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Impact of Brexit on the Global Economy

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Abstract

Objective: To analyze the impact of the United Kingdom's decision of leaving the European Union on the financial markets, and on the global economy as a whole.
Methods: In this paper, the impact is inspected in a comprehensive manner, by dividing the aftermath into four categories-United Kingdom, European Union, Non-EU European nations, and the world. Parameters such as inflation, real per capita GDP growth, stock and foreign exchange market, current and capital account balance, and strength of the currency have been discussed in this paper, to pinpoint the variable that has been affected the most.
Findings: We see that Sterling has become volatile and has weakened investor confidence, reduced real per capita GDP, immigration has slowed down, and trade deficit has increased. In all, the rate of growth of the economy has decelerated. The prevailing macroeconomic uncertainty has shown ambiguous results for a few variables as of now, but the real picture will become clear-cut and perspicuous once UK actually leaves the EU.
Conclusion: The effects of Brexit will prove to be far reaching, enough to unsettle UK's markets and the economy for the next few decades. UK will need to adopt certain measures to get out of this economic slump, because as of now, the cons definitely overweigh the pros.
Keywords: Brexit, United Kingdom, European Union, Pound, Euro.

1. Introduction

Europe has been divided into fifty sovereign states and earlier, each nation used to constitute its own laws and framework keeping their own interests in mind. This was a complicated, tedious and a time consuming process. Assuming rational behavior, it was likely for these independent laws to clash with one another. European nations used to engage in frequent and bloody wars, which culminated in the Second World War. The excessive economic and human catastrophe was instrumental in making the nations realize that enforcement of democracy was the need of the hour and the best way to overcome this Gordian knot was to enter into a political and economic union. This finally became effective on 1st November, 1993, and led to the creation of a single European currency, the Euro, a common market in Europe with lower tariff rates than those outside this market, and greater pan-European integration. From Figure 1 (Conference Board Total Economy Database), we see that the GDP per capita in EU was about 47 to 49% in 1950s, and swiftly gained momentum in the 60s, the decade that marked the formation of the European Communities [1]. This is also acknowledged as the first pillar which constituted the EU. Many other European nations joined the Communities in the 70s and the 80s. In the 90s, the East Germany also became a part, thus leading to the establishment of the European Union. From 1993 to 2015, EU has witnessed economic development and prosperity, with per capita GDP level winging its way to around 70%. Consequently, EU got the recognition of a hub of immense civil and business opportunities, chiefly because the migration process became plain sailing.

As a result, there was a steep rise in the number of immigrants in Europe, as shown in Figure 2, (Paul Reynolds, 2002), and that created new problems for the member states. A transfer of resources from the hands of European citizens to the immigrants was set in motion. There was a huge surge in unemployment throughout the nation, and this sparked the very beginning of the discussion about UK leaving the European Union. This public emotion continued until 2015, when the United Kingdom Independence Party (UKIP) raised this issue during the elections (see Euroscepticism in UKIP). Essentially there were two schools of thought. UKIP firmly believed that the problems of UK would abbreviate if they exit the EU. On the other hand, a huge chunk of the population still thought of it as a bad move.

