Northern Trust

WEEKLY ECONOMIC COMMENTARY

October 21, 2016

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- **Breaking Up Is Hard to Do**
- **Brussels Will Play Hardball With the U.K.**
- **Concerns Over Currency Manipulation Have Faded**

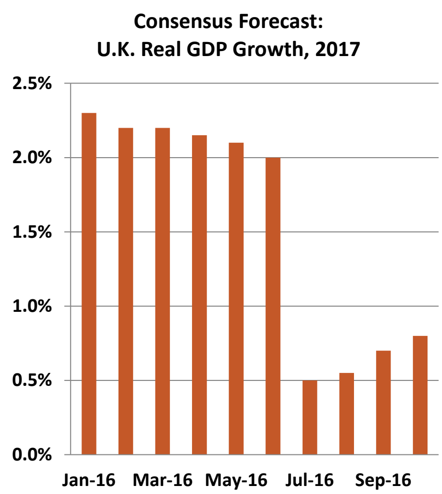
Parting is such sweet sorrow,
That I shall say good night till it be morrow.

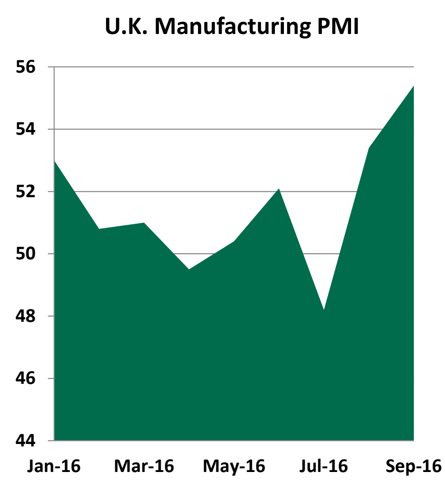
-- Romeo and Juliet

Shakespeare was certainly not naïve to the challenges of governance. He wrote extensively and elegantly about managing alliances in many of his plays. But even the Bard would struggle to find words to describe the impending separation of his United Kingdom from the European Union (EU). The parting is likely to be anything but sweet.

The narrow victory for the Brexit camp last June led many analysts to predict the worst. Doomsayers anticipated the British economy would fall headlong into recession as uncertainty over the country's future led businesses and consumers to pull back. Investors would find other destinations for their capital, the FTSE index would crash and London property values would return to Earth's orbit. Political knock-ons in the worst case scenario included secession by Scotland and the reunification of Ireland. The United Kingdom (not to mention the Union Jack) looked like it might require substantial redefinition.

After the initial hysteria, however, calm settled in. The less that Brexit was discussed, the more its consequences receded in the collective consciousness. Forecasts for U.K. economic growth first stabilized, and then improved. And forward-looking economic indicators provided cause for cautious optimism.





Source: Bloomberg

There was silence on the negotiating front, largely because the two sides were scurrying to formulate their positions and to appoint spokespersons. But some suspected that there was back-channel bargaining going on that would preserve the substantial commerce that exists between the U.K. and the rest of the EU. There were even those who dared hope that British leaders were quietly pursuing ways to revisit the decision to leave the EU.

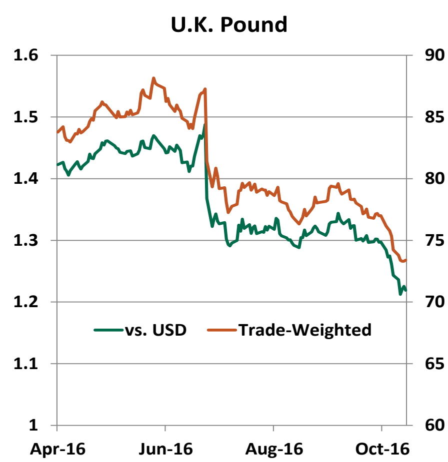
Unfortunately, reverie was replaced by reality at the U.K. Conservative Party congress earlier this month. At that meeting, Prime Minister Theresa May provided a definitive timeline for the onset of formal negotiations (the end of March) and took a somewhat defiant tone in staking out her country's position on Brexit. She promised to press for continuity of full trade relations while conceding nothing on the question of free migration and governance from Brussels. It sounded like a very hard line.

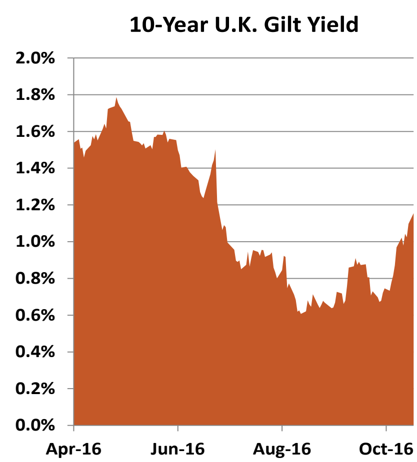
Brexit is back on the front burner.

