

The costs of Brexit for UK economy

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Abstract. *Leaving the EU without a deal in place for future trading agreements would be the worst-case scenario for British economy. In the long-run Brexit is expected to reduce UK living standards due to the declines in trade and foreign direct investments. The British economy will suffer from the losses implied in the export sectors due to the fact that 45% of its exports are destined to EU members. The potential loss of importance for the City of London will generate a fragmented European financial market that will reduce systemic risk. On the other hand, market participants could face a dual regulation on financial markets, increased uncertainties and frictional costs. The plan to design a Capital Market Union will create a strong competition for London, while Frankfurt and Paris are eager to absorb the financial services lost by British economy.*

Keywords: banking union, financial markets, financial services, trade policy.

JEL Classification: E44, E66, G20.

Introduction

The Brexit vote was a hard response from the left behind voters to the political class and European Union. The EU immigration policy strongly backed by Germany proved to extend the existing divergences between member states. After the sovereign debt crisis, there were a lot of contradictory perspectives in the European model regarding the design of the Banking Union (North-South collision), the immigration policy, the austerity policies imposed by the European Commission or the foreign policy towards Russia. Brexit demonstrated that EU lack of legitimacy on different problems created a strong sense of frustration at national level in several member states. The negotiation between EU and Great Britain would be a real challenge due to the short timeline (since the trigger of Article 50, the deal between the two parties has to be agreed in two years) and the multitude of subjects in discussion. The paper raises the problem of the costs implied by Brexit from an economic perspective, taking into account the dimension of the export sectors of Britain and the role of London as the main financial center of Europe. It is clear that both sides in the negotiation process will try to minimize the costs and increase the benefits. UK negotiation position comprises two alternatives; either it will battle to remain a part of the Single Market, in which case it will have to offer some concessions, or it will trade under WTO rules and fight for the its companies passporting rights to operate in EU.

Literature review

The negotiation process that started after the invocation of Article 50 will be a short and tight one. There are a multitude of problems to agree on, from trade policy to the Single Market or the “Brexit bill” that has to be assumed by British economy. Great Britain position is awkwardly unclear at this moment, even if all the economists agree that in the negotiation process EU has a clear advantage. As Sampson (2016) emphasized UK position is weaker due to the fact that *it did not participate in trade negotiations for the past 40 years, and currently has very little negotiating capacity. Nonetheless, it needs diplomatic expertise to provide information on the objectives and strategies of its negotiating partners.* In order to sum up a list of potential costs for the British economy, the problem was approached from different standpoints. The timeline of 2 years is rather short and it will be very hard to reach an agreement due to the fact that Germany elections are at the end of 2017 and no clear direction in the negotiation process can be achieved in EU without its approval.

For elaborating a proper image of the trade potential losses, Dhingra et al. (2016a) reveal that the negative impact of Brexit would be only marginally offset through bilateral trade agreements with US, Canada or Southeast Asia. The gravity model equations imply an overall income reduction estimated between 1.3% and 2.6%, and once they include the long-run effects on productivity, the national income loss increases to a figure between

6.3% and 9.5%. The commercial relations with EU will become more complicated and expensive, resulting in a trade diversion away from EU.

Kohl, Brakman and Garretsen (2017) emphasize that the GDP reduction implied by Brexit is estimated between 1% and 6%, depending on the variables used in the equations and the benefits generated by the long-run trade policies of British authorities. Prior to the UK joining the European Economic Community (EEC) in 1973, around one third of UK trade was related to this region. In 2014, the 27 other EU members accounted for 45% of the UK's exports and 53% of imports, while EU exports comprised 13% of UK GDP. The integration in the EU Single Market provided higher trade benefits for UK consumers through reduced prices in goods and services. The export sectors benefited from better opportunities that led to increased sales and profits for British companies.

Terzi (2016) emphasized that *the core of the single market is focused in the concept of Schumpeterian creative destruction: once countries open their borders to European competition, some firms (the most unproductive) will exit the market, allowing for a redistribution of resources to the most competitive*. Unfortunately, this process creates losers and winners, while some discretionary national policies result in long-term unemployment or permanent migration. The huge difference between the core and the periphery in the European model cannot be ignored and the overall regional policy of EU (for the period 2014-2020 regional policy was allotted 0.4% of EU GDP per year) was merely a disappointment.

