

## Brexit Uncertainty Influencing the Global Economy

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Britain's political landscape is one of the main contributors reshaping the global economy by skewing risks to the downside. Output growth was moving slightly upward before the U.K.'s referendum vote to leave the European Union (Brexit) (*Chart 1*). However, in the wake of the Brexit vote, the global growth outlook has been revised marginally downward, and the Dallas Fed's G-40 global economy aggregate index (excluding the U.S.) forecasts marginally slower growth than previously expected.

The Brexit vote June 23 and developments in Japan have been the major events leading to the modification of the 2017 global growth outlook since mid-June. Risks to the outlook have increased; with political and economic uncertainty in the euro area and concerns of a hard landing (an abrupt drop in output growth instead of a gradual decline) in China are among the largest.

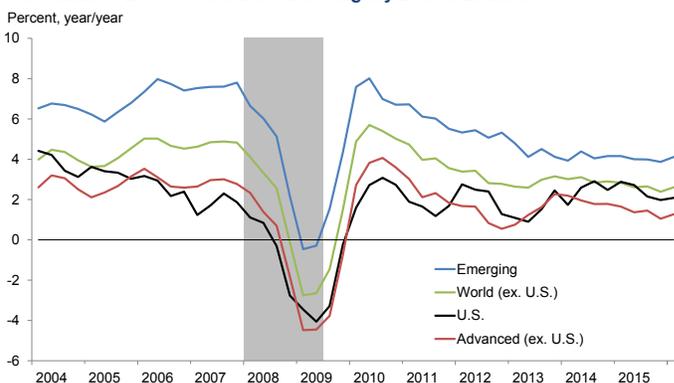
### Global Growth Outlook Still Uneven

The economic consequences of the Brexit vote are still unclear, and this has obstructed current investment and spending decisions as well as financial valuations for the U.K. and the euro area. Some economists are convinced the U.K. will enter recession in 2017, while others have predicted minor negative effects. The International Monetary Fund's World Economic Outlook for July revised 2016 and 2017 U.K. growth downward by 0.2 and 0.9 percentage points, respectively, from April's projections. Although India was also revised down slightly, it is still expected to have strong growth of 7.4 percent both this and next year. Japan is likely to have slightly better growth than previously predicted because the start date of a planned consumption tax hike was pushed back and fiscal stimulus is expected following elections to Japan's upper house. The former will contribute to the deflation problem.

### Global Inflation Outlook Relatively Unchanged

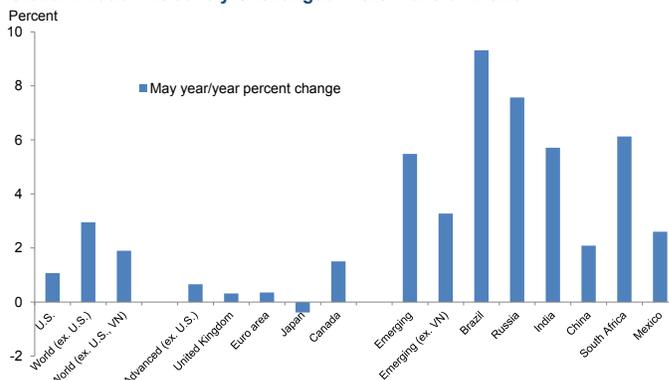
Japan is still experiencing deflation, with year-over-year inflation at -0.4 percent in May (*Chart 2*). With the recent appreciation of the Japanese yen, coupled with meager output growth expectations, the Bank of

**Chart 1**  
First Quarter 2016 Growth Increases Slightly Before Brexit Vote



NOTES: Aggregated using U.S. trade weights. Shaded bar indicates global recession. Last data point is first quarter 2016.  
SOURCES: Database of Global Economic Indicators; Haver Analytics; author's calculations.

**Chart 2**  
Global Inflation Relatively Unchanged in the Wake of Brexit



NOTE: Euro area and Russia are June year-over-year percent inflation. VN stands for Venezuela.  
SOURCES: Database of Global Economic Indicators; Haver Analytics.

Japan is expected to be under its target rate of inflation for the foreseeable future. As for the U.K., the devaluation of the pound sterling is likely to trigger higher inflation. Inflation in foreign advanced economies remains very low, whereas emerging economies continue to experience mixed inflation reports.

