

International Center for Enterprise Preparedness (InterCEP)

Brexit and Implications for Businesses

Web Forum

On July 21, 2016, InterCEP held a web forum to discuss Brexit and its implications for the private sector. The discussion was led by three panelists:

- Alex White, Country Analysis Director at the Economist Intelligence Unit (EIU)
- Dr. Nicholas Economides, Professor of Economics at New York University's Stern School of Business.
- Robert Hall, Director of Security & Resilience Network at London First

Context for Brexit and the perspective of the Economist Intelligence Unit

Alex White discussed the potential implications of Brexit for the UK economy and Europe and presented the EIUs perspective on what is likely to happen in the next few years based on current information.

The success of the Leave campaign was considered a huge shock by many. In hindsight, more people should have seen it coming given the debates that were taking place and the populist rhetoric used. However, the political elites did not see it coming. The reason for that is that British political culture has traditionally proceeded by evolution and not by revolution. The norm is for the political system to take small steady steps. The idea that the UK would vote for this big break is not consistent with that historical experience. There were many adverts and strategies that the Remain campaign could have used but did not, because they did not see this coming.

What are the expected impacts of Brexit?

As a result of the referendum results, the EIU has revised its economic forecast for the UK. Economic growth will be negatively impacted. Some of the key forecasts include:

- Economic growth for 2020 is forecasted to be as much as 6% less than it would have been before the referendum
- Investment and consumption will decline
- The British pound will level out at around 1.24 relative to the U.S. dollar over the course of 2017
- Unemployment is expected to rise
- General government debt will reach levels well over 100% GDP

Despite these forecasts, the impact of Brexit are not expected to be a “Lehman moment”. Financial markets are weathering the situation well and have adjusted. This is not surprising since Brexit is not a critical shock to the global financial infrastructure.

However, Brexit has permanently changed the outlook for the economy in the UK. The economic growth potential will be lower than the EIU expected before the vote.

The current EIU forecast is predicated on the assumption that the UK gets a good trade deal with Europe and maintains a relatively open trading relationship with the European Union (EU). This would be similar to the trade agreement that Norway currently has. But there are some concerns about whether this will be accomplished.

First, there is a capacity constraint. The UK is a member of the EU now and has no experienced trade negotiators. The UK will need 500 or 1,000 experienced trade negotiators in order to negotiate trade agreements with the EU, the United States and others.

Second, there are concerns over what will happen with regard to the movement of people. According to some, the referendum should have been about migration. The electorate was sold a message that Brexit would mean closing migration and the movement of people without incurring economic impacts. However, the EIU team does not believe the UK will get a good trade deal without allowing for the movement people.

As a result of these concerns, it is unclear whether the UK will get a good trade deal with the EU. It’s difficult to envision many scenarios where the economic forecast is better than the EIUs base case. Theresa May, the new prime minister in the UK, is saying Brexit means Brexit without explaining in detail what that means.

Is there an opportunity for a reset?

At this point the electorate has responded to the referendum and the EIU’s perspective is that it is highly unlikely that the UK will not leave the EU. There are commentaries that Scotland and Northern Ireland may veto the referendum, but according to the EIU this is unlikely because the consequences for the political system of not following through would be very serious.

The question then becomes, will it be a hard Brexit or a soft Brexit? A soft Brexit would mean good access to the EU market and some reductions on the movement of people.

The EIU expects that the UK will invoke Article 50 before the end of the year. This is due to the fact that too much uncertainty would be harmful to the markets. Mrs. May said Article 50 will not be invoked before the end of the year. So perhaps this will not happen until early 2017. Once a country invokes Article 50 there is a period of negotiations that can last two years. Hence, the assumption is that the

negotiations are likely to go through the first half of 2019. Mrs. May will have to sell the idea that there will still be movement of people.

Ongoing instability in the UK Labor Party also complicates the political landscape. The lack of planning on behalf of the public service and conflict within the political parties create doubts on the establishment's ability to govern effectively. One of the things that the UK has benefited from in the past is the premium associated with political stability. That political stability premium is now lost.

Other expected outcomes for the UK at this point include:

- Recovery from the economic recession expected for 2017 will be underway by 2019, however, the structure of the economy may change
- A second Scottish referendum is not expected at this point
- London-only work visas may be an option

Brexit and the European Union

In terms of the European context, it is important to note that the EU has been in crisis since 2009-10. This crisis has expressed itself in different ways: migration and refugees, Greece and Brexit. The "Grexit" issue may come back before 2020. There are Institutional failures in the EU that allow the region to muddle through and create ambiguity about what route it will take.

What the EIU is concerned about is whether the EU has the capacity to muddle through multiple crises, including migration, Brexit, a potential banking crisis in Italy, Greece, etc. When you consider all these problems together they begin to seem unmanageable. So the EIU is actively reviewing its forecasts for the EU.

In terms of data privacy issues, that is a European competency. As the UK leaves the EU it will have to work on these regulatory issues. This is an important institutional issue and data privacy regulations will have to be transposed into UK law. The EIU does not believe there is a desire to move away from these laws since that would create uncertainty.

A Historical Context for the UK's Membership in the European Union

Dr. Nicholas Economides provided an overview of the reasons why the UK became part of the EU in the first place. He noted that after WWII Britain found itself on the side of the victors but lost its empire. The country incurred high debts to finance its participation in WWII. The U.S. took the place of Britain as world leader. In the 1940s and 1950s Britain faced a high debt burden and there was low growth and food rationing.

