



# BREXIT

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Presentation to DABE

October 14, 2016

The views expressed are those of the author and do not necessarily reflect the views of the Federal Reserve Bank of Dallas or the Federal Reserve System

# Overview

- The U.K. and the “European Project”
- Background to the referendum
  - U.K. ambivalence
  - Loss of sovereignty
  - Immigration
- Economic impact
  - Near term – currency depreciation
  - Medium term – increased uncertainty; recession likely
  - Long term – will depend...
- What happens next
  - “Article 50”
- Longer-term implications
  - Eventual break-up of EU?

# Background: the U.K.'s tortured relationship with the EU

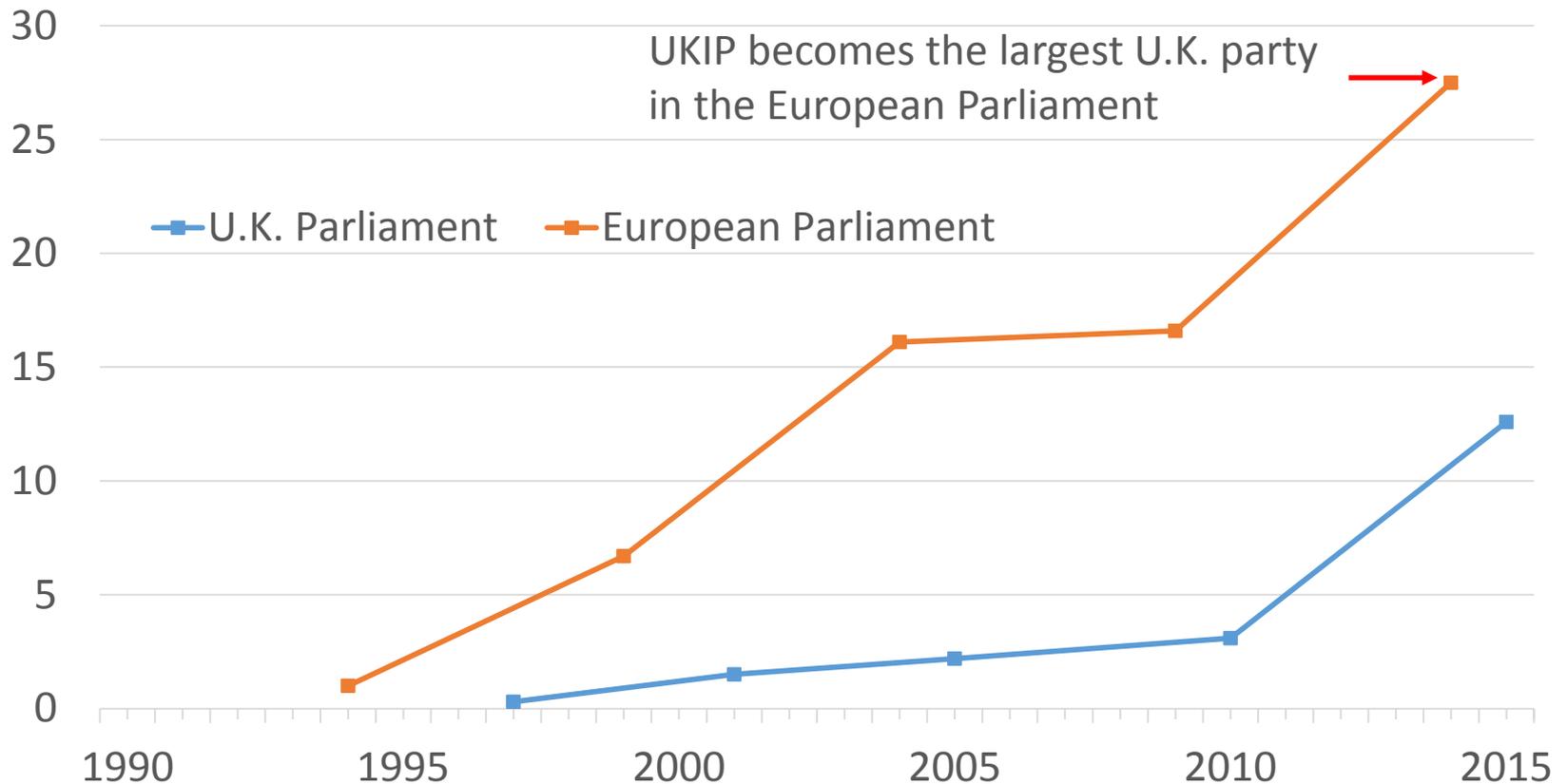
- Origins: ECSC, EEC, EURATOM
  - U.K. not a founding member
- Application to join in 1960s vetoed by de Gaulle
  - Joined with Ireland and Denmark in 1973 in first expansion
- Stronger support for free trade aspect of integration than political dimensions
  - Founding member of European Free Trade Association (EFTA) in 1960
- Opted out of single currency and Schengen agreement on borderless travel
- Ambivalent relationship
  - “...we have our own dream and our own task. We are with Europe, but not of it. We are linked, but not comprised. We are interested and associated, but not absorbed.” (Winston Churchill)

# The referendum

- First referendum on U.K. membership held in 1975
  - Two thirds vote in favor of membership
- Hostility of elements in Conservative Party to Europe
  - Rebate negotiated by Mrs. Thatcher in 1985
  - Internal Conservative Party divisions over Europe resulted in Mrs. Thatcher's ouster as Prime Minister in 1990
- Tensions within the Labour Party over EMU
- Rise of U.K. Independence Party (UKIP)
  - Opposed to EU membership

# Rise of euroskepticism among U.K. electorate

UKIP share of vote in parliamentary elections (percent)



# Euromyths; “Colorless green ideas sleep furiously”

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- Africa, Circus artists** – [EU funding for African acrobats and trapeze artists, July 2015](#)
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- Agriculture, subsidies and fraud** – [CAP spending and fraud out of control, Aug 1993](#)
- Agriculture, three-crop rule** – [EU tells British farmers what they can grow, Nov 2014](#)

