DAVID HALE GLOBAL ECONOMICS

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Brexit: Deflation, Demographics and Debacle

By Robert Madsen

Executive Summary

The United Kingdom has opted out of the European Union and will find it difficult to reconsider that decision. The focus in London will accordingly now shift to reorganizing discredited political parties, forming a new government, managing the Scottish problem, and then, probably, beginning the two-year process of leaving the EU.

Implications for the United Kingdom

- The UK economy will go into recession in 2017, shrinking by 1%. It will then recover moderately although in 2020 it will still be 5-7% smaller than if Brexit had not occurred.
- Financial conditions will tighten. The pound will fall to a level 15-20% below its pre-Brexit level and interest rates will rise. Having lost capital over the last few days, banks will constrain their new lending and corporations and households will react by limiting their investment and consumption, respectively. Continental demand for British housing will slump.
- British financial institutions will lose some of their business to other financial centers and see profitability deteriorate. The proposed merger of the LSE and the Deutsche Bourse will not proceed, and some firms will relocate personnel to the continent.
- Many industries will exhibit poorer revenues and profitability. UK pharmaceutical firms will have more difficulty selling in Europe because London will have less influence over EU regulation. The same is true, to a lesser extent, of telecoms companies. Exporters will benefit from depreciation but may encounter greater barriers to entry in Europe.

Implications for the Rest of the World

- Global GDP growth will decelerate by 30-50 basis in late 2016 and 2017.

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- The United States and Japan will serve as safe havens. Inflows of capital will cause JGBs and Treasuries to appreciate, and both the yen and the dollar will strengthen. The Fed will not hike interest rates in 2016 or 2017, and the BOJ will intervene frequently to fight yen appreciation.
- The UK has legitimized the process of leaving the European Union and over the next 3-5 years other countries will follow, each precipitating a new round of international turmoil.
- The BOJ, the PBOC, and probably the ECB will all loosen policy to weaken their currencies—as will, effectively, any additional defectors from the European Union. Protectionist sentiment and the possibility of currency wars will both increase.

Brexit may well be the first step in the unraveling of the Eurozone. That process will exercise a deflationary effect on the global economy, making GDP growth, inflation, and wage improvements more difficult to achieve.

Brexit: Deflation, Demographics and Debacle

Since 2008 the global economy has been fundamentally broken. With the partial exception of the United States, global and national GDP growth has been tepid at best and prices have exhibited disinflation or even deflation. By at least one definition—several consecutive years of sub-potential economic growth—the advanced industrialized world has been in depression for the better part of a decade. Governments have tried to revivify their economies by running large budget deficits, and central banks by expanding their balance sheets and by inventing ever more creative ways to loosen monetary policy. Yet nothing has worked and the people of many countries have grown progressively more dissatisfied with their governments. The Brexit decision should be seen in part as a result of this post-2008 depression and disgruntlement, as should its economic and financial ramifications as they unfold over the coming weeks and months. Unfortunately, the aftermath of Brexit is likely to bring an intensification of the very problems that gave birth to that mistake and greater probability of similar errors elsewhere.

Deflation

The vast majority of today's business leaders and economists grew up thinking that demand almost always exceeds supply and hence that inflation is the greatest threat to a country's wellbeing. Historically, however, that was not the case. For the vast majority of human history supply rose faster than demand and prices tended to fall, producing deflation that rendered debts ever more difficult to sustain. That changed with the 20th century, when two world wars, reconstruction after those wars, and the very high rate of household formation that produced the Baby Boom generation boosted demand considerably. Important as well was the advent of monetary authorities with a decent understanding of economics and the tools necessary to help smooth out the business cycle. The Great Depression, however, raised the possibility that shortfalls in spending could persist for long periods of time even in a world with modern central banking.

Such has in fact been the situation since 2008. There are several reasons for a significant deceleration in price appreciation over the last few decades. The earliest was the addition of China and India to the global labor force sometime in the early or middle 1990s, which put downward pressure on wages throughout the world. A second was an acceleration in technological innovation, since one of the main purposes of such creativity—perhaps its main purpose—is to obviate the need for relatively costly human labor. Still another factor was the aging of the wealthy populations in Japan, much of Europe and several other OECD economies since older people save much and spend little. These factors did not cause deflation, or serious disinflation, in the early or middle 2000s in large measure because the Federal Reserve inflated asset bubbles that enriched the American people and enabled them to keep purchasing goods and services even as consumption in the rest of the world flagged. When the largest bubble in history collapsed in 2007-2009, the global imbalances suddenly unwound and there was no source of demand to replace a suddenly retrenching American household sector. The underlying deflationary tendencies were thus revealed and anxious governments reacted with deficit spending, causing national debts to rise sharply, even as central banks moved from progressively less effective Quantitative Easing programs to negative interest rates and other radical new programs.

