Economics

DBS Focus

Brexit endgame – deal or no deal

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- *The Brexit deadline is 29 March*
- *The odds for the UK to extend this deadline is not as tenable as the recent appreciation in the British pound suggests*
- *Pushing for a snap election and/or a second referendum will require a lengthy extension that clashes with the European Parliament election scheduled for 23-26 May*
- *Leaving with a withdrawal agreement will require much compromise from hard Tory Brexiters, the Democratic Unionist Party (DUP) and the EU27, especially Ireland*
- *Failure to do so would eventually lead a disorderly no-deal Brexit*
- *A no-deal Brexit could be substantially negative for the GBP. A correction deeper than 18% depreciation after the 2016 referendum cannot be discounted*
- *According to the Bank of England, the worst-case scenario would see the British pound plunge by 25%*

UK faces three options on Brexit

The United Kingdom faces three options on Brexit ahead of the 29 March deadline to exit the European Union. The risk of a disorderly no-deal Brexit has emerged after the House of Commons rejected, on 15 January, by 432 votes to 202 Prime Minister Theresa May's withdrawal agreement with the EU.

Table 1: What can happen on 29 March?

Brexit (Most likely)	Delay Brexit (Unlikely)	No Brexit (Improbable)
With May's deal	To avert no-deal	Revoke Article 50 & maintain status quo
Without a deal	Election and/or 2nd referendum	

Lately, hopes have emerged for UK lawmakers to request Brussels for an extension of Article 50. In looking to avert a no-deal Brexit, debate has increased for the UK to extend Article 50 to hold new elections and/or a second referendum. The EU, however, needs assurances that the UK is not simply kicking the can down the road.

With the European Parliament elections approaching on 23-26 May, the EU would probably prefer the UK to revoke Article 50, abandon Brexit and remain in the EU until UK lawmakers know what they want and can agree on. Put simply, the risk of a no-deal Brexit cannot be totally ruled out.

Second referendum – more noise than reality

There are major hurdles to a second referendum to resolve the political deadlock that prevents UK lawmakers from implementing the decision of the first referendum.

First, there is no clear political support for a second referendum. The Scottish National Party, Plaid Cymru (from Wales), the Green Party and Liberal Democrats have joined forces to call for a second referendum on Brexit but lack the numbers to make one happen. Prime Minister Theresa May and Democratic Unionist Party (DUP) Leader Arlene Foster have spoken against a second referendum. Tory members generally support Brexit and a hard one at that. Opposition Labour Party Leader Jeremy Corbyn and Chairman Ian Lavery have pledged to accept the result of the first referendum.

Table 2: UK votes at Brexit referendum on 23 June 2016

Country	Share of voters	Turnout 72.2%	Remain 48.1%	Leave 51.9%
England	83.8%	73.0%	46.6%	53.4%
Wales	4.9%	71.7%	47.5%	52.5%
Scotland	8.6%	67.2%	62.0%	38.0%
Northern Ireland	2.7%	62.7%	55.8%	44.2%

Second, it takes time to hold any UK-wide referendum. The Brexit referendum on June 23, 2016 was held 13 months after the Conservative Party secured a parliamentary majority at the general elections in 2015. It took 8-9 months for the EU Referendum Act 2015 to come into full legal force on 1 Feb 2016 from the bill's introduction on May 28, 2015.

The referendum was held 4 months after Prime Minister David Cameron's announcement on 20 Feb 2016 to hold one. This is likely to be lengthened on the Electoral Commission's recommendation (in its report on the 2016 EU referendum) that legislation for the regulation of referendum campaigners should be clear at least six months before the start of the regulated referendum period. **A second referendum would require the UK to request a lengthy extension of the Brexit deadline possibly into 2020.**

Snap elections – political support is lacking

UK lawmakers need to override the 2011 Fixed-term Parliaments Act to push for snap general elections. This is easier said than done.

The House of Commons needs to secure a two-thirds majority vote to support new elections. Prime Minister May took this path for the snap election held on 8 June 2017 and it cost the Conservative Party its majority in parliament. The party does not Mrs May to lead them into the next election due in 2022 but they cannot replace her for the next 12 months after she survived the party leadership challenge last December.

