

Brexit - What next?

After months of deadlock, there's finally some good news on Brexit. The European Council has voted to move negotiations on to start talking trade, but plenty of challenges still lie ahead. Here's where we expect the focus to turn next

In this bundle

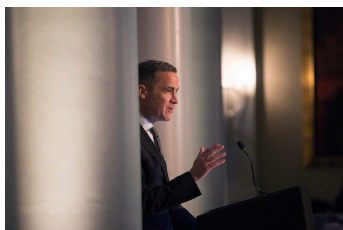


United Kingdom

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Source: iStockphoto

Progress at last

After months of deadlock, the EU and UK have finally reached a deal which allows the European Council to declare 'sufficient progress' to move onto trade talks. The UK has reportedly agreed to meet all of the financial commitments set out by the EU earlier this year. They have also accepted that the European Court of Justice will have a role to play in policing citizens rights, formally a big red line for the UK government.

But the big sticking point was the Irish border. The wording agreed earlier in the week, which committed to "no regulatory divergence" on the island of Ireland, raised fears within the Democratic Unionist Party (DUP) that this could weaken Northern Ireland's access to the UK internal market. But a series of additional commitments - including one that guarantees "unfettered access" for Northern Ireland to the overall UK market - appears to have reassured the DUP.

Now these 'divorce issues' are resolved, here are the seven things we'll be focusing on in 2018.

1 Is a transition deal now a given?

Almost. Now that the European Council has agreed 'sufficient progress' has been made, this should allow for a fairly swift agreement of a two or three year transition period after March 2019. There is increasing consensus that businesses need confirmation of this by March 2018 if they are to avoid enacting contingency plans for a 'cliff edge'. That should be possible, mainly because the more controversial elements of the transition - abiding by EU law and allowing free movement - have already been accepted by the UK. Equally, several legal matters also need to be resolved, so it may not be until later in the first quarter when the transition is agreed on paper.

Either way, the agreement of a transition would be a positive for the UK economy as it should help unlock at least some short/medium-term investment.

2 Will a two or three year transition period be long enough?

A big fear of Brexit-supporting ministers is that the transition period could lead to an indefinite period where the UK is neither in nor out of the EU. This is partly because the next election is scheduled for 2022, and an extended transition could leave the government vulnerable to suggestions it hasn't brought the UK entirely out of the EU.

But does this give firms enough time to adjust? The complexity of modern supply chains means many goods often travel multiple times between the UK and EU before being sold in the single market. The BMW Mini and pints of Guinness are good examples. These processes will take time (and money) to re-orchestrate.

