Q&A-Sterling seen rallying to 1.38; UK government's 'levelling up' agenda implementation to offset post-Brexit growth hit: BRICs economist Jim O'Neill

Former Goldman Sachs chief economist Jim O'Neill sees the British pound to rally to 1.38 versus the U.S. dollar if the government is able to implement its 'levelling up' agenda which involves heavy infrastructure spending.

"If we can get above (1.38), a good chance the pound will rise to 1.45," O'Neill, currently chair of British foreign policy think tank Chatham House, told the Reuters Global Markets Forum on Tuesday, January 12.

"I couldn't see it permanently above 1.50," he added.

Brexit alone could cause a hit to UK's growth of 0.1%-0.2% to UK growth trend, but successful implementation of 'levelling up' would offset that decrease, said O'Neill, best known for coining the BRICs acronym for the fast-growing economies of Brazil, Russia, India and China.

"Altogether, because UK has reasonable demographics, UK could grow 2% per annum still, over the long term."

Following are edited excerpts from the conversation:

Q: What long-term economic fallout for the UK would you expect from the Brexit deal, especially considering doomsday calls of economic implosions or investment freezes after 2016 didn't really materialise?

A: I think the Brexit deal, was a relief. In that sense, it was welcome. But even this deal weakens the UK economically, especially because of fresh red tape, and of course, the vast part of services falls outside the deal. I would question also the implication in your question. The UK was weakened by the four years fall out, especially in terms of rather weak investment.

There was no dramatic implosion, but the economy certainly suffered, especially in terms of investment spending.

Q: Would you see the UK as a more or less attractive destination for foreign investors post-Brexit (given the desperate need to fund the long-term current account shortfall)?

A: In a way, the government is fortunate that the final deal coincides with the mess from COVID-19 as it is very hard to measure the impact from Brexit separately from the pandemic consequences. It is very hard to conclude anything other than Brexit economically is a negative, all else equal.

But, 1) It is not the most important thing facing the UK future; and 2) Recovery from COVID-19 will dominate in next two years. On this, I am with the optimists. The UK is in a good position on vaccines, one of the best in the world. Things could look quite different by Easter here.

And it is also the case that domestic productivity challenges are a much bigger threat to the economy than Brexit. So, so-called 'levelling up' is very important. I expect, eventually, the government will do more on this.

Q: What measures do you expect the government to take, or that they should take, to aid the 'levelling up'?

A: On 'levelling up', they already announced - it got no attention - an important change for infrastructure investing spending approval procedures, in the so-called Green Book. This was in the late Autumn spending review. From now on, they will analyse projects more on their productivity boosting potential rather than value for money, which is the approach that dominated for decades, and added to the circular benefits of successful locations with a lot of people, but penalised the opposite. They will pursue more devolution, giving greater powers to metro urban areas, and give them more monies to invest locally. It is much more important.

Q: Do you see this as enough to compensate for the losses that will come from Brexit?

A: If they get it right -- a big IF -- yes, it is more than enough. I will give you an example. The worst of all independent estimates about the consequences of a no deal Brexit was for a -11% GDP hit over 15 years. From 2008-2020, 12 years, the undershoot to previous trend productivity was close to 2% per annum, so over 20%. Much worse than the Brexit hit. So successfully boosting productivity is crucial for the UK, especially for many unproductive regions.

Q: Where do you see UK GDP over the long-term, say in 10 years, compared to where they would have been if Brexit had never happened?

A: Not simple to answer. If nothing else changed, perhaps a hit of 0.1%-0.2% to UK growth trend. But if 'levelling up' succeeded, and UK regions productivity were to rise to levels of London, this would more than offset. Altogether, because UK has reasonable demographics, UK could grow 2% per annum still, over the long term -- more than the EU average. It makes UK assets interesting. Because if it is true, then the UK equity market and, still to some degree, the pound are cheap. But a lot obviously rides on 'levelling up'.

Q: With that in mind, what's your outlook on UK markets and the sterling?

A: Because of these ideas, I have been quite bullish for the pound since many months ago. I think we will rally more to 1.38 (vs. U.S. dollar), and if we can get above that area, a good chance the pound will rise to 1.45. I couldn't see it permanently above 1.50.

Against the euro I would also anticipate some rise, but more modest.

Q: Looking at the other side, how do you think the EU comes out of Brexit? Would you say the EU actually become tougher and resilient?

A: I think the EU losing the UK, in itself, is a negative. It makes the EU 20% smaller, or close to it. And it makes it harder for the EU to pursue competitiveness and productivity enhancing initiatives, it will add to its tendency to protect rather than compete. It will, of course, make life easier for the negotiators without the UK, and give France more influence, especially with the end of Merkel's reign. So, it might become tougher, but less resilient and economically weaker. The EU is now more dominated by countries with poor demographics and low growth potential. Both Italy and Germany have poor long-term demographics, as does virtually all the Eastern bloc.

Q: So, the Union will go beyond pandemic solidarity? Do you see a real risk others will now view exiting as doable, or has the torture of the past four years of tedious negotiations and political upheaval been enough to deter anyone else?

A: I think the risk of others leaving is, currently, low. But if the UK were to persistently do better, I would imagine, unless this causes more genuine reform in the EU, others would get more tempted. The government will unveil the "new, Global Britain" in coming weeks, perhaps ahead of its hosting of the G7.

Q: What significant differences will Brexit make to economic policymaking, in terms of trade, migration, and also fiscal and taxation policy?

A: The Johnson government is torn, between traditional market values and interventionism. And global Britain will see this contradiction repeatedly. The UK will still try to attract skilled migrants from all over the world.

On fiscal policy, it will try to keep an easy policy for as long as the markets will let it get away with -- which I share as being sensible. I have been trying to persuade HMT to consider shifting from inflation-targeting to nominal GDP (NGDP) targeting in this regard -- I quickly add, with no success yet! I think it is time to shift away from simple inflation targeting, as the Fed has started to do.

Q: How do you see BoE monetary policy and exchange rate policy impacted over time? May be more active FX management like Switzerland? Or any other models you see coming up?

A: I don't believe the UK should engage in active FX management. I think if they adopted NGDP-targeting, this would be big enough. I think, especially with the politics of inequality, tax challenges and fiscal deficits, boosting NGDP would seem unescapably attractive.

The euro area should do the same -- but little chance of that!

Q: Do you see the independence of the BoE coming under pressure at any point hereon, especially as time to normalise approaches?

A: I think, it is unlikely, in any formal way. But informally, I think the pressure on the Bank to consider broader issues, is likely to remain, and if the economy stays weak, grow.

Q: Do you then see BoE giving in and altering its monetary policy and get into exchange rate management?

A: No, I do not see them getting into exchange rate management. Wouldn't serve any purpose for the UK.

Q: A follow-up to NGDP-targeting -- is that seriously under consideration? Is there a timeline to it?

A: I think HMT officials are against NGDP and would argue, in practise, it can be followed under the current regime in effect. But I believe some people in/around government think NGDP targeting is sensible and will push for it.