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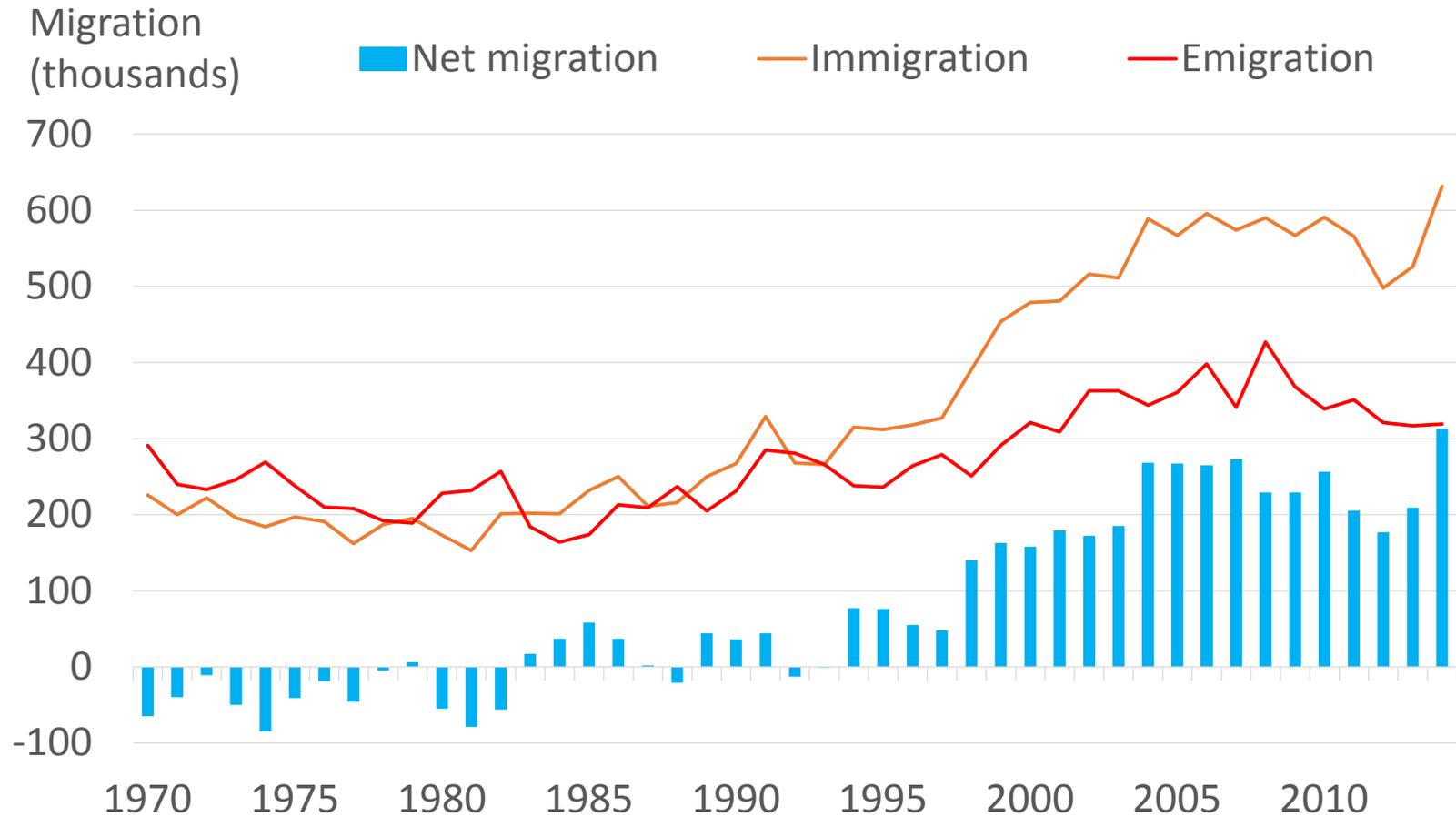
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# Euromyths...



