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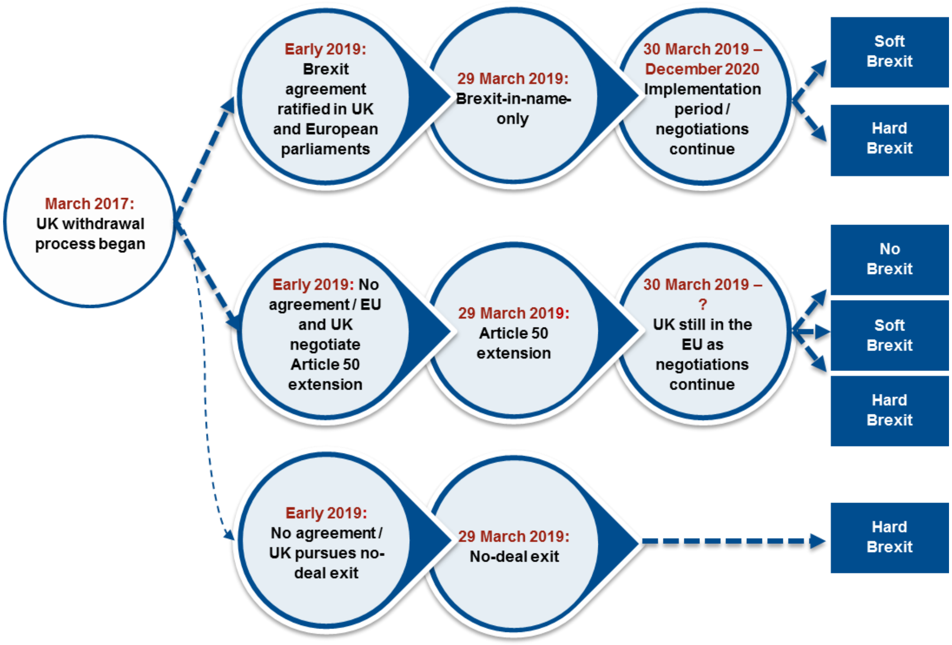
Brexit Outlook 2019: UK and EU to avoid no-deal Brexit, but uncertainty to linger well beyond 29 March

Scope anticipates either a transitional 'Brexit-in-name-only' with an agreement of some kind or an Article 50 extension by 29 March 2019. Prime Minister Theresa May is currently well short of the needed parliamentary majority to ratify the Brexit deal, with the question now on how *much* parliamentary dynamics will shift going forward and how *willing* the EU will be in offering further assurances on contentious areas of the agreement. In a scenario in which a deal cannot be ratified by the British Parliament by this March, an Article 50 extension appears probable in that case, as opposed to a no-deal Brexit. Brexit-related uncertainty will linger well beyond 29 March, increasing a cost on the UK (AA/Negative) economy already totalling at least 1% of GDP.

Brexit will feature centrally in 2019 as the current chapter ends with the UK's two-year Article 50 negotiation period concluding on 29 March. While the UK and the EU reached agreement on the terms of a draft withdrawal agreement (the so-called "divorce" bill) after some 17 months of negotiations (signed off on at a European Council summit on 25 November), the divisive nature of Brexit has precipitated significant opposition within the UK to the deal.

In a report released in August 2017, Scope stated its view that the most likely end-state of negotiations is a long-run soft Brexit (Scope's baseline). Next to this, an eventual no-Brexit 'Breversal' is the second most probable outcome. In Scope's view, either soft Brexit or Breversal is meaningfully more likely than hard Brexit (the latter defined as the UK exiting the single market and customs union). Building towards this long-run end-state, in the near term, Scope has expressed that either: i) a transitional 'Brexit-in-name-only' with an agreement of some kind (and entry into a near-identical transition period in which true negotiations on the future relationship would begin) or ii) an Article 50 extension (and the UK's status inside the EU) is the most probable transitional outcome by 29 March 2019. Here, one way or another, the UK appears set to remain in *nearly all* institutions of the EU for at least a period directly after 29 March 2019, whether the UK is formally a member of the EU in name or not.

