

Hard choices, hard Brexit, hard luck

The ECB unveiled its Covid-19 response this week, so how impressed was our Carsten Brzeski? The hard truth of Brexit is becoming clearer; we've got that covered. Hard luck for the US economy amid the crisis - the Jameses Knightley and Smith cover that in our podcast pick. And finally some good news! The outlook for commodities, hard and soft, is looking better

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By James Smith



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European Commission President Ursula von der Leyen

In short

- **The issues:** Fishing unlikely to be the issue that derails talks; level playing field, and how to govern the deal, remain thornier issues.
- **The decision:** Negotiators themselves probably don't hold the key to a deal now: the EU is unlikely to meaningfully shift its stance, and the political decision in London hinges on a wide range of factors. We still think a deal is narrowly more likely than not.
- **The choreography:** The return of the Internal Markets Bill doesn't necessarily torpedo talks - there is still time for the controversial clauses to be removed before it is voted into law (likewise for the forthcoming Taxation Bill).

- **The timings:** There really isn't much time left - the European Parliament needs time to read the deal, even if it votes on 28 December. And there is no easy way to extend the transition period in its current form. Talks can't really stretch much beyond this week.
- **The pound:** There's currently limited risk premium in the pound, meaning limited upside if there's a deal, but profound downside if there's not.

1 The issues

Is this finally the week where a post-Brexit trade deal gets agreed?

Well, if you compare the latest reports to those back in February when negotiations began, you'd be forgiven for thinking that nothing has really changed. The core issues - fishing, level playing field, and governance - remain the same.

Fishing has been catching a lot of the headlines over the weekend, and there are mixed reports on whether a compromise is near. However we don't expect this to be the thing that collapses talks. While it is a highly symbolic issue for both the UK and Northern European states (particularly France), both sides need a deal. Britain exports the vast majority of what it catches, while Northern European fleets rely on access to UK waters. Ultimately it appears to be a question of numbers.

All of this masks the deeper issues of level-playing field and governance. The EU wants to ensure the UK maintains its standards on things like the environment and state aid, and that it doesn't dilute them over time. In the event of a breach, the EU could impose tariffs, but importantly it wants the ability to 'cross-retaliate' in one sector if rules are broken in another.

2 The decision

While these latter two issues remain a challenge, it's worth asking whether the chances of a deal really hinge on what negotiators are able to come up with in these final hours?

Despite all the noise, the EU is unlikely to walk back from its core objectives detailed above in the final stage. The unveiling of the Internal Markets Bill back in September has diluted trust, and Brussels will be keen to future-proof the agreement when it comes to standards and governance.

Equally, Prime Minister Boris Johnson's decision on whether to agree a deal is unlikely to be swayed solely by what is agreed at the eleventh hour. This is a 'big picture' decision, and one that will be influenced by a range of factors.

The following would argue in favour of a deal:

- With Covid-19 restrictions likely to remain tight at the start of 2021, this is not a good time for supply chain disruption (though some delays are likely even if there is a deal in place).
- Recent polling has shown the Conservatives more-or-less level pegging with Labour, perhaps suggesting Johnson needs a 'win'.
- A 'no deal' scenario could put further impetus into the Scottish Independence campaign,

- something the government is keen to avoid.
- On the world stage, the absence of an agreement risks leaving the UK government more politically isolated at a time when the US and EU are likely to be rebuilding ties under the new Biden Administration.

However, a number of Conservative MPs have signalled they would not be comfortable with the compromises a deal would entail. This opposition probably isn't enough to block a deal in Parliament, particularly given recent reports that Labour may vote in favour if there is a vote. But it will still be a factor weighing heavily on the PM's decision - not least because before he was leader, Johnson was among MPs pushing for a more arms-length Brexit agreement.

All of that makes assessing the chances of a deal very tricky. We're still inclined to think there will be an agreement, but really it's not much more than 50:50.

3 The choreography

Choreography matters a lot in international politics. It helps shape how deals are perceived at home, and this time appears to be no different. Expect plenty more headlines of 'walking away' and 'vetoes' over coming hours.

However, the stage-management of this is made trickier by the return of the Internal Markets Bill to the House of Commons today, with controversial clauses re-inserted after the Lords removed them last month. The government is also poised to unveil a Taxation Bill on Tuesday that may contain further 'notwithstanding' clauses, giving ministers further powers to override parts of last year's withdrawal agreement.

If either of these bills were to pass through both Houses and become law, then that would presumably mean game over for negotiations. However, neither bill will get to that point straight away, leaving a window in which the government could still remove the offending clauses if a deal is done.

If an agreement is reached, then according to [RTE](#), the committee tasked with implementing the Northern Ireland protocol could meet to tie up any remaining loose ends. That in turn could be a catalyst for the government to take out the controversial parts of the legislation.

