Economic Viewpoint

Desjardins
Economic Studies
www.desjardins.com/economics

July 8, 2016

Monetary policies post-Brexit

On June 23, British citizens chose to terminate its membership of the European Union (EU). It is still early to assess the economic and financial impact, both in the United Kingdom and elsewhere, but this outcome plunges the economy and markets in considerable uncertainty. Central banks are at the bedside of the economy since the last crisis, and even before the Brexit, there was a perception that their capabilities had greatly diminished. However, given their inflation stabilization mandates, it is expected that some central banks will feel compelled to intervene further. This *Economic Viewpoint* takes stock of the state of play for the Bank of England (BoE), the European Central Bank (ECB), the Federal Reserve (Fed) and the Bank of Canada (BoC). We conclude with a reflection on policy mix implications.

The decision of the British to end their EU membership (Brexit) caused shockwaves in global financial markets. In an analysis[1] published after the result, we documented the initial market reaction and discussed the economic, financial and political consequences of the outcome. In sum, the main implication of Brexit is the injection of a large dose of uncertainty in a context that was already very fragile. For central banks, Brexit raises serious questions. In many cases, monetary policy has possibly already gone too far. We have already argued that the experience with negative rates was a failure[2]. In other cases, the flexibility to address a large shock is extremely limited.

Brexit is the sort of event with the potential to materially destabilize financial markets. The experience since 2008 demonstrates the degree to which a global recession led by a financial crisis can have prolonged devastating effects. The context of ultra-accommodative monetary policy is itself symptomatic of a global economy that has never really recovered from the last crisis and its offspring. Now that a shock occurs, it still lies with central bankers to avoid the worst. In the next sections, we review the state of play for the major central banks and discuss the scenario that appears to us as most likely, in light of Brexit.

[1] Desjardins, Economic Studies, *Economic Viewpoint*, “Brexit: The economic, political and financial fallout – One more uncertainty in an already shaky global situation”, June 27, 2016, www.desjardins.com/ressources/pdf/pv160627-e.pdf?resVer=1467062779000.

[2] Desjardins, Economic Studies, *Economic Viewpoint*, “The negative rates experiment doesn't look successful – Central banks would be better served by other policy tools”, March 1, 2016, www.desjardins.com/ressources/pdf/pv160301-e.pdf?resVer=1456841192000.

BANK OF ENGLAND: MARK CARNEY SHOULD FAVOUR A PROACTIVE APPROACH

It is naturally in the United Kingdom that the referendum carries the most serious consequences for the conduct of monetary policy. In their repeated warnings until the day of the referendum, official institutions, either British or supranational, were unequivocal about the fact that the Brexit would have a significant negative impact on the U.K. economy. The U.K. Treasury estimated an impact on GDP of between 3.6% and 6.0% on a 2-year horizon. The Organisation for Economic Co-operation and Development (OECD) estimated a drag of 3.3% by the end of the decade. Without committing to a numerical estimate, the BoE did not hesitate to talk about a slowdown and the possibility of a technical recession in the short term.

It is early to measure the effects of the referendum. The composite PMI in the United Kingdom has exceeded the expectations of forecasters in June, listing a decrease of only 0.6 point against the 1.0 point decline expected by the consensus. However, the vast majority of responses to the survey were collected before the referendum. In the services sector, for example, 89% of responses were made before June 23. It is therefore only the July data that will provide a complete picture of the initial economic impact of Brexit. One still notes that the PMI index in the U.K.’s construction sector experienced its biggest drop since 2009 in June, despite the fact that 80% of responses to the survey took place before the referendum. This could be a preview of the likely performance of several economic indicators in July.

