

A HARD BREXIT COULD COST THE EU EUR33BN IN ANNUAL EXPORTS

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The odds for a no-deal Brexit at the end of 2020 have considerably increased to 45%. While we do still expect a last-minute compromise, given the social, political and economic consequences of such an outcome on top of the continuing Covid-19 crisis in the UK and across Europe in general, a Hard Brexit could cost as much as EUR33bn in annual EU exports, with Germany (EUR8.2bn), the Netherlands (EUR4.8bn) and France (EUR3.6bn) hit the hardest. In the event of a no deal on 1 January 2021 (probably announced after mid-November to allow at least one month of preparation), the UK could see a -5% contraction in GDP and a -15% drop in exports, besides inflation beyond 5% for at least six months. This latter will mainly be driven by the strong rise in import prices (+15%) on the back of: (i) higher average import tariffs on total imports (+1pp to 2.6%¹); (ii) a significant rise in non-tariff barriers (supply-chain disruption, administrative hurdles, increased transportation costs and time) — estimates² suggest these could act as a +10% ad-valorem tariff on product value for imports coming from countries such as France, Germany or Spain, as they are part of the Customs Union and the Single Market, and around +5% on imports coming from Norway, a member of the Single Market but not the Customs Union. (iii) a forecasted -10% depreciation of the sterling (see Figure 1).

Import prices will rise the most for the following categories (i) footwear, headgear, umbrellas, whips, riding-crops, feathers, artificial flowers (+21%), (ii) textile materials (+21%), (iii) animal products and live animals (+20%), and (iv) food and beverages (+20%) – see Figure 2. Depending on the nature of imports, their sensitivity to changes in prices varies – in general, we expect a higher elasticity on second necessity goods such as high-tech products, machinery and equipment, automotive etc.

Taking into account the rise in import prices as well as the import sensitivity to prices (on average 0.4), we calculate that Germany could lose as much as EUR8.2bn of its exports to the UK in value (11.2% of its exports to the UK and 0.6% of its total exports). The Netherlands will see its exports decrease by EUR4.8bn (10.5% of its exports to the UK) and France by EUR3.6bn (11%) – see Figure 3 for the most exposed European countries and products.

We expect the authorities to step in in the case of a Hard Brexit. The BoE would significantly ease the stance of its monetary policy. Key interest rates are expected to go into negative territory and QE to be increased by GBP250-300bn, similar to the Covid-19 package, and at least double

¹ https://www.eulerhermes.com/en_global/news-insights/economic-insights/brexit-trade-tricks-wont-be-enough.html

² <https://www.instituteforgovernment.org.uk/sites/default/files/Economic%20impact%20of%20Brexit%20summary.pdf>

compared to our baseline scenario (see Figure 1). On the fiscal side we expect 4% of GDP in additional measures in 2021 (against 2% in the baseline scenario), with a focus on infrastructure spending, protection of consumers' purchasing power (prolonged VAT rate cut and consumption vouchers) and liquidity measures for companies.

We expect a Free Trade Agreement (CETA++³ type) with the EU to be agreed by mid-November. However, we don't exclude the possibility that a longer transition period is agreed upon to allow enough time for a full ratification. Hence, we expect an FTA to be implemented only by mid-2021. It's worth mentioning that if an agreement between the UK and the EU is not finalized by the end of October / mid-November, there won't be enough time for a full ratification of the FTA before the end of the year. Hence, we don't exclude the possibility of a technical extension of the transition period despite the commitment of both sides not to do so. The intensification of the sanitary crisis could also be a trigger for the extension of the transition period and the implementation of the FTA in a smooth way. In our baseline scenario, we expect the UK economy to continue to struggle throughout the sanitary crisis, with GDP contracting by -3% q/q in Q4 (-11.8% in 2020), and a weak and unstable recovery afterwards until 2022 when a vaccination campaign could allow a return to normal.

It is worth noting that, as of mid-October 2020, the UK is planning to enforce as many as 22 trade deals with non-EU countries or trade blocks as of 01 January 2021 in case no agreement with the EU is reached before the end of this year. In addition, 16 similar deals with other partners are still under negotiation. If the latter cannot be formally signed before late December, the UK will have to trade with such countries under WTO terms as of 01 January 2021. Finally, the UK secured mutual recognition agreements (or MRAs, that is, agreements in which countries recognize the results of one another's conformity assessments) replicating EU arrangements, with the U.S., New Zealand and Australia. It also managed to sign an FTA with Japan, with whom an MRA is currently being contemplated.

