United Kingdom: An assessment of the risks from ‘no deal’ Brexit

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1. Introduction

The extent of the division within the UK government was laid bare when both Theresa May’s Brexit secretary, David Davis, and foreign secretary, Boris Johnson, resigned from the cabinet in response to the government’s proposal for a future relationship with the EU. On top of this, the so-called ‘Chequers plan’ was summarily rejected by the European Commission.

With a divided government, no viable plan and the UK due to leave the EU in less than seven months’ time, fears of a ‘no deal’ Brexit are now more widespread. This has been recognised by policymakers. Mark Carney, governor of the Bank of England, said that the possibility of a ‘no deal’ Brexit is “uncomfortably high”. Liam Fox, the international trade secretary, said that the chances of the UK leaving the EU without a deal are “60-40”.

We think the odds are considerably lower – perhaps around 15% currently – but agree that the risk has increased. In this report we look at what a ‘no deal’ Brexit would mean in practice. We then consider scenarios for UK GDP growth in the event of ‘no deal’ over a three year horizon.

2. ‘No deal’ Brexit

Theresa May has repeatedly stated that “no deal is better than a bad deal” amid bluster and brinkmanship during the negotiation phase. But what would ‘no deal’ mean in practice?

(1) Tariffs under WTO rules

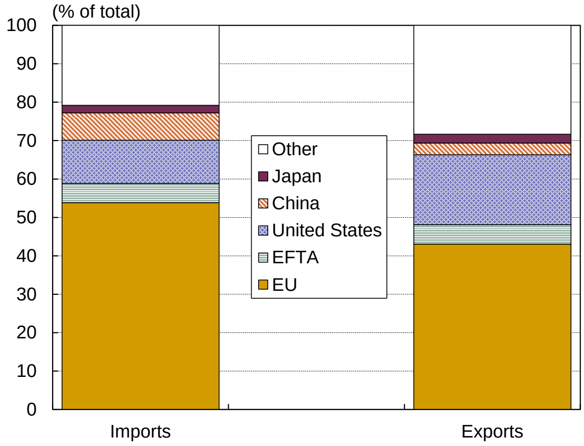
The UK would leave the European single market and trade with the EU as a regular member of the WTO. All 28 EU countries are WTO members (as is the EU in its own right). Under WTO rules, members cannot discriminate between their trading partners, and the same market access and tariffs must be granted to all other WTO members on a ‘most favoured nation’ (MFN) principle. That is, if a country improves the benefits that it gives to one trading partner, it has to give the same “best” treatment to all the other 163 WTO members so that they all remain “most-favoured”. The main exception to this is that countries can enter into free trade arrangements that discriminate against goods from outside (such as the EU, or NAFTA).

Currently, the bulk of UK trade (Chart 1) is with the EU or EFTA[1]. In a 'no deal' scenario the UK would leave the single market and the freedom of movement of goods would no longer apply.

1 The European Free Trade Association, a free trade area comprising Norway, Switzerland, Iceland and Lichtenstein which participates in the single market with the EU

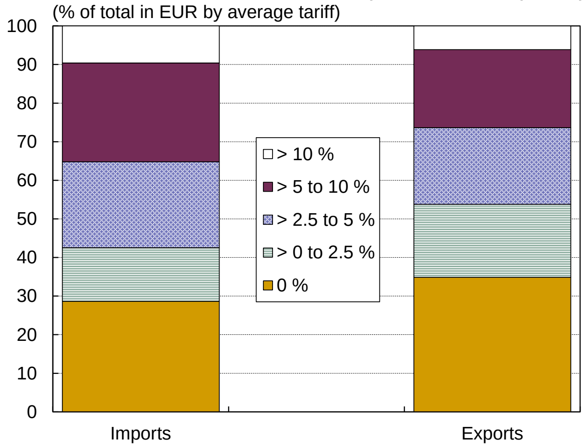
The WTO MFN system has helped to steadily reduce tariffs, but they still exist. Chart 2 shows UK trade with the EU in 2017 by HS category matched with the equivalent EU MFN tariff rate. Assuming that the UK maintains a similar schedule, a lot of trade would be subject to no or low tariffs in the event of a 'no deal' situation. But tariffs of over 5% would apply to more than 20% of exports, and some important industries would be affected. Perhaps most notably, the tariff on UK car imports to the EU would rise to 10%. UK car exports accounted for around 8% of total UK exports to the EU, or 0.7% of GDP, in 2017. The EU would not be able to reduce the tariffs on cars without reducing them for all WTO MFN trading partners.

