THE ANALYSIS OF THE ECONOMIC IMPACT OF BREXIT ON THE EUROPEAN UNION

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Abstract

The European Union has been considered over time a guarantor of the regional stability and prosperity, being also recognized as one of the most influential player in the global economic arena. However, the European Union has recently faced significant political and economic challenges, such as the migration and refugee crisis, the United Kingdom's withdrawal, the increasing power of Russia and the enhancement of the terrorist threat. The purpose of this paper is to present the economic consequences of the United Kingdom's withdrawal from the European Union, a decision that represents a turning point in the history of over half a century of the regional group. In this regard, the study encompasses the critical review of the literature on this topic and the analysis of the relevant statistical data. The perspectives of theoreticians are extensive and sometimes diverging. While some analysts believe that Brexit will undermine the European integration project, others consider that the effects will be manageable by the remaining 27 Member States. Analyzing the statistical data on GDP, stocks of FDI, trade in goods and services, we have revealed that the United Kingdom plays an important role in shaping the economic power of the European bloc. Consequently, with the completion of Brexit, it is likely that the economic power of the European Union will diminish, particularly in terms of GDP and trade in goods and services.

Keyword: European Union, Brexit, economic power, international trade
JEL Classification: F15, F50

I. Introduction

Over the last decades, reputed theoreticians and policy makers have manifested their admiration towards the European integration process, defining it as a success story and a fundamental pillar of the regional stability and prosperity. However, the European Union (EU) has recently faced significant political and economic pressures, such as the slow economic growth, the persistence of high levels of unemployment in

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many Member States and the expansion of the populist political parties that share Eurosceptic views. According to Archick (2016), the most significant challenges facing the community bloc are: the migration and refugee crisis, the withdrawal of the United Kingdom, the increasing power of Russia and the pronounced terrorist threat. In the view of another analyst (Sampson, 2017, p. 163), the period following the Second World War was characterized by the expansion of the global economic and cultural globalization and the establishment of the economic and political integration within the European continent. In this context, Brexit can be regarded as a deviation from the regional integration project, calling into question the future stability of the European bloc and the implacability of the globalization process.

As a result of the referendum organized by the British government on 23 June 2016, the electorate decided with 51.9% of votes the withdrawal of the United Kingdom from the EU. The legal basis for the withdrawal from the EU is represented by the Article 50 of the Treaty on European Union, which states that the EU and the British Government have two years to reach an agreement. After the end of this period, the United Kingdom will lose its EU membership, even if the agreement will not be concluded, unless the Member States will unanimously decide to extend the negotiations. On 29 March 2017, Britain formally presented its intention to leave the EU, triggering negotiations to reach an agreement. This agreement will determine the framework for the withdrawal of the United Kingdom and will be negotiated on the basis of the guidance provided by the European Council and in accordance with the negotiating directives adopted by the Council of the EU (Council of the European Union, 2017).

II. Theoretical and empirical approaches on the consequences of Brexit

The literature that brings to the forefront the topic of Brexit is vast and contains heterogeneous views regarding the potential economic consequences and the framework that will govern the future relations between the two parties involved. Some experts argue that Britain’s decision to withdraw from the EU could undermine the European integration project, determining other Member States to demand preferential conditions or to be excluded from certain policies coordinated by the supranational institutions. At the same time, Brexit may lead to a long period of uncertainty, division and introspection at Community level, particularly during the transition period, when the two parties try to establish the terms of divorce (Taylor, 2016). Taking into consideration the United Kingdom’s influence on foreign and defense policy, Brexit might diminish the role of the EU as a global actor. In contrast, other analysts suggest that Brexit could shape a stronger European bloc, being able to pursue a deeper integration without Britain's opposition (Archick, 2016, p. 12).

Other analysts (Pisani-Ferry et al., 2016, pp. 1-2) consider that the equilibrium of economic and geopolitical power could change significantly in the following period, the supremacy being obtained by states with vast population and strong economies. In this new landscape, it is uncertain whether Germany, France and the United Kingdom, influential states within the European continent, will be included in the category of major winners. Moreover, the EU will have to manage Britain’s divorce so that this process does not significantly affect the Member States at a time when they already face major challenges in terms of security, migration and well-being of citizens. In the view of Pisani-Ferry et al., the situation is worrying for the stability of the continent, taking into consideration the existing interdependencies between neighboring states, the experts recalling that United Kingdom can leave the EU but cannot relocate from the European continent.

