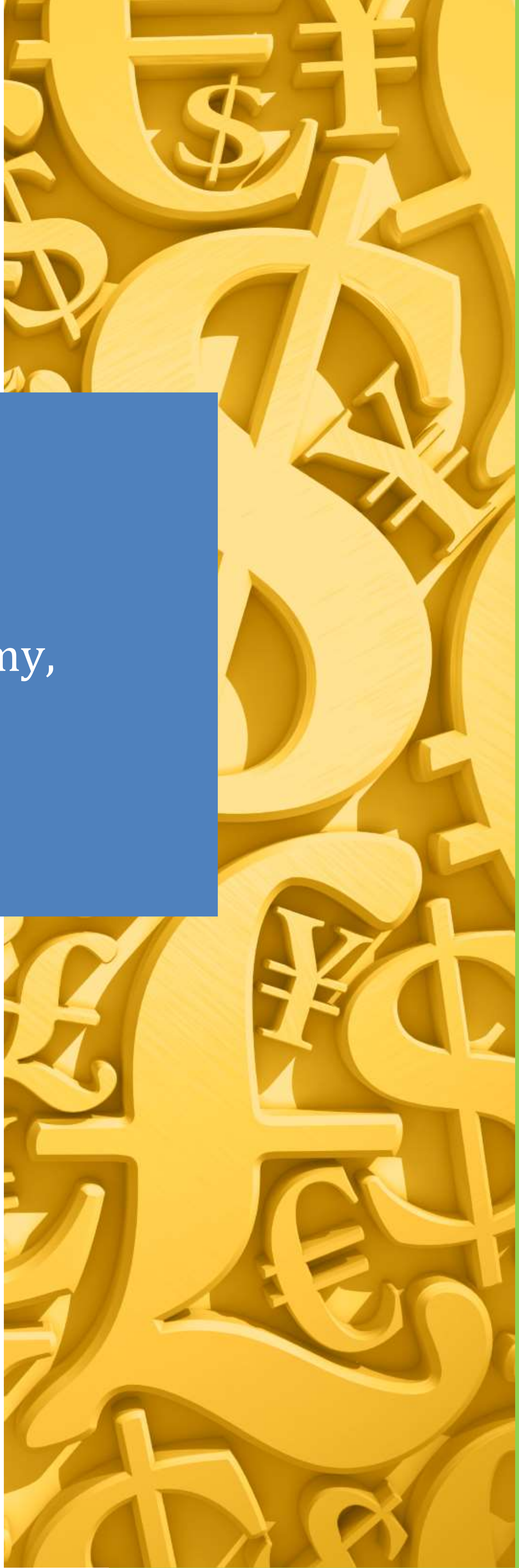
Brexit

Consequences for the British Currency, Economy, and Market

Prepared by: Aleksandar Gjurovikj
(2017/2018)



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Introduction

The BREXIT, or the British exit from the European Union, begun with the UK campaign in 2016 in which the UK general public decided on a referendum question. British, Irish, and commonwealth citizens, over the age of 18, who resided in the UK along with UK citizens living abroad, who have been part of the electoral registration in the UK in the past 15 years, participated at the referendum which took place on June 23rd, 2016. The question was "Should the UK remain a member of the European Union, or leave the European Union?"

During the campaign, but in particular after it, due to the LEAVE result, BREXIT caused tumult in the British economy as it caused uncertainty and raised the political risks. The political risks of this calibre usually cause similar effects in every country in the world. The essay aims to explore the consequences of BREXIT on the British currency, economy and development. It is structured in several sections focused on the short-term, mid-term, and long-term impact on the British currency and economy.

Brexit's Consequences for the UK currency and economy

On June 23rd,2016, the United Kingdom organized a referendum in which two streams of politicians stated their arguments as for why the UK should terminate, or extend its membership in the European Union. The UK citizens in a very narrow victory voted to LEAVE the EU.

According to Mauldin (2016) and Coleman (2016), the most important reasons as to why conservative British politicians wanted to organize this referendum were: the perception of a dysfunctional EU economy, the fear from the loss of British sovereignty to the EU, and the discontent of British voters with the political elitisms of the UK major parties that have endorsed "remaining in the EU. Loss of sovereignty, or the authority of the state to govern itself was a major issue (Coleman 2016), as the British perceived the intensive EU centralization in the past decades as a shift of power from individual member states to the central EU bureaucracy in Brussels.

