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UNITED KINGDOM
2020-2021 OUTLOOK

A LONG HARD WINTER

27 October 2020

WORKING EVERY DAY IN YOUR INTEREST AND FOR SOCIETY

GROUP ECONOMIC RESEARCH

CONTENTS

SUMMARY OF OUR SCENARIO

A LONG HARD WINTER

After a post-lockdown mechanical rebound, the growth rate slowed over the summer. A faster, sooner slowdown than expected, which is likely to accelerate over the last quarter of the year and, as a result of Brexit, early 2021. **Post-lockdown growth did see a fleeting bout of strength due to the combination of favourable factors that are gradually dissipating.** The extraordinary Coronavirus budget stimulus was concentrated in the second and third quarters (£166 billion out of a total of £192 billion for the current fiscal year, based on OBR and BoE estimates). Its purpose was to preserve employment and business survival as much as possible, to prevent the destruction of production capacity; at the time, the virus' impacts were believed to be temporary. Government generous measures continued to protect employment and household income during the relaxation of social distancing measures in June and July, a period that coincided with a decline in the infection rates.

However, this period that was favourable to economic recovery is now behind us. Since the start of September, infection cases have gone back up, forcing the British government to announce new restrictions on social life for the next six months. Importantly, the government is starting to worry about the state of post-crisis public finances, with a budget deficit projected to hit £370bn this year (17% of GDP) and public debt set to exceed 100% of GDP. The change in the budgetary policy stance is clearly visible in the statements of the Chancellor Rishi Sunak who is now promising only to save "viable" jobs. The unemployment rate has already begun its upward climb (4.5% in August, compared to 4% in February) amid record redundancies. It is likely to sharply increase in the fourth quarter to nearly 8%, as the Coronavirus Job Retention Scheme expires at the end of October and is replaced by a less generous system that does less to incentivise employers to preserve jobs if their workload is smaller.

Our scenario therefore assumes considerably slower growth in the fourth quarter, at 2.4% quarter-on-quarter (with downside risks), after 16.9% in the third quarter, due to the resurgence of the pandemic, the expectation of a significant spike in unemployment, the lessening of budgetary stimulus in the months ahead, and Brexit-related uncertainties. On the other hand, a potential strong rebuilding of inventories before Brexit represents a distinct upside risk for GDP growth in the fourth quarter.

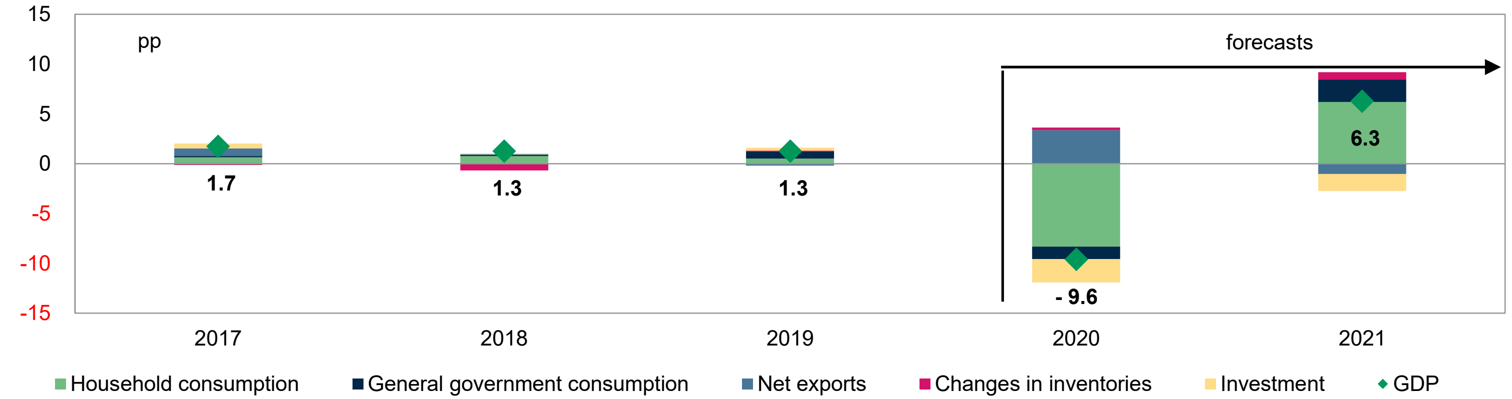
The recovery is highly uncertain and surrounded by downside risks. By its very nature it is contingent on the Covid-19 pandemic's progress and on advances in treatments and vaccines. Households are likely to remain cautious in their consumer spending, with preference for deleveraging and precautionary saving. Businesses will continue to cancel or delay investment projects. The unemployment rate is expected to peak in the first quarter of 2021, but its decline is likely to be slow, especially since the sectors directly affected by the crisis are also the ones where productivity is the lowest, suggesting that the necessary sectoral reallocation of capacities will be difficult and lengthy.

After a 9.6% decline in GDP expected this year, we anticipate a 6.3% rebound next year, which would leave GDP at the end of 2021 below what it was at the end of 2019. CPI inflation is expected to remain below the BoE's 2% target and volatile as temporary factors affect the levels of prices. The BoE will likely maintain rates at record low levels in the coming years on the back of persistent spare capacity. We do not expect a negative key policy rate in the near term, but this is a possibility in 2021, if the inflation outlook remains weak and if the banking sector's situation allows it. It could be a possibility in a "no deal" Brexit scenario alongside more asset purchases, as the BoE is looking for ways to increase its monetary policy headroom. We continue to expect the EU and the UK to sign a bare bones free-trade agreement that would avoid the imposition of customs duties, but non-tariff trade barriers (customs checks, regulatory controls, etc.) are set to come about post-Brexit and disrupt commerce in early 2021.

SUMMARY OF OUR SCENARIO

FORECASTS

Contributions to annual GDP growth



Sources: ONS, Crédit Agricole SA/ ECO

United Kingdom	2018	2019	2020	2021	2019				2020				2021			
					Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP (%)	1.3	1.3	-9.6	6.3	0.6	0.0	0.3	0.1	-2.5	-19.8	16.9	2.4	0.7	0.9	1.3	1.3
household consumption	1.3	0.8	-13.4	10.5	-0.2	0.5	0.0	-0.4	-3.0	-23.6	15.8	5.0	4.0	1.5	1.5	1.5
public consumption	0.6	4.1	-6.6	11.3	1.4	2.0	-0.6	0.7	-3.9	-14.6	15.0	4.0	2.0	2.0	2.0	2.0
investment	0.4	1.5	-13.1	-9.8	2.0	-1.0	1.4	-1.7	-1.0	-21.6	15.0	-5.0	-5.0	-2.0	-0.5	-0.5
change in inventories*	-0.7	0.1	0.3	0.7	0.4	-1.7	-0.8	1.6	-0.5	-0.7	2.1	0.2	0.0	-0.2	0.0	0.0
net exports*	0.1	-0.2	3.4	-1.0	-2.1	2.8	1.1	0.4	-0.5	3.6	-0.4	-0.7	-1.3	0.0	0.0	0.0
Unemployment rate (ILO)	4.1	3.8	4.5	7.4	3.8	3.9	3.8	3.8	0.0	3.9	6.1	7.9	8.0	7.6	7.3	6.9
Inflation (CPI, YoY%)	2.5	1.8	0.8	1.3	1.9	2.0	1.8	1.4	1.7	0.6	0.6	0.5	0.7	1.5	1.3	1.8
Core CPI (YoY%)	2.1	1.7	1.1	0.9	1.9	1.7	1.7	1.6	1.6	1.4	1.1	0.4	0.6	0.9	0.7	1.6
General gov. balance, % GDP	-2.2	-2.1	-16.8	-14.4												
Public debt % GDP	85.7	85.4	108.5	116.2												
Bank rate**	0.75	0.75	0.10	0.10	0.75	0.75	0.75	0.75	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Gilt purchases (bn £)	435	435	435	745	435	435	435	435	645	745	745	845	845	845	845	845

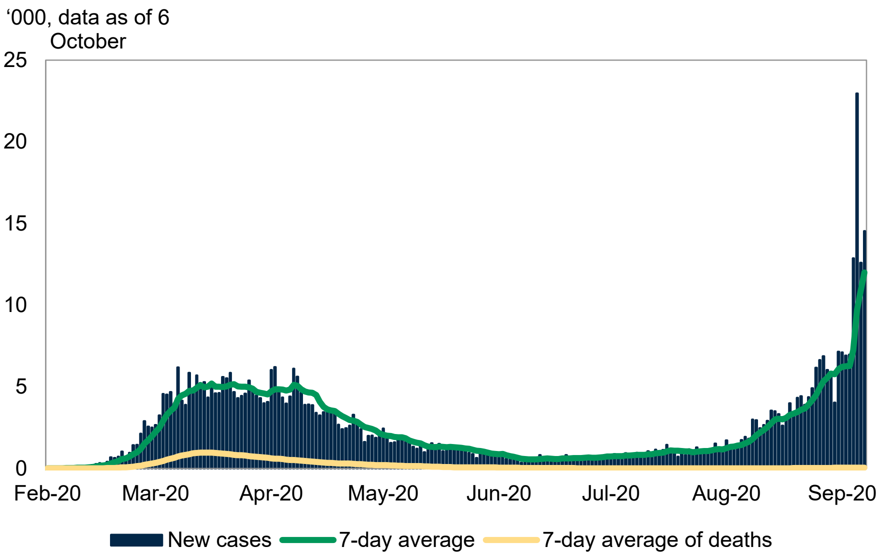
** Contributions to GDP growth*

*** End of period*

Source: ONS, BoE, Crédit Agricole S.A.

