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IS ‘NO DEAL’ BETTER THAN A BAD DEAL ON BREXIT?

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As time has moved on and negotiations have failed to make ground on key issues regarding the UK-EU relationship, concerns have risen about the likelihood of a ‘No Deal’ Brexit, which would see the UK crash out of the EU without a trade deal. Our base case remains for an FTA with customs union between the UK and EU but we flagged in our latest update that the risk of ‘No Deal’ (aka WTO) outcome has risen. This note highlights the implications of this scenario for sectors and the economy in the UK and EU member states.

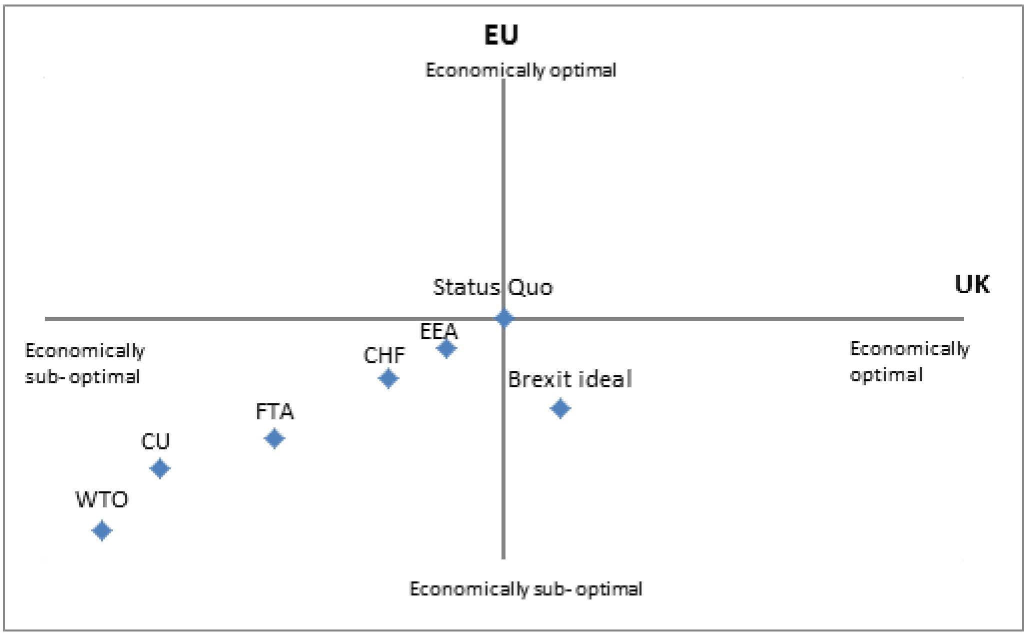
Table 1: ‘No Deal’ Brexit scenario

Scenario	Description	Waymarks	Market Implications
No Deal	UK-EU goods trade governed by most-favoured nation WTO rules High non-tariff barriers for services sector UK-determined regulation and legislation UK immigration controls with no special allowance for EU citizens	May remains in place but reverses course to avoid party breakdown Hardline Brexiteers elect a leader that supports their agenda and takes a harder line with EU Negotiations between UK and EU turn hostile Labour party refuses to support Conservative deal Article 50 period extension is not granted	Range for Gilt Yields : .75 - 1.00 Sterling Trade Weighted Move: Fall 10-15%initially but retraces some over 3-6 months following Range for IG Credit Spread: Sell off to 1.80, led by banks and insurers Equities: FTSE 100 outperforms 250 with major rotation out of exposed sectors (domestics, financials)

Source: Aberdeen Standard Investments. This is an opinion based on our estimates at time of preparation. It may be superseded any time without prior notice.

Across the constellation of Brexit outcomes, ‘No Deal’ is by far the worst economic deal for the UK and EU because it is the scenario with the most tariff and non-tariff barriers relative to the status quo (EU membership). However, this does not consider political incentives that are the key forces driving and determining perceptions about the final deal. The severity of the economic impact for the UK in such a scenario would depend on the choices the UK makes about key issues like tariff levels, third party trade deals, immigration controls and how to use policy to smooth through the disruption.

Chart 1: No Deal is the worst outcome for both sides economically



*WTO = No Deal, CU = customs union, FTA= free trade agreement, CHF=Swiss model, EEA= European Economic Area, Brexit ideal = access to single market but with control of labour flows and no contributions to EU. Source: Aberdeen Standard Investments (2017)

Who loses most if the UK and EU cannot agree a deal?