Brexit proved that the leave behind voters are a force that cannot be neglected. The impact of globalization, the structural changes in the economies after WWII and the technology revolution created an entire segment of population that can be perceived as permanent losers. Unfortunately, EU failed to integrate the unreformed labor markets with the skill-bias of technology shocks. The deal between the two sides has to limit the mutual damage, because if it flops, Brexit will transform a political problem into an economic one.

Methodology

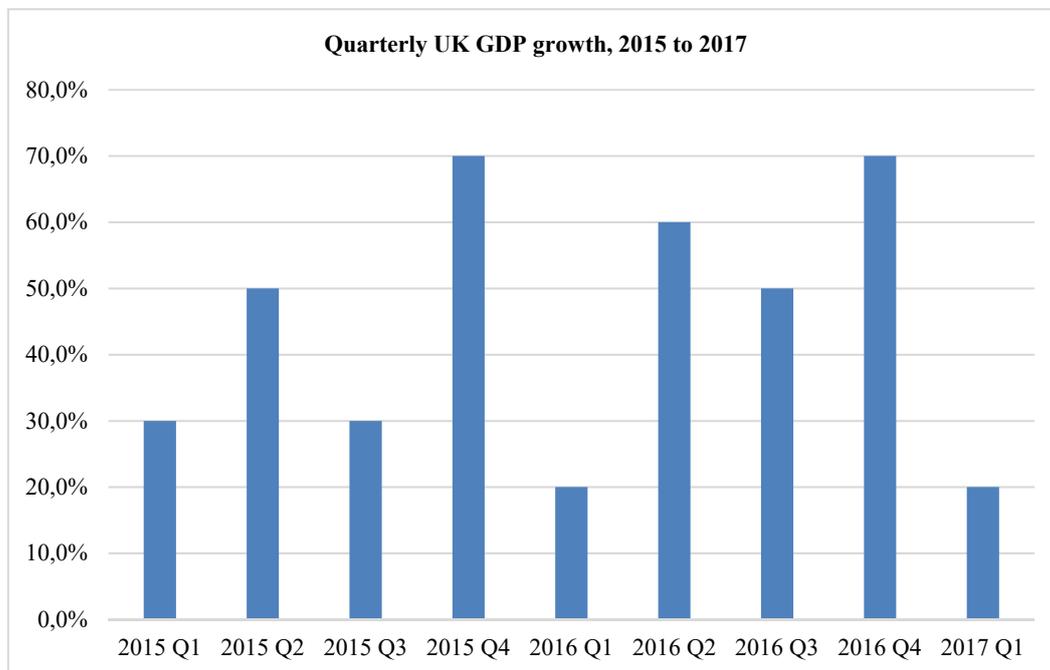
The paper analyzes the implications of the Brexit process to the economy, and especially to the export and financial sector. The most urgent challenge after the trigger of Article 50 would be to secure a new trade agreement with EU, while trying to limit the number of protectionist measures by both sides. As Sampson (2016) emphasized it is very important to know *whether the reference point for UK-EU negotiation is membership of the Single Market or trade under WTO rules*. Analyzing the impact in the financial services, it is evident that UK should struggle to secure tariff-free access to EU markets or passport rights for financial services. Any of these concessions from EU will imply negotiation costs for UK, such as: a "Brexit bill" as high as 60 billion euro (UK contributions to EU budget until 2020) or guaranteeing the "four freedoms" integrated in the Single Market.

Analyzing the GDP growth figures, there are clear signs of weakness derived from investors perceptions regarding the economy. The investment component of the economy will be affected because the negotiation process will imply rising uncertainty over different sectors regulation.

It is evident that since the beginning, the negotiation process will shape the perspective of a soft or hard Brexit. The study of other states experience in the European Free Trade Association provides a clear image of the trade-offs that Britain will have to exceed in order to smooth the negative impact on its economy. Trade negotiations will imply a bargain of competing objectives between the two sides, an idea also embodied in the reciprocity principle that guides WTO rounds of negotiation.

Analysis

Brexit implications started to appear in UK economy since the first quarter of 2017. The GDP growth rate started to decrease due to a reduced level of private investments and a loss of financial services business. The perspective that EU will take the opportunity to impose trade barriers to UK services exports scared companies and led to future plans of production delocalization. Protectionist regulation from EU will determine an increase in consumer prices, higher costs for imported inputs and capital goods and important price distortions in the business supply chains.



