Economic Insight

Brexit: A blind date better than a bad breakup

October 15, 2018

Author:

Ana Boata
+33.1.84.11.48.73
ana.boata@eulerhermes.com

Executive Summary

- Ongoing discussions about the details of the divorce agreement combined with a polarized political landscape in the UK have increased the likelihood of a 'No deal' and resulted in higher uncertainty. The cost of such uncertainty could be as much as -0.1pp of GDP growth per quarter between now and making a deal, due to financial stress on the sterling, contingency stocking by companies and depressed consumption.

- We continue to expect a 'Blind Brexit' (70% likelihood), that is, a last-minute deal with the EU where both sides agree on a Free Trade Agreement with very close ties. This should pave the way for a transition period – by the end of 2020 – during which there will be no changes to the trade in goods and services and no migration control. Temporary market relief is expected in the aftermath of the agreement, with the pound to euro exchange rate going back to 1.14 after reaching a low point of 1.06-1.09 at end of 2018.

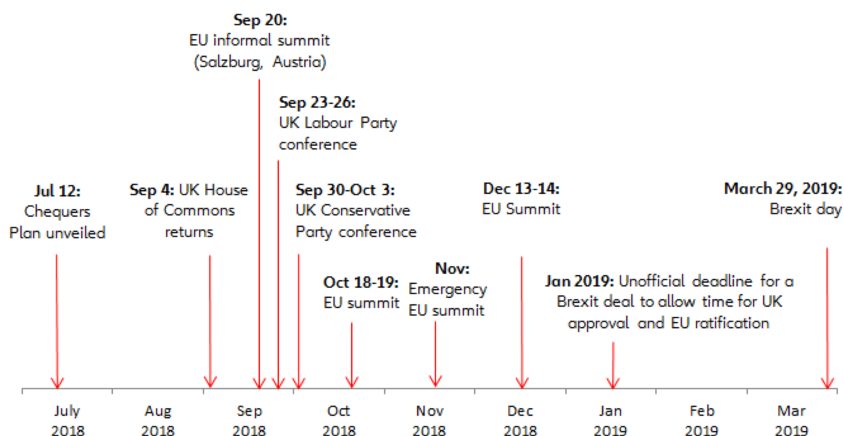
- In a 'No deal' scenario (25% likelihood), the UK will exit the EU under the WTO conditions. This means around 4% to 5% of mutual import tariffs. Overall, we would expect the GBP/EUR to fall to 0.88 in late 2019. Total good export losses for the UK would reach GBP30bn in a year. Top EU losers on exports of goods include Germany (~EUR8bn in the first year following the EU exit), the Netherlands (~EUR4bn), France (~EUR3bn) and Belgium (~EUR3bn).

The ghost of a 'No Deal'

On July 26th, the EU rejected the Brexit deal the UK proposed in July (the Chequers plan) as it did not align with the indivisibility of the four EU freedoms (people, goods, services and capital). The EU judged this proposal as creating additional red-tape and bureaucracy on the collection of duties (the UK proposed to take care of duty collection for goods having the EU as a final destination). The EU also judged the deal as potentially creating unfair competition for EU companies in the services sector and reemphasized its concerns at the EU Summit in Salzburg on September 20th. Indeed, goods and services are strongly interlinked: 20% to 40% of the total value of each good is linked to services. Should the UK deregu-

late the services market, for example, this could allow them produce cheaper goods compared to the EU.

Figure 1: Brexit timeline



Sources: Allianz Research

In response, the EU proposed two solutions: (i) a Norway type of agreement or (ii) a Comprehensive Economic and Trade Agreement (CETA) type of agreement with EU membership for Northern Ireland. For the moment, the UK rejected both proposals. The first solution was considered to go against the referendum result, as it doesn't allow the control of EU migration flows. The second solution was seen to increase division within the UK.

In addition, the risk for early elections before March 2019 cannot be excluded[1] . First, Theresa May's majority is dependent on the 10 seats from the Democratic Unionist Party from Northern Ireland. Second, the Labor Party (257 seats/650) is now advocating for a second referendum, or general elections, before March 2019. Third, Boris Johnson announced his proposal for a "Better Brexit" which can make "Hard Brexiters" even more vocal.

Given the lack of unity in British Brexit policies, we increased the likelihood of a 'no deal' to 25%.

We believe Theresa May will manage to avoid a political crisis as Conservatives would be afraid of Labor leading the elections; and elections would delay Article 50 beyond the current deadline (29 March 2019). Also "Hard Brexiters" are unlikely to launch a confidence vote against Theresa May or vote against a Brexit deal, as she may manage to secure a (very thin) majority thanks to 56 MPs from the opposition – excluding Labor.