Plenty could hinge on the phone call on Monday evening between Johnson and European Commission President Ursula von der Leyen.

4 The timings

In an ideal world, Brussels will be hoping that a deal can be wrapped up ahead of the European Council meeting on Thurs/Fri. But given the number of missed deadlines in the past, we wouldn't guarantee it.

The problem is that there is only a very finite amount of time left. While the European Parliament could meet as late as 28 December to ratify a deal, they do need time to read it. In an extreme scenario, the European Council [could in theory agree to provisionally apply the deal](#) - that is allow part or all of it to kick in - before the European Parliament has had a vote. But this is unprecedented for an issue of this magnitude and it's unlikely the EU will want to go down this path.

Unfortunately, there is no straightforward way to extend the current transition period beyond 31

December. In theory, both sides could reach a sideline agreement which could facilitate an extension, but this would be hugely complicated and perhaps impossible in the time left. And in any case, the political willingness in the UK to agree to an extension is probably fairly low.

Having said that, if there is an agreement, there may be various sideline measures taken to give businesses more time to adjust to the new rules. The UK has already signalled most traders will not need to file customs declarations for the first six months, for example.

5 GBP: Highly asymmetric reaction function

As we argued in our [2021 FX Outlook: Back on track](#), we perceive the GBP reaction function to the UK-EU trade negotiation outcome as asymmetric. In other words, we see modest upside in the case of a deal but profound downside in the event of no deal. This is because there is fairly limited risk premium currently priced into GBP (around 2% following today's decline – which is still well below the around 5% mis-valuation observed early this year and in 2019).

In the case of no deal (not our base case) we expect a profound GBP collapse – EUR/GBP above 0.95, possibly briefly touching parity – due to the fact that this outcome would come as a surprise and investors have not been pricing this in. This is evident in the [latest speculative positioning](#), where we observed a position-squaring of GBP shorts (from 12% to 5% of open interest, as per the CFTC data).

In the case of a deal (still our base case), we look for a one-off GBP rebound to EUR/GBP 0.88 as the uncertainty fades away. Still, compared to the possible GBP downside, the scope for sterling gains is more limited, both in the near-term and over the medium-term. Again, this is due to the limited risk premia priced in (hence, limited scope for a rebound).

What's more, the soft nature of the trade agreement (as envisaged in our base case) may cause permanent damage to the UK economy and should limit the scope for sterling to materially outperform. In addition, the pound does not show signs of meaningful medium-term mis-valuation (based on our BEER model) despite the profound fall in sterling since 2016. Hence, we would look for a one-off bounce to EUR/GBP 0.88 and expect the cross to stay around this level throughout 2021.

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ING economists James Knightley and James Smith were approached by the European-American Chambers of Commerce to see if they could shed some light on what Brexit might mean for the US, European and UK economies in 2021.

In this podcast they look at how the economic relationships between the three blocs may develop and what it means for business. They also examine the potential shifting dynamics in political relations that a Joe Biden Presidency brings to the table and how this could influence future trade agreements between the three sides.

[Find out more about the EACCNY's Brexit Musings podcast here](#)

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Snap | 10 December 2020

ECB: Bridging the time to herd immunity

The European Central Bank did not present a big new bazooka but a well-engineered extension of all well-known instruments to ensure that the current level...



Source: Shutterstock

Extend rather than increase monetary stimulus. This is the main takeaway from today's ECB meeting. As expected, the ECB left interest rates unchanged but decided on a set of recalibrations to its existing measures, all aimed at extending the current monetary stimulus by roughly nine months. Why nine months? Well, ECB President Christine Lagarde explained it clearly: with nine months, the current measures are extended until early 2022, the moment when - according to the consensus expectation of virologists and vaccine experts - herd immunity in the eurozone should have been achieved and the economic recovery can finally take off. Here are the main elements of the ECB's policy decisions and the most interesting comments from the press conference.

Today's main ECB decisions

- **Pandemic Emergency Purchase Programme:** The ECB's emergency quantitative easing programme will be increased by €500 billion to a total of €1.85 trillion, to ensure that net purchases will last at least until March 2022.
- **Reinvestments:** The reinvestments of the principal payments from the PEPP purchases will run at least until the end of 2023.
- **Asset Purchase Programme:** The ECB's 'traditional' QE programme to bring inflation back to

- target continues to run at €20bn per month, open-ended.
- Pandemic emergency longer-term refinancing operations (PELTROs): The ECB's emergency funding scheme will be continued into 2021, with four operations.
- Targeted longer-term refinancing operations (TLTROs): The ECB's funding-for-lending scheme will be extended by 12 months until June 2022, and the amount banks can get from the ECB was increased to 55% of the eligible loan stock, from 50%.
- Collateral: The easing of collateral rules was extended in line with the extension of the TLTROs until June 2022.

