The Commonwealth

Discussion Note

Commonwealth Central Bank Governors Meeting 2016

Brexit and the Potential Challenges for Monetary Policy

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Abstract

This brief aims to stimulate discussion among Commonwealth central bank governors on the monetary policy implications of Brexit. It takes its broad direction from a recent paper entitled 'Brexit: its implications and potential for the Commonwealth', which discusses the channels through which Brexit could affect Commonwealth countries. The present paper concludes that, in the worst-case scenario, the ability of developing countries to respond by means of monetary policy will generally be limited, particularly because of the prevalence of exchange rate anchor frameworks in the Commonwealth. Nonetheless, the paper urges countries with significant ties to the UK to pay attention to movements in key aggregates.

Governors may consider the following questions for discussion:

- What are the Brexit implications for Commonwealth countries?
- What does the current state of monetary policy in Commonwealth countries imply for future policy action?

1. Introduction

Brexit is occurring at a time when many developing countries are being hit by multiple shocks, including lower oil and commodity prices. While direct trade and finance links to the UK may not be significant for all developing countries, Brexit certainly represents a new external disturbance which highly exposed economies may need to prepare for (Mendez-Parra et al. 2016).

In particular, Brexit could have consequences for economic and financial stability in developing countries, through channels such as external demand and global trade, liquidity and portfolio rebalancing. Spill-over effects are likely to be associated with changes in capital flows, higher volatility in currency and financial markets, and restricted access to liquidity. The extent of these effects is likely to vary across countries depending on, among other determinants, their scale of exposure to developed markets, their own

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cyclical positions, the stability and depth of their financial systems and the type and scale of their monetary authorities (Fic 2013).

Commonwealth countries, particularly those most vulnerable to external shocks, will need to devise strategies to mitigate any negative Brexit impact. This would entail devising plausible policy responses once disengagement of the UK from the EU has officially begun and its form is better known (Mendez-Parra et al. 2016).

The Commonwealth discussion paper on Brexit asserts that there are varied potential implications for Commonwealth countries, depending on the nature and strength of their existing linkages with the UK (Commonwealth Secretariat 2016). This finding highlights the need for member countries to adopt a nuanced approach to monetary and fiscal policy reactions to Brexit. The Commonwealth analysis concluded that the impact from Brexit, if it materialises, is likely to be felt in the areas of trade (with some effects on specific goods industries and exports, and particularly on tourism services), remittances, investment, development assistance and potentially debt.

This paper seeks to explore the implications of Brexit for monetary policy in Commonwealth countries, through its potential to affect exchange rates, net international reserves, interest rates, inflation and growth, for example.

The paper finds that Commonwealth monetary authorities' ability to respond to possible shocks from Brexit are limited, based on these institutions' monetary policy frameworks, exchange rates and key macro-economic indicators.

2. Monetary policy implications of Brexit

Commonwealth developing countries follow a more restrictive monetary policy framework than their advanced country counterparts, as reflected in the preponderance of exchange rate anchors and stabilised (whether de facto or de jure) and managed exchange rate arrangements. This is particularly the case in the Caribbean and Asia-Pacific regions, where there is a high reliance on different forms of quasi-fixed exchange rate regimes. These differences in monetary policy arrangements, the current health of important monetary policy aggregates and the potential implications for the wider economy, given potential fallout from Brexit, are analysed.

In a sense, one could deem an analysis of this sort quite premature, especially given the uncertainty around what will happen in terms of new UK–EU trade arrangements, and the uncertain implications of Brexit for non-European countries. Nevertheless, the main purpose of this note is to initiate discussion among policy-makers on the myriad of external shocks including Brexit. The growth outlook for many Commonwealth countries is moderate, with limited fiscal and monetary policy space to weather future economic shocks.