At the end of April 2017, the sterling was 13% lower against US dollar and 9% lower against Euro, than on the day of the referendum. This signifies that the investors expectations for the economy have weakened, while the costs of the imported goods and services increased sharply. The figures of the inflation for the first quarter of 2017 (2.7%) support this conclusion, on the medium term the consumption component of the GDP being directly affected. Great Britain holds almost 7% of the global stock of foreign direct investment (over 1 trillion Euro), being on the second place after United States. Half of the direct investments comes from EU member states, so a “hard Brexit” could signify potential large disinvestments and a huge loss for UK economy. British research firms could be excluded from EU 80 billion Horizon 2020 fund, creating negative effects for innovation and technological progress.

The ability of Britain to design its own financial framework post-Brexit will be counterbalanced by the need of market participants to trade in Europe. The European financial system will become less integrated and more unstable. The outcomes of the Banking Union will create additional vulnerabilities, because the entire set of regulations described in (Hrebenciuc, 2017) will be put under a question mark: *The new configuration of the European Banking Union will include a set of measures focused on ensuring stability in the system:*

- *Single Supervisory Mechanism performed by ECB.*
- *National Deposit guarantee schemes.*
- *Single Resolution Mechanism.*
- *Direct recapitalization through the European Stability Mechanism.*

A further potential danger could be a vicious feed-back loop (Danielsson et al., 2016a) that could end with a depreciated sterling, rising inflation and falling bond prices. In this case the long-term sustainability of the pension funds would be put under risk affecting the entire British financial system. The probability that the European authorities will try to increase the roles of Frankfurt and Paris in the European financial markets is high. In order to achieve this objective, the entire regulation will have to be designed in order to attract the clearing house business and to move the focus of the capital markets investors away from London.

The potential design of the Capital Markets Union will not include Great Britain and the integration of the European financial markets will create a strong competition for London. As described by (Danielsson et al., 2016b) Britain and EU had different approaches to regulation. British regulation is based on common law, transparency and self-regulation (assumes that rules should be applied only where a clear need is demonstrated), while the European approach is constructed on civil law and tries to regulate in a prescriptive way. Due to these evident differences, the separation of the British financial market from Europe will potentially create additional losses for investors and companies. In the meantime, the City of London might lose its major financial center status, while many financial market participants will operate under dual regulation of EU and UK.

The Brexit will increase fragmentation, it is known that highly integrated systems with unified rules and reduced frictional costs have many vulnerabilities and encourage the creation of too-big-to-fail institutions. While fragmentation is not efficient from this perspective, it also derives benefits from a reduced systemic risk for the financial system.

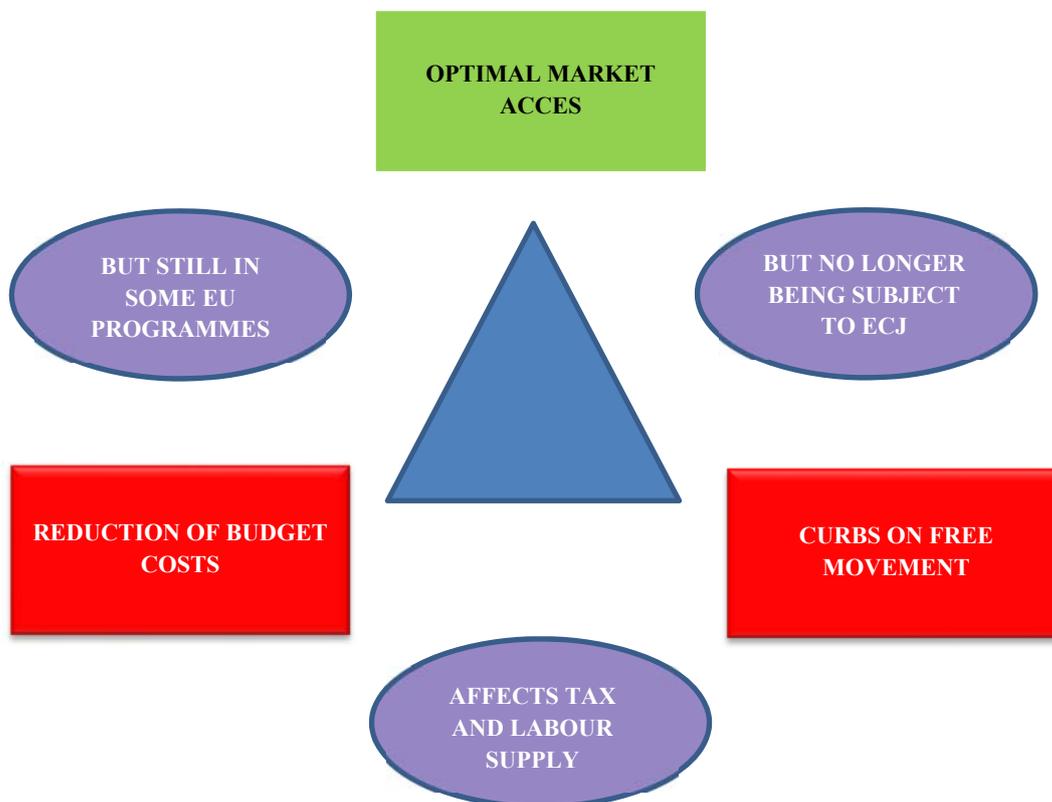
Analyzing from a financial perspective UK contributions could remain close to its membership dues. The Brexit bill imposed by the departure from the European Union is comprised from three main elements:

1. British commitments to the 2014-2020 EU budget framework, an amount estimated at roughly 30 billion euro.
2. Investment commitments to the cohesion policy of EU (ex. Motorways construction in Poland), UK share could total 17 billion euro.
3. EU Pensions Scheme, in 2016 the unfunded pension sums all over EU totalized 60 billion Euro. UK may be prepared to cover its own nationals, but European officials insist that all liabilities are a joint responsibility, as Eurocrats work for EU, not for their national governments. The figures estimated for this commitment should stand around 10 billion euro.

These costs are problematic for UK economy which failed to properly reform its labor market. Analyzing the income inequality through Gini coefficient, the rise from 0.32 in 1986 to 0.36 in 2014 is rather big. As a comparison, in 2014 Germany had a Gini coefficient of 0.29, while Greece registered 0.34, both smaller than UK. The potential losses implied by trade disintegration and UK possibility of no longer be a part of European supply chains creates the premises for an even worse Gini coefficient in the future. As Iain Begg (2017) stated, *it is very hard to manage trade disintegration and capture the costs at this moment. UK trilemma tries to accomplish a perfect equilibrium state that involves three components: an optimal access to the Single Market, an efficient curb on free movement (that will imply protectionist measures from UK side in order to satisfy the leave behind voters) and a reduction of budget costs that could create additional space to maneuver for social policies.*