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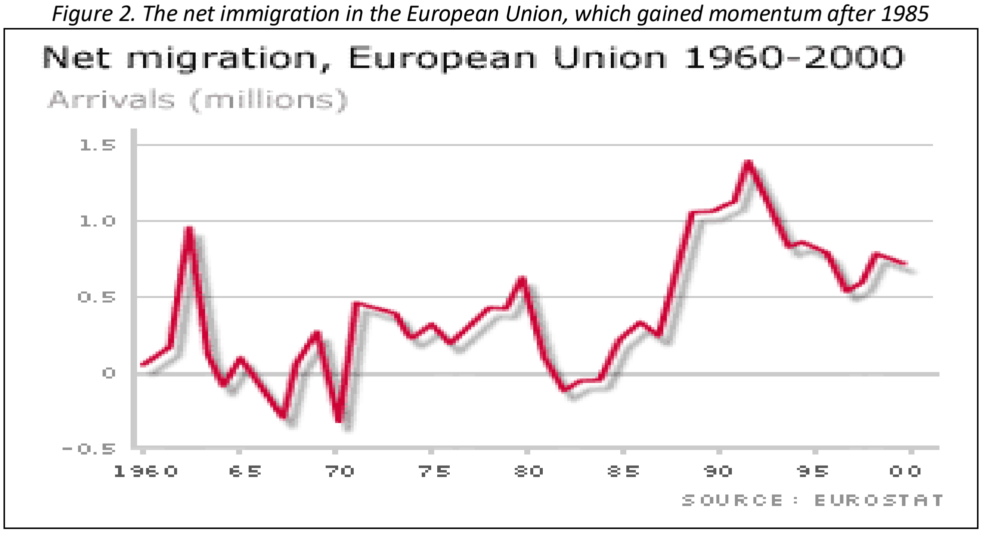
Figure 1. GDP per capita in European Union, from 1950 to 2012. The increasing trend here demonstrates the fact that EU has enjoyed a high per capita GDP for the past 60 years

Eventually, the United Kingdom held a referendum on 23rd June, 2016. The vote was in favor of leaving the EU by a margin of 51.9% in favor to 48.1% against [2]. Immigration was a key concern that influenced votes in favor of leaving the EU. The UK is thus due to leave the EU on 29 March 2019.

Figure 2. The net immigration in the European Union, which gained momentum after 1985



2. Negotiations

Prime Minister Theresa May laid stress on ending the jurisdiction of the EU law. In January 2017, she confirmed that the UK government would not seek permanent single market membership [3]. On September 22, 2017, May announced the offer of 20 billion Euros over a two year transition period, and a continued acceptance of immigrants from Europe on 9th October 2017, she notified the parliament that it is possible for Britain to operate as an 'independent trading nation' if no trade deal is reached with the EU. According to the EU divorce bill, EU is demanding a sum of around 50 billion pounds from UK as it leaves the EU [4].

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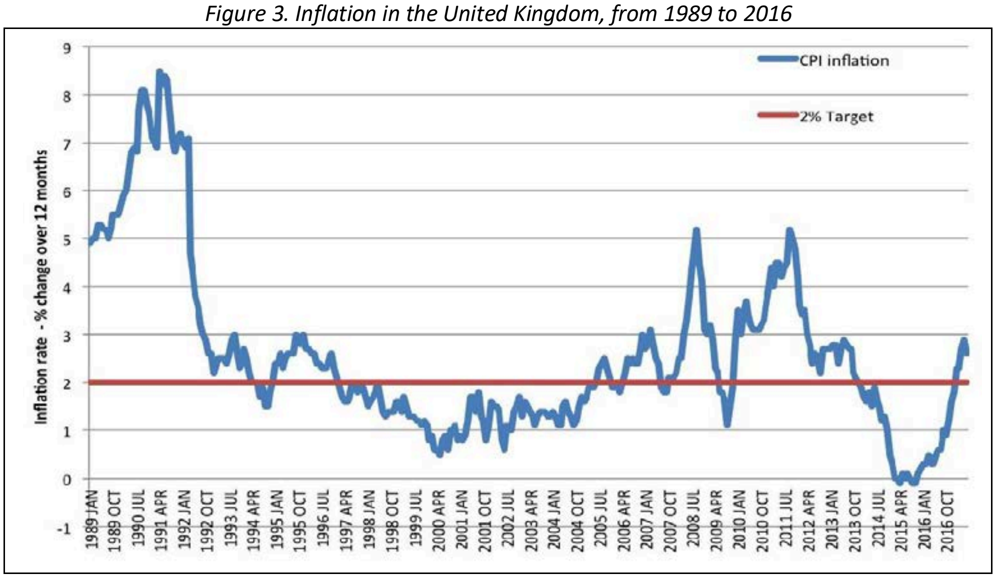
3. Impact on Financial Markets

