

A HARD BREXIT COULD COST THE EU EUR33BN IN ANNUAL EXPORTS

20 October 2020

ANA BOATA

Head of Macroeconomic Research
ana.boata@eulerhermes.com

ANITA POULOU

Research Assistant
anita.poulou@eulerhermes.com

The odds for a no-deal Brexit at the end of 2020 have considerably increased to 45%. While we do still expect a last-minute compromise, given the social, political and economic consequences of such an outcome on top of the continuing Covid-19 crisis in the UK and across Europe in general, a Hard Brexit could cost as much as EUR33bn in annual exports to the EU, with Germany (EUR8.2bn), the Netherlands (EUR4.8bn) and France (EUR3.6bn) hit the hardest. In the event of a no deal on 1 January 2021 (probably announced after mid-November to allow at least one month of preparation), the UK could see a -5% contraction in GDP and a -15% drop in exports, besides inflation beyond 5% for at least six months. This latter will mainly be driven by the strong rise in import prices (+15%) on the back of: (i) higher average import tariffs on total imports (+1pp to 2.6%¹); (ii) a significant rise in non-tariff barriers (supply-chain disruption, administrative hurdles, increased transportation costs and time) — estimates² suggest these could act as a +10% ad-valorem tariff on product value for imports coming from countries such as France, Germany or Spain, as they are part of the Customs Union and the Single Market, and around +5% on imports coming from Norway, a member of the Single Market but not the Customs Union. (iii) a forecasted -10% depreciation of the sterling (see Figure 1).

Import prices will rise the most for the following categories (i) footwear, headgear, umbrellas, whips, riding-crops, feathers, artificial flowers (+21%), (ii) textile materials (+21%), (iii) animal products and live animals (+20%), and (iv) food and beverages (+20%) – see Figure 2. Depending on the nature of imports, their sensitivity to changes in prices varies – in general, we expect a higher elasticity on second necessity goods such as high-tech products, machinery and equipment, automotive etc.

Taking into account the rise in import prices as well as the import sensitivity to prices (on average 0.4), we calculate that Germany could lose as much as EUR8.2bn of its exports to the UK in value (11.2% of its exports to the UK and 0.6% of its total exports). The Netherlands will see its exports decrease by EUR4.8bn (10.5% of its exports to the UK) and France by EUR3.6bn (11%) – see Figure 3 for the most exposed European countries and products.

We expect the authorities to step in in the case of a Hard Brexit. The BoE

¹ https://www.eulerhermes.com/en_global/news-insights/economic-insights/brexit-trade-tricks-wont-be-enough.html

² <https://www.instituteforgovernment.org.uk/sites/default/files/Economic%20impact%20of%20Brexit%20summary.pdf>

would significantly ease the stance of its monetary policy. Key interest rates are expected to go into negative territory and QE to be increased by GBP250-300bn, similar to the Covid-19 package, and at least double compared to our baseline scenario (see Figure 1). On the fiscal side we expect 4% of GDP in additional measures in 2021 (against 2% in the baseline scenario), with a focus on infrastructure spending, protection of consumers' purchasing power (prolonged VAT rate cut and consumption vouchers) and liquidity measures for companies.

We expect a Free Trade Agreement (CETA++³ type) with the EU to be agreed by mid-November. However, we don't exclude the possibility that a longer transition period is agreed upon to allow enough time for a full ratification. Hence, we expect an FTA to be implemented only by mid-2021. It's worth mentioning that if an agreement between the UK and the EU is not finalized by the end of October / mid-November, there won't be enough time for a full ratification of the FTA before the end of the year. Hence, we don't exclude the possibility of a technical extension of the transition period despite the commitment of both sides not to do so. The intensification of the sanitary crisis could also be a trigger for the extension of the transition period and the implementation of the FTA in a smooth way. In our baseline scenario, we expect the UK economy to continue to struggle throughout the sanitary crisis, with GDP contracting by -3% q/q in Q4 (-11.8% in 2020), and a weak and unstable recovery afterwards until 2022 when a vaccination campaign could allow a return to normal.