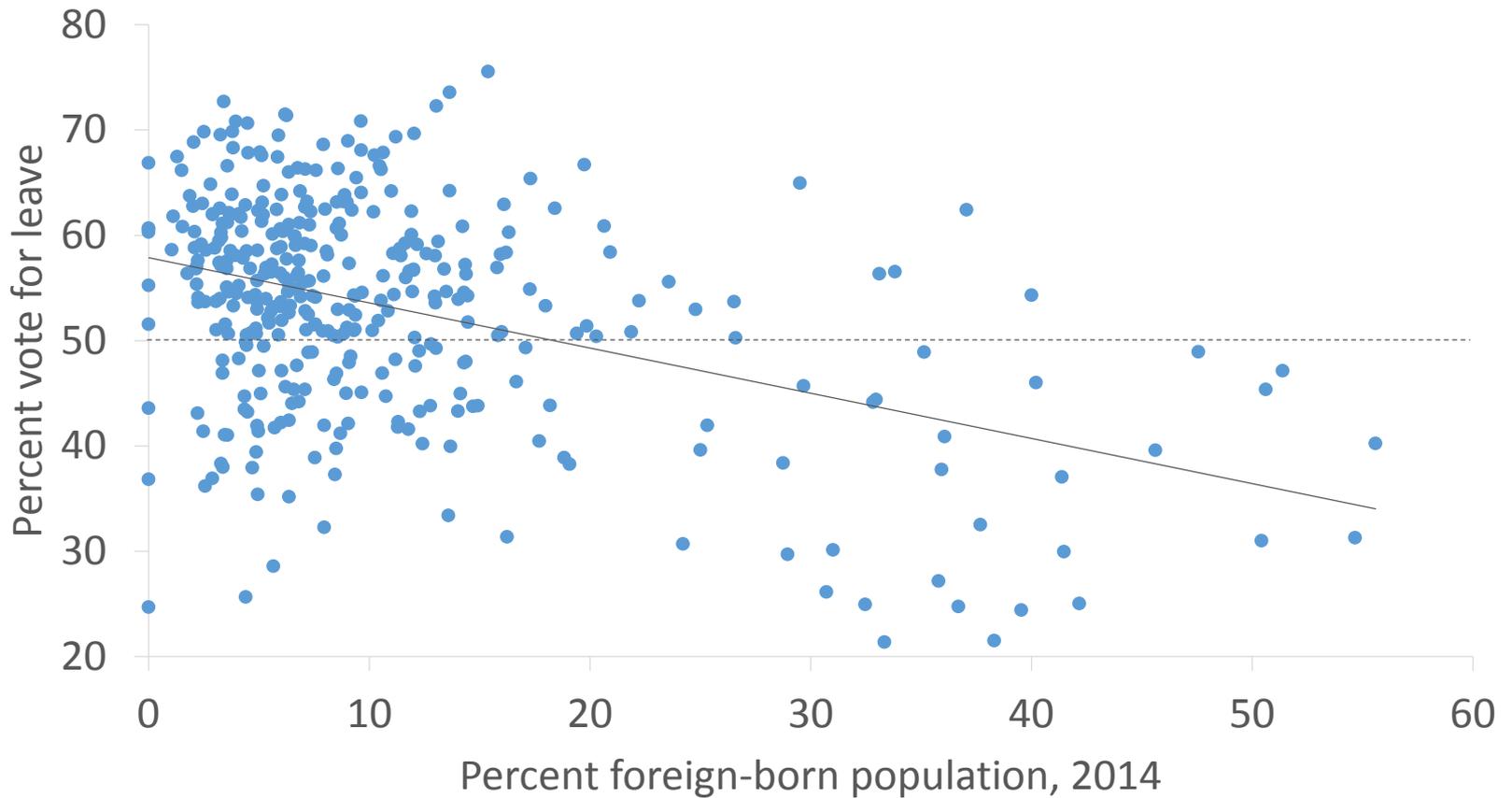
# The surge in U.K. immigration



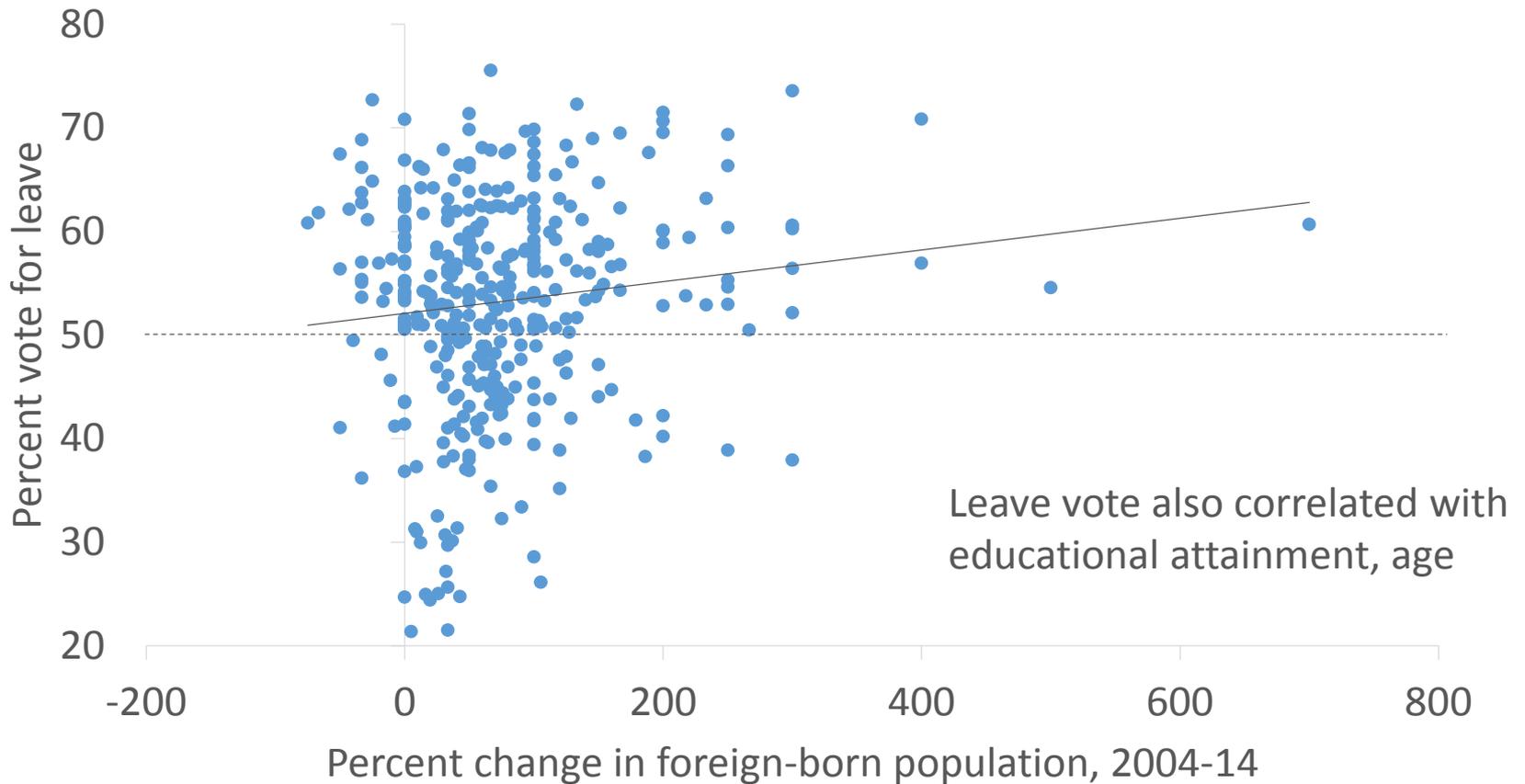
# The referendum and renegotiation

- Referendum promised in 2013 when it was not expected that the Conservatives would win a majority
- 2015 election outcome a surprise
- Results of renegotiation announced February 2016
  - Economic governance: no discrimination against non-€ countries, no responsibility for bailouts
  - Competitiveness: implement fully the internal market, lower administrative burdens on SMEs
  - Sovereignty: U.K. special status confirmed
  - Social benefits and free movement: limits on movement and “welfare migration”

