January 14, 2021

New horizons

Leaving the EU, the UK sets sail for an uncertain future

With the end of the transition period the UK enters a new era and uncharted territory. Having secured a narrow trade deal with the EU the immediate economic impact will be mitigated somewhat. Nevertheless, non-tariff trade barriers and regulatory uncertainty, particularly in the financial sector, will cause near-term disruptions and headwinds in the future, exacerbated by a lack of preparedness.

Source: iStock

A trade deal, at last

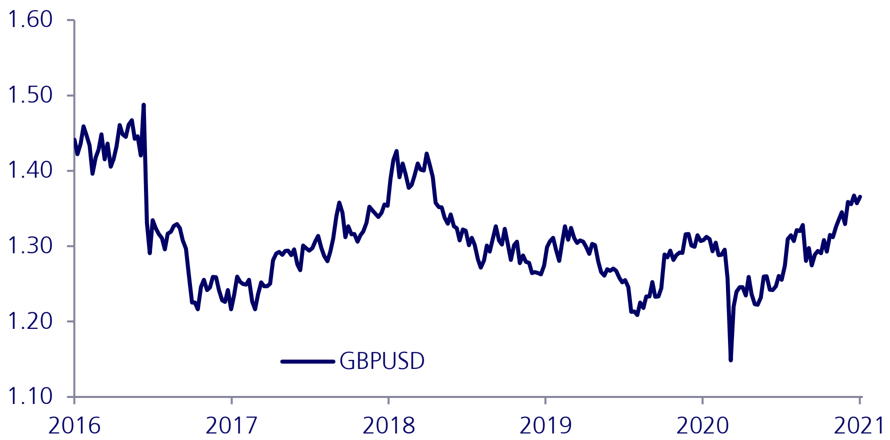
With the beginning of the new year the UK opens a new chapter in its relationship with the EU and the rest of the world. After months of tenacious negotiations and the passing of several proclaimed deadlines the EU and the UK finally reached an agreement on a trade deal. Although it is a relatively narrow agreement it will help to mitigate the economic impact of the UK leaving the EU single market and customs union. Failing to reach a deal would have led to the implementation of tariffs, particularly in sectors like car manufacturing and agriculture.

Worst case avoided, but the economy will suffer nevertheless

We welcome the agreement as it helps to avoid the most disruptive split between the two trading partners. Leaving the EU without a deal would have cost the British economy an additional 2% of GDP according to estimates made by the Office for Budget Responsibility (OBR). Nevertheless, the UK economy is still estimated to be about 4% worse off in the long run compared to remaining a member of the EU. A lot will depend on potential future agreements with the EU and other trading partners, though, as well as the UK government's ability to create an attractive environment for business activity, employment and investment by exploiting its new-found regulatory sovereignty.

The current trade agreement with the EU may provide a basis for future negotiations, which are expected to continue for years. However, the difficulty of even reaching a consensus on the underlying narrow trade deal reflects the challenge of reaching an agreement on a broader range of issues, at least in the near term.

Sterling rises as the hardest form of Brexit has been avoided



Source: Bloomberg

Keeping EU market access will be a constraint for new UK regulatory standards

An important objective for the UK in the negotiations was that the European Court of Justice (ECJ) would have no direct role in the enforcement of the agreement and the resolution of disputes. That goal was achieved as the implementation and execution of the trade agreement is overseen by a joint committee made up equally of UK and EU representatives, with a number of specialized sub-committees.

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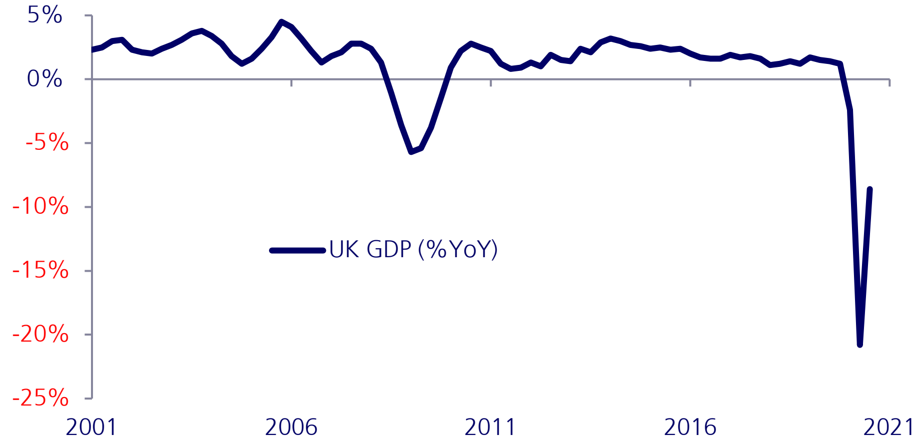
Brexit will weigh on the recovery from the COVID-19 pandemic



Source: Bloomberg

One of the most contentious topics during the negotiations was the EU's push for a level playing field to prevent the UK from undercutting EU firms with regard to a broad range of regulatory standards. Based on the agreement that was reached, the UK is now technically free to set its own rules in areas such as environmental standards and labour laws but with the risk that its EU market access will be restricted if it deviates too much from the EU standards. In practice this means that the UK will either have to keep its regulatory framework close to the EU's or face additional economic damage caused by punitive EU measures.