3.1. Impact on the United Kingdom

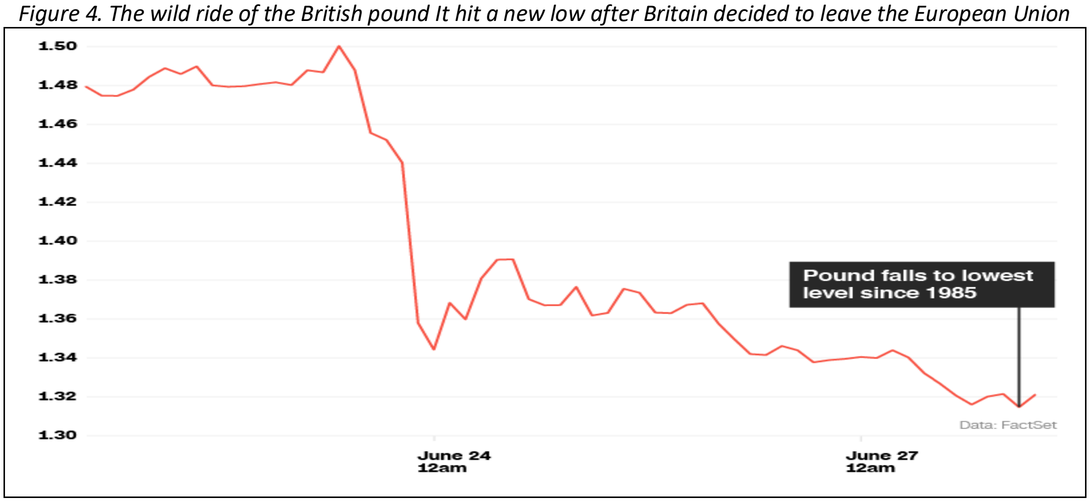
Since the referendum, UK has witnessed a loss of 1.3% of GDP, and the labor productivity has fallen even further behind rivals. Moreover, Figure 3 (ONS-D7G7-July 2017) shows that inflation has risen by 1.7%, in contrast with almost no inflation in 2015 and the first half of 2016, thus increasing the price of imports. Construction has decelerated largely because of a weaker pound. UK has lost its AAA credit rating, which will augment the government spending in the future.

Figure 3. Inflation in the United Kingdom, from 1989 to 2016



Brexit has thrown global stock and currency markets into disarray. Figure 4 (CNN Money) shows that the Sterling plunged to a 30 year low. The volatility of the foreign exchange market will lead the traders to invest in other markets, thus triggering gigantic amount of capital outflows-a capital account deficit. This will continue for quite some time because the new deals won't be able to make up the difference so easily. This outflow will perhaps make deficit funding harder in UK. Companies with large earnings from UK will be seen struggling because of the slowdown in domestic growth [5].

