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Brexit and the End of the Great Policy Moderation

ABSTRACT The United Kingdom's vote to leave the European Union, informally known as Brexit, marked the end of the period of broad economic policy consensus that emerged in liberal democracies from the 1980s onward. The main consequence of Brexit is a large and widespread increase in uncertainty, which can be observed in forecast dispersions and financial variables. Why did Brexit make the United Kingdom, and indeed the world, fundamentally more unpredictable? I present two main reasons, one idiosyncratic to Brexit and one broadly applicable. The first is the binary nature of post-Brexit arrangements—"hard Brexit," or no Brexit. The second, much wider issue is the rising mistrust of experts and consequent demise of the liberal economic policy consensus.

The Great Moderation in macroeconomics refers to the broad decline in the volatility of output and employment in the United States and other advanced economies during the postwar period (Blanchard and Simon 2001). The Great Recession put an abrupt end to the Great Moderation. The United Kingdom's vote to leave the European Union, I would argue, marks the end of the period of broad economic policy consensus that emerged in the 1980s.

I consider the consequences of Brexit in terms of its impact on economic and policy uncertainty in the short and medium runs, in both the United Kingdom and the rest of Europe. Uncertainty regarding the outcome of Brexit negotiations under Article 50 of the Treaty of the European Union has an impact on financial variables (such as exchange rates) and economic variables (such as investment). And though it is difficult to forecast Brexit's impact on the United Kingdom, its impact on the rest of Europe is even more difficult to assess. To illustrate this point, I consider the possibility that Brexit might trigger significant changes in the European Union's foreign and defense policies.

Table 1. Pre- and Post-Brexit 2017 Forecasts

Indicator	*June*	*July*	*August*	*September*
Mean forecast				
GDP	2.08	0.48	0.68	0.90
Consumption	2.17	0.61	0.97	1.32
Investment	4.28	–3.29	–2.76	–2.12
Standard deviation of forecasts				
GDP	0.34	0.88	0.65	0.57
Consumption	0.40	1.35	0.86	0.79
Investment	1.39	3.25	3.35	2.96

Source: HM Treasury (https://www.gov.uk/government/collections/data-forecasts).

I. Increased Uncertainty in the United Kingdom

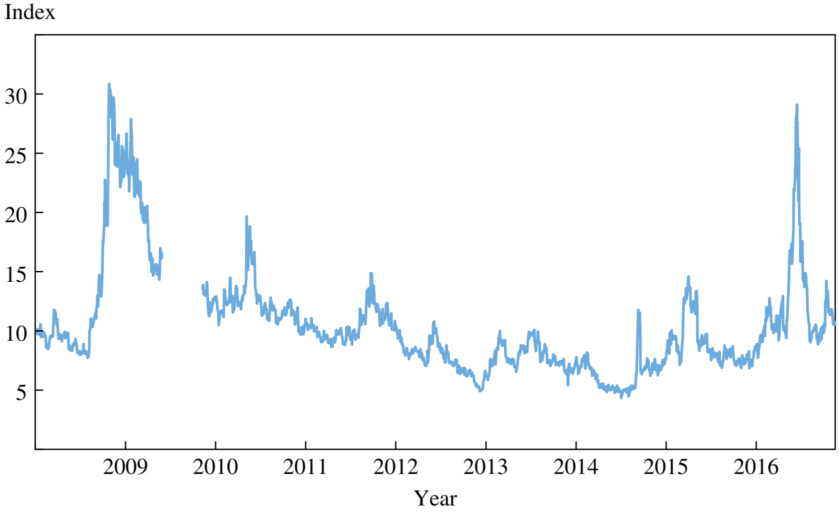
In the days following the Brexit vote on June 23, 2016, the *Financial Times* Stock Exchange 100 Index fell sharply, and sterling depreciated against the currencies of the United Kingdom's trading partners. Stocks quickly recovered, but the currency has continued its drift lower. Coupled with stable or falling government bond yields, the stock market recovery has been interpreted by some commentators as reflecting muted optimism that Brexit's effect on the United Kingdom's economy will not be too severe. But the stock market's recovery is not very surprising, given that a large proportion of revenues for companies in the *Financial Times* Stock Exchange 100 Index originate outside the United Kingdom—as much as three-quarters, according to one study (Capital Group 2013). A depreciating currency is good news for profits denominated in sterling.