In the early 1960s the country decided to apply for EEC membership. For a number of years it was not admitted because Charles De Gaulle considered the UK's close ties with the U.S. a threat. But in 1973 Britain joined the EEC.

The 2016 Referendum and Brexit

Dr. Economides also provided an overview of some of the main expected impacts of Brexit, explaining that Prime Minister Cameron held a referendum on whether the UK should stay in the EU or leave it for reasons that have more to do with the internal dynamics of the Conservative Party. The result of the referendum was the success of the Leave campaign. What are the immediate economic effects of the referendum results? Brexit was not predicted. The markets predicted the Remain side would win. As a result, there was a fallout because of the readjustment of the financial markets given this new information. US, EU and UK stocks are now doing okay but the weakening of the pound is expected to persist for some time.

What will happen in the UK? Significant political changes. Cameron resigned, May became minister. Davis and Johnson were Leave supporters and now hold important positions. In the Labor Party, there are also big changes taking place. The referendum result is not law. A law needs to pass parliament for Article 50 to be invoked. Once this happens, there will be two years of negotiations.

How will these negotiations happen? Britain would like to “negotiate before the main negotiation”. May would like to delay invoking Article 50 until she can define what conditions would prevail in terms of relations with the EU when the Article is invoked.

These preliminary negotiations may take some time. However, the EU is refusing those preliminary negotiations so there is uncertainty about what will happen. Davis has threatened a unilateral action of halting immigration. The EU wants a quick resolution because it is worried about other countries conducting referendums. From a negotiation point of view, the EU wants to present a tough stance because they want to show that there are benefits to being in the EU. At the same time they don't want to be perceived as punishing the UK.

There are several potential negotiation scenarios:

- Scenario 1 is a bad divorce. This would mean high tariffs for the UK and also a significant distance between the UK and the EU. The result could resemble something like the relationship between Turkey and the EU.
- Scenario 2 would be something similar to the relationship that Norway and Switzerland have with the EU. This would mean good access to the EU market.
- Scenario 3 would be that Brexit is not carried out at all. This could happen, for example, if a high-level election is won based on Brexit not happening. This scenario has a low probability.

We have already seen the short-term impacts of Brexit on the UK economy. What are the medium-term economic effects? That depends crucially on how close the relationship between the UK and the EU is after the negotiations. Will there be something like scenario 1 or 2? Trade could be impacted significantly through tariffs and customs. There could be different regimes of regulatory supervision on financial transactions. What regulations are in place will make a big difference. Agricultural policy is crucial for EU. How the UK is affected by agricultural policy will be an important issue. The movement of people across states is critical too.

Trade between the EU and the UK is more important to the UK than to the EU. If tariffs are imposed, then the UK is likely to lose much more. That puts the negotiators on the UK side in a tough position.

London has been a significant financial center. For example, all major U.S. banks have their offices in charge of Europe in London. With the UK leaving the EU, some of them might move to Frankfurt, Paris or Dublin. London may end up having less standing in the financial world. The London Stock Exchange and Deutsch Börse were about to merge. Now this may not happen because the regulation of the London Stock Exchange will be different from that of Deutsch Börse. The divergence of financial regulations between the UK and the EU may halt this merger.

There may also be other significant political implications. A consequence of Brexit may be an increase in Germany's dominance of the EU. This may lead to other referendums in countries such as France and Italy that may not want to see Germany increase its influence. It also might lead to France creating an opposing pole to Germany.

In summary, the negotiations between the UK and the EU are likely to be long and unproductive. This process will hurt the UK but will not have much of an impact on the EU or the global economy.

Other Potential Impacts of Brexit

Robert Hall from London First summarized some key potential non-economic impacts of Brexit based on an event held in London earlier in the day that addressed this topic.

Security and resilience require better information sharing between the public and private sectors. Unless the Brexit negotiations lead to better bridges there will be challenges related to migration, terrorism and ethnic tensions. Bilateral engagements with some countries in the area of security can be effective, but they are typically not as effective as being part of the EU. With DNA testing of foreigners for example, this can take minutes through EU arrangements but several months outside it. It is important to ensure that the security aspects of Brexit are addressed. If migration becomes the key issue of Brexit, the UK is likely to need much more significant border security and a much larger budget in this area.

There is a division within the UK over Brexit, and this is about inequality and globalization. The vote for leaving was by those who have felt they had nothing to lose, and they wanted to 'take back control'.

And these demands could exacerbate tensions. Community engagement will be critical to reduce tensions and allow the country to move in a positive direction. Brexit is very likely to happen and there will be a need to mitigate impacts. Uncertainty about the process means it will be difficult to manage risks and confidence needs to be built.

Some additional points made in the discussion between the panelists and other participants were:

- The same forces that led to Brexit are at play in other countries. Significant segments of the population want change and believe that the elites have not delivered. This is true in France and in the Netherlands, for example, and these movements could gain momentum.
- Referendums by simple majority present challenges since they relate to complex topics that are difficult to communicate. Allowing parliaments to debate these topics and make decisions would lead to better outcomes.

Additional Resources:

- The Economist Intelligence Unit – United Kingdom: <http://country.eiu.com/united-kingdom>
- London First: <http://londonfirst.co.uk/about/>
- NYU-Stern Faculty Examine the Implications of “Brexit”: <http://www.stern.nyu.edu/experience-stern/faculty-research/stern-faculty-examine-implications-brexit>