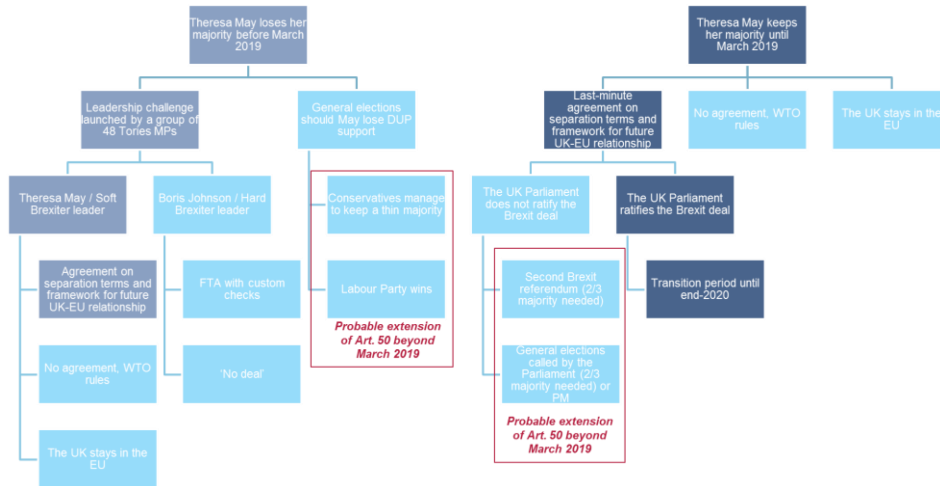
The cost of uncertainty

Higher uncertainty is already having financial costs, notably on sterling. Based on the expected trend of the Economic Policy Uncertainty Index and simulated shocks[2] , we calculate that the GBP/EUR would reach a low of 1.06–1.09 at the peak

[1] Early elections have to be triggered by either Prime Minister May or the Parliament as soon as October in order not to need an extension of Article 50 beyond 29 March 2019 (11pm GMT). As a reminder, an extension of Article 50 needs unanimity from the EU states.
[2] Plakandaras, V., Gupta, R., & Wohar, M. (2017): „The Effects of Brexit on the Pound: Towards a Currency Crisis?"

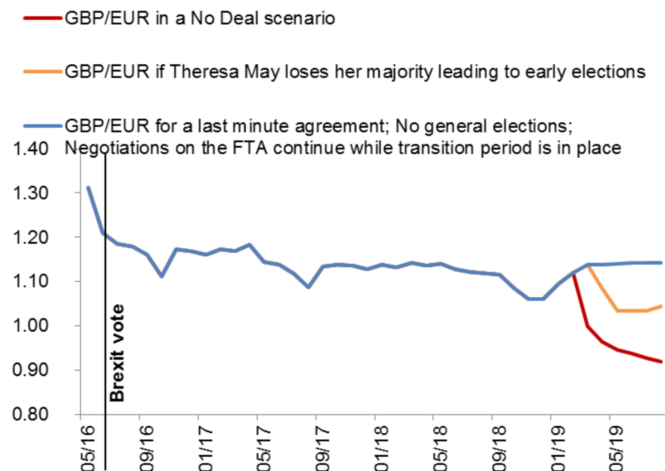
of tensions in November-December. This would mean on average a -3% depreciation per month until a deal is concluded.

Figure 2: Political scenarios by March 2019



NB: The darkest blue has the highest probability
Sources: Allianz Research

Figure 3: Scenarios for the Sterling in the aftermath of Brexit



Sources: Euler Hermes

The rise in uncertainty could cut UK GDP growth by as much as -0.1pp per quarter over the next two quarters while pushing companies to strengthen their contingency stocking in an environment of low domestic demand. Thus, rising uncertainty triggered a downward revision of our GDP growth forecast by -0.1pp in 2018 and 2019 to 1.3% and 1.2% respectively.

The more the uncertainty shock persists, the more it damages the economy, as it can result in negative wealth effects through tighter financial conditions, a weaker consumer, and fragile company profitability.

(1) Negative wealth effects would be accentuated by the slowdown of activity in the construction sector, which could register a more rapid adjustment should uncertainty rise. Already, price growth has been cut in half since the Brexit vote.

(2) Over 2016 and 2017, consumers lost -0.6pp in purchasing power with a trough in mid-2017. Supporting the actual levels of consumption, albeit weak, would require an adjustment of the saving rate. The latter stands at a historically low level (4.4% in Q2 2018). Hence, we expect consumer spending to continue to slow down: +1.3% in 2018 after +1.8% in 2017 (it stood above 3% prior to 2017) and +1.0% in 2019.

