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Possible Economic Impact of Brexit

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In a June 23, 2016 referendum, a majority of British voters supported the United Kingdom (UK) leaving the European Union (EU), stunning global financial markets that expected the vote to fail (see CRS Insight IN10513, *United Kingdom Votes to Leave the European Union*). In the immediate aftermath:

- Some equity markets fell by as much as 7% in value (the Dow Jones industrial average fell by 600 points, or 3.5%), erasing nearly $3 trillion in equity value.
- The British pound depreciated against other major currencies by its largest amount in one day; the U.S. dollar, the yen, and other currencies appreciated sharply.
- Some London-based American, European, and other foreign banks began reconsidering their UK presence due to concerns that Brexit will jeopardize their EU "passport" status that allows them to operate throughout the EU.
- Standard & Poor's and Fitch downgraded UK sovereign debt, Fitch downgraded Bank of England debt, and Moody's downgraded the UK's credit outlook status, raising borrowing costs and risks of potential domino effects onto other credit ratings.
- Questions arose about London's continued status as the largest global financial center and the prospects of increased global economic risks.

These events reflect growing concerns including: 1) the evolving political leadership crisis; 2) uncertainties about the process for UK disengagement from the EU; and 3) the short- and long-term economic effects. Financial markets likely will be volatile over the near term as the UK and the EU sort through these issues. Much uncertainty also looms over the UK's trade and economic arrangements and the corresponding legal and regulatory frameworks. Trade is equivalent to about 60% of the UK economy, largely due to reduced trade barriers with the EU through the EU's Single Market. The UK is the second largest EU economy after Germany.

Impact on Financial Markets

The Brexit vote immediately affected international financial markets through changes in exchange rates and shifts in capital flows, which affected the value of the British pound and UK business investment. Brexit concerns reportedly have steered investment funds toward the United States, amplifying upward pressure on the yields of U.S. Treasury securities and the value of the dollar. A higher-valued dollar and capital inflows make U.S. exports more expensive, lower import prices, interest rates, and consumer prices, and increase imports. Emerging economies are wary of a stronger dollar, fearing its potential negative contagion effect on their economies by drawing away much-needed capital.

Uncertainties about Brexit's impact on international capital markets reportedly factored into the Federal Reserve's announcement on June 18, 2016 to postpone raising U.S. prime interest rates. Fed Chairman Janet Yellen indicated that, "[I]t [Brexit] is a decision that could have consequences for economic and financial conditions in global financial markets. If it does so, it could have consequences in turn for the U.S. economic outlook that would be a factor in deciding on the appropriate path of policy." Moody's asserted that "[I]n the absence of a trade agreement that preserves core elements of the UK's current access to the Single Market, the UK's real GDP growth would be materially lower. Barriers to trade will not only result in lower trade but also negatively impact competition, innovation and productivity." Economic impact assessments of Brexit by various international organizations mostly indicate a small negative impact, e.g., the International Monetary Fund (IMF) projected that the UK's economic growth rate will slow to 1.6% in 2016, or about 0.5% below earlier estimates.

Impact on Trade

A Brexit vote does not immediately affect the UK's trade with other countries, but could in the future. Brexit would return authority to the UK to set its own external tariffs and broader trade policy, an authority currently with the EU. While the UK's trade policy trajectory is unknown, the economic implications of returning trade policy to the UK may be mixed. It could benefit the UK to the extent that it lowers tariffs below current EU rates, but detrimental if the UK loses access to the benefits of the EU Single Market and existing EU preferential trade arrangements. It also raises issues regarding the status of the U.S.-EU free trade negotiations to conclude a Trans-Atlantic Trade and Investment Partnership (see CRS In Focus IF10120, *Transatlantic Trade and Investment Partnership (T-TIP)*).

Under Brexit, the UK's trade with EU members would potentially be on less favorable terms if the UK lost preferential access to the Single Market. EU tariffs on the UK would most likely be re-imposed to World Trade Organization (WTO) most-favored-nation (MFN) levels, depending on the terms of the negotiated withdrawal and subsequent UK-EU negotiations.

Brexit also would require the UK to re-establish its trade terms with other countries. Multilaterally, the UK is an individual member of the WTO, but is represented through the European Commission and has terms of trade through commitments as an EU member (e.g., MFN tariff levels) in the WTO. Under Brexit, the UK would presumably remain a WTO member, but likely have to renegotiate its terms of trade within the WTO. There apparently is no precedent for doing so, the process is unclear, and the negotiating period may be lengthy.

In addition, Brexit could affect the UK's trade relations with countries with which the EU has preferential trade arrangements. The UK could lose access to the benefits of existing EU trade agreements with key partners such as South Korea unless it negotiated otherwise. Brexit likewise could affect the UK's potential access to EU trade agreements that have been concluded but not yet entered into force—such as the Comprehensive Economic and Trade Agreement (CETA) with Canada—and those under negotiation—such as the plurilateral Trade in Services Agreement (TiSA) and the T-TIP with the United States (see CRS In Focus IF10311, *Trade in Services Agreement (TiSA) Negotiations* and CRS In Focus IF10120, *Transatlantic Trade and Investment Partnership (T-TIP)*). Many potential scenarios exist for renegotiating those agreements and future negotiations, but the UK would likely have less negotiating power without the EU's full economic heft. Brexit also could affect the EU's positions in trade negotiations with other countries. For instance, there is speculation that Brexit could impede the T-TIP negotiations, given the UK's role as a liberalizing force in the EU. Other possibilities include the United States and UK pursuing their own a bilateral free trade agreement or investment treaty or the UK joining T-TIP as a third party.