Figure 1: Brexit timeline and scenarios



Source: Scope Ratings GmbH

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An unstable period ahead

The lead-up to Brexit Day is likely to be highly volatile

As Parliament resumes debate around the Mrs May's deal this week, the lead-up to Brexit Day in March will be highly volatile, and the situation before 29 March could get worse before it gets "better". In the near term, Prime Minister May has survived a Tory leadership challenge on 12 December. In the challenge's aftermath, the Prime Minister's position has been strengthened somewhat as Brexiteer dissenters now cannot call another such motion for one year. In Scope's view, the easier route for change in the Conservative Party has always been if Theresa May in the end were to resign, which is possible were it to become clear the Brexit deal cannot make it through Parliament.

A scenario in which the Prime Minister resigns would align with a possible Article 50 extension

In any scenario of a resignation from PM May, this would lead to a fresh Conservative leadership election becoming necessary and present significant, undesirable disruption at this sensitive juncture. Any such scenario aligns with a possible Article 50 extension (as well as increases the likelihood of fresh general elections), owing to a probable change in the UK's negotiation objectives thereafter. One scenario in which PM May is replaced with a more hardline, pro-Brexit politician who seeks any 'no deal plus'[1] or 'managed glidepath' could raise political and financial uncertainty, lack the parliamentary support to approve a hard Brexit, and at one extreme, may increase the likelihood of no Brexit at all.

PM May remains short of the needed parliamentary majority

The vote on the deal was originally tabled for 11 December before Mrs May postponed it owing to a lack of support. Intentions are now for a vote in Parliament the week of 14 January. However, it is not at all clear that the draft Brexit deal can pass in Parliament even this month absent additional clarifications and assurances, including those from the EU – such as on the Irish backstop (which Scope noted in August 2018 would eventually involve an all-UK customs union with the EU), an upgraded legal status regarding the non-binding declaration on the UK and EU's future relationship, and/or a greater role for the UK Parliament in negotiations on future UK-EU relations.

Were the Brexit deal not to pass on an initial go this month, the government must present to Parliament within 21 days detailing how it plans then to proceed[2], with Parliament allowed to amend this motion and express backing for alternative Brexit strategies[3]. In the scenario of a deal being rejected in Parliament, and especially were "indicative votes" eventually held in Parliament – clarifying what form of Brexit, if any, could pass, the question then becomes how willing the EU would be thereafter to respond and tinker further with some areas.

All depends now on parliamentary dynamics

All depends now on parliamentary dynamics as the window closes before March 2019

In Scope's view, the dynamics in the UK Parliament *will* shift over time, with the critical question on when and whether it shifts adequately to get Mrs May "over the line". Parliament's back is not against the wall yet so to speak with just under 3 months still to Brexit (although time is needed moreover for ratification in the European Parliament), and concerns of even worse alternatives than the government's deal will only increase as remaining time recedes. There could be a second or even third time around in the House of Commons thereafter were an initial go to fail, particularly were further EU assurances given.

The eventual outcome depends on if DUP MPs and enough Brexiteers will be forced in the end to vote for some form of less-than-sought-for withdrawal deal out of fear of fresh elections and Brexit being stopped altogether if not and/or soft-Brexit advocates vote for it

[1] Jacob Rees-Mogg has proposed a 'no deal plus' that would involve a reduced Brexit Bill of GBP 20bn (from the agreed GBP 39bn) and maintenance of the 21-month transition period, but the UK would become a third country outside of the EU orbit at the end of the transition period which would "provide both sides with time to prepare for a departure on to World Trade Organization terms, or for the activation of the comprehensive free trade deal that the EU has offered".
[2] http://www.legislation.gov.uk/ukpga/2018/16/section/13
[3] https://www.theguardian.com/politics/2018/dec/04/mps-seek-power-to-amend-plan-b-brexit-motion-if-may-loses-vote

out of fear of hard or no Brexit at all. Alternatively, there is a significant possibility, however, that Remainers obtain enough support to block the deal altogether, which precipitates a forced Article 50 extension scenario (which is the scenario to facilitate the space of time to continue negotiations, if not hold early elections and/or a second referendum).

