

In case you missed it: Deal or no deal?

Is a Brexit deal finally within reach? EU Brexit negotiator Michel Barnier said this week that the bloc was willing to offer an unprecedented partnership to the UK. We explain what this means for the pound and why it makes sense for Europe, which is facing its own set of challenges in the form of a 'silver tsunami'

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GBP: Barnier's Brexit Boost

GBP markets were caught off guard as the EU's Brexit negotiator Michel Barnier said they were "ready to propose a partnership the likes of which has not existed before with any third country". This is something that most hadn't thought was possible and may see a partial reassessment of no deal Brexit risks that lends support to a politically-infested pound



Source: istock

Leveraged funds that are short GBP could bail on more positive Brexit headlines



Source: ING, Macrobond, CFTC. Note: Positioning data as of 21 Aug 2018

Summary: Chasing GBP lower on no deal Brexit risks becoming highly unattractive

While the politically-infested pound has been living on a prayer in recent weeks, we think that a lot of bad news is now priced in – such that risk-reward no longer favours chasing the marginal pricing in of no deal Brexit fears. The pound's sharp 0.7-0.8% rally in response to Barnier's somewhat constructive comments (albeit the rest of the rhetoric towing the usual EU party line) reflects this risk-reward trade-off. Given the extent to which leveraged funds have turned short GBP in recent months (see chart above), we feel that GBP will now be more sensitive to constructive Brexit headlines – versus being vulnerable to negative (or status quo no deal Brexit) noise. More positive Brexit headlines could see leveraged funds further bail on their short GBP positions; a neutralisation of GBP positioning would see GBP/USD moving back to the 1.31-1.32 area (EUR/GBP back to 0.88-0.89).

Indeed, when it comes to Brexit and the currency, talks between the UK and the EU are not necessarily the primary short-term risk. In fact, some investors may have found comfort from the UK-EU talks – especially as it was clear that the EU isn't actively looking to push the UK off any Brexit cliff edge (which makes sense given that a no deal Brexit would be somewhat damaging to both economies).

The inherent willingness of both sides to find a Withdrawal Deal solution should serve as a bit of a backstop to the degree of no-deal Brexit risks priced into the currency. But when it comes to GBP and political risks, it is far too early to signal the all clear; the biggest test for the pound will be the return of a divided UK parliament from their summer recess and the upcoming Party Conference Season. A murky UK political backdrop may continue to put a dampener on GBP upside in the near-term – but we do think that a good chunk of Brexit negativity is priced in and look for a stable, albeit Brexit-headline-sensitive, GBP.

Below we reiterate some of our short-term and medium-term views – as well as our Brexit scenario analysis matrix.

Short-term outlook: UK politics is the biggest stumbling block for the pound

We believe the politics will continue to outweigh the economics for GBP in the short-term – especially if the Brexit strategy of UK government remains one that is seemingly trying to fit a square peg in a round hole. Only a concrete resolution between UK and EU officials over the Irish backstop dispute – which would effectively finalise the Withdrawal Agreement and significantly reduce the odds of 'No Deal' Brexit – would trigger a material move higher in GBP over the coming months.

There are two probabilities for GBP investors to consider: (1) the **perceived** odds of a no-deal and (2) the **actual** odds of a sudden regime shift in the UK-EU trading relationship:

1. **The perceived odds of a no-deal Brexit have materially increased – and this is likely to keep GBP under pressure in the near-term as politicians take Brexit towards the brink of a cliff-edge.** There are signs that GBP markets are already pricing in a large degree of political uncertainty (GBP's reduced sensitivity to macro data surprises and relative interest rates; a pick-up in short GBP positioning; the breakdown in high-frequency correlation between EUR/USD and GBP/USD).
2. **But we still feel the actual odds of a cliff-edge Brexit are significantly lower – with economic logic to triumph over political ideology in the end.** The odds of a sudden economic regime shift – and a sudden switch to WTO trading rules between the UK and EU is a highly improbable scenario in our view. We still believe that this outcome will be avoided at all costs by politicians – and if this is the case, then we do not subscribe to the idea of another sharp Brexit-related GBP depreciation over the coming months (not least given that we're already at weak levels).

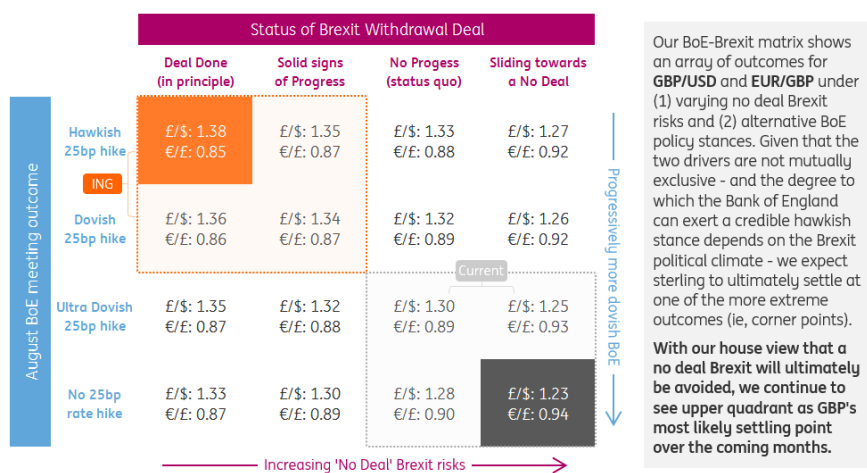
Medium-term outlook: Look for GBP to move sharply higher once structural Brexit risks fully fade

While we are short-term GBP bears, we remain constructive on the medium-term prospects for GBP – given our house-view that a politically acceptable withdrawal deal will be struck between the UK and EU.

Based on the BOE's latest r^* estimates, we note that the term structure of UK interest rates is around 75-100 basis points too low right now. Long-term UK interest rate expectations will remain distorted by Brexit no-deal risks in the immediate future – and any sustained shift higher in the UK curve won't transpire until some of these Brexit tail risks have been concretely taken off the table. Indeed, throw into the mix the unique Brexit uncertainties surrounding the UK economy – and this renders r^* an almost redundant factor for UK rate markets right now. Indeed, when we think about the conceptual factors that drive r^* – demographics, productivity, fiscal policy, savings-investment imbalances, demand for safe assets – one could argue that these would look inherently different in a 'soft' versus 'hard' Brexit world.

