Brexit: How businesses can think about its potential impact

18 May 2016

Summary

As the referendum draws closer (June 23), many business leaders ask what Brexit would look like and what its likely impact would be on firms and industries. To navigate these issues, this note looks at the following three questions:

- What is the broader economic value proposition of EU trade membership?
- How easy would it be for Britain to replicate it?
- What would be the likely impact on key macro variables relevant to businesses?

The benefits to the UK economy are often understated, due to structural and institutional benefits that come on top of the trade value with the EU. To replicate this broader value proposition in a Brexit scenario, the UK would need cooperation from key political partners. The EU, however, has incentives to impede an easy deal, so as to discourage other nations from leaving the union. Given the uncertainty of the political dimension, recent impact studies provide credible directional estimates at the national level – which are consistently negative. To further gauge the impact on their businesses and sectors, business leaders can look at key macro variables relevant to them.

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1. The broader economic value proposition, including structural and institutional benefits to the UK economy, far exceeds the value of trade with the EU

- A narrow measure focuses on the value of the UK's trade with the EU (Figure 1)
  - Total exports represent 28% of the UK's GDP; 47% of that trade is with the EU
  - A further 13% of the UK's exports are covered by EU-3rd country agreements
  - A further 21% of UK exports are to countries that currently negotiate with the EU (including TTIP)
  - Thus, medium-term only 19% of UK exports are likely to be non-EU related
- Beyond the nominal value of EU trade, there are important structural and institutional benefits to the UK economy: (1) productivity pressures (2) institutional value of trade (3) the external growth environment
- *(1) Productivity pressures:* Classic arguments for free trade centered on exploiting comparative advantage. Today, the benefits of competitive pressures are a key argument, as they force firms to operate on, or near, the productivity frontier. This is an important long-run benefit to the economy and there is empirical evidence of this effect after the UK's 1972 accession to the EU.
- *(2) Institutional cost of free trade:* Trade is not a given, but a process that requires constant maintenance – in other words, free trade is not free of cost. This includes a plethora of institutional elements, such as dispute arbitration, standards and frameworks. The cost of this would be made explicit in case of a Brexit.
- *(3) The growth environment:* The new growth environment – slower world GDP and trade growth (**Figure 2**) – highlights an additional value proposition. On its own the UK represents less than 3% of world trade, while the EU without the UK would be 30% still (**Figure 3**). Membership thus provides more bargaining power and protection to the UK than having to negotiate on its own.

2. How much market access would be lost post-Brexit is uncertain, but it is likely that Britain would face political obstacles to easily replace its current trade regime

- Recent research has quantified Brexit's impact on the economy, with consistently negative impact (summary of impact studies in **Figure 4**)
- Yet, while the direction of findings is very consistent, the spread of quantifications highlights the speculative nature: we do not know Britain's likely success at replacing its trade regime.
- Realistically, however, Brexit will mean some loss of openness and access – there are two EU-related scenarios worth special mention:
    - Scenario 1: UK follows the Norway-Switzerland precedent. This means near-equivalent access to EU markets, but without a say in the block's governance and rules. A possible, if unfavorable (to the UK) scenario.
    - Scenario 2: The EU makes it harder for the UK to reach an agreement so as to discourage further exit scenarios in other EU countries. The Franco-German alliance has strong incentives for this scenario.
- If forced to choose a scenario, business leaders might reasonably pick a base case where some treaties can be concluded reasonably fast – but the major, now bilateral treaties would take time and run into complications (e.g. President Obama warning the UK would "go to the back of the queue").
- The challenge to rebuild trade agreements is considerable: **Figure 5** highlights the degree of fragmentation of the UK's trade relationships. While the UK would need only 8 bilateral agreements to cover 80% of its exports (one of which would be an EU-agreement representing the 27 members), there is a long tail of 18 additional countries worth more than $1 billion in UK exports, and an additional 132 countries to cover all existing exports (for some of which there would be synergies).
- Further, **Figure 6** highlights the complexity of UK's export portfolio – which drives the complexity of negotiations. The number of products that Britain exports are in line with Germany's or the US', while Switzerland and Norway have a considerably lower complexity.
- Thus it is reasonable to expect lower market access initially, which may be rebuilt over time – yet while the UK rebuilds there would be damage from attrition (e.g. trading partners switching to other suppliers)

3. Business leaders can gauge the broad impact on their firms by looking at the directional change to macro variables that constitute their business environment

