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The final push for a Brexit trade deal?

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The Brexit process has entered yet another critical period after last week's EU summit. There are just 10 weeks until the UK transition period will end and UK PM Johnson has seemingly hardened his stance, demanding a change in approach from the EU. Despite this we still believe that a deal, albeit limited in scope, is still more likely than not. But the two sides have different priorities and each would have to make difficult concessions to reach an agreement so a complete breakdown of talks cannot be ruled out. As trade talks resume, we consider five key questions below.

1) What is the current situation?

The UK and EU will today resume talks after the EU's chief negotiator, Michel Barnier, and the UK's equivalent, David Frost agreed to "principles for further negotiations" (here). GBP/USD surged 1.5% on the news and this development certainly helps reduce the risk of a no-deal. But those risks have by no means been completely removed and the next three weeks of negotiations, which will take place every day, will be crucial with compromise needed on both sides to close the gaps that still remain.

It is now clear that there are two possible outcomes: 1) a zero tariffs/zero quotas FTA ('limited deal') or 2) talks collapse and UK trade with the EU lapses onto WTO terms ('no trade deal').

There have been nine rounds of negotiations on the terms of the FTA since the process began in March. This has yielded some progress in areas such as goods trade, but "persistent serious divergences" remain as the EU put it after the last scheduled round. Governance, state aid and fisheries, the main remaining obstacles to any deal, were widely anticipated to be problematic at the start of the process. There was little documented progress on these areas during the last rounds of talks.

It became apparent that the process could only be taken so far by Barnier and Frost. Now it seems that it will be up to political leaders to get any deal over the line given the nature of the concessions that will be needed and the difficult task of presenting these to domestic audiences.

Key Brexit dates

29 Sep	Internal Market Bill (IMB) passes UK House of Commons
1 Oct	EU gives UK a month to respond to Letter of Notice concerning IMB
15-16 Oct	EU summit
31 Oct	EU target deadline to conclude legal text of deal
23-26 Nov	European Parliament Plenary Session
Late Nov/early Dec (tbc)	IMB returns to House of Commons
10-11 Dec	EU summit
14-17 Dec	European Parliament Plenary Session
31 Dec	UK transition period ends

Source : MUFG Bank Economic Research Office

There were signs of more political involvement with calls between Johnson and both European Commission President von der Leyen and other national leaders in the run-up to last week's EU summit meeting, while the summit itself was a chance for EU leaders to take stock of progress. The message afterward was that the EU is "absolutely determined" to reach a deal with the UK – "but not at any price".

Johnson's statement after the summit contained tougher rhetoric. While not completely walking away from talks, he said that a "fundamental change of approach" was required from the EU in order to find agreement. He said that the UK should prepare for a 'no trade deal' situation. Despite this harder line, the market reaction was muted with sterling falling by just 0.3% against the euro. It can be hard to separate bluster and posturing from legimate policy statements, with the default assumption now tending towards the former. But as stated above, negotiations are under way again with renewed momentum to close gaps through compromise.

2) What effect has the virus had on negotiations?

Any judgement on the likelihood of a deal requires a lot of guesswork and assumptions. A lot hinges on how much the UK government really *wants* to find an agreement. The official line has usually been that it doesn't matter: "in either case the UK will prosper" said Johnson in February. Whatever Johnson may say in public, we think that the coronavirus crisis has changed the calculation: the resulting economic and political pressures may increase the chances of a deal.

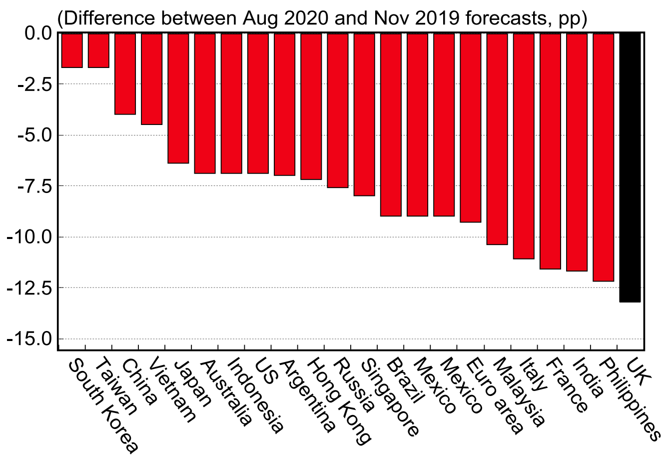
The additional disruption of 'no trade deal' would not be especially welcome for either side after the virus crisis. The additional effect on the EU economy as a whole may be marginal, but there would be a significant impact for the closest member states (e.g. Ireland, France, Belgium). It is the UK economy that would suffer the most, though – after already suffering more from the virus shock than any other European economy.

