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R&R Weekly Column
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UK: The Return Of Brexit Tensions And The "No-Deal" Risk

Last week the UK government presented a bill to regulate the smooth functioning of the internal market following the withdrawal of the UK from the EU on January 31st, 2020, which will exert its full effects starting from January 1st, 2021, at the end of the so-called transition period. As has been widely reported by the media, many clauses of the internal market bill override the provision of the so-called Northern Ireland (NI) protocol, which was signed between the EU and the UK alongside the Withdrawal Agreement (WA) in order to ensure that a physical border between Northern Ireland and the Republic of Ireland does not return following the UK's departure from the EU.

As was clear from the very beginning, the implementation of the so-called Irish backstop would have effectively put a customs and regulatory border in the Irish sea, de-facto breaking the "union" of the Kingdom, while leaving Northern Ireland within the EU customs union. For that reason, Theresa May repeatedly refused to accept that option, considering that "no UK prime minister could ever accept" such a condition. Boris Johnson instead revitalised the plan, and that was the key to unblocking the negotiations with the EU in November 2019, perhaps knowing that he would have reneged that pact less than a year later.

The UK government has explicitly said in parliament that the internal market bill would break international law and that the government's intention was in fact that of overriding the Withdrawal Agreement with domestic legislation. Top EU officials (starting with the leaders of the Council and the Commission, Charles Michel and Ursula von der Leyen, respectively) have called on the UK to respect the pacts signed with the Withdrawal Agreement and the NI protocol (*pacta sunt servanda*, tweeted von der Leyen).

Where does all this leave the ongoing UK-EU negotiations? The two sides agreed that any deal would need to be reached by the EU Council by October 15th, to give enough time for EU parliament and national parliaments to ratify the treaties. For this reason, the EU sent the UK the ultimatum of either withdrawing the internal market bill or making it compatible with the Withdrawal Agreement and NI protocols by the end of September 2020, in order to have at least 15 days to make a final attempt to strike a skinny free-trade agreement (FTA): this FTA would be even less ambitious than the one the EU recently signed with Canada (the so-called *Canada-minus* FTA). But it is self-evident that, given the tight schedule, the risk of a no-deal scenario has returned with a vengeance.

Is this just hard-ball negotiation tactics by Boris Johnson? One could suspect that, with deadlines approaching, the two sides are trying to play chicken to see who gives up first. That's a possibility. However, Boris Johnson is on the record saying that for him a no-deal scenario is a perfectly legitimate and desirable outcome. Also, "no deal" is the only logically consistent end-point of his entire Brexit campaign. Finally, no deal is the only way the UK would have a proper and final clean break from the rest of the EU, allowing maximum freedom in terms of state aid, taxation and regulatory divergence. It would be the final and cherished prize to secure in return for all the hardship of Brexit. Therefore, we do not think that this is just negotiation tactics. If the final outcome is no-deal, Johnson would sell it as his personal victory.

What's wrong with a "no-deal" outcome? While the UK can gain something in the short term from reneging on the pact with the EU that was signed just a few months back, doing so would represent a terrible precedent. For a country aiming at "striking trade deals around the world" (such as the one it recently signed with Japan) as the "Leave" propaganda said, being perceived as a counterparty that not only does not respect its word, but does not even respect the treaties it signs, would be a terrible signal to send to other countries that could be potentially interested in striking a deal with the UK. The UK has taken hundreds of years to move from encouraging piracy to providing one of the most reliable legal systems in the world. If Boris Johnson decides to go down that route, it could cause severe damage to the country's international reputation. With the UK already being one of the countries hardest-hit by the economic repercussions of Covid, its PM needs to be careful in inflicting more damage from the effects of a no-deal Brexit, even if (as we discussed in our column of May 11th) he could get away with it in the short run by blaming Covid for the economic consequences of a disorderly exit from the EU.

Our Recent Publications

- Flash Previews: While Remaining on Hold In September, The BOE Is Likely To Mull Further Stimulus and The BOJ To Sound More Upbeat, *by Brunello Rosa and Karmen Meneses, 11 September 2020*
- Review: ECB Warns About Strong Euro, But Leaves Policy Stance Unchanged, *by Brunello Rosa, Fawaz Al Mughrabi, 10 September 2020*
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- **GEOPOLITICAL CORNER:** Putin Plays Chess In Belarus, *by John C. Hulsman, 8 September 2020*

Looking Ahead

The Week Ahead: US Consumption Likely to Remain Subdued And Central Banks To Remain On Hold

In the US, in August retail sales are expected to remain subdued at 1.1% m-o-m (*p:* 1.2%). The Fed is expected to remain on hold at its September 2020 FOMC meeting, the first meeting after its Chair Powell announced the CB would tolerate higher inflation.

