BANK OF AMERICA

TRANSCRIPT

Title of Meeting:	Bank of America 2021 Global Liquidity Speaker Series *UK Update: exploring the impacts of Brexit, COVID and potential negative interest rates.*
Date:	9FEB21
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Coordinator

Good day and welcome to the UK Update Exploring the Impacts of Brexit, COVID, and Potential Negative Interest Rates hosted by Hannah Boaden. My name is Sanj. I'm the operator for the call today. During today's presentation your lines will remain on listen-only. [Operator instructions]. I would like to advise today's conference call is being recorded.

And now I would like to hand over to Hannah. Please go ahead.

Hannah

Thank you, Sanj. And welcome everyone to today's Liquidity Speaker Series, and thank you for dialing in. I'm Hannah Boaden. I head up the DTS Liquidity Product team here in EMEA. And I'm joined today by Rob Wood, who is our Chief UK Economist at Bank of America Research, also based here in London.

Rob, welcome and thank you for joining us today. We very much look forward to hearing your insights. Today we'll be discussing the impact of Brexit and COVID in the UK, what have we seen so far, and what 2021 may have in store. And then we'll also be looking at how the current environment has brought up the topic of negative rates here in the UK.

Let's start with the impact of Brexit first. Rob, as we know, the UK formally left the European Union on the 31st of December after a long transition period, with the new rules governing the relationship between the EU and the UK taking effect on the 1st of January 2021. We're now over a month in, so what are the top changes that have impacted the UK economy and what impacts are yet to come that we haven't seen?

Rob

Hi. Well thank you for having me on. Look, the honest answer to this is that no one really knows at this stage. We're only a month in, data is pretty thin on the ground. We have a lot of anecdote, but that anecdote is hard to compare to where we were. A lot of it doesn't have a long background, so it's not easy to look at year-on-year or what's a normal level for these things. And what I'll come back to shortly is Brexit is a long run issue, not a short run one, so looking for short run impacts is really not looking in quite the right place.

That being said, what are the main impacts? Well the UK left the EU in January 2020 through a transition period that ran for 12 months—sorry, 11 months. It's since signed a trade deal and left that transition period, so we're out of the EU, out of the transition period, trading on the terms of that trade deal.

Unusually for a trade deal, the terms the UK traded on changed overnight on the 31st of December last year. Normally when countries implement a trade deal they'll be smoothing that over many years because those changes can cause quite significant shifts in the economy as tariffs and trade barriers and various capping on tariff trade barriers go up or down. So it normally stood that the UK and EU very unusually implemented them overnight.

The most obvious impact of this so far has been disruption to some industries. The clearest one is fishing, so shellfish for instance. Some shellfish are simply forbidden from being exported into the EU by a third country, and the UK shellfish industry used to export a lot of these fish, which it now can no longer do. So you've seen in the newspapers a lot of reports of various companies going bust and shutting down because their export markets are gone.

This goes wider to other to other kind of fish. Fish is particularly an issue here because the UK catches fish, or used to catch fish, and have it processed in the EU, and there are certain restrictions on exporting unprocessed fish from third countries.

Agricultural products have also been disrupted to a greater degree. This particularly affects agriculture, because agricultural products face more onerous checks at the border than other groups do and a higher proportion of the checks.

The disruption seems to extend beyond agriculture, though. As best as one can tell, there have been increased numbers of rejected exports and imports on both sides of the channel, and many firms you can see are worried about the increased administration costs to do with the paperwork that they now have to fill out, again, as you try to order something from abroad. But you'll also notice that customs charges are sometimes added to purchases now as well.

So those have been the major impacts so far. For the most part, the industries that are particularly heavily affected are relatively small, so that's fish. What's unknown really is how widely that disruption spreads among sectors that account for large proportions of the economy, and only time will tell. And of course some of these disruptions may ease over time as companies get more used to filling out forms, something that won't ease. And that's really sort of the voyage of discovery that Brexit takes us on.

Going back to the deal, what is the deal and why is this disruption there? Well the deal is that there will be no headline tariffs or quotas on UK-EU trade. But that trade will be subject to a range of non-tariff barriers to trade. And this means you have health checks on food products. You're going to have to fill out extra customs forms, customs declarations, there are rules of origin requirements. A good exporter from the UK to EU now has to have a certain proportion of its value produced in the UK.

