THE VIEW

Economic Research

BREXIT:

THE FINAL COUNTDOWN MAY TAKE LONGER

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EULER HERMES

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- We continue to expect a last-minute agreement which would allow avoiding a disorderly Brexit on March 29th, 2019. This could take the form of (i) a ratification of a revised Brexit deal by the UK Parliament on February 14th or slightly later; (ii) an extension of Article 50 to July or December 2019.
- Given the EU's tough stance on renegotiations and the tight dead-lines, an extension of Article 50 looks increasingly likely. A decision to extend the exit date, opens 3 relevant options: (i) a renegotiated Brexit deal allowing the UK to exit the customs union after a predetermined period of time; (ii) a second referendum; (iii) a softer Brexit following a change in political leadership.
- While the cliff-edge scenario will likely be avoided, the uncertainty about the conditions of an exit and the trade relations after exit will remain significant. The reluctance of investors and dampening effects on trade will presumably cut annual real GDP growth by 0.3pp leading to an economic growth of +1.2% in 2019 and +1.0% in 2020.
- From an economic point of view, a sensible long-run agreement be-tween the UK and the EU would require a workable compromise on the Irish border issue, zero tariffs on goods and "passporting rights" for the UK's financial sector. As the UK also wants autonomy in negotiating trade relations with non-EU countries, a Norway type of Free Trade Agreement would be required. But at present there does not seem to be a majority in favor of such solution in the UK. Alas, the negotiations on future trade relations will be at least as difficult as on the exit agree-ment. Therefore we expect a prolonged transition period beyond the end-2021. Uncertainty will prevail and growth in the UK economy might not exceed an average of +1.5% over the transition period.

+ 1.2%

GDP Growth in 2019

WHERE WE COME FROM

Brexit is proving much harder to tame than a Shakespearian shrew. As expected, on January 15th, the UK House of Commons rejected Theresa May's Brexit deal. Only 202 out of 650 votes of MPs were favorable (31%).

No less than 118 Conservatives and 10 MPs from the Northern Irish DUP (Democratic Unionist Party) from May's caucus voted against the deal. However, this was not a real surprise as already in the no-confidence vote in December 2018, 117 Tories had voted against the Prime Minister (PM).

Following the defeat, Theresa May presented her plan B to the Parliament, i.e. to renegotiate with Brussels the Irish backstop solution which is the main source of disagreement among the hard Brexiteers.

After several days of debate, the Parliament voted on proposed amendments to the EU Withdrawal Bill. Two of them got approved on January 29.

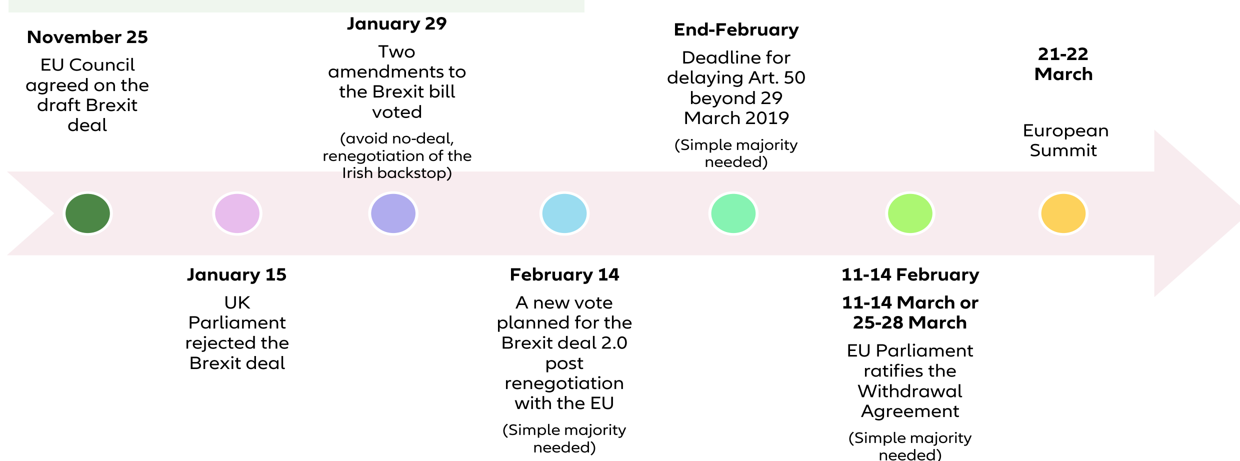
The first amendment, known as the Brady amendment, was approved by 317 to 301 MPs, and officially requires PM Theresa May to renegotiate the deal with the EU, possibly by introducing an-end date to the Irish backstop, after which the UK can leave the customs union without an agreement with the EU on the solution to avoid a hard border on the Irish island – the so called 'Malthouse compromise'. Theresa May had been supporting such a modification of the exit deal and she now has Parliament's official backing.

