Policy Brief

The United Kingdom's Brexit vote leads to a major economic shock

Dr. Giovanni Cozzi, GPERC and Prof. Terry McKinley, CDPR, SOAS
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This Policy Brief projects the economic impact over the next five years of the United Kingdom's recent vote for Brexit. It is not based, however, on any agreement during this period between the EU and the UK on the latter's terms of exit.

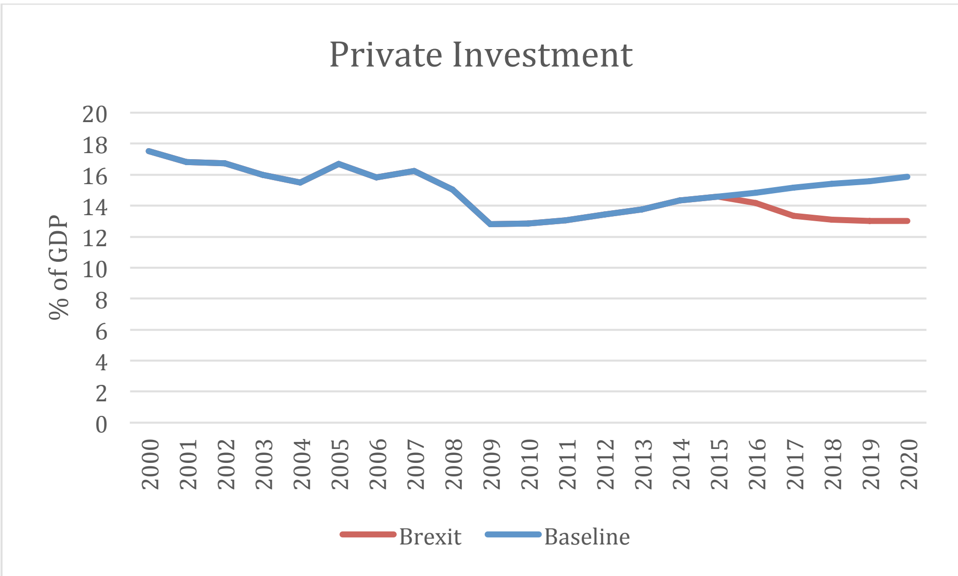
For comparison purposes, this publication simply juxtaposes the results from a Brexit-based scenario to those drawn from a Baseline Scenario that assumes the non-Brexit condition of 'Business as Usual'. Both scenarios are based on using the CAM global macro-econometric model (see, for example, the recent CAM-based Policy Brief on Global and European Imbalances, GPERC Policy Brief #11-2016, 13 July 2016).

The Brexit scenario is based on making a small set of reasonable assumptions, mainly with regard to investment, consumption and the exchange rate (see similar assumptions made in the 'Managing Chaos' article in *The Economist*, July 2-8).

Investment and Consumption

In the Brexit scenario, private investment is assumed to fall noticeably, most likely due to continuing economic uncertainty. While investment is 14.6% of GDP in 2015, by 2020 it would decline to 13%. This represents about an 11% drop (see **Figure 1**).

Figure 1. Private Investment as % of GDP



This outcome would contrast sharply, for example, with the increased level of almost 16% projected for 2020 by the Baseline ('Business as Usual') Scenario (due partly to implementation of the Juncker Plan and increased European Investment Bank financing).

Consumption is also projected to decline, but to a somewhat lesser extent than investment. Consumption in per capita terms would fall by 8% over the next five years (from approximately 23,530 US$ in 2015 to 21,630 US$ in 2020).

The likely cause of this decline is the projected rise in the prices of imported consumer goods (which is already happening), continuing uncertainty about household incomes and continuing government austerity policies. We assume at this point that the government continues to pursue its strategic objective of closing its fiscal deficit, by both increasing its revenue and reducing its expenditures.

