Brexit – Half way there...

The outlook for the UK economy, negotiations and markets with one year to go

THINK Economic and Financial Analysis
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Brexit – Half way there

The outlook for the UK economy, negotiations and markets with one year to go

With one year to go until the UK formally leaves the EU, talks are entering the most difficult phase yet.

Negotiators have as little as six months to agree on a high level framework for future trade, allowing time for ratification by EU members.

> "Talks are entering the most difficult phase yet"

The UK has unveiled it's preferred model for trade, although it has been met with a cold reception by EU officials. Negotiators are fiercely opposed to the UK 'cherry-picking' elements of the single market.

Finding a workable solution for the Irish border is also a key concern. Failure to resolve this issue remains a big – if not the biggest – risk to agreeing a deal. So compromise will be key over the next six months.

We could see the UK stepping back from key red lines – a tough ask for Prime Minister May given the divisions within her government. A looming customs union vote in Parliament could be the next big test for the UK leader.

Still, we believe both sides need a positive Brexit deal. For Britain, almost half of exports go to the EU. And with the UK set to be Europe's youngest and most populous nation within 25 years, access for EU firms will become even more important than it is today.

> "We could see the UK stepping back from key red lines"

For businesses, the agreement of a transition period after Brexit lifts one big layer of uncertainty. But there is still a question of whether 21 months will be long enough for companies to adjust. The possibility of a 'cliff edge' in 2020 remains a tail-risk for firms.

This uncertainty, alongside ongoing consumer caution, is a key reason why we expect growth to struggle again through 2018. In principle this takes some of the heat off the Bank of England. But with wage growth on the rise, as well as global economic prospects improving, policymakers look set to hike rates again in May.

This, alongside the recent agreement of a transition deal, should continue to give the pound a lift. We see GBP/USD at 1.53 at the end of 2018.

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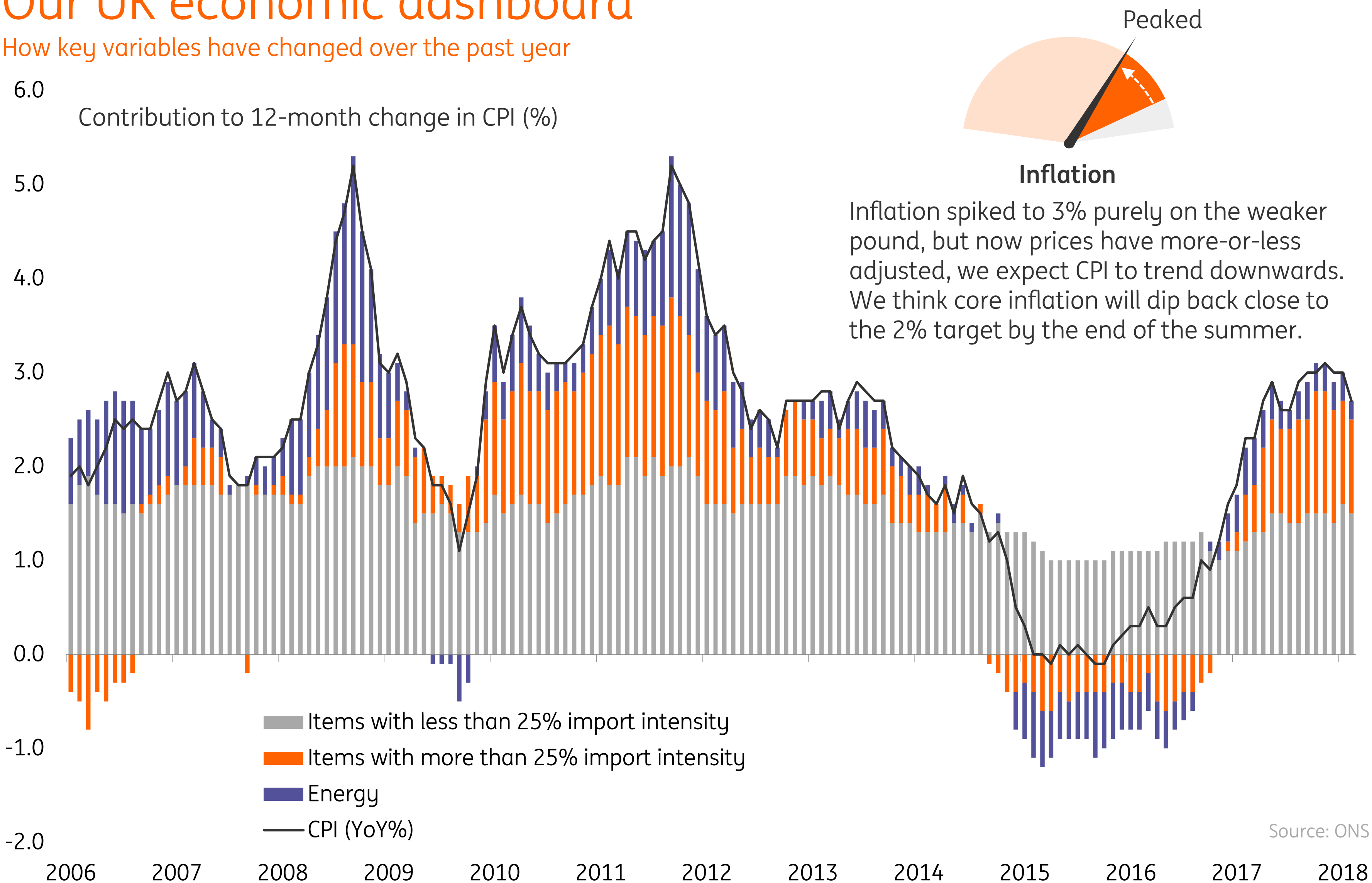
The economy

Light at the end of the tunnel?

