FX FOCUS

4 April 2018

British pound

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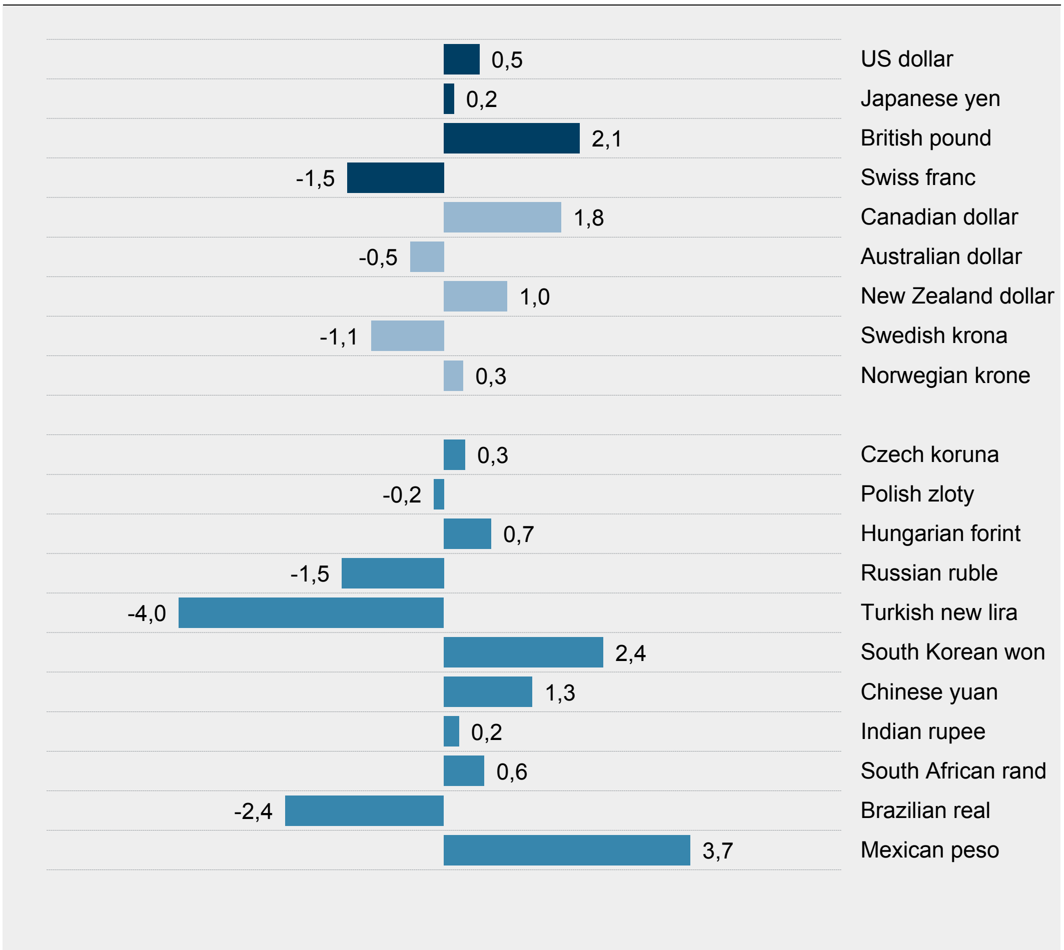
- Among the industrialized currencies, the British pound recently appreciated the most. In the emerging markets, the Turkish lira, especially, lost ground, while the Mexican peso advanced robustly.
- The pound sterling continues to be shaped by political developments. Progress in the Brexit negotiations as well as the imminent interest rate hike by the Bank of England helped the currency. In spite of the most recent results, however, problems in the negotiations are predetermined, and the pound is thus threatened with temporary setbacks. But in the final analysis, the Brexit negotiations are heading for a compromise. The euro-pound exchange rate should continue to fluctuate within the range of 0.85 to 0.90 for the rest of the year.
- Helaba Currency Forecasts

Performance on a month-over-month basis

% vs. euro compared to the previous month (from 03/05 to 04/03/18)