Chart 1: UK Trade (2017)



Source: ONS, MUFG Bank Economic Research Office

Chart 2: UK Trade with EU by MFN Tariff (2017)



Source: Eurostat, WTO, MUFG Bank Economic Research Office

Lastly, we note that the director general of the WTO has said that it is "very unlikely" that the UK will have agreed new schedules on tariffs and quotas with non-EU countries by March 2019. But he also said that it would not be "the end of the world". It may mean cumbersome talks and perhaps dispute settlement proceedings further down the line – but trade would continue while the UK's new schedules are being certified.

(2) Non-tariff barriers

Liam Fox, the international trade secretary, admitted recently, it's "not tariffs that are the real barriers in the global economy – it's the non-tariff barriers". These are any other measures that may reduce international trade, such as licensing, quotas, standards and rules of origin. The EU looks to remove such barriers from intra-EU trade, with the principle of mutual recognition ensuring the member states allow goods that are legally sold in another member state to also be sold in their country. For goods trade, the absence of mutual recognition would mean increased customs handling times and documentation compliance. UK ports handled over 1470 million tonnes of goods over the most recent four quarters of available data – only the Netherlands, Italy and Spain moved more. Dover, one of the most important UK ports and the biggest roll-on/roll-off ferry port on Europe, does not have the infrastructure to deal with an increase in such checks and could see particularly long queues. The port's head of policy warned of “regular gridlock” on the roads surrounding the port. Other UK ports and the Eurotunnel freight link would likely experience similar problems.

There is some contingency planning on the other side of the channel – France, Belgium and the Netherlands have all announced increased recruitment of customs officials to help deal with any increase in bureaucracy post-Brexit. Meanwhile, the UK has begun the phased launch of a new electronic service (Customs Declaration Service, or CDS) for managing customs declaration processes. It is likely to be fully operational by early 2019. The decision to do this was taken before the Brexit vote but the system improves the UK’s ability to deal with any increase in customs declarations. These measures may mitigate the problem to some extent, but long queues at customs still seem likely.

(3) Services

Customs chaos would be a very visible effect of a ‘no deal’ Brexit. But perhaps more important could be the effect on services trade. According to UK data, the UK had a surplus in services trade with the EU worth around 1.4% of GDP in 2017 (and a deficit in goods of 4.7% of GDP).

For the UK, exports of financial services are most significant. London is the most important European financial centre – over 95% of euro-denominated derivatives are cleared on UK infrastructure. In the event of ‘no deal’ we expect the EU would find a stop-gap measure, perhaps temporary equivalence to UK-based clearing houses, in order to reduce financial instability in Europe.

We note that the majority (almost 60%) of UK services trade is with non-EU member states. In fact, only Malta and Ireland traded less with the rest of the EU in services as a proportion of total services trade in 2016. Extra-EU trade is often under the terms set out in the WTO’s General Agreement on Trade in Services (GATS), which also has a MFN clause.

(4) The timing of ‘no deal’

The timing of a ‘no deal’ scenario is not clear. The UK and the EU aim to have a ‘Withdrawal Agreement’ covering topics such as a transition period, citizens’ rights and the financial settlement agreed by October 2018. This would be presented alongside a ‘political declaration’ on the framework for the future relationship. Michel Barnier has said that 80% of the Withdrawal Agreement has been agreed. Naturally, though, the 20% outstanding includes the more contentious issues such as the future of the border on the island of Ireland.