Table 3: Representation in the UK House of Commons

Political parties	Jun 2017 snap election	May 2015 gen election
Conservative Party	317	330
Democratic Unionist Party	10	8
Labour Party	262	232
Scottish National Party	35	56
Liberal Democratic Party	12	8
Sin Feinn	7	4

Total seats: 650; Majority: 326 seats; 2/3 majority: 434

The other option would be to topple Prime Minister May and her government via a no-confidence vote which the Labour Party attempted and failed on January 16. While there is nothing to stop Labour from calling another no-confidence vote, there were two lessons from its recent defeat. First, the vote demonstrated that Tory and DUP members, when threatened, will stand united behind their coalition. The DUP's support was critical in preventing a collapse in the government. Second, the DUP was only against the withdrawal agreement (i.e. the Irish backstop) negotiated with the EU with not its negotiator, Mrs May.

Table 4: Vote of confidence against PM Theresa May's government held on 16 January 2019

Political Parties	Confident 325	No confidence 306
Conservative Party	314	-
Democratic Unionist Party	10	-
Labour Party	-	251
Scottish National Party (SNP)	-	35
Liberal Democrat	-	11
Independent	1	4
Plaid Cymru (Wales)	-	4
Green	-	1

EU prefers No Brexit to extending Article 50

When Prime Minister May triggered Article 50 nearly two years ago, the objective was to facilitate a clean exit by the UK from the EU by positioning Brexit on 29 March before the European Parliament elections on 23-26 May this year. This would no longer possible if the UK requests from Brussels an extension of Article 50.

Table 5: Brexit extension clashes with EU calendar

14-25 Feb	21-22 Mar	29 Mar
House of Commons recess	UK's final summit as EU member	**Brexit Day**
18 Apr	**23-26 May**	**2 July**
Last voting session of EU Parliament	**EU Parliament elections**	First sitting of EU Parliament

The European Council would be reluctant to delay Brexit because of the political and logistical problems that comes with the decision. Technically, the UK would still be part of the EU, and as such, would require British voters to elect Members of the European Parliament (MEPs) in May. Apart from whether the UK can be operationally ready for this election, voting for MEPs would also bewilder the British people already struggling to make sense of Brexit.

The European Parliament would face many questions on how to manage UK's MEP seats especially if Brexit is delayed beyond the first sitting of the newly-elected European Parliament on 2 July. **In our view, Brussels would probably prefer the UK to cancel Brexit than to extend Article 50 to push for a snap general election and/or second referendum.** The European Court of Justice has, on 10 December, offered an alternative option for the UK to unilaterally cancel Brexit before the 29 March deadline, on the condition that no withdrawal agreement has been entered with the other EU27 states.

Endgame will probably be a "deal or no deal" Brexit

Ironically, UK lawmakers have returned to square one, pushing for amendments in the very withdrawal agreement that they had rejected on 15 January. The ideological divide remains wide, not only within the Conservative Party, but also with Labour. During the 2017 snap election, the Conservatives had campaigned on the platform that "No deal is better than a bad deal" while Labour refused to accept a no-deal Brexit. Until UK lawmakers unite on what they want, the EU will stand firm that agreement remains the best offer on the table.

Table 6: UK House of Commons rejected on 15 January 2019 May's Brexit agreement with the EU

Political Parties	Support 202	Against 432
Conservative Party (Tory)	196	118
Democratic Unionist Party (DUP)	-	10
Labour Party	3	248
Scottish National Party (SNP)	-	35
Liberal Democrat	-	11
Independent	3	5
Plaid Cymru (Wales)	-	4
Green	-	1

In the end, no one wants UK to exit the EU without a deal. But as Prime Minister May aptly put it, "simply opposing no deal is not enough to stop it".

