

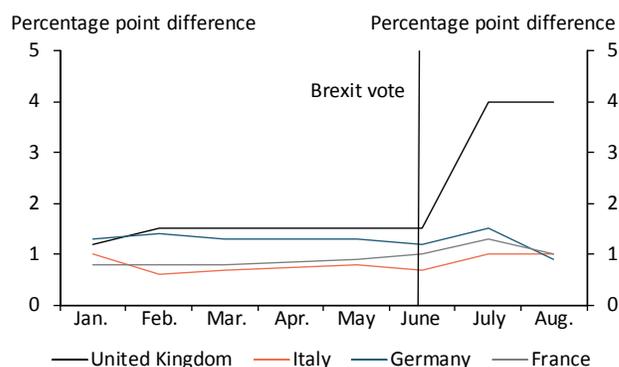
Global Uncertainty in the Wake of Brexit

By Craig S. Hakkio and Nicholas Sly

The United Kingdom's decision to leave the European Union has raised uncertainty about near-term economic growth, medium-term commercial and financial relationships between European countries, and long-term trend growth in the United Kingdom and the euro area. These distinct sources of uncertainty influence the U.S. outlook at different time horizons with different potential consequences. Unless uncertainty leads to severe financial stress, evidence and theory suggest heightened uncertainty is a major concern for the United Kingdom, a modest concern for the European Union, and a relatively minor concern for the United States.

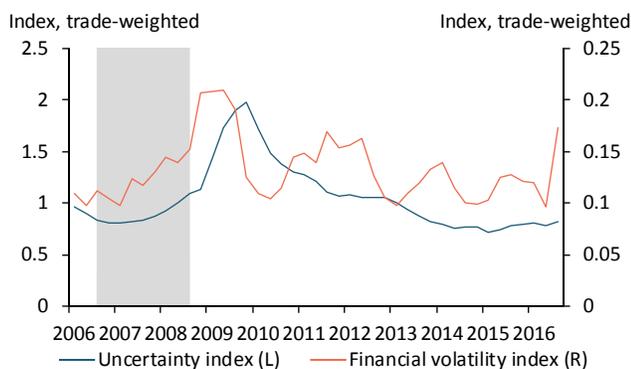
Uncertainty about U.K. growth in 2017 increased dramatically following Brexit, while uncertainty about growth in other major European countries increased only slightly in July and returned to previous levels in August. Chart 1 shows a measure of near-term growth uncertainty across several major economies in Europe, constructed as the difference between the high and low forecasts for real GDP growth from Consensus Economics.¹ Specifically, the difference between the high and low forecasts for U.K. growth rose to 4 percentage points, while the difference in other nations' forecasts increased by less than a half of a percentage point. In addition, the subtle rise in growth uncertainty for other large European economies dissipated quickly, disappearing almost entirely two months after Brexit.

Chart 1: Changes in growth uncertainty within the euro area after Brexit



Sources: Haver Analytics, Consensus Economics, and authors' calculations.

Chart 2: Near-term global uncertainty and financial volatility indices



Note: Gray bar denotes NBER-defined recession.

Sources: Haver Analytics, Bureau of Economic Analysis, Consensus Economics, and authors' calculations.

Outside the United Kingdom and euro area, global economic uncertainty about near-term growth was little changed even as financial volatility increased. Chart 2 shows an index of foreign growth uncertainty among U.S. trading partners alongside an index of foreign financial volatility. We construct the uncertainty index using the difference between high and low growth forecasts for 17 of the United States' largest trading partners with weights equal to the share of exports going to each country. We construct the financial volatility index using variation in interday sovereign bond prices across countries, again using U.S. export shares as weights for each country.² The chart shows little change in global economic uncertainty after the Brexit vote: the level of the uncertainty index has remained near its

lowest value observed over the last decade. In contrast, foreign financial volatility spiked following the Brexit vote. The increase in financial volatility is among the largest observed over the last decade.