If there is no ratification of the Withdrawal Agreement then the UK would be set to leave the EU on 29 March 2019 without a transition period and would immediately be on ‘WTO terms’ with the EU. A ‘no deal’ scenario could come later, though. If the Withdrawal Agreement is ratified (with the accompanying political declaration on the future relationship) it would allow a standstill transition period until 31 December 2020. However, it is conceivable that talks on the future relationship could break down during the transition period. At the end of that the UK could still lapse onto WTO terms for trade with the EU27, albeit with some obligations to the EU agreed.

Note that in our scenarios below we assume a ‘no deal, no transition’ situation, but much of the discussion would also apply to a transition period followed by a breakdown in talks.

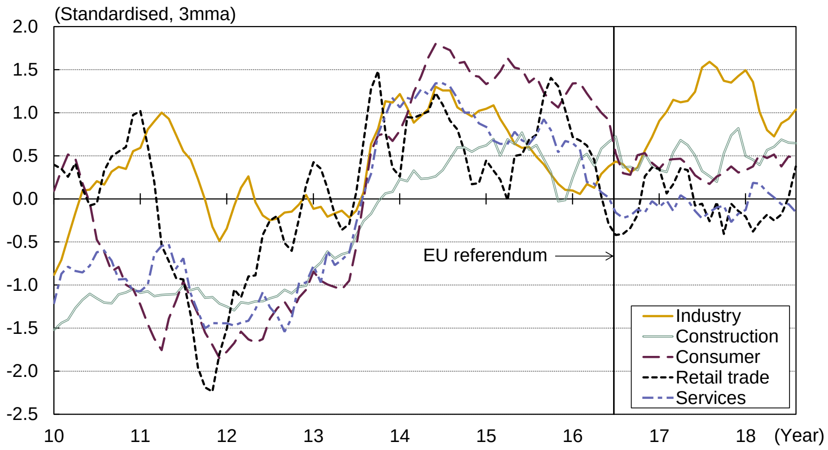
3. Effects on the economy

A ‘no deal’ Brexit would affect the economy through various channels. We focus on five below: confidence, financial markets, trade, investment and public finances.

(1) Confidence

To estimate the effect on confidence, we start by looking at the effect of the referendum result itself. Chart 3 shows the European Commission’s various sectoral surveys. Apart from in construction, which tends to move in longer cycles, confidence weakened across the board in the run-up to the vote. There were further declines in the aftermath, although industrial sentiment improved as the depreciation in sterling made UK exports more competitive. But there was no ‘cliff edge’ drop in sentiment.

Chart 3: UK Confidence Surveys



Source: European Commission, MUFG Bank Economic Research Office

In the event of a ‘no deal’ situation, we expect that industry sentiment would fall sharply as the prospect of increased barriers to trade – both in the form of tariffs and regulation – would more than offset the boost from an even weaker pound. The negative effect on confidence in the service industry may largely depend on the new terms for financial services exports. As mentioned, we expect the EU would allow some sort of transition period of continuity to avoid financial market instability. There could be some other cushioning – consultants and lawyers may well report increased output as businesses contend with new circumstances.

To our minds, business confidence would be affected more than consumer confidence, at least initially. After all, 17.4 million people voted to leave the EU and many would remain optimistic about the future despite any short-term disarray. Importantly, the labour market is very tight. Unemployment, at 4%, has not been lower since the early 1970s. There would likely be job losses in a ‘no deal’ scenario as firms adjust, but the labour market starts from a strong position. High labour market flexibility in the UK should prevent a pronounced increase in the structural rate of unemployment. The cyclical component would most likely increase, though, dragging on consumer confidence over the medium term. Consumers would also notice higher inflation as weaker sterling pushes up the price of imports, although there would be some lag.[2]

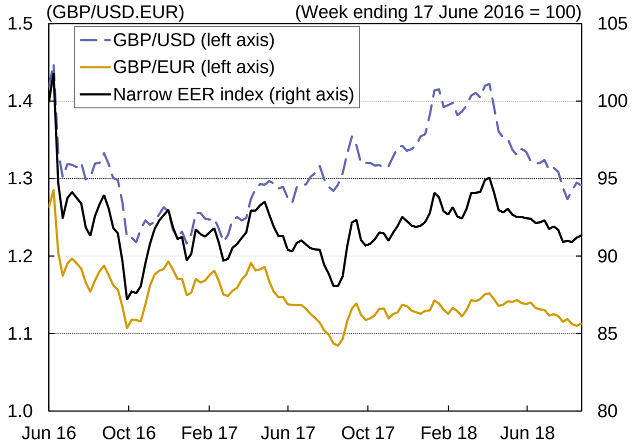
2 See here: www.bk.mufg.jp/report/ecoeu2018e/BTMU-Economic-Brief-UK20180219.pdf

Overall, we think confidence for both business and consumers would weaken as the likelihood of 'no deal' increases, and further as the reality of the new arrangement becomes apparent.

