FX FOCUS

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Brexit

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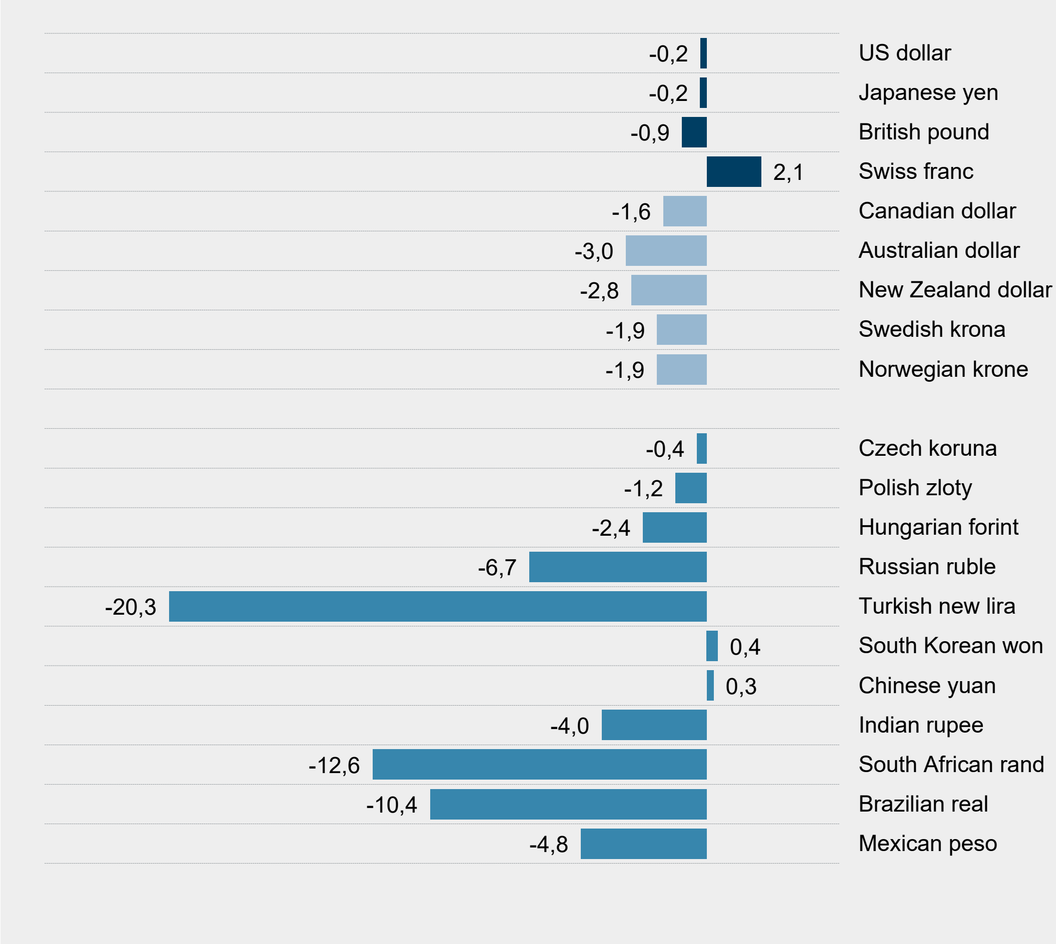
- The Brexit negotiations are entering the hot phase. The pound sterling is suffering from concerns about a "no deal" scenario. In terms of substance, however, the discrepancies can be bridged after some mutual accommodations. Ultimately, a compromise between Britain and the EU is more likely, as both parties want to avoid a "chaos" Brexit. The British pound should benefit from this, especially since the currency is fundamentally inexpensive.
- The decline in the value of many emerging market currencies worsened, especially for the Turkish lira. The currencies from Scandinavia and Oceania also declined. Safe investment havens were in demand, especially the Swiss franc.
- Helaba Currency Forecasts

Performance on a month-over-month basis

% vs. euro compared to the previous month (from 08/06 to 09/04/18)



