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No-Deal Brexit: Trick or Treat(y) Uncertainty and the Future of the UK Economy

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Despite the recently struck agreement between the UK and the EU, the prospect of a No-Deal Brexit remains tangible due to the demand for an unkempt postponement on the part of the British Parliament. Although the question of the consequences of such a shock has given birth to a lengthy literature, little attention has been paid to its financial aspects. This policy brief aims at clarifying the debate by tackling these considerations, while drawing some policy recommendations.

1. INTRODUCTION

Over the past two months, the Johnson's Government gesticulations around Brexit have made the possibility of a No-Deal Leave increasingly tangible. This week-end, while the Brexit crisis seemed to finally come to an end, uncertainty arose again after the question was discussed in Parliament. While the House of Commons asked for an unkempt postponement, Boris Johnson maintained its commitment to respecting the agreement struck last week. The prospect of a No-Deal Brexit remains after all, and this could lead to disastrous consequences.

The evaluations of these ever since the Referendum, have exhibited an important degree of division (Whyman and Petrescu, 2017), with estimates ranging from almost 0-consequences (Gudgin et al., 2017) to near-Apocalypse (Bank of England, 2018; Prime Minister's Office and Department for Exiting the European Union, 2018). Most of these quantitative studies have focussed on real-economy effects, through trade, productivity, import price inflation and so on (Busch and Matthes, 2016; Chang, 2018; Whyman and Petrescu, 2017).

There is, by contrast, comparatively little quantitative work on the financial aspects of Brexit, to the exception of a few studies (Bank of England, 2018; Djankov, 2017; Gudgin et al., 2017; Sapir et al., 2017). True enough, the UK's financial system looks more solid than a decade ago (Bank of England, 2018), and the country is seemingly back on more stable tracks (Keen, 2017). Yet, concerns remain regarding record-high levels of unsecured private debt and low private savings. Plus, the UK is highly dependent on large capital inflows to sustain a strong pound and to finance its trade deficit. As such, a large and brisk capital account reversal could yield adverse consequences largely ignored by modelling framework due to their methodological limitations (Burgess et al., 2016).

Hence, the purpose of this policy brief is to bring some clarity to the debate on the possible consequenc-

es of a hard Leave, by presenting its financial aspects alongside the real-economy dimension. I will then draw some policy recommendations to deal with the post-shock period. Our first-best recommendation would be to step away from a finance-based economic structure. However, given the constraints weighing on the UK in the current period, a more realistic policy would be to target consumption demand, at least as an intermediary goal.

A REAL-ECONOMY HIT

Ever since the Leave campaign won – and even before – numerous studies, quantitative or not, on the possible impacts of Brexit came out. Table 1 gives an overview of the main estimates of short-run losses.

TABLE 1 - MAIN ESTIMATES IN NO-DEAL SCENARIOS

Author(s)	Institution	Date	Shock Date	GDP Losses (Worst-case)
Booth et al.	Open Europe	2015	2016	-2.23% (Trough)
Baker et al.	NIESR	2016	2016	-2.9% by 2020, -3.3% (Trough)
	IMF	2016	2016	-4.5% by 2021; -6% (Trough)
	HM Treasury	2016	2016	-7.5% (Trough)
	PwC	2016	2016	-5.5% by 2020, -3% (Trough)
Gudgin et al.	Centre for Business Research (Cambridge)	2017	2016	No Growth losses after the shock, No differential by 2020
	Bank of England	2018	2018	-10.5% by 2020; -8.5% (Trough)
Erken et al.	NIESR	2018	2018	-2% Growth by 2020
	HM Government (Prime Minister Office)	2018	2018	-9.3% (Trough)
	IMF	2019	2018	-5% by 2020), -6% (Trough)
Marc Carney	Bank of England	2019	2019	-5% (Trough)

Source: Author's own elaboration. Trough indicates the highest scenario-baseline spread between the date of the shock and 2020. Only studies reporting GDP losses were included, and other macroeconomic results, such as inflation and unemployment, are left aside for the sake of clarity.

Variations across modelling exercises also come from differences in retained causality channels, and on the emphasis put on each of them. The following can be found across models:

1- Trade: A No-Deal would entail a transition to a WTO regime for EU-UK relationships. The UK would lose all the advantages of being within the Single Market and would see its transaction costs increase. Plus, in a globalised world, EU-UK trade is not a closed system, and barring the UK access to the Single Market may have the ripple effect of making harder the UK's access to fast-growing markets through the EU (IJtsma et al., 2018). A no-Deal Brexit would also have structural consequences in the longer run by disturbing the country's positioning within global value chains (Cappariello et al., 2018). This is particularly true for the financial sector, which could lose its passporting rights¹ and suffer from barriers to data flows (Godin, 2019). Sapir et al. (2017) estimate that up to 17% of UK assets could move to the Continent, while Djankov (2017) reports 12-18% possible losses in revenues for the City, costing up to 10% of the financial centre's jobs.