No-deal Brexit fallout for GBP could be worse than the Brexit referendum

Hence, it is prudent to be guarded against false optimism that the UK would avert a no-deal Brexit on 29 March. Even Fed Chairman Jerome Powell cited, on 30 January, hard Brexit as a geopolitical risk for the Fed pause. Despite expectations that the impact would not be material, Powell noted that a disorderly Brexit is an unprecedented event risk that could lead to disruptions in the Eurozone economy and financial market. From Powell's perspective, it is not the job of policymakers to predict, but to prepare for possible and potential shocks from a negative Brexit outcome.

Table 7: The Brexit referendum resulted in two rounds of trade-weighted depreciation in the British pound

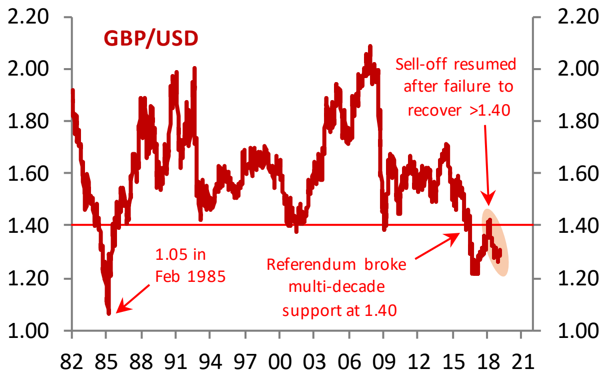
% change vs USD

	Round 1	Round 2	Total
From	23-Jun-16	6-Sep-16	23-Jun-16
To	7-Jul-16	11-Oct-16	11-Oct-16
GBP	**-13.2**	**-9.8**	**-18.5**
EUR	-2.8	-1.8	-2.9
CHF	-2.1	-1.9	-3.1
AUD	-1.8	-1.9	-1.0
JPY	5.3	-1.4	2.6
CNY	-1.5	-0.8	-2.1
PHP	-1.2	-4.3	-4.5
SGD	-0.9	-2.4	-3.0
TWD	-0.7	-0.7	1.3
KRW	-0.4	-1.4	2.7
THB	-0.3	-2.4	-0.9
INR	-0.2	-0.0	1.1
VND	0.0	-0.0	0.0
MYR	0.1	-2.3	-3.9
IDR	0.8	0.7	1.7

The main takeaway from Brexit was a post-referendum trade-weighted depreciation in the pound. Asian currencies were clearly more resilient than their European counterparts due to their limited trade exposure to the UK and geography. With financial markets caught off-guard by the shocking and unexpected "Yes" vote, there was a flight to safety into the Japanese yen during the first sell-off in the sterling in June-July 2016. The yen did not reprise its safe haven role during second sell-off in September-October because the Trump Rally had bolstered financial markets into and after the US presidential election in November. This coupled with a US dollar rally into a Fed hike in December resulted in a slower trade-weighted depreciation in the pound during the second round.

These post-referendum experiences suggested that if no-deal Brexit materializes on 29 March 2019, it would result in another trade-weighted depreciation in the pound. The negative spillover effects into the European and Asian currencies will probably be greater than those experienced during the referendum.

Chart 1: BOE's worst-case scenario for a disorderly Brexit sees GBP/USD falling to its 1985 low



Sources: DBS Research, Bloomberg data

According to the Bank of England, the worst-case scenario of **a disorderly Brexit** is a 25% devaluation that **would return the pound to its all-time low of 1.05 in 1985**. This will be deeper than the total 18.5% fall over 3-4 months seen immediately after the referendum in June 2016. This is not an unreasonable outcome.

If Brexit is not extended, Britain and the Eurozone are near the end and not at the start of Brexit negotiations, and ill prepared to cope with a no-deal Brexit. This **comes at the worst time when world economy has become cyclically vulnerable** to the slowdowns in the large economies (Eurozone, China and Japan), weakness in the tech sector, higher US interest rates and US-China trade tensions. The US dollar is also underpinned by America's relatively stronger growth/inflation/rate outlook against other Developed Market countries. Taking everything into consideration, **Emerging Asian economies will probably be less inclined to resist depreciation.**

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).