We'll also need to see actual signs of a UK economic recovery – and positive UK data surprises over coming months could also lift short-term domestic rates and the pound. Our medium-term bullish GBP view – which sees GBP/USD at 1.40 (EUR/GBP 0.85) at the turn of the year – is partly based on this structural re-pricing UK interest rates driven by a fading Brexit risk premium.

ING's GBP Brexit scenario analysis matrix



Our BoE-Brexit matrix shows an array of outcomes for GBP/USD and EUR/GBP under (1) varying no deal Brexit risks and (2) alternative BoE policy stances. Given that the two drivers are not mutually exclusive - and the degree to which the Bank of England can exert a credible hawkish stance depends on the Brexit political climate - we expect sterling to ultimately settle at one of the more extreme outcomes (ie, corner points).
With our house view that a no deal Brexit will ultimately be avoided, we continue to see upper quadrant as GBP's most likely settling point over the coming months.

Source: ING FX Strategy. Note: Current = Current GBP dynamics; ING = Medium-term GBP house view

Source: ING FX Strategy

Author

Viraj Patel

Foreign Exchange Strategist

+44 20 7767 6405

viraj.patel@ing.com

Report | 30 August 2018

The silver tsunami is almost upon us

Eurozone growth is being threatened by several structural challenges, not least an ageing population. And that's going to add yet more challenges to numerous economies, not least Germany, Spain and Italy Click on the link below to read the report



Elderly people in Paris protest against a proposed pension reform, September 2017

Author

Bert Colijn

Chief Economist, Netherlands

bert.colijn@ing.com

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

US: Still feeling it...

Consumer confidence has improved again in August as the strong jobs market, massive tax cuts and buoyant asset prices keep households in the mood to spend



Source: iStockphoto

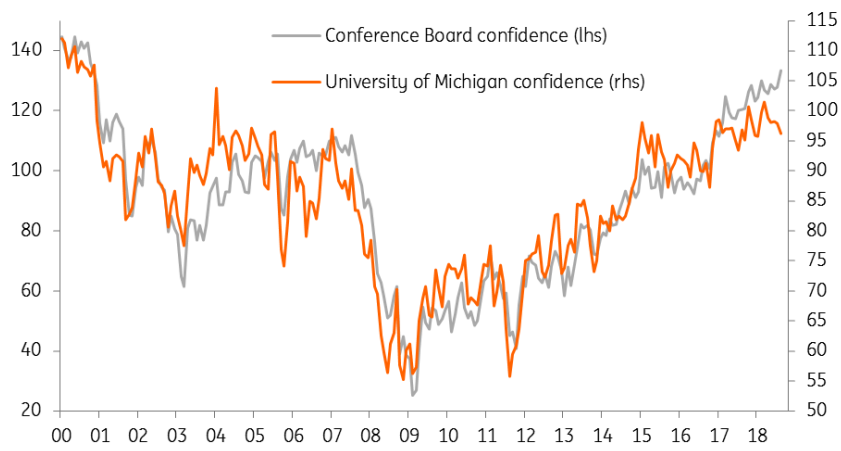
The final reading of August University of Michigan consumer confidence has improved to 96.2 from the preliminary figure of 95.3 and suggests households remain very positive on their own personal situation and that of the US economy. This follows from last week's Conference Board measure, which rose to an 18 year high. However, the chart below shows there is some divergence between the two series emerging right now, which we should keep an eye on.

With the jobs market going from strength to strength and tax cuts putting more money in peoples' pockets, there is a strong appetite to spend. Rising home and equity market prices are also boosting household wealth, so it is little surprise to see optimism is at such strong levels. The only thing missing is wage growth, which continues at a subdued 2.7% rate - slower than headline inflation of 2.9%. If we can see the pay story improve (we look for wage growth to pick up to 2.8% next Friday) this could see sentiment hit new record highs.

As such we expect consumer spending to remain a key driver of US economic activity. Consumer spending rose at an annualised rate of 3.8% in 2Q18, and we look for another 3% figure in Q3, helping to fuel full year US GDP growth of around 3%. With annual inflation at or above 2% on the headline and core (ex-food and energy) measures this suggests the Fed will continue hiking rates in a "gradual" fashion. We look for both a September and a December Fed rate hike with two

further moves next year.

US consumer confidence measures - 2000-2018



Source: Macrobond

Author

James Knightley

Chief International Economist, US

james.knightley@ing.com

Sweden: Krona at multi-year low and decline isn't over yet

SEK continues swimming naked. Despite reaching a new multi-year low vs the EUR, we look for further SEK weakness (to EUR/SEK 11.00) as both domestic and external factors weigh on the currency



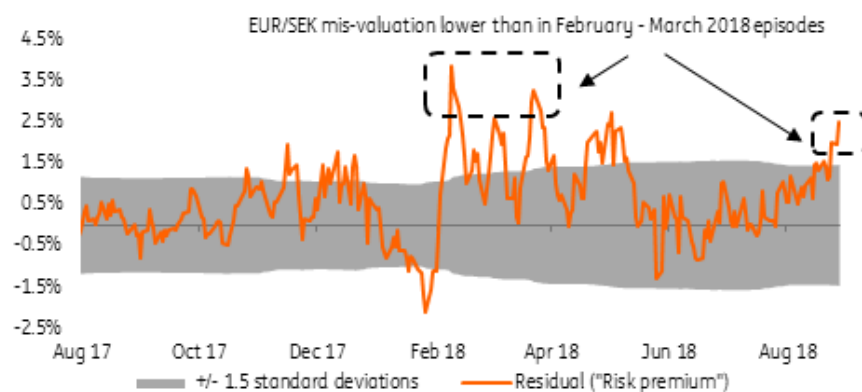
A new multi-year low

EUR/SEK broke above the May high of 10.6960 reaching the highest level since 2009. This is in line with our bearish SEK view and our non-consensus target of EUR/SEK 11.00 by the year-end.

