S-Finanzgruppe
Deutscher Sparkassen –
und Giroverband

STATEMENT BY THE SPARKASSEN-FINANZGRUPPE'S CHIEF ECONOMISTS

The Chief Economists of the Sparkassen-Finanzgruppe are concerned that the risk of the United Kingdom (UK) crashing out of the EU single market and customs union without any agreement remains high.

- Even if the chances of a comprehensive (free) trade deal being struck in the time remaining are close to zero, it is nevertheless still possible for the two parties to agree on rudimentary partial agreements and to postpone the timetable in exchange for tighter ratification later.
- The UK is being particularly affected by the coronavirus pandemic. The economic losses being sustained are equally huge. A possible "No Deal" outcome would place an additional and lasting burden on the British economy and should therefore be avoided in the UK's own best interests.
- Structural change has already begun. Banks are already relocating business from London to the mainland, with Frankfurt am Main being one of the beneficiaries here.
- In the financial sector, the European Commission has already resolved in a first equivalence decision for the period after 1 January 2021 that the rules for British central counterparties (CCPs) will remain unchanged for a further 18 months in the first instance.

30. November 2020

Authors
Uwe Burkert - LBBW
Uwe Dürkop - Berlin Savings Bank
Jochen Intelmann - Haspa
Dr Ulrich Kater - DekaBank
Christian Lips - NORD/LB
Dr. Jürgen Michels - BayernLB
Dr. Reinhold Rickes - DSGV
Dr. Gertrud Traud - Helaba
Prof. Dr. Carsten Wesselmann
- Kreissparkasse Cologne

Coordinator:
Dr. Sonja Scheffler
sonja.scheffler@dsgv.de

Brexit – is there an end in sight?

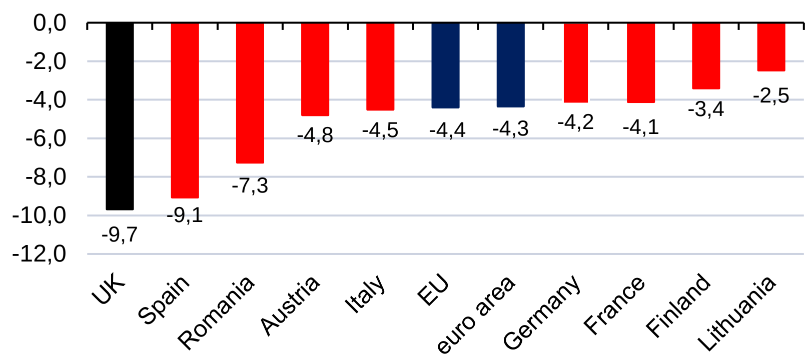
Trade negotiations with EU are in their endgame

The Internal Market Bill is putting an additional burden on negotiations

The clock is ticking down fast, but a breakthrough is still not in sight: UK negotiations with the EU on a trade agreement are in their endgame. British Prime Minister Johnson allowed the deadline for extending the transition phase during which the UK remains part of the EU's single market to elapse at the end of June. This means that the transition period will expire on 31 December 2020 unless both sides strike a political deal to extend it. The main sticking points continue to be future state subsidies in the UK ("level playing field") as welll as the fisheries issue. The Internal Market Bill adopted by the House of Commons, which undermines the international-law provisions written into the Northern Ireland solution in the EU withdrawal treaty (avoidance of a hard customs border on the island of Ireland), is another source of dispute. Although the House of Lords has thrown out this piece of legislation, the government has already announced that it intends to adhere to it for the time being. Moreover, the House of Commons is adamant that it will only turn its attention back to the Internal Market Bill in December. If a trade agreement has been reached by then, the controversial points in the Billl will presumably be deleted because that is the precondition for a deal. Otherwise, Johnson will abide by his Bill.

The United Kingdom is currently bringing up the rear in Europe

Percentage change in gross domestic product Q3 2020 vs. Q4 2019



Note: The data has been adjusted for seasonal and working-day effects
Sources: Eurostat, BayernLB Research

