

## Latest UK-EU deal no game changer for sterling

The global risk environment and a potential narrowing in UK-Eurozone interest rate differentials are likely to prove more important drivers of sterling than the new UK-EU deal. Our preference is for EUR/GBP to find support in the 0.87/0.88 area and end the year closer to 0.89/0.90



Britain's Prime Minister Rishi Sunak and European Commission President Ursula von der Leyen have reached a deal on Northern Ireland's trading arrangements

### Windsor Framework makes life easier for businesses trading with Northern Ireland

The UK and EU have, at last, agreed a deal that makes life easier for firms trading between Great Britain and Northern Ireland (NI).

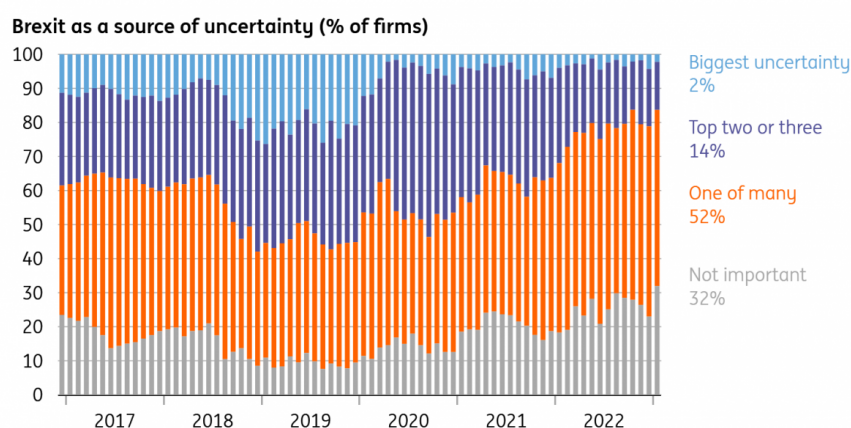
Recall a key objective of the original Brexit deal, signed in 2019 by then-Prime Minister Boris Johnson, was to keep an open border within the island of Ireland. The solution effectively kept NI in the EU's single market for goods, thus necessitating customs and agri-food paperwork on shipments moving across the Irish Sea from the British mainland.

The new "Windsor Framework" agreed this week is designed to ease many of the major frictions that have arisen as a result of that original deal. The new framework introduces trusted trader schemes and green/red lanes at ports, while dealing with specific contentious issues like chilled

meat exports – effectively making permanent various grace periods that had been successively extended since 2021.

But while all of this is undoubtedly a welcome move – and underscores a healthier relationship between London and Brussels – the economic impact is likely to be negligible for the UK economy as a whole.

## Brexit is no longer a key uncertainty for businesses



Source: Bank of England

## New agreement doesn't improve trade terms between the wider UK and EU - nor is it likely to boost investment

In part, that's simply because Northern Ireland makes up only around 2% of UK economic output, and if anything Northern Irish economic growth has been more rapid than the UK as a whole over recent years. There's no compelling evidence that issues surrounding the NI protocol have negatively impacted overall UK activity.

Instead, we need to be asking two questions:

Firstly, will the Windsor Framework herald a wider improvement in UK-EU trade relations? If nothing else, it effectively removes the tail risk of the EU suspending the overall free-trade agreement, something that had been a remote possibility when relations had soured under previous UK leaders. Healthier relations also open the door to future deals in other areas, and indeed this week's deal opens the door to the UK re-entering Horizon, the EU's science programme.

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*The reality is that Brexit is no longer a key source of uncertainty among businesses*

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But such mini-deals are unlikely to make material differences to the overall trading environment between the UK and EU. There's little prospect of the UK re-entering the single market or customs union, and the result of the next election (due by January 2025) is unlikely to change that. Labour, which is currently leading the polls, is signalling it is unlikely to seek wholesale changes from

Brussels.

The additional trading barriers brought about by the UK-EU free trade agreement were a contributing factor to UK export underperformance through the pandemic. Britain missed out on the recovery in world trade in 2020/21, though admittedly the data has looked a bit brighter recently, thanks to strong services exports through last year.

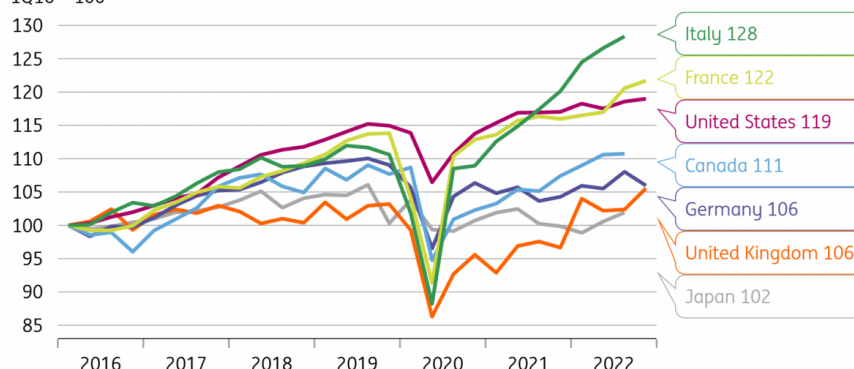
The second question we need to ask is whether the new agreement will boost investment. Brexit uncertainty has undoubtedly contributed to the underperformance of UK investment since the 2016 referendum. The level of non-residential investment has noticeably undershot the US, Italy and France (though less so Germany).