Overall, we expect growth of +2.5% in 2021 (see Figure 1), as the effective EU exit under a FTA (a CETA++) is likely to materialize in 2021, either on 1 January 2021 or a later stage if both sides agree they need more time for ratification and implementation. In this Soft Brexit scenario, EU export losses would stand at EUR18bn. Meanwhile, in the UK, import prices are expected to rise by +6% on average due to a -3% depreciation of the sterling and the rise in non-tariff barriers detailed above. Hence, despite the overall fall in import tariffs (-0.7pp to 1%), under a Soft Brexit scenario, imports of products from the plant kingdom will experience a +8% price increase, followed by imports of paper and cardboard (+7%), pearls, precious stones and metals, metals clad, imitation jewelry, coins (+7%), mineral products (+7%) as well as wood, charcoal, cork, articles of straw and plaiting materials, and basketware (+7%) – see Figure 2. The rise in import prices will increase inflation beyond 2% in H2 2021 while reducing corporate margins.

³ CETA ++ means the UK will be out of the Customs Union and Single Market but with almost zero tariffs on goods and equivalence for all financial products

Figure 1 – Brexit scenarios and related economic and financial impacts

	Soft Brexit with very-last minute compromise and FTA implementation by mid-2021 (55%)		Hard Brexit on Jan 1 st , 2021 with likely comeback into negotiations during 2021 after early elections (45%)	
	2020	2021	2020	2021
GDP growth, %	-11.8	+2.5	-10.9	-4.8
Consumer spending, %	-13.3	5.9	-12.0	0.7
Total investment, %	-26.8	-15.1	-26.8	-25.8
Exports, %	-13.7	1.8	-13.7	-13.0
Inflation	0.7	1.5	0.7	4.5
Unemployment rate	7.0	8.5	7.0	10.0
GBP/EUR, annual change	-7.0	-3.0	-9.0	-10.0
Business insolvencies, %	4.0	31.0	4.0	53.0
Monetary policy	QE increased by 5% of GDP (around GBP100bn) and implemented until mid-2021, rates unchanged at 0.1%		Rates cut into negative territory and QE increased by GBP250-300bn, similar to the Covid-19 package	
Fiscal policy	2% of GDP in 2021 (after only 1.5% in 2020) mainly focused on infrastructure spending and tax cuts		4% of GDP in 2021 mainly focused on infrastructure spending and measures to protect consumers purchasing power. State guaranteed loans prolonged until end-2021.	
Gilt expectations and equity strategy	10y GILT at 0.4%(eoy) FTSE 100 at -22%/yoy (eoy)	10y GILT at 0.6%(eoy) FTSE 100 at +10%/yoy(eoy)	10y GILT at -0.2%(eoy) FTSE 100 at -50%/yoy (eoy)	10y GILT at 0.1%(eoy) FTSE 100 at -10%/yoy(eoy)

Sources: national sources, Allianz Research

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Hard Brexit		Soft Brexit	
Footwear, headgear, umbrellas, whips, riding-crops, feathers, artificial flowers	21%	Products of the plant kingdom	8%
Textile materials	21%	Paper or cardboard	7%
Animal products and live animals	20%	Pearls, precious stones and metals, metals clad, imitation jewelry, coins	7%
Products of the plant kingdom	20%	Mineral products	7%
Food and beverages, alcoholic beverages, vinegars, tobacco	20%	Wood, charcoal, cork, articles of straw and plaiting materials, basketware	7%
Transport equipment	19%	Textile materials	7%
Animal or vegetable fats, oils and waxes	19%	Miscellaneous goods	7%
Plastics and rubber	18%	Chemicals	7%
Leather, furskins, saddlery, harness, travel goods, handbags	16%	Plastics and rubber	7%
Articles of stone, plaster, cement, asbestos, mica, ceramic products, glass and glassware	15%	Machinery and electrical equipment	7%

Sources: WTO, ITC, Allianz Research

Figure 3 - Export loss by country & Brexit scenario in value (top 5 main exposed sectors), EUR million