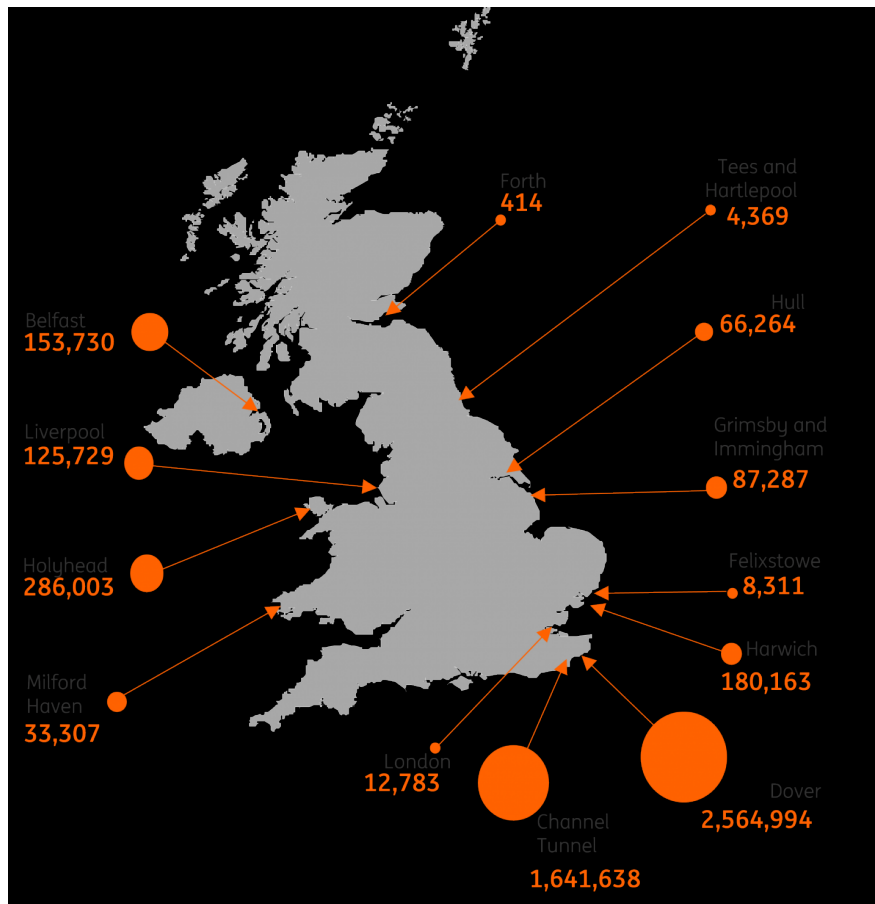
Logistics are also a big consideration. At Dover, less than 1% of lorries arriving and departing require checks^[1]. Given the sheer number of lorries that pass through, maintaining a frictionless border will be key. The British Freight Transport Association has said that adding even two minutes to the process could generate queues of up to 17-mile queues on the M20 motorway. Part of creating a fluid customs process will require new staff, but this too takes time. For instance, it takes three years to train a new customs official in Germany, and two years in France.

^[1] *Implementing Brexit: Customs* (Institute for Government report)

Of course, there is the potential for the transition period to be extended. If negotiations take longer than expected, it is unlikely that the UK government would walk away and trigger "cliff edge" Brexit having worked so hard to avoid it this time around.

While this may upset the most hardline of Brexiteers, the government compromises made so far suggest they are increasingly acknowledging the need to minimise the threats to the economy and jobs.

Lorry traffic at selected UK ports (no. of lorries)



Source: Institute for Government, Department for Transport

3 Will there eventually be a deal?

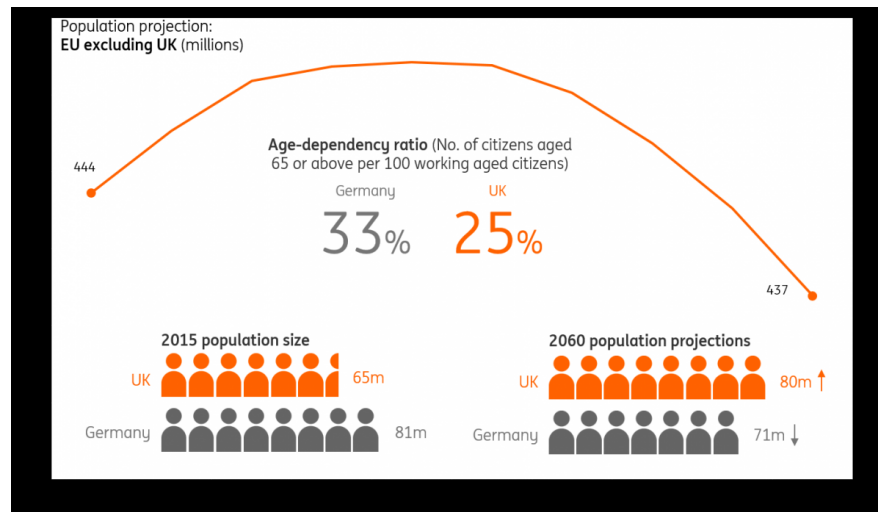
Given the volume of trade done between the UK and the EU, the impacted supply chains, the millions of jobs and tax revenues, a deal makes sense for both sides.

