Brexit Update

AIB Treasury Economic Research Unit

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Big Change to move from Single Market to FTA

The EU and UK have set out their opening positions for the negotiations that start on March 2nd on their future relationship post Brexit. They have very different views on what a free trade agreement will look like. The EU is insistent on a level playing field for trade, with close regulatory alignment and a common set of enforceable rules. The UK is adamant that it will no longer be an EU rule taker and there will not be regulatory alignment. Thus, the upcoming trade talks are likely to prove very difficult, with the UK also ruling out an extension to the transition period beyond end 2020. As such, the talks could see the return of sterling volatility, with the currency losing some ground.

We expect some form of trade deal will be agreed, probably by end 2020, as it is the best outcome for both sides. The reality is that a free trade agreement will mean far from frictionless trade and be much inferior to the Single Market. While not a full hard Brexit, trading with the UK under a FTA will become much more difficult and costly for both exporters and importers, with negative economic consequences. Businesses will need to prepare for a changed trading relationship with the UK, with increased administration and compliance costs and likely transport delays.

EU-UK FTA will mean an end to frictionless trade

- The UK's departure from the EU on January 31st was a low key affair in the end. The eleven month transition period to end 2020 that is now in situ, means that the impact of what is a momentous event will not be felt until next year and beyond. For 2020, the status quo is maintained and nothing really changes. Thus, those trading with the UK can carry on as before until the end of the year.

- It is still quite unclear what exactly Brexit will mean for the UK and by association economies like Ireland, with which it has a close economic and trading relationship. The upcoming negotiations on the future relationship between the UK and EU will determine the true nature and impact of Brexit, especially in regard to trade,

- These will not be like normal trade negotiations which are about removing existing trade barriers such as customs duties and quotas, as well as eliminating non-tariff barriers. Instead, the talks will focus on how much of the current structures that permit frictionless free trade between the UK and EU can be retained—in other words, how far the UK moves away from the Single Market rules, in addition to leaving the EU Customs Union.

- The EU Trade Commissioner Phil Hogan, has cautioned against complacency, saying it does not seem to be widely appreciated that we are starting the most difficult part of the Brexit process. Part of the reason for this EU caution is its belief that it will be virtually impossible to meet the UK demand to conclude a comprehensive trade deal by the end of the year. The UK government is insisting on accelerated talks and has ruled out an extension to the transition period beyond end 2020, saying a trade deal can be done within this time frame.

- Another reason for caution is that the EU and UK have very different views on what a trade deal will look like. The EU is insistent on a level playing field for trade, with close regulatory alignment and common rules. The UK is adamant that it will no longer be an EU rule taker and there will not be regulatory alignment. However, it is likely that the UK will have to agree to some minimum standards in any trade deal. Note though, that this does not necessarily mean full alignment with EU rules.

- The reality is that any free trade agreement will mean far from frictionless trade and be much inferior to the Single Market. It will involve a more detached trading relationship between the UK and the EU. This is especially true for services, as FTAs generally relate to merchandise goods. Those trading with the UK will face a whole set of non-tariff barriers, including customs clearance documentation, compliance with rules of origin and additional regulatory requirements. Businesses will need to prepare for this new trading environment.

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Canadian style trade deal a poor substitute for Single Market

Essentially, a FTA will imply fewer obligations for the UK but reduced access to the Single Market. Furthermore, the more that the UK wants to avoid having to abide by EU rules and regulations, the poorer the access it will have to EU markets. A Canadian style free trade agreement appears to be the UK's preferred template for a deal. Under this trade deal:

- *Tariffs do not apply on most goods, but some tariffs and quotas remain, e.g. on some food products.*
- *Canada has access to only some parts of EU Single Market in services.*
- *Most notably, financial services are not included under the trade deal, which would be a big drawback for the UK financial firms, who would lose the benefits of passporting rights within the Single Market.*
- *Trade in goods between the EU and Canada is also still bound by Rules of Origin – i.e. a sufficient proportion of the product must originate in Canada to qualify for zero or low EU tariffs. Complying with these rules can be a major additional cost for firms.*
- *Most Canadian products must also comply with EU regulations to gain access to the Single Market as the EU recognises Canadian rules in only a minority of product categories.*
- *Canadian companies cannot use the court system to pursue trade grievances, unlike in the Single Market. Instead, firms have to rely on the Canadian Government to raise cases with a disputes arbitration tribunal established under the free trade agreement. Thus, it is more difficult for firms to enforce rights.*

EU equivalence regime far from a panacea for financial services

In terms of financial services, the EU has developed an equivalence regime that it uses to allow firms from third-countries (i.e. non-EEA countries) to operate in the Single Market. However, it is far inferior to the Single Market passporting system for EU financial services companies.