May also took the opportunity to take a swipe at the Bank of England (BoE). BoE Governor Mark Carney was front and center in the weeks after the referendum, helping sustain confidence by preemptively announcing an interest rate reduction and a new round of quantitative easing (QE). The BoE was credited with providing much-needed stability and direction during an interval where the government had neither.

But Ms. May expressed the view that quantitative easing was a failed strategy, and promised to end it. (Apart from the efficacy of the proposal, it seemed to violate the spirit of central bank independence, which troubled some investors.) In place of QE, the Conservatives proposed to end the austerity promoted by the previous government and replace it with fiscal expansion. The new spending would be directed toward infrastructure and financed with low-cost government borrowing.

We've suggested in the past that central banks have progressed beyond the edge of their effectiveness, and should not press too much further. And many countries see promise in an infrastructure program, even amid high government debt levels. But the tone and substance of May's message proved alarming to the markets. Sterling fell close to its lowest level in 70 years, and U.K. government bond yields nearly doubled.





Source: Bloomberg

Interestingly, these developments may force the Bank of England to follow the Prime Minister's preferred course. The weak currency, combined with higher oil prices, has the potential to lead U.K. inflation past the BoE's 2% target. Mr. Carney and his colleagues may find themselves boxed in between their commitment to price stability and their desire to provide support at a time of economic uncertainty.

And that uncertainty promises to increase considerably in the coming months. Prime Minister May's strong remarks provoked an equally strong reaction from the remaining members of the EU. Germany and France have pledged that there will be no negotiations until Article 50 is invoked. They have also made clear that they are not interested in "a la carte" proposals from the U.K., which could serve as a precedent for other nations to tailor their EU memberships. If Britain is forced to choose between accepting all EU terms or none of them, the outcome might be the latter. This "hard Brexit" would be maximally damaging to the U.K. economy.

Negotiators face a gauntlet of challenging topics.

There are a multitude of streams that will be the subject of discussion, each with important complexities. Resolving issues will not be easy. If the two sides eventually reach agreement, details will be reviewed by the European Parliament and the national legislatures of all EU members. This could take time and be hindered by the same parochial obstacles that are presently challenging ratification of a free trade pact between Canada and the EU. The result could be a prolonged transition from the current state to an uncertain new one, with several steps along the way.

We continue to think that the potential economic loss to all parties from a deep separation will be sufficient grounds for compromise. The concerns expressed by Britain over borders and Brussels are shared by other EU members, so there may be a mutual willingness to re-set standards on both for the entire community.

But success is by no means assured. In the interim, there will be trouble in what Shakespeare called a "demi-paradise."

Positions Harden on the Continent

Lady Margaret Thatcher famously 'handbagged' the European Union (then known as the European Economic Community) into granting the United Kingdom a rebate on its contribution to the European budget. Her successors John Major and Tony Blair continued the posture of British exceptionalism by securing opt-outs from the EU on the common currency and the Schengen Area's border controls agreement.

But it is unlikely that current prime minister, Theresa May, will have similar luck as she presses forward with Brexit negotiations. Sentiments on the other side of the English Channel are stiffening, for political and economic reasons.

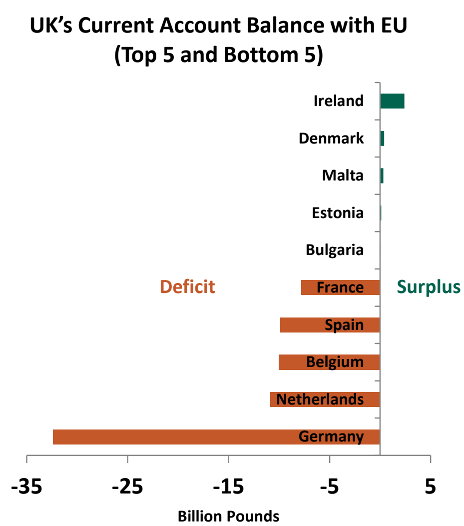
France is scheduled to hold presidential elections in April-May 2017, a month after the British government plans to trigger Article 50. Alain Juppé, the leading candidate for both the centre-right nomination and the French presidency, has promised to take a hard line on Brexit negotiation. He wants the European parliaments, and not Westminster, to set the agenda for Brexit negotiations.

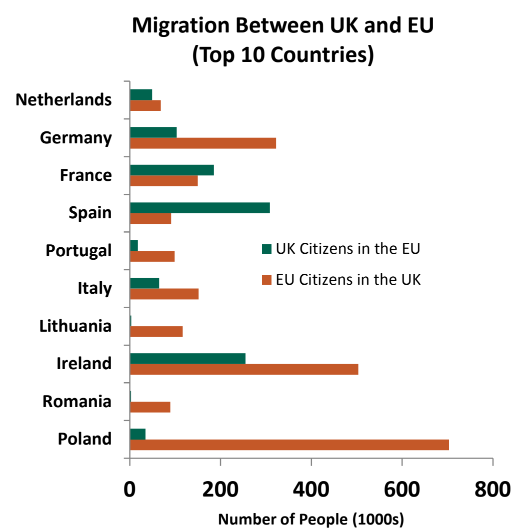
The stance taken by François Hollande — the incumbent French president and the likely socialist candidate — is also ominous. Holland has stated that "There must be threat, there must be risk, there must be a price" for Britain.

