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Brexit deal brings some good news at the end of a tough year

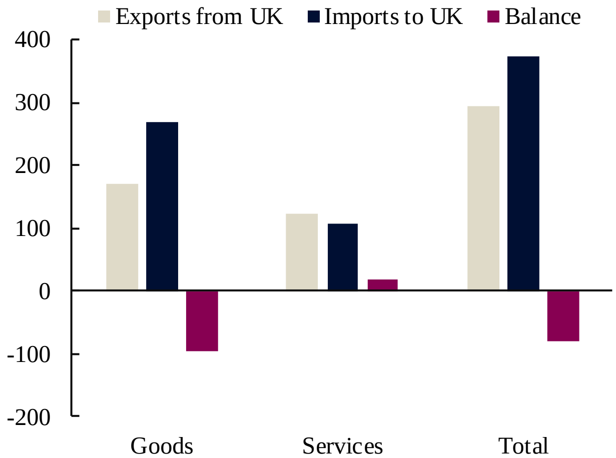
After dragging on for years the Brexit odyssey reached a conclusion on Christmas Eve. The United Kingdom (UK) and European Union (EU) agreed a trade deal with barely enough time before the end of the transition period on the 31st December. Negotiations went to the last moment to allow both sides to demonstrate to their domestic constituents that they had fought to secure the best possible deal. Of course, running down the clock also effectively forces the UK and EU parliaments to accept this deal or face falling over the "No Deal" cliff. The deal is mutually beneficial delivering relatively free trade in goods (i.e., zero tariffs and zero quotas), which is much better than the tariffs that would have been required under World Trade Organisation (WTO) rules in the event of "No Deal".

Inevitably, both sides needed to compromise to get the deal over the finish line. The consensus is that the UK gave more than expected on fisheries, whereas the EU softened its insistence on unilateral retaliation if the UK undercuts its labour, environmental or state-aid rules in the future. Both parties agreed on a new framework to jointly manage the fish stocks in the EU and UK waters, with a five and a half-year transition period to reduce EU quotas in UK areas. The deal also expresses the desire of both sides to maintain high levels of protection in social labour rights, tax transparency and state aid with effective domestic enforcement. However, it includes a dispute settlement mechanism and the possibility for both parties to take remedial measures. The deal will also maintain co-operation in areas including transport, energy and social security coordination with the UK continuing to participate in several EU programs for the next budget period until 2027.

Unfortunately, the deal still has its limitations. Therfore, Brexit will still cause disruption in a number of key areas in the New Year. We consider three issues here: non-tariff frictions for goods trade, no deal for services trade and endless negotiations complicated by divergence rather than convergence.

First, goods trade will still face greater non-tariff frictions than during the transition period. Research indicates that few businesses on either side of the English Channel are prepared for the changes in paperwork and additional checks (customs, veterinary and rules-of-origin) that will apply from 1st of January. This is likely to cause disruption at ports and queues of trucks to continue into the New Year. There was a taste of similar disruption in the past few weeks, which was caused by the introduction of Covid-19 testing for truck drivers in response to the new strain of the virus prevalent in the south of the UK. There may be a period of grace as the UK will phase in new customs formalities over six months, which may mitigate some of the disruption, but there is no guarantee that the EU will reciprocate.

UK trade with EU member states, 2019
(GBP Bn)



Sources: UK Office for National Statistics, QNB analysis

Second, the disruption will be greater for services trade as the deal focused only on goods trade. Indeed, there is almost nothing in the deal for Britain's biggest single export sector, financial services. Services account for around 80% of the UK's economic output and a large share of its exports, so critics argue that the UK made a mistake by prioritising fishing and manufacturing, which are economically much less significant. The deal does not incorporate any mutual recognition of professions qualifications or passporting rights for financial services. Indeed, the EU has yet to hand down a ruling on equivalence for financial-services regulation, without which cross-border business will be severely restricted. The EU has also not yet made a decision on data adequacy, which is essential to enable the cross-border flows of personal data that service businesses need. Both decisions are unilateral ones for the European Commission, which could be withdrawn in future even if granted soon.

Third, negotiations will continue even with Brexit done. The deal involves setting up 25 specialist committees, ministerial councils and working groups to cover important areas including aviation safety, medicinal products and intellectual property. Frequent negotiations are inevitable with the EU since it is UK's nearest neighbour and largest trading partner. Indeed, this has been Switzerland's experience ever since rejecting EU membership in the early 1990s. A challenge for future negotiations is that they will be carried out with the UK seeking to diverge from EU standards. That is in contrast to most trade deals which benefit from the goodwill of parties seeking to converge on common standards.

Fortunately, the down-side risk of a no-deal Brexit is now firmly off the table. So, the deal is good news for both the UK and EU, having reduced uncertainty and boosted sentiment. However, the UK economic outlook still faces headwinds from the limitations of the Brexit deal in addition to grappling with a nasty wave of Covid-19. Therefore, the UK is likely to experience a more anaemic recovery than the rest of Europe despite the continuation of significant support from both fiscal and monetary policy.

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