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UK Economic and Brexit Update

With a trade deal hanging in the balance, we examine the key sticking points in UK-EU negotiations, areas for possible compromise and ramifications for the British economy

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Key takeaways

- **Brexit:** A deal is now at best a 50:50 probability. The key factor will be whether the Internal Market Bill makes its way through the Commons and Lords successfully. If so, the EU is highly unlikely to sign a free-trade agreement with the UK given the lack of trust, and threat of withdrawal agreement breach. However a deal shouldn't be completely ruled out, and is still possible if the bill fails/is watered down, but would require the UK to reluctantly relax its red line on state aid. It's clear the government won't do a deal at any cost.
- **Economy:** We expect a 17% jump in UK GDP in the third quarter, but this will still leave the economy some 8% below pre-virus levels. The recovery looks set to stall with unemployment expected to rise to 8-9% by year-end.
- **Bank of England:** Further QE round is likely in November. Negative rates are still a possibility, but we think policymakers are more likely to lower the rate on the Term Funding Scheme for SMEs as a first step.
- **Covid-19:** The UK's testing system has been comparatively stronger than many in Europe on a per capita basis. This has helped to keep transmission contained over the summer although cracks are starting to appear. For now, the government is likely to prioritise limiting gatherings over re-closing parts of the economy as cases begin to rise.
- **Markets:** Despite a slide recent sterling slide, a lack of risk-premium embedded into EUR/GBP and neutral speculative positioning suggests further downside potential. 'No deal' could see EUR/GBP head above this year's high of 0.95 and potentially toward parity.

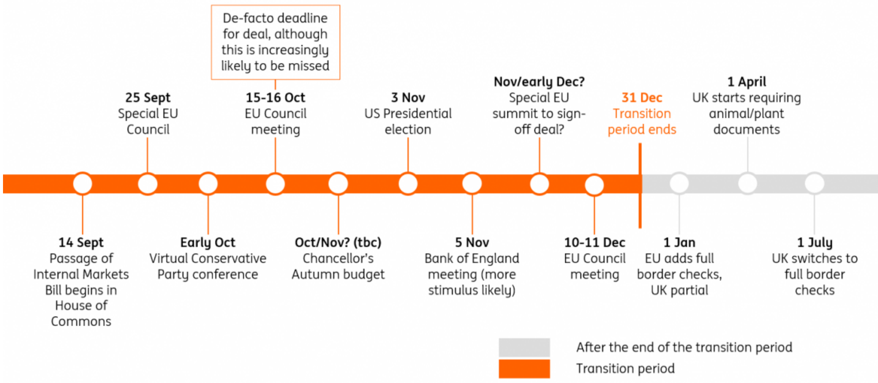
Is a deal still possible? At best, we think it's 50:50 now…

- **The bold nature of the Internal Market Bill** has led many to conclude this is designed to inject pressure, or a sense of crisis, into talks to try and generate movement.
- **It has drawn comparisons to 2019,** when Parliament was prorogued (also ruled unlawful).
- **But the move will reduce trust between negotiators.** The EU won't agree to a new deal if there is any risk of the Withdrawal Agreement being breached, and may look at legal action if the bill is passed.
- **Key question now is whether this legislation passes through Parliament.** There is talk of amendments, although unlike last year the government has an ample majority in the House of Commons. It may, however, face trouble in the House of Lords.
- **A deal is still possible,** if the legislation fails to pass or is watered down. But even then it would require a compromise on 'state aid', and current UK rhetoric suggests it is highly reluctant to do so.
- If the bill passes, then it looks increasingly likely that 'no deal' will be the most likely scenario.

What is the Internal Market Bill and why has it come about?

- State aid has long been the key dividing issue in negotiations. The UK wants full control to support industries in future. The EU wants reassurance, perhaps in the form of an independent regulator, that the UK won't abuse these powers and put European firms at a disadvantage.
- However the Northern Ireland Protocol (i.e. the backstop) says the UK must abide by EU state aid rules where it might affect NI-EU trade – something that is potentially far reaching.
- The UK government is therefore proposing to give ministers power to override this requirement, as well as on export summary declarations for goods leaving NI, and on the need for tariff payments on goods crossing the Irish sea.
- This is widely interpreted as a breach of international law

Trade timeline: Key dates surrounding UK-EU negotiations



What needs to happen for a deal to be done?