German elections are slated for late autumn next year and leaders of the major parties are also taking a dim view of the Brexit negotiations. Leaders of the Christian Democratic Union (Chancellor Angela Merkel) and the Social Democratic Party (Sigmar Gabriel) have reiterated the importance of embracing all aspects of membership in the Union.

Economic and political considerations will deter compromise with the U.K.

On the surface, EU leaders stress their commitment to the four freedoms (goods, services, capital and people) that bind members together. But there are economic reasons why European nations might be reluctant to concede to the U.K. Firstly, even though Europe runs a trade surplus with the U.K., any short term cost of losing access to the British market is outweighed by the long run economic benefits of preserving the single market for European businesses. Secondly, manufacturing currently located in Britain can be re-shored to cheaper locales on the continent post-Brexit. Finally, Paris, Frankfurt, Luxembourg and Dublin are competing to take over the role of Europe's financial capital from London.





Sources: Office of National Statistics, United Nations

To be sure, the positions of French and German leaders are also designed to defuse the populism that is sweeping across Europe. If Britain is allowed to pick and choose elements of the membership, it would certainly embolden factions in other EU countries to press for more sovereignty over borders and policies. A demonstrable success of Brexit would embolden anti-EU political parties like the Front National in France and the Alternative for Germany that threaten centrist incumbents in European capitals.

So, a hard negotiating line could be a net positive for Continental economics and politics, leaving little incentive for Brussels to compromise with Britain. Thus, in the words of Donald Tusk, the President of the European Council and former Prime Minister of Poland, the choice may come down to No Brexit or Hard Brexit.

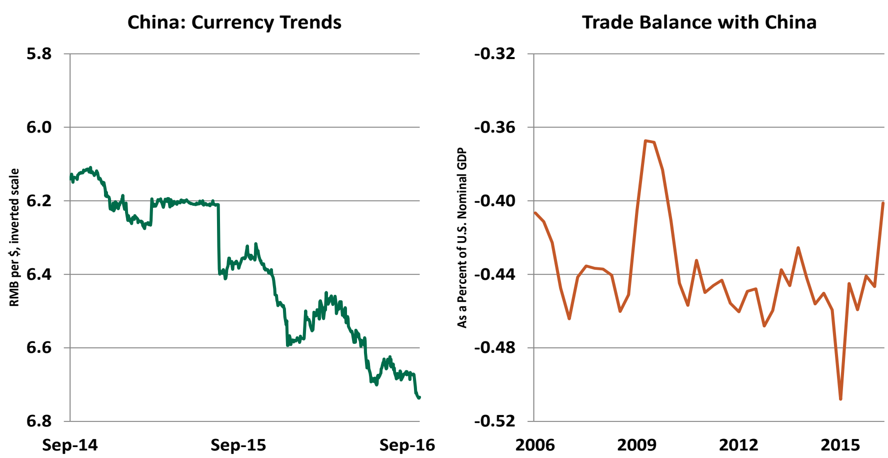
Turning Down the Temperature

Support for global trade rests critically on the expectation of a level playing field between countries. There have been persistent claims over the years from the U.S. Congress that trading partners are not playing fairly. In particular, there has long been a suspicion that Chinese authorities are keeping their currencies artificially low to increase exports.

Acting on these concerns, Congress passed the Trade Facilitation and Trade Enforcement Act of 2015. The Act calls for the Treasury Department to look for three key elements to determine whether a country is acting unfairly: a significant bilateral trade surplus with the United States, a current account surplus above 3% of GDP and persistent one-sided intervention in foreign exchange markets.

If these criteria are met, a country would then be identified as a currency manipulator. That prompts bilateral talks to remediate the issues; if these discussions fail, the U.S. president would be required to take corrective action. As noted [here,](#) Presidents can even impose tariffs by executive order, a threat which has been made on this year's campaign trail.

Concerns over currency manipulation have diminished.



Source: Haver Analytics

The U.S. Treasury's latest report, released this month, took a softened tone. It concluded that no economy satisfied all three criteria and no major trading partner was manipulating its exchange rate with the dollar. In particular, the report removed China from its watch list as it no longer meets the criteria of a currency manipulator.

The report implicitly acknowledges that the relative strength of the U.S. economy and the attraction of dollar-based assets have resulted in an appreciation of the dollar. Natural forces, not intervention, appear to be driving events. Further, the anxieties over China's trade practices have been tempered by the fact that the U.S. trade position with China has been improving.

It may also be the case that the U.S. views currency management as just one element in the complicated relationships America shares with China and other Asian nations. Cooperation on geopolitical issues may diminish the appetite to make an issue of trade policy. Whatever the motivation, a more peaceful tone on currency manipulation is very much welcome.