Brexit Update

AIB Treasury Economic Research Unit

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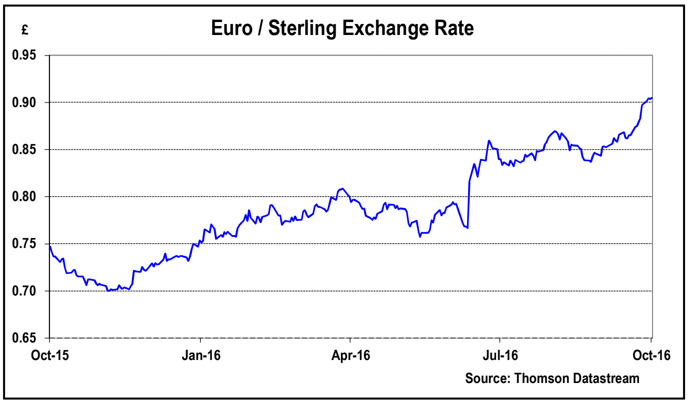
Sterling to Remain Under Pressure...

Growing signs that the UK could be heading for a 'hard' Brexit, which would see it lose access to the Single Market, triggered **a fresh wave of sterling selling in the past couple of weeks.** This has seen the pound fall close to $1.20 with the euro climbing above 90p. Indeed, in one short 'flash crash' episode, driven by computer-trading in thin Asian markets, sterling dived below $1.15 and the euro hit 94p.

We have been warning since the start of the year that sterling could drop below $1.25 with the euro hitting 90p, if a 'hard' Brexit became likely. We are now at these levels and the pressure remains on sterling. It looks to be **moving into a 90-94p trading range against the euro and a $1.17-1.23 band against the dollar.** Such low sterling -dollar rates have been seen only once before, for a brief period in 1984-85.

In 1967, following a 14% devaluation of sterling, Harold Wilson, the British Prime Minister, told voters that nothing much had happened to the "pound in your pocket". The UK authorities' very relaxed attitude to the current Brexit-related sharp decline in sterling risks repeating Wilson's mistake of playing down the economic damage that this can cause.



The UK's many experiences of sharp sterling falls show that such episodes have not helped to rebalance the economy. The UK has continued to run large balance of payments deficits in recent decades despite major bouts of sterling depreciations. Rather, **sharp sterling falls have tended to be followed by a marked rise in inflation and declining living standards.**

... With Tough Negotiations on Brexit to Come

The trigger for the latest bout of sterling weakness was the announcement by the UK Prime Minister, Theresa May, that she intended to **trigger Article 50 in the first quarter of next year.** This will set in motion the formal process for Britain's withdrawal from the EU, with the UK likely to leave in the first half of 2019.

What most concerned the markets, though, was the hard line taken by the PM that it would be a clean break with the EU, with the UK becoming a "fully independent, sovereign country". The **UK wants to take back control over immigration** and the PM has ruled out adopting the Norway or Switzerland models, where some sovereignty is ceded in return for access to the Single Market.

EU leaders have made it abundantly clear, though, that **the Single Market is not some a-la-carte menu** where you choose the bits you like and leave the rest. They have emphasised that the freedom of movement of people is one of the core principles for accessing the Single Market. Indeed, Donald Tusk, Head of the European Council, has warned that the "only real alternative to a hard Brexit is no Brexit".

The **Brexit negotiations are going to be very difficult.** The first thing to note is that the **UK does not have a veto** over the terms of the exit deal, which greatly weakens its negotiating position. Furthermore, the UK has become deeply entwined within the EU over its near 45 years of membership and untying this Gordian knot will be no easy exercise. In particular, there is likely to be considerable wrangling over **the bill that the UK will face on exit** to cover its legacy EU financial obligations as a result of shared payment liabilities.

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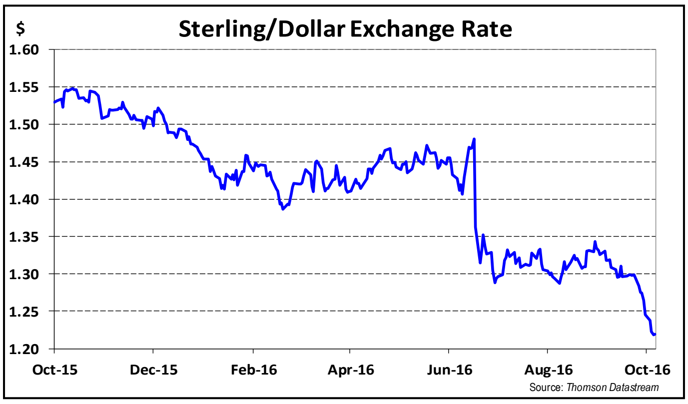
Choice of Hard Brexit or No Brexit?

Meanwhile, the EU has indicated that talks on a trade deal with the UK can only commence after it leaves the EU. Any interim arrangements allowing the UK to maintain some access to the Single Market post Brexit will be difficult to agree if the British Government continues to insist on regaining control over immigration and the full return of sovereignty. Thus, **the choice facing the UK at the end of the exit negotiations may indeed be binary – hard Brexit or no Brexit.**

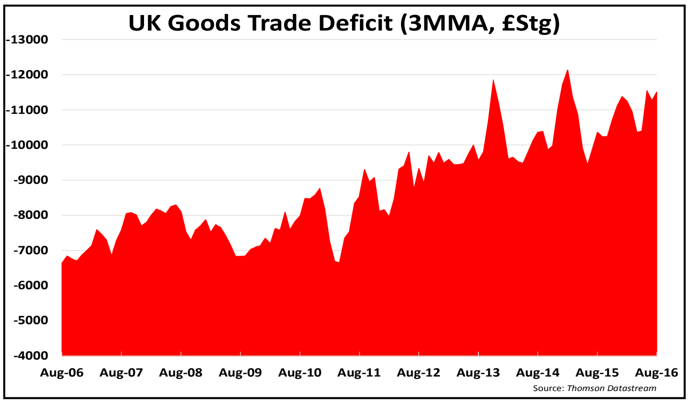
A hard Brexit would see the UK leaving the EU Customs Union and Single Market, while it would no longer be part of the trade deals that the EU has in place with many other countries. The **UK would most likely have to fall back on WTO rules** in such circumstances. These require a member state to apply a common set of tariffs to all countries with which it has no trade agreements.



In this regard, **the EU applies significant common external tariffs on imports** from such countries. These would also have to be levied on imports from the UK in the absence of some form of trade deal. Meanwhile, if the UK decides to impose tariffs on imports it will raise input costs and consumer prices. However, if it decides on very low or no tariffs, it will weaken its hand in negotiating new trade deals with the EU and other countries.

UK Economy to Slow

The loss of access to the Single Market would be very damaging to the UK economy, especially in terms of the impact on foreign direct investment and trade. One has to wonder whether the UK Government will in the end concede ground on control of immigration to maintain some form of access to EU markets. Indeed, the UK Parliament may attempt to block an exit deal that does not include this.



In the meantime, **UK growth is likely to slow as a result of rising inflation, falling investment and heightened uncertainty.** The UK's large current account deficit could also become problematic if the substantial capital inflows that are required to finance it begin to dry up on Brexit concerns, as seems likely.

In such circumstances, there may have to be a **large rise in national savings to reduce the deficit to more manageable levels,** which implies a significant decline in spending relative to income. Domestic policy may have to be tightened to help bring this about.

Overall then, **further downside risks lie ahead for the UK currency**. It is not hard to see why some forecasters are predicting that we could be heading for parity between sterling and the euro if the UK continues on the road towards a hard Brexit.

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