scale in favor of the dollar, especially with a more fragile economic recovery in the EU versus the US. On June 8th, the ECB made its initial purchase of corporate bonds worth EUR348 million marking an aggressive start to put it on track to buying at least EUR7 billion worth of corporate bonds per month. While this amount is relatively small compared to the EUR80 billion sovereign bond purchases per month, it is expected to be more targeted, lowering borrowing costs for businesses in the Union.

Chart 4: Monthly Foreign Exchange Rate Changes



Source: Thomson Reuters

Commodity currencies are divergent. The sharp recovery in oil prices was not mimicked in other commodities which poses the question of the sustainability of the current price rally. The Australian dollar is on the defensive due to sluggish iron ore performance in addition to the mounting probability that the Reserve Bank of Australia may increase easing. As a result, the AUD has been teetering around 0% YTD in May and June after it reversed April’s 7% peak. By the end of June, the Australian dollar stood at USD0.74, up-ticking by 1.7% YTD.

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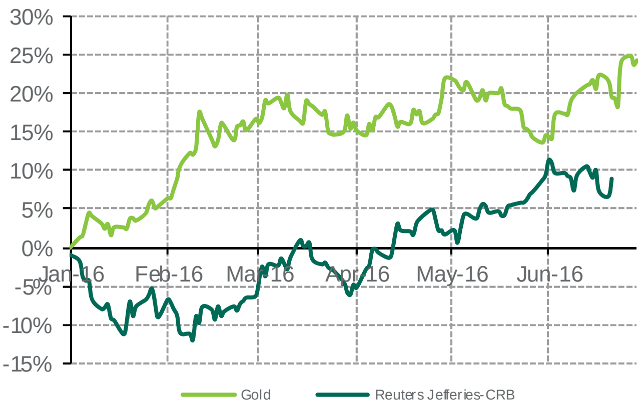
Commodities

Commodities Firm on Weaker USD

According to the Reuters//Jeffries CRB index, commodity prices surged to 8.7% YTD by the end of June, extending a five-month period of gains. Main drivers included rising oil prices and a weaker supply prospect on agricultural commodities. Despite the recent upturn, however, the World Bank maintained its downward revised outlook of non-energy commodities of -5.1% Y/Y with metals falling 8.2% in 2016. The global slowdown boils down to demand and supply, and with much of the commodity super-cycle investment momentum leaving the market overstocked, demand is lagging behind. Broad-based strengthening in the US dollar also reflected negatively on commodity producing emerging and developing countries, leading the IMF to reduce global growth forecast for 2016 to 3.4% from previously 3.8%. Approaching mid-2016, the commodity turnaround which took place since February remains under heavy scrutiny from investors as fundamentals continue to exert downward pressure on commodity prices. Even in isolation from the oil story, industrial demand is sluggish, commodity supply is ample, and the USD is still on an appreciating trend.