Sources: Bloomberg, Helaba Research

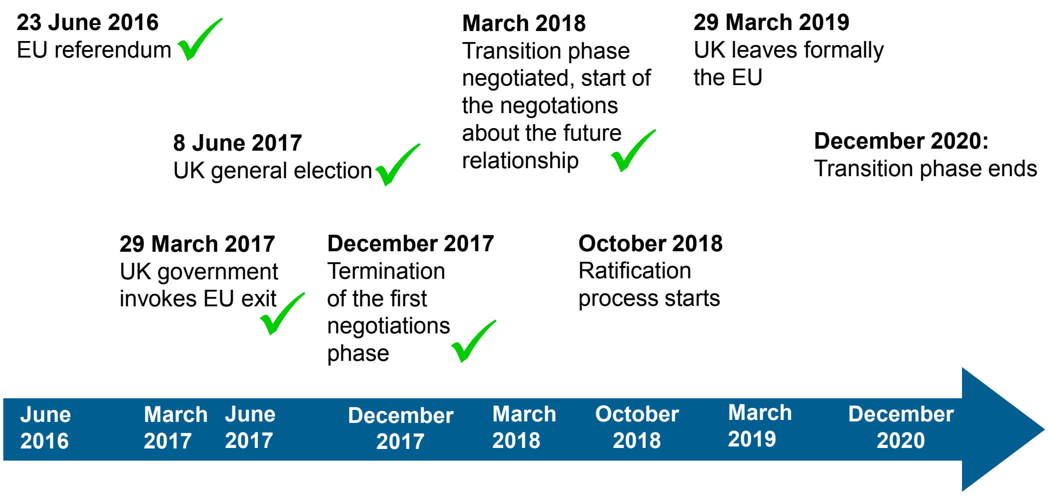
GBP: Brexit progress

The Brexit talks have taken the next hurdle. The United Kingdom and the EU have agreed on a transition phase that will follow the exit and last until the end of 2020, that is, more than a year and three quarters. With that, negotiations about the future relationship can now get under way and the exit agreement can be finalized. However, the latter is the prerequisite for the transitional phase taking effect. After all, according to Barnier, the EC's chief negotiator: "Nothing is agreed upon until everything is agreed upon". The British pound responded with a small leap of joy. Still, the euro-pound exchange rate continues to trade in the middle of the band of 0.85 to 0.90.

Transition phase agreed on

The transition phase is to begin after the official exit from the EU at the end of March 2019. Since considerable regulatory changes will presumably go along with the Brexit, an adjustment period is sensible for both sides. In fact, the British had hoped for an even longer transition. However, among other things, the multi-year financial framework of the EU, which ends in 2020, argued against that. During this phase, the same rules as before will largely continue in force. This concerns above all trade and citizenship rights. The restrictions on the free movement of labour or concerning fishing rights, which were favoured by some Brexit supporters, were not agreed on. With that, the United Kingdom will remain a quasi member of the Union until 2020 in spite of the formal exit from the EU. However, the country cannot be compelled to adopt newly enacted EU rules during the transition period. Moreover, the British will be given the right, important to them, to negotiate and enter into free trade agreements with third parties. As it is, the British will have to renew about 40 international trade agreements, which so far have been in force within the framework of their EU membership. Additional free trade agreements with the US or other large countries will be difficult for the reason alone that there are limited administrative capacities. All in all, the British were willing to compromise when further progress in negotiations was necessary – as also happened last December.

Brexit schedule



Sources: Helaba Research

Treaty blueprint exists

A 129-page treaty blueprint about the exit agreement exists. According to the colour coding, there is agreement between the British and the EU on around 75 % of the text. As already announced at the EU summit in December, there is largely agreement when it comes to citizenship rights and financial obligations. However, still unresolved points of contention concern especially the border between Ireland and Northern Ireland and the role of the European Court of Justice.

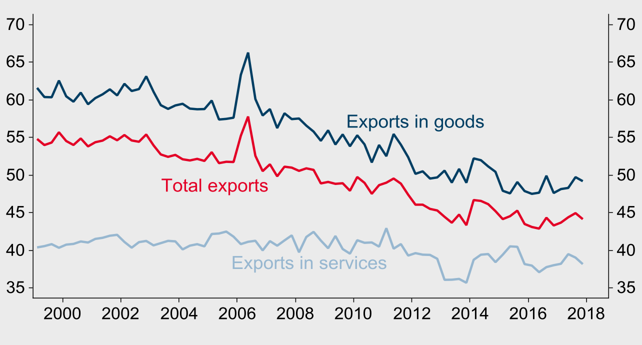
Beyond these last-mentioned issues, there seems to be substantial agreement, which means that it is only a question of time until the final Brexit agreement is in place. The exit agreement is to be finalized by October 2018 and ratified in the following months by the EU and the British. Then – and only then, once the exit agreement has been ratified – the transition phase would go into effect. During this period, the future relationship of the British to the EU could still be negotiated. However, all of this will not happen so easily. For the British, the exit treaty is a rather irksome obligation. More important to them is the future relationship to the EU. Negotiations about this issue are set to begin shortly. The time frame for a comprehensive trade agreement is clearly seen as too short for it to be concluded by the fall of 2018. However, the UK will hardly agree to an exit treaty as long as there are not at least basic agreements about the future relationship. The details could be still hammered out during the transition period. As it is, in formal terms a trade agreement between the UK and the EU can be logically agreed upon only one second after the Brexit, since the EU is allowed to conclude trade agreements only with non-members. Without a decisive convergence about the future relationship, all agreements in the exit treaty or during the transition period would be null and void. Apart from this, the ratification process also carries with it substantial risks.

