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INTERNATIONAL ECONOMIC REPORT

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SECOND DELAY OF BREXIT DECISION; SECOND REFERENDUM PROBABLY WILL LET VOTERS CHOOSE BETWEEN CUSTOMS UNION OR 'BREVERMIND'

SUMMARY

- As expected, the UK and EU extended the deadline to choose a Brexit policy a second time to October 31.
- Britain's political paralysis is because the 2016 referendum was a mandate to leave the EU, but without costs for voters. Brexit would have larger costs and smaller benefits than believed before the referendum.
- The UK economy is weakening as Brexit-related uncertainty weighs on business activity. Y2K-style stockpiling is temporarily lifting manufacturing and retail sales, but will soon give way to contraction.
- A mild British recession is likely in the second and third quarters of 2019. If so, the impact on the US economy will be very small since the UK is only two to three percent of global GDP.
- More importantly, the tail risk of a "Hard Brexit" seems very unlikely after Parliament voted to rule it out as a policy option in March, and to extend the negotiation twice (so far) to prevent it.

As expected, the European Council (the heads of state of the EU countries) on April 10 approved a request from the UK for a second extension of the Brexit negotiation, pushing out the deadline for the UK to choose its course forward to October 31. Parliament authorized Prime Minister Theresa May to ask for a second extension on April 9, after voting April 8 to reject a number of variations on the three concrete choices to resolve Brexit – either leaving the EU with a deal, leaving without a deal, or staying a member. The EU and UK first extended the Brexit negotiation March 21, after Parliament voted on March 12 to 14 to reject similar variations on those same options.

Britain's political paralysis stems from the core dilemma of Brexit: The June 2016 referendum, which narrowly favored Brexit, created a democratic mandate for the UK government to withdraw from the EU. But since Brexiteers argued before the referendum that Brexit would create huge benefits and few costs, the government has no mandate to impose tangible costs of Brexit on voters. As it turns out, those costs would be large: The Bank of England's analysis predicts that a no-deal Brexit would cause a recession as severe as the US Great Recession. This is primarily due to how Brexit would interrupt trade with the EU: Both British and EU customs authorities, as well as the private logistics industry, lack the customs clearing capacity to keep UK-EU supply chains functioning normally if the EU imposes customs checks on the Channel Tunnel. To ensure a steady flow of essential goods through this bottleneck – chemicals for water treatment plants, lifesaving drugs for hospitals, and so forth – the British government would have to ration shipping capacity for the private sector after a no-deal Brexit. This would impose huge costs on manufacturers, retailers, grocery stores, and many other businesses, and cause large job losses.

Withdrawing with a deal would mean less economic pain, but also less political benefit. Before the referendum, Brexiteers imagined that the UK export market was so important to the rest of the EU that the EU would make unprecedented concessions during the withdrawal negotiation and give them an amazing sweetheart trade deal. Instead, EU negotiators attached top priority to a political consideration: Preserving the 1998 Good Friday Agreement, the peace deal that ended Ireland's 20th century civil war ("The