The decision of the British electorate to leave the EU will have a notable impact on the two parties involved, the economic effects deriving mainly from the obstruction of the trade flows and labor movement and the reconfiguration of the investment patterns (Lawless and Morgenroth, 2016). Pisani-Ferry et al. (2016, p. 1) argued that there are strong interdependencies between the EU and United Kingdom, so that the prospects for the two economies to be independent in a predictable time horizon are minor. Furthermore, the analysts consider that one of the biggest economic uncertainties for the United Kingdom derives from the prospects and prosperity of the Eurozone. At the same time, the successful completion of the reform process initiated at Community level is essential for the future of the EU, regardless of the course of Brexit.

In the near future, the EU should create reforms leading to growth and job creation, and in particular to provide a more solid foundation for the euro area (Pisani-Ferry et al., 2016, pp. 2-3). Consequently, a result that would isolate the United Kingdom and diminish the incentives to reform the EU architecture would not be in the interest of any of the parties in the long run. From analysts' perspective, issues regarding the euro area reform and the future framework that will govern the relations between the two sides are deeply interconnected. Pisani-Ferry et al. (2012) pointed out that enhancing the integration of the euro area, for example by creating the banking union, have called into question the future relationship between the two sides before the referendum. Similarly, Sapir and Wolff (2016) pointed out that even if the British electorate voted in favor of maintaining the EU, the United Kingdom would have to define its relationship with a reformed euro area.

At the moment, reputed institutions and experts around the world are conducting quantitative studies to assess the Brexit's economic impact on the two parties involved. In this regard, Emerson et al. (2017, p. 8) have shown that both sides will record economic losses, but they will be disproportionately shared to the benefit of the European bloc. According to the experts, the losses recorded by the EU will be 10-15 times smaller than those of the United Kingdom, taking into account the 1 to 5 ratio between the United Kingdom's GDP and the EU's overall GDP. From the perspective of Emerson et al., the losses will be minor for the European group, ranging from 0.11% (for optimistic scenarios) to 0.52% of GDP (for pessimistic scenarios). Given that these amounts are calculated as aggregate values until 2030, the annual average could range from 0.01% to 0.05% of GDP. For the United Kingdom, losses would vary between 1.31% and 4.21% of GDP by 2030, depending on the Brexit scenario. However, econometric models that include the impact on foreign direct investment (FDI) reveal that potential United Kingdom losses could reach 7.5% of GDP by 2030.

Sampson (2017, p. 129) has empirically proven that Member States will register a decline of trade flows conducted with the United Kingdom after the completion of Brexit. However, with the exception of Ireland, EU losses will be smaller than those of the United Kingdom. According to Sampson, in a favorable situation, Brexit will lead to a decrease in consumption by 0.14% per capita in the EU. From a pessimistic perspective, the percentage will reach 0.35%. At the same time, it is noteworthy that the third countries may benefit from the United Kingdom’s withdrawal from the EU due to the effects related to trade distortion, but the quantitative effects will be negligible compared to the losses that will affect the two parties involved. However, Roja-Romagosa (2016, pp. 9-10) has demonstrated through empirical research that the decrease of the EU’s exports to the United Kingdom will vary between 1.7% (if will be concluded a free trade agreement between the two parties) and 3% (for WTO scenario). In contrast, for the United Kingdom, exports will fall by 21.8% or 12.5% depending on the scenario.

Lawless and Morgenroth (2016) analyzed the potential consequences of Brexit if the two parts will not reach an agreement. In this situation, the United Kingdom will no longer be included in the single market and the trade relations between the two sides would be governed by the existing multilateral rules. In this respect, Lawless and Morgenroth analyzed the EU’s common customs tariff, pointing out that after the United Kingdom's withdrawal, goods traded between the two parties would be subject to customs duties ranging between 2%-11%. Price increases induced by customs duties would determine a decrease in exports to the United Kingdom with 30%, resulting a decline of 2% in the share held by the European bloc in the world trade. According to the calculations made by the two analysts, Ireland and Belgium would be the most affected Member States, registering a reduction of 4% and respectively 3.1% in total exports. In contrast, the customs duties would have a minor effect on other countries such as Estonia and Finland, which would register a decrease of 0.3% in trade flows. In contrast, United Kingdom’s exports to the EU would decrease with 22%. Taking into consideration that this reduction would apply to the trade flows conducted with each Member State, the effect on the United Kingdom would be greater than that recorded by the EU.

