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Brexit trade agreement avoids no-deal, but disruptions and persistent uncertainty weaken UK outlook

The UK and EU trade deal represents another step in a drawn-out, phase-by-phase Brexit. While the UK is expected to ultimately maintain significant access to the single market, the new customs border and uncertainties around the access to the single market for UK services raise economic costs.

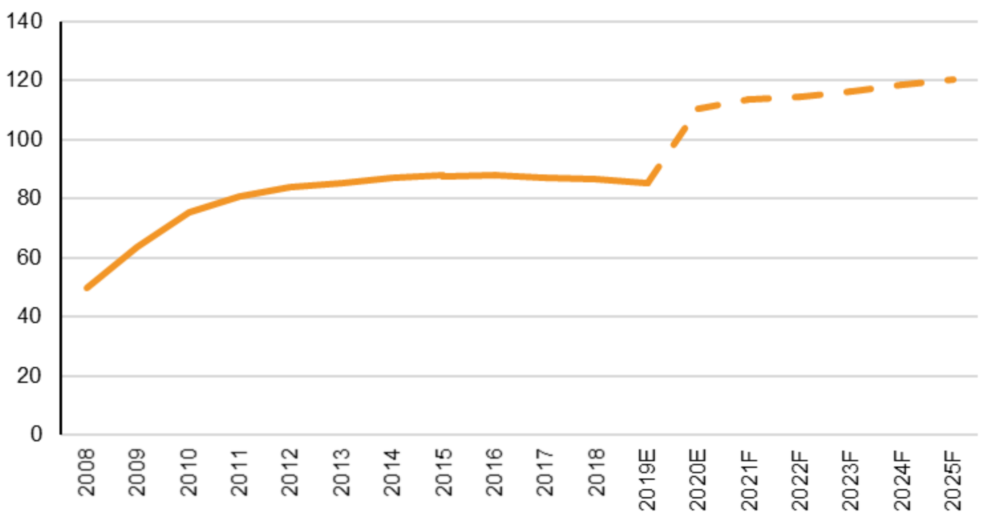
We had expected that the UK would strike a free-trade agreement with the EU despite the market's concern about a possible "no-deal", so the last-minute accord in December was no surprise. The rolling over of tariff- and quota-free trade in goods was largely in line with the roll-over of existing preferential trade arrangements that the UK has pursued with other trading partners outside the EU as an intermediate step in exiting the customs union.

However, exit from customs union – to be itself phased in over three stages and in full force only from 1 July 2021 in the case of imports to the UK – has created trading friction and produced immediate economic losses as companies see longer delays, higher operating costs and lower productivity. This is even though grace periods granted – such as a one-year standstill on rules of origin documents – have eased disruption at the border.

The trade and cooperation agreement has prevented a devolution to WTO-based trading rules with the EU. In addition, a principle of "managed divergence" implies either party reserves the right to retaliate in the case the other side is considered to have gained an unfair advantage. So, while the UK has secured greater sovereign privileges in determining its own laws, cooperation with the EU on regulation under a new "partnership council" and capacity for the other side to impose tariffs – in the case deregulation is considered unfair – are expected over time to reduce disparities. The mechanism should space out any areas of divergence and resulting trading frictions to over a long period.

While December's arrangement largely excludes services, this is consistent with the highly incremental and drawn-out Brexit that Scope has long anticipated, under which divergence with the EU is taking place over successive phases after extensions of Article 50, a transition state, lately an exit from the customs union with associated grace periods, and, in the end, agreements around additional, complementary trading agreements with the EU for sectors excluded from December's preliminary arrangement.

Figure 1: UK general government debt, % of GDP



Source: IMF, Scope Ratings GmbH forecasts

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December trade deal another step in an incremental process

Focus shifts to services agreements

Brexit is far from over. December's trade agreement, while thin, was never intended as a singular settlement. It is rather a first fundamental framework around which a more extensive set of trading agreements will ultimately be agreed to define the long-term EU-UK economic relationship. As services were hardly discussed to date, with an agreement on goods trade the priority during the limited 10-month negotiating period, the focus will now be on reaching supplementary arrangements for critical services sectors including financial services.

Expect financial-services arrangements to be likewise "dynamic"

The two sides are seeking a non-binding memorandum of understanding by March 2021 on the export of financial services, including services such as euro clearing currently operating with temporary access to EU markets as talks continue. However, more time is likely to be required than March before Brussels ultimately grants any fuller EU access for UK financial firms. We expect any such agreement or agreements around financial services to be "dynamic" – granting regulatory equivalence and thus full market access for select UK financial industries to "passport" to the single market, and vice versa, but with an understanding that such equivalence can be retracted should regulatory standards diverge – mirroring the agreement in goods.

Restrictions on divergence to limit scale of trading separation in the long run

Nevertheless, we expect that the outcome of negotiations long term to result in a "soft" Brexit. Non-regression clauses embedded in trade agreements and other limits on UK-EU trade divergence – such as the Irish Backstop that would reproduce any friction in trade with the EU with friction in trading inside the UK itself, damaging the UK's internal market – will limit the degree of separation in the longer run. They will ensure preferential access to the single market for UK businesses long term.

The final relationship could resemble a Swiss-esque framework

The final EU-UK relationship could resemble something akin to a Swiss-like framework except with a faster-track negotiating process given support in accelerating talks from the series of self-imposed cliff-edge Brexit deadlines over the past – and negotiated in reverse with the UK having started from fully-frictionless trade. However, there will be persistent uncertainty due to the constant risk that changes in UK law could reduce access to the single market, so UK-based businesses are likely to continue to relocate activities to the continent – ensuring a steadily growing cost from a "slow-burn" Brexit even as the cliff-edge form of an abrupt no-deal Brexit has been repeatedly avoided.

Permanent damage to the City of London

In addition, the City of London faces permanent damage in waiting for a definitive agreement on financial services in the months ahead in which select UK financial services have at least transitionally lost passporting rights, such as investment banking and securities trading on behalf of clients in those EU countries where national regulators have *not* as yet extended grace periods to UK firms. The European Central Bank has said that banks will ultimately shift EUR 1.3trn of assets to the euro area. In the end, the UK has secured a deal for the trade in goods where it has a trading *deficit* with the EU, but not one as comprehensive in services where it stands to see losses to a trading *surplus*.

Extra customs-related cost

The introduction of a customs border with associated rules of origin and local content requirements has furthermore increased economic costs – especially when the coronavirus pandemic has increased the importance of and pressure on just-in-time supply chains. HM Revenue & Customs estimated that post-Brexit arrangements will add GBP 7bn (0.3% of GDP) of bureaucracy in trade with the EU.

Brexit, third Covid-19 lockdown, add to public-finance strains

The UK enters this new Brexit phase amid the near-simultaneous introduction of a third national Covid-19 lockdown, which will add to stress on public finances. We see upside pressure on government debt already estimated at more than 110% of GDP this year, up from 85% in 2019 (**Figure 1, cover page**), in view of the double-dip economic contraction, additional fiscal stimulus to address economic fallout from lockdown plus the additional economic and fiscal costs of Brexit – the latter which, while more modest and much more spaced out by comparison with the sudden, severe cost of the Covid-19 crisis near term, might pose more significant long-term economic and institutional consequences.

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