François Dupuis
Vice-President and Chief Economist

Jimmy Jean
Senior Economist

514-281-2336 *or* 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

In light of the elevated recession risk in the United Kingdom, it is almost a given that the BoE will ease its monetary policy. The Governor of the BoE gave an important signal on June 30, when he said that monetary stimulus will probably be necessary during summer. It is thus understood that although the sudden drop in the pound since the referendum should result in an increase in inflation in the near term, the BoE will give priority to growth. This is even more compelling given the fact that the United Kingdom is in a political vacuum after the resignation of Prime Minister Dave Cameron, Boris Johnson's surprise decision not to succeed him, and internal mutiny within the main opposition party. With the many unanswered questions (who will head the government, who will invoke Article 50 of the European constitution, what is the future of London and its status as a financial hub, will there be a new referendum in Scotland, etc.), the uncertainty should hurt growth over a long period.

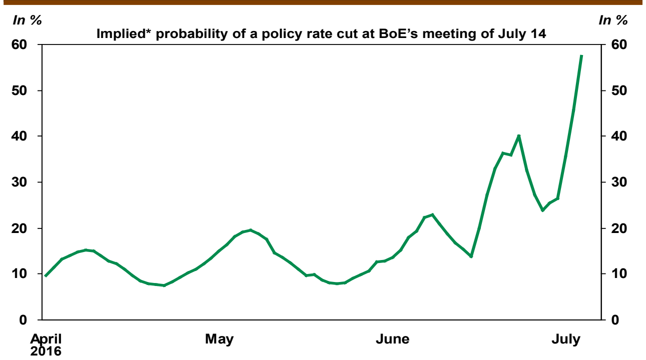
The debate on the BoE is more about the "when" and "how." Is it necessary that the BoE awaits data confirming the economic shock? If so, it could wait until its meetings of August or September before acting. However, the BoE has every argument on hand to justify a proactive approach, and a July rate cut looks highly likely. Already, pressures from property fund investors to withdraw their cash are an important sign of instability. Mark Carney has indicated in this regard that the risks to the U.K. financial system were beginning to "crystallize".

The challenge for the BoE is still to find a way to adequately stimulate the British economy. The BoE's Bank Rate is still at the level it had determined as the floor during the financial crisis (i.e. 0.50%). But the advent of negative policy rates several parts of the world has shattered the notion of a mandatory floor above zero. In May 2013, a report from the BoE indicated that there was no technical or operational obstacle to the BoE bringing its main policy rate into negative territory, although it warned that maintaining rate below -0.50% for an extended period might encourage depositors to withdraw their liquid assets from the banking system.

Even if BoE officials have not ruled it out, an entry in negative territory would be surprising in the case of the United Kingdom. In their assessments of negative rate policies, BoE officials raised concerns about the detrimental effect on bank profitability, long before these concerns were validated by the experience of European banks this year. British banks are already at the heart of a fundamental uncertainty, as they could be on the cusp of losing a lucrative part of their business in the advent that the European financial centre moves away from London. The time would thus be hardly appropriate for a policy that is inherently adverse to bank profitability.

A more plausible scenario is a reduction in policy rates, possibly to near zero, accompanied by a new wave of quantitative easing. At this point, prompt easing is heavily discounted in market valuations (graph 1). The associated slide in bond yields in the United Kingdom is all the more spectacular in that it has occurred despite rating agency Standard & Poor's stripping the country from its AAA rating on June 27. The agency in fact downgraded the United Kingdom by two notches, to a AA rating, something unheard of for a AAA-rated sovereign nation. Other rating agencies have also performed downgrades to the U.K.'s debt rating. The sharp fall in U.K. bond yields despite these revisions is testament to the limited amount of suitable stores of capital in situations of turbulence.