The free movement of goods and services is complemented by the free movement of capital, which represents a constitutive freedom of the internal market. The free movement of capital guarantees the free access of FDI at Community level, so that companies from the United Kingdom can invest in the other Member States without any restriction. This prerogative is crucial for the United Kingdom’s financial sector as financial and insurance activities accounted 7.9% of gross value added in 2014. The United Kingdom is one of the most important destinations for investors from third countries who perceive this country as a bridge to the Continental Europe (Busch et al., 2016, pp. 14-15). On average, the United Kingdom capital market is almost twice more developed relative to GDP in comparison with other European countries. Also, the shares held by the United Kingdom in the sectors that compose the capital market range between 25% and 75% (Wright, 2016, p. 4).

From the perspective of Wright (2016, p. 4), United Kingdom has contributed to the consolidation of the EU's economic power by imposing itself as the most important financial center on the continent. The prerogative to provide financial services across the EU is stipulated in a multitude of directives and regulations covering banking, investment and insurance and financial infrastructure. In accordance with the rights conferred by the single passport, a European financial institution that has been authorized by the national authority has the right to establish branches or to provide services in any EEA Member State without the need to obtain additional authorizations or licenses. According to estimates, more than three-quarters of EU companies using passports rights based on MiFID are located in the United Kingdom. Recently, the European authorities have made significant efforts in order to stabilize and reform the financial markets by completing the regulatory gaps and strengthening the financial supervision. As a result, the regulatory environment has become more complex, also extending its scope (European Parliament, 2017).

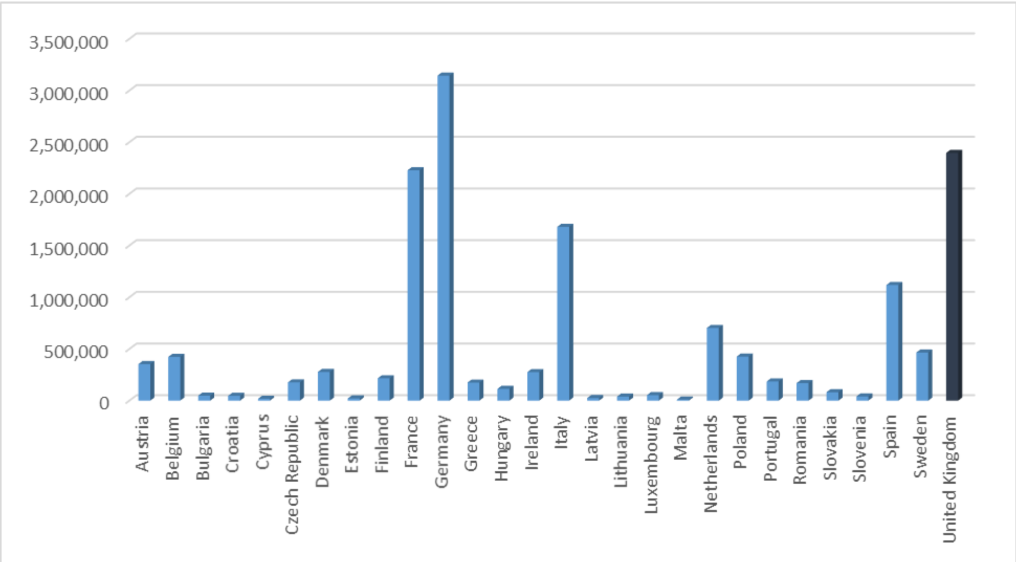
III. Will Brexit erode the economic power of the European Union?