Our UK economic dashboard

How key variables have changed over the past year

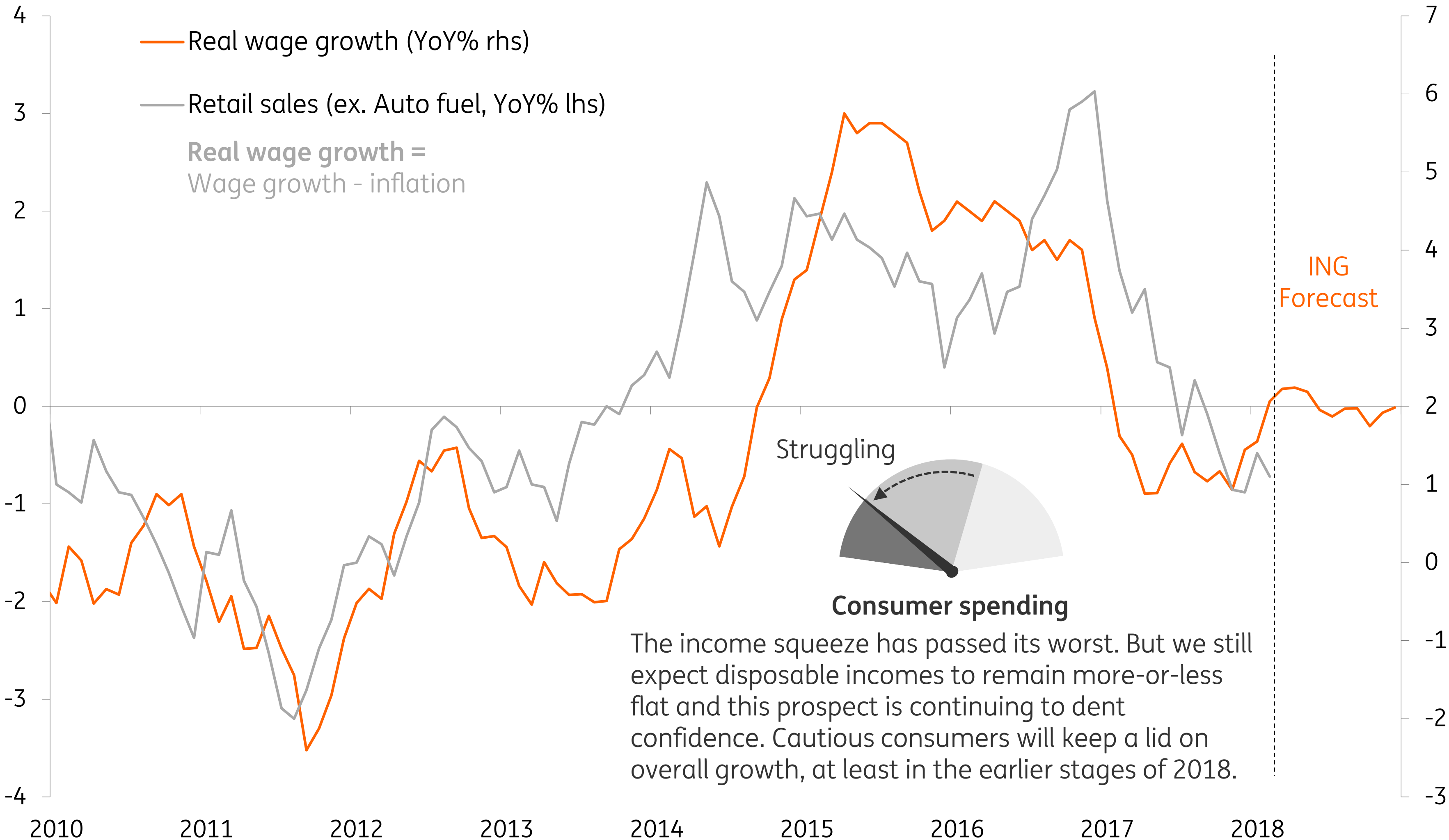


Inflation

Inflation spiked to 3% purely on the weaker pound, but now prices have more-or-less adjusted, we expect CPI to trend downwards. We think core inflation will dip back close to the 2% target by the end of the summer.

Our UK economic dashboard

How key variables have changed over the past year



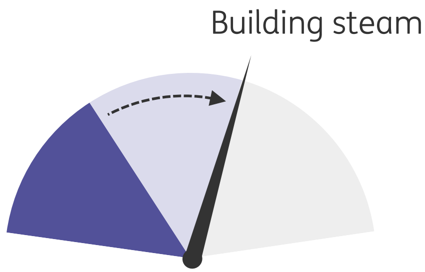
Consumer spending

The income squeeze has passed its worst. But we still expect disposable incomes to remain more-or-less flat and this prospect is continuing to dent confidence. Cautious consumers will keep a lid on overall growth, at least in the earlier stages of 2018.

Source: Macrobond, ING

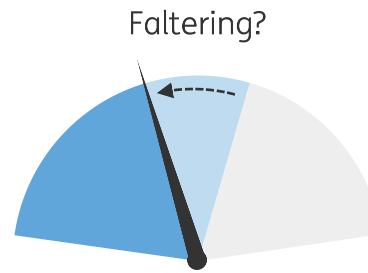
Our UK economic dashboard

How key variables have changed over the past year



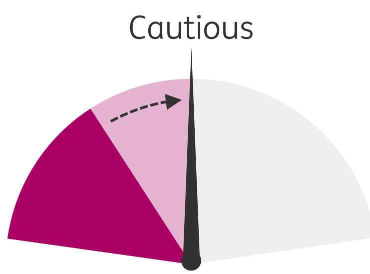
Wage growth

Firms appear under growing pressure to lift pay to retain/attract staff. It's early days, but there are more and more signs that pay is rising faster.



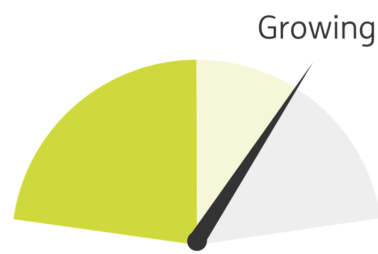
Hiring

There are tentative signs that the dip in hiring at the end of 2017 was only temporary, but if we're wrong, this could be a sizable economic risk in 2018.



Investment

Investment intentions have picked up off their lows, but with uncertainty over the final Brexit deal set to persist, we see few signs of an immediate pick-up.



Trade/manufacturing

Manufacturing has been a clear bright spot in the UK economy, with global growth and to some extent, the weaker pound, driving new orders

How does UK growth compare globally?

Given all the warnings of recession around the Brexit vote, you might say growth of 1.6% in 2018 ‘could be worse’.

But with global growth set for its best year since the financial crisis, **we think the UK economy should be growing almost twice as fast** – or at a similar pace to the US.

Consumers in Europe and the US are the most optimistic they’ve been since the early-2000s, while confidence in the UK remains close to multi-year lows.

