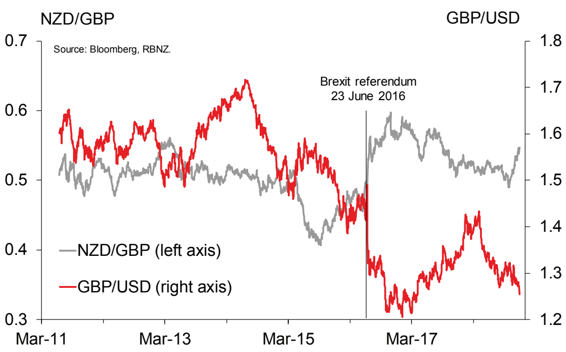
London calling

An update on Brexit and the New Zealand economy

The UK's decision to exit the European Union will have wide reaching implications for its economy. There will also be spillovers for other countries, including New Zealand. However, with Brexit day – 29 March 2019 – fast approaching, there is still little clarity around how the exit from the EU will occur. In this article we look at what's been happening in the negotiations and how conditions in the UK are evolving. We also take a look at some of the issues Brexit raises for New Zealand businesses.

Figure 1: Pound sterling



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- Prime Minister May's proposed Withdrawal Agreement has failed to gain support, and its not clear she'll be able to broker a deal that will be acceptable to both the EU and UK parliaments.
- In addition to ongoing negotiations on both sides of the Channel, the coming weeks and months could see significant changes in the UK's political landscape, along with related volatility in financial conditions.
- We expect that the UK will eventually reach an exit arrangement that leaves it closely aligned to the EU. But exactly how and when such an outcome is achieved is a matter of considerable uncertainty. And no matter what the outcome of exit negotiations is, the UK is in for a period of continued weak economic activity.
- The UK's importance as a trading partner for New Zealand has diminished over time, but it is still a key market for agricultural exports like lamb, and for tourism. The nature of New Zealand's trading relations with the UK could be in for a shake up over the coming years.

1. Where are we in the exit negotiations?

Exit negotiations between the UK and EU have hit an impasse. In November, UK Prime Minister Theresa May negotiated a withdrawal agreement which aimed to engineer a smooth exit from the single market. The Prime Minister and the EU also signalled their intent to develop a free trade agreement to ensure continued close ties between the two regions, particularly in the trade of goods (that sort of continued close relationship and alignment of policies is often referred to as a 'soft' Brexit).

However, the Prime Minister's proposed agreement was met with a tidal wave of opposition from both sides of the political spectrum in the UK. Many of the objections were focused on the so-called 'backstop' for the Irish border. In the event the UK and EU couldn't agree on the terms of their future trading relationship, the backstop would have avoided the imposition of physical barriers along the border between Ireland and Northern Ireland by keeping all of the UK within the EU Customs Union for a period. However, that risked leaving the UK tied to the EU indefinitely, even after Brexit. There were also objections to the extent of post-Brexit contributions to the EU Budget during the 21 month transition period, currently estimated to be around £39bn. Furthermore, throughout the proposed transition period the UK would remain subject to EU regulations, without having a say in their determination.

The above concerns saw several of the PM's own ministers choosing to resign rather than support the agreement. In addition, the Conservatives' support partners in the UK Parliament, Northern Ireland's Democratic Unionist Party, also refused to back the agreement and abstained from voting with the Government in some recent votes in protest.

Facing certain defeat in the House, the PM scuttled the vote on the agreement at the eleventh hour.

2. Where to next?

Mrs May will now return to Brussels to try and renegotiate the Withdrawal Agreement. If some concessions can be reached, particularly around the Irish backstop, the agreement could come back for a vote in the House of Commons over the coming weeks. However, it's not obvious what changes could be made. The EU leadership has been adamant that the existing deal is as good as it's going to get for the UK. And even if some amendments can be made, there's no guarantee that UK MPs would support the agreement, with deep divisions on Brexit on both sides of the house.

If no concessions can be brokered with the EU, there is the risk of changes in the political landscape in the UK. That includes the possibility of a vote of no confidence in the embattled Prime Minister. If such a vote was called and she lost, the impact on exit negotiations would depend on who steps into the role. There is some risk that a new Prime Minister would pursue a 'harder' Brexit (that is, one where the UK and EU's economic and regulatory environments are not as closely aligned as they are now, but where the UK is free to determine its own policies).

Another possibility is a general election. This could be triggered in a couple of ways, but the earliest it could realistically occur is late January/early February. Recent polling has Labour and the Conservatives neck and neck, but neither looks likely to command an outright majority. If Labour did take office, we could see a 'softer' Brexit and increases in public spending. However, many of Labour's policies are regarded as negative for business conditions.

There are also growing calls for a second referendum. The European Court of Justice has recently ruled that the UK can revoke its Article 50 decision to leave the EU. That opens the door for a 'people's vote' on Brexit that might provide direction for policy makers. However, there are big questions about what would actually be on the ticket: would it be a vote on leaving the EU, the terms of the divorce agreement, or some combination of the two?

Finally, there is also the real possibility of a 'no-deal' Brexit, which would involve the UK exiting the EU without an agreement on future trading relationships. This could be a managed exit that involves a transition period. Or it could be a 'hard' Brexit, which would involve a sudden departure from the EU on March 29 without clarity around future trading relations. The latter would be a nightmare scenario for the UK, and would likely prompt a significant downturn in activity and confidence, with related disruptions to financial conditions. In either case, a hard border would be necessary between the Republic of Ireland and Northern Ireland.

Given the significant risks associated with a 'no deal' Brexit, there is unlikely to be political appetite for such an outcome. Instead, we expect that the UK will ultimately reach some arrangement that leaves it closely aligned to the EU. But exactly how and when such an outcome is achieved is a matter of considerable uncertainty.