EUR, mn	Hard Brexit	Soft Brexit
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Germany	8 198		4 215	
	Transport equipment	2 855	Transport equipment	1 268
	Machinery and electrical equipment	1 359	Machinery and electrical equipment	825
	Chemicals	752	Chemicals	437
	Plastics and rubber	603	Base metals	304
	Base metals	540	Plastics and rubber	295
Netherlands	4 827		2 579	
	Machinery and electrical equipment	1 046	Machinery and electrical equipment	632
	Chemicals	825	Chemicals	484
	Mineral products	469	Mineral products	293
	Transport equipment	438	Transport equipment	192
	Textile materials	327	Musical, optical, photographic, cinematographic, measuring, checking, medical or surgical instruments, clocks and watches	156
France	3 629		1 947	
	Transport equipment	759	Transport equipment	373
	Chemicals	477	Chemicals	276
	Machinery and electrical equipment	426	Machinery and electrical equipment	258
	Food and beverages, alcoholic beverages, vinegars, tobacco	305	Pearls, precious stones and metals, metals clad, imitation jewelry, coins	180
	Pearls, precious stones and metals, metals clad, imitation jewelry, coins	286	Food and beverages, alcoholic beverages, vinegars, tobacco	145
Belgium	3 159		1 591	
	Transport equipment	969	Transport equipment	423
	Chemicals	409	Chemicals	242
	Plastics and rubber	284	Plastics and rubber	137
	Mineral products	216	Mineral products	135
	Textile materials	207	Machinery and electrical equipment	114
Italy	2 567		1 320	
	Machinery and electrical equipment	393	Machinery and electrical equipment	239
	Textile materials	382	Textile materials	151
	Transport equipment	309	Transport equipment	138
	Chemicals	215	Chemicals	128
	Food and beverages, alcoholic beverages, vinegars, tobacco	212	Base metals	110
Spain	2 091		1 021	
	Transport equipment	717	Transport equipment	323
	Products of the plant kingdom	206	Chemicals	100
	Chemicals	174	Products of the plant kingdom	83
	Textile materials	155	Machinery and electrical equipment	82
	Machinery and electrical equipment	137	Base metals	82
Norway	2 116		802	
	Mineral products	1 879	Mineral products	719
	Base metals	52	Base metals	19
	Chemicals	43	Chemicals	14
	Machinery and electrical equipment	29	Machinery and electrical equipment	11
	Transport equipment	19	Transport equipment	7
Ireland	1 418		751	
	Chemicals	306	Chemicals	184
	Food and beverages, alcoholic beverages, vinegars, tobacco	226	Machinery and electrical equipment	116
	Animal products and live animals	200	Food and beverages, alcoholic beverages, vinegars, tobacco	97
	Machinery and electrical equipment	193	Animal products and live animals	84
	Mineral products	82	Mineral products	51
Poland	1 355		699	
	Machinery and electrical equipment	298	Machinery and electrical equipment	180
	Transport equipment	191	Transport equipment	85
	Food and beverages, alcoholic beverages, vinegars, tobacco	171	Miscellaneous goods	69
	Miscellaneous goods	116	Food and beverages, alcoholic beverages, vinegars, tobacco	54
	Chemicals	85	Chemicals	49
Sweden	805		447	
	Transport equipment	165	Mineral products	77
	Mineral products	123	Transport equipment	73
	Machinery and electrical equipment	92	Paper or cardboard	57
	Paper or cardboard	90	Machinery and electrical equipment	56
	Wood, charcoal, cork, articles of straw and plaiting materials, basketware	79	Wood, charcoal, cork, articles of straw and plaiting materials, basketware	47
Denmark	739		408	

	Base metals	232	Base metals	141
	Machinery and electrical equipment	153	Machinery and electrical equipment	92
	Animal products and live animals	63	Animal products and live animals	25
	Food and beverages, alcoholic beverages, vinegars, tobacco	58	Chemicals	25
	Textile materials	46	Food and beverages, alcoholic beverages, vinegars, tobacco	23
	708		381	
Czech Republic	Machinery and electrical equipment	267	Machinery and electrical equipment	161
	Transport equipment	162	Transport equipment	71
	Base metals	73	Base metals	42
	Miscellaneous goods	49	Miscellaneous goods	29
	Plastics and rubber	39	Plastics and rubber	20

Sources: WTO, ITC, Allianz Research

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