Four questions following the latest Brexit breakthrough

After months of bumpy discussions, negotiators have reached an agreement on a post-Brexit transition period. But will it be long enough for businesses to adjust, and what happens next?

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1 What has been agreed?

Following lengthy negotiations over the weekend, Michel Barnier and David Davis announced on Monday that both sides have finally reached an agreement on a post-Brexit transition period. The deal, which will be formally agreed at the EU leaders summit later this week, will create a period of time from the end of March 2019 (when the UK formally leaves the EU) until December 2020 where the UK's relationship with Europe will remain virtually unchanged. This will allow for the completion of talks on the final Brexit deal, as well as giving businesses time to adjust.

During this time, both sides have agreed that citizens "who arrive in the UK during the transition period will have the same rights as those arriving before". And in what appears to be a win for the government, the UK will be able to negotiate trade deals with non-EU countries during the transition (to come into effect afterwards). UK ministers have often cited the ability to sign third-country trade deals as a key advantage of Brexit.

But in what appears to be a fairly big concession on the UK's part, both sides have agreed the need for a 'legal backstop' option should the final Brexit deal fail to address concerns over the Irish border. This would effectively keep Northern Ireland within a customs union, which has previously raised concerns in the Democratic Unionist Party (DUP) over barriers to trade within the UK's internal market. Theresa May said herself only a couple of weeks ago that "no UK prime minister could ever agree" to such a backstop.

It's worth remembering that technically none of this is legally binding until the full withdrawal agreement is ratified later in the article 50 process. But the strong commitment this deal brings will remove a fairly big layer of uncertainty for firms, and should be enough to discourage firms from enacting contingency plans for a no deal 'cliff edge'. What's less clear, however, is quite how much investment will be unlocked as a result of the agreement, particularly as there are still several question marks hanging over the ultimate Brexit deal.

2 Will a 21-month transition be long enough?

Perhaps not. According to EU negotiators, the goal is to agree on a high-level political declaration on the future relationship before the UK formally leaves in March next year, leaving the finer details to be thrashed out during the transition period. As Michel Barnier said himself at the press conference, that's a "short period of time to do so". Remember the EU-Canada deal took seven years to agree and sign-off.

But even if a deal can be swiftly negotiated, that still begs the question of whether there will be enough time for businesses and government departments to adjust. For businesses, many of whom rely on supply chains that see goods move multiple times between the UK and EU before hitting the single market, it will take time to re-orchestrate operations.

For the government, logistics will be an important factor. Is there enough time to train new border staff? David Davis has previously said between 3000 and 5000 new staff will be needed. It will also take time to develop new IT processes, as well as physical customs infrastructure.

3 Could the transition period be extended?

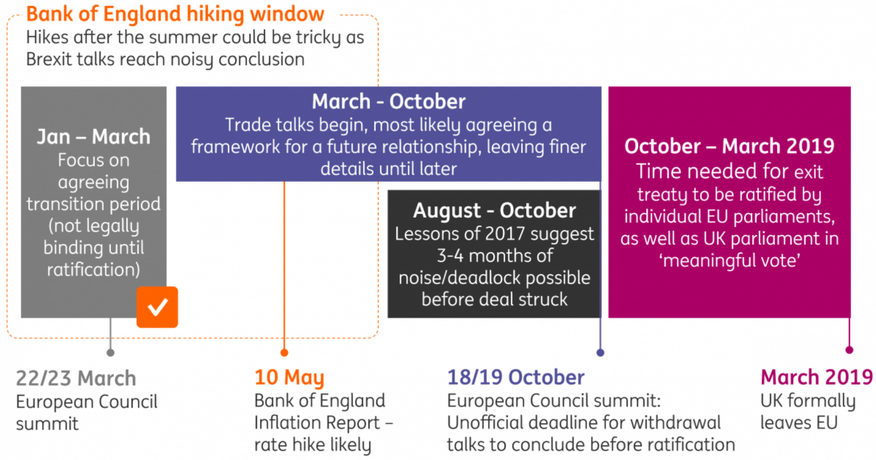
Possibly. Whilst there are economic and practical arguments that suggest a longer transition may be necessary, the current timeframe largely reflects political factors. From the EU's perspective, the decision to end the transition in December 2020 coincides with the end of the current budget period.

A longer transition would almost certainly require the UK to contribute to the EU budget after 2020, something that would be politically challenging for the UK government to accept at this stage. It's also worth bearing in mind that the next UK election is scheduled for 2022, and a longer transition could leave the government vulnerable to suggestions it hasn't brought the UK entirely out of the EU.

From Monday's agreement however, it's not immediately clear whether the EU would ultimately be open to an extended transition period. European Officials initially floated the possibility of a transition lasting as long as three years, earlier on in the negotiations. But in the latest deal, there is reportedly no legal wording that would leave the door open to a possible extension – something which, according to the FT, the UK had been pushing for over recent days.

That said, if negotiations were to take longer than expected, it is unlikely that governments on either side of the debate would be too keen on walking away and triggering a possible "cliff edge" Brexit in 2020, given the threat to the economy and jobs (and having worked hard to avoid such an outcome this time around).

The 2018 Brexit timetable



Source: European Commission, ING

4 What comes next?

Now that a transition has been agreed, the immediate focus will turn to finding a practical solution to avoiding a hard border with Ireland. As we noted last week, neither of the potential options put forward by Theresa May earlier this month (new technology or a 'customs partnership') appear to have alleviated concerns in Brussels and Dublin.

Away from the negotiations, markets will also be paying close attention to the Bank of England when it meets this Thursday. In principle, the agreement on the transition period bolsters the Bank's assumption that the adjustment to the post-Brexit world will be "smooth". That, combined with the stronger momentum we've seen in wage growth over recent months, makes it all the more likely that policymakers will hike rates in May. We may see the Bank make subtle hints at this in its statement this week, perhaps by echoing some of its language from December that the latest progress is "likely to support household and corporate confidence".

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