Brexit: not the final frontier. What happens if a deal is reached … and what happens if it isn't

Economic commentary

18 September 2020

Key points

- It is still HSBC's view that the UK and the EU will reach a limited agreement, as regards their future trading relationship, before the Brexit transition period ends on 31 December. But it will not be a comprehensive settlement, with negotiations on many issues likely to continue for months or years.

- The risk of a 'no-deal' outcome has risen over the past few weeks, especially after the presentation to Parliament of the Internal Market Bill, which by the UK Government's own admission will breach its obligations under the withdrawal agreement. The pound has already fallen, as the foreign exchange markets price a higher probability that no agreement will be reached on the ongoing relationship.

- A shift to trading with the EU on WTO terms, with no special arrangements for sectors such as haulage, aviation, and banking, would present businesses with additional headaches at a time when they're already struggling with the Covid crisis. And in such a scenario, economic growth during 2021 would be slower than might otherwise have been the case, with the post-Covid recovery process taking longer. The Bank of England is expected to respond with a further cut in interest rates and an expansion of quantitative easing.

After the unprecedented political dramas which unfolded during the second half of 2019, which began with the prorogation of Parliament and ended with a clear win for the Conservatives in last December's general election, it was easy to hope that the final phase of extricating the UK from the EU would go off more smoothly. Indeed, Brexit has languished well down the agenda for most of this year, as politicians, businesses, and the general public have grappled with the implications of the coronavirus pandemic. In truth though, Brexit was never something that any business with commercial ties to EU countries could ever afford to ignore: irrespective of what happens at the end of the transition period at 11pm on 31st December, many things will change. But it was only with the reports in the Financial Times on 7th September, trailing the Government's intention to pass legislation which would breach the Withdrawal Agreement, that the issue has once again become problematic.

continued overleaf …

HSBC UK

In this note, we have sought to summarize the current state of the negotiations between the UK and the EU and how the rumpus over the Internal Market Bill may help or hinder the chances of reaching agreement on the future trading relationship. We also consider the immediate economic impact if the transition period ends without a deal having been reached, and what would be the likely response of financial markets and of the Bank of England. As has often been the case with our Brexit commentaries, our economic analysis is largely driven by the shifting political landscape, which means that **the shelf-life of this note is liable to be short**. It also means, sadly, that there is less scope for the colourful charts and graphics which we normally rely on to relieve the tedium of our prolixity.

Breaking international law

It's a rare thing for a Minister of the Crown to stand up in the House of Commons and state explicitly that the Government is prepared to breach international law. But that is precisely what Brandon Lewis, the Northern Ireland Secretary, did on 8th September (albeit that he also argued that any breach would be limited, and only in specific circumstances). The power for ministers to take such actions are contained in the Internal Market Bill, which received its Second Reading in the Commons on 13th September. The aim of the Bill is to ensure that the UK's internal market for goods and services continues to function effectively once EU law no longer applies. The Bill has also prompted something of a spat between Whitehall and the devolved administrations, who would prefer these matters to be sorted out through a system of 'common frameworks' rather than through primary legislation.

The parts of the Bill which have caused such a furore are those which would allow the Government to 'dis-apply' some elements of the 'Protocol on Ireland and Northern Ireland', which forms part of the Withdrawal Agreement concluded last October and formally signed in January this year. The Government argues that, in the absence of a Free Trade Agreement (FTA), the EU may seek to impose onerous checks and documentation requirements on consignments which are shipped from Northern Ireland to Great Britain, even though Article 5 of the Protocol states clearly that nothing should impede the unfettered flow of goods.

The Government is also concerned that its ability to support British businesses could be restricted, in some circumstances, by the application – under Article 10 of the Protocol – of the EU's rules on state aid. It's a little counterintuitive to see a Conservative administration arguing for higher levels of state intervention. Perhaps memories of the somewhat mixed results of government interventions from the 1940s and 1970s are now fading; or perhaps, in the context of an economy recovering from the Covid crisis, there might be more appetite to offer help to start-up enterprises.

It is not yet clear whether the Government's fears are well founded or, even if they are, whether the Government's actions were necessary. The Government could simply put the Internal Market Bill through Parliament and then amend it early in the new year in the event of a 'no-deal' exit. Were it not for the offending clauses (Nos. 41-45), the Bill would easily sail through Parliament, causing upset only to MPs and peers representing nationalist parties.

It is too soon to know how much concerted opposition the measure will face in the House of Commons. As a concession to backbench Conservative MPs who were unhappy with the original proposals, the Government has included an amendment which stipulates that Parliament must give its approval before ministers take any action to implement any parts of the Internal Market Bill that would be in breach of the Withdrawal Agreement. This change is similar to an amendment – now dropped – that had been proposed by Conservative backbencher Sir Bob Neill, and may be enough to smooth the Bill's passage through the House of Commons.