The UK position has already softened on the divorce bill and the role of the European Courts of Justice and it seems as though they are also edging back from the "no deal is better than a bad deal" scenario. The EU is also recognising the importance of getting a positive agreement for both sides by acknowledging the need for a transitional period. Nonetheless, the actual trade discussions will be tough and protracted, but two factors argue in favour of a mutually beneficial deal.

Firstly, the worst case scenario of no deal and the adoption of World Trade Organisation Rules would introduce tariffs on trade. On average they amount to 2-3%, but a wide range of food products will be hit particularly hard. This could see upward pressure on prices and a further squeeze on spending power. But the key issue is the wide criteria. For example, the full US trade schedule contains 192,275 different lines of tariffs, which means companies can face tough choices on optimising their production processes if they have to import multiple different types of components. Dispute settlement also takes a long time - typically a year and up to 15 months if there is an appeal - a period during which trade can be heavily impacted.

The second reason that argues for a positive deal is demographics. The fact that birth rates have declined across the EU, means that Europe's population is set to fall over coming decades. However, in the UK the birth rate has increased in recent years, fuelled by immigration. Consequently, the EU predicts that the UK is set to overtake Germany as Western Europe's most population nation within the next 20 years. From the EU's perspective, having access to a growing market that is on its doorstep and is cheap to export to clearly makes sense, particularly when the domestic market is being squeezed.

Demographics give an extra incentive for a deal



Source: Eurostat, ING

4 When will the UK and EU agree a trade deal?

Now that some of the more thorny issues of the Brexit process are resolved, PM May will reportedly sit down with her cabinet over the coming weeks to try to agree on a "model" for the trading relationship by the spring to give businesses a better understanding of the direction of travel. After that, the UK government's official position is that it expects to strike a trade agreement before exiting in March 2019.

But taking off three to four months for ratification leaves less than a year to agree on a deal, which is a very short timeframe. So it's possible that at least some elements of the talks will continue into the transition period. One consequence of this is that, without a concrete idea of what trading environment the UK will actually be transitioning into in 2021 or 2022, companies are likely to remain cautious when it comes to longer-term investment even after a transition is announced. Until details emerge, this effectively means the 'cliff edge' risk is still present, albeit two or three years later. It's worth remembering too that, in the EU's words, "nothing is agreed until everything is agreed".

5 What will the trading arrangement look like?

'Imaginative', 'creative' and not 'off the shelf' were all phrases used by Prime Minister May in September to describe the bespoke trading arrangement she'd like to agree with the EU. The European Economic Area (EEA) option would require free movement (a big red line). The free-trade option, like the Canada-EU deal, would get around this by allowing the UK to control migration, and enable it to strike separate trade deals with other countries. But crucially, access to services

(including finance) is notoriously difficult to negotiate as part of free-trade deals. This is why David Davis is now talking about the need for a "Canada plus-plus-plus" arrangement that includes services, which accounts for more than 70% of the UK economy.

So can the UK agree on a half-way house? Well, clauses embedded in existing free-trade deals mean that whatever the EU offers the UK on services, it would also have to offer to other countries that it already has agreements with (Canada and South Korea for example). This means there is a reduced incentive for the EU to offer the UK a bespoke deal, which makes it more likely the UK will ultimately have to choose between the Canada-style free-trade agreement or the EEA.

6 Will Prime Minister Theresa May stay?

Since the general election in June, PM Theresa May's position is perceived to have weakened. This has led to questions over how long she can remain in office, particularly as opinion polls were suggesting the public is dissatisfied with the government's handling of Brexit.

The fact that the Prime Minister has been able to reach an agreement with the EU on 'sufficient progress', having navigated a delicate path within her own party and with the DUP, could help to repair this image. By and large, the government has also successfully avoided a large fallout over the politically-sensitive 'divorce bill', and the first opinion poll after the announcement of the deal has seen the Conservative's popularity bounce. They now have a narrow lead of one percentage point over Labour.

Nonetheless, PM May remains vulnerable, and a fresh leadership challenge in 2018 can't be fully ruled out should negotiations falter. We also have to recognise that there is always the potential for a by-election to be called as there are typically four to five a year. So given PM May's wafer-thin majority the government could still fall, paving the way for new elections.