Government revenue would increase from 17% of GDP in 2015 to about 18.5% in 2020 while government expenditures would decline from 22% of GDP to about 20.5%. As a result, government net lending is projected to decline from -4.8% of GDP in 2015 to -2% in 2020, dampening aggregate demand in the economy in the process.

Exchange Rate and Current Account

There has already been an immediate sharp devaluation of the nominal value of the British Pound in the immediate aftermath of the 2016 Brexit vote. But this declining trend is projected by the Brexit scenario to continue through 2020.

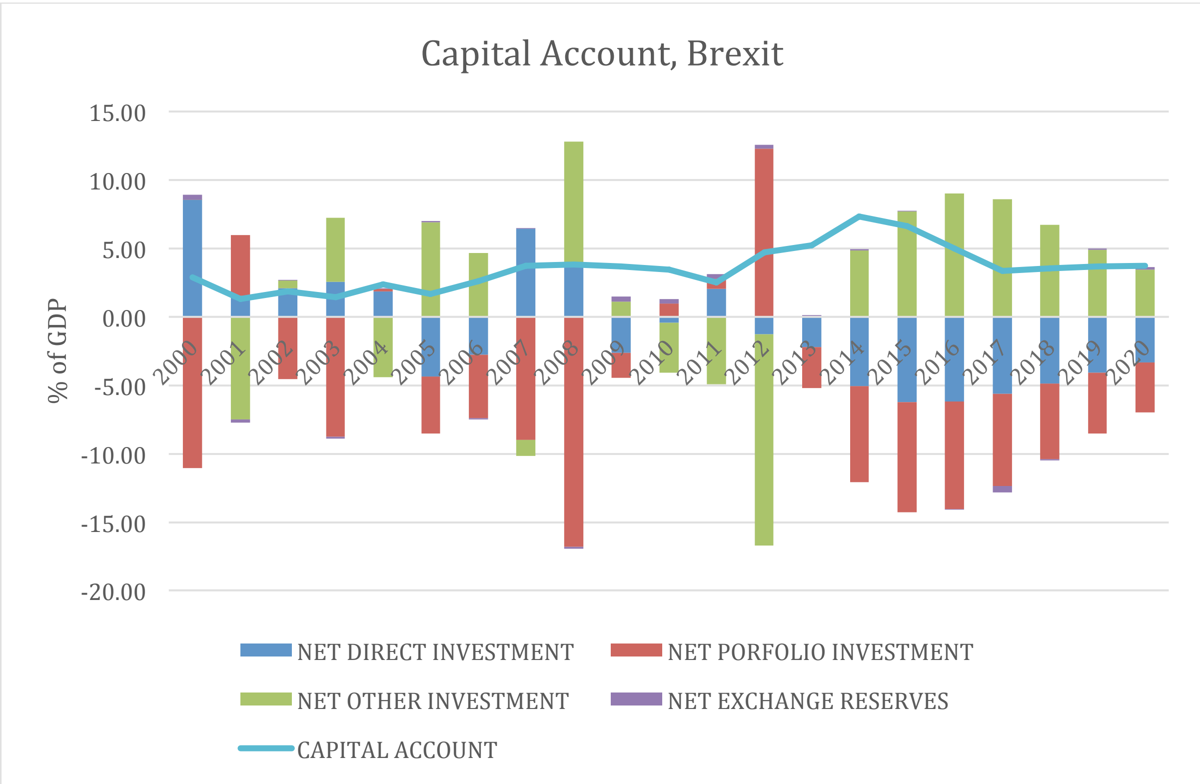
By that year, the nominal value would have declined by about 10%. Not surprisingly, the UK's current account would improve appreciably over the next five years.

As a ratio to GDP, the current account would narrow from the abysmally wide deficit of -6.1% in 2015 to -3.5% in 2020. This effect is not surprising given the devaluation of the Pound. In sharp contrast, under the Baseline Scenario, the current account would remain mired at the very high level of -6.3% by 2020.

