The Global Economy – 09/16

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on the most relevant events in the global economy
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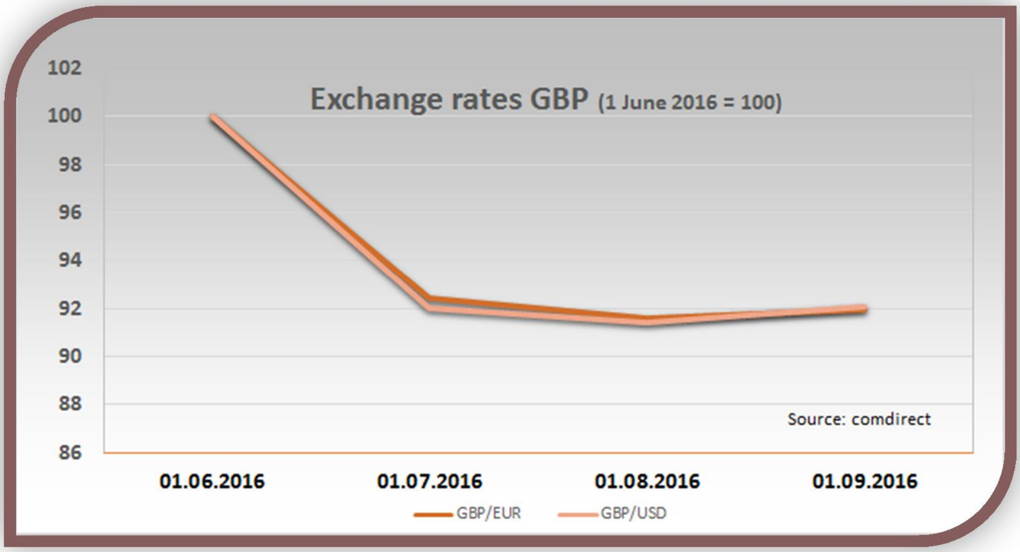
New exclusive series: Brexit as it unfolds

With this issue of "The Global Economy", we kick off a new, exclusive series for our subscribers: A running, in-depth analysis of the people and stratagems around Brexit as it unfolds.

Let's start with an overview of the people in charge of Brexit and the pending negotiations with the EU, for it will be very much these five men and women shaping what will become either a 'soft' or 'hard' Brexit (the latter option meaning the UK even to leave the European Economic Area, too).

Theresa May: The Prime Minister, outside of the Chancellor of the Exchequer, certainly is the most reluctant Brexiteer of the pack; yet she vowed "Brexit means Brexit!" on the very first day of office and, indeed, doesn't have much of a choice if she does not want to be toppled by her overwhelmingly pro-Brexit backbenchers. However, for the time being, she is carefully equivocating, signalling on the one hand not to hamper migration from the EU too much in order to preserve as much common market access as possible. Yet on the other, she has effectively dished an Australian-style points based immigration system which had been one of the battle cries of the Leave campaign – not because it might be too restrictive, but rather because she deems it not strict enough.



Philip Hammond: The Chancellor of the Exchequer is not only the most reliable ally of the Prime Minister, but certainly also the most equanimous minister at the Cabinet table. Never hiding that he was strongly in favour of Remain, he has left no doubt that he is prepared to discard his predecessor's austerity policies wholesale in order to protect Britain's economy from the impact of Brexit. His traditional Autumn Statement in October will provide the details as to how far he is prepared to use deficit spending to secure that aim. Together with Theresa May, he ought to water down the most radical Brexit policies advocated in Cabinet so that a 'soft' Brexit might be feasible at all.

Boris Johnson: Divide et impera – Theresa May has studied her classics. By dividing the fief of the pending Brexit negotiations with the EU into three different departments – two of them newly created at that – she has, on the one hand, forced the lead of the Leave campaign to help to sort the mess out he has helped to create, yet on the other she has deprived him of the power to try and manoeuvre Number 10 in a quagmire where only a 'hard' Brexit is left as an option. For now, the lion has been tamed, putting on a sheepish face instead of the familiar wolf's grin on his opening tour around Europe, and we very much expect him to keep that low profile, necessitated by diplomacy – in spite of himself.

David Davis: Somewhat the enigma among this group of Five, the newly created Secretary of State for Exiting the European Union is what you might call an unabashed Europe basher. Yet he never got into the specifics as to what exactly grates him about Europe, and, just as frustratingly, he has been continuing that lack of clarity ever since he has been promoted to Cabinet. Hence, he might pose the greatest risk towards a 'hard' Brexit: He's the man in control of the British staff in Brussels, and exactly because of his diffuse want to liberate Britain from Europe, he might insinuate unexpected policies and stratagems yet to create much trouble for the Prime Minister.

