FX FOCUS

27 January 2020

British pound / Brexit

AUTHOR
Christian Apelt, CFA
phone: +49 69/91 32-47 26
research@helaba.de

EDITOR:
Claudia Windt

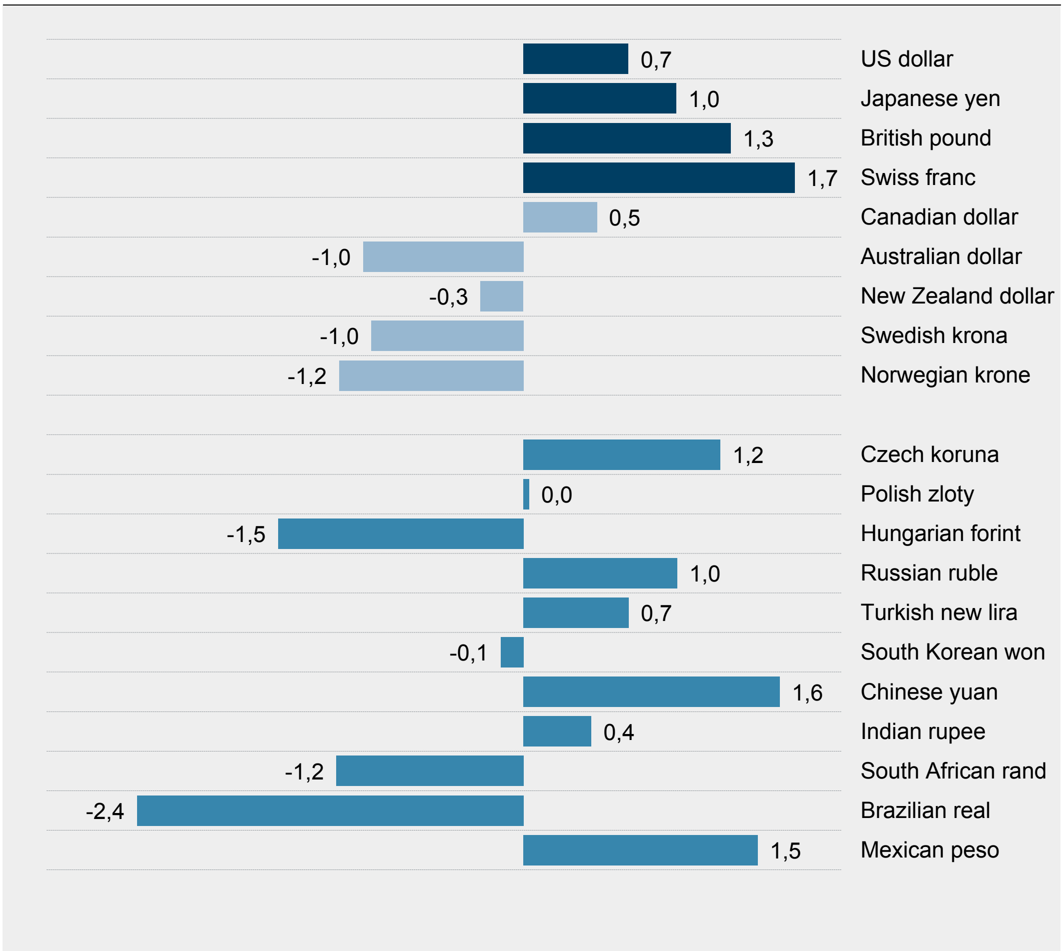
PUBLISHER:
Dr. Gertrud R. Traud
Chief Economist/
Head of Research

Helaba
Landesbank
Hessen-Thüringen
MAIN TOWER
Neue Mainzer Str. 52-58
60311 Frankfurt am Main
phone: +49 69/91 32-20 24
fax: +49 69/91 32-22 44

- Brexit is finally around the corner, but this has hardly moved the British pound lately. Following the successful exit agreement, negotiations on the future relationship are now on the agenda. Despite what is only a short transition phase until the end of 2020, a free trade agreement is realistic, although this will not resolve all issues. The pound should appreciate again against the euro only during the course of the year, if the negotiations over the future relationship go well or the British economy shows more dynamism.
- The British pound appreciated on a month-over-month basis. The Swiss franc was likewise among the winners, as was the Chinese yuan. The Scandinavian currencies and the Australian dollar weakened.
- Helaba Currency Forecasts