It is worth noting that, as of mid-October 2020, the UK is planning to enforce as many as 22 trade deals with non-EU countries or trade blocks as of 01 January 2021 in case no agreement with the EU is reached before the end of this year. In addition, 16 similar deals with other partners are still under negotiation. If the latter cannot be formally signed before late December, the UK will have to trade with such countries under WTO terms as of 01 January 2021. Finally, the UK secured mutual recognition agreements (or MRAs, that is, agreements in which countries recognize the results of one another's conformity assessments) replicating EU arrangements, with the U.S., New Zealand and Australia. It also managed to sign an FTA with Japan, with whom an MRA is currently being contemplated.

Overall, we expect growth of +2.5% in 2021 (see Figure 1), as the effective EU exit under a FTA (a CETA++) is likely to materialize in 2021, either on 1 January 2021 or a later stage if both sides agree they need more time for ratification and implementation. In this Soft Brexit scenario, EU export losses would stand at EUR18bn. Meanwhile, in the UK, import prices are expected to rise by +6% on average due to a -3% depreciation of the sterling and the rise in non-tariff barriers detailed above. Hence, despite the overall fall in import tariffs (-0.7pp to 1%), under a Soft Brexit scenario, imports of products from the plant kingdom will experience a +8% price increase, followed by imports of paper and cardboard (+7%), pearls, precious stones and metals, metals clad, imitation jewelry, coins (+7%), mineral products (+7%) as well as wood, charcoal, cork, articles of straw and plaiting materials, and basketware (+7%) – see Figure 2. The rise in import prices will increase inflation beyond 2% in H2 2021 while reducing

³ CETA ++ means the UK will be out of the Customs Union and Single Market but with almost zero tariffs on goods and equivalence for all financial products

corporate margins.

Figure 1 – Brexit scenarios and related economic and financial impacts

| | Soft Brexit with very-last minute compromise and FTA implementation by mid-2021 (55%) | | Hard Brexit on Jan 1 st , 2021 with likely comeback into negotiations during 2021 after early elections (45%) | |
|---------------------------------------|---|--|--|--|
| | 2020 | 2021 | 2020 | 2021 |
| GDP growth, % | -11.8 | +2.5 | -10.9 | -4.8 |
| Consumer spending, % | -13.3 | 5.9 | -12.0 | 0.7 |
| Total investment, % | -26.8 | -15.1 | -26.8 | -25.8 |
| Exports, % | -13.7 | 1.8 | -13.7 | -13.0 |
| Inflation | 0.7 | 1.5 | 0.7 | 4.5 |
| Unemployment rate | 7.0 | 8.5 | 7.0 | 10.0 |
| GBP/EUR, annual change | -7.0 | -3.0 | -9.0 | -10.0 |
| Business insolvencies, % | 4.0 | 31.0 | 4.0 | 53.0 |
| Monetary policy | QE increased by 5% of GDP (around GBP100bn) and implemented until mid-2021, rates unchanged at 0.1% | | Rates cut into negative territory and QE increased by GBP250-300bn, similar to the Covid-19 package | |
| Fiscal policy | 2% of GDP in 2021 (after only 1.5% in 2020) mainly focused on infrastructure spending and tax cuts | | 4% of GDP in 2021 mainly focused on infrastructure spending and measures to protect consumers purchasing power. State guaranteed loans prolonged until end-2021. | |
| Gilt expectations and equity strategy | 10y GILT at 0.4%(eoy) FTSE 100 at -22%/yoy (eoy) | 10y GILT at 0.6%(eoy) FTSE 100 at +10%/yoy(eoy) | 10y GILT at -0.2%(eoy) FTSE 100 at -50%/yoy (eoy) | 10y GILT at 0.1%(eoy) FTSE 100 at -10%/yoy(eoy) |