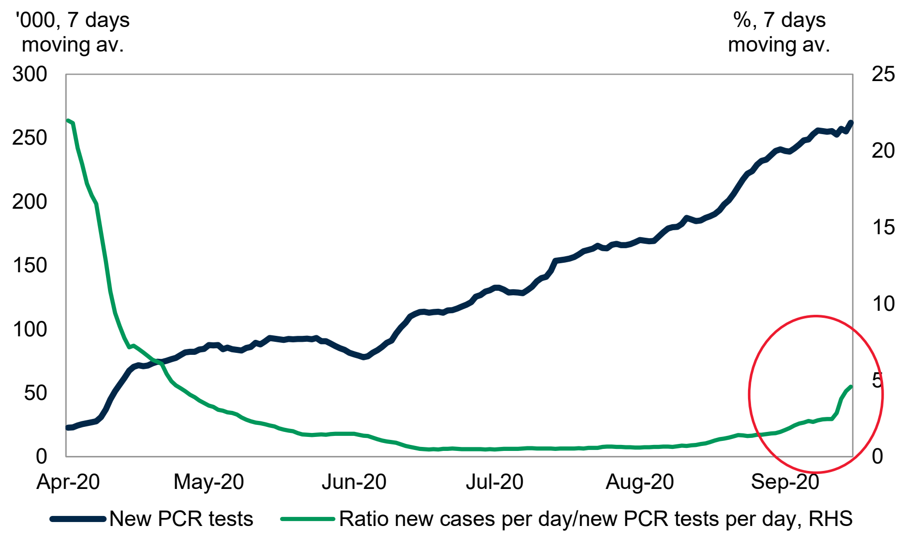
PANDEMIC RESURGENCE AND NEW SOCIAL RESTRICTIONS

The second wave, very different from the first one



Sources: Gov.uk, Crédit Agricole SA / ECO

New cases Covid climb up relative to the number of tests



Sources: Gov.uk, Crédit Agricole SA / ECO

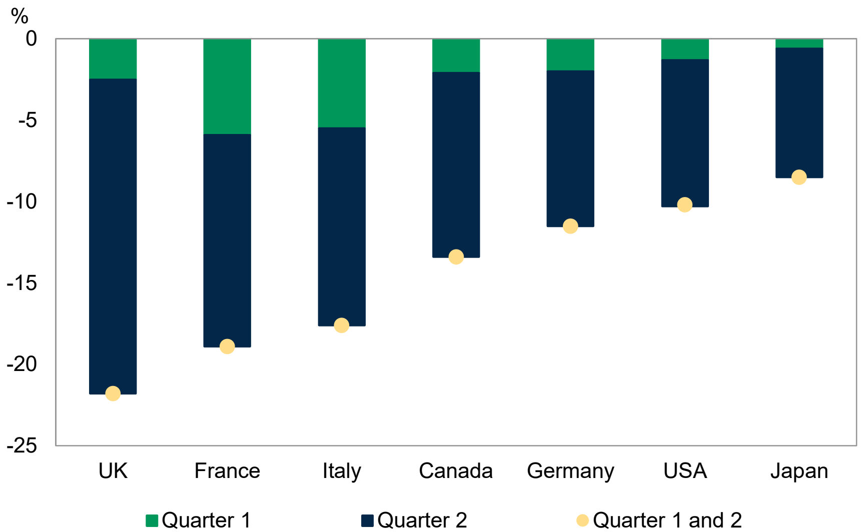
The resurgence of COVID-19 cases led the British government to announce new restrictions on social interactions in September, including a "six people max" rule for meetings among people from different households (with some exceptions such as civil ceremonies where the limit is 15), as well as the closing of bars and restaurants between 10 p.m. and 5 a.m. beginning 24 September. Working from home whenever possible is also being heavily encouraged.

According to official data, one in eight people in England has been tested for coronavirus since the launch of NHS Test and Trace on 28 May. The goal is to reach 500,000 tests a day by the end of October. However, the idea that the resurgence of COVID-19 cases since early September is due to stepped-up screening is untrue, because there has been a marked increase in the daily positivity rate.

THE COVID-19 CRISIS AND THE LATEST ECONOMIC TRENDS

ONE OF THE HIGHEST GDP DECLINES IN THE WORLD

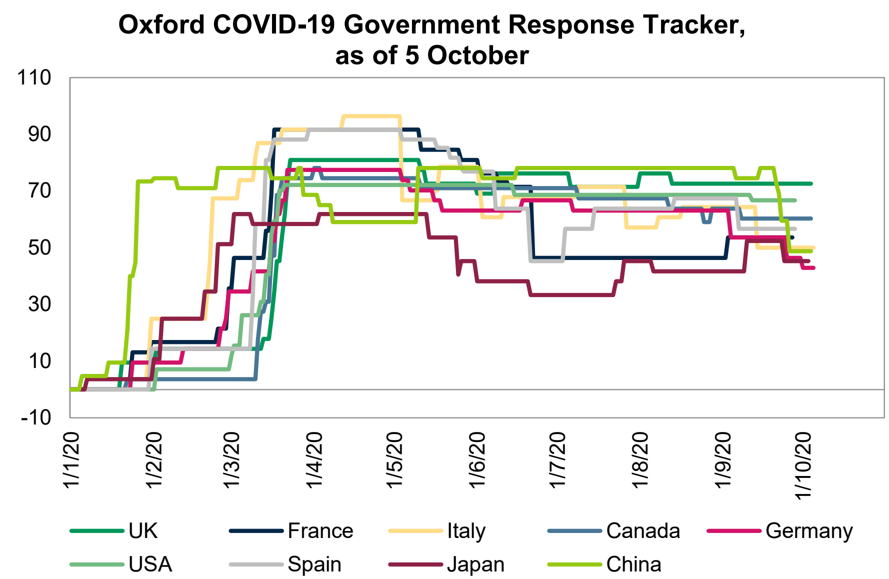
Record high contraction in the first half of the year among the G7 countries



Sources: ONS, Crédit Agricole S.A. / ECO

GDP contracted 19.8% quarter-on-quarter in the second quarter, its worst performance since the 1955 start of the quarterly GDP series, after a 2.5% decline in the first quarter. GDP saw a cumulative 21.8% decrease in the second quarter compared to the fourth quarter of 2019, the worst performance of any G7 country. Year-on-year, GDP declined 21.5%. In terms of levels, it was at its lowest point since the first quarter of 2003.

Partly related to a more protracted lockdown



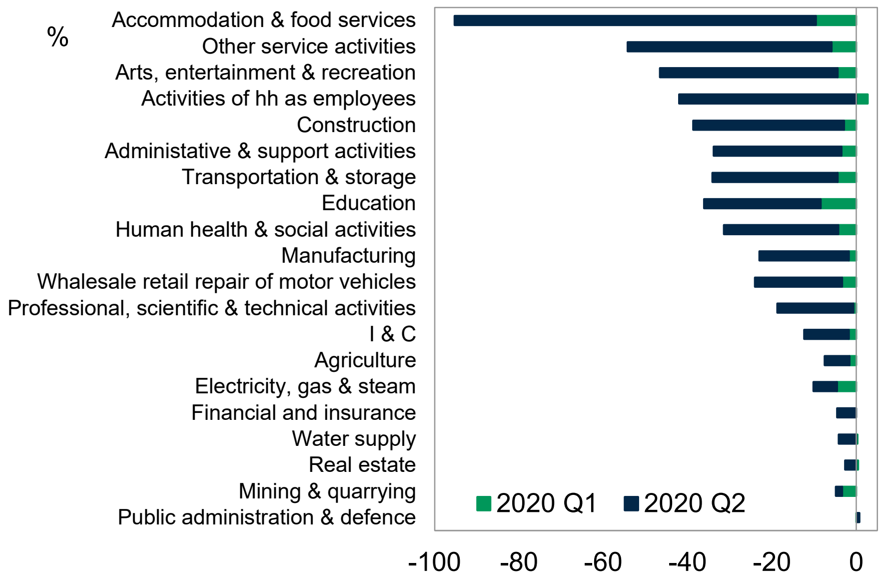
Sources: Oxford University, Crédit Agricole SA / ECO

The lockdown went into effect on 23 March, one week after France. It included a ban on all social events and gatherings, as well as the closure of "non-essential" businesses. As the health crisis was brought under control late, the lifting of social distancing measures took longer, and was not done evenly throughout the country. The manufacturing and construction sectors reopened beginning on 13 May in England, but non-essential businesses did not reopen until 15 June, and pubs, restaurants, and hotels had to wait until early July.

THE COVID-19 CRISIS AND THE LATEST ECONOMIC TRENDS

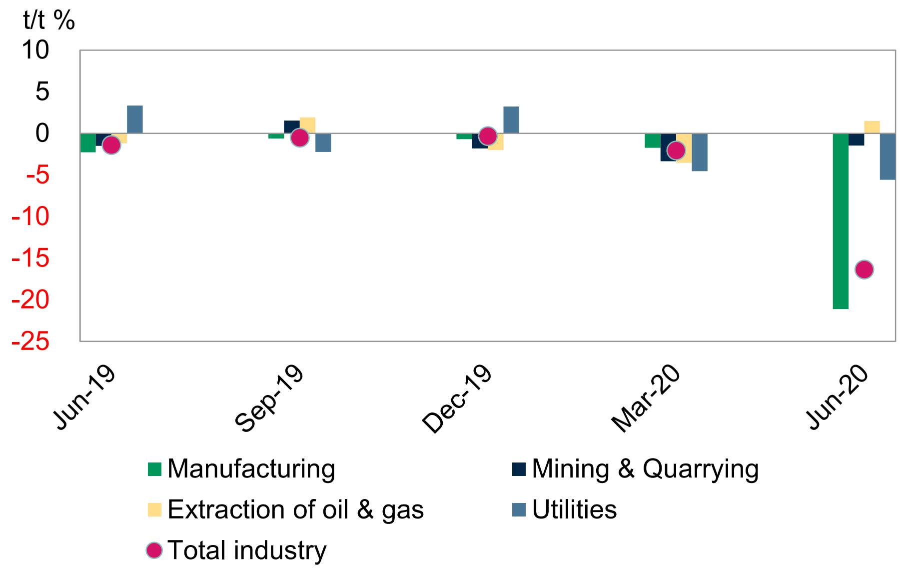
AN ECONOMIC CRISIS THAT HAS HIT EACH SECTOR DIFFERENTLY

Output declined most in the sectors of « social consumption»