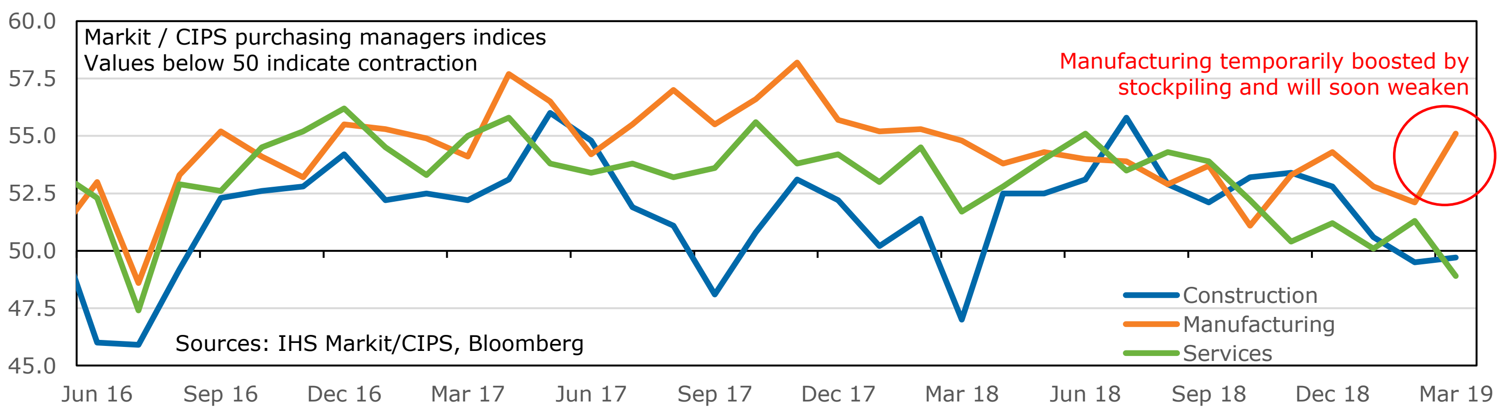
Troubles"). The Good Friday Agreement requires an open border between Northern Ireland and the Republic of Ireland, since it grants people in Northern Ireland the right to claim British citizenship, Irish citizenship, or dual citizenship, and to travel to their country of citizenship freely. To keep the border open, and to keep Ireland's customs rules the same as the rest of the EU's, the withdrawal agreement requires the UK to accept EU customs rules and economic regulation on an open-ended basis. Negotiators named this clause in the withdrawal agreement a "backstop" that would only apply if the EU objects to Britain's proposal for post-Brexit trade arrangements. But the EU has already rejected Britain's trade proposal, which would have allowed the UK to import goods from outside the EU prohibited in the EU, while still keeping an open border between Northern Ireland and Ireland. That would create an obvious back door for imports the EU prohibits to enter its economy. As a result, the "backstop" is the default outcome of the withdrawal agreement. And so, the withdrawal agreement prevents free trade agreements between the UK and countries outside the EU – which many Brexiteers saw as one of Brexit's main benefits.

The third option is for the UK to exercise its right under EU law to unilaterally cancel Brexit. Parliament might justify the choice democratically by holding a second referendum, which would allow voters to reevaluate whether Brexit still makes sense with its larger costs and smaller benefits now clear (opinion polls show a narrow majority of Britons now oppose Brexit). When Parliament voted on the various policy options for Brexit in March and April, the choices that came closest to winning a majority were joining the EU Customs Union (a closer relationship with the EU than laid out in the withdrawal agreement, and one supported by the main opposition political party Labour) and holding a second referendum. Despite the Prime Minister's opposition to a second referendum, the UK's most likely path forward is for Parliament to overrule her, and hold a second referendum on either joining the EU Customs Union or cancelling Brexit.

In the meantime, the UK's economy is weakening as uncertainty weighs on business activity. The UK statistics agency's most recent monthly GDP report for February showed sluggish growth, much of which looked like front-loaded purchases by households and manufacturers, who were doomsday prepping ahead of the original March 29 Brexit deadline. Real GDP grew 0.3 percent in the three months through February from the prior quarter. Retail sales rose 0.8 percent on the quarter; media reports reminiscent of the Y2K scare described some Britons stockpiling canned foods and other nonperishables. Similarly, manufacturing output jumped 1.4 percent, which the statistics agency attributed in part to manufacturers adding to inventories in case of supply chain disruptions. Activity in industries that cannot stockpile looks bad: Construction output fell 0.6 percent on the quarter (See chart).

A mild UK recession seems likely in the second and third quarters of 2019 as front-loaded purchases end. Since the UK is just 2-3 percent of global GDP, a mild UK recession's impact on the US economy would be extremely small. More importantly, the tail risk of a "Hard Brexit" seems very unlikely after Parliament voted to rule it out as a policy option in March, and to extend the negotiation twice (so far) to prevent it.

BRITISH ECONOMY WEAKENING IN EARLY 2019 WITH RECESSION LIKELY IN THE SECOND AND THIRD QUARTERS, BUT IMPACT ON THE US ECONOMY WILL BE VERY SMALL



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