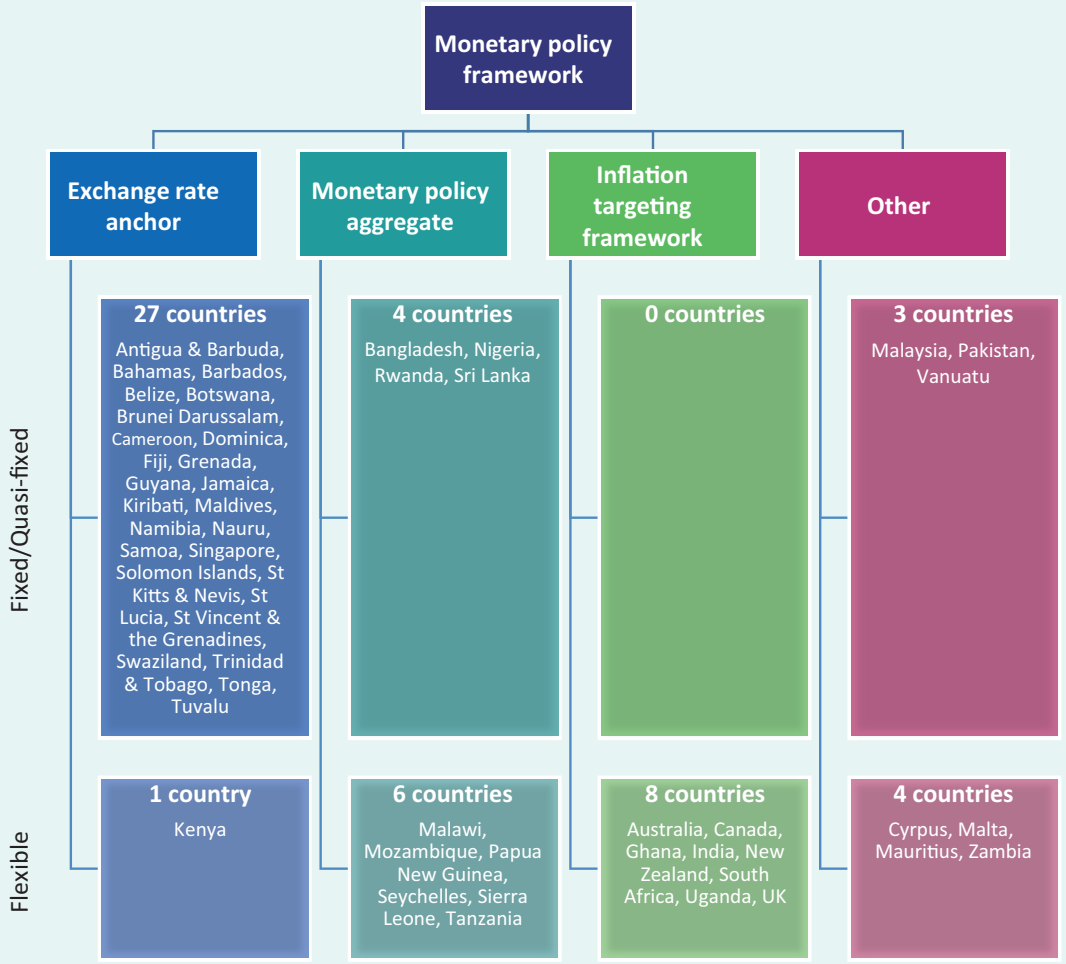
The Commonwealth is an organisation of a diverse pool of countries and there are considerable differences in the monetary policy frameworks and exchange rate arrangements (Figure 1). The policy options available to Commonwealth central banks to effect changes in the economy and, by extension, their ability to respond to any negative implications from Brexit will be conditioned by the prevailing frameworks.

Inflation targeting is the framework of choice in the developed Commonwealth, while several LDCs engage in monetary aggregate targeting. The majority of Commonwealth central banks have an exchange rate anchor, indicating that monetary policy autonomy is limited. Exchange rate anchors are particularly common among Commonwealth small states in the Caribbean and Pacific regions, and these countries mostly follow the US dollar. However, some anchors are tied to composite currency baskets, the South African rand, the euro and the Singapore dollar.

Worthy of note is that no Commonwealth country's exchange rate is pegged to the pound sterling and the majority are either de facto fixed or quasi-fixed. The implication here is that most Commonwealth currencies, at least those that have not been adjusted, are currently appreciating against the pound (Figure 2).

