Brexit Update

AIB Treasury Economic Research Unit

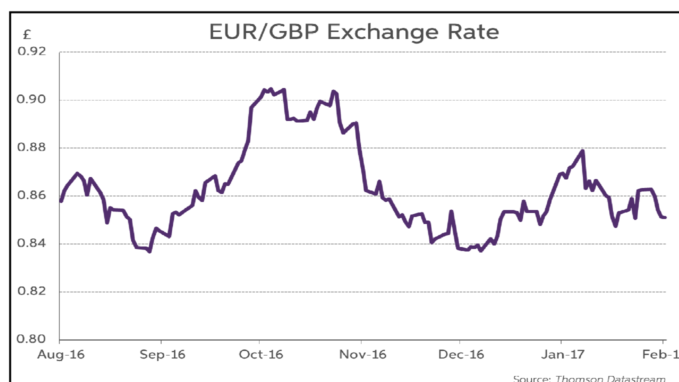
13th February 2017

Sterling more stable as UK prepares to trigger Article 50

Sterling fell sharply last year on concerns over Brexit. The currency hit 30-year lows against a strong dollar, falling through key support levels at $1.37-1.38, before declining to a $1.21-1.27 range. The euro made significant gains against sterling, with the EUR/GBP pair generally trading in an 84-90p range since last summer, up from 70p towards the end of 2015.

It is important to remember, though, that sterling appreciated by nearly 20% on a trade-weighted basis between 2013 and mid-2015. Thus, in reality, it has returned to levels against the euro that were seen earlier in the decade. Indeed, sterling traded at even lower levels against the euro during 2009-2010.

Sterling has become more stable since the autumn. It has managed to regain some ground against the euro, rising back up to 85p, even though it looks like the UK could be heading for a 'hard' Brexit. The **UK economy has held up much better than expected,** with strong GDP growth of 0.6% in both Q3 and Q4. Growth forecasts for the UK for 2017/18 have been revised upwards. Hence, the markets now think that the next move in UK rates will be upwards, with the economy holding up and inflation on the rise.



Meanwhile, the **UK government remains on course to trigger Article 50 next month,** removing another element of uncertainty. The UK also seems increasingly confident that it can secure a trade deal with the EU. All this has helped create a more positive backdrop for sterling at a time of heightened political risks in the Eurozone and the US.

The UK currency could remain quite stable for much of this year, given that there is likely to be little real news flow on the Brexit negotiations in the months ahead, and with market attention more focused on elections in Europe instead. Elections in the Netherlands, France, Germany and possibly Italy are expected to see eurosceptic parties do quite well. Meantime, concerns about Greek debt have resurfaced in markets recently.

Downside risks, though, remain for the UK currency next year as the exit negotiations come to a head. The talks, by that stage, are likely to be fraught and punctuated by crises, with much uncertainty about the final outcome. There is still a real risk of an outcome that is very negative for the UK economy and sterling.

Prime Minister May confirmed last month that the UK would **leave the Single Market** on its departure from the EU. She also indicated that the **UK would not remain a full member of the Customs Union** and is likely to seek sectoral customs agreements. However, she did stress that the UK has a strong desire to reach a comprehensive free trade deal with the EU to avoid major disruption to both economies.

The indications from the EU are that the formal negotiations on the future trading relationship with the UK will not commence until after it leaves the EU. Thus, **it is unclear at present what arrangements, if any, an exit deal will contain in regard to trade.** The UK has expressed a preference for a transitional period that allows for a phased process of implementation of new trading arrangements. The EU may not agree to this, especially with the UK set to leave the Single Market and impose controls on immigration from the EU. It is important to note that the **UK does not have a veto over the exit deal**, which weakens its hand in the difficult negotiations with the EU. Indeed, the UK Government has warned that it may not be able to reach a deal with the EU on Brexit.

