Brexit Update

AIB Treasury Economic Research Unit

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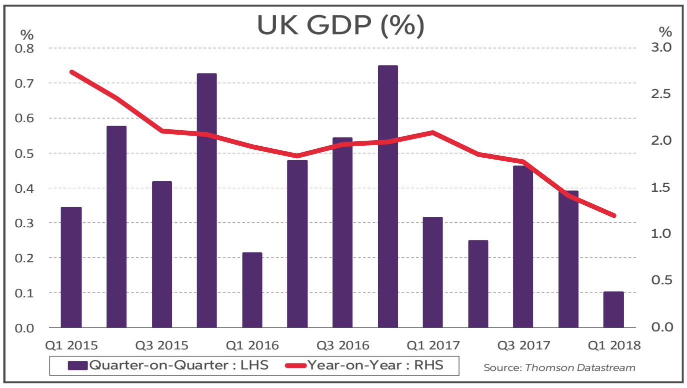
Still Much Uncertainty Over Brexit As Exit Date Nears

Brexit is casting a long shadow over the UK economy. It may have taken some time to register, but the UK referendum vote in mid-2016 to leave the EU is now really reaping its toll on activity. The UK has gone from being the fastest growing major economy ahead of the vote to the slowest by the final quarter of 2017, with even Japan and Italy surpassing it.

This trend continued in the opening quarter of 2018, with **UK GDP rising by a paltry 0.1%, and the year-on-year growth rate slowing further to 1.2%, the weakest since mid-2012.** This is at a time when the world economy has gained momentum, with the IMF forecasting close to 4% global growth this year, up from 3.2% back in 2016. Survey data for April point to ongoing weakness in activity in the UK.

Brexit has hit the economy in two ways in particular. The big rise in UK inflation, following sterling's sharp fall in the aftermath of the referendum vote, has resulted in a marked slowdown in consumer spending. Meanwhile, the uncertainty surrounding Brexit is weighing on business investment and construction activity.



The UK is set to leave the EU next March, but there is still a complete lack of clarity in terms of what shape Brexit will take. The EU and UK have agreed 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 Brexit Withdrawal Agreement that is due to be concluded between the EU and UK in the autumn.

However, **the UK has yet to decide on what kind of trade relationship it wants with the EU after the transition period ends, especially in regard to customs arrangements.** This will form a crucial element of the Withdrawal Agreement. The UK Prime Minister is finding it very difficult to come up with a plan for future customs arrangements that satisfies everyone in her cabinet as well as the EU. The UK is looking for an arrangement that will largely maintain customs free trade with the EU, avoid a hard border on the island of Ireland and yet allow it to negotiate it own independent trade deals with third countries.

There is very strong resistance in parts of the UK Government to the PM's preferred option of a customs partnership with the EU after the transition period ends. The arrangement would see the UK collecting tariffs on behalf of the EU for any goods coming to the UK that were subsequently destined for another EU member state. Businesses could claim back tariff rebates on any goods that stayed in the UK.

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. This will require the development of technology that would be able to track goods from port to consumer. The EU has its doubts about whether the system would work. However, if the onus is put on businesses to show that the goods have been used or consumed in the UK in order to be able to claim a tariff rebate, it could get the green light from the EU. The Irish Government appears to leave to door up for such an arrangement in some recent comments, saying that "it is something that perhaps we could make workable".

Brexiteers, though, see such a customs partnership as hindering the UK's ability to negotiate trade deals with other countries and not consistent with an independent trade policy and are thus strongly opposed to it. **The deep divisions in the Conservative party on the issue mean that it could be a challenge to get any withdrawal agreement through Parliament. Thus, much uncertainty still abounds about Brexit as the clock ticks towards next March's exit date.** It will be interesting to see if any progress has been made on customs arrangements by the time of the next EU Heads of State meeting on the issue at the end of June.