Liam Fox: The new Secretary of State for International Trade has been a leading figure in the Leave campaign, and some kind of a spokesman of the Tory right, too. However, his department will be in charge to negotiate and sort out the specifics of the disentanglement from the European Economic Area, if it comes to that – in terms of strategy, he will not be as instrumental as those mentioned above. That notwithstanding, he speculated in July that the UK might well have to leave even the European customs union, without any denial or even correction from No. 10. His most important task will be to settle the new trade deals with an array of countries having indicated an interest in keeping up unimpeded trade relations with the UK, see below.

From a more general perspective, it has become transparent that there had been no preparations for Brexit whatsoever by the Cameron government – leaving the May government in an utter want for strategy, as has been amply demonstrated by an obfuscating David Davis on his first appearance as Secretary of State in the Commons. The elephant in the room, of course, is: When will the negotiations be kicked off by triggering Article 50 of the EU treaty? Admitting to our initial expectation in early July that this would happen as soon as this month, by now we harbour no doubt that HM Government is playing for time, hoping to reach a "national consensus" (Davis) with the Scots, Welsh, and Northern Irish about the actual aims of the negotiations. However, the government must not overstretch it, when many foreign investors have warned already that they will shelve all investment if negotiations are not started soon.

The Japanese industry, among particularly important foreign investors, has sent somewhat mixed signals: Insurers' and banks' promise to stick with London is but one upside to the City. Yet on the other, manufacturers, and particularly car manufacturers at that, have made it clear that access to the common market is part and parcel to their presence in the UK. At the same time, European banks such as UBS threaten big job losses in case of a hard Brexit.

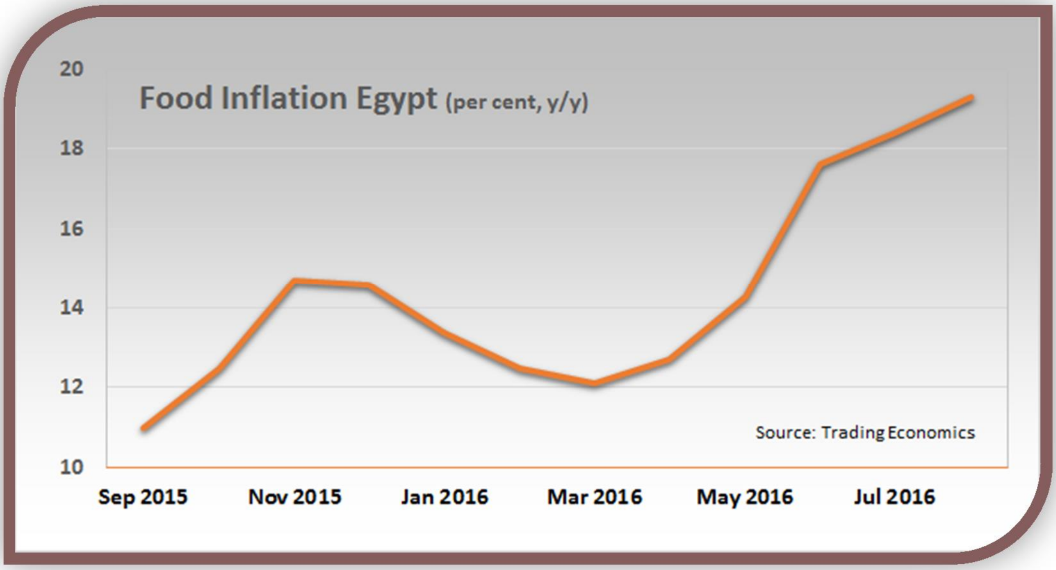
The Commonwealth, however, seems to be standing firm with Britannia. Australia's Malcolm Turnbull has promised a most extensive free trade deal with the UK once she leaves the EU; Mexico and Singapore have indicated a strong interest in trade deals, too. Britain, thus, will certainly not be isolated when Brexit is enacted – but it's going to be a hell of a piecemeal to restore the trade links she is about to forfeit with the EU's common market.

