

Economics Group

Special Commentary

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Brexit—Now What?

Executive Summary

British voters have surprised most market participants by their decision to exit the European Union, and there has been a violent reaction in financial markets to the unexpected development. New terms regarding trade in goods and services and movement of individuals between the UK and other members of the EU will now need to be renegotiated, and uncertainty over those terms likely will depress British investment spending. The UK could be facing a mild recession in coming quarters.

In theory, Brexit should have few direct effects on the global economy because the UK economy accounts for only 4 percent of global GDP. However, there are also the indirect effects to consider. The tightening in financial markets that has occurred today, if maintained, could exert a slowing effect on economic activity in many economies. An eventual unraveling of the EU, although not very likely in the near term, cannot be completely discounted in a medium- to long-term framework. Geopolitical uncertainty could have a depressing effect on economic activity via weaker investment spending. We are not at the point where we would forecast a global recession based on Brexit, but we are prepared to adjust our views in coming weeks as events dictate.

Surprising Result Leads to Significant Market Fallout

Voters in the United Kingdom went to polling stations yesterday and decided, by a margin of 52 percent to 48 percent, to seek exit (a.k.a., Brexit) from the European Union (EU). Although polls had been neck and neck leading into the voting yesterday, most market participants had assumed that most undecided individuals would ultimately vote to remain in the EU. Because financial markets were not priced for Brexit, the resulting fallout has been intense. The Japanese Nikkei index fell 8 percent last night and stock markets in Europe are generally off 5 percent to 10 percent as of this writing. The British pound has been hammered, plunging in overnight trading to a 31-year low against the dollar.

So does yesterday's result mean that the UK will soon be leaving the EU? Not exactly. For starters, the referendum is actually not legally binding. Only Parliament can pass the requisite legislation to leave the EU, and three-quarters of the Members of Parliament (MP) are on record as being personally opposed to Brexit.¹ That said, a MP likely would be committing political suicide if he or she went against the wishes of their constituents on such an important issue as Brexit.

Assuming that Parliament eventually approves legislation to leave the EU, the UK would then begin negotiations with the EU over the terms that would govern most of their bilateral economic interactions going forward. Under the terms of the Single Market, there currently is free movement of goods, services and people between the UK and the 27 other members of the EU (EU-27). The UK and the EU would have a minimum of two years after Parliament approves Brexit to renegotiate new terms regarding trade in goods and services and movement of individuals. In reality, the negotiations could stretch on for longer than two years. In the meantime, a period of uncertainty will set in as the negotiations take place.

The reaction in financial markets to Brexit has been intense.

The UK must now renegotiate terms of trade in goods and services with the EU.

¹ <http://www.bbc.com/news/uk-politics-eu-referendum-35616946>.



Will Brexit Lead to a U.K. Recession?²

Our most recent forecast, which was completed two weeks ago, looks for continued modest economic growth in the UK through the end of 2017 (Figure 1). However, that forecast was predicated on the assumption that Brexit would not occur. Clearly, we need to rethink our forecast in light of yesterday's vote. In short, there seems to be significant downside risks now to our most recent forecast.

Figure 1

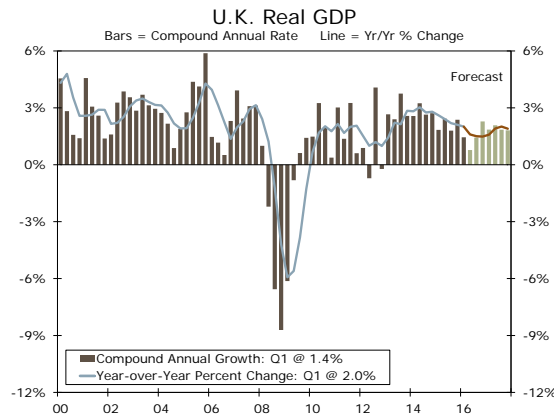
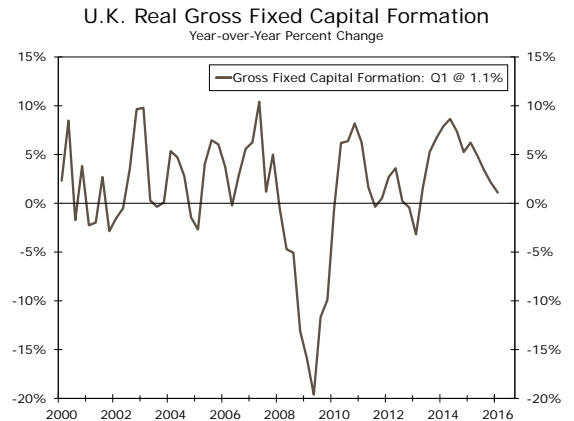


Figure 2



Source: IHS Global Insight and Wells Fargo Securities

Uncertainty related to Brexit likely will depress investment spending in the UK.