(2) Financial markets

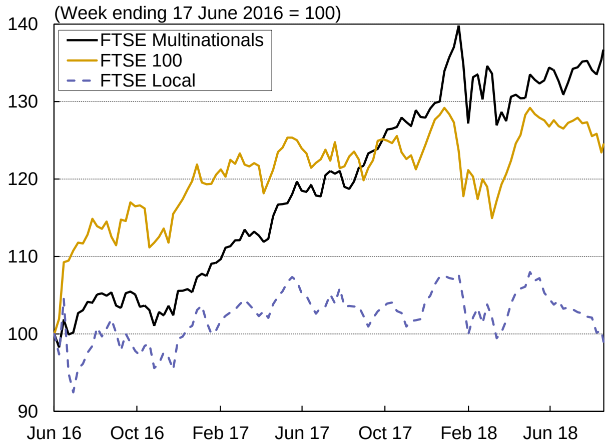
The initial effect on confidence, particularly for business, may depend in large part on the reaction of markets. The aftermath of the referendum on 23 June 2016 offers a useful guide to what could be expected. The day after the vote, sterling was down around 8% against the dollar and 6% against the euro. The GBP/USD pairing is now below 1.30 and down over 12% compared to the day of the referendum (Chart 4). There could be a similar substantial fall if a 'no deal' Brexit becomes more likely – our global markets research team have a 'no deal'/deal range of 1.15 – 1.45 for GBP/USD. Meanwhile, the weaker pound has generally been a tailwind for UK equities because many FTSE 100 companies generate the majority of revenues outside of the UK. But we do note that the FTSE local index (over 70% of sales in the domestic market) has clearly underperformed the multinational index (over 30% of sales outside the domestic market) since the referendum (Chart 5).

Chart 4: Trade-weighted Sterling and Pairings



Source: BoE, ONS, MUFG Bank Economic Research Office

Chart 5: UK Equity Indices



Source: Bloomberg, MUFG Bank Economic Research Office

Lastly, turning to government bonds, 10Y yields fell by around 35bp immediately after the referendum as market participants expected BoE easing. This was duly delivered on 4 August 2016. Since that cut, the BoE has embarked on a very gradual hiking cycle with two 25bp increases. But, as we discuss in the outlook section below, we expect the BoE would probably reverse this in the event of a damaging 'no deal' situation, so we would look for weaker gilt yields. Overall we expect market moves to materialise relatively gradually as the shape of the future relationship becomes clearer, in contrast to the sharp reactions immediately after the vote. Both sides want to avoid a 'no deal' outcome gradual so there is unlikely to be a very sudden swing towards it – instead, markets would likely respond to the clock ticking down to March 2019 alongside a steady drip of rumours about deteriorating negotiations.

(3) Trade

There were no signs of any acceleration in UK export growth after the EU referendum, despite the supposed advantage of weaker sterling for UK exporters. In fact, the latest quarterly figure, for Q2 2018, was particularly concerning at -3.6% QoQ. We note the weakness in UK exports of semi-manufactures in Q2. One factor could be foreign firms reducing exposure of their supply chains to UK goods by trying to source intermediate inputs from other countries. Indeed, the UK PMI new export orders index plunged in August to 47.4, the lowest since 2014.

