Brexit begins…

Now that Article 50 has been triggered, this is what we expect from the economy, sterling, the negotiations and crucially, the final Brexit deal

Economic and Financial Analysis
Updated 29 March 2017

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Brexit begins: What to expect from the economy and politics over the next two years

Nine months on from the referendum, the British government has finally triggered Article 50, sounding the starting gun on two years of Brexit negotiations. From the outset it is clear they are not going to be easy or straightforward. **Already there are disagreements over the negotiation process** - the EU wants the divorce finalised before agreeing new terms while the UK wants parallel discussions. At the same time, EU demands for a severance payment of up to €50bn from the British are raising the hackles of Brexit supporters and the UK press.

Upcoming European elections will make already tense discussions even more challenging. **There is a perception among many in the UK that the rise of anti-establishment/anti-EU parties in several European countries means the EU want to make leaving look as painful as possible.** The EU needs to deter others from following the UK's path. While Nexit-supporting Geert Wilders failed to gain power in the Netherlands, Marine Le Pen remains in with a chance of becoming the next French President. Italy is even more troubling; two of the three leading parties in opinion polls are anti-EU.

Despite the posturing, **we believe both the UK and the EU need a positive Brexit deal.** In the case of Britain, 44% of UK exports go to the EU, which generates jobs, incomes and tax revenues. More than half of all the goods and services the UK imports come from EU nations so any barriers to trade run the risk of higher prices for UK consumers and businesses. For Europe, the UK is a hugely important market and frictionless cross border trade is an imperative for modern supply chains.

Nonetheless, **politics will dominate the economics, at least in the early part of negotiations.** This means uncertainty for business. Already there is survey evidence suggesting UK businesses are cautious about putting money to work. Should negotiations be perceived to be going badly then worries about the UK's future relationship with Europe could see business drift away from the UK. This may result in rising unemployment with asset prices coming under pressure. **Should sterling fall further due to Brexit worries, then inflation will stay higher for longer, squeezing spending power in the UK economy.**

Nonetheless, foreign businesses are reluctant to exclude the UK from investment decisions given it is a large and fast growing economy (by European standards). Consequently, there may be some contagion for Europe too. Even worse, if there is electoral success for anti-EU parties, the prospect of EU break-up could return. **Toxic politics, combined with economic dislocation and financial contagion would likely lead to recession across Europe.**

Another Scottish independence referendum would complicate the Brexit process. We doubt that the British government will allow it to happen before Brexit negotiations are concluded on the simple basis that **negotiating two divorces at the same time will be almost impossible.** Nonetheless, this means political uncertainty will be prolonged, which will weigh on UK asset prices and sterling.

A positive UK-EU trade deal is clearly mutually beneficial. Assuming elections in Europe generate results pointing to renewed EU solidity the risk of a punitive deal for the UK will recede. Moreover, we believe it is in the EU's interest to have strong relations with the UK. After all, demographic factors mean that the UK will be Europe's most populous nation and its largest economy within 30 years. Having ongoing access to this market will become even more important than it is today. With the UK also indicating it is prepared to make ongoing financial contributions there are huge incentives to negotiate a deal that can benefit all.

What's inside?

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Please note, this report has been updated now that the UK has triggered Article 50.
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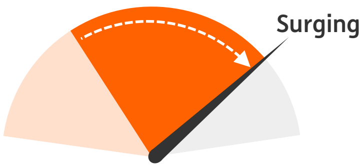
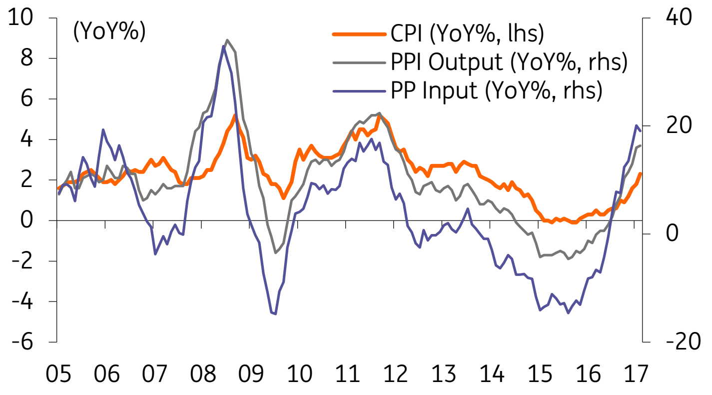
Our Brexit Economic Dashboard: Why the UK's economic resilience is fading

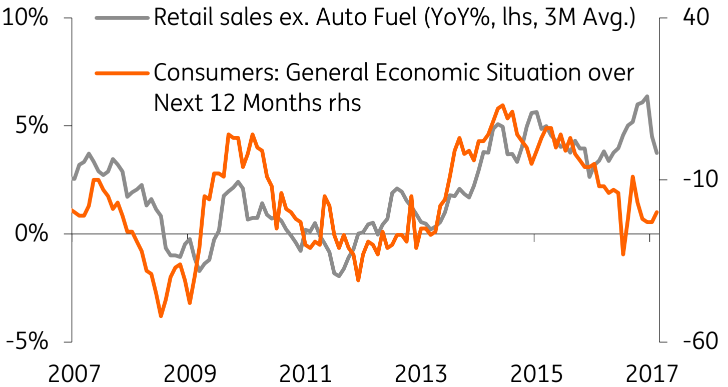


Inflation

The fall in the value of the pound has caused import prices to surge. Headline inflation has already hit 2.3% and we expect it to peak above 3% in the second half of 2017, as sterling's depreciation fully filters through to prices. That peak is both higher and occurs earlier than the Bank of England's projection.