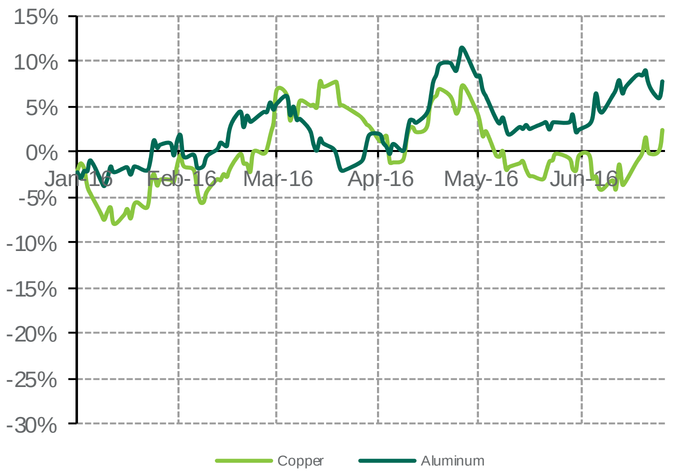
Chart 5: Reuters Jefferies vs. Gold



Source: Thomson Reuters

Copper prices inflected mid-June and managed to end the month at a gain of 2.4% YTD standing at USD4,818/ton. The Rio Tinto mining group approved its copper mind expansion in Mongolia, adding to the already oversupplied market. On the other hand, aluminum prices held steadier due to production fluctuations in China and the shut-down of high-cost smelters. Hence, the per ton price of aluminum stood at USD1,624 , upturning by 7.8% YTD. Strong investment demand and safe-haven buying allowed gold prices to surge 24.3% since the beginning the year through June, standing at USD1,319.3/oz. The adoption of negative interest rates in a number of developed economies such as Japan and the EU and the deferral of the Fed's rate hike, in addition to Britain's exit from the EU increased the attractiveness of gold. Physical demand for gold remains weak in India and China, the two largest gold consuming countries. In India higher prices and uncertainty over the government's current restrains are putting demand on hold, especially after the 1% Indian jewelers tax imposed in March led to strikes. In China, demand has been weak due to New Year holidays and a slowing economy. Gold mining has been trending lower due to lower investment although depreciating producer currencies and lower cost of production should provide some support for mining activities.

Chart 6: Base Metals



Source: Thomson Reuters

By the end of June, prices of agricultural commodities surged 10.7% YTD according to the S&P/Goldman Sachs Agricultural Index highlighting mounting supply concerns. Wheat futures remain depressed as supply woes in Western Europe was geographically limited. Heavy precipitation in France favored disease development in crops, thus firming prices early June. By the end of the month, however, wheat had already wiped gains and relapsed into negative territory, falling to 444 cents/bushel. The El-Nino weather event impacted North Eastern Africa, Indonesia and parts of the US, leaving some countries with the worst drought in 50 years. By the end of June, soybean and corn futures have priced in risks from the weaker output. Soybean prices surged 30.4% YTD to USD1.14/bushel while corn prices rose by 16.5% to 431.5 cents/bushel.

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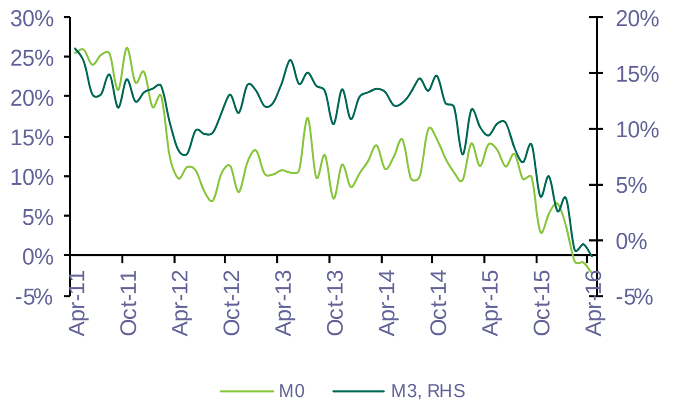
Money & Inflation

Liquidity Concerns as Deposits Fall

In the month of April, broad money supply shrank 1.5% Y/Y, exacerbated by lower oil returns and falling deposits. Deposits with SAMA dwindled by 8.4% Y/Y as both bank deposits and public financial institutions deposits respectively fell by 6.2% Y/Y and 48.9% Y/Y. The decline which is markedly considered the largest since November 2009 was contrasted by a 3.6% upturn in cash in vault and a 0.9% uptick in currency outside banks. The monetary base thus stood at SAR298.2 billion falling by 2.2% Y/Y. Spending cuts in addition to new government revenue sources highlighted in the National Transformation Plan (NTP) put the Kingdom's economy in a major shake-up treading an uncharted path away from oil. The budget deficit which currently stands at 15% of GDP is taking a priority seat at the economic reform plan which poses a new challenge for the Kingdom's monetary system as it deals with a liquidity squeeze, currency pressures, and the momentum demand for credit. So far, the government has been financing its budget deficit by the sale of local debt in addition to drawing down foreign reserves. Government bonds issuances surged by an annualized 163.1%, standing at SAR140 billion by the end of April. Net foreign assets at SAMA tumbled for the 15th consecutive month in April to 15.7% Y/Y, a four-year low standing at SAR2.14 trillion.