GDP

The statistical data provided by Eurostat illustrates that the aggregate GDP of the European group reached € 14,908.8 billion in 2016. The Member State that contributed the most to the consolidation of the EU's economic power was Germany, which registered a GDP of € 3,144,050 million, representing 21.1% of the overall GDP. In the ranking follows the United Kingdom, the indicator under review reaching € 2,395,801 million, which corresponded to a percentage of 16.1% in the EU's total GDP. Figure 1 highlights that other countries that recorded significant amounts in 2016 were France (€ 2,228,857 million), Italy (€ 1,680,948.1 million) and Spain (€ 1,118,522 million). The Member States with the lowest values for this indicator, contributing less than 0.3% to the GDP of the European bloc were Lithuania, Latvia, Estonia, Cyprus and Malta.

Figure 1

GDP recorded by the Member States of the EU in 2016 (million euro - current prices)



Author's processing based on data provided by Eurostat

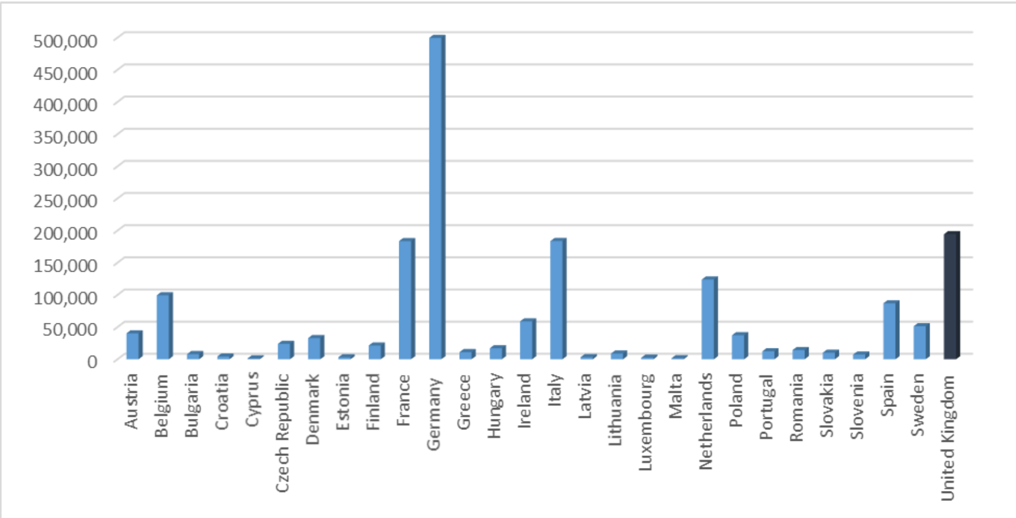
Overall, taking into consideration the significant share of the United Kingdom in overall GDP (16.1%), it is likely that the EU's economic power will partly be eroded with the completion of Brexit. Consequently, in the short term, it will be difficult for the EU to regain its leadership position held until 2014 and to surpass the United States of America. At the same time, in the long run, the EU will have to define a strategy that will ensure strong economic growth on the background of the threat posed by the emerging economies from the Asian continent.

Trade dimension

Figure 2 highlights the value of the exports registered by the Member States of the EU in 2016. It is noteworthy that Germany held the supremacy, exporting goods that amounted € 499,720.2 million, which corresponded to a percentage 28.9% of total exports registered by the European bloc. The second position was occupied by the United Kingdom, which provided goods to third countries which valued € 194,458.8 million, representing a share of 11.1% in total. In the ranking follows Italy (€ 183,856 million) and France (€ 183,766.7 million), both countries having a share of 10.5% in the overall exports of the EU. Other European countries that exported goods above the value of € 50,000 million in 2016 were the Netherlands, Belgium, Spain, Ireland and Sweden.

Figure 2

Exports of goods of the Member States of the EU in 2016 (million euro)



