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Brexit at Two Months: A Slow Burn in European Integration

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OVERVIEW

Markets have absorbed the initial economic shock from Brexit, but navigating the new landscape will remain a challenge. Two months after the vote, the politics of Brexit is producing a lengthy and uncertain renegotiation of Britain's place in Europe and the world. Such extended uncertainty is likely to produce a long-lasting drag on both UK and European economies, which could ultimately threaten the viability of the European Union (EU).

BREXIT AT TWO MONTHS

The June 23 Brexit vote was not a "Lehman moment," as some analysts had feared. That it did not cause a financial market freeze similar to what followed the fall of Lehman Brothers in August 2008 is a result of the strong central bank action to calm markets and subsequent monetary easing from the Bank of England. Markets have stabilized and the recent economic data has been solid, leading many market analysts to declare the crisis over.

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Such optimism is premature. For the United Kingdom, which before the vote was expected to grow at 2 percent annually, the damage to growth still could be severe, perhaps on the order of 2 to 3 percent of gross domestic product over the next eighteen months. This contraction reflects the substantial political and economic uncertainty created by Brexit and its likely effect on investment and consumer demand. The exchange rate depreciation and easy monetary policy will provide a powerful offsetting boost, but it will take time to be felt. The United Kingdom remains on the front line of this event.

The more difficult question is the extent of contagion to the rest of the world and in particular Europe, given the EU's weak economy and its population's increasing frustration with its economic prospects. As in the United Kingdom, uncertainty about post-Brexit relations is likely to weigh powerfully on investment throughout Europe. Financial stability is also an issue: European bank stocks continue to underperform and the continental banking system is struggling with the legacy of the crisis and weak profitability. Lower interest rates will not help on that latter score. The European Central Bank can ensure adequate liquidity to troubled banks, but it cannot make them lend. If Europe wants above-trend growth in this environment, fiscal policy will need to do more.

Looking ahead, I see two systemic market risks coming out of Brexit. The first is the potential for lengthy negotiations to extend the exit process at a significant economic cost for markets that crave certainty. This tension is the result of a disconnect between economic and political timelines. The second risk is that it will distort decision-making by European policymakers on critical economic questions. Although many of Europe's challenges would have presented thorny problems absent Brexit, the UK vote creates a low-growth, populist environment in which decision-making will be even more difficult. Consider each of these drivers in turn.

A DISCONNECT BETWEEN POLITICAL AND ECONOMIC TIMELINES

Immediately after forming her government, UK Prime Minister Theresa May announced her intention to trigger Article 50 at the end of 2016, beginning the formal process of Britain exiting the EU. Now, there are reports that invoking Article 50 may be delayed until the end of 2017 and a formal exit delayed until the end of 2019.

Tremendous economic uncertainty is likely to persist for some time.

In one respect, this delay simply reflects the reality of the difficult environment facing the UK government in negotiating a favorable deal with Europe. Upcoming elections in 2017 in France (May) and Germany (likely October) mean that Britain does not know who its principal negotiating partners will be, and it is hard to imagine either of those countries making significant concessions ahead of their votes and risking domestic backlash. The UK government itself is far from ready as it launches a come-from-behind effort to put in place the right people, gather the necessary information, and prepare positions before negotiations. Until recently, the UK government had less than ten people with substantial trade negotiation experience, far short of what will be required to negotiate the thousands of new rules and conditions determining the United Kingdom's future relationship with the European Union.

One response to this monumental task would be for the UK government to seek an off-the-shelf solution, mirroring the agreements that countries such as Norway or Switzerland have. Putting aside questions of whether Europe would be prepared to offer such a deal, substantial questions have been raised about whether these countries' relationships with the EU represent appropriate models for the UK economy, which is larger and more complex. Further, such an agreement would require the United Kingdom to accept freedom-of-movement rules, an anathema to pro-Brexit voters. Another approach would be to exit the EU without a new arrangement in place, which would mean that tariffs default back to World Trade Organization levels, and then later the United Kingdom could seek to negotiate a bilateral trade agreement with Europe. But this option, though easier to implement, would sacrifice a close link with Europe that many British—especially those participating in the financial markets—believe is needed for the United Kingdom to restore strong growth and protect its preeminent status as a major financial center. These considerations suggest that the United Kingdom needs a bespoke deal, customized and negotiated to meet the specific conditions facing the United Kingdom and Europe. Such a deal could take years to negotiate. Note that, although the terms of exit are to be agreed in two years and can be approved by a qualified majority of the EU members, the new trade agreement will be far more complex and requires unanimity among EU members. It could be several years before there is clarity about the economic relationship that guides the United Kingdom and Europe.

Tremendous economic uncertainty is likely to persist as long the United Kingdom's future relationship with Europe is unknown, damaging business and consumer confidence and producing a substantial drag on investment as firms wait for greater clarity on the new economic model. Still, at some point, jobs are likely to begin to shift to the continent in anticipation of London's reduced access to European markets. (Such shifts will be perhaps most visible in finance given London's role as a leading financial center.) This tension between the market's desire for certainty and the new, extended timeline for exit will not resolve easily. So far, markets have remained relatively calm, supported by strong central bank action. But that could change, and quickly, if signs of a substantial economic downturn or a flight of capital from London reach damaging levels. In that case, pressure on both the UK government and its negotiating partners on the continent to seek a quick agreement could increase.