An agreement on a rudimentary partial deal would still be possible

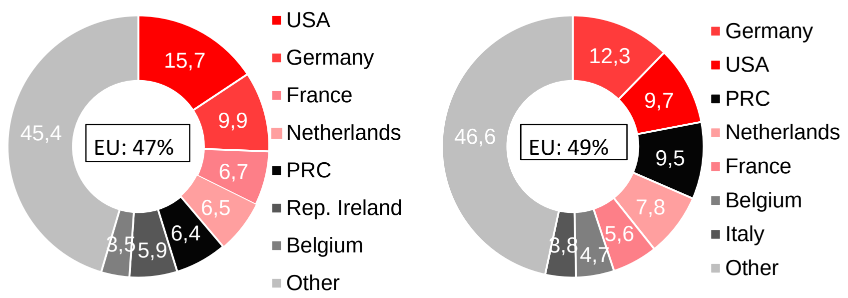
Even if the chances of a comprehensive (free) trade deal being struck in the time remaining are close to zero, it would still be possible to agree on rudimentary partial agreements and to postpone the timetable in exchange for tighter ratification later. Two developments speak in favour of this. For one thing, the coronavirus pandemic is taking a particularly heavy toll on the United Kingdom: the UK has suffered the highest number of deaths due to Covid-19 infections in Europe. For another thing, the degree to which the UK economy has collapsed since the outbreak of the coronavirus crisis has been without precedent: no other country in the EU has sustained greater economic losses so far (cf. the chart on page 2). The renewed wave of infections this autumn will undoubtedly delay the economic recovery, as the UK is also back in lockdown on account of the second wave - much to the displeasure of some members of Johnson's Conservative Party. A possible "No Deal" outcome would impose an additional burden on the British economy, which Johnson cannot really afford.

The election of Joe Biden reduces the likelihood of a rapid trade agreement with the USA

With Donald Trump's defeat at the polls in the US, the prospects of a bilateral trade agreement being quickly wrapped up with the United States have rapidly diminished - the USA is the most important trade partner for the UK after the EU (cf. the chart on page 3). Future President Joe Biden, on the other hand, is not an advocate of Brexit, so far tending to be a proponent of strong confederations of states. Moreover, Biden already made it clear n the stump during the election campaign that a free-trade agreement between the USA and the UK would not be reached if, in the event of a "No Deal" Brexit, a border between the Republic of Ireland and Northern Ireland became necessary again, endangering the peace between the two countries ("Good Friday Agreement"). In order to prevent the complete collapse of UK international trade on 1 January 2021, Johnson must at least be prepared to forge rudimentary (partial) agreements with the EU.

The UK is heavily dependant on the EU on the external-trade front

The UK's main customer countries and main supplier countries in 2019 (percent)



British exports and imports to Germany, and to the EU in general, in 2019

Imports to the UK		Exports from the UK	
from the EU	EUR 292 billion	to the EU	EUR 187 billion
from Germany	EUR 79 billion	to Germany	EUR 40 billion

Sources: GTAI, ONS, BayernLB Research

What is more, after the recent departure of Johnson's chief adviser Dominic Cummings and of his Director of Communications Lee Cain (the former is considered the architect of the successful Brexit campaign), the access of "Vote Leave" Brexit hardliners to the government has been further weakened. Although Johnson is not admittedly expected to suddenly make a complete U-turn in terms of trade agreements with the EU - important Brexit hardliners such as Michael Gove continue to dominate Johnson's policymaking - an opportunity is nevertheless beckoning: were the British Prime Minister to now adopt a different, more moderate policy, he could blame Cummings for many of the political decisions he has taken so far. If partial agreements are reached with the EU, it should be easier for the prime minister to defend his policy if an upswing emerges next year, with UK GDP growth rebounding to about 4%, in the wake of the historically deep (coronavirus-related) recession of 2020.

The departure of chief adviser Cummings offers Johnson an opportunity to adopt a more "moderate" tack

Clearing rules are going to remain in place until mid-2022

In the financial sector, the European Commission has already resolved in a first equivalence decision for the period after 1 January 2021 that the rules for British central counterparties (CCPs) will continue to apply unchanged for a further 18 months in the first instance. The commission already announced this step in July, pointing to the potential risks to financial stability that might otherwise arise. The backstory here is the high market share of UK CCPs in pan-European clearing business. In accordance with this, the UK's future market access in the financial sector is not part of the ongoing negotiations but will instead be regulated going forward by unilateral equivalence decisions from Brussels. The EU considers a total of 28 such equivalence decisions to be possible for the UK in the financial sphere.

Rules for UK CCPs will remain unchanged for 18 months in the first instance

Meanwhile, the relocation of banking business away from London is gathering momentum, with Frankfurt am Main one of the major beneficiaries on this score. According to Deutsche Bundesbank, financial institutions have so far shifted balance-sheet items amounting to EUR 278 billion to Germany alone and intend to increase this amount to EUR 675 billion by the beginning of 2021. According to the Bundesbank, 40 credit institutions, securities firms and financial-services providers in Germany have obtained new licences or else have had the scope of existing licences extended. Brexit banks licensed in Germany are planning to transfer 2,500 employees to the EU by early 2021, although the Covid-19 crisis is admittedly delaying the planned increase in staff. While many international financial institutions are locating in Frankfurt in order to be in the immediate proximity of the ECB (responsible for supervision), many institutions are expanding their trading operations in

The exodus of banking business from London is picking up speed

Paris. Amsterdam, Dublin and Luxembourg are likewise vying for the favour of financial institutions from London.