Sources: ONS, Crédit Agricole SA / ECO

In industry, Covid-19 has aggravated the pre-existent recession



Sources: ONS, Crédit Agricole SA / ECO

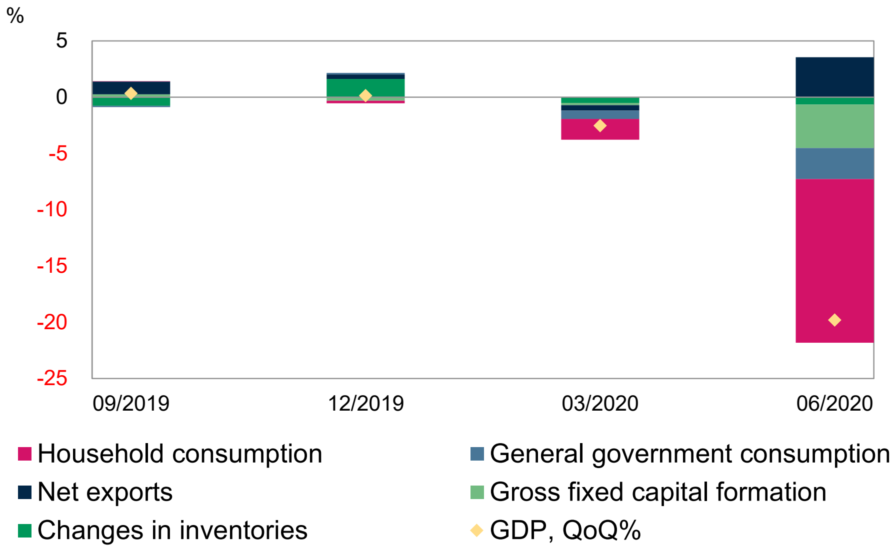
The biggest declines were recorded in the hospitality sectors (-87% between Q2 2020 and Q4 2019). But arts and recreation, construction, and education dropped by more than 40%. Public services, real estate, and agriculture were among the least affected. Generally speaking, the more human contact is involved in a sector, the more its output declined. Although the direct effects of the lockdown were concentrated in certain industries, the shock had ripple effects on other sectors due to falling demand, particularly for intermediate goods.

The manufacturing industry contracted 20.2% in the second quarter, particularly due to the closure of numerous plants, thereby worsening the recession that the sector had been experiencing since early 2019. The manufacturing sector had already been suffering the entire previous year owing to the Chinese-American trade war, troubles in the auto industry, Brexit-related uncertainties, and the collapse of the global industrial cycle, which have led to a staggering 75.7% drop since the first quarter of 2019.

THE COVID-19 CRISIS AND THE LATEST ECONOMIC TRENDS

GDP CONTRACTION IN THE FIRST HALF OF THE YEAR WAS DRIVEN BY DOMESTIC DEMAND

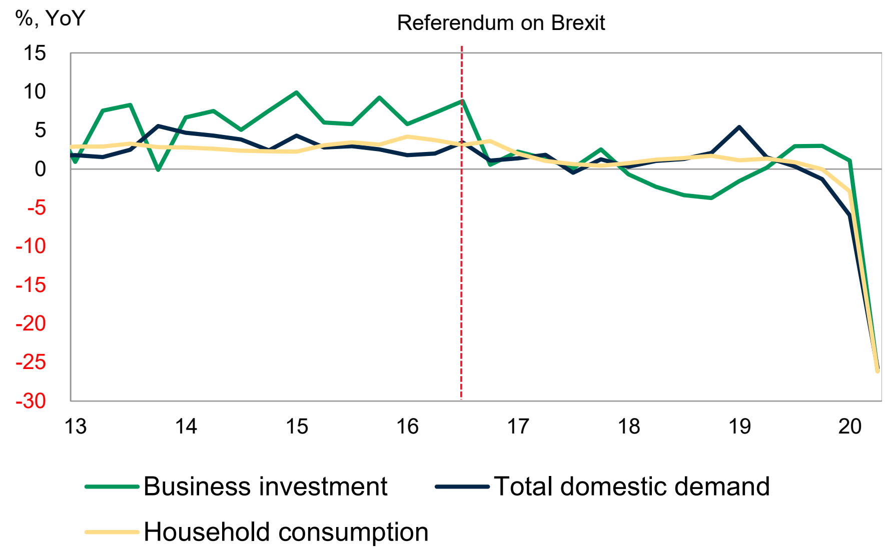
Quarterly GDP variation: expenditure breakdown



Sources: ONS, Crédit Agricole SA / ECO

Household consumption collapsed by 23.6% in the second quarter. This was the third straight quarter of decline, leading the savings rate to rise to 29.1%. Corroborating the sector-based output analyses, the decrease in household consumption chiefly reflects the fall of spending on restaurants, hotels, transportation, recreation, and culture. Public consumption fell 14.6%, due to decreased activity in the healthcare and education sector, while only public investment rose during the quarter, by 19.3%.

Internal demand has been in recession since Q2-2019 on the back of weak business investment

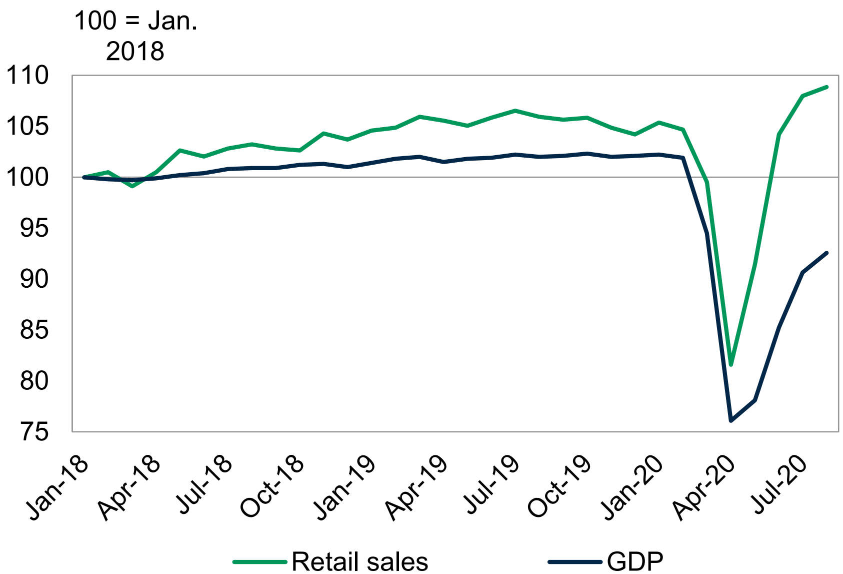


Sources: ONS, Crédit Agricole SA / ECO

Business investment declined (-26.5%) for the third quarter in a row. Housing investment contracted 41.6% over the quarter. GDP details also reveal a significant depletion of inventories, contributing -0.7 percentage points to growth, after -0.5 in the first quarter. Imports contracted in line with domestic demand (-22.7% over the quarter), even more than exports did (-11% over the quarter). As a result, the trade balance made a positive contribution, equal to 3.6 percentage points, to growth in the second quarter.

THE POST-LOCKDOWN RECOVERY HAS BEEN VIGOROUS, BUT INCOMPLETE AND UNEVEN

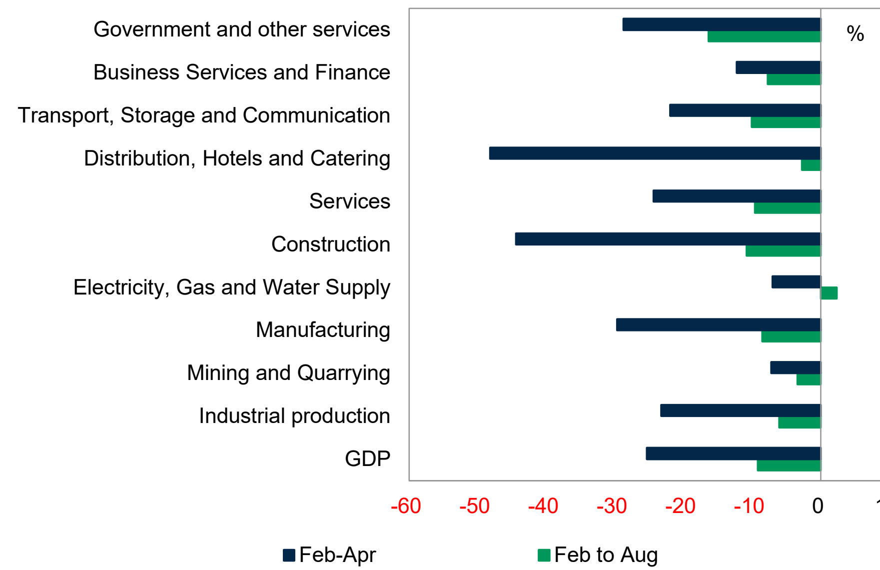
Retail sales have rebounded strongly to above pre-crisis levels



Sources: ONS, Crédit Agricole SA / ECO

With the gradual loosening of social distancing measures over the summer, the post-lockdown recovery seems to be driven primarily by household consumption, particularly by consumer spending in goods. Retail sales rose 33.5% between the end of April and the end of August, helped by online sales. To a large extent, this results from pent-up demand related to purchases that could not be realised during the lockdown and a substitution effect from consumption of services to that of goods. Growth in final household consumption in the third quarter is expected to be much more moderate than the rebound in retail sales, due to the social barriers that restrict consumption in the services sector.

Incomplete recovery: variation of output peak-to-trough and following the recovery (monthly data)

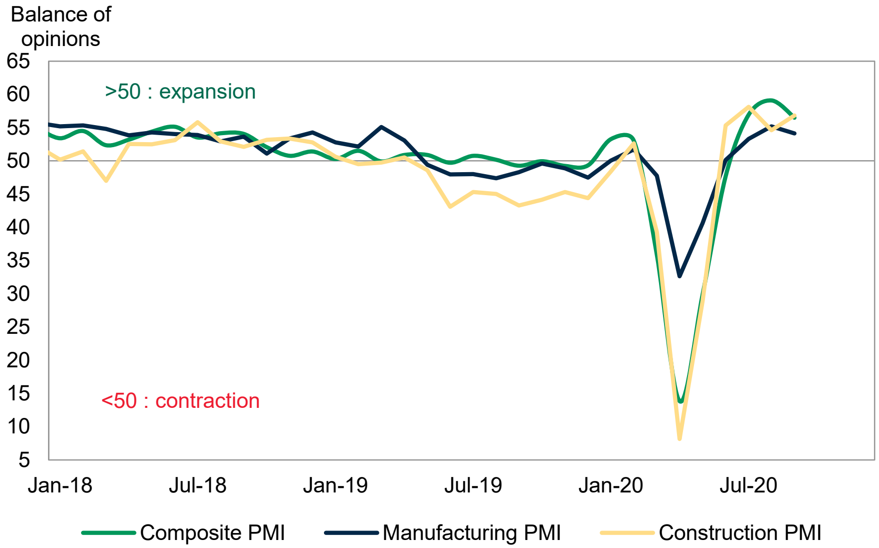


Sources: ONS, Crédit Agricole SA / ECO

GDP recovered 21.7% between its April low and late August. It is still 9.2% below its February level. In August, the rate of growth slowed for the second month in a row (to 2.1% month-on-month). After a vigorous rebound from May to July, industrial output practically stagnated in August (0.3% month-on-month), with a clear slowdown in manufacturing (0.7%). The service sector also slowed down (2.4% over the month after 5.9% in July). The food and accommodation services sector was a major contributor to the recovery, supported by the government's "Eat Out to Help Out" programme in August.