7% of EU exports go to the UK while over 44% of UK exports go to the EU so we would expect the UK to be much more affected in aggregate from a 'No Deal' Brexit. That said, underlying the headline figure, the impact of a 'No Deal' Brexit would not be felt evenly across the EU. Some member states have much higher exposure in goods or services trade than the EU average, so the disruption for these states would be larger (see Chart). Ireland stands out – unsurprisingly– as highly exposed to changes in goods and services trade with the UK.

Chart 2: Goods trade between UK and EU

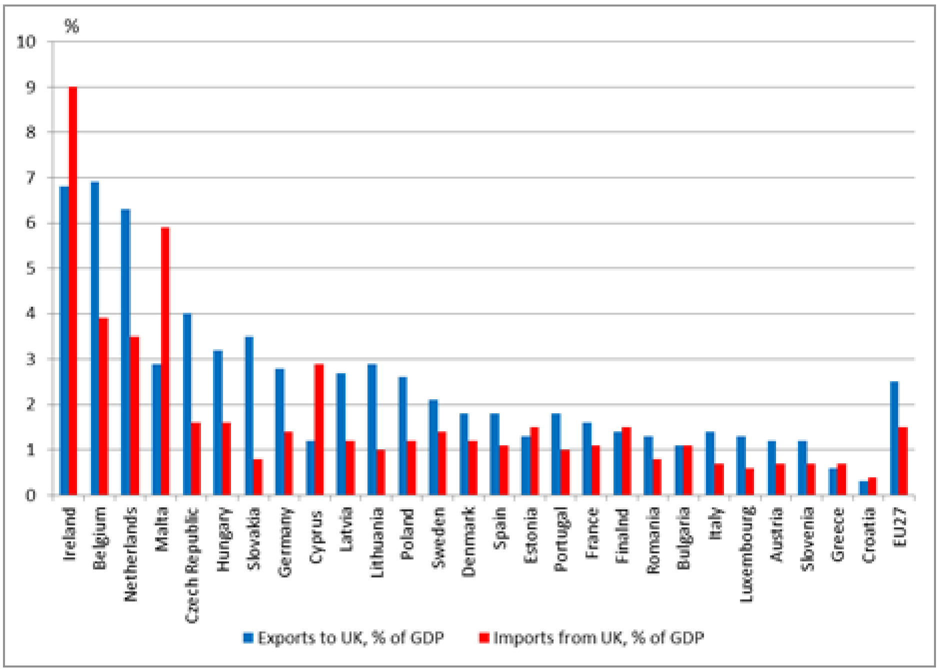
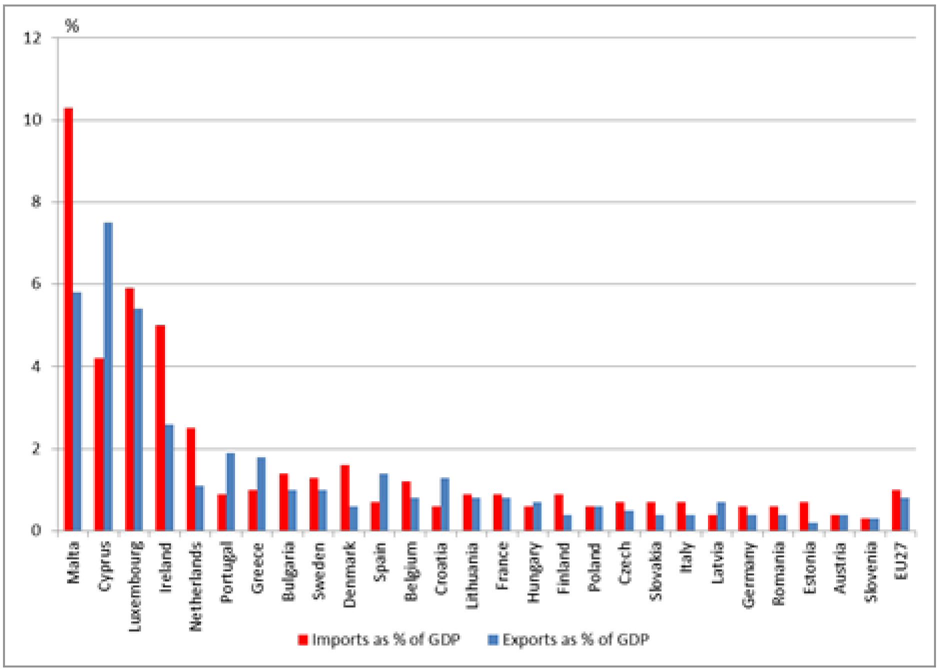