7 Will the Bank of England hike again in 2018?

While the announcement of a transition deal should unlock some short-term business spending, there are still some Brexit 'ifs'. The jobs market is also showing early signs of faltering, which could limit the potential for a takeoff in wage growth next year. This will keep a lid on consumer spending, and in turn, overall 2018 growth.

Another rate increase is therefore not guaranteed, although policymakers have signalled they would be comfortable with a hike next year. A move in February or May certainly can't be ruled out, particularly if a transition is swiftly agreed.

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BoE keeps options open despite Brexit breakthrough

The Bank of England acknowledges recent progress in Brexit talks, but keeps its cards close to its chest on the possible timing of a future hike



Source: Bank of England

As the dust settles on the Bank of England's historic rate hike in November, the committee unanimously opted to keep policy unchanged this time. But the statement did come with some intriguing clues on the Bank's thoughts on Brexit.

Back in November, it caught a few people off-guard by saying there are "considerable risks to the outlook". This time, that phrase has disappeared and instead replaced by an acknowledgement of the recent positive steps made in the negotiations. Bank officials and Governor Carney, in particular, have been vocal about the importance of a transition period, and the latest set of minutes note that a swift announcement of this in the new year would "reduce the likelihood of a disorderly exit".

The question now is whether this is enough for the Bank to hike again in 2018. Well, both in this latest statement and back in November, the BoE effectively told markets that it would be comfortable with a follow-up hike next year. But we still think this is far from a done deal, at least for now.

We still think another rate hike is far from a done deal

While the announcement of a transition would help unlock some short/medium-term investment, there are still a number of "ifs". For example, it's not clear whether a 2-3 year transition will be long enough for some firms to adjust, given the complexity of many modern supply chains. And without a concrete idea of the trading environment the UK will transition into in 2021 or 2022, companies are likely to remain cautious when it comes to longer-term investment, even after a transition plan is announced.

Growth is also a key consideration. While the Bank has rationalised this year's sluggish momentum in the context of a lower economic 'speed limit', the persistent consumer slowdown will still require policymakers to tread carefully when tightening policy further.

Perhaps with all of this in mind, the Bank has kept its cards fairly close to its chest - and there were no hints that market rate expectations are too low nor that rates may need to rise over "coming months". In the minutes, policymakers noted they would perform a complete assessment of Brexit progress in February.

But if the Bank does intend to hike again in February, or more likely, May, then officials still have some work to do to get markets on the same page. With the first hike priced in for November, markets will keep a close eye on speeches and interviews as we head into 2018.

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GBP: Brexit Breakthrough

It looks like GBP is breathing a sigh of relief as Season 1 of 'Solving Brexit' comes to an end. But be sure to tune in again in January as the narrative turns to transition and trade



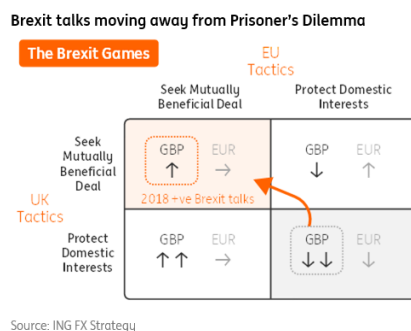
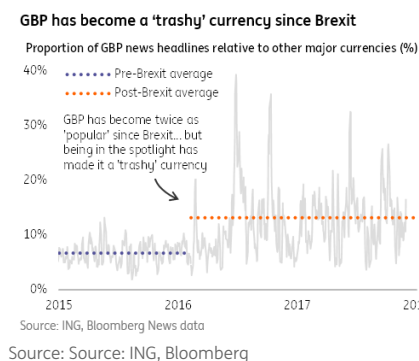
Source: iStock

