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The economic costs of Brexit

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Britain voted to leave the European Union (EU) last month, a move that many economists believe will cost their economy considerably. This storyline seems to imply that the EU government creates prosperity. A closer examination, I think, reveals a different interpretation, and offers hope that Britain might fare better than expected.

Paul Krugman, Nobel Prize winning international trade economist, estimates that Britain's GDP will be 2% lower due to Brexit. Other estimates suggest a potential 5% GDP loss for Britain, with Europe's GDP falling by 0.5%. Under either scenario, Britain would suffer effectively a significant and protracted recession.

Financial markets provide a battleground for conflicting visions of the economic future. Events investors see as bad news drive stock prices and currency prices lower. Financial markets reacted negatively to Brexit: the British pound hit a 30 year low, while the London and New York stock indexes declined by 3%, and Moody's reduced its rating for British government debt.

The prospect of reduced trade between Britain and Europe and the U.S. drives this pessimism. The EU has significantly reduced trade barriers across Europe, and its rules govern trade by members with other nations. Britain's exports and imports have increased fivefold since the Single European Act of 1986 began substantial trade liberalization. British companies sell more in Europe, and European companies can operate in Britain, both producing jobs. The availability of goods from Europe lowers Britain's cost of living.

International trade increases prosperity in Britain. But British and European businesses – the private sector – produce the goods and services which get traded and hence the prosperity, not these nations' governments. The EU has played a vital role in getting the nations of Europe to finally stop preventing their citizens from trading. EU bureaucrats do not create Britain's wealth.

Indeed, the EU currently does much to reduce prosperity. For example, the EU has cemented into place costly national controls on agriculture. And thousands of EU regulations limit economic freedom. A recent Cato Institute report cites overregulation by the EU of "everything from the labor market to the electric power consumption of toasters" as a source of Europe's declining growth rate.

Britain must now establish trade policies with the EU and other nations, including the U.S. Perhaps Britain will choose to restrict trade, and perhaps the EU and U.S. will enact trade barriers with Britain. If so, Britain's trade will decline and the recession economists and financial markets fear will ensue. The recession would be due to government policies blocking international trade, not a lack of access to wealth created by EU bureaucrats.

We do not fully understand the emergence of government policies. One factor, however, offers hope that trade barriers will remain low. The factor is the influence of the seen over the unseen, as first described by economist Frederic Bastiat. The direct, immediate and visible economic consequences of policies weigh more heavily in our thinking than the indirect and future effects. Bias for the seen vs. the unseen affects both our individual choices and democratic politics.

Normally the seen vs. unseen dynamic favors restrictions on trade as imports begin to rise. I was growing up in Detroit when Japanese and German imports first started significantly hurting U.S. automakers. The costs of imports – layoffs, unemployment, and idle factories – were highly visible. The benefits were harder to see, like greater availability of low cost, high gas mileage cars. Congress threatened trade restrictions in the early 1980s, so Japan agreed to voluntary export restraints, costing American consumers.

Britain's economy is already highly integrated with Europe. Consequently trade barriers will cause highly visible job losses; one estimate is 80,000 jobs lost just in London. Restrictions on trade with Britain will also mean job losses for European firms. The seen vs. unseen dynamic should work against trade barriers.

We will see if Brexit leads to new trade barriers and a recession. But the EU has not created wealth, merely ended the disruption of trade and prosperity across Europe. And the economic costs of Brexit, if they materialize, will be due to new government restrictions on trade.