Brexit Update

AIB Treasury Economic Research Unit

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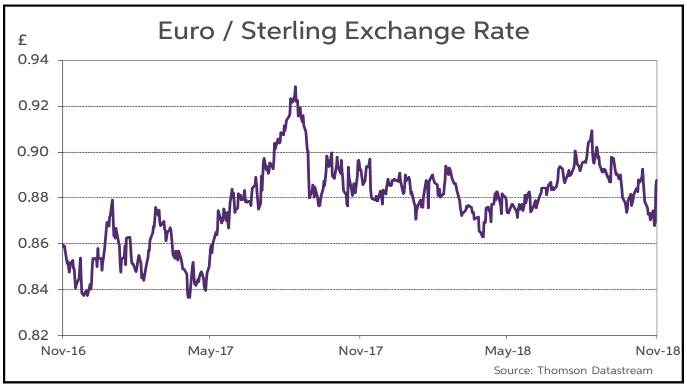
Withdrawal Agreement faces major opposition

A Withdrawal Agreement (WA) has finally been agreed between the EU and UK. The WA will form the basis of a legally binding Treaty. It outlines in great detail the various aspects of what is involved in the UK's exit from the EU. It covers key areas including citizens rights, financial settlement, a UK/EU customs arrangement backstop and a transition period.

- **In terms of citizens' rights,** the text covers the protection of the existing rights of the estimated 3 million plus EU citizens in the UK and over 1 million UK nationals in EU countries
- **For the financial settlement,** the agreement details the methodology for calculating the UK's financial obligations to the EU. It is estimated the net exit bill will range between €40bn-45bn over the next few years
- **The third key aspect of the Brexit deal is the Transition period.** As it currently stands it is to end on December 31st 2020. During this time, the UK will continue to participate in the EU Customs Union and Single Market and will have to adopt any new EU laws, but will no longer be part of EU decision-making. Over this period, the UK and EU will negotiate their future trading relationship. However, if more time is needed, the transition period can be extended, as a once-off, by mutual agreement
- **The most contentious aspect of the WA is in relation to a backstop to avoid a hard border between Ireland/ Northern Ireland.** The backstop will only become operational in the event of a failure to reach agreement on a EU -UK future trading relationship. **Under a backstop scenario, there will be a single EU-UK customs territory,** whereby a basic customs model (fishery products are excluded) would be operational between the EU and UK. This would avoid the need for tariffs, quotas and rules of origin checks. Both sides have also agreed on measures to ensure a 'level playing field' in such circumstances including in relation to state aid, competition, taxation, environment and labour protection
- **Within this backstop there is a specific protocol for Northern Ireland**, where the full EU customs code will continue to apply, thereby enabling goods and people to be able to cross the Irish border without the need for checks. In other words, in the event of the backstop being triggered, the UK will be in a 'shallow' customs regime with the EU, whereas NI will be in a much deeper customs arrangement. There will also be a requirement for certain checks on goods travelling from the rest of the UK to Northern Ireland. **A Joint EU-UK Committee will decide if and when the backstop can be terminated (i.e. cannot be a unilateral decision).**

Subsequent to the publication of the draft WA, a high level outline on the framework for the future relationship between the EU and UK was also released. It states that in terms of goods trade, the objective is a comprehensive free trade area. Meanwhile for services, it envisages "ambitious, comprehensive" arrangements that go "well beyond" WTO rules. For financial services, it makes specific reference to an arrangement based on equivalence (where EU grants foreign financial firms market access if it deems their domestic rules to be equivalent/closely aligned to EU rules).



It was always likely that the EU and UK would reach an agreement. **The key challenge is whether Prime Minister May can get the deal through parliament**. These difficulties have been highlighted by ministerial resignations, including that of her Brexit secretary, in opposition to the WA. There is the potential for further resignations and a possible leadership challenge. **The next key scheduled event in the Brexit process is the special EU leaders' Summit on November 25th** to sign off on the WA. Following that, the focus will very much centre on the UK parliament and whether its approves the Brexit deal. There is strong opposition, with elements of the Conservative party, the DUP and other political parties saying they will vote against the WA.