2- FDI Flights: Mainstream studies usually see FDIs as greenfield (actual investments in plants and machinery), and therefore as an increase in the supply of capital. Any reduction would therefore depress domestic investment. Many observers have nonetheless expressed doubts on the economic importance of FDIs in the UK, which are to a great extent composed of profit-shifting operations and mergers and acquisitions (Gudgin, Coutts and Gibson, 2015).

3- Exchange Rate: FDI withdrawals and lower exports will harm significantly the value of the pound, which has already been stuck to record-low levels since the referendum. Although some authors (Gudgin et al., 2017; PwC, 2016) argued that past the short-term shock, J-Curve effects will boost the UK's competitiveness and help resorb the country's trade deficit, Aiello et al. (2015) showed that UK exports are relatively unrelated to the real exchange rate, casting doubts on this hypothesis.

4- Inflation: For Breinlich et al. (2017), the pound's depreciation that followed the Referendum translated into a 1.7%-acceleration of CPI inflation. Accelerating inflation would harm a quite fragile recovery of real wages, depressing demand further.

5- Uncertainty and unpreparedness: Higher spreads, risk premia and interest rates would slow down investment, already depressed by lower outlet prospects on the domestic market. Many investment projects have already been suspended since the referendum, and an important question on the matter is whether they will indeed be realised after the shock or if they will be plainly cancelled. Plus, the chances of brisk and violent reactions could augment if uncertainty does not abate. Finally, some

modelling exercises (Bank of England, 2018) include short-term disturbances at the border, due to custom and supply-chain unpreparedness, whose scope is uncertain due to contradictory estimates (Carney, 2019; Operation Yellowhammer, 2019)².

Detrimental estimates were either reached by doubtful modelling frameworks (Gudgin et al., 2015) or with highly pessimistic hypotheses on the degree of supply-chain preparedness (Bank of England, 2018; Carney, 2019). As such, with regards to purely real-economy effects, the Bank of England's latest estimate (-5% GDP shock) could be regarded as an adequate higher bound for short-run losses.

FINANCIAL ASPECTS

Despite the importance of these factors, the studies above rely on theoretical premises that have traditionally overlooked financial determinants emphasised by post-Keynesian analysis³ (Dullien, 2017; Keen, 2017). My own estimates relying on an enhanced version of the Bank of England's SFC model (Burgess et al., 2016), despite some quantitative uncertainties, clearly point at possibly unsustainable dynamics coming from the degradation of households' and non-financial companies' (NFCs) net lending positions (Daumas, 2019). In this respect, three other channels could be added to the list:

6- Household Debt: Despite some improvements, British households' debt levels remain at historically high levels, with poor households struggling to repay their unsecured debt commitments (Collison, 2019). The debt-to-income ratio sticks around 130% and saving rates are low. Any large shock on either unemployment or property prices could put many households' solvency in jeopardy and therefore harm consumption demand.

7- Corporate Debt: In the event of a hard Brexit, corporate bankruptcies could soar and spread to the financial sectors, hence entailing major losses for UK financial institutions (Godin, 2019). The BIS also signalled the dangers coming along corporations' increased reliance on market finance and corporate bonds (Carsterns, 2019).

8- Capital Flights and Sudden Stops: The UK relies heavily on its ability to attract large capital inflows to finance its current account deficit. A shock as large as Brexit could entail large capital withdrawals. These "hot money" flights (Guttman, 2016) in particular may prove very instability-prone, and provoke a capital account reversal (Busch and Matthes, 2016). This could endanger the re-financing of UK agents, and weigh on real wages due to exchange rate swings. Bank of England officials recently reported concerns over the flightiness of UK's foreign financing, which has increased since 2016.

1- Passporting rights allow UK firms to bypass regulatory barriers on imports.

2- The Yellowhammer Papers are a Government Note published in September hinting at possibly highly disruptive disorders at the border, due to the severance of key supply chains in food and medicines. This assessment stands in sheer contrasts with Marc Carney's relatively optimistic appraisal of the UK's state of preparedness, leading to the 3-points downward revision of the Bank of England's worst-case scenario effects.

3. The only exception is Gudgin et al.'s 2017 assessment, the authors using a stock-flow consistent model in the tradition of Godley and Lavoie (2007), which includes credit-cycle (Borio, 2014). However, the role of credit in their Brexit scenario is unclear, and their modelling of household borrowing is still rudimentary, as they do not model the financial sector explicitly (Gudgin, Coutts and Gibson, 2015).