Chart 3: Services trade between UK and EU

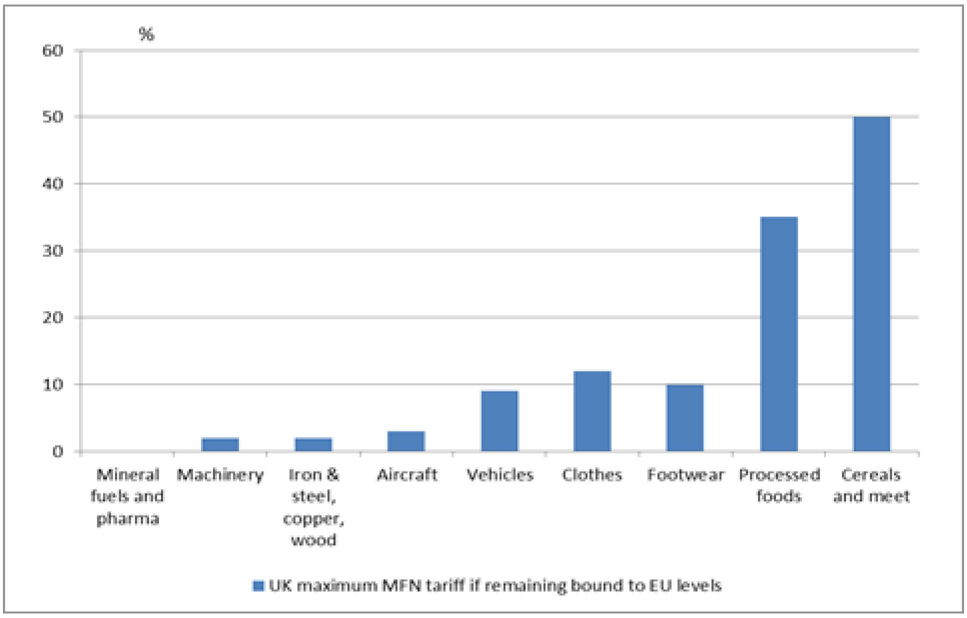


Source: European Parliament (as of 2016)

How would tariffs change in a 'No Deal' scenario?

However, it is not just the volume of trade but the type of trade that will determine the country-level impact of 'No Deal' Brexit. Currently, the UK enjoys tariff-free trade with the EU. In the case of a no-deal Brexit, this tariff schedule would change, reverting to WTO member rules. The UK is currently a member of the WTO through the EU; outside of EU membership, the UK could opt to alter its tariff schedule as an independent WTO member or match to the EU's common external tariffs. The European Parliament estimates an average MFN tariff for the UK using EU levels and given its sector composition is ~4%, but highlights a wide range depending on sectors.