In the EZ, core CPI inflation is projected to rise to 1.2% y-o-y (*p:* 0.4%).

In Japan, the BoJ is also seen to keep its policy rates unchanged at -0.1%.

In England, the BoE is expected to leave the key interest rate unchanged at 0.1%.

The Quarter Ahead: US-China Tensions Remain Elevated, Brexit Uncertainties Linger; Central Banks Remain Cautious

In the US, the government has revoked the visas of more than 1,000 Chinese students and researchers–who are deemed to be a security risk. The move follows a statement by President Trump in May aimed at Chinese nationals suspected of *“having ties to the military, stolen data, and intellectual property”*.

In China, Beijing is expected to impose *"reciprocal restrictions"* on all American diplomats in response to earlier curbs on the activities of its embassy staff in the US. The unspecified countermeasures will apply to all US embassy and consulate staff, as well as the consulate-general in Hong Kong. Also, China will keep opposing a forced sale of TikTok's US operations by its Chinese owner ByteDance, and would prefer to see the video app shut down in the US, rather than be sold to potential US buyers–such as Microsoft and Oracle.

In the EZ, ECB’s President Lagarde statement that *“the ECB would carefully monitor the exchange rate*” was perceived as dovish by the markets and led to EUR appreciation. President Lagarde also reiterated that *“the bank is ready to do more, if needed”*.

In the UK, PM Johnson has accused the EU of *“imposing a full-scale trade border down the Irish Sea and a food blockade”* between Northern Ireland and the rest of country. Meanwhile, the UK struck its first big post-Brexit trade deal, as it reached a historic agreement with Japan–expected to increase trade by GBP 15bn per year. The deal entailed a compromise on agriculture, under which the UK will have access to *“export quotas for cheese and other products that have not been used by the EU”*. The agreement with Japan comes at a crucial moment for Johnson, as his move to unpick parts of the Brexit withdrawal treaty risks the collapse of trade talks with Brussels.

Last Week’s Review

Real Economy: Global Risks Hamper The Recovery, Inflation To Rise, Central Banks Maintain Easing Bias

In the US, the number of ‘unemployment benefits claims’ remained unchanged at 884K in the week ending on September 5; while the number remains high, ‘claims’ were below 1m for two weeks in a row–for the first time since March. In August CPI inflation increased to 1.3% y-o-y (*c:* 1.2%; *p:* 1.0%) and core-CPI rose to 1.7% y-o-y (*c:* 1.6%; *p:* 1.6%)–the highest rates since March.

In the EZ, in Q2 the economy shrank by -11.8% y-o-y (*p:* -3.7%)–the biggest contraction on record, but lower than initially estimated (*c:* -12.1%); as coronavirus-related restrictions hurt most sectors, the EZ is officially in recession.

In Japan, in Q2 the economy shrank an annualized -28.1% (*c:* -28.6%; *p:* 27.8%)–the biggest slump on record, reflecting the severe impacts of COVID-19.

Both the ECB and the BoC kept their main policy rates unchanged – at 0.0%, and 0.25%, respectively. Both CBs reiterated their willingness to support the economic recovery, as necessary.

Financial Markets: US Stocks Decline, Led By Technology; Bonds Stable. Oil Down, Gold Up

***Market drivers*:** investor sentiment was hampered by concerns about: *i)* the fundamentals-valuation disconnect; *ii)* slowing progress in the US labor market; and *iii)* delays in COVID-19 vaccine development, as AstraZenica paused its trials. Global stocks declined w-o-w (MSCI ACWI, -1.2%, to 566) driven by the US (S&P 500, -2.5% to 3,341)–where equities fell for the second straight week, as technology stocks experienced their worst pullback since March. In Europe, stocks rose (Eurostoxx 50, +1.7% to 3,316) lifted by positive economic data, in spite of *i)* disappointment that the ECB did not announce additional stimulus; and *ii)* renewed fears of a hard Brexit.

