The road to Brexit: journey's end

Economic commentary

11 January 2021

Key points

- Even with the new UK-EU Trade and Co-operation Agreement (TCA) in place, there will be new barriers to the movement of goods, services, investment, and people between the UK and EU countries. Over the long term, it is likely that this will result in the UK experiencing slower economic growth, and weaker productivity growth, than would have been the case if the UK had either not left the EU or had opted to remain in the Single Market.

- There are policies that could mitigate these effects, especially in the fields of trade promotion, deregulation, and migration. But such policies typically take many years to bear fruit; and, in the case of migration, political sensitivities mean that a return to a more liberal approach is unlikely in the foreseeable future.

- With the Brexit process now completed, the focus of 'identity politics' will turn inwards to focus on the constituent countries which make up the United Kingdom. In Scotland, opinion polls during the past 18 months have shown a majority in favour of Scottish independence. Should the Scottish National Party win an overall majority of seats in the forthcoming elections to the Holyrood Parliament, it will be hard for the Westminster government to resist demands for a second referendum.

Since the EU referendum of June 2016, Brexit has been a regular feature of our economic commentaries: along the way, we have seen many dramatic twists and turns, as the political establishment has torn itself apart over competing visions of the post-Brexit world, or whether the process could be halted or reversed. With the outcome now settled, these are our concluding thoughts (we promise) on what has been a long and tortuous process.

While businesses in the UK and the EU will face challenges during the next few months as they grapple with the practicalities of the new Trade and Co-operation Agreement (TCA), this note considers the longer-term economic and political impact on the UK of its decision to leave the EU. The impact of the break with the EU is, admittedly, currently overshadowed by the grim Covid situation: but it is, nevertheless, a very significant moment in the UK's economic and political history, and one whose consequences will reverberate for many years.

For many people who voted to leave the EU, the choice that they made was more about sovereignty and control, than it was about economics. With this in mind, the governments headed by Theresa May and Boris Johnson have made it a priority, ahead of economic considerations, that the UK should fully control its own laws, borders, and finances. And throughout the process, it's been a constant refrain of the business community that the government hasn't been listening to their concerns.

continued overleaf …

HSBC UK

Economic commentary

Identity trumps economics

Regaining the sovereignty that was progressively pooled with the EU during the UK's 47 years of membership will very likely come at an economic cost. It's not the first time that voters have put identity ahead of economics. The creation of the Irish Free State back in 1922 was a similar choice, as would, probably, be a vote for Scottish independence. These are perfectly valid choices: ordinary people sometimes value other things, more than a few percentage points of annual GDP growth. Nonetheless, the economic cost is still real enough: the introduction of new barriers to trade, investment, and the movement of people between the UK and its closest neighbours is likely to result in a relative under-performance, small enough not to be immediately noticeable, that will accumulate over many years, as the benefits of economic integration that accrued during the 1990s are unwound.

It's fashionable these days to scoff at the results of economic models. But they can offer useful insights into the likely outcome of shifts in economic policy, which is what Brexit amounts to. There are various models, which can in turn be fed with different assumptions about post-Brexit policies. In the vast majority of cases, however, they conclude that leaving the EU will impose a long-term economic cost on the UK.

The logic behind these models is fairly straightforward. Economic theory holds that 'open' economies do better, compared to economies which restrict access to goods, services, and people from abroad. The most dramatic examples of this positive effect are what happened to China and India after they took decisive actions to open up their economies, from the late 1970s and early 1990s respectively. The only *caveat* is that, while there is plenty of empirical evidence about what happens when economies become more open, there are hardly any examples in modern times of economies doing the opposite. The assumption is that the positive effects of opening-up are reversed, but this hasn't been tested, or at least not until Brexit.

Erecting barriers to trade blunts competitiveness, and thereby curbs the incentive for businesses to invest. It also inhibits the mechanism of comparative advantage from working efficiently, so that the international distribution of investment and production is less optimal. Most studies have concluded that, even with a free trade agreement (FTA) with the EU, the UK economy is likely to become less trade-intensive over the long term, with exports and imports either falling in relation to GDP, or increasing at a slower pace than would otherwise have been the case. This also leads to uncomfortable conclusions about productivity growth, which over recent decades has been a bugbear for the UK (and other advanced economies). The Office for Budget Responsibility (OBR) estimated, in its March 2020 *Economic and Fiscal Outlook*, that productivity in the UK was already 1.4% lower than would have been the case without Brexit. Numerous other studies have looked at this topic, and although their estimates of the decline in productivity vary widely, none have produced results suggesting that productivity growth will be stronger. The reduction over a 15-year period is on average around 4%, albeit that if the OBR's assessment is correct, then around a third of this hit has already been taken.