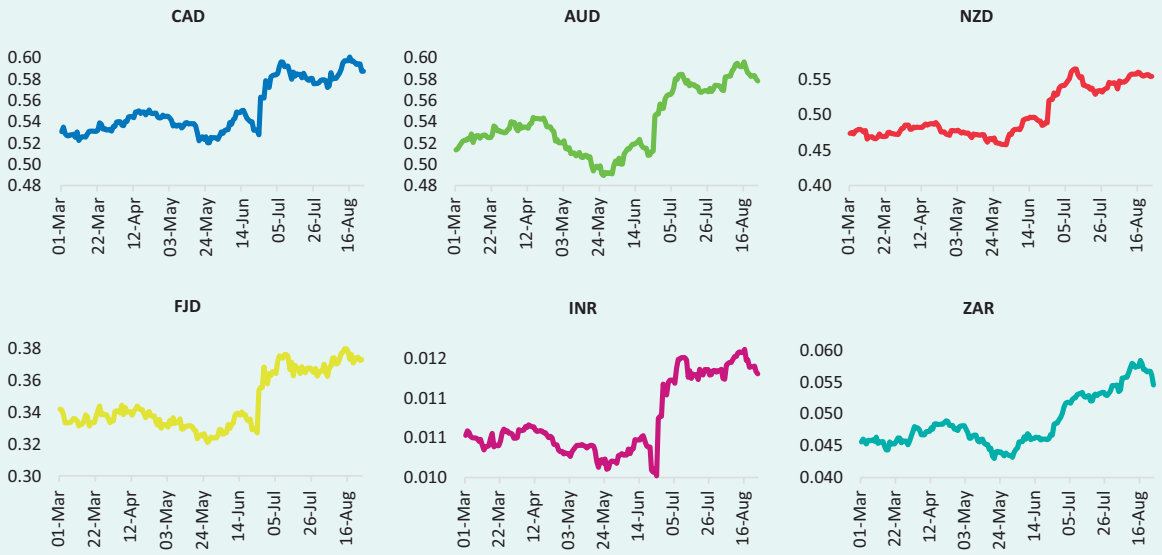
Even for countries whose monetary policy frameworks allow active monetary policy, average central bank policy rates and the high risk of deflation reflect a general limitation on Commonwealth countries to use these instruments. This limitation is further exacerbated considering that the US Federal Reserve's policy rate is still being held at well below 1 per cent. In the Commonwealth, most central banks seem to have adopted a fairly accommodative monetary stance since 2008, but policy rates are still nowhere as low as those observed in the

Figure 1 Monetary policy frameworks and exchange rate regimes in the Commonwealth



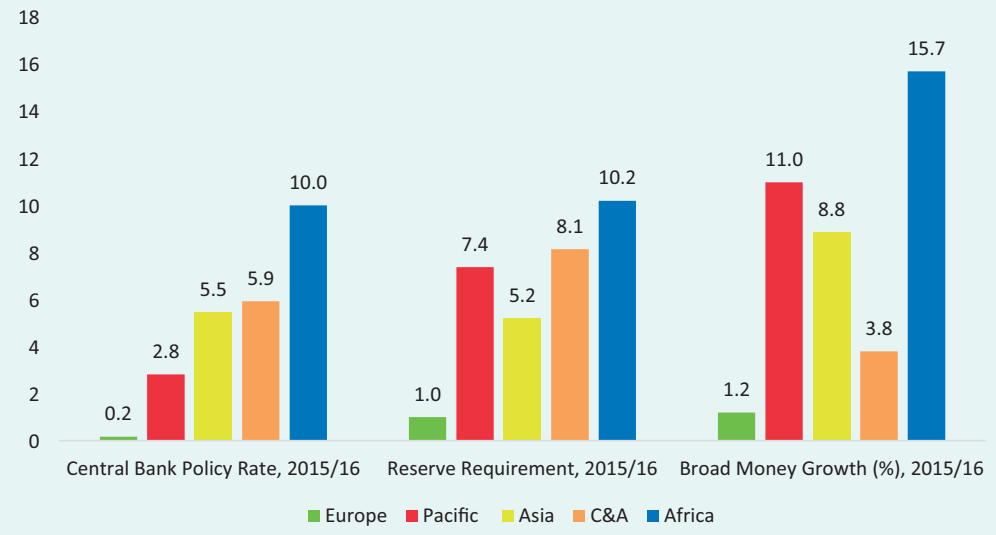
Source: *Annual Report on Exchange Arrangements and Exchange Restrictions, IMF, 2014*

