GLOBAL
ECONOMY

5/18

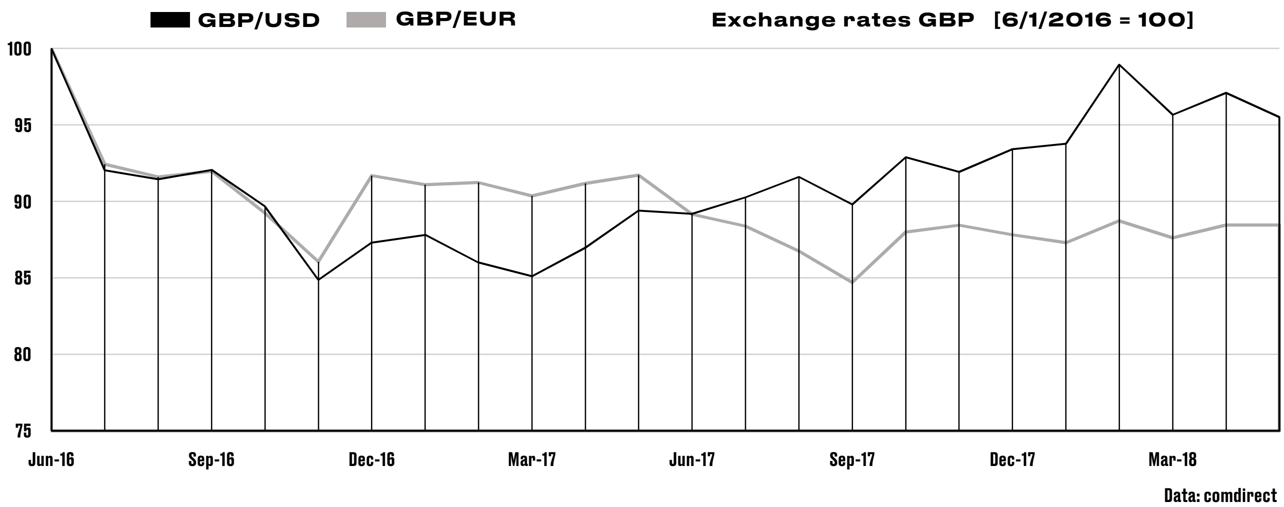
African free trade zone promising step into right direction

Weakness of Swiss franc should prove temporary

J.S. Research

The matter of customs union becomes primary bone of contention as Brexiteers threaten rebellion

In this period of relative Brexit calmness, we have thought it about time to give our readers a roundup of the developments so far and to provide a perspective for the remaining time until Brexit-legal next March. It might be surprising, but we still retain both our very pessimistic view and outlook on the issue, in spite of all the apparent progress so far. Primarily, that is down to the quality of the agreements (or rather truces) reached, both on the domestic as well as the Brussels front. Theresa May has managed to stay on against all expectations. The UK and the EU27 have struck deals on the exit bill, expats rights, and transition. Yet at closer inspection, both achievements start to crumble. In both instances, the agreements are political memoranda of understanding in the broadest possible terms, all subject to the details being fleshed out in in the fall. In Cabinet, a temporary truce had been reached by agreeing on a solution to the matter of leaving or staying in the customs union, issuing the abstract declaration that there will be no return of a hard border in Ireland. Yet not only does nobody know how to bring this about. Also, just recently the truce has been shattered with the matter of the or a customs union emerging as the central bone of contention about which the Brexiteers, fearing to be tricked into a BRINO („Brexit In Name Only"), are adamant not to yield. Both Liam Fox, the International Trade Secretary, and Boris Johnson have dug their heels in on this already. Meanwhile, the Lords have presented the government with a real challenge when they voted in favour not only of retaining a customs union with the EU, but also to stay in the Single Market. In the face of this development, Downing Street even deemed it necessary to deny that a defeat in the Commons over the issue of customs union would necessarily trigger the fall of the government. Yet it is hard to see how such a scenario could result in anything other but the complete loss of the Prime Minister's authority, triggering a leadership election among the Conservative Parliamentary Party. Much the same is to be expected if Theresa May gives in to the Europhiles in Cabinet, by way of making a full u-turn and promoting some sort of *a* customs union: In that case, too, Brexiteers will mount a leadership rebellion against the Prime Minister. This really is a hell of squaring the circle. In