Chart 4: Sector level EU MFN tariffs

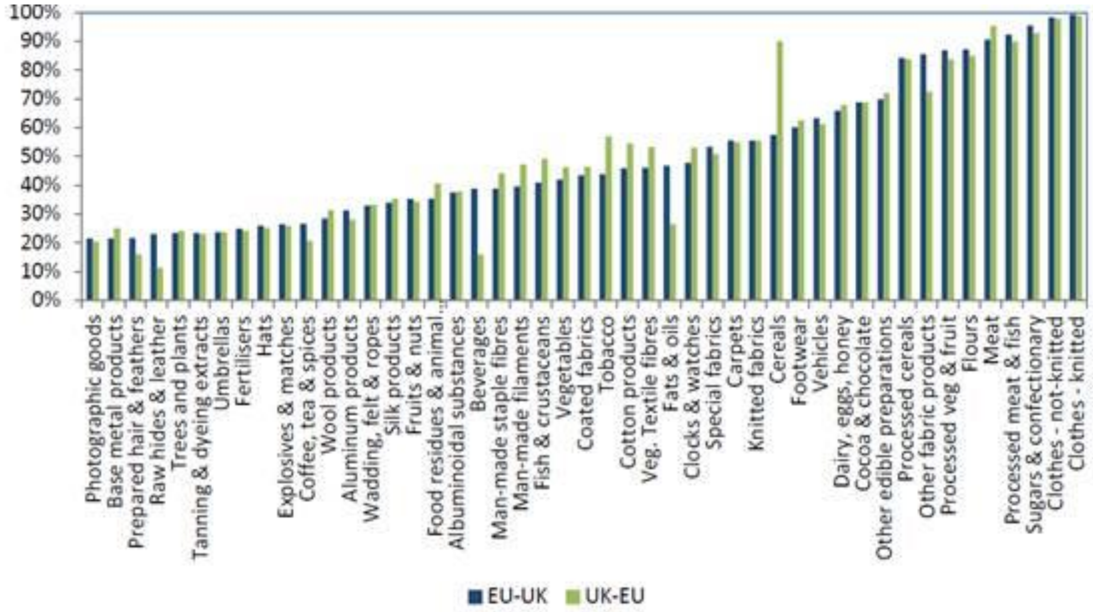


Source: European Parliament (as of 2016)

The Economic and Social Research Institute (ESRI) modelled the impact of tariffs on trade reduction for different sectors based on elasticity estimates, which gives an indication of the sectors most exposed to changes in UK-EU tariffs (see Chart 5). Clothes, food and vehicles are the sectors most exposed to a 'No Deal' Brexit. Food is subject to high tariffs, so it is not surprising to see such large reductions. Auto vehicles exports are not in the highest MFN tariff range (~10%), but are estimated to be highly sensitive to price changes.

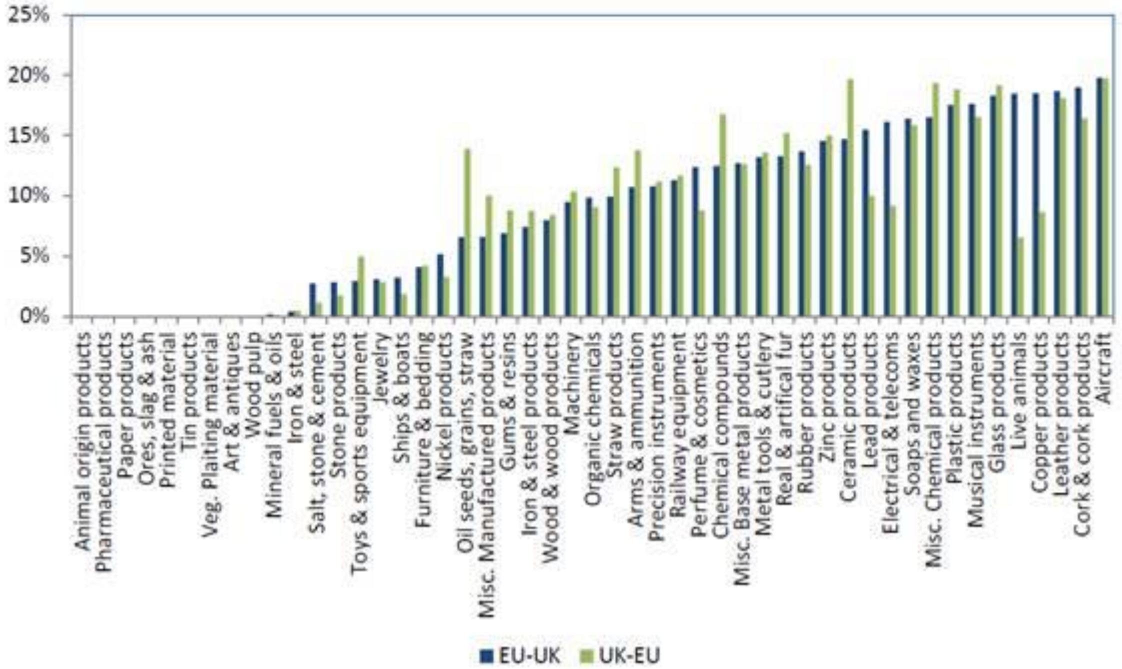
This analysis should be seen as the worst case of the worst case as it assumes full pass-through of the tariff increase to prices, which will in reality vary by product/sector depending on firm profitability, supply chains, substitutability etc.

