UNITED KINGDOM

OUT OF THE FRYING PAN INTO THE FIRE?

While UK GDP has bounced back since May and has made up half of lost ground caused by the Covid-19 pandemic, the economic crisis is still far from being over. In particular, concerns are mounting over the labour market, as the government's furlough scheme will be terminated in the next few weeks. Meanwhile, the end of the transition period that maintains the UK in the EU's single market and customs union is coming up fast. Disagreements during the negotiations raise fears about the UK leaving without a trade agreement, which could have an even bigger impact on the economy in the long term than the current crisis.

According to data from the Office for National Statistics (ONS), UK GDP dropped by nearly 20% in the second quarter, which was the biggest fall in Europe. Over the first half as a whole, only Spain did worse than the UK (see chart 2). The ONS monthly GDP index rebounded in May and then has continued to rise in June and July (last available data).

Nevertheless, GDP is still close to 12% below its pre-pandemic level[1], which mainly owes to the services and construction sectors (chart 3). In particular, the index for the accommodation and food sector is still 60% below where it was in February – in April it was 90% below that level.

GROWTH AND INFLATION (%)

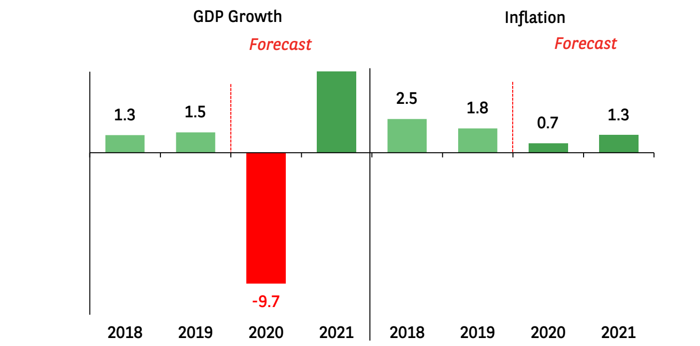

CHART 1 SOURCE: BNP PARIBAS GLOBAL MARKETS

THE PROTRACTED EFFECTS OF THE ECONOMIC CRISIS

After slumping earlier this year, economic activity is now on the path to recovery. However, the economic crisis will be felt for some time, as the authorities' response delayed some of its adverse effects. One example is conditions in the labour market, where more than twelve million individuals have benefited from the government's furlough scheme (Coronavirus Job Retention Scheme, CJRS) and its support programme for the self-employed (Self-employed Income Support Scheme, SEISS). However, the government is planning to replace these programmes in October and withdraw some of its support to businesses. As a result, fears are rising about a surge in the unemployment rate, as some firms will not be able to pay the full wages of their employees.

Admittedly, thanks in part to these programmes, the unemployment rate has only marginally increased since the Covid-19 crisis started, reaching 4.1% in July. However, advanced indicators suggest that UK payrolls already dropped by about 700 000 between March and August. The Bank of England forecasts that the unemployment rate will reach 7.5% at the end of the year – with the young and low-skilled workers likely to be the most affected. Nevertheless, Chancellor Rishi Sunak, who thinks that *"indefinitely keeping people out of work is not the answer"*, has pledged to continue to be "creative" to find ways to support the labour market.

GDP GROWTH (%)

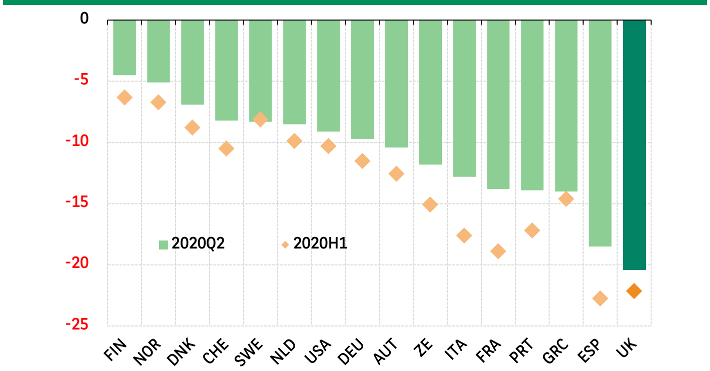

CHART 2 SOURCE: EUROSTAT

Another consequence of the crisis, inflation will probably remain weak in the coming months, which could push the Bank of England to loosen monetary policy further if economic conditions were to deteriorate again. CPI inflation dropped back to 0.5% in August[2], owing to the impact of the crisis on demand, the drop in oil prices earlier this year, the temporary cut to the VAT rate for the hospitality sector, and the Eat Out to Help Out scheme – which provides 50% discount up to GBP 10 for the clients of participating restaurants. The Bank of England forecasts that inflation will remain under 1% at least until the start of 2021, which is much below its medium-term target of 2%.

BREXIT, THE OTHER MAJOR THREAT

Meanwhile, the end of the transition period, established in the Withdrawal Agreement signed between the UK and the European Union (EU), is coming up fast. If the period is not extended, which is very likely, the UK will leave the EU's single market and customs union on 31 December 2020. However, the negotiations for a free-trade agreement between the two parties are making little headway. After eight rounds, there are two key stumbling blocks to an agreement.