Oliver Mangan
Chief Economist
oliver.n.mangan@aib.ie

John Fahey
Senior Economist
john.j.fahey@aib.ie

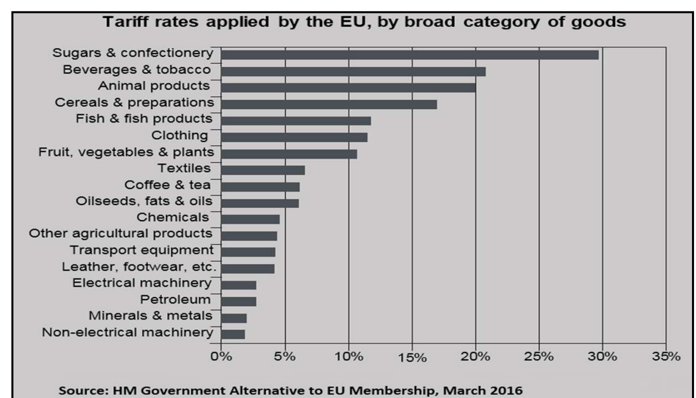
Dara Turnbull
Economist
dara.c.turnbull@aib.ie

AIB

‘Hard’ Brexit would impact trade and economy

The Prime Minister has indicated that the UK could opt for no deal at the end of the exit negotiations on the basis that “**no deal is better than a bad deal**”. Parliament will be given the choice of accepting the deal negotiated by the Government or rejecting it, which also increases the risk of the UK leaving the EU without any deal. In such circumstances, the **UK would have to fall back on WTO rules**, which would involve tariffs. It would also lose its free market access to countries with which the EU currently has free trade deals.

WTO rules 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 a range of common external tariffs on imports from such countries, most notably in relation to food products. The EU would have to levy these tariffs on imports from the UK in the absence of some form of trade deal post Brexit. 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.



It now **seems that the UK will also leave the EU Customs Union** as it wants to negotiate its own trade deals with third countries. EU trade with the UK would be clearly impacted by this, with a lot of increased costs, delays and paperwork. There is likely to be a requirement for customs checks and clearance, as well as compliance with regulations on rules of origin, production standards, etc.. Such **non-tariff barriers are seen as more damaging to trade than the tariffs** themselves. Meanwhile, goods going from one part of the EU to the other, that move through the UK, will require **TIR** (Transport Internationaux Routiers) carnet customs documentation to avoid import duties and taxes—the goods will also have to be bonded and in sealed lorries.

Irish businesses would be well advised to start preparing for the possibility a ‘hard’ Brexit, given that free trade between the UK and EU could end in 2019. Those importing from the UK could be faced with increased administrative costs, tariffs and customs checks. Large retailers would no longer be able to treat the UK and Ireland as one market, as many big multiples with operations in both countries currently do. Meanwhile, Irish exports to the UK, most notably in the food sector, could be hit with significant tariffs and face increased competition from third countries in the UK market.

Both the UK and Irish economies have performed better than expected in the aftermath of the vote for Brexit last June. The real test, though, will be Brexit itself. The **ESRI has forecast that a ‘hard’ Brexit which sees a fall back on WTO rules, would result in a big decline in trade with the UK, and depress Irish growth** and employment. It estimates that there could be a 20% fall in trade with the UK, with a decline of close to 4% in the level of Irish GDP than otherwise would have been the case. There should be some offsetting positive effects, though, in particular increased foreign direct investment, most notably from the UK.

Significant declines in UK GDP also seem likely in the event of a ‘hard’ Brexit with WTO rules. Trade and investment in the UK would be quite negatively impacted. A further marked fall in sterling is likely in such circumstances. However, **we will have to await the outcome of the Brexit negotiations**, **probably in late 2018**, to see whether the UK manages to retain relatively unfettered access to EU markets or, instead, has to fall back on WTO rules. The outcome of these talks will be hugely important for the UK, Ireland and sterling.

This publication is for information purposes and is not an invitation to deal. The information is believed to be reliable but is not guaranteed. Any expressions of opinions are subject to change without notice. This publication is not to be reproduced in whole or in part without prior permission. In the Republic of Ireland it is distributed by Allied Irish Banks, p.l.c. In the UK it is distributed by Allied Irish Banks, plc and Allied Irish Banks (GB). In Northern Ireland it is distributed by First Trust Bank. In the United States of America it is distributed by Allied Irish Banks, plc. Allied Irish Banks, p.l.c. is regulated by the Central Bank of Ireland. Allied Irish Bank (GB) and First Trust Bank are trade marks used under licence by AIB Group (UK) p.l.c. (a wholly owned subsidiary of Allied Irish Banks, p.l.c.), incorporated in Northern Ireland. Registered Office 92 Ann Street, Belfast BT1 3HH. Registered Number NI 018800. Authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority. In the United States of America, Allied Irish Banks, p.l.c., New York Branch, is a branch licensed by the New York State Department of Financial Services. Deposits and other investment products are not FDIC insured, they are not guaranteed by any bank and they may lose value. Please note that telephone calls may be recorded in line with market practice.