Brexit in 2020: Lots of questions and no quick answers

The UK is set to leave the EU this month, but the uncertainty is unlikely to end there. An extension to the 11-month standstill transition period looks increasingly unlikely, which means the way Britain trades with Europe may well change in 2021. The risk is that we won't know exactly how until much later into this year

British Prime Minister Boris Johnson is seen returning to 10 Downing Street in London following December's General Election.

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Expect another turbulent year for Brexit

Within just three trading days of December's UK election, the initial optimism about a smoother EU withdrawal quickly gave way to concern about the next stage of negotiations.

Investors are probably right to be cautious - 2020 has the potential to be another turbulent year for Brexit.

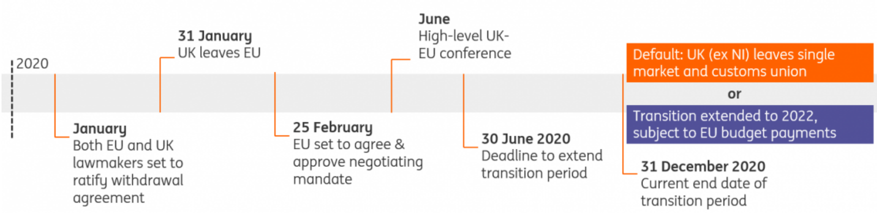
To recap, December's election result, which saw Prime Minister Boris Johnson's Conservatives gain an 80-seat majority, now virtually-guarantees ratification of the withdrawal agreement – the deal agreed between the UK and EU back in October. That means the UK will almost certainly leave the

EU smoothly at the end of January.

But the discussions on the terms of future UK-EU trading arrangements have barely got started. Remember the withdrawal agreement covered mostly ‘exit issues’ – that’s things like the UK’s financial obligations, citizens’ rights, alongside a trading framework to avoid frictions along the Irish border.

The current direction of travel is towards a free-trade agreement between the UK and EU – but exactly what form that will take, and the length of time it will take to negotiate, are both still subject to change.

The Brexit timeline for 2020



Source: ING

Don't count on an extension to the transition period

What we do know, however, is that once the UK leaves the EU later this month, it will enter a standstill transition period currently set to last until the end of 2020. Until then, the UK’s trading relationship will Europe will remain unchanged, allowing time to agree and implement a new future trading relationship.

That’s a lot to do in 11 months – or even less once you factor in time to agree a negotiating mandate, and to seek ratification for the final trade terms.

The EU is open to a two-year extension to this transition period, but it will come at a cost. Britain would need to continue paying into the EU budget beyond 2020. The withdrawal agreement says an extension must be agreed by June at the latest.

> *Most now suspect the government won’t extend the transition period*

PM Johnson has long signalled he doesn’t want a longer transition period, a commitment which he is in the process of embedding into UK law.

Of course, come June there’s nothing stopping the government quietly changing the law again and extending the transition after all. The Prime Minister has much more flexibility in Parliament now, and his recent hawkish language may simply be post-election messaging to his newly-won voter base.

But for now, this seems unlikely. Most now suspect the government won’t extend the transition period, and instead will try to negotiate a free-trade deal by the end of 2020.

Can a trade deal be struck in 2020? Perhaps just about...

This will undoubtedly be challenging. Trade negotiations are typically multi-year projects. The EU-Canada deal famously took seven years from start to finish, and lead Brexit negotiator Michel Barnier has said it's unlikely everything will get agreed this year.

That said, most trade experts reckon it would theoretically be possible to agree a basic, tariff-free agreement covering goods trade this year – if (and it is a fairly big 'if') the UK signs up to most of what the EU will ask for.

At the heart of Brussels' wish-list are so-called level playing field commitments. These are designed to prevent the UK gaining a competitive edge by deregulating, and would require the UK to mirror EU rules on things like workers' rights, environmental standards and state aid. And as these rules evolve, the EU will expect the UK to keep pace (a system known as 'dynamic alignment').

Without all of that, Brussels may insist on imposing tariffs on some goods to offset any regulatory disadvantage facing EU-based firms.

Then there are the EU's more strategic interests, which may include fishing rights, as well as keeping the UK closely aligned on food/animal standards.

Source: Shutterstock
Britain's Prime Minister Boris Johnson prepares to speak during his first cabinet meeting after the general election

Will Boris Johnson be prepared to accept the EU's demands?

So will Boris Johnson be prepared to accept this level of alignment? It's tempting to say that December's landslide election victory gives the PM space to pivot towards a closer EU relationship. A less economically risky trading relationship might arguably be safer when it comes to the next election.

But everything Johnson has said over time about Brexit suggests he has genuine concerns about alignment with EU rules. Whether this thinking will change as the negotiations get underway and the potential trade-offs become more visible is, perhaps, the key question for 2020.

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It is possible though that Number 10 will ultimately accept the level-playing field commitments. In fact, the heavy emphasis on the December 2020 deadline may be partially designed to focus minds within his party later in the year.

Several Conservative MPs will presumably not take kindly to the EU's demands above. But when faced with the alternative of an extra two-years of transition, it is possible that many will be reluctantly prepared to accept this kind of agreement.

After all, it was exactly this tactic - the threat of further delay - that allowed the Prime Minister to rally his party behind October's deal and the substantial concessions contained within it.

A free-trade agreement isn't frictionless

Even if a trade deal can be agreed during 2020, the UK economy still could face some fairly large changes at the start of 2021.

Despite the name, a free-trade agreement (FTA) does not mean frictionless trade. It will involve plenty of costs and bureaucracy – and one particular headache for firms could be so-called rules of origin.

To qualify for zero-tariffs, UK firms selling goods to Europe will likely have to prove that their products are sufficiently British-made. For goods that have come through a complex supply chain, documenting the origin of a product's value is not always easy – and often it is simpler and cheaper to pay the tariff than it is to try and document origin.

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Don't forget too that a free-trade agreement covering goods will do very little for services – which account for 80% of UK output. An FTA-style agreement will most likely see an end to financial passporting, as well as automatic rights on data-sharing, among other things.

What is not clear at this stage is how far both sides would be willing - or legally able - to go to cushion the blow.

We may well see a series of unilateral actions taken to keep services trade moving – at the very least covering things like aviation. Both sides are also reportedly aiming to reach agreement on financial equivalence and data-adequacy agreements by the end of this year. It is possible that other 'patches' emerge to help prolong certain access rights for UK services.

Don't expect quick answers

Whatever happens, one thing looks fairly clear: we aren't going to know the answer to many of these key questions until much later in 2020.

If the transition period is not extended by June, then it will be a very uncertain race to get a free-trade agreement ready by the end of 2020.

Failure would mean an abrupt exit from the single market and customs union for British firms, and this is the key reason why we aren't expecting a big rise in UK investment this year.

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