Brexit Update

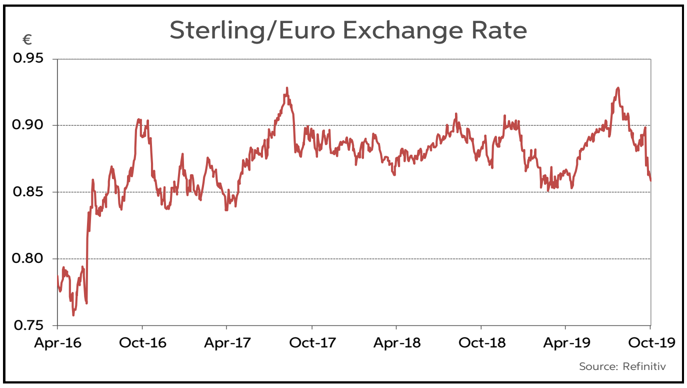
AIB Treasury Economic Research Unit

23rd October 2019

Revised Deal Could Prove More a Hard than Soft Brexit

The **revised Brexit deal** was signed off at the EU Heads of State Summit last week, but **getting it through the UK Parliament is proving to be a challenge.** In particular, the government has failed to get the Withdrawal Bill rushed through Parliament by October 31st, meaning that **a further extension to Article 50 is now on the cards.** This will leave the government with the options of attempting to get the Bill through Parliament over a longer time period, or seeking to have an early general election. It would hope to win that election and have the Bill approved in the next Parliament.

The revised Withdrawal Agreement, if eventually approved by Parliament, will pose plenty of future challenges for the Irish and UK economies. It does provide for a transition period during which time the current trading arrangements with the UK will stay in place. The transition period is due to expire at end 2020 and be replaced with a Free Trade Agreement, although this time frame could be extended by up to another two years.



This revised deal is not a soft Brexit. The UK is leaving the Customs Union and Single Market. Thus, **once the transition period ends, new trading rules will kick in.** Those trading with the UK will need to lodge customs declarations forms to have clearance to move their goods. This will result in new administration costs and likely delays in trade.

Furthermore, **any new UK-EU trade deal will be much inferior to the Single Market,** especially if it is done by a UK government that wants to go down the route of regulatory divergence and the UK being able to set its own customs duties. Thus, while the revised deal would mean that a hard land border is avoided on the island of Ireland, **within the next couple of years a hard border could appear in the Irish Sea between Great Britain and the Republic** and in the English Channel between the UK and EU.

The limited analysis done to date on the effects of a Brexit deal based around a free trade agreement shows a significant negative impact on the Irish economy. **Trade will suffer after the transition period ends** as the fall-out from the UK leaving the EU Customs Union and Single Market starts to bite. Further, the more the UK wants to "take back control" and have its own different regulatory and customs regime, the more limited will be any Free Trade deal with the EU. Thus, we could be left with what, in effect, amounts to a hard Brexit after the transition period ends.

But Could Prove Good for Northern Ireland Economy

The revised agreement, though, could prove quite beneficial for the Northern Ireland (NI) economy as it is the one part of the UK that will **retain free access to the EU Single Market for goods.** Meanwhile, NI goods are to continue to have "unfettered" access to the rest of the UK, although they may require some summary pre-clearance documentation.

It is important to note that the main **checks on trade with Great Britain will relate to goods moving from there to NI.** Even then, it is clear from the text of the revised Withdrawal Agreement that the focus of the proposed new Customs arrangements is on goods being brought into NI from another part of the UK **that are "at risk of subsequently being moved into the Union".** Thus, a good deal of NI trade with Great Britain could be exempted from customs checks.

There has been much talk about divergence between NI and the rest of the UK. However, there are already many examples of such divergence, such as the adoption by NI of the same corporation tax rate as the Republic. NI will be in a strong position to capture a growing share of foreign direct investment if the current Brexit deal is ratified, given that **it will retain free access for goods to the Single Market, while still having "unfettered" access to the UK market.** No wonder, a senior UK Cabinet Minister has called the revised agreement a "cracking deal" for NI.