Core currencies · Rest of G10 · Currencies of emerging markets

Sources: Bloomberg, Helaba Research

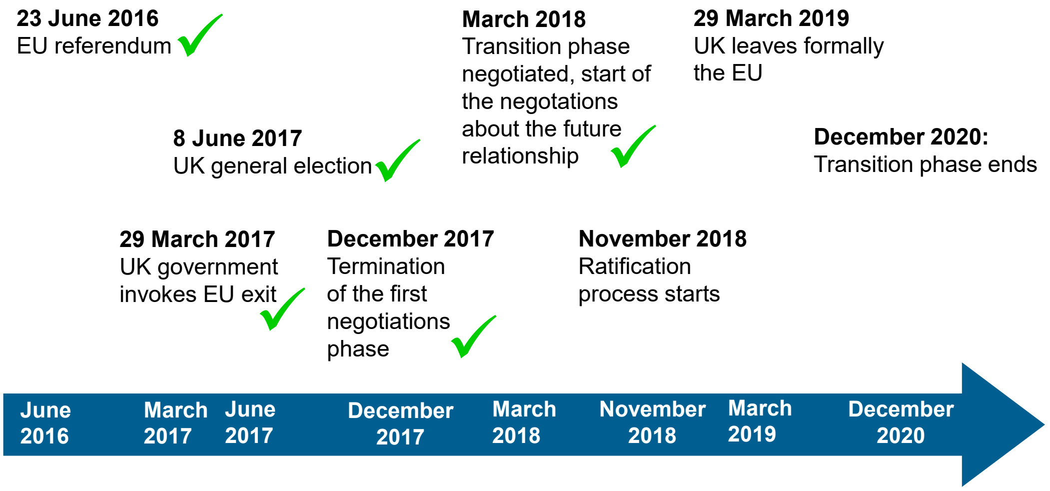
GBP: Deal instead of chaos Brexit

The Brexit negotiations are entering the decisive phase. Nervousness is growing; concerns about a “no-deal” scenario are increasing. Warnings are coming from both parties. The British pound is weakening, the euro-pound exchange rate temporarily climbed above 0.90. Is there a real danger of a chaotic EU exit and a collapse of the British economy and of the pound sterling?

“Divorce agreement“ and a deal about the future relationship

On 29 March 2019, at 11 p.m. British time, the UK will leave the EU according to plan. The terms of the exit are being negotiated in the "divorce agreement," which must be concluded with a certain lead time due to the ratification process. The EU summit for that process was scheduled for mid-October. In view of the stagnating negotiations, the hope now is that a resolution will be achieved in November. The "divorce agreement" regulates financial obligations, rights and duties etc. between the UK and the EU. Following the exit from the EU, there is supposed to be a transition phase until the end of 2020, during which the current status remains almost unchanged – but the British are allowed to conclude trade agreements with others in the meantime. The future relationship between the UK and the EU does not need to be clarified by the end of March. However, in return for their – financially costly – approval of the "divorce agreement," the British want a deal on the future relationship. For reasons of time alone, only fundamental matters can be agreed upon, and the details will only be worked out later. Meanwhile, the EU is showing more willingness to negotiate the future relationship in a timely manner.

Brexit timetable



Source: Helaba Research

Ratification

On the British side, the “divorce agreement“ must be approved by the House of Commons and the House of Lords. On the European side, this agreement is ratified by a simple majority in the EU Parliament and by a qualified majority in the EU Council. The member states, i.e. all national parliaments, would have to ratify the agreement, if this deal should change the EU treaties or provide new agreements, e.g. free trade agreements between the EU and the United Kingdom. That would be very time-consuming and carries the potential for political blackmail by individual countries. The EU is presumably trying to bypass the road via the national parliaments when it comes to the ratification of the "divorce agreement." That process would be necessary only for a full free trade agreement between the EU and the UK at a later date – because of the transition period, there is more leeway for such a case.

Political conflict in the UK

In addition to the debate with the EU, the focus in the recent past has been on the political dispute within the UK. Brexit Minister Davis and Foreign Minister Johnson resigned in protest over the government's White Paper on the future relationship with the EU published in July. In the House of Commons, which is more critical of Brexit, it should in principle be possible to find a majority in favour of a "soft" EU withdrawal, if the Brexit cannot be avoided after all. However, Prime Minister May prefers her own majority with the votes of the ruling Conservative Party (including the Northern Irish DUP) in the final vote on an agreement. A significant part of the fraction – albeit a minority – prefers a harder course on the Brexit. Missing votes may come from the opposition, but the Labour Party, for reasons of party political tactics, could also let May crash and burn.

Are new elections or a new referendum likely?