# EU referendum results based on stock of foreign-born

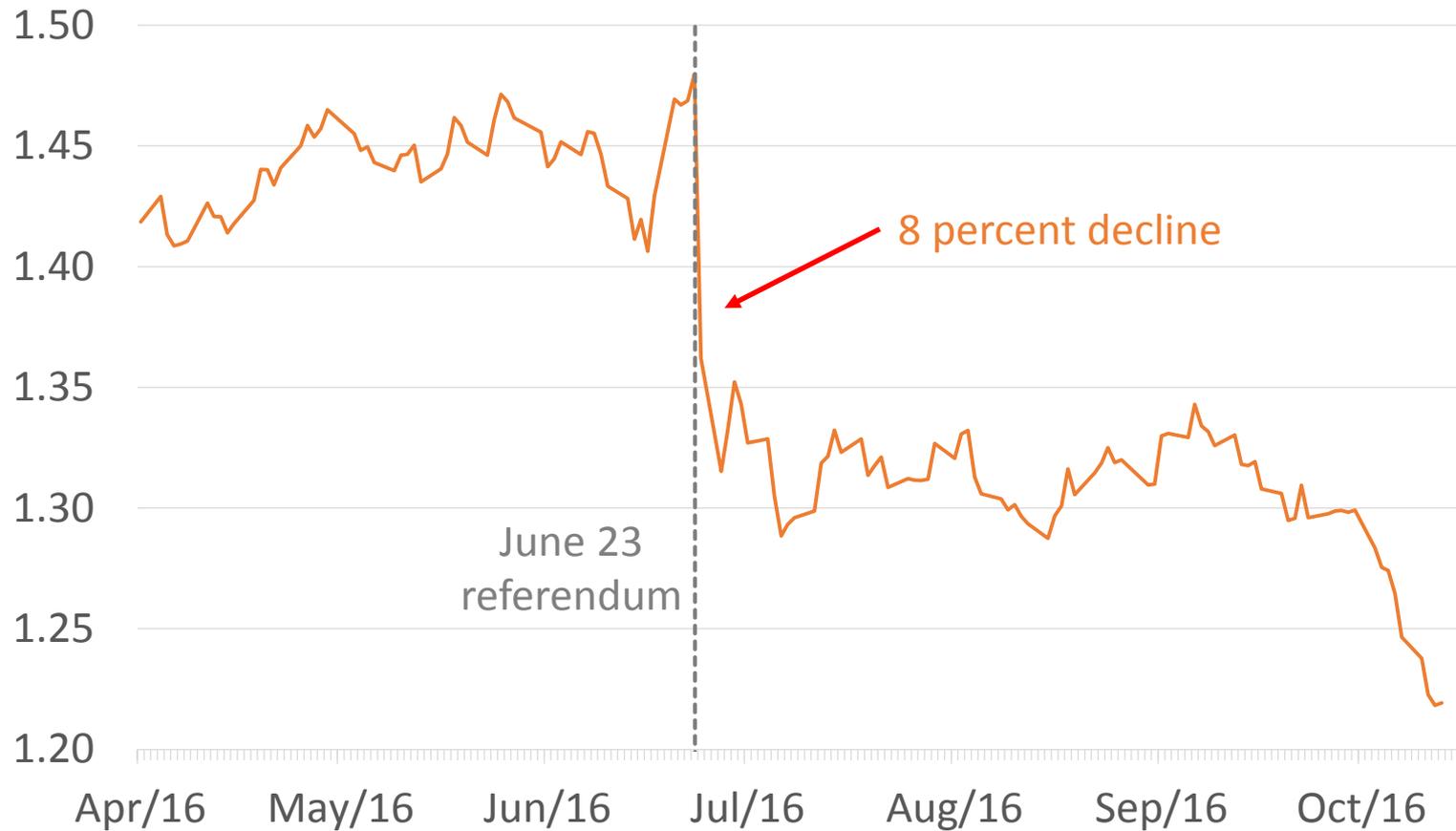


# EU referendum results based on inflow of foreign-born



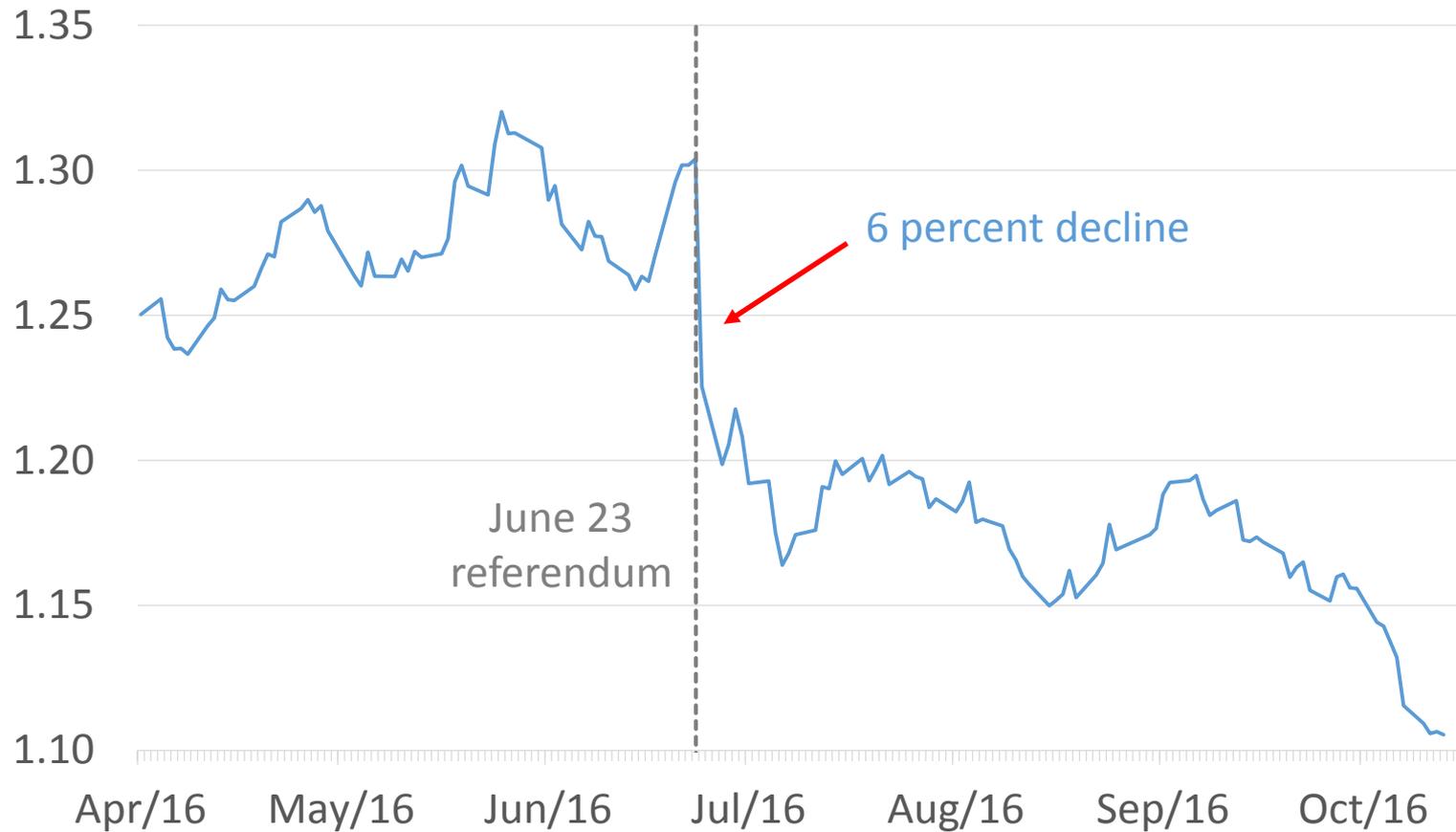
# Exchange rate effects

USD/GBP



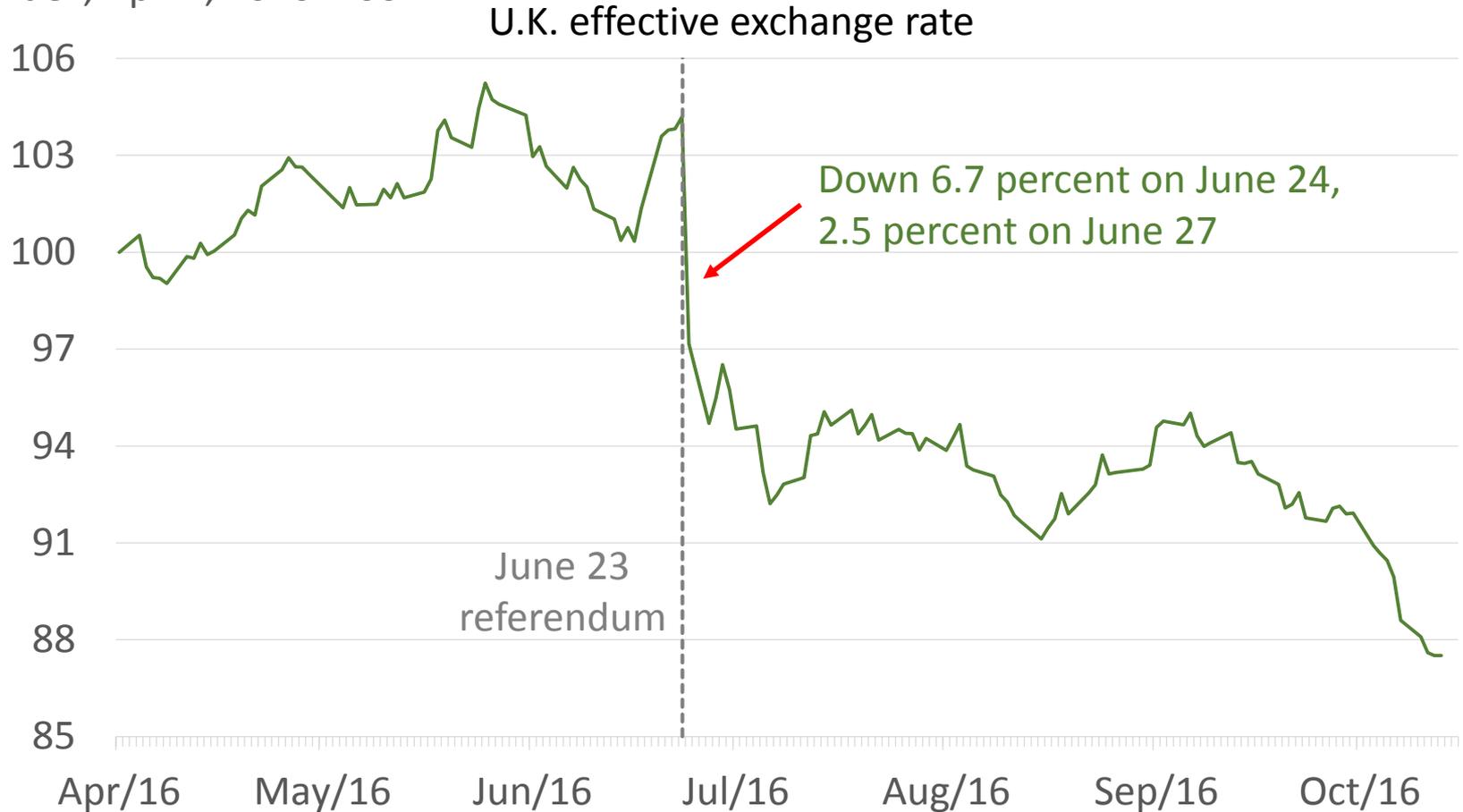
# Exchange rate effects

Euros/GBP



