“The Economics of Brexit”

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International Commerce and the World Economy

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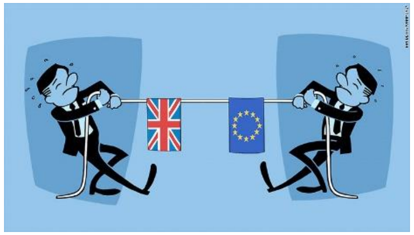
Background

- June 23, 2016, UK voted in favor of leaving EU
- After vote, political focus was on when to signal intention to leave via Article 50 of Lisbon Treaty
- March 29, 2017, UK formally notified EU of its intention to leave
- Article 50 allows for withdrawal negotiations to last for period of two years, i.e., up to March 29, 2019
- Initial issues: outstanding financial liabilities of UK, future status of EU citizens living in UK, and framework for future UK-EU relations

Background



- The "Leave" campaign provided no guidance as to what form Brexit should take
- Not surprisingly, there has been considerable economic uncertainty over future UK/EU trading relationship
- Essentially, there are three basic options:
  - UK remains part of EU's Single Market by joining European Economic Area (EEA)
  - UK and EU could sign free trade agreement (FTA)
  - UK and EU trade under MFN terms of WTO

Norway Option – "Soft-Brexit"

- Joining EEA is closest to remaining in EU Single Market
- UK would have to commit to four freedoms: free movement of goods, services, capital, and labor
- EEA members must adopt all EU legislation pertaining to the Single Market, i.e., employment law, consumer protection, product standards, and competition policy
- EEA members also contribute to EU budget
- Trade barriers between EU and EEA are higher than within EU - countries not in customs union, i.e., set their own external tariffs and negotiate FTAs separate from EU

FTA Option

- FTAs differ greatly in depth, scope, and effects on trade
- EU's recent FTAs do less than Single Market to harmonize economic regulation and do not guarantee market access for services such as finance
- UK could form customs union with EU, but it would not cover services trade, and UK could not negotiate FTAs outside of EU
- Outside Single Market, UK not bound by EU regulation and courts, and free to restrict immigration from EU
- To achieve any greater level of economic integration, would have to make concessions, as did Switzerland

WTO Option – "Hard-Brexit"

- WTO option favored by hardline "Brexit-eers"
- UK would completely extricate itself from EU, applying MFN tariffs to all trading partners
- UK could seek FTAs independently of EU, but would lose access to Single Market for goods and services
- No requirement to retain free movement
- UK's imports from and exports to EU subject to tariff and non-tariff barriers
- Costs of trade would rise due to customs checks, and border controls

Economic Background

- Most UK trade is with EU: 47% of UK exports go to EU, and EU is source for over 50% of UK imports
- Varies by sector:

Table 1: UK Trade with the EU as a Percentage of Total Trade (2015)

Industry	% of UK Total Exports to EU	% of UK Total Imports from EU
Food and Live Animals	69	65
Beverages	37	70
Mineral Fuels	62	5
Animal & Vegetable Oils	77	63
Chemical and Related Products	44	64
Manufactured Goods	47	51
Machinery and Transport	39	56
Misc Manufactured Goods	42	36

Source: UN COMTRADE. Data is at the SITC 1 Digit Level.

Economic Background

- Prior to June 24, 2017 referendum, several studies forecast effects of BREXIT – e.g., UK Treasury, OECD, and LSE
- UK Treasury and OECD studies got significant public attention prior to vote – both summarily dismissed as "fearmongering" by "Leave" campaign
- Use similar methodologies to analyze potential UK/EU trading arrangements after BREXIT
- Both focus on potential short-term and long-term economic impacts of BREXIT
- Similar results being generated by more recent studies

UK Treasury Study (May 2016)

HM Treasury

- Study focused on near-term impact of UK leaving EU over two-year period after vote
- Evaluated combined effects of *transition* to new trading arrangement, *uncertainty* and feedback from changing *financial conditions*
- Uncertainty driven by 4 processes:

  (i) terms of UK withdrawal under Article 50

  (ii) new trading arrangement with EU

  (iii) new trading arrangements with rest of world

  (iv) changing UK regulatory/legislative framework

UK Treasury Study (May 2016)

HM Treasury

- Two scenarios: "shock" assuming UK negotiates bilateral agreement with EU, and "severe shock", assuming default to WTO membership
- UK monetary policy: central bank rate held constant
- UK fiscal policy: support for economy through "automatic stabilizers" – with implications for borrowing and public debt
- Global economic conditions: "severe shock" assumes financial contagion with EU – reducing EU GDP by 1%
- Ignores additional downside risks of financial crisis and/or "sudden stop" due to current account deficit

