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News Uncertainty in Brexit U.K

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After the Brexit referendum the behavior of the U.K. economy defied expectations, as it did not exhibit a V-shaped recession, but a slow decline in production. We address this puzzle through the lens of a setup with heterogeneous firms facing non-convex capital adjustment costs. We model the referendum as a news shock, with the time horizon and the content of the news being uncertain.

Brexit uncertainty is informed by expectation data from the Decision Maker Panel, a novel survey of U.K. businesses, where each CFO provides probability distributions over the expected Brexit date and the long-run expected outcome of Brexit on firm-level sales, for different Brexit scenarios. We show that the long expected duration of the negotiations is key for the model to reproduce the post-referendum behavior of the U.K. economy. Intuitively, if the chances that uncertainty resolves in the short run are small, only relatively few firms find it worth to pay the inefficiency cost associated with an investment freeze.

Concurrently, if the expected horizon of the news is longer, anticipation effects are smaller. The long-run effects of Brexit implied by U.K. business expectations are large, entailing losses of 4.8% and 7.7% of GDP for Soft and Hard Brexit, respectively. The transitional dynamics under policy uncertainty show that the referendum has produced significant economic damage, with a three-year cumulative loss of about 2% of GDP.