Tariffs have been avoided, but many UK sectors will face more headwinds

Average EU tariffs are low, but some sectors like car manufacturing and agriculture would have been hit hard in the event of a no-deal Brexit. Nevertheless, even with a deal, some sectors will face more headwinds than others.

Although fishing only makes up a tiny fraction of the economy, contributing about 0.02% to UK GDP, disagreement on future quotas and access rights almost led to a breakdown in negotiations. Now, the EU will give up 25% of its current quota of fish in UK waters with annual negotiations on fishing rights starting in 2026.

For a number of sectors, including energy, aviation and transport, the agreement provides a more specific framework, though it falls short of conditions applied while the UK was part of the EU single market. For example, life for British logistics and haulage firms will become more difficult and less profitable. Their trucks won't be allowed to move as freely within the EU as before, forcing them to move back to the UK before re-entering the EU. Similarly, UK-based airlines won't have the same possibilities to provide intra-EU flights as before.

Uncertainty remains high for the financial sector

The biggest gap, however, is that the deal does not cover services, the lion's share of the British economy and almost half of its exports.

The financial sector is particularly vulnerable as UK firms have lost the passporting right to get full access to the EU market. The EU has only temporarily granted equivalence for British regulatory standards and only in specific areas that were crucial for the EU. Future rules will have to be negotiated, but the uncertainty will weigh on the sector, particularly as the EU can unilaterally revoke its decision at short notice.

In a memorandum of understanding published together with the agreement the two parties commit to providing more details regarding the equivalence frameworks for financial services over the course of 2021. Nevertheless, activity and investment are likely to suffer until there is more clarity. As an example of this, nearly 6bn EUR of EU share dealing shifted away from London on the first trading day of the new year. More lost business is to be expected in the coming months.

Another open question relates to data handling and protection. The corresponding regulatory adequacy will be an important topic in future negotiations with broad implications on security and police databases as well as many data-related services.

Lack of preparedness exacerbates the near-term disruption

A narrow deal is better than no deal, but the UK will face major changes and potential disruptions in the coming months and quarters. The agreement means there won't be new tariffs or quotas, but the British economy will face a plethora of new rules when dealing with the EU including safety regulations, rules of origin, veterinary checks, export declarations, the loss of automatic recognition of professional qualifications, travel and work visa for longer stays and even potentially higher roaming charges. All this will lead to more red tape, higher costs and more frictions in trade and business activity.

Trade disruptions will be exacerbated by the fact that UK businesses are ill prepared on average for the post-Brexit framework as shown in a recent report published by the National Audit Office. As an example, HM Revenues & Customs estimates that in 2021 270 million customs declarations will have to be processed annually compared to about 55 million before Brexit. It is expected that 40% to 70% of the lorries travelling to the EU are not ready for EU customs requirements. Under the government's reasonable worst-case scenario up to 7'000 lorries may need to queue when entering the UK.

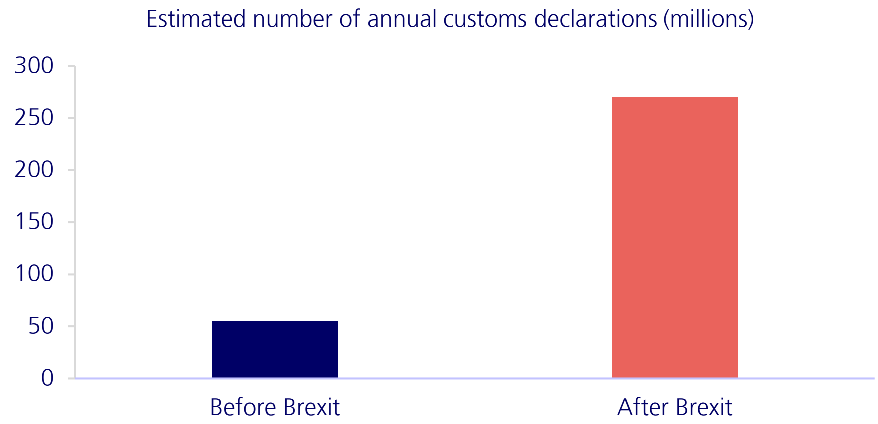
The COVID-19 pandemic made Brexit preparations more challenging

Back in March 2020, the Border and Protocol Delivery Group (BPDG) reported that eight of the nine key elements of government and border industry readiness it was monitoring were at significant risk of not being delivered by January 1, 2021. Areas rated at the highest level of risk were IT systems, infrastructure, data, customs agents' capacity, and trader and haulier readiness.

