

ECONOMIC AND MONETARY AFFAIRS

BREXIT - POSSIBLE ECONOMIC IMPACT FOR THE EURO AREA AND THE EU

BACKGROUND

On 23 June 2016 the UK held a referendum on its membership in the EU. The majority of the British people voted for Britain's exit from the EU (Brexit). The British Prime Minister announced her intentions to trigger the EU withdrawal procedure before the end of March 2017.

Issues to be address pertain to the short run, when the impact of the uncertainty is key. In the longer term trade disintegration is likely to play a powerful role. Brexit is also a manifestation of discontent among EU citizens and could therefore provide an opportunity for far-reaching reforms that would make the euro stronger?

INSIDE

This leaflet provides a background and abstracts of relevant studies prepared by the European Parliament's Policy Department A on Economic and Scientific Policy

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Against this background, the Committee on Economic and Monetary Affairs (ECON) requested analytical notes from key monetary experts to address the economic and financial impact of Brexit, for its November 2016 session of the Monetary Dialogue. The publications have been prepared by the Policy Department A of the European Parliament (EP) and are available in the relevant section (Monetary Dialogue) of ECON internet website.

IN-DEPTH ANALYSES

In-Depth Analysis on 'An assessment of the impact of Brexit on euro area stability' by Christopher Hartwell, Center for Social and Economic Research (CASE) and Roman Horvath (Charles University and CASE)

According to the authors of the analysis, the withdrawal of the UK from the EU will have several consequences for the stability of the EU, both in the short- and the long-term. Brexit has the potential to decrease trade integration between the EU and UK via direct and indirect trade effects. Heightened political uncertainty as well as uncertainty regarding the outcome of negotiations about the new institutional setup between the EU and UK is likely to amplify the adverse trade disintegration effects. For the longer-term, the fact that Brexit occurred may point to deeper issues with the EU and especially the euro area's reputation. However, Brexit and the continued mistrust of EU institutions allows for an opportunity to substantially re-think the institutional structure of the euro area from first principles.

In-Depth Analysis on 'Uncertainty after the Brexit vote: Economic effects and legal aspects' by Michael Hachula (DIW Berlin), Rosa Lastra (CCLS, Queen Mary University of London), Michael Piffer (DIW Berlin) and Malte Rieth (DIW Berlins)

The Brexit vote has led to an increase in uncertainty about the economic prospects of the UK and of the EU. The authors of the paper first document this generalized increase in uncertainty using a variety of indicators. Then they assess empirically the impact of the uncertainty shock from the Brexit vote using a counterfactual analysis based on historical data. They find that adverse uncertainty shocks dampen economic activity in both the UK and the euro area, but more so in the latter region. These differences are traced back to different monetary and real exchange rate responses across regions. Lastly, the main sources of legal uncertainty are highlighted: the interpretation of Article 50 of TEU, the litigation pending before the UK Supreme Court, the unwinding of the membership in both the customs union and the single market, and the models for the future trading and financial relations between the EU and the UK.

In-Depth Analysis on 'The impact of Brexit on the stability of the euro area' by Pauro Ferreira Campos (Brunel University London, ETH Zurich and IZA Bonn) and Corrado Macchiarelli (Brunel University London and London School of Economics)

What is the impact of Brexit, which is the British decision to withdraw from the EU, on the stability of the euro area? This is a difficult question that, given the uncertainty surrounding it, may benefit from a novel approach. Euro area asymmetries depend on the degree of integration among euro member states or, more specifically, on the relative strength of core and periphery sets. This paper argues that assessing the "core content" for each Member state may help address questions about the stability of the euro area. The analysis on the extent to which economic activity in the UK is synchronised with that in the euro area shows that it increased with the single currency. The paper also discusses the need for going beyond this standard analysis of business cycle synchronisation. The construct of a "core-ness index" (CMCI) shows that the core-periphery pattern has significantly weakened after the introduction of the euro.

The investigation of the CMCI determinants concludes that it is strengthened by euro membership and weakened by product market regulation. In this light, the paper concludes with novel policy implications to increase the "core content" of Member states and, consequently, shore up the stability of the euro area after Brexit.

In-Depth Analysis on 'Brexit and the future of the Euro' by Karl Whelan, University College Dublin

This paper discusses the potential implications of Britain's exit from the EU for the future of the euro. The British economy has not yet been negatively affected by the referendum result and the impact of the depreciation of sterling on the euro area economy should be limited. Of greater concern are the longer-run economic and political implications of the UK leaving the EU. The evidence points towards the likelihood of a "hard Brexit" in which increased trade barriers between the UK and the EU harm both British and European economies. That said, the risks are asymmetric: It is the UK economy that is going to suffer more, particularly with the likely reduction in financial sector employment. Over the longer term, the greater risks to the EU are political in nature rather economic. The Brexit referendum illustrates that the EU is less popular than many imagine. It also shows that blaming the EU for a wide range of economic problems can be an effective populist political strategy for anti-EU political groups. The political threats to the continued existence of the EU appear to be higher now than ever before.

The Compilation of the studies above will be soon available on the ECON website dedicated to the Monetary Dialogue.

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The five policy departments are responsible for providing - both in-house and external - high-level independent expertise, analysis and policy advice at the request of committees and other parliamentary bodies. They are closely involved in the work of committees which they support in shaping legislation on and exercising democratic scrutiny over EU policies. Policy departments deliver policy analysis in a wide variety of formats, ranging from studies and in-depth analyses to briefings and the Fact Sheets on the EU. This written output serves a variety of purposes by feeding directly into the legislative work of a specific committee or serving as a briefing for delegations of members.

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The *Monthly highlights* provide an overview, at a glance, of the on-going work of the policy departments, including a selection of the latest and forthcoming publications, and a list of future events. To receive this publication send an email to:

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