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Impact of Brexit on the UK economy

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Abstract: **Britain decided to leave the European Union on June 23rd, 2016 post the general referendum. This decision is widely known as "Brexit". This paper evaluates the UK macro-economic dynamics and the implications of Brexit on UK economy.**

The paper assesses the present economic drivers and data points along with providing inferences by applying the widely accepted macro-economic frameworks.

This paper also provides insights to the challenges faced due to Brexit in the business environment and possible considerations to tackle them in medium to long term, for the policy makers.

Keywords: **business environment, UK macro-economic, UK economy, policy makers.**

1. BREXIT OVERVIEW

Britain decided to leave the European Union on June 23rd, 2016 post the general referendum: Leave votes won by 52% to 48%. The referendum turnout was 71.8%, with more than 30 million people voting. European Union is based on the idea of a single market, characterized by four freedoms: the free movement across borders, of goods, services, capital, and people. Three prime-ministers (David Cameron, Theresa May and Boris Johnson); multiple negotiations, campaigns and rallies since the Brexit referendum and yet there is uncertainty– deal, no-deal.

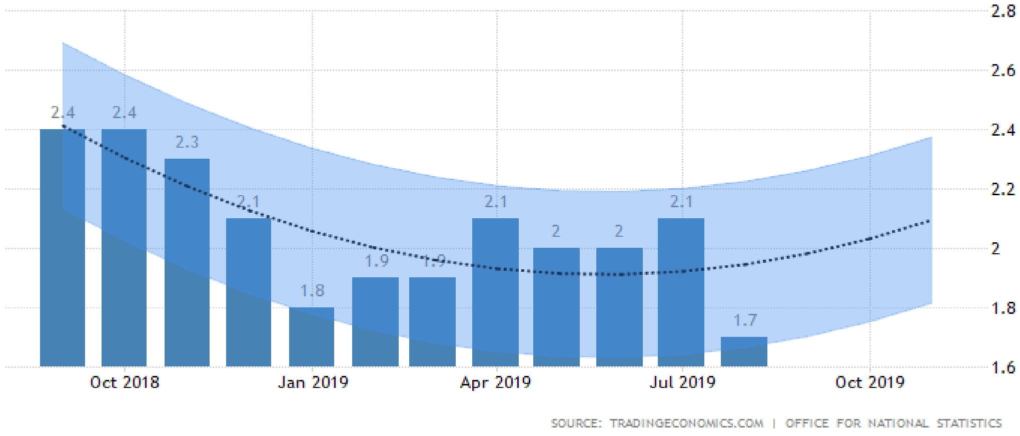
2. ECONOMIC IMPACTS: KEY AREAS, SECTORS

This paper evaluates the UK macro-economic dynamics around the key economic indicators viz. Inflation, currency exchange rate, unemployment rate, interest rates, consumer spending, business investments, government expenditures, net exports/imports etc.

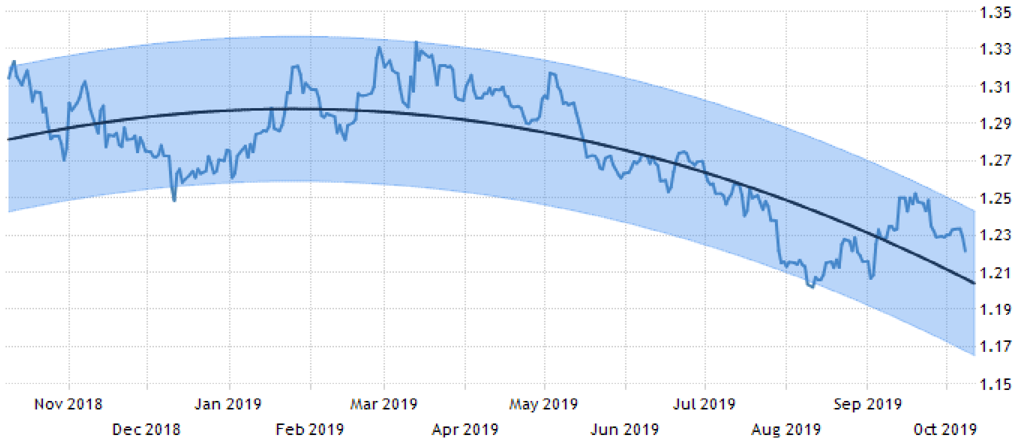
- UK Economy Fundamentals
  - UK Credit Ratings
    - Britain lost its top AAA credit rating, meaning the cost of government borrowing will be higher.
  - Impacts on Scotland, Wales, northern Ireland
    - England and Wales voted to leave while Scotland and Northern Ireland both voted to stay back in the EU