Scope has suggested five factors will force negotiators to avoid no-deal Brexit

Implied here, in the case of Parliament rejecting the deal and there being no deal in the period before 29 March, Scope considers a last resort extension of Article 50 talks to be more probable than a no-deal Brexit from the EU. Here, Scope has suggested five factors continue to compel negotiators to reach some form of arrangement with the EU that avoids no-deal:

1. The significant and asymmetric economic impact 'no-deal Brexit' would have on the UK;
2. Far from adequate no-deal exit preparations with limited time remaining, even as contingency planning in the UK[4] and EU has accelerated;
3. Inadequate UK parliamentary support for a no-deal exit alongside a UK civil society that does not back no-deal;
4. A no-deal Brexit jeopardises the open border between North and South Ireland, and would increase questions about Scotland's future in the Union;
5. Initial UK plans to swiftly enter WTO trading terms in a no-deal scenario are unlikely, meaning that the UK could enter trading limbo in a no-deal exit.

Brexit uncertainty to endure well past this March

Brexit will remain a central source of uncertainty for well beyond March

Whether the UK exits the EU and enters a transition or Article 50 is extended, Brexit will remain a central subject matter in the UK political discourse for a period of time well beyond March and easily over the course of 2019. The EU's chief Brexit negotiator, Michel Barnier, as well as the UK have already been contemplating an option embedded in the withdrawal agreement to extend Britain's transition out of the bloc into 2022, if the current transition to December 2020 proves inadequate to reach a new trade deal[5]. Due to the complicated interconnections at play, the UK Treasury has argued that the process for a successful hard Brexit from the single market and customs union could require a full decade.[6]

An Article 50 extension could facilitate new elections and/or a second referendum

In the scenario that the deal is blocked and Article 50 extended (with the UK still in the EU after 29 March), this could come with an early parliamentary election and/or a second referendum after March. Fresh general elections could, for example, hypothetically bring a coalition of the Labour Party, the Scottish Nationalist Party and/or the Liberal Democrats. Such a coalition could then be in position to call a second Brexit referendum – even if Labour leader Jeremy Corbyn has stated his personal opposition to this. But any referendum date is unlikely to be any sooner than six months after it is called[7] – edging the time horizon into late 2019 if not 2020. The outcome in any referendum is obviously unclear at this stage and depends on how a referendum were phrased. It is worth noting, however, recent YouGov polling[8], which showed 63% of Britons support remaining in the EU, if the alternative were the government's withdrawal agreement, while 58% support remaining in the EU, if the alternative were a no-deal exit. The European Court of Justice ruled that the UK can unilaterally revoke Article 50, and it could do so without altering the

[4] The UK Cabinet has agreed to implement "in full" plans for a no-deal scenario, including 3,500 troops put on standby and GBP 2bn of funds made available for contingencies. Further warnings to voters and businesses are to follow.
[5] A new customs arrangement could moreover take 24 months "from certainty" before being ready, meaning it is unlikely to be fully in place by December 2020.
[6] HM Government. "The process for withdrawing from the European Union", Cm 9216, February 2016.
[7] Sargeant, J., A. Renwick and M. Russell. "How long would it take to hold a second referendum on Brexit?" LSE Brexit Blog, 5 September 2018.
[8] https://www.theguardian.com/politics/2019/jan/05/brexit-corbyn-electoral-catastrophe-yougov-poll

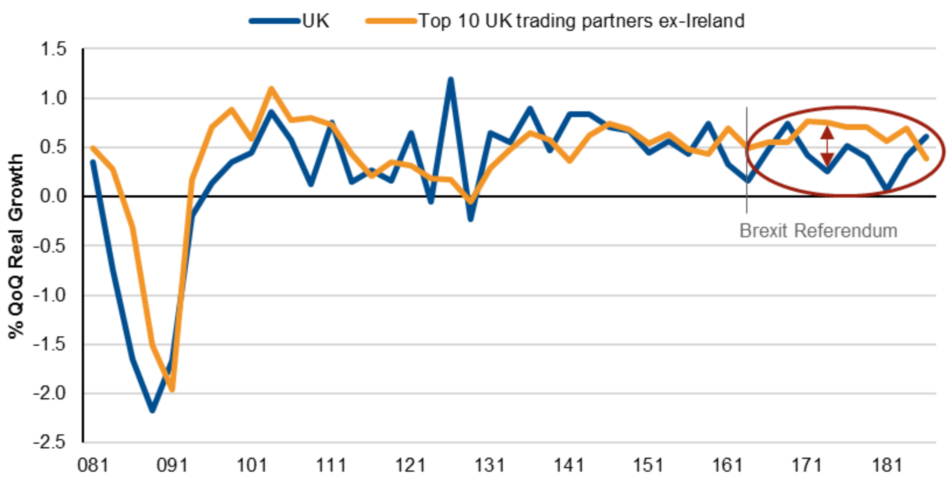
terms of membership (i.e. all opt-outs would remain), suggesting a route remains open to Breversal.