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Sterling sensitivity to Brexit likely to heighten

Given the heightened uncertainty over whether the UK parliament will sign off on the Withdrawal Agreement and the relatively tight timelines to get everything resolved (UK due to leave EU at 11pm on March 29th 2019), we are likely to see increasing sterling sensitivity to Brexit newsflow. We got an example of this when news broke of the Brexit Secretary's resignation last week. Within minutes, sterling had weakened by over 1.5% on the exchanges. This was reflected in EUR/GBP rising up from 87p to regain ground up in 88p territory. At the same time, GBP/USD fell, declining from the $1.30 mark to struggling to hold onto the $1.28 handle.

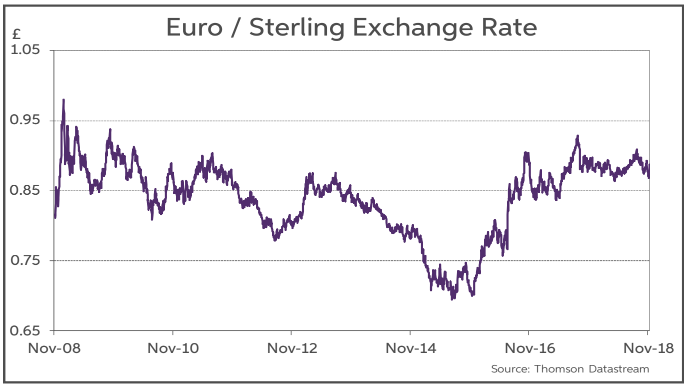
The big event for sterling will be the vote in the UK parliament on the Withdrawal Agreement. Following the recent resignations from the UK cabinet, the increasing dissent within the Conservative party in general, likely DUP rejection of the deal, as well as Labour and the SNP voting against it, it will be very difficult for Theresa May to be able to get the deal through parliament.

History is interesting in this regard. The UK joined the EU in 1973 (or EEC back then) on the back of a Parliamentary vote, not a referendum. However, as now, the then Tory Prime Minister, Ted Heath, faced strong opposition from within his own party to EU membership, with a significant number of Conservative MPs voting against it. The vote was only carried when 69 Labour MPs defied their party leader and crossed the floor to vote with the Government in support of membership. We doubt that Theresa May will be able to rely on such support from the opposition benches on this occasion.

There is a real risk that we could be entering a parliamentary logjam in the UK whereby no Brexit option - Withdrawal Agreement, No-Deal or Remain- can command majority support. There is clearly though, a large majority that want to avoid a no-deal hard Brexit, which is probably why sterling remains confined to its narrow trading range of the past 15 months. Two options would seem to arise in the event of such a logjam: request the EU to push out the date for Brexit by a number of months and/or go back to the people for what would be a third vote on EU membership since the UK joined in 1973.

Ultimately then, if the politicians can't agree on a way forward, the matter may have go back to the people. Parliament could also ask the government to go back to Brussels and try to get a better deal. There could be a change of leadership in the Conservative party. There could be another general election. **All of above involve huge uncertainty and would likely result in a very volatile backdrop for sterling.**

From a currency viewpoint, if the market fears over a no-deal-hard brexit scenario escalate, EUR/GBP is likely to break out of its 87-90p trading range, rising up towards the 93p level hit last summer. It could reach the 95p mark that was last seen in 2009. EUR/GBP may even hit parity in the scenario where the UK crashes out of EU with no deal in a very disorderly Brexit. Even if the UK leaves with a deal, it may not be clear what the long term EU-UK trading relationship will be for a number of years. As a result, the upside for sterling may be limited and EUR/GBP may move down to 85-86p in such circumstances.



What has been lost sight of in recent days, though, is that the probability of the UK staying in the EU has risen, given that the matter could yet go to another referendum. Sterling should make significant gains if the UK remains in the EU. EUR/GBP could move back down towards the 80p level in such a scenario, especially with UK interest rates also likely to rise.

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