QNB Economics
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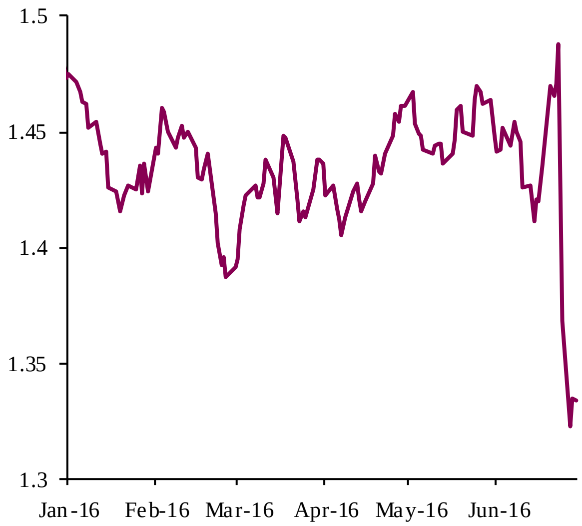
Brexit—a new headache for the global economy

Against the odds, the referendum on whether the United Kingdom should leave or stay in the European Union (EU) was narrowly won by the Leave camp. The results sent shockwaves through political circles and financial markets. The British prime minister has stepped down (although he will stay in office until a successor is chosen). The pound fell 10.3% to its lowest level since 1985 and global stock markets dropped sharply as investors rushed to safe havens. The credit rating of the UK has been downgraded by the three major rating agencies. Brexit is likely to have major implications on the UK economy and, to a lesser extent, the economies of the neighbouring Euro Area. Whether it triggers an outright global crisis remains to be seen. The Middle East and North Africa (MENA) region will probably be insulated, provided that the crisis remains localised and does not spill over to the rest of the world leading to a significant negative impact on oil prices.

Brexit is likely to prove damaging for the UK in the short term with analysts expecting zero or slightly negative growth in the second half of 2016 and early 2017, down from the 1.9% expected by the International Monetary Fund in April. Heightened uncertainty is the main culprit. There is uncertainty about the likelihood and the timing of the initiation of the exit process. There is uncertainty about political succession in the UK, both in the government and the opposition. And there is uncertainty about the future of Scotland, which might seek independence again having voted overwhelmingly in favour of staying in the EU. There is even uncertainty about whether the UK will actually go ahead and leave the EU. Such uncertainty is likely to lead to businesses delaying their investment decisions and consumers behaving more cautiously, leading to slower growth.

On the policy side, the Bank of England faces a major dilemma. On the one hand, the worsening of the growth outlook should lead to lower interest rates in order to stimulate the economy. But lowering rates now would likely result in further depreciation of the pound, stoking future inflation.

GBP:USD



Sources: Bloomberg and QNB Economics

The Euro Area is also likely to be affected by the Brexit shock, with most analysts expecting growth to fall by around 0.5% to 1.0% in 2016. This is mainly due to the uncertainty shock, which affects the Euro Area to a lesser extent than the UK. The region is also likely to be negatively impacted by the slowdown in the UK as it results in lower demand for exports.

On the global level, Brexit has triggered major risk-off sentiment and resulted in capital flight out of emerging markets (EMs) into safe havens. Analysts around the world are revising down their forecasts, with Brexit likely to shave off around 0.2% from global growth to reach 2.8%. If Brexit triggers a full-fledged global crisis (still not our baseline, but a material risk nonetheless), then demand for oil could be negatively impacted with adverse effects for oil prices.

While the prospects of a global economic crisis are uncertain, what is less uncertain is the expected large liquidity injections by the wold’s major central banks. The Bank of England is likely to lower interest rates to zero once the pound stabilises. The European Central Bank is likely to both lower interest rates and extend its quantitative easing programme to offset the negative shock of Brexit. The Bank of Japan will also probably ease policy to counter the effects of safe haven flows which are pushing up the value of the yen and hurting Japanese competitiveness. In this environment, the US Federal Reserve is unlikely to raise rates until December at the earliest to avoid any rapid appreciation of the US dollar which would be detrimental to growth.

The MENA region is probably insulated from the Brexit-induced turmoil, provided it does not turn into an outright global crisis. There are basically two channels through which Brexit would impact MENA countries. The first is the trade channel. However, trade links with the UK are relatively small. Qatar has the largest export exposure to the UK in the region. Nonetheless, total exports to the UK account for only 1.6% of Qatar's GDP. The second is the financial channel. Markets' appetite to finance MENA sovereigns might diminish with heightened risk aversion. But even this risk is mitigated by the fact that a number of MENA countries have already tapped the market earlier this year, satisfying their financing needs.

Overall, the British exit from the European Union is likely to be a slow and protracted process, dominating headlines for months to come. Our baseline view is that the risks are likely to be contained in the UK and, to some extent, the Euro Area. But contagion to the rest of the world through trade and, especially, financial market linkages could pose a real risk in the future.

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