Source: Macrobond



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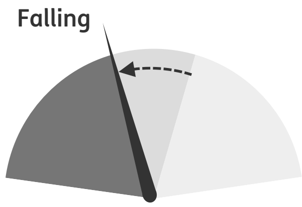
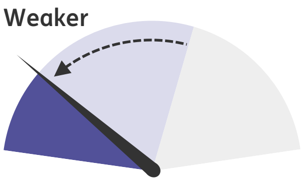


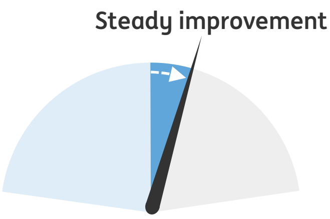
Consumer spending

Surging fuel and food costs are really starting to eat into disposable incomes. At the same time, wage growth is plateauing. Given the weaker hiring outlook and downside risks to house prices, it seems 2017 will be a tough year for consumers. Confidence has already fallen and inflation expectations have spiked.



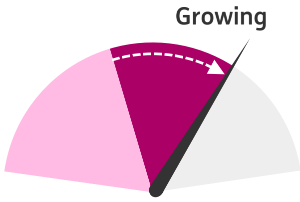
Hiring

Jobs growth has come to a standstill as firms react to higher costs and an uncertain outlook.



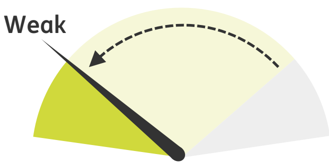
Trade

The weaker pound is taking its time to boost trade (so-called J-curve effect). We expect exports to gradually increase this year.



Manufacturing

Production is riding on the wave of sterling weakness and better growth prospects abroad.



Investment

Surveys suggest businesses are wary of investing and prefer to sit on their hands given Brexit uncertainty

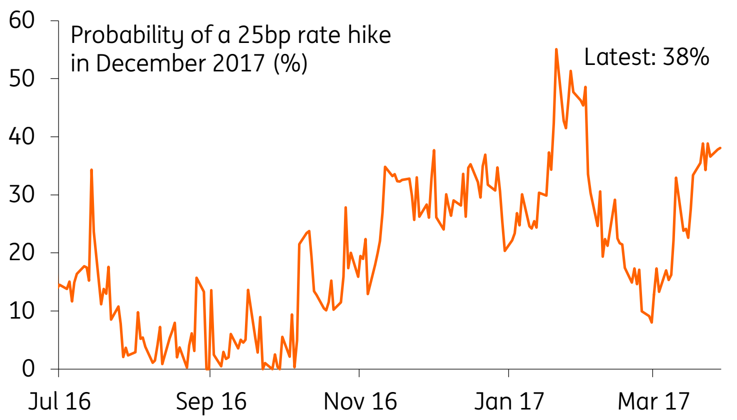
We expect no rate hike in 2017 or 18. Weak growth matters most for the Bank of England

The March Bank of England MPC meeting saw Kristin Forbes vote for an immediate 25bp hike. The minutes warned that it would "take relatively little further upside news" to get others following, having previously suggested they have "limited tolerance" to above-target inflation.

But given that the current inflation spike should be largely temporary, we don't expect the Bank to react with rate hikes. Instead, we think the squeeze on consumer spending will increasingly become the Bank's number one concern.

We aren't forecasting another cut in Bank Rate, but **we don't anticipate any change in policy at least until the end of 2018.**

But the latest hawkish shift has helped lift rate hike expectations significantly, providing support to the pound.



Source: Bloomberg   Based on the UK OIS curve, as of 27 March

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How will the negotiations pan out?

Now that Article 50 has been triggered, the UK will have two years to agree both a divorce and a deal on its new relationship with the EU. This will be challenging, with the length of time it took Canada to agree a trade deal highlighting the problem. The government's assumption is a deal will happen, but **we suspect that a transition period, or "implementation phase" as Theresa May has described it, will be required**. Otherwise it will probably mean UK-EU trade operating under World Trade Organisation rules. This will see the introduction of barriers, such as tariffs and quotas, on trade worth more than half a trillion pounds per year. **The UK will also have to rapidly negotiate deals with non-EU countries** as it will no longer operate under the EU umbrella.

It will be very tough to agree a complete trade deal within the two year period...

The "Barnier Timeline"

Two year negotiation period once Article 50 triggered

- **March 2017** Article 50 triggered
- **1-3 months** Preparation time
  - March: **Dutch elections**
  - April/May: **French elections**
- **6-8 months** EU wants to deal with "divorce" arrangements first
  - September: **German elections, Italian elections (?)**
- **10-11 months** Negotiations on future deal between UK and EU
- **4-5 months** Deal ratified by 27 individual EU members
- **March 2019** UK formally leaves EU

Once the UK has initiated the two year exit process, it's likely to take until the European Council meeting at the end of June before negotiations properly kick-off. The first step is for the EU to work out its priorities, which will happen at a EU27 summit on April 29.

The EU's lead negotiator, Michel Barnier, has said that the EU wants to sort out "divorce" terms before anything else, saying that this alone could take until December this year.

The UK is more keen on a "parallel" approach, whereby the debate on the UK's exit bill takes place at the same time as discussions on a future arrangement.

Assuming Barnier's proposed schedule is followed, this would leave a very short amount of time to negotiate a deal. Remember that it will take a few months for the final deal to be ratified by every EU parliament.

Remember CETA? The EU's trade deal with Canada took seven years to negotiate

The CETA EU-Canada free trade deal was seven years in the making, but was almost scuppered by the Wallonia regional government in Belgium.

