



Center for Geoeconomic Studies

Global Economics Monthly
May 2017

Harder Times Ahead for Brexit

Robert Kahn, Steven A. Tananbaum Senior Fellow for International Economics

OVERVIEW

Bottom line: British Prime Minister Theresa May's decision to seek early elections comes as the economic costs of Brexit are becoming more apparent. While the removal of electoral uncertainty may be helpful in Brexit negotiations, the new relationship between the United Kingdom (UK) and the European Union (EU), as well as the rest of the world, will take years to work out. An extended transition to an uncertain future will further stress UK and EU economies.

Britain's economy weathered the initial shock of the June 2016 Brexit vote impressively well. The economy proved resilient, supported by solid consumer spending and a better export environment after the fall of the British pound. Economic policy played a role, as the central bank stepped in with timely support and the government sensibly reversed its pre-vote threats of fiscal cuts. The International Monetary Fund (IMF) now projects growth in the United Kingdom at 2 percent in 2017, nearly a full percentage point higher than expected last fall, though more recent indicators suggest activity may have peaked.

The primary cost of Brexit was never to be measured by short-term dislocation, but rather through the long-term reduction in investment and reduced efficiency.

But the primary cost of Brexit was never to be measured by short-term dislocation, but rather through the long-term reduction in investment and reduced efficiency that comes from lost access to Europe's common market and a less prosperous economic future. Economists estimate that the loss in UK gross domestic product from Brexit ranges from 1.5 percent to 9.5 percent, equivalent to up to one-third of the growth in the next decade. This cost is mostly attributable to increased barriers to trade and migration

and to the financial services sector shrinking as a result of limits to cross-border activity. The wide range for the potential cost underscores the inherent uncertainty involved in the calculation. Even the highest figure could underestimate the cost of closed borders to the UK economy in terms of vibrancy and innovation.

The ultimate outcome, of course, depends on the new arrangements that are negotiated. Prime Minister May's invocation of Article 50 of the Lisbon Treaty in March brought the challenge ahead into sharp relief. Formally, the Article 50 process begins a two-year negotiation of the terms of Britain's exit and involves difficult questions about Britain's remaining financial commitments to Europe and the rights of expatriates once Britain leaves the European Union. In recent weeks, EU negotiators have taken a tough stance on both these issues, calling for concessions from the UK government—such as perpetual EU rights for their citizen residents in the United Kingdom—that, while perhaps not macroeconomically significant, touch on the fundamental sovereignty concerns that energized Brexit voters.

Meanwhile, the machinery of the European Union grinds slowly forward. The broad terms of reference for the upcoming exit negotiations will be approved at the April 29 EU Leader's Summit. The next step will be to agree on legally binding negotiating directives to guide the commission. This allows a formal start to negotiations in late May or early June. Even the most cheery optimists do not expect a breakthrough this year. As politically challenging as agreeing on the terms of the divorce arrangements may be, the more difficult and ultimately more important decisions concern the future arrangements between Britain and Europe. If, as Prime Minister May has famously said, "Brexit means Brexit," the United Kingdom ultimately will be willing

to exit Europe's single market to control immigration. But it is hard to imagine that the timeline envisaged in Article 50 will allow agreement on all the details of such an arrangement. The election cycle—most important, the ongoing French elections and German elections in the fall—makes it impossible for leaders to make tough decisions on the future of Europe. After those elections, and allowing some time for preparation, negotiators will have roughly nine months beginning early in 2018 to make the critical decisions on the path forward, in order for the exit agreement to be confirmed and implemented by the March 2019 deadline imposed by the Lisbon Treaty.

It could take a decade or more to fully negotiate the terms of Brexit and achieve the unanimous agreement of all European countries. Hence, the most likely outcome is a Brexit followed by an extended transitional period in which Britain receives many of the benefits of free trade with Europe and in return accepts many EU rules. During this period, negotiations on the long-term relationship would continue. Some experts have suggested that Britain join the European Economic Union (the “Norway model”) during this transitional period, perhaps with the idea that the arrangement would become permanent if the negotiations falter. Membership in the European Economic Union would give Britain access to Europe's single market and some EU programs in exchange for a financial contribution while the longer-term arrangement is being negotiated.

As I have written in the past, the extended timeline for a political resolution, and the increasingly likely prospect of an extended transition, is at odds with private market participants' need for a resolution of uncertainty. Long-term investment decisions take time, as does the relocation of jobs and production to the continent, and the regulatory approval process adds to the challenge. All this suggests that, although investors have been patient and there has not been substantial movement of jobs to the continent so far, the pressure to make long-term decisions will intensify in the coming years, leading to investment and job shifts that could, in turn, affect the politics of Brexit. The disconnect between political and economic timelines remains a significant, and underappreciated, cost of Brexit.

The disconnect between political and economic timelines remains a significant, and underappreciated, cost of Brexit.

The risks are clear and significant, and an interim solution during the transition could prove too politically difficult for a UK government that has campaigned on restoring sovereignty. Meanwhile, Europe continues to struggle to move forward with economic and financial union at a time of mounting discontent. A chaotic Brexit is a serious risk.

CONCLUSION

The challenge of launching a fundamental renegotiation of Britain's economic and political relationship with Europe—a process that could take a decade—is straining political consensus in the United Kingdom and on the continent. Brexit will produce a Britain that is poorer and less of an economic and financial power than if

it had remained in the European Union. At the same time, the Brexit vote adds to the populist and inward-looking centrifugal forces pulling at Europe.

At best, investors face a difficult transition to a highly uncertain future. The political instinct in cases like this may be to delay, but markets operate on a different timeline. Investors will need to make decisions on where to invest and operate and where to employ their workers. Even if Britain and Europe ultimately agree on a new, strong free-trade arrangement, the disconnect between political and economic timelines ensures that markets will increasingly struggle with the uncertainties created by Brexit. Economically, Brexit is bad for the United Kingdom and bad for Europe.

Looking Ahead: Kahn's take on the news on the horizon

Venezuela

Rising political unrest has prompted nervous market response and forced the country into increasing expensive funding deals. This situation has intensified concerns about the country's commitment to its debt service of \$3.5 billion in October and November.

Group of Twenty (G20)

The debate on economic openness versus protectionism has come to dominate recent G20 discussions. A call to resist protectionism was omitted from its April communiqué, ensuring a showdown on this issue at the July leaders' summit in Germany.

Greece

Greece and its European creditors agreed on further reform measures in pension and income tax, which will enable the country to receive further funding to meet its July repayments. European policymakers have expressed confidence that a deal on debt will be agreed and that the IMF will participate in the next Greek program. But no progress was made at the recent IMF meetings, ensuring that there will once again be a last-minute cliffhanger this summer.