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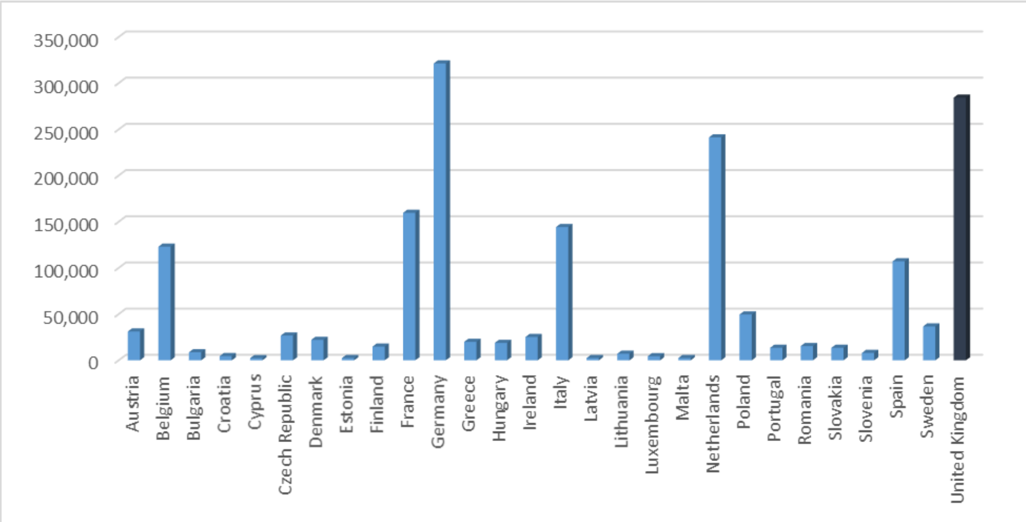
As far as the imports registered by Member States are concerned, Figure 3 shows that Germany held the leading position, registering an amount of € 321,416.5 million, which corresponded to a share of 18.8% of the total exports. The United Kingdom also imported goods representing € 284,349.5 million, respectively a percentage of 16.6% in the total imports recorded at EU level. Other important trade actors taking into consideration the value of imports of goods were the Netherlands (€ 241,360.6 million), France (€ 159,664.6 million), Italy (€ 144,288.8 million), Belgium (€ 123,075.8 million) and Spain (€ 107,177.5 million).

Figure 3

Imports of goods of the Member States of the EU in 2016 (million euro)



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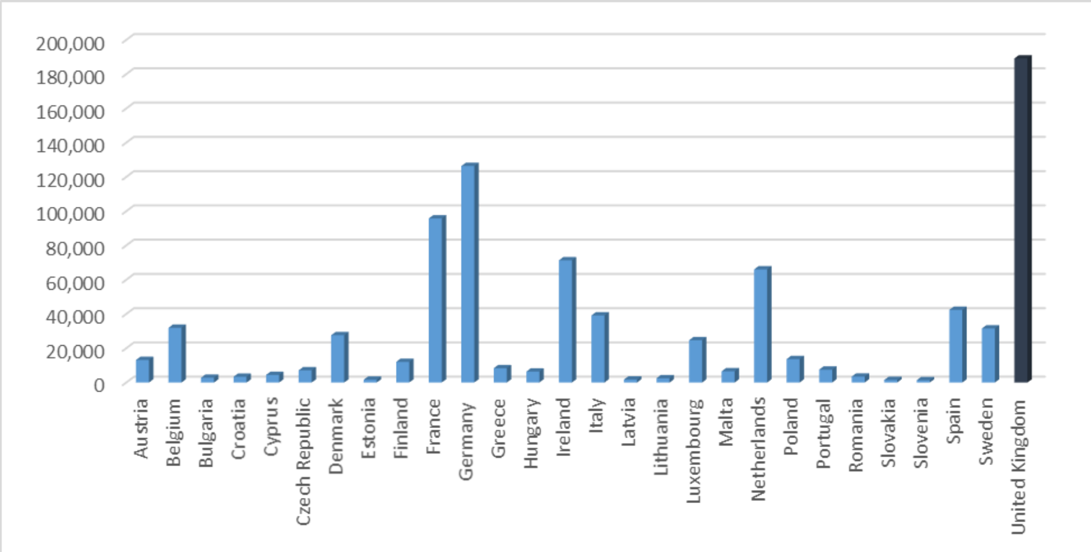
Trade in services contributes significantly to the economic power of the EU, amounting € 1,556,734.9 million in 2016. According to Eurostat, the exports of services of the EU's Member States amounted € 844,894 million. Figure 4 highlights that the United Kingdom held the supremacy in terms of exports of services, the value registered in 2016 amounting € 189,191.9 million. Germany ranked second, with trade flows in services totalizing € 126,410 million. Other countries contributing to the strengthening of the EU's trade power were France (€ 95,775 million), Ireland (€ 71,326 million) and the Netherlands (€ 66,069.2 million).

