

Deal or no deal – Brexit deadline is close

With fragile negotiations the risk of a disruptive Brexit remains high

As always, a looming deadline tends to focus minds. The latest signals of a rapprochement between the EU and the UK are therefore promising. Nevertheless, time is quickly running out and there are many obstacles on the way to an agreement. The risk of a no-deal Brexit remains high. However, leaving the EU without an agreement would cause major disruptions for the British economy.



Source: iStock

“ We will leave the EU on 31 October, deal or no deal. The way to get a good deal is to prepare for a no deal.

”
Boris Johnson

While an exit agreement between the EU and the UK is still possible and should be in both parties' interest, Boris Johnson's latest proposal was met with scepticism by EU representatives and time is quickly running

out. Therefore, the risk of a no-deal Brexit is high, whether it happens by accident or by design.

But what exactly does a no-deal Brexit mean for the UK? Given the myriad of legal and economic links with the EU that have grown over several decades and the lack of any truly comparable precedent it is impossible to quantify the impact of the UK leaving the EU without an agreement. Nevertheless, it is very

likely that Britain will suffer major disruptions, particularly in the short term.

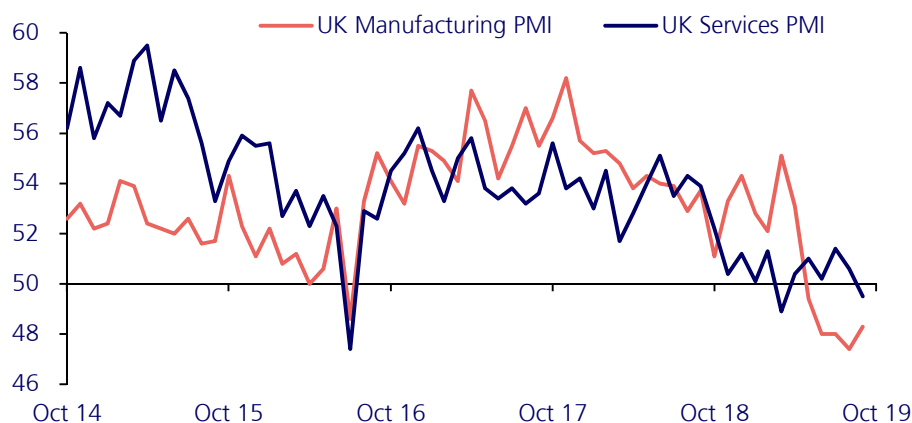
Lacking a ratified withdrawal agreement (or an extension of Art. 50), the UK would cease to be a member of the European Union on October 31st. It would therefore be considered a third country from an EU legal perspective. Trade, for example, would then be governed according to WTO rules. While many countries trade with the EU on WTO terms, the change to the new regime would literally come overnight in case of a no-deal Brexit.

Most of the EU's trading partners have a whole range of trade facilitation arrangements in place, but only few such provisions exist between the EU and the UK. Therefore, trade between the UK and the EU will feel a major and very immediate impact. To begin with, UK exports to the EU will face external tariffs imposed by the EU. Given that the average tariff rate is in the low single digits this should not have a major impact overall. However, some sectors will be hit harder than others, particularly food and drink as well as the car industry which face higher tariff rates.

Tariffs are a nuisance but non-tariff barriers may cause real disruption

The real disruption to trade between the UK and the EU will therefore not be caused by tariffs but by non-tariff barriers, like border

Brexit headwinds weigh on the business outlook



Source: Bloomberg

administration, customs controls and regulatory certifications. For example, goods entering the EU from the UK will be subject to the payment of VAT which will need to be paid upon importation. Lacking any agreement or trade facilitation UK exports to the EU will have to undergo testing and sampling to confirm whether they comply with EU regulatory standards of which the UK will not be part anymore.

Most of the points of entry for UK exports on the EU side do simply not have the necessary infrastructure to process large volumes of third-country imports. Of course, the EU could facilitate the handling of trade flows from the UK. However, given that it would then have to relax the rules for all its trading partners under the WTO most-favoured nation rule, the EU is very unlikely to do that. UK exports to the EU, which make up almost half of all the UK's exports, will thus face significant headwinds from day one of a no-deal Brexit, weighing on economic growth.

