Potential economic impacts of Brexit

5 AUGUST 2016

In this note we summarise recent events following the UK's EU referendum vote on 23 June 2016. We also set out the range of potential economic effects in both the short and long term. We will continue to assess the situation as the government develops its negotiating position. We will send updates to our forecast subscribers and provide our clients with bespoke analysis.

The consensus among economists is that Brexit is likely to have a negative net effect on the economy. Losses are likely to outweigh any economic gains, in both the short and the long run.

Political uncertainty has subsided since the referendum. However, few seem to know when or how the UK government will trigger Article 50 (to start the process of leaving the EU). That is creating uncertainty about domestic economic policy although some action is now being taken. In particular, on 4 August 2016, the Bank of England announced an initial package of measures with the aim of stabilising the economy.

In the short term, we expect continued uncertainty to **dampen growth, as business investment and household consumption weaken**. There is also the risk that currency depreciation and volatility will exert **upward pressure on prices**.

The long-term economic effect will depend heavily on the nature of any trade deals the UK strikes with the EU and the rest of the world. Currently, there is little indication of what those deals will look like. Long-term immigration policy also remains an unknown. Both of these will also have implications for other aspects of macroeconomic performance, including the public finances.

Any **new trade barriers risk curbing trade growth**. If the UK no longer has full access to the EU Single Market, the UK's attractiveness for Foreign Direct Investment may also fall. Consequently, the UK's **sectoral competitiveness and productivity may suffer**.

Should UK economic growth falter, **falling tax receipts and rising benefits payments will widen the budget deficit**. Any further downgrade in the UK's credit rating may also raise public borrowing costs. Meanwhile, any migration restrictions may reduce flexibility in the labour market.

At present, it is **difficult to see how any prospective reduction in regulation would compensate for this slower growth**.

Table 1: Summary of impacts

Short term: uncertainty*		Long term: trade deals*	
Business investment	-	Trade	-
Household consumption	-	Inward investment	-
Exchange rate	-	Domestic competitiveness	+/-
Inflation	-	Productivity	+/-
Government bond yields	-	Public sector net expenditure	+/-
		Labour market flexibility	-
		Credit rating	-

Source: Cambridge Econometrics.
* - denotes negative macroeconomic impact, +/- denotes an overall ambiguous impact.

The following pages provide more information on the above.

About our analysis

Cambridge Econometrics applies its models and quantitative approaches to carry out in-depth and objective economic assessments. This includes UK analysis that accounts for the interdependencies in the modern global economy. This work also extends to individual sectors and geographic regions.

We will publish elements of this analysis on our website. If you are interested in the detail or want to discuss how we can provide you with specific economic analysis, please contact Chris Thoung at ct@camecon.com.

Introduction

This note summarises recent events in the wake of the UK's EU referendum vote on 23 June 2016. It also summarises the literature on the potential economic effects both in the short and long term. As such, it does not attempt to set out a single vision of the likely path of the economic post-Brexit. We will assess the situation as it develops and publish updates as events warrant.

The economic impacts of leaving the EU will depend heavily on the exit negotiations and any subsequent UK trade agreements with the EU and the rest of the world. Different agreements will have different implications for trade, investment and government finances. For example, the outcome of UK membership of the European Economic Area (the 'Norway option') would be quite different to a situation where the UK relies solely on World Trade Organisation arrangements to govern trade.

No one knows how long the exit negotiations and trade deals will take. The longer they take, the more protracted the uncertainty.

Potential short run impacts

Uncertainty about the UK's trade prospects and policy response is likely to have many negative economic impacts:

- Businesses are likely to postpone investment until they can see a clearer picture of the UK's trading conditions. Likewise, consumers may defer spending until they feel more confident about their job prospects.
- We have seen a depreciation of Sterling and this may be sustained by heightened risk premia. The Bank of England estimates that half of Sterling's depreciation from November 2015 to May 2016 was attributable to the referendum[1]. Since the vote, Sterling has fallen substantially against the US dollar, at times to levels below those seen during the 2008 financial crisis.
- Currency volatility is also likely to increase. Between 23 June and 1 July, the GBP-USD rate has fluctuated by an unprecedented amount in the post-Bretton Woods era[2].

± Before the referendum, economists expected uncertainty, Sterling's depreciation and lower growth forecasts to reduce demand for Sterling-denominated assets, including government bonds (gilts). However, early signs suggest that demand for gilts has been sustained, despite the heightened uncertainty. The yield on ten-year debt reached its lowest ever rate at the second debt issue after the referendum.

\- A sharp depreciation of Sterling is also likely to make imports more expensive. This could put upward pressure on domestic prices. Higher inflation would depress real wages, which may reduce household consumption.

\+ A sharp depreciation of Sterling could reduce the price of domestic products denominated in foreign currency. All else being equal, this could bolster UK exports and exporters' profits in Sterling. However, the individual effects on competitiveness and demand will depend on factors such as contract terms, dependence on imports[3], and exporters' pricing decisions.

± Monetary policy will have to balance controlling inflation with stimulating demand. On 4 August 2016, the Bank of England announced an initial package of measures, signalling its tolerance for higher inflation in the near term to prop up aggregate demand. Key

[1] See Bank of England, *Inflation Report May 2016.*
[2] See Bank of England, *Financial Stability Report July 2016*.
[3] Globalised supply chains increasingly mean exported goods contain imported components. Any currency depreciation is likely to make imports more expensive. Exporters may pass on any increased costs when selling their products.

elements of the package include a cut in the Bank Rate to 0.25%, and an expansion of the asset purchase scheme to £435bn.