The post Brexit research on the public opinion, revealed that the propaganda which capitalised on British concerns over immigrants influenced the "LEAVE" decision (Coleman 2016). EU laws provide the right for citizens from one EU country to travel, live, and work in another EU country. In the UK, it resulted into inflows of hundreds of thousands of eastern Europeans, who have immigrated to Britain in order to find a job. The propaganda blamed the immigrants for distorting the UK population structure and that quickly turned people against the EU, instilling them with a desire to leave the Union in a hope that they will be able to regain the sovereignty they lost in the past decades.

After Brexit, the Prime minister, Cameroon (a vivid supporter of the "REMAIN" campaign), resigned, the parliament was dismissed, and new general elections were held. Nine months after the referendum, the new Prime Minister Theresa May, activated the official mechanism which will bring the LEAVE vote to reality – the article 50 of the Lisbon treaty.

Once the process has been triggered, the time frame allowed for Britain to remain in the EU is 2 years. The time is required for negotiating purposes. The period can be exceeded by a unanimous agreement from all EU countries. If there is no agreement reached after the two-year period, Britain automatically leaves the EU and all existing agreements with the member states seize to comply

By voting to LEAVE the EU, however, the British created a political risk, which affected the UK economy at a short, middle, and long term. According to Kegley and Wittkopf (2004) a political risk is defined as an uncertainty about the present and future of the country in terms of its stability and growth.

Short term consequences

In line with Schiller (2008) a short-term time span, in business and economic terms, is defined as a period that lasts from 0 to 12 months after a particular event. In the case of Brexit, the short term consequences on British currency and economy were the following:

1. Depreciation of the pound against all major currencies in particularly the US dollar; and
2. Inflation of prices because of the rise in price of imported products.

A currency is a form of a financial system of money used in a particular country (Kegley and Wittkopf 2004, Schiller 2008). The exchange rate is a concept which determines the price of currency in terms of another. Exchange rates are determined by the supply and demand of currencies at the foreign exchange markets. As any other commodity, money is traded at these markets, while the exchange rate is the price for the money and depends on the global supply and demand. In simple words, the supply and demand curve of currencies, determine the equilibrium price, or the exchange rate. If the demand for the currency increases at the global markets, the exchange rate will appreciate. In the other way around, the currency depreciates, i.e. it becomes cheaper (Schiller 2008).

On June 23rd, 2016 when the British voted to exit the European Union, the political risk associated with the future of the UK resulted in many investors losing interest for the British pound. The drop in the demand for the GBP caused an immediate 15% depreciation of the currency against all three major global currencies: the US dollar (Figure 1), EUR (Figure 3) and the Japanese YEN (Figure 2). The GBP experienced a similar decline against the EUR in 2009, after the 2007-2008 global financial crisis started in the US; however, following the Brexit vote, it reached a 31-year low against the USD and the YEN.

Figure 1 GBP/USD Exchange rate

Figure 2GBP/JPY Exchange rate

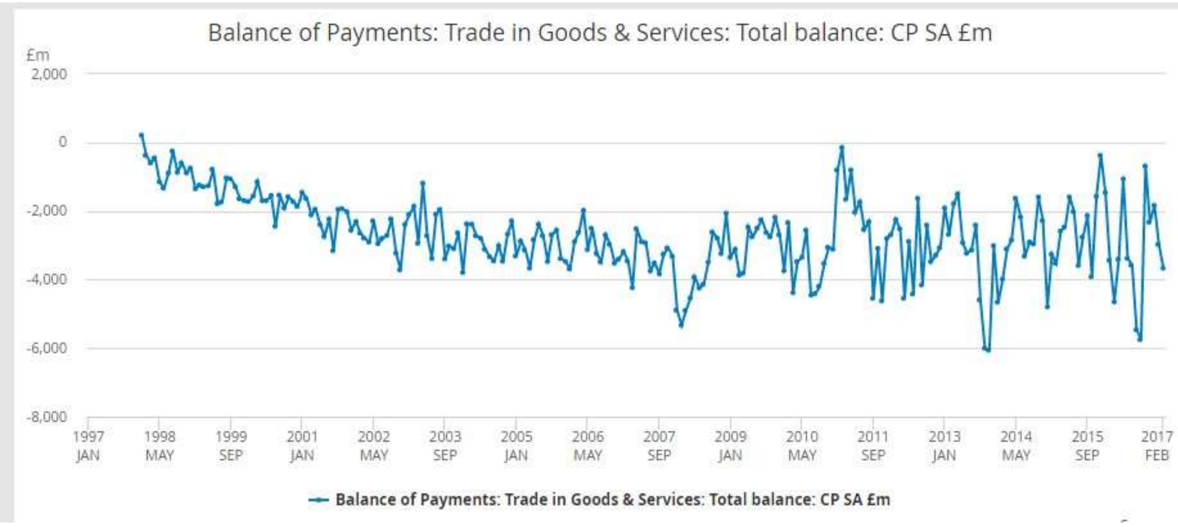
Figure 3 GBP/EUR Exchange rate

Source: Bloomberg (2017)

