UK-EU deal no gamechanger for Britain's economy and public finances

Monday's European deal with Britain is a positive first step, but it won't massively boost the economy, nor help avoid tax rises in the autumn. Further regulatory alignment might do that and would help boost sterling. But existing UK and EU red lines make that a daunting task

EC President Ursula von der Leyen and UK Minister Keir Starmer following the summit

A helpful first step but a gamechanger? Probably not

After weeks of anticipation, the UK and EU have agreed a partial reset in economic relations, nine years after Britain's landmark decision to leave the bloc.

The UK's Labour government has secured its manifesto commitment of a veterinary agreement. That means the UK will formally realign with European agricultural/food standards, removing the need for cumbersome border checks and paperwork. In return, European fishing boats will gain access to UK waters for a further 12 years. And the deal sets the scene for an agreement on youth migration, a key Brussels ask. Both sides have also agreed closer defence cooperation.

Does this mean the UK is de facto back in the EU? No – far from it. Is it a game-changer for the UK economy? Also no. But is this a helpful step in the right direction? Yes. And could it set the scene for even closer economic ties? Perhaps.

Context: The UK government needs growth

The context to all of this is that the UK desperately needs to boost its public finances. And to do that, the government needs the independent Office for Budget Responsibility to boost its growth forecasts. That's the key to unlocking more money for other government priorities while avoiding painful real-terms spending cuts, without raising taxes.

The economic benefit of any UK-EU deal will hinge just as much on the fiscal stimulus it unlocks – or fiscal tightening it avoids - as it will on the deal itself.

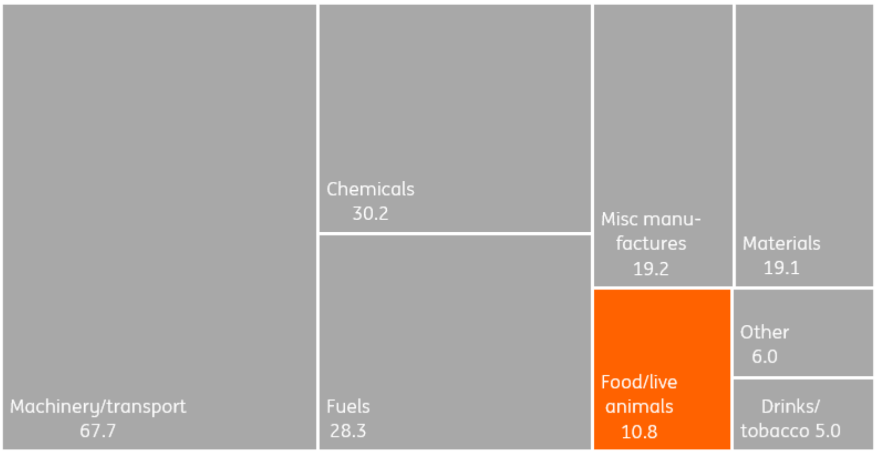
Convincing the OBR to upgrade its growth assessment isn't an easy task. But Brexit is a rare example of a policy which sparked major changes to its forecasts. The OBR reckons the trade barriers that came about after the EU's exit will permanently lower UK productivity by 4%. The Treasury hopes closer EU ties could claw back some of that loss.

What's been agreed so far – chiefly the deal on food standards – is unlikely to do that. Food/live animal products accounted for 6% of UK goods exports to the EU in 2023 (or 3% if you include services). Food products may be disproportionately affected by red tape at the border, and the changes will make a big difference to the sector. But the numbers simply aren't big enough to move the needle on overall economic growth.

Access for UK defence companies to EU funding – details depending - will help at the margin too. But generally we doubt this deal on its own will convince the OBR to change its outlook in any meaningful way.

UK agricultural exports to the EU aren't huge

UK goods exports to the EU (2023 GBP bn)



Source: ONS Pink Book

Closer alignment could unlock £10bn in headroom

That would almost certainly change if the UK succeeded in negotiating a broader reset in economic ties. The next obvious step would be for the UK to sign up to the EU's rulebook on products beyond agriculture.

