

Brexit

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<https://andrewbenito.github.io/AlphaBetEcon/>

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Of Macro and Markets

1. Financial markets gauge and price **probabilities** of different outcomes, including **macro** outcomes
 2. Capital Markets **update** these probabilities and scenarios rapidly in response to **news**
- ▶ **Brexit** an example
 - ▶ Contrast: 'short-termism'

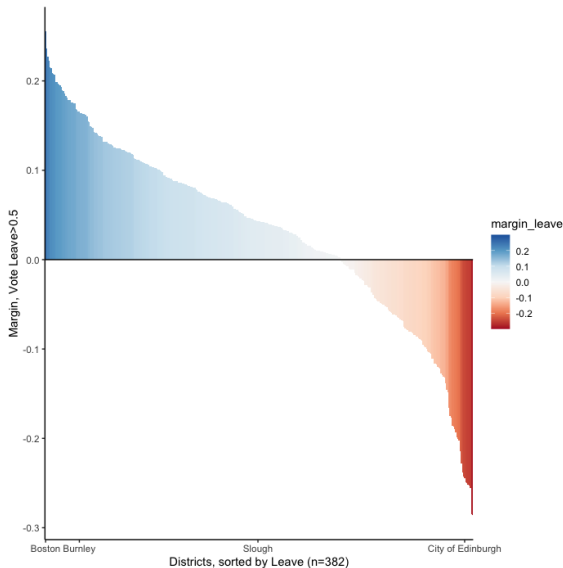
Legal/institutional change: "Britannia Waves the Rules"

1. June 2016 EU Referendum: UK **rejects the status quo ante**, without specifying the **alternative** to EU membership
 - ▶ **Economics** a partial reversal of the 50y+ Globalisation trend
 - ▶ **Politics** unprecedented in EU to reject status quo; to **Leave**
 2. Changes UK position within Rodrik's **Globalisation 'Trilemma'**
 - ▶ Less globalisation (more trade frictions with EU Single Market)
 - ▶ ...prioritising national Sovereignty.
 - ▶ EU and its Single Market are a (big) regulatory union
 3. A **discontinuity** between EU Single Market and *any* trade deal
 - ▶ ...within EU, UK specialised in financial services, HE, autos. A *services-based* economy (not covered by *any* trade deal)
- ▶ Complicates the task for **financial markets** of pricing probabilities and scenarios

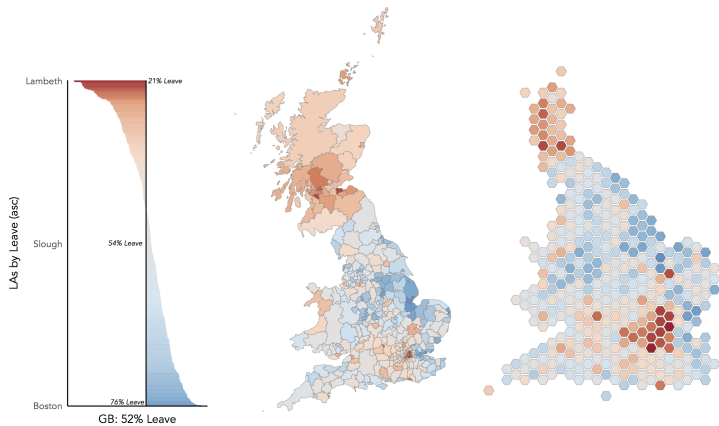
Why the UK chose more Sovereignty over Globalisation

- ▶ Trade view now recognises **concentrated costs** of Globalisation
 - ▶ Some benefits of G are dispersed eg. lower margins;
 - ▶ Some benefits concentrated in London eg. financial sector, HE
 - ▶ Capitalised in housing/CRE prices - inhibiting **internal mobility**
 - ▶ Regionally **unbalanced** and Politically **fragile**
- ▶ **Trigger** Pre-crisis belief in trickle-down (across regions) no longer supported post-crisis: bailouts vs. fiscal austerity and prolonged productivity slowdown
- ▶ Ditto, perception of costs and benefits of EU **immigration**
- ▶ **Brexit** a vote against the 'London' Consensus that had prioritised Globalisation over Sovereignty. A symptom. Yet...
 - ▶ Who is **sovereign?** (Gov or Parliament? Which Government?)
 - ▶ **Identity** UK and Ireland in EU allowed being a Brit *and/or* Irish

The Brexit vote: divided by locality; two-thirds of districts voted Leave



Regional separation – national and/or urban



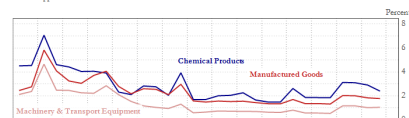
LA outlines contain National Statistics data © and OS data © Crown copyright and database right 2015
Equal area cartogram by Ben Flanagan, ESRI UK

► Boston votes Leave!

