MONETARY POLICY OF EUROPEAN CENTRAL BANK AFTER BREXIT

Valentin Mihai Leoveanu[1]

Abstract: *The result of the referendum on Great Britain leaving the European Union have led to major disturbances in European and international financial markets, which made necessary the intervention of central banks in European countries. Responsible for price stability and financial stability in the euro area, the European Central Bank has acted and acts in order to limit the negative effects that such an event has and will have in the future. In this respect, the present study aims to highlight the causes that led to Brexit, the economic, financial and monetary effects of this decision on the countries in the euro area and the EU, the implications for the conduct of monetary policy of the ECB, in particular on the monetary tools used and their effect, and the answer of the ECB to Brexit concerning the trend of Euroarea economy. The results of research underline the importance of ECB measures regarding the support of a healthy economic growth in Euro area and a sustainable macroeconomic stability in European Union.*

Keywords: *unconventional measures, accomodative monetary policy, transmission mechanism, forward guidance, SWOT analysis*

JEL Classification: E42, E52, E58, O23

1. INTRODUCTION

The result of the referendum on Great Britain leaving the European Union have led to major disturbances in European and international financial markets, which made necessary the intervention of central banks in European countries. Responsible for price stability and financial stability in the euro area, the European Central Bank has acted and acts in order to limit the negative effects that such an event has and will have in the future. In this respect, the present study aims to highlight the causes that led to Brexit, the economic, financial and monetary effects of this decision on the countries in the euro area and the EU, the implications for the conduct of monetary policy of the ECB and the ESCB, in particular on the monetary tools used and their effect, and the answer of the ECB to Brexit concerning the trend of Eurozone economy. The results of research underline the importance of ECB measures regarding the support of a healthy economic growth in Euro area and a sustainable macroeconomic stability in European Union.

United Kingdom is not a part of the Eurozone, it is not using the euro as single currency and therefore it is not subject to the regulations of the ECB's monetary policy. Thus, keeping the national currency in transactions in its own economy, the UK, by the Bank of England, has its own monetary policy which includes all the advantages and disadvantages arising from this attribute of national sovereignty.

At the same time, however, Britain is (still) in the European Union, an integrating economic organization in Europe with strong social and political overtones, which is a free-association consented to European democratic countries with market economies. The European Union is the second largest economy in the world in 2016, considered globally after the US, with a GDP of $ 16.5 trillion in nominal terms and a GDP of $ 19.7 trillion in real terms, this time in second place after China, according to the International Monetary Fund (IMF, 2016a).

With a nominal GDP of 2,577.3 bn. Euro 2015, UK is the second largest economy integrated EU after Germany, and other important economic indicators are: nominal GDP per capita of 39,600 euro, GDP (PPP) per capita of 31,600 euro, public debt of 89.2% of

[1] Asistent univ. dr., Universitatea din Bucureşti, Facultatea de Administraţie şi Afaceri, valentin.leoveanu@faa.unibuc.ro

GDP, budget deficit of -4.4% of GDP, the annual inflation rate 0%, and unemployment rate 5.3% (Eurostat, 2016).

The EU referendum took place on 23 June 2016 and 51.9% of the people of the United Kingdom voted to leave the European Union. Once British citizens voted to exit the EU, this is affecting and will affect both the UK economy, and the EU economy, and at the same time, but – it is seen - to what extent, will affect the monetary policy of both the BoE and the ECB.

This paper attempts to highlight some possible threats to the economies of EU countries (still including UK among them) in the sense that central banks, through their monetary policies and exchange rate will have to face these threats and, in particular, other economic and financial effects resulting from the exit of Britain economy from the EU.

2. LITERATURE REVIEW

The scientific literature on monetary economics tries to highlight three competing models that describe the economy at the macro level. The models try to represent economic structures that constrain monetary authority in choosing its monetary policy. According to the neoclassical model, long-term monetary policy can only affect inflation. According to post-Keynesian model, monetary policy can affect inflation, unemployment, income distribution and growth. In the Keynesian model, monetary policy affects, too, inflation, unemployment and real wages, but uses an economic logic very different from other models (Palley, 2007, p.4-5).