Capital Inflows and Outflows

Figure 2 shows that capital inflows into the UK would decline markedly between 2015 and 2020 under the Brexit scenario.

Figure 2. Capital Inflows into the UK, Brexit Scenario



Inflows would be comprised mostly of Direct Investment and Portfolio Investment. In 2015 these two components essentially accounted for the total net inflows of capital into the UK, amounting to about 14.3% of GDP. But by 2020, these two dominant items would shrink to about 7% of GDP.

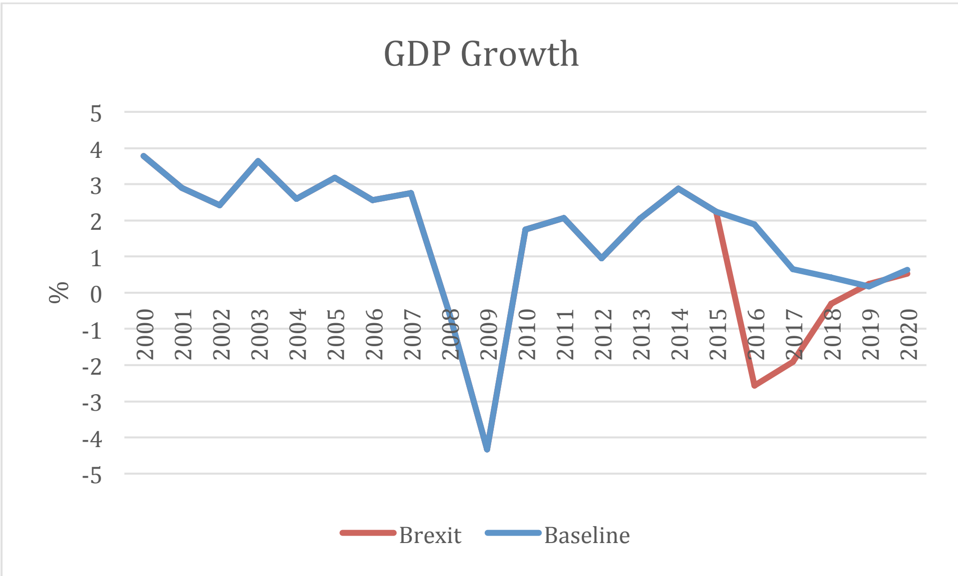
Over the same period, capital outflows would also diminish. Comprising mainly Net 'Other Investment' (e.g., banking flows to other countries) and minor holdings of foreign-exchange reserves, these outflows would decline from about 7.8% of GDP in 2015 to only about 3.6% by 2020.

The implication of these two trends is that the United Kingdom could become a diminished international financial centre over the next five years as a result of the Brexit vote.

Economic Growth

As a result of the trends described above, the Brexit scenario projects that GDP growth would slide into recession in 2016. Its growth rate would drop sharply to about -2.5% (see Figure **3**).

Figure 3. GDP Growth



In 2017 this rate would still be -1.9% and in 2018 -0.3%, before it would turn mildly positive thereafter. Hence, in the short term, there is likely to be a heavy economic cost for the United Kingdom from voting for the Brexit option.

But there would have been a meagre average rate of GDP growth of only 1.3% during 2016-2020 even under the Baseline Scenario. In other words, the UK was already projected to stagnate economically over the next five years, independently of the Brexit vote.

Concluding Remarks

While the UK economy was already projected to slow over the next five years, the vote for Brexit would likely lead to even greater economic deterioration—especially if government policies of austerity were maintained. Both investment and consumption are projected to fall significantly, dragging down economic growth with them.

The country's current account might indeed improve as the Pound plummets in value. But financing from capital inflows would also be greatly diminished. Thus, the UK's cherished position as a major international financial centre is likely to be noticeably weakened.

Corresponding authors:
Dr. Giovanni Cozzi, g.cozzi@gre.ac.uk
Prof. Terry McKinley, tm9@soas.ac.uk