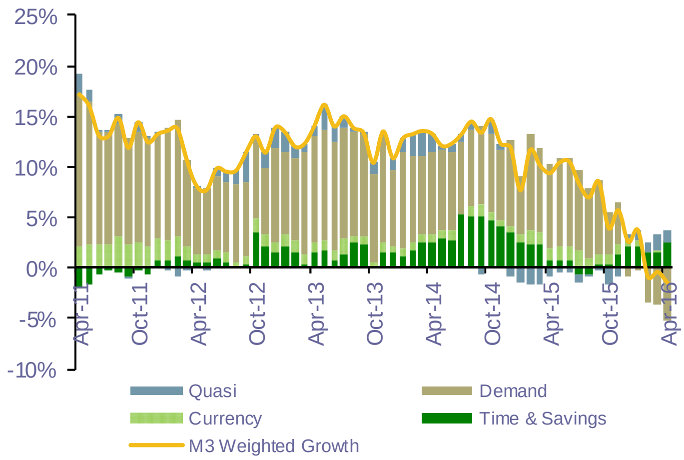
Chart 7: Growth in Monetary Aggregates



Sources: SAMA and NCB Estimates

The reduced revenue stream lessened the trickle down of liquidity which pressured local banks. As the government slowed payments to contractors and suppliers and started borrowing from local and soon international banks, the dry-up of liquidity affected banks largest funding base, demand deposits. By the end of April, demand deposits extended a four-month consecutive decline with yet the largest dip of 8.6%, standing at SAR981.6 billion. On the other hand, time and savings deposits reached SAR406.1 billion, upturning the most since December 2014 at 12.7% Y/Y. The contrasting movement in these deposit accounts indicate a rising propensity to save for businesses and individuals under the currently dismal economic prospects. The sum of currency outside banks, demand deposits and savings deposits brings M2 money supply to SAR1.15 trillion, down by 2.8% Y/Y. Quasi monetary deposits are on the rise for fifth consecutive month on the back of increased deposits of foreign currency. In April, quasi money recorded a surge of 9.9% Y/Y, standing at SAR210.3 billion.

Chart 8: Money Supply, Contribution



Sources: SAMA and NCB Estimates

The inflationary situation in the Kingdom continues to reflect the removal of government subsidies and the diminishing base effect of low oil prices. In the month of April, the annualized growth in inflation recorded 4.2% mainly driven by housing and utilities surging by 7.5%. The transport category recorded the fourth month of double-digit inflation, of 12.5% Y/Y. The largest growth rate seen in the consumer basket during the month was for tobacco surging by 20.6% Y/Y. Despite food and beverages providing a downside pressure to the overall index, upside pressure from other categories are expected to keep inflation above 4% this year.

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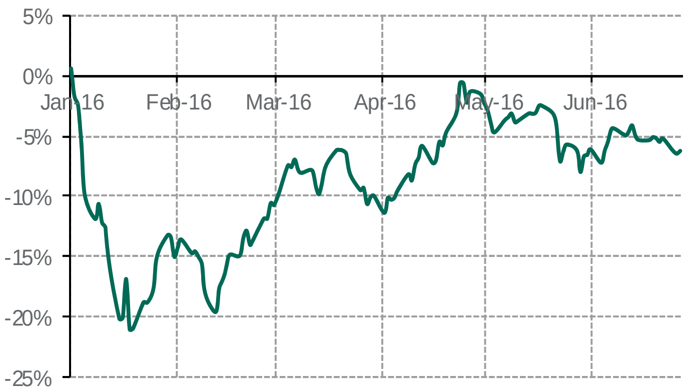
Capital Markets

Seasonality Intensified by Unexpected

Global financial markets were roiled on the outcome of UK's referendum as over 17 million voted to leave to European Union. More than USD2.5 trillion dollars was wiped in value during the next trading day as widespread sell-offs pressured equity indices and commodities alike. The MSCI World index registered a 4.8% drop by the end of Friday, the biggest one-day drop since August 2011. The FTSE100 lost 3.1% as investors scrambled throughout trading hours with heightened volatility as they factor in the unexpected decision. Meanwhile, France's CAC40 declined by 8.0% and Germany's DAX retreated by 6.8% as concerns over EU's unity resurfaced. The chaos resonated across the pond in US equity markets as the major three indices, the DOW, S&P500, and NASDAQ registered drops of 3.4%, 3.6%, and 4.1%, respectively. Even though the Japanese Yen had significantly appreciated due to safe haven demand, this compounded the fall in the Nikkei 225, losing 7.9% driven by possible reduced competitiveness for exporters, its biggest drop since April 2000. As for the domestic market, Tadawul investors were allowed more time to assess their outlooks given the Friday-Saturday weekend for the Saudi market. After initially dropping over 4%, the market ended the first trading day, post the UK vote results, with a loss of 1.1%. We expect markets to remain volatile going forward as further analysis and forecasting on the aftermath of the referendum unfold and draw a clearer picture on the demands of the UK people.