This was another issue that came up over the past month. The UK, it turned out, used to be a distribution hub for certain types of food imported from non-EU countries, and so they come into the UK and then be split up and exported to the rest of the EU. This can't happen now without tariffs because the food isn't produced in the UK. So it will face a tariff if it's exported into the EU.

So that's the deal. Those non-tariff barriers add cost to all exports and imports. This happens on exports and imports with all sorts of other countries, so it's not spectacularly unusual, but it is a huge change. And the lack of those costs was one reason the UK traded a lot more with the EU prior to this Brexit agreement, and why it's likely to trade considerably less after it. You add a cost to something, you'll probably do less of it.

These non-tariff barriers or behind-the-border barriers are particularly significant for services. And where possibly the most obvious one—it isn't the most obvious because you've seen it in food—but one of the more obvious implications of the Brexit deal is that UK financial sector passporting was ended.

Finally, another implication is on trade within the United Kingdom, so between Great Britain and Northern Ireland. Due to the Northern Ireland protocol, to avoid a hard border on the island of Ireland, there are certain checks that now happen that didn't used to on trade between Great Britain and Northern Ireland, which is also causing disruption and some goods not being as widely available as they were in Northern Ireland, or at least the systems often having to be changed.

So that's the very short run. And it really is a voyage of discovery that there aren't really any precedents for this sort of change in trading relationships this quickly. And there isn't a whole lot of data at the moment, so we're flying blind.

I think, you know, you asked where are the effects going to come, and this really actually gets to the meat of Brexinomics, if you like. Brexit changes in trade terms are a long run thing. It's not about the short run and then they go away. You change trade terms, they tend to have an effect that builds over many, many years. The models and the estimates that you may or may not have seen published over the previous few years are almost exclusively about those long run impacts. Broadly speaking, they estimate that the type of deal the UK has signed will cut UK GDP in the long run by somewhere between 5% and 7.5% relative to where it would have been.

So it doesn't mean GDP falls by 5% to 7.5%. It just means it grows 5% to 7.5% less than it would have done otherwise. And those effects are probably going to build very slowly, so it's like you're going to see a huge effect in only one year. The shift will probably build over 10 or 15 years.

It goes beyond just simply the reduction in trade flows. Trade flows tend to drive productivity anyway. But also the increased effective competition that firms in the UK faced because they had a very large, effective market with the EU, those competitive pressures will fade somewhat, which will likely reduce productivity growth in the UK.

Also, a lot of inward investment into the UK was predicated on the UK being party to the market. The UK was seen as, if you like, the door or the bridge into the EU, relatively low regulations, but the same accesses are drawn out; that inward investment is likely also to be curtailed.

Now please just finally before we get to move on, don't take this to mean that there aren't ever any opportunities from Brexit. Of course for individual firms there will always be upsides and downsides, and when you start throwing pieces in the air, it will be helpful to some. And indeed there were certainly examples in the papers just the other day, Liverpool Port has gained a lot of business as firms reroute shipments away from landing on the east coast of the UK to avoid disruption. So within the UK there's been some relocation of output. But from a macroeconomic perspective, these changes are likely to be a significant long run drag on the UK economy.

Hannah

Thank you, Rob. That's really interesting. And clearly some immediate challenges identified, but also lots still to come clear as time moves forward. But looking forward to the remainder of the 2021, we're living in an era of managing a global pandemic, but whilst still navigating through post-Brexit uncertainty. What do you envisage as the biggest challenges we'll face throughout 2021, and what glimmers of recovery can we see this year?

Rob

Yes. So my forecast has three parts. I think of it as slow, fast, slow. The immediate challenge of course is getting through lockdown and continuing to vaccinate significant numbers of people, which the government is doing at the moment. Until we get out of lockdown, our output is going to be extremely weak, and I'm looking for a 6% quarterly fall in output in the first quarter. Just to put that in context, that's the entire peak to trough fall in the financial crisis, and it's likely to come in the first quarter of this year.

The challenge from the UK—and we will grow strongly through this year given the vaccine rollout. Those lockdown restrictions will be eased if that vaccine works, and given where they start from growth will pick up very strongly.

