Post-Brexit trade deal still possible despite rollercoaster talks

Despite the latest round of UK-EU talks ending a day early, it's too early to conclude that the chances of a trade agreement are falling. We still narrowly suspect a deal will be forthcoming, but the economic impact will still be significant when the transition period ends later this year

British Prime Minister Boris Johnson (R) and European Commission President Ursula von der Leyen meeting earlier this year

Source: Shutterstock

UK-EU trade talks have hit a new low

Brexit talks have always been a bit of a rollercoaster and now appears to be no exception.

Two weeks on from the UK and EU's joint commitment to 'intensify' talks, the latest round of negotiations have ended a day early, with EU chief negotiator Michel Barnier signalling that "serious divergences remain".

But most commentators, ourselves included, still feel that a free-trade agreement can be feasibly signed this year

So should we take from this that the chances of a deal being struck are fading? We don't think so, although it does go to highlight that the chances of no trade agreement are higher than the probability of 'no deal' was last October.

There's little doubt that the timeline for talks is highly compressed by usual trade negotiation standards. And Covid-19 has only added further strain, with reports that civil servants previously allocated to trade have been reallocated to the coronavirus response.

But most commentators, ourselves included, still feel that a free-trade agreement can be feasibly signed this year. That's because ultimately it all boils down to a narrow set of issues, and despite those promises of intensified talks a few weeks back, the amount of negotiating time available is not really the core problem.

Compromise is possible but not guaranteed

Compromise is undoubtedly possible. We've written many times about fishing, which is the most obvious of the more contentious issues that seem fudgeable.

Even on state aid - the issue that is the crux of the impasse - a number of potential compromises have been proposed. The *FT* summarised some of them this week, including one that would see both sides mutually agree to a set of principles for subsidies, potentially overseen by independent regulators.

Another way forward, mooted in *The Spectator* a few weeks back, could involve the UK signing up to the EU's level playing field requests initially - but importantly signalling that it could move away from them in the future, in the knowledge that the EU would respond with tariffs.

> *The real issue with state aid is that there is a fundamental difference in the way both sides view the issue*

This is undoubtedly unusual - it's hard to think of an example of a country signing up to a free-trade agreement, with the expectation that it would diverge from it in future years. It also has the potential to be pretty unstable, and the EU will seriously question how this divergence can be reasonably monitored. Enforcement mechanisms associated with trade deals tend to be geared more towards isolated breaches rather than fundamental shifts in approach.

But despite some potential avenues of compromise, the real issue with state aid is that there is a substantial difference in the way both sides view the issue. The UK, in particular, wants greater autonomy to aid the recovery from Covid-19, and rightly-or-wrongly state aid has come into sharper focus as the government has responded to the virus.

There are growing concerns about firms' preparedness for changes in trade terms

The upshot is that a deal is still probably, narrowly, the most likely outcome. But either way, we shouldn't expect to see much movement until closer to the de facto October deadline.

From the perspective of markets though, the much bigger question should be what impact all of this will have on the economy - and the likelihood is that the effect will be large.

A large chunk of businesses are unlikely to be fully prepared

The UK government has said it will apply light-touch checks to goods arriving from the EU early-on, reflecting the reality that customs processes and associated hiring are unlikely to be ready for the new volume of checks required when the transition period ends.

That may cushion some of the initial impact, although of course there are likely to be full checks on entry to the EU, and this has the potential to cause initial disruption at the ports on both sides of the channel.

The bigger issue though is that a large chunk of businesses are unlikely to be fully prepared. This time last year, it was estimated that there were 240,000 firms who only export to the EU - and the risk is that with Covid-19 occupying companies' resources at the moment, many won't have the capacity to prepare for life outside the single market/customs union.

The risk is particularly acute for small-medium enterprises, many of whom won't have the margin to absorb the additional costs associated with customs clearance, transport costs and if there's no deal, tariffs.

The UK is at risk of a slower post-virus recovery

The jury is out on exactly how this will play-out at a macro level, and we'll be writing more about this in the coming weeks. Some have made the argument that the sheer hit to GDP from coronavirus will mask the hit when the transition period ends later this year.

That's probably true to some extent - and perhaps in a more optimistic post-virus scenario (for instance one where a vaccine is found later this year), it's possible that the negative impact from Brexit is partially offset by further relaxation in social distancing.

Still, it's worth remembering that the sectors likely to be most affected by UK-EU trade disruption - the likes of manufacturing for example - are not necessarily the same as those hit by Covid-19, which has affected the likes of recreation and hospitality most heavily.

We, therefore, feel the UK is at greater risk of a slower overall recovery, and the change in trade terms could add further pressure to unemployment, which is unfortunately already showing signs of rising as businesses begin to adapt to the post-Covid landscape. This is one reason why we don't think the economy will return to pre-virus levels until 2022, at the very earliest.

In the near-term, all of this also has the potential to add further downside for the pound. Our FX team reckons the lack of an imminent breakthrough in negotiations could push EUR/GBP to 0.92 this summer. You can read our FX strategist Petr Krpata's full analysis here.

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