Brexit Update

AIB Treasury Economic Research Unit

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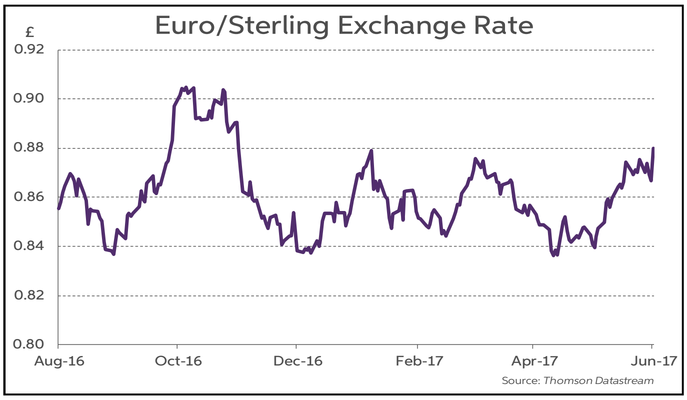
UK Election Result Could Increase Prospect of a Soft Brexit

Markets had been expecting that the Conservative Government would be returned with an increased majority in yesterday's UK general election, with both stock and gilt markets making gains over the course of the campaign. In a big surprise, though, **the Conservative Party lost its majority**, although it is still on course to form the next government as a minority administration. The indications are that Prime Minister May intends to lead the new government, but questions are being raised about her long-term political future.

Sterling lost ground overnight, falling by 1.5-2.0%. The impact on the currency may have been contained by the fact that it weakened in recent weeks, especially against the strengthening euro, as polls showed a narrowing of the Conservative lead over Labour. The euro is trading at around 88p this morning, with sterling down near $1.27 versus the dollar.



The fall-out in financial markets from the election has been largely confined to sterling. Asian markets were up overnight and UK stock markets are opening mixed this morning. The FTSE 100 is up by around 0.5%, possibly helped by the weakening of sterling, while the FTSE Mid-Cap 250, which is more representative of the domestic economy, is down by some 0.8%.

A minority Conservative government will soon have to commence formal negotiations with the EU about the terms for Brexit. The **election result adds greatly to the already considerable amount of uncertainty around Brexit.** It could delay the start of the negotiations. It could also make it more difficult for the UK government to get an exit deal through Parliament given that it will not have a majority.

There is **speculation that the election outcome increases the prospects of a 'soft' Brexit** as a minority Tory government will have to be more cognisant of the views of the opposition which tends to favour reaching a deal with the EU and a softer Brexit. The 'hard' Brexit UKIP party also performed very badly in the election. The Prime Minister's tough line on Brexit in the election does not seem have worked either. This may be one reason why the fall-out for sterling and UK financial markets has been limited this morning.

The negotiations on Brexit, though, are likely to prove very difficult. It had been suggested that the talks would commence as early as June 19th, but this start date might now be delayed somewhat. The negotiations are expected to last until near the end of next year. The EU Commission will conduct the negotiations with the UK on behalf of the remaining 27 EU member states.

The UK does not start the negotiations from a position of strength. It will now have a weakened minority government facing a united EU. Brexit will have a bigger impact on the UK economy than the EU. The agenda and timeline for the talks are being set by the EU and the UK does not have a veto on the final terms of any deal. Prime Minister May has stated that no deal is better than a bad deal. However, this argument does not stand up to scrutiny as two-thirds of UK trade is with the EU or countries that have free -trade deals with the EU. Thus, **it is hard to envisage a worse outcome for the UK than no deal on Brexit**.

Oliver Mangan
Chief Economist
oliver.n.mangan@aib.ie

John Fahey
Senior Economist
john.j.fahey@aib.ie

Dara Turnbull
Economist
dara.c.turnbull@aib.ie

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Three Stage Process to Brexit Talks

The **consequences for the UK of no deal** and thus a hard Brexit are likely to include the introduction of tariffs as well as burdensome customs checks, slowing down trade, increasing costs and disrupting supply chains. Trade and investment are likely to be hard hit with expectations that it could tip the UK economy into recession.

The EU will also be negatively impacted by Brexit, in particular those countries like Ireland which conduct a significant amount of trade with the UK. Thus, **Mr Barnier has indicated that no deal is not the EU's "scenario"** and it very much wants to reach an agreement with the UK. The EU has set out a clear framework and timeline for the talks, as well as some key conditions that need to be met to reach an agreement. It envisages three stages to the talks, which it says must be carried out in a set order.

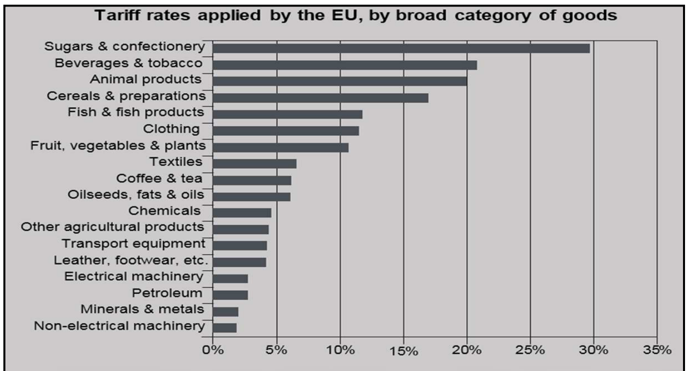
The EU is insistent that the first stage of the negotiations must deal with removing uncertainty created by the UK's decision to leave the EU. It has three issues in mind in this regard; guaranteeing the rights of EU citizens living in the UK and UK citizens living in the EU; agreeing the 'divorce bill' or the amount to be paid by the UK to cover its outstanding liabilities; and the issue of the new borders of the EU, specifically Northern Ireland.

Once agreement in principle is reached on these issues, **the negotiations can move on to stage two, covering the outlines of a new partnership between the EU and the UK. A key part of this partnership will be a free-trade agreement.** Unlike other free-trade deals, this is likely to involve regulatory divergence rather than convergence, as the UK is leaving the Single Market. The EU is insisting that divergence does not turn into "regulatory dumping". Thus, guaranteeing a level playing field for trade, with common rules and regulations that are legally enforceable is a key condition for the EU of any trade deal, something that may not appeal to the UK.

It will take a number of years to negotiate a comprehensive free trade deal. However, if the broad outlines of a deal can be agreed, then the EU has indicated that the **talks can move to stage three. This covers the transitional arrangements** that will need to be put in place in the period between when the UK leaves the EU in March 2019 and a full trade deal is agreed.

The EU has indicated that any transitional arrangements must be subject to EU law and respect the Single Market, which again may not appeal to the UK, but would minimise the disruption to trade. It is clear, then, that **a long, hard road has to be travelled in the Brexit talks, with many hurdles to be cleared,** if a deal is to be done.

Tariff rates applied by the EU, by broad category of goods



Source: HM Government Alternative to EU Membership, March 2016

The alternative is no deal and a 'hard' Brexit, with a fall back on WTO rules involving tariffs and customs controls. The accompanying graph is a list of some of the tariffs that the EU applies on imports from countries with which it has no trade deal. These would also apply to the UK exports to the EU in a 'hard' Brexit, with the UK also likely to impose tariffs. Thus, **it is in the interest of both the EU and UK to reach some form of exit deal**.