Graph 1 – Markets expect a prompt BoE rate cut



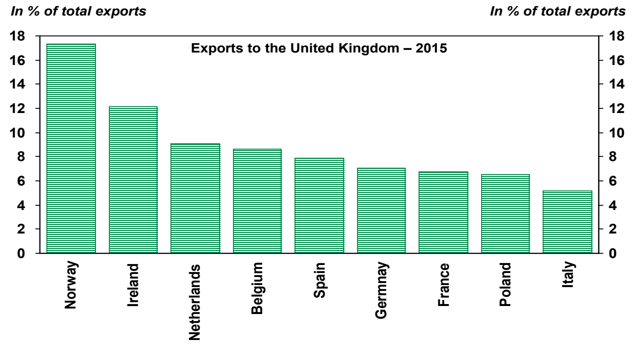
* According to overnight indexed swaps.
Sources: Bloomberg and Desjardins, Economic Studies

THE EUROPEAN CENTRAL BANK MAY NEED TO USE CREATIVITY

European financial markets have been affected as much, and in some case even more than in the United Kingdom. The brief incursion of the German 10-year bond yield in negative territory had triggered concerns on June 15. But on July 5 the yield stood at -0.18%, after a decisive plunge below zero triggered by the referendum result. European equity indices reacted to the referendum's outcome just as violently as U.K. indices. On June 24, losses of 8.0% were recorded in France, 6.8% in Germany and 12.5% in Italy.

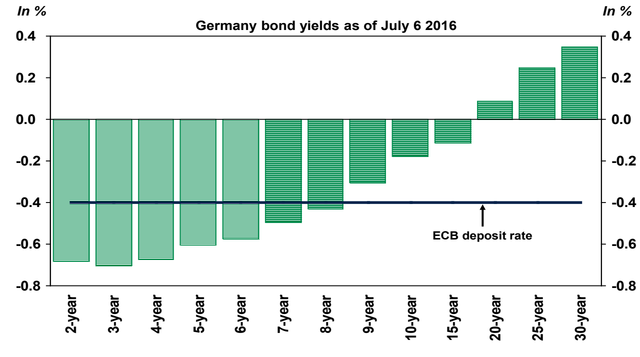
Economically, the effects of Brexit on the U.K.'s economy will penalize already tepid European growth. The United Kingdom is the first export destination for the EU. Norway, Ireland, Belgium and the Netherlands are among the countries with the highest concentration of exports to the United Kingdom (graph 2 on page 3). In addition to lower demand for European goods resulting from the economic shock, the sharp depreciation of the pound against the euro

Graph 2 – A number of European countries have significant trade exposures with the United Kingdom



Sources: World Bank and Desjardins, Economic Studies

Graph 3 – The ECB cannot currently purchase bonds with a maturity shorter than nine years



Sources: Bloomberg and Desjardins, Economic Studies

will make these goods less attractive from the perspective of the British. Taking a broader perspective, the OECD estimates that economic consequences will combine with financial effects to cause a loss of 1% in real GDP by 2020 for the EU.

In this context, the ECB could feel compelled to do more to support its economy. The task, however, proves complicated, with monetary policy already extremely stretched. The ECB has established a negative deposit rate policy in 2014, and has recently expanded its securities' purchase program to include corporate bonds. In March 2016, the ECB nevertheless clearly stated its reservations about the idea of bringing its deposit rate deeper into negative territory. Banks' financial health, especially in Italy, is a major concern, and negative rates impinge on these institutions' profit margins. It is true that the second version of the targeted long-term refinancing operations (TLTRO II) announced in March allows banks to offset the detrimental effect of negative rates (conditional on them increasing their granting of credit). However, the first round of operations has seen disappointingly weak take-up (€399B, mostly rollovers of old loans). The mitigating influence on the penalizing effect of a negative deposit rate is thus very limited so far, and it would be surprising if the ECB added fuel to the fire by further lowering the deposit rate from its current level of -0.40%.