Performance on a month-over-month basis

% vs. euro compared to the previous month (from 12/26/19 to 01/24/20)



■ Core currencies ■ Rest of G10 ■ Currencies of emerging markets

Sources: Bloomberg, Helaba Research

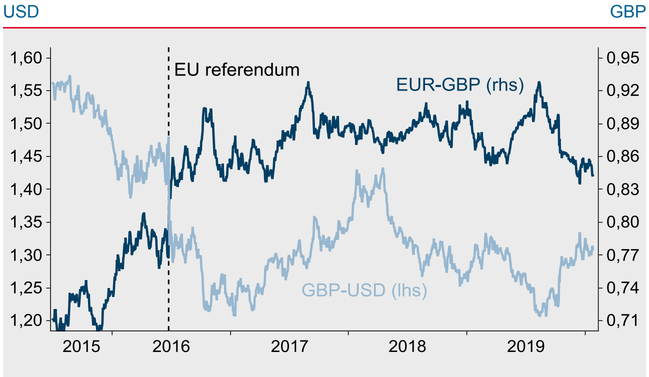
GBP: Finally, Brexit!

The Brexit is coming! The public is hardly interested in it anymore; instead, "Megxit" – the withdrawal of Prince Harry and his wife Meghan from their royal duties – is dominating the headlines. Despite all the gloomy predictions, the United Kingdom will leave the EU on 31 January in an orderly fashion – the approval of the EU Parliament, which is still required, is likely to be a mere formality. After three extensions of the deadline, some drama at EU summits and, above all, in the British House of Commons, the Brexit legislation has been finally adopted. Thanks to the clear election victory of the Conservatives, approval in Parliament was almost problem-free. The British pound no longer responded to it.

After the deal is before the deal

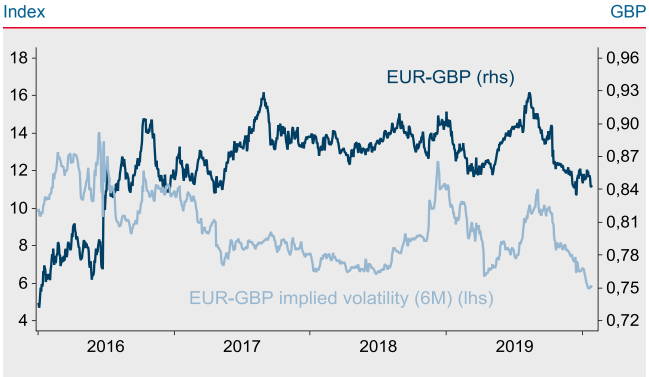
After the official EU withdrawal at the end of January, the transition phase will begin, which is initially scheduled to last until December 31, 2020. During this period very little will change de facto in the relationship between the British and the EU. The transition phase can be extended for up to two years, but the British government would have to apply for this by July 1, 2020. However, the government has ruled out an extension of the deadline not only verbally, but also legislatively. The future relationship is to be negotiated during the tight time frame of this transition phase. Thus, what is true of "Phase I" of the US-China trade agreement is also true of Brexit: after the deal is before the deal! If, on the other hand, neither an extension of the deadline nor an agreement is reached, there is the threat of another abrupt introduction of border controls on January 1, 2021, with corresponding economic consequences.

