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TD Economics

Brexit proceeds on schedule: UK invokes Article 50 of the Lisbon Treaty, officially beginning the two-year negotiation of the terms of separation

- Today, the President of the EU council, Donald Tusk, received a letter from UK Prime Minister Theresa May that officially declares the UK's intent to part ways with the EU.
- Negotiations on the terms of the breakup between the UK and EU can now officially proceed over the next two years, with the hope that an agreement will be reached by the deadline of April 2019.
- Market reaction has been relatively muted this morning, with early weakness in the GBPUSD unwinding following news of the delivery of the UK's letter to the EU.

A long road ahead for the UK and EU

- Negotiations on the terms of the breakup between the two parties are likely to begin slowly, as both sides take the time to form an internal agreement on their initial bargaining positions.
- There are a number of important issues that will have to be ironed out between the two parties. One early hurdle is the question of who is responsible for payment of the legacy costs of the UK's exit from the EU. These costs are estimated to be as much as €60 billion by the EU, while the UK thinks they should be responsible for much less (about £3 billion). An amicable agreement on this front will help set the tone of negotiations on other matters.
- Another early issue will be the status of UK and EU citizens. Optimistically, an early agreement that recognizes the rights of each party's citizens would further help set an optimistic tone for negotiations on other matters such as market access and financial services passporting.
- One of the most contentious points will be how much access to the EU's single market the UK will be allowed. Perhaps most importantly, the UK would like to maintain passporting rights to the EU for its financial services sector, but the EU has made it clear that it would like much of the euro-oriented financial trade to occur within the EU. Reduced access to the EU will hurt the UK's financial services industry.
- There is no doubt that the EU has the upper hand in negotiations, being the larger economy. However, it is still in their interest to reach some sort of amicable agreement, setting the stage for trade negotiations with the UK after April 2019, (although it is possible that the EU will relax its stance on this point and agree to some sort of trade framework before then). It should be noted that negotiating a new trade agreement between the UK and EU within the next two years is a lofty goal, as trade agreements between the EU and other nations have historically taken many years before being ratified by EU parliaments.

Economic costs of Brexit to be borne primarily by the UK

- The UK economy has performed well following the referendum, with household consumption remaining resilient despite increasing uncertainty about the future of the UK. Nevertheless, rising inflation is expected to take a bite out of the purchasing power of UK households this year and next, which should result in a gradual deterioration in consumer spending. Similarly, the Eurozone has proven resilient as well, with growth firming in the second half of last year despite fears of a break-up of the EU.
- Although the total economic costs of this breakup are still unknown and will ultimately depend on the new relationship between the UK and the EU, we anticipate that the long-run growth of the UK economy is

likely to slow by about 0.3 percentage points as a result of Brexit beginning in 2019. This is due mainly to a slower migration of workers to the UK, and a slower pace of business investment that could dampen productivity growth.

Still a lot of unanswered questions

- The future of the UK remains unclear. Yesterday the Scottish Parliament voted to hold a second referendum on remaining a part of the UK, with the intent of calling the referendum within the next 18 months. Ultimately the UK parliament has the final say on whether another referendum will be held and when, and the current government has no inclination to discuss the future of the UK while negotiating the breakup terms with the EU. Both Scotland and Northern Ireland voted to remain as part of the EU in the UK referendum last June, and both may seek to ensure that the UK does its best to avoid a hard breakup with the EU.
- While unlikely, the UK may decide to walk back on Brexit and remain within EU. There is some uncertainty about the legality of the UK referendum with Britain, and it's unclear if an invocation of Article 50 by an EU member state is irrevocable.
- Perhaps the most important unknown is what the new trade arrangement between the UK and the EU will ultimately look like. Both parties are at the start of a long and bumpy journey that could result between either of two extremes of a new trading relationship that is very similar to the current one, or a devolving situation where tariffs are reimposed according to WTO rules.

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