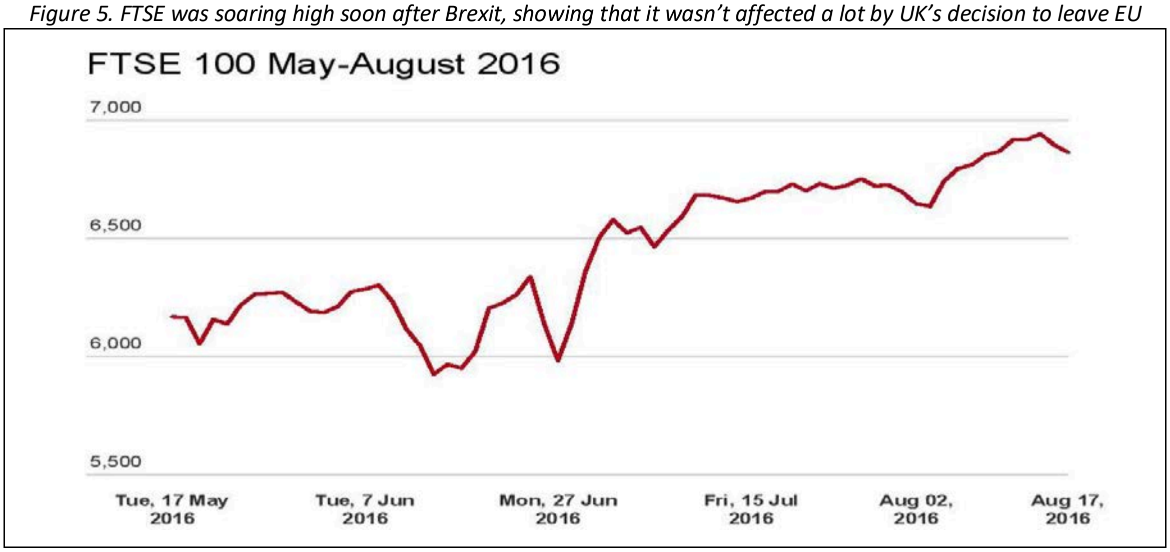
Figure 4. The wild ride of the British pound It hit a new low after Britain decided to leave the European Union



FTSE 100 saw a fall of about 3% by the close of trading on 24th June 2016, thus indicating a stock market crash (Enrico Onali, 2016). On a global level, more than two trillion dollars of wealth was wiped out in equity markets. However, Figure 5 shows that after the initial slump for the first few days, FTSE 100 picked up quickly, contrary to what was expected. This mainly happened because the member companies of FTSE 100 generate about 75 to 77% of their revenues outside the UK and do relatively little business in Britain. This means that they are making more now when the Sterling is weaker [6]. Therefore this growth can be seen simply as a currency effect and nothing else. FTSE 100 might appear to have successfully brushed aside Brexit, but is still underperforming if compared to dollar or euro. The weakness of the pound might keep on helping FTSE in the future, but the continuing volatility that prevails in the market can cause the share movements to proceed in either direction. In short, post Brexit, the stock market of United Kingdom will become harder to navigate [7].

The sectors that have flourished since the creation of a single common market in EU are mainly investment banking, insurance and foreign currency trading (Jenkins and Agnew, 2016). These sectors will encounter a serious blow once the benefits of a single common market cease to exist for the UK. The complex supply chains of MNCs will become back-breaking to manage now that UK has decided to be no longer a part of EU. Brexit will reduce UK's real per capita income in both medium and long run due to macroeconomic uncertainty. UK will experience a steep fall in business as well as consumer confidence. This fall in confidence and authenticity will dent mortgage demand and this will be unpropitious for the housing market. It is plausible that Brexit will make UK poorer by creating new barriers to FDI, trade and immigration. Reducing the number of immigrants would hurt Britain's businesses, public services and higher research. Health sector will also be adversely affected because UK suffers from understaffing and has been recruiting doctors and nurses from the rest of the Europe for a long time.

Figure 5. FTSE was soaring high soon after Brexit, showing that it wasn't affected a lot by UK's decision to leave EU



The banking system of UK will have to impose self restraints, leading to a stagnant rate of growth in the banking sector. One of the important consequences will be that the number of depositors might exceed the number of loan seekers. This can be said considering the fact that due to the economic volatility following Brexit, Britons will prefer not to invest their funds in UK, hence raising the amount of deposit in banks, and decreasing the demand for loans for investment projects at the same time. The economic slump will cause the banks to function as non performing institutions. Banks would not be able to lay off workers immediately due to their labor laws, [8] thus increasing the amount of disguised unemployment in the economy [9].