- Recent impact studies are not only limited by the political uncertainties of a post-Brexit world, they also offer little sector-specific guidance.
- However, business leaders can meaningfully identify the macro variables that matter most to their companies and their sectors
- Foreign and domestic demand
    - **Export volumes:** Reduced volumes with EU trade partners and 3rd-party partners
    - **Impact dimensions:** a) tariffs b) uncertainty (e.g. arbitration procedures, standards, frameworks and c) administrative costs
    - **Domestic demand:** downshift in line with impact estimates
- Prices
    - **Exchange rate**: the pound would likely fall, both short-term and structurally, given the loss of productivity. However, current rates likely prices in the probability of Brexit

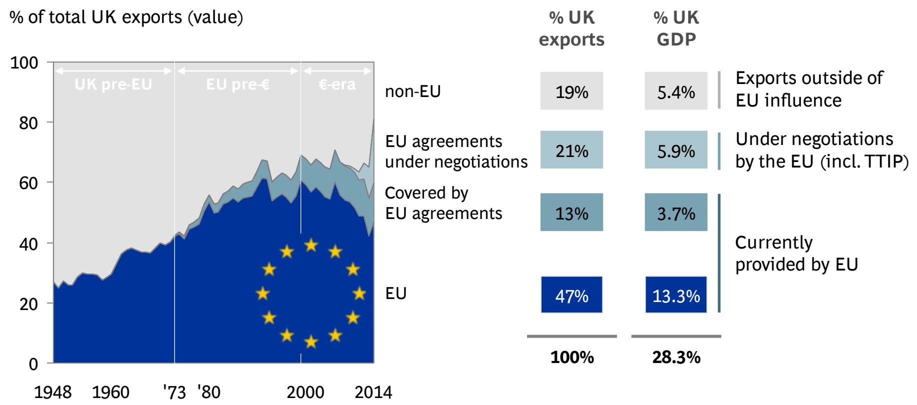
  - **Interest rates**: likely to fall to help absorb the shock. However rates are structurally so low that changes further changes will only be felt by highly rate-sensitive industries
- <u>Business climate/attractiveness</u>
  - **FDI**: would plausibly decline as UK could no longer capture European scale advantages
  - **UK as gateway:** Weakening of HQ value proposition for multinationals operating on the continent
  - **Professional services:** Downstream impact on services catering to UK-based European operations of global business
  - **R&D and subsidies** – Britain captures disproportional share of EU budgets
  - **Other:** Arbitration, standards, regulation etc: non-tariff barriers would go up
- <u>Structural aspects</u>
  - **Economies of scale**: Reduced opportunity to realize scale across European markets
  - **Productivity growth:** Less exposure to competitive pressures and the incremental benefits to productivity growth

Trade research has long highlighted a positive relationship between more openness and economic growth, yet Brexit is an example of an ongoing trend towards less openness in the political processes of the rich world (e.g. US election campaigns). There are, of course, non-economic considerations to the Brexit proposition, but in the context of slowing world growth and trade the proposal seems at least ill-timed. While Britain represents less than 3% of world trade, the broader political repercussions of Brexit would be significant. However, if betting markets are to be believed, the stay-campaign has little to fear: current odds of a Brexit stands at just 25% (**Figure 7**).

Figure 1

60% of UK exports to EU or via EU-sponsored agreements

A further 21% of UK trade is with countries currently negotiating EU agreements, incl. TTIP



Note: Above analysis based on exports of goods; Historical (pre-2014) figures for "EU agreements under negotiations" are high level estimates based on TTIP (started in 2013), EU-India (started in 2007) and other trade agreements under current negotiations; Historical figures for "Covered by EU agreements" are simulated by using linear interpolation between 1973 (UK joining the EU) and 2014; Definition of EU is held constant (EU28) throughout the series
Source: IMF Direction of Trade, Eurostat, European Commission, BCG Center of Macroeconomics analysis

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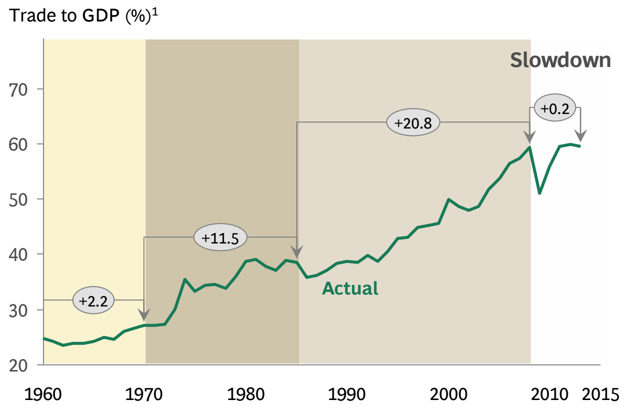
Figure 2