Trade-intensive sectors like manufacturing, mining and agriculture will be hit particularly hard

Clearly, the whole of the UK economy will be affected by Brexit through multiple channels including presumably a weaker currency, rising import prices, trade disruptions, an uncertain outlook weighing on business investment and consumer spending, a fall in net migration and many more. However, sectors that are very EU-trade intensive, like manufacturing, mining and agriculture will be hit much harder than others. In addition, some sectors which have a high share of EU workers, like manufacturing, construction or retail, would be particularly hard hit by tougher immigration laws after Brexit. The impact of lower net migration on the availability of workers and labour costs has already been visible in the past few months.

The financial sector is vulnerable despite transitory provisions between the EU and the UK

The financial sector, which is very important for the UK economy, will also face more hurdles after Brexit. Given the integration of the UK and EU financial markets, there has been collaboration between the respective regulators to prepare for a no-deal Brexit to avoid a major systemic shock reverberating through European capital markets. In many cases, financial service providers from the UK have received transitory permissions to assure continuity e.g. for central counterparties or clearing and depository services. Nevertheless, uncertainty regarding an extension of these provisions and the prospect for less favourable terms in the future will still weigh on the sector and its willingness to hire and invest.

Temporary provisions have also been announced in other sectors like aviation or transport, but they are all relatively short termed, hardly reduce uncertainty for businesses and cover only a fraction of all affected areas.

Unilateral trade facilitation would put the UK at a disadvantage in future trade negotiations

Leaving the EU without an agreement would therefore be a significant headwind for UK exporters and other parts of the economy. On the other hand, the UK could try to mitigate the impact by unilaterally lowering tariffs and facilitate imports from the EU. Nevertheless, the WTO most-favoured nation rule would be a reason why the UK may be reluctant to do this as it would then have to do so for all WTO trading partners. That would mean giving away a significant amount of bargaining power in future trade negotiations with other nations. And even if the UK was willing to accept that, increased documentary checks and legal procedures at the border will reduce the throughput of incoming transport vehicles, clogging points of entry and causing supply chain disruptions.

Trade and investment will suffer most by a no-deal Brexit but households are not immune, either. A potential substantial depreciation of sterling, translating into higher import prices and thus lower purchasing power, will weigh on consumer spending. Negative wealth effects from a fall in house prices and the stock market would most likely be an additional drag.

The Bank of England (BoE) is likely to cut rates and may restart QE in case of a no-deal Brexit

Given that the EU accounts for almost half of total UK exports of goods and services, a no-deal Brexit is therefore expected to cause major headwinds to the UK economy through trade disruptions, a currency-induced fall in purchasing power affecting both consumers and businesses as well as weaker spending by the private sector given the uncertain outlook.

In deciding its reaction to a post-Brexit slowdown, the BoE could focus on a currency-induced rise in inflation as an argument to keep its monetary policy steady or even tighten it to support the pound. However, we think it's more likely that the BoE will try to soften the impact of Brexit by cutting rates and potentially even restarting its QE program. The rate cut would provide some support to households with variable rate mortgages by lowering their debt service costs. However, as gilt yields are already low, monetary policy would only have a limited effect on the economy, though BoE actions would be crucial to stabilise the banking sector.

The government will provide fiscal stimulus to soften the impact

In addition to the support from monetary easing, potentially more important will be an increase in government spending. Chancellor of the Exchequer Sajid Javid has announced an additional 2bn GBP of Brexit funding in September, on top of the dedicated Brexit spending announced under the former government. These funds are intended to boost capacity at borders and ports as well as supporting Home Office and the Department for Transport. In addition, the government has signalled its willingness to loosen its fiscal constraints to boost spending in a number of

areas. For example, the Office for Budget Responsibility (OBR) estimated earlier this year that the fiscal situation allows for a "Brexit reserve" of 27bn pounds. Including a variety of other fiscal pledges the potential stimulus, which is not purely Brexit related, could amount to around 2% of GDP. While this is unlikely to be enough to fully compensate the negative impact of a no-deal Brexit, it provides the government with significant fiscal firepower and will help to mitigate the downturn.

In theory, given the lack of a withdrawal agreement, the UK government could use some of the funds it set aside to fulfil its commitments it agreed to with the EU in the initial divorce settlement, like its share of the EU's future annual budgets. However, the UK government will not be able to fully spend the funds from the divorce bill if it wants to keep access to a broad range of EU programs and activities.

Brexit is disruptive in the short term while policy will shape the longer term impact

While Brexit will lead to disruptions in the short term, particularly if it happens without a withdrawal agreement, the longer term impact is less clear. Post-Brexit economic and political development will crucially depend on the immediate reaction of monetary and political authorities and even more on longer term policies, particularly with regard to tariffs, trade, taxes, regulation and immigration.

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