  - Negotiations for final status of Scotland and Northern Ireland to exit EU or stay : uncertainty is looming
- Hard/Soft exit will have impacts on economy

- Inflation and Exchange rate: Trend and further impacts
  - Inflation: The inflation has triggered to new highs due to Brexit with upward pressure to further increase the inflation around 1.90 in 12 months.
  - Inflation increase forecast : around 2.00 by FY2020



- Exchange rate :
  - The pound is weakened against the USD and other major currencies. As compared to 2014 numbers the GBP has weakened by approx. 29% against the USD (~1.7 to ~1.2 GBP/USD)
  - The pound has weakened against INR (many other currencies of emerging markets)



- Bonds, Pension funds, Annuities :
  - Gilt yields have fallen to historic lows following the EU referendum result and defined benefit (DB) pension scheme deficits continue to rise.
  - Bonds have also risen in value. The yield on British government bonds, called gilts, fell as investors scrambled for safe-haven assets.
  - Annuities have taken a hit, with pension companies cutting the amount they will pay the newly retired.
- Trade :
  - FDI (foreign Direct Investments): The UK is the largest recipient of FDI in the EU. Brexit reduces the attractiveness of the UK as a gateway to Europe.
  - It could also lead to a reduction in investment from the rest of the EU, which is the biggest source of FDI in the UK.