The capital account deficit will not be offset by a current account surplus, because UK will be forced to limit production due to lesser availability of capital mainly in the manufacturing sector, (manufacturing sector suffers a huge blow owing to a sharp fall in car production), thus causing the quantity of imports to exceed exports. Therefore the balance of payment equilibrium will not be attained. International banks that have set up offices in UK have been making use of both Pound and Euro to carry out trade for many years. If Sterling continues to fall, the purchasing power in UK will keep on declining; hence the value of the funds these banks own will go down. Now, if the British Prime Minister, Theresa May concludes the ongoing Brexit negotiations on the terms that UK won't be accepting Euro for transactions in UK, then the Euro deposits in these banks will be nothing more than a liability. The banks will be required to convert their funds entirely in terms of pound. Due to the volatility in the value of Pound, these banks might possibly undergo huge losses in this process of conversion. Because of this, they could lose few of their existing EU clients, and won't be able to land any new EU client either.

One possible solution would be that these banks shift or expand their setup in the European Union. But they would lose their UK clients in the process, so this involves a tradeoff. Other than that, they could wait for the negotiations to conclude before coming to a decision, thus bearing whatever losses that come their way in this period. Either way, they suffer. In the short run, a BOP deficit could fuel UK's economic growth by boosting exports, but in the long run the nation would become a net consumer and not a producer of world's economic output. The foreign lenders would start having doubts as to whether or not will they be able to get an adequate return on their investment, which would lead them to withdraw their funds from UK. This would cause the Pound to further lose its value relative to other currencies [10].

The recent figures suggest that a weaker pound has been unable to increase UK exports, and that the trade deficit has widened since the day of the referendum, with British exports to non-EU nations falling by 7.9%, and those to EU nations increasing only by 2.7% (Angela Monaghan, 2017). Financial markets will lose cohesion and disintegrate in a lot of small segments, causing a loss in efficiency, and making them more sensitive to the vulnerabilities of EU. The uncertainty over future trade arrangements between EU and UK, and the falling rate of growth of business in their home market will weaken the demand in supply chains suggesting that businesses are being cautious in their investments and are exploring other markets, to ensure that they continue earning a certain profit percentage on their investments. This will put a damper on UK's FDI [11].

The money will get drifted towards the world's share market and this will increase the share demand and consequently the share prices. This exorbitant rise would make the share price beyond the reach of small investors. To take advantage of this situation, new fraudulent IPOs might get floated by share market players to obtain the funds of these investors, thus causing them to lose their money. This bad faith will prevent these small investors to plough the money back into the market. On top of everything, UK will be left with lesser bargaining power and will have no access to the new deals EU signs with other nations, for example the ones that are presently being negotiated with Japan and US.

Brexit might lead to utter madness and havoc in the Northern Ireland, who voted for Britain to stay in the European Union. Ireland has remained undisturbed and composed for the past many years due to the fact that both UK and Ireland have been the members of EU. According to a 2017 report from International Monetary Fund (IMF), the overall medium term impact of Brexit on Ireland would be "Negative and Significant", especially on employment in rural parts of the country [12]. Table 1 (Macroeconomics and Brexit in the boardroom) summarizes the short and the long run effects of Brexit on UK's exchange rate, inflation rate, trade, GDP and other factors.

Table 1. Summary of potential Brexit impacts on the UK Economy

Short to Medium Run	
Parameters	Impact
Exchange Rate	10 to 25% depreciation in the value of pound
Inflation	0.5 to 1.5% higher CPI inflation rate
BoE Interest Rates	Up to 1% higher policy rate in medium run
GDP	0.5 to 1.5% lower GDP growth in the first few years
	Long Run
Parameters	Impact
Trade	5 to 10% fall after UK exits the EU
Tariffs	Up to 4.4% average tariff rate after the exit
Labor force	1 to 2.5% smaller workforce by 2021
Wages	0.2 to 0.6% higher wages for low skill jobs in some industries
Public Finances	1 to 2% of GDP increase in government deficit per year
Regulations	Lower costs of regulations representing up to 0.7% of GDP
GDP	Between 4 to 6% lower GDP level by 2031

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3.2. Impact on the European Union