# Exchange rate effects

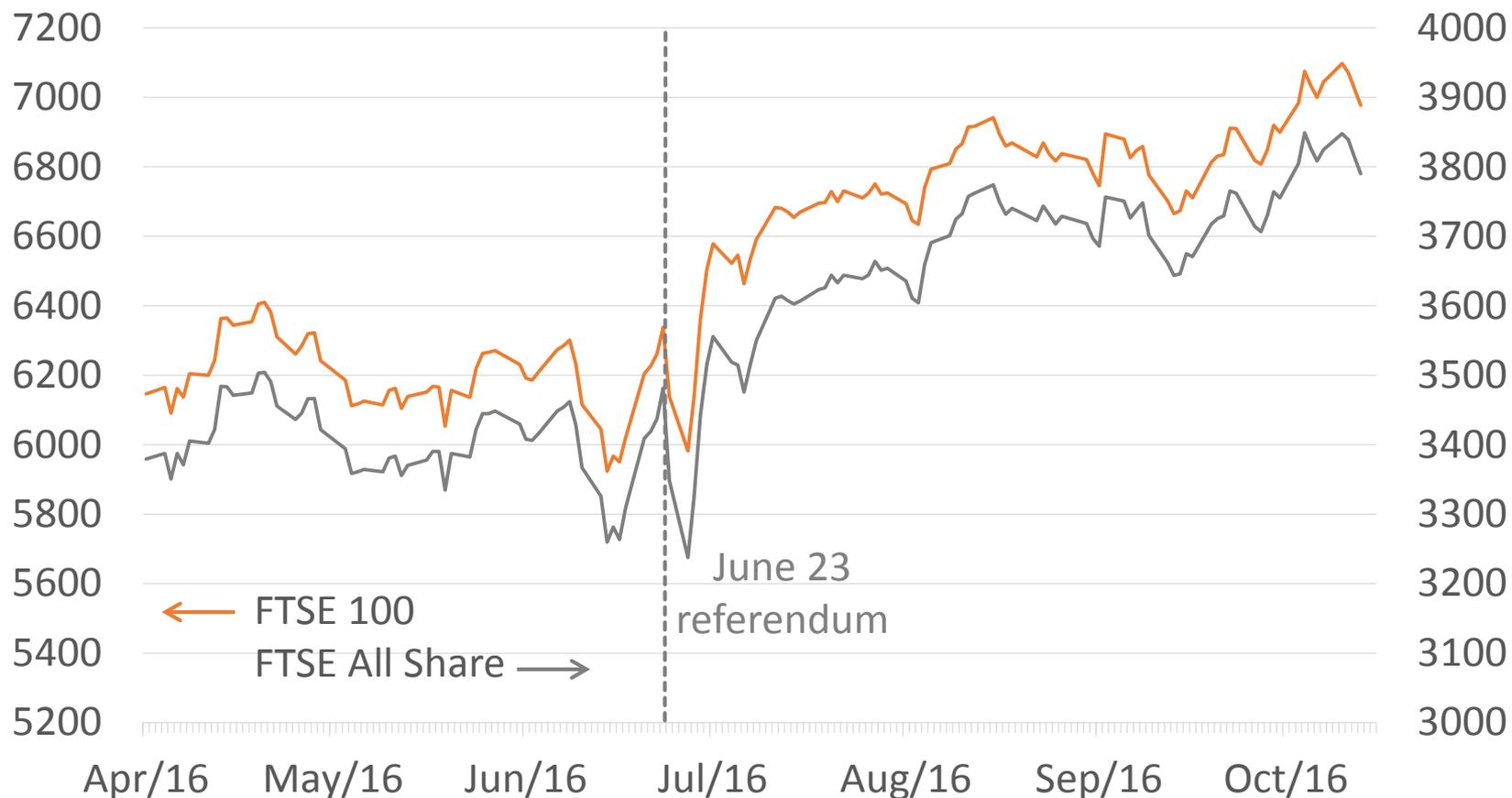
Index, Apr. 1, 2016=100



# Effects on the U.K. stock market

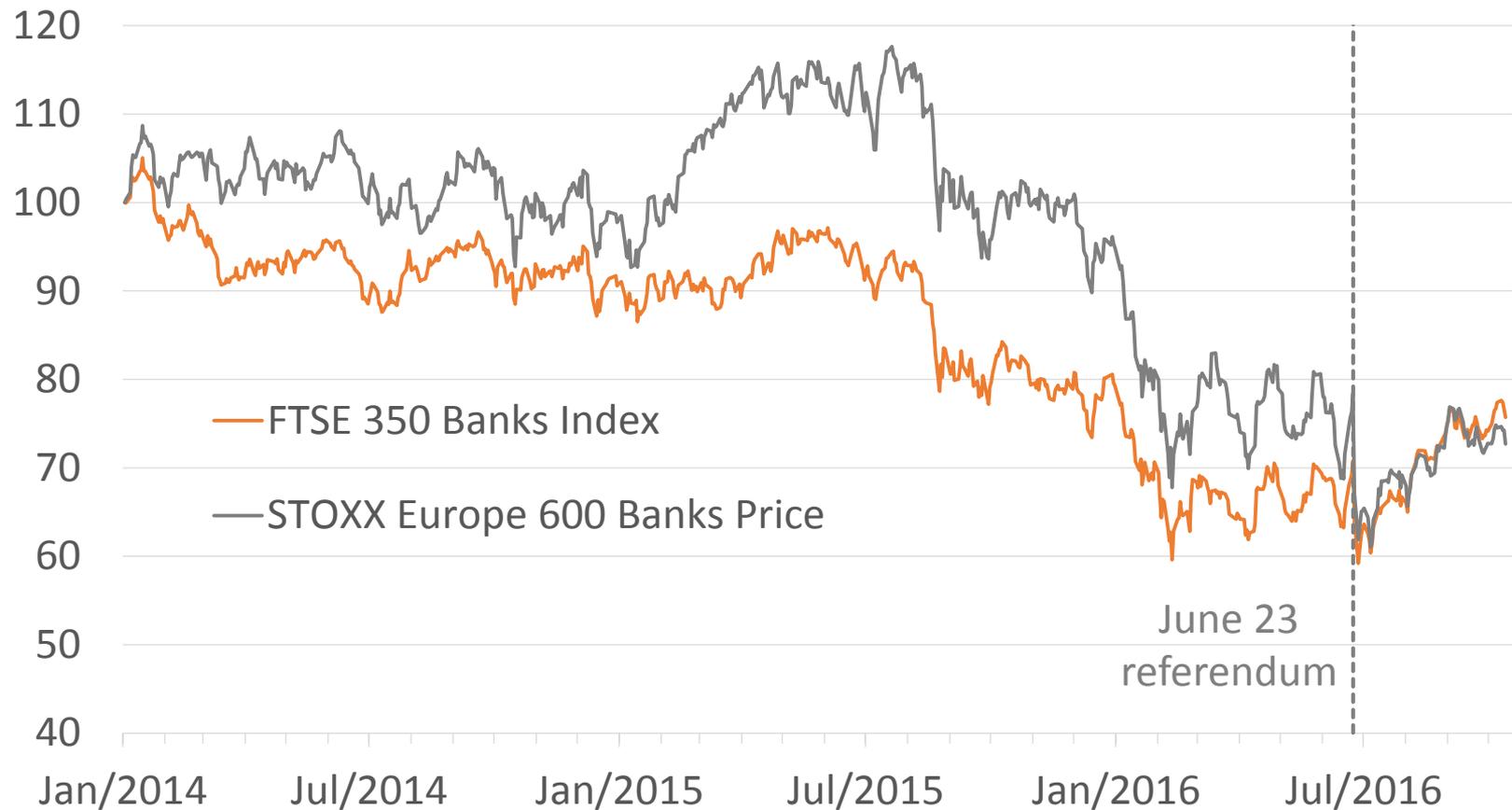
Index, Jan. 2, 1984=1000

Index, Apr. 10, 1962=100



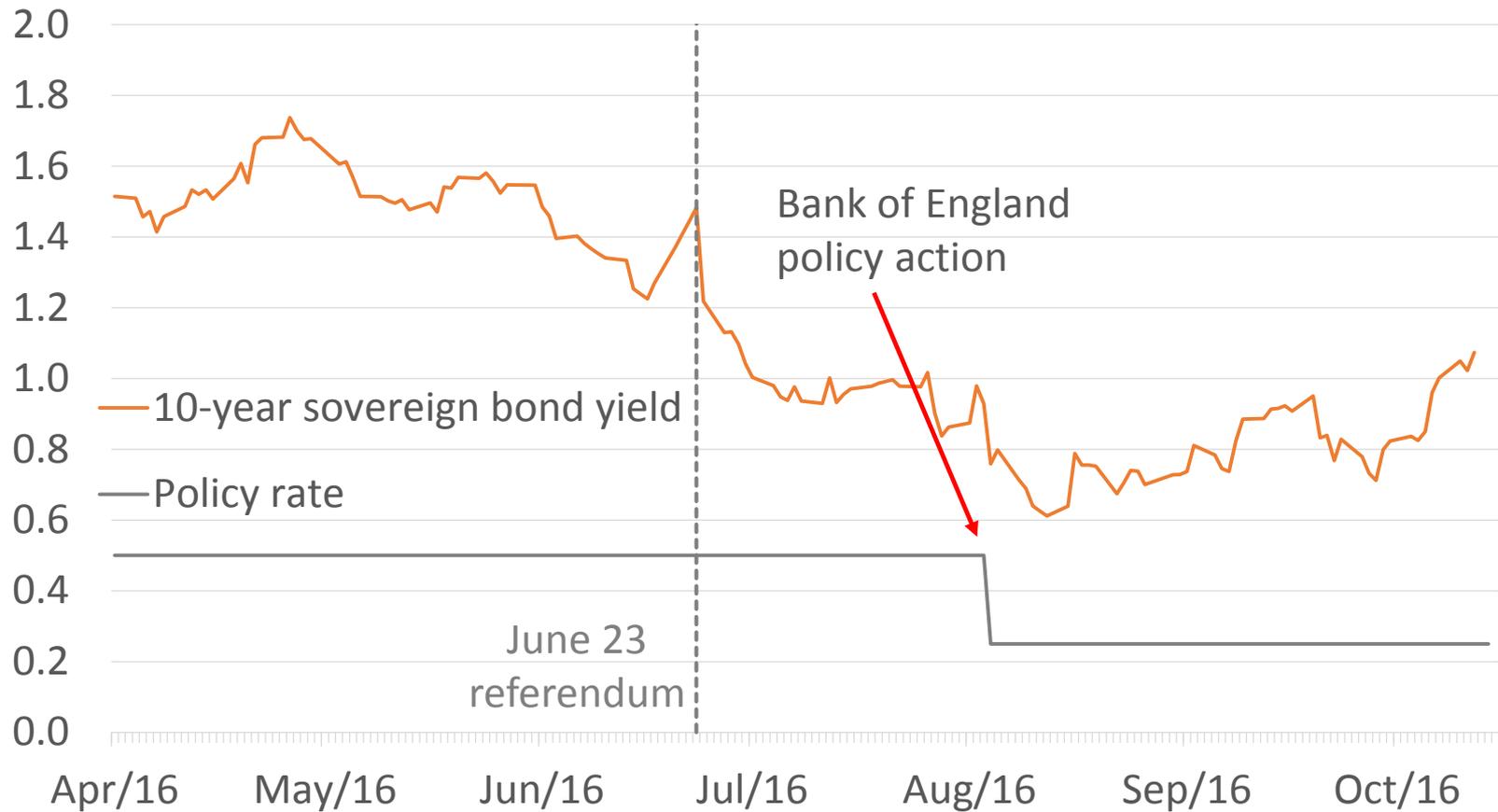
# U.K. and European bank stocks

Index, Jan. 2, 2014=100



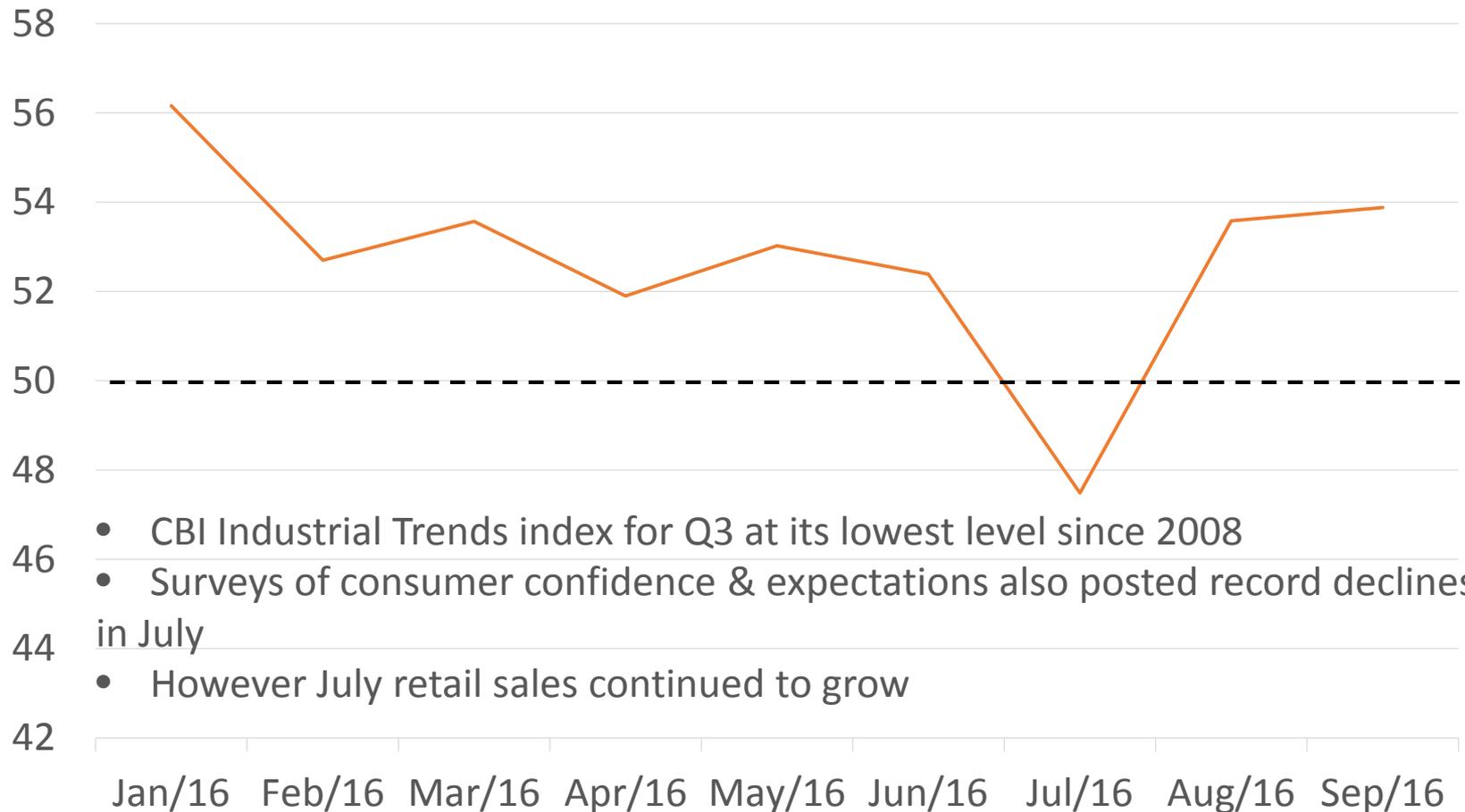