Read [Swedish Krona: Swimming naked?](#)

SEK risk premium still below February / March 2018 levels

% residual (a gauge for risk premium) between EUR/SEK fair value and spot.



Source: ING

Domestic and external factors are still SEK negative

As per [Swedish elections: Muddy waters](#), we see the Swedish krona very vulnerable in the current environment as both domestic and external factors point to more SEK weakness. On the domestic side, the upcoming elections on 9 September should keep SEK risk premium in place (and even lead to further widening as the SEK discount vs EUR remains lower compared to the episodes earlier in the year – as shown in Figure 1).

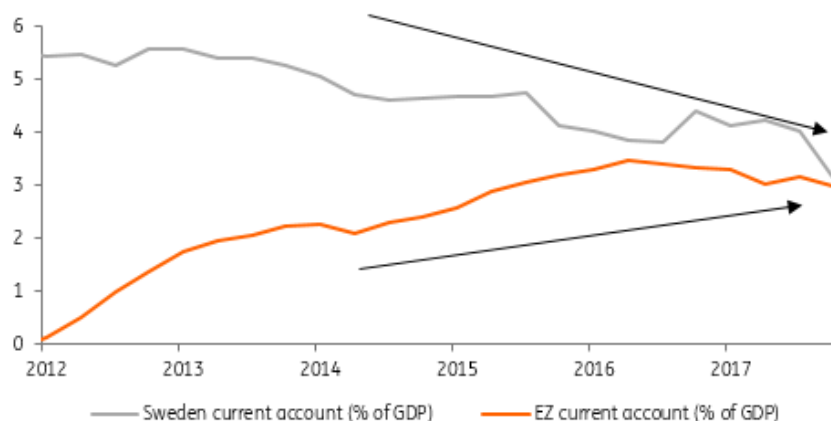
In addition:

- the dovish Riksbank (we don't expect the central bank to provide help to the battered SEK on the 6th September meeting – if anything we see a risk of a modestly dovish language),
- slowing economy (as per today's very weak July retail sales),
- deteriorating Swedish current account vs EZ (Fig 2), and
- cheap funding costs

should all keep SEK under pressure for the remainder of the year.

On the external side, the spectre of trade wars is a clear negative for SEK as Sweden is a small open economy, thus vulnerable to concerns about the direction of the global trade.

Swedish current account advantage deteriorating

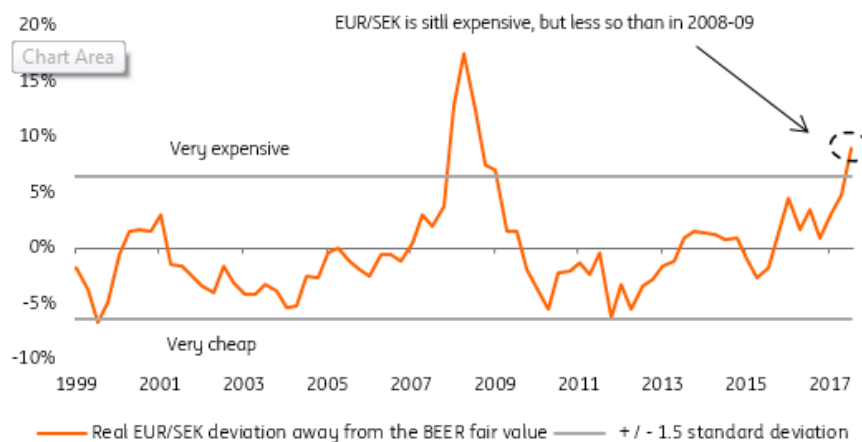


Source: ING, Macrobond

SEK to continue underperforming NOK

In the relative value space, we continue to favour long NOK/SEK positions as (a) elections will weigh on SEK and (b) the Norges Bank rate hike in September will support NOK. NOK/SEK to break above the 1.10 level rather soon.

SEK is cheap but lacks a catalyst for a reversal



Source: ING

SEK is cheap but no catalyst for a reversal

While we recognise the SEK medium term undervaluation vs EUR (13% based on our BEER valuation framework – as per Fig 3) – at this point there is a little catalyst for this mis-valuation to be corrected.

As is the case for sterling or the Turkish lira – two prime examples of undervalued currencies both in the G10 and EM FX space, where the sharp mis-valuation is unlikely to correct in the absence of a profound catalyst.

Author

Alissa Lefebre

Economist

alissa.lefebvre@ing.com

Deepali Bhargava

Regional Head of Research, Asia-Pacific

Deepali.Bhargava@ing.com

Ruben Dewitte

Economist

+32495364780

ruben.dewitte@ing.com

Kinga Havasi

Economic research trainee

kinga.havasi@ing.com

Marten van Garderen

Consumer Economist, Netherlands

marten.van.garderen@ing.com

David Havrlant

Chief Economist, Czech Republic

420 770 321 486

david.havrlant@ing.com

Sander Burgers

Senior Economist, Dutch Housing

sander.burgers@ing.com

Lynn Song

Chief Economist, Greater China

lynn.song@asia.ing.com

Michiel Tukker

Senior European Rates Strategist

michiel.tukker@ing.com

Michal Rubaszek

Senior Economist, Poland

michal.rubaszek@ing.pl

This is a test author

Stefan Posea

Economist, Romania
tiberiu-stefan.posea@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Jesse Norcross
Senior Sector Strategist, Real Estate
jesse.norcross@ing.com

Teise Stellema
Research Assistant, Energy Transition
teise.stellema@ing.com

Diederik Stadig
Sector Economist, TMT & Healthcare
diederik.stadig@ing.com

Diogo Gouveia
Sector Economist
diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Ewa Manthey
Commodities Strategist
ewa.manthey@ing.com