After a relatively long and stringent lockdown, UK GDP data for August shows that output remained more than 9% below its pre-virus level. The slowing pace of the rebound was disappointing given the absence of any major restrictions in August and the additional boost from the government's subsidised meal scheme. With the renewed spread of the virus prompting more restrictions, any hopes for a short, sharp 'V-shaped' recovery now look fanciful. Indeed, out of all the economies covered by MUFG Bank Economic Research Office, we have downgraded the UK 2020 GDP outlook by the most relative to our pre-virus outlook. We now expect UK GDP to fall by around 12% this year, followed by a limited rebound next year which will leave total output well short of its pre-virus level.

UK Monthly GDP

Source: ONS, MUFG Bank Economic Research Office

Revisions to our forecasts of GDP growth in 2020

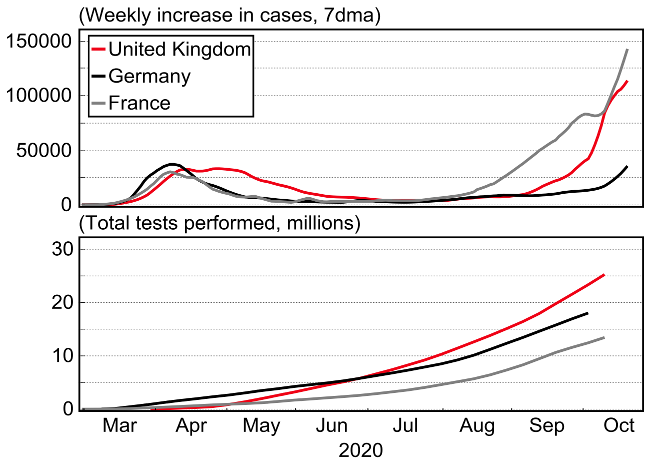


Source: MUFG Bank Economic Research Office

There is also considerably higher political pressure on the Johnson government than would have been expected after last year's election success – again mostly caused by the coronavirus crisis. Criticisms include the decision to implement lockdown measures later than in most European countries. This may have contributed to the virus remaining prevalent in the UK for longer during the initial wave and in turn meant that restrictions had to remain in place for longer. The UK was also slow to increase its Covid testing capacity compared to countries such as France and Germany. Now, the aggregate figure of tests performed for the UK is greater than in those two countries yet question marks remain about the ease of access to tests in the UK and the efficiency of the contact tracing and isolation element. The system has not prevented a sharp rise in discovered Covid cases over recent weeks (although it is becoming apparent that the UK is not alone in that regard).

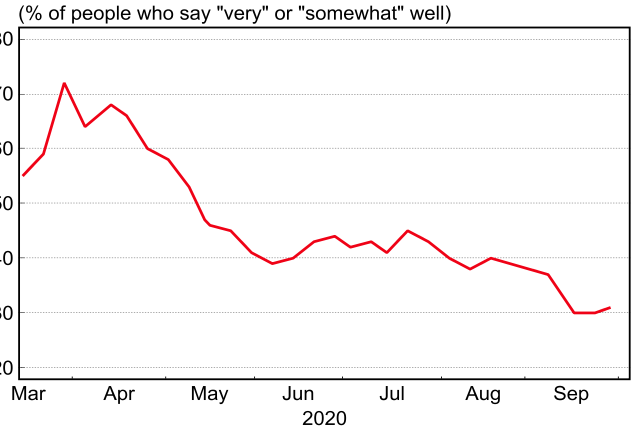
Polling suggests that most people think the UK government is handling the crisis badly, while Johnson's personal approval ratings have steadily worsened since April. Johnson's election pledge was to "get Brexit done". The UK has now left the EU but the story is not over. A messy 'no deal' crisis, with all the associated disruption and during a global pandemic, would surely be politically challenging. Taken together, we think the economic and political challenges of the virus will have moved the needle when it comes to the UK government's desire for a deal.

COVID-19 Confirmed Cases and Testing Capacity



Source: ECDPC, MUFG Bank Economic Research Office

Polling: How well is the government handling the issue of coronavirus?



Source: YouGov, MUFG Bank Economic Research Office

3) What about the UK's Internal Markets Bill?