In the book "Monetary Theory and Policy" (Walsh E.C., 2010, p.31-32) the author shows that there is a general consensus regarding the long-term relationship between money, prices and output namely that there is a correlation between money growth and inflation of 1. Instead, the correlation between money growth and inflation and real growth of the output is considered to be close to zero, although it can range from slightly positive to low inflation rates to negative at high inflation rates.

Theory and practice of monetary economics is based on several scientific principles (Mishkin, 2010, p.2-3) derived from economic theory and practice that has guided the thinking and the decisions of the vast majority of central banks in setting monetary policy, such as: a) inflation is always and everywhere a monetary phenomenon; b) price stability has important benefits for economy; c) there is no long-term trade between unemployment and inflation; d) expectations play a crucial role in determining inflation and the transmission mechanism of monetary policy in the economy; e) financial frictions play an important role in business cycles and so on.

Taxonomy of monetary policy regimes is evidenced by Manolescu (Manolescu, 2009, p. 268) and has the following types: based on monetary targeting regime; exchange rate targeting regime; the inflation targeting regime; regime implicit nominal anchor.

The advantages of inflation targeting as a monetary policy regime are highlighted by some economists as Svensson (Svensson 2009) by the following characteristics: provides transparency of communication with the economic environment; focus on price stability; giving up futile chase after optimality in particular idealized models.

Regarding the monetary policy run by the European Central Bank, the practitioners have stressed that the financial structure of the euro area differs from that of other major economies such as the US, the fact that banks play a crucial role in financing the economy and the transmission mechanism policy monetary (Delivorias 2015). ECB operations consist mainly of refinancing operations, which contrasts with the US Federal Reserve system where operations mainly consist of purchases and sales of assets on the open market, as greater emphasis in the US economy on the capital markets.

European economist Delivorias (Delivorias 2015 p.11-19) highlighted the staging actions taken by the ECB after the international financial crisis as follows: I) First phase of the crisis (2008-2010): the banking crisis; II) Second phase named The first phase of the sovereign debt crisis (2010-2011): Program on securities markets; III) The third stage of the crisis (2012-2014): final monetary transactions (OMT) and further orientation (forward guidance); IV) Current and future trends (2014-present).

3. BREXIT: CAUSES AND EFFECTS

The causes that led to the exit of The United Kingdom from the EU were primarily political and social, but depended also by the British culture and people psychology, with fewer roots of economic nature as several survey agencies of public opinion revealed. Thus, the campaign in favor of exiting the EU was based on issues like sovereignty and migration and less on economic issues, as a survey of Ipsos MORI reveals among the main causes; the status of UK in the EU (32%) and migration (48%) and only after the economic situation (27%) (Ipsos Mori, 2016).

In other polls taken, among the answers received in favor of leaving the EU the voters have brought as motivations: “the principle that decisions about the UK should be taken in the UK” and “offered the best chance for the UK to regain control over immigration and its own borders.” (Lord Ashcroft Polls, 2016).

Demographic and cultural factors have weighed much in the vote cast in the referendum, so that the older population (over 65 years) participated in voting in greater numbers compared to the young (18-24 years) (90% versus 64%) along with other British in category “older, white, socially conservative voters in more economically marginal neighborhoods” which felt less integrated with the EU than other European citizens.

The main fears and complaints of British people are related to the fact that EU institutions will not reform to de-bureaucratization and limit their interventions in most aspects of economic, social and political, but on the contrary, they will increase their interference more pronounced than nowadays thus registering increasingly higher costs for the population. Also in terms of costs, it highlights that as they make strides towards achieving the monetary union, fiscal and political costs will be increasingly higher for UK.