ING 2018 Growth Forecasts

1.6%

2.4%

3.0%

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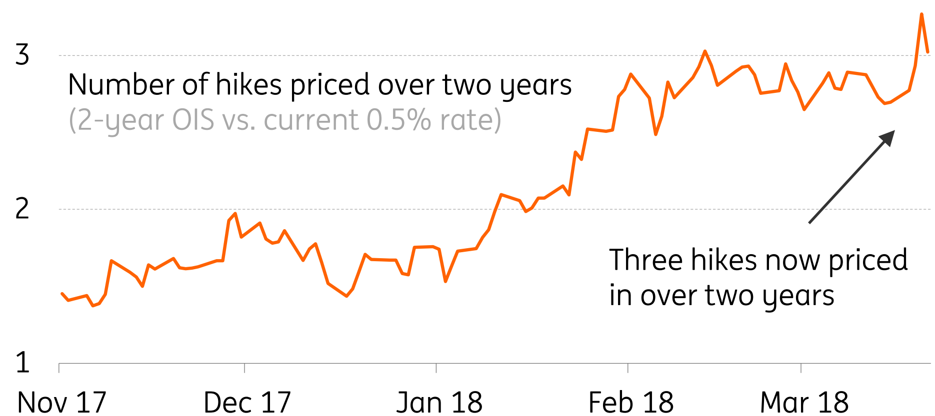
Carney's clipboard: A May rate hike looks increasingly likely

With the economy still struggling to get up to speed, and core inflation set to return fairly rapidly to target over the next few months, on the face of it there's less pressure on the Bank of England to tighten policy further.

But the Bank is increasingly focused on the better wage growth figures, as well as the latest Brexit progress.

We expect a rate hike in May, and markets are more-or-less on-board with this idea too.

But with Brexit talks set to reach a noisy conclusion later this year, a second 2018 rate hike may be a challenge.



Source: Bloomberg

But Brexit could scupper a second rate hike later this year

Bank of England hiking window
Hikes after the summer could be tricky as Brexit talks reach noisy conclusion

Jan – March
Focus on agreeing transition period in-principle (not legally binding until ratification)

March - October
Trade talks begin, most likely agreeing a framework for a future relationship, leaving finer details until later

August - October
Lessons of 2017 suggest 3-4 months of noise/deadlock before deal struck

October – March 2019
Time needed for exit treaty to be ratified by individual EU parliaments, as well as UK parliament in 'meaningful vote'

22/23 March
European Council summit: Agreement reached on transition period

10 May
Bank of England Inflation Report – most likely time for a hike

18/19 October
European Council summit: Unofficial deadline for withdrawal talks to conclude before ratification

March 2019
UK formally leaves EU

The Brexit deal

Now the real fun begins...

Progress check: Where the Brexit talks are up to...

Attention is turning to the vision for post-Brexit trade as well as a solution to the Irish border.

Divorce costs

Agreed

Both sides reached an agreement on the UK's post-Brexit financial liabilities in December 2017.

Transition period

Agreed

A transition period will keep the UK in the single market until December 2020 under an agreement reached in March.

Dispute resolution

More work

Both sides are still working on a plan for settling disputes during the transition, alongside the role of the European Courts of Justice after Brexit.

PM May's recent speech hinted at accepting ECJ verdicts in certain areas, blurring an earlier red line.

Brexit Deal

Early days

The UK has outlined its vision for trade, but it has been met with a cold reception in Brussels where cherry picking is a big concern.

Talks will continue over coming months, most likely looking to form a free-trade agreement. Realistically, negotiations could extend well into the transition period (and maybe even beyond).

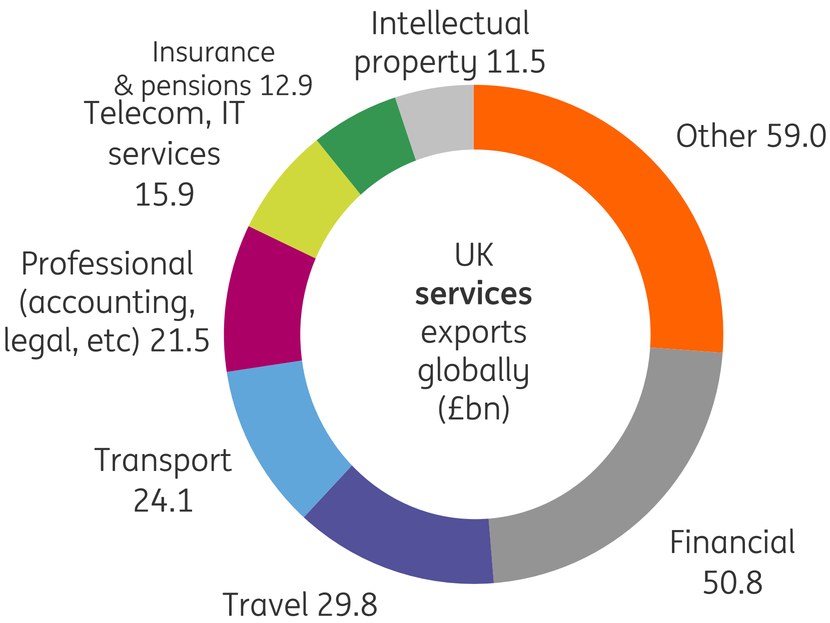
Irish border

More work

Both sides have agreed the need for a 'backstop' option should the overall Brexit deal fail to avoid a hard border.

But negotiations are no closer to reaching an agreement on a more optimal solution.

