Economic Viewpoint

The British pound and the Brexit crisis: time to reflect

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KEY MESSAGES

- The rise of the long-term UK gilt market at a time of Brexit and wider political crisis is puzzling; the solution to the riddle most likely lies in the irrational forces fanned by inflationary monetary conditions. Read on! .
- Question: could the next Conservative PM pursue a different monetary policy path from the present Brexit-phobic and inflation-prone path? Possibly but not immediately!

European political turmoil transcends UK

No great surprise that the pound sinks when the UK Parliament vote on Brexit "deal" is cancelled, but why did long-term gilt yields fall? That is the core of market irrationality in this matter. If there is really fear of capital flight from the UK should that not drive up long-term rates – reflecting the decrease in attractiveness of UK assets and the greater difficulty of the UK in attracting global savings?

Market apologists explain it all in terms of the UK monetary stance – the BoE governor has indicated clearly the view that "no deal" means UK economic slowdown and in fact recession, and so rates under BoE control would fall; and the long-term interest rate market in the UK has like all other European fixed-rate markets (and Japanese) become highly manipulated by the central bank (in this case the BoE). Of course that power to manipulate is based on an emperor's new clothes myth, but long may that myth continue.

Consumers and business spenders in the UK may well turn out to be more rational than the gilt market. They realize that "no deal" does not equal "crash out". A new Conservative Prime Minister say in February, with a newly united party behind him or her could signal immediate intent to move towards a WTO-style exit, inviting a restart of trade negotiations at a later date, but meanwhile enter into a transitional arrangement with the EU for a year to 18 months. Surely with the growing budget crises in Europe and weak governments, Berlin, Paris and Brussels are not collectively about to say no to UK budget contributions from Spring next year or suffer dislocation amongst their heavy exporting firms to the UK.

At one level the Merkel counter-coup in the CDU (see EV, 10/12) may decrease the chances of EU-UK accommodation, given the Chancellor's hard line on "keeping EU together and setting examples". But the Merkel Government is now very weak and may even collapse after the EU Parliament Elections this June (the SPD could exit the coalition). And the prospect beyond that is minority CDU-led minority government facing fierce opposition from the AFD on the right and the Far Left. The UK may well be able to take advantage of this situation in pressing forward with negotiations for an accommodative "No deal" outcome.

And meanwhile we should see the weakness of Sterling in a global setting where this currency is undermined by growing global financial risks. A time of falling European financial shares, growing concerns about emerging markets (especially China), is not in general good for the pound, and that is true now, Brexit or no Brexit.

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