All EU member states will have to approve the eventual UK-EU trade deal and some constitutions require regional parliaments within a country to do likewise. The fear is that the UK could effectively be held hostage as member states try to get concessions from the EU on issues unrelated to Brexit.

2009-2016

Length of time it took to negotiate CETA deal

What are the UK's "divorce" costs, and will they really amount to €50 billion?

- Pension liabilities (eg, defined benefit schemes of EU employees)
- Funding for projects already underway
- Unpaid budget commitments
- Loan guarantees

Various European leaders have estimated that the UK's liabilities amount to roughly €50bn. Other European ministers have reportedly put it closer to €40bn.

However, the UK House of Lords Financial Affairs sub-committee have said that Britain would be in a "strong" legal position on exit costs and the EU's estimates are "hugely speculative". Brexit Minister David Davis have said that the final bill will be "nothing like" the estimates being floated by European leaders.

Apart from high-level estimates, there is limited clarity on the breakdown or details of the exit bill. According to the Guardian newspaper, a leaked internal EU memo said that the bill could range from €15-80bn depending on the assets/liabilities included.

The bottom line is that the negotiations on this issue are not likely to be straightforward, and are not fully independent of the final terms of a UK-EU deal.

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The current state of play

The UK accepts it won't keep membership of the single market, but is seeking something that is close, minus the free movement of people. This is not something the EU is keen to give. Senior EU officials have stated that the UK should not be "better off" outside the EU with Prime Minister May responding that punishing Britain to "make a political point" would only make Europe "poorer". The deep economic and financial linkages between Europe and the UK suggest that a sensible agreement can be achieved. More than half a trillion euros of trade is conducted between the UK and the EU each year – which keeps millions of people in work. It is also important to **remember that an agreement on services is just as important as one for goods.**

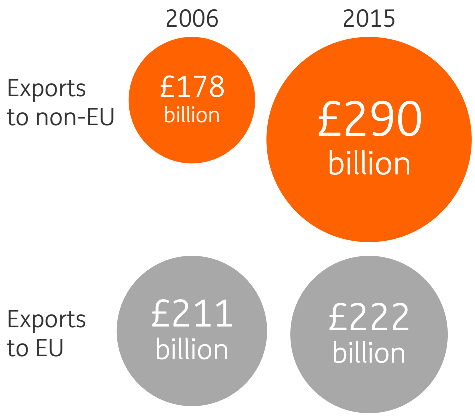
Three facts about UK trade: Why a deal on services matters just as much as goods

Non-EU vs EU exports

The UK's ability to win trade deals with other countries is being seen as one of the benefits of Brexit. Certainly, **exports to the EU have grown less quickly than exports to non-EU countries over the past decade** (5% versus 60% growth). Negotiating trade deals with the likes of the USA and China could see that growth gap widen further.

Nonetheless, the UK still exports a quarter of a trillion pounds worth of goods and services to the EU, on which millions of jobs are dependent. From the other side, it's also worth noting that EU exports to the UK have grown by 28% between 2005 and 2015.

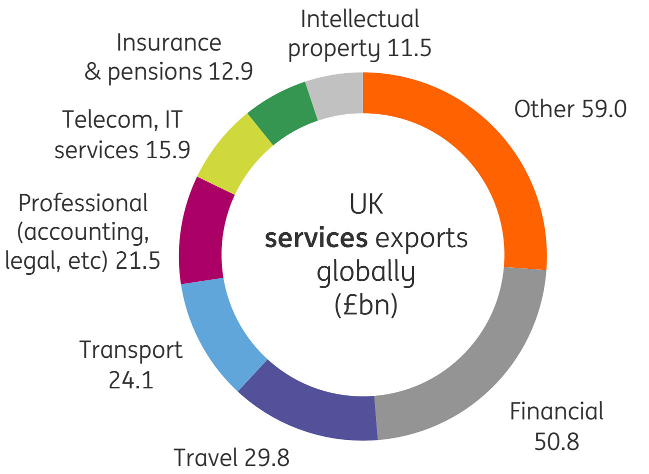
Value of exports of goods & services



Source: ONS

Services just as important as goods

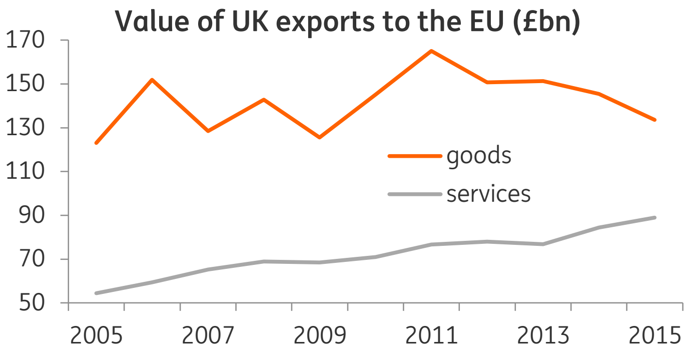
So far much of the media commentary has been focused on goods, with cars and aircraft attracting plenty of headlines. However, global **financial services exports are more than twice the value of vehicle exports.**



Source: ONS

Services are where the growth has been

The value of UK goods exports to the EU has barely changed in 10 years, yet service sector exports have risen 65%. Globally, the UK exports £50bn more in goods than services, but this gap is narrowing rapidly



Source: ONS

Financial services: Passporting and equivalence

Under the EU's passporting system, financial firms that are authorised in an EU or EEA state can trade freely in any other. **Once the UK leaves the EU, British financial firms may have to apply for a licence in each EU country,** but the range of services they can offer would be more limited.