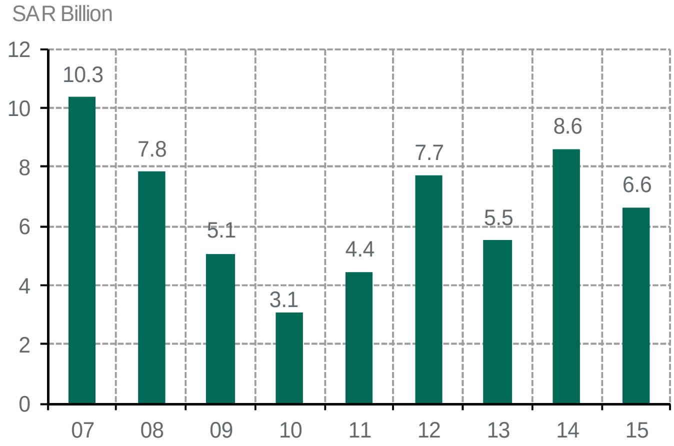
Chart 9: Tadawul All-Share Index



Source: Tadawul

During the month of May, Tadawul retracted by 5.3% M/M following the previous month's 9.4% gain. In anticipation of the summer season, the cyclical trend of outflows was evident by the decline in average daily traded value volumes which registered SAR5.1 billion during May, 12.8% less than April's average daily traded volumes of SAR5.9 billion. In addition, the muted trading is also attributed to the anticipation of the Holy month of Ramadan which has pressured the level of activity in the market this month as capital is withdrawn for consumption expenditure. On a sectoral basis, only the media and energy sectors registered gains at 2.0% and 1.3%, respectively, while the retail sector remained flat for the month of May. Among the losing sectors were the hotel and real estate, posting the worst performances with a decline of 11.7% and 10.0%, respectively. During the first five months of 2016, the hotel sector had lost 41.7% while the best performing sector was petrochemicals, registering a gain of 4.2% on the back of oil's rebound to around USD50/bbl.

Chart 10: Average Daily Traded Value



Source: Tadawul

As for the primary market, the third Initial Public Offering (IPO) for 2016 concluded with the usual strong appetite. Lazurde Company for Jewelry offered 30% of its SAR430 million capital for the public, totaling 12.9 million shares at a premium price of SAR37. The IPO offered individual investors the opportunity to invest in 3.87 million shares and the other 70% was allocated for institutional investors. The shares offered for individuals were oversubscribed by 293%, accumulating SAR419.7 million, well above the required SAR143.2 million. The primary market is expected to remain active over the coming years as Saudi Vision 2030 plans to privatize government assets which will have a positive effect on IPO activity.

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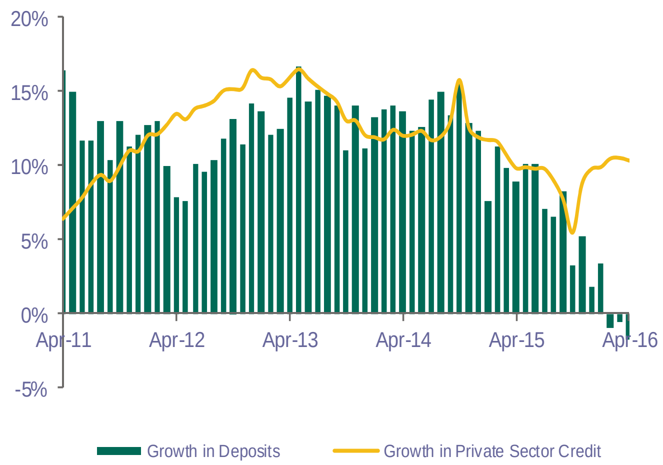
Loans Market

