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THE UNCERTAINTY AND IMPLICATIONS OF BREXIT TO THE UK AND EU

Introduction

The Centre for Economic Performance (2016) states that since the United Kingdom referendum to withdraw from the European Union, predominantly referred to as 'Brexit', standard measures point toward a substantial rise in uncertainty. Bloom (2009) describes uncertainty as the incapability of economic agents, for instance, investors, politicians, or consumers to develop clear expectations about forthcoming economic developments. Accordingly, in the context of the United Kingdom's vote to leave the EU, there is considerable uncertainty concerning the future arrangement of trade relationships after Brexit has been effected. Schwab (2016) states that the financial consequences of the UK's 'leave' vote are being experienced already. Additionally, there are high likelihoods of these effects increasing once Article 50 of the Lisbon Treaty is implemented. The Lisbon Treaty instigates the withdrawal process of a member state from the EU (Schwab, 2016). Also, the Bank of England (2016) notes that because of Brexit, there is a material slump in the prices of certain euro-area risky assets. For example, bank equities will likely suffer where the fall in prices is aggravated by concerns regarding the profitability of some banks in the euro region. Besides, slower growth in the UK, as stated by the Bank of England (2016), could also impact export growth in the euro region to some extent. Accordingly, this paper analyses the uncertainty, as well as implications of Brexit to the United Kingdom and the European Union.

The Uncertainty and Implications of Brexit to the UK and EU

The European Commission (2016) notes that the results of the referendum to leave the EU, which took place on the twenty-third of June 2016, have altered the settings for the way ahead. For instance, the vote to withdraw from the EU has caused a considerable increase in uncertainty, sudden exchange rate fluctuations and financial market instability. Furthermore, Breinlich et al. (2016) assert that the developments instigated by Brexit, including the rising uncertainty brought about by what is likely to be a prolonged period of withdrawal from the EU negotiations have the capacity to damage the recovery in the European Union. However, the European Commission (2016) suggests that while uncertainty is anticipated to dissipate eventually, future changes in the political and economic relationships between the United Kingdom and EU Member States might have an enduring effect on the medium to long-term economic outlook. However, present economic conditions according to Fichtner et al. (2016) and the European Commission (2016), is chiefly influenced by the uncertainty of the impact due to the result of the United Kingdom's vote of withdrawal from the EU. Hence, without clear information regarding the circumstances after the implementation of Brexit, for instance, policy responses, the mobility of products, labour and services, as well as trade patterns, it is hard to outline the 'new equilibrium'; and as such, it is difficult to specify an optimum adjustment path. Therefore, according to the European Commission (2016), this indicates that the uncertainty shock might possibly develop quite differently in terms of duration and dimension.

Also, as noted by the Bank of England (2016), the sterling ERI (Exchange Rate Index) has slumped by nine per cent since the 'leave' vote on the twenty-third of June 2016 as shown in Figure 1; and by fifteen per cent since its peak in November 2015. This shows a sharp decline against both the US dollar and the Euro. As such, the Bank of England (2016) states that this could point to concerns that, depending on the results of any upcoming negotiations, withdrawing from the EU has the possibilities of reducing the competitiveness of the UK. Nevertheless, there remains considerable uncertainty regarding how the UK will approach forthcoming trading engagements, as well as the implications for competitiveness. As viewed through Walduck (2016) and the Bank of England (2016), this also has the probability of increasing the risk premium needed by investors to hold sterling-denominated assets.

Figure 1: The Sharp Fall of the Sterling Exchange Rate after the Referendum

Source: Adapted from Bank of England (2016)

Following Brexit, the exchange rate has sharply dropped, and as such, the outlook for growth in the short-to-medium term has deteriorated significantly. Accordingly, the plunge in the UK's sterling pound has high chances of pushing up CPI (Consumer Price Index) inflation in the short-term (Bank of England, 2016; Acs, Szerb & Autio, 2016). The World Economic Forum (2016) explains that in the actual economy, even though the unconvincing medium-term outlook for activity is a sign of a downward review of the supply capacity of the economy, imminent weakness in demand has the probability of opening up a margin of spare capacity, together with a subsequent upsurge in unemployment. In line with this, the Bank of England (2016) asserts that latest surveys of trade activity is optimistic, with analysts being confident that the UK economy will at least realise minimal growth in GDP (Gross Domestic Product) in the second half of 2016.

Nevertheless, the European Commission (2016) states that in the case of moderate uncertainty concerning Brexit, the vote has an inhibiting impact on the short-term growth of the economy. On the other side, a bleak uncertainty shock would intensify the risk premium and hence financing costs; and as such, encourage households to consider precautionary savings (Centre for Economic Performance, 2016; European Commission, 2016). Also, because of Brexit, other EU Member States are currently directly affected because of the depreciating sterling pound, and through reduced demand for products and services in the United Kingdom; this has reduced their exports. In addition, Dhingra et al. (2016) and European Commission (2016) suggest that the certainty is also likely to affect consumption, as well as investment in the rest of the European Union, although to a smaller level than in the UK.