In short, the ECB tweaked all its instruments to extend the current level of monetary accommodation until spring 2022.

Main takeaways from the press conference

In the ECB's macro-economic assessment there were very few surprises. Back in September, the ECB had still been optimistic on the fourth quarter but the recent lockdowns mean it now expects a contraction. As a result, the ECB's staff projections for 2021 were revised downwards but revised upwards for 2022. The staff projections show GDP growth rates of -7.3%, 3.9%, 4.2% and 2.1% for the years 2020 to 2023. With the expected roll out of a vaccine, according to the ECB, the medium-term prospects for growth have improved, which explains why the ECB sounded somewhat less alarmist with its risk assessment, adding that the downside risks have become less pronounced.

As regards inflation, ECB staff expect headline inflation to come in at 0.2%, 1.0%, 1.1% and 1.4% in the period from 2020 to 2023. These are slight downward revisions for 2020 and 2022. However, the forecast of 1.4% for 2023, even without taking today's decisions into account, indicates that more action will be needed to bring eurozone inflation back to target.

Against the background of a recent strengthening in the euro exchange rate, the ECB and ECB President Lagarde could not avoid addressing this topic. Contrary to the unclear message on the exchange rate at the September meeting, the wording was clear today: the ECB doesn't target exchange rates but the exchange rate plays an important role for price developments. Therefore, the ECB will monitor the exchange rate "very carefully going forward". Very little more Lagarde could have said on this one.

No big bazooka but central bank engineering

All in all, today's ECB meeting was rather unexciting with a well-balanced and well-considered extension of the well-known policy instruments. No big new bazooka. The ECB continues to follow two main aims: keep financing conditions as favourable as possible and prevent any new euro crisis on the back of an unwarranted widening of government bond yields (a.k.a. keeping the transmission mechanism smooth). The ECB has linked its policies to the virus and the vaccine. All measures are now timed and tied to the assumption that the vaccine will bring herd immunity in all eurozone countries by the end of 2021. Tweaking the duration of all measures is still possible, a real stepping up of the measures is really not. For the time being, the ECB is leaving the big bazookas to governments and concentrating on real central bank engineering.

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Source: Shutterstock

European Central Bank HQ, Frankfurt

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Source: Shutterstock

Hope for the best, prepare for the worst

The medium-term economic outlook has undoubtedly brightened in the past few months with financial markets buoyed by favourable vaccine news while fears of a protracted and difficult Presidential transition have eased. Data flow has pointed to an ongoing recovery while hopes of another fiscal stimulus have recently been revived. This more positive backdrop helped the 10Y Treasury yield to touch 98bp last week, nearly double the 4 August low of 51bp.

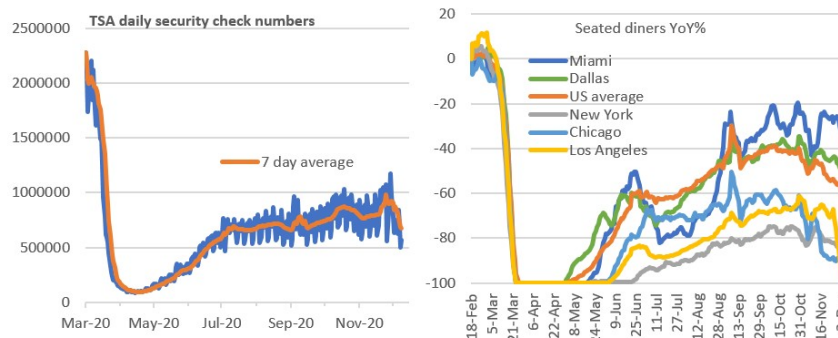
Yet, the US economy is not completely in the clear. While a vaccination programme is coming, it will take time before it is distributed to enough people to allow a full return to “normality”. In the meantime, Covid-19 cases are rising sharply and containment measures are being re-introduced at a heavy economic cost. This window of vulnerability could last perhaps three or four months during which restrictions on movement could push up unemployment and weaken activity.

Moreover, we have been talking for months about another fiscal stimulus to help tide the economy over before a full economic reopening. The latest comments from Senate Republicans suggest we

shouldn't hold our breath despite recent signs of movement.

Then there is the Treasury's decision not to extend the emergency lending facilities, which clearly disappointed senior Fed officials who had a preference for keeping it as a backstop should conditions deteriorate.

Less movement & less spending = fewer jobs



Source: Macrobond, ING

Forcing the Fed's hand?

The Federal Reserve believes fiscal policy is the best way to support the economy in the face of a second wave of the pandemic, but there is a school of thought that believes the Fed should do more themselves. This is a tricky situation though. With borrowing costs still close to record lows and credit markets functioning smoothly there is little they can seemingly do to boost the economy aside from emphasising they aren't going to raise rates anytime soon.