About new elections, a second referendum, or an extension of deadlines has been speculated for some time – as a way out of this dilemma. New elections are a high-risk gamble for the Conservatives, which backfired already back in 2017 with the loss of their own absolute majority. According to polls, they would endanger their governing majority. While many Brexit opponents would like a second EU referendum, it is questionable to what extent the conservative government could sell this to its voters, the majority of whom are in favour of Brexit. Theresa May has even described this as "betrayal of democracy". In addition, the parliamentary and organisational lead-time until March 2019 would be extremely tight. The outcome of a second referendum would also be very uncertain. The polls may show – as things stand now – that EU supporters have a slight lead. However, short-term events could have a decisive influence and flip the result. A second referendum is therefore not a promising alternative. The British government may be hoping for an extension of the deadline. However, only the EU member states decide this, and the decision must be unanimous. From the EU's point of view, the pressure of time is a negotiating advantage that it will hardly give up. In fact, EU chief negotiator Barnier ruled out an extension of the deadline. This option is therefore hardly likely.

Negotiations about "divorce" and future relationship

"Divorce agreement" quite far?

In principle, the British and Europeans are overall not that far apart in the negotiations. In the draft of the "divorce agreement" published in March, there was consensus on a solid 80 % of the text passages. For example, there is broad agreement on the UK's financial commitments. The British are to transfer 40 to 50 billion euros to the EU for commitments to the EU budget, European programmes, pension obligations, etc. The status of foreign EU nationals currently living in the UK and vice versa is not very controversial. The Northern Ireland-Ireland border, on the other hand, is problematic. The goal is to avoid a "hard" border including customs controls. However, Britain rejects – hardly surprising – a customs border between Northern Ireland and the rest of the country. The EU is calling for a backstop solution for this border as long as no agreement is reached on Britain's future relationship with the EU. The British proposals so far have not convinced the EU. A fundamental solution that still needs to be found for transactions at all British borders with the EU could also be applied in Northern Ireland. From an economic point of view, trade on the Northern Ireland-Ireland border is not very important.

A "divorce agreement" will hardly be concluded without a convergence on the future relationship. The British Government has finally presented a plan for this in the form of its White Paper. The basic British course remained unchanged: Withdrawal from the single market, but as much free trade as possible. As the EU does not tolerate any watering down of the free movement of workers in the single market, the British will have to leave. A customs union, for which there are also sympathies in the British parliament, excludes the possibility that the British could have trade agreements of their own. A conservative government will hardly agree on.

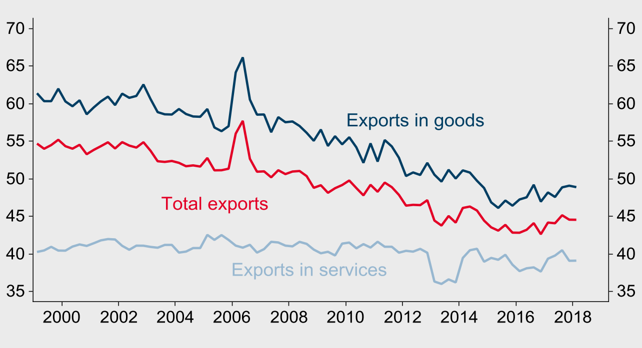
British White Paper

The proposal includes a free trade area for goods so that goods can continue to be traded duty-free and according to uniform standards. The latter would thus be determined de facto by the EU. Services – especially in the UK's important financial sector – are not included, however. The free movement of workers will be restricted. In the services sector, the British would lose direct market access, i.e. British banks would lose their EU passports. The banks could avoid this by setting up subsidiaries in the EU – where they do not already exist –, which would at the least mean higher costs for banks and jobs for the financial centres in the EU. For the financial sector, the British propose that standards should be mutually recognised according to an equivalence model. However, the EU is reluctant to do so, not at least in the hope of attracting as much business as possible from London to the continental financial centres. However, London does remain the dominant financial centre in Europe, which means that companies from the EU remain – more or less – dependent on it.

The British Government has already gone a long way to accommodate the EU. The EU's reaction to the proposal was rather negative. For example, the EU criticised the idea of the British collecting import duties for the EU at their border. There is great interest on both sides in a largely undisturbed trade. The British want this agreement despite their trade deficit, as just under half of British exports go to the EU (the flow in the other directions is only around 7 %). The EU, especially Germany, generates a large surplus in trade in goods with the UK. The German government could thus push for a compromise within the EU. In bilateral trade in services, the British generate a surplus of more than 1% of GDP. Due to the expected trade barriers, especially non-tariff barriers, the British balance could tend to deteriorate – to the EU's advantage. On the free movement of workers, quotas would be a workable compromise for EU citizens. In detail, there are still some points of contention on regulatory issues, such as the designations of origin of foodstuffs. But these could also be clarified after the formal exit from the EU. Calling all of this pure "cherry picking" by the British points to the certain dogmatism, which the EU representatives in particular reject.