In the case of ‘no deal’ the UK would then be subject to the EU’s WTO MFN tariffs, as discussed above. Looking at imports, over the short term, it is likely that the UK government would replicate the EU schedule for goods tariffs initially (and then later attempt to negotiate better terms). The direct effects of tariffs matter, but non-tariff barriers are likely to be the main drag. For example, without mutual recognition, UK products would be subject to border controls when entering the EU. Lorry freight over the channel would be most vulnerable due to the lack of infrastructure and personnel to check compliance. Exports of goods to the EU would slow considerably. And this would come at a time when increased protectionism is slowing trade growth globally.[3]

3 See here: http://www.bk.mufg.jp/report/ecoeu2018e/specialreport_20180802.pdf

Overall, a ‘no deal’ Brexit would mean that trade between the UK and EU would be permanently lower than in our bespoke FTA scenario. We would also expect goods trade between the UK and the EU to weaken ahead of the UK’s departure from the bloc as firms on the continent seek new suppliers. There would then be a sharp decrease in trade once the UK has left as the reality of increased customs friction is made clear. This would gradually ease to some extent as governments on both sides of the channel invest in customs infrastructure and personnel and firms become used to changes in regulation.

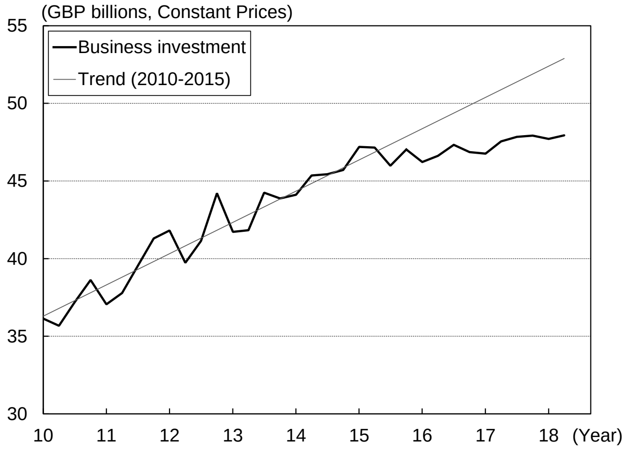
(4) Investment

Uncertainty, both before and after the referendum, has resulted in three years of below trend business investment in the UK (Chart 6). Looking ahead, survey measures of investment decisions (BoE Agents’ scores, BCC, CBI) remain subdued – but have not deteriorated following the cabinet resignations after the Chequers plan. In the event of a ‘no deal’ scenario, however, we would expect the picture to become bleaker.

Domestically, the confidence shock and uncertainty mentioned above would be a significant headwind. Export-orientated manufacturing firms would be reluctant to invest in capital until accustomed to new trading relationships – and then the increased friction would likely mean investment below the recent (lower) trend. There would be a similar picture in agriculture with farmers concerned about the loss of EU subsidies (although perhaps longer term a shift towards more capital intensive farming is likely as it becomes harder to attract seasonal workers from the EU – the effect on migration flows is another channel through which economic activity may be affected).

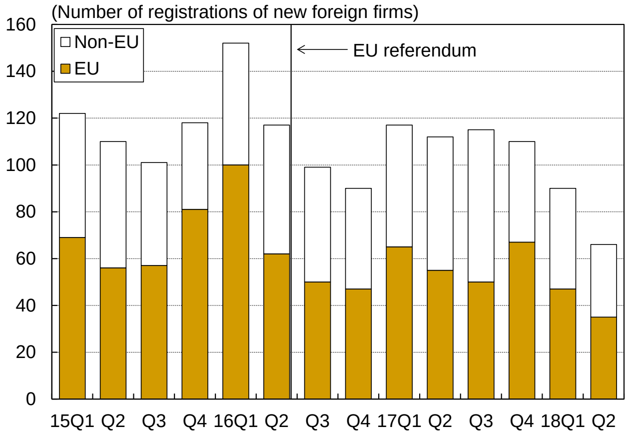
We also worry about foreign direct investment into the UK. Before the referendum was announced, the UK was considered a ‘gateway to Europe’ – of the 28 EU member states, its pro-business regulation, flexible labour market, English language and access to financial services were attractive when considering locations for a European HQ. These factors will remain, but in a ‘no deal’ Brexit scenario it would lose access to the single market and therefore much of its appeal. Chart 7 shows the number of new foreign firms registering as businesses in the UK. In Q2 2018 there was a fall of 46% YoY (and the available data for July suggests Q3 will be even worse). In the event of a ‘no deal’ Brexit we expect very weak flows of foreign investment into the UK over the short term. Moreover, some already-established firms may reduce operations. Car manufacturers, dependent on very integrated international supply chains, may move operations to other countries for example. Further ahead, it is likely that foreign investment would remain very weak without easy access to the single market.