Demographics

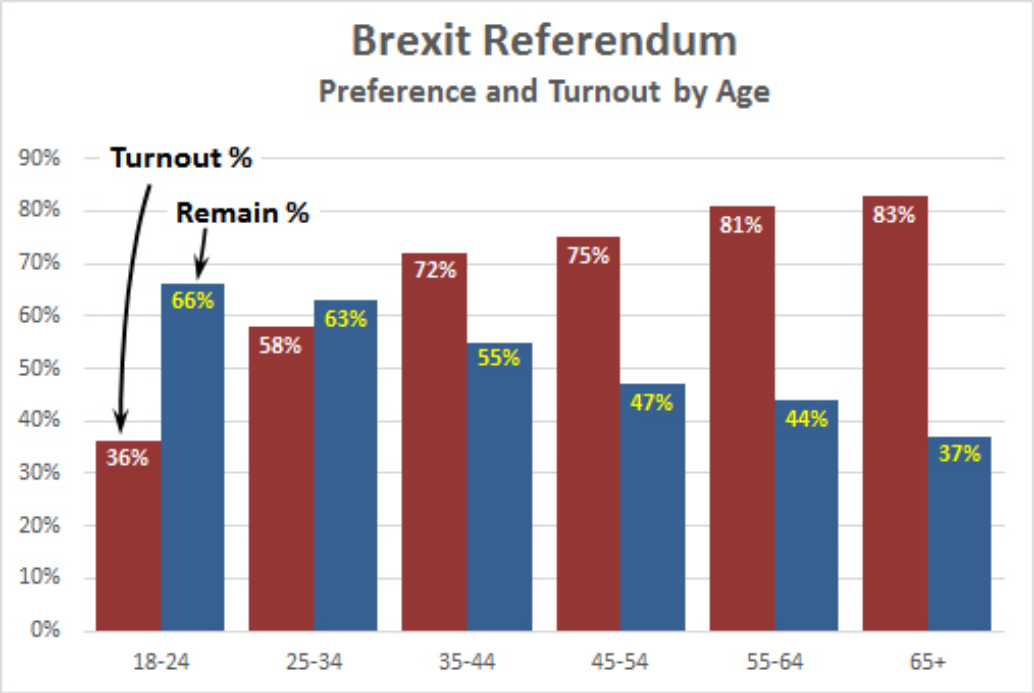
The demographic piece of the puzzle merits special attention for several reasons. First, as Japan's economy has shown for the last 25 years, the aging of a population can depress household spending—and hence corporate investment and GDP growth—for decades. The failure of the Bank of Japan, which began quantitative easing not in 2008 as is often thought but as early as the banking crisis in 2000-2002, to stimulate growth or decent inflation indicates that monetary policy may ultimately be unable to generate rising prices in the absence of reasonably strong aggregate demand. Those are ominous signs for today's world, where the problem of bad demographics has not yet peaked. Large numbers of legal and illegal immigrants spare the United States much of the trouble caused by the aging of its baby-boom cohort, but that benefit that must surely be offset internationally by the nascent transition in China, where both the total population and the labor force have only just begun to contract.

Third, and crucially important for understanding Brexit and more generally OECD politics, is political disillusionment. Global GDP growth and inflationary pressures would probably have decelerated in the late 1990s if it were not for the technology bubble that the Fed inflated after the 1997 and 1998 crises and the subprime bubble that it inflated in the middle 2000s. Absent those distortions, people in the major economies might have seen their wages and retirement funds stagnate much earlier, presumably leading to disenchantment that would have manifested at the polls. But the Fed and other central banks postponed that reckoning with their very low interest rates until the disaster of 2007-2009, meaning that the downturn that then ensued was more precipitous than would otherwise have been the case. Since then the world has become a much less hospitable place for people nearing retirement, middle-aged men who lost their jobs and are no longer employable, lower-class workers, and anyone concerned about his country's fiscal future and its ability to meet its healthcare and pension obligations. Throughout the OECD, in short, lower and middle-class and older people feel that their governments have broken the social contract. It is hard to overstate the significance of the consequent anger.