But even if the Bill gets through the Commons unscathed, it will undoubtedly face a more hostile reception in the House of Lords. Their lordships can't reject a Government measure out of hand, but they can prevent its passage until the next session of Parliament. In other words, they could, if they wished, stop it from becoming law before the end of the transition period. More likely, they would put down a series of amendments, triggering a ping-pong process between the two houses.

The threat of legal challenges

If the Government doesn't backtrack, it is also likely to face legal challenges. The EU has indicated said that it will begin proceedings at the end of the month, using the arbitration mechanisms included in the Withdrawal Agreement. Beyond this, it's quite possible that the matter could end up before the domestic courts, perhaps culminating in another high-profile Brexit-related case going before the Supreme Court.

The motives of the Government for taking this stand at this moment are not clear. Various possible explanations have been aired: that the Government was simply unaware of what it was letting itself in for when it signed the Withdrawal Agreement; that it believes this approach will pile pressure on the EU to make concessions in the current negotiations; that it's seeking a diversion from the rising count of COVID infections; or, that it's preparing the way for some difficult climbdowns in order to secure an agreement with the EU. It should be remembered that last year the logjam in the negotiations was broken when Boris Johnson's Government signed up to much the same arrangements for Northern Ireland that Theresa May's government had not been prepared to countenance.

The key dates in the process from here will be the 30th September, after which the EU has threatened legal action, and the 15th October, which is the date of the EU summit which is scheduled to sign off on any agreement. Any deal will also have to be approved by the European Parliament, and while this is unlikely to be problematic, it's reckoned that 26th November is the last date on which MEPs will be able to consider the matter.

What if there is a deal?

For all the recent uproar over the Government's Internal Market Bill, and the ongoing disagreements over fishing rights and state-aid rules, it remains HSBC's view that some sort of deal will be struck. Quite simply, it is very much in the best interests of both sides to do so. It's quite possible that only a 'bare bones' trade agreement will be concluded, one that would allow for goods to move between the UK and the EU, and vice versa, without any tariffs or quantitative restrictions. If the two sides can get to that point without falling out, the scene could be set for further agreements to be reached, covering aspects of services, such as haulage, aviation, telecoms, banking, insurance, recognition of professional qualifications, and data localization.

Even in this relatively benign outcome, any business that is involved in trading goods with the EU, whether as an exporter or an importer, will face new frictions. Consignments which have hitherto been able to move freely within the EU's Single Market will from 1 January be subject to all the checking and paperwork required when goods are moved across international borders. Those who already trade with non-EU countries will know what is involved; but it may come as more of a jolt for those who have until now only traded with EU countries.

The bottom line is that businesses will face higher costs, which they may struggle to pass on to their customers. HMRC has estimated that some 260 million extra forms will need to be filled in each year, and there is a real risk of disruption in the early months due to a shortage of suitably-trained staff, both in HMRC and at freight agents, and concerns that the IT infrastructure may not be ready.

Economic commentary

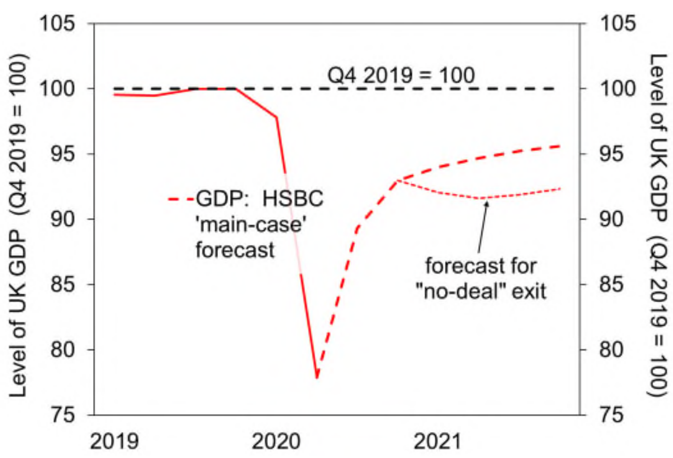
What if there isn't a deal?

If the wheels really do fall off the negotiating cart, then all trade in goods between the UK and the EU would revert to the rulebook of the World Trade Organization (WTO). Around 40% of goods imported to the UK from the EU would be liable to tariffs, while a similar proportion of UK exports would face tariffs when they arrived in the EU. Tariffs would range from a few percent of their value to upwards of 50% for some agricultural goods, especially cereals, meat, and dairy products. It's worth noting that the new UK Global Tariff, which will apply to all imports from 1st January, is a little more generous than the EU's Common External Tariff, although many of the levies on agricultural goods are still very high. And the UK authorities will mitigate some of the burden by allowing firms up to six months to pay import tariffs, and will initially apply only a 'light touch' inspection regime. This is, however, unlikely to be reciprocated for goods entering the EU from the UK, with the added requirement that food and animal products can only enter via certified Border Inspection Posts. On top of the tariffs, the loss of mutual recognition would require many goods to be tested before they could enter the Single Market. There would also be considerable disruption to trade in services, including among other things the loss of 'passporting' rights for UK banks, issues on where data can be stored, and new and less efficient arrangements for road haulage and airlines.