The UK will not lose access to the Single Market immediately, so British goods and services will continue to enter EU-27 countries duty free, at least until a new trading relationship can be negotiated.³ Therefore, there likely will not be any immediate Brexit hit to UK exports. Arguably, the depreciation of sterling, if maintained, could actually strengthen British export growth in the near term. However, uncertainty about the eventual trading relationship between the UK and the EU-27 could cause British businesses to curtail investment until the picture becomes clearer. Growth in gross fixed capital formation has weakened in recent quarters, and there is anecdotal evidence suggesting that Brexit uncertainty has played a role in slowing investment growth (Figure 2). Growth in capital spending could clearly turn negative in coming quarters.

There is also the uncertainty of the legal status of the 2 million or so workers of EU-27 origin who currently reside in the UK. Will they be able to continue to work in the UK? The answer to that question will need to await the outcome of pending UK-EU negotiations. Although workers from EU-27 economies will not be immediately kicked out of the UK, will those individuals want to buy homes in the UK if their legal ability to remain in country is in doubt? Uncertainty could negatively impact home sales as well as residential construction.

There is also the future status of the City of London as Europe's financial capital to consider. Although the UK is not a member of the Eurozone, London is unquestionably the financial capital of Europe. As a member of the EU, the British financial system falls under the EU regulatory umbrella. Can London remain the financial capital of Europe if the UK is no longer under that regulatory umbrella? Non-residential construction in the City of London likely will be negatively impacted as financial services firms weigh their options on the continent. In sum, the likely near-term hit to investment spending occasioned by uncertainty could be enough to push the UK economy into a modest recession later this year.

² For further reading see "Brexit, Stage Left: What Is at Stake?" (March 2, 2016) which is available upon request.

³ The UK sends roughly one-half of its exports to the EU-27 and it receives a similar proportion of its imports from those countries.

The EU-27: Direct Effects of Brexit Should be Manageable

As we wrote in a previous report, the direct effects of Brexit on the EU-27 should be manageable.⁴ On average, EU-27 countries send about 7 percent of their exports to the UK, although Irish dependence on its neighbor across the Irish Sea is double that percentage (Figure 3). A Brexit-induced recession in the UK and sustained euro appreciation against sterling would weaken growth at the margin for exports from euro area economies, but the hit to exports likely would not be large enough to drag most of those economies back into their own recessions.

Figure 3

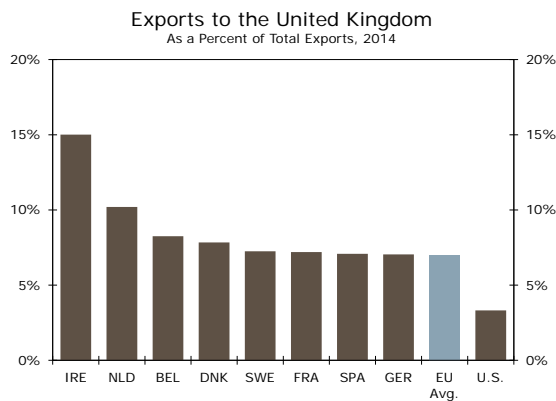
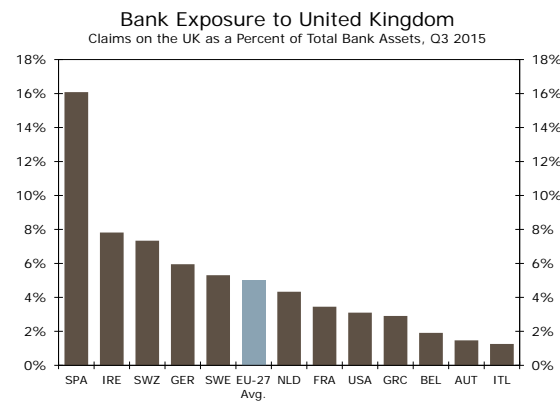


Figure 4



Source: IHS Global Insight, Bank for International Settlements and Wells Fargo Securities

As shown in Figure 4, banking systems in most EU-27, with the notable exception of Spain, have only modest amounts of exposure to the United Kingdom.⁵ Therefore, a recession in the UK, should one transpire, should not lead to a generalized banking crisis in Europe. In sum, the direct effects of Brexit on the EU-27 should be limited. As we discuss in further detail below, however, there could be significant indirect effects of Brexit on the EU-27.

Limited Direct Effects for the U.S. Economy As Well

Like the EU, the direct effects of Brexit on the U.S. economy appear to be rather limited. American exports of goods to the United Kingdom totaled \$56 billion last year (Figure 5). However, this figure pales in comparison to the \$218 billion that went to the EU-27, not to mention the \$1.5 trillion of total U.S. exports last year. The UK accounted for less than 4 percent of American exports of goods in 2015, which is equivalent to only 0.4 percent of U.S. GDP. Even if the UK economy slips into recession, which would depress British demand for American goods, the direct economic impact on the U.S. economy would be miniscule.