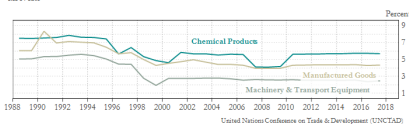
Rejecting the Globalisation trend I

Import Tariff Rates

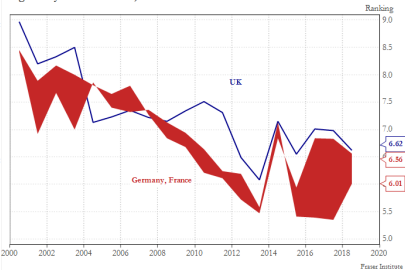
Effective applied tariff



MFN rate



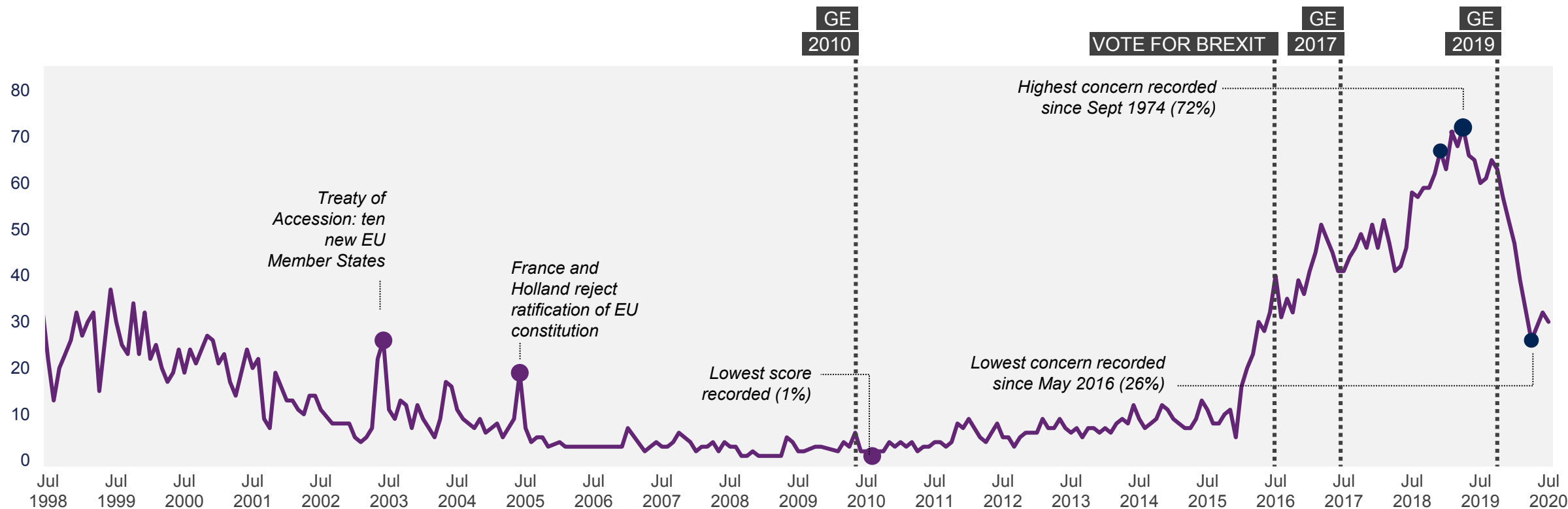
Regulatory Trade Barriers, Non-Tariff Trade Barriers Index



- Yet **Trade** has not really featured as a major UK political issue

EU / Europe / Brexit

What do you see as the most/other important issues facing Britain today?