Reasons for optimism: Economic incentives for a deal

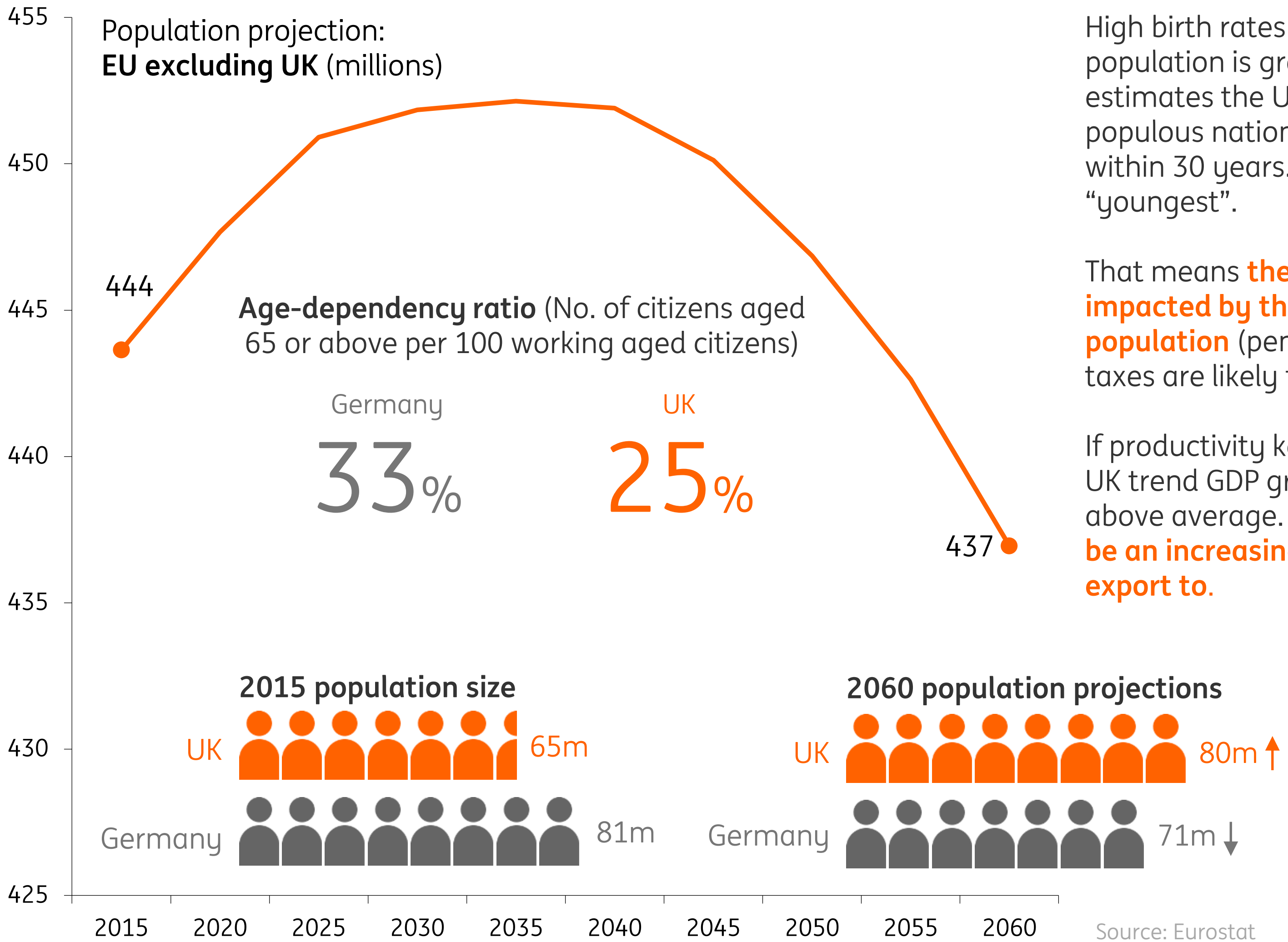


Source: ONS

The UK's ability to win trade deals with other countries is being seen as one of the benefits of Brexit. Certainly, exports to the EU have grown less quickly than exports to non-EU countries over the past decade.

But the UK still exports a quarter of a trillion pounds worth of goods and services to the EU, on which millions of jobs are dependent.

Reasons for optimism: Demographic incentives for a deal



High birth rates mean the UK's population is growing quickly. The EU estimates the UK will be the most populous nation in Western Europe within 30 years. It will also be one of its "youngest".

That means **the UK will be less impacted by the cost of an ageing population** (pensions & health) and taxes are likely to be structurally lower.

If productivity keeps pace with Europe, UK trend GDP growth should be well above average. **This means the UK will be an increasingly attractive market to export to.**

Source: Eurostat

“No deal” – is WTO really better than a bad deal?

What tariff applies to you? Examples from the USA WTO tariff schedule

MFN Applied Tariff						
of ...es	Average of AV Duties	Minimum AV Duty	Maximum AV Duty	Duty Free TL (%)	Number of Non-AV Duty	HS code description
	(9)	(10)	(11)	(12)	(13)	(18)
1	14.9	14.9	14.9	0.0	0	Woven fabrics containing predominantly, but < 85% artificial stapl
1	8.5	8.5	8.5	0.0	0	Woven fabrics containing predominantly, but < 85% artificial stapl
1	14.9	14.9	14.9	0.0	0	Woven fabrics containing predominantly, but < 85% artificial stapl
2	15.9	12	19.8	0.0	0	Woven fabrics containing predominantly, but < 85% artificial stapl
2	18.5	12	25	0.0	0	Woven fabrics containing predominantly, but < 85% artificial stapl
2	18.5	12	25	0.0	0	Woven fabrics containing predominantly, but < 85% artificial stapl
2	15.9	12	19.7	0.0	0	Woven fabrics containing predominantly, but < 85% artificial stapl
1	14.9	14.9	14.9	0.0	0	Woven fabrics containing predominantly, but < 85% artificial stapl
1	12.0	12	12	0.0	0	Woven fabrics containing predominantly, but < 85% artificial stapl
1	0.0	0	0	100.0	0	Woven fabrics containing predominantly, but < 85% artificial stapl
1	8.5	8.5	8.5	0.0	0	Woven fabrics containing predominantly, but < 85% artificial stapl
1	12.0	12	12	0.0	0	Woven fabrics containing predominantly, but < 85% artificial stapl
1	12.0	12	12	0.0	0	Woven fabrics containing predominantly, but < 85% artificial stapl
1	8.5	8.5	8.5	0.0	0	Woven fabrics containing predominantly, but < 85% artificial stapl
1	12.0	12	12	0.0	0	Woven fabrics containing predominantly, but < 85% artificial stapl

Source: WTO

14.9% Woven fabrics: < 85% artificial staple fibres, mixed principally/solely with **man-made filament, dyed**

0.0% Woven fabrics: < 85% artificial staple fibres, mixed principally/solely with **cotton, yarn of different colours**

8.5% Woven fabrics: < 85% artificial staple fibres, mixed principally/solely with **cotton, printed**

Navigating WTO tariffs is no easy task.
A download of the US “simple” spreadsheet, offering a fairly broad summary of tariffs, comes to 19,575 lines.

It also takes time
Dispute resolution takes time to resolve, complicating efforts of firms to get their goods to market

What is the UK asking for on Brexit?

Managed Divergence: How the "Three Baskets" approach would work

1 Full alignment

In the first basket, effectively nothing changes: The UK abides by EU rules – but the UK would retain the "right to diverge" in these areas in future.

Possible examples include aviation, manufacturing (to ensure frictionless supply chains) and medicine

3 Divergence

The final basket would involve different regulations and different goals. This would be where the UK would go it's own way completely in cases where it perceived EU rules to be burdensome.

Possible examples could include certain services and some forms of manufacturing (e.g. Hoovers)

2 Mutual recognition

Here, both sides would mutually recognize one another's rulebooks, enforced by a dispute resolution mechanism to maintain a level playing field. This would allow UK regulation to differ to the EU's, whilst achieving the same goals.