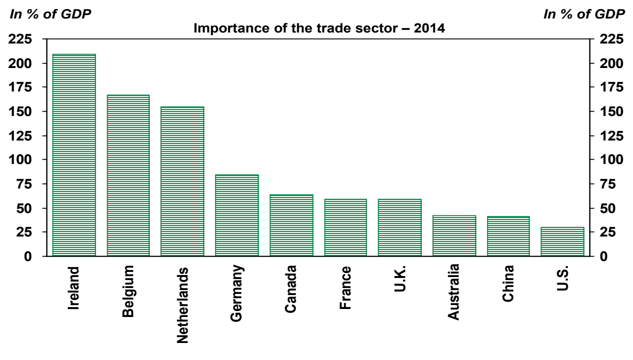
Rather, the ECB is more likely to delay the scheduled end of the securities' purchase program, now established at March 2017. It could also announce another increase in the monthly amount of securities it acquires (€80B) but to do so, it will likely need to adjust its purchase allocation policy. Under current arrangements, the ECB may not purchase bonds yielding below the rate on deposits. A significant proportion of German bonds, with shorter maturities, are thus rendered ineligible (graph 3). The ECB may concentrate its purchases in the longer end of the German yield curve but doing so, it may quickly bump into another constraint: the 33% limit to the ECB's holding share of a given issue. This is not to mention the questionable effectiveness of a policy aimed at reducing already very low rates.

There have been some speculations as to a possible modification to the method of allocation of sovereign bond purchases, so that it is determined by the relative size of each country's outstanding debt, rather than by countries' contributions to the ECB's subscription capital. This would allow purchases to be oriented towards the bonds of peripheral countries, such as Italy, Spain and Portugal, where a reduction in borrowing costs may be somewhat more beneficial. However, such a strategy would bump into the inevitable opposition from Germany, which does not tolerate the suppression of market forces guaranteeing a certain budgetary discipline. Otherwise, the purchase of additional corporate bonds is a sensible option but it is still a very illiquid market in Europe, resulting in implementation obstacles that do not arise in the case of sovereign bond purchases.

TOO SKITTISH FEDERAL RESERVE TO EXPECT RATE NORMALIZATION THIS YEAR

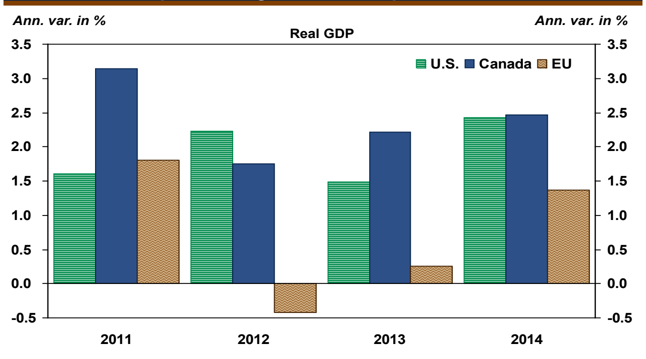
The direct effects of Brexit are much less threatening to the United States. Between 2011 and 2015, only 3.5% of U.S. exports took the direction of the United Kingdom. While it is true that the United States send almost 15% of its exports to the EU, the fact remains that the importance of trade activity to GDP is comparatively low in the United States (graph 4 on page 4). United Kingdom and EU slowdowns should not therefore have a major direct impact on U.S. growth prospects. In that respect, the United States would not necessarily find itself in unknown territory. Recall for instance that the economies of the United States and Canada had continued to exhibit respectable paces of growth in 2012, while the EU was experiencing a recession (graph 5 on page 4).

Graph 4 – The United States does not depend much on trade



Sources: International Monetary Fund and Desjardins, Economic Studies

Graph 5 – The North American economy had not been overly disrupted during the last European recession



Sources: Bureau of Economic Analysis, Eurostat, Statistics Canada and Desjardins, Economic Studies

With that in mind, Fed officials have expressed mixed opinions with respect to Brexit. Many acknowledged that the direct impacts were rather limited. James Bullard of the St. Louis Fed said on June 30 that there will probably be little impact on the U.S. economy. John Williams of the San Francisco Fed, abounded in the same direction on July 5, relativizing Brexit with the early-year concerns on the Chinese economy. These had been to him a source of much greater concern.