Chart 5: Sectors with trade reductions over 20% in 'No Deal' scenario Source: ESRI (as of 2016)



Source: ESRI (as of 2016)

Chart 6: Sectors with trade reductions under 20% in 'No Deal' scenario



Source: ESRI (as of 2016)

Taking into account these sectoral constraints, the ESRI also provides estimates of the impact on trade reductions between the UK and EU member states. This kind of modelling is highly complex and subject to assumptions made by the authors regarding elasticities, so should be read with wide confidence intervals. The countries with the greatest falls in trade with the UK include Germany, Ireland, Italy and Belgium. However, the impact on these countries' total trade as a share of GDP varies significantly: Ireland sees its total trade fall by 4.2%, Belgian trade falls by 3.1%, German trade falls by 2.5% and Italian trade falls by 1.7%.

Table 2: Trade reductions in 'No Deal' relative to bilateral and world trade by partner:

Table 5: Trade Reductions relative to Bilateral and World Trade

	% of trade with UK	% of total trade	% UK trade with EU partner	% of total UK trade
Austria	20.22%	0.62%	24.77%	0.13%
Belgium	35.08%	3.13%	25.67%	0.97%
Bulgaria	30.45%	0.78%	17.52%	0.02%
Cyprus	11.33%	1.14%	33.44%	0.04%
Czech Rep.	31.78%	1.67%	19.32%	0.13%
Germany	34.14%	2.54%	19.44%	1.98%
Denmark	39.81%	2.53%	24.35%	0.18%
Spain	38.56%	2.87%	25.64%	0.73%
Estonia	7.49%	0.19%	22.48%	0.02%
Finland	5.54%	0.27%	26.59%	0.12%
France	24.88%	1.56%	20.92%	1.23%
Greece	28.35%	1.20%	27.15%	0.08%
Croatia	14.97%	0.26%	26.94%	0.01%
Hungary	28.60%	1.11%	28.44%	0.12%
Ireland	30.56%	4.17%	27.61%	1.53%
Italy	29.88%	1.65%	26.85%	0.76%
Lithuania	23.51%	1.05%	20.84%	0.02%
Luxembourg	16.08%	0.62%	14.82%	0.01%
Latvia	9.45%	0.48%	17.15%	0.01%
Malta	24.71%	1.59%	26.37%	0.03%
Netherlands	22.10%	1.98%	15.59%	0.89%
Poland	30.58%	2.08%	20.78%	0.25%
Portugal	33.04%	2.22%	27.70%	0.11%
Romania	43.42%	1.89%	23.77%	0.08%
Slovakia	59.11%	3.27%	21.35%	0.03%
Slovenia	20.83%	0.47%	21.63%	0.01%
Sweden	13.93%	1.00%	22.99%	0.33%
Total	30.47%	2.13%	22.25%	9.83%

*The model output reflects predicted reductions based on UN trade data from 2015 and elasticity estimates from Imbs & Mejean (2016). It does not predict a time period over which these reductions play out. Source: ESRI (as of 2016)

Are tariffs the only challenge for goods exporters in a 'No Deal' outcome?

Without customs union membership, substantial checks would be required on the thousands of lorries that pass across the Irish and French border each day, as well as delays to air freight and shipping. These checks would be needed because of the requirement for adherence to rules of origin to certify that the products being transported are compliant with the terms of the free trade agreement. The effect will vary from firm to firm, depending on inbuilt supply chains (see the Company Assessment below for details).

Ireland has been the stickiest element of Brexit negotiations thus far and is highly exposed to these disruptions. Economically, Northern Ireland is highly reliant on the Republic - and vice versa, to a lesser extent. Excluding intra-UK trade, Northern Irish exports to Ireland account for 35% of its total exports. Irish data is only available for goods exports; Northern Irish trade accounted for about 1% of Ireland's goods exports, with UK as a whole accounting for 12% of exports.

Of particular note, agri-business is treated as an all-island value chain, with 25% of all raw and pasteurised milk sent from North to South for production of milk products and 40% of lambs brought across the border for processing. More generally, parts of manufacturing are also all-island; a European parliamentary report from 2016 highlighted that Guinness production results in 13,000 border crossings per year while Bombardier has more than 60 suppliers in Ireland. The labour market across the border is also highly mobile; 30,000 workers cross the border to get to work on either side every day. However, we see the key challenge coming via goods rather human travel across borders, with the Common Travel Area predating EU legislation.