Persistent Double-Digit Growth

As oil revenue shrank on falling oil prices, the Kingdom, among other oil exporting gulf countries, are increasingly taping capital markets in order to maintain and induce growth. This credit-induced growth comes at a time where widening fiscal deficits is adversely impacting sovereign credit ratings. Moreover, with much of SAMA's monetary policy constrained to preserve the long-standing dollar peg, the Kingdom had to balance between repatriating foreign assets and issuing debt. In the month of April, Saudi Arabia's net foreign assets sank for the 15th consecutive month by 15.7% Y/Y , standing at a four-year low of SAR2.14 trillion. As for debt issuance, the Kingdom began issuing sovereign development bonds in the second half of 2015 for the first time since 2007. The next move confirmed by the Saudi officials is the debut of the first international bond at about USD15 billion possibly in July. The issuance will include several tenors up to 30 years in maturity and will be followed by an additional bond issuance later this year of a yet unspecified amount. Lower sovereign credit ratings with a negative outlook for the Kingdom as declared by S&P, Moody's, and Fitch will likely pressure the Kingdom's debt pricing and place higher borrowing costs compared to other GCC countries. Early speculation suggests that the Kingdom's 10-year yield could be around 4% which is higher than that of Qatar and Abu Dhabi which were issued earlier this year.

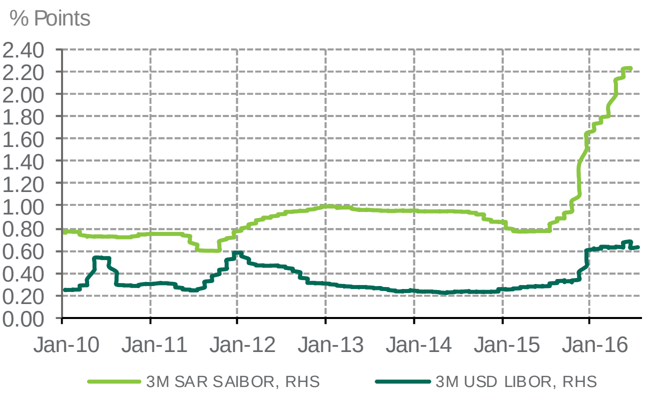
Chart 11: Private Sector Financing



Sources: SAMA and NCB Estimates

On the other hand, the National Transformation Plan which was announced in June is considered to be credit-positive, and could lead to a swift recovery in the Kingdom's credit rating which in turn would reflect on lower borrowing rates in the future.

Chart 12: Liquidity and Risk Detector



Source: Thomson Reuters

As for the local credit market, the consolidated balance sheet of Saudi banks shows that growth in private sector credit remained strong at 10.4% Y/Y by the end of April. Bank credit to the private sector fell to single-digit growth rates during the second half of 2015, bottoming out in October of the same year at 5.5% Y/Y. However, since February of 2016, SAMA raised the cap on how much more lending banks can extend relative to their deposits. Previously, the loan-to-deposit ratio guidance limit stood at 85% but as banks started to face the prospects of a liquidity squeeze, SAMA allowed them to leverage an additional 5% to reach 90% which is still below the ceiling other GCC countries impose on their banks. In contrast, deposits marked the third consecutive monthly decline, shrinking by 1.7% Y/Y. By the end of April, total bank credit extended to public and private sector enterprises amounted to SAR1.417 trillion which is up 10.0% from a year ago. Total bank claims on the public sector marked the 13th month of decline, falling by 24.2% to SAR250.5 billion. As bank credit to the public sector does not exceed SAR46.5 billion, the bulk of lending to governmental entities happens in the form of investments in government securities, bonds, and treasury bills. Saudi banks' holdings of SAMA bills dwindled by 72.3% Y/Y to SAR64.2 billion, the largest annualized decline since October of 2005. On the other hand, the unutilized lending capacity from holding less SAMA bills helped banks absorb the government bond issuances which surged by 163.1% to SAR139.9 billion.

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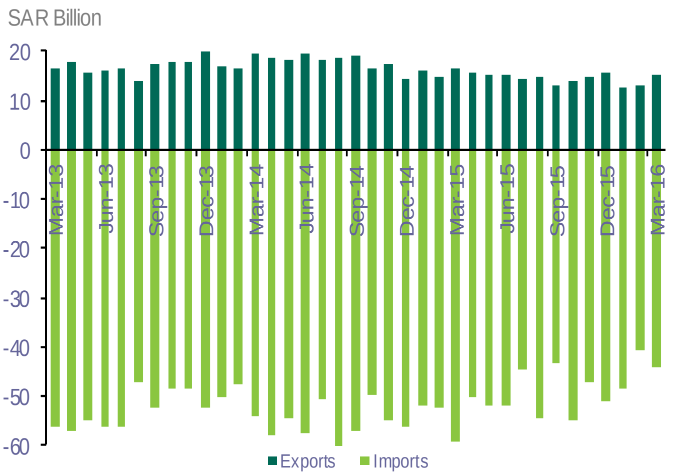
External Trade