The Internal Markets Bill (IMB) legislation would allow parts of the Northern Ireland protocol to be disregarded unilaterally. This seems to be a deliberately provocative move: the protocol was agreed less than a year ago, and UK ministers have openly acknowledged that backtracking on this would breach international law. The UK government may believe that the threat to the Irish border may extract concessions from the EU, or that a crisis is necessary to disguise any eventual concessions.

However, once the dust settled it became clear that the Bill would not immediately derail negotiations. The EU wrote a formal letter of notice to the UK on 1 October, requesting a response within one month (this is a potential flashpoint if a deal has not been agreed by November). The EU has also said that the Bill must not pass into UK law if any deal is to be agreed. This would be a while away still; the Bill has had initial approval from MPs but it is now passed to the House of Lords before a return to the Commons. In the event of a deal it could easily be abandoned (the UK government could simply explain that it is no longer needed). This might be the sort of theatre that is needed to sell a deal, but the choreography of any reciprocation (e.g. the UK more accepting stringent governance if the French back down on fisheries, say) will be challenging with both sides reluctant to be seen as the first to concede any ground.

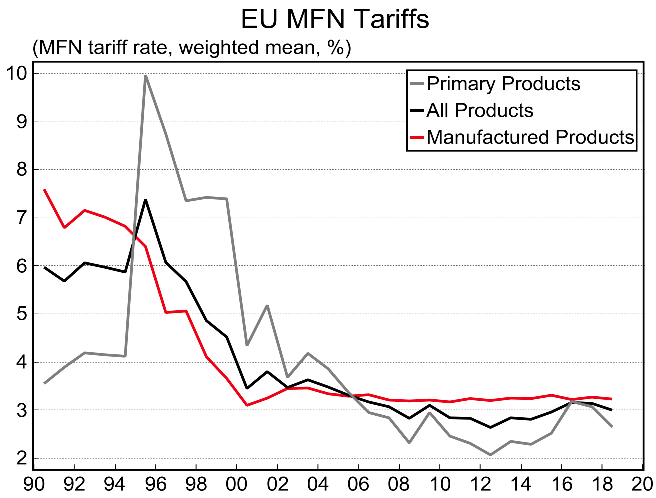
4) What would be the economic effect if talks break down?

Immediately after the transition period there may not actually be much difference between a limited trade deal or no deal. Trade will become more complicated either way. Even if there is a zero tariffs/zero quotas agreement, it would still mean an increase in friction for UK exports to its biggest trade partner with the burden of extra paperwork. There may be infrastructure issues too. Queues and disruption at ports feel inevitable with the Covid crisis likely to have affected preparations from exporters and the civil service. Indeed, a quarter of respondents to a recent Institute of Directors indicated that their businesses may not be ready for a 'no trade deal' Brexit.

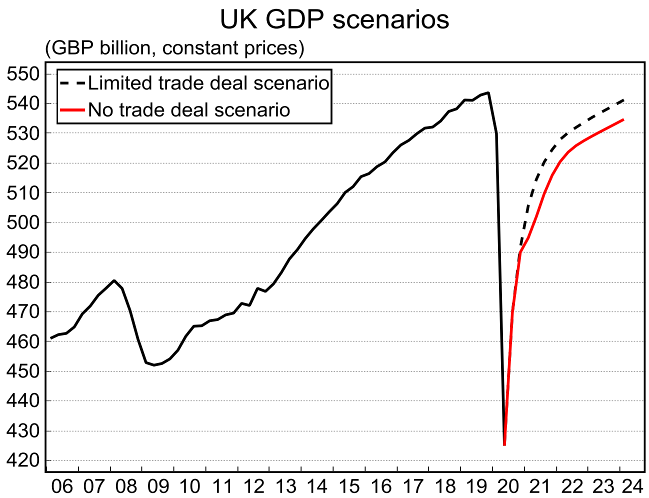
If the case of no deal, the EU's Common External Tariff (CET) would apply to UK exports. The tariff rates would generally be quite low (averaging less than 3% for non-agricultural goods) and in many cases these would also be mitigated to some extent by the boost to UK exporters from weaker sterling. The effect would not be uniform, though. Some sectors, such as car and food production, would suddenly face much higher tariffs and their exports to the EU would become less competitive.