Fixed income: w-o-w, bonds rose mildly (BAML Global, +0.2% to 297.8); the yield on US Treasury notes declined modestly (10y UST, -6bps to 0.67), pulled down by the news of the pause in the AstraZeneca trials.

FX: w-o-w, the USD gained against most currencies (DXY, +0.7% to 92.719; EUR/USD, +0.1% to 1.185).

***Commodities*:** oil prices fell below 40 USD/b for the first time since July (Brent, -6.6% to 39.8 USD/b), as Saudi Arabia cut oil prices for some customers. Gold rose (+0.5% to 1,942 USD/Oz.), supported by market interest for safe heavens–as longer-term CB interest rates ticked higher.

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The picture in the front page comes from this website

Abbreviations, Acronyms and Definitions

a	*Actual*
AKP	*Justice and Development Party, Turkey*
ann.	*annualized*
ARS	*Argentinian Peso*
avg.	*Average*
bn	*Billion*
BoC	*Bank of Canada*
BoE	*Bank of England*
BoJ	*Bank of Japan*
bpd	*Barrels per day*
bps	*Basis points*
BS	*Balance sheet*
c	*Consensus*
C/A	*Current account*
CB	*Central bank*
CBB	*Central Bank of Bahrain*
CBK	*Central Bank of Kuwait*
CBT	*Central Bank of Turkey*
CDU	*Christian Democratic Union, Germany*
CNY	*Chinese Yuan*
CPI	*Consumer Price Index*
DJIA	*Dow Jones Industrial Average Index*
DJEM	*Dow Jones Emerging Markets Index*
d-o-d	*Day-on-day*
DXY	*US Dollar Index*
EC	*European Commission*
ECB	*European Central Bank*
ECJ	*European Court of Justice*
EIA	*US Energy Information Agency*
EM	*Emerging Markets*
EP	*European Parliament*
EPS	*Earnings per share*
EU	*European Union*
EUR	*Euro*
EZ	*Eurozone*
Fed	*US Federal Reserve*
FOMC	*US Federal Open Market Committee*
FRB	*US Federal Reserve Board*
FX	*Foreign exchange*
FY	*Fiscal Year*
GCC	*Gulf Cooperation Council*
GBP	*British pound*
GDP	*Gross domestic product*
IMF	*International Monetary Fund*
INR	*Indian Rupee*
IPO	*Initial public offering*
IRR	*Iranian Rial*
JPY	*Japanese yen*
k	thousand
KSA	*Kingdom of Saudi Arabia*
LN	*Northern League, Italy*
M5S	*Five Star Movement, Italy*
m-o-m	*Month-on-month*
mb	*Million barrels*
mb/d	*Million barrels per day*
MENA	*Middle East and North Africa*
MHP	*Nationalist Movement Party, Turkey*
mn	*Million*
MPC	*Monetary Policy Committee*
NAFTA	*North-American Free Trade Agreement*
NATO	*North Atlantic Treaty Organization*
OECD	*Organization for Economic Cooperation and Development*
Opec	*Organization of Petroleum Exporting Countries*
p	*Previous*
P2P	*Peer-to-peer*
PBoC	*People's Bank of China*
PCE	*Personal Consumption Expenditures*
PE	*Price to earnings ratio*
PM	*Prime minister*
PMI	*Purchasing managers' index*
pps	*Percentage points*
pw	*Previous week*
QCB	*Qatar Central Bank*
QAR	*Qatari Riyal*
QE	*Quantitative easing*
q-o-q	*Quarter-on-quarter*
RE	*Real estate*
RBA	*Reserve Bank of Australia*
RRR	*Reserve Requirement Ratio*
RUB	*Russian Rouble*
SWF	*Sovereign Wealth Fund*
tn	*Trillion*
TRY	*Turkish Lira*
UAE	*United Arab Emirates*
UK	*United Kingdom*
US	*United States*
USD	*United States Dollar*
USD/b	*USD per barrel*
UST	*US Treasury bills/bonds*
VAT	*Value added tax*
VIX	*Chicago Board Options Exchange Volatility Index*
WTI	*West Texas Intermediate*
WTO	*World Trade Organisation*
w	*Week*
w-o-w	*Week-on-week*
y	*Year*
y-o-y	*Year-on-year*
y-t-d	*Year-to-date*
ZAR	*South African Rand*
2y; 10y	*2-year; 10-year*