Brexit Update

AIB Treasury Economic Research Unit

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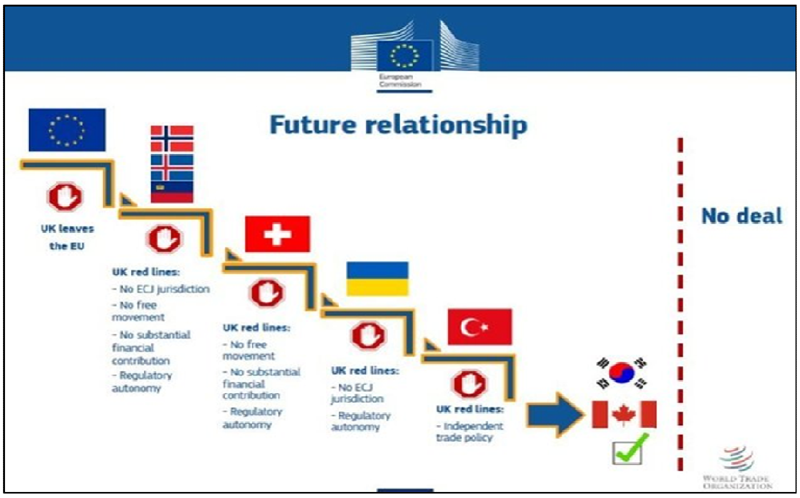
Battle Lines Drawn in Brexit Trade Talks

This month has seen both the **UK and EU outline preliminary positions on the shape of any future post-Brexit trade deal. The UK is looking for a broad-based, ambitious, bespoke trade deal,** but with the flexibility to opt in and out of various parts of the Single Market, which would then give it the freedom to set its own rules and regulations for the sectors that don't have full access, as well as negotiate trade deals with other countries. The UK would like what PM May has called a **"three baskets approach",** with three kinds of regulation post-Brexit: for some sectors, the UK would fully align with the EU rules, in other sectors the UK wants some divergence to be permitted and in a third area there would be no regulatory alignment with the EU.

This is seen as "cherry picking" by the **EU, which has completely ruled out "a pick-and-mix approach for a non-EU member" to the Single Market.** The EU has indicated that there is "no possibility to have some exclusive form of single market for some part of our economies". It says this is simply not in the EU's interests.



The EU believes the UK's decision to leave the Customs Union and Single Market, its intention to set and enforce its own rules and regulations and leave the jurisdiction of the European Court of Justice, as well as its desire to negotiate trade deals with other countries, implies that only a limited form of trade deal can be reached with the UK, similar to the free trade agreement with Canada.

Thus, the most that the EU is prepared to offer the UK at present is a Canadian style deal, largely based on tariff free trade in goods. The EU points out that any deal will not make trade between the UK and EU frictionless or smoother. Instead, Brexit will make trade more complicated and costly for both sides. **It notes that whatever free trade deal is put in place will be inferior to the Single Market.**

There is some common ground between the EU and UK. Both want tariff free trade in goods. The difficulty, though, lies in whether they can agree on customs free trade given that the UK wants to be able to set its own external tariffs. **Different external tariffs as well as different regulatory standards, would mean that customs checks would be required between the EU and UK, even if a free trade deal is agreed. Customs is a major obstacle to be overcome in the talks.** It also incorporates the issue of how to resolve the very tricky Irish border question and avoid a hard border in Ireland. This will be difficult to achieve in the absence of some form of common EU-UK customs area or union.

Services are not normally covered in free trade agreements either and this sector is likely to be the biggest casualty of the UK's decision to leave the Single Market. The UK is pressing hard to include financial services as part of any trade deal as it is a key part of the UK economy. The EU is resisting this, although it is open to **allowing some market access for services in a trade deal, but it will be a very much watered down version of the current Single Market in services.**

While there are major obstacles to be overcome, **we expect that the Withdrawal Agreement to be concluded between the EU and UK, probably later this year, will include a transition period**, paving the way for a soft Brexit in March 2019. To a large extent, we think the final terms of the Withdrawal Agreement will be shaped by the attitude of the UK. **The more the UK wants to "take back control" and set its own rules and regulations and do third country trade deals, the poorer the access it will have to the Single Market.** Customs controls are likely in this scenario and a free trade deal will be limited in scope to mainly avoiding tariffs on goods. This is the difficult choice facing the UK.