Chart 6: Business Investment



Source: ONS, MUFG Bank Economic Research Office

Chart 7: Registrations of New Companies in the UK



Note: Excludes crown dependencies and overseas territories.
Source: Companies House, MUFG Bank Economic Research Office

(5) Public finances

Theresa May said in June that there will be extra funding for the National Health Service (NHS) which would be helped by “the Brexit dividend, the fact that we’re no longer sending vast amounts of money every year to the EU”. Our calculations suggest that the UK paid around 200 million EUR to the EU on a weekly basis in gross terms last year. Taking into account the money that the UK receives back, net payments to the EU were around 85 million EUR weekly (0.2% of GDP annually). In fact, the Office for Budget Responsibility (OBR), the government’s independent fiscal watchdog, wrote in July:

> *“Our provisional analysis suggests **Brexit is more likely to weaken than strengthen the public finances** overall. There will be direct savings from the net contributions to the EU budget that the UK will no longer have to make, but it is unclear how much will be available after payments towards the agreed withdrawal settlement and other Brexit-related spending commitments.”*

This refers to the ‘divorce bill’ that the UK has agreed with the EU of over 40 billion EUR (around 2% of GDP). This will cover the UK’s commitments to the EU budget until 2020 and other outstanding commitments and liabilities – and would likely be due under international law even in ‘no deal’. Meanwhile, the 2017 Autumn Budget set aside 3 billion GBP (3.3 billion EUR) of funding for Brexit preparations. After Brexit, the UK exchequer would also receive any customs duties. Currently these are collected by the UK on imports from outside the EU and then transferred to the EU (less 20% for collection costs). This amounted to around 3.5 GBP billion in the 2017-18 financial year, or 0.46% of total government receipts.

Overall, the notion of a ‘Brexit dividend’ seems spurious. However, in the event of a ‘no deal’ Brexit we would still expect some fiscal stimulus. Improving public finances (the budget deficit for the last financial year fell to 2.1% of GDP, the lowest since 2001/02) mean that government would have more scope to try to cushion the economy from any shock.

4. Outlook

(1) Politics and policy

A ‘no deal’ scenario would mean high political uncertainty. The next general election is due in May 2022, but an earlier election would be possible as the government’s small majority leaves it vulnerable to a confidence vote tabled by the opposition. Currently, polling is fairly balanced between the two main parties. The opposition Labour party, embroiled in anti-Semitism row, has failed to capitalise on Brexit-based divergence in the government.

Political change may be the only way for the UK to buy more time. The EU may be willing to maintain the ‘standstill’ transition period even in the absence of an agreement on the future relationship, or the UK could look for an extension to the Article 50 negotiation period. This would require all 27 other EU member states to agree at a European Council level – but it would not go to the European Parliament (EP). An agreement could therefore happen fairly quickly. However, if still a member of the EU, the UK would then be legally obliged to participate in the EP elections in May 2019. With five year terms, how would the EP be restructured if the UK leaves part way through? Something concrete – an election or another referendum – may be enough reason to wait, but otherwise an extension seems unlikely.

On monetary policy, Carney said after the August BoE meeting that it is “not as simple as saying Brexit equals a reduction in interest rates”. There could be an argument for hikes. A ‘no deal’ Brexit would probably mean weaker sterling and higher inflation. On top of this, any tariffs would push up prices further. But given how the BoE responded to the result of the referendum in August 2016 by cutting rates and expanding QE – based on business surveys rather than meaningful hard data – we would expect a similar response to a ‘no deal’ scenario.