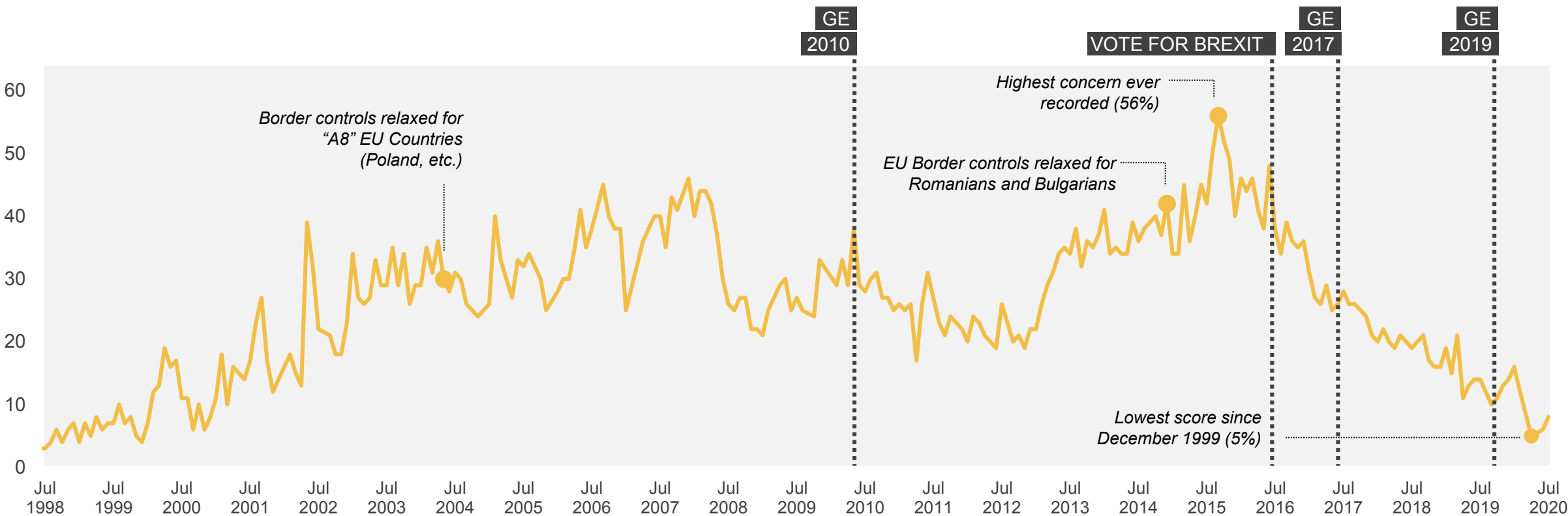


Base: representative sample of c. 1,000 British adults age 18+ each month, interviewed face-to-face in home
N.B. April 2020 data onwards is collected by telephone; previous months are face-to-face

Source: Ipsos MORI Issues Index

Immigration / Immigrants

What do you see as the most/other important issues facing Britain today?

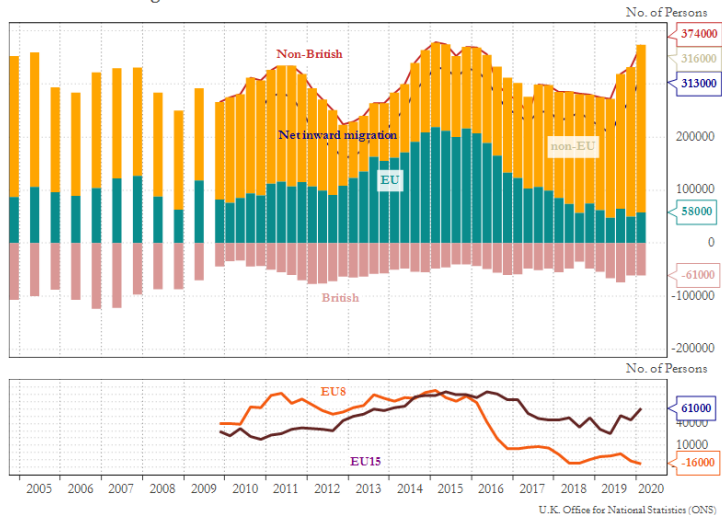


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Rejecting the Globalisation trend II – EU Immigration