The costs of the Brexit process continue to accumulate

Uncertainty will continue to raise the economic cost of Brexit, even if no-deal is avoided

As such, economic and financial uncertainty will remain high in 2019, which matters not just for the domestic economy, but also for foreign companies and investors whose cash helps finance the UK's wide current account deficit. Scope estimates that, even if the UK sidesteps a no-deal exit, Brexit has already cost the economy well above 1% of GDP since the referendum (**Figure 2**). Were Brexit uncertainty to extend past this March, as anticipated, this loss of output would continue to accumulate. The UK economy grew 0.6% quarter-on-quarter in Q3 2018 – the quickest rate since Q4 2016 – however this rate of expansion slowed since to 0.4% quarter-on-quarter in the three months to October 2018. The UK economy will see a slower annual rate of growth in 2018 of about 1.4%, in comparison with 2017's 1.8%, and 2019 growth will remain soft owing to weak investment tied to economic uncertainty, the unwind of inventory stockpiling for no-deal Brexit contingencies after no-deal Brexit is avoided alongside less buoyant export performance as the European and global economies slow. As Scope expects the UK to sidestep a no-deal exit, contagion from Brexit to the European economy in 2019 will stay modest and linked mostly to ongoing subpar growth performance in the UK.

Figure 2: UK economy versus top 10 trading partners, %QoQ GDP growth



Source: National statistics institutes, Scope Ratings GmbH

Implications for the UK's sovereign ratings

The accrual of Brexit costs can be meaningful to the UK's credit rating

Brexit costs, including the impact on long-run growth potential, are accounted for in Scope's Negative Outlook on the UK's ratings. The accumulating economic costs of Brexit uncertainty can be consequential for the UK's long-run debt sustainability alongside the pound sterling's standing as a leading global reserve currency. Scope affirmed the UK's AA rating in August 2018 along with the Negative Outlook.

Under a Brexit-in-name-only scenario this year, while an agreement on a transitional arrangement for the 2019-2020 period would be viewed favourably by Scope, this also extends the period of uncertainty and associated adverse impacts on the economy. While a reversal scenario may no longer be immediately on the table should the UK exit in coming months, most other options – including various soft and hard Brexit scenarios – remain conceivable. The UK will have less say than it does now as an EU member, and potentially less market access to the EU after the transition ends. However, any action by Scope on the UK's ratings, even in the scenario of a permanent arrangement involving EFTA membership, would depend on the path to securing the arrangement – with emphasis on the importance of reducing economic uncertainty – and on the quality of policy in other economic and fiscal areas. If a harder form of soft Brexit becomes more likely, and/or if economic resilience weakens materially or policy drifts adversely, Scope could envision a one-notch downgrade of the UK's ratings to AA-. Conversely, if a soft Brexit is secured ensuring full access to the single market and reducing economic uncertainty significantly, the rating outlook on the AA ratings could be changed to Stable.

Under an Article 50 extension this year, if this leads to an early election and/or a second referendum and eventual reversal scenario, or, alternatively, a long-run Norway+ model down the road, this could be credit positive. However, any stabilisation of the rating outlook under this scenario remains contingent on a solid policy framework and swift reduction in political and economic uncertainty, driving an improvement in business conditions. If in the scenario, for example, new elections were to lead to a Labour government that eventually reverses or softens Brexit but implements anti-market policies in other areas, weakening the economic climate and/or damaging long-run fiscal sustainability, this could remain credit negative.

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