Other influential officials, however, have played the card of caution. On June 21, during her testimony before the U.S. Congress, Fed Chair Janet Yellen warned against the potential impact of financial volatility on the U.S. economy. She also expressed concern with respect to a spike in risk aversion that could lead the U.S. dollar higher. Fed Governor Jerome Powell has highlighted some tightening of financial conditions. The influential president of the New York Fed, William Dudley, said for his part that Brexit meant "clouds on the horizon" for monetary policy.

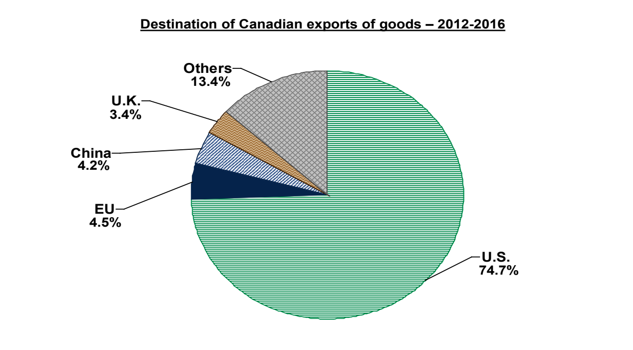
There seems to be a better consensus around the idea that it is still early to assess the effects of Brexit on the U.S. economy. The officials therefore seem relatively confident in a baseline scenario where the negative impact of Brexit is limited. However, the probability of an alternative scenario characterized by significant contagion seems high enough to require some vigilance. The Fed is particularly aware of the increased risk of financial volatility in the post-Brexit world, at least so long as there is no clarity on what happens next in the United Kingdom. In this context, and with a looming U.S. election on top of it, we do not see the Fed reaching the state of mind enabling it to confidently pursue the normalization of its monetary policy this year. Although we have performed very little adjustments to our U.S. economic outlook, we now believe that the Fed will wait until March 2017 before announcing its next rate hike.

A VIGILANT BANK OF CANADA, BUT THE BAR REMAINS HIGH FOR RATE CUTS

Unlike those of the Fed, BoC officials have been much less vocal on the referendum implications, either before or after the event. On June 20, Governor Stephen Poloz merely offered that the referendum's outcome could pose new risks worldwide, which could lead the BoC to review its forecasts. The BoC will present its new economic outlook on July 13, when it will release its *Monetary Policy Report*. But it would be surprising to see major adjustments to the Canadian economic outlook, at least adjustments strictly related to Brexit. In its previous report, published in mid-April, the BoC had identified five risks and Brexit was not even listed.

The Canadian economy has little exposure to Europe, sending 3.4% of its exports to the United Kingdom and 4.3% to the EU, as opposed to the nearly 75% that take the direction of the United States (graph 6) . This need not mean that the BoC will not be vigilant. After all, until the oil price shock hit the Canadian economy with full force, global headwinds were more often than not cited by the BoC as an argument to justify maintaining an accommodative monetary policy, much to the dismay of those who demanded concrete action to curb the acceleration in household debt.

Graph 6 – Exports to the United Kingdom account for a small share of total Canadian exports



Sources: Innovation, Science and Economic Development Canada and Desjardins, Economic Studies

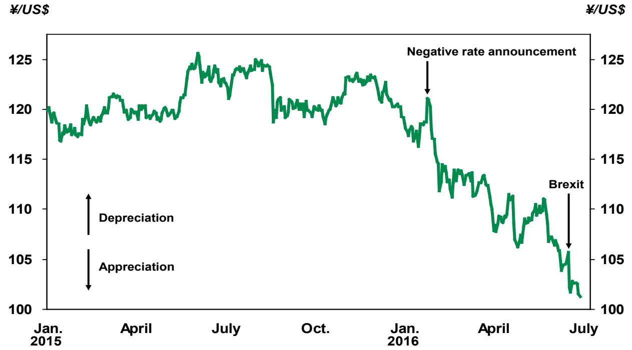
Nevertheless, vigilance is not synonymous with intervention. While the Canadian economy is weakened by the capital expenditure cutbacks in the natural resources sector, in addition to temporary disruptions related to Fort McMurray forest fires, Brexit itself should not alter the picture to an extent that would require further easing. The BoC currently has two allies. First, the federal government: Canada stands out among several countries, with a currently expansionary fiscal policy. Second, the currency: any spike in risk aversion related Brexit should result in capital flows to the United States, raising the value of the U.S. dollar and thereby increasing the attractiveness of Canadian goods and services to Americans.