EU takes half of British goods

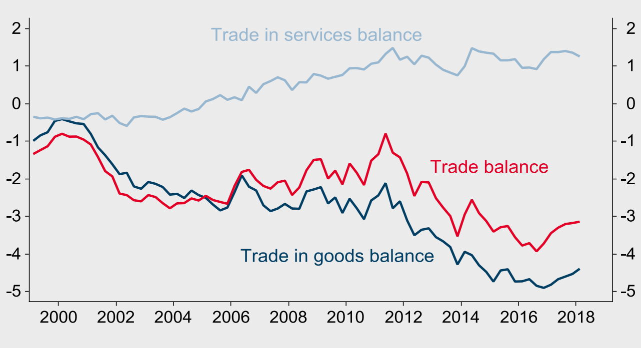
EU share in % of British exports



Sources: Macrobond, Helaba Research

British trade deficits in goods with the EU

Share in % of British GDP



Sources: Macrobond, Helaba Research

"No-Deal" scenario as a deterrent?

In spite of the sometimes quarrels and public warnings, an agreement is not far off in terms of substance. The concern over the "no deal" scenario should even promote a willingness to compromise on both sides. Perhaps that is precisely why this horror scenario is increasingly the subject of discussion. An exit from the EU without an agreement will undoubtedly have negative economic consequences. Their magnitude depends on the extent to which both parties make arrangements for this case and continue to cooperate in some form after a failed agreement. In addition to the expected short-term negative consequences – whether slight or massive – the British economy would also suffer in the long term from the lack of market access (for more information on the "no deal" scenario, see the grey-shaded box).

Repercussions of the “No Deal” scenario

If, contrary to expectations, no agreement is reached because of failed negotiations or failed ratification, we would be in the "no deal" scenario. When it comes to the negotiations, the principle is: nothing has been agreed until everything has been agreed, and that also includes the agreed-upon transition phase until the end of 2020.

Trade in goods between the UK and the EU will then follow WTO rules. Accordingly, import tariffs apply on both sides – on average in the mid single-digit range, if the WTO even has rules for the products in question. Non-tariff barriers are more important than tariff rates. This means that if the standards for certain products are no longer recognized, the corresponding import ceases. Without an additional agreement, for example, chemical products from the UK would no longer comply with the European Chemicals Directive and they could no longer be exported to the EU. The withdrawal from the European Medicines Agency that went along with the Brexit meant that drugs approved in the UK did not receive approval for the EU. Non-tariff barriers thus automatically take effect in some sectors.

Trade in goods is likely to suffer above all for practical reasons. The introduction of customs duties and thus controls at British and EU borders makes trade more difficult. Although preparations have begun, there will presumably be a lack of personnel and space on both sides, especially in the initial phase, so that considerable delays are to be expected. Overall, the higher costs of processing and customs duties will have a noticeable impact on foreign trade, especially the more complex the supply chains are. Bottlenecks in individual products are possible, which in turn can lead to production downtimes.

Also, without a new agreement there will be restrictions on air traffic between Britain and the EU. This means that British airlines will no longer be allowed to fly into the EU, and EU airlines will no longer be allowed to fly abroad from the UK. The British should be able to make up with their own safety system for the withdrawal from the nuclear power plant monitoring regime (EURATOM) that went along with the Brexit.

British banks will instantly lose direct access to the single market, as the planned transition periods will no longer apply. EU banks in the UK will probably not suffer any major restrictions out of concern for London’s status as a financial centre – at least during a transitional phase of up to three years. Legal uncertainties regarding financial derivatives concluded before the referendum in the UK cannot be ruled out.

There are transitional arrangements for residency and work permits for EU nationals living in the UK, so this issue should not pose a problem in the short term. In the longer term, these rules could be changed again. The rules are less clear for Britons living in the EU.

Many of the effects mentioned are short-term in nature. Problems at border controls can be reduced considerably over time, in extreme cases the British simply wave the trucks through at the border. Regulatory issues should be resolved at least in some areas out of mutual interest – at least with transitional solutions -–such as in air transport, for example. The consequences of a "no deal" scenario depend not least on whether the EU and the UK cooperate at a minimum level or seek confrontation.