Trade intensity of global growth has slowed

Discontinuity in long-run data



- Trade slowdown not just driven by slow growth
- Controlling for global GDP growth trade discontinuity persists

1. Trade is the sum of exports and imports of goods and services measured as a share of gross domestic product 2. Based on 1960 – 2009 CAGR
Source: World Bank, BCG Center for Macroeconomics analysis

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Figure 3

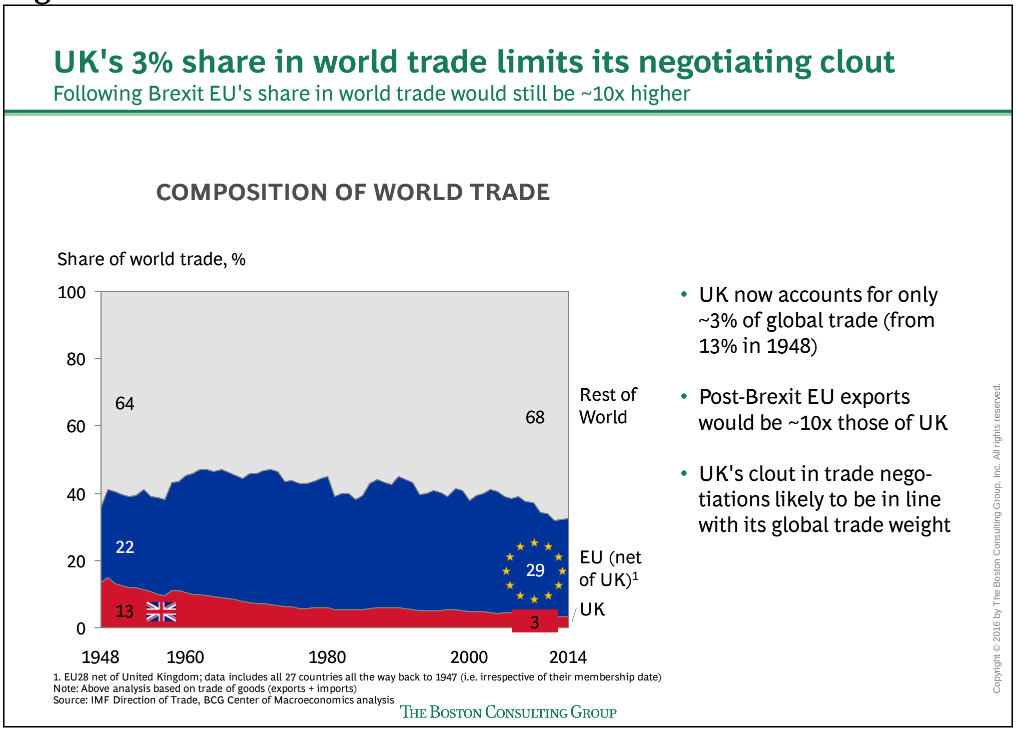


Figure 4

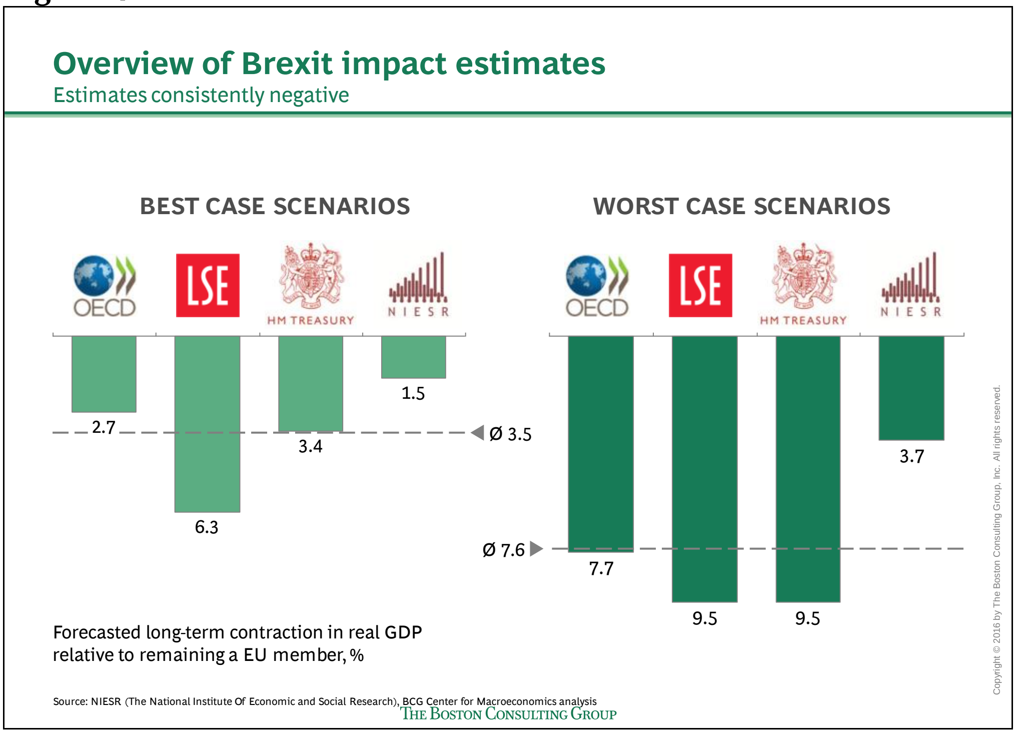


Figure 5

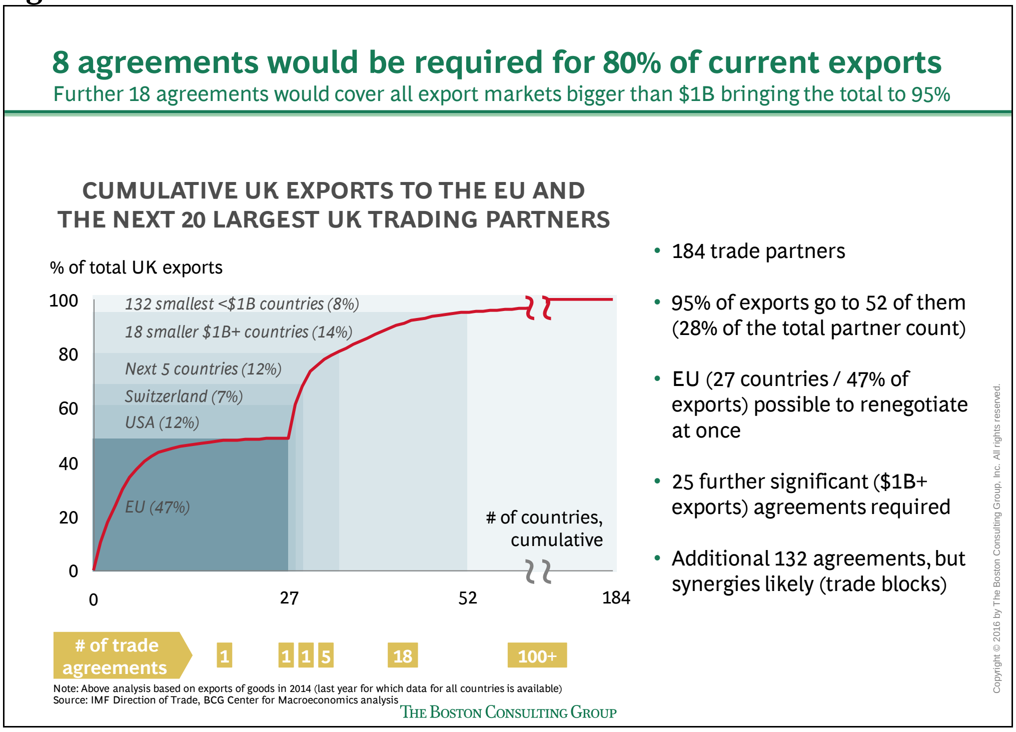


Figure 6

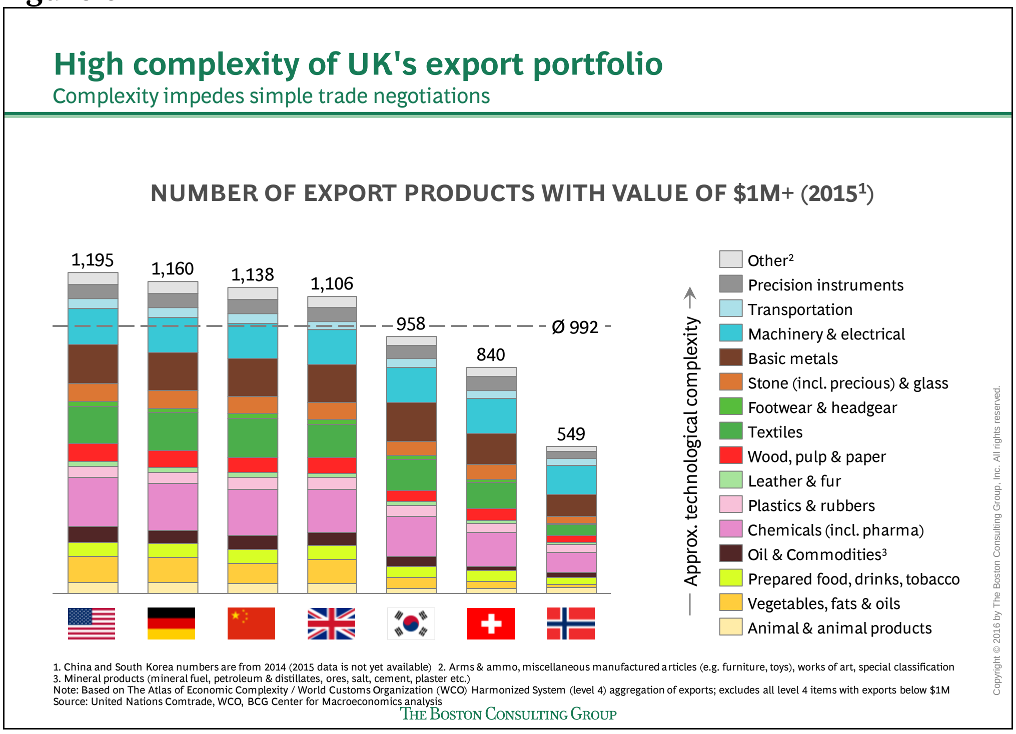
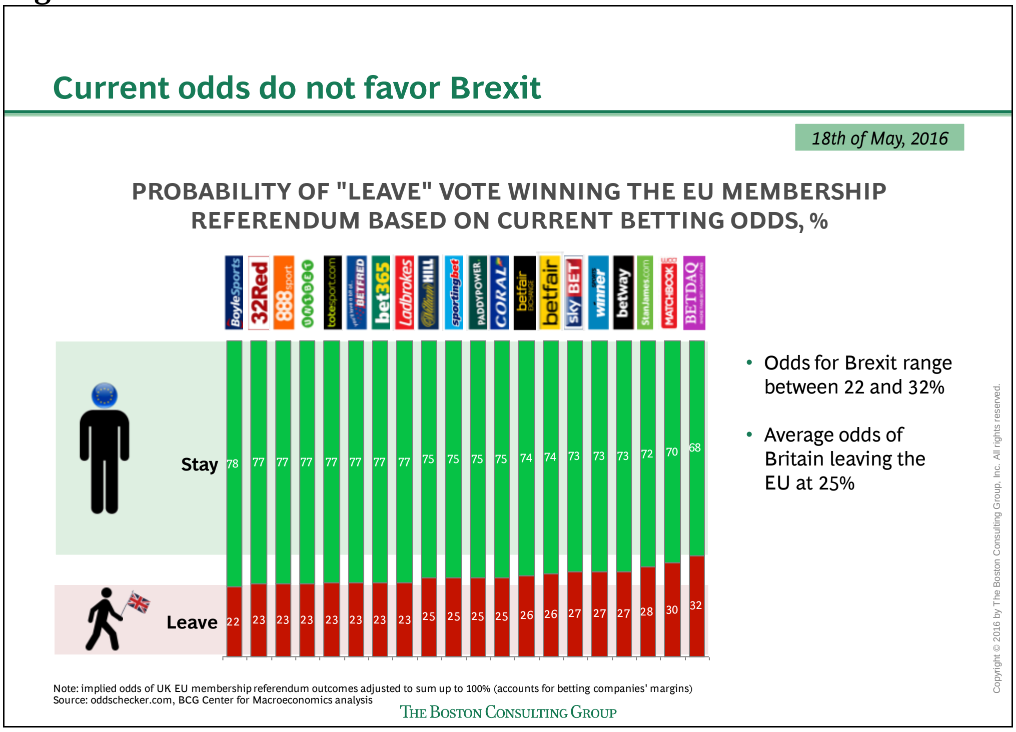


Figure 7


Current odds do not favor Brexit
18th of May, 2016
PROBABILITY OF "LEAVE" VOTE WINNING THE EU MEMBERSHIP REFERENDUM BASED ON CURRENT BETTING ODDS, %
Stay
78 77 77 77 77 77 77 77 75 75 75 75 74 74 73 73 73 72 70 68
Leave
22 23 23 23 23 23 23 23 25 25 25 25 26 26 27 27 27 28 30 32
• Odds for Brexit range between 22 and 32%
• Average odds of Britain leaving the EU at 25%
Note: implied odds of UK EU membership referendum outcomes adjusted to sum up to 100% (accounts for betting companies' margins)
Source: oddschecker.com, BCG Center for Macroeconomics analysis
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