Sources: national sources, Allianz Research

Figure 2 – Increases in import prices (rounded) for Top 10 most impacted products

| Hard Brexit | | Soft Brexit | |
|---|------------|--|-----------|
| Footwear, headgear, umbrellas, whips, riding-crops, feathers, artificial flowers | 21% | Products of the plant kingdom | 8% |
| Textile materials | 21% | Paper or cardboard | 7% |
| Animal products and live animals | 20% | Pearls, precious stones and metals, metals clad, imitation jewelry, coins | 7% |
| Products of the plant kingdom | 20% | Mineral products | 7% |
| Food and beverages, alcoholic beverages, vinegars, tobacco | 20% | Wood, charcoal, cork, articles of straw and plaiting materials, basketware | 7% |
| Transport equipment | 19% | Textile materials | 7% |
| Animal or vegetable fats, oils and waxes | 19% | Miscellaneous goods | 7% |
| Plastics and rubber | 18% | Chemicals | 7% |
| Leather, furskins, saddlery, harness, travel goods, handbags | 16% | Plastics and rubber | 7% |
| Articles of stone, plaster, cement, asbestos, mica, ceramic products, glass and glassware | 15% | Machinery and electrical equipment | 7% |

Sources: WTO, ITC, Allianz Research

Figure 3 - Export loss by country & Brexit scenario in value (top 5 main exposed sectors), EUR million

| EUR, mn | Hard Brexit | | Soft Brexit | |
|-------------|------------------------------------|--------------|------------------------------------|--------------|
| Germany | 8 198 | | 4 215 | |
| | Transport equipment | 2 855 | Transport equipment | 1 268 |
| | Machinery and electrical equipment | 1 359 | Machinery and electrical equipment | 825 |
| | Chemicals | 752 | Chemicals | 437 |
| | Plastics and rubber | 603 | Base metals | 304 |
| | Base metals | 540 | Plastics and rubber | 295 |
| Netherlands | 4 827 | | 2 579 | |
| | Machinery and electrical equipment | 1 046 | Machinery and electrical equipment | 632 |
| | Chemicals | 825 | Chemicals | 484 |
| | Mineral products | 469 | Mineral products | 293 |

| | | | | |
|---------|---|-------|---|-----|
| | Transport equipment | 438 | Transport equipment | 192 |
| | Textile materials | 327 | Musical, optical, photographic, cinematographic, measuring, checking, medical or surgical instruments, clocks and watches | 156 |
| France | 3 629 | | 1 947 | |
| | Transport equipment | 759 | Transport equipment | 373 |
| | Chemicals | 477 | Chemicals | 276 |
| | Machinery and electrical equipment | 426 | Machinery and electrical equipment | 258 |
| | Food and beverages, alcoholic beverages, vinegars, tobacco | 305 | Pearls, precious stones and metals, metals clad, imitation jewelry, coins | 180 |
| | Pearls, precious stones and metals, metals clad, imitation jewelry, coins | 286 | Food and beverages, alcoholic beverages, vinegars, tobacco | 145 |
| Belgium | 3 159 | | 1 591 | |
| | Transport equipment | 969 | Transport equipment | 423 |
| | Chemicals | 409 | Chemicals | 242 |
| | Plastics and rubber | 284 | Plastics and rubber | 137 |
| | Mineral products | 216 | Mineral products | 135 |
| | Textile materials | 207 | Machinery and electrical equipment | 114 |
| Italy | 2 567 | | 1 320 | |
| | Machinery and electrical equipment | 393 | Machinery and electrical equipment | 239 |
| | Textile materials | 382 | Textile materials | 151 |
| | Transport equipment | 309 | Transport equipment | 138 |
| | Chemicals | 215 | Chemicals | 128 |
| | Food and beverages, alcoholic beverages, vinegars, tobacco | 212 | Base metals | 110 |
| Spain | 2 091 | | 1 021 | |
| | Transport equipment | 717 | Transport equipment | 323 |
| | Products of the plant kingdom | 206 | Chemicals | 100 |
| | Chemicals | 174 | Products of the plant kingdom | 83 |
| | Textile materials | 155 | Machinery and electrical equipment | 82 |
| | Machinery and electrical equipment | 137 | Base metals | 82 |
| Norway | 2 116 | | 802 | |
| | Mineral products | 1 879 | Mineral products | 719 |
| | Base metals | 52 | Base metals | 19 |
| | Chemicals | 43 | Chemicals | 14 |
| | Machinery and electrical equipment | 29 | Machinery and electrical equipment | 11 |
| | Transport equipment | 19 | Transport equipment | 7 |
| Ireland | 1 418 | | 751 | |
| | Chemicals | 306 | Chemicals | 184 |
| | Food and beverages, alcoholic beverages, vinegars, tobacco | 226 | Machinery and electrical equipment | 116 |
| | Animal products and live animals | 200 | Food and beverages, alcoholic beverages, vinegars, tobacco | 97 |
| | Machinery and electrical equipment | 193 | Animal products and live animals | 84 |
| | Mineral products | 82 | Mineral products | 51 |
| Poland | 1 355 | | 699 | |
| | Machinery and electrical equipment | 298 | Machinery and electrical equipment | 180 |
| | Transport equipment | 191 | Transport equipment | 85 |
| | Food and beverages, alcoholic beverages, vinegars, tobacco | 171 | Miscellaneous goods | 69 |
| | Miscellaneous goods | 116 | Food and beverages, alcoholic beverages, vinegars, tobacco | 54 |
| | Chemicals | 85 | Chemicals | 49 |
| Sweden | 805 | | 447 | |
| | Transport equipment | 165 | Mineral products | 77 |
| | Mineral products | 123 | Transport equipment | 73 |
| | Machinery and electrical equipment | 92 | Paper or cardboard | 57 |

