Economic Policy Movements in the Event of 'No-Deal' Brexit Shocks

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There is a general consensus that the prospect of leaving the European Union has and will further hamper economic activity in the UK. Numerous economic bodies have modelled the consequences arising from various scenarios of EU exit, with academic and policy-related literature conforming to the informed opinion that economic output will be left lower than its 'no-Brexit' trend with large and persisting negative output gaps. Given the likely economic loss in the short term to long term illuminates several possible responses to be considered when undertaking monetary and fiscal policy. The nature of the economic policy response will depend on (a) the nature of the shocks and (b) the stabilising ability of the UK economy to self-adjust and absorb. This piece will outline the stances that economic policy can take to buffer the shocks.

Conformity of a No-Deal Brexit Problem

Should the 31st October pass without a 'deal' or a further extension, the UK will be subject to the terms under its WTO agreement for the foreseeable future. There is a credible and material risk that the UK leaves the EU without a deal or transitional agreement in place. Changes in such probability have been filtered through into movements in the sterling exchange rate against core currencies and expected short-term interest rates. We have also seen a variable response of labour input in light of stagnating investment willingness. Betting odds have tended towards such probability. Market participants expect that such exit would lead to a substantial loosening of economic policy and have adjusted accordingly.

Demand & Supply Shocks with Stabilising Responses

In the short run, policy-makers can stabilise GDP growth by allowing some flexibility in their remit to adhere to inflation targeting over the short term horizon. However, this option would be cancelled out should wage growth pick up, which is a credible possibility given actual unemployment is tending below its equilibrium 'natural' level and the bargaining position moving against higher general perceived prices. Should policy-makers believe that inflation expectations would adapt if monetary policy did not offset an EU exit-related inflation spike would further undermine the power of accommodative monetary policy.

In the long-run, a slowdown in capital, investments and productivity growth would further render monetary policy redundant and would leave little room for the conventional counter-cyclical fiscal policy to respond.

The chief response of short run economic policy, monetary policy, will depend on the direction and magnitude of the shock to aggregate demand and supply. If merely a negative demand shock, the most favourable scenario of negative shock, would mean that monetary policy can respond in its conventional manner by lowering the Bank Rate signalling limited scope for a return to more neutral rates for an extended period. This could be supported by further asset purchases and support for commercial bank lending through the altering liquidity positions. Should manipulations of the risk premia not prevail, which is highly likely given the status-quo of the zero-lower bound, would illuminate a role for countercyclical fiscal policy. It is yet to be seen whether the new Chancellor would act in a manner to relax the fiscal rules. However it is more likely that there would the presence of both demand and supply shocks which could the playbook more complicated.

A No-Deal Brexit would mean that the level of inflation for a given level of excess demand will be higher as a negative supply shock would mean that the supply path adjusts downwards. This would result in a lower long run path. This is further hindered by the short-run supply constraints fuelled by Brexit, for example, adjusting with labour rather than investments, contingency planning and price rigidities. The monetary policy response is dependant on the pull of (a) excess demand in the economy with policy reducing by increasing Bank Rate placing downward pressure on inflation and (b) deficient demand with policy injecting inflation into the economy with reduced Bank Rate. The nature of these 'policy pulls' tells us what the policy-makers preferences are to inflation versus output following shocks in supply. These preferences are critical in the scenario of a No-Deal Brexit. A 'Doveish' preference of policy will lead to a smoother path of output without threatening the credibility of the 2% inflation target. Inflation is allowed to respond by more than output. This implies slow adjustment of output to its trend value and a less restrictive path for monetary policy. Should policy preference be more 'Hawkish' would suggest a greater response in output over inflation implying tighter monetary policy within its lower bound.

Whilst supply based shocks filter through into the productive capacity of the economy, there is growing evidence to suggest that demand will also be affected through various transmission channels. A case of No-Deal Brexit would build uncertainty into the system with business investments taking their present deferral trend. Labour then becomes more of a variable input response with the potential for greater employment around flexible working arrangements (societal concerns). We could see declining FDI inflows, with the subsequent potential for declining portfolio investments into the banking system. Whilst consumer spending has remained rather buoyant, the hit on investments and net trade could equilibrate the economy towards reduced inflationary pressure. Both functions of monetary and fiscal policy will have to act in order to stabilise demand against the backdrop of supply concerns. Nonetheless, policy will have to be primed to act in an expansionary position as long as wages do not respond to any temporary spikes in inflation and remain consistent with the long-run expectations. However, countercyclical fiscal policy should not prevent fiscal authorities from meeting the social requirements for required social care, infrastructure and education. It could be argued that the greatest impacts of a No-Deal Brexit would be felt in the long run (weak productive capacity, lack of innovation) within which monetary and fiscal policy would be unable to address such structural issues.