

Last minute Brexit deal merely avoids the worst

- **With the last-minute Christmas Eve agreement, the implementation of tariffs for EU-UK trade has been avoided and we have no doubt that it will finally be confirmed also by the EP. Financial markets took the Brexit agreement with relief.**
- **The agreement covers goods trade, fisheries, defines a level playing field and contains a dispute settlement mechanism. It thereby finishes the long period of fundamental uncertainty regarding the EU-UK relations.**
- **That said, trade in services is not covered and new impediments to trade will emerge due to regulatory requirements and bureaucracy. As a result, trade growth will be hampered relative to the pre-Brexit period thereby constituting headwinds to growth.**
- **All in all, barring major negative surprises on implementation the envisaged effects from the new EU-UK relations are broadly in line with our expectations. This leaves the development of the pandemic and of lockdown measures as the major growth risk for 2021. Financial markets should be supported by the significant reduction of uncertainty on the EU-UK trade relations.**

A last-minute deal avoids falling back to WTO rules: After intense and painful negotiations, the UK and the EU finally agreed on Christmas eve on a Trade and Cooperation agreement. This prevented both sides to fallback to WTO rules. Notwithstanding the so far missing (but almost certain) consent of the European Parliament, the deal already came into effect on January 1, 2021 (31.12.2020 11 pm GMT in the UK) on a preliminary basis. The deal itself contains over 400 pages with an additional 800 pages of annexes. Several details of the deals will still be fixed in the future. Basically, the deal is a free trade agreement augmented by a range of other topics. The key features are:

No tariffs in goods trade: In essence, both sides agreed to keep a tariff-free and quota-free access to each other's goods markets, provided specific rules of origin and product standards have been observed. However, the UK leaves the EU Single Market and is thereby treated as a foreign country to which the usual customs formalities such as customs declarations and border checks will apply. This will also especially be true for the agricultural sector where health certificates and other safety obligations will come into effect.

Fisheries were another major sticking point to find a deal. The agreement foresees that the UK will regain 25% of the EU catch (in value terms) in UK fishing waters over a period of five and a half years. Thereafter, both sides will hold annual negotiations about the quotas. If the UK revokes EU access to its waters, the EU will be allowed to apply tariffs on UK fish exports.

Some agreement on transportation: Regarding aviation, the UK will remain in the European Common Aviation Area. This allows passenger and cargo planes still able to fly and land in the EU from the UK. EU domestic flights will be able by founding subsidiaries. Concerning road transport, UK and EU trucks will also be able to perform up to two additional operations in the other party's territory.

Level playing field: The UK and EU have agreed various provisions to ensure a level playing field, but the UK successfully rejected EU demands for dynamic equivalence (i.e. the UK to keep in lockstep with EU standards). Moreover, there is no role for the European Court of Justice (ECJ) anymore. Both parties committed to upholding high labour, social and environmental standards below which neither must not go. There will be a review after four years to ensure the level playing field was working. Moreover, if either side rejects to agreeing on a new floor for standards, the other may apply tariffs subject to the approval of an independent arbitration panel. An arbitration panel would meet within 30 days and adjudicate. Furthermore, both sides will handle subsidies transparently. If it is found that subsidies have distorted trade substantially, either side may take unilateral actions e.g. implement tariffs or quotas after consultation. There will also be an overarching UK-EU governance committee. The UK and the EU will create a joint body called the Partnership Council to manage implementation of the agreement.

Citizen's security: Beyond narrowly economic issues the deal also covers topics like law enforcement and judicial cooperation in criminal matters, protection of fundamental rights and personal data, data exchange and anti-money laundering provisions. However, the UK will no longer be part of the European Arrest Warrant system nor member of Europol or Eurojust but keep access to the Schengen Information System.

That said, it is important to keep in mind that this last-minute deal considerably falls behind the situation when the UK was still part of the Single Market and entails new obstacles even for goods trade:

No comprehensive agreement on services trade yet reached: As the deal basically covers trade in goods service providers will in principle be treated on a reciprocal basis which is a large step back compared to the Single Market rights to offer services EU-wide.

- Most noteworthy, limitations apply to financial services which are the UK's most important service exports to the EU (9% of total goods and services exports). Both sides committed to find a "Memorandum of Understanding" on regulatory cooperation on financial services by March 2021. While UK financial firms will be able to (and largely did already) establish a physical subsidiary within the EU to serve the market, the EU system to granting financial services trade will be governed by "regulatory equivalence" (i.e. the EU grants market access to financial firms if their "home" rules are deemed "equivalent" to the EU rules). However, the deal does not include provisions relating to equivalence but leaves that to a separate process. Financial firms in London are reported to have already shifted 7,500 jobs and assets with GBP 1 tr to new EU locations.
- Regarding other services, France is said to have successfully kept the audio-visual sector out of the deal (the UK hosts around 1,400 broadcasters which are about 30% of all channels in the EU).
- Finally, regarding professional services, the deal does not include the mutual recognition of professional qualifications (e.g. for doctors, nurses, dentists, architects, vets, engineers). This recognition has to be granted now by individual member states.

Costs in goods trade to rise: Many businesses have filled their stocks ahead of the deal. However, it is expected that customs procedures and formalities will lead to substantial trade frictions over the first

months of this year. More generally, estimates of such bureaucracy costs vary strongly, but could reach up to 0.9% of GDP. This is considered the loss of exiting the EU Single Market. The ties in goods trade between both regions already loosened over the past years: In 2019 the euro area goods exports to the UK almost stagnated whereas the ones to the rest of the world grew by 3.2% and from Jan to Oct 2020 the pandemic induced shrinking of exports to the UK was much more pronounced than to the rest of the world. Looking ahead, we conjecture that higher trading costs will contribute to the shift of euro area value chains out of the UK (e.g. car industry) and to a lesser degree also the other way around.

End of Brexit uncertainty leaves Covid-19 pandemic as the key activity risk: In sum, the deal has avoided the materialization of a worst-case scenario (shaving off about 0.5 pp of 2021 GDP growth in the euro area and 1.5 pp in the UK) and is broadly in line with what we had expected. The UK has given priority to sovereignty rather than to close regional cooperation. The resulting reduction in uncertainty will be conducive to activity and financial markets. We continue to deem the negative economic impact to the UK higher than to the EU (especially on services). This stems simply from the fact that the EU27 exports to the UK amount to 3% of GDP (goods only 2.5% of GDP) while UK exports to EU amount to 13.4% of GDP, goods to 7.7%. That said, the short-term economic outlook will much more rely on the development of the Covid-19 pandemic. In both regions, lockdown measures are being tightened given the latest worsening of the pandemic situation. Hence, barring major negative surprises on the implementation of the Brexit deal the pandemic is now the outstanding risk factor for the UK as well as the euro area.

Kind regards

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