While greater clarity on EU relations is helpful, the reality is that Brexit is no longer a key source of uncertainty among businesses. Where half of firms saw Brexit as a top-three source of uncertainty back in 2019, it's now just one in six, according to Bank of England survey data (chart above). Instead, it's the wider economic environment - and outlook for energy prices - that will be the key driver of investment over coming quarters. Investment intentions bounced in late 2021 post-pandemic, but have since fallen back.

## The UK has underperformed on investment

**Gross Fixed Capital Formation excl. dwellings**

1Q16 = 100



Source: Macrobond, ING calculations

Calculated using OECD National Accounts data, and excluding dwellings investment from total gross capital formation

## GBP: Welcome news, but not a game changer

Sterling has been doing a little better over the last few sessions and has appreciated around 0.7% against the euro – its key benchmark in Europe. The sterling move has been slightly larger against the dollar, though here GBP/USD looks to be riding on the back of a stronger EUR/USD after today's release of the high Spanish and French February inflation data.

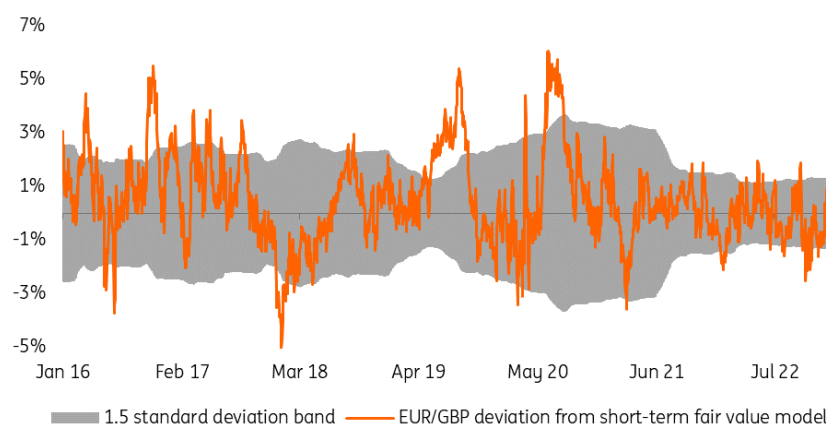
As above, James outlines that this Windsor Agreement looks unlikely to deliver a step-change in UK growth prospects. The question is, however, whether the prospect of improved political relations with Brussels reduces some kind of hard Brexit risk premium embedded into the pound.

Trying to put a number on a risk premium in FX markets is always difficult. In the past, we have used our Financial Fair Value (FFV) models to try and work out where FX pairs should be trading on

historic relationships – and then identifying any aberrations as some kind of risk premium.

In this FFV model are market drivers like short-term rate differentials, relative and global equity performance and the shape of the yield curves. As our chart outlines below, there have been periods – like during Brexit deal discussions in 2019 and during the early stages of the pandemic – when GBP had traded with a 5% risk premium. In other words, EUR/GBP was trading 5% above the levels suggested by the FFV model.

## ING's EUR/GBP financial fair value estimate



Source: ING

However, more recently EUR/GBP has been trading in line with short-term financial variables and suggesting the tail risk of a hard Brexit (i.e. a complete break-down in the post-Brexit UK-EU trading relationship) has not really featured in sterling. This suggests that this new agreement need not necessitate a significant sterling rally.

Instead, we expect sterling this year to be driven by a combination of relative growth/monetary prospects and the overall risk environment. This latter factor remains an important driver of sterling given the UK's large twin deficits and the relatively large size of the financial sector in the UK economy.

What's the view? It seems pretty clear that eurozone and UK interest rate differentials are going to narrow as the European Central Bank plays catch-up with the prior Bank of England tightening cycle. At the same time, the global risk environment remains tentative as sticky inflation forces central banks to tighten into recessions.

Our preference is for EUR/GBP to find support in the 0.87/0.88 area and end the year closer to 0.89/0.90. GBP/USD is a different story, where we continue to look for some Federal Reserve easing by the end of the year and a weaker dollar. Our baseline view assumes that GBP/USD finds support under 1.20 in this first quarter and manages to trade in a 1.25-1.30 range by year-end.

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