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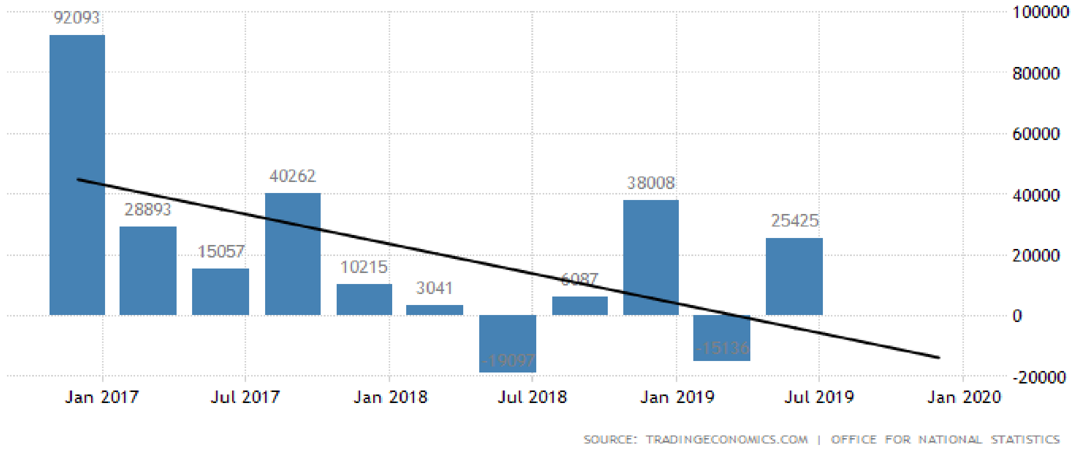
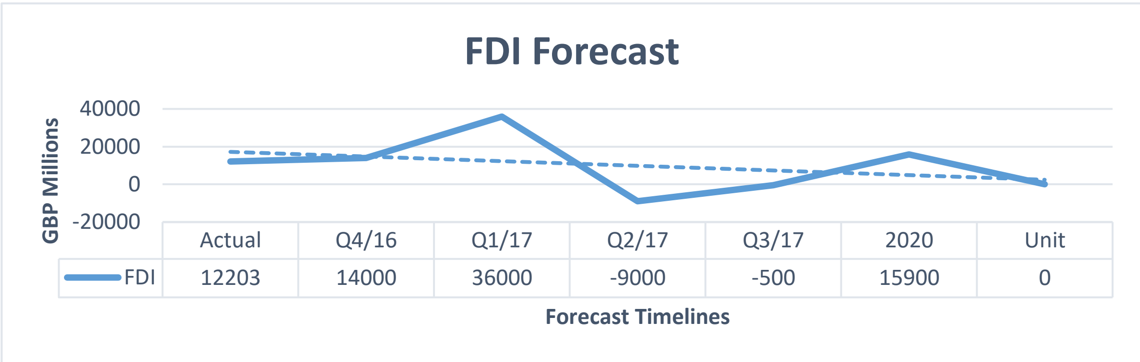
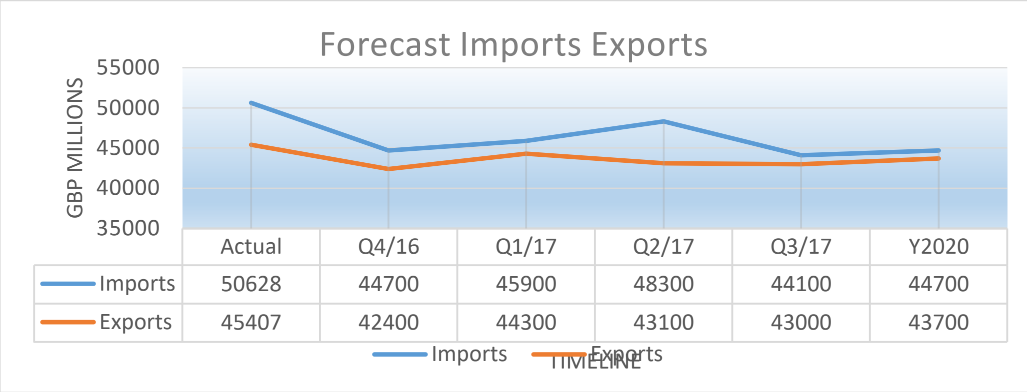