9- Uncertainty and market volatility: Uncertainty will also touch financial markets, and trigger significant market instability (Bank of England, 2019), which could result in asset mispricing, likelier herd behaviours and lower animal spirits.

Given the stronger resilience of the UK's core banking sector (Bank of England, 2018) and the slowdown in household borrowing (Bank of England, 2019) over the past few months, Brexit is unlikely to be a large housing/household debt crisis similar to the Great Financial Crisis (GFC). Its core banking system, with adapted policies, could fare relatively well. More worrying is the growing shadow-banking side (ESRB, 2018) of the UK's financial system that was not stress-tested. Significant uncertainty and market volatility coupled with drastic capital withdrawals could put these institutions in dire straits. The difference with the GFC would be its more direct link to NFCs. Higher volatility and an over-cautious market-lending sector would deprive NFCs of the funding they need. Worse, too high uncertainty could trigger fire sales by favouring herding behaviours (Bouleau and Giraud, 2018).

True, the UK did go through a similar situation back in 2016, after the referendum. But today, uncertainty is higher than ever, and market confidence has hit a record low. There are therefore significant risks for financial disturbances in case of hard Leave, coming first and foremost from uncertainty and market volatility.

POLICY RECOMMENDATIONS

At best, the UK will be dancing on the edge of the financial cliff if the policy stance is adequate. In that respect, the country's priority in the aftermaths of the Leave will be to tame uncertainty as much as possible. In the short run, this will amount to two things. First, a strong fiscal policy stance going beyond automatic stabilisers, which will help create outlets, abate good market uncertainty and relieve animal spirits. Second, the UK will have to design as fast as possible a new regulatory framework by creating clear rules of the game and going for the easiest bureaucratic solutions. A strong monetary arm will also be necessary, especially through the activation of currency swap lines between the ECB and the Bank of England to maintain a constant flow of euros.

Our analysis has also shown the potentially destabilising effects of a finance-based economic structure. This element and its subcomponents introduce indeed a built-in uncertainty component within the UK's macroeconomic structure. Demand is fickle due to more unstable job prospects for households flowing from labour repression (Dögüs, 2018), and their necessity to rely on unsecured debt. The NFC sector depends significantly on the availability of foreign funds and on the stability of financial markets. Finally, housing bubbles are still on despite a slowdown.

A solution immediately coming to mind would be the implementation of a major industrial policy (Inman, 2018) aimed at reducing the role of City in the UK econ-

omy. However, this would be a highly disruptive change in a country whose structure relies on services and is heavily reliant on imports, and whose productivity growth has lagged behind that of its OECD counterparts (Haldane, 2018). A more achievable goal which could partially reduce the instability component would be to target consumption demand, through three avenues:

1- Stepping away from austerity and restoring public services is an utmost necessity. The May government did take some steps in that direction, by increasing public-sector wages and pouring money into the NHS and other services. Such expenses must be maintained and even increased, whatever the extent of the shock. The UK has also had a long-lasting infrastructure deficit in education (Coelho, 2015) and transports (Bowman, 2015). To the extent that infrastructures and public services are redistribution in kind, such policy steps would have the desirable effect of unbinding the budget constraint of households and limit their reliance on unsecured debt. A meaningful social housing policy would also limit the potentiality of housing crises.

2- The rise of finance has come hand in hand with the rise of personal income inequality. Tackling the latter by better redistribution in cash would have similar effects to public service and infrastructure investment, stimulate domestic demand directly due to high consumption propensity in the lower tail of the income distribution (Lavoie, 2015), and help households to deleverage. Plus, to the extent that the financial system has built on the availability of large private savings from the wealthiest (Dögüs, 2017), this could in the very long run help tampering the structural role of finance in the UK economy.

3- Finally, strengthening labour market regulation would put a brake on the worrying development of the UK gig economy, which today employs one adult out of ten (Partington, 2019), and help wage recovery. In addition, more stable job prospects would stimulate consumption due to lower uncertainty. This would also induce UK firms to invest in labour-saving technologies (Storm and Naastepad, 2012), and would stimulate overall innovation through heightened cost-competition between domestic firms (Agell, 1999). The UK economy would also be less sensitive to macroeconomic shocks.

However, this would only be a partial remedy. The UK is constrained by its need to finance a large current account deficit and to maintain a relatively strong pound. As a consequence, the government will have to maintain the attractiveness of the City, at least in the waiting for better days. While it is unlikely that London's charms will totally wane for all investors (Godin, 2019), competition from Europe will likely rise in the future (Howarth and Quaglia, 2018). This could be for the best, to the condition that the UK finds another jewel to develop, a hard task indeed.



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