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Waiting for Godot – Brexit postponed again

Disorderly exit avoided for now, but uncertainty lingers on

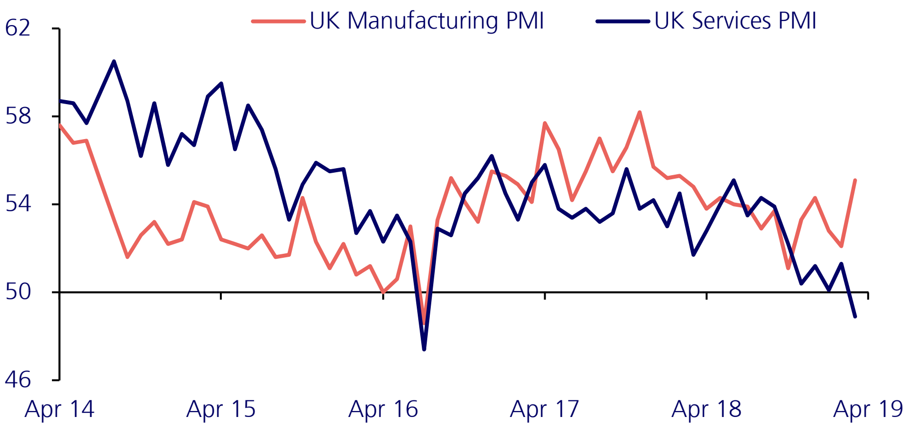
The extension to Article 50 until the end of October reduces the immediate risk of a hard Brexit. However, it also prolongs the period of uncertainty for firms and households and will therefore continue to weigh on the growth outlook. Political risks remain high and brinkmanship on both sides of the Channel could still lead to a disorderly Brexit.

Source: iStock

> "The choices we now face are stark, and the timetable is clear. I do not pretend the next few weeks will be easy."
>
> Theresa May

The fact that a disorderly Brexit has been avoided for now is positive but an almost seven-month extension to Art. 50 is not necessarily good news for the economy as the business outlook remains clouded. The ongoing talks between Theresa May and the opposition could result in the UK remaining in a customs union with the EU, which would remove a lot of uncertainty for firms and households. However, political risks remain high and new elections are another possible scenario that could weigh on the growth outlook in the coming months. The extension period would be cut short if Theresa May's initial withdrawal agreement with the EU passes in the UK parliament. The chances for this happening are slim but, facing a longer than expected Brexit delay, some pro-Brexit Tories may decide to support the deal after all.

Uncertainty weighs on growth – stockpiling boosts manufacturing



Source: Bloomberg

Brexit uncertainty is weighing on business activity

It is now almost three years since British voters decided to leave the European Union by a margin of 51.9% vs. 48.1%. While the initial slump in business sentiment proved to be short-lived the ongoing uncertainty regarding the future relationship of the UK with its most important trading partner is increasingly weighing on the British economy. While the manufacturing sector benefitted from stockpiling ahead of the looming Brexit deadline in March, the Services PMI fell to 48.9, below the threshold of 50 that marks the difference between economic expansion and contraction.

Reacting to the political uncertainty firms are delaying their investment decisions while households are holding back on spending as well. New orders have deteriorated in each of the past three months representing the longest negative sequence since the financial crisis. Investment intentions in manufacturing have fallen to the lowest level since 2010, with actual business investment falling on an annual basis last year. Clearly, given the clouded economic outlook, the willingness to commit to new projects is very limited.

The relatively short extension to Art. 50 until October 31 does not remove the uncertainty. Firms will remain reluctant to invest in new business and households are likely to refrain from spending a lot on major items. The period of sluggish growth is therefore likely to linger on and continued underinvestment has the potential to harm longer term growth prospects. In addition, it is likely that firms which have increased their inventories ahead of the Brexit deadline will want to wind them down, putting a drag on growth in the coming months.

The border barrier remains a conundrum

Most of the questions regarding the withdrawal agreement, like the divorce bill and EU citizens' rights in the UK after Brexit and vice versa, have been settled relatively smoothly. However, the question of how to avoid a hard border between Northern Ireland and the Republic of Ireland remains a major stumbling block that could still lead to an uncoordinated Brexit.

In order to avoid both a hard border for goods crossing the land frontier with Ireland and a customs border in the Irish Sea that would separate mainland Britain from Northern Ireland, Theresa May agreed to keep the whole UK in a customs union with the EU during the transition period lasting until the end of 2020 and potentially even longer. This arrangement goes against the interests of many pro-Brexit Tories as it keeps Britain bound too closely to the EU in their view.

The Prime Minister tried without success to convince the parliament, and in particular members of her own party, to support her withdrawal agreement with the EU. The deal has been rejected three times already - though by a shrinking margin. As the government was unable – or unwilling – to offer other Brexit options parliament took over control.

The UK parliament fails to agree on an alternative plan but a customs union with the EU could materialise as a compromise

In a series of indicative votes the UK parliament failed to reach a majority on any of the options presented with regard to Brexit. With 49.25% of MPs supporting it, the proposal to keep the UK in a customs union with the EU came closest to winning a majority while the option for a second referendum received the highest number of supporting votes (268 yes vs. 295 no).

The option to remain in a customs union with the EU could therefore crystallise as an alternative to either leaving with no deal or accepting Theresa May's withdrawal agreement. The customs union option also seems to be a common ground in Theresa May's talks with opposition leader Jeremy Corbyn.

Remaining in a customs union would help to avoid a hard border between Northern Ireland and the Republic of Ireland, which has been one of the EU's key objectives in the negotiations on the withdrawal agreement. On the other hand, the option to remain in a customs union with the EU has been rejected by a significant majority within the Conservative Party, making it difficult for any Tory Prime Minister to accept.

Hard Brexit postponed – for now

Lacking a majority for any of the presented alternatives, the House of Commons did find a consensus on at least one thing: it very narrowly, by just one vote, accepted a motion to avoid leaving the EU without a deal.

A disorderly Brexit would undoubtedly have a significant impact on the British economy in the short term and it's about a lot more than just trade. Agreements covering a wide range of topics including aviation, energy, drugs and financial services could technically cease to be valid after Brexit if there is no willingness from both the UK and the EU to temporarily extend the cooperation.

While the short-term impact of a disorderly Brexit would be substantial the longer-term effects are less clear and would significantly depend on fiscal and monetary policy reactions. The Bank of England would most likely cut the Bank rate back to its post-crisis low or even further and could restart, or at least signal its willingness to restart, its quantitative easing programme.

The UK parliament's support to avoid a no-deal Brexit and the extension to Art. 50 until the end of October reduce the imminent risk of a hard Brexit. However, brinkmanship both within the UK as well as between the UK and the EU could still lead to a chaotic Brexit and the continuing uncertainty will undoubtedly impact growth prospects.

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