Economist’s Weekly Market View

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Asymmetric risk for sterling as Brexit end-game begins

After the UK Parliament rejected the Withdrawal Agreement (WA) by an overwhelming margin in the Meaningful Vote on January 15th, the deal looked dead in the water. However, last week saw quite a turnaround when Parliament voted that it would accept the WA if the so-called Irish backstop was “replaced by alternative arrangements to avoid a hard border”.

However, it is going to be a major challenge to agree alternative arrangements to the current backstop that would prevent a hard border between the Republic and Northern Ireland. If this was an easy task, then viable alternatives would have come to the fore during the negotiations on Brexit over the past year. A re-hash of previously rejected ideas, such as using as yet undeveloped technology, would not be an acceptable solution.

The EU remains very firm in saying that the WA cannot be re-opened and thus there can be no re-negotiation of the Irish backstop. The Irish government has also been steadfast in its refusal to countenance any re-negotiation of the backstop. In these circumstances, the UK could be left facing the choice of accepting the current WA or leaving the EU without a deal, possibly sometime later this year after an extension to Article 50.

A difficulty for the EU is that the UK Parliament has not specified what type of alternative arrangements it wants to replace the current backstop in order to be able to support the WA. There is no guarantee that if the EU was to agree to some new arrangements on avoiding a hard border, they would be acceptable to the UK Parliament.

Thus, February and March could prove to be the two most torrid months yet in the Brexit process, as the clock ticks down towards the UK’s scheduled departure date of the 29th March. It is very hard to say with certainty how events will unfold, but we do not expect much movement in the next couple of weeks.

Later in the month, efforts could begin to find some modification to the backstop that might not require the reopening of the WA, but could still be made legally binding. The closer to the March 29th deadline that any change is agreed, the more likely that it may be accepted by the UK Parliament, in order to avoid a no-deal hard Brexit.

Sterling has made good gains in the past month on rising hopes that a no-deal hard Brexit can be avoided at end March, if necessary by seeking an extension to Article 50 to delay Brexit. It has risen from $1.26 at the start of the year to around the $1.31 level, while the EUR/GBP rate has fallen back from 90p to near 87p.

We see the prospects for sterling as very much asymmetric at current levels. The upside potential is likely to be limited as an exit deal will still leave a lot of uncertainty about the future relationship between the UK and EU, with difficult trade talks to come in the next couple of years. Thus, the euro may decline only slightly to around 85p. On the other hand, if the prospects of a no deal hard Brexit start to grow, then sterling can be expected to fall quite sharply.

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