THIRD QUARTER: STRONG REBOUND EXPECTED DUE TO A FAVORABLE CARRYOVER EFFECT

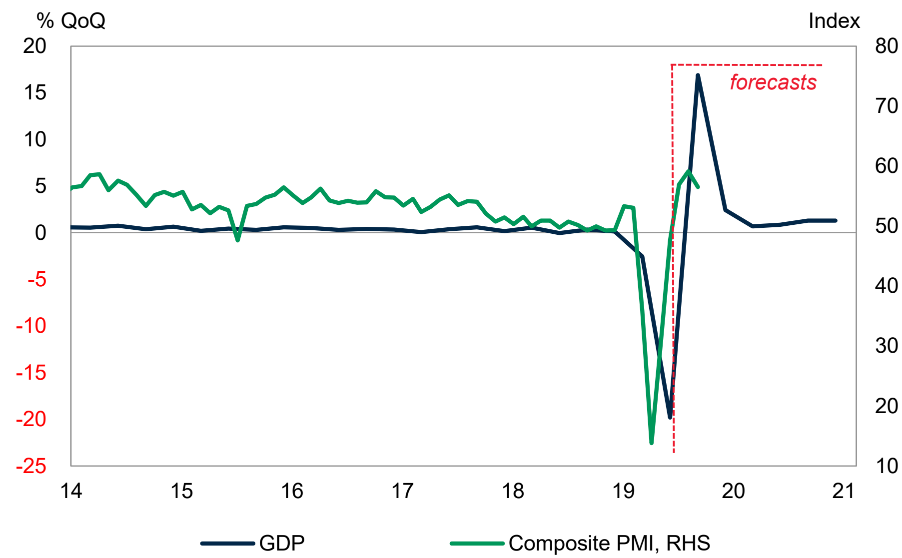
PMI surveys continue to suggest expansion of activity, albeit a slowing one



Sources: IHS Markit, Crédit Agricole SA / ECO

PMI surveys of purchasing managers (end-September data) indicate that the economy is continuing to slow down, while still remaining comfortably in expansionary territory. In services, the PMI indicated that growth remained solid in September, despite a decline in food services as a result of the expiry of the government's "Eat Out to Help Out" programme, and in other consumer sectors. However, those surveys have a lag relative to hard economic data, as they missed the early slowdown observed beginning in July.

The rebound in Q3 is likely to be sustained, but the underlying momentum is losing steam

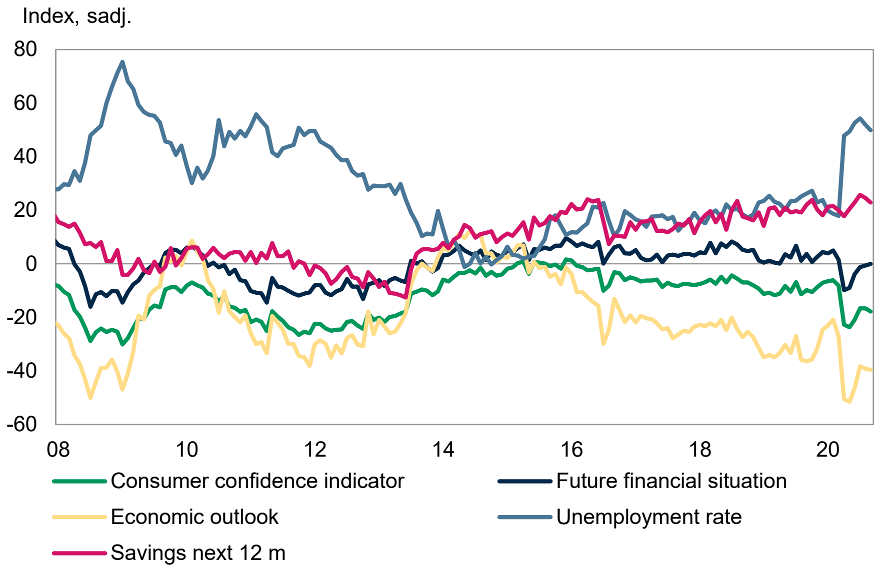


Sources: ONS, IHS Markit, Crédit Agricole SA / ECO

Third-quarter growth will benefit from a favourable base effect (6.8%) from the end of the second quarter, due to the solid rebound in May (2.6% month-on-month) and June (9.1% month-on-month). But in reality, the recovery slowed in July in most sectors, and surveys suggest that it is likely to continue its deceleration in the months ahead. Several factors are involved: the resurgence of Covid cases, stricter social distancing rules, the upcoming increase in the unemployment rate, the uncertainty of Brexit and the persistent risk of a "no-deal" scenario. We therefore foresee a marked growth downturn in the fourth quarter.

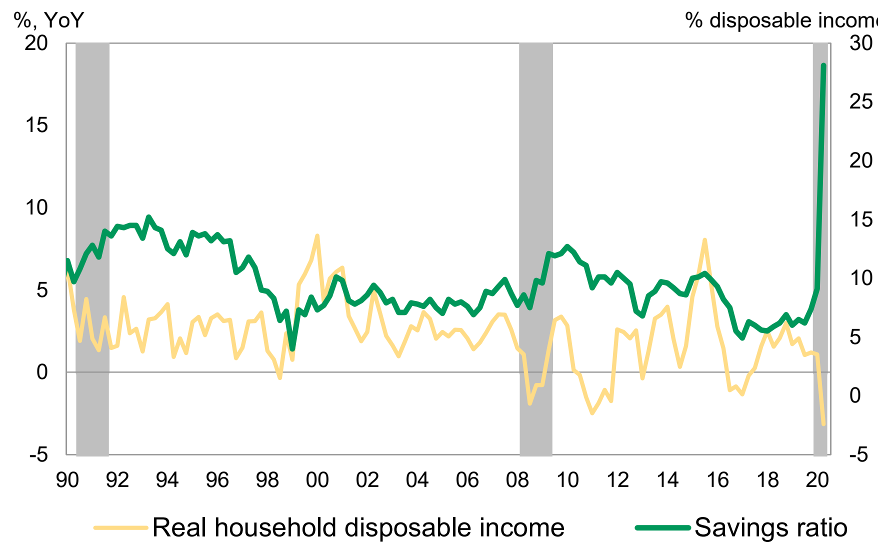
CONSUMERS REMAIN (VERY) CAUTIOUS

Consumer confidence is low



Sources: EC, Crédit Agricole SA / ECO

The savings ratio is likely to remain abnormally high



Shadow zones represent recession periods.

Sources: ONS, Crédit Agricole SA / ECO

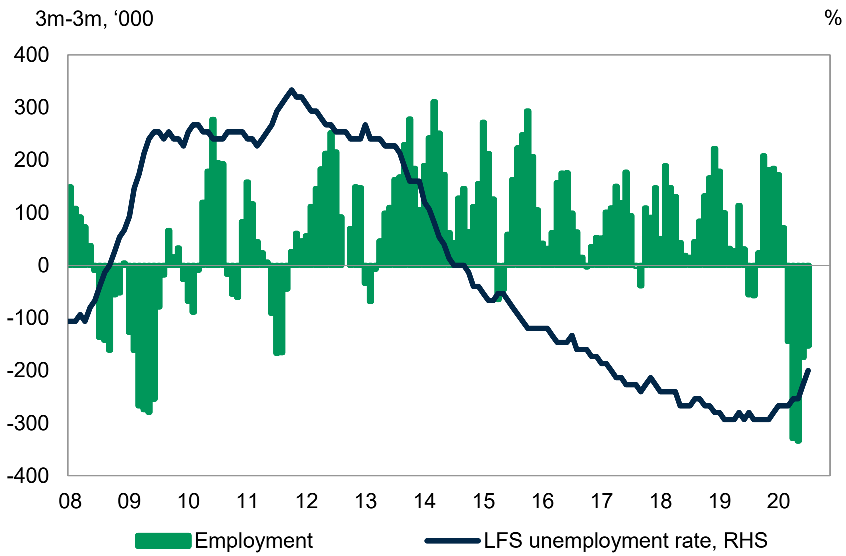
Consumer confidence remains low due to fears of a sharp rebound in joblessness and an anticipation of deteriorating economic and financial situation. The government's generous fiscal support has protected incomes, without preventing them from declining. According to government estimates, between February and May, its actions provided support amounting to 20% of the average employed household income. Although this has made it possible to protect income, and even increase it for the very poor, aggregated gross disposable income declined in the second quarter (-2.8% QoQ).

The decline in household consumption in the second quarter (-23.7%) combined with a less sizeable decline in gross disposable income (-2.8%) caused the savings rate to skyrocket (to 28.1%). According to the BoE, deposits into household accounts rose £17bn on average per month from March through June, compared to £5bn in the six months before. The savings rate is expected to drop in the short term, as the economy has reopened, while still remaining at relatively high levels (precautionary savings, limited consumption of social activities and tourism).

