

Japan's demand for 'seamless Brexit' is a timely warning against hubris



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5 SEPTEMBER 2016 • 6:35PM

Britain is likely to scrape by without any economic contraction this quarter and seems almost certain to avoid a recession this year. Few could have hoped that the immediate Brexit squall would blow over so quickly.

The record one-month jump in services activity in August clinches a spate of remarkably resilient figures, more or less neutralizing the cascade of crashing indexes in July.

Markit's combined gauge of services and manufacturing is back up to 53.6. This is higher than it was before the referendum vote, and higher than it is currently in the eurozone, where Schadenfreude has proved short-lived. It is no longer implausible to suggest that the UK economy might outperform the eurozone this quarter, and nor should this be a great surprise.

The 12pc drop in sterling against the euro - compared to its trading range earlier this year – is a macro-economic stimulus for Britain. It is a form of macro-economic tightening for the eurozone, creating an extra headwind as it struggles to break out of a deflation trap.

Britain's short-term resilience is hard to square with warnings from the British Treasury in their benchmark 'shock scenario' before the vote: a severe recession, a 500,000 surge in unemployment comparable to Lehman crisis over two years, and a surge in Gilt yields – a set of claims dismissed at the time as sexing up the dossier by Nobel trade theorist Paul Krugman.

Yet caution is in order. We are in a 'Phoney War' phase, oddly like the seven-month lull from September 1939 to April 1940 when little seemed to be happening in Western Europe.

The proper test of Brexit will play out over several years, and exactly how it is executed will determine whether it is a success or failure. The new worry among City bankers is that hardliners in the Tory Party will succumb to hubris, seizing on the benign data so far to push for a very hard Brexit.

The Japanese foreign ministry fired a wake-up salvo over the weekend, releasing a 15-page document prepared by the "Hagiuda Task Force" on the implications of Brexit. It is a sobering reminder of what is at stake, all the more so since it comes from a friendly country with intimate economic ties.

"In light of the fact that a number of Japanese businesses, invited by the Government in some cases, have invested actively in the UK, which was seen to be a gateway to Europe, and have established value chains across Europe, we strongly request that the UK will consider this fact seriously and respond in a responsible manner," it said. Half all Japanese investment in the EU goes to Britain. The sunk costs are enormous.

The document lay out the demands in blunt terms. The current tariff rates and customs clearance procedures must be maintained, along with guarantees to prevent multiple sets of charges as components move back and forth across the Channel in a complex, interlocking supply chain. Failure to do so would render the existing model for the Japanese car industry in the UK almost unworkable.



Japan's Shinzo Abe meeting the Queen

It wants continuation of the 'single passport' system for financial services, and clearing of euro transactions in London. "If Japanese financial institutions are unable to maintain the single passport obtained in the UK ... they might have to relocate their operations from the UK to existing establishments in the EU," it said.

The task force insists on mutual recognition of 'Authorized Economic Operators', which could not occur if Britain fell back to the minimalist terms of the World Trade Organisation. If the UK fails to retain the European Medicines Agency, Japanese pharmaceutical companies might shift research and investment to mainland Europe.

It wants guaranteed “access” for EU and UK nationals to work in each other’s country, which is not the same thing as free movement of labour or benefit rights. While the paper stresses that Japan “respects the will of the British people”, it cleaves to the status quo. “The message is essentially that nothing should really change,” said Raoul Ruparel from Open Europe.

The wish-list could perhaps be achieved through a halfway house such as entry into the European Economic Area, the ‘Norwegian model’. It is totally incompatible with the hardline demands of the Brexit triumvirate.

The task force paper is probably music to the ears of 10 and 11 Downing Street, and its release during the G20 summit may have been co-ordinated. It strengthens Theresa May’s hand as she tries to steer through treacherous waters, and pushes within the cabinet for a compromise soft Brexit - or a “seamless Brexit” as Tokyo calls it.

Japan’s demarche should not be read as a threat to Britain. The document is equally addressed to the EU, making it clear that the EU’s own credibility is on the line and that any attempt to ‘punish’ Britain would be intolerable.

It urges the EU to recognize that Britain cannot on its own deliver these terms, and that EU officials must “heed the voices of Japanese businesses to the fullest extent and to do their utmost to cooperate in taking the necessary measures to advance the Brexit negotiations,” it said.

The thrust is clear. A vast economic structure has been built over the decades on the assumption of unrestricted trade and financial transactions between Britain and Europe, and “drastic changes” would be morally unjustifiable. Since it is the EU that is threatening to put up commercial barriers – not Britain – much of paper is directed squarely at Brussels, Berlin, and Paris.

A new post-referendum order is emerging in the world. The US has subtly pivoted. It is no longer warning of Armageddon for Britain, switching instead on how best to ensure that the UK’s withdrawal from the EU is the least destructive possible.

“We’re going to do everything we can to make sure that the consequences of the decision don’t end up unraveling what is already a very strong and robust economic relationship,” said President Barack Obama at the G20. Washington’s enormous power will increasingly be brought to bear on the Europe just as much as it is being brought to bear on Britain, an equivalence that was lacking during the Brexit campaign.

The late summer rebound in the UK is a welcome reprieve but it means little. The health of the British economy will be determined by investment decisions stretching out over ten to fifteen years, and many of these will be taken by powerful interests in Asia and the US. Japan’s polite but unprecedented intervention is a diplomatic cannon shot.