The first obstacle is about ensuring a level playing field, which means setting up a framework to keep competition between the two parties open and fair in the long term. While this had been agreed to in the Political Declaration that laid the foundations of the ongoing talks, British negotiators are now refusing both to commit to maintaining

1 https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/gdpmonthlyestimateuk/july2020
2 https://www.ons.gov.uk/economy/inflationandpriceindices/bulletins/consumerpriceinflation/august2020

high standards and to put in place appropriate mechanisms to prevent distortions of trade and unfair competitive advantages.

Fisheries is the second source of dispute. While the UK would like to take back control of its waters, the EU negotiators want to maintain access for EU fishermen on terms similar to those that applied while the UK was in the EU.

What's more, the UK seems to have hardened its negotiating stance in recent days. Prime Minister Boris Johnson has announced at the start of September that the UK would "move on" if no deal was found before 15 October. The government has also presented draft legislation – the Internal Market Bill – that would break with some aspects of the Withdrawal Agreement, even though the text is legally constraining.

While the aim could be to win concessions from the EU, the possibility of an exit without a trade deal is real. According to most economists, that could have a big bearing on economic growth in the UK in the long run (see chart 4). Given the share of their production they export to the EU, some sectors, such as electronics, would particularly suffer from this kind of divorce (see chart 5).

In the meantime, the UK seeks to replicate the free-trade agreements the EU has signed with the rest of the world. The aim is to prevent a return to basic WTO rules, as these would put many tariff and non-tariff barriers to trade.

So far, the UK has signed roughly twenty trade deals with a total of fifty countries[3]. The most important is the one signed with Japan in September. However, except on certain aspects – such as financial services, digital technologies or e-commerce – the deal does not go much further than the one that ties Japan with the EU. What's more, according to the British government's own estimations, the deal that was just signed will only boost UK GDP by GBP 1.5 bn in the long term, which is equivalent to 0.07% of 2018 GDP[4].

Overall, the countries with which the UK has signed trade deals so far represent only 10% of the country's total trade (imports and exports). By comparison, EU countries represent nearly 50% of the UK's total trade. This underlines how important a trade deal with the EU would be for the UK economy.

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BREAKDOWN OF GDP AND ITS COMPONENTS

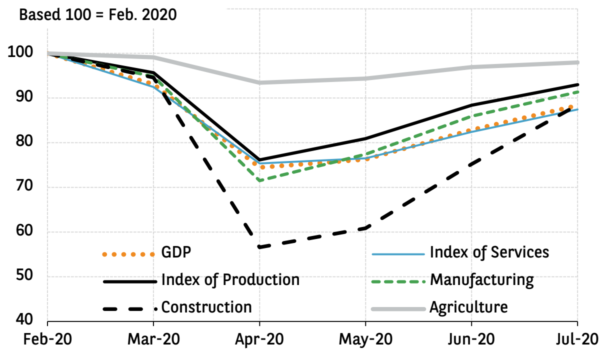

CHART 3 SOURCE: ONS

LONG-TERM IMPACT ON UK GDP OF RETURN TO WTO RULES

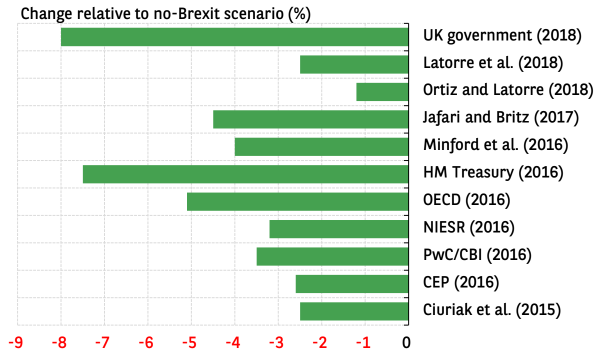

CHART 4 SOURCE: VARIOUS

SHARE OF UK PRODUCTION BY SECTOR EXPORTED TO EU (%)

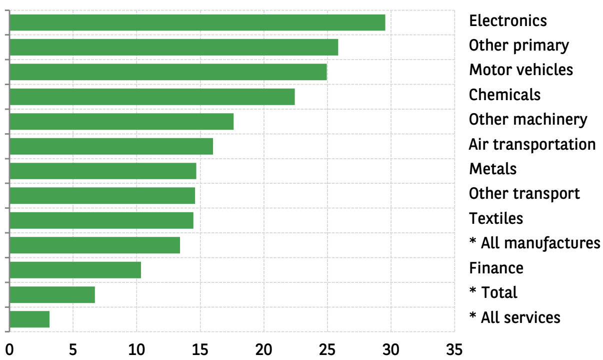

CHART 5 SOURCE: PIIE

3 https://www.gov.uk/guidance/uk-trade-agreements-with-non-eu-countries
4 https://www.gov.uk/government/publications/uks-approach-to-negotiating-a-free-trade-agreement-with-japan/uk-japan-free-trade-agreement-the-uks-strategic-approach