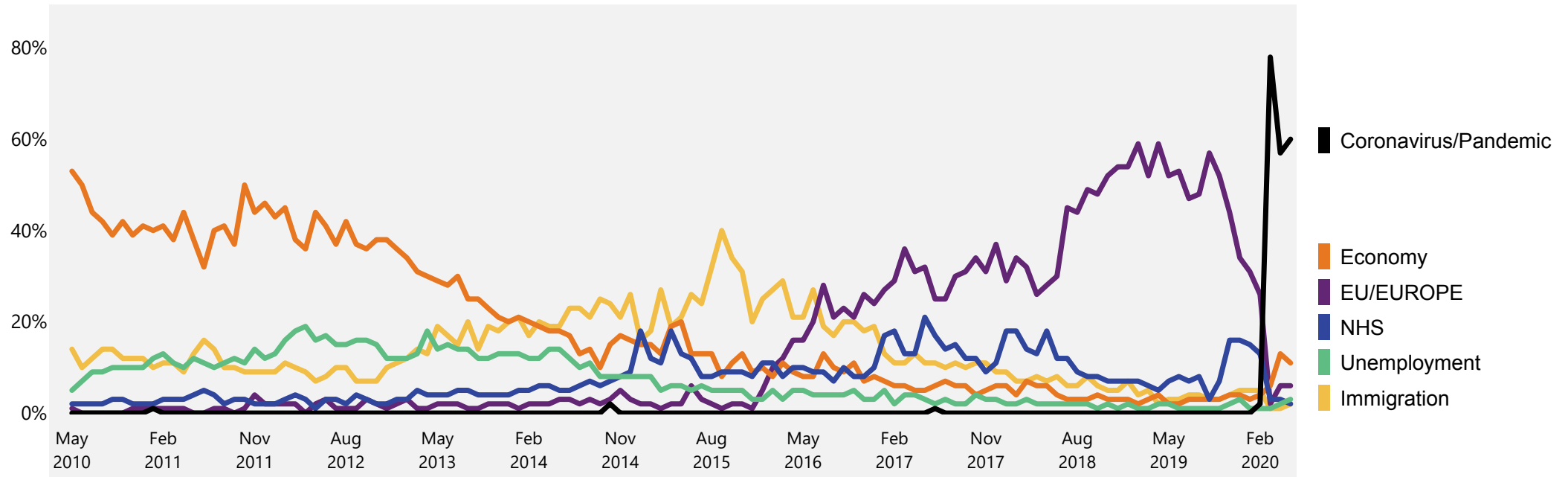
A shift from EU migration



Single Biggest Issue 2010 - 2020

What do you see as the **most important** issue facing Britain today?

Top mentions %

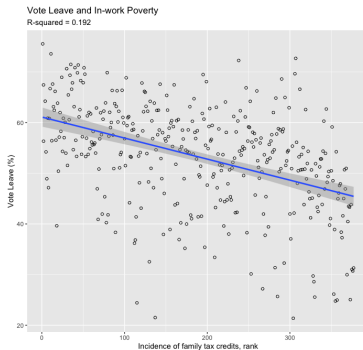
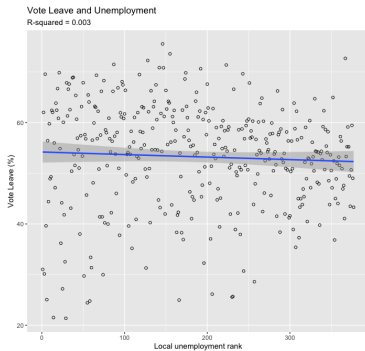


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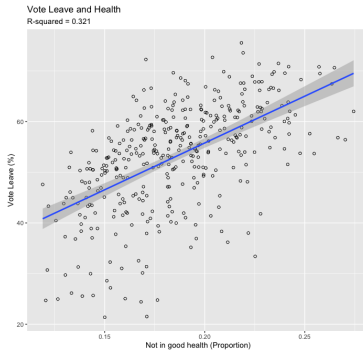
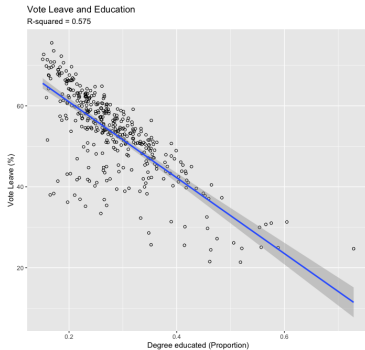
Left behind by Globalisation / the policy consensus?

