BANK OF FINLAND
BULLETIN

BANK OF FINLAND ARTICLES ON THE ECONOMY

Table of Contents

Three months after the Brexit vote – the current state of play

12 OCT 2016 1:00 PM • BANK OF FINLAND BULLETIN 4/2016 • MONETARY POLICY

At the end of June, 17.4 million people voted for the United Kingdom to leave the EU. Share prices plummeted, the value of the pound crashed and the country was plunged into high political turmoil. The faster-than-expected appointment of a new prime minister helped to dampen political uncertainty, and market reaction quickly subsided. The effects on the real economy will be evident only later. Three months after the referendum, the UK has still not notified the European Council of its intention to leave and is still an official EU member state.

Surprising result of the historic vote

In January 2013, David Cameron, the leader of the Conservative Party, promised to hold an in–out referendum on EU membership if the Conservative Party won the 2015 general election. With the Conservatives winning the election, David Cameron became the Prime Minister and the referendum was held on 23 June 2016. To Cameron's surprise, the Brexit camp won by 51.9% to 48.1%. The turnout of voters was the highest since the 1992 parliamentary election, which was preceded by, among other things, Margaret Thatcher's resignation, the Persian Gulf War and signing of the Maastricht Treaty.

Political turmoil in the aftermath of the referendum was high within the government and opposition parties alike. Cameron announced that he would resign, but judged that his successor would not be known before the autumn. However, the new Leader and Prime Minister was chosen by mid-June, with the appointment of Theresa May, the former Home Secretary. The faster-than-expected appointment of the new Prime Minister eased political uncertainty considerably. Theresa May appointed David Davis as Secretary of

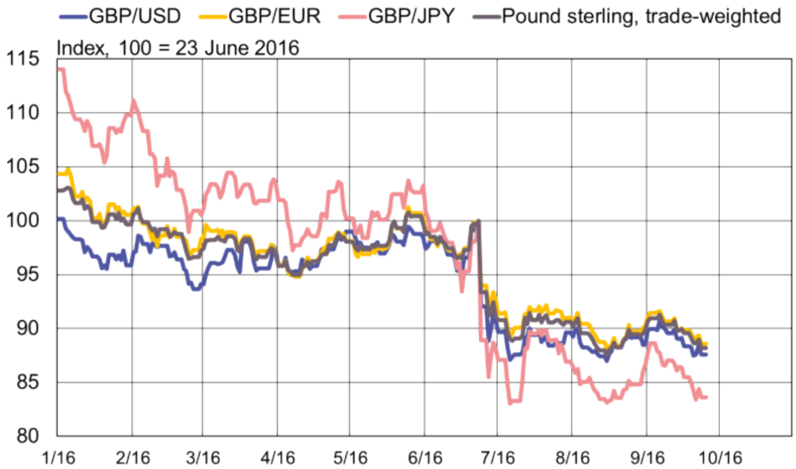
State for Exiting the European Union, Boris Johnson as Foreign Secretary and Liam Fox as International Trade Secretary. All three had publicly campaigned for the Leave camp.

The pre-referendum assessments of the Brexit's impact channels were unanimous. The short-term effects would be reflected in increasing political and economic uncertainty, higher financial market volatility, increased equity market risk premia and a weaker pound. Shaken economic confidence would erode investment sentiment and rein in recruitment.

The longer-term effects depend on the future bilateral relations between the UK and the EU. In an unfavourable scenario, foreign trade declines, capital inflows decrease and the financial sector contracts. Labour market mobility weakens and technological development and productivity suffer. The weaker pound leads to inflation rising above the target level. Consumption and investment edge down.

Chart 1.

Pound sterling around 10% weaker than before the Brexit vote



Sources: Bank of England, J. P. Morgan, Macrobond and calculations by the Bank of Finland.

28 September 2016
bofbulletin.fi
33844@Chart4

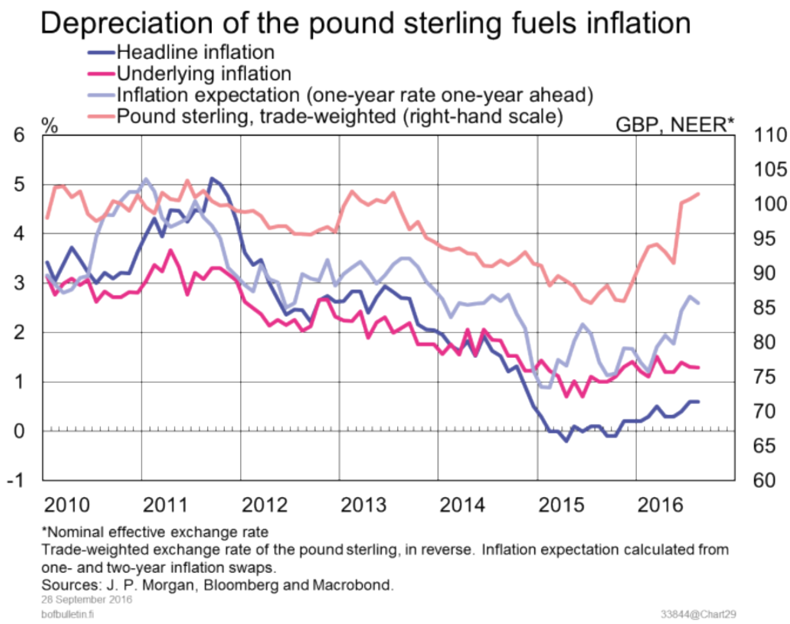
The short-term effects materialised as expected. The markets reacted instantly to the surprising referendum outcome. The pound weakened and global stock markets lost over USD 2000 billion in value the day after the vote. Fuelled by weaker economic prospects and safe haven demand, government bond yields fell and the price of gold rose. Market turbulence was short-lived, however. Share prices have largely rebounded and market volatility has moderated. The depreciation of the pound has also supported UK stock indices. The pound has stabilised on a trade-weighted basis at a level more than 10% below the pre-referendum level. The longer-term effects depend largely on the outcome of future negotiations. So far, there is little statistical evidence available on the effects of the Brexit vote on the real economy.