The second amendment, known as Spelman amendment, was approved by 318 to 310 MPs and also got the vote of a Tory MP. It states that the Parliament can reject a "no Brexit deal". However this amendment is non-binding and the government can choose to overrule it.

As we argued in our recent Brexit update, the true deadline for a last-minute agreement is mid-February in order to allow enough time for ratification by the EU Parliament (see timeline below). A last-minute agreement, our baseline scenario, could either be (i) a ratification of the present Brexit deal or a slightly modified one through EU concessions by the UK House of Co mons or (ii) a delayed Brexit through an Article 50 extension until July or December 2019.

Theresa May has until February 13th to renegotiate the Irish backstop with the EU and submit the potentially modified deal to a new vote in Parliament. As the EU has emphasized that the Withdrawal Agreement already approved by the European Council is not for open for renegotiation, this scenario seems rather unlikely. More time will be needed. The EU has confirmed it is open to extending Article 50 if the UK requests it.

Figure 1 Brexit short-term timeline



Source: Allianz Research

A DELAY IN BREXIT SEEMS LIKELY

Given the tight calendar for Brexit and the unwillingness of the EU to reopen negotiations, we think there is a higher probability for an extension of Article 50 than for significant changes to the deal until mid-February.

However, there is still a chance - albeit a very slight one - that the Labor party supports Theresa May Brexit deal on February 14th – to ensure a 'soft Brexit', and to keep the UK in the customs union for long. The motivation might be to avoid opening the 'Pandora box' of the Irish backstop now, but rather to work on a compromise with the EU during an extended period for negotiations on the planned Free Trade Agreement.

The Scottish National Party and the Liberal Democrats are also in favor of a 'soft Brexit' and different statements suggests that less than 120 Conservatives are Hard Brexiteers (with less than 20 being happy to leave without a deal if needed).

By extending Article 50 and avoiding a disorderly Brexit, the recession risks for the UK would be significantly reduced. As we and many other observers have argued a no-deal Brexit would mostly likely push the UK economy into recession for two consecutive years as it would dampen trade, disrupt supply chains and halt investment plans.

A devaluation of Sterling would further erode purchasing power and reduce consumption (read more on the impact of 'no Brexit deal').

Should the political deadlock continue even after an extension of Article 50, the chances for a second referendum would materially rise (presently there is no consensus for a new referendum in Parliament where a 2/3 majority would be needed).

A second referendum is not without risks as the polls still show close results between the 'Remainers' and the ‚Leavers'. The divide in the UK`s society and its political parties and the lack of political cohesion will not disappear with a new referendum.

Especially in case of a „remain"-vote in a second referendum, new elections would seem to be likely. At present, however, the likelihood of new elections is rather low. General elections would require a 2/3 majority in Parliament which means that 100 Conservatives need to be in favor of it.

According to present polls they could not be certain to remain in power. Another path of events could be a resignation of Theresa May with a new Conservative leader taking over. This, however, would not solve the impasse created by lack of consensus on the right form of Brexit in British politics.

Figure 2: Brexit scenarios and economic forecasts

	2016	2017	2018	2019			2020	2021		
	Pro-Brexit vote in June	EU exit negotiations with EU	EU exit negotiations with EU	Last-minute agreement by March, July or December 2019 (extension of Art 50) (70%)	No agreement, disorderly Brexit, WTO rules (25%)	Stay in the EU (5%)	Transition deal	Soft Brexit (55%)	Limited FTA (40%)	Hard Brexit (5%)
Real GDP (y/y)	1.8%	1.7%	1.3%	1.2%	-1.0%	1.8%	1.0%	1.5%	0.5%	-0.5%
Real private consumption (y/y)	3.1%	1.8%	1.5%	1.5%	-1.0%	2.1%	1.1%	1.6%	0.8%	-0.6%
Real business investment (y/y)	-0.2%	1.6%	0.2%	1.2%	-4.0%	2.6%	1.1%	1.4%	-4.0%	-3.0%
Real total exports (y/y)	1.0%	5.4%	1.5%	2.0%	-5.0%	2.0%	1.8%	1.7%	-2.5%	-4.0%
Real total imports (y/y)	3.3%	3.2%	0.9%	2.5%	-6.0%	3.0%	2.3%	2.2%	-3.0%	-5.0%
Inflation (CPI, y/y)	0.9%	2.7%	2.5%	2.2%	3.5%	2.0%	2.2%	2.1%	2.7%	3.0%
BoE benchmark interest rate	0.25%	0.50%	0.75%	1.00%	0.75%	1.00%	1.25%	1.50%	1.25%	1.25%
GBP/EUR (eop)	1.17	1.13	1.12	1.15 - 1.20	0.84 - 0.87	1.20 - 1.25	1.15-1.20	1.15 - 1.20	0.97 - 0.98	0.79 - 0.81
Business insolvencies (y/y)	0.0%	-3.0%	10.0%	9.0%	20.0%	2.0%	6.0%	1.0%	4.0%	6.0%