Figure 4

Exports of services of the Member States of the EU in 2016 (million euro)

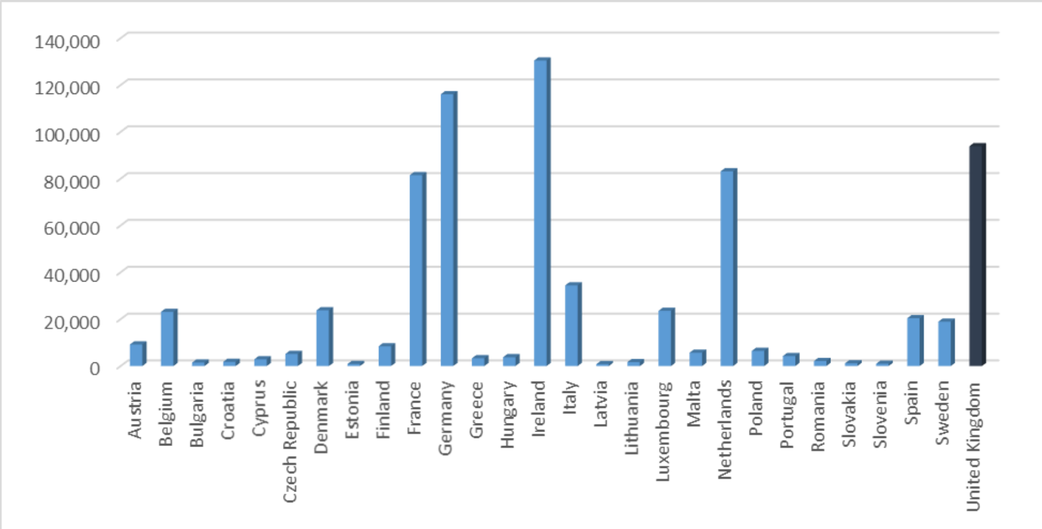


Author's processing based on data provided by Eurostat

The data provided by Eurostat reveals that the EU's imports of services reached the value of € 711,840.8 million. The most important importer was Ireland, with trade flows reaching the amount of € 130,469 million in 2016, being followed by Germany with € 116,086 million. In the ranking follows United Kingdom, which imported services totalizing € 93,864.4 million. Consequently, it is noteworthy that the United Kingdom is an important player in terms of trade of services, being a net exporter (the trade balance of services recorded in 2016 was € 95,327.5 million, representing the highest value at EU level). Other Member States which recorded important values in terms of imports were the Netherlands (€ 83,152.9 million) and France (€ 81,515 million)

Figure 5

Imports of services of the Member States of the EU in 2016 (million euro)



Author's processing based on data provided by Eurostat

Gros (2016) highlighted that the economy of the United Kingdom has undergone structural changes over the last decades, which emphasized the role of the tertiary sector. In the mid-1990s, the exports of goods were three times greater than the exports of services and the main trading partners were the other Member States of the EU. Nowadays, the United Kingdom trades a significant volume of services with the third states, the exports reaching € 189,191.9 million and imports € 93,864.4 million in 2016 (Eurostat). According to the information provided by Trade Map, the main services exported by the United Kingdom are other business services, financial services and tourism, transport, telecommunication, information and information services. The main importers of services provided by the United Kingdom in 2016 were the EU (€ 108,909.6 million), United States of America (€ 74,029.3 million), Switzerland (€ 16,130.4 million) and Japan (€ 7,896.9 million).

The main suppliers of services for the United Kingdom were the other Member States of the EU (€ 93.864.4 million), the United States of America (€ 34.079.2 million), Switzerland (€ 4,800.8 million) and Japan (€ 3,448.6 million) in 2016. It is noteworthy that the United Kingdom imports roughly the same categories of services it exports such as: tourism, other business services, transport, financial services, telecommunications, IT and information services. As far as the intra-EU exports of services are concerned, they reached the value of € 110,273.6 million in 2016, while the intra-EU imports € 92,873.5 million.