ING Analysts

James Wilson
EM Sovereign Strategist
James.wilson@ing.com

Sophie Smith
Digital Editor
sophie.smith@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Adam Antoniak
Senior Economist, Poland

adam.antoniak@ing.pl

Min Joo Kang

Senior Economist, South Korea and Japan

min.joo.kang@asia.ing.com

Coco Zhang

ESG Research

coco.zhang@ing.com

Jan Frederik Slijkerman

Senior Sector Strategist, TMT

jan.frederik.slijkerman@ing.com

Katinka Jongkind

Senior Economist, Services and Leisure

Katinka.Jongkind@ing.com

Marina Le Blanc

Sector Strategist, Financials

Marina.Le.Blanc@ing.com

Samuel Abettan

Junior Economist

samuel.abettan@ing.com

Franziska Biehl

Senior Economist, Germany

Franziska.Marie.Biehl@ing.de

Rebecca Byrne

Senior Editor and Supervisory Analyst

rebecca.byrne@ing.com

Mirjam Bani

Sector Economist, Commercial Real Estate & Public Sector (Netherlands)

mirjam.bani@ing.com

Timothy Rahill

Credit Strategist

timothy.rahill@ing.com

Leszek Kasek

Senior Economist, Poland

leszek.kasek@ing.pl

Oleksiy Soroka, CFA

Senior High Yield Credit Strategist

oleksiy.soroka@ing.com

Antoine Bouvet

Head of European Rates Strategy

antoine.bouvet@ing.com

Jeroen van den Broek

Global Head of Sector Research

jeroen.van.den.broek@ing.com

Edse Dantuma

Senior Sector Economist, Industry and Healthcare

edse.dantuma@ing.com

Francesco Pesole

FX Strategist

francesco.pesole@ing.com

Rico Luman

Senior Sector Economist, Transport and Logistics

Rico.Luman@ing.com

Jurjen Witteveen

Sector Economist

jurjen.witteveen@ing.com

Dmitry Dolgin

Chief Economist, CIS

dmitry.dolgin@ing.de

Nicholas Mapa

Senior Economist, Philippines

nicholas.antonio.mapa@asia.ing.com

Egor Fedorov

Senior Credit Analyst

egor.fedorov@ing.com

Sebastian Franke

Consumer Economist

sebastian.franke@ing.de

Gerben Hieminga

Senior Sector Economist, Energy

gerben.hieminga@ing.com

Nadège Tillier

Head of Corporates Sector Strategy

nadege.tillier@ing.com

Charlotte de Montpellier

Senior Economist, France and Switzerland

charlotte.de.montpellier@ing.com

Laura Straeter

Behavioural Scientist

+31(0)611172684

laura.Straeter@ing.com

Valentin Tataru

Chief Economist, Romania

valentin.tataru@ing.com

James Smith

Developed Markets Economist, UK

james.smith@ing.com

Suvi Platerink Kosonen

Senior Sector Strategist, Financials

suvi.platerink-kosonen@ing.com

Thijs Geijer

Senior Sector Economist, Food & Agri

thijs.geijer@ing.com

Maurice van Sante

Senior Economist Construction & Team Lead Sectors

maurice.van.sante@ing.com

Marcel Kloek

Senior Economist, Netherlands

marcel.kloek@ing.com

Piotr Poplawski

Senior Economist, Poland

piotr.poplawski@ing.pl

Paolo Pizzoli

Senior Economist, Italy, Greece

paolo.pizzoli@ing.com

Marieke Blom

Chief Economist and Global Head of Research

marieke.blom@ing.com

Raoul Leering

Senior Macro Economist
raoul.leering@ing.com

Maarten Leen
Head of Global IFRS9 ME Scenarios
maarten.leen@ing.com

Maureen Schuller
Head of Financials Sector Strategy
Maureen.Schuller@ing.com

Warren Patterson
Head of Commodities Strategy
Warren.Patterson@asia.ing.com

Rafal Benecki
Chief Economist, Poland
rafal.benecki@ing.pl

Philippe Ledent
Senior Economist, Belgium, Luxembourg
philippe.ledent@ing.com

Peter Virovacz
Senior Economist, Hungary
peter.virovacz@ing.com

Inga Fechner
Senior Economist, Germany, Global Trade
inga.fechner@ing.de

Dimitry Fleming
Senior Data Analyst, Netherlands
Dimitry.Fleming@ing.com

Ciprian Dascalu
Chief Economist, Romania
+40 31 406 8990
ciprian.dascalu@ing.com

Muhammet Mercan
Chief Economist, Turkey
muhammet.mercan@ingbank.com.tr

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com

Sophie Freeman

Writer, Group Research

+44 20 7767 6209

Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

James Knightley

Chief International Economist, US

james.knightley@ing.com

Tim Condon

Asia Chief Economist

+65 6232-6020

Martin van Vliet

Senior Interest Rate Strategist

+31 20 563 8801

martin.van.vliet@ing.com

Karol Pogorzelski

Senior Economist, Poland

Karol.Pogorzelski@ing.pl

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

Viraj Patel

Foreign Exchange Strategist

+44 20 7767 6405

viraj.patel@ing.com

Owen Thomas

Global Head of Editorial Content

+44 (0) 207 767 5331

owen.thomas@ing.com

Bert Colijn

Chief Economist, Netherlands

bert.colijn@ing.com

Peter Vanden Houte

Chief Economist, Belgium, Luxembourg, Eurozone

peter.vandenhoute@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

Gustavo Rangel

Chief Economist, LATAM

+1 646 424 6464

gustavo.rangel@ing.com

Carlo Cocuzzo

Economist, Digital Finance

+44 20 7767 5306

carlo.cocuzzo@ing.com

Snap | 31 August 2018

Eurozone core inflation declines to 1% and becomes a bigger worry for ECB

Headline inflation drops to 2%, but the real story is core inflation falls back to 1%. The ECB will monitor this carefully in the coming months as core inflation needs to pick up for the conditional path of monetary tightening



Source: Shutterstock

Headline inflation remains elevated due to the energy price jump in the first half of the year, causing energy price growth to be 9.2% in August. This effect has started to slowly fade out of the inflation rate, meaning that inflation will slip below target in the months ahead. Core inflation is therefore much more interesting to look at. For a sustained higher inflation rate, it needs to move up, and the much-anticipated acceleration has so far failed to happen.