Brexit will surely disrupt the internal equilibrium of EU. With Britain out, the rest of seven non euro nations will account for about a mere 15% of EU's economic output, in contrast with more than 30% with UK in. Belgium and Netherlands, the countries closest to UK can lose high volumes of trade because of Brexit [13] Germany, being the second most attractive nation for non EU investors has an edge over the situation, owing to its large market, excellent infrastructure, diverse economy, productive labor economy, notable tax benefits, and a politically stable framework. Germany has determined EU's response on issues like Eurozone crisis, refugees, and the Ukraine war. Brexit would further establish Germany's hegemony over EU and foster discord within the supranational organization. In the European Council, a 41% vote can block any legislation. Judging from this, UK, France and Germany can together form a blocking majority. After Brexit, it will only take 33% vote, meaning that France and Germany can form a blocking majority. Ultimately, EU would be left with no counterpoise to the Franco-German dominion.

Following Brexit, the credibility of Euro might get affected too because UK played an important role in popularizing Euro in trade and investment. The United States dollar could gain out of this entire scenario by functioning as a mediator between the euro and the pound, if the negotiations state that only Pound will be accepted in UK. Therefore, one of the primary agendas of establishing Euro throughout EU (to end dollar supremacy) will be relinquished. Brexit will fan the flames of Euroscepticism across Europe. Investors who earlier invested largely in Europe will now consider other options hence causing a diversion of foreign assets and wealth to other rival nations. Thus, Europe's rate of growth will experience a decline.

Brexit will undermine the economic as well as political order for which EU is known around the world, thus damaging EU's cohesion and ruining their international reputation. Anti immigration parties will gain strength throughout Europe. By bagging the favor of France and Germany, even these parties would become able to bring in an anti-EU vote [14]. The new EU will definitely be poorer, weaker, less liberal, less secure, more protectionist and more inward looking on top of that, EU's links to the United States will become more fragile and shaky. Table 2 depicts the Brexit sensitivity Index for the nations in the European Union.

Table 2. Brexit Sensitivity Index- Brexit's impact on the remaining EU nations

	Exports to UK as a % of GDP	Export Factor	Financial Sector Claims on an ultimate risk basis including derivatives and guarantees (BIS data, % of GDP)	Financial Factor	Inward FDI/GDP (%)	FDI Factor	Bidirectional migration as a % of population	Migration Factor	BSI index (sum of all factors)
Ireland	10.6	1.0	40.3	0.5	5.8	0.9	17.2	1.0	3.5
Malta	7.1	0.7	58.0	0.8	6.3	1.0	7.5	0.4	2.9
Luxembourg	5.3	0.5	73.3	1.0	6.0	0.9	0.0	0.0	2.4
Cyprus	7.5	0.7	8.1	0.1	6.3	1.0	8.5	0.5	2.3
Switzerland	1.3	0.1	65.1	0.9	6.0	0.9	0.4	0.0	2.0
Belgium	6.8	0.6	3.8	0.0	5.6	0.9	0.5	0.0	1.6
Netherlands	6.7	0.6	11.4	0.1	4.7	0.7	0.4	0.0	1.5
Spain	2.7	0.2	44.9	0.6	3.8	0.6	0.9	0.1	1.5
Norway	7.4	0.7	3.9	0.0	1.4	0.2	0.4	0.0	1.0
Sweden	2.7	0.2	21.9	0.3	1.9	0.3	0.2	0.0	0.9
France	2.0	0.2	10.6	0.1	3.1	0.5	0.5	0.0	0.8
Germany	2.8	0.2	22.7	0.3	1.5	0.2	0.5	0.0	0.8
Denmark	2.7	0.2	6.2	0.1	2.3	0.4	0.8	0.0	0.7
Lithuania	3.9	0.4	2.8	0.0	0.0	0.0	5.1	0.3	0.7
Latvia	2.5	0.2	3.9	0.0	0.0	0.0	4.9	0.3	0.5
Canada	0.8	0.0	10.5	0.1	1.4	0.2	0.0	0.0	0.4
Finland	1.8	0.2	8.5	0.1	0.7	0.1	0.3	0.0	0.4
Hungary	3.5	0.3	4.0	0.0	0.0	0.0	0.2	0.0	0.4
Italy	1.6	0.1	13.2	0.2	0.2	0.0	0.4	0.0	0.4
Austria	1.5	0.1	5.9	0.1	0.6	0.1	0.4	0.0	0.3
MEDIAN	2.8	0.2	10.6	0.1	0.0	0.3	0.5	0.0	0.8