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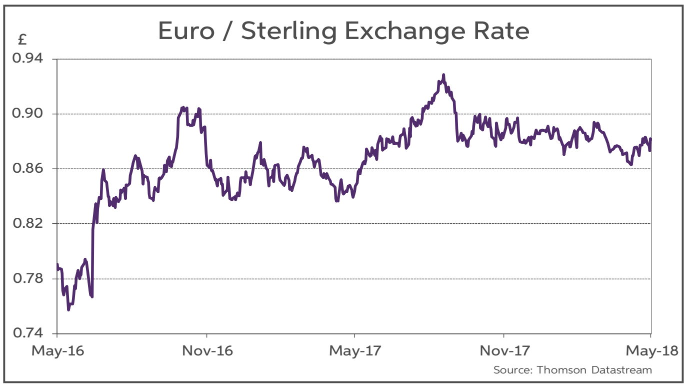
Sterling awaits clarity on Brexit negotiations

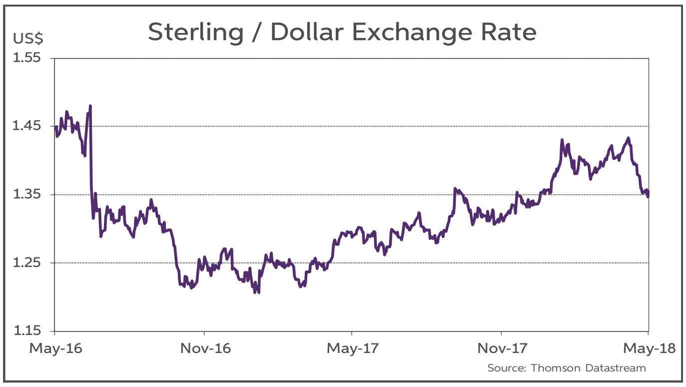
Sterling fell sharply in the aftermath of the UK referendum vote for Brexit in mid-2016. The currency hit 30-year lows against the dollar, falling from $1.50 before the vote to as low as $1.20 in late 2016. Brexit concerns also saw sterling lose significant ground against the euro, with EUR/GBP rising sharply from the 70p level near the end of 2015 to a high point at around 93p in August 2017.

However, **sterling has managed to move off its lows and regain some ground since last summer.** The currency was helped by an unexpected rate hike from the Bank of England and growing hopes of a soft Brexit. Against a weaker dollar, it rose above the $1.40 level in Q1 2018 and in mid-April reached a new post referendum high of $1.437. The UK currency also recovered some lost ground against the euro. This resulted in EUR/GBP falling out of the 87-90p range that had been in place since last September, trading as low as 86.2p in mid April.



However more recently, weaker than expected UK data (incl. March CPI inflation and Q1 GDP), combined with comments from the BoE Governor playing down the prospects of a May rate hike, saw sterling's rally go into reverse. EUR/GBP has moved back to around the 88p level, with GBP/USD back down below $1.36 against a generally stronger dollar recently.

The progress of the Brexit negotiations, as well as economic data and the timing of the next BoE hike, will be the key factors impacting sterling for the remainder of the year. **The currency's focus is likely to shift very much to the Brexit talks as they enter their final stages in the autumn.** A withdrawal agreement will need to be finalised between the EU and UK later this year in order to pave the way for a soft Brexit and provide for continuing free trade during the transitional period that is to last until end 2020.



EUR/GBP seems likely to trade in an 87-89p range, until markets get clearer signals on the outcome of the Brexit talks. If it becomes increasingly evident that a soft Brexit is on the cards, then sterling should make some gains, with the euro moving down to 85p and cable rising back above $1.40. However, if the talks run into real difficulties later this year and a hard Brexit becomes increasingly likely, involving the imposition of trade tariffs and customs checks, then EUR/GBP could move up towards 95p, with cable falling well below $1.30.

Overall, while the negotiations are likely to prove difficult, especially in regard to future customs arrangements, **we believe that the EU and UK will be able to conclude on a withdrawal agreement in the autumn.** It could prove a challenge to get the deal through the UK parliament, but a soft Brexit seems the most likely outcome for the UK in March 2019.

Our base case, then, is that sterling is likely to have strengthened by end year on the back of a Brexit deal, aided also by a further hike in UK interest rates. **Political uncertainty in the UK, though, remains a risk** for the currency as it is clouding the outcome of the Brexit negotiations and future of the minority Conservative government.

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