± Surveys since the referendum have signalled mixed sentiments in the business community:

- A Bank of England survey[4] found the majority of UK firms consulted have yet to change their near-term employment and investment plans, despite a marked increase in uncertainty. Nevertheless, a third of them expected to change their plans negatively in the next twelve months.
- However, other surveys[5] report lower business optimism and dampened expectations for new orders in the near future. The latest Flash UK PMI[6] reports new orders in services falling at their quickest rate in over seven years. The composite index in the same survey dropped to a level unseen since April 2009.

Potential long run impacts

The biggest impact of leaving the EU will likely be on the (dampened) trade prospects of the UK. However, a clearer picture will only emerge once exit negotiations have taken place:

- Generally, economists anticipate that volumes of trade will be lower after Brexit than if the UK were to remain in the EU. The extent of this will depend on whether the UK can establish free trade agreements for both goods and services, on similar (if not better) terms to its current arrangements. Otherwise, trade costs (such as from tariffs and regulations) could rise, for both UK and overseas businesses. This will be particularly important with respect to trade in services.
- Export demand from the EU is likely to fall. It is possible that demand will increase from outside of the EU, but we do not expect this to compensate for the reduction in EU demand. Overall, economists expect trade to make a lower contribution to UK GDP growth. Any short-term improvements in the trade balance from depreciation are likely to precede longer-term deterioration, depending on the trade deal.
- Investment activity between countries will also likely reduce. Of particular concern is that Foreign Direct Investment (FDI) into the UK may fall, reducing investment in the capital stock and, in turn, dampening sectoral competitiveness and productivity. This is partly because the free movement of capital between the UK and the EU is likely to be more restricted than previously. FDI into the UK may also grow more slowly because of diminished access to EU markets.
- The UK's future immigration policy remains unknown. However, should there be tighter controls on the movement of people, economists expect a reduction in labour market flexibility in terms of numbers and skills supply.
- From a distributional perspective, the Centre for Economic Performance estimated all income groups would incur losses from leaving the EU[7]. In their analysis, middle-income households stand to lose more than those in the richest and poorest income brackets.
- The sectoral composition of the UK economy may change. Some analysts expect financial services companies to relocate some of their UK activities to the EU. This is particularly likely if the UK faces greater restrictions on trade in services.

---

[4] See Bank of England, *Agents' Summary of Business Conditions, July 2016 Update*.
[5] For example, Deloitte, *Deloitte CFO Survey: 2016 Q2* and CBI, *Manufacturing prospects muted after Brexit – CBI*.
[6] See the press release for Markit, *Flash UK PMI July 22nd 2016* here.
[7] Breinlich, H., Dhingra, S., Estrin, S., Huang, H., Ottaviano, G., Sampson, T., Van Reenen, J. and Wadsworth, J. (2016), "BREXIT 2016: Policy Analysis from the Centre for Economic Performance", June 2016, available at http://cep.lse.ac.uk/BREXIT/.

- A less-open market may reduce competition in the UK. This will increase the potential for inefficiencies and could dampen innovation.

+ However, if there is a reduction in regulation, it may improve efficiency. However, the scope for gains may be limited. The World Bank already ranks the UK among the highest in the world for ease of doing business[8].

- The downgrades to the UK's credit rating following the referendum may have long-term negative economic repercussions, and could increase borrowing costs.

- There may be a reduction in research and development investment, which could dampen long-term economic growth. According to The Royal Society[9], the UK received €8.8bn in research funding over 2007-2013 from the EU. Although non-EU countries can access EU research funding, UK institutions are concerned that this will be more difficult after we leave the EU. Migration controls may further constrain research and development.

+ The primary direct impact on public finances will be a reduction in the UK's net financial contribution to the EU. According to some estimates, this is currently around £8bn a year. The amount of any future UK contribution to the EU (if there is one) will depend on the final negotiated relationship between the UK and the EU.

± However, leaving the EU will have secondary effects on public finances:
  - Given expected lower UK economic activity, tax receipts will fall and welfare payments may increase. Public sector borrowing will therefore be higher.
  - Given lower GDP growth and higher levels of borrowing, the debt-to-GDP ratio will rise, increasing debt interest payments.
  - Perhaps in recognition of the economic uncertainty, the government has abandoned its commitment to run a budget surplus (having previously waived its commitment to a budget surplus by 2019-20).

- Economists estimate that a fall in national income of just 0.6% would have a negative impact on the public finances equivalent to any gains made from the removal of all EU contributions. It is reasonable to expect that, on balance, the secondary impacts will have a larger effect on public finances.

- The economic prospects in the rest of the world may also change. Reduced economic growth in the UK, coupled with increased uncertainty elsewhere in the world, may dampen economic growth in the EU and other countries around the world. This may feed back to the UK through trade and investment, further dampening economic growth.

Conclusions

The UK economy is already feeling the short-term ramifications of the referendum vote. There remains substantial uncertainty around the precise timing of triggering Article 50. Until then, the persistent uncertainty will damage confidence and dampen growth prospects.

The longer-term implications depend heavily on the post-membership landscape (politically and economically). Any substantial barriers to trade (and migration) with the EU will likely damage economic growth in the medium to long term.

[8] According to the World Bank's Ease of doing business index, available at http://data.worldbank.org/indicator/IC.BUS.EASE.XQ
[9] The Royal Society (2015), pages 10 and 14: *UK Research and the European Union: The role of the EU in funding UK research*.