The UK would like a deal that leaves the current situation in place. However, several European governments are opposed. Instead, they want European related financial activities conducted in countries that are directly regulated by the ECB.

This could see jobs moving from London to the Continent with the UK less able to export financial services. Another downside is that London is Europe's only global financial centre and if it is weakened too much, other business could go to Asia or the Americas.

An alternative is for the UK to operate under "equivalence" rules. Here UK institutions could get similar access to what they do now so long as the EU agrees that the UK's standards of regulation and banking supervision is the same or more stringent than in the EU. This would require the UK to match changes to EU law without any influence over the law.

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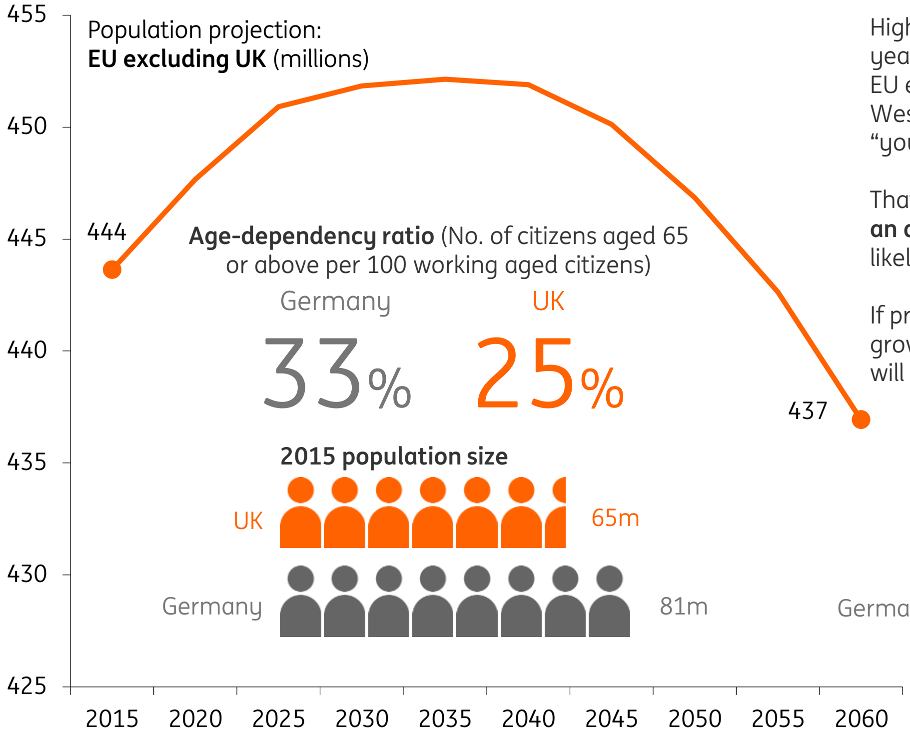
Updated 29 March 2017

Scenario for a deal – the good…

44% of UK exports go to the EU, which generates jobs, incomes and tax revenues. More than half of all the goods and services the UK imports come from EU nations so any barriers to trade run the risk of higher prices for UK consumers and businesses. This also underlines the importance of the UK as an export market for Europe while frictionless cross border trade is an imperative for modern supply chains. **A positive trade deal is clearly mutually beneficial**, but the political rhetoric is not encouraging. Assuming elections in Europe generate results pointing to renewed EU solidity the risk of a punitive deal for the UK will recede. After all, **the UK will soon be Europe's largest economy**, is prepared to make financial contributions and is a hugely important export market. This suggests there are major incentives to negotiate a deal that can benefit all.

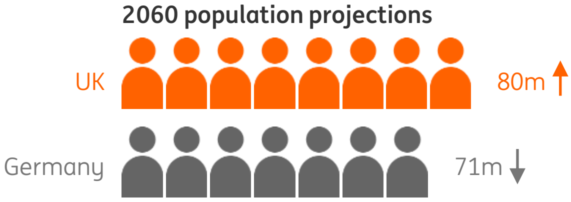
Population dynamics make the UK increasingly attractive for European exporters



High birth rates, driven by immigration over previous years, means the UK's population is growing quickly. The EU estimates the UK will be the most populous nation in Western Europe within 30 years. It will also be one of its "youngest".