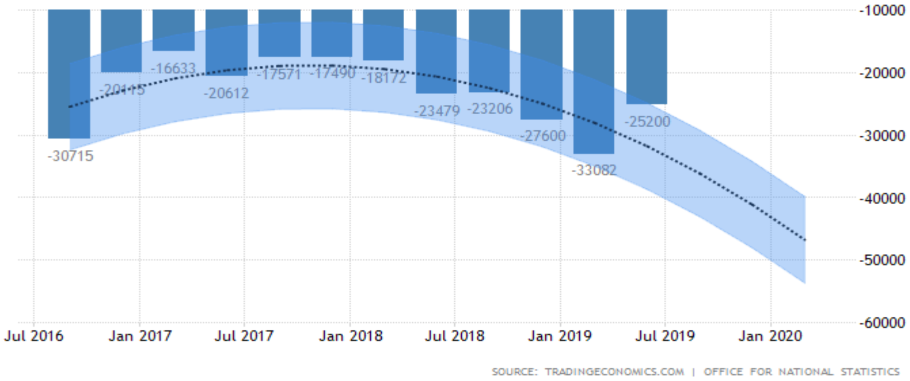


- o Major sectors impacts: financial services, banking, insurance, healthcare, pharma, heavy industries, automobiles, telecom, tourism etc.
  - ▪ After the Brexit vote, Morgan Stanley cut its 2018 earnings forecasts for UK banks by 12 to 27 per cent because of the “macro implications” of the Brexit vote
  - ▪ In Order to infuse liquidity in the economy, and avoid recession the banks are reducing the interest rates : Bank of England cut interest rates from 0.5% to 0.25%
  - ▪ Uncertainty would loom for Pharma, NHS and life sciences companies given that majority of the operations span across EU. The R&D budget cuts would be likely.
  - ▪ Demand for the metal in the UK has never recovered since the financial crisis, remaining 30% lower than pre-2008 levels, while energy costs, business rates, and environmental taxes have further squeezed the industry.
  - ▪ Telecommunication companies could also be deprived of access to EU R&D funding, including in high-profile emerging technologies like 5G, IoT, robotics, cloud, clean energy, security, and automation and smart cities.
  - ▪ The airfares to increase due to Brexit given the airlines would no longer operate seamlessly between the UK and rest of Europe.
  - ▪ RYANAIR has slashed its growth plans for the UK market while slamming the Government's handling of Brexit negotiations, warning that airfares could climb if a crucial airline access agreement cannot be agreed with Brussels
- o Current Account (CD) :Imports, Exports

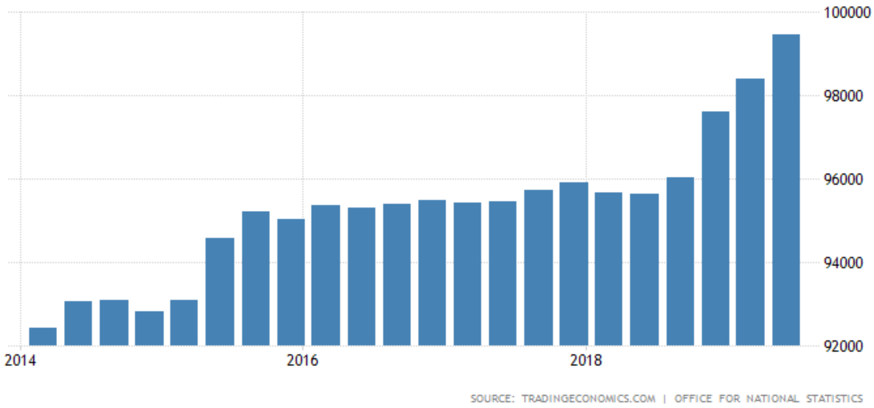
- It is projected that the trade deficit going to widen in near term till the Brexit is formalized;



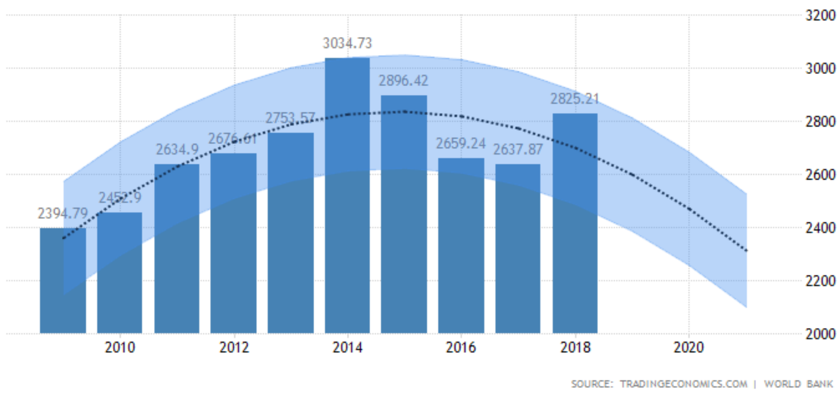
	Actual	Q4/16	Q1/17	Q2/17	Q3/17	Y2020
Imports	50628	44700	45900	48300	44100	44700
Exports	45407	42400	44300	43100	43000	43700