An economy that is less productive is likely to expand at a slower pace. Among the many studies that have been published, the modelling exercise conducted by HM Treasury in November 2018 concluded that, under a "typical FTA" scenario, and assuming also that there was no change to migration policy, then the level of GDP 15 years after Brexit would be between 3.4% and 6.4% smaller. In the event, what the UK has negotiated is better than the typical FTA; but migration arrangements have altered considerably, with the introduction of the new 'points based' system from 1 January. Assuming, for the sake of argument, that the switch from EU membership to the new TCA causes GDP in 15 years' time to be 5% smaller than it would have been if Brexit hadn't happened, then this equates to an average reduction in annual GDP growth of 0.35 percentage points. In other words, while we might applaud an annual GDP expansion of 2% in any given year, there will be the lingering thought that, had it not been for Brexit, that rate might have been 2.3-2.4% instead.

Economic commentary

Mitigating measures

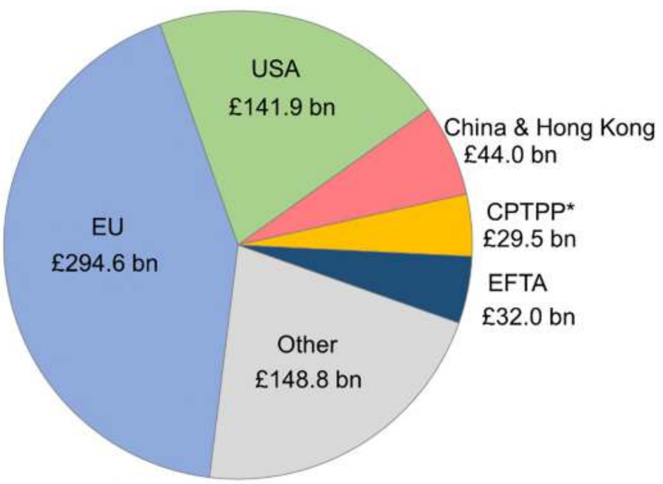
There are, of course, things that can be done to offset at least some of the negative effect of the new frictions with the EU. These fall into three areas of policy: promoting increased flows of trade and investment with non-EU countries (for example by striking new free trade agreements); deregulation; and migration.

Having concluded the TCA with the EU, and having successfully 'rolled over' the most important of the EU's trade agreements with other countries, the UK has started negotiating new FTAs with the United States, Australia, and New Zealand. Britain will also be seeking more comprehensive arrangements than those that have been carried over from the EU in relation to Norway and Turkey. Given that the USA is easily the biggest national market for British exports of goods and services, a comprehensive FTA with America will make a significant and positive difference – though it should be remembered that whatever is agreed, the relationship will not replicate what was available with the EU when the UK was part of the EU Single Market.

A trade agreement with China would also bring significant benefits, and in that context the recently-concluded investment agreement between the EU and China shows what's still possible, even against the current backdrop of strained geopolitical relations. Britain will also submit a formal application to join the Comprehensive and Progressive Agreement on Trans-Pacific Partnership (still widely known as just 'TPP') in January. This is the new trading bloc, from which the USA withdrew at the start of President Trump's term in office. Even without the USA, its eleven members still account for around 13% of global GDP (albeit that four of them have yet to ratify the deal). Outside of these, any other FTAs are likely to be in the "nice to have" category, and will make only a negligible difference to the size of the economy and the pace of GDP growth.

In modelling the economic impact of Brexit for the UK, the results will look more favourable if the assumptions include a significant degree of post-Brexit 'deregulation'.   Indeed, during the recent negotiations, one of the most intractable issues was the perception, on the EU side, that the UK might gain an 'unfair' advantage by igniting a bonfire of regulations. And most people, when asked, will say that they are all in favour of getting rid of "red tape". But when something goes wrong, people tend to want more, not less, regulation, recent examples being banking regulation after the financial crisis, and building regulations after the Grenfell Tower disaster.