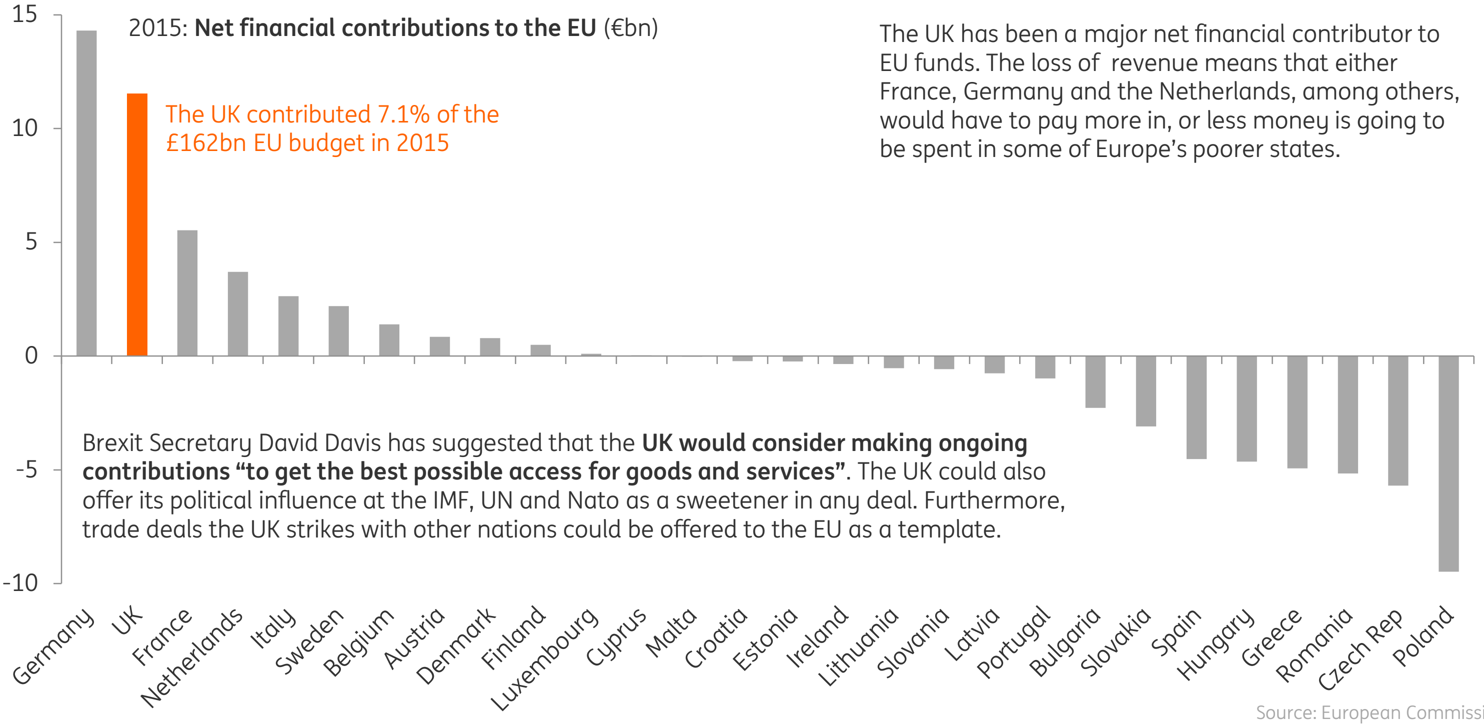
That means **the UK will be less impacted by the cost of an ageing population** (pensions & health) and taxes are likely to be structurally lower.

If productivity keeps pace with Europe, UK trend GDP growth should be well above average. This means the UK will be an increasingly attractive market to export to.



Source: Eurostat

The UK could continue to make a positive financial contribution



The UK has been a major net financial contributor to EU funds. The loss of revenue means that either France, Germany and the Netherlands, among others, would have to pay more in, or less money is going to be spent in some of Europe's poorer states.

Brexit Secretary David Davis has suggested that the **UK would consider making ongoing contributions "to get the best possible access for goods and services"**. The UK could also offer its political influence at the IMF, UN and Nato as a sweetener in any deal. Furthermore, trade deals the UK strikes with other nations could be offered to the EU as a template.

Source: European Commission

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Scenario for a deal – the bad... and the ugly...

While both sides will start the Brexit negotiations seeking a deal that will minimise economic damage and hopefully generate positive results for their respective electorates, things could go very badly. **The political backdrop means there are significant challenges** and, in the UK's case, this uncertainty could see more corporates choosing to sit on their hands rather than investing in their businesses. British households could also become more cautious, leading to a sharper slowdown in activity than we are anticipating. Should sterling come under further pressure due to Brexit worries, then inflation will stay higher for longer, squeezing spending power in the economy. Even worse, if there is electoral success for anti-EU parties, the prospect of EU break-up could return. Bad politics, combined with economic dislocation and financial contagion would likely lead to recession across Europe.

Delays over the deal could see UK growth slow sharply

The UK has been a major recipient of foreign direct investment (FDI), but uncertainty over the UK's future trading relationship with the EU is making foreign businesses cautious on putting more money to work in the UK. The British government has been working hard to encourage investment (Nissan, for example), but if a Brexit deal can't be agreed and barriers to trade are introduced, then foreign businesses will have to think long and hard as to whether it makes sense to use the UK as a base for exporting into the EU.

Likewise, British businesses are increasingly wary about investing more in the UK given the lack of clarity on the relationship. A recent survey by Ipsos Mori suggested that **10% of the UK's largest corporates were already moving some business out of the UK** with 58% saying that they are already feeling a negative impact on their business from Brexit.

A combination of weaker UK growth and business activity with jobs potentially moving abroad could see unemployment rise. This will add to worries about UK asset prices (including sterling) while also leading to a deterioration in government finances.

In turn this could result in credit downgrades and higher borrowing costs, resulting in a vicious downward spiral.

