What Kind of Brexit are we Heading Towards? Reflections on the Current State of Play

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In this blog, we review the current state of Brexit negotiations and the likely economic outcomes from each. The overwhelming majority of economic models estimate that Brexit will have a negative long-term impact on GDP, although there is a relatively wide spread of estimates depending on the precise assumptions made and what kind of Brexit actually occurs. Forecasting short-term growth on the basis of these estimates is not really possible: the most likely outcome is a prolonged period where the economy underperforms relative to its previous potential (i.e. positive but low growth). However, there is certainly a risk of a sharper slowdown in the event of a disorderly Brexit.

In other words, whilst medium-term GDP growth will likely be somewhat lower than it otherwise would have been and the probability of a recession has been modestly raised versus a continuation of the pre-referendum status quo, the risk remains low in absolute terms. Nevertheless, given these prognostications, it is unsurprising that GDP growth has slowed since the referendum. According to the latest figures, quarterly growth has averaged 0.4% since the referendum compared with 0.5% in the same period beforehand. There is a strong argument, however for considering Brexit-related economic effects to have begun when the EU Referendum Bill was first announced in the Queen's Speech on 27th May 2015 as investments may have been delayed until companies (and people) knew the results.

Since the announcement over 3 years ago, the UK economy has grown 4.5% (i.e. approximately 1.5% per annum) compared to 6.5% in the 3 years before that (around 2.1% per annum). Given that the global economy (and especially Europe) has enjoyed stronger growth in the later period, this is prima facie evidence of a Brexit-related slowdown. More rigorous academic work has come to the same conclusion[1]. The Bank of England estimates that Brexit has already cost every household in the UK £900.

There remains a strong degree of academic consensus (with a handful of notable exceptions) that a "no-deal" Brexit would significantly worsen long-run prospects for growth in the UK. The leaked impact assessment produced by The Treasury (the UK Government's finance department) suggest that in the case of a "soft" Brexit, in the long-run, annual GDP would be in between 0.6% & 2.6% below what it would have attained in a status quo scenario. As the economy would take some time to move towards this equilibrium and such an arrangement would almost certainly entail a transition period, the possibility of a Brexit-induced recession would be low. In contrast, a "no-deal" Brexit would lead to a reduction in annual GDP of between 5% and 10.3%, according to the same

[1] Born, B, G J Mueller, M Schularick and P Sedlacek (2017), "The Economic Consequences of the Brexit Vote", CEPR Discussion Paper No. 12454.

document. These estimates are in the range of estimates produced by academics, although we cannot rule out the possibility of smaller (or larger) impacts.

With the obvious caveats that these are estimates based on a particular set of modelling assumptions and that this is a long-run equilibrium to which the economy would adjust over several years, there are good reasons to think that a no-deal scenario would entail a significant short-term "shock" that could push the UK into recession. In particular, the reliance of many UK businesses on pan-European supply chains makes them extremely vulnerable to any border controls. The immediate loss of passporting rights for service-sector firms (with no transition period) will also cause contingency planning to be enacted more quickly than it otherwise would, with a likely loss of business in the interim.

A no-deal scenario could have enormous effects were the UK to suddenly leave the European Aviation Safety Agency, European Medicines Agency, European Chemicals Agency and other similar bodies. Cross-border broadcasting (see our blog on this here) would be immediately in jeopardy and the haulage sector would face severe problems as the UK defaulted to pre-EU arrangements (the 1968 Vienna Convention and European Convention of Ministers of Transport). Furthermore, the UK will need to put into place open-skies arrangements with *all* its global counterparts to keep aircraft flying and it will lose access to all those free trade agreements it currently enjoys as an EU member (including with Turkey, Mexico, South Korea and many others). Whilst the prospect of aircraft being grounded remains remote, there is a real possibility of other partners playing hardball (as the example of the US has shown) without the backing of the entire EU behind it. In any event, a sudden "no deal" exit will cause a significant economic shock and would greatly increase the risk of a recession.

Brexit hasn't actually happened yet of course, and thus far many businesses have been waiting for the UK Government to provide "clarity" on their Brexit plans. Ironically, the depreciation in Sterling immediately following the referendum outcome may have helped to boost UK export competitiveness in the short-term. However, the reinvestment plans of companies are now entering a stage where further delays are no longer feasible and plans have to be made now.

Ultimately, though, the political situation in the UK remains febrile and the outcome is thus extremely difficult to predict. It does seem that the UK is heading towards a form of Brexit that would entail lasting economic costs, although how large these are likely to be is highly uncertain. One might also speculate as to how they are spread, although the ongoing support for Brexit in the face of such academic consensus is perhaps indicative of a lack of public trust in economics in particular and academic research more generally. Work by the Centre has also uncovered a belief that the economic costs of Brexit are a price worth paying for some imagined restored "sovereignty". It remains to be seen whether such perceptions by Leave voters continue if the economic costs of Brexit become "real".