(3) Non-financial corporations' margins lost -2.5pp since the start of 2016 when the sterling entered its depreciating trend. The fall is expected to continue given the recent wage growth acceleration. Significant labor market shortages should keep wage growth above +3% y/y for the coming months. We believe that some UK companies will increasingly look for domestic suppliers in order to protect their margins, notably in those sectors where dependency on imports is high: automotive, chemicals, machinery and equipment, retail and agri-food. Some local capacity will be freed-up by the fact that there is an increasing number of EU companies which start to switch from UK to EU suppliers. Some recent examples have confirmed this trend. Fears of custom checks between the UK and the EU or a hard border with Northern Ireland have increased.

Last minute deal: A blind date between the UK and Europe?

Our central scenario (70% probability) continues to be a last-minute agreement by January 2019 which would validate the 21-month transition period. January 2019 is the minimum must-have time to allow ratification by the UK Parliament and the EU (European Council, European Parliament).

An agreement is likely to give temporary relief to financial markets and notably to the sterling. We estimate the sterling to rebound to 1.14 by April 2019. The Bank of England is expected to continue on its path of one rate hike (+25bp) per year, with the next one to come in Q2 2019.

However, the political declaration on the future Trade Relationship with the EU is likely to lack very concrete details and to look more like a "Blind Brexit". It will most probably state that both sides agreed to work on "a Free Trade Agreement (FTA) with very close ties". While the outlines of an agreement on the future EU-UK relationship may be included along with the divorce deal, a formal trade accord would not be published out until the end of the transition period, deemed to end in December 2020. This would be in the interest of both sides, notably the EU given the uncertainty related to the next EU Parliament composition and the European Commission.

2021: Norway is the way

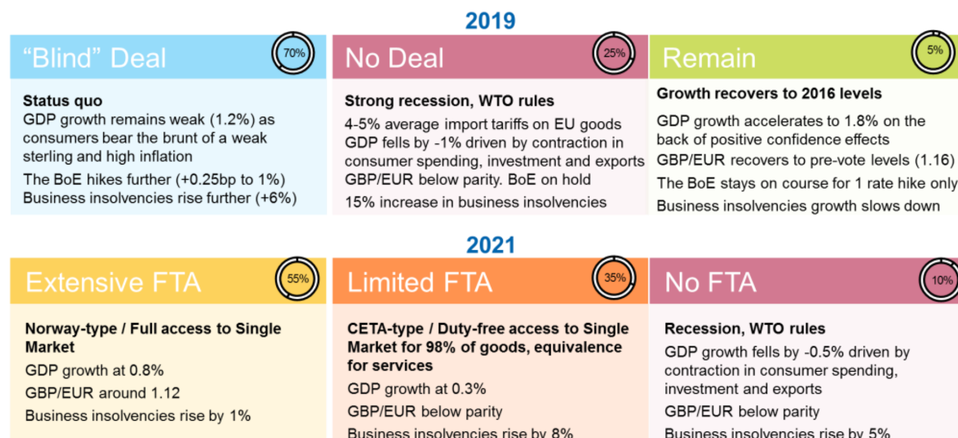
An 'Extensive FTA' similar to Norway in 2021 – our central scenario – would avoid Ireland's dislocation. It would also allow Conservatives to keep their majority in the Parliament as they depend on the 10 seats from the Democratic Unionist Party from Northern Ireland.

Pros. The Norway-type of agreement would mean that the UK will join the European Economic Area (EEA). This will give the UK full access to the Single Market for industrial goods, excluding some agricultural and fisheries products, while requiring minimum physical custom checks. The services sector would also have full access to the Single Market which would allow the UK to keep passporting

rights instead of requiring equivalence status[3] . In addition, the UK would be able to negotiate bilateral FTAs with third countries.

Cons. The UK would not be able to control EU migration and the EU rules would need to be respected. In addition, the UK would not have any voting rights within the EU institutions or changes in regulation. The UK will need to copy or replicate all the 40 FTAs with around 70 countries that the EU has in place currently. Ten of the UK's top 50 export markets for goods were covered by EU trade agreements, which represents around 11% of UK trade, while the ones that are currently close to finalization or awaiting ratification account for another 25% of UK trade.

Figure 4: Summary Brexit scenarios



Sources: Allianz Research

A 'No Deal' would be a case of bad breakup for companies

Should the EU and the UK not be able to find an agreement by March 29th 2019, in the absence of an extension of the Article 50, the UK will exit the EU under the WTO conditions. According to our estimate there is a 25% probability for this scenario.

