Mind the gap

Brexit negotiations have been extended, but the clock is still ticking down

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- With less than two weeks until its scheduled departure from the EU, a political deadlock in the UK has left the Brexit process in turmoil.
- The resulting economic uncertainty reinforces our expectations for weak economic activity in the UK and further tilts the risks for GDP growth over the coming year to the downside.
- Our expectation has been that the UK would ultimately leave the EU with some form of agreement that still allows for a close trading relationship. However, it's looking doubtful that the necessary political consensus will be achieved over the next two weeks. As a result, there is the risk of a long extension to the Brexit negotiation period, as well as the possibility of a general election and/or a second referendum. We cannot rule out the possibility of the UK leaving the EU without a deal.

What's happened?

The UK was scheduled to leave the EU on 29 March 2019. However, with the UK Parliament struggling to reach a consensus on the terms of its departure, the remaining 27 EU nations agreed for that date to be extended to 12 April 2019. That extension was intended to provide embattled UK Prime Minister Theresa May with time to secure support within the UK Parliament for the exit agreement she negotiated with the EU.

But despite being able to convince some euro-sceptic members of her own party to back her plan, PM May's proposal was still voted down on Friday, 286 to 344. That is the third time her proposal has been defeated. Notably, the PM has not been able to secure the support of her supply and confidence partners, the Northern Ireland Democratic Unionist Party. And without their support, the PM needs to secure the backing of some opposition Labour Party members, the chances of which are low.

Where to next?

This will be (another) pivotal week for the UK. Prime Minister May is scheduled to notify the EU of the UK's intentions regarding Brexit on 8 April. If the House of Commons agrees to a path forward that is also acceptable to the remaining 27 EU nations, the EU will grant a further extension to 22 May 2019 to allow for the precise details of any exit agreement to be determined. However, if the House of Commons cannot reach an agreement, the UK needs to indicate how it intends to proceed with Brexit.

The House of Commons is scheduled to hold a series of indicative votes on Monday to see if there are any options that a majority of MPs will support. The options that will be considered are likely to be along the lines of a 'softer' Brexit, which would leave the UK closely linked to the EU. However, given the current fractured state of UK politics, there is serious doubt that any sort of agreement will be reached. In fact, in addition to voting on the PM's proposed withdrawal agreement, the House of Commons recently held indicative votes on potential paths forward, including the possibility of leaving without a deal. None of the proposed paths forward was able to win a Parliamentary majority. The earlier indicative votes point to a customs union being the option that would garner the most support in Parliament.

It's also looking likely that PM May's proposed Withdrawal Agreement will come back for a fourth vote. However, it's not clear what further changes she can make, particularly given the EU's repeated comments that it will not re-open the Withdrawal Agreement. In addition, there is a procedural hurdle the PM needs to clear – Parliamentary rules limit the ability to repeatedly vote on the same piece of legislation without substantial changes. That means it may not even be possible to hold a fourth vote on the agreement.

What if the UK Parliament can't reach an agreement on its withdrawal from the EU?

If the UK Parliament cannot agree on the terms of its exit from the EU this week, they will need to decide on an alternative path forward. The default position is that the UK will exit the EU on 12 April 2019 with no agreement on future trading relations (a so called 'hard' or 'no deal' Brexit). That would risk a significant downturn in the economy, and MPs have already voted against such an outcome.

One option for the UK is to seek a **further extension** to the negotiating period. An emergency European council summit has been scheduled to consider such a proposal if necessary. However, if exit negotiations continue beyond

22 May, the UK would need to participate in European parliamentary elections, and the EU is opposed to the UK doing so if it is simply going to leave in short order. As a result, the EU is likely to insist on a long extension, at least until the end of 2019 and possibly until the end of 2020. Such an outcome is likely to be very unpopular with voters and politicians in the UK. On top of that, the EU has repeated that it will not just grant an extension to prolong the negotiations; there needs to be a clear path forward, the lack of which is precisely what has led the UK to its current constitutional crisis.

Given the political deadlock, there is a growing chance of a **general election** in the UK. Following her latest defeat in the House, the PM noted that *"I fear we are reaching the limits of this process in this house,"* arguably indicating that she is seriously considering this option. The PM cannot unilaterally call an election, but she can ask the House to vote on such an option, with the motion requiring two-thirds support. It's likely that the opposition would back such a motion. The earliest polling could be held is 25 working days after the vote is called.

Current polling points to the significant risk of a hung Parliament in the UK if there is a snap election. Both of the major parties only have a little over 30% support. Snap election are often unkind to incumbent governments. In fact, PM May's decision to call one in 2017 is viewed as one of her biggest political missteps as it saw the Conservatives lose their outright majority in Parliament.

If there is a snap election, Mrs May is unlikely to stand. She has already signalled that she will step down before the end of this Parliamentary term. And if she is able to win support for her withdrawal agreement, her resignation will follow soon after.

There is also some chance of a **second referendum**. Parliament has already voted against such an option, but there is growing public support and the political impasse could see MPs shifting their stance. A referendum would take several months to organise. A Brexit referendum is likely to be particularly complex as voters may not just be asked to choose between 'Leave' or 'Not leave' options. Instead, they could be asked to rank a range of alternatives related to possible exit terms.

In the case of either a general election or a second referendum, there is some chance that Brexit is cancelled altogether. That follows a European Court of Justice ruling last year that the UK can unilaterally revoke its Article 50 decision to leave the EU.

We can't say with any certainty which of the above options is most likely. While we do expect that the UK will eventually leave the EU with some form of trading agreement, it may take a long time for that outcome to eventuate. And the UK's current political impasse means we cannot rule out a no-deal Brexit.

UK economic conditions

Brexit has already been a significant drag on UK economic activity, with annual GDP growth slowing to 1.3% at the end of 2018. Uncertainty around the economic outlook has been a significant drag on investment spending. While household sector conditions and employment have been more resilient, demand does appear to be cooling.

We expect that economic activity will remain subdued over the next few years and are forecasting GDP growth of 1.2% to 1.4% in 2019 and 2020. The EU currently takes around 44% of the UK's exports. Even with a smooth transition, trade with the single market will be slower over the coming years than it would have been otherwise. This will flow through to slower growth in incomes and lingering softness in investment spending. Recent political uncertainty reinforces the downside risks for growth, especially in terms of investment spending.

In the event that the UK leaves the EU without establishing new trading arrangements, economic activity in the UK would be significantly weaker than our already low growth forecasts. Estimates from the HM Treasury indicate that in the event of a 'no-deal' Brexit, UK GDP could be nearly 10% lower over the coming 15 years (compared to remaining in the EU).

The Bank of England's rhetoric has become increasingly hawkish over the past year, and it has signalled that rates could rise by around 25bps per annum in both 2019 and 2020. However, given the weak outlook for UK activity, and more general nervousness about global economic conditions, we can't realistically see the Bank of England hiking rates any time soon. We think the best course of action is remaining on hold. And in the event of a disruptive Brexit, the downside risks for the economy would take rate hikes off the table and could prompt cuts.

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