Jobs v. in-work poverty

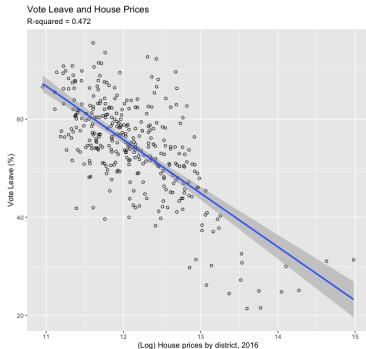


Left behind by Globalisation / policy consensus?

Education and Health



Left behind by Globalisation / policy consensus? Housing



- ▶ **House prices** capitalise local differences and **housing** became a major political issue in its own right (unlike trade).
- ▶ The Brexit vote was not about trade, even though some of its effects will be.

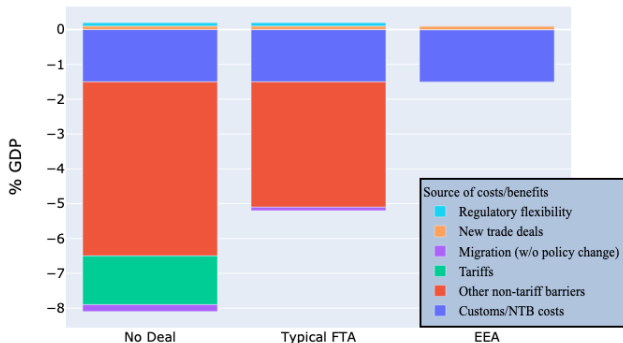
"Get The Message": 'Take back control' a free option



Brexit economics: 'Textbook'

- ▶ **Steady-state** A weaker real exchange rate needed to crowd in new exports, as access to EU export markets is reduced.
 - ▶ Lower living standards / productivity. Reduced gains from trade (which are gains from specialisation in a larger market).
 - ▶ Trade **gravity** means 'global Britain' won't compensate
- ▶ **Transition** Legal trade arrangements **unchanged until Jan-21**. (Forward-looking) GBP weakens anticipating new steady-state
 - ▶ **Uncertainty** weighs on business investment.
 - ▶ But **lower GBP** supports non-EU export margins
 - ▶ Yet, it squeezes household real incomes through higher inflation...
 - ▶ ...although households 'smooth-through' this;
 - ▶ ...encouraged by BoE policy, incl credit, easing.
- ▶ FX and Interest Rate markets key in **smoothing adjustment**
- ▶ Institutional questions unresolved. Bouts of **risk premium**

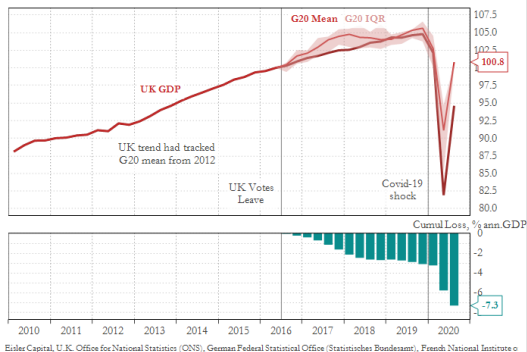
Brexit in the Long-run (or **Project Fear?**)



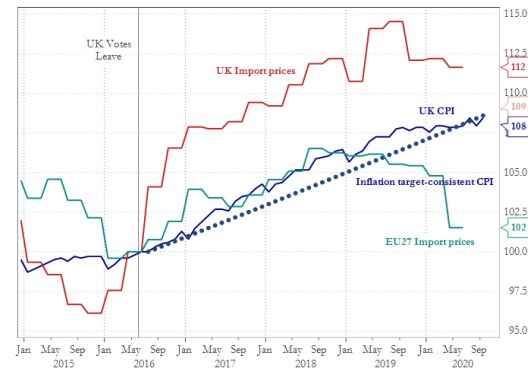
Source: EU Exit, Report by HMG, Nov, 2018

UK Gov. estimates for how the level of GDP (in 2030) would differ for different versions of Brexit, relative to remaining in the EU.