Possible examples include environmental standards and financial services

But the UK's proposals have been met with a cold reception

Key EU concerns

Cherry picking

This is perhaps the biggest concern – EU officials are adamant that the single market is indivisible. Under the UK's model, it would effectively remain in the single market in some sectors, and move out in others.

More leavers

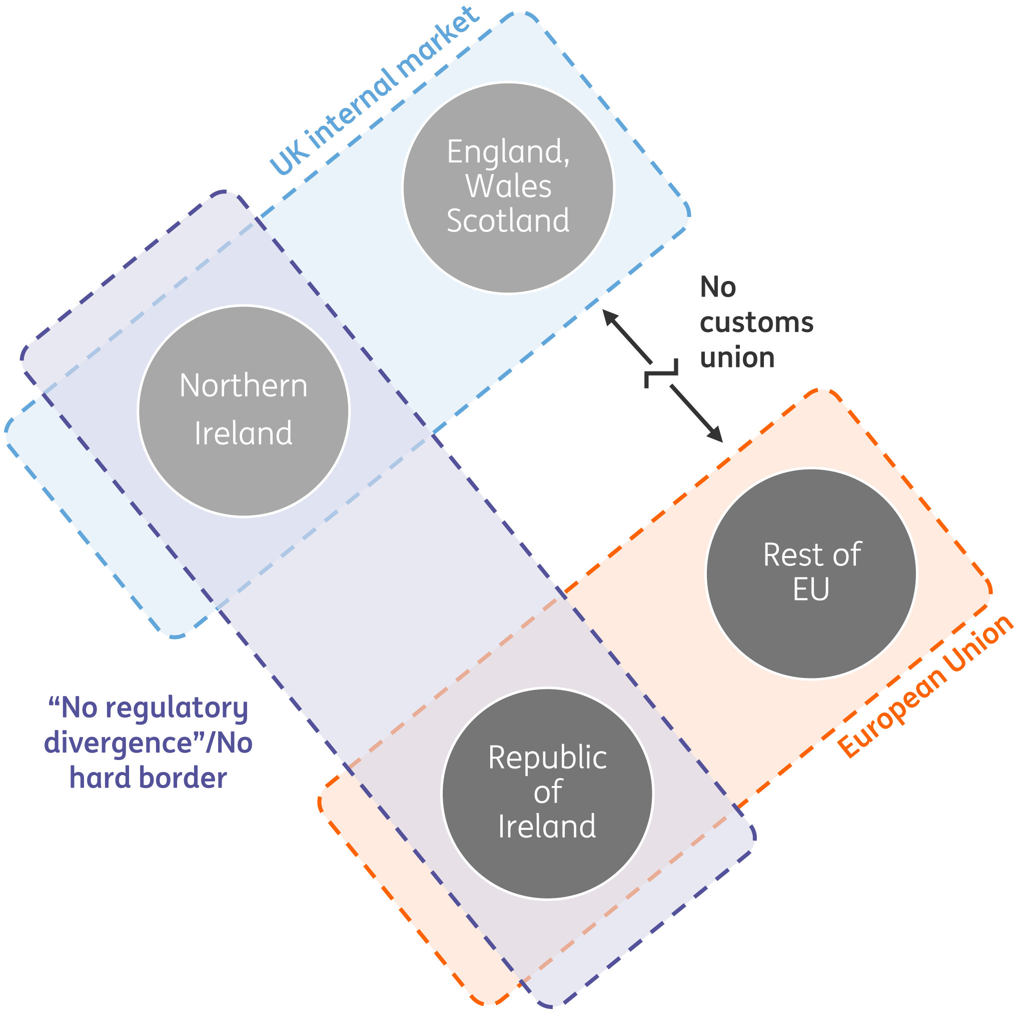
The EU fears that a deal that sees the UK thrive could embolden EEA members to demand concessions, or encourage more Eurosceptic nations to consider leaving the union.

Practical problems

With 28 countries in the negotiations, each with different industry interests, agreeing what economic sectors fall into each basket could be a logistical nightmare.

Squaring the circle: Can a hard Irish border be avoided?

The EU is seeking greater clarity on how border checks can be avoided when the UK leaves the customs union



The UK government has suggested two possible ways of avoiding a hard border with Ireland:

1) Technology (e.g. pre-customs notifications)

2) 'Customs partnership' (when a good ultimately destined for the EU arrives in the UK, EU rules/tariffs are applied – avoiding the need for additional checks at the UK/EU border)

Neither has been deemed suitable by EU negotiators, and talks will focus on this issue intensively over the next couple of months.

Could Blockchain be the answer?

Distributed ledger technology allows real time tracking of a good through the supply chain, reducing the need for paper work. It helps cut fraud and reduce transit times.

This could help reduce the need for manual checks at the border, easing pressure on infrastructure and congestion – although of course, this approach is largely unprecedented.

Brexit options: No choice ticks everyone's boxes

	UK Red Lines/Priorities				EU Red Lines	
	No Free Movement	Negotiate trade deals	Access for services	No ECJ jurisdiction	No "hard" Irish border	No cherry-picking
EEA (Norway option)	X	X	✓	X	✓	✓
Customs Union	✓	X	X	✓	✓	✓
Managed Divergence/ Three baskets	✓	✓	✓	?	X	X
Canada-style FTA (No "plus")	✓	✓	X	✓	X	✓

Prime Minister May's big test

The House of Commons will vote on customs union membership in what will be a big test for the government

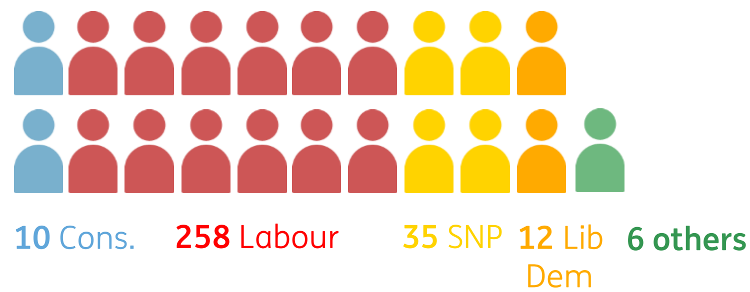
The UK government has been clear it wants to leave the customs union in order to pursue trade deals with non-EU countries.

But the opposition Labour Party has now made it official policy to remain in a customs union. There are reportedly a number of Conservative MPs who agree.