Actual effects on the real economy will become evident later

The referendum outcome was immediately reflected in survey results. In July, the purchasing managers' indices (PMI) for manufacturing, services and construction fell below 50. The composite PMI index combining all the sectors fell from 52.5 in June to 47.5 in July. A value below 50 forecasts contraction in economic activity. However, the initial shock had already abated in August and, except for the construction sector, the PMI indices rebounded to over 50. In July, retail trade confidence continued the downward trend that had begun in the early part of the year, and consumer confidence plummeted. In August, confidence improved notably also according to these survey results, even though it was still markedly weaker than in the early part of the year.

Statistical data released after the vote have partly been stronger than expected. Retail sales were considerably above expectations in July, growing by 1.5% from June, but dipped in August. Industrial production fell behind expectations in July. The depreciation of the pound supports export companies but, at the same time, pushes up import prices, weakens developments in household real income and fuels inflation – the first indications of which were already evident in June as higher inflation rates. With the weakening of the pound, import prices rose in July by 6.5% year on year, and headline inflation picked up to 0.6% in July–August. The first official GDP data for the third quarter will be published at the end of October.

Chart 2.



In August, the Bank of England cut its economic growth forecast for the UK for 2017 by 1.5 percentage points, to 0.8%. It also announced more extensive quantitative easing than expected. Even though the statistical data released towards the end of summer were partly better than expected, the Bank of England also held to its view on the effects of the Brexit in its September meeting. If the next economic forecast published in November remained consistent with August projections, the Bank of England would be ready to cut the Bank Rate further. In September, the British Chamber of Commerce also downgraded its growth forecast for 2017 to 1%. The downward revisions to the economic forecasts are particularly based on a sharp decline in imports and investment as a response to the weaker pound and increased uncertainty surrounding the business environment. Corporate fixed investment was already contracting in the UK in the first half of 2016, and the trend is projected to continue. The stock of foreign investment also contracted in the first half of 2016, by 10% on the previous year.

When will Brexit actually take place?

Article 50 of the Lisbon Treaty provides guidelines for a member state's process for leaving the EU. The process is initiated when the UK notifies the European Council of its intention to leave[1]. The terms of the departure will be negotiated in accordance with guidelines agreed by the European Council by unanimity. The withdrawal agreement will need to be adopted in the EU by a qualified majority by the Council (without the UK's participation) and will also require the consent of the European Parliament and that of the UK. Until the negotiations are closed, the UK remains an official EU member state.

Article 50 provides a two-year time-limit for the withdrawal negotiations, which can be extended by a joint decision. If no agreement has been concluded by the deadline and there is no unanimity about the extension of the negotiations, the UK's membership in the EU ends and the UK becomes a country outside of the union. It could, for example, trade under the terms of the World Trade Organization for international trade (WTO rules).

Theresa May has stated that she will not submit the Article 50 notification to the European Council before the end of 2016. The UK needs time to prepare its own negotiation strategy. The negotiations would accordingly commence in the early part of 2017, at the earliest. It is unclear whether negotiations on future bilateral relations between the UK and the EU would start simultaneously with the withdrawal negotiations or only after the UK has officially departed from the EU. The more tailored the new relations will be, the longer it will take to negotiate on them. The agreement will probably necessitate both unanimity and national ratification. It takes on average several years to conclude free trade agreements. The CETA agreement between the EU and Canada has been cited as the most ambitious trade agreement so far in the EU, and it has still not been ratified, even seven years after the start of the negotiations.

Trade policy falls within the competence of the EU and trade agreements are concluded at the Union level. When the UK leaves the EU, trade agreements made by the EU also cease to apply to the UK. This means that the UK needs to negotiate new trade agreements with all trading partners outside the EU. Since trade policy has been centralised in the EU for decades, the UK also presently lacks the national resources and expertise for trade negotiations.

---

1. There is currently a dispute in the UK over whether the submission of the withdrawal notification to the European Council, and hence triggering of Article 50, necessitates official Parliamentary approval.

There are several alternatives for bilateral relations between the UK and the EU. For the UK it is a question of choosing between two dimensions: the tighter relations with the EU are preferred, the more the UK must give up of its political independence. Economically, without doubt the most negative alternative would be for the UK to become a fully external country, in which case WTO rules would apply to trade between the EU and the UK. At the other extreme, the UK would follow Norway and join the European Economic Area. In that case, the price for the UK to access the single market would be both acceptance of the four freedoms (goods, services, people and capital) and volumes of EU legislation with no possibility of influencing decision-making in the Union.

The EU Commission named former EU Commissioner Michel Barnier as the chief Brexit negotiator. Barnier takes up his post at the beginning of October. He has served as the Vice President of the Commission and has previously been in charge of internal markets and financial services, for example. The EU has repeatedly stressed its basis for the negotiations: there is no access to the single market without acceptance of all four freedoms. It is almost certain that the fog surrounding the negotiations will not clear during this three-year forecast horizon. The longer the uncertainty about the future lasts, the greater the effects of the referendum will be.

Tags

- United Kingdom
- markets
- Brexit
- withdrawal negotiations