Calm after the storm for the pound sterling



Sources: Macrobond, Helaba Research

Pound fears are gone, volatility has declined



Sources: Macrobond, Helaba Research

Exit agreement clarifies a number of issues

At least the withdrawal agreement does regulate citizenship rights, financial obligations, the Northern Ireland issue, and certain transitional problems, so that the "chaos" at the end of the year would probably not be on the same scale as it would be in case of an unregulated Brexit. Thus, the treaty clarifies the rights of citizens living there, of employees and self-employed persons in the United Kingdom or the EU. When it comes to foreign trade, the change will be determined by the transition phase to the future relationship, as is also the case with how intellectual property and public contracts are handled. Important are the financial provisions, which list Britain's financial obligations. For example, the country must pay its contributions to the EU budget and to EU programmes for 2019 and 2020. It assumes a proportionate liability for outstanding commitments, pensions, etc. But at least the United Kingdom – that is, the Bank of England – will receive back the capital it paid into the ECB (!) and the European Investment Bank. According to British estimates (OBR), the net payments thus amount to around 36 billion euros. Incidentally, this is less than originally estimated, since the British have been paying into the EU funds regularly for a longer period of time due to the drawn-out Brexit process.

Northern Ireland

The border between Ireland and Northern Ireland played a decisive role in the negotiations. Different from the originally planned "backstop" clause, the additional protocol now contains a solution that could in principle be permanent. This border remains open for the time being, regardless of how the United Kingdom regulates its future relationship with the EU. Northern Ireland will remain part of the United Kingdom's customs territory, but will also comply with a limited number of EU single market rules. In other words, goods from Great Britain destined only for Northern Ireland will remain duty free. In contrast, goods originating from Great Britain or a third country and imported into the EU via Northern Ireland must be cleared through customs. In a sense, the control then takes place on the Irish Sea instead of at the Northern Irish border. This gives Northern Ireland a special status, which Unionists in Northern Ireland complain about, but which could pay off economically. It remains to be seen how practicable this solution will be in the long term or to what extent it will be abused. Incidentally, the Northern Ireland Parliament can dissolve this special status if a sufficient majority so decides.

Free trade agreement instead of single market

The upcoming negotiations on the future relationship will focus primarily on foreign trade, i.e. how the exchange of goods and services will take place after the transition period. According to the political declaration on the future relationship, both parties want to develop an "ambitious, comprehensive and balanced economic partnership" under "fair competitive conditions". The Conservative government rejects both Britain's participation in the EU single market – so that the free movement of workers can be restricted – and membership in the customs union – so that Britain can conclude its own trade agreements with third countries. Instead, Prime Minister Johnson is seeking a free trade agreement with the EU, and thus a rather looser tie with the Union. A free trade agreement differs generally from the single market: customs procedures and controls are basically provided for. The regulatory guidelines are not harmonised, but those of the receiving country apply. Regulatory cooperation takes place on a voluntary basis.

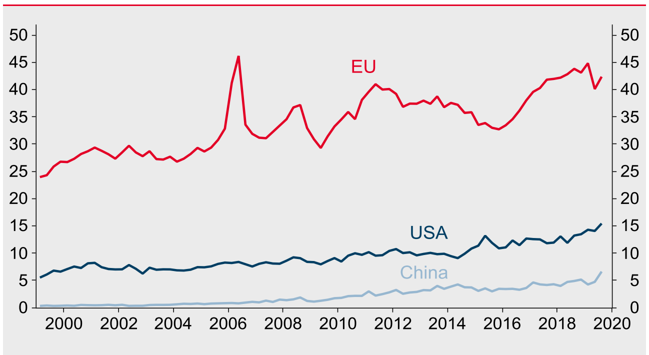
EU is the dominant export destination for the British

%, EU share of British exports

Sources: Macrobond, Helaba Research

USA no replacement for the EU as export target

Billion GBP (quarterly values), British exports of goods



Sources: Macrobond, Helaba Research

Extensive customs controls as a burden

According to the political declaration, customs duties or quantitative restrictions should be avoided. However, customs procedures and controls may be necessary to protect the "integrity of the markets". In principle, such customs controls and regulatory aspects should be facilitated as much as possible. British Chancellor of the Exchequer Javid recently said that there would be no alignment with EU regulations. The further Britain moves away from the EU, the higher the economic costs will be. British industry, in particular, is likely to face greater problems in this case. Even if the movement of goods were to remain duty-free, extensive border controls could disrupt supply chains, which would damage Britain as a production location. Differences in product standards or approval rules increase costs, especially for British companies, since the EU market is generally more important to them than the British market is to EU companies. Many industrial sectors in the UK are unlikely to gain much from divergent regulation, as exports outside the EU would hardly compensate for the losses – not even an agreement with Donald Trump and the US. As a result, industry is likely to put pressure on policymakers not to move too far away from the EU. Otherwise, the UK as a production location is likely to suffer in the long term.