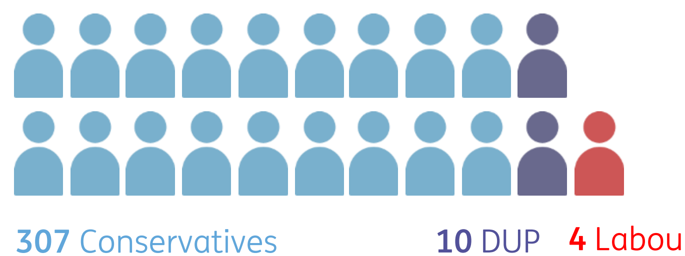
The issue will reach a tense conclusion when MPs vote on an amendment committing the UK to remain in a customs union. The vote has been pushed back by as much as two months, but when it happens, it could be very tight given the Conservative's slim majority in parliament.

A defeat would be a major (and potentially fatal) blow to Theresa May's leadership.

321 MPs **In favour** of keeping UK in customs union



321 MPs **Against** keeping UK in customs union



Sin Fein, the speaker and a vacancy means there are 8 non-votes

Source: Estimates by the FT as of 27 Feb 2018

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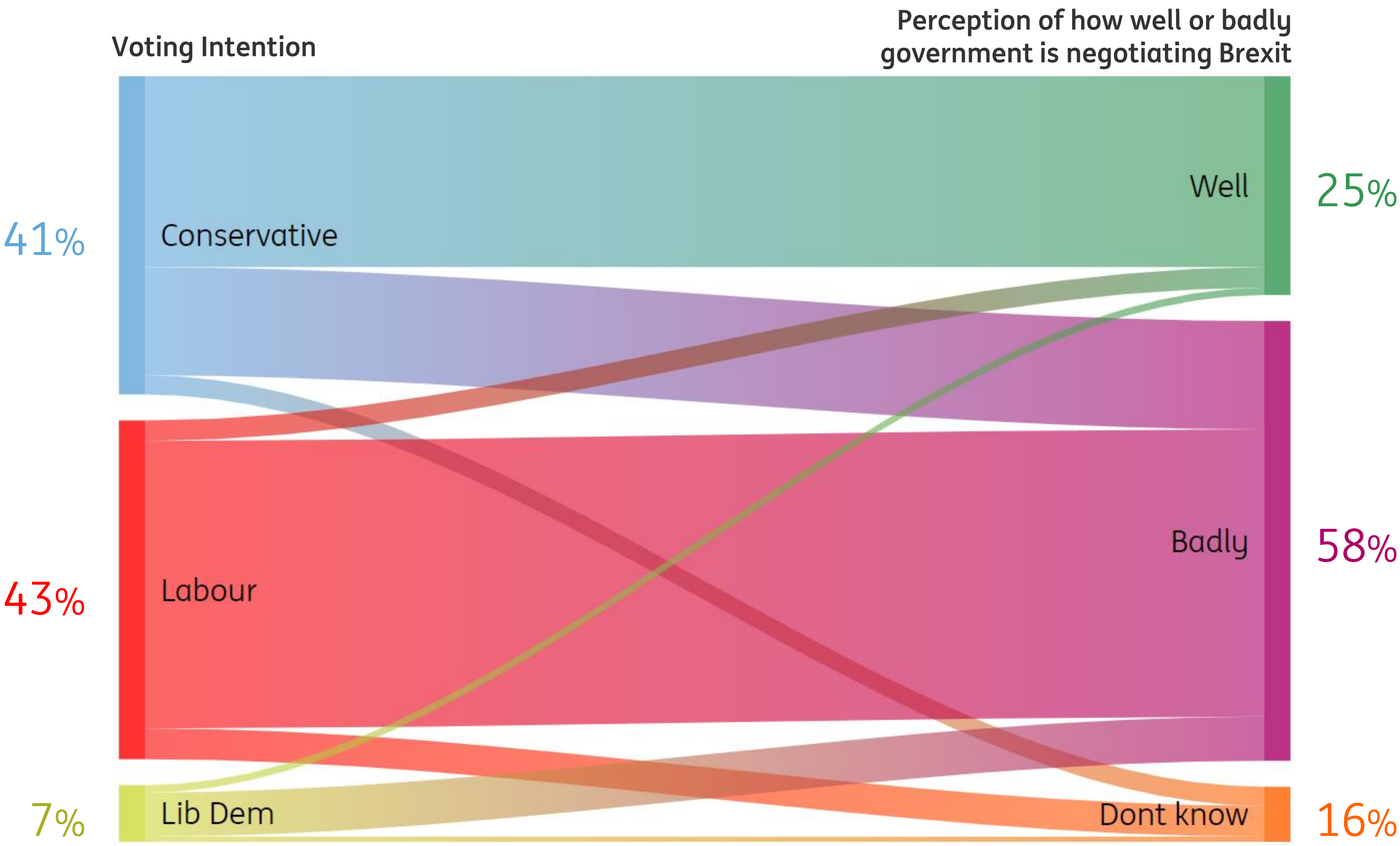
Public unimpressed by government's Brexit handling

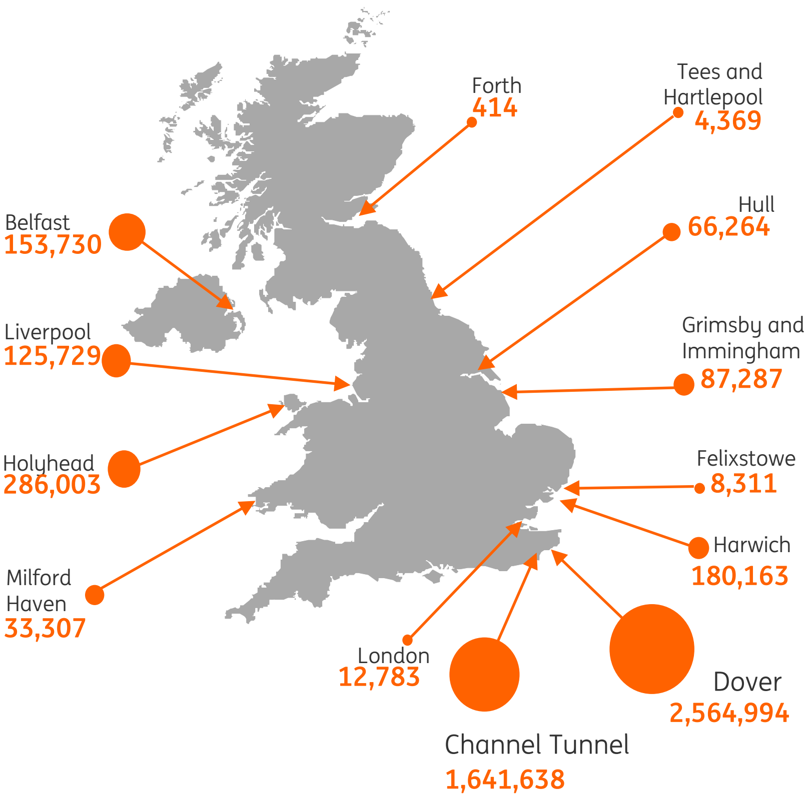
Labour now lead in the polls, while only 25% of voters think the government is doing well at negotiating Britain's exit



Source: YouGov Voting Intentions Poll 5-6 March

Is a 21-month transition period long enough?