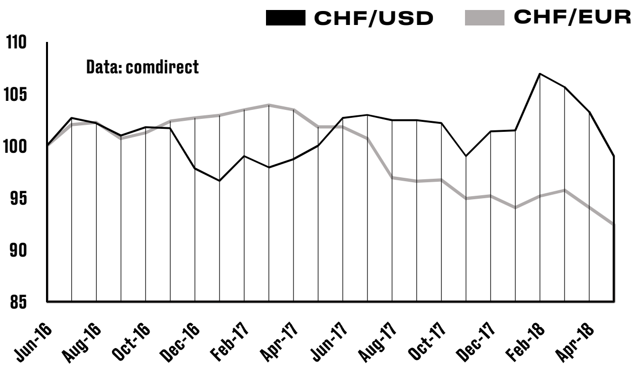
Brussels, too, the putatively final deals on the exit bill and expats rights are anything but final; rather, they prescribe general terms along which both matters are to be handled. The daunting task now is to transfer those into detailed legal terms demanded by the EU27 if any deal were to be struck by October. Hence, the haggling over the matter of customs union has resulted in yet another fudge, delaying the Commons' vote on it until October rather than having it done with by June. In any case, HM Revenue & Customs (HMRC) says it is far from being ready to take over full customs controls in less than a year's time, much less the kind of a complicated „Customs Partnership“ pursued by the Prime Minister; in that model, Britain would collect the EU's duties at her borders and pass them on to Brussels. The head of HMRC puts the time needed for implementing such a partnership at as much as five years – way beyond the transition of two years agreed in March. Jacob Rees-Mogg, leader of the Tory Brexiteers, has left no doubt as to his judgement of the idea: „completely cretinous" was his characteristically blunt choice of words, while the Foreign Secretary has called it “crazy”. If that were not making things intricate enough, Amber Rudd, the Home Secretary and beside of Chancellor Philip Hammond the most europhile of Cabinet ministers, resigned over an affair involving the civil rights of migrants from the Commonwealth in an effort to shield the Prime Minister from a media storm threatening to spin out of control. In Rudd’s office followed the not-so-europhile Sajid Javid, the former Secretary for Housing, Communities and Local Government, only to make his credentials plain when at a key meeting of the Brexit Cabinet Select Committee he tipped the balance away from Theresa May’s favoured customs partnership model, leaving No. 10 in disarray. Officials, though, later rushed to say that the customs partnership model was anything but dead and would be returned to the drawing board in an effort to find a solution palatable to all. Pushing the matter of customs union to the latest possible date might not be possible, though: The EU demands for the UK having its solution for the Irish Border sorted out until the summit in June. But that intricate issue is, of course, inextricably linked to that of customs union, which is why the Brexiteers fear being blackmailed into a general agreement on the simple continuation of the customs union as it exists. Otherwise, the EU back-stop solution signed off by the Prime Minister in March applied in which Northern Ireland would remain in the customs union, but not the rest of the UK, creating a customs border in the Irish Sea – something the DUP in particular, Theresa May's Northern Irish allies would never accept. Meanwhile, Brexiteers in the Conservative Parliamentary Party have taken to openly threatening the Prime Minister with an all-out rebellion if she should stick to the customs partnership model. Thus, we stick to our projection that sooner or later, this whole situation cannot but result in a Brexiteer coup d’état, defenestrating Theresa May and replacing her with a hardliner, deliberately risking the failure of the negotiations in Brussels. Most commentators seem to fail to grasp that in spite of their parliamentary minority, Brexiteers wield the power in the Conservative Party; in reach of their lifetime’s goal, they will not give in without a fight.