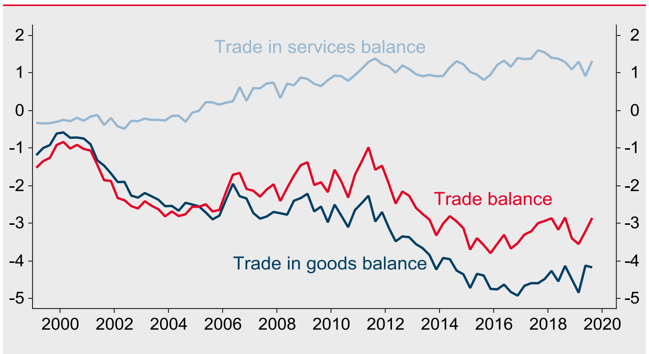
"Level Playing Field"

More general aspects will also be of enormous importance in the negotiations. For example, the EU warns against "dumping" and insists on a level playing field. This is about social standards, environmental protection, taxes, state aid, and competition law. Although even in the EU uniform guidelines do not apply in all fields, in some cases there are minimum requirements. The issue of environmental and climate protection is not generally a major source of conflict at present, as the British are more advanced than many EU countries in terms of climate targets. As far as workers' rights are concerned, a Conservative British government in particular could impose restrictions. It is also arguing for tax cuts. However, a reduction in corporate taxes has recently been postponed. Since the British government also has to finance itself somehow, there are ultimately limits to tax competition. Moreover, European standardisation is still pending in this area anyway. State aid for companies should actually be taboo for Margaret Thatcher's political heirs. As the governments´ support for the British airline Flybe shows, this may well become a sensitive point in the negotiations. The same applies to the awarding of public contracts. The agricultural sector is fundamentally difficult in the EU. Fishing rights are also complicated; here, for once, the British have the upper hand, as the EU – especially French fishermen – is pushing for market access to British waters.

However, the bilateral balances of trade offer hope for compromise. In trade in goods, the EU has a significant surplus over the United Kingdom, so that here too is great interest in reaching an agreement. The British government should quickly be able to agree on largely duty-free trade with the EU in goods. Exceptions could be individual, mainly agricultural products. However, product and regulatory standards are becoming more complicated. Contrary to some statements, the British have little to gain by moving too far away from the EU. The closer the British orient themselves to EU standards, the more customs controls can be facilitated. In the current political environment, Johnson will not be able to afford a policy of "social clear-cutting" or massive tax cuts ("Singapore on the Thames") if he does not want to be punished in the next elections. It can hardly be avoided that British companies or exporters will then have to comply with EU rules, in which the British have no say – the Swiss are in a similar position. However, this does not rule out the possibility that the British may wish to deviate from EU rules in certain areas.

Trade deficit in goods, surplus in services

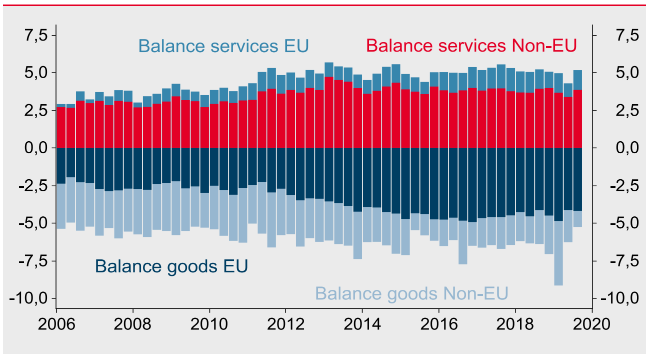
% of GDP, British foreign trade with the EU