The UK's major trading partners: exports (2019) by trading blocs and major countries



*Trans-Pacific Partnership countries: goods only
Source: ONS

Economic commentary

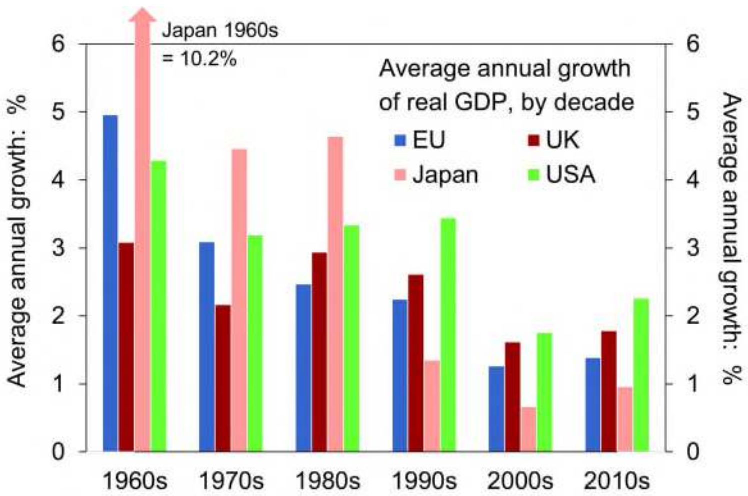
The UK Government claims, in any case, that it doesn't intend to enter a regulatory 'race to the bottom'. Gaining a competitive edge in this area will, therefore, need to be about more agile forms of regulation. The reforms that are now under way for supporting agriculture, through the Agriculture Act, are a case in point, allowing the UK to adopt a different approach from the EU's Common Agriculture Policy, and to alter the direction of policy more quickly. The same is true of the proposals for reform of the shipping sector to make it more attractive for vessels to be registered in the UK.

In all the excitement about the trade agreement with the EU, the changes to UK immigration rules have tended to be forgotten. Under the 'points' system that applies from the start of this year, it is now harder for UK employers to hire low-skilled (or at least lower-paid) workers from EU countries. There is some flexibility in the new system, mainly for workers covered by a list of 'shortage occupations': but the Home Secretary's recent decision not to add bricklayers to this list suggests that the Government isn't keen to pursue this approach. Immigration remains a highly emotive and political issue, so that a major relaxation of the rules seems unlikely in the near future.

Leaving the EU isn't without some economic advantages. For one thing, the pound is likely to remain at a lower level against other currencies than would have been the case had the EU referendum result gone the other way. This will make British goods more competitive in export markets and will help cushion the additional costs of tariffs and non-tariff barriers. But the government hasn't tried to interfere in the foreign exchanges since the early 1990s, so there is no guarantee that sterling won't revive. That looks unlikely during the next few years on account of the UK's relatively poor fiscal position, but it can't be ruled out. Certainly, trade flows haven't had much to do with exchange rates since the Bretton Woods system broke down in the early 1970s.

The other obvious benefit from not being in the EU is the ending of the UK's financial contributions. Net payments amounted to £10.9 billion in the 2019/20 fiscal year, and are expected to come in at £10.1 billion in the current year; and under the terms of the financial settlement contained in the Withdrawal Agreement, the UK will hand over £11.3 billion in the 2021/22 fiscal year. It's only in subsequent years that the cost falls sharply. In its latest *Economic and Fiscal Outlook*, published in November, the OBR reckoned that the cost of the settlement will fall to just £1.7 billion in 2025/26, a reduction over today's outlay equivalent to about 0.4% of GDP. In other words, it's a meaningful saving, but it will take several years to materialize.