Season 1 of 'Solving Brexit' ends on a high... as divorce deal is agreed

- In what is quickly turning into a reality TV show, the latest episode of 'Solving Brexit' has ended on a high for GBP, as a last-minute deal between Theresa May and the DUP on the Irish Border has enabled initial Brexit divorce proceedings to be wrapped up. In a joint statement with PM May in Brussels, the EU's Jean-Claude Juncker said that 'sufficient progress' has now been made – such that Brexit talks can move onto discussions over a future trade deal.
- While the divorce details will still need to be ratified by respective domestic politicians (EU leaders and the UK government), it looks as though this is now just a formality. While agreeing a 'divorce bill' has little economic significance for the price of GBP, the political significance of progress in Brexit talks is quite profound – not least as it reduces the tail risk of a 'no deal' scenario and a complete breakdown in negotiations.
- Our game theory application to Brexit negotiations is proving a handy framework for analysing the political risks to GBP. While much of 2017 has been marred by UK and EU

politicians playing 'hardball' with one another, the resolution of a Brexit divorce deal suggests the tide may be turning in a constructive direction. Politicians moving away from seeking to protect their own domestic interest (the Prisoner's Dilemma scenario) – and slowly moving towards a mutual agreement – is unambiguously positive for GBP.

- GBP is broadly higher on the news, although we may see some profit-taking as a reassessment of the Brexit political games looks to already be priced in. While the hard part (trade talks) is still to come – and a realisation of this may keep GBP/USD capped at 1.3550/1.3600 in the near-term (EUR/GBP around 0.8650/0.8700) – we do ultimately believe that there is more upside left in GBP over the next 3 months.

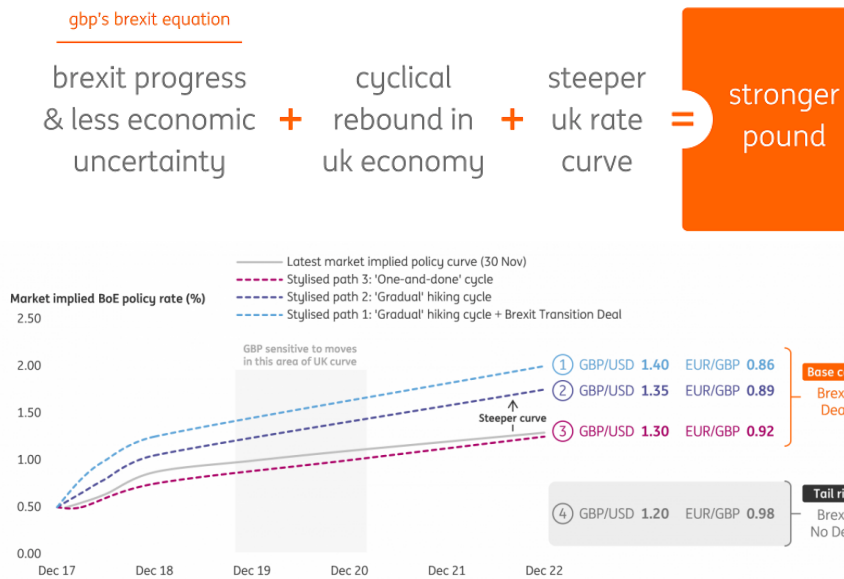


1.40

We look for GBP/USD to move up to 1.40 were a Brexit transition deal to be agreed in early 1Q18

Brexit transition deal is a weak GBP's antidote

- We believe that GBP markets are underestimating the cyclical economic benefits of a Brexit transition deal. Judging by GBP's rally since early November, a reassessment of the Brexit political games looks to already be underway.
- But we feel there is more upside to come – especially if a transition deal were to be signed, sealed and delivered in 1Q18. Our 'GBP Brexit Equation' (below) demonstrates the chain of logic here. With a range of indicators suggesting that the UK economy is at a standstill, a reduction in medium-term uncertainty may rekindle some of the 'animal spirits' among consumers and firms – and see more cash put back to work over the coming year. At a time when the BoE is in tightening mode, positive revisions to the UK growth outlook – and a subsequently steeper rate curve – could be a powerful pick-me-up for a weak pound.



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