| | | | | |
|----------------|--|-----|--|-----|
| | Paper or cardboard | 90 | Machinery and electrical equipment | 56 |
| | Wood, charcoal, cork, articles of straw and plaiting materials, basketware | 79 | Wood, charcoal, cork, articles of straw and plaiting materials, basketware | 47 |
| Denmark | 739 | | 408 | |
| | Base metals | 232 | Base metals | 141 |
| | Machinery and electrical equipment | 153 | Machinery and electrical equipment | 92 |
| | Animal products and live animals | 63 | Animal products and live animals | 25 |
| | Food and beverages, alcoholic beverages, vinegars, tobacco | 58 | Chemicals | 25 |
| | Textile materials | 46 | Food and beverages, alcoholic beverages, vinegars, tobacco | 23 |
| Czech Republic | 708 | | 381 | |
| | Machinery and electrical equipment | 267 | Machinery and electrical equipment | 161 |
| | Transport equipment | 162 | Transport equipment | 71 |
| | Base metals | 73 | Base metals | 42 |
| | Miscellaneous goods | 49 | Miscellaneous goods | 29 |
| | Plastics and rubber | 39 | Plastics and rubber | 20 |

Sources: WTO, ITC, Allianz Research

These assessments are, as always, subject to the disclaimer provided below.

FORWARD-LOOKING STATEMENTS

The statements contained herein may include prospects, statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such forward-looking statements.

Such deviations may arise due to, without limitation, (i) changes of the general economic conditions and competitive situation, particularly in the Allianz Group's core business and core markets, (ii) performance of financial markets (particularly market volatility, liquidity and credit events), (iii) frequency and severity of insured loss events, including from natural catastrophes, and the development of loss expenses, (iv) mortality and morbidity levels and trends, (v) persistency levels, (vi) particularly in the banking business, the extent of credit defaults, (vii) interest rate levels, (viii) currency exchange rates including the EUR/USD exchange rate, (ix) changes in laws and regulations, including tax regulations, (x) the impact of acquisitions, including related integration issues, and reorganization measures, and (xi) general competitive factors, in each case on a local, regional, national and/or global basis. Many of these factors may be more likely to occur, or more pronounced, as a result of terrorist activities and their consequences.

NO DUTY TO UPDATE

The company assumes no obligation to update any information or forward-looking statement contained herein, save for any information required to be disclosed by law.