Customs checks did exist between Northern Ireland and the Republic of Ireland from 1972 onwards, with 17 HM Customs and Excise boundary posts at points in the border. Although there were over two hundred more possible crossings, they were not approved for vehicular travel. Returning to this situation would be highly costly, if it was even viable, given the extensive check infrastructure would be required, not to mention creating political tension in the region. There are also a number of farms that straddle both sides of the border, as well as a number of other businesses and even communities. Without a deal, the normal functioning and political stability in these places would be significantly altered.

What about the services sector?

Services account for almost 80% of UK GDP and employment, 44% of gross UK exports and 66% of value-added exports. Financial services and travel services are the largest services exporter in the UK, with 40% of UK financial services exports going to the EU. Calculating the costs of 'No Deal' for services is more complex than for goods, given services sector would face less visible barriers to trade in the form of non-tariff barriers. However, the OECD estimates that barriers to services sector trade with the EU are four times greater for third parties than for single market members so we would expect a 'No Deal' outcome to significantly challenge this sector.

Perhaps the best way to categorise the impact is to use OECD's services trade restrictiveness indicators. These are restrictions on foreign entry, restrictions on movement of people, barriers to competition and regulatory transparency. In a 'No Deal' scenario, all of these indicators would be affected, as EU services legislation, regulations, and free movement of labour would no longer apply. For example, European leadership has always preferred Euro clearing to take place within the Eurozone, but the UK won a case to retain membership at the ECJ due to the "free movement of capital" element of EU membership, which no longer holds in this scenario. Additionally, the Institute for Government has pointed out that agreements with third parties through EU membership – such as its insurance agreements with the US and Switzerland – would need to be re-established.

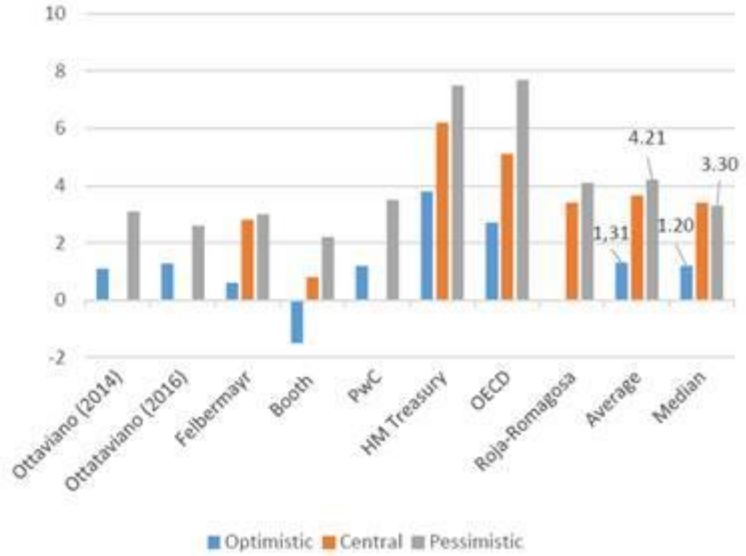
Furthermore, services trade would be affected by changes to goods trade because the two are inherently linked, with services often supporting production and distribution. As a result, a 'No Deal' scenario would be a double hit for services: directly through higher non-tariff barriers and indirectly through contraction in goods exports.

What does this all mean for headline GDP in the UK and EU?

In a 'No Deal' scenario, the risks are asymmetric – with the UK likely to suffer much more than the EU-27. In such a scenario, we would expect to downgrade our GDP forecasts for the UK substantially, underlined by a significant change to the composition of UK growth as a result of sharply higher costs to consumers and firms reliant on EU export markets, while government spending rises to smooth the disruption. There is a sizable literature that attempts to model the impacts of 'No Deal' on the UK and EU economies. That said, any model estimates should be read with wide confidence intervals given the complex and often subjective assumptions that have to be built in to model these risks.

The European Parliament impact assessment argues that "the imposition of standard WTO tariffs would result in UK exports dropping by almost 10 percent, while EU exports would drop by about 2 percent". In 2017, the European Parliament found that across the literature, EU 27 losses average a cumulative 0.5% for 'No Deal' Brexit out to 2030 – relative to staying in the EU – while UK losses average a heftier 4.2% of GDP cumulatively to 2030, or 0.4% annually.

