Sterling could rise 5% on long Brexit extension

With just weeks to go before the UK is due to leave the European Union, speculation is mounting that more time will be needed to reach an agreement. But what would an extension of Article 50 mean for sterling and the UK economy?

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	Shorter extension e.g. 2-3 months	Longer extension e.g. 9-12 months (or longer)
Pros	+ More politically acceptable in the UK + Suitable if deal agreed by March and some extra time needed to get legislation through parliament + Avoids headaches surrounding European elections	+ More realistic time to find solution + Big year for Brussels (finalising budget/filling top positions) so kicking the can further could make Brexit less of a distraction for the EU in short-term
Cons	- If a deal isn't found quickly, it could create problems if UK has no MEPs. An A50 extension beyond July could therefore open door to legal challenges - Are two to three months enough time to find a solution?	- UK would need to stage European parliament elections, which could be politically awkward in Britain
UK economy	Assuming a deal is not in place before an extension begins, a 2-3 month delay would keep the 'no deal' risk alive. While it's possible the Article 50 period could be extended again, firms will be aware that each time this happens, the risk of the EU saying 'no' will grow. For businesses, a series of small extensions would also mean they are theoretically never more than 3-4 months away from 'no deal', which will increasingly take it's toll on investment. For similar reasons, consumer confidence would likely stay under pressure (currently at a post-2013 low). Individuals are likely to remain wary when it comes to big-ticket purchases and may opt to maintain savings, despite a better fundamental backdrop for consumers.	A longer extension would provide more reprieve for businesses, which may unlock some hiring & capital spending (particularly with a short investment horizon). However, having come to the cliff edge once, it's possible firms will use the extra time to insulate themselves from another 'no deal' scenario. The reason for extending Article 50 will matter a lot – e.g. a second referendum would take time to arrange and prolong uncertainty, but a lot would depend on whether 'no deal' was an option on the ballot paper. Either way, with the imminent 'no deal' threat off the table (at least temporarily), consumer spending may modestly recover. After all, the fundamental backdrop is improving: the jobs market has been resilient, helping to lift wage growth, while inflation has eased off.
Bank of England	If a deal is agreed and the UK leaves the EU after only a short delay, then a rate hike could come back into play. Given the likely near-term hit to growth, August may be too early, but if wage growth continues to perform strongly, a November rate rise is possible. However if the deadlock continues and Article 50 is extended again (maybe more than once), we think the chances of a rate hike this year would fade - particularly given the BoE's recent downgrade to its 2019 growth projections.	A Brexit delay to the end of the year or beyond may tempt policymakers to hike rates over the summer. The BoE has signalled it would like to gradually tighten policy further, with the economy operating with little or no spare capacity. However, this relies on the economy regaining momentum through the second quarter. If it doesn't, then it's equally possible that a long extension to Article 50 could result in a prolonged pause at the Bank of England.
Markets	Trade-weighted GBP is just over 3% higher this year, suggesting that some of January's Brexit optimism is still in the price. While a short delay in Article 50 could generate a temporary 1-2% rally in GBP (e.g. EUR/GBP to 0.85, GBP/USD to 1.33), the return of 'no-deal' fears in a few months could see gains quickly evaporate. The UK money market curve has flattened some 10-12bp from the highs seen in mid to late January. 5-10bp could go back into the curve on a short delay. However, little clarity over whether the BoE would have a window to hike would limit the steepening.	GBP rallied to the best levels of the year in January, when the Cooper-Boles amendment held out the prospect of a long delay (and even a route to a second referendum). Confirmation of a 9-12 month delay, buying time for alternative policy paths, could trigger 4-5% GBP gains (EUR/GBP to 0.83, GBP/USD to 1.36). October was the last time the UK money market curve felt confident in pricing in a 25bp BoE hike over the coming 12-months. A long delay and the scope for a BoE hike this August could see the curve steepen 25-30bp out to the two-year horizon.

Source: ING

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