THE COVID-19 CRISIS AND THE LATEST ECONOMIC TRENDS

BADLY HURT LABOUR MARKET CONDITIONS

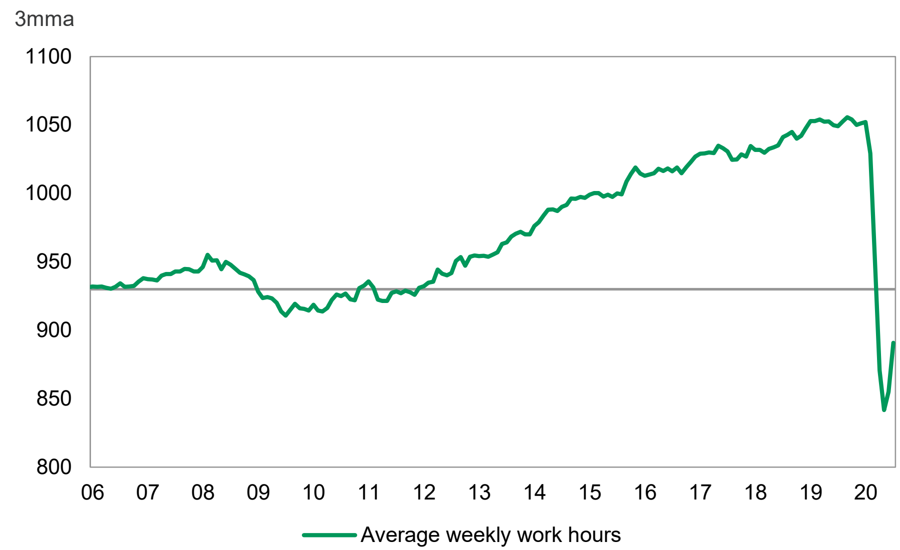
The unemployment rate started to climb in the third quarter



Sources: ONS, Crédit Agicole SA / ECO

The unemployment rate increased to 4.5% in August (three-month average) against the backdrop of a record rise in redundancies (+114,000 to 227,000, their highest level since July 2009). In comparison, the historic record for redundancies was 311,000 during 2008. Employment declined 482,000 between February and August, despite the fact that people on furlough were still counted as employed. Official statistics show that 4.8 million jobs were on CJRS as of 31 July, and 2 million self-employed people were on SEISS as of 31 August, for a total of 20% of the workforce.

After a record 15% fall in Q2, hours worked rebounded, but still remain low



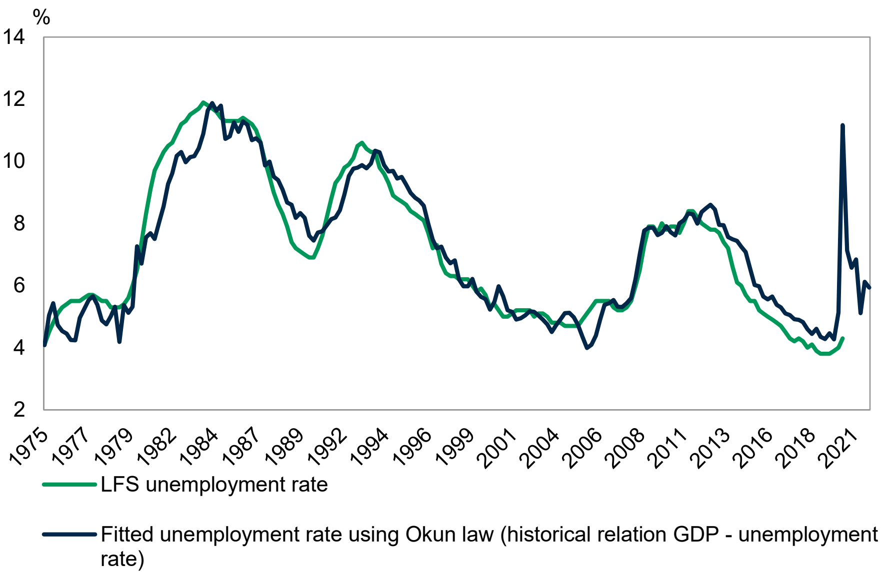
Sources: ONS, Crédit Agricole SA / ECO

The claimant count (the number of people receiving Universal Credit or unemployment benefits) hit 2.7 million (8% of the workforce) in August. Furthermore, the number of people without work (but not officially considered as unemployed), such as the economically inactive who may begin to seek work, and those who are still employed but temporarily away from work for coronavirus reasons and without earnings (wages or CJRS) stands at nearly 2 million (5.8% of the workforce). The "real" unemployment rate is therefore probably close to 10% (around 3.4 million individuals).

THE BASIS OF OUR SCENARIO

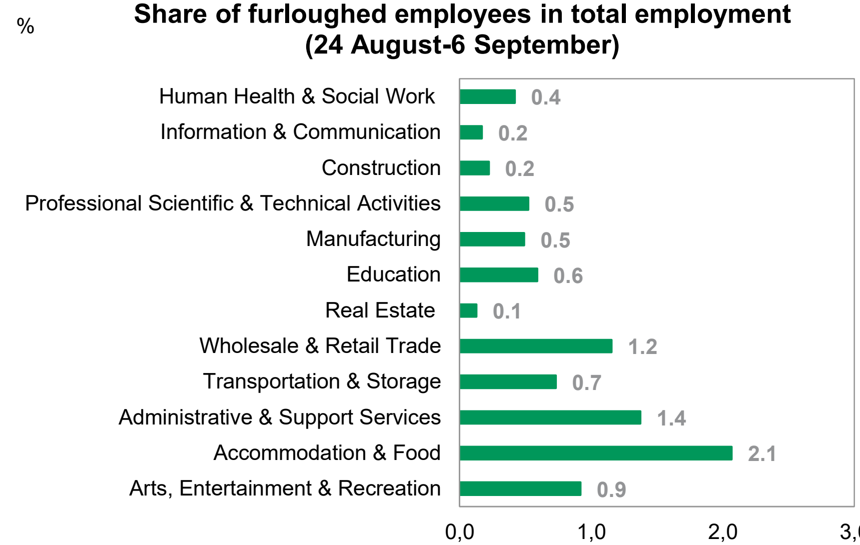
UNEMPLOYMENT IS SET TO INCREASE SUBSTANTIALLY IN THE FOURTH QUARTER

Without the government's measures, the unemployment rate could have exceeded 10%



Sources: ONS, Crédit Agricole SA / ECO

The government has recognised it "cannot save every job"

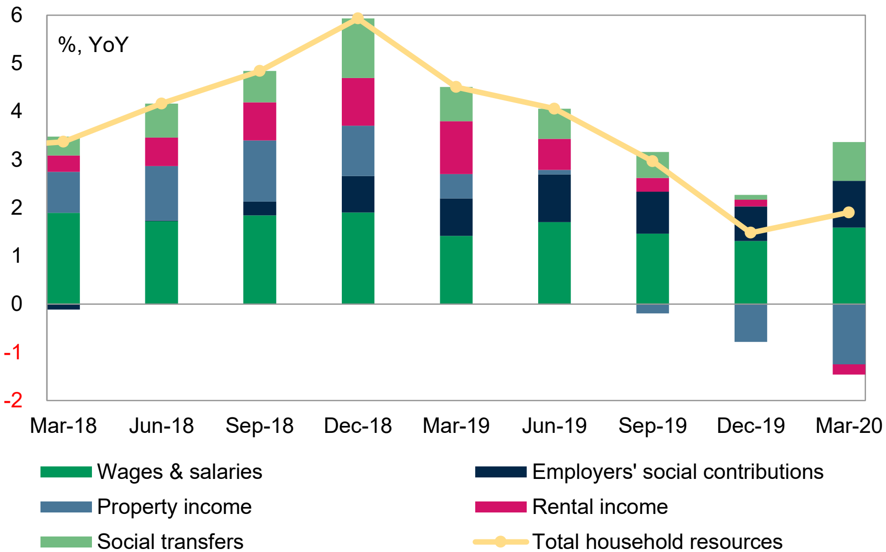


Sources: ONS, Crédit Agricole SA / ECO

The unemployment rate is expected to rise to nearly 8% of the economically active population in the fourth quarter, from its current 4.5% as a result of several factors. The first is the return of some inactive people to the labour market as they start to look for a work (rise in participation). The second is the likely possibility that a part of the furloughed individuals become redundant if they are not reintegrated by their company. The third is the expected increase in layoffs in the wake of the expiry of the CJRS in late October and its replacement on 1 November by the less generous Job Support Scheme (JSS). The new scheme is meant for employees who spend at least 33% of their regular working hours at work. For these employees, employers must pay at least 55% of their normal salary, and the government 22%. This system was expanded on 9 October to cover businesses that will be forced to cease operations due to government restrictions, with government contribution being 67% of the employee's normal wages (while the employer is not required to pay any share of wages).

HOUSEHOLD CONSUMPTION: WEAK FUNDAMENTALS

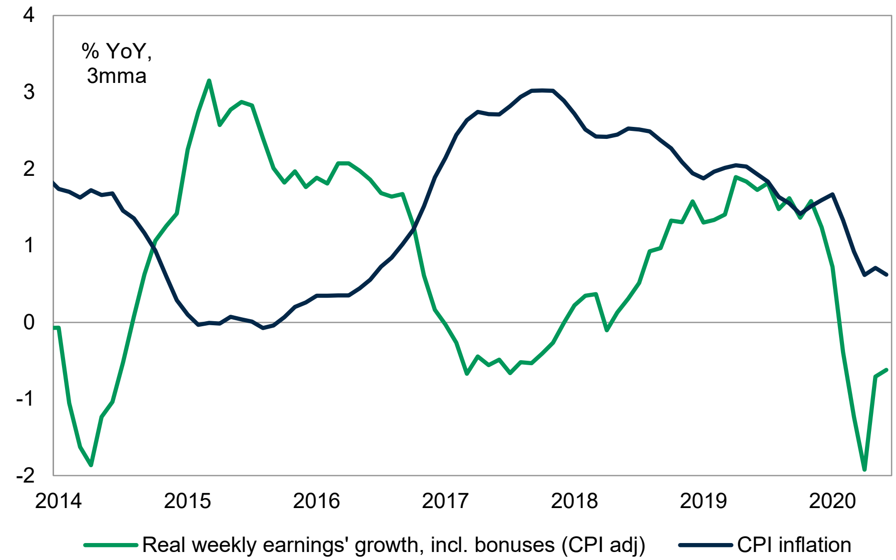
Contributions to growth in household resources



Sources: ONS, Crédit Agricole SA / ECO

Caution in consumer behaviour is expected to last for as long as the pandemic persists, and at least until a vaccine becomes available. The areas most at risk are obviously tourism and social activities, which involve a high degree of human contact. While government measures are restricting the consumption of services, the consumption of goods may continue to benefit from a substitution effect. However, more fundamentally, the increase in the unemployment rate, falling purchasing power and the uncertainty about future incomes are expected to weigh on final household consumption.