In the short term, the British economy is likely to suffer massively under the "no deal" scenario; the economy would shrink temporarily. If, after some time, the British and the EU cooperate or reduce organisational problems, growth should recover by the end of 2019. The pound sterling is under pressure. After briefly overshooting, the euro-pound exchange rate should level off at parity. Inflation is likely to jump due to tariffs, temporary product bottlenecks, and currency devaluation. The Bank of England will nevertheless ease its monetary policy. Higher risk premiums on British government bonds could temporarily overcompensate for the interest rate cut. A confrontation course between the UK and the EU would result in a longer and deeper recession in the UK. The depreciation of the pound would be more massive, government bond yields would rise sharply.

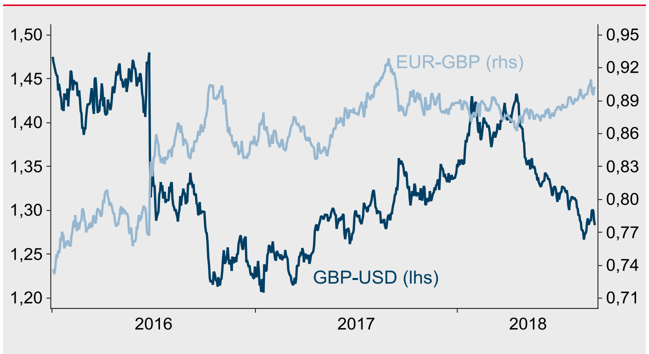
Regardless of short-term policy, longer-term effects cannot be prevented in the "no deal" scenario. The lack of access to the EU internal market will encourage both British and foreign companies to relocate their production to the continent in order to avoid customs duties, border formalities, and other trade barriers. Investment in the UK should expand much more slowly over a longer period of time. Beyond the short-term economic effects, such a scenario will weigh on the British growth path for years to come.

Compromise continues to be the most likely scenario

In the end, the negotiations depend not only on the substance, but also on whether there is a great interest in failure. On the British side, a soft Brexit would be the simpler solution should it come to that: the Brexit hardliners prefer it to no exit from the EU, the Brexit opponents to a "no deal" scenario. Even the EU has a great interest in the current difficult international environment not to be burdened by a chaos Brexit – despite certain political dissonances within the Union. In the coming weeks and months, the British and the EU could argue even more fiercely in the classic Brussels manner and the talks could already be considered a failure. In the end, however, pragmatism should prevail and, in our view, the negotiation should lead to a compromise solution within the framework of the British proposal, even if there are still risks in the ratification process.

Pound weakening against euro and US dollar

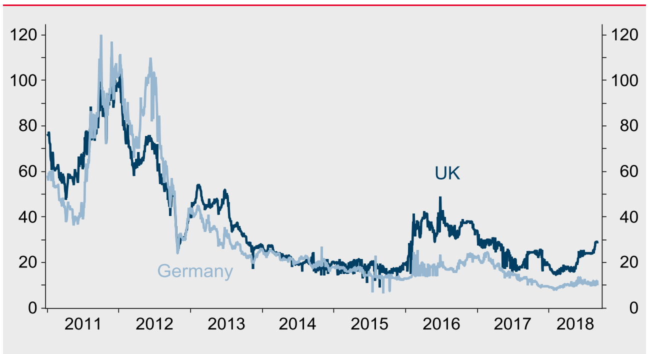
USD GBP



Sources: Macrobond, Helaba Research

Slightly higher credit default premiums for the UK

CDS (Credit Default Swaps, 5 y.) in basis points



Sources: Macrobond, Helaba Research

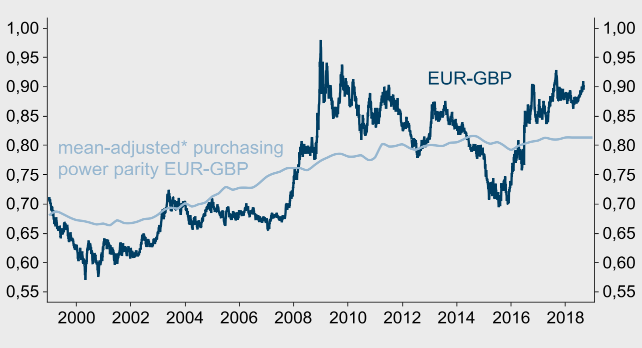
Pound recovery in case of a deal

Pound fundamentally cheap

The British pound moves with the ups and downs of the Brexit talks. The "ticking clock" increased overall concerns, and the pound lost ground against the euro and the US dollar. The euro-pound exchange rate is quoted around 0.90. A further depreciation of the pound cannot be ruled out in the short term in this nervous market environment. Overall, a risk premium weighs on the British currency. In purely fundamental terms, the pound should be stronger. In the long term, the pound is undervalued against the euro and the US dollar, as the adjusted purchasing power parities suggest. The pound's increasing interest rate advantage against the euro points in a similar direction. The Bank of England raised its key interest rate to 0.75 %, while the ECB postponed its interest rate turnaround to the second half of 2019. However, the yield differences are currently somewhat distorted, as the risk premium on British government bonds have risen slightly due to Brexit concerns – this is indicated by the credit default premiums.