Figure 2 Selected exchange rates against the pound sterling (2016)



Source: *Historical exchange rates, UKForex, 2016*

Figure 3 Monetary policy instruments



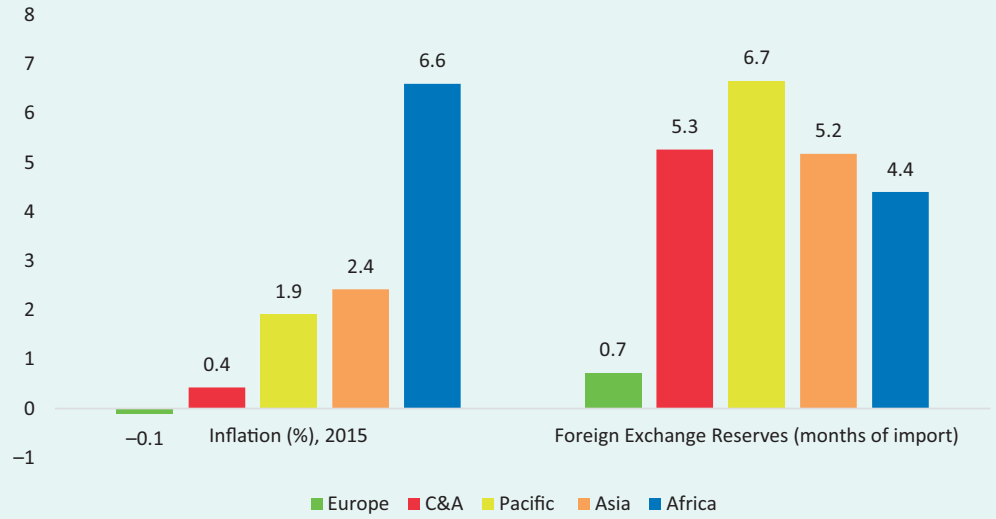
Source: *IMF and relevant central banks.*
Note: *C&A – Caribbean and Americas*

US (0.5 per cent) and the UK (0.25 per cent).[2] Additionally, though there does not seem to be a large degree of financial repression among Commonwealth countries, reserve requirement ratios are indicative of liquidity reduction policies under some monetary frameworks (Figure 3).[3]

Deflation rather than inflation is a worry in several Commonwealth jurisdictions; not surprisingly, given the lacklustre growth globally and the low inflation rates observed across most advanced countries (Figure 4).[4] Further, 10 Commonwealth countries hold foreign reserves already below the IMF-recommended level of 3 months' worth of imports, which increases the potential of monetary policy implications should there be surges in foreign exchange volatility due to Brexit; this specifically affects those countries in the group that have committed to an exchange rate anchor framework.[5]