Households face another squeeze in real earnings

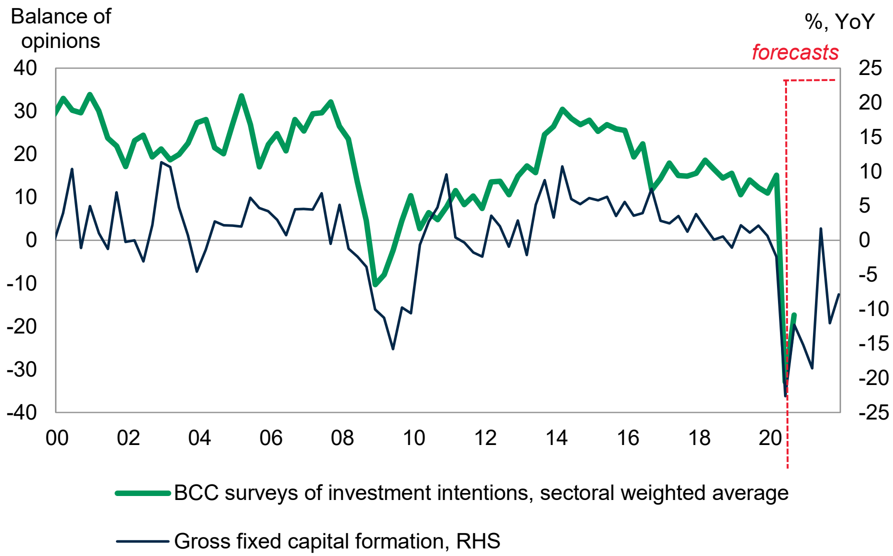


Sources: ONS, Crédit Agricole SA / ECO

Growth in total pay was unchanged year-on-year in August due to a decline in bonuses offsetting positive growth in regular pay. Nevertheless, wage growth fell to 0.8%, from 2.9% in February. Although the decline in inflation (from 1.7% in February to 0.2% in August) has provided some help to purchasing power, real earnings growth has become negative (-0.6% in August). Pressure on wages is likely to remain low, due to protracted period of labour market slack. The sectoral reallocation of spare capacity is likely to be slow given that many of the job losses are expected to be in low-productivity, low-qualification sectors.

UNCERTAINTIES ARE WEIGHING ON INVESTMENT (COVID-19, BREXIT, GLOBAL TRADE TENSIONS, ETC.)

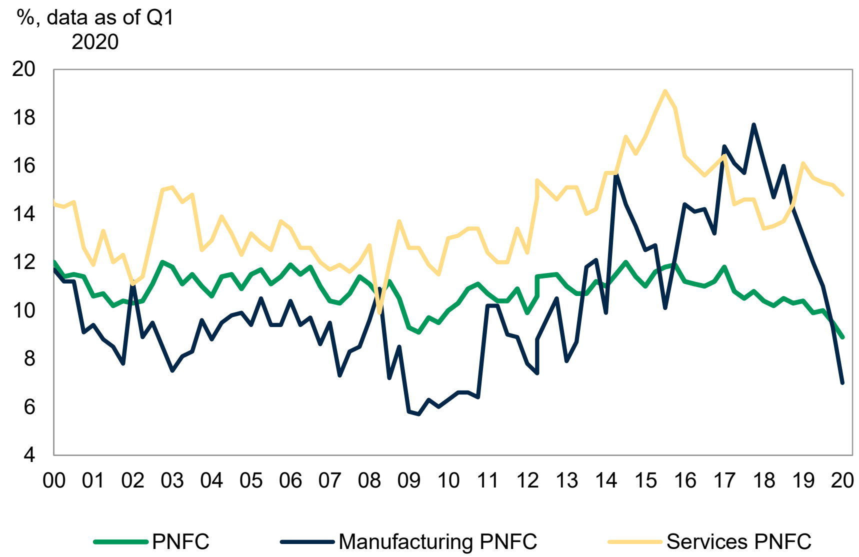
The recovery in investment is surrounded by downside risks



Sources: BCC, ONS, Crédit Agricole SA / ECO

Corporate investment intentions rebounded in the third quarter but remain at levels below the 2008 crisis. According to the BoE's Agents' Scores survey, investment plans have been cancelled or postponed due to the uncertainty, particularly in the aviation, automotive, and petrol sectors. Investments that have been made are primarily for essential equipment and maintenance, rather than discretionary or strategic projects. In some cases, investment was accelerated to improve online services, allow remote working, or protect employees from the virus.

The net rate of return has fallen below the levels of the global financial crisis



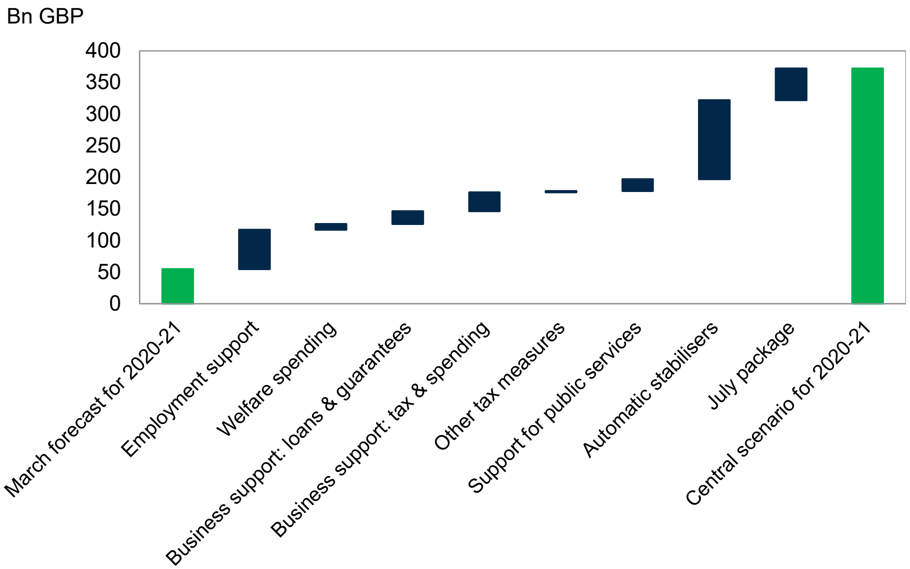
Sources: ONS, Crédit Agricole SA / ECO

While employment and wages were largely preserved during the first half of the year, productivity declined heavily (-1.8% in the second quarter, its biggest decline in four years), due to a fall in output (-21.5%) that was larger than the decline in the number of hours worked (-20%). The growth in unit labour costs literally exploded, reaching 27.4% year-on-year in the second quarter. Profitability, which was already under pressure before COVID-19, especially in the manufacturing sector and the continental shelf, is expected to fall to an unprecedented degree in the second quarter.

THE BASIS OF OUR SCENARIO

EXTRAORDINARY BUDGET STIMULUS EXPECTED TO SUBSIDE

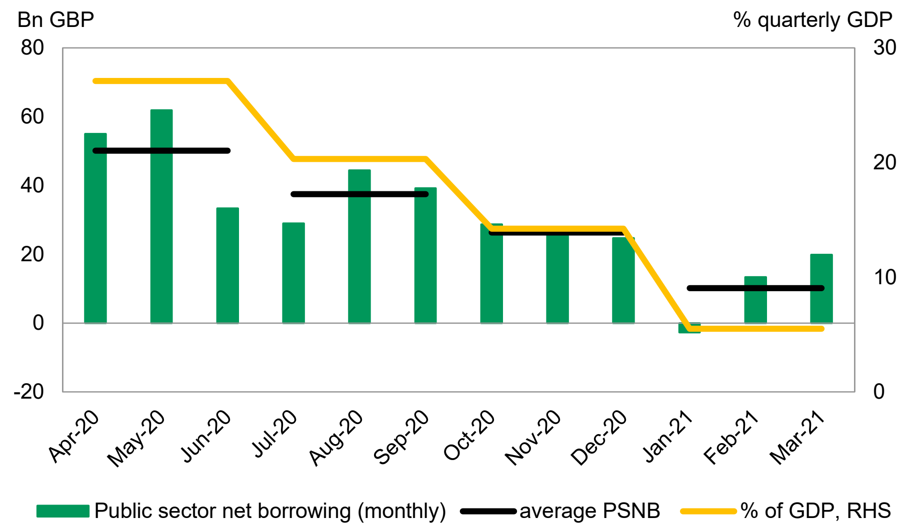
The public deficit expected to reach GBP370bn in the current fiscal year (17% du PIB)



Sources: OBR, HM Treasury, Crédit Agricole SA / ECO

The government has provided extraordinary support to households and businesses in connection with the COVID-19 crisis through employment and income support schemes, grants, business loans and guarantees, tax relief, etc. According to the latest OBR estimates (before the September measures), the direct impact of discretionary measures on the budget deficit stands at £192bn for the current fiscal year (nearly 9% of annual GDP).