In theory, that shouldn't be too difficult, given that the UK hasn't made much use of its autonomy to change these rules. The 'CE' mark – showing a good complies with EU regulations – is still generally accepted in the UK.

Were that to be negotiated, then the OBR might be convinced to revise up those productivity forecasts by say 1% - or around a quarter of the original estimated loss.

Not all of that benefit would arrive straight away, and crucially, it's what happens by the end of this decade which matters for the fiscal rules. Realistically, this scenario might see the OBR revise up its growth forecasts by 0.1% a year, which we think would double the Treasury's existing £9.9bn headroom – or money it has available after the fiscal rules are met. An extra £10bn roughly equates to the revenue raised by a 1pp rise in employer National Insurance, or a little more than 1pp hike in the basic rate of income tax, according to UK Treasury estimates.

Could the UK align further on services or rejoin a customs union?

Those numbers could be higher were the government to realign on services, perhaps by agreeing to a wide-reaching "mutual recognition" agreement of professional qualifications. Remember, the EU single market for services isn't nearly as developed as it is for goods. But Brexit still made life a lot more complicated for service-sector companies – and remember the UK is overwhelmingly a services economy.

Then there's a customs union, which would remove all tariffs. While that's generally true already, it is contingent on exporters demonstrating where a product and its various components originate, which is often a costly and complex task. A customs union would get rid of that, but would also heavily reduce the UK's ability to negotiate third-country trade deals.

Further talks look complicated

All of this sounds good on paper, but it is worth remembering that the UK government has formally ruled out wider single market access or rejoining a customs union. And even if those red lines are watered down, as they may well be, the past few weeks have demonstrated how very challenging this will be politically.

The EU is visibly reticent to offer the UK anything that resembles its relationship with Switzerland, which aligns on goods standards but also contributes financially to certain EU programmes and initiatives, and allows freedom of movement.

For the UK's part, the negotiations on a youth mobility deal have shown how reluctant London is to cede any sovereignty on immigration. That's motivated in no small part by Nigel Farage's Eurosceptic Reform Party's very strong performance in this month's local elections. This red line severely limits how far the EU is likely to go in granting wider market access for UK goods and services.

There is also an asymmetry in urgency. The UK needs quick results if it wants the OBR to make meaningful forecast changes at the autumn budget (late October/early November). The EU is in no such hurry.

Tax hikes still look likely

So yes, a broader deal on goods regulation would – in isolation - just about help the government avoid another painful tax hike later in the year. Whether such a deal is possible in practice is much less certain. And would it require the UK to make contributions to the EU budget? Presumably, the answer is yes, and that would provide a partial offset to any fiscal gains.

Even if the OBR can be convinced to incorporate the new EU relationship positively into its forecasts, other forces are acting in the opposite direction. The OBR's productivity forecasts generally look too optimistic and are ripe for downward revisions. Market rates have also been generally higher since the March projections were put together.

That's why we still think the government will struggle to avoid further tax hikes in the autumn, even if it negotiates closer ties in talks with the EU this summer.

Sterling: The long march to pre-Brexit levels

It's taken nearly nine years, but on a trade-weighted basis, sterling is now barely 2% away from the levels it traded at before the June 2016 Brexit referendum, *writes Chris Turner.* Driving that strength since 2022 has undoubtedly been the UK policy rate sticking much closer to US than eurozone levels. And more recently, the loss of confidence in the dollar (which has a 21% weight in the sterling index) has had an important say.

The case for sterling to push ahead much further does not look particularly strong at the moment. As James mentions above, today's deal seems unlikely to unlock a major positive reassessment of the UK economy by the OBR. At the same time, we see the risk of UK services inflation finally turning lower in a meaningful manner and allowing the market to price in more dovish Bank of England policy.

We can see EUR/GBP continuing to trade a 0.84-0.85 range this summer, with GBP/USD trading 1.30-1.35. But the scope for further UK-EU deals this year suggests the risks to those sterling forecasts are to the upside.

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