Exports Shrank 9.1% Y/Y in March

The Kingdom's non-oil trade figures released for the month of March show that non-oil exports fell 9.1% Y/Y, valued at SAR 15.1 billion. The series of declines which intensified in tandem with falling oil prices is still letting off steam, even so with oil prices firming up recently. However, the changing nature of Saudi exports is promising more weight for non-oil exports in the country's trade balance. The shift comes as a part of the National Transformation Plan aims to triple non-oil revenue to SAR530 billion by 2020 and prioritizes the reduction of government transfers and optimizes its services. As a reflection of this vision, the Saudi non-oil private sector PMI recorded 54.8 in May, the highest since December 2015. On the other hand, imports plunged by 25.6% Y/Y, standing at SAR44 billion. The government's new efficiency measures coupled with the broad-based dollar strength have contributed to keeping imports muted. The balance of trade gap shrank 32% compared to the same period last year.

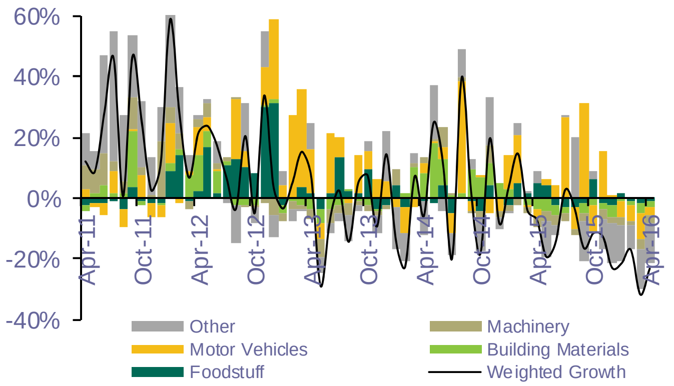
Chart 13: Saudi Non-Oil Trade Balance



Sources: SAMA and NCB

By composition, the value of non-oil exports in March was concentrated in plastics and chemical products at 33% and 24.4%, respectively. Exports of plastics were valued at SAR5 billion declining by 2.6% Y/Y while exports of chemical products stood at SAR3.7 billion tumbling by 19.8% Y/Y. Exports of base metals also dwindled on an annual basis, posting a 13.3% drop to SAR 1.3 billion. By destination, around 14.9% of non-oil exports headed to the UAE with a value of SAR2.2 billion, surging by 20.9% Y/Y. Non-oil exports to China are still negatively trending owing to the ongoing Chinese slowdown. Compared to last year, the Kingdom's non-oil exports to China sank 25.8% to SAR1.2 billion. India's share of the exports topped Singapore at SAR894 million, accounting for 5.9% of the monthly total. On a Y/Y basis, exports to India were also down 32.9%.

Chart 14: Attribution Analysis of Letters of Credit Opened



Sources: SAMA and NCB

On the import side, machinery and electrical equipment accounted for 24.2% of the import bill at SAR10.7 billion, dwindling by 32.6% Y/Y. Imports of transport equipment make up around 19.7% of the import bill which, at SAR8.6 billion, have declined by 12.7% Y/Y. Imports of base metals tumbled 29.1% Y/Y to SAR4.1 billion in line with slowing capital expenditure on mega projects. The largest share of the import bill came from the United States which stood at SAR6.3 billion accounting for 14.4% of the monthly total. In comparison to last year, however, US imports to the Kingdom declined 12.7%. Imports from China which account for 13.5% of imports also indicate sizeable declines of 26.9%, standing at SAR 5.9 billion. Imports from Germany declined the most on a yearly basis, losing 31.3% to SAR3 billion pressured by slowing demand in the Kingdom in addition to favorable foreign exchange rates.