One thing is certain, however: rate normalization is not for tomorrow in Canada. Just as Brexit prompts the Fed to more patience, if only to properly assess the situation, we believe that the BoC will remain on the sidelines for a long period. Stephen Poloz himself stated on June 15 that "patience is still required" before the Canadian economy can once again grow at a sustainable pace. Next year, the effects of fiscal stimulus measures should be in full swing, and we doubt that the BoC would rush and risk undermining the efforts of the Finance Department, which is offering a valuable hand. All in all, we believe that the BoC will wait until April 2018 before declaring its next rate hike.

IN ASIA, WILL THE BANK OF JAPAN GO FROM WORDS TO DEEDS?

The post-Brexit risk aversion impulse has applied significant additional upward pressure on the yen (graph 7), in an environment where inflation and inflation expectations are weakening, and where some activity indicators such as industrial production and household consumption remain anemic. The Bank of Japan (BoJ) dived into the world of negative rates in January but rather than depreciate, the yen has appreciated since. Japanese officials have threatened to intervene on the foreign exchange market in recent months. Prime Minister Shinzo Abe even asked the Finance Minister Taro Aso to closely monitor the currency, and to take appropriate measures. However, no gesture in this direction has been taken so far, suggesting that the BoJ could be harbouring doubts on its ability to influence the yen on its own (not to mention the diplomatic pressures coming out of the United States).

Graph 7 – The additional strength in the yen since *Brexit* amplifies the BoJ's headaches



Sources: Bloomberg and Desjardins, Economic Studies

Meanwhile in China, the rise of the U.S. dollar that followed Brexit is a concern. The authorities devalued the reference exchange rate by a sizeable 0.9% on June 27, raising fears that China might have jettisoned the orderly devaluation approach it had subscribed to. A new capital flight episode represents a key risk for China and if Chinese monetary authorities choose the path of rapid devaluation, the consequences could be destabilizing for global financial markets. This would in turn give an additional justification for other central banks to maintain highly accommodative conditions, or even offer more monetary stimulus.

CONCLUSION: BREXIT COULD FORCE A CHANGE IN ATTITUDE ON THE POLICY MIX

A credit rating agency described the Brexit as a "seminal moment". Only time will determine the correctness of that characterization. For central banks, which are already heavily engaged in supporting growth, Brexit could mark the genesis of a rush toward increasingly irresponsible (negative rates) or archaic (competitive devaluation) policies. Or it could mark a genuine awareness of the limitations of monetary policy, and a move towards greater coordination between monetary and fiscal policies.

The current bond market environment implies that in several cases, such as Europe or Japan, it is downright costly for governments not to borrow more to boost growth. Governments who are adamant to very strict fiscal discipline despite negative rates, implicitly show a preference to bear this opportunity cost, rather than risk a spike in borrowing costs if investors lose confidence in their fiscal management. This can however imply a sub-optimal macroeconomic response to extremely favorable borrowing conditions.

An economic shock from Brexit could potentially help overcome that blockage. In this regard, Canada is exemplary: in its case, it was the oil price shock that initiated the movement. The Liberal Party won the last election by promoting a recovery strategy via public investment in infrastructure, saying openly that monetary policy was nearing its limits. Will the "seminal moment" mark the beginning of a rebalancing in policy mixes elsewhere? It will be an issue to follow.

Jimmy Jean
Senior Economist