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Key Brexit Events Lie Ahead for Sterling

Brexit concerns have seen sterling lose significant ground in the past couple of years, with EUR/GBP rising sharply from the 70p level near the end of 2015 to a high point of around 93p in August 2017. **The UK currency, though, recovered some ground last autumn,** helped by an unexpected rate hike from the Bank of England, some better economic data and hopes that agreement can be reached on a soft Brexit when the UK departs from the EU in March 2019. This has seen EUR/GBP move down to trade in a very narrow 87-90p range since last September.

The progress of the Brexit negotiations is likely to be the key factor influencing sterling in the period ahead. There are hopes that the outcome of the talks will be a soft Brexit, with transition arrangements agreed that allow for continuing free trade between the UK and EU for a period after Brexit occurs in March 2019. It is hoped that a full trade deal can be negotiated in the following couple of years that will come into effect once the transition period ends, most likely at the end of 2020 or in early 2021.

Nonetheless, given the political backdrop in the UK and its desire to regain full sovereignty, there is still a risk of a hard Brexit when it leaves the EU in twelve months time that has a negative impact on the economy and trade. **There are a number of significant events on the road to Brexit that could impact on sterling in the coming year**;

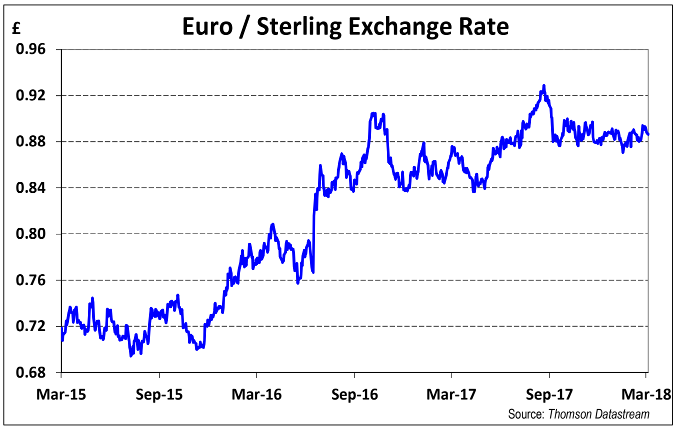
- **Getting agreement on a transition period.** This is on the agenda of the upcoming EU summit on March 22/23rd, when the proposal to offer the UK a Canada style free trade agreement will be discussed by the EU Council. It is unclear if the EU and UK will be in a position to reach agreement on a transition phase at this meeting. The aim was to reach agreement by March, but progress has been slow this year in the Brexit talks.

- **A House of Commons vote on whether or not the UK should remain in the Customs Union** is expected before the summer, with a risk that the Government's decision to leave will not be supported, with significant political consequences possible if this occurs.

- **The nature of the Withdrawal Agreement that is likely to be finalised later this year** to ensure an orderly Brexit. The Agreement will need to be ratified by the EU and UK Parliament, so it is generally assumed that the discussions need to be concluded by late autumn to allow sufficient time for ratification.

- Tensions in the Conservative Party over Brexit could result in the **fall of the UK government** in the coming year, with **Labour under Jeremy Corbyn winning a subsequent general election.**

A change of government could prove very negative for sterling if it leads to very radical changes in economic policy and much uncertainty in markets. The euro could rise to parity versus sterling. Meantime, a **hard Brexit**, whereby the Withdrawal Agreement does not provide for a transition period and the UK has to fall back on WTO rules, would be very negative for the UK economy and **cause renewed falls in sterling,** with the euro likely to rise to around 95p or even higher.



On the other hand, if it becomes increasingly evident that **a soft Brexit is on the cards for March 2019 under the current government, then sterling should make some gains.** Getting agreement on a transition period, a change of heart by the UK Government that sees it agree to some form of a customs union with the EU and a trade friendly Withdrawal Agreement that avoids a hard Brexit would all be positive developments for sterling. The euro would most likely fall back to 84-85p by end year, with a move down towards 82p or below possible if there is a provision in the Withdrawal Agreement to form some type of new UK-EU customs union.