You Brexit. You Buys It.

Having sold the British people a bill of goods on Brexit, PM Theresa May paid a steep political price in January, suffering the largest parliamentary defeat in modern British history. While the defeat was decisive, it did nothing to clarify the future of U.K. and EU relations. The political stakes are high; the economic stakes even higher; and there is no clear path forward.

Deeply Entagled Economies

The EU economy is the second largest in the world and the U.K. is its second largest member. The depth of their integration extends far beyond tariff elimination to include common regulatory standards, mutual recognition of professional qualifications, "passporting" of financial services, unimpeded foreign direct investment (FDI), and free labor movement.

The proximity of these two large economies and their frictionless borders have encouraged ever-deeper trade relations. The EU is the U.K.'s largest trading partner, with EU-related imports and exports accounting for 30% of U.K. GDP. About 45% of the U.K.'s exports are to the EU and 53% of the U.K.'s imports come from the EU. U.K. and EU firms share deeply integrated supply chains, with inputs crossing borders many times in the manufacturing process. Nearly half of the U.K.'s imports and exports of intermediate goods are with the EU.

The financial sectors of the U.K. and the EU are also deeply intertwined, as there are few barriers to cross-border trade in financial services. U.K. banks underwrite half of the debt and equity issued by EU businesses and are counterparties to over half of the OTC interest rate derivatives traded by EU companies and banks. U.K. asset managers invest £1.4 trillion on behalf of EU clients. Financial services generate 7% of U.K. GDP and 11% of tax revenue, half of which derive from business with the EU.

Brexit's Dynamics of Disintegration

Brexit would likely unleash dangerously disruptive dynamics. An increase in trade costs and frictions would reduce trade volumes and GDP and increase unemployment. Productivity improvements would be impeded by reduced competition, fewer opportunities for specialization, and lower FDI. Lower productivity and falling migration would reduce potential output. Uncertainty would boost risk premiums on U.K. assets, contributing to a tightening of financial conditions. Inflation would rise as higher tariffs and falling sterling hit consumer prices. Monetary policies to counter rising inflation would add to the contractionary forces unleashed by Brexit.

Some of Brexit's ill effects would be immediately felt. Border bottlenecks would quickly disrupt supply chains. Financial services now freely provided across borders could cease abruptly with changing regulations. Uncertainty would immediately widen risk premiums on U.K. assets, tighten financial conditions, reduce credit availability, and undercut sterling. Tighter financial conditions and slower output growth would erode the credit quality of U.K. borrowers, hurting bank profitability and financial sector stability.

Other effects would be longer lasting. The ending of the mutual recognition of product quality and safety standards would necessitate a lengthy recertification process. The restructuring of the economy away from export industries to produce goods now imported would be a prolonged process. Reduced productivity growth would also be an enduring feature of a less open and competitive post-Brexit economy. With lower productivity growth and reduced migration – EU migrants represent 5% of the U.K. labor force and a much higher share in certain industries – trend growth would remain below its pre-Brexit trajectory for a sustained period.

The Bad and Ugly

Brexit has no good outcome. Anything short of a reversal of the decision to leave the EU will exact a heavy economic toll. The magnitude of the toll will depend on the degree of economic integration salvaged in the post-Brexit world. The Bank of England estimates that in the best Brexit case of a continued close economic partnership with the EU and an orderly transition process, U.K. GDP would be between 1¼ - 3% below its pre-Brexit trend by 2023. In a disorderly "no-deal, no-transition" Brexit, U.K. GDP would be 8% below trend, unemployment would increase to 7½% from 4.1%, inflation would peak at 6½% from 2%, house prices would fall by 30%, and commercial property prices by 48%. Although the Brexit's impact would be concentrated on the U.K., the EU would not be spared. The IMF estimates that a disorderly Brexit would cut long-run EU GDP by 0.8-1.5% from trend.

Brexit is but one of the panoply of policy missteps now amplifying global market uncertainty. Heightened uncertainty created by unpredictable policies coupled with high valuations across assets are the main reasons for our current conservative investment posture.

1001 Nineteenth Street North, 16th Floor
Arlington, VA 22209 USA

+1 703.243.4433 TEL
+1 703.243.2266 FAX

strategicgroup.com