On the other side of the ledger, the United States received \$58 billion worth of goods imports from the UK. The sharp decline in the value of sterling versus the U.S. dollar, if maintained, will reduce the price of British goods which are imported into the United States, everything else equal. However, the United States receives only 3 percent of imports from the UK. In other words, lower prices of British goods would have little direct effect on U.S. inflation rates via import prices.

Direct financial effects on the U.S. economy also appear to be limited. American bank exposure to British entities (i.e., households, businesses and the government) totals nearly \$500 billion, but this amount represents only 3 percent of total U.S. bank assets. A UK recession could cause some of this exposure to turn to non-performing status, but it likely would not have a meaningful on the overall American financial system. Americans own \$1.3 trillion worth of British securities, 70 percent of which are UK equity securities (Figure 6). But with \$70 trillion worth of financial

The direct effects of Brexit on the US economy should be limited.

⁴ See “How Would EU Countries Be Affected by Brexit?” (April 14, 2016).

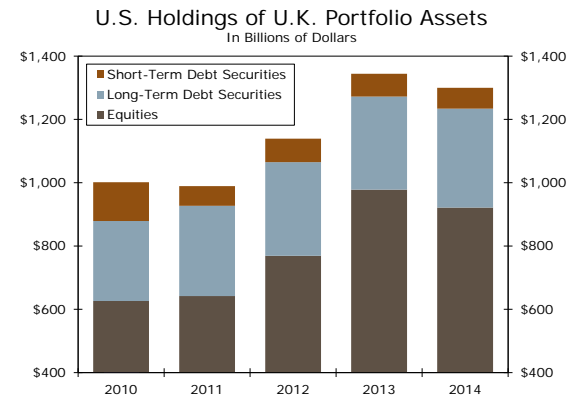
⁵ The overall exposure of the Spanish banking system to the United Kingdom is inflated by Banco Santander’s ownership of Abbey National.

assets, household balance sheets in the United States would be little affected by lower prices of British securities, if those prices declines were confined solely to British assets.

Figure 5



Figure 6



Source: IHS Global Insight and Wells Fargo Securities

Indirect Effects Could Be More Significant Than Direct Effects

But therein lies the rub. As today’s meltdown in global financial markets painfully demonstrates, price declines have not been limited to only British securities. The sharp fall in stock prices in most economies and the widening of credit spreads represent a tightening of financial conditions. If financial conditions remain tight in coming weeks, economic activity in many economies could decelerate from already lackluster rates of growth.

There are also the political effects, and their potential fallout on economic activity, to consider. Anti-EU nationalist parties in many European countries have been emboldened by the Brexit vote and are now calling for their own referenda. Most of these nationalist parties are on the political fringe, and we do not expect a wave of EU referenda anytime soon on the continent. However, the EU bureaucracy is not warmly embraced in most European countries, and the idea of exiting the EU could fall on fertile political ground in some of those economies. Although EU leaders are currently in the process of “circling the wagons” an eventual unraveling of the EU should not be idly dismissed out of hand.

Europe has been integrating economically and politically for the past 50 years or so. Brexit is the first reversal of that integration. It seems that populist and nationalist sentiment around the world has not been this high since the 1930s, and there are some important elections coming up later this year and in 2017 (e.g., in the United States, France and Germany). In our view, Brexit is a monumental decision that could potentially start an unwinding of the globalization that has been in train for the past few decades. A period of heightened geopolitical uncertainty would not be conducive for robust growth in investment spending in many of the world’s major economies.

Conclusion

In theory, yesterday’s decision by British voters to exit the EU should have few direct effects on the global economy. Although the UK economy could slip into a mild recession in coming quarters, it accounts for only 4 percent of global GDP. A downturn in the UK, when considered in isolation, is not likely to produce a global recession.

But that is not the end of the story. There are also indirect effects to consider. The tightening in financial markets that has occurred today, if maintained, could exert a slowing effect on economic activity in many economies. An eventual unraveling of the EU, although not very likely in the near term, cannot be completely discounted either in a medium- to long-term framework. Geopolitical uncertainty could have a depressing effect on economic activity via weaker investment spending.

Will tightening in financial conditions be maintained?

Will globalization start to unwind?

We are not at the point where we would forecast a global recession based on Brexit. For starters, policymakers, especially central banks, could respond in coming days and weeks to the financial shock with even further policy accommodation. Much will depend on the evolution in financial markets in coming weeks. In general, however, Brexit is a major development, not only in an economic sense but also in a geopolitical one. The full implications of Brexit are impossible to foresee at this time, but we are prepared to adjust our views in coming weeks as events dictate.

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