How do near-term growth uncertainty and financial volatility affect the U.S. economic outlook? The evidence in Sly (2016) indicates that heightened uncertainty about near-term foreign growth and greater financial volatility among U.S. trading partners each act as an independent drag on the demand for U.S. exports. The sudden change in financial conditions illustrated in Chart 2 suggests that near-term export activity may face some headwinds. However, the potential drag on total economic growth through these few channels is quite limited.

U.S. exports account for approximately 12 percent of GDP. Only a quarter of those exports are to the European Union, and a much smaller share of exports—less than 1 percent of U.S. GDP—are to the United Kingdom. Together, the small share of exports in GDP and small change in economic uncertainty across major trading partners, albeit with a substantial change in foreign financial volatility, suggest the potential drag from uncertainty in the wake of Brexit is small. The prospect of Brexit could affect U.S. exports through channels other than uncertainty. In particular, the results of the vote have renewed concerns about financial stress in Europe. If financial conditions worsen across the continent and lower economic growth, the reduction in demand for U.S. exports—and the resulting effects on U.S. GDP growth—could be more significant.

The effects of medium-term policy uncertainty are more difficult to estimate, as the future commercial and financial policies that will dictate the structure of European economic relationships are unknown. Negotiations between the European Union and United Kingdom will likely result in larger trade barriers than are currently in place, but these negotiations are still several years from resolution. The cloud of uncertainty about the future of trade policy is likely to reduce trading activity even before any European barriers are put into place. Analyses by Handley and Limao (2015) as well as by Pierce and Schott (2016) confirm that trade policy uncertainty indeed acts as a drag on trading activity. Over the medium term, if reductions in trading activity due to policy uncertainty within Europe lower overall growth, the resulting reduction in demand for U.S. goods could act as a headwind to growth that may not be resolved for a couple of years.

Once negotiations between the United Kingdom and European Union conclude, Brexit will result in structural shifts in the European economy with implications for the United Kingdom's and euro area's long-term growth. Barriers to international trade can reduce competition between national economies. Also, limits on worker flows between countries can affect labor market outcomes. Each of these mechanisms can affect the overall performance of the U.K. economy and the euro area economy going forward. Consensus Economics suggest that many believe long-term growth in the U.K. will slow upon Brexit. The median forecast in February 2016 (before the Brexit vote) for U.K. growth over the 2024–2028 period was 2.2 percent, while the forecast declined to 2.0 percent in August 2016 (after the vote). However, the median forecast for Euro Zone growth for 2024–2028 actually rose from 1.0 percent in February 2016 to 1.4 percent in August 2016.

Although transitory slowdowns in foreign growth can drag on U.S. economic performance, perhaps surprisingly reductions in trend growth among U.S. trading partners are less likely to pull down long-run growth,

particularly trend shocks that occur within G7 countries such as the United Kingdom, Germany, France, and Italy (see evidence in Blonigen, Piger, and Sly 2014). Thus, greater uncertainty about long-run growth in Europe may be a relatively smaller concern for the U.S. outlook.

Overall, the U.K. vote to leave the European Union left several sources of uncertainty for the global economy in its wake. Short-term and longer-term uncertainty are likely to lead to some reduction in U.K. GDP and potentially longer-run growth, but the transmission to the United States is likely to be small. First, exports are a relatively small share of U.S. GDP, and exports to the United Kingdom are less than 1 percent of GDP. Second, while longer-term uncertainty will likely lead to a longer-term reduction in U.K. GDP, the transmission to the United States is likely to be much smaller. Provided that financial conditions across Europe do not become too strained, the evidence suggests that heightened uncertainty is a major concern for the United Kingdom, a modest concern for the European Union, and a relatively minor concern for the United States.

¹ Sly uses this measure of growth uncertainty, while others suggest that differences in forecasts reflect disagreement that may not be the same as uncertainty (D'Amico and Orphanides 2008). Regardless of the nomenclature, we focus on this measure of uncertainty because of its robust association with U.S. export activity.

² Specifically, uncertainty for each U.S. trading partner is measured as the spread between the highest and lowest growth forecast for the current year as reported by Consensus Economics. Foreign financial volatility is measured as the standard deviation in interday prices for 10-year sovereign bonds for each country. Both uncertainty and financial volatility are measured at a quarterly frequency.

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