(2) ‘No deal’ scenarios

Any GDP scenario for ‘no deal’ in March 2019 should be taken with a pinch of salt as there are many unknown factors and moving parts. We note that most pre-referendum forecasts for Brexit have not fared especially well after overestimating the shock to consumer confidence. But, acknowledging the very wide margin for error, we hope it is still a useful exercise to summarise our thinking. First, recognising the uncertainty, we split the ‘no deal’ scenario into ‘clean’ and ‘messy’ versions, which are described in Table 1.

Table 1: ‘No deal’ scenarios

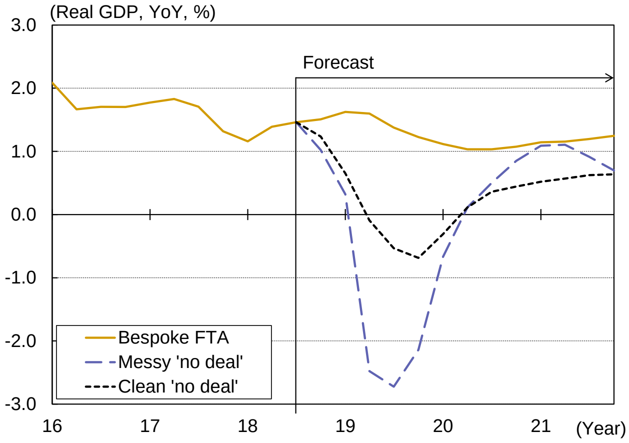
	Scenario 1: Clean ‘no deal’	Scenario 2: Messy ‘no deal’
Negotiations:	‘No deal’ gradually emerges as most likely outcome ahead of March 2019.	Progress towards a bespoke FTA deal before a last minute collapse in negotiations.
Political uncertainty:	May continues as PM.	Change in Conservative leadership and another general election.
Consumer confidence:	Consumer confidence remains relatively robust.	Consumer confidence plummets.
Policy support:	Some fiscal stimulus measures in Autumn Statement, BoE easing.	No support from fiscal (beyond automatic stabilisers) or monetary policy.
Relationship with the EU:	EU and UK remain on relatively amicable terms.	High animosity with EU.
Financial services:	Financial services trade continues under an ‘equivalence’ basis.	Market volatility amid increased barriers to financial services trade.
FX:	GBP/USD around 1.20.	GBP/USD at 1.15

Source: MUFG Bank Economic Research Office

We take a baseline scenario predicated on an orderly Brexit on bespoke FTA terms with a transition period, and simulate shocks to confidence, markets, trade, investment, and public finances. The results are shown in Chart 8, with the breakdown by expenditure components in Table 2:

Chart 8: Bespoke FTA vs 'No Deal' Scenarios

(Real GDP, YoY, %)



Source: ONS, Oxford Model, MUFG Bank Economic Research Office

Table 2: GDP scenarios with expenditure breakdown

(Constant prices, % YoY)

Scenario 1: Clean 'no deal'						
	GDP	Private consumption	GFCF	Government consumption	Exports	Imports
2018	1.3	1.2	1.1	1.1	0.6	0.2
2019	-0.2	-0.1	-1.4	1.6	-3.7	-3.3
2020	0.2	0.3	-0.2	1.5	-1.1	-0.6
2021	0.6	1.0	0.4	1.4	0.7	1.4
Scenario 2: Messy 'no deal'						
	GDP	Private consumption	GFCF	Government consumption	Exports	Imports
2018	1.3	1.1	0.8	1.1	0.4	0.2
2019	-1.8	-0.6	-6.0	1.5	-9.9	-7.8
2020	0.2	0.2	0.1	1.3	-1.5	-1.0
2021	1.0	1.1	1.1	1.1	3.2	3.3

Source: ONS, Oxford Model, MUFG Bank Economic Research Office

Even in the optimistic, cleaner scenario we expect there would be a recession, albeit relatively mild, with real GDP growth averaging -0.2% in 2019. Net exports provide the main initial drag as barriers to trade (especially non-tariff barriers) are raised significantly and both firms and the civil service take time to adjust. Consumer spending also suffers from the initial shock and remains subdued as the weaker pound leads to higher inflation. Economic activity remains weaker than in the 'deal' scenario in 2021, dragged down by still-sluggish investment growth. We look for increased support from government spending throughout, though.