Future relationship

The British government continues to pursue an exit not only from the European domestic market, but also from the customs union. By contrast, Jeremy Corbyn, the leader of the opposition Labour Party, favours remaining within the customs union. The government wants an extensive free trade agreement with the EU, one that also encompasses services, if possible. However, unlike in the Single European Market, the free movement of labour is to be restricted. But the willingness of the EU to include services – especially financial services – is quite limited. The British financial industry will presumably need subsidiaries for business in the EU. Moreover, the EU will set the rules in this regard – in the future without a British veto right. When it comes to the trade in goods, the mutual advantages argue for an easier agreement. After all, the EU takes in nearly half of all British exports. Conversely, the EU generates a massive trade surplus with the UK. Still, the EU is likely to demand further concessions from the British in return for market access, such as at least a limited freedom of movement for labour.

EU takes half of all British goods

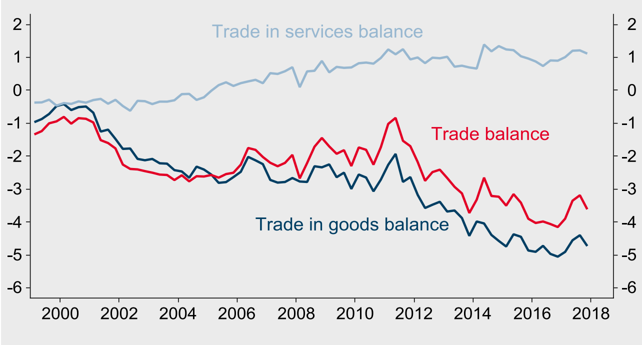
EU share in % of British exports



Sources: Macrobond, Helaba Research

British trade deficit with the EU

Share in % of British GDP



Sources: Macrobond, Helaba Research

Deal likely

There are thus still plenty of contentious issues in the negotiations. And the typical Brussel dramaturgy almost requires that the talks are at times close to collapsing. If that happens, concerns would also increase temporarily within the financial markets. The time table could be delayed. However, in the final analysis the British have so far always shown themselves very willing to compromise. This will presumably hold true also when it comes to the final agreement or the future relationship. Contrary to what Prime Minister May has stated, the Brexit hardliners in the UK should prefer a bad deal to no deal or no Brexit at all. The current tough negotiation by the EU commission will presumably be reined in by the separate interests of the large countries. We therefore continue to posit a compromise similar to what we have sketched out above. Still, problems are foreseeable when it comes to customs processing or other regulations, though they should become problematic only after the transition phase.

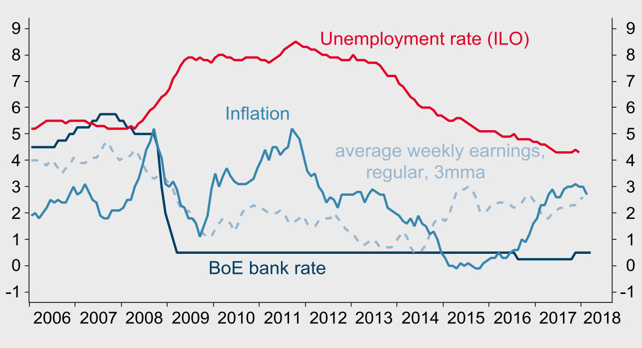
So far the Brexit has had hardly any economic effects. The pound depreciation and the loss of purchasing power did dampen private consumer spending. However, business investment in 2017 grew at a surprisingly strong rate of around 4 %, thus GDP expanded by 1.8 % in 2017. However, as the Brexit draws closer, it is possible that the uncertainties that come with it could hamper the willingness to invest. Certain signs of weakness can already be seen in the housing market. As a result, the British economy should grow in 2018 by only 1.3 % and thus noticeably slower than in the euro zone (2.0 %).