# U.K. interest rates

Percent

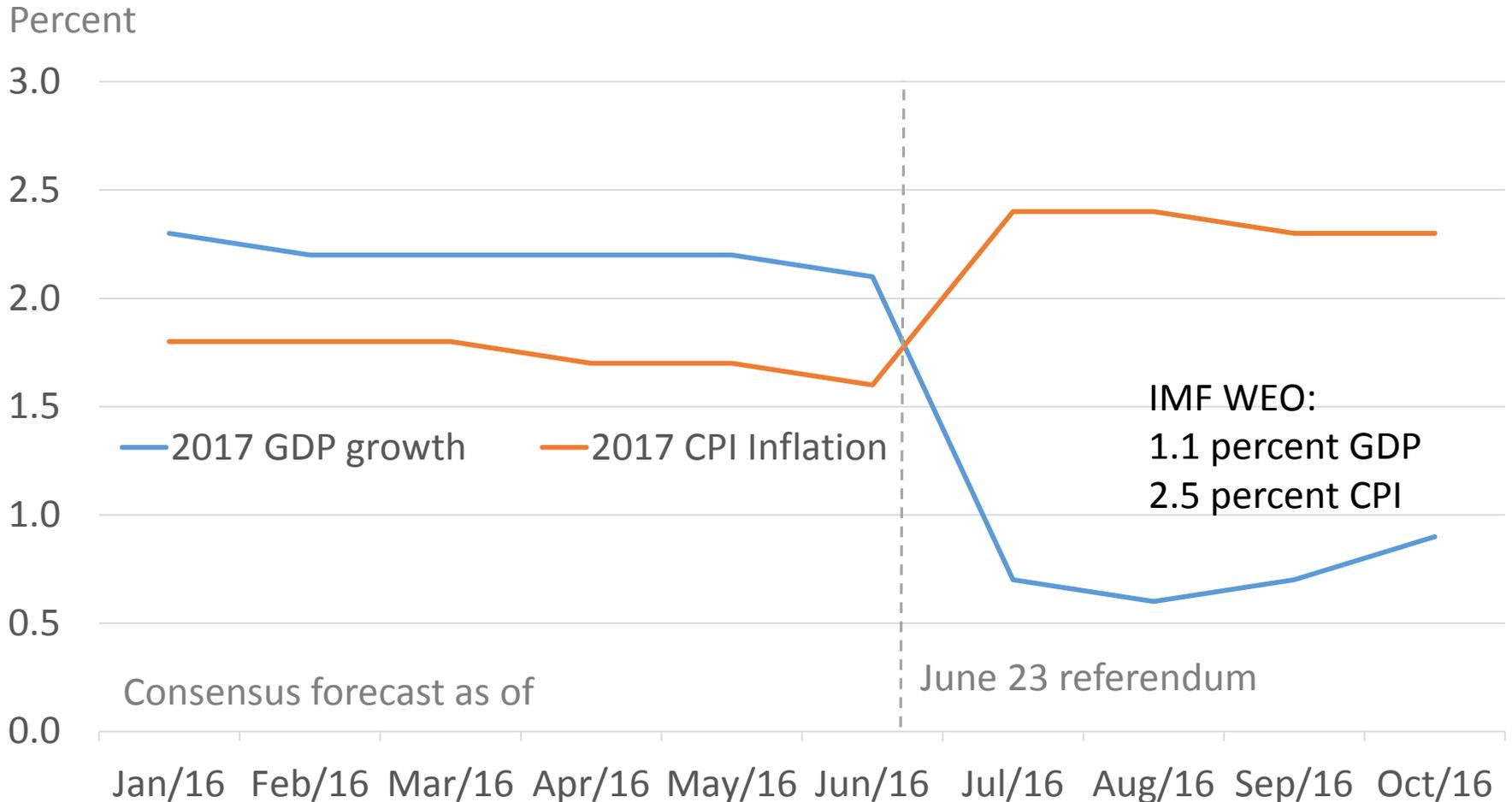


# Mixed signals on economic fallout

Diffusion index, 50+=expansion



# Impact on expected growth and inflation in 2017



# Impact on GDP growth expectations

	Percent, year over year (Revision <b>up</b> / <b>down</b> )			
	Before BREXIT vote		After BREXIT vote	
	<b>2016</b>	<b>2017</b>	<b>2016</b>	<b>2017</b>
United Kingdom	1.9	2.1	1.6 <b>(-0.3)</b>	0.7 <b>(-1.4)</b>
Euro area	1.6	1.6	1.5 <b>(-0.1)</b>	1.3 <b>(-0.3)</b>
Germany	1.7	1.5	1.6 <b>(-0.1)</b>	1.3 <b>(-0.2)</b>
France	1.5	1.5	1.5 <b>(0.0)</b>	1.3 <b>(-0.2)</b>
United States	1.9	2.3	1.9 <b>(0.0)</b>	2.2 <b>(-0.1)</b>

