ECO FLASH

N°21-01

6 January 2021

BREXIT: THE WORST HAS BEEN AVOIDED

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The United Kingdom has since 1 January fully exited the European Union, and a free-trade agreement has been found, as has been customary with Brexit, at the last minute.

While that is good news for the British and European economies, Brexit is still "hard" and will surely trigger substantial economic losses in the long term.

Here we are. The UK has since 1 January departed from the EU in economic terms. While the country officially left the EU on 31 January 2020, a transition period had maintained it within the EU's single market and customs union until the end of 2020. During this period, negotiations were held in order to define the terms of the two parties' future relationship. The British and European negotiators eventually found a trade and cooperation agreement on 24 December 2020[1] (see box). This agreement covers the following topics: trade in goods and in services, digital trade, intellectual property, public procurement, aviation and road transport, energy, fisheries, social security coordination, law enforcement and judicial cooperation in criminal matters, thematic cooperation and participation in Union programmes[2]. It includes a free-trade agreement with no tariffs or quotas on any goods. The negotiations were stuck on three points for many weeks, but compromises have eventually been found.

The first main disagreement concerned the two parties' commitment to respecting a "*level playing field*", which means a framework that aims to maintain open and fair competition in the long term. The Europeans initially wanted the British to align dynamically on their standards – environmental, social, fiscal, etc. This would have forced the UK to keep pace with the EU's standards if those were to be raised in the future. Meanwhile, the UK insisted on regaining full sovereignty over the setting of its regulation, particularly on the topic of state aid. In the end, the two parties committed to *"uphold common high standards"* and agreed on *"detailed principles on state aid to prevent either side from granting unfair, trade-distorting subsidies"*. Moreover, each party will have the right to take *"unilateral measures to safeguard their economies against unfair competition from the other party"*.

The second major point of divergence concerned fisheries. On this issue, the UK had the high ground as the dispute had to do with access to UK waters for EU fishermen. While the Europeans initially asked unchanged access conditions – which means unlimited access – the UK offered to reduce the quotas for European fishermen by at least 60% and to renegotiate their access every year. Finally, in light of the limited capacity of British fishermen and of the importance for them of the EU market, European fish boats will continue to have generous access to UK waters until at least 2026, renouncing to only 25% of their quotas by then. Only from this date will the conditions be renegotiated annually.

Finally, the British and European negotiators could not agree on the governance of the agreement, which means on a dispute resolution mechanism. As the Europeans wanted, there will be a single governance framework for the overall agreement. Disagreements, including on topics such as level playing field and fisheries, will be discussed by the Partnership Council, which will be tasked to oversee the implementation of the deal. In case the Partnership Council failed to solve the issue, an independent arbitration tribunal will settle the matter through a binding ruling, which could include the reintroduction of tariffs or quotas. Should one party fail to respect that ruling, the other will have the possibility to "*cross-retaliate*", which means to impose sanctions in other economic sectors.

1 EU-UK Trade and Cooperation Agreement, Press release, European Commission, 24 December 2020.
2 Questions & Answers: EU-UK Trade and Cooperation Agreement, European Commission, 24 December 2020.

This free-trade agreement has prevented a return to the WTO base rules for the exchanges between the UK and the EU, which would have meant the imposition of tariffs and quotas. As such, that is good news, particularly for the British economy – the EU is, by far, its main commercial partner. That said, given that it has left both the EU's single market and customs union, Brexit was still "hard". Despite this agreement, the shock to its economy could therefore be substantial. The Office for Budget Responsibility (OBR), which provides independent forecasts to the Treasury, estimates that the *"new trading relationship [will] lead to a long-run loss of output [for the UK] of around 4 per cent compared to remaining in the EU"*. According to the same source, a no-deal exit would have cost an additional 2 percentage points of GDP[3]. Therefore, while a break down of the negotiations would have been harmful for the British economy, it is the exit from the EU's single market that would in any case have had the biggest negative impact on activity.

Investors made no mistake about that. The pound barely reacted to the news that a deal had been found, suggesting that this scenario was already priced in to the market. However, the British currency has risen by less than 2% against the euro since the two parties said on 11 December that a no-deal exit was the most likely scenario. The deal therefore does not seem to generate much optimism among investors. In fact, at EUR 1.12, the pound remains nearly 15% below where it was right before the Brexit referendum in 2016. Admittedly, that also reflects the particularly large impact of the Covid-19 crisis on the British economy and the country's persistent current account deficit. However, the pound was already very weak before the pandemic started and that deficit largely predates the referendum. According to us, Brexit will have important consequences for economic policy in the UK. We anticipate that the government and the Bank of England will have to maintain much more accommodative fiscal and monetary policies than would otherwise have been needed[4].

In addition to its substantial impact on the economy, and partly because of it, Brexit could have major political consequences. The Scottish Parliament and the Northern Ireland Assembly both voted on 30 December to reject the deal found by the negotiators. In 2016, the Scottish and the Northern Irish voted for Remain by 62.0% and 55.8%, respectively. Admittedly, Scotland voted by 55.3% in 2014 to remain in the UK. However, at the time, some were concerned that leaving the UK could mean the end of Scotland's membership to the EU.

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THE AGREEMENT'S RATIFICATION PROCESS

The EU-UK Trade and Cooperation Agreement was found on 24 December after nearly ten months of negotiations. On the British side, both the House of Commons and the House of Lords approved the agreement on 30 December. The Queen then gave Royal Assent to the deal, which officially became UK law only a few hours before the end of the transition period.

On the European side, the agreement came too late to be approved by all parties in due course. The ambassadors of all twenty-seven EU member states therefore approved the provisional application of the deal until 28 February 2021. Unless that deadline is postponed, the European Parliament and then the European Council will need to give their consent to the agreement before then. While MEPs have warned that they will not just rubber stamp the deal, it is quite unlikely that they will reject it.

3 Economic and fiscal outlook – November 2020, OBR, 25 November 2020.
4 United Kingdom: what will be the economic consequences of a hard Brexit?, BNP Paribas, *Eco Conjoncture n°9*, 30 November 2020.

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Edited by the Economic Research – BNP PARIBAS

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Head of publication : Jean Lemierre / Chief editor: William De Vijlder

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