Economic Uncertainty in the UK: How Brexit Set the Stage for Crisis

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I. INTRODUCTION

On June 23, 2016, a referendum in Britain determined the country's decision to exit the European Union, a phenomenon commonly referred to as "Brexit." The results revealed a close divide, with 52% of voters favouring departure and 48% opposing it. After prolonged debate and intricate negotiations, Brexit officially came into effect on January 31, 2020. This decision was primarily driven by three factors: sovereignty, immigration, and economic concerns. While sovereignty and immigration influenced public sentiment, the economic impact of Brexit remains one of its most critical outcomes. This paper focuses primarily on the economic dimensions of Brexit.

II. THE J-CURVE HYPOTHESIS AND BREXIT

The J-curve hypothesis, introduced by Magee (1973), suggests that depreciation of a country's currency initially worsens its trade balance, followed by improvement if the Marshall-Lerner Condition (ML) holds. According to this condition, if the combined elasticity of demand for exports and imports exceeds one, depreciation will eventually benefit the trade balance. This "J" shape on a graph represents the short-term decline and subsequent long-term improvement expected in the trade balance. Following Brexit, it was anticipated that the British pound (GBP) would depreciate, initially worsening the UK's trade deficit but eventually leading toward balance. Contrary to this expectation, the UK faced an asymmetric trade cycle. For example, while the trade balance showed a surplus of £22,763 million in Q2 2020, it shifted to a deficit of £33,408 million by Q1 2022, remaining at £18,778 million in Q2 2024 (statista). Additionally, while UK exports grew at a compound annual growth rate (CAGR) of 5.19% from 2020 to 2024, imports rose by 5.90%, widening the trade deficit (sources: ONS, Department for International Trade, GOV.UK).

What Went Wrong? Several factors inhibited the anticipated J-curve effect post-Brexit. Alongside global disruptions such as COVID-19, the Russia-Ukraine war, and ongoing crises in West Asia, the inelasticity of the UK's exports played a crucial role. UK exports—including industrial machinery, financial services, aircraft parts, pharmaceuticals, and aviation engines—are largely inelastic, meaning that while GBP depreciation made exports more competitive, demand did not increase significantly. Thus, the J-curve hypothesis did not hold true in the Brexit context.

III. THE OVERLAPPING IMPACT OF COVID-19

The overlapping impact of COVID-19 complicates the isolation of Brexit's economic effects. The pandemic caused global supply chain disruptions and significant energy and food price shocks. The UK economy faced a historic downturn, with GDP contracting by 19.4% between April and June 2020, during the first national lockdown. Though a 17.6% rebound followed as restrictions eased, the contraction had long-lasting effects. Public health measures, including social distancing, travel restrictions, and the closure of non-essential businesses, led to a 19.8% decrease in GDP between April and June 2020. Household spending fell by over 20%—the largest quarterly decline on record—as expenditures on restaurants, hotels, transportation, and recreational activities plummeted.

IV. THE RUSSIA-UKRAINE WAR AND THE WEST ASIA CRISIS

The Russia-Ukraine war and ongoing crises in West Asia are placing significant economic pressure on the UK, particularly through inflation, rising energy costs, and disrupted global supply chains. By early 2024, UK inflation reached 6.2%, exacerbated by a 40% rise in wholesale gas prices due to the Ukraine conflict, pushing household energy bills up by 54% since early 2023.

This inflationary trend extends to food prices, with global wheat exports (25% sourced from Russia and Ukraine) contributing to a 10% increase in cereal

prices. The region's sunflower oil exports also saw price hikes, further impacting food production costs in the UK.

The Bank of England responded with successive interest rate hikes, bringing the base rate to 5.25%—up from 0.1% pre-pandemic—to stabilize prices, which raised borrowing costs and dampened consumer spending. As a result, UK GDP growth slowed to an annualized rate of 0.4% by Q3 2024, a significant decrease from the pre-crisis level of over 1.5%.

High energy and fuel prices, with Brent crude oil fluctuating around $100 per barrel and UK petrol prices reaching £1.55 per litre, are further straining living costs. Ongoing West Asia tensions, especially those impacting OPEC production, prevent relief in energy prices despite high demand. Although the UK's unemployment rate is stable at around 4.2%, stagnant wage growth amid high inflation limits consumer purchasing power.

UK consumer confidence, now at its lowest since November 2020, reflects the strain from the Russia-Ukraine conflict and the West Asia crisis. These events continue to keep commodity markets volatile, affecting essential imports like metals and semiconductors, crucial to the UK's automotive and electronics industries. The Bank of England warns of persistent inflation risks as the UK faces a complex and uncertain economic future.

V. CONCLUSION

Brexit has undeniably left the UK in a complex economic landscape marked by inflationary pressures, supply chain disruptions, and currency depreciation. While sovereignty, immigration, and economic autonomy were key motivations behind Brexit, the economic aftermath reveals a far-reaching impact that Brexit advocates may not have anticipated. The anticipated benefits of currency depreciation, as posited by the J-curve hypothesis, were overridden by the inelasticity of major UK exports and additional global disruptions, including COVID-19 and geopolitical conflicts. Rising costs of living, declining consumer confidence, and a modest GDP growth rate signify the current economic climate. As the UK navigates persistent inflation, supply chain vulnerabilities, and volatile global markets, policymakers face the critical task of stabilizing the economy while fostering sustainable growth. Economic resilience in the face of uncertainty will depend on strategic interventions and adaptability to both domestic and international challenges.

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