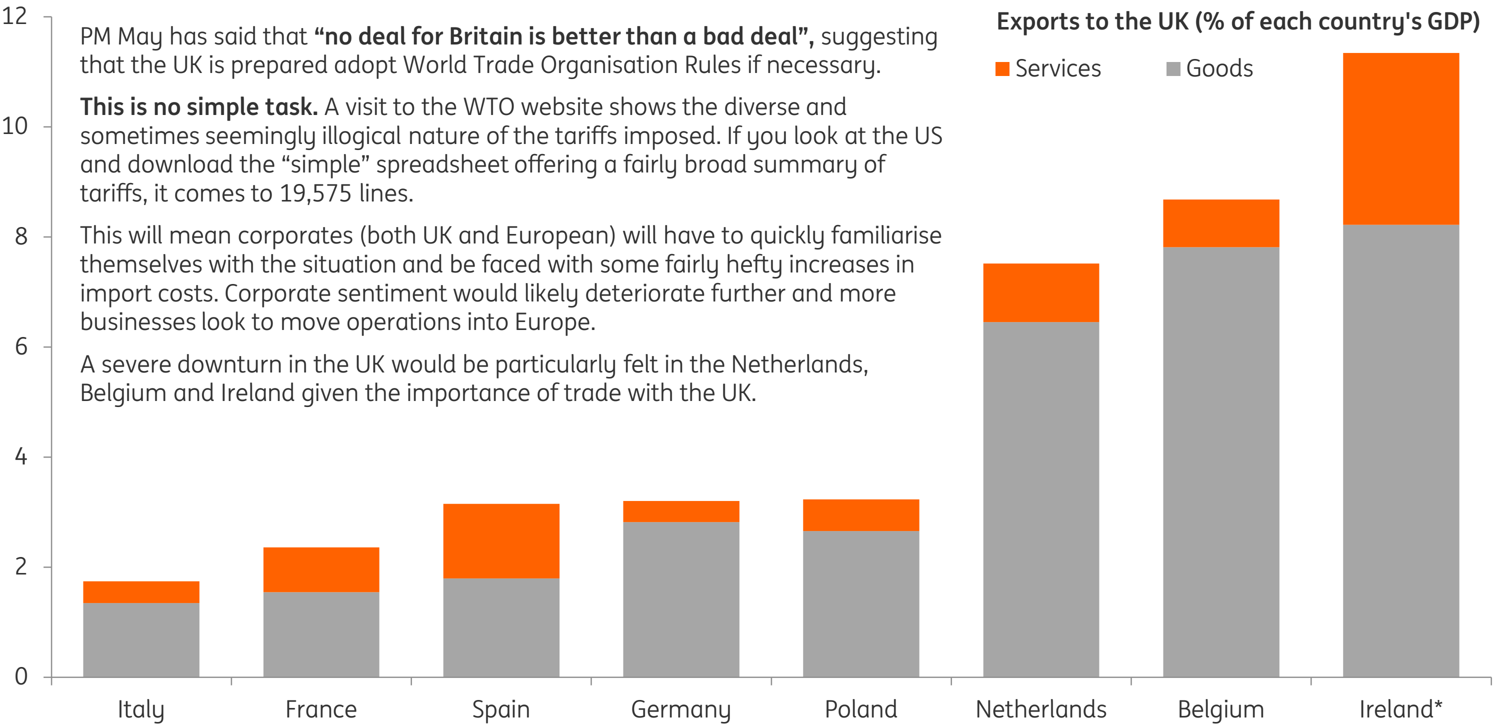
North West Europe is most vulnerable to a bad deal

PM May has said that **"no deal for Britain is better than a bad deal"**, suggesting that the UK is prepared adopt World Trade Organisation Rules if necessary.

This is no simple task. A visit to the WTO website shows the diverse and sometimes seemingly illogical nature of the tariffs imposed. If you look at the US and download the "simple" spreadsheet offering a fairly broad summary of tariffs, it comes to 19,575 lines.

This will mean corporates (both UK and European) will have to quickly familiarise themselves with the situation and be faced with some fairly hefty increases in import costs. Corporate sentiment would likely deteriorate further and more businesses look to move operations into Europe.

A severe downturn in the UK would be particularly felt in the Netherlands, Belgium and Ireland given the importance of trade with the UK.



Source: Macrobond *Irish exports to the UK by value are equivalent to 11.3% of Irish GDP

But it could be worse...

Giving the UK the "greatest possible access" to European markets appears to be the economically rational choice for both sides.

But the UK is concerned that mainstream European politicians are looking to make an example of the UK in order to shore up support for the EU. The UK government's response has been that it isn't in Europe's interest to punish Britain to "make a political point", which in any case would only make Europe "poorer".

These political risks may recede. Dutch parties have ruled out working with Geert Wilders' right-wing party PVV and he will not be a member of the new government. Meanwhile, polls suggest Le Pen may struggle to win in France and Germany is likely to return a mainstream government in September.

But the big uncertainty is Italy, which goes to the polls within the next twelve months. The concern is that the first and third place parties in opinion polls are both decidedly anti-EU. Should the next Italian government decide that they want a referendum on leaving the EU (this will require constitutional change), then the **EU could be inclined to take an even tougher line in Brexit negotiations to make leaving look as unattractive as possible in an act of EU self-preservation**.

In a worst-case scenario, fears of EU break-up could see toxic politics combine with economic dislocation and financial contagion, which would spell disaster for the European economy – not just the UK economy.

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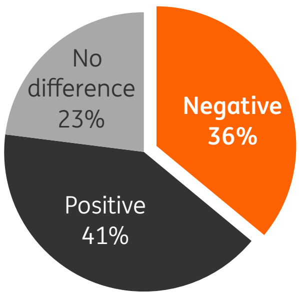
Voters still seem happy with Brexit and the government. **But will that last?**

PM Theresa May's tough stance on Brexit is being well received by opinion polls. Of course, this is partly because the Labour party opposition is being viewed as weak in the polls.

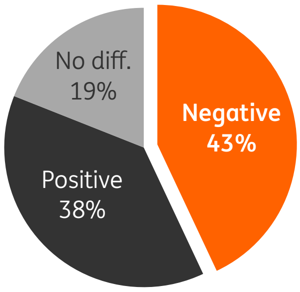
Currently only 14% of people think Labour leader Jeremy Corbyn would make the best prime minister, compared with 47% for PM May (source: YouGov)

But if the economy slows, particularly closer to the 2020 general election, then the government's popularity could start to fade.

What impact will Brexit have on **life in Britain**?



What impact will Brexit have on the **economy**?