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According to the given data, Ireland's exports to UK comprise 10.6% of their GDP, which is a considerable amount. Following Brexit, the price of imports for UK has risen, because the Pound has become weaker. That means UK won't be able to import the same amount as they used to before their decision to leave the EU. Lesser import demand will mean that Ireland will be exporting less to UK in the times to come, thereby incurring substantial losses in their export revenue, and consequently a decline in their GDP. Norway (member of European Economic Area) Belgium, Malta and Cyprus are some of the nations that will also suffer losses due to the high export index. The nations that will have the least effect on their exports are Canada, Switzerland (both are not members of EU), Austria and Italy.

The EU nations that get most of the inward foreign direct investments from UK are Malta, Cyprus, Ireland, Luxembourg, and Belgium.UK has experienced huge capital outflows and lesser investment demand since Brexit. Hence it has lesser funds to invest in the business interests of these nations. Consequently, these nations will have to look for other potential nations to attract more FDI. Unless and until they are able to do so, lesser FDI will directly translate into lesser growth and development.

From the table, the migration factor for Ireland is equal to 1. Therefore stricter migration laws in UK following Brexit will decrease the number of Ireland immigrants in UK substantially. This means that citizens of Ireland who used to migrate to UK in search of better opportunities and income will have a lot to lose, due to the reduced size of their labor market. This can increase unemployment in Ireland, which would also mean a decline in their GDP. For the rest of the nations, the situation remains more or less the same. Overall, the Brexit sensitivity Index is the highest for Ireland, followed by Malta, Luxembourg, and Cyprus. This means that these nations have the most to lose because of Brexit, and they would need support from other EU nations to pull themselves out of their apparent economic slump and to get back on track.

3.3. Impact on non-EU nations

The European countries that are not a part of EU and that have sizeable pound reserves will find themselves restricted chiefly to UK for trade and will need Euro reserves for transactions in the EU if the European Union repudiates the acknowledgment of pound for trading and investment. This will force these nations to put their considerable pound reserves in the Gray market, hence stimulating illegal trading practices such as smuggling. This can create turbulence in the law and order situation of Europe. Alternatively, nations having an abundance of euro reserves will have to resort to other feasible alternatives to carry out transactions with Britain.

Non-EU companies in UK will get affected by limitations on the free movement of labor and capital, as well as goods and services. Furthermore, if UK plans tax restructuring, the international corporate might relocate their UK holding companies to EU member states. If labor limitations are enforced after Brexit, it will require the non EU employees separate work visas for UK and EU. This will increase the administrative as well as processing costs.

Russia is believed to be one of Brexit's massive beneficiaries. Quite a few analysts have come to the conclusion that Europe's desire to punish Putin for his aggression in Ukraine will shrink greatly following Brexit. If this happens, EU will probably embrace Russia as an alternative partner to compensate for the economic blow due to Brexit. Contrary to this perception, Brexit can cast the economy of Russia into troubled waters. Russia is greatly threatened by the reduction in oil prices, because there is a high probability that the sale of shares in Rosneft, Russia's largest oil company get postponed or even abandoned. This will induce a reduction in trade, and will have a negative effect on Russia's markets.

