Q&A-Brexit to reduce UK GDP over long term; No impact expected on BoE monetary, exchange rate policies: Tony Yates, former BoE MPC advisor

UK's growth level is expected to scale down over the long-term due to the "thin deal" Brexit, but there will be no impact of Britain's exit from the European Union on the Bank of England's monetary policy or the country's exchange rate policy, **Tony Yates, former senior advisor to the Bank of England's monetary policy committee,** told the Reuters Global Markets Forum on Monday, January 11.

"The relatively thin deal negotiated will send our GDP level to a trajectory around 4%-5% below what it otherwise would have been if we had not left the single market," said Yates, who is currently senior advisor at Fathom Consulting.

Yates said he didn't expect the pound to weaken post-Brexit as its effects are already factored in.

Following are edited excerpts from the conversation:

Q: What long-term economic fallout for the UK do you expect from the Brexit deal, considering doomsday calls of economic implosions or investment freezes after 2016 didn't really materialise?

A: I think that long term predictions of the effect of Brexit will be born out; that is to say that the relatively thin deal negotiated will send our GDP level to a trajectory around 4%-5% below what it otherwise would have been if we had not left the single market.

The fact that we haven't seen complete chaos after the end of the transition is -- 1) Because we managed to conclude a deal of sorts, 2) Because firms have pulled back from cross border activities as they try to figure out what to do next and, 3) Because of the effect of COVID-19 on economic activity.

I have a somewhat unsubstantiated hope that the impact of COVID-19 on remote working, IT and organizational structure generally might mitigate this somewhat as weightless activities, which in principle ought to be less dependent on physical border arrangements, are able to continue.

Q: How would that GDP trajectory compare to a situation if Brexit hadn't happened?

A: If you compare the trajectory in and out of the EU it would be 4%-5% lower at all points after about 5 years. There is the worry that our long-term growth rate would be affected, i.e., that the difference between in and out would grow forever. I think this is a possibility, but it would not be my central projection. This is GDP per head by the way. Actual GDP is going to be lowered further by labour force shrinkage, caused by lower net migration than otherwise for a while.

Q: Will economists ever be able to demonstrate that the UK has suffered from Brexit?

A: Demonstrating that will be hard as we won't see the in-trajectory. After some years econometricians will be able to detect it. But there will be lots of moving parts in the comparison, so it won't be the sort of evidence that convinces Brexiters for sure. After all, the evidence on the effects of trade barriers historically -- usually lowering them -- was well documented, but this did not weigh on the Brexit discussion in the UK much.

Q: Over the long-term, say a 10-year horizon, do you see macros (trade, jobs/wages, inflation, productivity, digitization) getting impacted negatively on the whole, compared to where they would have been if Brexit had never happened?

A: The path for real wages will follow roughly the path for GDP per head that I sketched. Inflation -- I don't think this will be materially affected. After all this is a monetary policy phenomenon. If we had had a no-deal, we might have seen quite a large hiatus in economic activity that could have left the BoE struggling to revive inflation and activity for a while, but we did not -- this is aside from temporary supply effects on prices.

Q: What is the prospect for negative rates in the UK?

A: I think that negative rates are a possibility, but unlikely. You can now see some (BoE MPC) members debating them openly, and they are clearly not against them on principle, and prepared to assess the case on its merits. But so far, they have preferred not to go there, viewing them as not sufficiently stimulative, and too much of a risk. (MPC member Gertjan) Vlieghe has been the most clear and consistent on this. Personally, I hope that they don't bother, and that instead they leave it to fiscal policy.

Q: Does BoE's current activity smell of monetary financing too much?

A: What the BoE and government are doing jointly certainly smells of monetary financing -- because it is monetary financing! However, the real question is whether the BoE has been leant on to set aside its monetary policy objectives, and I don't think this is the case yet. So far, you can make a good case that the quantitative easing (QE) is consistent with the inflation target.

At some point, fiscal and inflation target demands on QE will start to differ, and that will be the point at which independence is properly tested. People naturally worry whether there is private pressure brought on the BoE, but I doubt it.

This would require a complicated conspiracy involving both policy committees -- with several members having a strong interest in doxing and becoming the hero -- and dozens of senior staff close enough to retirement to enjoy the thought of leaking it.