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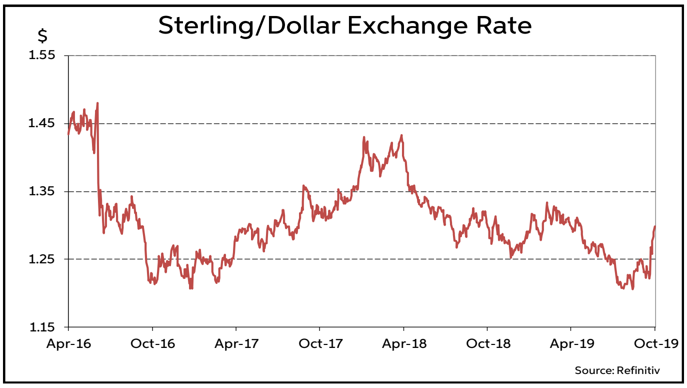
Sterling Rallies, But Could Slide Again in 2020

Sterling has made good ground in sometimes volatile trading over the past two months on growing hopes that a no-deal Brexit would be avoided. **The past fortnight has seen significant gains in particular as it became clear that a deal was in the offing and the UK would not crash out of the EU in a disorderly hard Brexit at the end of October.** Cable has climbed from $1.22 to as high as $1.30 in the last two weeks, while the euro had dropped from 90p to a low of 86p versus the UK currency.

Sterling has held on to the bulk of these gains despite the difficulties in the getting deal ratified by the UK. **The EU is expected to grant the UK's request for a further extension to Article 50. This is likely to pave the way for an early general election** in the UK, though this will require the support of two-thirds of MPs. The Conservative Party would almost certainly put the revised Brexit deal at the centre of its campaign and be fairly confident of winning the election. Labour will campaign on the back of getting a softer Brexit deal that would keep the UK in the Customs Union and then putting that deal to a referendum. Of course, we could also get another hung Parliament, still deadlocked over Brexit. However, this could also lead to another referendum.

We see only modest further upside for sterling if the deal is approved by Parliament, either before or after an election. There is considerable, strong technical support for the euro at around the 84-85p level against sterling, which may be difficult to overcome. Furthermore, **this deal points towards a relatively hard Brexit** as it will see the UK leaving the Customs Union and Single Market. This will have negative long-term consequences for the economy.



There is also **considerable uncertainty about the future trading relationship** between the UK and EU post the transition period. **Next year's trade talks are likely to prove very difficult** if conducted under a Conservative government. The more the UK wants to "take back control" and have its own different regulatory and customs regime, the more limited will be the Free Trade deal it can conclude with the EU.

The EU has been very clear all along that it will insist on a level playing field in any trade deal, so that "regulatory divergence does not turn into regulatory dumping". It has stated that guaranteeing and enforcing "common rules" will be a crucial part of any trade deal. This may be a bridge too far for a Brexit orientated UK government.

Indeed, **a hard Brexit leaning Conservative government could be prepared to fall back on WTO rules rather than sign up for a trade deal that requires the UK to closely follow the rules of the Single Market in return for market access. This would be very much a hard Brexit,** but occurring at the end of the transition period, rather than when the UK leaves the EU.

Overall then, we think it could prove a challenge for sterling to register further significant gains. Near term, though, short positions against sterling are likely to continue to be closed out if the deal is ratified by the UK Parliament, which should support the currency**. Some further modest gains are thus likely in the event that the revised Withdrawal Agreement is eventually approved by Parliament. We could see the euro decline to around the 84p level.** Meanwhile, cable could rise towards $1.35, helped also by some strengthening of the euro against the dollar.

Next year, though, could see downward pressure and volatility re-emerge for the UK currency given that the next phase of Brexit, trade negotiations, are likely to prove difficult and protracted, with a very uncertain outcome. We would not be surprised to see the 90p level revisited against the euro.

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