Sources: Macrobond, Helaba Research

Surplus in services especially outside the EU

% of GDP, British foreign trade cumulatively



Sources: Macrobond, Helaba Research

Services

When it comes to services, the United Kingdom will leave the single market more clearly, especially since the EU has little interest in easy market access for the British because of its trade deficit in this area. However, the world market also plays a greater role for Britain here, and the high trade surplus with the non-EU underpins this. Financial services are the main focus. The British demand a broad principle of equivalence. British banks will lose the EU passport, but they could still do business in the EU because of the recognition of regulatory standards. The EU will probably refuse the British full equivalence. After all, it is not unlikely that the British, freed from the EU, will noticeably relax the rules for the financial sector. The willingness of the EU to compromise can only be seen in the context of the entire negotiating package. Even if the leading role of the London financial centre will not be called into question, a certain amount of financial business is likely to be shifted to the EU. This offers Frankfurt the chance of improving its position in the European financial centre competition. More than 30 foreign Brexit banks have decided in favour of the German financial centre – no other banking centre can compete with that.

Many construction sites

The general freedom of movement for workers who are EU in the United Kingdom will be restricted. However, as the British are dependent on foreign workers in certain sectors, it would not be a great sacrifice for them to allow limited quotas of EU workers into their country. Even British payments into EU funds – beyond the "divorce bill" agreed in the exit agreement – are conceivable. Cooperation in research, security policy, policing, and intelligence services also offers opportunities for a general rapprochement.

In view of the multitude of questions and problems, the period up to the end of 2020 for discussions on the future relationship is far too short. Since the Johnson administration is currently ruling out an extension of the transition period, the pressure for a negotiated solution is high. However, Boris Johnson's opinion could change – not for the first time. Although not provided for in the treaty, a later extension of the transition phase cannot be ruled out if there is political will on both sides. Currently, an end on December 31, 2020 is more likely.

Splitting up the negotiation package?

If an extensive trade agreement is not possible due to time pressure, it would have to be correspondingly thinner. The negotiating package could also be split up, which would speed up ratification and thus provide more manoeuvring room. The first part would only concern EU matters, so that approval in all states would not yet be necessary: freedom from duties and no quantity restrictions, recognition of some basic standards, level playing field provisions, fishing rights etc. In some cases, transitional solutions could also be found again. The other part would then more strongly affect the competences of the individual states and would require ratification at national level. Here, complicated regulatory aspects – especially for services – or other open questions could be addressed. This part could then take effect only at a later date.

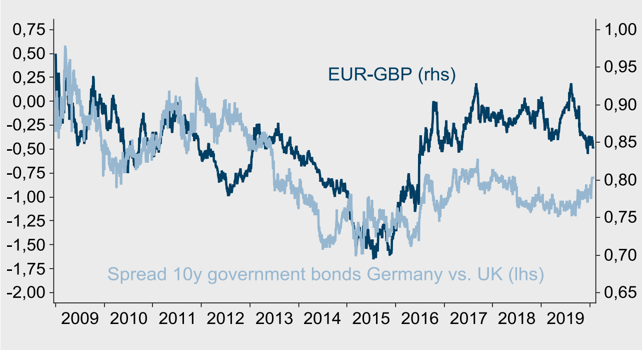
If there is no agreement at all, the "hard border" will come overnight on December 31, 2020. Compared to previous Brexit dates, however, there would be more time to prepare. If it became apparent in the negotiations that the British were to move away from the EU significantly in terms of regulation, i.e. extensive customs controls would be necessary anyway, the difference between a deal and a "no deal" would not be so large. Accordingly, companies would be better prepared. However, this does not mean that a "no deal" would not have serious economic consequences, though not a very deep recession as in the case of a "chaos Brexit".

