Brexit Update

AIB Treasury Economic Research Unit

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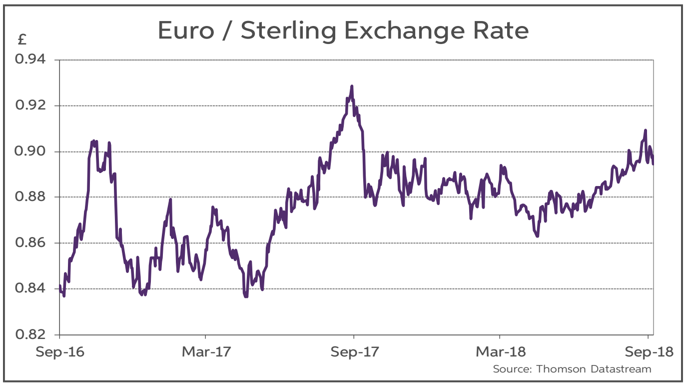
Sterling under pressure as risks rise of 'no-deal' Brexit

Sterling weakened over the summer as concerns grew that the UK may crash out of the EU without an exit deal in March next year. The euro rose from 87p at the end of May to touch 91p in late August. More recently, it has moved back below 90p to trade closer to 89p, with sterling aided by some positive headlines in relation to the Brexit negotiations. Overall though, the UK currency remains very sensitive to Brexit related newsflow.

There are two major hurdles that need to be overcome in the next six months if the UK is to avoid a no-deal/ hard Brexit. First, the UK and EU must reach agreement on an exit deal. Second, the UK Government will need to get the exit deal through Parliament. Limited progress has been made in the negotiations with the EU since the spring, amidst continuing **deep divisions in the UK Government about Brexit, in particular on the UK's future trading relationship with the EU.**

The Prime Minister's preferred option on trade, as set out in her so-called **Chequers plan**, is a customs partnership arrangement that would **see the UK collecting tariffs on behalf of the EU** on any goods coming into the UK that are subsequently destined for an EU member state. The **UK would also continue to adhere to EU standards for goods, in what is described as a "common rulebook".** The UK Government argues that goods could then flow freely from the UK to the rest of the EU and across the Irish border without further tariffs or rules of origin checks.



However, this is likely to require the development of technology that would be able to track goods from the point of entry to the final consumer. **The EU has its doubts about whether this can be done and, indeed, if the proposed dual-tariff customs scheme would ever work.** It has indicated that it would not sub-contract out the collection of any of its tariffs to a country outside the EU. It also has concerns that the UK is looking to cherry pick by wanting to maintain access to only some parts of the EU Single Market.

There are wide divisions between the UK and EU that will make it difficult to reach an exit agreement. However, both sides seem keen to do a deal. It may be that an exit deal can be left vague and more aspirational in regard to the issue of future customs and trading relations. These details could be left to be ironed out in detailed trade negotiations that are supposed to follow Brexit.

Even if an exit deal is agreed, the deep divisions in the Conservative Party over Brexit mean **that it will be a difficult exercise for the minority Government to get the agreement through Parliament.** It is hard to see an exit deal being reached that satisfies everyone. Disagreements over Brexit have already seen the resignations of two senior Cabinet Ministers in July in opposition to **the Chequers plan.** The upcoming Tory party conference at the end of this month could be particularly challenging for the Prime Minister given her **Chequers plan has found little support amongst the party membership.**

It has also found very little support in Parliament, including amongst Conservatives MPs. Many Eurosceptic Conservative MPs seem prepared to vote against any exit deal that maintains a close trading relationship between the UK and EU. On the other hand, many MPs favour the UK remaining within the Customs Union. They believe that the Prime Minister's dual-tariff scheme is unworkable, while it also excludes the key service sector of the economy. Essentially, the preference of many MPs comes down to a Canada style free-trade agreement for goods or remaining in the EU Customs Union for goods and services. These options are miles apart.

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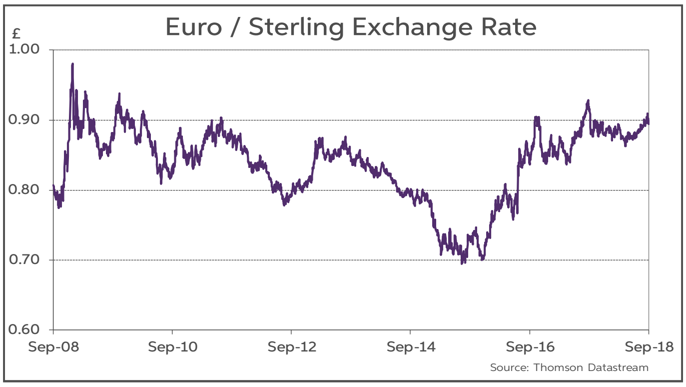
Scope for further falls in sterling in run-up to Brexit

Thus, the **UK Parliament could well end up deadlocked over an exit deal.** The deal negotiated by the Prime Minister would need the full support of her party to be approved by Parliament, but this seems unlikely at present. There is insufficient common ground within Parliament to support some form of alternative deal.

A failure to ratify an EU exit agreement by Parliament would create a political crisis in the UK. There could be a leadership challenge to the Prime Minister, a general election, even a second Brexit referendum or an extension sought to the March 2019 exit date.

The fraught political backdrop is making markets nervous, as it would seem that any outcome is possible on Brexit. Sterling is likely to remain out of favour until markets get clear signs that an exit deal can be reached. Indeed, given that there are **likely to be difficulties in getting an exit deal through the UK Parliament, the upside for sterling may be limited, even if a deal is agreed with the EU.** EUR/GBP may only return to an 87-89p trading range.

On the other hand, if the risks of a no-deal, hard Brexit continue to rise, the euro could move up to around the **93p rate** hit a year ago. It may even reach the **95p level** last seen during the financial crisis back in 2009, if Parliament becomes deadlocked on an exit deal. Indeed, **sterling could even fall to parity** in the event that the UK crashes out of the EU without any deal in a very chaotic hard Brexit next March.



Such **currency moves would pose major difficulties for Irish exporters to the UK.** Hence, it would seem prudent for them to look at hedging sterling currency exposures. They could also consider other means to reduce currency risk, such as netting sterling receipts against payments by sourcing some of their inputs in sterling.

Both importers and exporters trading with the UK also need to start looking at **the implications for their businesses of other aspects of a possible no-deal, hard Brexit.** This could include the introduction of tariffs on some goods, delays in moving goods between Ireland and the UK and through the UK to mainland Europe, impact on supply chains, as well as increased administration costs and a new regulatory environment in the UK as it decouples from the EU.

The **general expectation still is that some form of deal will eventually be done,** which will include a transition period after the UK leaves the EU next March, thereby avoiding a disorderly Brexit. The **UK is in no way prepared for a no-deal hard Brexit and the disruption to trade that would follow.** Key supply chains would suffer severe disruption as a result of delays at ports, with talk of resulting scarcity of food and medical supplies.

Even some Eurosceptic MPs are now arguing that Brexit needs to be seen as a two-step process, whereby the UK leaves the EU next March but does not fully disengage until a free trade agreement is concluded with the EU at a later date. This would necessitate some form of transition period in the interim.

How the UK gets to this point, though, is still very unclear and uncertain. **The UK could still crash out of the EU with no deal as a result of political stalemate.** The increased risk of a no-deal, hard Brexit with all its negative consequences means that firms should be preparing for the possibility of such an outcome given that it could be just over six months away.

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