In a 'no Brexit deal' scenario, the monthly depreciation would hit -11%, bringing the GBP/EUR to 0.88 in late 2019. Overall, we expect GDP growth to fall by -1% in 2019.

What needs to be done for trade in goods?

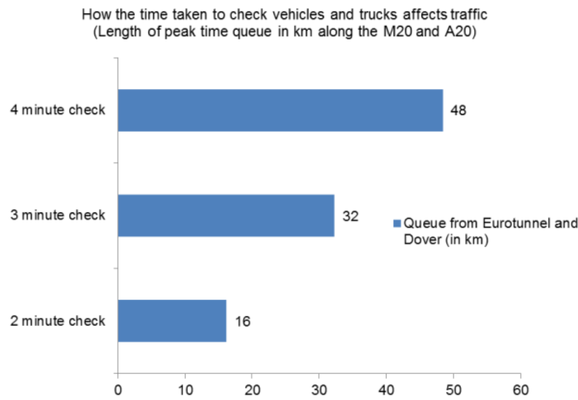
Custom checks will be needed as soon as March 29, 11pm GMT if no transition time is agreed. This will mean additional administrative costs for UK companies but also for EU ones. Estimates from Imperial College London point to the fact that two extra minutes of additional controls at the border (in addition to the current two minutes) would translate into 32 km of queues which would more than triple the existing queues – see Figure 5. This would leave drivers waiting almost five hours on the route.

The UK will establish its own Import Tariffs, which will be communicated in the coming months. The EU will apply customs and excise duties in the same way it does to goods from countries outside the EU with whom it does not have a FTA (e.g. China, the US) – see Figure 6. On average, it will mean 4% to 5% tariffs. Tariffs and

[3] The equivalence regime has the disadvantage of the EU being able to cancel it at any time when deemed necessary

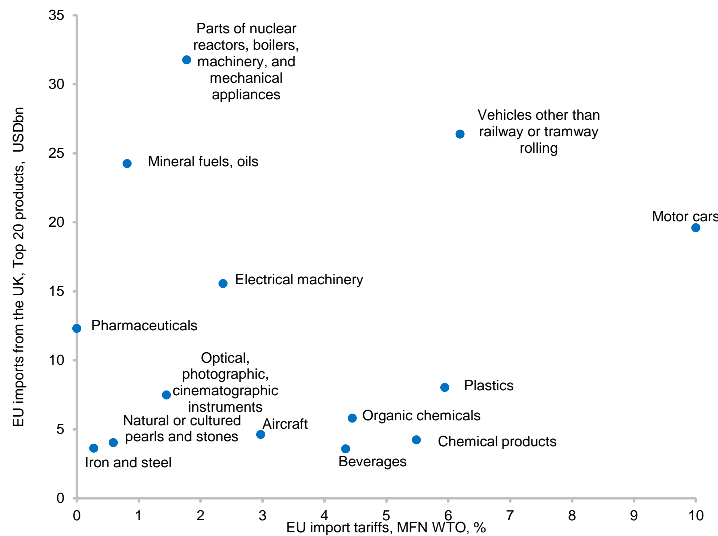
quotas with all WTO member countries would need to be agreed by next March. Given the short time, it is very likely that the EU current ones are implemented. The UK has already submitted an official request at the WTO in this respect. In addition, the UK seeks to transition all trade agreements the EU has (around 50), which seems unrealistic for day 1 as they need approval from all States that signed a deal with the EU. Transition phases would thus be needed.

Figure 5: Additional time needed should custom checks be introduced



Sources: Imperial College London, Allianz Research

Figure 6: EU's WTO MFN applied import duties – top 20 products imported from the UK



Sources: WTO, Allianz Research

Additional burdens come from the administrative paperwork that will be required, including having the following: a valid EORI number; an Import / Export declaration as custom checks will be introduced; a safety and security declaration by the carrier of the goods (haulier, train, vessel, airline) which comprises Exit Summary Declaration (EXS) and Entry Summary Declaration (ENS); engagement with a custom broker, freight forwarder or logistics provider or acquiring the software and securing necessary authorizations from HM Revenue & Customs; submittal of the Entry or Exit declarations in appropriate time (road traffic: at least one hour before

arrival; flights and sea shipping: between two and four hours depending on the type of transport). For exporters, this will allow them to export the goods before they leave the UK. In some cases an export license will be needed; classification of the goods (final and components, specify what they are made of, purpose of usage and origin); and payment of VAT & import duties (incl. excise duties).

