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Economics Group

Special Commentary

Our Latest Thoughts on Brexit

Executive Summary

With the March 2019 Brexit deadline quickly approaching, we wanted to take an opportunity to update readers on our latest views on Brexit. We still think a deal will be reached and ratified by E.U. and U.K. parliaments before the March 2019 deadline, and we expect the pound to move higher on balance over the coming weeks and months if that expectation is realized. However, we expect Brexit uncertainty to persist beyond March 2019, limiting the potential longer-term upside for U.K. economic growth and for the pound.

An Update on Negotiations

Amid the deluge of headlines around Brexit, it can be challenging to maintain a grasp on where exactly we are in the broader Brexit process. As it currently stands, the E.U. and U.K. are working toward a withdrawal deal, which covers a wide range of issues relating to the actual process of the U.K. leaving the E.U. It is important to note that this withdrawal deal does not fully address how the two economies will trade with each other after Brexit, and is likely to do so only in vague and high-level terms. Instead, it will likely stipulate that the U.K. will have a “transition period” after March 2019 (through December 2020, or perhaps longer) during which the U.K. will largely maintain the same trading relationship with the E.U., allowing for an extended period of time to work out a more comprehensive trade agreement. According to official comments, most of the withdrawal deal has been agreed, while media reports today suggest the last key outstanding issue—the Irish border backstop—has finally been agreed upon. If those reports are confirmed, it seems that a withdrawal deal could be within reach, and may be finalized by a special E.U. summit this weekend (November 17-18) or at an E.U. leadership summit scheduled for December 13-14.

Even if a deal is struck, however, it must still be approved by the respective parliaments in the U.K. and E.U.—given internal divisions, it seems likely that the U.K. parliament will be a particular hindrance. Thus, even if a deal is reached by mid-December, it may not be approved by parliament until early 2019. That would likely leave the pound vulnerable to large swings in both directions—higher after a deal is first reached, lower as U.K. parliament deliberates and higher again once the deal is given final approval. Despite the volatility, our base case scenario (greater than 50% probability, in our view) is that a withdrawal deal will be reached and approved by parliament before March 2019. In that scenario, we expect sterling to move higher on balance over the coming months.

What if the E.U. and U.K. are unable to reach a withdrawal deal before March 2019, or what if U.K. parliament blocks the deal? Perhaps the most obvious possibility is a “no-deal” Brexit outcome, where the U.K. leaves the E.U. with no agreement in place on March 29, 2019. The implications of that scenario are highly uncertain, but it seems that trade between the two regions would be dictated by World Trade Organization (WTO) rules, implying the imposition of tariffs on a wide range of goods where no tariffs existed before. That merely scratches the surface on the wide range of economic disruptions from a “no-deal” Brexit, but in our view the overall economic implications would likely be highly negative for the U.K. economy and the pound would likely fall sharply.

This report is available on wellsfargo.com/economics and on Bloomberg WFRE.
However, even if a deal is not reached before March 2019, a “no-deal” Brexit outcome is not inevitable. One alternative scenario would be a leadership challenge to Theresa May, or a new U.K. election entirely. A new U.K. leader could be more able to navigate the competing factions in U.K. parliament and find a way to reach a deal with the E.U. and shepherd it through parliament, while separately, a new leader could also perhaps try to derail the Brexit process. Another scenario would be a “second referendum.” This new referendum could take several different forms, including a repeat of the original question from June 2016 (“should the U.K. remain a member of the E.U. or leave the E.U.?”) or a different form entirely. For example, if the E.U. and U.K. reach a deal but parliament tries to block it, there could be a referendum on whether the populace wants to accept the deal or leave the E.U. without a deal. Finally, legal reports\(^1\) indicate that the U.K. could perhaps try to revoke Article 50 in an attempt to reverse the Brexit process entirely.

These scenarios bring their own challenges and in many cases could lead to renewed uncertainty. Moreover, a new election or second referendum would likely require an extension of the March 2019 Brexit deadline, which would need unanimous approval from E.U. member countries. However, these scenarios could nevertheless help the U.K. economy—and the pound—avoid the worst-case “no-deal” Brexit outcome.

**BoE to Hike Rates Further Despite Soft Economy**

Amid all the noise around Brexit negotiations, it is easy to lose sight of U.K. fundamentals, including economic growth performance and the monetary policy outlook. Starting with the economy, U.K. growth has been fairly underwhelming over the past few quarters. Real GDP growth has been running below 2% since the initial referendum in mid-2016, and rose just 1.5% year over year in Q3. Our forecast is for U.K. GDP growth of just 1.2% in full-year 2018, albeit with a moderate pickup to 1.6% in 2019. Much of that weakness has been driven by business investment, which fell 1.9% year over year in Q3. Meanwhile, the U.K. consumer has fared better of late as inflation has eased and wage growth has pushed higher. Indeed, consumer spending accelerated to 4.2% year over year in Q3, the quickest pace of growth in more than a year (Figure 1). Looking ahead, while we see room for a moderate pickup in U.K. economic growth next year, it is hard to envision a more significant acceleration in U.K. economic activity. Indeed, Brexit uncertainty is likely to persist after March 2019 as the focus turns to discussions around a more comprehensive U.K.-E.U. trade deal. That ongoing uncertainty could be a headwind for business investment in particular, which has already been quite weak, although consumers may be more resilient in the face of that uncertainty.

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While U.K. economic growth will probably be fairly underwhelming in the coming quarters, the Bank of England (BoE) still seems poised to continue gradually raising interest rates. As a reminder, the BoE has already raised rates 50 bps over the past year or so, and recent rhetoric from the central bank is consistent with further hikes ahead. Indeed, at its meeting earlier this month, the BoE said that the output gap is likely closed (i.e., there is no spare capacity left in the economy), while it also noted a growing degree of excess demand and a further building in price pressures. This language and signaling suggests to us that the BoE is keen to raise interest rates, but with Brexit uncertainty hanging over the economy, is unlikely to do so until that uncertainty is lifted. However, if as we expect a Brexit withdrawal deal is reached and a “no-deal” Brexit scenario is avoided, we see potential for BoE rate hikes to resume shortly after March 2019 as U.K. economic fundamentals come back into focus (Figure 2). In particular, we expect two 25-bp rate hikes from the BoE in 2019, with the first likely to come in Q2-2019.

Conclusion
After months of continued uncertainty surrounding Brexit negotiations, recent media reports suggest that policymakers have reached an agreement on the final issue regarding the Irish border, meaning a withdrawal deal may be finalized at an upcoming E.U. summit. Although recent developments are a promising sign for the ultimate outcome of negotiations, a final deal may not be approved by the U.K. parliament until early 2019. While we still see a final agreement being reached by the March 2019 deadline, we also look for Brexit uncertainty to remain after this timeframe, which could limit U.K. economic growth prospects and potential upside for the pound. Economic growth in the U.K. has proved lackluster in recent quarters, with real GDP growth remaining below 2% year over year since the initial referendum. Business investment remains depressed, and even if a withdrawal deal is reached before March 2019, the next step of negotiating a more comprehensive U.K.-E.U. trade deal could continue to weigh on business sentiment. That said, in our base case scenario where a deal is reached before March 2019, we look for a modest pickup in economic growth compared to this year and for the pound to move higher in coming months. Given a successful withdrawal deal, we then look for the BoE to gradually resume its tightening path in the second half of 2019.