UK Treasury Study (May 2016)

HM Treasury

- Conditioned on alternative assumptions about long-term effects of BREXIT in 15-year period after referendum – evaluated by UK Treasury (April, 2016)
- Gravity and CGE models used to forecast UK will be poorer due to permanent reduction in trade, FDI, and productivity (Tables 2, 3)
- Central estimates of long-term reduction in GDP used for “shock” and “severe shock” scenarios
- Use CGE model to estimate transition, uncertainty and financial conditions impact on demand, supply and asset prices (Table 4)

Long-Run Impact of Brexit:

Table 2: BREXIT effect on UK trade/FDI/productivity after 15 years			
	EEA	Bilateral	WTO
Trade (%)	-9	-19	-24
FDI (%)	-10	-20	-26
Productivity (%)	-2.8	-6.0	-7.7

Source: UK Treasury (April, 2016)

Long –Run Impact of Brexit:

Table 3: Annual economic impact of Brexit on UK after 15 years*			
	EEA	Bilateral	WTO
GDP level (%) - central	-3.8	-6.2	-7.5
GDP level (%) - range	-3.4 to -4.3	-4.6 to -7.8	-5.4 to -9.5
Cost/capita (£)- central	-2,600	-4,300	-5,200

Source: UK Treasury (April, 2016) – UK average income £ 28,000

- Comparable estimates to 2030

	OECD	Dhingra et al.
GDP level (%)	-5.1	
GDP level (%)	-2.7 to -7.7	-6.3 to -9.5
Cost/capita (£)	-1,520 to -5,000	-4,200 to -6,400

Source: OECD (April, 2016), Dhingra et al. (2018)

Short-Run Impact of Brexit:

Table 4: Immediate impact of Brexit on UK after 2 years*

	"Shock"	Severe shock"
GDP	-3.6%	-6.0%
Inflation rate (% points)	+2.3	+2.7
Unemployment rate (% points)	+1.6	+2.4
Sterling exchange rate index	-12%	-15%

Source: UK Treasury (May, 2016)

<u>* OECD comparable estimate to 2020</u>

GDP -3.3%

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Source: OECD (April, 2016)

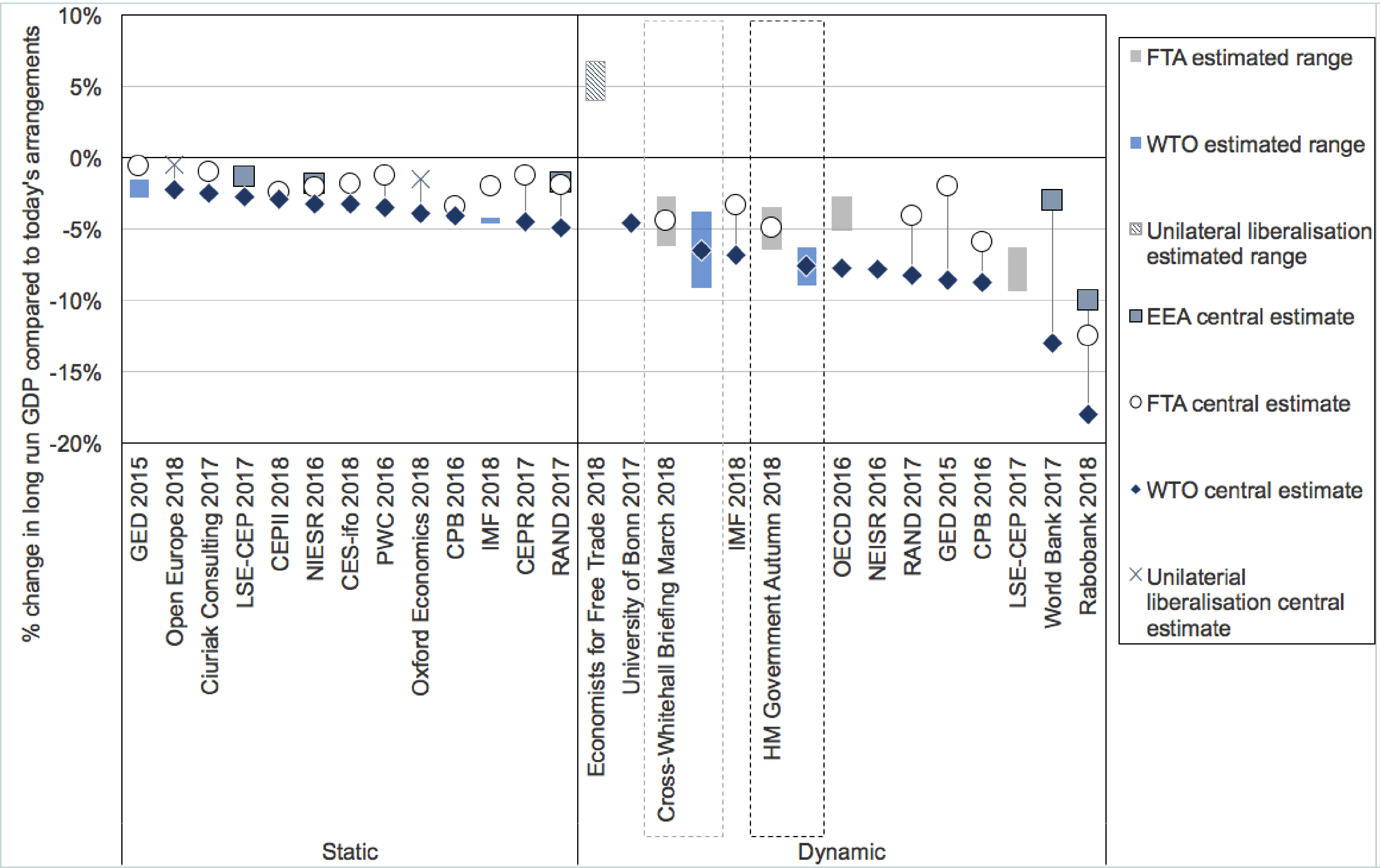
Trade Impact of Brexit:

Table 5: Long-Run Change in UK Trade Flows after Brexit (%)

	Total Exports	Exports to EU	Total Imports	Imports from EU
‘Soft’ Brexit	-9	-25	-8	-22
‘Hard’ Brexit	-16	-43	-16	-38

Source: Dhingra et al. (2018)

Other Studies of Brexit…….



Source: UK Treasury (2018)

Why Did People Vote for Brexit?

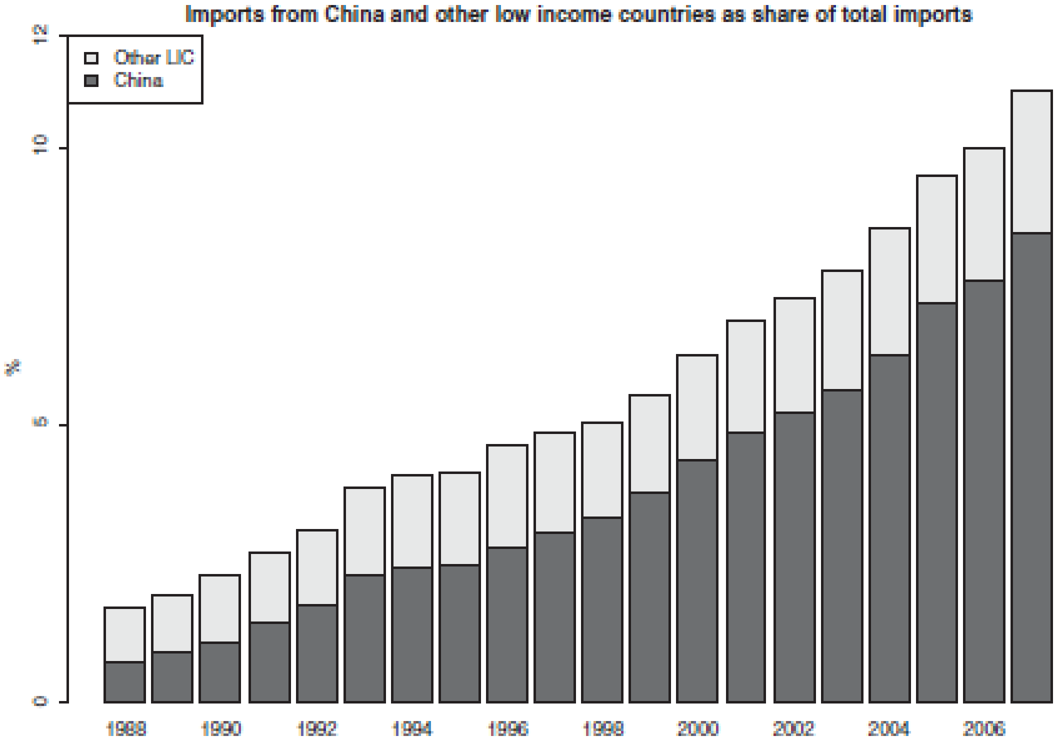
- If the consensus is that Brexit will hurt UK economically – why did people vote for it?
- Most discussion has focused on wage effects of EU immigration –but little evidence that it has affected either average employment or wages
- Two plausible hypotheses (Sampson, 2017):
  - EU membership erodes British sovereignty
  - Scapegoating of EU by those who feel left behind
- If the first, Brexit will be judged a success, but if the second, Brexit does nothing to mitigate voter discontent

Why Did People Vote for Brexit?

