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Don’t believe the Brexit prophecies of economic doom

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The shock and horror at the Brexit vote has been loud and vociferous. Some seem to be revelling in the uncertainty that the referendum result has provoked. The pound falling in value, a downturn in markets – it lends credence to the establishment’s claims before the referendum that a Leave vote would lead to economic Armageddon.

But there are plenty of reasons to reject the consensus that Brexit will be costly to the UK’s economy. Even though markets appear stormy in the immediate aftermath of the vote, the financial market reaction to date has more characteristics of a seasonal storm than of a major catastrophe.

We were told that the consensus of economic experts were overwhelmingly opposed to a Brexit. Lauded institutions – from the IMF, OECD to the Treasury and London School of Economics – produced damning forecasts that ranged from economic hardship to total disaster if the UK leaves the EU. Yet 52% percent of the British electorate clearly rejected their warnings.

Something that my professional experience has taught me is that when an “accepted consensus” is presented as overwhelming, it is a good time to consider the opposite. Prime examples of this are the millennium bug, the internet stock frenzy, the housing bubble, Britain exiting the European exchange rate mechanism (ERM) and Britain not joining the euro. In each of these examples, the overwhelming establishment consensus of the time turned out to be wrong. I believe Brexit is a similar situation.

Downright dangerous

The economic models used to predict the harsh consequences of a Brexit are the tools of my profession's trade. Used properly, they help us to better understand how systems work. In the wrong hands they are also downright dangerous. The collapse of the hedge fund Long-Term Capital Management in 1998 and the mispricing of mortgage backed securities leading up to the 2008 financial crisis are just two of many examples of harmful consequences arising from the abuse of such models.

The output of these often highly sophisticated models depends entirely upon the competence and integrity of the user. With miniscule adjustment, they can be tweaked to support or contradict more or less any argument that you want.

The barrage of dire economic forecasts that were delivered before the referendum were flawed for two main reasons. First, they failed to acknowledge the risks of remaining in the EU. And second, the independence of the forecasters is open to question.

Let's start with the supposed independence of the forecasting institutions. While economists should in theory strive to be independent and objective, Luigi Zingales from the University of Chicago provides a compelling argument that, in reality, economists are just as susceptible to the influence of the institutions paying for their services as in other industries such as financial regulators.

Peer pressure

Another challenge faced by economists is presented by the nature of the subject matter. Economics is a social science which, at its heart, is about the psychology of human social interactions. Many models try to resolve the difficulties that human subjectivity causes by imposing assumptions of formal rationality on their models. But what is and is not rational is subjective. In further recognition of this difficulty the sub-discipline of behavioural economics has evolved.

Herding is a concept that has been used to rationalise financial market bubbles and various other behaviour. It describes situations in which it seems rational for individuals to follow the perceived consensus. Anyone who has found themselves in a position where the majority of their company has a radically different view to their own will have experienced the difficulty of standing out from the crowd.

In 2005-06, various people (including myself) presented the view that house prices would crash. While some audiences were sympathetic, the majority view at the time was both hostile and derisory. Challenging the received wisdom exposes you to feelings of isolation.

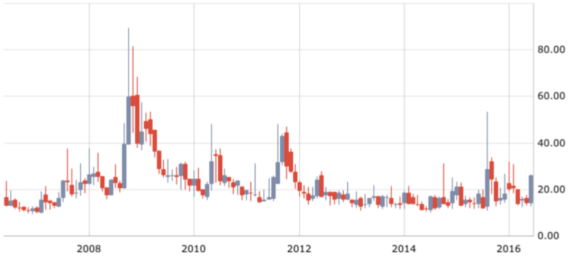
Received wisdom among academia has been that the EU is a force for good that should be defended at all costs. Respected colleagues are incredulous that anyone with their education and professional insights could think otherwise and remain part of the academic "in" crowd. In such an environment, it is very difficult to challenge this orthodoxy.

I – and the bulk of the UK population – might have been convinced by the pro-Remain economists if they had been a little more honest about the limitations of their models, and the risks of remaining inside the EU.

Market reactions

Despite reports of markets crashing following the Brexit result, when you put the current level of volatility in context of other shocks, market conditions are not as bad as they might seem. The FTSE 100 is still higher than it was barely two weeks ago and the more UK-focused FTSE 250 is currently higher than it was in late 2014. This is the kind of volatility that markets see two or three times a year.

The volatility index for the US S&P, known as the VIX or the "fear gauge", is what is widely used to measure how uncertain global financial market participants are about the outlook for stocks. When the Brexit result was first announced, the VIX moved sharply, but has since settled in the mid-20s. To put this in context, the all-time average is 20.7, the all-time closing low is 8.5 and the all-time closing high on Black Monday in 1987 was 150. More recently during the financial crisis, it reached a closing high of 87.2 in November 2008.



VIX volatility chart. CBOE

Other financial indicators also moved rapidly as the referendum results came through. On the face of it, the Japanese market suffered a severe shock falling almost 8%. However, the 8% fall in the Japanese stock market is almost exactly matched by an 8% gain of the Japanese yen relative to the pound. Therefore, the net effect for UK-based investors in Japanese equities is close to zero.

The fall in the value of the pound following the Brexit result is also not as bad as it may first appear. The size of the fall was exacerbated by the previous day's assumption that Remain would win. There is also precedent for a dramatic fall – after the ERM crisis – which proved beneficial for many British exporting companies and arguably helped sustain the economic recovery of the 1990s.

A lower pound benefits companies that add most of the value to their products inside the UK, and companies that sell their produce on international markets. This includes exporters like pharmaceutical company GlaxoSmithKline, drinks company Diageo and technology company ARM – all of which saw stock price gains on the morning after the vote. Companies that rely on imports and add little value within the UK will be hardest hit in the short term as they adapt to the exchange rate volatility.

There will undoubtedly be winners and losers from the UK's decision to leave the EU. But indexes for volatility are already lower than they were in February this year, suggesting that markets are not abnormally worried about the outlook, and UK government borrowing costs are at an all time low. This is further reason to reject the pre-referendum consensus that Brexit would bring economic doom.

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