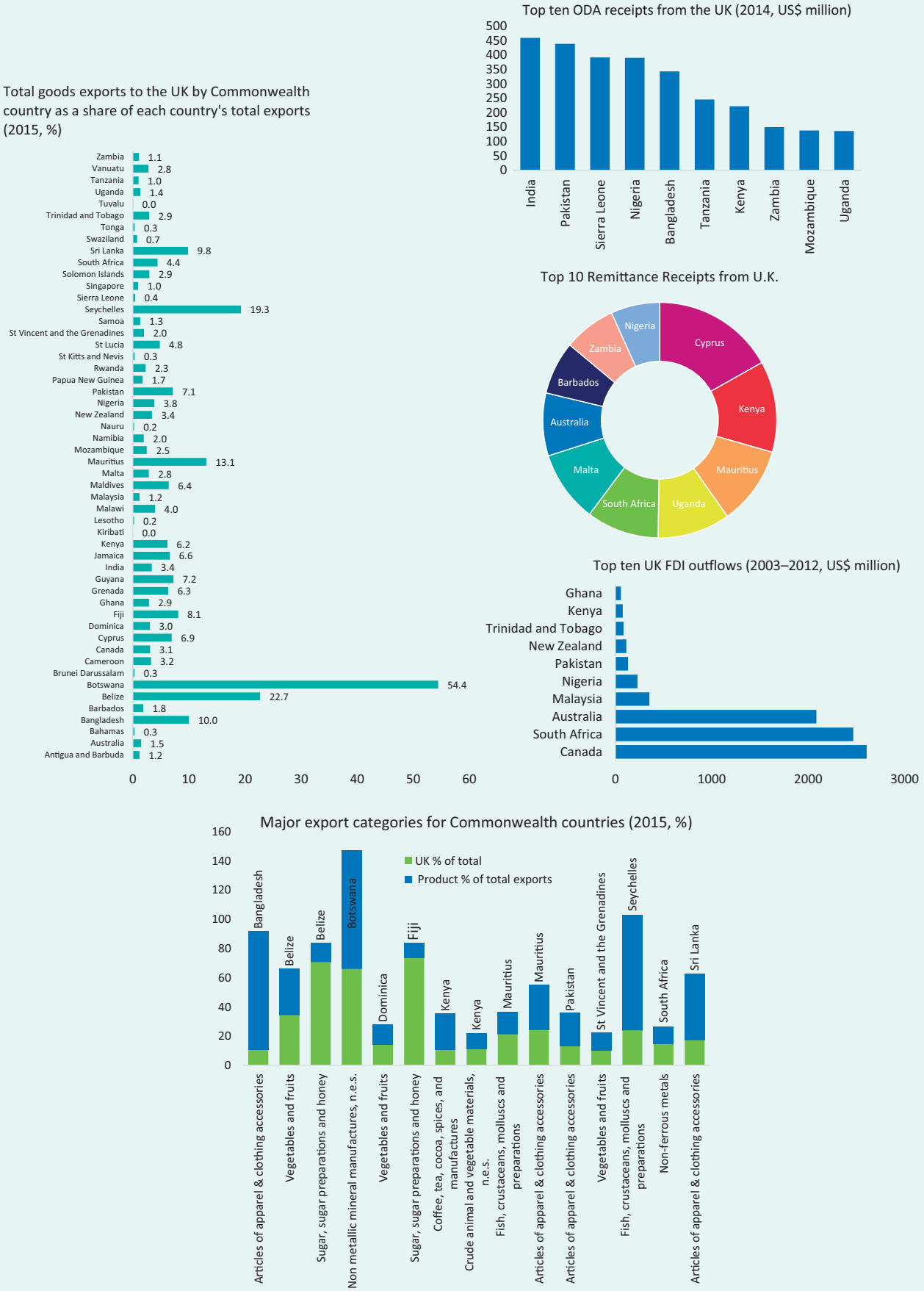
Countries with strong links to the UK via exports and limited de facto monetary policy flexibility, Botswana and Bangladesh for example, should be mindful of the reserve and exchange rate implications of Brexit (Figure 5). Allowing domestic

Figure 4 Key monetary policy indicators



Source: *IMF and relevant central banks.*
Note: *C&A – Caribbean and Americas*

Figure 5 Commonwealth trade, remittance ODA and FDI inflows



currencies to appreciate against the pound could harm their competitiveness and further exacerbate any capital losses that could stem from possible new UK trade arrangements. Additionally, any chance of weaker capital flows would put pressure on their central banks to maintain the stability of the currency, particularly those operating under fixed or quasi-fixed exchange rate regimes.

In Asia and the Caribbean, central banks should pay close attention to the flow of remittances, FDI (particularly Pakistan) and tourism flows. Capital flow risks from these channels could present similar monetary policy challenges given the objective of anchoring the exchange rate. This threat is somewhat amplified in countries such as Belize, whose central bank could potentially have the challenge of countering a backlash on vegetables, sugar and tourism receipts. Seychelles also has a fairly strong linkage with the UK given its share of UK exports. However, the central bank's autonomy over the exchange rate provides more flexibility to adapt to future challenges.

