Brexit: Five thoughts as decision time looms

We think a UK-EU trade deal narrowly remains the most likely outcome of talks, but time is not on anyone's side. A deal would unlock some modest upside for sterling, but a lack of risk premium means there is potential for plenty more downside should talks end without an agreement

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.

Author

James Smith
Developed Markets Economist, UK
james.smith@ing.com

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