Likely only one interest rate hike in 2018

Given the rather robust economy to date, the Bank of England is no longer pursing quite such an expansionary monetary policy. After all, inflation is clearly above the target of 2.0 %. Still, at most recently 2.7 %, inflation has passed its peak. The inflationary effects of the pound depreciation will show up less and less. The labour market is probably a greater concern to the central bank. In the face of the low unemployment rate of 4.3 %, wage growth is still at a moderate level, though it accelerated most recently. Because of its latest rhetoric and two votes in favour, signs are pointing to an interest rate hike by the Bank of England in May. Since growth is likely to lose impetus as the year progresses and inflation should go into reverse, the central bank is likely to limit itself to one move on interest rates this year.

Bank of England about to raise interest rates

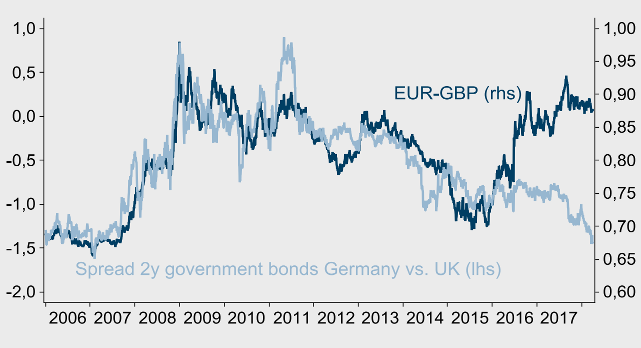
%, % yoy



Sources: Macrobond, Helaba Research

Yield advantage hardly helping pound sterling

% points GBP



Sources: Macrobond, Helaba Research

Euro-pound rate continues in sideways band

Thanks to the prospects of higher key rates, the pound has expanded its advantage over the euro noticeably on shorter maturities and somewhat on longer ones. However, the effect on the exchange rate was limited, and the euro-pound rate dropped slightly to 0.87. Since the Brexit vote, the interest rate differences have lost influence. They are clearly being trumped by the political development; a kind of risk premium is weighing on the pound. Since the Brexit negotiations are continuing and will presumably run into more troubled waters at various times than was the case most recently, the pound should come under pressure again. In addition to monetary policy, the pound is also supported by a rather favourable valuation in historical terms. The euro-pound exchange rate is likely to continue moving in the range of 0.85 to 0.90 for the rest of the year, and in the process trade more at the upper or lower end of the range depending on the state of the negotiations. By contrast, the pound should weaken more noticeably against the US dollar at times, since the US central bank is moving ahead more definitively with its interest rate hikes. The pound-dollar exchange rate could temporarily slide even below 1.30.

Helaba Currency Forecasts

	Performance year to date	1 month	current*	Forecast horizon at end ... Q2/2018	Q3/2018	Q4/2018	Q1/2019
vs. Euro	(vs. Euro, %)						
US dollar	-2,2	0,5	1,23	1,15	1,15	1,20	1,20
Japanese yen	3,4	0,2	131	125	125	128	128
British pound	1,7	2,1	0,87	0,90	0,90	0,85	0,85
Swiss franc	-0,5	-1,5	1,18	1,15	1,17	1,15	1,15
Canadian dollar	-4,0	1,8	1,57	1,50	1,47	1,51	1,51
Australian dollar	-3,7	-0,5	1,60	1,49	1,47	1,50	1,50
Swedish krona	-4,6	-1,1	10,30	9,70	9,50	9,20	9,00
Norwegian krone	2,3	0,3	9,62	9,00	8,90	8,80	8,80
Chinese yuan	1,1	1,3	7,72	7,48	7,48	7,68	7,68
vs. US-Dollar	(vs. USD, %)						
Japanese yen	5,7	-0,4	107	109	109	107	107
Swiss franc	1,6	-2,0	0,96	1,00	1,02	0,96	0,96
Canadian dollar	-1,8	1,2	1,28	1,30	1,28	1,26	1,26
Swedish krona	-2,5	-1,6	8,40	8,43	8,26	7,67	7,50
Norwegian krone	4,7	-0,2	7,84	7,83	7,74	7,33	7,33
Chinese yuan	3,4	0,9	6,29	6,50	6,50	6,40	6,40
US-Dollar vs. ...	(vs. USD, %)						
British pound	4,0	1,5	1,41	1,28	1,28	1,41	1,41
Australian dollar	-1,6	-1,0	0,77	0,77	0,78	0,80	0,80

*03.04.2018

Sources: Bloomberg, Helaba Research ■