The challenge, and that's the fast part of this through Q2 and Q3, as lockdown restrictions are probably eased we're going to see very, very strong growth. The challenge to the UK is completing that recovery, so getting from where we are back to a position where unemployment is not elevated, where output is back to where it was before COVID.

And this is really a big challenge for the economy. On average UK output for the past 12 months has been over 10% below where it started. We've become sort of immune to these numbers, so they're conditioned on these large, huge numbers for changes. But these numbers are absolutely enormous. As I say, the peak to trough fall in output in the financial crisis, which was the worst recession in 100 years, or deepest recession in 100 years, that was between 6% and 7%. We've been running for 12 months with output more than 10% below where it started.

What this means is a lot of costs are built up on balance sheets. A lot of it on the government, which is good news because the government is in a position where it can spread paying those costs back over a very, very long period of time. So it doesn't have to restrain the economy dramatically. But a lot of them are on private sector balance sheets, particularly firms, and what we saw after the financial crisis was significant deleveraging. And that's what corporates at the moment say they're on the whole focused on, these defensive strategies, which you see cost raising cash flow, which is likely to restrict investment.

Households are likely to be cautious. They tend to be after unemployment and when unemployment goes up. And as soon as these emergency middle market actions by the chancellor through the furlough scheme, as soon as these end it's likely that unemployment will rise and that will likely leave consumers relatively cautious.

So the real challenge here is getting from where we are now, which is a very, very depressed level of output, back to something more normal. We'll make big progress on that in the second and third quarters as we stop preventing people from spending money. And it's that final bit that's going to be the real, real challenge. It'll be a real challenge for the government and the chancellor. The chancellor seems to want to begin cutting back fiscal policy. And indeed on his current plans, UK fiscal policy will become highly contractionary from 2022, which to my mind is too soon if we want to guarantee this recovery.

It's going to mean the Bank of England will need to keep policy highly stimulatory throughout this period in order to try and encourage this recovery. That's why the Bank of England is now putting negative rates as an operational policy. With bank rate at 0.1% it doesn't really have any ammunition left to do anything if the economy were to turn out worse than it expects, so it has made—or will make—negative rates an operational possibility by August.

Beyond those two issues, the UK finally faces a significant challenge from potential growth. This is the rate the economy can grow without setting off inflation. This used to be about 2.5%. The UK used to be able to grow 2.5% year after year after year. That's what we aimed for. Post the financial crisis that fell to about 1.5%, and now it has probably fallen to somewhere around 0.5% a year.

There's a lot of reasons. One is very weak business investment. Another is that the population is aging, so people are leaving the labor force rather than joining it. Immigration is likely to slow, and productivity will likely be depressed by this crisis. There are views on both sides, but on balance likely depressed. UK productivity historically has not grown really for the last decade. UK growth has been driven by a rising labor force and investment, and both of those have likely slowed now.

And particularly the challenge for the UK is the population. Best estimates suggest the population has fallen about 1.3 million since the beginning of last year, with about an 8% fall in the London population as people have emigrated. And this will be a very significant challenge to returning to pre-COVID output levels if those people do not return.

Hannah

Thanks, Rob. That's very, very insightful. And you did just touch on negative rates, but I'd like to just delve into that in a little bit more detail. There has been a fair amount of press attention on the concept of negative rates in the UK. Can you just tell us a little bit more about negative rates and whether we are likely to see the Bank of England utilize this as a recovery tool in the short-term to medium-term?

Rob

Sure. So I mean I would say on the previous bit these challenges I've just described apply to a lot of the world, not just the UK, and so a lot of these are generic. The UK actually will likely see considerably faster growth than the rest of the world in the second and third quarter, partially because of where we come from. The UK GDP fell more than most of the world through 2020, so has been able to catch up. But also because we have been vaccinating much faster than most other countries, which should allow us to ease our lockdown a little bit faster than everywhere else. Those longer term challenges that come afterwards are pretty generic everywhere, although the UK does face the specific challenges of Brexit and the population.

On to negative rates. I'm forecasting the Bank of England will stay on hold for bank rate, thus I'm not forecasting negative rates. But they are now the Bank of England's marginal tool. It's the thing that they will turn to I think if they need more stimulus. And if I'm right that the UK potential growth is about a half, and that recovery will not be complete, it's likely that the Bank of England will be casting about and looking at what extra stimulus it can add.