Pound sterling undervalued

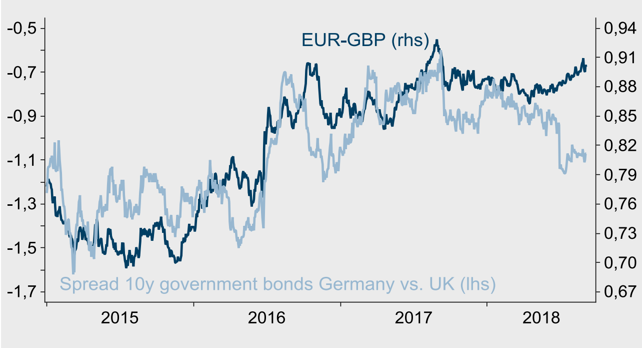
GBP



* PPP adjusted for the mean deviation of 10.6 %;;
Sources: Macrobond, Helaba Research

Pound with clear yield advantage

% points GBP



Sources: Macrobond, Helaba Research

Pound sterling will benefit from compromise

In view of the uncertainties, the Bank of England will presumably exercise caution until mid-2019 and not raise interest rates. Although inflation is elevated at 2.5 %, it is already past its peak. Growth lost momentum due to uncertainties. However, there are no signs of a significant downward dynamic. Growth is expected to be 1.3 % this year and – assuming a deal – only marginally lower in 2019. Under the latter hypothesis, the Bank of England should resume its cycle of interest rate hikes in the second half of 2019 and not act as hesitantly as the ECB – to the benefit of the pound. Above all, a Brexit agreement would reduce risk premiums and give the British currency a boost already in the final quarter of 2018. The euro-pound exchange rate is likely to fall towards 0.85, although the uncertainties resulting from ratification will continue into next year. With further easing and an additional monetary policy tailwind, further gains for the pound are possible in the course of 2019. The pound will then also gain against the US dollar. The dollar-pound exchange rate should climb from just under 1.30 recently to 1.35 initially and then over 1.40 by mid-2019.

Helaba Currency Forecasts

	Performance year to date	1 month	current*	Forecast horizon at end ... Q3/2018	Q4/2018	Q1/2019	Q2/2019
vs. Euro	(vs. Euro, %)						
US dollar	3,7	-0,2	1,16	1,15	1,15	1,20	1,20
Japanese yen	4,8	-0,2	129	125	123	125	125
British pound	-1,4	-0,9	0,90	0,90	0,85	0,85	0,85
Swiss franc	3,7	2,1	1,13	1,17	1,15	1,15	1,15
Canadian dollar	-1,2	-1,6	1,53	1,47	1,47	1,51	1,51
Australian dollar	-4,7	-3,0	1,61	1,47	1,47	1,50	1,50
Swedish krona	-6,6	-1,9	10,52	9,90	9,70	9,50	9,40
Norwegian krone	1,3	-1,9	9,72	8,90	8,80	8,80	8,80
Chinese yuan	-1,3	0,3	7,91	7,88	7,94	8,22	8,16
vs. US-Dollar	(vs. USD, %)						
Japanese yen	1,1	0,0	111	109	107	104	104
Swiss franc	0,0	2,3	0,97	1,02	1,00	0,96	0,96
Canadian dollar	-4,7	-1,4	1,32	1,28	1,28	1,26	1,26
Swedish krona	-9,9	-1,6	9,09	8,61	8,43	7,92	7,83
Norwegian krone	-2,2	-1,6	8,39	7,74	7,65	7,33	7,33
Chinese yuan	-4,9	0,1	6,84	6,85	6,90	6,85	6,80
US-Dollar vs. ...	(vs. USD, %)						
British pound	-4,9	-0,7	1,29	1,28	1,35	1,41	1,41
Australian dollar	-8,1	-2,8	0,72	0,78	0,78	0,80	0,80

*04.09.2018

Sources: Bloomberg, Helaba Research ■