Regarding the effects, vote for the exit from the EU led to major political changes in the UK, generating a shock wave in the administrative, political and economic structures of EU and had and still has major repercussions by the uncertainty and the risks posed by the future process of separation that will impose future economic, social and political UK relations with the EU.

A study made by IMF specialists (IMF, 2016b) highlights the short and long-term effects of Brexit on UK and global economy:

- the global outlook for 2016-17 has worsened, despite the better-than-expected performance in early 2016;
- there was an initial financial market turbulence, reflected by a pound weakening of about 10 percent; a lower equity prices in some economic areas, like European banks; and an yields decline on safe assets;
- the forecasts for UK economy have been revisioned downward, with growth revised down by about 0.2 percentage points for 2016 and by close to 1 percentage point in 2017;
- in spite of a strong domestic demand with a rebound in investment in the euro area, the 2016 growth projections continue to be slightly higher, but the 2017 growth was revised down by 0.2 percentage points relative to April 2016 and unresolved issues in the European banking system could conduct to an intensification of bank distress in vulnerable economies like Italy or Portugal;

- in this respect, „policy makers in the United Kingdom and the European Union have a key role to play in helping to reduce uncertainty. Of primary importance is a smooth and predictable transition to a new set of post-exit trading and financial relationships that as much as possible preserves gains from trade between the United Kingdom and the European Union" (IMF, 2016b);
- major central banks must be prepared to provide both domestic currency and foreign exchange liquidity, so that they must support investors confidence in market resilience.

Also an IMF brief information from July 19, 2016 about the policy conduct they say that a "combination of near-term demand support and structural reforms to reinvigorate medium-term growth remain essential" for advanced developed countries, that manifest "significant economic slack and a weak inflation outlook." (IMF, 2016c). The IMF indications to central banks are to avoid relying too much on monetary policy instruments to stimulate domestic economies.

As for UK and its monetary policy implications, the Financial Stability Report of the Bank of England from July, 2016 shows that "The [Financial Policy] Committee had identified the following channels through which the referendum could increase risks to financial stability:

- the financing of the United Kingdom's large current account deficit [...];
- the UK commercial real estate (CRE) market [...];
- the high level of UK household indebtedness, the vulnerability to higher unemployment and borrowing costs of the capacity of some households to service debts [...];
- subdued growth in the global economy, including the euro area [...]; and
- fragilities in financial market functioning [...]" (BoA, 2016).

4. PERSPECTIVE OF ECB MONETARY POLICY AFTER BREXIT

In ensuring functionality and fulfill its objectives for any central bank it is important the transmission mechanism of monetary policy to the economy. In this regard, considering the three major global central banks - the Federal Reserve, the European Central Bank and the Bank of England – they are highlighted differences between them like:

- the monetary transmission mechanism is specific for each central bank considering financial markets development, as is the case of the BoE and the FED which MTM is mainly done through financial markets in contrast to the ECB which MTM is mainly done through banks;
- there is a single Treasury and a single sovereign debt for the FED and the BoE to deal with in spite of the ECB that have to deal with nineteen Treasuries and sovereign debts;
- there are more than one primary objective for monetary policy for the FED and the BoE, while the ECB has only one: price stability;
- there are limits regarding the ECB function of lender of last resort, in contrast with the FED and the BoE;
- there is a more complex process for decision making at the ECB than at the FED or at the BoE;
- there is less transparent process of decision making at the ECB than at the FED or at the BoE due to the failure to publish the minutes of its Governing Council meetings;
- there are a lot of differencies in using "unconventional or non conventional measures" (as the case for the FED and the BoE) or "non standard measures" (as for the ECB) (Dehesa, 2012).

After the global financial crisis in 2008 and with the aftermath of a combined banking and debt crisis in 2009-2010, the ECB policy measures were primarily focused on the difficulties in the transmission process.