The EU equivalence regime is limited and patchy, applying to only some financial services, with a number of important sectors excluded. Furthermore, there is no uniform equivalence regime across the sectors that are included. It is the EU Commission that makes all the decisions on equivalence so it is a one-sided approach to trade. Crucially, equivalence can also be altered or withdrawn unilaterally by the EU, making it unattractive for foreign businesses as there is no certainty around the rules.

The UK is seeking an enhanced equivalence regime that is both comprehensive and permanent. This would ensure that UK firms could maintain access to the Single Market after the transition period ends. The EU has ruled this out, rejecting the idea of a "bespoke agreement" that would provide UK financial services firms with continued unfettered access to the Single Market.

Geography, size, history and politics all matter in trade talks

The UK is also demanding that, in general, it should be treated like other third countries that have trade deals with the EU. In reality, though, there are some key differences between the UK and other countries with such trade deals, like Canada. One is geography as the UK is a neighbouring economy to the EU, while most other countries are continents away. Second is scale, as the UK is a large economy, much bigger than a country like Canada, whose GDP is only 60% that of the UK.

Third, the UK is a very large trading partner of the EU, which takes eight times more imports from the UK than Canada. Fourth, the UK has just left the EU and is leaving the Single Market and Customs Union, which brings a different political element to trade discussions. The EU will want to make it obvious that there is a cost to leaving. Thus for all these reasons, the EU is going to adopt a cautious approach on the type of trade deal it offers the UK.

Overall then, it looks certain that what replaces the Single Market for the UK when the transition period ends is a much inferior EU-UK trade arrangement. In effect, the UK will be swapping fewer obligations and more autonomy for far less unfettered market access. As a result, the UK will find itself with more limited access to EU markets from 2021, with Irish and other EU countries' access to the UK market also facing restrictions. The UK government's position is that it is prepared to pay an economic price to regain such autonomy and 'take back control'.

Firms need to get ready for big changes in UK trade

Trade will be far from frictionless under a FTA, with increased administration, compliance and delays. While not a full hard Brexit, trading with the UK will become much more difficult and costly for both exporters and importers, with negative economic consequences. Thus, businesses will need to prepare for a radically changed trading relationship with the UK. In particular:

- *UK will be outside EU Customs Union so both exports and imports will need new paperwork, even if tariff free trade is agreed that implies no Customs Duties*
- *Get registered to continue trading – will need Customs Registration Numbers for both Ireland (EORI) and the UK*
- *Customs Declaration forms will need to accompany all goods – firms may need a Customs Clearance Agent*
- *Establish with Revenue if a Deferred Payment Bank Account is required to cover any Duties or VAT on imports. Firms will need to contact their bank if they need to open such an account*
- *Trade in some agri-food products likely to require additional veterinary checks and health certs*
- *Compliance with onerous rules of origin may be required for some goods*
- *Check with their suppliers and customers that they have new paperwork in place*
- *Land bridge route via Great Britain to mainland Europe will also be impacted. It will probably need transit documentation and possibly sealed containers, with delays likely at ports*
- *Establish if cash flow impacted by trade frictions and increased costs that requires additional working capital*

Move to FTA will lower economic growth

Both Copenhagen Economics (CE) and the Irish Central Bank have published reports recently that try to quantify the impact on the Irish economy of an EU-UK FTA that replaces the Single Market. The Central Bank estimate that it would lower Irish output by 3.5% in the long run, while CE put the negative impact at 4.3%.

CE also estimate that a favourable free trade deal that was based on the Revised EU-UK Political Declaration would reduce GDP by between 3.2% and 3.9%. The impact on growth is likely to be felt over time given that trade would not suffer an immediate impact from tariffs and quotas.

