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THE LONG-TERM ECONOMIC IMPLICATIONS OF A BREXIT MIGHT NOT BE AS NEGATIVE AS MANY STUDIES SUGGEST

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The long-term economic implications of a Brexit might not be as negative as many studies suggest. The UK government could seek more favorable solutions on trade than the default options of the WTO framework or bilateral renegotiations of all the treaties. Moreover, economic policy has a role to play in mitigating the negative consequences. The long-term economic implications may thus be overstated, but the immediate risks may instead be underestimated. Brexit would act as a catalyst and trigger a typical balance of payment crisis, with a likely deep depreciation of the GBP and potential negative spillovers in the global financial markets.

The devil is in the detail

We are only days away from the UK referendum on its membership in the European Union and the outcome remains highly uncertain. Financial markets are already jittery. But what would be the true economic effects of a Brexit? Many studies have been published over the past few months. Many look very much alike. Many have even shared the same econometric model. Few voices break away from the pack. Almost all show a very negative effect on the British economy over the short and long run. However, simulations must be managed carefully, and it is necessary to scrutinize the details and underlying assumptions of these studies.

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HM Treasury as a benchmark

Take, for example, the "official" estimates of the HM Treasury. Although representative of many other studies, they sparked controversy for the unusual position taken by a public institution. In the two scenarios of "shock" and "severe shock", there is a negative impact that reaches 3.6 and 6.0 percentage points of GDP, respectively, over two years, which would bring the British economy into a recession. This would be coupled with an increase in inflation between 2.3 and 2.7 percentage points and in unemployment between 1.6 and 2.4 percentage points, along with a collapse in housing prices (to which British voters are very sensitive), an increase in the public deficit, and finally, the GBP's depreciation by between 12 and 15%. Where does all this negativity come from, and is it reasonable?

What is "neutral" for trade?

As with most simulations, the HM Treasury made "neutral" hypotheses, which do not require too many subjective judgements and do not assume any policy reactions. Following a Brexit, trade agreements signed by the EU would no longer be valid for the UK. By default, they would be replaced with two possible arrangements: (1) going back to the WTO framework for trade or (2) a renegotiation of all trade agreements on a bilateral basis, which the study realistically assumes would take over 15 years.

However, the UK government could probably do better, and thus, less negative (although much more arbitrary) assumptions can be made. For example, the UK could join the European Economic Area (EEA), in line with what already happens with Norway. This would allow full access to the European Single Market, although it would have two major drawbacks: (1) the UK would have no say in EU decisions and would simply accept what the other 27 EU countries decide when it comes to trade and the Single Market, and (2) the UK would continue to pay a contribution to the EU that is higher than the current "rebated" amount. These are very significant problems, especially from a political point of view, but the EEA solution would limit the potential economic damage.

With skillful negotiations and a constructive attitude on the part of the other EU countries, there is a chance to do even better. The UK government, for example, could try to stretch the two-year transition until a complete revision of the European Treaties, which may well take several years. In the renegotiation of the Treaties, the UK, together with other EU countries, could try to spell out the conditions for a free trade area (and cooperation in other areas) that would *de facto* replace the EU. This option would also be very difficult politically, but not impossible, and it would reduce economic consequences due to uncertainty and limit the potential damage.

Don't neglect the power of economic policies

Moreover, in HM Treasury simulations, another important technical assumption was made—no policy change. In essence, the Bank of England and the British government would do nothing as a result of a Brexit other than letting the so-called "automatic stabilizers" work (i.e., the automatic increase in unemployment benefits when unemployment increases). This assumption could be perceived as extreme, although technically fully justified. At any rate, the Bank of England could inject liquidity and, through massive purchases of securities and transactions with the banks, prevent an increase in the borrowing costs for the economy. Moreover, the government could implement counter-cyclical policies to mitigate the negative impact on growth and jobs. In conclusion, the medium to long-term impact would not be as devastating as many of the existing studies suggest.

Risks are concentrated in the short term and are related to financial markets

The immediate risks may instead be underestimated. A preview of what might happen has already been observed in financial markets over the past few days, with the recorded sharp fluctuations of the GBP. Brexit can act as a catalyst and shed light on a fundamental problem of the UK economy. In 2015, the trade deficit reached 6.7% of GDP (5.2% of the current account). In the final quarter of last year, the latter reached 7.0%. This occurred alongside the general government's net borrowing (EU definition!), which had declined but still stood at 4.4% of GDP in 2015.

Until now, substantial foreign investment inflows into the UK (and some repatriation of British investments from the rest of EU) had offset the current account deficit. However, guess what would happen if this net inflow suddenly disappears due to the heightened uncertainty of a Brexit? There would be a typical balance of payments crisis, which would require a significant depreciation of the GBP to bring the external accounts back to balance. The 12-15% depreciation assumed by the HM Treasury would be a good reference point. However, financial markets tend to anticipate future developments, and therefore, this devaluation can take place within a few days or, at most, a few weeks after the referendum's outcome. Needless to say, such a large shock could have significant repercussions globally. A Brexit could potentially quickly change from an economic thriller to a horror comedy.