Latest UK voter intentions

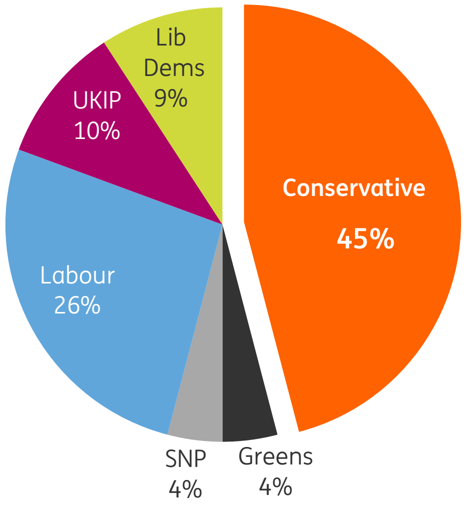
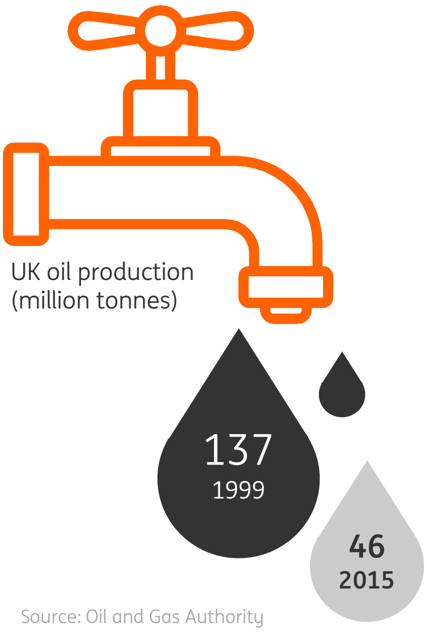


Chart sources: Guardian/ICM polls



Source: Oil and Gas Authority

Will the UK still be in one piece after Brexit?

Scottish nationalists are again pushing for a second independence referendum on the basis that Scotland is being forced to leave the EU against the wishes of its people – it voted 62-38% to remain. Scottish First Minister Nicola Sturgeon is looking to hold the vote sometime between late 2018 and early 2019. This could potentially allow an independent Scotland to remain part of the European single market even though the rest of the UK is leaving.

Prime Minister May is reluctant to offer it, certainly not before Brexit negotiations are concluded in early 2019. Opinion polls are volatile, but **the general trend suggests the Scottish population still narrowly favours staying part of the UK.**

Economically, Scottish independence looks challenging given the sharp fall in the oil price. Last year, Scotland ran a fiscal deficit of 9.5% of GDP according to figures published by the Scottish government. This is equivalent to £2800 more being spent per person than was raised in taxes, including oil and gas revenues.

Like Scotland, the people of Northern Ireland voted to remain in the EU (55.7-44.3%). It has the only land border between the UK and the EU so it is seen as the easiest route for avoiding potential tariffs and for entering the UK illegally. However, there has been free movement between the UK and Ireland since 1923 and Ireland isn't in the EU's Schengen zone (which means that Ireland retains border controls with other EU countries). Nonetheless, the type of trade deal achieved will be most acutely felt here.

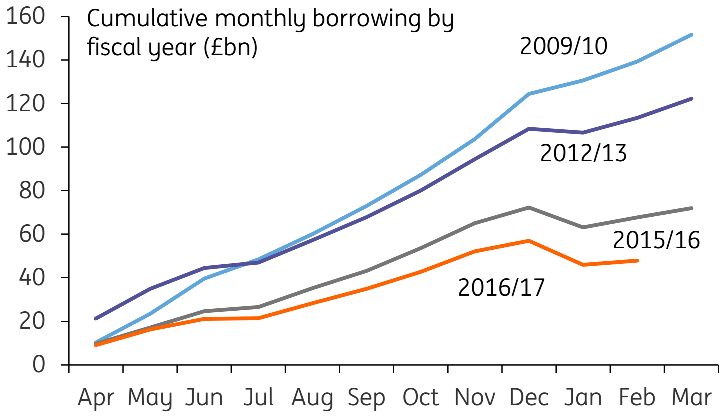
Chancellor maintains a "tight grip" on the UK budget and builds up Brexit war chest

The latest Office for Budget Responsibility forecasts give Chancellor Hammond £26bn to keep in the piggy bank, whilst complying with new fiscal rules (maintain borrowing less than 2% of GDP by 2020).

That gives him some room to ramp up spending if the UK's formal exit from the EU in 2019 is turbulent for the economy.

Until then, the squeeze on consumer spending and persistent Brexit uncertainty looks set to weigh on government revenues (VAT in particular) over the coming years.

As such, with the government still targeting a balanced budget within seven years, **there is little prospect of a relaxation in tight spending plans whilst Brexit is still being negotiated.**



Source: Macrobond

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What does this all means for markets? It could get worse for GBP, before it gets better…

We expect the triggering of Article 50 to have more of a symbolic impact on GBP; while nothing will change to the fundamental UK outlook, it will serve as reality check that a tricky few years lie ahead as Brexit negotiations unfold and a new UK-EU economic relationship takes shape. GBP price action since the Brexit vote reflected some weighted distribution of the various end-game outcomes, with the probabilities shifting as news emerges.

In the short-run, we believe the broader risks to GBP continue to lie to the downside, at least until the tail-risk of a 'messy divorce' has been taken off the table. Any initial stalemate in negotiations – and failure to gain clarity on the post-Brexit UK financial and investment climate – will continue to weigh on GBP. The long-run outlook remains a function of the final Brexit deal, with single market access and future of the UK financial sector key factors.

