Brexit imperils the confidence of strangers (Martin Wolf, FT, June 14th 2016)

The uncertainty caused by a vote to leave the EU might trigger a sharp turnround in capital flows

Suppose that the Leave campaign, which one might call Project Lie, wins the referendum next week. How bad might the economic consequences over the next few years be? Alas, they might be very bad indeed.

Mark Carney, governor of the Bank of England, noted when launching the May Inflation Report: “The [Monetary Policy Committee] judges that the most significant risks to its forecast concern the referendum.” Moreover, he added, “a vote to leave the EU could have material economic effects — on the exchange rate, on demand and on the economy’s supply potential — that could affect the appropriate setting of monetary policy”. The latest Inflation Report adds that the campaign has already partly caused sterling’s depreciation.

The UK Treasury has provided a thorough analysis of short-term risks. This is, inevitably, controversial. But it is important to remember that the Treasury is notoriously sceptical about the EU. Its main scenario is that gross domestic product would be 3.6 per cent lower after two years than if the UK voted to stay, unemployment 520,000 higher and the pound 12 per cent lower. Under a worse scenario, GDP would be 6 per cent lower, unemployment 820,000 higher and sterling 15 per cent lower. The Institute for Fiscal Studies has added that — instead of an improvement of £8bn a year in the fiscal position if the net contribution to the EU fell — the budget deficit might be between £20bn and £40bn higher in 2019-20 than otherwise.

Far more important than such inevitably uncertain forecasts is the analysis of the three channels through which Brexit would work in the short term. These are the “transition effect”, which would come from the perception that the UK had become permanently poorer; the “uncertainty effect”, which would come from unavoidable ignorance about the post-Brexit policy regime; and, finally, the “financial conditions effect”, which would work via the perception that the UK was a less appealing and riskier place in which to invest money.

An important question is whether modelled possibilities capture all the tail risks. The answer is that they do not.

The Treasury argues that the economy might reach a “tipping point” after which worse outcomes would occur — thus “a shock to sterling might cause a sudden contraction in foreign currency lending to UK banks”. Since about half of banks’ short-term wholesale funding is in foreign currencies, reduced access to such funding could then cause further significant financial instability.

An obvious source of fragility is the huge current account deficit. This reached 7 per cent of GDP in the last quarter of 2015. Mr Carney has stated that the UK is dependent on “the kindness of strangers” for sustaining its current standard of living. More precisely, it depends on their confidence. The current account deficit brings risks even in normal times. But the uncertainty caused by Brexit might cause a sharp turnround in capital flows. Net inward foreign direct investment might collapse, for example. The results could include a sharp decline in sterling, a fall in the prices of sterling-denominated bonds and a jump in the inflation rate.

If this were merely caused by a negative shock to demand, the MPC could respond with expansionary policy. Even so, it would be forced into unconventional policies, possibly including negative rates, given how low interest rates are. But, if Brexit were also viewed as a negative shock to supply (as it would almost certainly be), the case for monetary offsets would be weaker. The higher prices would then be a way to deliver the needed suppression of real demand. (See charts.)

A crucial source of fragility, on which the Treasury naturally says nothing, is political. After the referendum, the UK would cease to have a government in any meaningful sense. The Conservative party, with a tiny majority, would be deeply divided between its pro and anti-European wings. The opposition Labour party is already deeply divided on this and many other issues.

Out of this morass would have to come a competent government with a view of what it wants to achieve in complex negotiations with the rest of the EU and the world. It would then have to undertake these negotiations with partners that have many other concerns and would regard the UK with a poisonous blend of hostility and contempt. It would have to decide whether to keep or modify the laws created by more than four decades of EU membership and, if the latter, how to do so. It would have to manage the impact of Brexit on the coherence of the UK and its relations with Ireland. While doing all this, it would have to manage the economy, the fiscal position and the minutiae of political life. Anybody who believes the leaders of the Brexit campaign could manage all this is surely taking illegal drugs.

Moreover, the consequences of Brexit are unlikely to be limited to the UK. The direct impact of British economic instability on the world might not be large, though the eurozone is not in a good position to cope with negative shocks. But the indirect effects might be sizeable. Outsiders might view the UK's departure as a sign that the EU is a sinking ship. Inside the EU, nationalists and xenophobes would take heart. Brexit might, in such ways, prove an important blow to the EU. At the least, it would force a huge diversion of attention and effort. Yet perhaps the most important consequence might be as a signal of the sheer power of populist forces. If the UK can choose Brexit, maybe Donald Trump will become president of the US.

Brexit, in sum, might be a big economic shock and not just for the UK. This is largely because of the fragility that precedes it and the many uncertainties that would follow it. The referendum is itself irresponsible. The outcome might well prove devastating.