Brexit

The political implications of the worldwide malaise are profound. First, in several countries there has been a political polarization that has brought strange characters to the fore. The United States exemplifies that: a decade ago few would have predicted that a socialist would survive so far into the primary season or that a anti-establishment candidate such as Donald Trump would garner the Republican nomination.

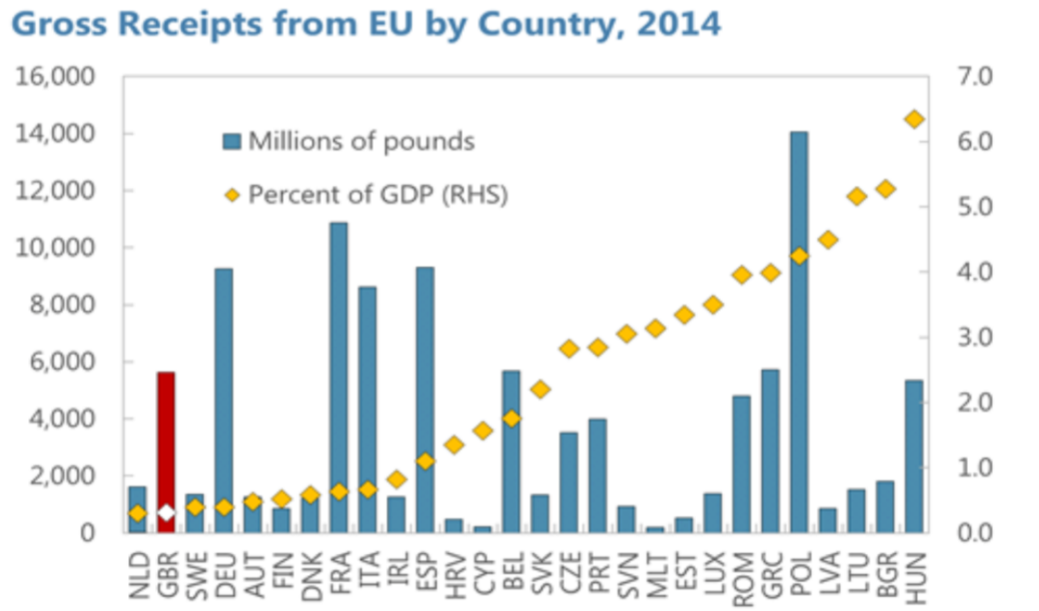
The center has weakened at the expense of more extreme parties in France and other countries as well. In many places nationalist parties have capitalized to one degree or another on the popular dissatisfaction, with Japan at the moderate end of that spectrum, China in the middle, and Hungary at the farther end. Yet another implication in much of the OECD is a new generation gap, with younger workers remaining relatively comfortable with the status quo but older people feeling a more acute sense of betrayal and voting accordingly.



Source:Mother Jones

This resentment contributed significantly to the Brexit debacle. The truth is that the United Kingdom benefited greatly from membership in the European Union: the British paid comparatively little to participate in that body and gained, in exchange, political influence, easier trade relations, and preferential access for its banks and other financial institutions. The proposal this spring to merge the LSE and the Deutsche Bourse underscores the advantage to the City of maintaining a strong foothold in the EU. Leaving that union was consequently a decision born not of logic but of pique, a sense among many voters that their country was going in the wrong direction and had sacrificed too much sovereignty to unelected bureaucrats in Brussels.

Anti-immigrant sentiment, probably the most important single factor in the Brexit movement, was itself stoked by fears among blue-collar and middle class voters that their jobs were being taken by foreigners—an impression that owes much to years of slow GDP growth, low inflation, and stagnant wages. It is regrettably difficult to see how Brexit will ameliorate any of those problems.