3. Future EU and UK trading relations

Assuming Brexit occurs, the UK and EU will have to renegotiate the terms of their future trading relationship. While the exact nature of any agreement will depend on the political landscape in the UK, at this stage the two sides are aiming to develop a free trade agreement that ensures continued close trade in goods. However, more open trading agreements (like those with Norway and Canada) would require significant concessions from the UK, like the free movement of people or contributions to the EU parliament. That would risk undermining the original decision to exit the EU.

In the absence of new agreements, the UK's trade will be governed by World Trade Organisation rules. This would provide the UK with regulatory flexibility, including the ability to set its own level of import tariffs with the EU and control of migration. However, this is not a panacea. In the absence of a preferential agreement, the EU would impose an extra tariff on UK goods. And if the UK sets tariffs on EU imports at low levels to encourage trade, it would be required to extend a similar arrangement to other WTO members, diluting its bargaining position.

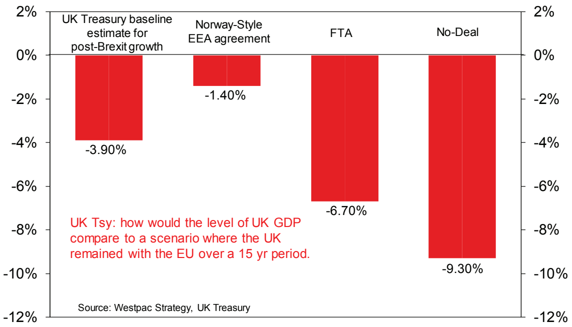
The UK and EU will also have to negotiate trading agreements for financial services, with the two sides expected to aim for an 'equivalence' arrangement. That would allow each side to determine its own regulatory framework, with access to the other's market permitted provided regulatory outcomes are similar. This approach would allow the UK to maintain control of its essential financial infrastructure after Brexit. Nevertheless, UK financial service providers are likely to find access to the single market is less open than at present.

4. What's the outlook for UK economic growth?

Brexit-related nervousness has already been a significant drag on the UK's GDP growth. We expect that growth will remain subdued over the next few years, with the risks tilted to the downside. The EU currently takes around 44% of the UK's exports. And even with a smooth transition, trade with the single market will be slower over the coming years than it would have been otherwise. This will flow through to slower growth in incomes and lingering softness in investment spending.

Recent work by HM Treasury (summarised in figure 2) looked at how the UK economy might fare under different post-Brexit trading relationships. It found that, whatever the outcome of exit negotiations, it's likely that economic growth in the UK over the coming years will be weaker than if it had remained within the EU. That's because of the impact of increased post-Brexit trade frictions (like tariffs and other barriers to trade), as well as changes in migration policy. In the event of a 'no-deal' Brexit, the Treasury estimated that GDP could be nearly 10% lower over the coming 15 years. The Treasury also noted that closer trading relationships, like membership in the European Economic Area, would have smaller (but still negative) impacts on growth, but would not deliver on the other aims of Brexit. For instance, under EEA rules, the UK would have to agree to the continued free movement of people and make financial contributions to the EU parliament.

Figure 2: Scenarios of potential Economic Growth Impacts from Brexit



5. Trade between the UK and New Zealand

After Brexit, the UK will need to negotiate new trade relationships with a number of other countries and regions outside of the EU. That includes New Zealand. The UK's importance for us as a trading partner has diminished over time - the UK now only takes around 4% of our exports. However, it is still an important market for exports like lamb and tourism.

The New Zealand Government has begun consultations for a post-Brexit free trade agreement with the UK, and hopes to secure improved access for primary and other goods. The timeframes for such an agreement will be dependent on the political developments in the UK.

It's expected that when the UK initially leaves the EU, there will be a transition period through to December 2020. During that time, existing EU-UK trading agreements will remain in place. That will provide time for businesses, including New Zealand exporters and importers, to adjust to the new trading environment. However, if the UK leaves the EU without a deal, New Zealand businesses trading with the UK could see significant disruptions to trade flows, along with associated volatility in financial conditions.

New Zealand Trade and Enterprise has identified several areas that businesses may wish to focus on ahead of Brexit[1]. Those include:

- The possibility of increased delays or administrative costs at borders. That's particularly important for businesses with operations or supply chains that span several European countries.
- Impacts on offshore staffing as the freedom of movement between the UK and EU changes.
- Changes in regulatory requirements for exports, including labelling.
- Possible changes in Value Add Tax for goods crossing the UK-EU border.
- The potential for increased volatility in the pound sterling.
- Whether contracts require amending to reflect the changes in UK-EU trading relations.

One of the key questions around Brexit is what it will mean for market access for New Zealand exports of agricultural products like meat into both the UK and EU. Currently, New Zealand is able to export a certain volume of agricultural products to the EU (including the UK) with no or only low tariffs imposed. After Brexit, this quota is likely to be split across the two regions based on how much of our exports each has taken in previous years. However, dividing up the existing quota in this way could hamper the ability of New Zealand exporters to respond to changing demand conditions between the two regions. New Zealand agencies have already given notice that this approach is not acceptable, adding to the objections voiced by Australia, the US and others.

While the impact of Brexit is likely to cause significant disruptions in the UK, the impact on broader global economic and financial conditions is not expected to be severe. Here in New Zealand, the main short-term risks relate to volatility in the pound Sterling.

New Zealand-UK trade statistics (Year to September 2018)

		Total	Goods	Services
Share of NZ trade (%)	EU (28 countries including the UK)	11%	10%	15%
	Eurozone (19 countries, excludes the UK)	6%	6%	8%
	UK	4%	3%	6%

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[1] https://www.nzte.govt.nz/export-assistance/regional-resources/europe/brexit

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