There is hope for higher core inflation though. Perhaps the most interesting data point to come out this summer was Eurozone negotiated wage growth, which jumped from 1.7% to 2.2% year on year in Q2. This significant acceleration brings wage growth to a pace last seen in 2012 and gives the first indication that the long labour market recovery is starting to lead to increasing wage pressures. Still, while concerns about the ECB being behind the curve have already been voiced, today's core inflation reading suggests the contrary.

In the coming months, the question remains whether businesses will dare to increase prices on the back of higher wage growth in times of weakening business confidence. Surveys indicate slower expected price growth in the months ahead as global economic uncertainty has impacted the business outlook.

The European Central Bank needs improved core inflation to stay on track for its conditional path towards the end of quantitative easing in December and a rate hike at the end of summer 2019.

Author

Bert Colijn

Chief Economist, Netherlands

bert.colijn@ing.com

France: Hard times for Macron

The last consumer spending figures were weak in July, while consumer confidence declined in August. The economic situation is not helping a government weakened by the departure of its most popular minister



President of France

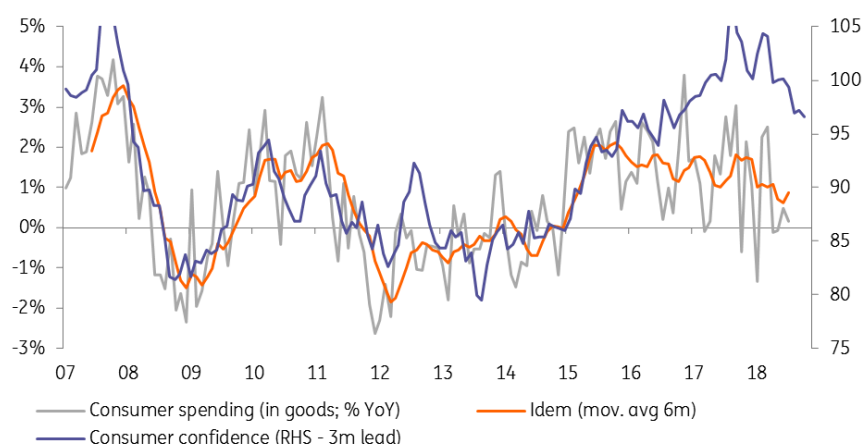
Household spending showed signs of weakness in July

Figures published this week by INSEE showed that household spending increased by a limited 0.2% month-on-month in July. Spending growth is still below 1% on the year. Looking at the long term trend, it seems that spending growth has been declining slightly since mid-2015 despite improvements in consumer confidence. Indeed, consumer confidence, which was also published this week, was at 96.6 in August, which is consistent with spending growth of almost 2% a year.

What the survey showed, however, is that the trend in consumer confidence is now down. While 96.6 remains a higher level than in any month between 2015 and 2016, it has been on a downward trend since December 2017 (104.3). Looking at the components, it appears that households are more positive about their savings now than in December, but this further improvement has been counterbalanced by returning pessimism about the economic outlook and, since June, a return of unemployment fears.

The latter comes from the fact that the unemployed population has increased almost every month since March despite an increase in hiring intentions and labour market reform (the effect of ending subsidised contracts has abated since June). In the service sector, the last PMI surveys showed that the improvement in the unemployment rate in recent quarters could pause unless there is an

increase in demand.



Source: Thomson Reuters

An air of déjà vu

It seems that the reform atmosphere and initial optimism generated by President Emmanuel Macron is now giving way to a more traditional French story: increasing savings are limiting spending, which is limiting demand and therefore employment growth, especially as external demand growth is subdued.

Macron therefore enters his second year in a more difficult economic situation, and in a weaker political position: his approval rating has declined from 40% to 32% in the Ipsos political barometer since April. Moreover, the resignation this week of his environment minister Nicolas Hulot, one of the heavyweights of the Philippe team and the most popular political figure in the government and among French political leaders (in July Ipsos barometer), has weakened Macron despite Hulot's efforts to minimise the impact of his decision. The departure deals a blow to Macron's image as a reformist. If his most popular minister does not believe that reform is possible in France, Macron will have his work cut out convincing others.

We currently expect a weak rebound of GDP in the third quarter. On the investment front, with high capacity utilisation and a high level of order books, we remain optimistic for 2018 but household spending will take more time to recover and adjust to higher oil prices. While private consumption growth should barely accelerate from the 1.1% reached in 2017, we think that GDP growth should reach 1.8% in 2018 and 2019.