Similarly, among the advanced economies and in Africa, there is more monetary policy flexibility to address capital flow disruptions, albeit not without consequences. Reserve requirements and interest rates in Africa are already relatively high, limiting the space that policy-makers have to address capital flow reversals due to Brexit. More room exists in the Commonwealth developed-country markets, as it is possible that they could benefit from a shift in FDI, should the UK economy succumb to the worst-case scenario.

Cyprus, Kenya, Mauritius, Uganda, Malta, Australia, Barbados and Zambia, when adjusting for changes in other aggregates, should bear in mind the impact on remittances, which could fall if the pound's slide continues. Import covers in these countries are already pretty weak, so a continued fall in remittances could increase exchange rate pressures. Similar threats should be borne in mind by the Commonwealth's largest ODA recipients, which are mainly Asian and African Commonwealth countries.

3. Conclusion

Existing challenges in the Commonwealth monetary policy environment, juxtaposed with the potential consequences of Brexit, imply the need for policy-makers to track the potential and future challenges for their monetary policies and think early about them. The relatively strong linkages of certain countries, including Botswana, Belize, Mauritius, Seychelles and Bangladesh, to the UK economy suggest an even greater urgency.

Responding to potential challenges will be affected not only by the current Commonwealth monetary policy frameworks and exchange rate regimes, but also by the current room for monetary policy engagement. This paper finds that several Commonwealth countries have less import reserve cover than required and comparably high reserve requirements and policy rates, that is, as of August 2016. The path of these indicators over the next two years and the response of financial markets to UK-EU negotiations on Brexit will have implications for country actions on monetary policy.

Notes

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2 The average central bank policy rate in the Commonwealth is 6.5 per cent.

3 This is clear in Fiji, Ghana, Guyana, Jamaica, Malawi, Maldives, Mozambique, Nigeria, Papua New Guinea, Seychelles, Trinidad and Tobago, and Zambia, whose central banks all require bank reserve holdings at least equal to 10 per cent of banks' total deposits. Advanced economies in the Commonwealth, e.g. Australia, Canada, New Zealand and the UK, do not have reserve requirements. In the rest of the Commonwealth, reserve requirements range between 1 per cent (Cyprus and Malta) and 22.5 per cent (Nigeria), giving an average reserve requirement of 7.8 per cent.

4 Belize, Cyprus, Grenada, Guyana, Solomon Islands, St Kitts and Nevis, St Lucia and St Vincent are all currently experiencing negative inflation rates. The only countries in the Commonwealth with non-negligible inflation rates are Ghana, Malawi, Nigeria, Pakistan, Sierra Leone and Zambia, which reflects the relatively high concentration of inflation in Africa.

5 Barbados, Guyana, Sierra Leone, Sri Lanka and Swaziland's reserve covers are hovering just above the 3-month required import cover.

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Annex

Table A1 Definitions of different monetary policy frameworks

Exchange rate anchor	The monetary authority buys or sells foreign exchange to maintain the exchange rate at its predetermined level or within a range. The exchange rate thus serves as the nominal anchor or intermediate target of monetary policy. These frameworks are associated with exchange rate arrangements with no separate legal tender, currency board arrangements, pegs (or stabilised arrangements) with or without bands, crawling pegs (or crawl-like arrangements) and other managed arrangements.
Inflation-targeting framework	This involves the public announcement of numerical targets for inflation, with an institutional commitment by the monetary authority to achieve these targets, typically over a medium-term horizon. Additional key features normally include increased communication with the public and the markets about the plans and objectives of monetary policy-makers and increased accountability of the central bank for achieving its inflation objectives. Monetary policy decisions are often guided by the deviation of forecasts of future inflation from the announced inflation target, with the inflation forecast acting (implicitly or explicitly) as the intermediate target of monetary policy.
Monetary policy aggregate	The monetary authority uses its instruments to achieve a target growth rate for a monetary aggregate, such as reserve money, M1 or M2, and the targeted aggregate becomes the nominal anchor or intermediate target of monetary policy.
Other	The country has no explicitly stated nominal anchor, but rather monitors various indicators in conducting monetary policy. This category is also used when no relevant information on the country is available.