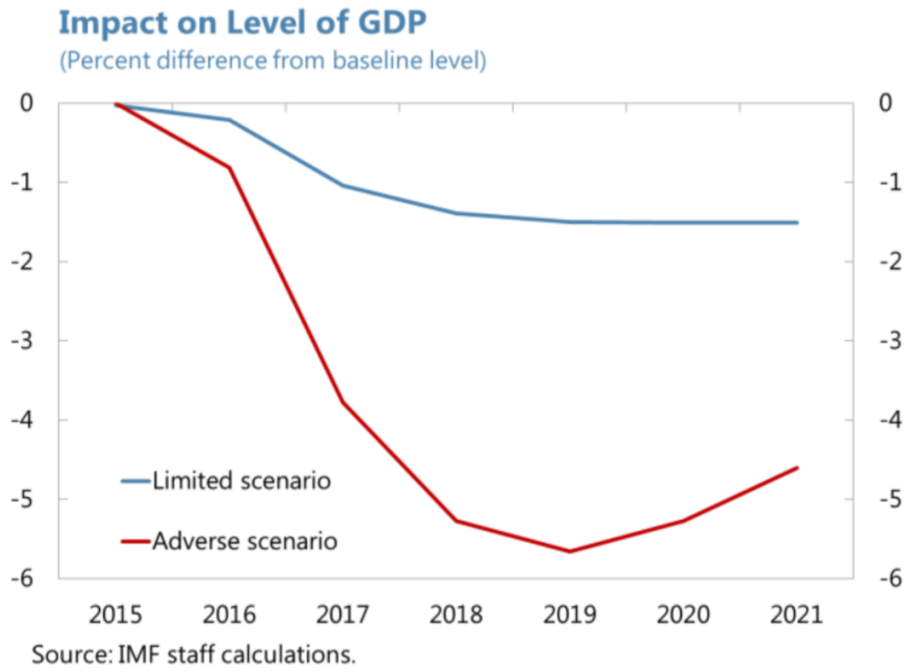
Sources: European Commission Financial Report 2014; IMF, *World Economic Outlook*; Federal Reserve Board; and IMF staff calculations.

Ramifications

The UK now faces serious challenges. Some commentators have noted that the UK could call a second referendum to reverse the Brexit decision but it is difficult to see how any British government could do that without inciting still more anti-establishment feeling. This is particularly true given that the Conservative Party is faltering and likely to choose a populist such as Boris Johnson as the next prime minister. Curtailing immigration from the mainland is therefore a high priority for any new government, an inevitable first step towards appeasing disgruntled voters and restoring the state's legitimacy. Equally existential is the likelihood that Scotland will now hold a referendum about membership in the United Kingdom and Northern Ireland may consider unification with Ireland, problems that are much more pressing than relations with the European Union.

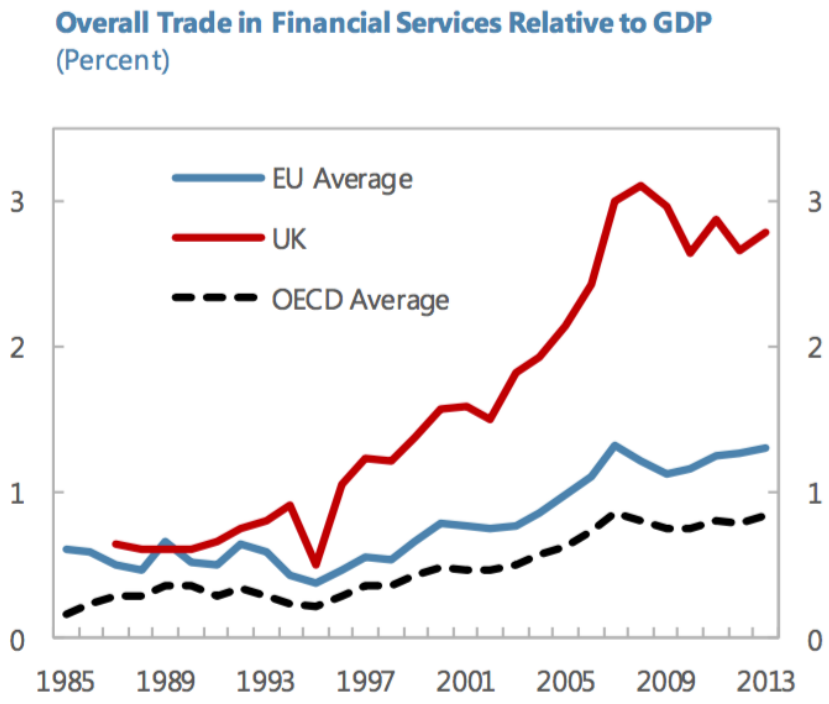
For its part, the EU now faces the prospect of other secessionist movements gaining traction among its 27 other members. Granting the UK exceptional control over immigration or other privileges in today's circumstances would merely encourage such separatism. The best bet is therefore that London will soon, in accordance with the recent referendum and the EU's preferences, formally notify Brussels of its intention to withdraw and begin the two-year process of separation.