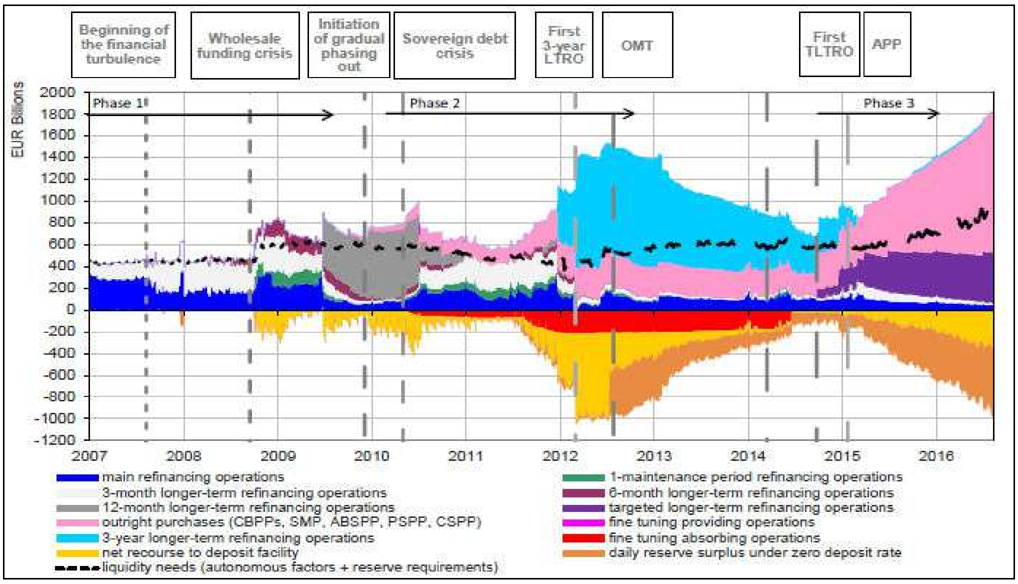

Fig. 1 Eurosystem balance sheet composition (EUR billions)
(Source: Praet, 2016)

Nowadays, the ECB is conducting its accommodative monetary policy through a set of complementary instruments like: targeted longer-term lending operations (TLTROs), asset purchase programme of public and private securities (APP), a policy of a negative rate on excess reserves, and charging zero interest rate on main refinancing operations.

The policy package is strengthened by the policy of forward guidance, having the following targets: the duration of asset purchases will be subject to a sustained adjustment in the inflation trajectory, and interest rates will remain low for a longer period of time (Praet, 2016).

There are three channels of transmission for these instruments: direct pass-through, portfolio rebalancing and signalling, which reinforce each other.

1. Using the „credit easing" tools, such as TLTROs and APP, the banks will be stimulated to create more loans simply by re-packaging the asset-backed securities (ABS), selling them on and collecting the cash as the spread between the interest rate at which the securities are sold to the ECB and the interest rate charged on the underlying credit. „This "credit easing" mechanism is expected to compress the spread between the financing conditions set in the capital market and the borrowing conditions faced by the individual borrowers in the bespoke market for individual loans."(Praet, 2016)

2. In terms of portfolio rebalancing, investors are forced to change their investment decisions from low-yielding assets to the asset with greater yields and maturity, to the assets with yield adjusted for risk. In this regard, banks are a major player in the chain of transmission in this market, by lowering their monetary reserves and orienting them by purchasing assets on the market, this process being amplified by ECB through a negative policy rate.

3. The signalling channel is intentioned to influence the expectations by both ECB purchases and rate of forward guidance. (Praet, 2016)