Brexit 'Transition' Economics: *Meh?*



Brexit 'Transition': Accommodating a higher price level through higher import prices on a weaker currency

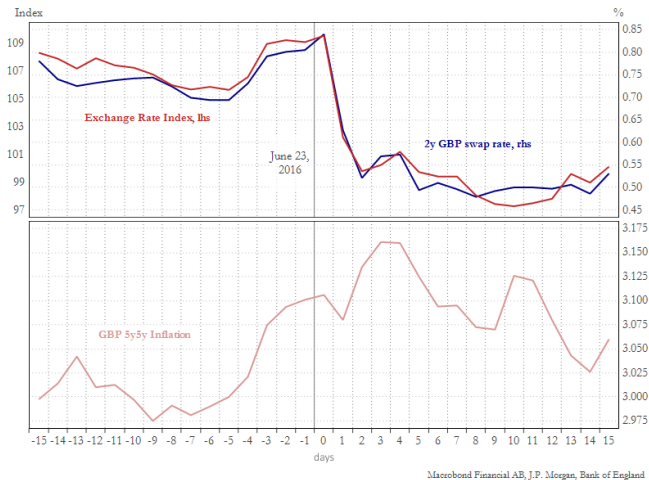


How to think about the financial market reaction

Brexit shock?	GBP	GBP Rates	Inflation
Weaker Demand	↓	↓	↓
Weaker Supply	↓	±	↑ (Short-run)
Institutional weakness	↓	↑ (Long-run)	↑

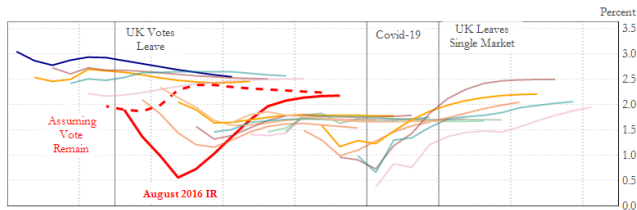
Table: Classifying the market reaction

What financial markets initially thought of it

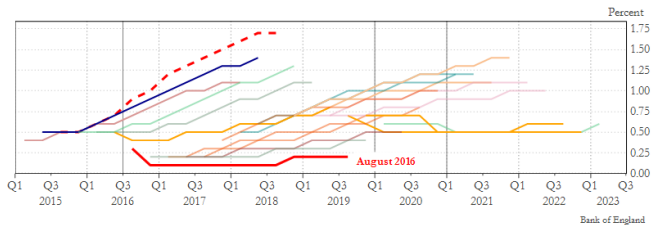


Brexit Transition: How macro views and markets evolved

BoE GDP Forecasts (made pre-Covid-19)



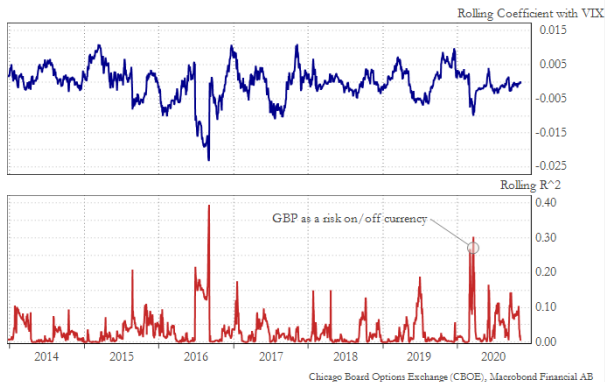
Interest rate forward curves (OIS)



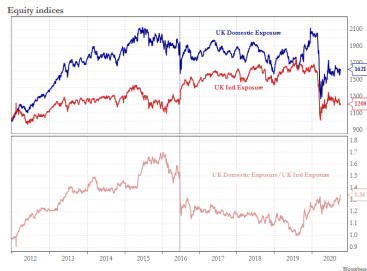
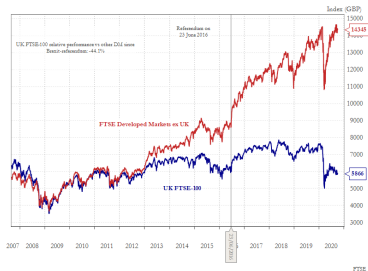
Sterling - a more 'risk on/off' currency

Sterling's time-varying sensitivity to Volatility

GBPEUR

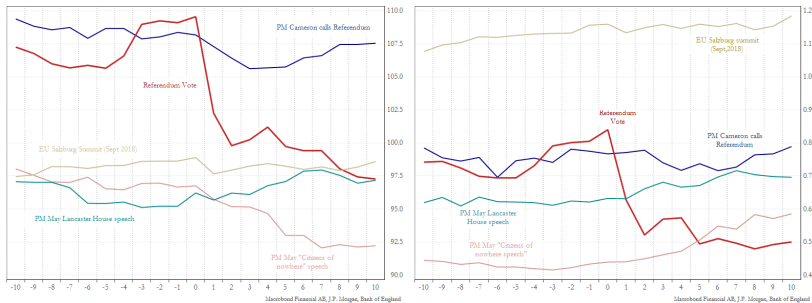


Equity markets signal weaker growth (or large sector-level compositional effects)