Author

Alissa Lefebvre

Economist

alissa.lefebvre@ing.com

Deepali Bhargava

Regional Head of Research, Asia-Pacific

Deepali.Bhargava@ing.com

Ruben Dewitte

Economist

+32495364780

ruben.dewitte@ing.com

Kinga Havasi

Economic research trainee

kinga.havasi@ing.com

Marten van Garderen

Consumer Economist, Netherlands

marten.van.garderen@ing.com

David Havrlant

Chief Economist, Czech Republic

420 770 321 486

david.havrlant@ing.com

Sander Burgers

Senior Economist, Dutch Housing

sander.burgers@ing.com

Lynn Song

Chief Economist, Greater China

lynn.song@asia.ing.com

Michiel Tukker

Senior European Rates Strategist

michiel.tukker@ing.com

Michal Rubaszek

Senior Economist, Poland

michal.rubaszek@ing.pl

This is a test author

Stefan Posea

Economist, Romania

tiberiu-stefan.posea@ing.com

Marine Leleux

Sector Strategist, Financials

marine.leleux2@ing.com

Jesse Norcross

Senior Sector Strategist, Real Estate

jesse.norcross@ing.com

Teise Stellema

Research Assistant, Energy Transition

teise.stellema@ing.com

Diederik Stadig

Sector Economist, TMT & Healthcare

diederik.stadig@ing.com

Diogo Gouveia

Sector Economist

diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux

Sector Strategist, Financials

marine.leleux2@ing.com

Ewa Manthey

Commodities Strategist

ewa.manthey@ing.com

ING Analysts

James Wilson

EM Sovereign Strategist

James.wilson@ing.com

Sophie Smith

Digital Editor

sophie.smith@ing.com

Frantisek Taborsky

EMEA FX & FI Strategist

frantisek.taborsky@ing.com

Adam Antoniak

Senior Economist, Poland

adam.antoniak@ing.pl

Min Joo Kang

Senior Economist, South Korea and Japan

min.joo.kang@asia.ing.com

Coco Zhang

ESG Research

coco.zhang@ing.com

Jan Frederik Slijkerman

Senior Sector Strategist, TMT
jan.frederik.slijkerman@ing.com

Katinka Jongkind
Senior Economist, Services and Leisure
Katinka.Jongkind@ing.com

Marina Le Blanc
Sector Strategist, Financials
Marina.Le.Blanc@ing.com

Samuel Abettan
Junior Economist
samuel.abettan@ing.com

Franziska Biehl
Senior Economist, Germany
Franziska.Marie.Biehl@ing.de

Rebecca Byrne
Senior Editor and Supervisory Analyst
rebecca.byrne@ing.com

Mirjam Bani
Sector Economist, Commercial Real Estate & Public Sector (Netherlands)
mirjam.bani@ing.com

Timothy Rahill
Credit Strategist
timothy.rahill@ing.com

Leszek Kasek
Senior Economist, Poland
leszek.kasek@ing.pl

Oleksiy Soroka, CFA
Senior High Yield Credit Strategist
oleksiy.soroka@ing.com

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

Jeroen van den Broek
Global Head of Sector Research
jeroen.van.den.broek@ing.com

Edse Dantuma

Senior Sector Economist, Industry and Healthcare
edse.dantuma@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Rico Luman
Senior Sector Economist, Transport and Logistics
Rico.Luman@ing.com

Jurjen Witteveen
Sector Economist
jurjen.witteveen@ing.com

Dmitry Dolgin
Chief Economist, CIS
dmitry.dolgin@ing.de

Nicholas Mapa
Senior Economist, Philippines
nicholas.antonio.mapa@asia.ing.com

Egor Fedorov
Senior Credit Analyst
egor.fedorov@ing.com

Sebastian Franke
Consumer Economist
sebastian.franke@ing.de

Gerben Hieminga
Senior Sector Economist, Energy
gerben.hieminga@ing.com

Nadège Tillier
Head of Corporates Sector Strategy
nadege.tillier@ing.com

Charlotte de Montpellier
Senior Economist, France and Switzerland
charlotte.de.montpellier@ing.com

Laura Straeter
Behavioural Scientist
+31(0)611172684
laura.Straeter@ing.com

Valentin Tataru

Chief Economist, Romania

valentin.tataru@ing.com

James Smith

Developed Markets Economist, UK

james.smith@ing.com

Suvi Platerink Kosonen

Senior Sector Strategist, Financials

suvi.platerink-kosonen@ing.com

Thijs Geijer

Senior Sector Economist, Food & Agri

thijs.geijer@ing.com

Maurice van Sante

Senior Economist Construction & Team Lead Sectors

maurice.van.sante@ing.com

Marcel Klok

Senior Economist, Netherlands

marcel.klok@ing.com

Piotr Poplawski

Senior Economist, Poland

piotr.poplawski@ing.pl

Paolo Pizzoli

Senior Economist, Italy, Greece

paolo.pizzoli@ing.com

Marieke Blom

Chief Economist and Global Head of Research

marieke.blom@ing.com

Raoul Leering

Senior Macro Economist

raoul.leering@ing.com

Maarten Leen

Head of Global IFRS9 ME Scenarios

maarten.leen@ing.com

Maureen Schuller

Head of Financials Sector Strategy

Maureen.Schuller@ing.com

Warren Patterson

Head of Commodities Strategy

Warren.Patterson@asia.ing.com

Rafal Benecki

Chief Economist, Poland

rafal.benecki@ing.pl

Philippe Ledent

Senior Economist, Belgium, Luxembourg

philippe.ledent@ing.com

Peter Virovacz

Senior Economist, Hungary

peter.virovacz@ing.com

Inga Fechner

Senior Economist, Germany, Global Trade

inga.fechner@ing.de

Dimitry Fleming

Senior Data Analyst, Netherlands

Dimitry.Fleming@ing.com

Ciprian Dascalu

Chief Economist, Romania

+40 31 406 8990

ciprian.dascalu@ing.com

Muhammet Mercan

Chief Economist, Turkey

muhammet.mercan@ingbank.com.tr

Iris Pang

Chief Economist, Greater China

iris.pang@asia.ing.com

Sophie Freeman

Writer, Group Research

+44 20 7767 6209

Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

James Knightley

Chief International Economist, US

james.knightley@ing.com

Tim Condon

Asia Chief Economist
+65 6232-6020

Martin van Vliet

Senior Interest Rate Strategist
+31 20 563 8801
martin.van.vliet@ing.com

Karol Pogorzelski

Senior Economist, Poland
Karol.Pogorzelski@ing.pl

Carsten Brzeski

Global Head of Macro
carsten.brzeski@ing.de

Viraj Patel

Foreign Exchange Strategist
+44 20 7767 6405
viraj.patel@ing.com

Owen Thomas

Global Head of Editorial Content
+44 (0) 207 767 5331
owen.thomas@ing.com

Bert Colijn

Chief Economist, Netherlands
bert.colijn@ing.com

Peter Vanden Houte

Chief Economist, Belgium, Luxembourg, Eurozone
peter.vandenhoute@ing.com

Benjamin Schroeder

Senior Rates Strategist
benjamin.schroeder@ing.com

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Gustavo Rangel

Chief Economist, LATAM
+1 646 424 6464

gustavo.rangel@ing.com

Carlo Cocuzzo

Economist, Digital Finance

+44 20 7767 5306

carlo.cocuzzo@ing.com

When value and price collide

What is and isn't acceptable in pricing can highlight fascinating insights into how consumers and businesses behave



Imagine you've bought tickets for yourself, another adult and two children to see a film at the local cinema of a national chain. You then search online and find you could have paid nearly half if you saw the same film with the same chain but somewhere else. This does not seem fair. This example is taken from a [BBC](#) press report noting parents' objections to paying £34.16 (\$40) for tickets to a cinema in Carmarthen in Wales compared with £19.00 in Cardiff, the Welsh capital. That's 45 percent less.