Kenyan state in flurry of business legislation as Volkswagen returns to the country – Monetary policy in Japan caught in quandary – Currency crisis in Egypt augments economic malaise

Kenya's Parliament as well as her government displayed two things in September: That they remain intent on improving governance standards just as much as they are prone to populist policies (indeed as every other democratic administration). Whereas the government has enacted laudable enforcement of the construction business's regulations when the industry has littered Nairobi in particular with insecure and unstable buildings, and has implemented mandatory interest on government agencies' invoices in arrears, the very law – likewise newly created – on which this mandatory interest rests risks a credit crunch for Kenyan small businesses. The Banking Amendment Bill 2015 stipulates that interest rates on loans must not exceed 4 percentage points above the Central Bank's base rate, and interest rates on deposits must not fall under 70 percent of that base rate, effectively shrinking banks' rate margins from as much as 13 percent to about 7 percent. Now you might think that that is still rather decent; but banks' incomes are not the problem here. The problem is about financing the private sector. The average interest rate on loans in Kenya stood at 18 per cent prior to the new legislation for a reason, and that was not (only) usury: It was the risk represented by small businesses taking those loans. By capping interest rates, it is rather likely that many of those small businesses, the backbone of the country's economic well-being, will either be driven into the hideaway dens of microlenders or even shut out from credit altogether (see section "Kenya" in the "Economic Ticker" on our website). So in the end, what certainly is not only good politics regarding elections in August 2017, but also bearing a compassionate motivation might very well turn out to be just the opposite. Incidentally, banks seem to have been starting shuffling money from their loan books into Treasury bonds and bills already. All the same, the sharpened enforcement of regulation towards the run-amok construction industry mentioned above undoubtedly is a good thing, particularly regarding this year's collapses of buildings in Nairobi, killing and maiming many people. Into the addition, just recently Kenyan authorities have signed a ground breaking 361MW energy deal within US President Obama's "Power Africa" initiative, aiming to further stabilise the country's power supply already among the more reliable on the continent. And, indeed, international investors increasingly become aware of Kenya's ever improving governance standards and investment framework; a prominent example has been Volkswagen resuming production close to Nairobi just this month which had been abandoned for four decades, thereby creating the company's third production site – the others being South Africa and Nigeria – in Africa only.

Haruhiko Kuroda really does sit between a rock and a hard place – even if he himself does not realise it. At its board meeting on September 20th, the **Bank of Japan** left her negative interest rate policy (NIRP) unchanged, just as, indeed, the volume of its bond buying programme. The market, however, was very much fearing even deeper negative rates, and indeed hoping for the abandonment of NIRP altogether, so the reaction to what is still rather impressive monetary easing was rather subdued, with the Yen ending the trading session towards the US-Dollar pretty much unchanged – certainly to the chagrin of Mr Kuroda and his colleagues. Though the Bank of Japan still feeds as much as ¥80tn a year into the economy, markets have grown accustomed to ever more quantitative easing which cannot be delivered, in spite of Mr Kuroda's assurances to the contrary. He cannot cut rates much deeper into negative territory without risking an all-out financial crisis triggered by capital-bleeding banks, insurers, and pension funds, and any additional bond buying or, as the new term reads, "yield curve control" will fail to serve their purpose: to get phlegmatic inflation expectations moving. In our opinion, by now it has become obvious that central banks have run out of options for further monetary easing, which, by definition, inevitably means relative tightening ahead – one of the reasons why the Yen didn't move that much at all. However, there's one option left, referred to in our publications often: Interestingly, no reference was made to helicopter money (distributing money directly to households and firms without the bypass of government bonds) at the BoJ's press conference. Eyeing Mr Kuroda's reputation for catching the markets off guard, he might be contemplating using the instrument to maximum surprise effect, pushing inflation expectations once and for all out of their hibernation. As we've said earlier: Expect the unexpected from Japan's monetary authorities.

