The citizens of the United Kingdom decided on a new path by rejecting the referendum to remain in the European Union. Where their winding path ends will not be known for some time. In the very near term, we need to ask:

- **Who runs the UK government?** Voters rejected the leadership of David Cameron in his support of “remain” both as prime minister and leader of the Conservative party. Substitutes are already circling around his corpse so that political uncertainty will inflate uncertainty and deflate confidence.

- **How do EU leaders react?** Political officials on the continent face a tradeoff between disciplining the straying member—so as to demonstrate that there is a high economic and political cost to leaving—and closing an open wound. The world seems sufficiently confused now that their initial response will be tinged toward regret and comfort, but revenge follows, served cold.

- **What do central bankers do?** The policy response is endogenous. The first impulse is to lay low and remind everyone that they remain open for business. The second is to accept the marking down of rate expectations. After that, buy, at least for the European Central Bank desirous of protecting periphery sovereigns. For the US, we believe the Fed is more firmly on hold, and the employment report does not matter because no one will expect tightening any time soon. For the Bank of England, confidence about economic prospects has been rocked, but so too has been the exchange value of the pound. Precedent suggests that the immediacy of a sharp drop of the exchange rate focuses the attention of a central bank, especially when its economy requires external funding associated with current account and government deficits. This suggests soothing words at first even as the Bank prepares to raise interest rates.
Market functioning is an issue as capital devoted to trading has been declining since the crisis, and the banks housed in London, uncertain about their future, will be conservative about their capital. More generally, any time that important asset prices move sharply, we risk learning something about someone’s balance sheet. We do not know who or what. That said, the release of the Fed stress yesterday afternoon was helpful. Assessed against a tough economic and market scenario and graded harshly by supervisors, the Fed found that all 33 banks retained a capital buffer when a very bad thing happened.

As for policies in advanced economies, the problem for the world is that an adverse demand shock cannot be offset by two of the major nodes of the financial system, as the European Central Bank and the Bank of Japan are pinned to their effective lower bound. With marked pressures on the British pound and the Fed less likely to tighten, appreciation of the euro and yen represents an unwelcome tightening of financial conditions.

As for emerging markets, appreciation of the dollar poses an equally unwelcome quandary: either continue to keep the currency stable vis-à-vis the dollar and tolerate appreciation relative to a basket of currencies or let local currencies slip. If the latter, the tactical problem is limiting the slip, recognizing that the record is discouraging. Chances are that this will be viewed as the least-worst option, as tolerating appreciation reduces activity domestically and intensifies the headwinds on global activity.