Tranquil pound

The foreign exchange market normalised somewhat after the general elections. The election victory of the Conservatives only led to a brief euphoria. Uncertainties remain with regard to Brexit, even though the great fear of a "chaos Brexit" has disappeared. Recently, exchange rates have even been reacting more strongly to economic data. Growth was disappointing in the final quarter. In view of the volatility in the data generated by the Brexit, this should not be given too much weight, especially since the most recent sentiment indicators recovered. To be sure, British growth should be somewhat lower at 1.0 % in 2020 after presumably 1.3 % last year. However, with a gradual easing of political uncertainty and additional fiscal impulses, the economic momentum will improve over the course of the year. On the basis of weaker economic and inflation figures, speculation about interest rate cuts by the Bank of England grew, especially as individual representatives positioned themselves in this direction. But will outgoing Governor Mark Carney – his successor is the head of the Financial Conduct Authority, Andrew Bailey – do Prime Minister Johnson that favour, of whom he is not all that fond? Nevertheless, an interest rate cut to 0.5 % cannot be ruled out entirely. However, that would presumably only burden the British pound temporarily, as the British yield advantage would still be noticeable in spite of a decline.

British yield advantage declined, but still pronounced

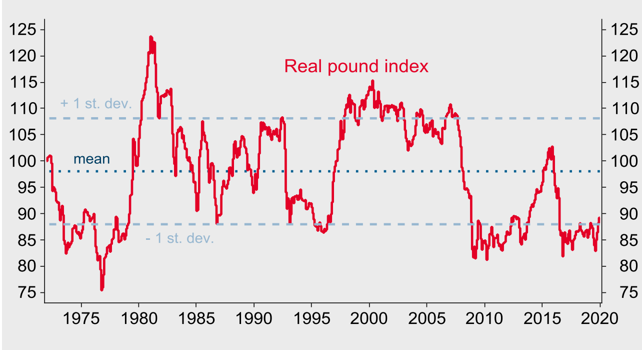
% points GBP



Sources: Macrobond, Helaba Research

Pound remains favourably valued

Real, trade-weighted exchange rate index



Sources: Macrobond, Helaba Research

Pound later with appreciation potential

Despite the recovery in the final quarter of 2019, the British pound is favourably valued from a long-term perspective. However, negotiations on the future relationship with the EU would have to go well for a further appreciation. Moreover, improved growth or the prospect of higher interest rates in 2021 could help the pound. For now, the euro-pound exchange rate should continue to fluctuate around 0.85, and only later in 2020 should fall in the direction of 0.80. By contrast, the British currency has more potential against the US dollar. The pound-dollar exchange rate could rise noticeably further and climb from most recently 1.31 to 1.40 and in the direction of 1.50. However, that also depends on whether the US overtakes the UK in terms of political chaos in 2020.

Helaba Currency Forecasts

	Performance year to date	1 month	current*	Q1/2020	Q2/2020	Q3/2020	Q4/2020
				Forecast horizon at end ...			
vs. Euro	(vs. Euro, %)						
US dollar	1,7	0,7	1,10	1,15	1,20	1,20	1,25
Japanese yen	1,1	1,0	120	122	125	125	127
British pound	0,4	1,3	0,84	0,85	0,85	0,80	0,80
Swiss franc	1,4	1,7	1,07	1,10	1,10	1,15	1,15
Canadian dollar	0,5	0,5	1,45	1,50	1,54	1,54	1,58
Australian dollar	-1,1	-1,0	1,61	1,64	1,67	1,67	1,69
Swedish krona	-0,5	-1,0	10,55	10,40	10,30	10,20	10,10
Norwegian krone	-1,3	-1,2	9,97	9,90	9,70	9,60	9,50
Chinese yuan	2,3	1,6	7,64	8,05	8,28	8,28	8,50
vs. US-Dollar	(vs. USD, %)						
Japanese yen	-0,6	0,3	109	106	104	104	102
Swiss franc	-0,5	1,0	0,97	0,96	0,92	0,96	0,92
Canadian dollar	-1,2	-0,2	1,31	1,30	1,28	1,28	1,26
Swedish krona	-2,1	-1,6	9,57	9,04	8,58	8,50	8,08
Norwegian krone	-2,9	-1,8	9,05	8,61	8,08	8,00	7,60
Chinese yuan	0,8	1,2	6,91	7,00	6,90	6,90	6,80
US-Dollar vs. ...	(vs. USD, %)						
British pound	-1,4	0,6	1,31	1,35	1,41	1,50	1,56
Australian dollar	-2,7	-1,6	0,68	0,70	0,72	0,72	0,74

*24.01.2020

Sources: Bloomberg, Helaba Research ■