Issue	Possible compromise	Likelihood of agreement
State aid	• Brussels drops insistence that the UK signs up to EU state aid rules with ECJ oversight permanently. • Britain sets up independent regulator to enforce a set of limits/rules on UK state aid, that EU leaders are satisfied won't lead to unfair competition. • This will take time to set-up, so in the meantime the EU may insist on a transition where UK continues to follow its rules with ECJ oversight	**Questionable given Internal Market Bill** • UK adamant it wants control over state aid, and has gone further by proposing to override these provisions in the Withdrawal Agreement.
Fishing	• Both sides drop initial proposals (EU maintaining status quo, UK wanting control over its waters). • It'll be a question of quotas, and how often these are renegotiated in future years.	**Possible – but only if wider deal reached** • UK exports majority of its fish, while EU fishing communities rely on access to UK waters. • A deal makes economic sense for both sides but would likely be the last thing to be agreed
Equivalence for financial services	• 'Enhanced' equivalence regime unlikely (the EU would need to offer this to other FTA partners) • The EU has signalled flux in its own rules may mean an equivalence assessment covering all areas may not be possible this year.	**Likely if there's a deal – although scope unclear** • While this is largely a technical, and unilateral, EU matter, agreement on a wider FTA would likely add political impetus for equivalence to be resolved.

Other issues	Governance	Border bureaucracy	Data sharing
	UK uneasy about EU proposal for one overarching deal, enabling future sanctions that could link different areas	Transit rights for lorry drivers, lower frequency of checks (eg for agri/ animal), trusted trade schemes etc	Data adequacy ruling likely, but concerns about future legal challenges

What does the new UK-EU relationship mean for 2021 growth?

We are unlikely to see a Covid-19 style collapse in GDP at the start of 2021. We'd need to see consumer spending fall for this to happen, and that's unlikely to be a direct consequence of the transition period ending.

But unlike the pandemic, Brexit is a more permanent drag on UK activity. Higher costs will hit firms, and this will compound the damage done by Covid-19 (see examples to the right).

The effect is likely to be a slower recovery relative to comparable European peers. It could also put additional strain on unemployment if the challenges broaden out to a wider range of sectors than those directly hit by the pandemic. We think it is likely that unemployment will reach 9% by late 2020/early 2021

Brexit will hit some sectors less affected so-far by the pandemic

Example: Agriculture

Covid-19 impact: Production fell by only 5% in the second quarter, compared to 20% for the wider economy

Brexit impact: Typically the highest tariffs (30%+ for dairy/meat). Subject to more intrusive (health) checks at borders compared to other goods

For sectors already hard hit, Brexit will compound existing costs

Example: **Car manufacturing**

Covid-19 impact: Production fell by 70% in second quarter

Brexit impact: 10% tariff if no FTA in place. But also vulnerable to disruption at the ports given just-in-time production. Could stockpile to compensate, but that's costly and many firms (especially SMEs in the supply chain) won't have resources

Mapping the next phase of the economic recovery

Phase 1: Covid-19 spread before vaccine

A — **Some local lockdowns/mild national restrictions.** Contact tracing and local measures largely sufficient to control outbreaks. Limiting private gatherings prioritized over re-closing businesses

B — **Widespread local lockdowns that are frequently implemented/removed.** Level of restrictions becomes gradually tighter. Majority of the economy stays open, but food, hospitality & tourism hit again. Uncertainty increases, dampens sentiment

C — **Return to national lockdowns.** Community transmission increases as more people are indoors during winter. National restrictions re-imposed, but don't last as long given countries enter lockdown earlier/more decisively

Phase 2: Vaccine development and roll-out

I — **Several vaccines viable. Roll-out begins in 2021.** First approvals in late-2020, but sufficient rollout not achieved before summer 2021. Social distancing measures fully-unwound from 2H21.

II — **Handful of vaccines viable. Differential roll-out in 2021 across economies.** Countries higher-up the orders list of successful vaccines see earlier roll-out and quicker emergence from social distancing rules.

III — **Vaccine development takes longer.** Disappointing phase III trials mean no vaccine candidate emerges until later in 2021. Local lockdowns and social distancing continue until 2022 or later

Three scenarios for the UK economy

Assumptions

ING base case

Scenario 1 A + I

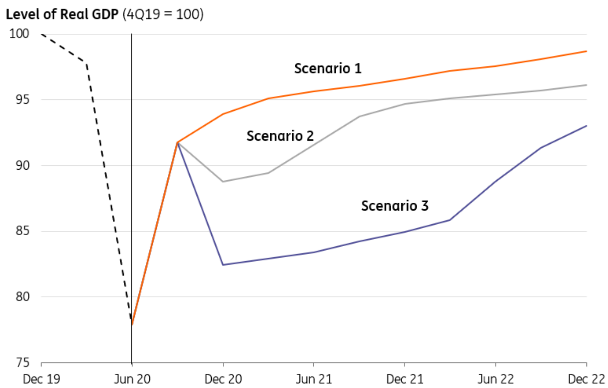
Local lockdowns used as vaccines rolled out during 1H21.

Scenario 2 B + II

Restrictions tightened but full lockdown avoided. Some vaccines rolled out in 1H21.

Scenario 3 C + III

National lockdowns return, while vaccine development takes longer than hoped



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