Although some progress has been made since then, the COVID-19 pandemic and several lockdowns have absorbed a significant amount of the government's focus making it likely that significant gaps with regard to preparedness for the post-Brexit era remain.

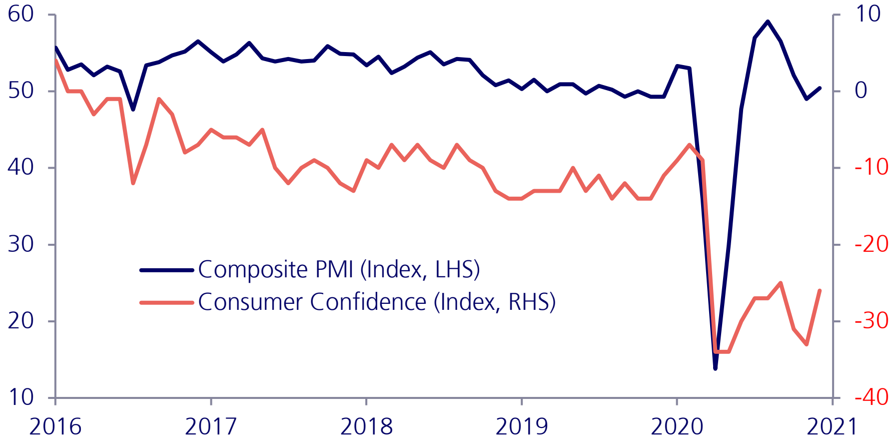
While the COVID-19 pandemic made preparations more challenging, the reduced traffic due to the imposed lockdown measures and lower business activity will somewhat mitigate the immediate impact of the new regime.

Red tape and trade frictions will affect profitability



Source: HM Revenue & Customs

An uncertain outlook



Source: Bloomberg

The UK will phase in some of the import controls, potentially violating WTO rules

In order to reduce the near-term supply chain disruption, the UK will apply less stringent rules to the inbound traffic from the EU for the time being. That could collide with the WTO's Most Favoured Nation rules at some point, however, as it would provide preferential treatment for EU imports.

Despite this, the UK government has announced that full import controls will not be in place until July 2021. Both businesses and government departments, therefore, have time until the middle of the year to make IT systems, infrastructure and resources fully operational. The majority of traders will not need to make full import declarations until then. Exporters into the EU, however, will feel the headwinds of non-tariff barriers from the beginning as the EU has indicated that it will apply the new rules from day one.

Political tension between the regions is expected to increase

Another aspect to keep in mind is the risk of increasing regional tensions within the UK. To avoid a hard border between Northern Ireland and the Republic of Ireland the withdrawal agreement between the EU and the UK that entered into force early last year saw the creation of an internal border between Northern Ireland and the rest of the UK, leaving Northern Ireland in the EU's single market.

Trade frictions and cost will increase for goods moving from mainland UK to Northern Ireland. At the same time, with the narrow trade deal at hand and Northern Ireland's special treatment, the risk is that Scotland, where a majority voted against Brexit, might push harder to get another referendum on independence.

New challenges, new opportunities

As indicated above, a significant part of the expected trade disruptions and economic loss will be felt immediately. The Bank of England, for example, expects a hit to GDP of more than 1% in the first quarter of 2021 because of Brexit.

Longer term, the shortfall to UK growth will sum up to a few percentage points of GDP. How material the welfare loss will be in the long run crucially depends on the UK government's ability to benefit from its new-found freedom to regulate and provide an attractive environment for people and firms to do business in the UK.

Future trade agreements are one aspect, but it will be even more important to set the right incentives in areas like business investment, migration, taxes, education and technology. All these will have a major impact on future productivity and potential growth. It will be challenging, however, to fully make up for the growth shortfall the UK will suffer by losing the deep market access to its biggest trading partner that it enjoyed as a member of the EU's single market.

It will take time for the economy to heal from COVID-19 and Brexit

The UK manoeuvres in a globalised world where trade and cross-border economic activities create a significant amount of value. However, trade requires market access, so the UK will have to compromise to reap the benefits.

Britain is paying a substantial economic price to gain more regulatory freedom. In the end, it may be able to recoup some of the lost growth if the government uses its new freedom wisely. It will be a long journey, though, with many obstacles on the way, adding to the economic pain created by the COVID-19 pandemic. Given the numerous headwinds, it will take longer for the UK economy to heal and get back to pre-crisis levels compared to other nations. And some scars are likely to remain for years to come.

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