Regarding economic forecasts, I would argue that the most salient fact is not so much the downward revision of the average forecast as the sharp increase in disagreement among forecasters. Incidentally, the increase in uncertainty provides an interesting testing ground for macroeconomic theories that emphasize the role of uncertainty.

I.A. Economic and Financial Uncertainty

Table 1 shows the mean professional forecast for 2017 GDP, consumption, and investment growth, as well as the standard deviation among forecasters, for June through September 2016. The June forecasts were published before the Brexit vote, and the July forecasts shortly after. Forecasters on average revised their very pessimistic post-Brexit forecasts higher. Uncertainty, as measured by the standard deviation of forecasts, increased significantly immediately after Brexit, and has remained elevated.

Figure 1. British Pound Volatility Index, 2008–16



Source: Bloomberg.

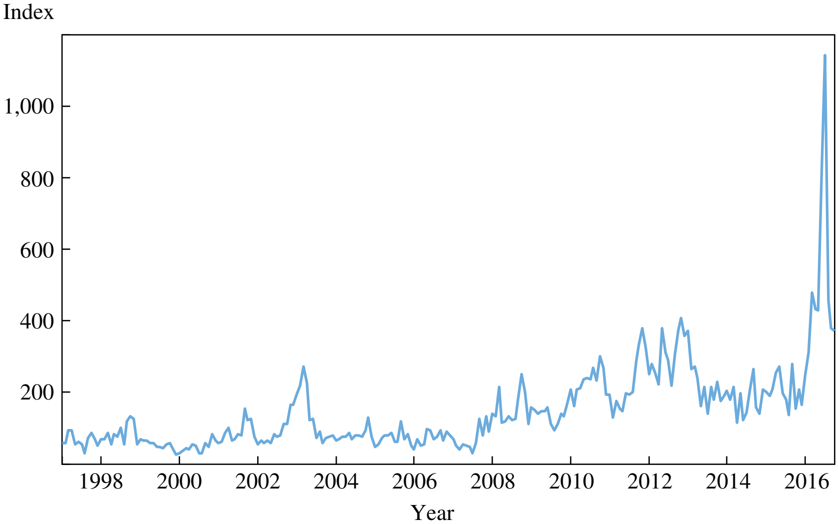
Increased uncertainty is also apparent in the foreign exchange market. Figure 1 shows the British Pound Volatility Index, a measure of the implied volatilities of dollar–pound currency options. The post-Brexit spike is striking, and rivals the increase in volatility at the height of the global financial crisis. Though the index quickly settled down after this spike, it remains elevated relative to its pre-Brexit levels.

I.B. Why Is Policy Uncertainty So High?

The economic and financial uncertainty regarding the United Kingdom mostly reflects a rise in policy uncertainty, which is apparent in the uncertainty index shown in figure 2 (Baker, Bloom, and Davis 2016). The increase in uncertainty is partly domestic—Brexit has induced significant turnover in British political circles. Moreover, the vote has revealed deep divisions between a pro-Brexit country, a pro-remain Parliament, and a government divided between these two camps.

It seems plausible, however, that a significant part of the uncertainty is related to the forthcoming negotiations between the United Kingdom and its European partners. I therefore interpret the rise in uncertainty as reflecting risk in the negotiations' outcome. And though this rise is not surprising, I would argue that its magnitude is. Why is it so hard to forecast Brexit's

Figure 2. U.K. Economic Policy Uncertainty Index, 1997–2016



Source: Davis (2016).

ultimate outcome? It is not as if U.K. and European diplomats and policymakers do not know each other well. And it is not as if a sensible "soft Brexit" option would not be in everyone's best interest. So why is it so hard to predict what will happen?

I would argue that the magnitude of the increase in uncertainty reflects the fact that the distribution of possible outcomes for the negotiations is probably bimodal, and that there is no soft Brexit option. Speaking in Brussels on October 13, 2016, Donald Tusk, president of the European Council, stated, "It is useless to speculate about 'soft Brexit.' . . . The only real alternative to a 'hard Brexit' is 'no Brexit.'" This statement should be taken with a grain of salt, for it was made in anticipation of the negotiations, but I would argue that it is basically correct. European leaders have all argued that the United Kingdom cannot retain access to the Single Market without accepting the free movement of European citizens. Conversely, U.K. prime minister Theresa May has made it clear that her government's priority is precisely to impose restrictions on European migration.