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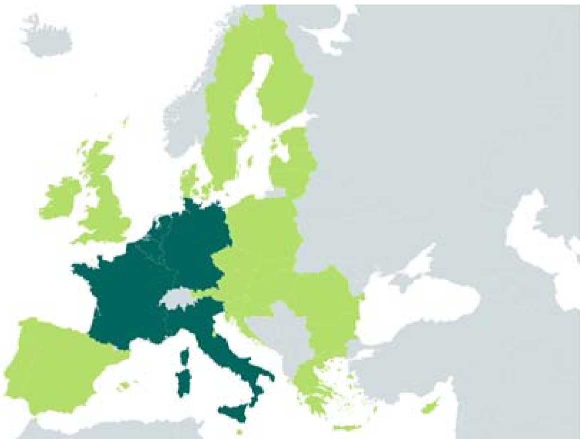
Special Focus:
Brexit Becomes Reality

The United Kingdom and Europe's relationship has been turbulent far before the latest referendum. In only its third nation-wide referendum, its outcome will have the greatest effect on its future. Going back to the end of World War II, European economies sought a means of integration and cohesion to rebuild their respective countries from the aftermath of the damages of war, an idea that was supported by Winston Churchill in his 1946 Zurich speech. A decade later, Britain rejected to join the six founding members of the European Economic Community (EEC), West Germany, France, Italy, Netherlands, Belgium, and Luxembourg. Following the initial success of the EEC, Britain's request to join in the 1960s was rejected a couple of times. It was only in 1973, led by Prime Minister Edward Heath, the UK was part of the economic building block of the European Union. In 1975, Britain conducted the first Europe-membership referendum and the results were 67% in favor of staying in. Fast forward to the 1990s and the Maastricht Treaty inked greater economic integration between Europe which resulted in more authority towards Brussels. Shortly after, the British government pulled out of the European Exchange Rate Mechanism and later talks of joining the single currency were rejected by the British as it touched upon their sovereignty. In 2013, the conservative party, led by David Cameron, was campaigning for a second term in office and promised to hold a referendum on UK's membership.

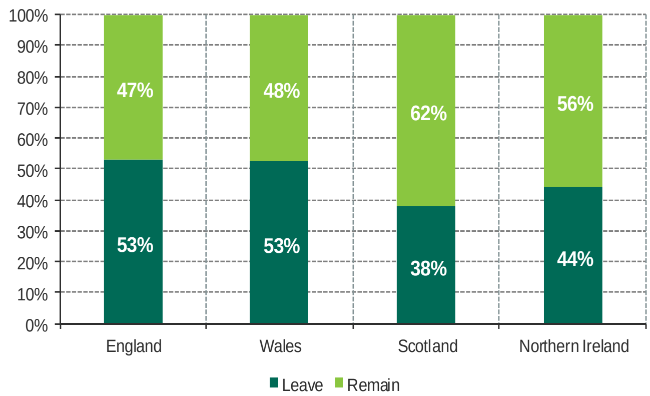
Chart 15: European Union Founders and Members



Source: European Union

The trade relationship between the UK and Europe has grown over the years as goods, services, and labor movements between the economies have grown due to reduced red tape measures and insignificant tariffs. According to the IMF, 51.4% of British goods were exported to the EU while it received 6.6% of the latter's export goods. While the trade flow is in EU's favor, Britain represents 16.2% of the EU's GDP. The argument of the "stay" campaign was that benefits were mutual and the repercussions of leaving the union outweighed leaving, rather simple which was their downfall. The UK is the third largest contributor to the EU budget, shelling out GBP18.8 billion in 2014. This figure was used by the opposition and interpreted into the "GBP350 million a week to Brussels" slogan that reached the working class much clearly. However, that did not account for the GBP5 billion rebates the UK receives and additional GBP4 billion from EU inflows which brings the total contribution to around GBP10 billion. On 23 June 2016, an unexpected 51.9% voted to leave a 43-year old membership which roiled financial markets. Poll results revealed that England and Wales were in favor of leaving the EU, while Scotland and Northern Ireland were content with the trade bloc. Moreover, voters reveal a generational divergence as the elderly opted to vote out while the younger generation wanted to remain.

Chart 16: Referendum Results by Country



Sources: British Office of National Statistics

Global markets reacted strongly as the British Pound dropped near USD1.32, the lowest level in over 30 years as the results were announced. Equity markets worldwide experienced wide sell-offs as investors reassessed their strategies and portfolios. Early forecasts predict a 2%-3% contraction in UK's GDP, a rate cut by the Bank of England, quantitative easing measures, and possible sovereign rating downgrades. Additionally, Scotland's Nicola Sturgeon said preparation for a second Scottish independence vote are "highly likely". The aftermath of the referendum remains a much debated discussion, however, the reaction of financial markets reveal the level of risk pertaining to the uncertain survival of European Union as well as the United Kingdom.

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