Analysis

Brexit: cause of the next global recession?

By Parik TULSIDAS
Senior Executive Treasury & Markets Afrasia Bank

THE economic history is fraught with periods of recession. Recession occurs when the business cycle contracts, resulting in a sharp increase in unemployment, along with substantial declines in output, consumption, and investment, a fall in corporate profits, and a collapse in financial markets.

Recessions have occurred in advanced economies several times in the past 4 decades – mid-70s, early-80s, early-90s and early-2000s. Economists believe that the global recession which started in 2007 was one of the longest and deepest recessions since the Great Depression of the 1930s.

Analysts generally consider that a country is in recession if it has registered 2 consecutive quarters of decline in its real GDP.

● Next Global Recession

Economists around the world have been scanning the horizon in search of the cause of the next global recession. The task has been difficult since a recession has never taken place in the face of low interest rates and low oil prices.

● LO and BEHOLD!

They may just have found the trigger: the departure of UK from the European Union [EU] - BREXIT - may have severe global economic and financial implications.

● UK / EU Relationship

Before dwelling on the implications of a BREXIT, let us rapidly highlight the relationship between UK and Europe, which has always been one 'en dents de scie'.

a. After the demise of the Bretton-Woods system in 1971, UK decided not to be part of the European Currency Snake, a system in which the currency is not permitted to fluctuate by more than + 2.5%.
b. UK joined the EU later in 1973 but left it in 1979;
c. The system put in place in 1971 was replaced by the European Monetary System and the ECU in 1979. UK declined to join the new system, which led people to conclude that UK always try to catch the train after it has left the station.
d. In October 1990, UK joined the EMS but withdrew from the system 2 years later on September 16, 1992 [Black Wednesday], after the pound sterling came under major pressure from currency speculators, led by George Soros.
e. On December 31, 1998, the Euro replaced the ECU and the Euro Zone was established without the participation of the UK.

To be consistent with history, UK now wants to exit from the European Union.

● What are the Global Implications in case UK leaves the EU Ship?

UK citizens are expected to vote on June 23, 2016. UK is sharply divided along political lines, and consensus is difficult to come by. It is believed that departure of UK from the EU could have 'tsunamic' implications for economies worldwide.

Selected officials of the Bank of England have, reportedly, been secretly working on 'the Bookend file', evaluating the potential financial implications if British voters choose to divorce EU. The UK economy is taking a gamble by pushing for an exit from the EU, dampening the UK economic outlook for 2016 and beyond. Those in favour of an exit state that UK is a net contributor to the Brussels budget and that EU membership is costing England jobs, and money probably in the billions of pounds per year.

However, this is greatly offset by the additional economic growth/gains generated by EC membership. Goods flow freely, with duty-free access amongst all 23 countries of the EU. The British economy would lose much of the nearly GBP200bn worth of exports it sent to the EU in 2015 [45% of British exports go to the EU]. An exit would also deliver a fatal blow to the City, the financial centre for all of Europe.

● Domino Effect

Europe would lose a similar amount of trade with the UK, taking a chunk out of GDP there. A weak Europe brings a stumbling China, which relies on the continent as its largest customer (even bigger than the US). And a shaking China would certainly torpedo US exports, increasing volatility in financial markets. EU being the world's largest entity, it is hard to see trouble there not spreading everywhere.

The turmoil is already visible in the forex markets. The Pound has fallen to its lowest level in more than two years against a basket of currencies. Besides, the trade-weighted pound index has declined to just over 10% since late last year, the most persistent and deepest sell-off for the pound since the global financial crisis of 2007-08. It seems UK is determined to shrink to a smaller country either by hook or by crook!