UK Watch

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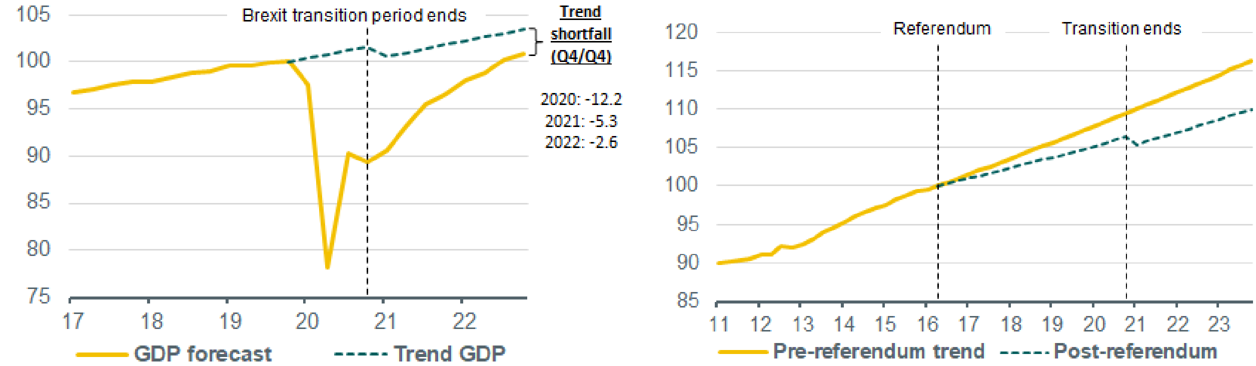
What damage will Brexit do – with or without a deal?

It has been said before that we are in a crucial phase for Brexit talks, but with the hard deadline of the end of the transition period just one month away on 31 December, the coming days truly are crucial. Our base case continues to be that a free trade agreement will be signed. However, what is not always widely appreciated is that even *with* a deal, Brexit has already been and will continue to be significantly economically damaging – primarily for the UK, and to a much lesser degree for its closest European trading partners.

Effect on the UK: A significant initial shock, followed by a pernicious dampening of potential growth – Estimates from both official and independent institutions suggest that, even with a free trade agreement (FTA) that involves zero tariffs and zero quotas (our base case), Brexit will – over time – reduce UK GDP by around 5 percentage points compared to a scenario of continued EU membership. This effect is made up of two key components: 1) the effect of border checks on the flow of goods (the initial shock) – a c.1.5pp decline; 2) the effect of nontariff barriers, such as divergences in regulations, and the need for additional cross-border approvals that over time hamper trade – this effect is estimated at c.3.5pp but spread over many (perhaps 10-15) years. We have incorporated these effects into our UK macro scenarios by reducing our 2021 growth forecast by 1.5pp as a one-off shock (i.e. the post-covid recovery would have been 1.5pp stronger than our forecast in the absence of Brexit), and by assuming a lower potential growth rate for the UK for the longer term effects. The near-term effect is masked by the extraordinary gyrations in GDP resulting from the pandemic, and we still expect Q1 GDP to register positive qoq growth despite the drag from Brexit. The longer term impact of nontariff barriers meanwhile appears to have been incorporated into the Office for Budget Responsibility’s latest estimate of the potential growth rate in the UK, which is just 1.6% - down from the trend rate of growth of 2% in the years leading up to the EU referendum in 2016, and almost half the pre-global financial crisis trend rate of 2.8%. We illustrate the effects of Brexit on both near-term and long-term GDP in the two charts below.

The effect of Brexit on potential output in the UK, in both the short (lhs) and long-run (rhs)

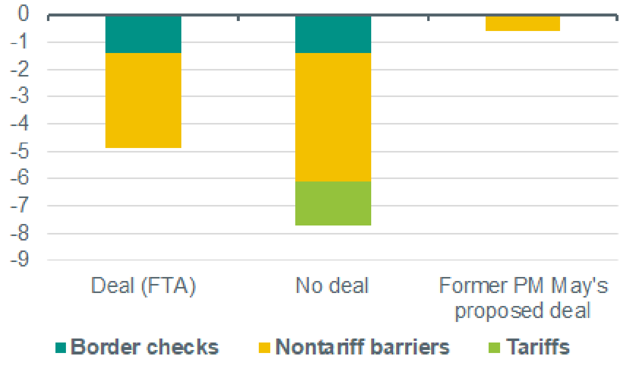


Source: UK Treasury, UK in a Changing Europe/LSE modelling, ABN AMRO Research

Effect on EU countries: With regard to the impact on growth in the remaining EU countries, most estimates suggest that the impact on aggregate GDP growth in the short term will be around a fifth to a quarter of the impact on the UK economy, while the longer-term impact is expected to be negligible. The impact will be largest on the UK's main trading partners - Ireland, the Netherlands and Belgium.

A no deal Brexit would be even more damaging, but the difference is relatively small – Estimates both by the UK government and the LSE suggests a no deal Brexit would lead to an additional c.2.5pp long term fall in GDP relative to a FTA deal. This includes the effect of tariffs (around 1.5pp) and even larger nontariff barriers, as the UK and EU's regulatory regimes are likely to see an even sharper divergence in a no-deal scenario. However, in either scenario the effect of both border checks and nontariff barriers is significant, and moreover it is much bigger than the effects of former PM Theresa May's proposed hypothetical deal. This proposed minimal or no border checks, either via a special arrangement with the EU or failing this via customs union membership (aka the Northern Ireland backstop), and minimal nontariff barriers due to planned regulatory alignment with the EU. The current government has taken a radically different course in opting for a free trade agreement with the EU, and as such, the difference between a deal and no-deal scenario is much smaller. Finally, note that even according to the UK government's own analysis, the potential mitigating effect of new trade deals with non-EU trading partners is tiny – in the order of 0.2-0.3pp at most, which does not even remotely offset the negative effects of Brexit. (Bill Diviney & Aline Schuiling)

Longterm impact of different Brexit scenarios on UK GDP, pp



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