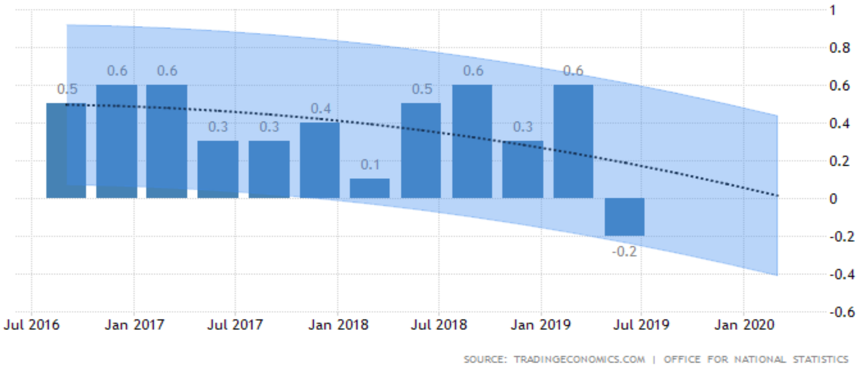


- GDP :
  - UK government spending has increased to boost the economy in-response to the ongoing challenges



  - The GDP growth forecast is on a downward trend
  - The growth rate is also on a downward trend





- Immigration, Visa Regulations:
  - Brexit impact would depend on the policy adopted by UK post Brexit (Norwegian or Swiss models) for free movement of workforce, skills and immigration policies therein.
  - At present Poland is largest source of UK immigrants. The remittances would be positive from UK point of view but there could be scarcity of skills of labor depending upon the policy adopted.
- IT Data management, storage
  - The hosting of data within mainland Europe or UK depends upon the policy adopted Viz. Safe harbor, data retention and sharing policy etc. movement of data through physical data-center movements would induce additional costs to UK companies.

There are many other areas, sectors impacted like security, housing markets, education, wages, productivity, Labor costs, etc. which are not covered in detail.

3. INFERENCES DRAWN: OVERALL IMPACTS

- With Pound weakening against the major currencies, if the central bank of UK wants to hold the exchange rate,
  - The monetary base has to be improve. This would put upward pressure on the interest rate.
  - The economy has to counter it with increased production in goods and services.
  - However, with increasing inflation, improving the production would not be economically viable. Which means central bank cannot stabilize both: the exchange rate and interest rate.
  - If the interest rate is allowed to be lowered then exchange rate is to be sacrificed.
- Given the trends and statistics as described above sections, Pound is allowed to be weakened with marginal reduction/holding up of the interest rates. Domestic focus has been the near term strategy: manage the uncertainty emanated by the Brexit shocks.
- Exit from the single market (EU) could lead to foreign company's investments exit from UK to more favorable destinations – emerging markets, South Americas, Africa etc. which would further deteriorate the CD.
  - Y=C+I+G+X-M
  - Assuming that consumption 'C' to remain fairly stable; Govt. spend to increase, Investments to decline (given weak sentiments, reduced FDI etc.) and widening CD : the overall output 'Y' has a downward pressure
- With the increase of goods and services prices and reduction in output, the UK inflation seems to be **Cost Push inflation**: the increase in prices is a result of absence of EU free market subsidies, low bargaining power of UK companies, higher costs etc. Increase in costs is not translating into increase in output.
- If UK follows contractionary fiscal policy and slow down the economy, prices would fall because of lesser demand for goods and services, but the Output will also fall (D2/S2 intersection)
- If they follow expansionary fiscal policy to boost the economy, the output will increase but this will result into even higher inflation and price rise (D3/S2 intersection)

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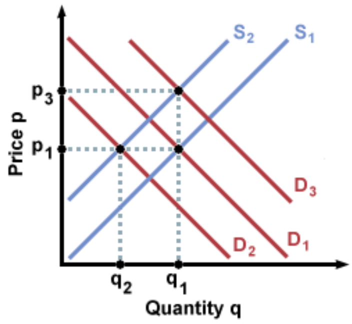

- At present UK has this tough job at hand to mitigate the above precarious position: boost growth or manage prices. Given that key economic indicators, all point tough times ahead for UK

- Given the circumstances, UK should try to manage to stabilize the prices immediately/control inflation and in the long run boost the economy by increasing the output : find new avenues, countries to trade and boost the economy.

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