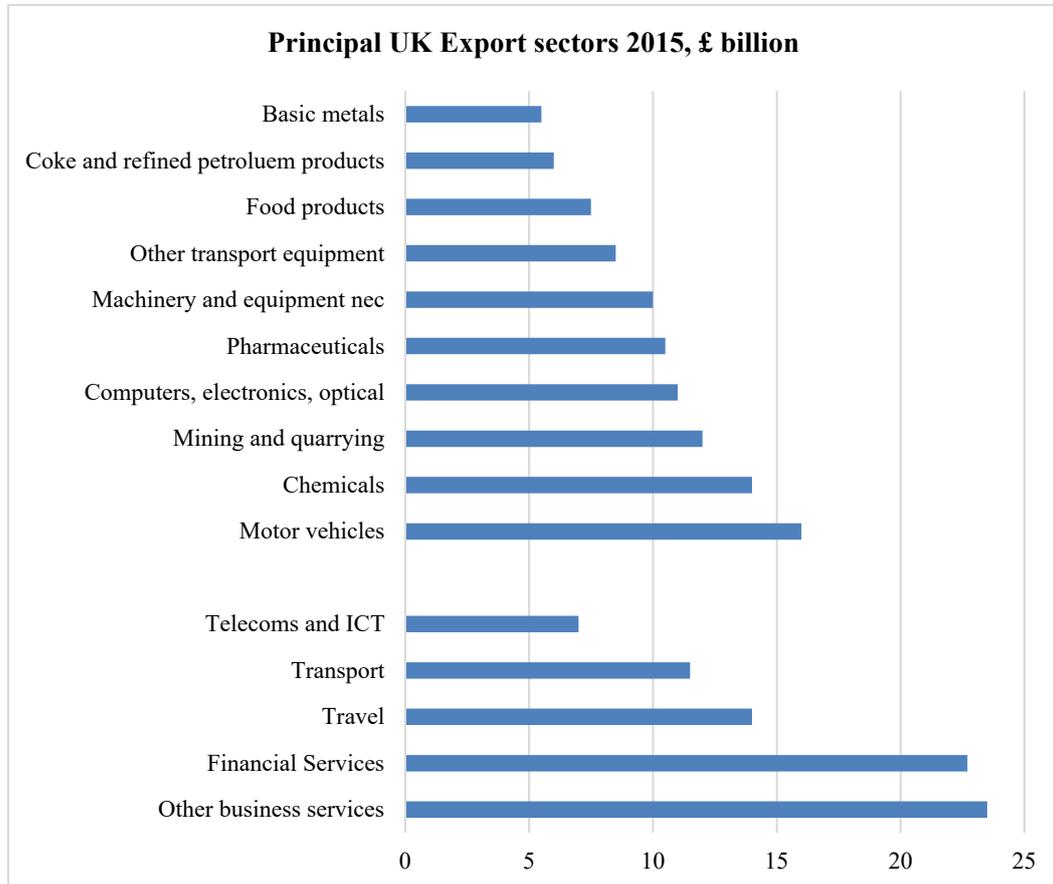
The potential benefits of Brexit could be: better regulation in UK (the common perception is that Bruxelles over-regulates and creates little space of maneuver in different sectors), opportunities for better trade deals with other partners (Southeast Asia, US, Canada) and avoidance of EU budget contributions until 2020 (hard to achieve if UK wants to benefit from the Single Market or passporting rights to operate in EU). In order to achieve a successful Brexit for both sides, the negotiation process has to start very quickly, without national remorse from several members and the perception that UK has to be punished for the national vote. From EU perspective, only three states have a share of exports going to UK larger than 8% (Ireland 14%, Netherlands 9.5% and Belgium 9.2%) and none of them are a dominating force in Bruxelles decision.

Trilemma of what UK wants



Source: Begg (2017).

Analyzing the principal UK export sectors, calculations reveal that financial services and other business services have over 45 billion sterling exposure to EU market. This figure reaches 2.4% of GDP in 2015 and a tougher regulation in these sectors could potentially provide large negative effects for British economy. The eventuality of “hard Brexit” could rapidly affect travel, financial services, other business services or motor vehicles sectors. The total exposure of these sectors represent over 4% of UK GDP. Taking into account some restrictive policies for immigration in order to please Brexit voters, the impact on the British pension funds sustainability is not negligible. In the EU labor markets, UK has been a net beneficiary of highly-skilled workers that brought comparative advantages in the services and financial sectors.



Conclusion

Brexit may signify a political absurdity transformed in an economic problem. The clear vote against globalization and UK inability to cope with global competition and technology revolution creates several problems for British authorities. UK will have to decide in the near future if it wants to further benefit from the Single Market or trade under WTO rules. Both perspectives may provide benefits, but surely imply costs that are hard to measure precisely at this moment. In order to achieve a “soft Brexit”, politicians have to study the examples of Switzerland, Norway, Iceland or Liechtenstein. Apparently, Switzerland has the best position in this group, but Britain will have to face tough questions about what it means to preserve sovereignty when EU is making rules over which it will have no say. The desire to escape the authority of the European Court of Justice or to curb the immigration policies in its favor will be hard to achieve if it wants to preserve access to the Single Market and passporting rights to operate in EU. Companies doing business in the Single Market must abide EU competition rules, as recent examples of Microsoft and Google proved.

UK export sectors are much largely exposed to EU than vice-versa. Until now, the City of London was by far the most important financial center in Europe, a fact that could be changed in the eventuality of a “hard Brexit”. Studies reveal that the negative economic impact could be large, and the GDP figures from the first quarter in 2017 seem to provide evidence in supporting this thesis. The stock of foreign direct investments from EU which stand at around 500 billion Euros could suffer a depreciation, especially in the sectors that are easy to displace. It is evident that the perfect equilibrium of UK trilemma will be hard to achieve.

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