In this regard, the Fed will leave the Fed funds target rate at 0-0.25% next Wednesday, promising to keep it there until the goal of maximum employment and inflation being "on track to moderately exceed 2% for some time" is met – their "dot" diagram will continue to suggest this won't happen before 2023.

We could see a change in guidance relating to the asset purchases, which currently stand at \$80bn of Treasuries and \$40bn of Mortgage Backed Securities each month. At present they merely comment that "over coming months" the purchases will continue "at least at the current pace". Officials have hinted they could make the pace of purchases more conditional on economic conditions. They may also make the point that tapering of purchases must happen before they would even consider raising interest rates more forcefully. This may, at the margin, help to press down borrowing costs.

Capping yields a step too far right now

They could be more aggressive and seek to keep a lid on longer-dated Treasury yields, fearing that if the 10Y yield continues to rise it could constrain the recovery. Action could involve focusing a greater weighting of asset purchases at the longer end of the yield curve at the expense of fewer purchases at shorter durations.

We have our doubts that they will do that just yet though and will instead keep it in their toolbox for future use. The 10Y yield remains below 1%, which isn't exactly threatening. We see it as more

of a tool that could be used if there is a perception that Treasury yields are rising too far too quickly. That is more likely in an environment next year with a full economic reopening and the Fed being wary that rising borrowing costs threaten to unnecessarily impede the recovery.

After all, once a critical mass of people receive the inoculation, which we assume will happen during the second quarter, this can give consumers both the confidence and the freedom to fully re-engage with the economy. With savings levels having been replenished, there is a sense that consumer service sectors could experience something of a boom as people “make up for lost time”.

Business investment plans that have been put on hold for more than 12 months may quickly get put into action and if we then get another fiscal stimulus package on the order of 3-4% of GDP under President Biden, this could be a recipe for very vigorous growth from 2Q21 onwards. This is likely to be reflected in upward revisions to Fed forecasts.

Previous Fed forecasts & ING's expectations for new Fed predictions (%)

	2020	2021	2022	2023	Longer run
Change in real GDP (ING Expectation)	-3.0	4.5	3.0	2.6	1.9
Previous Fed projection (Sep)	-3.7	4.0	3.0	2.5	1.9
Unemployment rate (ING Expectation)	6.7	5.2	4.4	4.0	4.1
Previous Fed projection (Sep)	7.6	5.5	4.6	4.0	4.1
Core PCE inflation (ING Expectation)	1.4	1.6	1.8	2.0	2.0
Previous Fed projection (Sep)	1.5	1.7	1.8	2.0	-
Federal funds rate (ING Expectation)	0.1	0.1	0.1	0.1	2.5
Previous Fed projection (Sep)	0.1	0.1	0.1	0.1	2.5

Source: Federal Reserve, ING

Inflation may also start to move onto the radar with vibrant demand coming up against supply constraints in many sectors – examples include numerous bars and restaurants that have permanently closed or airline fleets that have been cut back. In any case, there will be some upward pressure on annual inflation rates as the sharp price falls experienced during the height of the pandemic drop out of the annual comparison.

Following the BoC's lead?

We suspect the yield curve will steepen further in this environment with 10Y benchmark government borrowing costs set to test 1.5% in 2021. Should it rise swiftly, the Fed may adopt the Bank of Canada's strategy where it “recalibrated” its quantitative easing programme in October by shifting asset purchases towards the longer end of the yield curve while lowering the weekly purchases from “at least C\$5bn” to “at least” C\$4bn.

The BoC's argument was that household and corporate borrowing costs tend to be more influenced by longer-term government borrowing costs, which is the same as in the US, so by focusing spending there they could achieve the same amount of stimulus using less ammunition. This is a neat way of starting to extricate themselves from the situation the BoC finds itself in and we suspect will eventually be replicated by the Federal Reserve – just not yet.

And there may or may not be some technical nuances discussed

The Federal Reserve may comment on the pushes and pulls likely on the money market in the coming months. Liquidity in the system will be affected by the spend of a chunk of the \$1.5bn of reserves built by the Treasury and held at the Fed. This effectively gets injected into the system. And at the same time, T-bill issuance is set to fall, which means that this liquidity does not get mopped up easily. In consequence we could see some downward momentum in ultra-short money market rates.

The Fed won't want to see this go too far, as they would like to keep the effective funds rate above the 0% floor (the last thing the Fed needs is for negative rates to become an implied point of discussion). To avert this, the Fed could increase the rate it pays on excess reserves, which would at least coax some excess liquidity into this avenue, reducing the downward pressure on the effective funds rate.

This would be a purely technical move, more likely in the first half of 2021. Bottom line, any talk of a rate hike here is purely for market adjustment purposes; nothing further should be read into it. In fact, the passage of a stimulus bill and chunk of extra T-bills issuance could take care of the issue without the need for a rate adjustment at all.

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