Table 1 SWOT Analysis regarding ECB monetary policy after Brexit

Strenghts	Weaknesses
1. **ECB monetary policy operates by steering short-term interest rates, thereby trying to influence long-term interest rates and economic developments, in order to maintain price stability for the euro area over the medium term**	1. **transmission mechanism is still weak but records improvment**
2. **the monetary policy measures in place since June 2014 are filtering through to borrowing conditions for firms and households and are supporting credit flows across the euro area**	2. **the outcome of the UK referendum on EU membership surprised financial markets, but volatility has been short-lived–contained, in part, by expectations of countercyclical policy responses in major advanced economies**
3. **the monetary accommodation and a reduction in the pace of fiscal consolidation should help to support economic activity**	3. **weak connection between monetary policy and fiscal policy**
4. **the euro overnight index average (EONIA) remained stable during the review period (from 2 June to 7 September), while the EONIA forward curve flattened, mainly in the wake of the UK referendum**	4. **low interest rates environment**
5. **broad money continued to grow at a robust pace and Loan dynamics continued to recover gradually**	5. **Quantitative Easing means an excess of domestic liquidity in UK and Eurozone, and thus ECB could use LTRO policy and for US funding ECB could borrow from Fed using swap lines**
	6. **ECB only accepts collateral from European Economic Area (EEA) issuers if bonds are settled in the Eurozone**

Opportunities	Threats
1. **the euro area economy is relatively open, particularly when compared with other major economies, such as the United States, China or Japan**	1. **structure of the euro area economy (the world's third-largest economy after US and China; one of the world's largest economies in terms of population)**
2. **the recovery in euro area activity is expected to continue**	2. **the need for fiscal discipline is even stronger in a monetary union, such as the euro area, which is made of sovereign states that retain responsibility for their fiscal policies.**
3. **business and residential investment is expected to continue its recovery**	3. **economic structures vary across the euro area countries, causing differentials in economic performance between them; economic structures display limited fluctuations over the business cycle, but otherwise they change very gradually over time**
4. **Euro area labour market conditions should continue to improve over the projection horizon**	4. **some member states have current account imbalances after the start of the monetary union, which are in the process of being corrected**
5. **HICP inflation is projected to average 0.2% in 2016 and to rise noticeably to 1.2% and 1.6% in 2017 and 2018 respectively.**	5. **Euro area activity is expected to be negatively affected mostly through lower exports**
6. **external price pressures will contribute to a pick-up in inflation, with import price inflation expected to turn positive in 2017 following a prolonged period of four years of negative annual rates of change**	6. **there are significant Brexit-related downside risks to the euro area projections**
7. **over the projection horizon 2017-2018, the general government budget deficit and debt ratios are projected to be on a downward path in the**	7. **global trade remains weak**

eurozone	8. **global equity markets reacted strongly to the outcome of the UK referendum, with euro area banks being most affected**
8. **cross-border financial business with UK and other countries are made possible by EU legislation (investment services, payments, deposit taking and clearing) through MiFID**	9. **UK access to internal market and contribution to EU budget remain important issues**

Sources: ECB, Economic Bulletin, Issue 6/2016, September 2016; Motte F., Further aspects from the UK referendum on EU membership, HSBC France, June 2016

5. CONCLUSIONS

After the international financial crisis, in achieving its primary objective of price stability, the ECB resorted to policy instruments using both conventional and especially unconventional measures in order to ensure liquidity and regain market confidence, to reduce financial risks and to ensure the resumption of growth by stimulating lending.

In order to mitigate the negative effects of Brexit on Eurozone economy, the ECB must act taking into account the strenghts and the weaknesses manifested in its decisional and operational activity, but also the opportunities and the threats concerning the external financial and economic environment.

In this respect, the ECB will continue the accomodative policy based on instruments like: targeted longer-term lending operations (TLTROs), asset purchase programme of public and private securities (APP), a negative rate on excess reserves, and charging zero interest rate on main refinancing operations.

In the same time, the ECB will use complementary the policy of forward guidance, having the following targets: the duration of asset purchases will be subject to a sustained adjustment in the inflation trajectory, and interest rates will remain low for a longer period of time.

To the extent that policy makers in the EU and the UK will be able to make a reasonable transition to the exit of UK in order to bring multiple benefits to both sides and minimize the disadvantages, the ECB policy makers will have to fulfill tasks less difficult in regarding calming financial markets, maintaining investor confidence and improving economic conditions.

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