Lorry traffic at selected UK ports
Number of lorries, 2015



Source: Institute for Government, Department for Transport

Supply chains need time to adjust

Complex modern supply chains mean goods often travel multiple times between the UK and EU before being sold in the single market (e.g. BMW Mini)

These processes will take time (and money) to re-orchestrate.

There are logistical considerations too…

At Dover, less than 1% of lorries arriving/departing currently require checks[1].

An Imperial College study has found that adding even **two minutes** to the current customs process could generate queues of up to **29-mile queues** on the M20 motorway.

Avoiding this will require new staff, but this too takes time. For instance, it takes 3 years to train a new customs official in Germany, and 2 years in France.

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

Is a 21-month transition period long enough?

Both sides want to keep the transition time-limited…

Brexiteers want it over by next election in 2022 - don't want the Brexit decision reversed by a troublesome electorate

December 2020 coincides with end of current EU budget period – UK would likely have to pay to extend transition

… but businesses and the government will have their work cut out

Customs staff need be to hired and trained – David Davis has said up to 5000 new staff may be needed. To put this into perspective, Northern Ireland currently only has 57 Border Force officers

IT infrastructure to cope with customs pre-approval

New customs infrastructure needed – inspection posts at air and ferry ports

New road and parking for lorries at ports – space is very limited around Dover port.

The outlook for sterling

Livin' on a prayer

Economic and Financial Analysis

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We're bullish on the pound across the medium-term

Brexit progress, higher confidence and higher interest rate expectations look set to drive the pound higher

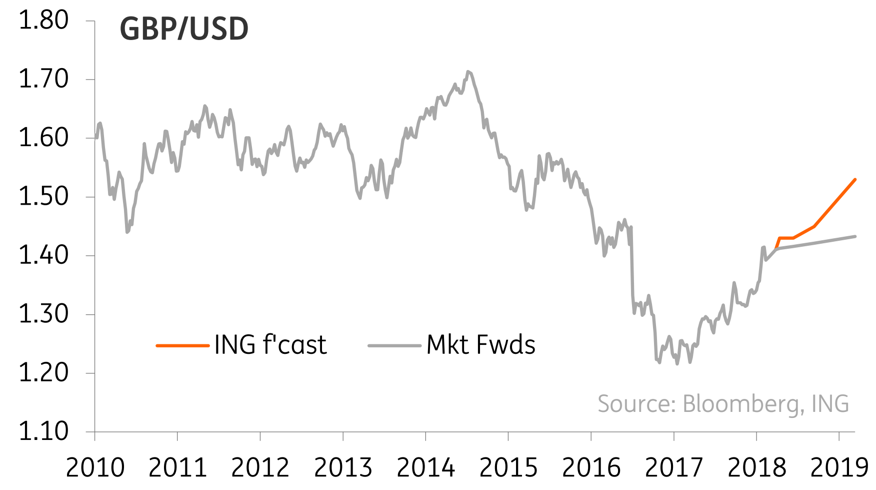
Short-term bias	Neutral
Medium-term bias	Bullish

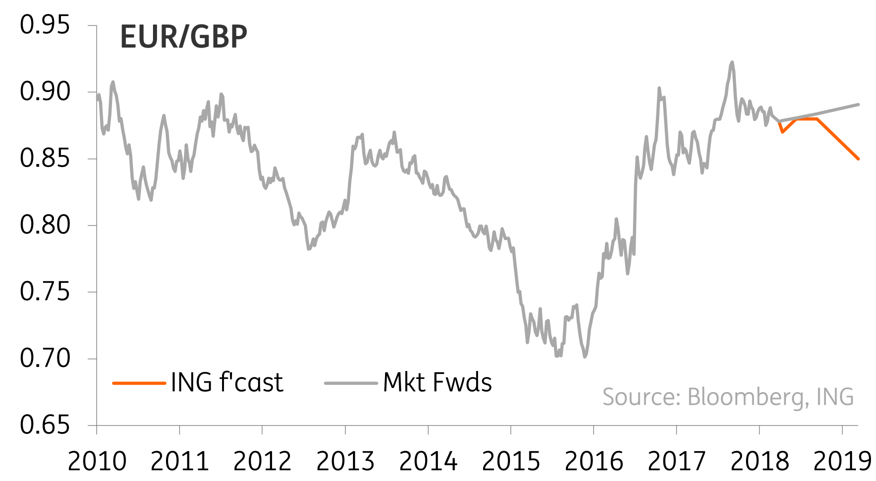
Key themes

- GBP trading with a short-term Brexit risk premium
- Bar to sell GBP on short-term political risks very high
- Long-run GBP outlook constructive on Brexit progress