But this year, this growth can be strong through the second and third quarter. But as you come towards the end of the year and into next year and as growth slows, I think it's more likely we're going to be asking the question, is the Bank of England going to do more rather than is it going to be hiking rates. And doing more for the Bank of England probably means cutting bank rate negative.

If it does turn negative, and this is why there's probably quite a high hurdle to it, you're not going to take a controversial measure like that unless you need to go significantly negative, that is from -0.5%. And so they're not going to stop at -0.1%. You only can't make it if they're going to go beyond -0.1%. Why take a super controversial action for hardly any stimulus?

So I'm not forecasting they do that, but certainly as we've learned through this year how complete this recovery has been, if there's any disappointment—and I suspect the risks are skewed in that direction—then the cautions will return as to what the Bank of England can do more of.

Hannah

Thanks, Rob. And we've seen negative rates being utilized in other countries, and in fact in some countries negative rates have been a concept for some time, the Eurozone and Denmark, for example. Do you think there is a success rate in other countries that could indicate that the Bank of England would be close to negative rates as a recovery tool?

Rob

The Bank of England are very split on this, and that's one reason it's very hard to have conviction that they will want to use it. Some members clearly think that negative rates work, and they use evidence from the Euro area, from Sweden, from other countries like in Japan that's implemented negative rates, and they see it as a positive thing. They think it will pass through to mortgage rates, it will lower borrowing rates, cut the exchange rate, and boost growth.

Some of the other members are more skeptical because of the potential damage to the banking system, and therefore, the question of whether this will indeed pass through to low mortgage rates or whether it will raise them. And there's quite a spirited debate at the moment actually about whether mortgage rates, which have gone up since the start of the COVID crisis despite the Bank of England cutting the bank rate, there's quite a spirited discussion about whether that is actually a result of banks being affected by the profitability or having profitability impacted by the market price in negative rates.

So will they take it positive or negative? At the moment they are highly, highly split on that, and that's why a negative rate is a very tricky thing to forecast. In terms of our view, we don't think negative rates really work. If they do work, they add very marginal stimulus and they come with large potential downside via the banking system.

The far more effective and safe policy stimulus to do in current conditions would be to run a much more expansionary fiscal policy, rather than the Bank of England really dredging the depths of the bow of monetary policy options for things that have really quite marginal effects and potentially large cost. That would be our view. That's not shared by the people who set interest rates.

Hannah

Great. And do you see that there has been success in other countries that have deployed this as a mechanism? Or do you think that it just turns into a period of negative rates and it's very difficult to get out of that cycle?

Rob

Well clearly the reason it is difficult to get out of negative rates is because central banks only tend to go there when they get desperate and they face a constraint about how far they can cut interest rates negative. So there's a very limited amount of stimulus you can get by this.

So it's not the negative rates necessarily that force you into a worse outcome, it's just that you don't have enough stimulus to get out of that position. And central banks tend to leave it too late because negative rates are highly controversial. So whereas when you're running out of ammunition you should really act very urgently, when that ammunition is highly controversial central banks tend to delay, and when you delay you are too late.

Do they work? As I say, I mean I think the evidence is pretty mixed. If you look at it across most of these countries, most of the central banks would argue that it does work and a large amount of the impact comes by cutting the currency. But you will find a large amount of research suggesting that it has significant drawbacks for credit creation and that over time the stimulus from negative rates, such as it was, plummets. So it doesn't work very well.

Honestly, the academic evidence is pretty mixed. Part of that is because relatively few countries have gone negative. They only tend to go there when they're already in pretty dire straits, inflation expectations, de-anchoring, for instance, and so it's very, very hard to isolate the effects. You can find some positive evidence. You can find some evidence against. Most central banks would say it works. Most bank analysts would say it doesn't.

Hannah	Absolutely, a difficult one to forecast, as you mentioned. One of those wait and see, I guess. We are nearly out of time. So we will finish up there. Rob, thank you ever so much for taking the time to share these insights today. It's certainly an ever-changing environment that we're living in right now and do really appreciate you speaking with me. And also, thank you to everyone for dialing in. Sanj, I will hand back to over to you, if that's okay?
Coordinator	Thank you, Hannah. That concludes your conference call for today. You may now disconnect. Thank you for joining. Have a very good day.

[END OF CALL]