The accusation of price gouging seems reasonable at first glance

A lack of alternative cinemas and therefore competition in Carmarthen has been blamed by a campaigner for the difference. To rub salt in the wounds, the price for similar tickets at the closer Welsh city of Swansea was £22.96 – still 33% lower. The objection is easy to understand, especially when parents are trying to entertain children during holidays and weekends, and when budgets are stretched. It's useful to note that incomes around Carmarthen are about 25 per cent lower than in Cardiff. The accusation of price gouging seems reasonable at first glance. After all, the cost of putting on the film is unlikely to be nearly double in one location compared with the other. The price difference and consumer reaction provide some interesting illustrations of how consumers

and businesses behave.

When different pricing for similar goods is and is not acceptable

People's willingness to accept different prices for similar goods is something that has been discussed many times by both traditional and behavioural economists. A traditional approach may recognise transactions costs, differences in quality, the convenience of getting something immediately, and supply and demand differences in specific places. On convenience and transactions costs, it appears reasonable from a traditional approach to pay extra and see the film in Carmarthen. After all, it takes about one hour and twenty minutes to drive from Carmarthen to Cardiff. A near three-hour round trip involves significant costs in both time and money which could wipe out the price difference. The 42-minute one-way drive to Swansea could do the same.



Source: www.geograh.org.uk Hywel Williams
The Vue cinema, Swansea

Behavioural approaches also suggest staying in Carmarthen to be a sensible choice. A common example of irrationality is the willingness of some to travel a half hour to get a certain amount off a low priced item (for example, to get a £5 discount on a £10 book) but unwilling to travel the same time for the same discount on a higher priced item (for example, to get the same £5 discount on a £50 jacket). According to both traditional and behavioural approaches, it is rational for the families to see the film in Carmarthen than travel to Cardiff. But that does not make it fair.

Defining fairness

Fairness is a tricky concept, especially when it comes to pricing. There have always been “sharp” operators – those who take advantage of their position to make a quick return. [A classic example](#) from the behavioural literature is the local hardware store that increases the price of the snow shovels during a heavy snowstorm. People consider that unfair. But if the hardware store needs to buy new stock to meet a surge in demand, and increases prices as a result, that is considered fair. The important thing appears to be to give people a reasonable explanation for the price differences. In technical terms, people have a reservation price or a reference point that they are prepared to accept as a fair price to pay. Stray too far from the reservation price and you can be

accused of being unfair. Economics Nobel laureate Richard Thaler explained this in [this article](#) back in 1983.

Stray too far from the reservation price and you can be accused of being unfair

Figuring out the appropriate reference price may depend on what is considered normal. For example, people seem willing to accept that a bank or other lender can and should charge a higher interest on a loan when the person borrowing the money has a poor credit history and therefore a greater risk of not paying the money back. Similarly, people are prepared to pay the same amount for goods at a national chain of supermarkets in a provincial town where commercial rents for the store are much lower than in a major city. One factor here could be that the reference prices appear to be set at the higher level appropriate to the major city. There is no need to imply that people are getting a bargain by shopping in the provincial town than the major city. Another important aspect is how easy it is to compare different prices. The example of the cinema chain highlights two challenges to the reference price. First, it was easy to compare prices. Second, it was seen as charging a higher price in one place rather a lower piece in another. People feel as if they are losing – and losses are felt much more severely than gains, as we explain [here](#).

Technology and fairness in pricing

Technology has the potential to change what we consider fair. The ability to change prices quickly as demand increases or decreases is one of the noticeable differences in the way that technology is changing the way prices are set. Companies that adopt a platform approach, where suppliers of a service can decide whether or not to work, may argue that higher prices in times of high demand encourage more suppliers to work and keep the ultimate price lower than it would have been otherwise. For example, if it starts raining and more people want taxis, increasing the price might encourage more drivers to stay on the road instead of going home because they have already made the amount of income they need that day.

Technology has the potential to change what we consider fair

People seem willing to accept this type of surge pricing but not different prices for the same good between customers based on data profiling from their internet search or social media activities. What is and is not acceptable in pricing has always been debated. New technology is presenting new challenges to this debate. The hard-pressed cinema goers in Carmarthen have a point. So too does the cinema chain. I have no idea whether enough people attend the cinema in Carmarthen to make it profitable. If not, new technology may even come to the rescue with some form of video streaming being a possible substitute to the traditional cinema experience.

Note: this article is based on a Twitter exchange between the author and Koen Smets (@koenfucius). Koen has written elegantly on this topic [here](#).