- Recent study carefully examines underlying causes of vote (Colantone and Stanig, 2018)
- Main result of study found that “Leave” share of referendum vote was systematically higher in regions more exposed to Chinese import shock
- No clear evidence that higher immigration was associated with support for “Leave”, except for arrival of immigrants from recent accession countries (Poland and Romania)
- Attitudes towards immigration reflected economic distress due to import competition

UK and Chinese Import Shock

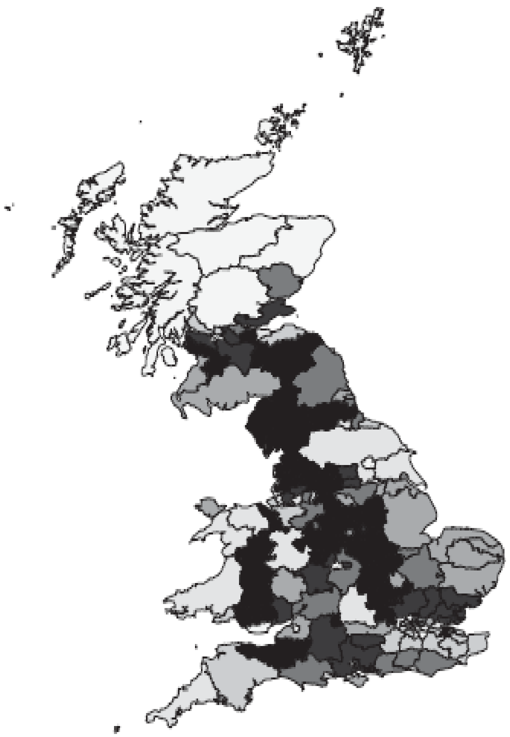
FIGURE 1. Evolution of the Relative Importance of Imports from China and other Low Income Countries in the United Kingdom.



Source: Colantone and Stanig (2018)

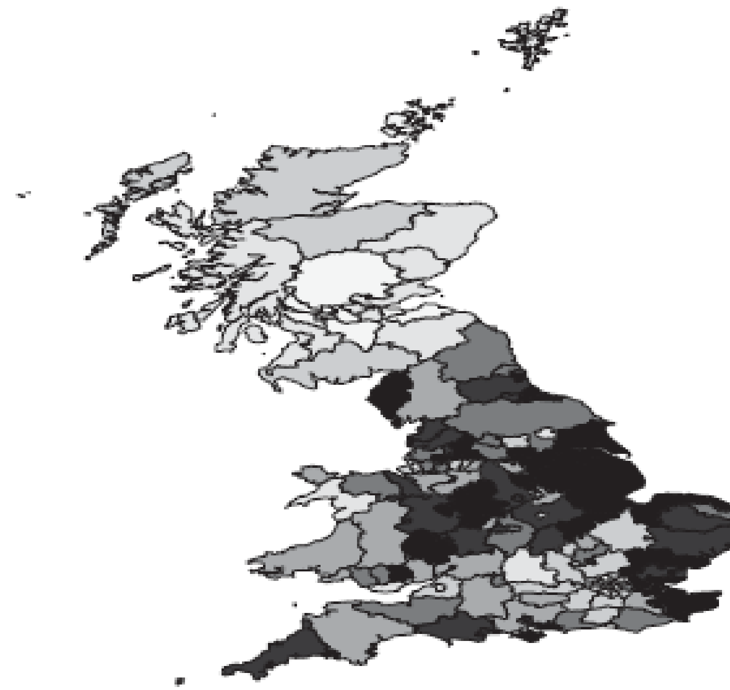
Brexit Voting Patterns

FIGURE 2. Strength of the Import Shock Across NUTS-3 Regions



Note: Darker shades correspond to stronger import shock.

FIGURE 3. Vote Share of the Leave Option Across NUTS-3 Regions.



Note: Darker shades correspond to stronger support for the Leave option.

Source: Colantone and Stanig (2018)

Current Status of Brexit

- UK government has negotiated withdrawal agreement with EU, covering transition to end of 2020
- Covers: (i) assets and liabilities; (ii) UK/EU citizens' rights; (iii) border/customs arrangements; and (iv) law/dispute resolution
- During transition, UK remains member of EEA, single market and customs union, EU law applies, and UK continues to pay into EU budget
- Irish border – "backstop" comes into force if no new trade agreement, i.e., UK remains in customs union
- Agreement rejected three times by House of Commons