Source: *Annual Report on Exchange Arrangements and Exchange Restrictions*, IMF, 2014

Table A2 Definitions of different exchange rate categories

Conventional peg	The currency is pegged at a fixed rate to another currency or a basket of currencies, where the basket is formed, for example, from the currencies of major trading or financial partners and weights reflect the geographic distribution of trade, services, or capital flows. There is no commitment to irrevocably keep the parity, but the formal arrangement must be confirmed empirically: the exchange rate may fluctuate within narrow margins of less than ± 1 per cent around a central rate, or the maximum and minimum values of the spot market exchange rate must remain within a narrow margin of ± 2 per cent for at least 6 months.
Crawl-like arrangement	The exchange rate must remain within a narrow margin of ± 2 per cent relative to a statistically identified trend for 6 months or more (with the exception of a specified number of outliers), and the exchange rate arrangement cannot be considered as floating. Usually, a minimum rate of change greater than allowed under a stabilised (peg-like) arrangement is required; however, an arrangement is considered crawl-like with an annualised rate of change of at least 1 per cent, provided the exchange rate appreciates or depreciates in a sufficiently monotonic and continuous manner.
Crawling peg	The currency is adjusted in small amounts at a fixed rate or in response to changes in selected quantitative indicators, such as past inflation differentials vis-à-vis major trading partners or differentials between the inflation target and expected inflation in major trading partners. The rate of crawl can be set to generate inflation-adjusted changes in the exchange rate (backward looking) or set at a predetermined fixed rate and/or below the projected inflation differentials (forward looking). Maintaining a crawling peg imposes constraints on monetary policy in a manner similar to a fixed peg system.
Currency board	A currency board arrangement is a monetary arrangement based on an explicit legislative commitment to exchange domestic currency for a specified foreign currency at a fixed exchange rate, combined with restrictions on the issuance authority to ensure the fulfilment of its legal obligation. This implies that domestic currency is usually fully backed by foreign assets, eliminating traditional central bank functions such as monetary control and lender of last resort, and leaving little room for discretionary monetary policy. Some flexibility may still be afforded, depending on the strictness of the banking rules of the currency board arrangement.
Floating	A floating exchange rate is largely market determined, without an ascertainable or predictable path for the rate. In particular, an exchange rate that satisfies the statistical criteria for a stabilised or a crawl-like arrangement is classified as such unless it is clear that the stability of the exchange rate is not the result of official actions. Foreign exchange market intervention may be either direct or indirect and serves to moderate the rate of change and prevent undue fluctuations in the exchange rate, but policies targeting a specific level of the exchange rate are incompatible with floating.
Free floating	A floating exchange rate can be classified as free floating if intervention occurs only exceptionally and aims to address disorderly market conditions and if the authorities have provided information or data confirming that intervention has been limited to at most three instances in the previous 6 months, each lasting no more than 3 business days.
No separate legal tender	The currency of another country circulates as the sole legal tender (formal dollarisation), or the member belongs to a monetary or currency union in which the same legal tender is shared by the members of the union. Adopting such regimes implies the complete surrender of the monetary authorities' control over domestic monetary policy.
Other managed arrangement	This category is a residual and is used when the exchange rate arrangement does not meet the criteria for any of the other categories. Arrangements characterised by frequent shifts in policies may fall into this category.
Pegged within horizontal bands	The value of the currency is maintained within certain margins of fluctuation of at least ± 1 per cent around a fixed central rate, or a margin between the maximum and minimum value of the exchange rate that exceeds 2 per cent.
Stabilised arrangement	A stabilised arrangement entails a spot market exchange rate that remains within a margin of ± 2 per cent for 6 months or more (with the exception of a specified number of outliers or step adjustments) and is not floating. The required margin of stability can be met either with respect to a single currency or a basket of currencies, where the anchor currency or the basket is ascertained or confirmed using statistical techniques.

Source: *Annual Report on Exchange Arrangements and Exchange Restrictions*, IMF, 2014