UK Prime Minister's Brexit Speech

May signals 'Hard' Brexit

As had been widely leaked, the UK Prime Minister today stated clearly that her aims for post-Brexit Britain were incompatible with membership of the EU Single Market and full membership of the Customs Union. Prepare for a 'hard' Brexit. As set out previously, the government's primary aims are the ability to restrict EU immigration and withdrawal from the jurisdiction of the European Court of Justice. The PM also signalled the end of "vast" UK contributions to the EU budget. But she hoped to retain selective access to customs-free trade with the EU and argued that a strong EU was in the UK's interests. The UK parliament will vote on any final deal but her aim is for a "truly global", outward-looking Britain. Although we now have clarity over the aims, how it will all work in practice remains uncertain and subject to a huge challenge of negotiation.

Simon Wells

Chief European Economist
HSBC Bank plc
+44 207 991 6718
simon.wells@hsbcib.com

Elizabeth Martins

Economist
HSBC Bank plc
+44 207 991 2170
liz.martins@hsbc.com

The UK will leave the Single Market and full Customs Union

The UK Prime Minister's keynote speech on Brexit reiterated in no uncertain terms that the government's priority is to have the ability to restrict EU immigration and withdraw from the jurisdiction of the European Courts. The speech added that the days of "vast" UK contributions to the EU budget would end. The PM accepted that these aims were incompatible with remaining in the Single Market.

Full membership of the Customs Union was also ruled out to allow the UK freedom to negotiate free trade agreements (FTAs) with non-EU countries. However, Mrs May hoped that some access for some sectors, for example the auto sector (where the government has already provided assurances to some companies), could be retained. However, she was understandably vague about what this 'cake and eat it' approach to the Customs Union might look like in practice.

The PM avoided using language of 'soft' or 'hard' Brexit. We think we were the first to coin[1] these terms more than year before the referendum (see *'A very British dilemma', February 2015*). Based on our original classifications, being outside the Single Market and full Customs Union is very much a 'hard' exit.

The speech set a goal of building a "truly global", outward-facing Britain that championed free trade. Mrs May seemed confident that the vote to leave the EU was also a vote to "embrace the world". While this may cheer free-market supporters, it may be less welcome from any Brexit voters who were hoping for a more protectionist or less globalised UK.

While the PM stated that (due in part to its history) the UK would prosper outside of the EU, she had different advice for the other member states. She stated that while she wanted a "truly global Britain" she did not want an "unravelling" of the EU, which would be bad both for Britain and other European states. She urged other European governments to reflect on the lessons of the Brexit vote.

[1] For an independent view on this, see "What exactly is a 'Hard Brexit' anyway?", Time.com, 17 January.

Mostly the language was soothing and conciliatory, with talk of European friends and partners, as well as "old friends and new allies". However, the PM made some thinly-veiled threats to the EU if it played hard ball when negotiating. She argued constructive negotiation would be in the interests of both parties, given integrated supply chains and the size of the UK as a destination for EU exports. In addition, she said that the UK could "change its economic model", perhaps by lowering taxes, if a good deal could not be struck. At one point she said that no deal was better than a bad deal.

What was new?

Much of the content had been anticipated following the numerous leaks over recent days. The broad vision of the UK outside of the EU was also largely in line with the one set out at the Conservative party conference last October. As a consequence, sterling rallied through the speech following falls in early trading yesterday as the markets digested the leaks.

There was, however, some new information. Importantly, both chambers of parliament (the House of Commons and House of Lords) will vote on the final deal with the EU.

The speech was organised into four key objectives, and 12 more specific points, laid out in Table 1. These points painted a picture of a stronger, fairer, more competitive, outward-looking Britain. But there was little comfort for a financial services industry still in the dark about its access to the European market post-Brexit. The main mention the sector got was as part of a ‘worst case scenario’, whereby the EU lost all access to the City if no deal was done. There was no further clarity on whether the prime minister would seek to replicate the sector’s current ‘passporting’ rights following the UK’s departure.

Mrs May also emphasised the importance of the common travel area between Northern Ireland and (EU member) the Republic of Ireland. This common travel area had been around since before either the UK or Ireland joined the EU, and the government would seek to find a practical solution to maintain it. How this sits with controlling immigration from the EU into the UK, and/or any other changes to customs arrangements, is likely to be a complicated question.