The bulk of the stimulus announced so far is concentrated in Q2 and Q3 2020



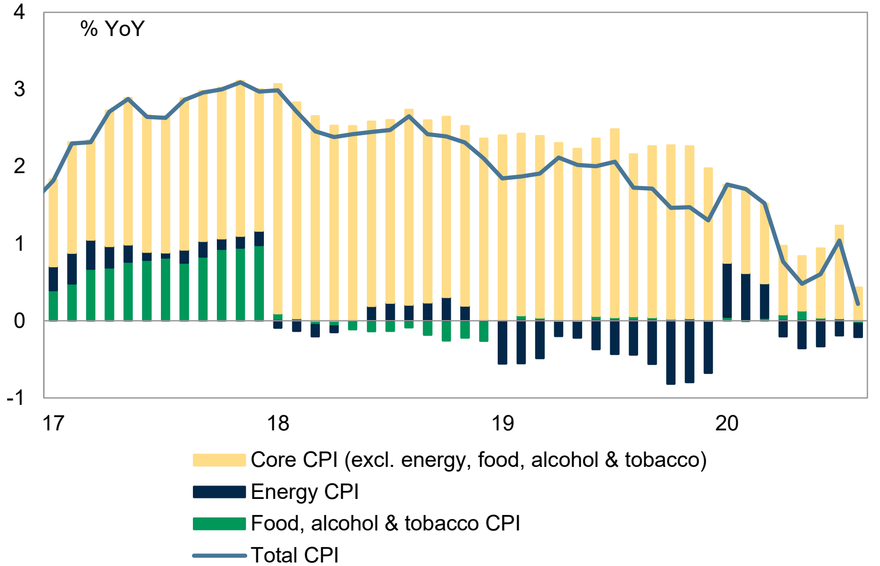
Sources: OBR, Crédit Agricole SA / ECO

According to BoE estimates, more than half of the £192bn of discretionary measures in response to COVID-19 (excluding the measures announced in September, for which it did not provide any estimates), were focused in the second quarter, or £108bn (or 19% of average quarterly GDP in 2019). Fiscal stimulus is set to decline in the third quarter to £54bn, while remaining significant (10% of quarterly GDP), before falling to £15bn on average in Q4 2020 and Q1 2021.

THE BASIS OF OUR SCENARIO

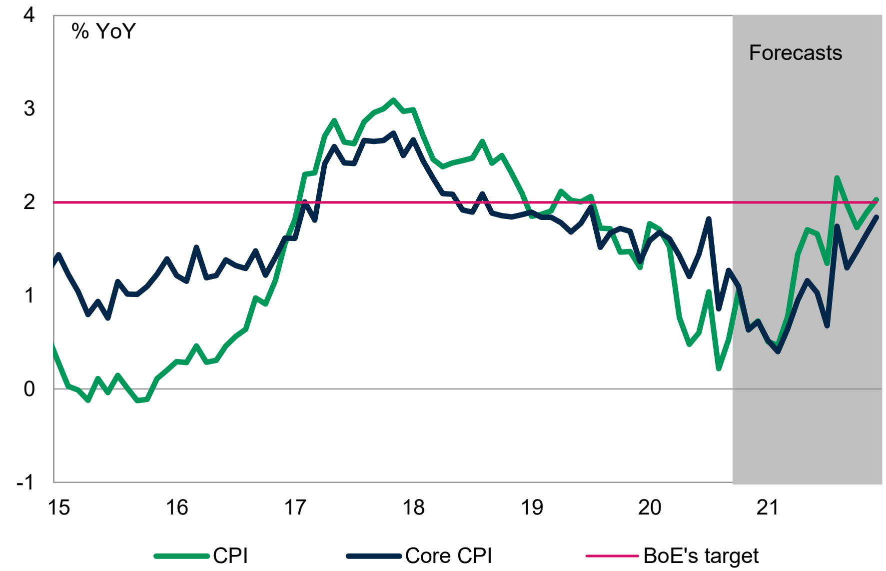
INFLATION IS LIKELY TO REMAIN VOLATILE AND BELOW THE BOE'S 2% TARGET NEAR TERM

Falling and volatile inflation (contributions to CPI inflation)



Sources: ONS, Crédit Agricole SA / ECO

CPI inflation expected below target in the short term



Sources: ONS, Crédit Agricole SA / ECO

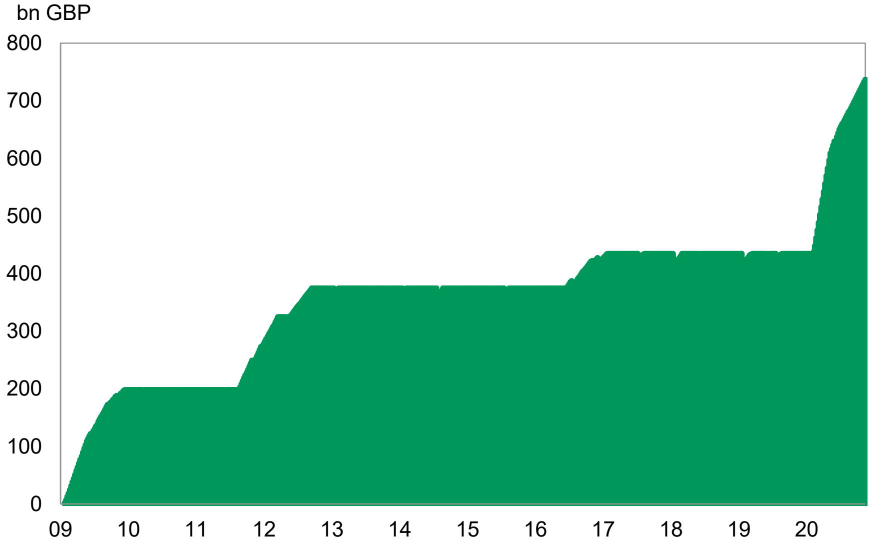
CPI inflation briefly rose to 1% in July, before dropping to 0.2% in August. The various measures put in place by the government to deal with the coronavirus will continue to generate high short-term volatility. In particular, the VAT rate was cut from 20% to 5% in the tourism and hospitality industries. Initially planned to last from 15 July to 12 January, this measure has been extended to the end of March. It is likely to remove 0.8 percentage points from the inflation rate during its implementation period and increase it by that same amount when the 20% VAT is restored.

Headline inflation is forecast to re-accelerate in 2021 with the dissipation of the effects related to the decline in the price of energy earlier this year and the return of 20% VAT in food service. However, core inflation is expected to remain lower as demand fundamentals are likely to be deflationary overall (high unemployment, decrease in budgetary stimulus, tightening of lending conditions). Furthermore, the GBP is expected to appreciate and hence weigh on imported inflation, if a free-trade agreement (avoiding tariff barriers) is reached between the UK and the EU in the weeks ahead, as we anticipate in our central scenario.

THE BASIS OF OUR SCENARIO

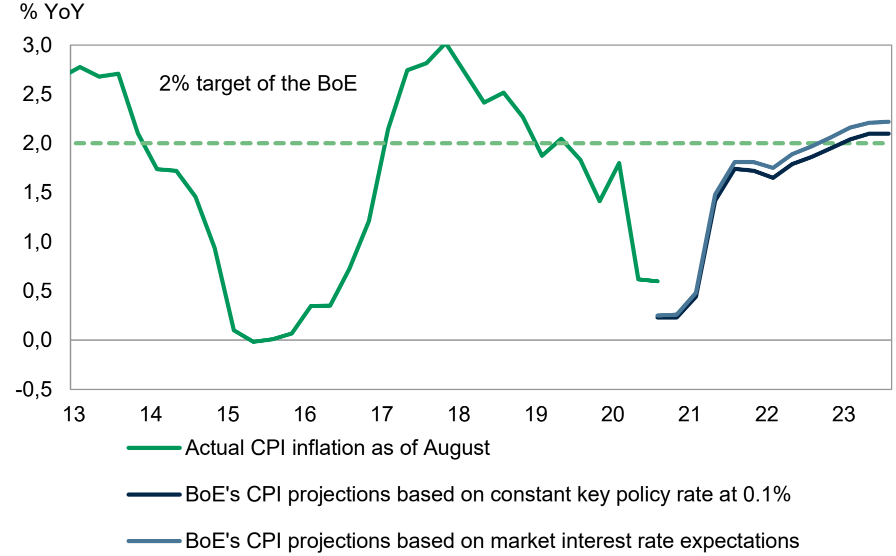
BANK OF ENGLAND: MORE QE LIKELY, BUT NEGATIVE RATES DOES NOT LOOK IMMINENT

The stock of gilts purchased by the BoE is set to reach GBP745bn by the end of the year (as per current BoE's plans)



Sources: BoE, Crédit Agricole SA / ECO

The BoE anticipates accelerating CPI inflation in 2021 and a return back to its target in two years



Sources: BoE's August monetary report, Crédit Agricole SA / ECO

Despite significant upward revisions in its growth and inflation forecasts (due to stronger data than expected), the BoE has retained its dovish stance due to the downside risks to the growth recovery and is considering the possibility of a negative key policy rate (currently at 0.1%). However, it has not yet taken a decision on the matter. In September, the MPC's minutes indicated that "the Bank of England and the Prudential Regulation Authority will begin structured engagement on the operational considerations (of a negative policy rate) in 2020 Q4". One month earlier, the BoE seemed less disposed to implement a negative key policy rate in the current environment, due to its potential impact on bank balance sheets. Moreover, its CPI projection was showing inflation rising to 2% by the end of 2022 under constant policy rate at 0.1%, suggesting that negative rates are not a decisive factor in the BoE's inflation expectations. We acknowledge that the likelihood of a rate cut has increased, but we are still ruling out the possibility of the key policy rate going negative this year in our central scenario. On the other hand, we are anticipating the BoE to announce an additional £100bn in asset purchases at its next meeting on the 5th of November.

FOCUS ON BREXIT: THE CLOCK IS TICKING

TOWARD A “HARD” BREXIT ON 31 DECEMBER 2020

Is a deal still possible?

Tensions have grown worse in recent weeks, particularly after the controversial UK Internal Market Bill, in which the British government is threatening to not abide by certain provisions of the Withdrawal Agreement signed with the European Union (EU) in October 2019, particularly the Northern Ireland Protocol. The problem is that this bill gives British ministers the authority to unilaterally revoke or amend export rules, such as customs declarations or other exit procedures for goods transported from Northern Ireland to the rest of the United Kingdom. As the United Kingdom had not withdrawn this bill as of the end of September, the EU began legal proceedings against the United Kingdom.

The European Summit on 15 October discussed the lack of progress on matters of interest to the Union and the need to continue negotiations in the weeks ahead. The time to reach an agreement is limited: at the time of writing, there are only 74 days left until the end of the transition on 31 December and about ten days until 31 October, the date Michel Barnier had set as the deadline for a deal that would allow the European Parliament enough time to ratify it.

Negotiations seem to be continuing in the days ahead, under strong pressure from the business world, which is still building hopes for a last-minute deal. There is no doubt that it is in the best political and economic interests of the United Kingdom and the EU to reach a deal, especially since COVID-19 has badly hurt the economic outlook. Despite all the rhetoric from Boris Johnson, a no-deal would damage the British Prime Minister, whose popularity is already sharply down. A deal is only possible if both parties make major concessions on key impasses (governance, fishing, and guarantees of fair competition).

