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Brexit and Its Economic Implications*

Forecasts are notoriously difficult to make. I am nevertheless sure that Britain's exit from the EU, the so-called Brexit, would be a bad deal both for the Brits and for the rest of the European Union.

Let us take a look at the present situation: Britain's economy is traditionally oriented towards openness and international trade, and its relations with the EU are very important. Half of Britain's exports are to other EU countries – prior to Britain joining the EU this figure was just 40 percent. The financial sector is particularly important, as it currently accounts for around eight percent of value added in the UK. In financial services the country recently posted a foreign trade surplus of GBP 90 billion, which represents five percent of British gross domestic product (GDP). A third of this surplus was generated by trade with EU states.

The country is also closely connected with its European partners in terms of investments: 46 percent of foreign direct investment in Britain comes from the EU. Conversely, British investors make 43 percent of their direct investments in other EU countries.

If British voters opt for an EU exit on 23 June, their decision will trigger negotiations over Britain's future relations with the EU that could take many years to conclude. For the economy, this will lead to a phase of uncertainty: investors and consumers will postpone spending until they know what is going to happen next.

If an exit were to go ahead, the British economy would face a period of considerable turbulence. Some optimistic studies predict that Britain may retain its access to the internal market, that London would remain Europe's leading financial centre and that the country would become more competitive than the rest of the EU if bound by less red tape. The fact that Britain would no longer have to pay its net contribution to the EU budget, amounting to 0.5 percent of GDP, would be another plus point. According to this optimistic scenario, a Brexit could generate gains totalling up to 4.5 percent of GDP.

These expectations, however, may prove unrealistic. Damage to economic exchange with the EU is almost unavoidable. To preserve full access to the EU internal market Britain would have to adopt the relevant European regulations – yet getting rid of such regulations is a key argument in favour of the Brexit.

According to recent calculations by the Ifo Institute, the potential trade losses related to a Brexit could reduce Britain's economic output by up to three percent. In addition, shrinking trade would also negatively impact the overall economic impetus, meaning that companies would invest and innovate less. If that is taken into consideration, the losses could amount to up to 14 percent of economic output. A study by the London School of Economics speculates that even losses of up to 20 percent are conceivable.

The decline in border crossing economic activity would also lead to growth losses in the EU. This would particularly apply to countries like The Netherlands and Luxemburg that have close links to Britain via the financial sector. Losses totalling up to three percent of GDP could also be expected in Germany, according to Ifo's calculations.

Another issue that has been paid little attention in the Brexit debate is its potential repercussions in the currency market. Sterling has already started to lose value ahead of the referendum and this depreciation will surely only accelerate if it leaves the EU. Several banks are predicting capital flight and that the British pound will plummet to below one euro. The Bank of England would have to combat this trend with interest rate increases. This, in turn, would badly affect the housing market, as many house-owners have taken on large mortgages that annually track interest rates.

Could a Brexit also diminish the markets' faith in the euro? If the Brits decide to leave, it remains to be seen whether other countries in the EU or the euro area will follow suit. To date no other EU states have expressed their intention to exit the union. In view of latent uncertainty in the wake of a Brexit, however, the euro could be expected to depreciate against the traditional “safe haven” currency the US dollar.

All of this shows that a vote in favour of Brexit would be economically irrational, but in a referendum there are no guarantees that the voice of economic reason will prevail.

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