The fourth objective was on an implementation phase to avoid what Mrs May described as a ‘disruptive cliff edge’. On this, Mrs May differentiated between an ‘unlimited transitional status’ and what she called ‘phased implementation’. In the latter, she stated that all of the terms of the final deal would be hammered out by the end of the two-year Article 50 negotiation period – so it won’t be a matter of leaving some details to be decided. Instead, there will be a period in which both the UK and EU can gradually prepare to implement the changes. While clearly the avoidance of a cliff edge is good news, we do not know how long such an implementation phase would last, and how it might work. And, like Mrs May’s other objectives, it is subject to negotiation: presumably, the government will want to have some meaningful change in the way it controls migration from day one after it leaves the EU. If this is the case, there will be a price to be paid, even in an implementation phase.

What next?

The next big 'Brexit event' will be the Supreme Court judgement on the government's appeal of last year's High Court ruling on whether parliament must approve triggering Article 50. This is expected this month although precise timing is still unknown. If the Supreme Court rules in favour of the government, today's speech may be the most detail we will get on the UK's ambitions before Article 50 is triggered and exit talks begin.

If the government loses its appeal it will need to pass a short bill. In theory, this should be approved by the House of Commons fairly quickly, although to ensure this the government may need to reveal more details about its aims and strategy. The Commons overwhelmingly supported a parliamentary motion in December 2016, which called for triggering Article 50 by 31 March 2017. But there would need to be a debate and the opposition support may require more disclosure. The House of Lords could also be a hurdle, and while the Lords could delay the 31 March deadline, ultimately they are unlikely to block Article 50 for long (see *'Ten questions on the process from here', 12 December 2016*).

Economic and market implications

Our FX strategists have argued that GBP is acting as a gauge for the 'hardness' of Brexit that the market is expecting. 'Hard' Brexit rhetoric should keep the downward pressure on sterling, despite today's modest rally. In turn, upward pressure on inflation should continue. Rapidly rising inflation is already upon us, as evidenced by today's above-expectations rise in CPI inflation to 1.6%, the fastest pace since July 2011 (see *UK Inflation (Dec), 17 January*).

With inflation set to continue rising well above target, the BoE faces an increasing dilemma. The BoE Governor has sounded more hawkish recently, emphasising that there are limits to the level of inflation that the MPC can tolerate. However, our view is that higher inflation will not be matched with higher wage growth, implying a squeeze on real incomes. Also, businesses may be adopting a 'wait and see' approach to investment until more clarity emerges on the details of the UK's future trading arrangements. This points to a growth slowdown through 2017. In this environment, we think the BoE will remain on hold at least until the end of 2018, despite rising inflation and growing market expectations of a rate rise.

Table 1: Theresa May's objectives and priorities

Objectives	Priorities
1. Certainty	1: We will provide certainty wherever we can
2. Stronger Britain	2: Leaving the European Union will mean that our laws will be made in Westminster, Edinburgh, Cardiff and Belfast
	3. A stronger Britain demands that we strengthen the precious union between the four nations of the United Kingdom
	4. We will deliver a practical solution that allows the maintenance of the Common Travel Area with the Republic of Ireland
3. Fairer Britain	5. Brexit must mean control of the numbers of people who come to Britain from Europe
	6. We want to guarantee rights of EU citizens living in Britain & rights of British nationals in other member states, as early as we can
	7. Not only will the government protect the rights of workers set out in European legislation, we will build on them.
	8. We will pursue a bold and ambitious Free Trade Agreement with the European Union.
	9. It is time for Britain to get out into the world and rediscover its role as a great, global, trading nation
	10. We will welcome agreements to continue to collaborate with our European partners on major science research and technology initiatives
	11. We will continue to work closely with our European allies in foreign and defence policy even as we leave the EU itself
4. No Cliff-edge	12. We believe a phased process of implementation will be in the interests of Britain, the EU institutions and member states.

Source: UK Government

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Disclosure appendix

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Issuer of report
HSBC Bank plc
8 Canada Square, London
E14 5HQ, United Kingdom
Telephone: +44 20 7991 8888
Fax: +44 20 7992 4880
Website: www.research.hsbc.com

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