Companies must be ready for border controls

After officially leaving the EU on 31 January and becoming a third country, the United Kingdom will exit the single market and customs union (a “hard” Brexit) on 31 December at midnight (Brussels time). It will either be with a partial free trade agreement (FTA), or no-deal Brexit under the terms of the World Trade Organisation (WTO).

Both scenarios will likely entail significant barriers to trade between the United Kingdom and EU. This “hard” Brexit is a result of both a lack of time to negotiate a deep and comprehensive partnership, given that the transition was not extended, and a lack of ambition on the part of the UK government (wishing no more than a Canada-like FTA).

Whether or not there is a deal, barriers to the free movement of goods, services, capital, and people will become reality post-Brexit. They will hinder trade of the United Kingdom not just with EU countries, but also with third countries with which the United Kingdom has not replicated the EU’s trade agreements (see below).

In its Border Operating Model with the EU, the British government has detailed the customs procedures and administrative formalities that exporting companies must follow at the EU border after the transition. Official estimates are forecasting 215 million customs declarations on average per year for British companies that export to and import from the EU (or twice that if you count the corresponding procedures for their European counterparts). This will require the hiring of 50,000 new customs agents and subject British companies to £7 billion in costs.

FOCUS ON BREXIT: THE CLOCK IS TICKING

TOWARD A “HARD” BREXIT ON 31 DECEMBER 2020

A last-minute deal would only be narrow in scope

We still expect that a deal will be struck in the coming days, although it will probably be only a limited agreement centred on goods. It is expected to prevent quantitative barriers to trade (customs duties, quotas), but would not prevent major non-tariff trade barriers which would come into force immediately after the end of the transition. These non-tariff barriers include various customs procedures and controls, including sanitary and phytosanitary tests, regulatory checks, licenses, verifications of rules of origin, etc. In services, there will be frictions at cross-border trade in areas where equivalence has not been approved. Given disagreements on level playing field and the lack of time to ratify a mixed agreement, services are expected to only partially be covered.

Compared to a no-deal scenario, an FTA would have the benefit of potentially including an implementation period for a fixed length of time, in order to enable the parties to continue negotiating a more comprehensive agreement. However, even under such a scenario, uncertainty would persist and continue to curtail business confidence and investment, which will be unfavourable to the long-term economic outlook. Whether the parties reach a basic agreement on goods only, or something more comprehensive, there will be new trade barriers and a partial coverage of services.

The Brexit process will continue after 1 January 2021

A free-trade agreement would make it possible to mitigate the impact of Brexit through removing tariffs on bilateral goods flows with EU countries and providing regulatory equivalence in some sectors. However, it will mark the beginning of a long process of economic disintegration and regulatory divergence from the EU, implying significant economic consequences.

As explained by The Institute for Government, some aspects of the deal could take months or even years to implement, and negotiations in certain areas may continue beyond Brexit. Whether or not there is a deal, companies will need time to adapt to new conditions.

Access to the single market will be less fluid and more expensive for companies and consumers in terms of the trade of goods and services. Capital and labour will be less able to move freely. In particular, the uncertainty resulting from the prospects of regulatory divergence would imply greater friction in connection with the trade of services than today. In the long term, some companies might not be able to bear the additional costs of doing business with the EU and will end up closing.

FOCUS ON BREXIT: THE CLOCK IS TICKING

TOWARD A "HARD" BREXIT ON 31 DECEMBER 2020

Is the United Kingdom prepared for the end of the transition?

The British government prepared four times for a no-deal scenario last year – before 29 March 2019, 12 April 2019, 31 October 2019, and 31 January 2020. It published a multitude of technical notices for companies, including an extensive documentation on border procedures. But many areas still lack clarity (see BCC's guidance dashboard). This is particularly true of the customs controls that are to be implemented under the Northern Ireland Protocol, whether or not there is a deal.

In a speech on 23 September on preparations for the end of the transition period, Michael Gove indicated that although 78% of companies have begun preparations, only 24% believe they are totally ready. 43% of companies still believed that the transition period would be extended, although the deadline to request an extension has long passed and the exit from the single market and customs union has been enshrined in law. In a worst-case scenario where only 50-70% of large businesses and 20-40% of small and medium-sized businesses would be ready for the strict application of new EU requirements, cross-border flows could be reduced by up to 60-80% compared to the normal rate, and under such circumstances, queues as long as 7,000 lorries might be seen in Kent.

State of negotiations on trade agreements with non-EU countries

Until 31 December 2020, the United Kingdom is still covered by the EU's trade agreements with third countries (41 trade agreements with 72 countries). But from 1 January 2021, the EU's trade agreements will no longer apply to the United Kingdom, as it is leaving the customs union. The United Kingdom is therefore seeking to replicate the EU's existing deals. Its priority is to negotiate free-trade agreements with the United States, Australia, New Zealand, and Japan. Its goal is to sign FTAs with countries that cover 80% of British trade in the next three years in order to become "a truly Global Britain".

So far, the United Kingdom has signed 22 trade deals with about 50 countries (including Switzerland and South Korea), representing 7.8% of its exports of goods in 2019. It is currently in talks to reach trade agreements with 16 additional countries (including Canada, Mexico, Singapore, and Turkey), representing 6.8% of its exports of goods (according to estimates based on data from the ONS).

An agreement in principle was reached with Japan (11 September 2020) and is expected to be ratified in the months ahead. According to official government estimates, it is expected to increase UK GDP by 0.07% in the long-term. Curiously, the anticipated rise in imports from Japan (estimated at +80%) is estimated to be much larger than the rise in UK exports to Japan (+20%). This means that trade with Japan should contribute very negatively to future UK growth. However, the UK government expects the agreement with Japan to benefit the UK economy through increased specialisation and reallocation of resources between sectors and toward more productive businesses. In 2019, Japan represented barely 1.9% of exports of British goods, and the same share of total imports.

Mutual recognition agreements have been signed with the United States, Australia, and New Zealand.

With countries with which the United Kingdom does not have a trade agreement, there will be customs duties on bilateral flows of goods under the WTO rules. From 1 January 2021, the United Kingdom will set up its new MFN tariff regime, the UK Global Tariff, which removes customs duties for about 60% of imported products.

It is very unlikely that the United Kingdom will be able to offset the loss of benefits stemming from EU membership through trade agreements with other countries. The compensatory effect on GDP of signing new trade agreements with the rest the world is estimated by the British government to be 0.2 percentage points over fifteen years (see below).

FOCUS ON BREXIT: THE CLOCK IS TICKING

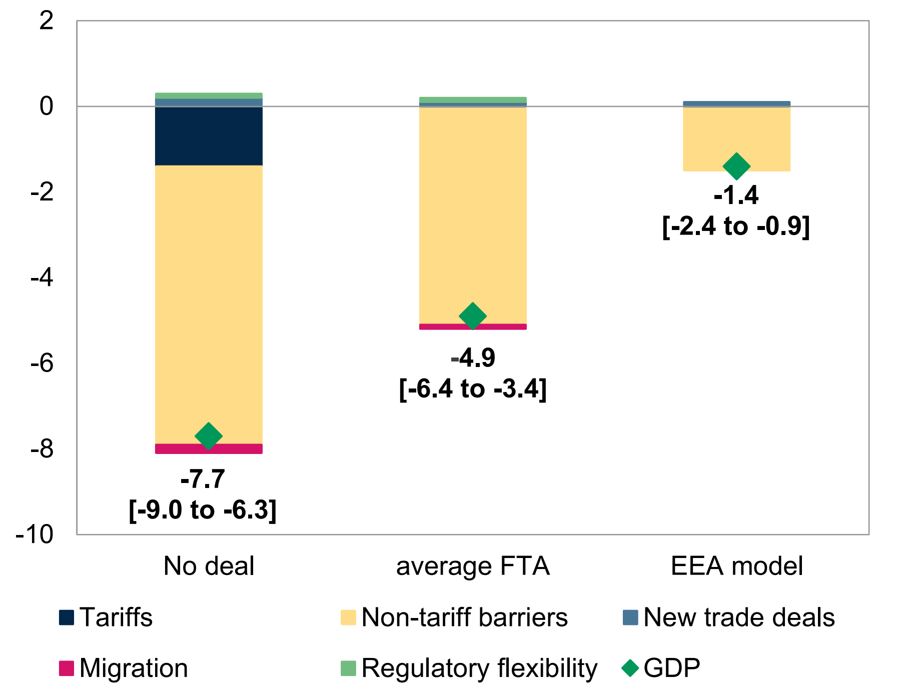
WHAT IMPACT ON GDP WOULD A "HARD" BREXIT HAVE?

Most studies, including the British government's analysis, show that a no-deal scenario and an FTA scenario will both be very expensive for the British economy. According to the British government's estimates, "No-deal" would potentially cut GDP by 7.7% (in a range of -6.3% to -9%) over the long term (over fifteen years) compared to EU membership (assuming that the provisions on the movement of people remain unchanged). Most of the impact would be felt through effects on trade, for which the British government has estimated an impact of -7.6%, with a 37% decline in trade volumes with the EU and a 6% increase with the rest of the world. An increase in non-tariff barriers contributes the most to the impact on GDP (-6.5 percentage points), followed by an increase in tariff-related barriers (-1.4 percentage points). In the event of no-deal, on 1 January 2021, the EU will apply its WTO tariffs to goods imported from the United Kingdom. On its side, the United Kingdom will apply its new Global Tariff regime, removing tariffs on a wide range of products, but some industries (including automobiles, fishing, and food processing) will still have customs duties imposed.

If a FTA is signed, tariff-related barriers between the United Kingdom and the EU would be eliminated (for products that respect conditions of origin), as would some non-tariff barriers. The impact on GDP in a FTA scenario is estimated to be nearly 5% in the long term. Companies that export to the EU will need to undergo new customs procedures and regulatory border checks that do not currently exist. Rules-of-origin verifications will be required. Companies whose exported products do not represent enough domestic value-added might see customs duties placed on their exports to the EU, even if there is a trade agreement (e.g. in the automotive or food processing sectors).

Long-term impact on GDP

% change in the level of GDP compared to EU membership over 15 years (assuming no change to migration arrangements)



Source: UK government, « EU exit, Long term economic analysis, November 2018 »