The Central Bank and CE estimate that if the UK fails to secure a FTA with the EU and moves to trade on WTO terms after 2020, in effect a hard Brexit, it would lead to a larger decline in Irish output of between 5 and 7%. Furthermore, the effects would be more front-end loaded, mainly occurring in the first two years after the end of the transition period, reflecting a quite immediate and sizeable impact on external trade.

A number of studies have estimated the impact of a FTA on the UK economy. The National Institute for Economic and Social Research puts the long run reduction in GDP at 3.5%, the IMF at up to 3.3% and the UK Treasury at 4.9%. In a no deal Brexit scenario, studies suggest that GDP could fall by 5-7%.

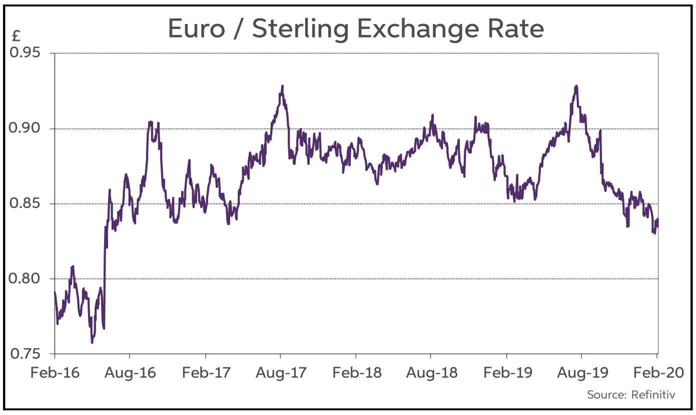
It is not surprisingly that the estimated impacts on the UK and Irish results are broadly similar under both scenarios as the UK is very dependent on the EU market (takes 45% of exports), while 40% of Irish indigenous exports go to the UK.

Trade talks pose downside risks for sterling

Markets seems relaxed about the outcome of the EU-UK trade talks. The recent strength of sterling, as well as the gains made by UK stocks before global markets were impacted by concerns about the coronavirus, point to expectations of a benign outcome to the negotiations, with little damage being done to the economy. There would seem to be a belief in markets that a favourable trade deal can be negotiated by the end of this year.

The negotiations, though, are likely to be fraught, especially in areas such as fishing rights, financial services and regulatory rules. Downward pressure could re-emerge on sterling this year, if as we expect, the trade negotiations run into difficulties. Already sterling is showing signs of volatility on the tough opening positions being adopted by both parties to the negotiations.

The UK is warning that it could quit the talks by mid-year if it feels sufficient progress is not being made and focus instead on preparations to trade under WTO terms. We could see the euro rise sharply towards the 90p level, if indeed it appears that we are heading for another cliff-edge hard Brexit date at end 2020, amid growing fears that a trade deal won't be agreed, with no extension either to the transition period.



Concluding Remarks - A deal is likely to be done

Our expectation, though, is that a FTA will be concluded between the EU and UK and probably before the end of the year. A trade deal is the best outcome for both sides. Even a very limited trade deal is better than no deal. The EU, though, is not going to allow the Single Market to be undermined by a large ex-Member State benefitting from lax regulations in regard to the environment, climate change, labour rights, state aid rules, tax laws and other areas. While the UK may not be required to be an EU rule taker, it is likely to have to agree to some minimum regulatory standards in any trade deal. Note that this would not imply full alignment with EU rules.

Any free trade agreement will be much inferior to the Single Market, leading to far from frictionless trade and be much different to the current trading arrangements. Non-tariff trade barriers will appear between the UK and EU given it is leaving the Customs Union and Single Market. Businesses will need to prepare for a changed trading relationship with the UK, with increased administration and compliance costs and likely transport delays. While not a full hard Brexit, trading with the UK under a FTA will become much more difficult and costly for both exports and importers, with negative economic consequences.

Finally, the upcoming trade talks are likely to prove very difficult, with the UK also ruling out an extension to the transition period beyond end 2020. Thus, the talks pose a downside risk for sterling, with another year of volatile trading likely to be in store for the UK currency. The next big date for sterling could be the end June assessment by the UK to see if sufficient progress has been made on the talks to allow them to continue into the second half of the year.

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