Over and above these bureaucratic hurdles, damage will be caused by the fact that extremely interconnected supply chains with the EU countries will become obsolete. This would lead to massive investment stops and production relocations over time.

Who will be the top EU losers?

In a WTO scenario, top EU losers on exports of goods include Germany (~EUR8bn), the Netherlands (~EUR4bn), France (~EUR3bn) and Belgium (~EUR3bn). In the WTO scenario, we would expect the pound to depreciate by 20% and the WTO tariffs (4 - 5% based on current EU standards) would apply. From the rise in tariffs, the top five most impacted sectors and countries are outlined in the table below.

Figure 7: Export losses from the WTO tariffs introduction by the UK, Top 5 sectors & total in the 6 biggest Eurozone countries, EURbn

Export losses from the WTO tariffs introduction by the UK, Top 5 sectors & total, EURbn

Germany		Netherlands		France	
Vehicles	-1.6	Vehicles	-0.2	Vehicles	-0.3
Plastics	-0.2	Electrical machinery	-0.2	Plastics	-0.1
Machinery equip	-0.2	Preparations of vegetables, fruits	-0.1	Beverages	-0.1
Electrical machinery	-0.1	Machinery equip	-0.1	Machinery equip	-0.1
Aluminium articles	-0.1	Plastics	-0.1	Preparations of cereals, flour	-0.1
Total	**-3.5**	**Total**	**-1.7**	**Total**	**-1.3**

Belgium		Italy		Spain	
Vehicles	-0.5	Vehicles	-0.2	Vehicles	-0.3
Plastics	-0.1	Articles of apparel and clothing	-0.1	Edible vegetables	-0.1
Preparations of vegetables, fruits	-0.1	Footwear, gaiters	-0.1	Preparations of vegetables, fruit	-0.1
Footwear, gaiters	-0.1	Preparations of vegetables, fruit	-0.1	Edible fruit and nuts	-0.1
Organic chemicals	0.0	Machinery equip	-0.1	Articles of apparel and clothing	0.0
Total	**-1.3**	**Total**	**-1.0**	**Total**	**-1.0**

Sources: WTO, ITC, Allianz Research

What needs to be done for financial services?

Firstly, the end of passporting rights implies that UK institutions operating in EU/EEA need to submit an application for authorization in the Member State where they operate. There is a risk that UK financial providers will not being able to serve clients in the EU/EEA (lending and deposit activities, life insurance, annuities). For EU/EEA institutions based in the UK there will be a temporary permission regime for three years post-Brexit enabling EEA passporting firms to continue operating in the UK. Asset management firms can continue to operate from the UK as the EU legislation gives the right to fund managers to delegate portfolio managements services to a third party in countries outside the EU.

Secondly, the UK-based payment services providers would lose direct access to central payment infrastructure (Target 2, SEPA) resulting in increased costs and slower processing times for EU transactions.

Thirdly, for derivatives contracts between UK and EU financial firms, permissions might be necessary from both sets of regulators to support continuity of service provision. Overall, we estimate that this scenario would cost the services sector up to GBP36bn.

ABOUT ALLIANZ

The Allianz Group is one of the world's leading insurers and asset managers with more than 86 million retail and corporate customers. Allianz customers benefit from a broad range of personal and corporate insurance services, ranging from property, life and health insurance to assistance services to credit insurance and global business insurance. Allianz is one of the world's largest investors, managing over 650 billion euros on behalf of its insurance customers while our asset managers Allianz Global Investors and PIMCO manage an additional 1.3 trillion euros of third-party assets. Thanks to our systematic integration of ecological and social criteria in our business processes and investment decisions, we hold a leading position in the Dow Jones Sustainability Index. In 2016, over 140,000 employees in more than 70 countries achieved total revenue of 122 billion euros and an operating profit of 11 billion euros for the group.

ABOUT EULER HERMES

Euler Hermes is the global leader in trade credit insurance and a recognized specialist in the areas of bonding, guarantees and collections. With more than 100 years of experience, the company offers business-to-business (B2B) clients financial services to support cash and trade receivables management. Its proprietary intelligence network tracks and analyzes daily changes in corporate solvency among small, medium and multinational companies active in markets representing 92% of global GDP. Headquartered in Paris, the company is present in 52 countries with 6,050 employees. Euler Hermes is a subsidiary of Allianz, rated AA by Standard & Poor's. The company posted a consolidated turnover of €2.6 billion in 2017 and insured global business transactions for €894 billion in exposure at the end of 2017.

Further information: www.eulerhermes.com, LinkedIn or Twitter @eulerhermes.

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

CAUTIONARY NOTE REGARDING 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 euro/US-dollar 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.