The GEM Project's Take on Brexit

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Good economic theories help us understand big events as they are happening. What we most want is guidance on how they are likely to play out over time, both the short- and long-run. Good models are especially valuable in circumstances of macro disruptions that lack convincing historical precedent. That is the case with Brexit, the shocking decision of the British electorate to leave the European Common Market. The on-going rending of the UK political fabric is inexorably pushing the country to a once unimaginable hard exit.

Generalized-exchange macroeconomics, constructed in the GEM Project as a superior alternative to market-centric thinking featured in the mainstream academy, is up to the high standards of good theory. In particular, the model provides reliable answers to the hard-Brexit questions that I get asked.

Will a hard Brexit cause a collapse in dollar asset prices along the lines of the Great Recession? This is the first question asked about any in-the-news macro disruption. With respect to a hard Brexit, the answer is a confident no. GEM modeling identifies the financial panic at the center of the 2008-09 extreme instability to be rooted in investor/lender uncertainty about the trend prospects for domestic economic stability. It demonstrates that stability expectations are rationally and coherently rooted in the prospects for aggregate nominal demand. (Chapters 2 and 3) It additionally shows that, in 2008, investors/lenders became uncertain about the credibility of the Federal Reserve's trend full-employment objective. Consequently, as intuitively modeled by Nancy Stokey, investors/lenders became inactive, delaying their acquisition of financial assets until credible market bottoms emerge. (Chapter 6 and 10) Postponing the pursuit of profit opportunities triggered the frightening 2008-09 contraction in total spending. More generally, the Project asserts that robust credibility of government policymakers' objectives of high trend employment and low inflation is sufficient to prevent nonstationary demand contractions and consequent great recessions/depressions

Today, by contrast with 2008, the is no meaningful uncertainty about the Fed's capacity, especially now that it is armed with lessons learned in the Great Recession, to prevent a collapse in demand. Profit opportunities will continue to be pursued, not postponed. Dollar asset prices will quickly weather the turmoil in Britain. (The analysis does imply a need for a watchful eye on ill-considered Presidential interference with the central bank, but that is a different problem.)

It is noteworthy that the extreme-instability modeling is not yet widely understood. I kept a hard copy of a scary headline in *The New York Times* (December 16, 2018): "Assume Crash Position: Are You Ready For The Financial Crisis Of 2019? The stock market has already had a terrible year, and the doomsayers see plenty of reasons why things might get worse." I am looking right now at my souvenir, pondering how much stressful noise is generated by the media's poor grasp of how the macroeconomy works. Good theories are also good for mental health.

Will a hard Brexit cause a U.S. recession? No. With the removal of the threat that a hard Brexit will induce U.S. investors/lenders to broadly forego profit opportunities, making sense out of the likelihood of a recession returns to the standard practice, also informed by generalized-exchange macroeconomics, of looking closely at the short-run mechanics of aggregate demand. (Chapter 6) The weakened Euro, if sustained, will eventually put a small dent in U.S. exports and provide a small boost to U.S. imports. The weakened Pound is much more likely to be sustained, but its effects on American domestic spending is tiny. Any U.S. recession that happens in the aftermath of Brexit would have happened anyway.

So will a recession happen anyway? As illustrated by *The New York Times*, that became a favorite scare question of commenters around the turn of the year. Recession talk has been damped by recent economic reports and financial-market behavior but will almost certainly be revived when weaker evidence surfaces prior to the 2020 election.. My reading of the state of total-spending dynamics over the next year and a half, a familiar and not particularly difficult exercise, is that betting on a cyclical downturn in that timeframe is a promising way to lose money.

Will a hard Brexit damage international security? The answer here is conditional. If Brexit presages the more general breakdown in global economic arrangements resulting from rural discontent, i.e., a reversal of globalization and trade, international security will be substantially damaged. The heroic postwar leaders who arranged economic interconnectedness in Europe deeply feared the capacity of that nationalistic continent to blunder into conflicts. Should we forget the brutal lessons of the 20th century? In another, broader 20th-century example, was the West more secure when the world's largest country, possessing a nuclear arsenal, was mired in a subsistence economy? I do not forget the Chinese famine when tens of millions of peasants died of starvation. Didn't opening up markets to Chinese exports, needed for substantial economic growth and rising living standards, significantly reduce the risk of horrendous choices by an inherently fragile totalitarian government?

Will a hard Brexit damage average living standards in Britain. Yes, significantly. Hoping that deconstructing the long-term trend toward interconnected global production can be accomplished at little cost is really stupid.

What's the most important message for western democracies from the looming Brexit disaster? The modern threat to the integrity of elections from bad actors is real and frightening. The Russians have already had enormous success in destabilizing both Britain and the U.S; success in Germany has so far been more limited but still significant. They and others will surely become more skilled at this dangerous type of warfare. The good news is that we, especially the U.S., are not without weapons. For example, with its grip on the global financial system, well-directed U.S. sanctions can impose costs on the Russian kleptocracy sufficient to make them stop interfering. The U.S. electorate must decide if they want Donald Trump to continue his own efforts, for whatever personal reasons, to thwart such sanctions past 2020. A powerful wave to reject Trump and his inexplicable fondness for autocracies would be too big for to Russians or other bad actors to pervert.

Final word. Globalization is a complex, difficult process that has increased average living standards in rich and poor countries. For example, the Peterson Institute for International Economics has estimated that average household income in the U.S. is more than $10,000 higher over the postwar period as a result of the expansion of trade. That, of course, does not give us leave to ignore the attendant substantial adjustment costs. The most effective response is a robust writ-large safety net, featuring effective human-capital acquisition and income support. The 1950s/1960s high-wage-rent, low human-capital assembly jobs are well described and understood in the GEM Project. The Project demonstrates what most economists already know: the restoration of such jobs today is simply not feasible. Promising to do so is a foolish, dangerous, deeply cynical policy. It is time for good economists, armed with good models, to take a stand.

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