Deferendum

Economist Insights

While many commentators are opining on the likely long-term economic consequences, should the UK vote to leave the EU on June 23rd, no-one can say for certain what those consequences will be. But one thing is clear –the effects of widespread uncertainty are already being keenly felt by the UK economy.

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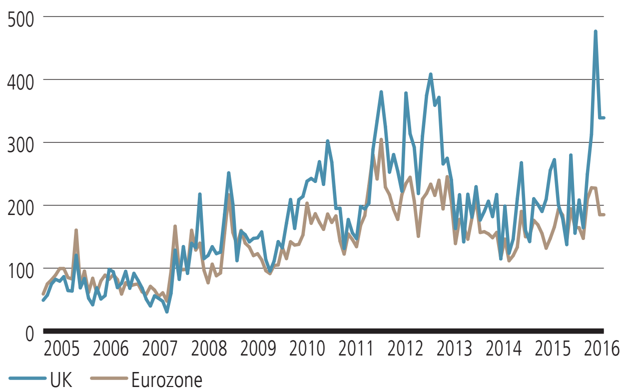
The debate about the referendum on the UK's membership of the EU is heating up. There is a lot of argument about the relative costs and benefits of staying in or leaving the EU, but that is all speculation about the future. But what about the impact on the UK economy today caused by simply asking the EU question?

Nobody in business or finance likes uncertainty, which is why people spend so much effort trying to predict the future. This is hard enough to do at the best of times. The referendum makes prediction very difficult, and the outcome is not even binary; a post-exit UK could have any of a number of potential relationships with the EU. Nobody really knows what economic policies would look like under those circumstances.

Thanks to some innovative work by Scott Baker[1], Nick Bloom[2] and Steven Davis[3] we have a way of measuring economic policy uncertainty. They compile a news based index by finding references in newspapers to uncertainty about economic policy. The resulting economic policy uncertainty indices reveal a stark divergence between the UK and the Eurozone (chart 1). In the past, uncertainty in Europe and the UK tended to move together. This year policy uncertainty in the UK spiked, and this is almost certainly the referendum effect.

Chart 1: Certainly uncertain

News-based policy uncertainty index for UK and Eurozone



Source: Baker, Bloom and Davis (www.policyuncertainty.com)

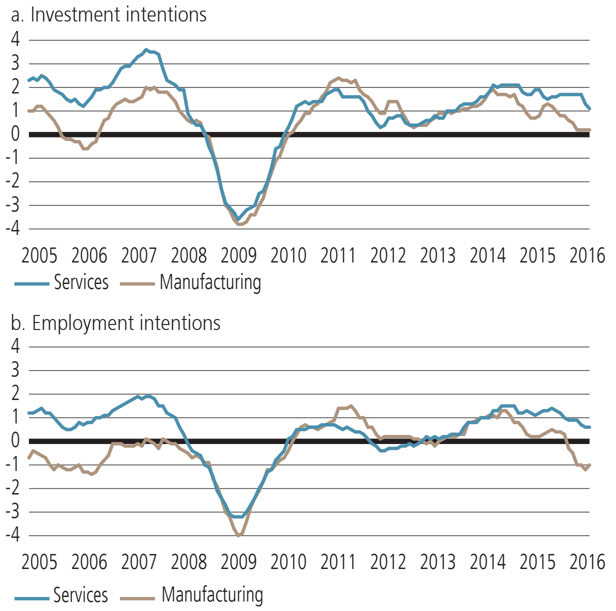
The first instinct when facing increased uncertainty is to defer whatever decisions we can until we have more information. For a household this will not be everyday spending on food or energy, but rather big ticket items like washing machines or a new car. For a business it will not be wages and running costs, but rather big investment plans or additional hiring. In the grand scheme of things, delaying a new factory or a new piece of equipment by a few months is not going to matter much.

[1] Northwestern University, Kellogg School of Management
[2] Stanford University
[3] University of Chicago, Booth School of Business

Sure enough, we can see investment and employment intentions shifting in the UK. This is very clear in the Bank of England (BOE) agent scores (not as exciting as it sounds; these are surveys by BOE regional offices). Investment intentions and employment intentions have both softened for several months now (chart 2), suggesting a growing reluctance to commit to anything long-term.

Chart 2: Not sure about this…

Bank of England agent scores (zero is neutral) for:



Source: Bank of England

The impact on manufacturing appears to have been more stark (although it is worth noting that manufacturing has slowed in the US as well). But manufacturing, which is involved in more international trade, may have more reason to be worried about the uncertain impacts on trade of a vote to leave.

The consequences for UK GDP in the first half of the year are likely to be strongly negative, and as such it makes it all the more likely that the BOE does not hike rates any time soon. The market has already pushed out the timing for the first rate hike until 2018 or even later.

We observed the same phenomenon in the USA a few years ago (see Domestic Disputes, 21 October 2013). At the time another government shutdown was looming. The US policy uncertainty index spiked and net business investment fell. Nobody wanted to expand capacity when there was so much uncertainty about the future. Once the uncertainty faded (the crisis was averted), investment spending returned.

Unlike the risk of US government shutdown, which would have been temporary, the EU referendum could have longer-term consequences. In the event of a vote to remain in the EU, the uncertainty would quickly fade. But if there is a vote to leave, the negotiations with the rest of the EU could take many years. Uncertainty could actually increase after the referendum, which could have prolonged consequences for the economy. Whatever the vote decides, the effect will create a short-term negative impact on the economy. In that event, the only certainty is that the Bank of England will consider deferring rate hikes even further into the future.