### Brexit Uncertainty Gives Little Comfort to Global Economy

Declining growth in the U.K. and the euro area isn't the only effect of the Brexit vote. The decision also

triggered another wave of banking share selloffs in the euro area, shedding renewed light on European banks' ability to handle the buildup of nonperforming loans. Tighter credit conditions caused by banking complications can further slow much-needed growth recovery in the euro area. The problem is most acute in Italy, where banks face an estimated €360 billion in problem loans.

Outside the U.K. and the euro area, the economic consequences of the Brexit vote will likely be negligible in aggregate. The U.K. represents 2.4 percent of global output and 3.3 percent of global trade in goods. When it comes to trade with the U.S., only 5.5 percent of total U.S. exports of goods and services (equating to 0.7 percent of U.S. GDP), end up in the U.K. Hence, the effect of the Brexit vote on the U.S. is expected to be relatively small. According to the Dallas Fed's simulations, a 1 percentage-point negative shock to U.K. real output growth is estimated to result in a decline of less than one-tenth of a percentage point in U.S. growth (*Chart 3*). The chart shows the corresponding deviation from baseline U.S. output growth.

### Brexit Leads Financial Markets into Temporary Unrest

The Brexit vote has led to turbulence in foreign exchange markets. Ahead of the Brexit vote, the British pound was appreciating against the U.S. dollar based on the expectation of a "remain" outcome (*Chart 4*). However, after the vote, the pound lost more than 10 percent of its value in a 24-hour period, marking the largest drop for the pound since floating currency began in 1971. The pound sterling appears to have stabilized around 1.3 GBP/USD.

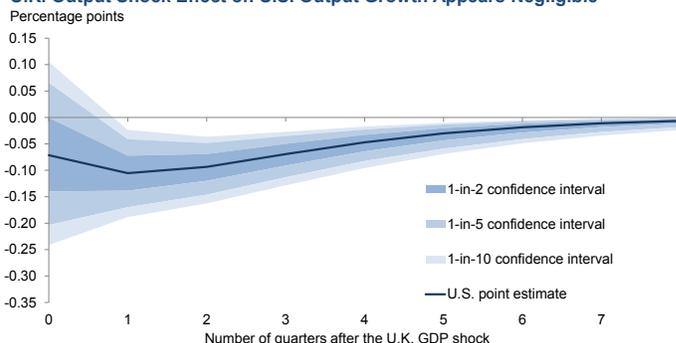
Since June 15, equity markets have also seen large movements. Immediately following the Brexit vote, all equity markets lost value but bounced back, concluding with gains. According to Standard & Poor's, the Brexit vote caused the largest single-day global stock market value loss on record (almost \$2 trillion).

The broad nominal-trade-weighted value of the U.S. dollar (from the Federal Reserve Board of Governors) appreciated by 0.9 percent, a relatively small increase compared with changes in exchange rates seen against individual currencies. Globally, long-term bond yields have also declined, partly due to investors' flight to safety caused by the Brexit uncertainty. The trade-weighted value of the U.S. dollar has appreciated 20 percent since June 2014. The strong dollar has led to declines in U.S. exports on a year-over-year basis. Exports were down 1.6 percent in May.

### Global Economy Is Still Fragile

The strong dollar, along with disappointing growth performance in foreign economies and the global slowdown in world trade, is exerting negative pressure

**Chart 3**  
U.K. Output Shock Effect on U.S. Output Growth Appears Negligible



NOTES: U.K. shock is a generalized negative 1 percentage-point shock to U.K. output growth. The simulations are based on the quarterly global vector autoregressive empirical model of growth described in "Impact of Chinese Slowdown on U.S. No Longer Negligible," by Alexander Chudik and Arthur Hinojosa, Federal Reserve Bank of Dallas *Economic Letter*, vol. 11, no. 5, 2016.  
SOURCES: Calculations based on the International Monetary Fund's DOTS database and the Dallas Fed's Database of Global Economic Indicators.

**Chart 4**  
Brexit Vote Uncertainty Leads to Turbulent Foreign Exchange Markets



NOTES: The start date is 10 a.m. June 15, 2016. Shaded bar represents the time between the Brexit vote and final results. Currencies used are the British pound (GBP), the euro (EUR) and the Japanese yen (JPY).  
SOURCE: Bloomberg.

on the U.S. trade deficit. Because the full effects of Brexit on the fragile global economy are still unknown, world leaders will be keeping a close eye on developments. In addition, the possibility of a Chinese hard landing still exists

–Arthur Hinojosa

### About the Author

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