Norway, Iceland, and Liechtenstein are members of the European Economic Area (EEA) but not of the European Union. They are allowed free entry to the European capital market, and accept the single European market regulations but they don't possess any voting rights. This way, Norway has already waved goodbye to much of its sovereignty just to gain access to the single market [15]. Norway has not much of a direct impact by Britain leaving the EU, because Norway's exports to UK are 8% only (Solrun F Faull, 2016). But Norway can be affected indirectly if this British exit creates far reaching effects; for example, UK being a giant economy might gain dominance following Brexit, thus reducing Norway's influence.

Following Brexit, if UK ended up becoming a member of the EEA to gain access to the single market, they would land in the same boat as Norway, losing their dominion once again. This would happen because for a non EU nation, gaining access to the single market would mean that they accept any new legislation that EU might adopt in the future, without having the power to say no to the legislation. This would be immensely ironic, because one of the primary reasons for UK leaving the EU was to gain more control over their legislation [16].

3.4. Impact on the world

After Britain, more countries might follow to leave the European Union. If this happens, a lot of trade deals would need to be restructured; especially those with US and China. Without UK, EU would find it harder to pull its global weight. Japan's financial market will pose the biggest threat to EU. At present, Japan has emerged as one of the strongest economies of the world, with considerable investment in the United States and many other nations. Japanese currency, yen is the third most traded currency in the foreign exchange market, after the US dollar and the Euro. Since 1973, Japanese government has maintained a policy of currency intervention, which means that yen has been under a dirty float regime, thus making Japanese exports cheaper in international markets (See Milestones in the yen's history) Because of this, Japan has been enjoying current account surplus for a long time. This way, Japan attracts a large number of investors to itself. Therefore, due to the volatility of European markets, traders can get pulled towards Japanese markets, and this will act as a stumbling block for Europe. As far as trade with UK is concerned, the Least Developed Countries (LDCs) [17] will be affected the most, mainly because of lower aid values and fallen exports; for example Bangladesh and Cambodia and all those countries whose exports to the UK are significant. Moreover, the negative impact of Brexit on EU's markets will also be a downside for the LDCs [18].

British Prime Minister Theresa May has given assurance that the developing countries will continue to benefit from duty free exports into the UK. She plans to help the developing countries grow their economies by reducing their poverty through trade Connor Murphy (2017) this means the developing nations need to liberalize their markets if they wish to increase their trade with UK. However, having an open economy will hurt the infant industries in these developing nations, thus hampering industrialisation efforts in smaller economies. Furthermore, Brexit can give rise to fierce competition between the developing countries, by reducing the import barriers. Hence, some developing economies face the risk of losing their foothold in the import markets of UK [19].

On the whole, the world financial market will grow in size in a more decentralized way, because investors earlier putting their money in Britain's markets will shift to other EU nations and possibly towards Latin America and a few Asian nations, like Singapore, Malaysia, Indonesia, Taiwan, Vietnam, India etc. The scrimmage between the euro and the sterling will increase the popularity of crypto currency. This virtual currency can create problems for the pre existing financial system. Owing to its commerciality, it will become difficult to monitor the transactions made using crypto currency, and even harder to keep a track of it.

4. Conclusion

Brexit is a pivotal decision, and has far reaching consequences, not only in the UK and EU, but also around many parts of the globe. UK has an incessant history of surviving the odds by itself, even after the Second World War. But it is still to be seen if it can survive this graciously or not. Although a lot of analysts believe that Ireland and Scotland will have a negative impact leaving the European Union, it is still possible that Brexit strengthen the ties between UK, Ireland and Scotland owing to the emergence of positive neo patriotism in the citizens of the United Kingdom.

At present, Asia has too growing economies, India and China, but India has an added advantage of being a democratic country with a greater openness and accessibility to their market, and having strong financial and economic fundamentals. Following Brexit, India comes to face with a huge opportunity to occupy a major position in the world financial market. Focus is being shifted towards non European markets as well, thus expanding the size of world market and fostering decentralization. This would enable the participation of many small sized economies all around the world.

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