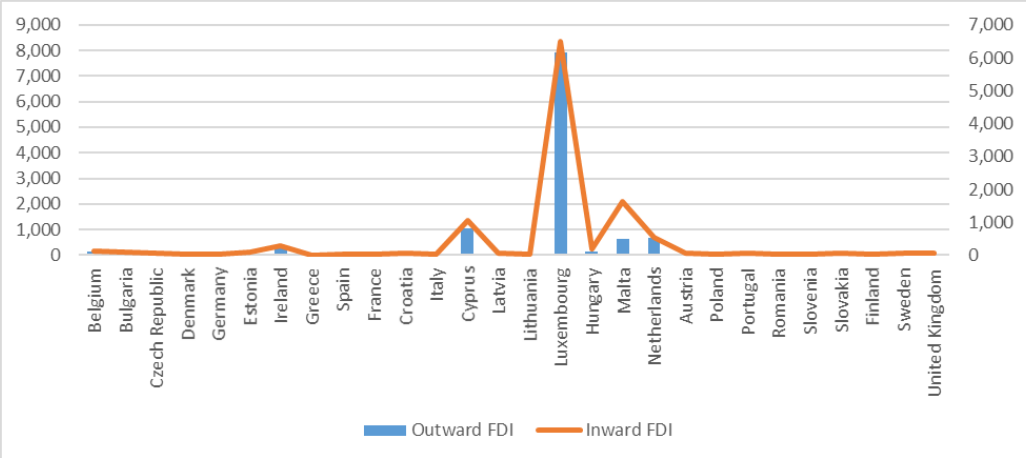
In conclusion, the United Kingdom has a major contribution in strengthening the trade power of the European group. In 2016, the British state ranked second in terms of exports and imports of goods, holding the supremacy in terms of exports of services. Taking into consideration these aspects, the EU's dominant position held at the moment in the trade area could deteriorate once the United Kingdom will no longer be a Member State. At the same time, the other Member States are unlikely to be able to offset the losses stemming from the withdrawal of the United Kingdom, which could reach an annual amount of € 500,000 million in the case of goods and € 300,000 million in services.

Investment dimension

Figure 6 highlights the outward and inward FDI stocks registered by the Member States in 2016. Referring to the outward FDI stocks, the supremacy was held by Luxembourg, which recorded a significantly higher value than the other countries, namely 7,909.6% of GDP. Cyprus ranked second, holding a significant FDI stock, totalizing 1,029.4% of GDP. The United Kingdom ranked 11th in the EU in terms of outward stock, reaching a percentage of 57.1% of GDP. As far as the inward FDI stocks are concerned, the countries with the largest shares were Luxembourg (6,504.4%) Malta (1,622.9%) and Cyprus (1,047.8%). The United Kingdom held a share of 55.1% GDP in terms of inward stock, a percentage that placed it at the middle of the ranking. Overall, the withdrawal of the United Kingdom from the EU will not have a significant impact on the outward and inward FDI stocks held by the European group. Consequently, the Member States with significant FDI stocks, such as Luxembourg, Cyprus, Malta, could offset the costs resulting from Brexit.

Figure 6

Outward and inward FDI stocks of the Member States of the EU in 2016 (% of GDP)



Author's processing based on data provided by Eurostat

Overall, United Kingdom, in its capacity of Member State, has significantly contributed to the consolidation of the economic power of the EU. According to the statistical data, the United Kingdom has a dominant position both in terms of GDP and in the area of trade of goods and services. Consequently, it is likely that the influence of the EU will diminish after the United Kingdom will no longer be a Member State, this fact being emphasized by the global shifts, notably the increasing economic power of the Asian economies.

IV. Conclusion

In conclusion, the main purpose of this paper was to analyze the economic consequences of Brexit on the EU. The perspectives existing in the literature are vast and sometimes contradictory. On the one hand, some theoreticians define Brexit as a deviation from the regional integration project, which could lead to a long period of uncertainty and division at the community level, also diminishing the economic power of the European Union. On the other hand, there are voices who claim that this event can lead to the consolidation of the European project, in the absence of the opposition stemming from the United Kingdom. The paper suggests that the challenges that are emerging towards the regional bloc, mainly the withdrawal of the United Kingdom, are threatening the economic power currently held by the EU.

The economic interdependencies between the United Kingdom and the EU, as well as the interest of the United Kingdom to preserve certain advantages, mainly in the area of financial services, are evidences that the two parties will reach an agreement until 30 March 2019. Finally, although the overall losses registered by the European group could be quantified after all the terms of withdrawal have been established, this paper suggests that the economic power of the EU could be eroded with the completion of Brexit.

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