Throughout the earlier phases of the Brexit process, it was HSBC's view that a 'no-deal' exit would tip the British economy into a mild recession, lasting for around three quarters. That scenario has been completely altered by this year's Covid pandemic and the resulting fall in GDP – probably a drop of around 10% over 2020 as a whole. We expect a return to positive growth of around 6% in 2021, as the economy climbs out of the COVID abyss. But much of next year's anticipated growth arises mechanically because of the comparison with this year when the economy was locked down for several months in the spring and early summer: even if the level of economic activity remained flat between the fourth quarters of this year and next, the annual growth rate in 2021 would still be around 3.5%. So a 'no-deal' exit won't stop GDP growth for next year from being positive: but it will slow the pace of the revival and mean that it takes longer for the economy to regain its pre-Covid level of activity.

HSBC's pre-crisis forecasts assumed that, in a 'no-deal' scenario, the level of GDP one year later would be some 3.5% less than would otherwise have been the case. While businesses and the authorities have now had more time to prepare, the imposition of tariffs would still constitute a significant shock and could cause considerable disruption for some sectors, especially the agrifood ecosystem. Applying a slightly less harsh 3% hit to the current baseline forecasts would cut next year's rate of annual GDP growth from 6% to more like 3%, and would leave the

A 'no-deal' exit could slow the recovery in 2021



Source: ONS, HSBC Global Research

economy 7.5% smaller than its pre-Covid size at the end of next year rather than 4.5% smaller. And irrespective of the progress that will be made towards 'normality' as vaccines, cures, or tests are rolled out, it would be a tall order to get GDP back to its pre-Covid level before the end of 2022.

There will also be a spike in inflation if a deal cannot be struck. This arises not only from the tariffs that will apply to many goods entering the country from the EU, but also from the more general increase in the price of imported goods resulting from the anticipated depreciation of the pound. These effects will be mitigated to a small degree by the increase in spare capacity that will result if the recovery takes longer. The annual rate of inflation would be expected to climb to close to 3% on the headline CPI measure, with the RPI measure rising to close to 4%. This spike would be brief, and would fade from the first half of 2022. In any case, the Bank of England would take no heed, choosing instead to "look through" a temporary spike, as it has often done in the past.

The response of financial markets to a 'no-deal' outcome is not hard to imagine, though predicting the precise extent of adjustments is rendered difficult by the shortage of historical precedents. In extricating itself from the EU without any follow-on arrangements, the UK would be erecting commercial barriers between itself and its largest partner for trade and investment. Much of the fallout in financial markets would be felt through a depreciation of sterling. The markets would be pricing in the uncertainty of the UK's ongoing relationship with the EU, as well as reacting to the immediate negative impact on the UK's economic growth prospects; they would also factor in the possible policy response of the Bank of England, and the diminished competitiveness of UK firms when trading with EU countries.

HSBC has long held the view that a failure to reach agreement with the EU would push sterling down to around $1.10. A year ago, would have implied an exchange rate of close to parity against the euro, but in the light of the dollar's recent depreciation, a rate of $1.10 against the dollar would now imply the pound falling to around €0.95 against the euro. It's worth noting that in the week after the furore over the Internal Market Bill erupted, sterling lost around 4% of its trade-weighted value.

Should it appear that the UK is indeed heading for a 'no-deal' exit from the Brexit transition period, the Bank of England's Monetary Policy Committee could respond as early as its meeting which concludes on 5 November. The MPC could trim Bank Rate to zero, either at that meeting or shortly thereafter, and could raise the target for asset purchases by £100 billion to £845 billion. Such moves would of themselves tend to push sterling lower, but would also raise expectations about the policy rate eventually being cut into negative territory. After all, it was for many years the Bank of England's mantra that 0.10% was the effective lower limit.

Irrespective of how events unfold in the coming weeks, one thing is clear. The UK will always be talking to the EU about something or other. The dates of 15 October and 31 December are just arbitrary deadlines imposed by politicians to signal the end of the UK's membership of the EU. The lack of an agreement, at that point, about what happens next would be economically damaging and will trigger a response from financial markets, but it's not the end of the story. As likely as not, something would soon be agreed, with discussions taking place on a wide range of issues of mutual interest over the years to come. The EU will always be our neighbor and we'll always have to engage with it.

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