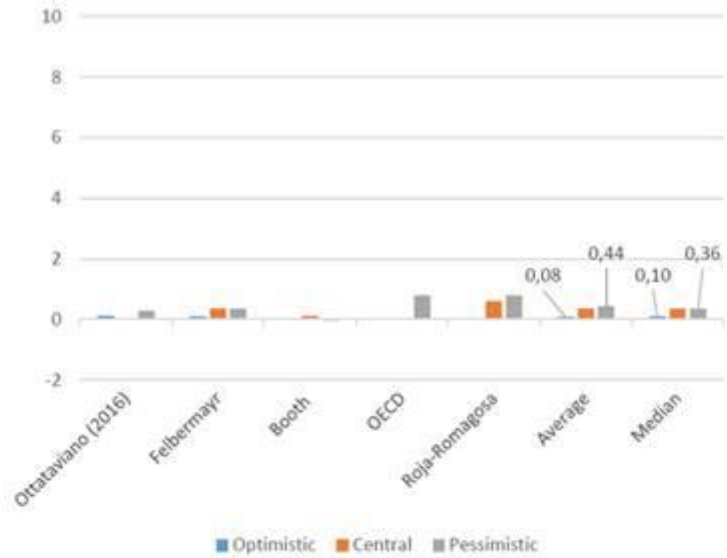
Chart 7: Impact estimates of scenarios on UK economy to 2030 (cumulative)



Notes: All changes are reported with an opposite sign, i.e. positive values express a reduction of GDP; Felbermayr (2016) uses GDP per capita.

*Note: Pessimistic is the reference point for 'No Deal' Brexit. Source: European Parliament (as of 2017)

Chart 8: Impact estimates of scenarios on EU economy to 2030 (cumulative)

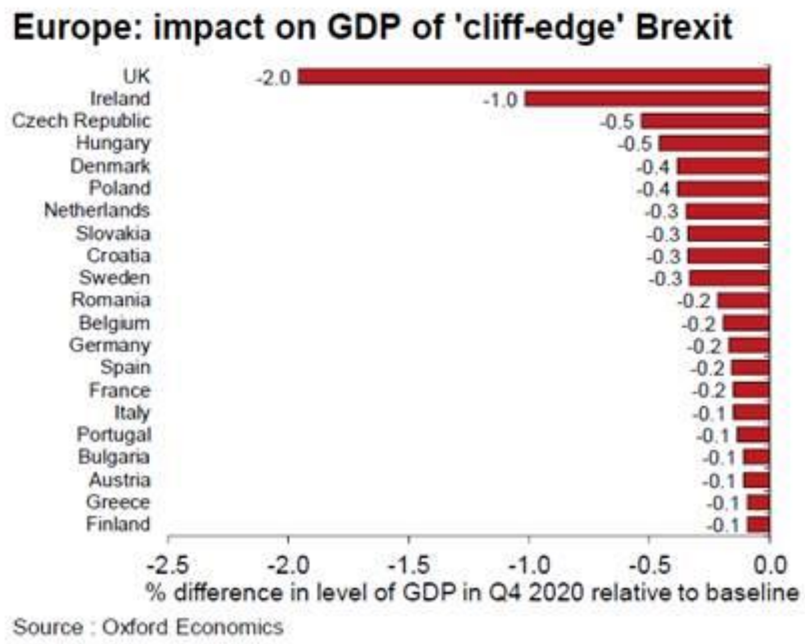


Notes: All changes are reported with an opposite sign, i.e. positive values express a reduction of GDP; OECD estimation for the EU is computed only for a nearer term scenario (2023); Felbermayr (2016) uses GDP per capita.

*Note: Pessimistic is the reference point for 'No Deal' Brexit. Source: European Parliament (as of 2017)

More recently, Oxford Economics have provided estimates for near-term GDP impacts in the case of 'No Deal' Brexit, which confirms the information in the literature regarding country exposures. They estimate that a 'No Deal' Brexit would shave 2ppt off GDP in level terms by end 2020, although this model is relative to the Oxford baseline forecast, which incorporates an assumption that the UK gets a deal with the EU, rather than the longer term work, which compare 'No Deal' effects to staying in the EU.

Chart 9: Short-term impact of 'No Deal' Brexit on UK and European economies



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