GBP to trade on the back foot in the short-run if we enter a Prisoner's dilemma situation

Currency reaction to initial Brexit negotiations

UK Tactics \ EU Tactics	Seek Mutually Beneficial Deal	Protect Domestic Interests
Seek Mutually Beneficial Deal	GBP ↑ EUR →	GBP ↓ EUR ↑
Protect Domestic Interests	GBP ↑↑ EUR →	GBP ↓↓ EUR ↓

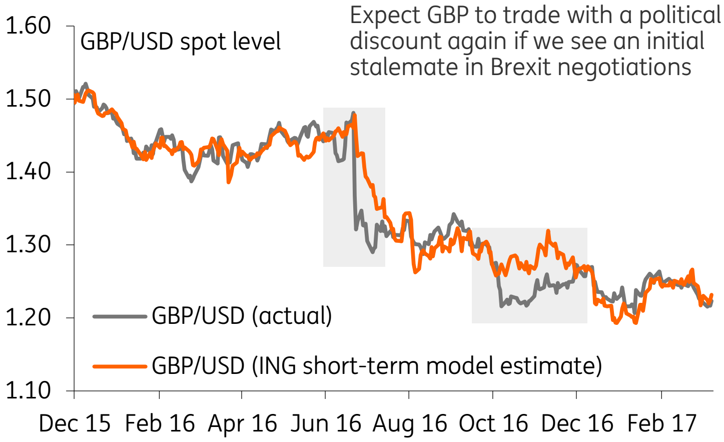
Source: ING

Remember prisoners dilemma…?
Initial Brexit negotiations could see both sides playing hardball and seeking to protect domestic interests. **GBP would bear the brunt of greater political uncertainty**

'Sell UK' warning signs

Political stalemate could trigger a sell UK theme in markets. We would expect GBP assets to underperform

Return of a GBP risk premium
Expect GBP to trade with a political discount again if we see an initial stalemate in Brexit negotiations



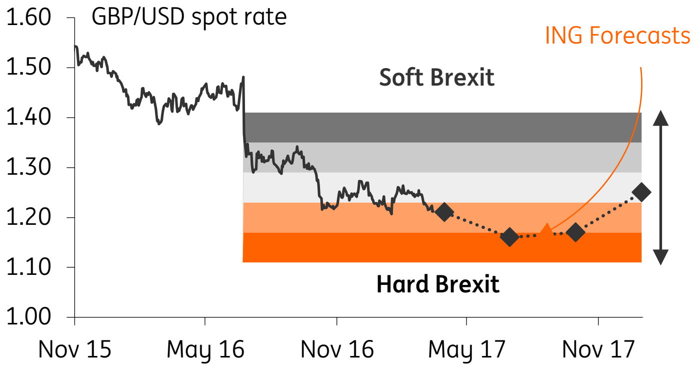
Estimates as of 14 March Source: ING, Bloomberg

GBP valuation a fluid concept until we see finer details of deal, but more risks lie ahead…

The long-run GBP outlook remains a function of the final Brexit deal but prolonged uncertainty – and a lack of meaningful progress in Brexit negotiations over the next few years – could unearth additional risks that are not currently being discounted by markets.

We have already seen the risks of a second Scottish independence referendum brought to the table. But equally, we do not rule out the risk of capital flight – in particular prior foreign direct investment that has been helping to finance the UK's sizable current account deficit in recent years. GBP's status as a reserve currency is also vulnerable.

All this leads us to conclude that there is one final leg of Brexit adjustment left. We look for GBP/USD to form a cyclical base below 1.20, while expect EUR/GBP to stabilise between 0.88-0.90.



Estimates as of 14 March Source: ING, Bloomberg

Three medium-term risks that add clout to the GBP fundamental outlook:

1. A second Scottish independence referendum

Scottish Nationalist Party (SNP) leader Nicola Sturgeon has called for a second independence referendum ("IndyRef2") but we don't expect Westminster to entertain any requests until a Brexit deal is close…

Still we estimate that greater risks of a UK break-up could drag GBP/USD 6-8% lower

2. Financing the UK current account deficit

Uncertainty over Britain's future **access to Europe's single market may deter inward investment** while Brexit negotiations occur.

BoE do not expect to see any near-term external refinancing difficulties for UK borrowers, **but risks of a sharp reversal of capital inflows** will remain.

3. GBP's reserve status

S&P have specified that were GBP's share of global FX reserves **to fall below 3%, then GBP may lose its reserve currency status.**

IMF data puts current share at 4.8% as of 1Q16. **GBP's reserve status is linked to London's role as a global financial centre.**

Access to the EU single market & continuity of UK financial activities matter for GBP

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Brexit begins
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Our key 2017 UK forecasts – lower growth, higher inflation and some GBP weakness...

1.8%
2017 Real GDP Growth

0.90
3Q17 EUR/GBP (eop)

2.8%
2017 Headline CPI

1.19
2Q17 GBP/USD (eop)

	2017F					2018F				
	1Q	2Q	3Q	4Q	FY	1Q	2Q	3Q	4Q	FY
GDP (% QoQ, ann)	2.0	1.2	0.8	0.4	1.8	1.2	1.7	1.7	2.1	1.2
CPI headline (% YoY)	2.2	2.9	3.0	3.1	2.8	2.9	2.7	2.7	2.7	2.8
BoE official bank rate (%, eop)	0.25	0.25	0.25	0.25		0.25	0.25	0.25	0.25	
BoE Quantitative Easing (£bn)	435	435	435	435		435	435	435	435	
GBP/USD (eop)	1.24	1.19	1.22	1.27		1.30	1.33	1.35	1.35	
EUR/GBP (eop)	0.87	0.88	0.90	0.88		0.87	0.86	0.85	0.85	

As of 29 March 2017

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