

Asymmetric risk for sterling as Brexit end-game begins

After Parliament rejected the Withdrawal Agreement (WA) by an overwhelming margin in the Meaningful Vote on January 15th, the deal looked dead in the water. **However, this week saw quite a turnaround when Parliament voted that it would accept the WA if the so-called Irish backstop was “replaced by alternative arrangements to avoid a hard border”.** Meanwhile, in a non-binding vote, which thus does not have any legal standing, Parliament also supported a motion that the UK could not leave the EU without a deal. Crucially, though, the Prime Minister indicated that a vote on a binding motion ruling out a no-deal Brexit, could be put to Parliament in mid-February.

The hard-line Brexiteers in Parliament have conceded ground in agreeing to support a softer form of Brexit, provided the Irish backstop can be renegotiated. They had become concerned at the risk that otherwise Brexit could be delayed or may not happen at all. However, **it is going to be a major challenge to agree alternative arrangements to the current backstop** that would prevent a hard border between the Republic and Northern Ireland. If this was an easy task, then viable alternatives would have come to the fore during the negotiations on Brexit over the past year. A re-hash of previously rejected ideas, such as using as yet undeveloped technology, would not be an acceptable solution.

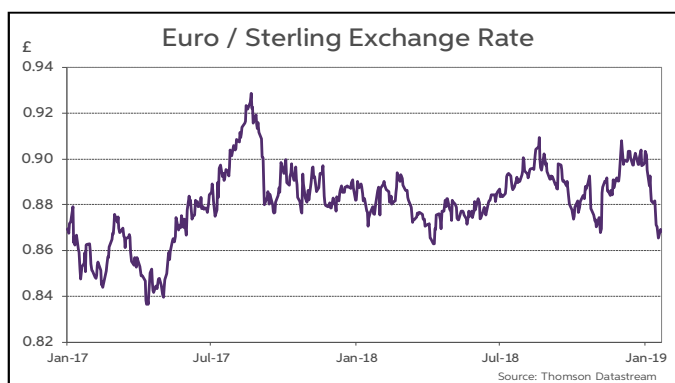
The EU remains very firm in saying that the WA cannot be re-opened and thus there can be no re-negotiation of the Irish backstop. The Irish government has also been steadfast in its refusal to countenance any re-negotiation of the backstop. In these circumstances, the UK could be left facing the choice of accepting the current WA or leaving the EU without a deal, possibly sometime later this year after an extension to Article 50.

All sides, though, want to avoid a no deal Brexit and the hard border that would follow between the Republic and Northern Ireland. However, by sticking rigidly to the current backstop in the WA agreement, the EU and Irish government risk that a hard border could become a reality if the UK eventually leaves the EU without a deal. **It would not be a surprise, then, if Ireland came under pressure to soften its position on the backstop** to see if some changes could be made that could allow the WA to be ratified by the UK Parliament, while still avoiding a hard border. However, it is still unclear how a hard border can be avoided if the UK leaves the Customs Union and Single Market.

Another difficulty for the EU is that the UK Parliament has not specified what type of alternative arrangements it wants to replace the current backstop in order to be able to support the WA. **There is no guarantee that if the EU was to agree to new arrangements on avoiding a hard border, they would be acceptable to the UK Parliament.**

Thus, **February could prove the most torrid month yet in the Brexit process**, as the clock ticks down towards the UK's scheduled departure date of the 29th March. It is very hard to say with certainty how events will unfold. However, there seems to be a growing mood in the UK for some form of managed exit. We expect **efforts will be made to find a workable compromise to the backstop on avoiding a hard border that might not require the reopening of the WA, but could still be made legally binding.**

Sterling has made good gains in the past month on rising hopes that a no-deal hard Brexit can be avoided at end March, if necessary by seeking an extension to Article 50 to delay Brexit. It has risen from \$1.26 at the start of the year to around the \$1.31 level, while the EUR/GBP has fallen back from 90p to circa 87p.



We see the prospects for sterling as very much asymmetric at current levels. The upside potential is likely to be limited as an exit deal will still bring a lot of uncertainty about the future relationship between the UK and EU, with difficult trade talks to come in the next couple of years. Thus, EUR/GBP may fall only slightly to circa 85p. On the other hand, if the prospects of a no deal hard Brexit start to grow, sterling can be expected to fall very sharply from current levels.

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