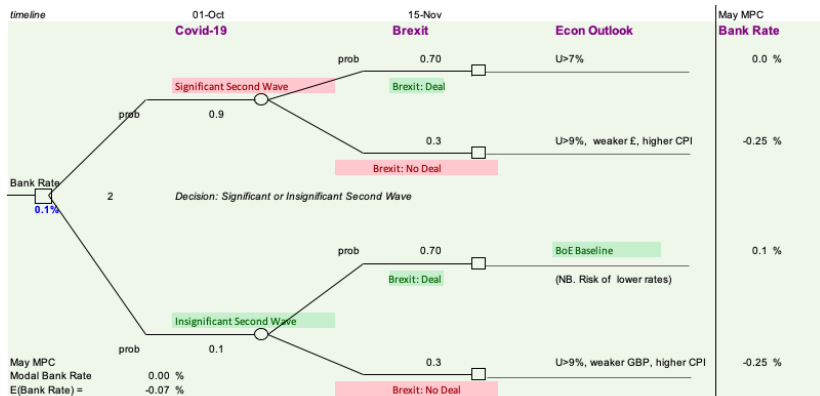


Bouts of risk premium. Short-lived institutional doubts?

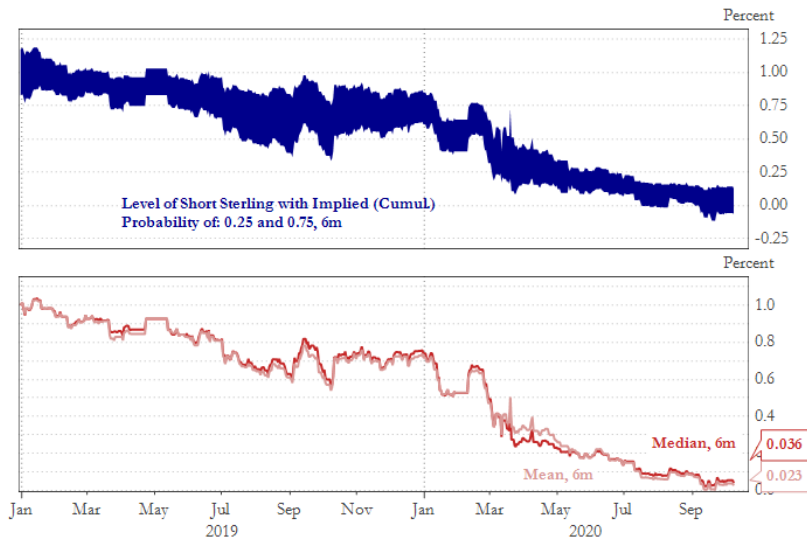
Sterling FX and 2y swap rates within days of Brexit-related Political events



Financial markets – what price for the BoE?



Financial markets price (downside) risks, a mean not a mode



Macro/Markets – Conclusions

- ▶ The Policy Consensus had been highly **localised** in its effects. Neither it, nor Globalisation, catered for most localities.
 1. **Macro** Institutional doubts about Brexit have been fleeting
 2. Brexit-related risks perceived as being about weaker future growth rather than the UK losing institutional strengths
 3. Instead, past **institutional strengths** allowed policy easing which kept Brexit adjustment costs low-ish (2% GDP)
- 1. **Markets** Financial markets price **means** not **modes**
- 2. **Updating risks** to a modal/central view has potentially large effects on market prices
- 3. Identifying what beliefs a view is **conditioned on** is as important as the view itself.
- ▶ UK...a Big Short or not? Institutions will be key and markets will reflect that.

A word cloud featuring the word "THANK YOU" in large, bold, black capital letters. Surrounding it are various translations of "Thank You" in different languages, including Spanish (GRACIAS, ARIGATO), Japanese (SHUKURIA), Korean (DANKSCHEEN), Chinese (TASHAKKUR ATU), and others. The words are arranged in a circular pattern around the central "THANK YOU" text.

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