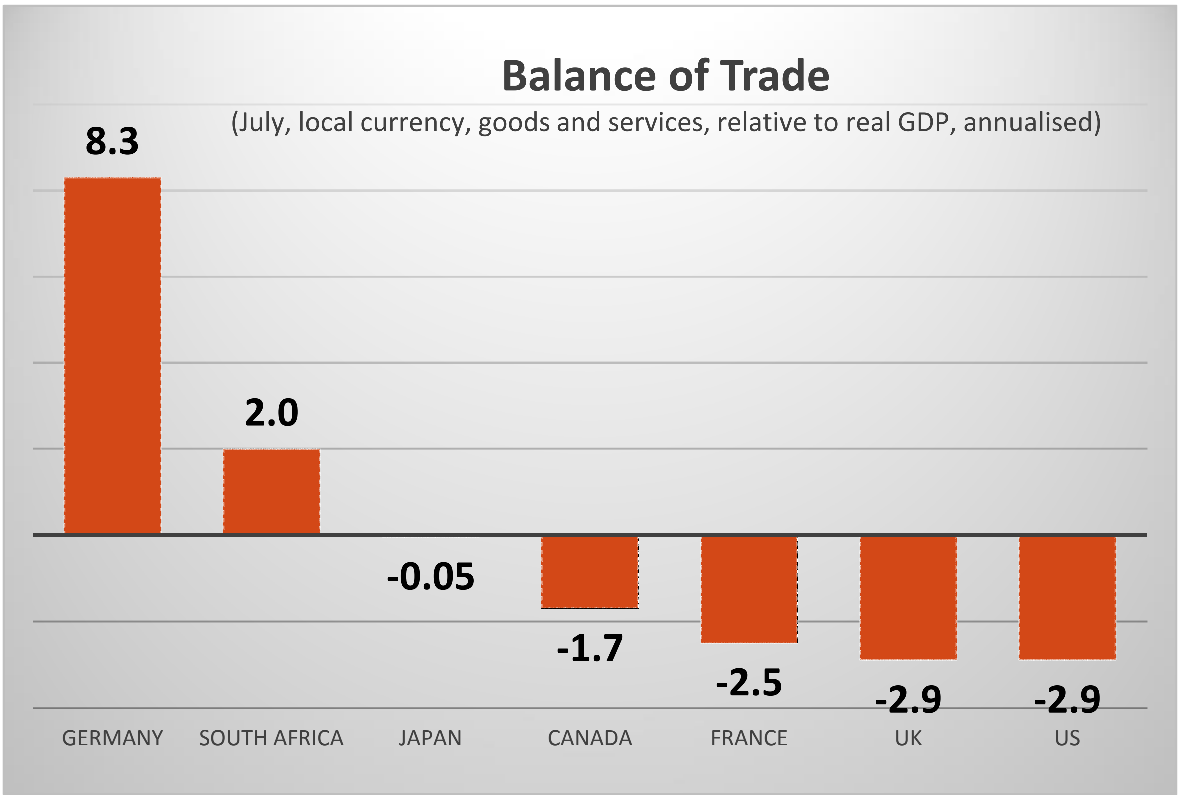
Ever since the overthrow of Husni Mubarak's regime, **Egypt's economy** has been on a downward trajectory. His military successor, Abd al-Fattah as-Sisi, has been pursuing economic policies of window-dressing and populist appeal, investing hundreds of millions, for example, into the enlargement of the Suez Canal when the country is in dire need of the most basic infrastructure in general. Inflation is getting out of control (the current reading is above 15 per cent and rising), government debt has been spiralling to over 90 per cent of GDP, the balance of trade is deteriorating, and, as a corollary, external debt is increasing precipitately. Hence, what would be bad enough on its own is now reinforced by an all-out currency crisis: The Egyptian Pound has been depreciating against the US-Dollar as well as the Euro by more than 10 per cent in a year, with much more downward pressure ahead; on a five-year basis, the currency has lost as much as 35 per cent and 20 per cent, respectively. The external position of the country thus becomes increasingly untenable, and is completely at the mercy of an unlikely stagnating US-Dollar. Once US rates will inevitably begin to rise, pushing the greenback higher, Mr as-Sisi's chickens will come home to roost, most probably heralding a rescue operation by the IMF. In the meantime, the country's economy is choked by the high inflation rate and the subdued intake of foreign exchange due to collapsed tourism in the wake of terrorism fears in the MENA (Middle East and Northern Africa) region. If you're engaged in Egypt, hold tight to your assets and do buy currency protection at any rate. If not, do stay clear of the country at least until US rates are rising and the mooted IMF rescue will have taken place. The political precariousness and related huge risk, however, will remain anyway.



Statistical bulletin – facts & figures

--- **Inflation** continued to pick up in Sweden, due to the central bank's weakening of the currency for months in a row. A turning point, therefore, in the Riksbank's policy might loom for 2017. Kenya's inflation rate has been stabilising around 6 per cent for the larger part of this year, and we expect it not to overshoot any time soon. --- **Business confidence** in Brazil started to emit signs of recovery after what has been one of the worst recessions in the country's history. It's too early days to sound the all-clear, but a decent recovery seems to be at hand. The statistic for New Zealand, however, stagnated, albeit on a solid level. --- **Industrial production** in South Korea seems to be establishing a slight upwards trend after three years of oscillating around zero. Spain's, on the other hand, begins to signal distress from the country's unending political stalemate, and stands to deteriorate even further if no solution will be reached in December's second snap election. --- **Consumer confidence** in Switzerland is in prolonged depression for months now, with no sign of abating. In the Netherlands, by contrast, it bounced up sprightly, pointing towards a decisive shift of sentiment. ---

Inflation (Aug., y/y)	Business Confidence (Aug., Pts.)	Industrial prod. (July, growth, real, y/y)	Consumer Confidence (Sep., Pts.)
•Sweden: +1.1% ↑	•Brazil: 53.70 ↑	•South Korea: +1.6% ↑	•Switzerland: -15.0 ➲
•Kenya: +6.3% ➲	•New Zealand: 15.50 ➲	•Spain: +0.3% ↓	•Netherlands: 8.0 ↑



Sources: Trading Economics, bloomberg, comdirect, own calculations

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