In our more pessimistic scenario the downturn is much more severe, but -1.8% annual GDP growth in 2019 would be comparable to recessions in 1970-1995 rather than that of the 2007-2008 global financial crisis (-4.2% YoY). Market volatility and political uncertainty weigh on business confidence, and investment falls sharply. A deteriorating labour market, as well as higher inflation, creates a headwind for consumers. Initially the main drag is from a plunge in exports in 2019 due to increased trade friction and less time for businesses to prepare. This causes a sharp decline in overall GDP growth. There is then scope for catch-up in 2021 as the new trading relationship beds in, although investment remains weak as production is moved elsewhere. Overall growth struggles to rise above 1% YoY. In this scenario there is little counter-cyclical support from the government beyond automatic stabilisers.

Of the two scenarios we would err on the side of optimism. Over the next few months it will probably become increasingly clear if a 'no deal' scenario is most likely and such an outcome would not be a surprise. Many businesses would have worked on contingency plans for such an eventuality since the referendum result. The UK government has also started to publish sectoral guides on how to prepare in the case of a 'no deal'. For consumers, the tight labour market should mean that household expenditure – over 60% of GDP – does not plunge initially, even in the face of higher inflation as sterling weakens further. We would look for a fiscal boost from the UK government – improving public finances allow it and there may be some pressure to prove a 'success' of Brexit. Also, while a 'no deal' scenario in name, we would still expect some cooperation between the EU and UK where there is mutual interest, notably in finance services to reduce market instability.

Looking further ahead, the outlook seems bleak. As hinted at in Chart 8, a ‘no deal’ Brexit would significantly reduce the UK’s potential growth. We would expect a persistent drag on trade with the EU, only slowly replaced by imports and exports from non-EU partners. Investment would weaken, dragging down productivity growth. Lower immigration from the EU would reduce the pool of available workers, both high- and low-skilled. Unemployment would rise and affect consumer spending which already faces headwinds.[4]

4 See here: www.bk.mufg.jp/report/ecoeu2018e/MUFG-Economic-Brief-UK20180607.pdf

5. Conclusion

Our central scenario for the UK’s future relationship with the EU remains a bespoke arrangement based around Canada’s FTA with the EU, with closer ties achievable by unwinding the current relationship rather than starting from scratch. But the fallout from the government’s long-awaited plan for the future relationship makes a ‘no deal’ scenario seem more likely. With no clear majority in the UK parliament for any single relationship model, we put the odds of ‘no deal’ at around 15% – and this may increase as we approach March 2019.

Breaking a window and having it replaced would raise GDP. Similarly, there may actually be some tailwinds to economic activity in the very short term as preparations and even precautionary stockpiling (if from domestic producers) add to economic activity. Government spending on customs infrastructure at ports, consultancy fees, and recreating regulatory bodies would also help over the short-term (but would increase public debt without raising the productive capacity of the economy).

That would be little solace. We note that there are not that many examples of countries *increasing* barriers to trade in recent history. This makes it hard to estimate the effects of a ‘no deal’ situation once the UK leaves the EU, but we are confident that it would damage the UK economy. Even in our more optimistic scenario we look for an immediate disruption to trade and confidence followed by the longer-term burden from reduced investment. The pessimistic scenario sees a much worse initial shock to confidence, markets and trade. In both cases, a ‘no deal’ situation would push the economy into recession and remain a drag on growth over our forecast horizon.

Further ahead, we fear that poor investment growth and looser trade links would probably result in (even) weaker productivity growth. The UK already compares badly on this front. We also worry that the economy would take time to adjust to the end of freedom of movement of people as many firms have grown accustomed to a ready supply of relatively cheap labour from the EU. A shift to capital investment may be unlikely amid higher uncertainty.

Lastly, while ‘no deal’ in name, we would still expect some cooperation with the EU where there is mutual interest. UK airlines would probably be allowed to continue flying between EU cities and we would expect at least a temporary reprieve for financial services. However, the EU would be mindful to show that there is a cost to leaving the single market.