NB:

Soft Brexit = Norway / Switzerland type of trade agreement
Limited FTA = CETA-type of trade agreement
Hard Brexit = WTO, Most Favored Nation principle will apply (equiv. to more than 5% weighted average on goods, 20% to 30% additional costs for trade in services)

Sources: ONS, Eurostat, Bloomberg, Allianz Research

UNCERTAINTY WILL CONTINUE TO WEIGH ON GDP GROWTH

Bearing in mind the rather unlikely scenario of a yes vote on PM May`s present Brexit proposal, which would be a clear upside risk for economic perspectives and market expectations, most other scenarios imply significant uncertainties with regard to the process of Brexit during the next months. In our analysis, the high level of uncertainty has shaved growth by about -0.3pp of growth in the past two years via a multitude of channels to the real economy. In our base case scenario of a "soft Brexit" and assuming moderate global growth, we expect the UK economy to expand by around 1.2 % in 2019 and 1.0 % in 2020 (see Figure 2).

Firstly, the dampening effects of Brexit uncertainty have come from a lower (and highly volatile) valuation of the Sterling, which diminishes households' real purchasing power and company margins through higher import prices. In order to compensate for the loss of real purchasing power, UK households have reduced their savings rate to a record low of 4.2% of the gross disposable income in Q3 2018. It has more than halved since the referendum. Furthermore, non-financial corporates' margins have reached their lowest level since early 2014 in Q3 last year. However, there is some upside potential. Should an extension of Article 50 be agreed upon by both parties – our baseline scenario-, then we estimate the sterling will reach levels of 1.15-1.20 in H2 2019.

Second, investment will remain weak as long as significant uncertainty persists. In Q4 2018, business investment is likely to have contracted for the fourth consecutive quarter. This would be the first time since 2009 for such a prolonged period of contraction.

Third, the labor market should remain tight as net migration flows from the EU remain negative and push wages higher (+3.3% y/y in Q4).

Fourth, real estate prices are adjusting downwards thereby contributing to negative wealth effects and deteriorating consumer confidence. Consumer confidence has reached the low levels seen in the aftermath of the Brexit referendum. The construction sector has been impacted by accelerating business insolvencies (+15% in 2018, the second highest increase after accommodation and food services).

Fifth, contingency stockpiling by companies has intensified since Q3 2018 and will pose downside risks in 2019 given the weakness of domestic demand. In some sectors such as agrifood, companies have planned 4 to 7 months of stocks.

Sixth, UK attractiveness will continue to deteriorate, notably with regards to foreign investors. Total M&A deals fell by 60% to GBP42.4bn on average since 2016. Several EU companies switch from a UK supplier to an EU supplier which in turn feeds into higher insolvencies in the UK market: +9% in 2019 after +10% in 2018. In addition, insolvencies of companies with a turnover of above 50M euros have risen in Q4. In total, 19 cases were recorded in 2018 against 15 in 2017.

Seventh, worsening business and consumer confidence coupled with higher risk aversion could trigger tighter loan availability by banks. The prevailing uncertainty could push the Bank of England to delay its rate hike expected in Q2 (+25bp to 1%).

For the long term development of the UK economy and its trading partners, the success of the negotiations on a Free Trade Agreement is essential. From a normative point of view it should involve a free and open border on the Irish island, zero tariffs on goods trade between the UK and the EU, as well as "passporting rights" for the UK`s financial sector. As the UK`s political ambition is to exit the customs union and to negotiate Free Trade Agreements with non-EU countries on its own, an economically viable and beneficial solution that takes account of the above seems to be a Norway-type of agreement. Given that the political opposition to such an agreement seems strong in the UK, the negotiations over the future trade agreement will prove no less difficult than the negotiations on the exit deal. Therefore, we expect an extension of the transition period beyond 2021! Hence, the process of Brexit will continue to generate uncertainty about the prospects for trade and investment and will therefore continue to keep UK growth below potential. Assuming a moderate growth of the world economy, we expect the UK to reach around 1.5% over the transition period, half of the 2000-07 average for example.

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