MORE OR LESS EUROPE

European policymakers face a parallel change in how best to respond to Brexit. Six years after the start of the eurozone debt crisis, Europe remains trapped in a tepid economic recovery characterized by low growth, high unemployment, and high public and private debt. Unemployment in the eurozone remains above 10 percent. Youth unemployment rates are often more than 20 percent, undermining a generation of Europeans' hopes for a brighter economic future.

Against this backdrop, Brexit marks the realization of a significant downside risk for the European (and global) economy. The euro area, which had started the year with stronger than expected growth momentum, now faces a potentially sizeable demand shock and increased concern about financial stability. It would have been difficult in the best of circumstances to deal with the range of economic challenges confronting European policymakers in the fall, including the recapitalization of Italian banks, financing additional migration related expenditures, and fiscal slippages that violate EU rules in several countries. Brexit makes navigating the political and economic minefields surrounding these issues all the more daunting.

Addressing these challenges requires a comprehensive approach of macroeconomic and structural measures. On the demand side, more support is needed. The region's creditor countries have resisted calls for fiscal stimulus, forcing monetary policy to carry the burden of support for recovery, and the resulting negative interest rates are punishing savers, damaging the balance sheets of banks, and raising concerns about financial stability. Notwithstanding legitimate concerns in Germany and elsewhere about financial discipline and responsibility for periphery debt, fiscal authorities now need to take more responsibility for supporting demand and sustaining popular support for Europe. But short-term economic stimulus measures cannot, on their own, restore Europe's promise. Disappointingly, structural reforms of labor and product markets also appear to have stalled.

Incomplete economic union continues to cast a shadow over the economy, but a divided Europe seems less likely than ever to move forward with the measures needed to make economic unity viable. The tension between European monetary union and national fiscal policies contributes to an imbalance in policymaking and a weakened capacity to respond to crises. Although some policymakers see Brexit as an opportunity to accelerate economic and financial integration, for others, the vote and the rise in anti-EU sentiment across the region illustrate the need to set aside ambitions of greater economic unity and focus on a narrower set of security, labor, and immigration concerns. The latter approach, however, risks condemning Europe to a low-growth future that almost certainly will undermine popular support for the European project.

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Nowhere is the dilemma starker than in the current debate over how best to resolve the problems of the Italian banking system. It is hard to imagine the eurozone financial system thriving in the absence of comprehensive banking union, and that requires strong regulation of banks, coupled with firm market discipline and limits on state support for inadequately capitalized institutions. In Italy, these considerations all pointed to the need for a comprehensive restructuring and reform effort, and, where state support was needed, for bailing in creditors. Yet, following the Brexit vote, a weaker outlook coupled with rising populist pressures against austerity have led Prime Minister Matteo Renzi to seek an exception to the bail-in requirements ahead of the upcoming referendum on constitutional reform. Although a sensible compromise on the bail-in requirement looks possible, it would be unfortunate for the future of Europe if it delayed a serious bank restructuring. Sadly, that scenario now appears the most likely.

Not surprisingly, calls for populist economic policies and less union have found fertile ground across Europe. The growing political and economic constraints on policy challenge the conventional wisdom that eurozone policymakers will make tough decisions on rescue packages if and when a crisis materializes.

CONCLUSION

Brexit is a shock, but one that plays out slowly, constrained by the complexity of the process, the high degree of unknowns, and the political constraints on decision-making in the United Kingdom and in Europe. The shock acts as a drag on growth and intensifies the risk that an incomplete European economic union will return to crisis. That may be the greater threat. If policymakers respond effectively to Brexit, the benefits could be substantial: a stronger global economy and an ebbing of the political and economic forces now pressuring UK and European policymakers. Conversely, failure to address the growth risks could cause broader and deeper global economic contagion.

Looking Ahead: Kahn's take on the news on the horizon

Japan

Prime Minister Abe announced a 28.1 trillion yen ($276 billion) stimulus package, but much of the package consists of loans, and fresh government spending is 7.5 trillion yen. Is it the start of a shift in major economies' industrial country fiscal policy?

Group of Twenty (G20) and China

G20 leaders' summit will be held in Hangzhou September 4 through 5. In their July meeting, G20 finance ministers and central bank governors expressed their concerns about heightened global risks due to Brexit. The upcoming leaders' summit will test China's leadership role in ensuring that G20 takes a more coordinated approach to fiscal policy and other critical issues including infrastructure investment.

Venezuela

Venezuela's economic crisis is deepening, and default seems a question of when rather than if. The government has debt repayments of $1.8 billion due in October and $2.9 billion in November, and is looking to a debt swap operation between the state oil company PDVSA and creditors to get through the year without default.