The economic implications of Brexit for the United Kingdom are generally negative. The pound has already depreciated roughly 10% and could over the next month fall as far again. Bond yields will rise and banks, partially decapitalized by the events of last week, must hike their lending rates. These developments will curtail corporate investment for two or three years even as uncertainty causes the household sector to increase its precautionary savings and reduce discretionary expenditures. Real GDP should consequently fall by about 1% in 2017 and continue weak through 2020, at which point national output will be 5-7% lower than would have been the case without Brexit.



On an industrial level the damage will be most acute in the financial sector. The merger with the Deutsche Bourse will not proceed, and UK banks will lose some of their business on the continent. American and other banks will cut back their staffs in London and relocate personnel to the European continent. The UK housing sector should also decline marginally as lending contracts and mortgage rates rise. British pharmaceutical companies will be hurt as well, since most of their sales are to the EU and subject to regulation by Brussels. The same is true to a lesser extent of telecommunications, where regulatory regimes and roaming charges will require frequent renegotiation.

Partially countervailing this damage will be an expansion in exports after the country regains its balance in late 2017 or early 2018, but the potential gains here will be limited by higher financing costs and the possibly new tariff barriers imposed by Europe.

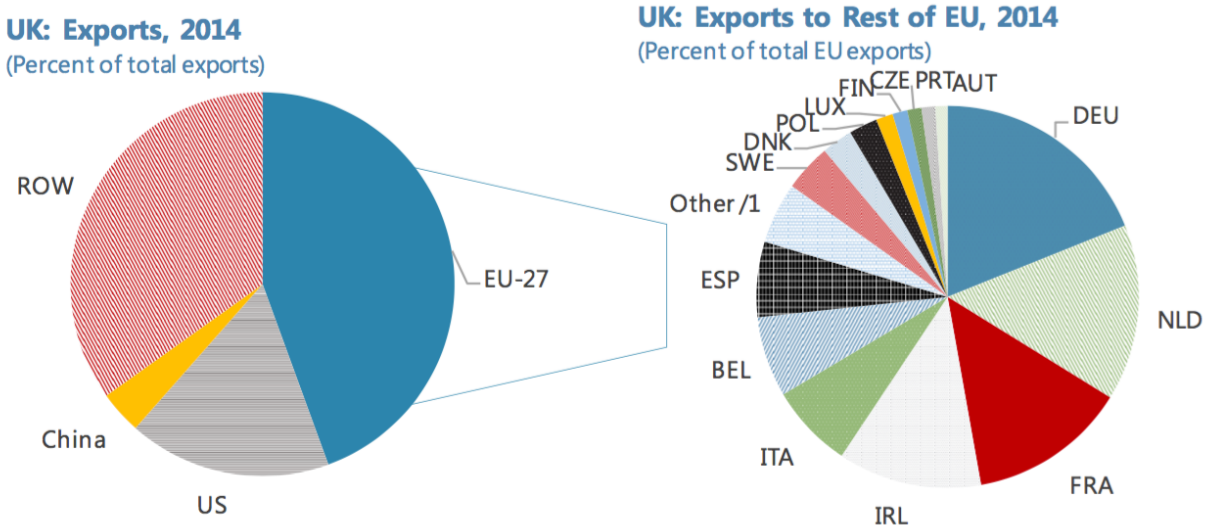


Sources: UNCTAD; IMF, *World Economic Outlook*; BoE calculations, and IMF staff calculations.