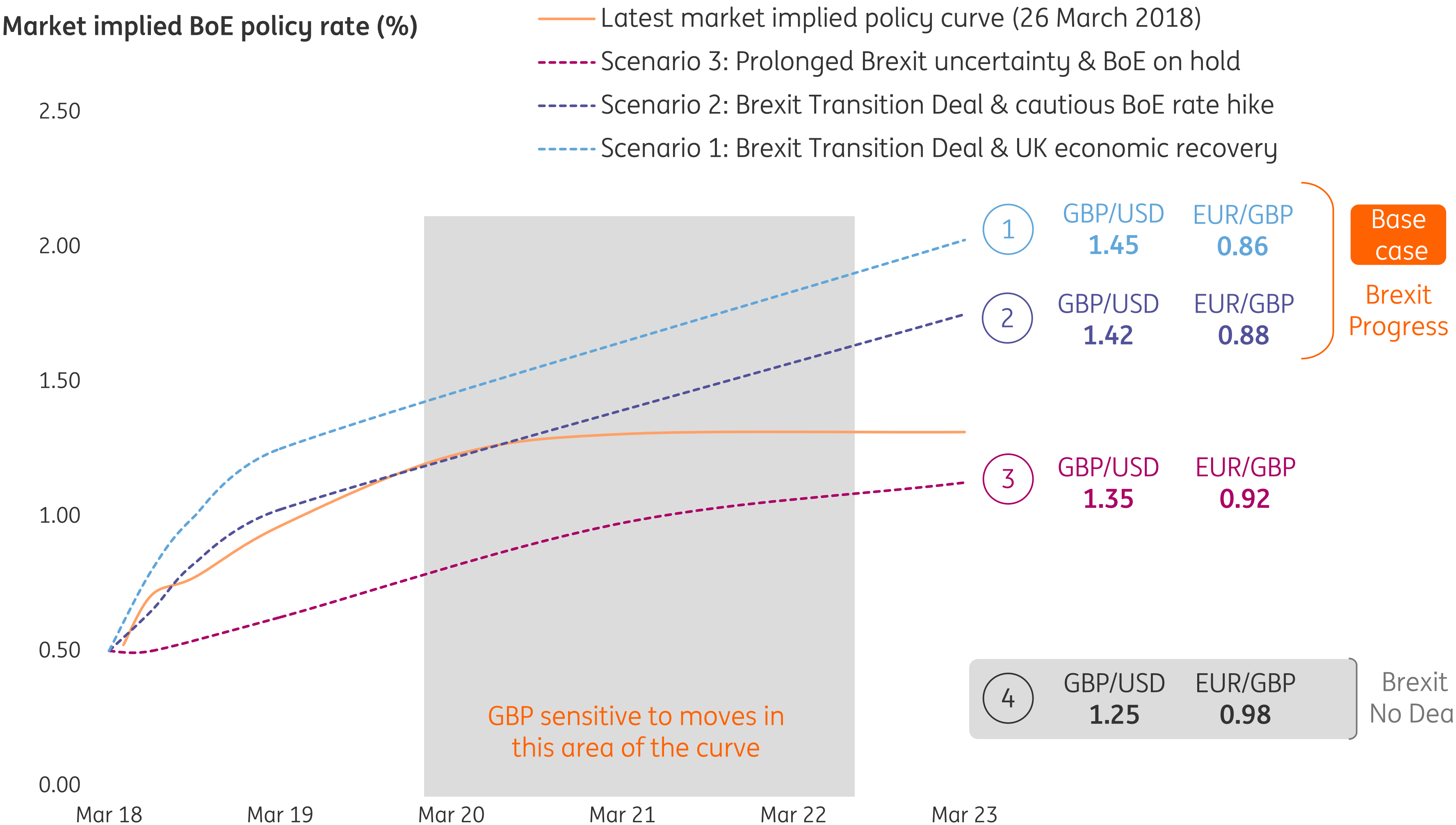
ING forecasts

	1Q18	2Q18	3Q18	4Q18
GBP/USD	1.43	1.45	1.45	1.53
EUR/GBP	0.88	0.88	0.88	0.85





Four potential scenarios for GBP over coming months



Source: Bloomberg, ING

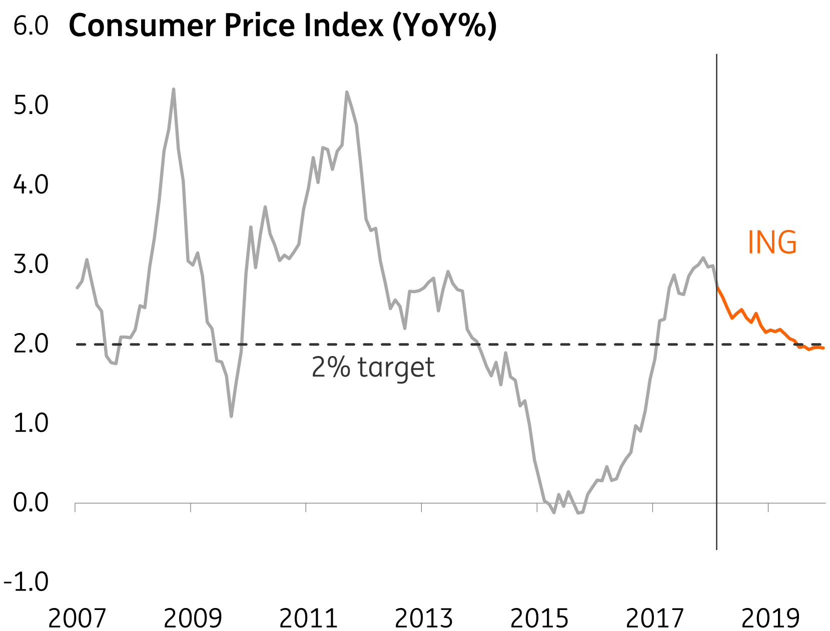
Our key UK economic forecasts

2.4%
2018 Headline CPI

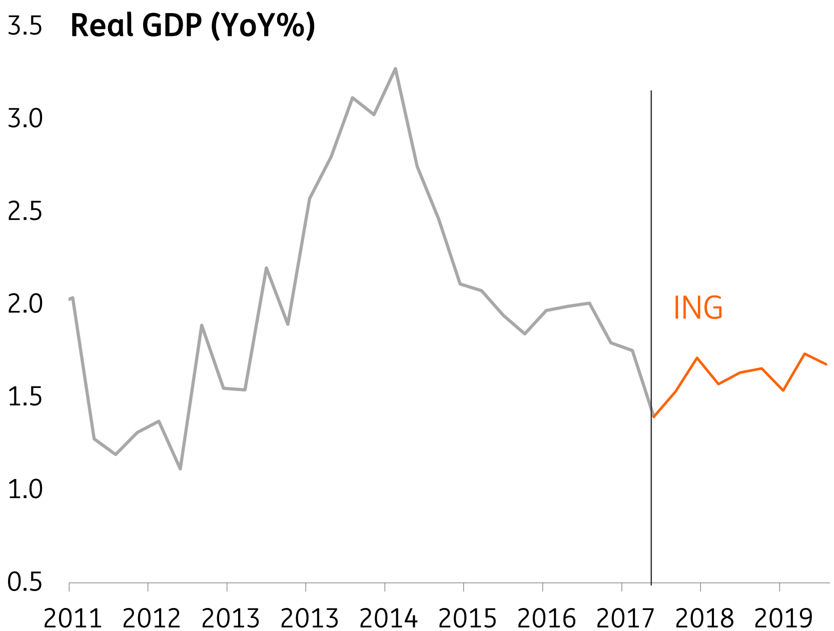
1.6%
2018 Real GDP Growth

2.0%
2019 Headline CPI

1.7%
2019 Real GDP Growth



Source: Macrobond, ING



Source: Macrobond, ING

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