André Sapir (2016) summarizes the various options for the United Kingdom. The World Trade Organization and free trade agreement options correspond to a hard Brexit. The European Economic Area or European Free Trade Association option really means no Brexit, and would require free labor mobility, which is not acceptable to the U.K. government and is therefore not really an option. The only soft Brexit option is the continental partnership proposal of Jean Pisani-Ferry and others (2016), which would allow partial labor mobility and a contribution to the European Union's budget in return for access to the Single Market. At this stage, however, European politics would make an agreement on this solution very unlikely. Finally, the availability of the Swiss option is unclear, given that Swiss voters have also rejected the free labor mobility clause.

Finally, even in a best case scenario, negotiations will take years. As Charles Grant (2016) explains, the United Kingdom faces not one but six difficult negotiations. It needs an interim trade agreement as well as an ultimate trade pact with the European Union; it needs to reenter the World Trade Organization as a full member; it needs new arrangements with the many countries that currently have an agreement with the European Union; and it needs to negotiate its ties to the European Union in foreign policy, defense policy, and judicial cooperation.

These facts, I would argue, explain the large increase in policy uncertainty that we have observed in recent months. This uncertainty is particularly important regarding the future of the City of London as Europe's financial center, because the passporting of U.K.-based financial institutions to the rest of Europe will probably end (Véron 2016).

II. Brexit's Broader Lessons

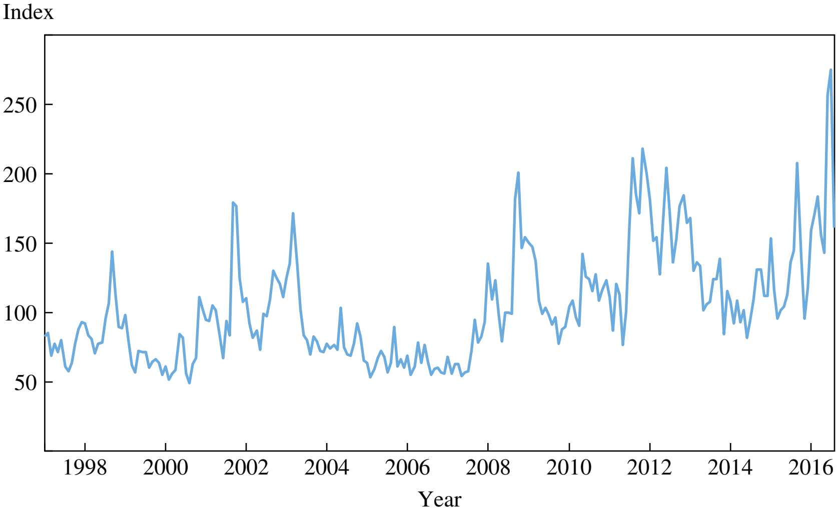
Brexit has important consequences for the United Kingdom, but also important lessons for the rest of the world. Here I highlight two: the declining role of experts in the policy debate, and the future of European foreign policy.

II.A. Brexit and the Mistrust of Experts

An overwhelming majority of academic economists, policymakers, and economic journalists firmly believed (and continues to believe) that Brexit will hurt the United Kingdom, and the European Union to a lesser extent. Based on this idea, most pollsters, and the betting markets, agreed that "rationality" would prevail and a majority of voters would reject Brexit. Then the vote took place, and they were shocked by the results.

As Luigi Zingales (2016) argues, "What we have observed in Britain and what we are observing in the [United States] with [Donald] Trump is a growing mistrust of voters toward experts." In this sense, Brexit is not an accident, but the symptom of a deep underlying problem that plagues our modern societies. What we, the experts, consider facts—that is to say, statistical evidence—are simply not believed by a large fraction of the population.

Figure 3. Global Economic Policy Uncertainty Index, 1997–2016[a]



Source: Davis (2016).
a. The series uses GDP weights, adjusted for purchasing power parity.