The news for the European Union is considerably worse. The day he called the UK referendum, Prime Minister Cameron legitimized the idea that individual countries could reconsider their commitments to the union and perhaps leave. British voters' rejection of the EU has gone further still, encouraging Spain, Italy, Greece, Poland, Hungary and several other countries to hold their own referenda. Even France and the Netherlands could now see the resurgence of movements in favor of abandoning the EU or, at the very least, demanding revision of the terms of membership. Given that many of these countries have suffered greatly from Germany's insistence on fiscal austerity—and hence a painful intensification of global deflationary trends—it is inevitable that the EU's next few years will be consumed in internal debate and probably one or more national defections. Eastern Europe will be an area of particular sensitivity because countries there, already straitened, will be hurt disproportionately by the tightening of financial conditions entailed by the shrinkage in the British banking system. Diplomatically, Europe—and the West in general—will lose ground to Russia, China, North Korea, Middle Eastern Extremists and other

rivals. For Brexit, the possible reorganization of the UK, potential additional departures from the EU, and restoration of public support for these institutions will leave little time to devote to geostrategic initiatives. Putin and other anti-Western leaders are probably salivating at the prospect that the EU's troubles may ultimately lead to the emasculation of NATO, resulting in a permanent shift in the balance of power.

Globally there is in the short term a small chance of a worldwide financial crisis, depending on how much damage has been done to the UK, European, and international banking systems. It also seems inevitable that world GDP growth will decelerate further over the next few years—perhaps 50 basis points per annum—as the rate of growth in British and European exports decelerates, which in turn will depress global prices slightly more. Central banks will accordingly persist in their extremely accommodative behavior—Janet Yellen cannot realistically tighten policy—and probably experiment further with negative interest rates and other novel ideas. The US and Japan will play their usual role as safe havens during the two-year transition, so yields on treasuries and JGBs will fall significantly farther.



Source: Office for National Statistics; and IMF staff calculations.
1/ "Other" includes countries with less than 1 percent of exports (BGR, CYP, EST, GRC, HRV, HUN, LTU, LVA, MLT, ROM, SVK, SVN).

The odds of "currency wars" have also risen. After adjusting to yesterday's earthquake and the aftershocks that will follow, in early 2018 Britain's export sector will expand due to the lower exchange rate. Roughly the same would be true for any other countries that departed from the EU, increasing demands from France and other weak members that the ECB take steps to devalue the euro and level the playing field. In the meantime Japan will surely have intervened to depress the value of the yen—it may do so as early as next week—and China may do the same. The UK's "leave" vote could thus presage more protectionism as well as a return to the global imbalances of the middle 2000s as most of the world uses depreciation against the dollar to import American demand.

The irony is that the Brexit decision will exacerbate the conditions that precipitated it. Slower global GDP growth implies that wages in most countries will remain flat even as looser monetary policy brings more capital gains to the rich. Anti-establishment sentiment will thus increase among both the middle- and lower classes and perhaps extend from older cohorts to the younger generation as well. Governments will be hard pressed to deal with such discontent, and social and political conflict are likely to increase marginally in many OECD and middle-income countries.

Another general effect of the Brexit vote is a worsening of many countries' fiscal situations. Presuming that central banks' monetary policies continue ineffective due to the lack of aggregate demand, governments will feel compelled to keep running budget deficits that add to their already mountainous debts. That need not trigger a financial crisis in any particular country since the finances of all of the big economies will deteriorate simultaneously, but it will eventually necessitate larger-scale defaults on entitlements and even on official borrowings.

Conclusion

Brexit is in large part a reaction to global trends—the aging of the world's wealthiest populations, disinflation and deflation, depressed GDP growth, a widening of the gap between rich and poor, popular anger against governments and transnational organizations, and fear that foreigners are stealing domestic jobs—that have been worsening for 25 years. Its effect, unfortunately, is to give more momentum to many of those trends through the end of this decade. If Brexit leads to additional defections either within the United Kingdom or from the European Union, those deleterious effects will be exacerbated and prolonged. None of these events need cause a global financial crisis but if governments and central banks make any significant policy mistakes, a debacle is surely conceivable. The 2007-2009 crisis, after all, was not inevitable either.

Robert Madsen was trained at Harvard, Stanford Law School, and Oxford University, as a Rhodes Scholar. He has advised three foreign ministries, two finance ministries, two central banks, and the Economist Intelligence Unit. He has served as Asia Strategist at Soros Private Funds Management, Executive Counselor at Unison, Advisor and Limited Partner in the Robert M. Bass Group, and Senior Economist at Asian Alternatives. He has been a Fellow at Stanford University's Asia-Pacific Research Center and then Senior Fellow at MIT's Center for International Studies for over a decade.