Exchange rate fluctuations affect the prices of goods and services produced in a given country by making them cheaper, or more expensive, than the products of other countries (Schiller 2008). In the case of the United Kingdom when the price of the British pound dropped, imports became more expensive. In economic terms, imports are defined as the sum of goods brought into one country from another. It is one of the basic elements of international trade along with exports. In simple words, countries have limited resources and they cannot produce everything they need, which is why they import, or buy goods they need and export, or sell, the surplus they produce. In economic terms, the exchange is named balance of payments, and is the monetary difference between exports and imports (Kegley and Wittkopf 2004, Schiller 2008).

Data indicate that since 1998, the UK economy has been in persistent deficit because of the balance of payment (the monetary difference between exports and imports) was constantly below zero (Figure 4). It implies that the UK has been importing more goods and services than exporting the same things. Figure 5 provides a detailed breakdown of the Current Account Balance by two specific industry categories: non-manufacturing goods and services and manufactured goods. From the graph it can be inferred that non-manufacturing goods and services dominate the creation of value through imports, in comparison to the manufacturing goods, which are in constant decline in the UK since the 1950's.

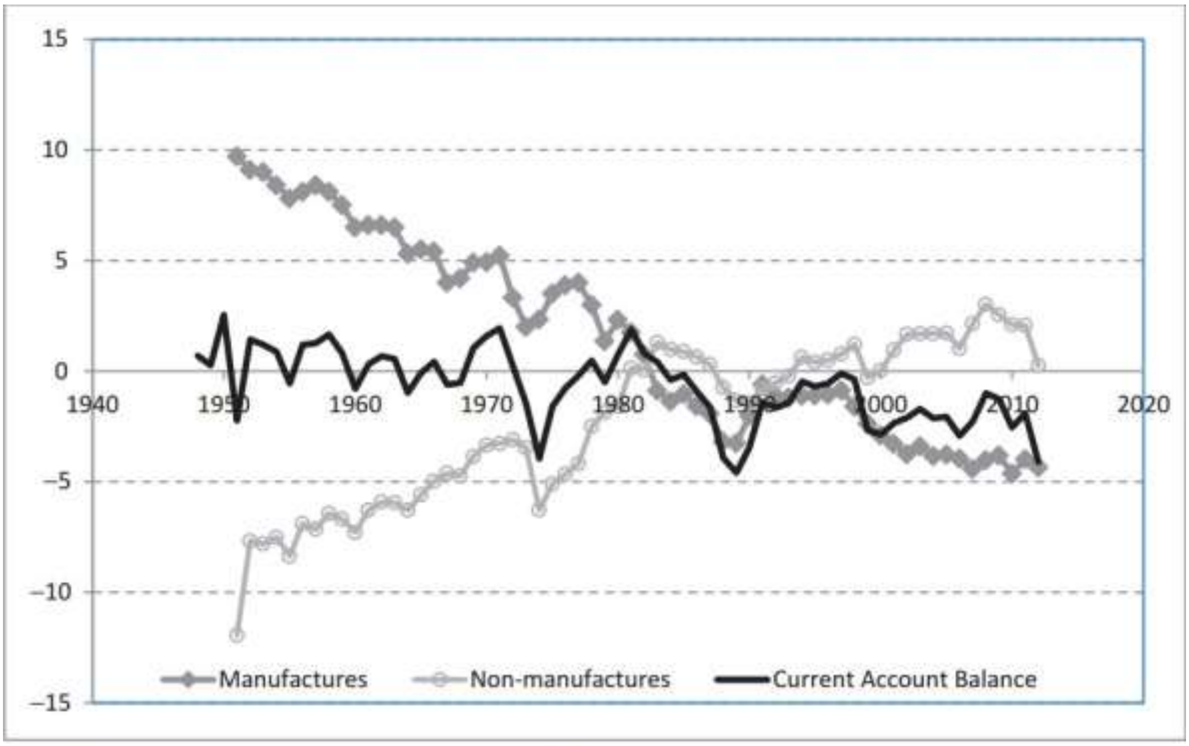
Figure 4 Balance of Payment: Trade in goods and services



Source: UK Office of national Statistics (2017a)

Food, beverages, clothing, and all other commodity goods and services, including travel, are in deficit i.e. the UK imports more than it exports. Therefore, the depreciation of the British pound made the import of these products and services more expensive for UK citizens and residents. In economic terms, the consumer prices increased i.e. UK had a higher inflation, or higher consumer price index (the index which measures the consumer prices).