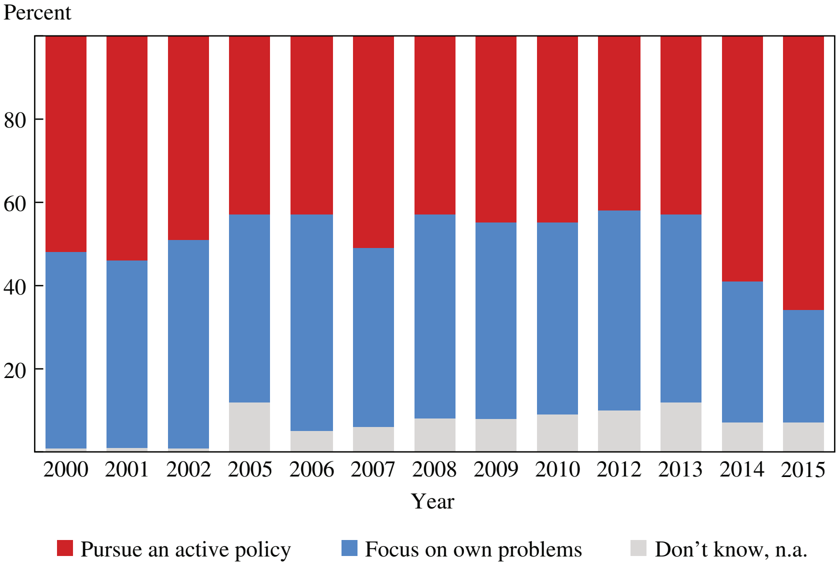
The disconnect between experts and citizens makes it much more difficult to promote evidence-based policies. To the extent that facts are less extreme than ascendant ideologies, such as nationalism and populism, this could spell the end of policy moderation. Perhaps reflecting concerns about the end of moderation, the increase in policy uncertainty following the Brexit vote was not confined to the United Kingdom, as shown in figure 3.

II.B. The European Union's Foreign Policy: A Perfect Storm

Brexit is happening at a critical time for the European Union's foreign policy. It is significant that the first meeting of EU heads of state without the United Kingdom, which took place in Bratislava, Slovakia, was devoted to defense, counterterrorism, and foreign policy. There are good reasons to be skeptical about EU defense and foreign policy; it belongs to the long list of EU talking points that perennially bear no fruit.

This time, however, might be different, for at least four reasons. First, the United Kingdom has always been opposed to the emergence of an independent EU defense policy because it thought, not unreasonably, that such a policy would undermine the role of NATO. But with the United Kingdom out of the EU, the terms of the debate are going to change.

Figure 4. Trend in German Public Opinion Regarding Foreign Policy, 2000–15[a]



Source: Center for Military History and Social Sciences of the Bundeswehr.

a. Survey respondents were asked the following question: How should Germany be active in international politics? (i) Pursue an active policy and assist in addressing problems, crises, or conflicts; or (ii) focus more on tackling own problems and keep out of the problems, crises, and conflicts of others.

Second, Europe's eastern and southern borders have become objectively more dangerous, from Russia under Vladimir Putin and its destabilizing influence in Ukraine, to Turkey drifting away from democratic rule, to Syria, Libya, and the refugees from the war-torn regions of the Middle East.

Third, U.S. president-elect Donald Trump has suggested that he might not provide military assistance to the Baltic states (Estonia, Latvia, and Lithuania) if they were invaded by Russia. This message resonated strongly in Europe, particularly in those countries that fear they might become the next Ukraine. Even if the Trump phenomenon proves temporary, the damage that it has done to NATO's credibility in Europe is likely to be permanent because it has very clearly demonstrated just how strong isolationism has become in the United States.

Finally, these events will force Europe to fundamentally rethink its defense policy at a time when German public opinion is slowly moving away from the isolationist stance that has prevailed since World War II. Figure 4 shows the growing support of German public opinion for a more active foreign policy.

Historically, the European project has focused on economic policy. But today there is no appetite anywhere in Europe for more economic integration, except perhaps for tax harmonization, which would indeed be useful. Conversely, the need for a European coast guard seems pretty obvious. One could then reasonably argue that the next steps in European integration could be in the realms of foreign policy, security, and defense.

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