Brexit Update

AIB Treasury Economic Research Unit

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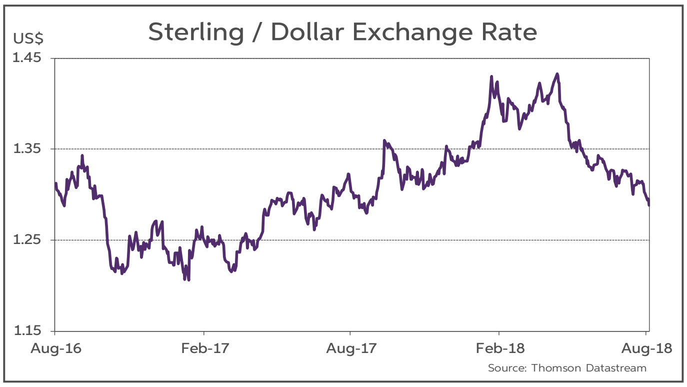
Soft Brexit still likely, but risk of 'no-deal' Brexit rising

The UK is set to leave the EU next March, but there is still considerable uncertainty about what shape Brexit will take. The EU and UK agreed earlier this year that there should be a post-Brexit transition period that would maintain the current free trade arrangements until the end of 2020. This is to be included in the Withdrawal Agreement that needs to be concluded between the EU and UK in the coming months to avoid a 'no-deal', hard Brexit next March.

However, **little progress has been made in the negotiations with the EU since the spring, amidst continuing deep divisions in the UK Government about the shape of Brexit.** These disagreements saw the resignations of two senior Cabinet Ministers last month, following the publication of the Government's White Paper on the approach the UK wished to adopt on Brexit. **The lack of progress in the negotiations is giving rise to fears that the chances of a 'no-deal', hard Bexit are increasing. This has been reflected in renewed downward pressure on sterling over the summer.**

The Exit Agreement that the UK and EU hope to strike before the end of the year consists of two elements. First, the Withdrawal Agreement, which will largely cover the technical aspects of the UK's departure, including citizens' rights, future budgetary contributions, Irish border, provision for the transition period etc. **Second, a 'political declaration' that will set out a broad framework for future economic, trade and security relations** between the EU and UK.



However, there are very differing views in the UK on what kind of future trade relationship it wants with the EU, especially in regard to customs arrangements. The Prime Minister has found it very difficult to come up with proposals that satisfies everyone in her Government, as well as the EU. **The UK is looking for an arrangement that will largely maintain free trade in goods with the EU,** avoid a hard border on the island of Ireland and yet allow it to negotiate its own independent trade deals with third countries.

The UK's preferred option on trade, as set out in its recent White Paper, 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" in the White Paper. The UK 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 consumer.

The EU has its doubts about whether such a system would ever work. It has also indicated that it would not sub-contract out the collection of any of its tariffs to a country outside the EU. However, it is in the interests of both the UK and the EU to reach an exit agreement and thereby avoid a 'no-deal', hard Brexit. Thus, while the EU has highlighted difficulties with the UK White Paper, it is seen as a basis for negotiation and despite major differences, the signals from both sides are that a deal can be done in the coming months.

It should be noted that while the Withdrawal Agreement will be legally binding, the political declaration on the future EU-UK relations is not. Thus, the political declaration element of any exit deal can be left vague and be more aspirational and largely fudge the issue of customs and trade. The declaration could leave these details to be ironed out in trade negotiations that are to follow Brexit. It is hoped that these will lead to a new EU-UK free trade deal being concluded before end 2020. **This offers the best approach of getting an exit deal completed in the coming months and also approved by the UK Parliament**. The exit deal will also need to be approved by the EU Parliament.

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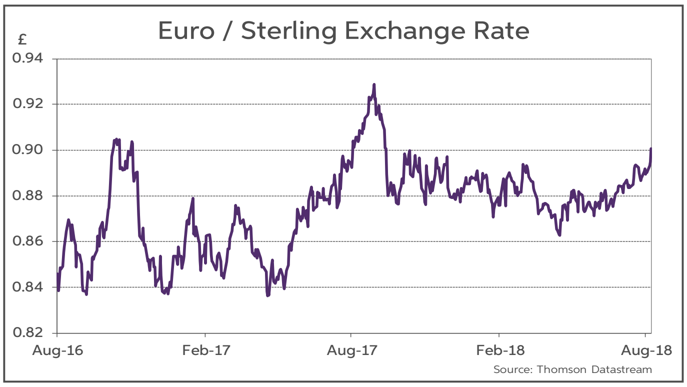
An EU Exit Agreement needs to get through UK Parliament

The deep divisions in the Conservative Party over Brexit mean that it could be a difficult exercise for the minority Conservative Government to get an EU Exit Agreement through Parliament, as it is hard to see an exit deal being reached that satisfies everyone. It would help, though, if, as we envisage, the political declaration element of the exit deal is left vague and fudges the issue of customs and trade.

It is also the case that the Government could fall if it fails to get the EU Exit Agreement through Parliament, leading to a general election. **Eurosceptic Conservative MPs will be wary of this in particular, as it could see Labour coming to power and delivering a very soft Brexit,** including the UK remaining within the EU Customs Union and possibly even the Single Market.

Thus for these MPs, they may take the view that Brexit is a process rather than a one-day event at the end of March. Their key objective may be to ensure that the UK leaves the EU, Single Market and Customs Union next March. They could then look to secure a harder form of Brexit in the subsequent trade negotiations with the EU, possibly under a new, Eurosceptic Conservative Prime Minister.

An EU exit agreement needs to be concluded by the end of the year at the latest, as it will take some time to get a deal approved by the UK Parliament and then implemented into law. It is likely that both elements of any exit deal- the withdrawal agreement and political declaration on the framework for future relations- will be put as one resolution to both Houses of Parliament for approval.



If carried, **Parliament must then legislate to implement the terms of the Withdrawal Agreement through a formal Withdrawal Bill.** This Bill would need to be passed before exit day, 29 March 2019, to give legal effect to the provisions of the Withdrawal Agreement. The House of Commons has the power to block ratification of the Bill by passing resolutions to this effect, which could lead to the UK crashing out of the EU without any deal. Thus, **a failure by Parliament to support an exit deal could see the Brexit issue put to another referendum vote**. The UK may need to seek an extension from the EU to the exit date in this scenario.

Overall then, there are **numerous hurdles to be overcome to secure a soft Brexit for the UK.** An exit deals needs to be concluded between the EU and UK before the end of the year. The agreement then needs to be ratified by the UK Parliament. **Even then, it will probably not be clear what is the final shape of Brexit**. The status quo would be largely maintained during the transition period that is to last from the exit date in March and end 2020. The difficult decisions in terms of future customs and trade arrangements could be left to the detailed negotiations on reaching a new EU-UK trade deal to be conducted during the transition period.

Sterling is likely to remain out of favour until markets get clear signs that an exit deal can be reached. Thus, it could trade at around 90p versus the euro over the next couple of months. Given that there may be difficulties in getting an exit deal through the UK Parliament, while uncertainty in regard to the precise nature of Brexit could extend into the transition period, **the upside for sterling may be limited even if a deal is agreed.** EUR/GBP may only return to a 87-89p trading range.

Of course**, if the chances of a no-deal Brexit continue to rise, then the euro is likely to move higher** to around the 93p level it hit last summer. It could even reach the 95p level that was last seen during the financial crisis back in 2009. Sterling could even fall to parity in the event that the UK crashes out of the EU without any deal next March.

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