Intelligence MEMOS

From: Jeremy Kronick
To: Central Bankers
Date: June 24, 2016
Re: **Brexit - The First Real Test of Low Interest Rates**

The Great Recession of 2008/2009 caused central banks to slash interest rates to historic lows. In light of the cross-border financial contagion happening at the time these were entirely appropriate decisions. However, in the intervening years, with strong economic growth failing to take hold, interest rates have been left at near-zero or even negative levels in most countries. Although most concern around low interest rates has centered on the threat of runaway inflation, which has not occurred, with the Leave campaign winning the Brexit vote the vulnerability to economic shocks in a low interest rate environment poses a new and potentially more menacing problem.

From an economic perspective, the biggest implication of Brexit on the global economy is uncertainty. Brits will face a slew of questions: Will current businesses headquartered in the City of London choose to move onto the continent? What would that mean for employment in Britain? As the Pound depreciates leading to domestic inflation, at least for a time, what are the implications for investment, trade, and consumption?

As Britain is, or was prior to the vote at least, the EU's second largest economy, it plays a significant role in the success of trade and economic growth for the remaining EU countries. But while the EU's immediate self-interest may dictate renegotiating the maintenance of a strong free-trade area with the UK, it may be prevented from offering this, by the implicit encouragement such a generous package would give malcontents in other EU countries. If the EU does suffer, there could be significant knock-on effects for the rest of the global market, including Canada.

What does all this have to do with low interest rates? If this uncertainty leads to slowdowns in large parts of the global economy, as suggested by the OECD, IMF, and others, the fact that central banks have not normalized interest rates since the Great Recession implies that they have lost their most important policy lever.

Do they have other options? Perhaps the most likely route is turning to an old friend and using classic open-market operations whereby central banks directly increase the money supply in the hope that they will be able to encourage increased lending and spending on goods and services. This would not require moving interest rates further into negative territory, a move that, while plausible, is fraught with unknowns.

Central banks in Western economies have been in a bind for a while now. They know full-well that "low for long" interest rates are problematic, but have had to deal with simultaneously slow domestic economic growth curtailing their ability to increase interest rates. Now a political ill-wind is adding to the economic uncertainty. We may soon see a new set of challenges, with our ability to weather them partially dependent on the creative responses of central bankers.

Jeremy Kronick is a Senior Policy Analyst at the C.D. Howe Institute