Commentary on Economic Implications of Brexit

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Winston Churchill once famously remarked, "You can always count on Americans to do the right thing - after they've tried everything else." It is unclear if you can count on the Brits to do the same after having shocked the world economy and political order by voting in favor of Brexit last week. The implications for the world economy are very much up in the air now, and depend on how British policymakers and European Union officials negotiate a post-Brexit agreement, on whether other E.U. members seek to exit the E.U. or negotiate new terms, and whether the United Kingdom splinters. Brexit could be the shot that upset the world trading system, the cross-country flow of people and ideas, and the world political order, or it could be a jolt that leads politicians to align their policies more closely with their constituents' desires and shocks voters to become more aware of the consequences of their actions and, ultimately, more responsible in their judgments.

Although there is tremendous uncertainty, one can consider different scenarios, and assess the likely implications for various regions of the world and industries. Some observations seem clear. First, heightened uncertainty discourages economic investment and slows economic growth and hiring. At a minimum, the Brexit shock will chill investment in the U.K. and E.U., which will reduce export demand from their trading partners. Second, and partially offsetting the first effect, the large decline in the exchange value of the pound (12 percent against the dollar as of this writing), and smaller decline in the euro, will make exports from the U.K. and E.U. more competitive, and potentially provide a short-run boost to their economies. Third, the financial services sector is in for an extended period of uncertainty and increased operating costs as new rules and hammered out, and companies decide where to base their operations. The emerging fintech sector, in particular, will be thrown a large loop, with potentially high rewards for platforms that are nimble enough to navigate the shifting jurisdictional and regulatory seas. Fourth, countries with dynamic economies and growing domestic opportunities that trade relatively less with the U.K. and E.U., such as the ASEAN region, are likely to be most resilient to the Brexit shock. Fifth, the periphery of the Euro Zone will be under renewed stress, and a panic in the banking system in Italy or elsewhere could cause great hardship. Fifth, the U.S. should be in a stronger position to weather the Brexit storm than most countries because domestic consumption, which appears reasonably healthy despite the drop in equities, drives the U.S. economy, because the U.S. is still a relatively closed economy, and because the dollar is considered a safe haven. Nonetheless, U.S. export industries will be under greater stress by a stronger dollar, the banking industry will face reduced interest rates, and the Federal Reserve will wait even longer before resuming the process of normalizing interest rates.

Finally, the political implications of Brexit could matter more than the direct economic effects, and are very difficult to handicap. For example, Brexit could signal a pervasive shift to nationalist platforms and populist candidates (as Donald Trump has claimed), or it could lead voters to recognize that politics is a serious business and that responsible policymakers can avert disaster (as appears to have been the case in Spain). To give Winston Churchill the last word, "The trouble with committing political [and economic] suicide is that you live to regret it."