# Digging into the details for the U.K. outlook

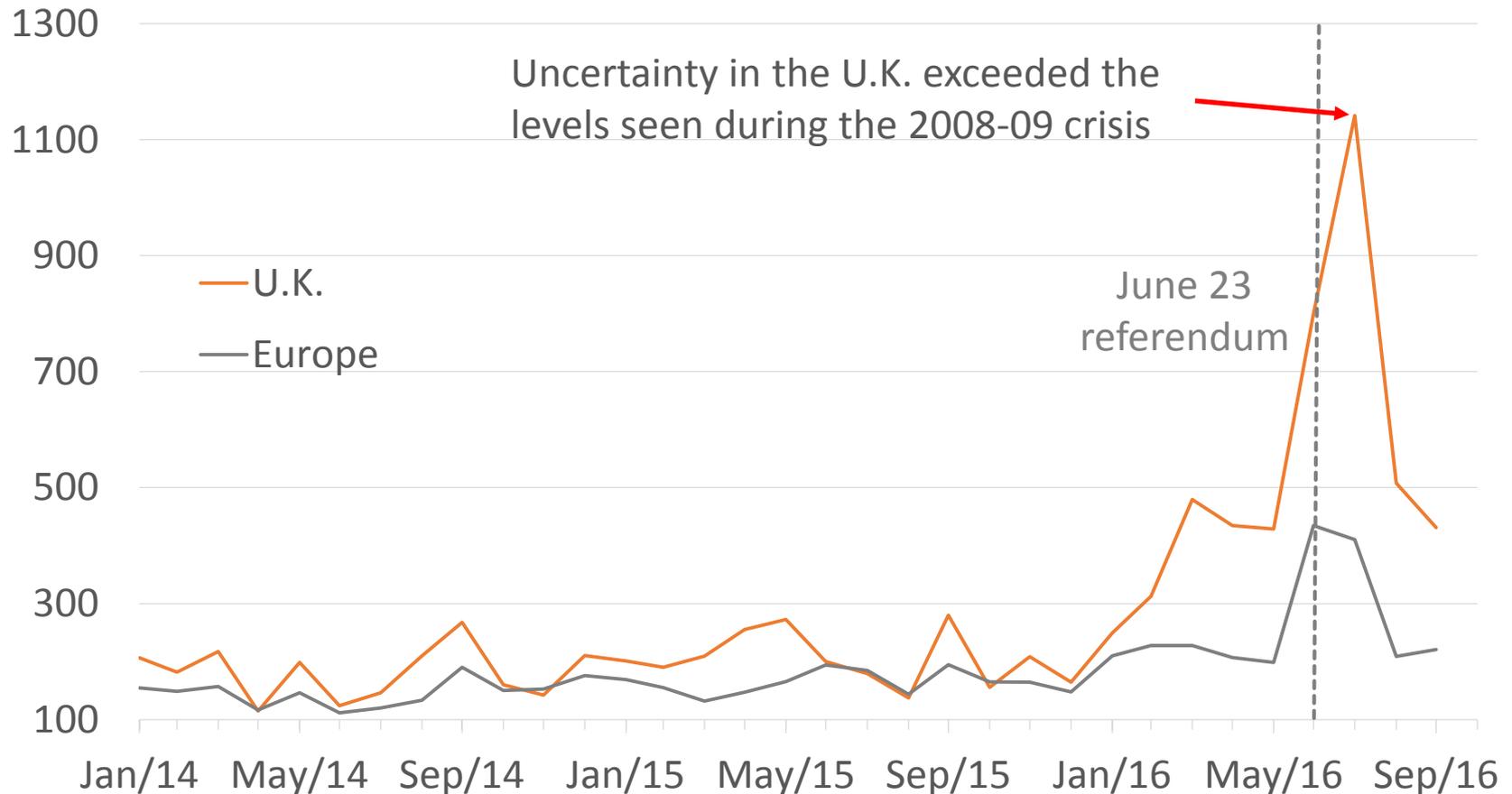
	Percent, year over year (Revision <b>up</b> / <b>down</b> )			
	Before BREXIT vote		After BREXIT vote	
	2016	2017	2016	2017
GDP growth	1.9	2.1	1.6 <b>(-0.3)</b>	0.7 <b>(-1.4)</b>
Household consumption	2.5	2.2	2.2 <b>(-0.3)</b>	0.7 <b>(-1.5)</b>
Gross fixed investment	1.7	4.3	-0.5 <b>(-2.2)</b>	-2.5 <b>(-6.8)</b>
Manufacturing production	-0.2	1.3	-0.1 <b>(0.1)</b>	-0.4 <b>(-1.7)</b>
Consumer price inflation	0.6	1.6	0.7 <b>(0.0)</b>	2.4 <b>(0.8)</b>
Unemployment rate	5.0	5.0	5.2 <b>(0.2)</b>	5.6 <b>(0.6)</b>

# More uncertainty about the outlook too

	Standard deviation of forecasts, percentage points (Revision <b>up</b> / <b>down</b> )			
	Before BREXIT vote		After BREXIT vote	
	<b>2016</b>	<b>2017</b>	<b>2016</b>	<b>2017</b>
GDP growth	0.2	0.4	0.3 <b>(0.1)</b>	1.0 <b>(0.6)</b>
Household consumption	0.2	0.4	0.4 <b>(0.2)</b>	1.4 <b>(1.0)</b>
Gross fixed investment	1.1	1.4	1.6 <b>(0.5)</b>	4.0 <b>(2.6)</b>
Manufacturing production	0.7	1.0	0.8 <b>(0.1)</b>	1.5 <b>(0.5)</b>
Consumer price inflation	0.2	0.4	0.2 <b>(0.0)</b>	0.5 <b>(0.1)</b>
Unemployment rate	0.1	0.2	0.2 <b>(0.1)</b>	0.4 <b>(0.2)</b>

# News-based Economic Policy Uncertainty Index

Mean=100



# Policy response

- Bank of England
  - June 30 – Bank announces that it will continue to offer Indexed Longer-Term repo operations on a weekly basis through end September 2016
  - Financial Policy Committee – announced reduction in the U.K. countercyclical capital buffer rate from 0.5% to 0% of banks' U.K. exposures with immediate effect after its June 28 – July 1 meeting
  - Monetary Policy Committee actions at August meeting
    - Cut Bank Rate; new term funding scheme; purchase up to £10bn corporate bonds; purchase extra £60bn of U.K. government bonds
- Fiscal policy
  - Plan to balance budget by 2019-20 abandoned

# What next? Article 50

- Invocation of Article 50 of the Lisbon Treaty
  - “The Treaties shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the notification referred to in paragraph 2....”
  - To be invoked before the end of March 2017
- Nature of new arrangement?
  - Norway? Switzerland? BRIFTA?
  - “We are going to be a fully independent, sovereign country, a country that is no longer part of a political union with supranational institutions that can override national parliaments and courts...So it is not going to a ‘Norway model’. It’s not going to be a ‘Switzerland model’. It is going to be an agreement between an independent, sovereign United Kingdom and the EU.” (Prime Minister Theresa May speaking to the Conservative Party conference, October 2, 2016)

# Conclusions

- BREXIT an unwelcome shock at a time of weak global growth
- Limited fallout beyond the U.K., so far...
- Period of uncertainty to last some time
- Key issues in negotiations: the “four freedoms”, fate of U.K. financial services sector (“Passporting”)
- Risk of contagion?