Therefore, despite the fact that the effects of Brexit on non-European Union economies are hard to deduce at the moment, the main impact is likely on the overall growth in uncertainty, from both an economic and political perspective. This is increasing risk aversion, as well as a culture of 'flight to safety'. As such, this could amplify upward pressures on currencies considered to be 'safe haven' (for instance CHF, USD, JPY), as well as weighing on business confidence and exports in several developed economies, such as Switzerland, Japan and the USA (Morgan, 2016; European Commission, 2016; Begg & Mushövel, 2016; Busch & Matthes, 2016). Therefore, Brexit is likely to affect not only the United Kingdom but also the rest of the European Union economy through a variety of transmission channels, primarily trade, uncertainty, migration, and investment. The heightened uncertainty in the United Kingdom, as well as other EU Member States, is likely to slow down investment decisions either by causing their cancellation or by delaying them, while waiting for uncertainty to diminish (European Commission, 2016). Also, the Bank of England (2016) states that it has been proven that the increased uncertainty surrounding Brexit is causing delays to key economic decisions, including; residential, as well as commercial real estate businesses, and also trade investment. Therefore, these are turning out to be costly, and will be difficult to reverse. For that reason, situation examination and determination of uncertainty shocks of diverse severities reveal a decline in investment growth in 2016, which could worsen in 2017. According to the European Commission (2016), these implications could be made worse should the uncertainty shock also harshly affect the financial system and result in tougher credit supply conditions. In addition, based on the duration and magnitude of the uncertainty shock, the effect on investment might bring about recession in the United Kingdom (Busch & Matthes, 2016; European Commission, 2016; Dhingra et al., 2016).

However, the Bank of England (2016) states that the MPC (Monetary Policy Committee) has deliberated on a variety of monetary policy devices, and what support each one should provide to the United Kingdom economy; especially to businesses and households. The MPC is mandated with supporting the economic policy of the UK government, together with its objectives for employment, and overall economic growth. Accordingly, the Bank of England (2016) notes that in an environment of increased uncertainty, as well as low interest rates, making use of a variety of tools would grow the effectiveness, and also the efficiency of the monetary transmission mechanism, mitigating any uncertainty with the supply and price of credit. Moreover, it would reduce its cost, and improve supply. Furthermore, according to ECB (2011), heightened uncertainty is able to have a direct impact on consumption through encouraging families to raise their precautionary savings, and postpone purchases. This pattern has been noted during previous times of growing uncertainty. For example, during the sovereign debt crunch, consumers became unwilling to increase spending or make major purchases (ECB, 2011). In addition, Balta, Valdés-Fernández & Ruscher (2013) claim that increased uncertainty is also able to impact consumption indirectly through its negative effect on employment creation, as well as economic growth, which would bring down the growth of disposable incomes more than any increase with inflation. As such, the growth of household consumption is thus expected to be lowered. Nonetheless, whilst the direction of these short-term impacts is known, the magnitude of the effect depends on the size, as well as the length of the uncertainty shock (Balta, Valdés-Fernández & Ruscher, 2013).

Even so, as stated by European Commission (2016), despite the uncertainty caused by Brexit, the past good record of employment growth, high levels of consumer confidence, as well as increasing wages, still moderate rates of inflation. Anderton et al. (2014) asserts that employment in the United Kingdom has also profited from structural reforms introduced after the recovery from the global financial crisis of 2008. Additionally, in some EU Member States, for instance, the UK, temporary fiscal measures appear to have supported a growth in employment. However, according to the Bank of England (2016), the increased uncertainty due to Brexit is expected to weigh on the United Kingdom's domestic demand growth. Accordingly, through trade links, this could lower activity growth elsewhere, especially within the rest of the European Union region, and also the USA. As such, the Bank of England (2016) explains that these developments could only to some extent be offset by the support to spending growth from drops in the United Kingdom, the European Union, as well as the USA regions.

Conclusion

To summarise, it has been noted that since the United Kingdom referendum to withdraw from the European Union, standard measures indicate a substantial increase in uncertainty. Moreover, it has been stated that Brexit has high probabilities of affecting not only the United Kingdom but also the rest of the EU economy through various transmission channels, including: uncertainty, trade, investment, and migration. In addition, it is evident that in the near term, the major effect of Brexit is heightened uncertainty, both politically and economically. These issues are likely to slow investment growth and private consumption, as well as affect foreign trade, primarily in the United Kingdom; even though other EU Member States also are likely to be adversely affected by Brexit. Also, Brexit has caused unexpected exchange rate fluctuations, as well as financial market instability. As such, the depreciation of the sterling pound is likely to push up CPI inflation in the short-term. Additionally, depending on the outcomes of any forthcoming negotiations, Brexit is likely to plummet the competitiveness of the United Kingdom. The depreciating sterling pound is directly affecting the EU Member States through lower demand for produce and services, which has reduced exports. Furthermore, based on the intensity and length of the uncertainty shock, the impact on investment may result in recession in the UK. The heightened uncertainty can also influence consumption indirectly through its negative impact on employment creation and economic growth, which might reduce the growth of disposable incomes, and encourage families to increase their precautionary savings, and suspend purchases. Finally, despite the uncertainty brought about by Brexit, the previous commendable record of employment growth, improved levels of consumer confidence, and rising wages, still moderate inflation rates in the United Kingdom.

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