In terms of imports *to* the UK, the new Global Tariff (UKGT) schedule would apply to goods from any country without an FTA with the UK – including the EU in the event of 'no trade deal'. This would see a lower average tariff than under the CET with all "nuisance" rates (under 2%) scrapped: good news for UK consumers, bad news for domestic producers whose main competitors are outside of the EU. Some UK industries would have an element of protection. For example, the 10% tariffs on cars *imported* to the UK would remain – and would apply to cars from the EU as well.

We also expect a drag on business investment, even there is a deal, with a period of 'wait and see' as firms try to gauge how post-Single Market economy will function. It is likely to be worse if no deal is reached. A recent Deloitte CFO survey suggested that around a quarter of firms would expect to cut investment in the event of 'no trade deal', and companies also indicated that they would be less willing to hire. A sharp rise in unemployment already seems likely to our minds as government income support is reduced, and this would be exacerbated in a 'no deal' situation.



Source: World Bank, MUFG Bank Economic Research Office



Source: ONS, MUFG Bank Economic Research Office

We assume that a limited trade deal would be built upon over time (e.g. adding mutual recognition of qualifications, etc.) while our 'no trade deal' scenario has no further progress after a collapse in talks. This would increase the divergence between the two scenarios over time. In reality, we think it is likely that the UK would come back to the table at some point to try again with the trade agreement, but overall we pencil in a difference in GDP of around 1% between the scenarios by 2024.

5) Will it be possible to distinguish the Brexit and virus shocks?

Deal or no deal, the enormous swings caused by the spread of the coronavirus will make it hard to isolate the economic effects of Brexit. They are very different problems though. The virus crisis is unusual in that it has precipitated a sudden fall in consumer spending, which tends to be relatively resilient in a 'normal' downturn in the UK. On the other hand, Brexit is likely to manifest itself mostly through a persistent drag on business investment and exports (at least initially).

At the same time we expect an eventual economic recovery from the Covid crisis as the virus is brought under control and demand returns in the most-affected areas of the economy. This is likely to dominate the effects of Brexit, with more jobs re-added in sectors such as travel and hospitality than are destroyed to the increase in trade friction, for example. So it will be hard to disentangle exactly what can be attributed to the UK's new relationship with the EU, but we expect there will still be evidence of a Brexit-related drag – deal or no deal. The timing may be different, though. It is plausible that demand could recover quickly in the event that a vaccine is developed and widely distributed but the damage from 'no trade deal' for producitivty and growth would remain relevant for years if there is no further progress towards (re)integration.

We had previously assumed that the Conservative government, keen to show that Brexit is an economic success, would implement looser fiscal policy after the transition period. Again, the virus has changed the picture. The deficit has ballooned after enormous expenditure on healthcare, the test and trace programme and income support measures. Debt reached 104% of GDP in September, the highest since 1960. The Chancellor has spoken about "hard choices" ahead. We think it will be several years before UK output returns to its pre-virus level, so any talk of fiscal tightening seems very premature to our minds, but it does suggest that significant targeted spending to mitigate the Brexit shock has become less likely.

Outlook – a deal remains most likely, but the clock is ticking

The EU has stated it would like any deal to be agreed by the end of October. This is probably still possible. It would neatly bypass the issue of the IMB, which has not yet been passed into law. We suspect the EU, relieved to reach a deal, would be pragmatic if the UK government presented it as a victory by suggesting that the Bill forced some concessions. Political spin for domestic audiences is inevitable and there would be relief after any deal is agreed.

The clock is ticking, though. Any deal would need to be ratified in the European Parliament. The last plenary session of the year will be held on 14-17 December, but time would be required beforehand for the preparation of legal texts and translations. That said, if a deal is agreed on good terms after this we suspect there could be a short extension to the transition period into 2021. Alternatively, the agreement could be applied provisionally while pending full ratification if the parts of any deal fall beyond the EU's "exclusive competence" and so require national approval as well. This was the case with the Canada–EU Comprehensive Economic and Trade Agreement (CETA) which was signed in 2016 but is still pending full ratification.

Overall, we still think that a deal is more likely than not. Negotiations are now continuing after the EU has offered to intensify talks and start work on legal text. It is unlikely to be the end of the melodrama, however. Both sides wants to show that a deal has been hard-fought, so it may be a matter of choreography. The UK in particular may want some movement from the EU it can present as a victory to distract from its own concessions that any deal would require. The more posturing and bluster, though, the greater the risk that a miscalculation could derail talks completely. The UK is already sailing close to the wind with the IMB. The risk of 'no trade deal' will only increase as the current 31 December deadline nears.

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