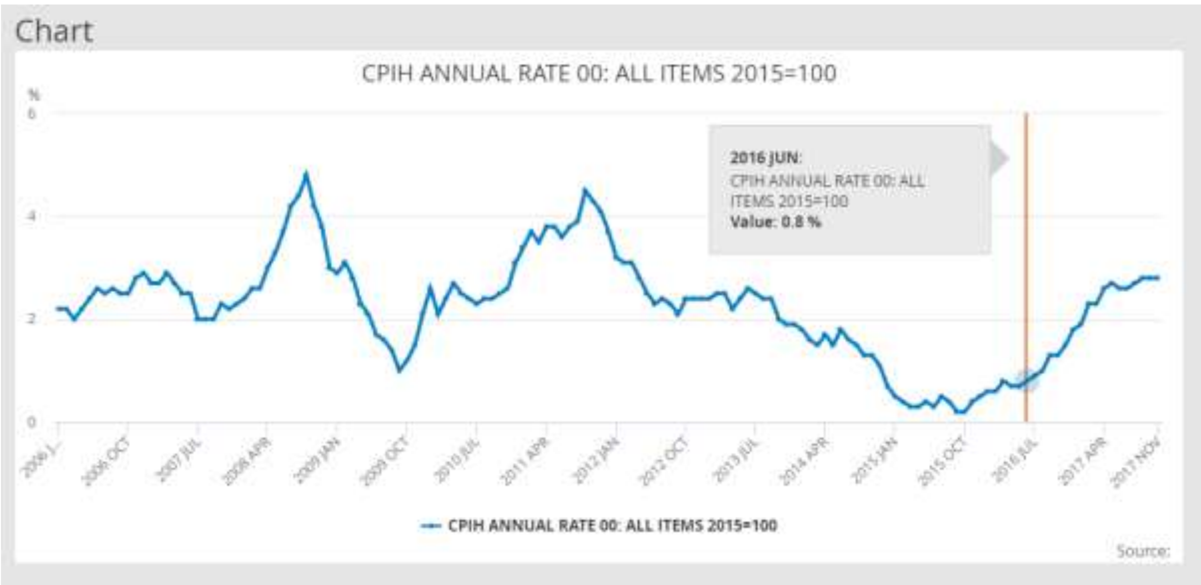
Figure 5.Current Account Balance



Notes: The figures for 2012 are estimates based on the first three quarters.
Sources: Rowthorn and Wells (1987), ONS (2012, 2013).

Data supports this argument. As one can see from Figure 6, since the BREXIT, which occurred on June 23rd, 2016, the inflation in the UK has risen from 0.8 to 2.3 %. In simple words, the political risk caused by the UK's choice to leave the European Union resulted in a short-term worsening of the UK's economic performance.

Figure 6 Annual inflation rate



Source: UK Office of national Statistics (2017b)

Mid-term consequences

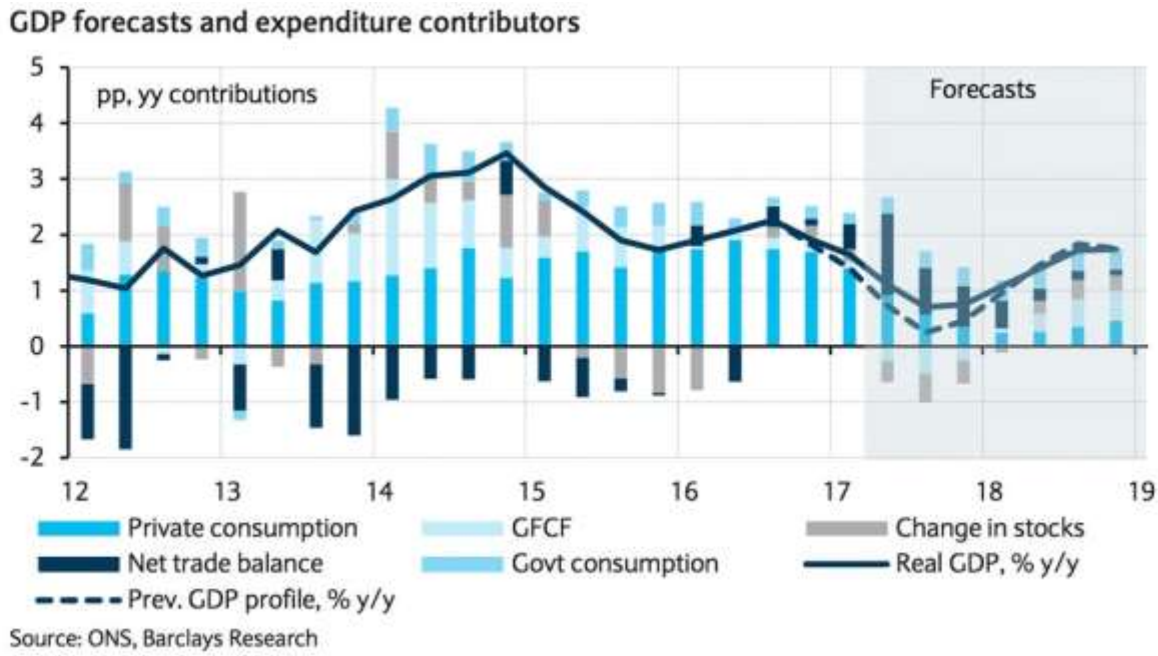
In business and economy, a mid-term time span defines a period that lasts from 1 to 3 years after the occurrence of a particular event. In the case of Brexit, the mid-term consequences are the following:

1. Decrease in GDP (Gross domestic product);
2. Further Depreciation of the pound against all major currencies; and
3. Inflation of prices because of the increase in price of imported products.

The GDP, or the gross domestic product, is defined as the currency value of all final goods, services and structures produced within a country's borders in a 12 month period. After the BREXIT, the political risk holds a strong potential for causing a decline in the UK's GDP value. Analysts support this assertion (Figure 7) (Fichtner et.al. 2016).

The depreciation of a currency usually positively influences GDP growth because of the increase in demand for the products and services of the country outside of its borders. It causes increase in exports and higher production of goods and services directly influencing the growth of GDP. However, in the case of the UK the situation is different. The structure of UK export is dominantly consisted of non-manufacturing goods and services, where the demand is not affected by the value of the currency as argued by Coutts and Rowthorn (2013). A good example of these services are the financial services, for which the demand will not increase, if the British pound depreciates, as the demand for these services proved to be generally inelastic in the past (Miethe and Pothier 2016). However, as Fichtner et.al. (2016) argue the fact that Britain is leaving the single EU market creates further uncertainty about the mid-term demand for UK products and services (financial included), which could cause decline in demand. This decline negatively affects further UK's GDP growth. According to the projections of Barclays, presented in Figure 7, there will be a decline in the GDP growth in the next 1 - 3 years.

Figure 7 GDP Growth and projections



The decline in the GDP growth will cause further depreciation of the British pound because usually when the country has slow economic growth and prospects, its currency is not attractive for investors. The further depreciation of the pound will lead to increase in inflation due to the same reasons as explained in the short-term impact (Kegley and Wittkopf 2004, Schiller 2008).

Long-term consequences

In the business and economy, a long-term time span defines a period that lasts from 3 to 5 years after the occurrence of a particular event. In line with the principles of the economic theory, in the case of Brexit, the long-term consequences are the following:

1. Low potential for GDP stabilization and significant growth (at least above 1%); and
2. Low potential for appreciation of the currency;

The British economy in the next 3-5 years will have a low potential for GDP growth along with a low potential for appreciation of its currency. The high political risks persist, as it is unclear how the Brexit will be implemented. The same results into caution among the domestic and international investors. For example the primary sectors as construction already saw a large decline in Investor's projects. The same is expected in all industry sectors, with a major risk of losing the global foothold in the financial industry if it moves in the EU. The situation could last despite government measures to fight it, as the political risks and uncertainty are still high and persist, until a clearer picture emerges on how a post-Brexit UK will look like, (Wielechowski and Czech 2016).

Conclusion

The United Kingdom referendum decision to leave the European Union on June 23rd, 2016 resulted into serious short-term and mid-term economic consequences. BREIXT had an immediate effect on the British pound which depreciated for 15 % against other global currencies. The pound was less desired by investors throughout the world because of the uncertainty of the British political future. The depreciation caused immediate inflation raising consumer prices, while it did not have a positive impact on British exports due to the dominance of non-manufacturing services in the export structure. Not only did the demand for British services not grow despite the cheaper pound, it even declined further as the political risks associated with the loss of the privileged access to the EU Single market, caused a decrease in demand for British products and services causing a decline in GDP growth. As Brexit has yet to happen and there are many "ifs", it is difficult to predict its impact on the British pound and economy on a long term base.

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