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G3 CENTRAL BANKS: TO HIKE OR TO CUT? THAT IS THE QUESTION...

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The waxing and waning in the outlook for global growth have been matched one-for-one by gyrations in the outlook for monetary policy in the United States. The statement following the April meeting of the Federal Reserve Open Market Committee (FOMC) opened the door for interest rates to be increased further at the June meeting. In short order, this was followed by statements from a number of committee members, and by Chair Janet Yellen herself, to indicate that U.S. interest rates were likely to be increase two or three times in 2016 and that we were likely to see the next increase within the near future.

Alas, growth levels did not support the committee's expectations. The final nail in the coffin for the June rate hike was the latest nonfarm payrolls report, which indicated that the U.S. economy created a measly 38,000 jobs in May (June's figure came in much higher at 287,000). Moreover, so weak was the data flow that the number of FOMC members who expect only one interest rate hike through the end of 2016 increased from one to six—exactly equal to the number of members on the Board of Governors that is led by Ms. Yellen. As the UK's vote to leave the EU (Brexit) weighs further on the outlook for growth, the U.S. debate about interest rate increases will most likely be postponed until 2017. Courtesy of a tightening in U.S. financial conditions following the strengthening of the U.S. dollar, the current cycle of monetary tightening is shaping up to be very unusual indeed: one hike followed by a pause of at least 12 months, possibly longer.

Amid an ever-stronger currency and an ever-lower stock market, the Bank of Japan (BoJ) jumped into action and decided to do….nothing! Again. In Japan, the prospects for a return to 2% inflation, and the outlook for corporate profits (and thereby the outlook for capital expenditure and growth), continue to weaken in tandem with the strengthening of the currency. The economy will see some fiscal support and, as a down payment, Prime Minister Shinzo Abe postponed the value-added tax increase that was scheduled for the spring of 2017. In addition, a supplementary budget of 0.5% to 1.0% of gross domestic product is scheduled to be announced sometime in the third quarter. At the press conference following the meeting of the monetary policy committee, Governor Haruhiko Kuroda duly noted that the BoJ stands ready to act if the virtuous circle between growth and inflation is not set in motion.

The challenge of the European Central Bank (ECB) was somewhat more manageable. Amid a backdrop of continued strong domestic demand, bank President Mario Draghi announced that the ECB is still in "wait and see" mode as monetary thrust from previously announced monetary policy easing has yet to hit the economy. Although the ECB's monetary policy stance is highly accommodative, it seems likely that further measures will be needed, and will be delivered, when European growth is hit by the confidence shock from Brexit.

IMPACT ON FINANCIAL STABILITY

Given the UK's preeminence within the financial services industry, Brexit has raised questions about financial stability. Financial stability is an important question, but one that is unlikely to be materially affected by Brexit. Why? There are three reasons. First, the vote on the EU referendum has been well telegraphed and opinion polls have underscored the need for financial institutions to be adequately hedged for an adverse outcome. Second, given the facilities put in place by central banks during the financial crisis and the abundance of local currency liquidity, it is unlikely that any depository institution will find itself in a situation where it is forced to engage in a fire sale of assets to raise liquidity. Third, U.S. dollar swap lines have been put in place between local central banks across the regions and the Federal Reserve. Through these lines, local central banks can ensure that local financial systems have adequate access to U.S. dollar liquidity.

The question of financial stability deserves greater scrutiny when it comes to exchange-traded funds and asset managers that offer overnight liquidity while they invest in assets that can only be liquidated over several days. For these funds, panicked withdrawal has the power to create important squeezes within the financial system. Fortunately, we have seen no signs of this happening yet, and anecdotal evidence suggests that many funds entered the referendum with high cash balances.

Across the emerging markets world, contagion could occur if UK banks, faced with a funding squeeze, are forced to disengage from global financing arrangements or if Brexit triggers a major risk-off episode that causes capital to retrench to central banks. The risk of the former is mitigated as UK banks, with the exception of a couple of financial centers in Asia, have significantly reduced their international exposure over the past couple of years. The pledge by the core central banks to monitor global financial conditions and to deliver liquidity when needed has put pressure on interest rates to fall in response to Brexit. This move has reduced the risks related to capital flight from the periphery of the financial system.

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