There is still a great risk of a "No Deal" outcome

If a "No Deal" outcome materialises, a veritable flood of customs clearance will descend on the UK

The risk that the UK will crash out of the EU single market and customs union on 1 January 2021 without an agreement remains high. The consequences would be serious: the Achilles heel for the UK are the ferry and freight ports along the English Channel. It is estimated that the controls which would become necessary post no-deal Brexit would extend delivery times by up to two days. That would hit freight forwarders who deliver on a just-in-time basis particularly hard. But deliveries of food - and, in particular, medicines - would also be significantly delayed. And there are many indications that the British government is not really prepared for the flood of customs clearance that would descend on the United Kingdom in the event of a "No Deal" outcome. For example, it is still completely unclear where checkpoints for lorries (trucks) are to be set up and who is to handle the deluge of customs declarations which would rain down on the UK.

Nevertheless, the negative economic knock-on effects should not be as high as they would have been in 2016

Nevertheless, the negative economic knock-on effects for the UK are not likely to be as pronounced as they would have been immediately after the in/out referendum vote of June 2016. More than four years have now passed and many companies have used this time to make adjustments (e.g. to their supply chains). By way of illustration, the share of aggregate UK exports to the EU has already fallen by 1.2 percentage points between 2016 and 2019. This means that the Brexit cliff has already grown less steep compared to 2016. In the case of a "No Deal" Brexit, however, a 2021 UK GDP growth rate two to three percentage points lower than under an agreement scenario (of whatever form) can be expected. A study by the London School of Economics, which has looked into the long-term consequences of a "No Deal" scenario, estimates that the level of British GDP in the ten years following a no-deal crashout would be around six percentage points lower than if the country were still in the EU. By way of comparison, the coronavirus crisis will knock “only” two percentage points off macrooeconomic growth over the same period, according to this calculation.

The EU’s coronavirus relief package will cushion the consequences of a "No Deal” scenario

The rest of the EU would also be likely to suffer from the negative consequences of a "No Deal" scenario, albeit to a much smaller extent. Here too, the time factor plays an important role. According to a study by Deloitte, exports by major German companies - Germany is currently the UK's most important trading partner within the EU - already fell by almost EUR 7 billion (minus 6 percent) to EUR 111 billion between the Brexit vote and the end of 2019. Over the same period, overall turnover of these companies in the UK receded by almost EUR 24 billion to EUR 171 billion, which corresponds to a negative growth rate of 12 percent. It is also worth pointing out that the EU's EUR 750 billion Reconstruction Fund has created an instrument for mutualisation, thereby boosting the confidence of international investors in the cohesion of the European Monetary Union. As a result, the risk of investors turning away from Europe in the event of a "No Deal" outcome - a develpment which would affect European periphery countries in particular - has been significantly reduced.

Conclusion

Everything is still open. However, the recent events mean that there is now quite a good chance of a (rudimentary) agreement being reached at the proverbial eleventh hour. Battered as it is by the catastrophic (economic) repercussions of the coronavirus crisis, the UK cannot really afford a "No Deal" outcome as well. It is to be hoped that this insight will dawn on the British government too, and that we will ultimately be spared a "No Deal" crashout.

Disclaimer

The present position paper prepared by the DSGV's Chief Economists does not necessarily reflect the position of DekaBank or the position of the respective Landesbanken and savings banks.

Imprint

Publisher
Deutscher Sparkassen- und Giroverband
Department of Economics, Financial Markets and Economic Policy
Charlottenstraße 47, D-10117 Berlin
Tel: +49/30/20225-5303
DSGV-Volkswirtschaft@DSGV.de
www.DSGV.de

Editorial deadline for this issue
23.11.2020

Design
Franz Metz, Berlin

Picture credits
pixabay/pidjoe

Responsible
Pia Jankowski - DSGV
Director
Head of Economics, Financial Markets and Economic Policy Pia.Jankowski@DSGV.DE

Dr. Reinhold Rickes - DSGV
Head of Department
Head of Economics
Reinhold.Rickes@DSGV.DE

Note
All publications in this series can be found at
https://www.dsgv.de/positionen.html#standpunkte

ISSN
2509-3851