African free trade zone another step into right direction, but implementation will take its time

It is a remarkable achievement to be credited regardless of the hurdles to come: The signing of an accord on the creation of an African Continental Free Trade Area (CFTA) in Rwanda at the end of March. In total, 44 leaders of state were present and supported the agreement, though only 27 were ready to sign it there and then. Nonetheless, Rwanda's President Paul Kagame rightly underlined that it had taken four decades to reach this milestone vital to liberate trade between African countries representing a mere 16 per cent of total African trade. Intra-African trade limps from often bad infrastructure and, even more so, from corruption. This has led to bizarre results: It is, for example, cheaper for an exporter based in Côte d'Ivoire to ship her products to France and to re-import them into Burkina Faso rather than directly exporting into the neighbouring country. Transporting a standardized container thirty miles inland in Nigeria can cost five times as much as transporting the same load over the same distance from a port in Britain. Regional organisations such as the Economic Community of Central African States (ECCAS), the Economic Community of West African States (ECOWAS), the South African Development Community (SADC) or, economically the most successful of the bunch, the East African Community

(EAC) have been first efforts on the cumbersome road towards more economic integration and less friction in trading across borders, though yielding very mixed results. Overarching these efforts is the increasingly influential African Union (AU), aiming for a continental common market one day, complete with a common currency. The CFTA, now, is the preliminary pinnacle of this development. Of course, there are still lots of obstacles to master: Implementing this mere memorandum of understanding will take a long time, until the last cleptocrats and border patrols will have bowed to the accord's provisions. Even more problematic is the temporary refusal of Nigeria, reeling from a leadership-vacuum left by ailing President Muhammadu Buhari, as well as South Africa, headed by Cyril Ramaphosa still battling to secure his position in a bitterly divided ANC, to sign the agreement. Without those two leading Sub-Saharan Economies, the CFTA will lack much of its relevance. All the same, the templates are there to emulate: The East African Community has created one of the rare, working customs unions on the continent with largely frictionless trade between, say, Kenya and Uganda: In days of yore, it could take six days to clear the border at Malaba. Today, it might be done with in less than thirty minutes. Provided that South Africa and Nigeria finally come round to sign the CFTA, too, we expect the agreement to deliver a major boost to Sub-Saharan economic growth, potentially creating the basis for a thriving manufacturing sector awaited for so long. The timing could not have been better: Stoked by a combination of renewed political stability (Kenya, and, potentially, Ethiopia), recovered commodity prices, and benign credit conditions, most Sub-Saharan economies have chalked up growth between four and seven per cent of last. Though even a free trade zone encompassing the whole continent alone is not sufficient to eventually bring about the much vaunted „Africa rising", it might turn out to be the necessary igniting spark.

Exchange rates CHF [1.6.2016 = 100]



Unusual weakness of Swiss franc to reverse once effect of sanctions against Russia peters out

It is perhaps the oldest and most widely recognized safe haven currency of all: The Swiss franc tends to be as impenetrable as the vaults and secrecy of the proverbial Swiss banks. Yet in the recent past, both have taken a hit simultaneously. The ‚Swissie', as the currency is known among traders, has continuoulsy devalued to CHF1.20 per Euro, a level the country's central bank had originally had to effect by persistent, direct intervention until in a big bang, it had to surrender that limit against investors' relentless buying pressure in early 2015. Meanwhile, Switzerland's banks and their regulators have been forced by the EU and other international bodies on the hunt for tax evaders to lift much of their unique secrecy. Has the Swissie ceased to be a bedrock of stability in a (less) volatile world, or is this a merely temporary bout of weakness? We strongly tend to the latter. Just as the markets' fear gauge, volatility was collapsing all over 2017 and right into January of this year, safe haven currencies such as the franc or the Japanese Yen were battered, too. Into the addition, the Euro, arguably the most important cross currency for the franc, has been pushed by a surprisingly strong recovery of the eurozone's economy and even more so by a totally premature expectation for the ECB to normalise its policy. Combined, these effects alone let the Swissie devaluate by as much as 10 per cent against the Euro over the course of two years. Yet the Swiss currency failed to recover when lightning struck markets in February, taking equities down by sometimes double-digit margins in a matter of weeks and triggering an explosion in volatility not seen in years. So why has the franc failed to capitalise on that? The culprit are the West's sanctions against Russia. As Switzerland has not been participating in the sanctions due to its traditional neutrality, Russian oligarchs (and state agents) have taken to pull francs from their Swiss accounts to balance the drain of foreign exchange. That, in turn, has created a persistent selling pressure on the Swissie being exchanged into Russian Roubles and US-Dollars. That effect, however, ought to subside in the coming months as liquidity outflows peter out. At the same time, we expect volatility to spike again, as triggers for that to happen are not in short supply: The drop-out of the US from the nuclear deal with Iran, the lowering trade wars between the US and the rest of the world, yields on US Treasuries signalling an end to the decades-old bull market for bonds, and a resuscitated greenback terrifying EM investors facing loads of debt nominated in foreign currency are each and on themselves enough to provide for further jolts; if combined, they might effect a mighty correction on the world's markets. Even without that actually happening, we expect the franc as much as the Yen (see last issue of this report) to appreciate in anticipation of such a scenario which, for the sheer number of factors in it, will not vanish into thin air any time soon. Additionally, the Euro's recent strength should prove to be short-lived now that inflation in the eurozone is decelerating again, just as economic activity appears to weaken. Indeed, when this report went to press, the franc had recovered to less than CHF1.20 per Euro already; so don't write off the Swissie just yet.