Q: Do you think markets have become disconnected from economic realities and surging due to expectations of further stimulus?

A: This is hard to explain, but a fundamentals version of it is something like -- thank goodness (U.S. President Donald) Trump is out, and we have a vaccine. I don't have a much more sophisticated answer than that really.

Q: What significant differences will Brexit make to economic policymaking, also considering the COVID-19-related easy policy?

A: Hard to say what difference Brexit will make. We are going to be subject to the straightjackets negotiated in the FTA (free trade agreement), so radical use of subsidies and regulatory departures is out, if the deal is to be respected, and would anyway face considerable opposition across the political spectrum here.

I think there will be a lot of talk of 'levelling up' - efforts to use regional and industrial policy to improve productivity outside London and SE (south eastern), but not much action, and no progress at all. I suppose I am saying that there are two big fundamental reasons for the 'disconnect' -- also a third, which is extremely low real rates of course. So, following that logic, then no, no big 'correction' as there is no error. But I don't hold to this view particularly strongly and I have almost no skin in the game of forecasting that either!

Q: Do you see Britain relying less and less on foreign capital?

A: I don't see any reason for the mix of foreign funding to change.

Q: What if more financial businesses migrate to the continent (though it's been modest so far)?

A: I'm thinking of those as intermediaries. So, question is -- what our current account deficit will be, and I'm guessing not much affected, and who will fund it -- I am starting from the view that the same people that funded it before will continue to.

Q: Do you see an 'opportunity cost' of new jobs not created as financial firms expand more in the euro area in future?

A: Yes, this will be part of both why the absolute size of the UK economy shrinks relative to the counterfactual, and also why GDP per head shrinks. The huge size of the financial sector in the UK has had its downsides, of course, in the past, so it may not be all bad.

Q: Do you not think this can be counterbalanced by the skilled visa policy allowing for immigration to the UK?

A: I think it can be mitigated, but FoM used to allow companies to redeploy people quickly, and it also made the UK an attractive place to be because people from the EU could come to London and jump from one firm to another. It is going to be harder to do that now. The city is also a network: and the benefits of being in it depend on who else is joining in. These network benefits can evaporate quickly. You see the same thing in other episodes where there is a large change in spatial distribution of activity, particularly in the U.S. with San Francisco, Detroit, Texas -- all changing dramatically over 40 years.

Q: How do you see monetary policy and exchange rate policy impacted over time? May be more active FX management like Switzerland? Or any other models you see coming up?

A: I don't think Brexit will have any effect on BoE monetary policy; or on exchange rate policy. At least not now we have navigated avoiding a no deal situation. That would have served up a large shock for the BoE to deal with. And there may be more hiccoughs as we get to review points, or if the ERG (European Research Group) takes over the Tory Party properly and force a breaking of the agreement. But BoE's mandate and strategy for achieving it won't change.

Q: Do you see that as a possible scenario?

A: There is definitely a risk of a disagreement breaking out, but I think it's not my central case. The vaguely sensible bit of the government now owns the deal. The Labour Party has now signed up to it. Central case is that every time there is an argument, we knuckle under.

Q: Do you see the pound weakening over time, post-Brexit, and would that further exaggerate Britain's chronic trade deficits long-term? Or would there be enough inflows to keep that mitigated?

A: It's not terribly popular to think from the textbook here, but I don't see the pound weakening due to Brexit as its effects will be baked in. That is unless there is a change in the deal -- if there is building pressure to renegotiate to take us closer to the single market, which would push the pound up; or a threat of a breakdown in the relationship, which would push it down.

Q: How damaging has Brexit (overall) and the lack of a clear deal yet for financial services been to London's role as one of the world's most important financial centres?

A: Damaging, but not entirely fatal, I would say. After all, and to borrow a Brexiter trope, this pre-eminence pre-dated accession to the single market.

Q: Any parting thoughts for us?

A: I guess the big issue is what the implications are going to be for the economy when we escape the immediate COVID-19 crisis. And to what extent the virus will be part of our lives in the future. There are lots of uncertainties. We could have a mini boom after the vaccination program is done. But then there is a lot of debt and about to be realized unemployment, which will weigh.