UK economic growth has outperformed Europe in recent decades



Source: European Commission, AMECO Database, December 2020

Economic commentary

The acid test

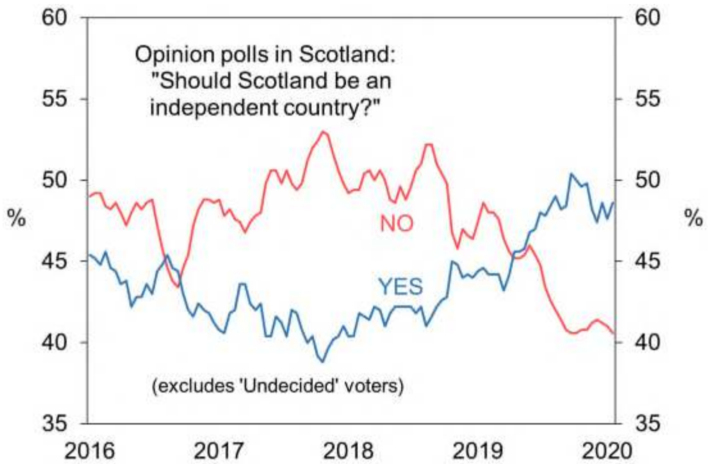
So how will future generations be able to assess whether the UK paid an economic price for leaving the EU, and if so how big was the cost. In the end, the best guide will be what happens to living standards relative to those in other advanced economies. The economic story of the UK during the past 70 years can be summed up as a period of under-performance from the 1950s, followed by a period of over-performance, starting from the 1990s. Compared with western European peers, the UK has generally achieved faster growth of GDP, with the advantage throughout the 2010s averaging out at around 0.4 percentage points a year. Given where growth rates are these days, that's quite a lot.

It's true that in terms of GDP growth per person, the UK's recent performance doesn't look quite as good. That reflects the UK's success, compared with many other countries, in attracting migrant workers. It's also true that the large influx of people was a significant factor in the referendum result in 2016. From an economic perspective however, an increase in population can bring advantages: it means that markets for goods and services expand more quickly, providing more opportunities for businesses; and it makes for a larger tax base, from which the government can fund public services. The big question then is what will happen in the 2020s. If UK growth rates slip behind again, then the obvious conclusion will be that it suffered economically as a result of Brexit. There might of course be other factors at work, including 'scarring' from the coronavirus pandemic, but the longer any under-performance lasts, the harder it will be to argue that something other than Brexit is the cause.

From one union to another

The after-shocks from Brexit won't just be felt in the sphere of economics. They will arguably be felt as keenly in the political arena, as the debate moves from Britain's membership of the European Union to the composition of the four-country union that is the United Kingdom. It's easy to forget that the referendum on EU membership took place less than two years after the referendum on Scottish independence in September 2014. In the run-up to that vote, one of the key arguments deployed by the unionist side was that an independent Scotland would have to leave, then apply to re-join, the EU. This rings rather hollow in view of subsequent developments. In the 2016 referendum Scots voted by a margin of 62% to 38% to remain in the EU. It's therefore no surprise that the UK's exit from the EU should ignite demands for a second independence plebiscite

Scottish independence back on the political agenda



Source: Wikipedia

Economic commentary

Opinion polls in Scotland have shown, over the past year or so, a clear and stable majority in favour of independence. At the same time, attachment to the Union appears to be waning among Conservative MPs and supporters in England, many of whom prize exit from the EU above the cohesion of the UK. One of 2021's biggest moments will therefore be the elections for the Scottish Parliament at Holyrood. These are scheduled for 6 May, but seem likely to be delayed. The partially proportional voting system makes it hard for one party to win an absolute majority of seats, but the Scottish National Party (SNP) managed this feat in 2011 and looks set to repeat it this year. In that eventuality, they would be able to submit a formal request to the government in Westminster for another referendum. The UK Government could, of course, reject such a request, but there would be little to prevent the Scottish government from holding an informal vote. Such a vote would have no legal status, but if it gained a large measure of support, as a percentage of the electorate, then it couldn't be ignored.

The issue of Irish re-unification also remains in play, albeit that in this case the mechanism for holding referendums is governed by the Good Friday Agreement of 1998. In any case, while the demographics have moved gradually in favour of the nationalist community in the past few decades, opinion polls don't show a majority being in favour of leaving the UK.

For businesses who are now getting to grips with the frictions of trading across borders with the EU, and across the internal border between Great Britain and Northern Ireland, there is a prospect, albeit probably not until the 2030s, of even more frontiers to contend with. It was always a possible consequence of the UK's departure from the EU that it would eventually lead to the break-up of the United Kingdom. It's by no means a done deal, but that prospect has become more likely as the Brexit process has run its course.

Mark Berrisford-Smith
Head of Economics, Commercial Banking
HSBC UK