Statistical Bulletin

Retail sales (Mar., y/y, real))

Portugal: +5.1 % ↑ Both food and non-food sales rose by a healthy rate in Portugal, thus confirming the upwards trend of the past months. The country's remarkable economic recovery over the past two years is thus mirrored by consumers.

UK: +1.1% ↓ Retail sales in the United Kingdom are slowing down rapidly, as British consumers take stock of Brexit-related uncertainty and real incomes squeezed by high inflation.

Inflation (Apr., y/y)

Turkey: 10.9% ↑ Turkey's inflation rate is of perennial concern to its households as much as foreign investors. As long as the central bank is hampered in its necessary rate increases by President Erdogan, double-digit prints are more likely to persist than not.

Malaysia: 1.3% ↓ Inflation in Malaysia has been all but collapsing, primarily driven by falling transport and communication prices, and deflating food as well as clothing. In the coming months, this development ought to persist.

Services PMI

France (Apr.): 57.40 → France's economy is just ticking on nicely, as is its services sector. If somewhat off from its heights over the turn of the year, the index remains at very strong levels indicating sound growth.

New Zealand (Mar.): 58.80 ↑ The services sector in New Zealand showed first signs of recovery from its election-induced slump of last year, even though the sector was not hit as hard as manufacturing. At current levels, the country's economy appears to taking up its former dynamic again.

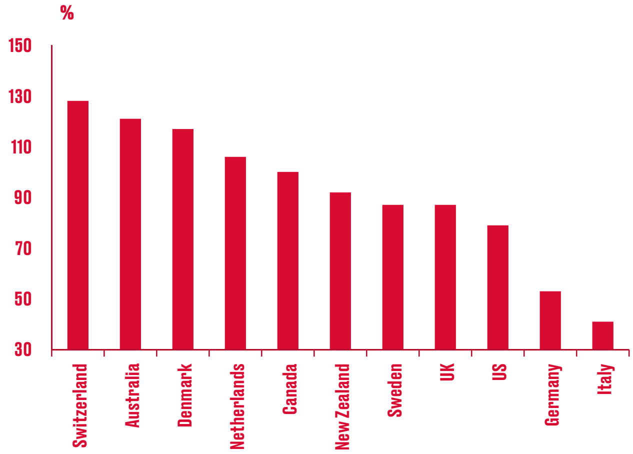
GDP growth (Q1/18, q/q, real)

UK: 0.1 ↓ Readers of this report (see last issue) weren't surprised by the UK's growth figures in Q1, which turned out to be much lower than anticipated by most analysts. Though some of that was due to the "Beast from the East", the numbers suggest a structural weakness.

Spain: 0.7 ↑ Spain's economy is just humming along without so much as a breather. Ever since end-2014, it has been growing by more than 0.5 per cent on a quarterly basis, easily outpacing most of the eurozone.

Household debt to GDP (Q3/17)

Perhaps surprisingly to many, Swiss households are leading the international table of indebtedness. Canada and New Zealand are hovering around the 100 per cent-level, whereas credit card-addicted US households are at the lower end of the list. Italy's households are among the most debt-averse.



Data: trading economics, bloomberg, comdirect, own calculations

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