Brexit Is Here: Implications

Economic Implications

- This is the first divorce in EU history. There is no precedent to estimate the magnitude of economic pain in UK, EU and the Rest of the World. The HM Treasury estimated that UK real GDP could fall by 3.6 percent over 2 years. Most likely this was an exaggeration to sway the votes. Other than the expected financial tsunami, no significant changes will occur in economic and trade relations for a while. Article 50 of EU will be invoked. It gives a two-year window to negotiate an exit from EU. Most likely the negotiation would be acrimonious. EU would make it difficult for UK lest it gives ammunition to anti-EU parties elsewhere wanting to separate from EU. The negotiation could drag on beyond the two-year window. The earliest divorce date would be January of 2019. In the meantime, the UK exports would benefit from a sharply lower value of the pound.
- In the meantime, a tsunami in financial markets has begun. Both the pound and the euro will fall sharply reverberating throughout the world. The mounting uncertainties will hurt consumption and investments hurting global economic growth. However, the effects of the tsunami will diminish as one moves away from the epicenter in UK and EU.
- UK will be the biggest economic loser. About 45 percent of U.K exports go to EU while the reverse is only 7 percent. Similarly, 48 percent of FDI into UK comes from EU while the reverse is only 9 percent. Shrinking trade and investment between the UK and EU would hurt economic and job growth. In addition, reduced immigration from EU will slow labor force growth shaving potential economic growth. Other countries most affected will be Ireland, the Netherlands, Spain, Germany, Poland, France, Italy and Romania. The U.S. and the Asian countries will be much less affected.
- In the U.S., the immediate effect will come primarily from gyrations in the financial markets. In the long-run, the stronger dollar and reduced demand from UK and EU emanating from slower economic growth will negatively affect the economy.

What will Central Banks Do?

- The banking system will be hard hit. In order to make sure that liquidity is not a problem in the financial markets, the Bank of England and ECB will stand ready to do whatever they have to in order to take out the bottlenecks. The Bank of England will cut the interest rate and purchase both government and corporate bonds to liquefy the financial markets.
- In the U.S., a possible hike in the interest rate by the Federal Reserve this year is no longer on the table. The U.S. central bank might have to cut the interest rate back to zero if economic and financial conditions worsen beyond expectations.

Geopolitical Implications

- The Brexit vote has shown that populism around the globe has gained momentum. They reject free trade, globalization, immigration and multiculturalism. The political parties wanting to leave EU has gained wings. Denmark, the Netherlands, Italy, etc. could contemplate abandoning the EU membership. EU disintegration would gain tailwinds. Economic and political cooperation in Europe would be much more difficult.
- In the U.S., populism from both right and left could benefit. The U.S. could become more isolated. UK would no longer be a strong voice for the U.S. in matters related to EU and Eastern Europe.
- Scotland, which heavily favored remaining in EU, is likely to have another vote for independence. Next time around, the separatists in Scotland could very well win. The United Kingdom could disintegrate.