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Economics

UK economic notes

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Brexit update: risks of near term UK political crisis rising

Oliver Harvey
Macro Strategist
+44-20-754-51947

It's been over a month since our last Brexit update. Whilst market attention has been diverted elsewhere, the Brexit process has continued to rumble forward in Westminster and Brussels, with the newsflow in recent days suggesting rising risks of a political crisis before agreement is reached on transition in March.

Deadlines slipping

As we argued last year, reaching sufficient progress at the December EU Council meeting was only the end of the beginning of Brexit talks. Negotiations would then have to move to the next stage. First, agreement on a transitional period by the March EU Council Summit, in order to provide certainty for businesses that the UK would not crash out of the EU in March 2019 with no arrangements. Second, an outline of a future trade relationship before the final Article 50 text is signed off at the October EU Council.

On the transition, the EU27 released uncompromising draft negotiating guidelines yesterday.[1] First, they require the UK to abide by the EU acquis without any formal say in decision making either over domestic legislation or any third party agreements (trade deals) signed during transition. Second, they extend the agreement reached on citizens rights at the December summit to the end of the transitional period (the UK's position was originally March 2017 and is now the UK's exit from the EU in March 2019). Third, they time limit the transition to 31st December 2020. There had been positive stories earlier this month that the EU27 would acknowledge the possibility transition could be extended beyond two years, as a 21 month transition was too short to sign a future relationship, but this appears to have been shelved.

On the future relationship, the UK's position continues to remain ambiguous. Prime Minister May has repeated her desire for a bespoke free trade agreement, while the EU has remained consistent that enhanced market access will require the UK to meet Single Market obligations, such as President Macron's comments that a deal for financial services would require EU budget contributions. The EU is due to release draft guidelines on the future relationship at the March 22-23rd EU Council. It is of some concern that the UK has yet to formulate a clear policy at this stage. In House of Lords testimony yesterday, perhaps acknowledging this, Brexit Secretary Davis said that Article 50 talks could run on beyond the October EU Council.

1 http://europa.eu/rapid/press-release_IP-18-463_en.htm

Finally, on the domestic front, Prime Minister May is under increasing pressure from Conservative MPs over both the lack of clarity on the future relationship and flagging poll ratings. In a sense, all the above are related. Prime Minister May is struggling to shape a political vision without committing to a decision on the future relationship with the EU27. The design of the transitional deal will itself require an understanding of the future. For example, we believe a twenty one month transition would be too short to negotiate and ratify a free trade agreement even along the lines of Canada's CETA deal, leaving EEA membership or WTO as the only realistic options at the end of 2020. Clarifying the future relationship now is politically unpalatable due to disagreements within the Conservative Party.

What happens next and market implications

Although the EU guidelines on transition are likely to be regarded negatively by Brexiteer MPs, all else equal, UK political incentives still seem aligned for May to compromise. Namely a lack of parliamentary majority that makes it impossible to walk out of talks with the EU27, and poll ratings that discourage a party rebellion for fear of a change in government. Given recent newsflow, an internal challenge cannot be entirely discounted, however. If this occurred before March, it could carry significant negative economic costs, with surveys suggesting firms would trigger contingency plans by then.

Bigger picture, the two binding constraints on the UK's Brexit policy remain a lack of a clear formulation of the future UK/EU relationship and the lack of time to negotiate it. As mentioned above, a 21 month transition would be too short to negotiate and ratify a bespoke free trade deal and we believe even the so called 'Canada option' would be too complex to negotiate in this short a time frame. This is not least as far from being off the shelf, the CETA deal is in fact a bespoke free trade deal in its own right suited to bilateral economic relations between Canada and the EU27.

In this sense, adopting a time limited transition reduces the UK's optionality rather than increasing it. It would leave EEA membership, or WTO rules as the only options after December 2020. In our view, it is more likely that the UK gravitates towards the former. The transition guidelines published by the EU yesterday are more detrimental than terms of EEA membership (although the UK would also have to commit to continued customs union membership as well as joining the EEA). Calls for a clean break with the EU27 are also losing political momentum as polling indicates increased public concern about the economic consequences of Brexit. The question is whether UK policy moves towards this option before March 2019 or during the transition itself. Below, we outline three possible scenarios:

Scenario 1 (base case): Transition agreed in March. Full A50 agreement signed off in October, but future relationship remains ambiguous until UK is in transitional period after leaving the EU in March 2019. UK joins EEA to buy more time, or adopts WTO rules in December 2020, with base case being the former. Market implications: limited upside until EEA confirmed as end-state, but in near term outlook remains dominated by growth and BoE outlook.

Scenario 2: Transition agreed in March, then May makes commitment on future relationship between March and October (either EEA or limited free trade agreement), likely triggering political crisis/leadership contest. Political crisis likely to result in fresh elections or new Brexit referendum. Market implications: 'hard' and 'no Brexit' tail risks rise, depending on result of new elections/referendum.

Scenario 3: Political crisis/leadership contest occurs before March. Market implications: bearish in near term as companies trigger contingency plans resulting in impact on growth. Medium term outcome likely to be similar to 2 above.

In sum, our base case remains that the UK and EU27 will reach agreement on transition in March, with more difficult decisions on the future relationship deferred to later this year or during the transitional period itself. While this is unlikely to generate much economic upside given UK policy remains leaving the Single Market and Customs Union medium term, it should continue to leave the near term market outlook dominated more by growth and Bank of England policy.

Nevertheless, recent newsflow has highlighted the risk that a political crisis is brought forward to before agreement on transition. If this materialized, the market implications would be bearish due to the tangible economic effects of Brexit contingency plans being triggered. Medium-term, due to the lack of time to negotiate and ratify a free trade deal during transition, the UK's options remain binary - a status quo arrangement based on EEA plus customs union, or WTO rules. Our base case is the former.

Appendix 1

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Global Head of Quantitative
and QIS Research

International Production Locations

Deutsche Bank AG
Deutsche Bank Place
Level 16
Corner of Hunter & Phillip Streets
Sydney, NSW 2000
Australia
Tel: (61) 2 8258 1234

Deutsche Bank AG
Mainzer Landstrasse 11-17
60329 Frankfurt am Main
Germany
Tel: (49) 69 910 00

Deutsche Bank AG
Filiale Hongkong
International Commerce Centre,
1 Austin Road West,Kowloon,
Hong Kong
Tel: (852) 2203 8888

Deutsche Securities Inc.
2-11-1 Nagatacho
Sanno Park Tower
Chiyoda-ku, Tokyo 100-6171
Japan
Tel: (81) 3 5156 6770

Deutsche Bank AG London
1 Great Winchester Street
London EC2N 2EQ
United Kingdom
Tel: (44) 20 7545 8000

Deutsche Bank Securities Inc.
60 Wall Street
New York, NY 10005
United States of America
Tel: (1) 212 250 2500