Author

Alissa Lefebre

Economist

alissa.lefebvre@ing.com

Deepali Bhargava

Regional Head of Research, Asia-Pacific

Deepali.Bhargava@ing.com

Ruben Dewitte

Economist

+32495364780

ruben.dewitte@ing.com

Kinga Havasi

Economic research trainee

kinga.havasi@ing.com

Marten van Garderen

Consumer Economist, Netherlands

marten.van.garderen@ing.com

David Havrlant

Chief Economist, Czech Republic

420 770 321 486

david.havrlant@ing.com

Sander Burgers

Senior Economist, Dutch Housing

sander.burgers@ing.com

Lynn Song

Chief Economist, Greater China

lynn.song@asia.ing.com

Michiel Tukker

Senior European Rates Strategist

michiel.tukker@ing.com

Michal Rubaszek

Senior Economist, Poland

michal.rubaszek@ing.pl

This is a test author

Stefan Posea

Economist, Romania

tiberiu-stefan.posea@ing.com

Marine Leleux

Sector Strategist, Financials

marine.leleux2@ing.com

Jesse Norcross

Senior Sector Strategist, Real Estate

jesse.norcross@ing.com

Teise Stellema

Research Assistant, Energy Transition

teise.stellema@ing.com

Diederik Stadig

Sector Economist, TMT & Healthcare

diederik.stadig@ing.com

Diogo Gouveia

Sector Economist

diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux

Sector Strategist, Financials

marine.leleux2@ing.com

Ewa Manthey

Commodities Strategist

ewa.manthey@ing.com

ING Analysts

James Wilson

EM Sovereign Strategist

James.wilson@ing.com

Sophie Smith

Digital Editor

sophie.smith@ing.com

Frantisek Taborsky

EMEA FX & FI Strategist

frantisek.taborsky@ing.com

Adam Antoniak

Senior Economist, Poland

adam.antoniak@ing.pl

Min Joo Kang

Senior Economist, South Korea and Japan

min.joo.kang@asia.ing.com

Coco Zhang

ESG Research

coco.zhang@ing.com

Jan Frederik Slijkerman

Senior Sector Strategist, TMT

jan.frederik.slijkerman@ing.com

Katinka Jongkind

Senior Economist, Services and Leisure

Katinka.Jongkind@ing.com

Marina Le Blanc

Sector Strategist, Financials

Marina.Le.Blanc@ing.com

Samuel Abettan

Junior Economist

samuel.abettan@ing.com

Franziska Biehl

Senior Economist, Germany

Franziska.Marie.Biehl@ing.de

Rebecca Byrne

Senior Editor and Supervisory Analyst

rebecca.byrne@ing.com

Mirjam Bani

Sector Economist, Commercial Real Estate & Public Sector (Netherlands)

mirjam.bani@ing.com

Timothy Rahill

Credit Strategist

timothy.rahill@ing.com

Leszek Kasek

Senior Economist, Poland

leszek.kasek@ing.pl

Oleksiy Soroka, CFA

Senior High Yield Credit Strategist

oleksiy.soroka@ing.com

Antoine Bouvet

Head of European Rates Strategy

antoine.bouvet@ing.com

Jeroen van den Broek

Global Head of Sector Research

jeroen.van.den.broek@ing.com

Edse Dantuma

Senior Sector Economist, Industry and Healthcare

edse.dantuma@ing.com

Francesco Pesole

FX Strategist

francesco.pesole@ing.com

Rico Luman

Senior Sector Economist, Transport and Logistics

Rico.Luman@ing.com

Jurjen Witteveen

Sector Economist

jurjen.witteveen@ing.com

Dmitry Dolgin

Chief Economist, CIS

dmitry.dolgin@ing.de

Nicholas Mapa

Senior Economist, Philippines

nicholas.antonio.mapa@asia.ing.com

Egor Fedorov

Senior Credit Analyst

egor.fedorov@ing.com

Sebastian Franke

Consumer Economist

sebastian.franke@ing.de

Gerben Hieminga

Senior Sector Economist, Energy

gerben.hieminga@ing.com

Nadège Tillier

Head of Corporates Sector Strategy

nadege.tillier@ing.com

Charlotte de Montpellier

Senior Economist, France and Switzerland

charlotte.de.montpellier@ing.com

Laura Straeter

Behavioural Scientist

+31(0)611172684

laura.Straeter@ing.com

Valentin Tataru

Chief Economist, Romania

valentin.tataru@ing.com

James Smith

Developed Markets Economist, UK

james.smith@ing.com

Suvi Platerink Kosonen

Senior Sector Strategist, Financials

suvi.platerink-kosonen@ing.com

Thijs Geijer

Senior Sector Economist, Food & Agri

thijs.geijer@ing.com

Maurice van Sante

Senior Economist Construction & Team Lead Sectors

maurice.van.sante@ing.com

Marcel Klok

Senior Economist, Netherlands

marcel.klok@ing.com

Piotr Poplawski

Senior Economist, Poland

piotr.poplawski@ing.pl

Paolo Pizzoli

Senior Economist, Italy, Greece

paolo.pizzoli@ing.com

Marieke Blom

Chief Economist and Global Head of Research

marieke.blom@ing.com

Raoul Leering

Senior Macro Economist

raoul.leering@ing.com

Maarten Leen

Head of Global IFRS9 ME Scenarios

maarten.leen@ing.com

Maureen Schuller

Head of Financials Sector Strategy

Maureen.Schuller@ing.com

Warren Patterson

Head of Commodities Strategy

Warren.Patterson@asia.ing.com

Rafal Benecki

Chief Economist, Poland

rafal.benecki@ing.pl

Philippe Ledent

Senior Economist, Belgium, Luxembourg

philippe.ledent@ing.com

Peter Virovacz

Senior Economist, Hungary

peter.virovacz@ing.com

Inga Fechner

Senior Economist, Germany, Global Trade

inga.fechner@ing.de

Dimitry Fleming

Senior Data Analyst, Netherlands

Dimitry.Fleming@ing.com

Ciprian Dascalu

Chief Economist, Romania

+40 31 406 8990

ciprian.dascalu@ing.com

Muhammet Mercan

Chief Economist, Turkey

muhammet.mercan@ingbank.com.tr

Iris Pang

Chief Economist, Greater China

iris.pang@asia.ing.com

Sophie Freeman

Writer, Group Research

+44 20 7767 6209

Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

James Knightley

Chief International Economist, US

james.knightley@ing.com

Tim Condon

Asia Chief Economist

+65 6232-6020

Martin van Vliet

Senior Interest Rate Strategist

+31 20 563 8801

martin.van.vliet@ing.com

Karol Pogorzelski

Senior Economist, Poland

Karol.Pogorzelski@ing.pl

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

Viraj Patel

Foreign Exchange Strategist

+44 20 7767 6405

viraj.patel@ing.com

Owen Thomas

Global Head of Editorial Content

+44 (0) 207 767 5331

owen.thomas@ing.com

Bert Colijn

Chief Economist, Netherlands

bert.colijn@ing.com

Peter Vanden Houte

Chief Economist, Belgium, Luxembourg, Eurozone

peter.vandenhoute@ing.com

Benjamin Schroeder

Senior Rates Strategist

benjamin.schroeder@ing.com

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

Gustavo Rangel

Chief Economist, LATAM

+1 646 424 6464

gustavo.rangel@ing.com

Carlo Cocuzzo

Economist, Digital Finance

+44 20 7767 5306

carlo.cocuzzo@ing.com

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