British pound plummets over "hard Brexit" fears

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The growing interaction between rising geo-political tensions and financial market volatility found dramatic expression on Friday when the British pound plunged in early trading as Asian financial markets opened.

The pound dropped by more than 6 percent in just two minutes on the back of reports that the United Kingdom would undertake a "hard Brexit," that is, a clean break from the European Union (EU), rather than a limited withdrawal which maintained access to the common market.

The plunge coincided with reports of a tough stance by French President Francois Hollande over the terms of the British withdrawal—the negotiations for which British Prime Minister Theresa May has said will begin by April.

"The UK has decided to do a Brexit, I believe even a hard Brexit," Hollande said. "Well, then we must go all the way through the UK's willingness to leave the EU. We have to have this firmness. If not, we would jeopardise the fundamental principles of the EU."

Hollande warned that unless a strong stand was taken, other countries would seek to leave the EU, while maintaining the advantages of membership without the obligations.

"There must be a threat, there must be a risk, there must be a price," Hollande said. "Otherwise we will be in a negotiation that cannot end well." His remarks came in a dinner address on Thursday night as markets opened in Asia.

Initial reports of the pound's plunge, which was followed by a recovery of most of its losses, attributed it to a mistaken "fat finger" trade or the malfunctioning of an automated trading algorithm, whose effects were exacerbated by thinner trading in the Asian markets.

However the rapid descent—the biggest drop in sterling since the 11.1 percent plunge on the day the Brexit referendum outcome was announced on June 24—followed a continuous fall in the pound this week. At point on Friday, it reached $1.1841, compared to around $1.50 on the eve of the referendum, before pulling back to $1.2434. That was down 1.4 percent for the day and 4.2 percent for the week.

British Chancellor Phillip Hammond issued a statement in Washington, where he is attending the meetings of the International Monetary Fund and the World Bank, seeking to calm markets. Speaking to journalists, he denied the government had decided to pursue a "hard Brexit" strategy. The only thing that had changed was May's clear statement on the timing of the issuing of an Article 50 notice, the formal mechanism under which official negotiations begin on the British decision.

But Hammond's remarks will hardly bring calm over the longer term. Describing the situation on Friday as one of "turbulence," he said he expected it to continue over the next five years, while negotiations took place.

The key question is whether, while formally leaving the EU, Britain remains part of the European customs union. If Britain made a complete break, trade relations with the EU would be conducted under World Trade Organisation (WTO) rules, rather than EU market arrangements—a situation that would impact adversely on British companies.

Hammond said no decisions had been made on the customs union question and the British government was "in the process of formulating our negotiating strategy."

British business leaders are concerned that the government could be moving toward a "hard Brexit." According to a report in the *Financial Times*, a letter drafted by the Confederation of British Industry (CBI) to the prime minister said any UK departure had to

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maintain special ties to the common market.

The CBI said barrier-free access to the single market "is vital to the health of the UK economy, especially to our manufacturing and service sectors" and the government "should give certainty to business by immediately ruling out this [WTO] option out under any circumstances."

The fears of a "hard Brexit" were compounded by the populist rhetoric invoked by May in her speech to the Conservative Party annual conference, in which she denounced an "international elite."

The CBI said: "The government must set out a clear road map for consulting with firms of all sectors and sizes to increase confidence that these complex decisions are taken on the basis of fact and a genuine understanding of the economic implications."

Bank of England governor Mark Carney said he believed the sudden fall in the pound, followed by a recovery, was a technical matter and he had asked the Bank for International Settlements to undertake an investigation.

The response of financial market commentators to the pound's plunge showed that they regard it as much more than just a "flash crash."

Morgan Stanley strategist Hans Redeker said the new British government appeared to have "undertaken an economic course which could bear substantial risks" and talk of a "hard Brexit" added to the problem.

Sterling stability is vital to the British economy. It depends on an inflow of foreign funds to finance its current account deficit, which runs at 6 percent of its gross domestic product. If financial markets fear a further major sterling devaluation, those funds could dry up.

According to Ulrich Leuchtmann of the German Commerzbank, the risk of a massive sterling devaluation has increased.

"It is therefore no surprise that we are more likely to see situations in which nobody still wants to offer a market for sterling sellers," he told the *Financial Times*. "The flash crash was more than a market anomaly. It was also a signal that a 'sudden stop' of current account financing is now more likely."

The impact of the sterling's fall was reflected in other financial markets. The UK stock market rose, because shares have become cheaper due to the lower value of the pound. However, the yield on the benchmark 10-year government bond—which moves in an inverse relationship to its price—moved up 11 basis points (0.11 percentage points), leaving it 23 basis points higher for the week, at just under 1 percent.

If interest rates continue to rise because of a falling pound, this will have a knock-on effect in financial markets, which have become ever more dependent on the inflow of cheap money to finance speculation, for which the City of London is one of the leading global centres.

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